REAL ESTATE RESOURCE MANAGEMENT STRATEGY

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Introduction

When formed, Trust was endowed with approximately one million acres located in Alaska. This acreage consists of both fee simple and partial land estates. The Trust's non-cash assets are most commonly described as "land;" however, this is a misnomer. It is important to identify these assets by their highest and best use. In terms of the Real Estate Management Plan, it is critical to distinguish real estate from all other resources, specifically land.

For the purpose of this plan, real estate is defined or identified under the following criteria:

1. All of the following must apply:

    a. Includes only the surface estate of a parcel;

    b. Be surveyed;

    c. It is property that has a material investment (basis) intended to add value; and

    d. Not currently being used for Trust programmatic or administrative purposes.

2. Some of the following may apply:

    e. The highest and best use is determined to be income generation through commercial development;

    f. Identified potential in the near term for generation of positive cash flow and/or;

    g. Specifically identified by the executive director of the TLO as real estate.

Real Estate Management Strategy

Trustees have expressed a desire for the TLO to produce more income revenue. Of all the asset classes that fall within the Trust's fixed asset base, real estate in its various forms provides the greatest potential for and the greatest control of predictable income revenue. Other assets owned by the Trust in differing industries have a much greater potential to produce principal income, but are often constrained by a variety of factors not affecting the real estate industry as it pertains to the Trust. These factors include the following:

- Legacy agreements not in the Trust's interest
- Remote locations
- Regulatory issues
- Need for significant investment by third parties
- Unpredictable commodity markets
- Environmental Concerns
- Social contract and public relations issues

With the desire to create predictable streams of income revenue and the factors listed above for other asset classes, there are several methods the Trust can use to generate cash flow as an active real estate investor. These may include:

1. Acquisition of existing income properties;
2. Leasing land;
3. Developing and leasing its own real estate;
4. Acquisition of land to develop income properties; and
5. Acquisition of existing improvements for redevelopment.

Of these options, acquiring existing income properties offers the quickest access to measurable return and can be a good balance of risk and return. By acquiring existing income property, decisions can be made based on current information and historical data. Typical development risks associated with entitlements, permits, construction and market timing are all removed from the equation. The consideration is that assets with little perceived risk also provide little return and have very limited upside.

Owning any type of real estate involves risk; income property is no exception. However, detailed due diligence, transferring risk to others where possible, and conservative investment guidelines will serve to reduce much of the risk. Leasing Trust land offers a high level of value conversion to the Trust, because the Trust has no basis in its land base. Leasing land is low risk but is not always a marketable solution and is affected by the availability and cost of financing. In addition, land leases are fully dependent on third party capital to monetize the property, and offers very little upside potential. From a building owner/developer perspective, land leasing can be an attractive alternative to paying cash for land when interest rates and the cost of borrowing are high. In addition, although the Trust owns a large land base there are very few parcels that are situated to be leased.

Self-development of Trust assets may add risk, for which a commensurate level of return must be expected. Development can take many forms. It may involve physical improvements as simple as clearing trees or improving drainage to a property. The physical improvements could progress to include a finished product for a tenant, known as a "build to suit". Other possibilities for development could involve changes to entitlement issues such as zoning or wetland delineation, or addressing title concerns such as easements or other clouds on the title.

Clearly more risk is associated with fully developing property as an investment strategy. The factors mentioned above add multiple opportunities for a project to be derailed or for costs to increase. Conversely, the value of development to the investor is the ability to maximize the value of the land and the opportunity to build exactly the type of structure that fits the investor/user's needs. The most common risk, and the one most difficult to control, is construction cost. Demand for new space has to outstrip the supply of current space before rents can rise to support the cost of a new building.

While full development of Trust land may be less desirable due to risk exposure, this option should remain. The level of risk of (self) development often comes with a commensurate level of expected return. The TLO will make improvements to existing real estate holdings where necessary to increase value for future transactions. The TLO holds a delegation of authority for construction procurement from AKDOT&PF, and is focused on utilizing this delegation to make material investments in the form of improvement projects that add value to certain existing holdings. Development efforts may involve physical improvements as simple as clearing trees or making drainage improvements.

The ability to procure construction independently coupled with prudent and capable construction management will enable the Trust to recognize greater revenues from these holdings than if the improvements were contracted out, or made by the end user of the parcel in a ground lease scenario. Additionally, building a competent in-house construction management program is a necessary step toward eventual full development of a "build to suit" project completed for an end user/lessee.

Acquiring and developing land, or acquiring existing improvements for redevelopment are the highest risk options and should be expected to provide the highest returns. The most likely scenario for a project of this type would be a joint venture with a partner who can provide the necessary expertise, insight into a market, and/or an opportunity not then available to the TLO.

While the primary focus of the REMP remains on the acquisition of existing income properties, becoming a developer eventually capable of completing mid-scale developments of a similar category to our acquisition targets could increase the diversity and revenue producing potential of the plan.

Risk Profile

Investment risk can be mitigated using a number of techniques. At its most basic, mitigation involves avoidance of concentrated exposure. This includes avoiding too much exposure to any single investment type and/or avoiding too much concentration in one location. Mitigation of risk may also involve sharing risk and/or assigning risk to others. The TLO will consider all of these techniques in managing the Trust's risk to new real estate investments.

1. *Asset Type*

There are a variety of income property types that provide varying levels of return and risk. Properties that produce income or cash flow are generally assigned a capitalization rate or "cap rate"[1] by the real estate market. In fact, the cap rate of income properties is possibly the single best way to judge the risk level of a property.

There are many major income property types: office, retail, industrial, hospitality, infrastructure, and multifamily residential to name the most prolific. The risk levels and cap rates vary as the need and other factors for product types change. The TLO will focus on projects that are the most likely to produce the desired returns, at acceptable levels of risk, over the proposed holding period.

1 Cap rates are used to estimate the investor's potential return on his or her investment. This is done by dividing the income the property will generate (after fixed costs and variable costs) by the total value of the property. If property is being evaluated for purchase using a cap rate analysis, the income would be divided into the total cost of the property.

The Trust should invest in high quality opportunities with durable cash flow. The TLO is not equipped to manage properties with intensive needs such as multifamily or hospitality and should only proceed with investment in such opportunities with exceptionally qualified joint venture partners. These factors should be considerations, but not necessarily criteria in evaluating target acquisitions.

2. Asset Location

Over-concentrating investment in one location or local economy is to be avoided. This is to minimize the effects of impacts from factors outside the Trust's control, such as an economic downturn or an oversupply of property type. There are also practical limits on the number of separate markets that a small staff can adequately manage.

Project Profile

Based on the guidelines above, the Trust is developing a commercial income property portfolio composed primarily of high quality commercial and industrial projects. As that portfolio is assembled, the following factors will be considered:

1. Single investments should not be too large in relationship to the portfolio as a whole in order to maintain diversity.
2. Properties within the Trust's portfolio should be above average in terms of quality, design and location.
3. Construction type should be of the most permanent materials, generally concrete and/or steel.
4. Tenant profile will be examined closely. In buildings with multiple occupants, the tenant mix should be compatible and the financial strength of the tenants should be very high. In single-tenant buildings, vacancy risk takes on a new dimension. Consequently, the quality of that tenant is the primary factor in deciding to make the investment. Only long-term leases with credit-worthy tenants would be acceptable for single-tenant buildings.
5. Variations from these principles can be allowed, but only after careful review.

Investment Return

There are several return factors to consider when underwriting a potential investment. The methods of determining if an investment fits the needs of the Trust for this plan will be cash-on-cash return,[2] net present value (NPV)[3], internal rate of return (IRR)[4] and return multiple.[5] Each factor defines the return on an investment in a unique and meaningful way and has its place in determining the overall fit of an investment with the plan.

Cash-on-cash return and cap rate will be the same at the time an asset is purchased. The two return factors will begin to diverge as a project progresses and cash flows change due to changes in revenue, expenses and financing. Financing will generally improve cash-on-cash return, as less principal is required to provide the cash flow, even when the payment of interest is considered.

NPV is an important tool when considering investment in an asset that produces a long-term income stream. Dollars in the future are not as valuable as dollars today, and NPV defines that future income stream into today's value based on a given rate. The rate used will affect the value of a given income stream, and the longer the income stream, the greater the effect of a change in rate. It is possible to have a negative NPV when other factors are indicating a good investment.

IRR and return multiple are quick tools to evaluate the strength of an income stream. Although IRR doesn't consider the time value of money, it is a good indicator of the value of a cash flow stream in relation to investment in its entirety. Return multiple is an easy expression of whether an investment will pay out more than was invested. Financing will also generally positively affect IRR and return multiple as less principal is used to generate the cash flow.

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2 Cash-on-cash return is a measure of cash return on principal invested for an individual time period, generally a year. It does not consider the time value of money. It is expressed as a percentage where a higher percentage is desired.

3 Net present value is a measure of a series of cash flows in current dollars based on a discount rate. The higher the rate, the lower the value. It is expressed in current dollars, and a positive value of even $1 is desirable.

4 Internal rate of return is a measure of a series of cash flows expressed as a percentage; it does not consider the time value of money.

5 Return multiple is a measure of the cash flow for a given investment as a whole. It is expressed numerically where a value of 1 means return is even with investment.

For the purposes of evaluating the success of this investment plan, the primary measurement should be the cash-on-cash percent of return followed closely by NPV. This is a result of the income nature of the investment returns; the cash will be used to fund programs in the future periods. The base rate to be used as the "hurdle" for new projects should be the current cap rate for commercial properties of the type being considered for acquisition. The NPV of projects should always be at or as close to positive as possible.

An important consideration for investment return is the income revenue available for use by the Trust. A property owned free of debt will provide the greatest immediate cash flow for the Trust. Debt will reduce the immediate cash distributions available, but for the following reasons is generally a wise tool to use when planning for the needs of a perpetual entity. With the use of debt, over time, many factors working in concert provide significant and increasing cash flows with ever-reducing principal investments in any single asset. Three key factors are property appreciation, inflation and loan amortization, with the linchpin for the equation being the nature of financing for a property.

Property appreciation from a variety of factors serves to increase the absolute cash flow from rent and other possible sources over time. Inflation serves multiple advantages to the financed property both devaluing the dollars paid back to the lender and increasing the cost to potential market competitors of emulating the asset. The use of debt and the ensuing loan amortization for the purposes of the Trust is also a strong positive as when the initial loan is paid off using income from the asset; the Trust owns a property free of debt effectively purchased by the tenants. In this regard, at the completion of two cycles of 50% fully amortized financing on a property, the Trust would own a property with no principal invested. What this means is the Trust would have an asset that could distribute significant income revenue using only income for its ownership, and have the potential to distribute millions of dollars of income revenue on its sale.

The TLO will take into account market factors as well as current and future needs of income revenue when making decisions about property financing.

Real Estate Investment Criteria

1. Focus

The TLO will focus primarily on acquisition of income revenue generating real estate. This does not exclude acquisition of property for strategic purposes to enhance the value of other Trust assets or provide for long-term income generation. Development opportunities on Trust land will also be pursued, and should focus on minimizing risks and maximizing returns otherwise unavailable.

2. Prudent Investor

Investments will be measured against the Prudent Investor Rule. AS 13.36.230 & AS 13.36.235. (See Appendix A.)

3. Asset Allocation

The principal investments in income property will be determined by trustees on a case-by-case basis. The target for principal investments in income property will be derived based on annual spendable income earnings targets to be met by the portfolio. As non-recourse debt will be used, the Trust's investment will be counted as the Trust principal at risk at any given time.

4. Asset Type

The Trust will focus on acquisition of commercial and industrial properties as well as lands with long-term ground leases. They should be of high quality and have strong tenants, or be uniquely valuable for other reasons.

5. Asset Location

To minimize concentration of risk, the Trust should consider the location of its assets as a whole. Investing in a variety of real estate markets will protect Trust assets from the fluctuations of a particular market.

6. Underwriting

Potential income opportunities should be measured based on their financial merits to include NPV, cash-on cash-return, IRR and cap rate. All parameters will have "hurdle" rates based on current market conditions and needs of the Trust.

7. Tenant Type

The business activities of the investment property tenants must not be inconsistent with the mission of the Trust.

8. Financing

Financing may be used to fund the investments, in order to mitigate risk and increase return. The loan to value ratio should be no greater than 66 percent, unless special circumstances can be clearly identified that justifies a higher ratio. In no case should the loan to value ratio be higher than 75 percent. The debt load for the overall portfolio should be targeted at 50 percent. By staggering the financing of properties over time, the debt load of the portfolio will always remain significantly under the initial debt of any one property. Additional consideration will be made as to the cost of financing in relation to return on the potential investment under the then current market conditions. The Trust will only use financing that is nonrecourse to the Trust.

9. Ownership

The Trust will utilize single purpose entities when deemed appropriate to hold its ownership interest in the projects.

10. Joint Ventures

The Trust will, from time to time, enter into joint ventures with appropriate partners. These partnerships should always be for the benefit of the Trust. The Trust should always strive to exercise control of the partnership and not hold less than a 50 percent interest, unless it benefits the Trust to do so.

Goals and Objectives

Goal 1: Provide a stable and predictable stream of income revenue.

Hurdle return rate for investment will vary based on the needs of the Trust and the Permanent Fund's projected 10 year return.

Purchase core properties that are:

i. Well constructed,
ii. Located in performing markets,
iii. Suited to the market,
iv. Attractive and appropriate for current tenants, and
v. Available with attractive in-place lease structure.

Use non-recourse leverage as appropriate to:

i. Increase total return for both the subject property and portfolio as a whole,
ii. Reduce risk, and
iii. Provide capital for other investment.

Goal 2: Protect the Trust from unnecessary risk.

Use single purpose entities to:

i. Own the property,
ii. Operate the property, and
iii. Obtain non-recourse debt.

Obtain the appropriate insurance to protect the:

i. Asset,
ii. Owner/entity, and
iii. Trust.

Use non-recourse leverage as appropriate to:

i. Increase total return for both the subject property and portfolio as a whole,
ii. Reduce risk, and
iii. Provide capital for other investment.

Use non-recourse leverage to decrease the Trust's principal investment.

Source the best professionals to manage the property, including:

i. Day-to-day operations,
ii. Leasing,
iii. Capital planning, and
iv. Construction.

Goal 3: Grow the invested principal

Identify and pursue properties located in markets that are:

i. In long-term growth cycles, and
ii. Have high barriers to entry.

Actively manage the properties:

i. Ensure that maintenance is managed to maximize long-term return.

ii. Balance expenses to maximize long-term returns to:

   1. Meet user needs, and
   2. Take an economical approach.

iii. Make capital project decisions to maximize long-term return to:

   1. Meet users needs, and
   2. Take an economical approach.

Appendix A: Prudent Investor Rule

AS 13.36.230. Standard of Care; Portfolio Strategy; Risk and Return Objectives

a. *A trustee shall invest and manage trust assets as a prudent investor would by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution.*

b. *A trustee's investment and management decisions respecting individual assets shall be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.*

c. *Among circumstances that a trustee shall consider in investing and managing trust assets are those of the following that are relevant to the trust or its beneficiaries:*

    1. *General economic conditions;*
    2. *The possible effect of inflation or deflation;*
    3. *The expected tax consequences of investment decisions or strategies;*
    4. *The role that each investment or course of action plays within the overall Trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;*
    5. *The expected total return from income and the appreciation of capital;*
    6. *Other resources of the beneficiaries;*
    7. *Needs for liquidity, regularity of income, and preservation or appreciation of capital; and*
    8. *An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.*

d. *A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.*

e. *A trustee may invest in any kind of property or type of investment consistent with the standards of AS 13.36.225-13.36.290.*

f. *A trustee who has special skills or expertise, or is named trustee in reliance on the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.*

AS 13.36.235. Diversification

A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.