Assessment of DNV Staff's "Analysis of District Leasehold Properties" Report dated January 14, 2002 and Staff's Presentation to Council on the Issue January 28, 2002.

Introduction

On January 28, 2002 Staff made a presentation to Council and the public, supplementing their earlier report of October 2001, defending the low returns on some $69 MM of district lands. This brief is to respond to the ***basic*** thrust of the Staff defence.

I offer these comments in the hope that Council will recognize a serious problem in the management of DNV leased properties. I also offer a potential solution to the issue, suggesting a means for obtaining evidence to support or refute my arguments at minimal relative cost to the district, with a large potential return.

Please, as stewards of the district's assets, ***act decisively and now*** to determine independently what returns should be obtained on DNV leased lands. If my arguments are substantiated, take the steps to obtain proper returns in the future.

Executive Summary

Staff has claimed that performance of the DNV category 3 real estate portfolio is good because the return is better than bonds. (In my brief, I will concentrate on category 3, (commercial) real estate).

I argued on January 28 that a proper comparator was equivalent commercial real estate, not bond returns.

Further thought and research has convinced me that Staff **is** using the wrong comparator in bond returns (and/or asking the wrong questions). As confirmation, I note that the current DNV lease contract gives instructions to its arbitrators, in setting the appropriate level of rent in the absence of agreement, that are consistent with my argument, and makes absolutely no reference to bonds.

If I am correct, two conclusions seem apparent: (1) Staff may be renegotiating leases (presuming they "walk the talk") using the wrong return targets, and (2) we do not know if $31 MM of category 3 real estate is performing well because DNV uses the wrong yardstick.. Item (1) may contribute to the low returns.

The anecdotal evidence I have suggests that the returns on category 3 properties are perhaps half of the appropriate level. If this is correct, the district is forgoing over $ 1 MM per year of revenue in this category alone.

I also note that the table of properties in the Staff report seems to miss some properties. Where is the gravel dock lease? What other properties are missing?

My conclusions remain as during my January 28 presentation to Council on this issue - that professional third party review is needed, with that third party reporting to Council. By Staff's own Jan. 28 figures ($5,000 per appraisal) in response to a question from Council, all 18 category 3 leases could be reviewed by an independent consultant for $90,000. Surely this is not an inappropriate **one-time** expense, given that anecdotal evidence suggests we may be losing $1 MM **annually** due to the use of the wrong yardstick and sub market lease rates. As a first step, get experts to confirm my argument on the proper "yardstick"; if I am correct, go the second step.

1) What is the Proper Comparator?

The overall question to be addressed is: "Are we getting good returns on our category 3 real estate portfolio?" To answer this, we need to compare our average return of 3.85% to *something* – we need a comparator or "yardstick".

Staff claims the returns are good because they are better than bond returns. They state that had DNV sold the land years ago, and invested the cash, the LGA would have forced the investments into low risk items such as bonds. Therefore, they argue, the proper comparator to determine performance is bond returns.

While DNV real estate *average* returns may be above bond returns, it is irrelevant. Here's why.

Some time ago (let's call it year 0), rightly or wrongly, DNV decided ***not*** to sell the land and invest the proceeds. ***Instead***, DNV decided to go into the real estate business and lease the land.

Once that decision was made, bond returns became irrelevant, except to defend the "sell vs. lease" decision at year 0. An accountant or forensic auditor may worry about that historical event, but a business person, in looking at the real estate portfolio performance, says "we're not in the bond business now; we're in the real estate business - what returns are others in the real estate business getting from equivalent properties?"

Let's look at two analogies to illustrate that bonds are the wrong yardstick of performance:

> 1) Suppose the district at year 0 had decided to plant potatoes on the land and go into the potato business. Would Staff argue that the test of success in the potato business is to compare it to bond returns? No, the test should be against the business we are in - potatoes – to measure *current performance.* Bond returns are only relevant if you want to argue you made the right decision years ago when you selected the potato business rather than selling the land and investing the proceeds in bonds.

2) Suppose that bond return was 10%, and the comparable real estate market and our commercial lease portfolio both stood at 5 %. Would anyone seriously say "Gee, our performance is horrible; we should be at 10%"? No, Staff would quite properly say that at year 0, some *other* people and some *other* Council elected the real estate business, and if relative returns stay as above forever, those other people made a bad call. ***BUT*** in terms of our performance as managers today, we are doing as well as "equivalent" properties under similar circumstances today, so our portfolio performance is good.

Please note that "equivalent" does not mean "identical", but may in fact be quite different properties brought to a common evaluation basis by a professional real estate appraiser.

In short, for other than second guessing past decisions made by others, the appropriate yardstick to determine the performance of the business we are in – commercial real estate – is the performance by other parties in equivalent real estate properties. We could also compare our own properties amongst themselves (some achieve returns over 9%), although this is a poor yardstick.

Hence, Mr. Rimmer's statement in his January 14, 2002 memo "The significant benefit over the most likely alternate investment in long-term bonds is self evident" may well be true, but he is defending the "sell vs. lease" decision made years ago. That is not today's question, which is "are today's returns on our real estate portfolio what we should expect?".

Please note that while the LGA (S. 336) limits investment of monies to low risk items such as bonds, it does *not* prohibit returns on properties or other investments from exceeding bond returns! Such a restriction would be ludicrous.

2) Is There Any Evidence to Support My Argument? The language of the current ground lease agreements appears to support my argument.

At the time of the 1978 lease arbitration referred to Jan. 28 by Mr. Rimmer, the leases contained no guidelines to the arbitrator for determination of a proper rent ("As in the instant case, the rent review clause provided for arbitration and did not prescribe any formula for determining the new rent": page 9 of the arbitration decision). This lack of direction makes an arbitrator's job much more difficult and the arbitration more expensive.

Staff therefore quite properly decided to include guidelines to future arbitrators, and incorporated these in clause 3.06 (attached) of the current ground lease contracts (LSE4 provided to me by Staff, Feb. 2002). Is the arbitrator instructed to look at some percentage of bond returns? No, they are instructed to set the rent at a percentage of "Annual Fair Market Rental Value" which is determined from "the estimate of the annual rent that willing tenants would pay to a willing landlord . . . . ***.determined on the basis of***

the comparative market approach based on similar lands and premises located in the area in which the Lands are situate". (Emphasis added). "Area" is not defined – it presumably could be the north shore or GVRD or even wider. The arbitrators are also instructed to use "appropriate appraisal procedures and methods of valuation", which presumably refers to bringing different properties to a common basis for comparison purposes.

The word "bonds" is not in the arbitrator's instructions. Adjustments are made for improvements and the like, but the comparator is, as it should be, to the business we are in – real estate – ***not to some business we rejected years ago***.

I continue to conclude that the comparator used by Staff is in error. In light of the language in the arbitration clause, I am puzzled as to how Staff can argue that bond returns are the proper comparator.

3) So What Does This Mean to Us?

Does this mean our returns are bad? Not necessarily. It just means we **use the wrong yardstick** to evaluate them.

However, this is a serious concern when $31 MM of properties is involved in category 3 alone, particularly when, from anecdotal evidence, the returns appear low. Return on our own properties range from under 2% to 11%!

It seems clear that an independent third party needs to assess the situation, and that party should report to Council. The questions should be:

(1) What is the proper "yardstick" for returns?
(2) Is our real estate portfolio performing as it should, and if not, why not?
(3) Can a comparative evaluation of non-identical lands be done?
(4) Can the return be improved, and if so, how, and how fast?
(5) Are there other uses for the lands that would improve returns to the district?

The first question we need to address, however, is "do we have a problem?" To date, Staff and some members of Council deny that a problem exists.

In addition, assuming Staff are "walking the talk", they may have the ***wrong target return*** in mind when they renegotiate leases. This may account in part for the low returns – some under even under bond returns. We need to bring the category 3 leases up to market as fast as possible.

Other Points

- I believe pre-paid leases should be avoided. The simple fact is that the funds from the prepay are probably spent rapidly, with no continuing annual return benefit, and probably for things nobody can remember. The question of whether the prepay was a fair amount is potentially contentious. With the non-prepay leases, continuing annual rent instills a discipline on Councils that in DNV have tended to use land sales proceed to pay operating and maintenance costs as well as projects. The prepaid leases should also be examined to determine if there are any reopeners.

- A group should examine whether the category 2 properties (free rent) make sense in the current environment, at least for some of the parties. Do they still meet all the district criteria? Are the criteria still appropriate? If they are providing such highly "valued services", why will people not pay market prices for them - why are they so heavily subsidized ($300,000+ per year at 8% pretax return)?

- Staff defends low rates of return on category 3 properties on a number of bases. Some factors may have merit, but to claim the "right of reversion" as one of them is hard to accept. Leases, unless with an option to buy, involve reversion – that is the nature of the beast.

  Staff also states that the rent is secured by improvements on the land, is not dependent on the tenant's credit rating, and furthermore that the DNV land is not subordinated to the lessee's lenders; hence low returns are acceptable. DNV's rent *does* depend on the credit rating – if the tenant goes broke, we end up with the land, some building which may or may not have any use, and searching for a new tenant. Secondly, DNV **owns** the land. Why would DNV ever grant the tenant's bank a security interest on DNV land? Furthermore, the land itself secures the rent – if he does not pay, DNV give him the boot! I therefore have trouble seeing these as reasons to accept much, if any, discount below market rents. Staff appears to see them as substantial factors.

- Staff also offers as a defence that all income producing leases went to public tenders (yet the policy allows 5 situations where tenders are not used). I believe a fair review of the policy terms under which public tenders take place will prove there are serious impediments to maximizing value. For example, the call for tenders can be as little as 14 days before acceptance of the bid. This will certainly limit many bidders as, unless information has leaked or been otherwise published much earlier, it leaves no time for investigation, financing, etc. except for very substantial bidders. This restricts the number of bidders.

- One might well ask why a Building Supplies Company gets a lease at 2.4% of assessed value, and an equestrian center at 9.4%. Why has LGBP Holdings a lease on **over $5 MM of land at 1.72%**, and the Parkway Childcare Center 11.6% on $120,000 of land? Even by Staff's yardstick, that return on ***$5 MM of***

land is too low. Are there valid reasons for these differences and these very low returns? Who is LGBP Holdings Inc. that they rate so favourable a deal?

- Mr. Rimmer claimed in the Jan. 28 Council meeting that, basically, he is the only real expert on ground leases, and that it really was not possible to do comparisons of DNV ground leases vs. others, as there are few comparable lands. Frankly, I find these arguments hard to credit. Professional appraisers have many methods to make comparisons between properties that are quite different, with or without improvements. The simple answer is to find out if appraisers can do this type of work.

- Mr. Rimmer or Mr. Sigston stated January 28 that a third party review of the category 3 leases would cost $5,000 each. Even if we had all 18 category 3 leases reviewed for $90,000, this represents 0.3% of the assessed value, hardly an inappropriate ***one-time*** expense when evidence suggests that our returns are low by perhaps a million dollars ***annually.*** This is particularly so if experts confirm that we have the wrong yardstick.

John Hunter, P. Eng.
February 14, 2002

Attachment: Arbitration clause from Lease Form LSE4

FROM DISTRICT LEASE DOCUMENT LSE 4

3.06 Instructions to Arbitrators. The Landlord and Tenant hereby irrevocably authorize and instruct the arbitrators appointed from time to time pursuant to article 3.03 that the annual rent for any Rent Period is to be equal to % of the "Annual Fair Market Rental Value" as at a date not more than 90 days prior to the first day of such Rent Period which amount will be equal to the Annual Fair Market Rent for the Lands.

The following provisions will apply to any determination of the Annual Fair Market Rental Value and the Annual Fair Market Rent for the Lands, (the Annual Fair Market Rental Value or the Annual Fair Market Rent for the Lands being so determined being referred to as the "Amount Being Determined"):

(a) The arbitrators will, except as herein otherwise required**, follow appropriate appraisal procedures and methods of valuation;**

(b) The Landlord and the Tenant will be entitled to present written evidence and written argument to the arbitrators;

(c) Within thirty days after the appointment of the third arbitrator the arbitrators will appraise and jointly determine the Amount Being Determined and, if the arbitrators are unable to agree upon the Amount Being Determined within the stipulated period of time, the three appraisals will be added together and their total divided by three and the resulting quotient will be the Amount Being Determined;

(d) If the low amount or the high amount is more than 15% lower or higher than the middle amount, the low amount or the high amount, as the case may be, will be disregarded and if one amount is disregarded the average of the remaining two amounts will be the Amount Being Determined and if both the low amount and the high amount are disregarded the middle amount will be the Amount Being Determined;

(e) After the Amount Being Determined has been determined the arbitrators will immediately notify the Landlord and the Tenant; and

(f) The arbitrators will give written notice to the Landlord and the Tenant stating their determination and will furnish to each a copy of such dermination signed by them not later than seven days after the Amount Being Determined has been determined.

For the purposes of this Article 3, the following terms have the following meanings:

(a) Annual Fair Market Rental Value" as at any date means the rental value of the Lands and Premises as though fully occupied on such date being the **arbitrators' best estimate of the annual rent that willing tenants would pay to a willing landlord for the Lands and Premises** on such date and on the basis that the tenant would be required to pay in addition to the annual rent, all expenses, costs, payments and outgoings incurred in respect of the Lands and Premises, including water, sewer, telephone, hydro-electric power, insurance and property taxes (but excluding ground rent), **determined on the basis of the comparative market approach based on similar lands and premises located in the area in which the Lands are situate;**

(b) "Annual Fair Market Rent for the Lands" for any Rent Period means the annual rent that a tenant dealing in good faith and at arm's length with the Landlord would pay to the Landlord pursuant to this lease for such Rent Period considering the existing Premises and existing use of the Lands and Premises permitted pursuant to article 4.01 and considering that this lease is a ground lease and the obligations of the Tenant hereunder with respect to the Premises;

(c) "Redevelopment" means at any time during the Term the construction on the Lands of a new building or buildings in substitution for or in addition to the Building;

(d) "Refurbishment" means at any time during the Term a restoration or renovation of all or any part of the Building, including the exterior thereof, which brings the Building up to a first class standard, having regard to the age of the Building at that time.

Note Bold Emphasis Added by J. Hunter Feb. 2002