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Image of a multi-tenant office building owned by state trusts located at 3350 Monte Villa Parkway Bothell, WA. *Source: CoStar*

Chapter 6
Commercial Real Estate Asset Class

Table of Contents

Executive Summary

Commercial real estate, as an asset class, consists of commercial properties subject to either ground leases or building/premises leases throughout the State of Washington. Each of these properties is leased to a third party or third parties. The table below provides a brief summary of the commercial real estate assets included within this sector and a portfolio conclusion on the Trust Value based on the following extraordinary assumptions.

We assume that all commercial real estate properties adhere to proper zoning regulations outlined in local general plans. If not fully compliant, we assume that each property is legally non-conforming to the proper regulations and development standards. As detailed in the introductory chapter, we assume that the ownership interest is non-transferable resulting in the land not being able to be sold. We relied upon information provided by the Trust Manager for all specific data regarding data files, leasing activities and financials, and size and ownership information. We assume the accuracy of all information provided is sufficient for the purposes of this valuation. We assume the qualities and conditions of the vacant spaces are below market grade as vacancies have persisted.

Importantly, the value appraised is the Trust Value, which is defined earlier in this report. This value type is applicable to all asset classes and subject to specific laws, regulations, or management policies that restrict the use, marketability, or sale of these asset classes.

Commercial Real Estate Asset Class Executive Summary				
	Premises Leased Properties (Urban)	**Ground Leases (Rural)**	**Ground Leases (Urban)**	**Total**
Leases	7	23	6	**36**
Acres	43	971	20	**1,034**
Stabilized Gross Revenues	$6,900,000	$1,200,000	$2,200,000	**$10,300,000**
Operating Cost 30% Deduct	($2,070,000)	($360,000)	($660,000)	**($3,090,000)**
Trust Net Operating Income	$4,830,000	$840,000	$1,540,000	**$7,210,000**
Capitalization Rate	7.50%	9.00%	7.00%	**7.53%**
Value Indication (Rounded)	$64,400,000	$9,300,000	$22,000,000	**$95,700,000**
Concluded Trust Value	**$64,400,000**	**$9,300,000**	**$22,000,000**	**$95,700,000**
Value per Lease	$9,200,000	$404,348	$3,666,667	**$2,658,333**
Value per Acre	$1,497,674	$9,578	$1,100,000	**$92,553**
Value per Gross Building Area SF (Improved Only)	$101			

Introduction

Commercial Real Estate Asset Class is located throughout the State of Washington, but it is mostly situated near urban locations.

INTRODUCTION

The Commercial Real Estate Asset Class is a small portion of the total acreage owned by the state trusts, but it represents an important opportunity to achieve portfolio diversification and potential for increased revenue. This asset class comprised 1,034 acres as of FY 2018.

It is helpful to keep in mind that land areas can be moved from one asset class to another asset class over time. For example, an area of the Timber Asset Class may be reclassified to the Commercial Real Estate Asset Class as its planned use changes to accommodate market conditions and opportunities.

As a general note, all dollar amounts reported in this chapter are nominal and have not been adjusted for inflation. Additionally, we note that all years referenced are fiscal years—not calendar years. The fiscal year for state trust lands begins on July 1 and ends on June 30.

Subgroups. For purposes of analysis and discussion, the Commercial Real Estate Asset Class has been divided into two subgroups:

- Premises leases (i.e., improved property leases)
- Ground leases

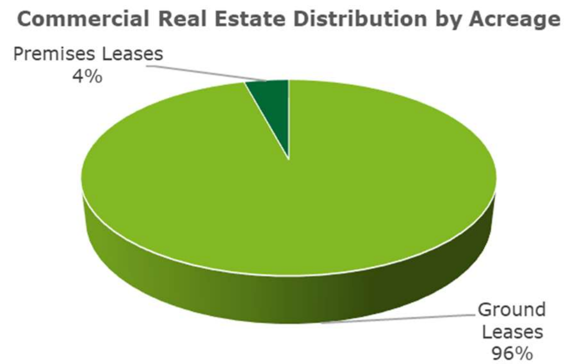
Based on acreage, most of the asset class is ground leased; however, most of the revenue comes from premises leases. The following chart highlights the acreage distribution for premises leases versus ground leases.

Commercial Real Estate Subgroup Acreage

FIGURE 1

Commercial Property Type	Lease Count	Acres
Ground Leases	29	991
Premises Leases	7	43
Totals	**36**	**1,034**

FIGURE 2



Commercial Real Estate

This asset class consists of commercial ground leases and premises leases. There are a variety of tenants across the asset class, including big box stores, single businesses, and small rural resorts.

The forecasted 2019 total gross revenue related to the Commercial Real Estate Asset Class is reportedly $10.2 million (rounded). The gross revenue from this asset class is reduced by a specific operating cost percentage deduction to account for management and operating expenses. The net cash flows from this asset class are distributed to the trust beneficiaries.

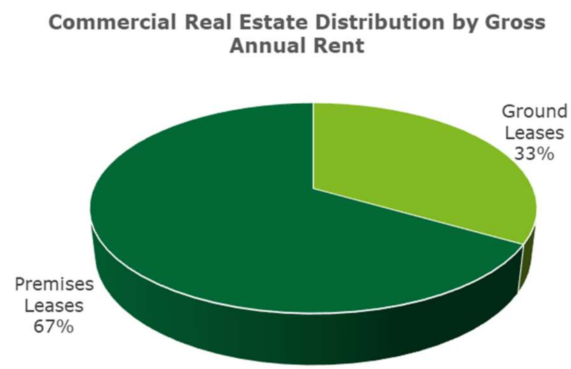
The following chart highlights the reported allocation of projected FY 2019 gross revenue (rounded) between premises leases and ground leases. As of the date of value, the Commercial Real Estate program had already calculated anticipated FY 2019 annual rents. As this represents the most recent and accurate data available at the date of value, anticipated FY 2019 gross revenue has been presented for each subgroup. All other asset classes are presented with FY 2018 actual gross revenues segregated by subgroup.

Commercial Real Estate Subgroup Revenue

FIGURE 3

Commercial Property Type	Lease Count	Gross Annual Rent (FY19 Projected)
Ground Leases	29	$3,400,000
Premises Leases	7	$6,800,000
Totals	**36**	**$10,200,000**

FIGURE 4



Premises Leases. With premises leases, the land and improvements are owned by the state of Washington and managed on behalf of trust beneficiaries, and both are leased to tenants. There are seven active premises leases on state trust lands that serve a variety of uses, including commercial warehouses, office buildings, and retail businesses. There is an office property (I-90 Lake Place Building B) that is currently vacant. If this building were leased, the total lease count would be eight for the premises leases subgroup. As described, the commercial real estate portfolio has vacant space, and our estimate of stabilized occupancy reflects a portfolio level occupancy. As such, no adjustment is made to account for differences in occupancy at the individual property level.

The improved real estate properties with premises leases are located in or near the larger urban Seattle/Tacoma metro area. Premises leased properties have an average land area of approximately five acres.

The majority of the premises leases are for single tenant properties with only one tenant in place. However, there is one multi-tenant office building located in Bothell, Washington and one multi-tenant retail building in Tacoma, Washington.

Ground Leases. With ground leases, the state of Washington owns the underlying land, but the building and site improvements are owned by lessees. Ground leases can also be used by tenants without any improvements for a variety of commercial uses. Typically, however, tenants lease the land and build improvements on the land. At lease expiration, the landlord often receives ownership of the improvements, and the asset may be moved to the premises leases subgroup. There are currently 29 state land trust sites with ground leases.

Ground leases are spread across 10 of the state's counties and are situated either in urban areas or rural and recreational areas. Ground leases are held on sites ranging from less than one acre to 200-plus acres of land. The average ground lease on state trust lands is for approximately 34 acres.

Commercial Real Estate Asset Class Ownership. The Trust Manager manages and operates state trust lands owned by the State of Washington for the benefit of designated trust beneficiaries. To be concise, this report uses the term "ownership" or "ownership interests" to describe the amount or percentage of gross revenue or land managed by the Trust Manager on behalf of specific trust beneficiaries, even though the land is owned by the State of Washington and not the trust beneficiaries.

The following charts present the trust ownership percentages based on acres and gross revenue received in FY 2018 for the Commercial Real Estate Asset Class.

Commercial Real Estate Asset Class Ownership Composition

FIGURE 5

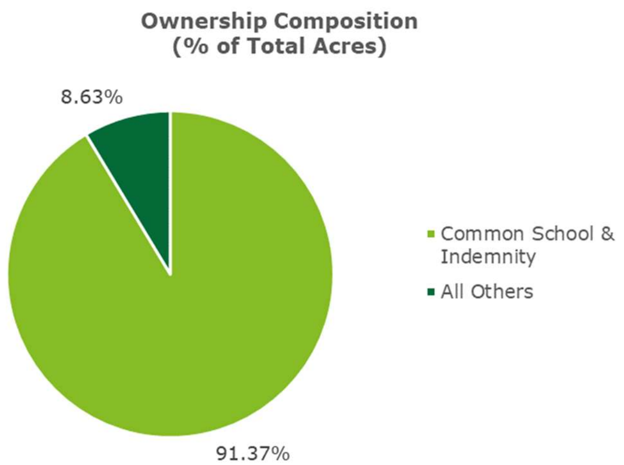
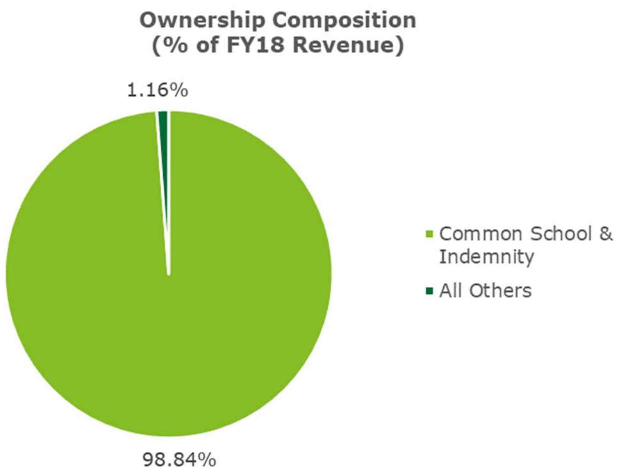


FIGURE 6



For the Commercial Real Estate Asset Class, the largest ownership share is held by the Common School and Indemnity Trust, which supports statewide public school construction and other designated programs. The beneficiary interests in state trust lands are the result of federal land grants to Washington at the time statehood was granted. The Common School and Indemnity Trust represents more than 90 percent of total acres and nearly 99 percent of FY 2018 revenue received from the Commercial Real Estate Asset Class.

A lack of commercial real estate land for the State Forest Transfer Trust is due to the preclusion of converting State Forest Transfer Trust land away from being managed for timber.

Physical Description

In FY 2018, the total gross acreage of the Commercial Real Estate Asset Class was approximately 1,034 gross acres spread throughout 12 counties.

FIGURE 7

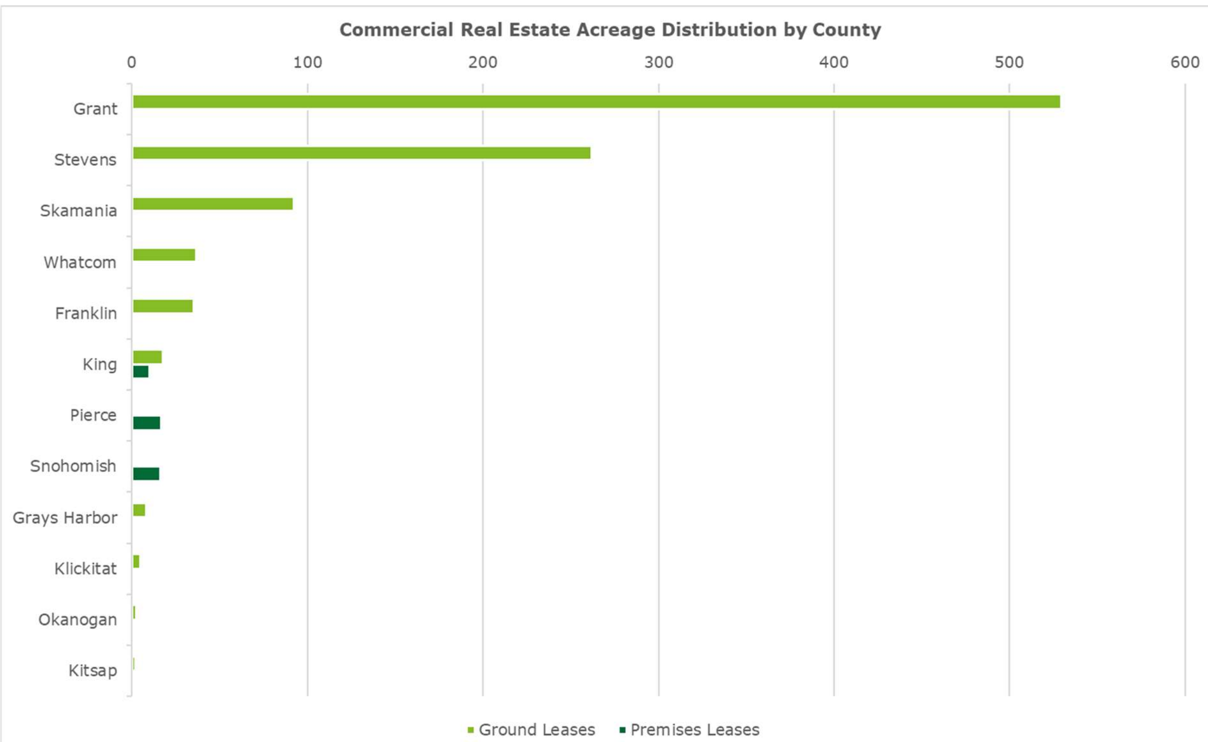


IMAGE SHOWS A 55,000 SQUARE FOOT MEDICAL OFFICE PROPERTY LOCATED AT I-90 LAKE PLACE IN ISSAQUAH, WASHINGTON (KING COUNTY). SOURCE: COSTAR

IMAGE SHOWS A 15,000 SQUARE FOOT RETAIL BUILDING LOCATED IN MUKILTEO, WASHINGTON (SNOHOMISH COUNTY), WHICH IS CURRENTLY LEASED TO WALGREENS. SOURCE: COSTAR

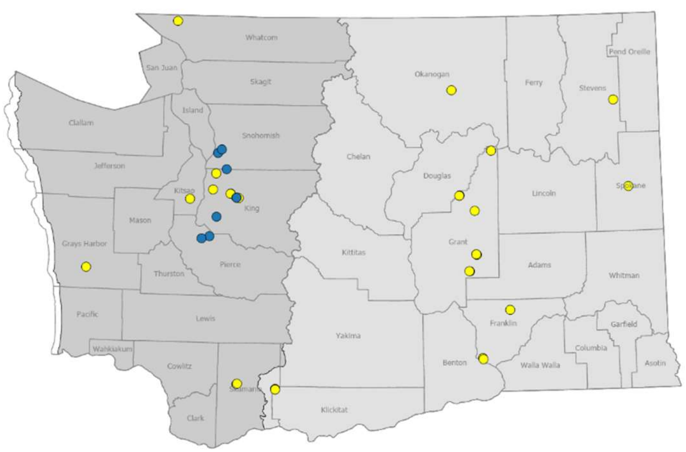
The following map highlights where leases (i.e., both premises leases and ground leases) in the Commercial Real Estate Asset Class are located across the state.

The following sequence of maps is presented to display the general area of lease locations only. These maps are sourced from the GIS database and are not meant to align with the exact lease and acreage totals provided by Trust Management for the Commercial Real Estate Asset Class.

In Figure 8, the blue dots represent premises leases and the yellow dots represent ground leases.

Map of All Commercial Real Estate Sites

FIGURE 8



Premises Leases. The seven premises leases include two retail spaces, a warehouse, a power center (i.e., retail park), and a single-tenant and two multi-tenant offices. Building improvements were built from 1984 to 2006 and range in size from 14,820 to 200,500 square feet. The largest is a 200,500 square foot (SF) distribution center in Everett, Washington, which is within Snohomish County.

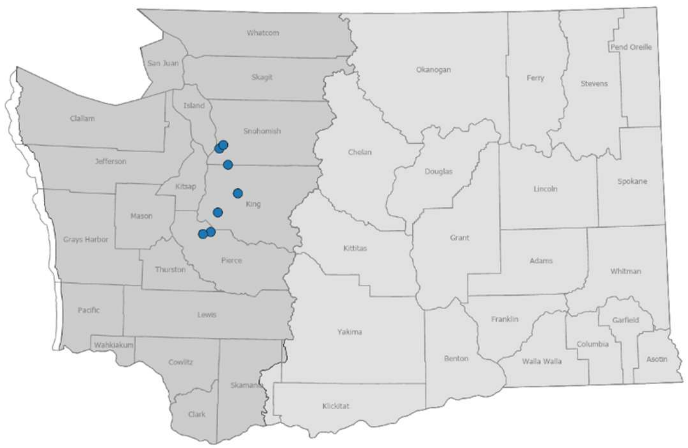
Approximately 43 acres of state trust lands are used for premises leases, which can be found in King, Pierce, and Snohomish counties around the Seattle and Tacoma metro areas.

The expiration dates for a majority of premises leases range from 2024 through 2026, although two single tenant leases expire in 2061 and 2081 (with rights to cancel every five years), which are longer terms more similar to ground leases.

The following map highlights the premises lease locations in the northwest part of the state.

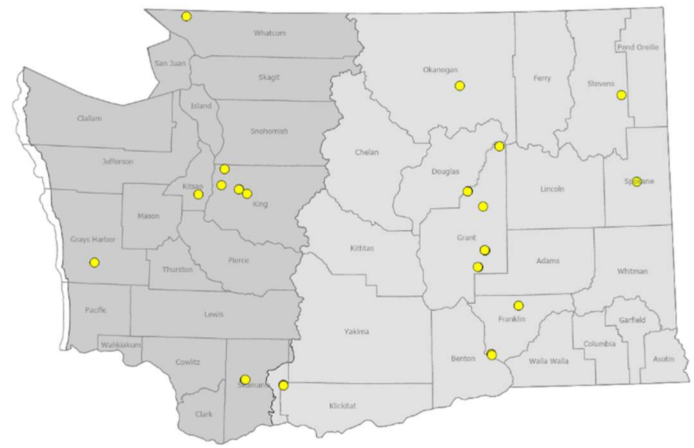
Map of Properties with Premises Leases

FIGURE 9



Map of Properties with Ground Leases

FIGURE 10



Ground Leases. There are approximately 991 acres of state trust lands used for ground leases. These leases are found throughout the state, although they are typically in more rural areas relative to the properties with premises leases. Expiration dates for the current leases in place occur between 2027 through 2069.

The majority of the acreage for ground leases is in Grant and Stevens counties. Nine ground leases comprising approximately 529 acres are found in Grant County, while one ground lease comprising approximately 262 acres (26 percent of the total ground lease acreage) is found in Stevens County.

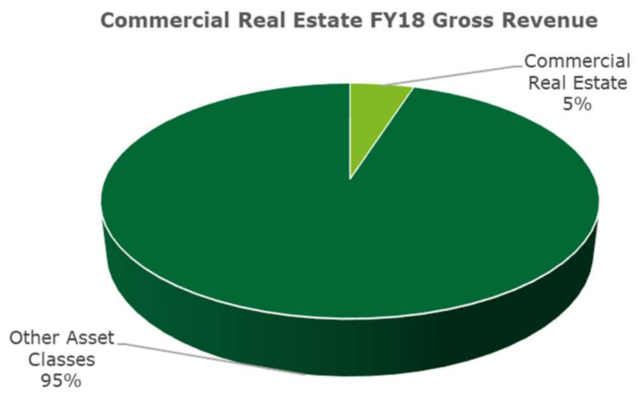
Information was not available regarding the improvements on ground lease properties, such as building size, age, and condition. This information is not recorded and tracked by the Trust Manager.

The following map highlights the ground lease locations.

Operational History

With approximately 1,034 acres (0.03 percent of all upland acreage owned by the state), the Commercial Real Estate Asset Class produces nearly 5 percent of the gross revenue for all of the asset classes.

FIGURE 11



COMMERCIAL REAL ESTATE ASSET CLASS REVENUE FROM 2007 TO 2018

For the scope of this project, we analyzed the operational history of each asset class. Operating information has been provided to the analysts for the past 12 fiscal years. Revenue amounts were not adjusted for inflation and are presented in this report as nominal values, not real values.

The chart below displays the total gross revenue[1] (before the operating cost percentage deduction) received from commercial real estate leases from 2007 to 2018 in nominal (not real) values.

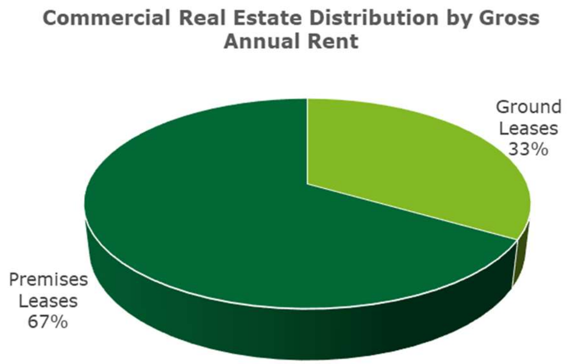
FIGURE 12

[1] Gross revenues exclude sub-sources 6, 3045, 4005, 5022, 5250, 6022, and 9088 as they are not included in reported operating cost percentage deduction totals.

The revenue above was not stacked to show the relative portions of ground leases versus premises leases because the Trust Manager's accounting system does not track historical revenue at the subgroup level.

However, we analyzed and categorized forecasted FY 2019 revenue (i.e., rental income) based on the relative portions of ground leases versus premises leases (i.e., improved property leases). The following chart highlights this distribution.

FIGURE 13



Premises Leases. Gross annual rents for premises leases are projected to total approximately $6.8 million in FY 2019, which comprises the majority of revenue received for this asset class.

The premises leases average approximately $971,000 in gross annual rent per contract, $158,000 per acre, and $10.70 per square foot.

The dollar per square foot calculation is determined by dividing gross rent by the square footage of the total gross building area, which includes the occupied square footage (534,129 SF) and vacant square footage (101,288 SF).

Ground Leases. Gross annual rents for ground leases are projected to total $3.4 million in FY 2019.

The ground leases average approximately $117,000 in gross annual rent per contract, or approximately $3,400 per acre.

The majority of ground lease revenue comes from ground leases in more urban areas of King County.

For FY 2019, the total revenue from five ground leases found in King County is projected to be approximately $2.1 million (63 percent of all ground lease rent). This revenue includes rent for commercial uses, such as office buildings, retail, supermarkets, and a veterinarian clinic.

Common School and Indemnity Trust. Since the Common School and Indemnity Trust has the largest ownership percentage for this asset class, we segregated the gross revenue received in each fiscal year to display the portion received by the Common School and Indemnity Trust versus the portion received by all other trusts. Note that the portions of revenue received for other trusts are miniscule for this asset class.

FIGURE 14

OPERATING COST PERCENTAGE DEDUCTION

In the Commercial Real Estate Asset Class, all costs are paid from annual revenue. As gross proceeds are received, an operating cost percentage deduction is applied and paid to the Trust Manager. From the trust beneficiary ownership position, there are no outflows of funds to operate and maintain the asset class; the Trust Manager budgets for actual costs and capital expenditures and pays these costs directly from the operating cost percentage deduction received during the year.

The operating cost percentage deduction is a percentage of gross revenues that is legislatively set. The percentage is typically between 25 percent and 31 percent of total gross revenue, depending on the management account associated with each trust ownership. Historical data reported in this analysis reflects actual blended rates deducted. We have used an estimated assumption of 30 percent for the operating cost percentage deduction of this asset class which has been applied in the direct capitalization method.

Note that most leases in the Commercial Real Estate Asset Class operate under a triple net lease structure in which tenants pay all operating costs and maintenance expenses.

Operating Cost Percentage Deduction versus Direct Operating Expenses. The operating cost percentage deduction is different than actual operating expenses and capital expenditures incurred to operate and manage the Commercial Real Estate Asset Class assets.

When the total operating cost percentage deduction for all asset classes exceeds actual operating costs and capital expenditures for the year, the excess is held in reserve for future years when the operating cost percentage deduction does not cover actual costs. The reserve balances are reported by fund and held in separate accounts—the Resource Management Cost Account, the Forest Development Account, and the Agriculture College Trust Management Account.

The Resource Management Cost Account in the state treasury is created and used solely for the purpose of defraying the costs and expenses incurred by the Trust Manager in managing and administering state trust lands, state-owned aquatic lands, and the making and administering of leases, sales, contracts, licenses, permits, easements, and rights of way as authorized (RCW 79.64.020).

The Forest Development Account was created in the state treasury (RCW 79.64.100). Money placed in this account is first used for paying interest and principals on specific bonds issued by the Trust Manager. Appropriations made by the legislature from the Forest Development Account to the Trust Manager are for carrying out forest management activities on state forestlands and for reimbursements of expenditures from the Resource Management Cost Account in the management of state forestlands.

The third account is the Agriculture College Trust Management Account. This account does not retain an operating cost percentage deduction, but the Trust Manager receives a direct appropriation from the legislature to conduct management work. The Trust Beneficiary retains all gross revenue.

The reserve balances for all asset classes as of June 30, 2018 were approximately $12.6 million (Resource Management Cost Account) and nearly $4 million (Forest Development Account). Over the last 10 years, the Resource Management Cost Account reserves reached a high of more than $17 million at the end of FY 2014 and a low of $800,000 at the end of FY 2009. The Forest Development Account reserves reached a high of $24 million at the end of FY 2011 and a low of just under $4 million at the end of 2018.

However, note that these are snapshots as of the end of fiscal years. In reality, the balances of the funds are constantly changing throughout each year with a much wider range. Reserves have been known to dip down to only a couple weeks of operating costs on a few occasions.

The following chart presents the dollar amounts of the historical operating cost percentage deduction from 2007 to 2018. The operating cost percentage deduction is proportionate to the gross revenues produced by the asset class each year—it rises and falls as earnings for trusts rise and fall and may not reflect increases or decreases in the Trust Manager's actual costs. These dollar amounts include both portions of revenue distributed to the Trust Manager from commercial leases and incidental revenue from trespassing fines, non-federal conservation programs, Initial Incident Report (IIR) restitutions, power charges, and other assessments. The costs are not segregated by subgroup (i.e., premises leases versus ground leases) as the Trust Manager's accounting system does not track historical costs at the subgroup level.

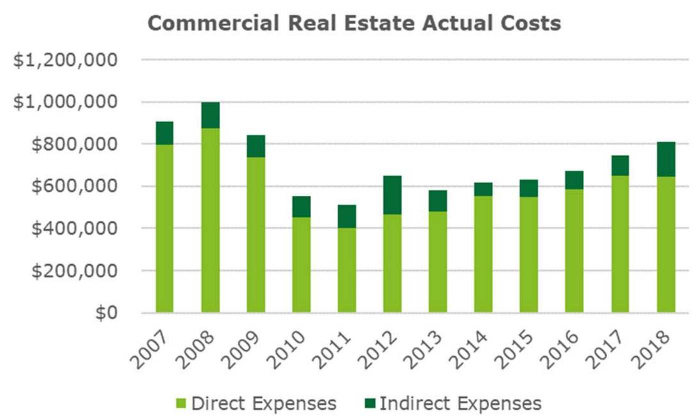
FIGURE 15

ACTUAL COSTS

The following is a discussion of the actual costs incurred by trust beneficiaries and paid by the Trust Manager from funds received as a result of the operating cost percentage deduction.

The following chart highlights the actual costs incurred by the Trust Manager, which are split between direct and indirect expenses.

FIGURE 16



Direct Expenses. Direct expenses include all costs directly related to managing commercial real estate properties, as well as allocations of general costs.

Currently, direct expenses include all costs <u>directly</u> related to:

- Property management
- Projects and planning

The allocations of general costs are related to:

- Uplands
  - Examples include environmental analysis, state lands training, and law enforcement
- Engineering and general services
  - Examples include resource mapping, surveying, and record keeping
- Infrastructure for state trust lands
  - Examples include infrastructure expenses with the key word "real estate."

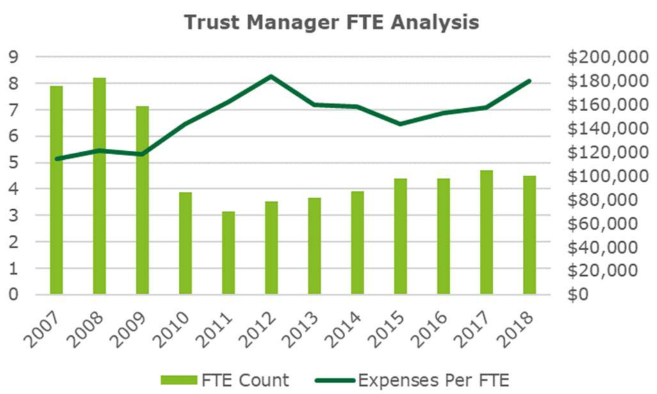
Note again that most leases in the Commercial Real Estate Asset Class operate under a triple net lease structure in which tenants pay all operating costs and capital expenditures. As such, direct expenses are normally minimal.

Indirect Expenses. Indirect expenses include all overhead costs allocated to the Trust Manager for:

- Administrative and agency support
- Adjustments
- Legal services
- Strategic investments
- Other administrative payments

As seen in the following full-time employee analysis, the Trust Manager typically retained between four and five full-time employees for the Commercial Real Estate Asset Class over the last four fiscal years. The total actual costs paid by the Trust Manager have ranged from $140,000 to $180,000 per full-time employee over that same period. These costs include all direct and indirect expenses, including salaries, as well as benefits and overhead.

FIGURE 17



NET CASH FLOW FROM 2014 TO 2018

The trust beneficiaries pay a portion of the gross revenue (i.e., operating cost percentage deduction) to the Trust Manager for operating expenses and capital expenditures. These costs include direct and indirect expenses. The cash flows net of the operating cost percentage deduction are then distributed to the appropriate trust beneficiary.

The following table summarizes the net cash flows distributed to trust beneficiaries over the past five fiscal years for this asset class. These operating cost percentage deduction amounts include both portions of revenue distributed to the Trust Manager from commercial leases and incidental revenue from trespassing fines, non-federal conservation programs, IIR restitutions, power charges, and other assessments. These cash flows indicate the Commercial Real Estate Asset Class provided trust beneficiaries with average net cash flows ranging from $5.9 million to $7.5 million per year.

FIGURE 18

	2014	2015	2016	2017	2018
Total Annual Gross Revenue	**$9,687,347**	**$8,315,189**	**$8,961,802**	**$9,665,572**	**$10,911,373**
Operating Cost % Deduct	($2,778,401)	($2,371,202)	($2,746,495)	($2,995,213)	($3,385,271)
% of Revenue	28.68%	28.52%	30.65%	30.99%	31.03%
Revenue Distributed to Trusts	**$6,908,947**	**$5,943,987**	**$6,215,307**	**$6,670,360**	**$7,526,102**
% of Revenue	**71.32%**	**71.48%**	**69.35%**	**69.01%**	**68.97%**

Note that some recent fiscal years may report an operating cost percentage deduction outside the anticipated range of 25 percent to 31 percent. The Trust Manager explained this is not uncommon as accounting adjustments usually take some time to fully implement.

Because all net cash flow funds are distributed to the trust beneficiaries, it is important to note that the Commercial Real Estate Asset Class is not able to hold cash funds to invest in upgrades, expansions, and transactional expenditures for typical commercial real estate items, such as upgrades, tenant improvements, and marketing.

Property Taxes and Zoning

The State of Washington is exempt from paying direct real property taxes; however, tenants are not.

PROPERTY TAXES

Property taxes are a local government's main source of revenue. Most localities tax private homes, land, and businesses based on the property's value.

Lands owned by the state are exempt from property tax obligations under the state constitution. However, because private lessees of state land receive the benefit of governmental services, the legislature imposes a leasehold excise tax on these private lessees under RCW 82.29A.

Leasehold excise tax is paid by the lessee to the Trust Manager when rent is paid, and the Trust Manager remits the payment to the Department of Revenue. Land that is not leased does not pay property taxes or leasehold excise tax. Generally, the leasehold excise tax on leased land is most often less than what property taxes would be for the same land.

Certain types of special taxes are still required to be paid by the Trust Manager, but they are generally limited and typically not associated with the assessed values of the real property. For example, the state is still required to pay a small amount to certain counties related to their surface water management practices.[2]

ZONING

Zoning classifications for different commercial real estate assets include commercial, business general, urban residential, and rural remote.

We assume that all commercial real estate properties adhere to the proper zoning regulations outlined in local general plans. If not fully compliant, we assume that each property is legally non-conforming to the proper zoning regulations and development standards.

[2] https://snohomishcountywa.gov/2003/SWM-Utility-Charges

Market Analysis

Commercial Real Estate Asset Class portfolio factors.

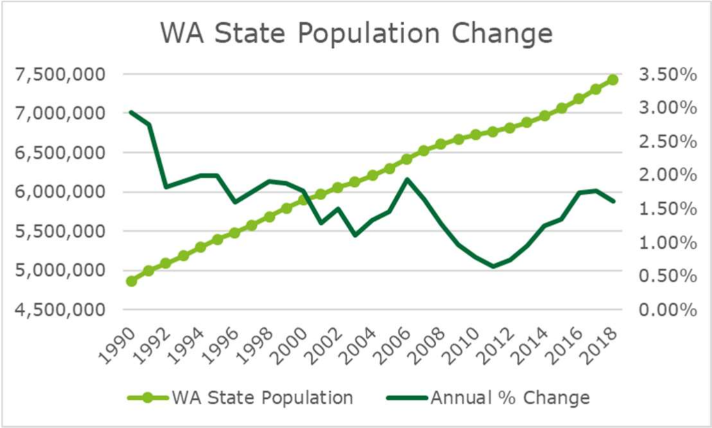
MARKET OVERVIEW

Historic and Current Demographic Trends

Washington State exhibited steady population growth from 1990 to 2018. The growth rate declined sharply near 2008, which is largely explained by the economic conditions of the time. In 2012, as the economy began to recover from the recession, the growth rate began to increase.

The state population totaled 7,427,570 in 2018, averaging 1.2 percent annual growth between 2008 and 2018. The overall population growth is forecasted to continue at a steady pace, with the population anticipated to rise above 9,000,000 by 2040.[3]

FIGURE 19



Overall Capitalization Rate Trends

An overall capitalization rate (OAR) is defined as the ratio of one year's net operating income provided by an asset to the value of the asset and is used to convert income into value when using the income capitalization approach.[4]

Since the 2008 recession, as property values continue to rise, overall capitalization rates for commercial real estate have generally decreased. Overall capitalization rates are the inverse of an income multiple, so lower overall capitalization rates result in higher values for the same net operating income that a property produces.

[3] State of Washington Forecast of the State Population, December 2018, forecasted by the Office of Financial Management.
[4] Definition sourced from the Sixth Edition of the Dictionary of Real Estate Appraisal.

Nationally, between 2017 and 2018, average overall capitalization rates for retail properties rose slightly, while average overall capitalization rates for office properties remained generally flat and average overall capitalization rates for industrial properties decreased steadily.[5]

According to the 2Q 2018 RERC report, the western region of the United States reported an average overall capitalization rate of 6.6 percent for suburban offices. The average overall capitalization rate for suburban offices located in the greater Seattle area was 6.1 percent, 50 basis points lower. Further, the Western United States had average overall capitalization rates of 6.2 percent for warehouses and 6.4 percent for neighborhood and community retail centers. The greater Seattle area reported 5.5 percent and 5.9 percent for warehouses and neighborhood and community retail centers, respectively.

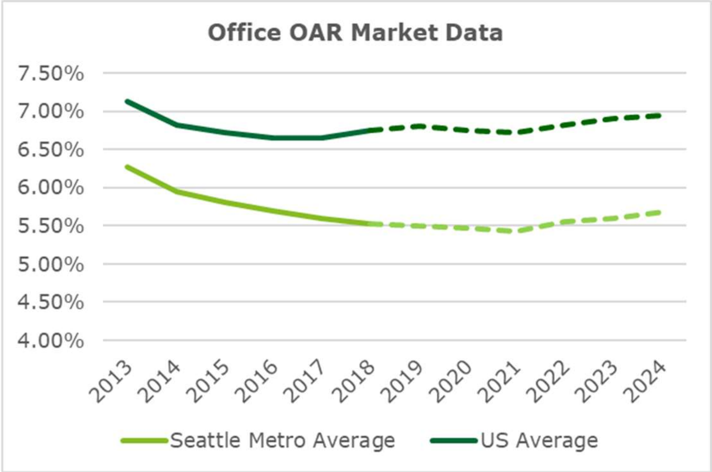
We also compiled sales transactions reported in the CoStar database for single tenancies with office, retail, and industrial uses. These transactions occurred two years prior to the valuation date and have similar age and size characteristics as commercial real estate assets owned by the trust beneficiaries. We found that the average overall capitalization rate for transactions found in rural areas throughout the state was nearly 8 percent, whereas the average overall capitalization rate for transactions located in the Seattle/Tacoma metro areas was only 6.27 percent.

Thus, in the state of Washington, average overall capitalization rates for rural transactions spread throughout the state tend to be higher than average overall capitalization rates for transactions in the state's more urban areas, such as the Seattle/Tacoma metro areas.

The following charts show overall capitalization rate trends in the greater Seattle metro area for office, retail, and industrial transactions sourced from the CoStar database. In general, the data indicates the Seattle metro real estate market is a healthy and strong performing market when compared to the overall national average. The charts clearly demonstrate that overall capitalization rates for the Seattle metro area are consistently lower than the national average. The charts include averages for the past five years and forecasts for the next five years.

Seattle Office Overall Capitalization Rate Trend Chart

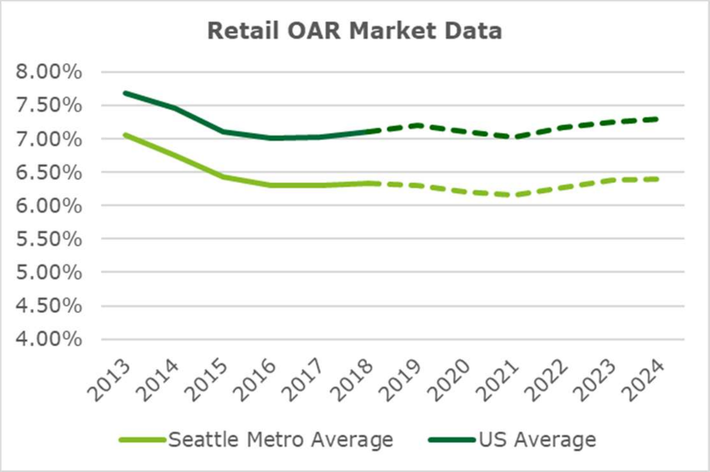
FIGURE 20



[5] PricewaterhouseCoopers (PwC) 2Q 2018 Investor Survey

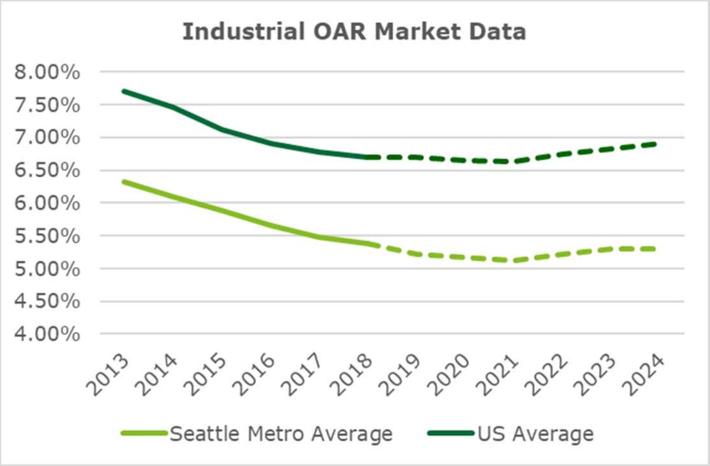
Seattle Retail Overall Capitalization Rate Trend Chart

FIGURE 21



Seattle Industrial Overall Capitalization Rate Trend Chart

FIGURE 22



This rate data is provided as background information. For an in-depth discussion on ownership limitations, the impact on the rates used, and the impact on rates selected please see the earlier chapters in this report.

Methodology

The income approach was the portfolio valuation method selected for this study.

Additional transaction data compares the results of the income approach for properties under premises leases[6] to comparable sales data.

Methodology

The income approach is the basis for the valuation of this asset class (i.e., portfolio valuation) because the properties currently produce annual income and the receipt of future cash flow benefits is expected. As secondary support, sales data was used to evaluate improved property estimates for premises leases only.

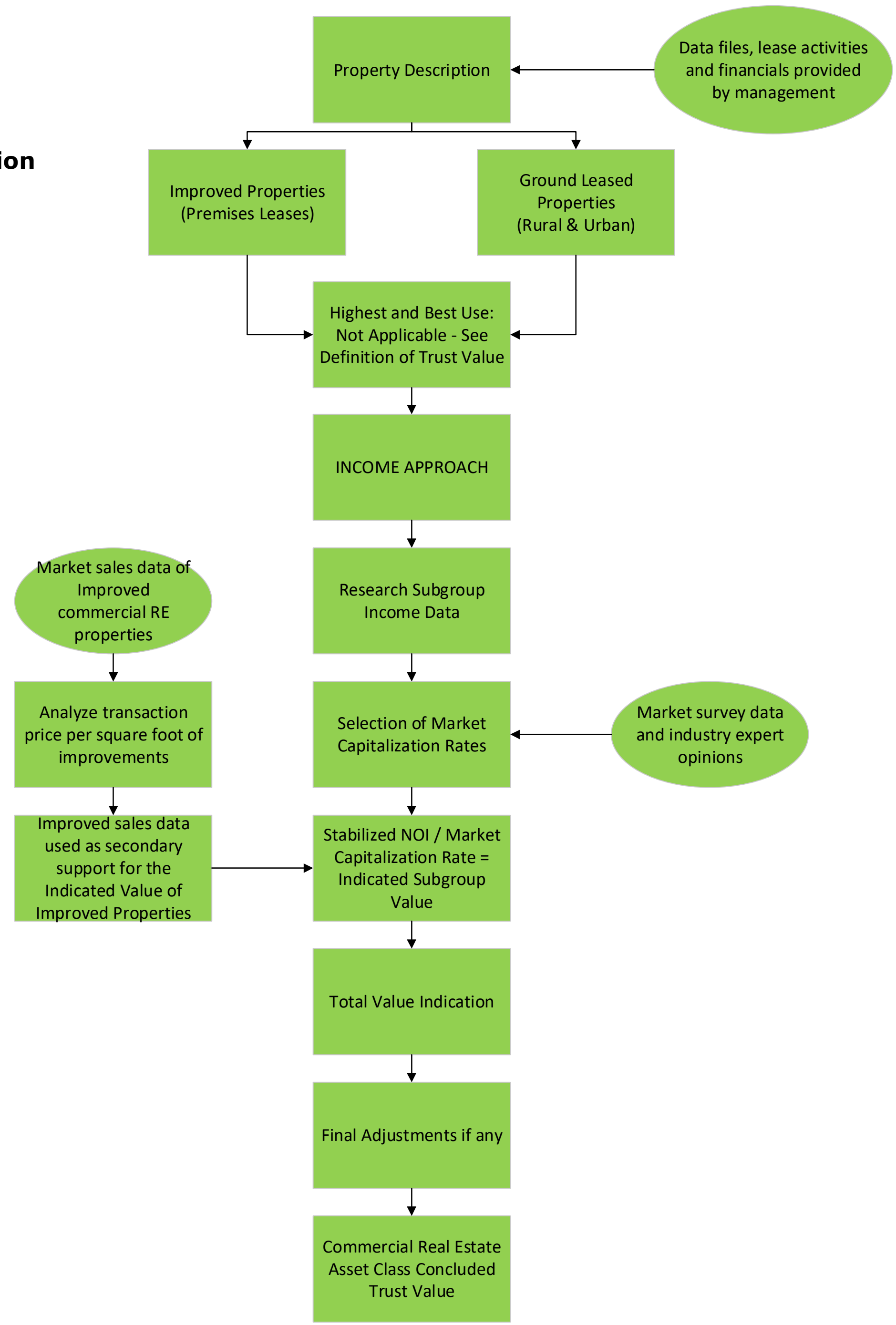
Transaction data for ground leases is limited; therefore, the data is not used to test the ground lease income approach. The Trust Manager's data files were the principal source of market and value information (i.e., annual gross lease revenue, direct and indirect expenses, and other financial information) and include lease activity obtained in the ordinary course of the management of assets.

Due to the nature of the cash flow stream this asset class produces through its negotiated leases, the income approach was the methodology utilized to evaluate the assets. Adequate amounts of market data existed to use the income approach.

[6] Comparable transaction data for ground lease properties was not readily available.

Commercial Real Estate Asset Class Valuation Flowchart

FIGURE 23



Data and Data Sources

Data was compiled and analyzed from multiple data sources. We obtained, read, and analyzed reputable industry publications that are widely known and utilized within the real estate industry by owners, operators, investors, managers, lenders, and appraisers of real estate. The main reports and databases used for this analysis include:

- PwC Real Estate Investor Survey (the "PwC Survey")
- IRR Viewpoint
- RERC Real Estate Report
- CoStar Market Report and Database
- RealtyRates.com Investor Survey

Data on sales with comparable overall capitalization rates was gathered from the CoStar database. PwC, IRR, and RERC reports were used for survey data on national and regional overall capitalization rates applicable to improved properties under premises leases. The RealtyRates.com Investor Survey was utilized for information regarding overall capitalization rates for ground leases.

Trust Value Analysis

As detailed earlier in this report, the value used in this report is Trust Value, which has substantially restricted limitations. We evaluated the trust ownership interest in the Commercial Real Estate Asset Class portfolio using the income approach because we believe it is the strongest indicator of Trust Value as it accounts for the limitations embedded within the Trust Value definition.

Income Approach

The income approach involves performing procedures that enable an appraiser to derive a value indication for an income-producing property by converting its anticipated benefits into property value using one of the following methods:

- *Discounted Cash Flow Method*: The annual cash flows for the holding period and the reversion are discounted at a specified yield rate. The discounted cash flow method was not used in this analysis.
- *Direct Capitalization Method*: One year's income expectancy is capitalized at a capitalization rate that reflects a specified income pattern, return on investment, and change in the value of the investment. The direct capitalization method was used in this analysis.

An Overall Capitalization Rate ("capitalization rate") is defined as a ratio of one year's net operating income provided by an asset to the value of the asset and is used to convert income into value in the application of the income capitalization approach.[7]

Given the leased nature of the land, which will result in stabilized annual income and cash flows into perpetuity, and ownership limitations that result in a lack of near-term reversion of the Commercial Real Estate Asset Class portfolio, the direct capitalization method is considered to be most relevant and has been utilized in this portfolio analysis.

[7] Definition sourced from the 6th Edition of the Dictionary of Real Estate Appraisal.

Extraordinary Assumptions

We assume that all commercial real estate properties adhere to the proper zoning regulations outlined in local general plans. If not fully compliant, we assume that each property is legally non-conforming to the proper regulations and development standards.

As detailed in the introductory chapter, the Trust Manager's ability to sell, exchange, or transfer state trust lands is limited by statute. For the purpose of this analysis, we assume that the ownership interest is non-transferable resulting in the land not being able to be sold.

We relied upon information provided by the Trust Manager for all specific data regarding data files, leasing activities and financials, and size and ownership information. We assume that all information provided is accurate and sufficient for purposes of this valuation.

We note that out of 635,417 square feet of improved properties with premises leases, approximately 101,288 square feet—16 percent of the portfolio—is vacant, including 23,000 square feet of space at the Creekview Building (vacant since 2014), 55,225 square feet of space at I-90 Lake Place Office Building B (vacant since 2015), and 23,063 square feet of space at the Boulevard Center (formerly OfficeMax, scheduled to be vacated in 2019).

We have not performed any sight inspections, and we assume the qualities and conditions of the vacant spaces are below market grade as these vacancies have persisted for several years. Further, the Trust Manager does not maintain a capital expenditure fund for marketing, leasing commissions, tenant improvements, and other items typically required to increase rental rates and/or occupancy. As a result, this analysis relies on the anticipated 2019 cash flow when determining a stabilized figure that represents future cash flows and assumes the stabilized revenue estimate to be an appropriate input for deriving the value indication.

Hypothetical Conditions

None noted.

Income Approach

The direct capitalization method is the approach used to estimate the Trust Value of the Commercial Real Estate Asset Class.

For the purposes of the portfolio valuation analysis in this report, the Commercial Real Estate Asset Class has been divided into subgroups:

- Premises leases
- Ground Leases
  - Rural
  - Urban

The ground leases subgroup has further been segregated for the valuation portion of this analysis due to the different level of risks inherent in rural and urban locations.

Urban ground leases are defined as ground leases found at any non-rural sites located in or around urban areas, including suburban locations.

ESTIMATED NET CASH FLOW

As highlighted in the "Operational History" section of this chapter, total gross revenue received from rent payments for the Commercial Real Estate Asset Class total approximately $10 million per year. We have estimated stabilized streams of revenue for the asset class based on analyzing historical averages and trends while acknowledging vacancies, anticipated FY 2019 income, and potential growth where applicable.

We have also estimated an expected stabilized operating cost percentage deduction of 30 percent based on historical deductions averaging near this blended rate.

In the following table, we segregated the stabilized gross revenue estimate of $10.3 million to each subgroup based on its revenue percentage allocation for anticipated FY 2019 gross revenue.

FIGURE 24

Commercial Real Estate Asset Class - Stabilized Income Summary				
	Premises Leases (Urban)	Ground Leases (Rural)	Ground Leases (Urban)	**Total**
Stabilized Gross Revenues	$6,900,000	$1,200,000	$2,200,000	**$10,300,000**
Operating Cost % Deduction	($2,070,000)	($360,000)	($660,000)	**($3,090,000)**
% of Revenues	30%	30%	30%	**30%**
Trust Net Operating Income	$4,830,000	$840,000	$1,540,000	**$7,210,000**

CAPITALIZATION RATE SELECTION

Premises Leased Properties. An overall capitalization rate of 7.5 percent has been selected to apply to the net cash flows of the properties in the premises leases subgroup. For further discussion regarding determining this capitalization rate, please reference the earlier chapter of this report that discusses rates of return.

Ground Leases. An overall capitalization rate of 9 percent has been selected to apply to the net cash flows of the properties in the ground leases subgroup found in rural locations, and an overall capitalization rate of 7 percent has been selected to apply to the net cash flows of the properties in the ground leases subgroup found in urban locations.

For further discussion about how these capitalization rates were determined, please reference the earlier chapter in this report that discusses rates of return.

DIRECT CAPITALIZATION

The capitalization rate is applied to the relevant portfolio revenue stream estimates, which have been stabilized for ground lease and premises lease properties, to derive a preliminary Trust Value indication for this asset class.

Premises Leases (Urban). The overall capitalization rate for premises leased properties is shown in the following table.

FIGURE 25

Direct Capitalization - Premises Leased Properties (Urban)		
Lease Count		7
Acres		43
Occupied Area		534,129
Vacant Area		101,288
Gross Building Area		635,417
Stabilized Gross Revenues		$6,900,000
Operating Cost % Deduction	30%	($2,070,000)
Trust Net Operating Income		$4,830,000
Capitalization Rate		7.50%
Indicated Value		$64,400,000
Value Indication (Rounded)		**$64,400,000**
Value per Acre		**$1,497,674**
Value per Gross Building Area SF		**$101**

The total value indication for premises leased properties is $64,400,000 (rounded), which equates to approximately $100 per square foot of improvements owned or $1,498,000 per acre.

Ground Leases. In the following table, the overall capitalization rates for ground leased properties are segregated by rural and urban locations:

Rural Locations. The total value indication for ground lease sites located in rural areas is $9,300,000 (rounded), which equates to an average of approximately $9,600 per rural acre.

FIGURE 26

Direct Capitalization - Ground Leases (Rural)		
Rural Ground Leases		
Lease Count - Rural		23
Acres - Rural		971
Stabilized Gross Revenues		$1,200,000
Operating Cost % Deduction	30%	($360,000)
Trust Net Operating Income		$840,000
Capitalization Rate		9.00%
Indicated Value		$9,333,333
Rural Value Indication (Rounded)		**$9,300,000**
Value per Acre		**$9,578**

Urban Locations. The total value indication for ground lease sites located in the Seattle/Tacoma metro areas is $22,000,000 (rounded), which equates to an average of approximately $1,100,000 per urban acre.

FIGURE 27

Direct Capitalization - Ground Leases (Urban)		
Urban Ground Leases		
Lease Count - Urban		6
Acres - Urban		20
Stabilized Gross Revenues		$2,200,000
Operating Cost % Deduction	30%	($660,000)
Trust Net Operating Income		$1,540,000
Capitalization Rate		7.00%
Indicated Value		$22,000,000
Urban Value Indication (Rounded)		**$22,000,000**
Value per Acre		**$1,100,000**

The combined value indication for the ground lease subgroup is $31,300,000 or approximately $31,600 per acre.

Income Approach Summary. The following table summarizes the total indicated values from each of the direct capitalization calculations.

FIGURE 28

Commercial Real Estate Income Approach Summary	
Total Lease Count	36
Total Acres	1,034
Premises Leased Properties (Urban)	$64,400,000
Ground Leases (Rural)	$9,300,000
Ground Leases (Urban)	$22,000,000
Trust Value Indication (Rounded)	**$95,700,000**
Value per Lease	**$2,658,333**
Value per Acre	**$92,553**

Improved Property Sales Data

Improved property sales data was used as secondary support for commercial real estate premises leases in the Commercial Real Estate Asset Class portfolio.

IMPROVED PROPERTY SALES DATA

The largest portion of revenue from the commercial real estate portfolio consists of improved property leases. As a test of reasonableness, the results of the improved property lease subgroup have been compared to transaction data. This is not a perfect comparison as the sales data reflects transactions without the limitations placed on state trust lands described earlier (e.g., inability to sell), but the data provides a broad overview and comparison of financial relationships based on income and value.

A comparison of ground lease assets was not performed due to limited transactions and the wide range of property types in this portion of the portfolio. Further, information regarding improvements (e.g., size, age) built on ground lease sites was not maintained by the Trust Manager, which further limited our ability to identify meaningful transactions.

There are seven active premises leases situated on approximately 31 acres. The total value indication for the improved properties is $64,400,000. This total has been allocated to each of the leases based on its respective gross annual rental revenue anticipated in FY 2019.

A total of 60 leased fee improved sale transactions were identified with retail, office, and industrial uses similar to those in the state trust lands portfolio. We have condensed the list to include 45 of the most recent and similar transactions.

The selected transactions represent office, retail, and industrial types that transacted from September 26, 2016 to June 1, 2018, and are spread throughout the Seattle/Tacoma metro areas. The transacted properties range in size from 11,880 square feet to 250,490 square feet. The overall capitalization rates range from 3.97 percent to 10 percent with an overall average of 6.63 percent.

Generally, leased commercial real estate investments are purchased and sold based on their ability to create income. Due to this, we have analyzed the transactions based on their income production. The transactions were plotted on the following graph to demonstrate the relationship between transaction price per square foot (depicted on the vertical axis or Y axis) and net operating income per square foot (depicted on the horizontal axis or X axis). A linear trend line was added to the transactions plus the allocated income approach indication for each of the estimates. This was compared against the concluded Trust Value for improved commercial properties owned by the trust beneficiaries.

In the following graph, the value indications for the subject portfolio's improved property leases fall near the trend line set by comparable market transactions.[8] Therefore, the market data supports the results of the income and value relationships demonstrated in the income approach prior to any final adjustments.

FIGURE 29

[8] The reader is reminded that the market transactions represent sales without the burdens and ownership limitations of the portfolio in the Commercial Real Estate Asset Class.

Value Conclusion

The concluded Trust Value of the Commercial Real Estate Asset Class is $95,700,000.

COMMERCIAL REAL ESTATE ASSET CLASS VALUE CONCLUSION

Using the income approach, the indicated value of the improved properties is supported by transactional data in the market. When combined with the indicated value of ground leased properties, the total represents the value indication for the Commercial Real Estate Asset Class.

This results in a concluded Trust Value of $95,700,000 for the asset class.

FIGURE 30

Commercial Real Estate Value Conclusion	
Total Lease Count	36
Total Acres	1,034
Premises Leased Properties (Urban)	$64,400,000
Ground Leases (Rural)	$9,300,000
Ground Leases (Urban)	$22,000,000
Trust Value Indication	$95,700,000
Concluded Trust Value (Rounded)	**$95,700,000**
Value per Lease	**$2,658,333**
Value per Acre	**$92,553**

INDIVIDUAL TRUST VALUES SUMMARY

The concluded Trust Value for the Commercial Real Estate Asset Class was calculated and allocated to each trust based on its share (i.e., percentage) of gross revenue for the asset class in FY 2018. The table below reflects the concluded Trust Value allocated to each trust.

FIGURE 31

Commercial Real Estate Individual Trust Values		
Trust	**Trust Value**	**%**
Common School and Indemnity	**$94,588,923**	**98.84%**
University Original	**$907,236**	**0.95%**
Charitable/Educational/Penal & Reformatory Institution	**$97,614**	**0.10%**
State Forest Purchase	**$46,893**	**0.05%**
Agricultural School	**$46,893**	**0.05%**
Capitol Grant	**$12,441**	**0.01%**
Total	**$95,700,000**	**100%**