

May 25, 2021

Dale R. Folwell, CPA
State Treasurer and Chairman, Local Government Commission
North Carolina Department of State Treasurer
3200 Atlantic Ave, Raleigh NC 27604

Dear Treasurer Folwell:

We are writing to reiterate concerns about the Bald Head Island Transportation Authority's (BHITA) non-recourse revenue bond application of \$56.1M which the Local Government Commission (LGC) is scheduled to reconsider on June 1. We urge you to hold the matter in abeyance pending resolution of major concerns surrounding the bond application, and BHITA's proposal to use the bond proceeds to acquire the Bald Head Island transportation system (System) from its current owner, Bald Head Limited (Limited), for \$47.75M.

Our letter is in two parts. The first explains why BHITA's proposed purchase price is unreasonably excessive, and, if paid to Limited, will unfairly harm BHI ferry riders who have no choice but to use the System. BHITA's proposed revenue bond issue is also excessive and, if approved, will subject the state and NC taxpayers to unnecessary credit risk. The second part outlines what BHITA should do to arrive at a reasonable valuation of the System, a lower acquisition price, and a smaller, less risky bond issue.

Why BHITA's Proposed \$47.75M Purchase Price and Its \$56.1M Bond Issue Are Excessive

BHITA agreed to a very high purchase price for Limited's transportation assets (\$47.75M) because its view, and Limited's view, of what the System is worth is inflated by the fact that two of its three components – the parking and barge operations – are unregulated monopolies that currently produce exceedingly high monopoly profits. Both are profitable enough to render the System as a whole – including the regulated BHI ferry – highly profitable.

In 2019, for instance, 102% of the System's total operating income came from Limited's parking (69%) and barge (33%) operations. That same year, the operating income margin (i.e., operating income/revenues) for the System's combined operations (i.e., parking, barge, and ferry) came to 26%, or 3.25 times the U.S industry median of 8% for all publicly traded firms; while the System's net income margin came to 25%, or 6.25 times the U.S. industry median of 4%. (See Table 1 below).

When appraised, highly profitable businesses routinely produce high valuations which this one certainly did. In 2017, Mercator International was hired by Limited to appraise the System, and subsequently estimated its enterprise value at \$55.8M. BHITA apparently accepted that valuation as a legitimate "starting point" and proceeded to negotiate against itself, with predictable results. (See page 34 of BHITA's Credit Presentation made to the LGC on December 3 & 4, 2020)

Second, as stipulated by the Ferry Transportation Authority Act, BHITA would have to finance whatever amount it eventually agreed to pay for the System by issuing non-recourse revenue bonds. In 2020, BHITA asked Mercator International to estimate how much ferry, barge and parking rates would have to increase in order to boost the System's prospective cashflow enough to service the amount of debt needed to finance the acquisition. In its *Bond Feasibility Study*, Mercator estimated that a 20 percent rate hike would be required to service a \$56.1M revenue bond issue that would be needed, pretty much

in its entirety, to pay Limited \$47.75M -- while maintaining an investment grade bond rating (i.e., BBB-). The BBB- bond rating was important because the LGC may have balked at approving a BHITA bond application that fell below investment grade.

Third, since the System's appraised value is as high as it is but only because users are already paying (unregulated) monopoly prices for parking and barge service, BHITA's proposal to raise rates by an additional 20 percent – in order to service \$56.1M in new debt needed to pay Limited \$47.75M – would effectively penalize System users twice. Once by being charged monopoly prices for parking and barge services in the first place; and a second time by requiring System users to pay for a bond issue that is as large as it is only because the appraised value of the System has been inflated by monopoly profits that Limited currently earns on its unregulated parking and barge operations, and that BHITA would need to continue earning in order to service the debt that it incurs to pay Limited. (See Tables 15-18 of the *Mercator Bond Feasibility Study*) In our view, this “double whammy” would constitute a highly questionable and patently unfair transfer of wealth from System users to Limited, and by extension, the Mitchell family estate that owns Limited. It is highly doubtful that this is what the NC legislature, and Senator Bill Rabon, had in mind when the Ferry Transportation Authority Act was enacted in 2017.

Fourth, since its bond issue is tentatively rated BBB-, or one notch above junk, BHITA will have very little borrowing capacity to raise additional capital should the System encounter unanticipated costs or revenue shortfalls that might result from damage done by a hurricane, or from capital improvements that need to be made to the System but currently are not reflected in *Mercator's Bond Feasibility Study* or BHITA's cashflow forecasts. Should either occur, BHITA may have no choice but to raise rates that much more. If a significant number of System users eventually refused to pay ever higher rates, BHITA could be forced to default on its revenue bonds given unnecessarily high levels of debt that it would be carrying relative to projected cashflows. Should default occur, the state and NC taxpayers would very likely be required to step in and keep the System financially afloat since BHITA is a state entity.

Where BHITA Needs to Go from Here

As part of its review of BHITA's bond application, the LGC should ask BHITA to undertake a couple of specific analyses that would encourage Limited and BHITA to agree on a lower, more reasonable acquisition price for the System as well as a smaller, less risky bond issue. One analysis would involve BHITA asking Mercator to evaluate how much debt BHITA could raise under Mercator's three growth scenarios subject to the following constraints: 1) user rates for the ferry, parking and barge service remain where they were at year-end 2020 through 2028, and then allowed to increase at the rate of inflation, and 2) BHITA's bond issue must be kept at a level that would produce a single A rating, or higher.

This analysis should help BHITA evaluate how much of its proposed \$47.75M acquisition price would constitute the difference between the market value of the System's parking and barge operations when operated as unregulated monopolies as they are today vs. monopolies subject to the same type of rate-of-return regulation that currently governs the BHI ferry. While this analysis represents an indirect and imperfect way of evaluating this difference, it should constitute a step in that direction which could be done quickly and at very little cost.

Keeping rates at current levels, adjusted only for inflation, would give BHITA a rough indication of how much new debt it could assume in order to purchase Limited's transportation assets at a price that at

least limits the premium that BHITA is currently proposing to pay for future monopoly profits and related cashflows generated by the System's unregulated parking and barge operations going forward. Similarly, stipulating a single A bond rating (or better) would give BHITA a better understanding of how much it would need to limit its acquisition price and initial bond issue in order to retain at least some flexibility to borrow capital near term that might be needed to deal with unanticipated costs or revenue shortfalls.

A second, more direct analysis would involve estimating how much the System would be worth if the underlying appraisal assumed that user rates and earnings for its parking and barge operation would be subject to the same type of rate-of-return regulation that currently governs the BHI ferry. This would involve estimating a regulated revenue requirement for the System as a whole which would constrain rates to levels that would generate enough revenue to allow the System to recover its operating costs, plus a fair rate-of-return on the System's rate base. The rate base would reflect the accounting value of the System's assets less depreciation on those assets. The fair rate-of-return could be stipulated at 10% which is what most regulated utilities are allowed to earn given that they operate with relatively lower financial risks than do businesses in competitive markets.

The Chair of the BHITA Board of Trustees is a former member of the NC Utilities Commission and hopefully could elicit help from the NCUC staff to go through these calculations on a rough basis, which should be sufficient. It would require, however, that Limited agree to release its prior-year statements for the System, preferably for each of the past ten years. Given that System users will be asked to pay off whatever amount of debt BHITA ends up borrowing to purchase the System from Limited, we continue to see no legitimate reason why these historical financial data should remain confidential.

If the data provide further evidence that the System's appraised value is as high as it is due to monopoly profits derived from Limited's unregulated parking and barge operations, BHITA needs to factor that into what it should reasonably pay for the System. To this point, it clearly hasn't done this.

Respectfully yours,

Robert T. Blau, CFA
5 Starrush Trail, Bald Head Island

J. Paul Carey
611 Currituck Way, Bald Head Island

cc: Honorable Beth A. Wood, CPA, NC State Auditor
Honorable Ronald Penny, NC Secretary of Revenue
Honorable Elaine Marshall, NC Secretary of State
Mr. Joshua Bass
Ms. Viola Harris
Mr. Scott Padgett
Mr. Edward Munn
Honorable Mike Philbeck, NC Speaker of House
Honorable Bill Rabon, NC State Senator
Ms. Sharon Edmundson, NC Deputy Treasurer
Mr. Timothy Romocki, Director, Debt Management, NC Department of State Treasurer
Ms. Susan Rabon, Chair, Bald Head Island Transportation Authority
Mr. J. Andrew Sayre, Mayor, Village of Bald Head Island

Table 1													
Bald Head Island Transportation System													
Financial Results Year Ending 12/31													
	Barge Operations			Parking Operations			Transportation			System Total			
	2019	2018	2017	2019	2018	2017	2019	2018	2017	2019	2018	2017	
Revenues	1,499,415	1,153,905	1,132,700	2,749,700	2,548,577	2,493,714	6,277,198	5,543,542	5,989,737	10,526,313	9,246,024	9,616,151	
Expenses	685,761	598,174	461,248	1,068,119	1,232,336	1,205,258	6,005,709	5,677,291	5,488,981	7,759,589	7,507,801	7,155,487	
Operating Income	813,654	555,731	671,452	1,681,581	1,316,241	1,288,456	271,489	(133,749)	500,756	2,766,724	1,738,223	2,460,664	
Depreciation	227,100	201,320	107,720	472,197	677,794	677,387	247,787	208,940	166,365	947,084	1,088,054	951,472	
EBITDA	1,040,754	757,051	779,172	2,153,778	1,994,035	1,965,843	519,276	75,191	667,121	3,713,808	2,826,277	3,412,136	
Other Expenses	230,681	224,690	117,368	473,127	497,103	478,980	365,469	437,295	366,612	1,069,277	1,159,088	962,960	
Net Income	810,073	532,361	661,804	1,680,651	1,496,932	1,486,863	153,807	(362,104)	300,509	2,644,531	1,667,189	2,449,176	
Operating Income Margin	54%	48%	59%	61%	52%	52%	4%	-2%	8%	26%	19%	26%	
EBITDA Margin	69%	66%	69%	78%	78%	79%	8%	1%	11%	35%	31%	35%	
Net Income Margin	54%	46%	58%	61%	59%	60%	2%	-7%	5%	25%	18%	25%	
(Source: BHITA Draft Bond Prospectus, 12/14/2020)													
Median Operating Income Margin – All U.S. Industries											8%	7%	6%
Median Net Income Margin – All U.S. Industries											4%	3%	3%
(Source: ReadyRatios)													