From:	Tim Romocki
To:	Cindy Aiken
Subject:	FW: Bald Head Island Transportation Authority
Date:	Tuesday, November 30, 2021 10:30:15 AM
Attachments:	LGC Letter Nov 29.pdf Mercator Seller"s Due Diligence January 14, 2018 (1).pdf

From: ROBERT BLAU <blaur@bellsouth.net>
Sent: Monday, November 29, 2021 7:54 AM
To: Dale Folwell <Dale@Nctreasurer.com>; Beth_wood@ncauditor.net
Cc: ronald.penny@ncdor.gov; emarshal@sosnc.gov; Sharon Edmundson <Sharon.Edmundson@nctreasurer.com>; Tim Romocki <Tim.Romocki@nctreasurer.com>; Susan Rabon <susanrabon@gmail.com>; Andy Sayre <jsayre@villagebhi.org>; Debbie Tomasko <Debbie.Tomasko@nctreasurer.com>; Paul Carey <paul.carey@icloud.com>
Subject: Bald Head Island Transportation Authority

Attached is a letter urging the LGC to reject the Bald Head Island Transportation Authority's (BHITA) proposed $56.1M revenue bond issue that would be used to acquire the Bald Head Island transportation system from its current owner, Bald Head Limited (BHL), for $47.75M. The letter details reasons why approving BHITA's bond application would subject users of the BHI transportation system to unreasonable costs, and the community of Bald Head Island and the State to an unnecessarily high degree of financial/default risk.

Also attached is a 2017 enterprise valuation study that was done for Bald Head Limited by Mercator International, and used by BHITA as part of its "due diligence" appraisal of BHL's transportation assets. Mercator International was subsequently hired by BHITA to conduct its *Bond Feasibility Study* which determined that BHITA could borrow up to $56.1M, and maintain an investment grade, BBB- bond rating provided it immediately raised user rates for ferry, parking and barge services by 20 percent. BHITA could do so because the BHI transportation system is a local monopoly that, once acquired by BHITA, would no longer be regulated by the NC Utilities Commission.

Mercator's 2017 study was finally released to the public on October 22, 2021 in response to a Public Record Request. All of this is discussed briefly in the attached letter. Since the 2017 Mercator study may not have been made available to the LGC, it is included herein.

Users of the BHI transportation system greatly appreciate the diligence that you and other members of the LGC have demonstrated in reviewing BHITA's bond application.

Robert Blau, CFA

November 17, 2021

Dale R. Folwell, CPA
North Carolina State Treasurer

Beth A. Wood, CPA
North Carolina State Auditor

Dear Treasurer Folwell and Auditor Wood:

It is our understanding that the NC Local Government Commission (LGC) may consider the Bald Head Island Transportation Authority's (BHITA) $56.1M revenue bond application at its December 7 meeting. We are writing to urge the LGC to reject BHITA's application on the grounds that borrowing $56.1M in order to pay Bald Head Limited (BHL) $47.75M for the BHI transportation system (System) would impose **unreasonable** costs on System users, and subject Bald Head Island and the State to a considerable amount of **unnecessary** financial risk.

We detailed reasons for this in our July 21, 2021 letter to you in which we explained that BHITA's $47.75M offer represents the **highest** price that it could possibly pay BHL and finance through a $56.1M investment-grade bond issue that S&P Global has tentatively rated BBB-, or just one notch above junk. Mercator International, BHITA's lead financial consultant, further estimates that borrowing $56.1M would require BHITA to immediately raise user rates for BHI ferry, parking and barge services by **20 percent** just to pay for debt service costs associated with its bonds. BHITA could do so because under the terms of the Ferry Transportation Authority Act, which BHL conceived, wrote and persuaded the NC legislature to enact in 2017, the BHI transportation System, which is a local monopoly, would no longer be regulated by the NC Utilities Commission once it is acquired by BHITA.

Even more problematic, the **entire** $56.1M that BHITA is proposing to borrow through its BBB-revenue bond issue would be needed to pay BHL $47.75M with the remaining $8.35M used to cover reserve requirements and related bond issuance costs. Thus, **none of BHITA's debt capital – or the added cash flow that results from a permanent 20 percent rate hike needed to service that debt -- would be available to spend on the transportation System itself**.

Therein lies a considerable amount of default risk. If unanticipated capital spending requirements were to arise in the next few years (e.g., due to damage caused by a hurricane, some other calamity, or chronic neglect), BHITA may be unable to raise additional capital needed to keep the System up and running. Given the amount of debt BHITA would already be carrying, a second (subordinated) revenue bond issue would necessarily be rated well below investment-grade which the LGC may be remiss to approve. Should that occur, BHITA could easily be forced to default on its bond payments, in which case the LGC would have to step in and oversee the System's operation until new ownership and related financing could be worked out. Because the community of Bald Head Island is completely dependent on the transportation System for moving people, goods and service vehicles to and from the island **daily**, shutting the System down even temporarily due to BHITA defaulting on its bonds would not be an option.

On November 2, in view of all of this, a clear majority of voters on Bald Head Island (i.e., 58%) registered their objections to BHITA's proposed deal with BHL by approving a general obligation (GO) bond referendum that would allow the Village of Bald Head Island to borrow up to $54M to purchase the transportation System and operate it as a municipally owned utility. They did so despite the fact that BHL, and the Mitchell Family Corporation which owns BHL, have said that they will not sell the System to Village of Bald Head Island, and that if the LGC does not approve BHITA's bond application in December, the System's ferry, parking and barge operations may be sold separately to other commercial operators (e.g., private equity investors).

In our view, the favorable outcome of the Village of Bald Head Island's bond referendum reflects a growing and widely held view among BHI stakeholders that BHITA has failed to do what it was purportedly created for; namely, to represent and protect the interests of those users who completely depend on the BHI transportation System. Instead, by proposing to borrow $56.1M though a revenue bond issue rated BBB-, thereby maxing out its borrowing capacity, in order to pay BHL $47.75M, BHITA has spent the last 4+ years working out a revenue bond application that **maximizes** the sales price of BHL's transportation assets -- all at a considerable cost to System users (e.g., an immediate 20% rate hike needed to pay debt service costs), and considerable risk to BHI and the State. Needless to say, none of this has inspired confidence, at least among BHI stakeholders, that BHITA can or should be trusted to manage the System going forward.

The question remains why BHITA put itself, and the LGC, in this position. BHITA asserts that the terms of the Ferry Transportation Authority Act and its two highly flawed real estate appraisals that formed the basis of BHITA's $50.9M "due diligence" valuation of BHL's transportation assets made them do it. Like the real estate appraisals themselves, we believe that explanation is incomplete to the point of being disingenuous.

In our July 21 letter, we noted BHITA's initial real estate appraisal done by the Worsley Real Estate Company purposefully excluded using the Income Approach which is widely regarded to be the best, and most accurate method of valuing income producing property. Worsley was explicitly instructed by BHITA's business valuation consultant, whoever that was, to exclude the Income Approach presumably because its use would have required BHITA to disclose BHL's prior-year financial statements for the transportation System. Members of the BHITA Board of Trustees were permitted to see those statements but only after signing a binding non-disclosure agreement (NDA).

Even so, by signing the NDA, BHITA, and its consultants, were effectively precluded from using these data to independently value the transportation System based on its **actual** financial performance. Had they done so, BHL's financial statements would have had to be released to the public, thereby violating the NDA. The fact that BHITA had no budget with which to hire its own independent financial and engineering experts also didn't help. Nor did the fact that none of the eleven political appointees to the BHITA Board of Trustees had the relevant expertise or prior experience needed to negotiate an acquisition such as this.

Instead, for its initial valuation, BHITA relied on a 2017 study **done for BHL** by Mercator International which estimated the enterprise value of the System at $55.8M. Apparently, that study was shared with Worsley in 2019 prior to his conducting BHITA's first real estate appraisal which, of course, turned out to be **two and a half times** what the Brunswick County tax assessor believes BHL's transportation related real estate assets are worth. Mercator's 2017 enterprise valuation also provided the basis for the *Bond Feasibility Study* that Mercator International **did for BHITA** in 2020. That study, in turn, determined how much public debt BHITA could potentially raise through an investment grade bond issue (i.e., $56.1M, assuming an across-the-board 20 percent permanent rate increase) and, thus, how much it could pay BHL (i.e., $47.75M).

On October 22, 2021, BHITA finally released the 2017 Mercator study in response to a July 9, 2021 Public Record Request filed by a resident and business owner on BHI. Since the 2017 study obviously had an important bearing on BHITA's "due diligence" valuation, as well as its bond application, and because it may not have been disclosed to the LGC, we are attaching a copy to this letter.

In the interest of brevity, we will not dissect the 2017 Mercator study. We will simply note that its $55.8M valuation of the BHI transportation system was 26 times the System's EBITDA for 2016, 19 times EDITDA for 2017, and was based on a series of **assumptions** that BHL, or another commercial operator, could raise **unregulated** parking and barge rates enough to generate the cash flows and terminal values needed to produce a valuation that high.

Of the $55.8M aggregate valuation, Mercator's 2017 study attributed only $3.5M (6%) to the regulated BHI passenger ferry -- despite the fact that the passenger ferry in 2017 accounted for 61 percent of the System's total operating revenue. BHL's **unregulated parking monopoly** at the Deep Point ferry terminal site was valued at $38.2M (69% of the total), while its **unregulated barge monopoly** which hauls all goods and service vehicles between BHI and the mainland, was valued at $14M (25%). Mercator's 2017 valuation also was predicated on **projected** operating income (EBITDA) margins on BHL's parking monopoly increasing from 71.7% of revenues in 2017 to **86.1%** in 2040, while EBITDA margins on its barge monopoly were projected to increase from 71.3% of revenues in 2017 to **83.2%** of revenues in 2040.

We would encourage the LGC and its staff to review Mercator's 2017 study carefully, particularly pages 62-75, and make its own judgement about the validity and reasonableness of its valuation. We also would urge the LGC to consider the **propriety** of BHITA hiring Mercator to conduct its *Bond Feasibility Study* shortly after Mercator had completed its $55.8M enterprise valuation of the System for BHL, the seller. BHITA's use of Mercator underscores why BHITA should have disclosed publicly all documents that had a bearing on its appraisal and its bond application as soon as they were available rather than keeping those documents confidential until after the LGC was initially expected to consider and approve BHITA's application last February. Very much to its credit, the LGC did not let that happen, and here we are.

In our opinion, Mercator's 2017 study, like the 2019 Worsley real estate appraisal and the second real estate appraisal that BHITA had done by Newmark Knight and Frank earlier this year in response to concerns about the validity of the Worsley appraisal, were all set up to exceed, or more accurately, **not constrain** the maximum amount of public debt that BHITA could raise through an investment grade revenue bond issue (i.e., $56.1M) and, thus, how much it could pay BHL (i.e., $47.75M) and arguably comply with the Ferry Transportation Authority Act.

As we noted in our July 21 letter, all of this was corroborated by BHITA itself in its July 6 response to the LGC's "must answer" Question 10. Question 10 asked why BHITA dismissed concerns that its proposed purchase price was well in excess of what Limited's transportation System might actually be worth (i.e., to a buyer other than BHITA) based on its actual operating income (EBITDA). BHITA responded:

> There is no standardized approach to valuation to this type of asset, as governmental acquisitions of privately held infrastructure assets are very rare. Furthermore, the Authority is operating under a statute that requires it to acquire assets rather than a business. EBITDA is a measure of profits that also takes into account variable tax rates and depreciation policies. **Because the Authority is not a for-profit entity, … the Authority did not focus on EBITDA as a valuation tool for either (market) value or (bond) feasibility…. [S]ince the Authority will be operating as a public entity rather than a private enterprise; its financial analysis and financial projections are all based on operating cash flows …. Rather than using a simple projection of the seller's historical net income to measure financial performance (and fair market value), the Authority worked with a feasibility consultant (Mercator International) to develop cash flow models as part of its due diligence of the transaction**. (**Emphasis added**)

In closing, we do not fault BHL for trying to maximize the sales price of its transportation assets in the manner in which it did. Using political processes to enhance, or attempt to enhance, the profitability of commercially owned monopolies is not a new or uncommon practice. We do fault BHITA, however, for agreeing to a deal with BHL that clearly would unfairly and unreasonably penalize users of the BHI transportation System (who BHITA purportedly represents), while subjecting Bald Head Island and the State to unnecessary financial risk.

As the 2017 Mercator study suggests, it is conceivable that BHL, or another commercial operator, could increase unregulated BHI parking and barge rates enough to "justify" an excessively high valuation. BHL's parking and barge operations, after all, are currently **unregulated local monopolies** that can be and, in our view, already are being exploited by BHL. EBITDA margins in the range of 80% of operating revenue are by definition excessive and, in this instance, clearly indicative of monopoly pricing abuse.

Yet, BHITA apparently accepted Mercator's 2017 valuation as reasonable and a "given," and proceeded to come up with its own inflated appraisal. As a result, after 4+ years of BHITA deliberating, the transportation System's fair market value remains a mystery. And the LGC is now being asked to approve a revenue bond issue that would: 1) privatize and monetize the System's future unregulated monopoly profits which would immediately accrue to BHL through the payment of BHITA's $47.75M offer price, and 2) socialize the default risk that would result from BHITA issuing $56.1M in revenue bonds rated BBB-, thereby tapping out its ability to raise more debt capital should unanticipated capital spending requirements arise near term, which they very easily could.

Many BHI stakeholders believe the latter outcome is offensive, particularly in view of the fact that: 1) current unregulated parking and barge rates are already unreasonably high and subject to monopoly pricing abuse; 2) the quality of regulated passenger ferry service during periods of peak use is deteriorating and will require additional expenditures to fix; and 3) Mercator International's projected cash flow increases that would result from an additional, and wholly unnecessary 20 percent rate hike should not be used by BHITA as a rationale for overpaying BHL and borrowing more debt capital than the transportation System can comfortably afford. Given the importance of the BHI transportation System to the community of Bald Head Island, we hope the LGC will see through this subterfuge and reject BHITA's bond application.

Respectfully yours,

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

J. Paul Carey
611 Currituck Way, Bald Head Island

cc: Honorable Ronald Penny, NC Secretary of Revenue
Honorable Elaine Marshall, NC Secretary of State
Mr. Paul Butler, Jr.
Mr. Mike Philbeck
Mr. John Burns
Ms. Vida Harvey
Ms. Nancy Hoffman
Ms. Sharon Edmundson, Deputy State Treasurer and Director NC State and Local Government Finance Division
Mr. Timothy Romocki, Director, Debt Management, NC Department of State Treasurer
Ms. Charlotte Mitchell, Chair, NC Utilities Commission
Ms. Susan Rabon, Chair, Bald Head Island Transportation Authority
Mr. J. Andrew Sayre, Mayor, Village of Bald Head Island
Mr. Peter Quinn, Mayor Elect, Village of Bald Head Island