The Regents of the University of California

INVESTMENTS COMMITTEE
November 16, 2022

The Investments Committee met on the above date at the UCSF-Mission Bay Conference Center, San Francisco campus and by teleconference meeting conducted in accordance with California Government Code §§ 11133.

Members present:	Regents Anguiano, Cohen, Makarechian, Matosantos, Pouchot, Robinson and Sherman; Ex officio members Drake and Leib, Advisory members Ellis and Steintrager; Chancellors Khosla, May, and Muñoz; Advisor Zager
In attendance:	Regents Chu, Elliott, Hernandez, Pérez, Reilly, Sures, and Timmons, Regent-designate Raznick, Staff Advisor Mackness, Interim Secretary and Chief of Staff Lyall, General Counsel Robinson, Chief Investment Officer Bachher, Executive Vice President and Chief Financial Officer Brostrom, Executive Vice President and Chief Operating Officer Nava, Senior Vice President Colburn, Chancellors Gillman, Hawgood, and Larive, and Recording Secretary Li

The meeting convened at 1:15 p.m. with Committee Chair Sherman presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of September 20, 2022 were approved, Regents Cohen, Drake, Leib, Makarechian, Matosantos, Pouchot, Robinson, and Sherman voting "aye."[1]

2. **REAL ESTATE INVESTMENT STRATEGY UPDATE**

[Background material was provided to Regents in advance of the meeting, and a copy is on file in the Office of the Secretary and Chief of Staff.]

Executive Vice President and Chief Financial Officer Brostrom introduced the item. The differences in accounting rules for capital assets affect the University's decision to acquire or develop property. UC believed that real estate could be purchased for investment within UC guidelines, which follow the Governmental Accounting Standards Board (GASB) rather than the Financial Accounting Standards Board (FASB). Mr. Brostrom explained that investment assets were recorded at fair value and acquired with the expectation of future income, while capital assets were acquired or constructed by the University, recorded at cost on the acquisition date, and depreciated over their useful life.

[1] Roll call vote required by the Bagley-Keene Open Meeting Act [Government Code §11123(b)(1)(D)] for all meetings held by teleconference.

Associate Vice President – Systemwide Controller Barbara Cevallos explained that GASB required that UC maintain an asset's classification made at the time of acquisition throughout the life of the asset. If an asset is deemed an investment at the time of acquisition, then it would stay an investment in financial statements regardless of how its use changes. Ms. Cevallos highlighted several criteria to determine whether something was an investment or a capital asset. Generally, property with less than 50 percent occupancy or current or planned would be considered an investment. Rental rates needed to be at market rate, and there could be no campus involvement in or influence over the building's day-to-day operations. University investment opportunities within the GASB structure had certain guardrails in place. For example, the Office of the CIO could purchase and operate housing near a campus and rent out some units to students at market rates, but it could not enter into a master lease with the University at certain rates for certain rooms. The Office of the Chief Investment Officer (CIO) could also invest in or develop a research park near campus and rent out portions of the building to UC tenants at market rate. Private institutions followed the FASB, which allowed them to purchase real estate as an investment, convert to a capital asset later, and realize investment gains in the interim.

CIO Bachher stated that housing for students, faculty, and staff and buildings with classroom and laboratory space have been limiting factors for growth at universities. Over the last eight years, the Office of the CIO has found its real estate investments near college campuses across the country to be very profitable. The Office of the CIO had about $500 million investment property in locations such as Santa Barbara, Santa Cruz, San Diego, and Berkeley, and was receiving a growing number of calls to participate in real estate investments. Mr. Bachher contrasted the high prices of properties bought and sold by third-party developers with the flexibility that the Office of the CIO could provide. He saw business opportunity rooted in investment principles, and he emphasized that the Office of the CIO was a commercial buyer, seller, and lessor in the real estate market. Mr. Bachher credited Mr. Brostrom with suggesting this opportunity.

Committee Chair Sherman asked if the Office of the CIO could develop property used by UC with the same terms and conditions as a third-party developer. Mr. Brostrom replied that the Office of the CIO could do this through a real estate management company. If the Office of the CIO developed the property directly, the University would need to check with its auditors regarding percentage of use. A property that was used only as classroom space would likely not be allowed, as opposed to a research park. Regent Sherman remarked that, if the University had available capital to invest, it might make more sense for UC to take on the role of the third party, who would typically provide the capital and development expertise.

Regent Makarechian gave an example of a property fully controlled by the Office of the CIO that it leased solely to UC at market rate and asked if this would be considered an investment asset. Mr. Bachher responded that the Office of the CIO was trying to determine this. Mr. Brostrom emphasized the importance of market terms and market rate. There could be no subsidy to the campus. Generally, the GASB would prefer that UC used 50 percent or less of the asset. The type of asset would also depend on the stakeholder. For instance, the Office of the CIO could invest in staff or faculty housing and it would be considered an arm's length transaction.

Regent Makarechian asked if the Office of the CIO's recent acquisition in Santa Barbara could be considered an investment asset if it leased the property to UCLA as hospital space. Mr. Brostrom replied that this would depend on the intensity of use. If used solely for the hospital, the property would qualify as a capital asset. To be considered an investment property, 50 percent could be leased to affiliated partners that were private entities.

Regent Makarechian asked if a property would be considered an investment asset if the Office of the CIO participates as a capital partner of a third-party developer. Ms. Cevallos responded that, if it is known from the beginning that the building would be used fully by a campus or medical center, then it would be considered a capital asset. If the building is purchased as an investment property with plans to lease at market rate to UC and others, then it would be considered an investment asset.

Regent Makarechian gave an example of the Office of the CIO providing property as equity to a third-party developer, who then leased the property to UCLA, and asked if such an example would qualify as an investment property. Mr. Bachher asked if the Office of the CIO could lease a property to UCLA to use as a hospital. Ms. Cevallos opined that, if the Office of the CIO leased a property to a UC campus solely the for the campus' use, the property would seem like a capital asset. UC should review specific examples with its auditor before making leasing decisions.

Regent Cohen noted that the Office of the CIO had a responsibility to generate returns and asked why it would matter how the investments were categorized. Ms. Cevallos explained that this presentation meant to clarify how the University would account its business decisions.

Regent Cohen asked what would happen if the auditor determined that an acquisition made by the Office of the CIO was a capital asset. Ms. Cevallos replied that such a determination would change the University's balance sheet. Regent Cohen asked if the University would own the asset instead of the Office of the CIO. Ms. Cevallos replied in the affirmative.

Committee Chair Sherman asked if the distinction was between making purchases through the pension and the endowment. Mr. Brostrom replied that the University would work with the Office of the CIO and the auditor to determine the nature of the asset at the date of acquisition so there would not be a different determination by the auditor years later. Regent Cohen stated that the function of the auditor was to discover issues after the fact.

Regen Cohen asked if the University would return the value of the investment to the Office of the CIO if a property were deemed a capital asset. Mr. Brostrom replied that fair market value would be returned. The Office of the CIO wished to ensure that investment assets do not become capital assets.

Regent Makarechian asked if the main difference was that UC could not mark to market capital assets. Ms. Cevallos replied in the affirmative. She clarified that the pension is part of the University, as is the Office of the CIO. The issue was how the acquisition was classified on the balance sheet and whether appreciation or depreciation of the property would be recorded. Properties purchased by the endowment or pension were considered investments. However, a building used solely by UC would be considered a capital asset and would not appreciate in value.

Regent Makarechian asked why the distinction was important if lease payments were still being made. Mr. Brostrom replied that the distinction was whether the University or the Office of the CIO realizes the appreciation.

Regent Pérez opined that the type of asset is determined at the time of the lease agreement, not at the time of acquisition. It puzzled him that the property could be leased to a private hospital but not to a UC hospital. He did not wish to prevent the Office of the CIO from making the best investment decisions to avoid the complexity of an accounting situation. Regent Pérez suggested consulting with an accounting firm to determine bright line rules.

Regent-designate Ellis asked how UC would explain the difference between rental rates to students. Mr. Brostrom stated that the Office of the CIO had a fiduciary obligation, borne out of accounting standards and the CIO's obligation to the Regents, to earn market returns and would rent to students, faculty, and staff at market rate. The campus could subsidize these rents separately. Campus housing was not constrained by this fiduciary obligation.

Advisor Lybarger asked how these investments would benefit UC students and staff, underscoring the UC community's desperate need for more housing. In her view, the Office of the CIO would be contributing to the housing crisis with these investments by acquiring properties close to campus that could instead (or possibly) be made into affordable housing. She asked if campus subsidies could be made into a model. Ms. Lybarger expressed concern that a third party managing property owned by the Office of the CIO would not be incentivized to hire UC employees. Mr. Bachher stated that the Office of the CIO would prefer to lease at market rate to UC community members. The Office of the CIO expected that property managers operate according to UC labor standards. Affordability was becoming more difficult given the location of UC campuses. However, the Office of the CIO's cost of capital was lower, and it was not charging as many fees, which meant a more affordable and more competitive product. Mr. Brostrom added that another benefit to the UC community was free land. At UC Santa Barbara, for instance, a portion of the ground lease paid by the developer would subsidize the cost of housing.

The meeting adjourned at 2:00 p.m.

Attest:

Secretary and Chief of Staff