

## **AFRH FINANCIAL BACKGROUND**

The Armed Forces Retirement Home is the nation's oldest retirement community for enlisted military veterans. The institution needs new sources of revenue to provide appropriate facilities and services to its elderly residents.

AFRH is an independent federal agency under the jurisdiction of the Secretary of Defense. AFRH relies upon its Trust Fund for operations, maintenance and construction of equipment and buildings. It receives no annual appropriation from Congress.

AFRH operates under severe financial constraints beyond its control. The Trust Fund is financed with a 50 cent payroll deduction from active duty military, fines and forfeitures from military disciplinary actions (which vary depending upon operational tempo), fees from residents which are capped at 35% of income (less than 1/2 of residents pay the maximum) and interest income. AFRH is restricted by law to investments in low-yield Treasury bonds. In addition, Federal law prohibits AFRH from soliciting contributions, applying for grants, or running capital fundraising campaigns.

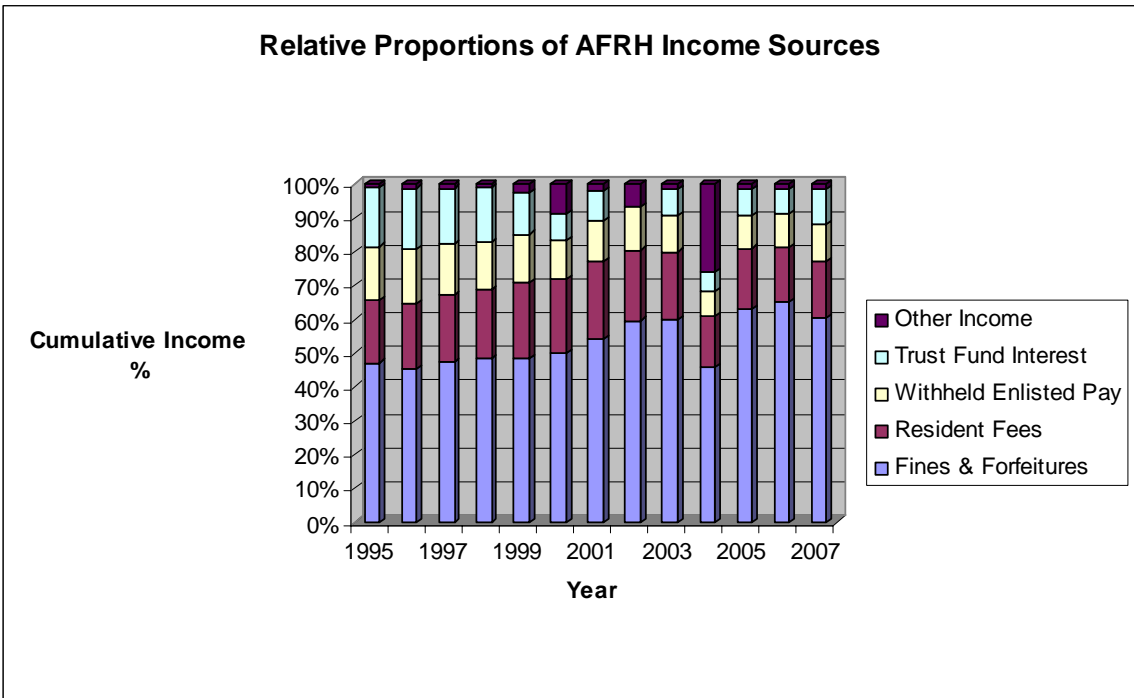
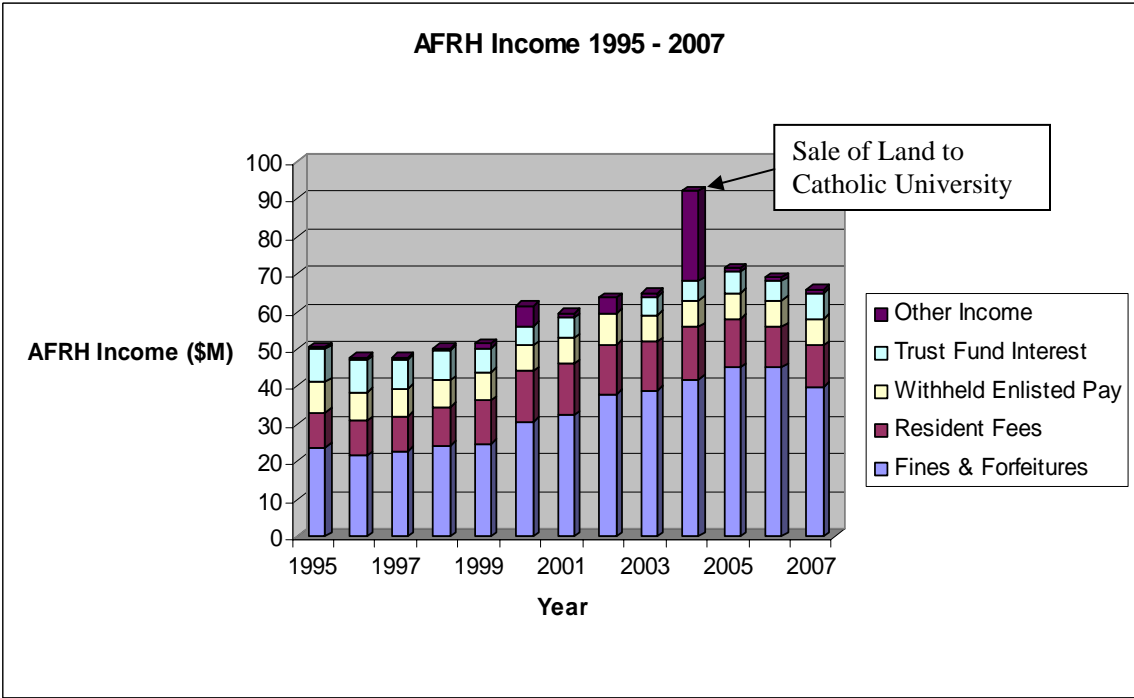
In addition to the structural constraints of its funding sources, in the past AFRH's finances suffered from wasteful spending and inefficient management, circumstances that were exacerbated by the increasing costs of maintaining over 100 buildings on the site. The AFRH Trust Fund fell from \$156 million to \$94 million in the period of 1995 - 2003, as previous administrators spent down the Trust Fund to pay for operational expenses.

This pattern of spending put the institution in jeopardy. To address this problem, Congress passed reform legislation in 2002 that directed the Defense Department to hire professional managers with experience in retirement communities to run the institution and bring costs under control and authorized the sale or lease of assets to generate revenue.

AFRH is currently developing a Master Plan which will guide development of the institution and revenue-generating development for the next 20 years.

## **INCOME SOURCES**

Sources of AFRH funds are described above. Currently, AFRH's largest source of income is the income gained from fines and forfeitures. A summary of income by source for the period 1995-2007 can be seen below.



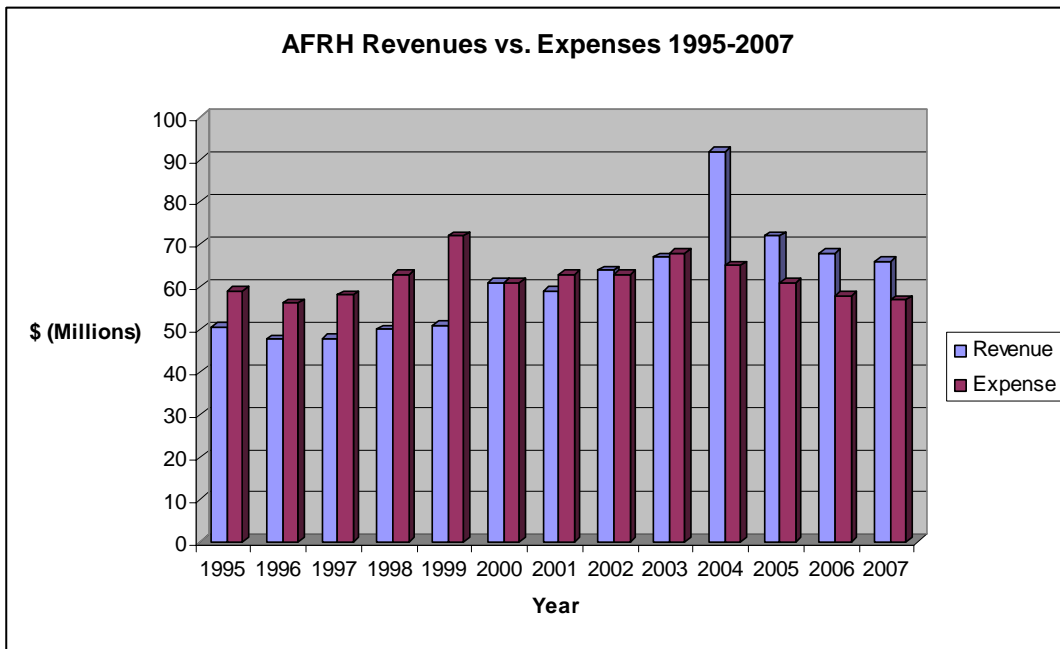
Historically, fines and forfeitures have been approximately 30-40% of AFRH's income. However, for the period 2003 - 2007, due to the wartime increase in military operations, income from fines and forfeitures has averaged over 60% of total income. The chart above shows an increase in the percentage attributable to fines and forfeitures from 45% in 1996 to 65% in 2006. Thus, the largest percentage of AFRH's income is its most variable. Income from fines and forfeitures nearly doubled from 1995 to 2006, from

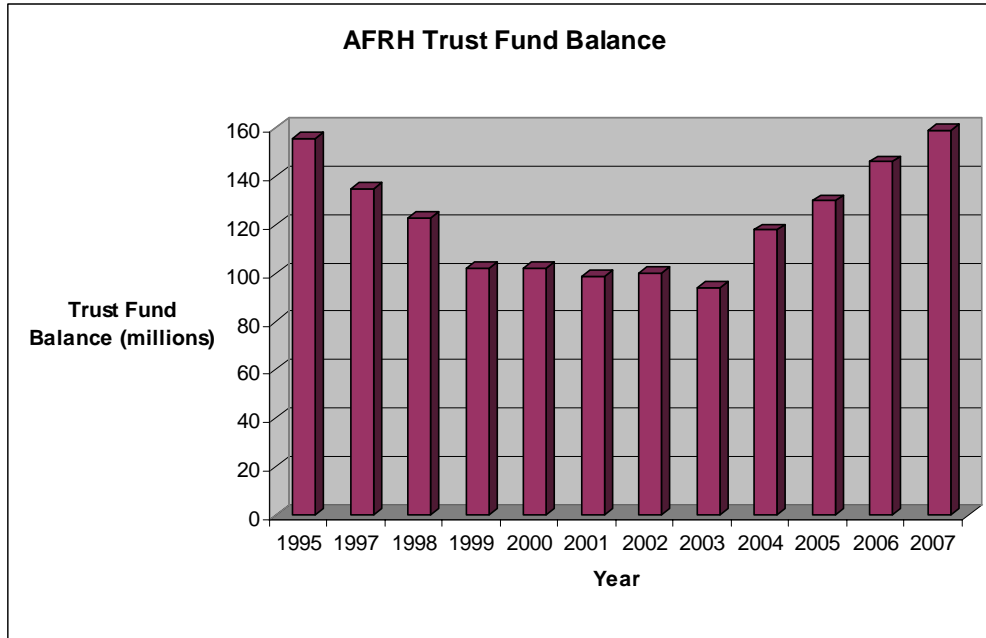
\$23million to \$45 million, and this is not a sustainable long-term trend. The other three major sources of AFRH's income (50 cent withholding, Trust fund interest, and resident fees) are relatively static, and will not increase significantly over time. (Other income, which is a relatively insignificant percentage of the budget in most years, was greater in 2004 due to the sale of property to The Catholic University of America.)

The instability of AFRH's largest income source and the lack of growth of its other income sources complicate long range financial planning and make it likely that inflation and anticipated increases in operations and maintenance costs for the aging infrastructure will outstrip available revenue sources in the near future. When military operations return to historical average levels, it is likely that AFRH will either operate at a loss or be unable to accumulate additional reserves needed to address required capital expenditures.

**AFRH ACTIONS**

AFRH has proactively taken many management actions to improve its fiscal situation. Since 2003, the administration reduced the operating budget by cutting staff from 736 to 298, brought both campuses (Washington and Gulfport) under single management, outsourced many non-core services from transportation to security on performance-based contracts, and closed many buildings as it consolidated operations. This has helped to stabilize the Trust Fund, but has not address the long term revenue-generation needs of the institution. In addition, the temporary closure of the Gulfport campus has reduced operating expenses and helped AFRH to rebuild the Trust Fund. However, the largest single reason for the recovery of the Trust Fund has been the surge in fines and forfeitures, which is an unsustainable long-term trend. The Trust Fund balance has returned to 1995 levels only as of 2007 as shown below.





## **AFRH FINANCIAL NEED**

AFRH faces significant financial challenges. In its planning efforts, it has identified two categories of capital needs - 'known' and 'known-unknown' capital needs.

In late 2006, AFRH completed a detailed facilities assessment that identified \$366 million in deferred maintenance and required capital improvements needing funding over the next 10 years. This includes items such as new roofs, new HVAC equipment, and replacement infrastructure. In addition to these specifically identified deferred maintenance and required capital replacement needs, AFRH needs approximately \$5.5 million for a new dementia center. Finally, AFRH will need an increasing amount of operations and maintenance funding to maintain aged infrastructure. Given that the Trust Fund balance stood at approximately \$159 million at the end of FY 2007, this known capital requirement represents a significant challenge.

However, the known capital needs are only a part of the problem. In addition to maintaining its current facilities, AFRH must begin to plan for the next generation of its residents. First, the residents are living longer and becoming more frail and sicker. AFRH needs new facilities in the short-term to cope with the changing health care requirements of its residents. Second, as the current generation of all-volunteer active-duty soldiers reaches retirement age, AFRH anticipates increased demand for housing and specialized services prompting the need for different facilities than the Home currently has. Third, soldiers are returning home with injuries which would have killed them in previous wars and with high levels of Post Traumatic Stress Syndrome. These veterans will require more specialized care and facilities. Thus, AFRH will need to undertake major refurbishments of a number of its facilities to meet the changing future needs of its residents.

AFRH will need significant funds and a reliable income stream to build new facilities to meet the changing needs of future residents and to maintain and modernize its existing facilities. The development of Zones A, B, and C is the mechanism by which AFRH is planning to generate an independent income stream to address its capital needs. Initially, AFRH plans to ground lease Zone A and generate revenue for the Trust Fund. The full development of Zone A is expected to take approximately 12-15 years. At that time, AFRH will have a much firmer picture of the revenue from that development, and will be in a position to determine if development of Zones B and/or C would be required to support AFRH's ongoing capital needs. At this time, in the absence of completed negotiations with its selected developer for Zone A, it is difficult to predict with any reasonable certainty the amount of income that the Zone A development will generate. Even once an agreement is reached, fluctuations in the real estate market will bear on the timing and amount of revenue that may be generated.

AFRH anticipates that the Zone A development will provide income to make substantial progress toward meeting at least its identified near term deferred maintenance and capital needs. Based on comparables, Zone A, developed with the program shown in the Master Plan could generate approximately \$215 million in today's dollars.