REIT Pay Practices Continue to Evolve

By: Christine Oberholzer Skizas, Jeff Joyce, Linda Pappas and Steve DeMaria

Partners

Aubrey Bout
Chris Carstens
John R. Ellerman
John D. England
R. David Fitt
Patrick Haggerty
Jeffrey W. Joyce
Ira T. Kay
Donald S. Kokoskie
Diane Lerner
Eric Marquardt
Jack Marsteller
Richard Meischeid
Steve Pakela
Lane T. Ringlee
John Sinkular
Christine O. Skizas
Bentham W. Stradley
Jon Weinstein

Introduction

The REIT structure was created in 1960 when President Eisenhower signed into law the REIT Tax Act. A wave of REIT formations and initial public offerings (IPOs) followed. Another wave of IPOs occurred in the 1990s. Historically, REITs tended to have relatively high insider ownership – founded by individuals, families or partners and, in some cases, eventually taken public. For many years, REITS generally maintained that tie to the original owners and, as such, the culture tended to be very much influenced, if not dominated by, the founder(s). Times have changed. Many companies have transitioned from founder/founder-family leadership to professional managers as companies have naturally matured at the same time shareholder activism has taken a more prominent role in influencing corporate policies and programs.

Today, twenty-one REITs are constituents of the S&P 500 and have a combined total market capitalization of over $430 billion. Of these twenty-one REITs that were publicly traded as of January 1, 2010, the total market capitalization of these companies has increased over 160%. As these statistics show, REITs represent a large and growing portion of the broader economy.

Key Findings

We reviewed the pay practices of the twenty largest REITs in terms of market capitalization to study how pay programs have evolved as the companies have transitioned from closely-held organizations to mainstream public companies.

- REIT incentive programs generally incorporate more subjective assessments of performance than typical - providing a mechanism to recognize the long-term and variable nature of real estate assets
- Eighty-three percent of the REITs utilize a performance-based LTI plan to deliver at least 50% of the target LTI award value
- Ninety percent of the REITs have implemented anti-hedging, anti-pledging and clawback policies
- All of the REITs received majority shareholder support in their most recent Say on Pay votes, but the level of support generally lags that of the general industry

We reviewed the public filings of twenty of the largest publicly-traded REITs in the United States to examine changes REITs have made to their executive compensation programs since 2010 – in the wake of Dodd-Frank and annual Say on Pay voting. We focused on design elements that we believe demonstrate a focus on shareholder value and stewardship. We present these findings for consideration as companies plan for the 2015 compensation plan cycle and beyond.

Annual Incentive Design

In 2010, of the twenty REITs we reviewed, over 50% utilized annual incentive programs that were entirely discretionary. In other words, the size of the bonus ultimately awarded was based on an entirely subjective review of performance. In 2013, only five of the twenty companies (25%) continue to use a purely discretionary approach to determining annual incentive awards, most likely due to increased shareholder activism and desire for increased accountability through quantitative, measurable goals.

The nature of the performance measurement has also evolved. In 2010, for those REITs disclosing formal measures and related weightings, FFO measures determined, on average, nearly 45% of the award opportunity, and qualitative/subjective factors averaged 30% of the weighting. In 2013, much is the same, with the average weighting on FFO reduced to 35% and the average weighting of qualitative/subjective factors at approximately 28%. Over this same period, companies incorporated other measures of performance in addition to FFO and qualitative factors, including balance sheet measures (e.g., Return on Invested Capital, leverage) and operating measures (e.g., customer/tenant satisfaction and occupancy) in an overall "scorecard" approach to evaluating and rewarding annual performance. Of the twenty companies we reviewed, 90% use multiple measures – with an average of four measures.

REITs have maintained a greater weighting on qualitative/subjective factors than we observe in other industries. Our experience suggests REITs differ in this manner for a number of reasons: 1) IRC Section 162(m) deductions are less important for most REITs due to their tax status, 2) with the long-term nature of many assets and their leases, some REITs' financial performance may be less variable so the Committee looks to other intangibles on which management can focus to drive value, and 3) because the desired emphasis may change year to year (e.g., development vs. leasing vs. divestitures), and rather than modify the system every year, the Committee identifies criteria it will assess in determining performance and payouts but utilizes its judgment in assessing actual performance at the end of the year.

Long-Term Incentive Design

In 2013, 83% of the companies reviewed delivered a portion of executive long-term incentive ("LTI") awards through a performance-based plan, typically accounting for approximately 50% of the targeted award value for the year. Only a third of companies utilized such plans in 2010 to deliver approximately one third of the targeted award value.

REITs have generally followed majority general industry practice in the design of long-term performance-based programs. Seventy-three percent of the companies with a performance-based LTI program use relative TSR as a measure of performance, which is by far the most common measure across broader industry. However, only half of those REITs use relative TSR as the **only** measure of long-term performance for incentive purposes, while most general industry companies use multiple measures. Most REITs use a portfolio of LTI vehicles and measures, which allows these companies to provide a competitive compensation opportunity while also aligning executive pay with the long-term and cyclical nature of real estate. Relative TSR can be a poor metric for many REITs, particularly smaller REITs for which a comparison to larger financial or general industry indices or peer groups is not relevant and for which a relevant number of peer/comparator companies is not available. This is a critical consideration, as asset class impacts investors' capital decisions and, as such, can result in swings in TSR across property sectors. If there are an insufficient number of relevantly-sized peers within a REIT's asset class then relative TSR may not be a plausible alternative.

The majority of the twenty REITs reviewed continue to use only one LTI performance measure, TSR, – not yet embracing broader industry practice of using multiple measures in the long-term incentive program. REITs that desire a performance-based LTI program but lack a logical comparison for relative TSR (and/or do not believe that relative TSR is good measure) have implemented programs that align executive compensation with drivers of long-term shareholder value. Among this group of twenty REITs, other measures used in the LTI program include economic profit, company-wide operational and strategic objectives, and net debt.

As ISS and Glass Lewis further discourage LTI programs to emphasize relative TSR and provide for payouts for at or below 50th percentile performance, more companies will likely undertake a more tailored approach to LTI design.

Governance

Eighty percent of the Boards of the REITs reviewed utilize an Independent Chairman or Lead Director. Approximately 90% prohibit pledging and hedging of company shares by employees and directors, and 90% have implemented clawback provisions that extend beyond the requirements of Sarbanes-Oxley.

Forty-seven percent of the REITs reviewed included in their most recent CD&A a discussion of shareholder outreach/dialogue. Nearly a third incorporated a discussion of realizable pay.

Does it Matter?

Our consulting experience suggests that many publicly-traded REITs, not just the largest, are abandoning the executive compensation philosophies that were part of their origins. Greater institutional ownership and emphasis on pay and performance alignment are influencing all companies and their Boards. Although each of the twenty largest REITs received majority shareholder support in the 2014 Say on Pay Votes, these REITs lag the general industry slightly in their level of support.

Average Support	Top 20 REITs	S&P 500
Pass*	88.9%	93.0%
Fail	N/A	41.0%
Total	88.9%	92.4%

* Greater than 50% shareholder support.

	Top 20 REITs		S&P 500	
	SUPPORT FOR ISS “AGAINST”	SUPPORT FOR ISS “FOR”	SUPPORT FOR ISS “AGAINST”	SUPPORT FOR ISS “FOR”
Average	66.4%	94.9%	67.2%	94.8%

If executive pay and shareholder return are aligned and properly correlated, investors are less concerned about the exact mechanics of how that result is achieved. When there is reason to call into question the appropriateness of the pay and performance alignment, the best defense a company can offer is a program that is objective, limits discretion and that reflects value creation.

General questions about this Viewpoint can be directed to Christine Oberholzer Skizas or Jeff Joyce by email at christine.skizas@paygovernance.com or jeff.joyce@paygovernance.com.