Segue — The REIT Transition to Strategic Compensation Decisions

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From solo to symphony—the case for a shift to a strategic platform is clear—it addresses industry trends while offering compelling benefits to boards, CEOs, management, and investors.

Compensation is music to any executive's ears, and although company compensation decisions are both personal and priority, they are also the target of increasing shareholder focus and ire. Ironically, given the issue's visibility as well as its importance for motivation and retention, most companies address compensation tactically—as an annual review, market calibration, and negotiation—reactive to mostly immediate business conditions and performance results. Given the corporate scrutiny in today's marketplace and the importance of retaining effective CEOs and executive leadership, this approach addresses only a portion of the scope of this important business element for a company. As seen in contemporary business management trends and practices, compensation is becoming more integrated into company operating strategy, guided by a long-term plan of its own, shaped by a multi-year perspective and well developed policy.

The underlying change involves a shift in the thinking and methods of compensation assessment from a tactical approach to a strategic perspective.

MARKETS, MANAGEMENT AND GOVERNANCE

For public companies, and public Real Estate Investment Trusts (REITs), the dynamics of determining executive compensation are complex, balancing the often competing interaction between management objectives, Board responsibilities, and investor concerns, in an environment of increasing transparency. For REITs, this dynamic is exacerbated by often counter-cyclical performance situations, such as in the period 1998 to 2000, when real estate fundamentals drove strong financial results at the same time that investor capital shifted to the broader market, hurting returns. As witnessed over the past three years, these dynamics also occur in reverse. The low correlation between REIT and broader market performance provides investors with strong diversification economics, but may also cause confusion over executive compensation. CEO/senior management and board compensation committee decisions must balance all of these issues, exerting caution during periods where investor returns are weak, regardless of financial growth results, while being more aggressive in periods of strong market performance. Despite the eco-

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practice demonstrates that decisions are driven by reaction to the immediate situation, past year results, and are reinforced by benchmarks of the compensation market at the time—what everyone else earns. In all, appropriate in part, but able to benefit from important improvements to achieve stronger governance.

Arguments for a free market rationale for determining CEO/executive compensation are compelling to participants, but realistic examination demonstrates that the compensation marketplace is neither free nor efficient, and even if it were, it would not be cleanly annual in nature. In addition to supply and demand constraints, compensation information, board makeup, director experience and relationships, differences in assessment approach and evaluation criteria, and the wide range of circumstances influencing performance, position, retention of executives, all contribute to prevent short-term steady state market equilibrium for executive compensation. If there is any sense of an efficient market for executive compensation it is long-term, comprised of multiple years of information, results and trends, blending the variables that influence award decisions over time.

Further, compensation is too important a corporate decision to make only with the short run in mind. Compensation is strategy and affects strategy—it is not just a tactical short cycle decision—and involves risk of retention, establishes expectations, creates motivation, and impacts the achievement of all company objectives. Whether market compensation is up or down in a particular year is an important perspective, but equally important and often overlooked is whether and how it also aligns with medium and long-term business performance that will play a significant role in determining shareholder value. Executive awards using long-term compensation vehicles are indeed intended as a long-term incentive, although short-term price trends can reduce this vehicle's intended reach. Correspondingly, annual awards focus on and reflect annual performance results. But between future potential equity opportunity and the immediate year's performance is a host of opportunity to better integrate compensation into enterprise strategy, align it with company business plans, and better match the temporal range of performance objectives, in turn building for compensation decisions.

COMPENSATION AS STRATEGY

This article sets the foundation for introducing certain changes to a company platform of compensation assessment, policy and practice that offer benefits and opportunity to REIT CEOs and their boards of directors (and compensation committees) in many areas, and are worthy of fuller exploration and evaluation. The underlying change involves a shift in the thinking and methods (the art and the science) of compensation assessment from a tactical approach to a strategic perspective, developing a more comprehensive and longer-term rationale for cash and equity structures, plans, and award decisions. Compensation is highly integrated into company strategy—the intersection of human capital and financial capital—and all corporate strategic business functions require a strategic framework for review. And so it can be with compensation. The often close to the vest management/board process can be modified, broadening to incorporate a more strategic framework for understanding, interpreting, and creating more defensible and stable decisions for CEO and executive pay levels throughout REIT market performance cycles. Trends in corporate governance confirm this transition, reinforcing the need for change, and the benefits to management, board, and investors. Most importantly, a shift to a more strategic platform facilitates the axiom—that in order for compensation effectively to drive performance, it must first be aligned with performance.

THE LONGER-TERM PERSPECTIVE

Perspective is at the root of the strategic issue. Driven by the public financial market's structural shortsightedness, and human nature's desire for maximizing financial reward, compensation assessment methods, in good times, are notorious for their inclination to the spot market representation of rising compensation levels, calibrating to the moment, and ignoring any less supportive past circumstances of compensation and performance for company or industry. When market performance is down, the opposite often occurs, focusing more on historic results, and reinforced by the limited market for executives, the need for retention, and the challenge of the economic times. Once again, these are realities in part, but the interjection of a broader and more strategic perspective can offer opportunity.

Compensation decisions are imbedded in corporate risk management. Setting targets, designing structures, defining awards, meeting the market, and motivating performance, all incorporate risk—of paying too much or too little, achieving business plan objectives, demonstrating market return performance, and aligning compensation with performance are outcomes where management likely has only partial control in the short run, but greater control over the long run. Retention of talent may be the reverse, where short-term action in relation to compensation postpones or avoids a potential separation, although studies rarely indicate that compensation is the sole factor in retention situations.

From a broader perspective for public companies, shifting certain aspects of compensation methods and decisions into a longer-term and more strategic perspective could pave the way to greater clarity of the performance/compensation relationship to investors, stronger rationale for compensation decisions, structures more consistent with the timing of achievement of performance, and greater alignment with the strategic plans and performance results of the company. Moving away from the extent of the share of compensation award related to a single year of financial or market performance results may improve the management of pay variances and further the longer-term view of building shareholder value. Although there is an important annual financial performance imperative to REIT portfolios, there are also many aspects of the business that are two, three and four years in their economic impact—development, redevelopment, repositioning, ventures, related businesses, strategic acquisition, and disposition, to name a few. These could be better aligned through more consistent compensation timeframes. In many respects, the gap between annual pay and long-term opportunity may be too large relative to overall business cycles, real estate cycles, and business management. Consider the time gap between annual awards, and a typical five- to seven-year hold on options, or vesting periods of five years on equity awards. Such changes in both thinking and method would stand the tests of investor scrutiny, clarify issues, and offer more consistent opportunity to REIT executives. A sometimes used example of a medium-term incentive vehicle is Shareholder Value Plans.

A NEW STATUS FOR REITS

REITs are maturing as a sector and as an investment option. The long-term stability of cash flow and dividends is being proven to the marketplace. Their low volatility (vs. broad market Indexes) and the impact of REIT investments on portfolio diversification and enhanced retirement planning are factors in their growing popularity among institutional advisors and individual investors. Despite the inevitable shifts in capital flow away from REITs when the broader equity market opportunity normalizes, REIT investment strength will keep them popular and attractive as an investment option. Whereas once REITs were identified as different and confusing—another asset class—now REITs are mainstream, incorporated in the S&P 500 (and many other market indexes) and widely discussed in investment circles and media. This is a time to strengthen investor perceptions.

We are in a period of weak economic fundamentals for many real estate products, and the anticipated lag relative to the recovery of the overall economy will place many REITs in a challenging position to sustain earnings and dividends on their long-term core portfolio. During this period, however, overall market valuation of real property and REITs has risen significantly, opening opportunity for strategic transactions, restructuring of debt, and raising capital. REITs will be stronger from implementing these short-term value creation actions, taking advantage of the market, creating a boost to earnings, while competing against substantial private capital seeking hard asset investment and yield. Sustaining REIT investment, providing clarity to performance, market cycles, and real estate fundamentals are essential as the broader market recovers.

Stepping back and looking at the characteristics of the business, the inertia of compensation practices, and the further expected economic challenges of real estate may well stimulate consideration of other perspectives in designing compensation plans. Many REITs have seen significant price appreciation over the last few years. Although Price/Net Asset Value (NAV) per share and Price/Funds from Operation (FFO)x have experienced levels above ten-year historic averages, FFO/share growth has generally declined steadily. A shift in investment capital to a broader equity market recovery may erase a portion of the gain, a further example of why the nature and structure of REITs may be better suited to compensation structures slightly different than the prevailing norm.

REINFORCING STRONG GOVERNANCE

With recent increases in market exposure/creditability, and in conjunction with current corporate governance issues, REITs will not escape the scrutiny and challenge of institutional and individual shareholder demands for stronger, more independent governance, and greater disclosure/justification for decisions. This will occur despite their current relatively strong reputation for governance, and REITs' high level of disclosure and scrutiny from market analysts. Although the major focus of corporate reform has been in the area of accounting and financial reporting, executive compensation is an issue of high visibility and viewed as warranting change. Securities & Exchange Commission (SEC) and Listing Rules for the New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotation System (NASDAQ) may soon alter the approval of stock plans, and ultimately the way in which options and other long-term incentives are structured and implemented. No change will emphasize the importance of justifying pay-for-performance more than the implementation of shareholder approval of executive equity plans. Public outcry regarding large stock option awards has no particular reason to be directed at REITs, and is evaporating as a corporate scandal issue. In its wake, however, expensing stock options may offer greater parity for other long-term, or medium-term, incentive structures offering opportunities for REIT executives.

New rules, approval processes, governance guidelines, and disclosure requirements will also increase the degree to which compensation committees are involved in the process of compensation decisions, and the amount of company resources required for effective compensation planning. Board compensation committees may decide to employ their own independent advisors for a compensation review, separate and apart from management, to increase their resources and involvement, and support their governance mandate. In time, financial reporting issues will subside in the mind of investors, but compensation will remain as a potential hot-button issue, exposed in proxy documents and media annually, and of obvious extreme personal importance to CEOs and senior executives. Again, the possibility of changes good for the company, the board, and executives loom in the compensation arena, and the most proactive action to meet a potential challenge is a stronger defense.

For REITs, compensation is an opportunity to demonstrate additional strong governance in a world of greater scrutiny and increasing challenge. If compensation committees become more involved and more independent with regard to compensation, so compensation methods can emerge to demonstrate a greater strategic context to provide stronger rationale. With more strategic methods, the foundation for more effective decisions will emerge, and will stand the test of time and performance. Investors are most interested in a more direct linkage between compensation and performance—the most often quoted issue and challenged result of board actions. Explaining this often elusive association will be improved and reinforced from the more strategic approach to compensation suggested herein. Further, as most compensation review is more comparative than performance-based, new metrics will play a role in advancing the assessment of compensation. Consistent and calibrated ratios using both performance measures and compensation, over time, may establish the long-term framework for decisions on an annual basis, along with current market information, demonstrating their interaction in useful ways for compensation planning and governance.

STRATEGIC COMPENSATION THINKING

Shifting to more strategically based compensation decisions requires asking essential questions, and discovering workable methods that answer these questions. Both CEO/management and boards of directors must work together to utilize new concepts and more refined versions of current methods, to better align performance and compensation.

Several key questions are presented below that help to define the shift to a more strategic way of thinking about compensation governance:

- How do you integrate long-term market performance with variable annual financial results, respond to capital market shifts, and not jeopardize compensation levels or the retention of strong REIT executives?
- How can compensation be used as competitive advantage in an environment that emphasizes alignment with market peers?
- How do you establish benchmarks of a REIT performance/compensation relationship, and apply it effectively to decision criteria?
- Can traditional compensation review methods effectively define industry/peer group relationships based on compensation as well as performance, and apply them to compensation planning?
- How does a compensation committee know when a key executive's compensation (or an executive team in aggregate) is truly aligned within the industry or a peer group?
- How is a board compensation committee assured that year-to-year compensation policy aligns with industry or peer group compensation/ performance relationships? For the CEO? For senior management? For the executive team?
- Given real estate and capital market cycles, is the focus on maximizing annual incentive opportunity really maximizing executive compensation over the longer period of intended retention?
- How can a more direct and explicit strategic (business plan) linkage be established with compensation levels, targets and awards?
- How can a company use compensation governance as a proactive investor relations tool?
- How do management and boards more formally incorporate a risk management evaluation perspective into compensation decisions?
- How can REITs better utilize the human resources (HR) function to bridge communications between management and board, and promote a more involved and independent committee governance?
- What compensation assessment methods offer greater independence for the board/compensation committee, without risk to the compensation objectives of management?

TRENDS LEAD TO STRATEGIC BENEFITS

The questions posed above are reflective of a more strategic thinking process related to executive compensation. But questions alone lead nowhere. Trends in the REIT sector of the economy also support a more strategic thought process related to compensation, as demonstrated by the 12 items in Table 1 on the following page.

As boards, CEOs and senior management respond to industry changes, the compelling benefits of a more strategic approach to REIT executive compensation are apparent (see Table 2 on page 70). The tangible benefits to the company, its board of directors, its CEO, senior executives, and its shareholders are well worth any perceived risk of adopting and implementing changes in the way compensation assessment and governance are achieved.

MAKING THE TRANSITION

This article has argued for a shift toward a revised model of effective compensation review/structure—more strategic in perspective, capturing the context of long-term results and better align-

Table 1: Twelve REIT Trends Necessitate Strategic Compensation Management

Active Governance	To sustain and strengthen their current reputation for governance practices, Boards will become more independent, involved, strategic and proactive. For some, training/education are involved. For all, scrutiny of compensation will continue, an area in which REITs can win additional investor confidence.
Selective Investors	Increased institutional status has come from proving a long-term horizon, diversification, and big returns over the last three years. With knowledge and in time, investors will become more selective, demand more from boards/management, and separate the best from the rest.
Maximizing Opportunity	Formulating compensation decisions will require more than just peer comparison. Establishing REIT performance/compensation relationships answers a key question of investors, and forms the strategic platform to maximize executive compensation opportunity over time.
Shifting Capital	Structural capital constraints and capital market shifts will continue to influence REIT market returns, often divergent from financial performance. Private vs. public investment competition will be won in part by governance—including compensation—as well as strategy.
Sustaining Creditability	Real estate's reputation in public markets continues to improve, building confidence. Clarity in communicating REIT accounting requires compelling investor relations in all areas. Compensation must be creditable absolutely, and relative to other investments.
Greater Transparency	The stock option controversy will subside, but transparency and disclosure requirements will not. Despite current focus on financial reporting change, compensation issues remain, and may soon exceed accounting as the "hot button" of shareholders.
Broader Comparison	Rising status and broader acceptance means that a REITs "closed" industry perspective is vulnerable. The inertia of compensation structure "like everyone else's" will shift to competitive edge objectives, market distinction design, and inclusion of out-of-industry benchmarks.
More Regulation	Companies face Sarbanes-Oxley, as well as changes in SEC rules, Committee Charters, mandates, disclosure, and policy/practice. SFAS 123 option treatment may have only a small impact on FFO/share, but may offer opportunity in long-term compensation structures.
Stronger Planning	REITs are maturing in strategy and execution, and methods to enhance the linkage of company medium-term objectives with compensation can clarify targets as well as expectations, reinforce retention, increase motivation, and link directly to strategy.
Generating Wealth	The REIT structure poses challenges in creating value for companies and wealth for senior executives. Turnover of family founder CEO leadership to professional management means a refocus on strategic and innovative compensation design as well as capital events.
Management Skills	A maturing REIT industry's CEO skills mix will shift from dominantly real estate/financial expertise, to include technology, marketing, branding, operations and strategic leadership—furthering the need for out-of-industry compensation benchmarks and effective succession plans.
Consolidation	The sector may have too many REITs to insure market distinction, and the cost of new regulation puts additional pressure on operational efficiency and the need for size. Small and medium cap REITs will feel it the most and the economic pressure for consolidation will be strong.

Table 2: Seven Benefits of Strategic Compensation Management

Strategy Clarity	Boards and investors are provided, for the first time, REIT industry, Peer Group and individual Position Performance/Compensation relationships, not just spot market data, and metrics providing a comprehensive and strategic perspective of compensation.
Benchmark Governance	Enhances creditability, reputation and leadership of REIT Board governance: improving both the art and science of compensation practices, mitigating shareholder issues, offering greater opportunity for management, and providing stronger/broader rationale for decisions
Performance Delineation	A strategic platform smoothes the impact of market and financial performance variability by incorporating historic relationships in the context of current decisions. As a predictive tool it can directly link compensation to Business Plans, enhancing retention, management of expectations and planning.
Maximized Opportunity	Strategic compensation management offers potentially greater reward for executives—from broader multi-faceted evaluation criteria, clarity of Peer Groups, motivation from well defined future incentive targets, longer-term/more structured opportunity, and a focus on competitive advantage.
Risk Management View	The strategic platform integrates compensation and performance into a risk/reward decision framework adaptable by CEO/Senior Management and Boards of Directors to the characteristics of individual companies, advancing REITs closer to contemporary compensation methods of larger companies.
Industry Leadership	Strategic compensation management offers the opportunity to proactively establish market-leading practices that clarify the relationship between compensation and performance and provide greater alignment of shareholder interests and compensation governance.
Enterprise Value	Strong, proactive and industry-leading governance of compensation will create marketplace distinction in investor confidence and investor relations, promoting investment capital and enhancing enterprise value.

ing the timing of performance, risk, and reward considerations. This more nuts and bolts presentation of the practical and analytical basis for more strategic assessment and decisions defines the transition to building a strategic compensation platform and meeting the challenges of contemporary corporate responsibility. A primer of some of the shifts in assessment, design and decision making for REIT executive compensation are presented in Table 3 on the facing page.

Opportunity derived from adjustments to traditional methods of REIT compensation decisions need not be rejected due to risk or inertia. In response to the issues of governance and disclosure, new and proven methods are emerging in many industries and can be adopted by leading REIT boards. A more strategic model of compensation assessment, structuring and decision can meet investor demands of a more transparent public market, address sought after clarity in the relationship between compensation and performance, reinforce effective independent governance, and define industry leadership, all the while promoting potentially greater financial opportunity. ■

Table 3: Twelve Transitions to Strategic Compensation Management

	Issue	Conventional Approach	Strategic Approach	Advantage of Strategic Approach
1	**Market**	"Spot" Market Benchmarking	Current Market + Long-Term Performance	**Compensation / performance relationship over time = foundation for strategic perspective.**
2	**Timeframe**	Annual	Current + Multi-Year	**Adapts to real estate lags/capital market shifts—smoothing counter-cyclical performance issues.**
3	**Benchmark**	Positions	Positions + Executive Team	**Recognizes interactive power of executive team and provides an aggregate executive perspective.**
4	**Peer Definition**	Pre-Defined	Based on Performance Relationships	**Allows look at similar companies aligned from *both* compensation and performance.**
5	**Peer Focus**	Product Based Peers	Product + Strategic Peers	**"Truer" Peer Group based on product type, size and performance/compensation relationship.**
6	**Philosophy**	Reward Based	Risk Management + Reward Based	**Strategic risk-reward context for more effective committee decisions and governance.**
7	**Outcome**	Comparative	Comparative + Predictive	**Facilitates clearer targets, stronger planning, and more direct integration of Business Plan objectives.**
8	**Approach**	Tactical	Strategic	**Multi-year design/assessment context enhances embedded single year adjustment perspective.**
9	**Measurement**	Market Benchmarks	Strategic Metrics	**Utilization of unique metrics integrating both performance and compensation measurements.**
10	**Design**	Bottom Up–from current pay components	Top Down—from Total Compensation Targets	**More creative design to meet individual retention and company competitive advantage needs.**
11	**Structure**	Existing	Progressive—Balanced Scorecard	**Aligns compensation opportunity with temporal characteristics of business objectives.**
12	**Calibration**	Horizontal	Horizontal + Vertical	**Adjusts for organizational hierarchy—not simply "company-to-company" position comparison.**