



**REIT Pay for Performance –
It's About "Time"**

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Aligning and governing the performance/compensation relationship can easily shift
from static and tactical ... to dynamic and strategic.

Although all industries have unique compensation issues, establishing "Pay for Performance" compensation in publicly held real estate companies confronts a critical dilemma, particularly in today's economic environment: How does the enterprise both motivate and retain key executive resources in the face of the lower operating results now and the shift away from real estate investment that typically follows in a recovering economy? Cash compensation suffers from the former followed by equity instruments becoming less effective as result of the latter. This seesaw cycle, fundamental to real estate, presents an intrinsic hurdle to those attempting to align compensation with enterprise performance.

Moreover, in light of recent scandals in other industries, how do real estate entities (although unscathed up to now) respond to investor perceptions of inflated executive pay and the concomitant governance issues as evidenced, for example, in the Sarbanes-Oxley legislation? In the wake of these legislative and regulatory changes to restore investor confidence, there is even the spectre of an SEC requirement for shareholders to approve all stock award plans. Although the real estate industry has long embraced at least the "philosophy" of pay for performance more than most, this corporate governance environment calls for more advanced methods to clarify, communicate and better rationalize compensation and performance.

Both because of and in spite these realities, The Bradford Group believes that true pay for performance for the real estate industry (specifically **REITs**) has never been timelier, regardless of the difficulties. Indeed over the last three years, while investment in REITs and their share values are up (creating capital formation and consolidation opportunity), real estate fundamentals in many sectors have declined, putting pressure on operating results. TBG's **Strategic Compensation Management** model directly addresses these issues by integrating executive pay into long term

enterprise planning as well as aligning it with all stakeholders, i.e. other employees and shareholders.

From Static to Dynamic

SCM does this by incorporating a number of different elements (or at least varying how these elements are used) into this process, customizing it specifically for the real estate industry and REITs in particular. Because of the previously mentioned fundamental lag in real estate, SCM uses multiple year **time** frames (3 years) rather than the standard annual analysis. Furthermore, although individual positions are necessarily evaluated, SCM *starts* with an assessment of senior executives taken as a **team**. Lastly, SCM emphasizes aggregate compensation over component breakdowns (such as base, bonus, etc.) typically analyzed in isolation. Taken this way, compensation can be viewed in its proper context - its impact on the **total** enterprise, i.e. strategically.

This approach has the effect of acting to smooth the impact and reaction to the fluctuations and inconsistencies endemic to real estate discussed above. Along with TBG's research and resulting proprietary metrics, this methodology also reveals the statistically significant relationships between REIT performance and compensation seen in the following table:

These calculations reveal two critical properties essential to understanding the interactions between REIT performance and executive pay: 1) The relationships are high enough so that the mathematical equations from which they were derived can be used *predictively* to indicate the *expected* industry compensation at every level of performance and 2) because they are not perfect 100% correlations (many company's compensation is not a function of its performance) they can be used *diagnostically* to reveal companies whose compensation is out of alignment.

In summary, analyzing compensation in this manner, i.e. finding the actual relationship between pay and performance through alternative uses of time, team and total, provides a workable and understandable methodology for optimizing what can be competing interest in today's real estate environment.

A Better Way to Benchmark

Conventional executive compensation planning and design begins by determining what the "market" is for like positions in peer companies within an industry. Typically this determination is made by researching and surveying what these others pay and then aggregating it in some fashion using some measure of central tendency such as average or median. Percentiles are then applied so that if an incumbent or recruit in question is considered above/below average, he/she can be pegged appropriately. The pay levels resulting from this practice become the "benchmarks" for each position.

Conceptually this traditional methodology seems germane but in practice is subject to risks, particularly over time. Once these results are manifest, they can take on a life of their own in that there is the natural tendency for companies to converge their rates at least to "market average". As this procedure is iterated periodically, these adjustments become the data for the next market survey which, in turn, feeds back on itself. The process becomes a self reinforcing cycle that provides it own internal *context* resulting in compensation becoming a tactical reaction to, in some sense, an artificial market.

The Bradford Group believes another, better context is required, particularly in today's economic and corporate governance environment. Not only should compensation be compared to what is paid to others, but it must be grounded in a frame of reference that gives it

external validity as well. TBG believes that contextual framework can only be *performance*. Pay has to become strategic, not tactical, and in order for that to happen it must be aligned directly with performance. The idea of "Pay for Performance" is nothing new, but actual implementations of it are rare. In practice what really happens is the "ratchet effect" described above, which works both ways. If compensation tends to converge to the middle, high performers are penalized and low performers masked.

Benchmarks are still needed; just better ones. What if there was a way to incorporate *performance* directly into these metrics? Not unlike price/earnings ratios used to compare stock investment risk, TBG has introduced Compensation/Performance Ratios as the way to provide this much needed context to pay benchmarks. Researching both compensation and performance in the REIT industry over time, TBG has derived statistically significant relationships resulting in the ratios (expressed as \$ of compensation per performance measure) displayed in the following table:

Benchmarks expressed this way become dynamic metrics rather than static or absolute because the number derived for each entity depends on their level of performance. Compensation becomes a function of performance rather than simply what everyone else does. In so doing it changes from what it has largely become, a market tactical commodity, to what it should be, a strategic imperative.

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Correlation Coefficients

	Senior Team	CEO	COO	CFO
Total Cash ¹	0.79	0.62	0.74	0.72
Total Compensation ²	0.79	0.73	0.77	0.77
Residential Cash	0.95	0.89	0.99	0.83
Residential Total	0.96	0.94	0.94	0.89
Retail Cash	0.75	0.67	0.76	0.78
Retail Total	0.70	0.67	0.83	0.73
Industrial Cash	0.91	0.92	0.66	0.97
Industrial Total	0.89	0.96	0.89	0.89
Office Cash	0.60	0.54	0.58	0.65
Office Total	0.82	0.75	0.70	0.98
Diversified Cash	0.94	0.93	0.57	0.93
Diversified Total	0.98	0.96	0.91	0.98
Hotel Cash	0.95	0.89	0.99	0.94
Hotel Total	0.88	0.86	0.74	0.86
Health Cash	0.74	0.72	NA	0.77
Health Total	0.84	0.88	NA	0.92

¹Base and bonus plus any other direct cash compensation vs. operating result performance

²Total cash plus the dollar value of equity awards vs. market performance

COMPENSATION to PERFORMANCE RATIOS

(in \$ per millions)

	<u>Top 5 CASH¹</u>	<u>CEO CASH</u>	<u>COO CASH</u>	<u>CFO CASH</u>	<u>Top 5 TOTAL²</u>	<u>CEO TOTAL</u>	<u>COO TOTAL</u>	<u>CFO TOTAL</u>
Residential	\$13,959	\$7,413	\$4,911	\$3,226	\$5,304	\$2,822	\$1,739	\$1,195
Office	\$13,732	\$3,641	\$3,677	\$2,665	\$6,395	\$1,720	\$1,561	\$1,118
Retail	\$21,307	\$6,038	\$4,517	\$4,234	\$15,320	\$4,521	\$1,977	\$2,824
Industrial	\$15,404	\$6,405	\$2,436	\$2,562	\$35,307	\$6,514	\$1,407	\$924
Diversified	\$30,545	\$11,392	\$7,562	\$6,755	\$12,146	\$6,034	\$3,566	\$3,015
Hotel	\$44,988	\$15,781	\$5,020	\$5,093	\$12,695	\$5,742	\$3,423	\$2,498
Health	\$20,026	\$11,488	<i>NA</i>	\$3,748	\$17,934	\$6,465	<i>NA</i>	\$1,916
All	\$18,447	\$6,388	\$5,474	\$3,866	\$9,966	\$3,654	\$2,065	\$1,964

¹All cash ratios are expressed in \$ per millions of EBITDA

²All total ratios are expressed in \$ per millions of Market Capitalization