Pay-For-Performance Alignment: A Re-Consideration

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The author argues that the current framework for evaluating the alignment between pay and performance for real estate companies should be revised.

In today's world, the rules governing the evaluation of executive compensation and performance alignment in the real estate industry are fairly simple and straightforward. Regardless of whether you are looking at the guidelines published by industry leaders Institutional Shareholder Services ("ISS") or GlassLewis & Co. ("GlassLewis"), the basic framework consists of evaluating the degree of alignment between a company's compensation levels and its performance on both an absolute and relative basis, with performance almost entirely defined as a company's total shareholder return ("TSR"), including both dividends paid and share price change, over a one- and three-year period.

By and large the evaluation of this alignment is based on how well the company's compensation levels respond to changes in the Company's TSR performance over these time frames. For example, ISS uses three quantitative tests to identify the degree of alignment between pay and performance, as follows:

- **Relative Degree of Alignment**—Is a relative performance test that compares the percentile rank of a company's Chief Executive Officer's pay and the company's TSR performance over one- and three-year periods utilizing an ISS selected comparison group, with a 60% weighting for the three-year period and a 40% weighting for the one-year period. To the extent that the company's relative TSR performance outranks its pay, there is strong alignment of pay and performance. Conversely, to the extent that the company's relative compensation outranks its relative TSR performance there is a potential misalignment of pay and performance. In order to measure this potential misalignment, ISS has established metrics of -30% that indicates a medium level of concern and -50% that indicates a high level of concern.

- **Multiple of Median**—Is a relative test that expresses the company's CEO pay as a multiple of the median of the ISS selected comparison group. This test is designed to ensure that a company does not overpay its CEO on an absolute basis regardless of how well it has performed relative to its peers. In order

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to determine whether or not a company is potentially over paying its CEO, ISS has established metrics as a multiple of the comparison group median pay of 2.33x that indicates a medium level of concern and 3.33x that indicates a high level of concern.

- **Pay-TSR Alignment**—Is an absolute test that compares the company's CEO's annual pay and the value of an investment in the company over the prior five-year period based on weighted linear regressions that calculate a five-year "trend rate." ISS quantifies the relationship between (a) the rate of change of the company's TSR performance versus (b) the rate of change of the company's CEO pay and has established a -30 correlation as a medium concern and a -45 correlation as a high concern, meaning that pay has increased at a higher rate than TSR (or TSR decreased at a higher rate than pay).

While such a general framework that evaluates the alignment of executive pay with corporate performance on both an absolute and relative basis is sound, the arbitrary selection of time periods to evaluate this alignment over is a significant flaw. Given the long-term nature of the value creation cycle in the real estate industry, it would indicate that a longer time horizon would be preferable. Additionally, while the ultimate shareholder returns generated are a critical concern to investors and do serve as a key benchmark, real estate executives should also be compensated for how well they execute on the things that are within their control and not solely on the performance of the market either on an absolute or relative basis, which is generally not within their control.

How Performance Should be Evaluated

The concept behind aligning executives' pay to the company's absolute and relative TSR performance is that this serves to align the interests of the company's executives with those of shareholders, who are the owners of the business. Unfortunately, this construct also tends to minimize the importance of another key concept, that company managers should be compensated based on how well they manage the things that are under their control.

Given these seemingly contradictory viewpoints, a new framework is proposed that includes an evaluation of both the company's fundamental operating and market performance on an absolute and relative basis. As the executives' day-to-day activities do not directly impact shareholder returns, the primary evaluation should be based on the company's fundamental operating performance, with a lesser emphasis on annual shareholder returns. However, since the absolute and relative level of shareholder returns are of concern to investors, they should continue to be considered, albeit over a longer time horizon.

Market Performance Evaluation

One of the critical terms to be determined in evaluating a company's market performance is the time horizon over which such performance is to be analyzed. While a one- and three-year period might be appropriate for certain industries like technology or retail, which have relatively short product life-cycles, the long-term nature of the real estate value creation cycle does not easily conform to such a short period. If one considers the two most significant value creation activities in the real estate industry—ground up development and re-development of underperforming assets—it becomes apparent that it takes a longer timeframe from start to finish. Real estate companies that focus on either strategy as a core component of their business can be at a distinct disadvantage to their competitors over a one- and three-year period because for an extended period of time they may have a considerable investment in non-income producing assets on their balance sheets:

- Ground up development, which can generate significant value for shareholders, from plan inception through completion can easily take over five years depending on the scope and complexity of the development project as, for example, many urban and even some suburban communities have complex entitlement, zoning and land use approval processes. As a result, a company that focuses on ground up development may have a considerable investment in non-income producing assets on its balance sheet for an extended period of time, which may cause it to generate lower returns to shareholders if its "story" isn't clearly understood by investors.

- The redevelopment process of underperforming assets can also require an extended period of time to complete. Commercial leases that generally have terms extending five to 10 years can complicate matters as they may need to be bought out, which is a negotiated process, or worse waited out to be able to refurbish the space in order to release it at market rents. Even if you consider the multi-family sector where lease terms are significantly shorter, generally no more than two years, the complete redevelopment of an apartment complex can take an extended time as the full refurbishment of individual units needs to be coordinated around the tenant move out activity of the complex, while common area improvements can be done irrespective of occupancy.

Additionally, it is not coincidental that in the private real estate investment sector, companies, who look to these types of value creation activities to generate returns for their investors, generally utilize investment fund terms of seven to 10 years, which allows for a more industry specific performance period from initial investment through value harvest.

Considering these industry specific factors, the proposed framework would measure the alignment of executive pay and shareholder value creation over a seven year period. This evaluation would act as sort of a governor in that while it is still important to ensure that there is sufficient linkage between shareholder value creation and executive pay over the long term it should not be the ***primary*** metric as over the short term in which annual compensation decisions are made it is completely out of the control of company managers and as such executives should neither unduly benefit from it or be penalized by it.

Fundamental Operating Performance Evaluation

In the intervening years, the new framework for evaluating the alignment between executive pay and performance would focus on the company's fundamental operating performance. The emphasis on the company's fundamental operating performance is justified because over the long-term it is the primary driver of shareholder value creation as it (i) funds the company's dividend stream and (ii) all things being equal, and assuming similar earnings multiples across each sector of the industry, will drive higher returns to shareholders based on earnings that are higher and of better quality. The framework would focus on an evaluation of the company's fundamental performance in several key areas, each of which will be described in greater detail in the sections that follow: (i) balance sheet management, including leverage and liquidity management, (ii) operating results, including FFO per share growth and accretive leasing, and (iii) progress on strategic plan milestones. Key to this proposed framework is that the performance will be evaluated on both an absolute and relative basis compared to the company's peer group:

- **Balance Sheet Management.** A strong balance sheet is especially important for publicly traded real estate companies, which are generally organized as real estate investment trusts ("REITs"), which are required to distribute a significant portion of their annual earnings to shareholders. A weakened financial condition can cause significant shareholder value destruction by limiting the company's dividend paying ability, particularly during periods such as the 2008–2009 financial crisis and subsequent economic recession. As such, a strong balance sheet is fundamental to preserving and growing shareholder value. In addition, a strong balance sheet enables REITs to successfully execute on acquisition strategies, which for many is an important component of long-term value creation for shareholders. Key measures of balance sheet strength include Net Debt to EBITDA and the more traditional Fixed Charge Coverage Ratio, which reflects a company's ability to generate sufficient earnings to meet its future debt repayment obligations. Additionally, the maintenance of adequate liquidity, consisting of cash and availability under lines of credit, is a critical measure of financial strength that also allows a company to be in a position to capitalize on opportunistic developments or weather tougher than anticipated economic conditions.

- **Operating Results.** As the primary driver of the company's dividend stream and in turn shareholder returns, the ability to grow earnings over time is a key component of the proposed framework's performance evaluation. One of the key measures of operating performance for REITs is funds from operations ("FFO") per share growth. FFO per share is a common measure of operating performance because it excludes from earnings, among other items, the effect of gains and losses from real estate sales and real estate depreciation and amortization, which allows investors, analysts and management to compare operating performance among companies and across time periods on a consistent basis. Supporting the growth of earnings is the company's ability to release space on an accretive basis. Accordingly, another key operating metric is the ability to consistently deliver GAAP and cash rental rate increases on lease renewals and re-leasing of space. The evaluation of these operating results would be considered from both an absolute and relative perspective as they are directly comparable across property types and markets and therefore serve to align the executives' pay with their day-to-day operating decisions.

- **Progress on Strategic Plan**

Milestones. A key determinant of a company's long-term ability to generate shareholder value is its ability to execute on its strategic plan. As a result of the 2008–2009 financial crisis many companies were forced to re-evaluate their long-term plans and make adjustments given the new economic realities. For some this has included attempting to become an investment grade rated company in order to access the debt markets to lower their overall cost of capital. For others it has included simplifying their business model to rely less on ground up development and has therefore led them to attempt to monetize their non-income producing assets. For still others, this strategic shift has required them to expand geographically into new markets and recycle assets out of poorer performing markets or asset types. While diverse in nature, strategic planning changes tend to have one thing in common—they require executives to make decisions and take actions that can negatively impact short-term stock price performance in order to create higher value for shareholders in the long term. Accordingly, the achievement of milestones during the interim periods should be a key consideration of the compensation program of a company.

Implementation of the New Framework

While the proposal of a new framework is not a guarantee of its adoption by the market, the conversation about the changed focus from a strict one- and three-year total shareholder return evaluation to a more nuanced approach that recognizes the importance of rewarding executives for the results in areas that they can control on both an absolute and relative basis is a critical one. If one looks at the development of the publicly traded real estate industry from an investment perspective, it began as primarily a fixed income investment with yield and the company's dividend as the main focus. Only over the relatively recent past, as price volatility dramatically increased, did significant share price appreciation become the primary driver of investment decisions. While not necessarily a negative development, this has the potential to incent executives to take excessive risks in search of short-term market returns. In order to keep executives focused on the prudent management of their businesses, the role of fundamental operating performance needs to be greatly enhanced in the evaluation of the alignment of pay and performance. This expanded emphasis can only be achieved through better communication with shareholders and their advisory groups to explain its importance and demonstrate the linkage between the fundamentals of the business and their long-term investment goals. In today's dynamic economic environment, this type of engagement with shareholders will benefit all as it will foster a better understanding of the motivations and concerns on both sides of the pay for performance debate, regardless of which framework is utilized.

Conclusion

The current framework for evaluating the alignment between pay and performance for real estate companies is conceptually sound in that it looks to the relationship between compensation and performance on both an absolute and relative basis. Unfortunately, it does not sufficiently consider either the long-term nature of the real estate industry or the key driver of shareholder value creation, fundamental operating performance, which is the true measure of executives' effectiveness. Given the significant potential impact of not getting this evaluation right—a "No" on Say on Pay, and a negative impact on a company's share price—both executives and investors need a new framework.