FTI INSIGHTS

Report

3RD Quarter 2015

Executive Compensation News and Views

Dodd-Frank Update: The SEC Finalizes the Pay-Ratio Rule

In August 2015, the SEC finalized the Pay-Ratio Rule in response to the Dodd Frank Act. All publicly-traded companies (with the exception of select smaller issuers, foreign issuers and emerging growth companies) will be required to disclose the following:

- Annual total compensation of the chief executive officer ("CEO");
- Median annual compensation of all employees of the company, excluding the CEO; and
- Ratio of the two amounts above.

The pay ratio will be required for fiscal years beginning on or after January 1, 2017, which means most REITs will first disclose this amount in the 2018 proxy statements.

Identifying the Median Employee

Companies will need to identify the median employee once every three years. The determination of the median employee will include anyone who works for the company inside or outside of the U.S. and will be based on amounts calculated in accordance with the Summary Compensation Table rules. In order to determine the median there are some nuances, including the following highlights:

- A company may use its total employee population or a statistical sampling of that population and/or other reasonable methods.
- Companies are permitted to annualize compensation for a permanent employee who did not work the entire year, such as a new hire.
- Companies are prohibited from adjusting part-time, temporary and seasonal workers pay to the full time equivalents.
- Companies may apply a cost-of-living adjustment for employees outside of the CEO's location but will also need to disclose the pay ratio without the cost-of-living adjustment.
- Companies that are in the midst of an acquisition may choose to omit employees obtained in a business combination or acquisition for the fiscal year in which the transaction took place if the deal is disclosed with approximate number of employees omitted.
- Companies may exclude up to 5% of its non-U.S. employees, as well as exclude employees in non-U.S. locations where such a disclosure would violate data privacy laws (which would ultimately need to be substantiated with a legal opinion.)

REIT Compensation and Governance Monitor

2014 Compensation Increases by 9% at the Median. 2014 compensation for executive officers increased by approximately 9% in the overall REIT industry based on an in-depth review of pay levels at the largest 125 REITs conducted by FTI Consulting. The compensation adjustments varied significantly by sector, with the multi-family and healthcare sectors experiencing the largest increases of at least 18% at the CEO level, while the finance sector experienced an overall decrease in compensation, with an approximate 11% reduction at the CEO level.

Board Compensation Continues to Increase. Compensation for Boards of Directors increased by 2% at the median in 2014. Companies elected to adjust Board compensation periodically rather than annually, as evidenced by the fact that only 46% of REITs increased Board compensation in 2014. REITs that increased Board compensation in 2014 did so by 13% at the median, further indicating that companies generally increase board compensation periodically by large amounts.

ISS and Investors Increase Focus on Compensation Structures at Externally Managed Companies.

The 2015 ISS Policy Survey included a question on how say-on-pay resolutions for externally-managed issuers should be addressed. Seventy-one percent of investors responded that ISS should recommend AGAINST the say-on-pay proposal when the external manager's level of disclosure about executive compensation payments or practices does not meet shareholders' informational needs. Investors also suggested that ISS in making recommendations should look at factors such as the amount paid under the management contract and how this compares with general and administrative expenses at internally-managed peers; the independence of the Board and compensation committee; stock price performance relative to peers; and any history of pay-related controversies or activism.

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REIT Compensation and Governance Monitor *(continued from page 1)*

Chimera Investment Corp. Internalizes Management.

In August 2015, Chimera Investment Corp. entered into employment agreements with senior management in connection with their internalization. Below are summaries of the contracts for the CEO and other executives:

CEO Contract. Matthew Lambiase will continue as CEO under a three- year contract that automatically renews on an annual basis, with the following key terms:

- *Base Salary* – $750,000
- *Target Annual Bonus* – $4.0 million target bonus, with a maximum payout equal to 140% target. The bonus will be determined 50% based on Return on Average Equity targets and will be paid in cash; 25% will be based on a three--year average TSR performance and will be paid in performance-based stock, and 25% will be based on discretionary factors and will be paid in RSUs.
- *LTI Awards* – Will be granted RSUs equal to $776,000 that will ratably vest over three years.
- *2015 guaranteed bonus* – For 2015, he will receive a guaranteed $2,329,000 bonus, plus a discretionary bonus up to $1,035,000 (75% paid in cash and 25% paid in RSUs)
- *Severance Payments* – Entitled to a severance payment equal to (i) 1x his salary, plus average annual bonus over the prior three years; (ii) 12 months COBRA coverage (18 months in connection with a CiC); (iii) pro-rata bonus, and (iv) accelerated vesting of time-based RSUs.

Other Executives. The other executives are subject to contract terms substantially similar to the CEO, with the following salaries and target bonus amounts:

- *Chief Operating Officer* – $750,000 salary; $2.7 million target bonus (maximum equity to 140% of target); and an RSU grant equal to $448,000.
- *Chief Investment Officer* – $300,000 salary; $1.6 million target bonus (maximum equity to 140% of target); and an RSU grant equal to $347,000.
- *Chief Financial Officer* – $300,000 salary; $1.5 million target bonus (maximum equity to 140% of target); and an RSU grant equal to $309,000.
- *General Counsel* – $750,000 salary; minimum bonus equal to 200% of his salary and a discretionary stock grant of 33% of his salary; and an RSU grant equal to $500,000.

ISS: Year 1 Impact of Equity Plan Scorecard (“EPSC”) on Plan Upsizing Proposals

For 2015, ISS released a new methodology to determine voting recommendations with regards to equity incentive plan proposals (which generally are conducted to increase the share capacity to issue future stock-based compensation). The EPSC will use a range of positive and negative factors within three main categories rather than a series of pass or fail tests under the previous Compass Model. The new model is based on a 100 point scoring system under three main categories (or “Pillars”), including:

- **Plan Cost (45 points)** – Based on a company’s industry and size, a certain “Shareholder Value Transfer” is allowable and is calculated based on (i) Value of new shares + remaining shares + unvested or unexercised grants / market capitalization and (ii) Value of new shares + remaining shares / market capitalization;
- **Plan Features (25 points)** – Reviews plan features such as minimum vesting requirements, single trigger for the vesting of stock awards in connection with a change in control, amongst other features; and
- **Grant Practices (35 points)** – Reviews the company’s burn rate (which represents an adjusted dilution calculation), estimated duration of the plan, CEO compensation practices, among other factors.

Out of a total 100 possible points within the EPSC, a score of 53 or higher will generally result in a positive recommendation for the proposal. However, there are certain factors that will result in an “AGAINST” recommendation regardless of the total score, such as the authority to reprice options without shareholder approval, excessive equity grants or a pay-for-performance disconnect.

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For annual meetings between February and June 2015, 331 companies within the Russell 3000 Index had proposals for both (1) an amendment to the omnibus stock plan and (2) Say-on-Pay. Only 12% of proposals for equity plan amendments from the Russell 3000 Index received a negative recommendation from ISS. Of these companies only one actually failed to receive a majority support for their stock plan proposal. Below is a summary of the voting recommendations from ISS for companies with both proposals on the ballot:

# of Russell 3000 Constituents	Description of ISS Recommendations
255	FOR vote by ISS on both proposals
16	AGAINST ("AGN") vote by ISS on both proposals
24	AGN vote: Amend Omnibus Stock Plan; FOR vote: Say-on-Pay
36	FOR vote: Amend Omnibus Stock Plan; AGN vote: Say-on-Pay

REIT Industry Activity Monitor

IRS Suspends Private Letter Rulings on REIT Spinoffs – Over the last two years, there have been 10 REIT spin-offs, which involve a REIT (or non-REIT) contributing certain of its real estate assets to a newly formed subsidiary company and then distributing the stock of this new company to the parent company's shareholders. For example, Vornado Realty Trust spun off a majority of its retail portfolio to become Urban Edge Properties. A non-REIT company would form a new subsidiary to hold and more efficiently manage the contributed real estate (such as Windstream Holdings, Inc. spinning off its real estate assets into the newly formed REIT Communications Sales and Leasing, Inc.). In both cases, the newly spun-off company would elect to be taxed as a REIT. If structured properly a spin-off can result in significant value to the parent company's shareholders.

Section 355 of the Internal Revenue Code provides that the distribution of stock of a subsidiary company by a parent company will be tax-free to both the parent and the parent's shareholders if certain criteria are met, three of which recently have become the focus of a Treasury Department study:

1. Before and after the tax-free spinoff, both the parent and spun-off subsidiary must be engaged in an "active trade or business"
2. The spinoff must have a non-tax-related business purpose
3. The spin-off must not be used as a "device" to distribute earnings and profits that otherwise would be taxable to the parent and its shareholders.

Over the years, taxpayers would apply for a private letter ruling from the Internal Revenue Service that a spin-off met these, and other, criteria and would be eligible for tax-free treatment. Over the last several years, the Internal Revenue Service has curtailed the scope of these private letter rulings. For example, the IRS will no longer rule that a spin-off has a legitimate non-tax business purpose. However, on September 14, 2015, the Internal Revenue Service and the Treasury Department issued Notice 2015-59 and Revenue Procedure 2015-43 stating that the IRS is currently studying how a spin-off by a non-REIT parent company should be treated for tax purposes and during this time period the IRS will generally suspend issuing private letter rulings for any ruling requests postmarked after September 14th.

The IRS has stated that no ruling will be issued if property owned by a parent company or the spun-off company becomes property of a REIT in a "conversion transaction" (i.e., a taxable C corporation elects REIT status or transfers property to a subsidiary that then elects REIT status) and no election is made to treat the transfer of the real estate assets as a taxable sale to an unrelated third party. This covers a non-REIT spinoff because the contribution of the real estate assets to a subsidiary that subsequently elects REIT status will create the "conversion" transaction.

Another area of concern is with non-REIT "opco/propco" spinoffs, where the parent (such as Windstream Holdings, Inc.) and the spun-off subsidiary (such as REIT Communications Sales & Leasing, Inc.) remain very closely connected following the spinoff by way of a lease of the subsidiary's newly acquired real estate back to the parent for use in the parent's operating business. This lease-back activity raises the question as to whether the separation was for legitimate non-tax business reasons warranting tax-free treatment under Section 355.

Given that the IRS has not provided a comment period deadline, it is not possible to predict how long it will take the IRS to study these issues, make a determination whether non-REIT spin-offs should be entitled to tax-free treatment and resume issuing private letter rulings. Also, while the IRS is not targeting tax-free spin-offs of REITs by REITs, there are concerns that the current no ruling policy will impact spin-off activity in general. Going forward, non-REITs will need to obtain a tax opinion before moving forward with a spin-off. However, tax counsel may conclude that it cannot issue a tax opinion with an acceptable level of certainty because of the issues raised in Notice 2015-59 and Revenue Procedure 2015-43.

Top REIT Performers –10 Best Total Shareholder Returns

	Company	Ticker Symbol	Year-to-Date
1.	CoreSite Realty Corp.	COR	35.22%
2.	Extra Space Storage Inc.	EXR	34.78%
3.	QTS Realty Trust, Inc.	QTS	32.37%
4.	Preferred Apartment Communities, Inc.	APTS	25.75%
5.	CubeSmart	CUBE	25.71%
6.	CyrusOne Inc.	CONE	22.15%
7.	Public Storage	PSA	17.37%
8.	Home Properties, Inc.*	HME	16.36%
9.	Equity LifeStyle Properties, Inc.	ELS	15.94%
10.	Sun Communities, Inc.	SUI	15.45%

Source: TSR as calculated by SNL Financial as of September 30, 2015
*Target of announced merger.

Sector Performance – Index Returns

	Index	Year-to-Date
1.	MSCI US REIT	(-4.26%)
2.	SNL Diversified	(-14.26%)
3.	SNL Healthcare	(-9.62%)
4.	SNL Industrial	(-6.84%)
5.	SNL Hotel	(-20.34%)
6.	SNL Finance REIT	(-7.12%)
7.	SNL Multi-family	8.61%
8.	SNL Office	(-6.51%)
9.	SNL Retail	(-3.48%)

Source: TSR as calculated by SNL Financial as of September 30, 2015

About FTI Consulting Real Estate and Infrastructure Solutions

The FTI Consulting Real Estate and Infrastructure Solutions practice has a singular focus on the real estate and finance industry and the capital markets that serve it. Our services are designed to create integrated financial, operating and tax solutions for clients with interests in real estate.

We provide an unsurpassed range of real estate advisory services, including merger & acquisitions, due diligence, valuation, lease consulting, restructuring, litigation support, forensic accounting, financial outsourcing, IPO advisory, REIT tax structuring and compliance, executive compensation, development advisory, cost segregation and private client services. We represent leading public and private real estate entities, including equity and mortgage REITs, financial institutions, investment banks, opportunity funds, insurance companies, hedge funds, pension advisors and owners/developers.

At FTI Consulting Real Estate and Infrastructure Solutions, we are, first and foremost, real estate professionals, which allows us to design compensation programs around the true drivers of value creation at real estate companies. Through our primary focus on real estate and the drivers of success in the industry, we are able to serve as facilitators to our clients, creating tailored and balanced compensation programs that effectively reward and motivate management and employees for the right kind of performance, while closely aligning the interests of employees with those of the company's shareholders and investors.

Our compensation practice is unique from other compensation consulting firms in that our practice is comprised of experts in the fields of both compensation and real estate. We have served as the compensation consultants and corporate governance advisors to over 75 public and private real estate companies, private equity firms and specialty finance companies on a host of compensation and corporate governance related matters.

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AT THE CRITICAL TIME™

About FTI Consulting

FTI Consulting, Inc. is a global business advisory firm dedicated to helping organizations protect and enhance enterprise value in an increasingly complex legal, regulatory and economic environment. FTI Consulting professionals, who are located in all major business centers throughout the world, work closely with clients to anticipate, illuminate and overcome complex business challenges in areas such as investigations, litigation, mergers and acquisitions, regulatory issues, reputation management and restructuring.

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