Incentive Program Design

The Evolution of Discretion Among REITs Annual Incentive Program Design

A 10-YEAR STUDY

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This article, covering annual incentive design, is the first of a series analyzing trends in REIT compensation design. Our next article will focus on the evolution of REIT long-term incentive plan design and is expected to be published in January 2021. If you are interested in learning more, please contact Rami Glatt, Principal at Semler Brossy, at rglatt@semlerbrossy.com or Rachel Ki, Consultant at Semler Brossy at rki@semlerbrossy.com.

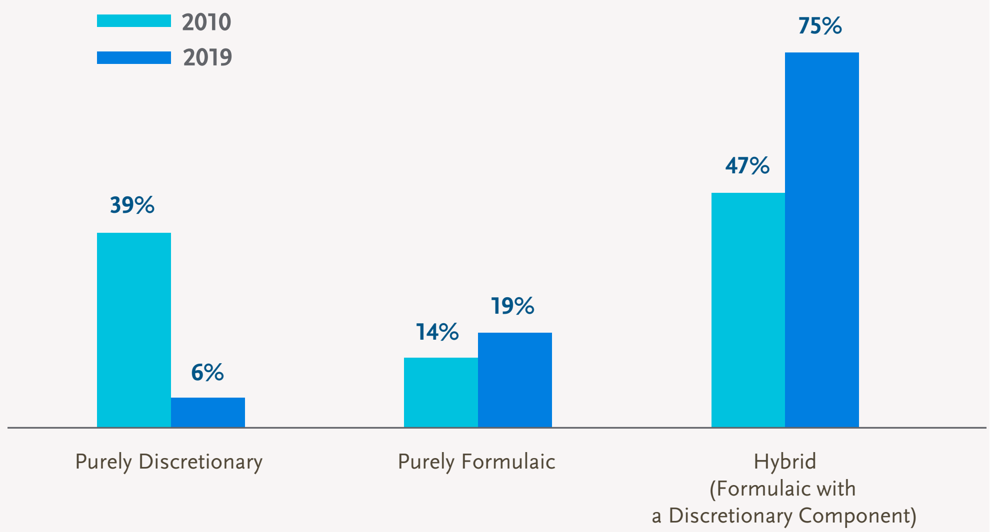
Semler Brossy Consulting Group has conducted a comprehensive ten-year study on publicly traded real estate investment trust (REIT) pay programs to understand the evolution of pay trends, emerging practices, and the driving forces underpinning the changes. Specifically, we have analyzed proxy statement disclosures of 70 of the largest REITs by total assets (ranging from \$4B to >\$40B), focusing on pay design for the CEO and CFO roles. Our sample is intentionally dispersed across various sub-industries (healthcare, industrial, hotel and resorts, office, residential, retail, diversified, and specialized) to ensure a holistic and collective perspective of the REIT industry.

Overview

Many REITs historically have incorporated discretion in their annual incentive plan frameworks, where the level of discretion has ranged from a minority weighting alongside formulaic financial components to a fully discretionary bonus determination. The use of purely discretionary plans has dramatically decreased, from 39% of REITs in 2010 to 6% in 2020, noting that many REITs continue to incorporate some level of discretion in their annual incentive programs.

The move away from purely discretionary frameworks can be attributed primarily to proxy advisor and shareholder demands for increased transparency and quantifiable performance in the Say on Pay era. Said simply, the term 'discretion' often carries a negative connotation and is misunderstood to be a tool to boost payouts. As such, fully discretionary programs place significant pressure on compensation committees to evaluate and reconcile pay outcomes with performance and to describe their decision-making process in a way that satisfies

Prevalence of Annual Incentive Plan Types
(n=68*)



** Note: 2019 programs exclude two companies who did not disclose a bonus program for the CEO or other executives.*

shareholders. This high "burden of proof" to justify payouts and the associated external Say on Pay risk are often not worth the added flexibility of a fully discretionary program.

Internal factors also can play into the decision of using purely discretionary programs, specifically the maturity and ownership structure of the REIT. Early-stage REITs may need the discretion to capture a wider range of objectives and priorities necessary to establish themselves in the market. However, as REITs mature, business objectives typically become more refined and financial outcomes are more predictable, allowing for the use of discrete and formulaic measurement to keep management accountable. Separately, REITs that have a more controlled ownership structure or a high founder influence are typically less vulnerable to Say on Pay risks. These companies may choose to turn to discretionary programs for maximum flexibility as they are more shielded from external scrutiny but may eventually adopt more formulaic plans if the ownership structure becomes less controlled.

Of course, fully formulaic plans can carry some drawbacks as well, particularly when the numbers fail to tell the full performance story. For this reason, REITs have continued to maintain flexibility in their annual incentive programs by incorporating various strategies that have appropriately balanced flexibility, transparency, and completeness with external responsiveness.

In practice, REITs typically employ one of two strategies and occasionally both in their annual incentive plan design to maintain flexibility:

1. The Hybrid Approach—Formulaic Plan with a Discretionary/Qualitative Component

PROS

Prevalence–aligns with broader market practice

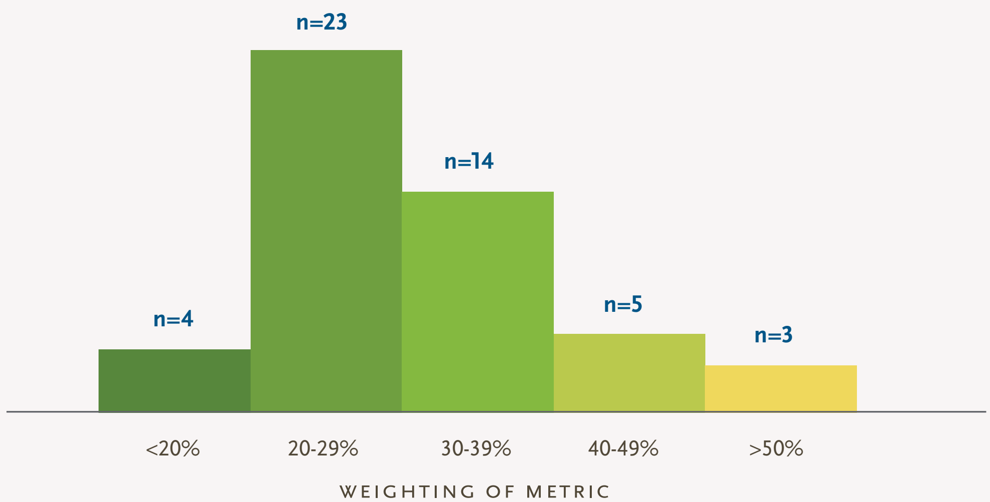
Flexibility–retains similar, albeit limited, levels of flexibility afforded by a fully discretionary program

CONS

Burden of Proof–requires a thorough review process at the committee level to justify discretionary outcomes

Disclosure–necessitates heightened disclosure of process and assessment outcome to avoid further external scrutiny

Distribution of Discretionary/ Qualitative Metric Weighting
(n=49*)

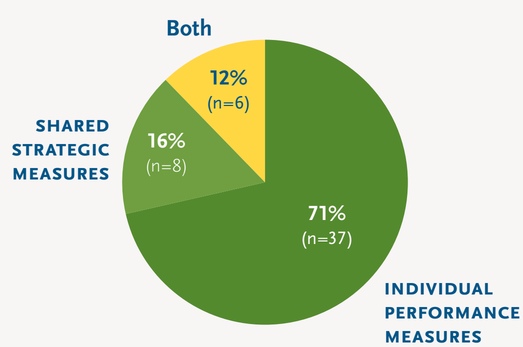


** Note: Excludes REITS with qualitative modifiers.*

Companies looking to retain some form of discretion can carve out a distinct, more qualitatively oriented component in an otherwise mostly formulaic plan. This "hybrid" approach was by far the most common type of annual bonus plan used among REITs ten years ago and continues to grow in prominence given the flexibility afforded by the discretionary component. In fact, the prevalence of these plans has materially increased among REITs over the past ten years, from 47% to 75%. We expect that REITs with purely formulaic plans might look to transition to hybrid plans going forward given the current volatility in financial performance in the wake of Covid-19. By effectively limiting the discretion to only a portion of the plan, typically 30% of the overall bonus opportunity, companies can maintain a meaningful level of flexibility while avoiding external concerns, particularly with accompanying strong disclosure of performance results and pay out rationale.

Companies structure this flexibility in one of two ways and, again, sometimes both: (A) Shared-strategic measures and/or (B) Individual performance measures.

Hybrid Plans: Qualitative Measures vs. Individual Performance
(n=51)



Companies that want focus on business objectives where precise quantitative measurement is less feasible can opt to carve out a discrete portion of their plan to subjective evaluation through shared-strategic measures. This approach provides flexibility to qualitatively measure performance in a very specific area of importance where perhaps the numbers do not capture the full story. Approximately 25% of REITs with hybrid plans used a shared-strategic measure in their annual bonus program. Of these companies, over half opt for operational objectives (e.g., leasing volume, cost control, development, etc.), highlighting their importance in REIT performance alongside more traditional financial measure such as funds from operations (FFO). These measures are generally shared across the management team such that all executives are measured on the same criteria and with the same incentive weighting levels. Further, these measures often do not contain strict goal levels (e.g., threshold, target, and maximum) but are assessed more holistically. To that end, companies can help ensure that these types of measures are viewed positively by external audiences by clearly articulating the measurement objectives, weightings, and the evaluation process undertaken to determine performance and pay outcomes.

Other companies may choose to limit their flexibility beyond the financial outcome to assessments of individual performance. Similar to the strategic measure approach, this can encompass a variety of objectives ranging from leadership to overall operational and financial performance. However, this assessment typically includes an assortment of objectives without distinct weightings allowing for more of a 'big-picture' review of performance and the ability to differentiate priorities and outcomes by individual. Here too, companies are advised to (1) ensure that their disclosure is sufficiently robust to avoid external criticism, and (2) highlight the evaluation process, types of performance considered, and the rationale for the assessment's outcome.

2. The Scorecard Approach—Diversifying Bonus Plan Metrics

PROS

Stability–less volatility in payouts over time given the diversified focuses of the program

Implementation–easily implemented without high Say on Pay risk

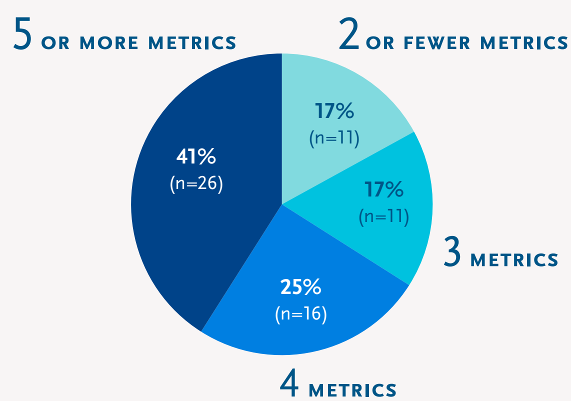
CONS

Line of Sight–can be difficult to communicate strategic priorities

Flexibility–generally affords less flexibility than a qualitative or discretionary component

Companies looking outside of the exclusive use of discretion can still achieve helpful levels of flexibility by measuring a large and diverse set of metrics to help ensure an appropriately balanced pay and performance outcome. This "scorecard" approach, even if most metrics are quantitative and financial in nature, diversifies the emphasis on any one specific goal in driving a payout. As a result, bonus payouts tend to be less volatile over time which is also typically a trademark of a purely discretionary program. This highlights the double-edge sword with this strategy—participants have a better opportunity to win in at least one category, but consistently outperforming in all may be more difficult.

Number of Metrics
(n=64*)



Note: Excludes REITS with purely discretionary programs.

Nearly two-thirds of the REITs studied use four or more metrics to determine their bonus payout, which is higher than the typical two- to three-metrics approach common across other industries. Notably, REITs that have transitioned from a purely discretionary plan to a partially or fully formulaic plan use on average five metrics in their current program to allow them to retain a similar level of flexibility as their prior plan. Further, the scorecard can exist effectively as a subset of the hybrid approach; companies can also include a shared-strategic/individual performance measure as part of the scorecard, though most tend to weight heavier on financial performance. External audiences often do not have a strong preference regarding the number of metrics in a plan, allowing for this strategy to be readily implemented from an external perspective.

Conclusion

Both designs discussed above are effective and compatible with modern governance standards and external expectations, leaving the choice of which to implement as a function of company needs and context (e.g., company maturity and ownership structure, viability of goal setting, desired level of flexibility, relative importance of assessing performance across financial, strategic, and individual performance outcomes, etc.). With the ever-changing landscape of business priorities and especially in the volatile era of Covid-19, it will be prudent for compensation committees and management teams to evaluate their existing approaches and determine whether it remains appropriate in the go-forward landscape. ■

For more information, visit us at SEMLERBROSSY.COM, *or reach us at 310.481.0180.*

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