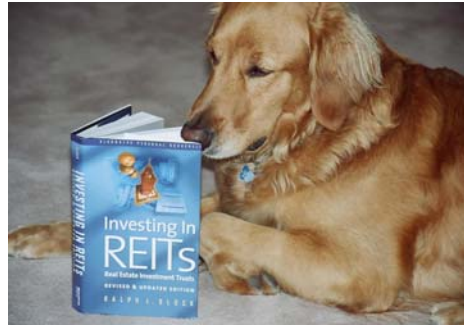


# "The Essential REIT"

October 24, 2006



*"Be who you are and say what you feel, because those who mind don't matter and those who matter don't mind." – Dr. Seuss*

*"An author is a fool who, not content with boring those he lives with, insists on boring future generations." – Charles de Montesquieu*

*"Writing is like prostitution. First one writes for the love of doing it, then for a few friends, and, in the end, for the money." – Moliere*

## 1. "Show Me the Money."

I don't know about you, but it seems to me that trying to comprehend the issues involved in executive compensation is as disorienting as attempting to navigate the streets of London at dusk. After studying the views of a few pundits on the topic, I feel as though I've gone three rounds with an angry Tasmanian devil. Take a look at some proxy statements, and run your eyeballs over the "Compensation" section. Salary + bonus for most CEOs add up to something eminently reasonable, *i.e.*, somewhere between a half a million and a million bucks at your typical mid-cap company. Not bad, but hardly "gross" or "disgusting."

Of course, there will often be a fair amount of confusion on the issue of what is "base salary" and what is "bonus." But executives' varying levels of *base* compensation, assuming such term includes both "salary" and "bonus," isn't really the most confounding part of the compensation conundrum. It's the *contingent* stuff: The "pay-for-performance," the option grants, and the "incentive comp," which in some cases can run well into the eight figures *per person* (before the decimal point). Here are just some of the issues that we face when attempting to discuss this topic intelligently and dispassionately:

The concept of "fairness" in executive pay is very important – but is as nebulous as one of Harry Potter's ghostly friends; what is reasonable to me may be grossly excessive to you. There is often also a confusion of purpose when we discuss this topic, *i.e.*, are we seeking to reward or to incentivize? To what extent should increases in shareholder wealth translate into additional executive compensation? Does providing massive

financial incentives to executives really produce superior investment returns? With respect to stock options, at least, the widely-respected Graef Crystal says not.<sup>1</sup>

How can executive compensation be structured to best align the interests of management with those of the shareholders? The hedge fund structure encourages fund managers to take significant risk by providing for incredible rewards for performance but not much penalty for failure; how should we structure compensation programs to encourage corporate executives to deliver excellent results yet avoid excessively risky business strategies? Should REIT organizations have somewhat different comp plans than the rest of Corporate America? If so, why?

As usual, I have no “right” answers to any of these questions. But, also as usual, that won’t stop me from discussing them. And you, dear reader, cannot be stopped from hitting the “delete” key.

**Base vs. Incentive.** There are at least two different aspects to executive compensation. One is to compensate an executive in a manner consistent with his or her assigned duties and responsibilities. Think of this as “base compensation” (which may include an easily achievable cash bonus), paid in return for doing an acceptable job, *i.e.*, doing what is expected for that position. The level of such compensation should, of course, vary with a number of factors, including the size of the company, the importance of the position, the complexity of the company and its business strategy, and even the size of the incentive compensation potential (if the potential rewards for outstanding performance are huge, the base salary should, in fairness, be modest – just as we don’t expect large dividend yields on Internet stocks).

There should be a reasonable but not excessive gap between the CEO’s base compensation and that of the top and middle-level executives, some of whom work even harder. Base compensation, of course, should have nothing to do with stock price performance, nor should it vary with profits or other company performance criteria. If the executive does his job in the manner expected of him, he earns his base pay. If he doesn’t, he should be terminated (figuratively, not literally).

Incentive compensation, on the other hand, is as lucid as the Mexico City skyline in August. What do we seek to accomplish with it? Is it to *reward* an executive for doing a job much better than what is expected of him/her, or because the shareholders have become much richer? And how do we measure this? Or is it to *incentivize* a set of executives to live, breathe and think company business, at work, at home and at play, in an effort to induce them to be so creative that they will do whatever it takes (within the bounds of law and ethics, of course) to enable shareholders to garner extraordinary returns? Any incentive compensation plan should be consistent with the desired objective – but it seems to me that too many Boards of Directors haven’t even figured out specifically what they want to accomplish with it

Let’s begin with the novel theory that the shareholders, not the executives, own the company, and look at incentive comp from that perspective. Most shareholders would accept the premise that their executives should receive a reasonably competitive base pay for doing their jobs with care, good judgment and intelligence, and be given the opportunity to earn significant additional compensation should their efforts result in company performance that’s above what’s expected. With that as our objective, let’s examine some good – and bad – principles.

**Stock vs. Cash; Long-term vs. Short-term.** I would think that public companies would want to encourage loyal, long-term shareholders to maintain, and add to, their stakes in the company. These sticky shareholders may be more willing to ride out the occasional bear markets and adverse product, market and economic cycles. This should result in less volatility in the stock price, which in turn helps to attract yet more shareholders and allows the company to make acquisitions via a more desirable currency. And it may avoid management distraction and middle-level optionee angst. Contented shareholders will also be more willing to pony up additional equity capital when the company needs it.

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<sup>1</sup> See his article, at [http://www.findarticles.com/p/articles/mi\\_m5072/is\\_30\\_24/ai\\_91093120/print](http://www.findarticles.com/p/articles/mi_m5072/is_30_24/ai_91093120/print), in which he says, “large stock options don’t seem to motivate excellence. Indeed, they seem to motivate relatively poor performance.”

This happy state of affairs might best be accomplished by the implementation and execution of a sound long-term business strategy that focuses on a multi-year time horizon. If this is so, shouldn't every incentive plan be designed to encourage the same kind of long-term thinking on the part of executives and employees? Accordingly, paying management in cash, and upon the accomplishment of short-term objectives, would seem to be counter-productive – like paying a football pro on the basis of the score at the end of the first quarter. Conversely, *stock* – not cash -- incentives, particularly if long-term in nature, would best align the management's interests with those of the company's long-term shareholders. Perhaps the best type of plan would provide for back-end loaded vesting or require a long holding period, thus insuring that executives who depart early for greener pastures leave plenty of money on the table.

**Eligibility.** I am not a big fan of Karl Marx, and believe that, while all employees are created equal, they don't all do work that's equally valuable to the shareholders. Nevertheless, the business that's successful on a long-term basis will have a solid base of employees who are loyal and motivated, and who can think of ways, almost every day, to make the company more profitable and effective at what it does. If so, then there is no reason to limit long-term incentive plans to only the top executives. *All* employees should be eligible. Naturally, the top dogs, being stronger and more voracious, should be able to snarf up the highest rewards – but, as in wolf packs, big kills should be shared even with the omega dogs.

**Are REIT Stock Options a Dumb Idea?** A quick detour...One may ask whether providing stock options to executives of companies whose stocks provide unusually high dividend yields such as REITs is self-defeating – or, at the least, ineffective. It is certainly true that a significant part of the investor's returns in such stocks will come from the dividends that holders of vanilla-variety stock options don't enjoy. Also, it may be argued that executives who've pigged out on stock options will have a significant incentive, perhaps adverse to many shareholders, to keep the dividend payments as miserly as possible and focus almost exclusively on goosing returns via increases in the stock price.

While these arguments have merit, stock options *do* have certain tax and reporting advantages not enjoyed by restricted stock grants. Furthermore, as REIT dividend yields have drifted downwards with cap rates and REIT growth strategies have become more clearly defined over the years, the dividend yield isn't the only reason for anyone to own REIT stocks. And yet, as I argue below, there is often no relationship between stock price movement and the contributions of management.

**Criteria.** Now we get into some really difficult issues, *i.e.*, what should trigger those really big paydays? Or, to put it another way, at what point or achievement level should the executives and other members of management earn the right to snag additional compensation above and beyond their already fair salaries? Every such dollar of compensation is a dollar no longer owned by the shareholders.

As is said of bull markets, we should acknowledge that increases in a company's share price, at least over a period of less than three years, frequently have little to do with investor or management genius. I've been haunting the stock markets for almost 40 years and, as sure as Sammy loves his biscuits, we know that the movement in share prices, even for as long as three years, often has little to do with the long-term value of a company; think of WEB's concept of weighing machines vs. voting machines. Stock prices move for many reasons, many of them having to do with the ever-present greed and fear of investors, and others relating to interest rates, macro and global issues, investment fads and trends and other exogenous influences.

Was Simon Properties worth less in 1998-1999 just because investors had to have dotcoms and couldn't care less about commercial real estate? Should a REIT's management be punished for that? Or, conversely, should they be rewarded simply because investors develop a new love for commercial real estate and push cap rates down to historic lows, which also, of course, will drive P/AFFO ratios to dizzying levels? Or, to put it more crassly, did Kilroy's executives truly deserve every penny of their \$72 million payday, which was due largely to Kilroy's stock price performance?

One might argue that stock-based criteria might still be reasonable if a company's stock price is measured against one's peers in a particular real estate sector. But even this contention is questionable; how much of SL Green's stock price outperformance in recent years has been due to the sizzling Manhattan real estate market, and how much to the value-creating activities of an outstanding management team? Even outside of

Reitville, rewarding executives on the basis of movements in stock prices is often arbitrary and more subject to the investment gods than the real-time performance of the company's executives. Wouldn't it be better – and fairer – to avoid, or at least downplay, stock price as a criteria for large executive incentive compensation?

Stock price-based compensation is, of course, just one of the problems with stock options, and stock options remain as common as business logos in the corporate world today. But what could replace them? More intelligently designed plans, that's what. The principal focus should be on the issue of whether the management team has created value for shareholders on a long-term basis – value beyond what's expected in return for the standard base compensation being paid to the executives and other employees. REITs, in particular, could look at a variety of measures: 5-year growth rates in free cash flow, preferably in comparison with the peer group (though this should be adjusted for leverage levels to avoid rewarding executives who goose AFFO growth by layering in increasing levels of debt), increases in estimated NAV over time, or even returns on new investments in excess of the company's weighted average cost of capital. Due to the capital-intensive nature of REIT organizations, the latter criteria, based as it is on intelligent capital deployment, would be particularly important to REIT investors.

Another approach, alone or in conjunction with those mentioned above, would be to focus on specific goals or tasks, some of which could be short-term and others long-term. The short-term tasks could provide for annual bonuses, while longer-term goals achieved would be rewarded in restricted stock, earned over time. These tasks might include building a JV investment business by attracting institutional capital, successfully integrating an acquisition, saving on G&A expenses, finding unusual development opportunities or acquisitions that are not widely marketed, or completing other achievements that enhance the short-term (and long-term) value of the company.

**How Much?** One of the most difficult issues for conscientious Board members is to decide on how big the incentive/reward package ought to be, both on an absolute basis and with respect to any one executive. In other words, even if the targets or assigned goals are all achieved, which provides significant wealth to loyal shareholders, can payments under an incentive plan be so huge that shareholders feel violated – or just want to find the nearest porcelain god into which to pray?

If shareholders are collectively enriched by \$400 million due to the actions of an extraordinary management team (assuming cause and effect can be linked), should they begrudge giving away as much as 20% of that (or \$80 million) to the guys who made it happen? After all, nobody complains about giving up 20% of hedge fund profits to its managers. Isn't the opportunity to create substantial wealth for oneself at least some part of the American Dream? Or does \$80 million simply offend our sense of "fairness" – whatever that is? I cannot answer the question of how much compensation would be necessary to meet the test of "gross and disgusting." Perhaps, here, we are left with the words of Justice Stewart in his concurring opinion in a US Supreme Court case defining obscenity: "I know it when I see it."

**A Workable Comp Plan?** It's easy, of course, to throw brickbats<sup>2</sup> and lodge criticisms. It's much more difficult, sitting down in a Board room, to devise an executive compensation plan that will provide incentives that might actually work, be reasonable in dollar numbers, create alignment of interest between management and shareholders, and be "fair" to both. Such a plan should also be workable from the perspectives of taxation and financial reporting, be understandable to all constituencies and not encourage some employees to quickly gather their winnings and ride off into the sunset. A really good plan is as difficult to develop as a shopping mall in Santa Monica, California.

But let's try, shall we? If I were a director of a REIT (which, of course, will happen only when the Cubs next win the World Series<sup>3</sup>), I'd be happy with a plan along these lines:

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<sup>2</sup> From Wiktionary: **brickbat** (*obsolete*): A piece of brick used as a weapon, especially if thrown, or placed in something like a sock and used as a club.

<sup>3</sup> The last time they won the Series was in 1908.

- Virtually all employees would have a stake in it, and be entitled to a substantial payday if the criteria are met – this is good for morale, good for business and is the right thing to do
- There should be both short-term and long-term components of the program, the former being task-based, much smaller in award size, and payable at the end of each year – and should *not* be based upon the company’s stock price performance
- Go easy on stock options; sure, they are easy to administer and have well-defined tax and accounting aspects, but they create conflicts of interests, are not well-suited to REIT organizations and may instill in the executives a desire to goose the stock price rather than to create long-term value – however, due to their advantages in simplicity, perhaps options are OK for “rank-and-file” employees
- The long-term program would enable executives, and perhaps other employees, to earn very substantial incentive awards, up to a designated maximum dollar amount based upon some percentage of the company’s equity market cap or net asset value, vesting over a period of no less than five years and payable in company stock; awards would be pro rated to new employees and executives who are hired in the midst of the 5-year plan
- Long-term awards would vest only upon achievement of *a mix* of several different sets of goals and criteria, such as: (a) stock price performance over the 5-year period, *but only in relationship to the REIT’s peer group*; (b) growth in company (not stock price) valuation over such period, perhaps measured by per share NAV growth plus dividends paid, but no awards should be payable unless this measurement exceeds the company’s cost of equity capital<sup>4</sup>; and (c) achievement of well-conceived 5-year business and strategic goals – this component might be revised annually, based upon changing circumstances and business conditions.

OK, laughter is now permitted. I haven’t spoken with any lawyers, accountants or independent directors, and they would no doubt tell me that a plan of the type suggested above would be: (a) rife with accounting problems, (b) impossible to draft with clarity, (c) incomprehensible to investors, (d) unpopular with REIT executives, and (e) otherwise totally unworkable. Perhaps so. But never underestimate the genius of smart lawyers and accountants when told that they need to get something done and that, if they don’t, someone else will be found to do it.

“Well, that was really brilliant of you, Block. You’re going to the NAREIT convention in two weeks, and hope to talk with some REIT executives about business and such. Based upon your half-baked theories set forth above, you’ll be lucky if every one of your appointments isn’t cancelled.” Perhaps so. But *someone’s* got to sacrifice his body for the good of cause. Might as well be me; it’s an old body anyway.

Best regards,  
Ralph (Block)

***Disclosure: I and/or the firm(s) to which I provide services may from time to time have long or short positions in some or all of the stocks (if any) mentioned above. Further, this “newsletter” is not intended as a recommendation for the purchase or sale of any particular security and is not intended to be investment advice – or any other advice for that matter. The statements made in this newsletter are my own personal opinions, and do not represent the views of Phocas Financial any other person, real or fictitious, or even the views of Sammy, my Golden Retriever. © 2006 Ralph L. Block***

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<sup>4</sup> “Cost of equity capital” is a term that’s often more squishy than a week-old persimmon, but should roughly equate, in my opinion anyway, to an internal rate of return expected by the REIT’s shareholders (or at least the most reasonable of them)..