REIT EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE INSIGHTS

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Current Challenges Impacting Compensation Design

The discussion and focus surrounding "strategy" and how that impacts REIT executive compensation programs has meaningfully increased. Best practice is to ensure that REIT compensation programs are directly aligned with the company's annual business and long-term strategic plans, which often requires deviating from the norm and possibly investor expectations.

Current Challenges in Designing REIT Compensation Programs

- **Setting Cash Bonus Goals - Especially In Periods of Declining Profits**
- **Designing Long-Term Incentives Beyond TSR Measures**
- **Appropriateness of Granting Special Awards**
- **Ensuring Proper Severance Program Are In Place**

1 Setting Cash Bonus Goals

The alignment of short- and long-term strategy with incentive plans should always be a driving force around compensation decisions. Being mindful of what needs to be accomplished in the short-term, even if it represents a decline from prior year's performance, allows employees to focus on current strategy and what needs to be achieved now to be successful in the long-term. Short-term incentives should be based on performance targets that are considered achievable, but require strong effort, which calls for a delicate balance of planning and forecasting.

Many REITs experience challenges setting bonus hurdles in periods of declining profitability, specifically when it may be appropriate to set a performance target that is lower than the prior year. Very few companies increase profitability every year for the life of the organization ("success is not a straight line") and accordingly, most REITs encounter this issue at some point. A few key considerations that should be analyzed include:

- "Maximum" payouts may need to include more significant stretch goals than prior plans since it is harder to justify above target payouts in periods of declining profitability and should require extraordinary effort.
- ISS guidelines state that in these situations "clear disclosed rationale for lowered financial performance targets" is necessary.
- If the decline is a direct result of mismanagement, paying significant value to executives to "fix their mistakes" may be harder to justify.

2 Designing Long-Term Incentives

Non-TSR metrics continue to increase in prevalence as REITs incorporate measures beyond TSR into their performance-based equity compensation programs in order to provide management with a more direct line-of-sight between company results and a payout, given the number of macro-economic influences on stock prices that are outside of management's control. Based on our "2018 Executive Compensation Report: Real Estate Industry Long-Term Incentive Compensation Practices", 37% of REITs use a non-TSR metric to determine the vesting of performance shares, but that percentage is projected to continue to increase.

Historically, REITs established a strong preference for TSR measures that provide fixed accounting treatment over other financial and operational measures that result in variable accounting and need to be marked-to-market on a quarterly basis (and may impact FFO results). REITs continue to use long-term operational measures more frequently in consideration of, but not limited to, the following:

- TSR has a strong reliance on macro-economic factors. Therefore, operational measures can help focus management on accomplishing long-term strategic priorities that may enhance long-term value.
- Many REITs are experiencing "disruptive" factors, such as large tenant bankruptcies or the market undervaluing their assets, that may require management to focus on amending their strategy. Incorporating the shifting strategy into the compensation program through long-term incentives can be a well-thought out approach given the long-term nature of real estate.
- Select investors and proxy advisory firms have been advocating for metric diversification beyond TSR.

3 Special Compensation Awards

The use of special one-time stock awards has declined in the REIT industry, as the concept has come under heightened scrutiny over the past several years by both proxy advisors and institutional shareholders. One-time awards without compelling rationale significantly increase the probability of negative say-on-pay results due to the fact that investors generally do not like this concept (as they prefer compensation structured in advance) and the impact it will have on the pay-for-performance alignment tests conducted by ISS and Glass Lewis (which typically measures CEO pay relative to peer companies). Additionally, institutional investors may have a policy against these types of grants, such as State Street Global Advisors who has a policy that if a large one-time payment "cannot be justified or explained", they will, at best, vote "Abstain" for Say-on-Pay if they do not vote "Against".

Boards and Compensation Committees may rightfully believe that there is a need from a business perspective to issue special incentive grants, but the threshold to approve these grants has increased and consideration of other alternatives is generally explored in detail (e.g., smaller annual grant adjustments, issuing only special performance shares, etc.). Recent examples of special equity awards granted outside of the regular compensation program include:

- The CEO of Kilroy Realty Corporation was granted a special retention award in connection with his new employment agreement equaled to $30,000,000. The award was allocated 45% to time-based RSUs that half vests at the end of years 3 and 4 and 55% to performance-based RSUs that may be earned contingent upon relative TSR over a 3-year or 4-year performance period.
- JBG Smith Properties granted a special award to executives and employees in connection with the Company's successful attempt to secure Amazon's tenancy pursuant to the HQ2 search. The total pool had a target value of $35 million and a maximum value of $55 million. The awards vest 50% based on time with half vesting at the end of years 3 and 4 and 50% based on relative TSR over a 3-year performance period.
- Pebblebrook Hotel Trust paid special retention cash bonuses equal to 50% of each NEO's base salary in connection with the successful merger with LaSalle Hotel Properties.

4 Severance Programs

Discussions pertaining to employment agreements, severance arrangements and change-in-control provisions in compensation programs (for both the C-Suite and the broader employee population) have occurred with greater frequency. The uptick in REIT M&A activity has emphasized the need to ensure that proper, market-based severance plans are in place. Severance and separation benefits are key elements of compensation that can help reduce the risk of litigation and provide a sense of security to employees.

A review of severance policies should include:

- Consideration of the most appropriate structure: employment agreements, individual severance arrangements or company-wide severance policy. The appropriate structure may be different for various employee levels.
- Identifying the right severance formula. Severance formulas for the C-Suite are usually based on a set multiple of salary and cash bonus, with multiples varying significantly based on the termination scenario and position level. Other employees often receive a payment based on either (i) a flat number of weeks based on years of service, (ii) a formula based on position level and years of service or (iii) predetermined sum based on position level.
- Ensuring the appropriate treatment of performance-based equity awards following a termination or in connection with a change-in-control.
- Review of tax implications of a change-in-control, including 280G and 4999 excise tax exposure (which results in a 20% excise tax on any compensation deemed "excessive") and 409A compliance. The tax assessment should also review strategies to limit excise tax liability.

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Our services include:

Competitive Compensation Review	Incentive Plan Design	Proxy-Related Services	Corporate Governance Services
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Pay magnitude and program structure	Pay mix	Calculate potential severance payments	Guidance on institutional investor and proxy advisor policies
Employment and severance agreements	Plan leverage and calibration	CEO pay ratio calculations	Board and executive evaluations
Salary banding and grading	Accounting and tax implications	Equity incentive plan design	Succession planning
Pay philosophy and objectives	Plan vehicle selection	Audit of compensation tables	Compensation risk assessments
Board of directors compensation	Payout calculations	Forecast pay-for-performance results under the ISS model	Corporate governance diagnostics

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