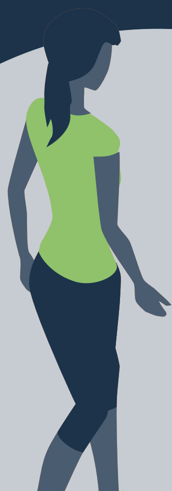
FPL Associates

REIT Compensation and COVID-19: Navigating a New Crisis and Compensation Considerations

A Guide for REIT Compensation Committees and Leadership

As we all know, we are experiencing unprecedented times on many levels, with the REIT industry not immune to the impact of the COVID-19 outbreak. At FPL, we experienced first-hand the Global Financial Crisis (GFC) and the actions taken by REIT Compensation Committees to navigate those turbulent times. While the full impact of the COVID-19 outbreak is too early to gauge, the following is meant to provide some context on the gravity of the current situation and acknowledge a number of compensation-related items that Compensation Committees and leadership should be mindful of to ensure key talent is motivated and focused in a time of uncertainty.



Background: A Tale of Two Crises

Although a dozen years ago, we are easily reminded of the GFC which was a very different type of crisis, one focused on leverage and liquidity. The market eventually took 18 months to recover from the nearly 60% stock price drop. Things looked dismal — development activity effectively halted, layoffs occurred, and transactions came to a standstill. However, REITs were a highlight, successfully raising capital and reworking their balance sheets, which largely led to outperformance of the broader industry for the first four years post crisis:

- Compared against each of the S&P 500, Dow Jones Industrials, NASDAQ Composite, and Russell 2000, the Nareit Equity REIT Index outperformed every one of those indices across each of 2009, 2010, 2011, and 2012 with the only exceptions being in 2009 when the NASDAQ outperformed the REIT industry and in 2011 when the Dow Jones Industrials outperformed the REIT industry (by a mere 10 basis points).

Leading up to this crisis in 2020, REITs had been performing quite well — the MSCI US REIT Index was at an all-time high and 50% of REITs announced earnings for fourth quarter 2019 that were higher than consensus analyst estimates. The industry was healthy, and ironically, the hotel REIT sector had the highest percentage (62%), surpassing earnings estimates of any property sector. This time around, the stock market went into bear market territory in record time and extreme market volatility persisted:

- Just 16 days to achieve bear market status — the next closest was over twice as long at 35 days during the Great Depression back in 1929. This drop was 10 times faster than the average of 164 days to achieve bear market status.
- Three of the 15 largest single-day percentage drops in history occurred from March 9–March 16.
- During that same week, one of the top 10 largest percentage increases in the history of the stock market occurred.

As can be seen in Exhibit 1, the equity REIT industry fell by approximately 42% and the mortgage REIT industry by 58% from the February 21st peak through March 20th – lodging/resorts and malls being hit the hardest. Additionally, REITs as an industry have thus far fallen faster than the S&P 500.

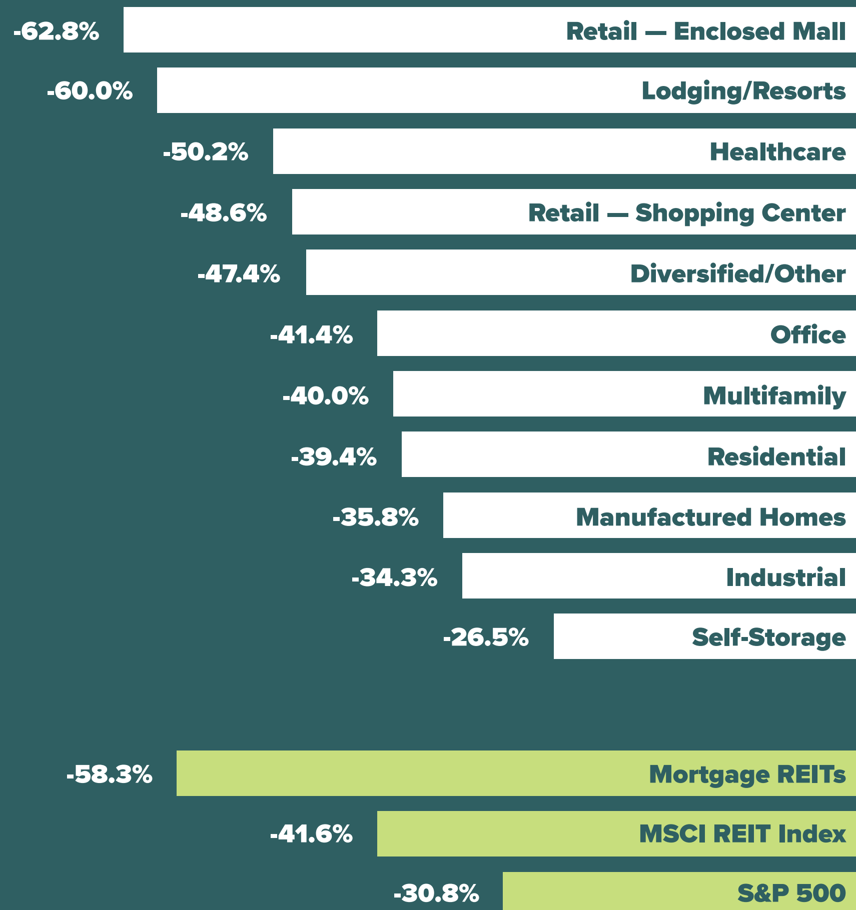


Exhibit I. Total shareholder return from February 21 to March 20, 2020

Source: S&P Global Market Intelligence

The issue this time around is extremely low visibility as to when the markets may recover based on events beyond anyone's control (which later on is why recalibrating any type of bonus goals for 2020 at this stage may be a futile exercise). At the beginning of March, the famed economist, Nouriel Roubini, who is often referred to as "Dr. Doom", stated "this is going to be a very severe, but short recession" yet just a few weeks later noted "The contraction that is now underway looks to be neither V- nor U- nor L-shaped...rather, it looks like an I: a vertical line representing financial markets and the real economy plummeting." Each of Bank of America, Deutsche Bank, Goldman Sachs, JPMorgan, Morgan Stanley, and UBS expect a massive contraction in Q2 GDP, with some already declaring the U.S. and global economy being in a recession and the remainder noting that we will inevitably get there in the coming months. Forecasts have seemingly been changing by the week with low visibility on how long it may take for a correction. One of the banks stated "These are truly unprecedented events with no adequate historical example with which to precisely anchor our forecast". Finally, a just released UCLA Anderson Forecast reported an outlook at the moment that the 2020 recession will be more severe but shorter than the 2008 financial crisis with a conservative estimate of 6.5% GDP loss in the second quarter and 7.8% a loss of real consumption.

> **"These are truly unprecedented events with no adequate historical example with which to precisely anchor our forecast.**
>
> — Torsten Slok, Chief Economist at Deutsche Bank Securities

The focus by REITs following the GFC to maintain stronger balance sheets and more liquidity (both of which have been utilized as REIT compensation metrics to incentivize management to safeguard against moments just like this) will hopefully provide REITs with a solid foundation to get through this unprecedented economic disruption. According to Moody's Global COVID-19 Impact Heat Map, REITs as an industry are in the low exposure category, although we acknowledge that lodging as a broader sector was listed by Moody's in the high exposure category. Clearly, certain segments of the REIT industry are likely to have a much more difficult hill to climb than others.

2020 Compensation Implications and Key Considerations

Consistent with that of most public companies, within the past two months, the vast majority of public REITs completed the compensation process, which included setting 2020 incentive goals and granting the next set of equity awards. The current turmoil in the financial markets and the unknown economic impact of COVID-19 has put into question the appropriateness and viability of these recent compensation decisions. While the impact of COVID-19 will play out over the coming months, certain compensation items should be acknowledged (presented in no particular order):

Reduction to Cash Compensation and Modifications to Board Pay: In normal times, rarely do base salaries get reduced — instead, base salaries at the executive level may remain flat over a period of time while other compensation components are adjusted upward. Back in 2008–2009, we observed that approximately 9% of public REITs reduced salaries at the executive level for symbolic purposes as well as to conserve cash and to avoid further cost cutting/workforce reductions. Additionally, similar actions may be taken to board compensation, which we also observed during the GFC, particularly in situations where a company had reduced its workforce and/or reduced/suspended dividends.

FPL Perspective: While we do not expect to see an industry-wide surge in salary reductions, pending the duration of the COVID-19 outbreak and the short-term impact to cashflows, we anticipate a similar number of salary reductions to once again occur. Already, four hotel REITs (Ashford Hospitality Trust, Hersha Hospitality Trust, Park Hotels & Resorts, and Pebblebrook Hotel Trust) have announced salary reductions to key executives (two of which also made adjustments to Board of Director pay), and while not REITs, both the the CEO and Executive Chairmen of Hyatt Hotels and Marriott International have each announced that they would forgo salaries (Hyatt will last through a furlough period and Marriott for the balance of 2020) and each of their executive teams would take a 50% cut in pay. Adjustments to board compensation may include a temporary reduction and/or a shift from cash compensation to equity awards.

Bonus Programs and Use of Discretion: Many REITs already have incorporated a 20–30% allocation to discretionary or subjective performance components into their annual incentive programs to ensure that the Compensation Committee has the ability to use business judgement and not just rigid formulas to compensate management. A discretionary component allows the Board to reward for performance during unplanned hardships when pre-established goals may become unrealistic, or even irrelevant. Already we have witnessed many public REITs withdrawing guidance for the year, less than a month after issuing it, and yet bonus programs tend to have a degree of alignment with the upcoming year's budget/guidance. We saw during 2008–2009 many REITs raising equity that was critical to surviving and paying down debt, etc., which in part was dilutive to earnings and FFO per share targets; however, Compensation Committees often times exercised discretion and adjusted bonus payouts to avoid any misalignment or conflict between what was best for the company and what was a bonus goal.

> **Modifying bonus programs at this time may be premature – with extremely low visibility we suggest a wait and see approach, but in all likelihood, this is an extraordinary year that ultimately will require discretion for evaluating performance across 2020.**
>
> — Jeremy Banoff, Vice Chairman, FPL

FPL Perspective: We would not recommend making bonus goal adjustments at this time or even midstream, particularly as reforecasting amongst extremely low visibility may be very challenging. Rather, akin to 2008–2009, we suggest letting the fiscal year play out and business results unfold. For year-end 2020, Compensation Committees should be prepared to engage in much more meaningful year-end discussion on what is the "right" amount of compensation in light of macro-economic circumstances — understanding what was beyond management's control and the extent by which leadership helped to successfully navigate through the times, while also being sensitive to any workforce reductions and lost shareholder value.

It will be critical to provide shareholders with significant transparency to understand the Board's decision-making process if significant discretion is exercised. Although proxy advisory firms (e.g., ISS and Glass Lewis) tend to disfavor subjective programs and using discretion, managing the business in the best interests of shareholders should be the absolute and primary focus - doing what is best for the company when confronted with extraordinary times should take precedence over how proxy advisory firms may react. Through adequate disclosure, hopefully investors will recognize when prudent decisions are made albeit outside of a traditional framework.

Performance Awards Based on Relative TSR and Other Measures. Shifting to long-term incentive programs, relative total shareholder return or TSR has by far been the most common metric across the industry. One major benefit to relative TSR is that it mitigates the impact of macro-economic conditions and will allow outstanding performance awards to retain value notwithstanding the significant decline in absolute TSR during this volatile period. In recent years, however, there has been a trend to incorporate performance measures beyond TSR to both deleverage away from TSR-only plans and provide a means to reward for more controllable financial/operational metrics that should create shareholder value. Depending on the financial or operational metric(s) used, the impact of a negative TSR year may be further mitigated and also help to refocus management efforts on performance factors within their control; however, at the same time and akin to the discussion above with respect to such metrics in a cash bonus program, they may now carry little motivational value. Note that discretion is rarely used in a long-term incentive program and modifying an outstanding award grant can have adverse accounting consequences.

FPL Perspective: There were only handful of instances in 2008–2009 where equity awards were modified and/or cancelled. In fact, due to the REIT industry's strong performance, as noted at the outset and after the GFC, many awards ultimately held value and were earned above target levels. In addition, with the prevalent rolling program award structure, whereby a new stock grant is made each year, to the extent stock prices do not quickly recover, the next round of equity grants are likely to contain some real upside potential.

Sector-Based Performance Peer Groups: In conjunction with the increased use of relative TSR, many companies have adopted a more tailored performance peer group that may reduce the impact of macro-economic factors on award payouts. For example, while hotel REITs have been amongst those most adversely impacted by the existing crisis, for those that have structured awards versus a defined peer group of other like-kind companies (e.g. hotels), it will allow the award to retain value if the company can outperform its closest competitors. By contrast, if a hotel REIT was being measured against a broader REIT index that may not be as impacted by imposed travel restrictions and cancellations, the outstanding performance awards would immediately feel worthless to the recipient.

> “There will be no one size fits all approach to 2020 compensation decisions, and meaningful thought and analysis will be necessary to determine the most appropriate solution for each REIT.
>
> — Katie Gaynor, Senior Managing Director, FPL

FPL Perspective: Although nothing to immediately do at this time, Compensation Committees should spend time this upcoming year to better understand the correlation in performance of its company with that of its peers, its industry/sector, and that of the broader REIT industry or another comparator industry/index. Backtesting analyses should be performed to fully ensure that selected metrics and relative comparisons are optimally established.

Absolute TSR Modifiers: The adoption of an absolute TSR modifier is an emerging best practice and one that has been gaining prevalence across both public REITs and public companies more broadly. Specifically, these tend to most commonly apply whereby even if the company outperforms a certain goal (such as relative TSR), a negative absolute TSR outcome (i.e., shareholders lost money) will result in payout being scaled back to some predetermined amount — awards are most commonly capped at target.

FPL Perspective: For those that currently use an absolute TSR modifier, the impact of such should be re-examined to understand the degree to which outstanding awards may be reduced and if an alternative modifier structure should be considered for new grants. It is important to understand the full spectrum of design parameters within a modifier framework and alternatives for consideration.

Other compensation matters that REITs may want to consider actively monitoring and reviewing include:

- **Profits Interests/LTIP Unit Book-Up Events:** REITs that utilize profits interests/ LTIP Units should do a strategic review of the impact of the share price declines and the potential to book-up previous equity grants. This may include analyzing available book-up events prior to the stock price drop and understanding if NAV may be relied upon to meet the book-up requirements.

- **Equity Grant Considerations/Review of Plan Capacity:** With a decline in stock prices, REIT should be sensitive to any stock grants that may need to be issued in the coming months, including:

    - Consider deviating from typical grant policy to ensure that awards are not overly dilutive and creating an unintended windfall to recipients (such as planned new hire grants) by using a trailing average share price instead of a spot price to determine the number of shares/options to be granted or consider granting in tranches over the next 2–3 quarters.

    - Actively monitor share availability in equity incentive plans to ensure ample capacity to issue 2021 annual grants as the need to replenish capacity may be sooner than originally anticipated.

- **Deferred Compensation Options:** Companies should review any potential benefit programs, including the availability of deferred compensation programs that may allow executives to hold shares without net settlement (which at depressed stock prices will require more shares to be sold to cover tax obligations).

- **Change in Control and Severance Policies:** REITs should also be reviewing their executive and broad-based severance policies to ensure that proper, market-based severance plans are in place. Depending on the period of time that REIT stock prices remain depressed, it could create an opportunity for mergers/privatization at opportunistic pricing. Accordingly, making sure your change-in-control severance provisions are appropriate may become critical.

- **Employee Stock Purchase Plans (ESPPs):** Many companies have ESPPs that may have served as a positive benefit to the employee base in recent times and during the 11-year bull market run. However, as stocks have quickly declined in value, there may be employees that are now reluctant to take advantage of participating this year. In being sensitive to cash-based needs of employees, no different than continuing participation in a 401(k), it is important to recognize that now may actually be an optimal time for many to participate in a company's ESPP.

- **Stock Ownership Guidelines:** The vast majority of companies have stock ownership guidelines for both executives and Directors. The most common structure within these types of policies is a requirement to own equity with a value that is a multiple of base salary for executives or cash retainer for Directors. With depressed stock prices, the value of what is owned is likely now worth significantly less. Companies should revisit their policies to understand the requirements and whether carve-outs currently exist for meeting a guideline and then falling below such due to stock price declines, without the need for executives and Directors to purchase additional shares to come back into compliance.

- **Virtual Board Meetings:** Many companies will now be conducting virtual board meetings. In a time of being required to shelter in place, it will be imperative for companies to equip their boards to function remotely which should include communicating more regularly with meaningful updates to ensure that the board continues to operate effectively during this time when oversight and strategic support is of upmost importance.

- **Proactive Communication:** Transparency and proactive communication is of critical importance during times of uncertainty to ensure that employees understand the impact this may have on them financially, which may include reassuring them that the focus is on the business and what is best for key stakeholders with compensation to be reassessed and handled reasonably and appropriately.

Lastly and most importantly, *do not panic!* These are extremely volatile times with more questions than answers. The disruption caused by the GFC looked dire, yet a big turnaround occurred for several years thereafter. While these crises are not completely analogous, it at least provides some key lessons and a beginning roadmap to navigate through the current uncertainty.

Being proactive and highly communicative amidst a remote and virtual world will be key for safeguarding your leadership and human capital to be in the best position to persevere. Please do not hesitate to reach out if we can be of help in any way, even if only as a sounding board during these unprecedented times.

We hope all remain healthy and safe and we look forward to being in touch.

Jeremy Banoff
Vice Chairman of FPL Associates L.P.

123 North Wacker Drive— Suite 1900
Chicago, IL 60606
jbanoff@fplassociates.com

Katie Gaynor
Senior Managing Director

3540 Toringdon Way— Suite 200
Charlotte, NC 28277
kgaynor@fplassociates.com