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Compensation Trends in Private Real Estate

2023

The past several years have represented a period of strong performance and significant competition for talent among private real estate firms. This period translated into compensation levels that were meaningfully higher than historical run rates. The private real estate industry is now contending with significant questions around inflation, interest rates, access to capital and underlying market fundamentals, causing many firms to revisit their investment strategy and capital sources. As firms adjust business plans, ownership structures and forecasted returns, private real estate compensation programs are also being reassessed and modified to ensure alignment with the company's short- and long-term strategy and objectives.

Below are four trends that Ferguson Partners has observed in 2023 at private real estate firms:

1 Increased Use of Non-Promote LTI Programs

Historically, promote or carried interest programs have been the foundation of most private real estate compensation programs. Promote programs align well with companies engaging in high-return real estate assets and focusing on value creation over a five to ten year investment period. For many companies, these programs continue to be appropriate and align well with the strategy, but for a growing number of private real estate firms, new or additional LTI programs are being implemented. There are several alternative LTI programs that can be put in place to effectively align evolving strategies and ownership structures with employee compensation. Some of the most commonly implemented plan types include:

- Enterprise equity (real or phantom)
- Cash-based LTIP often tied to profitability or investment returns
- Stock appreciation rights in the operating company
- Synthetic promotes
- Expansion of annual bonuses with a deferred cash component

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While many real estate firms have made meaningful changes to LTI programs, the reasons cited vary company to company and often include:

- Adjusting investment strategy, which may include focusing on Core or Core plus products and expecting lower returns or holding properties in an open-ended vehicle that may not produce meaningful incentive fees
- Change in capital partners
- Creating a management operating company
- Addressing succession planning needs
- Desire for more frequent payouts
- Expanding LTI eligibility to aid in retention

2 Expansion of Co-Investment Programs

In recent years, co-investment from management has grown due to increased investor and employee demand. Accordingly, firms have made a concerted effort to formalize or develop co-investment programs to further align interests. Programs can be structured in a variety of ways, with one of the key decision points being whether co-investment is required for select employees or offered as an optional total rewards benefit. Below are additional co-investment observations in the industry:

- While co-investment has long been prevalent in the investment management space, it is emerging as a trend in other types of real estate firms, such as family offices and developers, in order to remain competitive with third-party investors
- Firms that have historically offered co-investment on a one-off basis and without formal guidelines are opting to add structure to increase transparency, right-size individual amounts, and ensure co-investment is distributed evenly across all investments
- Employer-sponsored financing programs (either company balance sheet loans or favorable rates from bank relationships) continue to be attractive to help facilitate co-investment, particularly when an employee's commitment is required

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Co-investment has become an effective tool for employers to increase the effectiveness of total rewards programs without increasing compensation expense. When designing co-investment programs, it is important for firms to consider the following:

- Appropriate eligibility parameters considering the accredited investor requirement as well as the administrative burden required to expand participation to a broader group of employees
- Potential drawbacks of co-investment programs for participants, particularly for employees who have limited liquidity
- Alignment with current investment strategy and ownership structure
- Limiting "cherry picking" to ensure employees do not have an outsized interest in any one particular deal or fund

3 Enhanced Employment Protections for Key Employees

The utilization of employment agreements has increased significantly for private companies. Historically, employment agreements were used for incoming executives recruited from outside of the organization to assist in the recruitment process. It was less common for long-tenured employees to have similar arrangements as the protections often provided in employment agreements were not considered necessary by the employer or the employee. Disruption at private real estate firms has resulted in the expansion of employment agreements, particularly to formalize cash severance arrangements and equity treatment upon certain qualifying terminations.

Potential Benefits of Employment Agreements with Key Employees

4 Increased Need for Competitive Board Compensation

As private real estate companies scale over time, enhancing the governance structure becomes imperative and often includes adding new independent directors. As part of this process, establishing a director compensation program that is commensurate with the skills, time commitment, responsibilities and risk of being a board member is of upmost importance. Misaligned board compensation can result in unexpected challenges with the company's ability to effectively recruit qualified new members and maintain a sense of fairness amongst existing board members. Further, this can also result in a misalignment of interests between directors and owners.

Establishing a fair and equitable board compensation program often entails the following:

- Understanding board pay levels at similar organizations
- Considering if there are material time commitment differences amongst the company's directors, which could be the result of certain leadership roles or committee involvement
- Considering if board activity is expected to be steady or vary significantly year to year
- Contemplating if insider/family directors should be compensated and if so, at what level
- Considering if equity is an appropriate board compensation element

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The competition for qualified board members, especially diverse candidates, is at an all-time high. For real estate firms looking to expand or refresh their board of directors, a competitive and fair compensation program will be critical.

About Ferguson Partners Private Compensation Consulting Practice

Our private compensation practice provides objective and independent advice and guidance to ensure that a compensation program is competitive, balanced and well-aligned with a company's business model and strategy. With over 250 real estate projects conducted each year, Ferguson Partners Consulting holds access to the most comprehensive data in the industry, allowing us to advise clients on the most complex compensation matters. Our services and capabilities include:

Perform comprehensive reviews of pay levels and program design

- Covers all organization levels, functions, and regions
- Addresses all compensation components, incentive plans, and terms/conditions

Benchmark individual compensation levels against relevant market practices

- Develop customized peer group based on factors such as size, ownership, strategy, and geography
- Create customized analyses for each individual under study based on roles and responsibilities

Provide information and guidance to help interpret benchmarking results

- Help determine how to balance market data and internal considerations
- Provide strategic guidance for pay adjustments over time
- Develop salary structures
- Establish framework to differentiate pay for various functions

Design annual and long-term incentive plans with the following characteristics

- Reflects industry best practices
- Utilizes performance criteria tied to strategy and business objectives
- Aligns management's interests with those of all other key constituents
- Links pay to performance

Advise clients on how to navigate complex compensation issues related to the following:

- Alignment of incentives to support strategic initiatives and goals
- Changes in capital/fund formation and the impact on compensation
- Changes in ownership, leadership, and/or organization structure

Review and opine on other compensation-related matters, including the following topics:

- Employment contracts
- Co-investment
- Job descriptions and titles
- Benefits/perquisites

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