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REIT Executive Compensation and Talent Management Trends

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The commercial real estate industry as a whole has weathered some significant market changes in recent years, yet real estate investment trusts (REITs) "are still generally showing strong fundamentals" according to Fidelity Investments. Managing Directors Mike Esser and Bill Reilly work with a number of REITs and recently offered some insight on current executive compensation and talent management trends in this market.

Q: You work with quite a few public REIT companies. What are their compensation committees dealing with in 2023?

Mike: The biggest issue for most of my REIT clients has been goal-setting for their annual incentive and performance-based equity plans. REIT as an acronym is broad and different sectors within real estate have been impacted differently by Covid-19 and its macro effects. Consider the different challenges faced by skilled nursing and assisted living facilities, retail, commercial/office, and industrial/warehouse REITs versus those specializing in residential, multi-family, or laboratory space. Layer in the impact of rising interest rates and uncertainty regarding the economy in general, and the go-forward picture is foggy at best.

This continually evolving environment may require companies and their compensation committees to widen the performance ranges in their incentive plans to accommodate less visibility in setting goals and a wider range of performance outcomes. It also may require committees to exercise greater discretion—and be prepared to defend it—in performance determinations and payouts to account for the rapidly changing environment.

Bill: For my clients, the biggest challenges pertain to incentive award determinations for 2022, including potential use of discretion, the impact of continued economic uncertainty on incentive plan design and goal-setting for 2023, employee attraction and retention concerns, and preparing for the pay-vs-performance proxy disclosure requirements. The market for experienced talent remains strong, as does wage inflation. Rising interest rates and potential recessionary pressures are impacting margins, balance sheets, and the ability to raise capital to fuel ongoing growth, making incentive plan goal-setting more challenging.

Many REITs use a combination of quantitative and qualitative metrics within short-term incentive plans which allows for some additional flexibility in terms of award funding versus the broader market. However, compensation committees are very mindful of shareholder optics and the anticipated increase in external scrutiny of executive pay levels and practices, especially with the new proxy disclosures, which may not provide clear, useful information.

Q: It does sound like at least some talent management and human capital issues are of concern. In the last few years, we’ve seen boards in industries like retail and manufacturing talking more and more about these themes. Do you see the compensation committees in this industry similarly expanding their purview?

Bill: Boards, and in particular compensation committees, have become increasingly focused on various human capital topics, such as diversity, equity, and inclusion (DE&I), talent development, and employee engagement. This is true among REITs as well as the broader real estate market, and is not surprising, given strong labor markets over the past several years as well as employee expectations for more flexible and inclusive work environments.

Approximately half of publicly traded respondents within Pearl Meyer’s most recent executive pay practices survey (published in October 2022) included DE&I among compensation committee oversight responsibilities, with more than 40% also listing leadership and talent development. Additionally, the largest year-over-year increase in prevalence was for employee engagement, as reported by one-third of respondents.

Most REIT boards receive regular, periodic briefings on human capital issues, with the top HR executive seen as a strategic partner, unlike in the past, when this role was often primarily viewed as operational or administrative in nature. Compensation committees are also encouraging management teams to develop more formal strategies, policies, and measurement tools relating to environmental, social, and governance (ESG) objectives, with many REITs continuing to add and/or increase the emphasis on ESG metrics within executive incentive plans. We expect this trend to continue as boards increase their focus on human capital topics and their ability to create competitive advantages for their organizations.

Mike: I agree with Bill. Over the past few years the board’s remit has expanded to include monitoring and oversight of ESG, DE&I, and broad human capital, talent management, and leadership development.

The frankly huge scope of these issues has impacted compensation committees in particular, now frequently charged with a broader purview and often reflected in an updated name. We’ve seen examples like “human capital” or “talent and compensation committee.”

For the REITs that we work with, the “e” in ESG is particularly important in that it directly impacts the business, where an emphasis on energy efficiency, LEED, and other certifications are not just differentiators but expectations of the assets they own and manage. We have several clients that have incorporated ESG and DE&I metrics in their annual bonus plan scorecards or as discretely weighted metrics. And the committee and board is regularly updated on progress toward goals throughout the year.

Finally, there is an increasing focus on leadership and talent development within the REIT itself, as the competition for talent is intense, and includes private real estate firms that often have greater flexibility in crafting compelling career development and pay opportunities.

Q: So many REITs begin as private entities and eventually go public. How do you suggest these organizations move from an incentive structure that rewards past results to one that’s more public governance friendly and is forward-looking?

Mike: As the question suggests, perhaps the biggest compensation challenge is pivoting incentive plan design from an informal, retrospective “bonus” approach (characterized by a fair amount of discretion) to a prospective and more formalized and formulaic “incentive” common to public companies and favored by institutional investors. This transition can be difficult for private real estate companies that have historically been entrepreneurial in their approach, and where the timeframe to value realization can be long.

In addition, the vehicles utilized for long-term incentives are very different between private real estate firms and public REITs. Private firms are often focused on asset appreciation and value creation, so their LTI programs favor appreciation vehicles such as carried interests/promotes and OP—operating partnership—units. Public REITs are often asset management and income-focused, and their LTI programs are overwhelmingly full-value vehicles like restricted stock units or performance shares . Metrics within the plans differ too, with public REITs largely focused on funds from operations—also called “FFO”—in their bonus plans.

Bill: In terms of incentive plan design, public REITs are taking a more holistic view of performance, incorporating multiple metrics within short-term and long-term incentive plans. As mentioned, STI plans often include a combination of financial and strategic objectives, including ESG goals, which may be quantitative and/or qualitative. For LTI, most REITs use a combination of performance-based and service-based award vehicles to tie a portion of executive pay to longer-term, sustainable performance and value creation while also enhancing retention.

Among my clients, relative total shareholder return (rTSR) remains the most prevalent LTI metric, since relative goals are generally easier to establish than absolute ones, especially over multi-year periods. Further, there are plenty of REITs for inclusion in comparator groups, and relative TSR can promote strong shareholder alignment and support. Many REITs now also tie a portion of performance-based equity grants to one or more financial, operational, and/or strategic goals. Publicly traded REITs also need to be mindful of equity plan dilution and share usage levels as well as shareholder advisory group and institutional shareholder voting policies.

Regarding transitions: I have seen a number of privately held real estate organizations begin to adopt broader market governance practices *prior* to going public, recognizing their benefits regardless of ownership type. This is very helpful and typically starts with establishing a compensation philosophy to guide plan design and administration in support of desired program objectives. It also entails recruiting independent board members and establishing formal board committees to help with fiduciary oversight. REITs will also need to incorporate various governance policies prevalent among public companies, such as stock ownership guidelines, clawback policies, and stock hedging/pledging prohibitions or restrictions.

About the Authors

Bill is a senior advisor on executive and director compensation, helping committees and leaders set pay strategy, benchmark competitiveness, design incentives, and navigate contracts, severance/CIC, and governance expectations.

Mike has 25+ years experience advising boards and senior management on executive and director compensation strategy, including annual and long-term incentives and equity design, across a broad range of industries.

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