

Becoming More Active Managers and Overseers

By Judy Warner

Participants

Leigh J. Abrams

Director

Impac Mortgage Holdings

Pike Aloian

Director

EastGroup Properties,
Brandywine Realty Trust
Partner, Rothschild Realty

Carlos C. Campbell

Director

Resource America,
Pico Holdings

Christopher Y. Clark

Publisher

NACD Directorship
magazine and
Directorship.com

William M. Diefenderfer III

Chairman

CubeSmart

Donald E. Ellison

CEO, Chairman

Government Relations,
LLC

Michael F. Foust

Director

Digital Realty Trust

Suzanne Hopgood

Director

The Hopgood Group

Blake Hornick

Partner

Seyfarth Shaw

Andrew S. Levine

Director

SL Green Realty Corp.

Keith M. Locker

Non-executive Chairman
Sunstone Hotel Investors

Issues facing the directors of real estate investment trusts (REITs) are particularly affected by the dynamics specific to this special investment vehicle.

At a recent roundtable of REIT directors hosted by Seyfarth Shaw and moderated by partner John Napoli, who heads the law firm's national tax practice, those issues included say on pay, director compensation, balancing dividend yield versus stock performance and investor expectations of REIT boards in the new year.

The Current Environment

An investment memo issued in November by Cohen & Steers reported that U.S. REITs had a negative total return after posting a strong gain in October. The report stated: "Macro uncertainty, primarily regarding how Europe would handle its debt crisis, drove market volatility that had a bias to the downside. But REITs and other stocks surged at the end of the month—bringing year-to-date returns back to positive—when global monetary authorities provided much needed liquidity to European banks. Also fueling the late rally were better-than-expected U.S. economic data and China's decision to lower its reserve requirement ratio for the first time in three years." In addition, the third-quarter earnings season for real estate companies, according to the investment advisor, "generally exceeded expectations. Guidance for 2012 was modestly lowered, which was more a reflection of global economic uncertainty than a change in real estate fundamentals. REITs continued to demonstrate good access to capital at attractive rates."

Global uncertainty has led to "basically a fear factor in the general economy...and the compression of the business cycle is starting to make REITs think differently about their real estate assets," said Seyfarth Shaw Partner Blake Hornick, who chairs the firm's national securities practice. Hornick noted that the traditional REIT buys,

holds and manages assets that in a static economy "may not lead to much positive growth." Among the consequences is that shareholder value may not be as great as in the past and REITs may have to be more active managers of their portfolios amid a sea of economic, regulatory and other changes.

Having a Say on Pay

For instance, the 2011 proxy season was the first Dodd-Frank mandated but nonbinding say-on-pay votes were in place. In the main, the vast majority of these votes were favorable to the executive compensation program of the issuer. However, litigation stemming from negative say-on-pay votes has resulted in suits against some 10 companies, according to Seyfarth Shaw. Hornick opened the discussion by asking what the effect of say-on-pay votes has been for directors.

"If you look at the whole spectrum of publicly traded companies," said Jeff Morgan, president and CEO of the National Investor Relations Institute, "only about 40 companies had negative pay votes. That's a huge success. And I think what it has shown is that companies have been better communicators or become better communicators of their compensation packages, and investors—as you said—have an up or down vote."

So few negative votes on say on pay was an indication that the majority of shareholders think boards are doing a good job, said Robert Masters, general counsel and chief compliance officer at Acadia Realty Trust, a value-focused REIT that went public in 1998. "That there were such a tiny number of objections to what the boards had put into place says to me that boards are doing a very good job, and the majority of shareholders understand and like what boards are doing," Masters said, adding that "you don't need shareholder access to the proxy to know whether the board or management is doing a good or bad job—that's reflected in the stock market."

One effect of say on pay is that it forces directors to communicate. While the golden rule of real estate

is location, location, location, Donald E. Ellison, a Board Leadership Fellow of the NACD who has been non-executive chair of numerous boards, said directors should adopt a new motto: “communicate, communicate, communicate.”

Rather than an up or down vote, Masters suggested that communications should be more of a dialogue and proxy statements clearly written. Concurred veteran director Carlos C. Campbell: “Communications is a requirement on both sides. From the standpoint of the proxy originators, you have to be very clear and the executive summary must be precise.” This becomes particularly important for REITs that are “value plays rather than profit plays,” Campbell says. “If you are a value

plan, and what are the ranges of compensation calculated,” Locker said.

One participant asked for clarification on the SEC’s proxy access rules, specifically the differences between Rules 14a-8 and 14a-11. The D.C. Circuit Court in September invalidated the SEC’s Rule 14a-11, which would have allowed shareholders who own 3 percent or more of a company’s voting shares for more than three years to nominate director candidates. Even so, investors may still challenge board elections on a non-binding basis under Rule 14a-8. “What it leaves is the ability for shareholders to propose proxy access and put it on the proxy,” Morgan said. Use of that rule is expected to be limited.

Participants

Robert Masters

Sr. Vice President,
General Counsel, Chief
Compliance Officer
Acadia Realty Trust

Jeff Morgan

President, CEO
National Investor
Relations Institute (NIRI)

John P. Napoli

Co-Managing Partner,
New York
Seyfarth Shaw

Frank Poli

General Counsel, EVP
and Secretary
Cohen & Steers

Anthony Saitta

Managing Director
FTI Consulting

Robert S. Smith

Managing Director,
National Capital
Merchant Banking
Director, Tower Group
Former COO, Friedman
Billings Ramsey

Michael A. Torres

CEO
Adelante Capital
Management



John Napoli (left), Robert Masters and Anthony Saitta

play and you’re going out over several years and have an outstanding record of increasing shareholder value, that has to be clearly communicated so that shareholders understand the business model.”

However, new regulations requiring greater disclosure about director qualifications and compensation consultants have added further layers of information to the proxy statement. Has the pendulum on regulation swung too far? Keith Locker, non-executive chairman of the board of Sunstone Hotel Investors, was among the participants who think so. “You can get so lost in 30 pages of disclosure relating to the compensation consultants’ report that it may be a challenge for investors to focus on the main points, the key metrics and assumptions that go into a compensation

Napoli asked: “What questions should the board be asking management about capital market activities and plans to enhance shareholder value?” Michael Torres of Adelante Capital responded that “Generally, once a year we bring in an independent research firm” to help the board evaluate various capital opportunities.

“If you go back a number of years,” Hornick recounted, “REITs were supposed to be a nice, stable dividend, a chance for capital appreciation—a sort of a hybrid, if you will, between bonds and a pure equity play. Well, the world has now turned upside down, and shareholders want more equity appreciation because interest rates are so low, but what you need to do to increase the stock price may require an investment that might lower your dividend yield.”

The reality, offered one participant, is that it depends on your shareholder base—retail versus institutional. Institutional investors tend to be more forgiving about a lower dividend policy. Yet, according to Locker, you need to start with a strategic plan to determine what the company's capital needs will be. “The dividend yield to some extent,” said Masters, “reflects the quality of the portfolio. What's the strength and quality of that dividend over the long term?”

More companies, particularly REITs, are paying

they're doing....I think that as directors get more involved and that as the rules continue to evolve and there are more compliance requirements, there's more risk associated with being a director and compensation should continue to rise. But I think compensation should increase in terms of equity, giving directors more of a stake in the company so they receive the same benefit as well as pay the same price as shareholders based on how well the company performs.”



Blake Hornick (left),
Donald E. Ellison
and Pike Aloian

closer attention to the relationship between their dividend and net income. Said another director: “For some time we didn't pay too much attention to that, but now we're saying, ‘I only have to pay out this much, why don't we only pay out that much?’”

Too Much Compensation?

Napoli redirected the conversation from dividends paid to shareholders to compensation paid to directors. “What is considered adequate compensation? The reality is that it seems directors are more engaged and devoting more time to their director duties, preparing for and attending meetings and getting out to interact with customers, management and investors to better understand the business,” he said.

“It's a different conversation than executive compensation,” noted Anthony Saitta of FTI Consulting, “because clearly directors are performing an oversight role, so the stock price on a one-year or three-year basis will be reflected in what

At what point does compensation then become high enough that a director is no longer independent? “I think that's an individual question,” said Suzanne Hopgood, who has served on a number of boards in turnaround situations. “I've been on boards with people who said, ‘I can't afford to lose this board position.’ And my immediate response is, ‘Well, then, you're not independent.’” Optics are often the issue, she added: “I have been on workout boards, which typically are lower-paying, and the last thing in the world we would do is raise director compensation because regardless of how much time we put in or how much effort it would be a poke in the eye to the shareholders.”

When companies are dealing with uncertainty or financial difficulty, everyone from management to the board is working harder. “In fact,” said one participant, “our board chair generally says to us that ‘Effort is rewarded in heaven, and results are rewarded on earth.’” 