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AMPCAPITAL 

# RUNAWAY PAY AND CONFLICTS OF INTEREST

Governance issues in global listed real estate

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Global listed real estate has escaped the detailed levels of scrutiny on governance that other sectors have received in recent years, particularly in the United States (US). For reasons outlined below, most investors seem to have been content to categorise listed real estate entities as special cases to which the standard governance rules do not apply.

This is changing. Debate is currently raging on whether real estate investment trusts (REITs) in the US should bring their governance practices into line with other sectors.

To put the debate in context, it is common to find a REIT with poison pills at the ready, founders still in control of management and the board, very little board independence and even less board accountability. Only half of the REIT universe in the US has board accountability consistent with the norms of corporate America, according to Green Street Advisors.

While REITs have different corporate and tax structures and their registers tend to be dominated by specialist REIT investors, these factors alone do not explain the different approach to corporate governance.

The difference stems from the state that most US REITs are incorporated in – Maryland. Maryland has a law which enables REITs to call upon extraordinary anti-takeover devices and allows a board to change the date of director elections at any time.

This law protects boards from shareholder accountability in the name of shareholder protection, basically claiming that REITs need to be protected from activist investors who may swoop in and take control of the stock for an unfairly low price. It is a rationale that many investors are challenging.

This paper examines the governance issues that are unique to REITs globally and provides an investor perspective on what needs to change, as well as governance issues that are likely to be topical for the sector in 2017 and 2018. The issues that will be covered are:

- > Shareholder alignment – why alignment is so important
- > Anti-takeover devices in the US – why they should be removed
- > Runaway executive pay in the Australian property sector
- > Tax risk – when does tax minimisation become tax avoidance?
- > Board composition – what does a strong REIT board look like?

## The ESG series

Environment, social and governance (ESG) issues are key considerations for investors in global listed real estate. They represent the non-financial opportunities and risks that affect earnings and valuations, particularly over the long term. ESG issues are notoriously difficult to integrate in investment decisions but this is exactly why they are so valuable. They provide unique insights into the way in which sectors, industries and stocks are changing, and challenge the assumptions we all make about the future.

At AMP Capital, we study these trends in detail. It is an integral part of our investment process. In a series of reports, we are sharing our thoughts on the long-term environment, social and governance factors that we believe will shape global listed real estate over the next five to ten years, along with the investment implications for each:

- > PAPER 1: **Safe as houses?** Global real estate is literally exposed to the weather
- > PAPER 2: **Sharing everything and the last mile:** key social trends changing global real estate
- > PAPER 3: **Runaway pay and conflicts of interest:** governance in global listed real estate

## Shareholder alignment – why it is so vital, even for REITs

Listed companies with strong governance practices are typically more attractive to investors than those with poor governance practices. It is easy to understand why: investors are allocating capital to companies from the outside and have no choice but to trust management and boards to act in investors' best interests. Companies that are well-governed provide investors with the confidence that this trust is not being abused and interests are aligned.

Some of the signs that a stock is well-governed include:

- > Guidance on earnings appears credible;
- > Conflicts of interests are rare and when they exist they are managed well;
- > Management is appropriately incentivised;
- > The board is independent, diverse, experienced and operating as a team;
- > Succession planning is being managed;
- > There is a culture of transparency and accountability across the stock;
- > There are clearly stated systems and processes for dealing with risk, compliance breaches and whistleblowing.

As large investors, we are often asked for a checklist of best practice governance features. Unfortunately, it is impossible to compile such a list. Governance boils down to a set of structures that seek to align interests between those who are running companies (management and boards) and their owners (shareholders). These structures are designed to ensure that boards and management act in shareholders' best interests.

This means that the most appropriate governance structures for any listed company depends on the context and to some extent, the region in which it operates. The structures that make sense for one stock may not make sense for another.

Before investing in any listed stock, AMP Capital's investment teams consider the governance structures that are in place and whether those structures are appropriate. Some of the questions we ask include the following:

- > Is the stock being run in investors' interests, or management's interests?
- > Is the board independently overseeing management effectively?
- > Is there a culture of accountability?
- > Do the executive pay structures make sense and drive appropriate behaviour?
- > Do investors have access to the board and its management team?

These questions are designed to elicit the investment risk that may be missed when numbers alone drive an investment decision. They are asked regardless of sector.

Global listed real estate is not immune to the need for strong corporate governance profiles and an alignment of shareholder interests. In fact, given the long term time horizon that REITs are managing, corporate governance is arguably even more important in this sector.



## Does governance pay?

There is a live debate in the US at the moment about the investment case for governance in the REIT sector.

Some argue that because REITs are already highly-regulated with relatively inflexible corporate structures, they receive no additional benefit from adopting higher standards of governance. This means that there is no valuation upside for governance improvements<sup>1</sup>. This argument runs along the following lines:

- > Investors are less inclined to pay a premium for well-governed REITs because the sector is relatively stable with few instances of governance deviations that have cost shareholders;
- > Imposing further restrictions upon REITs is not required because operational freedom is already curtailed with requirements like the obligation to pay out 90% of net earnings;
- > There may already be less scope for agency problems given that REITs are highly transparent and assets are relatively easy to value.

AMP Capital acknowledges these arguments, but disagrees with the premise. We believe that sound governance structures are always important and relevant to assessing investment risk. In fact, governance is an extremely important consideration before investing in a stock and for the term of the investment. Governance is about protecting shareholder interests over the life of the investment.

It is also about ensuring that owners have a voice or, at the very least access, to boards at crucial times for the company that may involve an important transaction. For example, a stock with a staggered board that does not allow proxy access may be difficult for large investors to communicate with and be heard at a time when the stock is facing a crossroad. Boards that are insulated from owners may be less likely to make decisions that are designed to maximise value over the long term.

<sup>1</sup> CORPORATE GOVERNANCE TRENDS IN THE PUBLIC REIT SECTOR: AN EVOLVING LANDSCAPE, [www.goodwinlaw.com/viewpoints/2017/04/04\\_21\\_17-corporate-governance-trends](http://www.goodwinlaw.com/viewpoints/2017/04/04_21_17-corporate-governance-trends)



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## Anti-takeover devices in the US: it is time to opt-out

One of the most noteworthy trends in corporate America over the last 20 years has been increased board accountability.

Most stocks have introduced annual director elections, meaning that most company directors are up for re-election every year. If investors assess directors' performance as lacklustre, or believe that conflicts of interests impede their independence, directors can be removed within a year. This is the ultimate form of accountability to shareholders.

About 90% of the S&P500 have adopted this approach to director elections. REITs are the exception, with 50% adopting annual director elections, making them an obvious laggard on governance in their region.

Board accountability is just one governance metric on which REITs lag in the US. The Maryland regime (the Maryland Unsolicited Takeover Act (MUTA)) allows a stock incorporated in that state to withdraw annual elections at any time, even if its constitution has been changed to provide for annual elections, circumventing any move to stagger board elections. It is basically an escape clause for accountability to shareholders enshrined in law and renders the adoption of an improved governance structure to window dressing.

REITs can easily remove this governance risk by opting out of MUTA. By opting out, the legislative regime can no longer be called upon at a time that suits the board. However, only one-third of Maryland-based REITs have done this to date.

The two-thirds of REITs who are still clinging to the MUTA argue that the ability to stagger board elections at any time provides an important defence to corporate takeovers. They argue that it buys the board time to develop a defence. It may also provide enough time to explore all strategic options, which may include doing nothing.

Green Street Advisors names this the "stolen company" risk. REITs who want to keep hold of MUTA say they need the defences contained within MUTA in case a predator swoops in to make an unfairly low takeover bid then axes the incumbent board to push the bid through. These predators are commonly called activists. We cannot think of a single example of this occurring in the REIT sector. Indeed, for a stock to be "stolen" at an outrageously low price, shareholders would need to agree to the takeover. Why would investors agree to sell for an outrageously low price?

In fact, the opposite situation occurred in 2015 in a proxy fight between two large shopping centre REITs in the US. Macerich Co was approached by rival REIT Simon Property Group Inc with a 50% cash, 50% stock bid of US\$91.50 a share in 2015 that was later increased to US\$95.50.

Among many takeover defences adopted, Macerich's board invoked MUTA to stop annual director elections and block the bid. It rejected the offer and kept running the business as usual, with minor changes in strategy. The blocks were successful, shareholders were not given a say, and the takeover attempt was thwarted.

Shares now trade at US\$58 and the CEO of Macerich has been paid US\$27 million in the two years since then. Was Simon really the predator that needed to be feared and blocked? Would giving shareholders a voice on the deal have resulted in the stock being stolen for an unfairly low price? The share price since then suggests the answer would have been no.



## Other defences afforded by MUTA

There are other takeover defences contained in MUTA. Some of these are listed below.

- > The 'business combination' provision: five years must pass before investors with > 10% of stock can lodge a takeover/merger unless the board approves same. Once five years passes, a range of shareholder approvals need to be obtained.
- > The 'control share acquisition' provision: voting power is diluted once a number of ownership thresholds are reached, unless shareholder approvals for these ownership levels are obtained.
- > The 'MUTA' provisions: the board can unilaterally elect a board, enact a majority requirement for voting, require higher votes to remove directors or restrict director replacements, all of which can be done without obtaining shareholder approval.

The rationale for these governance exceptions are likely to be questioned by investors in the US in the next few years.

The issue is the unfettered discretion these exceptions bestow on boards and management. They place investors at the mercy of management and create a risk that decisions will not be made in investors' best interests. It is entirely possible, for example, that a takeover could be blocked by a board that is in investors' interests. This is a governance risk that need not exist.

## Runaway executive pay in Australia

While the availability of poison pills is likely to be the key issue in the US in 2017 and 2018, in Australia, the key issue is likely to be the size of executive pay. Australia does not have provisions like MUTA.

Executive pay in the Australian listed property sector is large and growing. In February 2017, the Australian Financial Review noted that property and healthcare chief executives have displaced their counterparts at the major banks in the list of the 10 highest paid chief executives in 2016. This makes the sector one of the highest paid sectors in Australia.

This reflects research AMP Capital commissioned in December 2016. This research, which was carried out by governance advisory Ownership Matters, found the following:

- > The REIT sector appears to be the highest paid sector in Australia, relative to complexity of businesses and the skills required to run these businesses.
- > Annual bonuses do not appear to be sufficiently at risk because high bonuses are consistently paid year after year.
- > Pay packets are quite heavily weighted to the short term, with annual bonuses making up around half of at-risk executive pay across listed property entities even at 'landlord' groups with substantial rental income where the short-term is unlikely to be easily influenced.
- > The overall size of pay does not appear to be related to the complexity or size of the REIT.
- > Most property entities use adjusted earnings in their incentive metrics. These metrics exclude costs that are borne repeatedly, especially tenant incentives which are designed to induce tenants to sign on the dotted line. These incentives are routinely excluded from the industry's preferred measure, funds from operations, despite the fact that they are paid to obtain or retain a tenant.
- > Reducing the size of cash bonuses in executive packages, especially at more passive entities, and ensuring adjusted earnings metrics do not exclude recurring costs would better align executive incentive pay to shareholder returns.
- > CEOs could have more skin in the game. High shareholdings tend to reflect high equity awards that have either vested or recently vested. Given high fixed pay levels, retaining higher levels of equity awards would be preferable.

We have previously written about the way in which CEO pay seems to be set in Australia and our concern that this approach is leading to never ending pay increases in the executive ranks.

In our white paper, *CEO pay: What are CEOs worth?*, we discuss the tendency for boards to set CEO pay after carrying out a global benchmarking study. This means that CEOs are inevitably paid at least as much as their global peers, irrespective of the job they have been hired to do and the skills needed to do that job well. With CEOs paid what their peers are paid, there is a self-perpetuating pay spiral upwards.

Fortunately, fixed pay appears to have plateaued across all sectors in Australia for the time being, with the Australian Council of Superannuation Investors (ACSI) reporting in its most recent annual CEO pay study that the median fixed pay for chief executives of ASX200 companies is now back at pre-2008 levels of \$1.7 million in 2015.

However, the size and frequency of bonuses for chief executives remains an issue, as well as the performance hurdles attached, particularly non-financial hurdles where the board's assessment of performance is quite subjective. On bonuses, ACSI found that in 2015, 93 per cent of chief executives in the ASX100 received a bonus equivalent to 76 per cent of their maximum entitlement,



implying that the vast majority of chief executives met and exceeded their bonus hurdles. This was the highest proportion of CEOs to receive a bonus since 2008. This leads to a concern that bonuses are being used to prop up static or, in some cases lower, fixed pay.

In the listed property sector, the trend is similar. Of 19 Australian externally managed REITs, Ownership Matters found that only five of 79 executives received less than 50 per cent of their maximum bonus potential and four of these five executives were at one REIT.

All but one REIT paid their executive teams more than 65 per cent, on average, in 2016. These are remarkably persistent bonus outcomes.

### Why is executive pay relevant to investment decisions?

At its most basic level, executive pay is an investment of shareholder funds in the management team. In this context, AMP Capital believes that remuneration should be fair, reasonable and aligned with shareholder interests.

Executive pay is also important because of the performance hurdles used to incentivise executive performance. The hurdles themselves provide investors with some important insights:

1. The board's strategic priorities. The board typically chooses hurdles that reflect priorities for the executive team.
2. Management's time horizon.
3. Which areas of the business are not likely to be focused on by the management team.

There is also the risk of perverse outcomes as executives typically focus their attention on the metrics being measured.

We also monitor the size of overall pay packets for the management team, given that high levels of pay can signal money-focused cultures which tend to focus on growth at any cost.

Our research on executive pay in the property sector has informed AMP Capital's engagement agenda for 2017. A key focus of our engagement this year will be the size of bonuses awarded in the listed real estate sector, the degree to which short and long term incentives are at risk, and the overall size of pay packets at REITs.



## Board composition – what does a strong REIT board look like?

Boards of directors play a number of important roles for investors. They independently oversee management, hold executives accountable, decide upon capital allocation, set the vision and long-term strategy, design executive pay packages, and set the culture and tone of the organisation.

In this context, the importance of their independence, skill set, industry and business knowledge, and commitment is clear.

Board quality is obviously crucial to any company's success but we argue that board quality is even more important in the property sector given the length of time horizon being managed.

Ideally, boards of real-estate companies would be comprised of directors who possess the following:

- > **Independence:** AMP Capital considers independence to be a valuable trait for directors as they make judgements and balance the conflicting interests of various stakeholders. Having said that, independence cannot be to sole criteria as it is vital directors possess the knowledge and experience to enable them to oversee management and make informed decisions about the strategic direction of the company.
- > **Skills:** In general, directors require skills in governance, finance, risk management, law, regulation, pay and people management. Given the nature of real-estate, it would also be beneficial for boards to possess experience in property development, construction, management, marketing, and investment. An understanding of how environmental, social and governance factors impact residential, retail, industrial and/or office properties, would also be helpful.
- > **Diversity:** It is of some concern that despite women being half the residents, tenants or shoppers in most properties, the boards governing these assets continue to be predominantly male. Not only is it now widely accepted that having greater gender-diversity on corporate boards leads to better decision making and better financial performance, but gender diverse workplaces are also seen as being generally happier and more productive. For more research on the benefits of diversity see AMP Capital's Insights Paper titled: *Gender Diversity, the real reason we are still talking about it*.
- > **Capacity:** Shareholders expect directors to be committed to their role. It is important that directors have the time to devote to discharge their director's duties. While short-term issues will always be a distraction, given the long-term investment horizon in real-estate, it can be argued that these directors must have more time for focussing on the long-term vision and strategy, than do directors in other industries.

### It has been said that:

**If long-term considerations are going to prevail over short-term interests, the board has to become bolder and more courageous in exercising its collective responsibility, setting the tone for the business to think about its mission in a different way. Directors need clarity about whose interests they are representing, what the trade-offs are, and how best to address conflicting needs<sup>2</sup>.**

## Tax risk

Tax will be a hot topic for institutional investors in 2017 and 2018. In a low growth environment, many governments are finding revenue bases under pressure. Some governments are responding by clamping down on sweetheart tax deals with other countries and imposing taxes to stop the flow of capital offshore.

In the EU, there is anger about some member country's deals with multi-nationals and intervention is occurring. In the US, the Trump presidency is attempting to carry out the most comprehensive tax reform in 30 years. In Australia, the use of offshore business units and marketing hubs is no longer palatable. Australia is also leading a multi-national investigation into tax minimisation strategies by foreign domiciled businesses conducting business here.

Globally, the goal posts on tax are moving. Not so long ago, it was acceptable to minimise tax by whatever means possible. Now, some forms of tax minimisation are viewed as tax evasion. Non-government organisations and think tanks are commissioning studies on the corporate use of tax havens and naming and shaming companies that have set up in low tax jurisdictions.

Before investing in a listed property entity, it is important to understand the entity's tax strategy, the board's comfort with the strategy adopted, and whether the entity is operating in one of the grey areas that are fast becoming redefined as tax evasion rather than tax minimisation. These are questions that AMP Capital's investment teams regularly ask management and boards.

<sup>2</sup> Building A Board for the Long Term (2015) Spencer Stuart: [www.spencerstuart.com/research-and-insight/building-a-board-for-the-long-term](http://www.spencerstuart.com/research-and-insight/building-a-board-for-the-long-term)

## Conclusion

Corporate governance is typically a critical component of an investment decision. Shareholders are allocating capital to listed companies with limited information about how that capital is being allocated. Investor confidence in the alignment of interests between boards and the companies' owners is crucial.

REITs in some regions, particularly in the US, have escaped the degree of investor scrutiny on governance that stocks in other sectors have received in recent years. This is partly due to the specialist types of investors in listed real estate and partly due to history. With most of the sector incorporated in Maryland with legislative poison pills available to be called upon at any time, governance changes at the company level have been superficial at best.

This is now changing, with investors in the US demanding the same governance profiles in listed real estate as in other sectors.

In Australia, an important area of focus for investors in listed real estate is executive pay. With global benchmarking studies behind pay levels, executive pay packets keep spiralling upwards. Bonuses and long term incentives need to be at risk and aligned with the investor experience. AMP Capital is focusing on this issue in particular this year.

Other areas of focus for investors in 2017 and 2018 will be tax risk and board composition. In an environment of mistrust of political and business elites globally, societies expect businesses to pay their fair share of profits in tax and are sceptical of tax minimisation strategies. Minimising tax is commonly seen to be avoiding tax. For investors, stocks' tax strategies are important to be across and comfortable with.

On board composition in regions like Australia and Europe, investors' attention is turning to diversity of thought, experience, gender and tenure. With listed real estate entities managing for the long term, board quality is crucial to a stock's success.

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