Addressing "Transition" Issues in Executive Compensation Planning

Navigating the Current Operating Environment

As current economic conditions cause increasing distress across most real estate sectors, industry executives are coming to terms with the reality that their current long-term incentive programs are worth significantly less than their value just a few years ago. At the same time, new business ventures are being formed by well-financed investors to take advantage of the increasing distress among many established real estate industry players.

What do all these companies have in common?

The companies are all confronting issues of "transition," or the impact of forces that will define the future state of their businesses. These transitions can include strategic shifts (e.g., diversifying capital sources or implementing rapid growth or expansion initiatives), ownership transitions, managerial and leadership succession, generational transition in family-owned businesses, M&A transactions, and re-positionings and restructurings. In times of business transition, it is critical to re-evaluate the company's executive compensation structure, particularly its long-term incentive programs, to ensure that these programs remain in alignment with the changing economics of the business and focus on employee retention.

How could these transition scenarios manifest in the current operating environment?

We have seen these transition issues play out in myriad ways, and we offer the following two typical examples:

— **Retail REOC**. As property values plummeted, and the company's equity value declined significantly, the board of directors realized that the resulting decrease in executives' collective net worth was becoming a critical retention concern and a threat to the company's long-term stability.

— **Newly Formed Private Equity-Sponsored Real Estate Investment Manager**. The senior executive management team of a newly formed entity recognized the fact that they did not have direct equity interests in the operating platform that they were building for a private equity sponsor, which meant that they were missing out on sharing in the significant value that they were creating as they executed their business plan.

What factors should companies consider in re-evaluating their executive compensation programs?

Given that an overarching objective of the executive compensation program is to align the interests of the executives with that of the business owners, as those interests change because of the transition, it is imperative that the compensation program change to remain in alignment. To ensure this alignment remains strong, the company should consider:

- The impact of new executives and whether they have an economic stake in the business;
- Whether the executives' annual and long-term incentive compensation opportunities remain within market norms and practices;
- Whether the metrics included in incentive programs are aligned with the current drivers of business success and investor value;
- Whether the in-place incentive programs are underwater and the likelihood of recovery over a reasonable period; and
- To the extent that current incentive programs are underwater, whether this presents a significant retention risk for executives.

Addressing the varied ways in which transition issues can impact a company and cause misalignment of interests between executives and business owners requires the assistance of a compensation consultant with significant experience in designing incentive compensation programs. This is especially important given that a key driver of business success is the ability to ensure that executives are appropriately motivated to achieve the company's key performance objectives and are retained over the long term.

FTI Consulting's Executive Compensation and Corporate Governance Solutions team provides objective and independent advice and guidance to ensure that a company's compensation program is competitive, balanced, and well-aligned with its business model and strategy. We take pride in our relationship-based approach, which enables our experienced professionals to leverage our extensive knowledge of the dynamics and key factors impacting our clients to create compensation programs that support organizational goals. This approach is only possible by engaging in relationship-driven consulting that focuses on the underlying strategy and culture at each company.

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