

Ripe For Attacks. Why REITs?

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Background

As most know, Real Estate Investment Trusts (REITs) are a relatively new structure at 25 years young. REITs only emerged in the early 90s due to the then-crisis in the real estate market during which falling property values resulted in a run on the bank by investors in the real estate mutual funds industry. This prompted the government of the time to allow a number of open-ended trusts to convert to publicly traded REITs.

This REIT conversion, which provided liquidity for fund redemptions and also allowed retail investors to maintain access to real estate investments, has arguably become one of the best success stories of the past three decades. Having the benefit of one of the most challenging times in the real estate market, the REITs who emerged from the painful market events of the late 1980s and early 1990s were more disciplined in their operations and financing structures, and further benefited from a material tax advantage in that there was no tax leakage at the trust level. REITs soon became an investor favourite at both the retail and institutional levels to the point that they now comprise over \$60 billion in total market cap. REITs such as RioCan REIT, whose market cap when it converted from a mutual fund in 1994 was about \$62 million, has now grown to over \$8 billion.

Growth Constraints and Governance Issues

After 25 years of robust growth, Canadian REITs now face material growth constraints as it is now getting harder to make accretive acquisitions. Having reached economies of scale, acquisitions must be large enough to matter to the bottom line and this alone puts REITs in direct competition with pension funds, who are non-taxable and, as such, have considerable cost of capital advantages. This, along with a number of other headwinds, have now put REITs in previously uncharted waters where they now often trade below their intrinsic value.

As provided above, the reason for REITs' success has been their focus on economic fundamentals, operational efficiency, and sound acquisitions. The REITs' immense success with investors had, up to recent years, shielded them from activism and, as a corollary, non-operational matters such as corporate governance best practices were not often top of mind for management or the board. Investors were happy and so was the board of directors, so there was never scrutiny or a need for a wholesale update of governance or compensation practices. In other words, the REITs' economic success to date resulted in them being out of touch with current models of good governance. Now that REITs have started to show signs of value gaps, their governance and compensation practices have come to light and together are serving as the REITs' Achilles heel for activist investors.

REIT Activism Gets Hotter, Then Hotter and Now Even Hotter

The first known Canadian case of REIT activism was in 2009 at InnVest REIT where Royal Host REIT requisitioned a meeting to nominate four trustees to the board only to see it withdrawn the day before the meeting. Since then, REIT activism has only grown with seven occurring in the past five years. In 2017 alone, there were three very public campaigns against REITs and many more behind-the-scenes campaigns and agitations. This is occurring in a sector with only approximately 33 TSX listed issuers. At Kingsdale, we have been involved in virtually every single REIT proxy contest or behind-the-scenes activity in Canada and believe this trend will only continue unless REITs start shoring up their defences. While certain activists have honed their REIT-hunting skills and thesis by engaging and attacking a number of REITs, REITs as a whole are less prepared for activists, specifically from a governance perspective. To escape an attack, REIT boards must begin to look inwards, review and update their governance and compensation practices, and assess their activism preparedness.

Amongst older public companies, shareholder rights and good corporate governance have evolved as part of a negotiated process with shareholders over the years. Through concessions as result of shareholder pressure or agitation, a form of universally acceptable “good governance” is agreed upon between shareholders and management. This process takes time and requires both management and shareholders to have had the benefit of time and particularly of challenging times where such issues are more highlighted. Public REITs, which have only been in existence for the past 25 years or so, and have had good performance to date have had neither sufficient time nor the challenges to have gone through the same levels of unitholder scrutiny as other sectors to have developed such governance practices. Recent market challenges however point to signs that this is rapidly changing.

Take the issue of executive compensation; in 2016 proxy advisor, Institutional Shareholder Services Inc. (“ISS”), adopted a formal policy on evaluating executive compensation practices at externally managed issuers (“EMI”). In its decision, ISS noted that “none of the currently identified Canadian EMIs had a say-on-pay resolution on ballot in the previous year”. REITs, a good portion of whom are externally managed, remain very behind as a group on say-on-pay adoption. To date, only seven real estate sector companies have voluntarily adopted say-on-pay as opposed to 35 energy sector and 52 materials sector companies. Two of seven REITs adopted say-on-pay only in 2017.

Ripe for Activist Picking

Perceived poor governance is one reason and often the guise under which activists target a company. However, when activists screen and evaluate companies to target, performance and valuation gaps are the determinants. After all, activists have their sights set on returns and are there to create value for their own investors. But since performance is relative, there is never a shortage of companies that relatively underperform in any given industry. To justify any causes of relative valuation gap or performance missteps, activists often rationalize and publicize underperformance with lapses in governance. Following that strategy, REITs then make ideal targets. REITs are simple to understand in terms of cost of capital, capital deployment and distributions and do not in aggregate have robust governance and compensation practices. In a proxy contest, perceived governance weaknesses that are normally ignored are given extra attention, particularly by proxy advisors ISS and Glass Lewis. Take Granite REIT’s proxy contest with FrontFour Capital and Sandpiper Group for example. In that contest, while trustee compensation had remained at an elevated level for many years, it had not become an explicit issue for unitholders until the activists highlighted these concerns. Granite had outperformed most of its peers in all relevant periods but its compensation practices and lack of strategy execution or disclosure thereof served as the board’s Achilles heel and led to the replacement of three trustees including the chair and vice chair by activist nominees. Perceived good governance matters!

Below are common features of REIT governance practices that have made REITs ripe for activist picking.

- REITs are not governed by corporate statutes but rather, their own declaration of trusts, many of which were drafted before the millennium. The Canadian Coalition for Good Governance (“CCGG”) has long advocated for the amendment of public REIT constating documents to add certain model provisions which provide the same level of basic investor rights provided in corporate statutes. Some REITs, for example, only allow for meeting requisitions by unitholders not holding less than 10% of the units while the CBCA equivalent threshold is 5% of shareholders. The defensive prowess provided by the constating documents may have created the illusion that REITs are difficult to attack. In reality, these governance deficiencies, if and when highlighted by activists during a period of underperformance, resonate with long-term unitholders as well as proxy advisors, cementing the conclusion that poor governance and unitholder disenfranchisement is the key cause for underperformance. REITs have often underestimated the influence of ISS and Glass Lewis on their institutional investors. In a contested situation, non compliance with ISS or Glass Lewis guidelines on governance issues can easily result in full or partial replacement of the board.
- REITs are also often led by founder-CEOs that control the management companies providing services to the REIT which is a remnant of the trust fund model. These related party transactions between the REIT and the management companies often become a focal point in proxy contests. Irrespective of whether it may be cost effective to maintain such arrangements (and it often is), the optics of such continuous non-arms length transactions creates perceived governance deficiencies. Boards of REITs may also reflect a close-knit group of individuals. For example, it is not uncommon to find that REIT boards are sometimes comprised of other members of the management company who are also family members to founder-CEOs or longtime advisors. This alone is a great ammunition for activists to spin a country club board narrative around. Trustee unit ownership and board diversity are important issues that have been out of focus for REITs up to recently.
- Internalization of external management functions are often seen as accretive and a form of good governance. However, these internalization transactions, which typically do not require unitholder approval, often come under scrutiny, especially when there is a large price tag. The timing of internalization may also become the focal point of activist attacks as was the case in Milestone Apartment REIT’s internalization transaction. A later acquisition transaction was delayed in garnering unitholder approval and received an against recommendation by ISS due partly to an earlier internalization transaction. It was the timing of the earlier internalization transaction that fueled dissident unitholder rhetoric even though the primary focus for all unitholders was the transaction price. This is also the current situation at Agellan Commercial REIT where the internalization value is a point of contention. Perceived governance matters, even in transactions.
- Finally, REITs, given their flow through characteristics, are attractive to retail investors. As opposed to traditional institutional investors, retail investors demonstrate a higher degree of voter apathy. Even today, some public Canadian REITs have voter turnout percentages in the low teens. For activists who are able to gain a sizable toehold, a low turnout means a low-bar to get majority of votes cast to replace the board. For other public REITs where there is heavy fundamental institutional investor ownership, ISS and Glass Lewis play the role of kingmaker and their recommendations are heavily influenced by the REIT’s governance practices in a contested situation. It is thus imperative for REIT boards and management to have a good understanding of ISS and Glass Lewis governance and compensation

guidelines and ensure that they are in compliance. Having the support of research analysts is not enough. While Granite REIT's management obtained vocal vote of confidence via several mainstream analysts reports, ultimately, both proxy advisory firms and the majority of unitholders disagreed and voted against the board's slate of nominees.

How to Be Prepared

Close the governance gap: Before any signs of lurking activists, proactively adopt some of the corporate governance best practices that are prevalent in other industries and are in ISS and Glass Lewis guidelines. Look beyond REIT peers when benchmarking governance – it does not help to benchmark against a sector known not to be models of good governance. Below are a few low-hanging fruits:

- Ensure that there is independent leadership to the board, combined Chairman/CEO positions is not effective governance
- Pay attention to executive compensation practices, especially change of control provisions, Canadian best practice dictates that employment contracts with executives contain double-triggered change of control provisions with severance payments not exceeding two times cash salary and bonus
- Adopt a say-on-pay vote; this will help shield compensation committee members in case there are compensation concerns and is a sign of good corporate governance
- Any related party transactions with independent directors outside the purview of the independent directorship should be closely scrutinized and avoided if possible
- If there are familial relationships on the board, think about board refreshment that could improve both perceived board independence as well as the actual independence

Know your unitholders: Unitholder engagement remains one the best forms of activist defense. For traditional institutional investors, make sure that engagement involves the governance teams rather than just portfolio managers. If unitholder turnout has historically been low, thinking about ways to improve voter turnout would serve REITs well before activists show up.

At **Kingsdale** we pride ourselves in being ahead of the governance and activist curve, having advised numerous activist and issuer clients. We would be pleased and delighted to speak to any REIT issuer and provide them with a bespoke vulnerability analysis and assist in their governance, compensation and activist preparedness analysis. It is that strategic advice that has often resulted in a win or a loss in an activist campaign.

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