RCLCO
Compensation Strategy – Best Practices
Q4 2023

RCLCO
REAL ESTATE CONSULTING

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55+
Years in Business

400+
Engagements Annually

>100
Employees Globally

RCLCO | REAL ESTATE ECONOMICS

Economics and market research services backed by 55+ years of analyzing trends and consultation to the best minds in real estate.

RCLCO | MANAGEMENT CONSULTING

Collaborative and actionable strategy planning, and operational, portfolio, and capital consultation to real estate enterprises.

RFA | RCLCO FUND ADVISORS

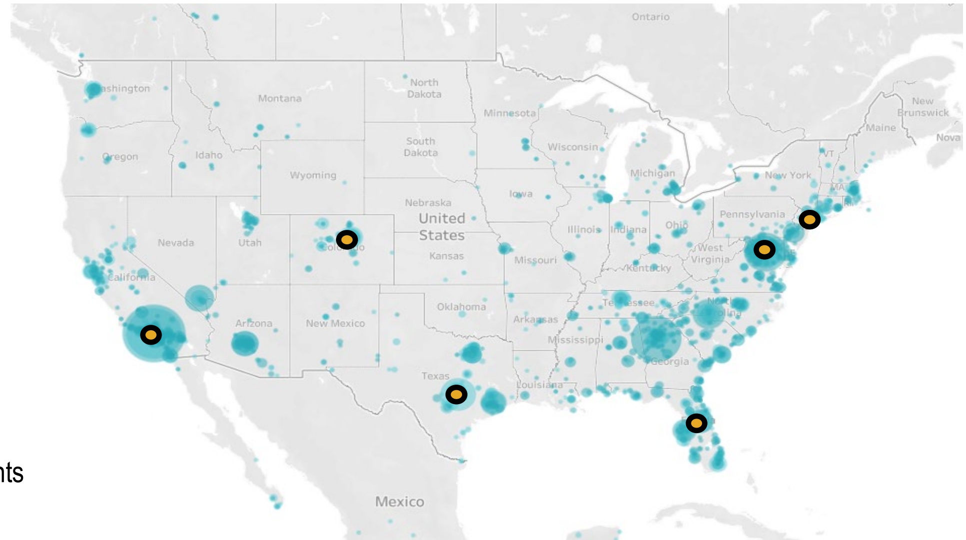
Customized real estate advisory to institutional investors built on a legacy of thought leadership and analytical rigor.

We Partner with Clients to Look Around the Corner

Since 1967, RCLCO has been the "first call" for real estate developers, investors, the public sector, and non-real estate companies and organizations seeking strategic and tactical advice regarding property investment, planning, and development.

RCLCO leverages quantitative analytics and a strategic planning framework to provide end-to-end business planning and implementation solutions at an entity, portfolio, or project level. With the insights and experience gained over 55 years and thousands of projects – RCLCO brings success to all product types across the United States and around the world. RCLCO is organized into three overlapping and reinforcing service areas: real estate economics, management consulting, and advisory services for institutional investors through RCLCO Fund Advisors.

Where We Work

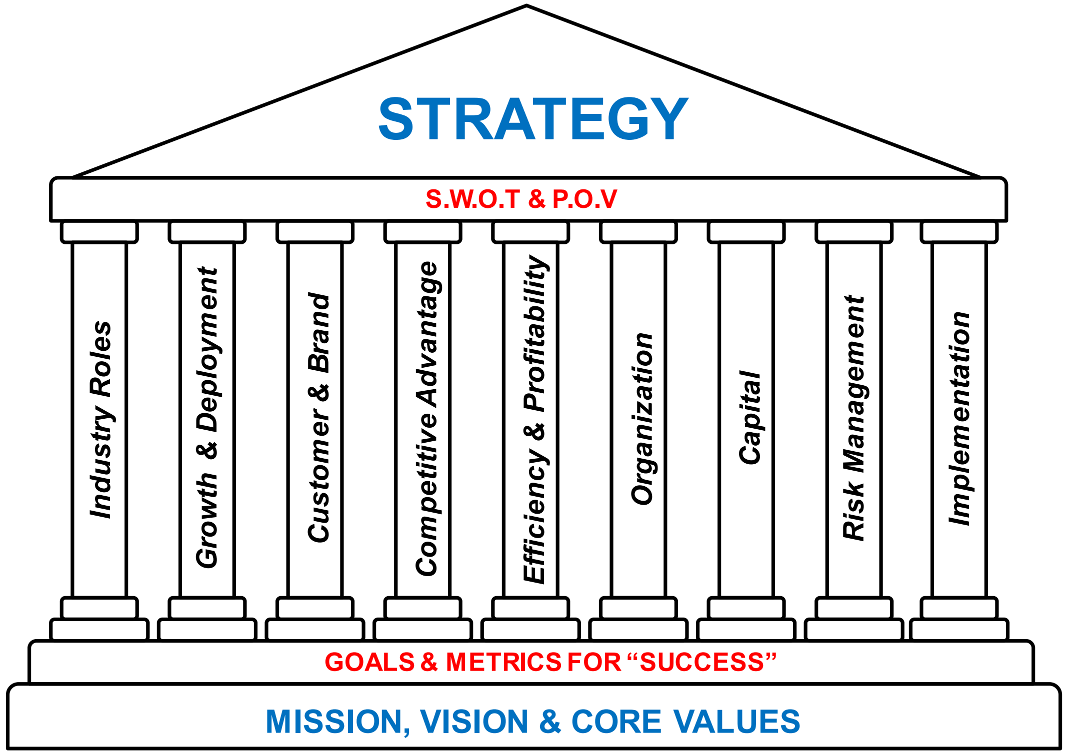


KEY
RCLCO Office Location
Larger dot = more engagements

Learn more about RCLCO at RCLCO.com

RCLCO Strategy Pillars

RCLCO has developed, and continues to perfect, a strategic planning process specifically for real estate companies. Using the RCLCO Parthenon meme as an organizing principle, we know that a well-rounded and robust strategy is built upon a foundation of mission, vision, values and goals; informed by an objective assessment of the internal company and external market environments; and informed under an understanding of internal company strengths and weaknesses and a point of view about how the external market environment will impact the company's strategy.



RCLCO PARTHENON	DESCRIPTION
S.W.O.T. & POV	Strengths, weaknesses, opportunities, and threats facing the company, and its point of view regarding key externalities
Mission, Vision & Values	What the company stands for and what it values
Goals & Objectives	What defines "success" and how to monitor progress/achievement
Industry Role Strategy	What the company does in the real estate industry
Customer & Brand Strategy	Delivering value to internal and external customers
Competitive Advantage Strategy	Skills and capabilities that enable the company to win the game
Growth & Geographic Deployment Strategy	Where the company does it and how it grows
Efficiency & Profitability Strategy	Optimizing the bottom line/economic performance
Organizational Strategy	Maximizing the effectiveness of the company, and developing a high performing team
Capital Strategy	Funding the strategy
Risk Mitigation Strategy	Optimizing access to and cost of capital
Implementation Strategy	Monitoring, acting, and prospering during all phases of the economic and real estate cycles and creating resiliency

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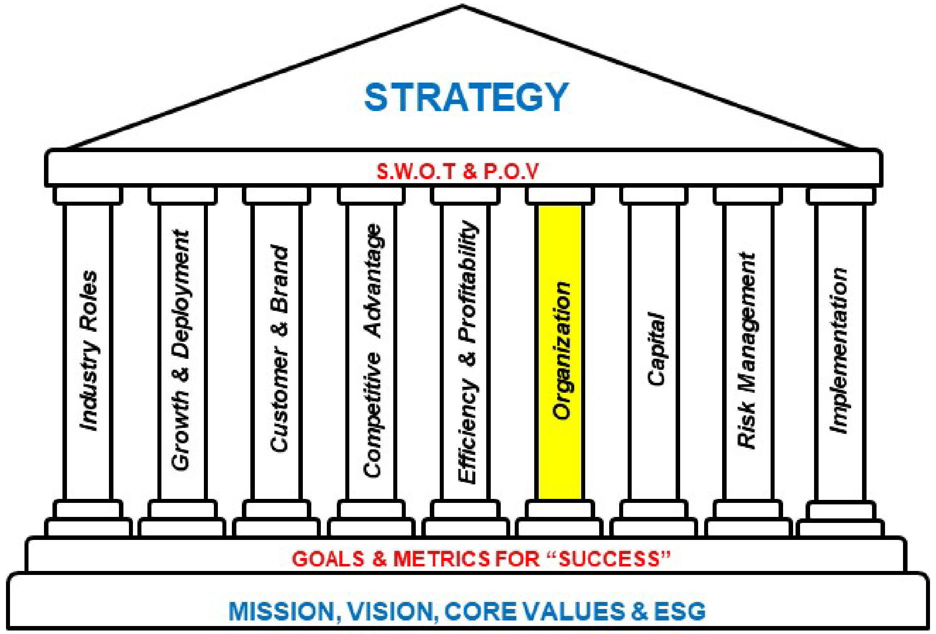

COMPENSATION STRATEGY – BEST PRACTICES

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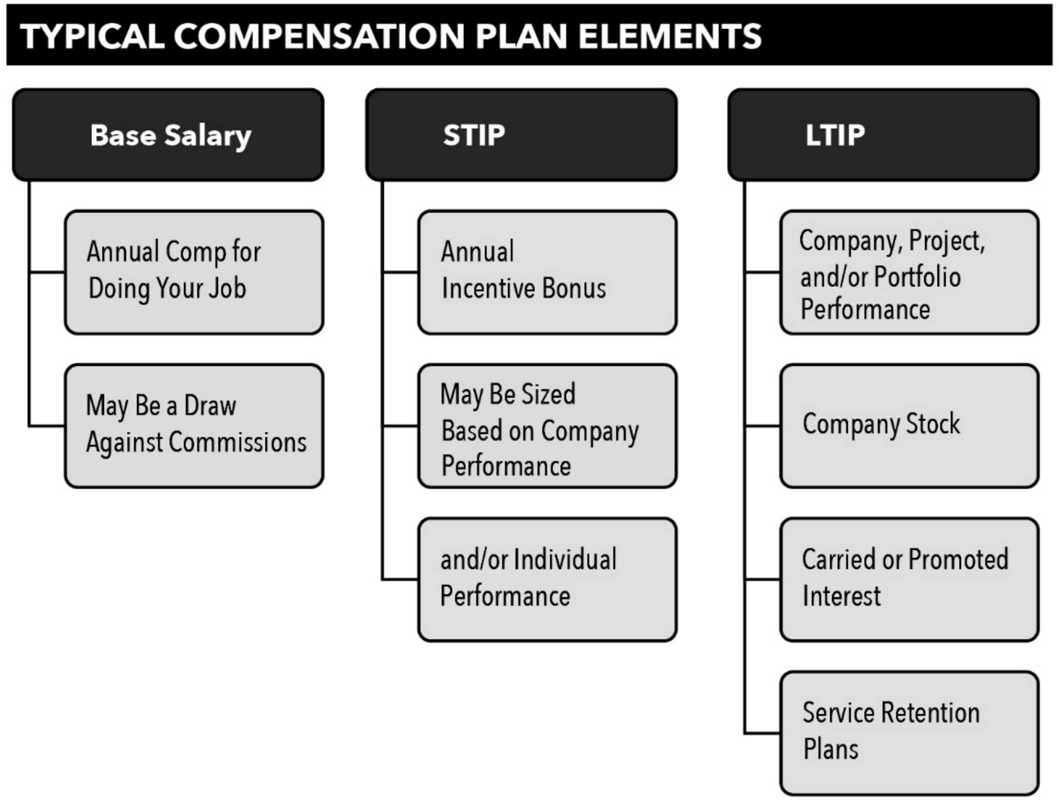
Compensation Strategy – Typical Elements

Compensation plans dovetail with and supports the strategic plan, and are typically designed to enable companies to:

- Attract and retain key talent necessary to execute its business;
- Align the interests and incentives of key team members charged with executing the strategy to focus on achieving the company's strategic goals and objectives;
- In the case of private companies, make "employees" feel like and behave like "owners;" and
- To share the wealth so that employees can make an attractive current income and build a nest egg for themselves and their families by doing very well for the company's owners, investors, etc.

COMPONENT	DESCRIPTION
Annual Base Salary	Typically, guaranteed, but not always, for example some brokers work on draws against commissions.
Short-Term Incentive Pay (STIP)	Typically, an annual bonus tied to individual and/or company performance.
Long-Term Incentive Pay (LTIP)	Typically, "upside" potential that can take the form of stock grants (both in public and private companies), profit sharing, carried interest or promoted interest in deals, portfolios or funds.



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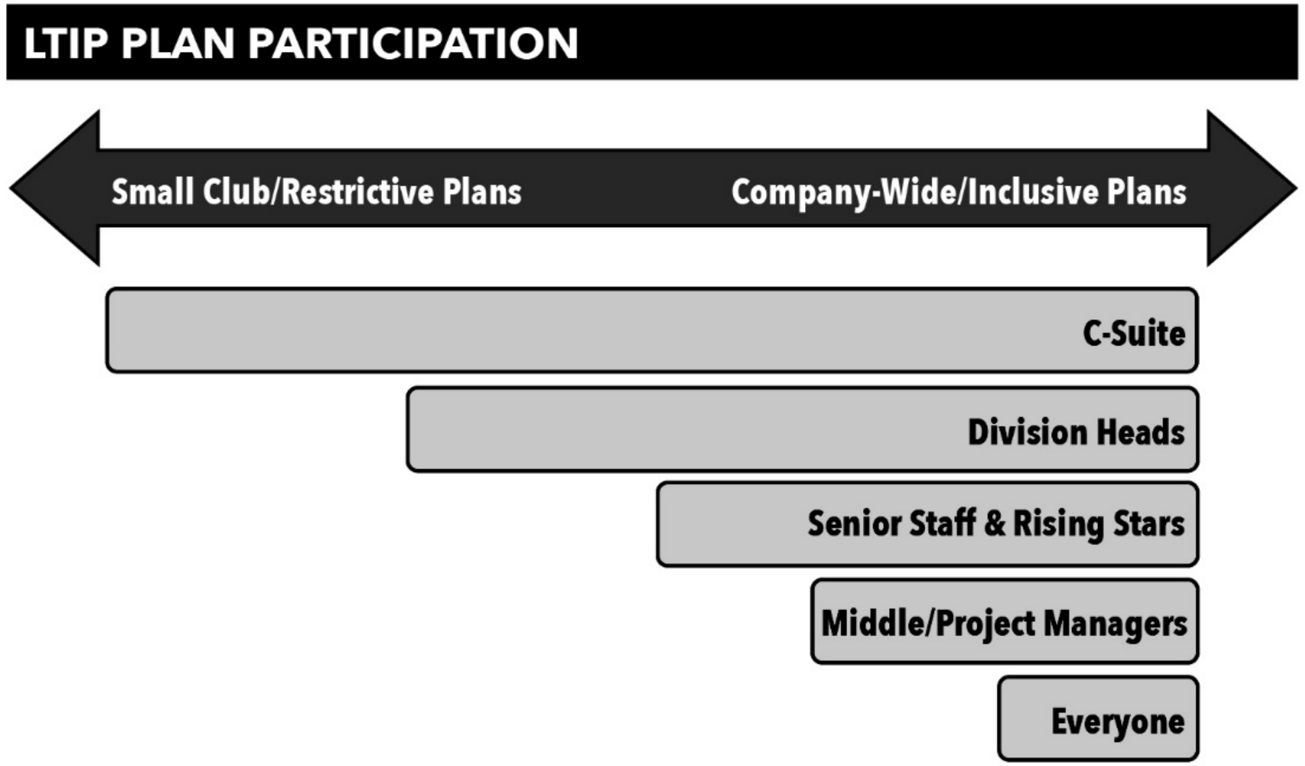
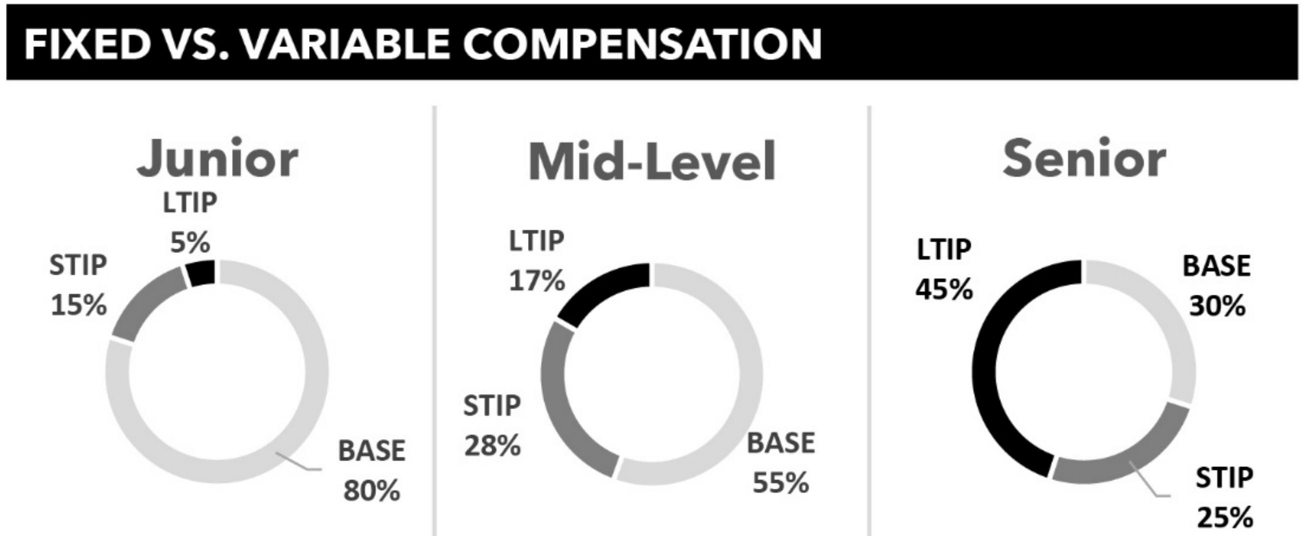
Compensation Strategy – LTIP Participation

LTIP participation varies widely in the real estate industry. At one end of the spectrum are companies that have restrictive LTIP programs, where participation is reserved for a relatively small group of key employees, typically the most senior leaders in the company. The relationship between fixed and variable compensation between annual "guaranteed" company and STIP and LTIP, typically changes materially with an employee's seniority and impact on profitability.





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Overarching Strategy Objectives

There is a consistent theme that runs through the objectives in most LTIPs programs, including:

- Achieve strategic goals and objectives;
- Align the incentives of the stakeholders (be they owners, investors, or shareholders) and key executives entrusted with executing the strategy of the company;
- Enable the company to compete for talent;
- Instill in participants a sense of ownership in, and loyalty to, the company to feel and behave like owners; and
- Share in the value that LTIP participants create.

Targets

Annual incentive compensation and LTIP award targets vary significantly from company to company, but generally:

- Increase in relationship to annual base salary the more senior the individual is in the company.
- For companies that include Junior Partners/VPs in their LTIP, annual incentive bonus compensation as a percentage of annual base salary ranges from 10% to 14% at the low end of the range, up to 50% to 75% of base at the high end.
- For Senior Partners/SVPs, 50% to 100% of base is fairly typical for annual bonus comp.
- The most senior team members are eligible for annual incentive bonus compensation equal to 100% to 200% or more of their annual base salaries.

Compensation Strategy – Best Practices

Mechanism(s)/Metric(s)

The mechanics and metrics used to size LTIP awards varies greatly, including:

- Some companies tie their LTIP awards to the overall performance of the company—this includes most publicly traded companies.
- Most private real estate companies use some combination of individual project performance, portfolio and/or company-wide performance metrics.
  - In these instances, project-level performance metrics generally apply to the more junior members of the team, and as an employee moves up the seniority ladder the metrics become increasingly weighted to division, portfolio, and then company-wide performance metrics.
- Some private company uses an "Appreciation Right Plan" in which participants are granted "shares" tied to the company's book value.
  - In these situations, the LTIP pays off through appreciation in the company's book value or stock value used for internal purposes.
- Still others use an annual cumulative "Awards Points" program in which LTIP payments are made annually based on net cash flows to company after return of equity and subject to waterfall hurdles.
  - The better the performance of the portfolio, the more the LTIP gets funded.

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LTIP Pool Size

- Public companies rarely set targets for the size of the LTIP pool in advance, rather senior management typically makes recommendations based on a review of comparable company data which is then approved by some version of a Compensation Committee.
    - Most public companies are moving away from options and are, instead, focusing their LTIP on restricted stock and performance shares to better align employee incentives with stockholder objectives.
    - Performance shares are typically tied to benchmarks (e.g., NCREIF, NAREIT, etc.) and grants are scaled up or down based on the company's performance relative to these benchmarks.
    - While there is no explicit target, backing into the number, the LTIP pool at one recent public company example ranges between 3% and 4% of EBITDA.
- On the private sector side, the methodology for determining the LTIP pool and the size of that pool varies widely, including:
    - In some cases, the size of the pool varies project-by-project and is negotiated individually with outside equity investors.
    - Some establish a very specific target, for example 10% of distributions to the company (after return of equity), with funding of the LTIP increasing as the cumulative returns to the company meet certain thresholds.
    - In the private equity world, often LP investors negotiate a specific split of the profits with their GP LTIP participants (after return of the initial investment), and while the exact split is a closely held secret, typically the range is between10% and 20% of profits upon exit/sale of an asset or fund.

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Form of Ownership

- Public companies use a combination of cash, option stock, restricted stock and performance shares in their LTIP.
- In the private companies, most offer some form of phantom equity or profit sharing as the basis of their LTIP, which is:
  - Typically, subject to some type of vesting schedule and, in some case, scaled up or down based on certain company/portfolio performance metrics.
- Most private companies have moved away from granting true ownership in deals, or do so only with limited voting and/or portability rights to ensure that they don't have outside "owners" that are no longer active in the company.
  - The exception to this rule can include the most senior partners in a company who are also typically co-investors with outside equity partners.

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Allocation to Participants

- Allocations of LTIP in private companies in the Peer Group generally fall into one of two buckets:

1. Static – shares/allocations are set at the onset of a vesting period and do not typically vary from year to year, or over the life of the investment; and
2. Variable – shares/allocations are typically made annually by some form of a Compensation Committee based on individual "contribution" metrics—these awards can and do tend to vary from year to year.

- Surprisingly, many private companies report having no scientific method to determine the amount of LTIP award for participants, however, based on our experience, allocations tend to fall in the following ranges:
  - Top five executives (CEO, CFO, and three Business Unit Leaders) = 40% to 50% of the LTIP pool; and
  - The remaining 50% to 60% is typically allocated to the remaining executive participants.
- In some instances, as much as 20% to 30% of LTIP pool is allocated to internal company co-GP participants to recognize the risk they are taking as equity investors.
- At the individual level, LTIP award allocations typically range from a low of 2% to 3% to as much as 15% or more per individual depending upon the position, seniority and level of "contribution."

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Vesting

- The range of vesting of LTIP awards ranges from 0 to as many as five years, with the most typical vesting period for both the public and private companies being four years.
  - Many of the companies have migrated away from static four-year cycles with one LTIP transaction every four years in favor of rolling, or overlapping cycles, tied to the (actual or synthetic) sale of specific asset(s) or in the case of closed-end fund(s).

Portability

- In the public companies, LTIP grants are only exercisable if vesting has been met.
- Few private companies make LTIP awards portable, and typically only the vested portion of LTIP awards are portable or must be put back to the company at current values upon separation with the company.
- Typically, participants need to be employed and in "good standing" to receive any unvested LTIP distributions.

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Hurdles/Provisions

- In most of the private companies where the LTIP participants share in a portion cash flows or capital events, distribution of LTIP is subject first to a return of equity, and in many cases, both return of equity and some level of preferred return or IRR hurdle before the LTIP pool is fully funded.
- However, beyond vesting and subject to return thresholds, there are generally no holdbacks.
  - LTIP participants generally do not run negative capital accounts; and are not subject to capital calls.
  - Generally speaking, LTIP participants only have upside potential and no downside risk, other than the fact that the LTIP may not be in the money.
  - Few companies require LTIP participants to co-invest, and fewer still allow for LTIP participant co-investment; although there are the rare instances where a company requires participants to invest so they have skin in the game.
  - Few companies allow participants to tap their awards early or otherwise use these funds as collateral on any company loans.
- Public companies have fairly explicit rules regarding portability of LTIP awards upon retirement, death, voluntary, or involuntary termination, but private companies are generally less rigid about what happens when these events occur.
  - In one example, if a participant resigns, they forfeit 50% of their LTIP award; if they are terminated for cause they forfeit 75% of their shares awarded for that year; and if they retire or die, they do not forfeit any shares, but they don't accumulate any new shares in the program and become diluted fairly quickly over time.

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Lessons Learned

- ***Too Broad*** – some companies have learned through experience that having LTIP participation that is too broad can dilute, or obviate, the objectives/incentives the plans are intended to achieve:
  - In these instances, companies have determined that it is better to allocate LTIP to a smaller "club" of more senior managers who can "move the needle" and have a positive impact on company performance/value creation.
  - LTIP participation that is too broad and only allocates de minimus awards to more junior participants can induce these participants to heavily discount the impact of the incentive program.
- ***Too Complicated*** – some of the keys to a successful LTIP program include clarity, transparency and simplicity. If an LTIP plan is so complicated that no one can credibly calculate the potential payoff, or if this is shrouded in secrecy, the impact is greatly diminished.
  - A successfully plan is one in which the participants believe that the value will be there, and the ownership/management team does a good job of communicating the status of the program on a regular basis.

Compensation Strategy – Best Practices

Critical Success Factors

- ***First, have one*** – LTIPs are very effective in aligning incentives and motivating your team.
- ***Targeted*** – limit the LTIP to a smaller group of key individuals who can make a big difference in the company performance, and thereby make it big enough for the participants so it is meaningful.
  - Include only those individuals who can influence results and are charged with delivering performance and adding value.
- ***Encourage Team Play*** - Create an appropriate business/geographic unit incentive together with a company-wide mother ship incentive so that people have both a line of sight on how their performance can influence results, and encourage people to play nice together and reduce silos.
- ***Maintain Dry Powder*** – save some capacity in your LTIP—don't allocate 100% out at the onset of the plan as you don't know where you will be five years out, and you need to reserve capacity to add new members, make adjustments for extraordinary performance, etc.
  - It is always possible to convert the initial allocation out at the end to 100% on a pro rata basis, but hard to dilute existing participants.
- ***Make it Simple, Stupid*** – your LTIP should be reasonably easy to understand, and you should provide clear documentation and communicate the status frequently.
  - Be transparent – show the math up front and provide progress reports, at least annually.
  - But keep it confidential – it is not necessary to share individual award allocations with the other participants.

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Critical Success Factors (cont.)

- ***Align Incentives*** – mimic owners objectives and don't get ahead of yourself and make interim payments.
  - If you plan to incent at the asset level, take a portfolio approach to the LTIP so that one great project does not pay out a ton of money while four others are struggling.
  - If there is no planned "exit event" and you have long-term hold model, then create "vintages," or pools of projects, with a five- to 10-year turn cycle.
- ***Make it Meaningful*** – annual comp/bonus should be meaningful and tangible tied to doing one's job, but LTIP should be reserved for accomplishing big goals and putting value in place.
  - Don't reward "non-performers" as richly as those responsible for executing the business (e.g., HR should only have the opportunity to earn LTIP that is 15% or 20% of the potential for the CEO, COO, Field Generals, etc.).
- ***LTIP is Just One Lever*** – recognize that non-monetary benefits and other expressions of appreciation can have a big impact as well—not just about LTIP—for example, courtside seats for the local NBA team can be a big motivator.
- ***Tie to company Goals*** – and effective LTIP plan reinforces and helps you achieve your strategic goals and objectives, and so…
  - Align LTIP incentives to the company's strategy, and provide an appropriate line of sight for participants so that they can see how their actions/activities can contribute to both the company and personal goals.

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Compensation Strategy – LTIP Structure Options

EXAMPLES OF LTIP STRUCTURES	GENERAL CONCEPT
Phantom Interest Plan	➢ Similar to a Stock Option or SAR (Stock Appreciation Right) for public companies where participants own "stock" in a company/portfolio.
Profits Interest Plan	➢ Percentage of company cash flow (often w/ loss makeup).
Special Class Units/Enterprise Value Plan	➢ Phantom units or stock representing a percentage of company equity value.
Carried Interest Plan	➢ Direct interest in the GP investment entity.
Special Purpose LLC	➢ Rather than direct investment in a deal, participants have a stake in a special purpose entity.
Co-Investment Plan	➢ Direct investment purchased (contributed equity capital) from participants personal funds.
Promote Share Plan	➢ Percentage of company/fund/GP promote.

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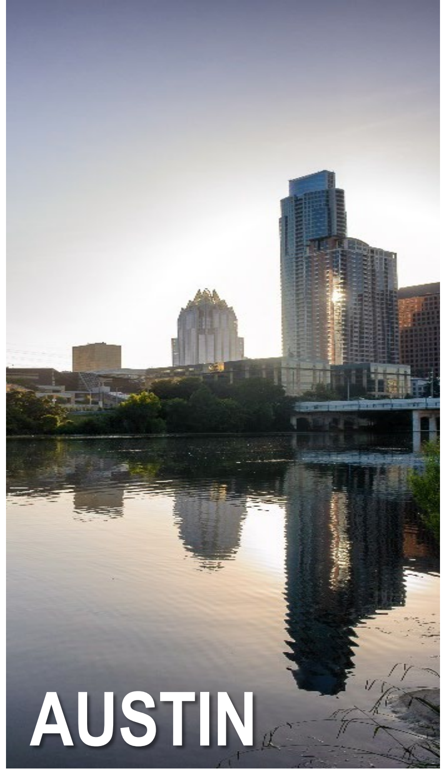

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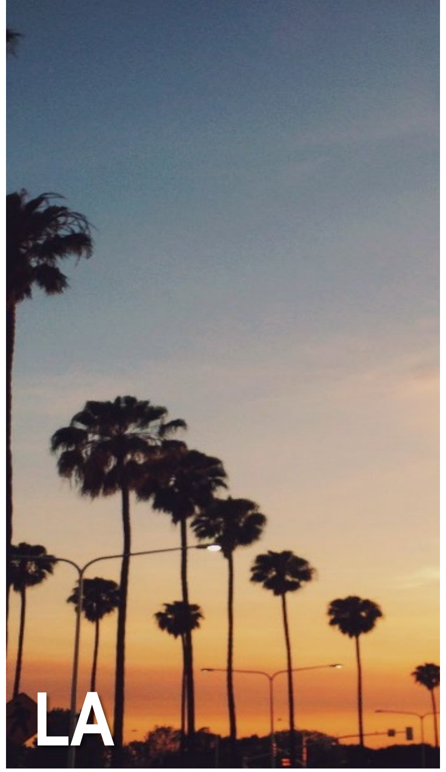

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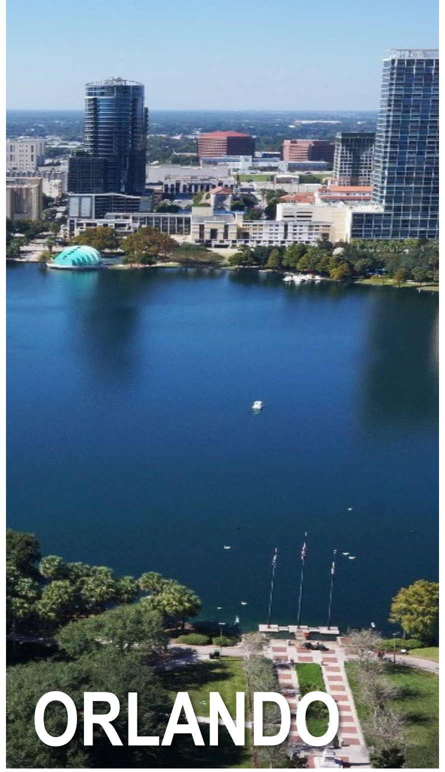

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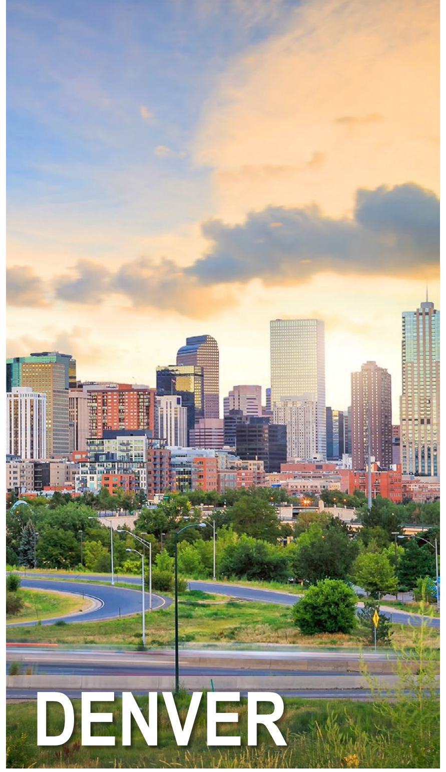

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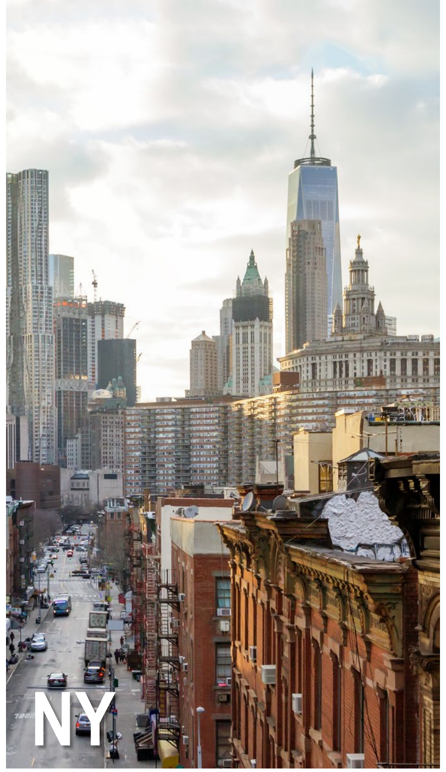

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