Shareholder activism in the REIT sector
Activists continue to build a case for change across a broad range of issues, including operational performance, strategic direction, asset concentration and allocation, conflicts of interest and corporate governance.
Shareholder activism is on the rise in the US. There were 473 companies targeted by activists in 2016, a 291% increase over the 121 companies in 2010.\(^1\) Figure 1 shows the increase in shareholder activism from 2010 to mid-2017; Figure 2 shows the outcomes of activist shareholder demands since 2010. Nearly 60% of campaigns since 2010 have been a catalyst for changes made by the target company.\(^2\)

Shareholder activism is a critical issue facing US REIT management teams and boards of directors. From early 2014 through the first half of 2017, activist shareholders have targeted 39 REITs, including 8 in the last 12 months. Activists continue to build a case for change across a broad range of issues, including operational performance, strategic direction, asset concentration and allocation, conflicts of interest and corporate governance.

Activist campaigns center on maximizing shareholder value and often make a variety of recommendations to best achieve this. The process of accomplishing this change can, however, be highly disruptive to a REIT’s day-to-day activities, and particularly to its management team, which needs to deliver a response.

REIT management teams have to do this within the confines of regulatory restrictions around investor communication, which very often puts them at a disadvantage in terms of the wider-market messaging. The result is that for a REIT management team, activist involvement is a significant burden.

Our analysis of 39 activist campaigns against US REITs since 2014 identified five REIT-specific themes that are intended to maximize shareholder value. These five themes and examples of specific actions are outlined in Figure 3 on page 4.

**Corporate governance**

Increased engagement with shareholders is an important component of enhanced corporate governance. REITs continue to mirror broader market trends in the area of increased proxy access and investor communications. Proxy disclosures are an efficient way to take the company’s targeted governance message to a broad audience of investors and other stakeholders. The portion of S&P 500 companies disclosing engagement has grown from 6% in 2010 to 72% in 2017.\(^3\) And directors are getting increasingly involved in this engagement. This year, 29% of companies that disclosed engagement with investors noted director involvement (this was 25% in 2016).\(^4\)

As we discussed last year,\(^5\) corporate governance in various forms is increasingly being raised as an area of focus for REIT investors, with strengthened board composition a particular focus for the REIT industry. Surveys conducted by the EY Center for Board Matters have found that investors across all industries want every board member to take an active role and contribute constructively to the companies’ governance and decision-making process. Some shareholders prefer to elect board members with a broad range of

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**Figure 1: US companies publicly subjected to activist demands**

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<tbody>
<tr>
<td>Value</td>
<td>121</td>
<td>152</td>
<td>233</td>
<td>322</td>
<td>376</td>
<td>426</td>
<td>473</td>
<td>204</td>
</tr>
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**Figure 2: Outcomes of public activist demands made since 2010**

- **Demand(s) at least partially adopted**: 8%
- **Demand(s) not adopted**: 33%
- **Withdrawn**: 59%

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\(^1\) Activist Insight; EY.
\(^2\) Ibid.
\(^3\) EY Center for Board Matters, “2017 Proxy Season Review,” June 2017.
\(^4\) Ibid.
experiences while others prefer board members who have specific skill sets and experiences in areas such as cybersecurity, digital or environmental matters. In either case, investors want board members whose experience and skills can inform their decision-making. Furthermore, shareholders are demanding that board members represent investors’ views fairly and equitably. This is particularly true with REITs, as we have seen many activists push for the election of their own nominees. Since the beginning of 2014, the industry has seen seven examples of activists taking a more drastic approach by insisting upon wholesale changes in the boardroom or C-suite. Activists also target underperforming REITs where dominant shareholders are seen as a block to needed reform. With director independence as a fundamental corporate governance concept, it is often the case that an activist-nominated director is a valuable addition to a REIT board.

Shareholder rights
Shareholders’ rights and provisions are a fundamental requirement for the ultimate owners of a company. Activist investors have targeted this area by looking to eliminate structures that impose restrictive practices or limitations on the ability of all owners to vote on the future direction of the company. Shareholders in general have become more engaged. The REIT industry has made significant progress toward recognizing shareholder rights as
evidenced by 34% of the 189 Maryland-incorporated REITs opting out of the Maryland Unsolicited Takeover Act (MUTA). MUTA allows REITs incorporated in Maryland to adopt a staggered board at any time. This gives REIT boards a powerful tool to deter or thwart change without consulting shareholders.

**Management structures**

Management structures remain an area of focus for activist investors. For example, externally managed REIT vehicles have been particularly affected; 31% of externally managed vehicles have experienced an activist campaign since 2014 versus just 13% for internally managed REITs. Externally managed vehicles have historically been plagued by concerns over alignment and fee structures, which are accentuated by perceived conflicts of interest. Whether warranted or not, activists have targeted these structures, given their view that they do not align management and shareholders as well as an internally advised model.

**Strategic direction**

Disagreements between shareholders and management over strategic direction are nothing new, but activists tend to challenge strategy in a more public manner. Compounding the issue is wide-ranging disruption and convergence being driven by rapid advances in technology, changing demographics and globalization. Just as other industries are affected by these advances, so too is real estate. Evolving market dynamics and advances in building design, construction and operational efficiency will fundamentally redefine the way tenants in all industries use real estate. This is challenging management teams and boards to stay abreast of trends that evolve rapidly. For those unable to keep pace, the risk of asset obsolescence is very real, with negative implications for portfolio value and the business generally. While new technologies will certainly present challenges for REITs, they will also lead to opportunities to better understand specific assets across their portfolios. This, in turn, will augment REIT management teams’ and boards’ abilities to make informed investment decisions and communicate why the strategic direction is appropriate.

Optimizing long-term capital allocation strategies is especially important to REITs. The EY Center for Board Matters has found that across industries, investors want to see that a company’s capital allocation decisions enable its long-term strategy and support value creation. Investors are demanding that boards and management teams provide better clarity concerning not only their decisions but also how those decisions that support corporate strategies are made.

**Alternative strategies**

Shareholder activists come well prepared to express their views with respect to a particular REIT. While recommending an alternative strategy is common, companies need to understand the views of their major shareholders. Our research shows investors across all industries believe there is a problem with short-termism in the marketplace. Many believe that companies are focused on the short term for a variety of reasons, including short-sighted management, high-frequency trading, quarterly research demands and targets, and the media. Some investors acknowledge that they themselves are partly to blame for the focus on the short term. Activist intentions and broader investor support remain critical issues for a management team to understand when an activist begins agitating for change; just because an activist group says it has talked to shareholders does not mean those shareholders necessarily agree.

**Looking at the business from a shareholder perspective**

Activist shareholder campaigns are very often a force for positive change but the process of accomplishing this change can be highly disruptive to a REIT’s day-to-day activities. An effective practice is for companies to view themselves through the lens of a shareholder group in order to identify areas for improvement.

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8 “Board Matters Quarterly,” EY Center for Board Matters, April 2017.  
9 Ibid.
This evaluation needs to be extensive and cover a range of financial and governance considerations (see Table 1). Activist campaigns focus on maximizing shareholder value, but, as our analysis last year revealed,\textsuperscript{10} this is not confined to underperforming companies. Approximately one-third of REIT campaigns have been against companies that have outperformed their peer group on either a one- or three-year basis. Where companies have outperformed across both time periods, we observed that activists are typically looking more closely at board composition, shareholder rights and general corporate governance.

REIT activists' demands for engagement continue to reflect the wider trend in corporate America of institutional investors reshaping the corporate governance landscape and challenging how boards think about fundamental issues such as strategy, risk, capital allocation and board composition. REITs are responding to investor demands by engaging more often and more directly with shareholders in an effort to improve transparency and accountability. Turning a critical eye inward toward the business is a vital practice. Scrutinizing the business through the eyes of an activist may ultimately lead to changes that maximize shareholder value.

\textbf{Table 1: 10 key business metrics/areas that REITs should consider evaluating on an ongoing basis are:}

<table>
<thead>
<tr>
<th>Business metric/area</th>
<th>Detail/key considerations</th>
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| G&A                                   | ▶ Is the company’s cost of running its business unjustifiably higher than that of its peers?  
▶ Is management’s compensation in line with industry standards?                                            |
| Leverage vs. peer group               | ▶ Are the company’s leverage ratios higher than its peer group?  
▶ Is the debt structure laddered and diversified? Do risk-adjusted returns compensate?                |
| Performance vs. peer group            | ▶ How has the company’s stock performed over the past one to five years versus its peer group?                                                           |
| Board alignment                       | ▶ Do any of the company’s board members have conflicts of interest or excessive demands on their time that may prevent them from prioritizing their board role? |
| Board structure and independence      | ▶ Does the company have a staggered/classified board structure?  
▶ Does it limit director terms?  
▶ Is the board acting independently of management?                                                      |
| Share price to net asset value (NAV)  | ▶ Are the company’s shares trading at a significant discount to the company’s peer group?  
▶ To NAV?  
▶ What is the company doing to close the discount gaps?                                                |
| Strategic focus                       | ▶ Does the company have a clear strategy relating to investments and capital allocation?  
▶ How has that strategy been communicated to shareholders and the wider market?  
▶ Does the strategy conflict with the market’s perception of best practice?  
▶ If so, what is the company doing to alter this dynamic?                                               |
| Communication/shareholder engagement  | ▶ Is the company actively and clearly engaged with shareholders regularly around its strategy, performance, priorities and governance philosophy? |
| Operations                            | ▶ How does occupancy and net operating income growth compare to peers?  
▶ Is the debt/equity mix in line with peers?  
▶ How well does the company manage development risk?  
▶ How well organized is the company around changes in consumer habits and tenant behavior due to disruptive technologies and changing demographics? |
| Management value-add                  | ▶ Have corporate transactions/development been well timed and accretive to shareholders?  
▶ Has NAV growth exceeded peers?  
▶ Has the company raised capital in an accretive manner?                                               |

\textsuperscript{10} EY, “Global Perspectives: 2016 REIT report”.  

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Shareholder activism
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