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REITs in 2021

For REITs – as for so much else – 2020 was a tale of two cities, of boom and bust, from strength in a few sectors, to silent streets, offices, shops, theaters and airports, and huge market dislocations, from which the world continues to slowly emerge. Many REITs are well positioned for strong recovery and growth as the pandemic slowly recedes. At the same time, REITs have learned important lessons from the seismic shifts experienced in 2020, some of which may require rethinking strategic plans and business models. In this unusually complex context, some of the key issues REIT boards will be grappling with as 2021 begins include:

1. Post-Pandemic Opportunities. As the pandemic fades, one of the tougher questions, particularly for the stronger REITs, will be how and when to go on offense, whether that means dusting off pre-Covid deals or deal-plans (in many cases with adjustments to price or exchange ratio, asset mix, personnel or other factors), new M&A ideas, levering up, share-buybacks, going private, shedding non-core assets or other strategic transactions. The uncertainties around the timing of vaccinations and the resurgence of infections, and in some cases new investor or lender constraints, are sure to complicate things.

2. Role in a Digital Society. Every traditional business enterprise, including REITs, has to ask itself how it will fit in in the rapidly digitizing economy. Whether it's e-commerce, remote working, telemedicine, telelearning, drones, self-driving cars, the app-ification of everything, or any of the other trends accelerated by Covid, real estate will never be the same. The debate will continue as to which of the changes precipitated or accelerated by Covid will stick, which will recede, and which have been turbo-charged, and only time will tell. That said, while it's tempting to assume that things will go back to the "pre-Covid normal", in most cases that's unlikely, and even incremental changes can have significant impact on revenues and business models.

3. Activism. Covid brought out activists, in the REIT world and beyond, in record numbers, sometimes just parking money in cheap stocks, but often seeking some kind of change or representation on boards in response to perceived underperformance. Managing proactively and reactively for activism is now a core part of the REIT landscape. Too often, activists are attracted by the simplistic notion that a quick flip of the real estate at nominal NAV will unlock value, without understanding the costs or complexity involved and without understanding NAV. Once in a while, they shake things up with interesting ideas, but care should be taken not to allow activists to disrupt operations or long-term planning or to dictate actions or results for the sake of short-term profits and without regard to longer-term implications. Boards have a variety of powerful tools at their disposal for successfully dealing with short-termist disruptors, and should not hesitate to deploy them as warranted. Preparation and advance planning are key, including ongoing evaluation of each REIT's tactical and defensive profile, and refreshment of board and management awareness of the landscape and how the game is played.

4. ESG. Covid may have provided a critical inflection point requiring all boards to recognize the importance of ESG, sustainability and corporate purpose to mainstream investors as well as special interest groups. The link between "value" and "values" has gained broad acceptance and support, and should be part of any long-range strategic planning. See our materials on ESG and risk management.

5. Board Best Practices. A well-functioning, collegial board that speaks with one voice is essential to navigating the complexity of dealing with Covid and other crises and the evolving REIT markets, particularly when activists come knocking or extraordinary transactions are considered. Board dysfunction or division was a clear factor in a number of sub-optimal outcomes in the last few years. Our firm's recent Some Thoughts for Boards of Directors in 2021 and Spotlight on Boards may be of interest in this regard.

6. M&A Custom and Practice. A number of the key transactions entered into and litigated in 2020 put a spotlight the importance of well-crafted agreements and sales processes that withstand scrutiny. As a number of recent deals have shown, there is no one-size-fits-all approach for structuring deals or running a process that achieves the best results for shareholders. REITs interested in exploring strategic alternatives – and we expect to see a number of these in 2021 – should be careful to set (and ensure that their internal records are consistent with) realistic price expectations. Unquestioning belief in internal or third-party NAVs is often a recipe for confusion and disappointment – in the real world, many favorable transactions that are in the best interests of shareholders fall below theoretical NAV metrics.

7. Shareholder Engagement. A handful of "passive" investors now own a third or more of the stock of many REITs. Understanding their perspective, and engaging with them, is an absolute necessity, and is best done well before a difficult vote or contest. Activists know them well and visit them often; their voice should not be the only one heard. At the same time, actively managed funds are increasingly wielding their voting power and influence behind the scenes, and obviously great care should be taken to maintain strong relationships and anticipate and resolve potential friction points with those investors as well.

8. Proxy Contests. The rise of the "passive" investors, the influence of the proxy advisors, and evolving relationships among active managers, analysts and activists has given activists a relatively easy path to winning board seats or influencing board composition and business strategy, even when they own a very small amount of stock. Boards should understand and plan for this, particularly where the activists seek just one or two board seats and various governance or other metrics show vulnerability. Among other steps, care should be taken to carefully monitor trading and changes in the shareholder base, and to address potential weaknesses before activists put a spotlight on them.

9. Financial Markets. The tidal wave of liquidity that washed broadly over the economy in response to the pandemic did not miss the REIT sector, which issued more than $10 billion in public equity since the pandemic began, while easily setting an annual record in 2020 for public debt issuance (roughly $50 billion since Covid, and at historically low rates). The Fed's announced intention to maintain the status quo until at least 2023 bodes more of the same in 2021 as investors continue to chase yield. While sub-sector dynamics will affect rates and other deal terms, near-zero interest rates, a large and growing private loan sector,

hundreds of billions of dry powder in the private equity space and tens of billions more with SPACs will continue to provide liquidity and should help more vulnerable players transition through both the immediate crisis and the longer term, while providing stronger REITs and sectors with funding for acquisitions and consolidation.

10. Market Checks and Other Deal Technology. Deal technology and market expectations continue to evolve, particularly in response to the stress tests of 2020. Prior assumptions and modalities need updating as companies think about mergers and acquisitions in 2021, in regard to both contractual frameworks and deal structures. Among many other matters that require very careful attention at the earliest stages of any deal, the complexity of the current environment may call for post-deal market checks rather than full or partial upfront auctions. Post-deal market checks can be an attractive tool for maximizing value, providing the benefits of an "auction with a floor." A no-shop coupled with a two-tiered break fee (low for an initial period and then climbing to a market percentage) is sometimes a helpful compromise between go-shops and ordinary no-shops. Negotiating the right balance of deal protections while preserving the ability to fulfill fiduciary duties is especially important as topping bids are increasingly considered and made. The pandemic has also focused attention on deal certainty and deal terms applicable during the period between signing and closing, and sparked an evolution in deal technology and terms that now requires careful thought and negotiation on both sides of any transaction.

11. Litigation. Deal litigation continues to be largely inevitable, but should not be allowed to wag the dog. If a process is properly conducted and the merger agreement properly crafted, the courts will afford boards wide latitude to determine how best to maximize shareholder value, with litigation/settlement costs and exposure controlled and kept to a minimum.

12. Executive Compensation. Compensation programs of REITs did not avoid the impact of Covid. Many directors and executives agreed to temporary fee and salary reductions for 2020, as well as to reduction or elimination of bonuses, with fees and salaries slowly returning to pre-pandemic rates in 2021. Performance goals set pre-pandemic for long-term incentives may seem unattainable, but boards may be reluctant to adjust outstanding awards until the longer-term effects of the pandemic on metrics are better understood. Preparation for activism or M&A activity, such as the regular review of termination protections and retention incentives on a clear day, is key to maintaining the management team's focus in the midst of these uncertain situations. Compensation committees should be well-versed in their executives' arrangements and have direct lines of communication with CEOs and CHROs, as well as outside advisors, so as to be in a position to react quickly in any context. Our Compensation Committee Guide addresses these topics in greater depth.

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Following the seismic shifts and extraordinary market conditions in 2020, both financial and real estate, 2021 promises to be a year of marked change and opportunity. As usual, preparation and planning for the known knowns and unknowns will benefit those REIT management teams and boards that invest the time and keep their eyes on both the horizon and the immediate landscape as it evolves with unprecedented speed and complexity.

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