Corporate Governance

June 23, 2014
DJIA: **16,937** | RMZ: **1030** | 10-Yr Treasury Note: **2.62%**

Green Street Advisors

Ranking the Public Real Estate Companies

Overview: The wide range of corporate governance practices within the REIT industry can meaningfully impact share prices. A systematic approach to evaluating the spectrum of practices is essential to gain perspective. The updated governance rankings contained herein provide the necessary framework.

Corporate Governance Highlights:

- Overall, the REIT industry stacks up in line with corporate America on governance
- There is more to good governance than "checking-the-boxes"; a full one-quarter of the Green Street ranking system is based on board conduct
- **Prologis, Host, DCT Industrial Trust,** and **DiamondRock** all recently took steps to ensure that MUTA, a particularly objectionable entrenchment device available to the 70% of REITs that are incorporated in Maryland, will never be used against shareholders. The other Maryland REITs should follow their lead.
- **LaSalle Hotel Properties** and **Mack-Cali Realty** became the latest REITs to do away with the classified board structure. The 10% of REITs that have retained this outdated structure increasingly stick out like sore thumbs.

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Corporate Governance
Overview

Corporate Governance
A Review of Governance Practices in the Public Real Estate Sector

Companies with good governance should and do trade at valuation premiums relative to companies with poor governance. Because of this, Green Street regularly and systematically assesses governance for each of the companies in our coverage universe. Our rankings take into account subjective factors specific to individual companies as well as objective factors unique to the REIT industry, both of which serve to differentiate these rankings from those published by governance ranking specialists (e.g., ISS). These governance scores constitute a key input in our primary REIT valuation model.

Assessing corporate governance is no easy task because it is comprised of so many different variables. Governance is a composite of structural features embedded in corporate charters and bylaws, the make-up and structure of the board of directors, and the attitudes and behavior of management and the board. The goal of providing a comprehensive overview needs to be balanced with the competing goal of keeping an eye on the big picture.

Our governance rankings are predicated on two key observations:

1. Companies have a litany of anti-takeover devices from which they can choose. The choices a company makes on this front send a strong signal about the board's attitude toward governance. It is fair to assume that boards that avail themselves of more potential anti-takeover devices are more likely to use them in a manner adverse to the interests of outside shareholders.

2. The center of governance in any corporation is its board of directors. Boards that make themselves accountable to shareholders via annual elections are much more likely to behave in a shareholder-friendly manner. Also, boards comprised of members who have no conflicts and/or have serious "skin in the game" are desirable.

Recent changes to the ranking system: Last September two changes were made to the governance scoring system: 1) greater emphasis was placed on board behavior (25 pts out of the maximum possible of 100 are now reserved for board conduct) and 2) governance scores for companies where insiders control enough votes to act as deterrents to activists/suitors were lowered. See Heard on the Beach – Let the Mob Rule, Sept 3 2013 for more detail.

Corporate Governance

The Ranking System

Green Street's Governance Scoring System: Our governance ranking system differs in two key respects from those provided by other evaluators: 1) our familiarity with the companies allows for subjective input; and 2) issues unique to REITs (e.g., quirks in Maryland corporate law, the 5 or fewer rule) are ignored by others. Scoring is on a 100-point basis with the key inputs highlighted below. A more thorough description of the variables can be found in Appendix D.

Category	Max Points	Ideal Structure
Board Rating:		
Non-staggered Board	20	Yes
Independent Board	5	80+%
Investment by Board Members	5	Large Investment by Numerous Members
Conduct	25	No Blemishes, Fair Comp, Leadership
Total	**55**	
Anti-Takeover Weapons:		
State Anti-takeover Provisions	12	Opt out/Shareholders Approve Change
Ownership Limits from 5/50 Rule	5	Limit Waived for Ownership by other REITs
Shareholder Rights Plan	10	Shareholders Must Approve Implementation
Insider Blocking Power	8	No Blocking Power
Total	**35**	
Potential Conflicts of Interest:		
Business Dealings with Management	6	No Business Dealings
Divergent Tax Basis of Insiders	4	Basis Near Share Price
Total	**10**	
Perfect Score	**100**	

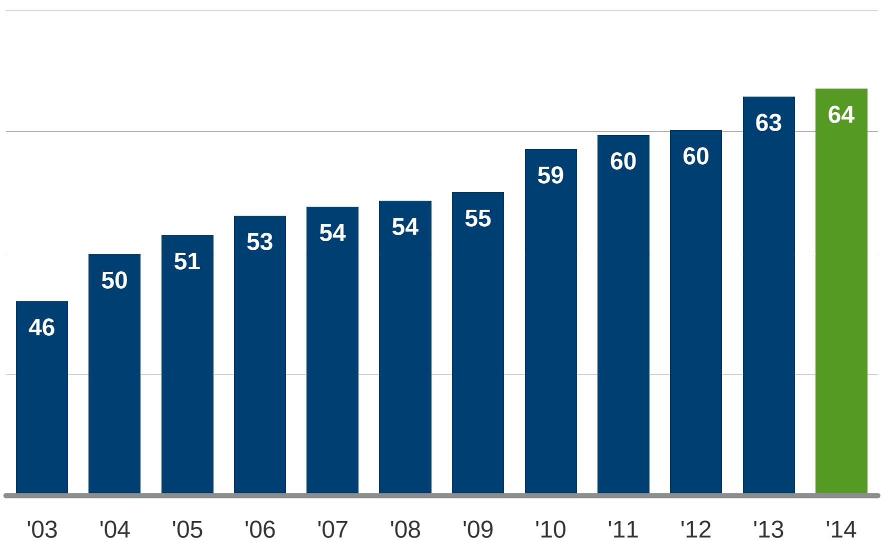
Insider blocking power: There are only a handful of REITs where insiders hold a blocking position, but it's a big deal where it exists. Because of that, a cap is placed on how many points a REIT where blocking power is present can score on the anti-takeover variables. For example, a REIT that scores a zero on the blocking power variable (because insiders own enough shares to effectively control any vote) will have any points credited for shareholder-friendly takeover elections the company has made cut in half.

This excerpt is from Green Street Advisors' Executive Compensation and Corporate Governance Report, June 23, 2014.

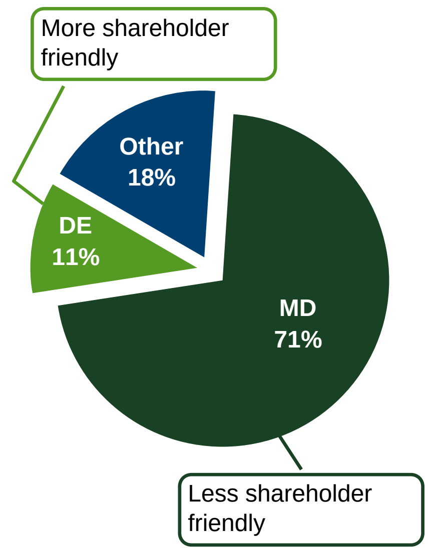
Corporate Governance
Notable Developments

Progress: The push over the past decade to clean up governance structures has led to a dismantling of takeover defenses across REITland and Corporate America alike. Only 10% of REITs retain the outdated classified board structure and a little less than that currently have a poison pill in place – impressive numbers that are comparable to the percentages for S&P 500 companies.

Average Corporate Governance Score



State of Incorporation



Getting Smarter on State Law

Boards have several anti-takeover devices at their disposal and a powerful one available to REITs incorporated in Maryland featured prominently in a takeover battle last year. **The Maryland Unsolicited Takeover Act (MUTA) permits a Maryland corporation to add various anti-takeover provisions, chief among them the ability to stagger the board, to its charter without shareholder approval.** Having a destaggered board, while at the same time retaining the ability to classify it (probably at just the time it matters most), is insulting to investors. REITs incorporated in Maryland should follow the lead of long-time corporate governance leader **Prologis** and the six other REITs that have taken steps to ensure that boards will never be reclassified, by leaving that power in the hands and votes of shareholders.

Highlights

MUTA — **DCT Industrial Trust, DiamondRock Hospitality, Host Hotels & Resorts,** and **Prologis** all recently added language to their corporate charters that prohibits staggering the board without first obtaining shareholder approval.

Destaggering — **LaSalle Hotel Properties** and **Mack-Cali Realty** became the latest REITs to do away with the classified board structure.

Conduct — Board members at **BRE Properties** responded to investor frustation and ultimately "did the right thing." Will the trustees at **Associated Estates** do the same or will investors' voices go unheard?

Corporate Governance
The Rankings

Wide Disparity: Some REITs have excellent governance structures; others have structures that give insiders enormous powers to ignore the wishes of shareholders. Clients with access to our "Data Tools" product can access detailed company-level scoring on our web site. Perfect score = 100.

Company	Score	Change
Prologis	98	+6
Health Care REIT	87	
Ventas	86	
Sunstone Hotel Inv	83	+4
DDR Corp	82	+1
DCT Industrial Trust	81	+8
DiamondRock Hospitality	81	+17
American Tower Corp	79	-6
Brixmor Property Group	79	+1
American Campus	77	
Equity Residential	77	+5
Highwoods Properties	77	+1
Retail Opportunity Investments Corp	77	-1
Boston Properties	76	
Federal Realty	76	
Digital Realty Trust	75	
Acadia Realty Trust	74	
EastGroup Properties	74	
Host Hotels & Resorts	74	+5
Post Properties	74	-2
Extra Space	73	
First Industrial Realty	73	
Camden Prop Trust	72	
Essex Property Trust	72	
Home Properties	72	
Retail Properties of America	72	+2
Tanger Factory	72	
Realty Income Corp	71	
Weingarten Realty	71	
AvalonBay	70	
Douglas Emmett	70	+1
National Retail Properties, Inc.	70	
Pebblebrook Hotel Trust	70	-9
Piedmont Office Realty Trust	70	
Simon Property Group	70	
Duke Realty Corp	69	-2
Kilroy Realty Corp	69	
RLJ Lodging Trust	69	-4
Cousins Properties	68	
CubeSmart	68	+5
EdR	68	+5
Equity Lifestyle Props	68	

Company (cont'd)	Score	Change
HCP, Inc.	68	+1
Kimco Realty	68	-1
MAA	68	
Regency Centers	68	+1
Spirit Realty Capital Inc.	68	-7
Westfield Group	68	-7
Healthcare Trust of America	67	+1
Liberty Property Trust	67	+3
Macerich	67	-1
Strategic Hotels	67	+4
Corporate Office Properties	64	-2
Public Storage	63	+5
UDR, Inc.	63	
Omega Healthcare Investors	62	+1
Alexandria Real Estate Equities	61	+3
LaSalle Hotel Properties	61	+12
CBL & Associates	60	-1
BioMed Realty Trust	59	-2
Sun Communities	58	+3
AVIV REIT, Inc.	57	
Brandywine Realty Trust	56	
Washington Prime	56	
Campus Crest Communities	55	-7
CoreSite Realty Corp	55	+2
AIMCO	53	
PS Business Parks	52	
Pennsylvania REIT	51	+1
Equity One	47	-2
Mack-Cali Realty Corp	46	+20
General Growth	44	
American Assets Trust	42	
Rouse Properties, Inc.	42	
Associated Estates	39	+4
Dupont Fabros Tech	38	
Washington REIT	37	
Felcor Lodging Trust	34	-2
SL Green Realty	34	-1
Empire State Realty	33	+1
Glimcher Realty Trust	33	-3
Healthcare Realty Trust	28	
Vornado Realty Trust	25	
Taubman Centers	18	+1
Average Score	**64**	**+1**

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Appendix D
Corporate Governance Ranking System – The Variables

I. Introduction
Companies with good governance should and do trade at valuation premiums relative to companies with poor governance. Because of this, Green Street regularly and systematically assesses governance for each of the companies in our coverage universe. Our rankings take into account subjective factors specific to individual companies as well as objective factors unique to the REIT industry, both of which serve to differentiate these rankings from those published by governance ranking specialists (e.g., ISS). These governance scores constitute a key input in our primary REIT valuation model.

Assessing corporate governance is no easy task because it is comprised of so many different variables. Governance is a composite of structural features embedded in corporate charters and bylaws, the make-up and structure of the board of directors, and the attitudes and behavior of management and the board. The goal of providing a comprehensive overview needs to be balanced with the competing goal of keeping an eye on the big picture.

Our governance rankings are predicated on two key observations:

1. Companies have a litany of anti-takeover devices from which they can choose. The choices a company makes on this front send a strong signal about the board's attitude toward governance. It is fair to assume that boards that avail themselves of more potential anti-takeover devices are more likely to use them in a manner adverse to the interests of outside shareholders.
2. The center of governance in any corporation is its board of directors. Boards that make themselves accountable to shareholders (via annual elections) are much more likely to behave in a shareholder friendly manner. Also, boards comprised of members who have no conflicts and/or have serious "skin in the game" are desirable.

II. About the Ratings
Our evaluation of corporate governance is separated into three key categories. The first of these is an evaluation of the make-up of each board, and, importantly, whether the board is accountable to shareholders. The second broad category measures the power that the board has to make governance decisions vs. the power vested in shareholders. The final category measures potential conflicts of interest between key insiders and shareholders. Our ratings are structured such that the "perfect REIT" would garner a score of 100, with the variables weighted according to the importance we believe they deserve.

A. Rating the Board
No aspect of corporate governance is more important than the composition of a company's board. Boards control enormous power. In the specific case of change of control issues, boards generally control the “trigger” with regard to some extremely potent weapons. In addition to these change of control issues, boards are responsible for ensuring that corporations behave in a manner consistent with the best interests of shareholders on all other fronts. Because the board's roles are so varied and important, any analysis of corporate governance has to place substantial weight on both the structure and membership of the board. 55 of the 100 points available in our rating system pertain to the quality and structure of the board.

As defined herein, the "perfect board" would have the four characteristics described below. Not surprisingly, these same characteristics constitute the variables we use to rate board strength.

1. **Boards should have an annual, not staggered, election of all directors.** Investors feel much more comfortable giving boards considerable power if they have a way of reigning in or firing boards that abuse those powers. **Accountability is so important that this is one of the most important variables (20 of 100 points) in our rating system.**
2. **A high percentage of directors should be independent.** The New York Stock Exchange has guidelines that afford considerable leeway for companies to define what constitutes an "independent" director. The idea that boards are left with discretion to make this determination strikes us as inappropriate, and our categorization of independent directors leaves much less room for business relationships between the director, or his employer, and the company.

3. **Multiple board members, including both insiders and independents, should hold sizable investments in the company.** Most board members today have impressive looking resumes, but when they don't "eat their own cooking", they tend not to utilize the skills that made them successful in the first place. Companies can promote this goal by paying board fees in stock, requiring members to hang on to that stock, and imposing share ownership minimums on board members.
4. **Reputation matters.** While this variable is obviously subjective, it is also very important. Some boards have been stress tested on change-of-control questions, many have dealt with issues where shareholder interests and managerial interests diverge, and all have dealt with executive pay questions. Our annual review of Executive Pay can have a big influence on this variable.

B. Evaluating the Anti-Takeover Tools

The primary entrenchment tools available to all companies are state antitakeover laws and poison pills. Anti-takeover devices that are more unique to the REIT sector include ownership limitations arising from the "5 or fewer" rule and the ability of founders/insiders to veto major transactions. It is impossible to determine ahead of time whether boards that have availed themselves of these tools would use them inappropriately, and it is also unwise to assume that a board that does not have certain of these features in place today might not put them in place when push comes to shove. Nevertheless, insight regarding the mindset of a board can be gleaned by reviewing which of these objectionable devices are in place.

1. **State Antitakeover Laws** - Well over half of the REITs in our coverage universe are incorporated in Maryland, a state whose corporate law (known by the acronym "MGCL") can be used to thwart the possibility of hostile takeovers. A number of other states have similar laws. MGCL establishes provisions that protect shareholders from "business combinations" involving "interested stockholders" as well as unsolicited takeover attempts. The key sections of this law serve as enormous impediments for hostile takeovers. A Maryland company may choose to opt out of these provisions, although boards generally hold the power to change prior elections any time in the future.

   - **Section 3-602: Otherwise referred to as the "Business Combination" provision.** The law prohibits for a period of five years a merger (or similar transaction) between a company and an "interested stockholder". An interested stockholder is defined as someone owning 10% or more of the voting stock. A business combination that is approved by the Board before a person becomes an interested stockholder is not subject to the five-year moratorium or special voting requirements. After five years, three things are required:
     1. Approval of the transaction by the Board of Directors.
     2. Approval by >80% of all shares outstanding.
     3. Approval by >2/3 of all shares excluding those owned by the interested stockholder.

   - **Section 3-701 through 3-710: Otherwise referred to as the "Control Share Acquisition" provision.** Defines a "Control Share Acquisition" as having occurred when a shareholder passes any of three ownership thresholds (20%, 33.3% and 50%). Once an individual or group passes one of these thresholds, voting power is stripped from their shares unless such voting power is reaffirmed by a 2/3 vote of shares not held by the acquiring person.

   - **Section 3-801 through Section 3-805: Otherwise referred to as "The Maryland Unsolicited Takeover Act (MUTA)":** Among other things, the law permits, without shareholder approval, the board of Maryland corporation to:
     1. Elect a classified board
     2. Enact a majority requirement for calling a special meeting of stockholders
     3. Require a two-thirds vote to remove directors
     4. Restrict the number and replacement of existing directors

   A REIT that has not opted out of these clauses would appear to be "takeover proof" absent the blessing of the Board. Explicit bylaw safeguards are necessary to ensure that these onerous laws can never be used to fend off a suitor absent the approval of shareholders. Companies incorporated in Maryland or similar states are accorded credit in our system if they have opted out of these laws. They are accorded more credit if they have bylaws preventing them from ever opting in. Companies located in states that don't have laws of this sort do not have these anti-takeover devices available, so they receive a good score in our rating system.

2. **Poison Pills or Shareholder Rights Plans** - Although their terms and conditions vary considerably, the stated purpose of a poison pill is to force potential bidders to negotiate with a target company's board of directors. If the board approves the deal, it may redeem the pill. If the board does not approve a bid and the potential acquirer proceeds anyway, the pill would be triggered. The "poison" in the pill is generally the issuance of a new class of preferred stock that is massively dilutive to the ownership and voting power of the suitor. Poison pills typically do not have to be ratified by shareholders, and even those companies that do not currently have a poison pill can put one in place subsequent to receiving a hostile bid. Our scoring gives credit for not having a pill in place (most REITs fit this category), and additional credit is given to companies that have explicitly transferred authority regarding poison pills to shareholders, instead of their boards (though rare, a small number of REITs have done this).

3. **Ownership Limits Arising from the "5 or Fewer" Rule** - One of the requirements in the tax code for a company electing REIT status is that not more than 50% of the outstanding shares of a REIT may be owned by five or fewer individuals ("individuals" may include certain entities). As a result, the vast majority of REITs have a rule restricting ownership of any individuals or entities to eliminate any chance that this rule may be violated. In most instances, the ownership limit is just below 10%, although for some companies where insiders (who are typically exempted from this rule) control a large amount of stock, the limit is more restrictive. More than any other attribute unique to REITs, the presence of these restrictions makes REITs harder to take over than is the case for other corporations.

   While the presence of these ownership limits is entirely legitimate, their use as an anti-takeover device has nothing to do with their original intent. Most potential hostile acquirers would present no threat of violating the "5 or fewer" rule. By way of example, if the acquirer is a REIT, the tax code allows a "look through" of the REIT entity to the numerous shareholders of that REIT. Because of this, the acquisition of a sizable share block by another REIT presents no cause for concern that the target's tax status would be compromised, but a Board could still use the ownership limit as a deterrent to a hostile takeover.

   The vast majority of REITs have ownership limitations in place, and most have written these limitations in a manner where they could be used by the board to deter a suitor. Since REITs have the entire arsenal of normal corporate anti-takeover devices at their disposal, it is objectionable that so many have made this added entrenchment device available as well. Credit is given in our scoring system to companies that have explicitly attempted to neutralize the anti-takeover aspects associated with their ownership limitations.

4. **Insider Blocking Power** - Companies where insiders control a large stake can, for all practical purposes, only be taken over if management agrees. And in many instances, management will never agree. Our scoring system penalizes companies where insider blocking power is present. Further, because this power trumps everything else, companies where insiders control the vote should not receive full credit on the other anti-takeover variables even if they've made the right choices. Companies with complete veto power will receive only half credit on the other anti-takeover variables, and companies with partial blocking power (i.e., 15-35% insider votes) will receive something between half and full. An exception is made in those cases where the interests of the controlling shareholder are aligned with those of outside shareholders; these companies are typically awarded full credit for their anti-takeover elections even though they score less than perfect on the insider blocking variable.

C. Potential Conflicts of Interest

Potential conflicts arising from divergent interests of key insiders and shareholders represent the final category of variables that comprise our governance ratings.

1. **Business Relationships with Management/Board Members** - REITs have come a long way from earlier structures in which they were generally externally advised, i.e., they contracted with insider-owned entities for most management services. Indeed, business dealings between insiders and their companies are either non-existent or immaterial at the large majority of the companies in our coverage universe.

2. **Extent to which Insiders' Basis Differs from Outside Shareholders' Basis** - A CEO who has been at the helm of a successful company for a long time generally has a tax basis in his shares that is much lower

than the basis of an investor who has built a position in recent years. Divergent tax bases can create a large difference in the way two parties perceive major transactions, such as a cash sale of the company. Because of this, interests of insiders and shareholders are generally better aligned where tax bases are more closely aligned. Because it is very difficult to obtain tax basis information for insiders, our ratings on this variable represent our best estimate based on how long insider shares have likely been owned and how much appreciation (and real estate depreciation) has taken place over that time. It is somewhat ironic that certain underperforming REITs score high on this variable solely because their stock prices have been stagnant, but in terms of rating governance, this is appropriate. It does, however, highlight the need to consider factors other than governance in selecting stocks.

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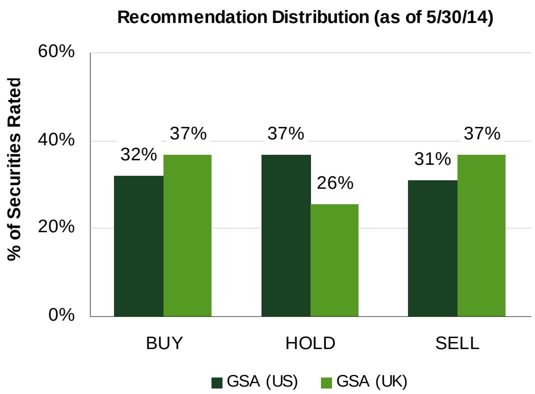

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Year	Buy	Hold	Sell	Universe[3]
2014 YTD	17.7%	14.6%	10.8%	14.4%
2013	4.1%	0.6%	1.7%	2.2%
2012	24.5%	24.7%	18.9%	23.0%
2011	18.9%	7.6%	-4.7%	7.6%
2010	43.3%	32.8%	26.6%	33.8%
2009	59.0%	47.7%	6.0%	37.9%
2008	-28.1%	-30.9%	-52.6%	-37.3%
2007	-6.9%	-22.4%	-27.8%	-19.7%
2006	45.8%	29.6%	19.5%	31.6%
2005	26.3%	18.5%	-1.8%	15.9%
2004	42.8%	28.7%	16.4%	29.4%
2003	43.3%	37.4%	21.8%	34.8%
2002	17.3%	2.8%	2.6%	5.4%
2001	34.9%	19.1%	13.0%	21.1%
2000	53.4%	28.9%	5.9%	29.6%
1999	12.3%	-9.0%	-20.5%	-6.9%
1998	-1.6%	-15.1%	-15.5%	-12.1%
1997	36.7%	14.8%	7.2%	18.3%
1996	47.6%	30.7%	18.9%	32.1%
1995	22.9%	13.9%	0.5%	13.5%
1994	20.8%	-0.8%	-8.7%	3.1%
1993	27.3%	4.7%	8.1%	12.1%
Cumulative Total Return	**10566.3%**	**856.2%**	**1.8%**	**961.4%**
Annualized	**24.5%**	**11.2%**	**0.1%**	**11.7%**

The results shown in the table in the upper right corner are hypothetical; they do not represent the actual trading of securities. Actual performance will vary from this hypothetical performance due to, but not limited to 1) advisory fees and other expenses that one would pay; 2) transaction costs; 3) the inability to execute trades at the last published price (the hypothetical returns assume execution at the last closing price); 4) the inability to maintain an equally-weighted portfolio in size (the hypothetical returns assume an equal weighting); and 5) market and economic factors will almost certainly cause one to invest differently than projected by the model that simulated the above returns. All returns include the reinvestment of dividends. Past performance, particularly hypothetical performance, can not be used to predict future performance.

(1) Results are for recommendations made by Green Street's North American Research Team only (includes securities in the US, Canada, and Australia). Uses recommendations given in Green Street's "Real Estate Securities Monthly" from January 28, 1993 through May 23, 2014. Historical results from January 28, 1993 through October 1, 2013 were independently verified by an international "Big 4" accounting firm. The accounting firm did not verify the stated results subsequent to October 1, 2013. As of October 1, 2013, the annualized total return of Green Street's recommendations since January 28, 1993 was: Buy +24.5%, Hold +10.9%, Sell -0.3%, Universe +11.5%.

(2) Company inclusion in the calculation of total return has been based on whether the companies were listed in the primary exhibit of Green Street's "Real Estate Securities Monthly". Beginning April 28, 2000, Gaming C-Corps and Hotel C-Corps, with the exception of Starwood Hotels and Homestead Village, were no longer included in the primary exhibit and therefore no longer included in the calculation of total return. Beginning March 3, 2003, the remaining hotel companies were excluded.

(3) All securities covered by Green Street with a published rating that were included in the calculation of total return. Excludes "not rated" securities.

Per NASD rule 2711, "Buy" = Most attractively valued stocks. We recommend overweight position; "Hold" = Fairly valued stocks. We recommend market-weighting; "Sell" = Least attractively valued stocks. We recommend underweight position.

North American Team

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