NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

October 11, 2017

Mr. Marc Goldstein, J.D.
Associate Director, Research
Institutional Shareholder Services
702 King Farm Boulevard, Suite 400
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Dear Marc:

We appreciate the time that you and your colleagues recently set aside to meet with us and to discuss certain issues with respect to listed U.S. REITs and REIT-based real estate investment in the United States. As we said at the meeting, we seek to open a dialogue and develop a relationship with ISS to share our perspectives with respect to important issues that may arise from time to time, to develop more fully our understanding of the procedures and practices developed by ISS and how they may affect our members, and to position NAREIT as a resource for you and your colleagues with respect to U.S. REITs.

To that end, we have prepared a short summary of the three primary topics we discussed during our meeting that reflect our views as well as certain attributes of listed U.S. REITs. The three issues include: 1) benchmarks for evaluating pay-for-performance of REIT CEOs; 2); voting policies regarding shareholder bylaw amendments; and, 3) appropriate metrics for characterizing the investment performance of listed Equity REITs.

ISS 2017 Qualitative Factor Screens for the Evaluation of REIT CEO Pay-for-Performance

Historical cost accounting for real estate assets implicitly assumes that the value of real estate assets diminishes predictably and linearly over time. Moreover, the historical cost of two basically identical assets can vary between two companies based on when the asset was purchased or put into service, further diminishing the usefulness of including depreciation expense when measuring or comparing the operating performance of REITs. Since real estate values instead have historically increased or declined with market conditions, real estate analysts and investors have considered analyses and presentations of operating results for real estate companies that use only historical cost accounting to be insufficient by themselves.

To overcome this problem, in 1991 NAREIT adopted the measure called Funds From Operations (NAREIT FFO) in the belief that it would be useful if consolidated after-tax income plus depreciation and amortization and excluding gains and losses from property sales were used as a supplemental measure of operating performance for Equity REITs. It was intended that use of NAREIT

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FFO would facilitate a more substantive and meaningful relationship between an equity REIT's share price and its operating performance, and thereby facilitate more useful and informative comparisons of the common share prices of different REITs. Thus, the original intent was that NAREIT FFO could be used to determine a supplemental capitalization multiple like a P/E ratio. Investors easily obtain a company's NAREIT-defined FFO either from a REIT's SEC or supplemental filings or through many data providers such as Firstcall Research and S&P Global Market Intelligence (formerly, SNL Financial).

As we noted during our meeting, several REITs expressed concerns to us that the metrics included in the 2017 qualitative screen were not particularly relevant for Equity REITs, which typically rely on NAREIT FFO, various adjusted versions of NAREIT FFO (AFFO) or property-level metrics such as net operating income rather than EBIDTA as measures of operating performance when establishing benchmarks for incentive compensation programs. Nearly all Equity REIT investors and analysts also use NAREIT FFO or derivatives thereof as the primary, albeit supplemental, measure of operating performance. In his widely-recognized text on REIT investment, the late Ralph Block noted, "Thus, a REIT's net income under GAAP, reflecting a large depreciation expense, has been determined by most REIT investors to be less meaningful a measure of REIT cash flows than [NAREIT] FFO, which adds back real estate depreciation under GAAP to net income."[1] Also, by excluding gains and losses on sales or real estate, NAREIT FFO avoids the variability to GAAP net income that is introduced when a REIT selectively sells an asset and books a gain or loss; such a gain or loss does not add meaningfully to an understanding of the REIT's current operating performance but rather is merely the liquidation/monetization of an asset that investors have already taken into account (by measuring NAREIT FFO and net operating income) when valuing the REIT.

Moreover, the Securities and Exchange Commission has recognized NAREIT FFO since 2003 as the standard non-GAAP supplemental measure of earnings for Equity REITs and requires companies that report various adjusted forms of NAREIT FFO to reconcile those adjusted measures to NAREIT FFO as well as to net income.[2] For more information on NAREIT-defined FFO, please read NAREIT's White Paper and related implementation guidance.

We were pleased to learn that ISS is reevaluating such metrics for the 2018 proxy season with consideration of industry specific benchmarks to more clearly align the evaluation of pay-for-performance with actual industry practice.

To assist ISS in this endeavor, we are attaching two pages from the 2017 NAREIT Compensation Survey of 143 REITs and real estate companies, conducted earlier this year by

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[1] Block, Ralph L., *Investing in REITs: Real Estate Investment Trusts*, fourth edition (2012), Bloomberg Press.
[2] See, SEC, Exchange Act Release No. 34-47226 (January 22, 2003), available at http://sec.gov/rules/final/33-8176.htm

FPL Advisory Group. These excerpts provide the most prevalent annual and long-term incentive performance metrics used to set incentive compensation.

Also in the compensation area, we note that during the past proxy season ISS introduced a new relative pay and financial performance assessment. For 2017, this assessment was considered only in ISS' *qualitative* analysis when the ISS quantitative screen (in which Total Shareholder Return ("TSR") was the only measure of performance) indicated misalignment of pay and performance. We understand that ISS is exploring integrating this new financial performance assessment into its *quantitative* screen starting in 2018.

In the new ISS relative pay and financial performance assessment for public companies generally, it is our understanding that ISS uses up to six financial metrics in addition to TSR; the relative ranking of the metrics varies by four-digit GICS industry group and not all metrics are used for all industries. We agree that it is appropriate for ISS to vary the metrics and weightings by industry because financial metrics are not one-size-fits-all connections to shareholder value. However, we believe that the methodology used by ISS to select the financial metrics and weightings for REITs was flawed.

As you know, the metrics that ISS introduced for REITs, in order of weighting, are: Return on Invested Capital ("ROIC"), Return on Assets ("ROA"), Return on Equity ("ROE"), TSR, Cash Flow from Operations, and Revenue Growth.[3] Of these metrics, we believe that the return metrics are particularly inappropriate for REITs because:

First, the calculation of ROE, ROA and ROIC is based upon a methodology that, in turn, is based primarily on GAAP net income. As discussed above, NAREIT FFO is more widely used by investors to measure a REIT's performance than GAAP net income.

Second, ISS uses a measure of equity that includes retained earnings in computing ROE and ROIC. Because negative retained earnings are prevalent among REITs[4] and a retained deficit reduces book equity, this definition can result in non-trivial overstatements of ROE and ROIC for REITs that have made distributions in excess of earnings compared with those that have retained earnings.

Third, in identifying comparison companies for REITs it is important to choose REITs that are operating in the same field or sector of the commercial real estate universe. For example, retail, office and multifamily structures have different patterns of returns and these sectors face different challenges and opportunities. Similarly, ISS should endeavor to measure companies against peers with similar amounts of debt and leverage in order to compare returns on a risk adjusted basis.

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[3] https://www.issgovernance.com/file/policy/pay-for-performance-mechanics-dec-2016.pdf

[4] Due to the non-cash nature of real estate depreciation, REITs routinely distribute "return of capital' distributions to their shareholders. *See* https://www.reit.com/sites/default/files/1099/HistoricalDividendAllocationSummary.pdf.

ISS 2017 Voting Policy Regarding Shareholder Bylaw Amendments

As we discussed, Maryland REITs and their outside counsel were surprised by the 2017 voting policy change announced by ISS because the relevant provisions of Maryland law, as well as several other states, have long authorized companies to permit concurrent shareholder bylaw voting at their discretion. As one prominent law firm commented, the 2017 ISS bylaw proxy voting policy change seemed unusual "in that it results in negative recommendations even in the absence of any recent action by the board to reduce shareholder rights and in the absence of any proposal or other action by shareholders of a particular company indicating their discontentment with the bylaw restriction".[5] Some REIT General Counsels (and their outside law firms) also told us that they were puzzled by ISS' assertion that this is a "fundamental right" of shareholders, noting that there is little support in published legal scholarship or judicial opinions for this position.

Notwithstanding any reservations, some NAREIT Maryland REIT members reported to us that they took the 2017 ISS voting policy change quite seriously. Our members reported that they consulted extensively with board members, as well as outside legal counsel, and engaged in outreach to their large shareholders to solicit their views.

Although NAREIT has not comprehensively surveyed its members, our sense is that many, if not most, Maryland REITs took a "wait and see" approach during the 2017 proxy season. Our members reported that many investors agreed that it was prudent to "go slow" in 2017. As ISS reported, no REIT governance committee members failed to be elected in 2017, but voting margins were marginally lower, perhaps reflecting the ISS new policy.

Several Maryland REITs have now informed us that they are willing to explore governance changes in 2018 that would be responsive to ISS' concern about bylaws. Some Maryland REITs have told us that they are broadly amenable to permitting shareholders concurrent authority (with their boards) to amend bylaws, as Delaware firms do, but are concerned that the 2017 ISS voting policy holds Maryland REITs to a higher standard than many Delaware firms as well as firms chartered in other states where supermajority voting rules for bylaw changes are prevalent.[6]

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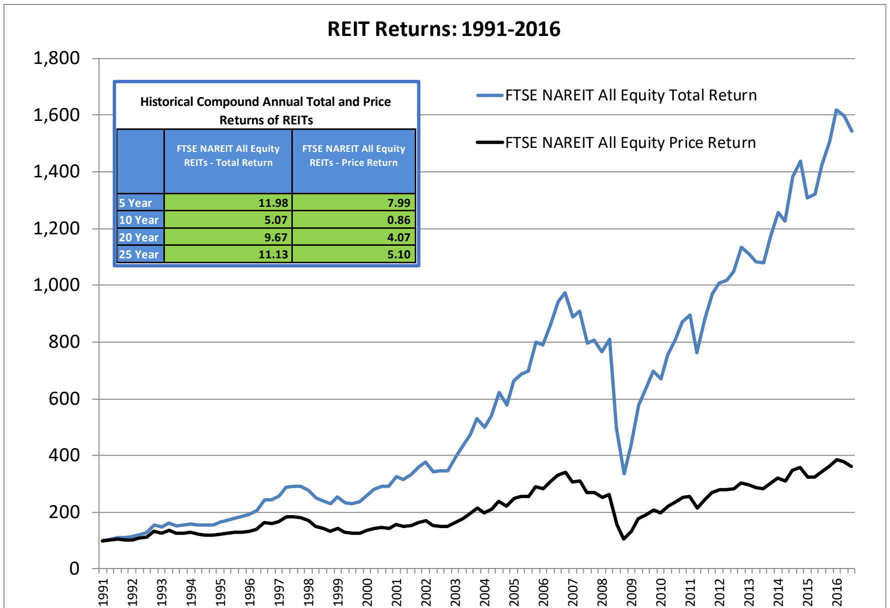
[5] Sullivan & Cromwell, LLP., 2017 Proxy Season Review (July2017) available at: https://www.sullcrom.com/2017-proxy-season-review.
[6] Scott Hirst, Frozen Charters, 34 Yale J. on Reg. (2017). Available at: http://digitalcommons.law.yale.edu/yjreg/vol34/iss1/3 (2017 survey reported in found that 41.9% 1,087 companies out of a sample of 2594 have supermajority provisions for amending one or more provisions of their bylaws); See also, Wilmer Hale, 2017 M&A Report (April 2017) available at: https://www.wilmerhale.com/uploadedFiles/Shared_Content/Editorial/Publications/Documents/2017-WilmerHale-IPO-Report.pdf (Supermajority bylaw voting provisions were present in 88% of IPO charters in 2015 and present in an average of 76% of IPOS in the period 2007-2016).

Some Maryland REITs have told us that they are exploring with their major investors specific ownership requirements for shareholder initiated binding bylaw amendments, *e.g.*, rules modeled on ownership thresholds that are prevalent for proxy access, or the right to call a special meeting. Some REITs have also said that they are evaluating structures that would reserve certain topics that are the traditional purview of corporate boards expressly for directors. Other REITs are exploring the possibility that any approval of shareholder-initiated bylaw changes would need to be approved at some level in excess of the majority of outstanding shares, as many Delaware corporations require.

We look forward to providing you and your colleagues with additional information and perspective as our Maryland REIT members develop their responses after consulting with their largest investors. You indicated that ISS also plans to engage in stakeholder outreach on this topic prior to finalizing its 2018 proxy voting policy. We look forward to learning the results of your additional outreach as well as your perspective with respect to such outreach.

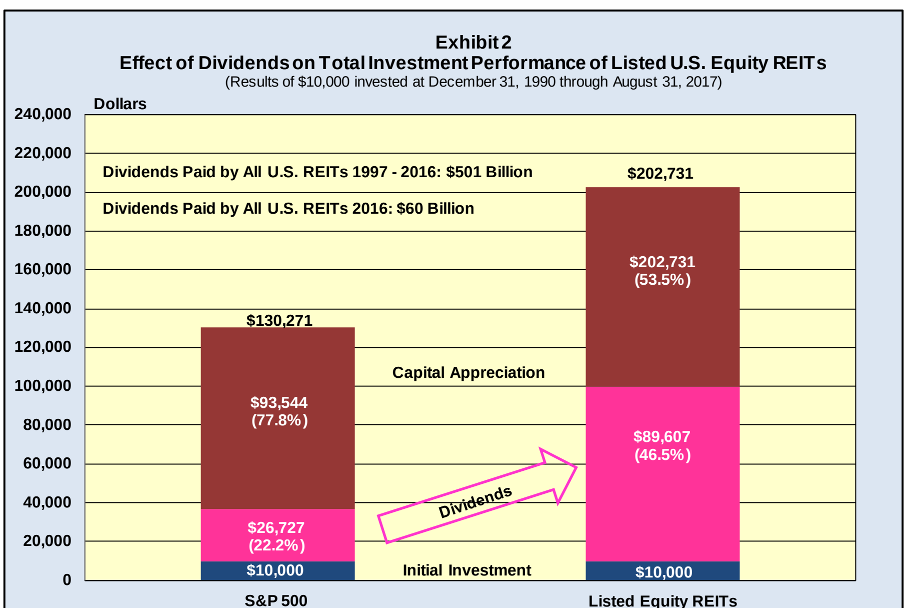
Reporting of REIT Investment Performance

As we noted in our meeting, some of our member firms have raised concerns about whether the graphs and charts included in ISS proxy reports give undue prominence to share price performance rather than to total shareholder returns. Owing to the distribution requirement of the Internal Revenue Code, REITs typically distribute all their taxable income as dividends to their shareholders. Thus, REIT common shares are widely recognized as providing relatively high income returns that have accounted for approximately one-half of total shareholder returns over recent decades. Exhibit 1, for example, compares price returns and total returns of listed Equity REITs over the period 1991-2016 using the FTSE NAREIT All Equity REITs Index. Clearly, the cumulative effect of regular dividend distributions reinvested over time has a dramatic effect on total shareholder performance. The two series illustrated in the exhibit paint starkly different pictures.



Source: NAREIT analysis of FTSE-NAREIT All Equity Index (total and price returns) via FactSet.

Exhibit 2 illustrates how the contribution of income returns to total shareholder returns of listed Equity REITs has appreciably exceeded in aggregate the contribution of income returns for all companies on average in the Standard & Poor's 500 Index. Nearly one-half of the total investment returns of listed U.S. Equity REITs over nearly 27 years has come from dividends, providing on average twice the dividend returns of stocks in the S&P 500. Over the same period, REIT stock price appreciation has significantly exceeded that of stocks in the S&P 500.



Source: NAREIT

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We are appreciative that ISS is willing to consider the selection of appropriate metrics for presentation purposes and to review possible changes with its outside vendors to visual presentations in the case of REITs to underline the important role of total shareholder return.

Again, we appreciate the time you and your team took to engage with us in a constructive discussion. We hope this summary will serve as a helpful reference going forward. Please do not hesitate to contact us if we can answer any questions that might arise or provide any additional information that you would find helpful.

Respectfully,

Steven A. Wechsler
President & CEO

Annual Incentives

Which of the following annual incentive performance measures does your company currently use or plan to use in calendar/fiscal year 2017?

The use of a Funds from Operations (FFO) metric is the most prevalent goal by participating companies with those companies using one of or a combination of (i) the standard NAREIT definition, those that use (ii) a "Core" or "Modified" FFO definition, and those that use (iii) Adjusted FFO. As one moves up the organizational hierarchy, Total Shareholder Return (TSR) and Investment Goals are used progressively more often. Also depicted is whether the measure is new to the program in 2017 as well as if the measure is utilized on a relative basis (usually to either specific peers or a broad based index) in addition to, or in place of, an absolute basis, for those companies that utilize it. The measures most commonly utilized on a relative basis are TSR and NAREIT Defined FFO.

	Organization Level				Measure New to the Program in 2017	Measure Utilized on a Relative Basis
	Executive Management	Senior-Level Professionals	Mid-Level Professionals	Junior-Level Professionals		
Total Shareholder Return (TSR)	33%	19%	12%	10%	1%	43%
Core or Modified Funds from Operations (FFO)	29%	23%	22%	20%	-	13%
Adjusted Funds from Operations (AFFO)	28%	21%	23%	22%	1%	21%
NAREIT Defined Funds from Operations (FFO)	27%	23%	18%	14%	1%	31%
Investment Goals (e.g., Acquisitions)	27%	20%	15%	14%	1%	5%
Net Operating Income (NOI)	26%	31%	28%	27%	1%	12%
Same Store NOI Growth	24%	20%	18%	16%	-	11%
Leverage Based Ratios/Balance Sheet Metrics	22%	11%	7%	6%	1%	7%
Leasing/Occupancy Goals	20%	23%	24%	21%	-	21%
Profitability Metrics (e.g., ROIC, ROE, etc.)	18%	17%	16%	14%	1%	19%
EBITDA	17%	12%	13%	11%	1%	17%
Funds Available for Distribution (FAD)	6%	4%	4%	1%	-	25%
Other	29%	31%	33%	38%	2%	7%

**Note: The table above is sorted by the Executive Management column*
Other: Discretionary/Individual goals

Long-Term Incentives

Which of the following long-term incentive performance measures does your company currently use or plan to use in 2017?

TSR is the long-term incentive performance measure used most often by participating companies across all organizational levels.

Also depicted is whether the measure is new to the program in 2017, as well as if the measure is utilized on a relative basis (usually to either specific peers or a broad based index), in addition to or in place of an absolute basis for those companies that utilize it. TSR is utilized on a relative basis by eighty-seven percent (87%) of participants that use this as a performance measure.

	Organization Level				Measure New to the Program in 2017	Measure Utilized on a Relative Basis
	Executive Management	Senior-Level Professionals	Mid-Level Professionals	Junior-Level Professionals		
Total Shareholder Return (TSR)	76%	59%	51%	57%	3%	87%
Profitability Metrics (e.g., ROIC, ROE)	22%	21%	20%	29%	2%	12%
Adjusted Funds from Operations (AFFO)	21%	18%	34%	48%	-	15%
Leverage Based Ratios/Balance Sheet Metrics	18%	13%	12%	24%	1%	14%
NAREIT Defined Funds from Operations (FFO)	18%	16%	20%	24%	-	27%
Same Store NOI Growth	14%	15%	15%	10%	1%	21%
Core or Modified Funds from Operations (FFO)	13%	15%	17%	19%	-	21%
Occupancy Targets/Growth	11%	13%	15%	10%	1%	18%
Dividend Metrics (e.g., growth/payout ratio)	9%	7%	10%	19%	-	18%
Dollar Volume of Investments	8%	9%	10%	14%	1%	18%
Other	17%	22%	34%	24%	-	9%

**Note: The table above is sorted by the Executive Management column*
Other: Discretionary/Individual goals