COMPENSATION PEER GROUP: GETTING IT RIGHT!

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Choosing the right executive compensation peer company has become a hotly debated issue in the board room. Companies use peer groups to assess and maintain competitive compensation levels, identify potential competitors, assess relative performance and defend compensation decisions. In short, getting the compensation peer group right in the beginning is absolutely key. Or, in other words, creating the wrong peer group not only creates the perception of a lack of governance in the compensation setting process, but it also often results in compensation that is too high or not closely competitive. In that case, digging a company out of that mess can become very complicated.

Where many companies miss the boat in the peer selection process, and understandably so, is the assumption that all competitors should be peers and all peers should be competitors. This is a mistake as it relates to executive compensation. These two groups are usually distinct from one another. A competitor is not necessarily a good comparator. A typical comparator peer group is made up of companies in the same industry, with similar size operations, commonly measured by revenue, assets, employees, and market capitalization, and it may or may not include some direct competitors. While competitors definitely should be considered for the peer group, many other factors should be considered for executive compensation peer company selection. Although this list is not exhaustive, the following five factors are considered are the most important ones to consider.

Size.

Market cap and annual revenue (assets for financial institutions), hold the highest correlation to executive compensation, although the market cap R^2 can get low in volatile markets like we're seeing in energy. Other potential size considerations are capitalization, enterprise value, net income, profit margin, number of employees, etc. Just as important as choosing which measurements are relevant to your company when analyzing peers, you should determine and utilize an appropriate range to assist in the selection of peers. A common practice is to identify potential industry peer companies that are no larger than 2.5x and no less than half the selected measurement (i.e. revenues) of the company. Direct competitors may fall outside of this range and need further review and thought prior to inclusion in the peer group.

Industry.

Reviewing companies within the industry is important, but it may be a frustrating task. An important point to consider is that every company is unique. Finding enough exact matches to be statistically valid is nearly impossible if the goal is to compare exactly the same company type and size. Therefore, do not focus solely on those companies in your small niche. Compensation practices and trends are generally similar across a certain industry. Therefore, reviewing the pay practices of companies in the broader industry and within a similar size range will yield results that are more applicable to your company. That way, you won't have to utilize only direct competitors that could be much larger and fall outside the scope of reasonableness. The key here is where can you draw talent from and where do you lose talent to, industry-wise.

Competition for Talent.

Simply put: Do you compete with certain companies for executive talent, and would these companies attempt to hire your company's executives for top-level positions? While a competitor in business and a competitor for talent may be the same, oftentimes they are not. A reasonable litmus: would your competitor considering hiring your CEO to replace its CEO? If yes, then it should be considered a peer comparison.

Performance.

Reviewing a potential peer company's historical performance relative to your company provides good insight into the decision to include it. Consistent under-performers may not likely be ideal peers for multiple reasons, including: 1) pay practices at under-performing companies may not be align to the market, and 2) if performance is measured relative to this group, it may create the perception of attempting to over-state actual performance as compared to the market. You should attempt to identify the strong performers, within the industry, and compare to those. Doing so will help better identify a more realistic peer group and potentially inspire companies to increase performance to the level of their peers. Lastly, strong performers typically have much more efficient total rewards programs that are crisply articulated and effective.

Geography.

A consideration that often arises is the geography of the company. While the geography of peer companies should be a consideration, it shouldn't be a key driver in determining the peer group. Specifically, if a company was looking to replace the CEO or CFO, it would not limit its search to the city where it's located. This logic would hold true if searching for a staff accountant, making geography much more important below the executive level. Therefore, when determining a peer company for executive compensation purposes, geography becomes less important. One other part to consider relating to geography is national versus international peers. Companies headquartered in the U.S. have international assets or are traded on an international exchange. However, utilizing international peer companies for executive compensation comparisons typically does not yield good comparisons since international executive compensation is structured so differently than the U.S.

Final Observations.

All of these factors are important considerations when developing a peer group to determine competitive executive pay. This list is not all-inclusive, and other factors such as operational footprint, business complexity, operating margins and more should be key components for peer group selection. Additionally, factors for compensation comparators below the executive level are very different. Often, competitors and geography are the major drivers for developing market competitive compensation.

Finally, the process used to analyze each of these factors and develop an executive compensation peer group is vital to the perceived validity and integrity of the final peer group. Companies should consider the use of independent outside advisors to initiate the peer group selection process. The job of management and the compensation committee is to review, provide insight and ultimately approve the final peer group. All in all, an independent process is critical when choosing a peer group.

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