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Peer vs. Competitor: The Importance of Distinction for Executive Compensation

KEY TAKEAWAY

A typical peer group is made up of companies in the same industry, with similar size operations, commonly measured by revenue, assets, and market capitalization, and may or may not include some direct competitors.

Impacts of a global pandemic, volatility in the markets, bankruptcies and consolidation through M&A activity has created a new business landscape… one no industry has completed escaped. The one area this impacts meaningfully is peer selection for compensation peer groups. To be sure, choosing a peer group can be a frustrating necessary task, exacerbated further by a shrinking universe of relevant companies. Companies use peer groups to assess and maintain competitive compensation levels, identify potential competitors, assess relative performance, and defend compensation decisions. Therefore, the importance of creating the right group cannot be overlooked. In fact, creating the wrong peer group not only creates the perception of a lack of governance with regard to the compensation setting process, it often results in compensation that is too high or compensation that is not competitive.

What is a compensation peer group?

A compensation peer group is a group of comparable companies carefully selected by compensation committees, proxy advisors, institutional investors, and compensation consultants to serve as a relevant market benchmark for setting executive compensation levels and comparing pay structures.

What are the most important factors to consider when selecting compensation peer groups?

Where companies often 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. Not true. Oftentimes, these two groups are distinct from one another. A typical peer group is made up of companies in the same industry, with similar size operations, commonly measured by revenue, assets, and market capitalization, and may or may not include some direct competitors. While competitors should be considered for the peer group, many other factors should be in the decision-making process. Although the following list is not exhaustive, the following five factors are critical considerations.

Industry

This is the obvious starting point in identifying relevant peers. Finding companies within the direct industry is important, but is becoming an increasingly difficult task. An important point to consider is that every company is unique. Finding enough exact matches to be statistically valid is next to impossible if the goal is comparing to 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 with tangential operations across a slightly broader industry will yield relevant results that are more applicable to your company, without having to utilize only direct competitors which may be much larger and fall outside the scope of reasonableness.

Size

Annual revenue (assets for financial institutions), more than any other measurement, holds the highest correlation to executive compensation. Other potential size considerations that should be reviewed are assets, market capitalization, enterprise value, net income, profit margin, and/or number of employees, etc. Just as important as choosing which measurements are relevant to your company when analyzing peers, an appropriate range needs to be determined and utilized to assist in the selection of peers. A common practice is to identify potential industry peer companies that are no larger than two times 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 prior to inclusion in the peer group.

Human Capital

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. It is important to identify those companies within your industry with which you compete for your top talent in order to assist in aligning compensation levels competitively.

Performance

Reviewing a potential peer company's historical performance relative to your company provides good insight into the decision to include them. Consistent under-performers may not be ideal peers for multiple reasons, including 1) pay practices at under-performing companies may not be in line with 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. Attempt to identify the relatively consistent performers to your company. This will help to better identify a more realistic peer group and potentially inspire companies to increase performance to the level of their peers.

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 in which it is 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 vs. international peers. Oftentimes, companies headquartered in the US have international assets, or are traded on an international exchange. However, utilizing international peer companies for compensation comparisons typically does not yield good comparisons since international executive compensation is structured differently than in the US.

Conclusion

Each of these factors are important considerations in the development of a peer group; however, the process used to analyze each of these factors and develop a 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. In all, an independent process is key.

It is natural to consider a competitor a peer for the simple reason that they are your competitor; however, many other factors should be involved in the determination of a true peer company. While competitors should not be ignored, they should not be the primary factor for establishing a reasonable compensation peer group.