

comparing apples to apples

Ensuring Integrity In
Your Compensation
Peer Group

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QUICK LOOK

- ⇒ Shareholders deserve a compelling rationale as to why specific companies are considered peers.
- ⇒ Peer-group data helps establish the “boundaries” of what is appropriate, but it rarely dictates the right answer without consideration of the company’s unique business situation and talent characteristics.
- ⇒ If the group is to be used for pay comparisons, 12 to 18 peer companies are optimal.

In the market-based world of executive compensation, peer groups serve as an essential yardstick. A company’s peer group of comparison companies should provide a reasonable gauge for assessing the competitiveness of company performance and executive rewards.

Now, with more executive compensation details open to public inspection, a company’s peer groups for pay and performance are up for debate at shareholder meetings and in the media. Under the new disclosure rules, companies must not only disclose the names of their peers, but also explain why those particular companies were selected, for what purpose and why they make up an appropriate set of comparators.



Unfortunately, peer groups have acquired a somewhat tarnished image and are becoming identified as one of the primary factors contributing to excessive executive pay. Critics point out that companies can too easily “choose” peers to provide a seemingly rational explanation for inflated and rapidly rising compensation. Further, they complain that if a company does not like the answers that one peer group provides, they can replace or rework the peer group to their satisfaction.

But shareholders deserve a compelling rationale as to why specific companies are considered peers: Are they direct business competitors (companies that compete for the same customers with the same or similar products/services) or talent competitors (companies that are an executive recruiting source or a destination for departing executives?) Companies can also qualify as peers because they serve as good yardsticks given the nature of their business or market characteristics.

In addition, shareholders want to know what function the peer group(s) plays: Compensation benchmarks? Performance comparators? Program-design references? In some cases, companies establish different groups for different purposes.

For example, a major consumer-products company had plenty of consumer-products peers appropriate for assessing its business performance. Yet when it came to pay comparisons, no other consumer-products company was in its league from the perspective of size or geographic diversity. To find true talent competitors, the company looked to other global companies of similar size with an equally complex operational structure.

Companies and boards are seeking ways to improve their peer groups in order to assure real value in the executive compensation decision-making process and avoid suspicion of manipulation. The following guidelines can ensure the integrity of the peer group for companies that are establishing a new group or assessing the current composition. Applying these guidelines has enabled some companies to develop a fair, appropriate and highly defensible peer group.

Step One: Define the Role of the Peer Group

The first step is to gain clarity about the reasons for using a peer group. The role of the peer group will have implications for the types of companies that would make up the group(s).

A peer group can help a company gain perspective on pay opportunities, pay levels and performance expectations. Companies typically use peer-group data to inform decisions about executive pay structure, executive cost structure and usage of equity, incentive design and performance comparison. (See Figure 1.)

More often than not, companies need one peer group for one reason and different peers for another, such as one peer group for performance comparison and another for pay comparison. The performance peers typically represent true business competitors—the yardsticks that indicate how the company measures up on financial measures and other key business indicators. The companies selected for pay comparison may represent a broader landscape (from an industry perspective) if the particular skills executives need are not industry-specific. Peers for pay also typically represent a tighter “size” range than performance peer groups.

For example, a regulated utility company uses one peer group to determine pay levels and to ensure an appropriate cost structure. This group of peers includes utilities with different business models and general industry companies, which represent the most likely sources of talent for staff positions. For performance comparison, the utility relies on a narrower group of regulated utilities, which have a similar business model, thus ensuring a fair basis for making performance comparisons.

As another example, a sporting-equipment manufacturer on a strong growth trajectory uses one peer group to benchmark the competitiveness of salaries, annual incentives and long-term incentives. Because its talent pool extends beyond direct competitors, the peer group contains both direct competitors and larger companies that have the leadership talent with the breadth of talent the manufacturer

FIGURE 1: ROLE OF PEER-GROUP INFORMATION

Comparisons For	Considerations
Executive Pay Levels	Reflects the cost of talent the company needs to run the business and ensures the company pays competitively <small>Note: A custom peer group provides this information only for the CEO and top five executives, unless comparable survey data is available for other executives</small>
Equity Usage	Aids in managing equity requirements relative to an external reference point
Incentive Design	Provides prevalence data and potential insights into creative design ideas.
Performance Comparison	Provides perspective regarding the alignment of compensation and performance at different levels of performance. <small>Note: This group can include different companies than the peer group for pay-level purposes.</small>

needs to lead the company forward. The company is an acquisition target, so it has a second peer group that serves as a reference for termination provisions (i.e., severance and change in control). That group includes companies similar to the manufacturer in terms of product, business strategy or distribution.

Step Two: Identify Screening Criteria

The desired role of a peer group determines, in large part, how the peer group is constructed.

A “good” peer group can be extremely difficult to define. Companies should watch out for these “red flags:”

- Significantly different business characteristics, e.g., dissimilar business models, different balance sheet, volatile performance, high level of family ownership
- Business competitors that are not primary talent competitors included as pay-comparison peers, or pay-group peers that have no history as a talent source or destination
- Peers that are significantly larger or smaller than the selecting company
- An industry or company in turmoil, e.g., experiencing wholesale leadership changes or rampant consolidation.

The following five criteria can help a company establish a solid basis for selecting peers:

1. **Size of group:** If the group is to be used for pay comparisons, 12 to 18 peer companies are optimal. Too few companies in the mix will test statistical integrity. One caveat: If the industry is consolidating, it is wise to select more rather than fewer peers, and to continually assess the impact of lost peers.
2. **Nature of Business:** Companies generally should be in the same business, meaning that at least 50 percent of a company’s revenue should come from the same source as its peers.

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3. **Talent Competitor:** The peers should represent logical sources of executive talent.
4. **Relevant Scale of Operations:** Peer companies should be within a reasonable size range, e.g., one-half to two times the size of the selecting company.
5. **Secondary Factors:** These will vary based on the characteristics of the selecting company’s characteristics. For example, revenue/earnings growth, financial structure, geographic focus and market capitalization could all be possible considerations depending on the selecting company’s strategy and market and business characteristics.

Step Three: Identify and Screen Potential Peers

Once the screening criteria are determined, the search is on for potential peers.

An apparel wholesaler wanted to assess its current peer group and determine whether a different mix of companies would be more appropriate. Its primary screening criteria included revenue, nature of business—apparel retail; department stores; and apparel, retail and luxury goods—and whether the

possible peer might be a talent competitor. Secondary criteria were wholesale/retail mix, geographic focus and similar market capitalization. (See Figure 2.)

Figure 3 shows how the company applied the screening criteria. When the company took a close look at its current peer group of just over a dozen companies plus another possible 10 companies, it discarded one current peer because industry consolidations had turned that company into a much larger enterprise, well beyond the ideal two-times revenue size. Another company was discarded because it lacked significant apparel revenue and also was not a true talent competitor. Two new companies that passed the screening were added to the peer group.

Step Four: Test the Validity of the Group











































This step involves testing the validity of the group to assure there are sufficient matches and that each adheres to the screening criteria established at the start of the analysis. In making this assessment, some screening criteria may carry more weight than others. On occasion, a company with different characteristics may be added to the mix because the company and/or compensation committee believe it has relevance beyond the objective criteria that can be screened. The selecting company must be prepared to explain and justify the inclusion of such an outlier so it is not perceived as manipulating the peer group.


If the comparison reveals that few true peers exist, a company should never feel compelled to force a peer group. Sometimes, compensation committees feel pressure to develop a custom peer group, but if this peer group is not meaningful, or if insufficient peers exist to produce statistically reliable data, it is better to compare against a broader set of companies such as general industry. (See the case study in the sidebar on the

FIGURE 2: SCREENING CRITERIA

	 =	 =	 =
Business Model	Similar complexity of product line, including significant apparel sales and similar wholesale/retail distribution mix	May not have same complexity in product line, but does have significant retail apparel sales or some wholesale/retail mix	No retail apparel and a substantial amount of sales are either 100% wholesale or 100% retail
Competitors for Talent	Has been a significant source or destination of talent in the past	Could be a potential source or destination of talent	Is not likely to be source or destination of talent
Wholesale/Retail Mix	Wholesale: 50% - 90% Retail: 10% - 50%	Wholesale: 25% - 95% <i>But outside of 50% - 90% range</i>	Wholesale accounts for a substantial amount of business or is less than 25% of business
Geographic Focus	U.S. Sales: 50% - 90% International: 10% - 50%	U.S. Sales: 25% - 95% <i>But outside 50% - 90% range</i>	U.S. sales account for a substantial amount of all of business or are less than 25% of business
Revenue	\$2.43B - \$9.74B (1/2 - 2x)	\$1.62B - \$14.61B (1/3 - 3x) <i>But outside of 1/2 - 2x range</i>	< \$1.62B or > \$14.61B <i>Outside of 1/3 - 3x range</i>
Market Cap	\$2.30B - \$9.18B (1/2 - 2x)	\$1.53 - \$13.77B (1/3 - 3x) <i>But outside of 1/2 - 2x range</i>	< \$1.53B or > \$13.77B <i>Outside of 1/3 - 3x range</i>

FIGURE 3: ASSESSMENT OF CURRENT PEER-GROUP CHARACTERISTICS

	Current Peers					
	TTM Revenue	Business Model	Comp for Talent	Wholesale/Retail Mix	Geographic Focus	Market Cap
Company A						
Company B						
Company C						
Company D						
Company E						
Company F						
Company G						

 - See definition in Figure 2 above.


Web site for an example of how one company dealt with this issue).

Final Thoughts

Peer-group data helps establish the “boundaries” of what is appropriate, but it rarely dictates the right answer without consideration of the company’s unique business situation and talent characteristics. Further, companies should avoid becoming over invested in specific statistical observations like median or 75th percentile. Valuation models are imperfect, and market data does not frequently enough consider risk/reward dynamics. It is better to consider a range of compensation values and position pay accordingly.

Companies should be prepared to explain how pay and performance levels are benchmarked relative to the peer group. The following prompts can help a company think through such issues:

- On a relative basis, within what competitive range should pay be targeted—above the median, around the median or below the median?
- Should pay positioning vary by role?
- Should compensation vehicles (e.g., stock options, restricted stock) be similar to or different from the most prevalent peer programs? Should the compensation program be leveraged more or less than typical in the peer group?
- How do performance metrics and goal-setting philosophy compare? How should absolute goals compare?

These are the types of issues that require attention to ensure the integrity of the peer groups and pass the sniff test that will be applied as soon as the peers show up in the proxy statement. 

EDITOR'S NOTE:

Go to www.worldatwork.org/workspan to read a case study of one company that needed to assemble a

custom peer group. Learn how your company can overcome similar challenges.

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