

Peer Group Pitfalls:

Overcoming Five Common Selection Obstacles

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After the Securities and Exchange Commission (SEC) enacted sweeping new rules in 2006 for the disclosure of compensation programs, institutional shareholders, journalists and governance advocates were provided a wealth of detailed new information about how publicly traded companies set executive pay.

One consequence is that the process of benchmarking executive pay has come under the microscope as never before. Creating a group of similar firms for direct market pay and performance comparisons has long

QUICK LOOK

- ⇒ Following the SEC's sweeping new rules in 2006 for the disclosure of compensation programs, the process of benchmarking executive pay has come under the microscope as never before.
- ⇒ Ideally, a peer group should include a mix of industry-relevant firms that are generally comparable in size.
- ⇒ Once companies develop an appropriate and defensible peer group, they will be well-positioned to collect relevant benchmark data.



been the critical first step to effective benchmarking, so it is natural that peer group selection practices are receiving particular scrutiny. It is important that companies put significant thought into the selection process.

Peer groups serve a wide variety of purposes, including comparison of pay levels, evaluation of pay design (including pay mix, selection of performance metrics, severance and contractual provisions, and equity instrument usage), and providing a perspective on relative financial and shareholder-return performance. It is widely understood that the ideal peers to consider regarding executive pay are like-sized firms that offer competing products or services and constitute a source of executive talent.

How many firms? RiskMetrics Group examined peer groups disclosed by the S&P 1,500 companies and found that 57 percent included between 10 and 20 companies. This is a sufficient sample size to minimize the impact of outliers when analyzing market data. If the peer group were much larger, it is unlikely that all the peer companies would be comparable in size and industry, not to mention the additional expense that would be incurred in collecting such a high amount of data. If the peer group were smaller, there would not likely be adequate data to reach valid conclusions.

But what is the proper course of action when your company cannot easily identify 10 to 20 peers that clearly “fit the bill”?

Obstacle No. 1: Our Competitors Are Generally Larger (or Smaller)

Company size often serves as a proxy for job complexity and scope when comparing executives who hold the same title at two firms. Within companies, revenue size generally offers the strongest correlation with pay levels,

with the exception of industries banking, where asset size may be more relevant.

Ideally, a peer group should include somewhat larger and smaller companies, such that the size of your own firm approximates the group median. However, there may be situations in which more than 75 percent of peer firms are significantly larger or smaller. If this is the case, there are two alternatives. The first is to employ regression analysis techniques to determine “predicted” pay levels for your company’s size. This will prove most useful when the data set is relatively large (at least 15 data points) and your firm is not the absolute largest or smallest in the peer group.

The second alternative is to use a reference point that is either above or below the median, in line with your firm’s size. For example, if revenue is at about the peer group’s 25th percentile, the 25th percentile pay position would be a more appropriate reference point than the median.

Other forms of analysis, such as financial performance, shareholder return, severance and change-in-control provision analyses are generally not as sensitive to company size and usually would not need to be adjusted for size differences.

Obstacle No. 2: We Have Outperformed (or Underperformed) Our Competitors

While it is tempting to use financial performance as a selection criterion, this approach is challenging because:

- The roster of potential peer group firms is narrowed.
- There are likely to be significant year-to-year differences in performance, requiring substantial turnover in the peer group roster. Year-to-year peer group roster consistency is generally preferable to the extent that companies remain relevant in terms of size and industry.

An alternative to basing selection on financial performance is to target

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pay at a level commensurate with your firm's performance relative to the peer group. For example, if three-year aggregate financial performance (based on measures that are meaningful to your investors and analysts) places your firm at the 65th percentile relative to its peer group, and your firm approximates the peer group's median size, it may be reasonable to benchmark pay relative to the peer group's 65th percentile.

Obstacle No. 3: We Generally Recruit Executive Talent From Larger Firms

As they grow larger and more complex, high-performing firms often target larger competitors in the recruiting wars. In such cases, a firm can construct an "aspirational" peer group that is comprised of those larger competitors for talent.

Aspirational peer groups of significantly larger and more successful companies have been rightly criticized when used as the sole reference point for benchmarking pay. However, they can be a useful supplementary reference point in the benchmarking process. For example, a company might want to develop two separate peer groups: one of size-relevant companies and another of aspirational peers.

The size-relevant peers provide a perspective on pay relative to similar firms, while the aspirational peers offer a perspective on pay levels among firms with whom the company is competing for executive talent. Data collected from the aspirational peers also can help pinpoint the extent to which pay correlates with company size in a particular industry, since the aspirational peer group will indicate pay levels for larger firms.

After considering pay levels among similarly sized and aspirational peers, a firm may decide to target pay at the 75th percentile for size-relevant

firms, based on firm performance relative to these peers and the extent to which pay levels vary between the two peer groups. If strong financial performance is sustained over time, the firm presumably will continue to grow, and the aspirational peers eventually will become size-relevant. If financial performance suffers, the firm should reconsider its 75th percentile stance, but continue referencing the same-size peers in setting pay.

Obstacle No. 4: We Have Few Clear, Direct Competitors for Our Product or Service Offerings

A company may have a shortage of peer group candidates because its direct competitors are foreign-based, privately held or subsidiaries of larger companies, and therefore are not required to disclose proxy data related to pay programs. Or, it may specialize in a particular niche that is not the primary source of revenue for many other firms.

In such situations, companies may use "like" industry firms as an alternative. Industry similarity is a meaningful predictor of pay levels and pay practices, so long as those companies' underlying financials, life cycles and risk profiles are similar. As an example, brewers, distillers and winemakers may all be considered like industries.

While the perfect match may not exist, specific factors to help identify the most similar peer firms would include size (by revenue, assets, number of employees, etc.); valuation multiples (e.g., market capitalization as a percentage of revenue); executive labor market similarity; international presence; investments in research and development; and similarity of customer base or suppliers.

In pursuing this strategy, be mindful of any differences in financial performance, choice of pay vehicles and actual pay levels between the firms

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most similar to your own in terms of product/service offerings (direct competitors) and supplementary peer firms added from like industries. It may be useful to isolate the most similar firms in a subgroup to more closely examine these aspects of pay and determine if there is a difference relative to the broader peer group.

Obstacle No. 5: Our Industry Is Consolidating, and Several of Our Competitors Were Acquired

Industry consolidation creates a good deal of angst among compensation practitioners by making it difficult to maintain a consistent year-over-year frame of reference for benchmarking purposes. But even when the roster of peer group firms changes as a result of merger and acquisition activity, it is possible and desirable to remain consistent in terms of the process used to identify peer firms.


A well-considered selection process will stand the test of time and provide a method for identifying potential peers, evaluating these potential peers based on appropriate criteria, and selecting the peers that are most appropriate for benchmarking purposes. Companies should revisit their selection process each year to determine whether new firms should be added and current firms removed. Where current firms have become “borderline”

(e.g., just outside of a revenue size or market capitalization size boundary criteria), some leniency may be exercised in order to maximize year-over-year peer group roster consistency.

In cases of industry consolidation, a consistent and thorough selection process will provide a rules-based process to eliminate those firms no longer appropriate based on size, to identify new peers that have evolved during the past year and are now appropriate for peer group inclusion, and to provide confidence that the peer group ultimately selected is valid for external benchmarking — even if there has been turnover in the peer group roster.

Conclusion

Once companies have developed an appropriate and defensible peer group, they will be well-positioned to collect relevant benchmark data to use in executive pay decision-making. However, benchmark data is only one piece of the puzzle. Factors like internal pay equity, wealth accumulation and the balance of risks and rewards that have been built into the company’s various incentive plans must be considered. In addition, benchmark data collected from peer group firms may be supplemented by industry pay surveys to provide a broader perspective, as well as by information collected during the

hiring process. Ultimately, companies are best served by pay decisions that are informed — but not handcuffed — by benchmark data. 

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