Peer group selection traditionally was a relatively simple process, in which companies focused on finding 10-20 firms of similar size and industry. There wasn’t much need for a more in-depth search, since peer companies were used primarily to benchmark pay and pay design practices.

Those days are gone.

With investors and the media keenly focused on measuring the link between pay and performance, the use of poorly chosen peer groups is increasingly viewed as a factor in inflated executive pay packages. Aside from unwanted attention to the Board and the company, the consequences of basing pay decisions on a peer group that is perceived as inappropriate include potential Say on Pay failures and voting campaigns against Board members.

This article examines a key – but often overlooked – factor in determining whether a potential peer company is really an apt point of reference: its alignment with the subject company’s business cycle.

Evolving Approaches to Peer Group Development

In constructing a peer group, Compensation Committees juggle a host of new considerations. Where once a second peer group might have been created if a comparison with corporate performance was needed, governance advocates today maintain that both metrics should be measured against the same group of companies. Among other analytics, companies are paying much more attention to ensuring that each peer company is sized appropriately by either revenue or, for financial firms, by assets and market capitalization in both cases.

Another difference is that it’s not enough for peer companies to be in the same industry classification: they also should have similar business model characteristics. Committees are digging deeper into whether a potential peer is primarily in the same business, related businesses or different business, and how their business model contrasts to the subject company’s. These decisions became paramount since peers, even if in the same industry classification, may either under or over perform the company under study solely based on how well the business model matches the company under study. For example, assume a company is in the P&C industry and 80% of the subject company’s business falls under P&C insurance while 20% is reinsurance. Contrast this to another
P&C company that has 20% in insurance and 80% in reinsurance. These companies are both in the P&C industry but have different business models.

The evolving approach to peer group construction must take into account three primary considerations:

- Business cycle
- Business model
- Company size

The Business Cycle Issue
In the last five years, there has been a shift in the design of long-term incentive programs. Companies are adding or putting more emphasis on performance-based vehicles instead of relying heavily on the use of stock options and time-vested restricted stock which do not require the forecasting or setting of future goals. Such performance-based vehicles may be based on absolute goals, relative goals or a combination, generally measured over three years.

The use of performance goals, particularly relative measures, heightens the importance of ensuring that the peer companies’ business cycles are reasonably aligned with the subject company. If not, there is an increased risk that payouts under the company’s long-term incentive program will be out of alignment with its performance compared to the peer group. Such mismatches can also have significant implications for Say-on-Pay comparisons and the ability to attract and retain senior executives.

The chart below illustrates how the business model cycle figures into a typical performance-based long-term incentive design:

<table>
<thead>
<tr>
<th>Year</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performance Cycle 1</td>
<td>Award payout 2016</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Performance Cycle 2</td>
<td>Award payout 2017</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Performance Cycle 3</td>
<td>Award payout 2018</td>
<td></td>
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</tr>
</tbody>
</table>

It is important to understand whether the company under study is in a cyclical business and how such cycles generally behave. The pay-for-performance analysis may yield either erroneous or controversial results if a comparison is made against peers that have different business cycles.
Assume the subject company is setting goals for the first performance cycle and is at the
top of its business cycle. If the majority of peers are at the bottom of their cycles – as an
extreme example – and set their performance goals accordingly, the measure of relative
performance three years later may not reflect a true pay-for-performance relationship.
One outcome could be that the subject company and many peers pay incentives at
target with large differences in performance.

**Putting the Peer Group Together**
The table below lists what are typically the most significant considerations in assembling
an appropriate and defensible peer group:

<table>
<thead>
<tr>
<th>Potential Sources</th>
<th>Selection Criteria</th>
<th>How It Will Be Used</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Industry search</td>
<td>• Size: Revenues, market cap, enterprise value, assets</td>
<td>• Benchmarking pay</td>
</tr>
<tr>
<td>• Current direct competitors</td>
<td>• Industry: Direct competitors, direct competitors of business units, all companies within an industry classification</td>
<td>• Benchmarking performance</td>
</tr>
<tr>
<td>• Peers used by major proxy advisory firms such as ISS, Glass Lewis, etc.</td>
<td>• Financial characteristics: Revenues, profitability, market cap, enterprise value, assets, capital structure (debt/equity ratios)</td>
<td>• Establishing the pay-for-performance relationship</td>
</tr>
<tr>
<td>• Firms that use the subject company as a peer</td>
<td>• Operating Strategy: Domestic, global, union, non-union, business mix, product offerings, service offerings</td>
<td>• Establishing incentive plan leverage</td>
</tr>
<tr>
<td>• Companies that compete for investment dollars</td>
<td></td>
<td>• Calibrating goal-setting</td>
</tr>
<tr>
<td>• Non-U.S. based companies</td>
<td></td>
<td>• Understanding long-term incentive vehicle selection</td>
</tr>
<tr>
<td>• Users of its products and or services</td>
<td></td>
<td>• Understanding long-term incentive design</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Establishing severance and CIC severance practices</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Understanding retirement program prevalence and design</td>
</tr>
</tbody>
</table>

Since it’s next to impossible to take into account all those factors when developing a
peer group, a suggested best practice approach would:

- Focus on peers aligned with size, industry, business model and business cycle. Within the business model, it’s very important to determine how the peers’ business cycles have aligned with the company under study.

- Be sure the Compensation Committee is familiar with the peers chosen by governance organizations, analysts and investment banking firms (i.e., peers that compete for investment dollars) but Committees should not be compelled to include these companies unless they meet the size, industry, business model and cycle alignment characteristics identified by Directors.
Assume the final peer group will be used for all purposes, although the Compensation Committee should review other sources of data to understand current and best pay practices to address specific compensation issues.

**Case Study Example**

One of our clients is a public company with customers in the aerospace, industrial, consumer, automotive, medical, and energy industries. It faced many common challenges in constructing a peer group:

- Very few direct peers, who ranged greatly in size
- The typical selection criteria (size, direct competitors, business unit competitors, customers) produced a peer group of very diverse companies with different business models and cycles
- Some direct peers were not based in the U.S. The client was able to use the foreign-based direct peers to evaluate performance, but could not benchmark pay levels because that information was not fully disclosed

Historically, the company used two peer groups. One was used one to measure pay and another to measure performance. This approach had been in place for several years. The committee believed the company needed to review the peer group approach to ensure that the two peer group approach and the composition of each group was consistent with current best practices of peer group construction. The Committee was also willing to consider establishing one peer group to measure pay and an index of companies to measure performance. The committee was also very aware that it needed to think in advance of how it planned to disclose the reasons for changing the peer groups and the approach the committee took to this analysis.

To construct a new peer group, we developed a customized, easily managed process as depicted below:
We eliminated nine of the 28 potential peer companies due to differences in:

- Business scope
- End market focus
- Size
- Performance

We tested the remaining group of 19 peer candidates to determine how they were aligned by performance against the subject company.

We created a graph to compare total shareholder return for the 19 potential peers to better understand potential business cycle alignment. The graph showed that the company's historical TSR performance aligned relatively well with the Energy Equipment & Services and Machinery sectors, but was most closely tied to companies in the Machinery, Metals & Mining industry. Historically, the subject company also aligned well with Aerospace & Defense companies, but the analysis showed their relative TSRs diverged in the past year.

The chart below illustrates our TSR analysis.

### The Peer Group Index Approach

However, we believed there was still too much variation in the TSR analysis to make the 19 potential peers a truly good fit and we recommended the company consider an index, which is a pre-selected set of companies to assess the company’s performance against its primary industry. Indexes, such as the S&P500, are commonly used on Wall Street,

While using an index to measure performance may be a better alternative than the subject company’s peer group, certain considerations should be kept in mind:
Many governance pundits believe a single peer group should be used to establish the pay-for-performance relationship and such changes are made by third parties who manage the indexes.

A company has no control over the selection of companies included in the index or any future changes in its composition.

If the company uses an index such as the S&P 500 that is much larger than the subject company’s peer group (typically 12-20 firms), a company may need to retain a firm to determine the accounting expense of the new long-term incentive program. These higher administrative costs should be considered.

The Final Analysis

We compared the client’s TSR against the proposed peer group and found limited alignment. We then looked at historic TSR performance of the peer groups listed below over seven years to address the last major consideration around peer group development.

The chart below compares:

- The subject company’s TSR performance
- The Russell Materials & Processing Index
- The Russell 2500 Growth Index
- The subject company’s current compensation peers
- The subject company’s current TSR peers
This analysis clearly showed the best business cycle alignment since 2008, as measured against TSR, was the Russell Materials & Processing Growth Index and this index could be a better alternative to measure company performance than the proposed peer group that will be used to benchmark pay.

The Recap

Peer group construction is a complex process with profound implications. We recommend these guiding principles to ensure you create the most appropriate group:

- **Understand size** – The companies in the peer group should meet best practices sizing criteria especially for revenues, market cap and assets for financial services firms. If some direct competitors turn out to be too big or small, analyze these companies separately.

- **Review business model alignment** – Research the business models of potential peers, avoiding those that stray far afield.

- **Analyze business cycles** – Review historic TSR performance to understand how business cycles may affect the pay-for-performance relationship.

- **Consider an index to measure performance** – While the use of a single peer group to measure pay and performance is a widely cited best governance practice, in some cases an index is a more appropriate. However, reliance on an index to measure performance may require additional explanation in public disclosures.

- **Be aware of proxy advisor peer groups** – While Compensation Committees should be familiar with proxy advisory firm’s standards for peer group selection, they should be an input but not be the prime or only consideration. Compensation Committees are best positioned to identify the most appropriate peers for the companies they oversee.

About the Author

Peter Lupo, Managing Director and Head of the New York office, joined Pearl Meyer & Partners in 2006 with more than 20 years experience with executive compensation and benefits programs in a wide range of industries. He has worked extensively with Compensation Committees and management covering a variety of needs, including developing compensation philosophies for national and global companies; drafting CD&As; developing incentive designs; and advising on change-in-control, executive benefits and perquisites issues.

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