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The right peer group for the right pay plan

Guiding principles for formulating a peer set that will withstand heightened scrutiny and promote rational pay decision making.

By Scott N. Olsen and Thomas M. Tabaczynski

Many journalists and compensation experts have written articles that lament rapidly increasing executive pay over the past few years. Some authors have cited faulty peer group development as one of the underlying causes. Peer groups, they imply, may have been created poorly by accident or perhaps without the use of expert assistance. They also indicate that there may be more overt factors behind some faulty peer groups, such as consultants that are advocates for executives or management that cherry-picks high-paying peers.

Given heightened scrutiny by investors and greater exposure of executive pay decisions due to new proxy disclosure rules, it is in the best interest of your company to develop an appropriate and durable set of peers that can withstand this scrutiny. Equally important, a relevant and well-crafted peer set will assist your company in making rational pay decisions.

To this end, we have provided our set of guiding principles — and one critical rule — for evaluating potential peer companies.

Guiding Principle 1: Relative peer company scope should be reasonable

Since there is a proven correlation between organization size and executive pay, common scope measures such as revenue, assets, market capitalization, and number of employees should be evaluated for each peer company to ensure that they fall within some reasonable range of current/anticipated size.

We typically recommend the use of one or more of these scope measures based on the industry in which a company operates — service companies may focus more on employees and revenues, financial services more on assets and market cap, etc. In reviewing size, we typically use one-half to two times a company's size as a guide to whether a company should be included in the peer group. However, the range for these metrics may vary depending on the size of the desired peer group and availability of relevant peer companies.

Guiding Principle 2: Industry focus and operational profile should reflect your business

Does the potential peer sit within the same industry? Does it operate in a similar manner to your

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business? Companies should review peer companies in their sector/SIC code/industry, however they wish to define it. Guiding Principle 2 uses a second screen — operational profile — as a filter for selecting potential peer companies.

Consider two companies in, for example, the cold storage industry. One operates cold storage warehouse space and provides supply chain solutions for grocery chains; the other rents cold storage trailers. While they are ostensibly in the same industry, they may not be appropriate peers because their revenues are not generated similarly, making size comparisons less valid.

However, not all companies engage in one single set of operations; many use varying approaches to the market. Therefore, in evaluating appropriate peer group composition you should consider industry specialization and the proportion of industry sectors represented by the peer group relative to those represented by your business. For example, if you are a generic pharmaceutical producer and also develop and market proprietary pharmaceuticals, it may not be appropriate to focus solely on firms that sell only proprietary products.

Four pointers on peer groups

- Take the time and effort to develop an appropriate peer group. Given the potential for investors to scrutinize actual peers and the fact that your organization will be disclosing them in your annual proxy statement, you will want to make certain, now more than ever, that executive pay is supported by competitive practice.

- Display relevant peer data for the compensation committee to use in its decision making. We also recommend that you display the companies that were studied but did not make the final peer set and explain why they did not. A display for the compensation committee may include a description of operations, revenue, market cap, and profit margin.

- Indicate how you evaluated these peers in the CD&A of your proxy to illustrate your organization's commitment to rational pay decisions and strong corporate governance.

- Resist the temptation to "tweak" the peer group annually. Instead, if you have defined a reasonable peer group, the annual review should not result in significant changes barring significant transaction activity or changes in business model.

— Scott Olsen and Thomas Tabaczynski

Guiding Principle 3: Competition for resources should be considered

In identifying appropriate comparators for pay purposes, consideration should be given to companies with which your organization competes directly for both investor capital and human resources. We believe that the competition for human capital is especially important in this process. Would the potential peer be a recruitment target for your company? Would you target senior executives from that organization? Likewise, would they be courting your employees and executives?

Guiding Principle 4: Attainability and quality of peer company pay data should be assessed

While proxy data can be easily obtained for any publicly traded domestic company, some organizations may have peers on the global stage. Foreign-owned companies or divisions of larger organizations may pose data collection challenges using publicly available sources.

Some compensation data houses will have access to data from private firms or divisions of larger firms. While peer information from these sources may not be disclosed in your firm's proxy statement, we recommend applying the same rigor in determining if they are appropriate peer companies for purposes of executive pay comparisons. Because companies may not participate in each compensation survey, the use of more than one source, depending on how many relevant peers are in each, may be useful.

Other factors also affect data availability and quality. Is the peer a new IPO? New IPOs can have significantly skewed share use and pay data and not enough data to determine how to "normalize" historic practices. Has the peer organization hired a new management team from outside the organization? New pay packages may reflect "make whole" payments to top executives leaving other organizations. Without historical data to help normalize new hire grants, it may be difficult to discern exactly what is happening on an annual basis with bonuses and long-term incentives. These peers should not be excluded automatically, but a judgment must be made regarding whether to use them for pay purposes in the current year. As they acquire another year or two of data, annual pay practices at these companies should become clearer.

Guiding Principle 5: Appropriate number of peer companies should be determined

Consideration should be given to the number of companies in your organization's peer group. Specifically, a sufficient number of companies should be identified so that your organization can secure statistically significant peer data for each of the top executive roles.

Typically, we target 12 or more peers and normally do not need to go beyond 20 companies (mainly because most organizations will not have 20 true peers). Expanding the peer group for the sole purpose of achieving statistically significant survey data results, however, would be questionable if those additional companies could not be validated by any of the other guiding principles outlined. For purposes of pay comparisons, relevant data is better than more data.

Guiding Principle 6: Relative peer company performance should be evaluated in the peer selection process — but not used as a selection criterion

In addition to the most common scope measures outlined above, certain key financial measures should be considered in validating the list of organizations. Do the peer companies have, for example, similar operating margins, financial leverage, or capital requirements? Significant differentials may be an indication that those companies actually operate in a different way. Do those differences mean that they would not consider your company's CEO, COO, CFO, or top human resources executive if they had an opening?

Would you target senior executives from the potential peer organization? Likewise, would they be courting your employees and executives?

Many consultants believe that performance must be considered and that a poorly performing company would not be a suitable peer for a strong performer. However, a poor performer with similar characteristics would be the first organization seeking executive talent from your organization. Performance is not a peer selection criterion; rather, it is a lens with which to evaluate your peer set. If you are performing at the high end of your peers it may make sense that your actual annual incentives would be toward the high end of the group. If you were performing higher over the longer run it would make sense that your total "at risk" pay portion of total remuneration is higher than your peers.

Guiding Principle 7: Sometimes peer organizations outside of the realm of the other guiding principles are appropriate

Now that we have laid out the framework for developing appropriate peers, we note that there can be exceptions. If your company seeks to identify "how" other organizations are paying their executives for certain activities, such as high growth, acquisitions, or significant divestitures, identifying and selecting peers in the same situation is appropriate. Remember the word "how" because a company in one of these circumstances is not likely to be a competitor for talent for your organization owing to a temporary, or business cycle, condition; therefore, it may not be a reasonable comparator for purposes of "how much."

These additional peers are appropriate to use to determine the "how" of pay, and not the level of pay. You can answer questions such as: Are company executives being provided significant equity in the divested company? Are they being provided significant acquisition bonuses? If the company is high-growth, what portion of incentives are provided in equity versus cash bonuses?

Rule: Board/compensation committee approval is necessary

Many peer lists are developed by management or at the behest of management. At the end of the day the peer group should be approved by the board or the compensation committee, period. Management may be involved, but board or compensation committee approval is required and is the foundation for many other evaluations and decisions made by the compensation committee or board relative to executive pay.

We hope that these guiding principles help you in your evaluation and development of a durable and relevant set of peer organizations. ■

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