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Perspectives

A Question of Relevance: A Five-Step Process to Ensure a Meaningful Executive Compensation Peer Group

By Myrna Hellerman, Elizabeth Stolarczuk and Spencer Moon

Executive compensation decision-making involves a large number of factors, including external pay comparability, internal equity, affordability, market pay practices, talent scarcity and regulatory requirements. Inevitably, however, the ultimate pay decision is greatly influenced by how senior leadership pay compares with pay at other organizations with which an employer competes for talent. Consequently, the identification and periodic renewal of an executive compensation peer group is integral to executive pay decision making, regardless of the organization's type or business model — publicly traded and private companies, public sector entities and non-profits.

This article describes a five-step process for the creation and sustenance of a well-structured executive compensation peer group. The experience of two different organizations with the process demonstrates how each employer customized the peer group to fit its unique business and operational circumstances.

Step 1: Decide Which Characteristics Your Organization and its Executive Compensation Peers Should Share

Shared organizational characteristics typically fall into four categories:

- Organization type,
- Financial and operational metrics,
- The geographic footprint in which the organization competes for talent, and
- Enterprise-specific characteristics, both quantitative and qualitative.

Although it is usually easy to identify the first three characteristics, it can be more difficult to agree upon the fourth. This is because enterprise-specific characteristics are subject to leaders' personal perspectives. The following statements are examples of such differences in perspectives from leaders at the same organization: "We should only consider organizations with a similar mission to ours." "Our peer group needs to exclude organizations that were established more than XX years ago." "We want our peers to have the same operating model as we have."

Figure 1 below illustrates how the shared characteristics identified by an actual for-profit organization (Publicly Traded Company ABC) and an actual non-profit organization (Private University XYZ) differed.

Figure 1: Shared Characteristics for Peer-Group Members

	Publicly Traded Company ABC	Private University XYZ
Characteristics	**Description**	
Type of Organization	A company in the technology, software, electronics, semi-conductor, security, telecommunications industry	A higher education institution*
Financial and Operational Metrics	Revenue: ⅓ to 3 times Company ABC** Market cap: ½ to 2 times Company ABC	Operating budget: ⅓ to 3 times University XYZ Full-time equivalent (FTE) students: ½ to 2 times University XYZ
Geographic Footprint	U.S. and Mid-Atlantic talent market	National and Midwest talent market
Enterprise-Specific Characteristics	Has international operations and/or globally sells products and solutions Has a similar number of FTEs or more FTEs than Company ABC Has a closely held, thinly traded ownership structure	Maintains a physical campus or location outside of the U.S. for degree-seeking students Offers online classes or degrees through full online classes or hybrid classes Maintains multiple campuses in the U.S., used for classes or educational purposes Offers pre-professional programs similar to University XYZ's Has a proportion of graduate to undergraduate students similar to University XYZ's

* Defined under the Carnegie Classification as a Master's Large program or more complex
** Expanded from ½ to 2 times to capture slightly smaller/larger direct competitors

Source: Sibson Consulting

Senior leadership and directors at both organizations acknowledged that they needed to anchor their executive compensation peer group with organizations of similar type, size and scope. They generally agreed about the geographic marketplace in which the organization competed for senior leadership talent. However, in both cases, they could not agree what other essential attributes their organization should share with its executive compensation peers. That decision would be made once a pool of candidates for the peer group was assembled and analyzed.

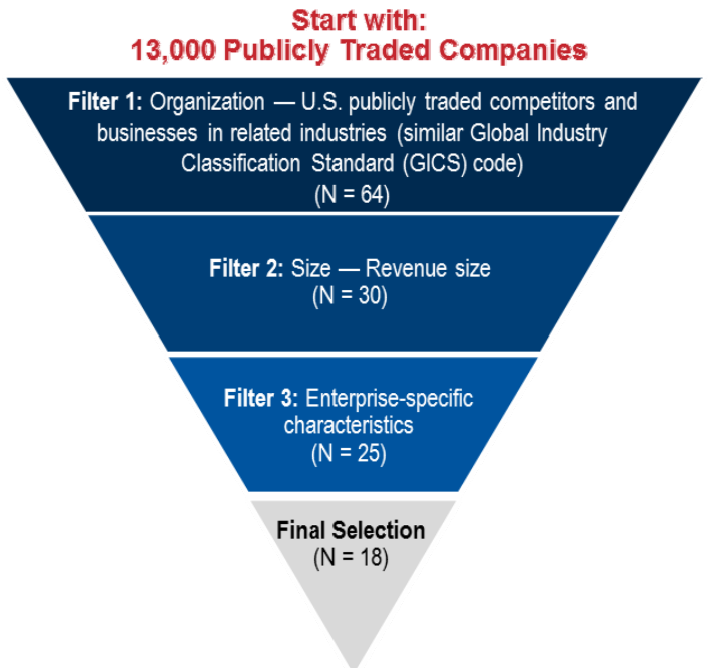
Step 2: Develop a Pool of Preliminary Candidates

Organizations can use filters to reduce the universe of potential peer group candidates to a more manageable size for further analysis. Figure 2 on the next page illustrates the application of a "funnel filter" that uses the shared characteristics developed by Publicly Traded Company ABC. Figure 3 on the subsequent page does the same for Private University XYZ.

For both organizations, Filters 1 and 2 in the funnels screened candidate organizations for type and size characteristics. In Filter 3, which is for enterprise-specific characteristics, Company ABC eliminated candidates that did not fit the specified organizational profile (*e.g.,* international operations and/or global product and solution sales). University XYZ, on the other hand, created a complexity-score matrix to evaluate candidates that emerged from the first two filters. The matrix assigned point values to each enterprise-specific characteristic. Only organizations that scored seven points out of the possible 10 passed through Filter 3.

University XYZ also added Filter 4, concerning the availability of data, to ensure that comparable data could be obtained for all organizations selected for the final peer group. (Data sources included Form 990 and other governmental filings, professional association studies and a custom survey.) The data availability filter was not necessary for Company ABC because Filter 1, which focused on the type of organization, had already limited its candidates to U.S. publicly traded companies, for which proxy data is available.

Figure 2: Using a Funnel Filter to Identify Peer Group Candidates for Company ABC



Source: Sibson Consulting

Before making the final selection of the peer group, both Company ABC and University XYZ enhanced their candidate pool by following steps 3 and 4 discussed below.

Step 3: Consider Organizations that Informed Outsiders Think Would Make Good Executive Compensation Peers

For publicly traded companies subject to the say-on-pay vote, informed outsiders include watchdog groups, financial analysts, investor proxy advisors and regulatory agencies. Of particular relevance are the peer groups developed by investor proxy advisors such as Institutional Shareholder Services (ISS) and Glass Lewis. Proxy advisors develop peer groups to evaluate CEO pay-for-performance alignment, a key influencer in their say-on-pay vote recommendations. Although the proxy-advisor peer groups were developed for a different purpose, they often can serve as a source of candidates for a company's executive compensation peer group.

For non-profits, partnerships and privately held organizations, the "Top-##" lists compiled by industry and trade associations, affinity groups, financial analysts and the media can be good sources of potential executive compensation peer-group candidates. It is important to consider only candidates that do not significantly differ in attributes that a prudent third party would consider relevant to executive compensation. In other words, the Mayo Clinic or Harvard should not be selected as a peer just because that organization shares the same "Top-##" list.

Step 4: Consider "Friends" for the Candidate Pool

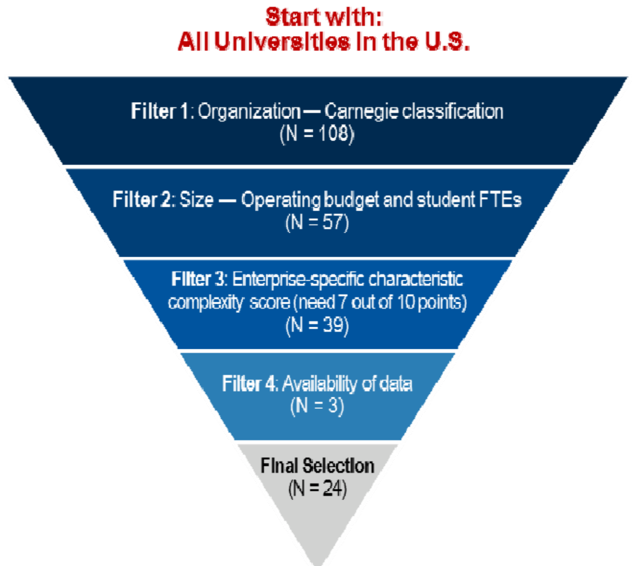
The investor proxy advisors have legitimatized the use of social-networking processes for peer group selection. Both Glass Lewis and ISS incorporate "friending" and shared networks concepts in their recently revised peer group selection methodology. Thus, organizations should consider candidates that "like" (*i.e.*, have already chosen) their organization as an executive compensation peer. Beyond the reciprocal "You chose us, so we'll choose you" approach, candidates might also emerge from an organization's "shared networks." (For instance, A wants to "friend" C. B is already A's "friend." C did not choose A as a "friend." However, C did "friend" B. Since B is A's "friend," A, B and C are part of a shared network.) (See Figure 4 below.)

Step 5: Make the Final Selection, Review Regularly and Refresh Periodically

Once the pool of candidates has been assembled, the organization uses the final selection filter to customize the "fit" of the peer group. The goal is 15 to 20 executive compensation peers. (See the sidebar "New Survey on Peer Group Shapes and Sizes" at the end of this article.)

The first step is to delete any preliminary candidates that made it through the filter process, but appear to be mismatches. Mismatches can occur because a potential peer, while sharing

Figure 3: Using a Funnel Filter to Identify Peer Group Candidates for University XYZ

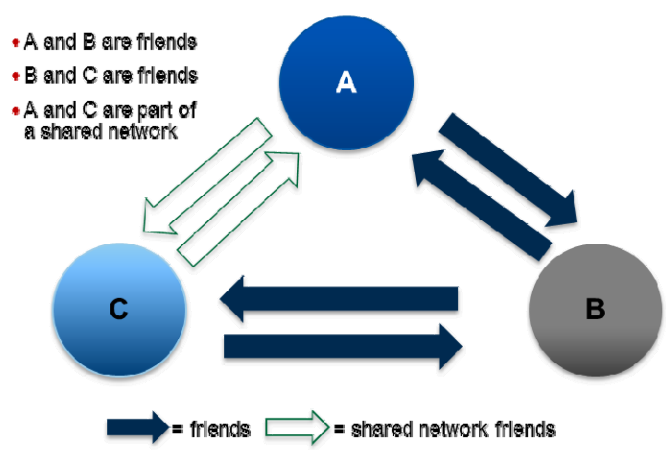


Sample Enterprise-Specific Characteristic Complexity-Score Matrix for Filter 3

Enterprise-Specific Characteristic	Complexity Point Value	Candidate A Score
#1	3	3
#2	3	3
#3	1	0
#4	2	0
#5	1	1
Total		7

Source: Sibson Consulting

Figure 4: Shared Network



Source: Sibson Consulting

similar size and organizational attributes, may be faced with significantly different financial, performance or operational imperatives and opportunities.

Next, evaluate the candidates that emerged based on input from informed outsiders and from the "friending" process. Although this assessment should take the organizations' size and shared characteristics into account, there is room for flexibility. For example, one non-profit decided to include an organization that matched on every shared characteristic except operating budget, and a publicly traded financial services company selected two outsized peers because a regulatory agency had determined that the three companies shared similar operational and management complexities.

Finally, an organization's executive compensation peer group requires regular monitoring to ensure its continued fit. Peers that become significant outliers to the size and shared characteristics should be removed. Viable candidates that emerge should be evaluated for possible addition. An annual revamp of the peer group generally is not required. However, it is appropriate to deploy the five-step process described above at least every three years to refresh and reshape the peer group.

Conclusion

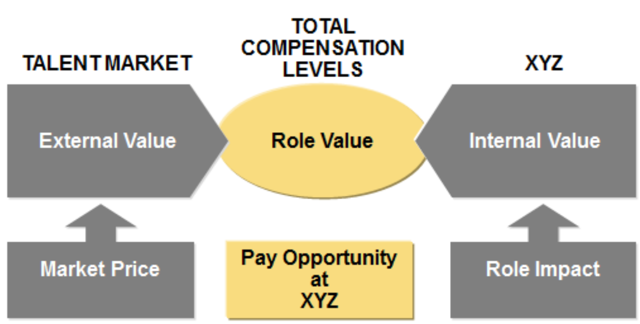
While peer pay comparisons are not the sole factor in the ultimate executive pay decision (see the adjacent sidebar "Beyond Peer Pay Comparisons"), the importance of external market data cannot be denied. Executive compensation peer groups help organizations compare their senior leadership pay levels and practices with competitors in the same talent market. Selection of peer comparators requires great care and, crucially, constant attention. Organizations that follow the five steps outlined in this article will develop a custom, relevant peer group that provides valuable input for their executive pay decisions and conforms with the expectations of regulatory and executive compensation watchdog groups.

Beyond Peer Pay Comparisons

It is often tempting to view market data as a definitive value for a certain person or role in an organization. However, there are two reasons why market data gathered from peer comparators should be considered only as the starting point for executive compensation decisions rather than the final answer:

1. ***Market values represent the value of the role, not the person.*** Market benchmarking matches job roles based on position responsibility. Market data does not recognize that an organization may have a particularly strong incumbent in the role, or does not recognize any retention needs that may be present. As such, certain individuals may warrant compensation beyond or below the benchmark level for their role.

2. ***Market values represent the value of the role to other organizations, not to the specific enterprise.*** Each organization places higher or lower emphasis on certain roles, based on its unique business and operational strategy. To the extent that an organization emphasizes certain functions more than others, it may be appropriate to position compensation accordingly. In making executive compensation decisions, decision makers need to identify the appropriate balance between the external and internal value for each executive, as illustrated by the figure below.



Source: Sibson Consulting

New Survey on Peer Group Shapes and Sizes

Once a rather stagnant component in compensation decision-making, executive compensation peer group selection has emerged as a dynamic "art form." In recent years, proxy advisors and compensation commentators have strived to standardize the shape, size and use of peer groups. However, rather than conform to outside norms, companies are reconfiguring their peer groups to uniquely fit their specific situation.

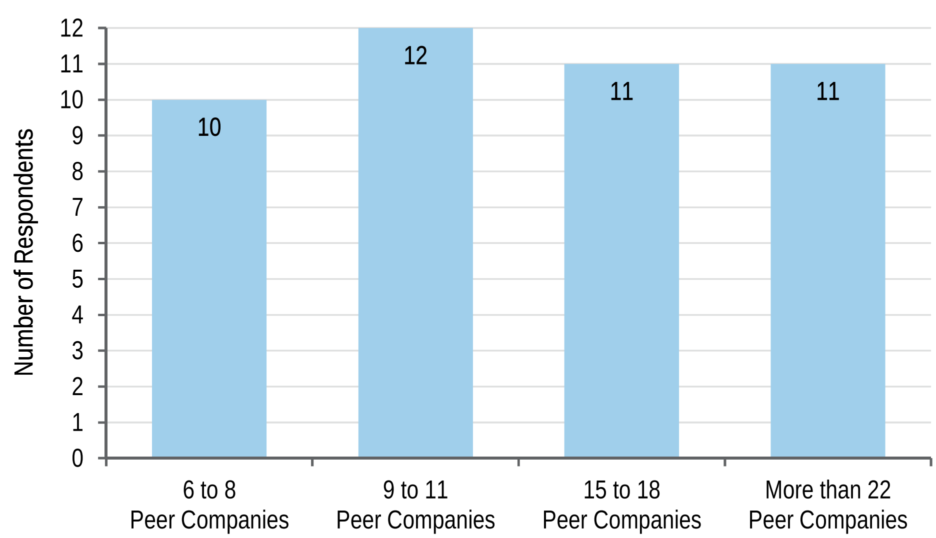
The diversity of employer perspectives on peer group shape, size and use is evidenced in the findings from a Sibson Consulting survey conducted at the 2012 National Association of Stock Plan Professionals conference in late fall. Sixty companies participated in the survey. A wide range of industries was represented including services, high-tech, materials and energy. Twenty-one of the participants disclosed revenues between $1 billion and $10 billion; 34 of the participants had revenues in excess of $1 billion.

Key Findings

Ultimately, each organization creates an executive compensation peer group that uniquely fits its specific situation. Key findings from the survey included the following:

- ***The number of peer companies included in respondent's peer groups was highly individualized.*** The number ranged from as low as six to more than 22 peer companies. (See Graph 1 below.)

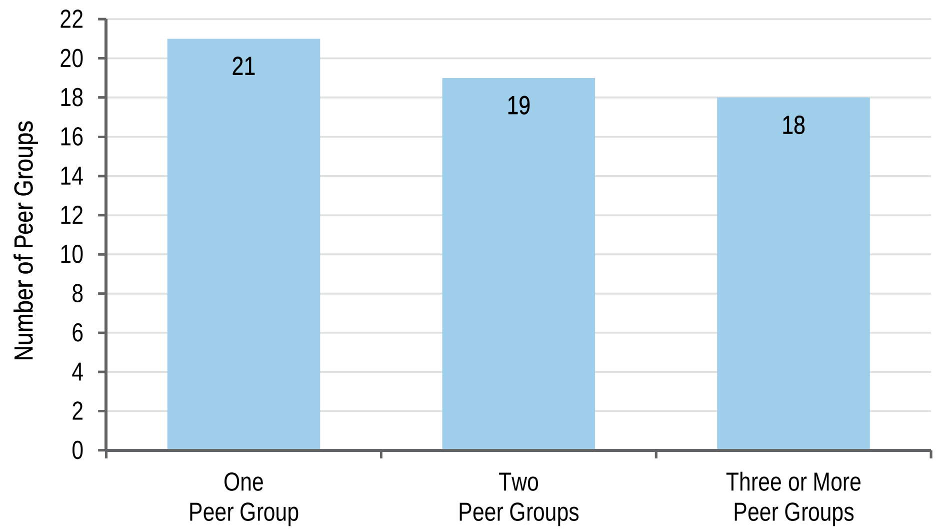
Graph 1: Number of Peer Companies in Respondents' Peer Groups



Source: Sibson Consulting

- ***The respondents' number of peer groups ranged from one to three or more.*** (See Graph 2 on the next page.) Some respondents indicated they had multiple peer groups to address different business segments or to compare pay at several employee levels.

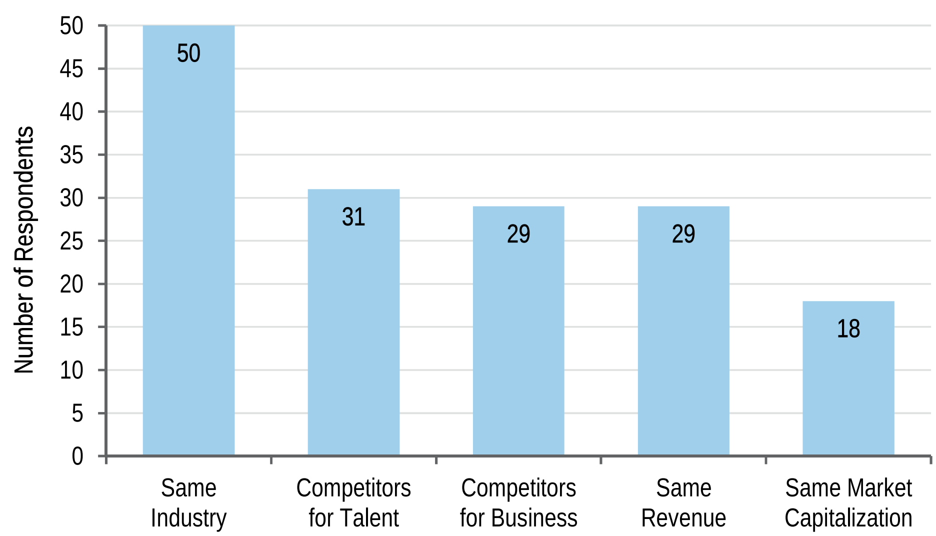
Graph 2: Respondents' Number of Peer Groups



Source: Sibson Consulting

- ***Respondents' peer group selection criteria varied.*** (See Graph 3 below.)

Graph 3: Respondents' Peer Group Selection Criteria



Source: Sibson Consulting

- ***Many respondents changed their peer groups during the previous year.*** Twenty-three respondents reported they had changed the composition of their peer group in the previous year. Most changes involved the removal of peers from the group. Although no dominant reason was reported, respondents said the peer company had become too large or too small, was no longer publicly traded or had ceased to be a good business comparator. Respondents also cited changes in the industry or the competitive environment or said they were responding to proxy advisor standards with respect to revenue and market capitalization.

- ***The vast majority of respondents used their peer group(s) as a market reference for compensation setting.*** For example: "Our peer group data is one of several reference points we use to determine appropriate senior leadership pay." Only two of the respondents used their peer group(s) to obtain an absolute answer for compensation setting (*e.g.*, "Our named executive officer pay will fall between +/- X percent of peer group median").

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