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Getting the Most from Your Compensation Peer Groups

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Executive compensation is a topic that attracts both attention and debate. To strike a balance between competitive pay and fairness—and to ground decisions in data—companies often rely upon compensation peer groups for key market context. Recent proxy disclosures, as tracked by Main Data Group, suggest that over 60% of publicly traded companies use compensation peer groups for benchmarking purposes, highlighting just how important companies view their industry's standards and the need to be ready to quantifiably address shareholder expectations.

Compensation peer groups include companies within the same industry and of comparable size and complexity. These companies are competitors for business, capital, and most importantly, talent. By benchmarking against these peers, companies can ensure their executive pay programs are aligned with market standards, which helps to attract and retain top talent. Ultimately, a well-designed peer group not only informs decision-making but fosters trust and confidence across all stakeholders—leadership teams, board of directors, and shareholders.

The initial challenge is to develop a peer group. The key is to outline a methodical approach while allowing for qualitative review and a degree of flexibility. At first glance, would Lululemon or Hilton Worldwide appear as ideal peers to Chipotle Mexican Grill? How about selecting Nike as one of McDonald's peers—special sauce and sneakers? To an outsider looking in this would appear nonsensical, but directors and leadership teams must remember that they are competing for a limited number of talented employees with skillsets that traverse specific products and services. This type of strategic peer group development lends itself to an iterative two-step approach:

1. Identify potential peer companies that meet a defined set of criteria; and
2. Assess the group of potential peers as a whole.

Identify Possible Peers

Cast a wide net when identifying potential peers. Include direct competitors, companies that have named your company in their peer group (i.e., "reverse peers"), peers of other companies of interest, and those companies that the proxy advisory firms have selected as peers for your company.

After creating a pool of potential peers, refine the group to focus on companies within the same or adjacent industries. An industry focus ensures that companies face similar market and regulatory conditions, making executive roles and responsibilities more comparable and, as a result, benchmarking more relevant.

Further refine the group to focus on companies within a reasonable size range for key metrics such as revenue, EBITDA, market cap, enterprise value, and/or number of employees. While the specific size metrics and reasonable ranges can vary by company, revenue often takes the lead as executive compensation is highly correlated with company revenue size. The additional size metrics provide valuable insights related to business model and structure, which can help identify the most comparable companies and lead to meaningful benchmarking.

Other important factors to consider are the complexity of a business and its life-cycle stage, for example pre-IPO, in turnaround mode, or experiencing high growth. Layering in these or other additional criteria can fine-tune the list of potential peers.

Collectively Evaluate Potential Peers

Reviewing the group in aggregate is equally important to the process as selecting individual companies. A simple starting point is to review sample size and company positioning. A group of about 10 to 20 peers provides meaningful data and minimizes the potential impact of outliers. A smaller group may not provide enough data to draw conclusions while a larger group may include less-comparable companies. Ideally, when it comes to size metrics, especially revenue, your company is positioned at or around median. This shows a balance of smaller and larger companies. You can also review the group dispersion (or the range of results from lowest to highest) across the size metrics. Lower is ideal, indicating less variation and yielding more meaningful results. Finally, consider whether there is sufficient representation across your selected criteria. In other words, is there a reasonable number of companies with similar products/services, business models, geographic footprints, etc.?

Bear in mind, no peer group is flawless. The development process is a balance between the trade-offs of selecting peers individually and evaluating how they come together as a group. As an example, you may need to balance the revenue and market capitalization results of the peer group—selecting company A over company B, which has lower revenues and higher market cap—to help right-size and improve your company's positioning to median for both metrics.

In another example, you may have a direct competitor that is aspirational in size and simply too large to reasonably include, but understanding their pay practices could be beneficial. In this case, you could substitute a different non-competing company that is still industry- and size-appropriate. This would minimize dispersion and produce a more sensible group. In these instances, it's best not to fully exclude the direct competitor—instead, consider tracking it as a "reference company" outside the actual peer group as a way to stay apprised of its pay practices.

Involve Principal Stakeholders

This process is often an iterative one as you test potential peers to arrive at the most effective peer group. When appropriate, seeking input from key executives, compensation committee members, and other stakeholders will help build consensus for the resulting peer group. This additional engagement can help ensure transparency and support.

Maintain Ongoing Relevance

As with most processes, once established, regular maintenance is needed to ensure it remains effective. Review the peer group annually to confirm continued relevance.

Do the current peers still fit from an industry, size, and business model perspective? It's not uncommon that current peers may fall outside the size parameters due to rapid growth or decline and thus, are no longer providing relevant points of comparison. Those that have been acquired will naturally fall out, but it may be worthwhile to review the new entity as a potential new peer.

Finally, are there any other companies worth considering as potential additions? This cycle comes back to the process of assessing the pool of potential peers. However, this time around there may be new companies that fit the selection criteria and that would enhance the peer group if added. Typically, an annual refresh might result in minor adjustments to ensure competitiveness in pay practices. Major alterations are likely if there is meaningful change in your size (acquisitions, divestitures/spin-offs, etc.), business focus, and/or business model. However, this is rare. Consistency within the peer group promotes benchmarking stability year-over-year and supports stronger long-term strategic planning.

Pursue High-Quality Peer Context

As the saying goes: garbage in, garbage out…quality in, quality out. Taking the time upfront to build and form a consensus on a high-quality peer group is highly beneficial. Confidence in the peer group will naturally translate market findings into actionable insights on traditional compensation items such as executive pay levels and pay mix.

Further, a well-designed peer group can provide context beyond how and how much to pay. For example, compare your pay and performance results to peers to identify any potential misalignments. A contributing factor to a misalignment may be goal rigor—specifically, goals that are too easy or too challenging to achieve. For perspective, compare your performance goals against historical performance results for both you and your peers. This can shed light on goal structures that fall outside of reasonable expectations. These are just a few ways peer data can provide relevant context during the compensation committee's decision-making processes.

Executive compensation strategies are continually evolving, and companies need to remain flexible and responsive. Peer groups play an important role in helping define market practices. Whether your goal is aligning with market norms or confidently standing out, a well-designed peer group enables informed, data-driven decisions.

About the Author

Kimberly is a principal at Pearl Meyer providing analytical and project management support for client endeavors across the country. She is committed to providing clients with efficient and effective analytical support and solutions to achieve desired objectives and help enhance performance. She is experienced in executive, board, and broad-based employee compensation assessments and strategies.

About Pearl Meyer

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