Pearl Meyer

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Constructing a Compensation Peer Group

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This is the second in a series covering Executive Compensation Essentials—a resource for every board, compensation committee, and management team.

Compensation peer groups are essential to any organization's pay strategy. This is the case regardless of whether they are public, private, or not-for-profit (although the data required to construct an apples-to-apples comparison is most prevalent for publicly traded companies). Peer groups provide market-based benchmarks which are a significant input for executive pay decisions and help organizations attract and retain talent while promoting fairness and transparency. While there is a clear and straightforward use case, developing a peer group is a deliberate, thoughtful process and demands careful consideration.

First Define Your Compensation Philosophy

Before diving into peer selection, it's crucial to clearly define your organization's compensation philosophy. Establishing the strategic objectives for the pay program upfront will provide a critical reference point throughout the peer group development process. Consider what compensation goals you aim to achieve, which should strike a balance between alignment with market standards, retaining key leadership, and ensuring internal equity.

Most importantly, **stay close to the business strategy**. Peer group choices need to be anchored in the unique aspects of your business—its type and maturity, performance priorities, and required leadership skills and capabilities.

Selecting Peer Group Members

Start with the science. Use proven analytical screens to develop an initial peer group that is logical and enhances the defensibility of the outcome. Basic screens based on the following criteria should guide initial selection.

- Primary Criteria:
  - Industry Alignment: Start by selecting companies within your industry or closely related sectors. Comparable market conditions and business dynamics ensure relevant comparisons.
  - Company Size: Appropriate relative size is critical, but the types of measures used for comparison can vary by industry. The most common focus is revenue, but other metrics such as assets, market capitalization, enterprise value, and employee count may be just as important (and in some cases more so). Once the key metric(s) are established, an appropriate size range should be set, typically 0.5x to 3.0x depending on the metric. Striking this balance ensures meaningful comparisons without skewing results.

- Secondary Criteria:
  - Geographic Scope: While geography matters less for executive roles than lower-level positions, local market comparisons may still be a relevant consideration.
  - Competition for Talent: Include companies that directly compete for your executive talent. In some cases, this may include companies that do not compete in the same industry.
  - Business Complexity and Stage: Consider the complexity of operations and the company's life-cycle stage—whether they're startups, mature entities, or undergoing rapid growth or restructuring.
  - Performance Stability: It's important to look at the financial stability and performance. Otherwise, reliable benchmarks can be distorted by underperforming organizations.
  - Peers of Peers: Most public companies disclose their peer groups, and reviewing them can provide valuable insights into industry practices. Looking at disclosures of direct competitors can uncover commonly referenced peers and identify companies that list your own as a peer.

Now add a dose of reality. The analytical process is a means to an end, not an end in itself. Supplement analytics with personal insight and experience, ensuring all relevant business or talent competitors are considered, even if they don't fully pass the analytical screens.

Refining and Finalizing Your Peer Group

Once a pool of potential peers is identified based on the defined criteria, then refine this list through deeper analysis. Start with the most obvious additions to the peers and expand if needed. Aim to finalize a peer group of approximately 12 to 20 companies to ensure a robust dataset. In some cases, the peer group may be smaller, but the key is to stop when any additions are diluting the relevancy of the overall market data. Now evaluate where the company falls within the overall peer group across your key metrics and determine if the company's alignment with this peer group is reasonable.

Aim for practicality, not perfection. Defining business and talent competitors is an evolving process, never static. No degree of precision or analytics will result in a peer group that lasts forever without frequent review and discussion. Peer group data can also be supplemented with survey data to provide additional context and market insights.

Governance and Oversight

Engaging your compensation committee in the review and approval of the peer group is essential. Clearly document all decision-making processes and rationales to ensure transparency and accountability. This not only ensures alignment with governance best practices but also reinforces credibility among stakeholders.

Recognize that human intervention is always required. Peer groups and pay data are starting points in a broader set of compensation discussions that encompasses many variables. Market data, no matter how seemingly precise, can never substitute for good judgment.

Conclusion

Creating and maintaining an effective compensation peer group is a continuous process.

Regular, thoughtful updates ensure the peer group remains relevant, reflecting any changes from mergers, acquisitions, or shifts in company market position. With a disciplined approach, management and compensation committees can confidently make informed decisions that support strategic objectives, enhance competitiveness, and meet stakeholder expectations.

About the Author

Malcolm Adkins is a managing director in Pearl Meyer's Houston office, and a staff manager and energy practice leader for the firm. He has over 15 years of compensation consulting experience with an emphasis on the assessment and design of executive and director pay programs, including assisting clients with compensation benchmarking and pay practices, annual and long-term incentive plan design, peer group development and pay-for-performance assessments, governance issues, and M&A support.

About Pearl Meyer

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