C-SUITE

An Equilar publication
Issue 24, Summer 2017

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Compensation Comparison

The ins and outs of how board compensation committees choose peers to benchmark executive pay

By Matthew Goforth and Dan Marcec

Designing executive compensation packages employs both art and science, and in the process of structuring executive pay, a majority of companies utilize an external set of comparator companies as a reference to inform pay decisions. Known as a peer group, this comparative exercise enables boards to assess pay levels and incentive structures at like companies for compensation decisions in support of executive talent recruitment, development and retention.

Pay for performance assessments by proxy advisory firms and institutional investors complicate the matter of constructing peer groups. These firms also often use their own peer groups for issuing companies as an additional point of comparison, frequently differing from a company's proxy-disclosed peer companies. Since such assessments weigh heavily in Say on Pay voting decisions, boards in the process of building an effective peer group closely consider the competing interests of the company, its investors and other stakeholders.

"Changes to peer group composition have been positive as they've added credibility to retrospective evaluations of pay versus performance alignment, as internal and external stakeholders are more likely to view the peers as having similar operational profiles and external influences," said Margaret Engel, Partner, and Matt Vnuk, Principal with Compensation Advisory Partners (CAP), who provided independent commentary for the recent Equilar report, *Peer Group Composition and Benchmarking*.

Companies most often disclosed similar industry classifications as criteria for peer group inclusion, with 442 companies in the Equilar 500—an index of the 500 largest U.S. public companies by revenue—naming this as a deciding factor in peer assessment. Revenue followed as the second-most popular peer group criteria, with talent being another common factor.

"Over the past few years, we have seen peer group development often include an increased focus on operating characteristics of a company,

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such as profit margin or percent foreign revenue, in addition to standard size screens such as revenue or market capitalization," said Engel and Vnuk.

Peer Groups Benchmarking

Most companies—95%—disclosed one compensation benchmarking peer group, with 4.3% utilizing two and less than 1% including three groups of peers in their proxy statements. Companies that leverage multiple peer groups often reference one group to assess the CEO's pay, and a separate group to assess the pay packages of other named executive officers (NEOs). Alternatively, one peer group may serve as a benchmark for the amount of pay while another informs decisions on incentive plan design.

"Companies use multiple peer groups for several reasons, such as understanding the difference between industry-specific and general industry data, when they operate in multiple distinctly different industries, or where they may want to review data from non-U.S. peers separate from U.S. peers," said Engel and Vnuk. "When multiple market reference points are used, in our experience, it is helpful to pre-define what is the 'primary' and what is the 'secondary' data point."

As an example, Dollar General disclosed separate peer groups for its CEO and non-CEO compensation decisions—11 companies were peers in both groups. The company also disclosed its use of proxy and survey-sourced data for the purpose of benchmarking its officers' specific roles. Since only the CEO and CFO are included in every proxy statement, beyond those positions certain companies will have to seek other sources to benchmark pay.

Furthermore, companies often choose additional peer groups to benchmark performance.

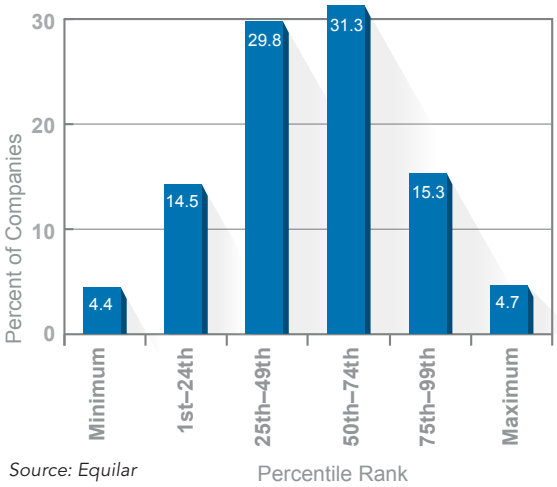
"Compensation peer groups and performance peer groups serve different purposes," said Engel and Vnuk. "Compensation peer groups are typically used as a reference point for setting target pay for executives. In contrast, performance peer groups are most often used to determine a formulaic compensation outcome, that is, the amount of incentive compensation earned."

It is a common practice for boards and their advisors to aim down the middle of their peer groups, both in terms of selection criteria and designing executive compensation packages. The Equilar study reflects the practice, where a majority (86.1%) of companies fell in the middle two quartiles of their peers as measured by revenue.

On the other hand, despite targeting median levels of pay, reported compensation in the proxy statement often falls in various distributions vs. a peer group for a variety of reasons. For example, 4.7% of the Equilar 500 reported the maximum CEO total direct compensation (TDC) among their peer companies, whereas 61.1% reported TDC in the middle two quartiles (Graph 1). Although TDC represents a mixture of compensation actually earned (salary and cash incentives) and accounting estimates of awards realizable in the future (stock and option awards), most companies still report annual CEO pay within a relatively narrow range bracketing their peer group median. These same CEOs also may fall elsewhere among their peers in terms of realized pay once long-term incentive awards, many of which are affected by company performance and stock price movement, are settled in the future.

"Compensation committees typically use the compensation peer group to test the degree to which pay and performance are aligned," said Engel and Vnuk. "In this process, the compensation committee evaluates relative pay positioning and compares it to relative company performance. The objective is to achieve alignment; for example, high pay and high performance or median pay and median performance are good outcomes."

Graph 1
Equilar 500 Pay Ranking vs. Peers



Source: Equilar

As an example, Wells Fargo disclosed a separate performance peer group ("Financial Performance Peer Group") from its compensation peer group ("Labor Market Peer Group") to determine payouts for performance awards. Though both peer groups were similar in scope, Wells Fargo disclosed that the performance group contained peers that it competes with for customers, whereas the compensation peer group included peers that it competes with for executive talent.

"It's crucial that company disclosure have credibility, both internally and externally," said Engel and Vnuk. "Proxy disclosure is a marketing tool designed to help external constituencies understand and buy into the rationale for a company-defined peer group. Inadequate disclosure can impact credibility, and potentially lead to adverse Say on Pay implications." CS

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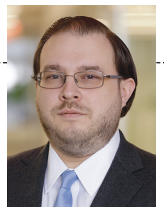

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