IOMA's Complete Guide to Best Practices in Pay-for-Performance

Peer Group Selection: More Important than Ever for Executive Compensation Decision Making

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Executive compensation decisions can be much more effective if you look at the right comparator data in the right ways, says Myrna Hellerman, Senior Vice President, Sibson Consulting, a division of The Segal Company (www.sibson.com). In particular, analysis of the data from the right peer group(s) for your company helps your company's compensation decision makers understand what it will take to attract and retain the executive talent you need. In addition, if your company is publicly traded, peer group data analysis also provides a solid foundation to use in creating your Compensation Discussion and Analysis (CD&A) documentation to comply with the new Securities and Exchange Commission (SEC) disclosure rules for executive pay.

Whether you are publicly traded or not, analysis of data from a thoughtfully selected publicly traded peer group can give you insights into the following:

Competitive compensation levels. "It's important to look at the level of base salary, short- and long-term incentives (LTIs), and other rewards provided by your comparators," Hellerman says. "You need to understand 'how much' is competitive in the marketplace for each component of the pay package as well as for the value of the total pay package."

Competitive pay delivery and design. "Compensation design has evolved quite a bit since the days of plain vanilla base and bonus packages. Employers have incorporated a multitude of pay vehicles (e.g. stock settled SARs, staking grants, long-term cash plans) into the packages that now are offered," Hellerman notes.

"The design also might include combinations of time and performance vesting. All of these variations make the plans more targeted and potentially more attractive to plan participants and, in turn, may make your plans less competitive."

Linkage between executive pay and performance. Having a well-thought-out, strategically created peer group can help you understand how the compensation payouts resulting from your company's performance compare with payouts from similarly situated companies.

"Paying for performance is more important than ever," Hellerman stresses. "When you compare your company's performance to that of your peers and then compare the 'total compensation spend' for your top five executives to the 'spend' at comparators, you can evaluate better how pay is directly aligned with performance."

Keep this in mind: The "say on pay" movement and the new SEC regulations are driving the emphasis on pay for performance. "The theme of paying for performance is becoming even more dominant as investor activism increases," Hellerman points out.

"The new SEC disclosure requirements have increased the emphasis on pay for performance. Now you need to disclose not only how much was paid but also the decision-making process and the specific performance achievement used to determine the payouts."

Peer Group(s) Selection

According to Hellerman, the "filter approach" is an effective methodology for establishing peer groups, assessing comparators, and determining whether you need more than one comparator group (see Figure 1: Filter Down to Determine Peers).

To determine potential peers, "filter" for companies that are talent and/or business competitors for your company, Hellerman advises. The following are suggested "filters" to consider:

✓ *Hoovers database*. Start with the companies worldwide that are in the Hoovers (www.hoovers.com) database. Hoovers, a company owned by Dun

& Bradstreet, publishes information on nearly 45,000 companies.

✓ *SIC or GIC code.* Next, select public companies with SIC or GIC codes that are relevant to your company.

✓ *Revenue.* Then screen for companies that have a similar size of revenue. Hellerman explains that these are companies whose revenues are between approximately 0.3 times and 4 times the size of your company's revenue.

✓ *Business model and product.* Next, select companies that have business models that are similar to your company's. Also, screen for companies that offer the same types of products as your company.

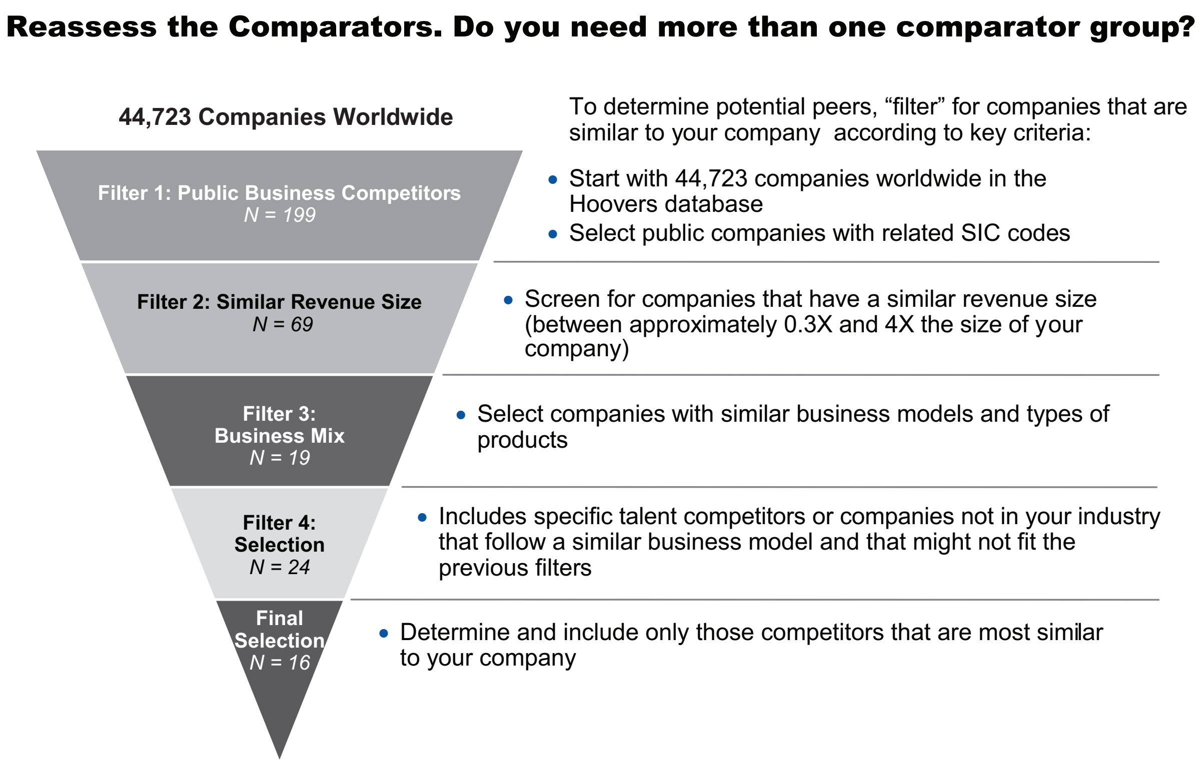
✓ *Indirect competitors.* Under this category, you would screen for companies that compete for the same talent pools as your company. Others to include here are companies that are not in your industry but follow a similar business model to your company (and do not fit the other filter categories).

✓ *Direct competitors.* Determine which of your company's competitors are most similar to your company and screen through this list.

"It is generally a good practice to get down to 10 to 12 comparators for each peer group you create," Hellerman points out. "Then use the peer group(s) as part of a grid that shows what peer group data and other data—for example, published compensation surveys—you will use to determine the competitive pay level and ultimately the compensation portfolio, for each key executive position.

"Look at each position (group of positions) you will be studying and ask, 'Which of these peer groups and which surveys will be most relevant to this position?' You might end up deciding that what makes the most sense for a particular position is to use all peer groups or you might use one peer group and one set of survey data," notes Hellerman.

Figure 1. Filter Down to Determine Peers



Source: Sibson Consulting

Good rule of thumb: Use at least three relevant filters to create each peer group.

Using Peer Group Data to Build Individual Pay Portfolios

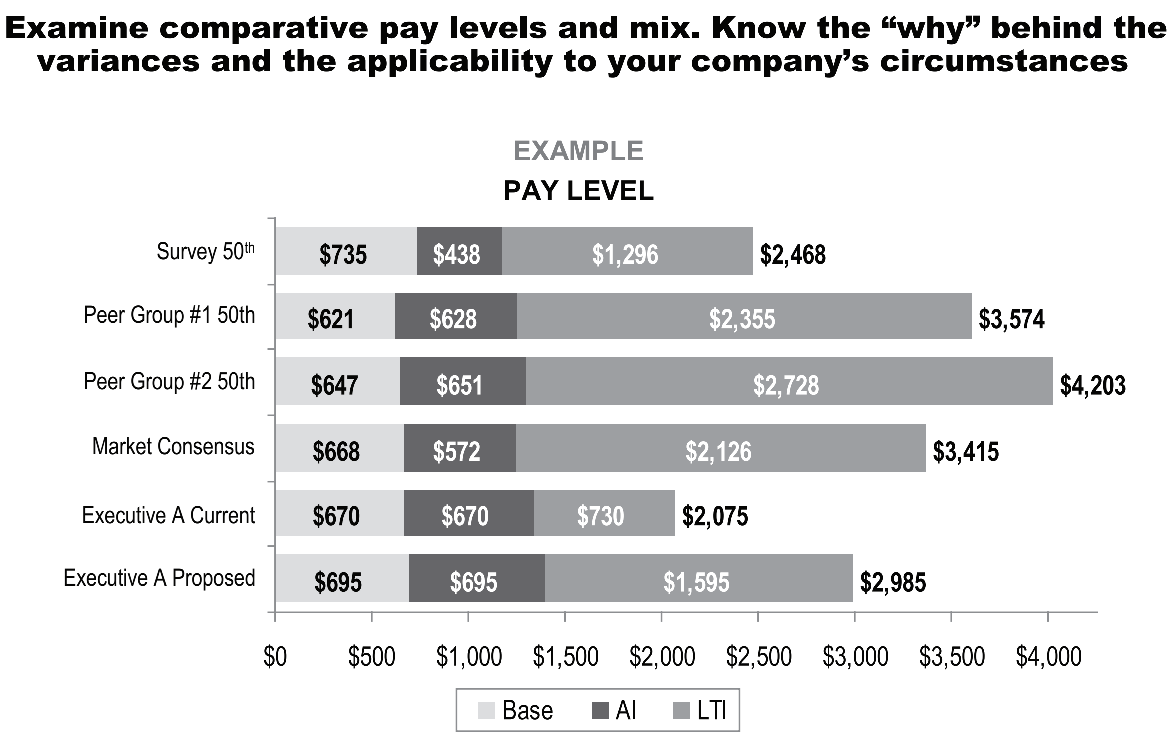
Peer group data (in conjunction with published survey data) are useful to build individual executive pay portfolios. "Obviously, these data inform pay-level determination and pay delivery vehicle selection. It also is important to note that the data are valuable for the creation of an appropriate pay mix," Hellerman says.

For example, Figure 2 shows data for Executive A at a company that wanted to drive and reward growth and deemphasize fixed base pay as an element of its compensation program for "Executive A." Hellerman explains how the compensation committee went about determining the right pay mix for the executive—and the company.

The company assembled both peer group and compensation survey data for Executive A (as well as for other key executives). The compensation surveys suggest a base salary for Executive A of $735,000. However, this base pay level was not supported by the actual peer-group analysis. The survey data also showed a prominence in base pay as part of the pay mix, and low annual incentive and LTI levels compared with the peer group. Since this company wanted to drive growth, the company believed the survey data were inconsistent with what it wanted to do. Survey data reflected a static, guaranteed base pay.

"Before its adoption of a multi-peer group analysis approach, this company would have looked at compensation survey data for 50th-percentile data. Such an approach would suggest that the company's current base pay of $670,000 for Executive A should have been much higher to be 'market competitive,'" Hellerman notes. "With the peer group data in hand, the company decided to pay a more modest base pay. So it moved the base pay up a bit to $695,000—a 4 percent increase."

Figure 2. Compare Pay Levels to Create the Perfect Mix



Source: Sibson Consulting

"The base-pay increase was based on general increases in base pay in the marketplace. This decision was consistent with the company's total compensation package for this individual to be weighted toward variable pay," she continues. "Consistent with the pay strategy, the company's annual incentive provided an opportunity that when the company met the target performance level, the executive would be paid one times base as an annual bonus. Thus, when the company moved up the base pay from $670,000 to $695,000, this increased the annual incentive *opportunity,* but not the fixed pay.

"Then the company looked at the long-term incentive (LTI) opportunity. It evaluated what was happening in the marketplace and considered the fact that it wanted to have most of the executive's pay—in fact, 75 percent of the pay opportunity—to be weighted in long-term incentives (delivered through a portfolio of vehicles). That way, the executive's *total pay opportunity* would be competitive," Hellerman says. "The company carefully considered balance and symmetry—two extremely important factors—and decided to provide a long-term incentive opportunity that is almost two times the base pay for this executive. The final mix looks like this: 25 percent of the total compensation is through base pay, 25 percent is in the bonus and the final 50 percent is in the LTIs."

Result: a peer-based pay-for-performance package. "Now this company has a pay package for Executive A that has a lot of variability and is truly driven by performance. (The same process was used for other key executives.) The incentives may or may not be paid out, depending on the executive's—and the company's—performance. The company rebalanced the mix so that when the executive wins, the shareholders win," Hellerman explains.

Key Questions to Ask as You Select Peer Group(s) and Use Peer Group Data

According to Hellerman, there are several questions you need to ask—and answer—when creating peer groups and using the data which are generated:

■ **How are the peers actually being paid?** "Look not just at level of pay but also look at how peers are actually paid," Hellerman advises. "What vehicles are companies using and how are they designing their programs?"

■ **What drives executives?** "Another way to put this is, 'What is actually driving our business performance and can we structure our incentives to focus executives on these measures?'" Hellerman points out.

■ **How did the peers perform?** "Peer performance informs executive pay decisions and discussions. You can tell an executive, 'Our company did better/not as well as the companies in our peer group(s). Your compensation reflects this outcome,'" Hellerman points out.

■ **Are we using the right performance metrics for our industry?** "By comparing the metrics your company uses to those being used by other companies both within and outside your industry, you will be better able to figure out whether your performance measurements for executives are on the mark or need to be tweaked. Even if your company is not publicly traded, a review of the CD&As from your publicly-traded peer group(s) can provide insights as to what is measured and what is achieved," Hellerman says.

■ **Are we using stretch metrics to determine performance targets?** "When the SEC reviews the CD&As, one of its prime themes is around metrics and pay for performance," Hellerman notes. "The SEC wants to know whether the metrics you're using are good, stretch metrics," Hellerman stresses.

The bottom line: True pay for performance, therefore, means paying executives to meet not just basic goals but goals that take them above and beyond. Once again, whether your company is publicly traded or not, peer group data from the CD&A provides insights into what has been achieved by your comparators.

■ **Would our choice of peer group make sense to an outside observer?** "Always keep in mind that you will need to explain your peer-group

The Proxy Picture—Then and Now

The new SEC disclosure rules require companies to provide more detail in their proxy statements on how key executives are paid. The more thorough your peer-group analysis, the more clearly you will understand what pay levels are competitive—and the better you will be able to explain in your CD&As your rationale in deciding what to pay key executives, notes Sibson Consulting's Myrna Hellerman.

"Today's CD&As require companies to be much more explicit on issues such as: to whom you compare, why you use that particular group of companies, and how you use the comparisons to influence your programs, to measure success, and to determine target pay," she explains. "There used to be a performance graph on proxy statements that showed how a company's return to shareholders stacked up versus the S&P [Standard & Poor's index] and a small group of companies in its industry. This information had limited, if any, impact on people's impressions of whether or not that company's executive pay was fair.

"Further, it used to be that if you did a proxy analysis of your business competitors, you would take a group of 8 or 10 competitors, pull their proxy data, look at what the median payer pays and use this as measure of comparison," Hellerman continues. "In effect companies would simply decide, 'We want to pay somewhere around the median.'

"Now companies also look at whom they are competing against in the business marketplace and in the executive talent marketplace. They are asking, 'Who is looking for the same leadership talent we need to attract and retain?' Companies also are asking, 'How are the companies that have the most successful business models rewarding *their* top people? Which are the companies that we admire most in terms of their business model or their success?' The old comparator paradigm was to look at five or so business competitors. The new comparator paradigm is to look at the companies at several peer groups (e.g. business competitors, talent competitors, admired/aspired to business model, etc.). So the concept of comparing to peers has been expanding quite dramatically," Hellerman points out.

And as the concept of peer groups expands, so do the discussions of executive compensation in companies' proxy statements, she notes. "Years ago, companies would present in their proxy an executive compensation discussion that for a typical company might be three or four pages in text and included two or three tables on executive compensation. Today it is not atypical to see 30 pages of text with 15 different tables accompanied by pages of footnotes.

"The data are very abundant now, which means you have a rich source of insights about your comparators. CD&As, while not providing *all* the answers, will help guide you and help you understand how organizations are using their pay programs to motivate and drive their executive's performance."

Indeed, the additional details about executive compensation in proxy statements is much more sophisticated than simply describing the mechanics of what companies do. "You get insights into the strategic aspect of pay design. CD&A data go way beyond the numbers," Hellerman points out. For example, there is such information as descriptions of organizations' LTI portfolio approaches, individual and company performance metrics (and the prior year achievement against those metrics), and a statement of the intent behind each plan design.

"More and more, HR/compensation professionals are expected to be able to navigate all that data about pay strategies and peer groups. By doing so, you can really determine how your company perform versus its peers and determine whether you are really paying for performance, using the right peers, and setting appropriate pay levels," Hellerman notes.

Suggestion for success: As you work on designing your executive compensation plan, think of yourself as a detective. "Now there is a much broader way of looking at peer groups and peer groups have become a much richer source of information," Hellerman points out. "The role of a compensation professional today is to be something of a sleuth—investigate and contemplate what is going on with other companies. Include companies that make sense in your peer group."

Best-practice example: Hellerman suggests that as you do your detective work, you investigate the Jones Lang LaSalle (JLL) proxy statement for a best-practice example. "Jones Lang LaSalle did a very good job of explaining peer groups in its proxy statement," she points out. "They used three peer groups as points of reference but, as they explained in their proxy, these groups were not the sole determinant of exactly what they pay and why they pay it."

analysis to key executives (and if you are publicly traded, in your proxy). Others are going to see, and perhaps question, the logic behind your decision. When you construct peer groups you will be using that data appropriately to support the decisions that are made about executive compensation at your company," Hellerman emphasizes.

Keep this in mind: "The peer group explanation on the CD&A provides great access to the layperson to get in there and really understand what is happening. Peer-group selection is the most accessible concept for investors and the media, who will be more than happy to voice their points of view on your peer group selection. That's why it's important that you use good logic in choosing your peer group," she says.

■ **Do we want to use this peer group for all of our positions?** "It may make sense to use the same peer group(s) for all of your executive positions. However, frequently, specific positions may require specialized comparisons. You need to ask, 'Should we compare a given executive's pay package to a peer group that represents other companies in our industry? Direct competitors only? Companies that are successful, regardless of their business sector?'" Hellerman notes.

■ **Should we be comparing at all?** If your business is extremely unique and your executives therefore have a very specific set of skills and performance targets, trying to nail down a peer group might be like forcing the proverbial square peg into the round hole.

Executive Compensation: It's an Art (as Well as a Science)

Hellerman points out that there is a high degree of factually informed artistry in what the company in the above example did in creating its pay package for Executive A—and artistry is exactly what is needed in determining executive compensation in this day and age. "The process of how we use pay data to come up with our pay approach is so much more complex and thoughtful than it used to be," she points out. "That's why the use of peer-group comparators is extremely important these days.

The bottom line: "The answer to the question of what to pay executives is no longer simple. You can't just say, 'We're paying at median of the peer group' or 'We're paying what the survey said we should pay.' You must look at the relevancy of all available and pertinent data. And by the way, this can drive the media and investor 'watch dogs' crazy because there's no right answer anymore," Hellerman concludes.