

Getting Executive Compensation Right with the Wrong Peer Group?

By: Gary Finch and Eden Jeffrey



Say-on-Pay, enhanced pay disclosure, performance-based compensation, and appropriate pay delivery are all key mandate issues facing the Board of Directors in both the USA and Canada. How can we spend so much time on enhancing compensation governance issues when we continue to disclose questionable compensation and performance-based peer (comparator) groups?

The goal of providing appropriate performance-based executive compensation means selecting and using the appropriate peer group(s) to begin with.

Our continuous board-based assignments to review company peer groups in compensation and performance (either set by the organization or the executive compensation firm), has disclosed some questionable results.

From a compensation perspective, the peer group helps drive executive compensation delivery and the pay delivery process. Choosing the most appropriate peer group is imperative, since the design and adjustments in the pay process are typically calibrated and disclosed in terms of the peer group.

The issue with most peer groups is that the designers of the peer group (board or external compensation consultant) give limited thought to the strategy, direction, complexity, or comparative size of the organization. Even worse, the choice of the compensation peer group may be manipulated by internal beneficiaries of the compensation system!

Choosing companies from different business sectors or with different sizes or scope of responsibility can drive compensation higher and results in the “ratcheting effect” on executive pay. Executive input into peer group determination needs to be carefully weighed since executives

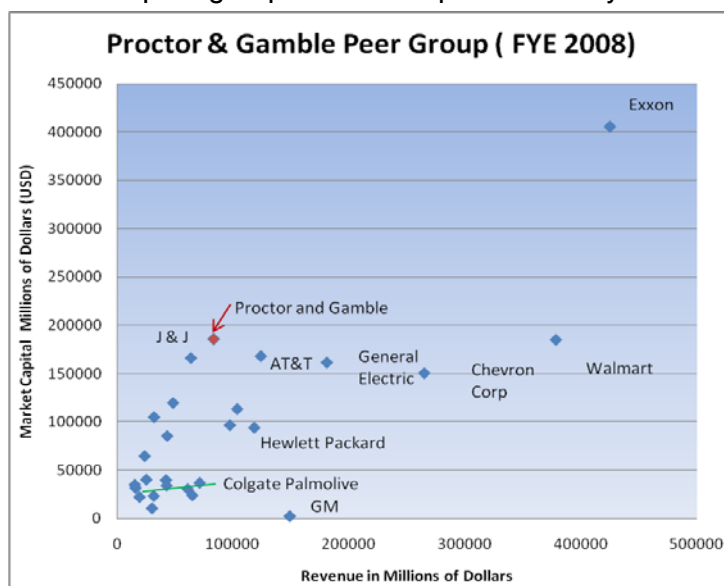
have a vested interest in including inappropriate peer companies inside the peer group.

In setting a peer group, the design should be independently determined by those that are not dependent on the results. An independent advisor, who is free from any conflict of interest, should be the key provider of this service.

According to Bill Mackenzie “*Institutional Investors expect advisors to answer only to the Board or its Compensation Committee since it is the Directors who are ultimately responsible for the executive compensation peer group and executive compensation decisions. It is hard to build a house if you don't have the grounding foundation to build on.*”

The Board must be familiar with the peer group decision-making process and understand the nature and rationale used to determine the peer group. The Board should also understand the risk and potential liability that may arise by using a process that does not produce an appropriate peer group. The Board must be confident with the peer group selection process.

The peer group below is **Proctor & Gamble's** disclosed proxy peer group for 2008 (filed 08/29/08). This 2008 peer group was developed externally and



based on: “companies with comparable revenues and/or market capital, companies that compete in the marketplace for business, and compete with the company for executive talent, and have similar pay models.”

- Should P&G, a consumer staples company, make their compensation comparable to companies like Exxon Mobil (oil and gas), AT&T (telecommunications), or Wal-Mart (retail) who operate in vastly different industry sectors?
- If comparative size and complexity is an issue, why include Exxon Mobil or Wal-Mart in this peer group where their revenues are approximately 500% that of P&G, or Colgate-Palmolive where revenues are less than a 20% that of P&G?
- Would P&G really compete for executive talent with Lockheed Martin or General Electric?
- Are there other companies where executives would more appropriately fit into P&G’s compensation peer group?
- Is this the best peer group for P&G? Would you be comfortable supporting the use of this peer group if you were on the board of P&G?

Determining an Appropriate Peer Group

“One of the first steps of compensation design is the selection of an appropriate peer group” says Bill Mackenzie

Some issues to consider when selecting an appropriate peer group include:

Size: Are the companies selected of similar size in terms of revenues, invested capital, enterprise value, market capitalization, or some other key strategic financial determinant? Are we being reasonable or just filling the peer group?

Scope: Are the companies national, international or global? Do they compete in one or multiple lines of business? Do they have similar regulatory and structural environments?

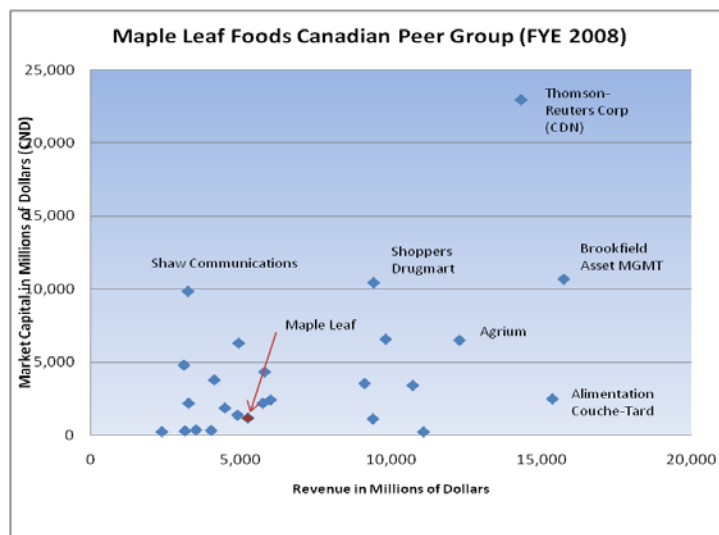
Life cycle: Are they a start-up company or a mature business? Are they operational and generating revenue and/or cash flow? Do they offer dividends? Are their products cyclical in nature?

Human capital issues: Could your current CEO work for companies within your peer group? Could your current top executives be replaced by potential candidates within your peer group?

In addition to determining peer groups for compensation, the same committee that uses these peer groups also has the mandate, responsibility, and accountability for the executive succession planning process. This fact should be discussed with your executive compensation advisor, and may over-ride or impact outcomes from using the proposed and pre-determined compensation peer group.

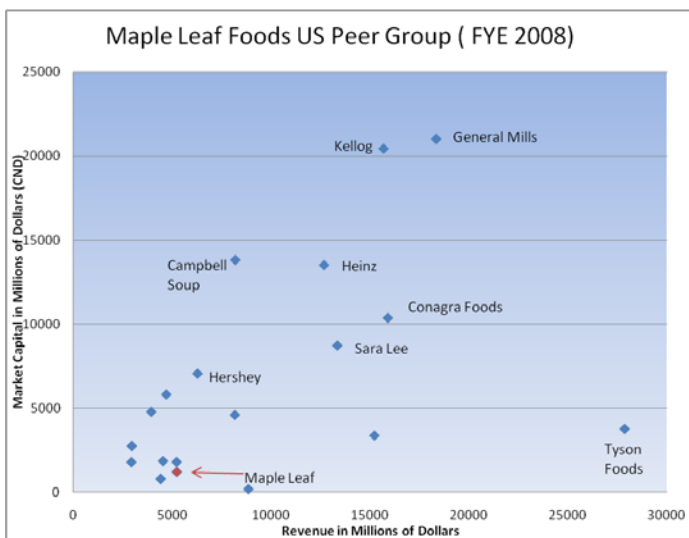
Peer Groups in Canada

The issues of human capital and financial performance peer groups also exist in the Canadian marketplace. **Maple Leaf Foods (MLF)** provides another example of a different type of peer group. Maple Leaf Foods’ 2008 compensation peer group included companies involved



in multiple business sectors including technology, materials, media and financial services sectors.

MLF’s is an international company (approx 5.2 billion in revenues and 1.2 billion in market capital (at 2008 FYE)). Within MLF peer group there were Canadian companies significantly larger than MLF. Examples disclosed included: Brookfield Asset Management (approx. 3x MLF revenues, 9x market capital, and global in nature), Thomson-Reuters (approx. 2.7x revenues, 18x market capital, and global in nature). At the same time there were very small companies such as Tembec (revenues 0.5x and market capital of 0.2x). Due to the international presence of MLF, they also include a US-based peer group, which is good. Unfortunately, MLF is at the small end of the peer group, as shown below.



- Does it impact short-term incentive as well as long-term incentive?
- Does it impact incentive grant sizes, vesting of grants or cash - how?
- How do we communicate this? How do we disclose this? Does the process make sense?
- Does diversification of product line or a national, international and global focus of business count and drive comparative performance?

So long as the Board is comfortable with the decision and can appropriately describe to executives and stakeholders, the decision should be reasonable.

There are some other Canadian processes in place to help assess appropriate peer groups. **Barrick Gold** provides an example of a different approach to appropriate peer group determination. While this group contains fewer companies than the MLF's example, it illustrates the importance of selecting appropriate peers for comparison.

Typical questions asked by Board of Directors:

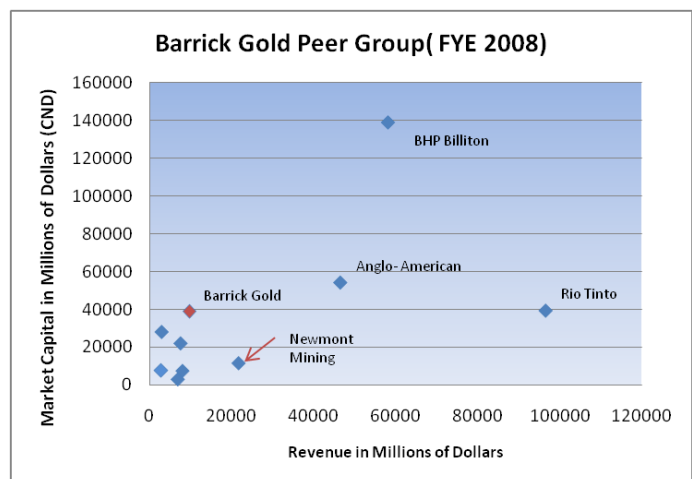
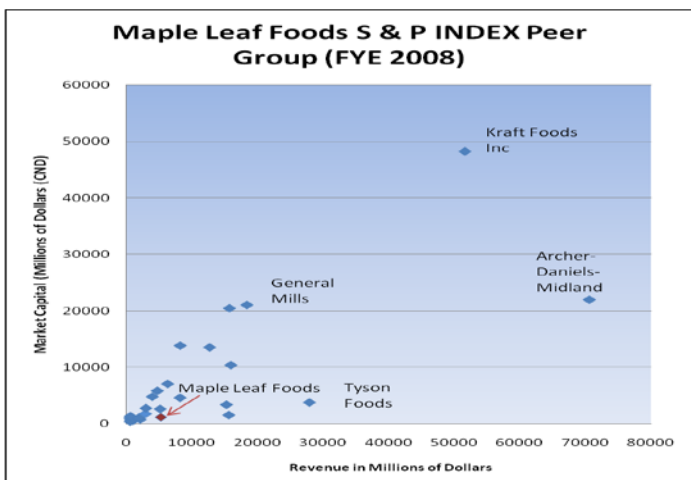
- Do these peer groups make sense to determine compensation for top executives at MLF?
- Do we mix, juggle and/or regress compensation elements between these peer groups to determine MLF's pay at top levels
- Is there likelihood that the CEO or even divisional President of ADM would take on the role of CEO at MLF's?

Would you be comfortable with these compensation peer groups if you were on the board of MLF's?

More companies are now starting to disclose their comparative performance peer group. In this case, MLF uses the S&P Food Index peer group (below)

Barrick Gold's 2007 peer group was *"reflective of the companies with which Barrick competes for talent or capital. The criteria for the review were selected to ensure that peers were similar to Barrick in size, scope, and complexity of operations."*

Specific criteria used for peer selection included: *"Gold and/or diversified metals mining companies with a concentration in exploration, development and mining/production; market capitalization ranging from one-third to three times that of Barrick; and global reach beyond a company's home country with operations, in most cases, in several countries and at least two other continents."*



Typical good Board questions include:

- What metric are we comparing?
- Why are we comparing this metric and will it impact pay?

According to Bill Mackenzie *"Profitability and share prices of mining companies are largely influenced by commodity prices. For Barrick Gold, performance relative to peer companies rather than absolute"*

performance is the important measure for incentive compensation. Since the price of gold often moves independently from other metals, the ideal peer group against which Barrick's relative performance is measured should include companies focused on gold mining."

Applying Mackenzie's definition to Barrick Gold's peer group may suggest the removal of both BHP Billiton and Rio Tinto, since both companies operate complex companies, with multiple business units and diversified products other than gold. Both are companies are larger than Barrick Gold and may inappropriately drive executive compensation higher.

Difficulties in Peer Group Determination:

While we hear "our company is unique" or "you will never find a peer group", this is rarely the case. It should be noted that for some companies involved in niche market or multiple businesses, it can be difficult to select an appropriate peer group. In these isolated cases, Boards have to be more creative in the selection process of appropriate peer companies and advise shareholders and investors the details of their thought process through inclusion in the Compensation Discussion and Analysis (CD&A) and/or Proxy Statements. Tony Griffiths states that *"this paper hones in on the importance of using relevant market data before evaluating pay and setting compensation structure"*.

It should also be noted that the issue of tradeoff between the quantity and quality of the number of peer companies in the peer group is also important. While peer groups should contain enough companies to be statistically significant, adding companies that are not relevant (for any number of reasons) will provide results that are not useful regarding compensation, performance, or performance-based compensation and pay delivery.

One final note:

It is important to remember appropriate selection also means choosing companies where enough information and data is available to complete comparative assessments. This means real data (not survey based data) must be used. As Boards are aware, "real data" has also now been mandated by the OSC to include in all Canadian proxy disclosures.

Financial information must also be available. Time frames need to coincide, and financial data needs to be "normalized" to ensure appropriate and accurate assessments on financial performance to be made.

Without clear understanding, clarity, transparency and appropriate disclosure of the fundamental "building blocks" of compensation, how can any of us feel comfortable on meeting all the new disclosure requirements we are required to meet if our pay delivery system is flawed?

Anthony (Tony) Griffiths is an independent business consultant and is currently a corporate director of a number of companies.

Bill Mackenzie's career in corporate governance extends over 20 years. Bill is currently senior advisor at Hermes Equity Ownership Services and has worked with the Canadian Foundation for the Advancement of Investor Rights (FAIR), CCGG and was President of Institutional Investor Services (now RiskMetrics)

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Phone: 416-493-1869
Toll Free: 866-505-2899
Fax: 416-493-1864

www.3xcd.com
Eden.Jeffrey@3xcd.com

Board Compensation E-mail
BoardCG@3xcd.com

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