Building A Compensation Peer Group: A Step-by-Step Approach

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Housekeeping: About Anthony "Tony" Eppert

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- Tony practices in the areas of executive compensation and employee benefits
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, and involve the substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- At Andrews Kurth LLP, we have a holistic and full-service approach to compensation matters, that considers all substantive areas of compensation, including:

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Housekeeping: Upcoming 2016 Webinars

- Upcoming 2016 webinars:
  - Preparing for the Next Proxy Season: Start Now (9/8/16)
  - Energy Companies: Compensation Governance Survey/Trends (10/13/16)
  - Identifying and Solving Pitfalls in Equity Compensation Administration (11/10/16)
  - The Importance of Miscellaneous Contractual Provisions: A Drafter's Perspective (12/8/16)

- Upcoming 2017 webinars:
  - To be announced in September
  - To suggest a topic for 2017, please e-mail Anthony Eppert

Today's Presentation

- The purpose of this presentation is to discuss how to effectively build a peer group for purposes of executive compensation analyses

- To that end, this presentation is intended to provide a step-by-step approach to building a peer group, including:
  - The general purpose of a peer group and how it is used;
  - Governance concerns in selecting a peer group, including the role of the Compensation Committee;
  - Criteria used to select peer members; and
  - Use of multiple peer groups

- Additionally, this presentation covers related specific issues, including:
  - SEC disclosure issues;
  - Peer group election for purposes of total shareholder return calculations; and
  - Thoughts from institutional shareholders, such as ISS

Background

- To properly conduct an analysis of competitive pay, a company should:
  - Step 1: Design a compensation philosophy
  - Step 2: Develop a peer group of similarly situated companies in the marketplace
  - Step 3: Collect market data for the executive positions from peer companies
  - Step 4: Analyze the collected market date for pay levels and delivery methods

- Addressing Step 2, peer group development is the process of developing a list of companies to serve as the "market" or "benchmark" for evaluating compensation levels for the executive officers

- An effective peer group should, to the extent possible, represent the organizations that make up the talent pool against which the company competes for talent

Background (cont.)

- Specifically, the peer group should shed light on a company's competitiveness of pay opportunities for certain executive officers, both total compensation and the various elements of compensation, including:
  - Base salary;
  - Annual bonus opportunity;
  - Equity incentive opportunity;
  - Percentage of pay subject to performance;
  - Mix between cash and equity;
  - Mix between short-term and long-term cash/equity opportunities;
  - Change-in-control transaction pay;
  - Severance pay;
  - Perquisites; and
  - Appropriateness of governance measures such as clawbacks, stock ownership policies, restrictive covenants, employment agreements, etc.

Background (cont.)

- Key considerations, among others, in developing a peer group for a company generally include:
  - Industry (*e.g*., companies providing similar services);
  - Size (*e.g*., companies with similar annual revenue, market value, total assets, employee population, etc.);
  - Location (*e.g.*, companies in large metro regions);
  - Market data sources available; and
  - Number of peers (typically 15-20 companies)
- Of the above, industry, revenue and market cap are the most often used metrics for determining a peer group
  - However, the financial services sector tends to use assets instead of revenue

Governance

- Ensure that the Compensation Committee is engaged in the process

- The Compensation Committee should document:
  - Its review and approval of the process,
  - Its review and approval of the criteria that was used to select the peer members,
  - Whether the data and analysis was objective, and
  - Any supporting rationale and third party opinions (*i.e*., typically, the compensation consultants report would be attached as an exhibit to the minutes of the Compensation Committee meeting that approves the peer group)

- Addressing third-party opinions, for example, Blackrock voting guidelines requires that third-party vendors conduct the peer group analyses

- Avoid using aspirational peer group members because:
  - A shareholder derivative action or specific shareholders could allege that the pay in question was in excess;
  - A common response from a Compensation Committee would be that such pay was consistent with market practice, i.e., the peer group; and
  - The response from the plaintiff shareholders would be that the peer group was aspirational (or certain of its members were aspirational), and therefore, the benchmarking was not accurate and was ill-informed

Governance (cont.)

- How should replacement peer companies be chosen if a peer member ceases to exist prior to the formal selection of a new peer member? Alternatives include:
  - Do nothing and have the defunct /acquired company removed from the peer group?
  - Have a replacement named by the Compensation Committee?
  - Use the average of an index (*e.g*., the S&P 500)?
  - Use a "dummy" peer member (*i.e*., the average of the remaining peers)?

- It is good practice to review the peer group on an annual basis for the following reasons:
  - M&A activity and spin-offs,
  - Bankruptcy,
  - Going private transactions,
  - Peer group member is acquired, and
  - New public companies becoming an available peer

Selection Criteria – Size

- Size of the peer group
  - Determining the appropriate size involves a balance between having a large enough number of peers to draw comparisons and relevancy
  - A common range for the size of a peer group is 15 to 20 (with 15 being the more common range)
  - Those companies with more than 20 peers typically come from niche industries where there are only a few companies of comparable size

- It is not uncommon for a company to have multiple peer groups for compensatory purposes
  - According to an Equilar study, approximately 11% of the S&P 500 disclosed in their proxy statement the use of more than one compensation peer group
  - For example, a company might use a comparative group for purposes of total shareholder return calculations, and then use another comparative group for all other purposes
  - As another example, a company might have a core compensatory peer group, but then use a much broader peer group for additional insight on pay practices

Selection Criteria – Size

- Key considerations in selecting peer companies include:
  - Industry ("GICS" is most common, Global Industry Classification Standard)
  - Revenue,
  - Market cap,
  - Employees,
  - Assets,
  - Geography, and
  - Other (*e.g.*, maturity of the company)

- The three we most typically use, and typically all at the same time through a **funnel/filter** approach, are:
  - Industry,
  - Revenue,
  - Market cap (accounting for similar performance characteristics), and
  - Business specific characteristics

- The use of "industry" as one of the selection criteria should be favored to maintain the accuracy of the benchmarking during unusual market conditions impacting that industry (*e.g*., energy sector)

Selection Critera – Key Considerations (cont.)

- Addressing market cap:
  - It's inherently volatile, and therefore, consideration should be given to using market cap in conjunction with revenue (*i.e.*, shy away from using market cap as the sole criteria except possibly for 280G calculations)

- For market cap and revenue, companies typically look at 0.5x to 2x their size, positioning the company at the median

- If the foregoing selection criteria produces too many comparable companies, then either:
  - The revenue or market cap scope is narrowed, and
  - Limitations such as geography and number of employees could be considered

TSR Calculations – Absolute TSR Formula

- TSR is simply stock price appreciation/depreciation, plus reinvestment of dividends, over a measurement period
  - Another way to look at it, is that TSR measures the return an investor would receive if he or she bought one share of common stock at the beginning of the measurement period, accumulated dividends during the measurement period, and then sold the common stock at the end of the measurement period

- An absolute TSR formula is calculated as follows:

$$\text{TSR} = \frac{\text{Ending Price} - \text{Beginning Price} + \text{Dividends}}{\text{Beginning Price}}$$

- The payout is then determined as a function of the company's TSR compared to predetermined goals (*i.e.*, it is not compared to the TSR of the peer group)
  - For example, if the company's TSR equals or exceeds x%, then the percentage of the target award earned equals x%

TSR Calculations – Relative TSR Formula

- A relative TSR program has the same math formula as an absolute TSR program; however, with a relative TSR program the payout is determined as a function of the company's TSR ranking/ratio compared to the TSR ranking/ratio of its peer group
  - For example, if the company's TSR percentile rank/ratio equals or exceeds x%, then the percentage of the target award earned equals x%

- The following represents a hypothetical (though typical) relative TSR program:

	Relative TSR Rank	Payout %
Maximum:	75th percentile	200%
Target:	50th percentile	100%
Threshold:	25th percentile	50%
Below:	Less than 25th percentile	0%

- In the above example, if the company's TSR rank relative to its peer group is at the 25th percentile, then the payout would be 50% of the target shares

TSR Calculations – Relative TSR Formula (cont.)

- The following steps are typically employed when computing relative TSR
  - Calculate TSR for the company and each member of its peer group,
  - Determine the sequential rank/ratio for each company in the peer group according to its TSR performance, and
  - Determine the corresponding portion of the award that should vest or payout

Relative TSR Design – Peer Group

- Picking an appropriate peer group is the first major step to designing a relative TSR program. Should the company use:
  - A market stock index such as the S&P 500?
  - A specified peer group of companies?
  - Or a combination of the above two?

- The typical considerations in selecting peer group members apply, including:
  - Industry,
  - Revenue,
  - Market cap,
  - Earnings, and
  - Possibly geography

- In terms of the number of peer group members (assuming use of a specified peer group), a goal should be to use enough companies in order to prevent:
  - Significant changes from one rank or percentile to the next; and
  - Distortions due to bankruptcies, M&A events, liquidations, going private, etc.

Relative TSR Design – Peer Group

- Generally, it is desirable to pick peer group companies that have strong correlation in stock price

- Addressing volatility, care should be taken to avoid matching a company with low volatility to a peer group containing high volatility (and vice versa)

- How should the relative TSR program address changes to members of the peer group of companies that occur during the measurement period due to bankruptcy, M&A activity or going private transactions?
  - Should it be fixed (*i.e.*, the number of peer group companies could then decrease over the measurement period due to, for example, an M&A event), or
  - Prior to the measurement period should there be a determination as to how replacement peer group companies will be chosen (*e.g.*, use a stand-in dummy entity with TSR that is deemed equal to the average TSR of all remaining peers), or
  - Should the choosing of a replacement peer group member be left to the discretion of the compensation committee of the board of directors

ISS Methodology on Peer Group Selection

- The FAQs for the ISS Peer Group Selection Methodology and Issuer Submission Process can be found here: https://www.issgovernance.com/file/faq/USPeerGroupFAQ_June2016.pdf

- The size of the peer group is generally between 14 and 24 companies based upon the following factors:
  - GICS classification of the subject company,
  - GICS classification of the subject company's disclosed peer group members, and
  - Certain size restraints relating to revenue (or assets for financial companies) and market value

- With a focus on choosing companies that push the subject company to the median of the peer group, ISS chooses peers in the following order:
  - From the subject company's own 8-digit GICS group,
  - From the subject company's peers' 8-digit GICS group,
  - From the subject company's 6-digit GICS group,
  - From the subject company's peers' 6-digit GICS group, and
  - From the subject company's 4-digit GICS group

- ISS gives priority to those peers the subject company has chosen and to those companies that have chosen the subject company as a peer

ISS Methodology on Peer Group Selection (cont.)

- ISS applies two size constraints in selecting a peer:
  - Revenue (within the range of 0.4x to 2.5x the subject company's revenue, though the range is expanded for companies with revenue of at least $10bb or smaller than $200mm)
  - Market cap (within the range of 0.25x to 4x the subject company's market cap, depending upon whether the subject company in question is a micro, small, mid or large cap company)

- If the subject company used multiple peer groups, then ISS will apply the peer group that the subject company used to benchmark the CEO's pay

SEC Disclosure

- Most public companies disclose a compensation peer group

- According to a recent Equilar report analyzing the S&P 500:
  - More than 95% of companies disclosed a peer group in their proxy statement;
  - Most of the proxies disclosed 11-20 peer group members, however, approximately 10% of the companies disclosed the use of more than 25 peer group members;
  - Industry and revenue were the most common peer selection criteria;
  - More than 50% of the companies shared a similar industry sector with at least 75% of their peers
  - A little less than 50% included a foreign corporation as a peer
  -

- Why? Because disclosure is required under applicable SEC rules

SEC Disclosure (cont.)

- What is “benchmarking”?
  - According to the SEC, it’s the use of compensation data of other companies as a reference point to justify (wholly or partially) compensation decisions
  - However, the SEC has accepted the argument that using comparative companies as a “market check” would not constitute “benchmarking”
  - The question: How is the company using the data?

- Under Item 402, if the company benchmarks, then the CD&A must:
  - Identify the peer companies by name,
  - Explain how and why these companies were selected for comparative purposes,
  - Identify any indexes that were used (*e.g.*, S&P 500), and why
  - Identify the desired benchmark percentage, if any (*e.g.*, 50%)
  - And if there is a desired benchmark percentage/range, then the SEC Staff expects the company to disclose where the actual compensation fell relative to the targeted percentile/range
  - If the company benchmarks to a range, or retains discretion to not benchmark, then it must disclose the extent of the discretion, and whether/how it was exercised

Don’t Forget Next Month’s Webinar

- Title:
  – Preparing for the Next Proxy Season: Start Now

- When:
  – 10:00 am to 11:00 am Central
  – September 8, 2016

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