Peer Groups: Executive Compensation Benchmarking Considerations for Public and Private Companies

Introduction

Attracting and retaining top executives is critical for a company's success. Boards of Directors play a vital role in ensuring the company offers competitive compensation packages that are both attractive to talent and aligned with shareholder interests. Compensation benchmarking – the process of comparing your company's compensation practices to those of similar organizations – is a key tool for achieving this balance. This article focuses specifically on the use of peer groups in compensation benchmarking, a crucial aspect for Board members to understand.

Understanding Compensation Benchmarking

Compensation benchmarking involves analyzing and comparing the total compensation offered by your company for a specific position against what other companies provide for highly comparable roles. This process typically includes using data from compensation surveys offered by consulting firms, industry associations (club surveys), online tools, or a combination of these sources.

Benefits of Compensation Benchmarking

Companies undertake compensation benchmarking for several reasons:

- **Competitiveness:** It helps boards confirm that total pay opportunities for executives are competitive and align with market standards. This ensures you attract and retain top talent.
- **Market Practices:** Benchmarking provides insights into existing and emerging trends in compensation structures, including the design of short-term and long-term incentive programs. This allows boards to combine an awareness of market practices with their company's unique business strategy.
- **Informed Decisions:** By comparing your total compensation package offered to those of peers, boards can make informed decisions about base salaries, and short-term and long-term incentive plans, ensuring these elements are fair and reasonable.

The Power of Peer Groups

The key to reliable benchmarking results lies in selecting the right "peer group" – a group of companies you compare your executive compensation practices against. This selection process is more an artform than purely an analytical exercise. It should be driven by your company's business and talent acquisition strategy, while considering the limitations of available data.

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Key Factors in Selecting a Peer Group

- **Sample Size:** Aim for a robust sample size of 10-20 companies to achieve statistically reliable results.
- **Financial Performance:** Consider companies with revenue within a range of ½ to 2 times your own.
- **Industry and Business Model:** Select peers within your industry segment and operating model such as brick-and-mortar vs. online operations.
- **Complexity:** Choose companies with a similar level of operational complexity to yours.
- **Target Customer Market:** Include competitors for your target customer base (B2B vs. B2C).
- **Target Talent Market:** Consider companies you compete with for talent, including where you recently recruited executives from.
- **Company Lifecycle:** In some cases other factors such as stage of your company's growth (startup, growth, mature, etc.) might be relevant.

Public vs. Private Company Considerations

In today's competitive landscape, the lines between public and private companies in terms of talent acquisition are blurring.

- **Talent Acquisition Trends:** As noted by a 2022 KPMG report, 71% of CEOs see talent retention as a top priority. This reinforces the need for both public and private companies to increasingly compete for the same talent pool.
- **Compensation Disparity:** Research by Aon in 2019 revealed that total direct compensation for private company executives can lag behind public company counterparts by up to 40%. The *gap narrows as revenues increase* for private companies and the *gap increases as revenue decrease*. The prevalence of long-term incentives in public companies is a significant driver of this disparity.[1]

Implications for Peer Group Selection

Publicly traded companies have a clear advantage when it comes to compensation benchmarking. They can readily access data from publicly available sources and disclose a well-defined peer group to shareholders. However, private companies face a different reality. Limited data availability on private company compensation can make traditional benchmarking methods challenging.

This is where a **hybrid approach** emerges as a valuable strategy. By strategically combining data from various sources, private companies can gain a more comprehensive understanding of the competitive landscape for executive compensation. Here's a breakdown of why, how, and when to leverage this approach:

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[1] Source: "With Public and Private Firms Competing for Talent, Have Executive Pay Packages Changed?", by Douglas M. Strey, Aon Total Compensation Measurement Survey; Q1 2019; other executives includes Chief Financial Officer, Chief Information Officer, Chief Legal Officer, Group President, Chief Human Resources Officer, Chief Operating Officer and Chief Administrative Officer.

Why a Hybrid Approach?

- **Limited Public Data:** Publicly available data on private company compensation is not readily available. This makes it difficult to rely solely on private company data for benchmarking.
- **Market Convergence:** The talent landscape is increasingly fluid. Public and private companies often compete for the same talent pool, particularly for larger companies. Understanding public company practices can provide valuable insights.
- **Comprehensiveness:** Combining data strengthens the analysis. By including multiple sources, you can mitigate potential biases or limitations within any single data set.
- **Future IPO Considerations:** If a private company anticipates going public in the future, understanding public company compensation practices lays the groundwork for a smoother transition.

Building Your Hybrid Benchmarking Model

- **Public Company Peer Group:** While data limitations exist, carefully select a group of publicly traded companies within your industry that share similar characteristics (revenue, size, complexity) to yours. This allows for relevant comparisons on total direct compensation, base salaries and incentives.
- **Club and Private Surveys:** Participate in industry or regional surveys conducted by professional associations or consulting firms specializing in private companies. These surveys offer valuable insights into compensation trends specific to your industry and company size segment.
- **Compensation Consultants:** Engage reputable compensation consultants with expertise in private company compensation. They can provide access to proprietary data and analysis, helping you interpret the combined data effectively.
- **Internal Data:** Don't neglect your internal data! Analyze historical compensation trends within your company and consider internal equity when setting compensation packages.

When to Consider a Hybrid Approach

- **Executive Recruitment:** When recruiting for a critical executive position, a hybrid approach can be particularly valuable. Understanding public company practices can help you craft a competitive compensation package to attract top talent.
- **Annual Compensation Reviews:** Incorporate a hybrid approach into your annual compensation review process to ensure your company remains competitive in the market.
- **Mergers and Acquisitions:** During mergers and acquisitions, understanding public company compensation practices can be crucial for setting fair and equitable compensation for executives from both companies.

Remember

- **Data Transparency:** Be transparent about the limitations of data for private companies and clearly document the rationale behind your chosen data sources and methodology.
- **Focus on Alignment:** The ultimate goal is to ensure your compensation practices are aligned with your company's talent strategy and that compensation opportunities are competitive in relation to pertinent market norms.

By adopting a well-defined hybrid approach, private companies can overcome data limitations and gain valuable insights to inform their compensation strategies. This allows them to attract and retain top talent while remaining competitive in today's dynamic talent market.

Conclusion

Compensation benchmarking, particularly with the strategic use of peer groups, is a powerful tool for Compensation Committees and Boards of Directors. By understanding your company's position in the market and effectively benchmarking your compensation practices, Boards can ensure they remain competitive in attracting and retaining top talent while fulfilling their fiduciary responsibility to shareholders.

By employing these strategies, Boards of Directors can leverage compensation benchmarking to create a sustainable competitive advantage in today's dynamic talent market.

References:

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