

# Selecting Appropriate Peer Groups

## - Human Capital and Financial Performance



### Why is a peer group selection so critical?

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.

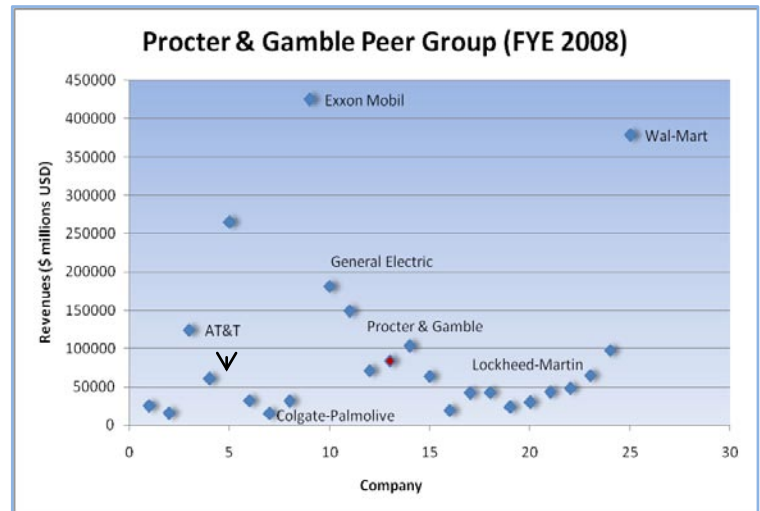
The issue with most peer groups is that the designers of the peer group (board or external consultant) give limited thought to the strategy, direction, complexity, or comparative size of the organization, or worse, the peer group members are manipulated by internal beneficiaries of the compensation system!

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

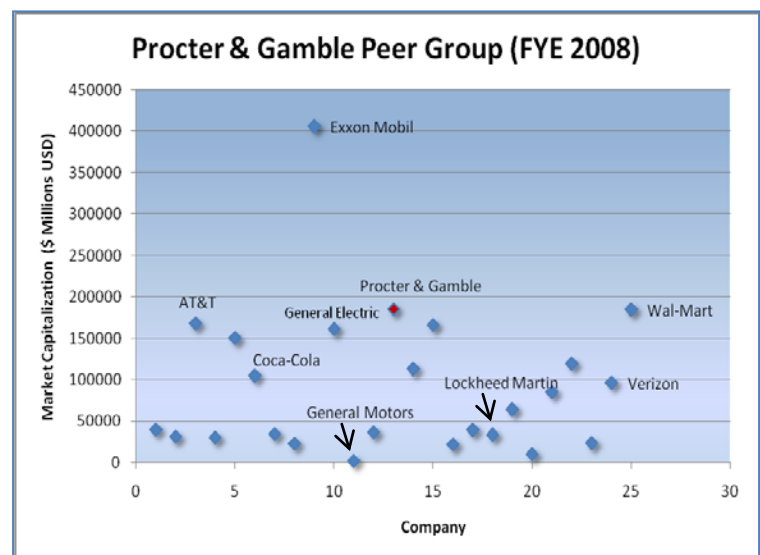
In setting a peer group, the design should be independently determined by those that are not dependent on the results. An independent advisor, who is free from any conflict of interest, should be the key provider of this service. Advisors should only answer to the Board since the Board is ultimately responsible for the executive compensation peer group and executive compensation decisions.

The Board must be familiar with the peer group decision-making process and understand the nature and rationale used for 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 peer group selection process.

The peer group below is **Procter & Gamble’s** disclosed proxy peer group for 2007 and 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.”



Is this peer group appropriate for P&G?

Should P&G be compared to companies like AT&T, Exxon Mobil or Wal-Mart who operate in different industry sectors? Would P&G compete for talent with Lockheed Martin or General Electric? Is it appropriate to include Exxon Mobil or Wal-Mart in this peer group when revenues for each of these companies are approximately 5 times that of P&G, or Colgate-Palmolive where revenues are less than a fifth of P&G's?

***“One of the first steps of compensation design is the selection of an appropriate peer group”***

Some issues to consider when selecting an appropriate peer group:

**Size:** Are the companies selected similar in size in terms of revenues, invested capital, enterprise value, market capitalization, or some other key strategic financial determinant?

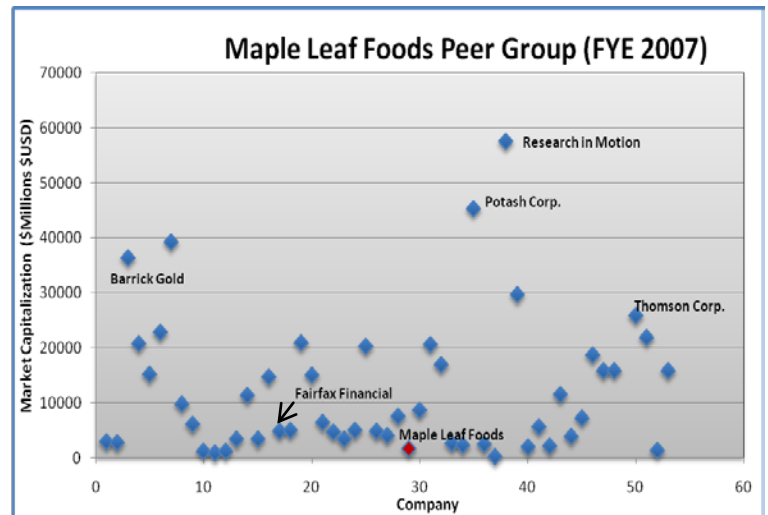
**Scope:** Are the companies national, international or global? Do they compete in one or multiple lines of business? Do they have similar regulatory and structural environments?

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

**Human capital issues:** Could the current CEO work for companies within your peer group? Could your current top executives be replaced by potential candidates within your peer group? *(As part of board mandate, boards should have a succession planning process in place for their CEO. Typically this responsibility is delegated to the Human Resource and Compensation Committee - or its equivalent).*

In the Canadian market, **Maple Leaf Foods** provides another example of a potentially problematic peer group. Maple Leaf Foods' 2007 peer group included companies involved in multiple business sectors including technology, materials, media and financial services sectors.

Within this peer group there were companies significantly larger than Maple Leaf Foods. Research in Motion (RIM) is more than 35 times the size of Maple Leaf Foods based on market capitalization, and RIM operates globally.



In addition, this peer group contained 16 other companies that are more than 10 times the size of Maple Leaf Foods.

Does this peer group make sense for Maple Leaf Foods? How do we attempt to use this peer group for pay determination, using linear regression? Does the comparative performance of Maple Leaf Foods make sense compared to this peer group?

#### ***Difficulties in Peer Group Determination:***

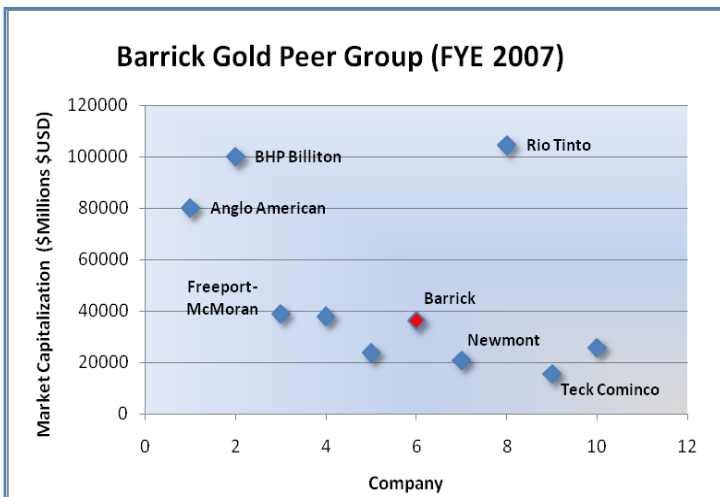
It should be noted that for some companies involved in niche markets or multiple businesses, it can sometimes be difficult to select an appropriate peer group. In these isolated cases, Boards may have to be more creative in the selection of appropriate peer companies.

It should also be noted that the issue of tradeoff between quantity and quality of peer companies 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 little in terms of useful results in terms of either compensation, performance, or performance-based compensation.

There are some good examples of appropriate peer groups. **Barrick Gold** provides an example of a more thoughtful peer group. While this group contains far fewer companies than the other examples, it illustrates the importance of selecting appropriate peers for comparison.

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."



The only possible question in this peer group would be the rationale behind including BHP Billiton and Rio Tinto, since both companies operate significantly more complex companies with multiple units and products (compared to Barrick).

**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) is 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 can be made. Companies must also supply timely and accurate assessments on all components of compensation.

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

[www.3xcd.com](http://www.3xcd.com)  
[Eden.Jeffrey@3xcd.com](mailto:Eden.Jeffrey@3xcd.com)

Board Compensation E-mail  
[BoardCG@3xcd.com](mailto:BoardCG@3xcd.com)

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