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How to Maintain a Relevant Peer Group in Fast-Moving Industries and Unstable Markets

Market volatility can trigger concern over the ongoing relevance of your peer group. We provide a checklist for ensuring your peer group remains appropriate in times of change.

The inherent disruption and volatility associated with the high-growth technology and life sciences sectors creates unique hurdles for maintaining consistent practices when benchmarking executive pay. Developing an appropriate peer group is essential to staying competitive in hiring and engaging top leaders at your company— but when industry-specific news or macroeconomic events cause dramatic stock market fluctuations, it's important to remain vigilant in assessing the continued relevance of your peer group.

The core purpose of a peer group is to understand the pay levels and practices at those companies most relevant to yours. And while there's no perfect formula for determining the most precise peers, guidelines certainly help. The baseline for most companies starts with industry and size, typically defined by market capitalization or revenue, and expands from there to include other characteristics like business and growth strategies, target customers, international footprint and maturity or lifecycle of the company.

Most companies review and make necessary changes to their peer group annually, typically in the summer for companies with a calendar fiscal year. Under typical business circumstances, an annual review won't result in more than 25% turnover among peer group companies, generally attributed to M&A activity and/or significant changes in the financial profile of peers. However, more substantial changes are warranted at times when there is a major company-specific event, such as a long-term technology or clinical setback, which could result in a complete overhaul of peer companies. Macroeconomic or industry-specific changes that trigger wild swings in valuations of your competitors might result in changes to your peer group that fall somewhere in the middle of the typical and complete overhaul scenarios described above.

It's a good practice to consider the relevance of your peer group on a regular basis and make changes as necessary. An annual peer group review— particularly in times of volatility and change— will ensure you have the most up-to-date and relevant peer group and that you're informed on both pay levels and pay practices for your executive team.

Many of our technology and life sciences clients have seen their own valuations or those of their peers drop by half or more at points in the past year. Political unrest, disruptive technology, the status of clinical trials and FDA approvals are just some of the events that are causing company- and industry-specific volatility. What follows is our list of recommendations for ways to evaluate your peer group as the stock market remains even more unpredictable than usual.

1. **Don't over-react**. As we've seen over time, just as quickly as the stock market can become destabilized, calm can be restored. It's important to ensure that necessary changes are made without overreacting and making too many wholesale changes, especially if the changes come outside of the normal business cycle and are widespread among a sector and temporary. Changing a peer group too drastically can result in significant year-over-year swings in pay and performance data and differing compensation practices. Just as you wouldn't drastically change your compensation practices in a downturn to something you aren't going to maintain long-term, the same goes for peer groups.

2. **Understand the governance landscape**. As with most things involving executive pay, you can't ignore proxy advisory firms' recommendations as well as the voting policies of your own shareholder base. It's been more than five years since ISS and Glass Lewis began closer scrutiny of companies' peer groups for size discrepancies. The common perception back then was that companies were creating peer groups that were aspirational and much larger than the target company's profile. Practices have changed and most companies now use more similarly situated peers. We're not suggesting all scrutiny has disappeared or that some companies don't still include unrealistic peers at times, but having a few companies outside of ISS and Glass Lewis' size guidelines is usually not going to raise alarm bells if they are true competitors and you have a diligent compensation process. Part of that process is good disclosure that gives your shareholders insight and confidence into your benchmarking practices.

3. **Fine tune around the edges**. While we caution against wholesale changes to your peer group unless there are major long-term changes to your company (see point #1), a volatile market can call for eliminating comparators that have fallen way below or above size guidelines. As discussed earlier, a good rule of thumb is around 25% turnover in your peer group during each annual review to eliminate the outliers that cease to be relevant to your business, but this can increase slightly during volatile times.

4. **Be aware of pay vs. size**. Ideally, a company will be positioned at the median of their peer group based on various size and financial metrics. Market and business disruptions can change that balance, resulting in, for example, a company being positioned at the 25th percentile vs. the 50th percentile. In this scenario, the company should be mindful of pay levels at multiple percentiles to ensure a strong pay for performance orientation of compensation programs. This doesn't always mean adjusting pay to benchmark at the 25th percentile— that could send the wrong message to current and prospective executives— but awareness of this changing relationship of pay to size will ensure you're not overly aggressive or aspirational with your pay positioning – particularly when dealing with the LTI awards.

5. **Review peer groups annually**. Some companies conduct an extensive review of their peer group every two or even three years. That's not often enough given current market conditions, and particularly if your company and/or industry is going through dramatic growth or change. An annual review is good practice and might result in fewer changes during each peer group review, providing stability in your benchmarking process and better continuity in your approach to executive pay decisions.

For more guidance on external benchmarking practices or to speak with a member of our compensation consulting group, please write to consulting@radford.com.

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