

Software Company Peers – The Top Comparators

One of the key factors considered by compensation committees in setting executive pay is an understanding of practices within their competitive market for executive talent. Typically, this understanding is based on an analysis of a carefully-selected group of peer companies. While this compensation peer group can be (and often is) used to assess a wide range of metrics, key elements of the annual executive compensation review are typically the magnitude of pay for each executive position (looking at both total compensation and the individual elements of pay) and the mix of vehicles used to deliver pay opportunities.

Since 2006, as part of the discussion and analysis of their executive compensation actions and decisions, public companies have been expected to address the competitive positioning of their pay programs. Typically, this disclosure describes in detail how the company assesses the competitive market and reveals both the peer companies that have been used for these purposes as well as the process used to identify and select these companies.

This Thoughtful Pay Alert examines the composition of the compensation peer groups used by the Compensation Committees of the software companies included in the Russell 3000 as disclosed in their definitive proxy statements. As discussed below, most of these companies also disclose the criteria that were used to identify and select the companies included in their compensation peer groups.

Our client experience and the research summarized herein suggest that the peer group selection process starts with relatively standard financial criteria, often including companies within a range of about half to twice the target company's revenue and a similar, although somewhat wider, range around market capitalization. The industry classification of potential peers, as indicated by the Standard & Poor's Global Industry Classification Standard ("GICS") methodology, is also an important factor. Beyond these considerations, however, it is critical to conduct a careful analysis of each potential peer, focusing on companies that are most relevant from a business perspective while also considering companies that may be a good fit but are just outside the desired financial criteria. A mechanical

Five Data Points that Software Companies Should Know About the Use of Compensation Peer Groups

1. **Prevalence of Peer Group** – More than two-thirds of the surveyed software companies disclosed the use of a compensation peer group in their most recent definitive proxy statement.
2. **Size of Peer Group** – Typically, these compensation peer groups comprised between 10 and 20 companies. However, of the companies with a disclosed peer group, 23 companies (18%) disclosed compensation peer groups of 20 or more companies.
3. **Peer Company Selection Criteria** – Industry similarity, revenue, and market capitalization were cited as the most common peer selection criteria.
4. **Comparability of Industry Sector** – While a majority of software company peers are drawn from the same industry sector, less than 15% of the companies with a disclosed peer group include only software companies in the group.
5. **Geographic Profile of Peers** – Companies in the San Francisco Bay Area exhibited a preference for local peers, with about half of the peers selected by companies headquartered in the Bay Area also coming from the same region. The distribution of peers for companies outside the San Francisco Bay Area is more diverse, with only 26% of their peers coming from the Bay Area.

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approach to peer selection may generate a group of companies that will be viewed with skepticism by executives and the Compensation Committee and omit companies that are direct competitors but just beyond the target size ranges or misclassified by the GICS framework.

Companies Reviewed

To better understand current practices involving the use of compensation peer groups in the software sector, this fall we reviewed the most recent publicly-available disclosures of the 184 software companies included in the Russell 3000. Our analysis focused on a subset of 126 companies that disclosed a peer group in their most recent applicable filing with the Securities and Exchange Commission. The companies that were excluded tended to be filers under the Jumpstart our Business Startups (“JOBS”) Act (which are not required to disclose a peer group) and companies that were being acquired. These companies varied dramatically in size, with annual revenues ranging from \$100 million to \$80 billion and market capitalizations ranging from \$100 million to nearly \$500 billion.

Each of the surveyed companies disclosed that the Compensation Committee of the Board of Directors had commissioned the development of a compensation peer group during the past two fiscal years and that an analysis of the compensation practices of the peer group companies had been used as a reference in the course of the Compensation Committee’s deliberations.

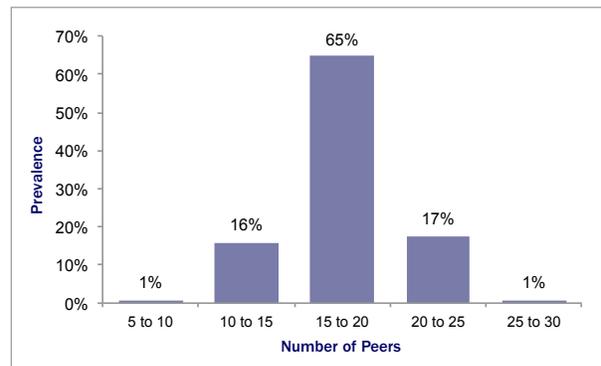
Size of Compensation Peer Group

At the median, the compensation peer groups of the software companies we analyzed consisted of between 15 and 20 companies, with 65% of the surveyed companies (82 companies) fitting into this category. Peer groups with fewer than 10 or more than 25 companies are rare, with a significant majority of peer groups consisting of between 10 and 25 companies.

Percentage of Software Peers

Further, we observed that the compensation peer groups of 70% of the surveyed companies (90 companies) consisted of between 70% and 100% other software companies (as categorized based on each company’s GICS classification). This includes 17 companies where the group was made up entirely of software companies. From another perspec-

tive, nearly 90% of the surveyed companies include at least one peer from outside the software sector and about 30% include at least four companies from outside the sector, highlighting the need for a thorough evaluation of the universe of potential peers.

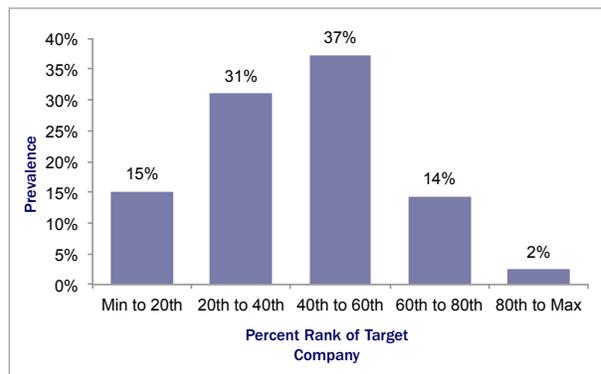


Comparability of Peer Group Companies

Typically, companies tend to select companies in the same industry, of similar size, and, where applicable, have a history of observed talent recruitment and/or departures between them to populate their compensation peer group. And, ideally, the subject company should approximate the median of the compensation peer group in terms of the key selection criteria.

Comparison to Median of Peer Group

While it is difficult to position a company precisely at the median of its peers, 37% (47 companies) were between the 40th and 60th percentiles in terms of annual revenue. Other surveyed companies tended to be below the median revenue of their peer group, with these companies ranking at

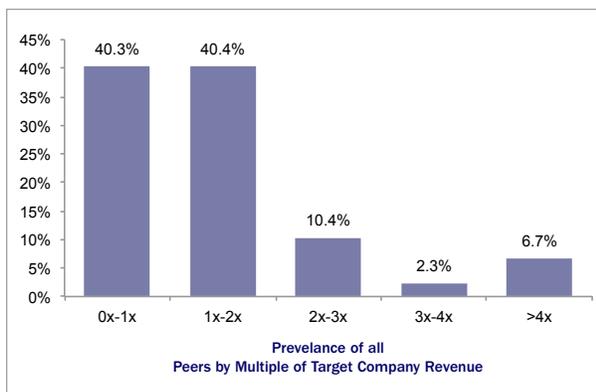


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the 40th percentile among their peers in terms of annual revenue, on average. Further, we observed that two-thirds of the surveyed companies were below the median revenue of their peer group.

Prevalence of Much Larger Peer Companies

Finally, we found that the inclusion of much larger companies (that is, companies with revenues three or more times larger than the subject company) as peers is rare in the software sector. More than 80% of the peer companies identified had revenues that were less than twice the annual revenue of the subject company. Of the peer companies identified, less than 10% had revenues that were in excess of three times the annual revenue of the subject company. Put differently, each company includes between one and two peers, on average, with annual revenue greater than three times its own. This confirms that software companies are careful to limit their peers to companies that are of comparable size from a financial perspective or well within their near-term projected growth projections. Where exceptions are made, they are often for a company’s most direct competitor(s) and should be viewed as reasonable in the context of the full peer group.



Common Software Peer Companies

Certain software companies are popular comparators within the industry sector and appear frequently in the compensation peer groups of other software companies. The 11 most popular software peer companies are as follows:

Software Company	Number of Appearances in Compensation Peer Group of Other Software Companies
LogMeIn, Inc.	31
Constant Contact, Inc.	31
Ultimate Software Group, Inc.	26
NetSuite, Inc.	24
Cornerstone OnDemand, Inc.	24
SolarWinds, Inc.	24
Demandware, Inc.	21
Marketo, Inc.	21
Yelp, Inc.	21
Autodesk, Inc.	20
Bottomline Technologies, Inc.	20

Overall, 73 different companies (including the companies previously mentioned) were included as peers in the compensation peer groups of other software companies at least 10 times.

Final Observations

Given the highly competitive nature of the general technology sector, it is no surprise that software companies tend to track the practices of their direct competitors and other similarly-situated companies when developing a compensation peer group. Not only can such a group serve as an objective measure of the attractiveness of a company’s compensation program to its current management team, today it has become a critical tool in gauging the effectiveness of the program from an investor perspective. Because the market is constantly changing, we recommend that Compensation Committees evaluate the ongoing utility of their compensation peer group at least annually and, where necessary, update the constituent companies to reflect your company’s growth (from both a financial and operational perspective) as well as changes to the peer companies themselves.

About the Authors

The authors of this Thoughtful Pay Alert are Mark Borges and Greg Loehmann, both principals at Compensia. If

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implement their executive compensation programs. If you would like assistance with your executive compensation program, or in reviewing and updating your compensation peer group, please feel free to contact us. ■

Need Assistance?

Compensia has extensive experience in helping the Compensation Committees of public companies design and

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

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