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UK Executive Pay & Governance

Executive Pay in the FTSE SmallCap

October 2017

Introduction

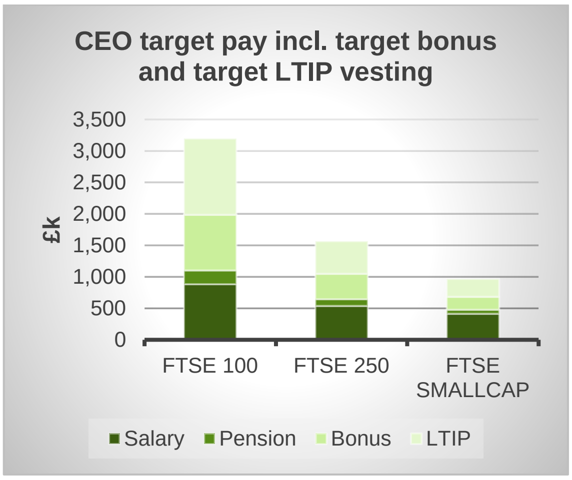
In this briefing, we explore the challenges faced by FTSE SmallCap companies when designing their senior executive remuneration policies. While some of these challenges are shared with larger PLCs, a number are specific to smaller quoted companies which add to the increasingly long list of issues faced by SmallCap Remuneration Committees.

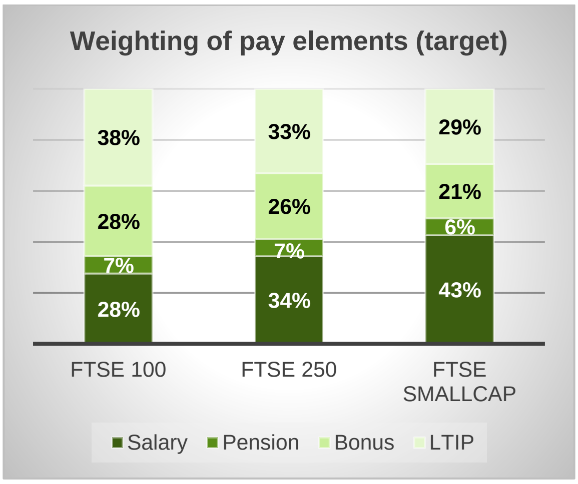
Setting the scene

In the vast majority of cases, the basic structure of executive director pay in the FTSE SmallCap mirrors that seen in the FTSE 350:

Base salary + Pension + Benefits + Annual Bonus + LTIP = Total Pay

That said, there are of course two important differences: (i) overall pay quantum is significantly lower in the SmallCap, and (ii) far less of the package comprises variable pay (in the form of bonus and LTIP):





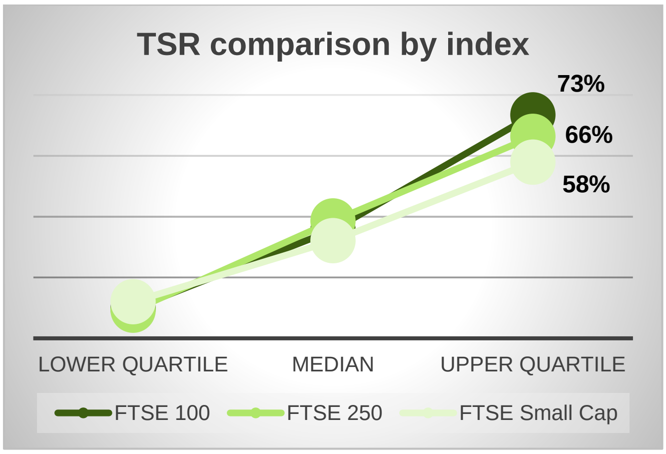
Note: Benefits excluded for ease of presentation.

Some commentators have questioned whether the relative lack of pay gearing in the SmallCap is counter-intuitive, as surely SmallCap companies are high growth, which should be reflected in more leveraged remuneration than their more "steady as she goes" FTSE 350 counterparts? However, this is probably a little simplistic. While a few SmallCap companies may have very high growth potential, most will have more market standard aspirations, which is perhaps borne out by the median P/E ratios across the main FTSE indices which do not suggest that SmallCap companies are perceived as having stronger growth prospects than larger companies:

	FTSE 100	FTSE 250	FTSE SmallCap
Median P/E ratio	18.4	17.3	14.9

Note: median ratios calculated by taking median P/E ratio of each company over a 3-year period and then taking the median figure for companies in each index.

The theory that SmallCap companies have inherently higher growth potential is further challenged if the TSR performance of each of the main indices is compared:



Note: Chart based on the TSR performance of companies in the FTSE All Share over the three-year period up to 19 September 2017 (excluding companies without a three-year trading history). TSR was calculated using three-month averages at the start and end of the period.

As can be seen, the chart above indicates that what has constituted upper quartile TSR performance for FTSE SmallCap companies in recent years - i.e. genuine high growth - is actually lower than for FTSE 100 and FTSE 250 companies.

However, the delivery of enhanced returns to shareholders over the short, medium and long-term will still be the primary aim of all SmallCap companies. The question, then, is how can the design of executive remuneration in the SmallCap support this goal?

Challenges

SmallCap companies face many of the same challenges as do those in the FTSE 350 when designing their senior executive remuneration policy:

Market competitiveness	Best practice compliance	Market practice compliance	Increasing regulatory burden	Increasing disclosure requirements
Shareholder activism	Adverse press coverage	Negative public perception	Avoiding complexity	Intra-Board tensions

However, there are a number of important issues that tend to be more relevant in the SmallCap:

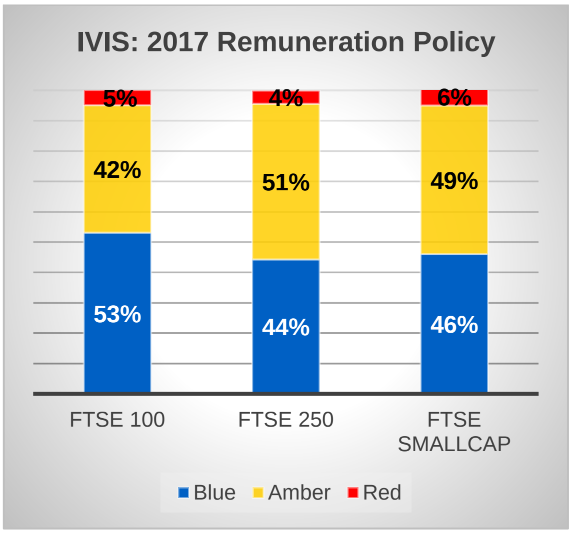
Profile of investors

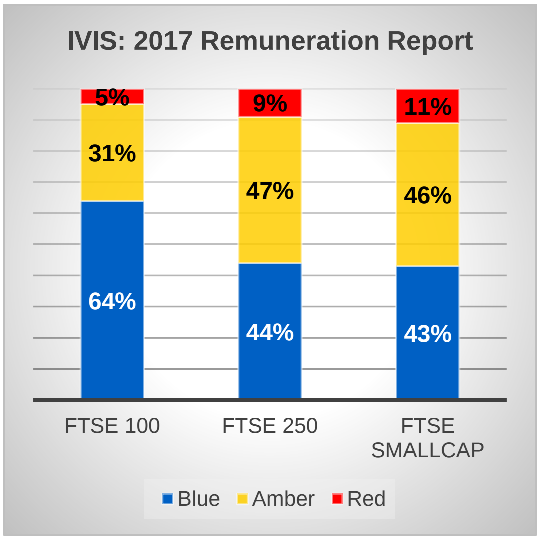
The share registers of SmallCap companies tend to be more concentrated, with a few larger shareholders. In addition, these larger shareholders are often not drawn from the more "compliance driven" end of the investor spectrum and tend to adopt a more "commercial" view of executive pay, which can provide SmallCap companies with more flexibility in pay design. The fact that these larger investors - by virtue of the size of their stakes as well as their general approach - are more likely to have closer relationships with management may also mean that they can be more pre-disposed to supporting pay models which sit outside the norm and which may offer higher potential rewards (albeit with these investors still being very keen on seeing how pay is linked to strategy and performance).

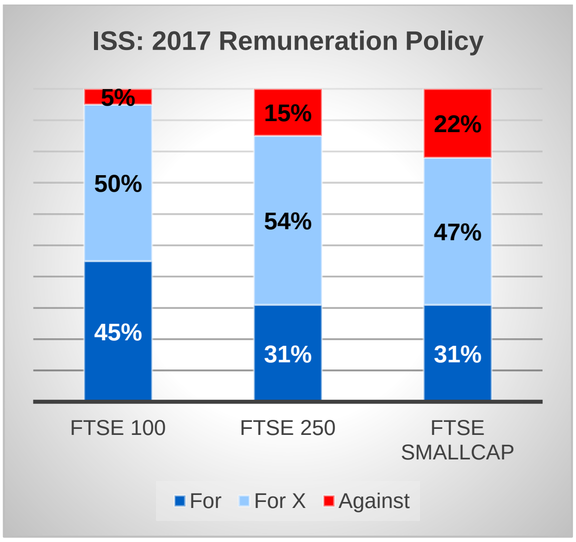
This poses the question of why don't SmallCap companies take greater advantage of this opportunity when designing their executive pay programmes, rather than tending to take the path of lesser resistance and adopting a more standard model?

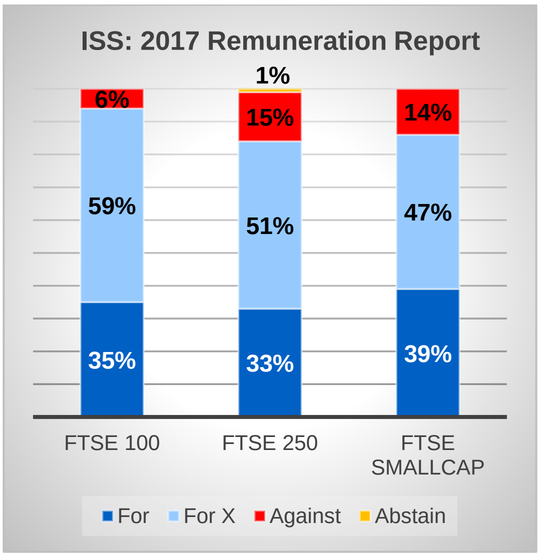
An answer to this may lie in the attitude of other shareholders on the register which have an instinctive preference for the conventional model, together with the approach taken by the main proxy voting agencies such as ISS, the Investment Association, Glass Lewis etc. By and large, the pay-related guidelines issued by these bodies apply equally to all FTSE All-Share PLCs, however large or small they may be, with less rigorous guidelines in place only for companies outside this index (e.g. AIM companies).

As a result, SmallCap companies are not given much more flexibility by these bodies in terms of pay, as evidenced by the fact that ISS/the Investment Association are no less likely to take issue with pay resolutions tabled by SmallCap companies as they are larger PLCs. Indeed, the analysis below suggests that SmallCap companies may be given an even tougher time:









Note: "For X" refers to a recommendation from ISS where concerns have been identified but there are mitigating factors which ultimately lead to a For recommendation.

Added to this, the smaller less activist shareholders in SmallCap companies may be more likely to simply follow the voting recommendations of ISS *et al*, with the (typically fairly modest) resources of an institutional investor's corporate governance function being more focused on the larger companies (often at the behest of the fund managers). Indeed, this could be another manifestation of a recurring issue SmallCap companies can face, that of a lack of coverage. It is far harder for a company to demonstrate how remuneration is linked to and supportive of strategy via a non-standard pay model if there is less appreciation in the market of what the company's underlying strategy actually is.

Therefore, a SmallCap company can find itself in the unenviable position of getting all its larger less compliance-driven investors onside during a pay consultation, only then to be confronted by many other smaller institutional shareholders voting in accordance with negative guidance from the proxy agencies. This can, at the extreme, cause the company to withdraw the relevant AGM resolution (examples of which we saw during the 2017 AGM season).

Size matters

One of the many pay-related governance guidelines that applies equally to large and small companies relates to dilution. Best practice states that only 10% of a company's issued share capital can be used for share plans in any 10 year period, with only 5% used for discretionary/executive schemes. 5% of the ISC of a FTSE 100 obviously goes much further than 5% of a SmallCap, but it isn't always the case that a SmallCap company will have correspondingly fewer participants in an LTIP. Yes, the SmallCap company may be able to buy shares in to satisfy awards which would not count towards the dilution limits, but there may be better uses for the cash.

Another approach would be to make the 10%/5% of shares go further, which raises the spectre of restricted share awards. Awards over fewer (typically 50% fewer) shares are made under a restricted share award compared to a traditional LTIP of an equivalent expected value. Therefore, restricted shares may well prove less dilutive (depending on the extent of vesting of the larger LTIP award), while also having the additional benefits of certainty of receipt and alignment with shareholders. Certainty of dilution impact is also delivered and, even if the SmallCap company believes that the use of restricted shares for main Board directors may be a step too far from a governance perspective, their use below Board could well be worth considering.

All of this ultimately goes back to the issue of affordability. SmallCap companies, by their very nature, are unlikely to be able to afford to apply the level of resources to executive pay that larger PLCs can call upon. And this is not just a reference to base salary levels, bonus/LTIP opportunity or share availability, all of which are generally lower in the SmallCap than the FTSE 350. SmallCap companies also tend to have smaller HR/Reward/Company Secretariat functions and will allocate a smaller budget to external advisors. All of this reduces the support that is available to the Remuneration Committee chairman, thereby increasing their personal time commitment which is, arguably, not reflected in the fees they receive for acting as Committee chair.

Things could be getting worse rather than better

As noted above, the proxy voting agencies adopt a largely "one size fits all" approach in terms of how their guidance should apply across the entire FTSE All-Share. Notwithstanding this, some SmallCap companies have - thus far at least - managed to adopt a less strictly compliant approach to some of the more detailed best practice guidance than larger PLCs:

Guidance	FTSE 100 (%)	FTSE 250 (%)	FTSE SmallCap (%)
Deferral in bonus	80%	66%	55%
LTIP post-vesting holding periods	75%	63%	36%
Share ownership guideline % (median CEO)	250%	200%	125%

That said, this "compliance gap" that currently exists between the SmallCap and FTSE 350 is likely to narrow. Furthermore, SmallCap companies will soon have to deal with the substantial changes to the corporate governance and disclosure regime that were trailed in the Government's response to the green paper on corporate governance reform. New legislative requirements will apply to all Main Market companies irrespective of their size, and the expected updates to the UK Corporate Governance Code may end up being interpreted as applying across-the-board to smaller as well as larger companies. As a result, SmallCap companies are likely to be faced with having to:

- calculate and disclose the ratio between CEO and average all-employee pay
- employ two-year post-vesting holding periods in their LTIPs
- seek and explain how the interests of wider stakeholders are taken into account by directors

- strengthen the voice of employees by either (i) designating a NED to ensure employees' views are noted, (ii) establishing a formal employee advisory council, or (iii) appointing a NED from the workforce

All of this will have to be done without any consideration given to (i) whether it is actually necessary for SmallCap companies and (ii) the lesser resources that SmallCap companies can call upon to ensure compliance.

The future

This could suggest that the future for SmallCap companies is not hugely encouraging when it comes to addressing the challenges of designing an executive remuneration policy that balances the aspirations of management, the Remuneration Committee and shareholders.

It would be very unfortunate if this fairly bleak picture becomes a reality. FTSE SmallCap companies are very important members of the quoted company environment in the UK. If they are faced with an ever-increasing regulatory burden, allied to an overly-rigid approach from their shareholders, the attraction of a premium listing in London may lose its appeal. This could lead to companies considering a foreign listing, or staying private (and therefore below the radar when it comes to pay disclosure). Neither scenario would be helpful to "UK PLC" as a whole.

Want to know more?

Please contact:

Rob Burdett
m: 07979 537 326
rob.burdett@kornferry.com

Simon Garrett
m: 07748 328 560
simon.garrett@kornferry.com

Deborah Hall
m: 07495 796 619
deborah.hall@kornferry.com

Jonathan Hutchings
m: 07408 802 787
jonathan.hutchings@kornferry.com

Chris Niland
m: 07779 270 334
chris.niland@kornferry.com

Andrew Udale
m: 07770 720 888
andrew.udale@kornferry.com

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