Directors' remuneration in FTSE SmallCap companies

March 2017

Introduction

This report provides analysis of trends in directors' remuneration within the FTSE SmallCap market.

The report provides analysis of trends in executive pay, including basic salary and incentives, as well as looking at some of the wider governance issues that companies may need to take into consideration when reviewing their remuneration in 2017.

With continued scrutiny of executive pay from shareholders, the media and Government alike, it is expected that 2017 will be another challenging AGM season. Although the main focus is on FTSE 350 companies we are seeing evidence that smaller companies are also experiencing resistance from shareholders. As many companies take their remuneration policy to shareholders for approval it is important to keep in mind that there has been a change in attitude over the last three years, and just because a policy received approval three years ago does not necessarily mean shareholders will continue to fully support all aspects.

Investor feedback demonstrates that there has been a significant increase in the number of companies seeking to consult on their remuneration policy, reflecting a level of caution and concern from companies nervous about hitting the headlines for all the wrong reasons. However in spite of this, there is already early evidence of companies receiving high levels of shareholder dissent.

Shareholders are also becoming more vocal in the face of substandard reporting generally, and over the past year we have seen a number of major investors issue new principles and guidelines for companies to adhere to.

In addition, in November 2016 , the Government published a green paper on corporate governance reform. This paper explores a number of ways to increase shareholder influence over pay and build upon the existing good governance practices already in place.

The consultation period has only just closed, but it appears likely that there will be changes required, for example the publication of the CEO pay ratio.

Given the changing landscape, it is anticipated that many companies will hold back from significant policy changes at this time.

Summary of key data findings

Practice at SmallCap companies continues to mirror that of larger companies in many respects*:

— Median basic salary increases remain moderate at around 3%, although the data also shows that one in five chief executives received an increase of 8% or above;

— Annual bonus remains a significant proportion of actual variable pay delivered; and

— Performance share plans have been implemented by all but a few companies, with EPS and TSR being the two most prevalent performance measures.

The use of deferred bonus plans has almost quadrupled since our analysis of executive pay in the SmallCap was carried out in 2014. This rise in the prevalence of deferred bonus plans suggests that companies are adhering to the demands of their shareholders, who are keen to see further long-term alignment. This change also reflects practice in the FTSE 250 and FTSE 100.

Although there are similarities with larger companies, there are also some significant differences.

Around a quarter of executive directors in SmallCap companies did not receive a bonus during the year. This is in stark contrast to FTSE 250 companies, where only around one in ten received no pay-out under their annual bonus plan.

The median pay-outs under annual bonus plans (as a percentage of salary) for executive directors are also considerably less than that seen in the FTSE 250.

This is driven in part by lower bonus potential maxima, but also suggests that targets have been tougher to meet for SmallCap companies, whether this is because the targets are set at a more stretching level is difficult to assess. The most common bonus performance metrics are profit coupled with personal/strategic measures.

Long-term incentive plan (LTIP) pay-outs for SmallCap companies remain low, with over half of executive directors receiving no gain from their LTIP during the year.

*The analysis in this guide is based on FTSE SmallCap listed companies which published their annual report and accounts up to 30 April 2016 as analysed by Manifest Information Services, an independent research organisation.

Governance and disclosure

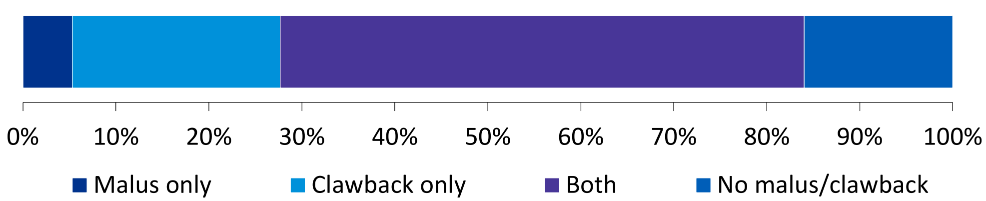
An overview of the key themes from the 2016 reporting season is shown below.

Remuneration policy

— Only 7% of companies have set a basic salary maximum, either in the way of a salary cap or maximum percentage increase. Most companies that do not have a basic salary maximum have stated that increases will not exceed that of the average employee but higher increases may be awarded in the case of exceptional circumstances.

— The majority of SmallCap companies (84%) now have a clawback and/or malus provision attached to variable remuneration. This has increased in the last two years.

Prevalence of malus/clawback in remuneration policy



— A number of SmallCap companies (36%) have implemented holding periods into their long-term incentive plans over the past two years, with two years being the most common holding period.

— The majority of remuneration committees retain some discretionary powers in relation to pay. This is particularly the case when considering the outcome of a formulaic annual bonus and/or long-term incentive. Committees typically retain the discretion to make a downwards adjustment to the outcome of incentive plans, given the underlying financial performance of the company. The use of discretion is an area of particular focus for shareholders.

Remuneration report

— Annual bonus performance measures were relatively well reported by companies, with just 10% of companies failing to disclose their performance measures.

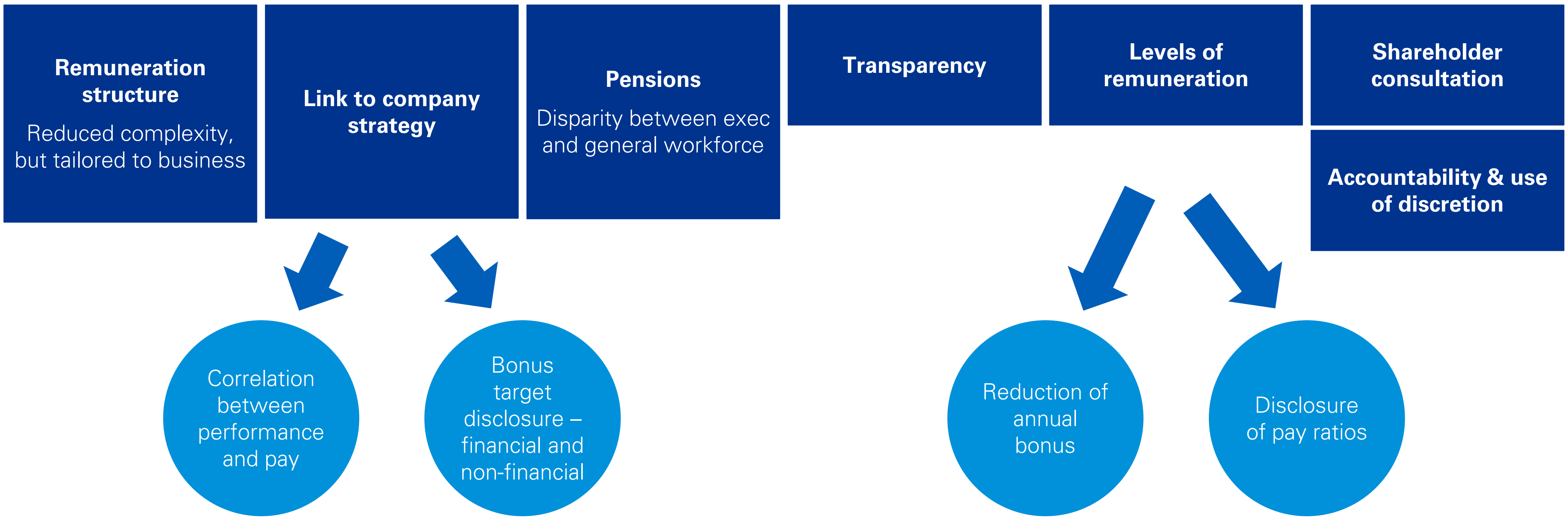
— Almost half (48%) of the SmallCap did not disclose retrospective performance targets, most commonly non-financial, with most companies using the commercial sensitivity exemption. Analysis shows that the retrospective disclosure of short-term financial targets tend to be well reported, although non-financial (personal/strategic) targets require greater disclosure in order to meet shareholder expectations.

— Only 10% of remuneration committees used their discretion during the year. This was mostly used in relation to leavers and to reduce annual bonus payments as a result of poor underlying financial performance.

Governance and disclosure (continued)

The shareholder perspective

Despite a vote of confidence from a number of investors over the 2016 AGM season, main market listed companies continue to be under ever increasing scrutiny from their investors and the general public in relation to directors' remuneration practices and disclosures. Over the past year, a number of investors have issued new principles and guidelines outlining their expectations in relation to directors' remuneration reporting. The new Prime Minister and the Government have also been forthright in their concern about executive pay and have submitted plans to strengthen the UK Corporate Governance code. Whilst there have been no amendments to the regulations yet, there is a consistent theme to the issues raised by the investor community and wider stakeholders (as set out below) and companies should keep this front of mind when considering their remuneration philosophies and structures, and when making relevant disclosures.



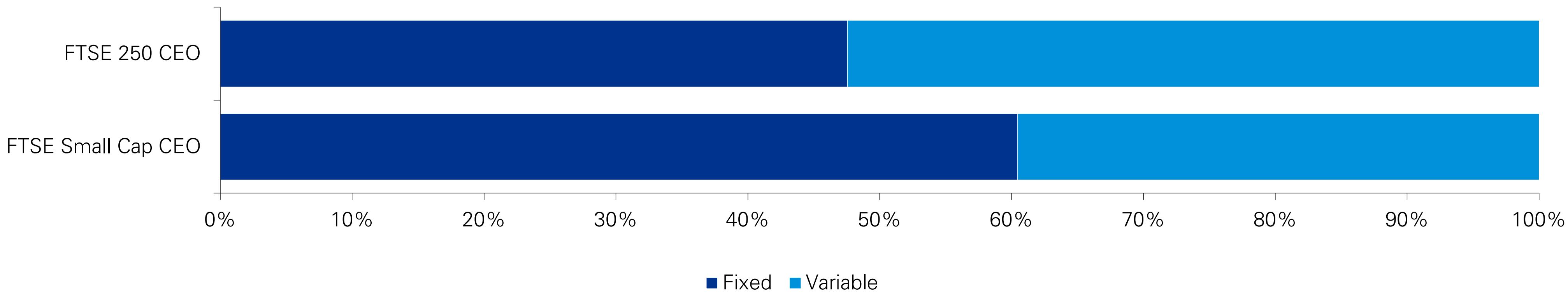
Remuneration mix

The chart below shows the median remuneration mix between fixed and variable pay for a chief executive of a SmallCap company. The remuneration mix is shown in respect of actual remuneration received in the year.

Most companies have an annual bonus plan and some form of LTIP in place. However, pay-outs under LTIPs in recent years have been low, with over half (51%) of chief executives receiving no LTIP pay-out during the year. The data shows that around 60% of actual remuneration delivered for the most recent year is fixed, which is slightly higher than for chief executives of a FTSE 250 company.

Fixed pay includes basic salary, benefits and pensions. Variable pay includes annual bonus payments and actual LTIP gains.

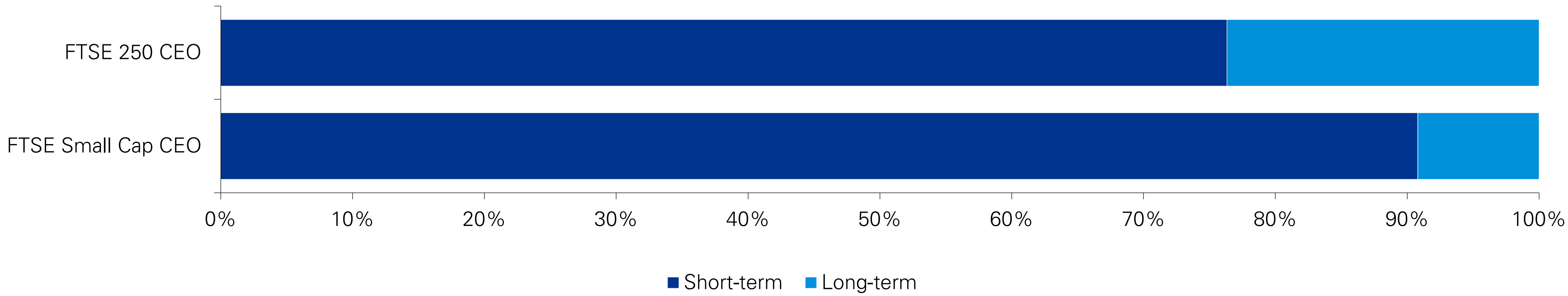
Mix of pay: Fixed: Variable



Remuneration mix (cont.)

Further analysis of the remuneration mix between short-term and long-term pay shows the majority of remuneration delivered is short-term. Short-term pay includes basic salary, benefits, pension contribution and annual bonus (which is not deferred). Long-term includes deferred annual bonus and LTIP gains. It is important to note that this reflects pay actually received rather than desired policy or the level of awards which have been made to an individual. The lack of pay-outs under LTIPs suggests that companies may not be receiving value for the cost of operating such plans, and that they may not be operating as effective incentives.

Mix of pay: Short-term: Long-term



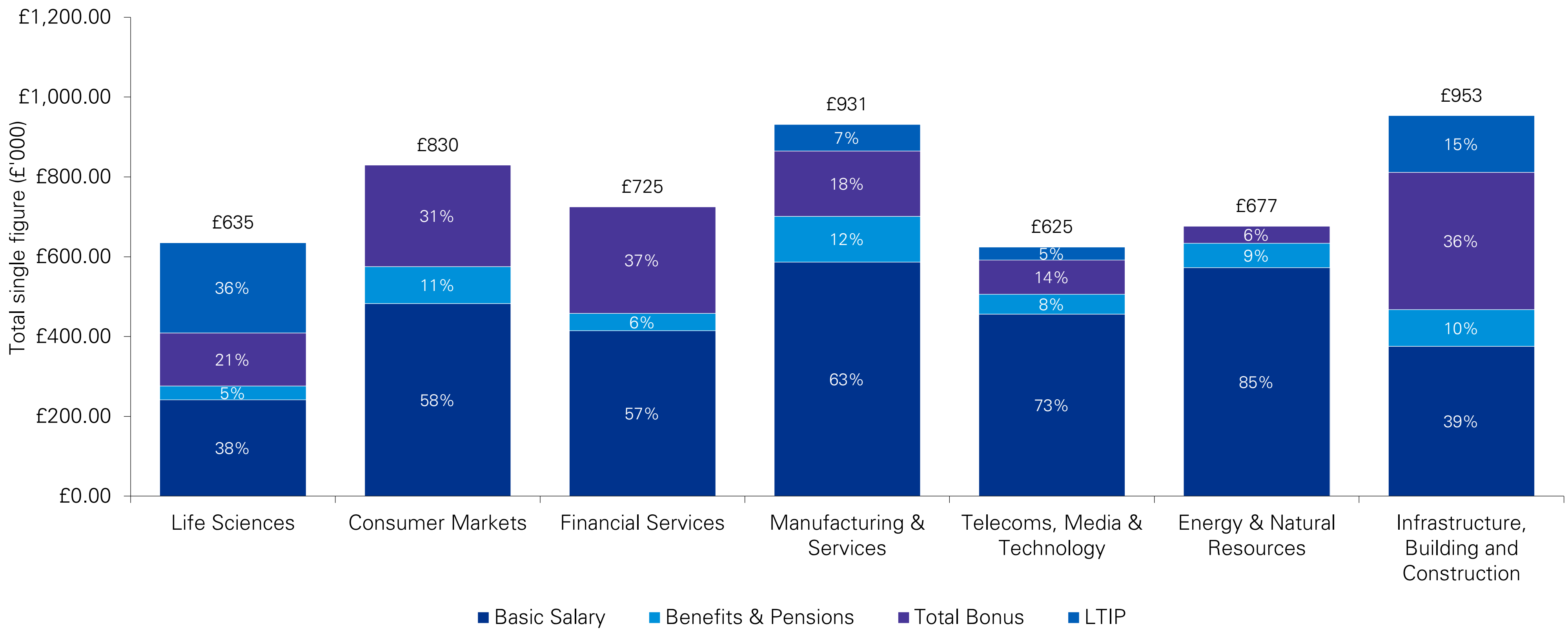
Further detail on incentive plans is included later in this report.

Mix of pay by sector

The chart below shows the mix of pay by sector at the median.

For a number of sectors the median company saw no LTIP pay-out during the year, and this is reflected in the chart below.

Median Chief Executive Remuneration by Sector



Basic salary, total cash and total earnings

Table below shows the basic salary, total cash and total earnings for each director.

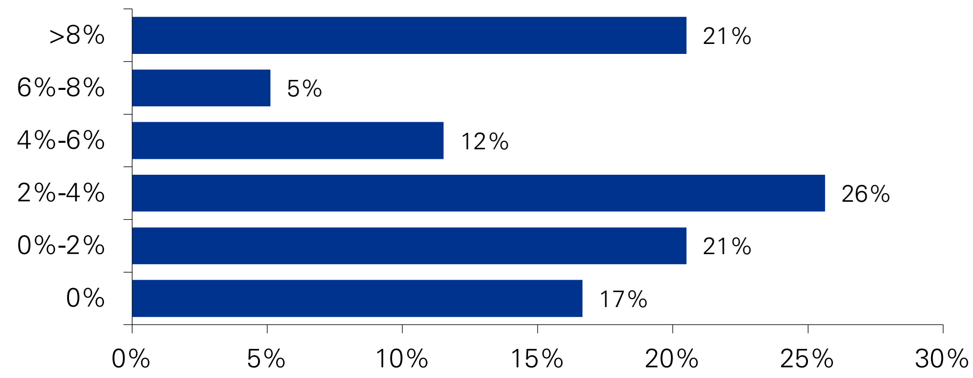
	Basic Salary			Total cash			Total earnings		
	Lower Quartile (£'000)	Median (£'000)	Upper Quartile (£'000)	Lower Quartile (£'000)	Median (£'000)	Upper Quartile (£'000)	Lower Quartile (£'000)	Median (£'000)	Upper Quartile (£'000)
Chief Executive	315	399	452	497	666	855	517	810	1,111
Finance Director	233	274	297	332	421	561	356	529	700
Other Executive Director	185	228	293	248	408	542	255	461	579

As shown in the chart below, basic salary increases have remained relatively moderate. Median basic salary increases during the year are broadly comparable with employees as a whole, with almost two thirds receiving a salary increase below 4%.

Median Basic Salary Increases				FTSE 250
	Lower Quartile	Median	Upper Quartile	Median
Chief Executive	2%	3%	6%	3%
Finance Director	2%	3%	5%	3%
Other Executive Director	1%	2%	5%	3%

There are some exceptions, with a fifth of chief executives receiving an increase above 8%. Significant basic salary increases were a key factor for shareholder dissent in the 2016 AGM season.

Percentage of basic salary increases awarded to Chief Executives



Basic salary by market capitalisation and turnover

The table below shows basic salary levels by market capitalisation.

Chief Executive – Basic Salary by market capitalisation			
Market Capitalisation	Lower Quartile (£'000)	Median (£'000)	Upper Quartile (£'000)
>£300m	398	436	466
£200m-£300m	297	365	425
<£200m	274	339	422
All	315	399	452

Finance Director – Basic Salary by market capitalisation			
Market Capitalisation	Lower Quartile (£'000)	Median (£'000)	Upper Quartile (£'000)
>£300m	257	287	302
£200m-£300m	205	251	297
<£200m	220	247	280
All	233	274	297

Other Executive Director – Basic Salary by market capitalisation			
Market Capitalisation	Lower Quartile (£'000)	Median (£'000)	Upper Quartile (£'000)
>£300m	200	251	284
£200m-£300m	224	286	342
<£200m	170	206	276
All	185	228	293

The table below shows basic salary levels by turnover.

Chief Executive – Basic Salary by turnover			
Turnover	Lower Quatile (£'000)	Median (£'000)	Upper Quatile (£'000)
>£400m	425	459	544
£200m-£400m	360	397	430
<£200m	282	334	411
All	315	399	452

Finance Director – Basic Salary by turnover			
Turnover	Lower Quatile (£'000)	Median (£'000)	Upper Quatile (£'000)
>£400m	285	300	338
£200m-£400m	244	266	288
<£200m	196	237	258
All	233	274	297

Other Executive Director – Basic Salary by turnover			
Turnover	Lower Quatile (£'000)	Median (£'000)	Upper Quatile (£'000)
>£400m	266	284	354
£200m-£400m	198	219	263
<£200m	173	212	301
All	185	228	293

Annual incentives

The vast majority of FTSE SmallCap companies operate an annual bonus plan. The table below shows the maximum bonus opportunity for chief executives, finance directors and other directors.

Maximum annual bonus opportunity (percentage of salary)			
	Lower Quartile	Median	Upper Quartile
Chief Executive	100%	100%	125%
Finance Director	100%	100%	125%
Other Executive Director	75%	100%	103%

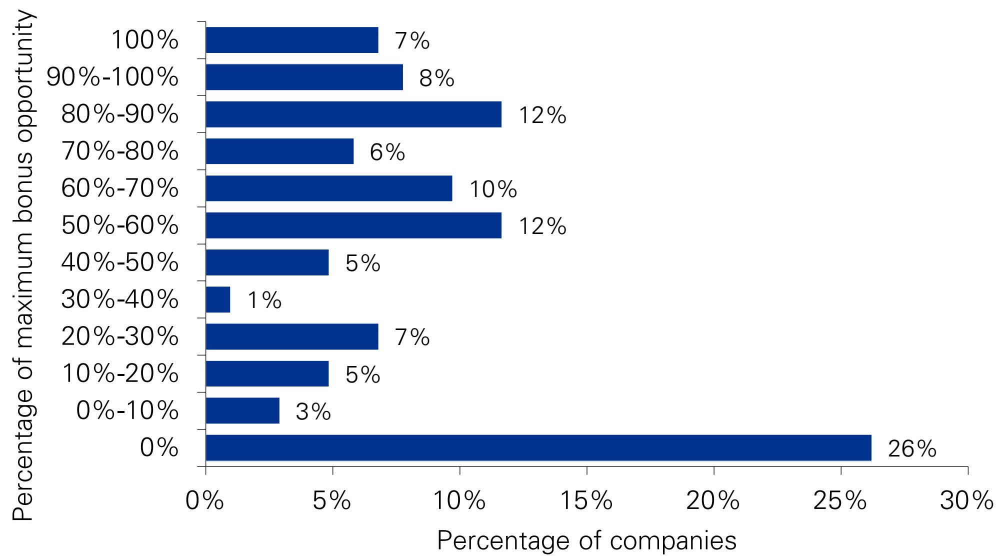
Maximum opportunity remains almost unchanged from the analysis carried out in our 2014 SmallCap report.

The table below shows the range of maximum bonuses for CEOs split by company market capitalisation.

Chief Executive – Maximum annual bonus opportunity (percentage of salary)			
Market Capitalisation	Lower Quartile	Median	Upper Quartile
>£300m	100%	125%	150%
£200m-£300m	100%	100%	110%
<£200m	100%	100%	100%
All	100%	100%	125%

Although the vast majority of companies operate an annual bonus plan, a quarter of chief executives received no bonus this year, and many others received significantly less than maximum, as shown in the chart below.

Percentage of maximum annual bonus paid by companies



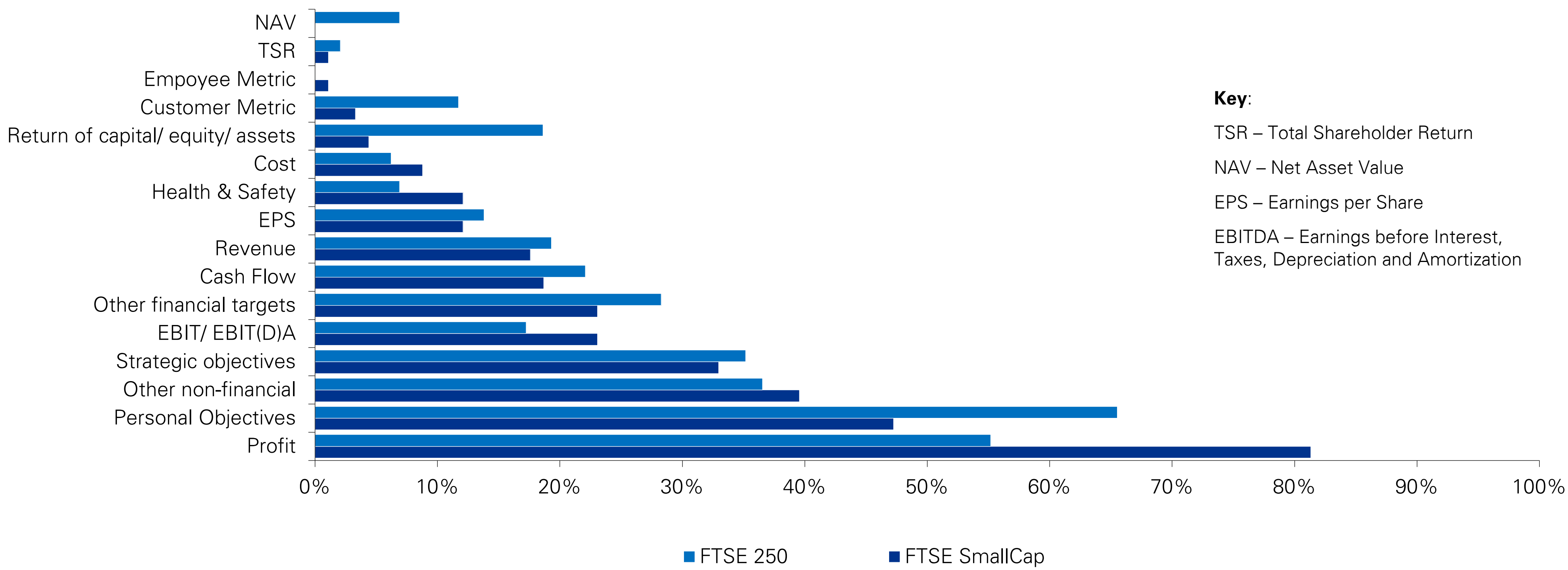
Deferred bonus plans

44% of SmallCap companies operate an annual bonus plan with some form of deferral attached, most commonly over a three year period.

Annual incentives (Cont.)

Performance conditions

The use of some form of profit measure, either as a single measure or in conjunction with some form of non-financial or personal objectives, continues to be the most common approach for performance conditions, as shown in the chart below. This is in line with FTSE 250 practice.



Key:

TSR – Total Shareholder Return

NAV – Net Asset Value

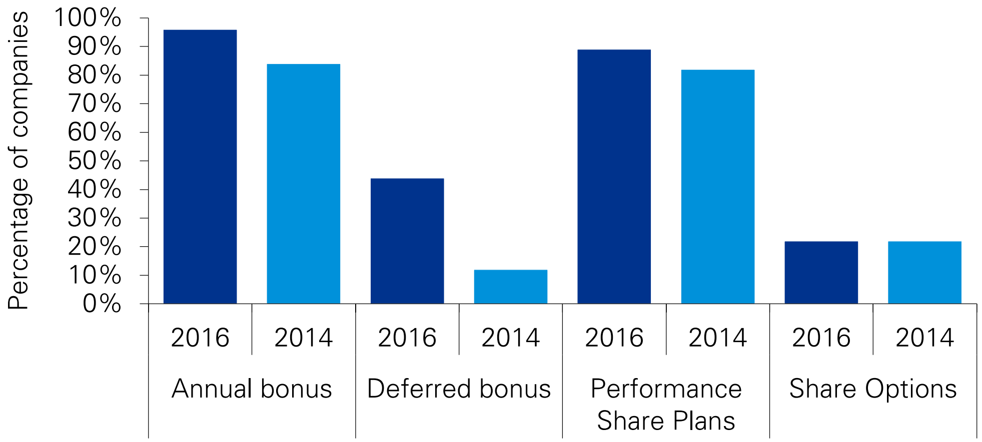
EPS – Earnings per Share

EBITDA – Earnings before Interest, Taxes, Depreciation and Amortization

Long-term incentive plans

Types of plan

The chart below shows the prevalence of incentive plans in the SmallCap market and how this has changed over the past two years.



Share options

Less than a quarter (22%) of companies operate share option plans at board level, remaining unchanged from 2014.

17% of these share option plans do not have performance conditions attached to them. The remaining plans most commonly have a combination of EPS and TSR performance conditions.

Performance Share Plans

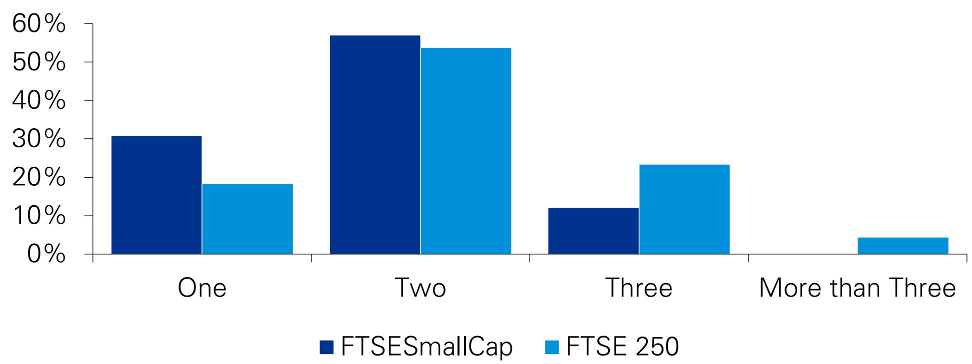
Performance Share Plans (PSP) are the most common form of LTIP, with 89% of SmallCap companies operating such a plan.

Of those that made PSP grants during the year, grant levels were as follows:

LTIP grant (percentage of salary)			
	Lower Quartile	Median	Upper Quartile
Chief Executive	100%	111%	149%
Finance Director	96%	103%	137%
Other Executive Director	72%	100%	185%

Performance conditions

69% of PSPs now use two or more performance measures, which represents a slight increase since 2014.

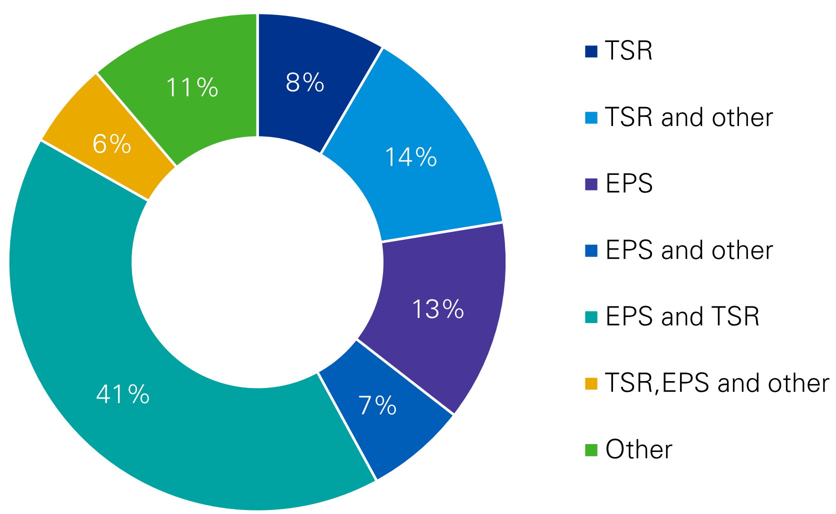


Long-term incentive plans (cont.)

Performance conditions

The use of some form of TSR measure, either as a single measure or in conjunction with another approach, is the most popular measure across the FTSE SmallCap.

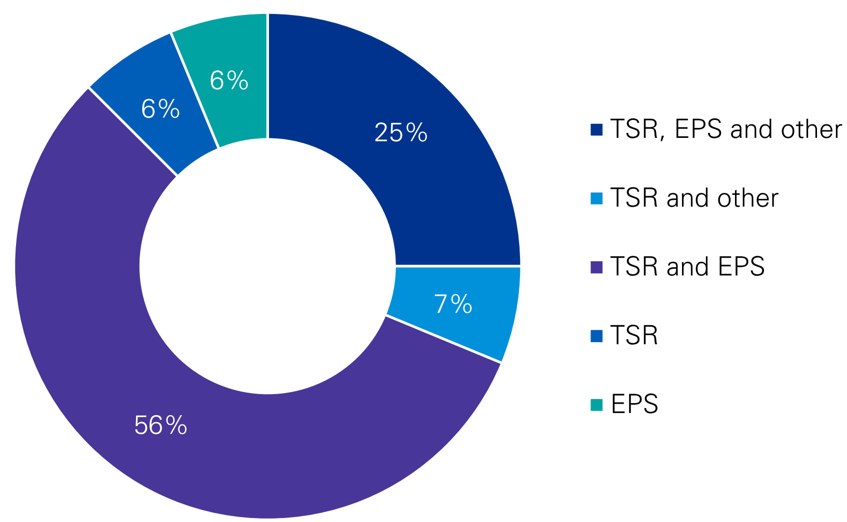
The following charts show the measures that are currently in use. 'Other' measures include profit, cashflow, share price targets and return on capital.



New and amended plans

The number of new and amended long-term incentive plans taken to shareholders in 2016 was twenty and two respectively, with the majority being performance share plans.

In line with existing practice, the majority of new plans incorporate TSR and/or EPS as a performance condition although some companies are incorporating a more business tailored performance measure.



Non-executive directors

The table below shows the basic fees for the roles of chairmen and non-executive directors, as well as the additional fees provided for the chairmanship or membership of a particular committee. Basic fees are exclusive of any additional fee which may be paid. Fewer companies pay an additional fee for membership of a committee compared to that of chairing the committee. Around two thirds of committee chairs receive an additional fee for their increased responsibilities whereas just 6% of companies pay an additional fee for membership of a committee. Payment of additional fees for chairing or membership of a committee has increased over recent years.

Non-executives have increasingly come under the spotlight from shareholders and regulators in recent years. The change to the voting rules on remuneration for listed companies has led to a higher profile role for the individual chairing the remuneration committee in particular, with a greater level of accountability and personal reputational risk. It is important to take into account the growing focus on the role and responsibilities of non-executives in the marketplace. This is likely to have an effect on fees over time.

There are a number of committees which may be operated, we have analysed the most common. Other committees can include, but are not limited to; Risk Committees, Corporate Social Responsibility committees and Investment committees.

Non-executive director fee rates	Lower Quartile (£'000s)	Median (£'000s)	Upper Quartile (£'000s)
Basic fees:			
Chairman	33	42	121
Non-executive directors	23	31	42
Additional fees:			
Senior Independent director	5	5	5
Chairman of the Remuneration Committee	5	7	10
Member of the Remuneration Committee	4	5	5
Chairman of the Audit Committee	4	6	10
Member of the Audit Committee	3	5	5
Chairman of the Nomination Committee	5	6	10
Member of the Nomination Committee	3	5	5

Methodology

The analysis in this guide is based on FTSE SmallCap listed companies which published their annual report and accounts up to 30 April 2016 as analysed by Manifest Information Services, an independent research organisation.

Data sources

Unless otherwise stated, all graphs and tables in this guide have been created by KPMG, from data provided by Manifest information Services. The data provided by Manifest information Services has been further analysed using the methodology outlined below.

Data sample

Market constituents and market capitalisation figures are set at April 2016 and turnover figures used for the analysis are as at the relevant reporting date for each company.

The positions included in the data sample are: chief executive, finance director and other executive directors. Other executive directors includes any main board position other than the chief executive, finance director, executive chairman and the non-executive directors. This typically includes operational directors, functional directors, chief operating officers.

To enable the remuneration components of each position to be analysed they have been split in to the following categories:

Basic salary

Annual salary received over a 12-month period as shown in the accounts (not necessarily set at annual review).

Total cash

The sum of basic salary, benefits, pension and total bonus.

Total earnings

The sum of total cash, the market value of any PSP gained during the year and the market value of any share options gained during the year. The final figure may also include some miscellaneous payments not shown in the published tables.

LTIP awards

LTIP awards are considered for the purpose of the guide to be awards where the vesting/performance period is longer than one year and have been categorised in the guide as:

— **PSP or Performance Share Plan** – A type of long-term incentive in which participants are allocated shares or, more commonly, rights to shares, the vesting of which is subject to the satisfaction of performance targets over a period of more than one year.

— **Share Option** – A type of long-term incentive structured as a call option that gives a right to buy a share some time in the future at the market value specified at the outset.

For the actual analysis, the face value of performance shares and options has been estimated for the individual grants using the share price on award or the exercise price of the option.

How KPMG can help

KPMG is one of the UK's leading advisors on employee incentives and executive compensation. We are a member of the Remuneration Consultants Group (RCG) and signatory to its Code of Conduct. We have a multi-disciplinary team and a wealth of experience within the FTSE SmallCap market, able to advise on market practice, corporate governance, incentive plan design, tax, regulatory and accounting aspects of UK and global incentive plans.

We work regularly with clients ranging from Main Market and AIM listed companies to private equity-backed and larger unlisted companies, as well as multinational groups headquartered both in and out of the UK. We have significant experience in advising on all of the following matters:

- Reward strategy and approach.
- Mix of pay and remuneration benchmarking.
- Remuneration committee governance.
- Remuneration regulatory compliance.
- Design and implementation of incentive plans.
- Corporate transactions.
- Accounting, valuations and modelling.
- Ongoing operation of incentive plans.
- Job evaluation and grading.
- Directors' Remuneration Reports.

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