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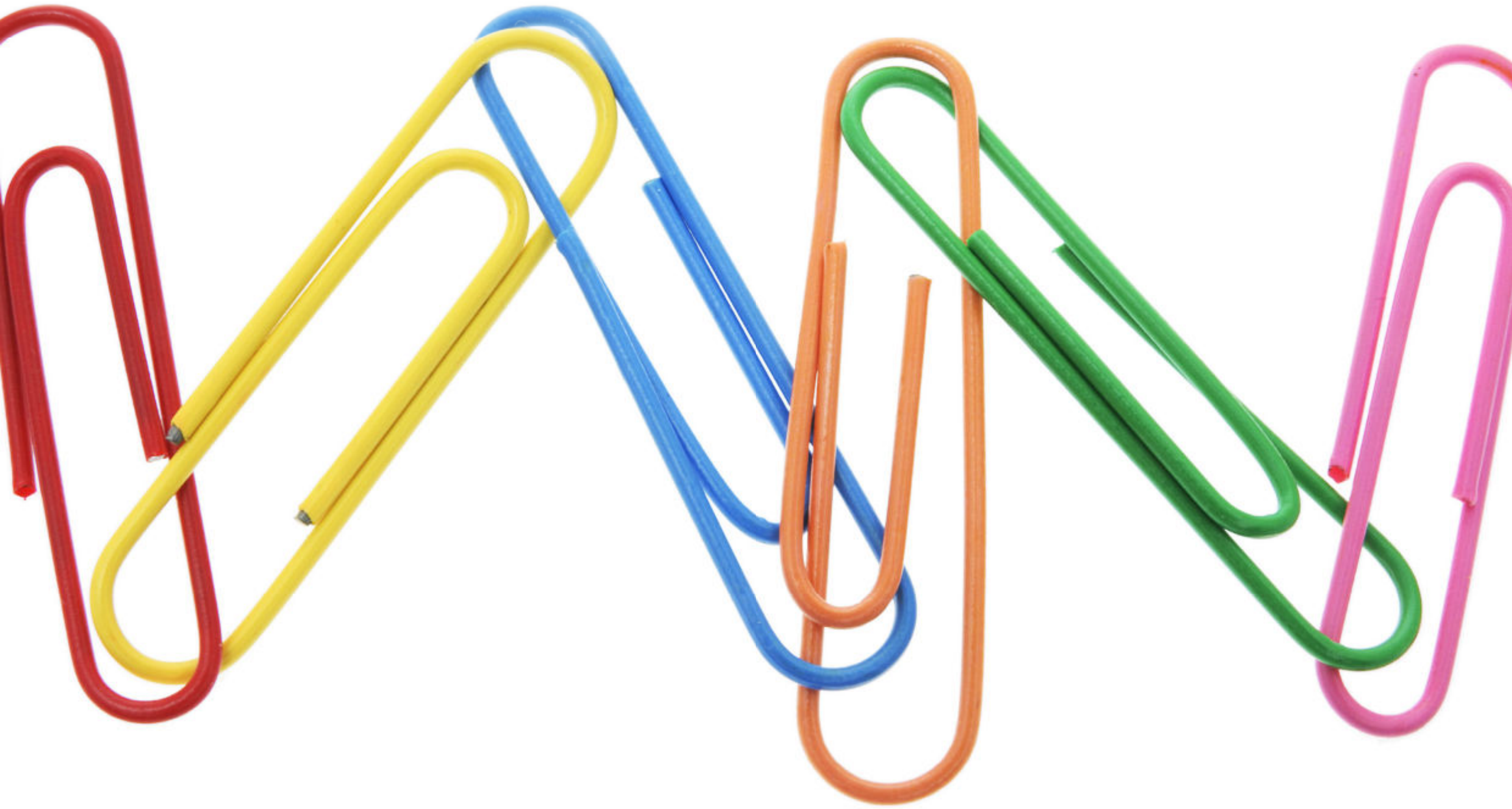
Directors' remuneration in smaller companies



April 2014

Overview from Juliet Halfhead

2013 was a strong year for FTSE SmallCap companies, with the index surpassing peak 2007 levels, despite concerns with emerging markets. Over the last year, FTSE SmallCap companies have outperformed their larger counterparts, with annual growth in the FTSE SmallCap index at 29% in 2012-13 and 35% in 2013-2014 as compared to FTSE 250 index growth of 22% and 19% respectively. An illustration of this is how the market capitalisation of our FTSE SmallCap group has increased since our last report. In 2013 median market capitalisation was £180m, this year it is £251m.

The past year has also been a period of consolidation for executive pay and policy. After a relatively tumultuous 2012, with vocal shareholder and investor bodies expressing their concerns over levels and structure of remuneration and disclosure, 2013 has been a quieter year. The number of companies who had votes of less than 80% in favour of their remuneration reports fell as did the overall number of companies where investor voting bodies raised specific concerns on remuneration related issues. Notwithstanding the increase in market capitalisation, the extent of changes to pay have been modest with a median salary increase of 2.5% and around 40% of companies giving no pay rise at all to their executive directors. Indeed our report discloses lower salaries against market capitalisation compared to last year. This is not an aberration – simply a consequence of increased market growth which is not being automatically translated into an increase in base pay, a practice which will be welcomed by voting bodies and institutional investors.

Median bonus and long term incentive opportunities are unchanged and there is a continued move towards reflecting best practice, via increases in formal shareholding guidelines amongst companies and the inclusion of malus and/or clawback provisions in incentive plans.

Our research indicates that remuneration arrangements in smaller companies tend to be simpler than in larger companies with most companies operating an annual bonus plan and one long term plan. The trend towards introducing bonus deferral continues, although this is still less common than in the FTSE 250. Our experience when working with Remuneration Committees has been a focus on ensuring that performance measures support the business strategy and reflect the key performance indicators of the business. There is also a focus on calibrating targets to provide an appropriate balance between setting suitably stretching performance targets to act as an appropriate incentive for participants and to deliver sustained business performance without encouraging excessive risk. Despite an upturn in performance across the FTSE SmallCap, bonuses continue to pay out at lower levels than in the FTSE 250. All of this points to a very real focus by Remuneration Committees on pay for performance which can be justified to shareholders.

A large proportion of the annual bonus amongst most companies in the FTSE SmallCap is based on some form of profit measure. Profit growth has been steadier over the period 2011/12-2012/13 and this has been reflected in lower annual bonus payouts compared to last year. This contrasts with vestings under long term incentive plans which have been higher than in previous years. EPS growth is dependent, typically, on performance at the end of the period relative to that at that start of the period. The higher levels of growth observed in the most recent periods reflect, in part, the fact that the start periods were in the financial crisis, and therefore growth is measured from a lower base point. Similarly, Total Shareholder Return (TSR) over the two most recent three year periods has been stronger reflecting a recovery in share price and returns since the downturn. EPS and TSR are the most common long term incentive performance measures and these results help to explain why, in a period in which bonus out-turn has fallen, amounts vesting under incentive plans have risen.

The impact of the new disclosure regulations on directors' pay have not impacted this report as it reflects data from report and accounts published before these provisions had come into effect for most companies. What we do know, from experience, is the additional work which these new disclosure requirements have caused companies. Our report this year includes an explanatory briefing at the end of each section on the impact of the new regulations and how that element of remuneration should be disclosed in the Directors' Remuneration Report. For those of you who have not yet prepared accounts under the new regime we hope that you find this useful and for those who already have, then hopefully this reinforces the lessons learnt along the way.

It will be interesting to see what new information we will be able to provide in our 2015 Be equipped report as a consequence of the increased levels of disclosure and we look forward to sharing this with you next year.

Juliet Halfhead
Deloitte LLP
April 2014

2. Main findings

Base salary

- Salary increases in 2013 were lower than in larger companies
- 2.5% median increase in 2013
- Almost 40% of companies gave no salary increase to executive directors in 2013
- Almost half of top full time executives received no salary increase in 2013

Incentives

- Little change to the incentive potential in annual or long term plans
- Increase in the use of multiple annual bonus metrics and a wider range of long term performance measures
- 50% of companies now operate clawback or malus provisions compared with 30% last year
- Lower bonus out-turns but higher vesting under long term plans

Pension

- Only 3% of executive directors continue to participate in a defined benefit plan
- The typical contribution to a defined contribution plan, personal pension plan or pension allowance is between 10% and 20% of salary with a median of 15%

Shareholdings

- 59% of companies have specific shareholding requirements in place compared with 52% last year
- The usual requirement is one times salary but 10% of companies require executives to hold more than this, and 16% have a higher requirement in place for top full time executives
- Around 40% of main board executive directors and 60% of top full time executives hold more than one times salary in shares

Non-executive fees

- Around 70% of non-executive directors and almost 80% of chairmen received no fee increase in 2013
- Typical fee levels for non-executive directors in FTSE SmallCap companies are between £35,000 and £45,000 with a median of £40,000
- Typical fee levels for the chairman of a FTSE SmallCap company are between £100,000 and £150,000 with a median of £120,000

Shareholders

- The ABI raised areas for concern (amber or red flags) in half of companies and the ISS recommended a 'vote against' or 'abstain' for a fifth of companies
- There have been fewer votes against the remuneration report in 2013 than in the 2012 season. 13% of FTSE SmallCap companies received less than 80% of votes in favour compared with 18% in 2012