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FTSE SMALLCAP: EXECUTIVE REMUNERATION TRENDS 2020

DECEMBER 2020

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The research in this report includes UK companies that published their Annual Report during the first half of 2020 (i.e. those with financial year ends between 31 December 2019 and 31 March 2020).

KEY TAKEAWAYS

2020 has been an extraordinary year. Most companies have, in some way, had their performance affected by COVID-19 and the resulting recession. At the same time, a majority of FTSE SmallCap companies have held a triennial binding shareholder vote on their remuneration policies.

The result of this has been ongoing moderation and restraint as companies have sought to respond appropriately to the crisis.

80% of FTSE SmallCap companies with March to June year-ends froze base salaries or delayed their FY 2020/21 pay review.

1/3 of FTSE SmallCap companies with March to June year-ends paid bonuses as usual, with the remainder either delaying payment, exercising discretion to cancel the bonus payment or failing to meet their bonus targets.

0% of maximum was the median bonus paid by FTSE SmallCap companies with a March to June year-ends.

59% when only including companies who paid a bonus.

Support for remuneration reports and policies remained high. The median vote on the remuneration report in favour was:

96.4% on the binding policy vote

95.6% on the advisory vote

However, investors may feel that further progress is required on certain best practice features:

>1/3 of FTSE SmallCap companies have not disclosed a plan to align executive director pension provision to the workforce; and nearly one-quarter have not introduced a separate policy on post-cessation shareholdings.

IMPACT OF COVID-19 ON EXECUTIVE REMUNERATION

In November, the Investment Association updated its Principles of Remuneration, and issued updated guidance on shareholder expectations during the COVID-19 pandemic. The updated guidance continues to emphasise the need to balance incentive outcomes for executives with the experience of shareholders, the wider workforce and other stakeholders. In particular:

- The IA does not expect companies that have participated in the government's job retention scheme, raised capital or have otherwise relied upon direct external support to pay bonuses for FY2020 or FY2020/21, other than in "truly exceptional circumstances."
- If a company has cancelled FY2019 or FY2019/20 dividends, this should be reflected through the operation of malus on deferred share awards or in FY2020 bonus outturns
- Inflight bonus and LTIP targets should not be adjusted to take account of the impact of COVID-19
- Remuneration Committees will be expected to exercise discretion to prevent inappropriate outcomes as and when awards vest, particularly where windfall gains have been created by COVID-19 related share price volatility.

We are now beginning to see how SmallCap companies responded initially to the pandemic. 30 FTSE SmallCap companies, with a March to June year-end, have reported their response to COVID-19 in their Annual Report & Accounts. Whilst the effect of the COVID-19 pandemic has varied by sector, these reports demonstrate the significant impact on the wider workforce and executive remuneration. Key takeaways included:

- Three quarters cancelled/suspended their final dividend;
- 60% reported furloughing employees;
- Over 40% reported a temporary salary/fee reduction/waiver for Executive Directors (EDs) and/or Non-Executive Directors (NEDs) - typically 20% reduction for three months; and
- 80% froze base salaries or delayed their annual pay review for FY 2020/21.

The impact on annual bonus for these 30 companies has been significant:

Average and median bonus outturns have **fallen** significantly among these companies for the second year in succession

33%	10%	17%	40%
Have paid a bonus this year	Delayed the bonus payment	Exercised discretion not to pay the bonus achieved under the formulaic outcomes	For the remaining percentage, no bonus was payable under the formulaic outcome

MARCH TO JUNE YEAR-ENDS - FTSE SMALLCAP BONUS OUTTURN AS % OF MAXIMUM

	2018	2019	2020
Average outturn	51%	37%	22%
Median outturn	57%	29%	0%

When only including companies who paid a bonus, the average and median bonus for 2020 was 56% and 59% of maximum respectively.

Ensuring 2021 bonus targets and 2021-2023 LTIP (Long-Term Incentive Plan) goals are robust but achievable is extremely challenging in a highly uncertain and fragile international economic environment.

REMUNERATION POLICY CHANGES

Simplification, increased annual bonus opportunities, and the introduction of annual bonus deferral were the main themes at those FTSE SmallCap companies which sought a significant change to their remuneration policy at 2020 annual general meetings (AGMs). Only a minority made significant changes to their remuneration policy this year, and most companies only made minor changes to update their 'best practice' features as required by the 2018 Corporate Governance Code. Overall, levels of support for remuneration resolutions at 2020 AGMs remained high.

MEDIAN LEVEL OF SUPPORT REMAINS HIGH

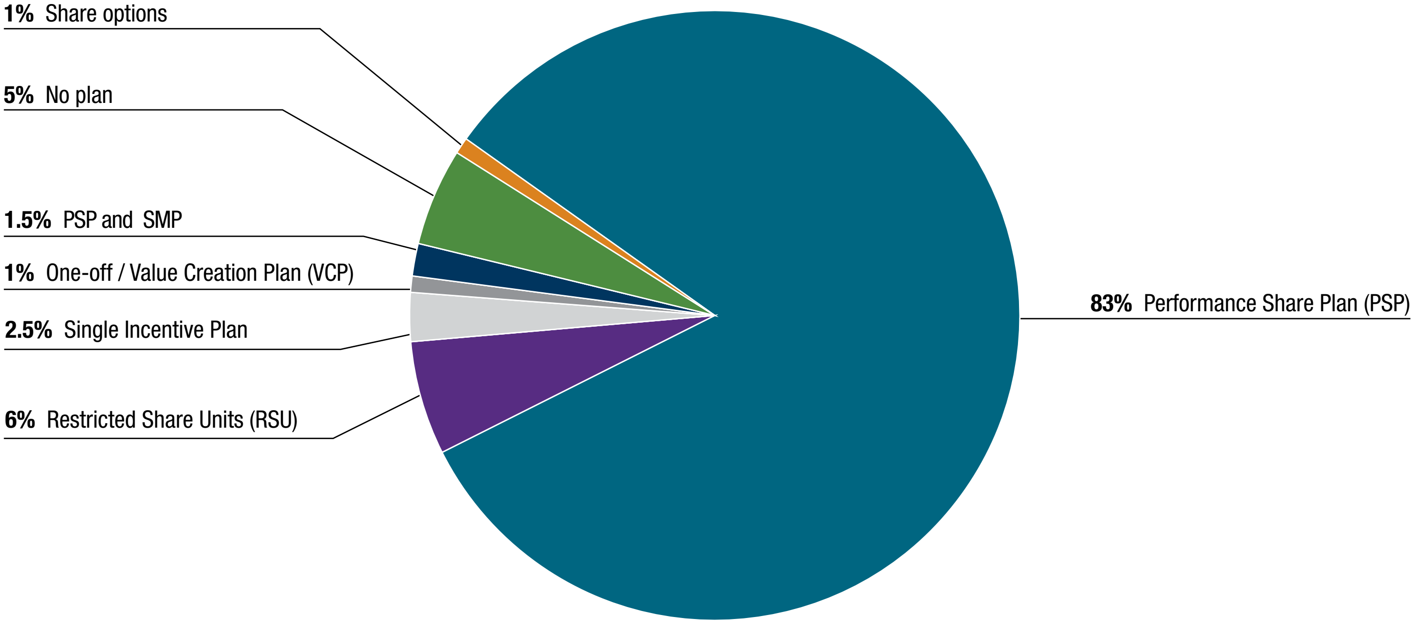
Remuneration Policy	Remuneration Report
96.4%	95.6%
(2019: 96.2%)	*(2019: 95.1%)*

Changes to simplify LTIPs were made at around 12% of companies with a policy vote. Just over half of these companies sought to replace a complex long-term incentive with a standard plan. For example, many companies replaced 'Value Creation Plans', 'Single Incentive Plans', and the operation of multiple long-term incentives with a simpler 'Performance Share Plan'. The remainder of these companies introduced a 'Restricted Share Plan', a type of plan which is slowly increasing in its prevalence and acceptance from investors (provided that investor stipulations including a reduction in quantum, longer vesting periods, and hard underpins are met).

A larger number of companies, around 16%, sought to increase the variable incentive opportunity. Most of these companies increased the annual bonus rather than the long-term incentive opportunity. This increase in short-term incentives appears to go against prevailing shareholder expectations that companies should focus incentives on longer-term sustainable performance. However, almost all increases were coupled with the introduction or strengthening of deferral, which helps provide alignment with shareholders and can facilitate the use of clawback and malus provisions. The increased use of deferral means that 84% of all FTSE SmallCap companies now operate some form of bonus deferral.

Against the continued economic uncertainty, the remuneration policy changes and trends for 2021 are hard to predict but it seems likely that the majority of companies will continue to be reluctant to propose increases to overall variable opportunities. Whilst variable pay opportunities may not increase overall next year, we may see more companies looking to rebalance quantum between annual bonus and LTIP whilst keeping the total incentive opportunity the same. Only 7% of companies seeking a policy vote took this route in 2020, but more might seek to do so in 2021, perhaps with a slight reduction to overall quantum or strengthening of deferral, if they expect continued volatility over the next three years. However, we would not expect a fundamental shift away from long-term incentives, as not all companies are affected by the pandemic in the same way. Companies in a turnaround situation, or who are confident of growth after the pandemic has passed, will be likely to seek to retain or increase the focus on long-term incentives.

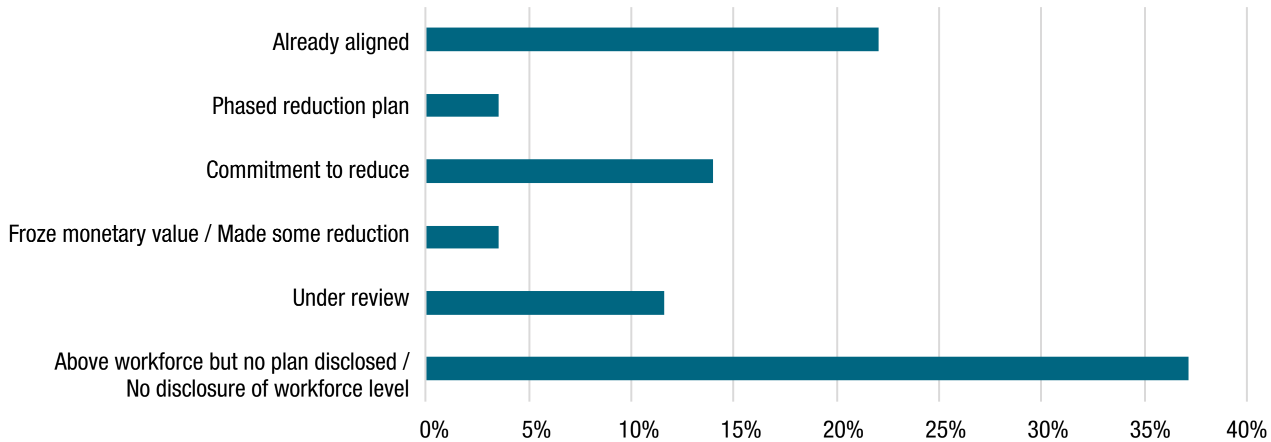
TYPES OF LONG-TERM INCENTIVES AVAILABLE TO EXECUTIVE DIRECTORS (SMALLCAP)



PENSION

There has been a wide range of responses to investor pressures to align executive director pensions with that of the wider workforce.

APPROACH TAKEN FOR CURRENT HIGHEST PAID DIRECTOR



Note: Only includes Year-ends after IA guidance came out. Excludes 8% that operate non-UK country specific plans or where the Highest Paid Director is not in the pension scheme.

20% of companies in the FTSE SmallCap have committed to reducing executive director pensions or have made some reduction, but over a third have not disclosed a plan (or do not comment on the level relative to the wider workforce).

By comparison, a greater number of companies in the FTSE 250 have committed to a phased reduction or a commitment to reduce (30% of companies).

Fewer than five companies have reported increasing the employer contribution levels for the wider workforce this year.

Unsurprisingly, given that most companies have not yet implemented reductions in pension, the median pension allowance in the FTSE SmallCap remains unchanged from last year.

HIGHEST PAID DIRECTOR EMPLOYER PENSION ALLOWANCE (% OF BASE SALARY)

	FTSE SMALLCAP Median
Highest paid director pension 2019	14%
Highest paid director pension 2020	14%
Pension policy (new appointees)	8%

This is a similar picture to the FTSE 250, where the median level for existing highest paid directors remains unchanged for 2020 (at 15% of salary).

POST-CESSATION SHAREHOLDING POLICY

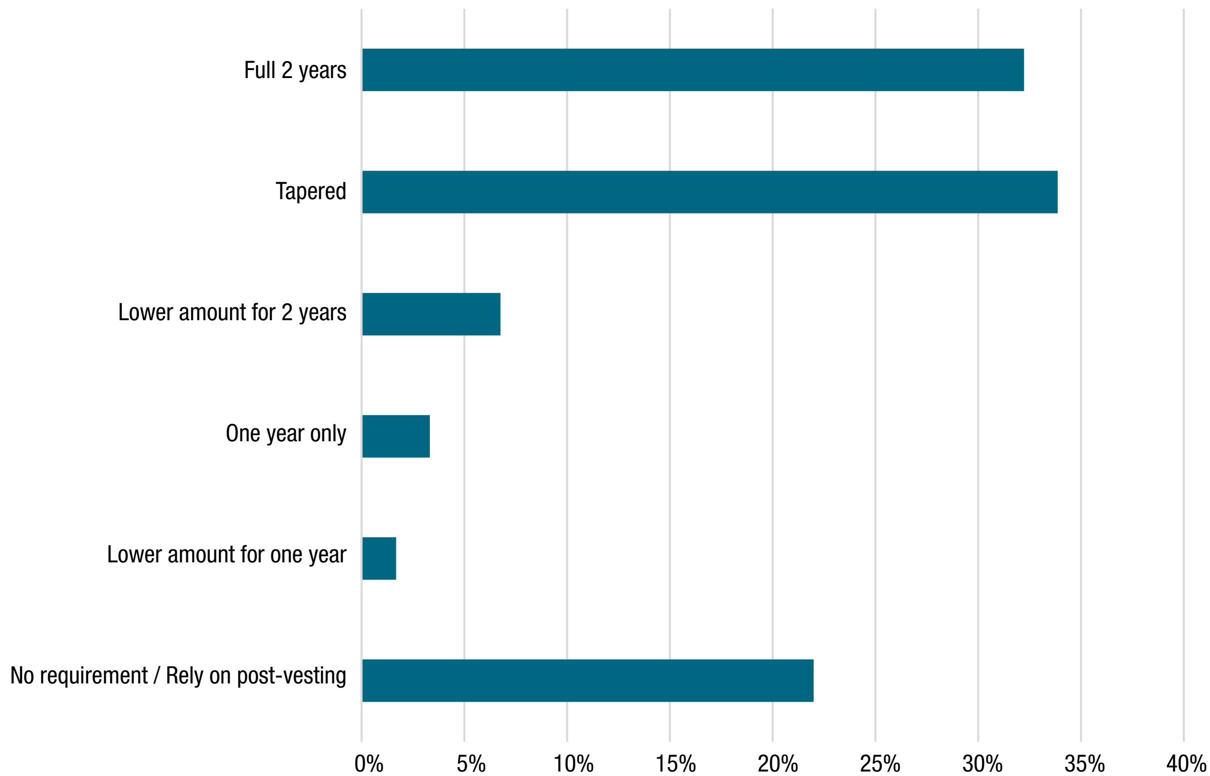
Under the 2018 UK Corporate Governance Code, companies are required to develop a post-cessation shareholding policy. Although nearly one-third comply with the IA guidance, which is a two-year post-cessation requirement with the same level of shareholding as the in-employment requirement (compared to 46% in the FTSE 250), the most common approach, of those that renewed their Remuneration Policy in 2020, is a tapering shareholding requirement for two years. 22% either do not have a requirement or rely on post-vesting holding periods. Of those companies that did not go through a policy vote, only 20% have introduced a requirement in 2020.

Many companies are still ironing out details regarding implementation, including:

- how the requirements will be enforced;
- the price used to calculate the holding requirement after employment has ended;
- when the requirement should take effect;
- whether this requirement should apply only to shares acquired from incentive plans or also to shares purchased by executives; and
- whether there are circumstances in which the requirement might be reduced or even waived.

For further information, please see our briefing note released in November 2020 by following this link.

SMALLCAP - APPROACH TAKEN BY COMPANIES WITH A 2020 POLICY VOTE

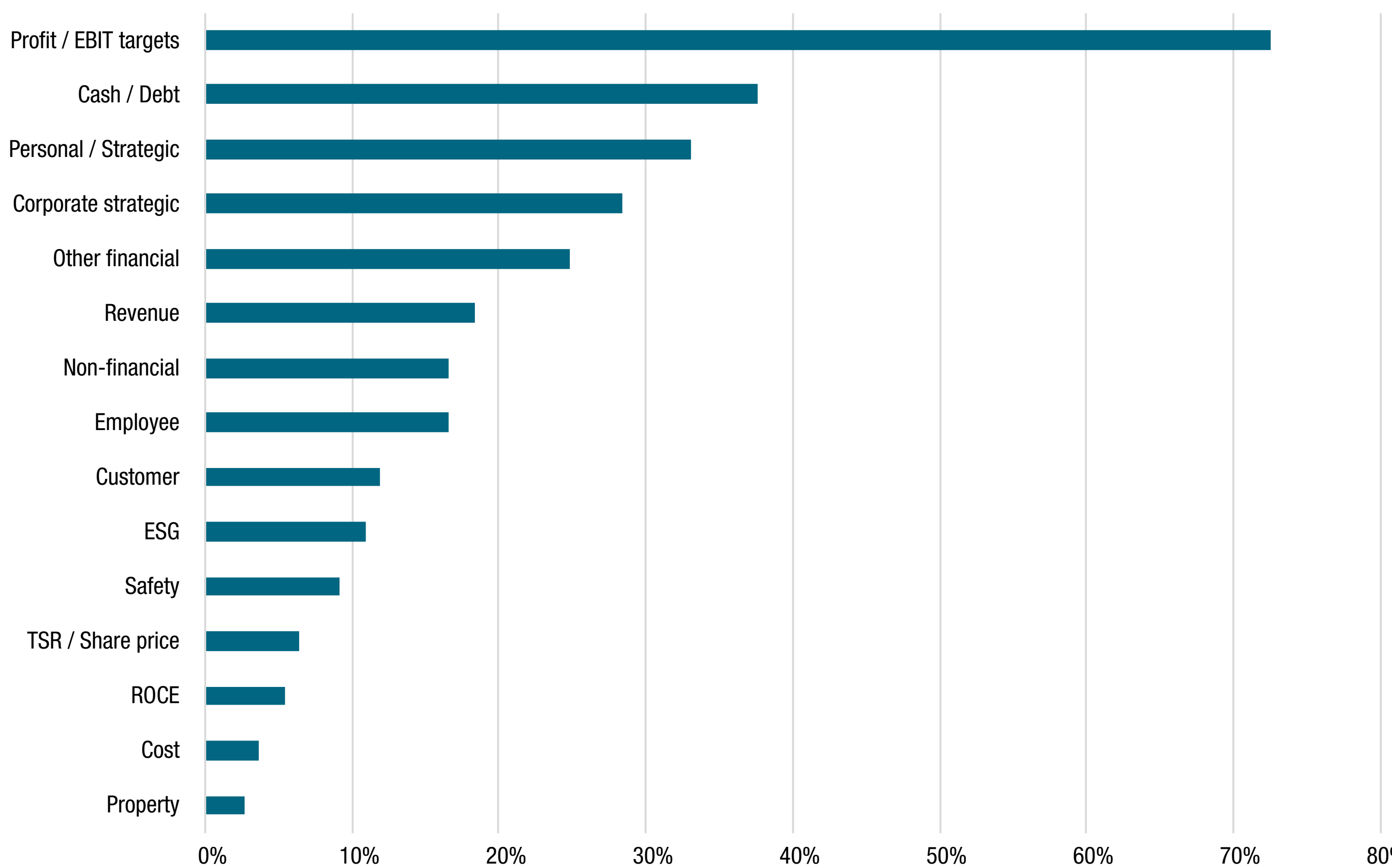


PERFORMANCE METRICS

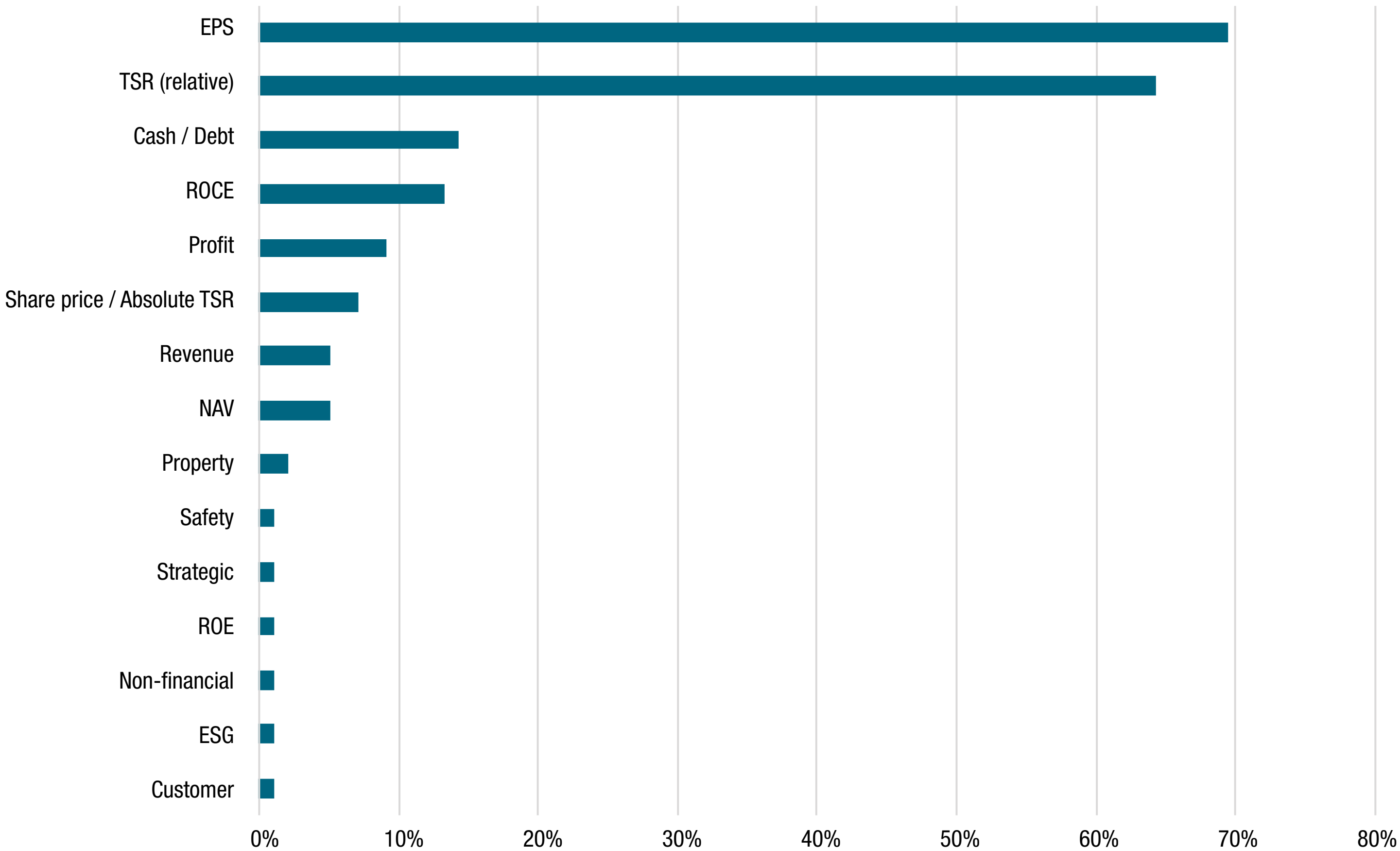
In annual bonus plans, profit/EBIT targets remain the most prevalent metrics, used in over 70% of plans. Interestingly, cash/debt metrics are the second most common metrics in the SmallCap this year, perhaps reflecting the focus of smaller listed companies as they navigate the current pandemic and resulting recession.

Environmental, social, and governance (ESG) metrics are increasingly of interest to investors. However, an analysis of the FTSE SmallCap indicates that, unlike in the FTSE 100 where ESG metrics are increasingly more common, only 11% use one or more ESG-type indicator in annual bonus plans - around half of these form part of strategic/personal metrics rather than operating as a standalone metric with a discrete weighting. By comparison, 19% of FTSE 250 companies and 35% of FTSE 100 companies use at least one ESG-type indicator.

ANNUAL BONUS PERFORMANCE METRICS



PERFORMANCE SHARE PLAN PERFORMANCE METRICS



There are different definitions of ESG metrics and KPIs. An environmental metric is a common choice, especially in energy, mining and manufacturing sectors. Social metrics such as diversity and inclusion, community involvement, colleague engagement, and safety are also common. Where companies have recently introduced a standalone metric with its own weighting, this is often balanced by a reduction in the weighting on strategic/personal metrics. COVID-19 may accelerate the introduction of such metrics as companies consider the interaction of their business with a wider range of stakeholders. Some investor scepticism about the reasons for introducing ESG measures remains, with the IA emphasising that they should only be used where they support the Company's long-term strategy.

In Performance Share Plans (PSP), EPS and relative TSR remain the most common metrics, with 52% of companies using two metrics and 27% using three or more (18% use one). ESG-type KPIs are not widely used in PSPs in the FTSE SmallCap, with less than 3% using a metric. By comparison, 6% of FTSE 250 companies and 15% of FTSE 100 companies use at least one ESG-type indicator.

Where used, across the whole of the FTSE, the weighting of the ESG metrics is typically between 5% and 20%, but there are examples of higher weightings. PSP plans are usually limited to "harder" measures based on financial outcomes and total shareholder return rather than "strategic" measures. However, shareholders are becoming more accepting of ESG metrics in recognition of the importance of this area and as ESG outcomes are becoming more quantifiable provided that the metrics align with the delivery of the company strategy.

CEO PAY RATIO

This is the first full year companies were required to report their CEO pay ratio. As expected, the majority of companies chose Option A as their preferred calculation methodology under the regulations (although a significant number of FTSE SmallCap companies also chose Option B), and the ratio varies by the size of the company as a comparison to the FTSE 250 in the table below shows.

UK regulations provide three different methodologies (Option A, B and C) for companies to choose when calculating the CEO pay ratio. Option A is preferred by investors and is the most rigorous approach, Option B uses the Gender Pay Gap reporting data as a starting point, and Option C provides the most flexibility when making the calculation.

CEO PAY RATIO: QUARTILE ANALYSIS

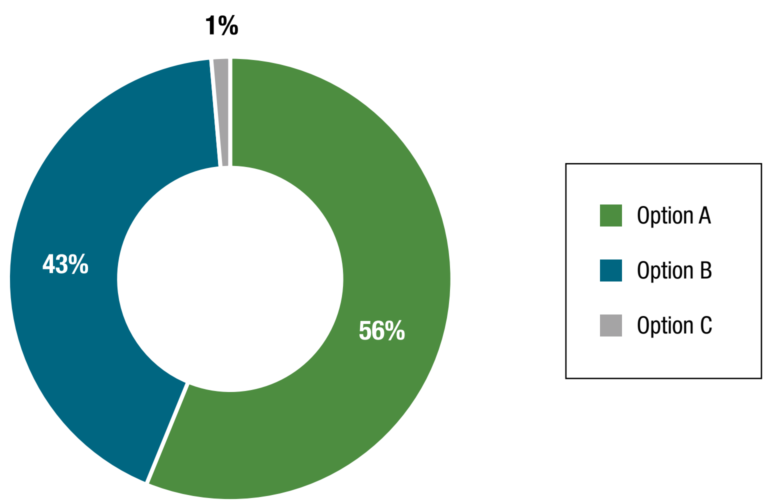
	LOWER QUARTILE	MEDIAN	UPPER QUARTILE
FTSE SmallCap	17	27	35
FTSE 250	22	32	61

A wide range of factors can influence the ratio, including:

- sector;
- workforce profile;
- incentive plan outcomes, and;
- the effect of the share price on LTIP vesting.

Companies will need to carefully draft their narrative to explain year on year differences in the ratio.

SMALLCAP: OPTIONS USED



CONCLUSIONS

Recent trends to simplify remuneration, introduce annual bonus deferral and align pensions have spread through the FTSE rankings and are reflected in the pay policies introduced by FTSE SmallCap companies. Restricted Share Plans are also slowly increasing in prevalence. However, the pace of change in the SmallCap still remains slower than in the FTSE 100 and FTSE 250. For example, there is less compliance with the IA guideline for post-employment shareholding requirements and more companies adopt a softer approach. Remuneration Committees will now be turning their attention to remuneration outcomes for this financial year and ensuring that they take account of the shareholder and employee experience during the COVID-19 pandemic. As the pandemic passes, companies will be reviewing their strategies and, as a result, how their existing remuneration policy and incentive structures can support their future goals. The increasing acceptance amongst many shareholders for a wider variety of incentive schemes, coupled with the prevailing exceptional circumstances, may provide an opportunity to seek closer alignment between strategic goals and remuneration outcomes, and re-consider how remuneration is structured throughout the whole organisation.

A&M Executive Compensation Services is well-positioned to advise Remuneration Committees and companies through this period. All of our engagements are led by a Managing Director, who attends all meetings, and is actively involved in all deliverables. This ensures you always have access to the right level of advice, particularly when making critical decisions under time pressure. Our Managing Directors have a combined 80+ years of experience in advising on executive remuneration matters.

We hope you have found this update, including the following data sheet, helpful. If you would like to discuss any of these developments further, or have other enquiries, please contact one of our Managing Directors, whose details are shown on the back cover.

QUICK REFERENCE GUIDE
FTSE SMALLCAP EXECUTIVE REMUNERATION DATA 2020

SALARY: QUARTILE ANALYSIS OF BASE SALARY (£000s)

	LQ	M	UQ
Highest paid director	400	453	523
Finance director / CFO	263	307	357
Other director	273	301	362

- Numbers reflect actual base salary rates and do not take account of temporary reductions

PENSION: QUARTILE ANALYSIS OF EMPLOYER PENSION ALLOWANCE (% OF BASE SALARY)

	LQ	M	UQ
Highest paid director 2019	8%	14%	18%
Highest paid director 2020	8%	14%	17%
Pension policy (new appointees)	5%	8%	11%

BONUS: QUARTILE ANALYSIS OF BONUS MAXIMUM OPPORTUNITY (% OF BASE SALARY)

	LQ	M	UQ
Highest paid director	100%	125%	150%
Finance director / CFO	100%	105%	125%
Other director	100%	120%	150%

- The majority of companies operate bonus deferral in the FTSE SmallCap

LONG-TERM INCENTIVES: QUARTILE ANALYSIS FUTURE GRANT POLICY (FACE VALUE OF PSP AWARDS, % OF BASE SALARY)

	LQ	M	UQ
Highest paid director	100%	150%	178%
Finance director / CFO	100%	125%	150%
Other director	100%	150%	150%

TOTAL TARGET REMUNERATION: QUARTILE ANALYSIS OF TOTAL TARGET REMUNERATION (£000s): (BASE SALARY + PENSION + BENEFITS + ON-TARGET BONUS + EXPECTED VALUE OF LTI)

	LQ	M	UQ
Highest paid director	915	1,096	1,428
Finance director / CFO	607	704	892
Other director	630	789	986

SINGLE TOTAL FIGURE OF REMUNERATION (£000s): (BASE SALARY + PENSION + BENEFITS + BONUS PAID/AWARDED + LTI VESTED): QUARTILE ANALYSIS OF THE SINGLE TOTAL FIGURE

	LQ	M	UQ
Highest paid director	585	777	1,212
Finance director / CFO	400	560	741
Other director	336	445	629

SHAREHOLDING REQUIREMENTS: MEDIAN LEVEL OF IN-EMPLOYMENT SHAREHOLDING REQUIREMENT (% OF BASE SALARY)

	LQ	M	UQ
Highest paid director	200%	200%	200%
Finance director / CFO	200%	200%	200%
Other director	200%	200%	200%

The FTSE SmallCap has been ‘struck’ as at 31 August 2020. The median market capitalisation of the Index is £237m.

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Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) for leadership, action and results. Privately held since its founding in 1983, A&M is a leading global professional services firm that provides advisory, business performance improvement and turnaround management services. When conventional approaches are not enough to create transformation and drive change, clients seek our deep expertise and ability to deliver practical solutions to their unique problems.

With over 5,000 people across four continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, leverage A&M's restructuring heritage to help companies act decisively, catapult growth and accelerate results. We are experienced operators, world-class consultants, former regulators and industry authorities with a shared commitment to telling clients what's really needed for turning change into a strategic business asset, managing risk and unlocking value at every stage of growth. risk and unlock value at every stage of growth.

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