



Hewitt

New  
Bridge  
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# Executive Remuneration in Small Cap Companies

A breakfast briefing organised by Hewitt New Bridge Street

**13 February 2009**

# Executive Remuneration in Small Cap Companies

Understandably total pay for executives tends to be highly correlated to the size of companies. However, arguably executives in smaller, more dynamic companies should have at least as great a proportion of the package representing variable pay as executives in larger companies. We have noted for some time that the variable pay opportunity for senior executives within Small Cap companies significantly lags FTSE 100 practice. This is evident in both the bonus potential as well as the value of long-term incentive awards. Is this situation indicative of a lack of alignment between executives and shareholders? Is this sustainable?

Even in the current climate where the risk-return relationship between pay and performance has come to the fore following the well publicised concerns of the FSA, the need to retain and motivate top talent is just as pressing among Small Cap organisations as larger companies. The issue needs to be examined from several angles. These include:

## **Quantum and gearing**

There are some interesting inconsistencies in the quantum and structure of senior executive pay. A typical functional head for a large listed entity can have some two to three times the level of incentive (as a multiple of salary) as the Chief Executive of a Small Cap. Does this imply that a senior functional director within a larger company has a greater influence over strategy and the direction of the business compared to a smaller company Chief Executive? It is also common for a divisional MD within a large company often to have a higher variable pay opportunity than the Chief Executive of an independent business of comparable revenue size. Does this mean the larger company role is more important? Another implication is that parent company size rather than the size of the division is key in determining the gearing of the package.

It may be then that the underlying assumptions in Small Cap pay need to be challenged and addressed.

## **Institutional investor considerations**

One of the reasons Small Caps have been left behind is the generally accepted 5% (over rolling 10 year periods) dilution guideline for discretionary equity plans. Given a smaller market capitalisation, this puts downward pressure on award sizes for smaller companies. Also, the accounting charge for equity awards is likely to have a bigger impact (as a percentage of profit) on smaller versus larger listed organisations. This is particularly pressing in the current environment given the impact of share price falls. It may be that the awarding of the equity needed to incentivise key talent could actually generate accounting charges that take the company from profit to loss. If we accept that executive pay should reflect how well the business is run for shareholders then the current economic climate with its fall in equity values may represent a good time to move away from these traditional constraints and develop a package structure with appropriately stretching metrics that provides a genuine pay for performance opportunity.

## **Talent management**

If there is less reward upside within the package of Small Caps then top talent has a limited incentive to pursue career development opportunities outside of larger companies. For larger company executives, it may be economically difficult to pursue a career development path outside of their current firm or within similarly sized organisations. The flip side of this is that smaller companies may not necessarily be attracting top talent as these executives are drawn to the higher variable pay opportunities offered by larger companies. It is crucial that Small Cap companies consider whether they have the best possible talent, effective leadership and development programs for nurturing that talent and consider whether they are able to bring in new talent as appropriate from the wider executive talent pool.

Small Cap companies, like the rest of the market, must test their own definition of 'pay for performance.' Clearly, the fallout from the economic downturn will result in new pay practices to take shape over the coming months that will likely see executives share more of the pain with shareholders as well as place companies' choice of metrics and target setting practices under the microscope. Nonetheless, it is unlikely that there will be a wholesale abandonment of a pay for performance philosophy and as such the current environment may provide the right rationale for Small Caps to revisit their approach to pay and address the limited variable pay upside and associated constraints on their executive talent sourcing and development.

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Please return this slip to the address overleaf,  
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Hewitt New Bridge Street  
6 More London Place  
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**Want to find out more?**

Contact                    Laura Joyce  
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Email:                     hnbs@hewitt.com

**The venue:**

Hewitt New Bridge Street,  
6 More London Place, London SE1 2DA

**The date:**

Friday 13 February 2009

**The time:**

8:30 a.m. – 10:00 a.m.

**Register now!**

