Hewitt New Bridge Street

Research Findings

Report on FTSE Small Cap Directors' Remuneration

2010/11

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Review of the Year and Likely Future Trends

Our 2010/11 report on directors' remuneration in the FTSE Small Cap is published at what some believe may be a critical time in the executive pay debate.

Remuneration Committees have had much to contend with when framing their executive pay policies over the last year. Investor scrutiny of directors' pay remains intense, with shareholders requiring companies to provide a very robust justification for any fundamental changes in policy – particularly where the policy change involves an increase in either fixed or variable pay levels.

In addition, regulatory oversight of executive remuneration has been further tightened. While the FSA Remuneration Code (published December 2010) only purports to have direct applicability to financial services companies, some of the Code's recommendations are likely to be embraced more widely. For example, the new Corporate Governance Code encourages companies across all sectors to consider the introduction of clawback provisions in both annual bonuses and long-term incentives. Also, changes to the Directors' Remuneration Report Regulations now require Remuneration Committees to explain how they have taken broader all-employee pay and conditions into account when setting the executives' remuneration. In addition, institutional shareholder guidelines now encourage companies to disclose how the issue of 'risk' has been reflected in pay practices.

Notwithstanding the fact that, to a large extent, a two year freeze on executive salaries has been imposed – during a period when past long-term incentive grants have been unlikely to deliver much (if any) value due to the economic downturn – accusations of 'fat cattery' continue to abound. That said, some would argue that companies should not be surprised at the continued criticism – bonus payouts still remain higher than many believe is appropriate.

Indeed, at the height of the downturn, when City-trader-style bonuses were being accused of bringing the global economy to the brink of collapse, it was argued that the entire 'pay for performance' model was, at best, a sham and, at worst, positively harmful. However, as equity markets (if not necessarily domestic economies) have come on a more even keel, the mood has changed somewhat. Consequently, the basic premise that a significant (but not excessive) portion of an executive's package should be linked to performance has been broadly accepted.

As a result, companies have returned to the age-old question of how to measure and reward performance, particularly long-term performance. The vast majority of LTIPs currently operate in a fairly traditional manner – regular annual awards are made that vest three years after grant subject to EPS and/or relative TSR targets. However, some companies are now challenging this approach. For example, we are starting to see more innovative thought given to the performance conditions used. Where there is a wish to use a financial target, rather than automatically defaulting to EPS, some companies are looking at measures more specific to their particular business and/or circumstances. It is encouraging that shareholders appear to be tentatively supportive of such moves, albeit often requiring that a significant portion of the award remains based on a traditional measure such as EPS or TSR.

The use of 'value creation' plans is also being considered by some companies, where a larger 'one-off' award is made with an absolute target set (perhaps based on share price, profit or some other metric). Once this absolute target is achieved, executives can share in any outperformance – possibly on an uncapped basis – with rewards delivered in either cash or shares.

It is very refreshing that companies are looking at alternative approaches and are willing to robustly defend them to their shareholders. However, many may still consider that a more 'tried and tested' route remains appropriate, provided that this approach still takes full account of the company's particular circumstances. If it does not, the pay policy will not resonate with executives and, in turn, will neither drive nor reward the right behaviours.

We hope you find this year's report of interest.

Key Statistics

Base Salary

- Of those FTSE Small Cap companies that disclose recent pay settlements, over 60% have frozen salary levels this year (compared to around 50% of FTSE 250 companies).
- The median salary of FTSE Small Cap Highest Paid Directors is around £340,000 (£475,000 in the FTSE 250).
- The median salary of FTSE Small Cap Finance Directors and most other Executive Directors is around £225,000 (£290,000 in the FTSE 250).

Annual Bonus

- The median annual bonus potential for Executive Directors is 100% of salary (unchanged from the previous year).
- Actual bonuses earned by all Directors in 2009/10 at the median were around 40% of salary (up from around 25% of salary for 2008/09). This compares to 60%-70% in the FTSE 250.
- 30% of companies require part of the bonus to be deferred in shares for a period of time (typically three years).

Long-Term Incentives

- The most common approach is the sole operation of a Performance Share Plan (around 50% of companies), although over 25% still operate option plans.
- Last year, FTSE Small Cap Highest Paid Directors typically received long-term incentive awards with an 'expected value' of around 55% of salary (compared to 75% in the FTSE 250). This broadly equates to an LTIP award with a face value of 100% of salary (broadly unchanged from the previous year).
- EPS and TSR remain the most common measures used in FTSE Small Cap long-term incentive arrangements. However, the use of other measures is increasing.
- Nearly 50% of companies have a formal shareholding guideline. The median level of shareholding required is 100% of salary for Executive Directors.

Pensions

- Defined Contribution pension plans remain the most common approach for Directors (65% of Directors), with cash supplements (particularly given the new pension tax changes) also becoming common.
- The median contribution to a Defined Contribution plan is around 15% of salary.

Total Remuneration

- Target total remuneration for Highest Paid Directors is around £755,000 (£1.2m in the FTSE 250). For Finance Directors and other Directors it is £477,000 and £485,000 respectively (£771,000 and £759,000 respectively in the FTSE 250).

Balance of Package

- Variable pay (i.e. annual bonus and long-term incentives) accounts for around 40% of a typical FTSE Small Cap Executive Director's remuneration package (compared to 25% in 2003 and 55% in the FTSE 250).
- Approximately 40-50% of variable pay relates to long-term performance (55% in the FTSE 250).

Service Contracts

- Service contracts containing notice periods of 12 months are now the norm. However, 17% of FTSE Small Cap companies have notice periods of less than 12 months.
- Around 25% of contracts have liquidated damages clauses. Of these, 30% disclose the inclusion of bonus in the calculation of the termination payment.

Non-Executive Directors

- The median Non-Executive Chairman's fee is £98,000 (£150,000 in the FTSE 250).
- Typically, fees for other Non-Executive Directors range between £35,000 and £40,000 depending on their role (£40,000-£50,000 in the FTSE 250).

Base Salary

Key Points to Note

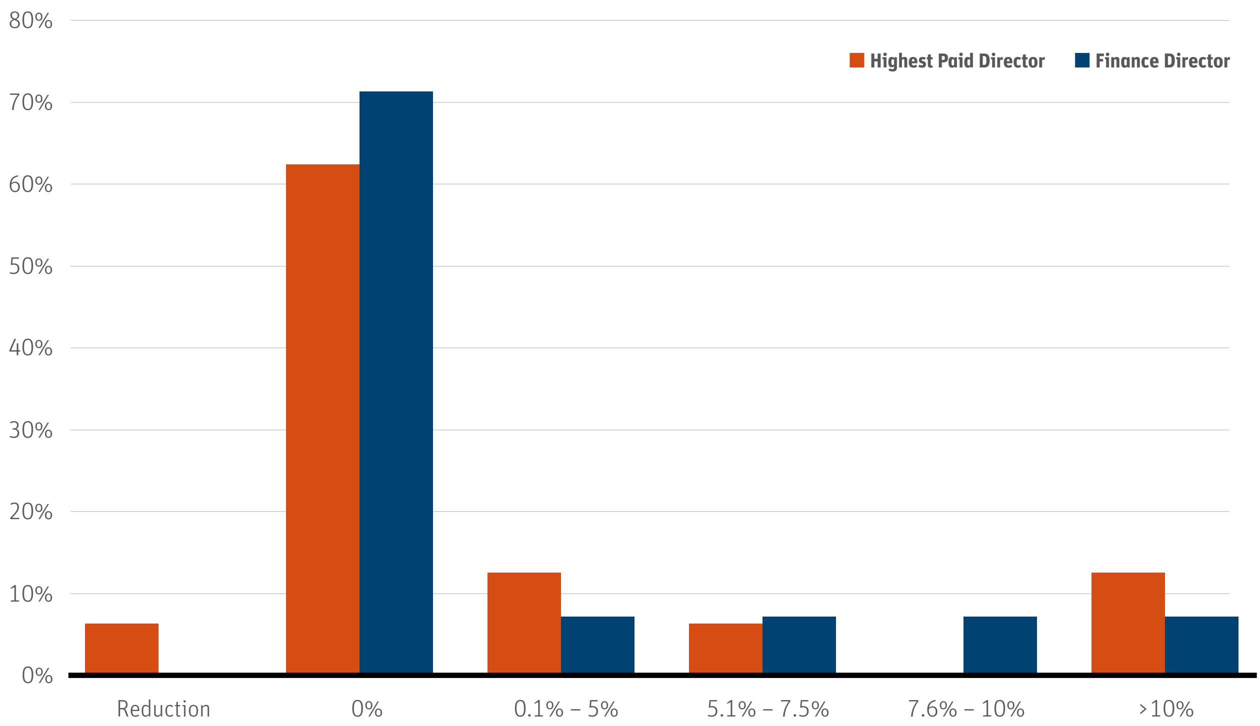
- Salary levels (and particularly salary increases) remain a key agenda item for Remuneration Committees.
- Over 60% of FTSE Small Cap companies which disclosed their pay settlement for 2010 disclosed a salary freeze for this year.
- Finance Directors' salaries tend to be around 65% of their CEO's salary.
- Executive Committee level roles tend to receive salaries around 60-65% of their Finance Director's salary.

Rates of Increase

Given the current fragile nature of the economy, salary levels and increases remain a sensitive issue for both Remuneration Committees and shareholders.

As a result, over 60% of FTSE Small Cap companies froze salaries for 2010, as did around 80% in 2009. This compares to over 50% in the FTSE 250, but only 35% in the FTSE 100. 40% of those FTSE Small Cap companies that froze salaries in 2010 also froze salaries in 2009.

Chart 1. Increases in Post Year-End Salary (where Disclosed) for the Highest Paid Director and Finance Director 31 December 2009 – 31 March 2010 Year-Ends Only



Base Salary

Salary Levels

Table 2 sets out a quartile analysis of Executive Directors' salary levels and Table 3 sets out data on Executive Committee level roles (i.e. the tier below the main Board).

There are some surprising results – for example the fact that the median salary for the Highest Paid Director is the same over the FTSE Small Cap as a whole as well as in the top and bottom half of the FTSE Small Cap (ranked by market capitalisation). Also, the median salary for Operational Directors in the top half of the FTSE Small Cap is lower than in the bottom half. In both cases, we would expect that salaries paid by the larger companies would be higher.

Table 2. Quartile Analysis of Base Salary

	FTSE Small Cap			FTSE Small Cap – Top Half			FTSE Small Cap – Bottom Half		
	LQ	M	UQ	LQ	M	UQ	LQ	M	UQ
Highest Paid Director	£274,000	**£340,000**	£400,000	£270,000	**£340,000**	£405,000	£276,000	**£340,000**	£399,000
Finance Director	£197,000	**£227,000**	£265,000	£200,000	**£240,000**	£275,000	£186,000	**£215,000**	£250,000
Other Directors	£182,000	**£220,000**	£292,000	£187,000	**£225,000**	£306,000	£170,000	**£220,000**	£265,000
Operational Directors	£186,000	**£225,000**	£303,000	£189,000	**£221,000**	£301,000	£183,000	**£250,000**	£303,000
Functional Directors	£150,000	**£186,000**	£265,000	£158,000	**£225,000**	£305,000	£153,000	**£178,000**	£231,000

LQ= Lower Quartile; M = Median; UQ = Upper Quartile

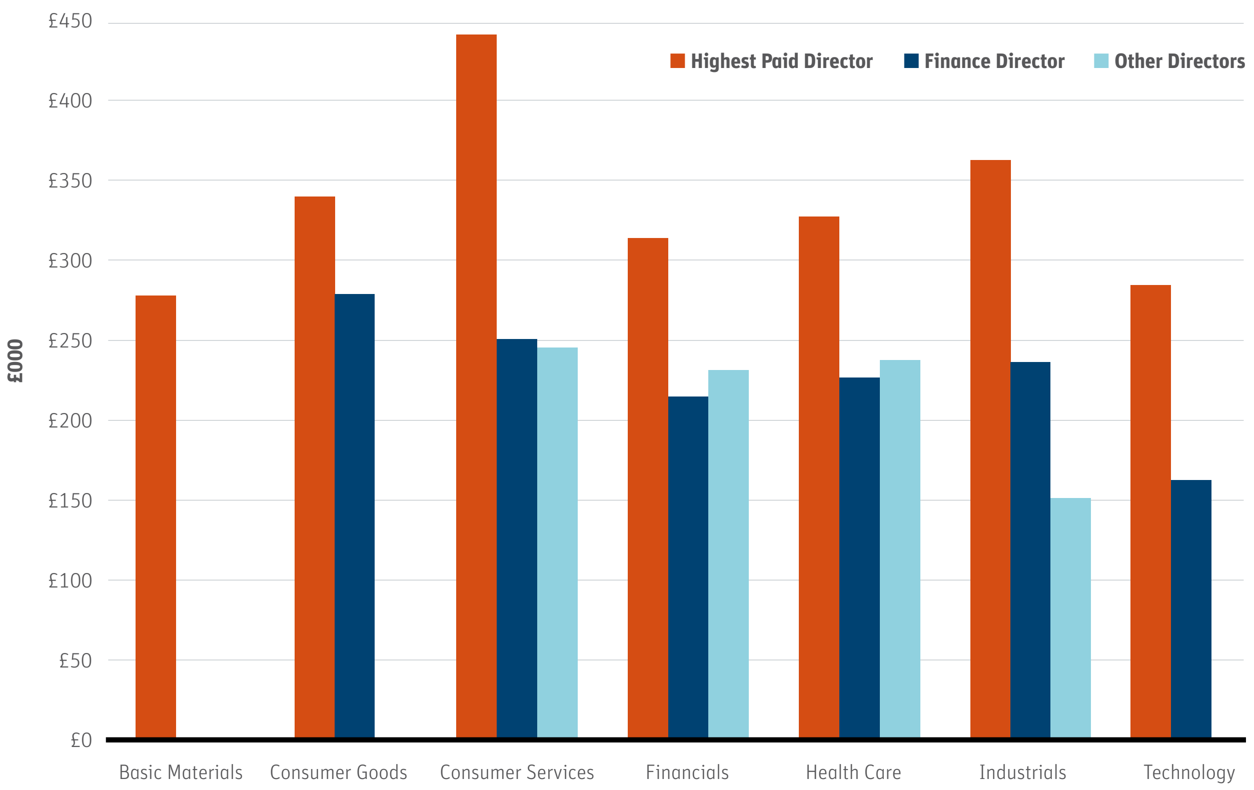
Table 3. Quartile Analysis of Base Salary for Executive Committee Level Roles

	FTSE Small Cap		
	LQ	M	UQ
Executive Committee	£123,000	**£142,000**	£163,000

Sector Analysis

Chart 4 shows median base salaries in different industries. As in previous surveys, we have only provided details for those industry sectors with a reasonable number (i.e. at least six) of executives in post throughout the year. Also, to provide a more meaningful analysis and to reflect the differing size of companies in each of these sectors, the data has been 'regressed' to a common market capitalisation of £151m (the FTSE Small Cap median as at 31 August 2010):

Chart 4. Regressed Base Salary by Industry



Companies tend not to only look at external market data when setting salary levels. Instead, typical pay relativities between posts are also considered. For example, FTSE Small Cap Finance Directors and other Directors tend to receive salaries of around 65% of their Chief Executive. That said, the actual differential in pay should reflect the specific role and responsibility of the particular Executive Director.

Looking at the next tier of executives, salaries of Executive Committee level roles tend to be around 60-65% of the Finance Director (although, once again, the relationship will be shaped by the specific role and sector).

Annual Bonus

Key Points to Note

- As a percentage of salary, bonuses earned in 2009/10 have increased compared to last year.
- The bonus payment to all Directors was typically around 40% of salary in 2009/10 (compared to around 25% in 2008/09).
- The median maximum bonus opportunity has remained unchanged since 2008 at 100% of salary for Executive Directors.
- 30% of companies require part of their bonus to be deferred in shares (typically for three years).
- Profit and personal performance measures are the most common annual performance metrics.
- Few companies thus far have disclosed the use of clawback provisions.

Maximum Bonus Opportunity

Chart 5 shows annual bonus potential over time and Table 6 shows a quartile analysis of bonus potential broken down by role and FTSE Small Cap group.

Of the companies that amended their bonus potential over the last year, 13 FTSE Small Cap companies increased their bonus opportunity (at least for the Highest Paid Director), with the typical increase being 25% of salary. Four companies reduced their bonus potential (median decrease 25% of salary), perhaps reflecting lower profit expectations.

Chart 5. Median Bonus Opportunity (as a % of Salary) for the Highest Paid Director 2003-2010

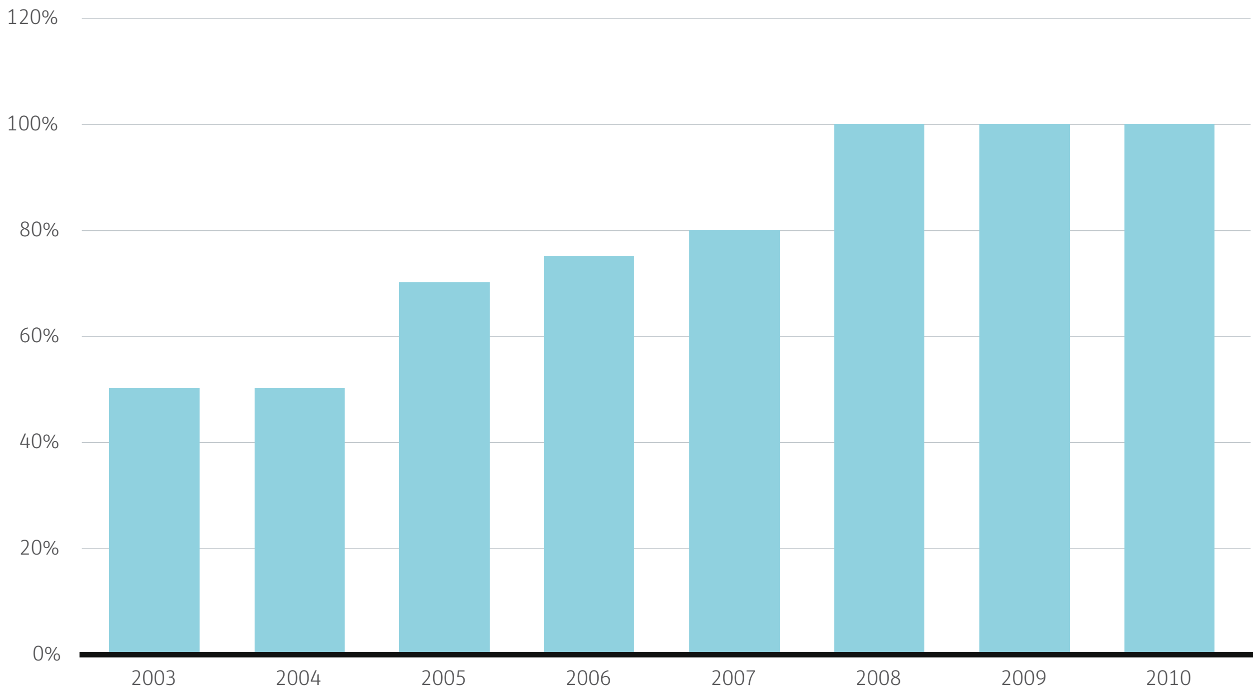


Table 6. Quartile Analysis of Bonus Opportunity

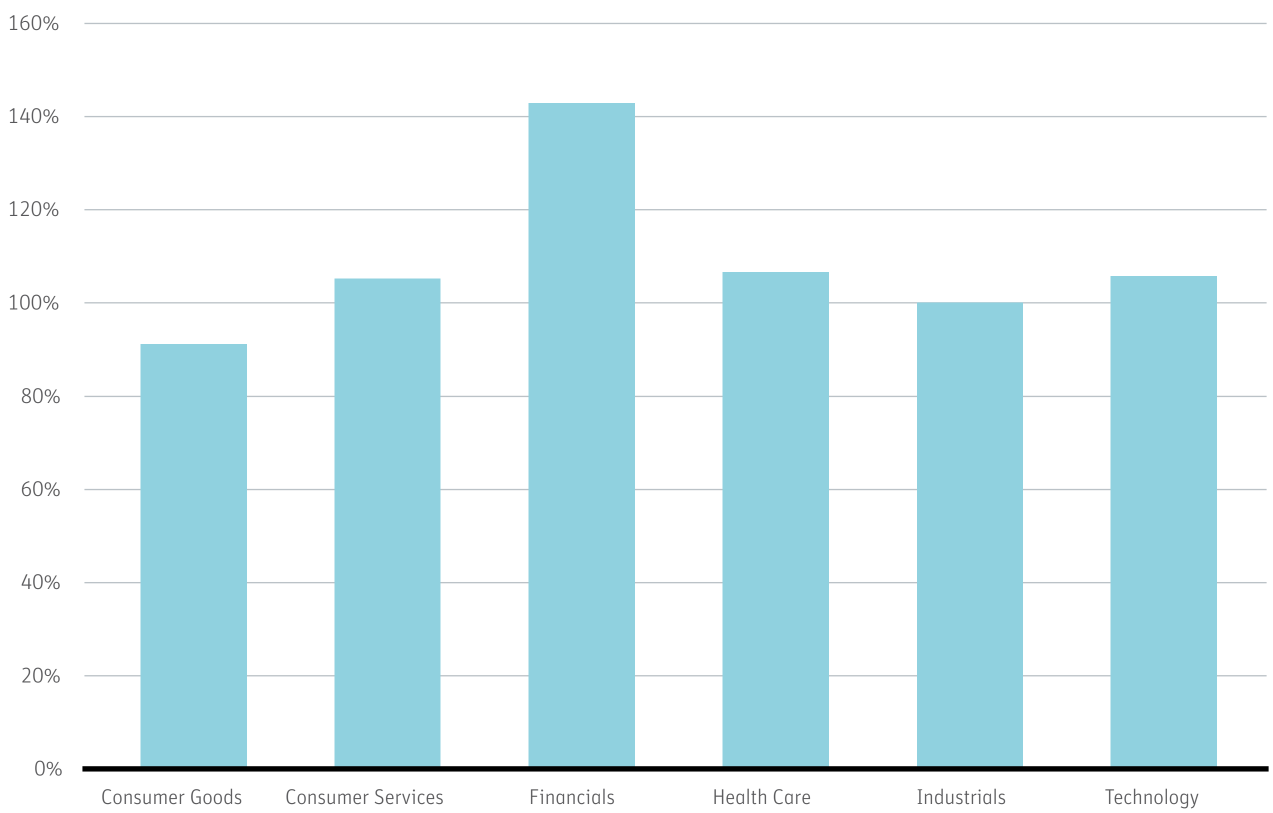
	FTSE Small Cap			FTSE Small Cap – Top Half			FTSE Small Cap – Bottom Half		
	LQ	M	UQ	LQ	M	UQ	LQ	M	UQ
Highest Paid Director	100%	**100%**	100%	100%	**100%**	113%	80%	**100%**	100%
Finance Director	75%	**100%**	100%	75%	**100%**	100%	75%	**100%**	100%
Other Directors	75%	**100%**	100%	79%	**100%**	100%	75%	**100%**	100%

Below Board, the median maximum bonus opportunity for Executive Committee members in FTSE Small Cap companies is around 60% of salary.

Sector Analysis

While the median maximum bonus opportunity is 100% of salary, there are some marked differences in practice across industries, with bonus opportunity amongst financial companies the highest (although not perhaps as high as some would expect):

Chart 7. Regressed Bonus Opportunity (as a % of Salary) by Industry



Annual Bonus

Target Bonus Opportunity

It is difficult to provide a completely robust analysis of typical levels of bonus that are payable for the delivery of a 'target' level of performance. This is because, while 80% of FTSE Small Cap companies disclose their bonus maximum, only 17% disclose their 'on-target' level of bonus.

That said, our experience suggests that the typical on-target bonus is around 50% of the maximum bonus opportunity.

Actual Bonuses Paid

As shown earlier, the median level of maximum bonus opportunity has remained unchanged at 100% of salary for a few years.

However, given recent economic conditions, it has been the level of bonus paid (rather than what could potentially be paid) that has attracted most interest. Chart 8 shows the median level of actual bonus paid as a percentage of salary. As can be seen, having fallen in 2009, bonus payments have increased in 2010. However, as a percentage of salary, they are still at a lower level than bonuses paid in 2007 and 2008, and lower than the bonuses paid in the FTSE 250 for performance last year (which, at the median, was 70% of salary for FTSE 250 Highest Paid Directors).

Chart 8. Median Actual Bonus Paid as a % of Salary: 2003 – 2010

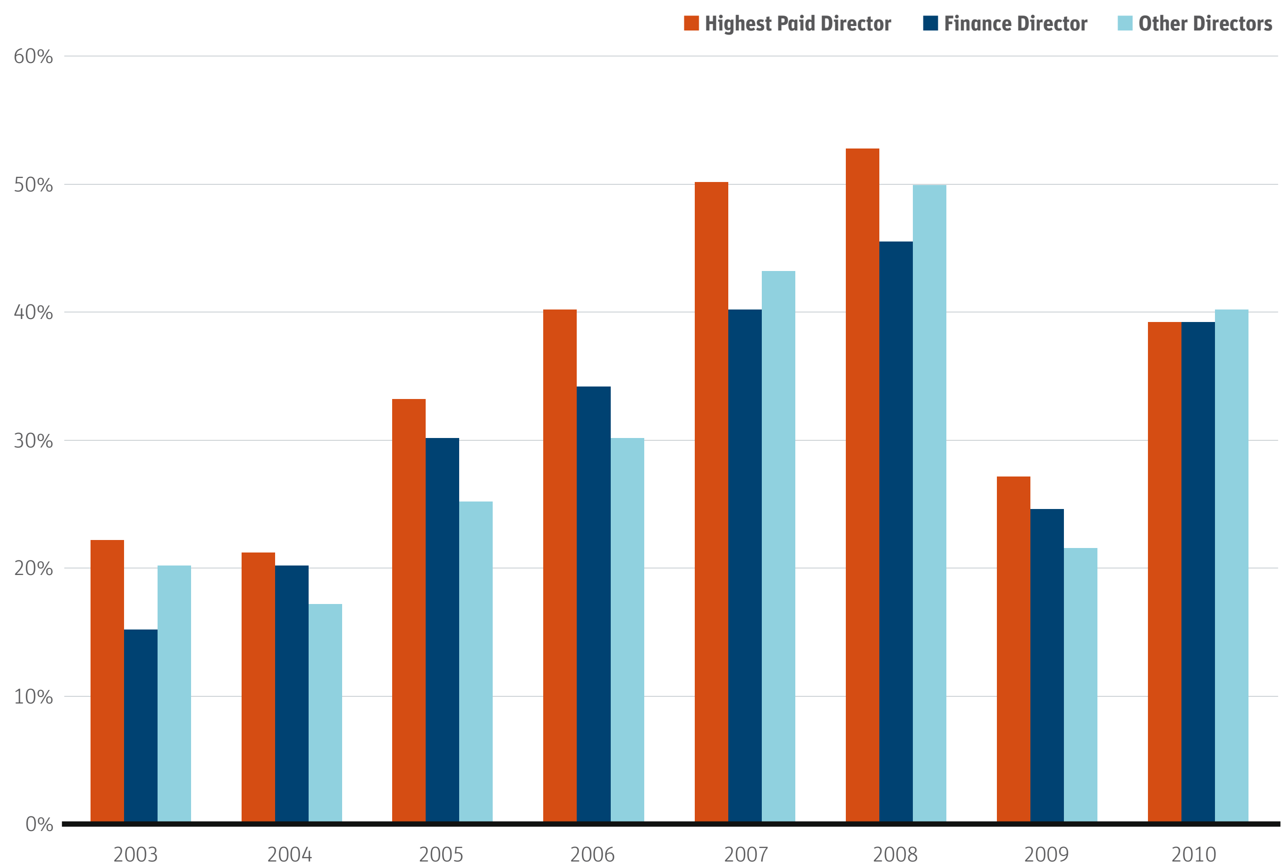


Chart 9. Median Actual Bonus Paid as a % of Maximum: 2003 – 2010

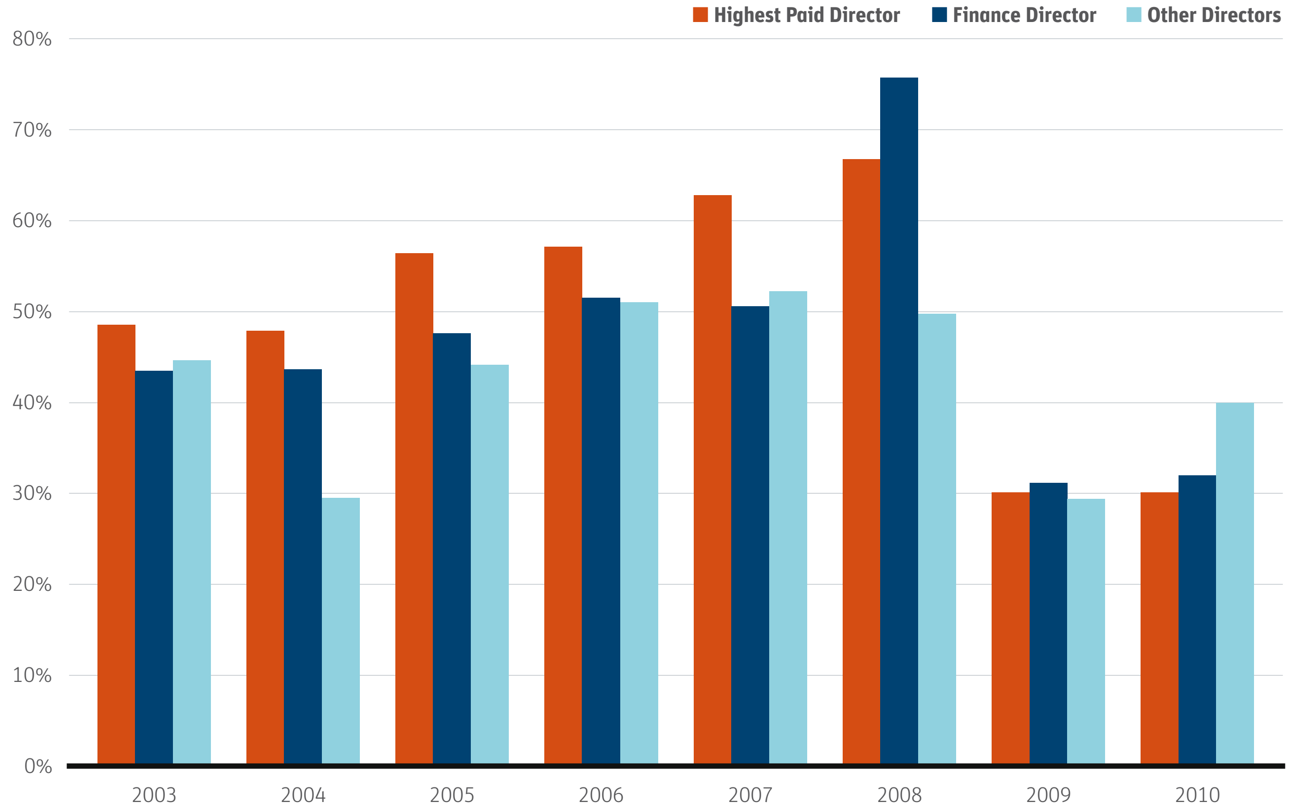


Chart 9 shows the median level of actual bonus paid as a percentage of the maximum. As can be seen, a bonus in excess of 50% of the maximum bonus opportunity – which is analogous to a target bonus level – was paid to Small Cap Highest Paid Directors from 2005 to 2008 but not in the last two years.

Table 10. Quartile Analysis of Total Cash

	FTSE Small Cap			FFTSE Small Cap – Top Half			FTSE Small Cap – Bottom Half		
	LQ	M	UQ	LQ	M	UQ	LQ	M	UQ
Highest Paid Director	£344,000	**£455,000**	£585,000	£369,000	**£484,000**	£702,000	£339,000	**£415,000**	£526,000
Finance Director	£234,000	**£290,000**	£384,000	£260,000	**£345,000**	£424,000	£225,000	**£260,000**	£300,000
Other Directors	£211,000	**£300,000**	£447,000	£242,000	**£337,000**	£456,000	£201,000	**£252,000**	£370,000

Table 10 shows the value of total cash i.e. salary and actual bonus paid. At the median, total cash levels are around 8% higher than last year, reflecting higher bonus payments.

Annual Bonus

Performance Measures

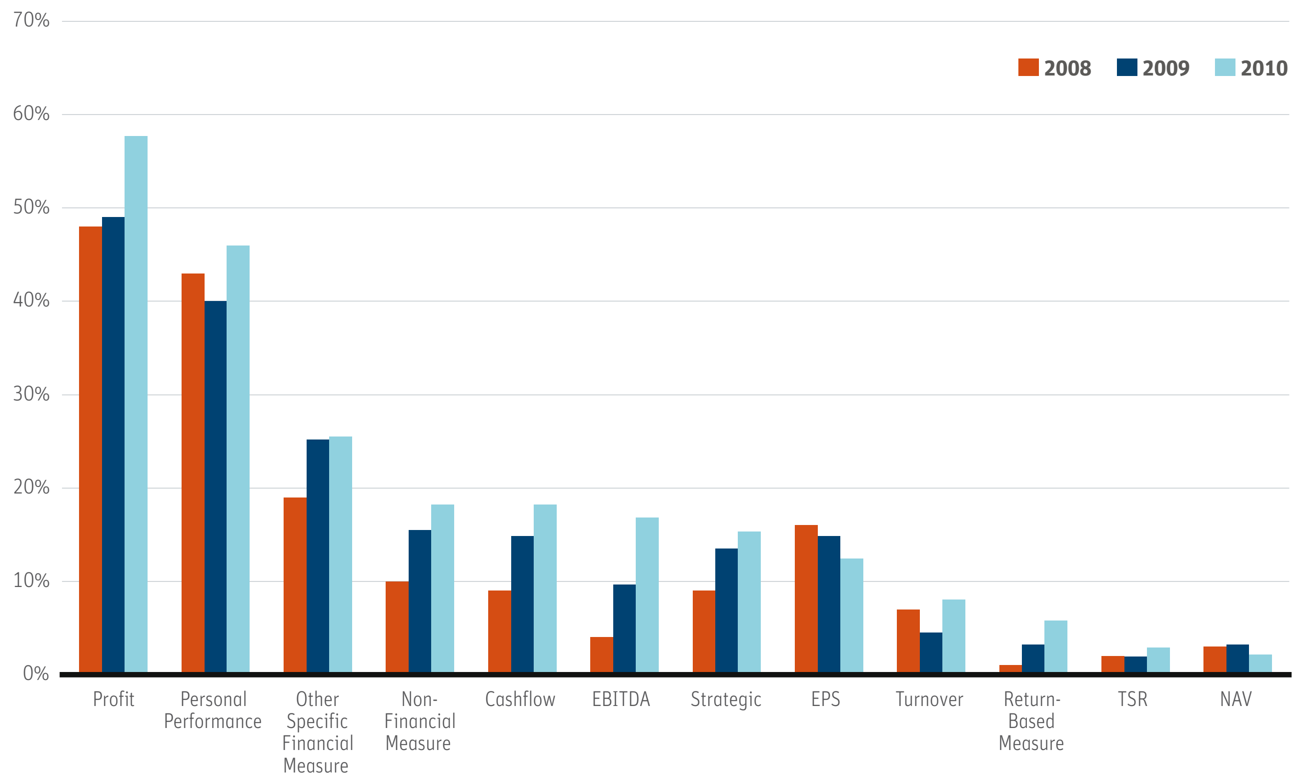
The metrics used to determine bonus payments are now the subject of considerable investor scrutiny.

Chart 11 shows that (i) the most commonly used financial measure is profit, (ii) over 45% of companies include an element of personal performance and (iii) over 15% also include non-financial measures. The non-financial measures actually used vary between industries but can include customer satisfaction and health/safety/environmental measures.

In our experience, where personal performance or non-financial metrics are used they tend to be a minority element of the bonus, typically only accounting for 15%-25% of the bonus. In addition, it is now becoming more common practice for no personal element of the bonus to be payable unless a threshold level of financial performance has been delivered.

Whatever measures are used, companies are now mindful to ensure that the targets themselves do not encourage executives to take undue risks, with the targets themselves often 'risk-adjusted' where it is practicable to do so.

Chart 11. Performance Measures in Annual Bonus Plans



N.B Companies may have more than one measure

Bonus Deferral

Amongst larger companies, it is now quite common for a portion of the bonus to not be paid out in cash immediately after the year in which it is earned, but instead to be deferred into shares, thereby (i) providing an alignment of interests with shareholders and (ii) acting as a 'golden handcuff' as deferred shares tend to be forfeited if the executive leaves during the deferral period.

However, only 30% of FTSE Small Cap companies (compared to around 50% of the FTSE 250) compulsorily require part of the bonus to be deferred in shares.

The most common level of deferral is 50% of any bonus paid and the typical length of deferral is three years (although around 30% of companies allow all or some of the shares to vest sooner).

More than 20% of the Small Cap companies that require part of the bonus to be deferred in shares also grant a corresponding award of 'matching' shares under a 'Share Matching Plan' (see LTIP section).

Bonus Clawback

Another way of addressing the issue of risk in bonus structures is via the use of 'clawback' provisions which allow the company to require the repayment of a past bonus (or some other form of redress) in the event of financial misstatement or misconduct. The UK Corporate Governance Code (which is directly applicable to companies with financial years commencing 29th June 2010) encourages companies to consider the introduction clawback provisions in not only annual bonuses but also long-term incentives.

While thus far very few companies have embraced clawback, we expect the incidence of such features (and bonus share deferral) to increase over time.

Long-Term Incentives

Key Points to Note

- The most common way in which FTSE Small Cap companies provide long-term incentives is via the sole operation of a Performance Share Plan (52% of companies), although 28% still grant options. Over 20% operate a Share Matching Plan.
- The median expected value of long-term incentive provision is around 55% of salary (i.e. equivalent to a 100% of salary LTIP award or 275% of salary option award).
- EPS and TSR are still the most prevalent metrics used in long-term incentives, often in combination. However, we are seeing more companies considering the use of other financial metrics (such as ROCE, cashflow etc.) and strategic targets.

Types of Long-Term Incentives

The two main types of long-term incentive arrangement traditionally operated by FTSE Small Cap companies are:

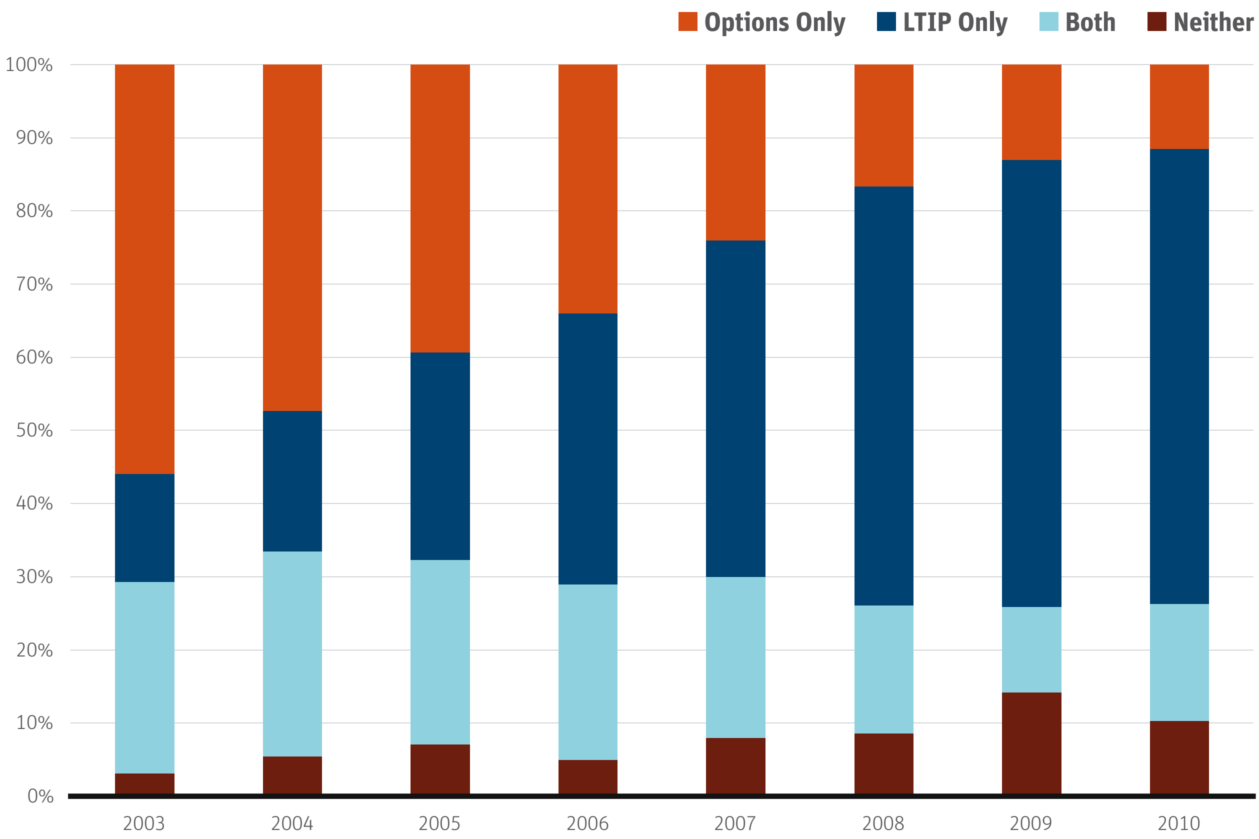
- Share option plans, under which market value options are granted that vest three years later subject to continued employment and performance conditions; and
- Long-Term Incentive Plans (or 'LTIPs'), under which conditional awards of whole free shares are granted which also vest three years later, again subject to continued employment and performance conditions.

There are two main types of LTIP:

- Performance Share Plans, under which conditional awards of shares are made without executives being required to invest in shares themselves.
- Share Matching Plans, under which conditional awards of shares are made that 'match' the number of shares invested (using bonus, other monies or shares already held) and retained by the executive in the Plan.

Chart 12 shows the split between companies using options and LTIPs over time. It shows that the use of LTIPs is now the norm, reflecting the fact that over the last few years companies have shifted away from using options (which are now viewed as a potentially overly-volatile incentive, worthless if underwater and which are typically less efficient than LTIPs from a dilution and accounting cost perspective).

Chart 12. Types of Incentives Available to Senior Executives: 2003 – 2010



While LTIPs remain the most common approach, there are limited examples of FTSE Small Cap companies considering whether there are other ways in which a long-term incentive could be provided to senior executives. For example, 'value creation' plans could play a role, under which an absolute target is set (whether based on share price, profit or some other metric). Once this absolute target is achieved, executives can share in any outperformance – possibly on an uncapped basis – with rewards delivered in either cash or shares.

'Restricted Share Plans' – under which share awards are granted without any performance conditions attached to vesting – remain very rare in the UK, at least for main Board Directors (they are slightly more common below Board level).

Long-Term Incentives

Award Levels

Amongst FTSE Small Cap companies, the median maximum annual limit in face value terms in a Performance Share Plan is 100% of salary (unchanged since our first FTSE Small Cap report in 2003) and in an Option Plan is 150% of salary (a fall from 175% of salary last year).

Share Matching Plans are structured differently. Companies tend to disclose the maximum level of match and investment (either as a percentage of the bonus payable or of salary). The most common level of maximum match is 1:1 (50% of companies), with around 20% of companies offering a 2:1 match. The corresponding typical up-front investment in shares (either on a compulsory or voluntary basis) is around 50% of salary.

As companies often operate more than one plan at the same time, it is important to look at the aggregate awards granted each year under all plans. Table 13 shows the actual expected value of awards made last year. It shows that the median aggregate expected value of awards for Executive Directors in the FTSE Small Cap was around 55% of salary in 2009/10 (unchanged from last year and compared to around 75% in the FTSE 250). This equates to an LTIP award of 100% of salary in face value terms (or an option award of 275% of salary).

Table 13. Quartile Analysis of Expected Value of Actual Long-Term Incentive Awards Made Last Year (as a % of Salary)

	FTSE Small Cap			FTSE Small Cap – Top Half			FTSE Small Cap – Bottom Half		
	LQ	M	UQ	LQ	M	UQ	LQ	M	UQ
Highest Paid Director	31%	**54%**	74%	38%	**58%**	79%	28%	**50%**	56%
Finance Director	29%	**53%**	66%	30%	**57%**	76%	28%	**47%**	55%
Other Directors	31%	**55%**	64%	42%	**59%**	70%	22%	**35%**	55%

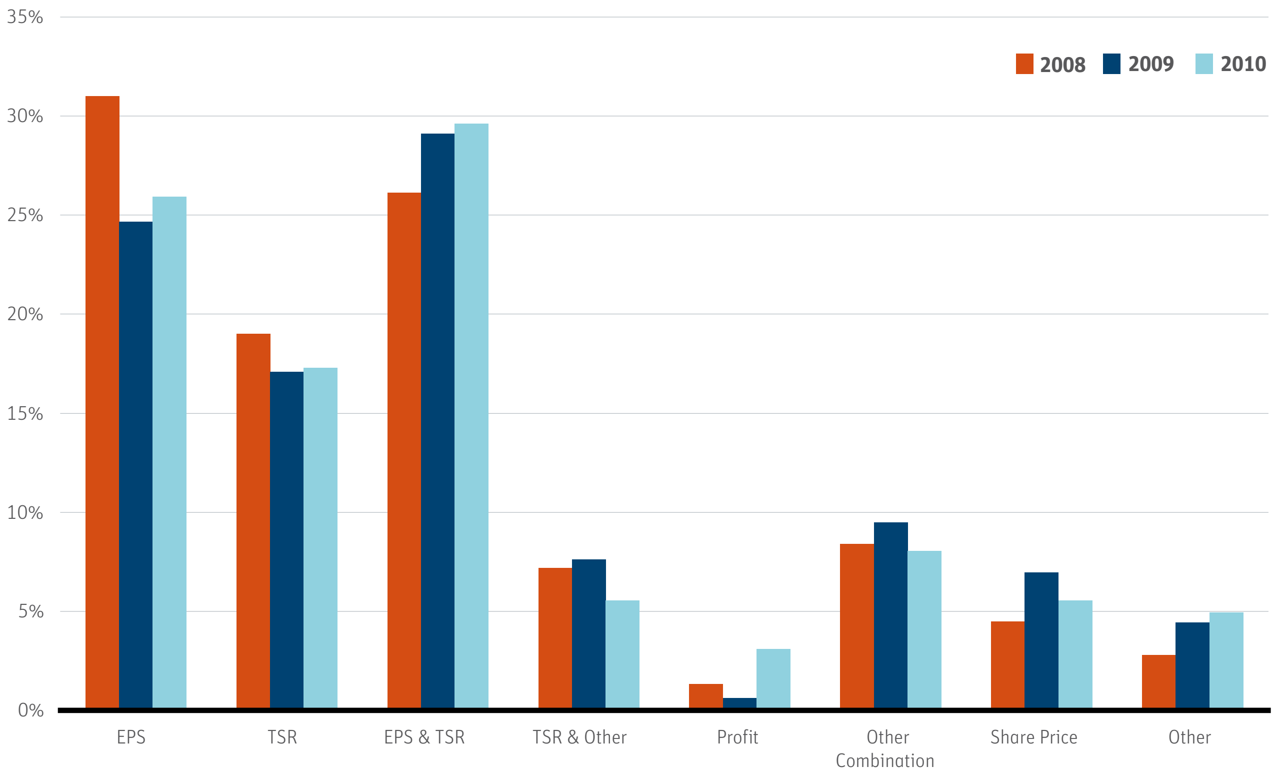
Executive Committee roles receive lower long-term incentive awards with an expected value of around 35% of (a lower) salary, which equates to a face value LTIP grant of 65% of salary or an option grant of 175% of salary.

Performance Conditions

Chart 14 shows the types of performance conditions used in LTIPs. EPS and TSR (the latter typically used as a relative measure) remain the most common measures (including when used in combination with another measure). In the vast majority of cases performance is measured over three years and awards vest at the end of this performance period.

While EPS and TSR remain the norm, we are now seeing more companies employing 'other' measures, often in combination with EPS and/or TSR. These other measures include cash flow, sales/revenue growth, operating margin and cost savings. However, despite calls for their use from some quarters (including the new Corporate Governance Code), few companies are currently employing 'non-financial' measures in their long-term incentives, perhaps questioning whether achievement of these measures can be determined objectively.

Chart 14. Performance Measures in LTIPs

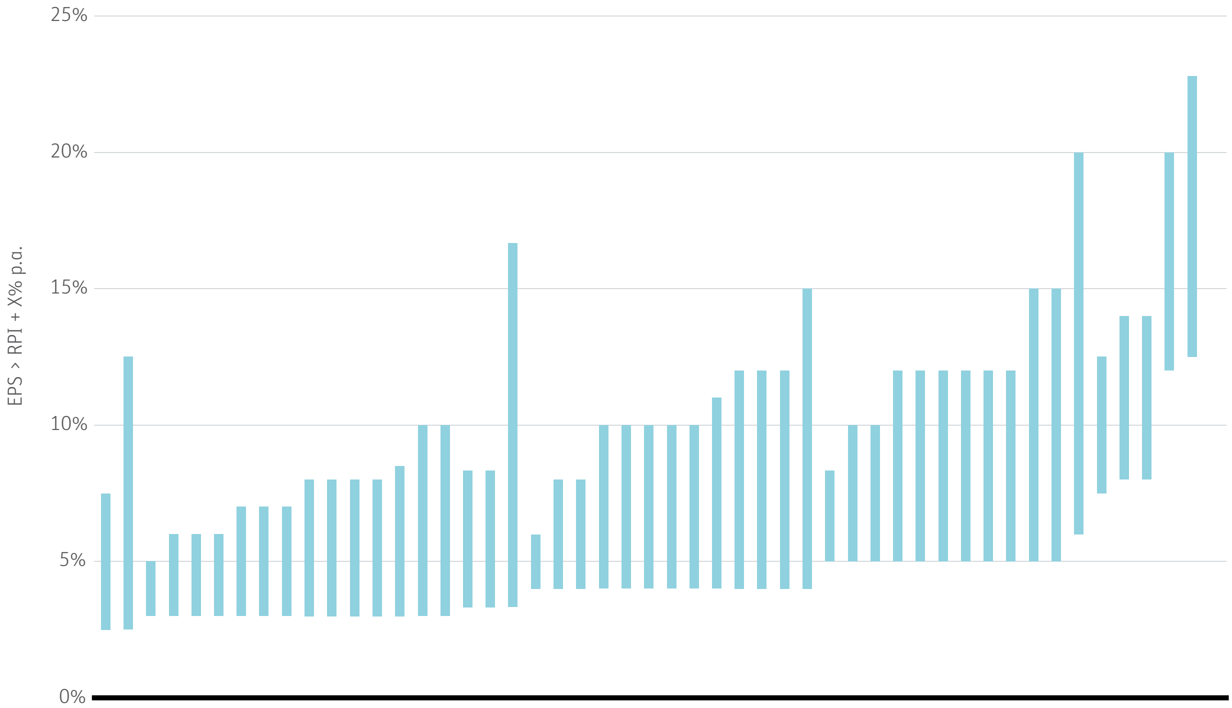


Long-Term Incentives

Chart 15 and Table 16 show details of how EPS and TSR targets are structured in LTIPs. In LTIPs using an EPS measure, the median performance range is EPS growth of RPI plus 4% p.a. to RPI plus 10% p.a.. However, when setting targets, particularly financial targets such as EPS, more consideration needs to be given to the specific circumstances and strategic objectives of the company, rather than to what targets are applied by other companies.

In LTIPs using TSR, all plans require the company to be ranked at least median for awards to start to vest (at which point typically 25% vests). While upper quartile performance is still the most common level at which awards vest in full, 18% of plans require above upper quartile performance for awards to vest in full.

Chart 15. EPS Targets for Minimum Vesting in LTIPs using an EPS against RPI Performance Measure



Each bar represents one plan

Table 16. TSR Targets for Maximum Vesting in LTIPs Using a Relative TSR Performance Measure

Maximum TSR Target	Percentage of Plans
> Top 10%	3%
Top 10% (i.e. upper decile)	3%
Between Top 10% and 20%	3%
Top 20% (i.e. upper quintile)	9%
Top 25% (i.e. upper quartile)	82%

Share Ownership Guidelines

Over 40% of FTSE Small Cap companies now disclose having a shareholding guideline for Executive Directors (compared to over 60% in the FTSE 250). The median level of shareholding required by CEOs and Executive Directors in FTSE Small Cap companies is 100% of salary (the same as in the FTSE 250). That said, around 10% of companies have a higher shareholding requirement for their CEO than other Executive Directors.

Clawback

As noted above, the new Corporate Governance Code requires companies to consider the use of clawback provisions in both annual bonuses and long-term incentives.

However, the use of clawback in long-term incentives is currently virtually unheard of. Plans that use financial targets such as EPS could perhaps fairly easily accommodate a clawback provision, on the basis that the impact on a financial target of a misstatement of results may be relatively identifiable, with the resulting overpayment clawed back. Greater challenges are faced when trying to enforce clawback on a TSR-based award, as the impact of the misstatement will be far harder to quantify.

The Total Package: Quantum and Balance

Key Points to Note

- Typically around 40%-45% of FTSE Small Cap Executive Directors' packages consist of variable pay, of which around 50% is focused on long-term performance.
- FTSE Small Cap packages tend to be less highly geared than their FTSE 100 and 250 counterparts
- Below Board executives' packages are less performance-linked than Executive Directors' packages.

Quantum

Chart 17 shows the total target/expected value of Executive Directors' remuneration packages, as well as the breakdown between each element of pay (further details of the methodology we have used to value each element of the package are set out on page 30). Table 18 provides a more detailed quartile analysis of target total remuneration levels and also divides 'Other Directors' into operational and functional roles.

Chart 17. Median Target Total Remuneration

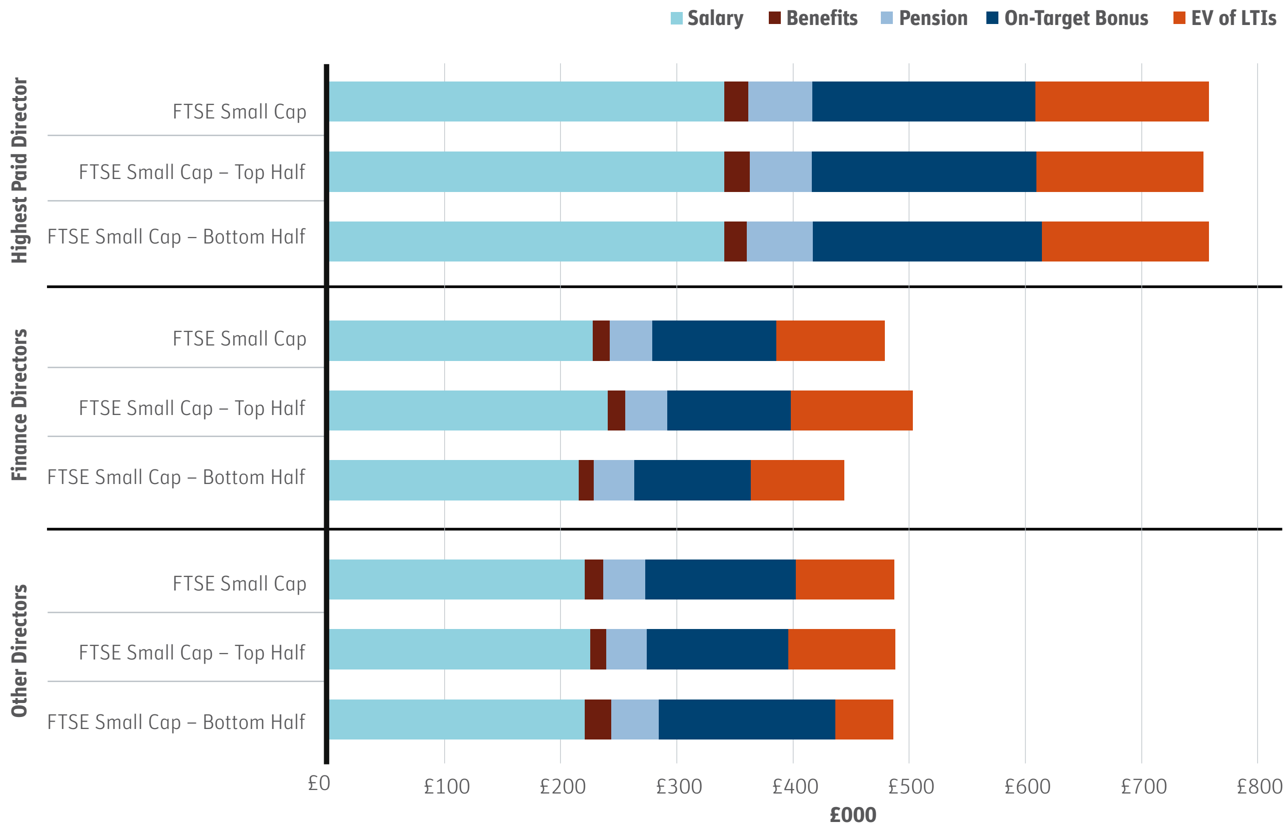


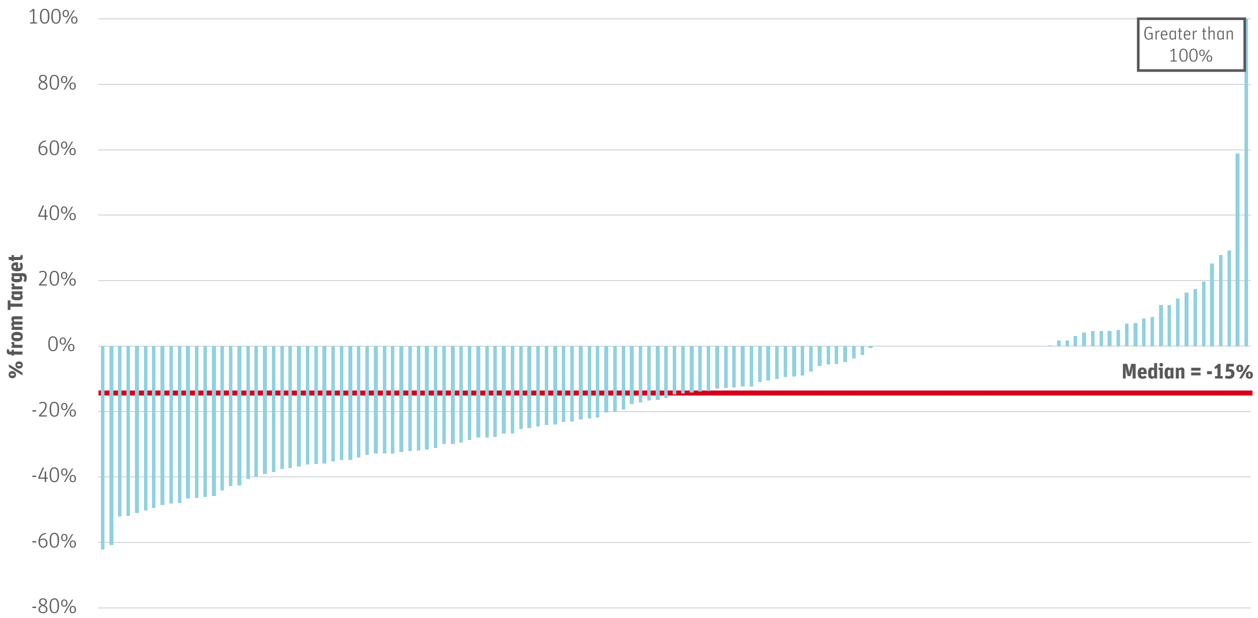
Table 18. Quartile Analysis of Target Total Remuneration

	FTSE Small Cap			FTSE Small Cap – Top Half			FTSE Small Cap – Bottom Half		
	LQ	M	UQ	LQ	M	UQ	LQ	M	UQ
Highest Paid Director	£541,000	**£755,000**	£956,000	£553,000	**£751,000**	£1,004,000	£534,000	**£755,000**	£882,000
Finance Director	£393,000	**£477,000**	£616,000	£423,000	**£501,000**	£625,000	£353,000	**£443,000**	£561,000
Other Directors	£315,000	**£485,000**	£621,000	£346,000	**£487,000**	£700,000	£281,000	**£484,000**	£588,000
Operational Directors	£339,000	**£499,000**	£682,000	£364,000	**£485,000**	£678,000	£319,000	**£529,000**	£699,000
Functional Directors	£234,000	**£353,000**	£525,000	£270,000	**£476,000**	£661,000	£233,000	**£316,000**	£422,000

As mentioned previously, in the current economic climate there is greater attention paid to what levels of reward are actually being delivered under incentive plans (both short-term and long-term). Therefore, we have analysed not only target total remuneration, but also actual payments last year based on actual bonus paid and the value of vested long-term incentives. The value of vested long-term incentives relates to the value of LTIP awards that vested and/or options that were exercised during the year but granted in earlier years (and, in relation to options, what individuals chose to exercise during the year even though they may have become exercisable in earlier years).

Chart 19 shows for each Highest Paid Director the variance between the actual total remuneration value and the target level. At the median, actual total pay last year was around 15% below the target level, which is similar to last year. Given the higher level of bonuses paid last year, it is surprising that actual payouts have not changed much from last year and that actual payouts remained below target level. This may well be due to the fact that, while higher bonuses were earned in respect of performance in 2009, long-term incentive payouts were hit hard by the economic downturn.

Chart 19. Actual v Target Total Remuneration for the Highest Paid Director



The Total Package: Quantum and Balance

Impact of Size of Company

Market capitalisation, in a stable environment, is accepted as one of the key drivers of pay levels. As an alternative, the 'size' of a company can be determined by turnover (which is usually less volatile than market capitalisation). The median turnover of FTSE Small Cap companies is £245m (if financial companies are excluded, for whom turnover is of less relevance). The medians of the top and bottom halves of the FTSE Small Cap ranked in terms of turnover are £419m and £90m respectively. Table 20 sets out quartile analysis for FTSE Small Cap companies for these three groups of companies.

Table 20. Quartile Analysis of Total Remuneration by Turnover

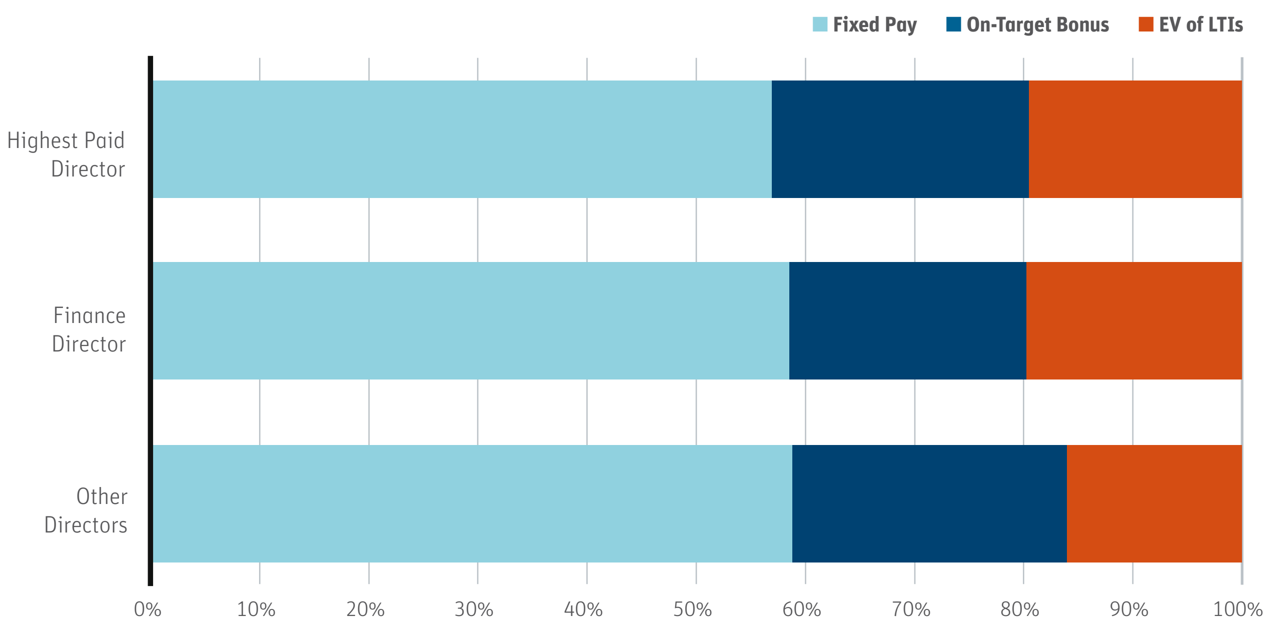
	FTSE Small Cap Median £245m			FTSE Small Cap – Top Half by Turnover Median £420m			FTSE Small Cap – Bottom Half by Turnover Median £90m		
	LQ	M	UQ	LQ	M	UQ	LQ	M	UQ
Highest Paid Director	£541,000	**£755,000**	£956,000	£729,000	**£855,000**	£1,044,000	£481,000	**£640,000**	£852,000
Finance Director	£393,000	**£477,000**	£616,000	£457,000	**£552,000**	£673,000	£341,000	**£433,000**	£496,000
Other Directors	£315,000	**£485,000**	£621,000	£479,000	**£555,000**	£746,000	£239,000	**£403,000**	£570,000

Fixed and Variable Pay

Chart 21 looks at the relative weighting between fixed and variable pay, as well as between short-term bonus and long-term incentives. It shows that around 40%-45% of an Executive Director's remuneration package is linked to variable pay (compared to approximately 40% in the previous year and 25% in 2003). Of the variable pay element, around 50% is linked to long-term performance.

Larger companies tend to have a higher portion of variable pay in their packages and a greater weighting on long-term performance. In the FTSE 250, 50% of packages tend to consist of variable pay, of which 55% is focussed on long-term performance. In addition, Highest Paid Directors tend to have more variable and long-term performance related pay than other Directors.

Chart 21. Fixed v Variable Pay by Role



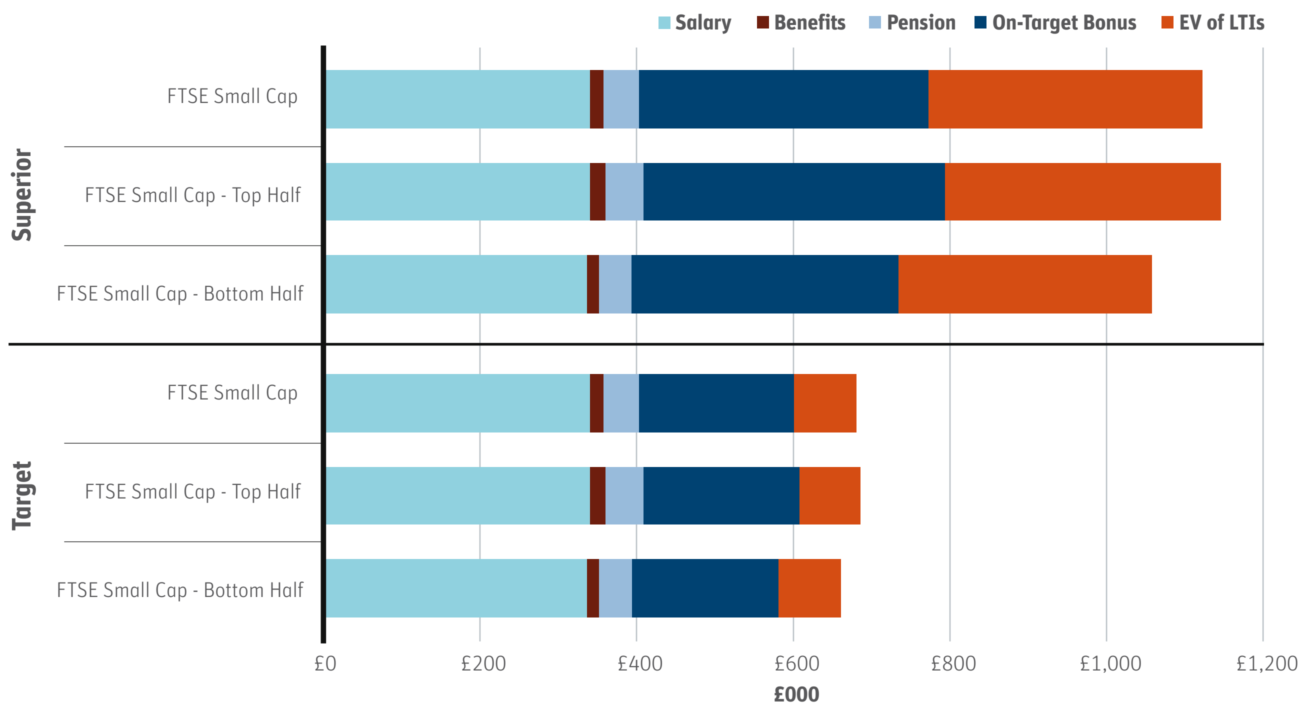
The Total Package: Quantum and Balance

Total Remuneration at Target and Superior Performance

To see how gearing in packages can impact on the ultimate value of rewards delivered, we have looked at the potential rewards that can be delivered assuming different levels of performance. Chart 22 shows the value of packages for 'target' and 'superior' performance for the Highest Paid Director. For target performance, we have assumed 50% of the maximum bonus is awarded, one-third of options vest (where granted), 25% of LTIP awards vest and there is share price growth of 5% p.a. over three years. For superior performance, we have assumed the maximum annual bonus is paid, all share awards vest in full which is accompanied by a share price growth of 10% p.a. over three years.

Chart 22 shows the potential leveraging effect of an increased weighting on variable pay, i.e. the greater the variable pay element, the more the package is worth at higher levels of performance. Remuneration at superior performance tends to be around 160% to 170% of the target performance level. This shows the importance of operating incentive plans (whether short or long-term) with genuinely challenging targets.

Chart 22. Total Remuneration – Target and Superior Vesting for the Highest Paid Director



Executive Committee

To provide further context, Table 23 sets out total remuneration data on FTSE Small Cap Executive Committee level roles (i.e. the tier below the main Board).

The median level of total remuneration of an Executive Committee member tends to be around 55% of the Finance Director's package. Further, only around 30% of an Executive Committee member's package is made up of variable pay (compared to over 40% for a Finance Director).

Table 23. Quartile Analysis of Total Remuneration for Executive Committee Level Roles

	FTSE Small Cap		
	LQ	M	UQ
Executive Committee	£224,000	**£254,000**	£284,000

Pension

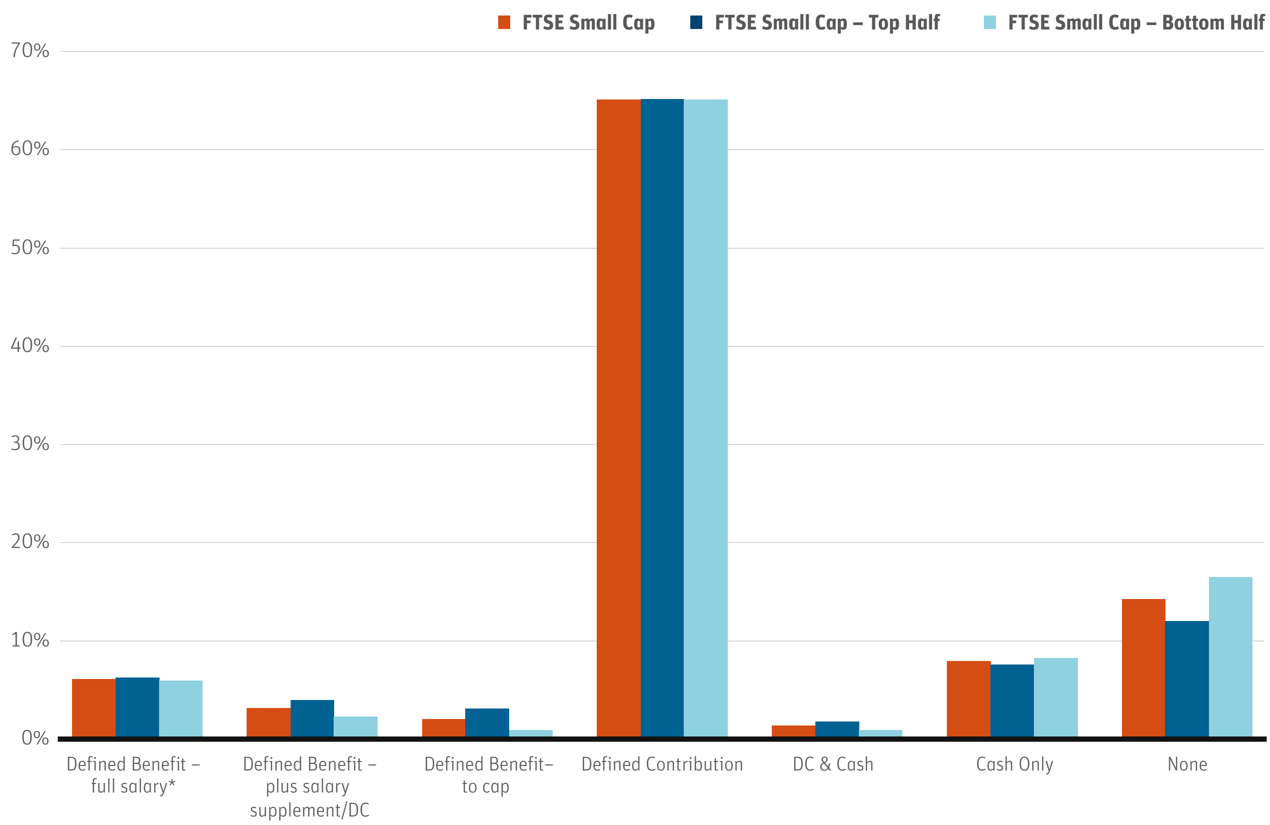
Key Points to Note

- Around 65% of Executive Directors participate in a Defined Contribution arrangement.
- The median company Defined Contribution rate is 15% of salary.
- The new pensions legislation is causing many companies to review their executive pension provision.

Types of Pension Provision

Chart 24 shows that the most common pension provision for FTSE Small Cap Executive Directors is the sole operation of a Defined Contribution plan (around 65% of Directors). If we just look at the pension arrangements offered to executives who joined companies during the last year, Defined Contribution plans remain the most common (75% of Directors) with 17% of new joiners not receiving any pension provision.

Chart 24. Types of Pension Arrangement (All Directors)



* Includes Directors that receive separate funded/unfunded arrangements

Defined Benefit Plans

Whilst some companies are closing Defined Benefit plans for new or all employees (due to the cost implications of their operation), others have tried to limit costs by reducing accrual rates for future service or are requiring executives to increase their contribution. Some companies are also trying to control costs by moving away from 'final salary' Defined Benefit arrangements towards 'career average' plans, i.e. pension is not calculated on the salary at retirement but on the average salary over the individual's career, thereby lowering the pension and the cost to the company.

Where a precise accrual rate is disclosed, the most common accrual is 60ths (40% of companies). A significant number of companies state that they provide a pension 'of up to two-thirds' (which could be any accrual rate up to 30ths). Around 10% of companies provide 30ths.

Defined Contribution Plans and Cash Supplements

Table 25 shows contributions to Defined Contribution plans. The median rate of contribution is around 15% of salary. Where individuals receive only a cash supplement, the median supplement is around 15-20% of salary. The difference in contribution rates between these two types of arrangements is due to variations in the constituent companies rather than for any other underlying reason. In fact, it would not be surprising for companies to contribute a lower amount to cash supplements due to the additional national insurance cost to the company of operating such arrangements (although it is not uncommon for this NICs liability to be borne by the executive).

Table 25. Quartile Analysis of Company Defined Contributions and Cash Supplements

	FTSE Small Cap			FTSE Small Cap -Top Half			FTSE Small Cap -Bottom Half		
	LQ	M	UQ	LQ	M	UQ	LQ	M	UQ
Defined Contributions	9%	**15%**	19%	10%	**14%**	18%	9%	**15%**	20%
Cash Supplements	12%	**17%**	23%	15%	**20%**	23%	10%	**15%**	20%

Future Developments

The pensions legislative landscape is undergoing some fundamental changes. The Government has significantly reduced tax relief available on pensions with an annual allowance of £50,000 from April 2011 (reduced from the current £255,000). The future of non-registered pension arrangements (such as EFRBS) is being considered under a separate anti-avoidance review. The move from Defined Benefit to Defined Contribution is accelerating and the NAPF/LAPF are calling for greater disclosure in relation to executive pension arrangements and to justify any differences from the arrangements of other employees.

As a result, many companies are once again feeling the need to review their executive pension provision. It is difficult at this stage to predict the likely outcome of these reviews. However, it may well prove to be the case that a number of companies close their final salary plans to existing employees, offering Defined Contribution plans instead but with the option of a cash alternative for individuals caught by the pension tax changes.

Contracts

Key Points to Note

- Notice periods are almost universally twelve months or less.
- Around 25% of contracts disclose having liquidated damages clauses.
- 30% of liquidated damages clauses are disclosed as including bonus in the calculation of termination payments.

The vast majority of Executive Directors' contracts have a notice period of 12 months (82%). While some shareholders encourage even shorter notice periods, only 18% of contracts have a notice period of less than 12 months.

There is an increased focus on how the termination payment of a departing executive is calculated, particularly in the current economic climate where avoiding 'rewards for failure' is a key concern.

Around 25% of contracts contain liquidated damages clauses (which specifically define upfront the compensation payable on termination). The remainder rely on general principles of mitigation. While there was a time when shareholders favoured liquidated damages clauses, they are now less popular as investors believe they can 'over-reward' a departing executive.

Best practice is for only salary to be included when determining compensation payments. However, around 55% of clauses include benefits, 17% include pension and 30% include bonus (where disclosed in company accounts, although disclosure on this issue is patchy).

We are also seeing a decline in contracts containing enhanced rights on a change of control (either to an increased notice period or a larger liquidated damages payment) in response to shareholder criticism of such provisions. Only 8% of FTSE Small Cap Executive Directors currently have enhanced protection on a change of control.

Non-Executive Directors

Key Points to Note

- Non-Executive Director fees have remained fairly static over the year.
- Over 60% of companies specify base and additional committee chair fees.

Table 26 provides a quartile analysis of Non-Executive Directors' fee levels in FTSE Small Cap companies, divided between Non-Executive Chairmen, Senior Independent Directors, Remuneration Committee Chairmen, Audit Committee Chairmen and other Non-Executive Directors that chair no committees.

Table 26. Quartile Analysis of Non-Executive Directors' Total Fees

	FTSE Small Cap			FTSE Small Cap – Top Half			FTSE Small Cap – Bottom Half		
	LQ	M	UQ	LQ	M	UQ	LQ	M	UQ
Non-Executive Chairmen	£70,000	**£98,000**	£120,000	£72,000	**£100,000**	£120,000	£68,000	**£89,000**	£124,000
Senior Independent Directors	£35,000	**£40,000**	£46,000	£37,000	**£43,000**	£49,000	£32,000	**£39,000**	£45,000
Audit Committee Chairmen	£35,000	**£41,000**	£46,000	£38,000	**£43,000**	£51,000	£34,000	**£39,000**	£44,000
Remuneration Committee Chairmen	£35,000	**£39,000**	£44,000	£36,000	**£41,000**	£45,000	£34,000	**£38,000**	£42,000
Non-Executives – Chair of no Committees	£30,000	**£35,000**	£40,000	£30,000	**£35,000**	£40,000	£30,000	**£35,000**	£40,000

Many companies now specify 'base fees' and additional fees for chairing a committee or for being the Senior Independent Director. Over 40% of FTSE Small Cap companies adopt this approach and disclose base and committee fees, compared to around 65% of FTSE 250 companies. However, only around 15% of companies disclose paying an additional fee to their Senior Independent Director.

These additional fees (which are already included in the above total fee analysis) are set out in Table 27. It is much less common for Non-Executive Directors to receive additional fees for being a member of a committee (less than 5% of companies disclose such a fee).

Table 27. Quartile Analysis of Additional Fees

	FTSE Small Cap			FTSE Small Cap – Top Half			FTSE Small Cap – Bottom Half		
	LQ	M	UQ	LQ	M	UQ	LQ	M	UQ
Audit Committee Chairman	£5,000	**£6,000**	£7,500	£5,000	**£7,000**	£7,800	£5,000	**£5,000**	£7,500
Remuneration Committee Chairman	£5,000	**£5,000**	£6,000	£5,000	**£5,000**	£7,500	£5,000	**£5,000**	£6,000
Senior Independent Director	£3,000	**£5,000**	£8,000	£3,000	**£7,500**	£14,000	£4,000	**£5,000**	£6,000

Methodology

The FTSE Small Cap has been 'struck' as at 31 August 2010. The median market capitalisation of the Index as a whole is £151m. The top half has a median market capitalisation of £223m and the bottom half of £94m.

The Executive Director data has been sourced from public disclosures in Report & Accounts and circulars and includes all March 2010 year-ends. Data has been provided for the:

- Highest Paid Director – either the Chief Executive or the full-time Executive Chairman;
- Finance Director; and
- Other Directors – i.e. other main Board Executive Directors, excluding Chief Executives, Executive Chairmen and Finance Directors. These 'Other Directors' have been split between 'Functional' roles (e.g. HR, Legal) and 'Operational' roles (e.g. Heads of Divisions).

Data on Executive Committee roles has been taken from our participatory 'Executive Total Reward Survey'.

Target total remuneration has been calculated on an 'expected value' basis. By this, we mean that a value has been attributed to each element of an executive's package. Table 28 sets out the assumptions used to calculate total remuneration. Only executives who have been in post throughout the relevant financial year have been included.

Table 28. Calculating Target Total Remuneration

Salary	Reported current salary or salary paid in the prior year. No ageing factor has been applied.
Benefits	Reported cash value.
Pension	Defined contribution plans or cash supplements – company contribution as a percentage of salary. Defined benefit plans – an annual value has been calculated using actuarial assumptions based on each individual's accrual rate, retirement age, pension increase post-retirement and employee contribution (assuming an average age of 50).
On-target bonus	On-target bonus as a percentage of salary, if disclosed. If not disclosed (as is the case in around 85% of companies), then we have assumed an on-target bonus of 50% of the maximum bonus potential. If neither the on-target nor maximum is disclosed (the case in around 20% of companies), then we have used the actual bonus paid last year as a percentage of salary.
Expected value of long-term incentives (EV of LTIs)	Based on the company's grant policy, if disclosed (as it is in around 25% of cases) or the actual awards of options and LTIPs made last year as a percentage of salary. We have then applied an expected value – for options 20% of the face value, for free share awards with performance conditions (i.e. LTIPs) 55% and for free share awards without performance conditions 100%.
Total remuneration	Salary + benefits + pension + on-target bonus + expected value of long-term incentives.

About Hewitt New Bridge Street

Hewitt New Bridge Street is the UK's leading executive remuneration consultancy. We have a single focus – to assist companies design and implement executive remuneration policies that will help them meet their business objectives.

We are a multi-disciplinary team, combining the professional skills of accountants, lawyers, reward experts, investor relations specialists and actuaries. We are a named adviser in the Directors' Remuneration Report of around 120 FTSE 350 companies and nearly 60 FTSE Small Cap companies, making us the most named adviser in both indices.

We are part of the HR Consulting business of Aon Hewitt, the global consultancy with over 29,000 associates in over 120 countries providing advice to our clients on a range of reward, executive remuneration, HR, pension and outsourcing issues.

If you wish to find out how we can help you, please contact us.

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