Better boards for growth companies

MAY 2023

A survey of Non-Executive Directors

Introduction

Growth companies play a significant role in the UK economy through the creation of wealth and jobs. This is well understood but what is often overlooked is the importance of a strong board, including its Non-Executive Directors (NEDs), to the ultimate success of a growth company. NEDs, in our view, play a critical role in supporting these engines of growth.

Yet in a world where the only constant is change, boards need to deal with sustainability agendas, diversity and inclusion, geopolitics and stakeholder expectations – never mind overseeing the company's operations and the serious legal and regulatory responsibilities that go with that. The role of a NED – particularly in a young and growing quoted company – has therefore become ever more challenging. Coupled with this, there continues to be increasing levels of scrutiny on the level of remuneration board members should be awarded.

To explore these challenges, finnCap and the Quoted Companies Alliance (QCA) have sought the views of more than 100 NEDs of smaller quoted companies – defined as having business growth as their main strategy and focus – to examine remuneration in the sector in the context of the role, the significant regulatory and legal responsibilities as a NED, the time commitments and comparable market pay practices.

The research was conducted by finnCap, among a sample of 102 NEDs. The qualitative and quantitative data was collected between March and April 2023 and is set out in this report.

What we learnt

Our key findings from the survey, in respect of smaller quoted company NEDs, were:

- The role differs from being a NED in larger and more mature businesses.
- There needs to be a conversation around remuneration, on the basis that:
  - The time involved typically exceeds the contracted commitment.
  - The work required and risk profile has increased significantly in recent years.
  - Average remuneration is not considered representative of the work and risk profile attached to the role.
  - Remuneration packages are perceived to be higher in other markets (public and private).
  - A significant number of NEDs are turning roles down.
- Further work is required in order to promote diversity in the boardroom.

Critically, the perceived shift in the risk/reward status of taking on a non-executive directorship in the UK has meant that it has become harder to hire – and hire the right people with the right experience.

Notably, a number of respondents commented that a key skill for a smaller quoted company NED is strategic insight. We believe this goes some way to illustrate the critical role that NEDs can play, particularly for young, growing companies. This in turn highlights the importance of having a deep pool of talent.

Opening Remarks

A JOB WORTH DOING

The risk for NEDs of large companies is that life always looks rosy at 35,000 feet. How can they hope to delve into the detail of a business that spans multiple divisions and geographies?

Fill the same role at a much smaller company and you are soon brought down to earth with a bump. These directors are mentors, caretakers, champions: necessarily more hands on, worrying about the detail without having to search it out.

Large and small company NEDs are tangentially connected but fundamentally different. From here springs the current debate over how much risk directors are willing to take – and how well they should be rewarded for doing so. Fundamentally, what motivates them to accept a role?

Growth companies deserve to have the best people gathered around the boardroom table to guide their journey. When the London markets are competing with the siren calls of overseas destinations, these personnel can help to anchor companies in their community too.

This report, for which we are happy to partner with finnCap, raises some concerns especially with its finding that so many would-be NEDs are turning down roles.

As any career-minded director knows, the time to start worrying is when the phone stops ringing. Incentives need to be appropriate so that some will always take the call.

Amid talk of boosting market liquidity and capital flows, we also must not forget how vital the pool of human capital is for growing quoted companies.

James Ashton, Chief Executive
Quoted Companies Alliance

We initiated this survey in March with two simple goals. Firstly, to engage better with our NED community by giving them an opportunity to voice their views. Secondly, to provide data that would prove and provide reasons for our anecdotal view that growing companies have struggled in recent times to attract the best NED talent.

On the former, we are delighted that so many NEDs took part, giving real ballast to this report and showing that the community has clear views that are worth discussing.

On the latter, the results have demonstrated that growing companies face a challenge when constituting the right board for their ambitions. These findings are worth addressing further.

From where we sit, companies are electing to stay private for longer. This is in part facilitated by the deep pockets of private equity who have been stealing a march on market share, but also due to wider public market malaise. We are advocates of growth companies and are champions of entrepreneurialism and want to ensure that public markets (and its wider eco system) are attractive to these businesses and, in turn, can support and reward their growth.

While the governance regimes adopted by growing companies – not least the excellent QCA Corporate Governance Code – encourage flexibility, this does not always translate into market practice. We want to further explore the underlying reasons deterring NED participation in this part of the market.

We therefore encourage all stakeholders to consider this report and their role in how we can make it more attractive to become a NED in the growth capital market arena.

Emily Watts, Director of Corporate Finance
finnCap Capital Markets

The findings in detail

The findings in detail

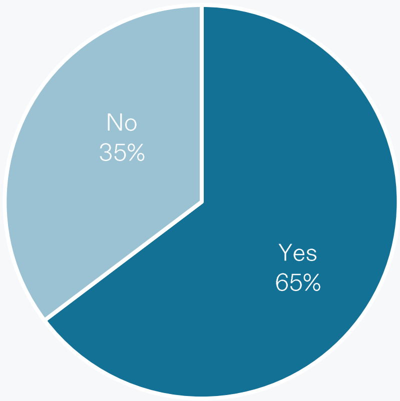
1. The role of the NED for smaller quoted/growth companies is different to that of mid/large-sized companies

KEY FINDINGS:

- Most respondents believed that the role of NEDs for smaller quoted companies is different to the equivalent role for mid/large-sized companies.
- Qualitative responses to the questions identified: 1) business experience; and 2) the shaping and setting of strategy, as core skills for smaller quoted company NEDs.

Q

Based on your experience, do you believe that the required skill set of NEDs of smaller companies differs from those required by mid/large-sized companies?*



*Excludes those who responded 'Don't know' (27 responses)

OUR VIEW:

- The conflict here is that corporate governance guidelines typically emphasise policing and oversight. However, in our view governance is about steering and guiding the organisation, including over the robustness and appropriateness of strategy and culture. The law and regulations are important because they define the boundaries, but they are not governance in themselves.
- Legally, one of the director's duties is to ensure the ongoing performance of the business. To do that well, NEDs need to provide guidance, which in turn requires engagement.
- In our experience, the role of a NED in a growth company can also vary considerably from one company to another, due to factors such as the size and the stage of development, the complexity of the business/operating model and the shareholding structure. In growth companies, the board often owns a large percentage of the company stock due to the presence of founder-CEOs; resources are much scarcer (for example, in terms of cash, company secretarial services and consulting), and the management team is often less experienced and less differentiated than in the larger-cap world. How a board acts and interacts with each other is critical.
- To attract people with the right experience requires recognition that the role of a NED in a smaller quoted company is a challenging and varied one, but which is not typically reflected in the remuneration available.

The findings in detail

2. The risk/reward of being a smaller quoted company NED has changed significantly in recent years

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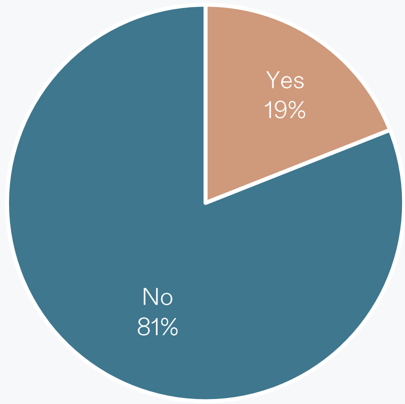
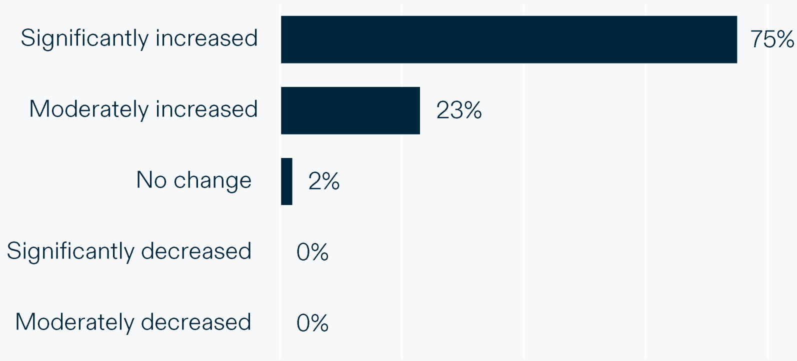
Do you think the average remuneration for acting as a NED for quoted companies is representative of the work and risk profile attached?



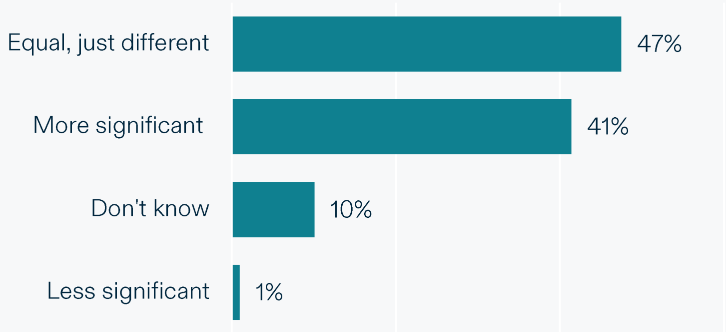
Q

Do you believe that the work required and risk profile attached to being a NED has increased in recent years?



Q

Do you think the workload for a NED of a smaller publicly quoted company is more significant or less significant than that at a more mature mid/large-sized company?



The findings in detail

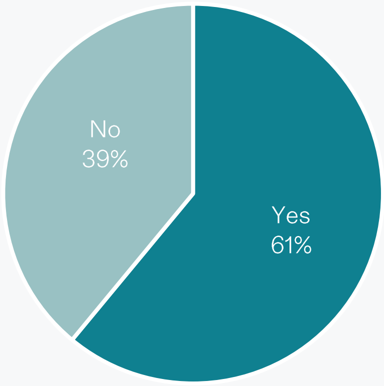
2. The risk/reward of being a smaller quoted company NED has changed significantly in recent years

KEY FINDINGS:

- Some 75% said that the work required, and risk profile attached, to being a NED has increased significantly in recent years.
- A total of 81% of respondents said that average remuneration for acting as a NED for smaller quoted companies is not representative of the work and risk profile attached.
- Some 61% of respondents have turned down NED roles because they felt that the fee did not reflect the work that would be required and/or risk profile attached.

Q

Have you turned down any NED roles because you have felt that the fee does not reflect the work that would be required and/or risk profile attached?



OUR VIEW:

- Smaller companies are often considered riskier due to resource and capital constraints and typically less experienced management teams. There have been a number of high-profile failures (and accompanying public criticism) that further compounds this perception.
- Inherently, the role of the NED is also riskier.
- There is a perception that remuneration does not acknowledge either the work required to be a NED or the risk profile attached and as a consequence a significant number of respondents have turned down NED roles.
- This suggests there is a positive correlation between remuneration and the access to NED talent for smaller quoted companies.
- Evidence suggests that NED remuneration has declined over the past two years, having marginally increased over five years[1].
- If risk has significantly increased and remuneration has not, it suggests that a rebalancing exercise is required.

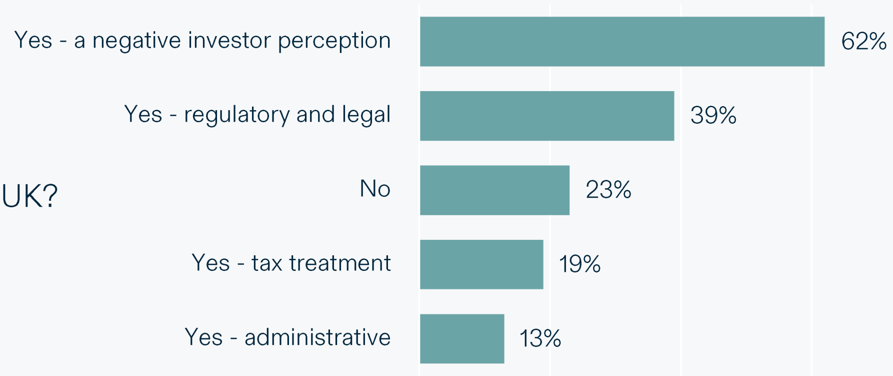
[1] QCA and YouGov 2022 Non-Executive Directors Survey

The findings in detail

3. There must be an open conversation in respect of remuneration

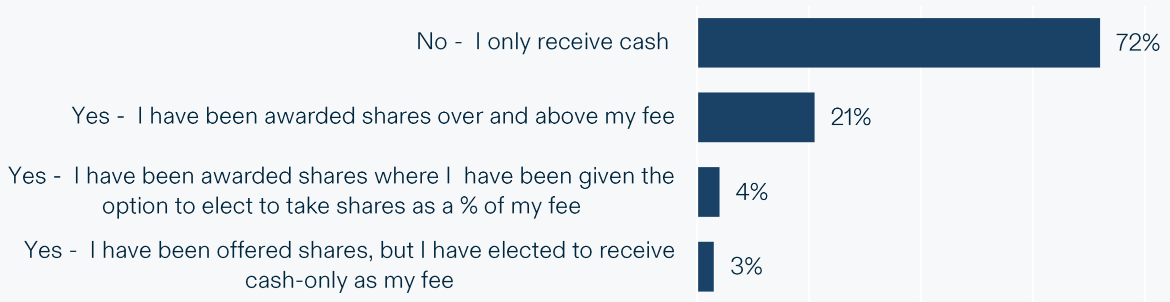
Q

Are there unnecessary barriers to paying NEDs in shares in the UK?



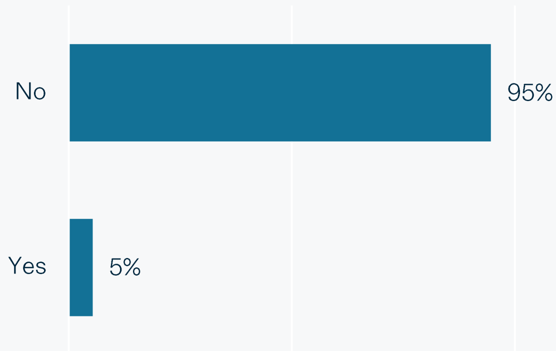
Q

Have you been awarded shares as part of your overall remuneration packages?



Q

Do you consider NED fees for quoted companies to be in line with NED fees for US-quoted companies or private equity-backed businesses?



*Excludes those who responded 'Don't know' (25 responses)

The findings in detail

3. There must be an open conversation in respect of remuneration

KEY FINDINGS:

- Some 81% of respondents believe that average remuneration for acting as a NED for smaller quoted companies is not representative of the work and risk profile attached.
- Some 95% said that they do not consider NED fees for smaller quoted companies to be in line with NED fees for US-quoted companies or private equity-backed businesses.
- As part of the survey we explored whether NEDs had received (1) shares and (2) share options/incentives as part of their overall fee; a minority of respondents confirmed that they have been issued shares and share options/incentives as part of their overall remuneration packages.
- The majority of respondents believe that there are unnecessary barriers to paying NEDs in shares.
- A total of 71% of respondents believe it is possible to develop a share options/incentives framework that preserves the independence of NEDs, although 29% of respondents opposed remuneration by way of shares or share options/incentives, as part of a NEDs remuneration package.

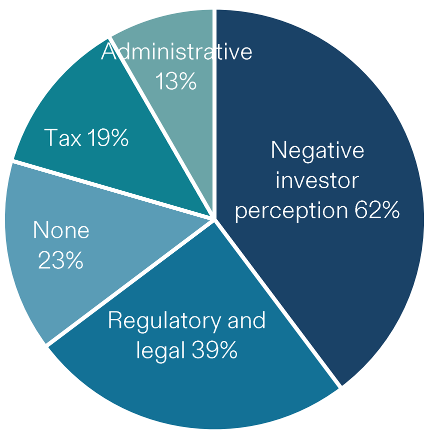
OUR VIEW:

- There is data to support the fact that British companies are finding it difficult to attract and retain executives because they offer smaller pay packages than rivals in the US. We believe there is direct read-across in respect of NEDs, which is particularly relevant to smaller company NEDs where skills are critical to overall strategy, as well as governance.

SHARES:

- Growth companies typically need to optimise their cash resources, therefore shares and share options/incentives can provide an alternative way to supplement the cash element of NED remuneration.
- The majority of respondents cited the key barrier to remunerating NEDs in shares was due to a negative perception from investors.
- Regulatory, legal and administrative concerns were also highlighted as practical issues that were barriers to issuing shares to NEDs.

The barriers to paying NEDs in shares in the UK were cited as:



- There appears, from the responses, to be a general misunderstanding about issuing shares to NEDs. NED share ownership is encouraged (although not required) and a number of respondents have indeed been issued shares/granted share options/awards. However, governance bodies are critical of meaningful share ownership (over independence), considered in the context of overall financial wealth, as well as share options/incentives (also over independence).

What the NEDs said:

"AIM rules and corporate governance guidance encourages [advisors] to be overly aggressive in determining fee levels; few have an understanding of the real role and indeed many NEDs themselves do not fully understand what an effective role means - too many boards stuffed with box tickers to satisfy the regulator."

"The UK Corporate Governance Code discourages the award of shares or share options to NEDs. However, for small cap growth companies where cash is scarce and where the expected workload of NEDs is higher than for more mature companies, such share or share option awards represent a pragmatic solution without compromising NED 'independence'."

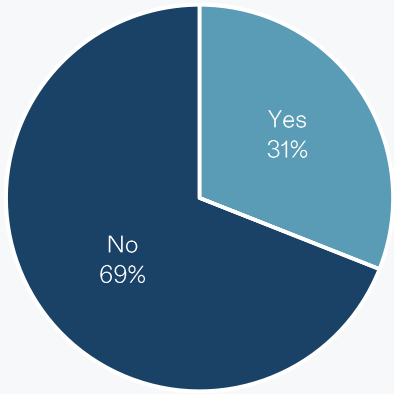
"The perception of lack of independence is the key one. However, as the PE model shows, alignment is a key driver of performance and success. Independence should not be impacted by having alignment of delivery."

The findings in detail

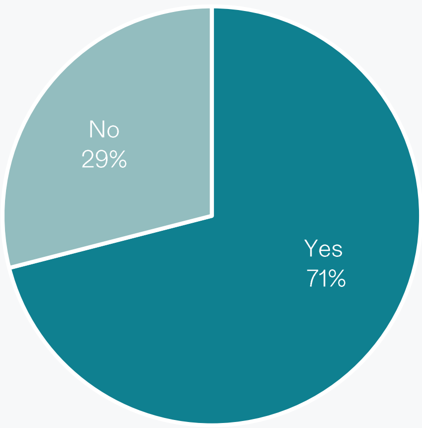
SHARE OPTIONS/INCENTIVES:

Q

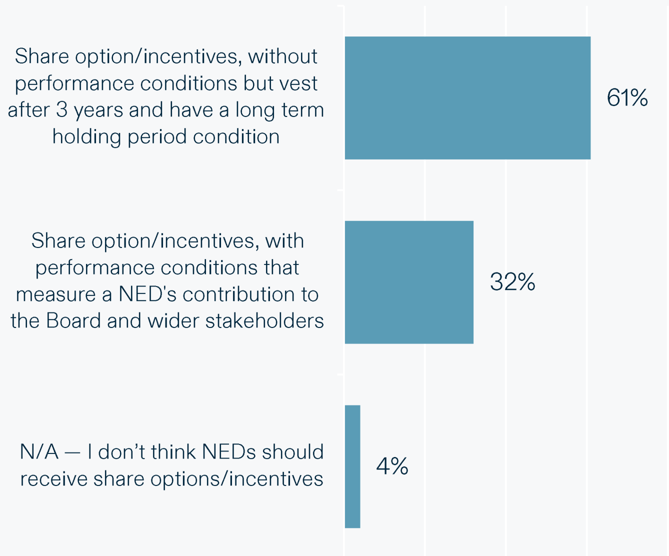
Have you been awarded share options/ Incentives as part of your NED fees?



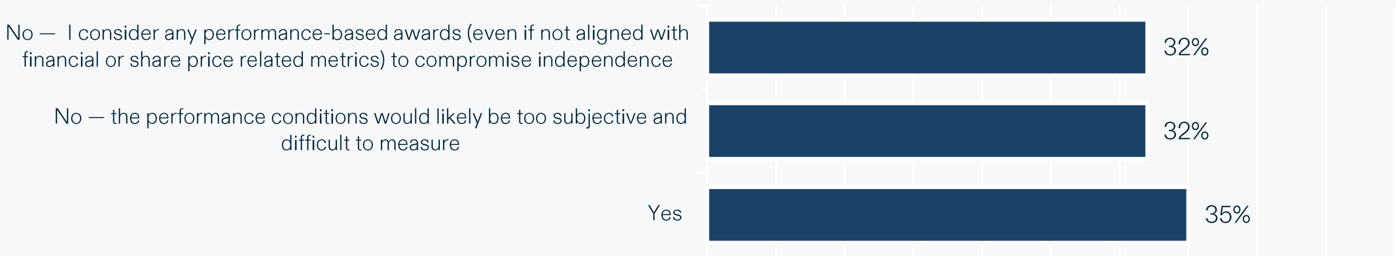
Q Do you think it is possible to develop a share options/incentives framework that preserves the independence of NEDs?



Q Do you think this would be best achieved by:



Q Could share options/incentives for NEDs promote better Corporate Governance? For example, through the inclusion of non-financial performance conditions such as a NED's contribution to the board and wider stakeholders?



The findings in detail

3. There must be an open conversation in respect of remuneration

SHARE OPTIONS/ INCENTIVES:

- There is a commonly held ideology among the investment community and policy voices that issuing NEDs share options/incentives is an irreconcilable conflict with independence.
- Despite this, some 31% of respondents have been awarded share options/ incentives as part of their overall remuneration package.
- Most of the respondents believe it would be possible to develop a share options/incentives framework that did not harm independence.
- The majority of respondents thought that this would be best achieved through options/incentives awards without performance conditions that vest over a three-year period and have a long-term holding condition.
- Some 35% of respondents believe that awards could even promote better corporate governance, although 32% said the performance conditions would likely be too subjective and difficult to measure.

What the NEDs said:

“Muddle and purist sentiment mean that companies don’t award share options to NEDs.”

“The key issue for me is separate from corporate governance. Part of the role of the NED is to help executive directors and senior management take better decisions to enable the company to prosper. The value NEDs can deliver in smaller companies is proportionately greater as smaller companies typically have stretched resources. Consequently, it is reasonable for NEDs to participate in the value created, providing it is not of such a significance that their independence might be compromised. This input into value creation is clearly in shareholders' interests.”

“A real risk that balance between governance and performance of the business is compromised and agenda becomes too stifled.”

The findings in detail

4. Further work is required in order to promote diversity in the boardroom

KEY FINDINGS:

- The primary barriers to achieving boardroom diversity, respondents say, are:
  - Recruitment difficulties/lack of candidates; and
  - Lack of sponsorship/mentorship.
- The key benefit of diversity was cited to be "reduced risk of 'group think'/increased diversity of thought".
- Qualitative responses indicated diversity is a divisive topic.

OUR VIEW:

- Corporate governance guidelines and, separately, policies apply certain recommendations on diversity. This is a "top-down" approach designed to force change in a marketplace that was otherwise resistant to change.
- There are inevitably growing pains borne from market pressure to apply a quota-driven NED structure. This is a pronounced issue for smaller quoted companies as if the risk/reward profile is already unbalanced, they are even less likely to attract the "top talent" from a more limited pool.
- We have still not fully addressed the structural inequalities and imbalances in ensuring we have the widest pool of talent available. The focus must be on the changes that need to happen to make a difference.

What the NEDs said:

"Allows new ongoing areas of discussion/debate to open up and be sustained."

"The correct people are better than diversity."

"Rubbish greenwashing points."

finnCap Group

QUOTED COMPANIES ALLIANCE

The way forward

The way forward

1. Bring back business judgment

We advocate a shift back towards business judgment. Key decisions such as board appointments and remuneration should be assessed on a case-by-case basis, rather than on benchmarks applicable to companies irrespective of size, sector or needs, such as those applied by shareholder proxy agencies. In effect, these are rules of conduct that are not legally binding although they have coercive power in constraining company behaviour.

These policies undermine the flexibility that the corporate governance guidelines provide; comply or explain has become comply or else. Although not compulsory, quoted companies do not have a real choice whether to comply or not because of the spotlight put on quoted companies by press and proxy agencies and an accompanying rise in negative voting recommendations and even shareholder activism.

In order to bring back business judgement and as a matter of good stewardship, shareholder proxy agencies need to properly engage with companies to understand the specific circumstances of each resolution they are providing a recommendation on.

However, the acceptance of business judgment relies on directors having built a meaningful relationship and trust with shareholders. It should be underpinned by articulation of company strategy and justification of decisions in the best interests of the company and its shareholders, taking account of wider stakeholders. The onus is on directors and shareholders to collaborate. Companies need to demonstrate good governance in managing shareholders and rhetoric around decision-making.

2. Review remuneration

Remuneration is part of a much wider decision-making process as to why to take a NED role. However, we believe it needs addressing based on the findings set out in this report.

The barriers to remuneration are primarily cited as a combination of cultural, legal and regulatory factors.

NED fees are typically set by benchmarking the UK quoted company cohort. In respect of issuing NEDs shares, governance codes and policies encourage non-material share ownership, however typically take a negative stance against share options/incentives for NEDs on the grounds of independence. Company law, which, whilst not a fundamental barrier, seems overly complex in respect of the rules around financial assistance. Tax implications are also cited as a barrier. While there is no legal or regulatory "hard-line" stance against overall fee or methods of smaller quoted company NED fees (other than the Financial Reporting Council's Corporate Governance Code in respect of share options and other performance-related elements for NEDs, which is not necessarily applicable to smaller quoted companies), the potential fallout from deviating from the "norm" can have dire consequences, whether through negative press coverage or through shareholder dissent/activism.

Remuneration is not considered to be aligned with private companies and comparable public markets, particularly in the US. Whilst we acknowledge that the landscapes are different, there are common themes. Certainly, awarding NEDs options is commonplace in both market places. Private companies can implement creative and/or potentially lucrative incentive arrangements behind closed doors.

Growth companies need to be able to compete for talent and in order to do so, remuneration needs to be competitive and perceived to take into account the work required and risk profile. Objectively, offering creative remuneration structures for companies that are cash-constrained or prioritising cash for growth in order to attract and retain talent appears to be a pragmatic solution.

However, we acknowledge that there is no one-size-fits-all approach, NEDs have different needs and preferences and not all want to be remunerated by way of shares or share options/incentives as part of their overall fee.

In order to review remuneration, we believe there needs to be:

- More analysis on remuneration for NED fees across comparable public markets and for private companies.
- More analysis on the legal, regulatory and tax constraints for different remuneration structures, including complexity around financial assistance, Market Abuse Regulation and disclosure obligations.
- A review of market wide policy on remuneration, particularly in respect of shareholder proxy agencies in the context of the influence they hold over voting recommendations.

The way forward

3. Build better boards

NEDs can and should make a significant contribution and if mobilised correctly can have a materially positive impact.

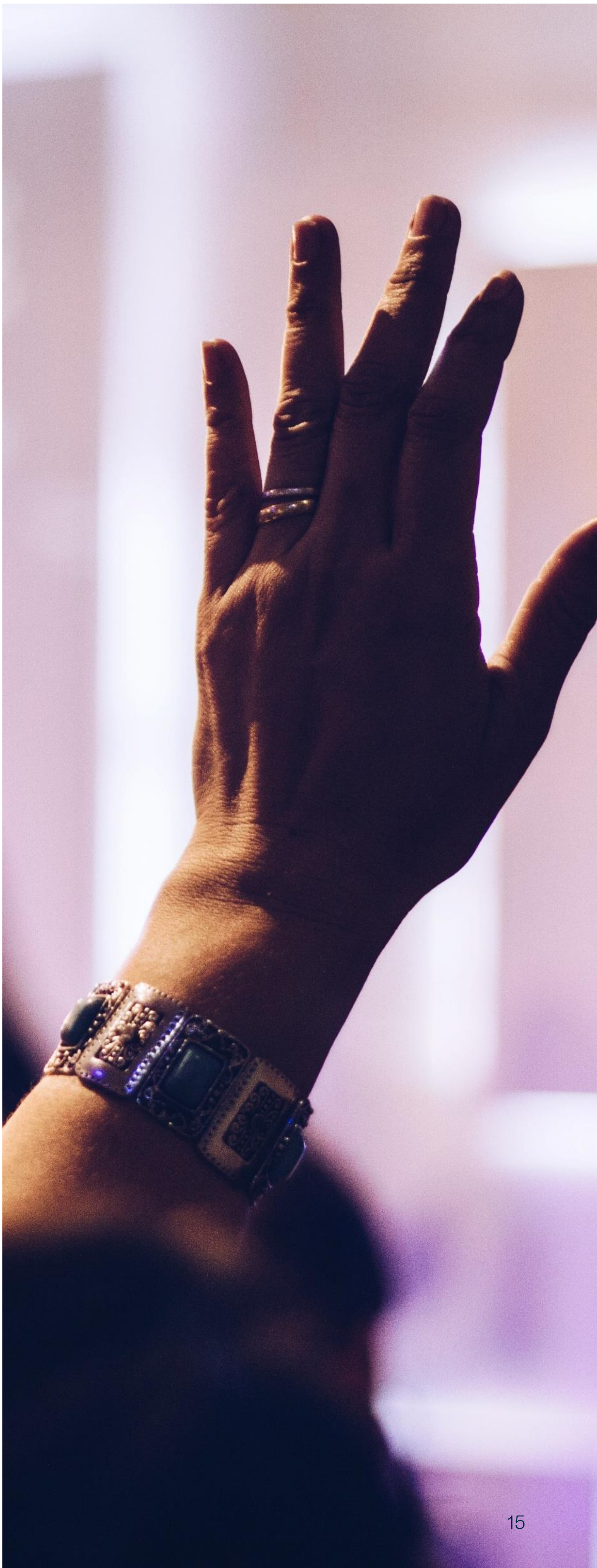
Building the right board is especially relevant for founder-led businesses or boards that could be accused of creating a "chumocracy". "Groupthink" prevents leaders from hearing dissenting voices, and that impedes effective crisis planning. A board needs to ensure it hears the alternative view.

Survey responses suggested that board selection has become a "box ticking" exercise, boards need to go back to defining the skill set in order to inform the selection process. Survey responses also indicated that board diversity has become a divisive topic. The board selection process needs to be thoughtfully designed to achieve strategic outcomes, this will help establish the right combination of background, experience, identity and skill. Diversity shouldn't be imposed without appropriate discussion, care and thought.

There also needs to be a market-wide strategy to widen the pool of diverse talent. Better education, training, management, sponsorship and mentoring will be critical elements of this and all market participants have agency in making this happen.

We identify the following areas to assist in improving boards:

- The NED appointment process: The remuneration committee needs to run a considered and transparent selection process that is designed to achieve strategic outcomes. A NED should have a full, formal and tailored induction and should understand the board's expectations about the role and how their performance will be measured.
- A continuous review of the board and the skillsets to ensure the NEDs skills and capabilities align with the business's requirements. A thorough annual evaluation of the board and its committees should be a minimum.
- Consider director re-elections on an annual basis.



About the QCA

The Quoted Companies Alliance champions the UK's community of 1000+ small and mid-sized publicly traded businesses and the firms that advise them.

We believe the public markets can be the best place for companies to source the funds to grow, operate transparently and distribute wealth, fairly.

The QCA seeks to inform policy in dialogue with regulators and government, showcase the latest thinking on leadership, investment, technology and governance through our events and research, and provide a forum to share good practice among our members, who are quoted on the Main Market, AIM and the Aquis Stock Exchange.

Informed by our six Expert Groups drawn from the membership, we campaign to ensure that regulation is proportionate, while maintaining the necessary protections for investors. Our QCA Corporate Governance Code is followed by the vast majority of AIM companies.

Small and mid-sized publicly traded companies represent 91% of the quoted sector. They employ around 2.1m people and contribute more than £25bn in annual taxation. Our goal is to create an environment where their potential is fulfilled, helping to ensure a healthy and resilient UK economy.

About finnCap Group

finnCap Group provides strategic advisory and capital raising services to growth companies.

We are small and mid-market specialists dedicated to providing the highest quality service to our clients both private and public.

We provide quality broking and fundraising capabilities alongside excellence in M&A advisory with a global reach. We have sold over 600 companies to date and are recognised as the No 1 ranked AIM Adviser, AIM Broker and LSE Main Market Financial Adviser.

finnCap Group always put clients first delivering your business ambition, whether that is to raise growth capital, IPO, refinance, raise debt for your business, execute an acquisition or sell your business.

Our specialist sector knowledge and entrepreneurial approach helps companies to achieve their ambition.

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