QCA/BDO
SMALL & MID-CAP SENTIMENT INDEX

July 2012 Issue 4

QUOTED COMPANIES ALLIANCE

YouGov
What the world thinks

BDO

INTRODUCTION
SCOTT KNIGHT, PARTNER BDO LLP

THE LATEST RESULTS FROM OUR SURVEY ACROSS THE SMALL AND MID-CAP QUOTED COMMUNITY UNDERLINES HOW FAR MARKET SENTIMENT HAS FALLEN IN RECENT MONTHS. THE CAUTIOUS OPTIMISM THAT CHARACTERISED THE START OF THE YEAR HAS GIVEN WAY TO UNCERTAINTY, AND WHAT AT TIMES FEELS LIKE ALL-PERVADING GLOOM.

We are, as Sir Mervyn King has told us, all being impacted by the “great black cloud of uncertainty” currently radiating from the eurozone. In these circumstances it is difficult to be anything other than pessimistic, which is pretty much how the sector feels at the moment.

However, our research also highlights that companies are looking to the future, beyond the current gloom, and are still remarkably upbeat about their own ability to grow. Furthermore, an increasing number are now planning to raise capital, which although not an explicit sign of growth, is nevertheless encouraging.

That said access to credit remains a problem with companies reporting credit conditions have tightened in recent months. In response, companies are increasingly considering public and private equity sources. The abiding impression is that banks are still hugely restricting lending despite claims to the counter. One wonders if the raft of new measures recently announced by the Bank of England designed to get banks lending will work, but what is not in doubt is that they are desperately needed.

The other main message from the survey is that the sector would like to see some liberalisation in financial reporting. Investors following the largest public companies may find the current detailed reporting useful, however, public companies in essence have to produce the same level of detail regardless of size.

Quarterly reporting in particular is singled-out as leading to short-termism, while the vast majority of companies and advisory firms feel that Annual Reports & Accounts are too long and complex. What is needed is more simplicity in reporting with meaningful narrative rather than short-term number crunching.

Small and mid-caps are not calling for wholesale reform; the majority still feel that AGMs are useful for example, but they do want to be free from regulation for regulation’s sake. If this can be achieved I am confident the sector can continue to thrive despite the current doom and gloom.

EXECUTIVE SUMMARY
TIM WARD, CHIEF EXECUTIVE, THE QUOTED COMPANIES ALLIANCE

LAST QUARTER WE SAW COMPANIES REMAINING UPBEAT ABOUT GROWTH. THIS QUARTER, THE TREND OF GROWING OPTIMISM HAS STALLED.

We are back to September 2011 levels for our many key confidence trackers. 69% of companies and advisors that are pessimistic this quarter, compared to 42% last quarter. Employment in our sector could also be affected – the mean expected job growth amongst companies has halved from last quarter – down to 3.6% this quarter from 6.5% in May. It is clear from these results that companies are reacting to the poor economic situation surrounding them.

However, in all this gloom, there remains a glimmer of hope. Companies are still optimistic about their own business prospects – albeit the score is at the lowest level since September 2011 themselves at 58.0[1] and down from 66.1 in May 2012.

Interestingly, the highest percentage of companies so far are planning to raise capital in the next twelve months – perhaps trying to build up reserves. Companies are turning their backs on the banks, with only 28% planning to raise capital through bank finance (down from 50% last quarter). Equity finance is the most preferred option, with 45% planning to use this means to raise capital.

Despite companies turning to the equity markets to raise finance, they are not particularly satisfied with this form of finance. This is similar to what we found in September 2011, with 58% of small and mid-caps companies seeing equity markets as hindering their development.

Out of those companies that are dissatisfied with their public quotation, 62% of companies say liquidity is the main reason markets are hindering. One way to address this is to consider changing some of the rules around how companies can issue shares.

We asked companies this quarter for their views on various reporting requirements. Small and mid-cap quoted companies believe they should be able to issue an average 24.8% share capital without having to provide a prospectus. At the moment they can only issue up to 10% before they have to produce a lengthy document. Needless to say, we will go back to the European Commission to see if we can push this limit up – as it will go a long way in helping small and mid-cap quoted companies to be able to raise finance more effectively.

Companies also believe they should be able to disapply pre-emption rights over an average of 17.9% of shares annually. This is a much higher figure than the 5% recommended in the Pre-Emption Group Guidelines – perhaps it is time to consider the effect of pre-emption rights on liquidity. There is, of course, a delicate balance between companies' need for capital and investors' need to be protected.

The double-dip recession and the Eurozone crisis are clearly taking its toll on small and mid-cap quoted companies – and affecting their prospects for growth. Access to finance and liquidity are key concerns and we must address how we can create an environment in which these companies can provide growth for the UK economy. Our results show that we need a focused debate on some of the reporting and share issuing requirements to ensure that they are appropriate for small and mid-cap quoted companies in order to guarantee that long-term value is being created for shareholders and the economy.

1 0 being very pessimistic, 50 neutral and 100 very optimistic

HIGHLIGHTS

71%

of small and mid-cap quoted companies are pessimistic about prospects for the economy in the next 12 months. **This is the most downbeat companies have been since September 2011.**

55%

of small and mid-cap quoted companies are optimistic about their own business prospects despite the gloom about the general economy. **But, this is at the lowest level since September 2011.**

46%

of companies anticipate further fundraising in the coming year, which is at the highest level since September 2011.

28%

of companies are likely to use bank finance as a way to raise funds in the coming year. **This is down significantly from April 2012 (50%).**

83%

of small and mid-cap quoted companies believe equity markets are either having **no impact or hindering their development.**

65%

of companies have not undertaken any planning for **any of the likely outcomes of the Eurozone crisis.**

69%

of small and mid-cap quoted companies think they should be allowed to increase the amount of share capital **they can issue without a prospectus from the current 10% to an average of 24.8%.**

74%

of companies and 47% of advisory firms believe that **quarterly reporting leads to short-termism among investors.**

69%

of small and mid-cap quoted companies think that annual reports and accounts are too long.

BUSINESS CONFIDENCE

GROWING CONCERNS ABOUT THE ECONOMIC OUTLOOK

Confidence across the small and mid-cap quoted community has fallen in recent months reflecting growing concerns about the macroeconomic outlook. Business sentiment across both companies and advisory firms has returned to the levels of the second half of 2011, highlighting just how brittle confidence in April was.

On a scale between zero and 100, where zero represents very pessimistic and 100 equals very optimistic, small and mid-cap quoted companies currently rank prospects for the UK economy at 38 compared to 47 in April. Advisory firms have also become equally as downbeat ranking prospects only slightly higher.

Worries over Europe and the uncertainty over the direction of the UK economy are significantly bearing down on confidence. It is far from clear how, or even when, the Eurozone crisis will end and, in the meantime, the likelihood of another prolonged recession increases.

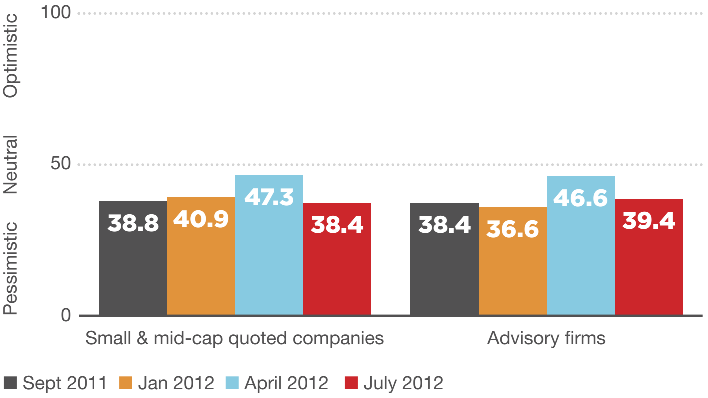
After the recession of 2008/09 many predicted it would be a long hard road to recovery. And yet the ongoing slog continues to surprise by its longevity, with the path to sustained recovery still looking far from clear cut. The UK economy has already sunk into another technical recession with the ominous events in the euro area likely to further dampen activity in the coming months.

Against this background, the Bank of England has again expanded its quantitative easing programme, as well as announcing plans for a major new loan scheme. This will be offered to banks on condition they pass it on to businesses and households in the form of cheaper loans and mortgages. Although at this early stage it is far from clear if these measures will work, they are a clear sign that the hoped for expansion in business investment is not occurring.

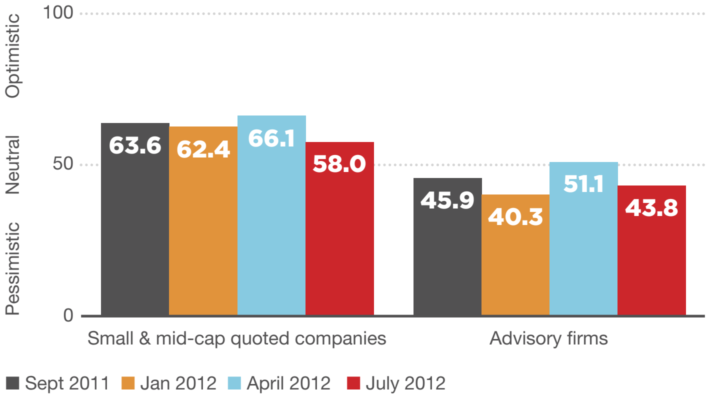
More positively, small and mid-cap quoted companies remain relatively upbeat about their own economic prospects, although confidence in the UK economy has also dipped. Nevertheless, the majority still rank prospects above the neutral 50 level, with the average score equalling 58. This suggests despite all the doom and gloom regarding the wider economy companies remain relatively confident about their own ability to survive and grow.

However, this confidence is not shared by advisory firms who are appreciably more pessimistic. After gaining ground in April, the majority of advisory firms once again have a negative view about the prospects for small and mid-cap quoted companies.

How optimistic or pessimistic do you feel about the UK economy over the next 12 months?



How optimistic or pessimistic do you feel about your own company's prospects/small and mid-cap prospects over the next 12 months?



FUTURE EXPECTATIONS
EUROZONE CRISIS HURTING ASPIRATIONS

Given the growing economic challenges, small and mid-cap quoted companies are unsurprisingly less bullish about sales growth than they were in April correlating with the confidence decline. However, the majority (68%) still anticipate turnover will increase over the next 12 months, with the average expected change in sales put at +9.7%.

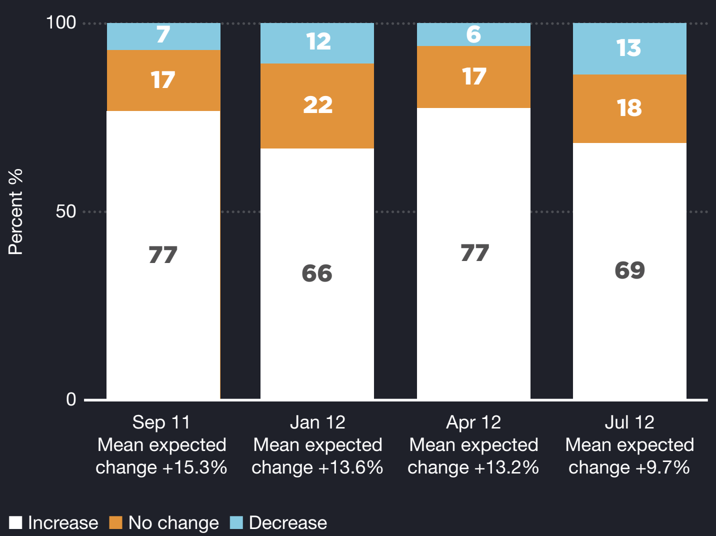
The continued capacity for small and mid-cap quoted companies to grow is a very encouraging sign and should not be overlooked given the potential gloomy outlook. However, this does contrast against an average expected change in turnover which is indicating a downward trend. This suggests that companies are finding it increasingly hard to achieve meaningful growth which could be a predictor of a continued downward outlook next quarter.

The worsening economic conditions are also having a growing impact on the ability of companies to improve their recruitment drive. Results show that only 45% of companies expect to hire in the next 12 months, which is down from the 55% reported in April. Ominously, 18% of companies anticipate cutting jobs over the same period which will ultimately have a knock on effect on employment levels once again.

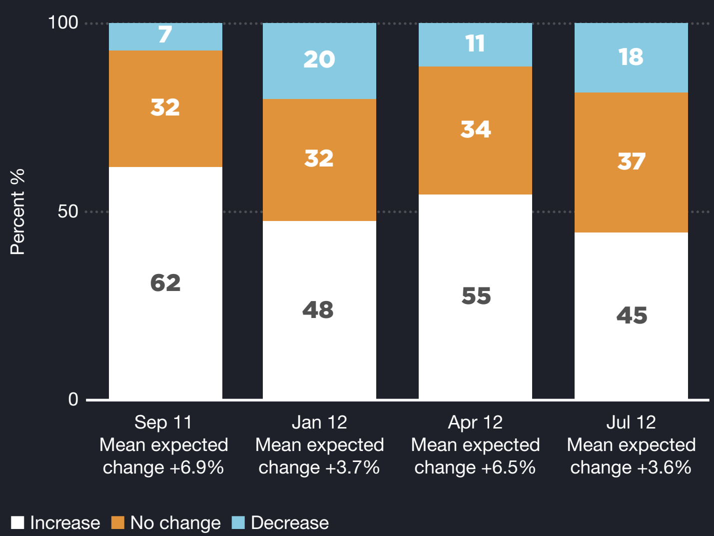
Views regarding the ultimate outcome of the Eurozone crisis are mixed. A third of small and mid-cap quoted companies believe that Greece, and at least one other country will leave the Eurozone, while a slightly lower proportion (27%) think just Greece will leave, and 25% think the Eurozone will remain intact.

Advisory firms are more explicit in believing that Greece, and at least one other country will leave the Eurozone, with half thinking this will happen. Just over a quarter (26%) believe the Eurozone will remain intact.

By how much do you expect your turnover in your business to change in the next 12 months?



By how much do you expect the number of full time employees in your business to change in the next 12 months?

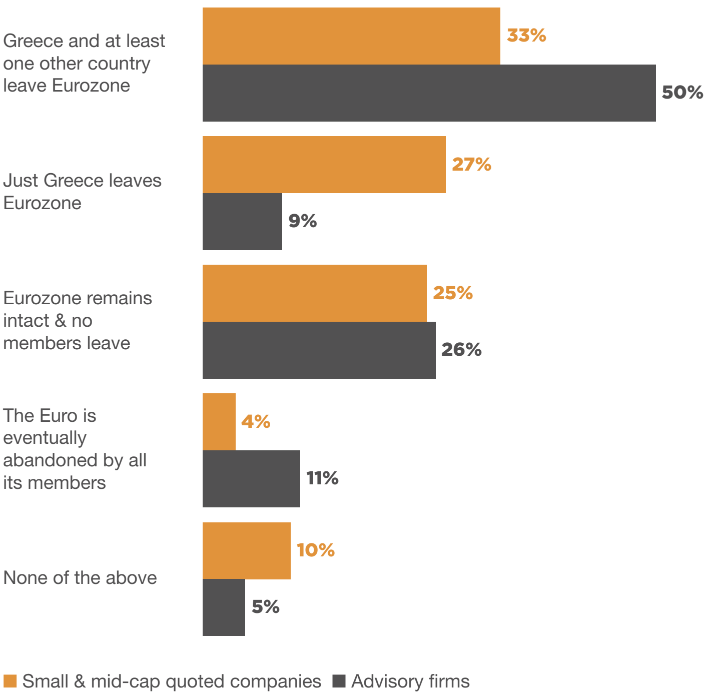


> Germany should either pay up and back a Eurobond or get out. Continuing uncertainty is the worst scenario”

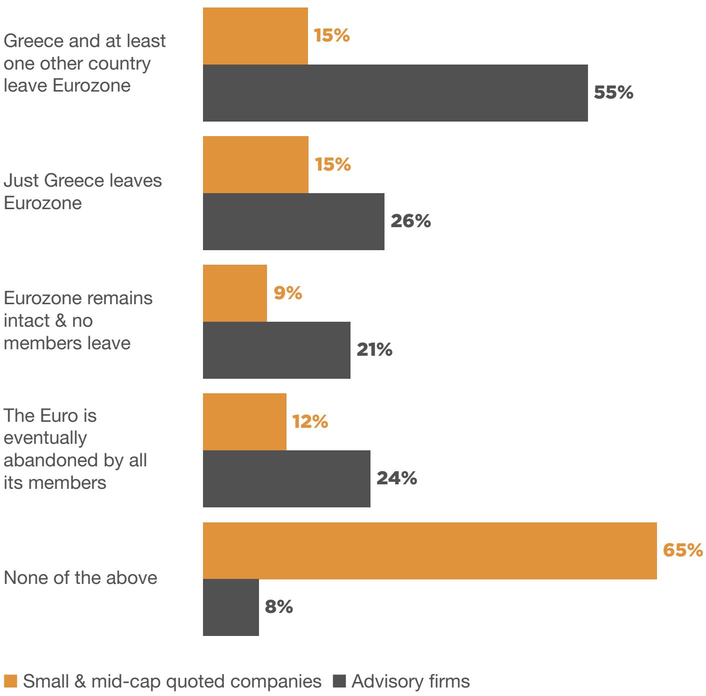
The majority of companies (65%) have not undertaken preparatory planning in the event of the possible Eurozone crisis outcomes. Where planning has taken place, it has mainly been associated with currency hedging and measures to limit exposure to Greece.

In contrast, 55% of advisory firms think companies should be actively planning for a scenario where Greece and at least one other country leave the Eurozone. The most common planning suggestions include repatriating as much cash as possible from countries in danger, and not using any law other than English or US for contracts.

What do you think the ultimate outcome of the Eurozone crisis will be?



Which, if any of these outcomes have you done planning for/think small and mid-cap quoted companies should be planning for?



QCA/BDO VIEW

Companies need to adopt a flexible approach to plans and budgets given the current uncertain circumstances.

> None, as this will take forever”

FUNDRAISING

MORE COMPANIES ARE NOW PLANNING TO RAISE CAPITAL BUT AVAILABILITY HAS DETERIORATED

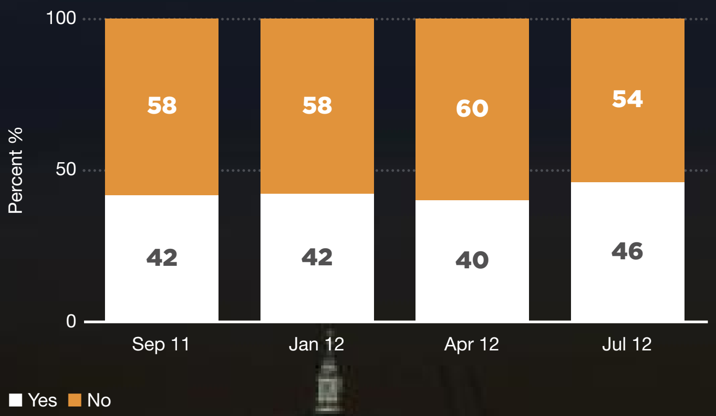
More small and mid-cap quoted companies are now planning to raise capital in the next 12 months than in any previous quarters. Just under (46%) are looking to raise capital compared with 42% reported in September 2011. Although this increase is relatively small it is an encouraging sign as it possibly implies many companies are looking to expand.

Despite encouraging signs regarding the general appetite for fundraising, credit conditions appear to have tightened in recent months. With the exception of listed debt issuance, companies believe it is slightly harder to raise finance via banking facilities, public and private equity sources.

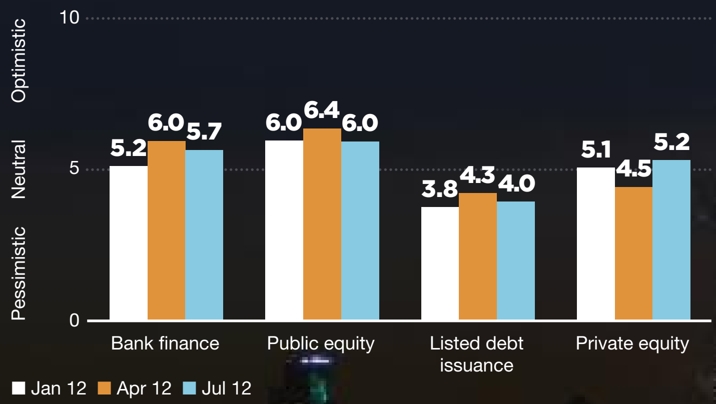
In terms of funding sources, public equity continues to gain in attractiveness largely at the expense of bank finance, which has dropped significantly. Of those looking to raise finance, just 28% of companies anticipate using banks, compared with 50% in April. This reflects the fact that companies are becoming increasingly dissatisfied with loan arrangements from banks.

Attitudes to equity markets in general have not altered much since September 2011. The majority of companies (58%) still feel that markets are hindering their own company's development.

Are you considering raising capital for your company in the next 12 months?



How easy or difficult would your company currently find it to raise finance through the following channels?

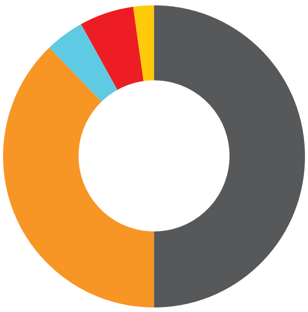


> **Poor market sentiment dampens all activity”**

A lack of liquidity continues to be highlighted as a problem. 62% of small and mid-cap quoted companies state that ‘lack of liquidity’ is why equity markets are hindering their development. One quote stated that there were ‘Low volumes and we are continually being told we are too small’ and is a view held by many companies, while others are “always worrying about the effect on the share price of short term results”. Another view shared by many is that the “time commitment to service [our] investor base is high and long term planning is impacted by short term views”.

However, a good number of companies are relatively happy with markets taking the view that “the market is not helpful at the moment but we believe that it will become more so in the future.”

What would be your preferred way of raising capital if the need arose in the next 12 months?



Apr 12

- Bank finance 50%
- Public equity 38%
- Listed debt issuance 4%
- Private equity 6%
- Other 2%

Jul 12

- Bank finance 28%
- Public equity 45%
- Listed debt issuance 6%
- Private equity 12%
- Other 9%

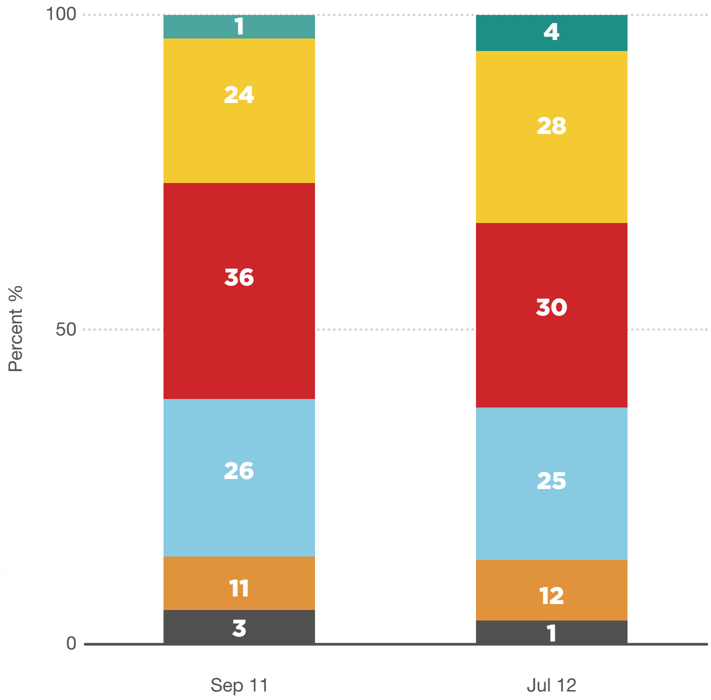
QCA/BDO VIEW

Illiquid equity markets for small and mid-cap quoted companies continue to be a clear and present problem. A holistic review of how to unblock these key economic pipelines for finance is long overdue.

How are equity markets hindering your company?

	Small & mid-cap quoted companies
Lack of liquidity	62%
Excessive regulation	38%
Costs of compliance	37%
Cost of advisory fees	26%
Lack of research	15%
Other	21%

Are equity markets currently helping or hindering your company’s development?



COMPANY REPORTING
EVOLUTION RATHER THAN REVOLUTION

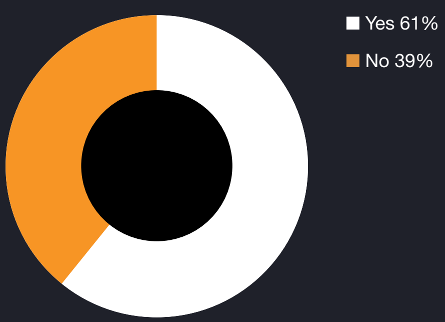
The majority (61%) of small and mid-cap quoted companies believe that AGMs should continue to be mandatory. Although one respondent observed that “[the] meeting is no longer relevant as it once was” the general consensus amongst companies is that AGMs are still useful.

Advisory firms were also generally supportive of AGMs with a similar proportion believing they should remain mandatory. “I always find I learn a lot when I attend an AGM and it gives you face time with the Board members” was how one advisor put it.

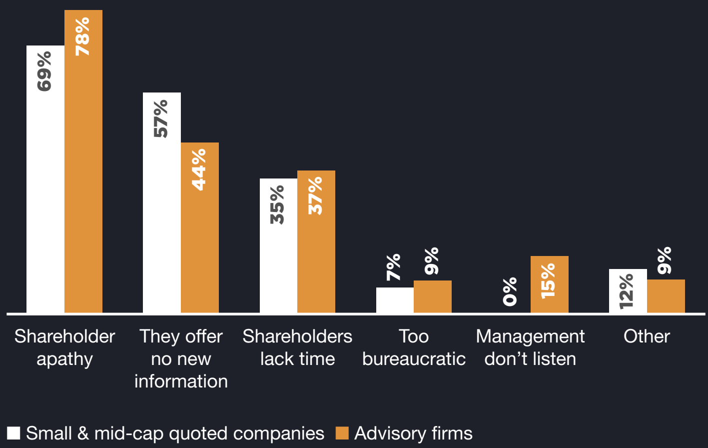
Shareholder apathy is identified as the main cause for poor attendance at AGMs, with 69% of companies and 78% of advisory firms singling out this reason. The lack of new information disclosed at AGMs is another common reason highlighted.

“Most smaller companies have large shareholders who are already involved in the management of the company and know what is going on” is how one advisor summed-up the situation, while others point out that “main shareholders have alternative access to management.”

Given that AGMs are often attended by very few shareholders, should smaller public companies be required to hold AGMs – a small number of shareholders could still request an AGM?



Why do you think AGMs for smaller public companies are typically poorly attended?



61%

THE MAJORITY (61%) OF SMALL AND MID-CAP QUOTED COMPANIES BELIEVE THAT AGMS SHOULD CONTINUE TO BE MANDATORY.

Lack of interest – companies should make a proper presentation”

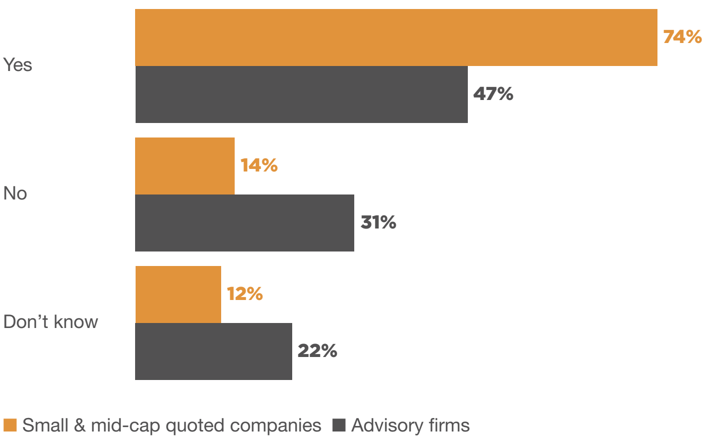
Company respondents’ view on poor attendance at AGMs

The vast majority (74%) of companies feel that quarterly reporting is leading to short-termism by investors, while two-thirds (66%) believe it has a similar impact on companies themselves. Advisory firms are less certain but also broadly agree with this view.

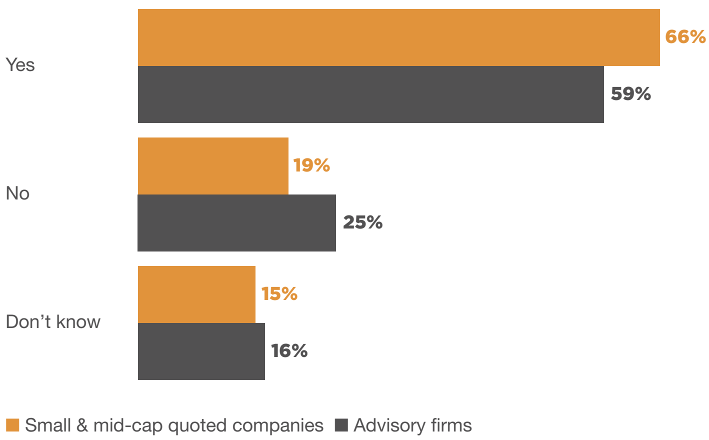
Companies and advisory firms agree that Annual Reports & Accounts are both too long and complex which is consistent with the findings from research undertaken in May 2011 by BDO who interviewed 250 Finance Directors, 114 Non-Executive Directors and 200 Fund Managers. 69% of companies and 62% of advisory firms believe they are too long, while similar views are held regarding the complexity of reporting.

Does quarterly reporting lead to short-termism by...

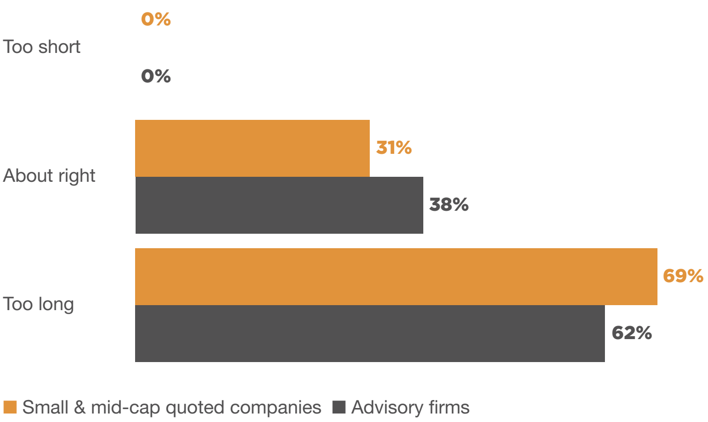
...Investors

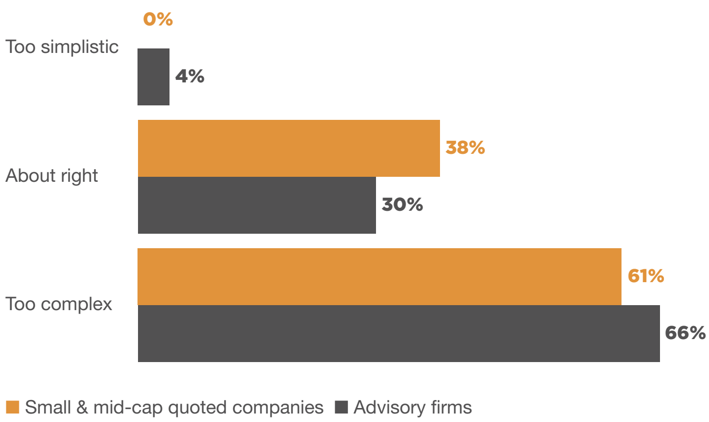


...Companies



Do you believe Annual Reports & Accounts are...



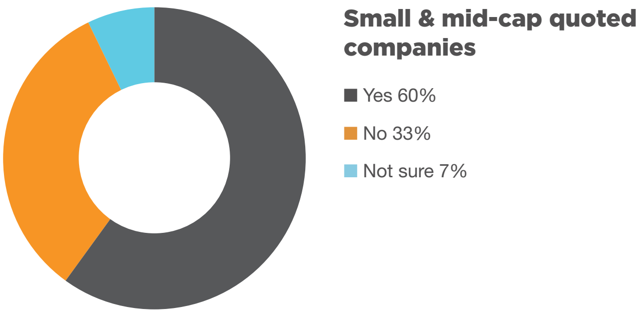


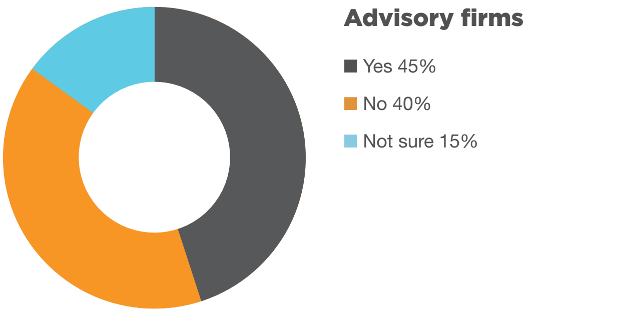
Despite believing Annual Reports & Accounts are too long and complex, the general consensus of opinion is that they do still nevertheless convey the key risks facing a company. This view is more strongly held by companies, with 60% agreeing with this observation, while only 45% of advisory firms feel the same.

On the topic of disapplying pre-emption rights, views are mixed. On average, small and mid-cap quoted companies and their advisors believe that companies should be able to seek prior shareholder approval annually to disapply pre-emption rights to a maximum of around 17% of their share capital. This is significantly higher than the 5% limit proposed for listed companies in the Pre-Emption Group Guidelines, which is promoted by major investor groups such as the ABI and NAPF.

The majority (69%) of companies and 56% of advisory firms believe that small and mid-cap quoted companies should be allowed to issue more than the current limit of 10% share capital without having to issue a prospectus. Across companies the average limit desired is 25%, while advisory firms feel the figure should be 21%. The Quoted Companies Alliance will continue to press the European Commission for an increase in the current limit.

Do Annual Reports & Accounts convey the key principal risks facing the company?

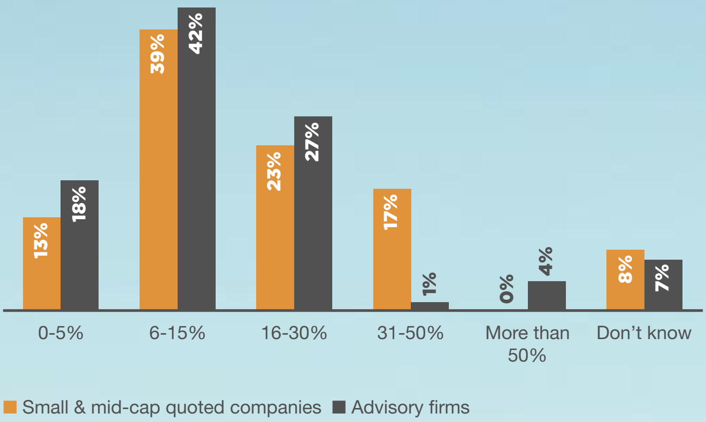




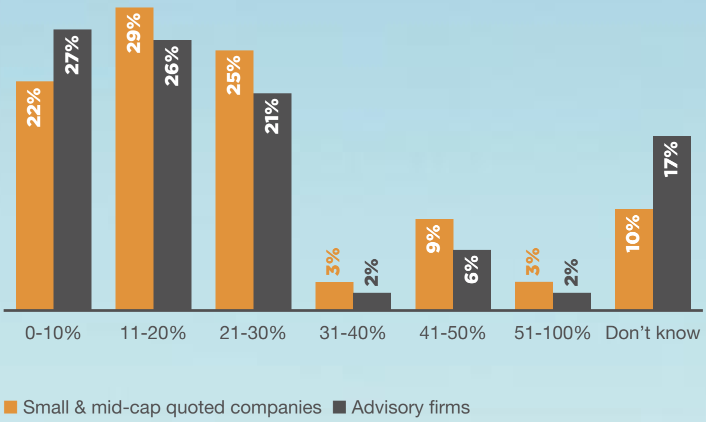
69%

OF ADVISORY FIRMS BELIEVE THAT SMALL AND MID-CAP QUOTED COMPANIES SHOULD BE ALLOWED TO ISSUE MORE THAN THE CURRENT LIMIT OF 10% SHARE CAPITAL WITHOUT HAVING TO ISSUE A PROSPECTUS.

Companies typically seek to disapply pre-emption rights over a limited number of shares annually to enable company directors to issue shares quickly to qualified investors. What should be the maximum percentage authorised annually?



What percentage of share capital should a small and mid-cap quoted company be allowed to issue without having to issue a prospectus?



QCA/BDO VIEW

It is time to explore how pre-emption rights affect liquidity and how prospectus issuance rules could be modified to enable companies to raise finance more cost effectively, whilst investors continue to be protected.

METHODOLOGY

THE QCA/BDO SMALL & MID-CAP SENTIMENT INDEX BY BDO AND THE QUOTED COMPANIES ALLIANCE (QCA) IS AN ONLINE QUARTERLY SURVEY ACROSS THE SMALL AND MID-CAP QUOTED SECTOR.

The report is based upon 204 online interviews (136 small mid-cap quoted companies, 68 advisory companies) with members and associates of the QCA. It was conducted between 18 June to 29 June 2012 by research company YouGov.

The responding sample is weighted by industry to be representative of small and mid-cap UK quoted companies, as derived by the London Stock Exchange.

Please note that not all scores in this report add up to exactly 100% due to roundings. The margin of error for the survey is +/- 8%.

Thank you to everyone who supported and participated in this survey.

If you would like further information on any of the issues covered in this report please contact:

Scott Knight
Partner
BDO LLP
55 Baker Street
London W1U 7EU
T: 020 7893 3319
E: scott.knight@bdo.co.uk

Tim Ward
CEO
The Quoted Companies Alliance
6 Kinghorn Street
London EC1A 7HW
T: 020 7600 3745
E: tim.ward@theqca.com

www.bdo.co.uk

www.theqca.com

www.yougov.com

BDO awards:

AUDITOR OF THE YEAR: LARGE FIRMS 2012

2012 WINNER OF 'AUDITOR OF THE YEAR'
2011 WINNER OF LEXISNEXIS TAXATION 'BEST TAX TEAM IN A LARGE FIRM'