QCA/BDO

SMALL & MID-CAP SENTIMENT INDEX

May 2013 Issue 7

QUOTED COMPANIES ALLIANCE

YouGov What the world thinks

BDO

INTRODUCTION
SCOTT KNIGHT, PARTNER, BDO LLP

THIS QUARTER HAS YIELDED SOME PLEASING AND ENCOURAGING SIGNS THAT CONFIDENCE IN BOTH THE ECONOMY AND OWN COMPANY PROSPECTS ARE ON AN UPWARDS TREND. WE HAVE ACHIEVED THE HIGHEST LEVEL OF THE INDEX FOR CONFIDENCE IN THE UK ECONOMY SINCE OUR REPORT WAS LAUNCHED BACK IN OCTOBER 2011. HOWEVER, DESPITE THIS SUCCESS IT IS IMPORTANT THAT COMPANIES DO NOT REST ON THEIR LAURELS, REMAIN VIGILANT AND STAY AHEAD OF THE PLAYING FIELD.

With news that the risk of a 'triple dip' recession is now behind us it is exciting to see what may develop over the coming quarter. The results of this report suggest access to capital has remained tough and it is crucial that companies are doing all they can to avoid hoarding cash reserves and stimulate an investment led return to prosperity.

Public equity is still the most popular form of finance despite the fact that it has become more difficult to obtain. This year we are witnessing increased movement in the equity markets with the number of IPOs slowly returning to robust levels. However recovery is still at a fragile state and needs more good news stories to sustain it.

One of the most interesting results to come out from this quarter is the fact that despite the increase confidence in the UK economy and own business prospects, the mean expected turnover has fallen. This result really highlights that we have to get used to 'the new normal' and appreciate that despite the fact we are seeing improved confidence, conditions for trading remain tough making it more important than ever that companies are using their non-executive directors (NEDs) knowledge to their fullest potential.

The aim for this quarter's report was to examine the role of the NED and the results obtained are most interesting. A generation ago, NEDs were brought in mainly for their extensive contact list but results from this survey confirm the demand and expectation for greater business knowledge and the provision of constructive checks and balances is where most value is added. They are also considered fantastic value for money amongst small and mid-cap companies with one company saying "The right non-executive for your business could be the best value consultant you could ever hire."

The UK economy is beginning to recover, but with more companies going bust coming out of recession than going into it, there is a clear need for the long-term vision and strategic overview that NEDs provide in order to offset the dangers of a post-recession economy, and allow businesses to begin to make plans for growth.

THIS YEAR WE ARE WITNESSING INCREASED MOVEMENT IN THE EQUITY MARKETS WITH THE NUMBER OF IPOs SLOWLY RETURNING TO ROBUST LEVELS. HOWEVER RECOVERY IS STILL AT A FRAGILE STATE AND NEEDS MORE GOOD NEWS STORIES TO SUSTAIN IT.

EXECUTIVE SUMMARY

TIM WARD, CHIEF EXECUTIVE, THE QUOTED COMPANIES ALLIANCE

CONFIDENCE IN THE UK ECONOMY CONTINUES TO IMPROVE AND, AT LONG LAST, IS NOW ABOVE 50 – INDICATING OVERALL OPTIMISM. SMALL AND MID-CAP QUOTED COMPANIES ARE ALSO INCREASINGLY CONFIDENT ABOUT THEIR OWN BUSINESS PROSPECTS WITH THE LEVEL RISING TO 65.4. BUT THE INCREASE IN CONFIDENCE IS DAMPENED BY NO MATERIAL CHANGE IN EXPECTED EMPLOYMENT LEVELS (AT 4.2%) AND A FALL IN THE AVERAGE EXPECTED SALES GROWTH FROM 11.2% TO 10.1%.

So we have companies more confident about their own and the UK economy's prospects and yet sales growth and job increases are not following suit. Perhaps the reason behind this is, whilst over 40% of companies are thinking of raising capital in the next 12 months (a steady statistic), there seems to be a view that raising capital is not particularly easy. A shortage of capital would inevitably lead many companies to scale back their growth targets even if they were more confident about their growth potential.

Public equity remains the preferred source of finance and is becoming increasingly favoured (up from 41% to 54%), followed by bank finance. This leads me to suggest that growth in the small and mid-cap space is all about stock market confidence. There is confidence about the economy and within our companies, but without the funds to fuel that growth, significant change won't happen.

Non-executive directors earn their pay

This quarter's survey looks at the role of the NED. Most companies (71%) believe that NEDs provide good value for money and sufficiently understand the business. They cost on average £31,185 per annum which works out at about £250 per hour.

The report shows a general view that executives, NEDs and shareholders should all take a longer-term view and this complements the newly launched QCA Corporate Governance Code for Small and Mid-Size Quoted Companies, which emphasises the need to ensure that a company has the structures and behaviours necessary to deliver long-term growth in shareholder value.

Conservative advisors

Advisors to the small and mid-cap community seem to be more conservative than their client companies and perhaps a little more cynical. It's interesting to see that, whilst there is a congruence of opinion about the UK economy generally with both companies and advisors equally optimistic, there is a marked difference in relative optimism about small and mid-cap prospects. This is mirrored with advisors expecting job growth of only 0.7% compared with companies expecting 4.2%. Perhaps this is tinged by what has been happening in the City over the last few years.

The only area where advisors seem to be more positive (in a cautious sort of way) is when asked whether the Budget has made the business environment for quoted companies better, worse or has had no overall effect. 63% of them said the Budget had made it a little better whereas only 47% of companies expressed the same view.

Very few felt the Budget had made things a lot better. The benefit of allowing AIM and ISDX shares into ISAs and abolishing stamp duty on AIM and ISDX share transactions is acknowledged by many, but the benefit is still awaited. The Quoted Companies Alliance is delighted with these policy announcements and we will continue to campaign for more fiscal incentives to fuel small and mid-cap growth.

HIGHLIGHTS

72%

of small and mid-cap quoted companies are optimistic about their own business prospects, **which mirrors the result in January.**

27%

of small and mid-cap quoted companies are pessimistic about prospects for the UK economy over the next 12 months, **down 6% from 33% in January.**

75%

of companies expect sales to grow in the next 12 months, with the average expected growth in turnover put at +10.12%, **down from January (+11.2%).**

57%

of companies expect to increase headcount in the next 12 months, **with the average expected change in employment growth put at +4.2%.**

54%

of small and mid-cap businesses prefer public equity for raising capital, **up from 41% in January.**

71%

of small and mid-cap quoted companies believe they get **good value for money from their NEDs.**

£250

per hour is the average wage for a NED in a small and mid-cap quoted company.

70%

of companies believe that NEDs contribute the most value to their companies **through their broader business experience.**

83%

of companies believe that their NEDS are **sufficiently independent from management** to provide a critical voice to the running of their company.

BUSINESS CONFIDENCE

For the first time in our Index, we witness small and mid-cap companies indicating optimism in the UK economy over the coming 12 months.

On a scale between zero and 100, where the 50 mark separates optimism from pessimism, small and mid-cap quoted companies currently rank prospects for the UK economy at 51.8 compared to 47.8 in January. Confidence in advisory firms followed a similar pattern, increasing to 51.4.

Companies were forced to endure a tough first quarter in 2013 with the coldest April on record and the threat of a 'triple-dip' recession looming. Now with both these issues behind us, small and mid-cap companies should cautiously consider this upwards trend towards optimism as an encouraging sign of more good things to come.

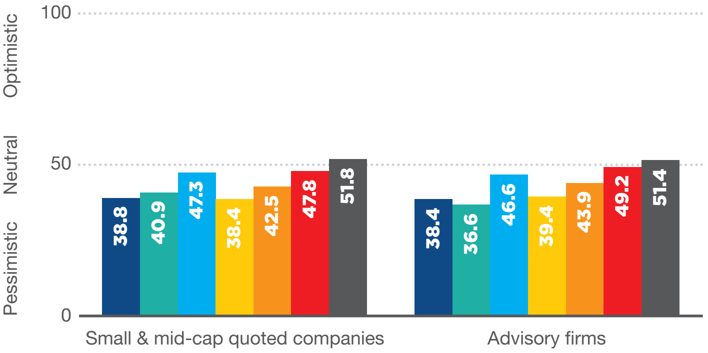
This bump in confidence can largely be attributed to improved output in the services sector with a small contribution from the production sector. We have also witnessed improving confidence in the equity market and improving financial conditions supported by lax monetary policy.

Furthermore, despite the controversial bailout of Cyprus, the state of the Eurozone appears more stable with small and mid-cap companies seemingly less at risk to the potential side effects a collapse of the Eurozone may hold.

Generally speaking business prospects remain uncertain with UK recovery still hinged on many external factors.

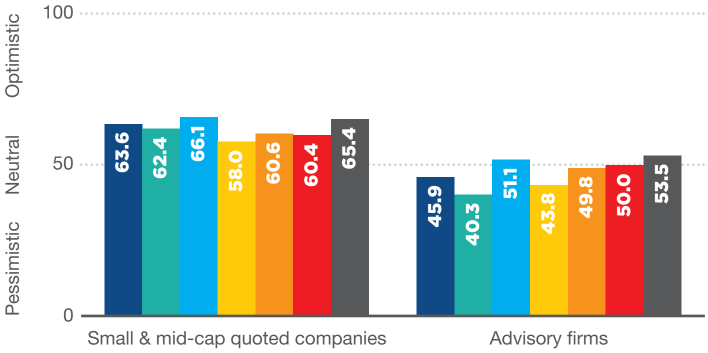
Companies remain optimistic about their own business prospects over the next 12 months with levels reaching the second highest we have seen since October 2011. Generally we have seen a steady upwards trend since July 2012 and this quarter marks the highest level of optimism shown from advisors who historically fall on the side of pessimism.

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



Oct 11 Jan 12 Apr 12 Jul 12 Oct 12 Jan 13 Apr 13

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



Oct 11 Jan 12 Apr 12 Jul 12 Oct 12 Jan 13 Apr 13

QCA/BDO VIEW

It is extremely encouraging to see optimism above the 50 mark. Over the past 18 months of our Index, there is a clear upward trend in optimism in the UK economy, which will hopefully continue.

However UK businesses must remain aware that they cannot afford to become complacent. The economy is still relatively fragile and external knocks may yet have a detrimental effect on our recovery. It must be remembered that despite the improvement in confidence we still have a long way to go before we reach pre 2008 levels.

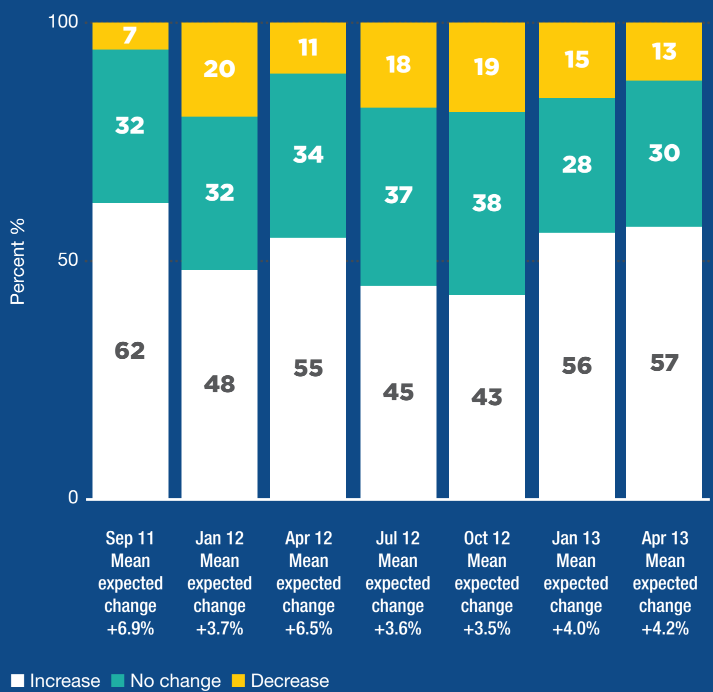
FUTURE EXPECTATIONS

Employment prospects in the UK look marginally better than the previous quarter suggesting things may be starting to look up. According to the ONS, the UK employment rate for those between 16 and 64 remains virtually unchanged at 71.4% but the vacancy rate is up 4% showing signs of improvement. However, the average advertised wage has fallen 4% and annual wage growth has fallen below inflation since 2009 making it increasingly difficult to gauge the true state of the market.

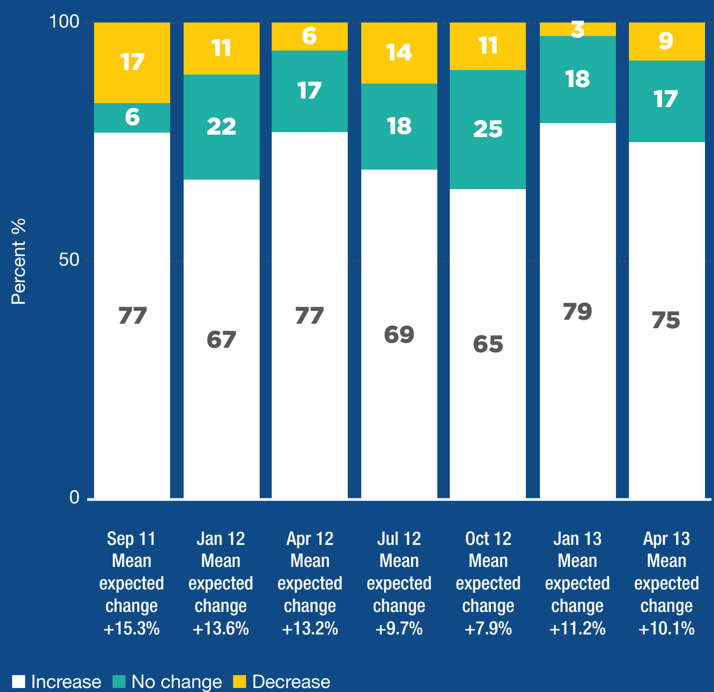
Despite the mixed condition in the UK job market, small and mid-cap companies expect to remain robust with 57% of companies expecting their work force to grow over the next 12 months. With the economic sentiment index at its highest level yet we could be forgiven for expecting greater levels of growth in terms of employment. However, this minor bump is in line with what we would expect to see with confidence being a leading indicator of employment growth.

A more interesting finding is the fact that the number of small and mid-cap companies expecting an increase in turnover has fallen along with the mean expected turnover. This relationship highlights the fact that despite businesses feeling more confident in the economy the market is still a tough place to trade.

Do you expect the number of full time employees in your business to change in the next 12 months?



By how much do you expect your turnover to change in the coming 12 month period?



QCA/BDO VIEW

This is the fourth consecutive quarter we have witnessed an increase in advisors' and companies' optimism towards the UK economy suggesting we may be witnessing a trend of upward optimism.

However this sustained rise in optimism has not translated to significant growth in expectations regarding company's employment or turnover. In fact, companies' expected turnover growth has gone down since the last wave, while expectations regarding job growth have only gone up marginally for both advisors and companies. This may be due to the concept of 'the new normal' having an impact on the psychology of businesses.

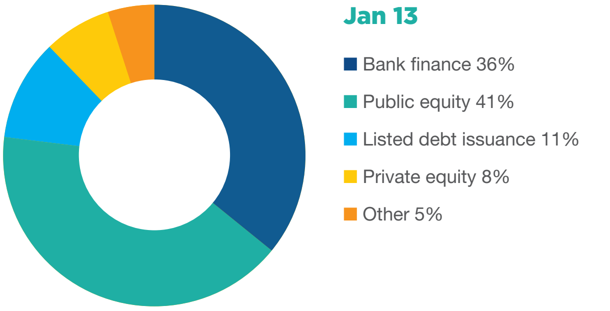
FUNDRAISING

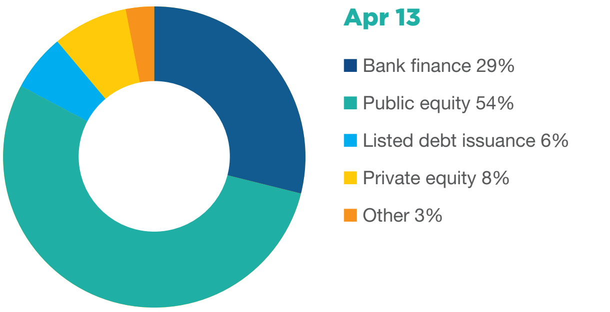
Overall both small and mid-cap companies and advisors believe obtaining finance is still relatively difficult to come by and has remained roughly unchanged since last quarter.

Public equity remains the most popular method to raise capital and has seen the number of businesses preferring this method grow from 41% to 54%. Bank finance has remained as the second most popular method but has fallen from 36% to 29%. Listed debt has also fallen in popularity over the last quarter with 6% of companies stating it as their preferred method of raising capital – down 5% from January 2013.

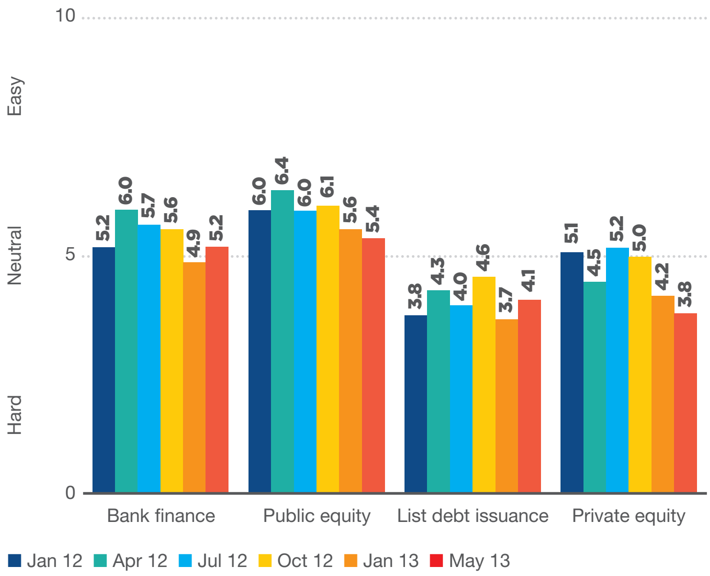
These results strangely demonstrate an inverse relationship against change in ease of access. Both small and mid-cap companies and advisors have suggested public equity is marginally more difficult to obtain but has grown 13% in popularity. Likewise bank finance is supposedly easier to access but is 7% less popular.

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





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



QCA/BDO VIEW

Perversely the sources to finance becoming more popular are becoming more difficult to obtain. This relationship between ease of access and popularity is difficult to explain but it may be attributed to the improving public equity market conditions. Some parties are suggesting 2013 is the year for the return of a healthy public equity market and our results imply this may be the case.

THE ROLE OF THE NON-EXECUTIVE DIRECTOR

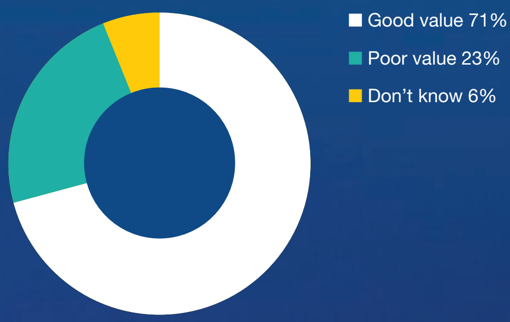
NEDs are an invaluable commodity to many quoted companies and when they successfully manage the difficult balancing act of their role they can bring an array of knowledge and experience to the board of a company. A good NED typically offers an objective strategic perspective, extensive contact list and specific skills which the board may lack such as experience during corporate transition.

With the ever growing concern over executive's remuneration we were interested to see whether the cost of a NED on small and mid-cap companies' boards presents good value for money.

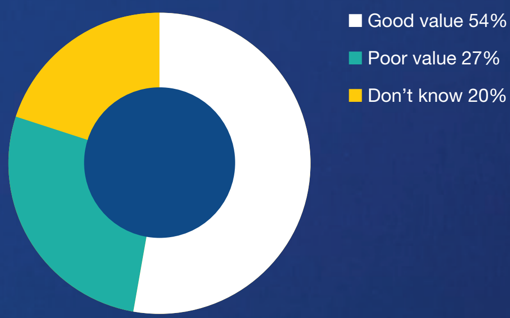
71% of companies believe that their NEDs are good value for money but interestingly only 54% of advisors believe they are good value for money. This difference can largely be attributed to the fact 14% more advisors answered 'don't know'. There may also be an element of conflict of interest as a 'valuable' NED could replace the function of certain advisors. Furthermore, advisors generally take a more cynical position.

Non-executive directors: Value for money

Small and mid-cap companies:



Advisors:



"The right non-executive for your business could be the best value consultant you could ever hire.

Small and mid-cap company's viewpoint

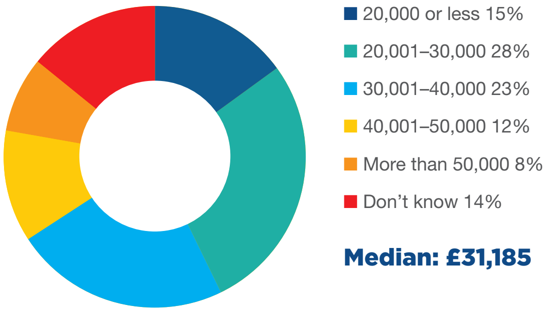
> **NEDs are one of the most valuable resources for a quoted company and currently they are 'cheap' compared with buying in that expertise via consultants or full time executives.**
> Advisor viewpoint

On average NEDs at small and mid-cap companies work ten hours per month. Based on the median annual salary of £31,185 the median pay per hour is £250.

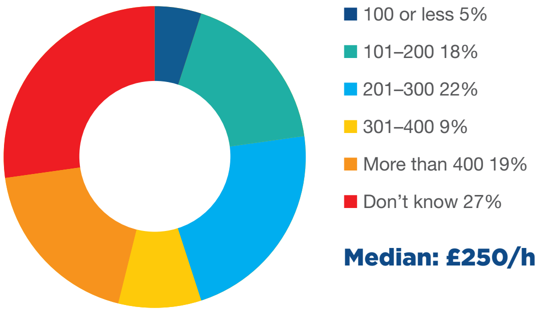
We found that the median number of NEDs at small and mid-cap companies was three. Based on the number of NEDs and average salary we calculated the total NED wage bill per year with the median totalling £105,000. For many businesses this is a relatively low fee in exchange for the experience and quality of advice received from many NEDs. With top level advisors such as partners in accountancy and law firms charging in the region of £500 per hour it is easy to see why the majority of small and mid-cap companies believe their non-executives are good value for money.

Three is the median number of non-executive directors in a small and mid-cap quoted company – which is higher than the minimum recommended in the UK Corporate Governance Code and the QCA Corporate Governance Code.

Non-executive directors: Mean salary per annum



Small and mid-cap companies pay per hour



Being a Non Exec is much harder work than the majority of those taking on the job assume before they start. It is also very rarely well paid in relation to the time and effort spent.**

Small and mid-cap company's viewpoint

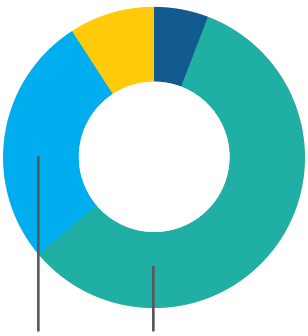
Most companies are happy with the number of hours worked by their NEDs, with 58% indicating that their NEDs put in as many hours as they should. However 36% do believe that NEDs should work more for their companies. Advisors are far more likely to be critical, with 80% believing NEDs should work longer hours, and only 17% indicating that NED hours worked are about right.

Of those that said they believe NEDs should spend more time than they currently do the average amount extra was 9.4 hours, when asking advisors the expectation was even greater with those who expect more from non-execs believing 11.2 additional hours should be committed.

58%

of companies believe that NEDs spend about the right amount of time working for them, while 80% of advisors believe that non-executives should spend more time working in their roles.

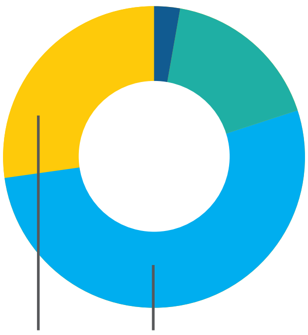
Non-executive directors – Perception of hours worked



Small and mid-cap companies

- NEDs spend too much time 6%
- About right 58%
- NEDs should spend 1–10 hours a month more 27%
- NEDs should spend more than 10 hours a month more 9%

Total should spend more: 36% this group believes NEDs should spend on average 9.4 hours more



Advisors

- NEDs spend too much time 3%
- About right 17%
- NEDs should spend 1–10 hours a month more 53%
- NEDs should spend more than 10 hours a month more 27%

Total should spend more: 80% this group believes NEDs should spend on average 11.2 hours more

The value of Non-Executive Directors

The results of this report have revealed an interesting change in the perspective of the stereotypical NED and his/her role. The findings suggest that we are moving away from feeling that non-executives are just a regulatory requirement. Instead we see companies saying that they are most valuable for providing broader business advice (70%), ensuring checks and balances are made on directors (65%) and improving corporate governance (54%).

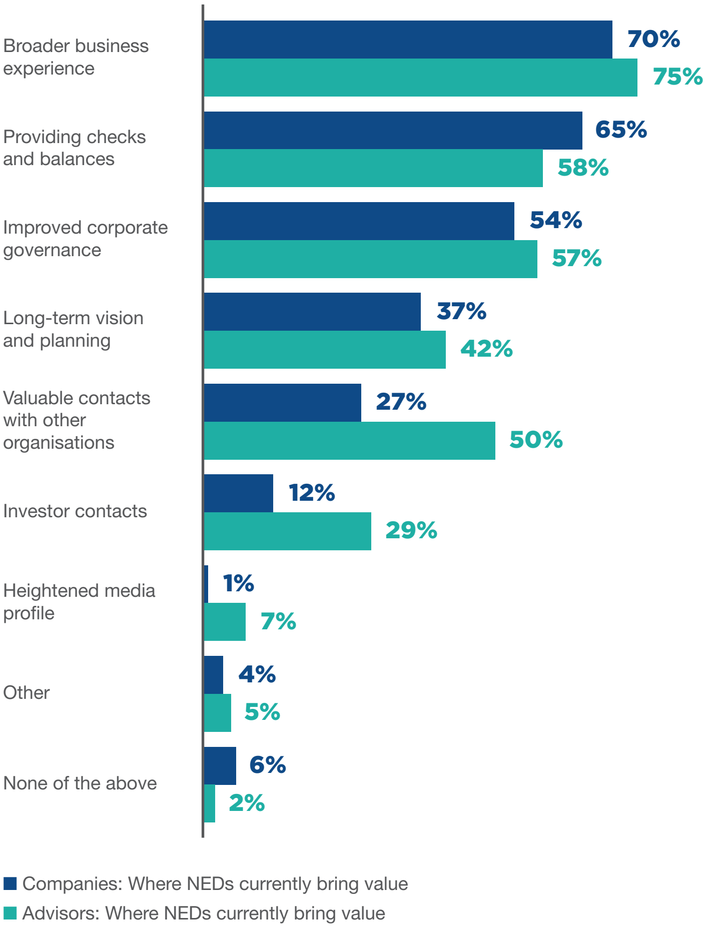
At the same time, companies still want to see non-executives bringing more external wisdom and outside contacts to their businesses. 45% want their non-executives to bring more valuable contacts with other organisations, 37% want more long-term planning from their non-executives and 31% want a greater number of investor contacts.

If done well, non-executive directorship is a valuable resource...Patchy performance from this resource in the past should not let it be under appreciated now.

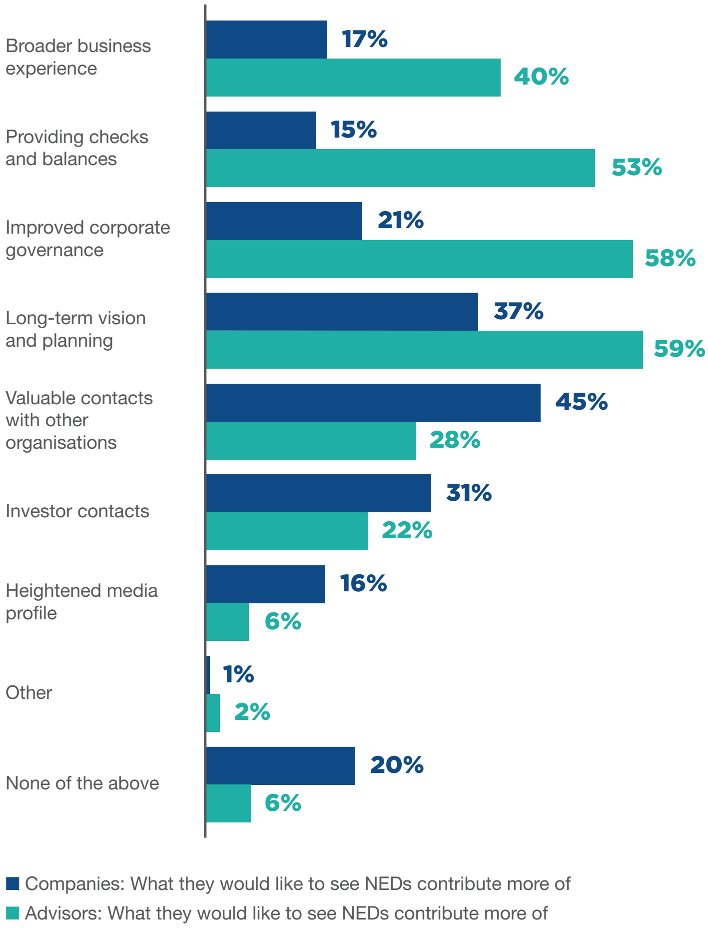
Small and mid-cap company's viewpoint

> **[Non-executive directors are] tremendous value for money, should always be chosen with care to make sure that, not only do they bring the expertise required, but the board chemistry works for them too.**
>
> Small and mid-cap company's viewpoint

Non-executive directors – where they are contributing value to their companies



Non-executive directors – What they should contribute more of



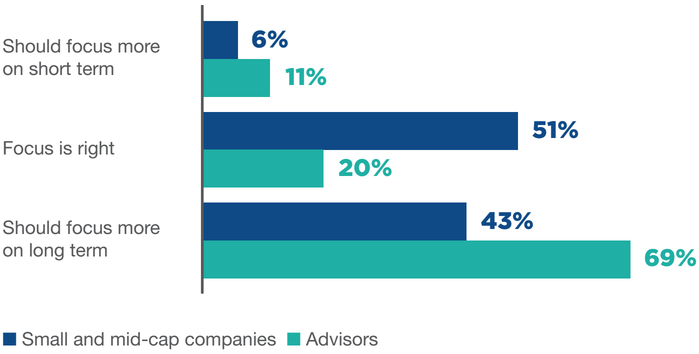
QCA/BDO VIEW

Both advisors and small and mid-cap companies have called for greater long-term vision and planning from their non-executive directors. With optimism levels at their highest since we launched this report it is crucial that non-executives help translate this increased optimism into growth.

Focusing on the long or short term

When looking at the strategic time frame non-executives operate, there is a clear disparity between what advisors believe they should be focusing on and where small and mid-cap companies think their focus lies. 69% of advisors believe that they should focus more on the long term whilst only 43% of companies think this should be the case. Additionally more small and mid-cap companies believe their focus is right whilst advisors are more sceptical with only 20% believing this to be the case.

Short term or long term perspective of non-executive directors



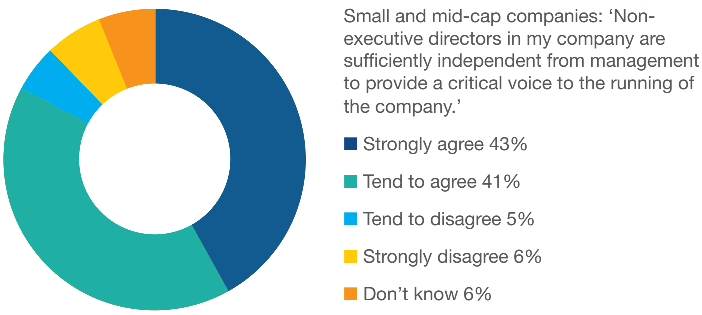
The role changes as companies grow: They need to be less independent but no less wise in early days

Small and mid-cap company's viewpoint

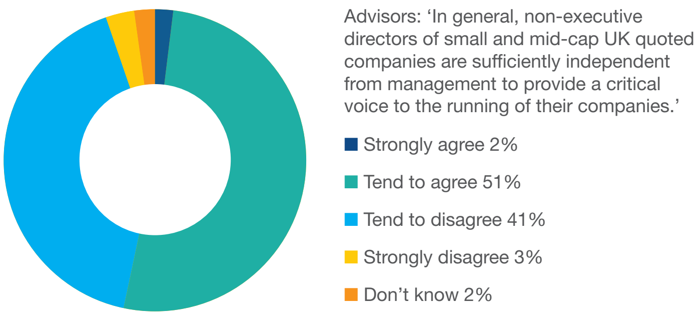
The independence of non-executive directors

There is again a clear disparity between the answers small and mid-cap companies gave and those that advisors gave when asked if NEDs are sufficiently independent from management to provide a critical voice to the running of the company. Throughout this report an element of scepticism has been prevalent from the advisors versus those answers provided by the small and mid-cap companies. This question highlights this difference strongly with 84% of small and mid-cap companies agreeing that there is sufficient independence of non-executives to challenge management, while 44% of advisors believe that they do not.

Independence of non-executive directors



Total agree: 84%



Total agree: 53%

Non-executives and their knowledge

Overall small and mid-cap companies and their advisors feel that NEDs are knowledgeable about the companies they work for. 90% of small and mid-caps and 95% of advisors believe that NEDs are very, slightly or fairly knowledgeable about their companies and its business performance.

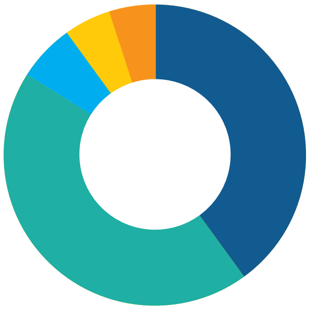
However, similar to other questions, there is some disparity between companies and advisors with 40% of companies classing their non-executives as very knowledgeable about their business and only 9% of advisors believing this.

“

Too little emphasis is placed on a non-executive's knowledge of a business and too much on the independence of unknowledgeable ones.

Small and mid-cap company's viewpoint

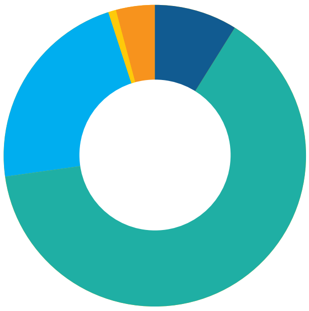
Non-executive directors – knowledge about their companies



Small and mid-cap companies: To what extent are your company's non-executive directors knowledgeable about your company and its business operations?

- Very knowledgeable 40%
- Fairly knowledgeable 44%
- Slightly knowledgeable 6%
- Not knowledgeable at all 5%
- Don't know 5%

Total knowledgeable: 90%



Advisors: In general, to what extent are the non-executive directors of small and mid-cap UK quoted companies knowledgeable about their companies and their business operations?

- Very knowledgeable 9%
- Fairly knowledgeable 64%
- Slightly knowledgeable 22%
- Not knowledgeable at all 1%
- Don't know 4%

Total knowledgeable: 95%

QCA/BDO VIEW

It is really positive that the knowledge levels of NEDs are so high. It dispels the myth that executives can keep them at an arm's length.

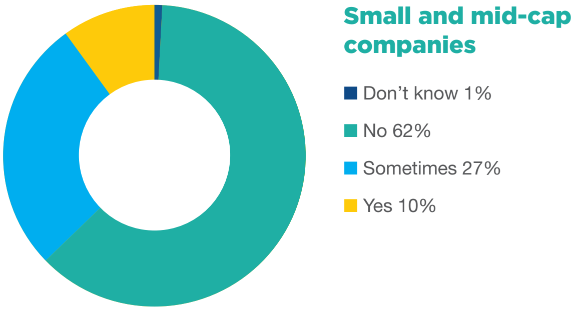
QCA/BDO VIEW

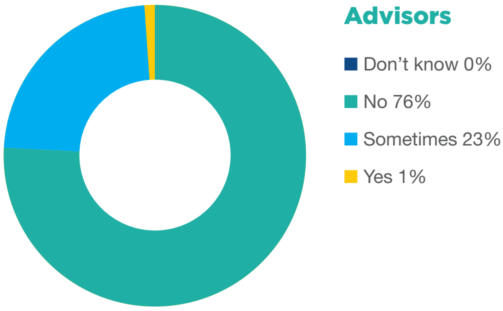
We accept that some AGMs do not provide valuable interaction between the directors and private investors but we believe that directors should always try to attend the AGM.

Non-executives and Annual General Meetings

37% of small and mid-cap companies believe that in certain circumstances it is acceptable for a NED to miss their company's Annual General Meetings. This is surprising when many would consider attending AGMs as one of the few opportunities to engage with private shareholders. The difference between how advisors and companies answered highlights that there is a clear gap in expectation between small and mid-cap companies and advisors.

Barring personal circumstances, is it ever acceptable for non-executive directors not to attend their company's Annual General Meetings?





Follow up on the Budget Announcement

Following on from previous surveys where we asked about fiscal incentives, we wanted to gauge the small and mid-cap quoted company sector's reaction to the Budget announcement in March.

The Autumn Statement in December 2012 brought the announcement that AIM and ISDX shares would soon be eligible to be placed in Individual Savings Account (ISAs) and, the Budget brought even better news that stamp duty on AIM and ISDX shares will be removed from April 2014.

When asked whether the Budget has made the business environment for quoted companies better, worse, or has had no effect, 43% of companies said no change and 47% said it made the environment a little better.

QCA/BDO VIEW

Given all the good news, we expected to see a greater number of companies saying that the Budget has improved the business environment. However, the relative levels may be because the announcements on stamp duty and ISAs for AIM and ISDX shares have not yet come into effect. We may see people getting more positive next year when the effects are felt.

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 222 online interviews (125 small mid-cap quoted companies, 97 advisory companies) with members and associates of the QCA. The survey respondents included 73% of small and mid-cap company employees in a board level position and 38% of advisors in a senior management position. It was conducted between 17 April and 01 May 2013 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
BDO LLP
55 Baker Street
London W1U 7EU
T: 020 7893 3319
E: scott.knight@bdo.co.uk

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

www.bdo.co.uk

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