



QCA/BDO

SMALL & MID-CAP SENTIMENT INDEX

May 2012 Issue 3

INTRODUCTION

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THE RESULTS OF THE SURVEY THIS QUARTER SURPRISED ME IN A NUMBER OF WAYS. FIRSTLY THE UPTURN IN CONFIDENCE WAS GREATER THAN I PREDICTED. HOWEVER WE LIVE IN SUCH FAST MOVING TIMES THAT ROBERT PESTON'S COMMENTARY THE NIGHT

BEFORE CHANGES OUR VIEWS THE FOLLOWING DAY ALTHOUGH I DO SENSE A RISE IN OPTIMISM AND A CHANGING MOOD AMONGST SMALL CAPS ALBEIT FRAGILE.

The second surprise was the low level of support for paying part of the non-executives remuneration in equity instruments. Numerous clients are keen to retain cash but want good quality NEDs. The level of involvement a NED needs to have today makes them more akin to a part time executive. Cash remuneration of £25,000 does not make it sufficiently attractive for many and in discussions with clients most support issuing restricted shares and keeping cash remuneration modest. However this clearly is not representative of the broader sector as the survey shows. Clearly the shareholding of the NED shouldn't become material to their net worth, but this is the exception rather than the rule.

The third surprise was the number of "don't knows" on the question of the role of the Proxy Voting Agencies. I sense this is a growing issue and if we test this again in 12 months time we will see opinions solidify. Those that did respond indicated that there is a growing concern about 'checkbox governance' rather than intelligent business stewardship.

The biggest surprise is that we, at last, found someone who thinks that red tape and bureaucracy will reduce. The long awaited bonfire of red tape; a cornerstone of the much needed supply side reforms seems as far away as ever.

The one result that came as no surprise was the strong support for a mandatory corporate governance code for AIM companies, 92% supported this on the basis that it is appropriate for the size and complexity of the business and it is based upon the principle of comply or explain. The levels of governance in AIM companies is, in my experience, generally good, there will be always be outliers but I think the result shows that most companies believe a mandatory code will demonstrate how good their governance practices actually are. The UK Corporate Governance code, issued by the FRC, would not be appropriate for most smaller AIM Companies but other guides, such as that published by the QCA could easily become the de facto code for AIM Companies.

Finally I would like to thank all those that responded and encourage anyone who has a burning issue that impacts the small cap sector to get in touch. We are happy to test responses to issues and bring attention to them where there is a clearer market view.

92%

THE ONE RESULT THAT CAME AS NO SURPRISE WAS THE STRONG SUPPORT FOR A MANDATORY CORPORATE GOVERNANCE CODE FOR AIM COMPANIES, 92% SUPPORTED THIS ON THE BASIS THAT IT IS APPROPRIATE FOR THE SIZE AND COMPLEXITY OF THE BUSINESS AND IT IS BASED UPON THE PRINCIPLE OF COMPLY OR EXPLAIN.

EXECUTIVE SUMMARY

TIM WARD, CHIEF EXECUTIVE, THE QUOTED COMPANIES ALLIANCE



WE ARE STARTING TO SEE SOME REAL BURSTS OF SUNSHINE IN THIS QUARTER'S RESULTS.

Small to mid-sized quoted companies' confidence about their business prospects has been modestly rising over the last three quarters and their

advisers are starting to agree with them. For the first time advisers are, on balance, positive about the prospects for small and mid-sized quoted companies.

In addition, over the next 12 months the majority of firms expect to hire more employees and expect turnover to grow steadily by about 13%.

Another glimmer of sunshine is provided by the news that access to finance appears to be improving with companies telling us that it is getting less difficult to raise finance through banks, listed debt issuance and public equity than it was at the start of the year. About 40% of companies are considering raising finance for their company in the next 12 months, consistent with previous periods – and 38% say that their preferred method is to raise equity on the market.

This is all encouraging news – especially as the UK is grappling with the double-dip recession. These results show the resilience of the small and mid-sized quoted company sector. Most importantly, small and mid-sized quoted companies are in an excellent position to drive UK economic recovery.

We also asked the sector for its view on corporate governance. An overwhelming majority of companies and their advisers (92%) support a corporate governance code for standard listed, AIM and PLUS-quoted companies that is appropriate to the size and complexity of the company and where it is mandatory to comply or explain. We see this as a very strong endorsement of the principles-based approach of the Quoted Companies Alliance's Corporate Governance Guidelines for Smaller Quoted Companies.

We also found a divergence in opinion as to whether non-executive directors are well enough informed to challenge management on their management of risk. 77% of small and

mid-cap quoted companies said that they believe non-executives are well enough informed. However, only 36% of advisers believe this. Perhaps companies need to discuss this issue more with their advisers.

The media continues to report various breakdowns in the communication of companies and their shareholders; regulators and the Government continue to explore ways to facilitate shareholder engagement. However, we found that the majority of small and mid-sized quoted companies (64%) feel that their institutional shareholders are very engaged or engaged with their company. The issue of shareholder engagement could be a 'non-issue' for small and mid-sized quoted companies.

The role of proxy voting agencies in the corporate governance space is something that is becoming more public; so we asked the sector about their views on them. While the majority of respondents 'don't know' what their view on proxy voting agencies is, those that did are largely negative about their role – they think that proxy agencies impair the dialogue between companies and investors and hinder good corporate governance. This is a debate that is just beginning. We may see that more companies develop a view once they encounter proxy agencies – and the results suggest these views may be more negative than positive.

We have also researched whether companies' behaviour when recruiting is beginning to change. Of those who have recruited to board positions or other executive positions in the last 12 months, 23% specifically sought out female candidates, with 38% having female candidates on the short list and 28% appointing a female candidate. This is a small sample, but nevertheless an encouraging result. Behaviours are beginning to change and diversity is clearly an important issue for the small and mid-sized quoted company sector.

All of our results show the potential of the small and mid-sized quoted company sector. These companies are ambitious to grow; being seen to have good corporate governance is important to them; and they are adapting to changing behaviours. There is no better time to help them drive growth. Let's hope the sun continues to shine.

HIGHLIGHTS

26%

of small and mid-cap quoted companies are optimistic about prospects for the economy in the next 12 months, **which is a considerable improvement to January 2012 (18%)**.

77%

of companies expect sales to grow in the next 12 months, with the average expected growth in turnover put at +13.2%, **only slightly down compared to January 2012 (+13.64%)**.

55%

of companies believe they will need to take on more employees in the coming 12 months, **with the average expected change in employment growth put at 6.5%, almost double the growth expected in January 2012 (+3.7%)**.

40%

of companies anticipate further fundraising in the coming year, **with 38% likely to use public equity**.

1%

of companies believe that regulation will decrease over the next 12 months, **with 78% fearing it will increase**.

92%

of companies support the idea of establishing a mandatory corporate governance code for standard listed, AIM & PLUS quoted companies, **which is fit for purpose and take into account their size and relative lack of complexity**.

47%

of companies believe that the recent Government approach to corporate governance is unnecessary, **with 30% thinking it is constructive**.

77%

of companies feel that the non-executive directors on their boards are well informed enough to challenge management on their management of risk, **but 36% of advisory firms believe non-executive directors of small and mid-caps are not well informed enough**.

64%

of small and mid-cap quoted companies believe that their institutional investors **are engaged or very engaged with their companies**.

BUSINESS CONFIDENCE

HOPE SPRINGS

Despite the UK economy entering double-dip territory, confidence among small and mid-cap quoted companies has improved noticeably in recent months. In addition, the normally downbeat advisory firms across the sector are also not as darkly pessimistic as they were a few months ago.

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 47 compared to 41 in January – so still in negative territory.

More surprising, advisory firms who have historically been the naysayers of the sector share this optimism also scoring prospects at 47. Moreover, both groups also now believe that the economy will do better over the year ahead compared to the last 12 months.

This improvement comes in the wake of mixed economic news. Many trade surveys are pointing to recovery and improving momentum, but the official figures suggest the economy is technically in recession again. Although this official estimate of growth will be subject to at least two revisions in the coming months, which some forecasters believe will lead to upward amendments, it is clear that growth remains painfully slow.

Meanwhile, as long as the Euro crisis continues, risks of a further debt crisis remain sizeable with recent political developments renewing concerns.

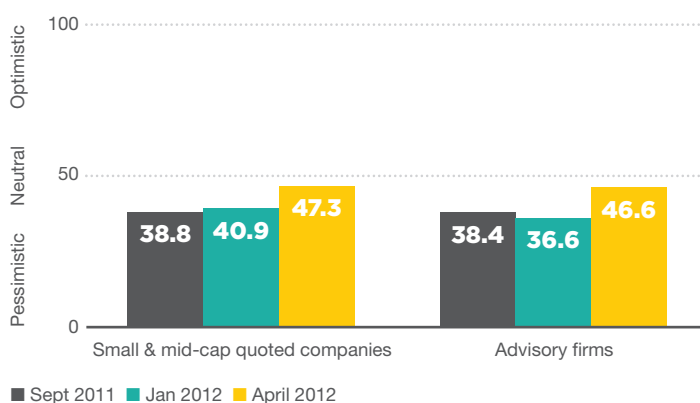
This mixed picture probably explains why, despite a definite improvement from the pessimistic mood prevailing at the start of the year confidence still remains below the neutral 50 level.

In terms of company sentiment about their own prospects over the next 12 months, optimism levels are continuing to increase. More than three-quarters (77%) of small and mid-cap quoted companies rank prospects above the neutral 50 level, with the average score equalling 66 compared to 62 in January.

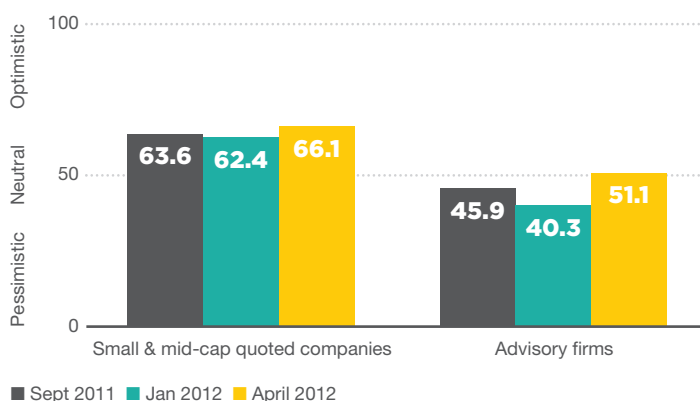
Encouragingly, advisory firms are also considerably more positive about the prospects for small and mid-cap quoted companies, ranking prospects at 51 compared to 40 in January.

This optimism probably stems to a large degree from the fact that despite technically being in recession again trading conditions across many sectors seem to be improving.

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?



QCA/BDO VIEW ▼

Underlying the optimism is an improving marketplace for companies. However companies and their advisors know that generating cash, maintaining profitability and raising finance will be key factors in delivering growth. We think this will be a difficult balancing act for many small and mid-cap quoted companies.

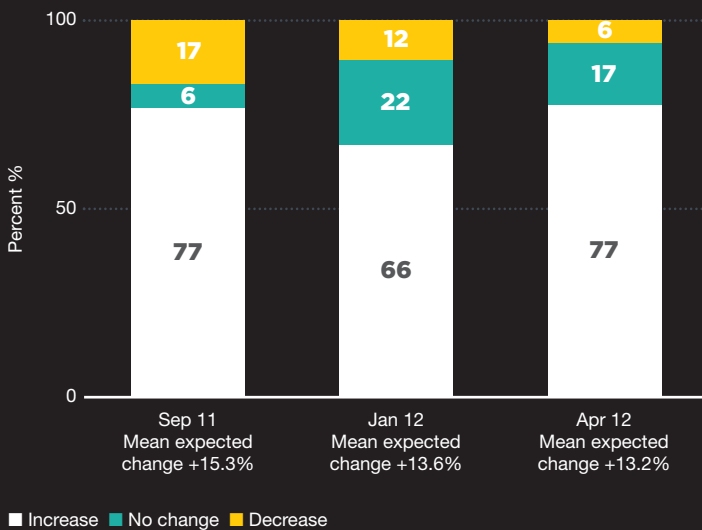
FUTURE EXPECTATIONS

CONCERNS STILL LOOM LARGE, BUT MOST COMPANIES EXPECT TO GROW REGARDLESS

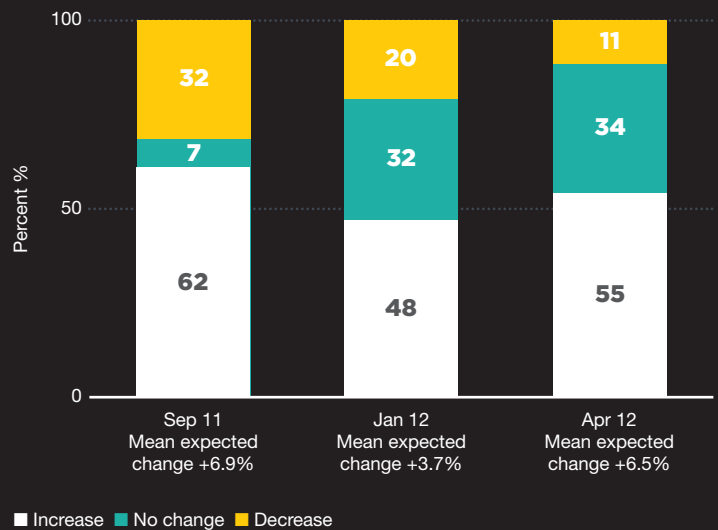
The vast majority of small and mid-cap quoted companies (77%) expect their own sales to grow over the next 12 months, which is a significant improvement compared to January. However, the magnitude of expected turnover growth has declined slightly. On average companies now anticipate turnover to increase by 13.2% over the next 12 months compared to growth of 13.6% in January.

Employment expectations are also up with just over half (55%) of companies believing they will need to take on more workers in the coming 12 months, with the average expected change in employment growth put at 6.5%. These figures represent a considerable improvement compared to January, but is still nevertheless below the figures reported in September.

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



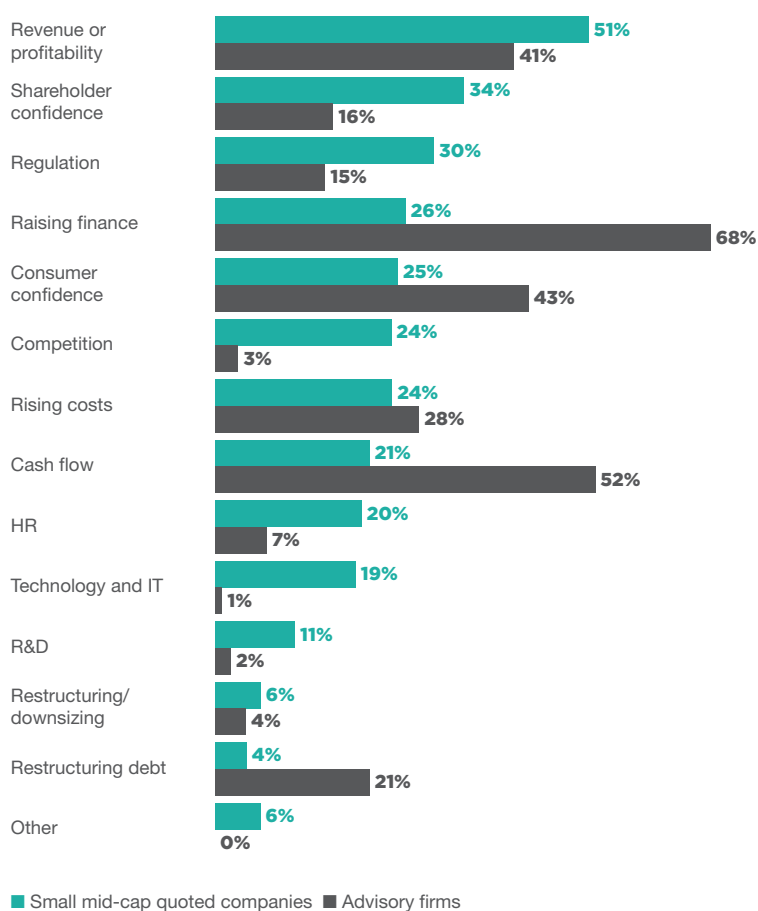
By how much do you expect the number of full time employees in your business to change in the next 12 months?



Despite expressing confidence in their ability to grow sales, small and mid-cap quoted companies single out concerns over revenue and profitability as the biggest challenge over the next 12 months. This suggests trading conditions although improving are by no means trouble-free with profitability in particular a concern.

Profitability also worries advisory firms with over half (52%) believing cash flow is a major challenge facing companies. Advisory firms also take the view that raising finance remains problematic.

Coming out of recession, what are the top three challenges faced by small to mid-cap UK quoted companies over the next 12 months?



QCA/BDO VIEW ▼

Companies believe that they must concentrate on delivering sales and profits, maintain their dialogue with shareholders and put up with more regulation. For advisors, it is all about cash.

We think that it is all of these things - the engines of growth need to be efficient and well-tuned; but they also need finance to fuel them.

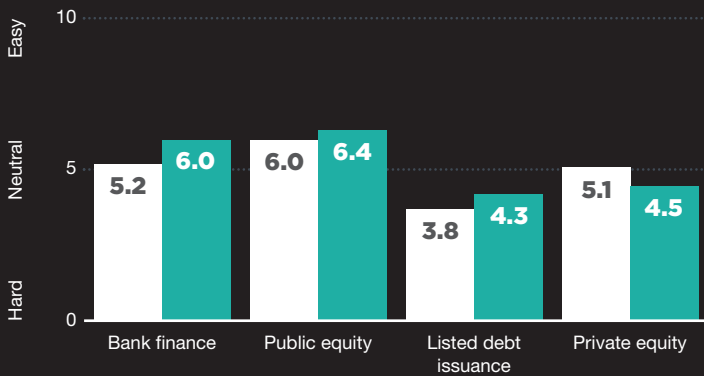
FUNDRAISING

CREDIT CONDITIONS TOUGH BUT EASING

Small and mid-cap quoted companies feel that credit conditions are easing slightly. With the exception of private equity funding, companies now believe it is less difficult to raise finance compared to the start of the year. However, companies are not witnessing a major breakthrough in lending with the majority still generally having a neutral view on financing.

In terms of funding sources, public equity is gaining in attractiveness largely at the expense of bank finance. Although banks are still the number one choice with half of all small and mid-cap quoted companies likely to use this source if the need arose in the next 12 months, public equity is gaining ground with 38% of companies now preferring this method. This suggests confidence in public markets is returning.

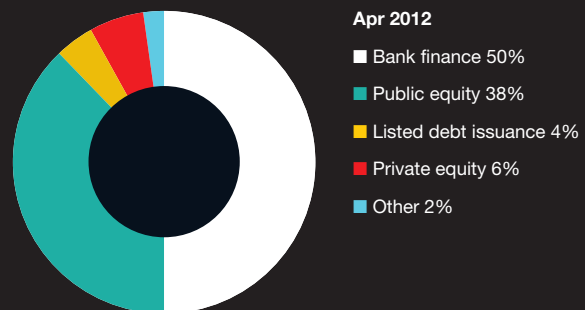
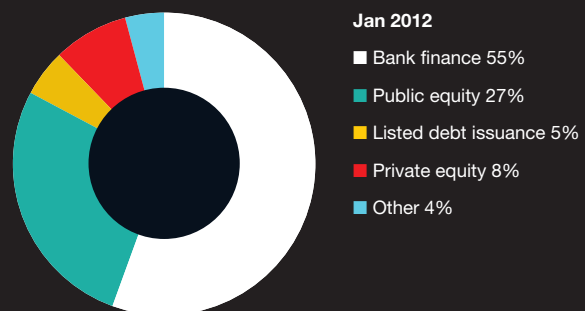
How easy or difficult would your company currently find it to raise finance through the following channels?



■ Jan 2012 ■ Apr 2012

In contrast, the use of alternative sources, such as limited debt issuance, private equity and other sources remains low with only 12% of companies indicating they would make use of them.

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



QCA/BDO VIEW ▼

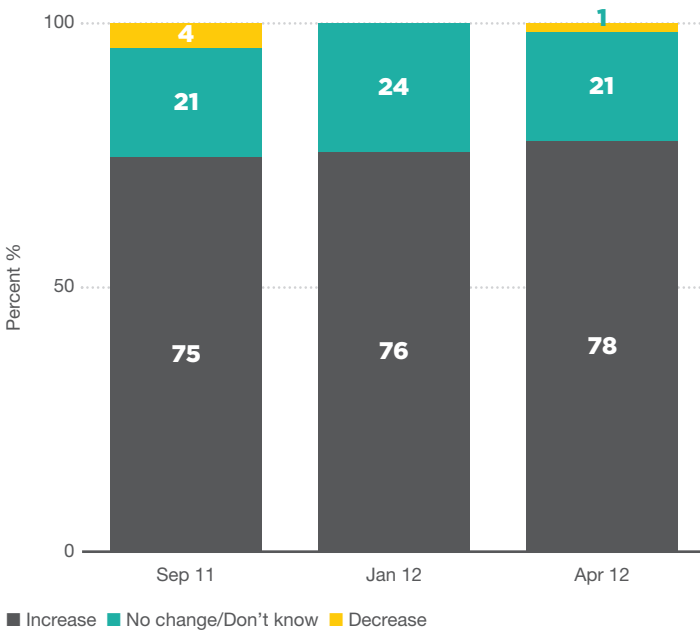
Public equity is increasing in favour as the preferred means of raising capital. We believe it is essential that as many financing options as possible are open for businesses to take advantage of. Flexible finance is key to the long climb out of recession.

REGULATION

EMPTY RHETORIC

Small and mid-cap quoted companies still firmly believe that the Government is regulation happy despite repeated assurances from Whitehall about creating a business friendly environment. Moreover, this belief has hardened over the last six months with 78% of companies now believing the amount of regulation affecting them is likely to increase in the next 12 months. "More red tape for little benefit" is how one company summed-up the current situation.

Do you believe the amount of regulation affecting your business is likely to increase, decrease or stay the same over the next 12 months?



78%

MOREOVER, THIS BELIEF HAS HARDENED OVER THE LAST SIX MONTHS WITH 78% OF COMPANIES NOW BELIEVING THE AMOUNT OF REGULATION AFFECTING THEM IS LIKELY TO INCREASE IN THE NEXT 12 MONTHS.

“

Regulatory burden continues to grow. Government attacks on wealth creators are a disaster for the image and morale of UK private sector”

”

More red tape for little benefit”

QCA/BDO VIEW ▼

Nothing the Government has done over the last year has shifted the mindset of small and mid-cap quoted company sector. They, and we, believe that regulation will continue to pile up and potentially stifle any potential growth that may arise from the relative optimism we are seeing.

CORPORATE GOVERNANCE

APPROACHING A NEW ERA

On corporate governance, opinions differ considerably with views extremely polarised regarding the recent approach taken by the Government.

Just under a half (47%) of small and mid-cap quoted companies think the approach taken is unnecessary. “It’s just hot air” is how one company describes it. Another popular view is that Whitehall does not have the experience or knowledge to adequately address corporate governance. In addition, any new rules or guidelines “would be decision making based on popularity with voters” and a “knee-jerk reaction to populist press comment.”

On the other hand, almost a third of companies (30%) view the approach taken by the Government as constructive engagement. “Capitalism needs an elected guardian of its behaviour. Government, if sometimes imperfectly, is fulfilling this role at a time when capitalism across the globe is under question” is a view held by a number of companies.

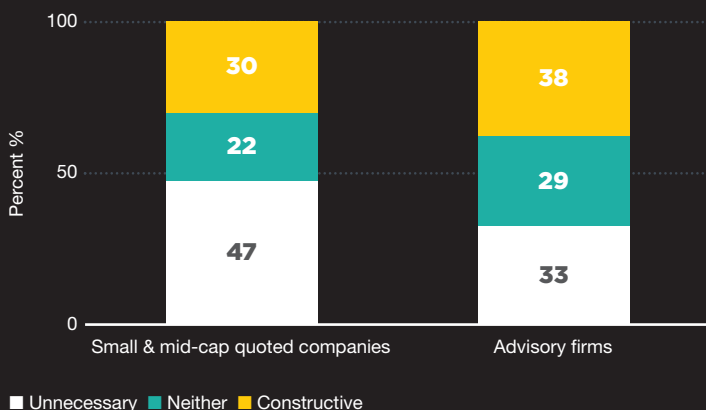
Advisory firms are more supportive of the Government judging that “whether or not you agree with the tone or method of intervention, it is helpful that something has happened to ignite a proper debate”. Others are more neutral with one advisor stating that “I don’t think they have a choice but to engage”.

The overwhelming majority (92%) of small and mid-cap quoted companies support the idea of establishing a corporate governance code for standard listed, AIM & PLUS quoted companies that is appropriate to the size and complexity of the company and where it is mandatory to comply or explain. This view is equally strongly held by advisory firms.

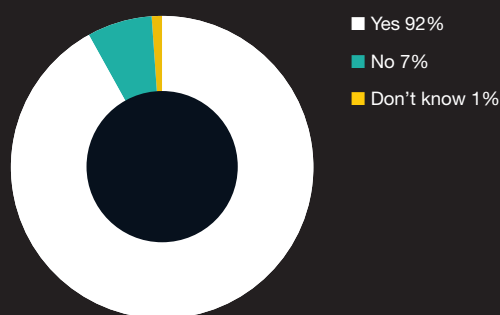


Government involvement could be a positive force but it tends to be a backside covering exercise addressing the popular headlines of the day”

Would you describe recent Government approaches to corporate governance as constructive engagement or unnecessary involvement?



Do you support a corporate governance code, which is appropriate to the size and complexity for the company and where it was mandatory to explain or comply?



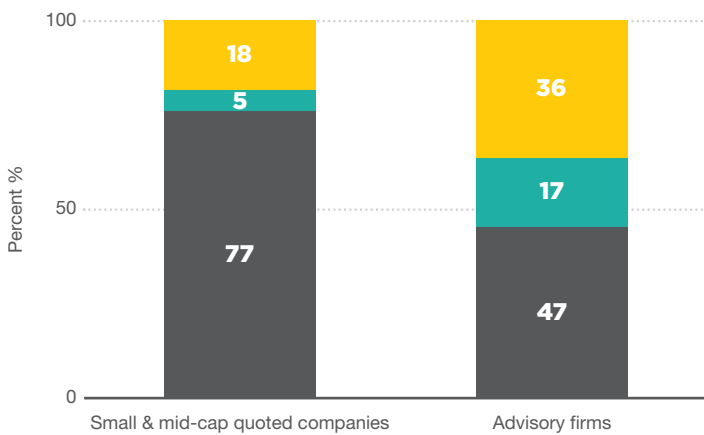
QCA/BDO VIEW

The call for a mandatory code demonstrates the increasing maturity of the small and mid-cap quoted community. We believe there is an increasing understanding that corporate governance underpins the development of effective strategies and the delivery of strong financial performance. It is not an end in itself.

Views differ regarding whether non-executive directors are well informed enough to challenge management on their management of risk. The majority (77%) of small and mid-cap quoted companies feel that the non-executive directors on their boards are sufficiently well-informed to make such challenges. However, a sizable proportion of advisory firms (36%) disagree, stating that the non-executive directors are not, in fact, sufficiently well informed.

This suggests a gap in perception exists with companies generally happy that non-executives are well informed enough, but advisors have significant concerns about the performance of non-executives.

Are non-executive directors on your board/on the boards of small to mid-cap UK quoted companies well informed enough to challenge management on their management of risk?



■ Yes ■ Don't know ■ No



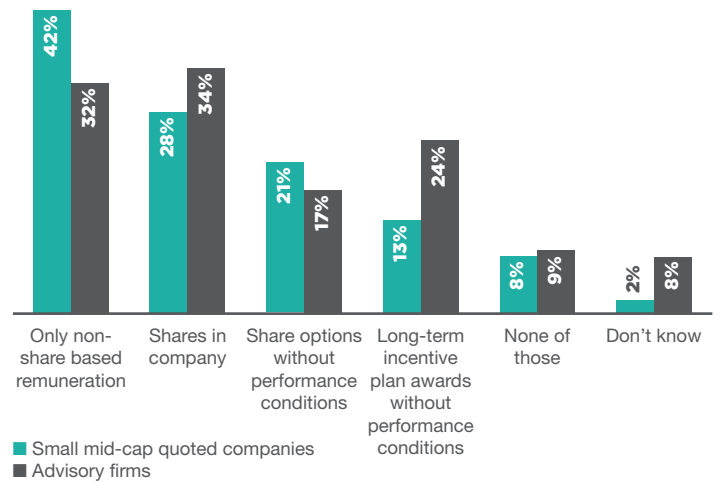
Uncompetitive packages engender less committed and mediocre management... if you pay peanuts you get monkeys"

Non-Executive Directors and their role in governance

There does not appear to be a clear consensus as to how non-executive directors should be paid. Although small and mid-cap quoted companies favour non-share based remuneration, considerable support also exists for share-based payment methods.

Advisory firms also have mixed views with around a third supporting non-share based remuneration and direct shares in a company, while almost a quarter (24%) favour long-term incentive plans.

Do you believe that non-executive directors of a company should be remunerated by any of the following?



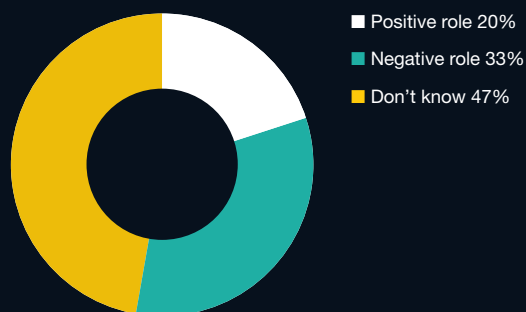
Too often executives are overpaid for mediocre and poor performance because their bonus scheme structures are too easy to satisfy"

Small and mid-caps undecided about proxy voting agencies

There is a great deal of uncertainty as to what proxy voting agencies do and whether they play a positive or negative role. Almost half (47%) of small and mid-cap quoted companies and advisory firms are unable to determine if agencies are positive or negative.

Where firm opinions are held, respondents tend to believe proxy voting agencies are undermining the governance efforts of companies, with a tick box culture highlighted as a particular problem.

Proxy voting agencies: positive or negative role?



“Proxy voting agencies tend to be tick box”

QCA/BDO VIEW ▼

A breakdown of engagement between companies and investors has been touted as the catalyst for a number of recent changes to the UK corporate governance regime. Companies have been accused of not providing investors with enough information and investors of being ‘absentee landlords’. However, our evidence suggests that neither of these stereotypes may be accurate – the small and mid-cap community seems happy with the levels of engagement between companies and institutional investors.

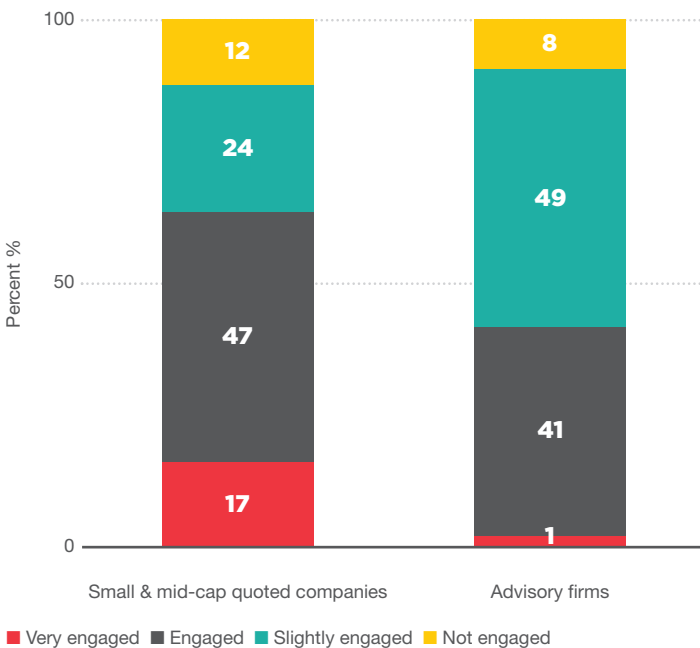
Whilst many small and mid-cap companies do not have a view on proxy voting agencies, it is clear that many who do are concerned about their impact. In light of the fact that companies are generally satisfied with their engagement with their investors, we believe that proxy voting agencies should do nothing to upset this dialogue. Overall, we need to monitor the power of proxy voting agencies and the role they play in corporate governance – and whether it is positive or negative.

Engagement of institutional investors better than expected

The small and mid-cap community seems happy with the levels of engagement between companies and institutional investors. The majority of companies (64%) feel that investors are either very engaged or engaged, with only 12% believing investors are not engaged at all.

Although advisory firms are less certain, with most (49%) believing investors are only slightly engaged with small and mid-cap quoted companies they have invested in, opinions are still remarkably positive.

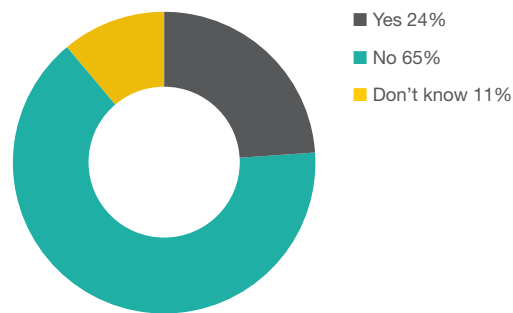
How engaged do you feel institutional investors are with your company/small and mid-cap quoted companies they have invested in?



Women on boards in small and mid-cap quoted companies

Across small and mid-cap quoted companies who have recruited board and major executive positions in the last 12 months (64 companies) almost a quarter (24%) have specifically sought out female candidates. Of the 64 companies, 38% had female candidates on the short list for a position, while 28% appointed a woman to a board position.

In the last 12 months, did you specifically seek out (or instruct recruiters to seek out) female candidates for the long list for a board or major executive position?



QCA/BDO VIEW

While only a small sample, these results suggest that small and mid-cap quoted companies are changing their behaviour. Diversity is something that is being taken into consideration in the recruitment process and this is beginning to feed through.

We believe that business initiatives such as the 30% Club are influencing behaviour in the small and mid-cap quoted company sector so that more companies are beginning to ask to see more female candidates. While Governments and the EU toss around the idea of quotas for women on boards, perhaps it may be better to see the effects of this change in behaviour. Regulation may not be needed.

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 235 online interviews (132 small mid-cap quoted companies, 103 advisory companies) with members and associates of the QCA. It was conducted between 17 April–1 May 2012 by leading research company YouGovStone.

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 percentages quoted through the document or in the accompanying charts may not add up to 100% due to roundings.

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:

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13%

OVER THE NEXT 12 MONTHS THE MAJORITY OF FIRMS EXPECT TO HIRE MORE EMPLOYEES AND EXPECT TURNOVER TO GROW STEADILY BY ABOUT 13%.



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