QCA/BDO
SMALL & MID-CAP SENTIMENT INDEX

February 2013 Issue 6

QUOTED COMPANIES ALLIANCE

YouGov What the world thinks

BDO

INTRODUCTION
SCOTT KNIGHT, PARTNER BDO LLP

THIS SURVEY CONTINUES TO SURPRISE; I AM PLEASED TO SEE THAT CONFIDENCE IN THE UK ECONOMY AMONGST SMALL AND MID-CAP COMPANIES IS AT THE HIGHEST LEVEL SINCE THIS INDEX WAS CONCEIVED. THESE RESULTS ARE NOT REFLECTIVE OF THE CONVERSATIONS I HAVE EVERY DAY WITH SMALL AND MID-CAP COMPANIES AND INDEED THE SENTIMENT FROM THE RECENT MINING INDABA CONFERENCE.

Companies' confidence in the UK economy still falls just below a neutral level; but after a series of poor economic results and fears of triple dip recession looming, it is surprising that companies are not more pessimistic. In a year where we have already seen high profile companies collapse it is exciting to see that many companies haven't taken a negative approach and horded cash reserves. However I still feel those companies that are capital constrained are in a holding pattern.

Despite a slightly pessimistic view of the economy it is encouraging that many advisors and small and mid-cap companies remain optimistic about their own business prospects. Results from our respondents suggest that we can expect to see headcount increase a healthy 4% and small and mid-cap firms on average expect revenue to increase by 11.2%. These strong figures emphasise the importance of the small and mid-cap markets as a key engine for growth.

The critical issue at present is the availability of capital. Companies have auspicious prospects but need capital to convert these into growth. The survey shows us that obtaining finance is becoming more challenging with respondents reporting that it is more difficult than 3 months ago. A liquid market is a prerequisite for growth amongst small and mid-cap companies.

The survey shows listed debt is the most difficult form of finance to obtain. Yet a number of companies are considering this is an option including Enquest. Historically listed debt has been the preserve of the Blue Chips. However increasingly it is emerging as a realistic option for some mid-caps. Personally I am positive about the outlook of the listed debt market.

Another surprise is the lack of knowledge about the listed debt market amongst both companies and advisors; however I am confident this will change over the forthcoming year. Increasingly small and mid-cap companies will be debating the pros and cons of listed debt with their advisors as a viable option for raising finances. For those who would like more information on listed debt, please download our flyer.

RESULTS FROM OUR RESPONDENTS SUGGEST THAT WE CAN EXPECT TO SEE HEADCOUNT INCREASE A HEALTHY 4% AND SMALL AND MID-CAP FIRMS ON AVERAGE EXPECT REVENUE TO INCREASE BY 11.2%. THESE STRONG FIGURES EMPHASISE THE IMPORTANCE OF THE SMALL AND MID-CAP MARKETS AS A KEY ENGINE FOR GROWTH.

EXECUTIVE SUMMARY

TIM WARD, CHIEF EXECUTIVE, THE QUOTED COMPANIES ALLIANCE

OUR INDEX IS A SURVEY OF LEADERS IN THE SMALL AND MID-CAP COMMUNITY. NEARLY THREE-QUARTERS OF THE CORPORATE RESPONSES HAVE COME FROM BOARD LEVEL PEOPLE – BOTH EXECUTIVE AND NON-EXECUTIVE. ON THE ADVISORY SIDE NEARLY HALF OF RESPONDENTS ARE AT DIRECTOR OR PARTNER LEVEL. THIS LENDS WEIGHT TO THE FINDINGS OF OUR SURVEY. IT IS COMPLETED BY PEOPLE WHO ARE HIGHLY INVOLVED IN, AND CARE ABOUT THE FUTURE OF, OUR SECTOR.

Leaders are sending a wake-up call to Government

Confidence in the UK economy has continued its upward trend and is now at its highest level yet and just beneath levels that would indicate optimism. Small and mid-cap quoted companies are also increasingly confident about their own business prospects.

The increase in confidence of small and mid-cap quoted companies is reflected in a greater desire to increase their work-force and grow revenue.

But this does not lead me to think that we are on the start of a clear path of growth. Despite this general increase in optimism, the small and mid-cap community is telling us that all the main sources of raising finance are becoming more difficult to access. While public equity remains the preferred source of finance, it is at its lowest level of popularity since our survey began 18 months ago. It looks as if, just as things get better, there is going to be a credit squeeze.

This is worrying. Small and mid-cap companies are looking to grow. But, they perceive finance as more difficult to obtain. If finance is not available, then we will not see long-term growth. It is as simple as that.

Fuelling growth

Government needs to be alive to this potential credit squeeze and ensure that these engines of growth have access to all the fuel they need. Some actions include:

Kickstart the markets – Someone recently opined that we are 18 months into a seven year bull market. We should all see this as a viable scenario. We could also bring back the '3i-model' and have the Government-backed Business Growth Fund invest capital into the public equity market through investing directly in quoted companies as well as private equity.

Incentivise people to invest in the engines of growth – the Government has taken welcomed action by looking at the inclusion of AIM shares into ISAs, but we need to go further. Reforming Entrepreneurs' Relief, reinstating the dividend tax credit for pension funds that invest in small and mid-cap companies and removing Stamp Duty for small and mid-cap shares would direct investment into the engines of growth.

Make bank debt more accessible – the Government-backed 'Business Bank' has a great opportunity to provide debt financing for growing companies, where high street banks may be less willing to. We need to ensure that it is properly funded and has well-formed plans which take into account growing public companies.

Raise awareness of alternative forms of finance – In this survey, we looked at public debt in more detail and found that not many people in the small and mid-cap sector knew about or were considering the public debt market. Just over half of small and mid-cap companies and just under half of advisors to sector are unaware of the London Stock Exchange's Order Book for Retail Bonds. Public debt is not suitable for every company; but there is a clear need for the market to educate and inform.

More importantly, the primary equity and debt markets need to be highlighted and promoted more so that as companies begin to grow they can underpin this growth with long-term capital.

HIGHLIGHTS

33%

of small and mid-cap quoted companies are pessimistic about prospects for the UK economy over the next 12 months – **down from 55% in October.**

72%

of small and mid-cap quoted companies are optimistic about their own business prospects – **up from 63% in October.**

79%

of companies expect sales to grow in the next 12 months, with the average expected growth in turnover put at +11.2%, **up from October (+7.9%) and July 2012 (+9.7%).**

56%

of companies expect to increase headcount in the next 12 months, **with the average expected change in employment growth put at +4.0%.**

76%

of companies and 85% of advisors either do not believe there is sufficient information to evaluate effectively the market for corporate bonds, **or are unsure about the availability of information.**

41%

of small and mid-cap companies would prefer to raise capital through public equity **if the need arose in the next 12 months.**

38%

of small and mid-cap businesses would be interested in issuing a corporate bond as an alternative source of finance where as **57% of advisors would recommend them to their clients.**

36%

of companies see non-dilution of ownership as the single main benefit of corporate bonds, with the current lack of equity investor demand second (19%). **Both these factors are in joint top place for advisors.**

BUSINESS CONFIDENCE

CLOSE TO A TIPPING POINT BUT NOT YET OPTIMISM

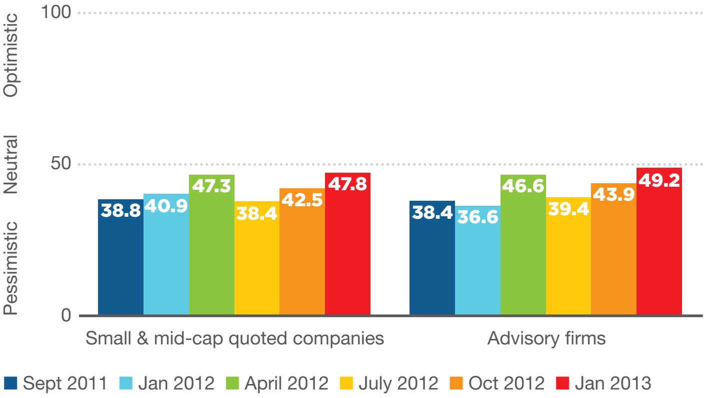
Confidence across small and mid-cap quoted companies has crept towards neutrality in recent months, but it remains below optimistic levels with both companies and advisory firms still relatively pessimistic about the outlook of the UK economy.

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 47.8 compared to 42.5 in October. Confidence in advisory firms followed a similar pattern, increasing to 49.2.

In the wake of a hard start to the first quarter of 2013, filled with high profile administrations and heavy snowfall affecting output, we should consider this uplift in confidence as an appealing sign that this could be a cautious start to economic recovery.

The main catalysts for this improved confidence stems from better than expected growth in the services sector and a slight improvement in the global economy helping stimulate export led growth. After many companies experienced solid but not spectacular Christmas trading periods its unsurprising to see that capital investment (a key indicator of confidence) remains low.

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



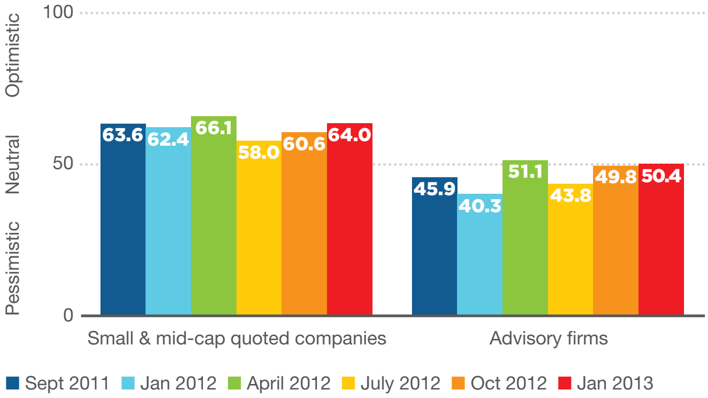
With the Eurozone crisis persisting and talk of leaving the EU on the horizon it is little wonder that companies are remaining cautious as many small and mid-cap company's strategies may be hinged on the outcome of these issues.

Business in general remains uncertain with the UK's performance largely linked to external factors. Because of this we are seeing many companies adopt a batten down the hatch mentality further delaying the UK's return to prosperity.

More positively, companies remain optimistic about their own business prospects over the next 12 months. 72% of small and mid-cap quoted companies rank prospects above the neutral 50 level, with the average score equalling 64.0 compared with 60.6 in October.

Advisory firms, who historically have been more pessimistic about business prospects fail to buck that trend this month as they rank prospects at 50.4.

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

Though an improvement in confidence these figures remain weak and below optimistic levels. It could be 2015 before we see real confidence in the economy and more likely would be 2016-17. In order to ensure confidence returns to pre-recessionary levels companies need to invest more capital and drive growth; to do this they need access to public capital. If the situation in the Eurozone improves it is very likely the UK will mirror the improvements as uncertainty about the economic environment is reduced.

FUTURE EXPECTATIONS

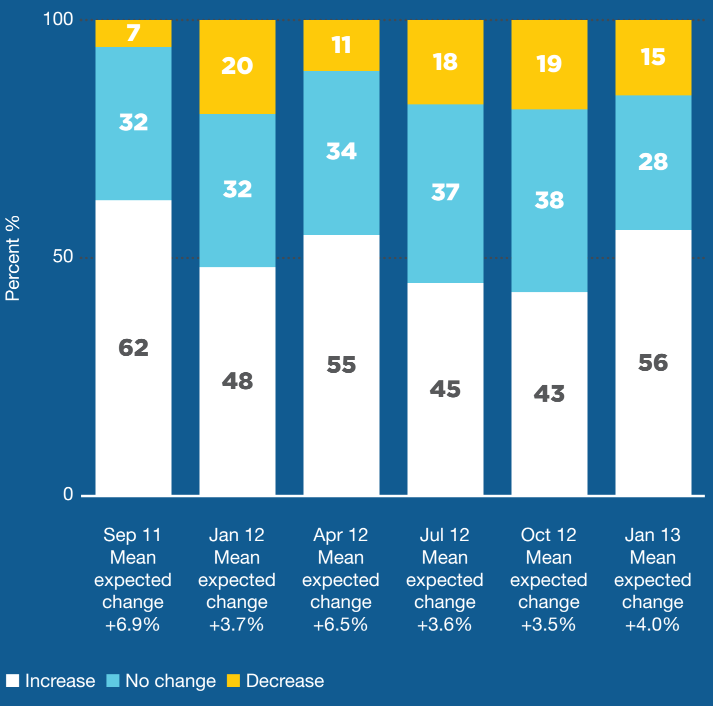
EMPLOYMENT FIGURES IMPROVING AND REVENUE EXPECTATIONS FOLLOW SUIT

A record number of people were in work last year after a boost to full-time and part-time working. An employment rate of 71% is the highest since records began in 1971. The jobs market has performed consistently while poor data has been reported for output. This creates an uncertainty about whether or how fast the economy is growing.

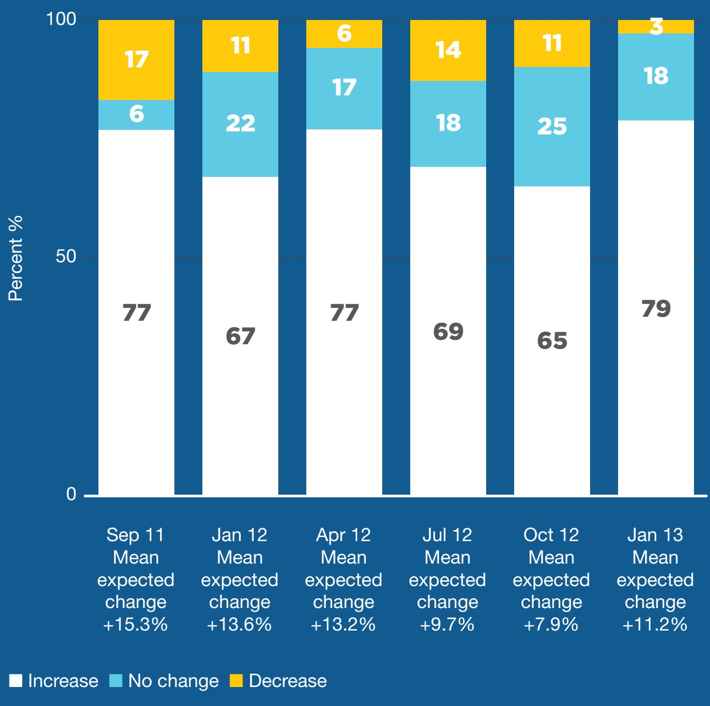
These strong employment figures may have contributed to the bullish attitude small and mid-cap firms have about their employment strategy over the next 12 months with 56% of firms expecting headcount to increase – the highest since September 2011.

This increase in expected employment is mirrored in expected sales growth over the next 12 months with 79% of small and mid-cap companies expecting revenues to increase over the next year. Also encouraging is the improvement in mean expected sales growth being upgraded to 11.2% from the disappointing 7.9% reported in October.

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

Interestingly we are seeing improved reported confidence which is also translating into improved employment prospects and revenue growth expectations. It is a positive sign to see improved confidence actually related to economic results. The real test for 2013 will be if the improved confidence translates into positive results over the course of the whole year. Companies are spending a lot less per year than pre-crisis levels at a time when they would be expected to make up for underinvestment in previous years.

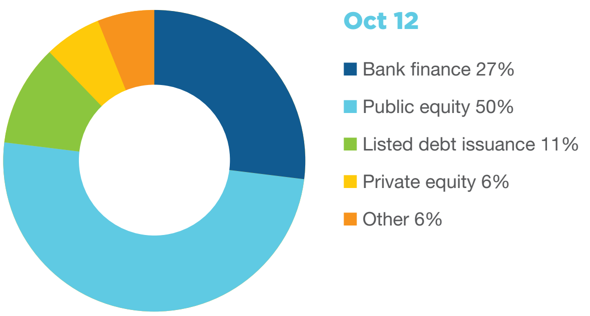
FUNDRAISING

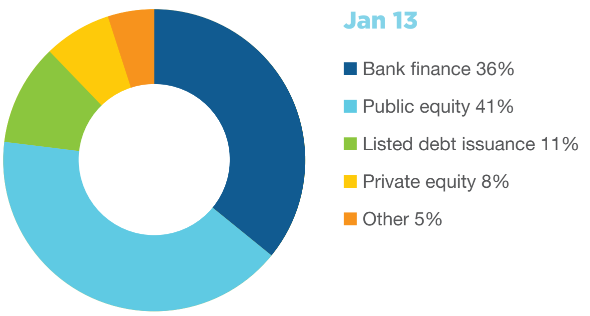
Both small and mid-cap companies and advisors believe obtaining finance has become more difficult over the last quarter. The credit situation appears to have got worse and generally speaking the majority are finding raising capital more difficult.

Public equity remains the most popular method to raise capital with bank finance in second. Listed debt has become more popular over the course of 2012 with 11% of companies stating it as their preferred method of raising capital – 6% more than 12 months ago.

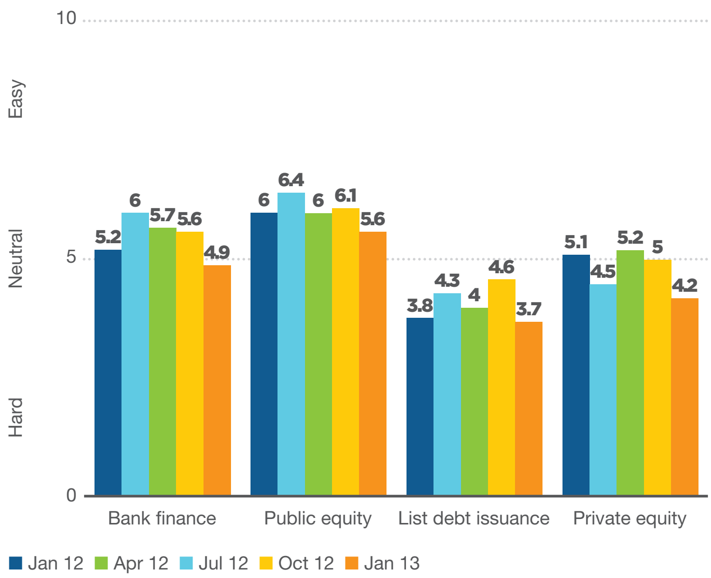
Interestingly this doesn't correlate with the reported ease of obtaining finances as listed debt is currently considered the hardest method to raise finance by small and mid-cap companies.

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 currently find it to raise finance through the following channels?



QCA/BDO VIEW

These results are worrying. While confidence in the UK economy and companies' own prospects is up, access to finance may be getting more difficult. Lack of available finance will stunt growth and Government should be taking action to ensure that there is not a credit squeeze right when we are on the tipping point of economic recovery.

More interestingly, equity finance has lost some of its popularity and is at its lowest levels since we started the survey. Companies seem to be seeking out alternative finance, such as corporate bonds and bank finance, as the primary equity markets remain somewhat stagnant.

CORPORATE BONDS

There are many benefits of raising capital through the issuance of corporate bonds but for a variety of reasons the market has failed to flourish amongst small and mid-cap firms. One of the key features of issuing corporate bonds is that it can be cheaper than raising finance through other methods, such as bank debt or a public share issue. Intuitively we would expect this to be a highly attractive feature to small and mid-cap businesses; in reality it has not been fully explored.

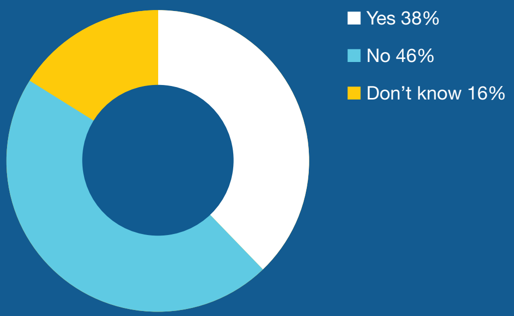
Interest in issuing corporate bonds is still low, but growth in the market is welcomed

38% of small and mid-cap firms would be interested in issuing debt as an alternative source of funding versus 57% of advisors who would recommend them to their clients.

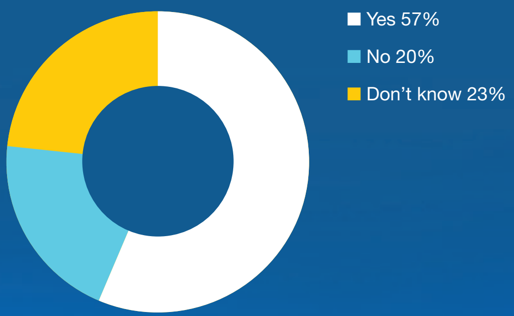
This is pretty similar to what we found in February 2012; when we asked if companies would consider issuing debt as an alternative to bank finance, 44% of small and mid-cap companies said they would be interested, and 66% of advisors would recommend it to their clients.

Demand for corporate bonds amongst the small and mid-cap sector remains low, with many still undecided about this financing option.

Small and mid-cap companies:
Would your company be interested in issuing a corporate bond as an alternative source of funding?



Advisors:
Would you recommend a corporate bond issue to your clients as an alternative source of funding?

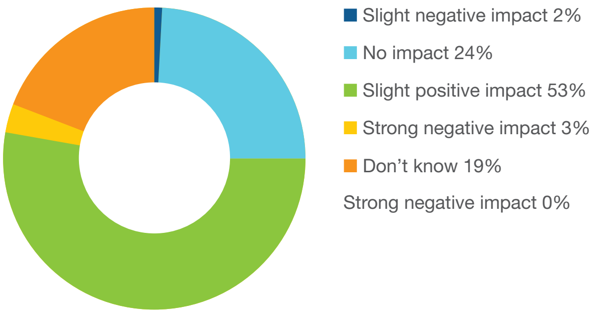


QCA/BDO VIEW

It is clear that there is a missed opportunity by small and mid-cap firms. While corporate bonds may not suit all companies, it is a growing market and one which will be well utilized in the future as knowledge of the possibilities increase. In another 12 months we believe the market will have developed and if similar questions were asked we would see very different results.

Despite the apparent lack of demand, growth in the corporate bond market for small and mid-cap companies is viewed as positive. Over half (56%) of small and mid-cap firms reported that growth in the corporate bond market will have a positive impact on companies over the coming year whilst only 2% believe it will have a negative impact.

On balance what impact, if any, do believe the growth in the small and mid-cap corporate bond market will have on companies over the coming year or so?

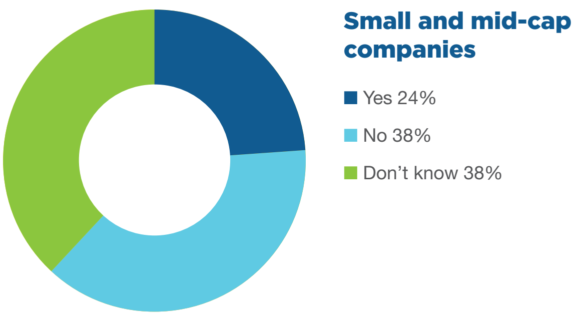


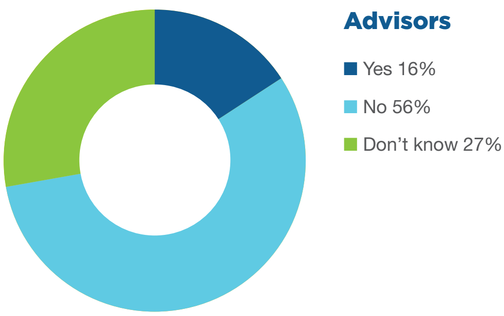
Lack of knowledge holding back demand for corporate bonds

While demand for corporate bonds remains relatively low, it appears that lack of knowledge about the process and market are at least partly responsible.

We found that 76% of companies and 84% of advisors either do not believe there is sufficient information to evaluate effectively the market for corporate bonds, or are unsure about the availability of information.

Do you believe there is sufficient information available for companies to evaluate effectively the market for corporate bonds?





Small and mid-cap quoted companies and their advisors also seem to know little about the London Stock Exchange's Electronic Order Book for Retail Bonds (ORB), which is a retail bond market launched in 2010. 61% of small and mid-cap companies, and 49% of advisors said they were not aware of the ORB. This reveals a good opportunity missed by many companies.

The London Stock Exchange launched the Electronic Order Book for Retail Bonds (ORB) in February 2010 as a means of improving liquidity and transparency of the retail bond market by providing the bond market for private investors. The ORB provides an excellent opportunity for smaller companies to offer debt as a method of financing at lower denominations and costs than other methods.

...small cap companies often do not have full time HR managers or in-house counsel, etc and seem to find it hard to get answers to simple questions without considerable time and expense.

Small and mid-cap company's viewpoint

Are you aware of the London Stock Exchange's electronic Order Book for retail bonds?

The benefits of and obstacles to issuing corporate bonds

When looking at the greatest benefits for small and mid-cap firms to issue corporate bonds as an alternative to issuing equity there is some interesting results. Non-dilution of ownership is seen as the single main benefit of corporate bonds by the most companies (36%), with the current lack of equity investor demand second (19%). Both these factors are in joint top place for advisors (28%).

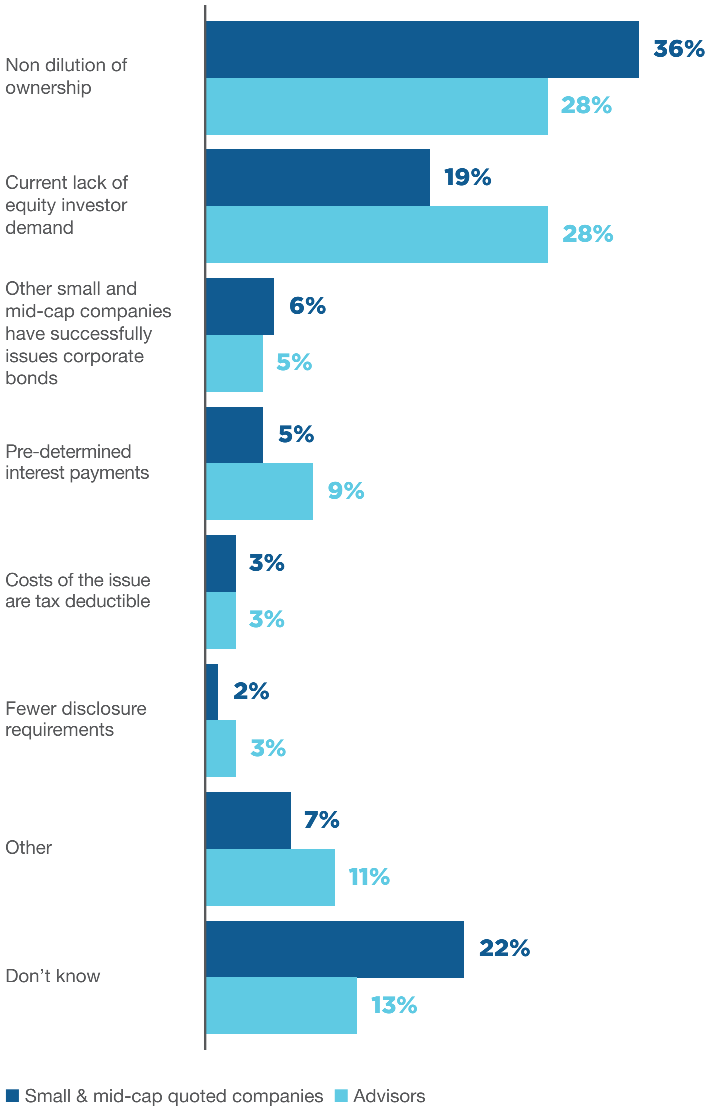
Conversely the single biggest obstacle (23%) for small and mid-caps seeking to raise corporate bonds is the fact that relatively few companies in the community have issued corporate bonds.16% agreed with advisors that the biggest issue is their lack of knowledge about the process and market.

QCA/BDO VIEW

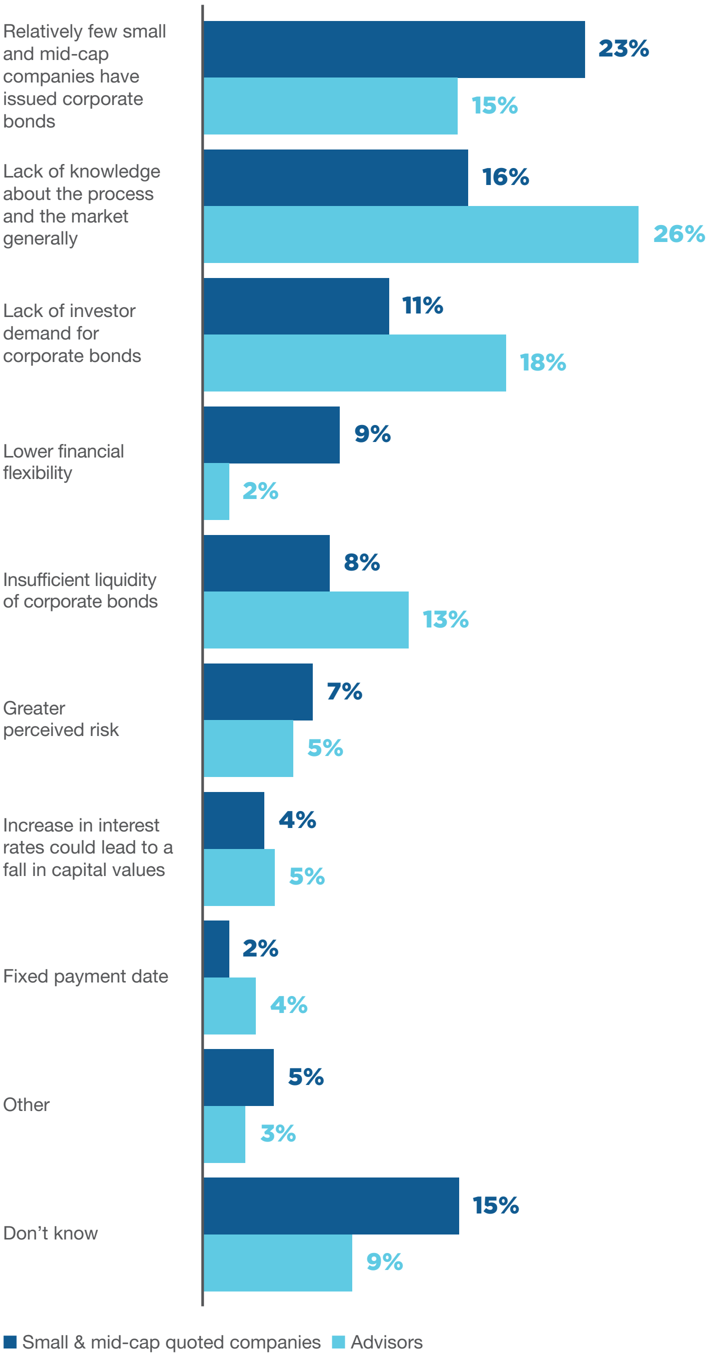
Information regarding the corporate bond market and the regulation that accompanies it needs to be more readily available and companies need to actively seek it out. The key reason we see an under developed market is due to the lack of knowledge warding people off exploring their various options. By making the market more accessible to small and mid-cap companies liquidity should increase thus stimulating investor demand. The ORB creates an efficient mechanism for corporate issuers that would like to distribute bonds to retail investors which should increase issues of bonds.

The widespread lack of knowledge of corporate bonds and their potential value (amongst both companies and advisors) means the UK economy is missing out on a potentially important driver of recovery at a crucial point when business prospects are improving but capital to fund growth is restricted.

What do you consider to be the single main benefit for small and mid-cap companies seeking to issue corporate bonds to raise finance, as opposed to issuing equity?



What do you consider to be the single biggest obstacle for small and mid-cap companies seeking to issue corporate bonds to raise finance, as opposed to issuing equity?



COMPANIES' VIEWS ON OTHER PROS AND CONS OF ISSUING BONDS:

"Share prices prohibitively low making issuing equity too expensive"

"fees too high to allow small issue"

"… many small and mid-caps do not fit the profile that investors in corporate bonds are looking for"

"Interest is tax deductible and would allow a more level playing field with Private Equity backed competitors"

"balance sheet management"

"Lack of quality of issuer in a risk averse investor universe"

"Dilutes bank influence by providing alternative debt instrument"

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 249 online interviews (137 small mid-cap quoted companies, 112 advisory companies) with members and associates of the QCA. 73% of the small and mid-cap quoted company respondents were employees in a board level position, while 46% of advisor respondents were in a senior management position. It was conducted between 15 January and 31 January 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:

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