QCA/BDO

SMALL & MID-CAP SENTIMENT INDEX

September 2013 Issue 8

QUOTED COMPANIES ALLIANCE

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BDO

INTRODUCTION

SCOTT KNIGHT, PARTNER, BDO LLP

IT IS EXTREMELY EXCITING TO FINALLY SEE GOOD NEWS AT A MACRO-ECONOMIC LEVEL STARTING TO TRANSLATE INTO A PICKUP OF CONFIDENCE IN THE UK ECONOMY. THIS QUARTER WE WITNESSED THE JOINT LARGEST BOOST IN CONFIDENCE THAT WE HAVE SEEN WITH SMALL AND MID-CAP COMPANIES NOW RANKING IT 58.2 – UP FROM 51.4 IN APRIL.

However, whilst there are signs suggesting that we are in line for a sustained period of recovery, businesses should be wary. With external shocks from Europe still a real risk, businesses should err on the side of caution.

Small and mid-cap companies will have undoubtedly been spurred by the fact that this year we have seen positive GDP growth for Q1 and Q2, as well as a pickup in the manufacturing and services sectors. Furthermore we are seeing an overall improvement in the value and volume of retail sales providing further encouragement that solid growth should be expected for the remaining quarters of 2013.

Firmly in the belief that we can follow an investment led return to prosperity, it brings me great pleasure to see that small and mid-cap companies are indicating that the situation surrounding access to capital has improved. Public equity, bank finance and listed debt issuance have all grown easier to obtain whilst private equity has grown only marginally more difficult.

This quarter the focus issue is corporate governance (following on from the role of the NEDs last quarter). Much has been written on the benefits of good governance and, whilst it is true that higher performing companies tend to have good governance, it is not clear whether good governance is the cause or the result. 21 years on from the game changing Cadbury report of 1992, it is encouraging to see that 72% of small and mid-cap companies see 'comply or explain' as very or reasonably important. A company having the confidence to explain why they do something differently rather than simply adhere to a rule book, is in my experience, a very healthy sign and it pleasing to see the survey shows 47% agree whilst only 15% disagree.

I am again surprised at the level of 'don't knows' on questions relating to proxy voting agencies. I regularly have conversations with clients who are impacted by their recommendations, and have concerns about transparency and ability to respond. It may be that the majority of AIM companies are yet to be impacted. Overall I believe these agencies perform a valuable role but 90% of those that expressed a view would like to see greater transparency around their recommendations and I suspect want to engage in a dialogue before the recommendations are published.

Finally, to top off a positive report, it is again highly pleasing to see the proportion of female candidates being appointed to boards increase. We did see the number of companies actively seeking women for board or senior management positions decrease, though more women were hired for these positions. This suggests a normalisation of improved equality with the need for positive discrimination becoming less pertinent.

FIRMLY IN THE BELIEF THAT WE CAN FOLLOW AN INVESTMENT LED RETURN TO PROSPERITY, IT BRINGS ME GREAT PLEASURE TO SEE THAT SMALL AND MID-CAP COMPANIES ARE INDICATING THAT THE SITUATION SURROUNDING ACCESS TO CAPITAL HAS IMPROVED.

EXECUTIVE SUMMARY

TIM WARD, CHIEF EXECUTIVE, THE QUOTED COMPANIES ALLIANCE

Introduction

Our results this time tell me that:

- we need to continue to keep a close eye on the availability of finance, even though the economy is getting better;
- too many companies are not seeing the benefits of good corporate governance behaviour;
- not many companies understand what proxy voting agencies do; and
- women are getting a better share of board and senior management places.

The world is getting more optimistic, but still some notes of caution

This quarter's survey shows that UK economic confidence continues to increase. We are now well above the tipping point between optimism and pessimism and a look at the trend over the last five quarters suggests that this will continue to improve.

Both companies' and advisors' expectations about hiring and growing sales has also steadily increased across the last five quarters.

Companies are telling us that raising capital is getting a little easier for public equity, public debt and bank finance, but not for private equity which has become more difficult in each of the last four quarters. Advisors still see finance as a key obstacle with all sources seen as difficult.

There remains a certain caution in this area, whilst optimism generally is increasing significantly. Lack of finance could be a key stumbling block to continued growth expectations.

Corporate governance – no tangible benefit?

It is interesting to see that 85% of companies either follow the UK Code or our own Quoted Companies Alliance Corporate Governance Code. What are the 7% not following a code doing? 16% of companies see no tangible benefit in following a code, whilst a vast majority of companies and advisors highlight an improved perception among stakeholders from following such codes. A good number of advisors see higher levels of investment emanating from such usage. But it's clear that, with the 16% seeing no tangible benefit, more work needs to be done to demonstrate the links between good corporate governance behaviour and a lower cost of capital.

It is good to see that 'comply or explain' as an approach is welcomed by companies and advisors, with 72% of companies saying that it is important in influencing effective corporate governance behaviour. Again, let's be aware that 28% of companies don't subscribe to this view; so we should not take this as a universal truth in the UK. I think that more work needs to be done in this area, in the growth markets in particular.

We echo the clear call of both companies and advisors who believe that AIM and ISDX companies should have to publicly state which corporate governance code they follow. Both exchanges should amend their rules to require companies to state which code they follow or give reasons why they choose not to follow a code. More transparency in this area will help companies and investors improve their dialogue.

Proxy voting agencies – not well known and not well liked

We have repeated some questions about proxy voting agencies that we asked last year. These agencies – I call them 'inbetweeners' – are not particularly well understood. Over a third of companies and advisors do not know whether they play a positive or negative role; and of those that do, two-thirds think they play a negative role. This is similar to the responses last year. In the same way as more work needs to be done on corporate governance, we need more information, more education and more transparency on the inbetweeners. A lot of this responsibility must fall at the feet of the fund managers that employ them.

Women on boards and in senior management – positive signs

We have also repeated questions on recruitment activity and whether more women are being hired in board and senior management positions. Of the 52 companies that recruited for board positions, 50% had female candidates on the short list and 37% appointed a female candidate. Similarly 10 out of 26 senior management positions were filled by female candidates. There seems to be a positive directional move towards increasing diversity in small and mid-cap quoted companies.

HIGHLIGHTS

76%

of small and mid-cap quoted companies are optimistic about their own business prospects – **up 4% on April.**

67%

of small and mid-cap quoted companies are optimistic about prospects for the UK economy over the next 12 months – **the same time last year only 8% of companies were optimistic.**

74%

of companies expect sales to grow in the next 12 months, with the average expected growth in turnover put at +12.49%, **up on April (+10.12%).**

68%

of companies expect to increase headcount in the next 12 months – at its highest level since our survey began – **with the average expected change in employment growth put at +4.66%.**

54%

of small and mid-cap businesses stated public equity as their preferred method for raising capital – **the same as we saw in April.**

50%

of small and mid-cap companies follow the UK Corporate Governance Code, **with a further 35% following the Quoted Companies Alliance Corporate Governance Code.**

72%

of small and mid-cap companies believe ‘comply or explain’ is **very important or reasonably important in influencing corporate governance behaviour in the UK.**

31%

of small and mid-cap companies that had an opinion believe proxy voting agencies **play a positive role in corporate governance.**

50%

of companies that recruited for board positions in the last 12 months had female candidates on the short list and 37% appointed female candidates to a board position – **both of which have risen since April 2012.**

BUSINESS CONFIDENCE

For a fourth consecutive quarter we have witnessed a boost in small and mid-cap companies' optimism in the UK economy for the next 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 58.2 compared to 38.4 in July last year. Confidence in advisory firms followed a similar pattern, increasing to 61.1 from 39.4 in July 2012.

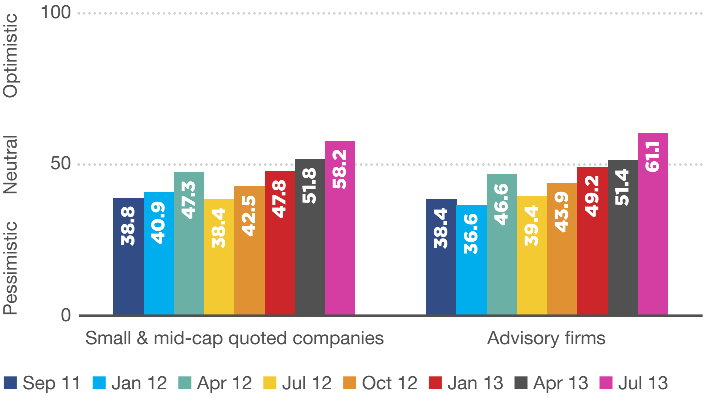
Over the last quarter we have seen some encouraging economic data with the highlight being the 0.6% growth in GDP. We have also seen manufacturing and services activity improve, as well as retail sales, volumes and values.

We are also seeing house prices pickup, although this is currently biased towards the South. As economic improvements feed into job growth, this should become better balanced.

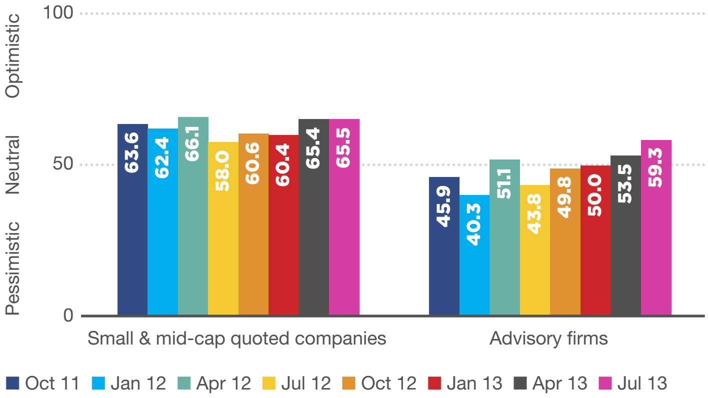
The newly appointed Governor of the Bank of England, Mark Carney, hinted in his debut public statement that the process of tightening monetary policy from the Bank of England is still some way off. It may be Q2 2015 before there are enough signs of a robust and self-sustaining recovery across the UK economy to support the case for a modest tightening of monetary policy, which is most likely to come in the form of higher interest rates.

With the UK economy showing signs of stabilisation at a macro level it is natural to see this translate into improved confidence amongst smaller growing businesses.

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

The outlook for the UK economy over the coming 12 months is one of cautious optimism. Whilst there are promising signs of growth ahead the UK is still susceptible to external shocks from Europe and for this reason businesses should err on the side of caution. GDP growth of 0.6% following the 0.3% we saw in Q1 is encouraging, but GDP still remains 3.3% below its pre-recession peak in Q1 of 2008.

However, we are seeing a clear upward trend in confidence in the UK economy in our index, with levels almost double what we measured last year in July 2012. If conditions continue to improve the tracker could top the 70 mark this time next year.

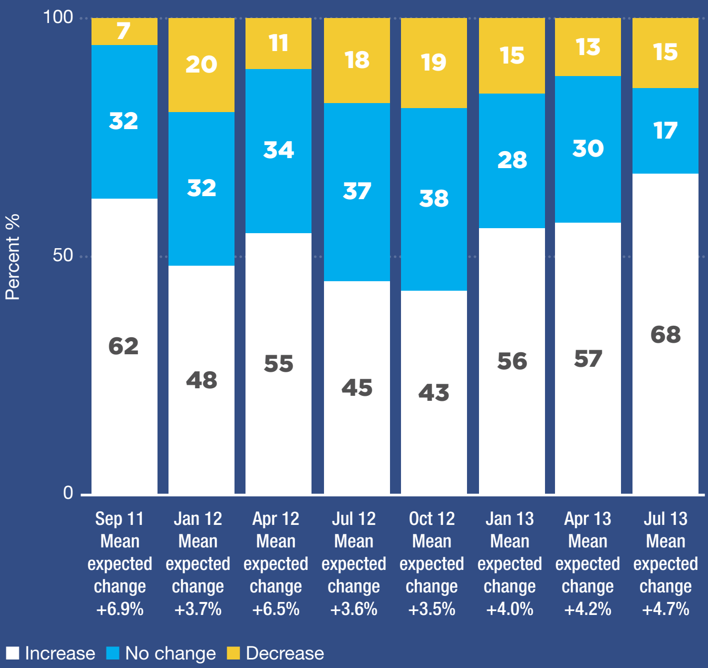
FUTURE EXPECTATIONS

The latest statistics from the ONS suggest that the UK job market has improved, albeit only slightly. The unemployment rate of the economically active population has fallen 0.2% to 7.8% and the number of vacancies has gone up over 10% year-on-year. However, total pay growth continues to lag behind inflation with no signs of an imminent improvement.

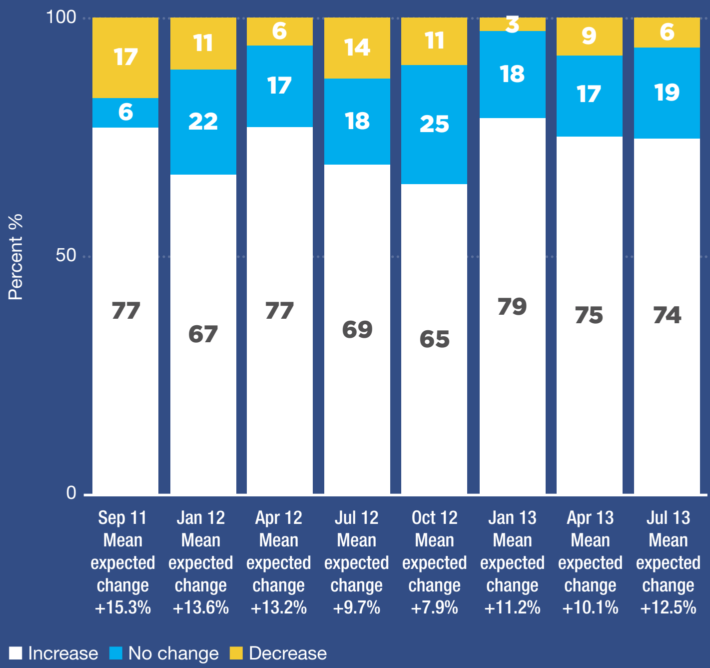
Employment prospects for small and mid-cap companies over the coming 12 months do, however, look considerably better with the mean expected increase in employment standing at the highest level since April 2012. Furthermore, it is extremely encouraging to see the large jump in the number of small and mid-cap companies expecting to see an increase in the number of full time staff over the next 12 months. With 68% of small and mid-cap companies expecting to see headcount increase over the next 12 months this marks the highest level we have seen since this survey began.

From a turnover perspective we get a slightly mixed picture, though on balance, things look considerably brighter for small and mid-cap companies. The number of companies expecting an increase in turnover in the coming 12 months has fallen slightly by 1% to 74%, whilst we also saw the number of companies who expect turnover to remain flat over the coming 12 months increase by 2%. However, we did see the number of companies expecting a decrease in turnover fall by 3% with the mean expected turnover increase to 12.5% – up from 10.1% in April. The improvement in mean expected turnover marks the strongest result we have witnessed since April 2012.

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

The improvements in both employment and turnover prospects at small and mid-cap companies are positive. The pickup in the economy appears to be translating into real-world results and it will be interesting to see whether these 'expectations' actually come to fruition.

Although the number of companies expecting turnover to remain flat has slightly increased this quarter it is encouraging to see that those who expect turnover to fall has decreased. This suggests that those companies who previously expected their turnover to fall are seeing an improvement in their prospects – probably a result of improved economic conditions.

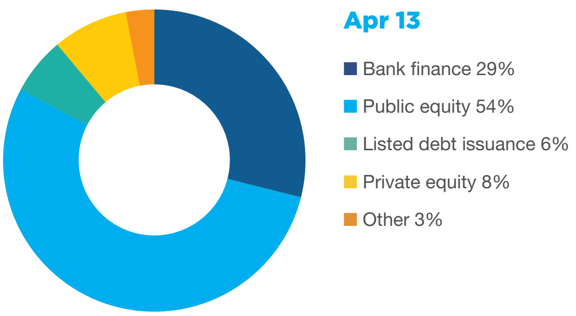
FUNDRAISING

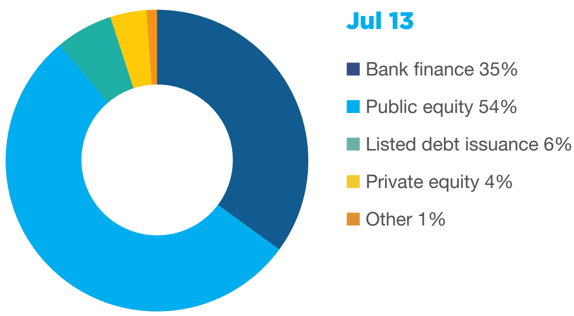
Over the last quarter we have seen small and mid-cap companies indicate that finance has become easier to obtain. Access to private equity has become marginally more difficult to obtain, dropping 0.1 points to 3.7 whilst public equity, bank finance and listed debt issuance have grown easier.

Public equity continues to be the most popular choice when it comes to raising capital, with 54% of small and mid-cap companies stating this as their preferred method. Bank finance has grown in popularity, with 35% now stating this as their preferred choice. Listed debt and private equity still lag far behind in popularity when it comes to raising capital.

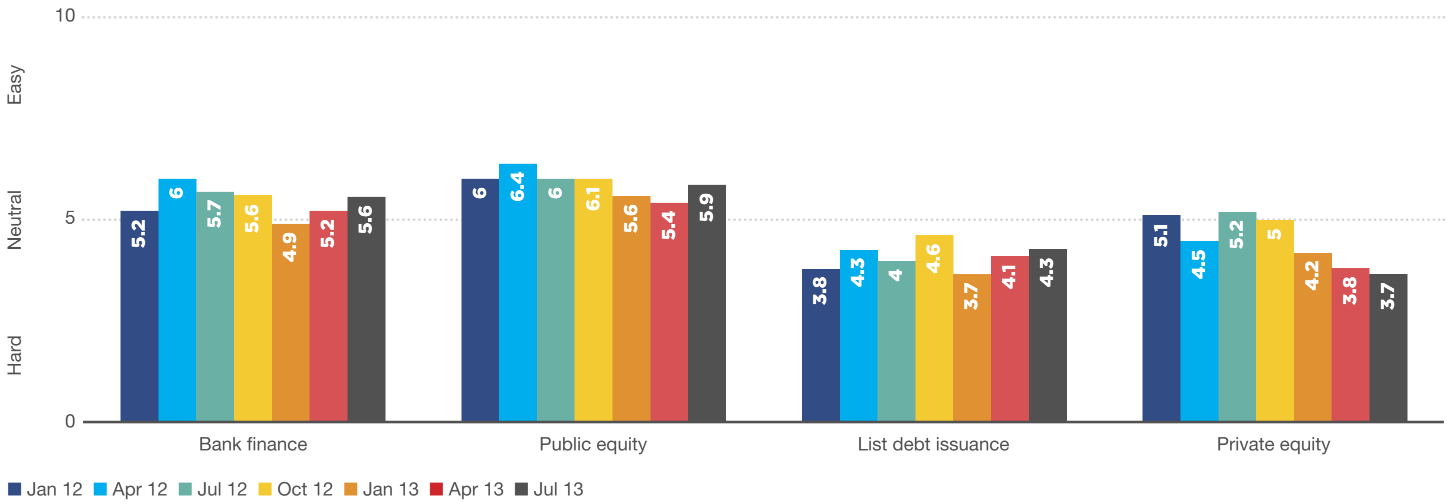
The results this quarter appear to be largely correlated to ease of access. With public equity indicated as the easiest method for raising finance it is unsurprising to see it remains the most popular. Private equity is the most difficult method of raising capital and its popularity reflects this.

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?



CORPORATE GOVERNANCE

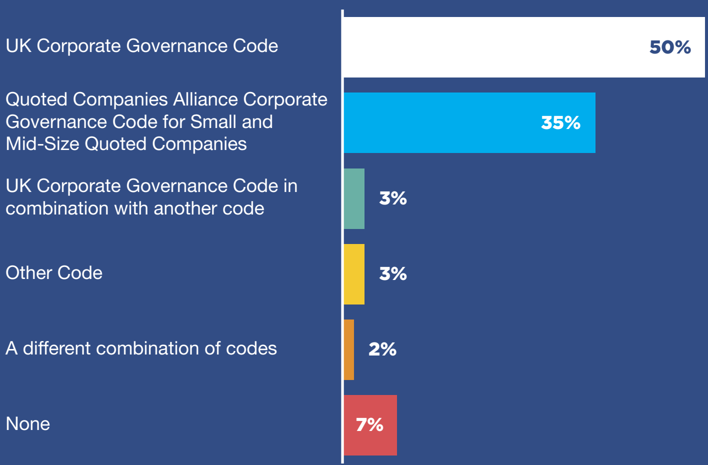
This year modern corporate governance celebrates its 21st birthday in the wake of the recommendations of the Cadbury report in 1992. Over two decades on, it is encouraging to see that over 93% of the small and mid-cap companies we surveyed follow a corporate governance code.

The UK Corporate Governance Code is the most popular set of guidelines for small and mid-cap companies with 50% of those questioned stating it as their preferred code. Second to this is the QCA Corporate Governance Code for Small and Mid-Size Quoted Companies with 35% adopting it.

Many small and mid-cap companies find it challenging following a corporate governance code, particularly the UK Corporate Governance Code, as a result of their size and stage of development. For this reason it is particularly pleasing to see that so many companies have a real appetite to adopt a code.

However, 7% of companies stated that they did not follow any code. These companies cited the size of their company and the effort required to follow a code as key factors for their decision of non-adoption. But, there were indications that these companies may be considering following a code.

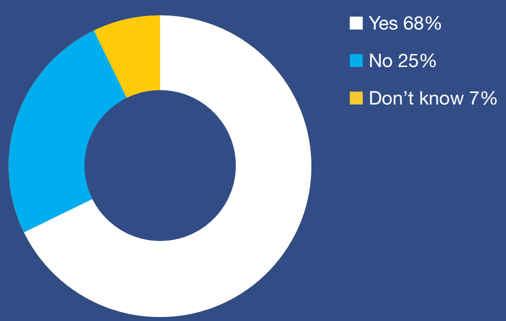
Which corporate governance code, if any, do you follow?



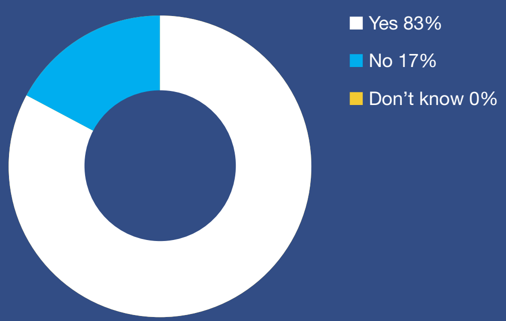
Interestingly the majority of respondents, both companies and advisors, were of the opinion that if you are an AIM or ISDX quoted company, you should have to publicly state which corporate governance code you follow. Furthermore the fact that 83% of advisors versus 68% of companies believe this suggests that those looking from an external perspective can see a real benefit of the greater transparency that this would provide.

Do you think AIM and ISDX companies should have to publicly state which corporate governance code they follow?

Small and mid-cap companies:



Advisors:



QCA/BDO VIEW

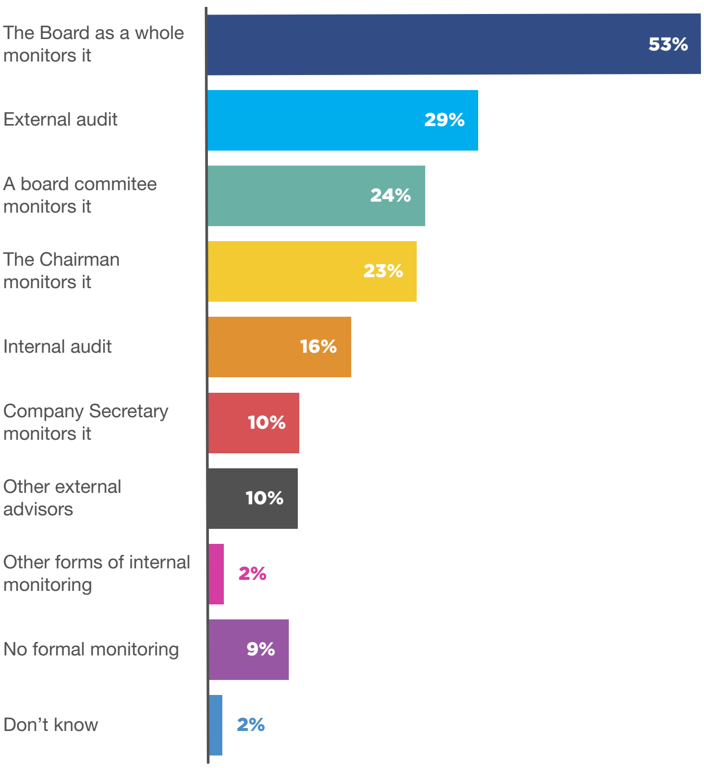
The difference between the advisors and the companies likely stems from the perceived additional effort the companies believe they may experience in stating which code they follow. The fact that the majority of small and mid-cap companies still believe they should publicly state this information is a telling sign of the benefits of doing so.

QCA/BDO VIEW

There is a clear call from the results that companies and advisors believe that AIM and ISDX should amend their rules and require companies quoted on those markets to state which corporate governance code they follow. We believe that this is a telling sign of the benefits that companies derive from being more transparent about their corporate governance arrangements.

One of the challenges of following a corporate governance code is ensuring and monitoring compliance. Of those companies that do follow a code, 53% monitored compliance through the whole board and 29% rely on the support of an appointed auditor. Perhaps most interestingly, 9% of those following a code have no formal systems in place to monitor compliance with their chosen code. The companies with no formal monitoring systems in place were all small cap companies with a turnover of less than £100m, which suggests that compliance processes may be correlated to the relative stage of development of the company.

Companies following a code: How, if at all, does your company monitor its compliance with your chosen corporate governance code? Please select all that apply

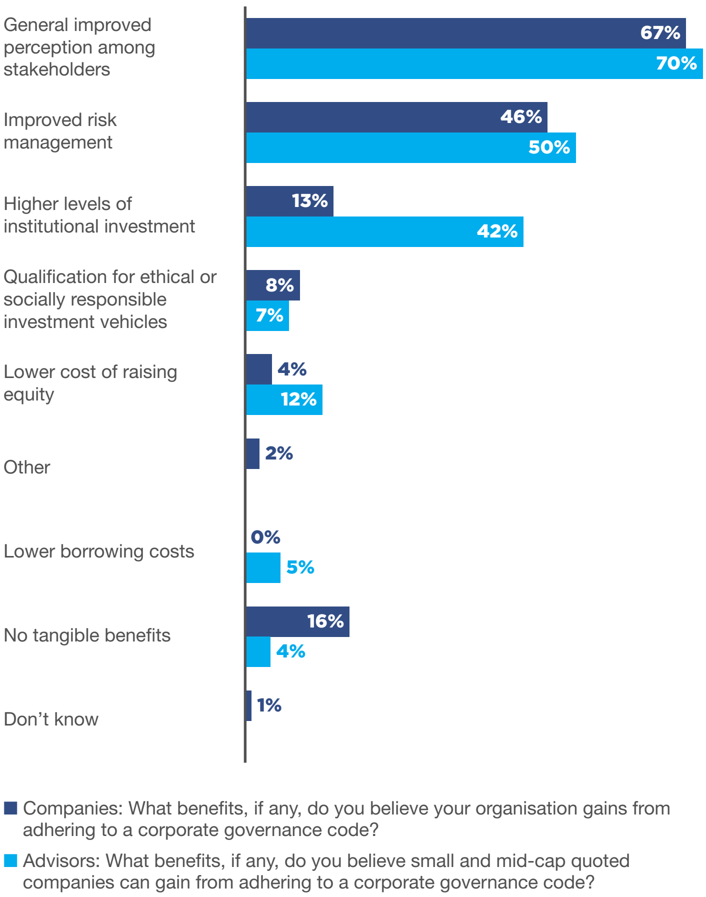


The benefits of corporate governance

It is clear that there are many benefits to be had from adhering to a corporate governance code with companies and advisors generally in agreement about the main benefits.

The top benefit in adhering to a corporate governance code identified by both advisors and companies is that it leads to a general improved perception among stakeholders, with around two thirds citing this. This is clearly important for quoted companies as it can have a strong influence in the long term growth of a company. Improved risk management is also seen as a key benefit by around half of respondents.

Top two benefits from adhering to a corporate governance code



QCA/BDO VIEW

The disparity between companies and advisors on the benefits of corporate governance, particularly its role in attracting higher levels of institutional investment, is interesting.

It suggests that small and mid-cap companies do not believe adherence to a corporate governance code leads to greater levels of institutional investment. This may suggest a lack of understanding by companies of the beneficial impact that effective corporate governance can bring on their shareholder base.

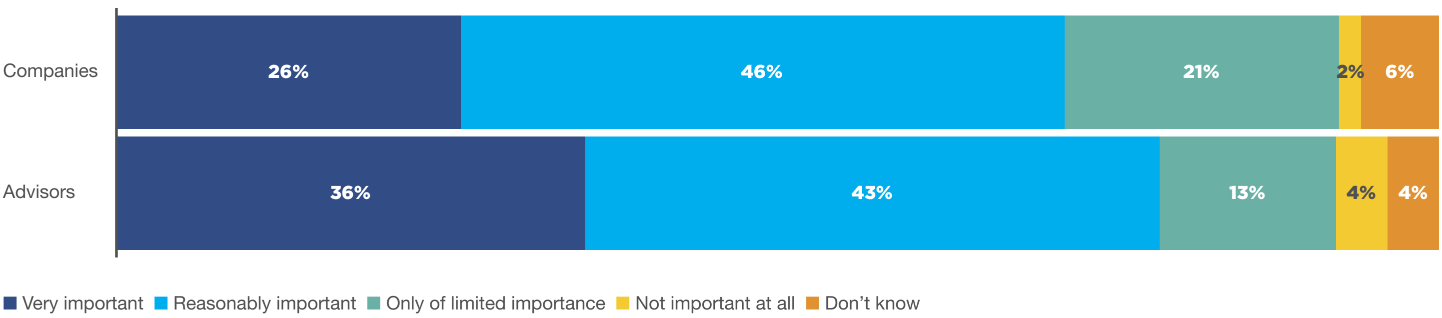
Comply or Explain

One area of debate surrounding corporate governance is the effectiveness of 'comply or explain' and whether we need to balance our code-based best practice approach with formal regulation. However, imitation is the sincerest form of flattery and the fact the 'comply or explain' concept has been copied, transposed and adapted in many Member States of the European Union as well as around 60 other countries worldwide suggests it is a highly praised system. Generally speaking the perception is that the UK's approach to corporate governance has brought benefits; however, this does not mean that this is the end of the work. Many believe that there is more to be done, especially with ensuring the quality of companies' explanations.

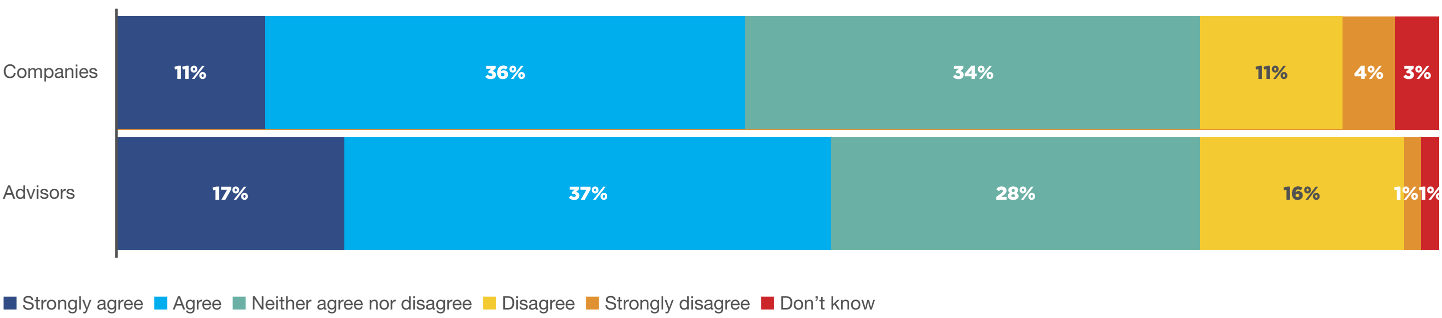
The majority of companies and advisors believe that 'comply or explain' is important in influencing effective corporate governance behaviour in the UK. Only 2% of companies do not believe it is important, with 92% believing it is of at least limited importance.

It is unsurprising to see such a high percentage of companies taking the stance that explanation is better than compliance. Good corporate governance is not a science but a reflection of human behaviour. Every company believes their circumstances to be unique and the flexibility of having the option to explain is highly beneficial to many companies. However, in any case, the explanation must be comprehensive and describe why compliance is not appropriate.

How important is 'comply or explain' in influencing effective corporate governance behaviour in the UK?



Do you agree or disagree with the following statement: 'Explanations are better than compliance when it comes to corporate governance'



…the quality of a company's explanations and reasons for non-compliance matter. To take a ridiculous extreme – a company saying that it is not complying 'because it did not want to' would be a situation where compliance was better than explanation.**

Advisor viewpoint

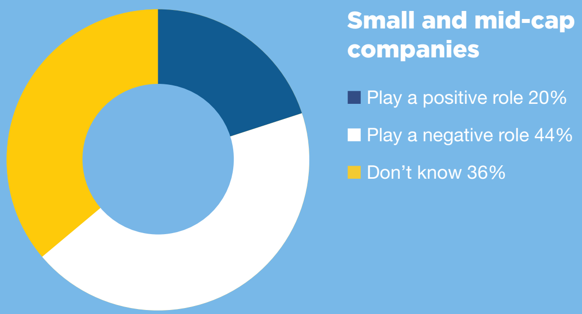
Proxy voting agencies

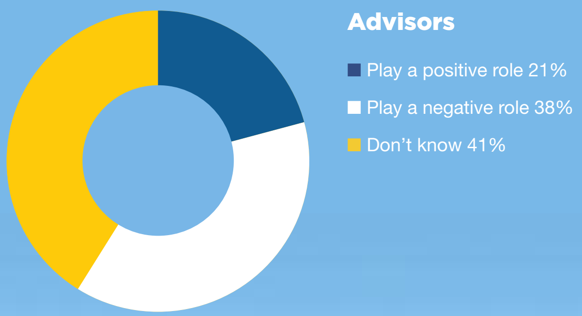
The role of proxy voting agencies is a major area of debate with many feeling they are impeding good corporate governance. Many institutional investors rely on the recommendations of proxy advisory firms in deciding how to vote. Some issuers may feel that the degree of de facto reliance gives proxy advisory firms the power essentially to dictate governance practices and pushes companies towards a tick-box compliance approach. Others may be concerned that the proxy advisors do not understand issues specific to that issuer or even that they get things wrong in their analysis.

Only 20% of small and mid-cap companies believe proxy voting agencies play a positive role whilst 44% believe they have a negative impact. In addition, the majority of companies and advisors believe that proxy voting agencies were either not transparent enough about their decision-making or would benefit from greater levels of transparency.

Surprisingly, however, for both of these questions a significant proportion chose not to voice an opinion, saying they did not know. This may be attributed to the fact that at the smaller end of the market companies are much less likely to have dealings with proxy advisors. Only 40% of companies had ever had a request to respond to a proxy voting agency.

Do proxy voting agencies play a positive or negative role in corporate governance?





20%

of small and mid-cap companies believe proxy voting agencies play a positive role whilst 44% believe they have a negative impact.

Proxy agencies provide a box ticking approach. They do not take account of any explanations provided by the company. Companies of our size cannot possibly comply with the UK Corporate Governance [Code] due to the cost of doing so.

Small and Mid-Cap Company viewpoint

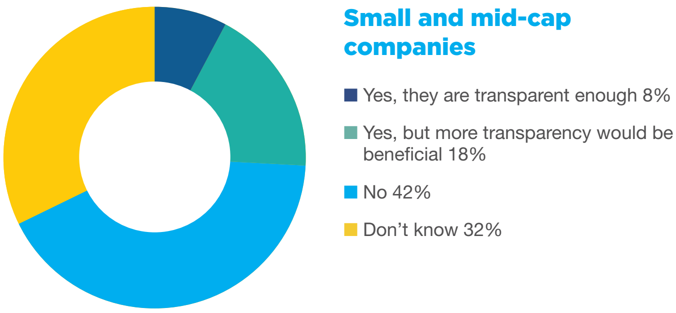
"[Proxy voting agencies] should be much more transparent themselves and provide an explanation as to why they themselves are recommending actions/positions on issues. They should also disclose their activities more to shareholders so that more balance is brought to bear in the whole stakeholder/company process. It would also facilitate better dialogue and better overall compliance and cooperation in achieving more effective governance.

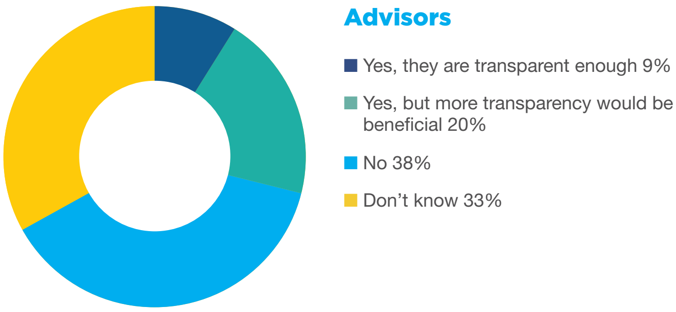
Small and Mid-Cap Company viewpoint

QCA/BDO VIEW

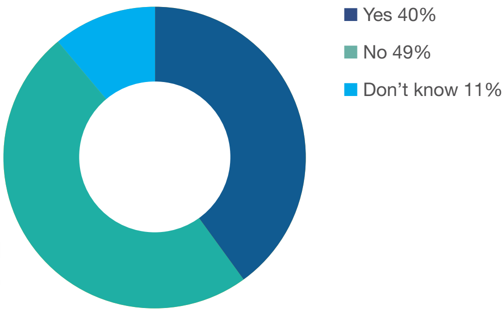
Proxy voting agencies play an important role in supporting investing institutions. However, for small and mid-cap companies, the consensus is that these organisations are impeding good corporate governance. They often provide little time to answer queries and, by nature of what they do, they may impair dialogue between companies and institutional investors.

Do you think proxy voting agencies are transparent enough about their decision-making process?



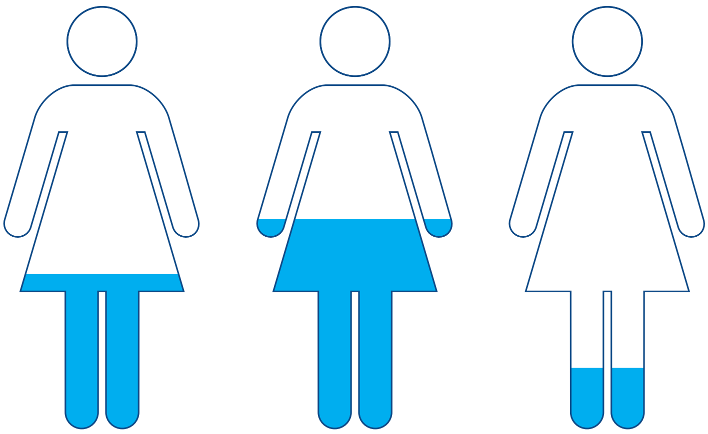


Companies: Have you ever had a request to respond to a proxy voting agency's query or voting recommendation?



Women on boards in small and mid-cap companies

52 respondents' companies recruited for board positions in the last 12 months



37%

Appointed a female candidate to the board

W3 April 2012 28%

50%

Had female candidates on the short list(s) for a board position(s)

W3 April 2012 38%

15%

Specifically sought out, or instructed recruiters to seek out, female candidates for the long list for these position(s)

W3 April 2012 23%

One year on, it seems that small and mid-cap companies are looking to increase the number of women on their boards. Of the 52 companies that recruited for board positions in the last 12 months, half had female candidates on the short list and 37% appointed a female candidate to the board. These are up 12% and 9% respectively from when we asked the same questions back in May 2012.

However, only 15% specifically sought out female candidates for the long list, compared to 23% doing so in May 2012.

QCA/BDO VIEW

It is highly encouraging that we are seeing an increasing percentage of companies that had women on their short list when recruiting for board positions. Furthermore the number of women appointed has also increased. We did see the percentage of companies specifically seeking out or instructing recruiters to seek out female candidates fall.

This may be attributed to increased awareness on the debate about women in board level positions; more women may be seeking out board positions; or a change in recruitment practices which would make it less necessary for companies to specifically request this.

However, there is still an imbalance between men and women on boards. More must be done to ensure that companies have diverse boards and actively seek out women for board level and senior management positions.

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 189 online interviews (113 small mid-cap quoted companies, 76 advisory companies) with members and associates of the QCA. The survey respondents included 77% of small and mid-cap company employees in a board level position and 58% of advisors in a senior management position. It was conducted between 04 July and 17 July 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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21 YEARS ON FROM THE GAME CHANGING CADBURY REPORT OF 1992, IT IS ENCOURAGING TO SEE THAT 72% OF SMALL AND MID-CAP COMPANIES SEE 'COMPLY OR EXPLAIN' AS VERY OR REASONABLY IMPORTANT.

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THE FDs' EXCELLENCE AWARDS ICAEW AUDITOR OF THE YEAR: LARGE FIRMS 2012

TAXATION AWARDS 2011 WINNERS

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