THE SMALL AND MID-CAP SENTIMENT INDEX

PULSE

INSIDE THE HEAD OF ED THE NED

EXAMINING THE GREY MATTER OF THE AVERAGE SMALL AND MID-CAP QUOTED COMPANY NON-EXECUTIVE DIRECTOR

03

ISSUE 14
SUMMER 2015

QUOTED COMPANIES ALLIANCE
YouGov What the world thinks
BDO

There's no such thing as an *average non-executive director* of a small or mid-cap quoted company...

...but, *if there were*, what kind of conversations would they be having this summer?

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THE SMALL AND MID-CAP SENTIMENT INDEX

PULSE

PULSE is a joint publication by BDO LLP and the Quoted Companies Alliance based on research conducted by YouGov

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Welcome to Issue 14 of PULSE, the report of our triannual Small and Mid-Cap Sentiment Index.

BDO and the Quoted Companies Alliance have created PULSE to give you more access to and flavour of the views you and others have expressed through our regular survey of the leaders of the small and mid-cap quoted company sector.

In this issue we have looked at our usual indicators: business and economic prospects, attitudes towards access to capital, together with expectations of job and sales growth over the coming 12 months.

Our survey took place immediately following the General Election and the results show a marked increase in confidence since January when uncertainty about the impending election was clearly impacting confidence.

Optimism in the UK economy and business prospects has seen a jump from companies and advisers; and companies' turnover expectations have hit a record high since this survey began in September 2011. This has resulted in the second highest mean expected employment growth for companies.

> *"Although business confidence is generally high across Europe, the EU is still a cause for concern and businesses should be preparing themselves for a variety of possible changes"*
>
> SCOTT

There has been no real change over the last survey in the preferred channels for raising finance, with public equity remaining the most popular with 47% of companies. Companies are starting to find it tougher to access bank finance and listed debt issuance, although there is a difference in the views of companies and advisers on this.

We also investigated the role of the Non-Executive Director (NED) and discover a significant gap between what companies and advisers think about the value for money they provide, the expertise they bring to the company and their level of independence.

> *"Advisers have differing opinions of non-executive directors to the companies they work for – NEDs need to better promote the value they bring in order to close this gap"*
>
> TIM

This poses several interesting questions including who is better positioned to judge this – the company or their advisers? PULSE paints an interesting picture of the profile of a typical NED, including the number of directorships they hold, how much they get paid and how the role has changed since we last researched this subject.

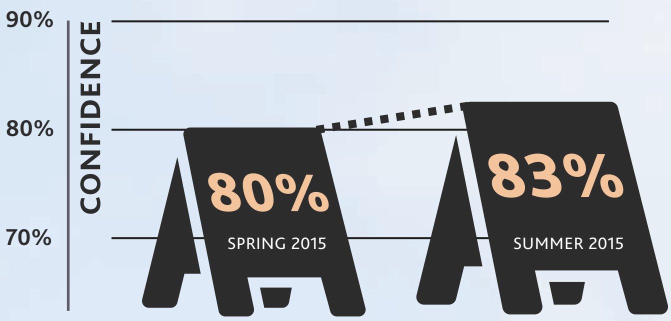
We also looked at the process of measuring board effectiveness, how often and how they are evaluated, along with the recruitment process for new members of the board.

The gender split of directors on boards is regularly reported on, including the 2014 Board Review, which BDO and QCA produced in partnership with Norman Broadbent, but in this issue of PULSE we looked at the board recruitment process over the past year in order to understand what is happening now in terms of women being appointed to senior positions.

In summary, there are some encouraging signs that more companies are seeking out and appointing female candidates.

We hope you enjoy PULSE and as ever, if you have any ideas for topics you'd like to find out more about, then please let us know.

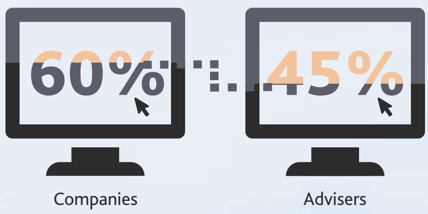
BUSINESS CONFIDENCE ON THE RISE POST GENERAL ELECTION



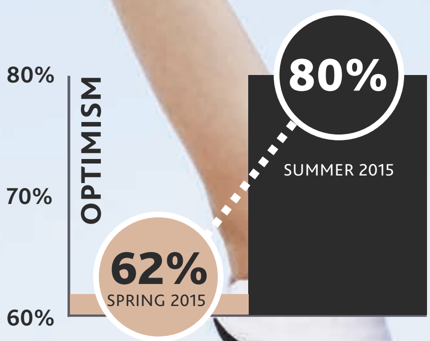
COMPANIES GROW MORE CONFIDENT IN THEIR OWN PROSPECTS. 83% of small and mid-cap quoted companies are optimistic of their own prospects over the next 12 months which is an increase from 80% in the previous survey.

COMPANIES EVALUATING THEIR BOARDS MORE OFTEN THAN REQUIRED.

60% of companies evaluate their board every year...

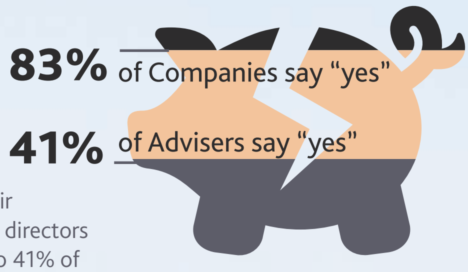


...but only 45% of advisery companies indicate they should do so.



CONFIDENCE IN THE UK ECONOMY PICKS UP. 80% of small and mid-cap quoted companies are optimistic about the UK economy over the next 12 months, a significant uplift from the 62% reported in the previous issue.

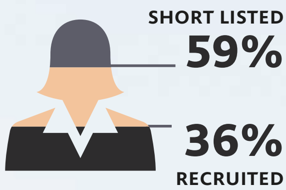
DO NEDS PROVIDE VALUE FOR MONEY?



83% of companies feel they receive good value for money from their non-executive directors compared to 41% of advisers who think the same. Interestingly, companies think they are getting better value than in 2013 when we last asked the question whereas advisers think they are providing worse value than then.

FEMALE BOARD APPOINTMENTS MAKING PROGRESS

Of the 49% of small and mid-cap companies that recruited board members in the last 12 months, 59% had women on the short list and 36% went on to recruit a woman.



EMPLOYMENT PROSPECTS IMPROVE.

77% of small and mid-cap quoted companies (and 88% of advisers) expect the number of full time employees to increase over the next 12 months - a continuation of the trend in recent months.

There's no such thing as an average non-executive director of a small or mid-cap quoted company but if there was, what would he look like? (And sadly it is still more likely to be a he rather than a she). Well, it depends on who's looking, as there's some difference between what a company sees and what an adviser sees.

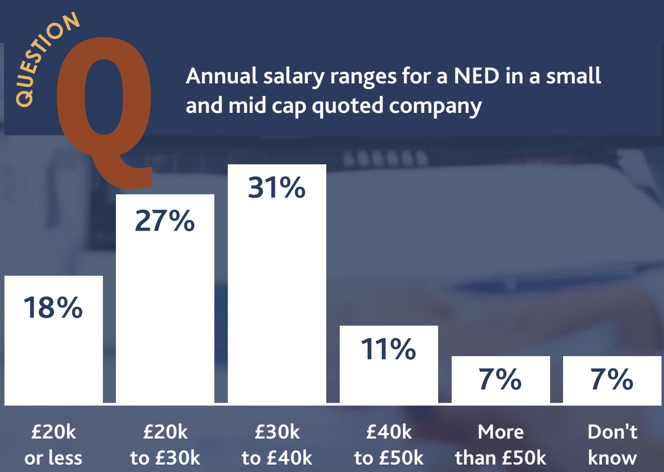
A LOOK INSIDE THE HEAD OF ED THE NED

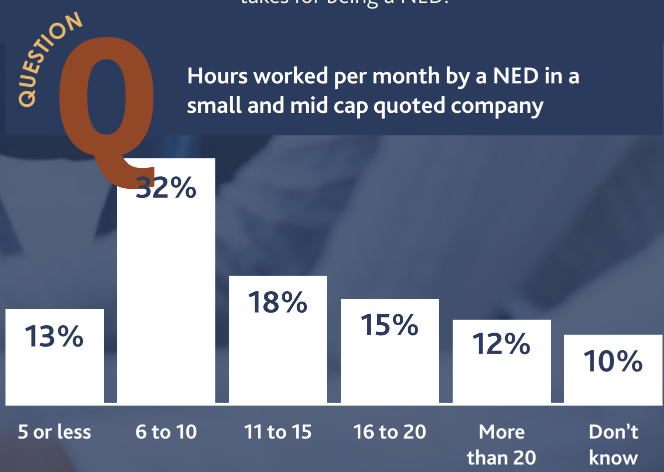
Our average NED, let's call him Ed, receives a fee of £33,400 per annum for each directorship he holds. He's had a 7% pay increase since 2013 so he's ahead of the inflation game. Ed works about 14 hours per month for his company - that's an hour less than in 2013.

Ed's peers have salaries that range from less than £20,000 to more than £50,000 per role. Some work less than five hours per month and others more than 20 hours.

Ed holds another two directorships so his total time commitment is 47 hours a month (or six full days) and for that work he earns £110,554 per annum.

Ed's full-time equivalent salary is about £330,000 per annum. He's surprised by that figure because he's often thought he doesn't get enough money to mitigate the risk he takes for being a NED.





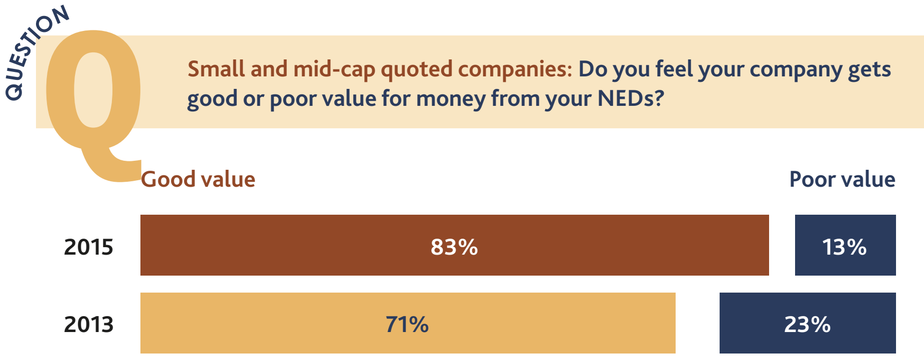
When Ed asks his executive peers at other companies whether they get value for money from their NEDs, 83% say they do. And, that's more than in 2013 when only 71% thought so. Ed thinks this shows that he and his peers are becoming a more professional and effective resource for their companies.

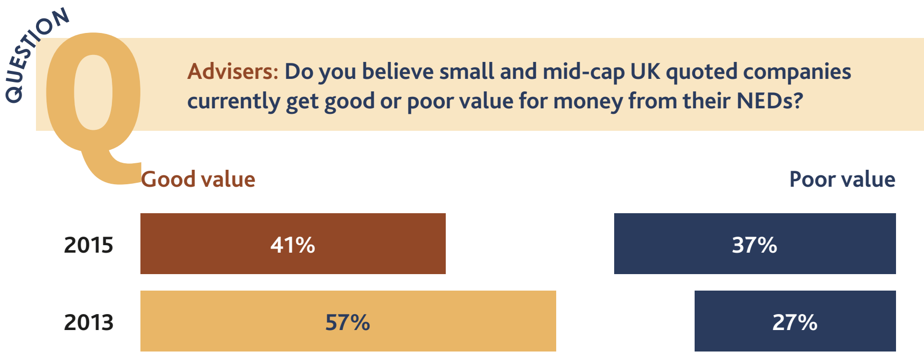
However, when he speaks to advisers, less than half (41%) tell him that he and his mates provide good value. That's down from 57% in 2013. And it gets worse, as more advisers (37%) think that NEDs actually provide poor value for money against 27% last time.

So who should Ed believe? The companies say things are improving but the advisers think things are getting worse. Should he work harder for each company he represents? Ed asks his peers and they suggest that he should add another couple of hours to his commitment. He's rather shocked when advisers tell him that to become more effective they would expect him to work around 23 hours per month on each role.

That's an extra day per month for each role and means his full-time equivalent salary would drop by approximately a third to £207,800. If advisers provide word of mouth recommendations to companies for future NED roles, then Ed supposes he probably needs to up his game to conform to the expectations of these advisers.

Ed also asked whether companies and advisers saw him and his ilk as being sufficiently independent from management to provide an independent and critical voice in running the company.





Many asked what was meant by sufficiently independent and he offered the view that small and mid-cap boards are made up of people who have broad business experience, can improve corporate governance and can provide appropriate checks and balances with a touch of long-term vision and planning.

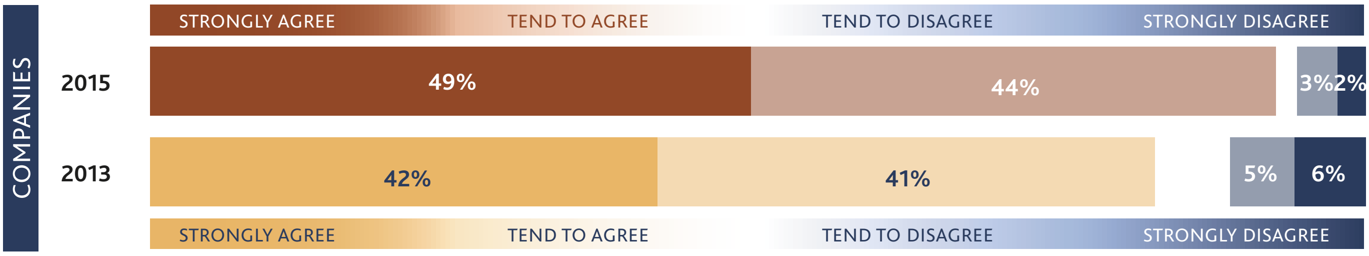
Some of these activities require independence from the company's operations; others require a high degree of participation in the business.

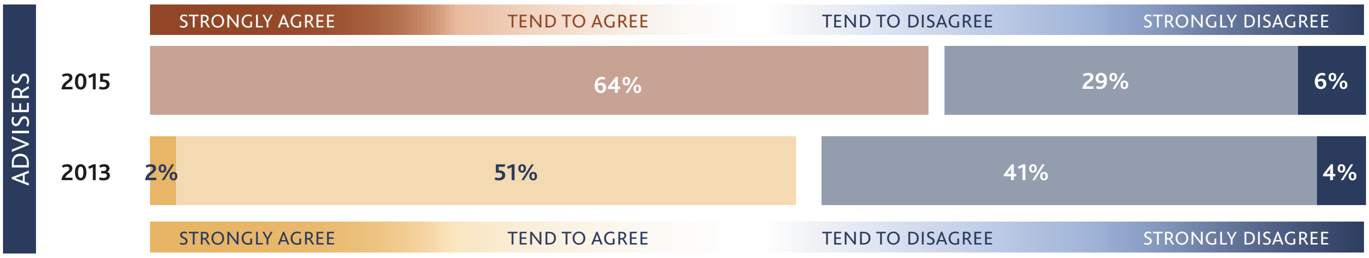
So his view is that independence is a state of mind and that it is needed at critical times, but not all the time.

He was surprised to learn that whilst only 6% of companies think that he and his friends are not sufficiently independent, as many as 34% of the advisers tend to that view. He will have to think more about how he demonstrates his independence to the outside world. He may think that independence is a state of mind but most advisers are not mind-readers.

QUESTION Q

"In general, non-executive directors of small and mid-cap UK quoted companies are sufficiently independent from management to provide an independent and critical voice to the running of their companies." How far do you agree or disagree with this statement?





In order to up his game, he asked where he could contribute more. The companies told him to bring more long-term vision and planning, together with an even broader business experience, to the boardroom table.

They'd also like to see him share some of his valuable investor and other contacts. However, they see corporate governance and providing the checks and balances as less important.

Ed is finding that what he thinks is an effective contribution is not necessarily what companies see as being an effective contribution. There's a need to clear the air on what is expected of him.

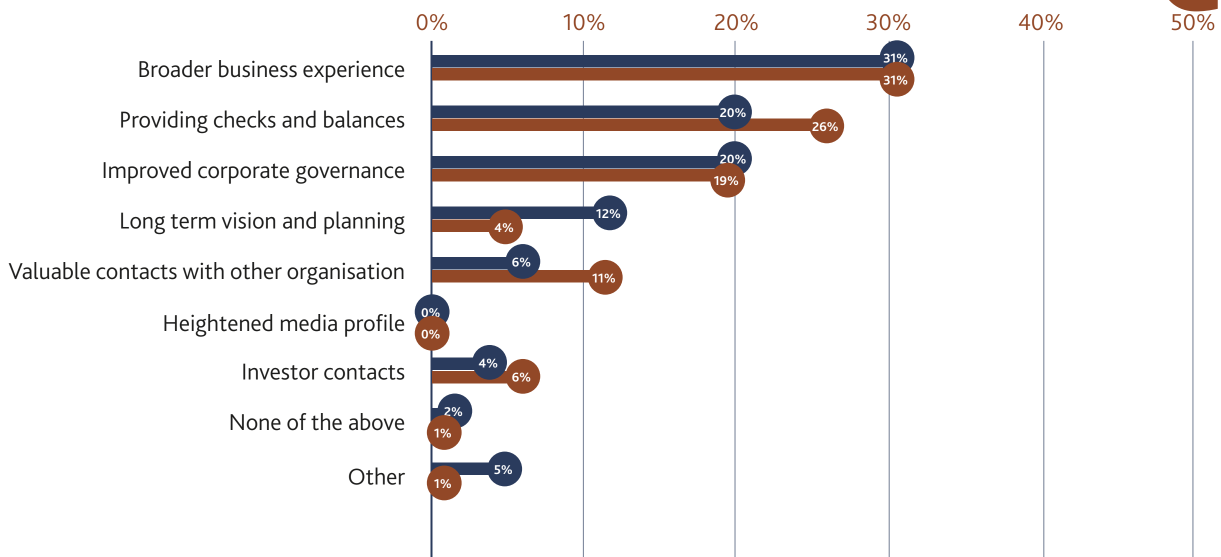
AREAS WHERE NEDS BRING THE MOST VALUE (PLEASE SELECT THE SINGLE MOST VALUABLE)

QUESTION

Small and mid-cap quoted companies: Where do non-executive directors currently bring the most value to your company?

QUESTION

Advisers: In general, where do non-executive directors currently bring the most value to small and mid-cap UK quoted companies?



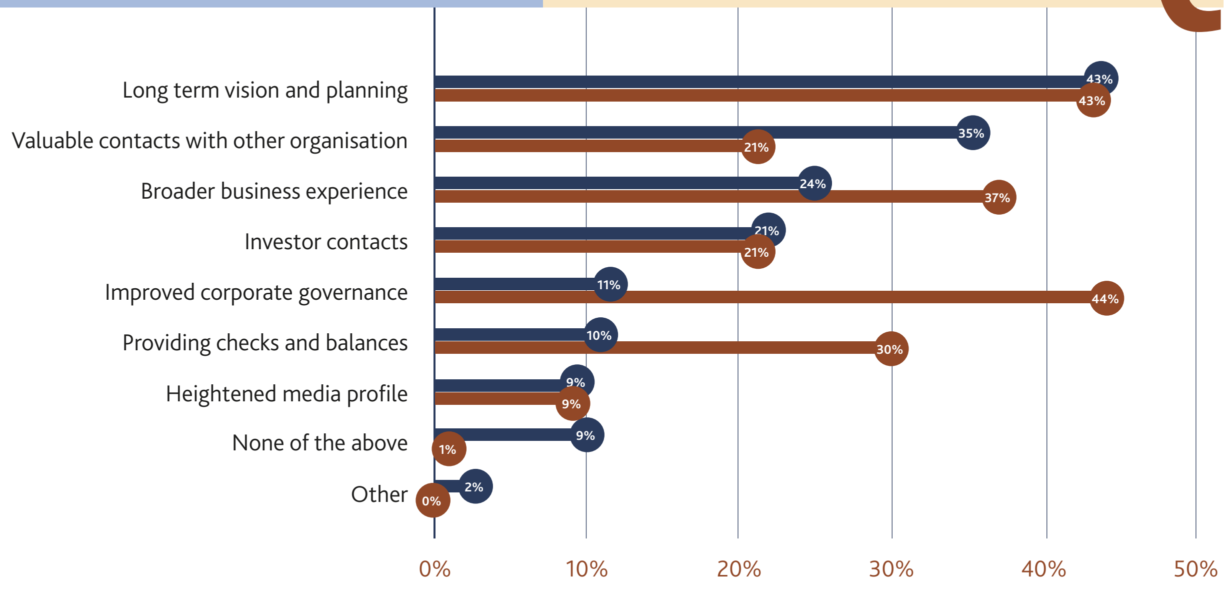
AREAS WHERE NEDS CAN CONTRIBUTE MORE (PLEASE SELECT ALL THAT APPLY)

QUESTION

Small and mid-cap quoted companies: Which of these, if any, would you like to see your company's non-executive directors contributing more of?

QUESTION

Advisers: Which of these, if any, would you like to see the non-executive directors of small and mid-cap UK quoted companies contributing more of?



When he asked the question of the advisers he received broadly the same answer except that they want to see more corporate governance expertise from him.

He's not surprised by this, as it is clear that with more disclosure required by policymakers about corporate governance behaviours and structures (such as the change to Rule 26 of the AIM Rules), there will inevitably be more external pressure to provide the necessary information and give comfort to the advisers.

There's a tension surrounding corporate governance where advisers want more and companies want less.

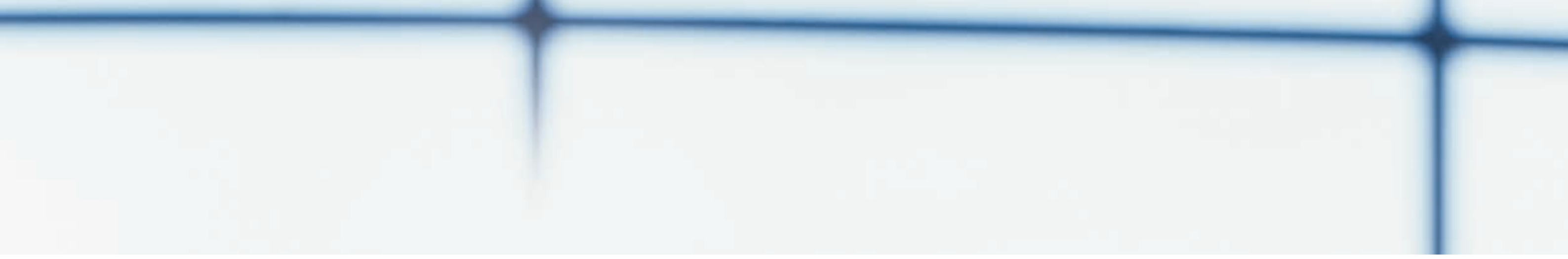
Ed feels that the inevitable outcome is that advisers (and investors) will prevail so he will have to start re-educating his board to demonstrate the good effective corporate governance practices in his companies. It's not enough to just do it; it needs to be communicated effectively too.

- **Ed knows he has to up his game. Small and mid-cap quoted companies share the view that NEDs are more effective in their roles than in 2013, but advisers aren't seeing this.**
- **He trusts that perception lags reality but he knows that he and his peers have got to demonstrate their true worth externally as well as internally.**
- **This may mean working harder, but it's probably more important to work on those things that benefit the boardroom and investors.**

Is creating the right board an art or a science? Our survey suggests there are some confusing messages coming from the evaluation process and when recruiting for board positions.

Companies in the small and mid-cap sector are using their own resources to review how effective their boards are. It's good to learn that they see this as an important feature of the board cycle as they evaluate their performance on a regular basis, with the vast majority (74%) doing so at least every two years.

The business of boards



Self-evaluation is the most pragmatic, but perhaps least objective way of doing so. But given the relatively small size of boards in the small and mid-cap space, this could be the most effective way. Most advisers agree with this approach of regular reviews performed within the organisation.

75% of advisers say every company should conduct an evaluation of its board at least every two years. According to companies the review of effectiveness of the board is usually self-assessment facilitated (72%) by the Chairman or Senior Independent Director, with very few (5%) using external software.

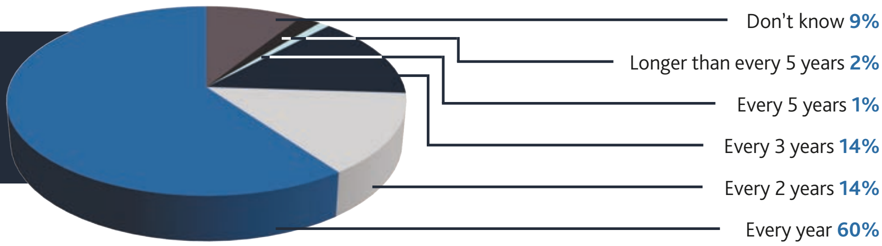
Presently only 6% of companies use external consultants. A similar majority of advisors (64%) think that companies should undertake self assessment by the Chairman or Senior Independent Director, with just 13% calling for the use of independent external consultants. What can we take from this? Anecdotally, companies are telling us that boards need to operate as an effective unit. It is no longer good enough to have a number of talented individuals – each director must be effective not only as an individual but also as part of a team. The evaluation process should assess the contribution and competence of individuals – and the performance of the team as a whole.

In assessing whether boards are effective, questions need to be asked about the skill sets available. So we asked what companies think their boards lack in terms of skills. Top of the list from companies comes "don't know" (21%). Boards need to be aware of what skill sets are required to deliver long-term value for their shareholders.

For one in five companies to say they don't know is worrying. The board evaluation process should assess the skills required so that the board can be benchmarked against these measures.

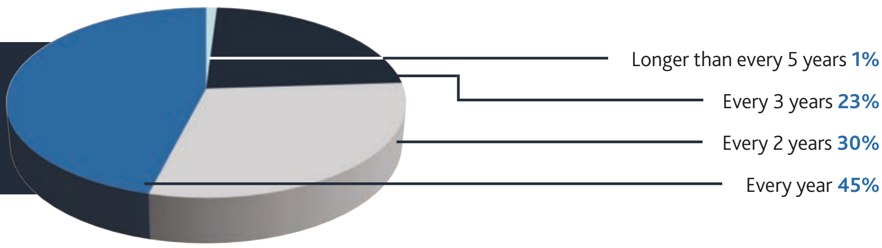
QUESTION Q

Small and mid-cap quoted companies: On average, how often does your company evaluate its board?



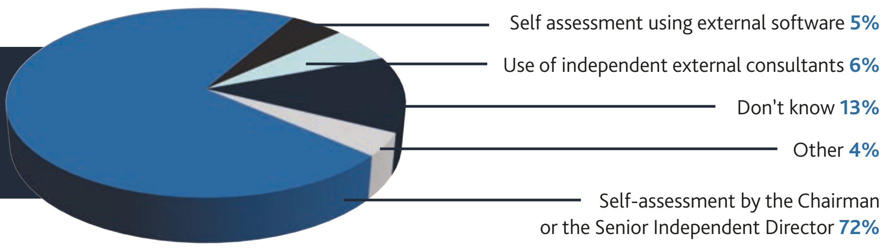
QUESTION Q

Advisers: On average, how often should small and mid-cap UK quoted companies evaluate their boards?



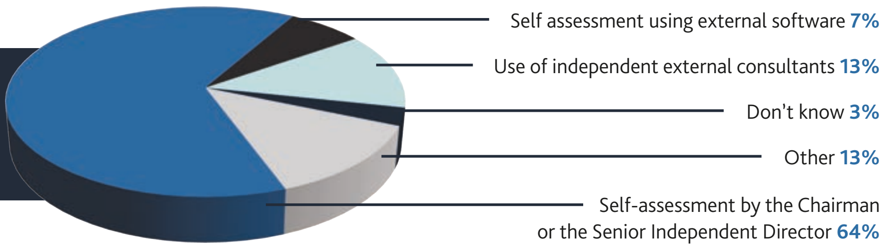
QUESTION Q

Small and mid-cap quoted companies: How do you evaluate the effectiveness of your board?



QUESTION Q

Advisers: How should small and mid-cap UK quoted companies evaluate the effectiveness of their boards?



Another interesting insight is the dissonance between the skills highlighted by companies and those highlighted by advisers. Companies look for company-specific skills whilst advisers want more knowledge and experience of equity market-related matters, including risk management.

41% of companies want NEDs to contribute more in the areas of sector experience (15%), corporate social responsibility (15%) and risk management expertise (11%).

In contrast, more than half of advisers suggest that areas such as equity market expertise (12%), financial regulation understanding (16%), corporate governance knowledge (17%) and corporate finance expertise (7%) are lacking on boards.

Perhaps they would like someone who has 'City' knowledge on the board to discuss such matters in reasonable depth – a friendly ear on the board.

So companies feel they lack the relevant skills to drive the business, whilst advisers feel there is a relative absence of skills relating to the company's presence on the stock market.

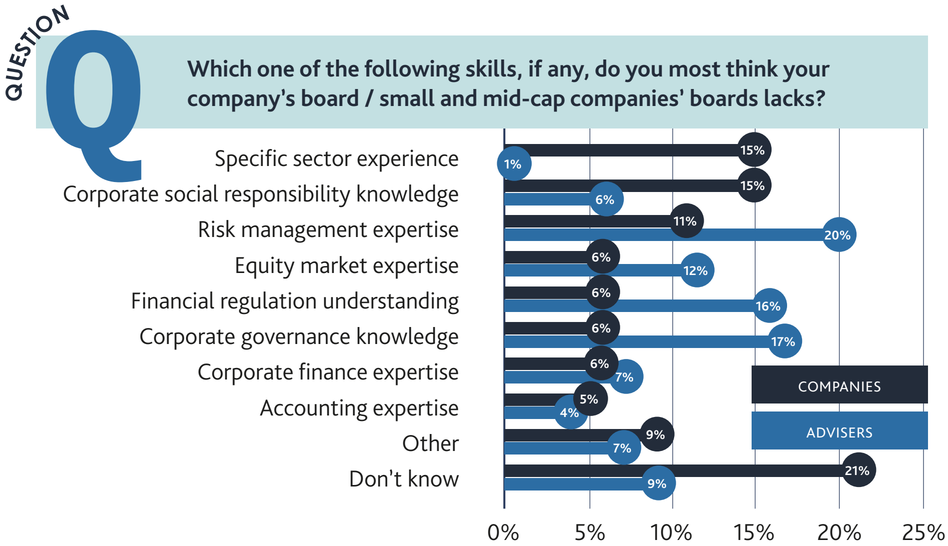
Perhaps the latter is related to self-interest.

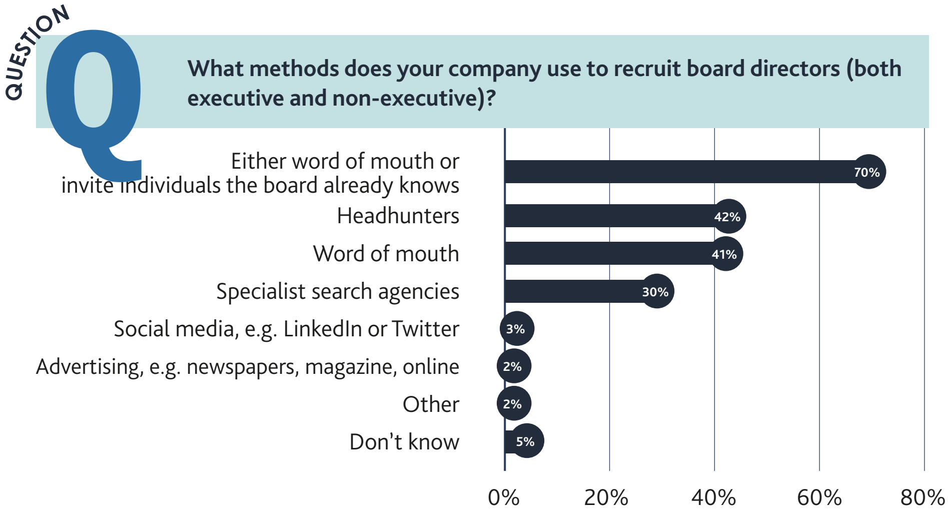
If a board could look after itself when it comes to City matters, would the advisers have to take less responsibility and do less work? However, would they find that they are left out of some discussions as a result?

In addressing these skill gaps, we asked companies what methods they use to recruit board directors. It's clear from the responses that companies tend to use word of mouth or invite people they already know to fill board positions.

This is a low-cost method and ensures a new board member is a known quantity on appointment. However, in this day and age one has to ask whether this will produce a candidate that will fill skill gaps and increase the breadth of knowledge and diversity of the board.

'Groupthink' could well be reinforced through hiring people from the same background or skill set – 70% of companies use word of mouth or invite individuals





that they already know, so this informal approach is the most used and perhaps the least likely to create a substantial change in board profile.

Headhunters are used by 42% and this may complement the informal approach. It will be interesting to see whether the profile of boards changes over the next few years as gender diversity and succession planning move up the agenda of policymakers and boards.

We are seeing a refreshing approach to board evaluation together with some doubt as to whether the right skill sets are being identified. There may be a move to using external recruitment consultants more often over the coming years.

We think there needs to be more discussion between companies and their advisers as to what the skill profile of the board should be and what skills it sources externally. There is much to do and consider. The right blend on the board is an art not a science.

Women on boards

In the last 12 months **61** respondents recruited for board positions...

59% *...had female candidates on the short list*

COMPARED TO ISSUE 8 SEP 2013 **51%**

36% *...specifically sought out female candidates for the long list*

COMPARED TO ISSUE 8 SEP 2013 **15%**

36% *...appointed a woman to the board*

COMPARED TO ISSUE 8 SEP 2013 **37%**

It is increasingly recognised that boards made up of people with a range of skills and experience tend to be better equipped to lead and grow businesses sustainably.

Diverse boards ensure that there is a broad set of skills represented, equipping companies better to tackle any challenges. Diversity among directors also enables healthy debate and challenge around a boardroom table, in turn discouraging 'groupthink' – one of the factors blamed for big business failures at the beginning of the 2008 financial crisis.

Recent reports show that UK PLC's boards are becoming more diverse in terms of gender. Following Lord Davies' review into women in the boardroom in 2011, the Government set a target of 25% of women on FTSE 100 boards by the end of 2015.

Today, women represent 23.5% of FTSE 100 board positions – almost double the starting point of 12.5% in 2011. The UK is well on its way to reaching this target at the end of the year, which shows that behaviours and attitudes are changing.

The pace of change is much slower at the smaller end of the market. Women make up only 18% of FTSE 250 boards, and there remain 23 all-male boards in the FTSE 350.

Research conducted by Norman Broadbent, in conjunction with BDO and the Quoted Companies Alliance, found that only 7% of non-executive appointments to AIM company boards in the last three years have been women.

Nonetheless, PULSE continues to find that small and mid-cap quoted companies are trying to build more diverse boards. Of the 61 companies that recruited for a board position in the past year, 36% (22 companies) specifically sought out female candidates for the long list.

Over half (59%) of the 61 companies had at least one woman on their short list and, of these, 36% went on to appoint a woman.

While more women are making it onto the short list, their chances of being appointed aren't that much greater, though they do seem to be on the rise. In 2013 only 51% of companies had women on their short list, versus 59% this time, while 37% of companies went on to appoint a woman compared with 36% this time.

Where we have seen a slightly greater change, is that a higher proportion of companies recruiting for a board position (15% in 2013 vs 36% now) are specifically seeking out women for their long list.

However, it seems to be the larger firms (£100m+ market cap) that are more likely to actively seek out women for the long list rather than smaller firms (<£100m) – 47% vs 26%. Larger firms are also more likely to have women on their shortlist (70% vs 48%).

business confide

January's survey for PULSE saw mixed results, and there was clearly significant uncertainty amongst both small and mid-cap businesses as well as the advisory community.

The forthcoming election was clearly causing significant uncertainty amongst companies and advisers alike. Expectations surrounding the general economy and own business prospects reached their lowest mark for 18 months.

Now we are the other side of the election, companies are more confident with the prospects for the country: the fact that a hung Parliament or coalition has not materialised is an influence here.

This has provided businesses with a firmer foundation on which to base their strategies, with companies surveyed now more confident that business conditions will improve.

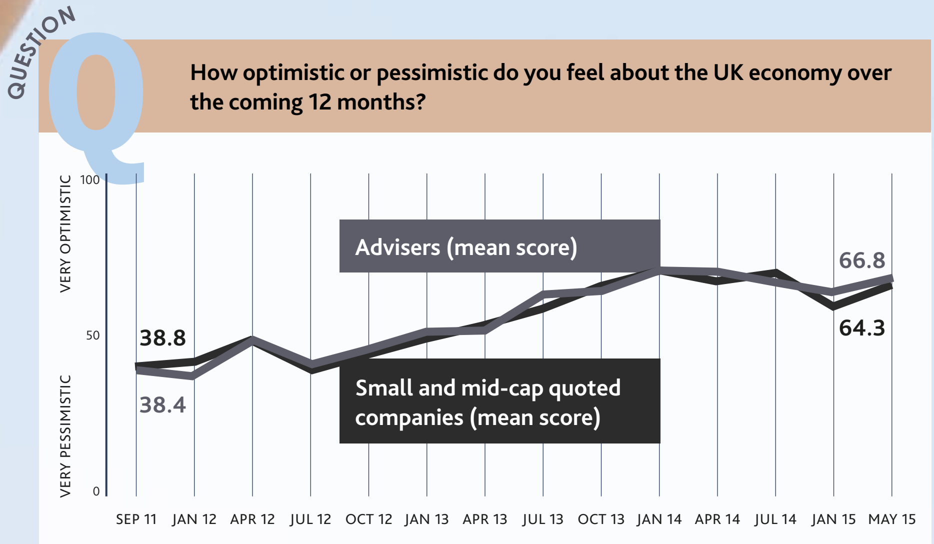
After dipping sharply in January, businesses' confidence in the UK economy is on the rise: the mean optimism score for companies in May now stands at 64.3 - up from 58.3 in January, and for advisers the score is 66.8 - up from 61.9 in January. The results from this survey mirror a number of other business sentiment surveys released this month, and show that companies are more confident about prospects for the UK economy following the election.

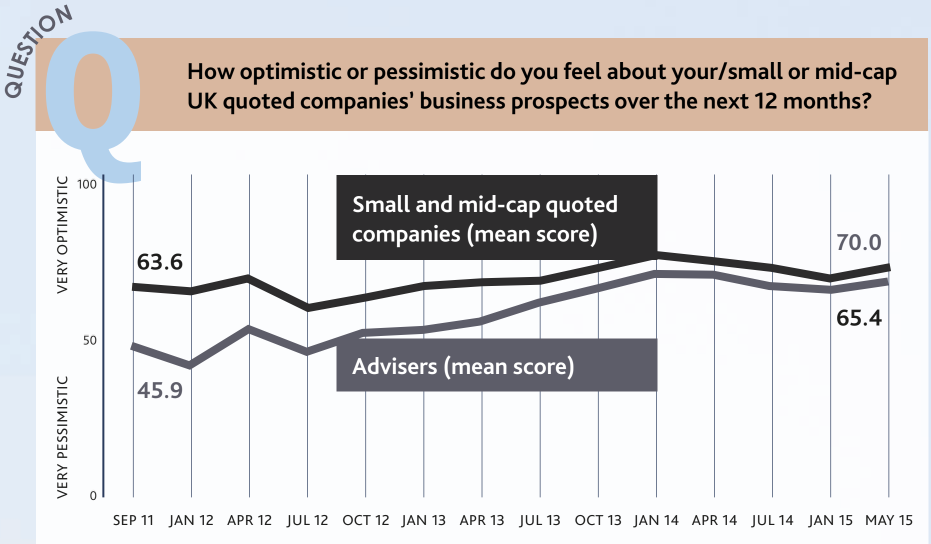
Optimism towards business prospects followed a similar trend in May: optimism amongst small and mid-cap companies about their own prospects and advisers' optimism about the prospects of companies had been falling steadily since January 2014, and the results from May show a rise in confidence once more.

nce
is on the up and up (and up)

Indeed, as we have seen in prior editions of PULSE, companies' confidence in their own prospects is greater than they hold for the UK economy.

Companies' confidence in their own prospects continues to be driven by a noticeable elevation in the company's performance, with 23% citing this as a major factor. Interestingly, 19% of companies cite opportunities in new markets as a reason for elevating confidence, up from 15% in January, which demonstrates a renewed confidence in the improving worldwide economy. This sentiment is backed up by the fact that just 11% (January 2015: 14%) now cite political uncertainty outside the UK as a negative driver on business performance.





business confidence

Some 17% also believe the new Government will help to drive increased performance, with political uncertainty now concerning just 2% of business (January 2015: 18%).

Advisers are even more positive about the new Government, helping to drive levels of confidence: some 40% cited the election results as a reason to drive higher levels of business confidence, suggesting confidence in the Conservatives' business policies.

However, despite advisers' confidence in domestic politics, some 19% now believe that political certainty outside the UK is a dampener for companies' business prospects. The figure stood at just 4% in January.

Problems within the Eurozone are failing to resolve quickly, and more certainty is needed that the new Government can reduce the deficit quickly and effectively as they claimed to be able to do in their election manifesto.

When it comes to hiring new staff, 77% of small and mid-cap companies intend to take on new staff over the next 12 months, up from 69% in January.

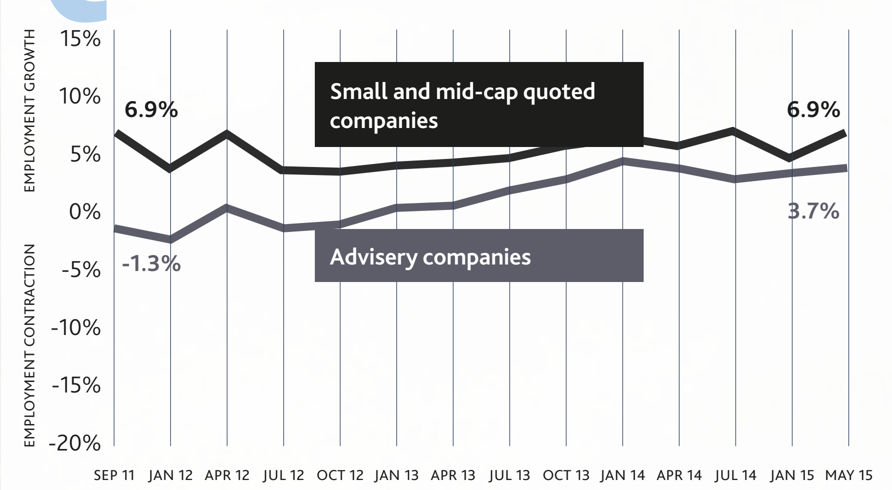
Just 6% intend to decrease staff numbers. Such positivity has not been seen since July 2014 and echoes the more upbeat economic sentiment felt amongst companies at the moment.

In addition, mean expected employment change has increased to 6.9%, its second highest level.

The expected increase in staff numbers over the next 12 months is perhaps explained by companies' expectations regarding turnover: the mean expected turnover change over the next 12 months according to companies is 17.4% - the highest figure since the survey began in September 2011, and some 1.7% higher than the previous high of 15.7% in April 2014.

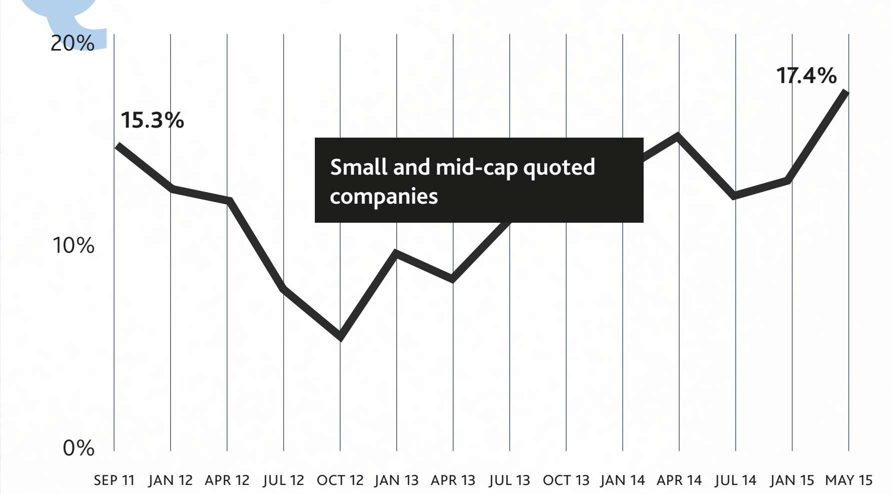
QUESTION Q

By what percentage do you expect the number of full-time employees in your company/small and mid-cap quoted companies to change over the next 12 months?



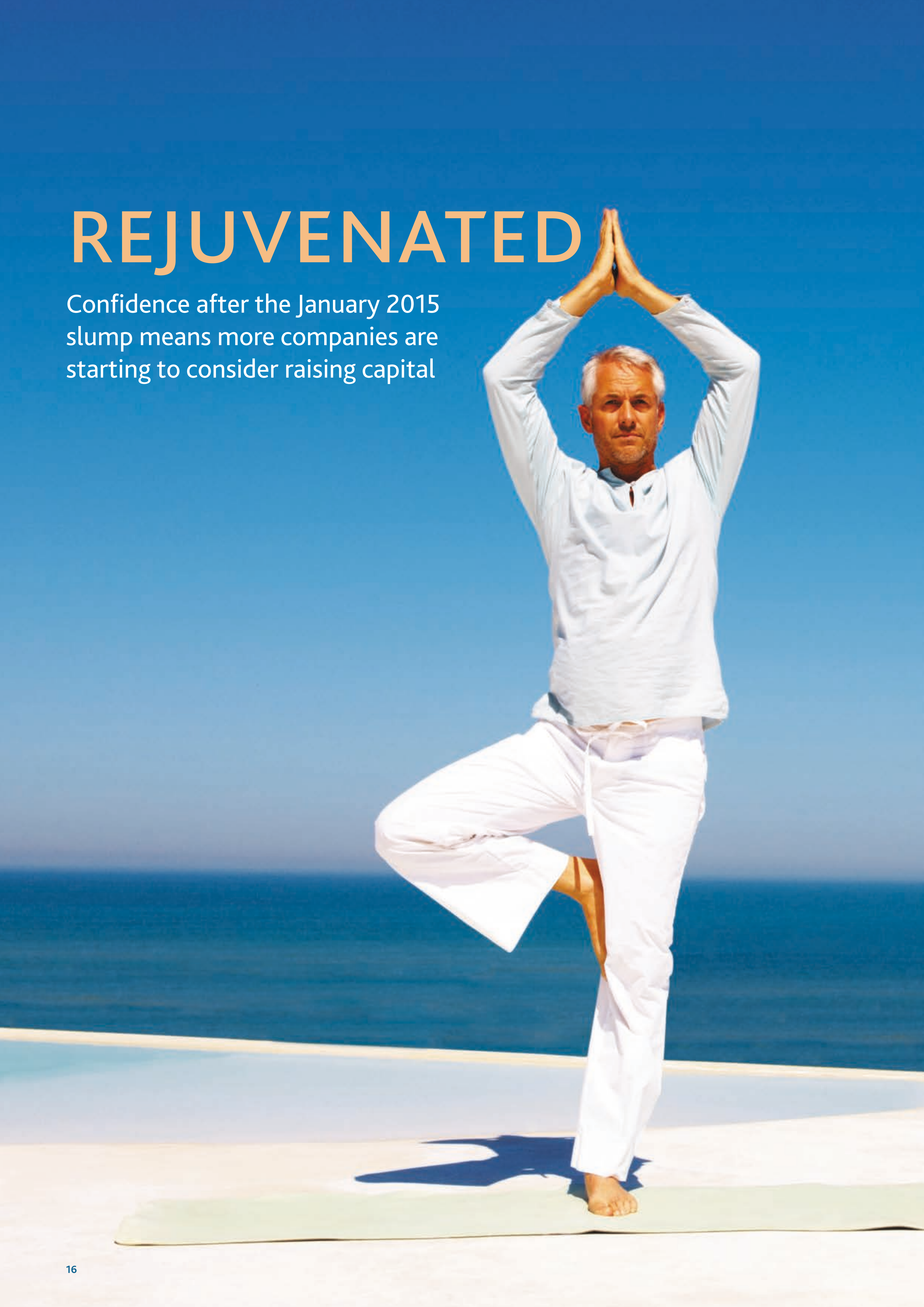
QUESTION Q

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



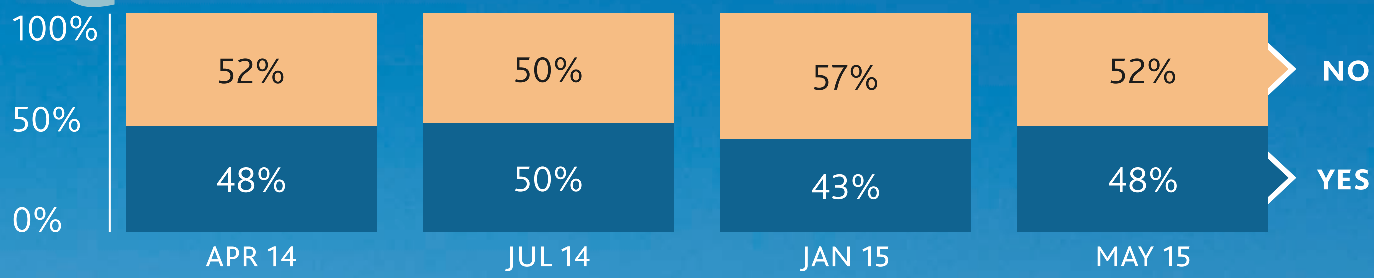
REJUVENATED

Confidence after the January 2015 slump means more companies are starting to consider raising capital



QUESTION Q

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



The slump in confidence in January 2015 meant the number of companies considering raising capital over the next 12 months fell to just 43% - down from 50% in July 2014.

However, the rejuvenated confidence amongst small and mid-cap companies which has boosted growth expectations, means 48% of firms are now considering raising capital in the next 12 months. This looks like a very positive signal for the growth of the sector.

There also appears to be a renewed confidence in raising funds from capital markets: for instance, 2014 was the biggest year for IPOs since 2000.

However, the first three months of 2015 saw a 44% decrease in the number of IPOs - and this dip of confidence in the capital market was also emulated in a reported decrease in secondary fundraising activity.

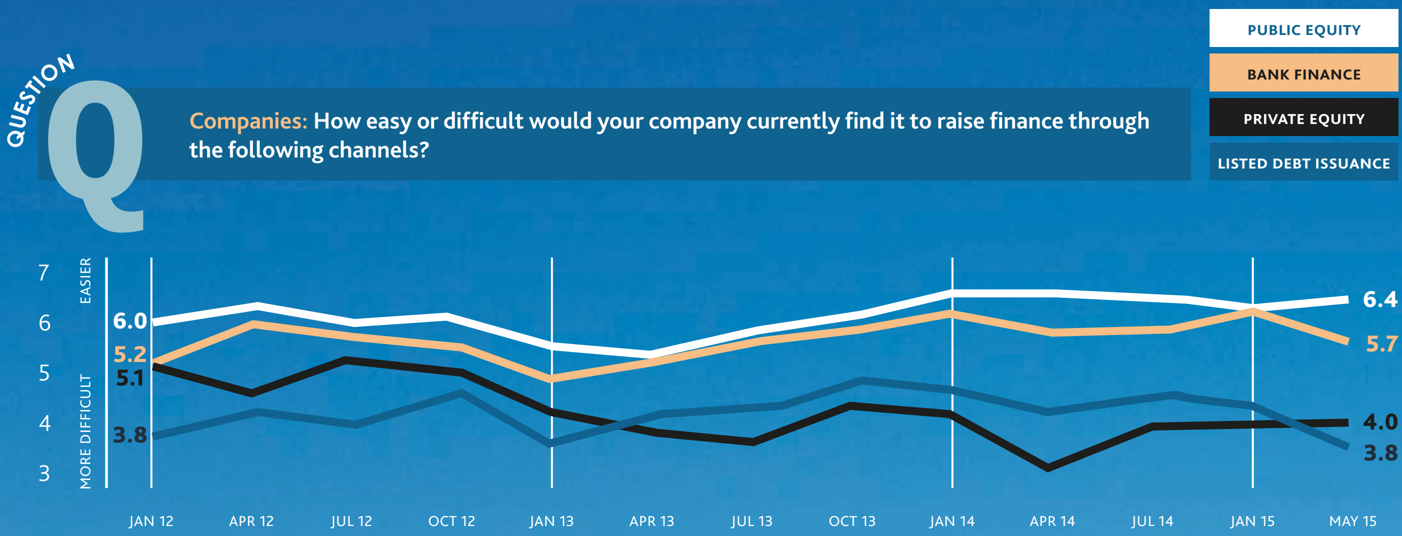
This phenomenon is backed up in our survey which shows that 9% of firms have selected “other” as their preferred method of raising capital: lesser used methods, such as invoice discounting and asset finance fall into this category. A growing number of respondents have stated they are exploring using private debt, industry grants or crowdfunding to acquire the capital they need to grow.

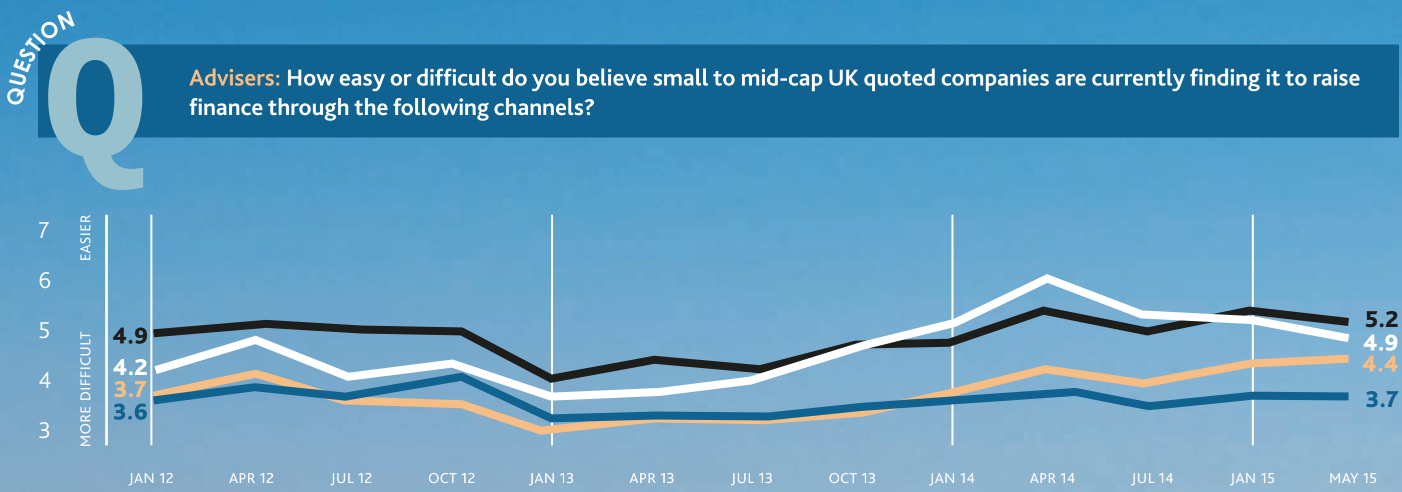
Now the economic situation is improving, the cost of raising capital is becoming less of an issue, and companies see the greater priority as choosing the source of capital which best suits the company's need: public equity might be chosen by companies that want to raise permanent capital or that do not feel in a position to service debt, whilst others choose temporary bank finance to avoid diluting equity.

Cost is still an issue for some companies and smaller private companies still find that bank finance is the cheapest method of raising capital for them, whereas companies who are already listed consistently choose the public markets to raise additional capital in order to get the most value from the cost of being listed.

The ease of accessing funds through public equity has remained largely the same since our last survey and, whilst some firms appear confident in being able to obtain funds through bank finance, confidence in accessing this method of finance has fallen from 6.1 in January 2015 to 5.7 in May.

Advisers’ views have barely changed, although confidence in companies being able to access finance through public equity has dipped slightly to from 5.2 to 4.9 – the opposite sentiment to companies themselves.





Many of the companies surveyed have commented that they are finding that they don't meet the size criteria or have the financial track record to be able to access the finance they need. The lack of equity finance available for smaller AIM quoted companies can be a real problem, whilst other companies, despite demonstrating exceptional year-on-year growth, have difficulty obtaining bank finance due to the lack of a financial track record.

Indeed, BDO's recent report, Filling the Funding Gap, showed that some 87% of midsize companies surveyed believed financial institutions did not understand their funding needs, and 55% claimed that lenders failed to understand their business at all. Although this survey also included privately-held companies, it still provides an indication of feelings held amongst mid-cap companies.

However, the results of our PULSE survey demonstrate that companies' confidence in being able to access funds is returning and, with the increasing options available, the continuing availability of cheap debt and the improving economic situation, we are confident that the sentiment will continue to lift further over the coming months.

METHODOLOGY

The QCA/BDO Small and Mid-Cap Sentiment Index by BDO and the Quoted Companies Alliance (QCA) is a triannual survey across the small and mid-cap quoted company sector. PULSE is the report of the survey's results.

The PULSE report is based upon 206 online interviews (133 small and mid-cap quoted companies and 73 advisory companies). It was conducted between 11th and 22nd May 2015 by research company YouGov.

Please note that scores in this report may not add up to exactly 100% due to rounding.
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 the issues covered in this report please contact:

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