February 2014

QCA/BDO
SMALL & MID-CAP SENTIMENT INDEX

ISSUE 10

CONFIDENCE REACHES NEW HIGHS

2013'S OPTIMISM DELIVERED REAL RESULTS

SALES AND THE ECONOMY DRIVING CONFIDENCE LEVELS

QUOTED COMPANIES ALLIANCE

YouGov
What the world thinks

BDO

INTRODUCTION

SCOTT KNIGHT, PARTNER, BDO LLP

We are (net) optimistic

This quarter shows that overall confidence levels continue to rise but importantly this is the first time that the number of optimists has outnumbered the neutrals and pessimists. There are still parts of the sector that are negative. The recent Mining Indaba conference clearly demonstrated some of the difficulties faced by mining juniors but generally deep rooted confidence continues to grow.

The importance of equity

The survey once again shows the importance of public equity as a source of finance. Many small and mid-cap businesses are high risk/high return investments and play an important part of any investment portfolio. Since last summer both the FTSE AIM All Share index and the FTSE Small Cap index have been performing very strongly and have outperformed the blue chips. Investors have seen the returns and gradually the other side of the equation, the appetite for risk, is returning and unsurprisingly most of the companies in the survey expect to outperform the indices. Whilst there is a natural bias most respondents know their prospects and pipelines are in a good place and most expect to grow revenues and headcount over the coming months.

Interest rates

As a consequence of the continued recovery we are now looking forward towards being weaned off low interest rates. Most companies (56%) expect this to occur in 2015 and, whilst 35% expect this to negatively impact them, 41% expect no impact. Given the low levels of gearing in most companies the sector appears in good shape to absorb this change.

There are still risks

Whilst the survey continues to show confidence indicators pointing in the right direction a number of risks remain. The election in the UK could create uncertainty; overseas the euro zone remains fragile; and if China sneezes the global economy will catch flu. However these are all outside of our control. What is within the sector's control is more positive than at any point since we started this survey three years ago.

AS A CONSEQUENCE OF THE CONTINUED RECOVERY WE ARE NOW LOOKING FORWARD TOWARDS BEING WEANED OFF LOW INTEREST RATES. MOST COMPANIES (56%) EXPECT THIS TO OCCUR IN 2015 AND, WHILST 35% EXPECT THIS TO NEGATIVELY IMPACT THEM, 41% EXPECT NO IMPACT.

EXECUTIVE SUMMARY

TIM WARD, CHIEF EXECUTIVE, THE QUOTED COMPANIES ALLIANCE

At the end of 2013 we saw confidence returning, job prospects improving and sales growth targets increasing. 2014 has started in much the same vein.

It's all about growth

Quoted companies' confidence in the UK economy has risen to a new high point for our survey and they and the advisory community are, on balance, optimistic for the first time in nearly three years.

This is complemented by companies' confidence in their own prospects which continues to rise; advisors too have finally moved into net optimism regarding small and mid-cap quoted companies' prospects.

Permanent capital builds hard working companies

Equity is a subject that it is beginning to move up the politicians' agenda. Having seen that bank lending is not going to be the universal financing panacea, policymakers are finally acknowledging that permanent equity capital has to be an essential ingredient of finance for growing companies. We have been calling for a review into whether UK equity markets are fit for purpose in helping small and mid-cap quoted companies to raise finance, grow and create jobs for some time now. So we were delighted that the Chancellor announced in the Autumn Statement that he intends to explore what can be done in this key area.

This survey again shows that for over 50% of companies public equity remains the preferred source of finance. Our survey also shows that access to such finance is becoming easier, with advisors believing that public equity is the only form of finance that is not difficult to obtain for small and mid-cap quoted companies. However, we must ensure that more UK companies see this as a viable channel for investment so that the public equity markets in the UK increase their market share.

The Government's review will help to ensure that equity markets are calibrated correctly so that the UK's engines of growth can have ready access to permanent capital which is vital for their success and for wider economic growth.

Last year's optimism delivered real results

Last year we saw real growth in the hard-working quoted companies we represent. Our survey shows that companies met their job and sales growth expectations. Share price performance reflected this growth with the majority of companies believing that they outperformed their chosen benchmark. Looking ahead into 2014 there is a strong feeling that this is set to continue.

Looking further ahead

I think these results should be viewed in the context of forthcoming events; I remain cautiously optimistic because, in just over a year's time, we have the uncertainty created by an election. Until then we can benefit from sure signs of recovery and the revival of the primary equity markets. As we get closer we may see a fall in primary market activity. This survey shows that the key factors driving confidence amongst quoted companies are threefold: sales, the general economic outlook and access to finance. We need all three of these to be improving to achieve sustainable growth.

Once again, I would like to thank you all for responding to our survey and also thank BDO for their continued support of this important initiative.

HIGHLIGHTS

91%

of small and mid-cap quoted companies are optimistic about prospects for the UK economy over the next 12 months – **up 12% on October 2013.**

92%

of small and mid-cap quoted companies are optimistic about their own business prospects – **up 9% on October 2013.**

84%

of small and mid-cap quoted companies expect sales to grow in the next 12 months, with the average expected growth in turnover at +14.35%, **down slightly on October 2013 (+14.75%).**

82%

of small and mid-cap quoted companies expect to increase headcount in the next 12 months, with the average expected change in employment growth at +6.63%, **up on October 2013 (+5.77%).**

Small and mid-cap companies believe that bank finance and public equity have grown easier to obtain since October, **but listed debt issuance has remained the same and private equity is slightly more difficult.**

78%

and 82% of small and mid-cap companies cite **the general economic outlook and own company sales performance** respectively as the factors currently driving confidence.

57%

of companies increased the number of full time employees in 2013 **and 61% saw their turnover increase in the same year.**

Revenue and profitability is the most commonly cited challenge for small and mid-cap quoted business over the next 12 months. **Existing market growth is cited as the greatest opportunity.**

56%

of small and mid-cap quoted companies believe interest rates are due to go up in 2015. **Over a third (35%) of businesses believe this will negatively impact them.**

BUSINESS CONFIDENCE

For a sixth consecutive quarter we have witnessed a boost in small and mid-cap companies' optimism in the UK economy.

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 69.3 compared to 64.1 in October 2013. The confidence of advisors in the UK economy has also increased, now standing at 68.8.

After a stronger than expected third quarter of 2013, the UK went into the final quarter of the year with some positive momentum behind it. Previous fears of a triple dip recession proved to be unfounded and, whilst growth does remain weak by historic standards, there are encouraging signs that the worst of the United Kingdom's economic woes are finally behind us.

Positive external factors, such as the easing of economic stress in Europe and the recovery in the United States, have played a key role. The UK economy grew 1.8% in 2013 – the fastest rate since 2007. The financial markets are no longer primarily concerned with increasing economic weakness and now turn their attention towards forecasting the next interest rate rise.

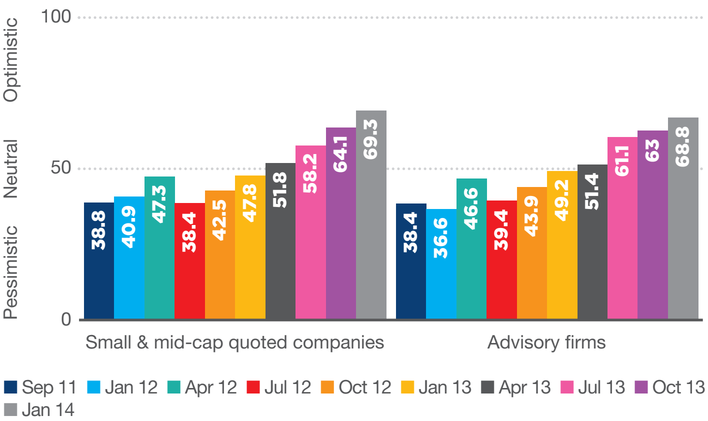
Consumer confidence has slightly dropped off the record levels that were seen in September 2013, but in reality it still stands far above the levels we experienced during the heart of the recession. There are also signs to suggest that businesses are ready to engage in some investment both in capital and people throughout 2014.

Inflation has fallen to 1.9% and, as a result, this marks the first time in more than four years it has gone below the Bank of England's 2% target. This was primarily led by a fall in the cost of recreational and cultural activities. Whilst encouraging, it should be noted that average earnings growth still stands at around half of the inflation rate and, as such, consumers are still worse off.

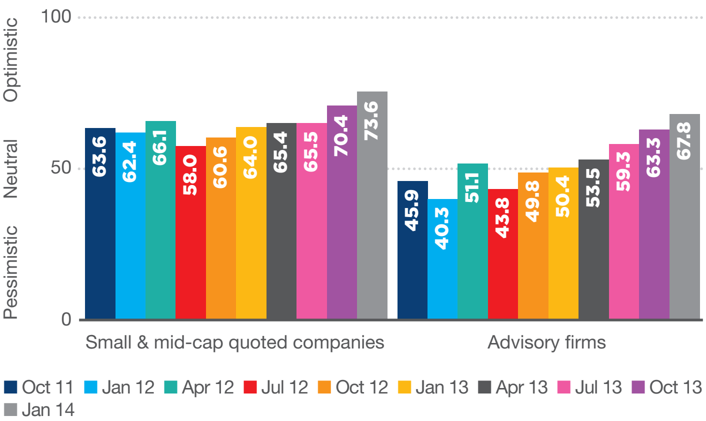
Whilst UK policymakers will be hoping for a balanced recovery we are, at least in part, likely to see a bit of polarisation – both between sectors and regions. We have seen some encouraging signs from sectors, such as manufacturing, services and construction, but from a consumer perspective we are also seeing lower savings, rising credit growth and increasing house prices. Geographically, the recovery is likely to remain dispersed with growth outside of tier one cities still sluggish. The government's control over the economy is always going to be imperfect, but many will take the view that growth of any description is better than the stagnation experienced over the last few years.

Alongside the strengthening confidence in the UK economy, small and mid-cap companies' confidence in their own prospects continues on an upwards trend this quarter. Small and mid-cap companies now rank confidence in their own prospects at 73.6 – again a new record for this survey. Furthermore this quarter represents the first time where both companies and advisors show a positive net optimism. More participants are outright confident than the combined total of those who feel neutral or negative about business prospects.

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

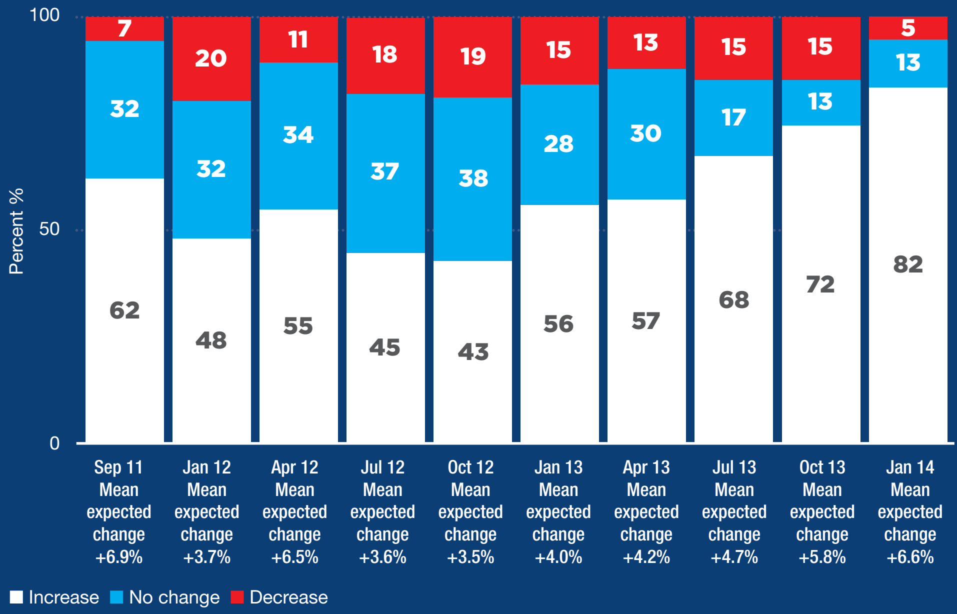
Confidence in the UK economy and small and mid-cap companies' own prospects have hit new highs for this Index. For the first time, the majority of advisors (53%) are net optimistic about small and mid-cap companies' prospects – there are now more advisors feeling outright optimistic about the sector than those with a neutral or pessimistic outlook. With more and more good economic news, we see increasing confidence – making us more optimistic that further economic growth in the small and mid-cap quoted company sector is going to occur in 2014.

FUTURE EXPECTATIONS

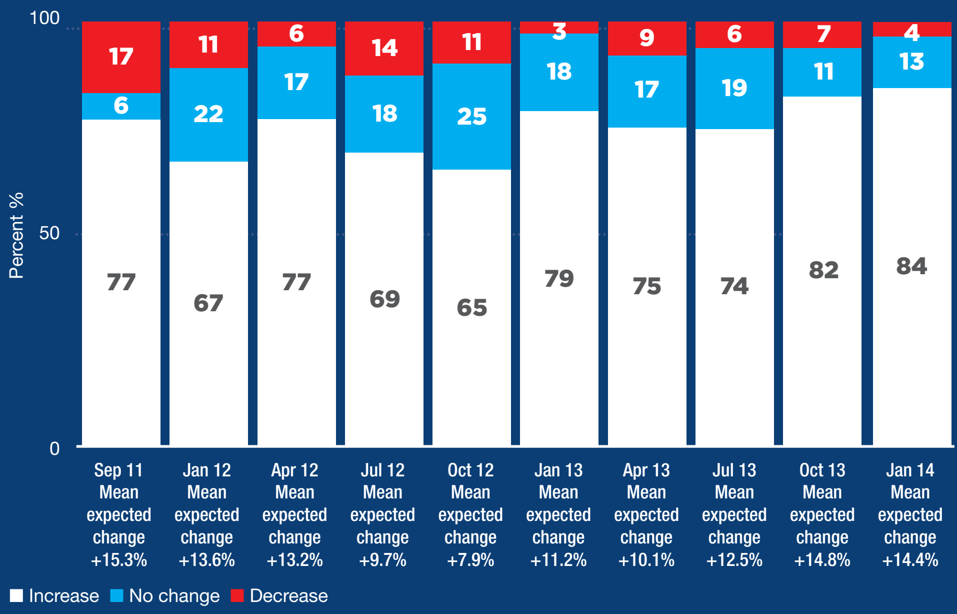
Whilst the level of UK unemployment still stands at an unacceptably high level, results from this survey suggest the outlook for employment is a positive one. This is the fifth consecutive quarter in which small and mid-cap quoted companies expect to see an increase in headcount over the next 12 months. As it stands, 82% of companies now believe they will increase the number of full time employees within their firm. Perhaps most encouraging is the fact that the number of companies expecting to decrease headcount has now fallen to 5% from 15% in October 2013. Furthermore, the mean expected increase now stands at 6.6%, the second highest level we have seen in this survey.

With regards to turnover things look equally positive. The number of companies expecting turnover to increase has again gone up this quarter and now stands at 84%. We also saw the number of those expecting a decrease fall from 7% to 4%, which represents the second lowest figure we have seen. The mean expected turnover increase now stands at 14.4%, down slightly on the last quarter.

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

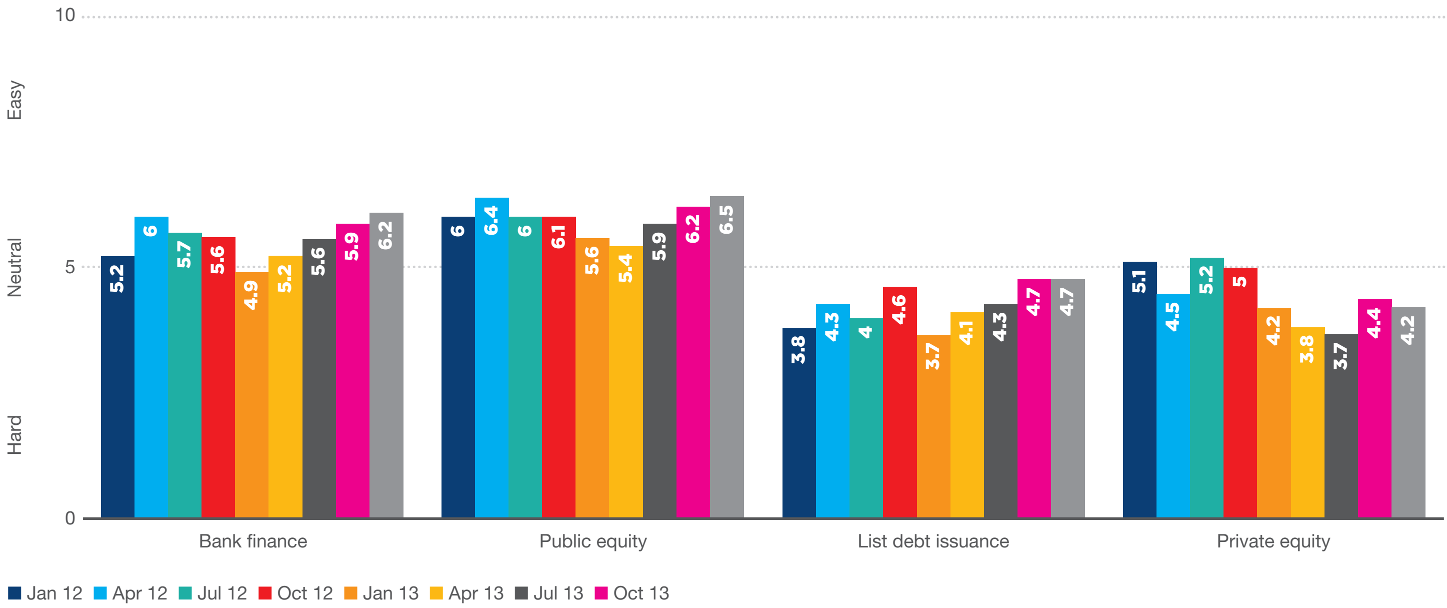
Small and mid-cap quoted companies remain bullish about their employment and turnover prospects for the next 12 months. However, companies have regraded their turnover growth prospects slightly from last quarter.

Last quarter we posited that we may well see record-breaking levels for turnover and employment growth, which has not happened. It may be that, whilst companies are increasingly confident, they are being more realistic in predicting what they can actually achieve in still demanding market conditions.

FUNDRAISING

The last quarter proved to be a mixed bag with regards to access to finance. Small and mid-cap companies feel private equity has become harder to obtain. Listed debt issuance, another form of finance considered difficult to obtain, remains flat. On a more positive note, public equity and bank finance has become easier to obtain, rising to 6.5 and 6.2 respectively on a scale of 0 – 10, where 0 is difficult and 10 is easy. Advisors also, for the first time since this survey began, rate public equity as not difficult to obtain – putting it at 5.1.

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



ON A MORE POSITIVE NOTE, PUBLIC EQUITY AND BANK FINANCE HAS BECOME EASIER TO OBTAIN, RISING TO 6.5 AND 6.2 RESPECTIVELY ON A SCALE OF 0 – 10, WHERE 0 IS DIFFICULT AND 10 IS EASY.

QCA/BDO VIEW

Companies continue to reiterate that access to public equity and bank finance is getting easier to obtain and the opinion of advisors is also moving in similar direction – albeit more slowly. This is testament to improvement in the public equity markets over the past few months.

Whilst small and mid-cap companies believe private equity has grown more challenging to access we don't believe this is due to lack of investor appetite. Many of the PE houses we have spoken to are showing increased confidence when taking on new investments and in part this increased difficulty may be attributed to greater levels of competition.

LOOKING BACK AND AHEAD TO 2014

As noted earlier, confidence in the UK economy is now at all an all-time high for this survey – more people are optimistic about the UK economy than those who are neutral or pessimistic. Companies also continue to feel increasingly confident about their own business prospects and plan to increase turnover and jobs throughout 2014. With confidence increasingly ticking up, we have been keen to understand what is driving that and to see whether small and mid-cap quoted companies performed to their expectations in 2013 and what their opportunities and challenges are coming up in 2014.

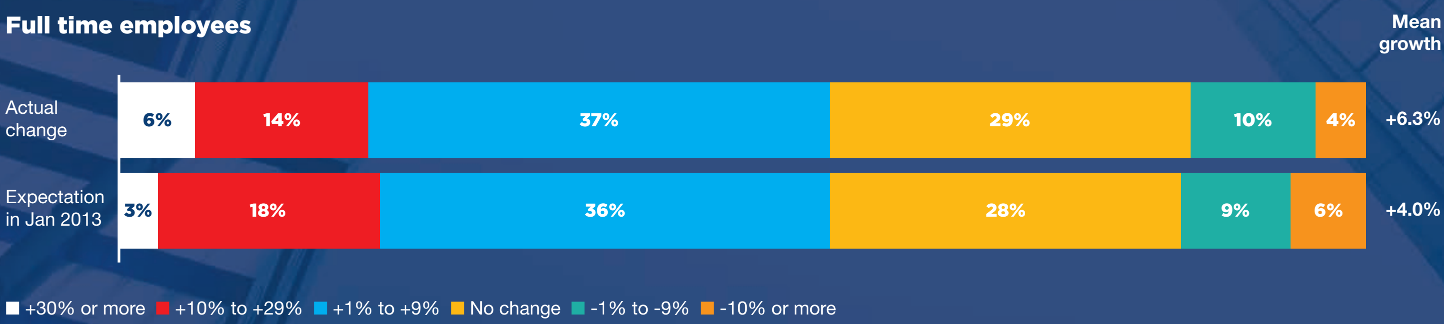
Sector performance in 2013

Throughout 2013, as UK economic recovery started to take hold, our Index showed confidence in the UK economy increasing each quarter – with similarly strong expectations from companies regarding their sales and jobs growth. This quarter we looked back at whether companies have met their expectations – and it seems that the majority have.

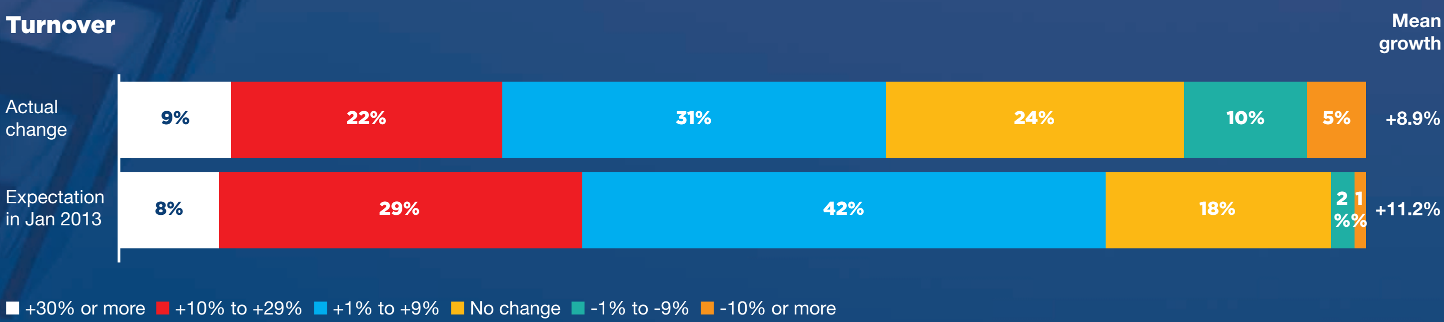
57% of small and mid-cap quoted companies increased the number of full-time employees in 2013. The mean job growth for all companies was 6.3%. This is broadly in line with the rate of job growth that companies forecasted at the start of 2013 – when they expected to grow their workforce by 4.0%. This even suggests that companies may have exceeded their expectations.

In terms of turnover, three in five small and mid-cap quoted companies (62%) saw their turnover increase in 2013. On average, companies grew their turnover by 8.9%. This is broadly in line with their forecasts on turnover growth for 2013, when small and mid-cap quoted companies reported an average expected 11.2% increase in turnover.

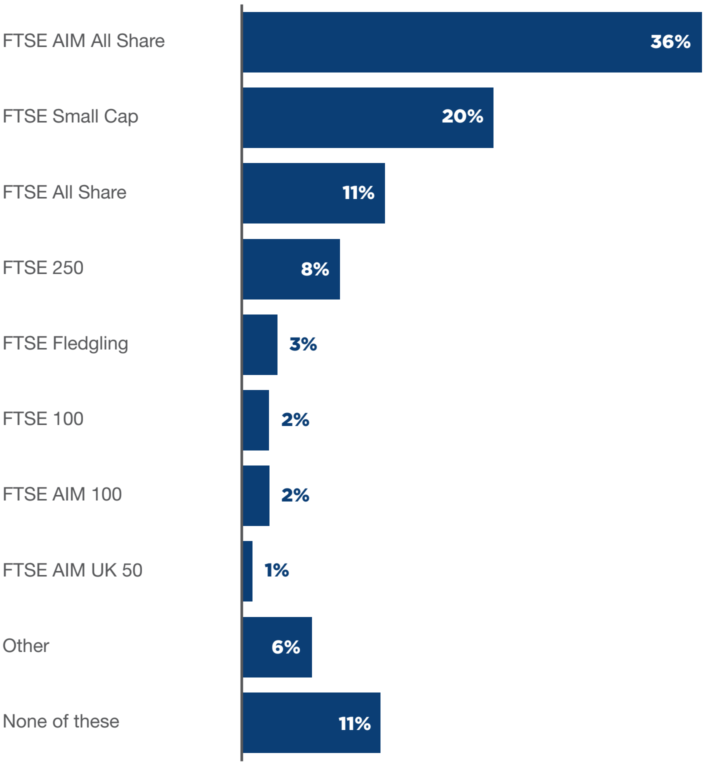
Full time employees



Turnover



Which index do you measure your share price performance against?



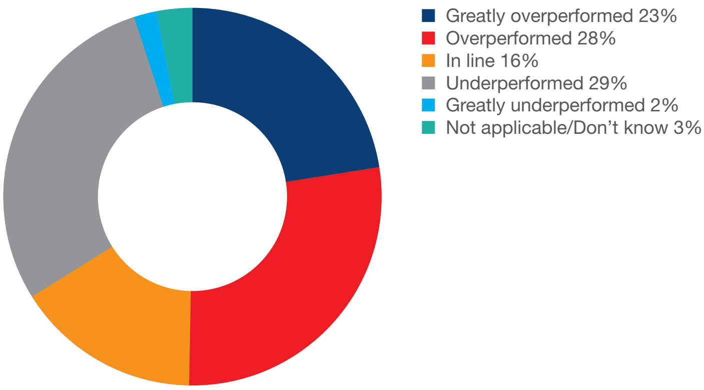
Share price growth was more mixed. 36% of small and mid-cap quoted companies measure their share price performance against the FTSE AIM All Share. 20% measure their performance against the FTSE Small Cap and another 11% against the FTSE All Share.

Just over half of companies (51%) stated that their share price either greatly overperformed or overperformed relative to the index that they benchmark against in 2013. Around a quarter (23%) of companies reported that their share price greatly overperformed and a similar percentage (28%) said that it overperformed. However, a sizeable minority (30%) said that their share price underperformed in 2013.

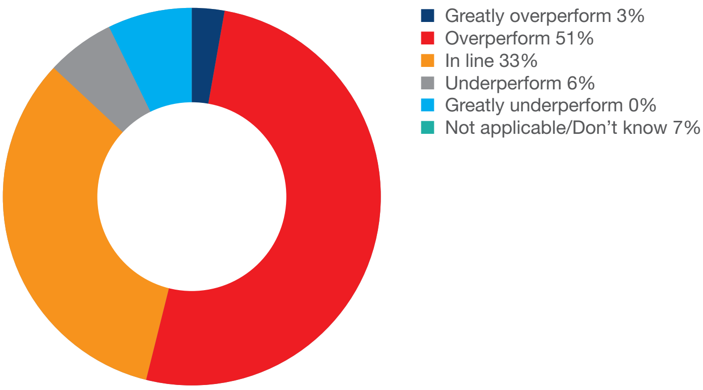
Out of the 44 companies that measured their share price performance against the FTSE AIM All Share, they were almost equally split between those that overperformed (43%) and underperformed (33%). Out of the 24 companies that measured their share price performance against the FTSE Small Cap, a majority (61%) overperformed and only 34% underperformed. Out of the 14 companies that measured their share price performance against the FTSE All Share, the situation was reversed – only 22% thought that they had overperformed and 46% net underperformed.

Furthermore, when we asked companies what they expect their share price to do this year, a similar amount (54%) said they expect it to overperform. 33% of companies expect it to be in line, and only 6% expect it to underperform.

Relative to the index you are generally benchmarked against, did your share price overperform or underperform in 2013?



And, again relative to the index you are generally benchmarked against, do you expect your share price to overperform or underperform over the coming 12 months?



QCA/BDO VIEW

The small and mid-cap sector is on the up - and grew throughout 2013. Companies largely met their expectations regarding turnover and job growth, which shows that the sector is an engine of growth and highlights its important contribution to UK economic growth.

However, share price performance in 2013 was not as clear cut, which is to be expected. Public equity markets in 2013 were only starting to recover and we did not start to see significant activity until the latter half of the year. We would expect share prices to take longer to recover than job and turnover growth - and so are not surprised to see similar share price predictions for 2014.

Factors driving confidence

Increasing confidence amongst the small and mid-cap sector appears to be fuelled by sales and improvement in the general economic outlook. A majority of companies (82%) state that their company's sales performance and the general economic outlook (78%) are the main factors having a positive impact on their confidence. Advisors to the sector also echo this sentiment.

Reasons for companies' and advisors' strong levels of confidence include improved equity markets, overseas markets improving, increasing product development, M&A opportunities, GDP growth and increased interest from investors.

However, nearly half of small and mid-cap companies (40%) and a majority of advisors (60%) view regulation and taxation as a factor negatively affecting confidence. Reasons for companies' and advisors' lack of confidence include red tape, market uncertainty, strong levels of competition, access to capital, uncertainty in the Eurozone and the UK's relationship with Europe.

Access to finance appears to be a positive factor for some and a negative factor for others in terms of how it affects confidence. Whilst 41% of companies and 48% of advisors say that access to finance is positively impacting their confidence levels, 17% of companies and 36% of advisors conversely believe that access to finance is having a negative impact.

ACCESS TO FINANCE APPEARS TO BE A POSITIVE FACTOR FOR SOME AND A NEGATIVE FACTOR FOR OTHERS IN TERMS OF HOW IT AFFECTS CONFIDENCE.

QCA/BDO VIEW

The high levels of confidence both in the UK economy and small and mid-cap companies' prospects seem to be driven both by perception and the reality of circumstances. A general feeling that the UK economy is on the mend is influencing people's positive attitude towards confidence, whilst a very tangible measure - increasing sales - is also playing a strong role in the sector's confidence. As a result, it is very likely that this confidence will continue to translate to continued growth throughout 2014.

However, access to finance remains an issue and could stifle growth levels. Some clearly are seeing finance flowing in, whilst others are still struggling to obtain it. As mentioned earlier in this survey, we have found that companies are reporting that access to public equity and bank finance has become easier; but, it seems from the open-ended responses that competition for finance remains tough. Ensuring that companies have access to finance is going to continue to be a real challenge.

POSITIVE FACTORS AFFECTING CONFIDENCE

"Market demand"

"Our overall sales pipeline is increasing on a monthly basis."

"UK demand growth"

"Acquisition opportunities"

"Our own investment in R&D providing positive results"

"Investor sentiment"

"Better news from the US on its performance and growth...The reports of the UK economy returning to growth"

"Effect of government policy in the run-up to the General Election supporting equity valuations"

"Institutions currently prepared to provide funding for the right company"

NEGATIVE FACTORS AFFECTING CONFIDENCE

"Increasing bureaucracy and red tape in tandem with the continuing lack of access to affordable debt-finance from banks"

"The UK's debt position and fear of adverse tax changes"

"Comments about the fragility of the recovery and that it might dip back again"

"Risk economy rolls over – uncertainty caused by September 2014 referendum, 2015 election and possible change of government with regulatory creep."

"Valuations still tight"

"Eurozone is still not out of the woods."

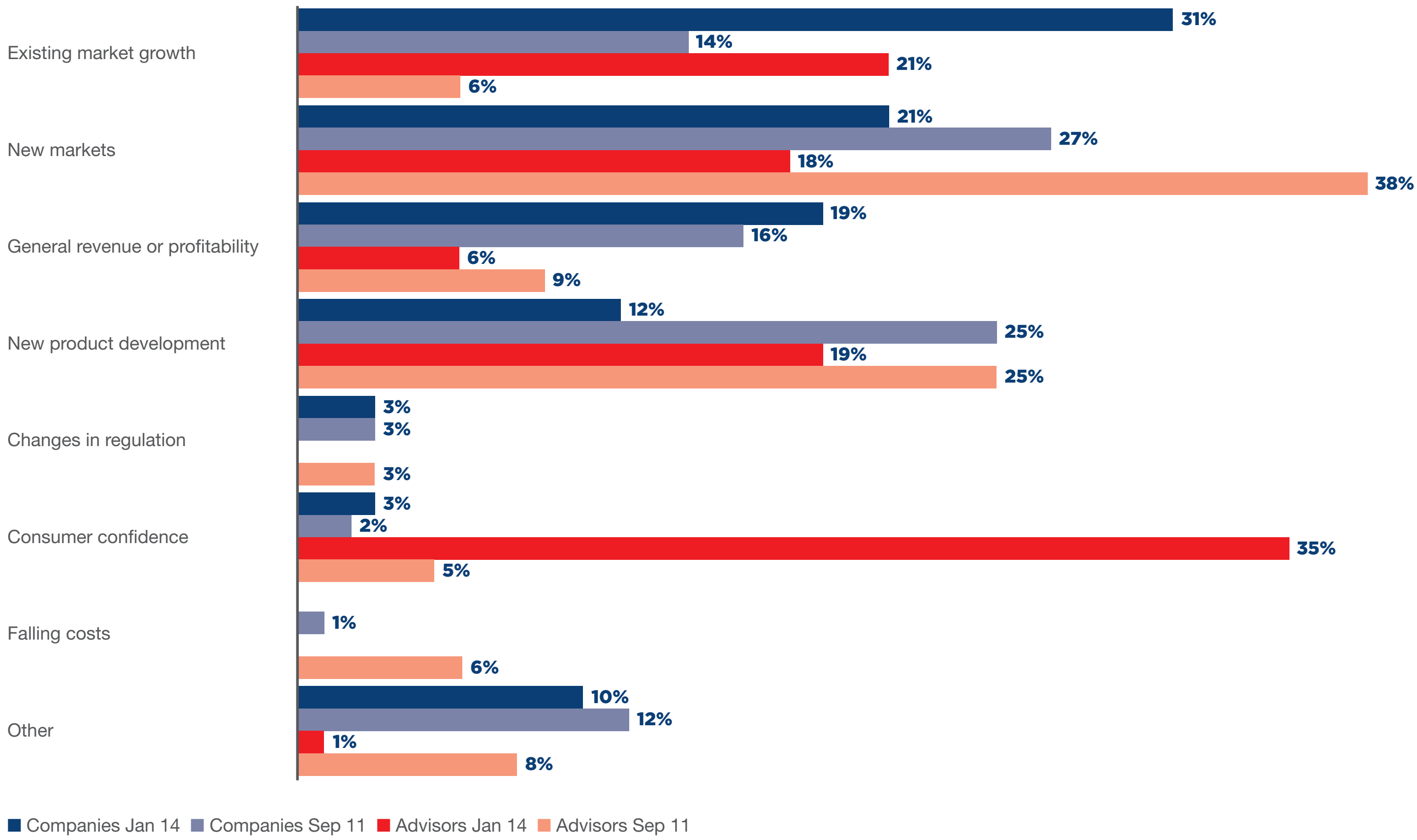
"More deals means more choice for investors, so smaller deals will have a harder time getting their funding."

Opportunities and challenges in 2014

31% of small and mid-cap quoted companies believe that existing market growth is the number one opportunity for the coming 12 months. This is followed closely by the opportunity to access new markets (21%) and general revenue or profitability (19%). These results are similar to when we asked this question in September 2011, when companies believed new markets (27%), new product development (25%) and general revenue or profitability (16%) were key opportunities.

On the other hand, 35% of advisors believe that consumer confidence is the number one opportunity, followed closely by existing market growth (21%) and the prospects for new product development (19%). When asked this in September 2011, consumer confidence did not even register as a number one opportunity; instead advisors thought new markets (38%) and new product development (25%) were the key opportunities.

The number one opportunity for the coming 12 months



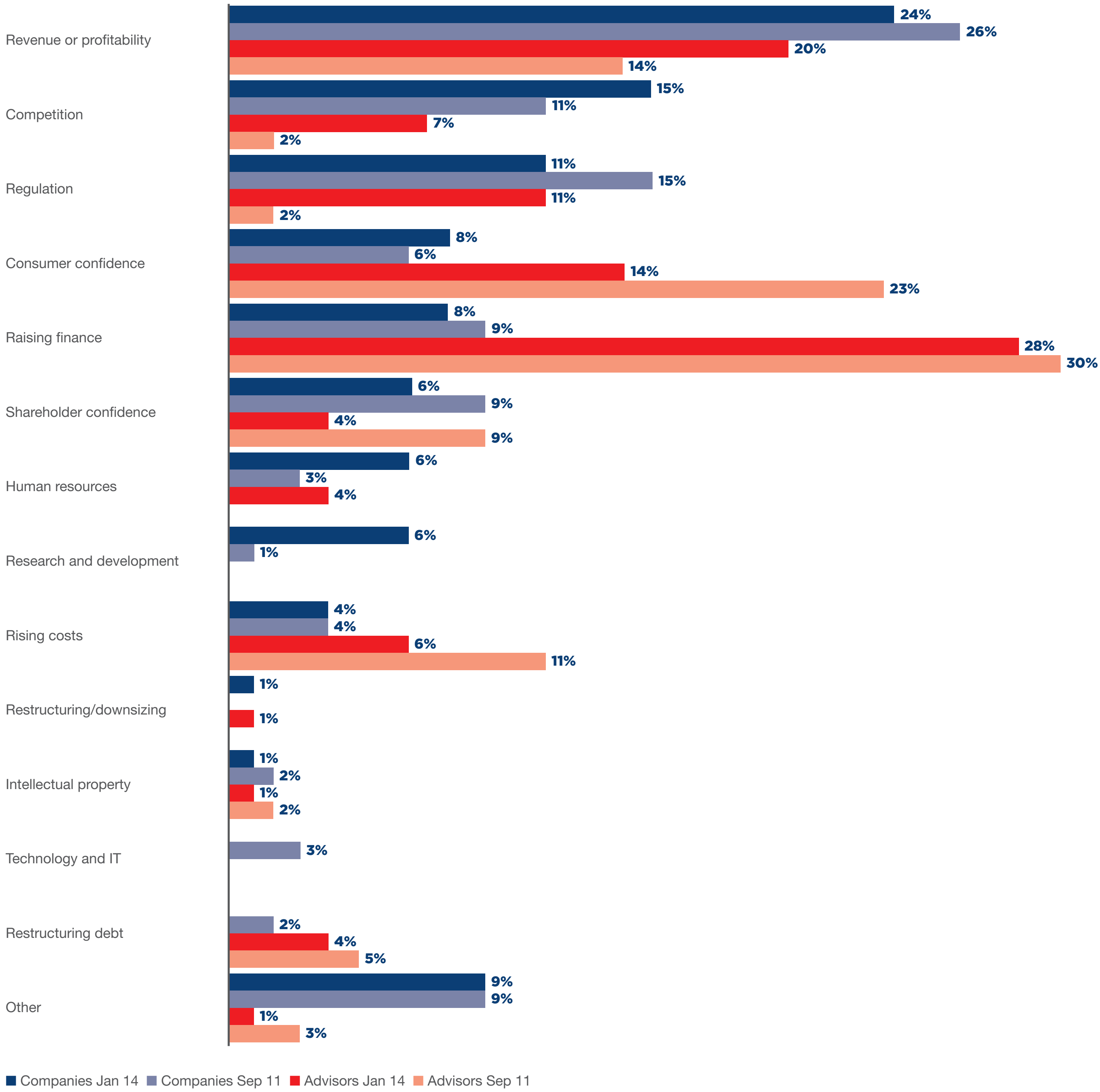
QCA/BDO VIEW

This quarter shows that aspects of growth can be both challenges and opportunities at the same time. Market growth – both in existing markets and the opportunity to expand to new ones – is a clear opportunity for companies. This is most likely a result of the general improvement and uptick in markets we have been witnessing since the latter half of 2013 and even early this year. Companies should exploit these good market conditions.

However, general revenue and profitability is reported as both one of the key opportunities and challenges. Increasing sales is what will bring more growth. But this will remain difficult to achieve – which may explain why we found companies slightly downgrading their anticipated turnover change this quarter. Similarly, consumer confidence is also cited as an opportunity and challenge, which suggests that growth will continue as long as consumers remain confident. Ultimately, these results show us that there are a lot of variables at play in determining companies' prospects for 2014.

The top challenge for companies this year is their revenue and profitability, with nearly a quarter (24%) of companies citing this, followed by competition (15%) and regulation (11%). Just over a quarter of advisors (28%) believe that access to finance will be the number one challenge, followed closely by revenue or profitability (24%). These results compare very similarly with what we found in September 2011.

The number one challenge for the coming 12 months



QCA/BDO VIEW

Following the better than expected news that unemployment rates fell to 7.1% in January 2014, the Bank of England has continued to rebuff rumours that an earlier than expected rate rise is on the cards. Whilst most in the sector do not think that this will happen, a sizeable minority think that a 2014 interest rate rise could still occur.

Many have posited that an early interest rate rise could have significant negative economic repercussions. Whilst most small and mid-cap quoted companies and their advisors are split as to what impact it will have, few say that an interest rate rise would have a positive impact on their business.

An early rise in interest rates is unlikely to benefit many businesses. But with Mark Carney, the Governor of the Bank of England, claiming interests rates would stay as they were (+0.5%) until unemployment falls below 7% (currently 7.1%), we believe these fears are without legs for at least another 18 months.

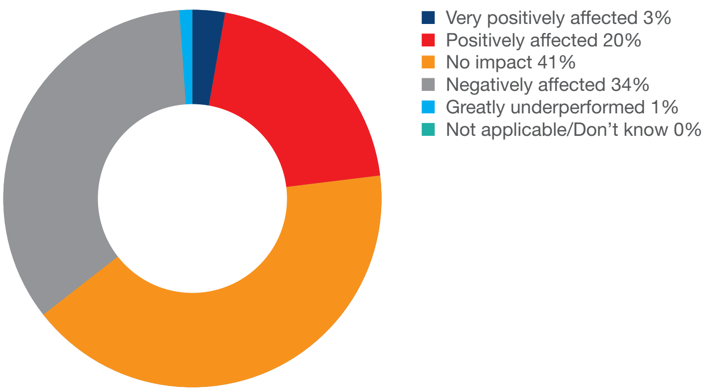
Anticipating interest rate changes

With the UK reporting good growth figures, coupled with falling levels of unemployment and inflation now below target levels, many see interest rate increases on the horizon. Despite this, Bank of England governor Mark Carney remains adamant that interest rate changes are not on the agenda at the moment.

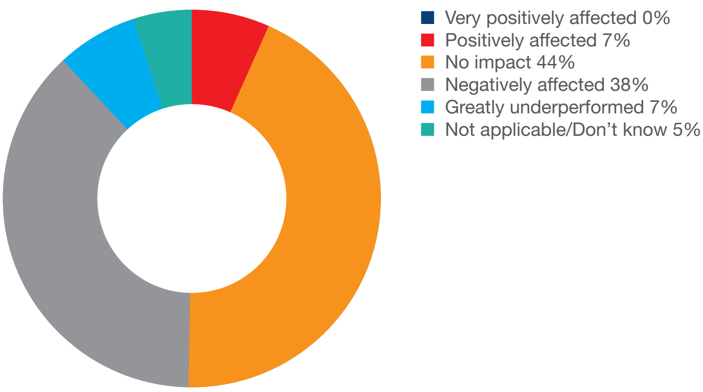
A majority of companies and advisors (56%) believe that UK interest rates will rise sometime in 2015 – with Q2 as the most likely time for this to happen. However, one in four (24%) small and mid-cap companies and 32% of advisors expect interest rates to rise this year – most likely in Q3 or Q4.

The effect of an interest rate rise on small and mid-cap quoted companies is uncertain. 41% of companies expect no impact at all, with another 35% of companies believing a rise in interest rates will negatively affect their business and 23% expecting a positive impact. Advisors are split between those that believe it will have a negative impact on the sector (45%) or no impact at all (44%).

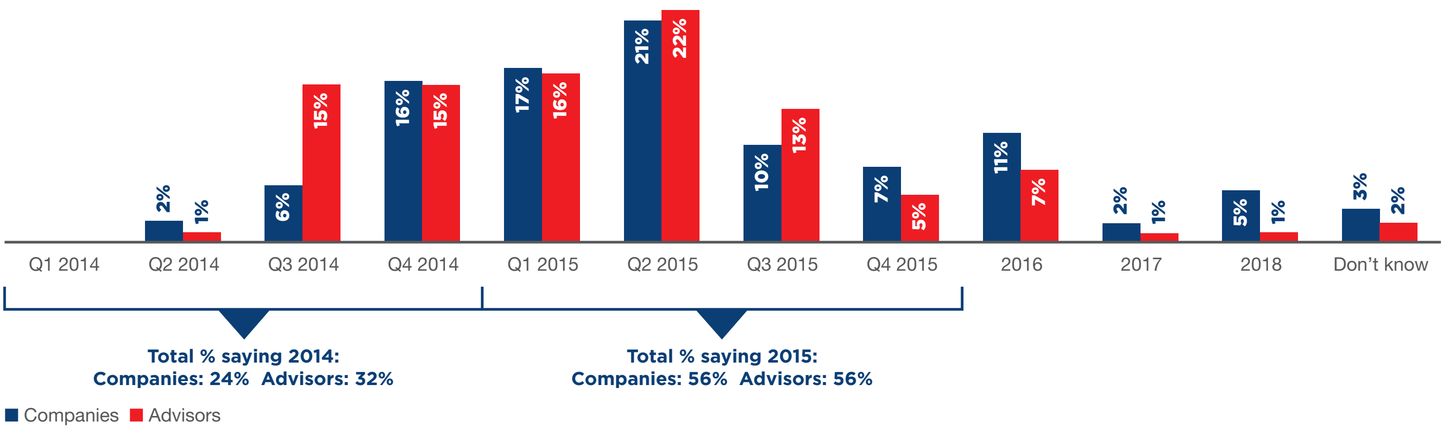
Companies: What will be the likely overall impact on your business when interest rates do rise?



Advisors: What will be the likely overall impact on small to mid-cap UK quoted companies when interest rates do rise?



When do you expect interest rates in the UK (i.e. those set by the Bank of England) to rise from current levels?



METHODOLOGY

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 215 online interviews (127 small mid-cap quoted companies, 88 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 48% of advisors in a senior management position. It was conducted between 14 January and 27 January 2014 by research company YouGov.

Please note that not all scores in this report 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 of the issues covered in this report please contact:

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TAXATION AWARDS 2011 WINNERS

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