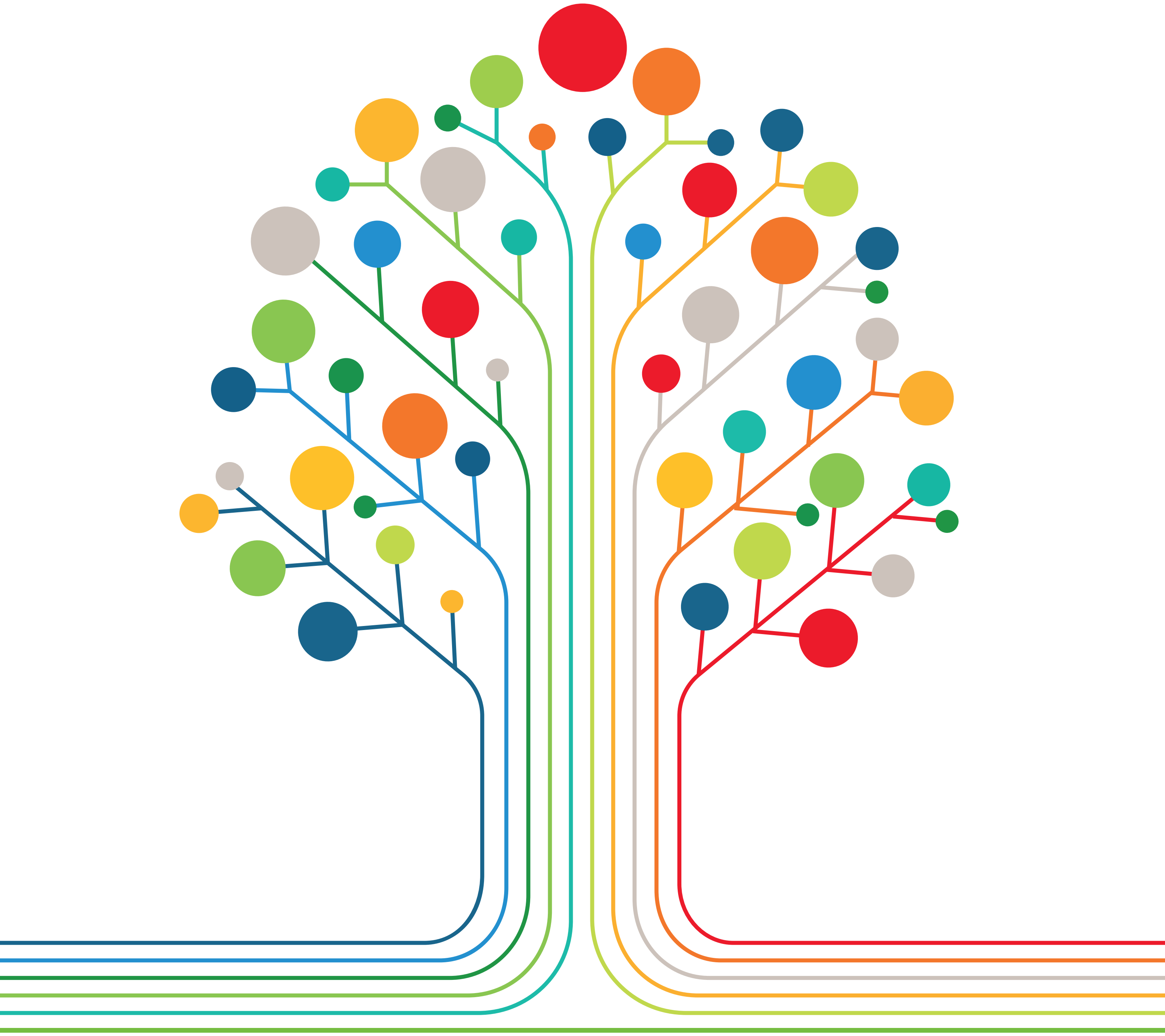
SMALL AND MID-CAP INVESTORS SURVEY 2017

INSIGHTS FOR COMPANIES SEEKING EQUITY INVESTMENT



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INTRODUCTION

This is the fourth edition of our Investor Survey. The feedback we have received since the first edition was published indicates that Quoted Companies Alliance members and RSM clients find it an extremely useful tool to understand the thinking of investors in the small and mid-cap market.

You will see that some things never change: cash is king; investors don't want to be surprised; Finance Directors (FDs) need to be a strong complement to their CEOs; advisers should be chosen with care; markets go up and down.

Consistency is the key to success in any market, and consistency in turbulent markets is more important than ever. But there are political and macro-economic changes that impact the small and mid-cap world - Brexit and Trump and consequent foreign exchange volatility being just three.

This year, in addition to the commentary on the previous year and future prospects, we have sought to garner views on which companies stood out in 2016; how companies should approach Brexit; the effectiveness of the growth market, AIM; as well as such issues as the involvement of private investors and the quality of Chairs and FDs.

One of the stand-out features of this report is the steady change in attitude towards AIM. Companies no longer feel the need to move to the Main Market when they hit a certain size. Not all investors are positive, but we sense a move towards a more favourable outlook for the market generally.

As one investor told us, "I think people have started to understand AIM a bit better. It was set up to be a platform for small growth companies to gain access to capital, not to behave like an index. I think people are getting their heads around the fact that it doesn't behave like an index and, there is actually the full spectrum of companies on there, from the very small, early stage of very risky [companies], to some really very high quality, established, profitable, good grade companies and actually it is just becoming more and more of the latter and less and less of the former... We are confident that AIM is travelling in the right direction now having had a lot of critics, you know, a decade or so ago. AIM plays a crucial role in the ecosystem of small-cap funding. I mean crucial to the GDP growth in this country, and it's an important cog in that. Politicians are talking about AIM more and understanding the position it plays in that ecosystem. It's like the ISA legislation change to allow AIM companies into ISAs, the abolition of the Stamp Duty on a purchase of AIM quoted shares. All of this is a result of the Treasury understanding the important role that AIM plays."

This bodes well for the future of our growth companies. A confident market structure provides such companies with a viable option to raise finance in both good and tougher times. It encourages new investors, both institutional and private, to consider investment in growth companies. It ensures that the high quality advisory firms remain committed to the market. The ecosystem for small and mid-sized companies clearly needs to be nurtured.

We are very grateful to the small and mid-cap investors who have given freely of their time to be interviewed for this survey and we thank them for their continuing support. They tell us that they do so because they believe in the small and mid-cap market; they believe in the future of small cap companies; and they want to help improve the markets and the performance of companies on those markets. Contributing to this survey is one way that enables them to do this. YouGov, who conducts the survey, holds comprehensive discussions with each investor which makes this more than a superficial report. The findings come from well-considered feedback. We hope you continue to find this report interesting and useful. Please feel free to give us feedback or ask us any questions about the content of this report or ideas for our future surveys.

Diane Gwilliam
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RSM

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METHODOLOGY

RSM and The Quoted Companies Alliance commissioned YouGov to undertake research into the current attitudes of UK small and mid-cap institutional investors towards the companies in which they choose to invest and the wider small and mid-cap market. 16 telephone interviews took place during October and November 2016 with the following individuals to whom we are extremely grateful:

David Stevenson – Amati Global Investors

Mark Niznik – Artemis Investment Management

Robin West – Invesco Asset Management

Judith Mackenzie – Downing LLP

Guy Feld – Hargreave Hale

Adam McConkey – Henderson Global Investors
(now at Lombard Odier Investment Managers)

Katie Potts – Herald Investment Trust

Ken Wotton – Livingbridge

Gervais Williams – Miton Group

James Thorne – Columbia Threadneedle Investments

Richard Power – Octopus Investments

Jim Maun – Fidelity Investments

Daniel Nickols – Old Mutual Global Investors

Andy Brough – Schroders

Richard Penny – Legal & General Investment Management

Siddarth Chand Lall – Hargreave Hale

KEY FINDINGS

Investors recommend that companies prepare for Brexit uncertainty as much as they can and do not wait for outcomes.

Investors see the market as better now than it has ever been with fewer failures and more quality despite ‘sediment’ at the bottom end. Investors are confident in AIM’s ability to support growth. It remains the domain of stock pickers.

A strong Finance Director who is willing to challenge the CEO is a must.

Nomads and Brokers are given a hard time by investors unless they have built up the trust over time to do a good job and to make the investors money. The most effective are those that conduct proper due diligence and offer a complete service including effective market making.

There is little pressure for companies to move from AIM to the Main Market unless investors fish only in the Main Market’s waters. Investors acknowledge that some large companies may wish to stay on AIM and are not worried about any out-dated associated stigma.

Fund Managers will support underperforming companies where they have trust in management and in their plan to turn things around. But they may still jump ship - if they can.

Not all investors see a Standard Listing as a good way to access the stock market.

Cash generation remains critical for investors when assessing corporate health.

Involvement in pre-IPO companies at an early stage is not for every investor; it depends on the resource available and a manager's interest in IPOs generally.

Chairs need to be proactive with investors if they want to be seen as a key contributor to a company's success.

Most managers want to see private investors involved in a stock as this helps liquidity and valuation. Too much interest can lead to unwelcome volatility when private investors take a short term view and overreact to events, good or bad.

New regulation (e.g. MiFID II and MAR) is mostly seen as little more than a process irritation but there remains a feeling that it could negatively impact the already limited amount of research available. One or two managers have major concerns about the undue cost and time associated with implementation.

INVESTORS LOOK BACK ON 2016

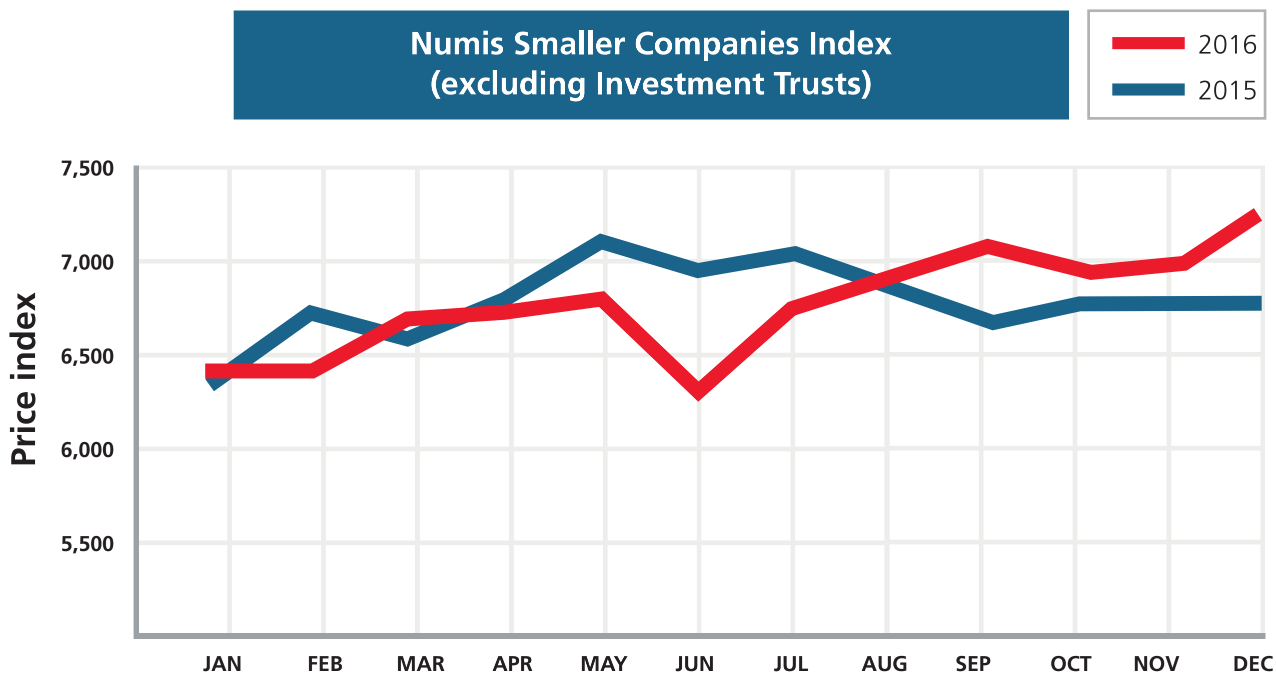
2016 saw steep falls in the value of small and mid-cap stocks in both January and February, the oil price bottoming out in January and then a recovery period. This recovery lasted only until the 'leave' vote at the UK referendum on EU membership which saw another drop in prices. However the second half of the year delivered strong price growth for small caps in particular.

In many instances smaller growth companies were less exposed than mid-caps to perceived weaknesses in the UK economy while many benefitted, like the largest UK listed companies, from the declining value of sterling. However performance was mixed, with commodity stocks in particular performing strongly.

Many small and mid-caps were able to show good underlying earnings growth throughout the year, making them seem like a safe-haven - a positive point that we saw to some extent in last year's report.

Underlying the general small and mid-cap market improvement was a perception that many other companies were in pain, with importers on the sharp end. However IPOs and secondary raisings crept back in after a quiet start to the year showing how new money can be available for the right business models.

Towards the end of 2016 what was hanging over the market was clearly both Brexit and uncertainty in the US following the election of Donald Trump as the next president. The UK Government continued to talk about stimulus but it was clear in the muted response to some company results that wider concerns were holding the market back. But at least, at the end of 2016, the FTSE 100 managed to beat the previous historic high set as long ago as 1999.



Source: Numis Securities Limited

Some Fund Managers found 2016 a difficult year due to the external events that meant company performance was not always reflected in share price performance while external volatility was hard to predict and therefore hard to plan for. However the chart on page 8 shows that the Numis Smaller Companies Index was up 8% and similarly the FTSE AIM All Share index was up 10% over the year.

M&A activity was limited in 2016 with one manager remarking that they were reasonably pleased that there wasn't more activity due to the relatively poor prices at which business was done.

Some of the smaller caps also suffered because asset allocation moved to larger stocks and to bonds, post-referendum in particular.

INVESTORS HIGHLIGHT THE COMPANIES THAT HAD A GREAT 2016

Companies mentioned as having a great 2016 made the most of what they had been given in terms of resource and opportunity. For some it was outsourcing or international market penetration which provided them with operational leverage, allowing them to be more resistant in times of low growth or changing economic conditions. The companies that operate in global markets had a nervous time around the EU referendum but some have come out unharmed, or even stronger as a result. Other businesses were unaffected and had earning upgrades because of the momentum of their businesses, rather than simply the benefits of currency.

Many investors mentioned strong companies being those who had made acquisitions over the last year, which one investor described as a 'self-help' strategy. Such companies often stand out as showing solid growth and performance. Upgrades in fragmented sectors, like retail or rail, were pointed out by one investor. JD Sports and Boohoo were cited for strong performance helped by consolidations and acquisitions. In the rail sector, mentioned as an underinvested area, there were some impressive contracts awarded which in some cases were a multiple of the market caps of those winning them, benefitting companies such as Tracsis, LPA and Petards, though they now have the challenge of delivery.

The ability to start paying dividends is mentioned as being a catalyst for a share price rise, due to the maturity and financial rigour that it suggests, while in addition companies which were already paying a good yield have increased their yield substantially.

Fever Tree, from one manager's perspective

Fever Tree is seen as a great example of a new consumer brand that is executed extremely well. Breathing new life into a tired sector it has stolen shelf space from historic incumbents and has expanded into other mixers, ginger beer and even cola as well as rolling out internationally. As one manager put it "It's a business that is growing its top line exponentially and is increasing its gross margin. It has about 100 employees, everything is outsourced so the operational leverage is brilliant. Plus with one third UK revenues and two thirds international, the referendum had minimal effect on them."

4imprint	Stobart Group	Diploma	Eco Animal Health	Blue Prism
Tracsis	Petards Group	LPA Group	Breedon Aggregates	Restore
Conviviality	CVS	Just Eat	Hill & Smith	Marshalls
Fever Tree	RPC Group	Informa	Phoenix Group	UBM
Boohoo	JD Sports		Accesso	Staffline

Accesso, from one manager's perspective

"They started in queuing hardware and software for leisure parks with the Qbot, a tool to avoid waiting in queues for a long time. The business has evolved and has penetrated the global leisure park market. Accesso has also gone into online ticketing. They have now signed a global contract with Merlin Entertainments to manage all their online ticketing for their venues around the world. Another expansion they did was moving into queuing for ski resorts. "It's a software business so they have high margin, capital intensity, addressing global markets. Accesso's got pretty significant dollar revenues, they are more than 90% US dollar revenues, and were unaffected by Brexit. They have strong structural growth and an overseas revenue."

Investors were impressed by new businesses that did well in 2016, showing outstanding growth and using concepts that didn't exist five years ago. Adapting to what the market wants is essential. One investor mentioned that successful companies are those "that have got a set, structural growth dynamic supporting what they're doing so the firm is fixed on what it's actually capitalised on." One example of this was Eco Animal Health that has a fairly new product that is supported by the latest legislative changes in terms of animal welfare, and can be sold internationally. They have spent a decade getting to this point, but "they're now capitalising very strongly on the opportunity that they've carved out for themselves."

INVESTORS' VIEW OF THE FUTURE

The view is certainly that the market in general is going to find it hard to make much progress in the near future in the face of macro-economic headwinds. High levels of uncertainty are thrown up by both political factors, such as Brexit, and economic factors, such as expected interest rate changes and rising inflation. Managers talk of capex budgets already being trimmed by firms in anticipation of a consumer spending squeeze or capex spend being postponed until absolutely necessary to prevent over-expansion.

The feeling from most managers is that equities will struggle to make many gains in the short-term. Muted reactions to company news provides evidence of this for managers.

At the time of interview, Brexit and the new UK Government were further to the front of managers' minds than Donald Trump's election. Brexit seems to be the greater cause for uncertainty which will not necessarily ease even once Article 50 is triggered and it becomes clear what type of Brexit the UK Government is able to negotiate.

Trump's victory is seen by some as simply increasing the global uncertainty while to others it is seen as a potential positive to global trade and GDP. As one manager put it "both events (Brexit and Trump) highlight that economic policy and market trends are likely to change more in the next three years than they have over the last thirty."

Managers also recognise that other macro issues such as a Chinese slowdown, unrest in the Middle East, and European elections, haven't completely disappeared either. Looking at the market specifically, it is felt, by some, to be a discrepancy in company valuations with some growth companies enjoying very high ratings while cyclical or value stocks are suffering. But this offers opportunities for stock pickers or those feeling some cyclical markets are now starting to look oversold.

One view of the market is that the trend for localism will grow, particularly if sterling remains cheap, with locally sourced products and services coming to the fore.

For IPOs, the 2016 market went in fits and starts and there is no real view of how 2017 overall may pan out, other than it may be slow again. There is a sense that getting offers away before the end of 2016, in a relative stable market, would have been prudent because 2017 is so uncertain. For one manager (not running VCTs) the view was that prices for IPOs were a little steep in 2016 as those with VCTs were fighting it out to get funds away in qualifying deals. IPOs for UK-focused consumer-oriented businesses were mentioned with particular scepticism for this group of managers.

All the managers interviewed were clear that their fund strategy was not going to change in 2017.

"What we want to invest in is high quality businesses which have got good market positions, degrees of intellectual property, degrees of pricing power, sensible balance sheets and are addressing markets that are attractive and growing. That is unchanged. But there is an attraction to businesses that have more overseas opportunity versus UK."

"People are importing goods that are now becoming much more expensive…so are UK consumers going to pay up for those goods, or are profit margins going to be squeezed? You know, that's a question that I don't know the answer to, but I want to try and pick companies that have some pricing power that will enable them to put up prices more than competitors."

"I think a lot of Fund Managers are going to have to evolve their strategies, to be more tuned in to the new market trends and new economic trends going forward"

2015 / 2016 / 2017 INVESTOR TIMELINE

2015

UK General Election

New Governement brings change + "inexperience"

Opposition considered "dysfunctional"

2016

Oil price bottoms out

FTSE AIM All Share hits 2012 lows

Brexit vote

Snap sell-off.

Sterling falls.

"Two toned" approach develops: investors chase overseas exposure.

US Election

2017

2017 headwinds

Expectation for: rising interest rates. rising inflation, uncertainty.

Macro worries remain:

- Article 50 triggered in Spring
- China slowdown, Trump effect, French & German elections.

"We're about 20% in mid-cap…we might go up to a third of the portfolio in the longer term but for the near term we will remain underweight and most focused on structural growth stories, and small and mid-cap, and AIM."

"At one level you feel you should be fully invested (as we think equities are cheap) but on another level you feel there could be some shock in the world that means there'll be better buying opportunities, so we've currently got slightly higher cash levels."

"[Right now] it's just the fear of the unknown more than anything else."

HOW THEY SEE BREXIT

Economic news in early 2017 was dominated by trying to get clarity around the UK Government's negotiation strategy and timings for triggering Article 50. With imperfect information the market was cautious, as expected. President Trump also initiated his policies in the US.

The fear domestically is that the UK political landscape looks fragile and unstable, with an "inexperienced" Cabinet and a "dysfunctioning" Opposition. The worry is that the market will be "very jumpy and spooked by political events over the next 12 months or so" causing unpredictability.

Some managers said they sold off after Brexit to remove particular exposure but on reflection felt it was too "knee-jerk" as those stocks quickly came back. However, some believe that they are now turning softer again. The expectation is that rising inflation and weak sterling will continue to squeeze consumer incomes with the result that discretionary consumer spending will have to reduce.

Managers who were too exposed to UK-focused stocks have clearly made changes to their portfolios, realigning to more overseas-facing areas. One manager stated they had moved towards capital goods, healthcare and software, but are stock picking and not looking to go sector specific per se, so as a result are not trying to outperform the index.

Another manager spoke about how they quizzed their investments about the potential impact of Brexit and most said it would be mildly negative, primarily because of the expected increased administrative cost and bureaucracy.

Besides the currency changes, managers reported a lot of emotive reactions by companies to Brexit that looked as though they might hit their investments quite hard, which included negative reactions from European suppliers and distributors. One manager said they were now positive for the short term and didn't expect to see the real impact on companies until the end of the first quarter of 2017.

The ramifications of Brexit on inward investment were unclear. One manager said that in the tech sector, for companies who are exporting, Brexit looks like a positive outcome for now. Giants like Amazon and Google are still hiring and investing and "there's no indication that the growth companies aren't continuing to commit quite heavily to the UK". However another manager said they were expecting a "diminution of inward investment into the UK" which will lead to slower growth if not actual contraction.

The market's reaction to Brexit is characterised as a 'two toned effect' – splitting firms by whether they have international or domestic earnings.

"Don't use Brexit as an excuse." - 7 pointers for companies

All companies face uncertainty from Brexit over the coming year but for those facing particular headwinds, fund managers were asked what tips they might have.

Most managers said that companies must simply concentrate on performing well and focus on their own business rather than worrying about Brexit. Don't use Brexit as an excuse.

There were however some particular points mentioned but many of them also feel as relevant to all companies as they do to those concerned specifically about the impact of Brexit:

1. **Make the uncertainty less uncertain:** Investors don't want to just hear about uncertainty. Companies should be able to make firm judgements about how Brexit might impact them, such as stating the quality of international relations and if they are changing, even if the results can't be quantified yet;

2. **Labour:** The availability of labour is likely to shrink when the UK leaves the EU. Companies need to start planning how they will avoid any labour shortages and be ready to answer investor questions with clear plans;

3. **Capex:** Holding back investment in the hope of greater certainty may cause more long-term problems than it solves. This will be very carefully monitored. Investors think that companies should go ahead where returns are visible (efficiencies, clear payback) but hold off major capacity investments;

4. **Efficiencies:** Importers and retailers need to work very hard to achieve efficiencies in the face of rising prices and rising minimum/living wage in the UK;

5. **Balance sheet:** Strength in the balance sheet is important. Cash conversion remains king;

6. **Under promise and over deliver:** This is the usual mantra of fund managers, but this is absolutely key when things are so uncertain. Investors are clear that companies need to build in 'wriggle room' in these uncertain times;

7. **Pricing:** Companies need strategies to increase prices, with an early pre-emptive rise being the best kind, before stronger inflationary pricing pressure builds.

HOW INVESTORS LOOK AT AIM

Investor attitudes to AIM

General attitudes to AIM

- More mature than it used to be, with larger companies and fewer failures/frauds
- Of greater interest to a larger number of investors
- Attractiveness and status have increased thanks to fiscal and regulatory changes (eg allowing AIM shares into ISAs)
- Commands more respect from the press
- Less biased towards one or two sectors
- Suffers from too much 'sediment' at bottom end

Nomads and Brokers

- Very mixed views of Nomads and Brokers working on AIM
- Quality is reported as being highly varied
- Best firms have established strong, personal relationships with investors where trust is key
- Best firms are those considered to have the highest levels of research, good quality due diligence and track record of making money for investors

Moving to the Main Market or a Standard Listing

- Most investors do not feel companies must 'move up' from AIM if it remains right for them
- Most feel AIM continues to offer sufficient governance and access to finance for their investees
- Few also believe that the Main Market confers some special status
- A Standard Listing is also not a hindrance as investors will do their own due diligence of any opportunity

Minimum Thresholds for New Listings

- This is a topic which engages some investors but not all
- In terms of free float, some call for at least 25% but majority do not want any specific rules introduced
- In terms of market cap, again investors interested in smaller companies don't want any limit on IPOs
- Investors say they will judge opportunities on their own merits and don't need regulations to be imposed

The effectiveness of AIM

One manager said that AIM can work very well by providing all the benefits of a full listing without the onerous demands and costs. The best companies can mirror the best attributes of a full listing and adhere to the general principles and governance levels but with the benefit of a cheaper and more flexible structure.

Managers pointed to how AIM has altered in that some large companies, which are premium growth, those over £500m market cap, have so far stayed on AIM to enjoy the cost effectiveness and avoid the extra restrictions of the Main Market. This is only really possible because investors will now habitually invest in AIM when previously they would wait for companies to graduate to the Main Market. What might initiate a move up is a failure for a firm to be properly rated on AIM for some reason or perhaps a demand to raise larger funds that might be harder to achieve on AIM.

Respondents mentioned the fact that the press is more respectful about AIM these days and better understands that it contains a very wide range of companies, from start-ups to real growth businesses. It plays an important role in the 'ecosystem of small-cap funding' and it has had political recognition of this through things such as the removal of stamp duty and change to ISA legislation. It is also more balanced than it used to be, having previously been dominated by fads such as mining or gaming, plus it has had some great successes such as ASOS. Some managers also point to the tax benefits (IHT) of being on AIM.

There were though some less positive thoughts with one manager calling AIM "devalued" and "a poor place to be" and that "the performance has been way below what a high risk market should be", while another called AIM's performance "an absolute disaster". One manager also said that AIM was clogged by a large amount of "sediment" at the bottom of the market; micro caps that can't get critical mass or the liquidity needed to attract investors. A lot of these companies are dysfunctional and shouldn't be listed. Another questioned the market's effectiveness due to the poor quality of some Nominated Advisers (Nomads) and Brokers, with managers seeing them as conflicted because it is in their interests to keep poor companies on the market. By contrast these managers agree it can work very well for individual companies with a great offer, or for management looking for tax breaks on their holdings, but they would like to see a little more control over quality.

However a couple of managers felt that the quality has improved, with better companies and also better advisers thanks to good work by the London Stock Exchange. There are also felt to have been fewer scandals on the market recently even though they do continue to happen. A view is that the financial crisis has killed the chances of less suitable companies coming to market while poorer performing businesses that are already listed have struggled for financing so there has been a flight to quality driven primarily by risk aversion.

Nomads and Brokers

For many of the managers questioned, the Nominated Advisers (Nomads) and Brokers working in the small cap market are of variable quality. Some are clearly well-regarded and trusted to do a good job as they are seen as bringing managers relevant and valued investment opportunities in credible companies. The flipside is that some other Brokers are negatively perceived and will be avoided with one manager saying "Some Nomads are dreadful, bordering on the negligent quite frankly…turning a blind eye to what they are getting involved in… some of these people need hauling up in front of a magistrate."

Investors want to impress on small and mid-cap companies that good Brokers reach parts of the investor community that weaker ones cannot. This is particularly true for IPOs as these two comments make clear: "when I look at an IPO, I'm much more likely to go for it if it's coming through a Broker that I have a strong relationship with, and that has had a good track record of successful flows", and "we want experienced sales people who we've got long term relationships with, and we want a house that's got a reputation for doing their due diligence on the IPOs". These comments are also relevant to companies already on the market.

There was also an interesting comment about a full service offering amongst Brokers who are "coordinators in that the broking, the sales, the corporate finance and the market making are, to some extent, aligned, i.e. they work together. Some… don't seem to do market making and therefore they place something and it goes down".

It was pointed out by some though that Brokers are in a difficult position. "There's a massive conflict of interest" as one manager says, referencing the commission structures that are used. Another says "The regulator has exacerbated the problem that commissions just aren't enough for Brokers to be motivated in the secondary market". Also, as we see later in this report when discussing recently introduced regulations, there is an expectation amongst some managers that smaller and less respected Brokers may go to the wall over the coming years leaving less competition.

The Brokers mentioned most often as being the best are those where the research, knowledge and due diligence were perceived to be of high quality, and where strong personal relationships have been established.

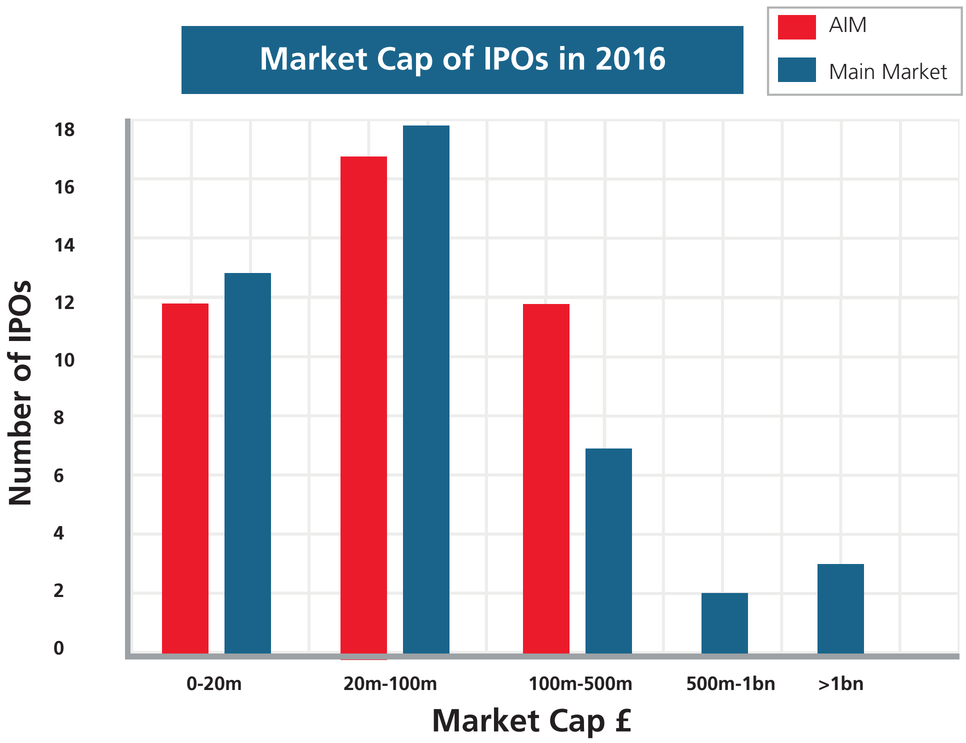
"I don't think they [Nomads and Brokers] do a bad job in general. They get a bit of a kicking most of the time when things go wrong."

Minimum thresholds for AIM IPOs

The issue of introducing minimum size and free float thresholds is one that gets discussed from time to time and the majority of investors interviewed think there should not be any kind of enforced minimum, either by value of company or size of shareholding floated. Instead it is just something that individual fund managers have to feel comfortable with when contemplating an investment. Any specific thresholds would be seen as unnecessary and 'burdensome.'

A few investors though do express an interest for a minimum float with suggestions ranging from 25% to 60%. These are guideline amounts rather than hard and fast rules to allow investors to see the investment case with clarity. One investor, however, feels the guidelines should be more rigid and hold tighter regulations, with a minimum threshold of 60% going to the public so that existing private shareholders would be unable to hold 50% or more. This avoids the problem of shareholders being unwilling to 'dilute' themselves. They say this shows that they fail to appreciate that if they're willing to accept a smaller stake in a much larger firm then the value to them and the investors is greater. Instead they are fixated on owning 50% of the company, so it stays a small, slow growth company.

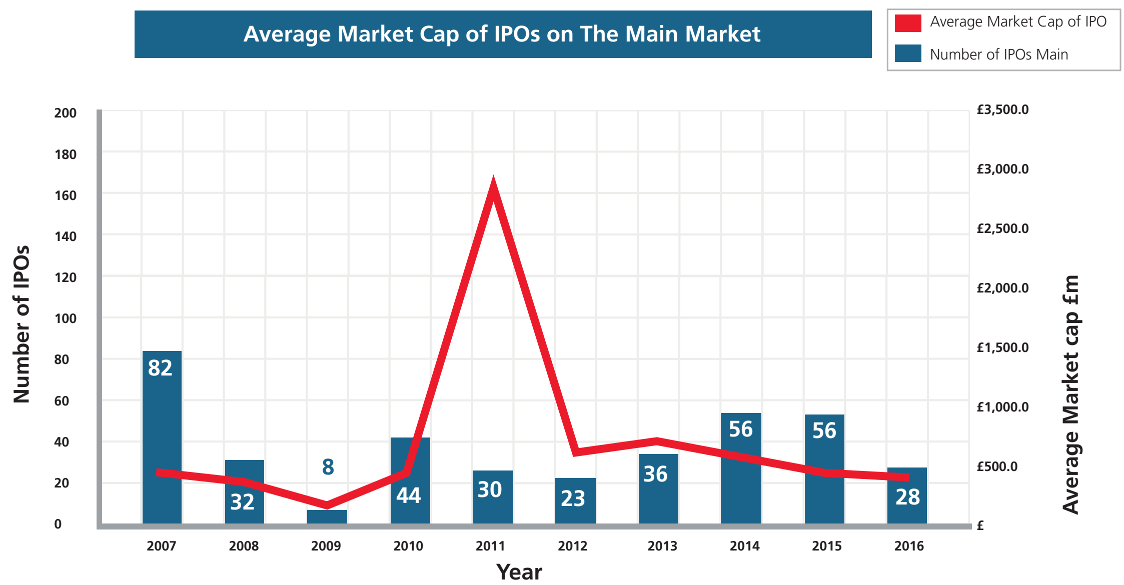
In terms of company size, and whether a threshold market cap is required for new listings, again it depends on individual managers with some quite happy to look at microcaps while others wouldn't contemplate any companies with less than a £50m or £100m market cap.

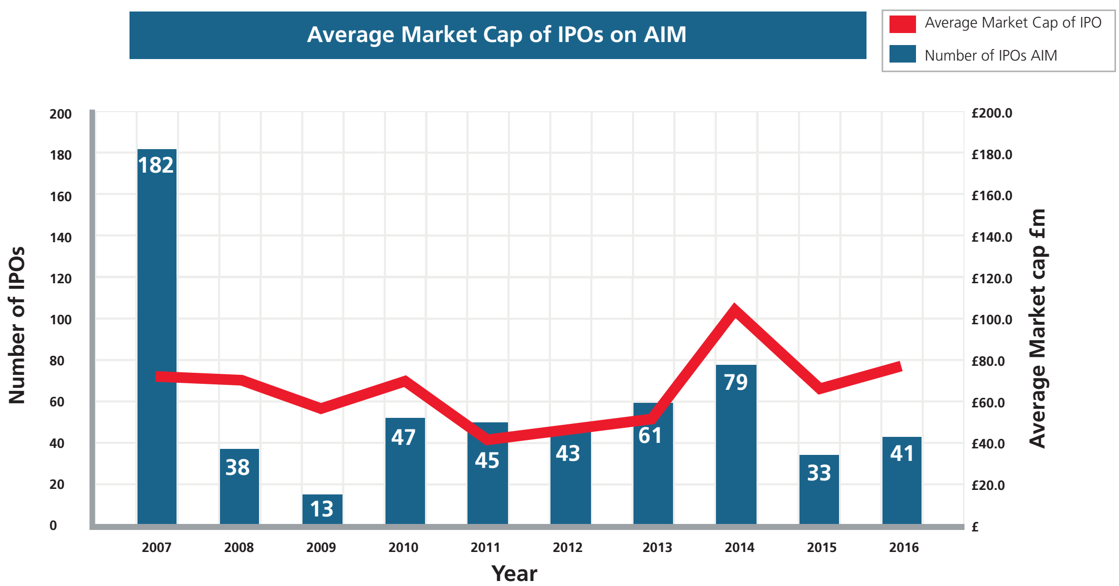


It is interesting to note that in 2016 there were more IPO companies with a market cap between £0-£20 million on the Main Market than on AIM, whereas there were more on AIM between £100 million and £500 million. Is this a sea-change?

One investor feels they would miss out on some potential opportunities if thresholds existed as they might put off or even prevent many good businesses from listing. The general consensus among the investors is that institutional buyers are capable enough to form their own judgements as to what a sensible risk-reward balance looks like. Attempting to legislate or regulate is a bad idea.

Self-regulation seems to be the most popular viewpoint. In effect investors are applying their own size and free float thresholds as part of their investment appraisal process.





The average market cap on both the Main Market and AIM has remained relatively consistent. The average range on the Main Market is between £500 million and £750 million with AIM between £40 million and £80 million.

"I know a lot of fund companies do have the view that [thresholds] should be bigger than a certain number. I absolutely don't have that view at all."

"Investors should be knowledgeable enough not to invest in these areas - if a company is valued at £50m and floats 25% it's just not worth it."

"Our hard won experience over the years is that really below £15m to £20m you're coming from such a low base. The businesses therein are probably at such an early stage or have such limited opportunity market size to go for that it just ups the risk profile significantly."

Moving from AIM to the Main Market

Most of the fund managers who took part in the research say that they are 'agnostic' towards where a firm is listed (with the obvious exception of those running IHT portfolios). There is broad agreement that companies can prosper by remaining on AIM because they will still attract the coverage and investment they need. However there remains the view of some investors that moving to the Main Market does somehow confer a status and maturity on a stock, though this may be stronger amongst those who don't normally fish in AIM's waters. The number of investors expressing this view is clearly on the wane.

As one manager put it "I think the AIM market has matured, and there is less of a negative stigma towards it than there has been historically". Also it works better for firms looking to make acquisitions than a main listing due to the more onerous Main Market rules.

For managers who restrict themselves just to the Main Market, the view is that AIM companies moving up are an important part of the lifeblood of the Main Market, with new companies replacing those that have moved higher or moved off completely. As one manager who invests more into larger companies put it "I think it's generally better to be on the Main Market than on the AIM, so I think I would encourage companies to do that, generally speaking."

What investors think of a Standard Listing

Managers were asked their opinion about a Standard Listing. They had distinctly mixed views here, ranging from not wanting to touch Standard Listed companies through to being quite prepared to invest if the "intrinsic merits of the company" are right. Others simply say "it doesn't matter to us", with the majority leaning towards not being that bothered if the investment stacks up.

One manager who is against Standard Listings said "The Standard Listing is the worst of every world really…it doesn't provide any corporate governance whatsoever…it doesn't come with any tax benefits. The fund managers I've heard talk on the subject say that they just wouldn't entertain investing in a company on the Standard List."

Another manager was a little more favourable, suggesting that there may be times in a company's life cycle where a Standard Listing is right, also saying "they've got to meet various tests to prove that they deserve the Standard Listing". In this case, investors are looking for companies to adopt strong governance and disclosure. This would be part of the due diligence regardless of where the company is listed. This does mean that a Standard Listed company would need to adopt greater governance levels than the Standard Listing might formally require (even though these match other European market requirements) if they are seeking investment.

"It doesn't really make a huge amount of difference to us, we'll look at everything on its own merit. I've got nothing against the AIM market, equally, I don't think that a Standard Listing is necessarily a massive benefit relative to being on AIM."

"It's a good thing, I think the AIM market is devalued, it's a poor place to be."

"We have made investments in Standard Listings and they've been fairly successful."

DESIRE TO BE INVOLVED IN PRE-IPO COMPANIES AT AN EARLIER STAGE

As we have seen in our previous reports, many of the investors in the small and mid-cap space think the earlier they can get involved in a potential new investment the better. A common objective is to get a greater understanding of businesses early on prior to listing, in the belief that it will help the whole investment process and help businesses to find the right investors to support them through to IPO.

However, there is a qualification that to get involved early, as an investor, the manager has to be properly set up in order to be able to do it, with a team big enough to devote the time as well as the capability. It involves a willingness to engage with the company on several occasions prior to IPO.

"You just have to get around the table and talk about the business, the risks, and the opportunities."

As one manager summarises it: "It takes time and a bit of frog kissing from a fund-management perspective, because you do spend more time than you would in a 45-minute presentation on an IPO, but there's a real benefit to it. If we just can manage to get the message across to the broking community, because they're so set in their ways of doing things traditionally, it would be really useful. You could also argue that early insight mitigates risk, probably because it effectively increases exposure to alternative investments which will have less correlation with other things."

Investors are looking to see if the company can set and achieve targets while they also claim that businesses can benefit by receiving guidance from investors in areas such as hiring a broker or setting targets. However the worry for companies is obviously that they may turn off potential future investors before they even reach the IPO beauty parade.

Not all managers are keen on this early contact. A couple do not feel it is beneficial to be involved earlier in the cycle because they aren't as interested in IPOs - they are keener for companies that have a track record on the market and a profit stream that can fund a dividend.

One investor said they have large enough numbers coming in as it is and they are quite happy to meet companies just before they float, so don't need to be involved in pre-soundings. They trust the companies to make a few decisions themselves but as investors they are hands-on once they do come on board.

THE INVOLVEMENT OF PRIVATE INVESTORS

Most investors think it is best for companies to have a mixture of investor types, including employees of the business. However there is a fine line to tread with regard to private investors. The view is that private investors can be "a double-edged sword" because their activity can add to a share's volatility that can run against long-term institutional shareholder interests. The worry is that private investors are often not investing for the long-term so shocks to the downside can be exaggerated in the short-term while uplifts are frequently sold into as private investors look to lock in short-term gains.

There is also a concern about companies trying too hard to court private investors with excessive PR activity and too many RNSs, as this often pulls in short-term holders and once marketing activity stops the price simply drifts down.

While private investor support can boost the liquidity for a share there is a fine line to draw here and one which quickly moves from positive to negative if too much ownership is in private investors' hands.

"It's a bit of a rodeo ride when it's entirely retail owned."

"A broader range of investors is only a good thing. The broader the better, really"

"At that end of the market, day-to-day liquidity waxes and wanes and if you choose a bad day with a small amount of retail selling when there's no institutional buying to mop it up, it can have a dramatic downside impact and you can unravel everything you have gained on the upside."

CASH GENERATION IS THE KEY TO SUCCESS

For most investors, cash generation is king. How well a firm can convert growth and profit into actual cash is where investors focus their gaze because the cash figures cannot be manipulated.

While some of those interviewed do not pretend to know the best way to collect cash and don't have the experience of having to tread the line between receiving timely payment versus the danger of potentially losing valuable customers, if they see deficiencies in cash, and they claim to be relatively easy to spot, then institutional shareholders will take finance directors to task. If however it is being invested in capital expenditure then the investment may well be seen positively.

There is also a claim that however good a firm may be at cash generation investors will always be looking for a little more. The view is that it should be at the forefront of every company's thinking as it reflects how well the company is run.

There is also a view that the amount of adjustments used in reporting is steadily increasing and so as a result the cash position is becoming even more important for investors to judge a firm's health.

"You know, it's all very well growing your profits, but you can capitalise costs, you can do all sorts of things to fiddle profit."

"You know there are those that are very good at it and those that always need encouraging to get it better… It's fairly transparent and obvious where there's some deficiency there and I know it's something that institutional shareholders are keen on and will pull up any FD on, quite hard, at a meeting."

WILL INVESTORS SUPPORT UNDERPERFORMING COMPANIES?

"We have to work out when what's going wrong is to do with the company and when it's to do with the markets it's in, whether it's to do with the competence of the people running it and their focus."

"Where we will sell is if we don't trust the management, we don't think they're being open with us, we think they're being over-optimistic about prospects."

"In a way, you revisit it as if you are almost a non-holder, and say 'Would I invest today in this business, knowing what I do?'"

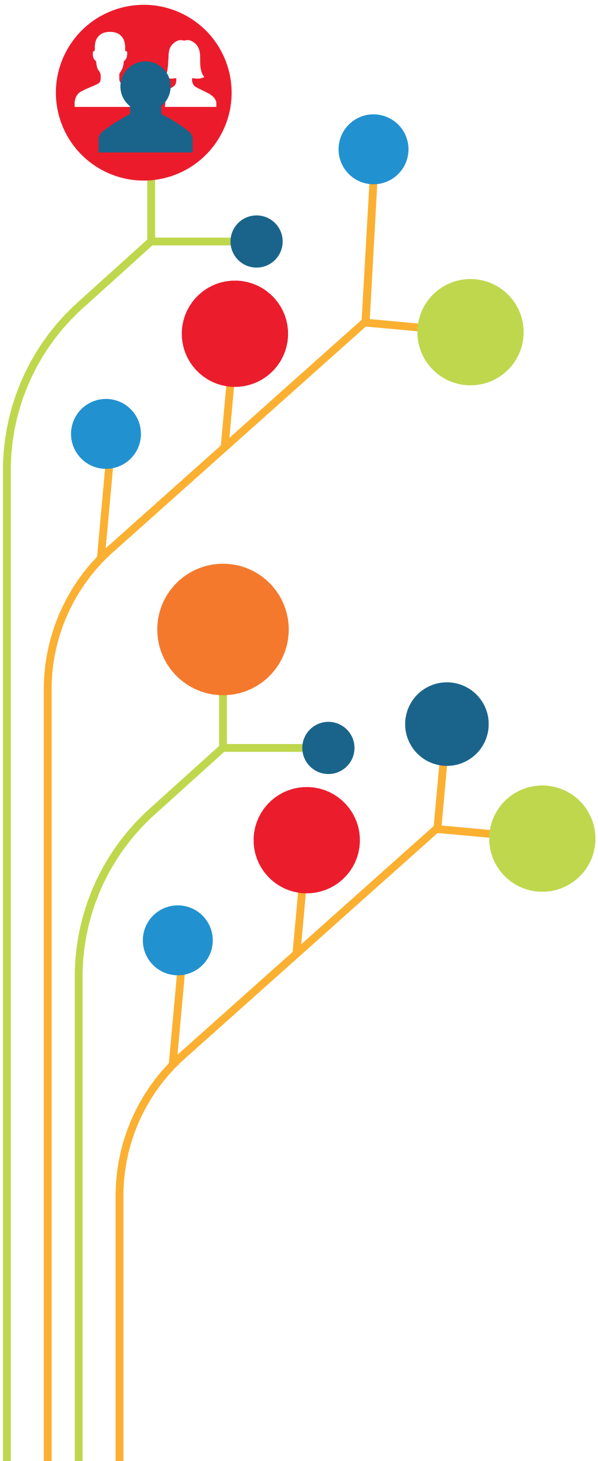
"It comes down to trust as to exactly what's gone wrong, have they bottomed it out? Often management teams can convince themselves that this [particular issue] was the only cause of it [the underperformance] and it's been squared off now and therefore there is no risk to future earnings. In which case, share prices can overreact on the downside and, if management are correct, then it's right to stay in and enjoy the recovery because your markets can overreact and become quite inefficient.

However, there are times when management teams have convinced themselves that they've bottomed out the issues but there are deeper problems which are endemic. Often two or three profit warnings might follow and its determining on a case by case basis exactly which of those categories a company might fit into. It may be triggered by an event, but if we think the investment case is deteriorating or has changed, or the competitive landscape has changed, those would be the triggers to sell. If there is a hiccough on the way that we do think is a one-off event, we will continue to support the business on an on-going basis."

WHAT INVESTORS LOOK FOR IN CHAIRS AND FINANCE DIRECTORS

In this year's report we wanted to better understand the views of investors when it comes to the makeup of boards in small and mid-cap companies.

In general, investors have strong views and care enormously about board composition with one investor saying that the smaller the firm is, the more important board composition becomes. Investors are looking for a blend of sector and PLC experience. Often the latter has to come from Non-Executives because it is rare to find executives who have public market experience alongside sector knowledge.



What makes a good Chair?

Investors are in agreement that an effective Chair is an invaluable resource. However there is still concern that a number of existing Chairs just aren't up to the job. There is the strong view that there is a dearth of talent. Some Chairs were described by investors as "just appalling, a waste of space" because they fail to challenge management by asking the difficult questions. It is clear that they are not representing the shareholders' interests. Indeed one investor draws a strong correlation between the best companies and their tendency to have the best Chairs.

It seems that the importance of the Chair is growing over time because the scrutiny around governance is growing. In response Chairs need to get onto the front foot. As one investor put it, historically they would meet Chairs and Non-Executive Directors when things went wrong but now the best ones are proactive and ask investors what they want from the organisation while also taking their responsibilities on matters such as remuneration far more seriously. One investor characterises this as an "increasing professionalisation" of the role. Others call for existing Chairs to become more active which may include more meetings with shareholders to find out what they actually want before trying to represent them to the rest of the board.

The concern can be whether the Chair is independent enough to make necessary management changes when they are needed. The investors must have confidence that the Chair is putting shareholders first and that they will get more hands-on when it is required. They are vehemently against those that simply turn up once a month and take the money. However, it is recognised that there is a fine line between the right level of involvement and retaining independence. A couple of investors do call on Nomads to be more active when it comes to Chairs, helping them to ensure that boards are balanced and Non-Executives are independent.

"Well I'd certainly like them [Chairs] to be more involved in knowing what the fund managers want. They hardly ever see fund managers and often they opine on what managers want without actually knowing exactly what they are wanting."

"I think in general terms, more [involvement] rather than less. You know, they are there to sense check, challenge, what is going on amongst executives. So they do need to do that, you know, with a sufficient level of focus. Clearly they don't want to interfere or micro-manage, but, you know, there's got to be clear challenge available when it's required."

"Understanding the Chairman of your business is equally important to meeting the CEO and the FD."

"If you're a longer-term investor then you need the Chairman to be working for the shareholders, you need him/her to be independent and objective about the capabilities of the operational people."

"If you've got a big stake in the company, the Chairman might give you a call, or the Chair of the Remuneration Committee might run the next LTIP plans past you. I actually think that's quite important, and more of that is generally better."

"A Chairman who has never spoken to his shareholders, you question what his sort of benchmark is for his role."

What makes a great Chair according to investors?

- Finds out what shareholders want
- Genuinely represents shareholders' interests
- Is clearly independent
- Takes responsibility for good governance, including remuneration
- Holds the executive to account
- Makes board and management changes when necessary
- Takes decisive action
- Has a reputation s/he wants to build and protect

The need for a strong Finance Director

Investors are agreed on what they want from a Finance Director in a small or mid-cap company – someone who not only has meticulous, detailed knowledge of the numbers but will also stand up to their CEO. In fact standing firm against a CEO, who may well be a headstrong entrepreneur with a dominant character, pretty much tops the list of FD requirements. The fear amongst investors is that too often the CEO will veer away from the targets promised to investors because their nature can be more instinctive rather than working to publicly agreed plans.

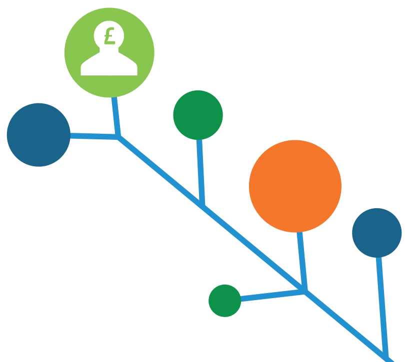
The skills required of a good Finance Director in a quoted firm are also thought to be quite different to those in a private firm. As well as meeting stated targets, once public the Finance Director has to be more of a public face who is able to market the company to investors. This includes being able to participate fully in investor meetings, not being a silent bystander while the CEO leads the whole discussion. This means the FD needs to be seen as an equal to the CEO and far more than just a financial controller. Also, once in a quoted company, the Finance Director will be making all their mistakes in public. One investor illustrated this by wanting Finance Directors who can say, "No, we can't make that investment this year. We have an obligation to hit this profit target and we're damn well going to do it, so that will have to wait or we'll have to compromise here or there."

The ability of the Finance Director also reflects on the CEO as a good CEO should be able to accept the criticism of an independent Finance Director as this will help to prevent CEOs making poorly thought out business decisions.

"The FD needs to, sort of, protect the financial integrity of the business and they need to be more than a financial controller."

"It's very stark for us when a Finance Director does or doesn't know the numbers in the meeting. People who've had to refer to schedules to pick out what we think should be very [straightforward], or numbers that should be at the forefront of their mind, that's a red flag to us. Finance Directors who do very little talking and come in the meetings, that alarms me too… I want it to be clear that they are more or less on an equal footing, strategically with the Chief Executive."

"Face up as an equal to the Chief Executive. That's really important. You get some quite headstrong entrepreneurs in the AIM market who have a very clear vision of where they want to take the business."



What makes a great Finance Director according to investors?

- Knows the numbers inside out
- Consider themselves as an equal to the CEO, stands up to him/her
- Ensures the business remains focused on the plan
- Focuses on cash conversion
- Actively contributes to investor briefings
- Is aware that any mistakes will be made in public

HOW INVESTORS REACT TO INCOMING REGULATIONS

New regulation (particularly MiFID II, but also MAR) is mostly seen as little more than a process irritation but one or two managers have major concerns about the undue cost and time associated with implementation.

The reactions to the changes brought about by MiFID II vary. For those with less focus on the smaller firms they seem less concerned that investment research may disappear simply because it won't impact them to the same extent as fund managers fishing in the lower part of the market may be hit. They believe that investment research is a necessary tool to help bring good companies to their attention. Managers more geared towards the smaller end of the market see MiFID II as possibly exacerbating the already low level of research available.

The worry for some is that, overall, the small and mid-cap market, which is already light on research, will suffer as even less research is produced due to the changes in how it is paid for and that much of the research that will get released will simply be Broker driven pieces. As one manager puts it, there is an expectation of less research in the market and what will exist could end up being "totally non-independent research that would probably have to be classified as financial advertising" as the only people writing research will be Brokers looking to "raise money at high fees". One manager says their company has already cut back on research and is likely to focus resources on "a smaller number of quality providers". However another is even more disparaging and thinks most of the research at the smaller end of the market is paid-for by companies anyway.

There are concerns about unintended consequences, with fears that costs of investing via VCTs will increase so preventing some investments being made, with the impact likely to be felt by early stage companies in particular. The problem is that the changes are seen as a 'one size fits all' approach which will hit the small end of the market particularly badly, where a single piece of research could make or break a company. There is also an expectation that some Brokers may go out of business completely. Although not mentioned by name MAR is seen to introduce a new level of process that is an unnecessary burden. It adds bureaucracy to a system that was already functioning satisfactorily. The burden falls on investors, Brokers and companies alike.

Investors commented: "It's a huge concern. It worries me more than the economy or anything else. It worries me to the point of actually reducing exposure to the UK because I'm just scared that we get our money locked up."

"Elephant in the corner. It hasn't really had an impact yet…the impact is potentially coming."

"I have no views. It's something that I just follow as and when I'm told to follow it"

"[The market is] certainly not over-researched, so anything that reduces the amount of research available on smaller mid-caps is a bad thing."

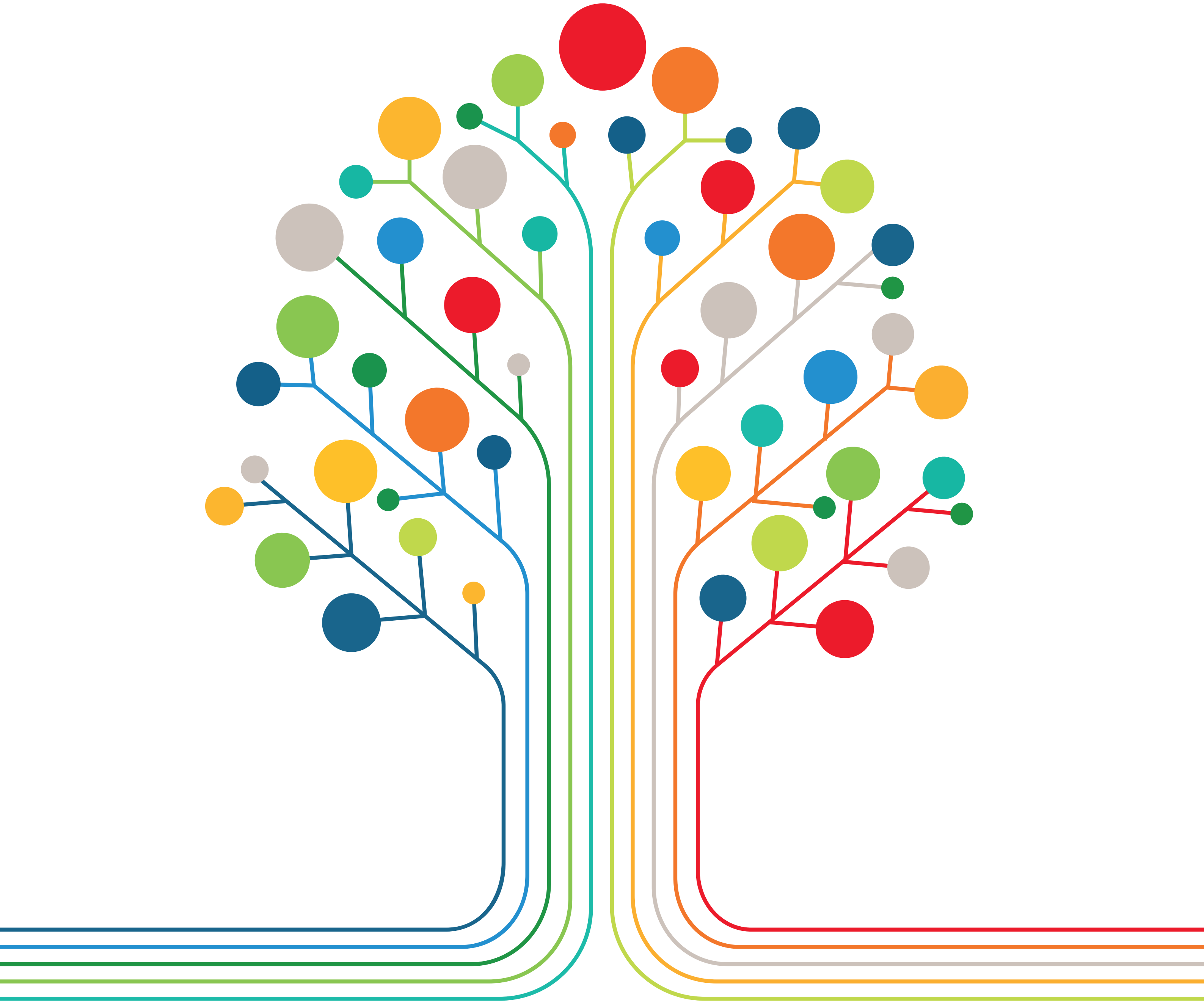
"Most of the small companies at the bottom of the market are paying for the research to be produced by their Brokers or their agents anyway. So, in itself, I don't think it'll make a very big difference."

Concluding remarks

It is clear from this year's survey that companies will need to step up their communications with investors, but not in terms of quantity. It is all about quality. We live in interesting times and our top tips for 2017 are:

- Don't use Brexit as an excuse
- Choose and use your advisers wisely
- Demonstrate healthy cash generation
- Manage your relationship with private investors
- Use your market listing effectively

We look forward to reporting the views of investors in 2018!



NOTES

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