QCA/BDO

SMALL & MID-CAP SENTIMENT INDEX

February 2012 Issue 2

QCA The Quoted Companies Alliance

YouGovStone

BDO

INTRODUCTION

SCOTT KNIGHT, PARTNER BDO LLP

THE RESULT OF THE SECOND QCA/BDO SMALL AND MID-CAP SENTIMENT INDEX ECHOES THAT OF THE FIRST, RESPONDENTS ARE NEGATIVE ABOUT THE ECONOMY AS A WHOLE BUT POSITIVE ABOUT THEIR OWN COMPANY'S PROSPECTS (COULD THIS BE THE ROBERT PESTON EFFECT?). THE FACT THAT SENTIMENT HAS NOT CHANGED SIGNIFICANTLY IN THREE MONTHS IS LARGELY WHAT WE EXPECTED. OUR AIM IS TO BUILD A LONG TERM INDEX THAT SHOWS REAL TRENDS RATHER THAN REFLECT THE PREVIOUS WEEK'S HEADLINES AND IN SOME CASES, TRENDS WILL TAKE SEVERAL QUARTERS TO DETECT.

With around 250 respondents we are pleased to see the survey is growing and gaining awareness in the small and mid-cap community. Many thanks to those who responded and to those who read the results but did not participate, please do so next quarter.

The relationship with shareholders that small caps want

The well coined phrase is that small and mid-cap companies want supportive shareholders. Does this mean they seek investors who having initially invested quietly sit by and let management get on with running the company and are happy to follow their investment when a fundraising is required?

I think not, they want shareholders that understand the business and its risks and who stick with the company so long as management deliver on milestones.

The result of this survey clearly shows small and mid-cap companies want shareholders to be rewarded with tax benefits for gains made for long term shareholdings. The fact that shareholders want long term investors is entirely logical. These are the investors that spend time understanding the company and are therefore best able to judge its performance. Such shareholders allow management to run the business to create long term value rather than manage news-flow. It also makes it worthwhile for the shareholder to seek to influence the running of the company, either in private session or in general meetings for small investors.

Measures such as allowing AIM shares to be included within ISAs and removing the 5% requirement before qualifying for Entrepreneurs' Relief are strongly supported by respondent companies. Here is an opportunity for Government to reframe the shareholder/ small and mid-cap relationship towards a longer term more engaged model.

The survey also shows a strong rejection of the Government's proposals on executive pay with 52% of small and mid-cap companies being opposed to the proposals and only 36% in favour. Reading through the quotes from respondents, shows there is a wide spectrum of views but many agree this is not an area Government should be meddling in, that it is largely a publicity exercise and most telling shareholders already have this power. Generally small and mid-cap companies feel their relationships with shareholders should be such that it prevents excess. Interestingly, there were a few comments that the shareholders who object the most are those that understand the issue the least. Small and mid-caps want shareholders that understand the market for corporate talent and are prepared to quietly tell the company when they start going wrong.

MEASURES SUCH AS ALLOWING AIM SHARES TO BE INCLUDED WITHIN ISAS AND REMOVING THE 5% REQUIREMENT BEFORE QUALIFYING FOR ENTREPRENEURS' RELIEF ARE STRONGLY SUPPORTED BY RESPONDENT COMPANIES.

EXECUTIVE SUMMARY

TIM WARD, CHIEF EXECUTIVE, THE QUOTED COMPANIES ALLIANCE

OUR SECOND SURVEY SHOWS THAT SMALL AND MID-CAP QUOTED COMPANIES CONTINUE TO REMAIN CONFIDENT ABOUT THEIR OWN BUSINESS PROSPECTS, DESPITE THE ECONOMY REMAINING IN THE DOLDRUMS. WHILST NO ONE IS FEELING PARTICULARLY BULLISH ABOUT THE UK ECONOMY AS A WHOLE, COMPANIES EXPECT ON AVERAGE TO SEE THE NUMBER OF EMPLOYEES INCREASE BY NEARLY 4% OVER THE NEXT 12 MONTHS.

And once again, pessimism about the economy is echoed in the area of compliance where most expect to see the amount of regulation increase a little. Small and mid-cap quoted companies do not seem to be buying the Government's continued focus on cutting red-tape and continue to feel the regulatory burden.

Despite companies' optimistic business prospects, most companies are not looking to raise capital in the next 12 months; but if they did, the majority would still try to do this through the public equity markets. There seems to be a shrinking potential appetite for bank finance within this environment. 36% of companies and 74% of advisors say that it is hard to raise finance through the banks compared to 23% and 67% when it comes to public equity. It would seem for many that raising any kind of finance is going to be tough in these conditions – whichever route is preferred.

In this survey, we asked the small and mid-cap sector for their views on the looming Budget – what they want to see in there (and what they did not). There is a clear desire by all that there are some key policies which would all have a significant impact on company performance.

The single most popular policy to appear in the Budget is the inclusion of AIM and PLUS-quoted company shares into ISAs - over a quarter of both small and mid-cap quoted companies and advisors believe that this would have the greatest positive impact on business. This result is particularly significant - over the past year or so, the Government and ministers have continually shot this

proposal down. It's no wonder that the majority of the small and mid-cap company sector felt in our last survey that the UK Government does not care about them.

Also, the removal of stamp duty on small and mid-cap company shares and reforming capital gains tax relief so that the 5% shareholding requirement for Entrepreneurs' Relief is removed and so that long-term investors can also qualify are highly desirable items to make a budget appearance.

Including AIM and PLUS-quoted company shares in ISAs, abolishing stamp duty and reforming capital gains tax relief are all measures that the Quoted Companies Alliance has proposed to the Chancellor and are easy to implement and overwhelmingly supported by small and mid-caps. They tie in to the much vaunted need for long-term investment and growth and recognise the importance and potential of small and mid-cap companies as the driver for economic growth. Any further delay in stimulating growth will stall our economic recovery by several more years. Now is the time to support small and mid-cap companies as the engines of growth with a range of Budget initiatives designed to lubricate and fuel their financing and business growth plans. The Government must stop consulting and start to deliver.

HIGHLIGHTS

63%

of small and mid-cap quoted companies remain pessimistic about prospects for the economy in the next 12 months, **which is a slight improvement compared to 70% in September 2011.**

67%

of companies expect sales to grow in the next 12 months, **with the average expected growth in turnover put at +13.6% (+15.3% September 2011).**

48%

of companies expect to employ more workers in the next 12 months, **with the average expected growth in employment put at +3.7% (+6.9% September 2011).**

42%

of companies are considering raising capital in the next 12 months, **which is unchanged from September 2011.**

74%

of advisory firms believe it is hard to raise bank finance, **but only 36% of companies agree with this view.**

52%

of companies are against the idea of binding shareholder votes on executive pay, **but 32% support the proposal.**

24%

of companies fear that personal taxes will increase in the Spring Budget.

85%

of companies believe allowing AIM and PLUS shares to be included in ISAs will have a positive impact on their business.

0%

of companies believe that regulation will decrease over the next 12 months, **with 76% fearing it will increase.**

BUSINESS CONFIDENCE

STABILISED BUT NOT YET BOUNCING BACK

Confidence among small and mid-cap quoted companies has marginally improved in recent months, but businesses remain cautious about the economic outlook. Worryingly, advisory firms across the sector have grown even more pessimistic since the autumn with confidence showing no sign of improvement.

On a scale between zero and 100, where zero represents very pessimistic and 100 equals very optimistic, small and mid-cap quoted companies currently rank prospects for the UK economy at 41 compared to 39 in September. Advisory firms currently score prospects at 37 compared with 38 in September.

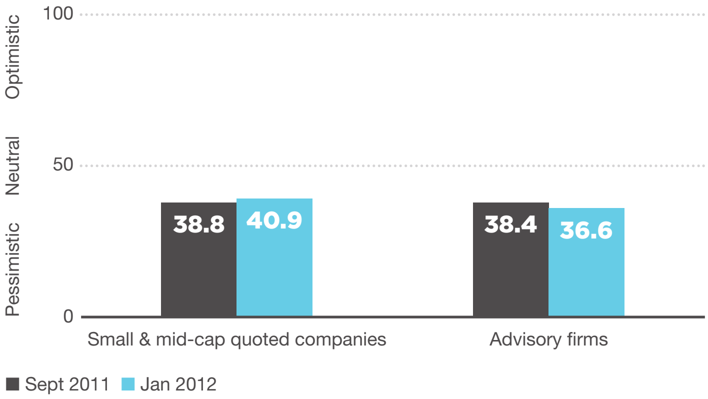
These results reiterate the pessimistic picture outlined last September with the real possibility of a second recession taking a heavy toll on confidence. Negative perceptions regarding the economy are being expressed across all sectors, with the Eurozone crisis adding to this gloom.

Yet bad as these indicators are, there are perhaps some limited grounds for optimism. Confidence has not significantly deteriorated. This confirms recent survey evidence from other sources that confidence may have stabillised. However, the path to sustained economic recovery still looks some way off.

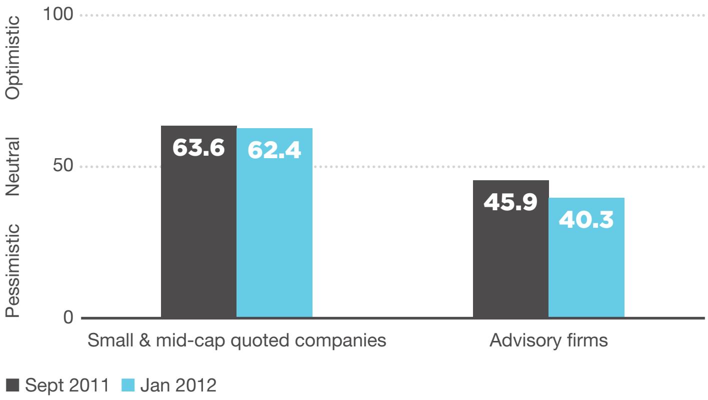
Despite a lack of confidence surrounding the economy, the majority of small and mid-cap quoted companies remain relatively optimistic about the prospects facing their own business. Although business prospect confidence has declined slightly it remains comfortably above the neutral 50 level (62). Given all the recent concerns about the weakness of the economy and the prospect of a double-dip recession, these results are better than expected.

In contrast, advisory firms are significantly less optimistic believing prospects for small and mid-cap quoted companies have deteriorated significantly since September 2011. Their ranking has fallen to 40 compared to 46 in September 2011.

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?



BDO/QCA VIEW

Small and mid-cap companies continue to remain confident about their own prospects where they feel more in control of their destiny.

It is interesting that there is such a divide in opinion between advisors and companies. Advisory firms continue to feel less optimistic about small and mid-cap companies' ability to grow. Perhaps it is the difference between an outsider and an insider – the advisors are constantly reminded of the deteriorating economic situation and focus on the difficulties facing companies. Companies however have to remain focused on the positives in order to keep the shop open – self-interest plays its part.

FUTURE EXPECTATIONS

GROWTH ASPIRATIONS WEAKER BUT STILL POSITIVE

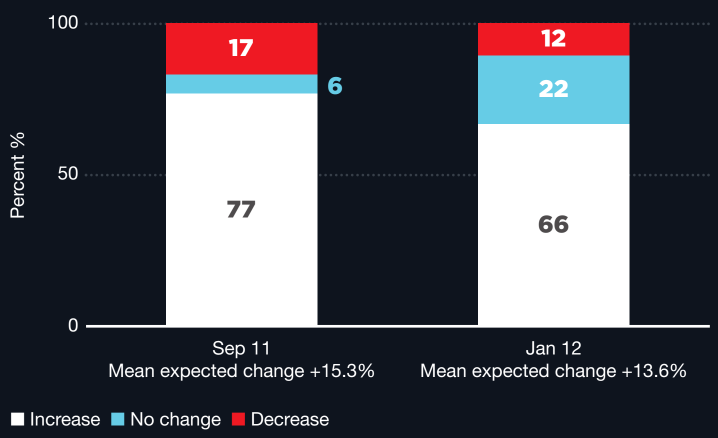
Small and mid-cap quoted companies are slightly less bullish about sales growth than they were in September. However, the majority (67%) still expect turnover to expand over the next 12 months, with the average expected change in turnover put at a healthy +13.6%.

For all the headline gloom concerning the economy, the fact that the vast majority of companies still expect turnover levels to expand is very encouraging. While there is probably some self-interest bias inflating these results, they do nevertheless suggest that small and mid-cap quoted companies continue to have strong growth aspirations.

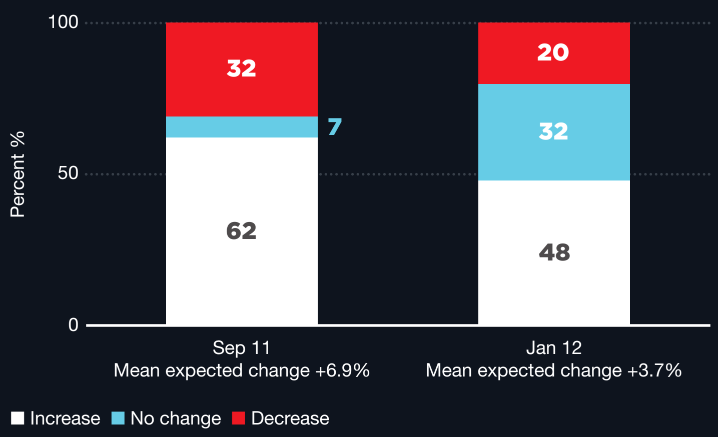
Small and mid-cap quoted companies are significantly more cautious about increasing headcount than they were in September. Less than half (48%) of companies expect to increase employees over the next 12 months, with the average expected change in employment growth now put at a modest +3.7%, compared with 6.9% in September.

Although these results point to further growth in jobs over the coming year, employment intentions have softened considerably. Eurozone uncertainty is causing some companies to revise down their plans for recruitment, while others are scaling back their plans in response to a lack of robust domestic demand prospects.

By how much do you expect your turnover in your business to change in the next 12 months?



By how much do you expect the number of full time employees in your business to change in the next 12 months?



BDO/QCA VIEW

These results present a positive outlook in a brittle economy. While small and mid-cap quoted companies remain positive, their predictions for growth have been slightly downgraded since September. This may be symptomatic of the fears of a double-dip recession.

FUNDRAISING
CREDIT CONDITIONS REMAIN TIGHT

The appetite for general fundraising remains relatively subdued with less than half (42%) of small and mid-cap quoted companies considering raising capital in the next 12 months, which is unchanged from September. In terms of funding sources, there are also no real changes in trends with 56% preferring public equity, 27% bank finance, and 17% favouring other sources.

Opinions differ considerably as to the ease of raising capital. Whilst advisory firms generally believe it is hard to raise capital, especially bank finance, companies have more of a diverse view. There is also a high degree of uncertainty by companies with regard to listed debt issuance and private equity funding.

This relatively low appetite for finance suggests the availability of credit remains tight. In addition, nervousness about the outlook may have led some companies to scale back investment plans.

How easy or difficult is it to raise finance through the following channels?

		Hard	Neutral	Easy	Don't know
Bank finance	Small/Mid-caps	36%	28%	29%	7%
	Advisors	74%	23%	2%	1%
Public equity	Small/Mid-caps	23%	29%	36%	12%
	Advisors	67%	26%	4%	2%
Listed debt issuance	Small/Mid-caps	48%	15%	10%	27%
	Advisors	64%	26%	0%	9%
Private equity	Small/Mid-caps	35%	24%	18%	24%
	Advisors	45%	41%	8%	6%

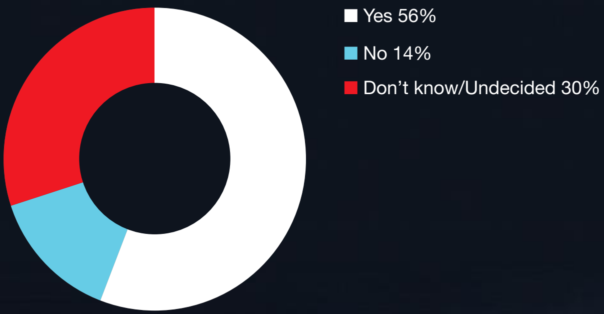
"PRESENT COSTS OF RAISING EQUITY TOO HIGH AT A TIME WHEN BANK FINANCE IS PROVING EVER HARDER TO OBTAIN"

COMPANY VIEWPOINT

Bond markets – a new financing route?

Respondents are positive about the idea of stimulating a bond market for small and medium-sized companies with 56% believing this measure is needed. This is perhaps slightly lower than expected given the current tight market for conventional debt financing.

The Government is considering stimulating a bond market for small and medium-sized companies as an alternative to bank finance. Do you think such a market is needed?



BDO/QCA VIEW

Confidence in raising finance remains at a low ebb. Advisors again believe that raising any type of finance will be consistently difficult for small and mid-cap companies. Companies seem to be split evenly in terms of how difficult they find it to access the varying types, which would suggest that the situation varies depending on your specific company's circumstances. This isn't surprising given the type of market we are all in – there are opportunities for some, while others feel squeezed by the continued economic downturn.

While raising capital remains difficult, the potential for a bond market for medium-sized companies is starting to be recognised. The Government is currently examining how it could stimulate this type of finance as an alternative to bank debt and equity for mid-cap companies and will report on it in the upcoming Budget.

REGULATION
RED TAPE WORRIES PERSIST

The vast majority (76%) of small and mid-cap quoted companies continue to believe that regulation is going to increase over the next 12 months, while nobody feels it will decrease. This overwhelmingly negative reading of the regulatory environment suggests companies remain highly sceptical of the Government's attempt to reduce regulation.

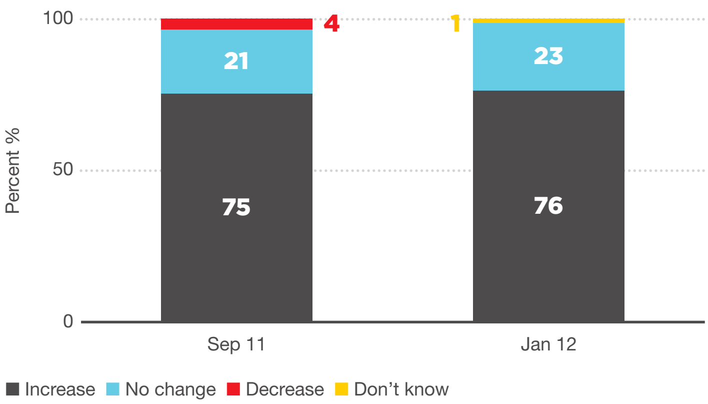
It is clear there is growing frustration with the Government at the lack of progress it has made on reducing regulation. Steady increases in the cost of doing business are becoming a huge challenge to small and mid-cap quoted companies, which ominously looks set to get worse.

Binding shareholder votes on pay

Under a third (32%) of small and mid-cap quoted companies and 35% of advisory firms support the idea of binding shareholder votes on executive pay. Many companies share the view that the proposal is "pointless posturing that hasn't been thought through," and "a headline grabber that will not make any difference." Others are concerned believing "it brings yet more bureaucracy to running a business and appears to be affecting the many to control the few."

However, some companies are supportive, judging that the initiative would "improve the public perception of corporate governance and behaviour," and that it will "encourage Remuneration Committees to be more responsible."

Do you believe the amount of regulation affecting your business is likely to increase, decrease or stay the same over the next 12 months?



Do you support David Cameron's proposal to introduce binding shareholder votes on executive pay for all UK PLCs?

Small & Mid-cap companies
- Yes 32%
- No 52%
- Don't know/Undecided 16%

Advisory firms
- Yes 35%
- No 49%
- Don't know/Undecided 16%

BDO/QCA VIEW

The Government continues to shout about cutting red tape – a prime example is its roll out of the 'Red Tape Challenge' this past year which encourages people to comment on any area of regulation that they feel is overly burdensome and does not add value.

However, companies clearly don't feel that Whitehall is delivering on its promise.

While the proposal of a binding shareholder vote has split opinion, many say it feels like it is largely a PR exercise. Overall this does not help the Government's current main aim to appear to be cutting excess regulation. It is not surprising that small and mid-cap companies continue to feel that Government does not care about them. The results do show a significant majority opposed to the plans compared to those supporting them.

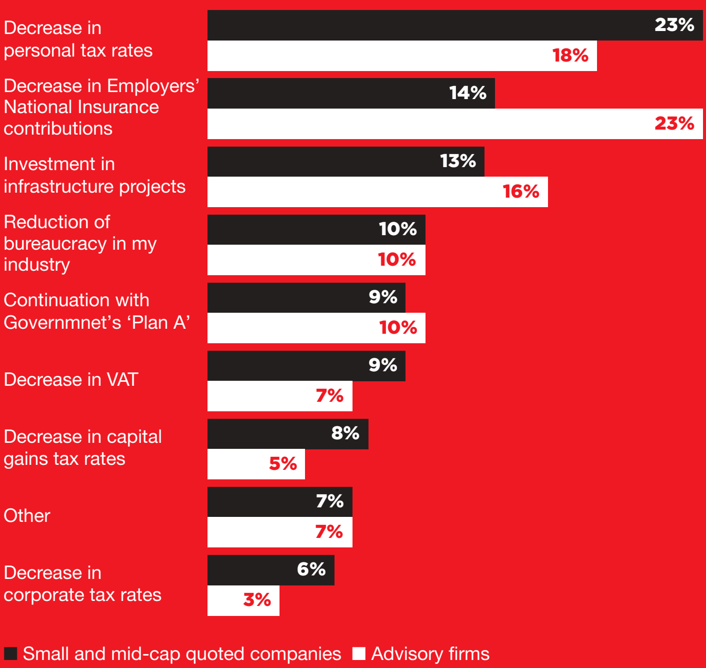
THE BUDGET

CREATE THE RIGHT ENVIRONMENT FOR BUSINESS

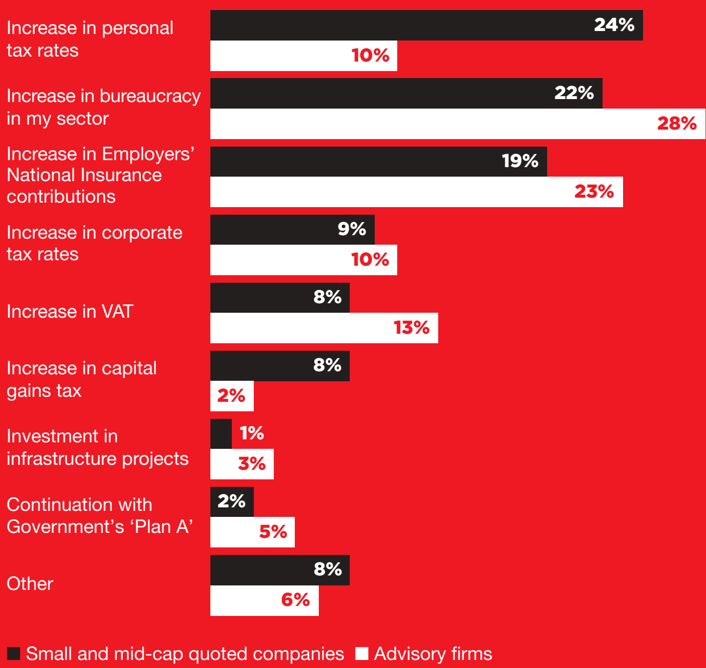
Reductions in personal tax and National Insurance are the principal actions most desired from the Spring Budget. Whilst small and mid-cap quoted companies want to see a fall in personal tax, advisory firms would prefer a decrease in National Insurance contributions. Increased infrastructure investment is another popular measure, while lessening industry bureaucracy ranks fourth.

Opinions are divided as to what to most fear from the Spring Budget. Small and mid-cap quoted companies most fear an increase in personal tax, closely followed by increased bureaucracy. Advisory firms are not really worried about personal tax, but have big concerns about bureaucracy and higher National Insurance contributions.

What policy announcement would you most like to see in the Spring Budget?



What policy announcement do you fear the most in the Spring Budget?



Gauging the impact of policies on companies

The inclusion of AIM and PLUS-quoted shares in ISAs and the reform of capital gains tax relief rates highly amongst small and mid-cap companies and advisors as having a positive impact on their business.

82% of small and mid-cap quoted companies and 86% of advisors believe capital gains tax relief to long-term investors that hold shares in SMEs for five years would have a positive impact. Many believe this move would help create a more stable investment environment, as well as generating more investor interest in smaller companies.

The removal of the requirement to hold 5% share capital before qualifying for lower capital gains tax is also viewed in a positive light. Many respondents believe this policy would help incentivise staff, and as such would help retain and motivate key employees. According to one participant in our survey, “it would allow widespread of employees to enjoy a significant financial benefit and give a different motivation to share schemes which currently have no tax advantage”.

What sort of impact, if any, would the following policies have on your business, were they to be announced in the UK Spring Budget?

Small & mid-cap companies	Negative	No impact	Positive	Don’t know
Eliminate stamp duty on trading in small and mid-cap quoted company shares	0%	18%	79%	3%
Remove requirement to hold 5% share capital before qualifying for lower rate of capital gains tax via Entrepreneurs’ Relief	1%	39%	54%	5%
Lower capital gains tax for long-term investors that hold shares in SMEs for 5 years	0%	16%	82%	2%
Allow VCTs to buy shares in the secondary market	0%	25%	64%	11%
Allow AIM and PLUS-quoted company shares to be included in ISAs	0%	8%	85%	6%
Costs of raising equity to be tax deductible up to a certain limit	2%	16%	77%	4%
Reinstate the dividend tax credit for pension funds	0%	37%	54%	8%
Remove the income tax liability on dividends on those stocks outside of the FTSE 350	0%	22%	72%	6%
Abolition of the 50% personal tax rate	0%	30%	67%	4%
Abolition of numerous tax reliefs in exchange for a lower overall corporation tax rate	6%	26%	56%	12%
Abolition of the small companies tax rate in exchange for a reduction in the employers’ national insurance rate for the first 20 employees	11%	41%	40%	8%
Simplification of the rules for tax losses including only a single pool of losses	0%	42%	47%	11%

The policy with the greatest impact: allow AIM & PLUS into ISAs

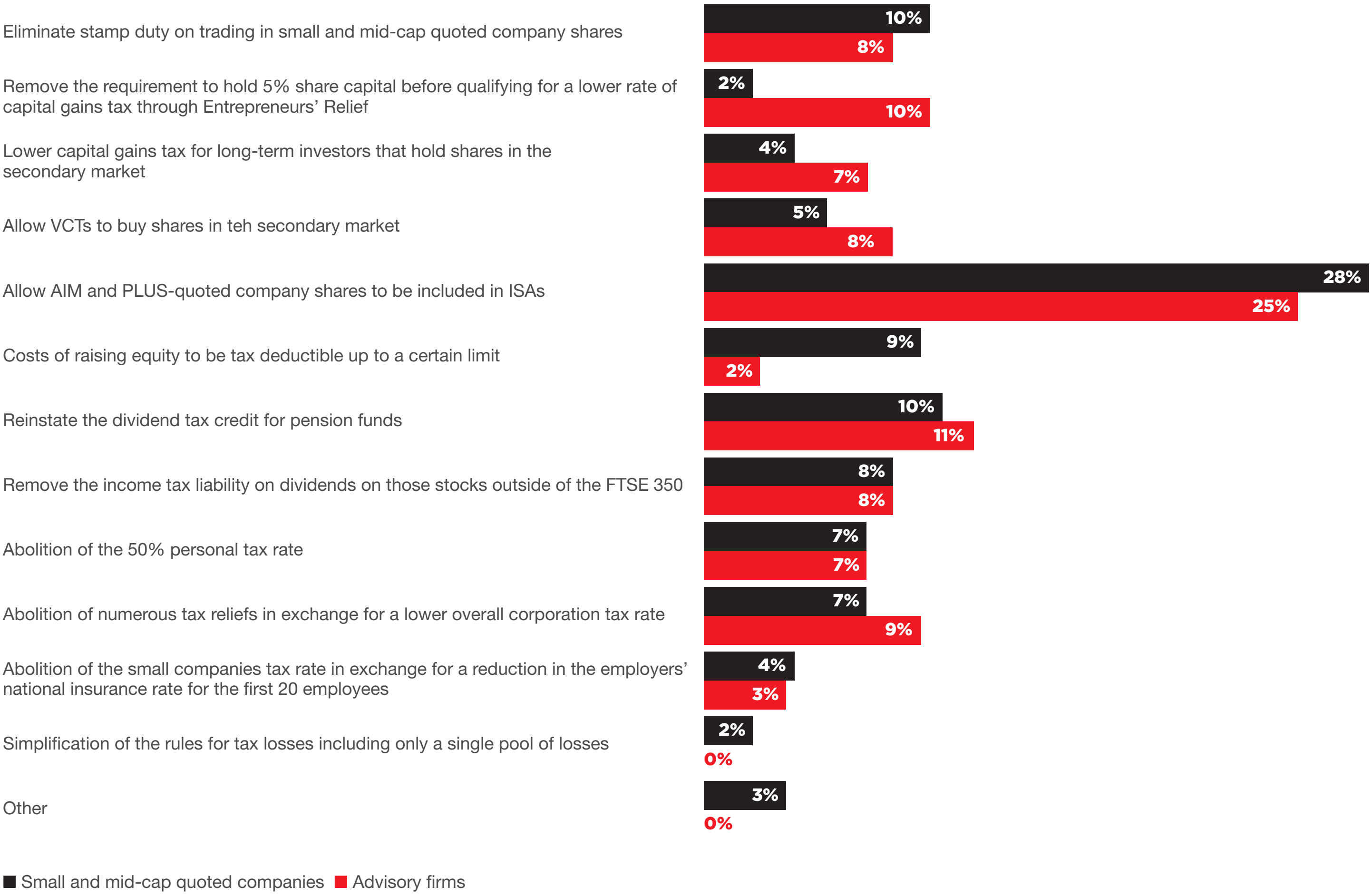
Out of all the potential policies that could be introduced, the overwhelming view of both companies and advisory firms is that allowing AIM and PLUS-quoted company shares into ISAs would provide the greatest positive impact to small and mid-cap quoted companies. In particular, many companies agree with the view that this measure would "expand the pool of potential investors very significantly," and "lead to long term shareholders."

Of the other policies, reinstating the dividend tax credit for pension funds is a popular choice, with some companies believing it would "reduce pension deficits overnight." Others believe this measure "may well encourage a partial reversal of the current trend away from equities to bonds bringing more capital to public markets."

"THIS WOULD OPEN UP OUR POSSIBLE INVESTOR POOL TREMENDOUSLY TO THOSE WHO CAN'T CURRENTLY INVEST IN US"

COMPANY VIEWPOINT

Which one of these policies would have the greatest positive impact on your business were it announced in the Spring Budget?



BDO/QCA VIEW

The small and mid-cap sector has spoken and the inclusion of AIM and PLUS-quoted company shares into ISAs is what they want. The Government has been very vocal against this proposal over the last few years, so it will be interesting to see if the Chancellor continues to shoot this down and the reasons for doing so. Capital gains tax reform is another area where small and mid-cap companies believe more can be done to encourage investment. The removal of the arbitrary 5% shareholding requirement for Entrepreneurs' Relief and extending the relief to long-term investors in SMEs would help to recognise all who contribute significantly to the growth and success of a business.

The small and mid-caps have made some clear proposals for the Government to consider that would increase the pool of much needed capital available. Surely this must be consistent with the much needed growth agenda?

METHODOLOGY

This is the second QCA/BDO Small & Mid-Cap Sentiment Index by BDO and the Quoted Companies Alliance (QCA). It is an online quarterly survey of the small and mid-cap quoted sector.

The report is based upon 237 online interviews (150 small mid cap companies, 87 advisory firms) with members and associates of the QCA. It was conducted between 19 Jan-31 Jan 2012 by leading research company YouGovStone.

The responding sample is weighted by industry to be representative of small and mid-cap UK quoted companies, as derived from London Stock Exchange data.

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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52%

OF SMALL AND MID-CAP COMPANIES REJECT GOVERNMENT PROPOSALS FOR A BINDING SHAREHOLDER VOTE ON PAY.

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