QUOTED COMPANIES ALLIANCE

RSM

YouGov
What the world thinks

SMALL AND MID-CAP INVESTORS SURVEY 2016

Insights for companies seeking equity investment

www.theqca.com
www.rsmuk.com
www.yougov.co.uk

Index

QCA/RSM
Small and Mid-Cap Investors Survey 2016

Insights for companies seeking equity investment

Introduction

In its third iteration, the QCA/RSM Small and Mid-Cap Investors Survey has now become an essential read for companies and their advisers. This report sums up the opinions of 16 well-known fund managers who are never fearful of expressing their views. It is an important summary of what "the money" thinks of the market in which they invest and what they feel the companies that they invest in should be doing.

If you find that some of the things they are saying are familiar, then that is good. Overall, they call for consistency, in terms of performance and expectations, from their investee companies. Their message is, therefore, consistently consistent!

The year has been volatile, with many economic and political events affecting markets, both for IPOs and secondary fundraisings. Yet, the small and mid-cap sector has been relatively sheltered from this volatility. Our investors tell us that they, too, have had a relatively good year. But, they point to a few concerns in the year ahead.

Fund managers are looking for companies that are open and honest; that are unwaveringly on-strategy; and can explain how an acquisition fits in with that strategy. It seems that they would trade faster growth for a smoother ride so that they can avoid the volatility experienced in other parts of the market.

This year we have seen more fund managers mention corporate governance and reporting generally. Corporate websites are seen by some investors as being a bellwether of how seriously a company takes corporate governance. The website is also used as the first port of call by investors who want to learn about a company.

It is clear that the quality of appearance and substance of some corporate websites is woefully lacking. Companies should listen to their investors and act upon their feedback if they are failing to optimise the effectiveness of all their communication channels. Remember that small and mid-cap investors meet hundreds of companies a year and they read hundreds of annual reports, preliminary statements and research material. This gives them substantial evidence to support what they tell us. So if they say that the best websites make annual reports and presentations available as it saves them so much time, then it is wise to assume that they are right; they are the judges and the ultimate owners of the companies. Their suggestions should not go unminded.

The annual report is singled out as a document that is relied on by investors to highlight fault lines in a company. Many investors use the report to identify how companies convert profit into cash and failure to show this is treated with caution. This is a consistent issue raised in many different forums by investors. It is also something that the Financial Reporting Council is urging companies to concentrate on and improve their reporting thereon.

The outlook for the coming year is, according to our participants, likely to be mixed and volatile. There is no surprise there, but they do not think that the small and mid-cap quoted company sector is due a downward rating. They believe that positive stories from companies in a good niche or with a proprietary product or service will be rewarded. When they find such companies, their intention is to stick with them.

We are extremely grateful to the small and mid-cap investors for their support and the time they have devoted (again) to helping us with this survey. We are sure you will find it interesting reading.

Diane Gwilliam
Head of Capital Markets
RSM

Tim Ward
Chief Executive
Quoted Companies
Alliance

Key findings

It has been a relatively volatile year, but the small and mid-cap fund managers we interviewed have generally performed well. They are also hopeful that 2016 will be a good year, as long as major global issues do not derail the wider market.

M&A activity has increased over the past year, which has led to a reallocation of investors' funds. On the other hand, fund managers thought that IPOs in 2015 were a slight distraction and of mixed quality and performance, with some viewing them as over-valued again.

Fund managers feel that UK small and mid-cap quoted companies have been sheltered from global and political turmoil, such as the Chinese economic slowdown, lower commodity prices, low growth from Europe and Grexit/Brexit worries. Given these circumstances, fund managers believe that their ability to stock-pick has become even more important, with them searching for quality stocks that will deliver returns ahead of their main benchmark.

Fund managers are looking for open and honest companies that have a clear strategy and then under-promise and over-deliver even at modest growth rates, and continue to do so over time. Strong cash flows, low debt and a track record are what appeals most.

When it comes to selling holdings, fund managers say it is often as much to prevent becoming overweight in a high performing stock or divesting a highly valued stock, as to move out of a poor performing one. However, fundamental changes to an investment, such as management, poor cash flow or low growth, can cause reappraisal, while better opportunities arising elsewhere can also trigger selling.

There is concern about the increasing amount of regulation for equity markets and the potential negative effect that they could have on market liquidity. Specific concerns include various aspects of MiFID II, including the ban on the use of dealing commissions to pay for investment research, and the recent changes to the Venture Capital Schemes in the UK.

Most fund managers have not changed their approach this year. Some have invested more in general technology and disruptive entrants in the pharmaceutical and financial services sectors, while others have targeted more leveraged stocks. For most, any recovery plays (such as commodities) remain unattractive.

There is a feeling that the quality of corporate reporting has improved amongst small and mid-cap quoted companies as best practice around disclosure and governance trickles down from the larger caps. However, many bugbears remain about transparency and accounting practices. The annual report and the website are both important sources of information for fund managers, in addition to face-to-face meetings, particularly where there is no independent research on a company.

Remuneration also remains a concern for many who will challenge perceived inconsistencies or where they feel it fails to align with shareholder interests. Overall, fund managers do not support the granting of performance-related share options to non-executive directors.

Mandatory audit tendering is welcomed, while paying the auditor for non-audit services elicits mixed views and is generally looked on with greater scrutiny than if split between accounting firms.

About the fund managers we interviewed

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.

Respondents were recruited from a pre-selected database of the UK's leading small and mid-cap institutional fund managers. 16 telephone interviews took place during October and November 2015 with the following senior UK small and mid-cap investors:

David Stevenson
Amati Global Investors

Mark Niznik
Artemis Investment Management

Robin West
Invesco Asset Management

Judith Mackenzie
Downing LLP

Guy Feld
Hargreave Hale Limited

Adam McConkey
Henderson Global Investors

Katie Potts
Herald Investment Trust

Ken Wotton
Livingbridge

Rod Oscroft
Legal & General Investment Management

Gervais Williams
Miton Group

Andrew Buchanan
Octopus Investments

James Thorne
Columbia Threadneedle Investments

Richard Power
Octopus Investments

Jim Maun
Fidelity Investments

Daniel Nickols
Old Mutual Global Investors

Andy Brough
Schroders

The funds managed include VCTs, EIS funds, growth funds, retail unit trusts and pension funds. All of the funds invest in UK and/or European small and mid-cap quoted companies and most of the funds benchmark against the Numis Smaller Companies Index.

The fund managers we interviewed have varying definitions of a 'small and mid-cap quoted company.' These usually are dependent upon the investment mandate that their fund has. The range varied from a small and mid-cap quoted company being one with a market capitalisation below £20m to those with a market capitalisation up to £1.5bn. Those who operate VCTs tend to define a small and mid-cap quoted company at the smaller end of the spectrum, versus those that run larger retail unit trusts or pension funds, who tend to say that an average market capitalisation of a small and mid-cap quoted company would be anywhere between £300m and £600m.

The market

Fund managers view 2015 as having been a recovery year for small and mid-cap quoted companies. Investors flocked towards these companies throughout the year in order to take advantage of the relative strength of the UK economy and as those stocks were perceived to be more sheltered from global political and economic events. Nonetheless, the number of IPOs in 2015 dwindled and the market remains volatile.

Review of 2015
The oil price collapse at the end of 2014 seemed to drive money into the relative safe haven of small and mid-cap stocks compared with the UK's large caps. Smaller stocks were perceived to be more sheltered from the global headwinds blowing particularly from China and also to have higher exposure to the strength of the UK economy. A flat Q1 in 2015 then lifted through Q2 and onwards after May's general election.

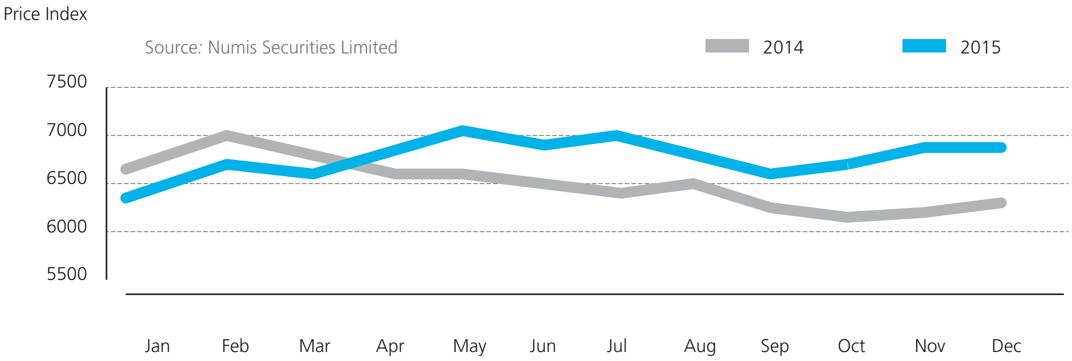
> "The small and mid-cap momentum was so strong in the first half of the year that it was quite tricky to keep up with it, and some of that was a little bit frothy.

> "I think more generally there has been an issue that share prices got ahead of what has been a relatively uninspiring longer period of very modest earnings upgrades, and in some periods, downgrades. So the market has generally just got more expensive as the year has gone on, until the more recent sell-off, which has helped address that a bit.

However, the view in retrospect is that the year has been a volatile one, but that volatility has provided opportunities for small and mid-cap fund managers. The smaller end of the market has become even more of a stock pickers' market, while the top end has been more correlated as it has risen relatively evenly across asset classes thanks to global monetary policy. The view is that earnings and dividends are now felt to be under pressure as profitability becomes more critical, but the general negative sentiment in the large cap company space has yet to really filter down to the smaller end of the market.

Most of the managers interviewed believe their funds will have outperformed their relative benchmark in 2015. The most commonly used benchmark is the Numis Smaller Companies Index, which has moved in a gentle upward trend since 2014. The year was stronger than most had expected and some fund managers mentioned that the certainty brought by a majority government in the UK has provided a clear environment for small and mid-cap quoted companies, helping their confidence going forward. Fund managers are also confident of their own positions going forward.

Numis Smaller Companies Index (excluding Investment Trusts)



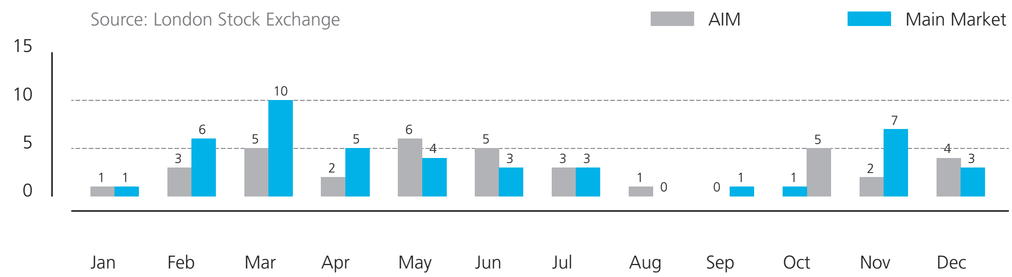
Half of the fund managers say that they experienced a net inflow of funds during 2015, with slightly less registering outflows and a couple in a neutral position. One fund manager pointed out his frustration with this, stating that his/her belief is that there has been a net outflow for ten of the past 11 years, despite small and mid-cap quoted companies being a strong performing sector over that period.

Another fund manager made the point that valuations of small and mid-cap companies have gone through a step change. Improvements in fundamentals have been rewarded when they happen, but there has been no general market rise, partly due to a drag from some sectors, such as natural resources. M&A activity has also provided a short-term gain for many of the fund managers.

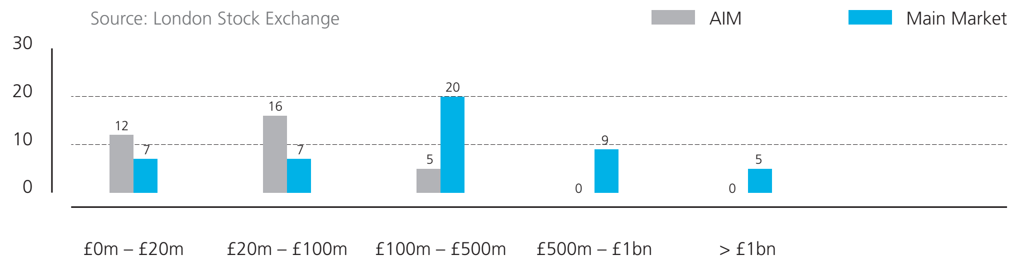
IPOs

The IPO market seems to have been somewhat of a continuation of 2014, with a steady flow of opportunities with patchy quality, but with slightly fewer options available than last year. There seems to be a feeling that while the sun is shining IPOs will keep coming, but there are signs that this is coming to an end, with some recent floats either not going well or being priced towards the bottom end of the range.

Number of IPOs on the UK Main Market and AIM 2015



Number of IPOs on the UK Main Market and AIM 2015 by Market Cap



Some fund managers complained that IPOs became too hectic at times and, as we saw in last year's survey, decision-making time frames were often too short. The quality of the companies coming to market was perceived to be mixed, with some thinking there was an improvement while others were not so sure, citing high valuations and fears about some of the overseas offerings and about private equity owners getting "greedy."

The shifting economic and political sands also made for a slightly turbulent IPO market. The UK general election was cited as having had an impact. However, the rising sentiment in Q2 post-general election, is believed to have provided a more "rose-tinted" view that helped get some small and mid-cap quoted companies' floats away, and at slightly higher prices than investors would have liked.

Some felt that the market would wobble in late summer driven by the negative news out of China, but despite that IPOs continued to come. Complaints about "punchy" prices driven by larger investment banks bringing them to market mirror our findings in 2014, but as one fund manager said, expressing his/her limited interest, "we're almost in shutdown mode on IPOs." However, several other fund managers made it clear that they are still open to well-priced opportunities and they believe the IPO market remains open.

Those who stayed away from IPOs in 2015 – avoiding the short windows for diligence or resisting inflated valuations – seem to have few regrets at not taking part. Nonetheless, others who did jump in felt that recent IPOs have on balance added value to their funds.

“If private equity vendors and brokers… continue to be quite so greedy, I think they will stifle the market.

“[Fund managers] are being somewhat more selective over what they are going for and what price they are willing to pay.

“Most of the stuff that has been coming through has not been attractively priced, or you take your chance on stuff that is largely coming out of private equity as opposed to coming from entrepreneurs… It's just not been that attractive a market. You know, you have to have a good reason to get involved with an IPO, given that you have got no history with the business.

“There is EU legislation that the Treasury and HMRC and all participants in the VCT and EIS market are trying to get their heads around. [These are] far-reaching changes potentially… so that has created our hiatus in AIM and the IPO and secondary fundraising market at the smaller end.

Few fund managers talked specifically about secondary fundraisings, but the sentiment seemed similarly positive to last year's – fund managers prefer secondary fundraisings to IPOs because the company can demonstrate a visible track record on the stock market.

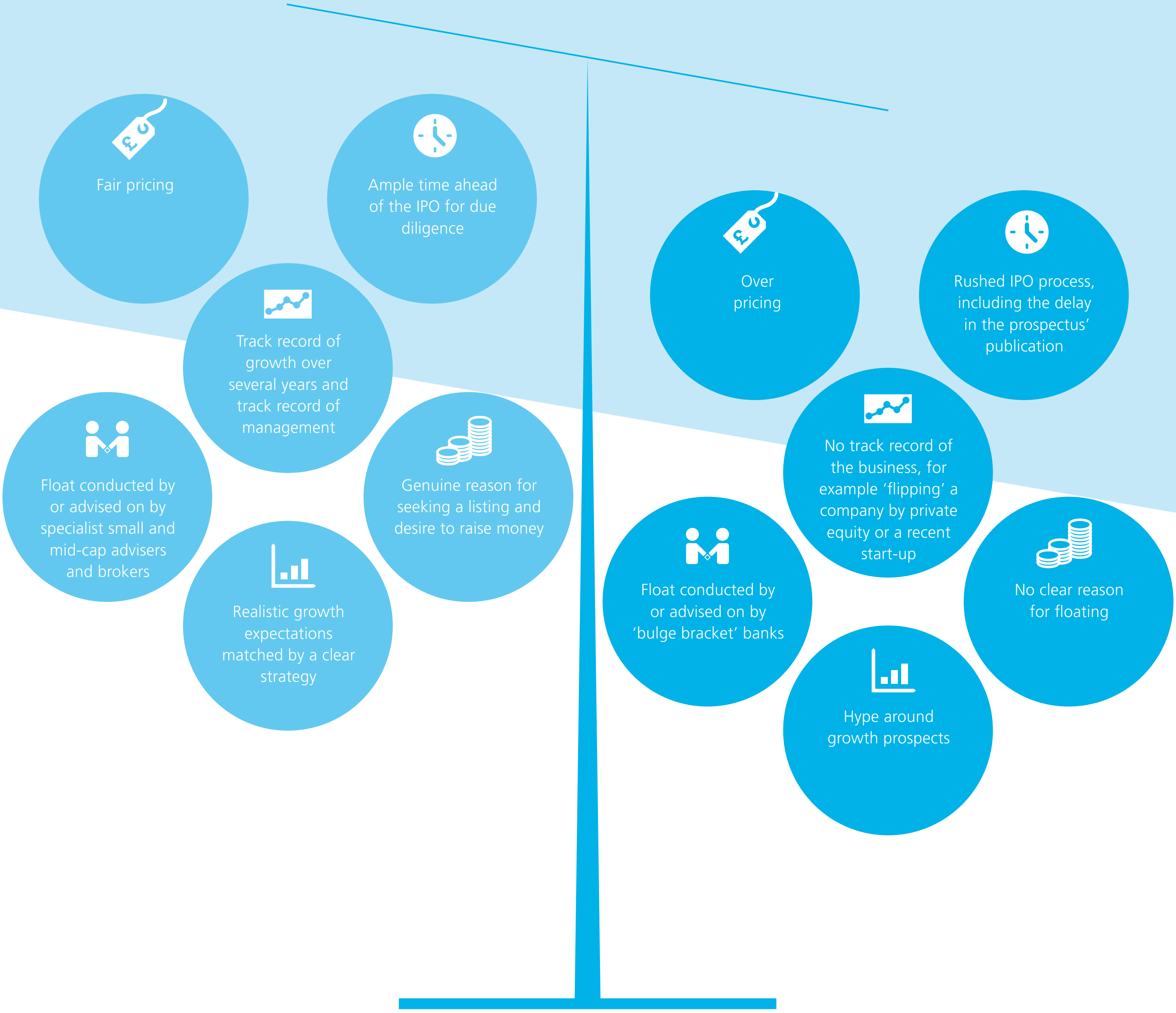
Some fund managers also seem to be keeping their eyes and ears open as lock-out periods start to expire from recent IPOs, but this is competing for attention with secondary fundraisings. As long as the broader economic outlook remains favourable, there is an expectation that IPOs and secondary fundraisings will continue.

For those running VCTs and EIS funds, the changes to the Venture Capital Schemes rules in the UK have been causing a headache as they try to understand the implications. Those running these funds believe that the uncertainty around the rule changes and delays in EU state aid approval of the schemes impacted some fundraisings earlier in the year, as VCTs reduced their activity and the number of small company IPOs tailed off.

> “I would say the IPO market was a bit more selective in the last twelve months. [There was] better quality, but also companies where the seller was willing to sell at a lower price.

> “Normally I say to all my investors, 'I don't like IPOs. [They are] always priced better for the seller than the buyer. [Private equity] is selling out; they've cooked the books to get it away.' …I've been surprised, there have been probably half a dozen that have been pretty good.

What makes an IPO attractive and unattractive to investors



M&A activity

Generally, there is a feeling that M&A activity amongst small and mid-cap quoted companies has picked up a little, particularly as a result of a trickle down from the larger end. Q2 of 2015 seemed more active in terms of M&A activity for the fund managers we interviewed, with many citing deals across many different sectors.

One fund manager made the point that his/her fund will support companies looking to do deals, but only if the deal is on-strategy. With organic growth looking tough, particularly with the difficult international backdrop, it is attractive to acquire momentum by building bigger businesses, but fund managers will always question whether these deals are intended to mask slower organic growth.

Low cost debt and relatively easy access to equity market fundraisings have made the timing right for acquisitions, particularly for businesses enjoying a strong balance sheet. Some fund managers are a little surprised that activity levels have not actually been higher. Certainly if wider market conditions remain as they are, then there is an expectation that M&A activity will continue, particularly if debt remains cheap and there are good acquisition targets available.

M&A activity may pick up even further. Companies have made cost savings to retain or boost profitability by making cuts in areas such as capital expenditure and R&D. This will inevitably start to impact their earnings without acquisitions.

The next 12 months

Most fund managers expect the next 12 months to show no real change given the low growth economy we are currently experiencing, although several of them preferred not to be drawn into making predictions.

> “There has been a reasonable amount of M&A activity. Frequently it’s the best companies that get taken out. You’re slightly sad to see them disappear… [But this year,] it’s the more average that’s being taken out…It’s companies that have got more room for improvement than rather stellar companies.

Several say they would not be surprised if there were periods of volatility in the market, but most do not perceive their part of the market as currently overvalued. So, underlying performance of companies is expected to be sound. Many expect small and mid-cap quoted companies to outperform the larger cap companies, but prices themselves may show a wider margin over the course of the year.

Views on the IPO market going forward are more mixed with some expecting it to dry up or become far more price sensitive, citing current intelligence that prices already tend to be at the lower end of valuations. Other fund managers believe there will be more IPOs coming through particularly if M&A activity frees up fund managers’ money to reinvest. Levels of M&A may remain good if debt remains cheap.

Certainly there is no expectation that the small and mid-cap quoted company sector is due for a down-rating. Fund managers feel confident that positive stock-specific stories will be rewarded and, therefore, the role of the fund manager will be an important one over the coming year.

> “You just find companies that have got some sort of structural growth dynamic to what they do – that they are not heavily dependent on the big economic cycles both in the UK or globally. Just find those companies and stick with them, and hope that they keep getting upgrades.

> “We’re all addicted to QE now and low interest rates, and when that comes to an end, there might be a shock to the system. I’m more cautious than normal.

> “What we want to focus on is the underlying businesses themselves – those that have a good niche and proprietary product or service and that can continue to grow, hopefully in almost all environments and create shareholder value in due course.

> “We really have not needed to worry ourselves about US interest rates, Chinese growth rates, or the solution being understood in Greece. It is more about, ‘Is the UK a good environment – a good place – to be doing business for small companies that operate within the UK?’. This is much more important to us.

Looking more broadly, views of the macro situation are reasonably varied. Most fund managers believe that the visible potential economic and political issues are already priced in, such as a Brexit, the Chinese economic slowdown, the potential interest rate rise, etc. However, unknowns remain and China and the US remain the biggest risk factors alongside some kind of ‘leftfield’ unforeseen circumstance. The infamous ‘unknown unknown’ was characterised by one fund manager in his/her view that “we’re currently living in the most dangerous time ever.”

The silver lining for small and mid-cap quoted companies is that they are often more insulated than the large, more international firms, though fund managers are not completely opposed to some currency exposure through their investments. Fund managers also cite the current low input prices as a benefit for small and mid-cap quoted companies.

Top concerns that could affect the market in 2016*

1. Chinese economic slowdown
2. US interest rate rises (and subsequently in the UK)
3. Middle East unrest
4. Russian political position
5. Quantitative easing and eventual unwinding of QE reliant positions
6. 'Brexit' and low European growth
7. Consumer debt levels
8. Failure of Chinese firms on AIM
9. Impact of MiFID II on the availability of investment research
10. Rule changes to the Venture Capital Schemes in the UK
11. Increasing cost of compliance
12. Regulation hindering market liquidity

*(In order of frequency of mention)

Fund managers’ strategies

Fund managers are still looking for companies that have a good story, good growth prospects and a strong strategy. Overall, their priorities have not changed. However, concerns about political or economic events, as well as the potential impact of, may be causing fund managers to tweak their strategies for 2016.

Changing priorities?
In terms of asset allocation, the majority of fund managers have not changed their stance over the year, but some did rebalance their holdings. Such tweaks may have been caused by dealing with fund outflows, but changes could also be opportunistic. One fund manager mentioned that he/she was looking for exposure to sound companies in structurally challenged industries; another was looking to reduce their exposure to AIM versus main board firms; and another was increasing exposure to more leveraged stocks.

> “Mid-caps – they are very much on everyone’s radar. So, they tend to be over-owned, over-researched and pretty expensive. We can find the odd things that are appealing though.

> “I would generally say that around 75-80% of the fund is… ‘on style,’ if you like, and 20-25% is a bit more tactical and opportunistic.

One fund manager also mentioned that he/she looked to hold more cash in the run up to the general election due to the uncertainty over the outcome.

In general though, the priorities for each fund remained relatively consistent. One fund manager talked about focusing on quality, while another said investors wanted dividend growth. Many mentioned that there is a trend toward moving away from larger cap stocks. The growth of the biotech sector on AIM was mentioned specifically as it now offered some “large, established, profitable…good growth businesses.”

There was also a complaint that finding value businesses was hard this year and those companies able to demonstrate consistent performance were felt by some to now be fully valued. Consistent growth and a consistent model that can be rolled out remains a priority.

Other changes to fund strategy mentioned include:

— moving away from unprofitable ‘nano’ companies;

— increased pharma/biotech exposure;

— decreasing exposure to domestic stocks and increasing exposure to engineering over housebuilders;

— ensuring no exposure to Chinese stocks;

— increased weighting in defence and construction materials; and

— not yet put money back into export and commodity markets, but watching closely.

Another area mentioned by one fund manager in particular was the payment of dividends. While few small and mid-cap quoted companies pay dividends of real significance, this fund manager believes that "investors are going to get obsessed with good and growing income," which will force a shift in focus for some fund managers if the market does indeed move that way.

One point to be considered though is that many investors' funds are indexed against the Numis Smaller Companies Index. Some fund managers mentioned that the index may move away from including some of the larger firms that are currently included. If this happens, fund managers will also reduce holdings in these larger companies, thus freeing money to go elsewhere.

Regulation

Most fund managers interviewed struggled to name any specific regulatory issues that were causing them real concern.

MiFID II was mentioned by a number of managers, as well as its potential implications particularly around investment research. MiFID II could result in a ban on the use of dealing commissions to pay for investment research.

At the moment, the cost of investment research is often bundled up in dealing commissions and the fund managers allocate a proportion of the commission they pay for dealing in shares to the brokers that have provided them with the research. The EU and FCA would like the cost of investment research and other services provided by brokers to fund managers to be more transparent, hence the potential change. A key consequence of this change could be that there is less research on small and mid-cap quoted companies, as fund managers and brokers that concentrate on these companies will have less money to spend on buying research and covering smaller stocks.

As one fund manager put it:

"There is a lot of broker research that we don't read – we're not entirely dependent on it. But, for the niche companies that we get involved in, there are certain brokers that offer very good coverage of them. So that would be a bit of an issue."

One fund manager noted that, as result of these changes, he/she is taking on a company research analyst, which means that, despite their fund being at a high overall valuation, the fund management company will not be increasing its profitability due to these increased costs.

Beyond the direct implication of less investment research, there was also the expectation from one fund manager that the market would lose some of the small and mid-cap investment banks and brokers. In general, there are worries that brokers are disappearing, which means less companies being brought to see the fund managers.

As mentioned earlier in this report, it has been a difficult period for those running Venture Capital Trusts (VCTs) and EIS funds, due to legislative changes to these schemes. The European Commission required significant rule changes to the UK's Venture Capital Schemes legislation (ie Enterprise Investment Scheme and Venture Capital Trusts) in order to comply with the new EU state aid regime. The result of this was a great deal of uncertainty throughout 2015 as to what changes would be needed in the UK and whether companies could continue to qualify as eligible companies for investment from the schemes, seeing as the new rules are more restrictive. This uncertainty resulted in a hiatus in those funds' activity and increasing concerns from fund managers about the knock-on effects that this could have on the liquidity at the smaller end of the market.

There are also complaints about the failure of so many Chinese firms listed in London, that perhaps regulation for international companies and their governance is not strong enough. Furthermore, there was a suggestion that NOMADs may not have done sufficient due diligence on these firms.

> "There is usually more than one reason for exiting a position or even just trimming it down.

One fund manager talked specifically about liquidity and how regulation is still felt to be holding back market liquidity, which then becomes a self-fulfilling, negative spiral of concern.

There was also the occasional mention of specific domestic UK policy, with the potential increase in the minimum wage being cited. One fund manager said "for the first time in fifteen years, we are sat watching to see what gets announced on budget day."

Key sectors

Most of the fund managers we spoke to run generalist funds – meaning that they are not limited in the sectors in which they can invest. Fund managers frequently mentioned that they were interested in technology and financial services sectors, which should come as little surprise. In fact, one fund manager said that he/she does not really have any key sectors that are of interest – whether or not they invest comes down to the individual company and the terms of the stock. As one fund manager said, "we like to be able to go out and almost kip in the car and meet the teams and the operations."

There was almost universal avoidance of "stuff you dig out of the ground," such as mining, commodities and extractive industries. One fund manager even noted that his/her fund categorically does not invest in those sectors. This most likely comes down to the fact that businesses in these sectors tend to be cash-consumptive. Small and mid-cap fund managers tend to look for the opposite – they want strong business models that generate consistent revenues.

When to sell

We asked fund managers about the events that would need to happen in a company in order for them to sell their shares. Essentially, it is often an opportunity-cost analysis regarding weight in the portfolio. Nonetheless, the following illustration sets out some of the reasons mentioned.

Five reasons why fund managers sell their holdings

Stock underperformance

- Stock quality not living up to expectations
- Worries about accounts or accounting procedures
- Profits warning

Positive performance

- Price growth means a stock makes up too large a proportion of portfolio
- Margin trading
- M&A
- Stock valuation looking too high

Macro changes

- Sector decline
- Emerging risks
- Legislative changes
- Changes to benchmark index

Other opportunities

- IPO or improvement in other stock offers potential better returns
- Stock has run its course, e.g. reached specific time horizon

Material changes

- Management change
- Strategy change
- Shift in competitive position
- Cash flow or debt position

The most attractive sectors to fund managers

Pharmaceuticals / biotech / healthcare (including medical technology) [1]

Engineering, including CleanTech and other disruptive technology in this sector

Media and telecommunications

Regional real estate

Technology/IT, including software and technology services

Financial services, including insurance and disruptive FinTech

Support services, such as recruitment and equipment hire

Manufacturing

Construction and housebuilding [2]

[1] Note that one investor conversely mentioned that he/she is limiting exposure to this sector.

[2] Note that several investors conversely mentioned that they are limiting their exposure to this sector.

Attracting and retaining investors

Investors are looking for a clear business story when seeking out companies to back. They want to invest in companies that come to market with a track record, that can demonstrate a business model that works, that have grown over time, and that have a strong reason for now looking for financing.

Key attributes that investors look for
A company's track record has to be delivered with integrity so that a trusting relationship between investor and investee can be established. Growth does not have to be necessarily fast; it just needs to be steady and accurately predicted. The business also must communicate well its plan.

Fund managers do not want volatility and the relative absence of volatility is one of the benefits they see of the small and mid-cap quoted company sector. Because so much of it is focused on the UK market, small and mid-cap quoted companies should actually be better protected and less volatile than many larger listed stocks.

Delivering on market expectations is the most important thing for investors. Then, as the business grows and their market changes, investors expect companies to reinvest cash flow in order to strengthen their position, either through organic change or through making some strategic acquisitions.

One investor specifically mentioned good corporate governance as being important for companies in terms of securing growth, noting that some small and mid-cap quoted companies can have weak boards, especially in reference to the quality of non-executive directors. Remuneration can also become an issue for investors, as well as conflicts of interest. But, the critical point is that investors must be able to see earnings growth, cash generation, return on capital and particularly recurring revenue.

Top five things that investors want to see companies doing

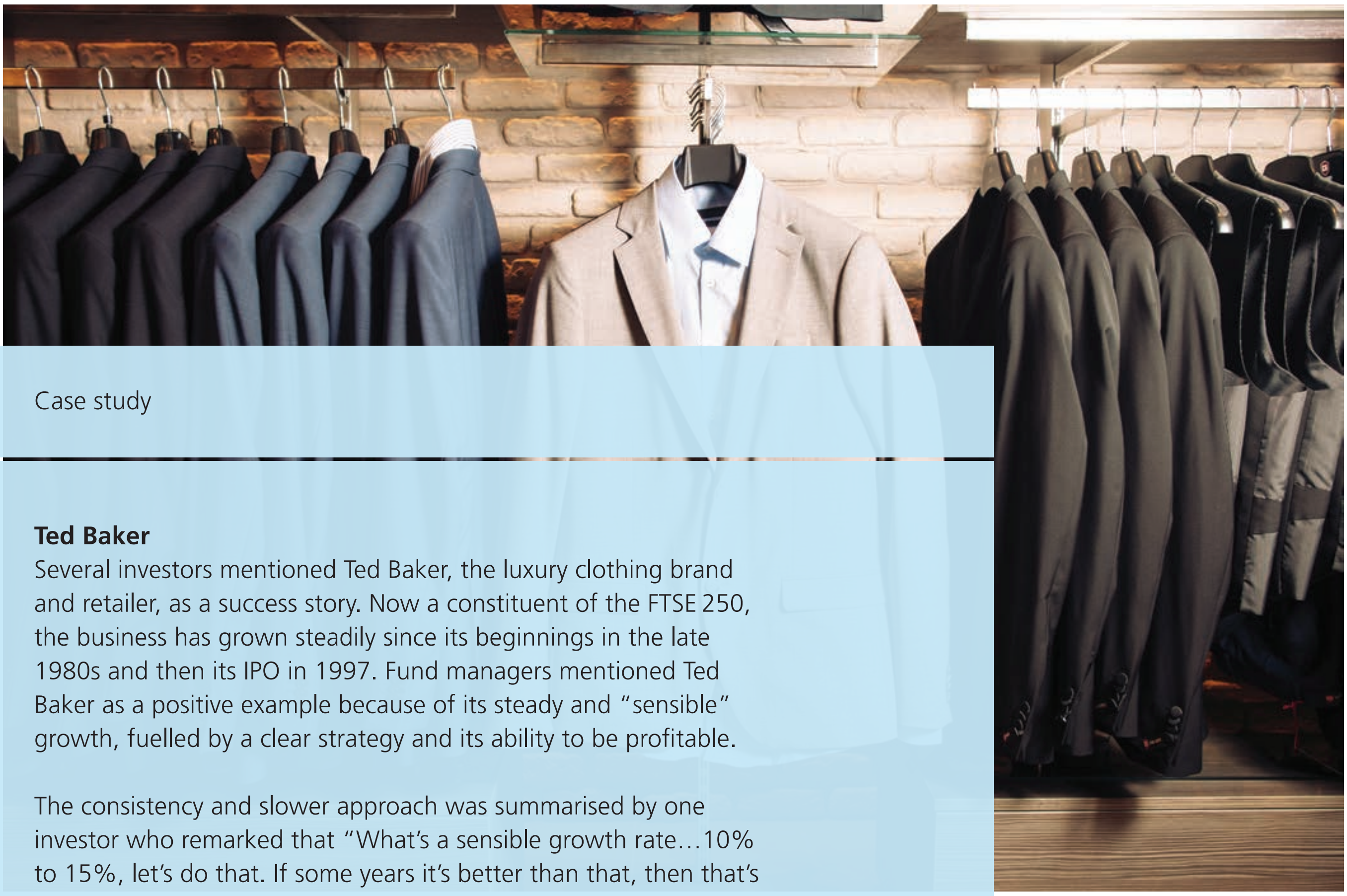
1. Delivering on market expectations
2. Earnings growth
3. Cash generation
4. Return on capital
5. Recurring revenue

Model quoted companies

When asked to name model businesses that have displayed the sort of characteristics that fund managers most admire, the companies mentioned were often those that had demonstrated consistent growth but without spectacular targets. Fund managers often used the word 'resilient' when describing model businesses. They look for firms that can weather tough times and continue to grow, either because these companies are working in a specific niche or working within particular regulations that provide some protection.

Companies named as model performers include:

- Avon Rubber
- Beazley
- Bilby
- Booker
- CVS Group
- Diploma
- Fever-Tree
- Fuller Smith Turner
- GB Group
- Halma
- Just Eat
- Melrose
- Restore
- Safestyle
- Scapa
- Sprue Aegis
- Staffline Recruitment
- Ted Baker
- Tracsis
- Tyman

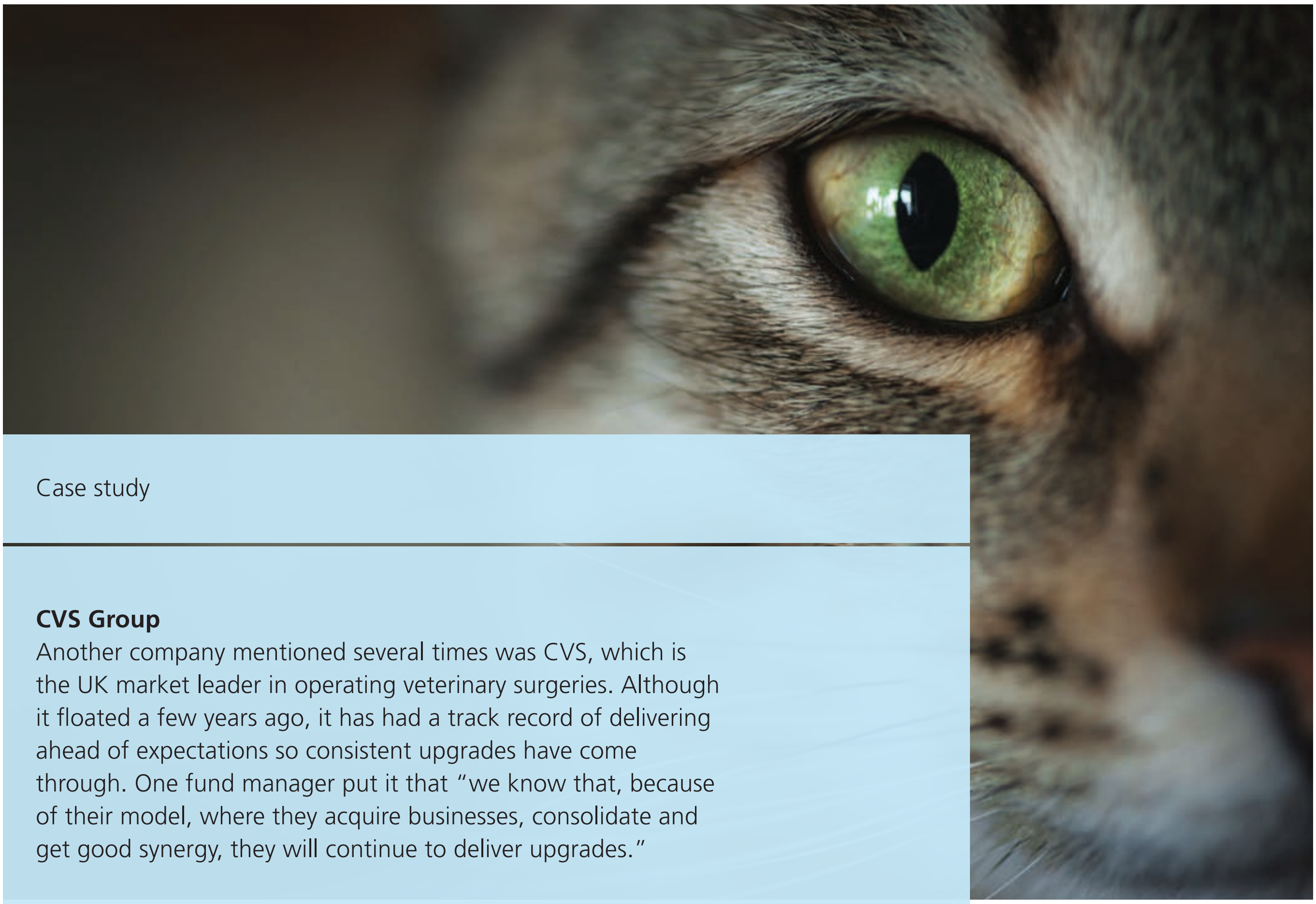


Case study

Ted Baker

Several investors mentioned Ted Baker, the luxury clothing brand and retailer, as a success story. Now a constituent of the FTSE 250, the business has grown steadily since its beginnings in the late 1980s and then its IPO in 1997. Fund managers mentioned Ted Baker as a positive example because of its steady and "sensible" growth, fuelled by a clear strategy and its ability to be profitable.

The consistency and slower approach was summarised by one investor who remarked that "What's a sensible growth rate…10% to 15%, let's do that. If some years it's better than that, then that's great, but let's not bank on it. If it's not quite that good in some years, let's not worry about it."



Case study

CVS Group
Another company mentioned several times was CVS, which is the UK market leader in operating veterinary surgeries. Although it floated a few years ago, it has had a track record of delivering ahead of expectations so consistent upgrades have come through. One fund manager put it that “we know that, because of their model, where they acquire businesses, consolidate and get good synergy, they will continue to deliver upgrades.”

The view was that by consistently under-promising and then over-delivering year-on-year a business will do better over the long-term than one with “gung-ho, really aggressive forecasts,” where the danger of missing targets is higher.

Corporate reporting

Overall, fund managers believe that reporting has improved over recent years. There remain complaints about boilerplate statements and sections in the annual report, particularly corporate governance. However, in general, fund managers believe that best practice is "dribbling down" into small and mid-cap quoted companies.

The standard of reporting
When asked to summarise the standard of corporate reporting across the small and mid-cap quoted company sector, fund managers' views ranged from "fine" to "pretty good really." But, a few mentioned that they had some concerns over the small number of companies that do it very poorly. Fund managers also noted that the quality of reporting tends to fall with the size of the company.

> "[Corporate reporting] is probably a lot better than it has been for a number of years.

> "I pay a lot of attention to reading a report and accounts because it is the only properly audited document you get each year.

> "There is not the time in the day to go through every single page of every single expense for all accounts. What we are trying to do is just make sure that qualitatively what has been reported is backed up. Again, I don't see that we have a problem in detecting that in 99% of cases.

Investors, while generally happy with the annual report and interim results, feel that other reporting and RNS activity (particularly RNS Reach) through the year has the danger of being "a load of puffed-up nonsense." There is a view that it is too qualitative and detracts from the overall quality of reporting, and some fund managers even believe that these forms of reporting can drive short-termism in the market as a whole. As a result, it certainly seems that most respondents are in favour of the legislative change in the Transparency Directive which makes interim management statements (IMS) no longer compulsory for companies on the Main Market to produce.

Another area of mild concern, or rather annoyance, is reporting GAAP and non-GAAP earnings and adjusted earnings. As one fund manager put it: "the trouble is that everybody's idea of adjustment is different."

While investors find corporate reporting an important tool to understanding the company, many investors believe that nothing can replace face-to-face conversations, where they can ask the company questions directly.

The Annual Report

As we have seen in previous years, investors say the most important element of the annual report and accounts is being able to reconcile profit against cash flow and the balance sheet, while keeping a close eye on debt. They then focus on the notes to the balance sheet, as well as checking through controversial points such as remuneration and share options.

Generally, it seems some reports get closer attention than others based on the reputation of the business, where it is in its cycle, its general performance and the length of time the investor has known it.

> “ I would like to see the companies being a bit braver and actually being a little bit more transparent on their corporate governance reporting.

> “ The main interest actually is in the front part of the section, and how they choose to outline their business. I think that’s very revealing as to how they see themselves and how good they are in terms of communicating how they see themselves.

What investors are obviously keen to avoid is finding that profit is based around accounting techniques that hide the real picture, due to capitalising costs, inappropriate depreciation rates, non-recurring items and other points that the investor needs to ‘normalise’. Also, any concerns raised in the audit report, such as a qualified audit opinion, would be a massive red flag to investors.

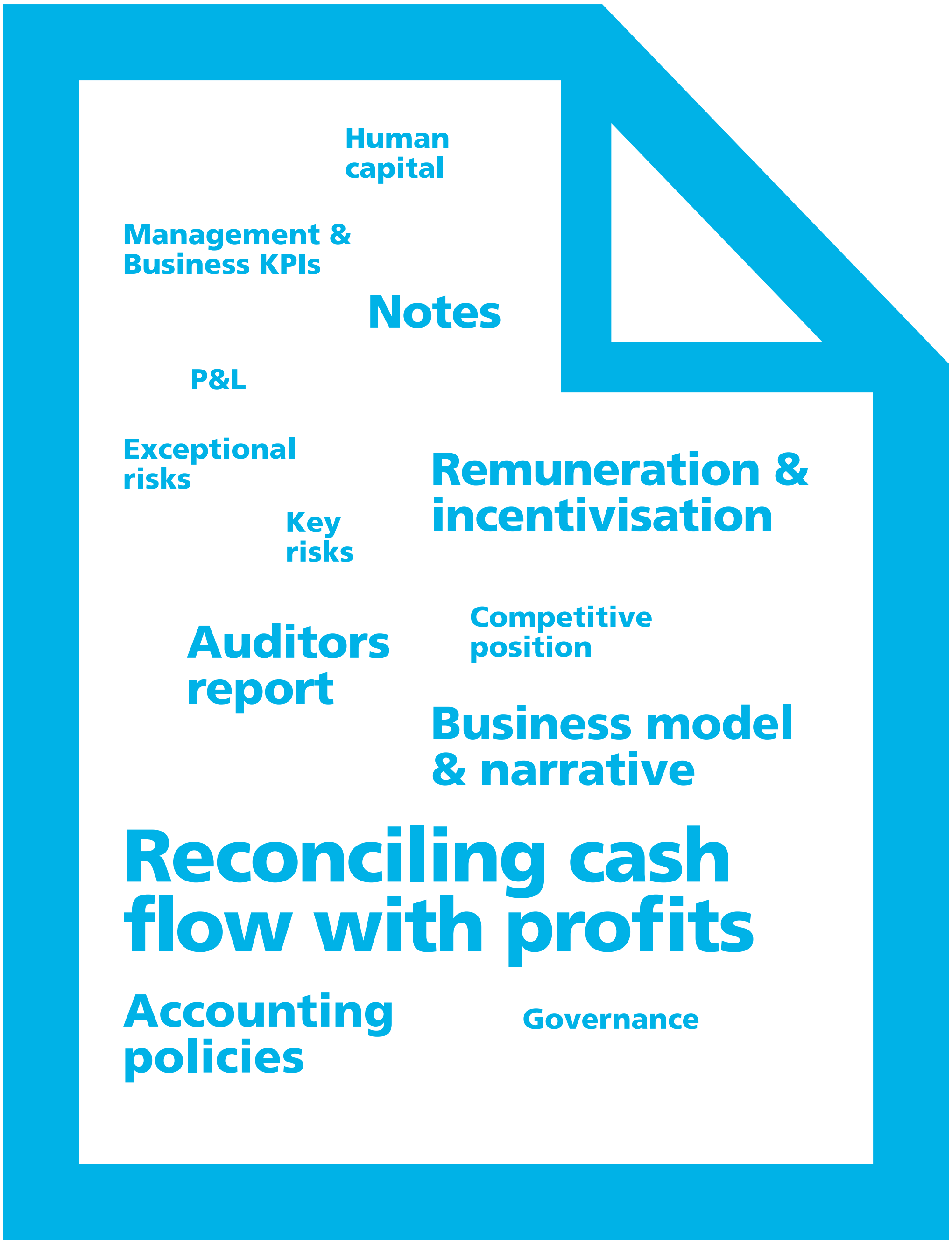
> “ …[I am] keen on movements in working capital, what they’ve included in exceptional items and what they’ve excluded.

> “ I look at …what the accounting policies are, particularly where there are significant estimations and judgements.

> “ I always like to see that profits equal cash, and if they don’t, then why. You can see that in the back of the accounts from the profit to the cash conversion.

> “ All of the back of the reports is always useful. [It] always makes for entertaining reading. Cash flow, acquisition accounting, relative costs of transactions, contingent liabilities, lease commitments… remuneration reports, perceptions of business, risk audits.

Most important elements of reports and accounts*



* (larger words received greater number of mentions)

Websites
Websites were also praised where companies have made historic annual reports and presentations available as it saves investors time in trying to hunt this information down. One investor stated that the website can act as a "bellwether as to how seriously they take corporate governance as well." Also, the website can have details that provide more information about the business' momentum, such as contract wins that have not been announced via RNS because they are not deemed to be price sensitive, but can show direction of travel.

Remuneration
Many investors say that directors' remuneration is something they frequently check in the annual report. Indeed several say they have team members who monitor directors' pay as they consider it to be very important. Essentially, they are looking for pay to be commensurate with performance and for long-term incentives to be in place to drive a positive result for all shareholders.

If there are perceived to be problems, then fund managers say they will get involved, particularly around long-term incentive plans (LTIPs) or "aggressive incentivisation or options being scattered all round the organisation," even though they might not get their way. Several state that they have voted down remuneration policies, but few have regrets even though it can sour relationships.

Fund managers do not always look negatively at director share dealings either, being sympathetic to an owner who may wish to realise some of his/her gains for lifestyle reasons, as long as they are not selling out completely or looking to take a back-seat. Such a sale can also increase the free float of the company, which is often welcomed by institutional investors.

It is also a bugbear in prospectuses when remuneration and share incentivisation plans remain blacked out until after the IPO.

Performance-related remuneration for non-executive directors
The idea of non-executive directors receiving performance-related pay and share options is generally frowned upon by fund managers. They want NEDs to be independent and any such incentivisation would usually be viewed as contradicting that perceived independence.

Nonetheless, some fund managers said that, in certain circumstances, they can see why remunerating in shares rather than cash might be appropriate, particularly at the smaller end of the market where cash may be at a premium and also when a NED has had to get his/her hands dirty, for instance by directly supporting the business's operations.

> " [The website] is one of the first places that we will look when we're researching a business.

One fund manager stood out by saying that his/her view is that the quality of non-executive directors in small and mid-cap quoted companies generally is not high and it is better to have them aligned with shareholder outcomes through a focus on share price, than allowing them to "effectively go native with existing management, rather than being… accountable to shareholders…Passive acceptance of the status quo is more damaging, in terms of conflicts of interest, than an active decision to make alignment with the shareholders." Some said they would prefer to see NEDs buying shares in the company out of their own remuneration. Others added that share option schemes were a definite no-no in their eyes.

Audit fees and non-audit services
Around half the fund managers noted that they tend to keep an eye on audit fees. More often than not their judgement about the fee is not only reviewing it as a single cost, but also to see what other non-audit services the auditor might be providing. They are looking out for any potential conflict of interest or cases where the fees have jumped. But, few fund managers volunteered any real examples where they had cause to take up the issue with the company concerned.

One other point mentioned by a fund manager, that probably goes across most of those interviewed, is that the audit fee can provide a guide as to how complicated the internal mechanisms of the company are.

> "[Audit is] a bit like a referee in a match; the best referees are the ones that you don't notice very much because they've done their job and that's that.

Other issues with the audit include fund managers seeing firms perhaps overpaying for a 'big four' firm when something a little smaller and better value might be more appropriate. Likewise a larger company which is still using a "very, very local, almost one man and a dog outfit" would be a red flag.

Investors seem to be fairly pragmatic, recognising that there may be a benefit in extending an auditor's role, particularly for smaller companies, into general advice and non-audit services. Few say that if they saw this in the accounts that it would be a red flag for them. However, the problem becomes potentially more acute as the company size increases and the independence of the auditor can be deemed to be under more pressure from the value of other fees available. Also, if there are other issues within the business and the auditor is providing non-audit services, then this can become problematic for investors.

Mandatory audit tendering
Putting an audit out to tender generally seems like a good idea, but there is no sense of urgency amongst investors that it needs to be mandatory for smaller firms. Fund managers can see the benefits of auditors getting to know a business over a number of years and there being some consistency in their approach to the audit. However, fund managers also think that tendering and rotation could be a positive as they can prevent complacency by bringing in fresh thinking and questioning of previous assumptions. Furthermore, by running an audit tender process, the company can ensure that what they are paying is cost competitive.

Most agreed that requiring companies to put their audit out to tender every ten years is appropriate, though some did mention that this exercise could be run every five years. Some fund managers noted that just the current practice of rotating the audit partner every five years is sufficient.

Top corporate reporting tips

1. Avoid boilerplate disclosures

Investors want to understand what your company does and why it does it. Including empty disclosures that do not provide any valuable insight is not helpful. Producing a quality annual report will build trust between investors and companies.

2. Spend time explaining remuneration policies to investors

Investors read the remuneration disclosures in the annual report very closely. Companies should ensure that their remuneration policies are clear and should be engaging with investors on this when there are significant changes and ahead of any votes at the AGM. Companies should expect push-back from institutional investors if their non-executive directors participate in performance-related share plans.

3. Focus on improving your corporate governance statements

Investors want to see small and mid-cap quoted companies taking governance seriously. Corporate governance disclosures in the annual report and on the company's website are key for investors in terms of understanding the systems and controls that are in place and, most importantly, why a company believes they are appropriate.

4. Explain why the auditor provides non-audit services

Investors understand the value in the auditor providing certain non-audit services for small and mid-cap quoted companies. However, it is best practice for the company to explain in its annual report how auditor independence and objectivity is safeguarded, especially in cases where the auditor provides significant non-audit services.

Notes

If you would like further information on any of the issues covered in this report contact:

Diane Gwilliam
RSM
T: 020 3201 8626
E: diane.gwilliam@rsmuk.com

Tim Ward
Quoted Companies Alliance
T: 020 7600 3745
E: tim.ward@theqca.com

About The Quoted Companies Alliance

The Quoted Companies Alliance is the independent membership organisation that champions the interests of small to mid-size quoted companies. We campaign, we inform and we interact to help our members keep their businesses ahead. Through our activities, we ensure that our influence always creates impact for our members.

Becoming a member enables you to:

- get access to a wider range of investors, as well as regulators and policymakers;
- benefit from our campaigning on regulation that affects quoted companies;
- receive free copies of our best practice guides;
- attend our practical briefing events (free of charge or at discounted rates); and
- stay ahead of the current issues affecting quoted companies with our timely updates and research.

Find out more at www.theqca.com

The Quoted Companies Alliance
6 Kinghorn Street
London
EC1A 7HW
020 7600 3745

Twitter: @quotedcompanies
LinkedIn: www.linkedin.com/groups?gid=1880307
YouTube: www.youtube.com/quotedcompanies

About RSM

RSM (formerly Baker Tilly) is a leading provider of audit, tax and consulting services to middle-market leaders, globally. We empower clients to move forward with confidence and realise their full potential. With around 3,500 partners and staff in the UK and access to more than 37,500 people in over 110 countries across the RSM network, we can meet our clients' needs wherever in the world they operate.

RSM is represented on the AIM Advisory Group of the London Stock Exchange and has been voted AIM Accountant of the Year in the Growth Company Investor Adviser awards, a record five times.

Find out more at rsmuk.com

RSM
25 Farringdon Street
London
EC4A 4AB

Twitter: @RSMUK
LinkedIn: www.linkedin.com/company/rsm-uk