

Arbor Square Associates: Private Equity Perspectives Series
Notes on the UK Climate for Private Equity and Business In General
13 May 2010

Traffic Light	Indicator	Data	Notes
Orange	UK GDP Growth (Q1)	0.2% Growth	The ONS official figures for Q1 growth were weaker than the 0.4% achieved in Q4 and expected by economists in Q1, though recent strong manufacturing output data (released on 12th May) suggests that the forecast for Q1 could be revised upwards to 0.3%. Furthermore, the National Institute of Economic and Social Research forecast growth in the three months to April 2010 to be 0.5%, lending weight to a more robust recovery in the UK.
Orange	US GDP Growth (Q1)	3.2% (annualised)	First estimate from US Department of Commerce. Lower than the expected 3.4%, and lower than the 5.6% growth achieved in Q4 2009. However, a surge in consumer spending, which accounts for the bulk of US GDP (3.6% growth - highest since early 2007 and significantly stronger than the 1.6% posted in Q4) could signify a sustainable (though muted) recovery. However, the pace of growth is lower than that seen both in the 1970s and 1980s recoveries.
	Output Sub-Sector Trends for Q1:		OECD
Green	- Manufacturing and Other Production Industry Output	0.7% Growth	Strongest pace of growth since 2006, and up on the 0.4% growth achieved in Q4 - overall up 1% on where it was a year ago. Other estimates (Chartered Institute of Purchasing and Supply/Markit) put growth at fastest pace since 1994, with the Purchasing Managers Index rising to 58 points in April (anything over 50 indicates rising activity), on the back of strong growth in overseas orders. Manufacturing contributes 14% to UK GDP. This strong performance saw the UK trade deficit narrow, but not materially.
Green	- Financial & Business Services	0.6% Growth	A dominant sector in the UK, continuing to gain momentum.
Red	- Distribution, Hotels and Restaurants	0.7% Decline	Includes retail - consumers impacted by cold weather early in the year and also possibly brought forward larger purchases into Q4 2009 due to the VAT increase on Jan 1st (hence weaker Jan and Feb).
Orange	- Construction	0.7% Decline	Despite a poor performance in Q1, more recent data shows a marked improvement, with the sector accelerating at its fastest pace since Sept 2007. The Markit/Chartered Institute of Purchasing and Supply construction PMI index rose to 58.2 in April from an unrevised 53.1 in March, with the biggest increase seen in the home-building sector. Construction accounts for around 6% of Britain's economic output.
Red	CPI Inflation	3.4% in March	Much higher than the 2% target and worrying against the backdrop of anaemic economic growth - MPC claimed to be 'surprised' by the current levels. Driven by the currency depreciation and the rebound in oil prices (sterling oil prices increased by 20% in Feb). However, BoE suggests that inflation would fall back to its 2% target level in two years time, even if interest rates don't rise. Euro area inflation also gathered pace, from 0.9% in Feb to 1.4% in March.
Orange	UK Interest Rates	0.50%	Monday's decision saw interest rates maintained at 0.5% for the 14th successive quarter. The MPC had postponed the rate decision meeting until after the General Election. Mervyn King warns that 'the crisis is far from over' and raised the possibility of further quantitative easing on publication of the quarterly Inflation Report this week.
Orange	UK Interest Rate Forecasts - Reuters Poll of Economists Feb-10	0.75% December; 1.25% Feb-March 2011; 2.25% by end of 2011	While many economists maintain the view that interest rates will remain at current levels for the rest of 2010, growing inflation concerns are such that a rate rise earlier in 2010 is increasingly possible. Mervyn King, however, recently predicted a further four years of low interest rates, to off-set the fiscal pain (tax rises / spending cuts) in store for the British public.
Red	Total UK Borrowing (end of March)	£890bn	Structural deficit is at a record high, up from £619bn at start of recession in April '08. Nick Clegg of the Lib Dems has agreed to the Conservative plans to make cuts of £6bn this year and to accelerate plans to cut the deficit over five years, with the reported approval of Mervyn King.
Red	UK annual public spending	£153bn	Less than last month's budget forecast of £166.5bn, but not materially - not considered to indicate any meaningful improvement.
Red	UK Net Debt as % of GDP (end of March)	62%	Furthermore, UK Net Debt as a % of GDP is expected to rise to 75% in 2014-5 (£1.4 trillion). S&P had expressed concern before the election over the lack of a decisive fiscal plan, potentially placing Britain's AAA rating in jeopardy. However, in a pre-Election Reuters poll of economists, the risk of a UK downgrade was estimated at just 10%.
Red	UK Budget Deficit (% GDP) for 2010 - Forecast	12% (European Commission Spring Prediction)	The European Commission predicts that the UK budget deficit will be 12% of GDP this calendar year, the highest of all 27 EU Nations, including Greece, and worse than the Treasury's own forecast. Despite concerns, the UK economy gained a vote of confidence as the Treasury saw the latest gilts auction attract the highest level of demand from investors since 1994, and was 2.47x over-subscribed. This follows significant swings in the bond market over the past week, on the back of political uncertainty.
Red	Tax Receipts	5% decline	Tax receipts for the year are 5% down on the previous 12 months, reducing hopes that a rise in receipts will help drive a turnaround in UK finances.

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	Credit Conditions Survey:		Bank of England Survey of bank and non-bank lenders, Q1 2010
	- Bank Lending	Decline	Net finance raised by private non-financial companies from UK banks and capital markets had fallen in February for the seventh month in the past eight.
	- Bond Issuance	Recovered in March	Gross bond issuance by non-financial companies recovered in March.
	- Business Investment	4% Decline (Q4 2009)	Much greater fall than seen in previous recessions - possibly reflecting increased cost and limited availability of business financing.
	UK Trade Position	Euro 2.1bn deficit	Narrowed, but not massively. Depreciation of sterling didn't have a marked impact on UK net trade in Q1 (in fact, net trade decreased GDP growth by 0.5% in the second half of 2009). Exports remained weak, possibly due to the inability of cash-strapped businesses to take advantage of increased competitiveness implied by the weak pound to expand into new markets at home and abroad. Could also be a result of reduced global demand for goods and services that the UK specialises in, particularly financial services which were a key driver of UK growth during the boom period. Worryingly, the MPC had hoped that the UK would benefit from strengthening exports to drive economic growth, but this is failing to materialise. What's more, the recovery in the Euro area (the destination of nearly half UK exports) is fragile, and could struggle to withstand the shock of the PIGS debt crisis. The rapidly weakening Euro is likely to further dampen European exports, though it should continue to stimulate exports. Indeed, the euro area went from a Euro 9bn trade deficit in Jan to a surplus of Euro 2.6bn in Feb, with exports growing by 2.7% and imports by 1.5%.
	Implications of Euro Area Debt Crisis (Greece, Portugal, Spain)	Cautious Optimism	Fears that the contagion of the Greek crisis would cause a cascade of sovereign debt issues across Southern Europe and beyond saw the jitters grip world stock markets last week. After Greece's sovereign bonds were downgraded to junk, S&P went on to downgrade both Portugal and Spain from their AAA rating. Commentators had feared this could prove to be the next 'Lehmans' - crystallising fears about the dire state of public finances in many European countries. However, the agreement between the IMF and EU ministers for a Euro 750bn rescue fund saw a degree of stability return. What's more, the EU Commission now has the right to pre-vet national budgets, Spain being the first to announce sweeping austerity measures. The US Federal Reserve also re-introduced its dollar-swap facility (emergency provision of dollars to central banks around the world), which was first set up in 2007 when banks stopped lending to each other. The measure was re-introduced when the cost of inter-bank three-month dollar loans increased at its fastest rate for 16 months.
	Euler Hermes UK cash-flow indices	15% Growth in cashflow (Manufacturing); 5.85% growth in cashflow (Services) - Q4 2009	Both manufacturing and services firms have recovered steadily during 2009, increasing cashflow in Q4 at the fastest pace for nine quarters (lower stock holdings key driver of increased cashflow, rather than increased profit).
	Euler Hermes UK profit indices	Decline	Ninth successive quarter of declining profits (price discounting was the most significant driver of reduced profitability).
	UK - Ease of Doing Business Index, 2010 (World Bank)	Rank: 5 out of 183 Countries	Moved up by one position from 6th place in 2009. Placed ahead of any other European economy. 1st = Singapore; 2nd = Hong Kong; 3rd = New Zealand; 4th = United States.
	EVCA - Benchmarking European Tax and Legal Environments	Rank: 4 (scoring 6 out of 10)	Ranked fourth, behind France, Ireland and Belgium. Results compiled in 2008.
	FTSE 100	4.9% Growth Q1	A decent performance in Q1 began rapidly reversing, on the back of market jitters over the Greek debt crisis, which led to a wave of sell-offs. The fear of 'contagion' had a global impact, contributing to falls on Hong Kong, Shanghai and New York markets as concern mounted. The FTSE 100 closed at a two month low on 5,411.11 at the end of Tuesday 4th. However, the rescue package agreed by EU ministers and the IMF, as well as formation of the coalition government in the UK, seem to be having a positive impact on markets.
	Unemployment - % UK	8%	Increased by 0.1% to 2.51 million over the three months to March and is at its highest level since 1994. Chartered Institute of Personnel and Development predict unemployment will peak at 2.8 million in 2010.
	Job Creation - KPMG / CIPD quarterly Labour Market Outlook	5% net positive on job creation for Q2	The KPMG/ CIPD quarterly Labour Market Outlook surveyed 800 private sector companies, and found a net positive figure of 5% in the balance of firms expecting to create jobs in Q2; that's up from -5% in the last quarter, and is the first time the index has been in positive territory for two years. However, the survey showed considerable region and sectoral variation, for instance charting a 20% net hiring balance for the South, compared with -25% and -23% for Scotland and Wales respectively. A pretty bleak public sector hiring balance of -43% has also been offset by much more positive story in the private sector.
	Job Creation - Antal International Survey	59% British firms hiring	More than France or Germany.

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Orange	Unquote Barometer	Subdued	European deal activity remained fairly stagnant, with deal volumes registering a decline in Q1, and values remaining roughly in line with Q4. However, the UK was one of the more active markets, with UK buyouts achieving a fourth consecutive quarter growth in deal volumes - 25 deals in Q4 and 30 in Q1 and accounted for more than half the value of the total European buyout market (Euro 4.76bn).
Orange	UK M&A (Grant Thornton)	Further decline	Q1 2010 saw a 14% decline in volume and 22% decline in value of M&A over previous quarter / however there was a rebound in Mid-Market M&A volumes.
Orange	UK PE as a % of M&A (Grant Thornton)	Stable	Similar market share to Q4 2009 (8% and 18% of Vol and Val respectively in 2010, compared with 9% and 17% in Q4 2009).
White	Bowmark Study (Jan 2010):		Survey of 132 CEOs and MDs of UK SMEs.
Red	- Bank Behaviour	Capital constraints	44% of respondents felt banks had tightened the terms on working capital facilities in the past six months; 39% said ability to access acquisition capital had worsened in last six months.
Green	- Business Optimism next 12 Months	73.1 - positive	Up by 6.3 points on previous year - over 89% of respondents expect an increase in profit and revenue over the next 12 months.
Red	- Employment next 12 months	Further decline expected	
White	Bowmark Study (Jan 2010) - Sector Performance:		
Red	- Manufacturing	Decline	Despite the positive contribution of manufacturing to the growth of the broader economy, the Bowmark study indicates that confidence continues to decline in the sector; profits down or static for 2/3 respondents; staff levels static or lower for 81%; 25% experiencing problems servicing debt. This is in spite of overall 0.7% growth in output. Could reflect decline in exports due to weak Euro area recovery.
Green	- Healthcare	Improvement	More resilient than most sectors, with nearly 40% reporting a 20% or greater increase in profits in past 12 months.
Red	Silverfleet - Buy and Build Activity	Weak	Despite the 'talk' about buy-and-build as a silver bullet in a low growth environment - capitalising on consolidation opportunities as competitors weaken - this hasn't translated in practice. The number of add-on acquisitions in 2009 fell by 50% - the lowest number since 2004. This partly reflects the Bowmark findings regarding availability of acquisition finance - expensive and hard to access in the context of the period of difficult trading most companies have struggled through.
White	Deloitte - North of England M&A Confidence Survey:		Survey of over 100 professionals in the PE industry - PE investors, bankers, lawyers.
Red	- Deal Flow (LTM)	Low Activity Levels	Deal flow, deals undertaken and average deal sizes all fell further from 2008 lows.
Orange	- Debt Pricing / Gearing	2.5x to 3.5x Debt Multiples	Expectations of banks and VCs are comparable on debt multiples; however, dislocation of expectations on pricing - 400-450bps for banks, 350-400bps for VCs.
Green	- Deal Flow Forecast	Tipping point - deal volumes expected to increase or stay same	M&A community (VCs, advisors, banks) in North expect deal volumes to either increase or stay the same (split 50/50), suggesting confidence that the market has 'bottomed out'.
Green	ICAEW UK Business Confidence Monitor	Growing confidence	Fourth quarterly rise in business confidence after a period of seven quarterly declines in confidence, between Q2 2007 and Q1 2009 - which was the tipping point for returning confidence. In Q1 2010, six in 10 are more confident in economic prospects facing their business over next 12 months, compared with 1 in 10 same time last year.
Orange	AIFM	Moving forward	JURI, The European Parliament's Legal Affairs Committee, was due to vote on the 10th May, but it was postponed once again for one week, to consider legal options. The hope within the private equity industry is for more positive progress, following a disappointing result from the last vote - amendments not perceived to have gone far enough. There is concern that change in UK Government could disrupt our role in the debate - Lord Myners suggests talks with Europe under Labour have been positive to date - the jury is out on the new coalition. Germany and France are seen to be in favour of tougher regulation, in opposition to the UK and US preference for lighter touch. The US treasury has also weighed in with concerns over impact on US hedge funds raising capital in Europe. Yesterday, European Commissioner Michael Barnier signalled that the EU was close to agreement with the US over the plans. The CBI voiced its concerns on Wednesday 11th May over the directive, in particular the forced disclosure of commercially sensitive data by private equity backed businesses.