Arbor Square Associates: Notes on the UK Economy Series
The Climate for Private Equity and Business In General
Third Edition: 11 February 2011

Traffic Light	Indicator	Q4 data	Q3 data	Notes
	UK GDP growth Q4 2010	0.5% decline	0.7% growth	The release of Q4 data by the Office for National Statistics (ONS) revealed significantly worse than anticipated figures, with a fall in overall GDP growth to -0.5%. The exceptionally poor weather in the latter part of the year was highlighted as a possible cause, as were weaknesses in the services and construction segments. Initially, the news that GDP had contracted prompted many to warn of a double dip recession, though as much improved figures began to emerge from the services and manufacturing sectors (see below), these concerns began to ease. Nevertheless, looking ahead, most forecasts predict little more than very modest growth, with a rise to 0.4% expected in Q1 2011.
	US GDP growth Q4 2010	3.20%	2.6% growth	In stark contrast to the news coming out of the UK, advance estimates released by the Bureau of Economic Analysis (BEA) suggested that real GDP growth in the US grew by 3.2% in the fourth quarter of 2010, driven by strong consumption and exports, as well as by a sharp fall in the level of imports. However, the growth figure did fall short of forecasts, which had expected growth of 3.5%.
	Output subsector trends for Q4			
	Overall production	0.90%	0.5% growth	Overall production output increased by 0.9 per cent in Q4 2010, almost double the figure seen during the previous quarter. Gains were driven primarily by the manufacturing segment, with positive contributions from electricity, gas and water supply, as well as agriculture, forestry and fishing. However, all other key sectors posted poor growth figures during the final three months, leading to the subdued overall figures.
	Manufacturing	1.40%	1.1% growth	Manufacturing output was the standout contributor to UK growth in Q4. Total output rose by 1.4%, compared with an increase of 1.1% in the three months to end September. After a slow start to the quarter in October, when output fell by 0.4%, November posted much better than anticipated growth of 0.6%. At the time, this took total year-on-year growth in manufacturing output to 5.6%. A further key measure to underline the bullishness in the manufacturing segment came in the December PMI index, which showed activity at manufacturing companies rising to its highest level in 16 years (58.3). This has continued into the new year: in January the manufacturing PMI rose even higher to a seasonally adjusted 62.0.
	Construction	3.3% decline	3.9% growth	One of the worst hit segments in the fourth quarter of 2010 was construction, which saw output decrease by 3.3%, compared with a rise of 3.9% in Q3. With most analysts pointing to the extreme conditions seen in December as the main cause for the poor Q4 figures, an improvement in the weather has indeed translated into better figures from the sector: The Markit/CIPS construction Purchasing Managers' Index, a key measure of construction activity, increased to 53.7 from 49.1 in December. For the first time since August 2010, activity in all three main construction areas — civil engineering, housing and commercial — were up in January 2011.
	Services (overall)	0.5% decline	0.5% growth	The total services output also suffered from the exceptionally cold period in the run-up to Christmas 2010, falling by 0.5% compared with a 0.5% gain the previous three months. The principal contributor to this decline was the business services and finance subsectors (see below). However, while the Markit/CIPS Purchasing Managers' Index for December reflected this, weighing in with a 20-month low of 49.7, the latest release, covering January, has seen a strong recovery in the index to 54.5.
	Transport & Communication	0.8% decline	2.0% growth	Unsurprisingly, the strong growth seen in Q3 within the transport, storage and communication segment was wiped out in the weather-affected final quarter, with a contraction of 0.8%. According to Markit, this subsector has showed the highest rise in input costs, reflecting the rise in fuel prices.
	Financial & Business Services	0.7% decline	0% flat	After a flat Q3, the financial and business services subsectors contracted by -0.7% in the final quarter of 2010, driven primarily by poor output from the computer services subsector.
	Distribution, Hotels and Restaurants	0.5% decline	0.8% growth	Output in the distribution, hotels and restaurants segment decreased by 0.5% in Q4 2010, compared with an increase of 0.8% in the previous quarter. The decline came largely as a result of weakness in the hotels and restaurants area.
	Government and Other Services	0.2% decline	0.6% growth	Although output in the government and other services segment also declined in the fourth quarter, the 0.2% drop was comparatively insignificant. It followed 0.6% growth in the previous quarter. According to the ONS, the recreation subsector contributed most to the decline in the final three months of the year.
	Retail Sales Volumes / Consumer Confidence	0.2% growth	1.0% growth	The latest data from the ONS, shows a mixed, and largely deteriorating, picture for retail sales. While retail sales volumes for Q4 2010 show modest growth against the previous quarter (0.2%) and same quarter of 2009 (0.4%), spiralling prices and, into the new year, the rise in VAT, are leading to a sharp deterioration. Retail volumes for December 2010 were down 0.8% over November figures. Meanwhile in January 2011, the GfKNOP index, a leading measure of sentiment among UK consumers, showed that confidence had plummeted at the fastest monthly rate in 17 years, falling from -21 in December to -29.
	CPI inflation	3.7% (December)	3.1% (September)	The CPI measure of inflation stood at 3.7% in December 2010, up from 3.3% a month earlier and, now, not far short of double the Bank of England's 2% target. Spiralling oil and food prices have helped to drive the inflation rate to these levels and the VAT increase at the beginning of 2011 will add further inflationary pressures. Indeed, inflation could rise as high as 5% in 2011 as the VAT rise filters into the headline figure. Retail price inflation (RPI), the measure by which most consumers view the market rose by 0.1% in January 2011 to 4.8%.
	UK interest rates	0.50%	0.50%	With inflation substantially exceeding forecasts, including those by the Monetary Policy Committee (MPC), the Bank of England has been under increasing pressure to raise interest rates from their 0.5% level. Andrew Sentance, who in June 2010 became the first member of the MPC to vote for a rate rise in nearly two years, was joined in the January 2011 vote by Martin Weale. The strong bounce back in the economy after the shock contraction in Q4 2010 lent weight to the case for an interest rate rise. Despite this, interest rates were again held at 0.5% in February, placing the emphasis on securing growth over curbing inflation, given the risk to the recovery posed by Government spending cuts and tax rises. Indeed, Mervyn King reiterated his view that current inflationary pressure was a temporary phenomenon, and that it would be back on target by early next year.
	UK net debt	£889.1bn (Dec 2010)	£863.1bn (Nov 2010)	In December 2010 UK net debt, <u>excluding</u> the temporary effects of financial interventions, stood at £889.1bn, compared with £743.5bn a year previously. It should be noted that for the first time, data for Royal Bank of Scotland and Lloyds Banking Group have been fully incorporated into the public sector finances. While this has impacted considerably on the statistics that <u>include</u> the effects of the financial interventions, it has not materially affected those (used here) that do not.
	UK net debt as a % GDP	59.3% (Dec 2010)	58% (Nov 2010)	The measure of UK net debt as a percentage of GDP has been under pressure for some time, as it has among many of the G20.

Hazel Clapham,
Arbor Square Associates
Direct Line: +44 (0) 20 7096 5078
Email: hazelclapham@arborsquare.com
Website: www.arborsquare.com

Traffic Light	Indicator	Q4 data	Q3 data	Notes
	UK Net Borrowing	£16.8bn (Dec)	£23.3bn (Nov)	The figures for December, which showed UK borrowing of £16.8bn (£15.3bn including interventions), was better than forecast and represents a fall from November's record high.
	Current Public Sector Budget Deficit	£13.5bn (Dec 2010)	£19.9bn (Nov)	The current budget deficit, excluding the temporary effects of financial interventions, stood at £13.5 billion in December 2010 (a deficit of £11.6 billion including interventions)
	Government support to banking stability (National Audit Office)			According to a report issued in December 2010 by the National Audit Office, the level of financial support provided to UK banks by the government has fallen from a peak of £955bn to £512 billion. However, the amount of capital borrowed by the Government to support the banking sector has risen by £7bn to £124bn since December 2009 and it is likely that the taxpayer will be providing support for some years to come.
	Banking Resilience (Bank of England Stability Report	Improved resilience, but persisting caution	Improved (summer 2010)	The banking sector is building on the more positive outlook that began to emerge in the middle of 2010. Capital ratios and profits have risen. However, the Bank of England's Stability Report issued towards the end of the year maintained a degree of caution. Over the course of the late 2010, concerns over sovereign and banking systems in certain European countries - most notably the Republic of Ireland and Iberian nations - had grown. While the impact on the UK banking segment appears to have been limited at this point, the risk of contagion is important given how interconnected the European banking segment is. There is also a medium term risk posed by the fact that the search for yield is driving capital out of advanced economies and into emerging market areas, which could lead to an overheated, and therefore more risky, environment.
	Bank Refinancing (Bank of England Stability Report)	Challenges remain		Although banks have voluntarily agreed to smooth Special Liquidity Scheme (SLS) repayment schedules to relieve the pressure of removing a refinancing wall due at the end of 2011, there remain significant challenges: if one includes funding supported by the SLS and the Credit Guarantee Scheme, approximately £400-500bn of wholesale debt is due to mature by the end of 2012.
	Gross bank lending	Decline		The Bank of England's Trends in Lending report, which had run as a monthly report from April 2009 to October 2010 has become a quarterly snapshot, the first edition of which was published in January 2011 and covered the period to end November 2010. Although the data for November itself did show an increase (of £1.2bn) in lending to UK businesses for the first time in nine months, the rate of lending overall fell by £5bn. Expressed as 12-month growth rates lending to UK businesses in September, October and November contracted by 5.7%, 5.5% and 5.1% respectively. These compare favourably with the average for Q1 and Q2 2010, which stood at -9.3% and -8.2% respectively. Despite the glimmer of hope offered by the November figures, early indications published in the latest report suggest that net lending to businesses was weak in December. Within this, it is worthy of note that lending to SME businesses continues to fall, though this is expected to reverse during 2011. It is interesting to note that the Q4 edition of the Deloitte CFO Survey, issued in January 2011, shows a much more confident picture where credit conditions are concerned (see below).
	Syndicated bank lending	Growth		According to the abovementioned Trends in Lending report, one brighter area within the UK landscape was syndicated lending. The total value of these facilities doubled in 2010 versus the previous year. Much of this is attributed to the refinancing of the huge volumes of loans structured during the peak of the market between 2003 and 2007.
	Bond issuance			According to the Bank of England's Q4 Asset Purchase Facility Report, spreads on UK non-financial investment-grade corporate bonds remained broadly stable over the three-month period. However, corporate bond yields did rise during the quarter, reflecting higher gilt yields, closing the period approximately 40 basis points higher. As a result, yields on corporate bonds have returned to the levels seen at the end of Q2 2010. As far as Sterling-denominated commercial paper in concerned, the market remained fairly stable over the Q4 period, with the total amount of this paper outstanding ending the year slightly up.
	Deloitte CFO Survey (Q4 2010)			The latest edition of Deloitte's CFO survey, released in January 2011, shows a sharp improvement amongst UK corporates. It is worth noting, though, that the report focuses on larger UK businesses: of the 126 CFOs surveyed 35 were from FTSE 100 companies and 45 were from the FTSE 250 list. As such it is not likely to reflect grass roots sentiment. Nevertheless, the findings were clear: while economic uncertainly remains a factor, improving confidence and appetite for risk are leading UK businesses to move from defensive positions to more expansion-oriented strategies. Interestingly, though, while CFOs were significantly more positive in Q4 about the potential for earnings growth than they had been for some time previously, much of this buoyant mood was driven by the prospects for growth from international markets; only 39% of respondents expected improving conditions in the UK to be the primary factor behind revenue growth.
				As far as the debt markets are concerned, the Deloitte CFO survey - again heavily influenced by the size of the companies surveyed - painted a picture in which the availability of credit is improving while the cost of credit is falling (the latter having dropped for 9 consecutive quarters).
	Business Investment (ONS)		3.1% growth (over Q2)	Published at the end of Q4, the latest business investment figures from the Office for National Statistics cover the Q3 period and show a rapidly improving picture. Q3 business investment was estimated to be 3.1% higher than the previous quarter (substantially reversing the narrow decline that had been published in the provisional results) and a full 8.9% above the same quarter a year earlier. The latest trend line has been underpinned by strong gains in private sector non-manufacturing, which increased by 3.7 per cent.
	UK Trade Position	£4.8bn deficit (Dec)	£3.9bn deficit (Nov)	According to the latest ONS figures, released on 9 February, the UK's trade deficit hit a record high in December 2010. The country's deficit on trade in goods and services increased sharply (by almost 19%) to £4.8bn from the figure of £3.9bn in November. This deterioration was driven by an increase in the deficit on trade in goods to £9.2bn (from £8.5bn in November) and a narrow fall in the surplus on trade in services (down to £4.4bn from £4.5bn in November). Once again, the weather has been cited as a key factor, as goods arriving in ports failed to reach their destinations due to badly affected transport links. Although the latest figures paint a gloomy picture, indications are that the balance of trade should improve as demand for UK goods and services increases in key trading partners such as Germany, while domestic demand for imports slows as the public sector cutbacks and growing inflation erode consumer appetite.

Hazel Clapham,
Arbor Square Associates
Direct Line: +44 (0) 20 7096 5078
Email: hazelclapham@arborsquare.com
Website: www.arborsquare.com

Arbor Square Associates: Notes on the UK Economy Series
The Climate for Private Equity and Business In General
Third Edition: 11 February 2011

Traffic Light	Indicator	Q4 data	Q3 data	Notes
	Euro-Area Risk	Persisting concerns	Returning confidence? (Aug 10)	Concerns surrounding the finances of a number of European states - chiefly Greece and Ireland - still dominate the Eurozone, as was seen at the World Economic Forum in Davos at the end of January 2011. Here the mood might have seemed much more upbeat than it had been a year earlier, but this masked a deep lack of confidence among many members that Greece and Ireland will be able to survive without some more significant intervention to restructure their debt problems. Such concerns extend to a degree to the ailing Iberian markets. Nevertheless, the trend line in key European stock markets remained strongly upwards, buoyed by the generally improving economic conditions, especially in core markets such as Germany.
	UK - Ease of Doing Business Index, 2011 (World Bank)	4th out of 183 (2011 rank)	4th out of 183 (2010)	According to the current rankings published by the IFC and World Bank (via www.doingbusiness.org), the UK has maintained its position near the top of the world league. It remains the 4th most conducive economy in which to do business, one rank ahead of the US and bettered only by Singapore, Hong Kong and New Zealand.
	FTSE 100	6.7% growth (Q4)	15.5% growth (Q3)	At the beginning of Q3 2010, the FTSE 100 index stood at its lowest level since the middle of 2009. However it grew sharply during the quarter, ending September 2010 on 5,549, a gain of more than 15%. The final three months of 2010 witnessed continued growth, but with a short, sharp correction at the end of November. In the end, the FTSE finished the year at 5,971, a rise of 6.7% during the quarter. Since the turn of the year, the index has largely remained below the year end figure, though at the time of writing the index sits at just under 6,100 points, an increase of over 3% in the quarter to date.
	Unemployment - % UK (ONS)	7.9% (three months to Nov 2010)		The latest figures issued by the ONS show that the UK unemployment rate for the three months to November 2010 stood at 7.9%, a rise of 0.2% on the quarter. Over the period, 49,000 people, the vast majority of them men, joined the ranks of the unemployed, taking the total number of those jobless to 2.5m. In regional terms, the West Midlands had the single most important effect on the statistics, with 48,000 more people becoming unemployed over the period. On the positive side, the North West fared the best in the period, with a total of 17,000 fewer people out of work, while Yorkshire, Scotland, the East and South East all saw growth in employment.
	Job Creation - KPMG / CIPD quarterly Labour Market Outlook			Based on a survey of 460 UK HR professionals, the latest CIPD/KPMG Labour Market Outlook survey, issued in November 2010, provided a marginally more positive view on the employment landscape. Overall, the report's 'net employment intentions' measure (ie the proportional difference between employers that intended to increase their workforce during the final quarter and those that intended to do the opposite), was positive for the third quarter in succession. As had been the case in the previous two reports the picture for the public sector was gloomy (in fact, increasingly so), though this was being compensated by strong demand coming from the private sector. However, the report did stress that the threat of redundancy programmes had actually increased and that the longer term prospects are flat.
	Job Creation - Antal International Survey	61% of UK firms hiring (Nov 2010)	60% of UK firms hiring (Jun 2010)	The most recent report by Antal International questioned over 9,100 companies during Q4 2010 about their recruitment activities. According to the report, 61% of UK firms claimed to be hiring, up marginally from 60% in June. Furthermore some 63% of UK firms expected to recruit in the following quarter (Q1 2011), compared with just 52% at the beginning of 2010. On the downside, more UK companies are also losing staff than they were in the summer. In sector terms, financial services and telecoms appeared to be the strongest.
	UK M&A (Grant Thornton)	Flat annual mid-cap UK M&A		Figures released at the beginning of 2011 by mid-cap corporate finance group Grant Thornton showed that the volume of mid-market M&A deals in the UK was flat in 2010, though values rose. In total 1,408 domestic mid-market transactions were recorded during the year, compared with 1,414 in 2009. However, values rose to £20.1bn from £12.3bn.
	ICAEW UK Business Confidence Monitor	Declining confidence	Confidence flat	The Q4 UK Business Confidence Monitor issued by the ICAEW and Grant Thornton showed a further sharp fall in business confidence on the back of renewed economic uncertainty. The fall is the third in succession after the indicator hit a post recession peak in the Q1 2010. In the latest data set almost one in four businesses are less confident about the coming 12 months, compared with one in five at the time of the Q3 report.
	Unquote Barometer/Europe Buyout Review	Q4 fall, annual rise		The quarterly unquote" Barometer, produced in association with Candover, recorded a drop in the number and value of private equity backed buyouts in the UK/Eire during the final quarter of the year. Although the decline in volume terms was minor (27 down to 23), the fall in value terms was more significant (€9.4bn down to €2.6bn) on the back of fewer deals in the top size brackets. However, the UK was the first European market to show any signs of rebounding following the 2009 crash in buyout numbers: overall the volume of deals grew by 55% in 2010 to reach 127. Meanwhile the rise in market value was much more pronounced, given the return of top-end buyouts, with deals worth €24bn completed during the year (up from €7bn in the debt-starved environment of 2009).
	Dow Jones - UK Venture Capital Investment			In contrast the rising fortunes of the buyout market, European venture capital activity continued to struggle in the final quarter of 2010, according figures released in February 2011 by Dow Jones VentureSource. VCs invested €843m in 230 European deals in the last three months of 2010, representing the lowest total of any quarter in 2010. Compared with the same quarter of 2009, completions fell by over 30% from 333 deals and total investment declined 16% from €1bn.
	EVCA Quarterly Activity Indicator Q3 2010			According to the latest EVCA figures, European private equity activities broadly remained subdued in Q3. The level of investments, divestments at cost and fundraising all fell from Q2 levels. The level of fundraising in particular reached its lowest level on record during the quarter.
	AIFM			The final version of the AIFM bill was eventually accepted by negotiators in late October 2010 and agreed on 11 November, despite resistance from private equity industry professionals right until the end of the process. According to the British Venture Capital Association (BVCA): "This remains a defective Directive. The EU has taken a hostile interest in the wrong industry at the wrong time and for the wrong reasons." Nevertheless, key concessions were achieved, the most important of which stated that third country funds would be able to obtain a 'passport' to invest in Europe subject to meeting certain criteria. Member states now have until 2013 to introduce the new regulations.

Hazel Clapham,
Arbor Square Associates
Direct Line: +44 (0) 20 7096 5078
Email: hazelclapham@arborsquare.com
Website: www.arborsquare.com