Arbor Square Associates: Notes on the UK Economy Series

The Climate for Private Equity and Business In General

Fourth Edition August 2011

Traffic Light	Indicator	Q1 2011 data	Q2 2011 data	Notes
	UK GDP growth	0.5% growth	0.2% growth (preliminary)	After rebounding into positive figures from the 0.5% contraction in GDP during Q4 2010, preliminary figures show that GDP in Q2 slowed from 0.5% growth to 0.2%. While industrial output was cited as the main brake on growth, it is suggested that a number of 'special factors' also affected economic activity, among them the extended bank holiday created by the royal wedding, the after-effects of the earthquake and tsunami in Japan, and the unseasonably warm weather during the quarter. Furthermore, the spending on 2012 Olympic tickets, which amounted to approximately 1% of GDP will not be recorded in the GDP figures until Q3 2012, when the games actually take place.
	US GDP growth	0.4% (re-stated down from 1.9%)	1.3% first estimate	The advance estimate for US GDP growth, released on 29/7 showed that real GDP in the US rose by a smaller margin than had been anticipated in Q2. The first estimate suggests that GDP rose by 1.3% in the three months to end June. The growth was positively influenced by exports, non-residential fixed investment, private inventory investment, and federal government spending. These were partly countered by drops in state and local spending and increased imports. This July release also sharply downgraded Q1 growth from 1.9% to 0.4%. The big news from the US these past couple of weeks has been the impasse over proposals to raise the US debt ceiling, currently at $14.3 trillion. It is with great relief that a compromise was finally reached this week, after much nail-biting wrangling between the White House and the Repulican congressional leadership, narrowly avoiding an unprecidented US default. The new deal has been a major destabalising factor for global markets. The Nikkei, Hang Seng and FTSE all saw modest rises on Monday morning (before Tuesday's deadline), in response to the news, although all ended the day down, on the back of new figures showing worse than expected US manufacturing activity.
	Output subsector trends for Q2 2011			
	Overall production	0.1% decline	1.4% decline	The stagnant overall economic growth in Q2 was largely driven by poor output of production industries, which declined by 1.4% and combined to lower GDP by 0.2%. The most significant falls in output were from the mining and quarrying industries (6.6% down), which were hit by maintenance programmes on North Sea installations, and in the supply of water, electricity and gas, which were affected by the unusually warm conditions in April and May.
	Manufacturing	0.7% growth	0.3% decline	Manufacturing output declined for the first time in several quarters between April and June 2011. It is now estimated to be more than 9% lower than the pre-crisis peak at the beginning of 2008. However, the picture could have been worse for the second quarter: heavy falls in manufacturing output in April (-1.6%) were offset by stronger figures in May (+1.8%). The weakness in April has been partly attributed to the additional bank holiday and the knock-on effects of the Japanese earthquake disaster. The Markit/CIPS Manufacturing PMI also fell in June, down from 52.0 in May to 51.3. It is at its lowest level since September 2009 and represents a sharp fall since strong growth at the beginning of 2011.
	Construction	3.4% decline	0.5% growth	After two successive quarters of sharp decline, the construction segment put in a relatively robust performance in Q2 2011, growing by 0.5%. However, the growth remains well below that seen in Q2 and Q3 of 2010 (7.2% and 3.7% respectively). The Latest Markit/CIPS UK Construction PMI published at the beginning of July reflected the relatively solid performance but also pointed to a slow-down in new business growth and a sharp drop in employment. This indicator also suggested that commercial and civil construction grew while housebuilding contracted.
	Services (overall)	0.9% growth	0.5% growth	The total output of UK services remained positive in Q2, growing by 0.5%, though this does represent a slow-down in the growth rate over the previous quarter. Q2 growth was propped up mainly by activity in the transport, storage and communication area (see below). The modest growth trend was reflected in the Markit/CIPS UK Services PMI, which outlined an environment where solid levels of new incoming business are being countered by employment stagnation and poor confidence levels. The headline Markit/CIPS Business Activity Index weighed in at 53.9 in June 2001, virtually unchanged from the previous six months.
	Transport & Communication	2.5% growth	1.1% growth	The modest overall growth in the services sector in Q2 2011 was driven primarily by comparatively strong advances in the transport and communication segment. Here, growth increased by 1.1 per cent. The Q2 figure is substantially down on the 2.5% growth rate seen during the previous quarter, though this had been driven by the sharp recovery in transport following the harsh winter weather. Land transport contributed most to the growth during the most recent quarter.
	Financial & Business Services	0.4% growth	0.7% growth	The financial and business services subsector was one of the few to see an acceleration in growth between Q1 and Q2 2011. Here the growth rate increased from 0.4% in the first three months of the year to 0.7%, with the most significant positive contribution coming from other business services.
	Distribution, Hotels and Restaurants	0.9% growth	0.3% growth	Distribution, hotels and restaurants grew by 0.3% during Q2 2011. This compares with an increase of 0.9 per cent in the previous three-month period. Hotels and restaurants made the largest contribution to the increase between April and June. Despite this modest slow-down in growth, the sector has grown by 1.5% versus the same quarter in 2010.
	Government and Other Services	1.1% growth	0.0% flat	Unsurprisingly one of the biggest casualties in Q2 was the government and other services subsector, which slumped to a zero growth from a 1.1% increase during the previous quarter. Health made the largest positive contribution to the quarter, partially offset by a negative contribution from recreation.
	Retail Sales Volumes / Consumer Confidence	Growth over Q4: 1.9% (value) 0.2% (volume)	Growth over Q1: 0.6% (value) 0.2% (volume)	The latest data from the ONS, shows a mixed but more positive picture for retail sales. In quarterly terms the value and volume of retail sales between April and June increased by 0.6% and 0.2% respectively over the first three months of the year. In monthly terms the value of retail spending in June was up by 0.3% over the previous month, while volumes rose by 0.7%. However, underneath the headline stats the news for food retailers is bleak: in volume terms, June sales from the predominantly food store sector decreased by 4.2%, the largest fall on record since the series began in 1988. Countering this, non-store retailing rose by 24.4% in June. Meanwhile, after rallying somewhat between April and May, the GfKNOP index, a leading measure of sentiment among UK consumers, dropped four points to -25 in June 2011, with decreases seen across all five measures.

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	CPI inflation	4.0% (March 2011)	4.2% (June 2011)	The CPI measure of inflation stood at 4.2% in June 2011, down slightly from 4.5% a month earlier, though still way above target. The modest reduction was driven mainly by falls in the prices associated with recreation and culture (down 0.9%). Other decreases in prices were seen in the miscellaneous goods, communications and second hand vehicles categories. Countering that were food and non-alcoholic beverages categories, where prices rose by 0.9% between May and June. There was also upward pressure from the price of fuel and lubricants. In the year to June, RPI annual inflation was 5.0%, down from 5.2 % in May.
	UK interest rates	0.50%	0.50%	In the face of domestic economic data, which shows a continuing weakness in the rate of recovery, as well as concerns over sovereign debt issues abroad, and slowing output growth in the US, the Bank of England's Monetary Policy Committee voted to maintain the bank rate at 0.5%. In addition the Bank also kept its programme of quantitative easing unchanged at £200bn. The bank rate vote was carried by seven votes to two, while the decision to keep quantitative easing level was carried eight to one.
	UK net debt	£903.4bn (March 2011)	£944.3bn (Jun 2011)	At the end of June 2011, net UK debt excluding the temporary effects of financial interventions stood at £944.3bn, compared with £903.4bn at the end of Q1 2011 and £803.7bn a year earlier.
	UK net debt as a % GDP	60.2%(March 2011)	61.9% (Jun 2011)	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. Since the first quarter of 2008, it has steadily risen from a little over 36% to its current peak.
	UK Net Borrowing	£23.9bn	£39.2bn	The UK's public-sector net borrowing figure stood at £14 billion in June 2011. This is down from some previous months, but higher than expected. In total, public-sector net borrowing stood at £39.2bn in the second quarter, up substantially from the first three months of the year. According to the ONS, the increase in borrowing was largely due to a 2% fall in income tax receipts.
	Current Public Sector Budget Deficit	£10.4bn	£11.8bn	The most recent ONS figures show a current budget deficit excluding the temporary effects of financial interventions of £11.8bn in June 2011 (a deficit of £9.8 billion including interventions). This represents a modest increase over the figures seen in March 2011.
	Tax Receipts (ONS)	£148.9bn	£121.1bn	Total UK tax receipts fell sharply in Q2 2011 from £148.9bn during the first three months of the year to £121.1bn. Despite this, the Q2 figure remains comfortably ahead of the same period in 2010 (£115.8bn).
	Banking Resilience (Bank of England Stability Report)	Improved resilience, but further caution needed		2011 saw the establishment of the Financial Policy Committee (FPC), a body charged with identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC (initially an interim body), will publish a Financial Stability Report twice a year. At a meeting in June 2011, the FPC proposed the introduction of a number of measures, primarily to toughen up monitoring and disclosure. The key risks to the financial system remain sovereign and banking strains, while longer term risks are posed by loan forbearance. There are also unwelcome signs that complexity and opacity are creeping back into some markets as participants look to generate higher returns in the low interest rate environment and these could amplify any stress that emerges. July also saw a round of stress testing for European banks by their national regulators, a process coordinated by the European Banking Authority. Of the 90 banks tested, eight failed and a further fifteen scraped through with just enough capital to satisfy the EBA's criteria. The failures included five Spanish banks, two Greek banks and one Austrian bank. All British and Irish banks passed the test.
	The Refinancing Wall (KPMG, June 2011)			A report published by KPMG in June 2011 estimated that there is over $4 trillion of corporate debt that is due to mature over the next four years - some $1.3 trillion of which is in EMEA countries. Given the continued economic uncertainties in many first world markets, inflationary pressures in emerging powerhouse economies and the ongoing battle for banks to rebuild their balance sheets, it is likely that many businesses will struggle to meet their refinancing needs and will have to explore alternative sources of funding.
	Gross bank lending	Decline	Decline (slowing)	The latest data from the Bank of England's Trends in Lending report, revealed that lending by all UK-resident banks and building societies had contracted by around £4 billion in the three months to May 2011, despite a strong showing in April (the first positive monthly figure for net lending since November 2010). Expressed as 12-month growth rates, lending to UK businesses in March, April and May contracted by 4.1%, 3.5% and 4.0% respectively. These figures compare favourably with the averages for Q3 and Q4 2010, which showed contractions of 5.7% and 5.1% respectively. According to the document, most major UK lenders report that syndicated lending continues to be driven largely by the refinancing needs of companies rather than for financing new investment projects. In addition, recent indicators of corporate distress appear to be broadly stable.
	Loan pricing		Improving	After increasing dramatically since the beginning of the financial crisis, spreads over reference rates on new lending have continued to narrow for larger and mid-sized businesses in Q2 2011, according to the Bank of England's Credit Conditions Survey. Spreads for smaller businesses, however, remain largely unchanged.
	Bond issuance	Recovering	Stable	According to the Bank of England's Q2 2011 Asset Purchase Facility Report, nominal gilt yields fell during the period, with rates on average around 15 basis points lower than at the end of Q1. Meanwhile activity in the Bank's APF continued to be driven primarily by conditions in corporate debt markets, where spreads on UK non-financial investment-grade corporate bonds increased over the latter half of the period. The market for sterling non bank investment-grade commercial paper was also broadly stable over the period.

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	UK Trade Position	£3.1bn deficit (April 2011)	£4.1bn deficit (May 2011)	According to the latest ONS figures, released on 12 July, the UK's seasonally adjusted trade deficit in goods and services grew to £4.1bn in May 2011 from £3.1bn in April. The deterioration was driven primarily by an increase in the deficit on trade in goods, which widened to £8.5bn in May from £7.6bn in April. Among these was a 13% surge in imports of semi-manufactured goods, notably chemical products, which rose 20%. Meanwhile, the surplus on trade in services fell slightly to £4.4bn in May from £4.5bn in April.
	Euro-Area Risk	Concern	Deepening worries	Concerns surrounding the finances of a number of European states have continued to worsen as 2011 has progressed. While the most pressing issues have surrounded the smaller economies of Greece (where a second bail-out package was agreed in July 2011) , Portugal and Ireland, the wider concern is that the debt crisis would spill over to much larger economies - chiefly Spain and, more recently, Italy. The very real possibility that Greece will default is prompting fears that other countries might follow. Greek GDP has crashed in the face of austerity, as has Irish growth. Meanwhile the Spanish economy is struggling to achieve any growth. In early July, bond markets launched an unexpected buyers' strike, driving yields on Italian debt to their highest levels in a decade and having a negative effect on Italian banking stocks, though this is widely believed to have been an overreaction to the state of risk in the Italian market. Nevertheless, Italy owes around a quarter of all government debt in the Eurozone and so any deterioration in conditions could have massive implications.
	UK - Ease of Doing Business Index, 2011 (World Bank)	4th out of 183 (2011 rank)		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.
	Business Investment (ONS)	3.2% decline	n/a	The most recent figure from the ONS on business investment are the revisions published in late June 2011 to the Q1 figures. These show that business investment total for the period (£30bn) is estimated to be 3.2% lower than the previous quarter, but 2.7% higher than the same period last year. The decrease was driven by private sector non-manufacturing, which fell by 3.6%, principally in other services. The increase over Q1 2010 came largely as a result of private sector non-manufacturing, up by 1.6%, and private sector manufacturing up 14.8%.
	FTSE 100	1.8% decline	1% decline	During the first three months, the FTSE 100 index broadly hovered within the 5,900 to 6,100 range, with one sharp correction down to around 5,600 in late March, followed by an equally sharp upturn. The first quarter finished 1.8% down. In Q2 2011, the trend had been largely downward until late June when it rallied. It finished the quarter just 1% down on where it began, but a full 2.2% below the peak during the three-month period.
	Unemployment - % UK (ONS)		7.7% (0.1% decline)	The most recent figures from the ONS, running to the end of May 2011, put the UK unemployment rate at 7.7% of the economically active population, down 0.1% on the quarter. The total number of unemployed people fell by 26,000 over the three months to May to reach 2.45 million. The overall fall in the number of jobless was driven by a reduction in the number of long-term unemployed (out of work for a year or more), which dropped by almost 40,000. However, the number of people unemployed for up to one year increased by 11,000.
	Job Creation - KPMG / CIPD quarterly Labour Market Outlook		Modest pick-up	Based on a survey of 391 UK HR professionals, the latest CIPD/KPMG Labour Market Outlook survey, issued in May 2011, pointed to a slight improvement in employment prospects in the second quarter of 2011. 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), had rebounded from -3 to +3 driven by growth in the private sector, but held back by continuing contraction in the public sector. Pay expectations have also recovered modestly, with the average expected pay settlement in the 12 months to February 2012 rising to 1.7% from 1.3% over previous report.
	Job Creation - Antal International Survey		61% of UK firms hiring (Jul 2011)	The latest quarterly survey of hiring and firing trends by Antal International, which covered over 12,800 organisations in 47 countries, has found that employment markets around the world finally appear to be stabilising. In the UK, 61% of companies are looking to recruit professional and managerial staff - one of the highest levels in Western Europe (and against the global average of 52%). However, on the flip side, the percentage of businesses looking to make redundancies is also higher in the UK than the average, though this is expected to ease. One of the most active sectors in the UK is currently the energy and renewable industry, with 79% of organisations hiring and 93% expecting to hire in the next three months.
	Deloitte CFO Survey (Q2 2011)	Decline	Decline(accelerating)	The Deloitte's CFO survey for Q2 2011 shows that the decline in business optimism seen in the first quarter has accelerated, with CFO sentiment falling at the fastest rate since the failure of Lehman Brothers in September 2008. Broadly speaking, confidence in the economic recovery has been hit, with CFOs rating the chance of a double-dip recession at about 33%. In addition the general consensus is that company profit margins will narrow over the coming year. This gloom is reflected in the current strategies preferred by CFOs, with cost control and a focus on increasing cash flows dominating. However, despite the gloomy mood, strong balance sheets, improved availability (and cost) of capital and a good flow of potential growth opportunities mean that CFOs remain willing to take greater risks.
	ICAEW UK Business Confidence Monitor	Declining confidence	Recovering confidence	The latest ICAEW/Grant Thornton UK Business Confidence Monitor shows that business confidence picked up in Q2 2011, following four consecutive quarters of decline, though it still remains well below the same point in 2010. It is also interesting to note that the change in the index has largely been brought about by a decline in the number of businesses that are less confident about prospects, rather than a growth in the proportion of businesses that are more confident. Most importantly, the report shows that financial performance continues to improve, with turnover and profit growth at their strongest level since Q3 2008, and growth expectations at their highest since before the recession.

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	PKF Deal Drivers UK	Strong start to the year		According to the latest edition of Deal Drivers UK, published in May by PKF in association with mergermarket, 221 UK M&A transactions worth £23.2bn were completed in Q1 2011. This represents a marginal increase in volume terms over the same quarter in 2010 (3.3%), but a much more significant increase in value terms (63%). The trend is being driven by deals at the larger end of the spectrum and growth in private equity backed activity. In sector terms the stand-out area is energy - especially in the wake of the Fukushima disaster earlier in 2011.
	Unquote Barometer buyout figures	Fall in volume and value	Modest rise in volume, sharp rise in value	While the Q2 unquote" Barometer, produced in association with Arle, recorded a slight increase in the number of European buyouts over the previous quarter (up from 103 to 106), the rise in value was much more dramatic, up from €12.2bn to €25.7bn. However, the growth in both volume and value was driven by non-UK markets - especially German-speaking regions and France, where activity surged. In the UK, the number of buyouts dropped from 37 in Q1 to just 20 and value eased from €4.6bn to €4bn. Only two of the top 10 deals by size were completed in the UK - the acquisitions of Group RAC by Carlyle (€1.15bn) and Environmental Resources Management by Charterhouse (€950m).
	Dow Jones - UK Venture Capital Investment	Value up volume down		According to figures released in May 2011 by Dow Jones VentureSource, the number of venture deals recorded in Q1 2011 reached their lowest point since this measure had been launched in 2000. In total only 182 venture deals were recorded during the quarter - a 35% decease on the corresponding period in 2010. In value terms however, the total €1.1bn invested represented an increase of 18% over Q1 2010. Healthcare remained the most important segment for venture investment, while the IT segment recorded its lowest quarterly deal flow and capital investment.
	EVCA Quarterly Activity Indicator Q1 2011			According to the latest EVCA Quarterly Activity Indicator, released in June 2011, the trends in European private equity flows were mixed in the first quarter of 2011. On one hand, the levels of divestments at cost and fundraising both showed significant upward movement, while new investment activity dropped. All three measures remain above the bottom of the market in Q2 2009, though only marginally so in the case of fundraising.