Arbor Square Associates: Notes on the UK Economy Series

The Climate for Private Equity and Business In General

Fifth Edition February 2012

Traffic Light	Indicator	Q3 2011 data	Q4 2011 data	Notes
	UK GDP growth Q4 2011	0.6% growth	0.2% contraction (preliminary)	According to preliminary figures released by the Office for National Statistics in late January 2012, the UK economy shrank by 0.2% in the final three months of 2011 - the first contraction since the final quarter of 2010. The figure, which could still be revised either way by up to 0.2%, is slightly worse than had been expected and represents a sharp fall in economic activity from the third quarter, when growth of 0.6% was seen. The slow-down has principally been driven by weakness in production sectors and construction (see below), while the hugely important services sector remained flat. Among the factors which may have influenced the declines are the unusually mild autumn and November's public sector strikes. Overall, GDP growth in 2011 is forecast to come in at 0.9% - less than half the original estimate of 2.1%. What's more, the IMF recently slashed growth forecasts for the UK in 2012 to 0.6%, compared to earlier estimates of 1.6%. However, the UK is expected to outperform France and Germany in 2012, where the IMF is forecasting GDP growth of just 0.3% and 0.2% respectively.
	US GDP growth Q4 2010	1.8%	2.8% first estimate	Despite the US population continuing to feel the pinch, the world's leading economy is showing signs that it is beginning to grow more strongly. The advance estimate for US GDP growth, released on 27/1/12, showed that real GDP in the US rose by 2.8% in Q4 - a full 1% higher than the confirmed figure for Q3. The estimated increase in real GDP in the fourth quarter reflected positive contributions from private inventory investment, personal consumption expenditures (PCE), exports, residential fixed investment, and non-residential fixed investment. These contributions were partially offset by negative contributions from federal government spending and state and local government spending.
UK Output - Sub-sector trends for Q4				
	Overall production	0.2% growth	1.2% decline	After moving into growth - albeit marginal - in Q3, UK production output contracted sharply in the final three months of the year, significantly affecting the full GDP picture. Overall, the seasonally adjusted index of production in Q4 2011 decreased by 1.2%, driven by falls in activity in three of the four main subsectors. Of those, manufacturing contributed the most to the decline, followed by electricity, gas, steam and air conditioning supply. Looking at year-on-year comparisons, production output decreased by a full 2.6% between Q4 2010 and Q4 2011.
	Manufacturing	0.1% growth	0.9% decline	Manufacturing output had a serious impact on the production figures, declining by 0.9% in the last quarter of 2011, compared with a slight growth of 0.1% the previous quarter. Beyond the continued weakness in the mining and quarrying sector (especially in oil and gas), manufacturing output has suffered in a number of areas such as pharmaceuticals, basic metals and metal products, wood and paper products and printing and electrical equipment. On the positive side, there was some growth in the output of transport equipment, other manufactured products and food, beverages and tobacco products.
	Construction	0.3% growth	0.5% decline	Despite having increased by 1.3% in year-on-year terms, the performance of the construction sector suffered considerably in the last three months of 2011, seeing a contraction of 0.5% after the 0.3% growth in Q3 and the 3.1% growth in Q2. This quarterly contraction was driven by an especially sharp 1.6% fall in output during November. In contrast, the latest Markit/CIPS UK Construction PMI published at the beginning of 2012 showed a more positive picture for December, with all three main construction sub-sectors seeing some growth in the final month of the year, though the longer-term outlook remains subdued.
	Services (overall)	0.7% growth	Flat	The total output of UK services effectively levelled off in the final quarter of the year, seeing neither growth nor contraction from the previous quarterly figure (a 0.7% growth). This comes despite some mildly positive monthly figures for October and November, where publishing and broadcasting, other professional services, administration and support services and computer services together contributed to positive month-on-month growth. Again, the flat quarterly estimate is not reflected in the most recent Markit/CIPS UK Services PMI, which showed that growth in the UK service sector had accelerated to a five-month high at the end of 2011. The survey showed that despite tough economic conditions there are signs that activity is picking up, with new business and enquiry levels rising on the back of marketing and promotional work. The main index in the survey registered a five-month high of 54.0 in December 2011, compared with 52.1 the previous month.
	Transport Storage & Communication	0.3% growth	0.1% decline	After having shown modest growth for the first time in 2011 during Q3, the transport storage and communication segment contracted again in the final quarter of the year - this time by 0.1%. Overall, output fell back in half of the dozen components that make up this section of the economy, with computer programming, consultancy and related activities, and land transport making the most significant contributions to the decrease. Versus the same quarter in 2010, output in this sector is also down fractionally by 0.1%.
	Financial & Business Services	1.2% growth	Flat	Output in the financial and business services sub-sector also levelled off in the final quarter of the year following its relatively robust growth of 1.2% in Q3. Despite this, the sector finished the year 2.1% higher than it had 12 months earlier. In Q4 2011, output increased in over a third of the sector's 21 components, with the buying and selling of real estate making the largest positive contribution. On the flip side, legal & accounting activities contributed most to the slow-down.
	Distribution, Hotels and Restaurants	0.2% growth	0.5% decline	The seasonally adjusted index for distribution, hotels and restaurants in Q4 2011 decreased by 0.5% over the previous quarter (a 0.2% growth). Q4 output fell in all but one of the sector's five components, with wholesale and motor trades having the most negative impact on the overall figures. Nevertheless, in year-on-year terms, distribution, hotels and restaurants saw growth of 0.7% on the output registered in Q4 2010.
	Government and Other Services	0.6% growth	0.4% growth	One of the only sections of the UK economy to register growth in the fourth quarter of 2011 was government and other services. Although the rate of growth slowed marginally, this area still expanded by 0.4% over the previous quarter, with output increasing in nine of the 13 components. Overall health, education and creative arts and entertainment made the most positive contributions. In year-on-year terms, this area saw robust growth of 2.5%.

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	UK Retail Sales		Growth over Q3: 1.7% (value) 1.1% (volume)	The latest stats from the ONS show a more positive picture for retail sales. In December 2011 an estimated £42.1 billion was spent in the retail sector, compared to £29.0 billion in November 2011 and £39.0 billion in December 2010. An overall £343.2 billion is estimated to have been spent in 2011 up from £326.2 billion in 2010. In quarterly terms, the value and volume of retail sales between October and December increased by 1.7% and 1.1% respectively over the previous three-month period. In monthly terms, the value of retail spending in December was up by 0.8% over the previous month, while volumes rose by 0.6%. The year-on-year figures, which show respective value and volume increases of 6.2% and 2.6% compared with December 2010, were driven largely by strong gains in the automotive fuel and textile, clothing and footwear stores segments, which had both been heavily impacted by the previous year's harsh winter. The ONS has also started to track Internet Sales and estimates that this segment accounted for approximately 10.9% of all retail sales (excluding automotive fuel) in December 2011 (£837m), compared with 9.1% in December 2010 (£652m).
	UK Consumer Confidence		38 Points (December 2011)	The Nationwide Consumer Confidence Index fell to new lows in December 2011, hitting 38 points, just two points higher than its historic low of 36 points, recorded in October 2011. The index currently stands 39 points below its long run average of 77 and 17 points lower than the same point last year (55 points in December 2010). This dip in consumer confidence cooincided with the highest rate of unemployment in the UK for 15 years, not to mention the escalating cost of living, which is rising at twice the rate of underlying wage growth. The gloomy Nationwide findings were corroborated by the GfKNOP index, a leading measure of sentiment among UK consumers, which dropped to -29 in January 2012, its lowest level since March 2009.
	UK CPI inflation	5.2% (September)	4.2% (December)	After peaking at 5.2% at the end of the third quarter 2011, the CPI measure of inflation has fallen steadily, in line with predictions, and closed the year at 4.2%. The pace of decline has also gained momentum. The fall between November and December was the largest one-month drop since November/December 2008, when the VAT reduction had a disproportionate effect; it was driven largely by the easing of petrol, gas and clothing prices. Clothing and footwear prices fell by 2.8% in December, as retailers slashed prices to try to entice reluctant shoppers over their threshold. Further significant falls are in the pipeline, on the back of recent announcments of gas and electricity price cuts. The only significant price increases in the figures that make up the CPI measure were in landline and mobile phone charges. Meanwhile, the RPI inflation figure also fell quite sharply in the final months of 2011, down to 4.8% in December from 5.2% in November.
	UK interest rates	0.50%	0.50%	Despite some better news coming from outside the Euro area, the heightened uncertainty closer to home and a slack labour market have dominated policy in recent times. Unsurprisingly , the Bank of England's Monetary Policy Committee voted to maintain the bank rate at 0.5% in January 2012. In addition the Bank also kept its programme of quantitative easing unchanged at £275bn. In both key decisions, the vote was unanimous.
	UK net debt	£967.5bn (September 2011)	£1003.9bn (December 2011)	At the end of 2011, net UK debt (excluding the temporary effects of financial interventions, such as bank bailouts) broke the £1 trillion barrier for the first time, to stand at £1,003.9bn. This compares with £967.5bn at the end of Q3 2011 and £883bn a year earlier. The Government has forecast that servicing Britain's debt will cost £47.6bn in the current financial year, rising to £65.5bn in 2016/17.
	UK net debt as a % of GDP	62.7% (September 2011)	64.3% (December 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 of over 64.2%. Compared with 2010, though, the rate of rise in this measure has slowed. However, as Guy Fraser Sampson pointed out at the recent Real Deals Mid-Market Conference in London, if you add in other liabilities, such as unfunded public sector pensions, it would likely exceed 200%...
	UK Net Borrowing	£27.7bn	£38.3bn	The UK's public-sector net borrowing figure stood at £13.7bn in December 2011, somewhat lower than in three of the previous four months and £2.2bn below the same point in 2010. Despite this, the overall quarterly figure for the last three months of the year stood at £38.3bn, compared with £27.7bn for Q3.
	UK Current Public Sector Budget Deficit	£21.5bn	£30.9bn	The most recent ONS figures show a current budget deficit, excluding the temporary effects of financial interventions, of £10.8bn in December 2011 (a deficit of £7.9bn including interventions). This represents a sharp fall over the previous month, but a big increase over the figure in October. Overall, the quarterly position shows a budget deficit of £30.9bn, up significantly over the preceding quarter, but down on the same quarter of 2010.
	UK Tax Receipts (ONS)	£133.5bn	£127.4bn	Total UK tax receipts fell in Q4 2011 from £133.5bn between July and September to £127.4bn. Despite this, the Q4 figure remains comfortably ahead of the same period in 2010 (£120.7bn).
	UK Banking Resilience (Bank of England Stability Report)	Improved resilience, but further caution needed (June 2011)	Build capital levels to protect against exceptionally threatening conditions (December 2011)	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, met for the second time since its creation in February 2011. At this second meeting , the FPC recommended that banks limit distributions and consider raising external capital in an effort to build capital levels during an exceptionally threatening time. It also reiterated its advice to the FSA both to encourage banks to build their balance sheets without harming the market and to build leverage ratio disclosure into their regular reporting before the beginning of 2013.
	UK Gross bank lending	Decline (slowing)	Growth, but lending remains weak	The latest data from the Bank of England's Trends in Lending report, published in January 2012, clearly shows that corporate lending conditions in the UK remain weak, mainly as a result of low levels of lending to smaller businesses. Nevertheless, there are some encouraging signs. Overall, the continued decline in lending during September and October 2011 was offset by stronger figures in November, which meant that the total amount of lending turned positive for the first time since 2008. The net monthly flow for November stood at £1.8bn, more than making up for the net losses of £1.2bn and £0.2bn in September and October respectively.

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	UK Loan pricing		Challenging	According to the most recent Credit Conditions Survey from the Bank of England, conditions in longer-term wholesale funding markets remained highly challenging in the final quarter of 2011, with high wholesale costs feeding through into loan pricing for new business. Furthermore, spreads over reference rates on new lending widened once again in Q4 and are expected to widen further in the coming quarter. Spreads on syndicated lending also increased during the quarter. Given this, it is unsurprising that demand for credit, especially among small and medium-sized businesses, was modest during the final three months of the year. With such muted demand, credit availability was slightly improved for most businesses.
	UK Bond issuance		Deteriorating liquidity	According to the Bank of England's Q4 2011 Asset Purchase Facility Report, nominal gilt yields continued to fall throughout the latter half of 2011, with rates on average around 45 basis points lower than at the end of Q3. Similarly, activity in the Bank's APF continued to be driven by deteriorating liquidity in corporate debt markets, with Q4 seeing an increase in the buying and selling of corporate bonds by the APF over the previous three-month period. UK non-financial investment-grade corporate bond yields also decreased a little over the quarter, but by less significant margins than seen in the gilts market.
	Deloitte UK CFO Survey (Q4 2011)		Fears of second credit crunch	The Q4 2011 edition of Deloitte's CFO survey, released in early January 2012, was dominated by the fears among UK CFOs of a Eurozone collapse leading to a second credit crunch and the consequent swings in asset prices and exchange rates. In all, 37% of respondents believed that one or more of the European member states would leave the single currency during the course of 2012. Unsurprisingly, given this overall backdrop, more than half of the CFOs questioned expect the UK economy to slip back into recession and 70% expect profit margins to fall. As a result, almost 90% of respondents believe that corporate spending should be reined in and balance sheets should be strengthened as a matter of urgency: now is not a good time to take additional risk onto the balance sheet. Nevertheless, businesses that generate significant revenues outside of the UK are generally more positive. And, as ever, there is clearly the feeling among many respondents that the challenging conditions will also offer up opportunities, most notably through acquisition or by implementing much needed overdue changes to their businesses or processes.
	UK Business Investment (ONS)	Q2: £30bn	Q3: £30.1bn (0.3% increase)	The most recent figures from the ONS on business investment (Q3 revisions, published in late December) show that the seasonally adjusted business investment total for the period reached £30.1bn, a fractionally higher amount than was recorded in the second quarter. Compared with the same quarter of 2010, business investment rose by 4.3%. Within the latest figures, total manufacturing investment rose by 6% to £3.7bn, compared with Q2 figures. However, these gains were almost cancelled out by the figures for the more important non-manufacturing segment, which showed a 0.5% decline in investment to £26.4bn between the second and the third quarters.
	UK Trade Position	£1.9bn deficit (October 2011)	£2.6bn deficit (November 2011)	After a very strong performance in October 2011, the UK's trade balance deteriorated in November, according to the latest ONS figures, released on 25 January. In November, the UK's deficit on the balance of trade in goods and services stood at £2.6bn, up from £1.9bn a month earlier, as exports to countries outside Europe declined. Surprisingly, exports to European trading partners held up over this period, despite the Eurozone woes. If the services figures are stripped out, the deficit on trade in goods weighed in at £8.6bn in the latest period, up from £7.9bn in October but roughly in line with the average over the last 12 months. Exports of goods fell by £0.4bn, or 1.5%, to £25.7bn in November, while imports of goods increased by the same amount (equating to 1.1%) to £34.4bn in the same period. Meanwhile the surplus in trade in services increased to an estimated £6.1bn, up fractionally from the previous month.
	Euro-Area Risk		Deepening concern	The Eurozone crisis continued to deepen throughout the latter half of 2011, leading many to predict one or more member states would be forced to drop out of the single currency. At the beginning of the third quarter, a second bailout for Greece was agreed, amounting to a comprehensive €109bn package of funding designed to resolve the Greek crisis and prevent contagion among other European economies. But despite this, knock-on effects continued to be felt: yields on government bonds in countries such as Spain and Italy rose sharply, and credit ratings for Italy were cut in September. The gloom intensified into the fourth quarter, though in late October, European leaders reached a "three-pronged" agreement to tackle the debt crisis. However, in December plans to tackle the crisis via changes to the Eurozone treaty failed due to objections by the UK and Hungary. Into the new year, further bad news came when Standard & Poor's downgraded France and eight other eurozone countries. Shortly after, the agency also downgraded the EU bailout fund.
	UK - Ease of Doing Business Index, 2011 (World Bank)	4th out of 183	7th out of 183	According to the current rankings published by the IFC and World Bank (via www.doingbusiness.org), the UK's position among the world's most business-friendly states has slipped a little: it ranks as the 7th most conducive economy in which to do business, down from 4th at the time of the last report. However, perhaps despite the anecdotal evidence to the contrary, it ranks as the easiest country in the world in which to secure credit.
	FTSE 100	14.5% fall	10% rise	During Q2 and the first part of Q3 2011, the FTSE 100 had enjoyed a relatively stable period, fluctuating mainly between 5800 and 6100. However, the index crashed dramatically at the beginning of August 2011 around the time that European Commission President Jose Manuel Barroso issued warnings that the sovereign debt crisis was spreading beyond the periphery of the Eurozone. However, after sinking to its lowest level in over a year (4,944) at the beginning of Q4, the index has generally regained some lost ground, with the exception of one sharp correction in late November. Overall the index rose by 10% during the quarter to reach 5,572 at year end.
	UK Unemployment - % (ONS)	8.1% (Jun-Aug)	8.4% (Sept-Nov)	Having varied little in the two years to mid 2011, typically hovering between 7.7% and 8%, the UK unemployment rate has deteriorated noticeably in recent months. According to the most recent figures from the ONS, which covers the three months to the end of November 2011, the unemployment rate has increased to 8.4%. In volume terms, this increase equates to some 118,000 people joining the ranks of the unemployed to leave the total at 2.68m. It is the highest unemployment rate since 1995 and the highest number of people out of work since 1994.

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	UK Job Creation - KPMG / CIPD quarterly Labour Market Outlook		Further deterioration	Based on a survey of over 1,000 UK HR professionals, the Autumn 2011 CIPD Labour Market Outlook survey, issued in November 2011, painted a somewhat gloomy picture of the UK's labour market. The main indications from the report pointed to a further weakening of the labour market in the following three months. 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 fallen from -1 in the Summer quarter to -3 in the Autumn - the second fall in a row and the lowest score since the winter of 2010. Continuing the prevailing trends, the private sector is still showing a strongly positive employment balance (+20), but it is steadily falling. Meanwhile the public sector continues to show a strongly negative balance (-50).
	UK Job Creation - Antal International Survey		48% of UK firms hiring (Jul 2011)	Published in December 2011, the latest quarterly survey of hiring and firing trends by Antal International, which covered over 19,000 organisations in 52 countries, has found that global employment markets for professionals and managers is bearing up comparatively well give the Eurozone crisis. However, the UK market shows a different picture, with the number of businesses recruiting for new managerial or professional roles dropping by 13% over the previous quarter to 48%. That said, the number of UK businesses planning to shed jobs also fell from the levels seen the previous quarter, suggesting that businesses are generally seeking to retain staff. Among the more active sectors in the UK are FMCG, pharmaceuticals and technology (hardware), which are the most likely to be hiring (79%, 75% and 73% respectively).
	ICAEW UK Business Confidence Monitor	Declining confidence	Sharply falling confidence	The latest ICAEW/Grant Thornton UK Business Confidence Monitor shows a very marked collapse in business confidence during the final three months of 2011. According to the report, the Confidence Index crashed from +8.1 in Q3 2011 to -9.7 in Q4 2011, its sharpest single quarterly fall since the survey began. It now stands at its lowest level since the bottom of the recession in 2009 and some 21.6 points below the same point in 2010. The main driver of the fall in the overall index is a sharp decline in the percentage of businesses that are more confident about prospects over the coming year, which has fallen from 39% at the time of the last report to just 26%. Based on the data, the report predicted a contraction in UK GDP of 0.2%, a figure which has since been corroborated by ONS preliminary estimates.
	Unquote"/Arle Barometer - UK Private Equity Buyout Figures	£3.5bn / 34 deals	£2.1bn / 26 deals	After a strong start to the year, with European deal activity up in Q1 and Q2, the buyout market somewhat tailed off, according to the Q4 unquote" Barometer, produced in association with Arle Capital. After slowing modestly in the third quarter, completions dried up in the final three months of the year. The UK market was no exception, with deal volumes and values falling by 24% and 42% respectively in the final three months of 2011.
	CMBOR - UK Private Equity Buyout Figures	£3bn	£2.3bn	The Unquote"/Arle data is corroborated by CMBOR's latest analysis, which shows similar declines in UK buyout activity at the end of last year - with deal values falling from £3bn in Q3 2011 to £2.3bn in Q4 2011. For the year as a whole, CMBOR calculates that the UK buyout market lost over a third of its value in 2011, with £12.1bn of deals closed during the year. This decline was mainly due to a fall-off in large transactions, with the mid-market remaining relatively robust, reflected in the average deal size of UK buyouts in 2011, which fell to £68.7m, compared with £102.6m in 2010. The high proportion of secondary buyout deal flow continued to be a theme in 2011, accounting for 45% of the value of all buyouts completed in the year.
	CMBOR - UK Exit Figures	142 (full year 2010)	151 (full year 2011)	Despite declines in deal flow, the UK private equity exit backlog continues to work its way through the system, with 2011 seeing another annual increase in the numbers of exits achieved. Of the 151 exits secured in 2011, roughly 1/3 were sold to trade buyers and 1/3 to other private equity firms. However, 43 of these exits involved 'sales to creditors' according to CMBOR.
	Dow Jones - UK Venture Capital Investment		Activity levels falling	In line with the trends in the buyout market, Q4 offered little comfort for venture investors in Europe, according to figures released in January 2012 by Dow Jones VentureSource. The number of venture deals recorded in Q4 2011 fell to its lowest point during the year, some 43% down on Q3 and 38% below the final quarter of 2010. In annual terms, levels of VC investment dropped by 14% in value and 19% in volume during 2011, leaving activity at its lowest level since the statistic was launched in 2000.
	Zephyr Monthly M&A report - Western Europe Deal Data	Deal volume: 4,859; Deal value: €109,598m	Deal volume: 4,832; Deal value: €144,825m	According to the latest Zephyr Monthly M&A report, Western European deal-making activity tumbled 61% from €69,104m in December 2011 to €26,786m in January 2012. The result was also significantly lower (38%) than the €43,102m the region attracted in January 2011. However, the picture for the UK is more positive - in January 2012, British companies received the bulk of investments in Western Europe, totalling €7,801m, 2% higher than the total for December 2011 (€7,682m), and 13% higher than a year ago in January 2011 (€6,930m). The UK also led by deal volume in January 2012 with 410 deals, more than 3.5 times the number targeting German businesses, which ranked second. This activity appears to reinforce a report published by Ernst & Young (6 October 2011) which highlighted that UK companies are more likely to embark on M&A activity in the next 12 months compared with their global peers as slack economic output forces corporates to look to deal making in order to target growth.

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