Arbor Square Associates: Notes on the UK Economy Series

The Climate for Private Equity and Business In General

Seventh Edition February 2013

Traffic Light	Indicator	Q3 2012 data	Q4 2012	Notes
Red	UK GDP growth Q4 2012	0.9% growth	0.3% contraction	After showing positive signs in the third quarter, the UK's economy once again shrank in the fourth quarter of the year, according to the preliminary estimates released by the Office for National Statistics in late January 2013. These early indications (subject to two further revisions) suggest that the country's GDP shrank by 0.3% in the period and remained flat between 2011 and 2012. The most significant contributor to the overall decline in the final three months of the year came from the production sector, which in turn was heavily influenced by issues in the mining and quarrying segment, as well as weakness across all manufacturing areas. There was also no positive offset from the services sector, which actually saw a marginal contraction over the quarter. On the more positive side, after three successive quarters of heavy contraction, construction output showed growth, albeit modest.
Amber	Economic growth forecasts for 2013		2013 Forecasts: 0.9%-1.2% growth	Growth forecasts for the UK economy in 2013 remain subdued on the back of domestic issues and eurozone-related problems. Published forecasts range from a low of 0.9% growth (OECD) to 1.2% (Office for Budget Responsibility). In late January 2013, the IMF cut its growth forecast for the UK by 0.1% to 1%. However, this remains substantially higher than the IMF forecast for the eurozone, which it predicts will contract by 0.1% this year.
Amber	US GDP growth Q4 2012	3.1% growth	0.1% decline	Following three quarters of healthy growth, the US economy unexpectedly slipped into decline in the fourth quarter of 2012, according to the first advance estimates from the Bureau of Economic Analysis. These estimates, which are subject to significant revisions, suggest that the US economy shrank by 0.1% over the previous quarter (3.1% growth). The BEA states that the fall in real GDP during the quarter came primarily as a result of lower private inventory investment and federal government spending, as well as a drop in exports. These negatives were partially offset by contributions from personal consumption expenditures (PCE), non-residential fixed investment and residential fixed investment. Imports fell too, cushioning the decline. Other commentators have also suggested that the hurricane that caused major disruption across large parts of the East Coast during the last quarter will also have had a negative effect. Overall, though, US GDP is expected to have grown by 2.2% over 2011.
UK Output - Sub-sector trends for Q4 2012				
Red	Overall production	0.7% growth	1.8% decline	After recording growth of 0.7% in Q3 (the first positive figures for some time) the UK's overall production output fell sharply in the final quarter of the year, declining by 1.8%. A major factor behind this was the mining and quarrying sector, which saw a decline of 10.2% after unscheduled maintenance problems at the UK’s largest North Sea oil field reduced overall oil & gas extractions during the quarter. If mining and quarrying are extracted from the economic figures, the overall GDP decline would improve to 0.1% from 0.3%. There were also declines in manufacturing (see below) and agriculture and fishing (down by 0.6%), partially offset by growth in utilities and water supply & sewerage.
Red	Manufacturing	0.7% growth	1.5% decline	The latest ONS figures show that the UK's manufacturing output fell back sharply into negative territory in the fourth quarter after having seen some growth between July and September. Overall, manufacturing saw a decline of 1.5% in Q4, versus growth of 0.7% the previous quarter. This represents the largest single quarterly decline in manufacturing since the first quarter of 2009, and it means that the decline for 2012 as a whole stands at 1.8% . Looking at the latest ONS monthly release for the Index of Production (covering November 2012), the most significant contributors to the drop in seasonally-adjusted manufacturing output were the manufacture of basic metals & metal products (-2.7%), electrical equipment (-6.4%) and computer, electronic & optical products (-3.4%). Positive contributions came from the manufacture of transport equipment (3.1% growth) and the manufacture of machinery & equipment, which rose by 3.6%.
Amber	Construction	2.5% decline	0.3% growth	Following three successive quarters of significant contraction, the latest ONS figures show that construction output returned to growth in the fourth quarter, increasing by 0.3%. However the outlook for the construction sector remains fragile: building work is still at low levels and the Markit/CIPS purchasing managers' index for the sector remained well below the 50 mark in December 2012, indicating no change in output. However, there is some cautious optimism among construction firms over the prospects for the next 12 months and businesses and new jobs are being created in the sector for the first time in several months.

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	Services (overall)	1.2% growth	Marginal decline, rounded to 0.0%	The total output of UK services shrank substantially in the final quarter of the year, declining from relatively robust growth of 1.2% in the third quarter to a marginal decline in the last three months (rounded to 0.0%). Overall, Q4 saw declines in 2 of the 4 main services segments, almost exactly matched by gains in the other two. Although it is difficult to quantify, it seems likely that a significant portion of this contraction is down to 'fall-back' effect following the major boost to the economy provided by the Olympics and Paralympics in Q3. Particular evidence of contraction was recorded in the following sectors: sports activities, amusement and recreation; accommodation services; food and beverages services; and land transport. The negative picture is backed up by the most recent Markit/CIPS UK Services PMI (Dec 2012), which pointed to a small drop in service sector activity - the first in two years. The survey's headline index dropped to 48.9 from 50.2 in November.
	Transport Storage & Communication	0.2% growth	0.7% growth	The seasonally-adjusted index for transport, storage & communication (TS&C) from the ONS grew by 0.7% in the final quarter of 2012, following an increase of 0.2% in the previous quarter. The most significant contributions to output in this area came from motion picture, video & TV and programming & broadcasting, which all made gains over the previous quarter when demand had been low due to the effect of the London Games. Year-on-year, output from the TS&C segment grew by 0.4%.
	Financial & Business Services	0.9% growth	0.4% growth	Output in the financial and business services sub-sector remained positive in Q4, though growth fell back somewhat. Overall this part of the economy grew by 0.4%, compared with 0.9% in the previous quarter. According to the ONS, employment activities made the most important positive contribution during the final quarter. In year-on-year terms, the financial and business services segment grew by 1.2% between the final quarter of 2011 and Q4 2012.
	Distribution, Hotels and Restaurants	1.9% growth	0.4% decline	One area where the 'fall-back' effect was clear was in the index for distribution, hotels & restaurants. Here, output was estimated to have declined by 0.4% in the final quarter of the year - in stark contrast to the third quarter, when it grew by 1.9%. Unsurprisingly, the largest contributions to the decrease were from retail, accommodation and food & beverage services. Distribution, hotels & restaurants increased by 1.7 % between Q4 2011 and Q4 2012.
	Government and Other Services	1.6% growth	0.7% decline	However, clearly the sector most affected in the post-Olympics period was government and other services, according to the ONS. Output in this sector slumped by 0.7% in Q4 2012, following an increase of 1.6% in the previous quarter. Sports activities, amusement and recreation activities made the largest contribution to the decrease, with a fall off the high in 2012 Q3 caused by Olympic ticket sales. Nevertheless, in annual terms output in this sector grew by 1.9% between the end of 2011 and Q4 2012.
	UK Retail Sales		Comparison with Q3: 0.1% decline (value) 0.6% decline (volume)	The latest retail sales figures from the ONS continue to show a mixed picture, though the longer-term picture is one of modest improvement. Compared with the same month a year previously, the December 2012 stats reveal that the seasonally-adjusted volume of goods bought was estimated to have increased by 0.3%, while the value of goods bought rose by 0.7%. Meanwhile, the year-on-year growth in quarterly terms is more significant: the volume and value of goods in Q4 rose by 0.6% and 1.2% respectively over the same period of 2011. And if automotive fuel costs are stripped out, these figure jump to 1.4% (volume) and 2.1% (value). However, December 2012 showed some weakness versus the previous month, as did Q4 versus Q3. Meanwhile, the news for online retailers continues to be relatively positive: in December 2012, online sales accounted for 10.6% of all retail sales, a drop of 0.1% from the previous month, but an increase of 1.2% compared with December 2011.
	UK Consumer Confidence	-30 (October 2012)	-26 (January 2013)	According to data from GfK NOP (UK), the index of consumer confidence in the UK improved to -26 in January of 2013 from -29 the previous month, though it still remains some way behind the 18-month high of -22 seen in November. In context, the current levels compare with an average of -9.5 since the measure was launched over 30 years ago. The latest survey showed that consumer appetite to make major purchases was at its highest level for a year.
	UK CPI inflation	2.2% September 2012)	2.7% December 2012)	The latest figures from the ONS show that the CPI measure of inflation remained steady at 2.7% (percentage change over 12 months) for the third month in succession. Although this is above the 2012 low point of 2.2% seen in September, it represents a significant fall from the 4%+ levels seen in late 2011. However, within the headline figure there were major areas of upward and downward pressure on inflation. As far as upward pressure is concerned, the most notable impact has come from increases in gas and electricity bills, as anticipated price rises have been implemented. Helping to offset these have been air fares, which have risen at a far slower rate than a year ago, and the price of motor fuels, which were down on the previous year. Meanwhile, the annual RPI measure of inflation stood at 3.1% in December 2012, up from 3.0% the month before.

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	UK interest rates	0.5%	0.5%	The Bank of England's Monetary Policy Committee voted unanimously in December 2012 to maintain interest rates at 0.5%. The Committee also voted (eight to one) to maintain the stock of asset purchases financed by the issuance of central bank reserves at £375bn. The single advocate of an increase in the asset purchase facility argued that that the poor growth forecasts merited such a move, while any upward pressure on inflation would be minimal.
	UK net debt	£1009.6bn (Apr-Dec 2011)	£1,111.4bn (Apr-Dec 2012)	According to the latest ONS figures, the UK's public sector net debt for the year to date (April to December 2012) stood at £1,111.4bn at the end of December 2012, equivalent to 70.7% GDP. At the same point last year the figure (excluding the temporary effects of financial interventions, such as bank bailouts) stood at £1,009.6bn, or 66% of GDP. This set of figures (as well as the three below also relating to public sector finances) has fuelled fears that the UK could potentially lose its AAA rating, as all three major ratings agencies have put the AAA status on 'negative outlook'.
	UK Net Borrowing	£99.3bn (Apr-Dec 2011)	£106.5bn (Apr-Dec 2012)	The UK's public sector net borrowing figure stood at £15.4bn in December 2012, some £600m higher than the same point in 2011. On the financial year basis, public sector net borrowing in the period April to December 2012 (excluding the capital payment recorded as part of the Royal Mail Pension Plan transfer in April 2012) was £106.5bn - some £7.2 billion higher than the same period in the 2011/12 fiscal year, when net borrowing stood at £99.3bn.
	UK Current Public Sector Budget Deficit	£85.2bn (Apr-Dec 2011)	£95.0bn (Apr-Dec 2012)	The most recent ONS figures show a current budget deficit, excluding the temporary effects of financial interventions, of £13bn in December 2012. This compares with a deficit of £12.5bn in the same month last year. In YTD terms, the deficit stands at £95bn for April to December, versus £85.2bn in the same period of 2011.
	Central government current receipts (ONS)	£381.5bn (Apr-Dec 2011)	£382.8bn (Apr-Dec 2012)	Central government receipts for December 2012 were £43.8bn, some £1.5bn (or 3.6%) higher than the same month in 2011. However, for the fiscal year to date, central government current receipts stood at £382.8bn in December - just 0.3% above the April-December figure for the previous fiscal year, underlining that spending continues to rise more rapidly than income.
	UK Banking Resilience (Bank of England Stability Report)		Continue to build capital levels to protect against heightened risk	The Financial Policy Committee (FPC) met most recently in November 2012. While it noted that there had been some improvement in the outlook for financial stability, most notably in the easing of concerns around severe eurozone stress, global growth prospects and financial conditions remain weak. The latest stability report warns that a number of factors are combining to imply that the capital buffers of UK banks remain lower than they may seem and that more rapid progress in tackling balance sheet issues and building capital buffers is needed. This would go towards protecting against the significant risk to the UK banking sector that remains, while still maintaining a flow of lending to the real economy.
	UK Gross bank lending		Further contraction in lending to UK businesses; but, cautiously optimistic outlook	The latest data from the Bank of England's Trends in Lending report was released in January 2013. Its findings again showed that lending to UK businesses continues to contract. Overall, the stock of lending fell by around £4bn in the three months to November 2012, despite a marginally positive outflow of cash in October. What's more, the overall picture is reflected across the corporate landscape, with lending to both SME businesses and large companies contracting. On a slightly more positive note, the report does point to the fact that some major UK lenders have indicated that they expect their net lending to SMEs (total lending, less repayments) to increase in 2013. Meanwhile, for larger groups it is notable that the total value of new syndicated lending rose in the final quarter of 2012, though the year as a whole fell short of previous years. As far as consumers are concerned, the picture is a slightly improving one: mortgage approvals by local lenders were higher in the three months to November than they had been in the previous three months, while total net consumer credit flows were positive over the period.
	UK Loan pricing		Improving picture in Q4	According to the latest Credit Conditions Survey from the Bank of England, released in January 2013, there is some further positive news in the UK lending market. Firstly, availability of credit to both domestic and corporate borrowers is reported to have grown in the fourth quarter, while demand has also shown signs of increasing across both segments. In addition, lenders have reported that spreads on both secured and unsecured lending to households tightened significantly in Q4, and were expected to tighten further in the first three months of 2013. Similarly, there is evidence to suggest that spreads on lending to large and medium-sized firms has also tightened significantly over the last quarter, though these have largely remained unchanged for small firms.

Arbor Square Associates
+44 (0)20 7993 2008 marcwhiteside@arborsquare.com
Website: www.arborsquare.com

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	UK Bond issuance		Liquidity picking up	According to the Bank of England's latest Asset Purchase Facility Report, covering the fourth quarter of 2012, conditions in the UK bond market are showing cautious signs of improvement. Although nominal gilt yields changed relatively little over the period, they did end up 11 basis points higher than they had been at the end of Q3. There are also signs that the corporate debt markets are picking up, echoing some of the commentary above: Sterling investment grade non-financial corporate bond spreads narrowed over Q4, indicating growing investor demand. And, while bid-ask spreads remain well below the levels seen at the height of the financial crisis, they are higher than those seen in 2010 and early 2011. Overall, the level of bond issuance remained very strong over Q4, far greater than in the same period in 2011 and significantly above pre-crisis quarterly averages.
	Deloitte UK CFO Survey (Q4 2012)		Increased optimism	After see-sawing sentiment throughout 2012, CFOs are looking ahead to 2013 with considerably more optimism than they were a year ago, according to the latest edition of Deloitte's CFO survey, released in January 2013. The main fears over the last year centred on the potential for the single currency to collapse and these fears have been significantly allayed. Also, the return to economic growth for the UK in Q3 had a positive effect. Nevertheless, the survey does indicate that the central fear for CFOs remains the economy: there is still real concern about the fragility of any recovery and CFOs expect growth to be difficult to come by. As a result, they remain defensive in terms of strategy. On the plus side though, there appear to be fewer worries about the financial stability of larger businesses, with fears about margins, cash flow and credit availability not ranking high. In fact, credit conditions are seen as relatively benign, with costs standing at their lowest levels since the beginning of the financial crisis. The fears surrounding a lack of growth appear to be more to do with a lack of opportunity, rather than a shortage of funding. Importantly, the report also suggests that CFOs are broadly supportive of the government's fiscal policies.
	UK Business Investment (ONS)	£29.3bn (Q2 2011)	£31.5bn (Q3 2012 Revised)	The most recent figures from the ONS on business investment (Q3 2012 revisions, published in December 2012) show that the seasonally adjusted business investment totals rose for the second quarter in succession, after several years of decline. Total business investment for Q3 rose by over £1.1bn - almost 4% - to reach £31.5bn. Compared with the same quarter of 2011, the increase was 5.1% or £1.5bn. Overall, non-manufacturing investment provided the bulk of the increase in Q3, rising by £1bn to £28.2bn (a 3.7% increase). Nevertheless, manufacturing investment actually grew at a proportionately higher rate over the same period, increasing by £100m (4.7%) to £3.3bn.
	UK Trade Position	£2.6bn deficit (Sept 2012)	£3.5bn deficit (Nov 2012)	The latest ONS figures, covering up to the end of November 2012, showed that the UK's deficit on seasonally adjusted trade in goods and services improved slightly in November, after deteriorating somewhat in October. Overall, the latest figure for the balance of trade shows a deficit of £3.5bn, down from £3.7bn in October, but up from £2.6bn in September. The November figure is also some £500m higher than it was in the same month of 2011. The marginal improvement in November was driven by a narrowing of the deficit in the trade of goods with the EU, which fell from £5bn to £4.6bn. The surplus in the balance of trade in services weakened slightly to £5.7bn from £5.8bn in October (£6.3bn in November 2011). In quarterly terms, the pattern looks more positive, with the deficit on trade in goods standing at £22.3bn in the three months to November - some £900m less than the preceding three months and £1.4bn less than the deficit in same period of 2011.
	Euro-Area Risk		Continuing concern, though some pressure eased	While the eurozone crisis continues to cause concern across global economic markets, the region is in a significantly more stable state than it was a year or even six months ago. Aggressive austerity measures in key markets such as Italy and Spain, though unpopular, have made inroads into curbing budget deficits and have eased pressures across the region. According to some commentators and senior economists, Germany's pro-austerity measures and the commitment by the ECB to spend heavily on bond purchases have played a key role in bringing the region back from the brink. Nevertheless, there remain significant headwinds for eurozone members - most notably the sluggish economic performance in the region. In December the ECB itself downgraded its 2012 forecast for economic growth in the eurozone to show a contraction of 0.5% (versus an original estimate of -0.4%), while the bank's 2013 forecast for the 17-nation bloc stands at -0.3%. Into 2013, regional concerns are being augmented by uncertainty over the outcome of upcoming Italian elections, as well as fresh political crises surrounding alleged corruption in Spain. Both of these important European economies still present real danger of defaulting on huge levels of debt, though the risk is much less than it was six months ago.

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	FTSE 100	1.8% rise	1.3% rise	The relative easing of the eurozone crisis described above is reflected in a much more robust performance of the FTSE 100 index over the second half of 2012. After having dropped very sharply to a low point of 5,260 late in the second quarter, the index recovered in the third quarter, rising by 1.8% from a starting value of 5,641 to finish the period on 5,742. The rise continued during the final three months of the year, though the index did suffer one sharp dip in the middle of the quarter, dropping back to 5,606. The index closed the year on 5898 - a rise of 1.3% - and has since climbed steeply to a high of 6,347 in late January 2013. This represents its highest level since the second quarter of 2008.
	UK Unemployment - % (ONS)	7.8% (Jun-Aug 2012)	7.7% (Sept-Nov 2012)	The UK's unemployment rate has continued to improve little by little since peaking in the middle of 2011. According to the latest figures from the ONS, which cover September to November 2012, the unemployment rate dropped in the period to 7.7%. This fall is a marginal one compared with the previous three-month period (0.1%), but is a more substantial drop versus the same period of 2011, when the unemployment rate stood at 8.4%. The annual comparison shows that the total number of people in employment increased by 552,000, the largest annual increase since 1989. Looking at micro trends, it is interesting to note that the fall in unemployment in the latest three-month snapshot is due entirely to a reduction in the jobless figures for men, with the number of unemployed women remaining stable at 1.08m. It is also important to note that the improvements in the job market are being driven by the private sector, while the public sector continues to shed jobs. The latest figures from the ONS (up to September 2012) show that the number of people employed in the public sector fell by 24,000 between June and September and by 324,000 in the year to September 2012.
	UK Job Creation - KPMG / CIPD quarterly Labour Market Outlook		Strongly improving picture	Based on a survey of over 1,000 UK HR professionals, the Autumn CIPD Labour Market Outlook survey, issued in November 2012, revealed that the strong pattern of employment growth emerging through the year looks likely to continue. The report's 'net employment measure', which tracks the proportional difference between employers that intend to increase their workforce during the upcoming quarter and those that intended to do the opposite, projected employment growth for the third successive quarter; the measure rose to +7 from +5 in the summer release. Within this, and reflecting the government's own figures, the private sector employment balance stands out at +18 (though it has fallen from +28 three months ago). Meanwhile the public sector balance has improved from –36 in the summer release to –17 during the same period, suggesting that public sector job losses are at least slowing. The erosion in private sector growth is most likely to be down to weakness in the manufacturing sector.
	UK Job Creation - Antal Global Snapshot		46% of UK firms hiring (Q4 2012)	The latest edition of the Antal Global Snapshot, which tracks hiring and firing trends in the world's most important developed and emerging economies, was issues in January 2012 and is based on data from some 17,000 organisations in 52 countries. According to the report, the UK job market remained stable over the quarter, with the percentage of companies hiring managerial or professional staff staying level at 46%. Meanwhile, the percentage of companies seeing a net reduction in staff levels stands at 30% - in line with other European nations and slightly lower than anticipated. In terms of the sectors currently hiring, construction & engineering, technology hardware, automotive & aerospace and consumer goods, showed the most positive current and predicted trends. Meanwhile, the banking sector is clearly the most likely to be shedding jobs now and in the short term.
	ICAEW UK Business Confidence Monitor (BCM)	+4.2 (Oct 2012)	+12.8 (Jan 2013)	The latest ICAEW/Grant Thornton UK Business Confidence Monitor (Q1 2013, released in January) shows that business confidence is gathering momentum and has reached its highest level since the Spring of 2011. The report reveals that the BCM index rose sharply in the most recent quarter to reach +12.8 from +4.2 three months previously. The confidence index equates to a predicted GDP growth of +0.4% for the first three months of 2013. Looking at the finding in more detail shows that respondents are broadly more positive for 2013 across most financial measures, with key predictions for turnover and profitability all rising, albeit at a slower rate than pre-crisis averages. However, one area of concern surrounds the potential to recruit the right management to be in place once the market turns the corner. There is also continued caution reflected in the relatively low levels of capital investment and salary growth.
	Unquote"/Arle Barometer - UK Private Equity Buyout Figures		Strong Q4 values, poor 2012	Although there was a small increase in the total number of European buyouts completed in the final quarter of the year - up 5 to 95 - dea volumes remain weak compared to historical levels; the last three quarters of 2012 all fell well below the quarterly average for the previous few years. However, the last three months did show a surge in buyout values as larger deals came back into the frame: in all there were eight European €1bn+ deals during the quarter, the joint highest of any quarter since Q3 2007. Four of the five largest deals took place in the UK (Annington Homes, B&M Retail, Premium Credit and Acteon); overall, the UK generated more than a third of all European buyouts in the final quarter and close to half their total value.

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	CMBOR - European Buyout Figures		2012 values slump	The latest figures from the Centre for Management Buyout Research (CMBOR) are somewhat at odds with the findings from unquote", though no detailed quarterly analysis was published by CMBOR. Overall, CMBOR recorded 544 private equity backed buyouts in Europe up to mid-December 2012, with a total value of €49.5bn. This represented a decrease of over 20% on the value of deals recorded in 2011 and the lowest value seen since 2009. CMBOR also registered an especially weak Q4 in terms of value. However, on a more positive note, the value of exits recorded in 2012 exceeded the value of new buyouts for the third successive year, despite weak public markets. In total, €51.3bn of exits were recorded in 2012, compared with €79.5bn the previous year.
	Dow Jones - UK Venture Capital Investment		Weak Q4 adds to annual decline	A weak final quarter for venture capital investment saw this industry segment fall below 2011 levels, according to the latest figures from Dow Jones VentureSource. In total, just 233 European venture deals worth €967m were completed during the final three months of the year - representing declines of 22% and 26% in volume and value over the same period of 2011. In annual terms, venture investors committed some €4.4bn to 1,074 deals during 2012, down 9% in terms of capital invested and 11% in number of deals completed versus the previous year. Despite seeing a decline in line with the overall European figures, the UK remained the most active market in 2012 as a whole, with domestic firms raising €1.4 billion of venture funding in 295 separate transactions. Germany, France and the Netherlands took the next three places in the rankings. However, perhaps the most worrying trend reported by VentureSource is the dearth of exit activity in the segment - especially via M&A routes: over the whole of 2012, just 145 venture-backed firms were exited via M&A, a 30% drop on 2011 and the lowest figure recorded in over a decade.
	MergerMarket M&A Roundup 2012		Values 5.4% down on 2011	According to the latest release from MergerMarket, 5,100 European M&A transactions worth $687bn were completed in 2012, leaving overall value some 5.4% down on the previous year. However, the value figure was boosted significantly by the deal between Glencore and Xstrata, which at $45.6bn represented a full 6.6% of European M&A value for the year. In sector terms, only defence and energy/mining/utilities saw any meaningful increase in activity during 2012. Meanwhile, an analysis of activity by region shows that UK/Ireland remained the most active in Europe, with 21.7% of the total market by value and 22.4% by volume.

Arbor Square Associates
+44 (0)20 7993 2008 marcwhiteside@arborsquare.com
Website: www.arborsquare.com