Arbor Square Associates: Notes on the UK Economy Series
The Climate for Private Equity and Business In General
Sixth Edition August 2012

Traffic Light	Indicator	Q1 2012 data	Q2 2012 data	Notes
	UK GDP growth Q2 2012	0.3% contraction	0.7% contraction	According to the latest figures released by the Office for National Statistics in late July 2012, the UK economy shrank by 0.7% in the three months to June - a far higher fall than had been anticipated. The heavy fall follows contractions of 0.3% in Q1 2012 and 0.4 in Q4 2011, meaning that the UK economy is witnessing its first double dip recession since the mid-1970s. As it had been the previous quarter, the most important factor behind the overall decline was a sharp drop in construction activity, though the ONS has also suggested that other external factors, such as the additional bank holiday and the poor weather throughout most of the Spring, may also have had a negative effect. In fact the Bank of England had predicted that the extra bank holiday could knock up to 0.5% off the GDP output over the period. Still, it is quite possible that subsequent data may reveal the fall to be less sharp and the effect of the Olympic games is expected to provide a boost to economic figures for the third quarter.
	BoE Quarterly Inflation Report	0.8% GDP growth (May 2012)	0% growth (Aug 2012)	On August 8, the Bank of England sharply revised its economic growth forecasts downwards as the reality of double-dip recession becomes more clear and the Eurozone crisis continues. In its latest quarterly inflation report, the bank has forecast that the UK will see no economic growth at all during 2012. This compares with forecasts of 2% a year ago and 0.8% at the time of the last report in May.
	US GDP growth Q2 2012	2.0% growth	1.5% growth (advanced estimate)	After posting robust growth figures for the first quarter of 2012, advance estimates from the Bureau of Economic Analysis suggest that some of the wind has been taken from the US economy's sails. In the first three months real GDP increased by 2.0%, while these preliminary estimates for Q2 suggest that growth has slowed to 1.5%. The growth in Q2 was driven mainly by continuing growth in personal consumption expenditures (PCE), as well as strong exports, non-residential fixed investment, private inventory investment and residential fixed investment. On the negative side, state and local government spending and imports affected the figures.
UK Output - Sub-sector trends for Q2 2012				
	Overall production	0.5% decline	1.3% decline	With output decreasing in four of the five production segments, the seasonally adjusted index of production declined by 1.3% in the second quarter of 2012, compared with a 0.5% decline in the first three months. Manufacturing contributed the most to the decline, followed by mining and quarrying, which dropped by 5.9%. Overall, production output decreased by 3.2% between Q2 2011 and Q2 2012
	Manufacturing	0.3% decline	1.4% decline	According to ONS data, the UK's manufacturing output fell for the fourth quarter in succession. Showing a fall of 1.4%, it was the largest single quarterly decline in manufacturing since the first quarter of 2009. The largest contributors to this fall came from the manufacture of pharmaceutical products & preparation industries and the manufacture of food, drink & tobacco. On the plus side, the manufacture of transport equipment has grown robustly in the last year. The Markit/CIPS UK Manufacturing PMI stood at 48.6 in June 2012, up slightly from the previous month's three-year low of 45.9. The average Q2 figure for the index is the lowest since Q2 2009.
	Construction	4.9% decline	5.2% decline	The latest ONS figures show that the seasonally adjusted index of construction output decreased by 5.2 per cent in Q2 2012, following a decrease of 4.9 per cent in the previous quarter. Overall, this means that construction output has decreased by 9.7 per cent between Q2 2011 and Q2 2012. Sharply falling public sector construction is one of the main factors behind the fall. The ONS figures are backed up by the latest Markit/CIPS UK Construction PMI published at the beginning of July, which showed the fastest rate of contraction in the index for well over two years. The latest monthly fall in the index was also the greatest since February 2009.
	Services (overall)	0.2% growth	0.1% decline	The total output of UK services shrank very marginally in the second quarter of the year, from a weak positive figure of 0.2% in Q1 to a slight contraction of 0.1%. Underlying this was a mixed performance in the sectors that make up the services output, with growth in business services & finance and in the government sector offset by a contraction in the distribution, hotels & catering and transport, storage and communications sectors. The fragile picture is underlined by the most recent Markit/CIPS UK Services PMI, which showed business confidence down to a six-monthly low against a backdrop of fragile demand, escalating costs and margins under pressure. The main index in the survey stood at 51.3, down from 53.3 in May and the lowest reading since October 2011.
	Transport Storage & Communication	1.0% increase	1.4% decline	The seasonally adjusted index for transport, storage & communication from the ONS decreased by 1.4 per cent in Q2 2012, following a 1.0 per cent increase in the previous quarter. Underneath that headline, output decreased in eight of the twelve components that make up the index, with the most notable negative contributions coming from computer programming, consultancy & related activities, postal & courier activities and air transport. Versus the same quarter last year, transport, storage & communication remained flat.
	Financial & Business Services	0.3% decline	0.1% growth	Output in the financial and business services sub-sector also returned to growth - albeit marginal - in Q2 after contracting by 0.3% in the first three months of 2012. In total, output increased in almost half of the 21 components that make up the index, with employment activities and legal & accounting activities making the largest positive contributions to the increase. Although business services & finance increased by 0.8 per cent between Q2 2011 and Q2 2012, growth is significantly lower than its historical average and this is a clear indication of weaker demand across the economy.
	Distribution, Hotels and Restaurants	0.3% growth	0.4% decline	The seasonally-adjusted index for distribution, hotels and restaurants decreased by 0.4% in Q2 2012, reversing the 0.3% increase seen in the previous quarter. The output for this segment is also down 0.3% over the same quarter of 2011. Q2 output fell in three of the sector's five components, with wholesale and retail having the most negative impact on the overall figures.
	Government and Other Services	0.3% growth	0.3% growth	According to the ONS, government and other services was one of the few sections of the UK economy to register any growth in the second quarter of 2012, maintaining the increase of 0.3% seen the previous quarter. Output increased in 10 of the 13 components, with health and sports activities, amusement & recreation making the most positive contributions to the overall growth. In year-on-year terms, this area saw relatively robust growth of 1.3%.
	UK Retail Sales		Comparison with Q1: 1.4% decline (value) 0.7% decline (volume)	The latest stats from the ONS show a mixed picture for the retail sales environment, with annual comparisons looking more healthy than monthly and quarterly comparisons. All retail figures for June dropped by 0.5% in value terms over May figures, but increased by 0.1% in volume terms. In quarterly terms, the decline was more uniform with Q2 figures declining by 1.4% and 0.7% in value and volume respectively over the previous quarter. However, compared with the same quarter of 2011 retail sales grew by 1.8% in value and 0.8% in volume, while June 2012 was up on the same month in 2011 by 1.9% (value) and 1.6% (volume). In the five-week period for June 2012, an estimated £32.7bn was spent (non-seasonally adjusted), up from £26.4bn in the four-week period of May 2012 and £32.1bn in June 2011. This equates to an average weekly spend of £6.5bn in June 2012, compared with £6.6bn in May 2012 and £6.4bn in June 2011. Among the key factors behind the latest figures were the slowing of store price inflation (down to 0.3% in June from 1.2% in May), the poor June weather and the bank holiday changes for the Diamond Jubilee celebrations.
	UK Consumer Confidence	44 points (April)	41 points (May 2012)	The latest (and last) edition of the Nationwide UK Consumer Confidence Index fell 41 points in May 2012 and is just four points above its lowest ever level of 37 in October 2011. The main Index is more than 34 points below its long-term average and is at its lowest level so far this year. The figures are not surprising given persisting economic concerns and the fact that consumers continue to remain cautious about making significant purchases. This is backed up by the latest GfKNOP index, a leading measure of sentiment among UK consumers, which has been stuck at between -29 and -31 for over half a year.
	UK CPI inflation	2.8% (May 2012)	2.4% (June 2012)	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 at the end of Q2 at just 2.4%, a further fall of 0.4% from the figure seen in May. This means that CPI inflation is at its slowest annual rate since November 2009 and in all likelihood will fall further in the coming months. According to some estimates, inflation on the consumer price index (CPI) may fall to just 1.6% by Q2 2013, with inflation for the year as a whole averaging 1.8%. During the second quarter, the most significant downward pressures on the CPI inflation came from clothing & footwear, transport and food & non-alcoholic beverages, while upward pressures during the period have come from recreation & culture where prices, overall, for audio-visual equipment have risen. Meanwhile, RPI annual inflation stood at 2.8% in June 2012, down from 3.1 per cent in May. The annual rate is the lowest since December 2009.

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	UK interest rates	0.50%	0.50%	The Bank of England's Monetary Policy Committee voted unanimously in July 2012 to maintain interest rates at 0.5%. On the back of poor business indicators both at home and abroad, the Committee also voted (seven to two) to increase the size of its asset purchase programme, financed by the issuance of central bank reserves, by £50bn to a total of £375bn.
	UK net debt	£1003.9bn (December 2011)	£1,038.3bn (June 2012)	At the end of June 2012, net UK debt (excluding the temporary effects of financial interventions, such as bank bailouts) stood at £1038bn, having broken through the £1 trillion barrier for the first time at the end of 2011. This equates to 66.1% of GDP and compares against net debt of £945bn (62.3% of GDP) at the same point a year earlier.
	UK Net Borrowing	£38.4bn (Q2 2011)	£14.9bn	The UK's public-sector net borrowing figure stood at £14.4bn in June 2012, some £500m higher than the same point in 2011. For the second quarter as a whole, total UK net borrowing stood at just £14.9bn, compared with £38.4bn for Q2 2011. However, this statistic is heavily distorted by two one-off transactions - firstly the £28bn transfer of the Royal Mail Pension Plan to the government and then a £2.3bn payment to the Government from the closure of the Special Liquidity Scheme. If these anomalies are discounted, net borrowing in Q2 2012 would stand at £45.2bn, some £6.8bn higher than in the same period the previous year.
	UK Current Public Sector Budget Deficit	£35.1bn (Q2 2011)	£41.6bn	The most recent ONS figures show a current budget deficit, excluding the temporary effects of financial interventions, of £13bn in June 2012. This compares with a deficit of £12.4bn in the same month lat year. The higher than anticipated deficit in June has prompted some to question whether the UK's Chancellor will be able to hit the Government's full-year fiscal goals. In quarterly terms, the deficit stands at £41.6bn for Q2 versus £35.1bn in the same period of 2011.
	Central government current receipts (ONS)	£119.1bn (Q2 2011)	£122.2bn	According to the latest ONS figures, central Government receipts for June 2012 were £40.9bn, some £1.4bn higher than in the same month in 2011. For Q2 2012, central Government current receipts stood at £122.2 bn - £3bn, or 2.5%, higher than in the same period of 2011.
	UK Banking Resilience (Bank of England Stability Report)		Build capital levels to protect against heightened risk	Following its most recent meeting in late June 2012, 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, continued to urge caution in the face of heightened risk. Amongst its recommendations was that the FSA should work with banks to ensure they build sufficient cushions of loss-absorbing capital and that for the time being these buffers should be above that set out to achieve Basel III standards. It is hoped that these bolstered financial cushions would support additional lending to the real economy, including via the planned 'funding for lending' scheme. The committees also urged banks to continue to show restraint with dividends and compensation
	UK Gross bank lending		Lending to UK businesses continues to contract	The latest data from the Bank of England's Trends in Lending report, published in July 2012, again showed that lending to UK businesses continues to contract. Overall, the stock of lending fell by around £3bn in the three months to May 2012, and lending to the sub-set of UK SMEs was also down. As far as larger groups are concerned, the drop in lending activity, according to lenders, largely reflects a lack of M&A activity, as well as the fact that many businesses had sought to bring forward re-financing discussions ahead of time and dealt with those issues during 2011. Meanwhile, the rate of secured lending to individuals was broadly stable over the three months to May, as was the level of mortgage approvals by all UK-resident mortgage lenders.
	UK Loan pricing		Widening spreads across UK industry	According to the latest Credit Conditions Survey from the Bank of England, demand for credit among UK businesses remains mixed according to the segment of industry: at the smaller end lenders reported that demand for credit had risen in the three months to the end of May 2012; meanwhile, demand from medium-sized firms was flat, while demand from larger companies dropped. As the report points out, the higher cost of wholesale funding for banks has continued to be passed on to the corporate and consumer sector. As such, lenders report that spreads have widened significantly on lending to medium-sized firms and have also widened for small firms. However, spreads remains level for large firms. Looking ahead into the third quarter, it is anticipated that spreads will rise significantly for firms across the board.
	UK Bond issuance		Deteriorating liquidity	According to the latest Asset Purchase Facility Report from the Bank of England, sentiment deteriorated considerably during the second quarter of 2012 on the back of growing concern over a number of Eurozone economies. As a result, nominal gilt yields fell over the period, with average yields coming in at approximately 40 basis points below those seen at the end of Q1. In terms of the UK corporate debt markets, Sterling investment-grade non-financial corporate bond spreads over gilt yields widened over the quarter despite a drop in corporate bond yields overall. Nevertheless, gross issuance over the period remained strong and the APF remained a net seller of corporate bonds.
	Deloitte UK CFO Survey (Q2 2012)		Fears of Eurozone fall-out and triple-dip recession	The instability in the Eurozone and general fears about poor macro-economic fundamentals continue to be the major concerns of UK CFOs, according to the latest edition of Deloitte's CFO survey, released in early July 2012. Although confidence has see-sawed significantly in previous quarters, the Q2 survey again showed that well over a third of UK CFOs think it probable that one or more European countries will leave the Euro before the end of 2012 (up from 26% of respondents in March). Commensurately, it appears that many of the larger UK corporates are stepping up their contingency plans in the event of Eurozone drop-outs. The slip back into recession is having a major impact on sentiment, with CFOs predicting a very strong likelihood of recession continuing until the end of 2012 or even a 'triple-dip' recession. Unsurprisingly, this climate of uncertainty is having a significant impact on corporate strategy and is leading to greater and greater risk aversion and defensive balance sheet strategies remain the order of the day.
	UK Business Investment (ONS)	£29.9bn (Q4 2011)	£30.5bn (Q1 2012 Revised)	The most recent figures from the ONS on business investment (Q1 2012 revisions, published in late June) show that the seasonally adjusted business investment total for the period rose by £600m - almost 2% - to reach £30.5bn. Compared with the same quarter a year earlier, business investment had risen by a more robust 14.8% (£3.9bn). Overall, the £0.6bn increase in the quarter came from growth in non-business investment , which grew by 2.2% to reach £27bn. Manufacturing investment, meanwhile, stayed virtually level at £3.5bn.
	UK Trade Position	£4.1bn deficit (April 2012)	£2.7bn deficit (May 2012)	The latest ONS figures, covering up to the end of May 2012, showed that the UK's deficit on seasonally adjusted trade in goods and services improved somewhat in May, falling to £2.7bn from £4.1bn in April (and £2.9bn in March). However, the May deficit is slightly larger than the same month of 2011 (£2.4bn). The improvement in the overall balance in trade during May came from a reduced deficit in the trade of goods, down from £9.7bn in April to £8.4bn in May. The surplus in the balance of trade in services remained level at £5.6bn. Excluding oil and erratic items, the seasonally adjusted volume of exports was 6.6% higher, and the volume of imports was 1.0% higher in May compared with April.
	Euro-Area Risk		Deepening concern	The Eurozone crisis continued to deepen throughout the first half of 2012, with predictions of a contraction in the region's economy compounding the crisis surrounding the rescue package for Greece and the rapidly escalating borrowing costs for the much larger Italian and Spanish economies. In June, Spain's Economy Minister indicated that the country would be formally making a request for up to €100bn in loans from Eurozone funds to try to help shore up its banks, but any optimism of a bail-out failed to improve sentiment and the cost of borrowing for Spain rose to its highest rate since the launch of the Euro. Although investor sentiment was improved by ECB hints that it would look at intervening to reduce borrowing costs for weaker Eurozone countries, the markets have as yet been unsure and bond prices continue to fluctuate. Investors have continually called for more direct action but so far this has failed to materialise.
	FTSE 100	1.2% rise	5.2% decline	After a relatively robust start to the year, the increasing turbulence in the Eurozone took its toll on the FTSE index during the second quarter. In Q1 the index rose from 5,700 points to a peak of nearly 6,000 points, and finished the period at 5,768 (1.2% up). However, early in the second quarter, after a short period of strong growth the index suffered a succession of very steep falls which saw it crash from a high of 5,875 (02/04/12) to 5,260 at the beginning of June. It went on to recover some of the ground lost before the end of the second quarter, finishing the period on 5,571 - some 5.2% down.

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	UK Unemployment - % (ONS)	8.2% (Dec '11 to Feb '12)	8.1% (Mar-May 2012)	Having peaked in the latter half of 2011, the UK's unemployment rate has improved a little in the first few months of 2012. According to the latest employment figures from the ONS - covering the period March to May 2012 - the number of jobless fell from 2.65m (December 2011 to February 2012) to 2.58m; expressed as a percentage, the unemployment rate now stands at 8.1%, down from a peak of 8.4% between September and November of 2011. However, underneath the headline statistics there were some more worrying trends, chiefly that the number of people out of work for more than two years rose in the period to 441,000, the highest level seen in 15 years. On the flip side, unemployment among the young (16-24 year olds) did improve slightly.
	UK Job Creation - KPMG / CIPD quarterly Labour Market Outlook		Improving picture	Based on a survey of over 1,000 UK HR professionals, the Spring CIPD Labour Market Outlook survey, issued in May 2012, showed the first signs of improvement in the labour market for over a year. After a steady rise in the implied rate of unemployment, the '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) improved from -8 in the previous report to +6. This equates to the highest net balance score since the Autumn of 2010. Although these positive signs seem to reflect some returning confidence, the poor economic news since the latest survey was concluded suggests that the figures this year may be somewhat volatile. The private sector is still showing the more positive employment balance (+25), but employment prospects in the public sector appear to be improving, although the trend is still negative (at -32, the scale of the fall in the public sector is less than it has been in some time).
	UK Job Creation - Antal International Survey		49% of UK firms hiring (Jul/Aug 2012)	The cautiously positive employment news for the UK is reflected in the snapshot of the market contained within the latest quarterly survey of hiring and firing trends by Antal International, which covered over 20,000 organisations in 50 countries. According to the report, despite the continuing Eurozone turmoil the UK's job market remained comparatively stable in the second quarter, with the number of companies hiring managerial or professional staff rising by 4% to 49%. However, the percentage of companies seeing a net reduction in staff levels has also gone up, though there are signs that this trend will reverse in the short term. In terms of the sectors currently hiring, medical, pharmaceuticals, packaging and luxury goods showed the most positive current trends, while banking, technology and retail are the most likely to be hiring over the coming quarter.
	ICAEW UK Business Confidence Monitor		Sharply falling confidence	The latest ICAEW/Grant Thornton UK Business Confidence Monitor (Q3 2012, released in July) underlines the fragility of the UK economy, showing its fourth largest decline since the measure had begun. Overall, the Confidence Index crashed from +12.0 in Q2 2012 to +1.1, with businesses downgrading their earnings forecasts in the face of continuing weak demand in the domestic market. The confidence index equates to a GDP growth of just +0.1% for the third quarter of 2012. Perhaps of more concern, forward-looking capital investment remains weak - predicted to rise by just 1% - suggesting that companies are likely to be holding onto any cash on their balance sheets. On the plus side, forecast growth in exports remains positive, with an increase of 3.6% predicted for the next year.
	Unquote"/Arle Barometer - UK Private Equity Buyout Figures		Falling deal volumes	European buyout volumes fell to their lowest quarterly total on record in Q2 2012, hit by poor economic conditions in the main Western European markets and the persistent issues associated with raising sufficient leverage. In total, just 72 deals worth €11.6bn were completed, down from 100 worth €9.3bn in the first three months of the year. Within that, the number of UK transactions recorded fell significantly from 44 worth €3.6bn in Q1 to 30 worth €2.7bn. Among the UK deals, the most notable transactions were the acquisitions of Four Seasons Healthcare by Terra Firma (€990m+) and the €240m buyout of College of Law by Montagu Private Equity.
	CMBOR - European Buyout Figures		Q2 volumes fall sharply	The latest figures from the Centre for Management Buyout Research (CMBOR) also chart the sharp decline in buyout activity in the second quarter. In total, the number of UK buyouts completing between April and June stood at just 37 worth £2.6bn, down from 66 deals worth £5.4bn in the first three months of the year. In half yearly terms, the picture is slightly more positive when looking at deal values, with the £8bn of UK deals completing over the first six months representing an increase of 38% on the second half of 2011. The number of UK buyouts coming out of insolvency in the first six months of 2012 has nearly matched the 16 seen in the whole of 2011.
	CMBOR - UK Exit Figures		Slow Q2	The UK exit market also slowed in Q2, though overall it showed relatively high activity levels in the first half of 2012, according to CMBOR. The total of £5.5bn of exits recorded during the period is more than triple that seen in the second half of 2011.
	Dow Jones - UK Venture Capital Investment		Values rise, volumes flat	In contrast with the generally negative trends in the later stage private equity market, the venture capital space saw growth in the second quarter, at least in value terms. On a pan-European basis the value of VC investments rose by almost 37% to hit €1.26bn in Q2, some way ahead of the €932m seen in the first three months of the year. Deal volumes remained relatively flat (273, versus 277 in Q1). The UK remains the most active market for venture investors, with some 71 deals worth €504m taking place between April and June - a 71% increase in value but 15% decline in volume over the same quarter of 2011.
	Zephyr Monthly M&A report - Western Europe Deal Data	4,930 - volume, €154.5bn	4,719 - volume, €190.3bn	According to the latest Zephyr Monthly M&A report, Western European deal-making activity is following a similar trend to the private equity market, with volumes continuing to fall while values strengthen somewhat. In total, 4,719 M&A transactions involving Western European companies were registered in Q2, compared with 4,930 in the first three months of the year. Over the same period, total M&A values rose significantly from €154.5bn to €190.3bn. The early signs for Q3 continue in the same vein, with volumes dropping to 1,295 in July - the lowest level for over a year - while values tumbled to €47.4bn, versus an average of well over €57bn in the six months to June.

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