The Gresham Monitor

A survey of UK middle market companies

January 2003

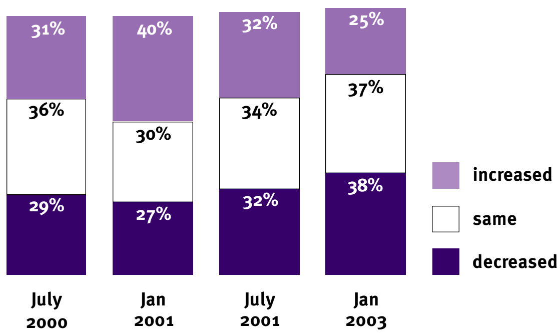
Economic factors which affect business performance are now top of the agenda for middle market managers. Their rising optimism about growth prospects for their businesses and the UK economy in recent Monitors has been tempered. And more are sitting on the fence. It seems they have become more cautious about the future in the face of myriad uncertainties ranging from the price of oil to the health of other economies.

Similarly, the number of companies expecting to undertake mergers and acquisitions activity has fallen by 18 points since June. Managers cite the health of the US and European economies, interest rate uncertainty and the fragility of consumer spending as factors influencing their deal intentions. Against that, 39 per cent still expect to do a transaction in the year ahead, reinforcing our belief that good management teams and companies will continue to seek backers and provide attractive investment opportunities.

Mixed performance signals

While companies' turnover figures are holding relatively steady, margins are coming under increasing pressure (see chart). Some 38 per cent of companies reported lower margins, the highest percentage since the first Monitor in July 2000. A similar number say margins are holding steady. In spite of difficult trading conditions, a quarter of companies surveyed managed to improve returns this time. Manufacturers were harder hit with 45 per cent reporting lower margins against 30 per cent of service companies.

Gross margins



The gap between the two is much narrower in terms of those reporting higher margins (23 per cent of manufacturers against 28 per cent of service companies).

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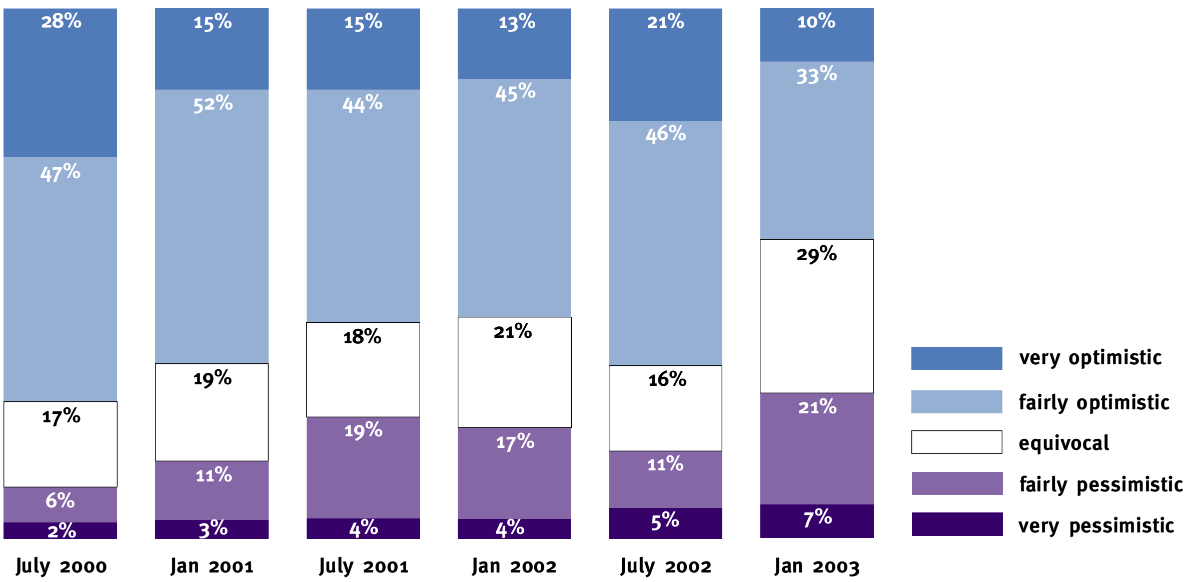
Turnover volumes holding up

Forty-eight per cent of the companies surveyed reported higher turnover than 12 months ago, against 53 per cent in the previous two surveys. Encouragingly that decrease is not mirrored by a comparable increase in those with falling turnover. Manufacturers found it harder than service firms to boost turnover (38 per cent against 60 per cent). On a brighter note, fewer manufacturers reported lower turnover (30 per cent against 33 per cent in July's survey). In contrast, more service companies said sales had fallen (15 per cent against 11 per cent last time).

Business prospects – the next 12 months



Confidence dented but not broken

Middle market managers' growing concerns are illustrated by the 24 point drop in optimism about corporate growth prospects for the next 12 months from 67 per cent in July to 43 per cent this time (see chart above). Not surprisingly, healthier companies felt more positive about the year ahead. Nearly three-quarters of those with higher margins are optimistic about prospects. Twenty-eight per cent of companies surveyed are pessimistic – the highest recorded since July 2000. Manufacturers are gloomier with 36 per cent pessimistic about growth prospects compared to 19 per cent of service firms.

Increasing caution in the middle market is demonstrated by the 29 per cent of managers who are neither optimistic nor pessimistic about the future – again the highest figure to date. Just 16 per cent were equivocal last time.

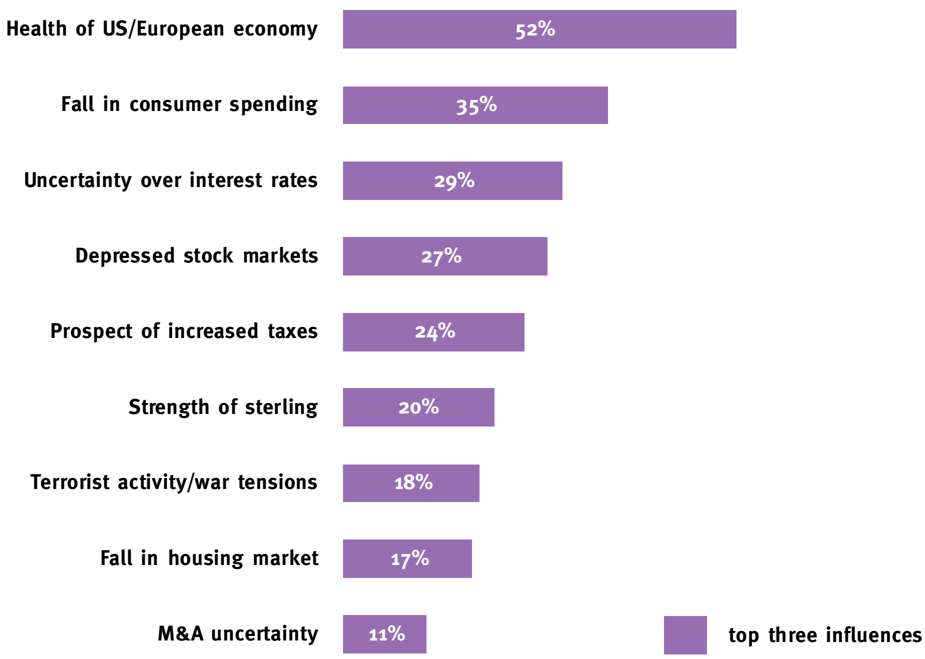
Economics temper transaction options

Concerns about fundamental issues which could affect their bottom line have tempered the enthusiasm managers showed in July for mergers and acquisitions activity in the year ahead. The numbers anticipating doing a deal fell from 57 per cent to 39 per cent this time.

Headline stories of terrorism and potential war are not uppermost in their minds (see chart below). Overwhelmingly, they cite concern about the health of the US and European economies as the biggest influence on whether or not they would do a deal. Over half rate it among their three biggest influences.

Other key issues they name as affecting their deal intentions – like consumer spending, interest rates, stock markets and taxes – must also reflect worries about the potential impact on corporate performance. For example, if sales volumes – currently supported mainly by consumer spending – fall off, it would impact the bottom line of companies throughout the supply chain.

Factors affecting M&A intentions



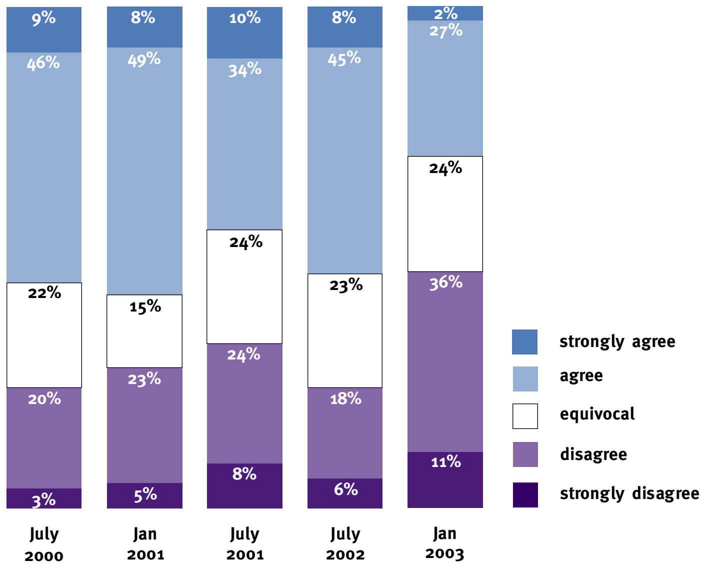
Still deals to be done

But the middle market is by no means devoid of potential transaction activity. Twenty-three per cent expect to raise external finance and nearly 19 per cent to buy another business. However, only eight per cent expect to sell part of their business and the same proportion expect to be taken over. Privately-owned companies are more keen to transact – two-fifths expect to do a deal against just over a third of subsidiaries.

Question marks over UK economy

Just 29 per cent of middle market managers are making plans based on the prospect of growth in the UK economy in the year ahead and 47 per cent are not. This reverses the position in July (see chart). But, as with corporate growth, a sizeable proportion (24 per cent) has adopted a 'wait and see' attitude. Although service companies remain more positive about economic growth than manufacturers (32 per cent against 26 per cent), the gap between the two has narrowed by 15 points since July.

Basing plans on economic growth



Jury is out on retirement age

The Monitor regularly surveys managers' attitudes to Government initiatives. Recent proposals to raise the retirement age to 70 receive a dusty response. Just under a fifth see it as a potentially positive move while 30 per cent think it could have a negative impact. Some 48 per cent expect it will have no effect on their business.

About the Gresham Monitor

Gresham is a UK private equity house specialising in middle market companies.

The Gresham Monitor is a regular survey of the UK middle market sector. This is the sixth issue and was conducted by NOP's Business Unit in November 2002. It sought a 'snapshot' view of factors affecting respondents' transaction intentions and monitored select aspects of their economic and corporate outlook and performance. The survey comprised board level interviews with directors of 100 middle market companies balanced between the service and manufacturing sectors, broadly reflecting the UK business population.

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