The Gresham Monitor

A SURVEY OF UK MIDDLE MARKET COMPANIES

July 2003

Do 53 swallows make a summer? That is the percentage of UK middle market managers surveyed who expect to undertake a transaction in the year ahead. It marks a return of confidence after their more tempered view six months ago. Optimism about growth prospects for their own business also shows signs of recovery.

In contrast, trading conditions have worsened with real pressure on sales, profits and staffing levels. More job cuts are expected in the year ahead. And while most shrug off potential negative effects from Middle East turmoil and the SARS virus, more are fence-sitting on the prospect of UK economic growth.

The future seems to be finely balanced. There are some encouraging signs from manufacturers though service companies are increasingly feeling the pinch. And the narrowing of the gap – foreshadowed this time last year – between vendors' and buyers' expectations on deal prices has taken place. This provides a better environment for deals.

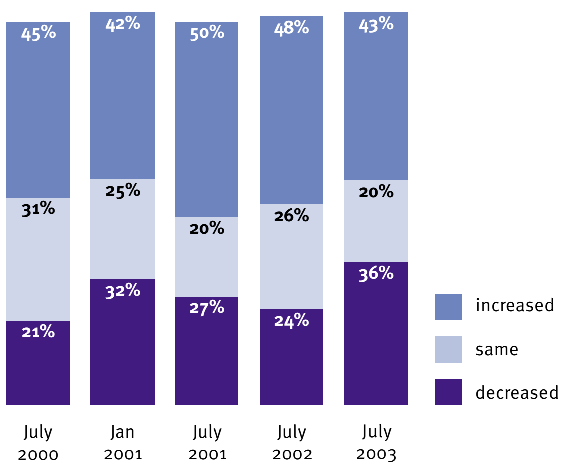
Profits under pressure

Over a third of companies reported lower profits in the last year – the most since the first Monitor in July 2000 (see chart). Those with higher profits fell for the third survey in a row.

The disparity between manufacturers and service firms has shrunk. Some 35 per cent of service companies reported lower profits up from 22 per cent a year ago. That compares to 36 per cent of manufacturers with lower profits, an eight point increase on last year's figure.

Although nearly half of companies in the North recorded increased profits, around a third (nearly twice as many as last year) said they were down. Only 40 per cent of Midlands companies improved earnings, a sharp decline on 52 per cent last year.

PROFITABILITY



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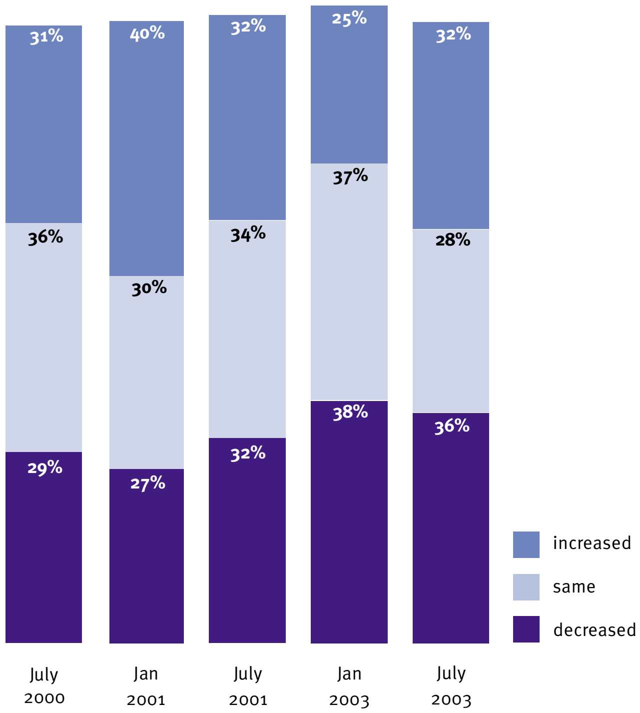
Margins favour manufacturers

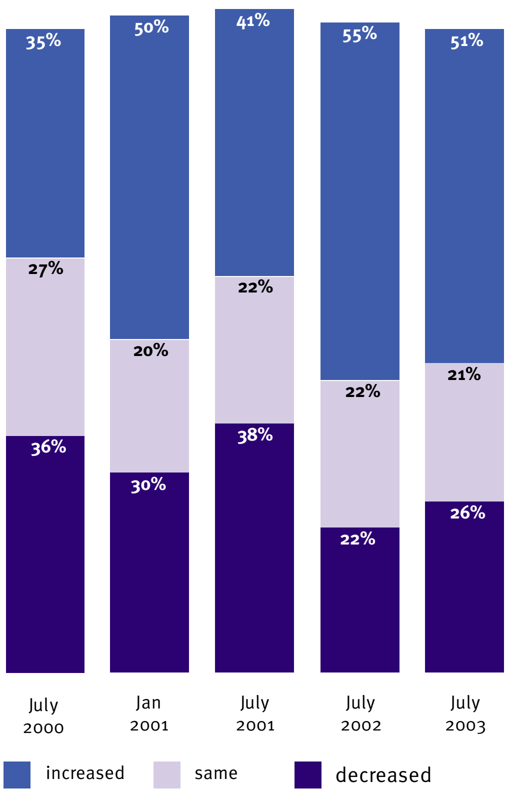
The gap between service and manufacturing companies also narrowed in terms of those reporting lower margins since the last Monitor in January. While 36 per cent of service companies experienced lower margins (up from 30 per cent six months ago), the proportion of manufacturers with lower margins fell from 45 per cent to 35 per cent. More of each reported higher margins than in January.

Overall a third of respondents reported higher margins in spite of tougher trading conditions – up from one quarter six months ago (see chart). Thirty-six per cent said margins had fallen – marginally fewer than in January. Northern firms made the brightest showing with 39 per cent enjoying higher margins against 32 per cent in the South and 25 per cent in the Midlands.

GROSS MARGINS



OVERHEADS



Sales static: focus on costs

Just under half of companies reported higher turnover. But 28 per cent suffered lower sales – the worst ever. Manufacturers proved most resilient – 43 per cent had higher sales (up from 38 per cent in January) against 50 per cent of service firms (down from 60 per cent). Over 12 months, twice as many service firms (22 per cent) reported falling sales against a static one-third of manufacturers.

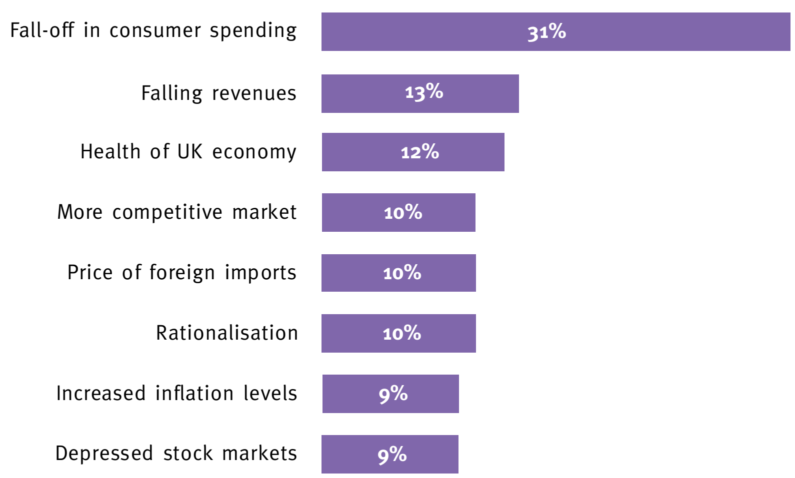
Cost controls were a priority. Fewer companies reported higher overheads and more cut costs than in July 2002 (see chart). Over 12 months, manufacturers improved their position. Some 44 per cent had higher costs – down from 52 per cent last July – against a little changed 57 per cent of service firms. Northern firms suffered most from higher costs – 60 per cent against 55 per cent in the Midlands and 38 per cent in the South.

Jobs cuts and more to come

Jobs are at risk in a middle market focused on overheads. A third of managers said their staff roster was lower than a year ago. And a third plan reductions in the next 12 months. More than half of the past year's job cutters expect more losses in the year ahead. This time, manufacturers swung the axe hardest – 44 per cent against 26 per cent of service companies. On the other hand, 34 per cent of all companies have increased staff numbers since last July.

Concerns over falling consumer spending, revenues and the health of the UK economy are the main drivers for reductions, as the chart shows. Interestingly, Government policies such as the increase in National Insurance Contributions (NICs) and potentially higher pension costs don't figure high up the list. Regionally, these factors were of more concern to Northern companies, with 8 per cent citing NICs and 4 per cent pensions.

MAIN FACTORS AFFECTING WORKFORCE NUMBERS



Euro support cooling

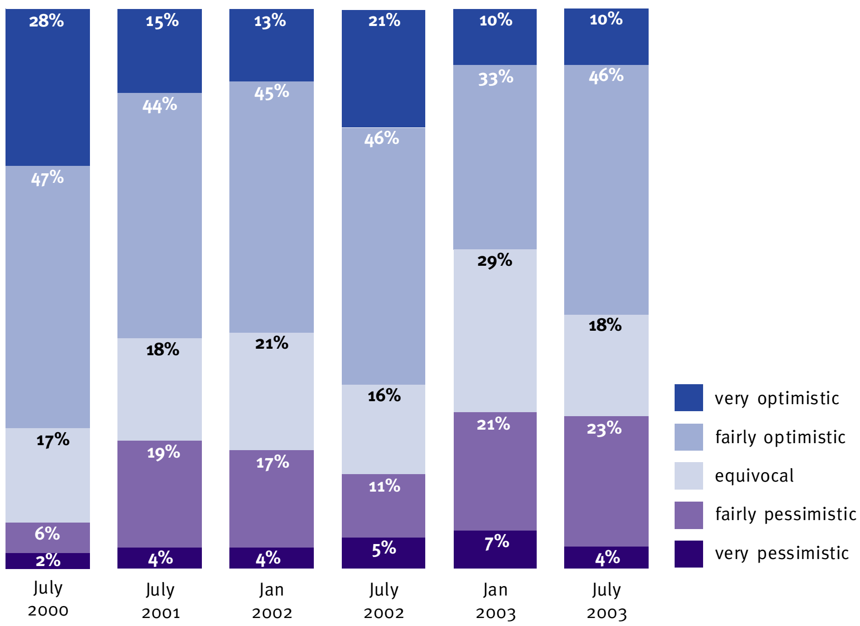
In spite of the more competitive trading conditions created by a weaker pound, middle market managers' attitude to Britain joining the European Monetary Union has cooled. Although 40 per cent think the UK should join the euro, that is well down on the 52 per cent in favour three years ago. Similarly, 40 per cent are against, up from a third in July 2000. Some 44 per cent of manufacturers are in favour against 36 per cent of service companies. Southern firms are most positive – 47 per cent in favour, compared to 34 per cent in the North and 39 per cent in the Midlands.

Corporate confidence returns

Middle market managers have recovered confidence in their own companies' growth prospects which appeared dented in the last Monitor. Some 56 per cent are optimistic about the year ahead (see chart), up from 43 per cent. Views have polarised since January when 29 per cent were sitting on the fence over prospects. The number of pessimists is little changed at 27 per cent.

Those companies operating with a stronger trading base are more cheerful looking ahead – eight out of 10 managers who reported an increase in turnover are optimistic about the next 12 months. Companies with fewer employees have a more positive outlook for their business than larger firms.

BUSINESS PROSPECTS – THE NEXT 12 MONTHS



Manufacturers mellowing

Overall, service companies remain more optimistic than their manufacturing counterparts (65 per cent against 44 per cent). But the proportion of service firms who are gloomy looking ahead has jumped to a quarter this time, up from just a tenth a year ago. This reflects the worsening trend for service firms in terms of profits and turnover.

In contrast, 29 per cent of manufacturers are pessimistic about prospects. Although slightly up on the 25 per cent who were gloomy a year ago, it's a strong improvement from January's Monitor, when 36 per cent were pessimistic.

Northern companies' confidence has taken the biggest knock. The number of optimists has dropped by 25 points to 52 per cent since last July. Pessimists about the year ahead, however, trebled to 30 per cent.

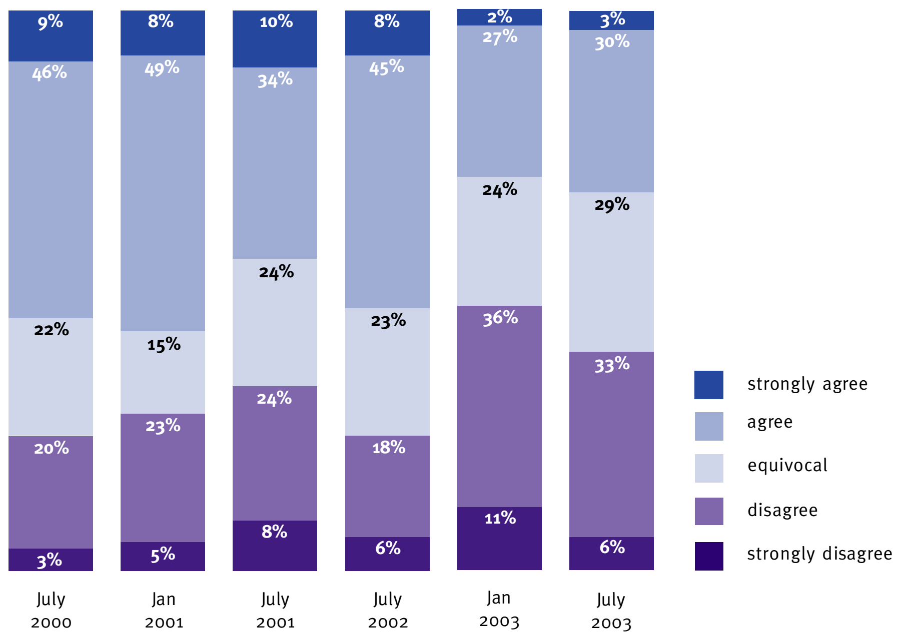
Cautious on economic growth

Twenty-nine per cent of respondents adopted a 'wait and see' attitude about how crucial UK economic growth is for their businesses looking ahead – the highest figure for fence-sitters to date (see chart).

A third are basing their business plans on the prospect of economic growth in the year ahead. Southern firms are more cautious than a year ago – 33 per cent are optimistic about the economy against 60 per cent in July 2002 while a third are pessimistic, up from a fifth a year ago. Forty per cent of firms in the North and Midlands are gloomy.

Manufacturers are sceptical – 27 per cent expect economic growth. Though little changed from January, that is sharply lower than the 41 per cent recorded a year ago. Service companies are also more cautious than a year ago – 37 per cent expect growth against 62 per cent last July.

BASING PLANS ON ECONOMIC GROWTH



Mixed impact of world traumas

Uncertainty about the domestic economy is more important to middle market managers than international upheavals. The majority believe international traumas such as Middle East unrest and the SARS virus will not badly impact their businesses. Sixty-nine percent feel SARS will not affect performance and 58 per cent believe that Middle East instability and the repercussions of the Iraqi war will not affect their businesses.

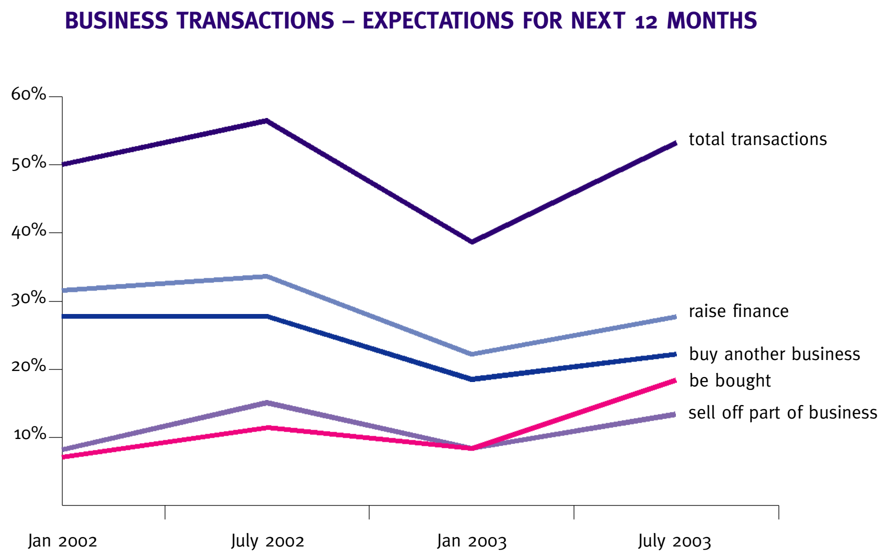
Manufacturers, with their international trade bias, are more concerned than service firms. Over a third feel the Middle East will negatively affect their businesses against a fifth of service companies and 30 per cent are concerned about SARS compared to 17 per cent of service managers. A third of Southern firms are concerned about Middle East factors against 28 per cent in the North and 24 per cent in the Midlands.

Hope for deals

The Monitor highlights a resurgence in middle market managers' enthusiasm for doing deals. Some 53 per cent expect to undertake a transaction in the coming year, up from 39 per cent in January, and not far shy of the 57 per cent recorded a year ago (see chart).

Raising finance and acquisitions remain the most likely transactions, though the figures are down from 33 per cent and 27 per cent respectively a year ago. Some 11 per cent intend both to raise money and buy a business in the next 12 months.

More managers expect to sell all (18 per cent) or part (13 per cent) of their businesses, up from 8 per cent for both in January. A year ago the figures were 11 per cent expecting to sell all and 15 per cent to sell part of their businesses. Companies under financial pressure are keener – almost a quarter of those reporting static or falling sales hope to sell.



Caution in the Midlands

Midlands managers are most cautious – 46 per cent expect to undertake a transaction, down from 68 per cent last July. Fifty-seven per cent of firms in the North and 56 per cent in the South anticipate M&A activity in the next 12 months, both up on July. A third of firms in the South expect to raise money, against a quarter in July 2002, while the number expecting to be bought has trebled to 21 per cent.

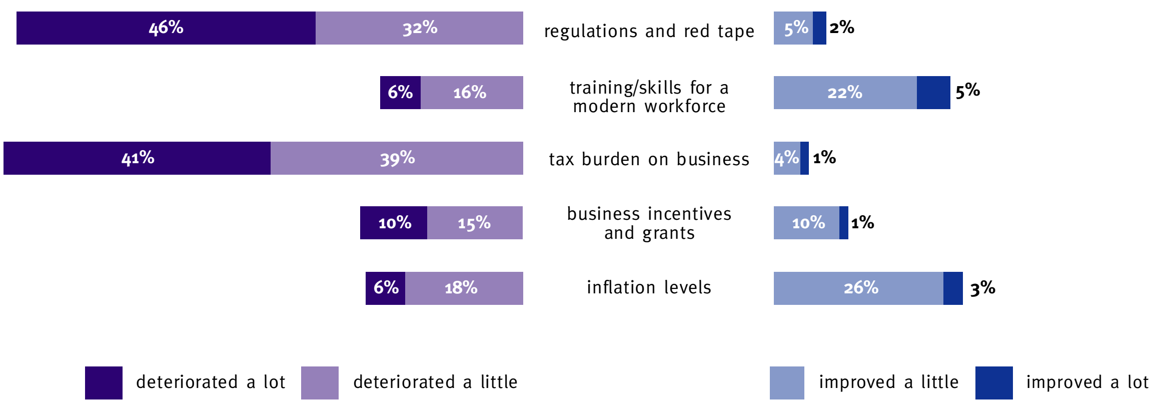
Just under half of manufacturers plan a transaction, well up on 30 per cent six months ago. Service companies are even keener – 56 per cent plan a deal, the highest recorded so far.

Government perception improves...

The Government still has its work cut out to win over middle market managers, two-thirds of whom feel it does not understand their needs. But that is a big improvement from last July when nearly three-quarters felt misunderstood. This time, nearly a fifth of companies believe the Government is trying to address middle market issues – the highest figure to date. In contrast, those feeling not at all understood has dropped to just over a quarter from 42 per cent a year ago.

Westminster is most out of step with manufacturers and companies in the North – 70 per cent of each group feels misunderstood. Some 57 per cent of service companies are unhappy but that is a healthy improvement on last year when two-thirds felt out in the cold. Nearly a quarter of firms in the South feel the Government understands their needs against 18 per cent in the Midlands and just 13 per cent in the North.

VIEW OF GOVERNMENT POLICIES OVER 12 MONTHS



...but taxes still a major burden

Four out of five managers, the most since the Monitor began, feel their tax burden has increased – no doubt exacerbated by higher National Insurance Contributions. Midlands firms feel increasingly hard-pressed by taxes – 84 per cent against 59 per cent in July 2002. Red tape and bureaucracy remain another major bugbear for all companies (see chart).

Overall, 62 per cent of managers say Westminster's policies have negatively affected their businesses in the past year. For Northern firms, the figure rises to 70 per cent. Some 29 per cent of respondents feel inflation levels have improved – well down on the 37 per cent feeling positive a year ago. Nearly a third of manufacturers think the position on incentives and grants has worsened.

The Gresham view

"Evidence of growing enthusiasm to do deals from the managers who run middle market companies is most welcome. There are also other factors which contribute to an improving environment for mergers and acquisitions activity which has been depressed for some 18 months.

The large disparity between buyers' and sellers' price expectations which drove vendor expectations sky-high – fuelled partly by unrealistic valuations of many dotcom companies – has all but disappeared. The tougher trading environment has introduced more realism into assessments of potential earnings. At the same time, the stability of a lower interest rate and inflation environment compared to three years ago is providing investors with a more sensible basis for financing.

However, trade buyers are scarce. Private equity investors currently fund around 60 per cent of deals. The economic picture is still vulnerable and companies face stiff competition. But the Monitor suggests that companies have a sharp focus on costs. The ability to manage growth within a cost-conscious environment is one of the key factors we look for in the teams we back. The Monitor's findings suggest there are quality managers looking for investors.

The gap between mooted and completed deals has shortened to more sensible time frames in recent months.

The future for the middle market may be in the balance, but it shouldn't take much to tip the scales in favour of a brighter outlook."

About the Gresham Monitor

Gresham is one of the few regionally-based UK private equity houses specialising in investing in middle market companies. Transactions are typically valued at between £5m and £75m. The Gresham Monitor is a regular survey of the UK middle market sector. It explores respondents' transaction intentions and their views on topical issues. The Monitor also tracks aspects of their economic and corporate outlook against actual performance. This is the seventh issue and was conducted by NOP's Business Unit in April 2003. The survey comprised board level interviews with directors of 200 middle market companies balanced between the service and manufacturing sectors.

These companies typically have turnovers of between £10m and £100m and employ 50 to 500 people, accounting for nearly a third of the UK economy.

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