

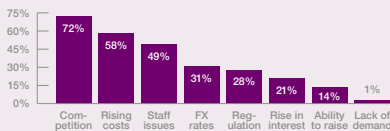
## Staff ▶

Employment prospects look better in the services sector than in manufacturing. More than half of service companies expect to increase staff numbers, compared with 38% of manufacturers. Overall, the picture is one of job prosperity, with only one in 10 service providers expecting to reduce headcount and 19% of manufacturers foreseeing job cuts.

## Threats ▶

Middle-market companies see competition as the greatest threat during the next 12 months – highlighted by 72% of respondents. Rising costs come next in terms of potential negative impact (58%), followed by issues such as staff availability, quality and cost (49%). Exchange rate fluctuations, regulation and interest rates are seen as the lesser of many evils. One telling statistic is the lack of concern about demand, with only 1% of our sample citing it as a factor.

THREATS PERCEIVED OVER THE NEXT 12 MONTHS



## Financing ▶

Interest in corporate activity has waned, with just 31% of those surveyed reporting interest in a deal over the next six months. It is therefore unsurprising that there is no strong trend in the appetite for external finance. Bank loans are still the favoured choice for 44% of those prepared to consider a financing option. Bank overdrafts are no longer in vogue, as only 21% of companies would consider them.

The number of respondents prepared to consider private equity and venture capital is 18%, with service companies more inclined towards this option than manufacturers.

Companies in the North are least likely to go down the private equity route (12%), compared with 23% in the South.

Companies willing to consider the raising of equity capital would now favour specialist private equity or venture capital houses, where the share of the vote has risen from 13% to 25% since the last Gresham Monitor. Banks are the second choice (15%, down from 26% in January).

# Optimism heads for a four-year high...

**W**ith seven out of 10 middle-market companies now expressing optimism regarding growth prospects, managers are more upbeat than at any time since July 2000. In spite of higher energy costs, rising interest rates and the continued threat of global terrorism, the number of pessimists has tumbled to a four-year low. Only 43% of respondents in January 2003 expressed optimism, but this has soared to 73%. Those describing themselves as very optimistic now represent 19% of the total, outnumbering the pessimists by two to one.

Middle-market managers taking a fairly optimistic stance about the future now account for 53% of all respondents,

the highest level since the first Gresham Monitor in July 2000. Manufacturers have led the charge towards greater optimism, as 68% are now upbeat, compared with just over half in January 2004.

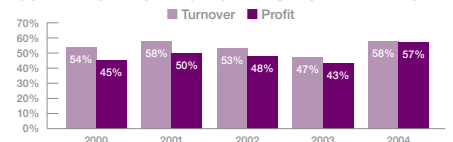
The last Gresham Monitor showed pockets of optimism – particularly among firms in the North. Not only do Northern businesses remain encouraged by the outlook, but optimism has recovered dramatically in the Midlands and South. While the South is the most cautious, seven out of 10 managers are now positive regarding future prospects, compared with just 56% in January's Monitor. Companies in the Midlands have now taken the lead, with three-quarters expressing optimism – up from 58% at the beginning of the year.

## ...supported by higher sales and earnings

**T**urnover and profit trends provide a firm foundation for this renewed optimism among middle-market managers. Those reporting an increase in annual sales now represent 58% of the total, a return to July 2001 levels – and a sharp rise from 42% in January this year. Companies experiencing a fall in revenues represent just 16% of respondents. Therefore, businesses with either consolidating or rising sales now account for 82% of those surveyed.

More importantly, higher turnover is being translated into greater profitability. Almost six out of 10 companies are reporting increased earnings. This is a dramatic improvement over January, when just 38% had experienced profit growth. This represents the best result since the inaugural Gresham Monitor four years ago. Those seeing reduced earnings now account for 18% of the total, down from 30% six months ago.

COMPANIES REPORTING HIGHER TURNOVER AND PROFIT



Midlands businesses are faring best, with 67% reporting a profit rise – double the number in the January survey. While the South is lagging, half the respondents have benefited from higher earnings, which represents a return to the July 2001 level. More middle-market managers in the North (55%) have reported profit growth this time around than in any previous Gresham Monitor. While service companies still lead in terms of sales and profit growth, manufacturers are catching up fast, with more than half reporting gains in turnover and earnings.

Turn to page 2 for more detail on the regional picture ▶

# Keeping close to customers

Overall, almost one in three managers cite proximity to customers and/or suppliers as the biggest advantage provided by their location in the UK. This is seen overwhelmingly as the key benefit for the service sector, but manufacturers identify infrastructure as the most important advantage.

While the three primary areas of customer location, infrastructure and staff availability account for almost 80% of the votes from middle-market companies, their relative importance varies significantly when geographical region or type of business is factored in.

Southern companies clearly put much more emphasis on being close to customers and suppliers, with 43% of managers nominating this as their main locational advantage. The only other factors to draw any real attention in the South are infrastructure (24%) and staff (16%).

“Working in hospitality, your staff are the most important ingredient of a successful business,” says Stephen Walker, chief executive of Individual Restaurant Company. “We currently have sites in Manchester, Alderley and Knutsford, and our staff really make the difference to those restaurants.

“The blend of hardworking staff and the higher quality of life and aspirational living has great advantages for a consumer business in the North.”

Among companies surveyed, a multitude of other potential geographical advantages attracted very little support: this shows just how clearly businesses rely on the three principal factors of customer proximity, infrastructure and staff availability.

Overall, in terms of disadvantages resulting from location, staff quality and availability comes top of the list, nominated by 22% of respondents. Lack of proximity to customers and/or suppliers has 19% of the vote, while only one in 10 managers views infrastructure as a problem. Other



Left to right: Individual Restaurant Company founders Edwina and Derek Lilley, Gresham's Christian Bruning, and Individual Restaurant Company chief executive Stephen Walker

**“ WORKING IN HOSPITALITY, YOUR STAFF ARE THE MOST IMPORTANT INGREDIENT OF A SUCCESSFUL BUSINESS ”**

In the Midlands, the quality and quantity of transport links mean that more than a third of respondents cite infrastructure as the leading benefit. Midlands-based businesses view customer proximity and staff availability as broadly similar in importance (21% and 19%).

In the North, one in three businesses state that the availability and quality of staff is the most positive factor in terms of their location. Proximity to suppliers/customers and infrastructure attract similar numbers of firms, at 19% and 16% respectively. Issues such as commercial property (6%) and the ability to live close to work (6%) are other benefits cited.

factors seen as negatives from a locational perspective are commercial property (8%) and local government regulation or taxes (7%).

More than 20% of companies in each of the UK regions nominate staff availability as a major disadvantage, with businesses in the South and Midlands viewing it as the biggest shortcoming but Northern firms placing it second to customer proximity. Only businesses in the South take a particularly dim view of commercial property issues, where this factor is nominated by 17% of respondents and ranks second behind staff availability. For those seeking office premises in the South, this will come as no great surprise.

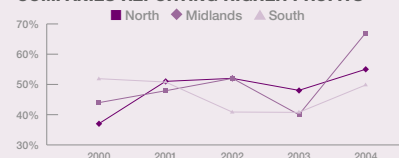
## Optimism ▶

Business confidence has recovered dramatically in the Midlands and South during the past six months. Middle-market managers in the former region are the most bullish, with three-quarters expressing optimism, up from 58% in January. And although the South trails the North in terms of a positive outlook, the 70% of managers in the region taking a bullish view compares with just 56% in January's Monitor. Business confidence in the North remains steady, at 73%.

## Profits ▶

Businesses in the Midlands lead the way when it comes to rising profits, which undoubtedly explains the high confidence rating (above). The 67% reporting an upturn is double the level in the January survey. The number of middle-market companies in the South and North seeing improved performance is also increasing, albeit at a slower rate. Half of respondents in the South (the highest figure since July 2001) are experiencing a rise in earnings; while more middle-market managers in the North (55%) have reported profit growth this time around than in any previous Gresham Monitor.

### COMPANIES REPORTING HIGHER PROFITS



## Sales ▶

Turnover is rising fastest in the North, with 63% of middle-market managers in the region reporting increased sales, up from 52% last time. However, recovery is most marked in the Midlands, where 60% of respondents are seeing turnover improving, a jump from just 39% in January's Monitor. Only 51% of managers in the South are experiencing an increase in sales, but this is still a substantial improvement on the 35% last time round.

# Sectors on converging course

**P**revious surveys have highlighted the marked differences in attitude between the manufacturing and service sectors as regards optimism, turnover trends and financing preferences. In particular, the gloom that descended upon UK businesses in 2002 and early 2003 hit manufacturing firms hardest.

The latest responses show a clear convergence as all parts of the middle-market environment improve. However, the two business segments remain divided on the nature of the biggest threats and challenges they face.

While 68% of manufacturers are now optimistic regarding growth prospects over the next 12 months, the service sector remains more bullish at 77%. However, the change in attitude among the manufacturers is dramatic, and the gap between the two groups has contracted by two-thirds since January.

Only 14% of the manufacturing companies admit to being very optimistic, compared with a quarter of service-sector managers. The number of out-and-out manufacturing pessimists is down to 12%, but still tops the 8% of service-sector bears.

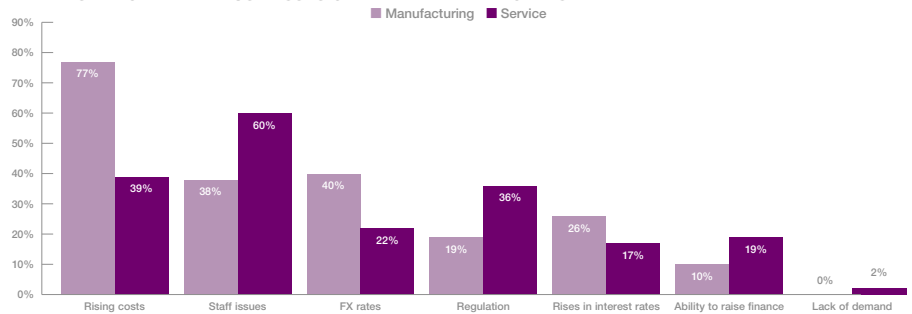
The link between optimism and financial performance remains strong, as a similar pattern of convergence exists when turnover and profits are examined. Of the manufacturing-sector respondents, 53% are now reporting increased year-on-year sales. Among service providers, 63% are experiencing a revenue upturn. Almost eight out of 10 manufacturers are now claiming flat or higher sales, close behind the service sector where 86% of respondents report the same trend.

In terms of earnings, 57% of all respondents are now seeing higher profits, with just 18% reporting a decline. Manufacturers are very close to the overall trend, at 56% and 21% respectively. Service companies remain marginally ahead, at 58% for higher profits and 15% for lower earnings.

The manufacturers are less likely to boost headcount, with just 38% considering hiring staff. In the service segment, 53% are looking to add personnel.

Considerable differences also exist in terms of the perceived threats in the two sectors. Almost eight out of 10 manufacturing managers identify rising

THREATS PERCEIVED BY BUSINESSES OVER THE NEXT 12 MONTHS



Andrew Steel, chief executive of Altair Filter Technology

costs as the biggest problem they face, although competition comes close behind. Forty per cent of manufacturers single out staff issues and foreign exchange fluctuations as major threats. A quarter see rising interest rates as the most critical factor, while 19% view regulation as the greatest obstacle.

“It is no secret that the manufacturing sector has been hard hit in recent years, and that we are likely to feel the brunt of any further interest rate rises,” says Andrew Steel, chief executive of Altair Filter Technology, a Hampshire-based manufacturer of gas turbine filters. “But the key to running a successful operation is finding a defensible niche and growing that market while controlling the cost base. You also have to work with the environment, and we have moved some operations to Eastern Europe and Mexico while ensuring that the value is created here in the UK.”

Among service providers, the picture is different. Competition is viewed as the biggest challenge by 76% of managers. Staff issues are seen as the next biggest problem (60%), with rising costs nominated as the key factor by just 39% of respondents.

## Capital convention ▶

A surprising area of sector convergence is in sources of external financing. While bank loans remain the first choice for both manufacturers and service companies (44% and 43% respectively), 15% of manufacturing managers would now consider private equity and venture capital options – closing the gap on 22% for the service segment. Private shareholders remain low in the financing pecking order (7% and 6% apiece). Two in 10 companies in both sectors would not seek to raise external finance at this stage. Of those prepared to consider the raising of equity capital, 27% of manufacturers and 23% of service providers would approach a private equity or venture capital specialist.

## Staffing issues ▶

It is probably no surprise that staffing issues are highlighted as the main threat by service companies. What is surprising is that they are also cited by 38% of the manufacturing sector.

Blue Group recruits into the healthcare, construction and telecoms sectors and it is seeing individual trends affecting these industries – all of which have a positive impact on recruitment. But, more generally, there is a premium on quality staff, explains John Zafar, chief executive of Blue Group.

“The recruitment sector is very much a bellwether for the economy. If you want to know how the economy is doing, just check the share price for recruitment stocks. There is a general return of confidence to the manufacturing and services sector, with financial services bouncing back strongly, as increased confidence translates into higher staffing levels.”

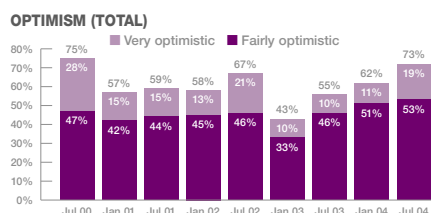
# The Gresham View



**I**n our last Monitor we flagged up the return of optimism among middle-market companies – led by the service sector and Northern firms in particular. Despite the macro-economic uncertainties, middle-market firms appear to have created their own success by cutting costs and improving their margins. Indeed, this is borne out by the current statistics.

Not since our very first survey in 2000 have we seen such a high degree of optimism. What is striking about these confidence levels is that they are based on a cautious realism and the effects of a six-month period that has seen the number of companies growing their revenue from 38%

to 58%. The real change has been in those companies claiming to be fairly optimistic, some 53% – the highest level ever recorded. The figure of 19% for those claiming to be very optimistic has been exceeded twice in the past. Nevertheless, overall levels are at their highest since our inaugural survey. Unsurprisingly, this optimism has manifested itself in the 45% of companies expecting to increase their staff numbers.



There has also been a marked drop in the pessimism figures – 10% now compared with 27% last time. It appears that the economic gloom perceived by middle-market companies has only just lifted, despite the continuing concerns of consumer spending, oil price shocks and a spiralling UK housing market.

That optimism appears to have spread to many other sectors of the economy. Most dramatic is the rise in optimism in the Midlands and among manufacturing concerns – perhaps surprising given an economic environment of punishing exchange rates and interest rate rises.

But it would appear that more of the UK's middle market is creating its

own success and, in particular, adjusting to what is increasingly a service culture. Manufacturing is no longer just about supplying a product but about being proactive in meeting a customer need. Service companies are also finding the environment more competitive, and are having to respond with a higher value-add proposition.

The upshot appears to have been a tail-off in corporate activity as just three in 10 claim to have a deal in their sights. Middle-market companies have responded to the tough environment by digging in and focusing on an even more valuable proposition for their customers. The end result is leaner and fitter businesses that are better able to respond to future challenges.

For Gresham, this is an exciting time. We have raised £235m in our Gresham III fund, and are looking for outstanding management teams in which to invest. Despite no discernable uptick in completed deal volumes in 2004 compared with 2003, we are confident that our regional network, coupled with our proprietary deal origination function, will ensure that we source the best opportunities. The objective for us remains to deploy capital in partnership with management teams in order to create value both for management and for our investors.

*Mike Henebery, director of Gresham's London investment team*

## About the Monitor

**G**resham LLP 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. This latest survey looked at how the middle

market finances business transactions, and monitored aspects of their economic and corporate outlook and performance. This is the ninth issue, and was conducted by ICM in April 2004.

The survey comprised board-level interviews with directors of 200 middle-market companies balanced between the

service and manufacturing sectors, broadly reflecting the UK business population.

These companies typically have turnovers of between £10m and £100m, employ 50 to 500 people and account for nearly a third of the UK economy, as measured by turnover and employment.

### London

One South Place  
London  
EC2M 2GT  
T: +44 (0)20 7309 5000

### Birmingham

Edmund House  
12-22 Newhall Street  
Birmingham  
B3 3GT  
T: +44 (0)121 200 0050

### Manchester

82 King Street  
Manchester  
M2 4WG  
T: +44 (0)161 833 7500