

## Optimism returns to early 2002 levels...

**M**id-market companies are more optimistic about business prospects than at any time since July 2002. The picture was gloomy a year ago, when only four out of 10 described themselves as very or fairly optimistic. This has now risen to six out of 10. Moreover, the 51% describing themselves as fairly optimistic is the highest percentage since July 2001, before the World Trade Centre atrocity rocked the confidence of the business world.

The number of pessimists has also fallen. The latest Gresham Monitor shows that 18% of respondents remain negative

about the outlook, down from 27% in July 2003 and from 28% a year ago. There are also far fewer fence-sitters: the equivocal vote is now 18%, compared with 29% in January 2003.

There are significant regional variations in how companies see the future. The number of companies in the North reporting a positive outlook has risen substantially in the past six months, to 73%. Levels of optimism in the South and in the Midlands have remained relatively stable, at 56% and 58% respectively.

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

## ...but still a twin-track economy

**B**usiness perceptions and priorities differ significantly between the service and manufacturing sectors: the latest survey reveals that manufacturing companies see cutting costs as their priority, while service companies are focused on improving margins.

Prospects for recovery appear brightest in the service sector, with companies in that arena more optimistic about the business outlook than their manufacturing peers. Nearly three-quarters of service-sector managers say they are positive about the future, compared with just over half of their manufacturing counterparts.

However, the manufacturing sector may be catching up. Optimism there has risen faster than in the service sector in the past six months.

Fewer service companies reported declining profits and turnover: just 6% experienced a fall in turnover, compared with 22% in the last Monitor. Greater

confidence in the sector also means that service companies are intending to participate in more corporate activity than manufacturing companies – and, among those contemplating a deal, there is more optimism about following through (93% compared with 79%).

One of the companies feeling the benefit of an improving economic outlook and increased corporate activity is 2escape2, an IT support services provider. Since Gresham's £6.6m investment in the firm last July, 2escape2 has already acquired two businesses and is pursuing further opportunities as part of its buy and build strategy.

Chief executive Terry Burt explains: "Generally, corporate spending is stable and that provides a great opportunity for any business in the service sector. Now is a great time to build our business in the IT support services sector in readiness for the expected upturn over the next 12 months."

### Deals ▶

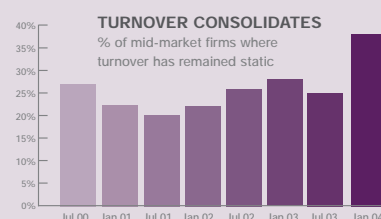
Corporate activity could be on the rise, with 54% of mid-market companies hoping to strike deals over the next 12 months. Of these, almost 90% are confident of securing their goals. Bigger companies are more bullish than most. More than a third of managers who postponed corporate activity planned for last year cited an uncertain economic outlook, and a further 21% say financing issues were the main obstacles.

### Profits ▶

Earnings are stabilising. There has been a sharp rise in the number of companies reporting flat profits (30% against just 20% in July 2003). In tandem, fewer companies experienced earnings erosion (down from 36% six months ago to 30%). Even the reduction in the number of companies experiencing profit growth, from 43% to 38%, can be seen as supporting a trend towards earnings stabilisation.

### Sales ▶

Trends in turnover track those in profitability, and sales seem to be consolidating at current levels. The number of companies reporting unchanged turnover has risen to a new high of 38% – and compares with just 25% at the time of the July Monitor. Falling sales were disclosed by just 19% of respondents, the lowest level since July 2000. As with profitability, the number of companies achieving turnover growth has fallen to 42%, a new Monitor low.



### Challenges ▶

Further evidence of a consolidating economy can be seen in what managers perceive to be their greatest challenge. Some 19% say increasing sales and achieving growth is the most pressing goal. This is followed closely by the need to improve margins (18%) and control costs (18%). The only macro factor to be highlighted was regulatory issues (18%).



Simon Inchley, director of Gresham's regional investment team

# Northern lights glow brightest

Seven out of 10 companies in the North had planned corporate activity in 2003, compared with fewer than five out of 10 in the South and in the Midlands. Of the Northern companies, 22% of respondents reveal that deals had to be postponed, compared with only 13% of those from the South. The climate proved particularly tough in the Midlands: 44% of companies from this region that had planned corporate activity did not go through with it.

There are significant regional variations in the reasons given for postponement. Reasons given by companies in the Midlands and in the South that had planned a deal included a worsening outlook for the economy. Northern managers were more likely to cite an inability to raise finance. Uncertainty about interest

Northern companies, 55% of those in the Midlands and 50% of Southern companies expecting to get involved in deals.

Optimism about completing such activity is sky-high in the South, with all companies planning a deal saying they expect to follow through. Confidence is also high in the North (89%), but somewhat less so in the Midlands (72%).

\* Regional samples are small and so are indicative only.

**M**id-market companies based in the North of England are far more optimistic about the business outlook over the next year than their counterparts farther south. Nearly three-quarters of Northern managers take a bullish view, compared with just over half in the South and in the Midlands.\*

## NEARLY THREE-QUARTERS OF NORTHERN MANAGERS TAKE A BULLISH VIEW

Levels of pessimism are highest in the Midlands: 30% of companies in the region say that the outlook is bleak, compared with 18% in the South and only 6% in the North.

These differences are reflected in turnover and profit figures over the past 12 months. In the North, 52% of respondents reported increased turnover, while four out of 10 said their profits were higher. Only 35% of Southern-based companies raised turnover last year, although 38% reported higher profits. In the Midlands, 39% of respondents said turnover had improved, while 33% saw profits rise.

rates was also a contributory factor to reduced dealflow in the Midlands.

"This optimism ties in with what we are hearing from companies first hand," says Simon Inchley, director of Gresham's regional investment team. "Mid-market firms in the North are looking forward to much brighter prospects this year. The environment appears tougher in the Midlands – but as the economy stabilises there are great opportunities for those firms that can take advantage of them.

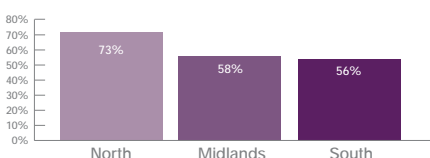
"Optimism doesn't directly equate with dealflow, as witnessed by the current year recovery in the Midlands deal volumes. But the overall environment in both the Midlands and North is now more conducive to increased corporate activity. This is a great time to be a private equity investor in the North and the Midlands," he adds.

Regional variation is less marked in the levels of corporate activity planned for the next 12 months, with 58% of

### There were also some marked regional differences among firms when asked about their top challenges...

- ▶ Just 6% of Southern firms are struggling to improve margins but it's the biggest challenge for 33% of Midlands firms
- ▶ 27% of Northern managers face tougher competition vs 12% both in the South and in the Midlands
- ▶ Only 3% of Midlands firms believe there is a worsening outlook for the economy against 18% in the South and 10% nationally
- ▶ Midlands firms are also more exposed to foreign exchange rate fluctuations, with 12% reporting it as a challenge – double the national average
- ▶ Employee turnover was also more of an issue for 21% of Midlands firms against just 9% in the North and 15% nationally
- ▶ While 17% of all businesses cited finding new markets or clients as an issue, a full 24% of those in the Midlands are struggling to expand their horizons. This compares with just 12% in the South

OPTIMISM AMONG MID-MARKET FIRMS



# External finance on the agenda

**R**ising optimism and increased corporate activity are likely to trigger more external fundraising this year, with three-quarters of firms surveyed looking to raise external finance. But, of these, the majority are still relying on traditional routes such as bank loans (55%) and overdrafts (53%) rather than tapping into a wide funding mix. Only 22% of respondents say they would rely on private equity funding or venture capital, with still fewer expecting to use private shareholders (18%). The stock market remains the least favoured option with just 6% considering it.

Manufacturers are less likely to seek additional funding (28%) than service-sector companies (21%). The manufacturers also have a slightly greater preference for bank loans (57%) than service providers (53%), which again highlights the more conservative approach of this traditional segment of industry. The newer service sector rates private shareholders more highly, at 21% compared with 15% for manufacturers.

A wide range of financing tools is a good thing for any firm, explains Mike Henebery, director of Gresham's London investment team. "Each deal should be tailored to suit the specific requirements of the business, accommodating both short- and medium-term financing requirements and the longer-term strategic development of the business. Equity finance can be a great tool for companies financing acquisitions or growth opportunities, and should form part of a diverse funding mix."

Mike Cleary, chief executive officer of 1st Credit, a debt purchase and collection business, says: "1st Credit raised equity finance from Gresham to allow us to cement our position as a leader in the capital-intensive debt purchase market. Continued support from Gresham has helped us to put in place the foundations for long-term growth."

In terms of seeking advice on raising equity capital, more than a quarter of managers express a preference for banks. An independent advisor is the most likely choice for 15% of respondents, closely followed by private equity or venture capital sources (13%). Fewer than one in 10 would call on peers or business contacts with previous experience of equity capital provision, and just 5% of respondents would use shareholders or investors.

Independent advisors are more likely to be used by service companies (19%) than by manufacturers (11%). Both groups have similar appetites for banks and private equity.

Companies in the South are more inclined to go down the private equity or venture capital route (18%), while those based in the Midlands are particularly averse to the use of independent advisors (just 3%).

The single most influential factor in choosing a private equity partner, and in seeking external finance, is track record or experience in the relevant field, cited by 20% of respondents. Understanding of market or sector is also important (17%).



Mike Cleary, CEO of 1st Credit (centre), with co-directors Charles Holland (left) and Najib Nathoo

## WANTED: EXPERIENCED NON-EXECUTIVE DIRECTORS

Most mid-market companies, especially the larger ones, see wide experience as the essential quality of a non-executive director: 40% of survey participants hold this view. The next most important attribute is deemed to be common sense or good judgement, cited by 13% of managers. Integrity, honesty and reliability, at 9%, come in just ahead of sector knowledge and skills, both at 8%.

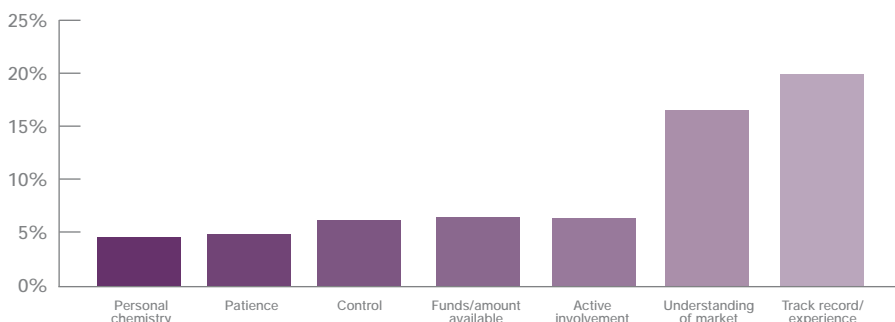
Given that larger concerns are more likely to have non-executive directors, the importance they place on wide experience carries additional weight. Almost six out of 10 companies with 250-500 employees see this as the most important quality, as do 46% of companies with turnover above £10 million. Sizeable companies also place extra importance on common sense and good judgement, with 23% mentioning this as a priority.

But non-executive directors have yet to win over all mid-market firms: more than a quarter of manufacturing companies say that they would not consider having one. Among service-sector businesses, the figure was lower – but still high at 17%.

Are manufacturing firms more conservative, more frugal or simply unconvinced about the benefits of a non-executive director?

### PERFECT PARTNERSHIPS

The main criteria for choosing a private equity partner for companies looking for external finance



# The Gresham View



**S**ince we first surveyed the corporate health of the UK mid-market in our Gresham Monitor in 2000, mid-market companies have been subjected to unprecedented levels of economic uncertainty. But as we go forward into 2004, the mid-market appears to be regaining confidence – and optimism levels are at highs not seen since early 2002.

Perhaps as a result of the recent difficult economic background, and with a period

of benign inflation ahead of us, companies are turning their attention inwards, renewing their focus on improving efficiency and cutting costs. In this Monitor, mid-market companies told us that their main concerns lie in winning new business, achieving growth and improving efficiency – far outweighing concerns over macro-economic conditions.

These results reaffirm our view that, for mid-market companies, significant progress can be made through operational and strategic improvements alone. Achieving this growth potential depends primarily on the calibre of a company's management team – the most important consideration in any investment Gresham makes.

Encouragingly, the return of cautious optimism among mid-market firms is matched by the determination to pursue growth, with 75% of companies planning to seek external financing to fund their growth ambitions in 2004.

The last 12 months have seen a period of consolidation in a difficult market, with many companies having delayed acquisition or expansion plans.

Companies cite a variety of reasons for having to postpone corporate activity, including a worsening outlook for the economy and uncertainty about interest rates.

What is clear is that mid-market businesses are adjusting to benign inflation and lower growth, and consequently corporate finance activity will be based on more realistic and traditional fundamentals, such as cashflow.

As optimism strengthens in the mid-market, we anticipate a busy year for the sector, driven by the return of delayed activity together with new projects.

Gresham's strong regional network of investment professionals, our dedicated portfolio team and biannual Monitor research keep us close to the issues that matter to mid-market management teams. We look forward with growing confidence to the year ahead and to working with a wide range of management teams to realise their ambitions for growth.

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

## About the Monitor

**G**resham is one of the few regionally based UK private equity houses specialising in investing in mid-market companies. Transactions are typically valued at between £5m and £75m. The Gresham Monitor is a regular survey of the UK mid-market sector. This latest survey looked at how the middle market

finances business transactions, and monitored aspects of its economic and corporate outlook and performance. This is the eighth issue, and was conducted by NOP's Business Unit in November 2003. The survey comprised board-level interviews with directors of 100 mid-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.

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