MERGERS AND ACQUISITIONS

IS IT A GOOD TIME TO INVEST IN THE UK?

The UK returned to growth in 2010. In the words of the Confederation of British Industry (CBI), the UK's 'voice of industry', GDP data showed "the UK exiting recession at the end of last year with a bit more momentum than initially estimated, more in line with our forecasts".

UK plc has passed the bottom of the recessionary cycle but concerns about a 'double-dip' remain.

Despite forecasting slower growth in the first quarter of this year of around 0.3%, data showed that the retail sector returned to growth, manufacturing production and orders, including exports, recovered to August 2008 levels, and business, investment and consumer confidence strengthened. And British exporters became more confident about future export growth than their counterparts in the Eurozone..

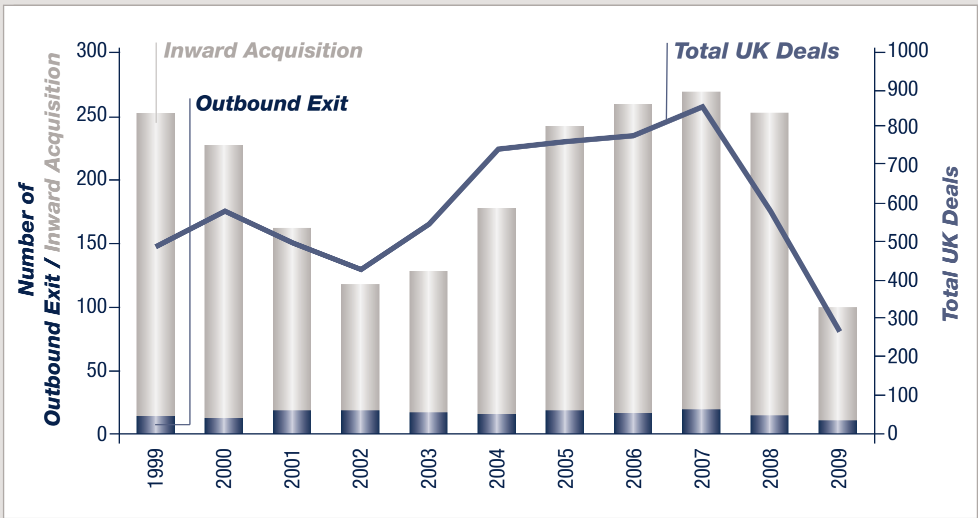
Nevertheless it is widely considered that the recovery will be "slow and fragile for some time"– some sectors are notably sluggish, financial and business services in particular. With households facing steep rises in fuel and other living costs, together with an increasing taxation burden and continuing fears of unemployment, consumer spending will remain under pressure for at least 2010. Despite renewed political stability following the recent general election, resulting in the Conservative-Liberal Democrat coalition, the principal challenge of reducing the budget deficit remains the same – and that will mean substantial public sector cuts and increased taxation, notably a rise in standard VAT to 20% from January 2011.

Following a real decrease in GDP in 2009 of around 5%, the forecast is for growth of around 1.3% in 2010 and 2.5% in 2011.

The European Investment Monitor reported in 2009 that the level of inbound investment 'projects' had fallen across Europe in general, although with the UK remaining top of the list. But another more recent survey this time by AT Kearney reported that the UK had in 2009 slipped from 4th to 10th most attractive place for investment, despite the 'advanced' economies still being regarded as safer havens in stormy times.

Unemployment has yet to peak – most likely in 2011.

NUMBER OF INWARD ACQUISITIONS AND EXITS OF UK COMPANIES 1999-2009 [1)]



The number of inward acquisitions to the UK was much reduced in 2009, reflecting the decrease in total M&A activity.

The relatively weak pound was a key reason – sterling devalued by around 25% since a peak in 2007, although recovering somewhat since this spring. The UK's monetary authority, the Bank of England, is focused on keeping inflation under control, and thus maintaining stability, even at the expense of the strength of the pound. But this could of course provide opportunities for investors and there are strong arguments as to why sterling is undervalued.

Inbound investment to the UK fell to a new low in 2009. It is expected to remain low during 2010, with businesses postponing foreign direct investment plans (to 2011).

[1)] Source: ONS   [2)] British Retail Consortium / ONS   [3)] BDO European Trends Report

Currency issues aside, UK is still a very good place to do business when compared to other countries, with a relatively benign business environment in terms of regulations, a generally non-protectionist regime and relatively uncomplicated takeover rules.

Fears of a ‘double-dip’ linger, with increasing commentary about potential interest rate rises into 2011, whilst there is new layer of uncertainty with the Euro and extreme indebtedness of a number of member nations. But from a UK perspective we look to have passed the bottom of the cycle – many new opportunities for the brave will open up and potential corporate investors might also just get a very good deal on the acquisition price.

> What do these mixed signals mean for acquisition strategies in the UK?

The recession has created new opportunities – although perhaps for the brave right now

Key Developments

- Opportunities for expansion. An increasing number of private companies with access to funding see the current climate as providing huge opportunities for expansion, and not just in their traditional UK markets. Private equity backed businesses seeking to grow aggressively are often highly focused on bolt-on or buy-and-build deals to supplement organic growth.
- Business valuations dropping. Price multiples are certainly likely to be lower than at the valuation peak of 2007, although whilst expectations are not as high, owners will be unlikely to see now as the best time for payback or to realise gains on their personal assets.
- Owners looking for quick exits. Businesses that are up for sale will probably have an important secondary factor at play amongst owner-directors: such as a desire for lifestyle-change, possibly through illness or age, or simply loss of appetite in carrying on the struggle of trading through continued difficult conditions; or a ‘natural’ slowing of demand for the product, the end of a particular business phase ie. winding down of long term contracts, or the erosion of competitive position through poor performance.
- A key factor is changes in capital gains tax – the basic relief limit was extended under the previous government, although the new UK coalition government has now implemented a significant increase in the marginal rate of capital gains tax for higher earners from 18% to 28%. Fortunately for someone looking to sell their business, the “Entrepreneurs’ Relief” limit to which a tax rate of 10% applies, is being further increased from £2m to £5m.
- Postponed previous plans: most ‘planned’ exits, corporate disposals or listings have been delayed ie. those which would normally have been expected to have taken place after a certain period but which fell during the recession – with nearly half estimated to have been delayed by at least two years.
- Opportunities to step in with underperforming or ‘distressed’ businesses. Many balance sheets that have survived the recession will have taken a battering – businesses having dipped into reserves to support cash flow whilst coping with reduced profits. Corporate insolvencies continue at an historically high rate, with commentators suggesting the rate of insolvencies has still to peak, even into next year, at something like 30,000 companies in the year.
- Support for or ventures with undercapitalised businesses that would benefit from the kick-start a capital injection would give. Most businesses will have been focusing on cutting costs / retrenchment and will now be looking to return to organic growth – they will probably require additional working capital to do so.
- Capital is becoming increasingly available, particularly in the form of asset-based finance, but also with apparently recovering appetite for backing buyouts and equity funding.

- Up to 28% of businesses are still looking for acquisitions.
- Returning consumer confidence over the winter, although wavering in the last few months – it was moving in the right direction to support organic growth but new uncertainties in the future seem to be having an effect.

> Key Sectors of M&A Interest

Particularly attractive sectors are seen as health care and education, energy and utilities, along with environmental services. 'Cleantech', renewable energy sectors such as wind, wave, solar, hydrogen and battery technologies, as well as businesses supporting nuclear "New Build" are interesting but long term. Growth in B2B services like facilities management and process outsourcing has tailed off but will recover with the economy. Whilst the UK moved to a service sector economy many years ago, manufacturing still remains a core part of UK industry and there is a growing view that this will have to revive in coming years, although only with investment from abroad or a significant change in market forces. Trade acquisitions that can optimise synergies will always be attractive.

Sectors likely to attract the most investment activity in 2010, according to Private Equity managers[3]

1. **Healthcare & education**
2. **Environment**
3. **Energy**
4. **Business services**
5. **Manufacturing**
6. **Retail**
7. **Financial services**
8. **Media & Telecoms**
9. **Technology**
10. **Leisure & Hospitality**

Opinion is split on retail / consumer facing businesses – some positive some very negative – but in our view retail will provide some great opportunities in the next few years:

- In the first quarter of this year non-food, non-store retail sales continued to show strong average growth over 15% compared to store-based sales[2]. Multichannel businesses continue to penetrate.
- Robust, long-term trends – for example DIY sales have held up and there is a new 'grow your own' gardening boom.
- Fashion retail / fashion trends – fickle, but consumers are always looking for new things

> Focus: Retailers moving in to the UK – truly multi-national retail

Earlier this year property agents in the UK reported that one in 10 stores had been left vacant as a result of the recession. But as the recovery gets under way empty shops will progressively find new tenants, often new names to the UK high street.

And out of the ashes arise new players… Woolworths' once mighty 900-store presence on nearly every high street is being occupied by stores from Clas Ohlson home and DIY products chain to Poundland's discount offerings. Sandwich and fast food chains such as Subway and Greggs continue to expand their UK high street empires.

In addition to domestic activity, some big names from abroad also have live plans to expand in the UK: notably US retailers Best Buy, Victoria's Secret and Forever 21 as well as a range of new European brands including Springfield and Women's Secret from Cortefiel – the 'Spanish Next' – and Vero Moda from Danish group Bestseller.

Strategies differ – from a national rollout to taking on a UK flagship presence on the high street in order to brand build and then rollout a multi-channel strategy.

Whilst total retail sales grew by 1.3% in volume in year on year, non-store grew by nearly 15%

H&M now plans to sell online in the UK from September, and ZARA, the spanish clothing chain, is set to launch online across Europe in the autumn.

It is far harder, however, for unknown retailers to make an impact in such a packed retail market. But it is not just the attention catching deals involving well-known names – mid-market opportunities will continue to arise and UK businesses for sale are advised to include overseas marketing in their sale plans.

The internet is now estimated to account for 8% of total UK retail sales

[2] *British Retail Consortium / ONS* [3] *BDO European Trends Report*

Recent private equity deals include Better Capital's rescue of Readers Digest, one of the UK's best known consumer magazines, and a turnaround acquisition by SKG of ENVY fashion retail outlets. Trade purchases include mail order group N Brown's acquisition of clothing retailer High and Mighty. We are now seeing a range of interesting retail businesses coming on to the market, or at least "reviewing options" and open to 'off-market' approaches.

Foreign takeovers can be contentious, particularly where there is suspicion of asset-stripping or transfer of production is on the cards. Consumers can become upset, at least temporarily, by changes to their long treasured national brands. But most in the UK are used to living in a global economy, and consumers have been happily embracing mass market services and products from abroad for decades.

After recovering over the winter, consumer confidence has wavered in the last few months, but spending is holding up.

One of the oldest and stereotypical national economic clichés, kindly reinforced by Napoleon, is that the UK is a nation of shopkeepers…. in fact the UK is a nation of hardened consumers and so there will always be an opportunity for new retail propositions, even during turbulent and uncertain economic times.

Coupled with the now established penetration of stable broadband across the UK and growth in mobile internet, the retail opportunities for multi-channel operators in particular will be very different from those experienced after the last recession.

KONTAKT
SEMPORA Consulting Ltd.
f.prosser@sempora.com
+44 (0) 7714 332 691