THE CURRENT STATE OF LENDING TO BUSINESSES AND M&A ACTIVITY IN THE UK

IS THERE LIGHT ON THE HORIZON?

In the run-up to the recession, when growth was just tailing off, rather than reversing, there was considerable talk about investing in 'recession-proof' businesses. But continuing fears of a double-dip recession, or as recently suggested by the Bank of England, a more drawn out recovery, will cast a shadow over business plan projections for some time.

Signs of a recovery in M&A market are still clouded by uncertainty

One would imagine that a buyer's market would prevail in the M&A market, but two key factors have meant that deal numbers remain low – the absence of leveraged finance and continuing uncertainty for 'cyclical' industries in particular.

Sellers are also reluctant to redeem the value of their years of hard-work at this point in time, when they will be unlikely to reach their previous expectations, let alone some of the often 'heady heights' of valuations that were around a few years ago. Hard enough to call at the best of times there were many business-owners struggling with the sell decision as the crunch crystallised – some completed, some will see out the recession and take a view then.

Wherever we are exactly in the economic growth cycle, at a macro level it seems clear that we have not yet seen the full effect on corporate solvency and employment and the resultant impact on disposable income, the widening taxation gap, and consumer confidence in general. All stakeholders have been waiting to see whether we are at the end of the destocking cycle, with orders starting to reflow.

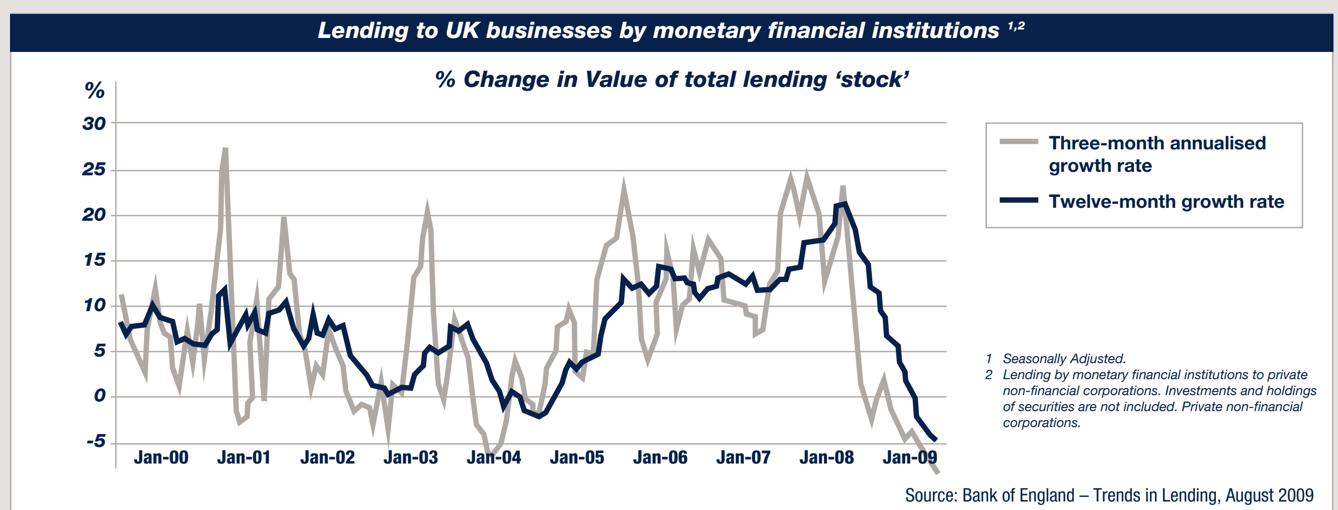
Even after the end of the general recession, a delayed consumer recession remains probablein the UK

Unfortunately there is increasing commentary around previously solid businesses that have seen it through the last year but who are now struggling to maintain sufficient working capital let alone support borrowing, if it were available, for further growth.

> Recent lending data and round up of expert commentary

Official data sourced from Bank of England and covering lending by all UK resident banks and building societies showed that the flow of net lending became and stayed negative in the first two quarters of this year (June: -£0.9 billion) **(see chart below).**

In terms of total lending 'stock' to businesses the first half of the year saw a net inflow to banks



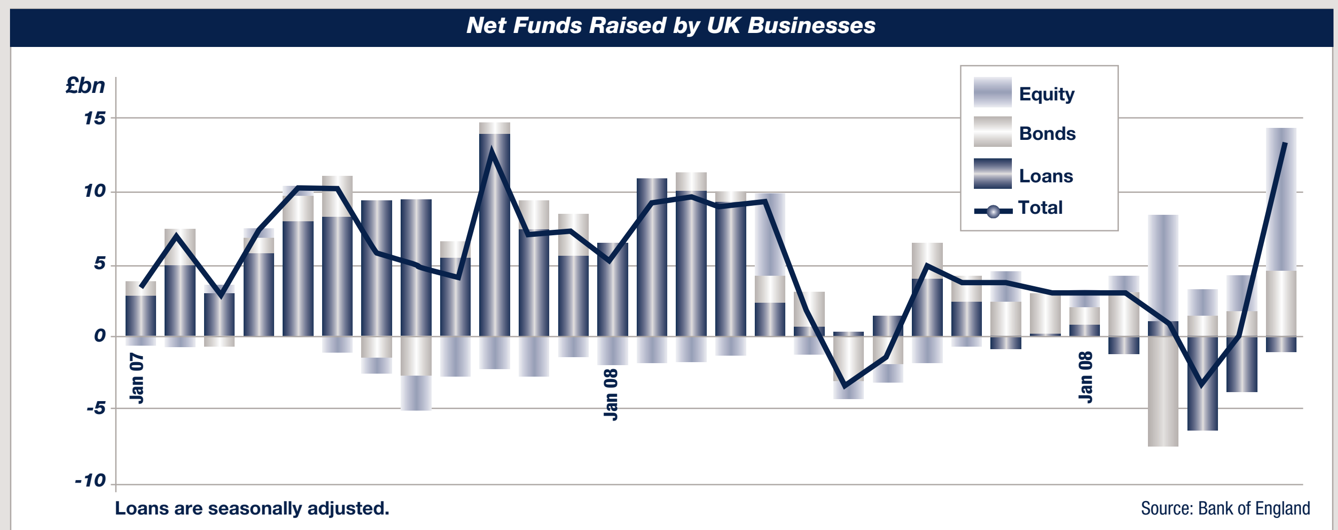
1 Seasonally Adjusted.
2 Lending by monetary financial institutions to private non-financial corporations. Investments and holdings of securities are not included. Private non-financial corporations.

Source: Bank of England – Trends in Lending, August 2009

In contrast, issue of equity was very strong in June, for example **(see chart below),** illustrating a change in corporate financing patterns. According to the 2009 Q2 **Deloitte CFO Survey,** companies "view their balance sheets as overleveraged, and have thus been raising equity". Some UK businesses were reported to have been repaying bank debt using funds raised on the capital markets, "contributing to the weakness in net lending".

A strong switch from Loans to Bonds and Equity as means of raising funds

Net Funds Raised by UK Businesses



Loans are seasonally adjusted. Source: Bank of England

Yet more recently this summer, the major UK lenders continued to report "very subdued demand for any net new lending over and above the refinancing of existing facilities".
The Bank of England stated that "several lenders felt that the period of intense destocking by companies was coming to a close, but they had yet to detect any significant increase in demand for loans to finance business expansion". Companies were also reported not to be borrowing to make acquisitions.

A tightening in the supply of credit over the past year has nevertheless contributed to weaker investment. The CBI **Access to Finance** survey indicated "some easing in the degree to which the availability of finance has been constraining investment. The impact on SMEs remains more severe than for larger companies".

At the same time, businesses are reporting reduced levels of capital investment. According to the British Chambers of Commerce **Quarterly Economic Survey,** investment intentions in Q2 were weaker than in the early 1990s recession. The Confederation of British Industry (CBI) **Industrial Trends Survey** suggested that in Q2 "the demand outlook continued to weigh heavily on businesses' investment plans".

Capital investment has also reduced

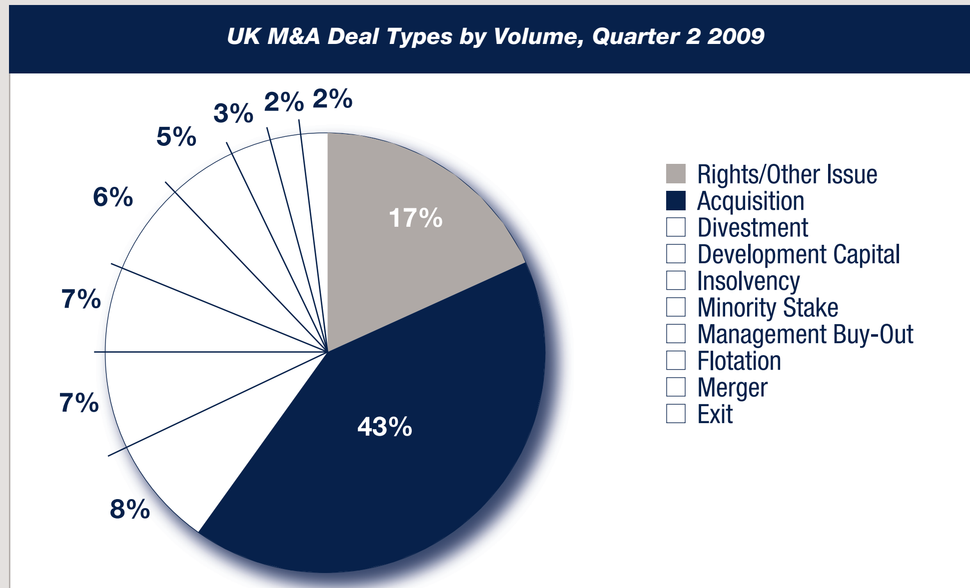
Latest figures from ONS show that Business Investment[1] for the second quarter of 2009 has indeed fallen – an estimated reduction by 10.4 per cent from the previous quarter, being 18.4 per cent lower than the second quarter of 2008. By the same measure manufacturing investment in the UK declined by over 18% over the year.

[1] Measured in chain volume terms, seasonally adjusted (CVMSA). ONS Statistical Bulletin: Business Investment: Provisional Results August 2009

> The M&A Market UK deal types

Figures from CorpFin[2] show that Acquisitions were the most common deal type in Q2 2009, accounting for 52% of all M&A and ECM transactions announced, but only second highest in respect of the deal value. Rights issues accounted for a total value of £30.8bn and 42% of the total deal value of deals announced in Q2 2009 in the UK.

UK M&A Deal Types by Volume, Quarter 2 2009



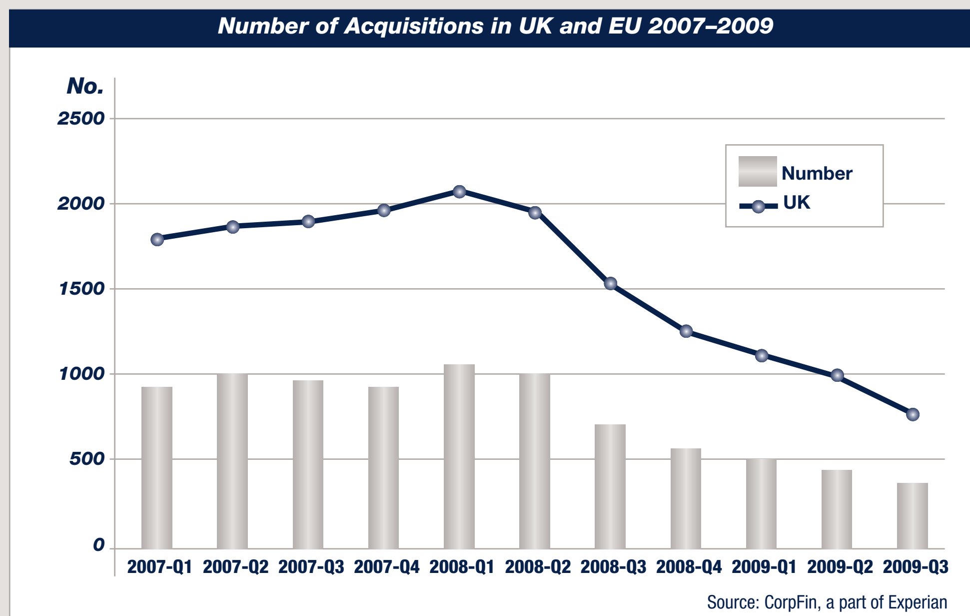
> Level of Acquisitions

Measured as "volume of Acquisitions recorded", M&A activity in Europe has fallen to under half the level of the peaks reached in 2007 and 2008, with Q3 2009 (at 375 for the UK compared to a high of 1055 in Q1 2008) being the lowest reported level for over 10 years in both the UK and the rest of the European Union (Q4 2002 being the last UK low).

The total number of Acquisitions, whether Trade or Private, declined significantly in late 2008 and has remained low in comparison to previous years

This is still a considerable level of activity if viewed as absolute numbers – nearly 2,000 deals reported in the UK in the last 12 months. (around 700 deals with values reported totalling £58bn) [3]

Number of Acquisitions in UK and EU 2007–2009



Source: CorpFin, a part of Experian

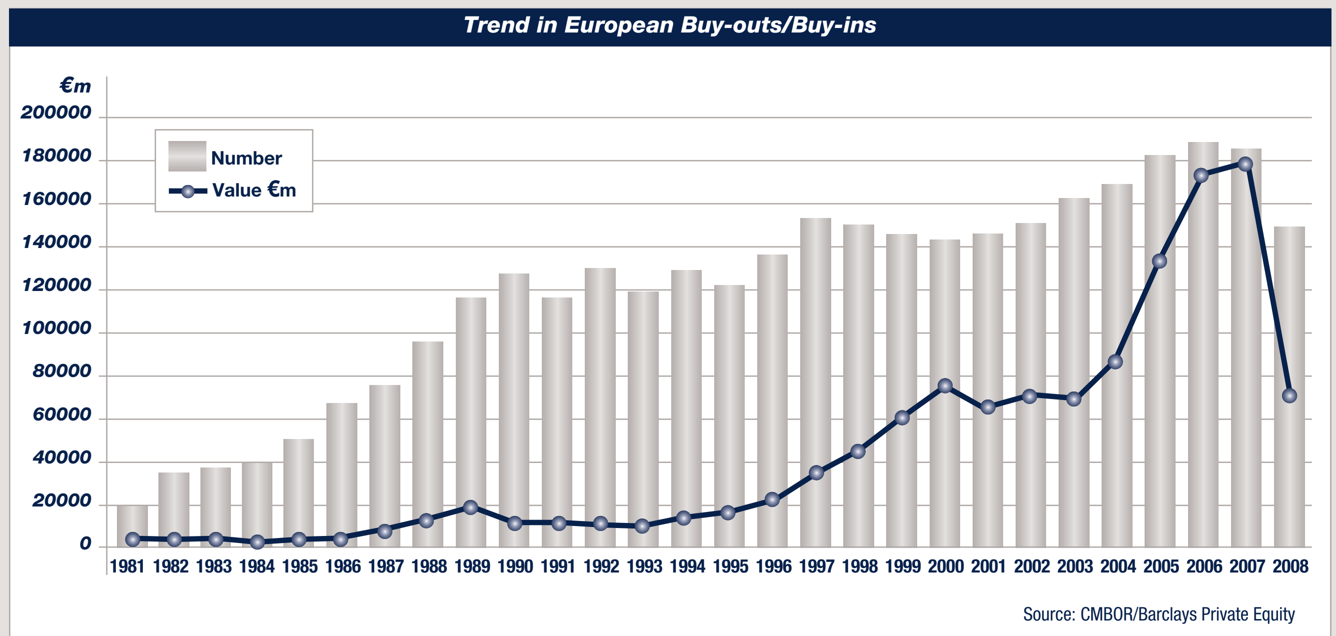
[2] Information reproduced by kind permission of CorpFin, a part of Experian.
[3] Note: Skewed by a number of large transactions

> Buy Outs and Buy Ins

According to the Centre for Management Buy-out Research (CMBOR), the Continental European buy-out market tumbled in 2008 to its lowest level for seven years. The market reached just €43.9 billion in 2008, a 60 per cent fall on the €108.2 billion of deals in 2007. The last time the market was at this level was in 2001 when it reached just €34 billion." An additional £25bn was accounted for by UK deals.

The Corporate Buyout in Europe "tumbled" in 2008 and continued to fall in 2009

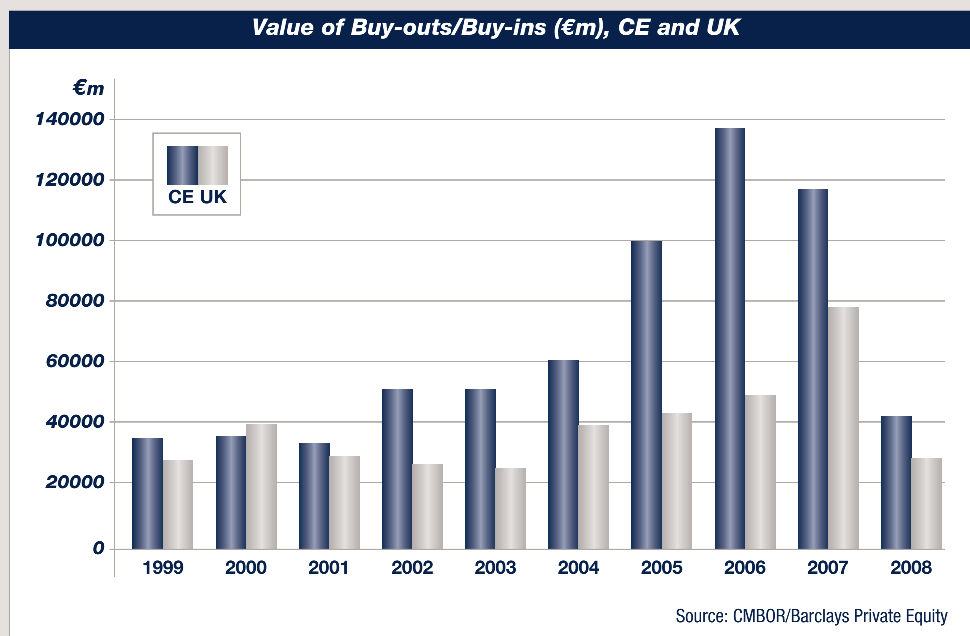
Trend in European Buy-outs/Buy-ins



Source: CMBOR/Barclays Private Equity

In their recent report Christiaan Marriott of Barclays Private Equity predicted for 2009 that: "The situation we have witnessed in the second half of 2008 is likely to be repeated [in 2009]. Until confidence returns to the market, most buyers and sellers will sit on their hands and wait for clearer signals on any potential recovery. There will be some good deals that find bank funding, but they will be few and far between."

Value of Buy-outs/Buy-ins (€m), CE and UK



Source: CMBOR/Barclays Private Equity

Anecdotally there would appear to be considerable amount of previously raised capital waiting for the bottom of the investment cycle. However, it would be hard to imagine that we will see a return to the buoyancy of the market for quite some time. It may also be much harder to raise new funds.

The number of 'mega-deals' of the 2000s has declined dramatically, with the mid-market continuing to see a comparative trickle. In a release earlier this year, David Brooks, Head of M&A at Grant Thornton commented: "It looks like the credit crunch has finally caught up with the mid-market, which had been more resilient to the crisis than top tier deals in terms of deal volumes. Potential bidders are shying away from cyclical industries as fears of a double-dip recession create uncertainty. "

For most buy-out houses, 2009 has turned out to be a year of limited new investment activity.

Private Equity houses are focusing on their portfolios – on a scale of near rescue conditions to prudent preparation for the future, which can include strategic bolt-on purchases or expansions – and on origination of potential deals and reviews of potentially attractive sectors and activities.

> The high level of distressed companies in the UK is an 'opportunity'

More than a third of management buyouts in the UK since the start of the year occurred at companies in administration, as private-equity firms target failed businesses. Private individuals or equity firms with cash and less reliant on debt have been particularly successful at concluding deals in this area (Source: CMBOR).

An increased proportion of deals this year has been as a result of corporate distress.

New guidelines on "pre-pack" Administrations may curtail purchases out of insolvent situations, and one can argue about the ethics here, but these do provide an opportunity for some and there remains a role for investors stepping in to maintain a business as a going-concern of some kind. Sadly, harsh reality has always been that, for the cash-strapped business, investors will be cautious about putting money into a balance sheet held up by shareholder loans.

In a European context analysts at investment banking and advisory firm, Close Brothers, reported that "the UK is home to more distressed companies than any other country in Western Europe, with 24% of all distressed assets based here.

"This was well ahead of Germany, which was ranked in second place with 14% of distressed companies, and Italy who came in third with 12%. France had just 6% of distressed companies in Europe."

Accountants Begbies highlighted the UK retailing, engineering, manufacturing and print and packaging sectors as having all faced serious financial problems in the second quarter of 2009 (Source: Business Sale Report).

> Return to Venture Capital

A positive development is that we will also probably see an increasing return to the principles of Venture Capital – mostly development capital but also start up and seed funding which is rarely available from the traditional banking sector.
At this 'lower' end of the market - ie unquoted companies, typically small companies looking for further investment capital - the role of Business Angel groups and smaller funds will remain important and will hopefully also continue in significance as we exit the recession and entrepreneurs look for external help, against a background of tight lending conditions. At the riskier end of the investment spectrum there are many smaller

businesses - the genuinely undercapitalised early-stage business with as yet unproven potential - that need some kind of funding that the traditional models have not adequately addressed.

Note: *Regarding Venture Capital Trusts and Enterprise Investment Schemes in the UK there is a £2m limit introduced in 2007 on the maximum investment that a company is allowed to raise in a year. Various bodies, suggest that limit be removed or temporarily relaxed (as we grow out of recession) to encourage entrepreneurial activity and assist the small and medium sized business sector.*

"The Equity Gap" With respect to smaller investment amounts ie. under £10 million the phrase 'equity gap' has arisen – defined for example by Key Capital as "being the market space that has been vacated by most institutional private equity investors as they have raised ever-larger funds, leaving relatively few investors prepared to invest amounts of much less than £10m."

The credit crunch has left the banks with reduced capital available to lend. Additionally, data from the Bank of England shows that the syndication market is much reduced, which has further affected the desire of banks to fund deals. Of course the effort and cost of doing a deal is also proportionately higher for the smaller deals. But with debt hard to come by, this end of the market may become increasingly attractive for larger investors.

> Conclusion

Whilst the level of investment may not quickly return to its peak levels of 2006-2008, Acquisition Finance and Private Equity in particular must remain an attractive and important source of financing and wealth creation in the UK.

Investors in businesses will be quick to apply the lessons learned from the recession

There is still appetite for deals and reportedly high levels of uninvested cash but continuing uncertainties mean we are not going to see a rush. Raising further cash from existing fund investors is likely to become harder as investors look harder at their realistic cash returns.

In turn we foresee:

- **Increased focus on the acquired company's business strategy and operations.**
- **Less reliance on leveraging deals through debt.**
- **More emphasis on the values of wealth creation through operating businesses successfully.**
- **Increased requirement for investor due diligence and post-deal support.**
- **Interest in certain businesses and sectors that have outperformed competition during the recession (and the reasons why).**

Deal information supplied and reproduced by kind permission of:
1 The Centre for Management Buyout Research (CMBOR), Nottingham University
2 CorpFin, a part of Experian

Other Sources:
- *Bank of England*
- *Business Sale Report / Business Data International*
- *Barclays Private Equity*
- *Key Capital Partners*

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