



Equilibrium nears in corporate finance market

In the previous edition of Corporate Finance Insight, we outlined the shift towards more regular activity. Since then, the market has been stabilising and we are seeing a fairer perspective as market forces reach a point of equilibrium.

Transactional activity has recommenced in the corporate finance world. Whilst large transactions such as Kraft-Cadbury indicate that large corporates can sense the way forward, at the other end of the scale, the market in sub £10 million deals is also showing signs of some activity.

Market activity had previously been characterised by the 4Ds (distress, dispute, death and divorce), but finally non-distress sellers are beginning to emerge and pricing between buyer and seller is becoming more aligned.

There is more certainty and comfort that the economic outlook has stabilised. Market sentiment has improved and plans can now be made with increased confidence in the future. Whether viewed collectively or individually, investors need and want to make a good return on their capital, and

with property markets faltering, and interest rates at an all time low, there is much focus on opportunities for investing in growing businesses. We have seen this particularly from overseas investors where sterling-dollar and sterling-euro relationships also benefit the inward investor.

Such is the transactional background to the market. In addition to these drivers, we are now seeing some further evidence that the economic market is picking up. As a result, we anticipate a tangible increase in the number of transactions as new growth and development opportunities emerge for which there will be funds available.

The third quarter of this year may not have been as busy as the halcyon days, but we have recognised a marked increase in activity from our clients, transmitting into real deals.

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Where are we now?

Stock markets are improving, commentators are calling the end of the recession and some banks at least are returning to profit. All good news you might think.

But unemployment is rising, and we know historically that businesses are most vulnerable to failure in the upturn after a recession – as they risk overtrading and are insufficiently capitalised to make it through the increase in business activity. Furthermore there are still capital constraints in the market.

Overall, the news is good, and more reassuringly, it extends towards the smaller end of the business spectrum. Emphasis is commonly placed on corporate UK, but the spread of employment and turnover (See table 1) is far broader than might be appreciated. In the UK, 99.8% of incorporated businesses have fewer than 250 employees and account for over 50% of the overall UK market turnover.

It's not surprising that the government recognises the importance of this small businesses arena and has taken some steps to support it.

Capital support for smaller businesses

Overall capital availability may have shrunk, but supply is still available at the sub £25 million debt level where the underlying business story supports the proposal, which is illustrated in table 2.

With a strong political objective of providing assistance to smaller businesses, the government has launched such funds and schemes as the Enterprise Finance Guarantee

Table 2: Lending to UK businesses

	12 month growth rate (%)				Stock outstanding (£ billions)
	2008	2009			2009
	Dec	June	July	Aug	Aug
Lending to UK businesses	8.6	-0.9	-3.5	-4.4	550
Lending to SMEs	12.9	3.3	2.3	1.6	120
of which, to small SMEs	10.0	6.9	7.0	6.4	35
Lending to small businesses	7.1	5.2	n.a.	n.a.	56

Source: Bank of England, BBA and BIS

and Capital for Enterprise funds. In addition, the underpinning of the banks with central Government financial support, has encouraged the banks to support the market for smaller deals.

Indeed the British Banking Association statistics reflect an increasing support for the small business. Figures released at the end of September indicated new lending to small businesses of £748 million in July 2009.

Commenting on the data, BBA Statistics director, David Dooks said: "Volumes of new lending to small businesses are holding up and, notwithstanding the recession, the stock of lending has grown 4% in the last year and the continuing number of start-ups are also encouraging. A contraction of past lending arrangements, representing prudent debt assessment and management by businesses and lenders, resulted in subdued net lending in July, but there has not been any material reduction in new credit availability." (Source: CCA statistics release Sept 2009).

The leverage teams in the sub £10 million deal space are also feeling the benefits of the political focus and emphasis from the more recent banking changes.

Peter Ibbetson, chairman of small business at NatWest and The Royal Bank of Scotland

commented, "We are approving 85% of loan applications we are receiving from businesses. There is no shortage of liquidity for the SME sector. Our priority is to help businesses through these difficult times by offering the right advice and the right financial backing".

Government sponsored initiatives

The government has a series of initiatives for businesses with turnover below £25 million. Debt finance is available through the Enterprise Finance Guarantee scheme. This is the replacement scheme to the Small Firms Loan Guarantee scheme and is intended to encourage bank lending where there is an acceptable business case but a lack of security.

The scheme guarantees up to 75% of the bank's lending in return for a small premium. The minimum loan amount is £1,000 and the maximum is £1 million.

Since its launch in January 2009, over 5,100 loans worth over £521 million have been offered, and of these more than two thirds were offered to businesses with a turnover of less than £1 million.

Table 1: UK Whole Economy – Private Sector (including public corporations and nationalised bodies)

Number of employees	Number of enterprises	% of Enterprises	Turnover £m	% of turnover
0-1	3,737,780	78.1%	263,021	8.8%
2-4	617,130	12.9%	210,984	7.0%
5-9	223,585	4.7%	177,975	5.9%
10-19	116,645	2.4%	190,499	6.4%
20-49	55,415	1.2%	251,897	8.4%
50-99	17,105	0.4%	171,373	5.7%
100-249	7,985	0.2%	164,183	7.9%
250-499	4,690	0.1%	240,264	9.0%
500+	2,959	0.1%	1,224,781	40.9%
TOTAL	4,783,285	100%	2,994,978	100%

Source: BIS Enterprise Directorate Analytical Unit

Mezzanine and equity

Enterprise Capital Funds (ECFs) address a market weakness in the provision of equity finance by using Government funding alongside private sector investment to establish funds that operate within the equity gap.

An equity gap arises where businesses with viable investment propositions fail to attract investment from informal investors or venture capitalists. In bridging this gap, ECFs aim to alleviate a significant barrier to enterprise and productivity growth. Ten such funds have been launched since 2006.

Enterprise Capital Funds are only available to viable limited companies with a turnover of up to £50 million. They must be prepared to sell a stake in the business in return for a capital injection and must demonstrate the potential for long-term capital growth. The minimum investment is £200,000 and the maximum is £2 million.

Enterprise Capital Funds have the potential in some instances to provide mezzanine finance.

As its name implies, mezzanine finance sits between lower risk debt and higher risk equity. Although it is usually associated with larger businesses, there are instances where PE houses will configure deals with such capital structure.

Octopus Ventures has a variety of private equity offerings, including an ECF. Rupert Bell of Octopus says: "SMEs face a lot of challenges in this environment and it's important that good companies get the support they need. There are some great businesses out there, with innovative products and services, clear strategies and strong management teams, which simply need extra backing and advice at this point. With the help of the Government, that's what we're looking to provide."

For larger transactions above £2 million, a good number of PE houses are prepared to lend. Their appetite will depend on the type of opportunity and every proposition would be reviewed on its own merits. However, all will consider the potential risk and reward and look for a good measure of their ability to enjoy a capital gain.

Certain houses may prefer certain sectors, whilst others will have an affinity for particular size or type of transaction.

Tax incentives for smaller business financing

Since the 1980's the government has used tax incentives to encourage individual investment in smaller businesses. Initially this was through the Business Expansion Scheme and in 1994 this was replaced by the Enterprise Investment Scheme (EIS), which subject to a number of rules, gives investors the opportunity to enjoy tax relief on the investment as well as subsequent tax-free capital gains.

The introduction of Venture Capital Trusts (VCT) in 1995 gave investors the opportunity to pool their funds and participate via professional fund management in a portfolio of smaller businesses with similar tax breaks to the EIS. Historically private equity houses raised finance from pension and insurance funds, and from large PLCs looking to balance their portfolios with small, high-risk, high-return investments.

As VCTs have gained both popularity and status as a portfolio investment (see Table 3), the smaller PE houses have attracted considerable funds from retail investors, which has in turn increased the supply of equity capital for smaller deals.

Other sources

In addition to VCTs, there remain a number of non-VCT PE houses who raise funds from the traditional PLC, insurance and pension market. They are particularly interested in opportunities to back MBOs and platform businesses for buy-and-build in a consolidating market.

Other sources of capital include family offices – essentially private offices for high-net-worth families – which occasionally look to invest family wealth into entrepreneurial businesses.

Whilst a number of business angels have emerged, they are more difficult to pinpoint and address through the investment process and also may not have sufficient additional equity injection if required.

Table 3: Number of VCTs and funds raised

Year	Amount (£million)	VCTs raising funds in the year	VCTs managing funds	Rate of Income Tax Relief (%)
1995-96	£160	12	12	20
1996-97	£170	13	18	20
1997-98	£190	16	26	20
1998-99	£165	11	34	20
1999-00	£270	20	43	20
2000-01	£450	38	61	20
2001-02	£155	45	70	20
2002-03	£70	32	71	20
2003-04	£70	31	71	20
2004-05	£520	58	98	40
2005-06	£780	82	108	40
2006-07	£270	32	121	30
2007-08	£230	54	131	30
2008-09	£150	46	129	30
Total	£3,650			

Source: UK national statistics

The corporate finance market outlook

Clearly there is increasing financial support for SMEs and as the global economic outlook improves, we can expect increased opportunities for vendors and acquirers alike.

The rationale for acquiring is changing from those seeking value from distressed sales. With greater certainty regarding market prospects, a number of corporates are actively seeking to purchase, either through market consolidation or expansion, and are offering more reasonable terms to vendors.

Additionally, a number of Management Buy Outs are now beginning to be mooted as delayed vendor retirement plans and corporate group disposals are advanced.

The vendors' perspective has also changed. Now that the economic impact of the credit crunch appears quantifiable, they are coming to a market that is more likely

to offer cash and more reasonable values for their businesses.

Although valuations have not returned to previous levels, the prospect of future increases in income and capital gains taxes are encouraging vendors to act now when they might realise a higher net value.

And to quote a number of advisers and financiers within the corporate finance community, the developing landscape in the post credit crunch environment is now beginning to be referred to as the 'new normal'. Valuations and lending multiples, whilst significantly lower than the heady days of 2007, are finding acceptance in both vendors and acquirers.

With good luck, fortune and some astute planning, 2010 could well be a year where when we can begin confidently to look to the future.

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