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Thames Valley Deal Team Times

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Out of recession in 2010…but just what is in store for the year ahead?

In the Spring 2010 edition of the Deal Team Times, we looked back on what had been a "turbulent and challenging 2009, and a far from certain 2010" ahead. Now, a year later, we can look back on a 2010 which could have been a lot worse than many had predicted – and new reasons for uncertainty for the year ahead.

2010 saw the UK come out of recession through a slow, drawn-out recovery. Consumer and business confidence has broadly (but quietly) held up. Whilst there have been some job losses (unemployment up 0.1% over the last quarter 2010), and some notable business failures (Pontins and Connaught for example), there have also been some positives.

Perhaps the single most awaited economic event of 2010 was the new coalition government's Comprehensive Spending Review ("CSR") announced in October. Although this review may now seem "old news" the significant effects of the announcements have yet to really be felt. There will undoubtedly be some suffering, but there are also real opportunities for segments of the private sector.

Technology, energy and mining sectors were the outperformers of 2010. More generally, manufacturing industries had a stronger year than service businesses, the former being driven by strong export markets – particularly from emerging economies. The service sector continues to suffer from a relative lack of consumer confidence.

On the capital markets front, the FTSE-100 index increased by nearly 10% over 2010, breaking the 6,000 mark just before the year-end for the first time since June 2008. However, despite this real sign of investor confidence and a significant level of public company deal activity during the year, the anticipated return of significant levels of IPO activity did not materialise as planned listings were delayed or pulled.

But what of the deals environment more generally? Was the increased level of M&A activity observed in respect of public companies replicated in other sectors of the economy? Absolutely! The Deal Team has been extremely busy since May 2010, helping private companies, owner-managed businesses and inbound clients to realise their M&A ambitions and maximise value for shareholders. This very high level activity was maintained throughout the remainder of the 2010, and into January 2011.

So what's the outlook for 2011?

It is likely to be the year in which the effects of the CSR are first really felt. VAT has already increased to 20%, and debate is continuing as to who is really bearing the additional cost (i.e. are the increases being passed on to customers?). The beginning of a new fiscal year in April will mean implementation of new, tightened public spending budgets, this surely having effects on both the public and private sectors.

Perhaps the single overriding economic uncertainly governing 2011 is the Eurozone debt crisis, its potential effect on the wider debt markets, and hence the UK economy. Portugal and Spain have hit the headlines again recently and Europe is, after all, the UK's biggest export market.

There is also increasing concern over the long-term credit-worthiness of the US. Locally, the Deal Team is seeing relatively low levels of companies in immediate financial difficulty. However, there is some speculation as to whether financing banks are waiting to see which amongst them will be the first to start calling in debts after which other banks may follow – leading to an increased level of company failures.

In the meantime "good book" M&A activity remains strong, despite the availability of debt still not being as good as it might be. The UK remains relatively cheap for overseas buyers, and there remains pent-up demand amongst both financial and private owners to realise existing investments. And there remains a pipeline of potential IPO candidates waiting in the wings.

Real opportunities exist for private companies to benefit from the effects of the CSR through outsourcing, JV or consolidation deal opportunities. And even within the public sector itself, our Deal Team's nationally-recognised experience in this sector means that we are ideally placed to advise and help realise strategic plans relating to (for example) the required restructuring of, and increased role of GPs in, the health sector supply chain.

As was the case this time last year, there are major uncertainties ahead in the macroeconomic environment, but we believe that this generates real opportunities in the deal environment, which we would be only too happy to help you with.

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Implications of the CSR for private sector industries

As widely reported, government is planning to reduce demand in the UK economy during the course of this Parliament through a combination of spending cuts and tax rises.

It is estimated that the public sector spending cuts could have significant knock-on effects on private sector gross output due to the impact on suppliers to the public sector (and their suppliers in turn). Almost half a million private sector jobs could be lost as a result.

The business services sector faces the largest impacts in absolute terms, with potential output losses of around 4% and over 180,000 job cuts due to reduced public sector demand in current areas of operations. On the other hand this may also be the sector that, based on historic trends, will create the greatest number of new private sector jobs to offset the squeeze on the public sector. In addition, there are signs that the coalition government may move the boundary between the public and private sectors in certain areas, thereby opening up new opportunities for business services companies – in some cases working with voluntary sector organisations.

The construction sector could see even larger relative cuts with an output loss of around 5% leading to around 100,000 job cuts. This reflects the greater exposure of this sector to cuts in public sector capital investment. Other smaller sub-sectors, such as office machinery and computers and weapons and ammunition, could see even larger relative cuts in output and jobs given their heavy reliance on public sector customers. The challenge for these businesses will be to diversify into other markets, both in the UK and overseas.

These effects relate to public spending cuts, but there will also be material impacts from planned tax rises, although these are harder to quantify at the sectoral level. There may also, however, be positive effects from the fiscal squeeze in terms of the possibility of interest rates remaining lower for longer and a reduced risk of a major financial crisis associated with a bond market revolt of the kind seen in Greece and elsewhere in the Eurozone earlier in 2010.

Quantifying these more positive effects is difficult, although in general we would expect (based on the experience since the early 1990s) to see labour-intensive service industries being the main source of new private sector jobs in the coming years, so helping to compensate for negative employment growth in the public sector and more traditional areas such as manufacturing, energy and utilities, and construction.

A sector likely to continue to see growth opportunities from spending cuts is outsourcing, and not only in back office services. As government and public sector organisations look to reduce their non-core, fixed cost operations, and increase the use of private and voluntary sector organisations in the delivery of front-line public services, organisations such as Serco are already highlighting opportunities for new business in their financial statements. Many are also seeking to form alliances with voluntary sector organisations.

Similarly, organisations with flexible supplies of labour, such as manpower service providers, will have new opportunities in future, such as partnerships between government and private sector manpower providers to performance manage and retrain staff, to find new employment for them where possible, and to manage redundancies where it is not.

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TelecityGroup acquires Internet Facilitators, supported by PwC's Deal Team

TelecityGroup, Europe's industry-leading provider of premium network independent data centres, announced on 2 August 2010 that it had acquired Internet Facilitators Limited ("IFL") for £21.1m. IFL is a carrier neutral data centre based in Manchester.

TelecityGroup is expanding its presence in commercial centres across Europe, and management believes that Manchester offers prospects for significant growth. The acquisition of IFL represented a unique opportunity, providing a complementary strategic fit with the group's existing presence in the city. The IFL facility will add 1,600 sqm (1.4MW) of high quality capacity to the existing group estate, and has the potential for significant further growth.

TelecityGroup's data centres act as connectivity hub facilitating the storage, sharing and distribution of data, content and media. The data centres are located in prime positions for commerce and connectivity including London, Amsterdam, Frankfurt, Paris, Stockholm, Manchester, Milan and Dublin.

The acquisition followed a period of extensive due diligence supported by our Deal Team.

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Debt market update

PwC's latest Debt Markets Update report showed that despite worries over the euro-zone and fears of a double-dip recession, Q3 of last year saw the markets record a strong period. Here, we take a look at the trends revealed by the report and the future of the debt markets.

The low interest rate environment has generated high levels of liquidity and the bond markets in particular have responded with high levels of issuances and tightened pricing. But whilst markets have responded positively to the increased chances of further quantitative easing (or QE2 as it has become known), this only serves to highlight the fragility of the current global economic environment.

The short-term outlook for lending remains positive but there is still a risk that markets will be subject to further volatility in response to macroeconomic developments. In the leveraged market, the large number of deals coming through at the end of 2010 had caused some concern amongst market participants as to whether the still-fragile European markets will cope with the level of deal flow. The successful syndication of these deals underlines the continued recovery of the leveraged finance market.

In contrast to buoyant levels of bond issuance and the recovery in leveraged finance, other credit markets are more subdued. Long term project and infrastructure finance will be significantly impacted by the Government's Comprehensive Spending Review. Whilst there is an undoubted long-term requirement for infrastructure projects, the current round of austerity measures being implemented across Europe is dampening demand for new finance in the short-term.

With the coalition government budget cuts spelling the death knell for programmes like Building Schools for the Future and the Comprehensive Spending Review likely to result in a number of other projects facing the axe, the outlook for project financings in the UK for the first half of 2011 is a continued low level of activity, that may not be helped by the rising speculation about a potential imminent increase in interest rates.

To download the full Debt Market report visit: http://www.pwc.co.uk/pdf/premium/uk-debt-market-update-q1-2011.pdf

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Vendor due diligence delivers value

A PwC Deal Team drawn from across the South East has provided vendor due diligence services to Siemens UK in relation to the sale of Roke Manor Research Ltd to Chemring Group plc.

Roke Manor Research Ltd is a leading centre for advanced technology research and development, based in Hampshire. Working in collaboration with government agencies, consortia and industrial partners, Roke has established a world class reputation for developing and delivering innovative advanced sensors, signal processing, communications and network solutions in the defence, security and industrial markets.

Chemring Group plc is a global defence business listed on the London Stock Exchange, with a market capitalisation of over £1bn. The group specialises in the manufacture of energetic material products, providing solutions for highly demanding requirements in the Countermeasures, Counter- IED, Pyrotechnics and Munitions markets. The innovation and development and now employs over 3,500 people in the UK, US, Germany, Italy, Norway, Spain and Australia.

Commenting on the sale of Roke to Chemring, David Smith, Managing Director of Roke said: "Joining the Chemring Group will provide the independence and investment required to enable our continued growth. Our focus remains on leading innovation in communications, information systems and electronic sensor technology."

Speaking about PwC's vendor due diligence report and process, Andy Bown of Siemens stated, "PwC's VDD report was an important part of the divestment process and was very well received by the bidders it was shared with. The report was a good balance of analysis and writing, allowing bidders to quickly understand the Roke business. Overall, we were very pleased with PwC's contribution to the project."

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Rapid relationship-building and team "brilliance" helps trans-Atlantic deal to complete

On 5 October 2010, the board of London main market listed AEA Technology plc, which provides environmental consulting services to businesses and governments, announced that it had entered into an agreement to acquire US-based ERG (also an environmental consulting firm) for approximately $83m.

The transaction was funded by a placing and open offer, further complicated by a capital restructuring and reverse takeover rules, which required a multidiscipline PwC team to undertake the role of Reporting Accountant and provide financial due diligence, tax and structuring advice.

The complexities of the deal process and the performance of work concurrently in the UK and US, meant that strong pro-active communication (both internally and externally) was key to ensuring that the project remained on track.

The ability of the PwC team to rapidly build relationships with both client and target was critical to the successful outcome of the acquisition process – with the client describing the PwC team as "brilliant".

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VAT recovery on deal fees – what's the latest?

One of HMRC's recent areas of focus has been to review the recovery of VAT by taxpayers on professional fees relating to activities such as corporate restructuring, re-financing, PE acquisitions and other types of deals.

Until recently the taxpayer's success in the BAA case and the AB SKF case appeared to have stalled HMRC in this respect. However, HMRC have recently succeeded with their arguments at the Upper Tribunal in the MyTravel case. HMRC's success is likely to give fresh impetus to their efforts to restrict the recovery of VAT in similar circumstances.

The My Travel case concerned a tripartite agreement between MyTravel, a number of financial institutions and a third party advisor. MyTravel sought to reclaim the VAT on the services provided by the third party advisor as its input tax. The Upper Tribunal restored HMRC's decision to disallow the company's claim for input tax. The court's reasons can be summarised as follows:

- It took the view that the there was a single supply of services by the third party advisor.
- The single supply of services was, in fact made to the financial institutions and not to the company,
- The company therefore did not receive the services wholly for the purposes of its business and the VAT was not input tax proper to the company.
- It acknowledged that although MyTravel had been involved in the appointment of the advisor, received a copy of the report and may have received some benefit from the report, this did not entitle it to recover the VAT as input tax.

The My Travel case confirmed the principles which should be used to determine whether a taxpayer should be able to reclaim VAT on deal costs. It may be possible to differentiate the MyTravel decision from other types of deals and there are actions which can be taken to strengthen the VAT recovery position.

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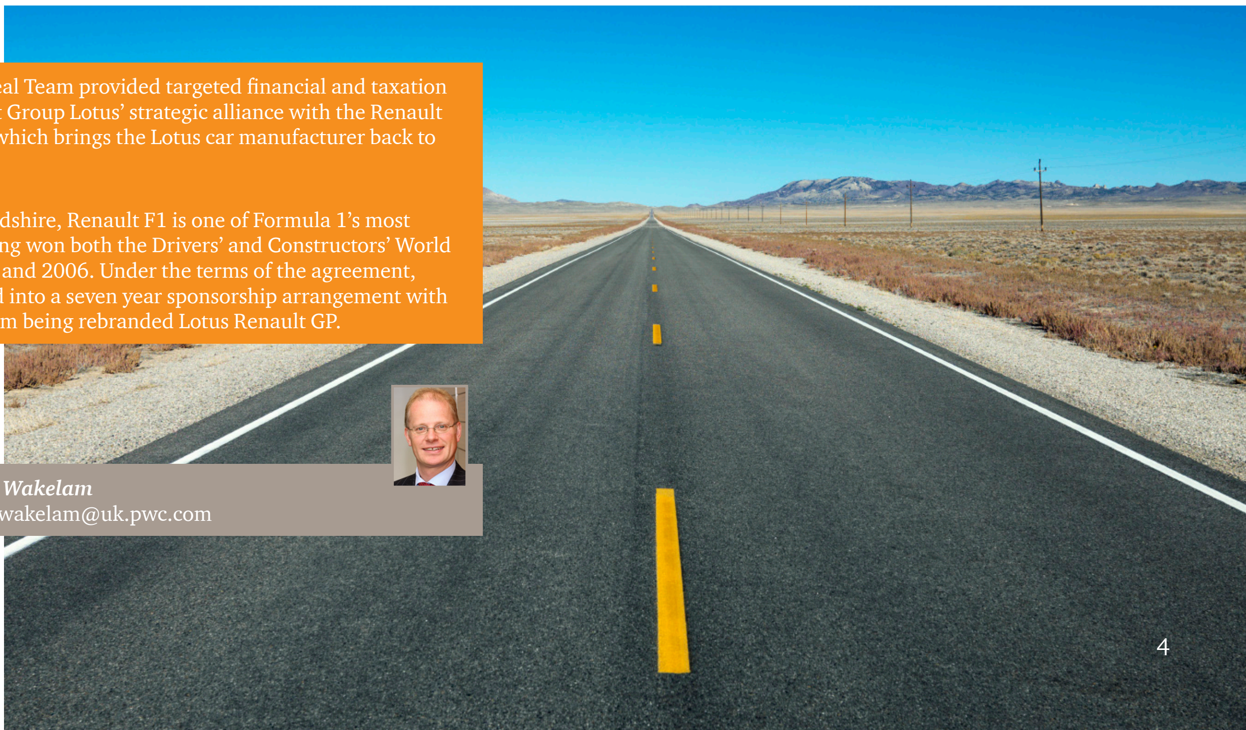
Group Lotus returns to the grid as Lotus Renault with support from the Deal Team



PwC's Thames Valley Deal Team provided targeted financial and taxation due diligence to support Group Lotus' strategic alliance with the Renault F1 team, a partnership which brings the Lotus car manufacturer back to F1 in 2011.

Based in Enstone, Oxfordshire, Renault F1 is one of Formula 1's most established names, having won both the Drivers' and Constructors' World Championships in 2005 and 2006. Under the terms of the agreement, Group Lotus has entered into a seven year sponsorship arrangement with Renault F1, with the team being rebranded Lotus Renault GP.

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News

2011 is a window of opportunity for tech M&A

The alignment of cash-rich trade buyers, private equity sponsors with funds to invest and continued improvement in financing liquidity is opening a window of opportunity for technology merger and acquisition activity, according to PwC's recently published Technology M&A Insights report.

To download the full Technology M&A Insights report visit:
http://www.pwcwebcast.co.uk/dpliv_mu/technology_insights_Jan2011.pdf

Corporate Finance partner and technology sector leader Andy Morgan said; "More high quality assets are now being brought to market as sellers seek to take advantage of the presence of cash-rich corporates with a renewed appetite for mega-deals, a resurgence of private equity buyers and improving capital markets.

"We are seeing a change in deal dynamics as appetite returns. The number of pre-emptive deals is on the rise with buyers originating deals rather than competing in traditional auction processes. Growth is firmly back on the corporate M&A agenda."

Compared with the cyclical low in 2009, technology sector deal volumes recovered over the course of 2010, while deal values rebounded more strongly. Some 393 deals completed in 2010, (up 32% from 2009) with a total value of €75.7bn – more than double the value completed in 2009. The recovery in M&A activity remains relatively cautious with both deal volumes and values still some way off the highs of 2007 and 2008.

Thames Valley Deal Awards open for entries

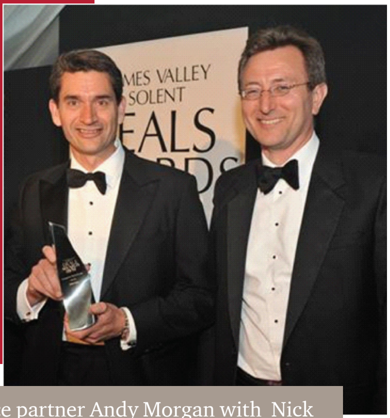
PwC is delighted to once again sponsor the Management Team of the Year award at this year's Thames Valley & Solent Deal Awards.

The Management Team of the Year award recognises the business leaders behind the deals that have shown exceptional leadership and vision, and acknowledges the hard work that goes into managing a business through the deals process.

Last year, we saw some inspiring examples of management teams that not only managed through a tough economic period but built significant value in their companies through successfully achieving a key merger or acquisition.

Nominations for the awards are open until Friday 4 March for deals between 1 January 2010 and 28 February 2011 and the winners will be announced at a gala dinner on the 7 April.

For further information about the Thames Valley & Solent Deal Awards or to enter, please visit www.dealsawards.co.uk



PwC corporate finance partner Andy Morgan with Nick Bray of Micro Focus, winners of last year's Management Team of the Year Award.

Meet the Thames Valley Deal Team

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