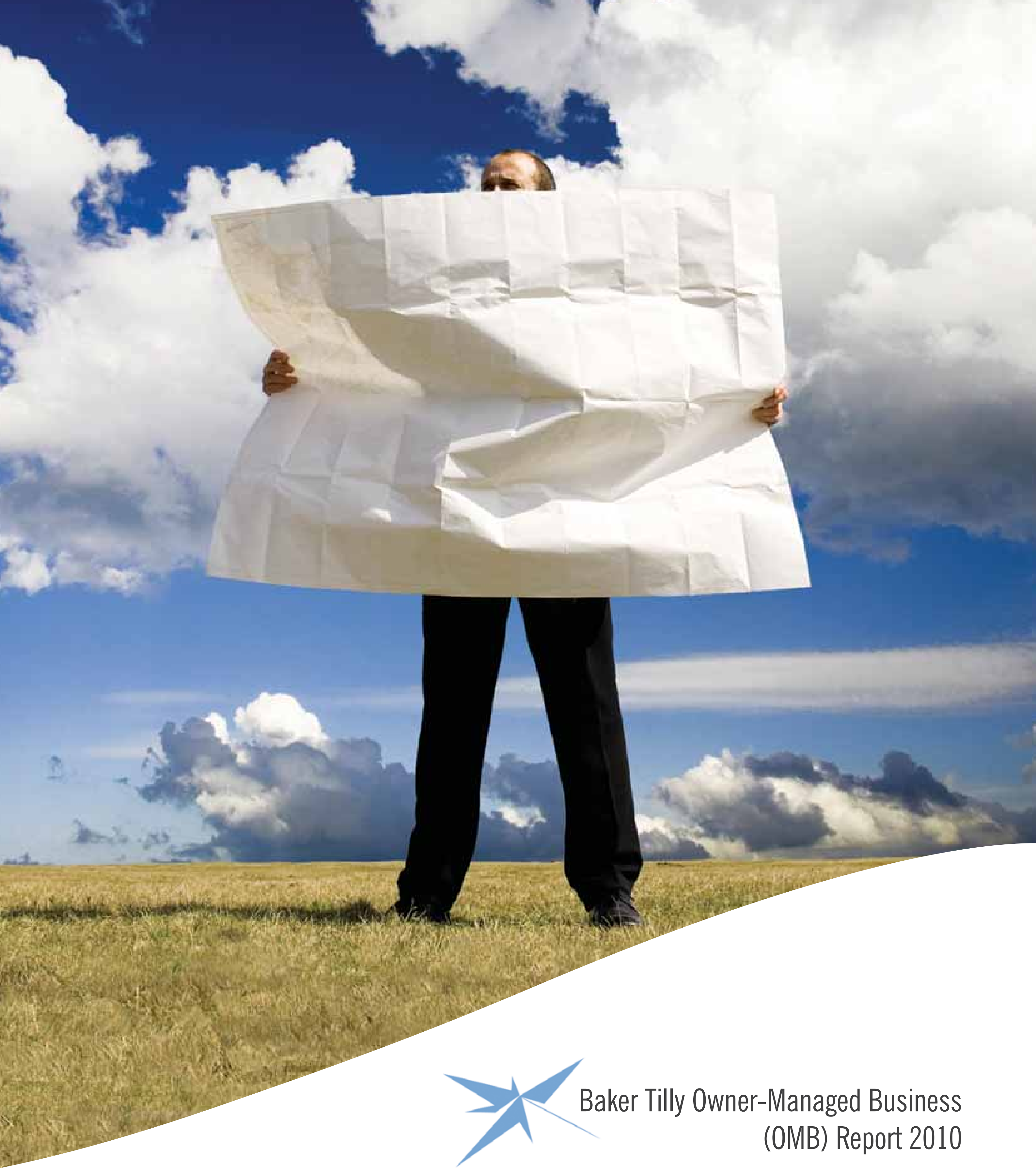


Baker Tilly Owner-Managed Business (OMB) Report 2010

www.bakertilly.co.uk/direction

BAKER TILLY

Owner-Managed Business (OMB) Report 2010

Baker Tilly spoke to 200 directors of owner-managed businesses (OMBs) in early 2010 to gather their opinions of what the current economic climate means for the nation's OMB community. We asked our respondents about a range of issues, including the outlook for sales, margins and profits, their employment plans, perceived threats, risks and opportunities for growth.

The responses of those taking part represent real experience. Rather than basing their assessment of future prospects on market reports and analysis by pundits, our respondents drew on factors such as their own order books and customer enquiries. As one director put it, "we look at the number of people through the door and how much they spend."

In this respect, our OMB survey represents a dispatch from the front line of the mid-size business sector at a crucial time for the UK economy. Its findings offer a unique insight into the impact of an unprecedented recession on OMBs and the outlook for the future as they see it.

Optimism and trepidation

A majority of owner-managed businesses expect to increase sales in the next 12 months. They are confident, for the most part, that they can maintain their gross margin and increase operating profit.

This demonstrates a distinctly more optimistic outlook than our last report 12 months ago when the economy was in the depth of the recession. This seems to suggest a consensus view that the worst is over now.

However, business owners and directors have some very real concerns, particularly surrounding the risks of a downturn in demand, a lack of credit to support their business plans and that increased tax, tax complexity and regulation may damage their businesses.

Therefore while they are generally positive and upbeat about their business prospects for the next year, they remain apprehensive about how the economic climate may yet impact them. They are also concerned that government may pose new challenges for them in the act of cleaning up the debris, after the worst financial crisis to strike the business environment in the last three quarters of a century.

"There are a lot of contrasting signs, if you walk around Milton Keynes you see a lot of building work going on. For example, there are large projects such as the new headquarters for Network Rail. On the other hand, you still see quite a few 'to let' signs. The truth is, if you have a sound business, you are probably doing okay at the moment, but for a lot of companies it still looks like a recession."

Jeremy Read, Audit Partner, Milton Keynes

Methodology, timing and uncertainty

Baker Tilly conducted 200 interviews with board directors at owner-managed businesses throughout the UK in order to gather their opinions on what the current economic climate means for the nation's owner-managed business community.

The survey covered firms across all industry sectors, and found that their outlook for the next 12 months was on the whole optimistic. Closer analysis however, reveals that their views about the prospects for the economy were mixed, depending on; which industrial sector they operated in, how large their turnover was and where in the country they were located.

In addition, the survey was carried out in the period from December 2009 to March 2010. This is significant in itself because for many businesses 2009 was a year of pain and general distress. Then, following the turn of the year and the sense of starting afresh, the forthcoming election loomed larger, creating an atmosphere of political uncertainty. This was also a period when the Bank of England's £200 billion quantitative easing programme was drawing to a close. It became apparent that the time was fast approaching when the public in general and business in particular would have to foot the bill for supporting the financial sector and the economy as a whole in the wake of the collapse of Northern Rock in late 2007 and Lehman Brothers in September 2008. Exactly what this might mean for those running businesses was not clear as the interviews for this report were being carried out. Nor is it clear as we go to press ahead of the general election.

For these reasons there is a sense of trepidation as owner-managed business leaders look out over the year ahead, trying to discern how their businesses can perform and do their best to manage them through the next stage.

Growth, growth, growth

Nonetheless, against this background respondents were significantly more positive this year than last with 61% expecting to increase sales as compared to a mere 19% a year ago. Only 25% of respondents thought that their sales would remain at the same level and 12% expected sales to decrease in the year ahead.

A similar picture emerged with regard to expectations of gross margin. Almost half, 48%, expected to increase their gross margin, 28% for it to remain the same and 22% expected it to decrease in the year. The overall picture suggests some degree of margin compression however, despite the expectation of overall sales growth.

"I was very interested to see the general level of optimism. My experience with my own clients suggests that the trading environment is expected to be very hard this year. Where there is optimism it tends to be about opportunities to keep costs low rather than raise turnover."

David Blacher, Business Services Partner, London.

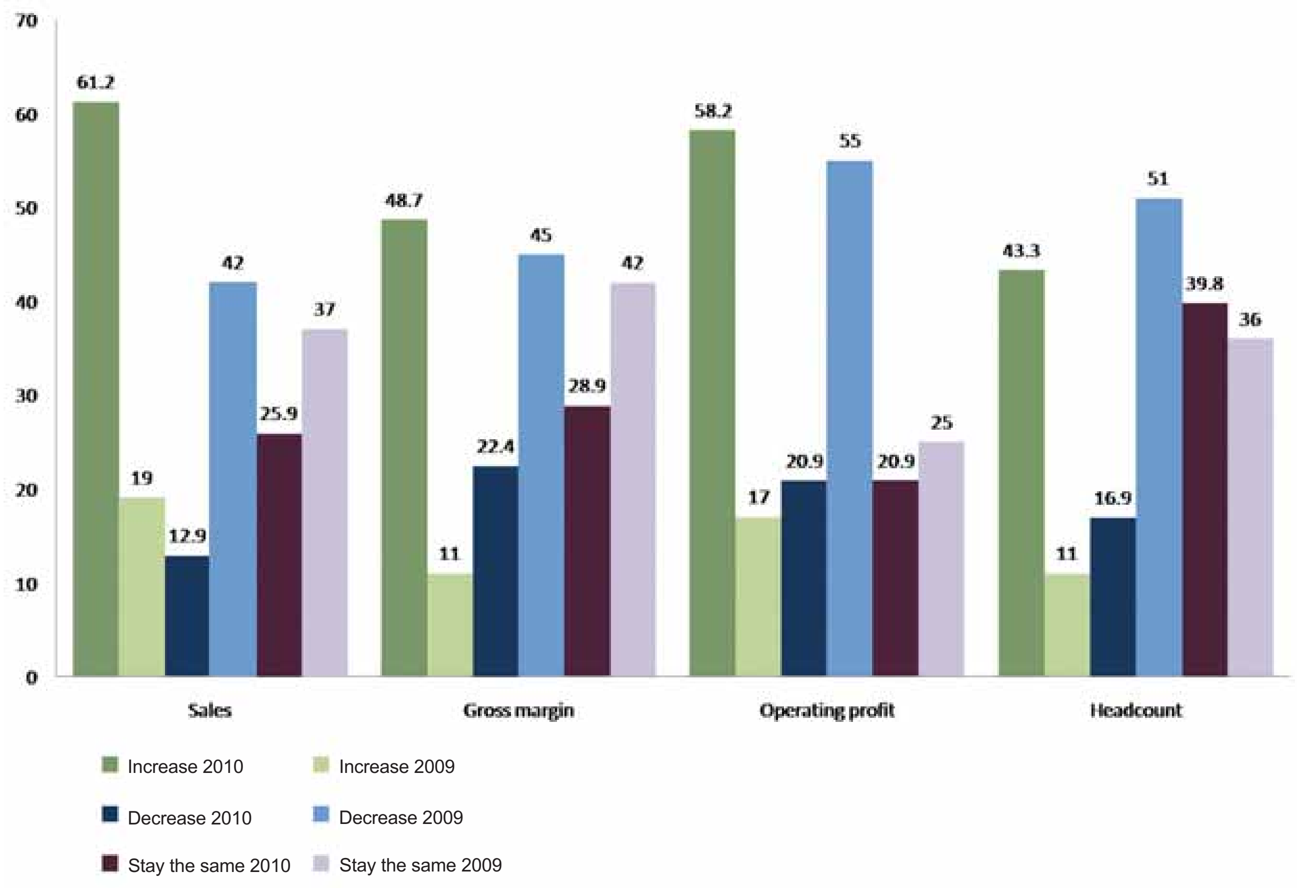
Respondents' views of operating prospects were more clear-cut. 58% expected growth, a marked improvement on last year's 17%. 20% expected operating profit to stagnate, a fall from last year's 15%. Only 20% expected operating profit to fall, again a dramatic fall from 55% when the same question was asked about respondents' outlook for 2009.

Expectations regarding employing staff are the least encouraging and perhaps demonstrate lingering concerns about the state of the world and local economies and apprehension about possible threats to business. 43% of those who took part of the survey expected to increase headcount, which was four times the number last year (11%). However 39% expected staffing levels to stay the same as compared to 36% a year ago – not a great deal of change. But this time around only 16% expected they would shed staff in the year ahead. This reflects veiled optimism. Last year more than half of respondents (51%) expected that they would reduce their staffing levels.

"Most people are not talking about further staff cuts, for the most part, if they needed to cut headcount, they have already done it. In fact, a great many have discussed the resources they need and are preparing to take on more staff."

Jim Clifford, Corporate Finance Partner.

In the next 12 months, do you think your company's sales, gross margin, operating profit and headcount, will increase, decrease or stay the same for your company? In all cases, we are referring to your UK operations, not global operations. Base: 200 respondents (2010), 300 respondents (2009). Figures shown as a percentage.

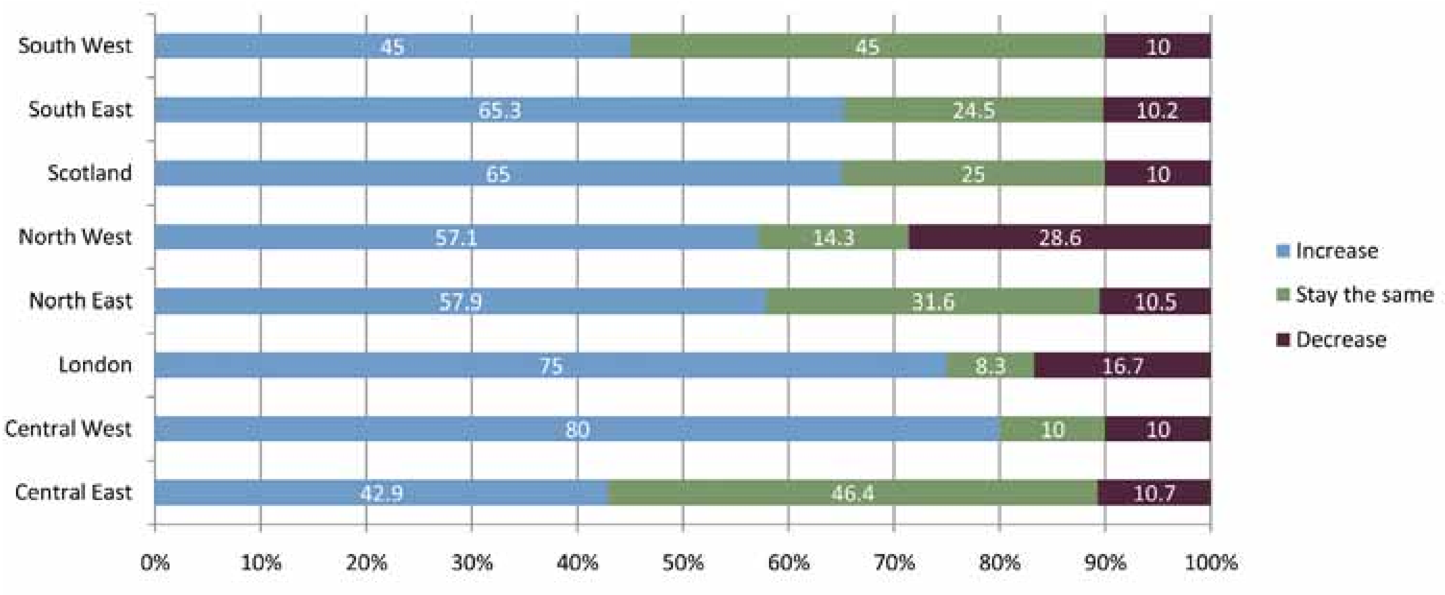


"What we've seen is companies are stripping out costs, reducing headcount and improving processes to survive the recession. As demand rises they may not be able to achieve the required levels of customer service."

Rowan Williams, Partner, London.

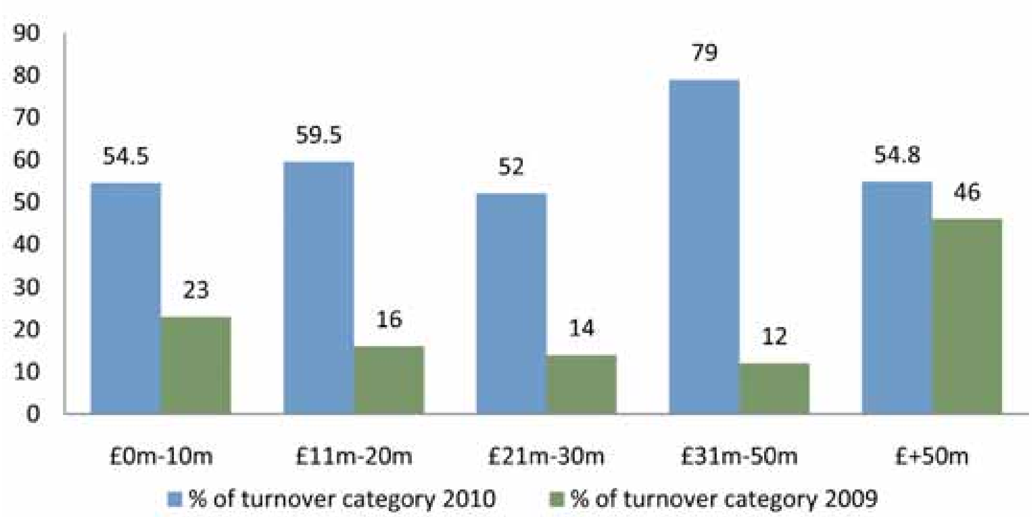
It is noteworthy however that there are significant regional differences in respondents' optimism surrounding sales growth. Those located in the Central West region, London and the South East were more optimistic while those in the Central East and the South West were markedly less hopeful about their companies' sales prospects.

Sales expectations by UK region. Base 200 respondents.



Optimism spanned all sizes of owner-managed businesses. The range of predictions varied, with those having turnover of between £31 million and £50 million being most optimistic while those with sales of £21 million to £30 million the least.

An optimistic increase in sales by company turnover. Base 200 respondents.



"In the past, big companies have tended towards 'just in time' supply chain management. Mid-sized firms have tended to steer clear of that, preferring to keep inventory levels high. The recession has forced them to reduce stocks, so to some extent they've been forced to adopt a just-in-time approach."

Rowan Williams, Partner, London.

Pragmatism vs political risk

Indicators

While respondents were generally optimistic about the prospects for their businesses in 2009 they remained pragmatic when it came to how they would assess whether of not the economy was improving. Rather than trusting government statistics on growth rates or economists' analyses, they were much more inclined to trust their own experience.

Half of respondents said that increases in sales, production, enquiries, tenders, and customers (footfall) were primary indicators of the economy picking up. Two typical comments were "[we look at the] number of people through the door and how much they spend." And "we monitor how busy we are as a company."

Only 10% of respondents relied on market intelligence and industry reports and even fewer, 7%, used a combination of indicators and advice from bank managers, colleagues' opinions and the media.

By contrast, one respondent from the financial services sector said, "We look at value of commission in the pipeline as of January this year as compared to January last year. We compare year-on-year figures. We keep our ears to the ground. And [monitor] what's happening in the commercial market for investors."

Indicators that owner-managed business people use to interpret the state economy are; their own judgment, market activity, the media, the availability of finance, increase in turnover, national employment rates, oil price, internal key performance indicators (KPIs), client budgets, increase in staff and retail price index (RPI) numbers. 6% of respondents, however, did not use any tool or technique to monitor the economy.

The same degree of realism among owner-managed businesses does not, it seems, extend to their hopes and aspirations for what the next government will do following the forthcoming election.

Political risk - taxation

Asked for their opinion on what would be the number one priority for businesses for the next government, "reduce taxation" was the most popular answer. Their definition of taxation included duty of various sorts, VAT, national insurance and corporation tax. The same view was reflected in Baker Tilly's Budget 2010 survey, where respondents favoured tax cuts and in most cases thought it was practical and good for the economy. Yet in light of all likely prospects this appears to a vain hope, if not a pipe dream.

"The UK has an enormously complex tax system, that's partly because governments use business and personal tax to change behaviour and partly through a need to raise revenues. The complexity is very unattractive to businesses."

George Bull, Head of Tax

There were some crumbs of comfort in 24 March Budget, including the doubling of the annual investment allowance to £100,000 and the entrepreneur's capital gains tax relief. The HMRC 'time to pay' offered a further stay of execution for those facing tax bills. Those in the house-building sector may benefit from the rise of the £250,000 threshold for stamp duty payable by first-time buyers. However, brewers will suffer from future increased excise duty and that fuel duty is also to be raised in stages. Following hard on the heels of the Budget, the Chancellor went on to say that cuts and economies to be made after the election would be more stringent than those under Margaret Thatcher, especially as far as public services are concerned. This will most likely negatively affect those owner-managed businesses that directly supply the public sector and many more besides.

Top of its list of priorities for the new government is to "eliminate in large part the structural current budget deficit over a Parliament. The first measures will start to take effect this year." How it would do so without raising a variety of taxes is difficult to imagine. It says it will cut government spending. It also says, "Our ambition is to create the most competitive corporate tax environment in the G20. To begin with, we will cut the headline rate of corporation tax to 25p or lower and the small companies' rate to 20p, funded by reducing complex reliefs and allowances." This is a statement of ambition but not of timing.

"The UK will not tax its way out of its present difficulties but tax has a role to play. The government will have to address the balance between the sibling rivals of tax and spend."

George Bull, Head of Tax

Availability of credit

After reducing tax, owner-managers next most favoured business priority for the new government was making credit more easily available. One respondent summed up the views of many when he said, “Funding is the key: banks should let up on funding and make lending easy. Address restrictions on credit terms, and penalty clauses on financial suppliers (e.g. 14 days terms and fines if they do not adhere). Support cash flow for small to medium sized businesses. Make things generally simpler.”

“The situation is slowly getting better, but very slowly. Banks have been under pressure to lend and the state-owned lenders do have to meet lending targets.”

Rob Donaldson, Head of M&A and Private Equity.

The 24 March Budget made some inroads on this saying that it would put greater pressure on the part government-owned banks, Lloyds Banking Group and Royal Bank of Scotland, to lend an additional £90 billion to businesses this year. How much government is able to influence the availability of credit is, however, a moot point. Moreover banks have become increasingly stringent in vetting credit applications since the start of the crisis and look unlikely to slacken these wholesale at the behest of government, especially if they are not, like Barclays and HSBC, beholden to them.

Beyond tax cuts and greater access to credit, other owner-managers’ priorities for the next government include cutting red tape and reducing bureaucracy (15% of respondents), economic stability (5%) and assistance to kick-start the construction industry (4%). What is clear as we approach the election is that political risk is looming as a standout factor in many ways. Businesses are concerned that they will have to fund the deficit out of scarce, hard-won earnings and that the actions of any new government will not in practice favour business. All parties pledge their support for businesses however as an article of electioneering faith.

Trends and opportunities

Baker Tilly asked owner-managed business people what, in their opinion, were the major trends and opportunities in their industry sector in the next two years. A varied range of comment resulted from our interviews of which the following were the highlights:

Industrial sector

There are increased opportunities to win export orders. This is largely conditioned by the weak pound, despite challenging economic conditions in the UK's key European export markets.

Meanwhile there is a continued trend in demand for environmentally friendly products and behaviours. Industry and the public are able to make use of grants to support adoption of low carbon practices and conserve energy. These are key industries for the future. The current government has pledged considerable support for wind power projects, both on and offshore.

While many companies are still feeling the effects of the recession, industrial sector respondents noted that there were opportunities to build market share in specific sub-sectors through bolt-on acquisitions.

Property, construction and development

It is likely that the housing market will recover in the next two years. This will produce more opportunities in the affordable housing sector in particular.

Confidence will also grow in the commercial sector and there is likely to be increased infrastructure building, especially where this is influenced by the London 2012 Olympics Games. This will also lead to further spend in the business services sector.

Retail

The retail sector will also benefit from the continued trend towards use of environmentally green products and locally sourced merchandise. There will be greater use of recyclable materials and materials that are green and energy efficient.

Threats, plans and regional differences

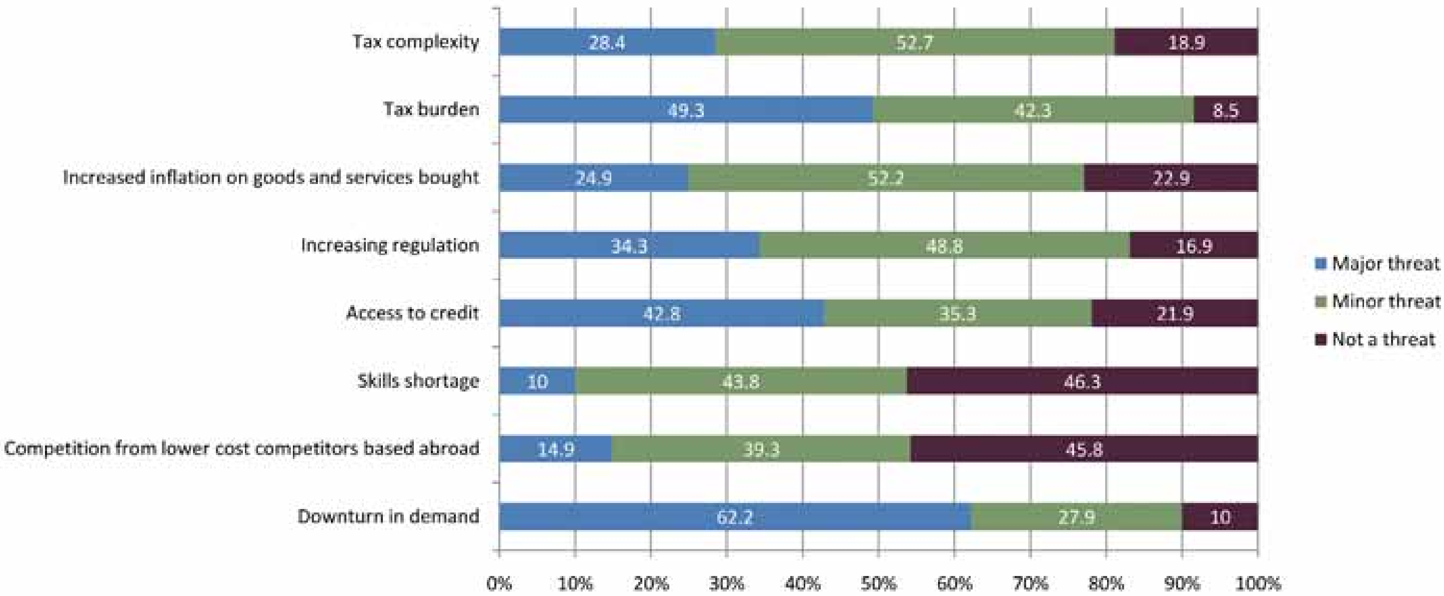
Just as owner-managers were optimistic about prospects of sales growth in the coming year, so they are naturally concerned if such sales growth is not, in fact, realised. This illustrates the concerns of many that a double dip recession or deflation could yet afflict the UK economy and undo the post crisis recovery so far achieved.

62% of those interviewed quoted "downturn in demand" as a major threat to growth or to profitability during the next two years. A further 28% regarded this as a minor threat – though a threat nonetheless.

Other major threats included the tax burden and access to credit. Minor threats included both of these and also increasing tax complexity, increased purchase price inflation and increasing regulation.

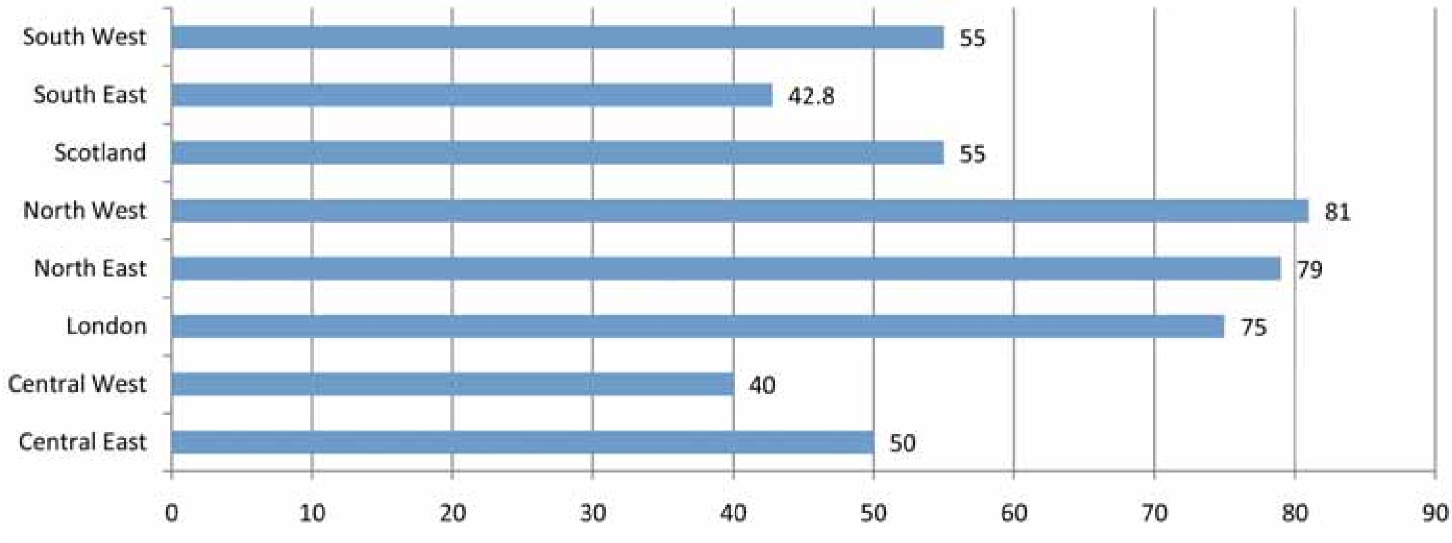
Also significant were the views that neither competition from lower cost, overseas competitors nor skill shortages posed threats. In light of the fall in the value of the pound sterling against the major trading currencies, the Euro and the US Dollar chief among them, and the high level of UK and EU unemployment, these views seem realistic.

Threats to businesses. Base 200 respondents



Given that downturn in demand was considered so large a threat among respondents we looked at whether there were differing degrees of concern depending on geographical region of the country. The results showed that the North West, North East and London were the areas where the threat was felt most keenly by between 75 and 81% of respondents. At the opposite end of the spectrum this was only regarded as a major threat by around 40% of respondents in the Central West and South East of the country.

Downturn in demand as major threat per region as percentage. Base 200 respondents



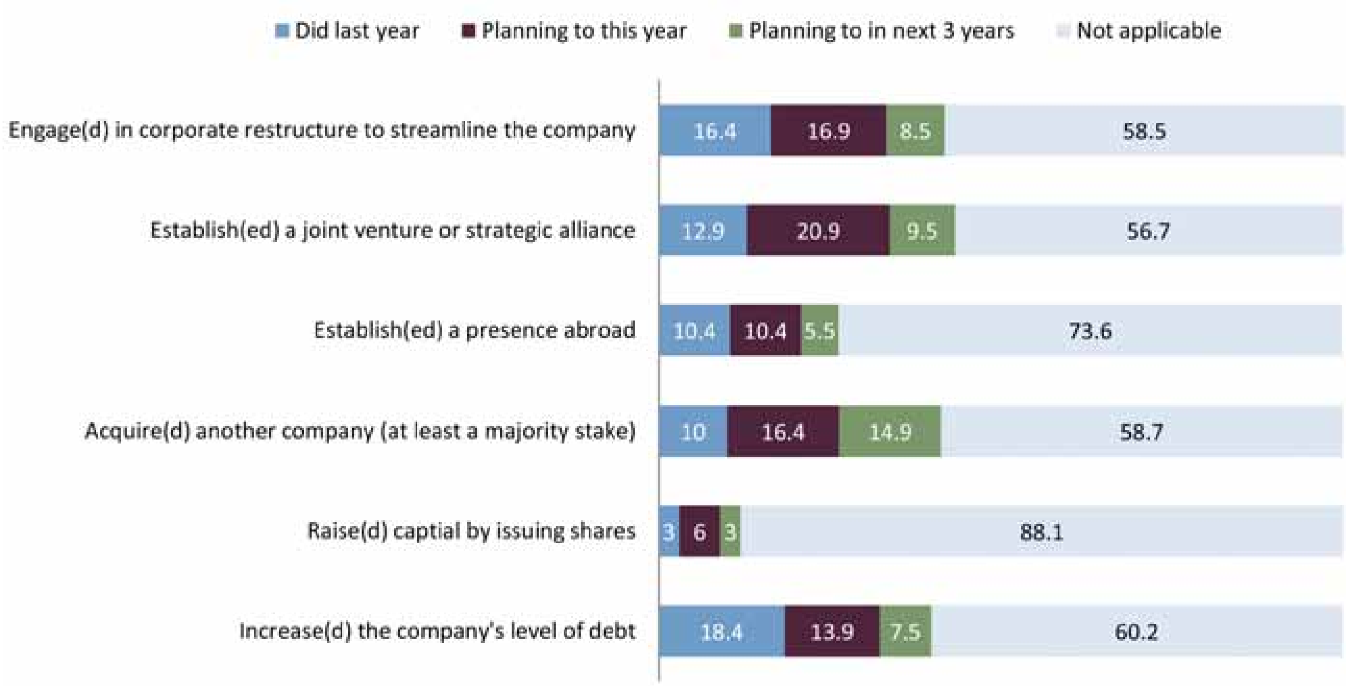
Plans

Looking out over the next three years, we asked owner-managers about their plans for their businesses.

20% said that they intended to establish a joint venture or strategic alliance with another company in the next year with a further 9% planning to do so over the next three years. More than 31% of respondents planned to acquire all or a majority stake in another company.

A total of more than 40% said they were either already engaged in corporate restructuring or would be in the future. Less than 40% planned to increase their company's debt level. Less than 27% planned to establish a presence aboard and less than 12% planned to raise capital by issuing shares.

In the last year have you...? Do you plan to do the following in the next year/three years? Base: 200 respondents



In addition to these plans we questioned owner-managers about various initiatives and how beneficial they might be. The initiatives were: developing a formal risk assessment or disaster recovery plan; putting a succession plan in place; writing an up-to-date business plan; providing flexible benefits for employees and offering employees a share option scheme.

Almost a third of respondents were unable to say whether such moves could be beneficial but a majority did rate an up-to-date business plan as either very or quite useful. Most were quick to recognise the benefits of all of the framed initiatives but whether they would implement them was unclear.

"Banks tend to demand to see evidence of risk management before they lend money, but even if that's not the case, businesses have learned the value of managing risk. That includes discussions about the resources they need - for instance, finance and the right staffing levels – and measures to take account of factors such as rising transport costs."

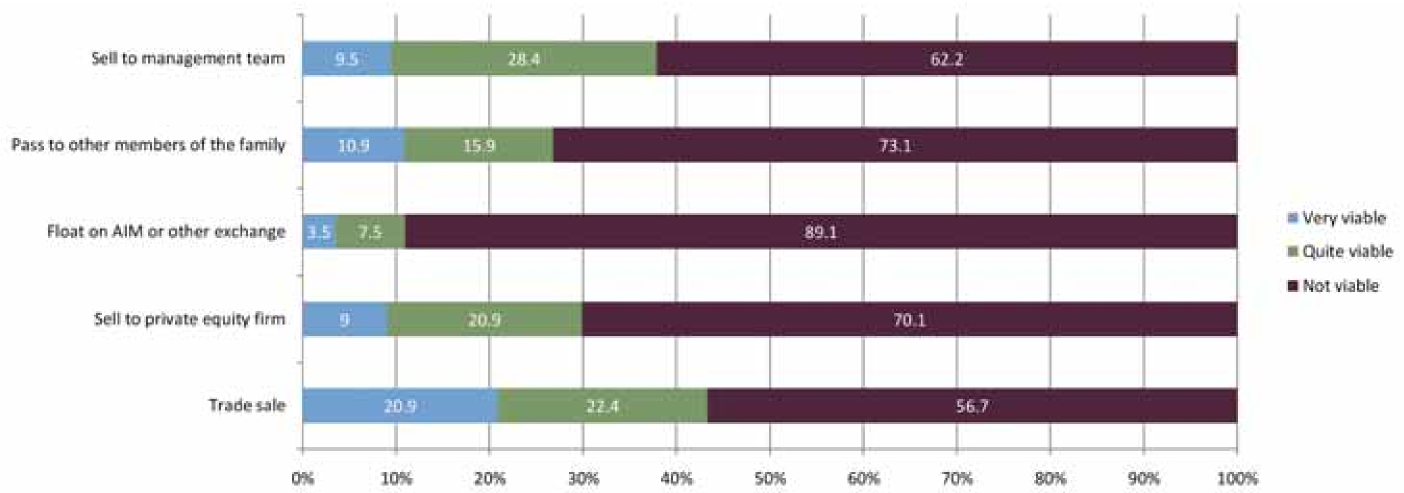
Jim Clifford, Corporate Finance Partner

Exits – more stability, fewer sales

We found that quite a large proportion of those who own more than 10% of the shares in their businesses intended to sell some or all of them within the next 10 years. Those intending to sell amounted to 64% of respondents. Of those 16% were intending to do so within five years and 31% within 10 years.

Apart from full or partial personal sales of shares, we asked owner-managers whether they were contemplating corporate actions with their business such as an outright sale or a listing on a public market.

Is your business looking at any of the following options? Base 200 respondents.



The vast bulk of respondents commented that all of the suggested exit routes were “not viable.” The most viable were trade sales, selling to a management team or selling to a private equity firm.

“What we’re seeing is a wider range of joint venture and partnership opportunities. For instance we’ve seem private companies partnering with third sector organisations.”

Jim Clifford, Corporate Finance Partner.

Comparing the latest finding with those from a year ago showed some slight changes in the number of owner-managed businesses planning to float on AIM or the main stock exchange. However, in general respondents are less likely to make trade sales, sell to a management team, sell to a private equity firm or pass the business to other members of the family.

With lower percentages choosing “very viable” and “quite viable” options for sale it appears that when comparing 2009 figures with survey findings from 2010, the economic climate amongst owner-managed businesses has increased its stability. Owners are less likely to sell. Though whether this is because of currently likely low valuations for businesses we were not able to establish.

About Baker Tilly

Baker Tilly is a leading independent firm of accountants and business advisers that specialises in providing an integrated range of services. We provide our growing and established business clients with audit, accountancy, personal and corporate taxation, VAT, management consultancy, corporate finance, IT advisory, restructuring and recovery and forensic services. The firm has national coverage through its network of offices and is represented internationally through its independent membership of Baker Tilly International.

www.bakertilly.co.uk/direction

Basingstoke | Bath | Birmingham | Brighton | Bristol | Bromley | Bury St Edmunds | Chelmsford | Chester | Crawley
Edinburgh | Glasgow | Guildford | Hereford | Hull | Leeds | Lerwick | London | Liverpool | Manchester
Milton Keynes | Newcastle | Saltaire | Stoke-on-Trent | Tunbridge Wells | Warrington | Watford

an independent member of BAKER TILLY INTERNATIONAL