Outlook 2012

Situation stalemate

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Overview

In early October 2011, Baker Tilly commissioned YouGov to conduct its *Outlook 2012* survey to gather the opinions of business decision makers.

Our aim was to understand the issues that are affecting small and medium-sized enterprise owners/directors in the current economic climate and their concerns about matters including business confidence, the anticipated challenges and opportunities for their businesses during 2012 and their top strategies going forward. 614 respondents drawn from across England, Scotland and Wales completed the survey.

At the time of our survey, business confidence for 2012 had fallen back to 2010 levels. Over half of respondents were more confident about the prospects for their own businesses than they are about their industry sector. However, similar proportions anticipated their sales, gross margins and profits will remain at similar levels to 2011, echoing the views of a number of economists and commentators that the economy is likely to remain stagnant in 2012.

Respondents' business strategies reflected a cautious outlook. Improving internal processes and systems was top of the list, with cost-cutting in third place. Developing new products and services and selling into new geographical markets were also among their top plans, suggesting that they are intending to tackle the challenges in the UK and global economies proactively to grow their sales.

More than 70% of respondents said that their banking needs during the previous year had been met. Moreover, fewer than 10% said that their banking needs had not been met. This seemingly contradicts the widespread media coverage surrounding the failure of banks to support small and medium-sized enterprises. A quarter of businesses expected to raise finance in the coming year, of which more than a third would do so by means of traditional bank lending. Asset-based lending was the route chosen by 25% of respondents, while 18% said they expected to raise funds through private equity or venture capital funding.

Continuing the trend of what we saw in our survey a year ago, the overall mood of respondents was again one of caution against a background of uncertainty. With huge volatility in the eurozone, US and global economies, this mood may quickly change.

Embattled confidence

With business confidence back at 2010 levels, the outlook for many businesses is stagnant for 2012 – but that is not the whole story.

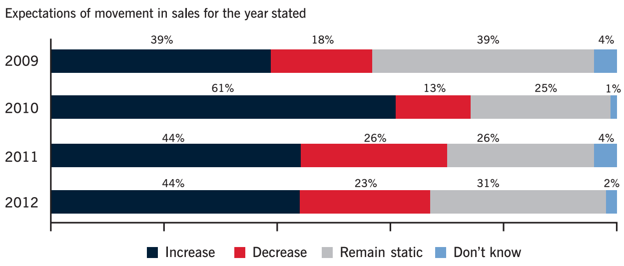
In brief

- Overall business confidence has dropped across all areas, back to levels similar to those seen in 2010.
- Business decision makers tend to feel more confident about the prospects for their own business in 2012 (54%) than about their sector (27%) or their region's economy (18%).
- Prospects for sales, gross margins and profits are that they will remain at levels seen in 2011.

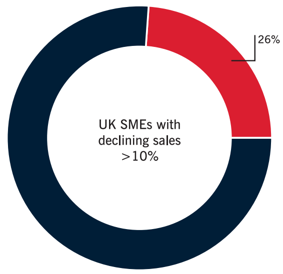
A high proportion of respondents to our *Outlook 2012* survey do not expect an increase in their sales, gross margins or profit in the year ahead. Our research for the Baker Tilly/Company Watch *SME Distress Monitor* published in Autumn 2011 found that "almost a quarter of SMEs across the UK saw a drop of over 50% in their profit before tax levels, according to their full 2010 filed accounts. In addition, over a quarter saw a decline of 10% or more in their sales figures."

The report concludes that "despite all efforts to preserve top-line revenue, global inflation and consumer caution is severely impacting the bottom line of businesses, whatever their industry sector."

Sales – The expectation versus the reality



Source: Baker Tilly Owner Managed Business survey 2009 and 2010; Baker Tilly *Outlook 2011* and *2012* surveys



Source: Baker Tilly/Company Watch analysis of 2010 filed accounts, Sept 2011

Outlook 2012 shows almost half of respondents have learned hard lessons and are seeking greater efficiencies within their businesses by improving systems and processes in order to achieve performance that is either as good or better than last year. This may not be a bad thing for their businesses in the long term but it means that growth is likely to be subdued in the immediate period.

However, this masks some additional trends that are both positive and negative. On the one hand, reports Rob Donaldson, Head of M&A and Private Equity: “Many businesses we are dealing with are in good shape. Trading in a recessionary environment is not a surprise to them anymore. They have taken action on costs, strengthened their balance sheets and garnered their cash.”

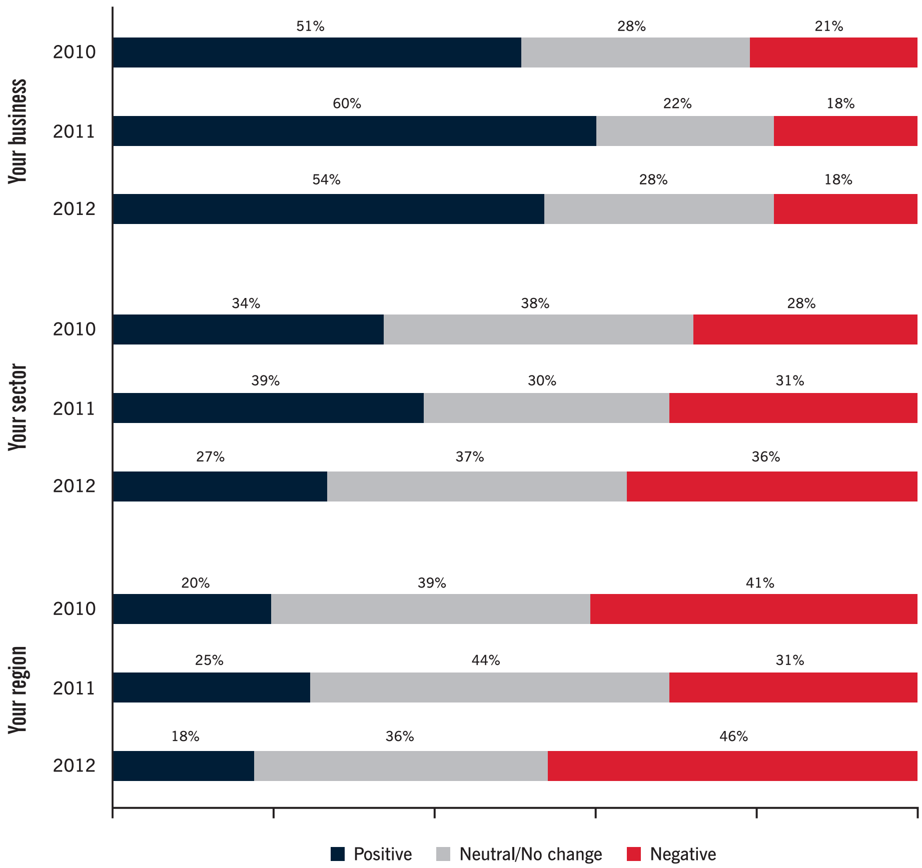
He adds that, on the other hand, businesses face an uncertain outlook coloured by worries over the impact of sovereign debt, the future of the euro and sluggish growth in the global economy. Therefore, they are loath to invest, though some bolder business owners and managers may be ready to take advantage and make acquisitions, for example, ahead of an upturn. Many businesses are, however, stockpiling cash having repaid debt, so reducing their dependency on the banks.

This is the good news. But there are many other businesses that are in a worse condition according to Guy Mander, a Partner in Baker Tilly’s Restructuring and Recovery team in Birmingham. Because of inflationary pressures, resulting in cost burdens that they are unable to pass on to their customers, these companies are living day to day, he says.

“While some businesses that have survived the recession are resilient and are in good shape to move forward, others are merely hanging on. They may have used up the cash reserves desperately needed to survive. They may also be benefiting from interest-only arrangements with their banks or have taken advantage of Time To Pay agreements with HMRC, both of which they may or may not be adhering to. However, any increase in creditor pressure may force several over the edge.”

For some of these companies, confidence in their businesses may be misplaced. What lies in store could be further cost-cutting, job losses and, potentially, insolvency. However, a degree of ‘corrective’ fall-out through insolvency may in fact act as an effective medicine for the wider economy, freeing up markets for stronger, more competitive, businesses to prevail. An increase in insolvencies may also result in opportunities for acquisitive businesses with cash to spend to buy market share or bolt-on operations, thus re-utilising otherwise moribund resources.

Business confidence 2010 – 2012



Source: Baker Tilly *Outlook 2010, 2011* and *2012* surveys

Managing risks and controlling cash

In brief

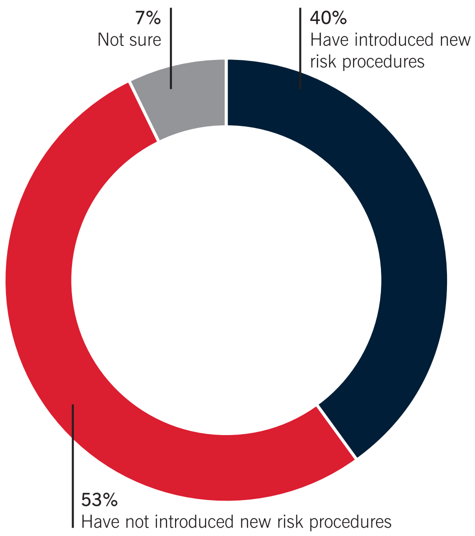
- Improving internal processes and/or systems is the top priority for business decision makers.
- 40% of businesses introduced new risk management procedures in 2011.
- Of these, the most common centre around credit control and implementing and monitoring more stringent risk registers/procedures.
- Other top priorities include the development of new products/services and direct cost-cutting.

In light of the external challenges besieging businesses, managing risks, costs and working capital as efficiently as possible has become imperative.

Processes and controls

Although we are already several years into the economic downturn and many businesses have already consciously tightened their internal operations during this period, improving control and efficiency remains a key point of focus for business leaders both now and throughout 2012. 40% of businesses said they had introduced new risk management procedures in 2011 and “improving internal processes and systems” was identified as the most popular strategy for 2012 among those surveyed. Cutting costs and consolidating products or suppliers were also listed among the opportunities that respondents identified for their businesses.

Focus on risk procedures



Source: Baker Tilly *Outlook 2012* survey, Oct/Nov 2011

Scrutinising the underlying infrastructure of the business – including its systems, controls and unglamorous back office procedures – needs to be an ongoing activity, according to Mark Taylor, Baker Tilly’s Head of Process Improvement.

“Are these suitable for what the business needs now and for the future?” he asks. “From our experience, common key business processes to examine include the purchase to pay process, sales orders to cash and, where relevant, stock management. These all contribute to the important task of managing the working capital cycle – the lifeblood of any business. Such processes may have been under the management spotlight for some time but many companies are still not exercising sufficient control.”

Finance and IT are other key back office functions that Mark says all businesses need to assess constantly to ensure they are delivering real value for money to the organisation. For many businesses, 2012 should be the year when they bite the bullet – taking fresh action to re-shape their internal systems and processes.

Fraud

Fraud discovery tends to increase in times of economic stress. It may involve a member of staff, customers or suppliers. While internal checks may be easier to carry out, Forensic Services Partner, Marcus McCaffrey warns that businesses should look carefully at their relationships with trading partners.

"You might, for example, find a supplier is trying to compensate for a downturn in business by providing inflated invoices for services that may not even have been delivered," he says. "However, if the business has not previously carried out an audit rights inspection as provided for in the supplier contract, it may not have been spotted before."

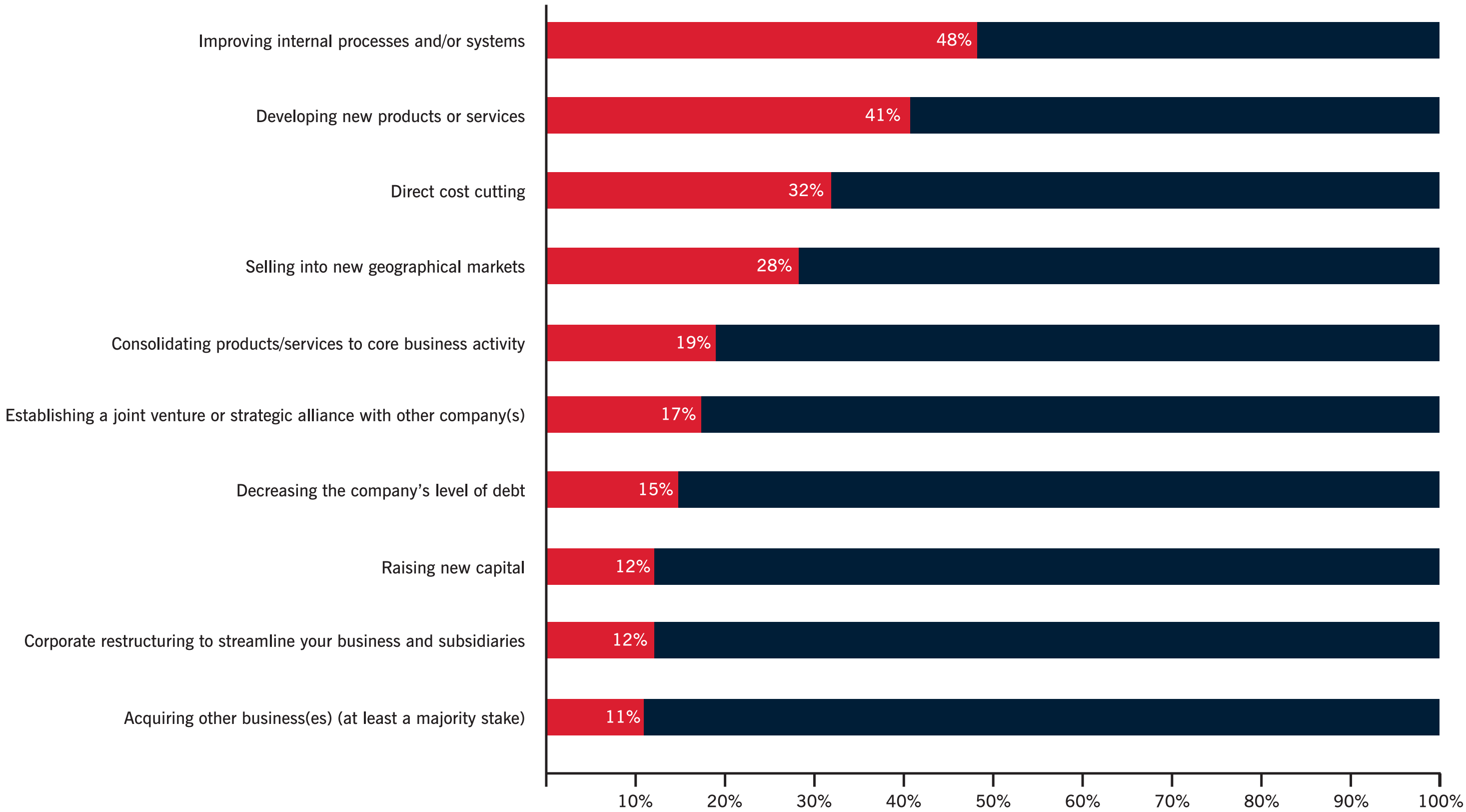
Working capital management

This is one process that many businesses could improve. "In the course of working with many different businesses, we frequently come across deficient credit control measures," says Restructuring and Recovery Partner, Sarah Batchelor. "We encourage them to collect cash more quickly through improving systems, to incentivise their customers to make early settlement and to issue invoices promptly."

Businesses often measure debtor days but the process of sending out invoices can often occur long after the sales activity that generated the invoice. As a result, cash is not realised as quickly as it could be. Many businesses can improve their working capital significantly by being more rigorous in these simple business disciplines.

Overall, evaluating process and risk management effectiveness should not be seen as a single event. It is a key part of management control and should remain under ongoing scrutiny to ensure it is fit for purpose, especially during a time of economic austerity.

Top 10 business strategies in 2012*



*Respondents were able to choose from multiple answers applicable to their business.

Source: Baker Tilly *Outlook 2012* survey, Oct/Nov 2011

The pursuit of new money

> *In brief*
> - Only a quarter of business decision makers expect to raise additional finance in 2012.
> - Of these, traditional bank lending is the preferred option (37%), followed by asset-based lending (25%) and private equity/venture capital (18%).
> - More than two-thirds (70%) of respondents say all or most of their business needs have been met by their bank in 2011.

While bank lending remains constrained, the findings of our survey raised a number of issues concerning access to credit for business owners and managers.

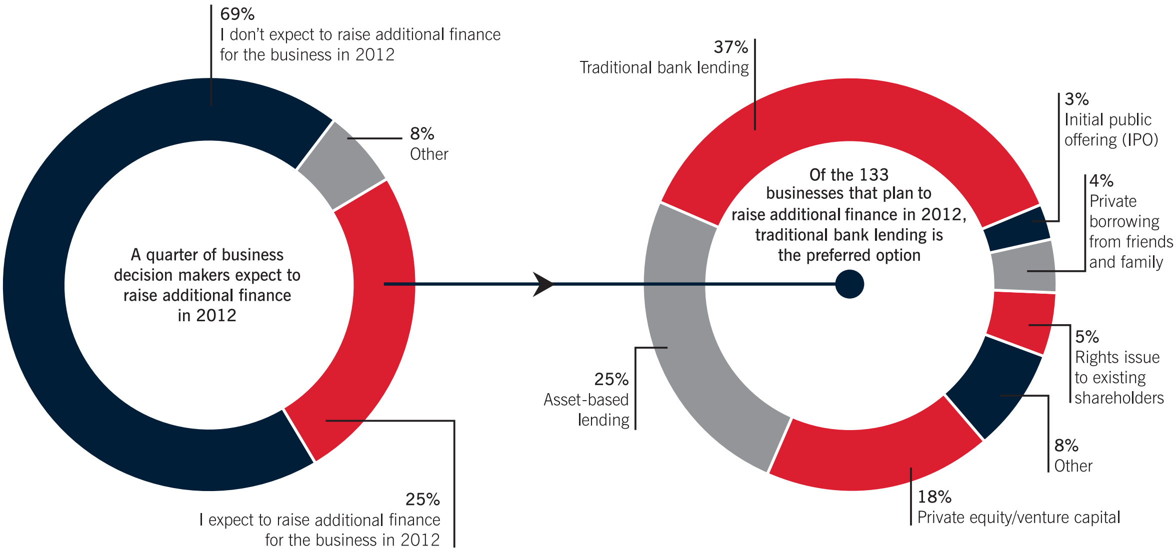
Banks

A quarter of respondents to our survey expected to raise additional funds in 2012. While more than a third of these said that they preferred to raise such funding via traditional bank lending, a question mark hangs over their ability to do so.

The Bank of England's October *Trends in Lending* reported that "the stock of lending to UK businesses overall contracted in the three months to August, as did the stock of lending to small and medium sized businesses…"

Given the findings of the Baker Tilly/Company Watch *SME Distress Monitor*, released in November 2011, that businesses are experiencing large falls in sales and profits, it is unsurprising that demand for lending is falling. "Servicing debt remains crucial to business survival," says Tony Wright, Baker

Raising finance



Source: Baker Tilly *Outlook 2012* survey, Oct/Nov 2011

Tilly Restructuring and Recovery Partner. "It is particularly concerning that our research shows almost one in every four UK SMEs has a liquidity ratio below one, indicating insufficient resources to meet their short-term debt and payable liabilities. Therefore, many businesses may be reluctant to add to their current debt levels.

Our survey result that found 70% of businesses are satisfied that their business needs have been met by their bank in the last year may simply be a reflection of fewer applications for new loans. Despite the availability of interest-only bank arrangements, some weaker businesses, unable to satisfy the terms, will not be in a position to raise further debt and may have very low cash reserves. Consequently, they are effectively "zombie" companies without a convincing case to offer bank lenders," Tony concludes.

Meanwhile, loans made by the big five business lenders – Barclays, HSBC, Lloyds, RBS and Santander – under the Government's £190 billion 'Project Merlin' were broadly on target after the first three quarters of 2011 at £157 billion. Of this total, £56 billion of the £76 billion earmarked for SMEs was also in line with the overall plan.

This sounds positive. However, as Baker Tilly's Head of M&A and Private Equity Rob Donaldson explains, while there is a lack of demand for business credit, the big five lenders and Project Merlin nevertheless cannot fill the gap left by foreign lenders who have quit the UK business lending market.

The businesses that do intend to raise new finance often do not present their case to bankers in a convincing manner. "Reliable management information and the ability to produce accurate, timely forecasts are invaluable when dealing with the company's bankers," says Peter Cooper, Head of Baker Tilly's Corporate Restructuring Team. "It allows bankers to gain an in-depth insight into the business as it is operating today and how it plans to move forward. Out-of-date, incomplete or erroneous financial information does not enable bankers to make a true assessment of the state of the business and undermines management credibility."

Alternative sources of funding

Rob Donaldson goes on to explain that the dearth of bank funds has driven business owners to look again at their funding needs. Some have concluded that long-term equity has a role to play in their businesses. Rob adds that the long downturn and recession has forced entrepreneurs to re-price their businesses to take account of current market conditions. These two factors, the willingness of entrepreneurs to consider some dilution and more realistic pricing have opened the door for private equity to take up some of the funding slack. Moreover, non-banks, such as newly raised mezzanine lending funds are also now playing a larger role.

Additionally, asset-based lending (ABL) is rapidly filling some of the vacuum left by traditional bank funding. "Lenders secured against receivables or other business assets such as inventory and plant and equipment have been rapidly seizing the opportunity and are now enthusiastically pressing forward," according to Steve Merchant, Baker Tilly's Head of Asset Based Lending.

Our *Outlook 2012* survey finds that the proportion of businesses expecting to raise funds by ABL has increased since 12 months ago. This is also reflected in the latest industry statistics from trade body the Asset Based Finance Association, which shows that ABL continued its double-digit year-on-year growth in the third quarter of 2011. This has been assisted by moves in bank regulation. "As asset-based lending is regarded as a low-loss form of funding, it requires less bank capital than corporate term loans, while being a flexible and cost-effective form of funding for businesses. We expect continued growth in ABL in the year ahead," says Steve.

Other challenging factors

In brief

- Increased costs directly to the business (69%), downturn in demand (63%) and tax complexity and burden (56%) are the top three threats to their businesses in 2012.
- The impact of economic woes in the eurozone and US (55%), consumer confidence (54%) and increasing regulation (53%) are also serious concerns.
- 58% still expect the Comprehensive Spending Review to have a negative impact on them.
- A quarter of business decision makers are unsure what impact an increase in inflation or interest rates would have on their business.

Our *Outlook 2012* highlights a number of additional issues concerning businesses operating in the current challenging economic climate.

International threats and opportunities

"Turmoil in both the eurozone and the United States poses a threat to UK businesses, particularly in light of the volume of business UK companies carry out in those geographies," says Geoff Carton-Kelly, Head of Special Investigations within Baker Tilly's Restructuring and Recovery practice.

Therefore, he is not surprised this was regarded as a significant threat by 55% of respondents to our survey.

Nonetheless, selling into new geographical markets ranked fourth among the top business strategies of respondents. They perceived demand for exports as a significant opportunity for their businesses.

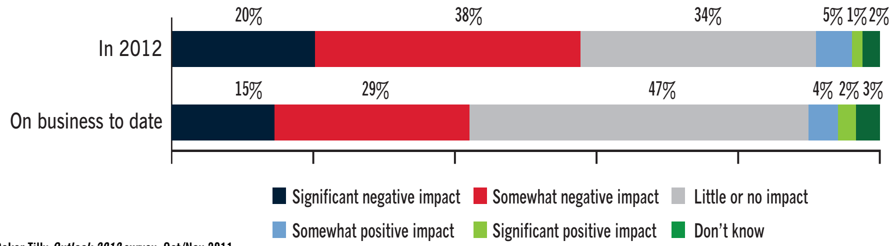
"UK industry can leverage relatively weak sterling to boost its overseas sales – as long as those trading abroad have the right products to export and take advantage of our flexible labour market," adds Geoff.

Government funding cuts

Fifty-eight per cent of respondents to our survey considered that public sector cuts would pose a threat to their businesses in 2012. "There is considerable uncertainty as to how and where public sector cuts will fall and how they will operate," explains Baker Tilly's Chairman of Public Sector Group and Head of Not for Profit Advisory, Jim Clifford.

He notes that amid such uncertainty, new forms of funding for public services are emerging. Social finance is developing as an approach, drawing non-traditional finance sources into involvement with charities and social enterprises. This is helped by the development of the shared value concept – that economic sustainability and the creation of social outcomes can exist alongside each other. Many are still concerned, expecting further casualties to add to the non-profits that have already closed. The sound response to this is for further restructurings and mergers and these are likely to become more common during 2012.

Impact of the Comprehensive Spending Review



Source: Baker Tilly *Outlook 2012* survey, Oct/Nov 2011

Personal insolvency

In 2012, the risk of personal insolvency could well increase, especially among business owners/managers.

Many business owners have used their personal assets, such as their savings or their homes, to underpin or guarantee the funding needed for their businesses. As those businesses have suffered from the downturn in the economy, owners have faced increasing personal financial distress.

"Unfortunately, the credit crunch has seen many owner-managed businesses operating in a reduced market and having to reduce their costs," says Alec Pillmoor, Head of Personal Insolvency at Baker Tilly. He goes on to explain that some managers did not commence their cost-saving quickly enough, so depleting their own resources, and for others the costs of restructuring required additional funding.

"Our fear is that, in 2012, more business owners will find that they are unable to service the personal borrowings that they have taken out to support their companies and as a result may themselves face personal insolvency," Alec concludes.

Poor consumer confidence

In November 2011, Nationwide Building Society's *Consumer Confidence Index* showed a modest pre-Christmas increase after five consecutive monthly declines. Research by GfK NOP, also released in November, showed that consumer confidence stayed close to its lowest level for two and a half years. Lack of consumer confidence came up in our survey as the fifth most influential threat to SME businesses, with over half of respondents expecting to feel its impact.

With the challenging outlook for the year ahead for employment, social benefits, and the costs of food and fuel, along with the wider global economic uncertainty, it is difficult to see what is likely to boost consumer confidence and bring renewed hope to some retailers which are already struggling. Distress on the high street will undoubtedly continue to dominate the headlines in 2012.

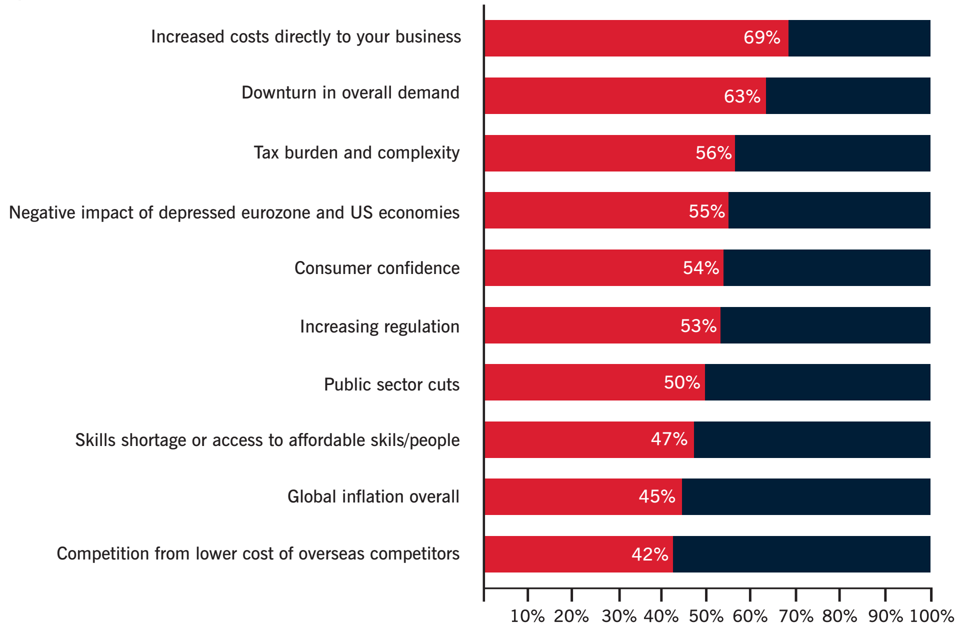
Rising costs to business

The latest published data shows inflation beginning to slowly fall, for example, the Office of National Statistics reported that annual consumer prices inflation (CPI) registered at 4.8% for November 2011, down from 5% in October. The retail prices index (RPI) stood at 5.2%, also down 0.2% on the previous month. The Bank of England's predictions in November 2011 were that inflation is likely to decline in 2012 from levels seen in 2011.

However, high direct costs remain a major issue for many businesses. In our *Outlook 2011* survey, a third of respondents were concerned about the rising cost of the goods and services they bought. Our *Outlook 2012* research shows that this has more than doubled to 69% of respondents.

Russell Cash, Restructuring and Recovery Partner explains: "Despite recent modest falls in inflation, high operating costs, driven by essential items such as fuel and certain raw materials, are a cash pressure which simply cannot be avoided. Businesses which are already operating on narrow profit margins and whose products may currently be in low demand are unlikely to be able to pass costs down to the end user. As a result of being tightly squeezed at both ends of their supply chain, I fear there will be an increase in businesses becoming insolvent over the next 12 months."

Top ten threats to businesses in 2012*



Source: Baker Tilly *Outlook 2012* survey, Oct/Nov 2011

*Respondents were able to choose from multiple answers applicable to their business.

Other challenging factors (continued)

Pension deficits
Continued instability in the capital markets has caused the value of company pension schemes to fluctuate significantly. For example, the combined pension fund deficits of FTSE 350 companies, on an accounting basis, are reported by Mercer to have increased by a third from £60 billion to £80 billion over the month of November 2011 alone. Bruce Mackay, Head of Covenant Assessment Services at Baker Tilly comments: "The volatile state of scheme deficits, coupled with a potentially growing squeeze on sponsoring employers' ability to fund those deficits, mean trustees must be super-vigilant in their management of scheme funding risks."

Baker Tilly's forthcoming *Pension Scheme Trustee Confidence Survey* explores these issues further and will be released at the end of January 2012.

Tax burden and complexity
Over half of respondents (56%) to *Outlook 2012* highlighted tax burden and complexity as a major threat to their business. "The Chancellor restated in the Autumn statement his intention to reduce corporation tax to 23% by 2014, when it will be the lowest rate in the G7 and one of the lowest in the G20," says Joe Burnie, Baker Tilly's Head of Tax. "However, the top rate of income tax remains at 50% and the tax on capital gains up to £10 million via Entrepreneurs Relief stays at 10%."

With regard to red tape, George Bull, Senior Tax Partner, suggests that HMRC's introduction of a new regime of record checks and security checks which delay tax refunds will only add to the burden. There is little evidence that the Government is heeding the concerns of business owners in this regard.

Improvements to existing venture capital tax reliefs, including a generous 50% tax relief on investments in very small start-ups under the newly created Seed Enterprise Investment Scheme, demonstrate that this Government is keen to encourage SMEs to raise funds from sources other than the banks.

Turning to international business, the proposed softening of the Controlled Foreign Companies regime, coupled with the additional incentives to encourage research and development and the lower taxes on patent income, should go some way to staunching the haemorrhaging of creative industries from the UK to less heavily taxed overseas jurisdictions.

Retaining and attracting talent
Baker Tilly's research shows that 47% of respondents believe that a shortage of skills and access to affordable skilled people is a significant threat to business.

"The SME arena is starting to see a shortage of certain types of skilled people in the marketplace," explains Media and Technology Partner, David Blacher. "Although businesses want to remain lean, they accept that they have to be careful in retaining those people that positively contribute to the business."

Businesses are increasingly turning to Enterprise Management Incentive (EMI) schemes offering share option arrangements to incentivise staff. "We have seen a resurgence in these of late, which makes perfect sense while the values of businesses tend to be lower," adds David.

Some glimmers of hope

Despite the doom and gloom, there are several opportunities that forward-looking businesses can maximise.

Increasing market share
Stronger businesses with competitive products and astute marketing skills may be well placed to grow their respective market share at the expense of weaker or ailing competitors. At the same time, businesses with the flexibility to add to their product offerings could move into adjacent markets that are underserved by incumbents or where significant players have fallen by the wayside, creating space for newcomers.

Increased activity in distressed M&A has yet to materialise in a major way. “While low interest rates persist, some businesses are struggling on, able to service their debt but with weak balance sheets,” explains Rod Donaldson, Head of M&A and Private Equity. However, he expects M&A activity to burgeon once the economy starts to pull out of recession and businesses aim to grow their market share, particularly through the acquisition of stricken market rivals.

Technological improvements
Almost half of respondents to *Outlook 2012* listed improving internal processes and/or systems as their top business strategy. In addition, a quarter of those polled identified technological development as an opportunity for their businesses.

Baker Tilly’s Head of Media and Technology, David Blacher says: “On the operational side, better, faster, more able systems can save time and money, while an increased focus on online promotion, sales and delivery can enable businesses to reach wider markets more quickly and efficiently.”

Smarter controls
Improving basic disciplines and doing the simple things better and more effectively can ensure business survival and its ability to prosper in the future.

“Crucially, it is about being able to maximise all opportunities, especially factors that are within the direct control of management,” says Mark Taylor, Baker Tilly’s Head of Process Improvement

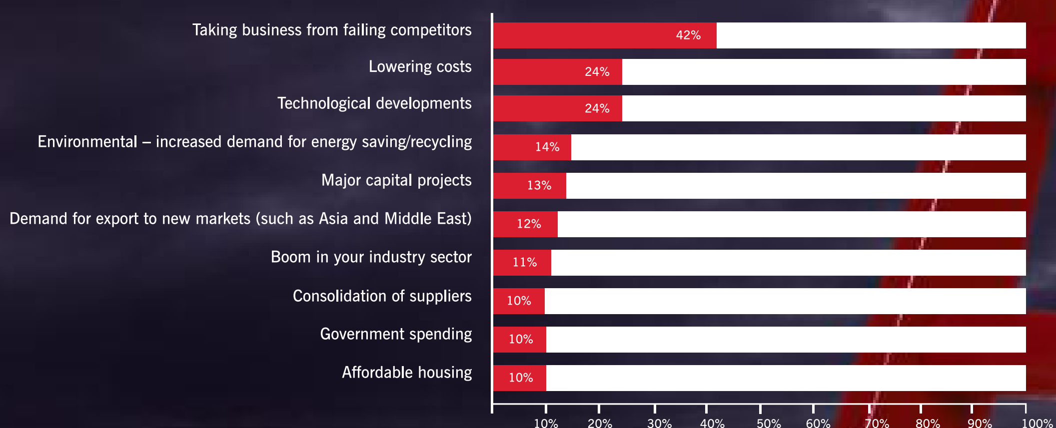
Low-cost borrowing
In general, the cost of borrowing looks likely to remain stable at least for the foreseeable future, according to Tony Wright, Restructuring and Recovery Partner. However, while base rates remain the lowest on record, the actual cost of funds to banks is far higher as they are obliged to offer depositors a premium to attract funds. For the average SME borrower, this means loan margins are at historically high levels of at least 3-4% above base, compared to half that in the boom. Similarly, arrangement fees are high and the level of bank funding is far lower than before. All this means that corporate liquidity will continue to be under pressure.

Selling in to new markets
Foreign exchange market commentators suggest that the level of sterling will continue to favour British exports into 2012. With this tailwind, UK companies that can hone their products to the specific needs of overseas customers have the opportunity to open up new international markets with competitive prices. This is not to say that global economic conditions will make this an easy task but an opportunity exists for those businesses that can demonstrate the right approach and product offering.

In brief

- Taking business from failing competitors is expected to present the greatest opportunity for 42% of respondents in 2012.
- The next greatest opportunities are lowering costs and technological development (both 24%), which may explain why developing products and services are also considered a crucial part of business strategy.
- More than 1 in 8 regard demand for exports to new markets (such as Asia and the Middle East) as an opportunity in 2012.

Top ten opportunities for businesses in 2012*



Source: Baker Tilly *Outlook 2012* survey, Oct/Nov 2011

*Respondents were able to choose from multiple answers applicable to their business.

Industry outlook

The challenges of the current business and economic environment affect the range of industry sectors in different ways.

The industries that have fared best have been those where the scope for improving internal controls and processes has enabled them to adjust to changing business conditions. In particular, those that are in a position to service debt and build up cash reserves are able to look ahead with guarded optimism, knowing that their cash resources may be able to sustain them through to better times.

Construction

Across the 31 companies in the construction sector that contributed to our *Outlook 2012* survey, the view of the general state of their industry is at best flat. While several from the sample were optimistic about the outlook for their businesses next year, far fewer were confident of the prospects for the sector as a whole.

This reflects recent Purchasing Managers' Index readings, while the mid-2011 picture from industry analysts Glenigan showed a decline in construction project starts, a sudden fall in hotel construction and a downturn in industrial, office and domestic housing construction.

"The fear is that these trends will continue into 2012," says Baker Tilly Restructuring and Recovery Partner, Mark Wilson. "House building in particular has fallen to extraordinarily low levels. The Government's housing initiatives that are moving forward are of modest proportions."

While the temptation is to look ahead to London 2012 and conclude that in London at least major project construction is booming, in fact much of the Olympic-related work is nearing completion. Meanwhile, other major road and rail projects up and down the country announced by the Government may not commence for two or three years because of the time required for public consultations, planning and tendering processes to take place.

Mark believes there is a "two-speed economy" in the sector overall. London and the South East appear far more active, although at a relatively low level compared with the boom years. Elsewhere across the country, the outlook is much bleaker. Cuts in public sector spending are a significant contributor to this.

***Challenges:** "Low-balling" – many builders have cut their margins to such a degree that they may be bidding for work at a loss, just to keep cash flowing. This is not sustainable in the long term. Maintaining margins in such an environment is a significant challenge. Smaller contractors will continue to be squeezed as the major contractors look to markets that are the traditional domain of SMEs.*

***Opportunities:** Some new large projects have been announced and this may indicate some loosening of Government purse strings. However, this is likely to benefit major contractors rather than SMEs. Government announcements on road and rail infrastructure projects represent opportunities for those that can change focus to these areas.*

Mark Wilson
Restructuring and Recovery Partner
Watford

T: 01923 657799
E: mark.wilson@bakertilly.co.uk

Real estate

Commercial real estate analysts IPD, reported in mid-December that, for the first time in 28 months, its *UK Monthly Index* had fallen. While the drop in property values was a marginal 0.1% nationally, it reflected "deep uncertainty" over Britain's hope of avoiding a worsening recession.

In residential property, The Royal Institution of Chartered Surveyors (RICS) noted on 13 December that buyer demand had risen nationally in the previous month. It also pointed out that economic uncertainty was preventing "any meaningful recovery". The pockets of good news are mostly in London and the South East. London is the only area in the country where residential property prices are rising according to research by Jones Lang LaSalle. Here, they increased by 2.1% in the year to August. Elsewhere, prices are still on the slide with the North East of England showing a loss of 7.8%.

A further major concern is highlighted by Alan Lovett, Head of Real Estate at Baker Tilly Restructuring and Recovery LLP. He points to research conducted into commercial mortgage backed securities (CMBS) by De Montfort University which shows that as at mid-2011, 15% of outstanding bank debt was either in breach or default. In addition, the position may be exacerbated by a large volume of CMBS which will mature in the next three years. In 2012 alone, the figure is £4.9 billion, twice that in 2011. The combined effect of uncertainty in the eurozone, tightening liquidity, rising unemployment and worsening consumer confidence, may impact property values further, although cash buyers may be well positioned to capture bargains.

***Challenges:** London and parts of the South aside, both residential and commercial property values are likely to fall. Obtaining bank debt for property purchase could prove difficult. Public sector cuts, increased unemployment, further falls in consumer confidence and tightening of liquidity are likely to act as a further brake on recovery in the already ailing property sector.*

***Opportunities:** Lower prices across much of the UK's commercial and residential market. Sooner or later, demand for residential property will result in further house purchases and arrest price falls. Yields for property investors will encourage investment once values have reached suitable levels.*

Alan Lovett
Head of Real Estate,
Restructuring and Recovery
London
T: 020 3201 8632
E: alan.lovett@bakertilly.co.uk

In brief

- Some sectors offer hope for more rapid recovery than others.
- Public sector cuts continue to threaten businesses in most sectors either directly or indirectly. But they also result in opportunities in several sectors.
- With consumer confidence at low levels and more job losses looking likely in 2012, sectors with direct consumer contact are likely to feel the most pain.

Manufacturing

The weakness of sterling, combined with low interest rates, has given UK manufacturers a competitive advantage. Meanwhile, years of taking out cost and relatively low wage inflation have also provided them with an edge in international markets.

This has led to growing optimism across the sector, which is reflected in our research. Of the manufacturers surveyed, 55% were optimistic about the prospects for their business, while only 11% took a negative view. Equally significant, 47% expected sales to rise, with only 14% predicting a fall.

However, the eurozone crisis and a sluggish US economy have dampened prospects. The Confederation of British Industry figures for November 2011 found 42% of manufacturers reporting "fewer than normal" orders. "Manufacturing has been on a rollercoaster ride," says Baker Tilly M&A and Private Equity Partner, Ali Aneizi.

"The sector is broad and the pressures facing different manufacturers vary. Some are still under cost pressure and face significant overseas competition – food and export-led businesses, for example, are having a difficult time as commodity prices are unpredictable and transport costs are high. Others are better off, with service-led precision engineering manufacturers feeling more positive and attracting interest from investors."

These high-technology businesses are often producing mission-critical components which keep demand levels high and margins strong. They tend to generate multiple revenue streams by supplying ongoing maintenance and services. Underpinning this is the UK's talent and expertise in advanced manufacturing. As a result, it has been the home of many world-leading technologies and there is no reason to suggest that will not continue.

Therefore, the picture is a mixed one across the industry as a whole, with uncertainty characterising markets in wider Europe and in North America.

Challenges: *Retaining customers in markets suffering from austerity measures. Retention and training of skilled staff. Funding capital expenditure and R&D in a difficult credit climate.*

Opportunities: *Focusing on high-margin/high-technology mission-critical products. Establishing additional revenue streams through ongoing support and maintenance. Continued weakness of sterling will enable UK firms to price competitively in international markets. Scope to outsource low-value elements of production to lower-cost providers.*

Ali Aneizi
M&A and Private Equity Partner
London

T: 020 3201 8604
E: ali.aneizi@bakertilly.co.uk

Media and technology

The convergence between traditional media and communications sectors and digital technology has continued throughout 2011 and will accelerate in 2012. The threats and opportunities for businesses across this sector both lie in their ability to embrace new technologies.

"Baker Tilly's work with many clients in the traditional media segments – TV production, music, publishing and advertising and marketing – has shown us just how vital it is that they embrace opportunities that technology offers, and adapt their business models accordingly," explains Baker Tilly's Head of Media and Technology, David Blacher.

He adds that, while the Olympic Games may bring limited opportunities to media businesses next year, the general outlook remains tough across the sector with competition intense and 2012 is therefore unlikely to see a significant increase in top-line growth for organisations in this arena. The trend during 2011 that saw online advertising overtake promotional activity conducted offline – through traditional media such as newspaper, television and street advertising – is likely to continue in 2012 and beyond. Moreover, publishing will also face new challenges with the wide-scale consumer adoption of mobile digital readers.

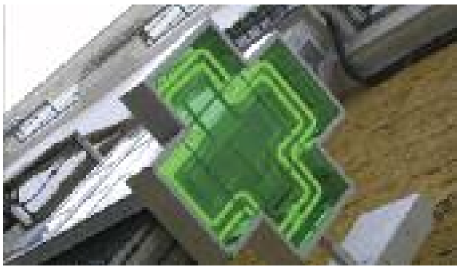
The major online brands such as Google, Amazon and Facebook will continue to wield significant influence on the marketplace as the use of social media and online retail expands further, accounting for a vast amount of media consumption. For businesses in the media and technology sector keeping pace with the way their customers experience media – smart phones, tablet computers, laptops, desktops – will be vital to their success. The easier businesses make it for their customers to consume media, the more success they will be likely to achieve in growing sales.

Challenges: *Reconfiguring business models to align with the demands of digital media. Keeping pace with technologies. Competition for customer attention through already intensely fought-over attention spans.*

Opportunities: *Ease of content delivery through online media. Borderless access to international markets. Rapid path to market for new products and innovations. Ever cheaper prices for technology tools. Availability of skilled employees nationally and internationally. Receptivity of corporate clients and consumers of online media.*

David Blacher
Head of Media and Technology
London

T: 020 3201 8652
E: david.blacher@bakertilly.co.uk



Healthcare

The healthcare sector faces some significant challenges, notably in the care home and pharmacies segments. Of the 26 medical and health sector organisations that responded to our survey, 69% said that public sector cuts posed a threat to their growth or profitability. In addition, 73% thought that the cuts would pose similar threats to the sector as a whole.

The much-publicised difficulties at Southern Cross throughout 2011 have drawn attention to the issues that care homes can face. Revenues are under pressure because of cuts in local authority expenditure and any rise in the level of interest rates will adversely impact those highly leveraged care home businesses that have not hedged their interest rate exposure over the longer term. Meanwhile, increases in staff costs, for example through rises in minimum wage levels or as a result of compulsory staff enrolment in company pension schemes, and increased utility costs are added risks beyond proprietors' and managers' control.

"Despite significant challenges, the sector has its attractions with positive demographic trends, the possible changes driven by the Dilnot report into fairer care funding and potentially attractive investment returns." says Baker Tilly Restructuring and Recovery Partner, Matthew Wild. "However, operators need to be closely monitored and lenders need to act quickly in the event of a downturn in performance, to keep their options open and to protect their security value."

With regard to pharmacies, their most valuable asset is their NHS Pharmacy Contract. Any prospect of its removal or that it is not properly vested in the business poses an immediate threat to the business and consequently to its lenders. Furthermore, competition from supermarkets and surgery in-house pharmacies and failure to diversify revenue streams in the face of such threats can pose serious concerns to even long-established pharmacies.

Challenges: *Public sector cuts at the national or local authority level pose the greatest threat to businesses in the healthcare sector. In addition, new regulatory measures and changes in staffing legislation can result in increased costs that are beyond the control of healthcare businesses themselves.*

Opportunities: *Ageing population demographics and ever-increasing public interest in health and wellbeing still make the outlook for the healthcare sector as a whole one of continued growth for those businesses with significant competitive advantages to offer.*

Matt Wild
Restructuring and Recovery Partner
Guildford

T: 01483 307000
E: matthew.wild@bakertilly.co.uk

Industry outlook (continued)

Retail

UK retailers have been battling the perfect storm of falling sales and rising costs for most of 2011 – most expect that this will continue through 2012. The consumer is being assaulted from all sides, leading to lower demand for most product categories, as well as an increased focus on "value" and "service". At the same time, company profits are under pressure with inflationary pressures increasing the price of products as well as staff and property costs.

Baker Tilly's Head of Retail, Rupert Eastell, sees some light at the end of the tunnel for those retailers that are adapting their offer to the consumer. Creating a more flexible supply chain to respond to the unpredictability of the British weather and consumer as well as developing a genuine cross-channel customer experience are what the winners are doing, and doing well. This almost certainly means having fewer stores. Providing the products that consumers want at prices they will pay, and combining this with great customer service, is undoubtedly the key to success.

While luxury and value retailers will continue to do better than most, department stores and supermarkets should trade well. However, those in the middle with no clear point of differentiation will have to work harder and smarter if they are not to go the way of others before them. While the problems of the high street make good press copy, this hides the many successful national and local retail businesses which are making healthy profits.

The Portas Review puts the future of the high street at the top of the agenda and it will be interesting to see the response to the recommendations. At the very least, it will act as a catalyst for further debate but really should lead to positive actions – the alternative is very uncomfortable for all concerned.

To conclude, 2012 brings little economic cheer to retailers. Cash and market share will remain critical. Those that respond through innovation in product, price and proposition will succeed.

Challenges: *Spending squeeze continues. Banks expected to toughen their stance. Further structural change as consumers change their buying habits for certain items e.g. books, electricals and music. Risks of further social unrest. Rent and rates increasing.*

Opportunities: *Going global. London Olympics 2012. Some supply chain price easing. Mobile technology as source of revenue and means of engaging with customers. To become a true cross-channel retailer.*

Rupert Eastell
Head of Retail
London

T: 020 3201 8000
E: rupert.eastell@bakertilly.co.uk

Motor retail

As motor retail is part of the wider retail sector, the prognosis for 2012 is gloomy and clouded by uncertainty. The high street is full of businesses under stress and for many retail-focused dealers, it will be impossible to avoid the knock-on effect of that. The Society of Motor Manufacturers and Traders' latest prediction is that the market will be a "stable" 1.96 million units in 2012.

The reason for any commentator suggesting no further declines in new car registrations is the relative strength of the fleet and business market which continues to dominate the statistics – in November 2011, over 55% of registrations were corporate sales. Therefore, for those manufacturers and dealers who have enjoyed strong sales of company cars and vans in 2011, the question is how long will this market continue to take up the slack in a sector where sales overall are trending at 20% below the pre-recession levels. Will the Government's Autumn Statement really give the corporate sector the confidence to continue investing in their fleets?

The dealers' representative body, the National Franchise Dealer Association, is predicting a 5% drop in sales in 2012 and for some dealers the decline will be greater. This is because 2011 has delivered a "two-speed" market. Some marques have enjoyed double-digit rates of growth, while others have seen falls of up to 30% in their sales. Dealer standards (premises, people and procedures) are contractual commitments and represent a fixed overhead of the dealer's business, so it is difficult to see how such declines in sales will not be accompanied by a decline in representation and a consolidation of certain manufacturers' dealer networks.

The first sign of this was Renault's announcement in mid-December 2011 that they are going to reduce their network from 190 to around 135. Unlucky dealers who will have received termination letters will continue to receive some ongoing support from Renault for a while and the hope is that the remaining dealers will enjoy a boost in profitability.

Challenges: *Dealers will continue to try and cover fixed overheads from aftersales, given that the third year of ownership is when customers traditionally abandon main dealers for the independent sector and 2011/12 is the third year of a decline in new car sales.*

Opportunities: *Given that new car sales will almost certainly decline in 2012, the opportunities lie in selling used cars that do more than 60mpg – these are the ones that will sell and which offer a niche market in themselves.*

Graham Bushby
Head of Motor,
Restructuring and Recovery
Birmingham/Milton Keynes
T: 0121 214 3122/01908 687826
E: graham.bushby@bakertilly.co.uk

Leisure and hospitality

Having announced strong half-year profits in early December 2011, the chief executive of major pub owner and brewer, Greene King, described his company's results as a consequence of certain food and beverage markets offering an "everyday indulgence" to consumers who are otherwise squeezed by a drop in discretionary spending. However, within days of this optimistic announcement, the FTSE 100 leisure group, Whitbread, saw a significant decline in its share price after issuing a stock market announcement cautioning against variable trading results on a month-by-month basis.

"As cost inflation continues to run ahead of wage inflation, disposable incomes will fall putting pressure on discretionary consumer spending," says Baker Tilly Restructuring and Recovery Partner, Peter Cooper. "It is therefore likely that certain consumer groups will reduce expenditure on leisure in the year ahead. This could lead to polarisation of some markets, with mid-range businesses being most affected as customers in the "squeezed middle" look to value for money alternatives, while wealthier groups continue to spend at the top end."

Since 2008, a significant proportion of top-line growth has been achieved through discounting and voucher offers at the expense of gross margin. To compensate and maintain the bottom line, operating costs have been trimmed to the bone. We question whether this model is sustainable in the medium term.

In the hotel sector, London outperformed most regions during 2011 but the latest surprise data suggests growth in revenue per available room (RevPAR) for London hotels is now static or even beginning to decline. Many commentators expect the Olympics to bring overseas money into the capital, although others caution against this view, suggesting outflow of local custom and a drop-off in tourist numbers could occur as people look to escape congestion and price hikes.

There is also some evidence that the main clearing banks are hardening their view of certain segments of the leisure and hospitality industry. Businesses may need to look to other sources of finance in the year ahead.

Challenges: *Maintaining/growing the top line in the face of a renewed squeeze on consumer spending and general economic uncertainty. The ability to cut cost without damaging operations. A lack of liquidity creating restrictions on working capital and CAPEX. Weather and unforeseen events.*

Opportunities: *The Olympics and Diamond Jubilee. Competitors failing due to poor strategic decisions in the face of current challenges. Availability of cheap leases and freeholds.*

Peter Cooper
Head of Leisure and Hospitality,
Restructuring and Recovery
London
T: 020 3201 8615
E: peter.cooper@bakertilly.co.uk

Business services

'Uncertainty' is the word to summarise the outlook for the business services sector as for many other industries, says Rob Donaldson, Head of M&A and Private Equity, who has worked on numerous transactions in the sector. "Businesses providing services to the public sector face a particularly challenging time," he adds. "Firms such as Serco and Capita will argue that there is opportunity in a time of austerity and there may well be. Yet with every public sector contract under scrutiny, there will inevitably be winners and losers."

As if to underline that point, half of the business services firms that took part in our *Outlook 2012* survey expected their UK-based sales, gross margin, operating profit and head count to increase in the coming year.

Those that can demonstrate an ability to service the public or private sector more efficiently and reduce cost are likely to prosper. Meanwhile, clients in the private or public sectors who have not previously gone down the path of outsourcing may well consider it in the restless hunt for efficiency. This could create new opportunities for business service providers.

Apart from keeping existing business and winning new ones, there remain some real challenges. The assets of many business services firms are their people and their expertise. Retaining and motivating skilled staff in an environment where they cannot expect substantial rises in their remuneration will require imagination and care. Yet with inflation running at around 5%, this could be difficult. The risk of losing key individuals will become more acute, especially as and when we emerge from the current economic stagnation.

Donaldson adds that there are some grounds for optimism: "The economy is more or less stable. Those businesses that are strong may be able to take market share and perhaps invest ahead of the recovery. It would be foolish to suggest that 2012 is going to be a vintage year for business services sector firms but I think there are grounds for hope."

Challenges: *Public sector contracts and the effects of government cuts. Retaining and remunerating skilled staff. Defining competitive advantage in a highly competitive business services marketplace.*

Opportunities: *Gaining market share from weaker competitors. Targeting skills and capabilities at clients where it is possible to add value to their business. Investment in staff and resources ahead of a recovery in the UK and world economy. When the recovery does come, it may appear more quickly than expected and catch out less well-prepared competitors.*

Rob Donaldson
Head of M&A and Private Equity
London

T: 020 3201 8619
E: rob.donaldson@bakertilly.co.uk

Professional practices

2012 promises to be another challenging year for professional service firms, which account for 20% of UK GDP. The impact of continuing financial uncertainty will be felt in many ways. These impacts reflect the fundamentals of the firm, the profession in which it operates and the service lines it provides. Challenges also lie in its geographical spread, the identity of its clients, its working capital requirements and, of course, the quality of its management. We expect continuing consolidation in all the professions with more firms failing or fragmenting.

Well-managed firms in certain segments of the legal profession are likely to see another difficult but ultimately successful year. By comparison, high street law firms, many of whom are already struggling, are likely to suffer a very tough year. Existing problems reflecting a shortage of working capital and the reluctance of clients to pay will be compounded by the arrival of big brands on the high street, including not only established UK brands such as Co-operative Legal Services but also major US brands including Rocket Lawyer and Legal Zoom.

For the property-based professions, those with well-capitalised clients who are able to take advantage of market conditions should continue to see a modest flow of new projects. However, uncertainty over the economy and the housing market will act as significant impediments to all the property professions.

Management shortcomings and cash shortages will inevitably take their toll. As firms prepare themselves for 2012, the focus should therefore be on diligent day-to-day management of the business, coupled with a clear understanding of resource and funding requirements 6-18 months out.

Challenges: *Firms which fail to meet client expectations can expect to be penalised in their marketplaces. Meanwhile, clients are taking full advantage of the economic environment, negotiating additional services, tight fees and relatively generous payment terms as a result. Margins are likely to suffer.*

Opportunities: *Notwithstanding the economic uncertainties, confidence remains relatively high in many professional service firms. Most see new work coming in the main through more effective competition. Some firms will be disappointed. Firms which have thought carefully about the structure of their service offerings, working closely with clients to deliver exactly what is required in the most user-friendly fashion, are well positioned to compete.*

George Bull
Head of Professional Practices
London

T: 020 3201 8609
E: george.bull@bakertilly.co.uk

Charities

Sustainability is the main challenge for charities in the medium to long term. Our recent survey, *Managing charities – Risks and opportunities* (Winter 2011/12), shows that income for most organisations has remained static. While there may have been cautious optimism that the sector's resilience and experience of operating in a tough climate would stand it in good stead, at least in the short term, it is now clear that the challenge it faces is long-term survival, especially as forecasts for economic improvement are consistently negative.

Government funding, which is key to the sector, has led to 42% of charities we surveyed seeing cuts in the last 12 months and nearly a third anticipate a further significant decrease in 2012. Many charities believe that the government spending cuts are the largest risk to their financial position and this, together with low bank interest rates and investment income, means there are further challenges ahead for organisations to overcome. Recent studies indicate more people are giving to charities, but the overall level of donations is falling. The first year of government funding reductions has seen some charities cut costs to the bone. The further cuts that will happen may cause charities to wind up services.

To tackle the funding challenge in part, we found that 16% of respondents to our survey are reducing their costs by collaborating with another charity or commercial organisation. 24% expect to do so in 2012. Of these, 43% have combined or plan to do so on specific fundraising projects. It is those who take practical and proactive action towards the funding challenge who will fare better.

Challenges: *Charities will have to accept the economic reality and ensure that, as far as possible, they control their funding position and manage their finances to give them the best chances of achieving sustainability, even if external factors are beyond their control. Strong financial management and robust internal control systems remain critical. Revisiting forecasts and risk registers will help trustees and management teams focus on key objectives and service delivery, while bearing in mind opportunities for collaboration and partnering as effective alternatives rather than a last resort when funding dries up.*

Opportunities: *As funders focus on the effective use of their finance in the payment-by-results culture, the implementation of evaluation techniques and key performance indicators that embrace both outcomes and effective fund management are required. This can satisfy public and private sector funders about the value that charities, and their funds, bring.*

Karen Spears
Head of Charities,
Restructuring and Recovery
Watford
T: 01923 657843
E: karen.spears@bakertilly.co.uk

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.

Outlook 2012 contributors:

Ali Aneizi	M&A and Private Equity Partner	020 3201 8604
Sarah Batchelor	Restructuring and Recovery Partner	020 3201 8657
David Blacher	Head of Media and Technology	020 3201 8652
George Bull	Head of Professional Practices	020 3201 8609
Joe Burnie	Head of Tax	01483 307000
Graham Bushby	Head of Motor, Restructuring and Recovery	0121 214 3122 01908 687826
Geoff Carton-Kelly	Restructuring and Recovery Partner	020 3201 8611
Russell Cash	Restructuring and Recovery Partner	0161 830 4027
Jim Clifford	Chairman of Public Sector Group and M&A Partner	01923 816400
Peter Cooper	Head of Corporate Restructuring	020 3201 8615
Rob Donaldson	Head of M&A and Private Equity	020 3201 8619
Rupert Eastell	Head of Retail	020 3201 8000
Alan Lovett	Head of Real Estate, Restructuring and Recovery	020 3201 8632
Marcus McCaffrey	Forensic Services Partner	020 3201 8000
Bruce Mackay	Head of Covenant Assessment Services and Restructuring and Recovery Partner	020 3201 8633
Guy Mander	Restructuring and Recovery Partner	0121 214 3304
Steve Merchant	Head of Asset Based Lending	0117 945 2144
Alec Pillmoor	Head of Personal Insolvency	01482 607200
Karen Spears	Head of Charities, Restructuring and Recovery	01923 657843
Mark Taylor	Head of Business Process Improvement	020 3201 8655
Matthew Wild	Restructuring and Recovery Partner	01483 307031
Mark Wilson	Restructuring and Recovery Partner	01923 657799
Tony Wright	Restructuring and Recovery Partner	020 3201 8653

Office Managing Partners:

Basingstoke	Mike Blain	01256 486800
Bath	Ruth Foreman	01225 822300
Birmingham	Simon Hart	0121 214 3100
Brighton	Jonathan Ericson	0845 057 0700
Bristol	Ruth Foreman	0117 945 2000
Bromley	Adrian Hollands	020 8461 8000
Bury St Edmunds	Stephen Duffety	01284 763311
Chelmsford	Stephen Duffety	01245 354402
Chester	Jill Jones	01244 505100
Crawley	Jonathan Ericson	0845 057 0700
Edinburgh	Robert Ross	0131 659 8300
Glasgow	Robert Ross	0141 307 5000
Guildford	Joe Burnie	01483 307000
Hereford	Kate Reid	01432 352222
Hull	Andrew Mould	01482 607200
Leeds	Paul Byrne	0113 285 5000
Lerwick	Robert Ross	01595 743520
Liverpool	Jill Jones	0151 600 2600
London	David Gwilliam	020 3201 8000
Manchester	Jill Jones	0161 830 4000
Milton Keynes	Terry Saunders	01908 687800
Newcastle	Jim Meakin	0191 255 7000
Saltaire	Paul Byrne	01274 536400
Stoke On Trent	James Rushton	01782 216000
Tunbridge Wells	Bill Owen	01892 511944
Warrington	Jill Jones	01925 424230
Watford	Terry Saunders	01923 816400

To contact any of the above, please call them or email *forename.surname*@bakertilly.co.uk

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