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Where is the smart money going in Support Services?





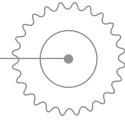
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Methodology

Over the course of the first quarter of 2010, Remark, the research and publications arm of The Mergermarket Group, canvassed the opinions of 40 private equity practitioners with experience of investing in the UK's Support Services sector. Respondents were asked to give their opinions on a number of issues, including the key opportunities and challenges that businesses in the sector face in the current trading environment, as well as their own firm's planned investment strategy over the coming months. All answers were confidential and results have been reported in aggregate.

Introduction



Support Services has long been a prime target market for private equity. The combination of robust recurring revenues providing a defensive quality to companies in the sector, coupled with long-term growth through a relentless trend towards outsourcing, has created a compelling investment proposition for private equity investors.

In recent years this attractiveness has been further underpinned by increasing government spending on outsourced services, yet with state budgets set for cutbacks is the Support Services party bound to be over? The changing political and economic landscape provides unprecedented levels of challenge to the Support Services sector through tough cutbacks at the government paymaster. Yet efficiency drives could provide the opportunity for further outsourcing from the public sector, and the survey confirms private equity's continuing interest in investing in innovative providers of outsourced services to public sector clients.

In the private sector outsourcing is well established, providing Support Services companies with growth over many years, but as the market has matured where are the developing areas for investment? Private equity has been an imaginative investor in the Support Services sector, frequently creating substantial national service providers through an effective buy-and-build strategy. But how many unconsolidated niches remain for the private equity deal origination teams still to mine?

These are some of the key areas addressed in this comprehensive survey of private equity. Post credit crunch, the sector's potential to offer predictability of cash flow and earnings growth has added to its investment appeal.

While deal activity in Support Services has not yet returned to peak levels, we are currently seeing a distinct change in sentiment, with the value of private equity deals completed in Q1 of 2010 already equal to that for the whole of 2009. This awareness of opportunity has not been lost on the larger quoted companies in the sector, where M&A activity and speculation has reached a high point with merger discussions involving Babcock and VT Group.



David Ascott
Partner, Corporate Finance
Grant Thornton UK LLP

What are private equity investors telling us?

The report reinforced our belief that Support Services is, and will continue to be, a hot sector for investment over the next 12-18 months at least. We drilled into this finding further to try and understand: why? What drives this interest? Where will activity happen? And, what are the challenges?

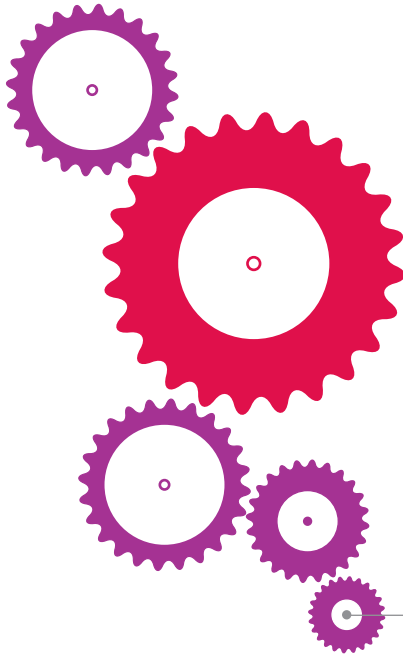
Below we have summarised some of the key findings from our research:

- Almost all (97%) of respondents plan to make an investment in the UK's Support Services sector in the next 12 months
- Of those surveyed, 72% predict the level of private equity investment in the sector to increase over the next 12 months
- However, over 80% perceive competition from trade players is set to increase
- The majority of respondents (56%) expect the bulk of upcoming investment activity by private equity funds in the sector over the next 12 months to fall into the £15m–£100m deal size range
- Recurring revenue streams, the potential to offer bundled services to the same customer base along with the possibility of growth via a buy-and-build strategy, are seen as the most important value drivers within the Support Services space
- The reliability of contracts was identified as a key issue that private equity funds will encounter during the due diligence process
- The challenging financing environment remains an impediment to transacting in the Support Services space, and 59% of respondents state that it is a significant obstacle to private equity related deal flow
- Despite expectations that government spending will be cut back, Support Services businesses with exposure to this arena are still considered to be attractive
- The majority of private equity investors have identified the Business Process Outsourcing (BPO) subsector as offering the greatest opportunity
- The majority of investors believe that the most probable exit route for private equity funded Support Services businesses will be through trade sale, rather than secondary buy-out or initial public offering (IPO)



UK Support Services in review

Support Services is a broadly defined sector that encompasses a wide range of sub-sectors. It is generally defined as the provision of services to private or public sector organisations that enable them to focus on their primary or core activities, or that enable the client organisation to perform key functions more effectively. For the purpose of this survey, we have divided the sector into four major sub-sectors: Facilities Management; Consulting, Advisory and Compliance Services; Business Process Outsourcing; and Operational Support.



Despite a significant level of historical M&A activity, the Support Services sector remains highly fragmented. While there are a number of well established, multi-disciplinary larger corporates, there are also a very large number of smaller businesses, providing services in a particular niche, or operating in a specific geography.

It is this fragmented structure that has supported the high volumes of mid-market deal activity historically, and the majority of respondents in this survey (56%) expect most investment activity in the sector over the next 12 months to fall into the £15m–£100m deal size range.

Unsurprisingly, looking back at the level of private equity related M&A activity over the last five years, the figures clearly reveal the impact of the banking crisis. In 2005 there were 98 private equity related M&A deals with an aggregate value of just over £5bn, rising to a peak of 120 transactions valued at £8.4bn in 2008. Following this there has been a sharp fall to much lower activity levels, with just 37 transactions announced in 2009 with a value of £1.1bn.



While overall economic recovery appears to be underway, deal flow has not yet fully recovered. However, the start to 2010 has proven to be particularly strong with a number of sizable transactions being announced, particularly in the mid-market. The largest private equity deal to date in 2010 is Advent's £274m acquisition of Xafinity. The outsourcing and consultancy services group has spent the last five years under the ownership of private equity fund Duke Street. Duke Street in 2005 paid £124m to buy the business from Hogg Robinson, the UK-based corporate travel agency.

In another notable deal this year, Bridgepoint Capital acquired LGC from LGV Capital in a £257m secondary buy-out. LGC, a provider of chemical and biochemical lab testing services, had been acquired by LGV in 2003 for £70m, which funded a number of bolt-on acquisitions to grow the business, supported by an increasing trend for organisations to outsource testing and inspection services.

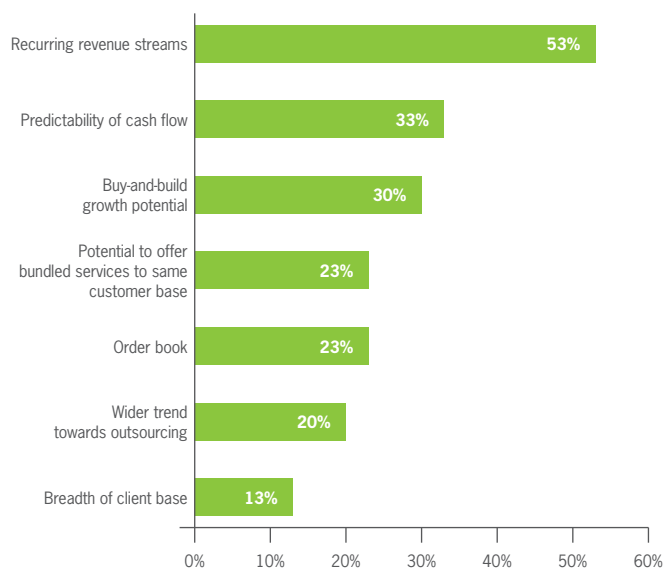
Following a challenging 2009 in which deal flow plummeted alongside the rest of the private equity market, the Support Services sector has started 2010 brightly with a number of new platform investments such as Apogee, Euro Environmental Group and the UK Drainage Network, together with some larger secondary buy-outs in the sector such as Xafinity and LGC. This underlines strong private equity interest in consolidation plays within the sector and the continued attraction of recurring revenues.



David Ascott
Partner,
Corporate Finance

Support Services and private equity – what attracts financial buyers to the sector?

Which of the following do you consider to be the key value drivers in the Support Services sector?



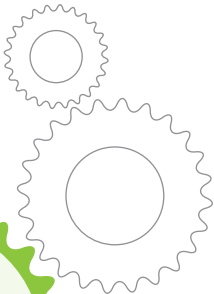
Respondents to the survey were asked what they considered to be the key value drivers in Support Services. A recurring revenue stream and predictability of cash flow feature high on the chart, with 53% and 33% of respondents respectively identifying these as among their key areas of focus.

We look closely at the quality and visibility of earnings based on the strength of customer relationships and the contracts that are in place. If a business' strategy is effectively aligned with its customers' needs, then it is naturally in a position to thrive with the support of the right private equity backer.

Dan Adler
Partner at growth investor Lyceum Capital

Another respondent added: “As a value driver in these businesses, recurring revenue is more important than the order book.”

Further, as the Support Services industry is a highly fragmented space, a number of buyers – private equity and strategic alike – have recognised the substantial upside to be gained from buy-and-build plays. Adler agrees: “Market consolidation is one of the core strands of Lyceum Capital’s proven investment model. A prime example of this is Carewatch, a provider of domiciliary care services which Lyceum Capital acquired in 2008. The investment has enabled Carewatch to make 11 add-on acquisitions, an ongoing strategy which has so far seen the business build a 149-strong UK-wide branch network and grow turnover by 180 per cent to £34 million.”



David Ascott
Partner,
Corporate Finance

A number of private equity firms have used a highly effective buy-and-build strategy to consolidate Support Services sub-sectors. This strategy continues to be widely adopted, covering a diverse range of sub-sectors including drainage repair, digital copier servicing and even funeral services. By leveraging a successful operating model across a much larger national platform, strong returns have been generated through consolidation.

In addition to generating scale and the potential for price/earnings arbitrage, there are also client-side drivers at play in buy-and-build. In both the public and private sectors, there is a trend among buyers of Support Services to seek to rationalise their supplier base, in order to manage costs and gain efficiencies, and as a consequence there are competitive advantages to be gained by developing multi-disciplinary capability. This has, for example, been clearly demonstrated in the compliance services sector, where a number of

providers have grown through acquisition, in order to sell a whole range of compliance related services (fire, health and safety, energy, etc) to the client base. While recognising the potential for buy-and-build plays in the space, Staffan Engstrom, Strategy Director at UK Support Services business Carillion PLC, cautioned that whilst Carillion has been very successful in this area, this sort of strategy is in fact “difficult to pull off for many players and requires exceptionally good management.”

A number of Support Services businesses have exposure to the building services or construction sectors, where activity levels have dropped significantly in the last two years. In such a harsh environment, Support Services businesses that are able to robustly buck the trend are likely to be regarded as highly attractive and probably deliver a ‘must have’ service to their customers. A good example of this is AMTECH, recently acquired by Primary for £35m. Customers need the information and services provided to win and execute work efficiently, and thus are prepared to continue spending money with AMTECH despite cutting budgets elsewhere.

Private equity businesses have to compete with trade buyers in their buy-and-build strategies. Last summer we were involved with the sale of Igrox, a pest control business, and specialist fire protection business UK Fire. Both companies would have made great bolt-ons to existing private equity portfolios, and certain discussions took place. However, ultimately both businesses were acquired by trade buyer Connaught in pursuing a strategy of building critical mass in all of the services bundled together in many of its framework contracts.

Mike Hughes
Partner,
Corporate Finance

This potential to offer 'bundled' services to the same customer base attracts nearly a quarter of respondents to the sector, with 23% saying it is the most important or somewhat important value driver. "Discretionary cutbacks in both the private and public sectors mean that companies that can demonstrate a compelling proposition, ie saving money and/or time, will be able to capitalise," states one respondent, explaining the importance of this potential.

Meanwhile, Robert Morgan, chairman of three private equity backed businesses, felt the chief attraction of Support Services business for private equity buyers lay in the high levels of cash conversion, and also the fact that generally capital expenditure requirements are low relative to other sectors.

Due diligence

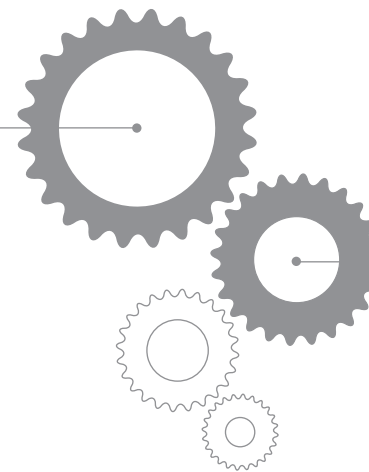
Meanwhile, one of the many consequences of the recent financial crisis is a longer due diligence process. The time spent on getting to know a potential acquisition target and gaining a strong understanding of how the business works, has grown longer and longer. The private equity firms surveyed for this report feel the same, but what do they actually look at and what do they feel are the key due diligence issues they encounter when examining business in Support Services?

Sixty-nine percent of respondents named strength of order book as a priority.

But for us it's important that we have a realistic and pragmatic view of the order book. Our experience is that it is important to go out and talk to the customers to understand the intricacies of each relationship.

Dan Adler

Partner at growth investor Lyceum Capital



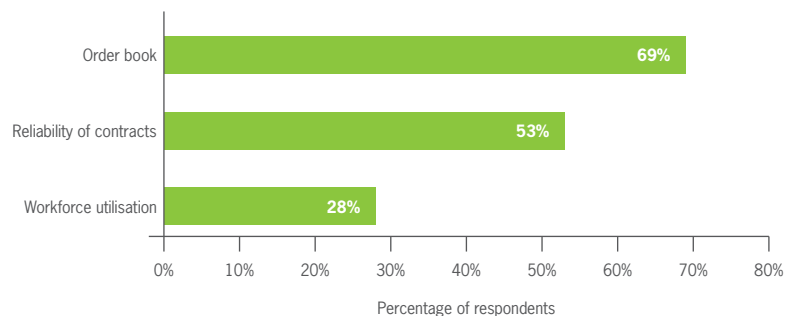
Fifty-three percent of respondents name the reliability of contracts as a key issue during the due diligence process. One commentator stressed that it is important to find out “how happy is the existing customer base.” Another respondent states that what you really want to be looking out for is the “quality of customer relationships,” adding, “this is more important than the order book; what is the likelihood of them going to someone else?” Another says that his fund particularly looks at “a proven likelihood of

customer continuation, ie exiting business with customer relationships intact.”

Finally, 28% of respondents cite workforce utilisation as the key due diligence issue encountered with Support Services firms.

These issues, however, must be seen in connection with each other, one respondent points out, explaining that they are “all vital and work in conjunction with each other.”

What do you consider to be the key due diligence issues encountered by investors in Support Services businesses?



Pete Dawson
Partner,
Transaction
Advisory Services

It is no real surprise that the order book and the reliability of contracts are a key concern of investors in Support Services businesses. This concern reflects the fact that the long-term relationships/recurring revenue often prevalent in Support Services business are among the features that attract investors. It therefore makes sense that this is a key area they look to validate during the due diligence process.

Unfortunately, work in this area is often not as easy as it sounds. Contracts are often unsigned or rolling from year to year, and typically have change of control provisions in any event. If management are exiting then the situation can be even harder to judge. Ultimately there is no substitute for private equity investors talking to a business’ key customers and getting a clear understanding of why the relationship works.

Challenges and opportunities

During the recent financial crisis, businesses from all different sectors were faced with the same major challenge: how to finance their corporate development strategies.

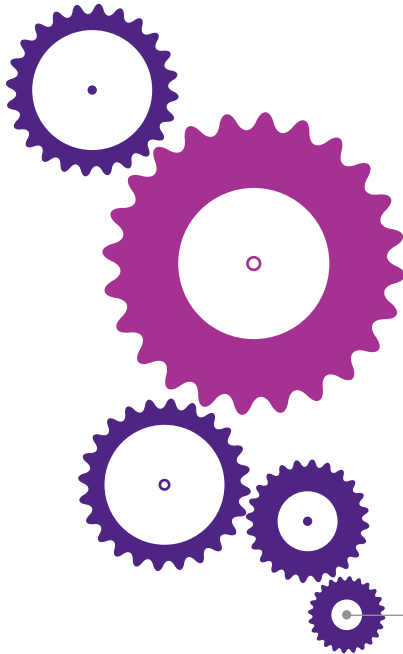
Frozen credit markets and an unstable and uncertain market environment paralysed businesses' ability to pursue development opportunities. The challenging financing environment clearly remains a constraint on businesses in Support Services – indeed, 59% of respondents state that it is a very significant or significant obstacle. However, sentiment is now more positive than 12 months previously.

A key challenge for many private equity-backed businesses in the Support Services space is of course how to deal with the high debt levels many of them are saddled with. A lot depends on when the business was acquired by private equity investors. Businesses bought at the height of private equity activity may be having a more difficult time than others.

Robert Morgan

Chairman of Atlas Interactive Energy Group,
Pulse Staffing Group & HT Forrest

Indeed, it is falling governmental spending and the ensuing budgetary pressure that most respondents identify as the biggest obstacle for companies in the sector – as identified by 90% of respondents. This circumstance may, however, also result in opportunities for well funded acquirers, as less resilient companies struggle to adapt to the changing business environment, and become takeover targets.



Adler agrees, stating that under these changing circumstances only the most streamlined and flexible companies will survive. Likewise, one respondent states that “the anticipated contraction in government spending will potentially result in a shake up in public services.”

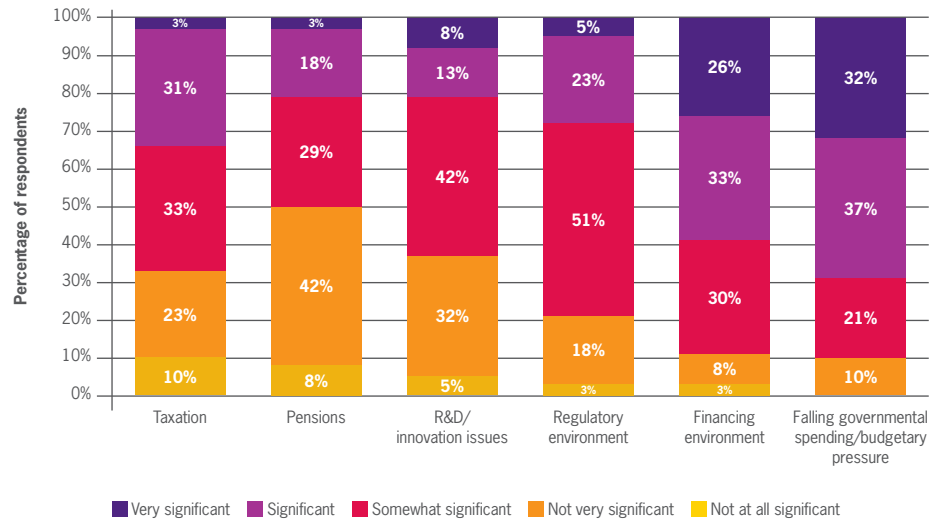
Taxation is a further obstacle that has emerged and is particularly prevalent in the run up to the election. One-third of respondents name it as a very significant or significant obstacle in the space.

Firms simply need to know what kind of tax regime they will be operating under in the coming years.

Dan Adler
Partner at growth investor Lyceum Capital

Engstrom remarked that all Support Services businesses are having to maintain focus on providing their clients with valuable services that allow those businesses to cut their cost base.

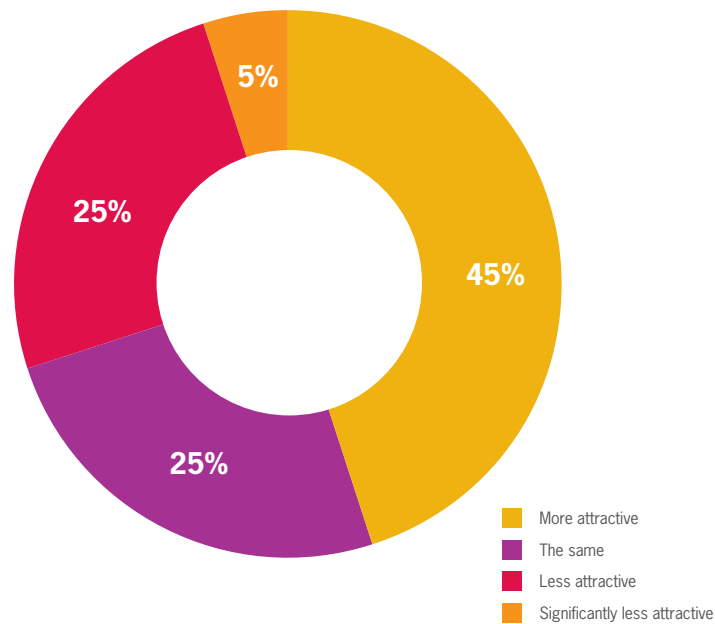
Please rate the following factors in terms of how significant an obstacle you believe they represent to UK Support Services businesses over the next 12 months



Constraints on the public purse

Support Services businesses with exposure to a public sector client base have historically been highly rated by investors, due to high levels of public spending in areas such as social housing, healthcare, education and transport & infrastructure.

Support Services businesses with exposure to a public sector client base have historically often been highly rated by investors. In the current climate do you view this market as:



Respondents to the survey were asked how they felt this would develop in the light of inevitable cuts in public spending. Interestingly, despite most recognising governmental spending and the ensuing budgetary pressure as a big challenge to the Support Services sector, 45% of respondents believe that these types of businesses will become more attractive, while 25% feel they will remain just as attractive as they were before the crisis.

Indeed, Engstrom felt that the expected government spending cuts will in fact provide great opportunities to businesses in the Support Services space, as public sector organisations seek further efficiencies and certainty over cost.

One respondent adds: “As contracts are being renegotiated, opportunities for companies capable of demonstrating a compelling proposition are opening up.” A second comments “bigger players will see this as an opportunity, particularly relating to new tenders”. “Governmental overspend and a deficit in the budget will mean many changes are on the cards,” a third respondent notes.

Adler agrees with the sentiments expressed by respondents.

Even with government spending cuts, services will still need to be provided and thus offer businesses in the space significant opportunities

Robert Morgan

Chairman of Atlas Interactive Energy Group,
Pulse Staffing Group & HT Forrest

The fact is the government will still need to provide those services, so demand will remain reasonably resilient, and Support Services firms will continue to be an attractive investment opportunity.

Dan Adler
Partner at growth investor Lyceum Capital

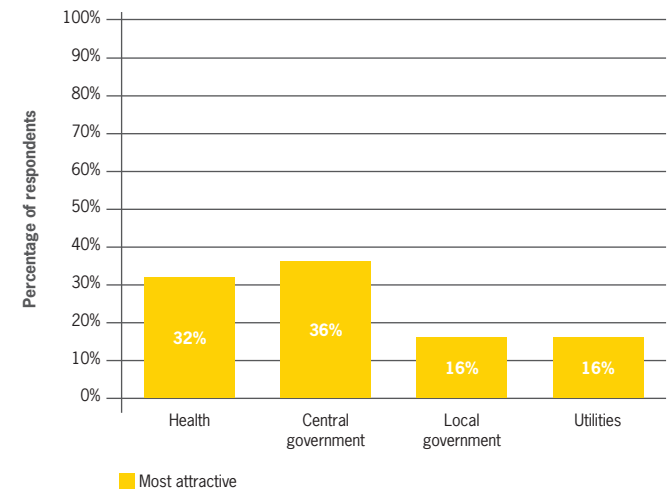
While total public sector spend will reduce, the need to control costs will result in increased government outsourcing opportunities for Support Services companies. For example, there are big gains to be made around estates management, as the government seeks savings on the costs of running Whitehall's £270bn estate, with new "strategic property vehicles" being created by 2011. Further efficiencies will be sought in management of local authority, NHS and other public assets, perhaps through the government's Total Place initiative. We anticipate some M&A activity as the larger players seek to acquire new skills and technologies to fully exploit these opportunities.



Neil Rutledge,
Director,
Government
Infrastructure &
Advisory

Over two-thirds of those surveyed (68%) identify the public sector segment of the Support Services market as an appealing investment space. Interestingly, more than one in three of these respondents (36%) say that the central government niche is the most attractive sub-sector to be in, while a further 40% say that it is either a very attractive (8%) or attractive (32%) market to be in. Likewise, the health sub-sector also garners a high proportion of investor interest with 32% of these respondents saying that it is the most attractive and a further 56% of respondents saying that it is either very attractive (36%) or attractive (20%).

Which Support Services markets do you view as most attractive?



It is interesting that more respondents (36%) found central government most attractive compared to local government (16%). We expect that this is because there is a perception that central government has deeper pockets than local government. Whilst this may well be the case, the flipside of this is that there is huge pressure on local government to reduce costs, with outsourcing being a key route for them. Central government on the other hand may outsource larger projects, which can be more lucrative. However, these are more susceptible to being put on hold than essential services provided by local authorities.

Pete Dawson
Partner,
Transaction
Advisory Services

Neil Rutledge,
Director,
Government
Infrastructure &
Advisory

The combination of challenging targets set by The Climate Change Act combined with new financial incentive mechanisms – ultimately funded by utilities consumers – provides a dynamic and profitable landscape for suitably qualified Support Services companies to engage with the public sector, particularly those able to finance low-carbon developments.

Simon Lowe,
Practice Leader,
Business Risk
Services

Counterintuitive as it may seem in a market that is about to be hit by a wave of cost cutting, the future looks bright for the Support Services sector. Regardless of whichever party is elected, the only question on any government or would-be government minister's lips is "how can you help me deliver more (or at worst the same) for less?" The conclusion that the market seems to agree on is that cuts in cost are acceptable, cuts in services are not acceptable, and that the answer lies in the private sector. The challenge for the sector lies in continuing to innovate to meet the requirements of cost reduction and improved service delivery.

Challenges for investors

Respondents to the survey were asked what obstacles needed to be overcome to deliver successful investment strategies in Support Services.

In common with other markets, identifying backable high quality management teams presents a challenge to the investor, with 66% of respondents rating this factor as a significant obstacle.

Another sizable obstacle private equity buyers see when they examine potential investment in the space is the increasing competition for deals from cash-rich corporate acquirers, which 59% view as a very significant or significant challenge. Engstrom further commented that: “The greatest competition that Carillion PLC are facing for acquisitions comes from fellow trade players.”

Competition, full stop – be it from cash-rich trade players or fellow private equity funds – is a constant challenge. We have to ensure management feel that we will provide the best route to fully realising their ambitions.

Dan Adler

Partner at growth investor Lyceum Capital

Naturally, the current debt financing environment along with price dislocation between buy and sell-side parties were also named as obstacles confronting private equity buyers. With regards to valuations, one respondent states that “price disparity is improving, but is still an issue.”

Morgan concurred, stating that while the valuation dislocation between buyers and sellers is still apparent, it is by no means as pronounced as it was a year or so ago.

Bankers lending to the Support Services sector in 2010 home in on the robustness of the contracts and repeat business. The scars are still fresh for lenders who settled for recurring relationships rather than recurring contracts in their Support Services portfolio. That said, improving credit markets are certainly helping the rising tide of Support Services deals.

David Ascott
Partner,
Corporate Finance

Business Process Outsourcing

Respondents widely predict the Business Process Outsourcing sub-sector of Support Services to offer private equity investors with the greatest opportunity in terms of growth and consolidation.

One of those surveyed states that there is a “strong environment for BPO given the move of corporates to a streamlined model,” further adding that there are “more efficient BPO models than previously.”

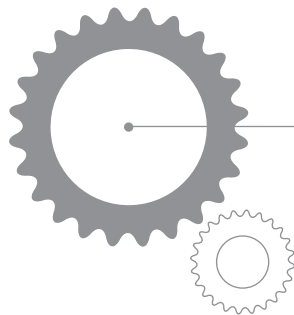
Of the 73% of respondents who identify BPO as a preferred investment area, more than four in five (83%) select payment services as one of their top three preferred BPO investment niches, closely followed by IT services at 75%. HR and payroll outsourcing also rank highly.

Operational Support

Investors surveyed also rate Operational Support as an attractive sub-sector. Fifty-two percent of those surveyed mention it as a preferred investment sector. One comments that he sees more potential activity here, identifying it as a “competitive area,” further adding that he expects to see “lots of potential M&A activity” in the space. Seventy-one percent of respondents cite logistics and distribution as the most attractive niche in the space, with document management services also ranking highly.

Facilities Management

One-third of respondents believe that the Facilities Management space will provide significant growth prospects in the year ahead. Within this group, a combined 54% of respondents identify both the security services and mechanical & electrical services niches as being of particular interest. Unsurprisingly, the more mature ‘soft FM’ markets such as washroom & hygiene services and catering are less well favoured.



Consulting, Advisory and Compliance Services

Just over one-quarter of respondents (27%) foresee Consulting and Advisory Services as market segments offering good growth prospects in the coming year. Increasingly demanding environmental legislation and regulation have led investors to see consultancy businesses providing services in this area as of greatest interest, followed by training services, a market where growth is expected to be underpinned by Return to Work and other initiatives designed to address unemployment created during the recession. Consulting and advisory services in more uncertain markets fare less well, with very little enthusiasm currently eg, for generalist recruitment services or marketing and PR services.

Looking at the question of sector preference more generally, one respondent comments that a specific sub-sector's attractiveness to individual funds "really depends on the appetite for risk," suggesting there are a number of variables that funds will need to consider before committing to a specific market. Another survey participant states that "each sub-sector of Support Services has merits, therefore it is impossible to specify which will have most opportunities."

Recalling the earlier commentary on generating growth through the cross-selling of complementary services, one respondent casts aside the assertion that within each of the sub-sectors, individual niches were more attractive than others: "I would not distinguish between them, as the opportunity lies in bundling a number of these services."

With the election looming and budget cutbacks a certainty, the public sector Support Services opportunity is probably best left to those existing players who can capitalise on the value for money agenda. Conversely, the private sector seems to provide a continuous flow of entrepreneurs and businesses seeking to re-engineer the Support Services landscape through innovation in the sector. BPO has been a prime target for this activity, particularly in the financial services sector where back-office processing has been widely outsourced and private equity firms have invested in areas such as international payroll and accountancy services and fund administration. Private equity investors seeking growth have followed the path of regulatory change to the environmental services sector, where legislation is driving strong demand for compliance and testing services.



David Ascott
Partner,
Corporate Finance

An interview with Staffan Engstrom, Strategy Director of Carillion PLC

Carillion PLC is one of the UK's leading Support Services and construction companies, employing around 50,000 people.



mergermarket: What does Carillion PLC look for in UK Support Services businesses?

SE: We look for high levels of synergies, reflected in three different ways: firstly, we look to achieve back-office and operational synergies that will allow us to evaluate costs internally. Secondly, we look for vertical synergies which, again, will allow us to cut costs internally; for example, replacing an existing sub-contractor with our own. Thirdly, we look for customer-related synergies aimed at building a strong customer base. Fundamentally, we look to provide highly integrated solutions to our clients.

mergermarket: How does Carillion PLC go about identifying targets?

SE: We use two approaches. On the one hand, we have a network of intermediaries who are constantly on the look out for opportunities which they pitch to us. In addition, we have our own research team that comes up with interesting ideas for us to look at.

mergermarket: What kind of strategies does Carillion PLC pursue after acquisition?

SE: Following an acquisition, we generally pursue an aggressive integration strategy to ensure that we are able to achieve the synergies that we aimed for. Along with that, we consider clear communication to be a central element to our strategy.

mergermarket: In what ways have/will private equity deals in the Support Services sector change due to the global financial crisis?

SE: The lack of private equity buyers led to a decline in attractive targets coming to the market, so throughout the crisis there was nothing of much interest to buy out there. It would seem that without private equity buyers, potential targets felt there would not be enough competition to do an attractive deal. However, now that private equity is making a comeback, we are seeing more companies considering a sale.

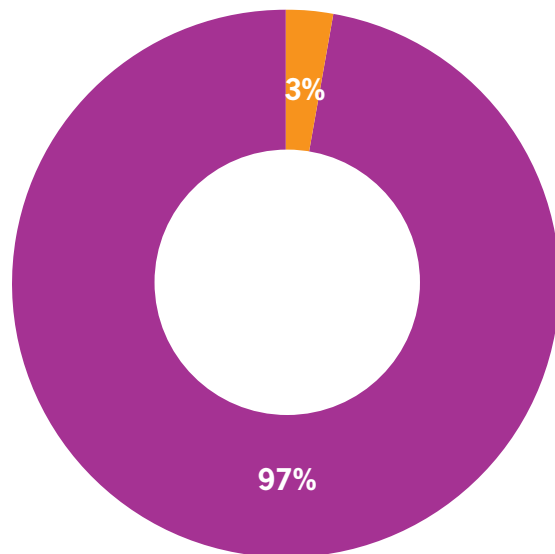
mergermarket: What benefits do private equity backers offer UK Support Services vis-à-vis trade buyers?

SE: The biggest benefit for a trade buyer is the higher levels of synergies that they can typically offer, driven by benefits of scale.

Looking ahead at investment activity – what is in store for the Support Services sector?

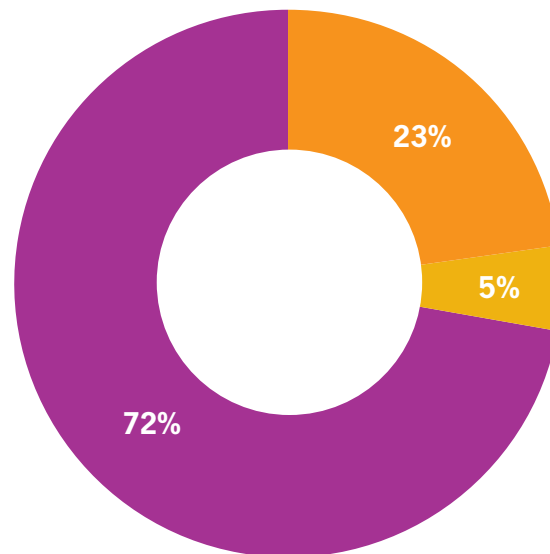
Support Services play a key role in supporting a vast variety of industries, and as the wider economy recovers so will businesses in that space, making them ever more attractive acquisition targets for savvy private equity investors who recognise the potential of this highly fragmented industry.

Does your firm plan to make an investment in the UK Support Services sector in the next 12 months?



Yes
No

What do you expect to happen to the level of private equity investment in the UK Support Services sector over the next 12 months?



Increase
Increase greatly
Remain the same

There are already a number of potential deals in the pipeline, indeed, we are seeing increasing deal flow, with more Support Services businesses coming to market, and it is fair to assume that a number of them will become targets for private equity funds.

Given the attractiveness of the sector, it comes as no surprise that almost all respondents state that their fund is planning to make a Support Services investment in the next 12 months. It follows naturally that 72% of respondents predict the level of private equity investment to increase over the next 12 months, 23% even expect it to increase greatly.

We have a strong pipeline of investment opportunities. Whichever government is in power, the general trend towards outsourcing will continue making the Support Services space ever more appealing.

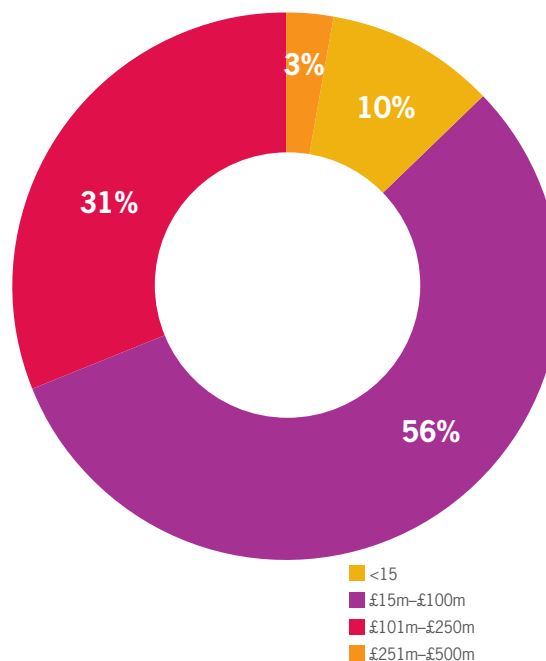
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Partner at growth investor Lyceum Capital

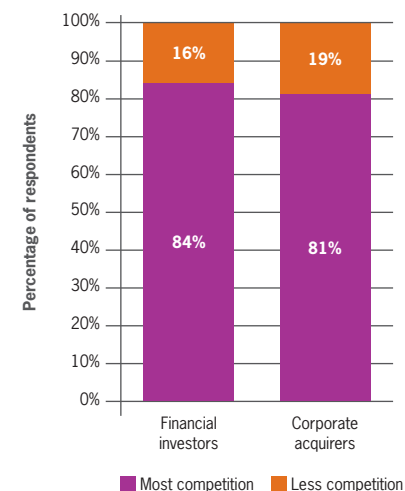
“There will be more opportunities due to non-core disposals,” one respondent predicts, while another foresees “more deals, partially due to a re-alignment in valuations.” Another states: “The past few years saw values at high levels which fell last year. With renewed outsourcing opportunities this should present opportunities for growth and some rallying in values.” However, these responses need to be considered against the backdrop of overall lower M&A levels as a direct result of the financial crisis. One respondent comments that recently “they [valuations] were lower than in previous years, but going forward we will see a return to more typical levels.” Engstrom fundamentally agreed with this and moved on to state that the industry is entering a particularly interesting phase in this regard.

Meanwhile, competition for attractive assets in the space is expected to heat up – 84% of respondents are expecting more competition from financial buyers, and 81% are predicting more competition from trade buyers.

In which deal size range do you expect to witness the bulk of activity from private equity in the UK Support Services sector over the next 12 months?



Compared to 12 months ago, how much competition is there currently for assets in the UK's Support Services sector from financial investors and corporate acquirers?



There are two forces at play: the private equity industry is looking to invest, while trade players are keen to get their hands on some of the Support Services businesses sitting in private equity funds' portfolios. Coupled with the continued attractiveness of business in the space, this should drive significant transaction activity over the coming months and years.

Dan Adler
Partner at growth investor Lyceum Capital

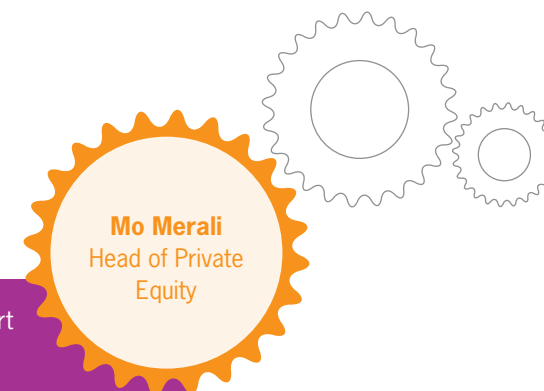
Financially sound corporates that have used the period of economic turmoil to reposition themselves and redefine their strategy are now ready to do deals. One respondent explains that we will see “increasingly more corporates making acquisitions, where they have strong balance sheets and are less reliant on the debt market for fundraising.” Another notes that “corporate acquirers have been focused on cost cutting and operational management; but growth now will come in the shape of M&A activity.” In fact, an aggregated 59% of those surveyed feel that competition from cash-rich corporate buyers will present a very significant or significant obstacle to private equity firms looking to invest in the sector in the next 12 months. Morgan qualified this view, stating that the level of competition for assets in the space depends on the sub-sector.

Businesses in the recruitment space, for example, are seeing a high level of interest from trade buyers. But private equity seems slow to react, perhaps due to the lack of cash flow lending from the usual suspect banks. He argued that this would lead to consolidating trade players executing potential buy-and-build strategies.

Robert Morgan

Chairman of Atlas Interactive Energy Group,
Pulse Staffing Group & HT Forrest

Private equity has been an integral part of the transactional activity in Support Services for over a decade, from providing development capital to fund the growth of smaller private companies to service broader markets and larger contracts, to supporting larger buy-outs of quality businesses to take them to the next level. The last few years have shown the even greater importance of the Support Services sector to the UK economy, with emergence of large Support Services ‘conglomerates’ and the greater focus and attention of private equity to seek out new opportunities. There will continue to be opportunities in this space for investors and management teams – and there will undoubtedly be some winners, but these will emerge from those investors and management teams who deploy innovative ways of managing the risk, structuring and funding deals, and have the flexibility and resilience to work through the minefield of the forthcoming public spending budgets.



Mo Merali
Head of Private
Equity

Exit routes

While private equity most certainly have come to see trade buyers as intense competitors in the quest for targets in Support Services, when they look to divest their portfolio companies many see trade sale as the most likely exit route.

In fact, 80% of respondents believe that trade sales will be the main exit strategy for private equity firms over the next 12 months.

However, the perceived attractiveness of Support Services by private equity will naturally play a role in private equity funds' exit considerations, with secondary buy-outs also considered likely. The financial crisis has empowered strong, cash-rich and acquisitive trade buyers to join the fray, while at the same time frozen credit markets have paralysed private equity funds' ability to execute on deals. However, even as this report is written, private equity funds are making a comeback, so the field remains open.

One finding of the report was that not a single respondent felt that an initial public offering would be the main exit strategy for private equity funded businesses in the sector. While there has been talk about IPOs making a comeback, Adler was still not surprised by this finding, explaining that Lyceum Capital regularly buys businesses that at the time of purchase are not on the radar to trade players.

When we buy a business, our preferred exit will always be a trade sale. Our strategy is to take niche businesses and build them into robust market players that have the scale, infrastructure, and growth strategy in place to make them of high strategic value to potential acquirers.

Dan Adler
Partner at growth investor Lyceum Capital

In the current economic climate raising debt remains difficult for asset poor companies, even if, as with many Support Services business, value is supported by contractual income streams. This will favour the trade buyer over secondary buy-out as an exit route, particularly as they can bring in synergy benefits like cross-selling services as well as reducing the central costs.

Ali Sharifi
Partner,
Corporate Finance



80% of respondents believe that a trade sale will be the main exit strategy for private equity over the next 12 months

An interview with Dan Adler, partner at growth investor Lyceum Capital

Dan Adler is a Partner at growth investor Lyceum Capital, where he is responsible for sourcing and executing investment opportunities.

The fund has a strong track record in the Support Services sector for executing considered consolidation strategies and successfully exiting portfolio companies via trade sales – all of which are key elements of private equity activity in the sector and are mentioned in this report.

Size-wise, Lyceum Capital's sweet spot is in the lower mid-market, investing between £5-30 million of equity in deals with typical enterprise values of £10-75 million. It has a £255 million fund, the majority of which is available for investment.

Currently, its portfolio consists of Synexus, a business which provides fully outsourced clinical trials for global pharmaceutical companies; McKinnon & Clarke, one of the largest energy procurement and compliance specialists in Europe; UKDN, the largest drainage claims manager in the home insurance market; Carewatch, a domiciliary care services provider; and Fox IT, an IT service management and governance firm. All portfolio businesses are UK-based.

mergermarket: Why does Lyceum include the UK's Support Services industry amongst its key investment sectors?

Dan Adler: The chief attraction of the sector is that it's one of the few areas in the UK economy with long-term underlying growth opportunities. There are many small but highly innovative businesses out there which, with our financial and operational backing, are in a prime position to make the most of the growth and development potential which exists.

With the right platform firm, the highly fragmented nature of the sector presents significant consolidation opportunities.

Through a focused acquisition programme it's possible to build a suite of complementary services which can be marketed to the same customer base - significantly boosting organic growth and creating a strategically valuable target for trade acquirers.

mergermarket: What does Lyceum look for in UK's Support Services businesses?

DA: When researching a sector we undertake in-depth analysis on the market structure, competitive landscape, prospects and economic drivers to gain a clear understanding of current and future growth trends.

We examine individual businesses operating in that industry and identify those which are best positioned to act as a solid base from which to build a diverse portfolio of services, target new areas of the sector and support rapid and large scale growth.

We also look at the management team to see if it has the qualities needed to drive this expansion and whether the business critical infrastructure and systems are in place to appropriately scale the company.

Naturally, we also look at what exit opportunities are likely to be open to us in the future as this shapes our entire investment strategy.

mergermarket: How does Lyceum go about identifying targets?

DA: We use two approaches. We, of course, work with a network of intermediaries, but we also have an internal origination team. Those two combined throw up plenty of attractive investment opportunities.

mergermarket: What kind of strategies does Lyceum pursue after acquisition?

DA: There are three key strategies we pursue. Firstly, we pursue organic growth via pure business development, such as launching new product lines or expanding into untapped markets. Secondly, we look at business improvement initiatives from a genuinely commercial point of view. Finally we look for buy-and-build opportunities which will deliver significant and sustainable growth.

mergermarket: In what ways have/will private equity deals in the Support Services sector change due to the global financial crisis?

DA: Leverage has become an increasingly scarce commodity, however a sensible amount of debt is still available for good deals. The lack of debt led to a hiatus in dealmaking during 2009, but we can see signs of recovery, and there is no shortage of appetite for the right asset at the right price.

mergermarket: What benefits do private equity backers offer of UK Support Services vis-à-vis trade buyers?

DA: Private equity backing of a Support Services business gives the firm an unparalleled focus on growth and maximising returns. Financial buyers have extensive experience of doing just that, and that experience is entirely at the disposal of its portfolio company. Executing successful buy-and-build strategies is just one example of how that focus can be turned into real returns on investment.

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