Where is the smart money going in Technology?
Methodology

Grant Thornton engaged IE Consulting, the research arm of private equity (PE) publication unquote”, to canvas the opinions of 40 PE and venture capital (VC) practitioners with experience of investing in the UK technology sector. All answers were confidential and unattributable. Where responses by PE and VC firms have been split, unquote” defines a PE firm as one which has an interest in buyouts. unquote” has applied definitions from information on investor company websites. The deal data in this report is accurate up to the end of the third quarter of 2012.
As financial advisors to the technology industry, we are constantly encouraged by the opportunities and growth potential the sector offers private equity. Technology has managed to perform well, even through challenging times, with innovative sub-niches yielding prime targets for investors and trade buyers alike.

The technology sector has been a shining light in an otherwise subdued private equity market in 2012. We decided to review the sector in-depth to understand more fully the strength and sustainability of current private equity appetite, and to explore what they see as the growth areas as well as the major obstacles for UK technology. To help us examine these issues, we conducted research amongst 40 private equity and venture capitalist professionals, who gave us their candid views on the sector.

Respondents were asked to give their opinion on a number of issues, including the investment landscape and prospects for the technology sector, the key technology growth areas going forward, as well as their own firm’s investment strategy moving forward. The findings highlighted the mixed feelings that private equity investors have about future investment in the UK technology sector, with venture capitalists being more bullish than private equity firms. However investors all see opportunities in the market.

Indeed, the technology team at Grant Thornton has continued to be very active, completing more than 20 mid-market transactions over the last 18 months. Working with dynamic technology companies both in the UK and internationally, our deep sector knowledge coupled with strong relationships with the investor community means we are ideally placed to add value and deliver successful transactions for our clients.

We hope that you find this report useful and look forward to supporting you in your ambitions for growth.

Key findings

- Over half of the respondents (57.5%) expect the level of private equity investment in the UK technology sector to increase over the next two years, with 10% of those expecting it to increase greatly.
- Cloud and Managed Services are the top two sub-sectors for investment.
- Many see the financing environment and Eurozone uncertainty as being significant obstacles for UK technology businesses over the next two years.
- Competition for the right technology deals is intense, with a balanced universe of trade and financial buyers, both domestic and international.
- Two thirds say they expect the major competition for deals to come from other UK private equity firms with a quarter citing UK trade buyers. Perhaps surprisingly only 23% saw overseas buyers as the prime competitors.
- 93% of respondents believe the main exit strategy for private equity backed investments in the UK technology sector will be a trade sale over the next year; only 23% expect to see a sale to other financial investors as an option.
- Any recovery in the IPO markets for private equity exits still seems more of a hope than an expectation, with only 8% seeing this as a credible option over the next 12 months.
UK technology sector in review

Over the past few years, the funding landscape has continued to present a challenging environment for businesses looking to grow. However, technology has remained an active market for investment, outperforming other sectors.

Private equity professionals experienced high levels of deal activity between 2007 and 2008, but 2009 onwards saw activity decline sharply, with many deals being put on hold. A number of those deals have gone on to be completed, but the downturn forced the market to adapt to a significant lack of bank finance, a situation that has persisted and given rise to an increase in alternative funding solutions.

The defining factor in deals leading up to the crash of 2008 was the ability to leverage investee businesses highly using bank debt. During 2006 and 2007 bank debt levels of up to 12 times earnings were not uncommon. This allowed private equity firms to acquire businesses at high valuations but with only limited equity investment – hence the feeding frenzy of leveraged deals.

In today’s market the mathematics of investment have changed. Private equity houses are still completing transactions but with much lower levels of external debt and a much more conservative approach in terms of which lenders they are comfortable dealing with. Many funds have flexed their deal structures to ease the lack of bank debt in the market and this increasing flexibility has allowed a number of deals to complete which would not have seemed possible back in 2009.

The market has settled down sufficiently now to yield a persistent, though lower level of deal activity. With deal volumes oscillating around 60%–70% of the 2008 peak, the technology sector has fared better than most.

According to unquote” data, the combined technology and telecommunications sector has consistently ranked within the top two most popular sectors for early stage and expansion investment and within the top three for buyouts. Overall, for all types of private equity investment, the sector is second only to the broad industrials category.1

1 Source: unquote”. Private equity investments across all sectors 2005–2012 to date, October 2012.
2012 has seen the return of private equity appetite for the largest UK technology deals. However, this has required significantly larger equity commitments from private equity houses compared with 2008 when mega-deals were last within the reach of private equity, and were backed by significantly higher debt leverage.

Overall, private equity has maintained a healthy 30% share of the total UK transaction market in the technology sector in 2012. The overwhelmingly mid-market characteristics of UK technology has kept deals firmly within the ambit of most of the active funds and has enabled private equity to compete on equal terms with trade buyers for the most attractive assets.

In general, the UK only sees a handful of technology mega-deals greater than $1 billion. Over the last 12 months the deal tables were topped by HP’s $12 billion purchase of British software firm Autonomy in October 2011. Other mega-deals include British IT services giant Logica plc – which was acquired by Canada’s CGI Group Inc. for £1.7 billion in August 2012 and Vista Equity Partners’ June 2012 acquisition of Misys for £1.27 billion.

Private equity deals in UK technology by deal type

<table>
<thead>
<tr>
<th>Count of deal</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deal type</td>
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<tr>
<td>Expansion</td>
<td>47</td>
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<tr>
<td>Early stage</td>
<td>17</td>
</tr>
<tr>
<td>Buyout</td>
<td>17</td>
</tr>
<tr>
<td>Secondary buyout (inc. partial)</td>
<td>3</td>
</tr>
<tr>
<td>Acquisition finance/Buy and build</td>
<td>1</td>
</tr>
<tr>
<td>Buyin and buyout</td>
<td>2</td>
</tr>
<tr>
<td>Secondary purchase</td>
<td>1</td>
</tr>
<tr>
<td>Seed</td>
<td></td>
</tr>
<tr>
<td>Turnaround/Restructuring</td>
<td></td>
</tr>
<tr>
<td>Grand total</td>
<td>88</td>
</tr>
</tbody>
</table>

Source: unquote*
The market still has a high degree of fragmentation with a large number of specialist niche providers, and this is creating real opportunities to capitalise on the accelerating convergence across the industry through the disciplined execution of buy and build strategies.

“This is highly attractive to private equity investors with the right management team”, says Andy Morgan, Corporate Finance Partner at Grant Thornton. “They are increasingly looking to deploy more capital behind existing platforms in segments of the market they understand, where they can build a business of scale to attract the interest of strategic trade buyers.”

Another key theme which has emerged this year is the return of public-to-private transactions, which account for 30% of the top ten private equity deals in 2012. Misys, Kewill and Workplace Systems have all left the market with private equity proving a more compelling route to growth and value for shareholders.

Levels of restructuring and distressed situation deals have remained low – a reflection of some relaxation in corporate IT budgets as investment is required to drive business change, reduce costs or ensure compliance. Andy Morgan comments, “Debt levels in the sector are still generally low relative to other markets where transaction activity was fueled by the excessive leverage of 2007/2008. There remains a backlog of transactions which are likely to filter through in 2013 and 2014 as capital structures start to unwind and refinancing requirements provide the catalyst for a liquidity event.”

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### CASE STUDY

**Tessella**

**Background**

Tessella is an IT services business, based in Oxfordshire, which provides outsourced software development capability to large research and development projects within the public sector and commercial organisations. It boasts an impressive client list including the British Library, the JET project, GSK and Akzo Nobel. Tessella is a global business with offices in the UK, US and the Netherlands. Recruited staff, the majority of whom have PhDs from the world’s best universities, are equipped to utilise their predominantly science and mathematics backgrounds in software development projects for commercial and research environments.

**Solution**

Grant Thornton advised the shareholders of Tessella on the sale of the business to its management team backed by Mobeus Equity Partners. Grant Thornton took the deal opportunity to Mobeus, recognising both a cultural fit and the advantages of a tried and tested Mobeus deal structure for the circumstances of Tessella and its stakeholders.

**Result**

The transaction values the business at £18 million and enables the founder, Kevin Gell, to move away from day-to-day management while retaining a key position within the business and on the Board.

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*The Tessella deal serves to illustrate the way that many PE houses are developing innovative structures to bridge their needs and those of vendors in a difficult market. Mobeus offered the vendors a combination of cash, high interest loan notes and a retained equity stake. The vendor loan notes and those of Mobeus, together with the investor stake and associated rights were equivalent in every respect. In a market where vendors cannot secure a high interest return on the cash they realise at exit, this deal structure was sufficiently balanced to facilitate the MBO of the business.*

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**Wendy Hart**

Head of Technology
Grant Thornton UK LLP

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Where is the smart money going in Technology? 5
### Top ten private equity deals in UK technology, 2012 – year to date

<table>
<thead>
<tr>
<th>Target</th>
<th>Target sub-sector and business description</th>
<th>Equity lead</th>
<th>Equity lead country</th>
<th>Vendor type</th>
<th>Deal type</th>
<th>Est. deal value (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Misys</td>
<td>Software – banking and investment sector</td>
<td>Vista Equity Partners</td>
<td>US</td>
<td>Public to private</td>
<td>Buyout</td>
<td>1,270</td>
</tr>
<tr>
<td>Vertu</td>
<td>Telecommunications equipment – handcrafted luxury phones</td>
<td>EQT Partners</td>
<td>UK</td>
<td>Foreign parent</td>
<td>Buyout</td>
<td>160</td>
</tr>
<tr>
<td>Kewill</td>
<td>Software – trade and logistics</td>
<td>Francisco Partners</td>
<td>US</td>
<td>Public to private</td>
<td>Buyout</td>
<td>103</td>
</tr>
<tr>
<td>BigHand</td>
<td>Software – digital dictation workflow software</td>
<td>Bridgepoint Development Capital</td>
<td>UK</td>
<td>Institutional investor</td>
<td>Secondary buyout</td>
<td>49</td>
</tr>
<tr>
<td>Autologic</td>
<td>Software – automotive diagnostic software products</td>
<td>ISIS Equity Partners</td>
<td>UK</td>
<td>Institutional investor</td>
<td>Secondary buyout</td>
<td>46</td>
</tr>
<tr>
<td>Workplace Systems</td>
<td>Software – workforce management</td>
<td>LDC</td>
<td>UK</td>
<td>Public to private</td>
<td>Buyout</td>
<td>41</td>
</tr>
<tr>
<td>International</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mimecast</td>
<td>Software – unified email management solutions</td>
<td>Insight Venture Partners</td>
<td>US</td>
<td>n/a</td>
<td>Expansion funding</td>
<td>39</td>
</tr>
<tr>
<td>CSL DualCom</td>
<td>Telecommunications equipment – dual path, security alarm signalling devices</td>
<td>Bowmark Capital</td>
<td>UK</td>
<td>Institutional investor</td>
<td>Secondary buyout</td>
<td>32</td>
</tr>
<tr>
<td>SkyDox</td>
<td>Software – Cloud-based document collaboration software</td>
<td>Scottish Equity Partners</td>
<td>UK</td>
<td>n/a</td>
<td>Expansion funding</td>
<td>20</td>
</tr>
<tr>
<td>Metronet</td>
<td>Telecommunications equipment – data infrastructure</td>
<td>LDC</td>
<td>UK</td>
<td>Institutional investor</td>
<td>Secondary buyout</td>
<td>15</td>
</tr>
</tbody>
</table>

*Source: unquote*. Deals with disclosed values.

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"In terms of leverage, there is a gap between the US market and what we are seeing in the UK and Europe: Debt capacity in the US is greater than here by a couple of turns of EBITDA.

To illustrate this, take the £103 million buyout of logistics software firm Kewill in July 2012. The competition came from two US PE-led bidders, Francisco Partners and Symphony Technology Group, both of which have a UK presence. The Francisco Partners-led deal was financed by Wells Fargo, and Silicon Valley Bank, which is indicative that US style financing is starting to transition over to the UK and European markets."
Survey findings

1. What will investment levels look like?

Prospects for investment in technology over the next two years look good. 57.5% of respondents expect the level of private equity investment in the UK technology sector to increase over the period.

Breaking these figures down, VCs are the most positive about the sector, with 70% of VC respondents saying that investment will increase versus 52% of PE respondents saying the same.

Investors have rediscovered their appetite for technology assets. A lot of technology businesses are now more attractive for financing, particularly for PE and banks, compared with a few years ago.

There are still the same financing realities, with banks setting a high quality threshold and wanting to limit their exposure, so successful deals will likely require either a club or a multi-bank deal for anything over £20-£25 million.
Respondents see Eurozone uncertainty (64.8%), the financing environment (53.8%) and falling consumer spending (42.1%) as being significant obstacles for UK technology businesses in the next two years.

Unsurprisingly, the economic backdrop, notably the ongoing uncertainty in Europe and the lack of consumer confidence are perceived to be key challenges for technology businesses in the UK over the next couple of years. Recognising the obvious linkage between the economy and the funding environment, the challenge of fund raising in the current environment is nonetheless a more tangible and immediate concern with over half of respondents acknowledging this.

One of the respondents comments:

“Our ecosystem is under threat, fund raising is really difficult. The actual landscape of fund supply has changed dramatically. There is a dual market with the multiplication of early stage VCs, but a very small number of big players who tend to sweep most, if not all, of the capital allocated to this category.”

Specialist VC Investment Partner

Another adds:

“While the financing environment is still difficult, it is relatively better in 2012.”

Generalist PE Investment Professional

“Whilst the financing environment remains a challenge for transactions generally, the technology sector has fared better than other sectors. However, there is an ever-increasing pool of money being made available to the sector – with a growing number of non-UK funds and corporates looking for investments and acquisition opportunities, together with a more flexible approach by existing funds using alternative capital structures to achieve returns.”

Mo Merali, Head of Private Equity, Grant Thornton UK LLP
Views from the banks

**Silicon Valley Bank (SVB)**

“At SVB, we focus on the technology, life science, cleantech, private equity and venture capital industries. Two of our major approaches to financing include growth capital; which involves providing working capital to finance growth in the IT sector, and acquisition finance; where we work with PE firms, complementing their equity. Regarding working capital, we provide invoice discounting, receivables finance, cash flow lending, and something that has grown popular lately: Software as a Service (SaaS) revenue lending. This is based on a subscription revenue model, and involves lending money based on a company’s future recurring revenues.

In lending ahead of the curve, we try to look at a company that is selling a service, product or software, that has become deeply embedded into their customers; for example, a payment system to a large retailer like Tesco, which has been rolled out across 440 stores.

The other type of financing we are heavily involved with is working with private equity firms where we provide senior debt on top of the equity that they are investing in a business in order to buy a company, or take it private or fund an acquisition. For example, we helped provide the senior debt financing for the US PE firm Francisco Partners, which has a UK presence, when it recently took the technology business Kewill Ltd private from being a public company.”

Oscar Jazdowski, Head of Origination, Silicon Valley Bank

**Barclays**

“Particular sub-sectors that are currently showing strong growth are Data Centres, IT Services, fast growing online businesses, and in particular, as this report has highlighted, Cloud-based offerings.

When assessing whether to lend to businesses in the technology space, we would expect the client to be able to demonstrate recurring revenue, an agile operating cost base which can be moved in-line with revenue growth or negative pressure, and the ability to protect their profitability margin.

With the current challenging market conditions, the development of new products and services to support business growth and investment is important. Barclays is participating in the Bank of England’s Funding for Lending Scheme, resulting in us being able to offer Cashback for Business - a loan that provides your organisation with an immediate cash injection of 2% of the loan amount*.”

Piers Deppe
Relationship Director, Technology, Media and Telecoms team
Corporate Banking, Barclays

* Available on term loans of more than £25,000 for three years or longer, your business receives an upfront cashback payment on the day the loan is drawn down.

“With the technology industry continuing to demonstrate sustained growth, the outlook for the sector is positive.”

Piers Deppe
Relationship Director, Technology, Media and Telecoms team
Corporate Banking, Barclays
3. Which sub-sectors are most attractive for investment?

When asked which sub-sectors they expected to present the most attractive investment opportunities 92.5% of respondents said Cloud was an attractive sector with 50% planning to make an investment within the next two years. One respondent adds:

“SaaS is exciting but Cloud is really the big trend at the moment – everyone talks about it and wants to invest in it. Virtualisation is also something we look at. We are looking at rising stars, not start-ups but companies that can already return a profit.”

**Generalist PE Investment Manager**

But they also see huge investment opportunities coming from technology firms that can store and analyse ‘Big Data’ (unstructured information generated by, for example, social networking or consumer buying behaviour).

Investors also see growth potential in mobile enterprise applications and voice and data convergence. One respondent adds:

“The mobile data services directed to individuals are likely to increase significantly. Mobile and desktop platforms are really going to be in demand in the next two years.”

**Specialist VC Investment Director**

Green IT however has fallen out of favour with only 10% of respondents planning to invest compared to 39% in our previous report published 2010.

“The findings of the research serve to illustrate the speed of change in the technology sector and the pace with which new business models and trends can take hold both in the wider market and in terms of investor appetite. When we produced an equivalent report to this in 2010, the focus of investors was on ‘green technology’. Now the concept of green IT has become less relevant as the move from ‘Capex’ models to ‘Opex’ models and the preponderance of Cloud has subsumed a specific focus on low energy solutions in the IT market. In 2010 ‘Bring Your Own Devices’ was an undefined trend and mobile payments technology still bleeding edge while defining Cloud in any meaningful operational way was beyond most. How things have changed in three years.”

**Wendy Hart**, Head of Technology, Grant Thornton UK LLP
The UK technology sector is diverse, with a particular focus on web and mobile software, niche technologies, and managed services. PE firms continue to be attracted to technology businesses which enable growth in web-related technologies. Consequently, there has been significant activity in technology sub-sectors such as Cloud, virtualisation and SaaS, which are all technologies that drive down costs and create business efficiencies for end users.

Whilst the UK technology sector still encompasses traditional technologies such as storage, databases, networking and Enterprise Resource Planning (ERP) software, it has been reinvigorated by newer web-centric solutions.

“We have seen significant growth over the last couple of years in service provision: specifically SaaS, Cloud, outsourcing, and shared services. The IT services marketplace has matured, with the services becoming much more secure, which has increased adoption at all levels. Furthermore, these technologies are enabling end-user businesses to hand over their non-core IT operations, and feel comfortable doing so, which is driving growth in the sector.”

Phil Keown, Head of Technology Risk Services, Grant Thornton UK LLP

By volume, the most active technology sub-sectors for investment over the last two years have been software, business support services, Internet, and telecoms equipment.

A review of Grant Thornton’s deals over the past 12 months shows clients in many of these hot areas of technology. For example, there were deals that involved managed services and Cloud specialists such as Iomart, Selection Services, and the £27 million institutional buyout of Onyx Group. Grant Thornton also advised Darwin Private Equity on its £50 million management buyout of the managed hosting services company Attenda.

Security and risk management also proved to be hardy perennials, with clients that include Bytes Technology Group, Commidea and Intelligent Data Systems.

“Software remains the dominant focus for deal activity in the UK technology sector. Software is truly back in vogue and a real hotspot – taking a record 70% share of the UK deal activity in 2012.”

Andy Morgan, Partner, Corporate Finance, Grant Thornton UK LLP

Private equity deals in UK technology by sub-sector

<table>
<thead>
<tr>
<th>Sub-sector</th>
<th>Year</th>
<th>Count of deal</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2005</td>
<td>2006</td>
</tr>
<tr>
<td>Software</td>
<td>31</td>
<td>41</td>
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<tr>
<td>Internet</td>
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<tr>
<td>Business Support Services</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Telecommunications Equipment</td>
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<td>11</td>
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<tr>
<td>Mobile Telecommunications</td>
<td>5</td>
<td>4</td>
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<tr>
<td>Electronic Equipment</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>Computer Services</td>
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<tr>
<td>Computer Hardware</td>
<td>5</td>
<td>2</td>
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<tr>
<td>Fixed Line Telecommunications</td>
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<td>7</td>
</tr>
<tr>
<td><strong>Grand total</strong></td>
<td><strong>88</strong></td>
<td><strong>97</strong></td>
</tr>
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</table>

Source: unquote"
CASE STUDY
Onyx Group

Background
Established in 1994, Onyx is an operator of data centres, business continuity centres and a provider of Cloud computing services and was listed in The 2011 Sunday Times Tech Track 100 which monitors the faster growing technology companies in the UK. The Company with annual revenues of circa £15 million, has its headquarters in Stockton-on-Tees and ten sites across the UK including London, Glasgow, Edinburgh, Newcastle, Teesside and Sheffield.

Deal
Grant Thornton advised ISIS Equity Partners (ISIS) on the institutional buyout of Onyx Group Limited (Onyx). In addition to funding the £27 million purchase price, ISIS has committed a further £15 million in fire power to fund further growth, enhancing Onyx’s geographical footprint and its ability to provide wider ‘on the doorstep’ services to existing customers.

Ian Marwood, Corporate Finance Partner at Grant Thornton says, “This deal is an excellent example of private equity’s appetite for managed services companies with recurring revenue models, and the ‘hot’ data centre sub-sector. The market offers great opportunities for further growth.”

Result
The deal will help Onyx to push ahead with its ambitious plans to grow the business. To date, Onyx has completed six acquisitions over the past few years which has seen its customer base grow to over 2,000 clients. It has expanded its geographical reach across the UK and developed new services and products that are tailored specifically to meet the needs of mid-sized businesses in niche vertical markets such as the professional services and financial sectors.

Mark Advani of ISIS commented: “Technology is making off-site hosting of data easier and more cost effective. The Onyx management team has done a great job of building a diverse, high service level provider of data storage and business continuity services with its existing investors.”
4. Where will competition for deals come from?

Competition for good technology deals will be fierce over the next 12 months. Two thirds of respondents say they expect this competition to come from UK private equity firms. Around a quarter of PE professionals see trade buyers, both domestic and international, as playing a significant role in the investment landscape.

One of the drivers of M&A in the UK technology sector is the acquisition of niche technology or capability by larger corporates. While trade valuations over the last three years have typically been constrained for all but the most strategic assets, to the extent that PE have consistently outbid trade for mid-market assets over that period, specialist services and innovative business models are starting to attract premium valuations again – from PE and trade buyers alike.

In general, it is the larger-scale UK and European assets that are attracting the attention of US PE houses, which tend to play in an area where they can deploy north of $50 million of equity, and more realistically north of $100 million. A good example of this is Vista Equity Partner’s acquisition of Misys plc.

“Steve Perkins
Head of Technology
Grant Thornton US

“The UK will see increasing interest from US PE firms in the technology sector. Part of the reason is that US technology PE firms are raising larger funds and finding it increasingly difficult to locate good investment opportunities in the US, so they are branching out. These trends are magnified through the portfolio companies because the UK tends to be their second largest market. As these portfolio companies look to grow and acquire, they are naturally focusing on the UK where they already have a presence and are familiar with the market. This is especially prevalent in the business application software sector.”
From which of the following do you expect to see increased competition for UK technology deals in the coming 12 months?

- UK PE firms
- UK trade buyers
- Trade buyers from outside the UK
- Business Growth Fund
- PE firms from outside the UK
- US VC investors
- SWF
- Corporate ventures
- LPs doing direct deals
- Large angels

Percentage of respondents

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**Chris Hodges**
Investment Director
Business Growth Fund plc

“The Business Growth Fund provides SMEs with long-term capital of between £2 million and £10 million in return for a minority stake. In the 12 months since we launched, we have invested over £35 million in five companies operating in the software, telecoms and digital media sectors. We are particularly attracted to ambitious management teams with platforms that exploit the explosion of new consumer devices, and the resulting changes in the way we work, shop and use our leisure time.”

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3 Sovereign Wealth Funds
4 Limited Partners
CASE STUDY

Bytes Technology Group

Background
Grant Thornton advised the shareholders of Security Partnerships Limited on its sale to Bytes Technology Group Limited. Based in Reading, Security Partnerships is a leading IT security specialist providing managed services and solutions to many corporate and public sector organisations. Security Partnerships has annual revenues of circa £10 million, the majority coming from recurring revenue streams through long standing customer relationships.

Solution
Grant Thornton ran a competitive auction process and received a number of offers from interested parties which delivered maximum value to the shareholders. The shareholders chose to work with Bytes Technology Group due to its pragmatic and commercial approach throughout the process. Two of the shareholders will remain within senior positions in Security Partnerships under Bytes Technology Group ownership, reflecting their confidence in the enlarged entity.

Result
The acquisition will enhance Bytes Technology Group’s capabilities, widening its current software offering to now include implementation and support services to customers.
5. What will the main exit strategy be for private equity backed investments?

The majority of PE professionals surveyed (93%) said they believe the main exit strategy for private equity-backed firms over the next 12 months would be a trade sale, with a smaller number (23%) saying it would be sale to another financial investor. Only 8% said the exit would be via an IPO. Although this indicates some hope for IPOs versus sentiment in the previous few years, it also indicates major reservations about the appetite of institutional investors and the inherent risks of a stock market flotation.

For many, another PE deal or a trade sale provides a better, and lower risk route to value.

There was a point in the cycle where investors were prepared to defer consideration of future exit options. In a consistently rising market and on the back of leveraged structures, it was assumed that there would always be a profitable exit available. In this market it is incumbent on management teams who are seeking investment to be very clear about the potential exit routes for an incoming investor and to articulate their business plan in context of an ultimate realisation.*

Wendy Hart
Head of Technology
Grant Thornton UK LLP

* Respondents were able to choose more than one answer.
Whilst the overwhelming investor expectation remains that strategic trade buyers will provide the most likely route to value on exit, reality shows a far more varied picture. In 2008, trade buyers truly dominated the landscape, accounting for more than 90% of the exit transactions for UK private equity investments in technology. This position has progressively normalised, returning to a more typical 50% level in 2012 as confidence has returned to the secondary buyout market. The options for exit today are well balanced, with both trade and private equity providing real and credible alternatives for good quality assets at competitive and strategic valuations. A more aggressive return of appetite in the public markets for technology IPOs in Europe would complete the picture.

"UK equity markets continue to suffer from a lack of confidence which means equity investors are still sitting on their hands and adopting a wait and see attitude. With only a handful of new technology IPOs taking place on UK equity markets in the past 12 months, the perception is that the US is the destination of choice with a flow of large high profile tech IPOs.

To address this issue, the government recently called upon the FSA for a relaxation of certain perceived barriers for technology companies going public in the UK. The most significant being a lowering of the shares in public hands threshold from 25% to something as low as 10% – a change targeted at the investment banking community who see the 25% threshold as too high a hurdle for them to ‘get an issue away’ in current markets, driving the migration of listings to US markets that already prescribe the lower 10% threshold.

And whilst the US can certainly cite several large high profile technology IPOs, a number of which have witnessed spectacular declines in their share price post float, the UK market can evidence quality, if at a smaller scale, rather than quantity with the recent IPOs of WANdisco and Perform Group currently sitting at share prices double their launch price."

Source: unquote*
Valuations and appetite

There is distinct value polarisation across the technology sector. Over the last 12 months, the average transaction value for private equity and trade acquisitions in the IT Services sector has been less than eight times EBITDA – which in itself represents a premium to equivalent valuation metrics on the public markets, reflecting the availability of synergies for trade and the attractiveness of managed services platforms for private equity.

Hosting assets have also consistently attracted strong double digit EBITDA multiples, whilst valuations of five to six times revenues have appeared almost common place for quality software businesses with scale and a genuine ‘SaaS’ model.

The bottom line is that competition is fierce for attractive assets in areas where pricing is strong, with Cloud and SaaS leading the way, and many private equity houses are prepared to pay handsomely for them.

Some PE houses have however steered clear of the eye-watering valuation metrics for pure play SaaS businesses with scale. In deals involving traditional technologies, value can often be generated through synergy driven plays, where you can take a lot of cost out of the back office through outsourcing, or web and Cloud-based delivery models. Many PE houses have focused instead on more mature businesses with an established customer base and recurring revenues driven by a traditional license and maintenance model. These platforms are frequently mid-market or sector focused with real and deep vertical market expertise.

Andy Morgan
Partner, Corporate Finance
Grant Thornton UK LLP

“Evidence from the deals that are getting done, suggests valuations have been holding up very well. In the ‘hot’ segments, such as SaaS and broader Cloud services, we have not seen any decline in valuations and in certain segments, we have noted a step-up. Data centres are a good example of this, as are certain areas of fintech, which are receiving premium pricing from trade and PE investors. For marginal deals, it is not a valuation issue per se, they are just not getting done.”
CASE STUDY

Gyron Internet

Background
Hertfordshire based Gyron Internet Limited (Gyron), a fast growing data centre infrastructure specialist, was founded by Robin Balen in 2000. Since then Gyron has enjoyed significant growth in the fast growing mission critical IT space. Gyron is now one of the UK’s leading providers of data centre services with a strong blue chip customer base supporting well known global IT and media groups.

Solution
Gyron was acquired by NTT Communications (NTT), based in Tokyo, Japan. Grant Thornton advised the shareholders of Gyron on the sale.

Result
Tim Blois, Corporate Finance Director at Grant Thornton, said, “Our brief was to deliver a solution which provided the business with funding to support its future growth, as well as advising the shareholders on how best to maximise the value of their investment. We were able to secure the option of a significant external investment package. However, it was no surprise to see a major overseas strategic acquirer such as NTT showing such strong interest.”
6. Challenges for UK technology businesses

Private equity reservations about technology

Whilst private equity sees numerous opportunities in technology, they also have some reservations about the sector, emerging technologies and the quality of the companies involved in the sector.

Some investors are wary of what they perceive to be a new social networking bubble. One private equity professional explains:

“For every Facebook, there are so many in the graveyard. The social media game is really popular right now, but you can do very badly at it. It’s important to check opportunities carefully and not invest solely based on trend.”

Specialist PE Investment Manager

Another says:

“Social media is now something of the past, as IPOs such as Groupon or Zynga are one of a kind. I’m really confused about how these businesses can be valued at such a high price. Could there be a pricing bubble for social media companies?”

Generalist PE Investment Director

Social media aside, one investor comments:

“Because Cloud is attractive, competition is tough and prices can be unrealistic or towards the higher end of the spectrum.”

Specialist PE Investment Manager

In general, there is a real wariness amongst private equity in investing prematurely, with one explaining:

“We tracked some of our companies for more than two years before investing. We are looking at good companies with a good price.”

Generalist PE Investment Professional

Many investors share this view, and argue that UK technology firms frequently have poor business and management skills, and a lack of entrepreneurial flair and even technical expertise.

As a result, there is a demand from private equity firms for better technology, commercial and management due diligence. And on the other side, they are looking for good business and sales know-how as well as technical expertise and a killer proposition from prospective targets.

Richard Joyce
Associate Director, Performance Improvement
Grant Thornton UK LLP

“The deal landscape has changed over the last few years. We have been asked to provide much more assurance and diligence on the technology, and the technology solutions that target businesses are employing. Consequently, the demand for our operational technology due diligence services has grown, whether that means looking at the target business’ IT products or solutions, or the technology being used by a non-tech business, but one which is very tech-enabled. It might be a media firm, a retail business or a professional services firm, whose revenues are driven by business process management software (BPM), for example.”
The challenge of scalability

A secondary concern for private equity is the ability of UK companies to scale, compared with those overseas, particularly in the US.

“There aren’t many successful UK stories compared to US companies.”

Generalist PE Investment Director

Another respondent says:

“Our businesses need more scale. They need to reach their critical mass, the middle size that they currently lack. Also the UK economy needs to be more stimulated for the sector to thrive. Right now a lot of early stage companies in some niches don’t get the necessary funding.”

Specialist VC Investment Director

“What the sector needs is more risk takers, and a culture-change that fosters entrepreneurs, private equity professionals feel.

“It all comes down to the culture of the country. People have to be willing to take risks, be challenged and not wait for any form of support. There is clearly a lack of entrepreneurs in the UK.”

Generalist PE Investment Manager

However, one of the greatest strengths of the UK technology sector is its innovation, and this is what will drive the sector forward.

Survey findings

“The challenges to scaling UK technology businesses rapidly has been a thorn in the side of the industry for years. There is a real opportunity here for PE houses with the skills, expertise and vision to really help UK technology businesses grow internationally. Capability in this area is becoming an increasing differentiator in the choice of investor for management teams.”

Wendy Hart
Head of Technology
Grant Thornton UK LLP
Challenges in securing investment

For business owners who require growth funding or an exit in the coming year, one of the greatest challenges is the much increased risk aversion of both private equity houses and trade buyers.

With access to capital more restricted than it has been in recent years, investment directors and business development directors are extremely cautious. This manifests itself in two key ways.

First, there is an ever tighter set of criteria which defines a business as an attractive investment or acquisition opportunity. This tends to relate to what that business has already delivered rather than, as one might expect, what it is able to deliver going forward. Better a business delivering sustainable but unexciting profits than one with an erratic trading record and an exciting piece of intellectual property. For the latter, private equity and trade are likely to prefer to wait for the case to be proven.

Second, the process of investment or acquisition has become elongated by the need to cover off every aspect of risk in due diligence and legal drafting. Whereas deals used to take an average of six months to conclude, they are in general, currently taking much longer even when there is clear will to complete on both sides. There are steps that management teams and shareholders can take in order to position themselves effectively for investment or acquisition, even in this challenging market. Entering the market with a degree of realism about deal multiples, deal structures and timetables is important.

Vendors who don’t appreciate the characteristics of a private equity-led deal in the current market are likely to be both disappointed and frustrated by the realities, and this can quickly sour relationships – turning a deal which could have been coaxed to completion into one which fails. Preparing your business intelligently to go to market is more important now than ever.

“Due diligence in private equity deals is a very exhaustive process, and has become more so in recent times. On technology deals the due diligence focus is very much more on the security of the IP, extent of customer dependency on the service/software, the quality of revenue streams with minute attention paid to the security, retention and sustainability of the revenues, coupled with basis of accounting, and most critically cash conversion. Investors and buyers are also much more particular on their choice of specialist advisers they use for due diligence on technology deals, as knowledge and experience is vital to provide the edge.”

Mo Merali, Head of Private Equity, Grant Thornton UK LLP
7. Opportunities for UK technology businesses

International opportunities

The UK is still an excellent location from which to grow business internationally for corporate acquirers, and current exchange rates deliver better value than a few years ago. The challenge for UK technology businesses is to look beyond the UK mid-market, and demonstrate that their solutions can translate successfully to international markets.

Over the last five years, volatility in the global market has inevitably had an impact on the volume of cross-border deals taking place.

The volume of investment by UK technology companies into emerging technology markets such as India, China, Brazil and Israel has remained relatively low, dropping off entirely in 2010, but seemingly returning with renewed vigour in 2011.

Our analysis of reported deals shows the US, Germany and Australia have consistently been the most popular countries for outbound M&A from the UK.

As part of our UK Technology Expansion Report published in April 2012, we asked 50 UK mid-market technology companies about their plans for future investment. 26% planned to invest in countries where their business already has a presence and a further 50% have no plans for investment at all. The remaining 24% planned to branch out into new markets.

In practice, this means that three quarters of those surveyed have no plans at all to push beyond existing markets. This is a concerning statistic when you consider the comparatively huge opportunity in the fast-growing, tech-friendly economies of India, China, Brazil and Israel.

- Of those with plans to invest 18% were planning domestic investment (UK).
- The Netherlands is the most likely country to be invested in over the next 12 to 18 months by respondents who at present do not invest there (33%).
- The US, Italy, Germany and France are also likely to be investment targets (all at 25%).

“In access to a large market is clearly an advantage for US companies in the start-up phase. However, the US market is open to foreign competitors. I have often found that foreign technology companies do not seem to have the US technology partnerships and network needed to really penetrate the US market.”

Steve Perkins
Head of Technology
Grant Thornton US
CASE STUDY

JAOtech

Background
JAOtech is a leading manufacturer of patient equipment and point of care terminals for hospitals. It is headquartered in Surrey and has offices in Taiwan, The Netherlands, The US and Germany.

Solution
Grant Thornton advised the shareholders of JAOtech on their acquisition by Barco NV, a Belgian technology company listed on NYSE Euronext.

Rupert Rawcliffe, Corporate Finance Director says, “The deal highlights the continued attractiveness of British niche high tech product manufacturers to global technology groups and also demonstrates the continued appeal of the Healthcare sector as an area of continued long-term growth.”

Result
The acquisition of JAOtech helps Barco to strengthen their position as a market leader in healthcare visualisation and in the patient point of care sector, whilst enabling JAOtech to achieve its growth potential with the support of a global backer.

Warren Kressinger-Dunn, CEO of JAOtech said, “Hospitals around the world are starting to consider the enormous potential of patient bedside entertainment and communication systems. This agreement allows us to capitalise on Barco’s leading position in the healthcare industry, which will definitely help us to expand our reach in the marketplace and become a world player in healthcare.”
Government-led initiatives

66% of respondents cited positive sentiment for government-led initiatives. For 31%, the jury is still out as to whether these initiatives will have any benefit for the long-term prospects of technology businesses in the UK.

“To create a dynamic sector the government would need to launch a fund with a reasonable scale. A billion pound fund for example to spread the financing to the whole industry and therefore make way for a changed perception of the technology industry in the country and in Europe.”

Specialist VC Partner

“Some are highly beneficial. Like the Technology Strategy Board – where the government has developed a national innovation agency whose goal is to accelerate economic growth by stimulating and supporting business-led innovation.”

Generalist PE Investment Director

“Maybe but I’m not convinced – it’s always the same thing – people expect the government to do everything but ultimately it is down to the people working in the sector to make things happen their way.”

Generalist PE Investment Manager

“They need to create a favourable environment, lower the taxation, and create a network.”

Generalist PE Investment Director

Do you believe that government initiatives, such as the Innovation Investment Fund, will have any benefit for the longer-term prospects of technology businesses in the UK?

- I don’t know
- Yes
- Maybe
- No

Survey findings

“Government’s Tech City banner has gathered some good momentum now and provides a sense of identity to a community with huge potential. There are businesses and products scaling globally and there are some real success stories emerging. There are challenges of course – in terms of availability of space, attraction of talent and finding funding from investors with the right appetite for risk – but the direction of travel is encouraging. We see it as a real and tangible near term opportunity.”

Steve Leith
Senior Manager, Assurance
Grant Thornton UK LLP

“Through our delivery of the GrowthAccelerator programme, we are seeing a strong correlation between businesses with growth potential and the technology sector. Our connections with growth funders mean we are also well aware of the appetite for technology companies presenting opportunities for exponential growth and we are helping align such businesses with appropriate funding. Over time we expect this intervention to increase the pool of mature technology businesses looking for PE solutions.”

Simon Littlewood
Head of Business Growth Services
Grant Thornton UK LLP
CASE STUDY
Darwin Private Equity

Background
Attenda provides outsourced IT services principally hosting to large and medium sized corporates in the UK. The company has built a broad client base of over 100 UK enterprises including bmi, St James’s Place and Travelodge. Attenda, which was established in 1997, has over 200 staff and achieved revenues of £28.5 million in 2010. The company was previously owned by staff and management and financial investors including M/C Venture Partners, Phoenix Equity Partners and Tarrant Venture Partners.

Solution
Grant Thornton advised Darwin Private Equity on its £50 million management buyout of Attenda. Darwin is backing Attenda’s existing management team, led by chief executive Mark Fowle, and will look to invest in widening its range of services and expanding its data centre capabilities. Grant Thornton’s Corporate Finance team worked closely with Darwin providing financial due diligence services.

Result
The Attenda investment was completed within a rapid transaction timetable – seven weeks from gaining access to the company – and included a full debt financing package from HSBC and Investec.
Tax breaks

Many PE professionals commented that there was a lack of entrepreneurial skills in the UK, or certainly a lack of encouragement for entrepreneurs. One saving grace has been the Government’s entrepreneurs’ relief, which enables them to pay a lower 10% rate of capital gains tax (CGT) when selling qualifying business assets they create, rather than the current CGT rate of 18% (28% for higher and additional rate taxpayers).

If the Government had chosen, at the height of the downturn, to increase the CGT rate for entrepreneurs from 10% to the standard rate of 28% or higher, the decision would have precluded many of the transactions which have come to fruition over the last couple of years.

“With savings rates on the proceeds of exits at an all-time low, business owners need to feel that they will achieve more by selling a stake in their business than retaining it. The present tax regime has been a factor in that decision for many of our clients. Even so, those PE firms prepared to contemplate structures for vendors which deliver them a reasonable yield, even if there is some risk attached to it, might find that more deals are unlocked.”

Wendy Hart
Head of Technology
Grant Thornton UK LLP

“Tax relief for companies engaged in R&D activity is more generous and wider in scope than ever before. This follows recent changes to the legislation and the government’s commitment to make the UK the most attractive place to start and invest in innovative technology companies. The relief allows for significant cash savings of up to 30% of qualifying spend and can give rise to a cash credit. If a company has changed its product or processes in the last two years it is likely to have undertaken qualifying activity, and should definitely consider making a claim. If a company has not already exploited this valuable relief, it may be behind its competitors and potentially less attractive to investors.”

Samantha Vanags
Head of R&D Tax
Grant Thornton UK LLP

The technology sector has also benefited from a variety of tax breaks such as the UK research & development (R&D) tax credits, which both small and medium sized and larger companies can claim.
Intellectual Property (IP) holding and tax efficiencies

The Patent Box is a new tax relief available from April 2013 to companies who make profits from patented technology and allows them to access a 10% rate of corporation tax on these profits, rather than the current rate of 24%. A product only needs one patented component for all of that product’s revenue to fall within the regime. Companies should therefore consider whether IP which would not normally have been considered for patenting, such as software, could in fact be patented allowing the company to benefit from this tax saving. Whilst some tax reliefs are affected by investments, in most instances the Patent Box should be available before and after an investment.

We have seen a number of challenges in recent deals arising from IP not being held in an efficient manner. As a result, complex tax and deal structures have been required causing a significant delay in completion. Companies should therefore review their IP portfolio and whether it is held in a commercially sound and tax efficient manner and, if not, consider restructuring it now.

In light of falling UK tax rates and the Patent Box legislation, where companies are looking to expand overseas, the type of operational structure to be applied should be considered to ensure the highest net of tax return. The choice of operational structure overseas (such as limited risk distributor, independent operating entity or sales and marketing agent) will impact on the appropriate transfer price with the UK and as such in which jurisdiction margins should be recognised. By getting your transfer pricing position right before undertaking any international expansion you can make the most of tax efficiencies and reduce due diligence risks.

Andy Morgan
Partner, Corporate Finance
Grant Thornton UK LLP

“The Patent Box appears to be an interesting development for those PE funds investing in businesses where patents are a possibility. Conventional considerations as to the value of patents in software businesses, for example, might justify review when there is a 10% tax rate on profits at stake.”
The rate of change in the underlying technology market shows no sign of slowing. The opportunities this creates to disrupt markets and develop new business models will continue to feed the pipeline of potential deals for PE houses and VCs.

The impetus for growth will be ignited by a number of key drivers. One is that although the exit horizon may have been pushed back for many technology businesses, many PE houses will still need to show some quality exits and realisations ahead of seeking to raise new funds in 2013. This will likely require some creativity to bridge perceived value gaps which will favour secondary transactions.

Second, the boardroom agenda in large technology corporates is firmly focused on growth. Pressure is building from investors and shareholders to deploy and generate returns on the vast amounts of cash currently held on balance sheet. This is in part driving the current wave of buy-backs, with Google leading the way in returning $3 billion to shareholders through its share buy-back programme. However the search for growth and tax efficient deployment of liquidity will also provide an added stimulus to transaction activity, particularly in Europe.

Recent evidence from both private equity and venture capital in the technology sector clearly illustrates an appetite for larger deals in both investment classes. There has been a real flight to both quality and certainty.

From a target business’ perspective you need to combine profitability, potential and scale if you are to raise private equity investment in the current market. The more interesting technology propositions for private equity are the ones where they can add real value to their investment; by leveraging a business into a new niche market, or helping it to scale and expand internationally.

Whilst there is a preponderance of seed capital available in the market, there is a growing gap for businesses requiring investment of £500,000 to £2 million, and a real challenge for those which are still pre-revenue. This focus is completely understandable in the context of risk and returns experience, but it does raise the question as to where the private equity investment opportunities of the future will come from? Government-led initiatives may prove part of the solution, but in order for the cycle to continue this gap needs to be addressed by the wider industry.

Identifying ways for PE houses to tap into genuine industry experience in the myriad sub-sectors which make up the UK technology landscape is crucial. This will enable them to make informed decisions about risk and return, and address the ongoing challenge of which opportunities to progress. For some, the operating partner model has been at least a partial solution, but it is some of the venture capital funds that have developed a greater level of network and expertise in the sector, which in turn allows them to be clearer in their articulation of the technologies and business models they most want to invest in.

Our view is that, whilst deals will continue to be done, overall activity is likely to remain at a similar level over the next 12 months. The current market is the new norm. However we do expect some hotspots for transactions where a step-up in activity will happen. For investors, creative deal structuring, clear differentiation and demonstration of their value add; combined with aggressive execution, will be the keys to securing the right deals. For businesses, the premium for quality and the prevalent market dynamics will create opportunities for the fleet of foot to benefit in terms of both transaction structure and pricing.
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Grant Thornton UK LLP

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Grant Thornton’s dedicated Technology & Innovation practice has an enviable track record of working with successful and dynamic technology companies, at all stages of their life cycle, to support their ambitions for growth. We offer solutions and advice in the following service areas:

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- audit and tax compliance
- business and strategic advice
- commercialisation of intellectual property
- corporate finance including M&A
- employment issues
- fund raising and flotations
- PPP/PFI schemes
- private client services
- risk management and internal audit
- specialist tax advisory services, including R&D tax credits advice
- transfer pricing
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We support the industry as members of Intellect and TIGA.

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IE Consulting has its roots in Europe’s first dedicated private equity data and news business and also leverages the global data and relationships of the Asian Venture Capital Journal. The team provides market analysis and marketing advisory services to new and established General Partners, Limited Partners, advisory firms and industry bodies and has built a strong reputation for its work across the private equity cycle.
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