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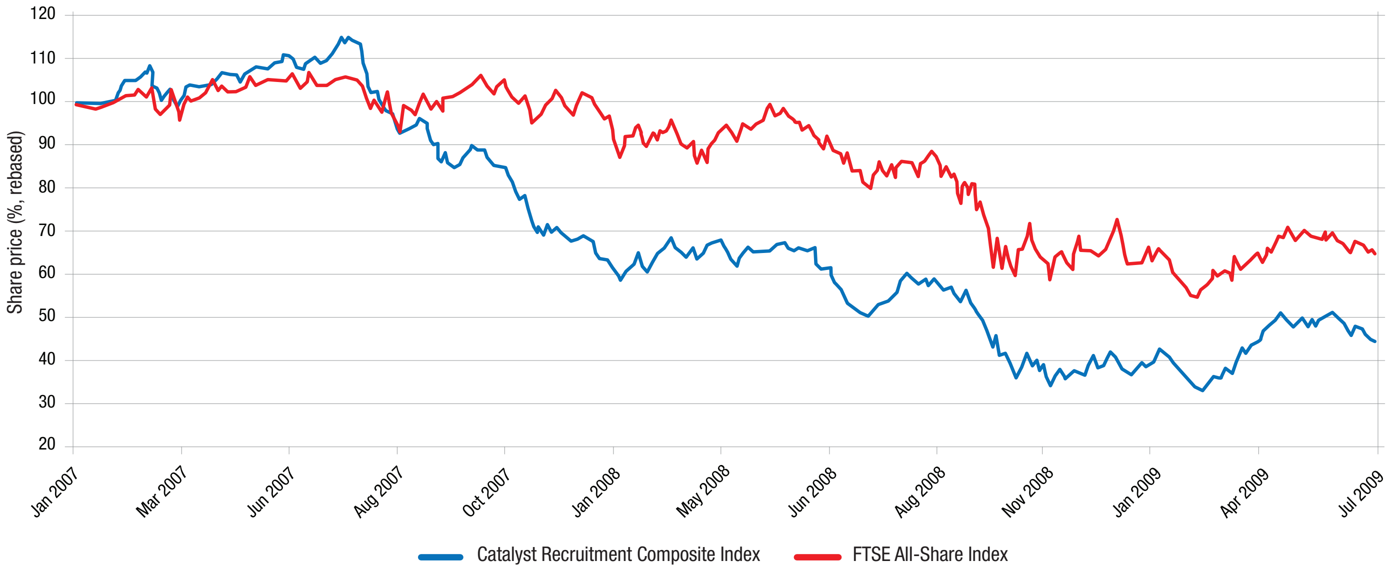
Introduction

The current global economic downturn has delivered a series of hard blows to the UK recruitment sector - overall market contraction, operational cash-flow stresses, low company valuations, redundancies and, to a lesser extent thankfully, bankruptcies. However, these dark clouds bring with them silver linings in the form of opportunities for stronger players to acquire and consolidate market positions, and to position themselves for superior valuations and exit opportunities when a market upturn arrives.

In this sector update, we look in more detail at the impact of the economic downturn on the recruitment sector, with a focus on valuation, trade buyers, private equity investors, and finally on recent and future deals. Our key conclusions can be summarised as follows:

- Recruitment valuations are suffering from a 'double whammy' effect of low current trading earnings and of low multiples due to investor focus on the near-term and cash preservation
- Based on historical analysis, we believe that recruitment valuation multiples are likely to begin to rise again in Q3-Q4 2009, followed by an economic recovery most likely starting in Q1-Q2 2010
- Trade buyers with cash for acquisitions do exist but are opportunistic and ultimately sceptical of the background surrounding current acquisition opportunities for reasons discussed. Private equity investors are also alive to opportunities to make money in the sector by exploiting low valuations but are facing a number of their own internal issues
- We believe that the next wave of deals will demonstrate a focus by buyers on resilience characteristics such as high visibility of earnings, strong recruitment methodologies and systems, and fixed cost base flexibility

Recruitment composite share price index



Current valuations

Starting from the price-earnings (PE) multiple high point for quoted recruitment stocks of July 2007, valuations of recruitment stocks have fallen dramatically, c.62% when analysed on an aggregate basis (see table below). These decreases exceed those of the wider stock market and we believe this is a function of the following 'double whammy' effect, which the market is bringing to bear on recruitment's quoted and private company valuations:

Most players are suffering poor trading performance to some degree

Depressed current earnings

Earnings performances are clearly at a low point currently, particularly amongst players with higher permanent recruitment sales mix, with weak geographic, sector and client exposures, and where fixed costs are high and inflexible. On this latter characteristic, the speed and decisiveness with which senior management teams have already moved to adjust headcount and fixed costs in line with business activity is a key factor in avoiding over-weight fixed cost bases.

A short-term focus by investors ignores the future upsides of recruitment

Investor over-focus on short-term investment horizons

Stock market investors, particularly the large institutional fund managers, are ignoring the 'upside' of recruitment stocks under the pressure to both conserve and generate cash in the short term (less than 6 months). These objectives are disadvantaging recruitment stocks whose true valuations should factor in future performance, particular in the event of an economic upturn when historically recruitment businesses outperform the rest of the market.

Comparison of average PE multiples

	March, April, May 2007	March, April, May 2009	% Change
Adecco SA	19.9	10.5	-47%
Harvey Nash Group plc	14.8	5.2	-65%
Hays plc	19.2	7.0	-64%
Hydrogen Group plc	20.2	6.3	-69%
Kelly Services Inc	22.1	16.7	-25%
Kforce Inc	17.5	14.8	-16%
Manpower Inc	21.2	8.0	-62%
Michael Page International plc	30.9	9.6	-69%
MPS Group Inc	19.4	10.7	-45%
Randstad Holding NV	25.3	13.4	-47%
Robert Half International Inc	20.9	13.1	-38%
Robert Walters plc	23.3	7.4	-68%
Spring Group plc	38.1	15.3	-60%
SThree plc	53.0	8.3	-84%
	24.7	**10.45**	**-62%**

Source: Catalyst Corporate Finance

Fair valuation

So when will recruitment valuations return to representing more of 'fair value'? This is a key question for investors but also for owners of private recruitment businesses who wish to sell their business at some point in time. Usefully, historical analysis provides us with two 'signposts' of when fair valuation is likely to be restored:

History indicates a 24- 28 months gap between recruitment valuation peaks and troughs

- Looking back over the last 5 or so economic recessions, there has been a period of c.24-28 months between the peak of recruitment shares and their low point (aka the valuation 'turning point'). See analysis below of the 2001-03 downturn. The most recent peak of the market for recruitment valuation was July 2007. Applying then the historical 24-28 months indicator would point towards a valuation turning point for recruitment in Q3 or Q4 2009. In simple terms, from this period in time we believe that recruitment valuations are likely to begin to trend upwards.

A "7 month rule" often holds true

- Historically, recruitment valuation multiples begin to rise c.7 months before the UK economy begins to grow again (the "7 month rule"). This trend occurs as institutional investors and their economists are watching market and economic macro movements closely and are well versed in reading the signals of a recovery. Most recently the 2001-03 downturn followed this pattern, recruitment valuation multiples rising 7 months ahead of the 2004 recovery.

Therefore, assuming a valuation recovery for recruitment in Q3 or Q4 2009, the 7 month rule would indicate an economic recovery around Q1 or Q2 2010. Interestingly, this prediction for the ecomomy is broadly in line with the consensus of most economists and market-watchers (although admittedly not all of them!).

Share price decline in last downturn

	Share price, % change peak to trough 2001-03	Duration
Harvey Nash Group plc	-99%	23 months
Hays plc	-82%	28 months
Kelly Services Inc	-38%	23 months
Kforce Inc	-76%	22 months
Michael Page International plc	-66%	24 months
Randstad Holding NV	-73%	22 months
Robert Half International Inc	-61%	24 months
Robert Walters plc	-84%	28 months
Spring Group plc	-62%	21 months

Source: Catalyst Corporate Finance

Trade buyers

What do valuation issues mean for trade buyers who may be looking for acquisition opportunities in this distressed market?

Selected trade buyers are still looking to acquire

Firstly and contrary to many widespread unfounded views, there are still a number of trade buyers looking for acquisitions, although admittedly these are significantly reduced in number compared to 12-36 months ago. Unsurprisingly, active buyers are tending to be players who are operationally resilient (as a result of their business models, favourable geographic spread, and recent strong decision-making amongst other factors) and who retain significant cash reserves that are ring-fenced to support growth, organically or by acquisition.

Opportunism and scepticism abound amongst buyers

Our on-going dialogues with these players indicates a mixture of opportunism and scepticism on their part in respect of M&A; opportunism in that they can use their cash and shares either to acquire market share or to evolve strategically at attractive valuations; scepticism over why deals would be “coming to market” unless there are serious, negative issues within the target business. Scepticism is also present in buyers’ minds over whether they can agree a valuation with vendors who may be expecting multiples achieved in 2006-7 when valuations were higher.

It is the competing tension between opportunism and scepticism which we believe will remain the key feature of buyers until valuations begin to rise again from late 2009 and early 2010 onwards. However, as valuations rise, we expect that opportunism will gain the upper-hand over the scepticism of buyers and the M&A market will begin to regain its lost momentum.

Vendors need to stay focussed on their exit and to actively prepare for this

Until this point in time arrives, owners of recruitment businesses who have an eventual exit in mind should identify and track their potential buyers. Doing so enables a better appreciation of when and why a buyer will want to acquire their business. Owners should also use the time to ‘shape’ and groom their company in preparation for the exit by sharpening strategic focus, reducing non-critical expenses and ensuring all key financial and legal documents are in order. Undertaking all of these activities invariably means that the valuation and terms achieved at exit will be enhanced.

Private equity

What then of private equity which over the last 5 years has been an increasingly active and aggressive buyer of recruitment businesses?

Private equity is suffering something of a 'perfect storm'

Many private equity houses are facing something of a 'perfect storm', namely owning businesses which are suffering because of low market demand whilst having to pay off the debt which they have used to reduce the capital outlay in the initial acquisition. Combined with this are the internal tensions created by their own financial backers (pension and endowment funds etc) demanding explanations for the under-performance of their investments. Additionally, many of these financial backers are also seeking to avoid future commitments to provide Private Equity houses with follow-on funding in an attempt to preserve cash to meet their own commitments elsewhere.

Many private equity house are 'overweight' in recruitment

It is also a factor that many private equity firms are restrained from investing in recruitment business as they are already 'over-weight' in the sector through existing recruitment investments. Only once their current recruitment investments are sold is private equity then able to invest in new opportunities in the sector. However, the slow-down in trade buyer appetite together with the effective closing of IPO markets has effectively cut off the exit routes for their existing investments.

Lack of debt and of experienced management teams is further limiting deals

Furthermore, to successfully complete deals, private equity requires two key ingredients, both of which are currently in short supply. Firstly acquisition debt finance, which is currently scarce for recruitment deals which are often now poorly regarded by acquisition bankers as being businesses where performance can fall dramatically. The second key ingredient is that of strong management teams who have experience of recruitment and of managing through a down-turn. Finding senior executives who fit the bill is a difficult challenge. The absence of these candidates, combined with the lack of available acquisition debt, is a very real impediment to new deals involving private equity.

Private equity investor interest endures

Yet despite the above factors, we find that private equity remains very much alive to the opportunity to buy recruitment assets at low valuations and to hold these through the upturn. Recent news and rumours surrounding interest by private equity in the likes of OPD plc and FDM plc are good examples of this investment mindset.

Recent & current deals

Looking at the M&A deals that have been completed in 2009 to date (see table below), we see a dramatic downshift in volumes as well as a number of other trends which support our views on valuation and trade buyer appetite.

- 2009 deals are orientated towards more stressed and distressed situations. This is reflected in low valuations at which the deals have been executed, which causes details of the deal terms to be withheld from public disclosure (admittedly though not in every case).
- Classic large trade buyers are noticeable by their absence as “completors” of deals in spite of their continuing interest to look. Instead they are being held back by scepticism over vendors’ intentions as well as by difficulties in agreeing fair values with vendors.
- In spite of continuing to express interest in new investing, private equity is not completing deals, hindered by a lack of funding ability and other internal operational issues.

However, beneath the surface of the deals that have been completed in 2009, we are seeing a tangible groundswell of activity around better quality, resilient recruitment businesses who are preparing for a sale from Q4 2009 or Q1 2010 onwards, when valuations are expected to be rising and when, importantly, vendors can exploit low levels of M&A competition as a result of other vendors intending to wait until 2011 and beyond to undertake a sale.

2009 UK Recruitment M&A activity

Date	Bidder	Target	Target Product Line	Deal value (£'m)
19 January 2009	Private Group of investors	Executives Online Ltd	Specialises in executive recruitment services for permanent, interim management and project management roles	n/d
6 February 2009	Phee Farrer Jones (Holdings) Ltd	RPCushing Ltd	Provides specialist media recruitment services	n/d
16 February	2009 Concept IT Ltd	Alan Morris Recruitment Ltd information technology sector	Provides recruitment service of technologists for the	n/d
13 March 2009	Interaction Staffing Solutions Ltd	Commercial Staffing Business of Kelly Services (UK) Ltd	Provides commercial staffing recruitment solutions	n/d
24 March 2009	Princely Holdings Ltd	Supporta Professional Services Ltd	Provides architectural and engineering consultancy services	n/d
27 April 2009	InterQuest Group Plc	Lanborne Consulting Ltd	Provides information technology sales recruitment services	n/d
1 May 2009	MBO backed by Penta Capital	GRS International Ltd	Provides recruitment services to financial and legal sectors	18.0
27 May 2009	Staffline Recruitment Group Plc	The Work Place	Provides temporary and permanent recruitment services	n/d
27 May 2009	Peter Hearn and Graphite Capital Management LLP	OPD Group Plc	Provides senior executive and board level appointments for specialist practices	10.3(1)
1 June 2009	Penna Consulting	Barkers Group Ltd	Provides recruitment consultancy solutions	9.0
11 June 2009	Korn/Ferry International	Whitehead Mann Group Ltd	Provides executive search, executive selection, and human resource consulting services	n/d
15 June 2009	CPL Resources Plc	Kenny-Whelan Associates Ltd	Provides outsourced staffing, recruitment and human resource services	n/d

(1) Offer made in May 2009

Source: Corpfin

Future deals

When the recruitment M&A market recovers in earnest, we believe that a number of trends will be seen that directly emanate from the economic recession. One such trend is likely to be the characteristics which buyers seek and which attract the highest valuation multiples.

Some traditional value characteristics will remain…

Firstly however, there are a number of recruitment business characteristics which will always attract premiums from buyers. These are unlikely to change and include having a strong and focused sector specialism, overseas operations of critical mass, stable management teams underpinned by structured succession plans, and clear and realistic growth opportunities ahead.

More interestingly, we believe that a new suite 'value characteristics' are likely to emerge and be sought after by buyers. We believe that these characteristics will include:

…but important new value characteristics will emerge

- Proof of trading and profit resilience during 2008/09, with a focus on senior management leadership and decision-making in the period
- Focus on visibility of forward earnings achieved through protected client relationships, genuinely differentiated service offerings, high calibre consultants, and control of scarce contractors
- Proof of established and proprietary systems and recruitment methodologies which demonstrate the 'substance' of recruitment businesses
- Fixed cost base efficiency (conversion rate metrics will be looked at by buyers with higher scrutiny) and its flexibility (operational gearing metrics are most relevant here)

Developing the right value characteristics will be key to maximising valuation in the future

For owners of recruitment businesses who are preparing for a sale at any point in the short to medium term, we strongly recommend a close focus on the above business characteristics as a way of maximising valuation. Developing a business around these characteristics carefully over time or demonstrating that these already exist is likely to be the key to achieving the highest valuations in the future.

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Catalyst is an award winning international corporate finance advisor specialising in company sales, acquisitions, and private equity or debt funded management buy outs.

Winner of the 2008 BVCA Award for Financial Advice of the Year, we advise clients across a broad spread of sectors on deal sizes up to £400 million in value, with a particular focus on the recruitment and support services market. Catalyst is also one of the founding members of Mergers Alliance International Partners.

Mergers Alliance is a dynamic international partnership of highly successful independent corporate finance firms focusing on mid-market M&A. The partners have 240 transaction professionals located in 42 offices around the world. In 2008 Mergers Alliance completed 62 deals worldwide with a transaction value in excess of US$4.5bn, making the partnership one of the top 20 M&A organisations in the world completing mid-market transactions.