YORKSHIRE & THE NORTH-EAST

Historic enterprise with a future

By Chris Tighe and James Wilson

Some of the most advanced engineering companies in north-east England today face a changed landscape after the merger of two Ministry of Defence agencies to create a body spending £16bn a year on military procurement and maintenance.

Defence and aerospace contribute £2bn to the economy in Yorkshire and the north-east and employ 20,000 people, according to Northern Defence Industries, a company set up to champion the sector's interests.

Among plants affected is BAE Land Systems' plant in Newcastle-upon-Tyne. It is one of the city's biggest manufacturers employing 636 people making armoured vehicle systems. BAE's other regional works include a facility at Brough on Humberside where Hawk training jets are built.

But the greater part of employment and spending is with hundreds of smaller and medium-sized companies that make a substantial part of their living as contractors to the likes of BAE and other "prime" contractors.

Typical suppliers have a few dozen staff and several million in annual sales – but together they employ about 14,000 and account for £1.4bn of defence spending in the region.

BAE last year spent £67m with almost 400 north-east companies alone.

"Eight to ten years ago we had quite a few defence-related plcs in the north-east and Yorkshire," says Robin Fox, director of business development of Northern Defence Industries. "We have just about lost all the plcs . . . but importantly for the region we have an incredible depth in the supply chain in the small and medium-sized enterprise (SME) sector. There are some very specialised companies working."

However defence spending is no gravy train. The sector has gone through great upheaval in recent years as government has grappled with how to get best value for money.

"The big issue for me is that over the last 15 years we've had an overemphasis on rabid competition," says Bill McGawley, an ex-operations director of the former Vickers tank plants in Newcastle and Leeds that are now part of BAE Land Systems.

Mr McGawley, now the vice-chairman of TDR Group, a Gateshead business involved in defence sector training, recalls the phase when contractors would present their "best offer", their "best and final offer" and then their "final best and final offer".

Crucial: defence and aerospace contribute £2bn to the economy in Yorkshire and the north-east and employ 20,000 people

Market movers in Yorkshire and north-east England

Leading rises	Market value* (£m)	% Change**	Leading falls	Market value* (£m)	% Change**
Tanfield	257.0	59.3	Zoo Digital	1.5	-53.2
Xpertise	3.3	53.1	Weather Lottery	2.5	-35.0
Vertu Motors	47.5	47.1	Debts.co.uk	21.9	-28.1
Imperial Energy	457.3	43.6	Real Affinity	2.4	-27.3
Amco	70.1	40.3	Newcastle United	80.5	-24.8
Romag	85.9	38.0	Surgical Innovations	11.7	-21.7
Severfield-Rowen	375.0	35.2	GTL Resources	35.8	-21.3
PM	17.5	32.0	Filtronic	109.8	-20.0
Quantica	23.3	27.9	Communisis	94.5	-19.0
Sinosoft Technology	30.6	27.6	Infoserve	4.1	-17.6

Sources: LSE; Thomson Datastream * As at end Feb ** Between end Dec and end Feb

Since the introduction in 2005 of the Defence Industrial Strategy, the dominant theme from government is partnership. Defence Equipment and Support (DE&S), which merges the Ministry of Defence's procurement and logistics agencies, will look to create long-term partnerships with a combined approach towards initial purchase and "through life" equipment maintenance.

Supply Chain 21 (SC21) was launched last year by the Society of British Aerospace Companies to make the UK supply base more competitive by creating more responsive and cohesive networks.

Briefing documents have talked of a "disconnected, fragmented supply base", "often poor" business relationships, waste and duplication and the interests of different parties not aligned.

Geoff Ford, chairman of Ford Component Manufacturing, a South Shields precision engineer, hopes SC21 can help UK companies reverse a drift of business to the US. "There seems to be a genuine desire on the part of UK primes to keep work onshore in the UK."

The SC21 vision is based on a common quality accreditation covering business process and manufacturing, which should reduce bureaucracy for accredited subcontractors. Accreditation should help win work and offset SME fears of being excluded from prime MoD relationships.

Mr Ford says SC21 must work. "If [SC21] doesn't work the primes [leading contractors] will have no credibility with other countries, our own government and their subcontractors," says Mr Ford, whose third-generation family business employs 175 people in South Shields and relies on aerospace and defence for 55 per cent of its annual £10m turnover.

Mr Fox of NDI says one opportunity this year for some defence-related SMEs is that the MoD lowers its threshold for advertising contracts, meaning smaller companies should get better sight of contracts that are the right size for them to bid for. "It is good news as far as we are concerned," says Mr Fox.

Steve Parkin, a director of Micro Metalsmiths, which supplies radar sub-assemblies and some components from its specialist precision foundry in North Yorkshire, says the MoD's desire to open up more direct opportunities for smaller suppliers is laudable – but it may not change much for his type of company.

"Rightly or wrongly is its more at the lower-tech end," he says. "Whether it will help us at the technical and engineering level is unclear . . . I am sure we will still be dealing with first-tier contractors."

Life leading Yorkshire clean energy drive

By James Wilson

A Yorkshire business incubator dedicated to green technologies is considering a fresh round of City fundraising amid booming investor interest in development of clean energy.

Life, based in Sheffield, is preparing to appoint brokers with the aim of seeking a second injection of finance following an investment last year by a consortium headed by Westhall Capital, the institutional stockbroker.

Philip Johnson, Life's chief executive, said: "We have validated our business model and done what we said we would in our business plan. We have a pipeline of opportunities to invest in the sector."

Analysts expect a substantial volume of capital to be invested in alternative energy and fuel efficiency in coming years, in spite of the mixed record so far achieved by companies in the sector. While some have prospered after public listings, others have struggled to maintain shareholder interest.

Life has helped several companies "graduate" to independence, including ITM Power and Voller Energy, which are both involved in developing fuel cell technologies and have joined Aim.

A third company from Life, CMR Fuel Cells, has also joined Aim while Disenco, which is based at the incubator and makes alternative combined heat and power systems, joined the Toronto Stock Exchange earlier this year.

Mr Johnson said: "The Aim market is up and down a bit but the sector itself is very hot and should remain extremely interesting for the foreseeable future."

ITI Energy, another company on the verge of leaving the incubator, last year raised £6m for investment in its gasification technology.

This year Barbara Thomas Judge, a well-known city figure who also chairs the UK Atomic Energy Agency, was appointed as Life's chairwoman. She is expected to play a big part in any new fundraising and Mr Johnson said: "She has a passion for the sector we operate in and she brings to the board the sort of experience that only bigger companies normally have. We get a lot of benefits."

Life currently has about 14 companies within the incubator. It usually works with client companies for an average of 18 months, providing advice and support in return for equity stakes.

The Westhall-led consortium invested £1m for a 40 per cent stake while the incubator also has backing from Eon. Mr Johnson says the power company is keen to be closer to innovation and learn about emerging energy technologies.

The development of Life – which sits atop the South Yorkshire coalfield near Orgreave, site of a notorious confrontation during the 1984-85 miners' strike – illustrates Yorkshire's ambitions to become a force in a new generation of cleaner energy.

The county is home to a lot of wind power investment and one of Life's companies plans to tap the tidal power of the Humber.

UK Reits are sticking to their tried and tested model

JIM PICKARD
PROPERTY

No one really noticed last summer when Land Securities, the biggest property company in Europe, introduced new "super-bonuses" for its best staff.

Ian Ellis, head of Land Securities' Trillium outsourcing subsidiary, received a £700,000 "super-bonus" while Mike Hussey, head of development, received £408,000.

These were on top of the usual cash and share bonuses and salaries.

No wonder few people batted an eyelid, given the group's strong performance in recent years. Shares in Land Securities have almost tripled since 2003.

The payments were also far from extravagant compared with remuneration in other parts of the real estate industry, especially among the private companies and top agencies.

At Helical Bar, a small listed property company, Mike Slade, chief executive, had a total package of £5.3m while two other directors got £3.7m and £2.6m.

The question of remuneration is worth raising right now as Britain adjusts to a world of real estate investment trusts (Reits).

Does it play any role in terms of how executives decide the future strategy of their companies? Consider this. Reits, in their original conception, were supposed to be vehicles which were all about income.

That is, the old business model of UK's property companies – generating capital growth with a small sliver of dividend yield – would be radically transformed.

But one by one, the new Reits announced that while there would be some increase in dividends, because they no longer had to pay tax, they would stick to their "total returns" platform.

In other words, shareholders will continue to make more money from growth in the companies' net asset value, and therefore the share price, than from dividends.

As a result, the sector looks set to yield under 3 per cent a year, less than in most other Reit jurisdictions in other countries.

A devil's advocate may ask whether some executives are motivated by their own remuneration packages?

If a Reit gave out all its available earnings, instead of reinvesting them in new developments and investments, it could pay a much higher dividend. But, assuming "yield compression" is now over, the shares would barely budge. As a result, share option schemes would be much less lucrative.

This is what it used to be like in the US, argues one banker, who says this explains why so many American executives were happy to accede to private equity buy-outs in recent years. "They were basically fed up that their shares didn't move."

Look at the shares of Equity Office Properties, which has just been bought by Blackstone for $39bn (£20bn).

Early last year, before takeover talk began, EOP's stock was trading at $30, the same as it was in 1998.

No wonder British executives may prefer a rather different business model. At least you could argue, however, that share options motivate executives to raise their companies' share price – which can't be bad for Reit shareholders.

Moreover, those looking for a high dividend of 5 per cent or so can still find it in the "Reit-petite" sector, the dozen or so Guernsey-based listed property trusts run by Invista, Axa, Foreign & Colonial and others.

These vehicles have the same tax advantages as Reits and are more committed to the income model. Yet while these used to trade at about 10 per cent more than net asset value, they have since lost that premium.

UK Reits, meanwhile, have lost their discounts to NAV and are trading at about the same level.

In Europe, by contrast, many Reits are at premiums of 20 or 30 per cent to their NAV.

The big question to ask right now is whether this arbitrage makes the UK Reits sitting ducks for takeovers, not least from US private equity groups with piles of money to spend.

Blackstone is understood to be raising $12bn for a real estate fund with $40bn of firepower while Morgan Stanley's next behemoth may have about $30bn to invest.

One should ask whether the assets of British property companies, at yields of less than 5 per cent, could sustain the type of leverage favoured by private equity funds.

Maybe not. Yet a fast-moving buyer could simply break up their wholesale portfolios, selling the fragments at higher prices to a range of buyers.

At the same time rumours about Unibail, the French company, planning to bid for Hammerson just will not go away.

Ironically, the excitement about Hammerson, whose shares are up 10 per cent on the month, may make a bid less likely. As Harm Meijer at JPMorgan points out, other companies now look much cheaper. The shares of Land Securities, British Land and Liberty International are all much lower now than at the New Year.

"We believe at the current share price, investors would be better to reduce their holdings and switch to other stocks," he wrote.

Analysts at Lehman Brothers have scotched the theory that British Reits are at a ridiculous discount to their French brethren.

Instead, Mike Prew suggests three reasons for the bigger premium in France.

First, valuers are more attuned to market pricing in the UK.

Second, British companies value their development programmes at open market value, unlike on the other side of the Channel where they are held at cost. And third, NAV growth in France looks stronger given the positive margin between yields and debt.

Antrim to expand as oil and gas reserves swell

By Peter Marsh

Antrim, an Aim-listed Canadian oil and gas company, plans to step up its activities in Argentina and the UK in the next few months following a large increase in its oil and gas reserves last year.

The company said at the weekend that its reserves rose at the end of December 2006 to 33.3m barrels of oil equivalent, compared to 6.2m barrels a year before. The increase is partly due to a re-evaluation of the size of its reserves in Tierra del Fuego, Argentina.

Antrim has also upgraded the valuation of its reserves in the North Sea, related to its acquisition of the UK Fyne and Dandy Fields.

The company reported net income of C$1.3m (£572,000) in the year to December 31.

That compared with a net loss of C$3.2m the year before, on revenues of C$13.9m in the latest 12-month period, compared to C$10m the year previously.

Antrim said that it expected to add to its exploration wells in Argentina in the coming year, as well as increase gas sales from Argentina after building a new pipeline.

As well as having an AIM listing, Antrim is listed on the Toronto stock exchange.

COMPANIES DIARY

Exit-fees curb may hit Northern Rock

MONDAY

Investors will be looking to see whether recent pronouncements from regulators about exit fees – fees charged to borrowers who want to move their mortgage before its expiry date – will have on trading at **Northern Rock**, the UK's fifth-biggest mortgage lender when it issues a trading update. The Financial Services Authority, the City's regulator, has announced that it will crack down on exit fees charged by mortgage lenders to customers who pay off their mortgages early or switch to an alternative provider. Such fees are thought to discourage homeowners from trying to benefit from competition in the sector. The FSA has told Northern Rock, among others, that the increase in fees must be justified or the fees themselves scrapped.

Northern Rock, the former building society which is one of the nation's fastest-growing lenders, reported record profits in January. It was helped by the UK's strong housing market and a reduction in bad-debt provisions. Strong net new mortgage lending rose by 13.4 per cent in 2006, almost double the lender's traditional share of the market. This was achieved by aggressive undercutting of the pricing on products which are offered by rival banks.

WEDNESDAY

■ **Mothercare**, the mother and baby retailer, is expected to have benefited from improved footfall and better weather when it gives details of its fourth-quarter trading performance. Under the stewardship of Ben Gordon, chief executive, the chain has embarked on a plan of fast international expansion via franchises, which has offset subdued growth in the UK. In the previous quarter, Mothercare reported a 0.8 per cent uplift in like-for-like sales in the UK – although the store performance was flattered by a fast-growing internet and catalogue business. Analysts are looking for better news in terms of both sales and margin growth.

■ Investors in **Aegis** will get their third chance in a year to pick sides in the stand-off between the media buying and market research group and its largest shareholder – the group run by French investor, Vincent Bolloré. Group Bolloré, the French conglomerate controlled by Mr Bolloré and his family, has a 29 per cent stake in Aegis and has forced the calling of an extraordinary general meeting of Aegis investors. It is the third occasion on which it has asked investors to vote on two non-executive directors that Groupe Bolloré has nominated to the Aegis board, following similar votes at the Aegis annual meeting in June and an EGM in November. The Aegis board rejected the nominees and twice before Aegis investors have agreed with the board. The two nominees are Philippe Germond, the former president of Alcatel, the French telecommunications supplier, and Roger Hatchuel, a well-known French advertising executive. On each occasion, 94 per cent of the non-Bolloré investors rejected the two men. In addition shareholder advisory groups such as RREV have made similar recommendations for Wednesday's vote.