



TRADE & INDUSTRY SELECT COMMITTEE INQUIRY INTO PUBCOS

A Submission by the Association of Licensed Multiple Retailers

June 2004

Introduction

1. The Association of Licensed Multiple Retailers (*ALMR*) welcomes the opportunity to submit written evidence as part of the above inquiry. It is important to note that our members reflect not only a diverse range of commercial perspectives but also different operating styles. In the context of this inquiry it is relevant to note that the lessor/lessee relationship exists between members of the Association. Our response therefore seeks to balance these views and provide an objective factual overview of the industry. As the only national trade body dedicated solely to representing the needs and concerns of licensed retailers, the Association is well placed to provide this.
2. By way of background, the *ALMR* was formed in 1992 specifically to represent the interests of those companies which own or operate multiple estates. Currently 93 companies are in membership, between them operating in excess of 27,500 outlets or just under half the UK pub estate. As well as pubs and bars, our members also operate restaurants, clubs and café bars
3. Members include major pub companies such as Punch, Unique and Enterprise, retail pub chains such as Regent Inns and Laurel and the retail estate of regional brewers – which tend to maintain traditional, short-term tenancy agreements. However, over two-thirds of our membership is derived from small independent companies operating 50 pubs or less under their own branding. These companies are neither brewer nor individual tenant but rather Multiple Lessees – directly managing their own operations but leasing the outlets from a range of property owners.

Market Overview

4. For the purposes of this submission we have defined Pubcos as companies with no brewing dimension who own their own properties but issue leases to individuals or multiple companies to operate them. The largest of these companies appear to be the focus of the current inquiry, but it should be noted that there are a large number of smaller pub-owning companies who operate the same model. Retail Pub Chains are exclusively managed operations whose property is either freehold or free of tie lease. Managed pubs are operated by employees or agents of the pub owner. Tenanted or leased pubs are operated by individuals or companies (Multiple Lessees) not related to the pub owner.
5. Over the past decade and a half, the total number of outlets in the UK has remained largely stable, but the nature of pub ownership has changed dramatically. The introduction of the Beer Orders in 1989 was a catalyst for unprecedented and unexpected change not only in the brewing industry but also the licensed retail sector. At the time the Beer Orders were introduced, the national brewers owned over half of all UK pubs and the share of the independent sector was negligible. This situation has been



dramatically reversed, with very many national brewers exiting pub retailing and the market share of independent operators more than trebling (see table 1).

- This growth is accounted for predominantly by the independent multiples, and principally the Pubcos, but also the Multiple Lessees holding Pubco leases. These companies have flourished under the new regulatory regime, usually through purchasing the excess estate of the major brewers.

Table 1: Ownership of UK Pubs

Type of operator	1989	Jan 02	Jan 04	% change 89-04
INDEPENDENTS				
tenanted/leased	neg	22,523	23,857	
managed	neg	10,657	10,268	
single outlets	16,000	17,130	16,850	
SUB-TOTAL	16,000	50,310	50,975	218.5
REGIONAL BREWER				
tenanted	9,000	5,495	5,972	
managed	3,000	3,176	2,617	
SUB-TOTAL	12,000	8,671	8,589	-28.5
NATIONAL BREWER				
tenanted/leased	22,000	1,110	0	
managed	10,000	1,400	0	
SUB-TOTAL	32,000	2,510	0	-100
TOTAL	60,000	61,491	59,564	

Source: ALMR members and Quantum Business Media

- At the same time, the nature of the retail on-trade market has become significantly more differentiated, with pubs increasingly competing alongside clubs, bars, restaurants and hybrid outlets. This trend will only increase with the implementation of the 2003 Licensing Act. From a customer's view point, this has resulted in the emergence of new, innovative venues and a much more dynamic and segmented market place than existed before.
- The 2000 review of the Beer Orders carried out by the OFT concluded that the overall entertainment experience, rather than just the presence and price of different types of beer is now far more important to those visiting pubs. As a result, the retail pub market now competes more strongly on the level and type of amenity rather than on price which it did pre-Beer Orders. It is the change in ownership within the sector which has indirectly prompted this – it has allowed independent entrepreneurs to create a niche, to thrive and to develop their business by taking on multiple leases from a variety of property owners.

Nature of Pub Ownership

- Consolidation in the UK brewing and pub retailing sectors has resulted in a concentration of outlets in the hands of a small number of players. Around a third of all pubs in the UK are owned by 4 major pub retailers – none of these has ownership of or connection to any brewing capacity nor do they operate vertically integrated business. Indeed, less than 15% of the UK pub estate is now owned by brewers.



Table 2 – Publican stats on pub ownership (April 04)

<i>Company</i>	<i>Total Outlets</i>	<i>Market Share</i>
Enterprise & Unique (subject to regulatory clearance)	9,093	15.3%
Punch	7,400	12.4%
Spirit	2,470	4.1%
Mitchells & Butler	2,077	3.5%
Greene King	1,684	2.8%
Wolverhampton & Dudley	1,605	2.7%
S&N Pub Enterprises	1,119	1.9%
Innspired Pub Company	1,066	1.8%

10. However, this is a concentration of ownership rather than operation. The growth in the Pubco estates in particular has enabled a large number of small, entrepreneurial multiple lessees – independent retail pub chains - to develop by providing new access to a wider range of premises. It is estimated that there are now 65 companies with an estate of 30 or more pubs which have no connection with brewing. Concentration of pub-ownership is expected to continue in the future, as retail pub chains seek to rationalise cost and maximise buying power.
11. The OFT’s review of the Beer Orders in 2000 noted that the emergence of the Pubcos and their growing market power provided real competition to the brewers and had had a positive effect on competition within the market as a whole.

Leasing Arrangements

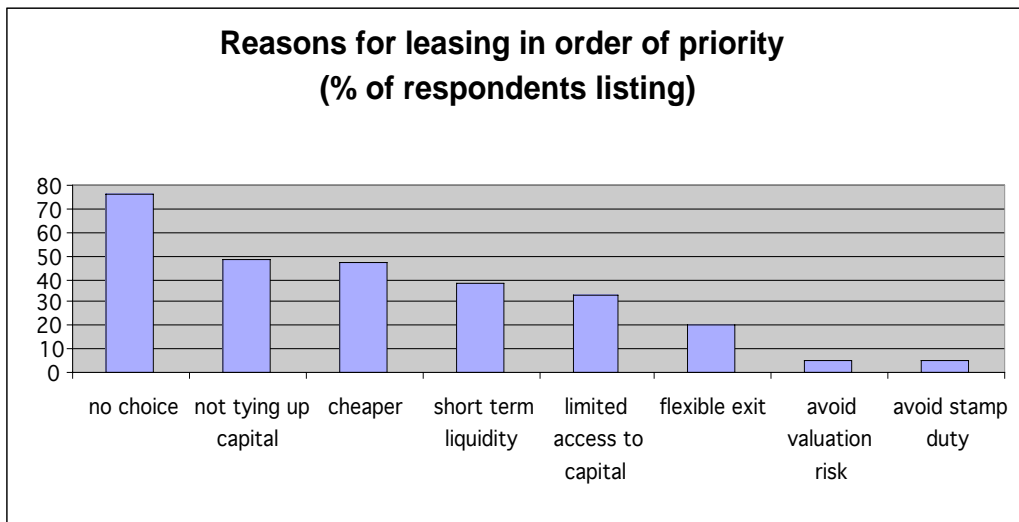
12. Around a third of UK pubs and bars are operated under lease from a brewery or pub company. The lessor retains ownership of the premises and provides both it and the business as a going concern in return for rent and often purchasing obligations. It is the nature of this agreement which is the subject of the current inquiry.
13. During the 1990s, two distinct models of leasing arrangements were refined: the traditional short-term tenancy agreement developed historically by the national brewers and still favoured by many of the regional brewers; and, the long lease developed initially by Intreprenneur and adapted by the pub cos. The difference between the two was essentially the length of the term and the degree of involvement of the property owner in the repair obligations of the outlet. Longer leases also have the benefit of accruing value to the tenant enabling to be assigned or used as a means of raising finance for further investment or expansion.
14. In today’s marketplace, the type of leasing arrangement available is as diverse as the range of outlets operating. A variety of terms are offered not only by different pub owning companies but within the Pubcos themselves. Flexible and varied terms are available and the ability to negotiate bespoke agreements is considerable – short or long term, and with various degree of tie depending on the nature of the agreement and the rental value paid. There is arguably now a wider choice of types of pub, landlord and tenancy agreement - but obviously this flexibility is reflected in the cost of the agreement.
15. The *ALMR* recently conducted a survey of its members looking at the nature of pub leasing arrangements as part of its submission to Government on the introduction of Stamp Duty Land Tax in the autumn of 2003. The survey was circulated to multiple



lessees and respondents were asked for information about their shortest, longest and average length of lease as well as rental values. The terms ranged from 1 to 999 years and a whole variety in between, with the typical lease terms being between 15-30 years. The lowest rent payable was £25,000 per annum with the highest being £155,000 in central London, with an average of £60,000. This is somewhat high for the pub trade as a whole, but is consistent with a sample of multiple lessees. An average annual rent of £35,000 is more common for singleton lessees of pubcos.

- 16. The same survey went on to ask respondents why they had chosen to lease in the first instance. The overwhelming reason was because they were unable to buy the freehold – either because it was not available or it was too costly to do so. The second reason was a preference not to tie up capital in property but to have it available for investment in the business – refurbishments or improvements to the outlet – and also for expansion.

Table 3



- 17. The pub leasing model is by no means perfect and the terms of reference of the current inquiry highlight some of the issues of greatest controversy and debate – the price at which beer is bought and sold, profit margins and rental values. On the one hand, tenants resist direct costs and constraints and, on the other, the landlord needs adequate compensation to reflect the nature and level of risk taken on as a property owner.
- 18. What is beyond doubt is that the business model for leases has to work for both parties – without stable and successful lessees the pubcos arguably have no business. The *ALMR* has sought to provide a factual commentary on these matters: where different viewpoints are expressed these have been recorded, but the *ALMR* has not sought to draw any specific recommendations, nor should the inclusion of any point be taken as expressing a collective industry position.

Exclusive Purchasing Obligations

- 19. Tenancy and leasehold agreements still invariably contain a clause that restricts the tenant or leaseholder to buying their beer and other drinks from the pub-owning company or its nominated supplier. In general, the tied portfolio offered through brewers and pubcos has widened since the introduction of the Beer Orders.



20. Pubcos buy their total beer requirements centrally and either sell it direct through their managed outlets or on to their tenants at a mark-up. Most of the agreements between national brewers and pubcos are long-term supply agreements, and most national brewers continue to supply their divested estates through agreements with the new owners. These agreements however tend not to be exclusive: Pubcos multi-source their product portfolio. As a result, tied pub company tenants typically have access to a wider range of products than the average brewer tenant. Nevertheless, many lessees would undoubtedly welcome a yet wider choice and a less restrictive tie.
21. These arrangements have been considered at some length by European and UK competition authorities. It is worth noting in this context that whilst the European Commission concluded that whilst all the major brewers' agreements were found to be in breach of Article 81 of the European Treaty – that is they restricted competition – the same Article was found not to apply to any of the non-brewery pubco agreements with single or multiple lessees: that is they were not, in themselves, anti-competitive. This is largely because they do not involve any degree of vertical integration. Notwithstanding that, even the major brewers' agreements were eligible for exemption because of the countervailing benefits they were deemed to provide to lessees.

Beer Pricing

22. Centralised beer purchasing allows Pubcos to maximise the wholesale discounts they receive and thereby sustain a separate profit stream over and above rental income to offset levels of capital expenditure and market capitalisation costs. The Pubcos argue that they need critical mass in order to negotiate attractive supply prices for their lessees, and this has, in no small part, driven recent retail consolidation. Pubcos reserve their right to keep the commercial secret of their own purchasing arrangements but nevertheless some concern has been expressed at the level of mark-up retained by them when the beer is sold on to lessees. Whilst they operate discount and/or incentive schemes, these often do not match the opportunities available to free-of-tie lessees.
23. It is difficult, however, to assess the question of beer prices, wholesale or retail, in isolation. They are part and parcel of the overall lease agreement and the price at which tied product is sold often reflects the flexibility of other terms. There is a fine balance to be achieved between wholesale profits and rents. In some cases, the discount is used to maintain rents at a lower level, particularly amongst the tied estate of the regional brewers, and to fund investment in premises. This has been acknowledged by the OFT. Any requirement to pass on the greater discounts would inevitably lead to commensurate changes in rent and thus higher fixed costs.
24. The OFT's review of the Beer Orders in 2000 found that increased independence and buyer power at the retail level had forced a reduction in average net wholesale prices of beer of some 15% in real terms between January 1992 and 2000, largely as a result of the increased discounts given by brewers to retail pub chains – something they felt had had a positive effect on competition within the market. This fall had not translated into retail prices, however, which had risen over the same period by just over 4.2%. It concluded that the discrepancy was primarily accounted for by the increase in the gross margins applied by retail outlets to draught beer to offset higher running costs eg. direct and indirect wage costs, government imposed red tape and legislative burdens and the ongoing programme of investment in outlets. In the case of the Pubcos, higher profits may be required to offset the capital invested in the estate and to make a reasonable return on the securitised business model.



25. It should also be noted in this context that under UK Competition law high prices and profits are not in themselves anti-competitive. Concerns only arise where key players within an industry are able to exploit their dominant position so as to earn supra-normal profits or otherwise distort competition. It was this situation that the Beer Orders were designed to rectify and recent scrutiny of mergers within the retail sector has not concluded that there is similar cause for concern in the current market place.
26. The Beer Orders required the publication of the brewers' wholesale price lists. This requirement remains in place despite the decision to revoke the Beer Orders. The obligation only provides information on the price at which beer is normally sold at the wholesale level. It does not indicate the price at which it is actually bought and sold on. It does not apply to the Pubcos in their intermediate role as the exclusive supplier (by virtue of the lease agreement) of product to the lessees.
27. There is now far less transparency surrounding the nature of product discounts obtained by Pubcos and the degree to which they are passed on to their lessees. Lessees are obliged to purchase product from the listed producers and at a price advised by the Pubco. These prices may be tempered by incentives and perhaps by negotiation, but nevertheless lessees often find it difficult to ascertain with any accuracy what is the real wholesale price, much less to compare wholesale prices between different agreements and thereby work out the 'value equation' that balances the rent, the wholesale prices and any countervailing benefit. Greater transparency in this area would undoubtedly be welcomed by lessees, but Pubcos and regional brewers would equally expect to preserve the commercial confidentiality of their deals with suppliers.

Rents

28. The basis on which annual rents are set is the subject of a complex formula taking into account market and trading conditions, the degree of flexibility in the other terms of the lease, the nature and extent of the tie and the degree of risk being undertaken by both parties. Principally, however, rents are related directly to the anticipated trading levels expected from a particular outlet and the net margins the lessee is likely to be able to achieve.
29. This is an imprecise science, but pubcos are increasingly willing to enter into detailed negotiations, to consider additional factors and to review rents accordingly. Examples of existing best practice include removal of upward only rent review clauses, use of review panels and arbitration, as well as concessions for struggling tenants. These are not yet widespread and scope exists for wider use and the development of benchmark arrangements. It is also incumbent upon tenants to take responsibility for ensuring that the agreement they freely enter into is fair and meets their needs. A recent survey quoted by Deutsche Bank highlighted that 40% of new lessees fail to take independent advice before committing to a lease arrangement. But the price for this flexibility is a higher initial annual rent or further restrictions on the lease.
30. The same is true of any commercial or business agreement and disagreements about the level of rent and the issues to be taken into account in its setting are common. We note that this matter is already subject to a Code of Practice which is now under review by the Office of the Deputy Prime Minister. We believe that this broad-ranging public consultation is the most appropriate means of airing and dealing with these concerns rather than on a sectoral basis.



Conclusion

31. The Beer Orders resulted in major restructuring within the pub and brewing industry and served to define the parameters within which the licensed retail industry has developed over the past decade and a half. Acting as a catalyst, they arguably (but unintentionally) allowed smaller, independent multiple businesses to develop and thrive, not least as a result of the emergence of Pubcos. In particular they have transformed the nature of pub visiting for consumers, offering better amenity, a better quality of service and a broader based appeal.
32. The ramifications of this are still being worked through in a commercial sense and we do not, therefore, believe that further wholesale restructuring of the industry or formal scrutiny of the sector is required to secure effective competition. Just as with the Beer Orders, the Association believes that there would be unexpected and unsatisfactory outcomes that would destroy confidence and disrupt an industry that is still in a state of flux. Moreover, in an industry which continues to function through small business units, it is the imposition of new legislative and regulatory burdens which impact on the competitive position of tenants, and indeed all companies within the sector, far more than the competitive structure of the industry.
33. The pub leasing model is by no means perfect and there will always be tensions inherent in this relationship as both sides seek to extract the maximum value and to obtain minimum risk to themselves from the arrangement. The key is achieving an acceptable balance to enable all sides to achieve commercial success. The different priorities are not necessarily mutually exclusive and can, with goodwill, be aired and resolved within the industry.