

With an eye on the future, **Jim Fallon** assesses options for the pub, bar and nightclub sector

Are acquisitions dead?

What does the future hold? That's the million-dollar question everyone wants the answer to. For the pubs, bars and nightclubs sector a number of reasonable assumptions provide a good insight into how the market may look over the next few years.

Market dynamics

A number of UK market dynamics are affecting profitability of the leisure sector in particular. A combination of the national minimum wage (NMW), energy costs and interest rates has the biggest impact (see table 1).

Since its introduction in 1999 the NMW has seen a compound annual growth rate of 5.8% and is expected to fall to a lower growth rate going forward; however, the NMW increases wages across the whole range of lower-paid employees – for example, it is difficult to maintain a bar supervisor's wage rate if staff at a lower level are receiving an increase. This has dramatically increased the labour-cost base of businesses in the UK leisure sector and will continue to have a similar influence.

Significant energy-cost rises have had a double effect on the sector by increasing the cost base of operators and at the same time reducing consumers' disposable income. However, we have now been through the step uplift in costs and the consensus forecast is for a more normalised rate of cost growth over the next few years (George Bush permitting).

A key effect of the benign interest-rate environment over a sustained period has been the rising confidence of businesses to take on increasingly higher levels of leverage, in the form of financial leverage through debt and operational leverage through sale and leasebacks. A combination of the two can have fairly dramatic effects if the top line is not in growth. The market sees interest rates rising to c.5% in the short term but remaining around this level or coming back in the medium-term.

Sub-sector dynamics

Focusing on the marketplace of pubs, bars and nightclubs sees a further level of upward pressure on costs, namely the increasing requirement to work in partnership with local authorities and the police.

This has led to cost increases relating to issues such

as extra doorstaff, extended seating and underage drinking clampdowns. Most operators will need to focus on building relationships with councils to work through these issues sensibly on a market-by-market and possibly a unit-by-unit basis.

All these areas lead to higher costs for operators and, therefore, downward pressure on profitability. The market is not in significant growth – in fact, industry-wide sales are probably flat, at best.

The main conclusion has to be that consolidation is inevitable. There is a huge incentive to reduce costs and the number of competing brands, create economies through scale and gain market share.

The recent past

Transactions completed in the recent past have often been highly leveraged through high debt levels and/or sale and leaseback structures. Opco/propco structures are often not ideally-suited to this industry, with a tendency towards attractive initial rental yields of 6% or less. However, these yields have guaranteed annual uplifts (typically 2.5% pa) for the length of the lease. This provides no flexibility for a market downturn. In a low-growth environment this structure leads to profitability reduction over the medium to longer-term.

The future shape of the market

A number of deals that have been carried out at high prices with limited synergies may well be struggling under excessive debt levels. Where opco/propco structures have been employed it is almost inevitable that the opco will struggle in the current macro-economic environment. The trick of giving a property high valuation due to achievable rent, and selling on the freehold at this value, only works while the rent is being serviced. The sale/leaseback solution is not a new paradigm. In some cases it is akin to pyramid-selling, where all seems fine until the music stops, revealing that nothing was there in the first place (or at least that what remains is only worth 60% to 70% of the amount paid for it).

Businesses with more sustainable operational and financial gearing structures should be in a strong position to lead this period of consolidation.

Chart 2 sets out the position of various businesses

on the leverage curve. However, it is important to note that this depiction ignores whether businesses are predominantly freehold or leasehold. A more appropriate measure would be fixed-charge cover ratios (profit before rent, depreciation, interest and tax over the total cost of rental payments and interest). This information is much more difficult to come by, but it is clear that private companies are usually more comfortable with a higher leverage position than public companies.

A word on smoking

Discussion of the industry's medium-term future has to include the impending smoking ban. Rather controversially, we do not expect the smoking ban to have a long-term negative impact on the industry. The transition is likely to result in a 12-to-24-month dip in turnover, but the best operators will innovate by accommodating smokers in outside areas or attract non-smoking customers. Those screaming the loudest will be those lacking the financial resources to develop outside areas or with limited scope to innovate. Smaller tenanted operators will find it most difficult to remain competitive. However, in the bars and nightclubs area, the impact will be minimal. Party-goers will party on.

Consolidators and consolidatees

Generally, the more crowded the market area, ie nightclubs or the high street, the greater the likelihood of consolidation through acquisitions. The dominant players would be expected to lead this consolidation.

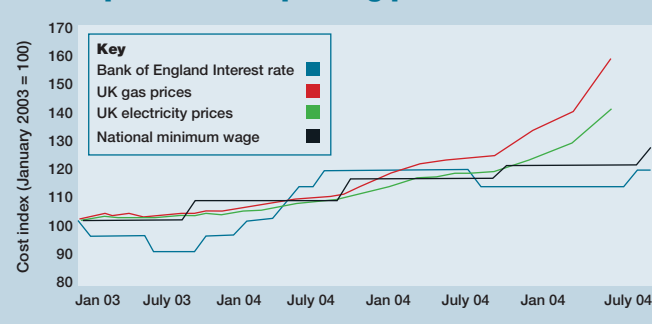
This simple analysis suggests further consolidation occurring in sub-sectors of community pubs, bars and late-night operators in particular.

We would also expect to see further consolidation in the pub-restaurant space in the medium-term. There is also a very large number of smaller operators, many of whom we would expect to see acquired in the short to medium-term.

In summary, the analysis suggests that the next few years will continue to see a significant level of merger and acquisition activity in this sector.

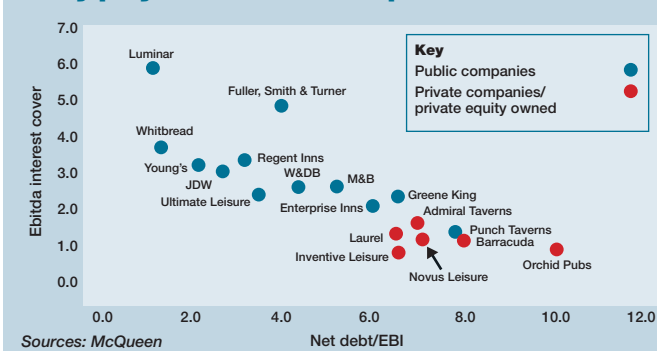
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1 Cost pressures impacting pubs



Sources: Bank of England, ONS, DTI

2 Key players in the marketplace



Sources: McQueen