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Finance

By Jim Fallon, partner, McQueen

Times are tough. Oversupply in the high street sector of the pubs and bars market from a few years ago has not washed through in its entirety yet. This suggests there are still a number of units to close before a market equilibrium is reached. In contrast, the casual dining sector has been growing well.

Are we transforming from a binge drinking culture to the continental café/brasserie utopia put to us by the political agenda? Importantly, how much of an impact will a consumer downturn have on trends in the sector over the next few years?

Late night bars vs. nightclubs

There will undoubtedly always be a part of the younger consumer demographic that likes to go clubbing and therefore continues to frequent nightclubs. As demonstrated by the high proportion of nightclubs' take being door money, many of those consumers do not buy drinks to the same degree as pub/bar goers.

However, as a result of licensing reform, later closing times of pubs and bars has had two effects. One has been to dissuade some groups of people from moving on to a nightclub. If you are with a group of friends and enjoying the environment, why change if the bar remains open? The second effect has been to cater for a new market that historically was lost somewhere in the middle. People who would like to have another drink or two but are not prepared to pay the entry to a nightclub may have gone home previously: now they often stay out.

It is unlikely that these trends will reverse. Therefore, we have seen the likes of Luminar continuing to develop category-killer nightclub offerings around the country whilst exiting the more marginal units.

In the pubs/bars sector, we have yet to see the long-anticipated high street consolidation. This is likely to occur to a degree over the next 12-18 months. As the various groups continue to fight for market share, there are likely to be winners and losers. The smoking ban has accentuated the differences between the more innovative operators and the rest.

Eating vs. drinking

What has certainly been a feature of the last 12 months or so is a marked convergence between certain aspects

of pub companies and casual dining restaurant operators. The rationale for this is relatively simple: as volume drinking continues to decline, eating out continues to grow. The eating out market is forecast to grow from circa £30 billion now to around £37 billion by 2012 (Mintel 2007). There is no wonder that this is an area attracting significant attention from pub companies and private equity.

Recent deals

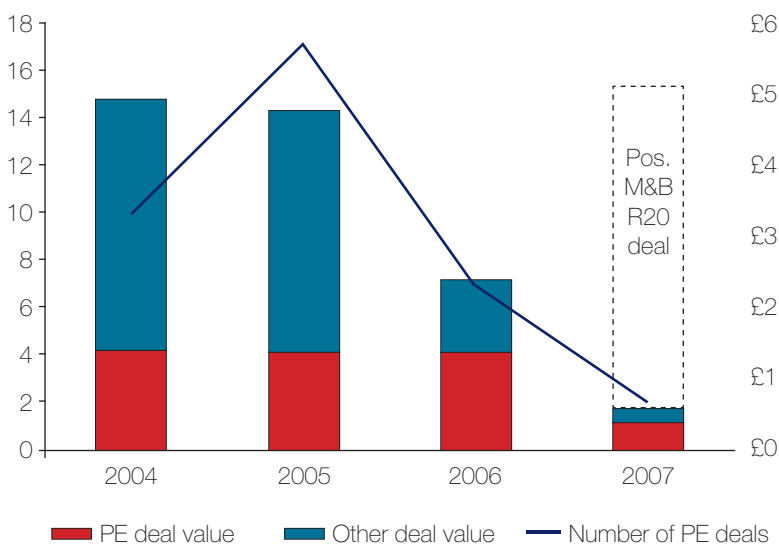
Within the context of these market changes, a number of recent transactions are worth mentioning. We have seen Greene King acquire Loch Fyne: an integrated pubs and brewery operation acquiring a restaurant business. Part of the rationale behind the deal is that a number of very good sites may be generating low returns as pubs and can therefore be successfully converted into restaurants. This makes perfect sense given the underlying demand-side dynamics of food in preference to booze.

Other transactions that follow a similar theme include Laurel's acquisition of La Tasca and Bluu's acquisition by Marston's.

However, this activity is not all one way. A number of years ago The Restaurant Group bought Blubeckers and, more recently, Brunning and Price. What this does demonstrate is that the two markets should not be considered in isolation.

Worth noting is that there has been very limited private equity activity in the pubs, bars and nightclubs sector in the last 12 months. A number of parties have found the market difficult and are therefore staying clear.

Value and volume of deals within the pub sector

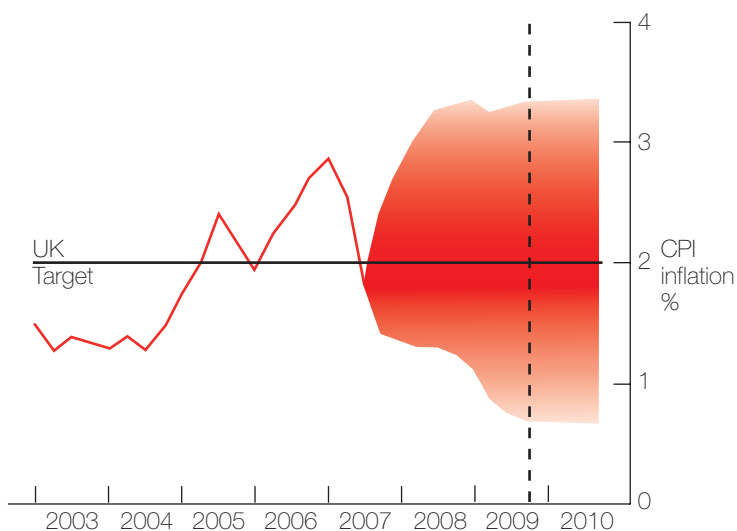


Consumer confidence

At the risk of sounding gloomy and with the possible exception of the South East, there is little doubt that we are currently experiencing a consumer slowdown across the country. This will also encompass the South East following the year-end bonus round at the investment banks (or lack of bonus round as will be the case for some).

During 2008, we are likely to see upward pressure on inflation, driven in large part by global commodity markets. This makes it very difficult for the Bank of England to utilise interest rates to alleviate the pain of a downturn (as rates should theoretically go up to offset inflation).

CPI fan chart – range of likely inflation to 2010



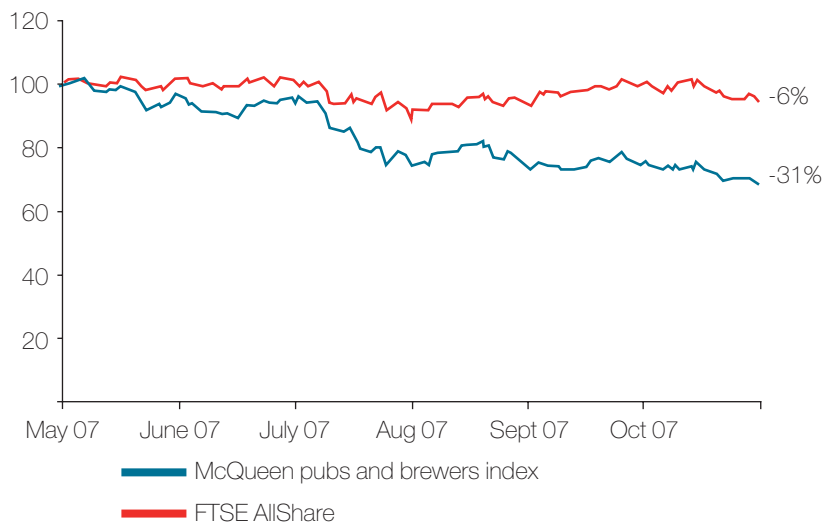
Source: Bank of England publications, November 07

However, it should not be forgotten that the slowing of consumer spending was exactly the desired effect of the interest rate rises in 2007 in order to cool the economy. Not long ago, Britain was heading toward a 15th consecutive year of growth; that was then and this is now. Following the credit crunch, which most educated people in City circles have been expecting for some time, a dose of reality has fallen over the country. Deal valuations, opco/propco structures, and excessive leverage have been curtailed. This is a positive development for the market over the medium-term. It is clear that there has been a bubble in the financial markets and that some level of correction was necessary at some point.

Investor appetite

From an investor's perspective, the sector has been downgraded over the last few months as underlying property values have fallen and concerns over trading, the smoking ban and general consumer confidence have taken hold.

McQueen pubs and brewers index (6 months to Nov '07)



From a private equity perspective, pubs have been out of favour for a while. Restaurants have been in vogue but this is likely to have peaked. Going forward, trade buyers and consolidation, rather than new entrants, will drive the acquisition activity in both pub and restaurant sectors.

And tomorrow?

A consumer slowdown may reduce the volume of transactions over the next year or so. However, the industrial logic of strategic consolidation and deals driven by economic efficiencies remains, and these are likely to continue.

The cost and amount of debt available following the market adjustment will bring valuations more into line with historical multiples. This may also reduce the ability of private equity and property companies to outbid trade buyers. Therefore, the future looks tough but brings with it opportunities, particularly for trade buyers with strong propositions.