

In the past year, five regional brewers succumbed to takeovers after many decades – if not centuries – of independence. **Jim Fallon** explores the reasons why and asks:

# Is consolidation inevitable?

A long time ago, before the Beer Orders, a relatively cosy oligopoly operated in the UK pubs and brewing industry. Things have certainly changed in the past 15 years.

The Beer Orders created an impetus to fragment the pub side and consolidate the brewing and brands side of the industry. We have seen the national brewers exit pub ownership and focus their capital on brand ownership and production. This has led to an inevitable consolidation process. While government pressure has restricted the ability to consolidate businesses to their natural conclusion, market share gains of the key brands are leading to a consolidation of power, in any event.

Since the initial fragmentation of the pub market, the continuing consolidation drive has increased in scale year on year. As with any fragmented mature market, consolidation is a natural process enabling operators to grow profits. This has been supported by an influx of capital from a variety of sources, which has inevitably increased asset prices.

This restructuring of the market has resulted in some fundamental changes in the competitive environment, impacting the smaller brewers and operators of pubs in particular.

In a mature (volume-declining) market such as UK beer, profit growth can only be achieved through price increases, cost reductions and/or market share growth. In order to grow market share and create pricing power, the level of marketing spend behind brands has become key. To make this efficient, brewers have focused large budgets on key brands which has increased the consumer switch from ale to lager, further declining UK ale volumes, and increased competitive pressures on smaller producers of beer

who are unable to compete on marketing spend.

At the same time large-scale pubco consolidation is reaching its final stages, which will result in the very large pubcos seeking profit growth from areas other than significant acquisitions.

With almost 70% of the UK pub industry cashflow being generated by the top five operators, they clearly have significant economies of scale, resulting in the ability to provide a quality product at a relatively low price point compared to the smaller operators. This could be referred to as the “Tesco effect”, whereby the profitability and market power of the leading retailers is used to re-invest a portion of margin gains back into the business to provide both a leading retail proposition and highly competitive pricing, thus further increasing market share. It is incredibly difficult for the smaller operators to compete effectively in this scenario, leading to reducing levels of profitability.

Life in the pub industry is difficult for everyone due to the cost pressures coming through: national minimum wage, utility costs, regulatory compliance, etc. The larger retailers are able to combat these pressures on profitability in a number of ways including: churning the estate and converting managed houses to tenancies; squeezing the brewers for improved volume discounts improving gross margins; premiumisation of the offering creating scope for some price improvement; refinancing to take advantage of lower costs of debt; acquisitions to create synergy value through cost reduction.

To demonstrate just one aspect of what this means practically for the smaller operators seeking acquisitions, the following example is useful.

Effectively, LargeCo (see panel above, right) can pay £136m and achieve the same post-interest profit in absolute terms, that is a 36% higher price. This is purely due to the effects of a lower cost of debt. There are also other benefits, relating to buying power in particular, which compound the problem for smaller operators.

This ability of the large pubcos to continue growing profit and improving scale creates a virtuous circle. The smaller players need to adapt to these market conditions or they will otherwise look forward over the next few years to flat or declining profitability.

However, due to the benefits of scale discussed above, acquisition multiples are at all-time highs. Even if multiples remain at this level going forward, the squeeze on profitability is likely to reduce business valuations over the medium term. Therefore, it is certainly worth considering whether now is a good time to exit the smaller pubco or brewing markets and reinvest elsewhere.

Of the five regional transactions carried out over the past 12 months, only one of them was carried out by way of an auction and this was not overtly public.

## The benefits of scale

	Acq'n value	Operating profit	Interest cost	Profit before tax
SmallCo	£100m	£15m	£7.5m	£7.5m
LargeCo	£100m	£15m	£5.5m	£9.5m

A wide auction process ensures that all potential purchasers are given the opportunity to offer their best price – though this does not necessarily mean that purchasers will not pay the same price (or possibly higher) for a confidential, exclusive acquisition. In a private bilateral deal, the threat of attractive assets being offered to a key competitor is ever present, effectively maintaining competitive tension.

In a market where the key to a successful business is the people, the uncertainty created by a disposal process lasting anywhere between three and six months can be very damaging. If managers in a pub estate expect their pubs to be acquired and converted to tenancy, some may be tempted to “manage down” profitability in the interim to ensure that the purchaser does not impose an overly high rent.

In an auction, the management and shareholders need to submit to their business (and their approach to managing it) being reviewed by their lifelong competitors, not to mention a long list of accountants, lawyers, property valuers, and so on. Often a quick confidential transaction with an experienced trade purchaser requiring limited due diligence is an attractive alternative, so long as the resulting valuation is similar.

A further vendor consideration in the sale of long-standing family owned businesses is the concern for their history and heritage. Will the purchaser continue to produce the beer brands? Will the local name that has been a feature of all the pub signs disappear? There is often an aversion to selling to a buyer who may then dissect and convert, and close or rebrand the business to maximise returns.

In the majority of business sales there is a preferred buyer who can pay more than most competitors. This could be driven by the ability to extract the most synergies, the lowest cost of capital, the greatest strategic need or a combination of all three. The trick is to ensure that this is the party the vendor engages with.

At the end of the day it is a judgement call as to whether the price on the table could be improved through inviting other potential purchasers into a process, versus the risk of material disruption to the business and therefore the likelihood of value loss due to the negative effects on current trading. In the right circumstances, a confidential transaction can prove advantageous to all parties.

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