How can food fill a £1 billion gap?

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Summary

- **Total pub sector sales will fall by £1 billion in 2008 and again in 2009.**
- **Pubs have identified food as capable of plugging this gap.**
- **But £1 billion is a big hole in the accounts of UK Pub PLC - it represents the entire output of the Chinese restaurant sector or the UK sales of Yum! Brands.**
- **Pubs will only increase their sales by £400 million this year and next – well below the required figure.**
- **Consequently, current estimates of 1,500 pub closures per year are on the low side.**
- **The knock-on effect of increased pub activity – much of it price-based – will also ensure closures in the restaurant (and quick service) sector**

Note:
- Pub sector sales were £22.5 billion in 2007.
- Food together with "associated" drinks, were responsible for 28% of total sector sales

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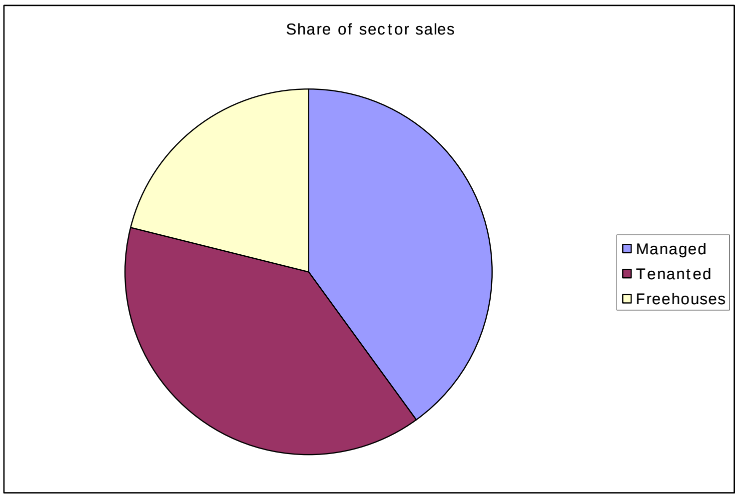
How big is the pub sector and how is it made up?

- **Horizons exclusive research reveals that the pub sector was worth £22.5 billion in 2007.**
- **Alcohol sales account for 66%.**

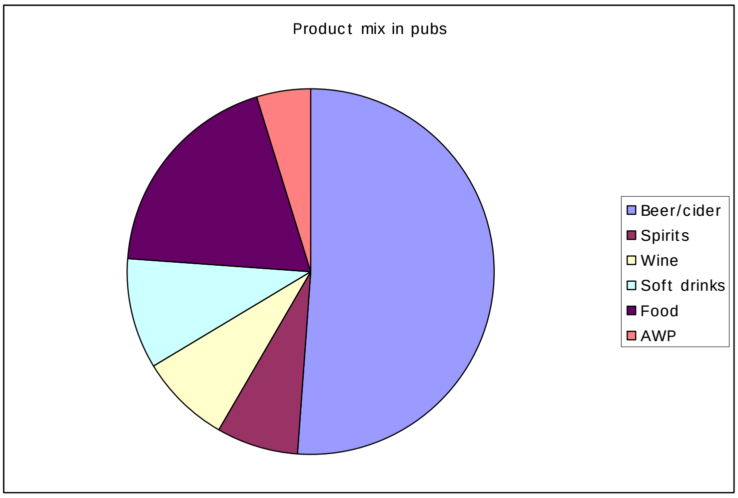
There has been uncertainty about the size of the pub sector for some time – for example, Mitchells & Butlers quote two different figures £19 billion and £25 billion on their website.

Added to this particular uncertainty is a further one concerning the structure of the sales mix, especially the differing role of "wet" and "dry" sales ie cold beverages, especially alcoholic drinks, on the one hand and food on the other.



This uncertainty can be dismissed as nothing to bother about. But not knowing how big the elements of the sector are is leading to a potentially disastrous decision making situation in light of the serious impact of a number of factors which affect the pub sector. Two issues in particular stand out – the ongoing reduction in alcohol demand especially from the "on trade" - primarily pubs - and the fallout from the smoking ban introduced in July 2007.

Horizons have been investigating these issues for some time and are now able to publish the results of the findings of their in depth research. These are summarised in the appendix to this report.



Our research also shows that managed pub turnover is slightly ahead of total sales from tenanted and leased pubs with freehouses taking up a further 13% of the total:

Alcohol sales at £14.9 billion represent 66% of total sales; food, on the other hand, is responsible for 19%:

How important are food sales?

- **Food plus "associated" drinks sales are £6.21 billion or 28% of total pub sector sales.**

In providing a figure for food sales, most operators include sales of "associated" drinks with their food – or "dry" - sales. These "associated" drink sales represent the drink that is consumed with the food.

In practice it is difficult to identify how much drink is consumed in "association" with food. A guest might, for example, have a pint or two in the bar before having a meal in the restaurant. Are these pre-meal pints "associated" with the food? One answer is, yes they are because they represent a substantial contribution to the guest's reason to visit the pub for a meal.

On the other hand, a counter argument is that the two episodes in this example – the pre-meal pints and the meal itself – are different occasions, and the pre-meal drinks might have been consumed whether or not the guest had subsequently eaten the meal.

In practice and typically, pub operators report "associated" wet sales as having the same value as dry sales. In other words, and to average it out over the whole sector, dry sales (excluding any associated drinks) are 19% of total pub sales; to this, pub operators will typically add a further 19% of "associated" drink sales. The total figure – 38% - is then reported as "food sales".

In our view this overstates the role of food, which we believe is closer to 28% when the true value of "associated" drinks sales are included.

We arrive at this figure as follows: restaurants (ie not pubs) sell £0.45 of cold drinks (alcohol plus soft drinks) for every £1.00 of food they sell. Applying this ratio to food sales in the pub sector, gives a sector-wide figure for food plus "associated" drinks of £6.21 billion, or 28% of total pub sector sales.

How is the food dynamic playing out in the pub sector?

- **Pub sector sales declined, in both real and inflation-adjusted terms, in 2006 and 2007. It is set to decline even faster in 2008.**

Of much more significance than the “true” figure of food sales, though, is what is happening to the food:drink dynamic over time, and what do the trends mean for the overall financial health of the pub sector?

The decline in alcohol volumes through the on-sector – especially pubs – is a long term phenomenon; on-trade beer volumes have fallen by a quarter since their peak in 1979. The reasons for this fall are varied and well-rehearsed and include: secular trends towards other forms of alcohol, and aggressive price competition from the off-trade (mainly supermarkets). To these must be added a number of time-specific issues notably the smoking ban (introduced in mid 2007), weather conditions in the summer of 2007, and adverse sporting results (all the time in the case of England).

So far as pub sales are concerned, the fall in beer sales has been masked by a number of counter factors that include rising sales of wine and spirits (and for a while, cider), above inflation beer unit price increases, and the sale of food.

The net result has been that beer sales (in value but not volume) and the overall value of alcohol sales (beer, cider, wine, and spirits) have increased steadily over the last several years at a time when food, too, was showing solid growth.

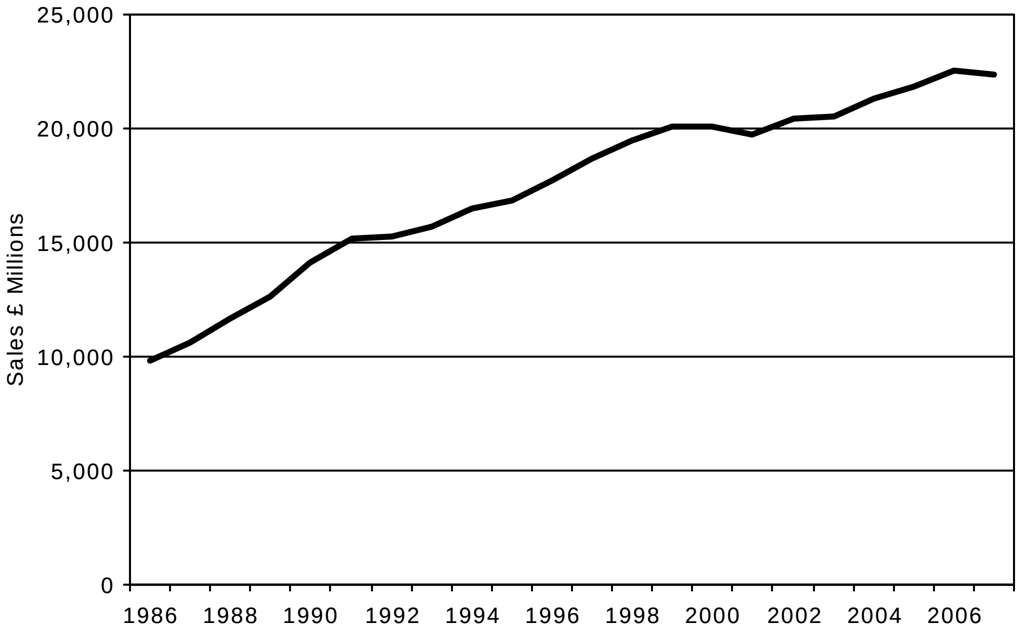
But in the last two years the balance has fundamentally shifted. The reduction in beer volumes accelerated from 2004, and while food sales grew, their growth was insufficient to overcome the decline in total alcohol values that started in 2006.

As a result, pub sector turnover declined, in both real and inflation-adjusted terms, in 2006 and 2007. 2008 is set to show an even faster decline.

In some more detail …

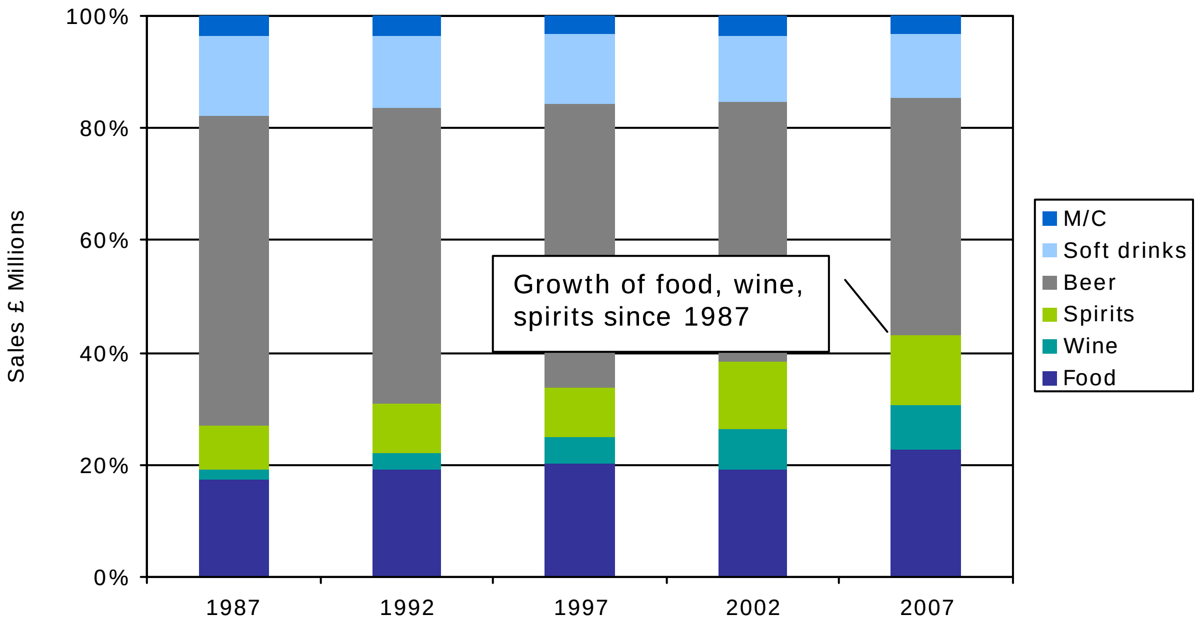
- **Turnover in the pub sector has shown steady and long term growth.**
- **The sales mix has changed fundamentally since 1987**
- **New product categories – wine, coolers, and cider and so on - have not halted the long term real decline in overall beer sales**
- **Food has filled the gap.**

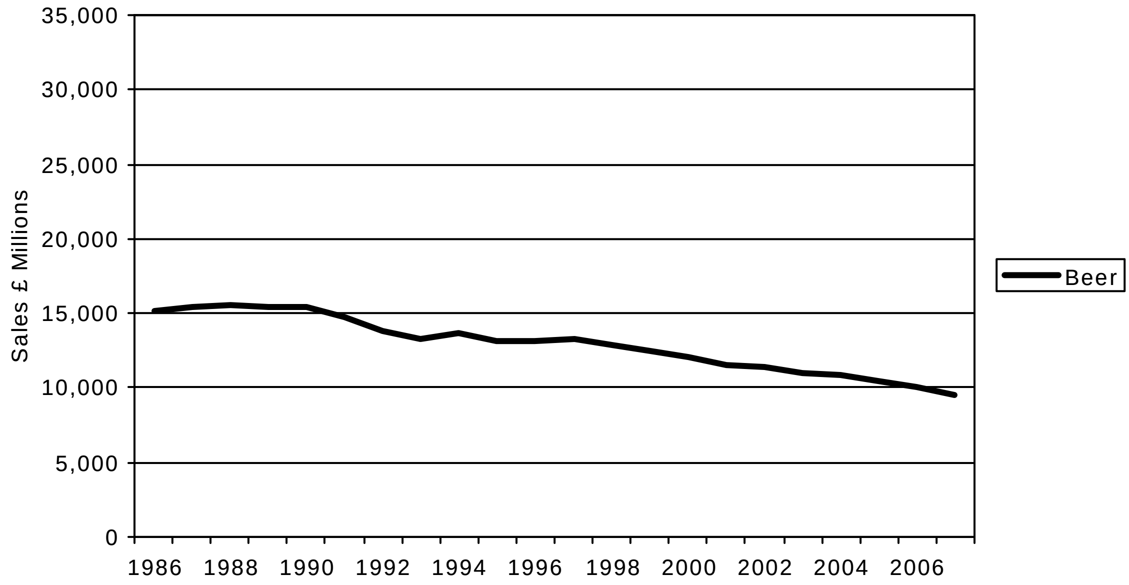
Pub sector sales have grown in most years over the last two decades:



Over the last 20 years the sales mix has changed significantly; beer has fallen from 55% of sales to 43% in 2007 while food, wine and spirits have increased their shares.

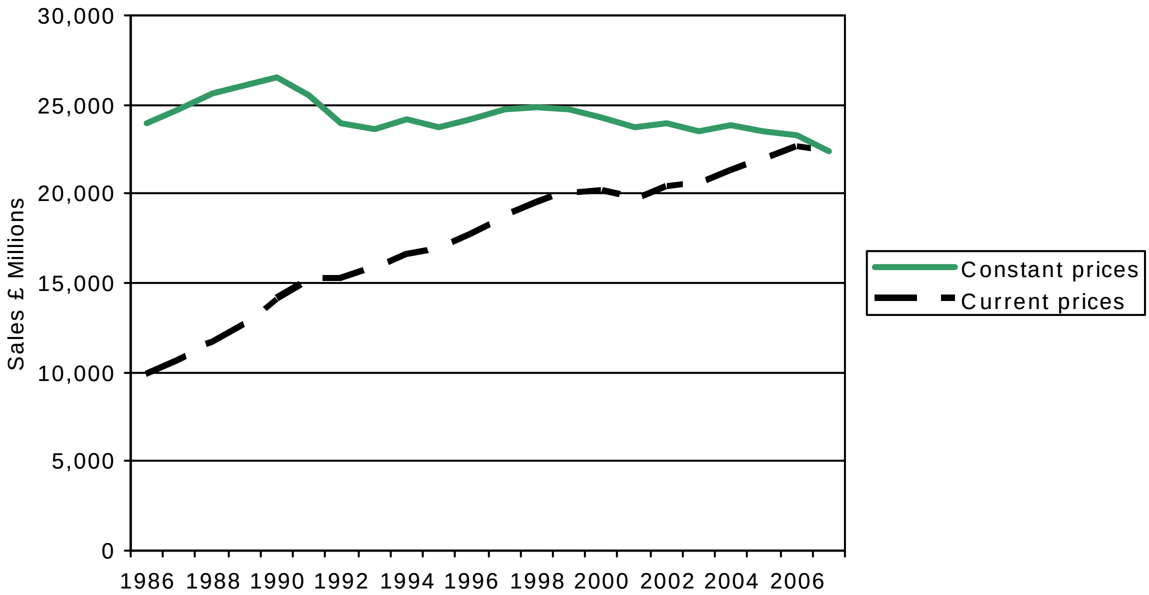
Indeed the pub sector has had of necessity to achieve these sales improvements, since beer sales have not only been declining as a share of total pub sales, but more significantly their sales have been falling in real, inflation-adjusted terms too.





The reasons for this fall, in real and in inflation-adjusted terms, have been noted above – overall declining beer consumption, competition from the supermarket multiples and one-off events.

The successful development of new product categories – wine, coolers, and cider and so on - has not halted the long term real decline in overall sales though. This chart reprises the line that shows growth in current prices; but reporting in current prices disguises the structural decline in the beer category for pubs. The figure for sales at constant prices highlights this fundamental decline:



Where to now?

- **The pub sector is at a watershed – sales have declined since 2006 and will continue to do so.**
- **Many operators believe food can fill the gap**

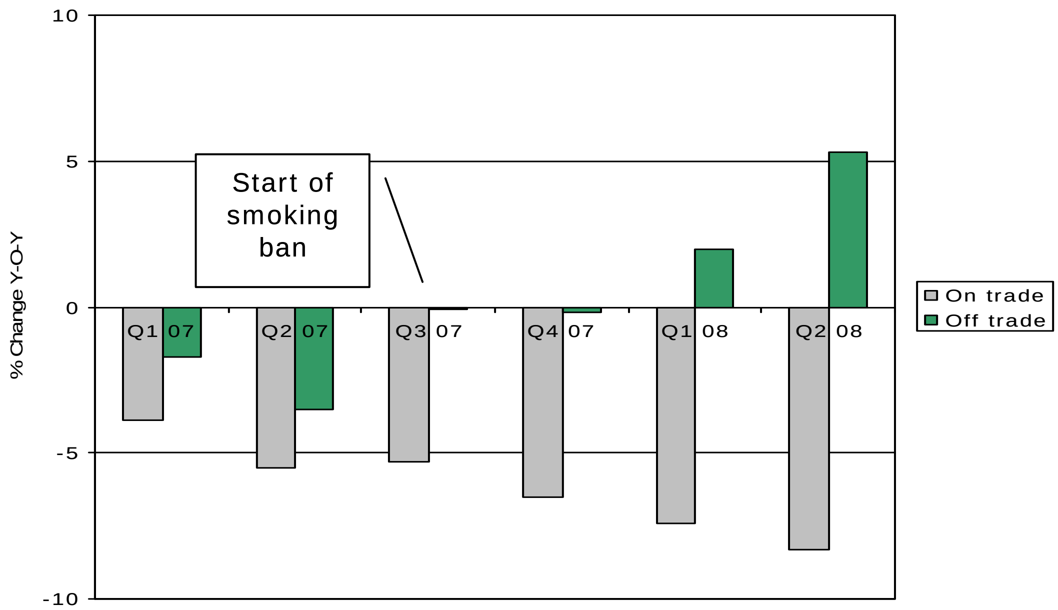
The pub sector has demonstrated resilience in fighting falling beer sales by developing new product categories. However, the well of new liquid products seems to have run dry – or, at least, is not sufficiently bountiful to offset the systemic decline in beer sales.

While the pub sector has been able to offset a 20-year fall with rising sales of other drinks categories, in 2007 for the first time, all these drinks-related efforts were insufficient to overcome the hydra-headed effect of the smoking ban coupled with low price off-trade beer offers.

Despite sustained efforts by the sector as a whole to advance the sale of food, the increase in 2007 was not enough to overcome falling wet sales.

The result was a decline in overall sales – not only in inflation adjusted prices but, for the first time, in current prices too.

And the really bad news is that 2007 was not a one-off. Figures for the first two quarters of 2008 show an accelerating rate of decline in the mainstay beer category (while, it should be noted, off trade sales started to rise):



So this then is the background to the rise – or prospective rise - in food sales in pubs

Food - the great hope

- **Despite the hype, food is unlikely to do all that is hoped for it**

The pub sector has identified a new category which appears to offer considerable promise. Dry sales – sales of food – are the hope for the future.

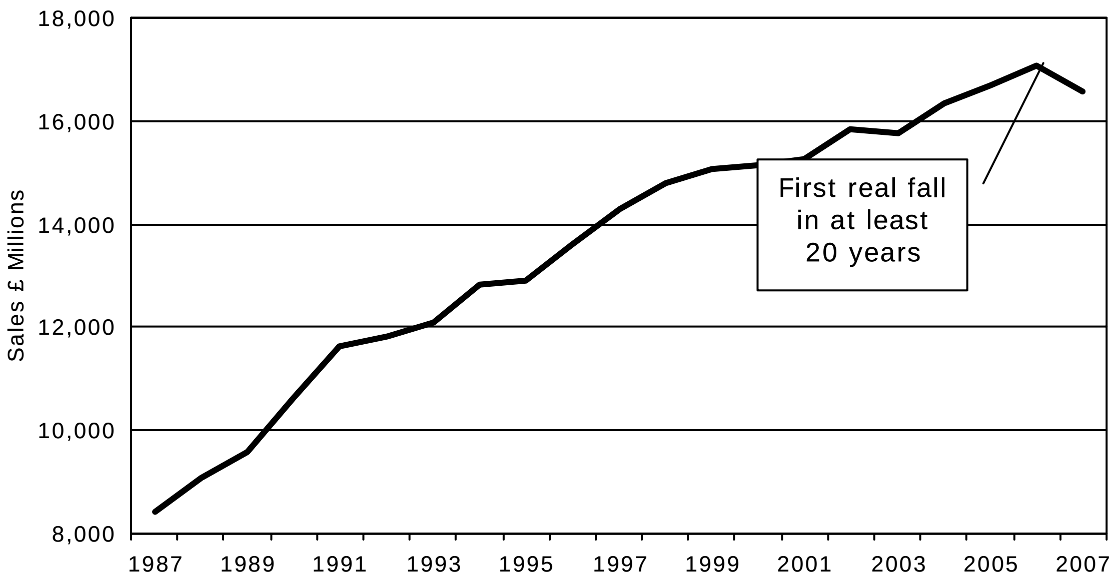
But it is worth noting a number of things about this.

For a start, pubs have been serving food for a long time, and since the early 1970s the sector has spawned any number of food-led offers – Beefeater, Harvester, Chef and Brewer for a start - as well as a list of long gone brands that include Cavalier Steak Bars, Falstaff Taverns, Sullivan's and Chaucer Inns. So serving food is nothing new.

Serving food in pubs started off as another useful income stream and a means to increase customer traffic. But the imperative to make a financial success of it is now crucial

The larger managed chains have been focusing on this for some time now. Marston's, for example, report that food accounts for 34% of turnover compared with 27% five years ago. And a significant part of Mitchells & Butlers almost 2,000 pubs are very much food-focused and led.

But the fall in beverage sales, in 2007, was the first real-term reduction in at least 20 years. The decline of -3% represented a £500 million hole in the accounts of UK Pub PLC:



And this year seems headed for a further loss. If the performance seen in the first half of 2008 is repeated in the second half – a very likely, even an optimistic, outcome – the loss could reach £1 billion.

This is a big hole for food to fill. It represents the entire output of the Chinese restaurant sector or the UK sales of Yum! Brands (KFC and Pizza Hut together).

Not so fast

- **Most pubs and publicans are not well placed to take advantage of food**

Even if food were to fill the £1 billion gap, account must be taken of several other factors especially the differing margins on food and beer (and other beverages).

The gap is more than £1 billion once account is taken of ingredient costs and labour, since the food margin in a pub averages under 30%. The margin on beverages is higher and, accordingly, if they are to make good the lost margin, pubs will have to sell more food than they lose in beverage sales.

An additional complication is the geometry of a pub. Very few pubs lend themselves to efficient restaurant service – they weren't designed with that in mind and consequently their layout, the available space for kitchens, the path from kitchen to table, location of refrigerators and a host of other factors mean that many pubs are less efficient than other foodservice operations, and therefore more costly to run.

What will be the outcome?

- **The target - £1 billion additional food sales per year – is too high**
- **Pubs will try to reach it by – amongst other things – competing with restaurants**
- **All will suffer**

Despite the drawbacks, pubs have shown that they can provide a meaningful foodservice operation. In aggregate pubs sold over £5 billion of food in 2007.

Let's assume that they can add the required £1+ billion a year to their combined turnover, what does that mean in practice?

It means increasing food turnover by 20% a year.

That is an almost impossible challenge even at the best of times. And if that wasn't difficult enough, the additional sales have got to come from somewhere. The out-of-home foodservice market – pubs, restaurants, quick service - was worth £17.3 billion in 2007 and represents an increase of £0.8 billion on the previous year. So pubs will have to attract all the growth in the market – and then about 20% more.

This is clearly unattainable. So we must look at the reality:

- For the first time, pubs are losing beverage sales in real terms
- Collectively, they are striving to make good the difference – in terms of both sales and profit - with food
- But, in aggregate, that is very likely to be beyond them – they lack the skills and resources
- Some pubs – and they are more likely to be in the managed chains – will undoubtedly succeed in plugging their income and profit gap with food.
- But most won't; they will suffer and many will disappear for good. Already this year is on track to see over 1,500 pub closures

But while pubs add food sales – or attempt to do so - the impact will be felt not only by the pubs themselves. In their efforts to win more food business, pubs will add additional capacity to an already overcrowded market populated, restaurants, fast food outlets, take aways and the like – as well as pubs. These competing sectors will feel the wind of competition from the pub sector. And no doubt the wind will be chilling because pubs, some but not all, will base their offer on extra low prices which many restaurants will strive to match.

This extra food capacity in the pub sector is, therefore, a recipe for massively slashed margins across the popular eating out segment. For undercapitalised operations - not only among pubs but also among restaurants, take aways and fast food operations - it means distress and failure.

The extent of this gloomy scenario will depend on several factors:

- The speed and extent to which beverage sales pick up again in the pub sector, or at least reduce the speed of their downward path
- The reality with which pubs, and their competitors in other sectors, approach pricing and cost control
- The speed with which the consumer slows down – and then speeds up? – spending on eating out.

The future for each of these, and the many other, factors is unknown. But what does seem certain is that pubs as a category will suffer – and many individual operations will pay the ultimate price.

Putting some numbers on this

- **Despite efforts to increase food sales, considerably more than 1,500 pubs will close each year**
- **And an unknown number of restaurants and quick service outlets will also close as a direct result of the food-led activity of the pub sector.**

Horizons' figures show that total sales, by restaurants (both full-service and quick service) plus the food and associated drink sold in the pub sector, amounted to £24.2 billion in 2007.

This was an increase of £3.2 billion over the 3 years since 2004 in current prices, and £1.7 billion in constant prices.

Forecasting over the next 3 years is especially difficult at this time of economic uncertainty. But earlier this year, Horizons forecast an increase of £1.8 billion between 2008 and 2011 at constant prices. That implies an increase of just less than £600 million each year.

Our analysis of the needs of the pub sector indicate that in order to survive in its current form, the pub sector must sell up to an extra £1 billion of food and associated drink each year.

We believe this is impossible. In fact we forecast that pubs will increase their sales by only £400 million a year – and the majority of that will come from pub restaurants ie pubs that now find they are selling more food than drink. The vast majority of pubs do not fall into this category.

There are too many variables to forecast how this will translate into actual company performance but it is safe to assume that current estimates of 1,500 pub closures per year are likely to be on the low side.

And to that should be added the knock-on effect of lower prices, and therefore reduced margins, that pubs, in their scramble for food sales, are likely to impose on the restaurant sector. Thus we would expect to see resulting closures in the restaurant (and quick service) sectors over and above any closures that would occur in any case and especially in the light of the current economic climate

Appendix: Alcohol, food and other sales in the pub sector

The pub sector is divided between pubs that are managed by their owners on the one hand, and pubs that are run under tenancy or leasing arrangements with their landlord, on the other. Pubs in the former group range from individually owned freehouses to pubs that are operated by large groups such as Mitchells & Butlers, JD Wetherspoon and Marstons.

The latter group, ie tenanted and leased pubs, is made up of pubs that are owned by pubcos. Pubcos include companies such as Punch Taverns and Enterprise Inns, who enter into tenancy or leasing arrangements with individual publicans (or in some cases, management companies) who run the pubs and pay rent, plus a percentage of beer purchase costs to the pubcos.

The reported turnover figures of pubcos include the rent that they receive from their tenants and lessees; their turnover figures do not include the total sales of the pubs run by their tenants' (or lessees). This is a similar situation to franchised businesses where the franchisor's turnover figure does not cover system-wide sales.

Our research shows that managed pub turnover is slightly ahead of total sales from tenanted and leased pubs with freehouses taking up 13% of the total:

Sales: 2007

	£ Million
Managed	8,998
Tenanted	8,765
Freehouses	4,734
TOTAL	**22,497**

This incomplete reporting of full sales figures confuses measurement of the total size of the pub sector. The following table shows the sales by pubs owned by the larger operators plus aggregated figures for smaller players- and crucially show total sales not merely rental income.

Sales: 2007

	£ Million
Punch	3,039
Enterprise	2,375
Greene King	1,079
Mitchells & Butlers	968
J D Wetherspoon	889
Marston's	569
Fuller Smith & Turner	200
Regent Inns	124
Others	13,303
TOTAL	**22,497**

Within this total turnover figure, beer (plus cider) is the most important line at 51% of total sales; alcohol in total accounts for £14,933 million or 66%. Sales of soft drinks, food and income from AWP (amusements with prizes, otherwise known as machines) account for the remaining 34%:

Sales: 2007

		£ Million
Beer/cider	11,474	
Wine	1,638	
Spirits	1,821	
Alcohol		14,933
Soft drinks		2,185
Cold beverages		17,118
Food		4,286
AWP		1,085
Others		13,303
TOTAL		**22,497**