Langton
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UK LEISURE: A REPORT ON RECENT TRADING

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SNOW, CHRISTMAS, RECENT TRADING & THE OUTLOOK FOR 2011

Feedback from clients & contacts suggests that snow, snow and more snow was followed by perhaps a better than expected New Year. Now the 4 January VAT increase is a major concern but where to from here?

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Contents

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Introduction:

- A brief thank you
- Initial thoughts re 2011
- A brief description of the issues
- Methodology

A brief thank you:

Langton Capital would like to thank those who contributed to the production of this brief document. Your comments have helped us to turn it around promptly and to add what we hope is some insightful detail. We would like to apologise to contributors where we have not had an opportunity to use the information supplied by them directly but we took all of it into account when producing this document.

Initial thoughts re 2011:

The continuing after-effects of the recession, tax rises, duty increases and perhaps ultimately interest rate rises have led to predictions of a not so happy New Year for the UK leisure industry in general and the on-trade in particular.

Regional heavy snowfall in November and nationwide snow and ice from the third week in December did little to help Christmas trading and, with three price rises(1) to pass on to consumers in as many months in the first quarter of what is now the current year, some have suggested that the future is cold and bleak indeed.

However, is possible that opinions have been tainted by a little poor weather. Comps are now easier(2) and, despite the fact that December may have been a disappointing month, current trading has been pretty good as some pent-up Christmas sales have come through and the issues warrant a fuller investigation.

A brief description of the issues:

Timing is everything. Dealing with issues in the short term is all well and good but longer term trends need to be addressed otherwise operators will spend all of their waking hours forever fire-fighting and may miss the big picture. Opinions may vary but we would suggest that there are three time periods (trend types) over which issues need to be dealt with, namely:

- **Secular** - That is longer term or permanent trends such as demographic changes, political or economic pressures, rising prices and the on trade's continuing struggle with the off trade.
- **Cyclical** - Recessions, sporting events, good and bad weather and Christmas come and go but we believe that it was unhelpful that this year's Christmas Eve and New Year's Eve fell on Fridays and thus wiped out two weekends.
- **Exceptional/Short-Lived**(3) - Problems here (and it's perhaps surprising that issues are more often negative than they are positive) can arguably be forgiven. The unfortunate impact of the extreme weather pre-Christmas across the country perhaps falls into this category.

Methodology:

Rather than run through December & early January's trading chronologically, we will take a thematic approach, examining first the secular (in our view the most important), then the cyclical and finally the exceptional (or short-lived) issues that the sector currently faces. This may lead to occasional repetition for which we apologise but we believe it to be the right approach as some issues (a.k.a. problems) will have a longer lasting effect on the sector than will others.

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Secular issues:

- Rising prices
- Government action
- Off-trade competition

Rising prices:

The on-trade will have to cope with at least three types of price rises in the coming three months or so. A number of beer (largely lager) and cider suppliers have stated their intention to raise prices in Q1 2011, the rate of VAT rose to a record rate of 20% in the UK from 4 January and the Duty on alcohol is due to rise by the rate of inflation plus 2% in March's Budget:

- **Supplier price rises:**
  - Diageo, Heineken and Carlsberg are all set to raise their prices – interestingly a number of regional brewers, such as Charles Wells and Brakspear, have said that they will not increase their own-brewed beer prices to their own tenants in the short term

> ***"These increases are going to be very damaging..."***

> ***Worth considering –*** *The moves by one or two regional brewers (to support their tenants via zero price rises) may leave the major pub companies with the vexed question as to whether they can or should follow suit.*

  - Heineken will add 7p per pint from 10th January to the wholesale price of its Bulmer's and Strongbow cider brands
  - Diageo will raise the price of Guinness by 5% from the 1st February
  - In a softening up move, Carlsberg warned of upcoming price increases at its last numbers in November and looks set to carry this through
  - There have been allegations made against the brewers for example "customer may...see supplier increases as profiteering, which increases their resolve to vote with their feet" and quite independently "brewers were quick to profiteer on the VAT increase...when inflation fell and some measures were negative, we never heard any price reductions"

> ***"...we are hit daily with spiralling costs due to...exchange rates, market availability, shortages, frozen ground etc..."***

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- A number of managed operators benefit from contracts that will hold lager/cider prices at their previous levels for months or in some cases up to a couple of years
- However, these operators will ultimately face higher prices and the pub companies that have such contracts in place will have to consider whether or not to pass price rises on to their tenants, even if they themselves are not yet paying the higher prices

- **VAT increases and the upcoming increase in Alcohol Duty:**
  - VAT rose to an all-time high rate of 20% on 4 January 2010
  - It has now risen from an albeit temporary 15% only 13 months ago to its present rate of 20%
  - The Chancellor has resisted invitations to commit himself to reducing VAT back to 17.5% once the deficit has been materially reduced
  - Tory comments along the lines of it being the 'fairest tax' would seem to suggest that it may be here to stay
  - Respondents see this as very visible and understood by their customers and believe that is should be easier than other increases to pass on
- **Beer duty is to be increased in the 23 March budget by between 5%-7%**
  - The increase will be 2% above the rate of inflation, in line with Alistair Darling's "alcohol duty accelerator" which was not abolished by the cash-strapped new coalition government

Worth considering – Beer Duty has risen by 26% since 2008 – it will rise by another 5% to 7% in March

- **How the pubs have reacted:**
  - There have been different views on how to deal with the various genre of price increases
  - The most common approach amongst larger organisations was to menu fix in November/early December to deal with the VAT increase on food, and then begin raising drinks prices at the start of January and to effectively deal with these price pressures one at a time
    - This has the advantage of allowing companies to bank a c2.1% price increase for an average of six weeks (at least on food sales) through H2 November and over the important Christmas period
    - A sizeable number of smaller operators (and a number of tenants, according to their BDMs), have decided to raise drinks prices in March/April, at the same time as the Budget and to coincide with

Worth considering - Cash margins versus percentage margins – During times of rising prices, operators will naturally prefer to maintain percentage margins as inflation then provides something of a windfall – this may not be possible during early-2011 some supplier price increases in order to avoid having to raise prices 3 times

- There is a building feeling that operators may have to swallow at least one of the price increases – this will clearly impact margins
- A relatively small number of operators increased liquor prices in November but consider that a further "potential 15p per drink is needed to break even on cash margin between now and April"
- One respondent commented 'it will take a lot of nerve to maintain margins once the Spring Duty and supply chain increases hit"
- There are arguably even more serious problems amongst tenanted organisations. Some BDMs are concerned that their tenants have not taken their advice into account and have even now, in early January and post the VAT increase, not yet changed their menu prices. This may leave pub goers faced with a rise in both food and drink later in January
- The fear here, of course, is that pub-goers will vote with their feet and, as one operator says, "volumes, we fear, will continue to decline"
- There are also indications that some tenants are fearful of jeopardising their relationship with their customers and may be taking their advice (i.e. that of their customers rather than that of their BDMs, accountants or bank managers) and are considering absorbing all drinks price increases themselves

"…fuel prices may drive distribution costs and potentially impact pricing later in the year…"

Worth considering – *There seems to be a building sense of exasperation amongst BDMs re the behaviour of their tenants*

Government Action:

This comes in a number of guises. Alcohol duty and the direction/nature of taxation is down to Government as, ultimately, is the governing of the relationship between the on-trade and the off-trade when it comes to the retailing of alcohol.

"…politicians all suck…"

- **With regard to the off-trade (see also below):**

- The general opinion amongst publicans and operators is that this administration is no more likely to resolve the supermarket drinks pricing debate than was the previous administration
- Scepticism abounds; as the Who sang 'meet the new boss, same as the old boss' and note comments such as "the new government has done nothing significant to help the pub industry, nor do they intend to"
- And a more restrained "the lack of movement on minimum pricing is frustrating"

"…there is no way the incumbent Government will address price differentials in an effective way…"

- **With regard to health and other issues:**
  - The Government is seen as keen to piggy-back on health issues to raise revenues
  - The continual growth of soft drinks' sales and the decline in alcohol sales, which was reported by some operators, could indicate the growing strength of the health lobby

Off-trade competition (see also Government above):

The UK's supermarkets have been a thorn in the side of the on-trade for many years now and at no juncture has it looked as though there would be any let-up in this pressure. Innovative pubs and pub companies have evolved their offer towards food, families, females, the grey-market, entertainment and ambience and away from a wet-led offering differentiated only by price. We would categorise comments and contributions to our survey as follows:

"The coalition is making all the right noises, but we need action…"

- **Changes in consumer behaviour (which are likely to be permanent or semi-permanent):**
  - There is a general concern with regard to preloading
  - The trade remains genuinely and deeply concerned that drink is sold at a loss into an unsupervised, park-bench/domestic party market by the big supermarket chains
  - The supermarkets are accused, probably rightly, of selling alcohol, a Known Value Item, at a large loss to generate footfall and then of ignoring any consequences flowing from these cheap sales
  - Supermarkets often sell alcohol to the general public at cheaper prices than the on-trade operators themselves can purchase it

"…many pubs, I feel, will absorb the increase as they are fearful of widening the price differential with the off-trade even further…"

- Bars may then be blamed for the behaviour of individuals who may not necessarily ever have been customers in the first place
- Operators see the on-trade as lacking in unity
- This is thought to be impeding the industry's efforts to mount an organised defence against the supermarkets and also against the much more well-organised health lobby (see above) and sensationalist media
- The Daily Mail comes in for particular criticism with the current Government accused of pandering to the newspaper's leanings in the same way that the previous Labour administration did

"Pocket money drinks prices for pre-loading and then the late night bars get to be blamed…(they are) no help at all!"

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Cyclical occurrences

- Continuing (post-recession) financial pressure on consumers
- Tenancy churn and the January effect
- The fall of Christmas/ New Year on a weekend

Continuing (post-recession) financial pressure on consumers

Leisure spending (as opposed to that on food & shelter) is discretionary and, as such, is particularly vulnerable to hard financial times as consumers tighten their belts. Whilst the recession officially ended in Q4 2009, spending remains under pressure and, with personal tax and perhaps interest rate rises in the pipeline, this is likely to remain a feature for some time to come:

- **Unemployment:**
  - With unemployment set to rise to a 17 year high of 2.7 million (or 9% of the workforce) according to the Chartered Institute of Personnel and Development, consumers in general will have less money to spend on leisure items
  - Arguably, although c91% of the workforce will remain employed, spending patterns may be impacted adversely due to an indefinable 'worry-factor'
- **Rising prices of commodities & essential items:**
  - Rising petrol prices led to fears amongst some contributors that destination pubs will be even more badly affected in January as customers are less inclined to travel
  - Rising prices of 'necessities' such as petrol will also adversely impact consumers' ability to spend on leisure items in general
  - A number of respondents pointed out that, with heating oil at up to c70p a litre, rural pubs found the going tough as a large portions of their client base were themselves out of pocket and had to choose between heating their houses or consuming alcohol
- **The threat of rising interest rates:**
  - Inflation was mentioned as a potential problem by a number of respondents, a particular fear being that rising prices may persuade the Bank of England to put up interest rates sooner rather than later

> *"…I expect there to be serious individual tenant failures in the first quarter…"*

Tenancy churn and the January effect

More than 10% of tenants are likely to churn in any given year. But on the 'plus' side, rising unemployment may have the effect of creating more potential tenants for pubcos as the recently unemployed may wish to run pubs. Amateurism is clearly a risk and, as regards seasoned tenants, a considerable number hand back keys in January (why wouldn't they?) and January 2011 could be heavy month for churn.

The fall of Christmas/ New Year on a weekend

New Year's Eve and Christmas Eve fell on a Friday this year, effectively denying the industry two of the busiest days of the week. Christmas Day on a Wednesday (therefore the two Eves on a Tuesday) would have been helpful but this unfortunate timing (i.e. sacrificing weekend days for the bumper Christmas trading days) will occur every 3 to 4 years and the trade just has to live with it.

> *"…we saw the fall of days working slightly against us…"*

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Short lived events

- The weather
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The late-November and December weather

Winter comes once a year but the end of 2010 has been exceptional. December 2010 was the coldest since the 1890s, beer gardens went empty, even paths to the front door had to be dug out and the year of 2010 as a whole was the coldest since the mid-1980s.

As regards the final six weeks of the year, snow fell in the North of England and in Scotland in late-November and autumn (yes autumn) temperatures fell to minus 14 in the major cities in the north and lower than that in the suburbs/rural areas.

Snow, ice, untreated pavements etc. hurt trade and, with the original deposits still on the ground, snow fell again around 17 December, this time extending to the South and West of England and to London. Drive-to venues suffered perhaps more than most and Christmas trade was lost (rather than postponed as might have been the case with some physical items such as Xmas presents or hard goods) and December, overall, was a disappointment which, in some instances, could be a pub killer. The play by play shows how the slow motion car-crash of a month unfurled.

- Large increases in Christmas pre bookings for casual dining and food-led pubs had led some to predict a buoyant festive season

Worth considering – *There are some concerns that food and drink stocks, which were tough to move around during the snow, may be unavailable or in the wrong places going forward*

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- The snow caused observers to re-assess their relatively bullish expectations (although the initial snowfalls were confined to the North East of England and Scotland) and elsewhere life went on
- Many parts of the country were hit twice, what would likely have been the busiest week of the year in the South East and London (3rd week of December) was heavily disrupted and large numbers of Christmas bookings were lost with a smaller number being postponed into January
- The heavy snow affected transport which made life harder for customers and for deliveries and, although heroic efforts were made to keep pubs supplied, there were some stock-outs at absolutely *the* worst time
- There were a number of very bad individual performances bring forth comments such as "…December was 37.5% down on December 2009…I think 2011 will be much worse…"
- The postponement of some functions into January may mean healthy early-2011 trading but consumers are not likely to be in as buoyant a mood as they would have been with a two-week holiday to look forward to
- Commentators were almost universally negative:
    - "…the snow on the weekend of 18th utterly wrecked whatever run-in to Christmas we may have expected…"
    - "…the third week before Xmas has severely dented our momentum…"
    - "…the residual problem of slippery roads and ice appeared to affect (particularly pensioner) trade well beyond the initial dump of snow…"
    - "…the snow (on 17th & 18th) came at the worst possible time…and 'mad-Friday' was a complete damp squib…"
    - It was "really damaging, both for the London-based operations and the suburban ones"
    - It was "a big pain" or "snow was terrible for business, especially in early December"
    - Or on a more restrained note "the snow was not insignificant…"

"…many people have rebooked (but) will dine more cheaply in January…with less people in the party…"

Understandably though rather perversely, the poor weather was felt most keenly by some of the normally more resilient operations as transport seemed to grind to a halt and even the rivers froze. We would suggest that:

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- Destination food led pubs were badly impacted by the bad weather with older, better off customers and families unwilling to risk life and limb for a nice meal in the country
- Operators were left cursing un-gritted roads but could do little about it
- Sounds silly but businesses in hilly areas fared particularly poorly
- Wet led local pubs performed relatively well; in some instances, their local populations were cut off by snow, couldn't get to work and couldn't go shopping etc. which left some (otherwise struggling) pubs as an attractive alternative
- Some have suggested that, despite its younger clientele, "late night has been hit pretty hard"
- Performance was heavily influenced by geography, with reports that on Saturday the 18th December certain units in snowed-under parts of the UK, e.g. Birmingham and Bangor, trading was down by 70%, whereas trading in Leeds which was spared the snow (but which had been badly hit earlier in the month and where consumers had been suffering from cabin-fever) saw an increase or 25% in trading

"…my guess is that Christmas 2010 was down in real terms on 2009…"

Towards the end of December, many operators believe that they got a taste of what could have been. LFLs in general for the end of the month rallied strongly and, though an element of it would have been down to under-spending earlier in the month, pubs and bars generally performed better than last year, leaving the more fortunate operators just into the black for a month that most had written off.

Worth considering – *when the snow let up, consumers had to decide whether to shop or drink and they chose to shop leading to comments such as "…eating out in shopping malls was ok…"*

Current and future trading:

Good trading has continued into the traditionally low-volume month of January. Of course, if an operator could have chosen a good month, it would have been December rather than the relatively flimsy January but stronger low-season trading is a good rather than a bad thing. Comments included the following observations re January:

"…we are promoting and discounting heavily in January (to) ease the pain for customers…"

- The fact that many of the Christmas parties that were booked for December and subsequently cancelled could be indicative of a bumper January for some operators
- We would inject a note of caution here, however, as the spirit and excitement of mid-December will be hard to replicate
- Furthermore, there will be a significant cash flow squeeze this month as many companies will have to pay their suppliers for last month's stock, they will have to pay Q1's rent in advance as well as Q4's VAT
- And January is still January & one respondent suggested "…my gut feeling is that eating out will feel a bit of a squeeze (in January)…"
- Respondents pointed out that less product was ordered around the time of December's snow suggesting that operators may have a limited amount of stock to actually sell, even if demand perks up
- And there is some concern that January trading 'proper' may not start until the second half of the month – e.g. "…I see next Monday as being the start of the very quiet period…"
- Overall, it's worth considering comments such as "anyone who looked to bank winter cash to hibernate until spring will have had a nightmare"

As regards pricing and promotions:

- Some contributors point out that discounting in January 2009 and January 2010 was severe and early signs are that it may be less so this year – see earlier comments on JD Wetherspoon and its January Sale etc.
- Other operators suggest that "the big boys are continuing to pile on pain through discounting and everyday low prices"
- Operators will be looking to pass through price increases where possible and are hoping that consumers, as they

Worth considering – *December week 5, which can be deadly quiet, was much better in 2010 as cabin-fever afflicted revellers came out*

January is "…looking good on paper for bars & restaurants…"

read headlines focusing on the rise in RPI, will accept this

- In some instances, margins will be improved as customer databases are mined - though 2010 offers are meaningful, discounting last year in some instances was even more profound

We're offering 20% VAT-free this Jan compared to 25% off last year "so we may be quids in"

As regards other issues:

"…we're offering 30% off to loyalty card customers for the next three weeks…"

- A number of observers expressed concern about the banks' attitude towards lending. There is very little of it but, where loans have already been made, operators are not sure whether to be grateful or very wary indeed when their bank seems willing to turn a blind eye to breaches.

Other leisure operators:

- Hotel companies
- Travel companies
- Betting & Gaming companies
- Health, Fitness & Visitor Attractions companies

Hotel companies:

Although time pressures have constrained us largely to the on-trade (pubs, bars, restaurants etc.), we did receive a number of comments from hoteliers. These included:

- The London and Provincial markets are still completely out of tune with each other; London remains very strong
- Airport hotels initially benefited from travel disruption but this was a relatively short-lived benefit
- Some believe that most operators in the Provinces had a worse 2010 than 2009
- Snow adversely impacted trading in the North and in Scotland in early-December
- Christmas trading was generally good – although more so after the big day itself, with New Year relatively strong – this accords with the trading patterns mentioned by on-trade operators
- Operators suggest that 'inflationary pressures are increasing' and say that they are 'having to work hard to hold food cost prices over the next 12 months'

> ***"Christmas trading bounced back after a difficult (rest of) December"***

Travel companies:

Clearly these were directly affected by the bad weather as travel was one of the first sectors to suffer in the wake of the snow. Comments include:

- Getting customers into the air has been difficult (or impossible) but forward bookings have been good
- Online booking systems have been one of the beneficiaries of the snow as consumers have struggled to spend elsewhere when they have been unable to leave their house
- Although customers have been wary of failed-deliveries where physical goods have been concerned, they have been happy to book holidays online
- Winter bookings are said to have been good with the snow, perhaps, giving would-be holidaymakers a feeling of what they were missing on the slopes

Betting & Gaming companies:

Bingo companies suffered as a result of their customers' demographics and we have covered this issue in greater detail in earlier notes. Betting shops opened but there was often little by way of sporting events to bet on. Casinos fared less badly and in all cases the snow-affected weeks were worse than others with a bounce-back in evidence towards the end of December.

Health, Fitness & Visitor Attractions companies:

Wherever leisure companies relied on travel, they suffered a loss of trade when the snow fell. Comments include:

- Car parks were a major issue, even when consumers could be persuaded to leave their fire-sides – drive-to venues were impacted more heavily than were 'walk-past' venues although longer term operators see faster growth coming from the former
- Cineworld has this morning commented upon the impact of the December snow – although it did not give details, it says that its sales were impacted
- Race course operators were clearly hurt by the reduced number of race meetings

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Notes:

1. *Namely the 4 January increase in VAT, the increase in Beer Duty (inflation plus 2%) due in the 23 March Budget and supplier price increases.*
2. *The first ten days of January, particularly the first full week after New Year, were blighted by snow in 2009.*
3. *It is important to note that the above assessment of what is long or short term is taken from present perspective and that exceptional events that happen to recur may be considered less exceptional with hindsight.*