EMCC case studies

Financial markets driving change at company level: Pubmaster

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This case study is available in electronic format only.
About the Pubmaster Group

Pubmaster is the third largest operator of tenanted public houses in the United Kingdom. It has supply agreements with national and regional brewers as well as other drinks’ suppliers in order to provide the tenants of its pubs with a range of alcoholic and non-alcoholic drinks. Pubmaster also provides marketing, business and information technology (IT) support, and training to help its tenants build successful businesses. The company employs about 270 people and has a portfolio of just over 3,000 pubs in the UK.

The current structure of the Group is the result of a sequence of reorganisations, acquisitions and disposals, and financial transactions, beginning in 1988 when the business was part of the Brent Walker Group. These changes were driven out of the necessity to develop an adequate management and financial structure to transform a business into a growing, profitable entity.

Brent Walker Group was a conglomerate with interests in alcoholic beverages, pub management, hotels and bookmaking. The pub business within Brent Walker was relatively small and comprised both managed and tenanted pubs. However, the pub industry was about to go through some major changes following a report on ‘The supply of beer’ by the Monopolies and Mergers Commission (MMC) in 1989.

The MMC report resulted in a change in UK legislation, collectively known as the ‘Beer orders’. For this case study, the ‘Tied estate order’ of 1989 is of particular relevance since it forced large brewers to review their pub estates. They had to either reduce the number of pubs to less than 2,000, or release half of the excess over 2,000 from their tied arrangements with the brewery.

Consequently, many of these brewers decided to sell a large number of tenanted and managed pubs. Over 19,500 pubs were sold between 1988 and 1992, according to the British Beer and Pub Association. Brent Walker bought 800 pubs in December 1988 to add to the 300 it already held. Brent Walker Breweries Limited initially operated these, but a new division, named Pubmaster, was created to manage the pubs separately from its other interests. This was a result of both the disposal of the brewery interests in 1992 and a generally poor reputation of the Brent Walker name at the time. This move reinforced the external perception that this was a separately managed part of the group, and contributed to clarify the company’s position regarding the new legislation.

The trading position of the Pubmaster business at the time was not strong. With beer consumption falling, it was more difficult to assess the financial risk involved in lending and there was a reluctance to extend further traditional funding for expansion. However, it is in the nature of a pub’s business to be continually refreshed and updated so that premises attract customers. An increasing popularity of theme-oriented pubs and the influence of trends and brands on consumer loyalty means that a pub operator has to be in a position to invest rapidly in order to remain competitive. This was not the case at Pubmaster and the management realised the need for a change in the financial structure to allow the business to move forward.

By the mid-1990s, the pub estate had grown considerably and, through the process of reorganisation and acquisition of assets, a number of companies were created that now make up the Pubmaster Group. For the purposes of this case study, the companies involved in these transactions are referred to as ‘Pubmaster’ or ‘the company’ but, from a commercial and legal point of view, a number of companies in the Pubmaster Group were involved. Figure one reflects the corporate structure.
The restriction on investment limited the number of acquisitions that the business could make. In general, it was normal for the company to buy the freehold of the premises it operated. In order to increase its portfolio, Pubmaster created a scheme in 1992 whereby it would lease pubs but retain an option to buy the freehold. Under this arrangement, it took about 600 pubs from Bass and over 170 from Whitbread, two of the large brewers making disposals at the time. In 1994, a further lease was taken on three portfolios of pubs held by the Scottish Amicable Life Assurance Society.

Options to sell the pub operations were being considered by Brent Walker but flotation was not deemed to be a viable route. Instead, the management decided to structure a traditional leveraged buy-out with HSBC in 1996. This move provided borrowing to fund the management’s purchase of equity. A venture capital firm Bridgepoint bought 30% of the equity while other principal investors WestLB AG and Rotch Property Group were also brought in. A roll-over bond option was held by Brent Walker. Pubmaster thus became a separate entity from Brent Walker.

The management buy-out in 1996 established the company on a sounder financial footing, and provided vital funds to invest in supporting the strategy of growth centred on development and acquisition. At the same time, the Pubmaster portfolio contained both ‘managed’ and ‘tenanted’ pubs. The management knew that the company could not compete effectively in the managed pub sector since they did not have sufficient premises of this type to make it viable. To do so would have meant increasing their portfolio to something over 200 premises, at the time equating to an investment of about £80 million. For Pubmaster, tenanted houses provided a more profitable business opportunity and therefore a
strategic decision was taken to dispose of their managed houses in 1997, thus raising £37 million. This move simplified business operations and provided a greater focus.

The management of Pubmaster began to look for other ways to raise long-term finance which fitted with the nature of the company’s business. At the same time, the venture capital company was looking for a way to exit the business. The concept of securitisation was at the time uncommon in the UK, though more developed in the US. Pubmaster spoke to a number of banks about securitisation and realised that this provided an opportunity to raise long-term capital based on the cash-flows generated from the pub estate.

The process of securitisation involved separating the pub assets of the company into those that would be included in the ‘Securitisation Group’ (as shown in figure one), and those that were not suitable to be included in the securitisation. An issue of secured notes was then made, providing the company with funds for investment against a fixed rate to be paid to the investors. The securitisation agreement sets out conditions that must be maintained over the period of issue, including debt service cover ratios (DSCR) for the different classes of notes.

In June 1999, Pubmaster’s first securitisation raised £305 million and funded the acquisition of 1,277 pubs. A first tap issuance of £109 million, completed in February 2000, reflected the acquisition of an additional 565 pubs. The pro forma EBITDA of Pubmaster rose from about £31 million at the end of fiscal year 1998 to £48 million (unaudited) at the end of fiscal year 1999.

The venture capital company, Bridgepoint, made its exit from the company after the first securitisation through an asset-backed buy-out, which was arranged by West LB. West LB also took an equity stake in the business as well as arranging and participating in the debt vehicle. A second bank, Lehman Brothers, became involved subsequently to arrange a follow-up round of financing and also took a participation in the equity of the venture.

In November 2002, a second tap issuance reflected the transfer into the Securitisation Group of 21 tenanted pubs acquired in Scotland in August 2001 (the Pubmaster Taverns portfolio), a further 38 pubs acquired in Scotland in January 2002 (the Pub.Com portfolio), and 1,200 pubs acquired in the UK in February 2002 (the Inn Partnership portfolio). The pro forma run-rate EBITDA from these acquisitions was £62.5 million on 28 July 2002.

**Company strategy**

The Offering Circular issued by Pubmaster Finance in November 2002 states the company’s main objective to increase shareholder value. This was to be done by improving the overall quality of the offering of each of its pubs and thereby maximising the income which is earned from each pub.

Central to delivering this strategy is Pubmaster’s programme of ‘churn, invest and acquire’. The three components to this model mean that:

- the company actively assesses the potential of pubs within its estate against set criteria and disposes of those that are deemed unprofitable. Since 1997, this is a formalised annual process in which pubs are classified as ‘Disposal Pubs’ when they do not meet the criteria set for return on capital, the income level for Pubmaster, and a sustainable level of income for the pub tenants. These pubs are then generally sold in blocks to other pub companies, with any remaining properties offered either as a going concern or for alternative use, such as residential development.
investment in pubs with development potential is discussed with the tenants in order to enhance the value of the business. In the case of a suitable project, an investment plan is drawn up. Investments over £10,000 require board approval. A tender process is used to select contractors to undertake the work. Over a five-year period, Pubmaster’s management then monitors the performance of the investment. This information is made available for the on-going process of investment.

acquisition of new properties occurs through a system of monitoring the marketplace, using a financial appraisal process to identify preliminary targets and to undertake more detailed assessments of revenue potential. Pubmaster prefers to secure an exclusive position with the vendor as early as possible in the purchase, and uses independent sources to check if the price is realistic for market conditions. Through acquisition, the company believes it can strengthen its financial position by improving operational synergies, such as IT and purchasing.

The role of financial markets as a driver of change

Management perspective

Traditional banks provided external finance to Pubmaster at the time it was created within Brent Walker. During a creditors’ meeting, it became obvious that a number of banks were involved, with little awareness among them of the whole picture. The agreed programme of ‘churn and invest’ offered Pubmaster a way to move forward, despite the fact that it would not borrow more at the time. However, it could, subject to certain conditions, retain the proceeds from disposals and reinvest in the remaining estate or make new acquisitions. This provided an opportunity to sell off the ‘bottom end’ of the portfolio and focus on its most profitable outlets.

The decision to remain a private company was felt by management to be an important one. While they lost the flexibility of trading equity, they were not forced to go to the public financial markets to raise money. For the time being, the management does not feel the need to review this decision. Working with a small number of significant investors suggests that there is less exposure to the volatility of the market, although the gathering pace of the dot.com boom in the late 1990s meant that many finance houses were moving investment from traditional businesses to high technology. At some point, Pubmaster thought this affected its relationship with the venture capital investor. In 2000, Bridgepoint was bought out of the company, four years into its investment, which is not unusual for this type of investor.

The management of Pubmaster first looked at securitisation as a means of financing growth. It represented a concept that they had ‘heard of’ and were ‘aware of’. They invited a number of banks to present on the subject; this helped them to identify which firms had the specialist knowledge in their teams. As it was not a form of finance commonly used by Bridgepoint, the venture capital house, there was a period of exploration and discussion between Pubmaster and Bridgepoint, clarifying how this would work and what it would mean in practice for all parties. There was some concern about Pubmaster going outside its original business plan, but these issues were overcome by the good fit between securitisation’s long-term provision of finance at stable rates (a cost of capital of about 7%) and the ability of Pubmaster’s cash-generating business to service the debt.

The churn account is, within the bounds set out in the finance agreements, at the total discretion of the Pubmaster management. This means that management can buy, refurbish, reinvest or upstream funds to the parent holding company according to the business’s requirements at the time. Within the estate, they also have authority to sell pubs that are classified as ‘non-core’. Core pubs in the Securitisation Group require consent from the Security Trustee before disposals can occur. This level of operational flexibility is not typical of many financing arrangements, and leaves management able to respond quickly to changes in the market place or to seize opportunities that arise. The decision-making process is significantly shorter. A key benefit is that transactions can be kept out of the public domain until exclusivity to negotiate has been gained.
Without the ability to acquire and dispose of properties through the churning process, there are limitations to the growth potential of Pubmaster. For example, there was perceived to be a general limitation in organic growth at somewhere around 7-8%. However, there is a difference in attitude between debt and equity holders, and the demands placed on the company are not the same from each source. Management has to strike a balance between the interests of the debt holders, who are anxious to protect the value of the underlying assets, and those of the equity holders who are more concerned with capital growth and prospective exit strategies for their investment. Management also balances the incentive of its financial advisers, who wish to generate fee income, with the strategic goals of the Group. This aspect of the relationship is successfully managed and the on-going involvement of WestLB since 1996 suggests that it remains satisfactory.

Pubmaster’s management also feel that its staff are a key group of investors. In the MBO, about 20 senior employees invested in the company. However, the opportunity was set up for all staff to invest. This was not done on the basis of share options or as part of the remuneration package. Instead, staff are offered shares for sale through an internal market (with accountants from PricewaterhouseCoopers setting the fair value). About 60-65% of staff have taken up the opportunity. It is believed to enhance motivation and to improve retention; it also makes employees think about waste and expenditure in a way which contributes to the success and profitability of Pubmaster.

Conclusion

The management team has successfully built a pub estate which started from a small base of about 300 premises in 1988 to one that has grown 10-fold to 3,100 premises in 2002. This counts as a major achievement. The decision to remain a private company rather than to go to the stock market, and particularly to seek out innovative ways of funding their business, is felt by the management to have played a key role in the success of Pubmaster.