William Hill PLC

Response to the Competition and Market Authority's (**CMA**) notice of possible remedies (**Remedies Notice**) in respect of the proposed acquisition by Ladbrokes plc of Gala Coral Group

Non-Confidential Version

Background

1 In its Remedies Notice the CMA has requested views on the following questions:

(a) whether divestiture of a Ladbrokes or Coral LBO in each of the 659 overlap areas in which the CMA has provisionally identified an SLC would be an effective remedy;

(b) what constitutes an acceptable minimum scale for any purchaser/purchasers of the divestments;

(c) whether Ladbrokes and Coral should be allowed to propose which LBO to divest in each local SLC area, subject to the consent of the CMA;

(d) whether the method or process by which the divestiture is undertaken should be prescribed, and if so, what factors are relevant to determining the appropriate implementation process; and

(e) how long a period of time should be allowed to Ladbrokes and Coral to secure binding contractual commitments from one or more suitably qualified purchasers to acquire the LBOs to be divested.

2 WH addresses each of these in turn. WH will respond separately to the CMA's provisional findings report, and does not therefore address that report and the CMA's substantive findings of SLCs in this submission. In particular WH is concerned that the basis for the CMA's local markets analysis is not sufficiently transparent. In places it is not clear how assumptions that have been made are supported by the evidence, or whether those assumptions have a material impact on the identification of local overlap areas. This will be addressed separately and in greater detail in WH's response to the CMA's provisional findings report. Nonetheless, WH is broadly supportive of the CMA's conclusion that there are SLCs both at the local and national level which must be addressed, whether by remedy or prohibition.

The CMA should not hesitate to prohibit the merger in the event that a suitable purchaser cannot be found

3 In principle the SLCs identified by the CMA could be addressed by divestment of a number of LBOs to a suitably qualified purchaser. However, in practice, for such a remedy to be effective the CMA will need to set an appropriately high bar to address both the local and national aspects of the SLCs identified in its provisional findings report. WH agrees with the CMA's observation that there is a "*not insignificant risk*" that no suitable purchasers will be found. As set out further below, the market remains challenging, and to compete effectively a buyer needs experience and scale. WH's own experiences suggest that previous divestments in this sector, even to buyers of scale, have not effectively remedied SLCs at local level. The CMA should therefore err on the side of caution and, in doing so it may be necessary for the CMA to prohibit the merger.

Suitability of purchasers

4 At 13.1(b) of its provisional findings report the CMA found that as a result of the aggregated loss of competition at the local level the transaction may be expected to give rise to an SLC at the national level within Great Britain. To address that SLC any new entity would need to have sufficient scale and experience to operate a credible LBO business which addresses both the local and national effects on competition.

5 WH agrees with the provisional view set out at paragraph 15(a) of the Remedies Notice that a suitably qualified purchaser would need to already have in place an existing LBO estate of a certain scale. This is necessary because only an operator with a certain level of scale will have the central infrastructure to credibly and profitably operate the business, including IT and software systems capable of integrating the divested LBOs, regulatory and planning capability, investment in media content and marketing. All of this is required to compete effectively on both a local basis (where the CMA has recognised that the constraints from smaller independent operators are relatively weak), as well as allowing it to scale its estate to present a viable national competitor. To compete as a viable national operator, alongside considerable expertise in the betting industry a purchaser would also require a sufficient pre-existing balance sheet in order to have the central scale and strength to:

(a) be able to absorb the risk from any new acquisition;

(b) adapt and develop the acquired stores; and

(c) create and/or develop an effective national brand.

6 Land based bookmaking is a business characterised by high fixed costs. Fixed costs are observed at the LBO level and in the need for LBOs as a whole to make a sufficient contribution to the large central fixed costs that are needed to operate a network of LBOs.

7 One area of high fixed costs that have to be met when operating an LBO network is the central infrastructure that is required to credibly and profitably operate the business. The scale of this is considerable. In KPMG's analysis for the ABB, [✂]% of head office costs were allocated to each LBO as this is the proportion that was seen, by the industry in general, as being variable with the number of LBOs in operation. In addition, a stepped function was applied for a further [✂]% of head office costs that would fall when a large proportion of LBOs (e.g. 25%) closed. What this means is that if 10% of a bookmakers' LBOs were closed, its central costs would decline by only [✂]%. If 25% of a bookmakers' LBOs were closed, its central costs would decline by only [✂]%.

8 Not only are bookmakers' central costs highly invariant to the number of LBOs in operation, they are also large. William Hill's central costs allocated to its LBOs were equal to [✂]% of its LBO revenues (i.e. total gross win from all betting and gaming activity) in 2014.

9 Therefore, the large, and largely fixed, central overheads required to support an acquirer operating the divested LBOs is a critical consideration in assessing which other companies could credibly operate the shops. An existing operator with an efficient existing infrastructure in running British land based betting shops is far more likely to be able to sustainably run the divested LBOs than a firm without this capability.

10 The second area of high fixed costs is observed at the LBO level. Analysis conducted by KPMG for the ABB showed that the majority of LBOs' costs are invariant to the amount of betting activity and that, on average, betting shops' fixed costs typically account for over [✂]% of an LBOs' total costs. This is because the LBO has to meet the considerable costs of maintaining a presence on the High Street, which include rent, rates, heating, lighting and other utilities, before a single customer passes

through the door. In addition, the LBO must pay its share of the content costs in order to have the television feeds which its customers expect, and employ an average of four full-time equivalent members of staff. The only significant costs that vary in proportion to the scale of stakes laid in a LBO tend to be taxes and levies. Everything else has to be paid whether the LBO has one customer betting a pound, or a hundred each betting a pound each.

11 LBOs' fixed costs are recouped from the profits made on the bets they take. If the amount wagered and gross win falls, there is little or no saving in an LBO's costs to be had. Thus over time, with declining gross win and a fixed cost base, profit contribution can become disproportionately squeezed. This is precisely why when betting shops' gross win fell by [✂]% between 2012/13 and 2013/14, and their costs went up by [✂]% (driven mainly by higher taxes on FOBTs), their profit contribution fell by [✂]%. A small reduction in sales can, therefore, have a very large effect on LBOs' profit contribution because of their high fixed cost structure.

12 It is important that, given the high level of sensitivity of LBO profits to relatively small changes in revenues, any acquirer of divested LBOs is able to absorb the risk of fluctuating – and declining – revenues.

13 The importance of being able to cover both LBO-level fixed costs and central fixed overheads is increasing. Having analysed detailed financial information from Britain's LBOs, KPMG found in its analysis for the ABB that:

(a) [✂] LBOs made a loss in 2014. This represented an increase from [✂] LBOs which posted a loss in 2013; and

(b) betting shop income (i.e. stakes less prizes paid out) was broadly constant between 2009-10 and 2013-4 at just over [✂] billion, divided [✂] between sports betting (including horseracing) and machine betting. But, as a result of rising costs, LBOs' EBIT has fallen from [✂]% of revenues to [✂]% over the period.

14 Thus, LBOs' ability to make a suitable contribution to fixed costs is systematically coming under increasing pressure over time. This is a view endorsed by the two merging parties as well as by the rest of the industry.

15 It will be essential, therefore, that any acquirer of the divested LBOs is able to suitably support its new shops given the need to cover very large fixed costs and in the face of a likely continuation of the trend in declining LBO profit contributions.

16 An existing online-only operator would not be a suitably qualified purchaser. The skills and expertise in running an online business are distinct from those required to carry on a retail business. For instance, the challenges associated with running physical shops, the significant work-force requirements, the planning and alternate regulatory landscapes as well as the different customer profiles[1] which require a different marketing approach, all mean that an online-only operator would not have the right skills and experience to operate a retail estate and would thus face significant difficulties in entering the LBO market in a short time-frame. Such a purchaser would not have the existing physical infrastructure that is needed to run a 400 LBO network and would have to build it from nothing. This would require substantial capital investment, complexity and time to establish the infrastructure, and it would need to be in place before the divestment takes occurs – otherwise it would not be possible to operate the divested LBOs. Further, any divestment, even to an operator such as Paddy Power or Betfred would require a transfer of services agreements (**TSA**) which would

[1] For instance the CMA concludes in its provisional findings report at 6.66 that: "*the majority of retail customers continue to have a strong preference for gambling in LBOs…*"

need to cover: transition between IT systems (which can vary significantly as between operators), negotiations for the use of satellite broadcast content from SiS and/or ARC, relationships with gaming machine suppliers such as Scientific Games or Inspired and other ancillary services related to the physical estate that is transferred. Although it would be possible for such a TSA to be negotiated with parties such as Paddy Power and Betfred who already have an existing estate, this would be far from straightforward and we anticipate that a TSA would be needed for a relatively extended period of time. Conversely, for such a TSA to be negotiated with a party that had no presence in the LBO market – such as an online-only, foreign or private equity purchaser – it would be so complex as to be prohibitive. This because they would have no pre-existing infrastructure to which to transfer, no relationships with media content or gaming machine suppliers to leverage nor any expertise in relation to the running of a physical LBO estate – for instance an online-only purchaser would be reliant on the parties to provide appropriately qualified personnel to run the LBO business.

17 Similarly a purchaser that is not currently based in Great Britain (for instance, in the island of Ireland) would not have sufficient local knowledge, brand-recognition or scale within Great Britain to present effective competition. The CMA's survey at Figure 10 on page 63 of the Provisional Findings shows that in total, 40% of Ladbrokes and 43% of Coral customers mentioned brand as a factor influencing their choice of LBO. Further, the Kantar survey at Figure 12 on page 65 of the Provisional Findings shows that brand familiarity is very important for 26% of customers, and fairly important for a further 50% of customers.

18 As noted by the CMA at paragraph 7.84 of its provisional findings report, a local operator or a small independent chain would not be a suitable purchaser as they exercise a "*constraint that is generally weaker than the constraint exercised by national LBO operators*". Similarly, as WH indicated in its previous submissions to the CMA (and as reflected by the CMA at paragraph 7.84(a) of its provisional findings report), small chains of independent LBO operators do not have the scale to operate across the same breadth of sports as national LBO operators, they cannot manage risk in the same way when taking bets and cannot spread significant central costs such as those for marketing and investment in technology which are necessary to compete effectively.

19 Consequently, in our view the only suitably qualified purchasers are the national chains currently active in the market i.e. William Hill, Betfred and Paddy Power. Each of these would struggle to absorb a divestment of circa 400 LBOs (or more):

(a) With an existing estate of almost 1,400 LBOs, acquisition of a divestment package by Betfred would likely create a substantial number of local area SLCs itself which would need to be addressed. This is also likely to be true for William Hill.

(b) Notwithstanding the likelihood that an acquisition by Paddy Power could also lead to a number of local area SLCs, at the end of FY 2015 Paddy Power only had an estate of 341 stores in the United Kingdom. A divestment package of up to 400 LBOs would exceed the size of its existing estate, and represent an increase of 117%. This would be a significant challenge for any business, not only financially but also from a operational perspective. On the basis of the figures set out above – whereby an LBO change of 25% would imply a movement of [✂]% in fixed costs, and a quarter of overheads vary in line with the number of LBOs, a 117% increase in the LBO estate would necessitate an increase in existing overheads of [✂]% (if not more). Again, much of this increase in overheads would need to take place before divestment was complete. Further, as noted in WH's initial submission to the CMA, Paddy Power is currently going through the process of integrating with Betfair – a substantial and likely resource-intensive process that will impede its ability to make any further acquisitions at this stage.

20 WH has not proposed criteria for a minimum efficient scale for a prospective purchaser as in practice the market structure makes the potential candidates clear. Even the largest of the independent bookmakers, such as JenningsBet (with a retail estate of around 100 shops) may not be able to finance or absorb a divestment of the scale that would be required in this case. Again, using the figures set out above an acquisition of another 400 stores for an operator with an LBO estate of 100 would necessitate an increase in existing overheads of circa [✂]%.

Divestment should, so far as possible, be made to a single purchaser for the remedy to be effective

21 At paragraph 14 of the notice of possible remedies the CMA requests views on whether it should require divestment to a single purchaser or to one or more purchasers in each of the 659 overlap areas in which the CMA has provisionally identified an SLC.

22 WH notes its agreement with the CMA's conclusion at 13.1(b) of its provisional findings report that the transaction may be expected to result in an SLC as a result of the aggregation of the reduction of competition at the competition at the local level. In order to remedy such an SLC the CMA would need to order divestment of the LBOs in such a way as to re-establish the third national competitive force that would be lost as a result of the transaction. As it will further explain in its response to provisional findings, contrary to the CMA's conclusions it also believes that there are SLCs resulting from entirely national dimensions of competition. Substantially fragmenting the divestment between more than one player would not allow a purchaser sufficient scale to address the national SLC.

23 Therefore it is important that, in order to address the national SLC, divestment is made as far as possible to a single purchaser. WH appreciates that divestment of a portfolio of 400 or more of the overlapping LBOs to the next largest players in the market – Betfred and Paddy Power – would almost certainly lead to local market issues in its own right, and as such if the local area SLCs are to be addressed it would not be possible for every one of the divested stores to be sold to the same purchaser. Nonetheless, care should be taken to ensure that the divestment package does not lose its weight or coherence, and the LBOs which are not divested to the main purchaser should not then be divided between several further purchasers (including for instance smaller independent chains).

24 Accordingly, in order to ensure that the remedy package is as comprehensive as possible, the CMA should not merely require that the divestiture is "substantially" completed prior to clearance, but rather both the primary and secondary purchasers of the divestments are identified and secured before clearance is granted.

Divestment to multiple purchasers will not be effective

25 Due to the small number of potential candidates to purchase LBOs, in order to approve divestments to more than one purchaser the CMA may find there are too few suitably qualified purchaser in order to address the local area SLCs. As set out above, even for such secondary sales, it will not be adequate to divest to anything other than an existing national LBO chain. This may well compromise the CMA's ability to address both the local and also national SLCs.

Upfront buyer requirement

26 The CMA has indicated that it would seek to approve any purchaser upfront and require any divestitures to be substantially completed prior to the proposed merger being cleared to complete.

27 WH re-iterates the points it made at paragraphs 58-60 if its initial submission:

WH has observed the abundant press speculation over the number of divestments that might, ultimately, be required for the CMA to clear the proposed merger. Whilst it accepts that, in theory, a LBO divestment package ought to be capable of resolving local market concerns, WH is conscious

that such a divestment may not be capable of re-establishing the third national force, which would be lost as a result of the merger.

It is questionable whether a divestment of even a significant LBO estate (e.g. to a private equity house or an entrant from outside the UK) would, in its own right, be sufficient to re-establish such a national force. Further, any new entrant would require:

- *a) considerable expertise in the betting industry;*
- *b) major back-office, management and compliance infrastructure. Any divestment driven purely by local market overlaps between LB and GCG would be geographically disperse, presenting clear logistical and management issues;*
- *c) a new brand, which would require an effective long term marketing strategy to generate a level of trust and credibility with a customer base used to a well known operator; and*
- *d) GC and other operating licences (on which, see above).*

WH is unlikely to be interested in acquiring any divested LBOs. Further, WH has doubts over whether the next largest players in the market (Betfred and Paddy Power) would meet the CMA's strict requirements for suitable purchasers, for the following reasons:

- *a) The acquisition of the full estate by either Betfred or Paddy Power would create material local market issues in its own right;*
- *b) It is unclear whether either has access to the necessary financial resources to re-establish the divested business as a credible national competitor. The CMA acknowledges that a highly leveraged acquisition of the divestiture package that leaves little scope for competitive levels of capital expenditure or product development is unlikely to satisfy its requirements. As well as the acquisition costs, costs of rebranding and refurbishment can be significant (refurbishing a LBO costs c.£150-170k per LBO). Paddy Power, in particular, is in the process of making a considerable investment in its [now completed] acquisition of Betfair which is likely to rule it out of any further acquisitions while it consolidates the two businesses.*

28 In light of these points, as well as its further submissions above, WH agrees with the CMA's analysis that "*there is not an insignificant risk that it would not be possible to find one or more suitably qualified purchasers and so to complete the divestiture*".

29 It is therefore right for CMA to anticipate and provide for the possibility that a sale may fail. In these circumstances, a requirement for up-front pre-merger sale to an approved suitable purchaser prior to the merger is essential.

Divestiture package: design and process

30 At paragraph 15(b) of the notice of possible remedies the CMA has requested views on whether it should allow the parties discretion to choose the LBOs which they will sell in the relevant overlap areas.

31 We note that in some previous cases the CMA allowed the parties to choose whether to divest the acquirer store or target stores in the area of overlap (for instance in *WH/Stanley* (2006), and *Cineworld/City Screen* (2013)). However, in such cases there were often no concerns over the prospect of a national SLC. Moreover, the current case can be further distinguished on the basis of the large number of overlaps and the dual local/national aspects of the SLCs identified. In this case, for divestment to be successful the overall divestiture package must be profitable and sustainable in the long-term to be attractive to potential purchasers and to allow for an effective third national force to be established.

32 It is not sufficient to assume that a suitably qualified purchaser will exercise their own judgment effectively and only acquire a package that it believes it can maintain and operate in the long run. Indeed, this is very clear from a review of the aftermath of the *WH/Stanley* acquisition, as a result of

which WH was required to divested 75 stores to Tote. These sales took place during 2005, but approximately 10 years later and despite LBOs having enjoyed a relative growth phase (for instance, FOBTs had only recently been introduced at the time of sale), [✂] stores – representing approximately [✂] of the total sold to Tote – have since closed and no longer operate as LBOs.[2]

33 Similarly, when creating a divestment package the merging parties will be conscious that the multiple on sale will likely be lower than at merger and again, this may drive the creation of a divestment portfolio where the primary focus will be to retain profit rather preserving local competition. For instance, when selecting the Stanley divestment portfolio, [✂]. Although to some degree closures may have been inevitable – even in a far more buoyant market – it is material that the divestment portfolio generated no other significant interest beyond the Tote.

34 WH has already flagged the regulatory pressures that LBOs are under and that in the medium term, the cost of meeting these new requirements presents a significant challenge for a long "tail" of already unprofitable LBOs. For remedies purposes, the CMA should closely consider whether the parties are able to skew the divestment portfolio with weaker stores as this will risk fundamentally weakening the nature of the remedy itself. In our view, to avoid this the CMA should evaluate the strength of each proposed divestment outlet individually (by comparison with alternative divestment stores) and collectively. It should consider both profitability and length of lease, which may affect future decisions to maintain the store.

35 In our view, the CMA should consider bolstering a divestment remedy (and thereby mitigating the risk of remedy failure) with closer scrutiny of the plans of potential buyers, including:

(a) requirements for and close assessment of the business plans of prospective buyers for the divestment business, including plans at store level;

(b) seeking commitments for stores to be kept open for a minimum period (such as three years) post-divestment, including from the merger parties for them to keep open retained stores in the overlap areas for a minimum period (such as three years) post-divestment; and

(c) require the purchaser to commit to medium term investment (including capital investment) in the acquired stores. In *Rank / Gala*, for instance, the CC set out up-front requirements for any purchaser to demonstrate its commitment to developing the divested business, including its internal assessments of the area, strategy and plans for developing it, as well as other ancillary requirements such as planning assessments. The CC also suggested that it could invite potential purchasers to demonstrate their suitability[3] as purchaser in the form of written submissions or even face-to-face meetings. Such requirements would be consistent with the CMA's Merger Remedies Guidelines (CC8) at 3.15.

Behavioural undertakings

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[2] We believe that the majority of these stores were closed pre-2012, and in any event largely before the acquisition of Tote by Betfair (although WH has not tracked the precise dates of closure).

[3] Which was also expected to be shown through "a convincing commercial and operation plan that described the purchaser's motivation for purchasing the licence and its intentions and abilities to develop and open [the business] including key milestones, anticipated timetable and status of the process.."

36 The CMA sets out its view at paragraph 12 of its notice of possible remedies that a behavioural remedy is very unlikely to be an effective remedy to the SLC or any resulting adverse effect that it has provisionally identified.

37 WH supports the CMA's view in so far as remedies such as setting odds or margins or other price-cap mechanisms would on their own be inappropriate and insufficient to address the relevant SLCs in this case. Nonetheless, as explored above, some behavioural requirements may be necessary enhance the core divestment remedy being proposed.

Timing

38 In establishing a timeframe for the divestment process the CMA should seek to ensure that the time-period reflects the parties' need for commercial certainty, balanced against the requirement to allow sufficient time for the parties to find suitable buyers. In any event the CMA should ensure that it allows a suitable period to carry out a detailed assessment of any proposals.