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Date
14 June 2013

Reference

Caroline Normand
Director of Consumer & Competition
Policy Directorate
Department of Business, Innovation
and Skills
1 Victoria Street
London
SW1H 0ET

Dear Ms Normand

Please find attached our response to the relevant sections of the consultation on Pub companies and tenants.

This document is being submitted on behalf of M&G Recovery Fund, but is reflective of other equity managers at M&G who hold shares in the sector.

M&G Recovery Fund is an equity fund investing primarily in UK companies with £7.1bn funds under management (as at 14th June 2013).

M&G is an investment business with over £228bn of funds under management invested in equities, fixed income and property (as at December 31 2012). We manage assets on behalf of a wide variety of investors across UK, Europe, Asia, the Americas and South Africa.

Within the Pubs sector M&G Recovery Fund has an equity holding in Enterprise Inns, although the wider M&G equity business also has equity holdings in Punch Taverns, Marstons and Greene King (and others – although those listed are the most relevant to this submission).

In addition to answers to some of the questions laid out in the consultation we wish to make these broad points:

- It is not clear to us that the Voluntary Code has failed.
- (1) In the Secretary of State's introduction to the consultation he states that "the self-regulatory approach, which was announced by the Government in November 2011, has not been sufficiently far-reaching". Given that only 18 months passed before the announcement of the consultation we are not clear that the Voluntary Code has been fully tested. This is particularly the case given that the consultation uses evidence from the British Institute of Innkeeping which is based on a sample of respondents taken over a three year period. In addition PICAS (Pubs Independent Conciliation and Arbitration Service) has only been in operation since 2012.
 - (2) We believe you have been made aware that one of the central pieces of evidence used to demonstrate that there is a need for a Statutory Code appears flawed and inaccurate. The 400+ calls to the British Institute of Innkeeping that are used as evidence of dissatisfaction were not all complaints. The company's recent interim results make clear that of the 178+ calls (37% of 400+) specifically regarding Enterprise only 4 were actually complaints.

- (3) All major pub companies have confirmed that they regard the Code as legally binding. Bodies such as Pubs Independent Rent Review Scheme (PIRRS) and Pubs Independent Conciliation and Arbitration Service (PICAS) have been set up and are in operation.

Despite the above points it may be that there are people who believe the Code does not work as well as it should. Given this, we believe that the focus should be on giving recent changes time to deliver, and also making the current system work better. Introducing a statutory code with everything this entails – the cost, bureaucracy, and time – is not an efficient use of government time or resources, and, when accompanied by potentially significant changes, has the potential to result in unintended consequences. There are many examples of other industries where additional bureaucracy and regulation have not 'solved' perceived problems, and indeed examples from the Pubs and Brewing industry such as the Beer Orders in 1989 which had massive unintended consequences.

- Review process

The Pubs and Brewing industry has been the subject of regulatory review, both in the UK and Europe over 40 times since 1969. The OFT has reviewed the business model on many occasions and as recently as October 2010 found that the tied model works well. As investors in any industry we like to invest for the long-term – and some certainty over the future structure of an industry is essential to minimising the cost of capital. Constant reviews and investigations of the nature that the Pubs and Brewing industry has undergone do nothing to instil investor confidence or help develop the long-term shareholder base of the industry.

- Reasons for the introduction of a Statutory Code and consultation

As stated above, the consultation seems to have, in part, been prompted by analysis of data from the British Institute of Innkeeping ("BII"). The consultation itself makes clear that one of the reasons for action being taken is that the BII "has received over four hundred complaints on its hotline over the past three years". BIS has since acknowledged that only four of these calls can be classified as "grievances" related to Enterprise Inns – so we would ask how many of the "over four hundred complaints" are actually complaints. It is worth pointing out that 4 grievances from an estate of 5,500 pubs do not seem extreme. In addition we understand that Enterprise Inns in particular pays for all new tenants to join BII and therefore the high level of total calls from Enterprise tenants is probably evidence (to some extent) that it is a valued part of the package offered.

- Alternatives to the current industry structure

As investors in some of the pub companies we would be very keen that they create long term value whilst dealing properly with tenants. We are concerned that if some of the proposals that are being made go through, they could significantly change the industry. In this scenario it is likely the boards of companies we invest in would seek to minimize any cash leakage from the business. For Enterprise in particular conversion to REIT status is something that may be attractive.

Conversion to a REIT, if it is the result of having become simply rent collectors with no interest in underlying trading is not something we believe to be in the best interests of the industry, including the tenants.

We hope that the responses we have made are clear and helpful and give some insight into our thinking as long-term, committed shareholders in the industry.

Yours sincerely,

Michael Stiasny



Department for Business, Innovation & Skills

Pub companies and tenants - A government consultation

Response form

The consultation will begin on 22/04/2013 and will run for 8 weeks, closing on 14/06/2013

When responding please state whether you are responding as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents by selecting the appropriate interest group on the consultation response form and, where applicable, how the views of members were assembled.

This response form can be returned to:

Pubs Consultation
Consumer and Competition Policy
Department for Business, Innovation and Skills
3rd Floor, Orchard 2
1 Victoria Street
Westminster
SW1H 0ET

Email: pubs.consultation@bis.gsi.gov.uk

Please tick one box from a list of options that best describes you as a respondent. This will enable views to be presented by group type.

Representative Organisation

Trade Union

Interest Group

Small to Medium Enterprise

Large Enterprise

Local Government

Central Government

Legal

Academic

Other (please describe): Fund Management Company

The Department may, in accordance with the Code of Practice on Access to Government Information, make available, on public request, individual responses.

Consultation questions

Q1. Should there be a statutory Code?

It is not clear to us that the Voluntary Code has failed.

- (1) In the Secretary of State's introduction to the consultation he states that "the self-regulatory approach, which was announced by the Government in November 2011, has not been sufficiently far-reaching". Given that only 18 months passed before the announcement of the consultation we are not clear that the Voluntary Code has been fully tested. This is particularly the case given that the consultation uses evidence from the British Institute of Innkeeping which is based on a sample of respondents taken over a three year period. In addition PICAS (Pubs Independent Conciliation and Arbitration Service) has only been in operation since 2012.
- (2) We believe you have been made aware that one of the central pieces of evidence used to demonstrate that there is a need for a Statutory Code appears flawed and inaccurate. The 400+ calls to the British Institute of Innkeeping that are used as evidence of dissatisfaction were not all complaints. The company's recent interim results make clear that of the 178+ calls (37% of 400+) specifically regarding Enterprise only 4 were actually complaints (not an excessive number in the context of owning 5,500 pubs).
- (3) All major pub companies have confirmed that they regard the Code as legally binding. Bodies such as Pubs Independent Rent Review Scheme (PIRRS) and Pubs Independent Conciliation and Arbitration Service (PICAS) have been set up and are in operation.

Despite the above points it may be that some people believe the Code does not work as well as it should. Given this, we believe that the focus should be on giving recent changes time to deliver and also making the current system work better. Introducing a statutory code with everything this entails – the cost, bureaucracy, and time – is not an efficient use of government time or resources, and has the potential to result in unintended consequences. There are many examples of other industries where additional bureaucracy and regulation have not 'solved' perceived problems, and indeed examples from the Pubs and Brewing industry such as the Beer Orders in 1989 which had massive unintended consequences.

Q2. Do you agree that the Code should be binding on all companies that own more than 500 pubs? If you think this is not the correct threshold, please suggest an alternative, with any supporting evidence.

We have not seen any evidence that suggests 500 pubs is the correct threshold.

- (a) It does not appear to us that compelling evidence has been presented that the size of the company (by number of pubs) has any bearing on the likelihood that tenants will face problems. Therefore, if a Statutory Code progresses we cannot see a reason to put a threshold in place.
- (b) If the threshold is set at 500 pubs then there has to be the risk that a two-tier industry is put in place as tenants for companies with less than 500 pubs will presumably want the protections of the code?

If there is to be a Code it does not seem to us unreasonable that it should apply to all pub companies, regardless of the number of pubs they own.

Q3. Do you agree that, for companies on which the Code is binding, all of that company's non-managed pubs should be covered by the Code?

Q4. How do you consider that franchises should be treated under the Code?

This is an area fraught with difficulty. First of all some definition of 'franchise' needs to be determined. Importantly this definition should avoid investing any new body with powers it does not want, or need (i.e. if a franchise is any agreement that is recognised as such by the British Franchise Association then the latter body will find itself with some considerable power and influence within the pub industry).

Q5. What is your assessment of the likely costs and benefits of these proposals on pubs and the pubs sector? Please include supporting evidence.

As significant investors in the UK stock market we look to invest in and engage with companies for the long term. One of the significant components of the attractiveness of a company's stock will be its 'cost of capital'. Many of the proposals raised will likely significantly affect the cost of capital of the companies within the industry and also the potential returns available.

In the current form proposals such as 'guest-beer', mandatory free-of-tie, and proposed prevention of flow monitoring could all have an impact on the returns of the pub industry, and the risks (and by extension therefore, the cost of capital). Broadly speaking the higher the cost of capital (how "risky" the industry and companies within it appear) the higher returns will have to be to justify investment. If returns fall and risks increase the industry will become less attractive to investors, companies will have less capital to deploy and longer term this could lead to more pub closures and impact on local communities.

Using the figures provided in the impact assessment we would note that the "transfer" from pub companies to tenants have been estimated at £102-254m. This would have a significant impact on the pub companies' profits and hence their attractiveness as investments, but it is not clear that the benefits have been as carefully calculated. There is an assumption that tenants invest this money in the pub (not guaranteed) and that this transfer is not lost elsewhere – possibly to the brewers through price increases to tenants. In addition there is no analysis of the costs of the failure of any one of the pub companies and the consequent impact this could have.

Q6. What are your views on the future of self-regulation within the industry?

As stated in the answer to Q1 we are not convinced that self-regulation within the industry has failed. We are aware that there are still tenants dissatisfied with their situation, but also recognise the realities of life: there will always be some people who are going through difficult periods, and this will have been exacerbated by the economic crisis. Self-regulation should not be deemed to have failed just because there are still complaints about the companies.

We do recognise that the pub companies will undoubtedly have made mistakes during their existence and that some tenants will justifiably feel aggrieved. The Pubs Independent Rent Review Scheme (PIRRS) has been in place since 2010 and Pubs Independent Conciliation and Arbitration Service (PICAS) since 2012. It would seem sensible to give these bodies time to operate before deciding that the system of self-regulation is broken.

We are also concerned that there is a presumption that the pub companies have no interest in the financial health of their tenants or their progress of their pubs. With the tied structure there

is clearly an inextricable link between pub companies and their tenants which means that the pub company has every interest in ensuring that the right tenants can survive and thrive in their pubs.

Q7. Do you agree that the Code should be based on the following two core and overarching principles?

i. Principle of Fair and Lawful Dealing

ii. Principle that the Tied Tenant Should be No Worse Off than the Free-of-tie Tenant

The Principle, as set out in paragraph 22 of the code, appears to value dry rent and wet rent as essentially fungible and of similar value to both tenant and pub company. In fact fixed and variable payments have different values depending on the situation of either the tenant or the pub company.

A more cautious tenant or one who fears a drop in sales (someone who one assumes would benefit from the protection that a statutory code might offer) would put a higher value on having some variable element to the rent and would therefore prefer to pay a total (fixed plus variable) rent that was higher than a fixed rent. On the other hand the more optimistic tenant would put a lower value on the ability to pay a variable rent and prefer a fixed rent. Of course most new tenants would start out in the latter camp but may eventually be grateful to be paying variable rent.

To the pub company the value of fixed and variable rents can also differ, depending on circumstances. In the past the industry perhaps made the mistake of treating the variable (wet) rent as if it were almost fixed. Many pub companies then borrowed against the presumed 'fixed', or at least stable, element of that variable rent. This arguably led to a loss of investment in the pub estate. A variable rent should encourage investment in order to help it grow. However it might need to be higher than a fixed rent in order to both to give cash for investment and in order to compensate for its variability.

So if variable rents are to be encouraged, and we believe that they should lead to more investment in pubs whilst also giving some protection to tenants, then making them equivalent to fixed rents would not do this.

In addition, even if fixed and variable rent is supposed to be of the same value, it is very difficult to determine what the appropriate level of beer sales should be to make the comparison. At what point in the life cycle of an individual pub should the comparison be made? We assume that this principle would most often be used when new tenancies are being offered. If it is based on the sales under a previous failing owner, then it is likely that the comparison would be unfair to the pub company, given the potential to grow sales and hence rent. If it is based on the sales of very successful publican then the comparison might be unfair to the prospective tenant.

So we would argue that Principle itself is questionable and the measurement of it is difficult. We make further comments on the differences between tied and free-of-tie in our answer to Q11.

Q8. Do you agree that the Government should include the following provisions in the Statutory Code?

- i. Provide the tenant the right to request an open market rent review if they have not had one in five years, if the pub company significantly increases drink prices or if an event occurs outside the tenant's control.*

We are not in favour of any party being able to 'cherry-pick' elements of a contract to change. If the right to request a rent review is included in the Statutory Code then it should be as part of a review of the whole contract. The idea that one part of a "package" should be reviewed with no reference to the rest would be of concern to us as an investor in any industry.

- ii. Increase transparency, in particular by requiring the pub company to produce parallel 'tied' and 'free-of-tie' rent assessments so that a tenant can ensure that they are no worse off.*
- iii. Abolish the gaming machine tie and mandate that no products other than drinks may be tied.*
- iv. Provide a 'guest beer' option in all tied pubs.*

The current proposals allow for significant leeway in the definition of guest beer. If there is not sufficient clarity/restriction then we should expect all tenants to buy outside the tie for their most profitable line. If every tenant did this (as one would expect given the economics) then this could have significant negative implications for the pub companies, their profits, and the industry's structure.

- v. Provide that flow monitoring equipment may not be used to determine whether a tenant is complying with purchasing obligations, or as evidence in enforcing such obligations.*

In the consultation it is clearly stated that "Clearly, it is entirely legitimate for one party to a contract to seek to ensure that the other party complies with the terms of that contract" (5.20). We are unclear why the Code should stipulate that flow monitoring equipment cannot be used to determine whether a tenant is complying with purchasing obligations. This is particularly the case given that, as we understand it, flow monitoring equipment cannot be used for the basis of legal action.

If the issue is one of "accuracy of data" (5.19) then surely the Code should stipulate that pub companies act with their best endeavours to work with the companies providing the equipment to improve the measurement process. This seems to be the direction that was suggested in "Pub Companies: Follow Up" (March 2010, Business Innovation and Skills Committee) when they say "flow monitoring equipment could be a helpful tool, for both pub companies and lessees but only if it is reliable".

As to the argument that "the model of the tied public house has been part of the British pub industry since at least the 18th century and for the majority of that time modern flow monitoring equipment has not been available. It is therefore clearly possible to operate a tied estate and to enforce the tie without the use of flow monitoring equipment" we would make two points:

- Clearly it is possible to run a railway network without computers, but we wouldn't choose to do it now.
- Speaking to an industry participant who was an area manager in the 1980s we were told that the way monitoring worked was that an area manager would spend one or two

days a month outside the beer wholesalers and would follow the trucks to see who/where they were delivering to.

Both of these points highlight the central point – flow-monitoring is one of the ways pub companies ensure that the tenant complies with the terms of the contract they share, and also appears more efficient, cost effective and sensible than the historic alternatives.

Q9. Are there any areas where you consider the draft Statutory Code (at Annex A) should be altered?

Q10. Do you agree that the Statutory Code should be periodically reviewed and, if appropriate amended, if there was evidence that showed that such amendments would deliver more effectively the two overarching principles?

Q11. Should the Government include a mandatory free-of-tie option in the Statutory Code?

- (a) Tenants can chose to sign up with a free-of-tie pub when they rent their pub for the first time, the fact that they are unable to get a free-of-tie pub through Enterprise Inns (for example) does not imply that the opportunity is unavailable – just that it is unavailable from that pub company. It is unclear to us why a pub company has to offer a free-of-tie option. Prospective tenants have the option to go elsewhere.
- (b) If the tenant is offered the chance to take a free-of-tie option it has a number of consequences which would likely affect pub companies and the strategic direction they choose to take.
 - a. A free-of-tie tenant is likely to lose all other benefits that the pub company offers as there is no reason to provide them when the pub company has no interest in the beer sales of the pub.
 - b. ‘Wet rent’ effectively allows both pub company and tenant to share the variable costs in the business. This free-of-tie approach could result in higher fixed costs for the tenant and will reduce the pub company’s interest in helping to drive the tenant’s beer sales.
 - c. Enterprise (and others) may choose to convert to REIT status (reducing tax payable to the state).
 - d. If the market is efficient one would expect to see the brewers putting up prices as they are faced by customers with far less purchasing power (the individual tenants).
 - e. Mid-market brewers who rely on the tie as an outlet for their products may choose to exit the market, reducing competition and choice, and potentially jobs.
 - f. If tenants can choose to go “free-of-tie” then this will introduce significant uncertainty to the pub company model which in turn will drive up the cost of capital as the companies involved find it harder to buy, plan and invest for the future – given that the shape of the estate will be considerably more uncertain looking forwards.
- (c) More free-of-tie pubs will not prevent further pub closures, in fact, as is recognised in the consultation document, free-of-tie pubs are closing at a higher rate than tenanted pubs.
- (d) We welcome the comments in the consultation document (5.40) that further independent analysis will be undertaken to look into the impact of a mandatory free-of-tie option and hope that the independent analysts will be mandated to consider data and information from both tenants and the pub companies themselves.

(e) Please see our answer to Q7 (ii) above in which we make further points about the desirability of having more free-of-tie (and hence fixed rent pubs) versus tied pubs which have a mix of fixed and variable rent. We believe that tied pubs give some safety net to troubled pubs and should encourage investment from pub companies

Q12. Other than (a) a mandatory free-of-tie option or (b) mandating that higher beer prices must be compensated for by lower rents, do you have any other suggestions as to how the Government could ensure that tied tenants were no worse off than free-of-tie tenants?

Q13. Should the Government appoint an independent Adjudicator to enforce the new Statutory Code?

Q14. Do you agree that the Adjudicator should be able to:

i. Arbitrate individual disputes?

ii. Carry out investigations into widespread breaches of the Code?

Q15. Do you agree that the Adjudicator should be able to impose a range of sanctions on pub companies that have breached the Code, including:

I. Recommendations?

II. Requirements to publish information ('name and shame')

III. Financial penalties?

Q16. Do you consider the Government's proposals for reporting and review of the Adjudicator are satisfactory?

Q17. Do you agree that the Adjudicator should be funded by an industry levy, with companies who breach the Code more paying a proportionately greater share of the levy? What, in your view, would be the impact of the levy on pub companies, pub tenants, consumers and the overall industry?