FEBRUARY 2019

THE RESTAURANTS AND BARS REPORT

TREND SETTER OR QUIET REGRETTER?

UNDERSTANDING CONSUMER BEHAVIOUR - THE KEY TRENDS SHAPING THE SECTOR IN 2019

IDEAS | PEOPLE | TRUST

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THE RESTAURANTS AND BARS REPORT

In this edition we start off by looking at the macroeconomic environment; as we edge closer to 29 March we assess how GDP growth, consumer confidence and access to employees have been negatively impacted by the UK's decision to exit the EU.

Up next are BDO's M&A specialists Tom Barnard and Rishi Verma who take a deep dive into the UK transactions market. The casual dining sector in 2019 cannot be discussed without referencing CVAs, which have shone a light onto leasehold gearing for restaurants, but investors are still hungry and for talented operators with strong brands deals flow will continue to be buoyant.

We're delighted to include an interview with industry leader David Shipton, MD of Pubs at NewRiver. David explains why wet-led concepts are still leading the way and how pubs must continue to evolve in line with consumer trends to stay ahead of this curve.

We follow this with a summary of the changing long term trends in consumer behaviour and our predictions for the year ahead, as well as a summary of the issues involved creating legislation around tips and tronc.

A WORD FROM MARK EDWARDS

Welcome to the bright and bubbly February 2019 edition of the Restaurants and Bars report.

As we mention a number of times in this report, it's been a year of highs and lows for the sector; Brexit uncertainty and a flurry of cost headwinds continued to challenge discretionary spend, impacting the high street and fuelling the resurgence of CVAs and even administrations. At the same time we see the results of a hot summer, the football World Cup and ongoing popularity of craft beer and gin - as noted in our last report - an understanding of consumer preferences will continue to distinguish the winners and losers in the sector. In essence this is determining what is a fad and what is a long term behavioural change.

A successful business over the next 3 years is going to have a focus on its story and heritage and ensure its authenticity, the customer experience, the use of effective technology for the benefit of the customer, health conscious options, premium offerings with personalisation a key driver, and, of course, the execution needs to be efficient and optimised.

I wish you all a successful and prosperous 2019.

Mark Edwards
Partner

ECONOMIC OVERVIEW

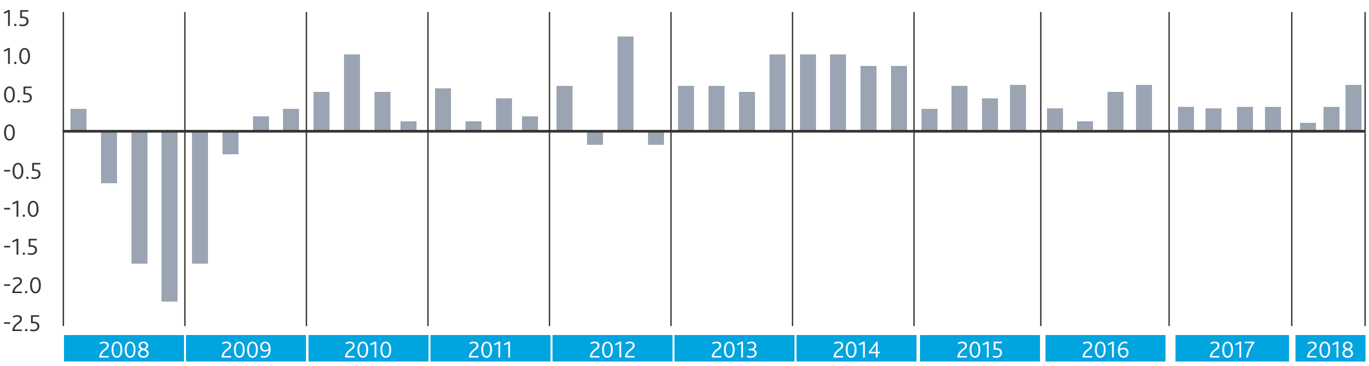
UK'S ECONOMY GROWTH RATE SLOWS GOING INTO AUTUMN

The UK economy grew by 0.6% in the third quarter of 2018, achieving a two-year high growth rate for a third quarter. Optimism fuelled by England's performance in the World Cup and the hot weather in July boosted retail sales and a recovery in construction, resulting in a surge in the economy in the first month of the quarter. Longer-term economic growth remains subdued with August and September posting flat results, ratifying concerns that this positivity has been fading since, due to uncertainty surrounding Brexit and the political turmoil around it.

Despite the forecast of 0.2% growth, business investment decreased by 1.2% in the third quarter of 2018, confirming uncertainty among businesses over the ability of the UK's government to agree with the EU on a deal ahead of Brexit on 29 March.

GDP GROWTH QUARTER-ON-QUARTER 2008-2018 Q3
GROWTH %

% GDP growth per quarter



SOURCE: OFFICE OF NATIONAL STATISTICS (ONS)

UK EMPLOYMENT RATE AT RECORD-HIGH BUT CONCERNS OF WORKERS SHORTAGE INCREASES AS EU WORKERS LEAVE

The UK's unemployment rate increased to 4.1% in the third quarter, up from the 43-year record low of 4.0% during the second quarter of 2018. Estimates from the Labour Force Survey show that both the number of people in work and the number of unemployed people increased in the three months to September. The employment rate was at a record-high of 75.5%, up from 75.0% during the first quarter.

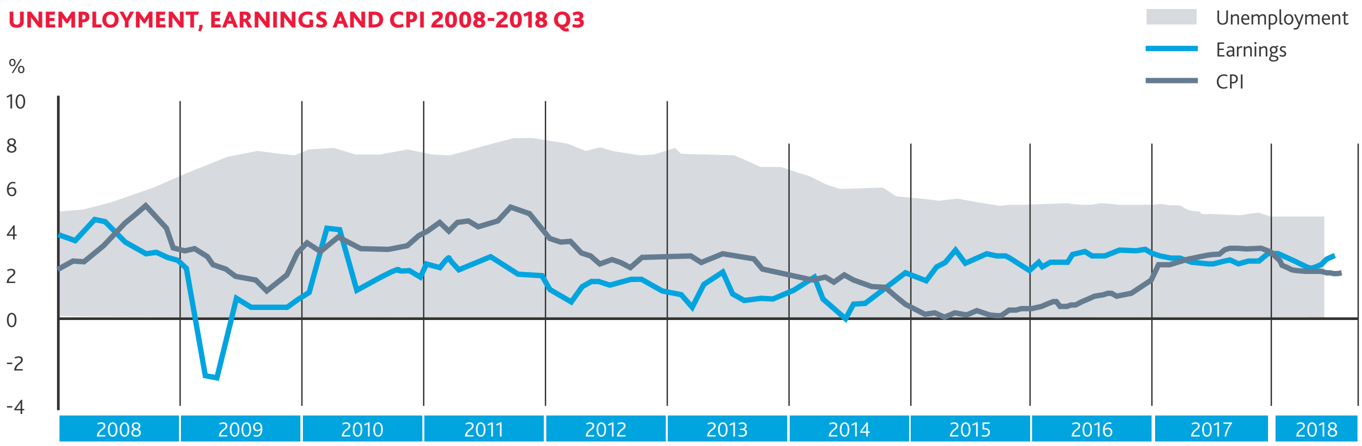
Latest figures published by the ONS showed a record number of vacancies as EU workers leave ahead of Brexit. According to the ONS, 2.25m people from the EU were in work in the three months to September - 132,000 fewer than for a year earlier. This decline represented the sharpest fall since records began in 1997, and it is primarily attributed to the decrease in the number of workers coming from the so-called “A8” eastern European countries such as Poland and the Czech Republic.

According to the ONS, workers' total earnings, (including bonuses), increased by 3.0% in the three months through September, compared with a year earlier. Latest estimates show that average weekly earnings in real terms, adjusted for price inflation, increased by 0.8%.

The UK inflation rate remained steady at 2.2% in November, despite expectations of a rise to 2.5%. However, it remained well above the Bank of England's 2% target. Prices continued to rise at a steady rate, particularly for utility bills and petrol, as crude prices recover; however, a fall in food and clothing offset the latter.

The pause in the downward trend of consumer prices reflects the difficulties of the sterling as Brexit negotiations develop and cost of imports goods remain high. The Bank of England now expects CPI inflation to remain on a downward trend over the coming months, reaching 2.0% at some point during the first quarter of 2019, but it will depend on how the market sees the development of a Brexit deal, as a positive agreement would deliver a higher pound and lower inflation.

UNEMPLOYMENT, EARNINGS AND CPI 2008-2018 Q3



SOURCE: OFFICE OF NATIONAL STATISTICS (ONS)

ECONOMIC OVERVIEW

continued

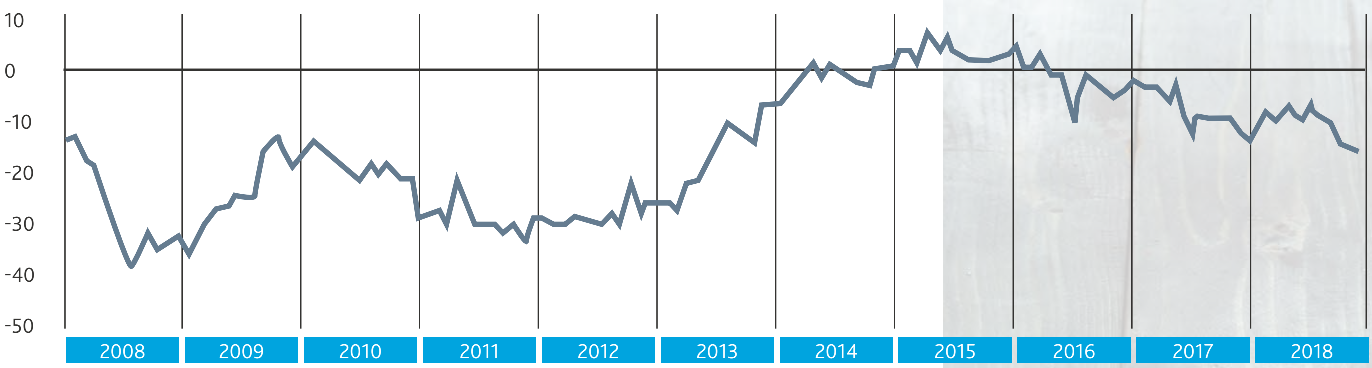
BREXIT WORRIES DRAG CONSUMER CONFIDENCE TO A FIVE-YEAR LOW IN DECEMBER

British consumer confidence decreased to a five-year low in December, dragged down by worries about the economic outlook in the approach to Brexit. GfK's UK Consumer Confidence Index scored -14 in December, as a result of the decrease in several other measurements such as general economic situation, Major Purchase Index and Savings Index.

Despite the government claims of an end to austerity, which according to experts should suffice to boost consumer confidence, coupled with accelerating wages growth, the prospects of a no-deal scenario continued to weigh heavily on UK's consumers attitude, during the crucial Black Friday and Christmas selling periods.

CONSUMER CONFIDENCE 2008 - 2018 YTD

CONFIDENCE INDEX



SOURCE: GFK CONSUMER CONFIDENCE INDEX

TRADING CONDITIONS

TRADING CONDITIONS:
THE NUMBERS

- Total sales up **7.1%**
- LFL growth up **4.1%**
- Pubs up **5.1%**
- Casual dining up **2.4%**

LONDON LFL UP **2.3%** VS.
REGIONAL 1.3% (OUTSIDE M25)

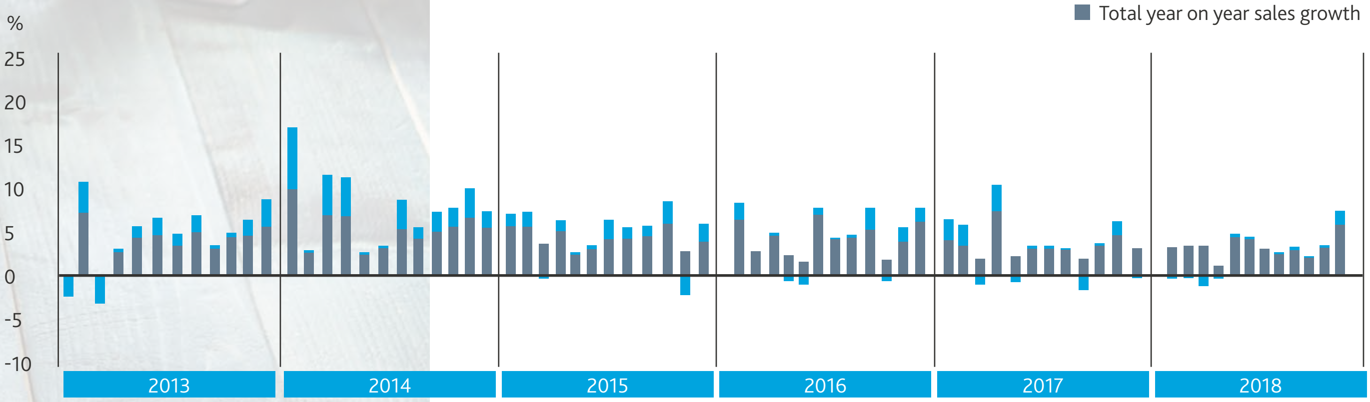
FESTIVE SEASON BOOSTS EATING AND DRINKING-OUT MARKET

According to the latest Coffer Peach Business Tracker, Britain's managed pub and restaurant groups experienced collective like-for-like sales grow of 4.1% in December, with pubs and bars (up by 5.1%) doing better than casual dining businesses (up by 2.4%).

London pubs and restaurants saw like-for-likes up by 5.0%, against a 3.8% increase in like-for-like sales outside the capital. Pub and bar groups continued to outperform restaurant chains both nationally and in London.

Total sales in December were up by 7.1% compared to same period in 2017. The strong performance witnessed by pub and restaurants across the country in December, helped by the prolonged holiday period, confirms the strength of the sector as consumers continue to drift towards spending money on experiences rather than buying fashion, with retail showing it's worst Christmas sales growth in a decade.

PUB & RESTAURANT SALES GROWTH 2013-2018 (YTD)



SOURCE: COFFER PEACH BUSINESS TRACKER

A ROLLERCOASTER OF A YEAR IN HOSPITALITY

M&A MARKET OVERVIEW

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2018 was not the quiet year many thought it would be. Reflecting on the last 12 months, there has certainly never been a dull moment in the restaurant, bar and pub sectors - a dream year for journalists with new “scoops” arising week in, week out. From high profile CVAs, the revival of the pub, mega M&A transactions and the rise of competitive socialising; we revisit a selection of the biggest talking points in the year.

A CHALLENGING MARKET

It is no secret, it has been hard out there. The challenging trading conditions have continued from 2017, with 2018 proving as tough for restaurants and bars as it has ever been. Operator’s best laid plans for the year were certainly not helped by the arrival of the ‘Beast from the East’ in late February.

The wider structural challenges showed no real signs of abating. Years of rapid expansion and supply side increases alongside a weak high street environment created an incredibly difficult environment to trade in. Trading conditions were only made harder by the multiple cost headwinds facing the sector: unsustainable business rates rises, rent reviews, NLW, and Brexit induced cost inflation and recruitment challenges.

Differentiation was the key to survival for many in 2018; however, as seen in the pub sector excess supply is slow to exit the market. As a result, it is likely 2019 will deliver a similarly challenging trading environment.

CVA: PART OF THE EVERYDAY VOCABULARY

Previously an unknown term for many, the ‘CVA’ quickly became a mainstream topic in 2018 and unfortunately, the conversation of ‘who may be next’ became a key talking point at sector events. The debate on the merits of entering into a CVA still rages on, with some of the

opinion that they just prolong the inevitable making it harder for the rest. Only time will tell, however; it is clear that with the help of a CVA a number of businesses have retained a profitable core and enter 2019 on a stronger footing.

The high profile CVAs have shone a spotlight onto the operational gearing of leasehold restaurants and bars. The rate at which profitable brands can decline as a result of reducing sales is quite scary - for every pound of sales lost, typically 40p - 50p is lost from Site EBITDA. In the current environment this has led to many operators requiring c. 4% LFL sales growth just to remain flat at Site EBITDA level. With the wider restaurant market in 2018 recording close to flat or negative LFL sales, the challenges for operators are clear.

A number of high profile brands entered into CVAs during the year including Jamie's Italian, Prezzo, GBK, Carluccios and Byron. Their respective challenges are well documented; however, with talented operators at the helm here's hoping 2019 serves the brands well. Whilst each brand has its own story, it was interesting to see that many of the sites closed by GBK were relatively recently opened. The relentless search for growth, seemingly prioritising over guest experience and site quality, has no doubt hurt some operators.

Going into 2019 a new dawn of diligence may be upon us. Investors are now diving deeper than ever to search for a hard and robust answers to the important question of how big a site footprint a brand can support.

INVESTORS STILL HUNGRY

Despite the pressures facing the sector, there was strong deal flow across 2018 focused on differentiated and well-managed brands operating in attractive subsectors of the market.

The three mega deals in the sector were the acquisition of Pret by JAB Holdings, Costa by The Coca-Cola Company and the unexpected acquisition of Duke Street owned Wagamama by The Restaurant Group.

In May, Bridgepoint owned Pret-A-Manger was acquired for £1.5bn by JAB Holdings, the investment fund of Germany's Reiman family, as part of a global acquisition spree with the aim to challenge Nestle in the coffee sector. The world-class UK brand was acquired for a reported EBITDA multiple of 15x, with JAB likely being enticed by its strong international footprint and promise of further overseas expansion. Pret demonstrated a touch of class by providing each member of staff with a £1k bonus on exit, recognising their staff's key role in the company's success. An idea replicated by Wagamama in their recent exit.

Whitbread seems to have found the ideal strategic buyer in Coca-Cola. Whitbread acquired Costa in 1995 for £19m, and delivered an astounding return for shareholders following a sale for c.£4bn (16.4x FY18 EBITDA).

The acquisition sees Coca-Cola boldly enter the fast growing and globally fragmented coffee market as one of the UK's largest players, and fills a gap in their extensive drink portfolio. There is no doubt there is a significant opportunity for Coca-Cola to rapidly internationalise Costa by leveraging their own world-class global distribution network.

> *"There was a strong deal flow across 2018 focused on differentiated and well-managed brands."*

A ROLLERCOASTER OF A YEAR IN HOSPITALITY

M&A MARKET OVERVIEW *continued*

In October, The Restaurant Group announced its controversial £559m acquisition of Wagamama. The investment allure is clear - Wagamama is a sector leader in the growing SE Asian market, aligned to structural growth trends, and should help revitalise TRG's leisure division. However, a price tag of 13x earnings represents nearly double TRG's existing market cap and is punchy for a leasehold business, despite outperforming the sector for four and half years.

With the acquisition now approved, delivering a fantastic 3.4x return to Duke Street, 2019 will be a busy year for the Andy McCue led group. No doubt the market will be awaiting with eager eyes to see if TRG is able to integrate the two businesses and realise the £22m of promised synergies.

In April, the Pizza Hut team, led by CEO Jens Hofma, completed a buyout supported by Pricoa Capital Group. The buyout signals the end of Rutland Partners involvement following the successful turnaround of the business.

June saw Trispan, a newcomer to the UK investment world, acquire a majority stake in Rosa's Thai Café. Rosa's has grown quickly to become one of the leading players in the branded Thai casual dining sector. MD Gavin Adair will lead the next phase of growth supported by Robin Rowland, Trispan's European Operating Partner.

THE RESURGENCE OF THE PUB

As discussed in our summer 2018 edition, pubs and particularly wet-led operators have played a prominent role in the sector over the last year following a number of years playing second fiddle to casual dining.

The pub sector has benefited from the return of the trade buyer. Punch, Brewdog, TRG and Fuller's all made acquisitions in 2018 and are expected to continue to invest in 2019.

Fuller's acquired Dark Star, the West Sussex Brewer, before following up with the acquisition of the six-strong Bel & The Dragon group. Laine Pub Company was acquired by Vine Acquisitions, The Draft House was snapped up by Brewdog, and TRG bolstered their pub credentials with the acquisition of the Karen Jones led Food & Fuel.

In February, Lonsdale Capital Partners acquired a majority stake in Simmons Bars, the 12-strong London-based bar group. Mainly appealing to 18-27 years olds, Simmons is known for its extended happy hours, good value and great atmosphere.

In July, Stonegate finally acquired the 33-strong Be At One group after a prolonged sale process. Be At One is the market leader in its space, and is known for its exceptional customer service and capitalising on the growing trend of premiumisation.

BGF invested £10m into Mission Mars, the operator behind the award winning venue Albert's Schloss. The Mission Mars team led by Neil Macleod and co-founder Roy Ellis have a track record of scaling hospitality businesses, and in Albert's Schloss they have created an incredible venue that has really taken the bar experience to another level.

August saw Imbiba invest £3.5m into Vagabond, the London-based wine bar business led by Stephen Finch. Vagabond has a differentiated model and taps into the trend towards experiences that allows amateurs and experts alike to sample wine before buying.

> *The pub sector has benefited from the return of the trade buyer.*

THE EXPERIENCE ECONOMY

The continued consumer shift towards experiential and immersive activities over retail has led to a boom in "competitive socialising", a relatively new but fast growing sub-sector of the UK leisure market.

Be it crazy golf, escape rooms or ping-pong, the flourishing concepts are yet to withstand the test of time leaving investors and operators divided on what their future holds. That being said, there has been no lack of interest from investors with several willing to bet that some of these businesses are here to stay.

The sector really grew up and hit the mainstream in 2018 with Flight Club, the tech-enabled social darts brand securing £15m of funding following a competitive investment round, whilst in December, Cain International led the investment into Swingers, a London-based crazy golf concept.

WHAT DOES 2019 HOLD AHEAD?

- **A re-focus on the guest experience:** The guest experience will need to align with estate growth on boardroom agendas, as the need to ensure brands continue to deliver and innovate for the consumer is greater than ever. New roles such as Guest Experience Director are being created to ensure brands have a real-time focus on all aspects of the guest experience. Collecting feedback and data to assist in obtaining valuable customer insights will be crucial to aid strategic decision making.
- **Continued M&A in the pub sector:** There continues to be many well-funded trade buyers actively looking for acquisitions. Watch out for Young's, Stonegate, Fuller's, Punch, M&B and Brewdog all actively looking to acquire in the space in 2019. Differentiated brands like Brewhouse & Kitchen, Barworks, Dirty Martini, London Cocktail Club, Inception Group, Alchemist, Arc, ETM, Coaching Inn Group and Darwin & Wallace will all be in the minds of investors. With sector standout Loungers appointing advisors ahead of a possible IPO, it will be interesting viewing. Finally, with Casual Dining Group appointing Rooney Annand as Chairman, could 2019 be the year that CDG diversify into the pub sector?
- **M&A in the SE-Asian sector:** With the sale of Wagamama and Rosa's in 2018, we expect investors to be looking at the best operators in the fast growing SE Asian sector. The Asian segment has experienced strong growth with its strong margins, convenience and healthy food credentials appealing to investors. Differentiated concepts such as Pho, Wasabi, Giggling Squid, HOP and Tonkotsu are well positioned to catch investor's eyes despite the challenging market.
- **Investment into Veganism:** 2019 already feels like the year Veganism has hit the masses. With Greggs flying out of the blocks thanks to its great Vegan sausage roll advertisement, and Veganuary proving popular, it would not be surprising to see a vegan concept invested in during the year. Investors will be looking actively to spot the winners in this fast growing segment.
- **Further innovation in competitive socialising:** Supported by the shift towards experiences, 2019 will likely bring further innovative social experiences to the hospitality market. As we understand darts will be the next format to be launched by Social Entertainment Venues under the Hijingo Bingo concept. Watch this space!

CONCLUSION

2018 really been a year of twists and turns but it is clear wet-led and experiential concepts are now strongly on the radar for investors. Innovation in the sector is at an all-time high and the whilst 2019 looks to hold many challenges, agile operators with differentiated offerings that are able to deliver exceptional and memorable experiences will continue to flourish.

INTERVIEW WITH NEWRIVER

Founded in 2009, NewRiver is a leading Real Estate Investment Trust specialising in convenience-led, community-focused retail and leisure assets throughout the UK. The Company's portfolio comprises 35 community shopping centres, 21 retail parks and almost 700 community pubs.

BDO talks to David Shipton, Corporate Development and Strategy Director of the Pubs Portfolio at NewRiver about being long-term investors in community pubs and the opportunities in the market.

Tell us about NewRiver and what you're up to in the pub's sector…

I joined NewRiver as MD of our pubs business in February 2017 to manage the company's growing pub portfolio and strategy, following the acquisition of 202 pubs in 2013 from Marston's and then later, 158 pubs from Punch Taverns in Sept 2015. We are very hands-on at NewRiver and quickly recognised how certain pubs were lacking investment and, in some cases, had been significantly underinvested and were under-performing as a result. We saw the opportunity to invest in the sector and work alongside pub partners to provide the support they need to make their businesses a success. We also identified that pubs can often have complimentary alternative uses on unused land and with our background in real estate, we saw the opportunity to re-activate that land and develop important complementary community uses including convenience stores and residential property.

In May 2018 we furthered our position as long-term investors in UK pubs through the acquisition of a pub company called Hawthorn Leisure which brought with it 298 pubs, a highly experiences team and importantly, an in-house operating platform to facilitate us to bring the management of the full portfolio in-house, create a platform for future growth.

The NewRiver portfolio now totals almost 700 community pubs across England, Scotland and Wales representing circa 20% of the total NewRiver portfolio, and the Company has ambition to grow the pub portfolio further to between 1000 – 2000 pubs over the next 3-5 years.

Our focus is on community, convenience and value led pubs and the majority are wet led. In our view, pubs have started to move away from the recent focus on dining; there has been an oversupply of restaurants choices in the market, so we're looking to find alternative opportunities to drive footfall.

How do you work with your pub partners?

NewRiver work in partnership with our pub partners, identifying opportunities to grow their pubs to ensure the success and sustainability of the business for the long term. For example, we came across an historical resistance to residential property development adjacent to pubs, with the assumption that they can potentially be noisy. But we don't see it that way, with the right noise prevention measures in place at the right times, we can reinvest returns from the residential development into the pub, upgrading the asset, as well as importantly, creating new customers. Located in the heart of their community, our pubs are also well placed to provide hotel bedrooms or residential lets above the pub and so this is another route that we explore to help increase revenue for the pub partners.

Following the acquisition of Hawthorn Leisure, we're pleased to report that we've recently completed the integration of the NewRiver and Hawthorn Leisure pub portfolios. Our strategic priority was the smooth integration of the two portfolios in order to create co-ordination, leverage shared expertise and create scalability for our pub portfolio. Bringing the management of our portfolio on to a single platform allows us to utilise modern technologies that help ensure a slick operating platform and efficient business processes. This platform will position NewRiver well as a long-term investor in community pubs, providing an effective platform in which to integrate any future acquisitions, creating scale and synergy. We also benefit from our depth of experience across a large and diverse portfolio allowing us to leverage economies of scale to drive down costs such as insurance and utilities, savings of which we can then pass on to our publicans. The integration will have an immediate positive impact on our FY19 as a result of unlocking £2 million of the £3 million of annualised costs synergies that NewRiver identified at the time of acquisition, with the remaining £1 million expected to follow in FY20.

In order to succeed in this market, pubs need pro-active publicans and a great offer. Some pub partners are highly experienced, whilst others can require a little more support. We have over 650 partnerships with people that wish to own run their own businesses, so we support them whilst respecting that it's their business. NewRiver provide a low cost entry to running a pub and a number of our pub partners have grown their portfolio with us to operate multiple sites and we're very supportive of that.

Looking ahead, what do you think about the prospects of the sector?

It will inevitably be a tough year in 2019. I've worked in sector all my life and in 1974 2% of beer was sold through off licenses, by 2015 over 50% of beer is sold through grocers. Pubs need great people and an attractive offer to succeed – but I would emphasise that you can succeed.

Consumer behaviours will continue to evolve, and pubs must focus on understanding what this means for their businesses and meet these changing customer needs. Millennials are frequently talked about and one of the trends that has emerged is a reduction in the consumption of alcoholic beverages, which could clearly pose a potential problem to pubs. But millennials do want to socialise, and a pub can be the focal point of the community for sports, culture or general social gatherings.

The approach to promotions is also changing, promotions used to be planned and advertised well in advance, but consumers don't want that anymore, they want real time updates and experiences, and promotions that are tailored in line with quality product choices.

In terms of products, pub partners have to be more agile and responsive to consumer trends; it's not enough to simply measure beer volume anymore. Pubs have to understand what consumers want to drink and offer a quality option at the right price. There was a time when a customer would have walked into a pub, asked for a coffee and been directed to the Costa down the road. Pubs can no longer afford to take this approach, they need to provide the coffee offer too and ensure it's a great product. With the reported trend that millennials have moved away from drinking alcoholic beverages, pubs need to increase their soft drink offering -sometimes I refer to the 'three Fs' - Fever Tree, Frobishers and Fentimans.

Looking ahead, there will be winners and losers over the next 12 months. Brexit is throwing up a great deal of uncertainty, but for us, we're in a strong position specialising in community pubs and we will look to acquire more pubs. Eventually, the uncertainty will end and whilst we're realistic about the likelihood of some tough economic times ahead, we're positive about the sector.

In the past, pubs had fallen by the wayside and needed to be redeveloped due to changing consumer behaviour. Much of this was led by oversupply, as the casual dining market has expanded and against a finite amount of disposable income. The pub can still be the focal point of the community and we're seeing many innovative uses of excess space from providing things like community libraries to computer centres.

And what about technology, where do you think pubs needs to focus their energy as consumer technology continues to evolve?

My degree was in computer science and maths, so whilst I'm certainly not a tech geek, I'm also not an instagrammer! Whilst I might have arrived late to this technology shift, the younger generation are digital natives and are teaching their parents and grandparents to become more digitally savvy. Social media is therefore increasingly influencing not just millennials, but all demographic ages.

David Shipton, NewRiver

Siri - where is the football on?
Devices and Apps make information like this accessible in real time and we need to make it as easy for the consumer as possible to know that we're hosting events or showing sport. Adapting to emerging trends can be a challenge, but pubs need to evolve like any other consumer facing business.

Pubs were traditionally the focal point of a community, and whilst social media may dilute face to face interaction, if applied wisely, it can instead be used to drive footfall and revenue. The Instagrammability of products and experiences should be embraced, for gone are the days when a pub partner could simply open the doors and expect customers to arrive. When certain products rise in popularity, such as the recent boom of gins and cocktails, pubs must capitalise on these opportunities. Having the right product, served with the appropriate brand of gin and accompanying fruit, in the right style of glass, can turn a simple drink into an experience and one which customers are prepared to pay a higher price for.

PREDICTING 2019

PROVENANCE, PREMIUMISATION AND PERSONALISATION

It is hard to avoid the news that restaurants, particularly in the casual dining sector, are struggling.

They face the perfect storm of rising rent and rate costs, increasing employment costs through apprenticeship levy, minimum wage and auto-enrolment, product price increases through exchange rate movements post the Brexit referendum and then also considerable top line pressure as consumer sentiment struggles.

You can't open a newspaper, or click on a news homepage without seeing the latest CVA application or hearing updates about previous ones – Jamie's Italian, Prezzo, Carluccios, Byron Burger – the list goes on. In the world of bars we also see continued pressure on late night spend although that isn't universal. Pubs have also seen some challenges in sustaining their top line and margins with the World Cup making up for some underlying challenges that are now beginning to show.

The sector has also been under the spotlight recently given the news surrounding Patisserie Valerie – and we have certainly seen significantly more interest in discussions around control environments than in previous years.

SO, WHAT HAS HAPPENED AND WHAT DOES THE FUTURE LOOK LIKE?

Clearly, there are no straightforward answers to this but broadly we have seen a very significant rise in the number of operators opening over the last ten years, which has led to over-supply. This in turn leads to greater competition and has led to one of two reactions from operators – some who have focused on maintaining margins and so reducing staff, or engineering the menu to derive value for the operator, and others who have focused on the consumer and ensuring a value for money offering, normally focusing on a niche product or market segment.

This is coupled with the perfect storm of costs mentioned above which again leads operators to consider where cash is spent and in some cases creating a capex time bomb, not dissimilar to that experienced in the hotel industry after the 2008 financial crash. If not preserving cash through limiting capex or reducing operating costs, then delivery has been the top line salvation for many operators over the past two years. The industry trackers for top line performance turned flat to negative in April/May 2018 but the delivery figures and the increase in pricing has hidden a wider trend of falling covers which has been prevalent for some years.

At the same time as the above, we have also seen a fundamental shift in the market. While I do not believe we are going to see a trend for more home cooking occasions, no matter what various fresh food delivery companies might say, we have certainly seen some changes in how people spend their disposable income. With the rise of online shopping there has been a significant decline in footfall in shopping centres and the average high street. This has resulted in various sites which were earmarked for retail operations being converted to food offerings, intensifying competition.

We are also seeing a real change in what people are prepared to spend their money on. There is a fight for each discretionary pound spent but this is far more finessed than simply retail vs eating out. The well documented desire for experiences among millennials, and others, has meant that a value offering is now more than location, food and drink quality, service and price. There is an interest in authenticity of what is on offer, its provenance and back story, with premiumisation and personalisation key.

> *"Success will fall to those who have absolute clarity about what their brand stands for and how to offer the value and experience that consumers require most efficiently."*

There is also a real driver for healthy alternatives which is fuelling an increase in vegan and vegetarian meals as well as a lower desire to drink alcohol. 25% of millennials claim to be teetotal or have minimal alcoholic intake which is a real change for operators to cater for and one which is not yet well dealt with.

In the pub trade, the wet-led operators have been faring slightly better than their food led rivals as they do not need such large investments in kitchen space and

it is less competitive for the spend – but this is led by those that focus on the premiumisation trend – craft beer, gins and tonics lead the way here. This is tricky to expand significantly however, and so cannot continue forever.

We should also acknowledge the coffee shops and the recent deal to acquire Costa from Whitbread by Coca-Cola demonstrates the belief that this market has further to go. The food offering at the big 4 coffee shops is below average and an opportunity but at what cost? If the current market conditions teach us anything, it's that focus on what you are known for, good at and can exploit will be the key to success.

Without doubt, current trading conditions are tough but with the challenges facing some operators there are undoubtedly opportunities for others. Success will fall to those who have absolute clarity about what their brand stands for and how to offer the value and experience that consumers require most efficiently. There is some discussion about consumers turning away from brands but I don't believe that to be true – there is simply less loyalty if you don't deliver on your promises and the expectations that are set, and there is a staggering amount of choice so there is a limited captive market.

A successful business over the next three years is going to have a focus on its story and heritage and ensure its authenticity, the customer experience, the use of effective technology for the benefit of the customer, health conscious options, premium offerings with personalisation a key driver, and, of course, the execution needs to be efficient and optimised. There might also need to be a little bit of luck…

TOP 10 PREDICTIONS

TIME FOR THE PROPERTY SEE-SAW

2019 will be the year that the power shift between tenants and landlords completes. The increasing acceptance by banks and investors that landlords returns need to be realigned will mean rent reviews become more favourable to tenants and opportunities for sites will increase.

FOCUS ON INDEPENDENTS

2018 saw near constant press attention on major chains and their CVA processes but 2019 will see the media attention switch to the loss of independent restaurants as cost pressures begin to really hit home and consumer sentiment continues to be shaky.

LEGISLATION ON TIPS AND TRONC

2019 will see legislation to determine the treatment of tips and troncs, no matter how much misunderstanding there is over the issue. This comes with a huge risk of it being rushed through and with significant consequences, some of which unintended.

LABOUR REMAINS THE NUMBER 1 CHALLENGE

The ongoing lack of clarity around Brexit will continue the uncertainty around where labour supply will come from.

FOOD MARKETS INCREASE IN POPULARITY

The challenges on the high street as well as in shopping centres mean there is increasing appeal in multiple operators on a single site as a destination in its own right.

RESTAURANTS RIDE TO THE RESCUE OF RETAIL

With excess floor space, particularly in the large department stores, whole floors could be designated to food offerings – as above with multiple operators in one space.

THE TREND FOR HEALTH CONTINUES

The latest fascination with veganism may fade but the general trend for less meat, less alcohol, and less sugar is likely to continue.

CARD OVER CASH CONTINUES APACE

2019 will begin to see the common practice of operators showing a very strong or even absolute view that no cash will be handled on premises. This is easier to administer but also better for fraud prevention which will be a key focus for the industry in 2019.

VALUE MENUS BECOME THE NORM

With trends becoming harder to follow it is likely that consumers will flock to set price menus and value driven specials. This goes beyond discounting but is part of the idea that a brand itself represents quality food for a sensible price.

THE KEY TO SUCCESS IS UPSELL

Whether through a bar, pub or restaurant consumers are willing to be led to spend more where the overall experience they are having is feeling fun and valuable. Whether upsell is through technology, at table service, product offering or pairing it will be a lot easier to earn a pound from an existing consumer than a new one.

WHEN WILL GOVERNMENT STOP TIPPING THE SCALES?

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As most operators will be aware, 3 months ago Theresa May announced at the Conservative Party conference that Government would enact legislation to regularise how businesses must pass tips to their staff.

It generated a reasonable amount of concern amongst operators and posed questions such as:

- Does this extend to service charge or just tips?
- Which groups of staff are affected?
- Can we keep any element of tips to cover our true costs (i.e. payroll, card commission)?
- Would this impact how current tronc arrangements work?

Unfortunately, Government has so far failed to provide further detailed commentary, despite a number of professional advisors proactively seeking clarification on behalf of their clients.

As BDO highlighted in a recent press article, there are a multitude of different policies adopted by businesses to manage the distribution of tips and service charges has been a source of discussion for many a year. Most customers are unaware that tips or service charge paid in non-cash forms can lawfully be retained by a business without any compliance risk to an operational tronc arrangement. In practice, there is a huge dichotomy in this regard. Some operators take nothing, some a reasonable amount, some more. For those that do retain, there is a reasonable argument that this is to cover genuine costs incurred (e.g. credit card commission and payroll fees). It is this retention, the so called "administration fee" that has led to repeated objection from customers, staff and unions.

Does the sector need legislation? An interesting question and a somewhat difficult one to answer. Most operators feel the sensible answer must surely lie in self-regulation with legislation being unnecessary. However, and playing devil's advocate, one cannot ignore that this has been tried in the past, lasted a few months and then things fell back to the way they were before. In effect, self-governance came and went, as press interest waned.

However, the majority of businesses did work within the framework outlined in the 2009 Department of BIS voluntary code of practice and more recently in 2018, UK Hospitality published guidance in the form of a Code of Practice that has the backing of Unite. In addition, HOSPA has published a comprehensive guide covering all aspects of dealing with tips and service charge and operating a tronc arrangement. One would have hoped this was enough if self-regulation is the right answer. On the flip side, there is still a huge differential in terms of retention made by some operators. Perhaps therefore, the only way there can ever be a level playing field is by way of legislation.

So what next? As this article goes to press, the Secretary of State has just published the "Good Work Plan". Covering a wide range of recommendations, there is specific reference to deductions from tips within the Fair Pay section. The concluding comments therein state, *"Government will legislate to ban employers from making deductions from staff tips"*. There is however, no timeline stated as to the likely introduction of such legislation and we suggest there will be a number of considerations to resolve before any such legislation can drafted and submitted for approval.

Consequently, our advice to operators currently remains unchanged. It should be business as usual until Government follows up with any legislative action. If they do, then it will apply across the sector and we will all have to consider the potential impact at that time.

In the meantime, tronc compliance remains high risk. Regular audits of the arrangements are well advised and do prove worthwhile. Any tronc is ever evolving and should be closely monitored by management to ensure arrangements are operating as intended.

BDO EXPERTISE

RESTAURANTS, BARS AND PUBS

BDO's national restaurants and bars sector comprises of industry specialists across audit, tax and advisory and offers clients expertise that is focused on their business and resolving unique challenges that arise within this sector.

BDO is recognised as the leading adviser to the restaurants and bars sector, blending sector knowledge and experience with practical advice which is aimed at making a real difference to our clients' success.

With a focus on the economic engine (mid-market) and private equity, we frequently advise entrepreneurial businesses as they grow and offer commercial insight that is founded on sector expertise. We know who is doing what in the market, we are able to benchmark our clients' businesses and provide information on current trends and issues over and above our competitors. With our dedicated transactional team, bolstering our audit and tax services, we are able to advise restaurant and bars throughout their full life cycle.

As thought leaders across the sectors, we offer commercial and technical updates, specifically tailored to restaurants and bars including our quarterly restaurants and bars reports. We also have a well-established network in the industry that spans finance directors, suppliers and advisers, and we are always willing to use this to our clients' advantage.

RETAIL, LEISURE AND HOSPITALITY EXPERTISE

As well as restaurants and bars, BDO has expertise across the retail, hospitality and leisure sectors with industry focussed teams across retail, hotels, travel and tourism, betting and gaming and professional sports. BDO has a breadth and depth of expertise across each of these industry segments, and we provide business and risk assurance, tax planning, corporate finance assistance, performance improvement advice and personal wealth management to our clients and have a thorough understanding of the sector.

We hope that you enjoyed our report and for information on our sector credentials or to receive our thought leadership reports in relation to any of these areas, please get in touch.

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18-12-1475