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TURNING CHALLENGES INTO OPPORTUNITIES

A STATE BY STATE REVIEW OF THE AUSTRALIAN PUB AND HOTEL SECTOR

- Pub and hotel market is facing challenges across Australia
- Limited opportunities to obtain finance to fund investment or acquisitions in the industry
- Regulatory and social factors continue having adverse impact
- However, opportunities for experienced operators with low gearing requirements

In this update, Taylor Woodings outline the challenges facing the pub and hotel industry on a state by state basis.

OVERVIEW

The national pub and hotel sector is currently facing a number of well publicised challenges that will continue to affect the trading environment, pub and hotel valuations, and the market for assets. Challenges include:

- proposals to increase government restrictions on the proliferation of Electronic Gaming Machines (EGMs);
- increased public opposition to gambling (both EGMs and other forms of wagering);
- more active policing of responsible service of alcohol (RSA) laws stemming from negative community sentiment towards excessive alcohol consumption, binge drinking and anti-social behaviour by patrons in licenced venues;
- rising competition and decreasing barriers-to-entry due to a range of new market participants serving alcohol, including venues recently established due to the introduction of small bar licences in most states;
- increased tendency for households to consume alcohol in the home, as opposed to licensed venues, as a result of:
 - stricter policing of drink-driving laws;
 - general economic conditions - rising interest rates, unemployment and other general declines in disposable incomes making buying cheaper, take-away alcohol more appealing; and
 - the proliferation of 'big box' liquor discounters, such as Dan Murphy's, expanding in the market.
- a move away from traditional high margin products such as draught beer to lower margin pre-packaged products such as premium wine and "alco pops";
- declining property values and limited debt and equity funding as a result of the significant economic decline caused by the events of the Global Financial Crisis (GFC);

- softening yields and reduced trading performance resulting in lower business valuations and/or property valuations. The exception to this is a small group of iconic venues and venues with future development opportunity, which can still trade on similar yields as they did at the height of the market several years ago; and
- smoking bans (although most of the impact of the bans was absorbed by late 2007).

Key Challenges Affecting the Industry

Financing Ability and the Availability of Debt

Freehold venues purchased during the peak of the market around 2007 were commonly financed on high loan to value ratios (LVRs) with valuations based on forecast expectations of peak-level profitability and strong valuation multiples. Anecdotal evidence suggests that in the current market finance is available for pubs and hotels. However, there are onerous conditions imposed on purchasers, especially for inexperienced or unproven operators. Evidence exists that conditions placed on purchasers for each asset class of pubs include:

Type of Investment	LVR	ICR	Other
Leasehold Interest	Max 40-50% LVR	Additional security or 2 times interest coverage required	Industry experience and secure lease essential
Freehold going Concern	Max 60% LVR	2 times interest coverage required	Industry knowledge required
Freehold Investment	Max 65% LVR	1.5 to 2 times interest coverage required	Strong tenant and lease terms required

Financers are only lending to borrowers with industry experience and with strong LVR positions, meaning those without significant operating experience and significant cash or equity face difficulties entering the market.

Gaming

The uncertain outlook for gaming and the real potential for further state and federal regulatory and policy changes has adversely affected the value of pubs and hotels, general market sentiment, and financing approvals. Of particular concern to the industry are recommendations made by the Productivity Commission in their report on Gambling and the more recent Gillard-Wilkie agreement in respect to gaming related matters.

The Productivity Commission Report recommended the following restrictions:

- the use of technology at venues to limit betting levels (known as pre-committment);
- warning displays at venues; and
- ATM withdrawal limits in licensed venues, except for casinos.

The possible impacts of the Productivity Commission Report and the Wilkie-Gillard agreement have the potential to significantly affect revenues in the gaming states (NSW, QLD, VIC) especially in heavily gaming-reliant venues.

NEW SOUTH WALES

1. State of the Market

Recent market activity, including a number of sales of iconic venues, should be viewed with caution. The current market could be described as a “distressed” market with transactions occurring under “distressed” circumstances with a prevalence of receiver and mortgage sales. Agents have reported that overall market enquiries have been low in recent times.

Sales results have been skewed by transactions that are essentially property investments first and foremost and pub deals second. However, there remains some potential value as experienced business operators move on opportunities to unlock value from distressed assets.

Other relevant factors currently affecting the market include:

- inconsistency in trading results in the second half of 2010 calendar year;
- negative media coverage of the industry and asset values;
- a number of high profile investors taking out opportunities in the sector;
- recent Receiver appointments to groups such as the ICON Group; and
- finance is not readily available to those looking to invest or refinance in the industry, and where it is available it is with onerous conditions.

2. Other Issues

Anecdotal evidence suggests that other relevant issues include:

- proposed changes to restrict the level of gambling and EGMs in venues;
- new competition from small bars and venues operating under alternative licensing arrangements;
- the additional costs of operating a venue under the developing RSA restrictions, such as those regulating the types of beverages that can be served, venue lockouts, and increased security costs for operators;
- the increasing power of security firms and the overall affects of decisions made by security providers;
- licensing and trading restrictions; and
- police presence and intervention.

3. Yield Expectations

Pub and hotel values have reduced significantly since the height of the market, reducing by up to 50 per cent in some instances. The combination of softening yields and reduced trading performance has resulted in lower values overall. Based on anecdotal evidence, the following table outlines the range of yields that may be expected for the New South Wales market. Exceptional iconic venues may still trade on a 7-8 per cent yield, although this is not common. Care must be required when applying yield as a benchmark across the board.

Venue Type	Freehold Going Concern (%)	Leasehold (%)	Freehold Investment (%)
Metropolitan	12-14	35-40	9.5-10
Regional	15-17	40+	12.5
Country	17-20+	50+	15

VICTORIA

1. State of the Market

It appears there is a two-speed Victorian market. Some venues, particularly in the Melbourne CBD, enjoyed a bumper Christmas and New Year with The Ashes and the Australian Open Tennis boosting visitors to the city.

However, there are clear signs that some operators outside of the CBD are struggling, evidenced by the collapse of the Days Group prior to Christmas. The Group consisted of six venues in metropolitan and regional Victoria. Some operators closed during the school holidays, as a result of limited patronage. Operators are hopeful that trading will return to normal with the start of the AFL season.

2. Other Issues

The Coalition Government has committed to easing the burden on small businesses and community-based clubs, with 2011 licence fees reduced by 50 per cent for non-gaming clubs, restaurants, BYOs and wine bars.

However, as a result of increased negative media scrutiny, the Government amended the Liquor Control Reform Act 1998 (the Act). The amendments to the Act tighten laws to prevent intoxicated individuals from attending licensed premises. Offences under the new legislation will result in an increase in the licence fee payable by the operator in the year following an infringement.

It is unclear whether the revised fee continues to apply to the venue, following a transfer of ownership to a new operator with a clean history. This could have a negative impact on values regardless of the valuation methodology applied. Additional restrictions on a non-compliant venue may also be applied, such as limited operating hours and additional security requirements.

Late night venues trading beyond 11pm will be further affected by these amendments as they are subject to the venue capacity multiplier, meaning those venues with previous infringements will be faced with increased licence fees. Gaming venues will continue to be impacted by legislative changes, such as the removal of ATM's by 2012, the introduction of pre-commitment mechanisms and maximum bet amounts on all EGMs.

3. Yield Expectations

Recently, there has been an increase in corporate activity with the sale of the Munday Group in late 2010. The Group sold for \$48 million on a multiple of 7.25 (yields of 13.8 per cent) and consisted of seven gaming leasehold venues. The sale of the Days Group venues also presents an opportunity for both individuals and larger operators. The venues are being sold through an expression of interest campaign.

Yields in Victoria generally appear to be tighter than in the northern states. These yields however have been based on limited sales evidence. It remains to be seen how robust these yield figures will remain in the coming year. Based on anecdotal evidence, we consider the following table outlines the range of yields that may be expected for the Victorian market.

Venue Type	Freehold Going Concern (%)	Leasehold (%)	Freehold Investment (%)
Metropolitan			
- gaming	9-12	14-20	7-10
- non-gaming	12-15+	25-40	6-10
Regional	10-15+	15-20	8-12
Country	20+	20-30+	10-15

QUEENSLAND

1. State of the Market

The Queensland hotel industry continues to suffer from negative sentiment perpetuated through the media. Reports continue to highlight a distressed market, with receivership appointments being reported as a matter of urgency.

Industry sources say that trade has decreased across the board over the last quarter for gaming and on-premise trade. Conversely, although data suggests that retail trade has increased in the last quarter, this activity can be attributed to the 'big box' liquor stores and does not represent the majority of smaller hotel retail sales.

2. Other Issues

The days of running profitable, uncomplicated pubs are over. Operators are now faced with increasing compliance and regulatory requirements that have been introduced by the State Government. For some inexperienced operators, this means financial pressures due to increased costs, such as security requirements and RSA compliance.

3. Yield Expectations

Current yields for Queensland pubs broadly fall into three categories (detailed in the below table). Based on anecdotal evidence, we consider the following table outlines the range of yields that may be expected for the Queensland market. Note that in some areas, A-grade or iconic assets can attract a lower yield.

Pub and hotel values have reduced significantly since the height of the market before the GFC. Although we have seen pub and hotel purchases in Queensland, purchasers are not prepared to pay a premium for the potential that they see in the venue. Sources in the industry say that current yields are more relevant to the pub and hotel industry than they were before the GFC.

Venue Type	Freehold Going Concern (%)	Leasehold (%)	Freehold Investment (%)
Metropolitan	12-14	25-35	7-10
Regional	14-20+	35-45	9-12
Country	17-25+	40-50	12-14

WESTERN AUSTRALIA

1. State of the Market

Overall, the industry in Western Australia is not enjoying the same level of profitability compared to New South Wales, Victoria and Queensland, as EGMs are not permitted in venues. However, Western Australian operators continue to provide gambling through wagering facilities, such as sports betting and services such as Keno. Overall, this has resulted in the Western Australian market developing venues with a greater focus on food and beverage offerings. In most cases, products are offered at a higher price than in the other states. Due to the mining boom, most venues are continuing to experience strong trading results. Most distress in the market has primarily been caused by price correction and excess debt levels from acquisitions during 2006-2008.

2. Other Issues

The Western Australian market has probably been the most stable of all markets nationally, with continued strong economic conditions driven by the mining boom in the state. Additional trading challenges are consistent with those in other states, for example the increase in small bars, an increase in packaged alcohol consumption off-site, and active policy debate around alcohol-related violence and binge drinking. These challenges will grow in Western Australia as the major supermarket chains move towards the full introduction of their 'big box' offerings.

On a positive note, the strong economy and continued interest in capital investment of the profits derived from the strong economy will continue to support valuations. This will be counterbalanced by the lack of appetite major lenders have to further exposure in the sector.

3. Yield Expectations

Anecdotal evidence suggests that in light of the current market conditions, valuations have again stabilised, although at lower levels than two years ago, indicating that the hotel market remains strong, especially for premium venues. Recent sales transactions for inner city hotels have ranged between 14-16 per cent for well run, recently refurbished, metropolitan hotels and down by 15-25 per cent for those in need of capital works or in declining regional and metropolitan market areas. Some challenges to yields will occur in 2011 as the fall out of a number of over leveraged groups surface, with buyers expecting a number of venues to be placed on the market.

Based on anecdotal evidence, we consider the following table outlines the range of yields that may be expected for the Western Australian market.

Venue Type	Freehold Going Concern (%)	Leasehold (%)	Freehold Investment (%)
Metropolitan	10-15	20-50	8-12+
Regional	15-20	20-40+	12+
Country	20+	20-40+	15+

OTHER AUSTRALIAN STATES AND TERRITORIES

Venues and operators in the Northern Territory, South Australia and Tasmania face similar issues to those detailed above. Overall, trading has been inconsistent, especially in regions heavily reliant on the tourist trade. The strength of the Australian dollar has continued to weaken the flow of domestic tourism, which has in turn affected venue trading.

HOW CAN TAYLOR WOODINGS HELP?

Taylor Woodings has extensive experience and knowledge of the pub and hotel sector, including:

- undertaking engagements to provide pre-lending reviews and business valuations for financiers considering funding operators in the pub and hotel sector, for acquisitions or other capital investments;
- undertaking appointments as Investigating Accountants to venue operators to provide a clear understanding of issues to the appointing bank;
- trading on numerous pubs and hotels as Receivers and Managers. We aim to improve trading results as a matter of urgency by utilising our network of industry contacts whilst actioning sales and marketing campaigns that achieve sales above expectations; and
- performing extensive forensic accountants reports and acting as expert witnesses in Court matters in relation to commercial disputes.

We have strong relationships with industry stakeholders including, valuers, operators, consultants, potential purchasers and specialised legal contacts. Taylor Woodings has seen an increase in the number of enquiries and appointments to pubs and hotels.

More Information

If you would like further information, please contact our team leader, Quentin Olde, or one of our team members.



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