Impact of recent economic trends on pubs and breweries

A report produced for the BBPA

November 2022

Contents

The sector is facing major economic shocks, with differential impacts and uncertainty on outlook – scale of potential exposure goes beyond what firms can offset

Brewers and pubs are facing major economic shocks

- Following on from major shock of Covid, sector is now facing two core shocks:
  - **Higher costs:** energy, commodity inputs, labour, and interest payments
  - **Weaker consumer demand:** cost of living crisis, which has not fully hit yet (energy & mortgage increases to come)
- Brewers are most exposed to higher raw material and energy costs – in a slim margin sector these will have to be passed on to the extent possible, or risk business failure.
- Pubs face these higher energy & input costs plus higher wages / labour shortages. And particularly exposed to cost of living crisis – with cutback on discretionary spend to come.

Businesses face differential impacts and uncertainty on outlook

- Common shape of impacts across firms, but model differences can affect exposure to specific cost shocks.
- Timing and magnitude varies across individual businesses
  - some already face higher costs and demand pressures
  - others are protected for now – a result of buying ahead, being 'lucky' with timing of energy contracts, or more resilient demand – but worry of future pressures
- The drivers of the shocks (Brexit, Covid, war in Ukraine, weaker £, higher interest rates) mean its duration is uncertain
  - Is it a temporary shock that will pass
  - Or a structural shift that businesses (& consumers) need to adapt to?

A few businesses may be able to weather the storm, but many face closure without support

- Firms focussed on options to mitigate cost increases through efficiency savings, and pass through in higher prices where possible.
- However combined scale of cost pressures is substantial, **equivalent to up to 6x pre-Covid margin for brewers, and 3x for pubs** – if these fully materialise then the viability of previously successful firms will be in question.
- Government action to support on energy costs helps for those immediately exposed, but time limited nature creates uncertainty for future costs next year.
- Smaller businesses are most exposed, as they lack the resources of the larger pubcos / brewers who are more likely to be able to draw on resources to 'weather the storm'.
- However even larger businesses may struggle if the "perfect storm" continues.

Range of potential ways that Government could support the sector

In principle Government support can take several forms, with each option having different benefits based on their cost, targeting and speed.

Type of support	How it can help	Illustrative examples
Reduce costs directly	• Tackle specific cost pressures on energy, labour and food & drink inputs	• Energy price cap – extend support beyond March • HGV driver training; hospitality visas
Offset higher costs with savings elsewhere	• Mitigate cost increases that are hard to tackle directly (e.g. commodity costs) by cutting business costs in other areas	• Business rates freeze / relief – in face of planned increase • Beer duty freeze / cut – in face of planned increase • Corporation tax / NICs cut
Reduce cost of doing business	• Defer upcoming regulatory changes to reduce operational complexity & associated compliance costs	• Deposit Return Scheme • EPR reform
Support business adaptation	• Make it easier for firms to make necessary changes to operate in new (higher cost) economic environment, while preserving incentives for businesses to adapt	• Extend super deduction / capex incentives • Access to financing / loans for efficiency improvements
Stimulate consumer demand	• Give consumers extra funds to boost spending at pubs	• Cut VAT, or other taxes • Specific vouchers

Targeted Government support for pubs and brewers can help sustain this important & vibrant sector

Pubs play an outsized role in communities across the UK – and depend on brewers

- Individually small businesses but collectively a big source of jobs
- Present in every part of the UK, which means benefits are widespread
- Goes beyond economic impact of jobs, to include role as social hub
- Brewers provide a key input to successful pubs

Pubs are particularly exposed to combination of cost and demand shocks

- Require energy to make pubs hospitable & run kitchens
- People intensive businesses hit by labour shortages & wage inflation
- Cost of living crisis risks cuts to discretionary spending – which exposes spend at pubs

All are exposed, but small independent firms face biggest risk

- Larger pubcos & brewers are more exposed to cost increases (due to larger bills) however they may have some resources to fall back on temporarily – cut capex / divi, issue debt
- This could help their managed pubs, and may also extend to some L&T pubs
- Independent pubs & brewers don't have access to these, so face closure if costs can't be covered

Closures will accelerate without external support

- Firms can only do so much to mitigate cost pressures & costs can't be passed through in full given demand headwinds
- Risk of widespread closures, with impact on jobs, communities and tax revenue – unless support to reduce costs

Ensuring a healthy pub sector will also help the brewing sector, which relies on the on-trade

- Brewers depend on healthy on-trade, and independents within that – important source of sales and profit
- Small and medium sized brewers typically even more so (as limited off-trade)

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The beer and pub sector is an important part of the UK economy, and UK society more generally

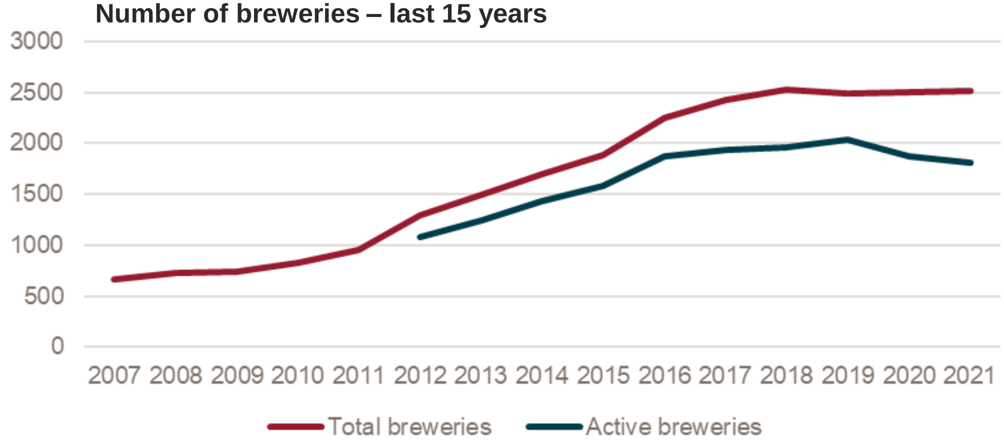
- Over 46k pubs in the UK, and over 1,800 active brewers. Vibrant and changing sector –the total number of pubs has been in steady decline since early 2000s; but rapid growth in number of microbreweries, and innovation in craft and no/low alcohol beer to meet changing habits.
- Overall beer and pub activity estimated to sustain 936k jobs, £14.3bn of wages and £26.2bn of GVA across the UK from direct, indirect and induced effects – with a significant contribution in every region of the UK, reflecting pub locations.
- The sector generates over £15bn in tax revenue – including £6.5bn in VAT (~5% of total receipts), £4.6bn in excise duty, £2.3bn in income tax/NICs and £1bn in corporation tax.
- The bulk of the contribution comes from pubs – at the heart of communities across the UK, serving residents & visitors, supporting jobs, and delivering social value through bringing people together and delivering social impact projects – and beer plays a key role in pubs. No/low alcohol beer also plays a role in improving health outcomes.
- Pubs support jobs for the young, and those looking for flexible work – nearly half of those employed in pub sector are under 25, and over half are part time.
- The sector's direct GVA contribution (£13.8bn) is estimated to be larger than, for example: the manufacture of motor vehicles; air transport; and motion picture, video and TV production.
- Spending in pubs plus off-trade beer sales are a meaningful share of consumer spending; total spent on beer (£13bn) equates to 1.1% of all consumer spending

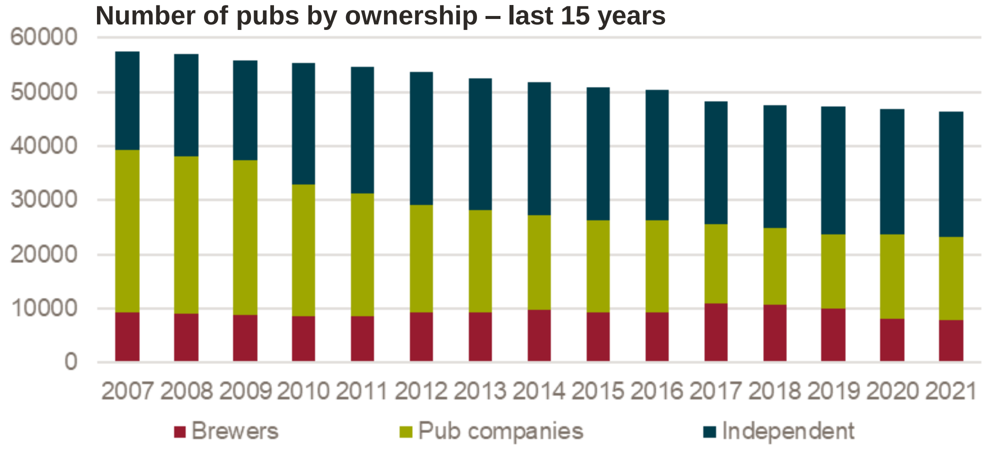
46K	Pubs in the UK
1.8K	Active brewers in the UK
936K	Jobs sustained
£26BN	GVA, across the UK
£15BN	Tax revenue generated

Sources: BBPA digital handbook (2021) – E5, E6, E11, E12; Oxford Economics Report for BBPA ('The Local Impact of The UK Beer and Pub Sector')

There is a diverse mix of pub & brewer business models...

- UK brewing sector is highly competitive by international standards – all main operators are present, unlike most other markets, with limited consolidation – and high duty rate.
  - Brewers range from scale of global brewers alongside a regional & craft scene, with a tail of microbreweries. Largest nine breweries account for c.90% of UK volume, while the tail of 1,800 account for just 2% of volume.
- Pub sector includes large & small chains, plus independents – with mix of op models
  - Half of pubs are independent, ~30% owned by pubcos, and remaining ~20% by brewers. 80% of pubs are SMEs – all independent and L&T pubs
  - ~30% of pubs are 'leased & tenanted' (L&T), where an individual rents the pub from a pubco / brewer for an agreed period; and ~20% are 'managed' by someone who works for pubco / brewer (both pubcos and brewers operate a mix of op models).
  - Pubs vary in their proposition focus between 'wet' and food-led, whilst some also offer accommodation. There has been a steady decline in share of 'wet' sales over the last 15 years as food sales have increased.
  - Long run decline in number of pubs over last 30 years, accelerated since 2001. Number of independent and brewer-owned pubs broadly stable over the last decade, but number of pubco-owned has nearly halved as marginal sites closed.

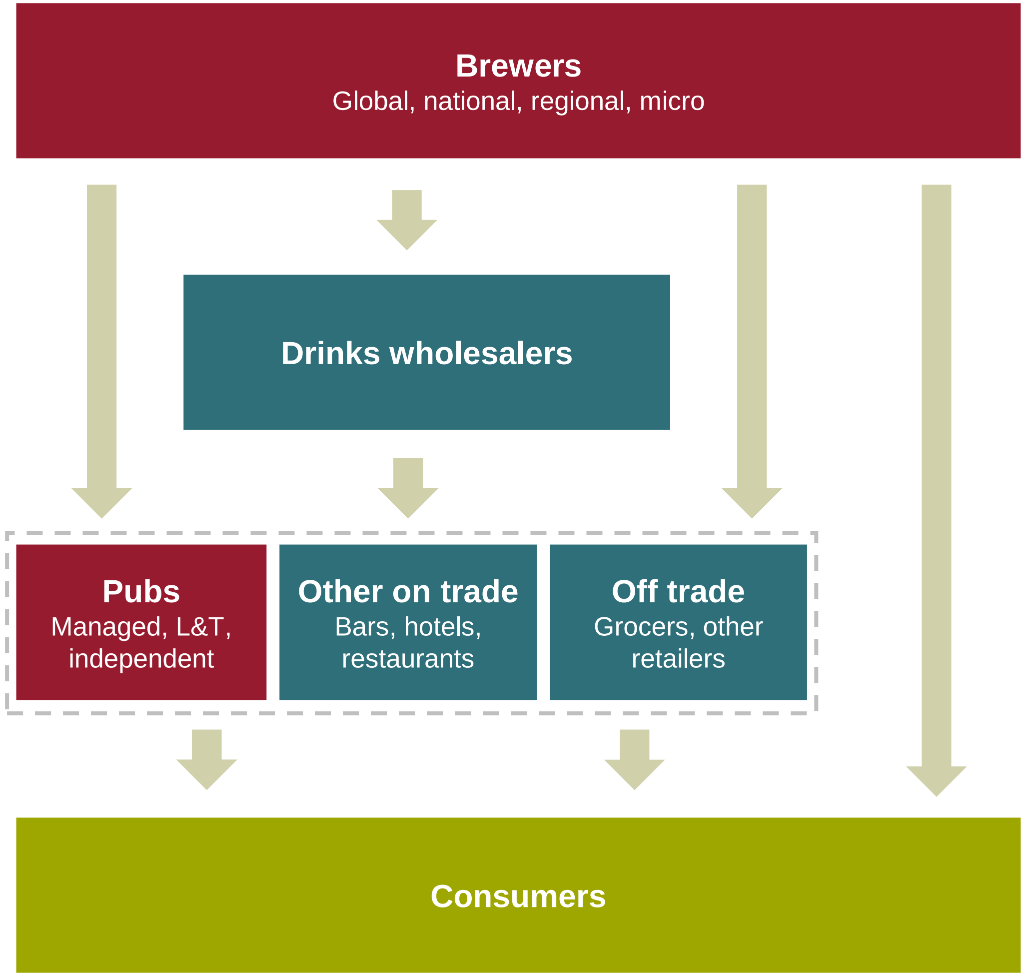




Sources: BBPA digital handbook (2021) – E5 and E6.

...and a symbiotic relationship between the two groups

- Brewers and pubs have a ‘vertical’ relationship. The extent of the links vary, from simple supply relationships (all pubs buy from brewers; all brewers sell to pubs), to partnerships, to vertically integrated firms who operate both pubs and breweries.
  - 1 in 4 brewers own pubs – more for the mid-size, where regional firms often operate both a brewery and pubs in the area
  - 40% of total brewery volumes go to on-trade, down from 50% in mid 2010s as the share of sales through the off-trade has increased
  - Smaller brewers typically have a higher share of sales to on-trade, while larger brewers have higher share to off-trade.
- Brewers employ sales teams to manage sales to the on and off-trade – on-trade sales teams are typically larger given less consolidated customer base than off-trade; but some use drinks wholesalers to manage this interaction instead.
- Brewers typically earn higher margins on their sales to the independent pub sector compared to sales to larger pubcos and the off-trade, where higher countervailing buyer power and larger volumes lead to lower average margins for brewers.
- Some brewers sell direct to consumers, typically online, but some also operate their own retail stores.



The economic model of a pub and a brewery affects their exposure to and ability to mitigate shocks – there are common themes, and some model differences

It is important to understand the economic models of brewers and pubs to understand their exposure to current economic shocks, ability to mitigate, and potential ways in which policy can support

Brewers

Common themes

- Production business – raw material commodity inputs
- Automated production, more people intensive sales
- Low margin business
- High duty rates- some of the highest in the world
- High level of fixed costs – economics rely on high utilisation

Model differences

- Size – unlock economies of scale
- Level of vertical integration with pubs
- On/off-trade sales mix, and size of sales force
- Insource vs outsourced activities
- Extent of contract brewing

Pubs

Common themes

- Economics revolve around individual sites (even if part of wider group)
- Food & drink the core COGS items
- People focussed business – customers & labour
- Discretionary spend, exposed to changes in demand
- Requires periodic pub refresh (capex spend)

Model differences

- Ownership / level of vertical integration with brewers
- Operating model – managed vs L&T vs independent
- Proposition focus – food, wet, accommodation
- Size, location type & customer profile

For a brewery, revenues need to cover ingredients, manufacturing & distribution – plus allow for investment in brand building, brewing facilities & infrastructure

The three main cost categories for brewers are duty, production and sales – with slim margins above those costs

- **Duty** accounts for a large share of (gross) sales – paid by brewers, with cost passed on to consumers via pubs / retailers. Duty rates vary by alcohol strength, which means duty levels can vary across brewers based on their product mix. Small brewer relief to reduce the burden for smaller operators.
- **Production** costs account for around half of total costs (ex duty) – of which raw materials (malt, hops, sugars, yeast) are the bulk, followed by energy & labour (brewers are not particularly labour intensive).
  - The cost of production is similar across beers – 'premium' beers generally do not cost more to produce, but the retail price differential comes through a brand premium supported by additional costs of brand building and positioning, inc packaging for off-trade and glasses & pumps in on-trade.
  - Larger brewers produce at significantly lower cost per hl reflecting scale economies. Efficient operations rely on high asset utilisation to spread fixed cost of operation, and optimised logistics
- **Sales & admin** account for around a third of cost base, with further costs for distribution & warehousing, and packaging.
- The cost profile (mix) is broadly similar across brewers, although model differences can affect the mix – these include on/off trade mix (which affects packaging), extent of outsourced activity (e.g. logistics), and contract brewing (which has production costs but no sales/marketing costs).
- Capex focusses on manufacturing kit, which does not need regular updates. Sector as a whole averages annual capex of 3.9% of sales or £243k per business.

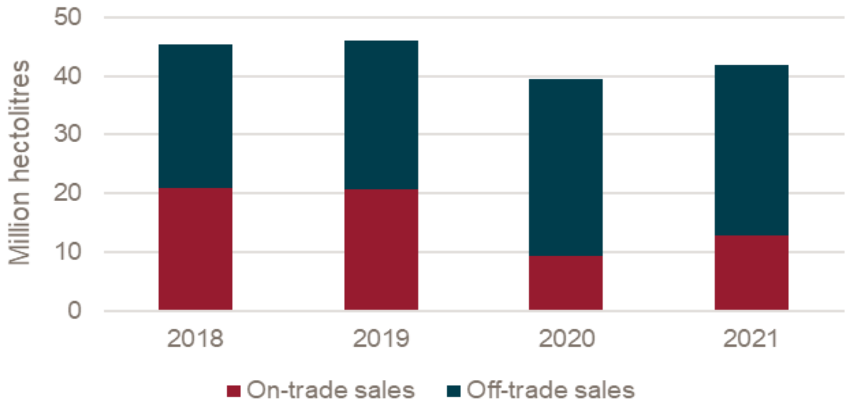
Illustrative brewer P&L - 2019	% sales (gross)
Duty	40%
Production	28%
- Raw materials	14%
- Energy & water	5%
- Labour (production)	5%
- Other production	4%
Distribution & warehousing	6%
Sales & admin	20%
Packaging	2%
Margin	**3%**

Source: Frontier analysis based on BBPA input and BBPA member data

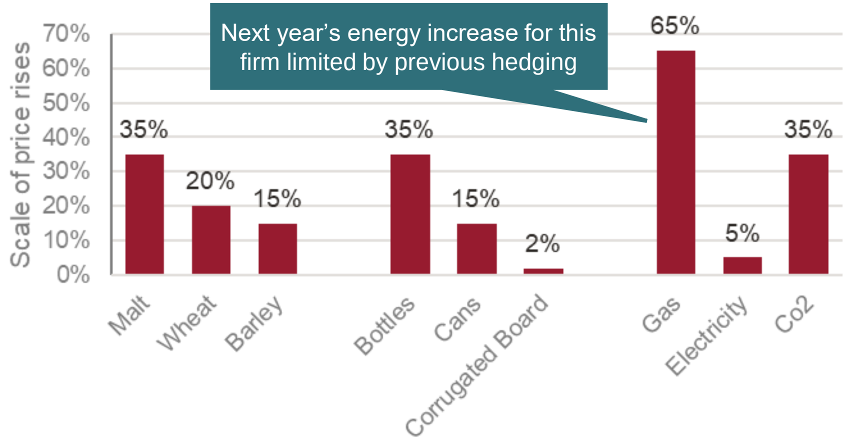
Brewers hit by Covid lockdowns that cut on-trade volumes, followed by increasing cost of raw materials and energy post-Covid

- Covid exposed brewers to lower sales through pubs, although those who also sell via off-trade (or direct to consumer) were able to rebalance to some degree. Total beer volumes were down 20-30% during each lockdown and remained below pre-Covid levels during the rest of 2020 and 2021, while off-trade increased to nearly 80% of total volume.
- Post-Covid, cost inflation picked up due to shortages and supply bottlenecks driving up costs of raw materials & distribution, before Ukraine war led to surge in cost of raw materials and energy. Further cost pressures from devaluation in the pound, which increases the cost of key $-denominated raw materials, along with rising interest costs for those with floating debt.
- Timing and magnitude of the impact on specific firms varies given different contract positions, levels of hedging and forward-purchasing across operators – but some exposed immediately to cost increases, and all will be exposed once contracts / hedging positions lapse.
  - **Energy** has become the #1 issue – those out of contract faced up to 400% jump, however Government support will cap exposure this winter at more like 130-140% increase. Outlook for 2023 remains uncertain but few expect costs to fall back to previous levels.
  - **Raw ingredients** costs already up 25% and expected to rise by at least 60% next year – if not more –as producers exposed to uncertain future energy costs.
  - Other increases in **packaging** costs, with glass bottles up at least 35%; **CO2**, a small input but shortages have spiked prices up ~3,000%; and **labour** up [6%], but less exposed to shortages facing pubs / wider hospitality.
- In addition, some brewers are exposed to fragile suppliers, where they have outsourced logistics to wholesalers – a slim margin sector exposed to high fuel costs and HGV driver shortages.

UK Beer sales split between on and off-trade



Example of next year forecast cost increases facing a specific brewer



Sources: BBPA- Digital Handbook A6 (2021) and BBPA member data

Sector working to mitigate cost increases, but scale of impact and nature of a low margin business need to be passed through

Combined cost increase equivalent to up to [8x] pre-Covid margin, of which energy the major contributor, followed by raw materials – sets scale of challenge to mitigate, or pass-through.

- Brewers taking various actions to mitigate cost increases through efficiency savings – in particular energy / water saving initiatives, labour savings, and range reduction.
- However there is a limit to how far these can be pushed, and brewery economics of high fixed costs mean volumes can't easily be scaled down to save costs; other changes come with additional costs (premiumisation) or margin implications (shift to lower margin off trade).
- Nature of cost increases in slim margin sector means there will be some cost pass through, but limit to what pubs can absorb given most challenged consumer environment in decades – and strong countervailing buyer power, particularly in off-trade and with larger pub groups.
- Larger brewers are more likely to be able to withstand temporary pressures – draw on financial reserves, cut dividends, borrow, or cut back on investment to weather the storm. But risks if global brewers choose to invest elsewhere, or brewers don't see a route to recovery.
- Small and medium sized brewers more exposed, in particular independent breweries, who don't have resources to fall back on so may be forced to shut down if they can't pass through costs.

Illustrative brewer P&L – 2019 vs 2023	Before	Scale of Increase	After
Duty	40%		40%
Production	28%		52%
- Raw materials	14%	+25%	18%
- Energy & water	5%	+400%*	25%
- Labour (production)	5%	+5%	5%
- Other production	4%		4%
Distribution & warehousing	6%	+5%	6%
Sales & admin	20%		20%
Packaging	2%	+20%	2%
Margin	**3%**		**-20%**

Scale of cost pressure to mitigate or pass through in higher prices

Source: Frontier analysis based on adjustments to Europe Economics' 2017 Small Breweries' Relief Scheme report using BBPA member data 2019 – 2022 and interviews

*400% is the scale of cost increases once the energy support package comes to an end at the end of March. Whilst the announced support is in place, the scale of increase is expected to be around 130-140%.

For a pub, revenues have to cover cost of goods (from breweries, plus other drink & food), people & operating costs – and allow for investment in buildings & environment

Vast majority of pub costs go on food & drink COGS and people, then tail of other op costs

- Food & drink COGS are ~40% of sales for a typical pub. People costs at ~25% sales, with high share of staff paid at NLW (so directly exposed to increases). Utilities and rates are each ~4% sales (pre energy price surge); other costs which include marketing, entertainment, maintenance add up to 7-10% sales.
- The cost profile (mix) is broadly similar across pubs, although model differences can affect the mix – these include: food vs wet led; size; ownership; and accommodation.
  - Food-led pubs earn higher gross margin to pay higher cost of chefs, but op margin not substantially different to wet-led.
  - Smaller pubs often operate with fewer people, and lower share of sales on labour. Larger managed pubs (av 2.5x higher average turnover) operate with bigger teams
  - Leased & tenanted pubs pay rent to pub company, typically around half of profit pre rent but can range from 35-65%.
  - Accommodation supports site profitability, but requires the right site & capital to furnish.
- Pub capex focusses on pub fit out and upkeep, which typically requires update every ~7 years – although cycle varies across operators. Sector average capex is 7.4% sales or £47k per business (increased to £65k in 2020 due to Covid measures)

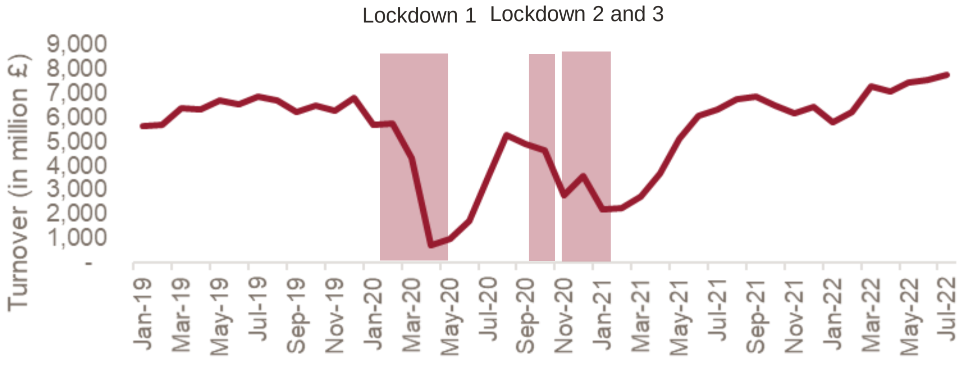
Simplified P&L, 2021 – Leased & tenanted - 2019	Wet-led	Food-led
COGS - drink	35%	15%
COGS - food	8%	23%
Gross Profit	**57%**	**62%**
- Drink	56%	57%
- Food	61%	65%
Wages	23%	28%
Utilities	4%	4%
Rates	3%	4%
Repairs & renewals	1%	1%
Marketing & entertainment	4%	1%
Other operating costs	14%	14%
Profit	**9%**	**9%**

Source: Frontier analysis based on “running a pub guide” 2022 and 2019, BBPA member data 2019 – 2022 and interviews

Pubs faced a major economic shock during Covid, and pressures have continued post-Covid with inflation in raw materials, wages & energy putting strain on pub viability

- Pubs hit by lockdown closures, followed by a £865m cost to make pubs ‘Covid safe’ on reopening; plus expanding and adapting their outdoor space during Covid.
- Differential pub volume rebound following reopening – some sites benefitted from staycation boom, while others remained hit by changing footfall patterns in city centre locations, and changing consumer drinks preferences prompted by lockdown.
- Economic pressures have continued post-Covid with inflation in raw materials, wages and energy putting severe strain on viability of pubs.
  - **Energy** is the number 1 issue, with out of contract pubs facing up to 4x higher prices compared to pre-Covid levels – a level that wipes out annual profit 2-3x over.
  - **COGS** increases driven by higher costs passed on by brewers, plus further increases of up to 20-40% for food – including exposure to weaker £.
  - **Labour** costs up to 10% higher, as pay rates have risen – including impact of higher NLW; although variation, reflecting local labour markets around a pub (shortages more acute in some locations than others).
- As with brewers, timing and magnitude of the impact on specific firms varies – but some exposed immediately, and all exposed once contracts lapse.
- Looking ahead, further inflation in COGS, energy, higher interest costs and weaker pound will add additional pressures. Plus the inflation-linked business rates increase due next spring will see further increases for pubs unless policy measures change.

Total UK Turnover of Food and Beverage services



Facing up to 4x higher energy prices for pubs out of contract (once gov support ends next year)

Up to 10% higher labour costs – high pay rates, but shortages for some pubs

Facing up to 20% higher wholesale price of beer if brewers pass through higher costs

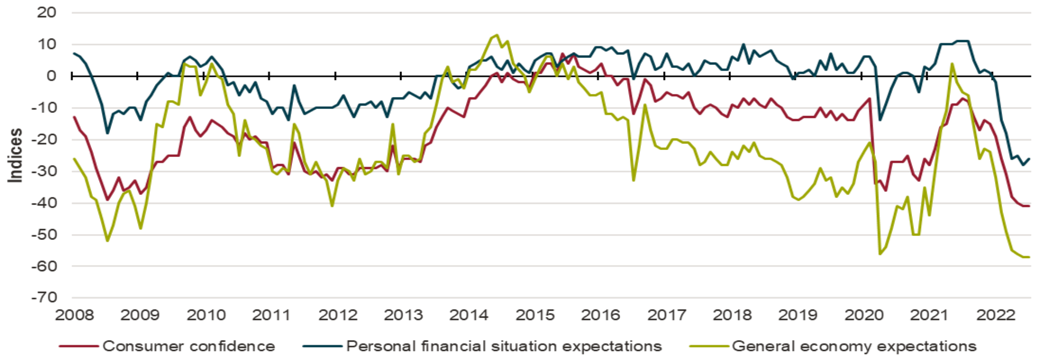
20-40% higher food COGS as raw material & energy prices increase supplier costs

Source: BBPA Digital Handbook - C12; Data from BBPA members

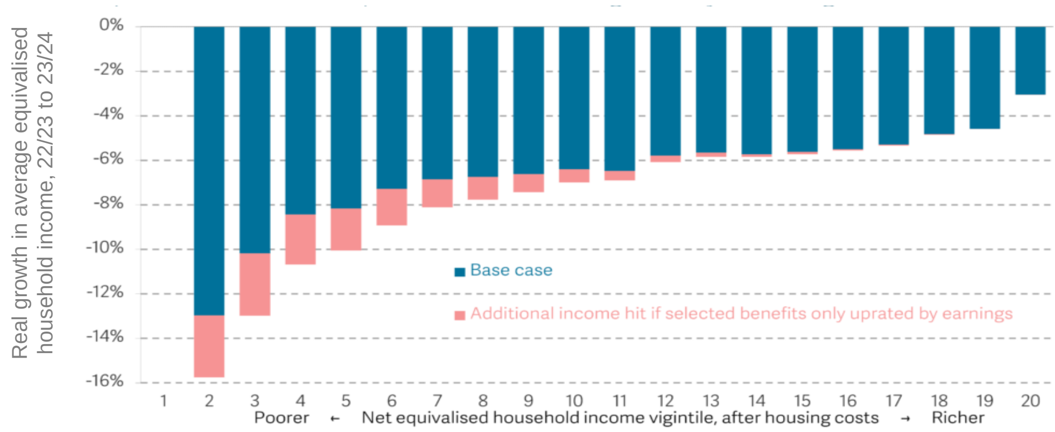
Pub sector also particularly exposed to consumer cost of living crisis

- Serious cost-of-living crisis facing households with surging inflation – in particular higher energy bills, food and fuel prices, and higher mortgage/debt repayments linked to rising interest rates.
- Food and fuel inflation already here, but higher energy and mortgage bills are yet to hit in full – big squeeze on disposable incomes for all households next year.
- Recently announced support for energy bills will ease pressure for some to some degree, but spending cutbacks and wider recessionary concerns remain
- Pub spending is a discretionary item and at risk of being cut back if finances are stretched. Starting to see impact on spending at pubs, and expected to worsen:
  - Recent CGA survey found 36% of consumers eating out less often due to cost of living concerns, and 45% expect to visit hospitality venues less frequently
- Some pubs will be more exposed to spending cutbacks than others, depending on the nature of the pressure on households and the proposition focus of the pub.
  - For example, upmarket pubs may be more protected as their consumers cutback less than midmarket pubs, whose consumers are more exposed; or pubs in tourist locations may see more resilient demand than those in city centre locations.

Sharp fall in consumer confidence this year, now at record lows…



…and major squeeze on household disposable incomes next year



Sources: GFK survey from Bank of England August report; Resolution Foundation

Pub sector is working hard in response to these challenges but can't all be offset – there will be cost passthrough, proposition changes, and closures

Scale of combined impact equivalent to up to [3x] pre-Covid margins – scale of challenge to mitigate or pass through

- Focus on changes to improve labour and energy efficiency, including (for some) decisions previously thought off limits, such as reduced pub opening hours or stopping food sales to save on people and energy costs
- Scale of impacts can't be offset by op cost savings or absorbed in margin – will need to pass through in higher prices to hold (or even increase) gross margin. The av. price of a pint already up 15p (4%) this year as a result, and pubs also redesigning menus – replacing ingredients (e.g. cod to 'white fish') & smaller portions ('shrinkflation').
- As with brewers, larger firms are more likely be able to withstand the temporary external pressures – draw on financial reserves, cut dividends or borrow more – but will need to cut back significantly on investment to weather the storm. Whereas if structural changes, can expect more structural responses – i.e. more site closures.
- Smaller firms more exposed, in particular independents who may close if they don't have resources to see them through, and L&T pubs will look for support from owners (pubco or brewer) and without that may also simply hand back keys / close.
- The extent to which rent remains constant in the event that pubs are making a pre-rent loss will vary. Some pubs will have agreements that link rent to profit while others will have fixed rents.

Average food-led L&T pub 2019 vs 2023	Before	Scale of Increase	After
COGS - drink	15%	20%	18%
COGS - food	23%	20%	27%
Gross Profit	**62%**		**54%**
- Drink	57%		48%
- Food	65%		58%
Wages	28%	10%	31%
Utilities	4%	400%*	21%
Rates	4%		4%
Other operating costs	17%		17%
Profit after rent	**9%**		**-18%**

Scale of cost pressure to mitigate or pass through in higher prices

Source: Frontier analysis based on "running a pub guide" 2022 and 2019, BBPA member data 2019 – 2022 and interviews

*400% is the scale of cost increases once the energy support package comes to an end at the end of March. Whilst the announced support is in place, the scale of increase is expected to be around 130-140%.

Contents

Report is based on input from BBPA, selected BBPA members, and external sources for wider economic context

1 Received Data from BBPA

- We received data from the BBPA, notably including:
  - 2021 digital handbook which summarises key monitoring data from a variety of sources. E.g. ONS, HMRC, and BBPA members;
  - BBPA survey data
  - Europe Economics small brewery relief report; and
  - Oxford Economics report on the impact of pubs and breweries.
  - Other industry reports

2 Conducted interviews with BBPA members

- We spoke to BBPA members
- These members cover the key types of brewers and pubs
- This allowed us to identify issues distinct to each organisational structure as well as problems faced by all.

3 Collected data from BBPA members

- We obtained data from members interviewed.
- Data varied by members but we received a mix of:
  - P&L data over 3 years (sometimes on a monthly basis)
  - Cost breakdowns
  - Current inflationary pressures
  - Estimated inflationary pressures over the next year

4 Sourced external benchmark-ing data

- We utilised external resources such as:
  - Office for National Statistics,
  - Bank of England,
- These sources provided evidence of the wider macroeconomic trends to deepen our analysis, such as the prices of different commodities used in the production of beer.

5 Analysed the qualitative and quantitative data

- By combining the qualitative and quantitative data we obtained, we were able to build a clear picture of the:
  - Landscape of the beer and pub sector
  - Different economic models of brewers and pubs
  - Current trends and their economic impact on brewers and pubs
  - How government could support the sector.