Competition policy and the legitimacy of finance: evidence from the deregulation of the UK brewing industry

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Traditionally the UK brewing model was one that incorporated vertical ownership and control of public houses (pubs). The political affiliation of the leading firms and their powerful lobbying interests were sufficient to thwart not just capital market interest but the public interest objectives of an emerging competition policy regime. Even the 1980s ‘merger wave’ that prompted a return to corporate specialization left the industry largely unchanged. However, influence over policy came to an abrupt and controversial end in 1989 in the forced divestment of the major brewers’ pub estates. Financiers seized the opportunity presented by the change in competition policy. In less than a decade the pub industry was the subject of ‘financialization’ with control migrating to independent firms, the ‘PubCos’, which were backed, and in some cases operated, by financial services intermediaries. The sustainability of this business model was questioned by the 2008 Financial Crisis, with several prominent PubCos struggling to survive and with no obvious exit route for their financial backers. In presenting this historical case study I draw attention to the interplay between competition policy and financialization, the latter of which derives legitimacy and is underpinned more generally by other features of the institutional environment.

INTRODUCTION

For nearly two centuries the UK brewing industry evolved with a vertically-integrated structure. In eighteenth century London brewers sought to control the retail distribution of beer as licences became restricted (Gourvish and Wilson, 1994). With subsequent licencing changes in the late nineteenth century, brewers in other parts of the UK acquired chains of pub estates which were largely operated by third-party tenants to control the distribution of their brewery production (Mutch, 2006). The attractions of distributing beer to a narrow regional area with some form of exclusivity are clear from a comparative historic study of returns on capital for selected UK brewer-retailers (Higgins and Toms, 2011).

That the industry survived into the 1990s with this structure even though an anti-trust inquiry in 1969 had identified that it might operate against the public interest, was due largely to the political voice of what was known as ‘The Beeragete’ (‘beer’ plus ‘peerage’) of wealthy family firms that controlled the industry (Bower and Cox, 2012). Moreover, in the post-World War II era when the market for corporate control was emerging, a Bank of England that signalled publicly its disapproval of debt-funded hostile bids offered general support to traditional firms and industries (Roberts, 1992). Hostile approaches by prominent financiers and outsiders such as property entrepreneur Charles Clore served to precipitate defensive industry consolidation in the early 1960s. The creation of what were known as the ‘Big 6’ national brewer-retailers - Allied-Lyons, Bass, Courage, Scottish & Newcastle, Watney Mann and Whitbread – led to wider concerns about market abuse which prompted competition policy intervention (Spicer, Thurman, Walters and Ward, 2012). Where the 1969 inquiry failed to force change, the 1989 inquiry, coinciding with an agenda of deregulation under Conservative Prime Minister Mrs Thatcher, led to the dismantling of vertical integration of
large scale brewing into its constituent production and pub retailing operations. In little over a
decade, financial intermediaries acquired, restructured and came to dominate the operation of
the downstream public house assets of the UK with the approval of regulatory policy.

In reflecting on this subsequent period of the ‘financialization’ of the pub industry
newspaper commentary of international brewer Heineken’s decision to acquire UK pub assets
informs a wider debate on the role of finance in all aspects of corporate and economic
activity: “How on earth did Royal Bank of Scotland become one of Britain’s biggest pub
landlords? The answer, of course, can be found in the era when retail banks thought banking
meant whatever they wanted it to mean” (The Guardian, 2 December 2011). The UK state-
owned Royal Bank of Scotland had been the owner of a portfolio of former Scottish &
Newcastle pubs since the early 2000s. In 2011, as several of the other financially-structured
pub models of the late 1990s and 2000s were struggling to survive in the aftermath of the
2008 Financial Crisis, it appeared that the mainstream retail banks might become
unintentional owners of many pub chains on the cusp of bankruptcy. In re-integrating the
former Scottish & Newcastle pub estate with the UK brewing operations it bought in 2007,
the Heineken decision identified a possible exit route for the financialized pub model -
perhaps ironic given the forced separation of industry assets through the 1989 ‘Beer Orders’.

My case study seeks to develop a deeper theoretical understanding of the interaction
between competition policy and financialization as two key elements of the institutional
environment that shape industry structure and operation. My empirical study describes the
evolution of the UK brewing industry through a competition policy-mandated change that
made way for the new business models created and held together, at least initially, by
financialization. Although this industry is somewhat unique in the culture and history of the
UK, the processes it illuminates are of wider relevance in developing a deeper understanding
of the organization and evolution of other industries as some researchers contemplate
financialization of US corporations as a potential threat to economic growth (Lazonick, 2010).

THEORETICAL BACKGROUND

Regulation and the capital markets represent two important points of interaction between
firms and the institutional environment within which they operate. The tensions and
constraining effect of each on firm behaviour and actions is well understood in both
theoretical and practical terms. For example, in implementing a growth strategy relying on
mergers and acquisitions, firms are charged with the dual task of persuading the competition
authorities of the merits of their case - ideally without recourse to a formal investigation – and
encouraging the financial support of bankers and shareholders. It is clear that the process of
discussion and negotiation with these institutional agents requires both powerful words and
actions; the extensive media campaigns, investor road shows and expert advisory support that
accompanies each major acquisition.

The management literature recognises the key role of the institutional environment as
a collective entity in shaping what firms do (Peng, Sun, Pinkham and Chen, 2009) in
particular in influencing structure and behaviour (Child and Rodrigues, 2011; Kostova, Roth
and Dacin, 2008) and researchers have noted the importance of firm interactions with the
competition framework of government (Barney, 2001; Shaffer, 1995; Shaffer and Hillman,
2000) as part of the process of aligning corporate strategies to the wider political context
(Oliver and Holzinger, 2008). Yet despite this evolving institutional literature that also
ecompasses co-evolutionary studies of power and politics in the strategic behaviour of firms
(Child, Rodrigues and Tse, 2012) studies of competition policy in action are rare (Peng et al,
2009) despite frequent calls for empirical analysis to further the understanding of the evolution of industrial architecture and firm boundaries (Jacobides and Winter, 2012).

In the following sections I draw attention to theoretical debates in related literature to expand on the hypothesis that regulation and competition policy is significant in legitimizing the role of capital market activity in inducing the changes evident in the UK brewing industry. Further, without change in regulation it is unlikely that financialization would find support. In considering broader historic debate it is clear that these two aspects of the institutional environment need to be considered in tandem in discussions of firm and industry structure. The constraining effect of US competition policy contributed to a thirty year post-World War II trend which saw the proliferation of diversified industrial conglomerates (Shleifer and Vishny, 1991). This owed much to the aggressive anti-trust oversight of horizontal mergers and the centrality of econometric modelling of mergers following the 1957 Du Pont monopolization case (Massey, 2000; Winerman, 2003). Although the conglomerate form emerged in the UK in this era, with the absence of a merger regulation in competition policy until 1965, restrictions on the distribution of capital, tax credits and capital controls led to the over-accumulation of capital within larger firms, which, absent a fully functioning market for corporate control underpinned a programme of unrelated diversification in the 1960s and 1970s (Roberts, 1992; Rowlinson, Toms and Wilson, 2007).

The central objective of competition policy is to ensure that consumers do not suffer as a result of an array of anti-competitive practices by dominant firms with policy makers retaining the ultimate sanction of forcing the separation of assets and defining the boundaries of the firm (Joskow, 2002). The fact that regulation might not be an efficient or effective mechanism to control management practices has been the subject of significant academic enquiry in regulatory economics and the political economy literature. The concept of ‘regulatory capture’ explains the behavior of interest groups in influencing public decision makers through corruption and manipulation at the extreme, to the mere eagerness to please private interests through the course of their repeated interactions (Dal Bó, 2006; Laffont and Tirole, 1991; Martimort, 1999). The more benign concept of intellectual capture is a manifestation of the power of words in the persuasive argument of firms incentivized as rational profit maximizers to ‘game’ the regulator. Although largely the domain of regulated utility-type industries, empirical studies have, however, identified political interference and forms of regulatory capture in the less frequent competition and merger policy process in both the US (Coate, Higgins, and McChesney, 1990), and Europe (Aktas, de Bodt, and Roll, 2007).

Although broadly defined in the finance and economics literature, financialization explains the trends of the past thirty years whereby finance and financial institutions have come to directly and indirectly influence the behaviour of firms in areas such as capital structure, dividend policy and fixed asset investment strategies (Orhangazi, 2008; Skott and Ryoo, 2008; Stockhammer, 2004) or the evaluation of the performance of a firm by a financial measure such as earnings per share (Lazonick, 2010). It is more specifically associated with the liberalization of the capital markets in the US and the UK where financial intermediaries, including activist investors, hedge funds and private equity firms have emerged and been active in precipitating structural change in particular firms and industries, aided by a process known as ‘securitization’ (Girón and Chapoy, 2012). Securitization took

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1 This is a financial innovation whereby contractual debt obligations, such as mortgages and car loans are pooled and packaged into capital market stocks and shares. Those backed by mortgage payments are called Mortgage-Backed Securities (MBS) and those backed by other types of payments are called Asset-Backed Securities (ABS). Particular types of ABS, known as a Collateralized Debt Obligations (CDO) that originated in the
financialization one step further in that it established different ways that participants, many of whom had no prior expertise as either managers of the underlying assets or who were otherwise new entrants to the capital markets could monetise the benefits from the debt markets (Jacobides and Winter, 2012).

The political economy literature broadens the concept of financialization to explain the structural transformation of capitalist economies at the expense of broader social implications (Becker, Jäger and Leubolt, 2012; Lapavitsas, 2011). The management literature has investigated in some detail the human resource cost of financialization in the practices of private equity group ownership, where, for example, the elimination of staff training and investment has underpinned the value-based control systems that tie manager interests to those of shareholders (Clark, 2009; Fiss and Zajac, 2004).

With regard to timeline, financialization is normally anchored in the 1980s ‘merger wave’ of hostile bids which were fuelled by financial innovation in the deregulated US and UK capital markets (Bhagat, Shleifer and Vishny, 1990). It was from this base that the so-called shareholder revolution of the 1990s emerged (Orhangazi, 2008, P 864). In this context financialization is usually considered to have a sole purpose of securing windfalls to financial intermediaries, of which private equity funds have become the most prominent protagonists (Wood and Wright, 2010). Contemporary media debate centres on the over-riding control of the financial system in these liberal economies manifest in a permanent restructuring of economic activity. An historic analogy is with the role adopted by the new manager entrepreneur elites that emerged in the 1920s and 1930s (Folkman, Froud, Johal and Williams, 2007).

The historic analogy is relevant as a theoretical extension of financialization is anchored more firmly in the organization structures and the relationship with competition policy that emerged as the market for corporate control was in its infancy (Hannah, 2007). The 1948 Companies Acts mandated more stringent financial disclosure requirements for listed firms so that external (institutional) shareholders could gain detailed financial information about the firms in which they invested (Roberts, 1992; Toms and Wright, 2002). It was these legislative changes that highlighted to financial entrepreneurs valuation mismatches of listed property portfolios (Bower and Cox, 2012). Although the capital restrictions that still remained, in addition to domestic-oriented banking activity tended to provide a limited restraining influence on managements as agents of independent shareholders (Jensen and Meckling, 1976), mergers and acquisitions activity, including hostile bids did occur as a process of intra-industry rationalization of production costs (Bhagat, Shleifer and Vishny, 1990; Franks and Mayer, 1996).

It was not until the 1980s that many of these conglomerate structures were dismantled in a return to corporate specialization, supported by deregulation of capital market activities (Porter, 1996). Political influence and lobbying to direct regulatory policy did not dissipate entirely, in particular, when mergers involved hostile foreigners; US lawyers Herzel and Shepro (1990) recounted the $21bn hostile bid from UK financiers, Sir James Goldsmith and Lord Rothschild for British American Tobacco which saw 200 members of the US Congress sign a letter urging the US State Department to block the deal. But in general, with policy moving in the direction of structural independence from the political system, the ‘public interest’ defence in competition policy which had tended to keep financialization at bay (in particular in the UK) and in so doing, was laying the foundation for finance-backed business models in their own right.

corporate debt markets in the 1980s in conjunction with the leveraged buyout phenomenon, are relevant to this case. These financial instruments are integral in the evolution of the 2008 Financial Crisis.
In the 1990s there was an active debate in the role of the capital markets in policing firm behaviour, as some notable protagonists of principle-agent theory such as Michael Jensen (Jensen and Meckling, 1976) considered that higher leverage was the best discipline in the Anglo-American divorced ownership model (Shleifer and Vishny, 1997). This was in stark contrast to the attraction – at least in national outcome terms – of the German model of ownership and control. In Germany major banks were more deeply embedded in the industrial base with supervisory roles on the boards of major German firms, supported by large equity investments that protected firms from wider capital market scrutiny (Fiss and Zajac, 2004). The downside of the Anglo-American model was seen in the experiences of the irrationally exuberant Dotcom era, of 1995-2000. Some firms, such as Enron, were seen as gaining more from the capital markets than from operating productively in their industry (Froud, Johal, Papazian and Williams, 2004). The exposition of the Enron business model informs a debate on the financialization of the energy industry, as well as the now infamous illegal corporate activity. Yet its very existence and survival owed much to the hyped investment environment that emerged and thrived in that era.

**DATA AND METHODOLOGY**

I seek by means of a detailed longitudinal case study to develop the theory of financialization as a process that emerges in conjunction with an interaction with competition policy. It follows the academic tradition of using case studies to enhance existing theories (Bansal and Corley, 2011; Doz, 2011; Eisenhardt and Graebner, 2007) notwithstanding the usual pitfalls of the methodology, namely subjectivity and lack of generalisability. However, given the complexity and time-dependency of the process involved this approach is considered optimal in seeking to develop complex phenomena such as path-dependency (Siggelkow, 2007; Sydow, Schreyögg and Koch, 2009) and interactions between firms and their institutional environment (Lewin and Volberda, 1999; Peng et al, 2009). This is in contrast to the more familiar cross-section statistical analysis that underpins much of the academic debate in both regulation of markets and in studies seeking to understand the role of financial services in industrial architecture.

The case study utilizes data and information collected and analysed from multiple sources, including firm archive and official regulatory documentation, some of which has only recent been made generally available through the National Archive and the London Metropolitan Archive. The availability of extensive official and archive information in the UK brewing and pub retailing industry is a reflection of its historic and continuing importance to aspects of UK society and its juxtaposition in the political infrastructure of the UK. This relates directly to the formulation and implementation of important anti-trust and merger policy decisions. Consequently as an industry study it presents a unique dataset from which to interpret important constructs such as political behaviour and institutional interactions (Child, Rodrigues and Tse, 2012).

Table I below lists the main official documentary evidence that I have interrogated to inform the study. It incorporates the data and information from anti-trust and merger inquiry reports and specific listing particulars from the firms, firm annual reports, data and information from the British Beer & Pub Association as well as various UK Parliamentary discussions as shown.

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2 A reference to comments made by Federal Reserve Board Chairman, Alan Greenspan, in a speech to the American Enterprise Institute in 1996
The timeframe for the study is a period of considerable upheaval as the centuries-old UK vertical brewing structure was dismantled. New entrants, largely finance-backed special purpose independent public house companies, known as the PubCos, gradually came to dominate the ownership of the industry’s property assets. Consequently, the industry has informed academic debates in various business and management-related literatures in particular in regulatory economics (Nalebuff, 2003; Pinkse and Slade, 2004; Slade, 2011) and in UK economic and business history (Gourvish and Wilson, 1994; Higgins and Toms, 2011; Mutch, 2006, 2010; Spicer, Thurman, Walters and Ward, 2012). As a closed-system industry, its interest to strategic management lies in both the transformation of the ‘Big 6’ brewer-
retailer firms from vertically-integrated regional operators to international brewers and spirits marketers (da Silva Lopes, 2002; Geppert, Dörrenbächer, Gammelgaard and Taplin, 2013). Two anti-trust inquiries (in 1969 and 1989) and several controversial mergers of the 1980s (Australian conglomerate Elders IXL’s hostile bids for Allied-Lyons and Scottish & Newcastle and the Guinness/Distillers affair) widened the industry’s appeal to a series of business and political discussions (Bower and Cox, 2012). Yet the system that had found political support through many different Governments, aided by political donations and high-level lobbying was broken apart by a competition policy-mandated change, paving the way for a change of ownership and control from brewing firms to finance-backed entities, as discussed is the following sections and summarised in Table 2 below.

**DISMANTLING THE UK BREWING INDUSTRY**

Traditionally, the UK brewing industry was vertically-integrated, with brewers owning outright or controlling through a tenant-supply relationship known as a ‘property tie’ the greater proportion of the UK’s public houses. In the latter part of the eighteenth century London brewers sought increasingly to control the retail distribution of beer as licences became restricted with around half of London’s pubs owned or controlled by brewers by the 1830s (Gourvish and Wilson, 1994: p128). With subsequent licencing changes in the late nineteenth century, brewers in other parts of the UK acquired pub estates, operated largely by tenants, as dedicated distribution for their production (Mutch, 2006). That the industry survived into the 1990s with this structural arrangement was due in large part to the political influence of ‘The Beerage’ (‘beer’ plus ‘peerage’) of wealthy family firms that controlled the industry (Bower and Cox, 2012), supported by a trade organisation, The Brewers’ Society, that acted as a private market-governance institution active in organising collective lobbying (Yue, Luo and Ingram, 2013).

During the late 1940s prominent financiers emerged in the UK whose paths would cross with the structure and ownership of the UK brewing and pub retailing industry as well as the fledgling international spirits industry. Most notable were Charles Clore who launched an unsuccessful hostile bid for London brewer Watney Mann, in 1959, and Sir Maxwell Joseph, whose firm Grand Metropolitan was successful in a hostile approach for Watney Mann in 1972, an acquisition that brought an associated stake in International Distillers & Vintners, the foundation of today’s global spirits leader, Diageo (Williamson and Rix, 1988). These hostile approaches triggered a “defensive anxiety” within the UK industry (Gourvish & Wilson, 1994, P 460). This precipitated a series of mergers among largely family-controlled firms in the early 1960s, creating what became known as the ‘Big 6’ national brewer-retailers of Allied-Lyons, Bass, Courage, Scottish & Newcastle, Watney Mann and Whitbread.

With the support of a generally benign competition policy regime, and the political lobbying efforts of the firms and their industry collective, the large firms were generally

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3 Table 2 shows that the bulk of the brewers’ pub portfolios were tenanted outlets; the brewer owned the pub and a tenant rented the property on (theoretically) below open market rental terms in lieu of an obligation to buy all beer, wines, spirits and soft drinks from the brewer owner (usually referred to as a ‘property tie’). In addition to this additional arrangements at that time included some that were similar to those in other Continental European markets with many independent pubs also being partially controlled by the leading brewers through the provision of subsidised financing in lieu of an exclusive supply contract (usually referred to a ‘loan-tie’). The degree to which this also acted against the public interest was discussed extensively in the MMC inquiry into Scottish & Newcastle’s hostile bid for regional brewer Matthew Brown in 1985 (MMC, Cmnd 9645).
supported and protected from the market for corporate control under the oversight of the Bank of England (Roberts, 1992). Yet the firms were well aware of a threat to their existence from the arrival of large scale sophisticated finance. Forming an investment structure, known as the Whitbread Umbrella, to protect not just its own family interests but also those of small family brewers with whom it had trading relationships, Whitbread’s influential former chief executive, Sir Sydney Nevile, noted the “present fever of finance in the brewing industry........I suggested that the interest of his company was merely to speculate in shares and then sell them to the highest bidder” (File note of conversation with a non-executive director of the Independent Commercial Finance Corporation on 27 March 1961, London Metropolitan Archives).

The ‘Big 6’ Oligopoly Era.

Following Charles Clore’s failed hostile approach for Watney Mann the amalgamations that formed the ‘Big 6’ brewer-retailers led to a substantial tightening of control over both domestic brewing as well as the UK’s stock of pubs. Table 2 below shows the extent of the pub estates of the Big 6 at the time of the 1989 anti-trust inquiry (By 1989 Watney Mann was owned by Grand Metropolitan and Courage was a subsidiary of Australian brewer Elders IXL as a result of 1970 conglomerate mergers involving Hanson Trust and tobacco combine Imperial Group).

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<tr>
<td>Allied-Lyons</td>
<td>2,199 (M) 4,479 (T)</td>
<td>Acquired by Punch Taverns and Bass (1999)</td>
<td>Hugh Osmond, George Soros and other financiers</td>
<td>Punch Taverns</td>
<td>Demerged managed pubs as Spirit (2001); re-acquired Spirit (2006); demerged Spirit (2011)</td>
<td>4,790</td>
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<tr>
<td>Bass</td>
<td>2,420 (M)</td>
<td>Demerged (2003)</td>
<td>R20 (Robert Tchenguiz); Piedmont (Joe Lewis) and Elpida</td>
<td>Mitchell &amp; Butlers</td>
<td>Enterprise Inns</td>
<td>1,605</td>
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<td></td>
<td>1,406 (T)</td>
<td>Divested (2000/1)</td>
<td>Royal Bank of Scotland</td>
<td>Heineken</td>
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<td>1,300</td>
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<td></td>
<td>1,870 (M)</td>
<td>Divested in tranches and retained pub restaurants</td>
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<td>389</td>
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<tr>
<td>Whitbread</td>
<td>4,613 (T)</td>
<td>Divested (2001)</td>
<td>Morgan Grenfell/Deutsche Bank; R20</td>
<td>Laurel Pub Company</td>
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<td>Greene King</td>
<td>766</td>
<td>Acquired Magic Pub Company (1996); Morland and parts of Marston’s (1999); parts of Laurel Pub Company (2004)</td>
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<td>2,290</td>
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<td>Marston’s</td>
<td>750</td>
<td>Previously named Wolverhampton &amp; Dudley. Acquired JW Cameron (1992); Marston’s (1999); Mansfield (2000)</td>
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Source: Firm websites and annual reports

*MMC, ‘Supply of Beer’ (1989); M = managed pubs; T = tenanted pubs

Notwithstanding a 1969 anti-trust inquiry into perceived anti-competitive practices emanating from the vertical ownership structure of the market the national brewer-retailers strengthened
their control of the industry in the 1970s and 1980s. Their attraction to property-backed financiers did not diminish; there was a second successful hostile approach for Watney Mann in 1972 from Sir Maxwell Joseph’s Grand Metropolitan (Williamson and Rix, 1988). However, neither this acquisition nor the 1972 acquisition of Courage by Imperial Group served to change the overall structure and operation of the industry. That the policy environment was benign and helpful to the incumbents was evident in the sanctioning of a voluntary agreement to reduce overall ownership of pubs, co-ordinated under the auspices of the industry trade association, the Brewers’ Society (Spicer, Thurman, Walters and Ward, 2012). However, although the control of pubs was reduced from around 70% in the late 1970s to closer to 50% by the 1980s, most of the reduction was due to sales of smaller tenanted pubs. In fact ownership of the larger and more profitable managed pubs actually increased during the 1970s.

The control of beer supply by the Big 6 was often cited as the reason why the price of beer in pubs rose consistently above the level of general retail prices. Yet, the market for corporate control did not work efficiently with respect to this industry. The era of corporate specialization prompted by the emergence of corporate raiders and the 1980s ‘merger wave’ (Shleifer and Vishny, 1991) left the UK brewers largely unscathed. This was not for the want of trying; Australian brewing/finance conglomerate, Elders IXL made two high profile and politically-charged attempts to acquire UK brewers in the mid-1980s. Finance entered the debate directly at the level of competition policy. Elders IXL’s 1985 hostile bid for Allied-Lyons was referred to the MMC by the Secretary of State (for Trade and Industry) on the basis that the bidder’s use of financial leverage might work against the public interest. Although the Bank of England failed to endorse this, the delay, and a high-profile media campaign through the conduit of The City, provided Allied-Lyons the time to enact the ‘poison pill’ defence of acquiring Canadian spirits firm, Hiram Walker before the bid was cleared (MMC, Cmnd 9892, 1986). Elders withdrew its bid but returned two years later with the more audacious and controversial bid for Scottish & Newcastle. The combination of intense lobbying and wide political backing for the influential Scottish & Newcastle ensured the bid was referred and somewhat uniquely, blocked (Bower and Cox, 2012; MMC, Cm 654, 1989).

Running concurrently with the Elders/Scottish & Newcastle inquiry, a general anti-trust investigation concluded that a complex monopoly existed in the UK beer market which could only be resolved by restricting the degree of industry vertical integration. A mandated upper limit of 2,000 pubs for any brewer was made, meaning that an estimated 22,000 pubs (30% of all pubs in England & Wales) would have to be divested by November 1992. The referral for a second anti-trust inquiry, if not this decision, came as surprise to a previously successful lobbying campaign spearheaded by the Brewers’ Society. Further high-level discussions between the industry and Government ensured some moderation to these terms, requiring the brewers to divest half of the excess of pubs in their stable over the 2,000 threshold (DTI Press Release, 89/745).

The 1989 inquiry anticipated that a less vertically-integrated beer market would both widen consumer choice and lead to more competitive retail pricing. While choice materialised quickly, aided by the ‘guest beer’ provision of the legislation (Day and Kelton, 2007) keener beer prices proved elusive and indeed as Figure 1 below shows the gap between pub beer prices (‘on-trade’) continued to widen relative to both general prices and wholesale beer prices (‘PPI’). Moreover, it is clear that the gap with supermarket prices (‘off trade’) also widened significantly. This has been viewed more recently in a less desirable light given the perceived link between under-priced alcohol and ‘binge drinking’. It is ironic that the vertical brewing tie emerged in London in response to legislation designed to promote beer and
reduce problematic gin consumption in Georgian London (the Sale of Spirits Act, 1750, commonly known as the Gin Act).

**FIGURE 1: Retail and Producer Prices of UK Beer**

The regulatory intervention through the structural remedy of the ‘Beer Orders’ was an extreme measure by policy standards. Indeed, some ten years later the Director General of Fair Trading described the remedy as a _draconian_ requirement that was disproportionate to the mischiefs the Beer Orders were designed to address (OFT, The Supply of Beer, 2000, paragraph 2.3). That competition policy might have misunderstood the transmission mechanism between wholesale and retail prices was highlighted in the dissenting letter of Professor M E Beesley in the 1992 Allied-Lyons/Carlsberg UK brewing merger, (MMC, Cm 2029, 1992, p 89). As the 1990s progressed it was clear that the adverse effects of the brewing complex monopoly transferred to an equally potent mechanism for controlling retail pub prices under the PubCos. The PubCos, whose very existence is traced to a change in policy and the legitimization of finance as a business model in its own right, were widely criticised for not passing on the benefits of the keener wholesale beer price terms they extracted from the brewers during the 1990s (Day and Kelton, 2007).

**The ‘Financialization’ Era.**
PubCos emerged to acquire blocks of tenanted pubs which the brewers were obliged to divest to comply with the provisions of the Beer Orders. Over the following decade full-scale financialization of the pub industry occurred as private equity-backed entities displaced established brewer operators attracted to the very same attributes that had first attracted the property financiers of the post-World War II generation. By the late 1990s the PubCos owned
and operated more than 50% of all pub outlets, as shown in Figure 2 below. Supporting the change in ownership was the ability of the PubCos to negotiate substantial beer discounts from a brewing industry struggling to reduce overcapacity at a time when UK beer consumption was also declining (Cm1227, pages 11-12; Cm2029, page 44). The combination of the well-publicised scale of wholesale beer discounts available and the evolution of the securitization market underpinned an active mergers and acquisitions strategy within the PubCo sector, as shown in Table 1 above.

**FIGURE 2: Independent Pub Company Ownership of UK Public Houses**

![Graph showing the percentage of Pub Company Ownership, Brewers' Ownership, and Other from 1960 to 2011.](source)

Source: Adapted from data supplied by British Beer & Pub Association, Statistical Handbook, 2012. 'Other' includes pubs held within holding companies, operated on a temporary contract basis and those that are part of chains with less than 30 outlets.

The origins of the PubCo financing model can be traced to the novel ‘breweries-for-pubs swap’ agreed between Grand Met and Elders IXL’s UK subsidiary, Courage (MMC, Cm 1227, 1990). This was the first merger in the immediate aftermath of the Beer Orders when the industry was adapting to change in UK competition policy, itself increasingly under the auspices of harmonization and oversight from European Commission policy directives (Cini and McGowan, 1998). Specifically under EC Article 81 (3), certain vertical agreements, including the UK brewers’ vertical tie had been granted a ‘block exemption’ but that expired in 1997. The uniqueness of the merger agreement between Grand Met and Elders IXL, in particular the partners’ use of upfront remedies to circumvent more obtrusive regulatory intervention, was noteworthy in that it established a more conciliatory approach to merger negotiations at the firm-firm level as well as firm-regulator level (Bower and Cox, 2013). Of particular interest to this analysis, as it forms the bridge from policy to subsequent financialization, is the evolution of the merged tenanted estate of 8,500 pubs. This combined
entity, known as Inntrepreneur Estates Limited (IEL), represented some 13% of the UK total pub stock in the early 1990s.

From its inception IEL was structured as an independent joint venture, managed on an arms-length basis with its own financing terms. The tenants were offered the opportunity to share in the potential rewards of the new structure through newly established 20 year assignable leases. Unfortunately as high profile complaints to the European Commission in the mid-1990s show (Case Number IV/35.628/F3 – a ‘super-complaint’ made by the Federation of Small Businesses on behalf of a group of former Inntrepreneur lessees) the terms were not necessarily beneficial to the tenants. The decline of property prices created significant operational as well as financial pressures and the joint venture parents were distracted by their other, more substantive operations in other industries and markets. Parts of the IEL estate were sold, largely to other small PubCos. More significant was a later series of transactions, firstly with UK investment bank Morgan Grenfell (part of Deutsche Bank) and then with Nomura Securities, which led to the Japanese bank becoming the UK’s largest independent PubCo by 1998, under the direction of prominent ex-Goldman Sachs financier Guy Hands.

The involvement of a well-known financier in the pub market precipitated interest from other financial institutions. Industry commentary from observers close to many of the deals drew attention to the weakness of the PubCo financing model. Profitability was flattered by unsustainably high rents, low levels of capital spending and keen beer supply terms that were unlikely to last. Moreover, Nomura’s financial backing owed much to the Japanese bank’s ability to borrow cheaply in Yen, and a deregulated Japanese banking industry that increasingly incentivised foreign investment (Hoshi and Kashyap, 2000, p164). Financiers were either not cognisant of, or chose to ignore data that showed IEL tenancy default rates close to 20% during the 1990/91 recession. In the economic recovery of the mid-late 1990s default rates naturally fell but these lower default rates were factored into many PubCo financing models in addition to the beneficial beer supply terms captured and retained in the PubCo centres. With an active market for securitization of rental cash flows (Girón and Chapoy, 2012) an apparent ‘money machine’ encouraged more ambitious merger strategies.

That financialization had come to dominate the structure and operation of the pub industry, was evident by the latter part of the 1990s, when private equity-backed vehicles were able to outbid long-standing industry operators for prime retail assets. The 1999 battle for control of the former Allied-Lyons pub estate is informative in this regard. While the interjection of the Secretary of State served to thwart the merger proposal of pub industry leader Whitbread, the ability of the finance-backed Punch Taverns to win the contest put financiers at the heart of the pub industry (The Lawyer, 1999). Punch Taverns had only been operating as an independent entity since 1997. Following a listing on the UK stock market, Punch embarked on an aggressive acquisition strategy funded by large amounts of debt secured against the firm’s property assets (The Telegraph, 2010), that led eventually to a proposed all-share merger with Mitchells & Butlers (M&B), the managed pub estate of the former Bass. Had this deal transacted Punch would have controlled one sixth of the UK pub market, with some 10,500 outlets. In the ensuing financial crisis of 2008, however, Punch’s fortunes went into dramatic decline with falling property prices and a weak pub trading environment forcing the resignation of its chief executive in January 2009, as the group courted bankruptcy. For its part, M&B, similarly engaged in financial engineering, was forced to concede that a pre-Financial Crisis interest rate derivative position established with property entrepreneur, Robert Tchenguiz, to enhance shareholder value had failed. The subsequent charge to the firm’s accounts of £274m was the basis for the resignation of the finance director and chief executive officers (M&B annual report, 2008).
In concluding this era understanding how the Royal Bank of Scotland, saved by the UK government and taxpayers in the Financial Crisis, came to own part of the UK pub industry is also important. As banker to Scottish & Newcastle it had supported that firm’s mergers and acquisitions growth strategy from its UK base through the subsequent internationalisation into European brewing. To reduce group debt following these increasingly large acquisitions (the acquisition of Danone’s French brewing operation, Kronenbourg in 2000) Scottish & Newcastle was forced to sell its pub estate. Initially it sold small numbers of tenanted pubs to Royal Bank of Scotland - in April 2000 a small chain of 447 outlets. With further disposals in 2001 Royal Bank of Scotland became a tenanted pub owner of 1,000 outlets. Scottish & Newcastle retained property management services under a management contract and a beer supply deal from its brewing division (The Telegraph, 2001). Ultimately, Scottish & Newcastle, under pressure from shareholders, sold its managed pub estate to the finance-backed Spirit Group, in October 2003.

Royal Bank of Scotland remained the owner of the former Scottish & Newcastle tenanted pubs and it is these assets that were acquired in 2011 by international brewer Heineken. It is with some irony, perhaps, that Heineken acquired these pubs, having acquired Scottish & Newcastle as part of joint hostile bid with Carlsberg in 2007. Although Heineken had a presence in the UK brewing industry for many decades through the conduit of a licence brewing and distribution agreement with Whitbread, it is significant that in developing its own directly controlled UK operation through Scottish & Newcastle brewing it has also chosen to re-acquire former Scottish & Newcastle pubs from a finance entity and in so doing recreate a vertical integration model not unlike the original Big 6 brewers.

CONCLUSIONS

The aim of my article is to highlight how competition policy interacts with finance and the capital markets in preventing or augmenting change in industry structure and the boundaries of firms operating within it by recourse to an empirical longitudinal study of the evolution of the UK brewing and pub industry. The requirement for a deeper understanding of firm and industry interaction with the institutional environment continues, in particular with regard to anti-trust and how firms adapt to and seek to influence institutional change and regulatory shifts in dynamic and complex environments (Child and Rodrigues, 2011; Jacobides and Winter, 2012; Peng et al, 2009). I presented an empirical study of an industry that was, by tradition, vertically integrated, and remained so for nearly two centuries supported by history, political voice and, perhaps, on reflection, a sound base in the theory of transaction costs.

The link between transaction cost economics and the regulatory environment lies in the oversight of vertical restraint in competition policy. Indeed, the transaction cost economics framework was established by Williamson in his early analysis of anti-trust and competition policy (Williamson, 1971; 1991; 2010). In a market with the potential for foreclosure efficiency benefits from vertical integration are unlikely to outweigh the welfare cost of the restraint of trade (Lafontaine and Slade, 2010). However, although the mostly econometric analyses highlights adverse welfare effects of vertical arrangements, legal scholars have cautioned that competition policy needs to be cognisant of the transaction-based attributes of incumbent firm organizational structures, the reasons why they emerged, and the consequences of changing them through divestiture (Joskow, 2002).

Although an extensive discussion of transaction cost economics is outside the scope of this article, its advantage to the UK brewing industry, the economic support for which was
dismissed by the 1989 ‘Beer Orders inquiry’, is relevant to contextualizing Heineken’s recent decision to acquire pubs from the Royal Bank of Scotland. For an international brewer with no prior ownership of public houses despite its long association with the UK brewing industry, this decision may be as significant in policy terms as it is in signalling that financialization has reached an end-point in this industry. The financialized business model of the PubCos might therefore constitute further examples of interim hybrid structures and new organizational forms, some of which are ultimately unstable, that emerge in other frequently vertically-integrated industries, such as the electricity industry (Delmas and Tokat, 2005; Russo, 2001) although several earlier empirical studies have shown that firms can co-exist for extended periods with organizational structures that are anomalous (Chiles and McMackin, 1996).

The change imposed by competition policy corresponded to the era of more readily available finance and financial innovation. Without the former the PubCo business model might not have emerged. It is perhaps more certain that without the latter, it would have remained a minority structural innovation; its wider acceptance owed much to the entry of a prominent financier, backed by the balance sheet of a leading international investment bank. Anchored in the era of securitization (Girón and Chapoy, 2012) and the financialized business model of firms such as Enron (Froud et al, 2004) the lower default pub rental cashflows and keener beer supply terms encouraged both new entry and consolidation. The PubCos were able to out-compete and out-bid traditional firms such as Whitbread in the acquisition of other attractive chains of pubs and restaurants.

The experience of the last few years in the aftermath of the Financial Crisis has shown that the PubCo model and some of the more esoteric financial instruments supporting it are fundamentally unstable. What appears to be unfolding is the destabilizing impact of strategies that are supported by financialization rather than genuine business logic in a financially repressed era. The consequences for policy makers in the politically and socially sensitive area of alcohol distribution are potentially significant. The ownership and structure of firms and the manner in which industry value chains operate today is the subject of a wider institutional and political debate, as the recent UK food industry scandals demonstrate. Certainly the Beer Orders did not anticipate the degree to which beer consumption patterns would change and in particular the significance of the take-home trade now controlled by the leading supermarket groups. Moreover, with financial and tax engineering a topical media line of inquiry in both the US and UK, ownership structures and novel business models that dominate other socially important sectors have come under greater scrutiny. A recent article concerning the former state-controlled UK water firms (‘UK water companies avoid paying tax’, The Telegraph, 15 February 2013) highlighted how this core domestic utility is now largely owned by non-UK domiciled financial intermediaries with highly leveraged financial arrangements. Financialization extends into an unavoidable discussion of what might happen in the event of a debt default by a firm that provides an essential public service. As we have discovered for the banking industry, tax payers are almost invariably the owner or lender of last resort, as indeed they became, albeit temporarily, for parts of the UK pub industry.

As part of the evidence presented to the inquiry, the Brewers’ Society commissioned an academic analysis by two leading University of Oxford regulatory economists, Professors Morris and Yarrow, to present a detailed set of reasons why vertical integration was an efficient organizational structure which did not act against the public interest (MMC, Cm 651, paragraphs 5.18-5.57 and Appendix 5.2).
REFERENCES


