

**22 March 2011**

**Punch Taverns plc**

**Strategic review update**

Punch Taverns plc ("Punch" or the "Group") announced in October 2010 that under its new Chief Executive, Ian Dyson, it had started a comprehensive review of the Group's strategy, operating performance and capital structure. Punch is today announcing the outcome of this review.

**Conclusions**

- Operating momentum in both the Managed and Leased businesses provides a solid foundation for the strategic review
- The Group's current strategy is not sustainable with structural change required to drive value
- The Managed business requires investment and development to accelerate its operational turnaround and drive growth
- The Leased business needs to be repositioned to maximise the long term value within the estate by downsizing to a core of around 3,000 high quality pubs
- There are limited synergies between the Managed and Leased businesses
- The Group's structure and financial position are barriers to realising value

**The Way Forward**

- Separation of the Managed and Leased businesses
- Achieved by the demerger of Spirit from Punch and the creation of two independent public companies
- Demerger expected to be completed before the end of the summer

**Commenting on the strategic review Ian Dyson, Chief Executive, said:**

"Change at the top of an organisation and a strategic review can provide a distraction from day to day operations and I am proud that this has not been the case at Punch. Our Q2 trading statement clearly shows that we have continued to build operating momentum over the last six months and this provides a solid foundation for our strategic review.

We believe that there is a significant value creation opportunity at Punch, with immediate upside in Managed and longer term upside in Leased. We do not believe that either opportunity can be maximised within the current Group structure and accordingly, we propose that the two businesses be separated. This will be achieved by the demerger of Spirit and the creation of two independent public companies.

A demerger will provide the platform to enable both businesses to focus on the very different strategies required to deliver shareholder value and will provide choice and liquidity for investors. Spirit will be positioned to deliver market leading sales and profit growth and to expand with the aim of becoming the UK's leading managed pub operator. Punch will be positioned to drive long term value by downsizing to a core estate of around 3,000 pubs with the aim of becoming the UK's highest quality and most trusted leased operator."

**ENQUIRIES**

**Punch Taverns plc**

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This announcement may contain certain statements about the future outlook for Punch. Although we believe our expectations are based on reasonable assumptions, any statements about future outlook may be influenced by factors that could cause actual outcomes and results to be materially different.

There will be an Analyst and Investor meeting today at 0900 (UK time) at City Presentation Centre, 4 Chiswell Street, London, EC1Y 4UP. A live audio cast and slide presentation of this event will be available on our website, [www.punchtaverns.com](http://www.punchtaverns.com) and subsequently available on demand. We recommend you register at 0845.

## **1. Approach to the strategic review**

The objective of the strategic review was to develop a plan for the Group that creates sustainable growth in shareholder value and represents the best way forward for the business and its stakeholders. The review focused on two broad areas:

- Strategy and operations
  - Detailed analysis and assessment of the UK eating and drinking out market;
  - Evaluation of Punch's position within this market and its underlying growth prospects, and review of the current operating plans for both the Managed and Leased businesses; and
  - Examination of the level of synergy between the Managed and Leased businesses.
- Capital structure
  - Review of its sustainability and appropriateness in the context of the plans for the Group's businesses.

## **2. Strategy and operations**

### **2.1 UK eating and drinking out market**

Detailed analysis of the UK eating and drinking out market has reinforced the well understood trends affecting the future of the pub industry. The key points to highlight are:

- The long term decline in drinking out in pubs will continue, driven by changing consumer behaviour, relative price positioning and the impact of regulation. The Group expects a 3.1% per annum decline in drinking out in pubs over the next five years;
- The long term growth in eating out in pubs will continue, driven by economic growth, changing consumer behaviour and improvements in the quality, service and value for money offering in the pub industry, particularly the managed sector. The Group expects 3.5% growth in eating out in pubs over the next five years;
- Geographic and demographic influences will become more apparent and more relevant for the future of the pub industry. In particular, there is an increasing north / south bias and pubs close to high population densities will outperform those in rural areas;
- The regulatory environment will continue to impact the positioning and fortunes of the pub industry; and
- The number of pubs in the UK will continue to decline with the leased sector experiencing a disproportionate amount of closures and the managed sector continuing to grow.

### **2.2 Punch's positioning, operating plans and performance**

#### ***Managed***

Our Managed business is a high quality, well located estate, with an attractive exposure to London and the South East and areas with higher population densities. Since Mike Tye's appointment in July 2008, there has been substantial progress in re-positioning the business through the improvement of operating disciplines, the upgrading of talent, the revitalisation and development of brands and investment in the estate. This repositioning has resulted in impressive recent like for like sales growth of 8.6% in the second quarter of this financial year and consistent outperformance against the competition over the last six months.

Whilst progress has been made, we believe there is much more to do and significant further sales, profit and value upside in the business. Our average weekly sales per pub and operating margin before rent are well behind our major competitors, but we believe that there are no structural reasons preventing us from closing the gap. We have a well positioned estate and we know our operating and investment initiatives are working. A continuation of the current operating momentum and investment in the business, supplemented by new initiatives such as Guest at the Heart and Pub in a

Box, gives us confidence that we can continue to grow sales and operating margins over the coming years.

There is also an opportunity to build the scale of key brands such as Chef and Brewer, Fayre and Square and Flaming Grill and increasingly we will add expansion of these brands to our focus on operational delivery. An important part of this opportunity is provided by the c.550 leased pubs within the Spirit debenture, the majority of which were previously managed pubs. Our initial assessment is that between 100 and 150 of these pubs are capable of being converted to one of our brands over the next few years and of achieving our 25% ROI hurdle rates.

In summary, our Managed business is well positioned to capitalise on the continued growth in eating out and has a well located estate. We have a strong management team, positive operating momentum and the potential to expand, all of which we believe represents a significant opportunity to drive sustained growth in shareholder value.

### ***Leased***

Since Roger Whiteside's appointment in November 2008, significant progress has been made in moving our Leased business forward. After two years of double digit declines in like for like net income, the business reported a decline of just 6% in the second quarter and, helped by the ongoing disposal programme, delivered the first increase in average net income per pub for three years. The Pathway to Partnership programme is succeeding in repositioning the reputation of the business and improving trends in beer volumes and rental incomes.

Whilst the business is profitable, generates free cash flow before debt amortisation and is clearly on an improving trend, it does continue to face a number of structural challenges. The leased sector as a whole is less well positioned than the managed sector to respond to changing market dynamics because of its continuing reliance on the declining drinking out market. In this context, our estate has a strong core of pubs but, overall, is not currently well placed to deliver long term sustainable growth.

If we also consider the financial position of the Punch A and B securitisations, which support the majority of the Leased business, then we do not believe that the current plan for the business will maximise value for shareholders. We need a more radical approach, targeting a core estate of around 3,000 high quality pubs over the next five years. This smaller core estate will account for around 75% of EBITDA and in the year ended August 2010 had an average net income per pub of c.£80,000. This will be a high quality, geographically well located portfolio, positioned to drive sustainable long term growth in profitable revenues and cash flow.

In order to maximise the value of the Leased business as we downsize to around 3,000 pubs, we need to organise the business into two divisions; core and turnaround, with each division having separate teams focused on the specific plans for each.

- The plan for the core division is to drive sustainable growth and embrace the Pathway to Partnership programme. We will attract the right partners through our new lease offers, including the new turnover based agreements currently being piloted, expand the Punch Buying Club, develop the skills of our BRMs and invest to grow food revenues.
- The plan for the turnaround division is to maximise short term returns with a clear focus on costs and cash flow. We expect to dispose of these pubs at a rate of around 500 per annum, fewer than the number that we achieved in 2009 and 2010, phased to ensure we balance speed of disposal against value. At the same time we will continue to drive the operating performance of these pubs and they will continue to be part of Pathway to Partnership and have access to the same support infrastructure as the core division.

In summary, while the challenges in Leased are different to Managed, we believe we have a good plan to move the business forward and to generate shareholder value. We have a strong core of high quality pubs which will generate sustainable growth and value over time. In essence, we are shifting the emphasis of the Leased business from quantity to quality.

## **2.3 Synergies**

We have examined the level and value of synergies between the Managed and Leased businesses and have concluded that they are limited. Synergies that did exist in areas such as financing arrangements, estate management and beer supply agreements have diminished over time as the market has changed and as the divergence in performance and prospects of the Managed and Leased businesses have widened. There is a limited amount of corporate shared services covering areas such as finance, human resources and property, all of which can be separated. As a result, we believe that there would be limited incremental operating costs associated with a separation of the two businesses.

## **2.4 Capital structure**

The Group is financed through three whole business securitisations, Punch A, Punch B and the Spirit debenture, and cash resources held at PLC. The majority of the trading assets of the business are held in the three securitisations.

In addition to the cash resources held at PLC, there are also around 200 unsecuritised short leasehold properties and the Group's 50% interest in Matthew Clark. The short leasehold properties currently give rise to an annual cash outflow of between £15 million and £20 million. We are exploring potential opportunities to mitigate this liability and have placed much greater focus on driving operating performance and investment in these pubs which, we believe, will reduce the cash outflow over time. We intend to retain Matthew Clark within the Group.

Spirit includes the majority of the Managed business as well as around 550 leased pubs. Actions taken to dispose of assets, repurchase debt and improve profitability have led to a reduction in the debt within this securitisation. As a consequence of this, we believe the Spirit debenture will support the growth, investment and development of the Managed estate while also facilitating cash returns to shareholders over time.

Debt repurchases and asset disposals have also reduced the absolute debt levels in Punch A and Punch B but leverage, as measured by net debt to EBITDA, has deteriorated due to the decline in profitability. As a result, while Punch A and Punch B continue to remain profitable and generate net cash flow (before debt repayments and disposals), they remain in a highly leveraged position and will require EBITDA support to maintain headroom in the DSCR covenant. This situation, together with some restrictions included in the debt documentation, inhibits the ability of the Leased business to execute its plan to downsize the estate and to deliver value for stakeholders. Accordingly, it is likely that, following the demerger, we will engage in some dialogue with bondholders with a view to optimising the capital structure. At this stage, it is not possible to be categorical about the timing, scope or content of such dialogue. In the meantime, we will continue to provide the required financial support to the securitisations to enable the Leased business to build on the progress it has made.

Whilst there has been considerable speculation about the Group electing to 'walk away' from the Punch A and Punch B securitisations, in reality we do not believe that this would be in the best interests of our stakeholders. It would remove the opportunity to create equity value in the Leased business and would negatively impact the management, operation and valuation of the entire Group. A 'walk away' leading to default and administration would also give rise to potential value loss due to the linkages across the wider group, including management services, supply arrangements, pension liabilities, group tax assets and intercompany financing arrangements.

## **3. Conclusions of the strategic review**

The following key conclusions have been reached:

- The Group's current strategy is not sustainable. Structural change is required to drive value;
- The Managed business requires investment and development to accelerate its operational turnaround, take advantage of the growth potential of the eating out market and to grow its estate;

- The Leased business needs to be repositioned to realise the long term value within its estate by downsizing to a core of around 3,000 high quality pubs and reorganising into core and turnaround divisions;
- There are limited synergies between the Managed and Leased businesses and therefore limited incremental operational costs associated with separating them; and
- The Group's structure and financial position is a barrier to realising value in the business. The Punch A and Punch B securitisations inhibit the ability of the Leased business to move forward, will continue to require PLC cash to maintain covenant headroom, and, have a negative impact on the value of the overall Group.

In light of these factors, we have concluded that the Group's structure needs to be simplified to better align stakeholder interests and to provide a stronger foundation from which both the Managed and Leased businesses can move forward independently to execute the different plans that are required to drive value over time.

#### 4. Demerger of Spirit

We believe that this process of simplification will be best achieved through the demerger of Spirit from Punch and the creation of two separate listed entities, Spirit plc and Punch plc. The benefits of a demerger are:

- Spirit and Punch are different businesses facing different challenges and opportunities. A demerger will enable the businesses to focus on the plans required in each to maximise value for shareholders and other stakeholders;
- There are limited synergies between the businesses and, indeed, we are concerned that the approach required to reposition Punch could negatively impact the ability to maximise value in Spirit;
- A demerger will enhance the visibility and transparency of both businesses;
- It will also provide choice and liquidity for all investors to choose to invest or not in the Managed or Leased businesses; and
- It will provide certainty and clear accountability, together with more targeted incentive arrangements, for management and employees.

We have completed a significant amount of the planning and analysis required for the demerger, but it remains subject to the finalisation of a number of areas, notably the composition of the Board and executive management teams of each business, certain legal, tax and regulatory matters, and the allocation of cash currently held by the Group. It is currently envisaged that PLC cash will be allocated broadly evenly between Spirit and Punch after deducting one-off demerger costs of approximately £30 million.

It is currently anticipated that the demerger will be completed by the end of the summer.

Following the completion of the demerger:

- **Spirit** will be positioned to deliver market leading sales and profit growth and to expand, with a view to becoming the UK's leading managed pub business.
- **Punch** will be positioned to drive long term value by downsizing to a core estate of around 3,000 high quality pubs, with the aim of being the UK's highest quality and most trusted leased operator.

- Ends -