Part II

Background and evidence

3 The merger situation and the companies involved

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Introduction

3.1. This chapter deals with the events leading up to the merger of Interbrew and Bass Brewers. It also describes the parties involved, their financial performance, the rationale for the merger, the justification for the price paid, the synergies arising from the merger and how the merger was funded.

Events leading up to the merger

3.2. Bass had been pursuing a strategy of building leading market positions in hotels, restaurants and pubs and branded drinks, by focusing on strong brands and higher-growth sectors. To this end, in the last three years, Bass has acquired the Inter-Continental hotel business and disposed of four gaming businesses in the UK and just under 2,000 pubs.

3.3. Whilst Bass perceived that it had a strong position in brewing in the UK, it saw little scope for growth strategies that would add significant value to its brewing business, other than domestic consolidation where regulatory approval remained a significant risk. Bass had previously attempted a merger with Carlsberg-Tetley in 1997, which had been blocked by the Secretary of State following the 1997 report. Accordingly, Bass decided to explore the possibility of achieving a sale of its brewing interests in the UK and the Czech Republic, with a view to enhancing shareholder value and focusing on its hotel and leisure interests.

3.4. Bass also perceived that there could be advantages in separating its brewing business from its pubs and hotels, thereby breaking the vertical integration of the two businesses. This might mean that a merger of Bass's brewing interests with another UK brewer would be viewed more favourably by the regulatory authorities, which would allow the creation of synergy benefits at the brewing level and

enable Bass to realize a higher price for the brewing business. After a transitional period it could also allow Bass's pub business greater freedom as regards the purchasing of beer.

3.5. Between December 1999 and January 2000 Bass held exploratory discussions with four potential buyers, including Interbrew. In February 2000, through its advisers, Bass issued a sales memorandum for Bass Brewers and thereafter the sale process was conducted as a controlled auction. Seventeen parties were identified (or identified themselves) as potential bidders and the sales memorandum was sent to twelve who expressed an interest; eight of these were international brewing companies and four were financial buyers.

3.6. First-round offers were received on 7 March 2000 from six of the trade buyers and one of the financial buyers and they ranged from £[✂] billion to £[✂] billion. The offer of £[✂] billion was from Interbrew and it was the highest offer by £[✂] million. After evaluating these offers, Bass allowed the principal contenders access to a data room containing confidential information regarding the performance of Bass Brewers.

3.7. Second-round offers were received on 10 April 2000 from three trade buyers and one financial buyer and ranged from £[✂] billion to £[✂] billion. All the offers were for cash consideration, except for one trade buyer who offered a mixture of cash and shares. As in the first round the highest offer, of £[✂] billion, was from Interbrew. It exceeded the next highest offer by £[✂] million.

3.8. Three bidders went forward from the second round of bidding for more detailed negotiations. Interbrew revised its offer on 16 May 2000 to £2.3 billion and it was granted a period of exclusivity commencing on 19 May 2000. Agreement was reached on 14 June 2000, whereby Interbrew agreed to acquire Bass Brewers for a cash consideration of £2.3 billion. Bass told us that it had accepted Interbrew's offer primarily because it was the highest bid and it was for cash. However, three other considerations had been important to Bass. These were:

(a) Although it was a condition of the bid that it was either approved by the European Commission or referred to the competent authorities in the UK, the bid was not conditional upon clearance by the UK competition authorities. This was of fundamental importance to Bass in its negotiations with Interbrew.

(b) Bass was able to negotiate an acceptable agreement with Interbrew in order to secure beer supplies for its pubs and restaurants. This agreement lasts for a period of [✂] years and commits Bass Leisure Retail (Bass's pubs division) to buying initially around [✂] per cent of its beer supplies from Bass Brewers. This decreases each year to around [✂] per cent in the [✂] and [✂] years.

(c) Interbrew was considered capable of completing the legal formalities in a timely fashion.

3.9. Since the merger satisfied the turnover requirements of the ECMR, it was notified by Interbrew to the European Commission on 6 July 2000. On 1 August 2000 the Secretary of State applied to have those aspects of the merger that related to the UK beer market referred back to the UK and this request was granted on 22 August 2000. Those aspects of the merger that did not relate to the UK beer market, namely the beer activities of Interbrew and Bass Brewers outside the UK, and FABs, were cleared by the European Commission on 22 August 2000. The merger, which had previously been approved by Bass's shareholders, became unconditional on the same date.

The companies

3.10. At the time of its acquisition of Bass Brewers, Interbrew was a private Belgian company with extensive interests in brewing worldwide. On 1 December 2000, Interbrew floated its shares on Euronext (the merged stock exchanges of Paris, Brussels and Amsterdam). Early dealings valued the company at around €14 billion (£9 billion). Bass Brewers was, until the merger, a subsidiary of Bass, which is a UK quoted company with extensive interests in hotels (it owns the Inter-Continental and Holiday Inn brands), pubs and restaurants. At 30 June 2000 Bass had a market capitalization of £6.5 billion.

Interbrew

3.11. Interbrew was formed in 1987 by the merger of two Belgian brewers, Artois, which also had interests in the Netherlands and France, and Piedboeuf. Over the last ten years Interbrew has acquired breweries in a number of Central and Eastern European countries, notably Hungary, Croatia, Romania, Bulgaria, the Ukraine, Montenegro and Russia, as well as in China and Korea. Most significantly, in 1995 Interbrew acquired the Canadian brewer Labatt, which doubled the size of the company and made it the fourth largest brewer in the world. Interbrew has historically concentrated on brewing and has not developed as a vertically-integrated company with interests in retailing.

3.12. By the end of 1999 Interbrew principally operated in five geographic regions—North America, Western Europe, Central Europe, Eastern Europe and Asia Pacific. Its beers were sold in 110 countries and it employed around 24,000 people. Sales volume (excluding minority interests) was 49 million hectolitres. Its major international brands were Stella Artois, Labatt Blue and Rolling Rock but it also had a wide range of national brands and speciality beers such as Jupiler, the leading brand in Belgium. It owned the market-leading brand in Canada, Belgium, Bulgaria, Croatia, Hungary and the Nanjing region of China. Interbrew styles itself as 'The World's Local Brewer', reflecting its aim of preserving and developing local brands, which it considers distinguishes it from other large international brewers.

3.13. In May 2000 Interbrew acquired the brewing business of Whitbread, WBC. WBC had an annual sales volume of around [✂] million hectolitres. The subsequent acquisition of Bass Brewers in August 2000, which had an annual sales volume of around [✂] million hectolitres (including exports and sales by its subsidiary in the Czech Republic), made Interbrew the second largest brewer in the world (with an annual sales volume of around [✂] million hectolitres). Following the mergers with WBC and Bass Brewers it employs around 34,000 people. Anheuser-Busch, the US brewer of Budweiser, which sold 103 million hectolitres of wholly-owned brands in 1999, is the world's largest brewer.

Financial performance of Interbrew

3.14. Profit and loss accounts and balance sheets for Interbrew for the five years ended 31 December 1999 are set out in Appendices 3.1 and 3.2 respectively. Some of the more significant figures derived from the accounts, together with various measures of performance and operating statistics, are analysed in Table 3.1 and considered in the following paragraphs.

TABLE 3.1 **Interbrew: profitability, 1995 to 1999**

	Years ended 31 December					
					BF billion	*£ million**
	1995†	*1996*	*1997*	*1998*	*1999*	*1999*
Operating revenue	98.0	120.3	133.1	145.2	181.6	2,671
Net turnover‡	75.9	92.3	101.3	109.5	130.8	1,924
Operating profit (before amortization of goodwill)	8.8	13.1	15.5	16.6	18.4	271
Profit attributable to shareholders	3.5	4.1	5.3	7.7	9.3	137
Average capital employed	43.7	55.4	54.6	62.6	85.6	1,259
						per cent
Return on sales§¶	11.6	14.2	15.3	15.2	14.1	14.1
Return on average capital employed§	20.1	23.6	28.3	26.5	21.5	21.5
Operating statistics						
Sales volume (million hectolitres)	28.9	32.9	34.7	38.6	49.0	49.0
Revenue per hectolitre¶	BF2,626	BF2,805	BF2,919	BF2,837	BF2,669	£39.25
Profit per hectolitre§	BF304	BF398	BF447	BF430	BF376	£5.53

Source: Interbrew published accounts.

*Using an exchange rate of £1=BF68.
†15-month accounting period.
‡Net turnover excludes duty, rebates and other operating income.
§Based on operating profit (before amortization of goodwill).
¶Based on net turnover.

3.15. Between 1995 and 1999 net turnover increased by 72 per cent from BF75.9 billion to BF130.8 billion (around £1.9 billion at £1=BF68). By comparison, sales volume grew by 70 per cent over the period, as a result of acquisitions made. There were significant acquisitions in Russia, the Ukraine, South Korea, Romania, Bulgaria and Bosnia Herzegovina in 1999. In addition, operations in Luxembourg were consolidated in Interbrew's accounts for the first time.

3.16. Over the same period operating profit (before amortization of goodwill) increased by 109 per cent from BF8.8 billion in 1995 to BF18.4 billion (around £271 million at £1=BF68) in 1999.

3.17. Average capital employed, which excludes goodwill, rose from BF43.7 billion in 1995 to BF55.4 billion in 1996, then fell slightly to BF54.6 billion in 1997 before rising to BF85.6 billion (around £1.3 billion at £1=BF68) in 1999.

3.18. Return on sales rose from 11.6 per cent in 1995 to 15.3 per cent in 1997 before falling to 14.1 per cent in 1999. Similarly, return on average capital employed rose from 20.1 per cent in 1995 to 28.3 per cent in 1997, before falling to 21.5 per cent in 1999.

3.19. Revenue per hectolitre and operating profit per hectolitre both followed the same trend as return on sales and return on average capital employed. Revenue per hectolitre rose from BF2,626 in 1995 to BF2,919 in 1997, before falling to BF2,669 (around £39.25 at £1=BF68) in 1999. Profit per hectolitre rose from BF304 in 1995 to BF447 in 1997, before falling to BF376 (around £5.53 at £1=BF68) in 1999.

Interbrew's activities in the UK

3.20. Prior to its acquisitions of WBC and Bass Brewers, Interbrew's involvement in the UK beer market had primarily been through a licence agreement with Whitbread drawn up in 1976, allowing Whitbread to brew and distribute Stella Artois in the UK until 2018, in return for a stream of royalty payments to Interbrew. With the acquisition of Labatt in 1995, Interbrew had also acquired two subsidiaries in the UK, supplying Labatt's bottled beer and running a small estate of around 500 pubs. However, these businesses were sold to Whitbread and Enterprise respectively in the following year.

3.21. In addition to licensing Stella Artois to Whitbread, Interbrew imported a small amount of Leffe, Hoegaarden and own-label beer into the UK and in 1997 it had granted a [✂]-year licence to Shepherd Neame to brew its Oranjeboom brand in the UK. These activities were administered by a UK subsidiary called Interbrew Services UK Limited. In the year ended 31 December 1998 this company recorded a turnover of £1.5 million and operating profit of £70,000.

3.22. Interbrew UK Limited was set up to acquire the business and assets of WBC in May 2000. WBC was a trading division of Whitbread and not a corporate entity in its own right, so a new corporate vehicle was needed. In the following paragraphs we consider the position and financial performance of WBC.

WBC

3.23. At the time of its acquisition by Interbrew, WBC was the UK's third largest brewer. WBC owned three breweries in the UK, at Salmesbury in Lancashire, Magor in South Wales and at Strangeways in Manchester. Whitbread's pub estate, which was not sold to Interbrew but has subsequently been put up for sale during the course of our inquiry, totalled some 3,700 pubs (2,000 of which were managed and 1,700 tenanted). As a result of the historical location of Whitbread's pub estate, in the on-trade WBC's beers are represented most strongly in southern England, north-west England, and Wales. They have a negligible market presence in Northern Ireland and a very small market share in Scotland. WBC employs around 3,900 people.

3.24. Prior to its acquisition by Interbrew, WBC brewed or marketed around 29 different brands of beer (see Appendix 3.3). Its biggest selling brands were Stella Artois (see paragraph 3.20) and Heineken, both lagers. Heineken has been brewed and marketed in the UK by Whitbread since 1969 under the terms of a licence agreement with Heineken Brouwerijen BV (HBV), which is a subsidiary of Heineken

NV. Similarly Whitbread has since 1988 been producing and marketing Murphy's in the UK under the terms of a licence agreement with MIBL, which is also a subsidiary of Heineken NV. Neither of these licence agreements was assigned to Interbrew as part of its acquisition of WBC (see paragraphs 3.28 to 3.29).

3.25. In addition, WBC supplies a number of its own ale brands, including Boddington's, its third largest selling brand. WBC also has a distribution agreement with Wadworth & Co Ltd (Wadworth) (a regional brewer) to distribute Wadworth 6X, which is a cask-conditioned traditional ale. WBC's principal brands (licensed and owned) and the percentages they represented of its total non-factored sales volumes and contribution to profits in WBC's most recent financial year are set out in Table 3.2.

TABLE 3.2 **WBC: brands and their proportion of sales volumes and profits**

	Percentage of sales volume	*Percentage of contribution to profits*
Licensed and distributed brands		
Stella Artois	*Figures omitted. See note on page iv.*	
Heineken		
Murphy's Irish Stout		
Labatt		
Rolling Rock		
Wadworth 6X		
Owned brands		
Boddingtons		
Flowers		
Trophy		
Whitbread		
Gold Label Barley Wine		
Other (around 11 brands)		
Total all brands	100	100

Source: Interbrew submission.

3.26. Interbrew pointed out that the figures required to compile Table 3.2 had been produced as a special exercise for our purposes, as WBC had not historically accounted for the profitability of different brands to the same degree of detail. To a certain extent the allocation of shared costs between brands was an arbitrary exercise and the results should be viewed as an estimate of brand profitability only. Also in a number of cases several similar products have been amalgamated under one brand family, without necessarily including all the products in that brand family (for example Whitbread Best Bitter, Whitbread Pale Ale etc).

3.27. Table 3.2 shows the extent to which WBC was reliant upon Stella Artois and the relative profitability of that brand compared with Heineken, the next largest brand, which accounted for a further significant part of WBC's sales volume. There can be quite wide divergences between a brand's share of sales volume and its share of profits, depending on the age of the brand, its market segment and the amount of marketing support it has received and continues to receive.

3.28. At the same time as the sale of WBC to Interbrew, Whitbread entered into a transitional agreement with Interbrew to leaseback WBC's brewery at Salmesbury, which brews Heineken and Murphy's. Whitbread also continues to employ all the brewing staff at Salmesbury, as well as marketing and account management employees for the Heineken and Murphy's brands. [*Details omitted. See note on page iv.*] Whitbread also has the right to supply these products to third parties. [*Details omitted. See note on page iv.*]

3.29. The purpose of these arrangements was to allow Whitbread to exit from brewing, whilst at the same time honouring the terms of its licences to brew Heineken and Murphy's until their licences expired or were terminated. HBV has subsequently given notice to terminate the Heineken licence, which will accordingly expire in [✂], if it is not terminated earlier in accordance with the terms of the contract or by mutual agreement. Whitbread has also given notice to MIBL, which means that the Murphy's licence will expire in [✂], if it is not terminated earlier in accordance with the terms of the contract or by mutual agreement.

3.30. As part of the disposal of WBC, Whitbread also negotiated a supply agreement under which WBC continues to supply beer to Whitbread's pub estate. The purpose of this agreement was to provide the parties with security of custom and supply respectively, for a transitional period. The agreement lasts for [✂] years and means that in the first year WBC will supply [✂] per cent of Whitbread's pubs' requirements for beer. This minimum purchase obligation declines by approximately [✂] per cent a year. The agreement also provides that, should the Heineken and Murphy's brands no longer be available for supply from Interbrew, for the reasons set out in paragraph 3.29, then Interbrew will make available comparable brands.

3.31. WBC distributes its own beers, factored beers and beverages supplied by third parties. In parts of the country where it is not cost effective to have its own network of depots and vehicles, it has negotiated access to the distribution networks of other brewers.

Financial performance of WBC

3.32. Profit and loss accounts and balance sheets for WBC for each of the three years ended 28 February 2000 and a forecast profit and loss account and balance sheet for the year ending 28 February 2001 are set out in Appendices 3.4 and 3.5. Some of the more significant figures derived from the accounts, together with various measures of performance and operating statistics, are analysed in Table 3.3 and considered in the following paragraphs.

TABLE 3.3 **WBC: profitability, 1998 to 2001**

				£ million
	Years ended 28 February			
	1998	*1999*	*2000**	*Forecast 2001*
Turnover				
Net turnover†				
Operating profit		*Figures omitted. See note on page iv.*		
Profit before interest and tax				
Average capital employed				
				per cent
Return on sales§¶				
Return on average capital employed§				
Operating statistics		*Figures omitted. See note on page iv.*		
Sales volume ('000 hectolitres)				
Revenue per hectolitre (£)¶				
Profit per hectolitre (£)§				

Source: WBC adjusted management accounts.

*53-week accounting period.
†Net turnover excludes duty on WBC brands and third party turnover on behalf of First Quench.
‡Before £[✂] million of reorganization costs.
§Based on operating profit.
¶Based on net turnover.

3.33. Over the whole period net turnover is forecast to [✂] by [✂] per cent from £[✂] million in 1998 to £[✂] million in 2001. By comparison, sales volume is forecast to [✂] by [✂] per cent over the same period.

3.34. Operating profit [✂]from £[✂] million in 1998 to £[✂] million in 1999. As a result of [✂] transfer prices and [✂] pension and bonus costs it [✂] to £[✂] million in 2000. Operating profit is forecast to [✂] to £[✂] million in 2001, WBC's first period of trading under the ownership of Interbrew.

3.35. Average capital employed [✂] from £[✂] million in 1998 to £[✂] million in 2000, and is forecast to [✂] to £[✂] million in 2001.

3.36. Return on sales [✂] from [✂] per cent in 1998 to [✂] per cent in 1999, before [✂] to [✂] per cent in 2000 and is forecast to [✂] again, to [✂] per cent in 2001. Return on average capital employed [✂] from [✂] per cent in 1998 to [✂] per cent in 1999, before [✂] to [✂] per cent in 2000 and is forecast to [✂] to [✂] per cent in 2001.

3.37. Revenue per hectolitre and operating profit per hectolitre both followed the same trend as return on average capital employed. Revenue per hectolitre [✂] from £[✂] in 1998 to £[✂] in 1999, before [✂] to £[✂] in 2000 and is forecast to [✂] to £[✂] in 2001. Profit per hectolitre [✂] from £[✂] in 1998 to £[✂] in 1999, before [✂] to £[✂] in 2000 and is forecast to [✂] to £[✂] in 2001.

Bass Brewers

3.38. The businesses sold by Bass to Interbrew comprised all its brewing interests worldwide with the exception of a joint venture in China, which was separately disposed of. The brewing interests sold to Interbrew are referred to as Bass Brewers. They principally consisted of its UK brewing operations (Bass Holdings Limited), including a 49.9 per cent stake in Tradeteam, the business and assets of Bass Beers Worldwide (BBW), which exports beer and other alcoholic drinks from the UK to over 79 countries, and around an 80 per cent shareholding in Prague Breweries, which owns three breweries in the Czech Republic. Bass retained its estate of around 3,000 managed pubs, which trades as Bass Leisure Retail, although it has subsequently announced its intention to dispose of around 900 pubs.

3.39. At the time of the merger on 22 August 2000, Bass Brewers was the UK's second largest brewer after Scottish Courage, part of S&N. It owns six breweries in the UK located at Glasgow, Belfast, Tadcaster, Burton-upon-Trent, Birmingham and Alton and employs around 4,000 people in the UK. Its principal beer brands are Carling, Tennent's Lager and Grolsch (lagers) and Caffrey's and Worthington (ales). These five principal brands have a proportionately higher media spend devoted to promoting them, accounting for over [✂] of Bass Brewers' total Great Britain media spend.

3.40. Carling is the UK's leading beer and lager brand, accounting for approximately 10 per cent of all beer sales and around a third of all sales of standard lager. Grolsch is brewed by Bass Brewers but marketed and distributed in the UK by a joint venture between Bass Brewers and Royal Grolsch NV, the owner of the brand, under the terms of a licence agreement. All the other significant brands brewed by Bass Brewers are also owned by them. For historical reasons relating to its former tied estate, Bass Brewers is represented most strongly in the UK on-trade in Scotland, Northern Ireland and the Midlands.

3.41. In total, Bass Brewers brews around 49 different beer brands in the UK (see Appendix 3.3), including Draught Bass (a cask-conditioned traditional ale), Carling Premier (a premium lager) and a range of beers under the Tennent's brand, which are mainly available in Scotland. It also produces and sells a number of FABs. Bass Brewers' main brands and the percentages they represented of its total non-factored sales volumes and contribution to profits in Bass Brewers' most recent financial year are set out in Table 3.4.

TABLE 3.4 **Bass Brewers: brands and their proportion of own-brand sales volumes and profits**

	Percentage of sales volume	*Percentage of contribution to profits*
Carling		
Tennent's Lager		
Worthington		
Grolsch		
Caffrey's	*Figures omitted. See note on page iv.*	
Draught Bass		
Carling Premier		
Stones		
Tennent's Super		
Others (approximately 40)		
	100	100

Source: Interbrew submission.

3.42. As with the analysis of WBC's brands it is inevitable that the allocation of shared costs between different brands is in some respects arbitrary. The results of the analysis of profitability should therefore be treated as estimates only. Carling accounts for around [✂] Bass Brewers' sales volume and [✂] of profits. The next largest brand, Tennent's Lager, which is mainly drunk in Scotland, accounts for [✂] per cent of sales volume but [✂] per cent of profits. As with WBC there is little correlation between the percentage of sales volume and percentage of profits of a brand, [*Details omitted. See note on page iv.*]

Tradeteam

3.43. Primary and secondary distribution of Bass Brewers' products and factored beers and other beverages is carried out by Tradeteam, which is a joint venture between Bass Brewers, which owns 49.9 per cent, and Exel, a distribution logistics company which owns 50.1 per cent. This arrangement was set up in 1995 when Bass Brewers sold its distribution network and transferred the relevant employees to Tradeteam.

3.44. Bass Brewers' primary objective in setting up Tradeteam was to reduce costs without sacrificing service standards. Exel saw Tradeteam as an opportunity to establish a more efficient beer distribution system, which would primarily serve the needs of the emerging retail pub companies. Exel was convinced that it made such overwhelming economic sense for each pub to receive one delivery of all the products it needed, rather than several deliveries from each different supplier, that in time such a distribution system would have to evolve.

3.45. Bass Brewers wanted to form a joint venture with Exel (and hence kept a 49.9 per cent shareholding in Tradeteam) primarily in order to safeguard service levels to customers, but also to benefit (through dividends) from the cost savings and business opportunities it hoped would arise. However, 95 per cent of Tradeteam's business currently comes from Bass Brewers and many third parties told us that they perceived it as being the distribution arm of Bass Brewers, and not an independent distributor.

3.46. The governance of Tradeteam and the relationship between its two shareholders are defined in two agreements: a joint venture agreement and a distribution agreement.

3.47. The joint venture agreement was originally set up to run for a period of ten years from 1995, but was extended after four years to a total of 15 years. The purpose behind this was to allow more time for the original vision behind Tradeteam to take effect (see paragraph 3.44), accepting that Tradeteam had so far failed to gain a significant proportion of non-Bass Brewers' business.

3.48. Amongst other things, the joint venture agreement provides for the board of Tradeteam to be comprised of three directors nominated by Exel and three nominated by Bass Brewers, as well as the managing director and commercial director of Tradeteam. The day-to-day management of Tradeteam is carried out by its dedicated management committee, on which Bass Brewers is not represented. [

Details omitted. See note on page iv.

]

3.49. Provisions also exist to ensure that Bass Brewers does not gain access to confidential or commercially-sensitive information about Tradeteam's customers, by limiting the information that is presented to the directors at board meetings or generally; and ensuring that the directors' legal rights are only exercised in circumstances where requests for extra information are justified. Again we have been told by Bass Brewers that no such requests for extra information have ever been made.

3.50. The distribution agreement sets the contract price at which Bass Brewers acquires the services of Tradeteam. This is based on an annual charge for primary and secondary distribution services derived from the cost that Bass Brewers itself incurred before transferring the business to Tradeteam. The annual price is adjusted according to various parameters, such as volumes and inflation, and is subject to periodic review. In secondary distribution in particular, the contract price has historically contained a high fixed cost element ([✂] per cent, now reduced to [✂] per cent). Bass Brewers also receives dividends paid out of the profits of Tradeteam, which thereby reduce the effective cost of services provided to it by Tradeteam. Further analysis of the effect of Bass Brewers' contract with Tradeteam on the distribution of beer for third parties is given in Appendix 4.5.

Financial performance of Bass Brewers

3.51. Profit and loss accounts and balance sheets for Bass Brewers for the four years ended 30 September 2000 are set out in Appendices 3.6 and 3.7. Some of the more significant figures derived from the accounts, together with various measures of performance and operating statistics, are analysed in Table 3.5 and considered in the following paragraphs. Captions describing figures that relate to Great Britain are annotated with 'GB'.

TABLE 3.5 **Bass Brewers: profitability, 1997 to 2000**

£ million

	Years ended 30 September			
	1997	*1998*	*1999**	*2000*
GB turnover				
Net GB turnover†				
GB operating profit		*Figures omitted. See note on page iv.*		
Divisional operating profit				
Divisional profit before tax				
Average capital employed in GB				
				per cent
Return on sales‡§				
Return on average capital employed‡				
Operating statistics		*Figures omitted. See note on page iv.*		
GB sales volume ('000 hectolitres)				
Revenue per hectolitre (£)§				
Profit per hectolitre (£)‡				

Source: Bass Brewers management accounts.

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*53-week accounting period.
†Net turnover excludes duty on Bass Brewers brands.
‡Based on GB operating profit.
§Based on net GB turnover.

3.52. Net Great Britain turnover [✄] by [✄] per cent from £[✄] million in 1997 to £[✄] million in 2000. By comparison Great Britain sales volume [✄] by [✄] per cent between 1997 and 2000, from [✄] million hectolitres in 1997 to [✄] million hectolitres in 2000.

3.53. Great Britain operating profit [✄] every year between 1997 and 2000 (allowing for the fact that 1999 was a 53-week accounting period) from £[✄] million in 1997 to £[✄] million in 2000. However, the variable performance of the international businesses (BBW, Prague breweries and the joint venture in China) meant that operating profit for the whole division fluctuated between a high of £[✄] million in 1997 and a low of £[✄] million in 1998.

3.54. Average capital employed in Great Britain [✄] every year from £[✄] million in 1997 to £[✄] million in 2000. Over half this [✄] was attributable to the reduction in trade loans. Loans to pub landlords were a common means by which brewers secured exclusive contracts to supply beer. These loans increased following the Beer Orders (see Appendix 3.8) as they were a major source of transitional funding for pub owners upon becoming independent of major brewers. They have subsequently declined due to the increasing use of bank finance.

3.55. Return on sales fluctuated between a high of [✄] per cent in 1997 and a low of [✄] per cent in 2000. Return on average capital employed [✄] from [✄] per cent in 1997 to [✄] per cent (around [✄] per cent on a 52-week basis) in 1999, before [✄] to [✄] per cent in 2000.

3.56. Revenue per hectolitre [✄] from £[✄] in 1997 to £[✄] in 1998, before [✄] to £[✄] in 2000. Profit per hectolitre [✄] every year from £[✄] in 1998 to £[✄] in 2000.

Rationale for the merger

3.57. Interbrew perceived that the brewing industry was going through a period of global consolidation, with recent transactions in Spain, Brazil, France, Portugal, Norway, Sweden, Lithuania, Denmark and the Czech Republic. A significant number of these transactions have been cross-border rather than domestic, reflecting the emergence of a small number of global brewing enterprises.

3.58. The management and shareholders of Interbrew considered that their company had the skills, resources and experience (particularly following the acquisition of Labatt in 1995) to partake in that consolidation as a major player. Accordingly, Interbrew had for some time been active in acquiring breweries in new geographic markets (see paragraph 3.11). These totalled some 30 acquisitions in ten years.

3.59. In the UK the beer industry (brewing and retailing) had also been in a state of change. The Beer Orders (see Appendix 3.8), implemented by the government in 1989, which were intended to increase competition in the beer industry and widen consumer choice, had resulted in a loosening of the tie between brewers and the on-trade and a new independent retail pub sector had emerged (the pubcos). In addition, the overall market for beer had been in decline, although the market for lager and particularly premium lager was still growing. There had also been a shift away from the on-trade to the off-trade (off-licences and supermarkets), trends which are expected to continue, and net wholesale prices had fallen in real terms over the past decade. As a result, conditions for the brewers had become more competitive, and they responded by trying to cut costs. Merger and brand or capacity rationalization is one part of this strategy.

3.60. These factors contributed to the decisions by both Whitbread and Bass to decide to exit brewing, thereby presenting Interbrew with an opportunity to expand in a very significant new market. Interbrew estimated that the UK market (brewing and retailing) was the largest single source of profits in the beer industry in Western Europe (representing some 30 per cent of the total profit pool). Furthermore, a significantly larger share of that profit pool was captured by retailers in the UK. Since Stella Artois, which was, by a considerable margin, WBC's most successful product, was owned by Interbrew, a merger between Interbrew and WBC was a natural outcome and indeed Whitbread believed that no other potential acquiror of WBC would have been willing to offer a comparable price.

3.61. However, whilst in financial terms the acquisition of WBC was compelling, Interbrew perceived that there would be significant advantages to it in acquiring Bass Brewers also. These were as follows:

(a) Interbrew identified a number of synergies arising from combining the three businesses, which it estimated would lead to cost savings of around £[✂] million a year. These are discussed further in paragraphs 3.70 to 3.74.

(b) There was a complementarity in the product ranges of WBC and Bass Brewers. WBC did not own or have a licence to a standard lager brand, the Heineken licence to Whitbread not having been assigned to Interbrew, but it did have Stella Artois, the top-selling premium lager. Conversely Bass Brewers did not own a major premium lager brand, the only significant premium lager in its portfolio being Grolsch, which is brewed under licence, but it did have Carling, the top-selling standard lager.

(c) The acquisition of Bass Brewers would give Interbrew access, through a majority stake in Prague Breweries, to the Czech Republic where it had hitherto not been active. Bass Brewers' presence in Italy, Spain, the USA and Canada would also complement Interbrew's existing business activities.

(d) Interbrew's international presence would provide a further platform to market Bass Brewers brands' overseas.

Justification for the price paid

3.62. As it does in relation to all its acquisitions, Interbrew assessed the amount that it was prepared to pay for WBC and for Bass Brewers using two methods. The first method was to carry out a ten-year

DCF (discounted cash flow) analysis in order to assess whether the investments would achieve a positive return.

3.63. The second method was to calculate the price as a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization), and compare this with EBITDA multiples attributed to other brewers—either quoted companies or occurring in recent transactions. EBITDA is a measure of operating cash flow and EBITDA multiples are widely used by merchant banks and others in assessing potential investments.

3.64. Interbrew's original DCF analysis used a post-tax weighted average cost of capital of [✂] per cent. Sensitivity analysis was also carried out by varying the terminal value of the business and the discount factor. These calculations suggested to Interbrew that the stand-alone enterprise values for WBC and Bass Brewers were £[✂] million and £[✂] million respectively. A value of £[✂] million was attributed to synergies (after deducting implementation and transaction costs). This gave a combined enterprise value of £[✂] billion, compared with the actual combined price paid of £[✂] billion (£[✂] million for WBC and £[✂] billion for Bass Brewers), resulting in £[✂] million of value creation. Interbrew subsequently reworked its analysis for us during the course of our inquiry, which resulted in a reduction of £[✂] million, taking the figure for value creation to £[✂] million.

3.65. The price paid as a multiple of EBITDA was similarly considered by Interbrew as a whole and in its constituent parts. The prices paid for WBC and Bass Brewers, the costs and savings from acquiring both companies, their EBITDAs and the resultant multiples are summarized in Table 3.6.

TABLE 3.6 **EBITDA multiples paid for WBC and Bass Brewers**

	WBC	*Bass Brewers*	*Synergies*	*Costs**	*Total*
Purchase price (£m)	400	2,300	N/A	(✂)	
EBITDA (£m)	80	242	(✂)	N/A	[✂]
Multiple of EBITDA	5.0	9.5	N/A	N/A	

Source: Interbrew submissions.

*Transaction costs £[✂] million. Rationalization costs £[✂] million.

3.66. Using either method it can be seen that Interbrew paid a relatively higher price for Bass Brewers than it did for WBC. However, the level of interest in Bass Brewers was much greater. Also, by that stage, the possibility of combining the two businesses offered Interbrew the prospect of realizing cost savings of £[✂] million a year.

3.67. Taking into account both transactions and the costs and savings expected to arise implied an overall EBITDA multiple of [✂] times. However, the multiple of EBITDA paid for Bass Brewers alone (9.5 times) was lower than the multiple paid by Heineken NV for Cruzcampo (12 times) and by S&N for Kronenbourg (11 times). Independent research carried out by Danske Securities suggested that the weighted average EBITDA multiple of ten quoted brewers was 8.9 times. Accordingly, Interbrew argued that it had not overpaid for Bass Brewers.

3.68. We also performed our own analysis of the premium or discount paid by Interbrew for WBC and Bass Brewers. Our analysis compared the after-tax cash return on investment, which we estimated to be £[✂] million [✂], with the annual cost of investment using a weighted average cost of capital of around [✂] per cent, which came to £[✂] million, leading to the conclusion that the price paid was broadly equivalent to [*Details omitted. See note on page iv.*].

3.69. We put our analysis to Interbrew who said that, whilst it was an accepted means of assessing a potential investment opportunity, as with many other techniques, there were some weaknesses with the approach, particularly if it were used in isolation. Interbrew pointed out that, since we had calculated a nominal weighted average cost of capital, it should be compared with the nominal after-tax return on investment. Interbrew did not accept that the nominal after-tax return on investment would be static over time. As well as the impact of inflation on costs and revenues, significant growth would come from capital expenditure savings and from FABs and exports, and this formed an important part of the valuation. In Interbrew's opinion their DCF analysis showing £[✂] million of value creation (see

paragraph 3.64) had been prepared using more sophisticated assumptions about nominal future cash flows and was therefore likely to be a more accurate calculation. Interbrew also told us that the WBC and Bass Brewers transactions would create value for Interbrew's existing shareholders by enhancing the rating accorded to the company on flotation (see paragraph 3.10).

Synergies

3.70. Interbrew told us that it expected to achieve synergy benefits and cost savings amounting to approximately £[✂] million a year after three to four years by combining the businesses of WBC and Bass Brewers with its own international business. These benefits and cost savings are summarized in Table 3.7 and commented on further in the following paragraphs.

TABLE 3.7 **WBC and Bass Brewers: synergies arising from the merger with Interbrew**

	per year
	£m
Details omitted. See note on page iv.	

Source: Interbrew submission.

3.71. [*Details omitted. See note on page iv.*]

3.72. [*Details omitted. See note on page iv.*]

3.73. [*Details omitted. See note on page iv.*]

3.74. Interbrew assessed the one-off costs of implementing these cost savings to be £[✂] million, [*Details omitted. See note on page iv.*] complete years of ownership of Bass Brewers. Their plans included the loss of about [✂] jobs out of [✂] and the outsourcing of a further [✂].

Funding of the acquisition and gearing

3.75. The acquisitions of WBC and Bass Brewers were financed through a debt syndication led by ABN Amro. The terms on which the funds were provided to Interbrew were base rate plus an average over time of approximately [✂] base points, implying an interest rate of around [✂] per cent currently.

3.76. Before its flotation on Euronext on 1 December 2000 (see paragraph 3.10) Interbrew estimated its pro forma EBITDA for 2001 to be €[✂] million (£[✂] million), with an interest expense of €[✂] million (£[✂] million), implying an interest cover of [✂] times. [*Details omitted. See note on page iv.*] This was achieved by the flotation, which raised €2.9 billion of new capital, thereby substantially increasing Interbrew's interest cover.