

Anticipated acquisition by Whitbread plc of the Premier Lodge Business from Spirit Group Holdings Limited

The OFT's decision on reference under section 33 given on 11 March 2004

PARTIES

1. **Whitbread plc** ('Whitbread') is active in three principal areas of the leisure industry: hotels, restaurants and health & fitness. It owns and operates 'Travel Inn', a chain of 298 branded hotels in the UK. **Premier Lodge**, the target business currently owned by Spirit Group Holding Ltd ('Spirit'), is itself a chain of 134 branded hotels in the UK.

TRANSACTION

2. Spirit launched a bidding process to sell Premier Lodge on 27 February 2004. Whitbread has formally entered this process and is one of several competing bidders. It has sought to obtain regulatory clearance of the proposed transaction in advance of the final outcome of this process.
3. A complete merger submission was notified to the OFT on 15 March 2004; the administrative target date for a decision in this case is therefore 12 May 2004.

JURISDICTION

4. As a result of the proposed transaction, Whitbread and the Premier Lodge businesses would cease to be distinct. Whitbread has confirmed that Premier Lodge's UK turnover exceeds £70 million, so the turnover test in section 23(1)(b) of the Enterprise Act 2002 ('the Act') is satisfied. In addition, the parties overlap in the supply of branded budget hotels, and the share of supply test in section 23 of the Act is met. If the proposed transaction is completed, a relevant merger situation will therefore be created.

RELEVANT MARKET

5. Branded budget hotels are a category of 'paid for' overnight accommodation. Chains such Travel Inn and Premier Lodge offer accommodation units at relatively low prices, charged on a 'per room' rather than a 'per person' basis. The rooms offered are typically of a standard basic design (virtually identical in all hotels within each chain) with standardised furnishing and fittings and en-suite facilities.
6. Branded budget hotels are a relatively new phenomenon in the UK. However, since 1992 the number of branded budget rooms has increased at an average rate of around 25 per cent per year. The first sites (frequently called 'lodges') were built in strategic locations close to main roads or airports. In recent years, however, branded budget hotels have expanded into city centres and suburbs. Whitbread submits that Travel Inn and Premier Lodge are broadly equivalent to 2-star hotels.

Product Market

Previous cases

7. In a previous case¹ considered under the Act, no firm conclusion was drawn on the scope of the product market for overnight accommodation. The view was taken, however, that branded budget hotels were thought to compete with a range of other accommodation in the UK, including 'budget' hotels (2-star), 'mid-range' hotels (3-star), 'upscale' hotels (4-star), B&Bs and guesthouses. A similar view has been taken by the European Commission in a number of its merger decisions.²
8. The OFT's investigation revealed evidence from various sources which in the main supported this approach.

¹ The anticipated acquisition by Spirit Amber Holdings of the Scottish and Newcastle retail pub estate (ME/1438/03)

² COMP/M.1596 – Accor/Blackstone/Colony/Vivendi
COMP/M.2197 – Hilton/Accor/Forte/Travel Services JV
COMP/M.2451 – Hilton/Scandic
COMP/M.2464 – Nomura Internation/Le Meridien Hotels
COMP/M.2510 – Cendant Galileo
COMP/M.2997 – Accor/Ebertz Dorint

Merging Parties

9. Whitbread proposes that all types of establishment offering overnight accommodation should be considered within the same frame of reference. It submits that B&Bs, guesthouses and star rated hotels constrain its pricing policies and that consumers switch between the available types of accommodation. To illustrate this point, Whitbread provided internal discussion papers on proposed development opportunities in Birmingham (1999) and at Heathrow (2002). These documents contain analysis carried out in respect of the competitive presence of a number of 3-star and 4-star hotels in the area of the prospective new build. In addition, Whitbread submitted monthly performance reports demonstrating that it tracks Travel Inn's performance relative to a range of competitors providing various types of hotel accommodation.

Customers

10. Corporate customers and travel agents maintained that accommodation is primarily chosen according to price and location. These responses indicated that the distinction between branded budget hotels and star rated hotels is blurred. One customer submitted that the quality of the rooms in both types of establishment was very similar, the main distinction being that star rated hotels tend to provide additional facilities such as room service and gyms. The majority indicated that customers would switch to other types of accommodation if branded budget hotels increased their prices by 5-10 per cent.

Market Research

11. Market research reports also indicate that the scope of the product market is wider than branded budget accommodation. Mintel³ reported in 2003 that branded budget hotels compete against a wide range of accommodation, from small B&Bs and guesthouses to established 3-star hotels. The report predicts that the competitive environment will continue over coming years as the lodges 'take on B&Bs, pubs and the unfocused 3-star hotel market'. Mintel also reports that no-frills budget hotels are also competing in cities against the growing sector of apartment hotels targeted at long-term business travellers.

³ 'Budget Hotels' April 2003

12. Further market research also provides some evidence of customers' switching behaviour. An earlier report on 'Budget Hotels' produced by Mintel in 2001 indicates that the growth of branded budget hotels has displaced business from many other types of accommodation, notably B&Bs and 3-star hotels. That report also states that: 'Given a choice, 53 per cent of consumers from the [consumer research] survey would stay in a guesthouse/B&B if a budget hotel was not available and 41 per cent would stay in a 3-star hotel'.

Competitors

13. In the majority of responses received from third-party competitors, it was submitted that branded budget hotels compete at least with star rated hotels. Some competitors argued that branded budget hotels also compete with B&Bs and guest-houses. One competitor proposed, however, that B&Bs were an imperfect substitute.
14. Three submissions were received from companies interested in the bidding process for the Premier Lodge business. They argued that branded budget hotels compete primarily with each other rather than with other types of establishment. They also suggested that branded budget hotels differ from other types of overnight accommodation due to factors such as price, amenities, location and branding. However, the third parties concerned did not provide sufficient probative or material evidence in support of an argument for a narrower frame of reference.

Findings

15. On the basis of the evidence gathered, it appears that substitutability on the demand side is relatively high, which indicates a frame of reference wider than branded budget hotels. It is plausible to consider a chain of substitution in existence between various types of star rated hotel – particularly in the mid-range – and branded budget hotels.
16. On the supply side, substitution could be effected by altering the facilities and standard of accommodation within an existing hotel; extending or reducing the range of facilities on offer; or converting premises previously put to uses other than the provision of overnight accommodation. In theory, alterations may not appear difficult. The responses from third parties, however, were mixed. One indicated that conversion of premises could be quite costly and time-consuming to implement and that it would be more expensive to convert existing premises (the respondent did not provide relevant cost estimates) relative to the cost of new build (which the respondent estimated to be between £25,000 to £35,000 per room). However, another third party estimated that the average cost to

convert existing premises to branded budget hotel standards would be closer to £5000, depending on the existing layout and the state of the building. Nonetheless there is evidence of conversion activity. In March 2004, Travelodge acquired the 4-star Drury Lane Moat House which it is now rebranding.

17. Overall, therefore, an appropriate product frame of reference encompasses at least branded budget hotels and mid-range star rated hotels. B&Bs, guesthouses and unclassified hotels may also provide additional competitive constraint.

Geographic market

18. On the demand side, customers seeking overnight accommodation are typically restricted to a specific local area. The boundaries of this area are determined by several factors including customer preference and the purpose of the overnight stay (e.g. leisure or business travel). For these reasons it is difficult to delimit the extent of these local markets precisely. The European Commission has previously identified local geographic markets comprising an entire city on the basis that one of the main features of the hotel sector is its individual city character: customers select hotels in the city where they stay.⁴ This is a reasonable starting point for determining those locations where Travel Inn and Premier Lodge overlap.
19. Branded budget hotels also compete to some extent at the national level. Hotel chains often have central reservation systems, as well as the advantage that they may be able to accommodate customers in another hotel within the chain if that customer's first choice is not available. The brand and reputation of the chain are also established nationally and discounts may be offered for more than one night's accommodation within the same chain.
20. The geographic frame of reference therefore has national and local dimensions and both of these will be considered in this paper.

⁴ Accor/Blackstone/Colony/Vivendi

HORIZONTAL ISSUES

Local Issues

21. Whitbread identifies 47 local areas of overlap between Travel Inn and Premier Lodge and has provided share of supply information on individual rooms offering overnight accommodation in the following categories of establishment:
 - (a) branded budget hotels,
 - (b) branded budget hotels, star rated hotels (1 to 3 star) and unrated hotels.
 - (c) all types of overnight accommodation.
22. In 46 of the 47 local areas, the parties will supply more than 25 per cent of all branded budget accommodation. Whilst there may be prima facie concerns, it is necessary to consider the constraints placed on the parties in order to assess whether there is realistic prospect of a substantial lessening of competition.
23. From the information we have received, it appears that branded budget hotels compete at the very least with mid-range star rated hotels. Post merger, the parties' share of the supply of all the accommodation of the type in paragraph 21(b) – which includes unrated hotels – will be less than 25 per cent in all but three of the 47 local areas. Although the OFT has not reached a firm conclusion on whether unrated hotels are an immediate competitive constraint and part of the frame of reference, we have no reason to believe that inclusion of unrated hotels in the share data on the above basis has masked any local competition concerns, given the other evidence available and in particular the general absence of customer concerns. On the share data provided on this basis, in Caerphilly, Dover/Folkestone and Maidstone, the parties' share of supply will be [30-40 per cent]⁵ [30-40 per cent] and [30-40 per cent] respectively. As far as Caerphilly is concerned, Whitbread has submitted that Travel Inn's data on reservations indicates significant cross-sales⁶ to and from Cardiff, Merthyr Tydfil, Newport and Bridgend. Given the accessibility of a city such as Cardiff, 8.3 miles away, hotels within that city may be expected to pose a significant constraint on the parties in the Caerphilly area. Travel Inn's data for the Maidstone area indicate significant cross-sales to and from Ashford, Dover, Folkestone and Sittingbourne. Equally for the Dover/Folkestone area, Whitbread points to cross-sales to and from Ashford and Margate. In the OFT's view,

⁵ Share of supply data in paragraph 23 put into ranges at notifying party's request

⁶ Cross-sales are bookings received by establishments in nearby areas due to the lack of availability of accommodation in the customer's preferred location. Cross-sale bookings are tracked through hotel reservations systems.

cross-sales data could suggest that customers regard accommodation in neighbouring areas as alternatives to the overnight accommodation offered by the merged entity in the areas in question. Given the general absence of customer concern made known to the OFT – including a specific lack of concern in relation to the three areas identified – the weight of evidence tends to suggest that the merged entity faces sufficient competitive constraints in local areas of overlap.

24. On the basis of a frame of reference that includes all types of accommodation, the parties' share of supply is further reduced. There are only two areas where joint shares exceed 25 per cent of all types of accommodation: Caerphilly ([25-30 per cent⁷]) and Dover/Folkestone ([25-30 per cent}). As discussed above, there appears, however, to be alternative establishments available to constrain the parties' pricing behaviour.
25. The constraint posed by alternative establishments is reinforced by the ease with which customers can switch between suppliers of overnight accommodation. Switching costs are rather low and Whitbread maintains that prices are transparent. Information sources available to customers include published guides, tourist information centres and the internet.

National Issues

26. Whitbread has also provided share of supply information at the national level, broken down in accordance with the categories set out in paragraph 21.
27. In the UK there are 15 main brands⁸ of budget hotel. These account for a total of 961 hotels and 61,067 rooms. Table 1 shows that, post-merger, the parties will supply [40-45 per cent⁹] of branded budget accommodation: an increment of [10-15 per cent].

⁷ Share of supply data in paragraph 24 put into ranges at notifying party's request

⁸ Some brands are owned by the same proprietor

⁹ Share of supply data in paragraph 27 put into ranges at notifying party's request

Table 1: National Branded Budget hotels - June 2003

Brand	Company	% Share of Hotels	% Share of rooms
Travel Inn	Whitbread	[25-35] ¹⁰ %	[25-35%]%
Premier Lodge	Spirit	[10-15%]%	[10-15%]%
Combined		[35-45]%	[35-45]%
Travelodge	Permira	[20-30%]	[15-25%]
Express by Holiday Inn	InterContinental Hotels	[5-10%]%	[10-15%]
Innkeeper's Lodge	Mitchells & Butler	[5-10%]	[1-5%]
Ibis, Formule 1, Etap Hotels	Accor	[3-8%]	[8-12%]
Comfort Inns, Sleeps Inn	Choice Hotels Europe	[<5%]	[<5%]
Days Inn	Cendant	[<5%]	[<5%]
Campanille	Societe du Louvre	{<2}%	[<2%]
Weatherspoon Lodge	Weatherspoon	[<2%]	[<1%]
City Inn	First Stop Hotels	[<1%]	[<1%]
Welcome Lodge	Welcome break	[<1%]	[<1%]

Source: Whitbread

28. Post-merger, the HHI measured by number of branded budget hotel rooms is 2658, which would indicate that the sector is concentrated. Based on this frame of reference, the increment at 821 would normally give rise to prima facie competition concerns. Three companies interested in the bidding process submitted that, due to the increase in share, the transaction would enable Whitbread to increase prices by approximately £1- 2 per room. Increasing a current room rate of £46 would represent a price increase of 4.35 per cent.
29. However, as discussed in the section on local issues, the weight of evidence received suggests that a frame of reference restricted to branded budget hotels in the UK is probably not a true representation of the competitive constraints within this sector.
30. Whitbread submits that budget accommodation represents 14 per cent of registered hotel rooms available in the UK (excluding up-market hotels) and 6 per cent of rooms available in all establishments. The 2003 Mintel report states that, out of the 84 million occupancies of overnight accommodation in the UK, approximately 20 million are spent in B&Bs, 47 million in mid-market hotels and 10 million in budget hotels. Post-merger, the parties' joint share of supply of overnight accommodation of the type in paragraph 21(b) above will be [$< 10^{11}$] per cent (increment [< 5] per cent). If all overnight accommodation is taken into account, the combined share of supply is reduced to 2.6 per cent (increment 0.8 per cent).

¹⁰ Share of supply data in Table 1 put into ranges at notifying party's request

¹¹ Share of supply data in paragraph 30 put into ranges at notifying party's request

31. The Travel Inn and Premier Lodge brands are reasonably strong at the national level. In addition, the central booking system used by chain hotels could put them at an advantage over independent hotels, although increasing use of the internet for hotel bookings may reduce the impact of central reservation systems and search costs for customers. However, even if they may slightly understate the parties' potential market position for these reasons, the parties' combined share of supply figures given in the previous paragraph are not considered sufficient to give rise to concerns in the light of other evidence considered.

BARRIERS TO ENTRY

32. Responses from third parties indicate that the principal barriers to entry into the branded budget/mid-range star-rated sector include the availability of new sites, build costs and the costs of establishing a brand.
33. Three companies interested in the bidding process for Premier Lodge raised concerns that the cost of entry was prohibitive due to the limited availability of land and the requirement for local planning permission. However, another third party submitted that planning permission was relatively easy to acquire in most areas. Whitbread has submitted that a total of 106 new branded budget hotels have either already opened in the UK or are scheduled to open over the period between 2003 and the end of 2004.¹² This suggests that such barriers are not insurmountable.
34. In relation to build costs, a Keynote report¹³ indicates that Malmaison intends to launch a UK branded budget hotel chain at a build cost of £9-10 million. One third party estimated that adding capacity would cost in the range of £25-35,000 per room. According to Whitbread, the cost of a new build could be offset by 'rentalisation': an arrangement whereby a third party investor provides part or all of the initial capital in return for an ongoing rental stream, or mixed used schemes within the new build - such as a gym or restaurant.
35. Branding may also increase entry costs. New entrants may have consumers' brand loyalty to the incumbent chains to contend with when trying to attract custom to their establishments and, as a result, existing brands may enjoy a strategic advantage. The 2003 Mintel report shows that branded budget hotels' advertising expenditure ranged from £167,000 to £4,592,000. Travel Inn was at the top end of the spectrum, spending the equivalent of £15,409 per hotel. One third party maintained that, post merger, it is less likely to enter the budget

¹² Whitbread's information is sourced from published brochures and press releases

¹³ Keynote report 'Hotels' November 2003

sector because it believed that entry barriers would be increased due to the high costs involved in developing a new, competing brand.

36. Re-development is an alternative entry channel. Existing hotels may alter facilities and thus reposition themselves as branded budget or mid-range star-rated accommodation. One third party estimated that the average cost to convert a room would be close to £5,000 per room depending on the existing layout and state of the building. Alternatively, franchising is a means of expansion. The 2003 Mintel report comments that groups like Choice and Express by Holiday Inn all follow this approach.
37. Although barriers to entry appear to exist, there is evidence of successful entry. The 2003 Mintel report highlights the success of Express by Holiday Inn in doing so. Some 50 hotels have been introduced in three years and the yields are 'highly acceptable' and compare favourably with those obtained from 'traditional' 3-star hotels. Whitbread submits that Sleep Inn and Innkeeper's Lodge have also entered within the last three years and points to Easyjet (believed to be looking at a budget sector with the brand EasyDorm) and the restaurant chain Yo! Sushi as potential entrants.
38. The Mintel report also asserts that brands such as Express by Holiday Inn, Days Inn and Sleep Inn have enormous potential to expand. Whitbread submits that the merged entity will account for 41 of the 106 new branded budget hotels planned to open in 2003/2004.
39. Overall, entry barriers would seem to feature within this sector, but are not insurmountable given the evidence of recent actual or planned entry and expansion.

BUYER POWER

40. Travel Inn estimates that the proportion of leisure clients relative to business clients is approximately [*information excised at notifying party's request*]. Large corporate customers and travel agents may benefit from buyer power. Responses from third parties indicate some customers receive discounted prices. However, other respondents submitted that, within the budget sector, there was little room to negotiate – this is almost certainly the case for individual consumers.

VERTICAL ISSUES

41. No vertical issues arise in this case.

THIRD PARTY COMMENTS

42. The majority of customers and other third parties did not raise any competition concerns. Three third parties (all of which are interested in the bidding process for the Premier Lodge business) raised concerns about increased barriers to entry and potential price increases. These issues have been discussed under horizontal issues and barriers to entry.

ASSESSMENT

43. The transaction qualifies on the turnover and the share of supply tests of the Act. The relevant frame of reference is considered to be no narrower than branded budget and mid-range star rated hotels. B&Bs, guesthouses, other star rated and unclassified hotels may also provide additional pricing constraint.
44. The parties will provide over 25 per cent of branded budget accommodation in 46 of the 47 local areas of overlap. However, the weight of the evidence indicates that alternative establishments, particularly mid-range star-rated hotels, will provide an effective constraint on the merged entity in all these areas. Furthermore, while entry barriers exist in this sector, they do not appear to be insurmountable since there is evidence of recent entry and planned expansion.
45. At the national level, the merged entity's share of supply of branded budget accommodation is in excess of 40 per cent. However, this does not give an accurate representation of the parties' market position since at least mid-range star-rated hotels are considered to provide an effective constraint. Taking these hotels into account, the merged entity's combined share of supply is less than 10 per cent and does not give rise to concerns.
46. The majority of third parties did not raise any competition concerns. Three companies interested in the bidding process raised concerns about barriers to entry and potential price increases, and these issues have been discussed under horizontal issues and barriers to entry.
47. Consequently, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.
48. This merger will therefore **not be referred** to the Competition Commission under section 33(1) of the Act.