4 The main parties and the proposed transfer

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Introduction

4.1. On 23 December 2002, an agreement was signed by SMG and its wholly-owned subsidiary SMG Publishing Limited (SMG Publishing), for the sale to Gannett of the publishing businesses carried on by SMG in the UK.

4.2. In this chapter, first we give a brief explanation of the sale agreement, and then describe the main parties involved. This is followed by details of the sale agreement including the price paid. Finally, we deal with the effect of the sale including projected future returns for the combined business.

The business to be transferred

4.3. In summary, the sale agreement provides for the sale of the entire issued share capital of certain subsidiaries of SMG Publishing engaged in the publishing business, including three newspapers—*The Herald*, the *Evening Times* and the *Sunday Herald*—along with an Internet business providing e-commerce and local content, and 11 speciality magazine titles, to Gannett. Gannett will pay to SMG £216 million[1] in cash, including an amount of £[✂] million for the repayment of inter-company debt. Under the terms of the agreement, certain pension liabilities will remain with SMG. Further details about the agreement are described in paragraphs 4.69 to 4.80.

4.4. Gannett is incorporated in the UK and is wholly owned by Gannett Co Inc, a US corporation described in further detail in paragraphs 4.5 to 4.10. Paragraphs 4.11 onwards include further details about Gannett Co Inc's UK subsidiary, Gannett.

Gannett Co Inc

4.5. Gannett Co Inc is a US corporation and is quoted on the New York Stock Exchange. As at 13 January 2003, the market capitalization of Gannett Co Inc was $20.1 billion (£12.5 billion). Its primary activities are the publication of newspapers and operation of television channels. It operates in 43 states in the USA where it publishes 94 daily newspapers with a combined daily paid-for circulation of around 7.7 million. Gannett Co Inc owns *USA TODAY*, which has a circulation of around 2.3 million, making it the USA's largest selling daily newspaper. In 2001 Gannett Co Inc had revenues of $6.3 billion (£4.4 billion) and operating income of $1.6 billion (£1.1 billion). Gannett Co Inc's headquarters are in McLean, Virginia and it employs around 51,500 people worldwide.

4.6. Table 4.1 shows summarized financial data for Gannett Co Inc for the years 1998 to 2001. In this table and throughout this chapter the primary measure used to discuss business performance is EBITDA, (earnings before interest, tax, depreciation and amortization, and certain exceptional and other non-trading items).

[1]Subject to adjustment based on certain asset values at completion.

TABLE 4.1 **Gannett Co Inc: summary financial data, 1998 to 2001**

				$ million	£ million
	1998	*1999*	*2000*	*2001*	*2001*
Turnover	4,709.0	5,095.4	6,222.3	6,344.2	4,372.3
EBITDA*	1,639.3	1,843.2	2,193.2	2,033.6	1,401.5
EBIT†	1,385.8	1,563.1	1,817.3	1,589.8	1,095.7
Long-term debt	1,306.9	2,463.3	5,747.9	5,080.0	3,501.1
Shareholders' equity	3,979.8	4,629.6	5,103.4	5,735.9	3,953.1
EBITDA on turnover %	34.8	36.2	35.2	32.1	32.1
EBIT on turnover %	29.4	30.7	29.2	25.1	25.1
Return on equity‡	21.0	20.6	20.0	15.3	15.3
Gearing ratio§	0.3	0.5	1.1	0.9	0.9

Source: Gannett Co Inc 2001 annual report/CC calculation.

*Earnings from continuing operations before interest, taxation, depreciation, amortization and non-operating items.
†Earnings from continuing operations before interest, taxation, and non-operating items.
‡Based upon average shareholders' equity (and income from continuing operations before non-recurring gains and accounting principle changes).
§Ratio of long-term debt to shareholders' equity.

4.7. The results for 2001 were significantly affected by several factors. Although revenues grew as a result of acquisitions made in mid-2000, the company's continuing operations suffered from a wide-spread decline in advertising revenue, which also contributed to a reduction in EBITDA. Average newsprint prices rose by 10 per cent in 2001, also contributing to the decline in earnings. Return on equity was reduced in 2001 by a combination of lower earnings and higher equity.[1]

4.8. Long-term debt increased in 1999 and 2000 largely as a result of acquisitions, including Gannett Co Inc's expansion into the UK with the purchase of Newsquest and Newscom (described in paragraphs 4.11 and 4.12), and acquisitions of US titles from Thomson Newspapers Inc and Central Newspapers Inc. During 2001, Gannett Co Inc used cash flow from operations to reduce debt. At 31 December 2001 Gannett Co Inc's gearing ratio was 0.9 and its interest cover ratio was 7.2.

4.9. Table 4.2 shows a breakdown of selected financial data for Gannett Co Inc by business activity. The company operates in two principal business segments: newspaper publishing and television broadcasting. In 2001, turnover attributable to newspaper publishing accounted for 89.6 per cent of total revenues and 10.4 per cent was attributable to broadcasting.

TABLE 4.2 **Gannett Co Inc: summary financial data 2001 by segment**

				$ million
	Newspaper publishing	*Broadcasting*	*Corporate*	*Total*
Turnover	5,681.6	662.7	-	6,344.2
EBITDA	1,769.7	317.4	–53.5	2,033.6
EBIT	1,400.6	249.8	–60.6	1,589.8
				per cent
EBITDA on turnover %	31.1	47.9	-	32.1
EBIT on turnover %	24.7	37.7	-	25.1

Source: Gannett Co Inc 2001 annual report/CC calculation.

4.10. Gannett Co Inc operates primarily in the USA and the UK. The 2001 Annual Report states that approximately 88 per cent of the company's revenues are from domestic (ie US) operations.

[1]Gannett Co Inc's 2001 annual report says this is due to non-recurring gains from the sale/exchange of businesses being included in shareholders' equity but excluded from the amount of earnings from continuing operations used in the calculation.

Approximately 11 per cent of the company's revenues are from UK operations, with the remaining 1 per cent from other foreign operations. The UK operations consist of the newspaper publishing business of Newsquest (see paragraphs 4.11 to 4.14 for further details).

Gannett's UK operations

Business structure and principal activities

4.11. As stated above, in 1999 Gannett Co Inc, through its wholly-owned UK subsidiary holding company, Gannett, acquired the entire share capital of Newsquest for approximately £922 million ($1.5 billion). This acquisition was the company's first significant investment outside the USA. At the time, Newsquest published 180 local newspaper titles in the UK, including 11 paid-for daily newspapers.

4.12. In June 2000, Gannett acquired the entire share capital of Newscom for approximately £444 million ($702 million). Newscom published a total of 97 daily and weekly local newspaper titles in the UK. Immediately following the acquisition, Newscom was renamed Newsquest Media (Southern) plc, and has now been registered as a private company.

4.13. In June 2001, Gannett acquired the Dimbleby Newspapers Group, publishers of a portfolio of weekly paid-for newspapers circulating in south-west and south London.

4.14. Following these acquisitions, Gannett is now the third largest publisher of local newspaper titles in the UK and the second largest publisher of weekly newspaper titles. It publishes more than 300 titles in the UK, including 15 daily newspapers.

History of Newsquest and Newscom

4.15. The following section outlines the ownership of Newsquest and Newscom prior to their acquisition by Gannett.

Newsquest

4.16. Newsquest was formed in January 1996 in order to effect a management buyout of Reed Regional Newspapers Limited (RRN). RRN was a subsidiary of Reed Elsevier plc, which had first established its regional newspaper business by acquiring the Worcester-based Berrows Organisation from News International in 1981.

4.17. Reed Elsevier subsequently made a series of acquisitions and disposals of local newspapers but for strategic reasons decided to sell RRN, which led to a successful bid by RRN's management, with the backing of Kohlberg Kravis Roberts & Co, a US private equity partnership.

4.18. Newsquest subsequently acquired Westminster Press in December 1996, virtually doubling its size. In October 1997 Newsquest floated on the London Stock Exchange.

Newscom

4.19. Newscom was originally incorporated as The Hampshire Advertiser County Newspaper and Printing and Publishing Company Limited in 1864. The name was subsequently changed to Southern Newspapers plc and in 1998 to News Communications & Media plc. However, the origins of the company's business go back even further than 1864 to the first publication of the *Southampton Herald* and *Isle of Wight Gazette* in 1823.

4.20. The company acquired the *Evening Echo (*now the *Southern Daily Echo*) in 1890. The *Bournemouth Evening Echo* (now the *Daily Echo*) was launched in Bournemouth in 1900 and the *Dorset Daily Echo* and *Weymouth Despatch* (now the *Dorset Echo*) was launched in 1921. The company grew considerably through a mixture of organic growth and acquisitions, but these three titles remained central to the company's newspaper publishing business.

Financial performance

4.21. For management purposes, Gannett's publishing acquisitions, including Newsquest and Newscom, have been integrated and are consolidated into a single entity referred to from now on as Newsquest. The consolidated management accounts for Newsquest are shown in Table 4.3 for the years 1998 to 2002. Gannett acquired Newsquest in July 1999. In June 2000, Newsquest acquired Newscom, and this is reflected in the growth in turnover and profits in that year, as well as an increase in headcount by around 2,500 employees. The UK acquisitions were funded by way of an inter-company loan from Gannett Co Inc and the interest on this loan is reflected in the figures for profit before tax. The operational performance of the businesses is discussed in terms of EBITDA and EBIT.

TABLE 4.3 **Newsquest management accounts**

					£ million
	1998	*1999*	*2000**	*2001*	*2002*
Turnover	305.8	316.7	495.5	512.8	515.1
EBITDA†	95.2	104.2	160.6	171.8	180.9
EBIT‡	83.3	91.2	142.2	154.3	162.4
Profit before tax	61.0	33.2	69.5	77.1	84.8
					no of employees
Headcount	5,752	5,890	8,386	8,514	8,498
					per cent
EBITDA on turnover %	31.1	32.9	32.4	33.5	35.1
EBIT on turnover %	27.2	28.8	28.7	30.1	31.5

Source: Newsquest management accounts.

*Including Newscom's results for the entire 12-month period.

†Earnings before interest, taxation, depreciation, amortization, exceptional items, share of associates and other non-trading items.

‡Earnings before interest, taxation, exceptional items, share of associates and other non-trading items.

4.22. As shown in Table 4.3, Newsquest's EBITDA margin increased from 31.1 per cent in 1998 to 35.1 per cent in 2002 and the EBIT margin increased from 27.2 per cent in 1998 to 31.5 per cent in 2002. Gannett told us that one reason behind the margin improvements was the ability to extend in-house printing across titles in the Newsquest group, which had reduced costs and raised quality, particularly in colour advertising (which attracts premium prices). Additionally, Gannett told us that its low cost of capital had enabled it to invest in capital projects, particularly colour capacity on presses and in the pre-press area, which had led to operational efficiencies and cost reductions.

4.23. Figure 4.1 shows a breakdown of Newsquest's revenue in 2002. Advertising revenue (in-paper display and classified advertising) accounted for the majority of revenue, comprising [✂] per cent of total revenue. Circulation revenue was the next largest revenue source, comprising [✂] per cent. Other revenues, mainly generated from printing for third parties, have become an increasingly important source of revenue for the company over the last five years, and now represent [✂] per cent of revenues. This reflects the acquisition of Southernprint, a heatset printing operation, as part of the Newscom acquisition.

4.24. Figure 4.2 shows a breakdown of Newsquest's advertising revenue in 2002. Classified advertising was the largest source of advertising revenue, comprising around [✂] per cent of total advertising revenues, with display advertising comprising the remaining [✂] per cent. Employment represented the largest source of classified advertising revenue, with automotive and property also being important sources. Display advertising revenue was principally local in nature, although [✂] per cent of advertising revenues were generated from national and provincial display advertising.

FIGURE 4.1

Newsquest: 2002 revenue breakdown

Details omitted. See note on page iv.

Source: Newsquest management accounts.

FIGURE 4.2

Newsquest: 2002 advertising revenue breakdown

Details omitted. See note on page iv.

Source: Newsquest management accounts.

4.25. The ratio of advertising revenue to circulation revenue was around [✂] times, and this ratio has remained fairly constant over the last five years. (Appendix 4.1 contains a table showing Newsquest's revenue breakdown over the period 1998–2002.)

4.26. Table 4.4 shows a breakdown of Newsquest's costs in 2002. The main cost category was employment. Newsprint was the second largest category, followed by other direct costs including transport and distribution, and production costs other than newsprint (printing and ink). Other overheads include occupancy costs, marketing costs and the cost of news services.

4.27. Table 4.5 shows extracts from Gannett's balance sheets for the years 1999–2001. At December 2001 net debt stood at £1.1 billion, largely comprised of a £1 billion loan from Gannett Co Inc, reflecting the acquisitions of Newsquest and Newscom. The gearing ratio stood at 2.3 as at 31 December 2001, and the interest cover ratio (operating profit divided by interest) was 1.7. The impact of the proposed acquisition on Newsquest's balance sheet is discussed in paragraph 4.81.

TABLE 4.4 **Newsquest: profit and loss (P&L) account**

	£ million	*% of revenue*
		2002
Total revenue	515.1	100.0
Costs		
Employment	19.3	31.3
Newsprint Other direct costs	[✂	]
Depreciation	18.5	3.6
Other overheads	(✂	)
Total costs	352.7	68.5
EBIT	162.4	31.5

Source: Newsquest management accounts/CC calculation.

TABLE 4.5 **Gannett: consolidated balance sheets, 1999 to 2001**

£ million

	1999	*2000*	*2001*
Intangible assets	1,011.8	1,461.0	1,471.5
Tangible assets	64.5	141.2	150.0
Investments	0.2	0.5	0.2
	1,076.5	1,602.7	1,621.7
Net debt*	–666.4	–1,134.1	–1,111.8
Other assets and liabilities	–41.8	–21.1	–22.6
Net assets	368.3	447.5	487.3
Shareholders' equity	368.3	447.5	487.3
Gearing ratio†	1.8	2.5	2.3

Source: Gannett statutory accounts.

*Loans net of cash balances.
†Ratio of net debt to shareholders' equity.

Management and corporate structure

4.28. Newsquest manages its activities around 16 sixteen geographic clusters,[1] or divisions, each containing local businesses running a range of titles including paid-for titles and free titles. The managing directors of the local businesses either report directly to the Chief Executive of Gannett or to the divisional managing directors who, in turn, report up to the Chief Executive of Gannett. The divisional managing directors then report up to the Chief Executive Officer of Gannett. The trading subsidiaries of Gannett (which together operate under the business name 'Newsquest') largely reflect the regional reporting structure of the business.

4.29. Gannett's planned management structure for the SMG titles is discussed in paragraphs 4.83 and 4.84.

[1]Midlands, Cheshire, Lancashire, Kendal, Essex, south London, north London, Southern, Bradford, York, North-East, South-West, Sussex, Oxford, Wiltshire and Wales.

SMG

Principal activities and recent acquisitions

4.30. SMG is incorporated in Scotland and is listed on the London Stock Exchange. Its market capitalization as at 14 January 2003 was £274.9 million. It is currently in the FTSE 250, the mid-tier index in the UK, and is one of Scotland's top 20 listed businesses.[1] SMG employs approximately 1,700 staff at its main operations in Glasgow, London, Aberdeen and Edinburgh.

4.31. SMG originated from the ITV franchise, Scottish Television, which acquired Caledonian Publishing (publishers of *The Herald* and the *Evening Times*) in 1996 for £120 million. SMG[2] went on to purchase Grampian Television in 1997. Turnover from television interests represented 50 per cent of SMG's turnover in 2001.

4.32. In March 1999 SMG entered the outdoor advertising market when it acquired Primesight plc for £35 million. In June of the same year, SMG acquired the cinema advertising company, Pearl and Dean Cinemas Limited for £22 million. Turnover from 'out of home' advertising interests represented 12 per cent of SMG's turnover in 2001.

4.33. In January 2000 SMG announced the proposed acquisition of Ginger Media Group Limited (Ginger Media), including Virgin Radio, for an aggregate consideration of £225 million, including £40 million in SMG equity. In the same month SMG announced a one for ten rights issue to raise approximately £58 million net of expenses. Later that year SMG announced its intention to raise up to £45 million by way of a cash placing of 14.6 million new ordinary shares. Turnover from radio interests represented 10 per cent of SMG's turnover in 2001.

4.34. SMG has a minority stake in SRH, the principal[3] commercial radio operator in Scotland. Through a series of transactions on the open market, SMG paid £46.2 million to increase its shareholding in SRH from 14.9 per cent at 8 December 2000 to 29.5 per cent at 27 March 2001. In total, SMG spent approximately £150 million to build up its 29.5 per cent stake. SRH's principal activity is the operation of nine local radio stations in Scotland. It also publishes 43 local newspaper titles primarily in Scotland and Ireland.

4.35. SMG also has minority interests in the national Channel 3 breakfast-time broadcaster, GMTV, and in Heart of Midlothian plc, the Scottish Premier League football club.

The publishing division

4.36. SMG's publishing division consists of the Group's newspaper and magazine publishing interests, including *The Herald*, the *Sunday Herald*, the *Evening Times*, and a stable of 11 specialist magazine titles, and an online content and advertising business, known as 's1'. Around 800 people are employed in the publishing division, with around 690 working for the three newspaper titles. Turnover from the division represented around 28 per cent of SMG's turnover in 2001.

4.37. The subsidiary companies involved in the transfer are shown in Figure 4.3.

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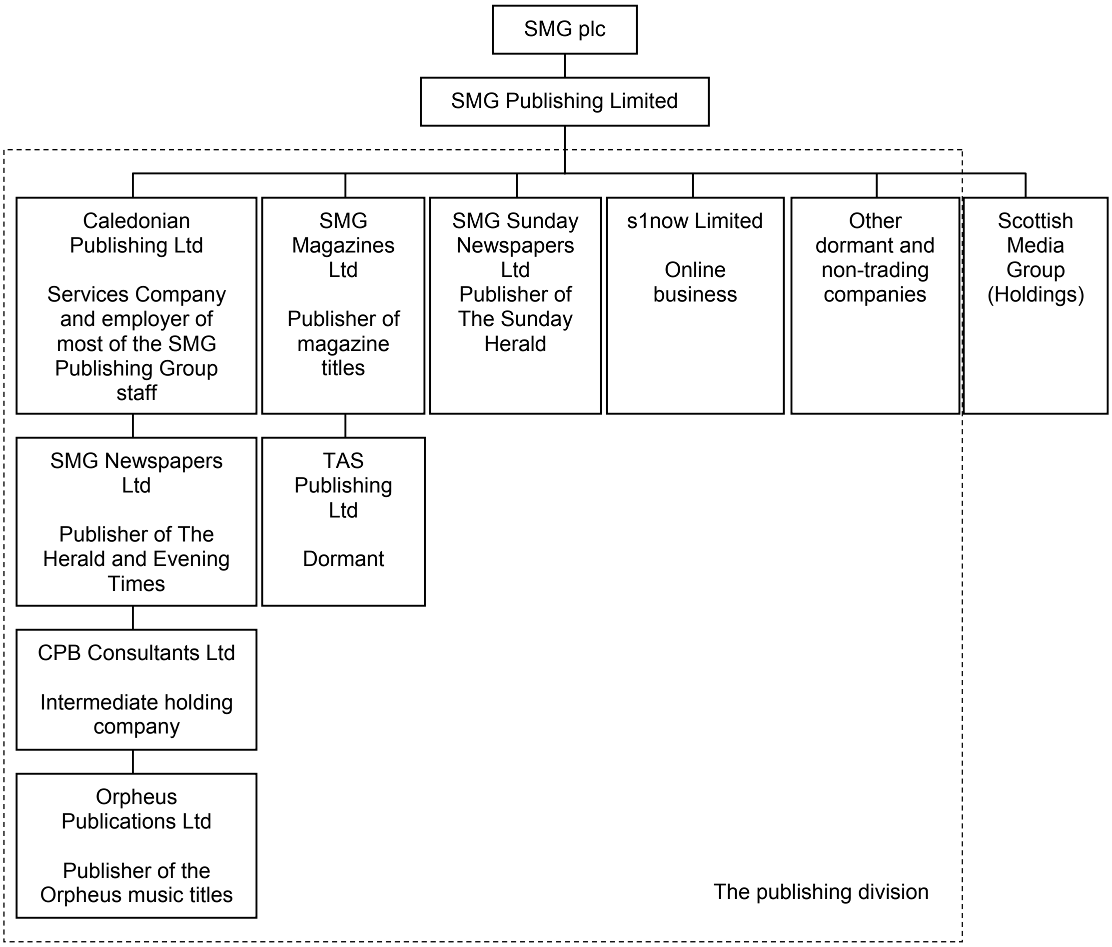
[1]Based on 2001 turnover of listed PLC's incorporated in Scotland.
[2]In June 2000, as part of a group restructuring, SMG plc was incorporated to establish a holding company for Scottish Media Group plc. Prior to this restructuring, acquisitions were made by Scottish Media Group plc. Scottish Media Group plc has since been renamed SMG Television Limited. For the purposes of this report, the term 'SMG' refers to Scottish Media Group plc in relation to acquisitions made prior to June 2000 and thereafter to SMG plc.
[3]SRH is the largest operator in Scotland and Northern Ireland, in terms of audience reach and the number of stations owned.

FIGURE 4.3

SMG Publishing subgroup structure



Source: SMG.

- *The newspaper titles*

4.38. *The Herald* has a long history, having made its debut as the Glasgow Advertiser in 1783, some two years before *The Times* was launched in London, and has survived several changes of ownership. In 1804 it became *The Glasgow Herald*. In more recent times it has become known as simply *The Herald*, reflecting a wider Scottish readership.

4.39. In the 1830s ownership of the title passed to George Outram & Company Limited, a company partially owned by George Outram, who was the editor of *The Glasgow Herald*. The *Evening Times* began circulation in 1876. George Outram & Company Limited went public in 1920. In 1979 Lonhro bought Scottish & Universal Newspapers Limited, which owned George Outram & Co Limited. Caledonian Publishing was created to effect the management buyout of the titles from Lonhro in 1992.

4.40. In 1996 Caledonian Publishing was bought by SMG for £120 million. The *Sunday Herald* was launched in 1999, for two principal reasons. First, in response to a perceived threat to the advertising revenues of *The Herald* from the ability of other publishers (including *The Scotsman* and *Scotland on Sunday*) to offer 7-day pan-Scottish advertising packages. SMG as a 6-day publisher was unable to compete with these packages. Second, SMG identified a gap in the market for Sunday quality newspapers in Scotland, providing an opportunity to access a younger and different audience to that of *The Herald*. (Further details about the SMG titles can be found in Chapter 5.)

- *Magazine titles and online interests*

4.41. SMG Magazines publishes a portfolio of weekly and monthly specialist magazines including *Scottish Farmer*, *Boxing News* and *The Strad*, serving the Agriculture, Boxing, Outdoor and Electronics sectors. Around 80 people work on the magazine titles.

4.42. s1 is an online content and advertising business consisting of a suite of four web sites, featuring jobs, entertainment & listings, property, and news, respectively. Around 20 people are employed at s1. Following the sale of its publishing division, SMG will continue to operate online services for its continuing media interests.

Financial performance of SMG and reason for the sale

4.43. Selected financial data are shown for SMG in Table 4.6 for the years 1998 to 2001. SMG announced its 2002 preliminary results shortly after this report had been substantially completed. They showed an operating profit of £28.3 million (2001: £37.1 million loss) on turnover of £278.4 million (2001: £280.8 million).

TABLE 4.6 **SMG summary financial data, 1998 to 2001**

£ million

	1998	*1999*	*2000 Restated**	*2001*
Turnover	207.4	242.7	300.5	280.8
EBITDA†	54.5	61.3	81.2	62.1
Depreciation and amortization	–6.1	–10.3	–22.4	–30.7
Share of profits of associates	-	1.7	2.2	5.9
FRS17 pension costs	-	-	–4.6	-4.1
Exceptional items	–7.2	–8.2	–10.0	–70.3
Operating profit/loss	41.2	44.5	46.4	–37.1
Investment write-back/profit on sale of investment	6.9	3.0	-	-
Interest payable and similar charges	–2.6	–5.3	–11.3	–27.1
Profit/loss before tax	45.5	42.2	35.1	–64.2
Shareholders' funds	62.2	77.2	224.2	97.8
Net debt	–29.0	–104.8	–300.4	–393.8
EBITDA on turnover %	26.3	25.3	27.0	22.1
Operating profit on turnover %	19.9	18.3	15.4	–13.2
Gearing ratio‡	0.5	1.4	1.3	4.0
Interest cover§	15.8	8.4	4.1	–1.4
Ratio of EBITDA to interest	21.0	11.6	7.2	2.3

Source: SMG annual report and accounts 1998–2001/CC calculations.

*Restated to reflect the impact of FRS17—Retirement benefits.

†Earnings before interest, taxation, deprecation and amortization, exceptional items, share of associates and other non-trading items (see Appendix 4.3 for a reconciliation to the statutory accounts).

‡Ratio of net debt to shareholders' funds.

§Ratio of operating profit to interest.

4.44. As can be seen in Table 4.6, SMG's net debt increased from just £29 million at December 1998 to over £300 million at December 2000, primarily due to the acquisition of Ginger Media, investments in SRH, and smaller acquisitions referred to in paragraph 4.32. Although the EBITDA margin remained stable, the operating margin declined from 19.9 per cent in 1998 to 15.4 per cent in 2000 largely as a result of a £4.6 million charge relating to pension costs. Interest costs increased in line with borrowing, further reducing profits. The interest cover ratio was 4.1 at December 2000 and the gearing ratio was 1.3.

4.45. In 2001 several factors combined to cause a marked deterioration in the financial health of SMG. First, the company suffered a 7 per cent fall in turnover (caused, it said, by the downturn in advertising markets) and a 24 per cent fall in EBITDA, caused partly by increased broadcasting licence costs. Second, further pressures on cash flow arose because of the acquisition of a further 8.7 per cent stake in

SRH, and continued investment in a new printing plant. These two factors contributed to a 31 per cent increase in net debt to £393.8 million. Third, the knock-on effect of the advertising downturn on the company's now considerable stake in SRH, led to a £56.3 million write-down of the valuation of SMG's investment. In addition there was a £5 million write-down reflecting the decrease in market value in SMG's 19.9 per cent shareholding in Heart of Midlothian plc, and a £9 million provision for reorganization costs relating to the new printing facility. These exceptional items, totalling £70.3 million, together with the decline in earnings, contributed to the company reporting a £64.2 million loss before tax.

4.46. As a consequence of this loss, together with a pension scheme deficit of £48.2 million and a write-down of goodwill in Ginger Media of £12.8 million, shareholders' funds more than halved to £98 million, contributing to the gearing ratio rising to 4 as at December 2001, and necessitating a re-negotiation of banking facilities. Although the 2001 accounts received an unqualified audit report, the audit report contained a note drawing the reader's attention to the importance of these negotiations to SMG's ability to continue as a going concern.

4.47. SMG's interim report for the six months to 30 June 2002, published on 10 September 2002, stated that SMG had restructured banking facilities to meet requirements until 30 June 2003, and that in the meantime it would either refinance again or make disposals. On the date of publication of the interim results SMG announced the sale of the publishing division.

4.48. In its announcement of the sale of SMG publishing to Gannett on 23 December 2002, SMG said that the reasons for the sale were to strengthen the group's balance sheet and to focus the group on its media businesses that operate in national advertising markets.

4.49. SMG said that the net disposal proceeds would be used to reduce the overall indebtedness of SMG.

Financial performance of the publishing division

4.50. Table 4.7 shows key financial data from 1999 to 2002 for SMG's publishing operations. Newspapers, magazines and the online operations are shown separately. [

Details omitted. See note on page iv.

]

TABLE 4.7 **SMG publishing division financial data, 1999 to 2002**

	1999	2000	2001	2002
				£ million
Details omitted. See note on page iv				

Source: SMG Information Memorandum (see paragraph 4.58) and management accounts.

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*Headcount figures for magazines are not available for the years 1999–2001.

- *Newspaper operations*

4.51. Table 4.8 shows revenue and earnings for SMG's newspaper operations (the SMG titles) over the period 1999 to 2002. The *Sunday Herald* is shown separately. This title was launched in February 1999 [*Details omitted. See note on page iv.*] (see paragraph 4.40). SMG estimated that without the *Sunday Herald*, the other titles could lose around £[✂] million a year in advertising revenues. Performance at *The Herald* and the *Evening Times* has been fairly stable over the period, and the decline in revenues experienced by these titles was offset by cost reductions, so that margins have increased slightly to [✂] per cent from [✂] per cent in 1999, despite suffering a temporary fall in 2001.

TABLE 4.8 **Revenue and earnings by title, 1999 to 2002**

£ million

	1999	*2000*	*2001*	*2002*
Revenue*				
The Herald and Evening Times				
Sunday Herald				
Total				
EBIT				
The Herald and Evening Times				
Sunday Herald				
Total				
EBIT on revenue				
The Herald and Evening Times				
Sunday Herald				
Total				

Figures omitted.
See note on page iv.

Source: SMG management accounts.

*Includes inter-group revenue—see paragraph 4.54.

4.52. Figure 4.4 shows a breakdown of the SMG titles' 2002 revenues. Circulation revenue at [✂] per cent of total revenues represented a greater proportion of total revenues for SMG compared with [✂] per cent for Newsquest (see Figure 4.2). This is due to the large number of free titles operated by Newsquest, whilst all three SMG titles are paid for. A further breakdown of revenues by title for the period 1999 to 2002 is in Appendix 4.2.

FIGURE 4.4

SMG titles: 2002 revenue breakdown

Details omitted. See note on page iv.

Source: SMG management accounts.

4.53. [

Details omitted. See note on page iv.

]

4.54. SMG's newspaper titles have an arrangement with SMG's television division under which they carry advertising for the television stations (see also paragraph 5.30). In exchange for this, the television stations in turn advertise the newspapers. SMG told us that these exchanges were carried out on an arm's length basis. The value of this inter-group advertising carried by the newspaper titles was £[✂] million in 2002 (2001: £[✂] million).

4.55. The main costs at SMG's newspaper operations are employment costs, at [✂] per cent of revenues, and newsprint at [✂] per cent of revenues. Other major cost categories include Editorial & Art costs, at [✂] per cent of revenues. This represents the cost of buying in editorial and art content from outside sources, and is additional to the editorial and art staff costs included within Employment. Breakdown of the SMG titles' costs for 2002 is shown in Table 4.9.

TABLE 4.9 **SMG titles P&L account**

	£ million	*% of revenue*
		2002
Total revenue		
Costs		
Employment		
Newsprint		
Editorial and art	*Figures omitted.*	
Marketing	*See note on page iv.*	
Depreciation		
Overheads		
Total costs		
EBIT		

Source: SMG management accounts.

4.56. Marketing costs include internal marketing costs incurred on a non-cash basis under an arrangement with SMG's television stations, discussed previously in paragraph 4.54. The value of these internal marketing costs was £[✂] million in 2002 (2001: £[✂] million).

4.57. Table 4.10 shows the SMG titles' indicative balance sheet as at 31 December 2001. This is largely comprised of tangible fixed assets, primarily the recently built printing facility at Cambuslang at a net book value of £40 million.

TABLE 4.10 **SMG titles' indicative balance sheet***

	2001
	£ million
Tangible fixed assets	
Stock	
Debtors	✂
Creditors	
Net working capital	
Net assets	

Source: SMG Information Memorandum (see footnote).

*Excludes intangible fixed assets, cash, debt, tax and inter-company balances.

SMG's projections for the continuing business

- *Profitability*

4.58. Table 4.11 contains an extract from the Information Memorandum[1] showing SMG's projections for the newspaper and s1 online businesses for the period 2003–2004, compared with results

[1]SMG Publishing Information Memorandum circulated to prospective bidders in September 2002.

for 2002. [

Details omitted. See note on page iv.

]

TABLE 4.11 **SMG titles and online financial data, 2002 to 2004**

	2002 Actual	*2003 Estimated*	*2004 Estimated*
			£ million
Revenue			
Newspapers			
Online			
Total			
EBITDA			
Newspapers		*Figures omitted. See note on page iv.*	
Online			
Total			
Estimated trade acquiror cost savings			
EBITDA available to trade acquiror			
EBITDA % available to trade acquiror			

Source: SMG Information Memorandum and management accounts/CC calculation.

4.59. In the Information Memorandum, SMG estimated the annual cost savings available to any trade acquiror at £[✂] million. These cost savings are analysed as shown in Table 4.12. SMG said that certain trade acquirors should be able to extract further cost savings of £[✂], for example in relation to production and editorial areas, but did not give any further details.

TABLE 4.12 **SMG titles' annual cost savings available to any trade acquiror**

	£ million
Volume discount on newsprint, ink etc	0.2
Volume discount on distribution costs	0.2
Operational support, legal and finance	1.3
Marketing	0.5
Circulation	0.4
Advertising sales	1.1
Senior management	0.3
Total	4.0

Source: SMG Information Memorandum.

4.60. At a meeting of the SMG Board on 16 August 2002 the proposal to sell the publishing division was [

Details omitted. See note on page iv.

].

- *Pricing*

4.61. [

Details omitted. See note on page iv.]

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

[

Details omitted. See note on page iv.]

TABLE 4.13 **SMG: current and projected year-end cover prices, 2003 to 2005**

pence

	*Current price**	*2003*	*2004*	*2005*
The Herald (M–F)	50			
The Herald (Saturday)	60			
Evening Times (M–F)	30		*Figures omitted. See note on page iv.*	
Evening Times (Saturday)	30			
Sunday Herald	90			

Source: Information Memorandum/business plan.

*February 2003.

- *Circulation*

4.62. [

Details omitted. See note on page iv.

]

- *Advertising revenues*

4.63. [

Details omitted. See note on page iv.

]

- *Costs*

4.64. [

Details omitted. See note on page iv.

]

The proposed transfer

The sale process and Gannett's bid

4.65. In August 2002, SMG's investment bankers prepared a valuation of the publishing division. This valuation indicated a range of £[✂].

4.66. SMG announced on 10 September 2002 that it was considering the disposal of its publishing division. SMG received over 30 expressions of interest in the publishing division, from which eight second-round bids emerged. The leading candidates for the acquisition appear to have been [

Details omitted. See note on page iv.

]. The second-round bids were in the region £[*Figures omitted. See note on page iv.*], while the final four bids were all in the range £[*Figures omitted. See note on page iv.*].

4.67. Gannett's second round bid was £[✂] million. However, after further due diligence Gannett increased its original offer to £216 million, on condition that SMG made certain guarantees regarding pension fund liabilities. On 23 December 2002, SMG and Gannett entered into the agreement described in paragraphs 4.69 to 4.80.

4.68. Gannett submitted an application to the DTI on 3 December 2002 seeking consent to the transfer of *The Herald*, the *Sunday Herald* and the *Evening Times*.

The sale and purchase agreement

4.69. The essence of the agreement is that SMG, through its subsidiary SMG Publishing (the vendor), agrees to sell the shares in its subsidiary companies involved in the publishing business to Gannett. The companies to be sold are shown in the structure diagram in Figure 4.3. We refer to these companies from now on as 'the Companies'. One of the Companies owns the printing facilities at Cambuslang, referred to in paragraph 4.57. The disposal agreement has the effect of excluding pre-existing tax and pension liabilities from the sale and these will remain the responsibility of SMG. The sale is conditional, inter alia, upon the Secretary of State consenting to the transfer.

Payments to be made on completion

4.70. Gannett is required to make a total payment at completion of £[✂] million in cash, to consist of £123 million for the sale of shares and £[✂] million in settlement of the inter-company debt outstanding at completion.

4.71. The consideration for the sale of shares is subject to adjustments to reflect the difference (up or down) between the value of certain assets (excluding property) at completion and £1.2 million.

4.72. The amount paid in settlement of inter-company debt is subject to adjustments to reflect the difference (up or down) between the £[✂] million (being an estimate of the amount due at completion) and the actual amount due at completion. There is a corresponding adjustment to the sale price for the shares so that the aggregate payment of £216 million is not affected.

Ancillary agreements

4.73. The sale and purchase agreement requires that several ancillary agreements be entered into. These include the following:

— *The Transitional Services Agreement* under which SMG agrees to provide certain services to Caledonian Publishing Limited (one of the Companies) for a maximum period of 12 months, including facilities services, payroll, archiving, IT support, mail room services and property licensing. The fees payable under the agreement are on a service-by-service basis.

— *The Long-Term Services Agreement* under which SMG agrees to provide certain ongoing services to Caledonian Publishing Limited including client reception services, security services and telephone services. The fees payable under the agreement are on a service-by-service basis and the term of the agreement is three years.

— *Sub-lease* by SMG Property Holdings Limited in favour of SMG Newspapers Limited of the advertising sales front counter area currently used by the newspaper business, for a period of three years at a rent of £[✂] a year and service charges and rates totalling £[✂] a year.

— *The Trading Agreement* between Caledonian Publishing Limited, SMG Television Limited and SMG Television Productions Limited, under which, for the three-year period beginning with the date of completion of the sale and purchase agreement, Caledonian Publishing Limited and SMG Sunday Newspapers Limited (another of the Companies) will commission SMG Television Productions Limited to produce advertisements and will place advertising with SMG Television Limited; and that SMG Television Limited will place advertising with

Caledonian Publishing Limited and/or SMG Sunday Newspapers Limited. The aggregate amount paid to SMG Television Productions Limited by Caledonian Publishing Limited and/or SMG Sunday Newspapers Limited and/or s1now Limited in each year, for such production, will be at least £0.25 million. The aggregate amount paid to SMG Television Limited by Caledonian Publishing Limited and/or SMG Sunday Newspapers Limited in each six-month period, for advertising, is to be at least £1.5 million. The aggregate amount paid to Caledonian Publishing Limited and/or SMG Sunday Newspapers Limited by SMG Television Limited, for advertising, in each six-month period is also to be at least £1.5 million.

Other terms

- *Pensions deed*

4.74. Caledonian Publishing Limited (one of the Companies) is the principal employer under the Caledonian Publishing Pension Scheme (the Caledonian Scheme). The Scheme had a deficit of about £20 million, based on the accounts of Caledonian Publishing Limited dated 31 December 2001. Some of the Companies and their subsidiaries participate in the Scheme. We refer to such Companies and subsidiaries as 'the relevant participating companies'. Some of the publishing division employees are members of other pension schemes run by the SMG group.

4.75. The sale and purchase agreement and other documents associated with the transaction provide for the following:

(a) The vendor will pay £10 million out of the consideration for the shares to the trustees of the Caledonian Scheme. The vendor will pay to those trustees a further £2.8 million on 31 March 2004 and a further £2.8 million on 31 March 2005, in addition to any ongoing statutory funding obligations.

(b) SMG will become the principal employer under the Caledonian Scheme and the relevant participating companies will cease to participate.

(c) Gannett will offer publishing division employees who are members of the Caledonian Scheme and other schemes operated by the SMG group, membership of an occupational pension scheme with broadly comparable benefits.

The trustees have released Caledonian Publishing Limited, conditional on completion, and those companies from all existing and further liability in respect of the Scheme.

4.76. SMG told us that there was no legal requirement on it to secure the obligation contained in *(c)* above, and it had done so because it was concerned to protect the interests of the publishing division employees, as well as to ensure that there would be no impact on workplace relations with its remaining employees. SMG put it to us that Gannett has a considerable incentive to comply with the provision, to ensure good ongoing workplace relationships with the publishing division employees.

4.77. The Newsquest pension scheme is a final salary scheme but does not currently offer identical benefits to the SMG final salary schemes (the Caledonian Scheme and the Scottish Television Retirement Benefit Scheme). Gannett told us that sections of the Newsquest Pension scheme would be established with terms that are broadly comparable to these schemes. All employees of the publishing division who are not currently members of the SMG final salary schemes would be offered membership of the Newsquest pension scheme, a defined benefit scheme, on similar terms to the rest of the Newsquest Group; SMG said that this could generally be seen as an improvement in pension provision.

4.78. SMG put it to us that provision *(a)* in paragraph 4.75 would improve the funding position of the Caledonian Scheme, and that together with provision *(c)* and certain other provisions agreed with the trustees of the Caledonian Pension Scheme, these steps would protect the position of the publishing division employees as well as the position of employees remaining with SMG.

- *Tax deed*

4.79. SMG will enter into a tax deed indemnifying Gannett against all tax liabilities arising up to the date of completion.

- *Protection of the purchaser's interests*

4.80. SMG has given an undertaking that for a period of two years following the disposal, it will not, inter alia, carry on or be engaged in or control directly competing magazine or newspaper businesses.

Funding of the proposed transfer

4.81. Gannett said that it would fund the acquisition through borrowings. The acquisition will increase Newsquest's gearing ratio from 1.4 to 1.8, based on latest available management accounts, as shown in Table 4.14.

TABLE 4.14 **Newsquest: effect of the transfer**

£'000

	November 2002	*Proforma*
Intangible assets	1,489.2	1,670.4
Tangible assets	149.3	185.5
Trading working capital	31.4	28.2
Net operating assets	1,669.9	1,884.1
Investments	0.4	0.4
Net debt	–943.2	–1,157.4
Other creditors	–54.5	–54.5
Provisions for liabilities and charges	–14.6	–14.6
Net assets	658.0	658.0
Gearing ratio*	1.4	1.8

Source: Newsquest management accounts/CC calculation.

*Ratio of net debt to shareholders' funds.

4.82. At the level of the Gannett Co Inc group, the effect of the acquisition on the gearing ratio will be a small increase from 0.65 to 0.71.

Gannett's projections for the continuing business

4.83. Gannett told us that it planned to run the SMG titles as a separate division. The editors of the three newspapers would continue to report to a managing director, who would in turn report into the Chief Executive of Gannett.

4.84. Gannett said that the titles would remain in one or more of the legal entities acquired. It does not intend to create a new holding company for the division, although it would be managed on a unified basis, as described in paragraph 4.83. Gannett told us that in time, it might reduce the number of trading entities in the division by transferring assets into one or two of the companies acquired. Under these plans, each title would continue to be owned by a company that was incorporated in Scotland.

4.85. The financial model for the acquisition that Gannett gave us showed a [✂] payback period (after tax and notional finance costs) and a post-tax internal rate of return of [✂] per cent. The key assumptions behind this model are discussed in the following paragraphs.

4.86. The model assumes that the cost of capital is [✂] per cent. Gannett told us that this was the hypothetical cost of capital for a stand-alone business unit and was higher than its actual cost of capital, which it estimated to be around [✂] per cent over the comparable period. This would shorten the payback period to around [✂] years.

4.87. [

Details omitted. See note on page iv.]

4.88. The financial model assumes increases in advertising volumes averaging [✂] per cent a year over the ten-year period to 2013. Gannett told us that these increases were based on industry projections supplied by the Advertising Association. Gannett had adjusted the projections according to its own experience and judgement.

4.89. The *Sunday Herald* is projected [✂]. This is more ambitious than SMG's most recent forecast for the title which projects [✂]. [✂], Gannett plans to increase revenues over those budgeted by SMG by around £[✂] million in the next two years. Gannett told us that it planned to improve revenues by increased cross-selling of advertising into the Sunday title from the other titles and by converting more weekday *Herald* readers into *Sunday Herald* readers.

4.90. Savings on newsprint are projected to be £[✂] million a year (a saving of around [✂] per cent on the current cost). Gannett told us that newsprint prices had fallen since the model was produced and that further savings might be available in this area.

4.91. [

Details omitted. See note on page iv.

]

4.92. Capital expenditure in 2003 is projected to be £[✂] million including £[✂] million on a new editorial system. Thereafter, recurring capital expenditure is projected to remain at £[✂] million a year increasing in line with inflation. This is in line with SMG's projections in the Information Memorandum. Gannett told us that because of SMG's recent £40 million investment in the new printing plant at Cambuslang it did not see a need for any large capital outlays in the foreseeable future. SMG told us that it anticipated the new presses would have a useful life of 15 years.

4.93. Contract printing revenues are forecast to increase by [✂] per cent in 2003 to £[✂] million a year and to continue at this level. This follows guidance in the Information Memorandum and is as a result of enhanced specifications and an increase in the volumes to be printed under the terms of a contract with Associated Newspapers Limited.

4.94. Gannett plans to increase EBITDA for the newspaper titles to around [✂] per cent by [✂]. The online business is projected to remain loss-making until [✂]. Overall, Gannett plans to improve the EBITDA margin to around [✂] per cent in the ten-year period to 2013, bringing the profitability of the operations more in line with that of the existing Newsquest business. As shown in Table 4.3, Newsquest's 2002 EBITDA margin was around 35 per cent.

Counterfactual

4.95. In the event that the proposed transfer did not happen, SMG told us that it would attempt to reopen negotiations with another bidder. SMG received 16 bids for the publishing division. As discussed in paragraph 4.66, a number of these bids were at a similar level to that of Gannett.