UK Commercial Leisure Bulletin

Spring 2010

"Both consumer spending on leisure, and rental growth on leisure assets, have been more resilient through this downturn than in other asset classes"

- The recession has been kinder to leisure operators than their retail peers, with spending on leisure continuing to be less volatile than many other categories of consumer spending.
- Last year cinema admissions hit their highest level since 2002. Operators are facing significant challenges ahead as they move to digital projection and delivery. However, the future opportunities for rejuvenation of viewing habits are enormous.
- Leisure investments have proved to be less volatile through this downturn, with rental growth in particular being more resilient than in other asset classes.
- We believe that 2010 offers a clear opportunity for owners of leisure investments to sell them at good prices to the those chasing lower risk investments.
- For those looking to enter this market in 2010, we think there are two options: focus on prime, or hunt down the active asset management opportunities, where the prospects for rental growth could be significant.

Image: Grants, Croydon - sold in March 2010 by Savills on behalf of X-Leisure to Scottish Widows Investment Partnership Pension Trust, in conjunction with Goldtique Group.

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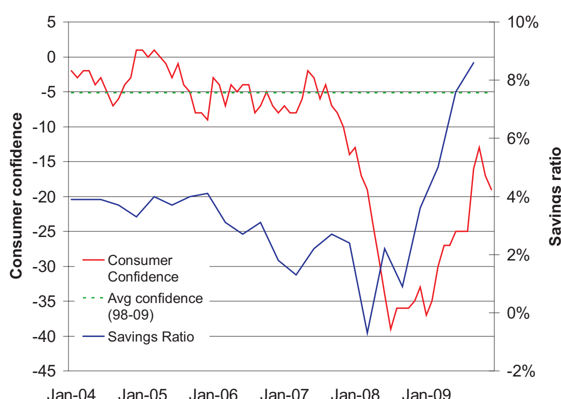
Consumer Trends

Spending on Leisure in 2009

The strapline on the front page of our Spring 2009 report was “the challenge for leisure operators in 2009 will be to stir consumers out of hibernation.” Did they manage it? In short, it seems they did better than some of their retail peers at prying discretionary spend from a cautious consumer, but 2009 will by no means go down as a boom year for leisure spending.

Fully understanding the consumer is never easy, and 2009 was no exception to this rule. If we follow the consumer confidence indices, it would appear that consumer sentiment reached its nadir in the first quarter of 2009. While the tone at the beginning of 2010 is by no means positive, it is significantly more positive than it was this time last year. However, if we look at the savings ratio, which is often a better barometer of what consumers are doing (rather than thinking), a different story appears. Indeed, it would seem that the savings ratio began to rise sharply at the same time as consumer confidence began to improve! Perhaps consumers began to be more confident about life once they had paid off a few debts and boosted their savings cushion?

Is consumer confidence recovering? Different measures tell different stories

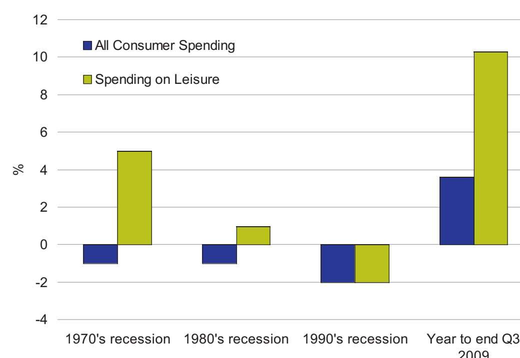


Source: GfK, ONS

Therefore, if consumers are saving more, they must be spending less. The key question for the leisure industry is what they were spending less on. We have long asserted that spending on leisure services is one of the least volatile areas of consumer spending. This “right to have fun” mentality has always seemed to prevail through recessions, at the expense of spending on big ticket items such as cars, technology and furniture.

Did 2009’s spending patterns prove this? We address the performance of different operators in the “Tenant Trends” section of this report, but the economic data clearly shows that leisure spending did hold up comparatively well. The sector was not immune from the cold waves of recession, with a 4.5% fall in spending on leisure services in the third quarter of 2009, compared to the third quarter of 2008. However, this was a temporary blip and leisure spending grew by 10% in the first three quarters of 2009, compared to 3.6% for all spending.

Leisure spending has been more resilient through this downturn than other segments



Source: ONS, Savills

Spending on Leisure in 2010

What will change in 2010? For many consumers the UK will be feeling pretty recessionary throughout this year, with a background of bad news on employment and business failures dampening consumer confidence. Indeed, for some areas of the UK, this year could actually be worse than last, as public sector spending cuts hits some regions particularly hard. Wales, Scotland and northern England being particularly in the firing line.

Consumer confidence will improve over the course of this year, and this will cause a modest 0.5% growth in private consumption. Spending will not begin to get close to “normal” levels until 2011 and we do not expect it to reach its long term trend level of 2.8% per annum until 2013/14.

Clearly spending on leisure services will not boom in this environment. However, 2009 showed that the leisure sector showed more robust growth than spending on all goods and services, and we expect this to continue throughout 2010 and 2011. Between 2010 and 2013 we are forecasting an average annual increase of 3% per annum. While this is by no means exuberant, it will be a platform for growth for successful operators.

2010 will see the consumer becoming less negative. We do not expect to see a sharp loosening in their purse strings, whilst the challenge for 2010 is the same as that of 2009 - persuading the consumer away from their sofas and into their local leisure scheme.

Operator Focus - Cinema

There are give or take 325 multiplexes in the UK, with approximately 3,600 screens. 70% are situated on leisure parks / schemes; 10% in pure retail environments (including shopping centres) and the rest being standalone or without any direct retail / leisure synergy. Approximately 500,000 sq ft of new cinemas have appeared in the last two years (20 new sites), at a combined cost of in excess of £65 million (fit out CAPEX). The pace of expansion has dropped from its peak of 1998 to 2001, when 100 new sites opened in four years at a combined CAPEX of circa £450 million. However, encouraged by growing attendances, new technology and a ready supply of sites (mainly in shopping centres), this has driven generic expansion up to the end of 2009. The likely lack of new supply, via the development pipeline from this point on, will curtail any short term generic expansion, so perhaps we are entering a phase of consolidation or, more excitingly, some corporate activity.

The core fundamentals to an investor in this sector are quite compelling:

- very long leases (minimum 20 years);
- key footfall driver (the average 8 screen cinema will expect to achieve a minimum of 400,000 admissions per annum);
- "affordable rents" i.e. pegged to a market level and / or performance;
- fixed increases or index linked rent reviews (typically 2.5% per annum compound or RPI linked);
- relatively generic properties, therefore, in the event of corporate failure, other operators are likely to pick up the slack. By removing the significant initial cost of fit out, rents look affordable - you might even get a premium.

On the downside, only one operator is seen as institutional grade, namely Cineworld plc which is now listed on the London Stock Exchange. This is perhaps perception as much as reality. The other main operators in the UK: VUE, Odeon, Empire and Showcase are privately owned companies which have, in the main, grown fairly rapidly over the last 10 years through leveraged private equity plays. They have good businesses but getting under their skin is challenging. Therefore, it is as important to understand the companies themselves. Whilst the platform may be solid, is there any growth in this industry? As Tim Richards, CEO of VUE Cinemas is quoted "auditoria have traditionally been dark 75% of the week" i.e. a cinema the size of a medium foodstore sites empty for a vast majority of the time. Once a cinema has reached relative maturity in terms of admissions, it is difficult to radically change this trend during normal trading hours.

However, what if:

- they show live sporting events attracting more males;
- they show live opera attracting more "greys";
- they enable "X-Box" mad teenagers to race each other on a giant screen;
- they attract a slight egotistical CEO to make a barnstorming address in a 200 seat arena with giant PowerPoint and surround sound?

These are just some of the initiatives which have been successfully trialled by the national operators. However, the big consumer revolution is 3D and digital technology. Some would argue this is as important to the industry as Al Jolson's first “talkie” in 1927; it is certainly one of the biggest technological and ground-breaking opportunities for cinema operators and the most exciting viewing experience for the consumer.

As we indicated previously, recessionary statistics suggest that leisure spending is reasonably robust and this recession appears to be supporting that. Good value offers such as branded restaurant and cinemas have remained resilient. Final cinema admission numbers for 2009 showed a 5.6% increase on 2008 at 173.5 million, up from 164 million in 2008. However, will an increasing raft of digital quality movies and world class 3D product further encourage the public to visit their local cinema?

Property challenges for the cinema operator and owner can, however, be costly. The average multiplex in the UK is over 44,000 sq ft. The average cinema opened in the last 5 years, excluding Cinema De Lux is closer to 25,000 sq ft. Efficient programming, viewing preferences, building improvement and experience has created some property pressure for the operators - many cinemas are just too big. Physical downsizing can be expensive but landlords should consider the positive implications of freeing up surplus cinema space for other leisure uses or even change of use for retail and/or foodstore. Planning will not always be easy but the sites usually offer good visibility, lots of car parking and an open plan build environment.

Cinema Facts

UK Cinema Provision	Avg screens per cinema	Avg seats per cinema	Avg 20 minute catchment	Avg screens in 20 minute catchment
	9	**2,043**	**447,502**	**33**
UK Cinema Rents	Avg 2007/8 (per annum)	Avg 2009 (per annum)	Avg 2009 £/sq ft	Avg size (sq ft)
	£638,890	**£645,066**	**£13.68**	**43,009**

Source: Savills

Tenant Trends

Occupational Review 2009

- Q4 2009 produced some strong and encouraging trading performances, particularly in the cinema and restaurant sectors;
- The door was ajar for more enticing and innovative offers from new entrants into the market, or from the re-branding of national operators e.g. BYRON, Jamie's Italian and Cote.
- Greater depth of demand and therefore competition for sites, particularly amongst the restaurateurs, but also kids play and new budget gym offers.
- Rental levels stabilised, except in some prime 'retail' pitches, where rents were at a premium to market average. Incentive packages have however increased.

BUT

- New in town provision (shopping centres etc.) have had a negative trading impact on selective, older out of town schemes.
- Continued health warning on selective nightclubs, gaming sector and mid-market health clubs.
- Off-trade sales remain a threat - see Domino's Pizza trading figures.
- Turnover may have been equal, or even positive on a like for like (LfL) basis, but consumer incentive offers (2 for 1 deals etc.) have eaten into margins.
- Some corporate casualties, such as Premium Bars and Restaurants (Living Room etc), went into administration in August 2009; Tootsies, owned by Clapham House Group, went into administration in October 2009, with the majority of the portfolio being acquired by Giraffe.

By way of demonstration, we have identified a selection of LfL results and profit / EBITDA results from 2009:

	Profit / EBITDA	YoY %	Period
Tragus 14 new restaurants 2009	£44.2m	+0.3%	Yr to Jun 09
Wagamama 6 new sites in 2010	£7.1m sales of £101m	+75%	Yr to Nov 09
JD Wetherspoon 39 new pubs opened	£66.2m	+13.6%	Yr to Aug 09
Gondola Group	£105.5m	+2.4%	Yr to Jun 09
The Restaurant Group 20 new sites in 2010	£36.3m	+3.0%	6mths to Jul 09
Carluccios	£7.6m	-3.8%	Yr to Dec 09
Cineworld	£24.1m	+12.1%	6 mths to Jul 09

LfL sales at Wagamama were up 13% for the 12 month period; Dominos up 8.4% for the full year to December 2009; The Restaurant Group were up 5.0% for the 6 weeks up to 27 December 2009; Mitchells & Butler up 3.4% for the same period and Novus Leisure (Tiger Tiger) were up 10% for the 6 weeks up to 2 January 2010.

As a consequence, backed up by the private equity desire to expand, there is a healthy list of requirements for 2010 / 2011.

There is, however, a collective downside to this private equity ownership. The lack of transparency at a corporate level, both in terms of trading performance and covenant strength, has been an undoubted barrier of entry to the investment market and a lag on investment values as a result. By definition, the private equity ownership has been a predominantly leasehold structure, stuffed full of debt, seeking rapid organic growth. Whilst many of the leisure operators still trade under this model, what has changed is the depth of tenant demand and thus the prospect of an alternative use and/or operator in the event of corporate failure.

The development pipeline has all but dried up, so generic growth for these operators will be difficult. Therefore, we expect to see more proactive asset management on established parks and schemes. This aggressive pursuit of the better schemes should, in theory, drive rents forward, perhaps at the detriment of more entrepreneurial brands in favour of national brands / covenants. It should certainly ensure that failing brands such as Old Orleans have an orderly queue of alternative operators snaking around the car park.

Prospects for 2010 - Restaurants

The restaurant sector has been remarkably resilient in 2009. Despite fears that consumers are tightening their belts, there is still underlying confidence in the eating out market and strong demand for quality sites in good locations. Many operators have confirmed that their expansion plans for the coming 12 months will remain on track with Tragus, The Restaurant Group and Gondola all expecting to open up to 20 new sites during 2010.

Well established buffet operators such as Cosmo, Jimmy Spices and Red Hot Buffet have been able to grow their estates and place their brands firmly in the minds of consumers, giving them a base to expand even further over the next few years. The recession has provided opportunities for buffet operators as consumers prioritise value and recognise the benefit of a fixed price menu.

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The test for these operators now is to build on their initial inroads and success, especially with the emergence of the budget gym market / children's play market who are all seeking similar sites in terms of size and location.

Ambitious restaurant groups with successful concepts will expand into secondary towns, while branded operators will seek new build mixed-use schemes, or access onto the better parks. By way of an example, the group which owns Romanos Grill on Festival Leisure Park, Basildon went into administration. Pizza Express, who have wanted to get representation at Festival Leisure Park for some time, not only paid a rent 10% higher than Romanos, but also a positive premium.

We cannot deny that this is an exceptional deal, but we expect the restaurant market will continue to thrive, driven by diversification, experienced operators and well managed brands. The better brands can, and are driving a harder bargain by way of cash incentives and longer rent free periods but rents are holding up at worst.

Prospects for 2010 - Health & Fitness

On the whole, there has been little organic acquisition activity in this sector for several years. Corporate activity pre-recession was mainly within the middle to upper tiers of the market, centred around racquet and health clubs. These operators are generally concentrating on retaining membership fees and market share rather than expansion.

It is the budget end of the market which is likely to expand aggressively in 2010 with new concepts such as The Gym, Pure Gym and Gym4All gearing up for activity:

- They are models based on flexible membership (reduced or no fixed term contracts).
- Dry clubs which are between 12,000-20,000 sq ft in locations with more than 100,000 people within a 20 minute drivetime.
- Cheaper monthly or even pay as you go fees £10-£15 per month.

Prospects for 2010 - Gaming

Eagerly anticipated results from Rank in 2009 showed a dramatic recovery from the significant losses in 2008, a position pretty much mirrored throughout the mainstream gambling operators. Revenues rose 3.4% to £540 million creating a profit of £52 million, up from a loss of £26 million in 2008.

However, our word of caution for the sector is not at a corporate level, but in their need for bricks and mortar i.e there is an increasing element of obsolescence in much of the existing real estate. Online gaming is having the two-fold effect of a) creating good margin business for the operators and b) keeping people at their desks / homes.

2010 is therefore a year of consolidation and legislation – there is an on-going battle to create a level taxation playing field amongst all the gaming sub-sectors. The triple whammy of the smoking ban, tax rises and demographic changes are still impacting hard, and so we expect to see more units come to the market, more difficult discussions with landlords on rent reductions/downsizing and possibly more enforced closures.

Leisure Investment 2009

Investment in leisure property has always been a relatively niche sector, however the volumes invested in the sector did peak at over £1bn per annum in 2006 and 2007. Since then the sector has seen a similar collapse in investment activity to the rest of the commercial property market, with less than £100m transacted in 2009.

These low volumes of investment last year are surprising when you consider that the “ideal” investment at the forefront of many investors minds last year was one that offered income security. Given that leisure is one of the few remaining sectors where lease lengths in excess of 10 years are the norm (many of which come with some element of indexation of rents) it is arguably one of the safest segments of the market. Furthermore, as we have highlighted in the Tenant Trends section of this report, the majority of leisure operators appear to have weathered the recession better than their retailing peers.

So is the more secure nature of leisure investments purely theoretical, or does the performance data support raising weightings to leisure property during periods of investor caution? The chart overleaf looks at average rental value growth on leisure properties compared to Retail and All Property. The difference is marked, with leisure rents stable over the 12 months to December 2009, while retail rents fell by an average of 6.1% and all property rents fell by 8.1%.

Lack of downside risk on income is clearly only part of the equation. Generally, sectors that are less volatile on the downside are also less exciting on the upside, and to a certain degree this is true for leisure. For example, if we look at the boom period of 2004-2006 the average annual rental growth for retail property

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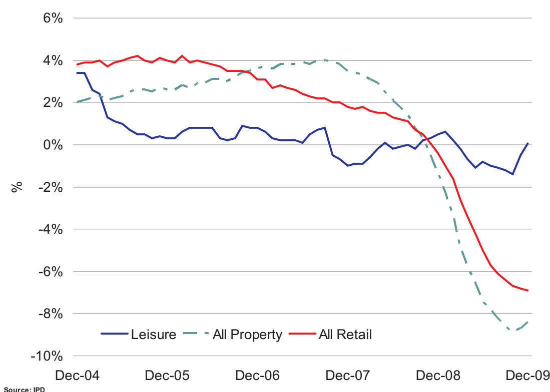
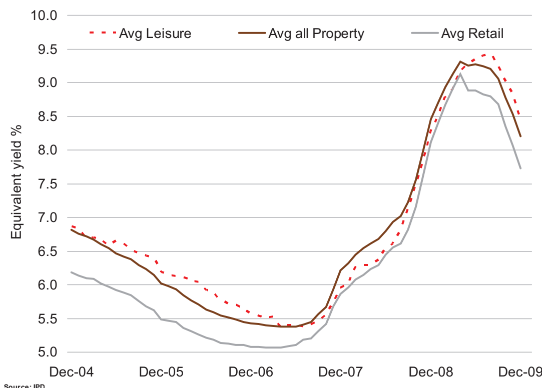
was 3.5% per annum, while leisure property only showed an average annual growth rate of 1.7% per annum. Not madly exciting, but for many institutional investors the prospects of stronger income security on the downside should compensate for weaker growth on the upside.

Leisure rental growth is less volatile



One area where leisure investments performed in line with the rest of the market last year was in terms of the hardening in yields. Whether one looks at the IPD data for average yields, or our own data on prime yields there was a sharp fall in yields towards the end of last year (58bps in average yields and 150bps in prime).

A yield gap has emerged between leisure and retail yields



Are leisure investments correctly priced in relation to other assets? Over the period 2001-2009 the average equivalent yield on leisure property has been 65bps higher than on retail, and 13bps higher than "all property". At present the gap in 100bps and 63bps respectively. Clearly there is some argument on this basis that the risks associated with leisure property investment might have been overstated in comparison to other asset classes. Does this hold true for prime assets as well? Prime leisure parks have typically shown yields that are 70bps higher than restricted retail warehouse parks and 155bps higher than Open A1 parks. At present the gap is 125bps and 225bps respectively.

The big question for 2010 is whether this fall was driven by renewed investor interest in the low risk nature of the sector, or whether it was just down to non-selective buying of leisure as part of the commercial property universe. If the answer is the former then the price rises are sustainable, however if it is the latter then investors might be surprised by the low rental growth coming out of the recession and prices may have to fall to compensate for this.

Leisure Investment 2010

Given that we expect 2010 to remain firmly recessionary in many people's minds, we believe that the stable trading of leisure tenants, and the relative lack of volatility in leisure rents will attract some risk-averse investors to on the sector in 2010. While much is being made of a recovery in London office rents, this is not the case outside the capital, or in the wider retail and industrial markets. Against a background of falling rents and rising voids in much of the rest of the commercial property market, prime leisure investments will continue to look attractive.

Given the predominantly institutional ownership of this sector it is unlikely that we will see an increase in the number of high quality leisure investments being brought to the market this year. The inevitable conclusion on pricing must be that we will see further falls in yields and rises in capital values this year. We do not expect the quantum of these changes to be as significant as they were in 2009.

However, as the economy and other commercial property sectors begin to bounce back in 2011, the rental growth being delivered by leisure properties will start to compare less favourably with other asset classes. Risk averse investors who are happy with a stable income return will remain buyers of the sector, but those chasing more exciting levels of growth will be drawn to other, more volatile areas of the market.

For those who currently own leisure investments, this clearly opens a window of opportunity in 2010. We believe that investor demand is likely to remain strong in 2010 for the comparative stability of this sector. This will lead to an element of over-pricing of assets in relation to their future growth prospects. For current owners of leisure assets, 2010 may well be the best year of this cycle to consider selling, due to a wider than normal spectrum of buyers who are prepared to

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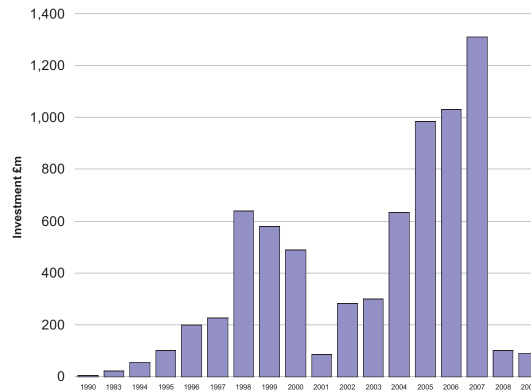
consider leisure investment. This is an important change, as in the past the sector has been perceived as relatively illiquid and dominated by a handful of specialist investors. An increasing recognition of the attractions of leisure investments has led to the broadest base of potential investors in this sector that we have seen in over five years. That said, the active asset management required to “outperform” in this sector should not be underestimated.

If you are contemplating entering the market, we see two areas of opportunity which are at opposite ends of the risk curve:

Prime - our definition of absolute prime covers a very small number of existing schemes, but will probably have 15 year+ leases (common place), index linked rents (common place amongst the anchor tenants), the better covenants (more difficult to ascertain) and in a retail micro environment. We have used Silverlink Leisure Park as an example, but there will be a few others. Here, the rationale is income protection, defensive stock at 7%+.

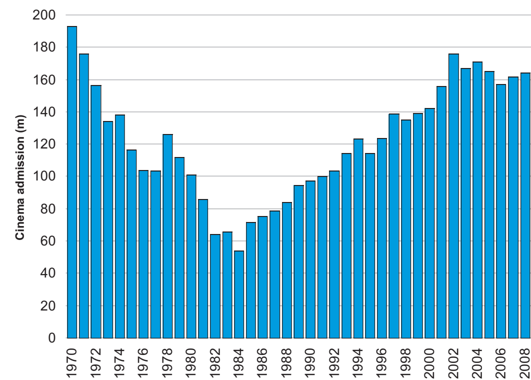
Asset management intensive - given our earlier comment on a relatively "buoyant" occupational market, there will still be schemes out there which have remained untouched by the aggressive asset manager. Too many owners are passive ones, a strategy not suited to owning leisure. We would particularly point to wet-led dominated town centre, or edge of town schemes, where bars / clubs are paying £10 psf to £15 psf for larger units. If the physical fabric allows, transformation to a softer scheme incorporating café bars and restaurants is unlikely to be constrained by the occupational deals or the planning regime. All this for 7.75% to 8% +.

Investment turnover



Source: Savills

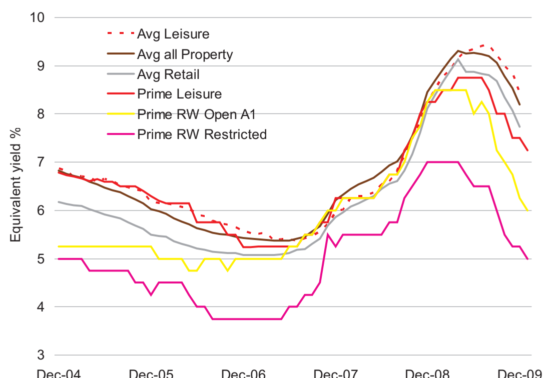
Cinema admissions



Source: CAA

Data and contacts

Yields



Source: Savills, IPD

Yields

Source: Savills

Absolute Prime <£15 million, 15 yrs unexpired, best covenants/retail environment **7.0% to 7.25%**	**Prime Pure Leisure** e.g. Crawley Leisure Park **+/- 7.5%**
Good secondary e.g. Cardinal Park, Ipswich **7.75% to 8.0%**	**Standalone prime “box”** **+/- 8.0%**

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