savills

Savills World Research
UK Commercial

Spotlight
UK Commercial Leisure

Q1 2013

SUMMARY

■ Household spending on leisure services has weathered this downturn better than spending on other services. We expect that it will continue to out-perform over the next five years.

■ There remains clear evidence of tenant demand in the cinema, health & fitness and restaurant markets. Operators are highly focused on catchment quality, but we are starting to see competition in some locations.

■ The investment market was relatively quiet in 2012, but leisure is now seen as a credible part of many fund's property exposure. This, and its core fundamentals, will continue to support investment into the sector.

"Over the last five years leisure has become progressively more important as part of the UK commerical property investment market."
David Bell, Savills Leisure

The Leisure Economy

One of the most longstanding themes of these reports is how spending on leisure services is more resilient to economic downturns than spending on other services. This recent cycle has proven that theme to be correct with leisure services spending over the last five years falling by 0.8% per annum, while total service spending has fallen by 1.4% per annum.

The last two years have seen real average earnings fall for the first time in over 30 years, and the importance of this cannot be underestimated. In part this was down to low earnings growth, but the biggest driver of this has been the higher than normal levels of inflation that have been prevalent in the UK for much of this downturn. 2012 saw the beginnings of a turnaround in the inflation trend, with the CPI measure falling from from over 4% in January 2012 to its current level of 2.7%. This slowing in the rate of inflation didn't happen as fast as we would have expected, primarily due to rises in food and domestic energy bills. However, the prospects for household spending generally are hugely dependant on a return to rising growth in real earnings.

Generally, we expect that the UK economic recovery will be more tangible in 2013 than it was in 2012. Unemployment will fall, albeit rather slowly and with a southern bias. The amount of spare capacity in the economy will mean that inflation falls below 2% in 2013, and heads on downwards to around 1.5% through 2014 and 2015.

This will be combined with the beginnings of real earnings growth, and a corresponding pick-up in consumer spending. If we don't see a recovery in consumer spending in 2013, then the UK will be in a very poor economic situation, as government consumption will be falling in 2013 and 2014. Our current view is that consumer spending will rise by 0.5% this year, and this will contribute to overall GDP growth of just under 1.5%. 2014 will be better, with consumer spending rising by more than one percent, and the GDP rising by 2.5%.

Spending on leisure services will continue to out-perform, averaging 1.6% per annum over the next five years.

Cinema occupational review

2012 was a year of consolidation for the cinema market, with each of the dominant multiplex operators Odeon, Cineworld and Vue acquiring smaller operators in a frenzied bid for market share.

Vue further enlarged its footprint across the UK with the acquisition of rival chain Apollo back in May of last year and into continental Europe with the takeover of chain CinemaX AG. Odeon followed suit with the acquisition of 4 existing Reel cinemas and 3 development commitments. Art House Cinema Group, who trade as Picturehouse were bought by Cineworld in December for £47.3m. Cineworld intend to retain the 21 strong theatre portfolio as a separate entity and will continue to grow the Picturehouse brand. Following the launch of their luxury concept, 'The Screening Rooms' at Cheltenham in 2011, Cineworld are looking to diversify further with the trial of a smaller format 'CineMini'. With increasing pressure to increase market share by their private equity backers, these operators look to offer further flexibility in their requirements.

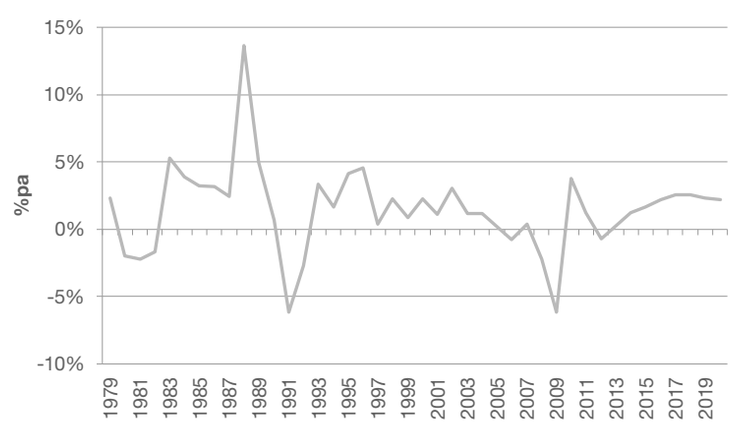
Remarkably, we are seeing operators go head-to-head on competing sites in towns in a bid to expand. Both proposed leisure developments in Bournemouth at West Central and Nautilus have cinemas committed. There is doubt that towns such as Bournemouth and Trowbridge, where two cinema applications are being considered, can support this number of screens. Rather, we consider it likely that it will be a question of 'first past the post' in terms of securing planning consent, funding and actually building out the schemes. In Telford, Odeon have committed to relocating their existing tired offer at Forge Gate to the new major leisure extension at Telford Shopping Centre. This will mean going directly against the new 11 screen Cineworld being delivered as part of Citygrove's Southwater Square leisure development, which is due to complete in 2014, only a stone's throw away.

UK cinemas enjoyed a bumper end to 2012 as ticket sales rocketed to £173m following the release of high grossing blockbusters such as Skyfall and The Hobbit. This followed a previously subdued start to the year as the effect of the Olympic summer impacted admissions. Reported revenues for Cineworld rose 2.4% during 2012. The most recent figures for Odeon and UCI for the 3 months to 30th September 2012 show sales down 13.8% on the same period in 2011, however Q4 results to date of release (27th November) were already up 29%, as big blockbuster hits marking the end of 2012 boosted Odeon's performance.

In a further market shake-up, Estates Gazette has reported that Terra Firma could look to sell the Odeon and UCI Group, which they purchased back in 2004 for £650 million in order to return cash to the fund's equity backers, with the sale likely to raise at least £1.2bn.

GRAPH 1

Household spending on leisure services



Source: Savills, Oxford Economics

Health & Fitness occupational review

The Health & Fitness market is made up of three tiers, of which each have very different agendas for the year ahead. At the top end of the market, operators such as Virgin Active and David Lloyd sit comfortably on their existing estates. David Lloyd are also on the hunt for 'personal training studios', with a requirement for 1,500 – 2,500 sq ft units in London and affluent market towns.

The 'squeezed' middle market operators such as Nuffield, LA Fitness and Fitness First are concentrating on retaining membership revenue and market share rather than expansion. This middle tier is struggling with highly geared balance sheets after the initial wave of rapid growth in the 1990s, followed by a spree of buyouts and consolidations. Fitness First was their first forced to restructure the business in 2012, emerging with new ownership, management, zero debt and a reduced property portfolio. 67 of the worst performing clubs were shed as part of the CVA process, with many snapped up by the budget sector.
In the current climate, a number of the mid-market offers, which used to offer a point of difference to the premium brands are now going to be under threat. The 'no frills' operators are undoubtedly targeting this area of the market and it is imperative that these clubs inject capital into their estates to stave off this competition.

The budget operators have been expanding aggressively for the past 4 years. In the race for dominance, Pure Gym and The Gym remain in pole position with nearly 100 clubs between them. Pure Gym has recently refinanced its £15m debt for further roll out. Likewise, The Gym has secured £35m of equity and debt from Bridges Ventures and HSBC. We expect the budget market to consolidate in the coming year and note that Pure Gym/ The Gym are likely to gear up for a sale now they have reached a critical mass in their estates. Other operators such as Fit4Less, Xercise4Less and easyGym are also in hot pursuit. EasyGym, who are advised by Savills, will open a further 6 clubs this year, including a flagship on London's Oxford Street.

Restaurant occupational review

In 2012 the restaurant market suffered from a lack of new opportunities. As a consequence, restaurant operators had to become more flexible in their approach to meet aggressive targets set at the beginning of the year. Despite the average spend in the restaurant sector contracting in the past two years, foodservice spend is expected to grow by up to 30% over the next four years.

High streets are becoming less attractive, with significant retail casualties and large volumes of vacant space creating an unappealing environment. Mixed use schemes are the priority as the operators benefit from sitting with retailers, providing both day/night time footfall and a higher return on capital.

Despite a significant dip in spending/ retail sales, the fundamentals for eating and drinking have not changed. The UK consumer is moving closer to mirroring the trends of our friends in the US by eating more of our meals out, be that for breakfast/ lunch or dinner. It is fair to say that Londoners have always taken the lead in this regard. With busy working lives, consumers are not just going out for special occasions; it is becoming part of our DNA.

The two sectors that still remain as popular as ever are the quick service restaurants such as McDonalds, Burger King, KFC and Domino's Pizza (alongside new Mexican offers such as Chipotle, Chilango and Barburrito), together with the mid-market casual dining sector i.e. Nando's, Wagamama, Frankie & Benny's, Pizza Express, and Prezzo.

The restaurant sector is very fluid with new concepts emerging all the time, quite often using London as a test case and then, if successful, rolling out across the UK. Detailed below are some operators currently on the acquisition trail, which we believe will

TABLE 1

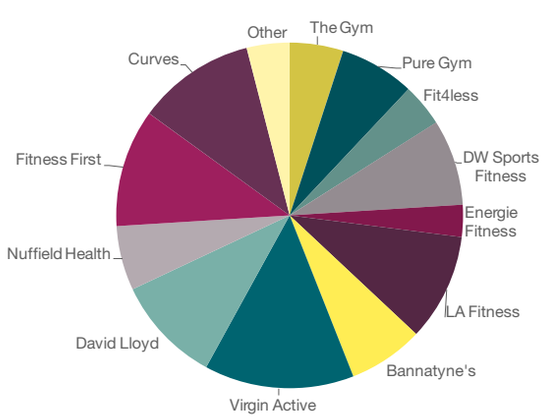
Comparative metrics of retail & foodservice

	Retail	Foodservice
Spend growth (2012-16)	+7.1%	+29.2%
Densities	-3.2%	+5.7%
Consumers/outlet	442	3080
Consumer penetration	Stable	Rising

Source: Conlumino

GRAPH 2

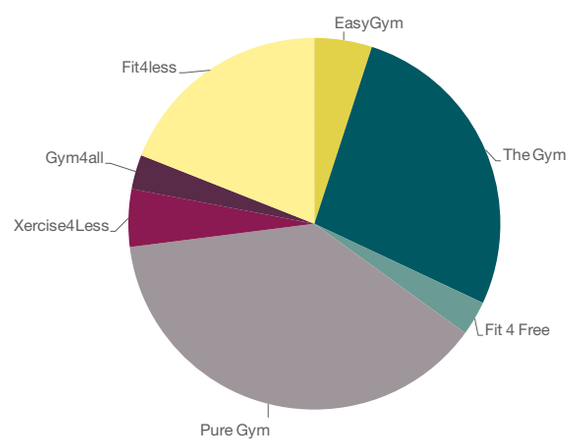
Gym operator's market share



Source: Savills

GRAPH 3

Budget gym operator's market share



Source: Savills

be ones to watch for 2013:

■ Wahaca: the Mexican street food restaurant has secured two new sites in London to add to their existing estate of 7 restaurants. The two units in question are the former Pitcher & Piano in Upper Street, Islington and the former Waterloo Bar and Grill opposite Waterloo station. The company has plans to open between 15-20 sites over the next few years.
■ Byron: the upmarket burger chain is set to open its first site in the north after securing a unit at the Liverpool One scheme. The group have already secured two further sites for this year, the former Fine Burger unit at the O2 Centre, Finchley and the former Pizza Express in Cowcross Street, Islington. They are also looking to add a further 8 units over the next 12 months.
■ Burger & Lobster: the fast growing concept launched by the owners of Goodman has opened its fourth site in St. Paul's, London. The group opened on the site of the former Le Pain Quotidien on Bread Street. They are looking for further sites in Covent Garden and also the City of London.
■ Bills: the rapidly expanding restaurant chain backed by Richard Caring has recently secured a unit in Bristol to add to its 14 strong estate. The company is planning another 12 for 2013.
■ Carluccio's : the ever popular all day Italian offer is still expanding at pace, and is looking to add 10 further sites to its UK estate, with openings in Worcester, Glasgow, Aberdeen, Peterborough, Colchester, Lincoln, Watford and Trinity, Leeds.
■ Coast to Coast (TRG): the new brand by the UK's largest casual dining chain have recently secured a unit in the Highcross scheme in Leicester. The company operates further sites in Brighton, Newcastle, Stevenage and Gunwharf Quays, Portsmouth. There are further openings planned for this year at Central Village, Liverpool and the Designer Outlet, Wimbledon.

Our view:
■ The UK restaurant market will continue to grow both in terms of value and size, due to the insatiable desire by the consumer to eat out more.
■ There were some high profile failures in 2012, namely Town Centre Restaurants and we expect further casualties in 2013, especially for operators who are heavily exposed on the high street. The strong will prosper and the weak will fall by the wayside.
■ The over reliance on discount vouchers for many operators is still a significant issue, and we believe there will be reduced discounts for 2013 as operators try and reduce consumers reliance on offers.
■ A number of company deals failed to come to fruition in 2012, and as a consequence we expect the Private Equity groups to be circling some restaurant targets ripe for acquisition.

Investment review

Like most property sectors, the commercial leisure market has suffered through the turbulent economic climate of the past five years and witnessed a significant drop in transactional activity. That said, over the past two years, comparative to others, commercial leisure has remained quite resilient with a reasonable amount of investment activity. In 2011, leisure was the only property sub-sector to witness an increase in transaction volumes from the previous year, with over £700 million of assets traded (excluding hotels and Central London). In 2012 however, volumes were approximately 35% down, at circa £450 million (this excludes Land Securities' corporate acquisition of the X-Leisure Unit Trust). After a quiet start to the year, 2012 saw a flourish of activity in the latter half with the sales of The Printworks, Manchester and The Gate, Newcastle-upon-Tyne, which totalled over £150 million.

Despite a drop in transaction volumes, the continued leisure investment activity has proved that investors still recognise the sector and are attracted by characteristics such as: higher yielding, long leases, strong national covenants and often stable, if not reversionary rents (open market and/or indexation). Whilst there continues to be strong demand from both UK funds and Prop Co's; with the majority of institutional quality leisure assets owned by these investors and most of them having requirements to buy, the availability of tradable stock remains low.

Defining prime in the leisure investment sector has been challenging during 2012 with one of the key drivers being price quantum. Traditionally, we would argue that this is between £10-20 million. However, it is evident that there is an appetite for leisure assets of £20 million plus, for the right stock with good property fundamentals and a strong location. The off market sales of The Gate, Newcastle-upon-Tyne (£60 million) and The Printworks, Manchester (£93.85 million), both for yields of circa 6.75% net initial yield, are indicative of this. The ongoing sale of The Light, Leeds will provide a further barometer for lot sizes in excess of £50m.

On a smaller scale, the sale of The Parkway, Bury St. Edmunds (£9.8 million) at 6.15% net initial yield provides substantial evidence for the prime leisure yield at 6.25% or better for assets valued at £20 million or below. For assets over £20 million, this moves out to 6.50%.

Whilst the bulk of demand in the sector has been for prime stock, we have seen an active market for asset management property, which is being sought by a variety of opportunity funds and property companies, often being sold through banks

Image: Coast to Coast, Brighton

and receivers. Examples include: Walkergate, Durham and Odyssey Pavillion, Belfast.

Looking back at 2012, over 55% of the transactional volume was for in-town, cinema anchored leisure destinations. With the recent bad press that the out-of-town retail market has received, together with the government plans to rejuvenate the high street retail pitch; we are of the opinion that in-town will be the location of choice in 2013 and beyond.

That said, car parking remains an important issues, especially for the family consumer, who will favour schemes with free parking. We are aware of recent objections from key operators on leisure schemes where parking regimes have been retrospectively implemented

Over the last 5 years, leisure has become progressively more important as an investment vehicle to the UK investment market, with UK institutions leading the chase. Land Securities have led the charge over the past 24 months, recently acquiring a further 42% of Capital and Regional and AREA's stake in the X-Leisure Fund, which together with their previous 12% holding provides them with a controlling share.

Looking forward into 2013 and beyond:

- We expect to see continued demand for prime, dominant stock with a strong trading platform. A preference for opportunities located in the south of the UK is still apparent, although, given the amount of institutional ownership, supply is likely to remain very tight.

- Leisure has developed into a more mature investment class and benefits from an ever-expanding target market. The number of UK institutions with active requirements has increased significantly over the past 18 months as more fund managers recognise the sector's strong investment credentials.

- Investor's focus will be predominantly aimed at 'family friendly' destinations (cinema/restaurants), rather than 'wet led' (pubs/bars/ nightclubs) and big box (bingo/ bowling) schemes. The popularity for 'in-town' schemes will continue, but demand for the traditional, good quality 'out-of-town' parks will also exist.

- The key characteristics of the leisure sector underpins the demand and since its reclassification as a sector of choice, the leisure market will remain 'one to watch' going forward.

The investment funding market

The pre-let development funding market is enjoying a significant renaissance across all direct commercial property sectors including particularly the commercial leisure sector. Key reasons for this are:

- The availability of bank debt (the traditional funding avenue for the development community) remains constrained, particularly for the development process.

- Forward funding allows a developer to define, subject to delivery, exit value and hence developer profit.

- The pre-let funding route provides the ability to hedge out the exit value and hence fix a key variable in the development process.

- A well structured funding package can enable a part only prelet scheme to be delivered.

- While a more involved process than a standing investment purchase, forward funding tends to provide a positive yield margin in favour of the investor of between 25 and 50 basis points when compared to the equivalent standing investment. It therefore delivers an additional return for the time and effort involved in the process.

TABLE 2

Key leisure investment activity - 2012/13

Date	Scheme	Location	Area (Sq ft)	Price	Yield	Purchaser
Under Offer	Walkergate	Durham	130,000	c £13.10 million	6.95%	Merseyside Pension Fund
Dec. 2012	Q-Leisure Park	York	60,000	£15.65 million	6.80%	USS
Dec. 2012	The Parkway	Bury St. Edmunds	40,000	£9.8 million	6.15%	LaSalle IM
Nov. 2012	The Printworks	Manchester	365,000	£93.85 million	sub. 6.75%	Land Securities
Sept. 2012	Southwater Square	Telford	100,000	£22 million (forward funding)	6.75%	Prupim
Sept. 2012	The Gate	Newcastle-upon-Tyne	210,000	£60 million	6.65%	The Crown
June 2012	The Electric Press	Leeds	80,600	£13 million	7.00%	DTZ IM
May 2012	Cornerhouse	Nottingham	225,000	£50 million	6.60%	Land Securities
Jan. 2012	Stevenage Leisure Park	Stevenage	200,000	£39 million	6.50%	Legal & General

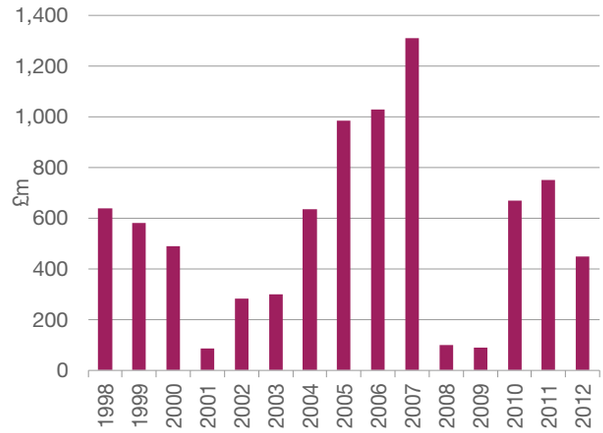
Source: Savills

■ Finally, funding provides certainty of timeline to the developer, investor and most significantly, the occupier.

The most recent transaction was Citygrove's forward funding of Southwater Square, Telford. This asset offered a UK institution the opportunity to fund a fully pre-let, 100,000 sq ft lesiure scheme in a strong location, where 60% of the income stream was subject to index-linked or fixed rental uplifts.

GRAPH 4

Leisure investment volumes



Source: Savills

Savills Leisure team

Please contact us for further information

David Bell
Leasing
020 7877 4516
dbell@savills.com

Carlene Hughes
Leasing
020 7409 8177
chughes@savills.com

Alexander Joslin
Investment
020 7409 8916
ajoslin@savills.com

James Hurst
Investment
020 7409 9927
jhurst@savills.com

Jonothan Holmes
UK Commercial
Investment Funding
020 7409 8826
jholmes@savills.com

Katrina MacKay
Management
0161 277 7215
kmackay@savills.com

Megan Brady
Management
0161 244 7768
mbrady@savills.com

Iain Maxwell
Lease Consultancy
020 7409 8811
imaxwell@savills.com

Mat Oakley
Research
020 7409 8781
moakley@savills.com

Stephen Toal
Research
0161 244 7735
stoal@savills.com

Savills plc
Savills is a leading global real estate service provider listed on the London Stock Exchange. The company established in 1855, has a rich heritage with unrivalled growth. It is a company that leads rather than follows, and now has over 500 offices and associates throughout the Americas, Europe, Asia Pacific, Africa and the Middle East.