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Spotlight
UK Commercial Leisure

Q1 2017

Image: Cornerhouse, Nottingham

SUMMARY

■ Consumer spending on leisure services grew by 7.8% in 2016. Despite economic headwinds this is forecast to continue to grow at 4% per annum over the next five years.

■ Occupational demand is continuing across all leisure sectors, though the rate of expansion is slowing in some segments. We expect to see further growth amongst smaller casual dining brands, boutique cinemas, boutique health & fitness, and new D2 offers such as competitive socialising and e-sports.

■ Investor demand for leisure assets is broadening. However, the availability of prime assets is limited, and this is not expected to change in 2017.

■ Prime leisure yields now sit between retail warehousing and shopping centres, and are expected to remain stable at 5% for the remainder of this year.

"Supply of quality leisure stock will remain tight, but pent up demand will ensure strong pricing for the rare prime assets sold." James Hurst, Savills

The leisure property market in the UK is currently relatively confused. On one hand, investors are increasingly enthusiastic about the sector's secure-income characteristics, yet frustrated by the lack of stock that is coming to the market. On the other hand, while tenant and consumer demand remains robust, there are definitely headwinds ahead that will affect operator's margins and thus their future growth plans.

The Leisure Economy

The British consumer's love for leisure spending continues unabated. According to the latest Family Expenditure Survey, the typical household now spends 22% of its weekly outgoings on leisure, compared to 14% on housing. Furthermore, the rate of growth in spending on leisure services has continued to grow faster than on other items (+7.8% in 2016 compared to +4% on all items).

However, we do not expect this exceptionally strong rate of growth to continue, as the outlook for household incomes and spending is weakening due to rising inflation.

February 2017 saw the CPI measure of inflation reach a three-and-a-half year high of 2.3%. This was higher than expected, though much of the rise was down to the volatile food, energy and petrol categories. Upward pressure on inflation is likely to continue, as the majority of domestic energy providers have announced that they will increase prices over the next few months. The other driving factor behind the recent rise in the rate of inflation is the weakening of the pound since last June's referendum on EU membership. Typically this can take up to 12 months to feed through to inflation, so the affects of the weak pound are likely to continue to rise over the next few months, before stabilising in the autumn.

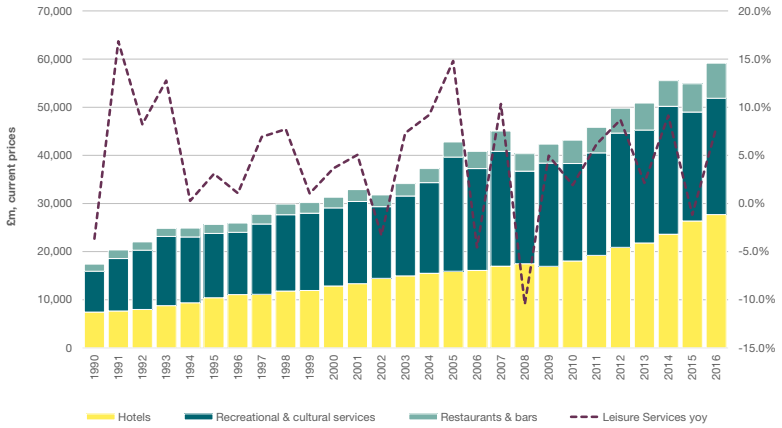
Rising inflation is not a huge issue for the consumer so long as earnings are rising at a stronger rate. However, earnings growth remains muted, and as inflation moves up to 3% this will result in real earnings growth falling back to zero, with an inevitable feed-through to weaker household spending growth.

There is some evidence that consumers are already reacting to the prospects of rising inflation, with the GfK survey of consumer confidence (Graph 2) showing a steady weakening in consumer confidence over the last 12 months, particularly when they are questioned about the overall economic situation.

However, as we have examined in previous Spotlights, the British consumer has previously demonstrated that they tend to cut back less on spending on leisure during difficult times than on other areas. This means that while we are forecasting a slowing in the rate of growth in household spending on leisure services over the next 12 months, the average annual growth rate over the next five years will remain a respectable 4% per annum.

GRAPH 1

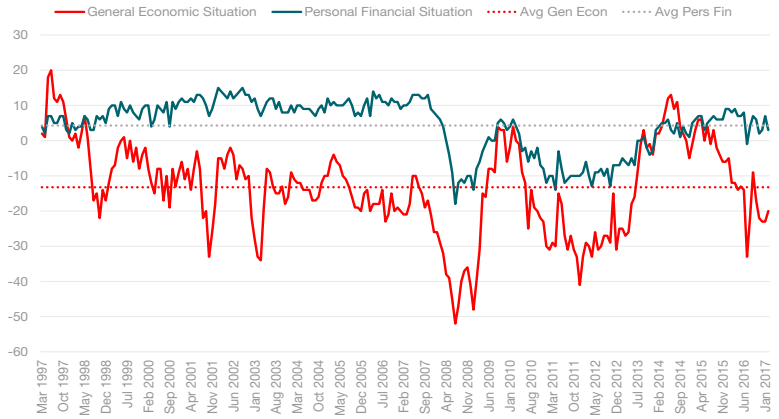
Spending on leisure services grew by 7.8% in 2016



Source: Oxford Economics

GRAPH 2

Consumers are concerned about the economic outlook



Source: Datastream, GfK

Occupational trends: Food & Beverage

The F&B sector has been one of the most buoyant in recent years, with a steady stream of new brands rolling out large expansion programmes across the UK, leading to strong rental growth in the most in-demand locations. However, cracks are showing in some of the larger groups, and the pressure on their margins will be increased by higher import costs, staff costs, and in some locations business rates.

We expect that the remainder of 2017 will be a period when the large mid-market chains are less acquisitive than they have been in recent years. However, the smaller casual dining groups such as Five Guys, Wahaca and Turtle Bay are expected to continue to add locations.

The impact of this will be most felt in secondary markets, where leasing is

more reliant on the 'stalwarts' of the F&B market and a more limited pool of target operators.

Another challenge to the mid-market is the continuing growth of the food-led A4 operators, and we expect this to continue as groups such as Living Ventures, Brewhouse & Kitchen, and Be At One continue to expand across the UK.

While some new premium brands have experienced tough trading as they have pushed outside London and the South East, there is still a steady stream of new entrants to the UK market, particularly in the more mainstream price bands. This year will see more interest in the UK from US brands, with Chick-fil-A, Tim Hortons and P.F. Chang's all currently looking at expansion beyond their home market.

Rental growth is likely to be more muted in 2017 than it has been in recent years, and we expect to see rents plateauing or falling in secondary locations. However, tenant demand will remain robust in outer London and the South East, as well as in affluent market towns, and this will put continued upward pressure on rents (albeit at a slower rate than in recent years).

Occupational trends: Cinema

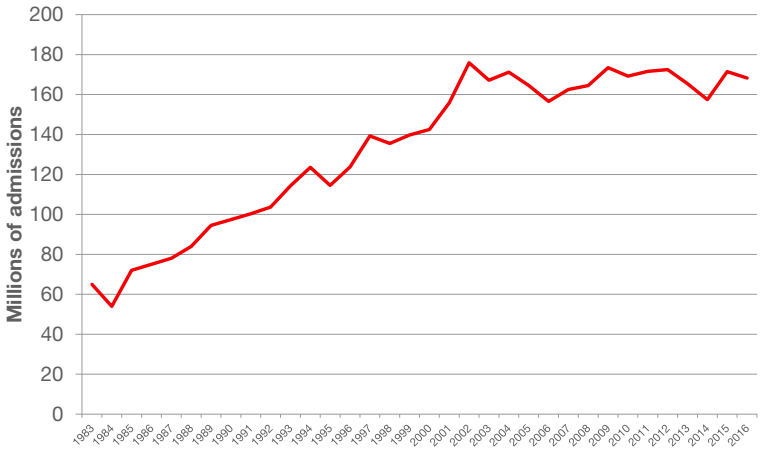
Cinema attendance in the UK fell by 2% in 2016 to 168 million visits. However, as Graph 3 shows, this is broadly in line with the average annual level of the last 15 years. The first two months of 2017 have been stronger than the same period last year (boosted by Disney's live action version of Beauty & The Beast). However, the release schedule for the remainder of 2017 is somewhat weaker than last year, which should mean that overall attendance this year will be broadly in-line with that of 2016.

Cinema operators are generally in good health, having been through the massive capex of digitalisation and being less exposed to rising costs and consumer restraint than some other areas of the leisure and retail market.

There continue to be operator requirements across the UK, with a wide variety in site sizes. Cineworld continues to focus on the megaplex, with its flagships typically being 40,000 sq ft plus. While The Light and Empire are focusing on 5–7 screen sites, and the boutique operators (Curzon, Everyman, Picturehouse) on 3–5 screens.

GRAPH 3

UK cinema attendance



Source: UK Cinema Association

Rents on new cinema deals vary significantly dependant on location (£12–£18/sq ft), and there remains some upward pressure in London and other core locations. However, the challenge for developers and landlords is the continuing steady rise in premiums that are being demanded by operators. These have risen from around £1m to as much as £3m over the last five years, and are now making a large number of planned cinema-led developments look increasingly unviable.

Occupational trends: Health & Fitness

The H&F sector is experiencing some similar dynamics to the cinema sector, in that there is a wide differential in the size of occupational requirements, and the rents that are being achieved.

The strongest segment of the market in recent years has been the budget sector, and we expect to see more growth in this segment, as well as some further consolidation. The pace of change is best illustrated by the dramatic growth of Pure Gym, which has become the UK's largest operator from a standing start seven years ago.

However, the strongest growth in occupational demand is now from the boutique sector, particularly in London and other affluent locations. The model for many of the new operators in this part of the market such as Barry's Bootcamp, F45 and Psycle is pay-as-you-go and class-led, and requirements can be as small as 3,000 sq ft.

We expect rents across the premium segment to continue to grow, and are witnessing rents of up to £50/sq ft+ being achieved in central London for the smaller floorplates where competition for space is intensifying.

Also in common with the cinema sector we expect H&F to be resilient in the face of a more cautious consumer, due to the continuing rise of the wellness agenda, as well as the more flexible nature of the current generation of pricing models.

Occupational trends: D2 leisure

The D2 sector has seen a burst of vigour over the last two years, partly due to the explosion in the trampoline sector. Continental (a major manufacturer of trampolining equipment) estimate that there are now more than 150 parks in the UK – a dramatic rise in a relatively short period.

We believe that growth in trampolining openings will slow off in 2017, and there will start to be some consolidation amongst operators. This will take some of the heat off rents, which currently range from £8–£20/sq ft dependant on location.

Another growth area in the D2 sector is 'competitive socialising' (Swingers,

Flight Club, Bounce). Operators in this segment are pitching themselves as the natural successor to traditional games in pubs, and combine activities with eating and drinking. Generally they are targeting basements in major conurbations (with a heavy bias towards central London), and the rents being paid by these operators are well ahead of more traditional users of this kind of space.

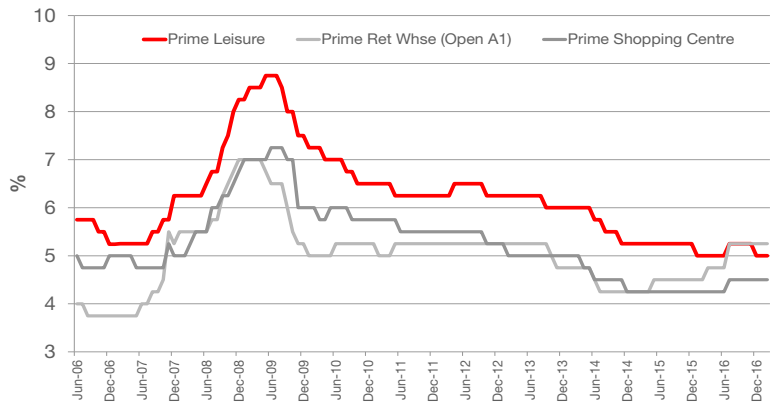
A final new potential new entrant to the leisure market is 'e-sports'. This term covers both participating and watching competitive online games, and has been given a boost by the recent falls in prices of virtual reality hardware. At present the only two operations in the UK are Game's 'Belong' concept, and Vue's link-up with Gfinity to create an e-sports arena at Fulham Broadway in London.

A sign of the potential for growth in this sector has been the increasing number of existing sports franchises that have started to make tentative steps into this space, an example of which is the recent acquisition of an e-sports team by the owners of the Philadelphia 76ers NBA franchise. Closer to home, both ITV and Sky Sports have made small investments in this area.

The potential growth for this sector is significant, with 43 million people watching the 2016 League of Legends World Championship online. However, e-sports can easily be watched from home, so the impact of its growth could as easily be negative as positive for the leisure property sector.

GRAPH 5

Prime leisure yield now sits between retail warehousing and shopping centres



Source: Savills Research

Investment

In the opening paragraph of this Spotlight we alluded to a rising investor interest in leisure being to some degree thwarted by a lack of willing sellers. This is the primary reason why the volume of leisure schemes that were traded in 2016 was so low (Graph 4).

2017 has started well, with £176m of transactions in three deals (£108m of which was DTZ Investors' purchase of the Printworks in Manchester). However, we do not expect to see a rush of new sales in 2017, as the majority of the current owners of good quality leisure schemes are also those who are looking to add more to their portfolio.

However, investor demand for leisure has broadened beyond its traditional base of a handful of expert funds and property companies. At present we are aware of significant requirements for the sector from both opportunistic and core investors. So, why has the sector suddenly increased in popularity?

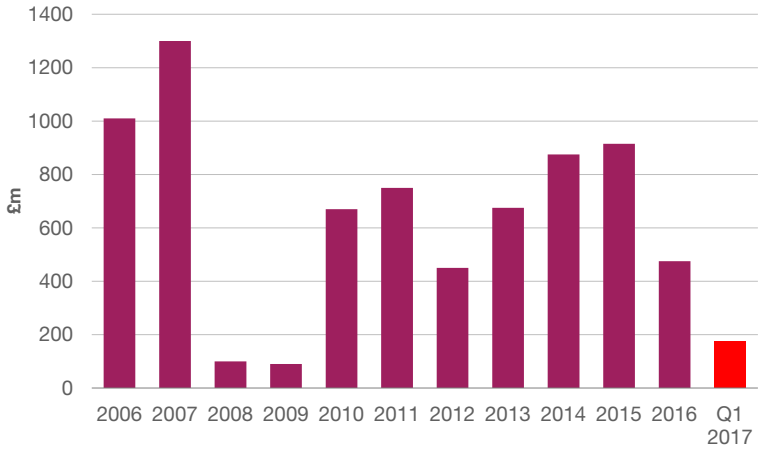
The primary reason for this rise in popularity is a reflection of the wider swing in institutional requirements towards secure income. Leisure in the UK is one of the last bastions of leases of more than 10 years, and 25-year leases with some level of indexation are still achievable. Furthermore, not only has the quality of covenants on offer in the sector improved, but so has the understanding of the more defensive nature of leisure spending.

Finally, and this is perhaps the reason why opportunistic investors are becoming increasingly prevalent in this sector, there is the combination of a need for very active management of leisure assets. For those owners who are prepared to actively manage their leisure assets the performance enhancement can be good, with real rental growth still being delivered by many subsectors of the leisure market.

The impact of this imbalance between buyers and sellers on pricing has been to keep prime leisure yields on more of a downward trend over the last two years than retail yields (Graph 5). Indeed, the fact that prime leisure yields now sit between retail warehousing and shopping centres for the first time is probably the best reflection of the fact that the sector has finally hit maturity.

GRAPH 4

Leisure investment volume (excl pubs & hotels)



Source: Savills Research

Key recent investment transactions

Scheme	Price £m	Yield %
Printworks, Manchester	108	5.90
Cornerhouse, Nottingham	65	5.25
Omni, Edinburgh	75.2	6.50
Star City, Birmingham	59	9.00
17-23 Parliament Street, Harrogate	8.55	4.70
45-59 Friar Street, Worcester	11.8	6.10

Outlook

■ While the UK consumer has been relatively relaxed about the process of exiting from the EU to date, we do expect to see heightening uncertainty over the next two years.

■ Uncertainty will combine with flat or falling real earnings growth to slow household spending growth. However, spending on leisure services is expected to be more resilient, and to grow at 4% per annum over the next five years.

■ We expect that the pace of expansion in the F&B sector will slow off this year, particularly amongst the mid-market brands. However, voids are likely to remain low in core locations, and this should result in stable or rising rents in such locations.

■ F&B and H&F rents in Greater London are expected to continue to experience upward pressure during 2017 as existing and new brands pursue expansion against a background of very low vacancy rates.

■ There will undoubtedly be some sales of prime leisure assets this year, as owners or developers either take profits, or view that they have asset managed the asset as far as they can.

■ However, the best sources of assets for investors who are looking to either enter the sector or increase their weightings in 2017 will be either off-market deals or forward funding of developments. Both approaches require a significantly higher time commitment, and development fundings are becoming challenging due to higher premia being demanded by cinema operators.

■ 2017's leisure investment volume will be higher than 2016, and more in line with the five-year average of circa £600m.

■ Strong investor demand for prime and secure leisure income streams will continue to support yields. We expect that the prime leisure yield will remain stable in 2017 at 5%.

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