UK Commercial Leisure Bulletin

Winter 2011

“2011 has seen the highest volume of turnover of leisure investments since 2007.”

Image: Cosmo Restaurant, Croydon

- We expect that consumer confidence will remain weak, and spending patterns cautious for much of the first half of next year. Thereafter, assuming a not too negative resolution to the Eurozone problem, we should see a pick-up in confidence and spending.
- 2011 has seen the highest investment turnover in the commercial leisure market since 2007. We expect that investment in the sector will remain popular in 2012, with a focus on the better schemes. However, trading volume will be restrained by a lack of institutional vendors.
- Tenant demand remains fragmented, with some leisure operators still firmly expansionist, while others are downsizing their estates. We expect this trend to continue into 2012.
- Consumer promotions (2 for 1’s etc) will maintain revenue in most cases, but will continue to impact on margins. The bigger brands are likely to be more aggressive and flexible on this policy.

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Consumer trends

Consumer economy

Recent UK economic news has been very mixed. On the positive side, the economy grew by 0.5% in the third quarter of 2011, according to the Office for National Statistics (ONS). The growth in the July-to-September period showed improvement compared with a 0.1% expansion in gross domestic product (GDP) in the previous quarter. The outlook remains unsettled, but despite the daily speculation about double-dips, it is still growing and not declining.

However, the latest economic forecasts from the Office for Budgetary Responsibility are slightly more negative in the short term than the consensus, with 2012 predicted to be weaker than 2011 at 0.7%. Thereafter the official forecast is for a fairly steady recovery, with the UK forecast to grow by 3.0% in 2015 and 2016.

Against this background it is no surprise that the consumer remains confused and cautious. Rising unemployment, currently around a 17-year high, means that confidence is low. The measure of consumer confidence, by GfK NOP, shows that consumer confidence is at its 10th lowest figure since it began in 1974 (-31). Consumers are becoming increasingly pessimistic about the UK's general economic situation over the coming year. Additionally, the climate for major purchases has worsened, suggesting the government can't rely on people spending their way out of a potential double-dip recession.

With inflation remaining high, albeit down from its latest peak of over 5% this month, the unpleasant new experience for the UK consumer that is negative real earnings growthwill remain the main drag on consumer spending and confidence until it falls. We remain of the view that inflation will begin to fall from January 2012, and this will begin to stimulate a pick-up in consumer confidence. Until then spending is likely to remain focused and cautious, particularly if the Eurozone situation is not resolved quickly and comparatively painlessly.

A weaker than expected recovery in the labour market would also delay the consumer recovery, and unemployment is currently forecast to reach 8.9% by the middle of 2012. The bulk of this rise will be driven by the public sector shedding jobs as part of the austerity programme. However, the losses in the public sector are expected to be softened by headcount increases in the private sector. If this does not happen, then unemployment will continue to rise throughout 2012, with a corresponding dragging effect on spending on both leisure and retail.

Investment review

As we approach the closure of a turbulent 2011, it is worth reflecting on a year which has seen the highest trading volume of stock since 2007. To date, excluding pure hotel transactions, c. £700 million has been traded with approximately £50 million in the market. Vendors have been a mixed bag of opportunists and traders, but very few forced sellers, perhaps a reflection of the now predominantly institutional ownership of the sector.

Key transactions include:

Scheme	Price £m	NIY %	Purchaser Type
Rotunda, Kingston	£50	6.35%	Fund
The Circus, Manchester	£20	6.75%	Private
Virgin Active (sale & leaseback)	£175	N/A	REIT
Feltham Leisure Park	£32.75	6.35%	Fund
Kingsmead, Bath	£20	6.30%	REIT
Stevenage Leisure Park	£40.5	6.50%	Fund

Of this, £123 million have been acquired by UK funds, £20 million by private, debt-backed buyer (Circus) and most interestingly, £195 million by UK REITS. The latter is a completely new entry into the pure leisure arena, whereby the likes of British Land and Land Securities have previously been sellers of leisure schemes (e.g. Valley Leisure Park, Croydon and The Gate). The return of the REIT is perhaps a reaction to occupational wobbles in the retail / retail warehouse sector and also the search for long-dated income with a growth / asset management story.

It is worth drawing comparisons with the retail warehouse investment sector, which has long been the benchmark for the pricing of its leisure equivalent. Traditionally, there has been a yield discount of 125 to 150 bps against equivalent prime assets, and 200 to 250 bps for "secondary". That gap has certainly closed, to 100 bps for prime and 75 to 125 bps for secondary. Comparing this portion of the market is not entirely scientific, but we can point to a few examples. Theatre District, Milton Keynes traded in Summer 2011 for c. £17 million reflecting a net initial yield of 7.75%. Equivalent retail assets traded include St. Catherine's Retail Park, Perth traded at £12 million (6.82%); Southampton Road Retail Park, Fareham traded at £11.10 million (7.06%) and Parkside, Pontefract traded at £6.40 million (6.77%).

In our opinion, this particular gap is not sustainable. Yield movements in "non-prime" retail warehousing have been pretty spectacular, mainly driven by, in many cases, an over-reaction to corporate concerns in the electrical and furniture sectors.

Investment review

Therefore, provided there is no more bad news in this arena, we would expect this gap to widen to perhaps 125 to 150 bps as a consequence of retail yield compression, rather than secondary leisure yields moving out further.

Turning to prime stock, as ever the pot of such assets is relatively small. However, of the 6 leisure assets highlighted above, 4 parks have been priced in the prime-bracket of sub 6.5% NIY. Given 3 of the schemes are in excess of £30 million, and at least 2 of them received bids from 5 to 7 funds, we can conclude that the pot of buyers has increased significantly from 2008 to 2010.

Arguably, there are now at least 6 active UK Institutions and a handful of UK REITS / equity-rich PropCos who could / would buy into this sector.

Why has this happened?

- Long leases (generally > 15 years) to improving covenants;
- Genuine market rental growth driven by paucity of new supply and strong demand from cinema and restaurant operators;
- Asset management opportunities for the better schemes which will not result in falling rents – premiums being paid for existing leases;
- Index-linked rents on many of the "big-box" operators;
- Concerns in other sectors e.g. secondary retail warehousing;
- Relative returns (see below):

There have been at least 2 interesting examples of a purchaser backing the asset management / demand story, namely Mansford's acquisition of Millennium Plaza, Cardiff and Skydome, Coventry. Both had significant voids, needed substantial CAPEX, but were in reasonable micro locations. Having sold Skydome to Mansford, we can understand their rationale. Having agreed a price of £13.55 million from the administrators to Targetfollow, this reflected a keen net initial yield of c. 5.60%. However, strong occupational demand for the vacant nightclub, albeit not pre-agreed upon completion, should result in a running yield in excess of 8.0%. Since buying the asset in July 2011, we understand they have already struck deals with a budget gym operator and a buffet-style restaurant to fill the nightclub void.

With regard to realistic returns, if we use the example of 2 of the most recent sales, namely Feltham Leisure Park and Stevenage Leisure Park, it is reasonable to forecast an ungeared return in excess of 8.00%, as is illustrated below:

Scheme	Price £m	NIY %	IRR (ungeared)	IRR (geared at 50% LTV / 5% finance cost)
Feltham Leisure Park	£32.75	6.35%	8.00%	10.72%
Stevenage Leisure Park	£40.50 (u/o)	6.50%	8.35%	11.10%

These returns have made modest assumptions on rental growth, applied fixed / index-linked rents where appropriate and assumed no yield shift between entry and exit. They also reflect a 5 year hold.

If debt was more readily available, we would expect this sector to be even more appealing given the geared returns available. That said, given the vast majority of leisure assets are fund owned (c.80% market share), we do not expect a significant increase in trading volumes. Of the debt-backed purchases made at the peak of the market in 2006 / 2007, we can only identify about 10 to 15 which may come under pressure due to refinancing deadlines, and hence the need for an equity injection. From a trading perspective, we hope this creates a bit of a "feeding frenzy".

Market review

Occupational Review

- As disposable incomes are hit by rising costs, taxes and a fall in household income, "leisure spend" has been continually squeezed throughout 2011, with consumers redefining their priorities for leisure activities.

- Despite this, Q4 2011 demonstrated some resilient performances from the stalwarts of the market, as consumers search for quality, consistency and value.

- Gondola, Restaurant Group and Tragus again saw improving sales with LfL figures reported at +4.5%, +3.0% and +2.0% respectively.

- As investors continue to seek long-established covenants, the likes of Gondola and The Restaurant Group have seized the opportunity to roll out new brands Byron Burger and Coast-to-Coast respectively, capitalising on landlords' risk-adverse sentiments in order to secure prime sites over rivals.

- Private-backed chains such as Wagamama, Nando's and Ed's Easy Diner have each opened a number of new restaurants this year, but are becoming increasingly location sensitive, as retail-led schemes remain the preference.

- However, the more aggressive operators seeking organic growth are considering an increasing number of pure leisure schemes. Buffet style operators are taking up large amounts of space, and the likes of Las Iguanas and Prezzo are moving onto their first leisure schemes.

- Eating-out remains the UK's No.1 leisure activity. In this tough economic climate, consumers shun big-ticket shopping items and foreign holidays, yet still value a meal out with friends at family meeting their menu, service and price point expectations.

- As a result, the eating out and drinking out of home market consistently out-paces the retail sector, with September like-for-like sales up 2.8%, compared to 0.3%, according to the latest Coffer Peach Business Tracker data.

- The drinking-out market is proving more resilient than 12 months ago, improved by better corporate governance (reduction of debt piles) and a focus on higher margin sales (i.e. food). At the budget end, drinks promotions appeal to the strapped-for-cash drinker, where Wetherspoon's excellent model shines through, reporting a 2.1% rise in LfL sales.

- Positive rental growth for prime shopping centres and leisure parks; we would cite Westfield Stratford as an example, where headline rents are approximately £50-£55 psf, plus a percentage of turnover.

BUT

- Where the strength of the mid-market chains and their corresponding consumer incentive offers make a quality product much more affordable, Pizza Hut's 'family' and 'value' oriented consumer has upgraded to offers such as Strada and Pizza Express. Pizza Hut has begun to fight back however, with a blitz of marketing to promote its new Pizzetta brand of healthier, less than 500 calorie offers.

- The 32 restaurant chain Chez Gerard Group was a major casualty of Q4, moving into administration in November. Eight of the group's central London sites were immediately purchased by Brasserie Blanc for a rumoured £10m, demonstrating the robustness of the London market.

- Cinema operators are finding it increasingly difficult to line up new openings. Despite a number of undeveloped sites, a lack of development finance has frustrated new schemes. Where good opportunities are delivered, particularly in town centre/retail locations, the top 3 operators are invariably bidding competitively.

- Struggling operators such as Punch Taverns and Enterprise Inns look to re-focus and dispose of unprofitable assets. Having completed the de-merger of its Spirit business in August, disposing of 398 pubs as a consequence, Punch Taverns are beginning to see growth in average net income, up +0.9% (first growth in 3 years). However, the damaging assets continue to bite into the company's finances, with a £359m loss reported for 2011.

- Likewise, Enterprise reported net debt of £302m, and have disposed of £238m of assets this year.

- The predicted demise of Luminar came in October, when the nightclub operator was placed in administration. Luminar were served a number of blows over the past few years, with the Licensing Act 2005, which introduced competition from the pub sector, the smoking ban and the rise in youth unemployment. We expect its core town centre concepts to continue to trade well and attract suitors. Some of the out of town portfolio will fare less well

Market review

Operator	Period	EBITDA (£m)	LFL (%)	Portfolio Gain/Loss
Tragus Group	Year to 29the May 2011	£41.2	+2.0	11+ (2011), 20+ planned for 2012
Greene King	Year to 31st May 2011	£276.6	+4.9	Acquisition of Cloverleaf Restaurants, Realpubs and 13 further sites. Disposal of 108. 300+ for 2012-2015
Punch Taverns	Year to 20th August 2011	£257.7	(-5.2)	Disposal of 398 sites
Enterprise Inns	Year to 30th Sep 2011	£366.0	(-1.7)	TBC
Mitchells & Butler	Year to 24th Sep 2011	£398.0	+2.6	53+ (including Ha Ha Bar & Grill)
The Restaurant Group	26wks to 3rd Jul 2011	£39.7	+3.0	16+ sites in 2011, 25+ expected in 2012
Gondola Group	Year to 26th June 2011	£114.5	+4.5	19+ for 2011
Cineworld	26wks to 30 June 2011	£25.6	+4.2 (gross box office)	3+ for 2011
JD Wetherspoon	Year to 24th Jul 2011	£66.8	+2.1	50+ sites in 2011, disposed of 2

Cinemas

Cinemas have traditionally proved fairly resilient to recessionary forces and are embracing new technology and media to react to both the product, but also to protect themselves from the 'stay at home' consumer. Cineworld's first half year results show box office receipts up by 2% to £113.9m, yet operating profits declined as a result of the significant cost of conversion to digital cinemas. We expect results for the second half of the year to be similar once announced.

Operators are being forced to look again at all areas of their discretionary spending, particularly given the improvements to home viewing technology in recent years. Cineworld is to roll out a new concept; "The Screening Room", with the first having opened this year at The Brewery in Cheltenham where Savills advised the landlord NFU. With leather seats, table service and a price point of approximately £17.00, the offer is very much targeted towards the more affluent consumer.

As the three main players Cineworld, Vue and Odeon look to grow their respective estates, significant barriers exist where development finance remains lacking, and the plentiful opportunities across the country remain untapped.

Boutique cinema operators such as Picture House and Curzon cinema maintain their positions in the market with both operators having a loyal following. Curzon, who have historically seen Central London as their heartland, are looking to spread their wings and build the brand, targeting regional University towns/cities such as Oxford, Cambridge and York. Savills have just been instructed to source suitable requirements.

The most anticipated cinema opening of the year, Vue cinema at Westfield Stratford, has already become the highest grossing cinema in the UK, superseding Vue at Westfield Shepherds Bush. We expect gross box office revenue to touch £10m next year

Restaurants

Despite the average spend in the restaurant sector contracting further, certain regions have shown remarkable resilience. London is a particular success story, benefiting from significant tourism trade and higher disposable incomes. Restaurant groups Gondola/Tragus continue to prioritise London and build their respective estates. Over and above this, the fundamental for eating and going out have not changed. Londoners eat and drink out more frequently than in other parts of the country, where eating out is not considered a big ticket item. Hefty premiums in order to secure units have now become commonplace, and rental levels are approaching the £100 psf mark in central locations.

Positive rental growth is still achievable for prime shopping centres/prime leisure schemes. The recently opened Westfield Stratford managed to attract 70 food and beverage operators at average rental levels of £50.00 - £55.00 psf. Savills are currently instructed on a new build leisure scheme in Bromley on behalf of Cathedral Group, attracting exciting operators such as Las Iguanas, Pizza Express, Nando's and Prezzo at headline rents of circa £35.00 psf.

See overleaf for other key lettings for 2011:

Market review

Scheme	Operator	Size (sq ft)	Rent (£/sq ft)	Lease Term	Incentives	Comments
Barbican Leisure Park, Plymouth	Chiquitos	5,000	£28.00	25 year FRI lease	6 months rent free	Open market letting 2011
Festival Leisure Park, Basildon	Zizzi	3,000	£31.00	25 year FRI lease, TOB year 15	12 months rent free	New development due in 2012
Wembley	Las Iguanas	4,000	£30.00	25 year FRI lease, TOB year 15	12 months rent free	New development due in 2012
Brewery, Romford	Zizzi	4,000	£34.00	25 year FRI lease, TOB year 15	12 months rent free	Open market letting 2011
02, Finchley	Wagamama	4,000	£37.00	25 year FRI lease, TOB year 15	9 months rent free	Open market letting 2011

Two trends that are increasingly impacting the restaurant market are social media and the continued threat of 'dine-in' promotions from the supermarkets. The rapid expansion of social media has effectively created a whole new market for enterprises to tap into. The restaurant industry is slowly adapting to these changes; where previously direct marketing via email was key, many websites now allow customers to 'follow' the restaurant via Twitter. These social network sites offer a more dynamic and interactive method of communication with customers, providing up to the minute news, promotions and offers.

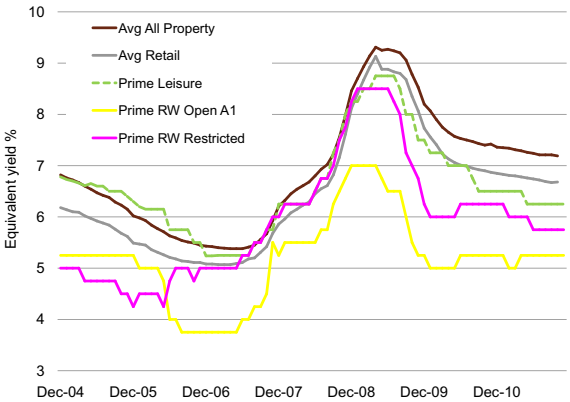
Supermarkets have taken advantage of consumers tightening belts, gaining customers from restaurants by offering 'dine in deals', usually including a three course meal and a bottle of wine for £10. These promotions attract customers keen to save money by eating at home, representing great value for money.

Finally we highlight the 'ones to watch' for 2012. Novikov Restaurant Group, a Russian operator with 50 establishments is set to open a restaurant in Mayfair by the end of the year. Each restaurant is a standalone brand serving 18 different cuisines. The Mayfair offer will consist of a standalone bar and two separate restaurants serving Asian and Italian cuisine. If successful, it could prove the catalyst to expand further in the UK.

Coast to Coast is a new concept being brought forward by The Restaurant Group. The format is casual dining for adults focused on American cuisine, including steaks/burgers and pizzas. The fit out is retro with low lit lamps, polished brass and cool furniture. The first offer opened in Brighton Marina, and a national roll out is now in the pipeline.

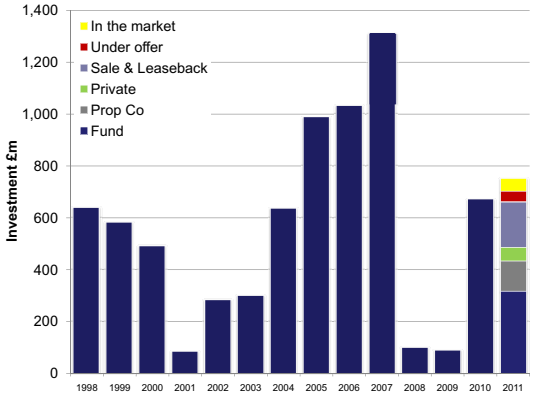
Data and contacts

Yields



Source: Savills, IPD

Leisure investment volume



Source: Savills

Absolute Prime (<£20 million) e.g Parkway, Bury St Edmunds & Silverlink, Newcastle **+/- 6.25%**	**Prime Pure Leisure** e.g. Feltham Leisure Park & Rotunda, Kingston **6.35%**
Secondary e.g. Theatre District, Milton Keynes **7.75% / 8.00%**	**Standalone prime "box" - London / best regional** **6.50% / 6.75%**

For further information please contact

Andrew McGregor
Investment
020 7409 8861
amcgregor@savills.com

David Bell
Agency/Development
020 7877 4516
dbell@savills.com

Mat Oakley
Research
020 7409 8781
moakley@savills.com

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