UK Commercial Leisure Bulletin

Autumn 2010

“We have identified over 2.5m sq ft of leisure product in the development pipeline.”

- Consumer confidence remains elusive, and we do not expect to see a sustained recovery for at least another 12 months.
- Our research shows a sharp increase in planned restaurant openings in 2010/11 over the levels seen in 2009/10.
- For the first time in many years the health club sector is upbeat, with a number of new operators looking to expand at the budget end of the market.
- The leisure development market is also starting to show signs of life after a long fallow period. We examine the pipeline and assess the risks and opportunities in leisure development.
- The volume of investment in leisure assets has boomed in 2010. Is this a reflection of the strength of the sector, a reaction to forced sales, or just a reflection of the general improvement in sentiment towards all types of property investment?

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Consumer trends

Consumer confidence remains elusive

Consumer confidence, while less negative than it was in 2008/9, remains markedly pessimistic and seriously volatile. While the economy has now been growing for three consecutive quarters, concerns about job security, house price stability, and most importantly the imminent comprehensive spending review are all putting consumers into a save rather than spend frame of mind.

So when will this change, and what will drive an improvement? While some retailers can anticipate a rush over Christmas and early January as consumers move to buy big-ticket items before VAT goes up to 20%, this is unlikely to affect the leisure market. A sustained pick up in sales, admissions and memberships will only come once consumer confidence is back to normal, and the spectre of 25%-40% cuts in public spending has been crystallised and factored in to people's perceptions of their own financial stability.

We have long been of the view that the three main factors that affect consumer confidence and spending are perceptions of the outlook for pay, job security and house prices.

Wage restraint is undoubtedly continuing with average pay settlements falling from 3% in 2008 to around 1% in 2010 (although they have picked up from 0% level seen in 2009).

The housing market is definitely showing signs of turning back downwards, with a rise in stock on the market and a fall in the number of purchasers, leading to either slowing rates of growth, or falls in prices, depending on which of the various indices you follow.

The labour market on the other hand presents a reasonably strong story. Total employment levels have been remarkably unaffected by the recession, with employment just over 1% below its pre-recession peak. Companies have clearly resorted to other measures than redundancy to tide them through the recession, including wage freezes or cuts, reductions in over-time, introduction of flexible working and freelance contracts etc. The recent trends in unemployment and employment are supportive of an improvement in consumer confidence with unemployment stabilising and employment levels rising over the last few quarters.

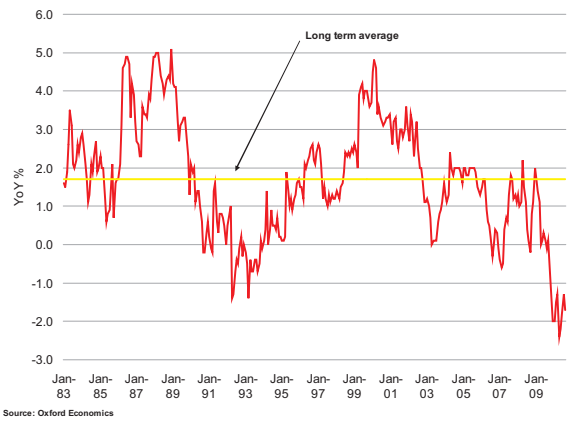
Pulling a variety of factors together is a new analysis produced by Sky News and Oxford Economics - "the Hard Times Table". This is a monthly index which seeks to analyse the personal finances of the typical man or woman in the UK, and track how they have changed over time. The index has a strong relationship with consumer spending, and will be well worth keeping a close eye on as the public sector austerity debate plays out over the next couple of years.

Generally the path of the index over the last 20 years has been upwards - no surprise given the fact that living standards have generally improved. The only exception to this upward trend is during recessions when it has tended to move sideways.

The really interesting line to watch is the de-trended analysis. This adjusts the index to reflect the assumption that living standards should steadily improve in an advanced economy like the UK. As the chart below shows, its is clear that UK consumers are currently enduring an unprecedented squeeze on their personal finances.

For most people in the UK the rising level of inflation over the last three years has exceeded wage growth, while at the same time unemployment has increased. Some of this has been offset but above inflation growth in benefits payments and a sharp fall in debt servicing costs, but despite this the index for July 2010 was 1.8% lower than in July 2009 - clearly we are not out of the woods yet.

Hard Times Table - Is this recession worse than that of the 1990's for the consumer?



Projecting the index forward to next year using Oxford's macro-economic forecast suggests further tough times for UK consumers to come, primarily due to high inflation, rising VAT, low wage growth and public spending cuts. A recovery thereafter looks likely as GDP growth feeds through to income growth and falling unemployment, and inflation begins to fall.

However, as far as the beleaguered UK consumer stands the recovery in consumer confidence and consumer spending is still 12 months away. For the leisure sector this means more of the same - heavy competition between in and out-of-home leisure pursuits, and a continuation of the focus in consumer's minds on value for money leisure offers.

Market review

Restaurants

- Family and branded operators have demonstrated robust trading over first half of 2010;
- Strong trading from well established brands such as Pizza Express and encouraging growth from new Asian entrants into the market such as Cosmo, Flaming Dragon and Jimmy's Spices;
- New specialist brands such as Jamie's Italian, Cote and Gordon Ramsay actively acquiring new units;
- Whilst turnover robust, margins are being squeezed by discount offers e.g. 2 for 1's;
- Emphasis on Shopping Centres and High Street locations due to guaranteed footfall and longer trading hours;
- Pressure on some out of town Leisure Parks due to the above BUT prime parks have continued to trade well off the back of booming cinema admissions. Secondary leisure parks struggling to gain new tenants and maintain rental levels;
- Active demand for in excess of 150 restaurant units over the next 12 months from just 7 operators;
- Most importantly of all, opportunities for significant rental growth (in the right locations !)

But, there are some words of caution:

- Is operator demand being fuelled by genuine consumer demand or are their private equity owners driving organic growth to enhance corporate value ?
- An increasing number of restaurants will put pressure on operators to attract the consumer, so we expect the discounting culture to continue;
- Food price inflation is a very real threat and will further squeeze margins;
- More marked regional disparity in trading performance.

The table in the next column details the current requirements for 7 of the most active restaurant groups in the market. What is interesting to note is the significant increase in numbers in 2010 from 2009.

Most operators have increased their requirements during this time and also changed their target locations with an ever increasing emphasis on in-town locations and areas of high footfall. With very little shopping centre development coming through the pipeline, it is likely that good quality High Streets will benefit.

Operator	2010/11	2009/10
The Restaurant Group Frankie & Benny's Chiquitos Garfunkels Bluebeckers	35 units to be split between shopping centres, leisure parks and standalone units for F&B's and pub sites.	15
Tragus Strada Bella Italia Café Rouge	20+	15
Gondola Pizza Express Ask Zizzi Byron	50 units – 95% High Street	30
Prezzo Prezzo Chimichanga *Café Uno* *	15 units (8 already in legals). Mix of all good locations.	30
Nandos	20 units – High Street and Central London	25
Las Iguanas	6 – 10 units – Shopping Centres and good town centre / edge of town Leisure Parks	5
Cote	10 units – High Streets only and opportunity lead	5
Total	160	125

* Recently bought Café Uno brand from Paramount - rebranding all 11 units to Prezzo and then revamping the brand and expanding.

So what has this increase in demand done for rents? There has been positive rental growth in the shopping centre sector, and in prime leisure parks. However rents in most secondary locations remain flat.

	Shopping Centre	Prime Leisure Park	Secondary Leisure Park
2008/ 2009	**Westfield, Shepherd's Bush:** £35 psf + 18 month package (+8% turnover) **Liverpool One:** 7,500 sq ft at £20 psf + 2 year package	**Xscape, Castleford**: £25 psf, 3 months rent free **Xscape, MK**: £35 psf at rent review **Valley Centertainment, Sheffield**: £28 psf, 12 months rent free	**Port Solent, Southampton:** £18 psf + 3 year incentive package
2010	**Westfield, Shepherd's Bush**: £37.50 psf + 12 month package (+10% turnover) **Liverpool One:** 7,500 sq ft at £25 psf + 3 month package	**Xscape MK**: £40 psf, 3 months rent free. **Barbican Leisure Park, Plymouth**: £29 psf, 6 months rent free	**Bentley Bridge, Wolverhampton:** £20 psf + 2 year incentive package

Market review & Investment trends

Health & Fitness

The health club sector remains upbeat with private equity groups circling the market and a number of new operators looking to expand primarily at the budget end of the market.

Whilst the budget market in the UK is still arguably in the embryonic stage, we are predicting a period of aggressive expansion with the majority of operators following in the well trodden footsteps of successful low cost brands such as McFit in Germany and Snap Fitness in the United States who have been trading successfully for the past 20 years.

Low cost gyms have the mid market health clubs as their primary targets, offering absolute flexibility to the consumer with either a monthly charge of approximately £14.99- £19.99 or a lower contract price.

We would advocate that 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 in grave danger as the 'no frills' operators begin to dominate.

The recent recession has created a strong trading environment for the low cost gym sector, as both new and existing formats jostle for position to expand.

A word of warning however - operators need to carefully select their sites, and keep true to their model in what is becoming a more competitive market. It goes without saying that both location and rent are key determinants of long term commercial viability.

There will inevitably be some failures along the way, especially in towns/cities where competition intensifies and the consumer has greater choice. These budget operators will locate next to existing premium offers, so expect some fireworks!

The Leisure team are at the forefront of the market, with Gym 4 All appointing Savills as property advisor to oversee a major development and acquisition programme across the UK following their first unit opening in Croydon, with further sites recently completed in Bradford, Nottingham, and Basildon.

Development

The UK leisure market continues to feel the affects of the economic downturn with the current recovery in a fragile state. Large scale leisure development has been at a virtual standstill through 2008 and 2009 as the banks continue to restrict lending with the leisure market being particularly out of favour.

One of the features since the beginning of 2010 has been the resurrection of the development market, and thus the new supply of specific leisure facilities. We could point to a number of reasons for this, but chiefly it is driven by occupational demand and a willingness for the institutional market to provide competitive forward funding. This is perhaps a return to the traditional role of the UK Funds in offering funding packages to developers as the banks have retreated from this arena.

We have totted up the number of new schemes in the pipeline and have comfortably got to 2.5 million sq ft. Some may be 5 years away, but a vast majority are a significant way down the design, planning and pre-letting route. Of this 2.5 million sq ft of supply, 75% will be cinema anchored, adding at least 80 new screens. In addition, there will be at least 75 new restaurants associated with these schemes. What is also telling, is that 90% of these schemes will be town centre, and thus closely linked to the retail environment. In the case of schemes such as Corby, Trowbridge and Aldershot, the retail will be an integral part of the development.

Central Village, Liverpool

Is there an inherent risk in the development of leisure? There is always a degree of risk associated with new development, but one of the features of this sector is the level of pre-letting which can often be achieved. Once the cinema anchor has been secured, and thus the key driver of footfall, the rest tend to follow. In the main, the big box anchors will seek a minimum lease term of 20 years, usually with fixed income kickers. Cinema rents have ticked up slightly, and capital contributions whilst significant, have come down. The fit out of these units remains very expensive (at least £125 psf from a shell handover), and the cinema will seek up to 33% contribution from the developer. Thus, cinema on its own is unlikely to be financially viable, but bolt on a minimum 25,000 sq ft of restaurants at say £25psf+, the scheme begins to make sense.

Savills recently advised on the successful £37.1 million forward funding of Lewis Building, Central Village Liverpool.

Investment trends

Construction work has already started renovating and converting the formerly unused upper floors of the existing iconic building adjacent to Liverpool Central Station. The property includes 80,000 sq ft of offices and a pre-let of the 125 bed Aparthotel to Adagio, an Accor and Pierre Vacances international collaboration, of which this will be the first in the UK. Odeon have also agreed a pre-let on 25,000 sq ft (8 screens), complimentary to their new 14 screen cinema at Liverpool One.

The team are also currently advising Spenhill in relation to three large mixed use schemes in Gateshead/West Bromwich and Yardley which includes cinema/budget hotel/pubs and restaurants amounting to approximately 500,000 sq ft of accommodation.

Investment trends

Of the £670.10 million invested in the leisure sector so far in 2010 (which includes budget hotel transactions), 50% is attributable to UK and European funds; 34% has been transacted by Property Companies (of which half was a single transaction, namely Land Securities buying O2, Finchley Road) and 14% representing corporate sale and leasebacks.

This quantum of activity is a significant increase in transaction volumes when compared to 2008 and 2009. Is this a reflection of the strength in-depth of the leisure investor sector, a reaction to 'forced sales' or merely leisure benefiting from a general improvement in property sentiment? Perhaps, all three, but it is worth exploring the vendor spread to better understand the trend.

Vendor activity has been dominated by the PropCo's, in the main responding to positive yield shift and therefore profit taking e.g. Matterhorn at O2, Finchley Road. The PropCo's accounted for 47% of market activity. The funds accounted for 26% of sales, but essentially in 3 transactions, namely Metro selling N1 Islington for £112 million and XLeisure selling 2 assets for £60 million. OpCo's i.e. sale and leasebacks, were the next dominant sector, with private sellers only amounting to 2%. This last sector is perhaps the most interesting as it would suggest that either there is limited pressure to sell amongst the debt-backed buyers, or there is a belief that values can improve further before banks feel the urge to crystallise problem loans.

In our last commentary in Spring 2010, we suggested that the definition of prime in the leisure category was very tight indeed. We stick to this principle and would re-enforce the issue of quantum. It is still our belief, albeit not tested since PRUPIM sold Tower Fields, Huntingdon to Legal & General IM for a net initial yield of 6.5% (May 2010), that the 'sweet spot' of value is £10 million to £20 million. The level of discounting above £20 million is naturally scheme/location dependent, but the inability to sell Xscape, Braehead and Rotunda, Kingston as we write this bulletin, would imply an extremely thin investor market for schemes over a particular quantum.

In our opinion, investor reaction can often be too simplistic when analysing these schemes. By definition, the larger schemes need to tick more boxes when it comes to operator performance, market penetration, asset management potential and underlying residual value. We understand that investor nervousness above say £30 million will reflect liquidity. However, surely each scheme should be assessed on its merits.

Take Xscape, Milton Keynes. Worth in excess of £50 million, XLeisure have recently moved the A3 rents on significantly with 2 lettings to Prezzo and Pizza Express to £40 per sq ft and 3 months rent free. This is a reflection of market dominance, good asset management and a cinema still achieving over 1 million admissions per annum. Rotunda, Kingston, where Odeon also achieved admissions at close to 1 million per annum, have A3 rents at £32.50 per sq ft. That looks out of kilter.

If we do take the simplistic view, then investors will continue to benchmark leisure with its equivalent retail warehouse asset. Therefore, if we take prime open A1 retail yields at 5.25%, the current yield gap of 150 bps is in line with the long term average. In our view, this historic pricing gap may now be over-cautious for investors who understand the sector. Given our assessment of prime being so limited (at +/- 6.75%), the implication is that a vast majority of leisure assets are priced at 7.50%+. Comparing the occupational market alone, i.e the strength of demand in the leisure sector compared to retail warehousing, makes the sector look pretty good value. Coupled with the property fundamental of long leases, often index-linked income, improving covenants and strong residential values, we are still campaigning to improve the leisure investment profile.

As we go to print, there is perhaps evidence of a shift in investor sentiment to "yield/covenant" deals. Freemans, Leicester has attracted interest from at least four buyers at around 7% (£14.5m+). The attraction being as much the 12 year income to Rank (£300m net worth) across the whole scheme, as the underlying trade and/or alternative use story. We wouldn't have classed this as prime due to its hierarchy amongst the competition, trading platform and micro-location. However, it is let for 10 years and to arguably one of the best covenants in the leisure sector, and it its adjacent to a 60,000 sq ft Morrisons foodstore.

What Would We Buy?

We have always maintained, that of all the property

Investment Trends

classes, the assessment of individual assets in leisure is one of the most important. Key to this is market dominance and operator performance. There is now sufficient depth amongst the A3 operators to demonstrate a degree of tenant pressure. Certain concepts will always drift in and out of fashion, but either the big chains react to this by refreshing their brands e.g. Byron or there are plenty of new / hungry operators keen to seek representation e.g. Cote, Jimmy Spices etc.

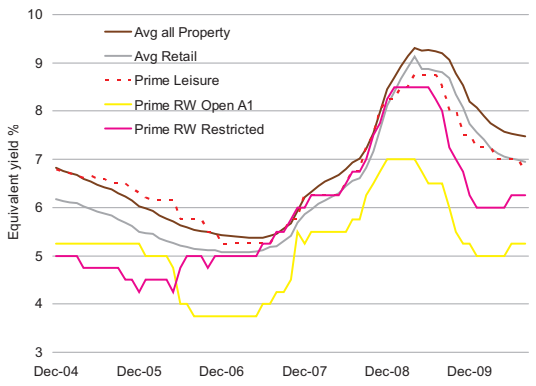
Linked to this demand is the continued success of the cinema. Admissions have grown annually for the last 3 years, connected not only to good product, but also investment into the circuits via new digital / 3D technology. To demonstrate this, when "Beowulf" was launched in 3D in November 2007, it appeared on 52 screens grossing £2.754 million. "Up", in October 2009, opened in 400 screens grossing £20.80 million, whilst Avatar in December 2009 opened in 468 screens grossing £71.50 million. For the first time, we believe the customer will now choose their cinema by reference to experience, as opposed to the closest to their home. This is crucial in assessing the micro investment decisions of quality, demand and longevity.

This is a long-winded way of saying that stock picking is key. However, we believe there are significantly more schemes than the restricted 'prime' definition would suggest. In no particular order, consider the following key criteria when investing:-

- Dominant cinema operated by one of the top 4 operators, or if not, would attract demand from this prime list;
- Out / edge of town scheme with sufficient parking and ease of access – consider underlying residual value e.g. Silverlink Leisure Park;
- Re-gear prospects – most cinema / big box operators will seek to re-gear once lease expiry is less than 10 years away. Opportunity to introduce index-linked rents or assist operator with capital for new technology e.g. Valley Leisure Park, Croydon;
- In town schemes which feed off retail environment, but are not overly reliant on 'wet' / late trade e.g. Brewery Quarter, Cardiff and The Gate, Newcastle;
- Asset management potential – could be rental growth prospects, or more likely a mix of growth / physical asset management, such as pub / hotel, food retail, residential etc. e.g. Great North Finchley and Theatre District, Milton Keynes;
- Flexible layout and preferably outside space for restaurants. Increasingly, operators are demanding external eating / drinking areas and will pay rent for it.

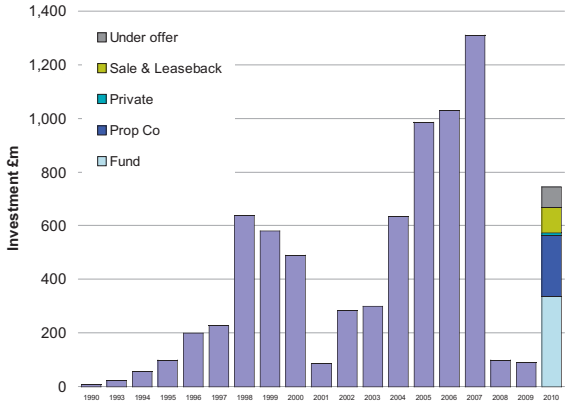
Data and contacts

Yields



Source: Savills, IPD

Leisure investment volume



Source: Savills

Absolute Prime <£15 million, 15 yrs unexpired, best covenants/retail environment **+/- 6.75%**	**Prime Pure Leisure** e.g. Crawley Leisure Park **+/- 7.00%**
Good secondary e.g. Grants, Croydon **+/- 7.50%**	**Standalone prime "box" - London** **Best regional** e.g. Virgin Active, Mill Hill **+/- 6.50%**

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