UK Commercial Leisure Bulletin

Summer 2011

"More sophisticated buyers have recognised that the leisure occupational market has remained remarkably robust"

Image: Theatre District, Milton Keynes. Sold on behalf of RREEF for £17m to Bursha Holdings

- Overall the leisure economy has had a comparatively good recession. While there are still significant headwinds out there, we do expect to see a staged recovery at a regional level from 2012.
- Tenant demand in the restaurant and pubs markets remains selective, but there are operators out there with expansion programmes.
- Investor demand has picked up sharply for leisure investments, both at the prime end of the market and where there are asset managment opportunities.

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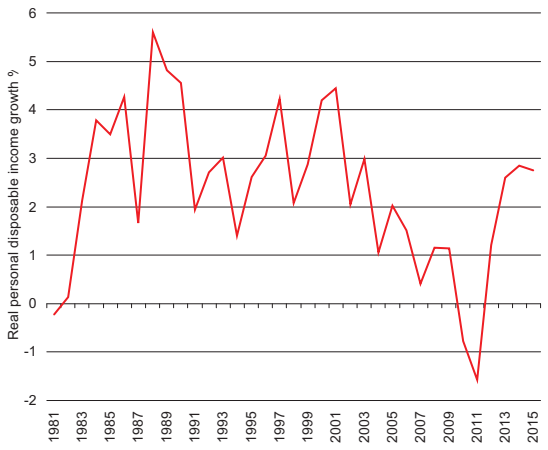
Consumer trends

Consumer recovery ahead, but which parts of the country will lead and lag?

Consumer confidence remains firmly negative, and perhaps quite likely so given the multiplicity of headwinds including high inflation, concerns about public sector austerity, a falling housing market and high unemployment. However, we believe that many of these headwinds will soften in 2012 and the recovery will begin. In this piece we focus on the shape of the recovery and which regions will be the leaders and laggers in terms of spending patterns.

The biggest challenge to the consumer recovery is the current imbalance between inflation and earnings. With average earnings growth running at only 2% per annum the UK consumer is facing the first year of falling real incomes for nearly 30 years. Real personal disposable incomes and earnings will continue to fall until inflation slows, and we believe that this is unlikely to begin until the middle of 2012.

Real personal disposable incomes will not begin to rise until 2012



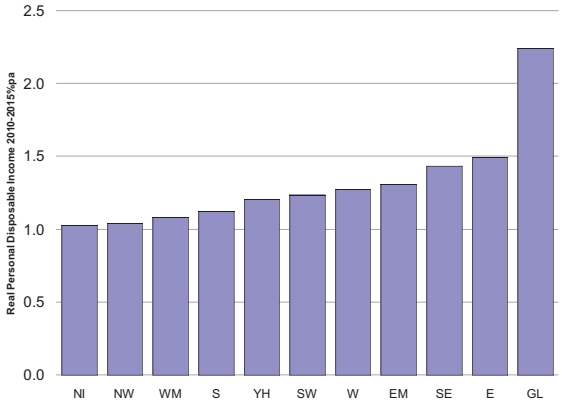
Source: ONS, Oxford Economics

2012 will see both a slowing in the rate of inflation, primarily due to the removal of VAT effects, and also the beginnings of an improvement in average earnings. However, the pace of the recovery will be firmly two-speed, with the South of the UK delivering a much faster recovery in real incomes than parts of the North.

Indeed, by 2014 the rate of income growth in the fastest growing region (London) will be double that of the slowest growing region (Northern Ireland). As we pick up elsewhere in this report, these regional differentials are already being seen in leisure operators expansion plans, and in the spread between regional rental growth patterns.

This phased recovery is nothing new to the UK, with the normal shape of a recovery being outwards from London. Indeed, given that London saw one of the largest falls in real incomes it is inevitable that it will see the strongest recovery. However, for leisure operators and retailers alike it is important to note that Greater London and the East are the only regions of the UK where real income growth will have returned to its boom level by 2015.

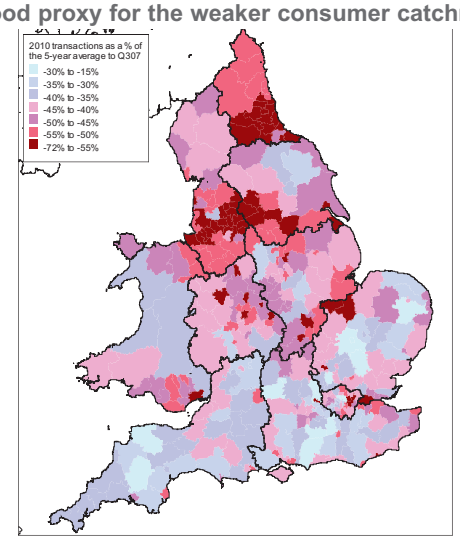
The rate of growth in real incomes between 2010 and 2015 will be split between the South and the rest



Source: Oxford Economics, Savills

The varying pace of the recovery will compound some existing structural problems at a regional and sub-regional level. Given the UK consumer's obsession with home ownership, the state of local housing markets is a major driver of consumer confidence and behaviour. Low levels of housing turnover and high levels of repossessions are being seen in the same areas of the country, and these are where we expect consumer confidence and spending to be weakest.

Areas where housing turnover remains low are a good proxy for the weaker consumer catchments



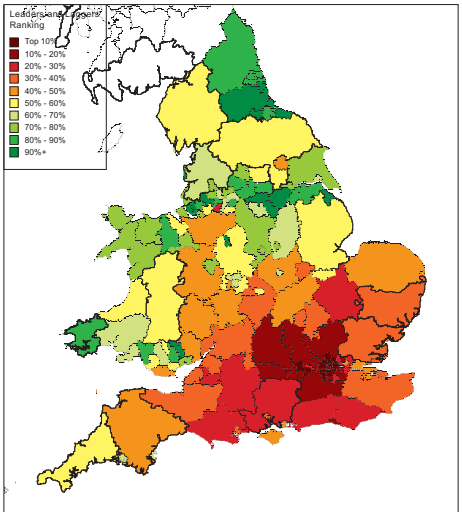
Consumer trends

Furthermore, if we accept that housing market and consumer recoveries are intrinsically linked, then the pace of the housing recovery at a sub-regional level should give a good indication of the leaders and laggers in terms of the likely recovery in consumer spending.

The residential research team at Savills have examined the shape of previous recoveries in the UK housing market, and have come to the following conclusions. First that the more equity rich areas of the country (predominantly London and the South) tend to lead the recovery, showing the strongest growth over the first five years of that period. During that time the lagging regions deliver virtually no growth in house prices. However, the second stage of the recovery sees the lagging regions delivering higher house price growth than the leading regions, as their own local economies reinflate.

The chart below shows the leading and lagging areas of the country in the last residential property cycle, with the darker colours showing those that will recover soonest. While the story is not as simplistic as a North/South divide, it does support our projection of a two-speed recovery in spending over the next five years.

House price recovery - the leaders and laggers

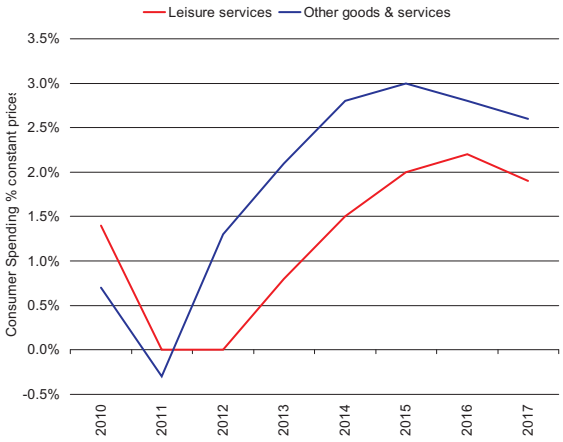


Source: Savills

So what does all this means for spending on leisure? We have demonstrated in previous issues of this bulletin that leisure spending is less volatile than some other areas of retail spend. How is this theory holding up in the face of the relatively unique economic situation that we are currently experiencing?

The latest official statistics for consumer spending point to a marginal contraction in overall spending in 2011, while spending on leisure services remains flat. As the consumer economy begins to recover in 2012 then spending on goods and services other than leisure services begins to accelerate faster, compensating for the deeper contraction in the wider economy in 2009 and 2010.

Spending on leisure continues to be less volatile than other areas



Source: Oxford Economics, Savills

Digging into the components of "leisure services", the hotel sector is expected to have the strongest bounceback in 2012, driven in part by the Olympics. Recreational & Cultural services, including cinemas, bingo and other non-food related services, is also forecast to show positive spending growth next year, while consumer spending in bars are restaurants experiences its second year of marginal contraction.

Overall it would seem that the leisure economy has had a comparatively good recession. Consumers seem to have traded downwards in terms of luxury, but by no means have given up on the leisure experience despite rising taxation and falling real incomes.

The inflationary pressure on real incomes will begin to reduce from 2012 (barring any further macro-economic shocks), and thereafter we expect to see a staged recovery similar to that out of previous recessions. There are still headwinds out there, particularly the question over the timing and pace of the inevitable rises in the base rate, but we remain positive about the prospects for consumer behaviour in the equity-rich catchments around the UK.

Market review

The outlook for the remainder of 2011 remains challenging for the leisure market, as the government austerity measures have begun to bite. Household budgets will be hit further as cost inflation increases and wage inflation decreases. In a shrinking market, the battle for customers will intensify.

Strong operators with good propositions will be able to thrive but only at the expense of their competitors. The impact is expected to be felt very differently across the regions with the South East, and London in particular, offering growth opportunities in the lead up to the Olympics.

The banks have played a very important role thus far in 2011, and will continue to do so in the future as they support or control businesses within the leisure market. Whilst we don't believe the banks will flood the market with distressed property, we have begun to see signs that they are taking more decisive action. We would cite Skydome,Coventry as an example, where Savills have recently been instructed to sell this asset of administrators Deloitte.

Restaurant

Eating out remains the UK's most popular leisure activity and continues to be one of the most dynamic sub sectors within the Leisure market.

The first 6 months of the year has represented a difficult trading environment for the restaurant operators.

Discounting will continue to be a theme, however a word of caution to operators who employ this tactic for an extended period of time, as whilst it may provide short term gain it could also provide long term pain! It is a dangerous precedent to target customers who are seeking a discount, as the clientele becomes less loyal, with the core customer base often becoming ostracised.

Consumers have become more discerning and are able to make informed choices about where they go and what will deliver value, particularly with the availability of the Internet.

Two relatively new brands that have embraced the consumer are Jamie's Italian and Cote, who in the main have centred their acquisition programme around London, which as highlighted previously is a considerably more buoyant market than the rest of the country. The main reason behind their success, though, is that they delivered what consumers want- a value proposition in terms of menu, service and price point.

Consumers eating out tastes are forever becoming broader and more sophisticated. Mexican chains have become the latest phenomenon with operators such as Wahaca who are due to open their fifth restaurant in Westfield, Stratford leading the charge.

The stalwarts of the restaurant market -Tragus / Gondola and Restaurant Group we expect will continue on their aggressive expansion plans, as the polarisation in the market between the weak and the strong will drive further consolidation.

Other operators we expect to aggressively expand are Wagamama who have recently been bought out by Lion Capital, together with Prezzo,Las Iguanas and TGI Fridays. Well run restaurants and restaurant companies can prosper in this difficult climate, as whilst there are undoubtedly challenges to be met, operators have to acclimatise to the ever changing environment and ensure they are at the top of their game!

Pubs

Without doubt, economic slowdown and changes in legislation have seen the hospitality industry facing challenges. Consumers have re-evaluated their spending and operators have been forced to make significant changes. 2010 was a difficult year and whilst many of the branded, managed house operators operators have managed to navigate through the stormy waters, many independent operators have had a much more difficult time.

Although the number of public house closures has fallen from the reported 50 per week in 2009 to around 30 at present, with Punch Taverns announcing earlier this year that it intends to sell approximately 2,300 pubs over the next five years and other pub companies likely to follow suit, the rate of closure may well increase once the austerity measures are felt more deeply.

Whilst many of the 'bottom-end' pubs are being purchased for cash or low levels of borrowing, more successful businesses are requiring funding, which is being thwarted by a lack of finance and so sales to independent operators within the trade are relatively few and far between. Sales of pubs for conversion to alternative use therefore continue at pace. For the six months to the end of June 2011 Savills has sold 65% of pubs for alternative use compared with 60% last year.

2010 did see the return of merger and acquisition activity following a dormant few years with major takeovers including Italian restaurant chain Carluccio's agreeing to a £90.3m takeover offer from Landmark and Mitchells and Butlers selling 333 pubs to Stonegate Pub Company, a new company funded by TDR Capital. The £373m deal equated to a multiple of 7.2 against EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation). This has continued with the attractiveness of good quality food-led

Investment trends

businesses highlighted when Geronimo Inns was acquired by Youngs in December 2010 for £60m. Greene King subsequently paid £53m in April 2011 to buy the Real Pub chain of 14 London based pubs. The deal involved 13 freeholds and one leasehold. The chain had an average weekly turnover of £24,500 and a forecasted average EBITDA of £450,000. This follows their £56m acquisition of the Cloverleaf carvery and pub chain with 12 sites in the Midlands and the north of England and a further 10 sites in the pipeline.

In conclusion, we expect to see the 2011 pub market characterised by pub companies and brewers continuing to look for managed house opportunities and rationalise their under-performing tenanted estates.

Investment review

In the last Savills Commercial Leisure Bulletin in Q4 2010, we suggested the following:-

- Prime initial yields for leisure were +/- 6.75%;
- Prime leisure yields were therefore at their 5 to 10 year average discount of 150 bps to the equivalent prime open A1 retail initial yield of say 5.25%;
- Our definition of prime leisure was a relatively small pot of properties where leases were at least 15 years unexpired, let to the best covenants, in the best locations (adjacent to a retail anchor) and crucially less than £15 million quantum lot size;
- Buyers in the leisure sector were almost exclusively UK funds or equity rich PropCos, as bank debt was almost non-existent;

What's changed in Q1 / Q2 2011?

- Prime leisure yields are now +/- 6.25%, therefore at a discount of approximately 100 bps to their prime open A1 retail equivalent;
- The pot of properties defined as prime is much broader, as witnessed by the sale of Rotunda, Kingston-upon-Thames for in excess of £50 million at a net initial yield of 6.33%;
- Whilst not formally tested, we would argue that for absolute prime leisure, a net initial yield of 6% could be achieved where the lot size, trading platform and security of income were bullet-proof e.g. The Parkway, Bury St Edmunds, or Silverlink, Newcastle-Upon-Tyne;
- The pot of buyers is also larger as there are at least two UK banks offering debt against prime and non-prime assets e.g. 65% leverage for the purchase of Theatre District, Milton Keynes (£17 million).

What Has Happened To Create This Quantum Shift?

It is our belief that a slightly more sophisticated buying market has recognised that the leisure occupational market has remained robust. There are of course exceptions, but in the main, cinemas, restaurants and café bars, have been trading well through difficult economic conditions, whereupon occupiers still have demand for strong trading locations.

Whilst dangerous to compare like for like trading on the retail high street or out of own retail locations, there remains a degree of affordability in leisure rents and the more successful operators have not committed to excessively marginal locations. In difficult times, this stability can be quite appealing. Of course, as we have commented many times before, when the market turns for the better, the level of growth in the leisure sector will not keep pace with its high street or retail warehouse equivalent, but for the moment, its defensive qualities are proving attractive.

In terms of the type of assets being traded, there is appears to be a polarising of quality and pricing, were buyers are more sophisticated, and in turn, consider carefully the trading platform of these leisure assets. Any lack of security offered by a poor trading history, cannot always be compensated by price as demonstrated by the current inability to sell assets such as VUE / Tiger Tiger in Aberdeen. In the main, the leisure assets acquired over the first two quarters of 2011 have either represented defensive stock or much more risky asset management opportunities offering double digit rewards if the letting strategy is successful.

The Circus, Manchester currently being sold by LaSalle Investment Management represents a good example of defensive, city centre stock whereby at least 50% of the value is pegged to Premier Inn (Whitbread Plc). At the time of going to press, this asset was under offer at just over £20 million at a net initial yield of circa 6.50%. We understand that this is being bought by a private Middle Eastern trust with a reasonable proportion of debt. Odeon, Epson is also in the market which can be bought for £9.4 million (6.75% net initial yield) which is arguably let to the strongest covenant in the leisure sector for 13+ years in a high street location, in a wealthy London borough.

At the other end of the scale, "risk/reward" asset management plays have been committed to by the likes of Mansford Holdings, who recently acquired Millennium Plaza, Cardiff for just over £10 million. Given the level of contracted income and significant void liability, this reflected a net initial yield of sub 5%. However, Mansford Holdings and their agents have already lined up 35,000 sq ft of restaurants to fill the vacant space, which is likely to convert into a running yield of well in excess of 7% with more lettings to come.

Investment Trends

Bank lending

In this section of the report Julian Bentham, a director in Savills' valuation team who specialises in valuations for loan security purposes, examines the current lending environment. If you have any queries on the current and future lending environment for property investment and development, or require further information on Savills' valuation services, then Julian can be contacted on 0207 409 9957.

Although the commercial property finance market continues to struggle with the legacy of the pre credit crunch lending, the last the 12 months has seen a strong increase in banks appetite to lend. The market continues to be dominated by the Germans although it is becoming more diverse with many previously established players returning to the market alongside several interesting new entrants. Those with liquidity and a desire to lend are mainly concentrating on the office, retail and logistics sectors with a focus on prime assets with few prepared to lend on secondary and with development finance still almost non-existent.

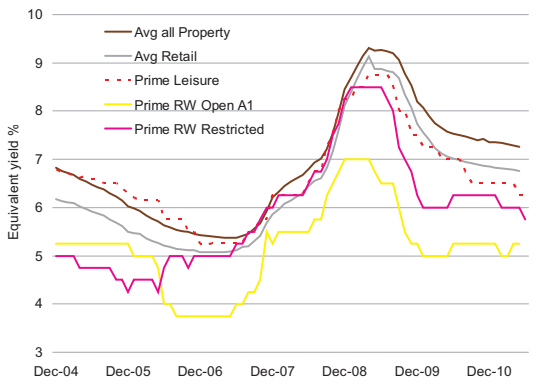
Generally the banks do not have a specific positive or negative policy towards leisure although it continues to be less favoured than the mainstream sectors reflecting the challenges which face the market in these post recession/slow recovery times. However, over the last year banks have become increasingly willing to look at the sector with emphasis on good quality standing investments. Banks are however nervous of standalone assets and prefer to look at schemes which are adjacent to retail warehouses and form part of an out of town agglomeration. Maximum loan values remain at 65%, whilst margins for the best product are in the range at 200-250 bps. Finance deals continue to be relationship driven and where banks are active in the sector they will follow their preferred clients with long established track records. Where the relationships are especially strong, then anything is possible, even development finance.

The biggest factor facing the financing of the market is tenant covenant strengths. Regardless of the long leases which are prevalent in the sector, once a bank starts digging into the financial strength of the tenant then they often become nervous. Nevertheless deals are being done. One of the largest financings this year has been Barclays Eastern Region's funding of the purchase of the £17million Theatre District, Milton Keynes which was acquired by a private investor in June. From a funding perspective, the appeal of the deal was the long, good quality income stream, secured against an asset which has been well managed and should see rental growth over the short/medium term. This deal defines banks attitude to financing the leisure market, where any prime assists will be considered. Furthermore, it hits the sweet spot of £10-20 million of debt finance in a single transaction.

We expect that banks will continue to be selective for the remainder of 2011, although we are aware of several banks currently considering some large scale leisure deals. This should result in 2011 being a strong year for the leisure finance market.

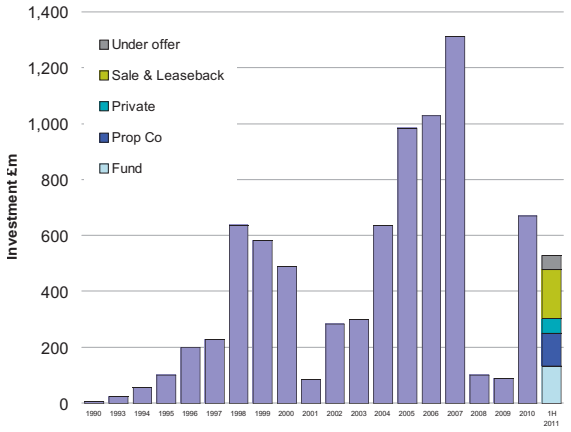
Data and contacts

Yields



Source: Savills, IPD

Leisure investment volume



Source: Savills

Absolute Prime <£20 million, 15 yrs unexpired, best covenants/retail environment **6.00%**	**Prime Pure Leisure** e.g. Crawley Leisure Park **6.25%+**
Good secondary e.g. Grants, Croydon **6.50%**	**Standalone prime "box" - London** **Best regional** e.g. Virgin Active, Mill Hill **6.50%+**

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