

Licensed Retail

Spring 2010

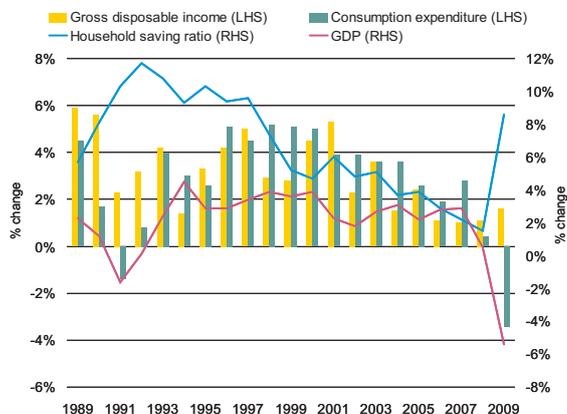
Occupier demand improves for quality premises in good locations, despite generally fragile confidence



- Signs of operational resilience, with some operators reporting positive like-for-like sales growth in 2009, although at the expense of margins in some cases.
- Some large multiple operators are pressing ahead with expansion into 2010, although at a lower rate than previously planned, looking to capitalise on increasing incentives offered by landlords.
- Investor appetite for pub/restaurant assets is returning.
- The publicised difficulties facing the tenanted pub companies has resulted in a divergence in pub and restaurant yields.
- The stronger covenants and locations typical to the branded restaurant sector mitigated the outward shift in yields, compared to pubs. However, both sectors saw yield hardening over the second half of 2009.
- Prime yields outside of London are now in the region of 6.5% for pubs (Central London achieving between 5% to 6%) and 6% for restaurants. A further 50bp fall is forecast over the next 6 months.
- Central London commands the most expensive rents, with top rents of between £45-50 per sq ft. However, the use of rent free periods has reduced the net effective rent paid by tenants.
- The 2010 Rating Revaluation may present some difficulties for operators and landlords/investors.
- Location should be key when assessing values as a strong location will ensure that if an occupier fails there will be interest from elsewhere.
- Licensed Retail's future fortunes will be dependent on the return of consumer confidence, but occupier demand remains for quality premises in good locations.

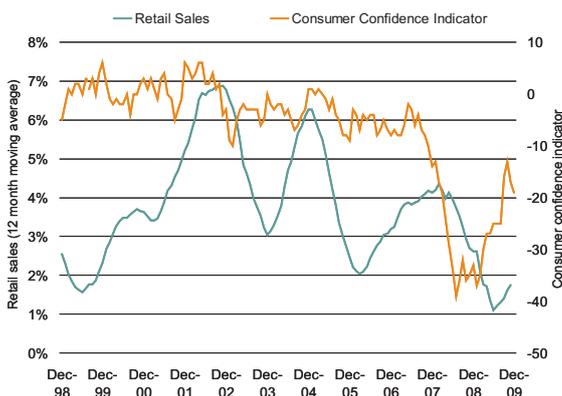
Market performance

Declining discretionary spend....



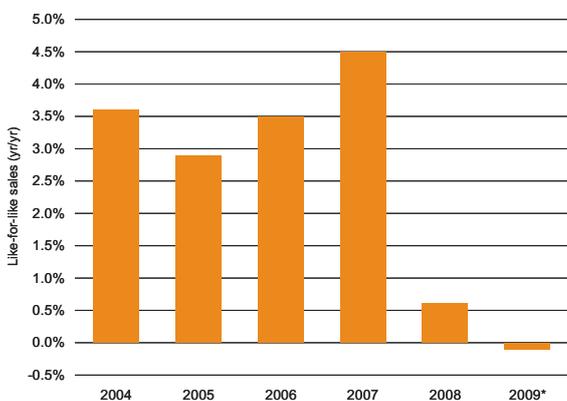
Source: ONS

...but consumer confidence has improved



Source: ONS; GfK NOP

Weakening operator performance



Source: Operators Annual Report & Accounts

Note: *Based on interim 2009 results in some cases
Average based on annual like-for-like sales growth reported by Mitchells & Butler; Whitbread; Punch Taverns (managed estate); Tragus Group; The Restaurant Group; JD Wetherspoon; The Restaurant Group; Marstons; Greene King

The pub and restaurant sectors have seen marked expansion over the last 10 years, largely driven by consumer spending growth. The recession has had its toll on the sector, particularly on the traditional pub operators, yet some have managed to weather the storm.

Prior to the recession disposable income levels had been growing by an average of 2.7% per annum, with discretionary spending in excess of this with annual growth of 3.8%. It was this growth that supported the expansion of the pub and restaurant operators. For example, during 2006 and 2007, Gondola, who operate restaurant brands Pizza Express and Zizzi, expanded their portfolio of restaurants by 44. JD Wetherspoon expanded by 149 outlets between 2001 and 2007. Operational performance over this period mirrors this. Average like-for-like sales growth across the major branded operators was 3.6% per annum between 2004 and 2007, peaking at 4.5% in 2007.

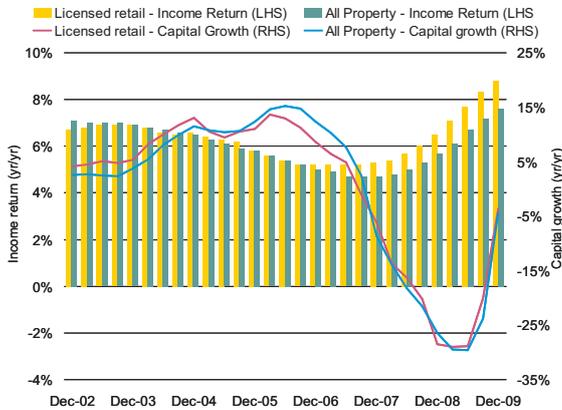
Yet, once the recession took hold in 2008, operators started to feel the pinch. While some have continued to report positive like-for-like sales it has tended to mean a squeezing of margins as operators increased marketing drives and launched 2-4-1 deals in order to boost trade. Those who took on significant debt prior to 2007, to fund expansion, were the most exposed to the downturn. Pub operators who lease pubs to tenants in particular felt the full brunt, off-loading in some cases large parts of their estate.

With consumer confidence returning and retail sales improving, it would appear that the worst of the recession may be over. The multiple operators are showing tentative signs of improved confidence by pressing ahead with expansion, although at a lower rate than previously planned. In some cases this planned expansion is in order to capitalise on the increasing incentives offered by landlords. JD Wetherspoon plans to open 250 new pubs over the next 5 years. Gondola have 11 new restaurants in the pipeline having opened 36 new premises during 2008/9. Tragus, despite having a previous target of 25 new sites a year, aim to open 15 new restaurants a year as part of their Cafe Rouge, Bella Pasta and Strada chains. Pub groups Greene King, Marstons and Mitchells & Butlers are also back on the acquisition trail. Greene King have already spent £43m acquiring pubs from competitors. Other notable transactions include the Heineken financed purchase of 425 pubs from the Globe Pub Company for £180m by EBP Pub Company.

Despite this future expansion, operators still remain cautious about future trading. Yet, despite this uncertainty, investor appetite for assets has started to return.

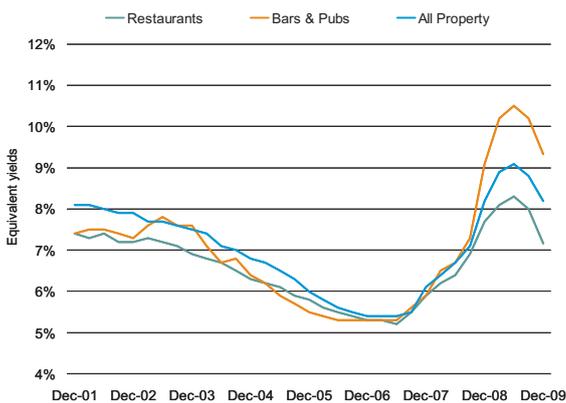
Investment performance

Income returns outperform



Source: IPD ©

Equivalent yields already hardening



Source: IPD ©

Indicative top rents in prime retail locations

	Restaurant/ bar (per sq ft)
London - West End	£45-50
Birmingham	£35
Bristol	£30-35
Cardiff	£35-40
Edinburgh	£30-35
Leeds	£30
Liverpool	£35-40
Manchester	£35-40
Southampton	£28

Source: Savills

The question is then, what is attracting investors to the sector?

As debt availability continues to be restricted, the smaller lot sizes typical to the sector have boosted investor interest as they are relatively easier to finance.

The enhanced income returns offered by Licensed Retail assets have also been an attraction, as the recession and subsequent falls in capital values have refocused investor attention on income. Prior to 2007 there was little differential in income between Licensed Retail and All Property, but once the down-turn took hold in 2008 a gap developed. As a result income returns on Licensed Retail have averaged 6.8% per annum over the last 3 years, exceeding the 6.0% achieved for All Property.

This outperformance has been supported, in part, by the slower decline in rents compared to other property sectors. According to IPD, rents for All Retail fell by approximately 6% during 2009. In comparison Licensed Retail saw a smaller 1.2% fall. Continued competition between operators for the best sites have mitigated any dramatic rental falls as have the rent free periods offered by landlords to attract tenants. Indicative top rents peak at £45-50 per sq ft in London and range from £28 to £40 per sq ft across the major regional cities. These top rents reflect those quoted in prime retail environments in the respective cities. However, the use of rent free periods means that the net effective rent paid will be below these levels. The length of rent free periods offered appears to have reached a peak suggesting that we may have hit the bottom.

While in-town/prime locations tend to attract the higher rent, reflecting the greater turnover potential offered by these locations, out-of-town sites can still prove attractive to operators. The lower rents, rates and service charges, typical to out-of-town locations, mean that these outlets can produce higher margins than those in more expensive locations. Therefore, these types of assets can offer attractive investment opportunities.

Improved investor interest has already fed through to yields. However, a divergence in covenant strength has opened a yield gap between restaurants and pubs. The well publicised difficulties in the tenanted pub sector have dented covenant perceptions, which have translated through to yield movements. According to IPD, which is considered as an average measure of the market, pub yields softened by approximately 517 basis points (bp) between Q207 and Q209. In contrast restaurant yields softened by 303bp. It is worth noting that this does not reflect movements in prime yields.

The stronger covenants and locations typical to the branded restaurant sector no doubt helped to mitigate

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the outward shift in yields. The same is also seen for those pub assets with strong tenant covenants as they are valued more favourably. This was demonstrated by the recent valuation, by Savills, of a portfolio of pubs let to JD Wetherspoon where yields ranged from 6.25% to 7.5%.

As seen across property in general, yield hardening became apparent over the second half of 2009. Prime yields for Licensed Retail have seen marked downward shifts since May driven by the weight of money targeting the sector and lack of supply.

Prime yields are now at circa 6.5% for pubs and 6% for restaurants, with Central London pub investments already achieving between 5% and 6%. For example, the London pubs sold at auction by Enterprise Inns in the final quarter of last year achieved an average yield of 5.79%. These were subject to 35 year leases granted back to Enterprise with sale prices averaging £1.96m. Further transactions are expected this year. For restaurants, a recent transaction in Soho where the tenant was a branded operator achieved a 5.25% yield.

Despite the apparent bounce back in the investment market, a certain degree of caution should still be exercised. Operational uncertainty still exists, meaning that values cannot be based purely on the current occupier. Locational factors are also of significant importance and yields in respect of properties occupied

by tenants who are regarded as strong covenants, such as Enterprise Inns, will vary and reflect the underlying quality of the site. This demonstrates the importance of location when assessing values as a strong location will ensure that if an occupier fails there will still be interest from elsewhere.

Redevelopment potential

The recent increase in purchaser interest for pubs have also been driven, in part, by the redevelopment potential for alternative uses. However, there are a number of key issues that must be considered when assessing the potential for conversion or development.

A pub (A4 Use Class) can generally be converted to a shop, fronted office (A2), café or restaurant without planning permission being required. However, if you wish to consider other alternative uses one of the first steps should be to check whether any local planning policies protecting against the loss of community facilities, which can include pubs, exist.

Where a pub protection policy does exist it may be necessary to demonstrate that there are alternative premises nearby and that, in its current use, the pub business is not viable. Prior to a planning application being submitted you will usually be required to market the premises to confirm the level of interest from potential purchasers. Agreement should be reached with the Council on the length and extent of the

Planning & Urban Design case study: Securing a change of use, Hunters Lodge

Hunters Lodge was a poor quality, vacant pub property with significant parking and garden areas located within a residential area, making it attractive for residential redevelopment. Several unsuccessful attempts had been made to secure planning permission for change of use to residential, but these had been refused due to proximity to a noisy arterial transport route and design concerns.

In order to overcome this, Savills Planning & Urban Design developed a series of layout options for

residential development and carried out extensive pre-application discussions prior to submission of an application. This also involved providing a detailed 'Design & Access Statement' including 3D images of proposed frontages.

The outcome from this was an outline planning consent for residential development, which provided the client the option to either sell the site with planning, therefore enhancing its original value, or to carry out the development.



Outlook

marketing process, plus the price, from the outset. A minimum of 6 months marketing is normally expected although in some instances it could be up to 18 months. A detailed and robust marketing report should also be provided to the Council with a planning application.

What is key when pursuing a change of use or redevelopment proposal is a close working relationship with the council. This can be essential to overcoming potential planning obstacles. Part of this will include providing good quality presentation material to justify design and ultimately the change of use.

Outlook

The truth is that we are not out of the woods yet. GDP annual growth was -5.2% for 2009, making this the longest and deepest recession of recent times. While consumers will not be basing their spending behaviour on what the National Statistics Office says, consumer confidence remains on shaky ground as demonstrated by the dip in confidence reported in December.

Operator confidence may be returning, but there remains a certain degree of caution for the year ahead. Disposals of under-performing pub assets will continue this year, but at a lower rate than seen in 2009. Despite shaky operational confidence we expect that prime yields in the Licensed Retail sector will continue to come in by a further 50bp over the next 6 months, although there will be individual variances reflecting location and operator.

The 2010 Rating Revaluation is also set to have implications. Every 5 years the Valuation Office Agency undertakes a revaluation of all non-domestic

properties in order to reflect any changes to rental values over the preceding 5 years. As such, the 2010 rating revaluation comes into effect on 1st April 2010, based upon market conditions as at 1st April 2008. Occupier perceptions are that rents have fallen since 2008, which could translate through to higher rates bills that do not reflect current market conditions. Whether this is the case or not, it is worth monitoring as an increase in rates, combined with potentially difficult trading conditions for 2010, could put extra pressure on an operator's bottom line. For those investors/landlords sitting on empty premises, this and the effects of the changes to empty rates relief, could have significant cost implications.

As in the mainstream retail sector, Licensed Retail's future fortunes will be dependent on the return of consumer confidence. Operators' expansion plans suggest that there will continue to be demand for quality space in good locations. This, combined with the smaller lot sizes, enhanced returns and the redevelopment potential offered by certain assets, should continue to attract investors.

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Additional services can be provided including Landlord & Tenant advice, valuation, planning and research advice on all aspects of commercial leisure. Regular appointments to act arbitrator or independent expert in respect of rent reviews and other disputes are received by the Leisure team from the RICS and other professional organisations.

Savills Planning & Urban Design

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Savills Planning & Urban Design can assist Leisure clients in viability testing development options, developing proposals, negotiating with local councils, preparation of specialist reports and surveys and the submission and determination of planning applications.

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