Executive summary

- Low government bond yields and falling yields on mainstream UK commercial property are fuelling investor appetite for non-traditional real estate, such as leisure
- Leisure stock has the highest reversionary rent potential among IPD sectors and offers a strong track record of attractive risk-adjusted returns alongside low correlations to traditional real estate asset classes
- Upbeat consumer spending outlook to underpin further growth of UK leisure sector
- The sustainability of an operator’s business is key to successful investment in leisure real estate

Strong growth prospects for leisure as UK economy recovers

Leisure is, arguably, one of the most diverse sectors of the UK economy, catering to residents and tourists alike through restaurants, cinemas, casinos, bowling alleys, sport centres, spas, golf courses, etc.

Together, the leisure sub-sectors account for a growing and sizeable slice of the UK economy and are well-placed to benefit from the recovery in consumer demand. According to the latest ONS data, the leisure industry has more than doubled over five years to reach an estimated total turnover of £176 billion.

The leisure sector has been an area of focus for M&G Real Estate for a number of years and has been the feature of some significant transactions, including the Gala Bingo portfolio (£173m) and the Bannatyne health clubs portfolio (£92m) – evidence of our research-led approach to investment.

Fig 1: Revenue by leisure industry sub-sectors

<table>
<thead>
<tr>
<th>Leisure industry</th>
<th>Revenue (£ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Betting and gaming</td>
<td>91.1</td>
</tr>
<tr>
<td>Restaurants and food services</td>
<td>28.0</td>
</tr>
<tr>
<td>Pubs and night life</td>
<td>28.0</td>
</tr>
<tr>
<td>Sport activities</td>
<td>15.0</td>
</tr>
<tr>
<td>Cinema, theatre and live entertainment</td>
<td>9.0</td>
</tr>
<tr>
<td>Recreational activities</td>
<td>2.3</td>
</tr>
<tr>
<td>Visitor attractions and other cultural activities</td>
<td>1.5</td>
</tr>
<tr>
<td>Health and business clubs</td>
<td>1.4</td>
</tr>
<tr>
<td><strong>UK leisure industry total</strong></td>
<td><strong>176.2</strong></td>
</tr>
</tbody>
</table>

Source: Office for National Statistics (ONS), Annual Business Survey 2013

“The leisure industry has more than doubled over five years to reach an estimated total turnover of £176 billion.”

1 For the purposes of this paper, we are using the Investment Property Databank definition for the leisure sector, which excludes hotels.
The standard method for estimating the contribution of an industry to the UK economy is to calculate its gross value added (GVA), which is then adjusted for taxes and subsidies and used in overall gross domestic product (GDP) calculations for the country as a whole.

Household spend on recreation and culture is now on the rise. Restaurant turnover in the UK, for example, has increased 39% since 2010 to reach £21.6bn in 2014, with dining out becoming an increasingly regular experience for many. A wider variety of leisure activities on offer, combined with an increase in ‘staycations’ as a result of the financial crisis, has driven significant growth in household expenditure towards these leisure activities.

The UK leisure industry is also a major source of employment, providing 2.2 million jobs in 2013. Its contribution in terms of employment (10%) is significantly higher than its contribution to GVA (3.5%). This can be largely explained by the prevalence of part-time jobs and the high labour intensity of many leisure activities.

Similar to the retail sector, drivers of the leisure industry are closely correlated to the health of the overall economy, and in particular to consumer confidence, consumer spending and disposable income levels.

The UK economy grew 3.0% in 2014, its strongest expansion since 2006 and the pace of growth has been largely maintained so far this year. Notably, activity actually accelerated across the service sector and particularly in the Hotels & Restaurants segment. Indeed, there was continued growth momentum across all the four main service sub-sectors.

Going forward, the macro-economic picture remains positive for the medium-term prospects of the UK leisure industry. Forecasts for UK consumer spending are upbeat and real disposable incomes are on a steady upward path in line with strengthening wage growth, low inflation and low interest rates. At present, the UK economy is expected to grow by 2.4% in 2015, underpinned by a healthy 2.7% rise in household consumption.

“Forecasts for UK consumer spending are upbeat and real disposable incomes are on a steady upward path in line with strengthening wage growth, low inflation and low interest rates.”
Diverse and transparent real estate market

From a real estate perspective, leisure arguably benefits from greater transparency than many other so-called alternative property sectors, potentially reducing the risks for investors.

The sector also enjoys great diversity – due to the wide variety of the businesses it includes – which means that it can offer attractive opportunities across the spectrum of investors’ return and risk requirements.

The range of opportunity can be further expanded by grouping together a number of smaller assets into a portfolio large enough to meet the scale requirements of institutional investors. In the case of Gala Bingo and Bannatyne acquisitions, our approach was to enter a lease with the parent company across a wide portfolio of properties – 52 bingo clubs and 39 health centres, respectively.

Investors can also gain exposure to the leisure sector through certain retail malls that are increasingly positioning themselves as leisure destinations with a combination of restaurants, cinemas, gaming arcades and other family attractions alongside the traditional shops.

“Leisure arguably benefits from greater transparency than many other so-called alternative property sectors, potentially reducing the risks for investors.”

Where leases are linked to open market rents, investors are able to grow the level of income in their portfolio to a larger degree. Broadly, this is the case for tenants within leisure parks, particularly spaces occupied by food and beverage outlets such as restaurants. These are currently benefiting from buoyant consumer demand, as evidenced by the strong spending growth in the Hotels & Restaurants sub-sector (highlighted earlier). As a result, leisure park assets are experiencing stronger income growth within the leisure sector and – thanks also to relatively long leases and strong covenants – represent an attractive income-type investment.

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Spaces occupied by operators within the Leisure Other sector, on the other hand, are often tied into leases linked to inflation (capped and collared). Such leases are traditionally associated with lower leasing risk due to the relatively predictable rental cash flows. Long lease assets with inflation-linked rents are ideal for investors such as defined benefit pension funds who are seeking to hedge their own inflation-linked liabilities over a time horizon which is longer than typically available in the fixed income markets.

Potentially the riskiest assets within the IPD leisure segment are those with limited alternative use value such as stand-alone golf courses or theme parks. While the operators of these facilities may be tied into relatively attractive long lease agreements, a poor covenant could leave an investor with real estate with no income producing ability in the event of receivership (though conversion of land use to residential can provide be a longer-term exit strategy). For such assets, it is more important than ever to analyse the business of the tenant before committing to buying the property.

<table>
<thead>
<tr>
<th>Alternative sector</th>
<th>Sub-sector</th>
<th>Examples of UK operators</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leisure Park</td>
<td>whole or part</td>
<td>Bowlplex Ltd, The Original Bowling Company, Triangle Fitness Virgin Active Ltd, The Restaurant Group Gala Leisure Ltd, Cineworld Estates</td>
<td>Entertainment outlets, typically comprising a mix of cinemas, bowling alleys, amusement arcades and rides; also bars, pubs and restaurants in leisure park locations</td>
</tr>
<tr>
<td>Leisure</td>
<td>Cinema (non-park)</td>
<td>UGC, Odeon, Tragus Group, Vue Entertainment</td>
<td></td>
</tr>
<tr>
<td>Leisure</td>
<td>Theatre</td>
<td>Qdos Entertainment</td>
<td></td>
</tr>
<tr>
<td>Leisure</td>
<td>Holiday Resort</td>
<td>Center Parcs, Parks &amp; Leisure, Verdant Leisure, Champneys</td>
<td>Includes health farms</td>
</tr>
<tr>
<td>Leisure</td>
<td>Other</td>
<td>Bannatyne Fitness Ltd, Nuffield Health Wellbeing</td>
<td>Including swimming pools, sports fields, golf courses, marinas and animal parks</td>
</tr>
</tbody>
</table>

Source: IPD, M&G Real Estate; examples based on current tenants in M&G RE properties.
Tenant covenants key

The leisure sector features specific financial drivers that investors need to assess in order to formulate their portfolio strategies. Unlike investing in office properties which are generally not specific to any particular company, an acquisition of a leisure asset is generally an investment in the operating assets of the tenant’s business. That places a lot of importance on the sustainability and success of the operator. However it also fosters a much greater commitment from the occupier – while a company can relatively easily move its staff to another office, relocation is much harder for the owners of a leisure park, restaurant, cinema or bowling alley due to the generally greater customisation of the sites and importance of the catchment area.

For occupiers, requirements are also somewhat different for leisure assets compared to, for example, offices or warehouses. The key criteria are:

- **Location**: Clear visibility and access to the site. A local resident profile and forecast visitor flows that fall in line with the target market of the particular leisure brand and its activities.

- **Affordability**: The level of wealth and affordability in the area will dictate the entry lead price to the premises. This should generate a revenue stream that is both commercially viable and in line with the operator’s aspirational market positioning (be that high-end or budget).

**Total occupier costs**: Rents in the alternative sector, including leisure, are often linked to occupiers’ performance measures such as earnings before interest, tax, depreciation and amortisation (EBITDA) plus inflation-linked uplifts. Therefore any weakness in the occupier’s turnover is negatively reflected in the rental income.

Strong risk-adjusted performance

Our research shows that, over the past 25 years, the leisure sector provided the third highest average annual excess returns (4.3%) compared to other property sectors and equities, while the annual volatility was among the lowest (standard deviation of 8.9%). On a risk-adjusted basis, the leisure sector ranked second against all asset classes. In other words, after residential, the leisure sector has compensated the investor most per unit of risk.

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Against a backdrop of positive economic data, UK real estate continues to attract substantial interest from investors. Despite yield compression, property still represents good value against bonds (IPD All Property Equivalent Yield of 6.0% at end of Q1 2015 versus UK 10-year gilts at 1.6%).

<table>
<thead>
<tr>
<th>Fig 6: Risk-adjusted returns (1989-14)</th>
<th>Average annual excess return above risk free rate (%)</th>
<th>Standard deviation (%)</th>
<th>Sharpe ratio (ranking)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Property</td>
<td>2.6</td>
<td>10.5</td>
<td>0.25 (7)</td>
</tr>
<tr>
<td>Leisure</td>
<td>4.3</td>
<td>8.9</td>
<td>0.49 (2)</td>
</tr>
<tr>
<td>Retail</td>
<td>2.8</td>
<td>10.2</td>
<td>0.28 (6)</td>
</tr>
<tr>
<td>Office</td>
<td>2.0</td>
<td>12.0</td>
<td>0.17 (8)</td>
</tr>
<tr>
<td>Industrial</td>
<td>4.4</td>
<td>10.2</td>
<td>0.43 (3)</td>
</tr>
<tr>
<td>Residential</td>
<td>6.0</td>
<td>9.2</td>
<td>0.65 (1)</td>
</tr>
<tr>
<td>Equities</td>
<td>4.6</td>
<td>15.5</td>
<td>0.30 (5)</td>
</tr>
<tr>
<td>Bonds</td>
<td>2.6</td>
<td>8.4</td>
<td>0.31 (4)</td>
</tr>
</tbody>
</table>

Source: IPD Annual Digest 2014, Bloomberg, PMA
Property yields in the UK are compressing and approaching, or in some cases, even falling below their historic lows. Real estate fundamentals are also improving with the resurgence of the economy. We expect, therefore, that property returns over the medium term will likely be driven less by further yield compression and more by rental growth.

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This puts the spotlight on sectors which are most able to deliver those rising rents. Two-thirds of leisure stock tenancies currently show reversionary potential (ie leases that will revert to their current market rent upon expiry or signing or renewing of a new lease contract). That is the highest share among IPD sectors, so the leisure property sector is well placed to take advantage of medium-term real estate performance prospects, and should deliver relatively strong income returns.
“Over the next three years, we forecast that income returns from leisure assets will consistently beat those from the broad IPD All Property Index, making the sector particularly attractive for income-seeking investors.”

**Diversification benefits**

Over the past 25 years, the leisure sector provided high diversification benefits (second only to residential) against the main commercial real estate sectors, equities and bonds. At 0.84, the leisure sector is most highly correlated to the retail sector. This is not surprising since the two share similar demand drivers (such as levels of disposable income) and their real estate performance is primarily determined by the success of the operator’s business in driving income.

**Portfolio optimisation**

Our research shows that adding leisure to a commercial real estate portfolio can boost risk adjusted returns and improve diversification. The next question is how much to invest in leisure.

To this end, we have derived an optimal portfolio composed of leisure, retail, office, industrial and residential assets which would achieve the strongest risk-adjusted return based on the highest Sharpe ratio. The model allocations are derived from historic total return performance achieved by each property sector between 1989-14. We considered three separate scenarios each constraining exposure to different sectors to varying degrees.

The first scenario imposes no exposure constraints to any of the real estate sectors and is intended to identify the optimal leisure allocation that would achieve the maximum risk-adjusted return based on a portfolio with no risk guidelines. The second scenario better reflects a balanced portfolio typically comprising no more than 40% exposure to any one sector. Lastly, the third scenario builds on the second but constrains the residential exposure to 5% to bring it broadly in line with the IPD universe.

**Scenario one: no sector exposure constraints**

In the first constraint-free scenario the investor would have achieved the highest risk-adjusted returns based on a portfolio with 20% exposure to the leisure sector, 20% to industrial and 60% to residential. This is not surprising given that over the 1989-14 period, the residential sector compensated the investor more for the volatility incurred, with leisure providing the second highest risk-adjusted returns.
Scenario two: balanced portfolio

In the second balanced portfolio scenario, the maximum risk-adjusted return, with a Sharpe ratio of 0.52, is achieved with a portfolio composed of 40% each in leisure and residential sectors and 20% exposure to the industrial sector. Interestingly, the Sharpe ratio stays broadly the same for leisure exposure ranging from 20% to 40%, with a consistent exposure to the residential sector of 40% and an industrial exposure varying from 20% to 40%. In other words the investor would not incur any changes in portfolio risk with up to a 40% allocation to leisure and 40% to residential.

Scenario three: balanced portfolio with 5% limit to the residential sector

Finally, the third scenario builds on the previous balanced portfolio model but further constrains exposure to the residential sector to 5%, broadly in-line with the IPD universe. Here, the highest risk-adjusted return, with a Sharpe ratio of 0.42, is achieved with a portfolio comprising 40% in both leisure and industrial, 5% residential and 15% retail. Similarly to the second scenario, the change in Sharpe ratio corresponding to varying degrees of exposure to the leisure sector from 0 to 40% is minimal, ranging from 0.34 to 0.42. From a risk perspective therefore, this result supports the case for investing in leisure with incremental exposure to the sector providing a consistent risk-adjusted return to a portfolio.

Summary and strategic implications

The leisure industry is well-placed to benefit from the UK’s economic recovery, and particularly from the positive outlook for consumer spending. Real disposable incomes are on a steady upward path thanks to strengthening wage growth, while low interest rates are encouraging people to spend rather than save. Restaurants, cinemas and other leisure outlets are likely to be key beneficiaries.

In real estate, the positive macroeconomic backdrop for the leisure industry creates an attractive investment opportunity, particularly at a time of very low bond yields and improving investor risk appetite. The scale of the leisure economy as well as its potential to provide secure income streams further supports investors’ shift into alternative property asset classes such as leisure. Indeed the reversionary potential of existing UK leisure tenancies (66% - the highest share among IPD sectors), is likely to contribute to further investment into the sector.

Our research shows that leisure offers relatively strong risk-adjusted returns as well as portfolio diversification benefits based on historic total returns. Portfolio optimisation analysis confirms the benefits of adding leisure stock to a property portfolio to maximise risk-adjusted returns.
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“Portfolio optimisation analysis confirms the benefits of adding leisure stock to a property portfolio to maximise risk-adjusted returns.”

In the context of a balanced portfolio (Scenarios 2 and 3), the Sharpe ratio remained broadly constant with leisure exposures increasing incrementally between 0% to 40%. Thus any degree of exposure to the leisure sector in line with typical risk guideline constraints for a balanced portfolio (max. 40%), would not compromise the achievement of the required returns for additional risk, supporting the case for increasing allocations to the leisure sector going forward.

Reviewing long term revenue prospects of a leisure operator is of paramount importance when investing in the leisure property sector. We recommend that investors pay particular attention to the growth potential of local resident and visitor catchments required to achieve critical mass, the level of their disposable incomes as well as their propensity to visit the leisure activity repeatedly throughout a year. This careful due diligence of the business’ bottom line will in turn ensure sustainability of a property investor’s long term income and investment performance.

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