EDISON

Reasons to be cheerful

UK leisure ready and waiting

8 April 2021

At the third and hopefully final time of asking after lockdown, the UK domestic leisure sector appears primed for meaningful recovery, assuming a properly managed relaxation of COVID-19 restrictions. Industry confidence, newly confirmed in company updates and front-line surveys, is driven by lessons learned during the pandemic, notably pent-up demand on 2020 reopenings and the benefits of technology. It is also driven by the prospect of a benign structural environment after COVID-19 and positive consumer behavioural shifts, led by delivery uptake as a growth channel for hospitality. Likely continued curbs on UK residents' foreign travel, which may be reinforced by the very success of the UK vaccination rollout, are another positive for domestic leisure. While stock market valuations may no longer be highly discounted, for the victors in this brave new leisure world the earnings spoils may yet be startling.

Edison themes

As one of the largest issuer-sponsored research firms, we are known for our bottom-up work on individual stocks. However, our thinking does not stop at the company level. Through our regular dialogue with management teams and investors, we consider the broad themes related to the companies we follow. Edison themes aims to identify the big issues likely to shape company strategy and portfolios in the years ahead.

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The pandemic's silver lining

There is a grim irony that COVID-19's exacerbation of longstanding structural difficulties in UK hospitality has thrown up undeniable growth opportunity for well-funded businesses. Increasing availability of prime sites at ever cheaper prices and on more flexible terms and the erosion of competition (estimated loss of up to 30% of restaurants) with the consequent increased supply of high-quality staff stand in marked contrast to pre-pandemic chronic overcapacity, frequency of 'me too' product, intense cost pressures and narrow margins, compounded by Brexit-led economic uncertainty. To this end, surviving companies have strengthened finances and accelerated implementation of initiatives, such as the use of technology in managing labour costs and driving customer loyalty. Delivery has predictably excelled, offering scope for operators with the right scale and brands.

Pushing at an open door

In addition to the boost to domestic leisure from persisting uncertainty about foreign holidays in 2021, there is welcome industry consensus ahead of reopening about pent-up consumer demand and a treat mentality, as shown by buoyant trading after the spring 2020 lockdown and despite subsequent and frustrating restrictions. Since the start of the pandemic, household savings have increased and household debt remains mostly unchanged, largely owing to a fall in spending on non-essential items over lockdown (the Q220 household savings ratio was the highest ever). For those who have suffered financially, low-ticket domestic leisure may well be an attractive option. Potential beneficiaries (see page 7) cover a mix of activities from family entertainment centres and escape rooms to gyms and hospitality.

The value of vaccination

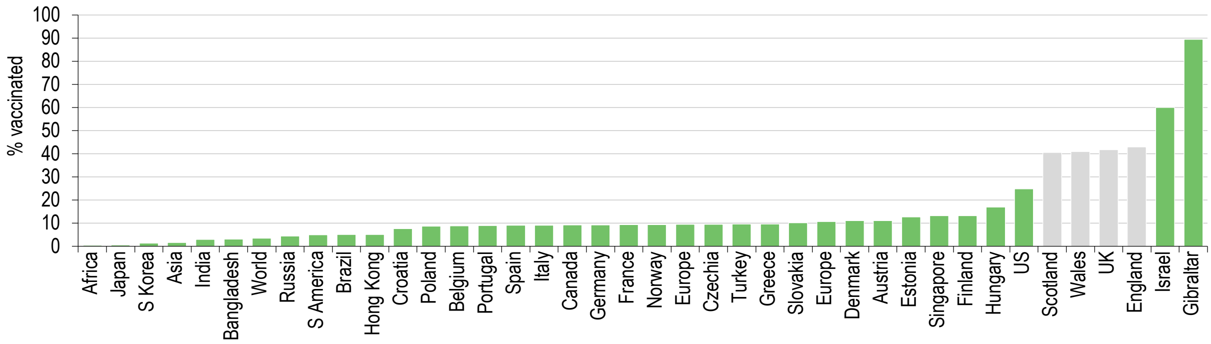
The UK has pushed ahead with a world-leading vaccination programme and looks set to emerge at the head of the pack from the pandemic. As social distancing and lockdowns give way to social spending, the leisure entertainment and travel sectors may be set for an earnings-based recovery. Valuations may have recovered but this relative earnings momentum may point to further outperformance in the months ahead.

UK consumer sector: The value of vaccination

The UK has faced a perfect storm over the past 18 months as the political distraction of Brexit led directly into a very serious COVID-19 crisis. Following a poorly informed initial response, the UK has pushed ahead with a world-leading vaccination programme and looks set to emerge at the head of the vaccination pack. We believe that as social distancing and lockdowns give way to social spending, the leisure entertainment and travel sectors may be set for an earnings-based recovery.

The announcements for England during February provide a timetable for the easing of restrictions out of the pandemic. Infection rates continue to fall in the UK and encouraging vaccination data suggests a high degree of protection from hospitalisation with COVID-19. The UK has been one of the quickest nations to vaccinate with over 40% of the population having received at least one jab, Exhibit 1. While not at the levels required to ensure herd immunity, with a significant proportion of the population having been vaccinated there is some scope for the current lockdown to be the last of its kind, if the relaxation schedule is properly managed.

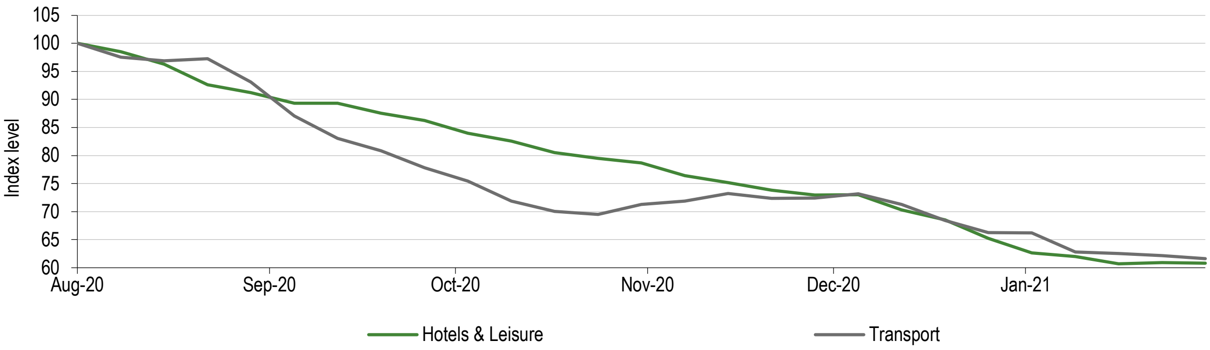
Exhibit 1: UK ahead of the pack in vaccinations



Source: Our World In Data, government statistics, 25 March 2021

English schools re-opened in early March, while non-essential retail is expected to reopen shortly. Pubs, bars and restaurants are likely to reopen in May, with social distancing measures remaining in place, while restrictions on the domestic tourism sector are likely to be lifted for the summer. Nevertheless, the prospects for international travel remain uncertain, with slow progress on the development of internationally recognised vaccination certificates but more importantly much lower vaccination rates in continental Europe compared to the UK. By the end of the year, the prospect of multivalent second generation of vaccines that provide protection against a wide variety of variants of COVID-19 may bring into view a progressive return to normality for international travel for 2022.

Exhibit 2: Second lockdown drove 2021 consensus estimates lower for transport and leisure

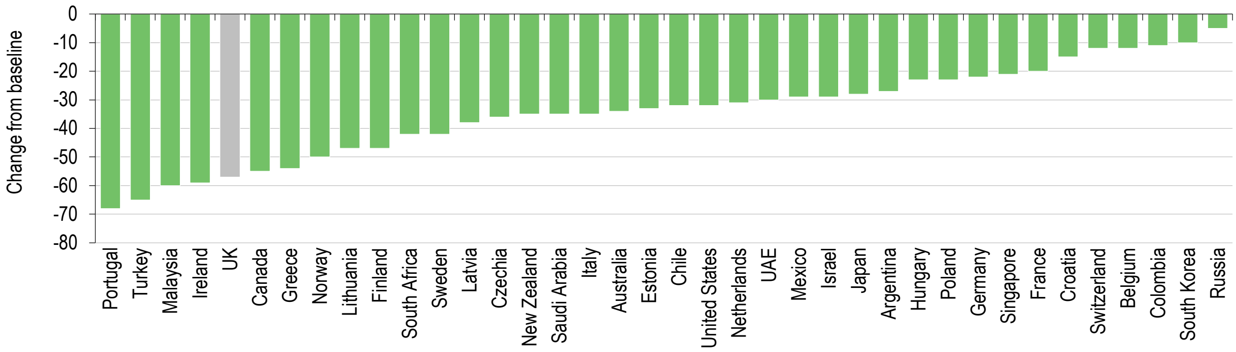


Source: Refinitiv, Edison calculations

The second wave of lockdowns has hit consensus 2021 earnings forecasts in the most exposed sectors hard. Since September, the UK transport, hotels and leisure sectors have suffered cuts to 2021 expected profits of over 30%. Only in recent weeks do earnings appear to have stabilised, Exhibit 2.

Google mobility data shows that the UK has been under one of the more draconian lockdown regimes on a global basis. Transport hubs were operating at a small fraction of normal levels, in sharp contrast to many other nations similarly dealing with COVID-19. Retail and recreation usage was also highly depressed on an international comparison, suggesting the scope for a large bounce-back as restrictions are lifted.

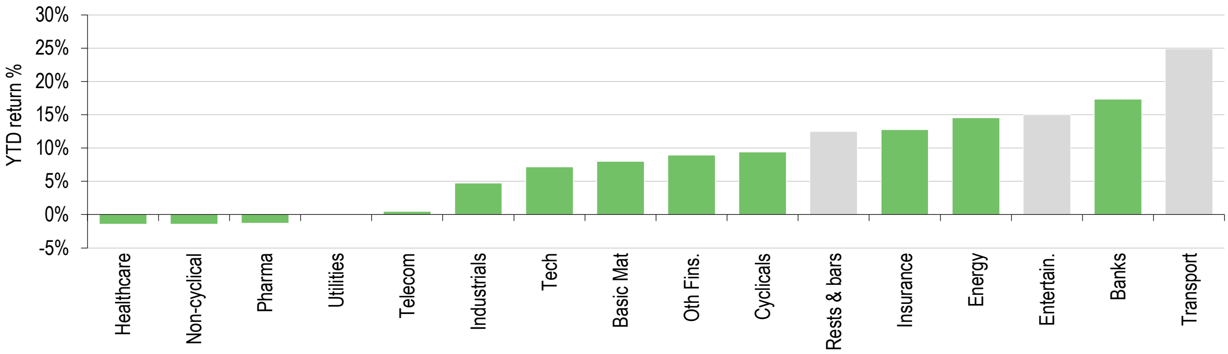
Exhibit 3: UK mobility still highly restricted in an international context



Source: Google mobility trends: transit stations, as of 21 February 2021

Since the start of 2021, investors have preferred to see through earnings downgrades and poor near-term trading. Year-to-date, the domestic leisure and travel sectors have been among the strongest performing in the UK. Defensive sectors have lagged in comparison. There is clearly some risk in this combination of rising prices and earnings downgrades, which represents a substantial vote of confidence in earnings prospects for 2021 and beyond. However, the fact that the UK has pushed ahead with its vaccination programme provides some comfort that investors, rather than going out on a limb, are instead getting ahead of a substantial improvement in operating performance later in the year.

Exhibit 5: Transport, leisure and entertainment have performed strongly year-to-date

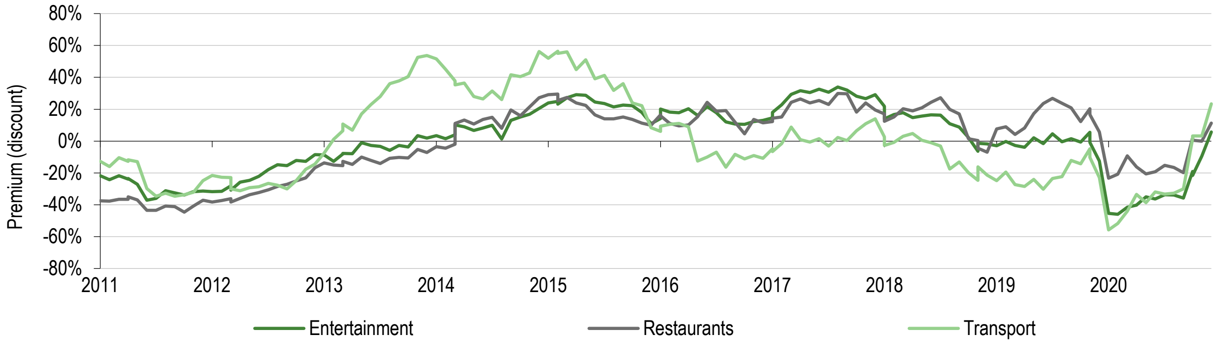


Source: Refinitiv. Note: Return shown in GBP. NCYC/CYCS: non-cyclical/cyclical sectors. Priced at 30 March 2021.

Balancing risk with the opportunity ahead

With the end of lockdown in sight, the focus is shifting away from questioning balance sheet strength and instead looking towards the earnings recovery in 2022. However, funding remains an important risk given the remaining uncertainty over the timing of the reopening of the hospitality industry. For any investment in the sector, we believe company balance sheets must be sufficiently robust to withstand a further six months of weak trading without recourse to shareholders. On the other hand, the larger listed leisure companies are comparatively well-placed to not only recover lost profitability but also gain access to opportunities where weaker and smaller competitors have failed during the pandemic.

Exhibit 6: Price/book valuations have rebounded from 10 year-lows



Source: Refinitiv, Edison Investment Research calculations

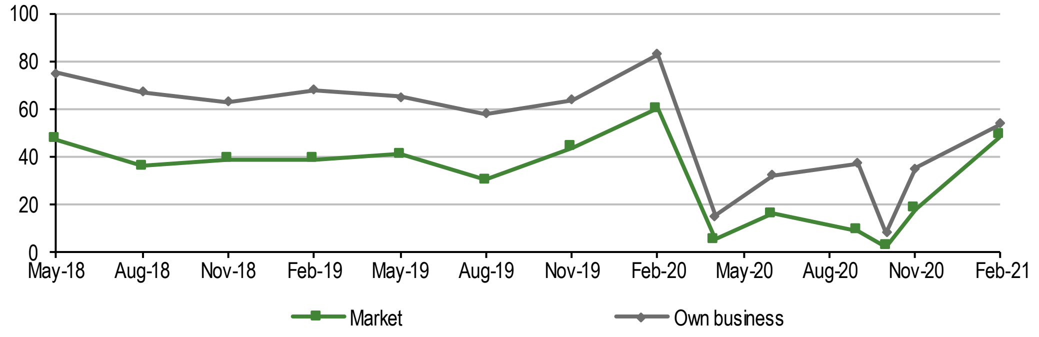
Investors have been swift to mark-up the potential for recovery as forward price/book valuations for entertainment and restaurant sectors are already at long-term average levels and in the case of transport modestly higher, Exhibit 6. Nevertheless, these sectors are still intriguing, in our view, as there are few segments of the stock market that trade close to long-term fair value and meet traditional value investment criteria, yet still have very strong earnings growth ahead.

Therefore while it is no longer the case that valuations are highly discounted, instead the theme must be that of ongoing positive earnings momentum. We believe investors will be looking to play this earnings recovery over the next six months as the efficacy of vaccination programmes becomes evident in the UK's COVID-19 case numbers. The companies with the strongest performance are likely to be those in a position to take advantage of the new trading environment to put themselves in a better competitive position, compared to prior to the pandemic.

Support from the front line

From operators across the hospitality sector there is an encouraging expression of confidence back at pre-pandemic levels. The recent authoritative annual hospitality Business Leaders' Survey by CGA with Fourth showed broadly 50% are confident about prospects over the next 12 months for both the sector and their own businesses (see Exhibit 7). Moreover, a slightly higher proportion, generally larger operators with typically 11 to 50 sites, expects to expand organically or by acquisition in 2021 as well as see entrants at least on a par with 2019. This is in marked contrast with activity last year, when according to the Market Recovery Monitor from CGA and AlixPartners there was a 5.1% contraction in licensed premises against a contraction of 1.8% in 2019, driven by an understandable dearth of openings (down 40%) to make up for the sector's habitual high rate of attrition (9% in 2020 vs 8% in 2019). Compared with pubs/bars, night clubs and restaurants overall, casual dining was especially affected with a near-10% net decline in sites in 2020, as were independents (c 75% of closures) and city centre operators.

Exhibit 7: Hospitality business leaders' confidence about sector prospects over next 12 months



Source: CGA Business Leaders' Survey 2021

Consumer confidence is predictably a key factor in business leaders' revived spirits with almost unanimous belief that there is pent-up demand, borne of such protracted COVID-19 restrictions. While arguably self-evident, it was fully backed up by consumer behaviour after the spring 2020 lockdown when over half of consumers according to the CGA returned within a month of reopening. Trading updates across the sector have substantiated this positive recovery, albeit in the case of dining boosted by the government's 'Eat Out to Help Out' campaign last August.

While pent-up demand may dissipate and a segment of the population may remain apprehensive about resuming out-of-home dining and social gatherings, recent research by the CGA, as reported at the CEDA Digital Event, highlights favourable consumer behavioural shifts. Uptake of delivery from restaurants and takeaways, unsurprisingly boosted by the pandemic, is expected to grow with two-thirds of those who ordered delivery for the first time or more often than usual saying they will continue their frequency of orders. Staying local, reflecting work from home and residual travel wariness, is also welcomed by the hospitality sector. Some three-quarters of business leaders felt that it would benefit their operations this year, while over half said they would be incorporating it into their current planning for site location, away from city centres. It remains unclear if there has been a fundamental shift to home-working although greater acceptance and practicality of 'remote' working and video conferencing as well as residential moves out of cities may instigate a durable change in spending patterns.

In economic terms, while the leaders' survey was conducted a month before the UK Budget, they expressed two main priorities for business on reopening, which were met in the Chancellor's statement:

- **Extension to a pause on business rates:** a 100% holiday will continue until the end of June, with the remaining nine months of the financial year seeing a discount in business rates by two-thirds.
- **Extension to cut in VAT:** a discount to 5% will continue on food, non-alcoholic drinks, accommodation and attractions until the end of September, when it will rise to 12.5% (still below the normal rate of 20%) for a further six months.

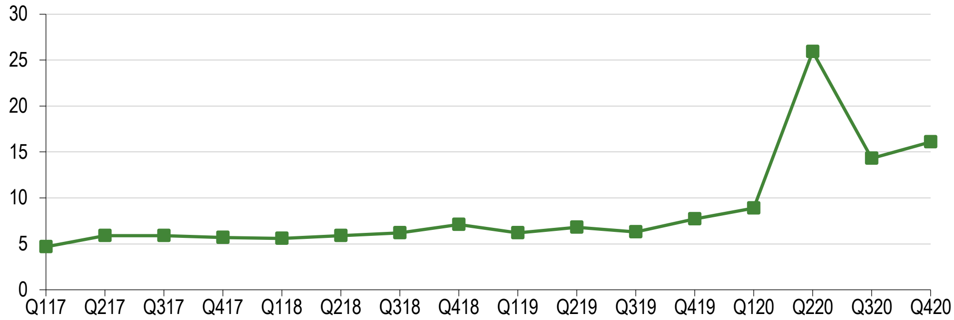
In addition, if less significant in the view of the hospitality business leaders:

- **Extension to furlough scheme**: the Coronavirus Job Retention Scheme, which had been due to close at the end of April, will run until the end of September. Employers will pay 10% towards the hours their staff do not work in July, increasing to 20% in August and September.
- **Increase and extension in grant amounts:** under a business restart scheme, grants of up to £18,000 may be available.

However, two other business requests, the application of VAT reduction to and cut in duty on alcoholic drinks, were not addressed in the Budget. The absence of a repeat of Eat Out to Help Out would not have materially disappointed leaders as the measure tended to be regarded more as a short-term fix.

A further economic spur is simply a consequence of the pandemic: an unprecedented rise in the UK savings ratio. As shown in Exhibit 8, in the decade up to 2020 this wavered between 5% and 10% only to climb to an exceptional 26% in Q220 before dipping to a still unusually high 14% in Q320. Latest figures for Q420 show a rebound to 16%, likely reflecting reimposition of COVID-19 restrictions.

Exhibit 8: UK households' savings ratio since 2017



Source: ONS (December 2020)

Less opportunity to spend on discretionary items such as eating out, holidays and travel, as well as saving on commuting costs while working from home may well have permitted those in secure employment to become 'accidental savers'. While it is likely that much will be maintained as savings, there is clear scope not only to exercise that pent-up demand but to indulge in more expensive 'treats' as recompense for doing without. This trend is anticipated by hospitality leaders, as represented in CGA's Hospitality Consumer Forecast, which shows 60% of consumers plan to treat themselves. Just as value offerings are believed also to grow in appeal for those who have suffered financially during the pandemic, including those on furlough (c 10 million) who may have thereby taken a 20% reduction in income, those who have missed out on support schemes and the doubling in those on Universal Credit since March 2020 to six million. Low-ticket domestic leisure may well be an attractive, affordable alternative to a foreign holiday.

As a result of COVID-19, a severely depleted hospitality sector, for example an estimated up to c 30% contraction in the restaurant market, and a fragile property market (among widespread reports Various Eateries is aware of many existing and new leaseholders negotiating significant rent reductions on leases, with some achieving rent free periods of up to two years) yields a more benign trading environment and offers significant opportunity for those groups that survive. To date high-profile casualties include Carluccio's, Café Rouge, Ask, Zizzi, Byron, Frankie & Benny's and Yo! Sushi (all recently in administration), with further to follow, given continued punitive conditions and weakened finances, such as business interruption loans and delayed creditor payments This provides an undeniable consolidation opportunity for a well-funded operator.

Selected companies with a primarily domestic leisure business

Recreation

- **Hollywood Bowl**
  UK's largest tenpin bowling operator (64 sites).
- **Ten Entertainment Group**
  Family entertainment centres (46 sites) anchored on tenpin bowling under Tenpin brand.
- **Gym Group**
  UK's second largest operator of low-cost, no-contract gyms (186 sites).
- **Brighton Pier Group**
  Brighton Palace Pier (free entrance; wide range of attractions) and nationwide premium bars (nine sites) and indoor mini-golf (eight sites at retail and leisure centres).
- **Everyman Media**
  Independent operator of premium cinemas (35 sites,117 screens).
- **Escape Hunt**
  Escape room experiences (10 sites).

Restaurants

- **Domino's Pizza**
  UK's leading pizza brand (over 1,100 stores).
- **Restaurant Group**
  Nationwide restaurants, mainly Wagamama and Frankie & Benny's (c 280 sites), pubs (c 80 sites) and travel concession catering (c 35 sites, primarily at airports).
- **Loungers**
  Café/bar/restaurants in England and Wales: Lounge (138 sites) and Cosy Club (30 sites).
- **Fulham Shore**
  Casual dining, mainly in London and south of England: Franco Manca pizzerias (53 sites) and The Real Greek restaurants (19 sites).
- **Various Eateries**
  South-East England. Coppa Club multi-use all day, terrace, café, lounge, bar and workspaces (seven sites, of which two with joint hotels) and Tavolino Italian restaurant (one site).

Pubs and bars

- **Fuller's**
  Premium pubs in the south of England (almost 400 sites, of which over 30 offer accommodation – c 1,000 rooms).
- **Young's**
  Premium pubs, principally in London and the South East (c 270 sites, of which c 30 offer accommodation).
- **City Pub Group**
  Premium pubs across southern England and Wales (48 sites).
- **Nightcap**
  High-energy party bars under London Cocktail Club brand (10 sites).
- **Revolution Bars**
  Nationwide operator of premium bars: Revolution (48 sites) and Revolución de Cuba (18 sites).

Lodging

- **Whitbread**
  UK's largest operator of budget hotels (Premier Inn, over 800 sites), more than half of which with restaurants, notably as Beefeater and Brewers Fayre.

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