

My Investment Thesis on GYM Group

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Gym Group enjoys a cost advantage facilitated by superior asset utilisation and a long runway for value accretive asset growth. GYM was founded in 2007 and is today the second largest low-cost gym operator in the UK. It runs 150 gyms and has 700k members. All revenues are generated from membership fees and joining fees. The company has a sense of purpose/coherent mission, which is to help people improve their wellbeing, whatever their fitness of financial starting point or location. The fact that consistently 30% of new members have never been a gym member before suggests this mission is being accomplished. This is a relatively capital-intensive business. However, while 30-40% of revenues are spent on capex, c. 4-6% of revenues relate to maintenance capex.

GYM is a market leader in a fragmented industry: There are over 2k private gym operators in the UK, running 3.7k private gyms. The ten largest operators account for c. 650 gyms, 18% of the total number of private gyms, and GYM accounts for c. 4% of all private gyms. The low-cost gym model has grown rapidly by addressing the barriers to gym membership: (1) high membership cost and (2) being tied into contracts. The proposition of "high quality, low cost" appears to be well received: GYM's net promoter score is very high: +60. 55% of new members come from referrals.

GYM can profitably offer average memberships 60% below private sector averages due to higher utilisation of site space (170 stations per gym vs. 60 private market average, and limited wet/racquet/café facilities/24-7 opening hours) and the employment of technology rather than employees for customer sign up and management. Customers enter the gym via a PIN entry system. The joining process is online, or via on-site internet connected kiosks, lowering customer acquisition and management costs.

In reviewing thousands of potential sites over the years GYM has developed relationships with landlords and property agents. It is conceivable that the brand and GYM's strong covenant rating may be competitive advantages when it comes to securing new sites with landlords.

Low cost gyms have been growing 50% pa but low-cost gym membership in the UK is still only 3%. Low cost gyms in the UK are 8% of the total. In the US and Germany half of gyms are low cost (and rising), accounting for the higher gym penetration rates in those markets. The low-cost segment in the UK has both taken share from the traditional segment and grown the market (in every year since 2008 >30% of new GYM members have not been a gym member before). This has resulted in low cost club CAGR of >50% since 2011. Initial site investment costs have declined as a result of economies of scale. Gym fit-out contractors are awarded contracts through more competitive tender processes, better terms are agreed with equipment suppliers and service providers such as cleaning. The economic return on marketing spend has improved as the number of sites and members has grown.

Estate maturation should improve margins: Average mature site EBITDA margin/ROCE is 47%/32%. Yet the average site EBITDA margin is 40%, and the EBITDA margin for the group is 30%. In my view the principal risks that may cause the future to unfold in a less favourable way than the above analysis anticipates are: (1) member churn/customer response to real disposable income erosion; (2) input cost inflation, and (3) irrational and aggressive competitive reaction.

Churn and customer demand elasticity: members can cancel without charge at any time. To re-join would incur a £20 fee. Annual membership attrition (cancellations net of re-joiners) is 100%; 30% of leavers re-join.

Management has stated that it does not consider cancellation to be a KPI for the business. This is for two reasons: (1) Cancellation improves membership yield as new members join at higher prices than cancelled members. And (2) the cost of acquiring a new member is less than the joining fee. This is due to marketing economies of scale and word of mouth recommendations (more than half of new joiners are costless referrals).

Competitive response: Mid-tier gyms may cut their membership fees to compete with the increased popularity of low-cost fitness clubs. However, despite prices 60-70% below mid-tier gyms, GYM's margin profile is vastly superior. This is also despite having a lower percentage of the estate comprising mature gyms vs. established non-growing mid-tier competitors. Mid-tier and premium competitors have lower margins than GYM. This lowers their headroom for profitable price cuts. The competitive response from the mid-tier/premium segment seems to have been benign. Mid-tier/premium operators have upgraded their service to warrant the premium they charge and/or have increasingly targeted the top end of the market which they argue is not addressed by the low-cost segment. Mid-tier and premium gyms have consistently increased their fees each year. One mid-tier operator, Fitness First, did attempt to create a low-cost arm, opening Klick Fitness in 2012 with 6 gyms. Just over 12 months later the group exited the sub-sector. The mid-tier peer group has been restructuring, with consolidation on-going in the market.

Leverage/recession risk: In the event of a recession prices and memberships may erode. GYM has high financial gearing in the form of operating lease obligations. Given GYM's operating leverage mature site profitability would fall significantly should the business experience a marked revenue decline. I estimate that a 20% drop in revenues would reduce the owner earnings to £17mn from £40mn in a no-growth scenario. This is still a 5% yield to the current market cap. Current adjusted net debt/EBITDAR = 3.5x; assuming the maintenance profitability of the estate this is 2.5x. This would be 6x with a 20% revenue decline assuming zero capacity to cut 100% fixed costs, or 3.8x based on maintenance profitability. Under these assumptions GYM's EBITDA margin would be 13%/ and maintenance EBITDA margin 35% vs. the current 30% rate (and 47% mature gym rate). It is difficult to envisage a 20% revenue decline due to the immaturity and increasing penetration of low-cost gyms, as well as the 60-70% price discounts vs. mid-tier competitors. When US membership growth was negative in 2012, Planet Fitness still grew its memberships by 28% yoy. This might suggest that the large discount lowers the price elasticity of demand for budget gyms.

High reinvestment rates mean GYM screens poorly: With a P/E ratio of 47x and a FCF yield of negative 4%, many investors will write off GYM's investment merits. However, owner earnings^[1] c. £40mn, a 12% yield to the current market cap.

These owner earnings are largely being directed to clearly above cost of capital projects. I estimate the total capitalised costs per new site are c. £1.5mn, and the economic profit per gym is c. £0.3mn, leading to after tax returns on incremental capital in excess of 20%. So, for every pound of owner earnings invested, GYM can create £2 of value. Unfortunately, the board has a progressive dividend policy with a 10-20% payout ratio target. With the company's unit economics and runway for growth I would prefer that 100% of earnings were reinvested in asset growth. However, 10-20% of reported earnings will be much lower than 10-20% of owner earnings. If 90% of owner earnings are reinvested an equity investment in GYM could yield annual returns in excess of 20%.

^[1] Calculated using mature rather than reporting margins, deducting maintenance capex and excluding working

capital inflows (these are driven by rent free periods on new sites and are therefore a benefit of asset growth).

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