Town Sports International Research (2/21/19)

Description: Owns and operates fitness clubs in the Northeast and Mid-Atlantic regions of the United States. They operate 181 fitness clubs, which includes 99 under the New York Sports Clubs, 29 under the Boston Sports Clubs, 10 under the Washington Sports Clubs, and 5 under the Philadelphia Sports Clubs brands, 16 under Lucille Roberts Clubs, as well as 3 clubs located in Switzerland; and operated 1 partly-owned club in Washington. Town Sports International Holdings, Inc. was founded in 1973 and is based in Jupiter, Florida.

Ticker: CLUB

Price: $5.52

Market Cap: $150M

Performance: -13.8% YTD

Let's call CLUB what it is. It's essentially a bet on a turnaround story after years of volatility and uncertainty about whether or not the company was going to make it. We wouldn't just argue that shares have fallen dramatically because the company isn't operating perfectly, but also because the company isn't very communicative with press releases/investor decks/etc.

Let's walk through some of the history briefly. In Q2 2014, CLUB experimented with a low pricing strategy in an attempt to attract more members. The move backfired badly though as the growth in club members did not overcome the revenue lost per member. As a result, comparable club revenues fell 15.7% in just 4 years.

Let's just take a look at the chart real quick as this was probably one of the darkest times for the company. This strategy almost costed the company everything as reports we've read actually said they dropped the price of their memberships from $49.99-$69.99 to as low at $19.95 and kept their offerings/value the exact same. Management at the time thought cutting the price by 50% would lead to more than 2x in members… not the case at all.

That price cut was back in Q2 2014, by Q4 2015 prices were raised and the company started focusing more on cutting costs than cutting prices. This saved the company because if they had continued on their path they would have most likely filed Ch 11 bankruptcy and it's apparent from the chart above that that is what the market was pricing in and expecting. Now with the stock pulling back we need to ask ourselves how much of a threat bankruptcy is and whether CLUB is worth investing in.

Fast forwarding a bit from late 2015, we arrive at the newly appointed CEO Patrick Walsh. Walsh is a known activist investor and has held stakes in numerous restaurant companies such as Red Robin Gourmet Burgers, BJ's Brewhouse and Denny's. He isn't your typical Ivy-League MBA Wall Street activist. He is known for stepping into places and focusing on the nitty gritty like turning air conditioners off at night to save money. Walsh has had great success in the restaurant business but now the question is whether or not he can pull it off in the fitness space.

As we look at CLUB, there are four things that currently worry us:

1. Competition
    a. There is most certainly not a shortage of gyms today at every end of the spectrum from Planet Fitness, to Retro, Club Metro, LA Fitness, 24 Hour Fitness, Gold's, Bally, local gyms, and so much more
2. Cyclical
    a. When the economy turns upside down, gym memberships tend to be the first things that go in one's budget as it's a quick way of saving $50/month.
3. Heavy Debt
    a. CLUB is sitting on roughly $200M of debt as per their latest SEC filing
4. Differentiation
    a. How is CLUB differentiating themselves in this crowded market? They aren't the Rolls Royce of fitness centers and they also aren't the Toyota's at the cost effective end of the spectrum. Sometimes being middle of the road in these cases isn't always the best.

Let's examine the company a little more now:

At the end of Q3, 2018 CLUB had 181 locations, this is up from 164 in the same quarter a year ago and the growth is attributed to acquisitions.

	2017					2018		
	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3
Clubs included in consolidated operating results:								
Clubs operated at beginning of period	149	148	148	163	149	164	164	175
Acquired clubs	—	—	16	2	18	2	12	7
New clubs opened	1	1	—	—	2	—	—	—
Clubs closed (3)	(2)	(1)	(1)	(1)	(5)	(2)	(1)	(3)
Clubs operated at end of period	148	148	163	164	164	164	175	179
Club included in equity investment at end of period (1)	1	1	1	1	1	1	1	1
Licensed club operated at end of period (3)	—	—	—	—	—	1	1	1
Total clubs operated at end of period (1)(2)	149	149	164	165	165	166	177	181

(1) Excludes one 20% owned club that operated under a different brand name in our Washington, D.C. region.
(2) Excludes three locations that were managed by us in which we did not have an equity interest.
(3) Includes one club that transitioned to a licensed location in the first quarter of 2018 and bears the "Washington Sports Clubs" brand name.

When we look at comparable sales, they're positive which is actually a good sign because for a while the company was negative. From the looks of it, positive comp growth is becoming a trend with the most recent quarter growing 1.5%, albeit its slowest growth since Q2 2017.

	2017				2018		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Comparable club revenue	0.7%	1.2%	1.8%	2.8%	1.7%	1.8%	1.5%

If we look below, membership dues revenue increased $23.6M, or 10.3%, in the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017, primarily reflecting the favorable impact from the newly acquired and opened clubs, higher average dues per membership and increased annual fees. These increases were partially offset by the impact of club closures (which if you look above was 6 for the year).

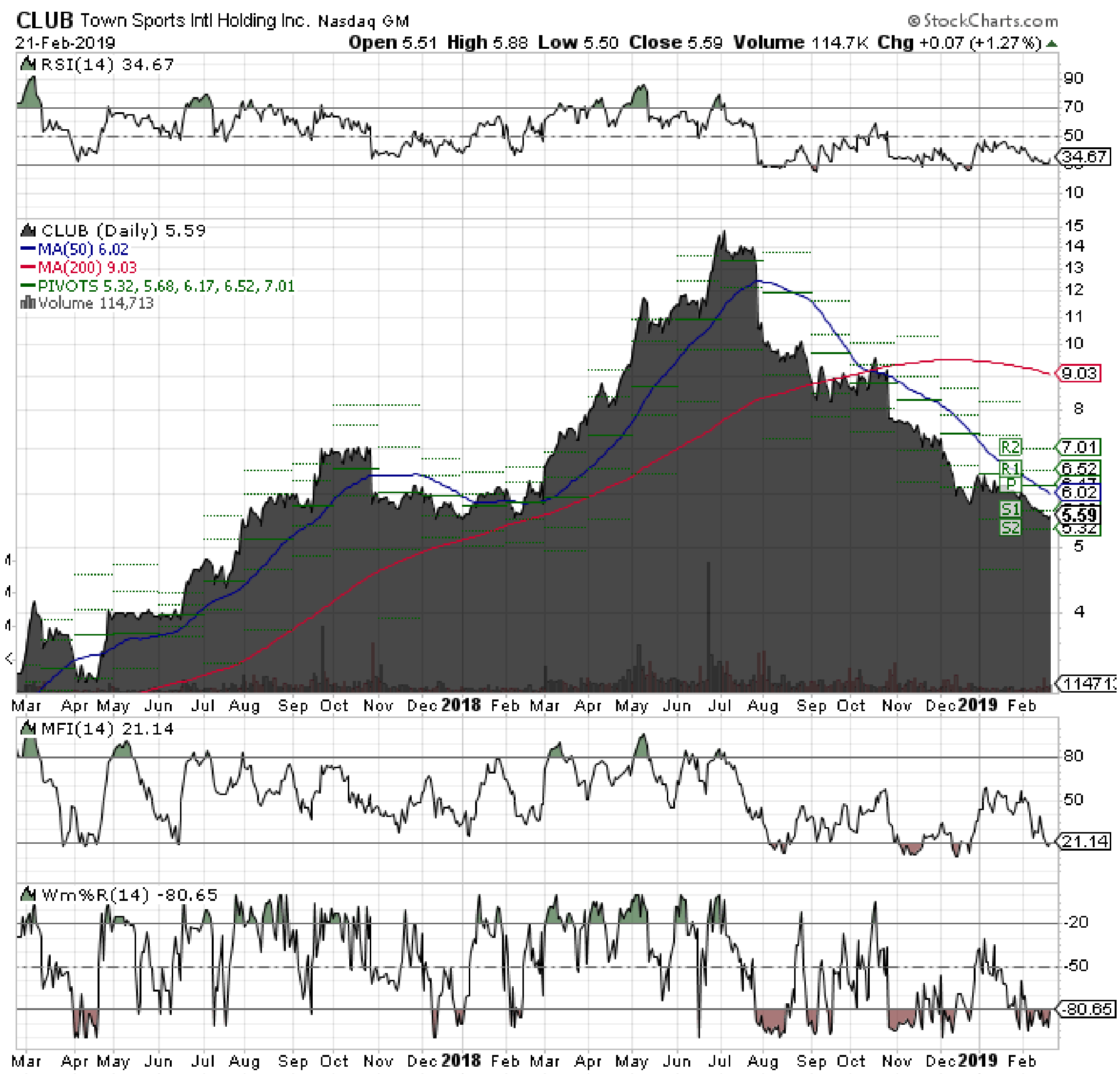
	Nine Months Ended September 30,				
	2018		2017		
	Revenue	% Revenue	Revenue	% Revenue	% Variance
Membership dues	$ 251,992	76.5%	$ 228,362	76.7%	10.3 %
Initiation and processing fees	1,006	0.3	1,953	0.7	(48.5)
Membership revenue	252,998	76.8	230,315	77.4	9.8
Personal training revenue	55,451	16.8	49,256	16.5	12.6
Other ancillary club revenue (1)	16,982	5.2	13,514	4.5	25.7
Ancillary club revenue	72,433	22.0	62,770	21.0	15.4
Fees and other revenue (2)	4,182	1.2	4,629	1.6	(9.7)
Total revenue	$ 329,613	100.0%	$ 297,714	100.0%	10.7 %

Given the company's current cash on hand of $50M and debt of $200M, and what appears will be around $13M in interest expenses for the year, we don't expect any more acquisitions (most recent one was back in 2016 when they acquired 16 Lucille Roberts Health Club locations).

What this leaves us with will probably only be organic growth of 1-2% in 2019, if not flat Y/Y just based off of comps we've seen and how they're trending.

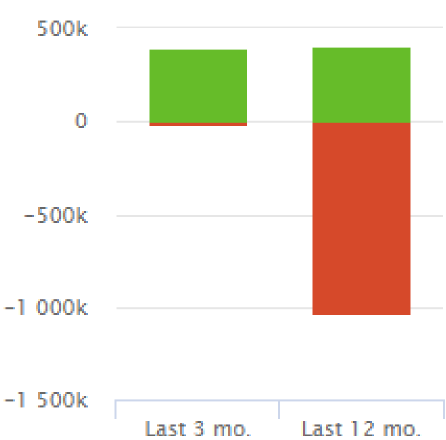
With this in mind, is CLUB attractive fundamentally now that it's pulled back from the mid-teens to $5? It's tempting as the stock trades at roughly 0.3x sales, the last twelve month's levered free cash flow is around $14.8M (unlevered $21.5M), and the EV/EBITDA multiples suggest the stock is undervalued. PLNT trades at 23x EBITDA, though it is a franchise model, Life Time Fitness went private at 10.5x, 24 Hour Fitness did the same at 8x, and CLUB is currently at 5.0x. If Walsh were to exit like he usually does he might be able to catch a valuation close to 50%-75% higher than where it currently trades conservatively speaking which is around $8 per share. We never recommend investing in a company because they might get bought out or go private but it does help serve as a gauge of what CLUB might catch a bid at.

When we look at the charts (see below) we are noticing that it is oversold on RSI, MFI, Williams %R, and that S2 support line looks like it may be a potential bottom for the stock, especially when looking at where it hovered for a while at the end of 2017 and beginning of 2018.



Because the company is cash flow positive, run by someone who seems to have steered the ship away from the iceberg at this moment in time, is oversold on many metrics, and has hit a point that is pretty cheap fundamentally, we'd say this is a pretty good entry point for a swing. We don't really like this company as an investment personally as we feel growth is slow, the company doesn't really provide you with much diversification as far as geographic locations goes, the product offering is kind of middle of the road as its not an upper class place like Intoxx/LA Fitness, and not at the bottom like a Retro/PLNT, and that could be serve as a solid reason comparable sales are so slow.

It's also worth noting that volume is pretty thin on this at around 74K shares a day and the volatility shouldn't be leaving anytime soon. Other notables do include that insiders have been selling a lot but Walsh has been buying. In fact, his latest purchase of shares was back in December where he bought $1.5M of stock at $5.98. Below is a graph of insider purchases and over the last 12 months a net of 632K shares were sold but a net of 376K shares have been bought over the last 3 months. This could indicate things may turn around soon especially with Walsh's recent pickup we just mentioned.



	3 MO.	12 MO.
# of Shares Bought	395,023	404,281
# of Shares Sold	18,375	1,036,656
Total Shares Traded	413,398	1,440,937
Net Activity	376,648	(632,375)

Like we said, this is not really an investment we'd push for as we don't see any big growth opportunities ahead and is more of a margin expansion/cost cutting play until the company knocks down its interest and principal and can then use their cash to grow their business. In summation, this looks like a good swing opportunity here and we have to give credit to Walsh, he's been doing a great job given what he's stepped into.