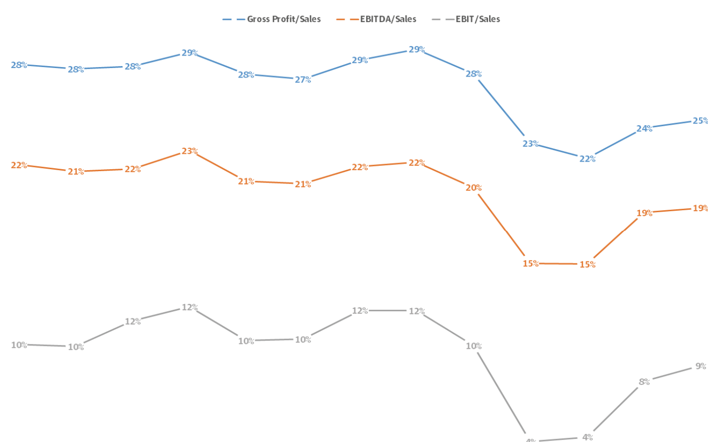
Town Sports (CLUB)

Town Sports (NASDAQ: CLUB)
Stock Price: $10.50



	EV/Sales	EV/Gross	EV/EBITDA	EV/EBIT	EV/Owner
Life Time Fitness	2.55	6.12	7.95	11.64	7.71
Weight Watchers	2.13	3.60	7.12	7.62	8.73
ClubCorp	2.62	9.77	11.91	22.52	16.62
Clublink	2.77	NMF	9.38	14.41	11.22
Accordia Golf	2.60	NMF	11.10	17.79	13.70
Minimum	2.13	3.60	7.12	7.62	7.71
Maximum	2.77	9.77	11.91	22.52	16.62
Median	2.60	6.12	9.38	14.41	11.22
Mean	2.54	6.50	9.49	14.80	11.60
Standard Deviation	0.22	2.54	1.81	5.10	3.26
Variation	9%	39%	19%	34%	28%
Town Sports	2.85	5.79	6.45	8.60	6.79

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Minimum	Maximum	Median	Mean	Standard Deviation	Variation
Sales	223	280	318	341	353	389	433	473	507	485	462	467	479	223	507	433	401	90	23%
Gross Profit	63	79	90	100	98	106	124	139	141	113	103	113	118	63	141	106	107	22	21%
EBITDA	49	60	68	78	73	80	94	104	103	74	71	87	91	49	104	78	79	16	20%
EBIT	22	28	37	43	36	40	53	58	50	18	18	36	41	18	58	37	37	13	34%
Receivables					2	5	8	7	5	4	5	6	6	2	8	5	5	2	32%
Inventory					1	1	0	0	0	0	0	0	0	0	1	0	0	0	49%
PP&E					358	397	447	526	607	657	665	661	671	358	671	607	554	126	23%
Working Liabilities					49	57	64	68	69	64	60	64	64	49	69	64	62	6	10%
Net Tangible Assets					312	345	391	465	544	598	610	603	614	312	614	544	498	122	25%
MARGINS																			
Gross Profit/Sales	28%	28%	28%	29%	28%	27%	29%	29%	28%	23%	22%	24%	25%	22%	29%	28%	27%	2%	0.09
EBITDA/Sales	22%	21%	22%	23%	21%	21%	22%	22%	20%	15%	15%	19%	19%	15%	23%	21%	20%	2%	0.12
EBIT/Sales	10%	10%	12%	12%	10%	10%	12%	12%	10%	4%	4%	8%	9%	4%	12%	10%	9%	3%	0.30
TURNS																			
Sales/Receivables					206.21	85.79	57.24	70.53	102.47	110.28	96.80	84.02	77.47	57.24	206.21	85.79	98.98	43.38	44%
Sales/Inventory					502.54	722.22	1011.87	1422.30	2716.94	2645.19	2096.99	1841.98	1315.88	502.54	2716.94	1422.30	1586.21	796.63	50%
Sales/PPE					0.98	0.98	0.97	0.90	0.83	0.74	0.70	0.71	0.71	0.70	0.98	0.83	0.84	0.13	15%
Sales/NTA					1.13	1.13	1.11	1.02	0.93	0.81	0.76	0.77	0.78	0.76	1.13	0.93	0.94	0.16	17%
Returns																			
Gross Profit/NTA					31%	31%	32%	30%	26%	19%	17%	19%	19%	17%	32%	26%	25%	6%	0.26
EBITDA/NTA					23%	23%	24%	22%	19%	12%	12%	14%	15%	12%	24%	19%	18%	5%	0.28
EBIT/NTA					12%	12%	14%	12%	9%	3%	3%	6%	7%	3%	14%	9%	9%	4%	0.47
GROWTH																			
Sales		26%	13%	7%	3%	10%	11%	9%	7%	-4%	-5%	1%	3%	-5%	26%	7%	7%	8%	1.21
Gross Profit		25%	14%	11%	-2%	9%	17%	12%	1%	-20%	-9%	10%	5%	-20%	25%	9%	6%	12%	1.99
EBITDA		23%	14%	13%	-6%	9%	18%	11%	-1%	-28%	-5%	23%	4%	-28%	23%	10%	6%	15%	2.28
EBIT		24%	33%	16%	-15%	11%	32%	9%	-13%	-65%	3%	93%	16%	-65%	93%	13%	12%	37%	3.04
Receivables					33%	263%	13%	-33%	-16%	-5%	22%	11%	11%	-33%	263%	11%	33%	89%	2.65
Inventory					-13%	-36%	3%	-47%	-38%	57%	-3%	34%	51%	-47%	57%	-3%	1%	39%	42.72
PP&E					10%	11%	14%	22%	11%	6%	-4%	3%	1%	-4%	22%	10%	8%	8%	0.94
Working Liabilities					16%	18%	8%	4%	0%	-14%	3%	10%	-8%	-14%	18%	4%	4%	11%	2.70
Net Tangible Assets					9%	12%	14%	23%	12%	9%	-4%	2%	2%	-4%	23%	9%	9%	8%	0.93

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SINGULAR DILIGENCE

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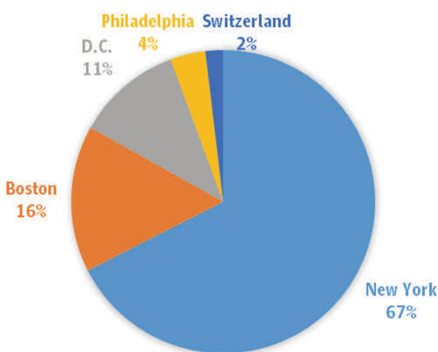
Town Sports (NASDAQ: CLUB): A Local Leader in New York City Gyms

OVERVIEW

Town Sports International was founded in 1973 in New York City. The company was originally called Town Squash. It started in the squash business. But that sport's popularity peaked in New York City before 1980. Town Squash converted its existing squash court locations into full fitness centers. The company was renamed Town Sports. Its best assets remained the space it controlled in Manhattan and elsewhere in New York City. The company expanded slowly throughout the 1980s. It mostly added clubs in New York City. Then the company began a more rapid expansion in the early 1990s. By 1995, Town Sports had expanded to 28 clubs in New York City, Boston, Washington D.C., and Philadelphia. Management envisioned even more rapid expansion. The company's owners decided they would not be able to finance the long-term growth of the business. So executives led a leveraged buyout of the company. Financial sponsors took 73% of the equity. Management took 27% of the equity. Town Sports added publicly traded debt to its balance sheet. According to one former executive: "That was sort of a defining moment for us because we had what we thought were the seeds of a very good business. Then suddenly we had the financial capacity to step up the growth. The company encompassed about 30 clubs at that point and through a number of financings, including a senior bond financing that's publicly traded, we fueled the company and have given it the capacity to grow to where it is today." Town Sports went from 30 locations in 1996 to 110 locations by 2001. At that point, the company had 73 clubs in the Tri-State (New York, New Jersey, and Connecticut) area, 17 in Boston, 13 in Washington D.C., 5 in Philadelphia, and 2 in Switzerland. Town Sports has never intended to expand internationally. The 2 locations in Switzerland were left over when the previous owners were bought out in the LBO. Town Sports never sold those locations. They added just one additional Swiss location in the decades that followed the LBO.



A total of 108 (67%) of Town Sports' 160 locations are in the New York area

The company operates under different names in different cities. The gyms in New York are branded New York Sports Club. In Boston, they are branded Boston Sports Club. In D.C., they are branded Washington Sports Club. And In Philadelphia, they are branded Philadelphia Sports Club. The gyms under each brand are organized as a cluster. This allows members to work out close to both their home and their work. It also provides Town Sports with economies of scale. For example, the company can run television advertising in Boston using the Boston Sports Club name and thereby advertise all 25 locations in the Boston area. Local competitors have far fewer locations. So they are unable to take advantage of economies of scale in advertising. Town Sports tries to develop a minimum cluster of 7 to 10 clubs in a city. This is easiest when a local competitor is willing to sell many clubs at once. Over time, that has become less common as Town Sports has controlled more of the clubs in each area. This creates a barrier to entry in the sense that a new competitor must enter an area with insufficient scale. Town Sports has a total of 160 locations. The largest market is New York City. The New York Sports Club brand is used at 108 locations. There are 37 New York Sports Club locations in Manhattan. New York Sports Club is by far the largest operator of gyms in Manhattan. The locations are small and target the local neighborhood. According to Robert Giardina (who has been CEO for the last 12 years), each gym's "...primary market is very small. It's two blocks to three blocks. So if you think about how people move in Manhattan, there are new neighborhoods developing every day. Ten years ago you think about the West Side in the 30s, there was very little residential. There's now a new population there. Same thing with the lower East Side. So you can think about the neighborhoods

where we don't have clubs that consumers don't want to travel that far. So we see ourselves having a lot of opportunity." The company has 37 locations in Manhattan right now. Giardina mentioned the possibility of adding another 10 to 15 locations to bring the total number of New York Sports Club locations in Manhattan up to 50 to 60. Town Sports controls most of these locations under leases that run from 15 to 25 years. The company owned one property in Manhattan. It just announced the sale of that building (151 East 86th Street) for $82 million. When that deal was made, Giardina said: "We are pleased to announce this agreement to monetize our 151 East 86th Street location in New York that will generate substantial value for our stakeholders. We are also excited for the opportunity to replace our 35 year old club with a brand new club at this same location upon the completion of the construction of a luxury high-rise building."

Town Sports leases all of its other locations. This makes comparisons with competitor Life Time Fitness difficult. The two companies need to be compared on their results in terms of enterprise value with capitalized leases relative to EBITDAR (Earnings Before Interest Taxes Depreciation Amortization and Rent). Town Sports seeks to lease whenever possible. Life Time Fitness seeks to own whenever possible. Part of the difference in philosophy reflects their original home markets. Life Time Fitness started in Minnesota where it is easy to buy affordable land to develop large centers. Town Sports started in Manhattan where it is necessary to lease expensive space just to place a small fitness center there.

Town Sports has smaller locations than Life Time Fitness. They have fewer amenities. Many are fitness only clubs. These lack the swimming pools, basketball courts, tennis courts, squash courts, and saunas that are present in multi-recreation clubs. In suburban locations, Town Sports is more likely to build multi-recreation clubs. In urban locations, Town Sports focuses on fitness only clubs. Town Sports' expansion into the suburbs was a result of following commuters. The company has clubs in places like Ridgewood, New Jersey because some of the members of its Manhattan clubs work in the city and live in the suburbs. Having a club in each location allows members to work out either at home or at work. They can also work out on both weekdays and weekends. Some of the members in the suburban clubs are only members at that gym. However, the reason for expanding into the suburbs was to serve the existing urban members and then fill out the rest of the memberships in a suburban gym with local residents that are not commuters. After the 2008 financial panic, Town Sports slowed its expansion plans and refocused on smaller format locations in urban areas instead of adding larger, suburban clubs.

Town Sports is the largest operator of fitness clubs in New York City and Boston. It is one of 3 equally sized (18 gyms) operators in the Washington D.C. market. It is the third largest operator in the Philly area and the 2nd largest operator in the city of Philadelphia itself (excluding suburbs). It is not a major competitor in Switzerland. And it does not intend to become one.

The company's strongest competitive positions are in New York City (especially Manhattan) and Boston. It is not possible for another competitor to duplicate Town Sports' position in someplace like Manhattan because of the difficulty in leasing 40 or so locations to build a cluster of similar scale. Such a large urban cluster creates a very big financial obligation. For example, Town Sports makes minimum rental payments of $84 million. If that rent is capitalized at 8 times (to make it comparable to the way LifeTime Fitness is financed with mortgages), the balance sheet would show $672 million in capitalized leases. Town Sports also has interest payments of $25 million. Total fixed charges are almost $110 million.

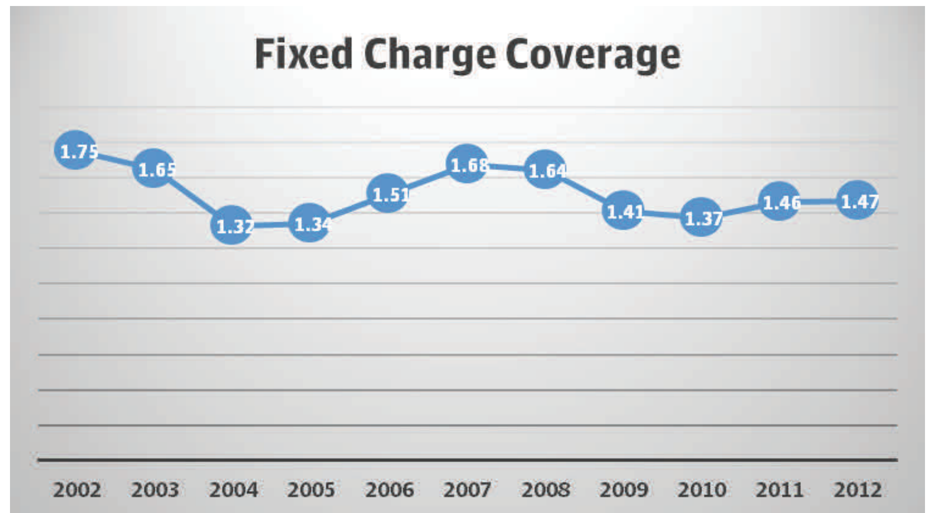
DURABILITY: *The Temptation to Add Too Much Debt is The Greatest Risk to Town Sports*

Town Sports' greatest source of durability is its network of local clubs in cities like New York and Boston. Town Sports is the leader in these markets. Leases are generally for 15 to 25 years. And about 60% of members stay beyond the first year. It takes time to lease a new location, get enough members to make the location profitable, and then duplicate the effort at least half a dozen times to build a cluster with economies of scale. Town Sports has already done this in both New York and Boston. It is the leader in both cities. The company is also in a three way tie for leadership in the Washington D.C. market. These 3 cities account for 94% of Town Sports' locations. The two markets, New York and Boston, where Town Sports is the largest local operator account for 83% of the company's locations. This is the part of the business that is most durable. It is also the part of the business that is hardest for a new competitor to duplicate.

The biggest risk to Town Sports is overleverage. Using debt and leases to quickly expand has been a problem in this industry. Bally Total Fitness entered bankruptcy in 2008. Crunch entered bankruptcy in 2009. The share prices of both Town Sports and Life Time Fitness plunged following the 2008 financial panic. This was obviously due to concern about meeting fixed charges (rent and interest payments) while also being able to refinance debt as needed. Debt refinancing is usually not as big a concern as it was during the panic. However, meeting fixed charges are a concern in all economic environments. Many fitness club operators have low fixed charge coverage. Since 2002, Town Sports has averaged a fixed charge coverage (EBITDAR/ Rent + Interest) ratio of 1.5. This is equivalent to a margin of safety of 34%. A decline of more than 34% in EBITDAR would cause cash flow before maintenance cap-ex to fall below the amount needed to pay rent and interest.

Maintenance cap-ex is low in the fitness club industry. But when financial obligations are excessive, even that low amount of maintenance cap-ex can become a problem. In the past, chains that needed to use all of their cash flow to pay rent and interest ended up with outdated locations.

Town Sports has often had high debt levels. Before the IPO, the company had debt equal to 4.5 times EBITDA. Since the IPO, debt (excluding capitalized rent) has been low. The only time debt/EBITDA went above 3 was during the financial crisis. The crisis was hard on gyms because of same store sales declines. In 2009, Town Sports had a 5.6% same store sales decline. In 2010, it had a 4.3% decline. This caused rent expense to increase from 18% of sales to 24% of sales. The lowest ratio of EBITDAR to fixed charges was still 1.34. That is why Town Sports was able to survive two recessions since its IPO (early 2000s and the 2008 financial panic) that bankrupted several competitors. Cash flow from operations far exceeds maintenance cap-ex needs. Over the last 5 years, Town Sports generated $361 million in cash flow. Maintenance cap-ex is just $20 million a year. So, the company was able to generate more than 3 times the amount of cash flow needed to maintain its existing gyms. Funding expansion is a different issue. Town Sports has never added more than 16 clubs in a single year. A small club costs about $2.5 million in capital expenditures. A large club costs about $4 million in capital expenditures. Average free cash flow (after maintenance cap-ex) was around $50 million a year since the financial panic. That amount is actually enough to finance just about the most aggressive growth plans Town Sports would have in a single year. As a result, the company has been able to pay down debt, pay a special dividend, and now consider a regular dividend. It is not clear whether a regular dividend is actually a good idea. In times of crisis (like 2008), any regular dividend would be subject to suspension. The fixed charge coverage is simply too low for the



Since 2003, EBITDAR averaged 1.5 times total rent and interest expense

company to be confident it could fund growth without access to financial markets. In normal times, Town Sports can refinance its debt. But in the midst of a crisis, capital spending might already have been budgeted for a year in which it became difficult to refinance debt.

This is an unlikely scenario. The 2008 financial crisis was extreme. And Town Sports survived the crisis. The company was even able to pay a special dividend in 2012. The board is now considering a regular quarterly dividend of around 15 cents a share. That would give an annual dividend of 60 cents a share. On the current stock price of $10.91, this would give a dividend yield of 5.5%. That sounds like something investors would like. But it would add more limitations to the company's already highly non-discretionary cash flows. With 24 million shares outstanding, a 15 cent a quarter dividend would add up to a payment of between $14 million and $15 million a year in promised dividends. That is a small item when compared to minimum rental payments of $84 million a year and even interest of $24 million a year. But the combination of these 3 items would further restrict Town Sports' financial planning to being similar to that of a regulated utility. Returning capital is good for investors. But it does add some risk to the long-term durability of the business. The company has plenty of free cash flow available now. But expansion plans were much slower since the recession. Before 2008, it was not unusual for Town Sports to need additional capital to fund its expansion plans. In the future, it seems unlikely this will be true. There are 2 reasons for that. One, the company has more mature clubs now. They are generating a lot of free cash flow. Two, the company has scaled back its planned expansion. Right now, they are on track to add just 6 clubs a year in each of the next two years. Even if the company announced a regular dividend that would require payments of $15 million a year to shareholders, the capital expenditures needed to add 6 gyms a year would not eat up all of the company's free cash flow. So, there is enough room for planned growth and a possible dividend yield of more than 5% at the current stock price.

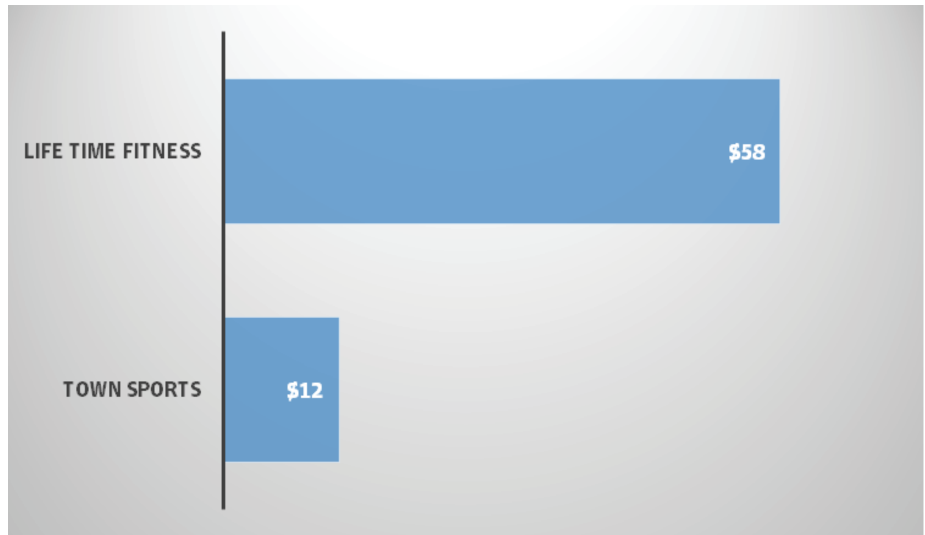
Town Sports is probably in a lower risk period in its history right now. The company is focused on adding smaller clubs in New York and Boston. The percentage growth in the location count is going to be much lower in the future than it was from 1996 until the crisis. Town Sports is unlikely to ever repeat that period of rapid growth. It is unlikely to ever need that much access to capital again. For the foreseeable future, the company will be able to fund any expansion with the cash it generates from its existing clubs. For that reason, Town Sports is on firmer financial footing than it had been in the past. The $82 million sale of the one property it did own adds to this financial security. However, management has discussed the possibility of both a

special dividend and a regular dividend. There is no indication that the company will be run more conservatively than it had been in the past. The board favors a high degree of leverage. But that is common in this industry. And Town Sports has survived the worst crisis it is likely to face in a long time. The same store sales declines in 2009 and 2010 were a test of the company's durability. Town Sports passed that test. It is a business with stable revenue. So the temptation to take on excessive leverage is the only real risk to the company's long-term durability.

MOAT: *Town Sports Has a Local Moat Around its Dense Network of Urban Clubs*

Town Sports has a moat around its urban clubs. The company controls clusters of clubs in expensive urban locations. Leases on these fitness centers generally run from 15 to 25 years. Having a cluster of 10 or more clubs in a local market allows Town Sports to have economies of scale. The company's local cluster is able to share advertising expense and have low administrative costs. The best positioned brand in the company is the New York Sports Club brand. A total of 108 centers in the Tri-State area (New York, New Jersey, and Connecticut) use the New York Sports Club name. Many of these clubs are in New York City. There are 38 locations using the New York Sports Club name in the borough of Manhattan alone. It takes time, money (expensive, long-term leases), and scale to reproduce the competitive position of New York Sports Club. The company's moat is widest in Manhattan specifically and New York City generally. Town Sports is the leading operator of fitness clubs in the New York and Boston markets. The company has weaker positions in Washington D.C., Philadelphia, and Switzerland. Any discussion of Town Sports' moat has to focus on the New York and Boston markets.

In the suburbs, the barriers to entry at the low end of the fitness center industry are very low. There are 22,000 operators of fitness centers in the U.S. Most operate just one center. There are 30,000 fitness centers in the United States. The vast majority of these offer limited amenities. The two companies with the widest moats in the fitness center business are Life Time Fitness and Town Sports. Life Time Fitness builds some of the largest centers in the United States. They own their own facilities. They often have a market share of 50% in the local area. Town Sports has a mix of urban and suburban clubs. The suburban clubs are at risk of higher competition than the urban clubs. Urban clubs target very small local markets. In Manhattan, Town Sports is normally drawing from a market defined by a radius of 2 to 3 blocks.



Town spends 79% less on advertising per member than Life Time

It is impossible to come up with an exact definition of urban and suburban clubs. For example, Town Sports has clubs in Northern New Jersey. These towns are generally referred to as suburbs of New York City. However, Northern New Jersey has a population density that is as high as many urban areas in other parts of the country. Town Sports gives the location of each club in its annual report to the SEC. Based on that information, it is possible to divide the company's locations into truly urban clubs, clubs near large cities, and clubs that are truly suburban.

Town Sports has about 83 truly urban clubs. The company has 60 clubs in New York City, 10 in Washington D.C., 7 in Boston, 3 in Philadelphia, 2 in Basel, and 1 in Zurich. These numbers refer to city locations only. The company has many more locations close to – but not actually in – these major cities. The company also has about 20 clubs that are clearly commuter clubs. They are in towns where people commute into a major city. These include towns like Fairfax, Virginia (a suburb of Washington D.C.) and Scarsdale, New York (a suburb of New York City). If an investor were to divide Town Sports' clubs into wide moat clubs, narrow moat clubs, and no moat clubs – the distinction would best be made between the 83 clubs inside cities, the 20 clubs in expensive suburbs of cities, and then the 57 clubs that are truly suburban. It is easiest for competitors to enter truly suburban areas, because the amount of miles covered in a short commute is much higher due to the possibility of commuting by car. In places like Manhattan, walking distance is important. In suburbs, driving distance becomes important. About a third of Town Sports' locations are in areas comparable to where Life Time Fitness places their centers. The other two-thirds of Town Sports locations are in areas that are truly urban. Life Time Fitness does not try to place clubs in those areas.

Town Sports has much greater location advantages than Life Time Fitness. In 2012, Town Sports spent $12 per member on advertising. Life Time Fitness

spent $58 per member on advertising. Town Sports benefits from dense urban clusters that can share advertising expense. The company also benefits from having much larger pools of potential members to draw from within just a few blocks. More people walk by the club. It is much easier to attract new members to the clubs. Once inside the club, Town Sports has to engage in the same sort of salesmanship as Life Time Fitness or any other gym. However, the cost of actually getting people into the gym is clearly much lower at Town Sports. This is largely offset by the high cost of real estate. Town Sports usually spends about 18% of its sales on rent expense. In a sense, Town Sports' best advertising is its high profile real estate.

Unlike Life Time Fitness, Town Sports also benefits from network advantages. Urban lifestyles are different from suburban lifestyles. Convenience is defined by public transportation routes and walking distances. Very few Life Time Fitness members make use of more than one location. The opposite is true at Town Sports. A total of 38% of all visits are from members visiting a location that is not their home gym. There is much greater use of different gyms throughout the same city. Town Sports wants to have enough locations to offer a club that is conveniently situated near a member's home and a different club that is conveniently situated near a member's office.

Town Sports is a mid-price, high convenience operator. It does not offer the kind of amenities at most of its clubs that would put it in direct competition for the market segment targeted by Life Time Fitness, Equinox, LA Fitness, and 24 Hour Fitness. Town Sports instead uses convenience to try to dominate the market in the few blocks around each club.

Town Sports has a weaker competitive position in the suburbs. The average suburban club is 40,000 square feet. A Life Time Fitness club averages 2-3 times the size of a Town Sports suburban club. The suburban clubs are larger than the urban clubs. However, they are much smaller than the largest, best suburban clubs that a competitor like Life Time Fitness focuses on.

The average Town Sports location has 2,000 to 4,500 members. This means they are less crowded than many franchised fitness chains. However, Town Sports is positioned between the franchise chains (like Planet Fitness and Crunch) and the resort style clubs like Life Time Fitness. The focus for Town Sports is convenience. The company has the most clubs conveniently located of any operator in New York or Boston.

The difference between Town Sports and Life Time Fitness is best explained by Town Sports' CEO, Bob Giardina: "We do really direct and position our clubs as the neighborhood gym." Like Life Time Fitness, Town Sports does not bet on any one exercise program. It changes the programs it offers as different fads grow and shrink in popularity over time. As Giardina explained: "I think customers get bored…people don't like to exercise, so you have to have enough variety to keep people moving into different functions. So 25 years ago, some of us may remember step programs. They were popular. Before that, it was Jazzercise. Today it is kettlebells. So the box has to stay flexible, and that is what I love about our product. The box is flexible. What we put in the box can move around. So we have to stay close to the members. We have to understand what their needs are."

Town Sports is not highly differentiated from other operators in terms of what programs it offers. The company's moat is purely the urban location of its entrenched clusters.

QUALITY: *Need for Tangible Assets Keeps Town Sports from Being a Great Business*

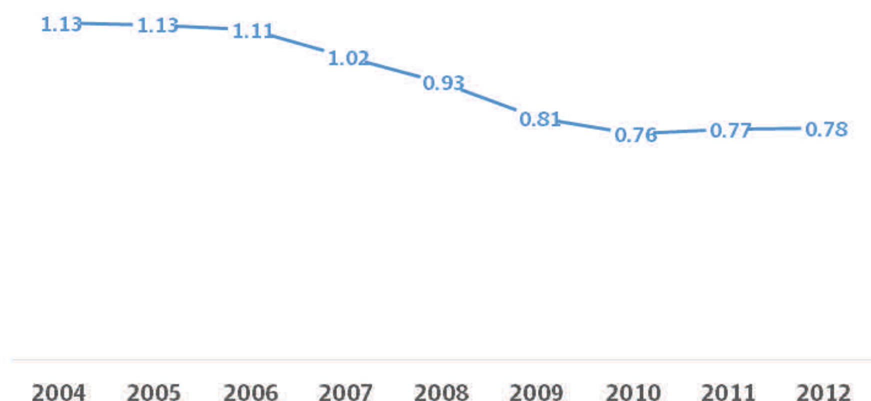
Town Sports has similar business quality to Life Time Fitness. The two companies have different sources of competitive advantage. They have somewhat different business models even at the level of each individual center. But they both are ultimately good businesses rather than great businesses. The need for capital keeps them from being great businesses. Most of that capital is needed up front. Some of it can be borrowed. Life Time Fitness owns its locations. Town Sports leases its locations for 25 years (15 years plus options that allow Town Sports to extend the lease for up to another 10 years). In addition to the long-term obligation created by having fixed rental payments for the next 15 years, a new club also requires capital expenditures. Town Sports invests $2.5 million in a 20,000 square foot club. A 40,000 square foot club (which is usually in the suburbs) costs $4 million to start-up. Each center takes up to 2 years to mature. The company targets a 4 to 5 year payback on its initial investment. The business model plans for at least a 20% rate of return. All of the investment is in property and equipment. In 2012, Town Sports had gross property, plant, and equipment of $680 million before accumulated depreciation. This reflects the actual historical investment in its properties. The amount shown under PP&E on the balance sheet is the net number. It is after accumulated depreciation. The company had over $84 million in minimum rental payments last year. For purposes of comparisons between companies that own their properties and companies that lease theirs, it is customary for analysts to capitalize leases at 8 times rent expense. This is equivalent to $672 million in long-term obligations. Working capital is not an important area of investment for Town Sports. The company collects initiation fees upfront and needs to keep almost no inventories or receivables. Net working capital was just $54 million in 2012. It is an insignificant item relative to the cost of the properties Town Sports controls and the equipment it puts in those properties.

Because upfront investment is so high, fitness center operators often use debt. Town Sports uses both debt at the corporate level and leases at the

individual fitness center level. These create significant fixed costs. Rent expense was 19% of sales in 2008, 22% of sales in 2009, and has now been 24% of sales in each of the last 3 years. This increase in rent relative to sales was caused by same store sales performing poorly in 2009 (down 5.6%), 2010 (down 4.3%), 2011 (up 1.8%). 2012 (up 1.6%) and 2013 (down just under 2% in the first 3 quarters). Other costs are more variable than rent, but most are still relatively fixed. For example, payroll declined just 8% from its 2008 peak to its bottom in 2011. During the same time period, revenue declined more than 10%.

The decline in same store sales does not necessarily reflect a decline in same store memberships. In fact, same store memberships only declined in 2009 (down 4.3%) and 2012 (down 1.4%). All other years saw same store revenue declines caused by declining revenue per member. Membership revenue accounts for only 79% of Town Sports' total revenue. The other 21% comes from areas like personal training. These are add-ons that are more discretionary. They declined faster and further in the recession. They have dragged down the overall revenue results since 2008.

Membership itself is fairly stable. The average member stays for 27 months (2 years and 3 months). About 40% of members are lost per year. About 13% of members move out of the local area. About 13% go from being inactive, paying members to cancelling their membership. The rest cancel for a variety of reasons including dissatisfaction and the need to reduce their personal spending. Town Sports has usually had little trouble replacing lost members. Attrition was 38% in 2007 and then peaked at 45% in 2009. It has since declined to 40% in 2011 and 41% since then. A number around 40% a year is normal. Town Sports has never had more than a 45% rate of attrition. Changes in the attrition rate were the cause of same store membership declines. An extra 5% of members quit in 2009 and same store membership fell 4.2%



Since 2008, sales have failed to exceed net tangible assets

(implying Town Sports could only offset 0.8% of the increase). In 2012, attrition rose by 1.1% and same store membership declined by 1.4%. This implies that Town Sports fell short of its needed level of new member sign ups in 2012 by at least 0.3%. At a normal attrition rate, the company still would have lost some net members. That is unusual in being the only year when that happened so far. Management claims Hurricane Sandy was probably responsible for this decline. That is possible. Town Sports is heavily concentrated in New York and New Jersey (including Long Island). These were the worst hit locations. Hurricane Sandy was the second costliest hurricane in U.S. history. It was by far the costliest hurricane to hit the Northeast. However, same store membership continued to perform poorly throughout 2013.

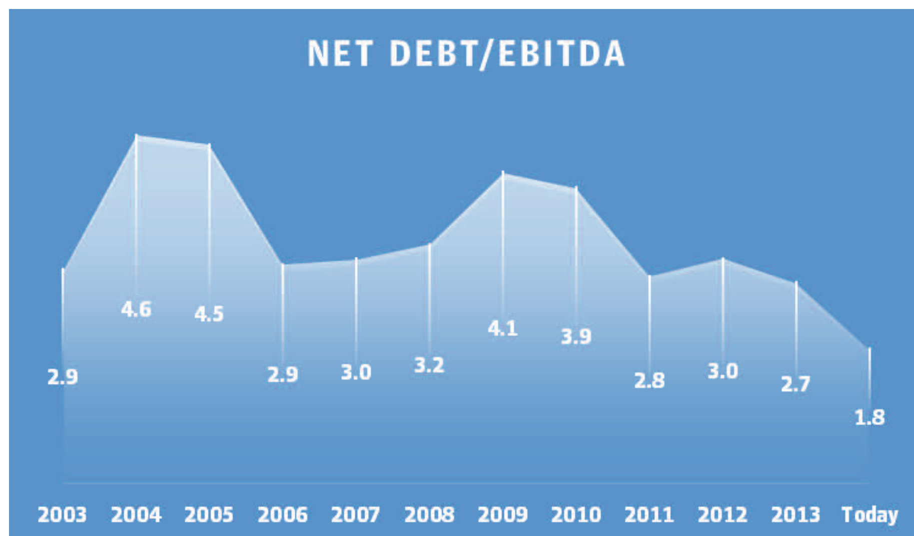
Town Sports has limited pricing power. The company increases its membership fees by 1% to 3% each September. This is essentially equal to a steady real price. The rate of increase is roughly the rate of inflation. This is due to customer stickiness in gyms generally. Clubs like Life Time Fitness are also able to raise prices a small amount each year. Town Sports is able to reach capacity at its gyms much faster than Life Time Fitness. This is because the gyms are much smaller, the locations are more urban, and the company is able to advertise in a region more continuously due to its clusters. Life Time Fitness has to begin its marketing push before it opens a new location, because that location is usually in an entirely new town for the company. Town Sports is often filling in its existing clusters. When the 38th club is added in Manhattan, it is being added to a region where people already see the presence of 37 other clubs using the same name and see ads promoting the brand. Town Sports does not have to start from scratch in terms of name recognition. This clustering leads to a dense location advantage. The company can spend a lot less on advertising than other gyms to attract the same number of replacement members. Town Sports is able to charge more relative to its operating costs other than rent. For example, Town Sports has a club level EBITDAR margin of around 47% compared to 34% for Life Time Fitness. But this advantage disappears when the cost of rent is included. That has ranged from 18% to 24% of sales. So, Town Sports is merely able to pass its high rent expense on to its customers. It can charge customers at its urban gyms more than other companies can charge for similar services in the suburbs. But operating urban gyms requires paying high rent. As a result, customers pay more but it is the landlord rather than the gym operator that benefits from this pricing power.

Town Sports can earn a return on capital of more than 13%. The company's EBITDA margin (after rent) has usually averaged 21% of sales. The company

had a sales turnover greater than 1 in all years prior to 2008. Maintenance cap-ex is about 4% of sales. High depreciation relative to maintenance cap-ex lowers Town Sports tax burden on reported income (net income understates free cash flow). So, without using any leverage (other than leases) Town Sports would have a 13% after-tax return on equity rather than an 11% return on equity. The company can borrow at rates much lower than 13%. Last year, interest payments were 8% of average debt. To the extent Town Sports uses debt, it will increase its return on equity above 13%. Under normal economic conditions, returns of 10% to 15% seem likely.

CAPITAL ALLOCATION:
Town Sports Will Increase Leverage and Return Capital to Shareholders

Town Sports has unusual capital allocation, because its cash flows are unusually predictable. The company uses a lot of leverage. It generally meets its fixed charges with just a 34% margin of safety. Fixed charge coverage is often around 1.5. The company pays high interest rates. Even in today's low interest rate environment, Town Sports paid an average of 8% of its average outstanding debt in interest. However, the company's return on capital is consistently higher than 8%. So the borrowed money creates value for shareholders. This leverage rewards shareholders with returns on equity that often exceed the 13% after-tax that Town Sports would probably earn if it used leases but did not use any corporate level debt. The best way to understand capital allocation at Town Sports is to think of the company as acting like a utility. The board has traditionally made the kind of capital allocation decisions that are more common at railroads, cruise lines, power companies, water companies, and real estate businesses. All of these businesses share the same need for lots and lots of tangible assets relative to sales. Sales tend to be fairly predictable. Margins are very wide. Financial security depends on



Town Sports has the lowest leverage in its history

asset turnover. Return on equity depends partly on operating leverage (asset turnover) and partly on financial leverage (the debt to equity ratio). Because Town Sports leases its properties instead of owning them, the company often has a negative tangible equity ratio. It has no book value. The best way to analyze Town Sports' ability to meet its obligations is to focus on a cash flow figure like EBITDAR (Earnings Before Interest Taxes Depreciation Amortization and Rent) relative to interest payments, rent, maintenance cap-ex, and capital spending on growth. At a minimum, Town Sports must always have a higher EBITDAR than it is required to pay out in interest and rent. These payments are outside obligations that must be met. Maintenance cap-ex is also a real requirement. However, it is very low relative to reported depreciation and amortization. As a rule, Town Sports takes about 10% of sales in depreciation expense while it actually only spends 4% of sales on maintaining its property and equipment. This causes it to understate its earnings by about 6% of sales a year. For this reason, it is best to ignore Town Sports' reported earnings and focus instead on EBITDAR versus interest, rent, and cap-ex.

When Town Sports went public in 2006, it had a debt to EBITDA ratio of 4.5. This is very high. It is high even for a company that does not use a lot of long-term leases. Generally, it is best to keep Debt/EBITDA at 3 or below if a company wants to maintain the ability to borrow more in the future. Town Sports' actions since the IPO reflect this fact. The company has usually kept debt at 3 times EBITDA or less. When EBITDA declined in 2009 and 2010, the company failed to keep debt under 3 times EBITDA. This ratio spiked to 3.8.

Today, the company's net debt to EBITDA is very low (1.77). The board is considering paying out a special dividend or starting a regular dividend of around 14 to 16 cents per quarter. This is largely the result of selling the company's only owned property in New York City for $82 million. That increased the company's cash balance to $150 million. Town Sports does not normally keep that much cash on hand. It is very likely the board will do something with the cash. In normal times, a leverage ratio near 3 times EBITDA would be the likely target. Although the company discusses debt versus EBITDA, an investor should focus on capitalized debt versus EBITDAR or simply EBITDAR versus fixed charges. Capitalized leases are a bit of a fiction. Analysts like to capitalize rent at 8 times the annual rental payment. In reality, Town Sports is not obligated to repay or refinance this capitalized amount. It is only obligated to make the rental payment annually for the length of the lease. This is a very big burden. It is a real financial burden. But it is spread out evenly over the 15 years each lease runs. Using the custom of capitalizing leases at 8 times rent, Town Sports has used a debt (including

capitalized rent) to EBITDAR ratio of 5.0 to 6.3 since 2003.

The better measure is the comparison using fixed charges. The simplest approach is EBITDAR/(Rent + Interest). This has varied from 1.34 to 1.82 over the last 12 years. The median level is 1.51. The number has been very stable. It has been stable because rent expense is much higher than interest expense. If interest expense was the bigger item, economic conditions would cause greater fluctuations for Town Sports. Leases are long-term and expire at different times. This causes very gentle changes in rental expense for Town Sports. Generally, rental expense has been between 3 and 5 times interest payments. That means that only 15% to 25% of fixed charges are tied to interest rates. Town Sports has very little debt due in the next 3 years. About $270 million of the company's $311 million of debt comes due after 2017. Town Sports has $150 million in cash on hand. The company's interest rate (8%) is not especially low. So, there is little refinancing risk. The real risk is simply failing to meet rent in an especially bad period for the company.

Although leverage is so high that fixed charges are met with only a small margin of safety, the risk of insolvency seems low. Town Sports survived the 2008 financial crisis. This was the period in which same store sales in the gym business were worst. It was also the period in which access to debt markets was most limited. Town Sports' stock price also plunged during this time. So it was not possible to raise much cash through any sort of equity offering. That episode was a good test for Town Sports. It is rare for consumer confidence, access to debt, and a company's stock price to all plummet at the same time and then for the adverse conditions to continue for a number of years. That happened to Town Sports. And the company had been expanding rapidly before the crisis. So, it was in a bad position. The company's survival then is a good indication that if it could still generate EBITDAR of more than 1.34 times rent and interest even in the worst conditions imaginable, it will be able to do so in the future.

The company's board is not conservative. When asked about the right ratio of debt to EBITDA, the company's CFO said: "We're very comfortable right now. I can tell you that. I think in general terms, anything under three, we've been very comfortable with…our business generates significant cash flow. And in the past, we've been higher than three and we've (been) comfortable with that."

Town Sports' only need for free cash flow is the development of new centers. They have scaled back their growth plans. In 2012, the CEO said: "…our focus over the next few years will be primarily New York and Boston urban markets. We understand those markets. We've been in those markets for over 30 years. We plan on strengthening those markets. And we've identified over 50 locations between those two."

Town Sports will produce much more free cash flow than needed over the next few years. Based on past capital allocation, it is likely they will increase leverage and return excess capital to shareholders. In 2008, they bought back 15% of the company. In 2012, they paid a special dividend of $70 million. The board is now considering a regular quarterly dividend that would give the stock a 5.5% dividend yield at today's price. Investors who buy the stock today should get a lot of their purchase price paid back to them in buybacks, special dividends, or regular dividends over the next few years.

VALUE: *Town Sports Trades at 7 Times Free Cash Flow*

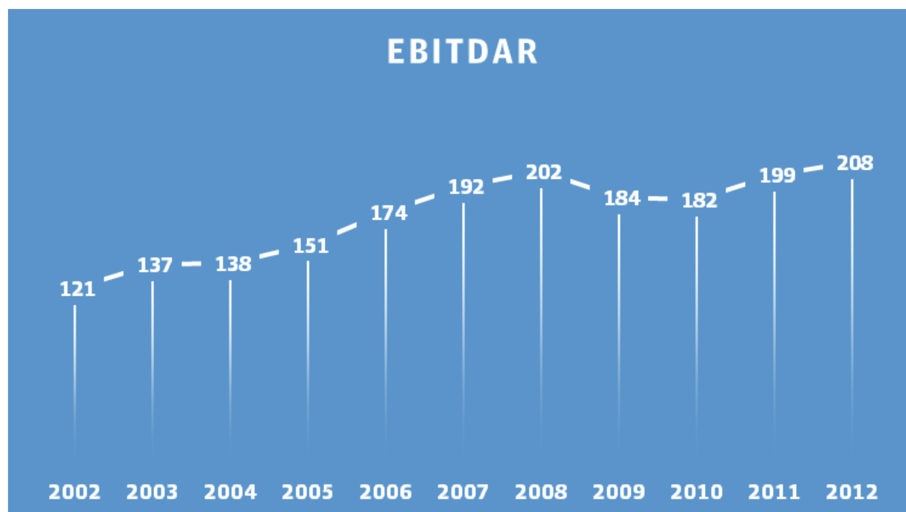
Town Sports is one of the cheapest stocks to appear in The Avid Hog. Even when leases are capitalized at 8 times rent and added to the company's market cap and debt, the enterprise value is less than 7 times owner earnings. Without these capitalized leases included in enterprise value, the ratio would be closer to 5. As a company with wide moats around its urban locations and a customer retention rate of 60% a year, Town Sports deserves to trade at about 10 times owner earnings. The value of the stock is more difficult to determine, because it depends on the leverage the company uses. It is easiest to start with the cash flow Town Sports is likely to generate and then compare the value of that cash flow to what is needed to pay landlords and debt holders. The rest belongs to shareholders.

In 2012, Town Sports generated $94 million of EBITDA. This is probably lower than the amount of EBITDA Town Sports could generate in an average future year. In 2008, the company had EBITDA of $107 million. There is no reason to believe that the fitness center industry will not one day reach the same levels of activity it had before the financial panic. Town Sports is not alone in having lower EBITDA than in the past. This is common among gyms. Many have not returned to their pre-crisis levels. Town Sports opened 23 clubs in 2007 and 2008. These new clubs would have been a drag on 2008 EBITDA, because they had not yet reached maturity. Management estimated those clubs would add $30 million in EBITDA under normal, mature conditions. This suggests the company had the potential to earn $137 million in EBITDA in 2008 if all of its locations had been fully mature. This number of $137 million in EBITDA is probably a good gauge of Town Sports' maximum earning potential on its current locations. The company ended 2012 with 6 fewer clubs than it had in 2008. However, Town Sports kept half of the members of these clubs by switching their memberships to another Town Sports location nearby. On a membership basis, Town Sports has almost the same number of members now as it did in 2008. But the company added a "restricted membership" option that includes about 38,000 members. Without these members, Town Sports would have about 40,000 fewer members now than it did in 2008. So the company is slightly below its 2008 levels in terms of memberships. Based on these figures, it seems certain that Town Sports' existing locations can

serve at least 510,000 full members. Revenue per member was around $1,000 a year before the crisis. Based on the company's EBITDA margins, it is clear that if the current store base operated at capacity it would generate about $110 million in EBITDA.

Maintenance cap-ex is about $25 million. This can be computed several ways. Normally, maintenance spending is 4% of sales. However, it can be assumed that maintenance spending is tied to the total amount of assets rather than sales. As the ratio of sales to assets declined since the crisis, it is possible that maintenance cap-ex will rise relative to sales (while staying stable as a percent of assets). An easier way to compute cap-ex is to simply average all of the company's capital spending other than new store openings from 2006 to 2012. Town Sports spent $132 million upgrading existing clubs. It spent $29 million on an IT system upgrade. Another $10 million went to renovating clubs. And $7 million was spent on a new laundry facility. That is $178 million in capital spending other than new store openings over a 7 year period. It averages out to $25 million a year. That seems like the level of capital spending needed to keep the business steady.

Normal EBITDAR is around $225 million a year. Maintenance cap-ex is around $25 million a year. That leaves about $200 million to pay rent and interest. The rest can be used to benefit shareholders by building new centers, buying new centers, buying back stock, paying a special dividend, or starting a regular dividend. Last year, rent totaled $117 million. So that leaves $83 million for interest payments and shareholders. Interest expense was $25 million. So, that leaves about $58 million in pre-tax profit for shareholders. This is a leveraged number. It comes after all rent and interest has been paid. At a normal tax rate of about 35%, this would leave about $38 million for shareholders. Town Sports has 24.10 million shares outstanding. Normal after-tax profit would be around $1.58 a share. The



Town Sports generated $208 million to pay rent, interest, and shareholders

stock currently trades at $10.91 a share. This suggest a P/E ratio of about 7. This does not match well with reported earnings. But a check of actual free cash flow is probably the better test. The best levered measure of free cash flow is simply to define free cash flow as cash flow from operations minus capital spending. Then the market cap can be divided by free cash flow to get a price to free cash flow ratio. Free cash flow was $38 million last year. That is exactly the same number that the owner earnings approach came up with. So, on a levered basis, Town Sports' shares are trading at about 7 times cash earnings. It is also worth checking a longer-term average. For example, all the post crisis years can be averaged out to see what free cash flow generation per year has tended to be. In 2009, free cash flow was $33 million. In 2010, it was $29 million. In 2011, it was $44 million. And in 2012, it was $38 million. The four year average is $36 million in free cash flow. That works out to almost exactly $1.50 a share in free cash flow. The stock trades just under $11 a share. So, a four year average of free cash flow also comes up with a price that is 7 times free cash flow.

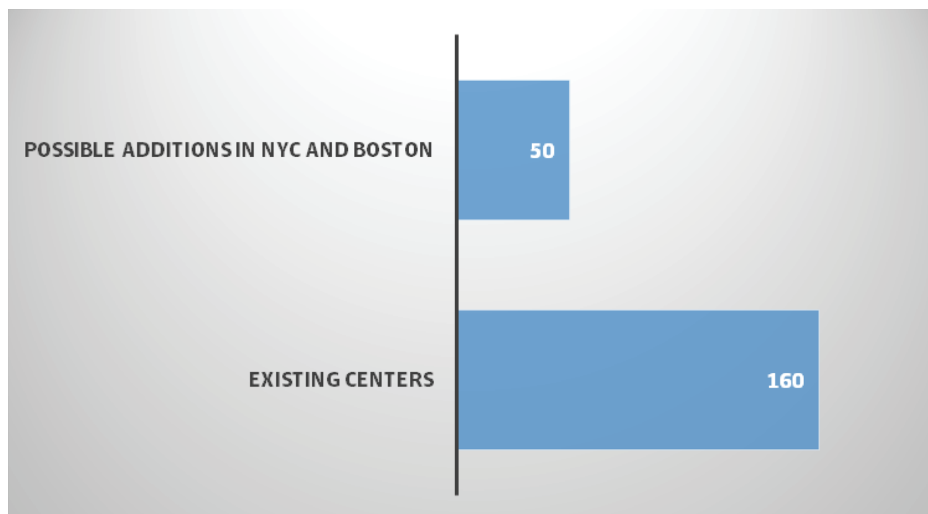
It is important to remember this is a leveraged number. The free cash flow yield for the stock is 14%. This is the amount of money relative to the market cap that should be available for dividends and buybacks. The margin of safety is much lower than this 14% number suggests. That is because Town Sports' leases are worth far more than the company's market cap. So a decrease in earnings before rent could cause the company to fail to meet its rent and interest payments. The 14% free cash flow yield is a good measure of the potential return in the stock. But it is a measure of upside rather than downside. The downside number to look at is the ratio of EBITDAR to fixed charges. Town Sports needs to generate enough EBITDAR to cover rent, interest, and maintenance cap-ex. A decline in EBITDAR of just 20% would cause a problem for shareholders. In that situation, Town Sports would be able to pay all of its rent and interest. But it would not be able to spend as much on maintaining its properties as it should. It also would have nothing left over to pay dividends or buy back stock.

Town Sports is equivalent to a highly indebted company with a P/E of 7. The stock's price to owner earnings is very low. But the margin of safety in the stock is not as high as that suggests. Shareholders are the first people at risk. Town Sports will halt buybacks and dividend payments before it will miss interest or rent payments. However, Town Sports has proven itself capable of surviving a crisis. The company's properties are performing below capacity. So the 14% free cash flow yield is probably an understatement of the future earnings potential of the company. The upside in Town Sports is very high. To

be priced in line with other stocks, the company's shares should sell for more than $23. That is more than double the current price.

GROWTH: *Town Sports Has a Lot Less Room For Growth Than Life Time Fitness*

Town Sports has limited growth prospects. The company's unleveraged return on investment is good. But it is not great. The need for an initial investment in a new location constrains the returns on capital. And the need to cluster clubs in metropolitan areas limits the number of cities Town Sports can enter. It is likely that growth will be low relative to the company's current size. So the value any growth adds to the stock is likely to be low. Investors will make more money from the possibility of a regular dividend, special dividends, or stock buybacks than they will make from sales growth leading the stock price higher. This is especially true during the next few years. Town Sports has scaled back its original growth plans. Right now, the company's plan is to focus on their two best markets: New York City and Boston. The CEO told analysts: "...we're going to stay very strict to the plan in terms of the next two to three years. We're on record now saying that we're going to stick with New York City and Boston. Once we fill those markets in, we have the other two markets in terms of Philadelphia and Washington. Beyond that, we would have to consider, but there's so much opportunity just in the New York (and) Boston (markets). We've identified more than 50 target markets in those areas alone. So at least over the next three to four years, I think we have our hands full." Town Sports has 160 centers. Adding a total of 50 more centers would only increase the company's size by about 30%. That growth would be spread out over a number of years. And having 50 target markets is not the same thing as actually building 50 new centers. Town Sports may decide not to completely fill in those two cities. It seems that while there is growth



New Centers in New York and Boston Could Add 31% to Town Sports' Size

potential, it is definitely limited. Town Sports will not be able to increase the number of centers it operates as quickly as Life Time Fitness. The company will reach complete maturity in New York City and Boston long before Life Time Fitness reaches maturity around the country. Clusters of urban gyms are a much more limited concept than huge suburban gyms.

Town Sports could eventually enter other cities. It is entirely speculative to consider what cities those might be. And Town Sports would need to accumulate a cluster of locations in a new city at once. It would not be the leader in any city it entered. Its prospects would be less certain than they are in the 4 cities Town Sports is already in: New York, Boston, Philadelphia, and Washington.

Town Sports will increase sales a few other ways. It will raise membership prices. The company has historically increased its prices by 1% to 3% each September. Competition for space makes new entry into urban markets more difficult than in cheaper suburbs. This slightly high bar for new entry combined with the natural stickiness of any customer to their neighborhood gym, makes it possible for urban gyms to raise prices about in line with inflation. At very high rates of inflation, it is not clear if this would still be true. But price increases have tended to track inflation in the past. Town Sports can also increase in center revenue. This is additional revenue that does not come from the membership fee. Instead it includes add ons like personal trainers. Town Sports has increased this revenue faster than memberships. However, it has not achieved the kind of cross selling success that Life Time Fitness has in its gyms. Town Sports' ability to add on revenue is probably lower than Life Time Fitness. Each of Life Time Fitness's gyms are bigger. Life Time Fitness is also a more sales driven organization. Town Sports has increased in center revenue from 14% of total sales in 2002 to 20% of total sales in 2012. This is impressive considering in center revenue is more discretionary than membership fees. It is common for basic services to hold up better than add ons during a recession. So it is clear that Town Sports has been trying to increase in center revenue. However, the company has only now reached the level of in center revenue (20% of total sales) that Life Time Fitness had 10 years ago. Today, Life Time Fitness gets 31% of its revenue from in center sources while Town Sports only gets 20%. On the one hand, this shows that Town Sports has room to improve. On the other hand, the company's store format does not seem as suited as the Life Time Fitness format to increasing revenue from sources other than membership fees.

Town Sports has one idea that Life Time Fitness does not. The company has

an entirely new concept it is planning to introduce in the same markets it is already strongest. It is called BFX studio. The CEO explained it as: "…it's a metropolitan product. So it could go into any metropolitan community across the United States. It competes very well against high-end clubs as well as low -end clubs…There are three distinct product lines there. There is the spinning product, there's the group exercise product, and there is the personal training product. All three of those products are now well received and consumers are willing to pay a premium to have an exclusive or an excellent experience in those products." Pricing works differently with BFX studio. It is possible that BFX will be more exposed to possible fads than the larger format clubs. The large format clubs can easily switch space from one use to another as the types of exercise people are interested in change. The BFX studio locations will be only 7,500 to 9,000 square feet. The company is targeting similar economics at these locations as they have on the larger centers. The capital expenditure will only be about half the usual amount. The cash flow generated would also be about half the usual amount. The payback period is hoped to be less than 4 years. However, all of this is speculative. There are already 160 centers using the traditional Town Sports format. It will be several years before the BFX studio concept has a number of mature locations to judge. The risk to the company appears small. There have been some small charges in launching the brand. The first few studios will cost $2 million each. If they do not perform as expected, the experiment can be stopped early. There is some upside in this concept. It is a natural extension for Town Sports in its best markets. And it is probably a safer strategic move than trying to take an urban concept into the suburbs. This way, Town Sports is focusing on their area of greatest strength. They are staying in some of the largest cities in the Northeast. The format of the locations is smaller. But the start up costs are not especially low. Most fitness centers around the country use cheaper real estate than these BFX studios will use. They also cost a lot less than $1.5 million to $2 million in initial capital expenditures. This is not the kind of model that would be most interesting to a franchised operation. It is a good fit for Town Sports. But it is entirely speculative. The filling in of New York City and Boston with another 50 or so traditional fitness centers is the least speculative area of growth. It is simply repeating a proven model. Some of these clubs have not been successful. Town Sports has closed a few when needed. But, the model has generally worked well. It is not a big gamble to expand to over 200 centers. But it is also not a big source of future growth. Town Sports will mostly be a high free cash flow generating stock. It will not be seen as a growth stock. The rate of future growth will probably be modest.

MISJUDGMENT: *The Greatest Danger at Town Sports is the Failure to Meet Fixed Charges*

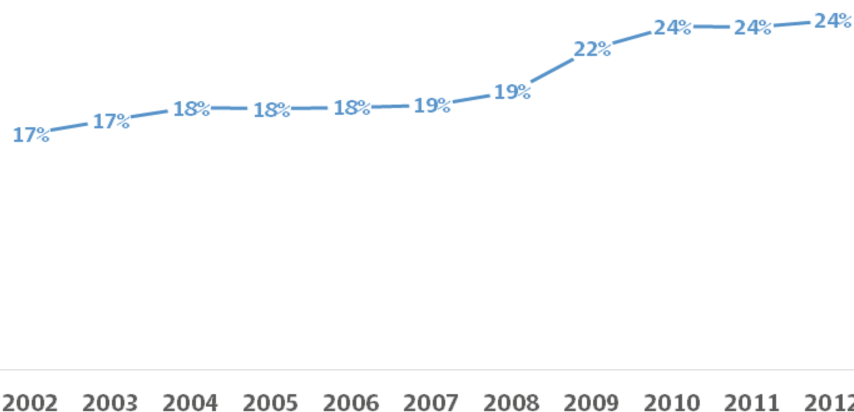
The greatest risk of misjudgment with Town Sports is the fixed nature of the company's expenses. There are several ways to value the company. One method is using enterprise value with leases treated as if they were debt with a face value that is 8 times annual rent expense. This is a common way to analyze companies with leases. However, it is potentially very misleading. Most public companies today borrow for shorter periods of time and at rates that are more variable than the expense on a 15 to 25 year lease. The leases are more similar to a mortgage than to general corporate borrowing. Rental expense never declined along with interest rates. The price Town Sports paid on its leases actually increased slightly throughout the crisis. If the company had been borrowing 8 times its rent expense in bank debt and then owning this real estate, the outcome would have been very different. On the one hand, access to credit would have become a serious problem during the crisis. So there would be very great refinancing risks. On the other hand, interest rates for business borrowers declined dramatically following the recession. Long-term borrowing at fixed rates would have been very cheap. This suggests that capitalizing the leases at 8 times rent actually understates the amount of capital that would be needed to buy Town Sports' properties outright. Based on the list of properties the company provides, this seems certain. The building Town Sports owned was just sold for $82 million. Some of the leases in Manhattan and elsewhere in New York City are in very expensive locations. It is not realistic to believe Town Sports could operate a business model where it owned many of its properties outright. The company has no intention of ever doing that. It has been in New York City for over 30 years. In that time, it has never made property ownership part of its business strategy. For this reason, it is more accurate to focus on Town Sports' cash flows relative to fixed expenses rather than attempting to create a highly theoretical measure of enterprise value by capitalizing the company's leases.

Town Sports is a cheap stock. Cash flows are fairly stable. Demand for gyms is somewhat cyclical. But if it were not for the very big financial crisis that happened in 2008, the company's results would not look so cyclical. The attrition rate barely moves based on consumer confidence. Attrition increased by just 5% of total members at the worst point in the financial crisis. This is an increase of just over 12% relative to the normal rate of attrition of 40%. Town Sports was even able to replace most of this additional attrition. That is surprising because marketing should be least effective at the low point of consumer confidence. For these reasons, it is unlikely that insufficient demand will cause insolvency at Town Sports.

The most likely cause of insolvency is excessive fixed charges. This happens in the fitness center business quite frequently. Most companies that have entered bankruptcy in this industry have done so because of rapid, debt fueled expansion. When consumer confidence declines at the same time debt

becomes harder to refinance, the company fails. However, it is worth noting that poor cost control was a factor in bankruptcies like Bally Total Fitness. Town Sports has never shown the kind of overhead cost increases that occurred at some of the failed gyms. So, operationally it has performed better than those companies that became insolvent. Of course, it has also used less debt than the bankrupt companies. This is the biggest factor in explaining how Town Sports has always survived difficult economic times.

The margin of safety for Town Sports in terms of EBITDAR to fixed expenses is low. It is between 20% and 35% depending on how you measure it. The most stringent test of EBITDAR would be to require Town Sports' EBITDAR to exceed rent plus interest plus maintenance cap-ex. The company has always been able to do that. So there has always been some cash flow from operations available to fuel growth, dividends, and buybacks. Historically, Town Sports did not buy back much stock or pay out much in dividends, because it wanted to expand. However, the company's planned future expansions are much too low to consume the free cash flow Town Sports is likely to generate. Today, Town Sports is generating about $38 million in free cash flow each year. A new center takes only $2.5 million to $4 million to build. Town Sports is also well below its usual level of leverage. It has more cash and less debt than normal. That is true despite paying a special dividend in 2012. Town Sports is likely to increase its leverage either by paying a special dividend, buying back stock, or starting a regular dividend. The board is considering a regular dividend of around 15 cents a quarter (60 cents a year). This would give the stock a 5.5% dividend yield. That is high compared to other stocks. But it is not nearly high enough to ensure Town Sports will not continue to deleverage. A 5.5% dividend yield is only about one third of the company's free cash flow. The current growth plans are not enough to use up the other two thirds of the



Since the financial crisis, rent expense increased from 19% of sales to 24%

company's free cash flow. In a couple years, Town Sports may speed up its growth to a level that consumes a lot of the free cash flow. But, until then, the company will deleverage unless it takes actions that return cash to shareholders.

This puts the stock in an interesting position. On the one hand, the greatest risk to an investor is the possibility that Town Sports will one day became insolvent. That would destroy the entire investment case for the stock. That risk is low. It is low relative to the company's own history. It is also lower at Town Sports than at many other fitness center operators. However, the risk of insolvency is higher at Town Sports than at Life Time Fitness. Life Time Fitness owns a lot of real estate. It has much lower fixed charges. And it is much more conservatively run than Town Sports in terms of debt use. But Town Sports is the least leveraged it has ever been. The company's locations are also closer to a cyclical low point in terms of use than a cyclical high point. Recent growth has been low and plans for near term expansion are very low. This means the risk of needing access to financial markets is very low now and will continue to be low for at least the next several years. Even if Town Sports does increase its rate of growth in the future, it will have many more free cash flow generating mature clubs relative to immature clubs while it expands, that the expansion should be more self-financed than ever before. Town Sports is a different stock than it once was. The company was a growth stock before 2008. Since 2008, it has not grown at all. But it has transitioned into being a high and stable generator of free cash flow. The stock price is very low relative to free cash flow. Most public companies have free cash flow yields closer to 5% than 15%. On a normalized basis, Town Sports is almost certainly selling for a free cash flow yield of 15% right now. The price is about 7 times earnings. It may be as low as 6 times (or less) normal earnings. The company has yet to reach the levels of revenue per member it did prior to the 2008 financial crisis. Even if the company never achieves pre-2008 levels of demand, it has still averaged about $35 million a year in free cash flow. This is around $1.50 a share for a stock that costs just under $11 a share. While the company is leveraged, a yield of 14% is excellent even for a junk bond.

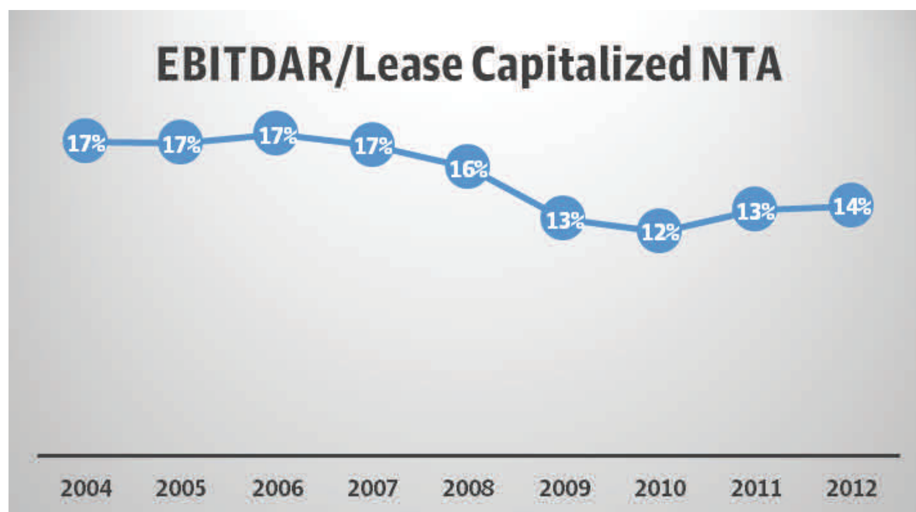
CONCLUSION: *Town Sports is a Decent Business Trading at a Great Price*

Town Sports is a good business at a very low price. It is not a great business. Without the use of leverage, Town Sports may earn a return on equity in the 10% to 15% range. However, the high free cash flow yield on the stock means that a lot of valuable growth is not needed to make Town Sports a good investment. As long as whatever free cash flow Town Sports reinvests in its business earns a double-digit rate of return, the company will not be destroying shareholder value.

The company may not retain as much cash flow as investors expect. Before 2008, Town Sports was more of a growth company. It did not produce positive free cash flow, because it used its cash flow from operations to fund the building of new clubs or the acquisition of existing clubs. The company slowed its growth rate. The planned expansion over the next few years is too small to soak up most of that free cash flow.

In 2012, the company's CEO outlined growth plans: "Our focus over the next few years will be primarily New York and Boston urban markets. We understand those markets. We've been in those markets for over 30 years. We plan on strengthening those markets. And we've identified over 50 locations between those two. So our average club will be about $2.5 million to build. Payback will be about 4 years with about 3,000 to 3,400 members. Growth (plans) over the next few years will be 3 to 6 next year, and we're looking at 5 to 12 clubs a year after. We're working on about 8 to 10 projects right now at different stages of the lease signing. So we're pretty excited by it. We see the opportunity. We expect to grow the business, while maintaining the 20% EBITDA margin. So, the growth will come from the cash flow of the business."

Town Sports has averaged over $35 million in free cash flow since the financial crisis. The company could fund the expansion of up to 15 clubs a year at a price of $2.5 million, if it did not pay dividends or buy back stock. There is no need to pay down debt, because Town Sports is less leveraged now than it has been at any time in the last decade. Growth plans are far below the amount needed to consume all of the company's cash flow. So much of an investor's return in the stock is likely to come from a regular dividend, a special dividend, or stock buybacks.



Town Sports has averaged a 15% return on its net tangible assets

Town Sports does not pay a regular dividend now. The company's board is considering a 14 to 16 cent a quarter dividend. A 16 cent quarterly dividend would add up to 6.1% of the stock's current price over a year. So the stock may end up having a 6% dividend yield (looking forward rather than backwards). After a full year of the company paying that much in dividends, it is possible dividend investors would be interested in the stock. There are not many companies paying 6% a year. An investor could create such a stock today by buying Town Sports today and waiting to see if the company does pay four full quarters of dividends at a 16 cent rate. Town Sports certainly has the capacity to pay such a dividend. On a cash flow basis, they would be able to pay a 6% dividend yield while covering that dividend more than twice over. So it would be a high dividend. But it would be secured about as well as the dividends of many stocks that yield less than 6%.

Of course, Town Sports does not have a history of dividend payments. So their capital allocation choices may not reflect permanent policy. They may just pay dividends and buyback stock at moments when they have a lot more free cash flow than they are spending on growth. At least for the next few years, investors can expect Town Sports to produce positive free cash flow and to return some of that cash flow to shareholders. Exactly how they choose to do so is speculative. But the board has never shown a preference for very low levels of leverage.

Today, growth plans are as limited as they have ever been while free cash flow is as high as it has ever been. Net debt is lower than normal, because of the $82 million sale of the company's one owned property. Town Sports will replace that club with a new one. But the new club will be leased. So there will be no need to tie up as much capital in the building itself as Town Sports had been. This is a one-time event. But it creates an especially unleveraged balance sheet relative to what management has talked about as the level they would like. When the company paid a special dividend, the resulting Debt/EBITDA level was 2.9. The CFO has mentioned a Debt/EBITDA level of 3 as being comfortable. So, the board may consider all capital in excess of the amount needed to keep net debt at 3 times EBITDA to be excess capital. If

that is the case, Town Sports will actually return more capital to shareholders than it generates in free cash flow right now. The company needs to at least pay out all free cash flow to stop deleveraging from continuing. A regular dividend could be a big help. But it is unlikely Town Sports would start the dividend at anywhere near the level needed to consumer all free cash flow. For that reason, Town Sports might also buy back stock.

Shareholders would get more benefit from a stock buyback than from a dividend. On a leveraged basis, the stock is trading at about 7 times free cash flow. Buying back stock would get the remaining shareholders a good return. Many stocks trade around 15 times free cash flow. So, Town Sports could repurchase shares at about a 50% discount to the intrinsic value of the stock. The stock is certainly worth closer to $23 a share than $10 a share. The exact intrinsic value of the stock depends on how an investor looks at leverage. Even with capitalized leases added to enterprise value, Town Sports is trading at less than 10 times owner earnings. The company should not sell for less than 10 times pre-tax profit. It is a very stable business in terms of customer loss and pricing. Attrition is usually 40%. It topped out at 45% in one year. Town Sports has a wide moat around its urban gyms. They have a good cost structure compared to other companies. Acquiring enough customers to offset attrition has been fairly cheap for Town Sports. They do not spend nearly as much on marketing to keep their gyms full as some other companies do. This is a result of their clustering strategy. It makes cash flow before rent expense (EBITDAR) quite stable. Rent expense has increased from 17% of sales about a decade ago to 19% before the crisis. It then spiked from 19% before the crisis to 24% today. Over time, Town Sports may be able to bring rent expense down from 24% to a number closer to 19%. But that is not necessary to justify buying the stock.

The evidence for Town Sports' economics before the crisis is limited. It was a different, growing company. And it had only been public for a short time. The years 2009, 2010, 2011, 2012, and 2013 provide a good 5-year average. They are a conservative measure of Town Sports' earning power because those were not good years for the economy or for spending on gyms.

Investors can think of Town Sports as a leveraged, high yield (14% free cash flow yield and a possible 6% dividend yield) stock. The company's return on capital is lower than most stocks featured in The Avid Hog. But the stock price is also much lower. That makes it a bargain.

Town Sports (NASDAQ: CLUB)
Appraisal: $37.80

Margin of Safety: 33%

Owner Earnings	
Lease Adjusted Earnings	
2012 EBITDA	$91 million
Plus: Rent Expense	$117 million
EBITDAR	$208 million
Lease Adjusted Enterprise Debt	
Rent	$117 million
Capitalized at 8 times	$936 million
Adjustments	
Owner Earnings	Add $117 million
Debt	Add $936 million

Business Value

CLUB's business value is $2,010 million.

- Pre-tax owner earnings are $201 million
- Fair multiple = 10x pre-tax owner earnings
- $201 million * 10 = $2,010 million

Fair Multiple

CLUB's business is worth 10x pre-tax owner earnings

- Quan thinks: "CLUB's network deserve at least 10x pre-tax owner earnings. Limited growth wouldn't justify a significantly higher multiple"

Share Value

CLUB's stock is worth $37.80 a share

- Business value is $2,010 million
- Net debt is $1,099 million
  - Debt: $311 million
  - Capitalized lease: $938 million
  - Cash: $150 million
  - Proceeds from the sale of NYC property: $82 million
  - $311 million + 938 million – 68 million – 82 million = $1,099 million
- Equity value is $911 million
- $2,010 million - $1,099 million = $911 million
- Equity Value = $37.80/share
  - 24.11 million outstanding shares
  - $911 million / 24.11 million = $37.80

Margin of Safety

CLUB stock has a 33% margin of safety.

- Business Value = $2,010 million
- Enterprise Value = $1,352 million
- Discount = $658 million ($2,010 million - $1,352 million)
- Margin of Safety = 33% ($658 million / $2,010 million)

	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBIT	EV/Owner Earnings
Life Time Fitness	2.55	6.12	7.95	11.64	7.71
Weight Watchers	2.13	3.60	7.12	7.62	8.73
ClubCorp	2.62	9.77	11.91	22.52	16.62
Clublink	2.77	NMF	9.38	14.41	11.22
Accordia Golf	2.60	NMF	11.10	17.79	13.70
Minimum	2.13	3.60	7.12	7.62	7.71
Maximum	2.77	9.77	11.91	22.52	16.62
Median	2.60	6.12	9.38	14.41	11.22
Mean	2.54	6.50	9.49	14.80	11.60
Standard Deviation	0.22	2.54	1.81	5.10	3.26
Variation	9%	39%	19%	34%	28%
Town Sports (Market Price)	2.85	5.79	6.45	8.60	6.79
Town Sports (Appraised Price)	4.19	8.51	9.48	12.67	10.00

ABOUT THE TEAM

Geoff Gannon, Writer

Geoff is a writer, blogger, podcaster, and interviewer. He has written hundreds of articles for Seeking Alpha and GuruFocus. He hosted the Gannon On Investing Podcast, The Investor Questions Podcast, and The Investor Questions Podcast Interview Series. He wrote the Gannon On Investing newsletter in 2006 and two GuruFocus newsletters from 2010-2012. In 2013, he co-founded The Avid Hog (the predecessor to Singular Diligence) with Quan Hoang. Geoff has been blogging at Gannon On Investing since 2005.

Quan Hoang, Analyst

Quan is a stock analyst. Quan won first prize in Vietnam's National Olympiad in Informatics in 2006. He graduated from Manhattanville College in 2012 with a B.A. in finance and a minor in math. In 2013, Quan co-founded The Avid Hog (the predecessor to Singular Diligence) with Geoff Gannon.

Tobias Carlisle, Publisher

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: a Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business Management (1999).