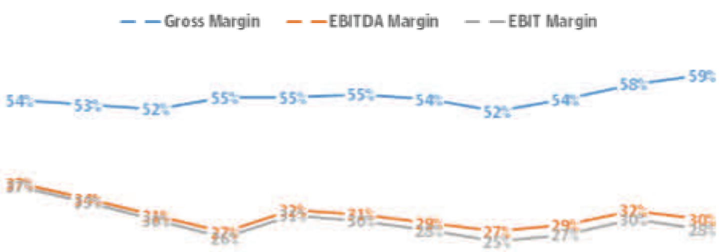
SINGULAR DILIGENCE

Weight Watchers (WTW)

Weight Watchers (NYSE: WTW)
Stock Price: $32.12



	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBIT	EV/Owner Earnings
Medifast	0.89	1.18	9.21	13.65	13.65
Nutrisystem	1.06	2.28	36.38	552.06	552.06
Tupperware	2.16	3.23	12.05	17.75	13.49
Life Time Fitness	2.78	6.66	8.65	12.67	10.04
Town Sports	3.15	6.4	7.13	9.5	7.96
Minimum	0.89	1.18	7.13	9.5	7.96
Maximum	3.15	6.66	36.38	552.06	552.06
Median	2.16	3.23	9.21	13.65	13.49
Mean	2.01	3.95	14.68	121.13	119.44
Standard Deviation	1.01	2.46	12.26	240.92	241.86
Variation	50%	62%	83%	199%	202%
Weight Watchers	2.25	3.79	7.51	8.04	9.21

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Minimum	Maximum	Median	Mean	Standard Deviation	Variation
Sales	810	944	1,025	1,151	1,233	1,467	1,536	1,399	1,452	1,819	1,827	810	1,827	1,399	1,333	335	25%
Gross Profit	439	504	538	631	676	814	835	728	791	1,047	1,083	439	1,083	728	735	208	28%
EBITDA	302	322	315	315	393	455	450	385	419	577	547	302	577	393	407	94	23%
EBIT	297	316	306	302	380	436	425	357	390	546	511	297	546	380	388	85	22%
Receivables	16	19	20	25	34	41	40	39	42	43	39	16	43	39	33	10	32%
Inventory	32	39	36	32	35	42	42	36	37	47	50	32	50	37	39	6	15%
PP&E	21	20	23	34	52	76	95	106	114	135	184	20	184	76	78	54	69%
Working Liabilities	49	56	67	82	100	128	139	136	151	184	197	49	197	128	117	50	43%
Net Tangible Assets	21	22	12	9	21	31	38	46	42	40	77	9	77	31	33	19	59%
Margins																	
Gross Profit/Sales	54%	53%	52%	55%	55%	55%	54%	52%	54%	58%	59%	52%	59%	54%	55%	2%	0.04
EBITDA/Sales	37%	34%	31%	27%	32%	31%	29%	27%	29%	32%	30%	27%	37%	31%	31%	3%	0.09
EBIT/Sales	37%	33%	30%	26%	31%	30%	28%	25%	27%	30%	28%	25%	37%	30%	30%	3%	0.11
Turnover																	
Sales/Receivables	49.5	50.1	50.8	46.2	36.1	35.5	38.3	36.1	34.8	42.7	46.4	34.8	50.8	42.7	42.4	6.4	15%
Sales/Inventory	25	24.3	28.5	35.6	35.1	35.3	36.3	38.5	39.7	38.7	36.4	24.3	39.7	35.6	34	5.5	16%
Sales/PPE	38.4	47.7	43.6	34.1	23.8	19.3	16.2	13.1	12.7	13.4	9.9	9.9	47.7	19.3	24.8	13.7	56%
Sales/NTA	39	43.9	83	127.4	58.5	47.8	40.1	30.7	34.6	45	23.8	23.8	127.4	43.9	52.2	29.5	57%
Returns																	
Gross Profit/NTA	2118%	2340%	4354%	6978%	3209%	2653%	2183%	1596%	1883%	2588%	1408%	1408%	6978%	2340%	2846%	1593%	0.56
EBITDA/NTA	1454%	1496%	2549%	3489%	1867%	1482%	1175%	843%	999%	1427%	712%	712%	3489%	1454%	1590%	807%	0.51
EBIT/NTA	1431%	1469%	2476%	3348%	1804%	1420%	1111%	782%	930%	1350%	664%	664%	3348%	1420%	1526%	786%	0.52
Growth																	
Sales	30%	17%	9%	12%	7%	19%	5%	-9%	4%	25%	0%	-9%	30%	9%	11%	11%	1.05
Gross Profit	30%	15%	7%	17%	7%	20%	3%	-13%	9%	32%	3%	-13%	32%	9%	12%	13%	1.1
EBITDA	45%	7%	-2%	0%	25%	16%	-1%	-14%	9%	38%	-5%	-14%	45%	7%	11%	19%	1.76
EBIT	52%	6%	-3%	-1%	26%	15%	-2%	-16%	9%	40%	-7%	-16%	52%	6%	11%	21%	1.93
Receivables	40%	-3%	17%	29%	44%	5%	-11%	5%	10%	-5%	-10%	-11%	44%	5%	11%	19%	1.74
Inventory	47%	1%	-16%	-4%	22%	16%	-10%	-19%	25%	32%	-12%	-19%	47%	1%	7%	22%	2.97
PP&E	9%	-20%	66%	30%	71%	33%	18%	8%	7%	29%	42%	-20%	71%	29%	27%	27%	1
Working Liabilities	14%	14%	26%	18%	25%	31%	-9%	6%	16%	28%	-10%	-10%	31%	16%	14%	14%	0.97
Net Tangible Assets	94%	-43%	-42%	0%	266%	-15%	71%	-11%	-4%	-3%	185%	-43%	266%	-3%	45%	100%	2.21

OCTOBER 2013

SINGULAR DILIGENCE

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Weight Watchers (NYSE:WTW) Has Fired its CEO, Suspended its Dividend, and Announced $150 Million in Cost Cuts

OVERVIEW

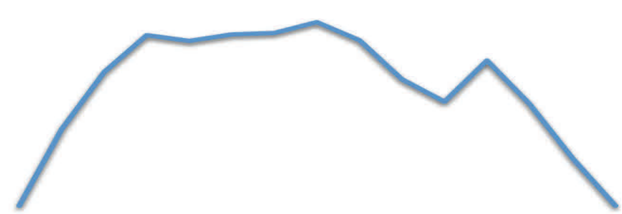
Weight Watchers has a long and stable history. Its very recent past – especially the last couple quarters – has been anything but stable. Earlier this year, Weight Watchers fired its CEO. Yesterday, the company suspended its dividend to save the $39 million in cash flow. With debt already more than 4 times EBITDA – and EBITDA sure to decline next year – Weight Watchers needs that extra cash flow to make sure it can meet its interest payments (which it should not have a problem doing) and its debt repayment in 2017 (which, at the rate the business is declining could be a problem).

On November 6th, the new CEO will have an investor day at which he will present a detailed turnaround plan. Weight Watchers' revenue is only starting to decline now. The company's operating profit is still roughly flat year over year. However, attendance is down about 16%. New sign-ups are down. This will – over the next year or two – flow through revenue and ultimately operating profit. It will be the most challenging year for Weight Watchers since it became a public company over 12 years ago.

The new CEO, Jim Chambers, has been frank about this: "I see now that the situation we are facing as a business is more difficult than it originally appeared…our top line momentum is weak across nearly all our business lines and geographies with steep declines in recruitment being the principal cause. This weakness has accelerated as we have moved further into 2013 and will continue into the fourth quarter and calendar year 2104 as the wave of free apps stealing trial in the category continues to adversely impact our online recruitment."

Yesterday, the board took emergency action. They suspended the dividend. The CFO explained why: "While we have a strong liquidity position today, it is important to note that our leverage is already over 4 times and given our business trends, will likely be higher next year. In light of this, the board elected to act proactively to build flexibility on the balance sheet to fund the company's transformation while preserving cash for future debt payments."

Things will get worse before they get better. With a lower subscriber base, revenue at Weight Watchers will decline for at least the next couple years. Although the company will cut $150 million in costs over the next 3 years, it will still have lower operating income in the next few years than it has had at any point in the recent past. There is no way to predict what will change this trend or when it will happen.



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Attendance (in millions)	36	47	55	61	60	61	61	63	60	54	51	57	51	43	36

If attendance keeps declining 16% a year for the next 2 years,
it will be back at 2000 levels

Unless an investor believes this pressure from free apps will be temporary it is impossible for him to come up with an owner earnings estimate and to value the stock. The only basis on which to invest in Weight Watchers is the belief that the company's results will normalize. Many investors do not expect Weight Watchers to return to its past record. More than 20% of shares are sold short. Those shorts have made a lot of money recently. The stock is down about 20% today.

Weight Watchers was founded 50 years ago in 1963. The company was started by a Brooklyn housewife named Jean Nidetch. Before founding Weight Watchers, she had hosted weight loss meetings with a group of overweight friends in the basement of a New York apartment building. About half of Weight Watcher's profit comes from this same source today. The company holds 40,000 meetings a week attended by a total of more than 1 million people. The vast majority of those in attendance are overweight women.

The American ketchup company Heinz bought Weight Watchers in 1978. They kept control of the company for 21 years. In 1999, Artal Group, a private equity firm led by Lebanese investor Raymond Debbane, bought Weight Watchers. The deal was structured as a leveraged buyout. Heinz received $735 million in cash. Artal put in $224 million of its own money. The rest was borrowed. Just 2 years later, in 2001, Artal took Weight Watchers public. The Weight Watchers IPO left Artal with more than 50% of the company's shares. Artal has never allowed its ownership stake to decrease below 50%. The head of Artal, Raymond Debbane, remains the Chairman of Weight Watchers to this day. So, Weight Watchers is effectively a leveraged buyout where a minority of the equity is in the hands of the public. Artal treats Weight Watchers as a private equity investor would despite the company being public. They repeatedly add debt and remove cash from Weight Watchers through increasing bank debt and doing large share buybacks. Artal never reduces its proportionate stake in Weight Watchers. They only sell enough stock to keep their percentage ownership steady.

Weight Watchers is what Charlie Munger calls a "cannibal". It gobbles up its own share count. After the 2001 IPO, Weight Watchers had 106 million shares outstanding. Today, the company has just 56 million shares outstanding. This 47% decrease in the company's share count has been achieved by borrowing, buying back stock, and then using free cash flow to pay down the debt. Weight Watchers also pays a dividend. Since the IPO, Weight Watchers has returned about $4 billion to shareholders. The company has returned $3.3 billion ($275 million a year) in stock buybacks and $624 million ($55 million a year) in dividends. This average annual return of capital of $330 million compares to average free cash flow of $262 million a year. Return of capital to equity holders has exceeded free cash flow to the extent Weight Watchers has increased debt. The company has about $2.2 billion in debt at the moment. This is supported by operating income of $511 million. With the exception of acquiring affiliates using the Weight Watchers name – which include franchisees and WeightWatchers.com – the company does not add capital to the business. Returns on tangible capital are nearly infinite.

Weight Watchers hosts meetings in 30 countries. A monthly pass costs $43. The average member stays with the program for 8 months. There are women who have returned to the program 3 or more times. So, an average stay of 8 months does not reflect the expected lifetime revenue from a customer. Lifetime revenue exceeds $344 (8 times $43) to the extent former members return to the program. Like all behavior modification programs (exercise regimens, Alcoholics Anonymous, etc.) members tend to lapse and recommit. Behavior modification exhibits inverse characteristics of addictive products. Members seek long-term benefits but face short-term discomfort. They often have the intention of losing weight, but need encouragement both in taking action and in maintaining good habits.

The fundamentals of the Weight Watchers approach: charging money, holding meetings, and encouraging self-monitoring have been shown to be effective in modifying all types of behavior. If you want to change a behavior and you pay someone to hold meetings and create a point system that forces you to keep track of your individual actions, you will be much more likely to succeed in changing that behavior. The program is extremely powerful from a behavioral science perspective. It works. And it works better than almost any other program that could be devised.

Technology will not change the effectiveness of Weight Watchers. It may change customer choice. Customers do not merely want an effective program. They prefer low pressure, low price, high convenience and effectiveness. Those goals require making trade-offs.

Like most weight loss companies, Weight Watchers has excellent product economics. The meetings business has an operating margin of between 20% and 30% in most years. The website has a 50% operating margin. Meetings are held in low rent locations. It costs less than $50,000 to fit out a new location. Meeting leaders are low paid. So Weight Watchers captures all the economic profit associated with its brand.

Weight Watchers is a brand name consumer habits business trading at 9 times owner earnings, requiring no capital to grow the business, and dedicated to returning all free cash flow to shareholders.

DURABILITY: *Weight Watchers Has the Most Consistent Record in an Inconsistent Industry*

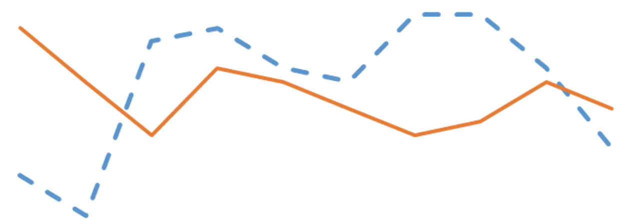
The greatest risk to Weight Watchers' durability is free apps. These web based programs like MyFitnessPal allow a user to monitor their calorie intake and even what they eat. In that respect, it is possible to duplicate the monitoring the Weight Watchers' program – the point system – provides for free. This can be done conveniently using an app on a smartphone, tablet, etc.

Attendance at Weight Watchers declined 16% globally in the past year. This decline in attendance will result in lower revenue, operating income, and earnings per share next year. Members stay with the program for an average of 8 months offline and 9 months online. So, a failure to sign up as many new members as last year can be used to predict lower revenue for at least the next 3 quarters.

This explains why Weight Watchers' stock has dropped dramatically in price. It also explains why 20% of shares outstanding are sold short. There is no doubt that this year's results will be worse than last year's. There is also no doubt that next year's results will be worse than this year's.

The only doubt is how permanent these attendance declines will be. Two times in the last 20 years, Weight Watchers experienced similar attendance declines. So this decrease in not unprecedented. Nor is all of the decrease due to free apps. Weight Watchers' meetings business has seen steeper attendance declines (for example, 20% in the U.K.) than the online business (where total subscribers is up 1% although new sign-ups are down). Much of Weight Watchers' attendance declines are due to ineffective marketing and to a lack of relative buzz compared to the competition.

The weight loss business experiences fads almost constantly.



	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Google	23%	20%	33%	34%	31%	30%	35%	35%	31%	25%
Weight Watchers	34%	30%	26%	31%	30%	28%	26%	27%	30%	28%

Weight Watchers has the same EBIT margin (29% vs. 30%) as Google with double the stability (2% standard deviation vs. 5%)

New diets – often much more specialized than Weight Watchers – get a lot of attention in a short period of time. These programs are often new and unique in a way Weight Watchers – which takes a very general approach, and changes very little over time – is not. The appearance of "The Atkins Diet", "The South Beach Diet", "Slimfast", etc. all impacted Weight Watchers attendance. However, none of these fads had enough staying power to permanently reduce Weight Watchers' long-term average attendance.

Free apps are both free and new. How harmful they end up being to Weight Watchers in the long-term depends on whether dieters are using the free apps primarily because they are free or because they are new.

Obviously, the whole idea of apps will not be new in a couple years. So, the newness of free apps – like the newness of any fad – will burn itself out within a couple years as it becomes a familiar part of the dieting landscape. Free apps will remain free. So, the risk of newness is a temporary risk. It is mostly irrelevant to valuing Weight Watchers. Despite the 16% attendance decline, Weight Watchers increased operating income slightly over the last year. This was due to cuts in marketing spending. When marketing is ineffective in generating sign ups, it can be cut to mitigate some of the attendance decline's harm to the bottom line. Weight Watchers' ability to cut costs means that short-term declines in attendance – those that last only a couple years – have relatively little importance in valuing the stock. Free cash flow is still positive in bad years. This allows continued dividends and stock buybacks. As long as previous attendance levels can be attained in several years, the influence of short-term attendance declines on the stock's intrinsic value is minimal.

Long-term attendance declines are different. They reduce the normal earning power of Weight Watchers' stock. It is unclear how durable free apps are. Consumer Reports did a survey showing that people were satisfied with free apps. However, they lost less weight with free apps than with Weight Watchers. They also stayed with free apps for a shorter period of time. The number of dieters that free apps gain in total is not very relevant to Weight Watchers because Weight Watchers' members account for only a small portion of all dieters. Most dieters are self-directed. They are less motivated than Weight Watchers' members. The extent to which free apps cut into the most motivated dieters – those willing to spend $344 on average over 8 months to attend meetings and those willing to spend $171 on average to use Weight Watcher's website – is the risk to Weight Watchers.

It is difficult to know how important price is to dieters. On the one hand, companies like NutriSystem, Medifast, Jenny Craig, and Weight Watchers have no problem attracting millions of dieters who could certainly attempt a no cost diet – a self-directed one – using information available on the internet, in a single book, etc. These customers must be relatively price insensitive to prefer paying hundreds of dollars to paying nothing. The effectiveness of for profit weight loss programs is much higher than self-directed dieting. For example, someone using Weight Watchers is 10 times more likely to lose at least 10% of their body weight than someone dieting on their own. In terms of effectiveness, Weight Watchers and self-directed dieting are not substitutes. Self-directed dieting is not effective. While an ineffective but free program is worth trying – in fact, most dieters opt to try to lose weight themselves – it has not destroyed Weight Watchers' business over the last 50 years despite the incredible proliferation of different diets. Such diets are also spread by word of mouth. None has ever achieved the staying power of Weight Watchers.

Weight Watchers' greatest strength is its effectiveness. Its greatest weakness is the level of commitment it requires. The former CEO of Weight Watchers put it best when he said: "…every Weight Watchers meeting is led by a person who is a successful member. The reason that is important is that facilitating a group support experience requires that the facilitator have a high degree of empathy in understanding and if you've never had a weight problem, you don't understand what it is. What's another model that we can think about like this? AA. Highly effective, really good at what they do. We don't tend to compare ourselves to them in marketing materials for a variety of reasons, but specifically if you look at …what's happening from a behavior modification point of view and why group support works, it's sometimes a useful analog to think of and it's very similar in terms of underlying philosophy that we apply in our meetings business."

The difficulty in gauging the risk free apps pose to Weight Watchers' durability is understanding how strong the preference is for effectiveness in behavior modification versus the desire for free and easy. When it comes to changing their own behavior, the vast majority of people will always prefer free and easy over effective. A small percentage of people with weight problems – only a few million at any one time – will opt for the tough, expensive, and effective approach.

The AA equivalent in weight loss is Weight Watchers. Free apps will be far more popular than Weight Watchers. However, Geoff believes they will not permanently cut into Weight Watchers' core audience: "Free apps will be the most popular weight loss program. They will not capture the most profit. Weight Watchers will continue to be the most effective program and most profitable program. It will never reach most dieters, because most people with weight loss problems never reach the point where they are willing to spend hundreds of dollars and do the hard work of committing to a program like Weight Watchers. However, Weight Watchers has never had a high share of the overall population of people with weight problems. What they've had – and will continue to have – is a huge share of the most motivated, least price conscious people. Even these people will spend most of their lives battling weight problems away from Weight Watchers. But when they are serious about losing real weight – 10% of their body weight or more – they will return to the program that is effectively Overeaters Anonymous."

MOAT: *Weight Watchers is 4 Times the Size of Its Biggest Competitor*

Weight Watchers is the dominant weight loss platform. It is the industry standard because it has been the best known and most used program for years. Weight Watchers has the most former members. So it is in the best position to get return business. It is also in the best position to get word of mouth referrals. As Weight Watchers's CEO explained in 2008: "…roughly six or seven out of 10 enrollments we get are at the recommendation of a friend or family member and that's word of mouth, and word of mouth frankly takes a while to build because word of mouth really starts to happen when members achieve success. And what we see in good programs is that good programs actually build over time as opposed to sort of one massive pop."

The economic advantages in weight loss come from system scale. NutriSystem and Medifast have high gross margins, but fail to keep operating margins above 10% on average. Weight Watchers can achieve triple their operating margin. This is due to scale.

Operating profit does not widen the moat in weight loss, because most companies do not need to reinvest their free cash flow in the business. Gross profit is the metric that matters, because it funds marketing. For example, Weight Watchers spends $344 million on advertising. NutriSystem spend $111 million. Medifast spends $245 million in total on selling, general, and administrative costs. Medifast uses a direct selling model. In many years, almost all of NutriSystem and Medifast's gross profit is spent on marketing. Weight Watchers spends only half its gross profit on advertising. Yet it still runs more ads than either of those companies. In fact, Weight Watchers could double its advertising spending – to $700 million a year – and still achieve the same roughly 10% operating margin as NutriSystem and Medifast. Neither NutriSystem nor Medifast could double their advertising spending without running up huge losses.

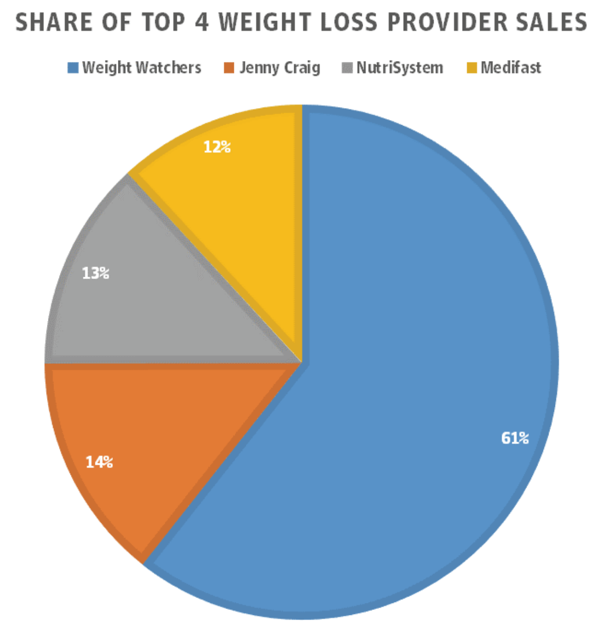
Weight Watchers also has lower costs than its competitors. The Weight Watchers system is not based on food replacement. It is just a behavior modification program. It is essentially just a support group equivalent to "Overeaters Anonymous". Food replacement systems are much more expensive. Jenny Craig's program costs $400 a month. Medifast and NutriSystem each cost $250 a month. Weight Watchers can charge just $43 a month for the meetings program and $19 a month for the online program.

Operating margin in the online business is entirely determined by scale. The cost to run a website scales very well. No competitor of Weight Watchers has enough subscribers – Weight Watchers now has 1.8 million online subscribers – to earn the same operating profit. Last year, it cost Weight Watchers $64 million to operate its online business. This works out to just $35 a year in online costs per subscriber.

It would be very difficult for other companies to ever run an online business as profitably. They lack the scale of active members. Some of this is due to poor retention rates. For example, the average NutriSystem customer stays with the program for 12 weeks or less. That's a 3 month average time till cancellation versus 9 months for Weight Watchers online. To achieve the same online economics, NutriSystem would need to attract triple the number of new sign-ups while keeping customer acquisition costs equal to Weight Watchers.

Weight Watchers's moat applies only to the people who are most committed to losing weight. About 4 out of 5 people who try to lose weight do it alone. These are not part of Weight Watchers's target market. The pool of potential customers for Weight Watchers is entirely limited to the 1 dieter out of 5 who is ready to really try to change their behavior.

The only way to understand Weight Watchers's moat is to understand what makes a weight loss program effective. The differences in



Weight Watchers's sales are 50% higher than the combined sales of its 3 biggest competitors: Jenny Craig, NutriSystem and Medifast

effectiveness between programs is huge.

For example, an investor might see NutriSystem and free apps as substitutes for Weight Watchers. They are competitors. But they are not close substitutes. The average NutriSystem customer sticks with the program for 3 months. The average free app dieter sticks with the app for less than 2 weeks. While the average Weight Watchers member paying for meetings sticks with the program for 8 months. Online members stay for 9 months. People stick with Weight Watchers 3 times longer than NutriSystem and 16 times longer than a free app.

Some people are successful using free apps. Just as some people are successful dieting on their own. However, there are basic principles of behavior modification that are well understood by academics. After years of struggling with overeating, dieters see these principles at work in themselves.

Here is one dieter explaining a personal preference for meetings over online: "I do not do the online although I do have access. Reason? I will not hold myself accountable. I need to go to the meeting and have someone watching over me so to speak. I swear it is like a confessional when I weigh in."

Another person who had success with MyFitnessPal explained why they prefer Weight Watchers: "I have been a member of MyFitnessPal for 2 years now. By July 2012, I lost 20 pounds, but I was never able to fully commit to the MyFitnessPal system. Even though I was provided with great tools for success, I still wasn't losing weight. A few weeks ago, I realized that this was because I had no real accountability. I personally joined Weight Watchers because it provides the accountability I am looking for. My leader encourages us to have a fruit or veggie with every meal, exercise often, and even encourages eating back some of our exercise points. I like being able to see the same people every week and see how their journey is progressing and share in our triumphs (and failures). I have never felt like I am dieting, just being cognizant of what I am eating…I say follow whichever plan you think you can stick to. For the stage of weight loss I am in right now, I love Weight Watchers (even if I have to pay them $12 a week)."

All diets work. The amount of effectiveness has been shown – in almost every study and survey – to be directly related to how long someone sticks with the diet. The Weight Watchers system – both online and offline – is structured and priced in a way that keeps people in the program longer than they stay with competitors. This explains why people lose the most weight with Weight Watchers.

Weight Watchers dominates the general approach. If someone just wants to be "cognizant" of what they are eating, if they just want accountability, they aren't going to prefer another group meeting approach or calorie counting approach over Weight Watchers. They may prefer NutriSystem because it provides the actual food packages in specific serving sizes, it has a low glycemic index, etc. Some dieters will prefer special approaches. But, the most effective and most general approach – monitoring behavior, peer pressure, a support group led by someone who has succeeded using the same program – is dominated by Weight Watchers.

Like software makers, weight loss providers roll out new updated versions of their system every couple years. However, the systems must stay compatible with the image they have spent advertising on and the member base they have built up over time. Especially because returning members are important in weight loss, a great deal of continuity in the approach is required. This is the real moat around Weight Watchers.

The Weight Watchers system is more effective than the NutriSystem approach, the MyFitnessPal approach, etc. And no amount of incremental change can turn those platforms into Weight Watchers. The amount of disruption caused by a true system overhaul both in terms of destroying goodwill built up by advertising and alienating the base of current and former members makes it very difficult to copy a competitor The Weight Watchers system and its scale is not something a competitor can duplicate.

QUALITY: *At 14% of Sales Marketing is Weight Watchers' Biggest Investment*

Weight Watchers has a 50 year history. It is the leading weight loss service provider in the United States and around the world. The weight loss business is fragmented. Most dieters are self-directed. Many companies compete using different strategies. However, Weight Watchers is much larger than these competitors by any measure. A commonly used measure of market leadership is relative market share. This is an especially important number when exact definitions of market share are difficult. Weight Watchers has 3 competitors with similar total sales: Jenny Craig ($432 million), NutriSystem ($397 million), and Medifast ($357 million). Weight Watchers has $1.83 billion in sales. When compared to its next largest competitor, Jenny Craig, Weight Watchers has a relative market share (leader market share divided by largest competitor's market share) of 4.23.

In most industries, a company with a relative market share of 2 or more (for example, a company with a 30% market share whose next biggest competitor had a 15% market share) would be considered to dominate its category. Weight Watchers' relative size in its industry is extraordinarily unusual.

Two of Weight Watchers largest competitors are public: Nutrisystem and Medifast. Jenny Craig is owned by Nestle. However, Nestle has hired Goldman Sachs to find a buyer for Jenny Craig. The sale process is ongoing. The combined sales of Jenny Craig, NutriSystem, and Medifast are $1.19 billion. This is just 65% of the sales of Weight Watchers alone. It is critical to understand this point to understand Weight Watchers. The gross profitability of Weight Watchers is not superior to the gross profitability of its closest competitors. Weight Watchers' excess returns come from being more than 4 times larger than its closest competitors.

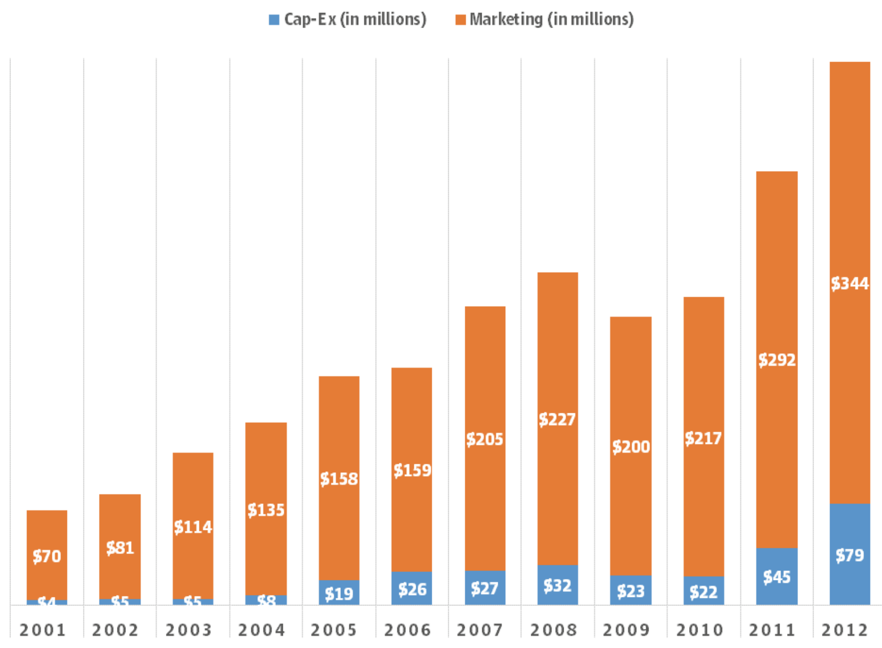
The best illustration of this point is the combined financial results of Weight Watchers' two public peers: Medifast and NutriSystem. Together, these companies spend $422 million on selling, general, and administrative costs. This is 93% of their combined gross profit of $452 million. Meanwhile, Weight Watchers spends $572 million on selling, general, and administrative costs (most of it on advertising). This is just 53% of Weight Watchers' gross profit of $1.08 billion. Weight Watchers earns so much more than its competitors – year in and year out – because the company makes 4.7 times the gross profit of each of those companies while spending just 2.7 times as much on marketing and administrative costs. Weight Watchers is also able to direct more of its fixed costs toward actual advertising spending than toward administration.

The gross profitability of Weight Watchers' competitors is good. However, their scale relative to Weight Watchers is extraordinarily weak. As a result, Weight Watchers consistently captures nearly all of the weight loss industry's profits.

Over the last 10 years, Weight Watchers has earned a cumulative $3.97 billion in operating income. NutriSystem earned $529 million over those same 10 years. Medifast earned $134 million. This unequal distribution of profit left Weight Watchers with 85% of the share of profit earned by publicly traded weight loss companies.

Weight Watchers achieved this dominant position over a period of 50 years. Word of mouth is important in the weight loss business. Between 60% and 70% of new Weight Watchers members are referred by someone who already went through the program. There are a lot of Weight Watchers alumnae (members are overwhelmingly women).

Each week, Weight Watchers holds 40,000 meetings with an average



Since 2001, Weight Watchers has spent more than $2.2 billion on marketing versus less than $300 million on cap-ex

attendance of more than 25 people per meeting. This results in more than 1 million people actively participating in the meeting program each week. Many more people pay for the program, but do not attend each week. A monthly pass costs $43.

Weight Watchers' online business now generates the same amount of profit as its offline business. There are 1.8 million subscribers. An online subscription costs $19 a month. Members stay with the offline program for an average of 8 months. They stay with the online program for an average of 9 months. While those sound like very short stays, Weight Watchers actually "churns" its members slower than many comparable programs. In fact, a Consumer Reports study showed that Weight Watchers' improved weight loss over other alternatives was simply due to members sticking with Weight Watchers longer. Lack of "stick-to-it-ness" is the main reason that free apps like MyFitnessPal perform worse than programs like Weight Watchers. Dieters lose weight on both programs. They just stay with Weight Watchers longer.

At today's member levels and the rate of attrition, nearly 1.5 million people will leave the Weight Watchers program each year. Like any weight loss program, some of these people will return. Customer acquisition costs for these "reactivations" are lower because it is easier to convince people who have lost weight on the program to return to it than it is to convince people to try Weight Watchers for the first time. Former Weight Watchers' members are also the source of all of the company's word of mouth referrals. In fact, the combination of reactivations and referrals accounts for the majority of people signing up with Weight Watchers each year.

Weight Watchers has been bigger than its competitors for a long time. No other weight loss provider has millions of members both entering and leaving the program each year. Weight Watchers has had millions of members for many years. The combined number of Weight Watchers alumnae must therefore be much, much larger than that of any weight loss company. This history of past scale ensures greater scale today. It also explains Weight Watchers operating margins.

When marketing is especially effective, Weight Watchers' meetings business is able to achieve operating margins near 30%. Now that the online business has sufficient scale, it has an operating margin of 50%. No competitor has operating margins anywhere near the level of Weight Watchers' meetings business or its online business. In each of the last 10 years, Medifast's operating margin has been below 15%. NutriSystem's best operating margin was 23% in 2006. This was an anomaly caused by very effective marketing. Three years earlier, NutriSystem had an operating loss. And three years later (in 2009), NutriSystem's operating margin had fallen to 8%. Meanwhile, Weight Watchers' lowest operating margin was 26%. Weight Watchers' operating margin has always been both higher and more stable than the operating margins of its competitors. This is caused by the company's scale. Competitors are able to achieve consistently high gross margins. However, whenever their marketing is less than perfect, they have difficulty keeping their advertising, selling, and administrative costs far enough below their gross profits to achieve good operating profits.

All weight loss providers have high gross margins and minimal capital requirements. Only Weight Watchers has scale. While competitors have been successful in short bursts due to effective marketing, they have been unable to build their supply of satisfied former members and drive consistent word of mouth referrals and reactivations to ensure consistent profitability. Without consistent profitability, these companies are unable to spend as much as Weight Watchers on advertising.

The result is always a greater number of members at Weight Watchers than at any competitors. Past scale supports present scale directly through reactivations and referrals. Present scale allows for consistently higher advertising spending than competitors. Higher advertising spending combines with referrals and reactivations to keep a constant scale advantage.

This scale advantage determines long-term margins. NutriSystem's 10-year median operating margin is 9%. Medifast's is 11%. Weight Watchers' offline business has a 10-year median operating margin of 29%. And the advantages of the Weight Watchers name have more than fully translated to the online business where the operating margin is now 50%.

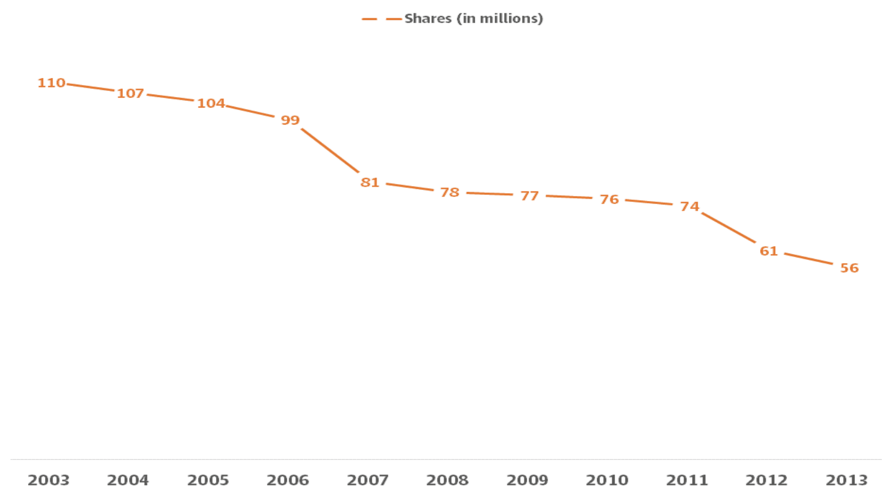
The product economics of weight loss are good. All companies can charge customers much higher than the gross costs of providing their service. The need for tangible assets is minimal. The one problem in the weight loss business is operating expenses. The difference between a 10% operating margin and a 30% operating margin is scale. Over the last 50 years, Weight Watchers has grown to a size no competitor can come close to matching.

CAPITAL ALLOCATION:
Artal Treats Weight Watchers Like a Publicly Traded Leveraged Buyout

Weight Watchers' capital allocation is set by Raymond Debbane and Artal. The vast majority of Artal's value is invested in Weight Watchers. So, return of capital from Weight Watchers is the main source of Artal's income.

Weight Watchers increased debt dramatically in both 2007 and 2012. In 2007, Weight Watchers added $799 million in debt. In 2012, the company added $1.36 billion in debt. In both cases, these large borrowings were used to buy back stock. In 2007, Weight Watchers spent $1.03 billion on share buybacks. In 2012, the company spent $1.5 billion on share buybacks. In total, the company has spent over $3.3 billion on stock buybacks from 2001 through 2012. That is more than today's market cap. Shares outstanding declined from 105.6 million in 2001 to 55.75 million in 2012.

Weight Watchers does not focus on the stock price when buying back stock. Instead, the company simply attempts to maintain a balance of debt and equity that will earn high



Since 2003, Weight Watchers has reduced shares outstanding by 6.5% a year

leveraged returns for shareholders – especially Artal. This is consistent with the way many private equity firms think. The focus in not on a value investing perspective – paying the lowest price possible for a stock buyback – but on the company's cost of capital.

Weight Watchers' former CEO explained the company's philosophy on share buybacks in 2012: "With respect to the tender, keep in mind the reason for doing the tender was because we've gotten to a point that we had felt that our capital structure had become inefficient with relatively high weighted average cost of capital, because we are so much heavily weighted toward equity and so we felt that this was a business that could take on more leverage, that could return and distribute back to shareholders. And we could have done that in a special dividend or we could have done it in the form of a share repurchase. We chose to do it in the form of a share repurchase as a way of returning value to shareholders while improving the efficiency of our capital structure. And we made the decision to do that when we did, because the debt market was there and everything else was sort of the timing was appropriate and so we made it independently of that. We weren't trying to time the market and we believe that you know while again we are disappointed and frustrated by some of the specifics around Q1, it has not changed our perspective on the long-term and frankly medium-term growth prospects…I think ultimately I have absolutely no doubt in my mind whatsoever that we are going to be driving significant shareholder value that is going to continue to validate that decision we made with the tender offer was really a smart one."

That has not proven to be true so far. Weight Watchers paid $1.5 billion to buy back 18.3 million shares. Those repurchases were made at roughly double today's stock price. The $1 billion spent repurchasing stock in 2007 was also done at a high price. In 2007, Weight Watchers spent $1 billion to buy back 19 million shares. Those repurchases were done at prices about 30% higher than today's stock price. However, the 2007 purchases were done at stock prices below our appraisal of Weight Watchers's intrinsic value. So, whether or not you view the buybacks as a success depends on whether you believe today's market price or our appraisal price is a more accurate gauge of the business's intrinsic value. This demonstrates the board's lack of concern with the price at which they buy back stock. They focus on cost of capital rather than intrinsic value.

To be fair, the cost of debt is extremely low. The effective interest rate on Weight Watchers' debt is between 3.5% and 4%. At interest rates below 5%, all of these buybacks have theoretically created value, because the cost of capital – in the form of debt – has been so incredibly low in recent years. So, in theory, all of Weight Watchers' buybacks add value. In reality, what Weight Watchers is doing is riskier than that simple calculation of interest costs versus expected future returns on the stock.

Weight Watchers now has $2.3 billion in debt. They must repay $1.15 billion in March 2017. Another $822 million must be repaid in March 2019. This bank debt is not fixed. So, an increase in interest rates can undermine any value created by those buybacks.

Despite its very high debt load (4.4 times EBITDA), Weight Watchers does not face solvency problems. Operating income was $511 million in 2012. The peak number was $546 million in 2011. At a 4% interest rate, that operating income covers interest about 5 times. The largest one year decline in Weight Watchers operating income since it went public in 1999 was less than 20%. Attendance is down 16%. However, operating income in the first 6 months of the year is up about 1% due to cost cuts. This will not last. Operating income will decline. However, even a 25% decline in Weight Watchers' operating income would leave the company with interest coverage of more than 3.5 times. The company could even survive a doubling of interest rates and a 33% decline in operating income occurring simultaneously. Each of those events would be extraordinary by historical standards. Together, they would only reduce Weight Watchers's interest coverage to 1.5 times. So, any solvency problems for Weight Watchers will be caused by debt repayment rather than an inability to meet interest payments. For this reason, there are no serious solvency risks to Weight Watchers over the next 3 and a half years.

Capital allocation within the operating business has been excellent. Weight Watchers has bought franchisees and the WeightWatchers.com website. The combination of these acquisitions have earned excellent returns. Weight Watchers spent $595 million buying franchisees from 2001 to 2007. EBITDA increased by $193 million in the meetings business. The acquisition of Weight Watchers online – previously, Weight Watchers owned just 20% of this affiliate – earned even better returns. Overall, Weight Watchers paid $381 million to buy the 80% of the online business they didn't already own. Last year, WeightWatchers.com produced $260 million in operating income. That means Weight Watchers spent $381 million to buy an additional $208 million in pre-tax earning power.

Weight Watchers has very unusual capital allocation. It is essentially a publicly traded leveraged buyout. The company targets a low cost of capital rather than attempting to time stock buybacks when the share price is lowest.

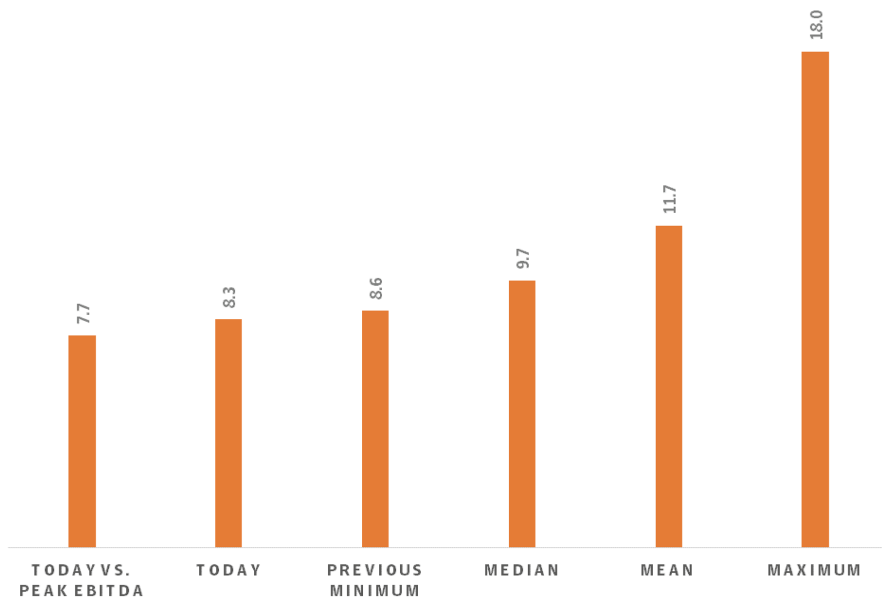
It is not in Artal's interest to time buybacks to a low stock price. Atal sells into these tenders. The company maintains a 52% ownership stake Artal sells a proportion of stock that will allow them to keep the same percentage ownership after the buyback and yet extract cash from selling shares of stock. Since the IPO, it has been possible for a shareholder to sell 1 of every 2 shares they owned and still keep the same percentage ownership. It is likely Weight Watchers will repeatedly leverage up and buyback more shares whenever they can. This is clearly Artal's strategy.

Weight Watchers' capital allocation is generally excellent. It is also predictable. The company has focused on its core. Acquisitions have been limited to buying businesses affiliated with the Weight Watchers system. Meanwhile, the company is certain to reduce its share count over time. Leveraged returns to shareholders will likely exceed unleveraged returns because Weight Watchers is using a lot of cheap debt. This transfers future returns from debt holders to shareholders. If interest rates stay low, the return to shareholders will be even higher than the one implied by Weight Watchers's owner earnings yield (Owner Earnings/Enterprise Value). Debbane's capital allocation at Weight Watchers is similar to that of many "Outsider" CEOs. This kind of behavior can greatly amplify returns for long-term shareholders. But the use of debt – especially the use of short-term debt equal to 4 to 5 times EBITDA – increases risk. Simply put, Weight Watchers is a publicly traded leveraged buyout.

VALUE: *At 8 Times EBITTDA: Weight Watchers is Cheaper Than It's Ever Been*

It is difficult to value Weight Watchers on a relative – or peer – basis. There are only a couple publicly traded providers of other weight loss systems. NutriSystem trades at 27 times EBITDA. However, NutriSystem's business has declined a lot from its peak. A better gauge of the value investors put on NutriSystem – assuming it can be turned around – is enterprise value to peak EBITDA. NutriSystem's peak EBITDA was $99 million in 2008. So, NutriSystem's ratio of enterprise value to peak EBITDA is just 4. The other publicly traded weight loss system provider is Medifast. That stock trades at less than 6 times EBITDA. However, in Medifast's case the most recent EBITDA figure happens to also be the peak number. Today, Weight Watchers trades at a little more than 8 times EBITDA. The company's price to peak EBITDA is a little under 8 times.

However, there is really no point in comparing Weight Watchers to either Medifast or NutriSystem as they do not share any economic traits. In fact, judged by the statistical record alone, Weight Watchers would be most comparable to a very basic consumer products company like food, beverage, or entertainment. Weight Watchers has stable gross margins and stable operating margins. Variation in the company's operating margin is extraordinarily low. This makes the stability of EBITDA very high. In fact, when Weight Watchers' results are smoothed using a 3-year average instead of a year by year comparison, fluctuations are so minimal that the average operating income, EBITDA, etc. always increases over any 3 year period. Declines in operating income greater than 20% are unheard of at Weight Watchers. The largest year over year decrease in Weight Watchers' EBITDA was a 14% decline. This happened during the financial crisis (from 2008 to 2009). By 2011, Weight Watchers' EBITDA had surpassed its previous peak by 27%. So, the greatest drop was a decline of 14% and it lasted less than 3 years. It also happened to occur during one of the worst economic events in the last century. None of the companies normally used as peer comparisons for Weight Watchers show anything like that resilience.



Weight Watchers is trading at a 15% discount to its 10-year median EV/EBITDA of 9.7

There are other publicly traded companies that share some traits with Weight Watchers. Gyms are a good peer group. They are consumer services companies. They focus on health and fitness. They are a discretionary expense. They are expensive. And, most importantly, they make their money off of a difficult to maintain behavior that results in high rates of attrition. On the other hand, gyms have inferior product economics to Weight Watchers. While Weight Watchers uses no net tangible assets, gyms must either buy a lot of property or must lease a lot of property. They require significant capital investment. Assets tend to be tangible. And asset turns are low. Gyms are not a bad business. But they are at best a good business while Weight Watchers has great product economics.

The two best gyms to use as a comparison for Weight Watchers are Town Sports International and LifeTime Fitness. Town Sports trades at 6.3 times EBITDA. The company's peak EBITDA of $105 million was reached in 2007. Town Sports has yet to return to its performance before the financial crisis. The price to peak EBITDA is about 5.3. However, this does not include capitalized leases – which is a very large item for Town Sports – so the number is a little understated. Regardless, Town Sports does look attractive, especially considering the difficult economic environment. The other publicly traded gym – also attractively priced – is LifeTime Fitness. This company – which does not have the same lease concerns as Town Sports – trades at a little under 8 times EBITDA. Today's EBITDA happens to be the company's peak EBITDA.

There is almost no consistency in how the market values weight loss companies or fitness companies. There is no "normal" multiple. Depending on whether a company is in or out of favor, the multiple can be almost anything. Historically, Weight Watchers did have a consistent multiple until the last few years. This is very different from other weight loss companies. Over the last 10 years, Weight Watchers' median EV/EBITDA has been 10. The mean has been about 12. This is consistent with how certain stable consumer products companies trade. So, it is likely Weight Watchers was viewed as a more consistent company than other weight loss companies, gyms, etc.

Weight Watchers advertises. However, it also uses something of a direct selling approach. It is an unusual hybrid business that way. The marketing is consistent with other consumer services companies – like gyms – that use advertising, "stores", and websites. However, the actual service is delivered by meetings leaders. These leaders have all gone through the program. As Weight Watchers' former CEO explained, the actual process of behavior modification – what happens in the meetings – is incredibly similar to Alcoholics Anonymous. This creates a greater sense of empathy and community. That makes Weight Watchers somewhat comparable to consumer products that are sold on a direct basis. The most similar companies – based on when they were started and the fact that they focus almost exclusively on women selling to other women – are Tupperware and Avon. In fact, Weight Watchers' 10-year financial results look much more like Tupperware and Avon than either Medifast or NutriSystem. Tupperware trades at 12 times EBITDA. Avon trades at 11 times EBITDA.

Another possible comparison group is food companies. Weight Watchers was owned by Heinz for more than 20 years. Weight Watchers' largest competitor is Jenny Craig. That company is owned by the global food giant Nestle. There are well sourced reports that claim Nestle has hired Goldman Sachs to find someone willing to buy Jenny Craig.

Historically, food companies have often traded at between 8 to 12 times EBITDA. A control transaction for Weight Watchers would likely occur in this 8 to 12 times EBITDA range. Because Weight Watchers has always surpassed its previous EBITDA peak – even during the financial crisis – within 4 years, peak EBITDA is a good way of normalizing results.

At the company's median historical EV/EBITDA ratio of 10 times its peak EBITDA, Weight Watchers would have an enterprise value of $5.77 billion. That would work out to more than $61 a share. Artal controls Weight Watchers. They have held the company now for about 14 years. There is no reason to believe they want to sell Weight Watchers. In fact, the single most likely buyer of the whole company would probably be Artal through a buyout of minority shareholders. If the company's stock stays very cheap for very long, that might happen. However, Artal already has control of Weight Watchers and Raymond Debbane (the head of Artal) makes the capital allocation decisions at Weight Watchers. So, there is little reason for Artal to buy out the minority shareholders. The only reason to do a buyout would be if Weight Watchers had borrowing capacity and a low stock price. Artal took Weight Watchers private once (buying the company from Heinz) and then took the company public. In theory, Artal could do the same thing again if it doesn't like the market price of Weight Watchers' stock. However, Artal has been happy to hold its stake in a public Weight Watchers for the last 12 years.

For most of its time as a public company, Weight Watchers has been priced like a stable consumer business (10 times EBITDA or higher). The company's product economics – the basic business model – is superior to that of almost all the peers considered in this article. It is far superior to the economics of NutriSystem, Medifast, Town Sports, and LifeTime fitness. In terms of financial results, the most comparable companies are old, established direct marketers with great brands like Avon and Tupperware. These companies trade at 11 to 12 times EBITDA. In the future, it is likely Weight Watchers will – if the market becomes less concerned about free apps – trade at more than 10 times its peak EBITDA. This would lead to a stock price above $60 a share.

GROWTH: *Weight Watchers Combines a Stagnant Meeting Business with a Growing Online Business*

Weight Watchers has a few possible sources of future growth: men, online, and business to business. Weight Watchers was founded as a company that helped obese women. To this day, men make up an insignificant part of Weight Watchers' total revenue. Men account for about 15% of the online business. This is higher than in the meetings business. Men are about as likely as women to be obese. In the U.S., there are about 40 million obese women and 40 million obese men. However, the addressable market for a weight loss company is two-thirds women and one-third men, because women are twice as likely to do something about their obesity as men are. Men who are not interested in dealing with their obesity in some way are not potential customers for Weight Watchers or any other weight loss provider.

As a rule, 9 out of 10 members at a meeting are women. So, Weight Watchers is overrepresented among women. The company's penetration rate among men is low. There are several reasons for this. One is that the Weight Watchers name is a long established brand that tended to be 90% women. This makes men less likely to think of Weight Watchers first when considering a weight loss provider. Jenny Craig is in exactly the same situation that way. They can attract men. But, men tend to think of Jenny Craig and Weight Watchers – quite correctly – as systems that are run by women for women. Men are a tiny minority of all groups at these companies.

Men are also less likely to want the group approach. They are more private about their weight loss. This is not unique to weight loss. It's a common difference between men and women when dealing with subjects like this – behavior modification, the stigma of being fat, etc. So, even without making much of an attempt to increase male subscribers specifically, Weight Watchers has been able to get 15% of their online subscriptions from men. This is much better than their meetings business.

The online business has been growing rapidly. Sales were $145 million in 2006, $158 million in 2007, $189 million in 2008, $198 million in 2009, $241 million in 2010, $404 million in 2011, and $508 million in 2012. This year – 2013 – is expected to be the first time WeightWatchers.com's revenue does not increase. Sign-ups are not sufficient to increase revenue for the full year. In the first half of the year, online revenue increased. But, this trend will not continue, because too few people have been signing up online in the last 6 months to fuel sales increases over the next year (this can be predicted on the assumption that people stay with the website for 9 months).

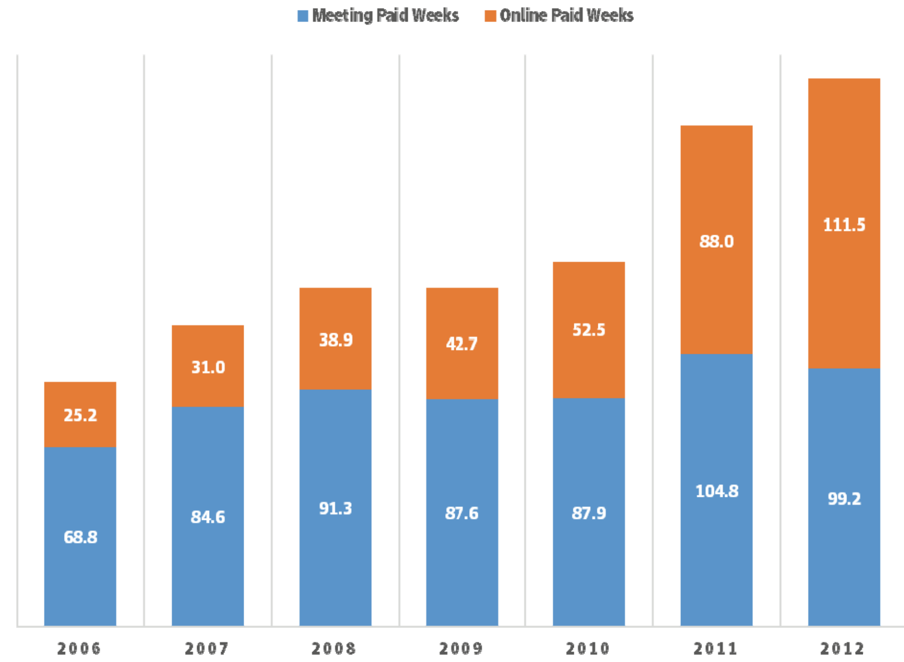
Since 2006, online revenue has increased 23% a year while operating income has increased 30% a year. The lowest operating margin was 32% (in 2009) and the highest was 51% (in both 2011 and 2012).

Today, an additional subscriber at WeightWatchers.com is worth as much to Weight Watchers as a member of the meetings business. This is not intuitive, because members pay much less online.

An online subscriber pays a monthly fee of $19 a month and stays with the program for 9 months. That results in total revenue of $171 per customer and operating profit of $88. A monthly pass subscriber for the meetings business pays $43 a month and stays with the program for 8 months. This leads to total revenue of $344 per customer. The operating profit is $103 per customer. So, despite costing 56% less than a meetings subscription, an online subscription provides just 15% less profit to Weight Watchers.

In reality, the profit picture is even better for the website. Because website expenses scale better than meetings expenses – they are more fixed, regardless of subscriber count – an additional website subscriber provides more than $88 in incremental profit. From a financial perspective, there is no reason for Weight Watchers to prefer a new offline subscriber to a new online subscriber. Customers may believe the company makes more on the meetings business. However, this is not true. The operating margin (51%) is higher in the online business than the offline business (about 30% in normal times). Today, the gap between the online margin (51%) and the offline margin (19%) is huge. However, this is a little misleading. If attendance in the meetings business is unusually low – and it has been declining in recent years – the offline operating margin becomes cyclically depressed. Furthermore, Weight Watchers charges its business to business investments to the offline segment. Right now, investment in business to business are being made ahead of any hoped for revenue. That business does not yet have scale. As a result, the added SG&A is pushing down margins by at least several percentage points.

Business to business is a more speculative form of growth. There are about 80 million obese Americans. Many of them are employees, have health insurance, etc. Obesity increases the risk of many costly health problems. A 10% reduction in body weight for the average obese American would have significant preventative health benefits. There are economic reasons why employers would want their obese employees to lose at least 10% of their body weight. So, employers can subsidize a weight loss plan. The most effective program for losing 10% of your body weight is Weight Watchers. It is 10 times more likely to achieve a 10%



Online paid weeks increased 28% a year from 25 million in 2006 to 112 million in 2012

weight loss than self-directed dieting. It has more than double the chance of cutting your weight by 10% than having a primary care physician direct your weight loss. There is little doubt that the highest probability of a 10% weight loss and lowest monthly cost of achieving that weight loss is Weight Watchers.

That doesn't mean employers will necessarily flock to the program. It sill costs money. An online subscription costs $19 a month. Weight Watchers wants employers to subsidize anywhere from 50% to 100% of the cost of a subscription. Weight Watchers is pushing the program. But it is impossible to estimate how eager employers will be to sign up. It is possible to predict that Weight Watchers will be among the preferred partners for this sort of business to business weight loss. It has low costs, proven effectiveness in multiple studies, lots of scale, the best brand name, etc. Competitively, Weight Watchers is well positioned in business to business. However, the extent to which employers want this service is unknown and will remain a matter of speculation while Weight Watchers rolls out this initiative.

As the former CEO of Weight Watchers explained, this business to business segment is basically a start-up: "Let me describe thematically what we're spending on…One is the health services organization, which is a collection of professionals largely recruited from health services companies, account management, project management, technical expertise, marketing folks, people like that. We're virtually building a company within a company, if you will. And so part of what we've been adding therefore is sort of headcount associated with that, and that's going to be showing up in the SG&A line. In addition, and ultimately this is going to be the biggest area of investment, is going to be the data collection, which is the outfitting of service providers with laptop computers, tablets, whatever the choice ultimately is going to be, to allow them to do real-time data capture at point of weigh-in."

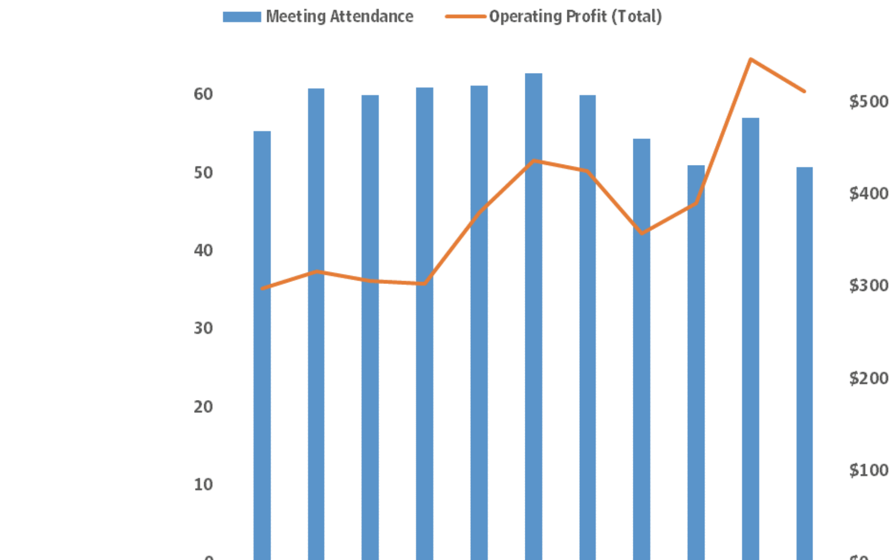
Quan is confident Weight Watchers can grow revenue by 5% a year long-term. Geoff is less certain: "Some of online is cannibalizing offline. It's not damaging because online has scale now. But, it's not pure growth either. I think men are a tough category for Weight Watchers to ever break into in a big way. I'm not hopeful there. And B2B is a big opportunity, but it's totally speculative. It really is a start-up. Of course, WeightWatchers.com was a start-up once too and now it delivers half the company's profit. The growth picture is not certain. But it is favorable."

MISJUDGMENT: *Can Weight Watchers Keep Charging Women Who Want the Best Results?*

The biggest risk of misjudging Weight Watchers is the risk of underestimating competition from free apps. The entire investment case for Weight Watchers is based on consumer psychology. The difference between an investor who is long Weight Watchers and an investor who is short Weight Watchers is probably their view of how much lasting harm they expect free apps to cause Weight Watchers.

Geoff expects very little lasting harm: "Two of the most powerful words in marketing are: new and free. Right now, free apps are both new and free. In a couple years, they will still be free. To most people, they will no longer be new. The novelty will have worn off. So the question is whether Weight Watchers is being harmed by the newness of these apps or the freeness of these apps. The folks who are short Weight Watchers believe it is the freeness of the apps. I don't think free is very important to Weight Watchers's customers. That means they don't pose a risk to Weight Watchers's durability."

It's important to keep in mind how big the market for free apps is and how small the market for Weight Watchers is. Weight Watchers does not need a lot of users relative to free apps. It just needs to be able to charge the members it has. Right now, Weight Watchers has about 1.8 million online subscribers. Monthly pass members in the U.S. are about 1.4 million right now. The number of obese women in the U.S. alone is about 40 million. Weight Watchers focuses only on those who are willing to pay for results. When Weight Watchers started its website



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Meeting Attendance	55	61	60	61	61	63	60	54	51	57	51
Operating Profit (Total)	$297	$316	$306	$302	$380	$436	$425	$357	$390	$546	$511

Over the last 10 year, Weight Watchers increased EBIT by 5.6% a year even while meeting attendance declined

in 2001, it had the – at that time –unorthodox strategy of being subscriber supported rather than advertiser supported. Ten years later, those online subscriber fees make up the majority of Weight Watcher's profit. Charging loyal members enough is a big part of Weight Watchers's success. Paid weeks in the meeting business grew much faster than attendance during the 2000s. That was achieved through the introduction of a monthly pass system instead of charging per meeting. This increased the revenue and profit of the meetings even when they had the same attendance levels.

At its peak (last year), Weight Watchers made $546 million in operating income. If you assume no cannibalization between the online and offline businesses – which is too aggressive an assumption – the sum of the peaks of those parts would be operating income of $640 million. Weight Watchers's meetings business only provided $250 million in EBIT last year. In 2007, the meeting business provided $384 million. This steep decline – caused either by free apps (unlikely, since it should affect the online business more than the offline business), poor marketing (very likely), and lower consumer confidence (probably) – has been masked by explosive growth in the online business. Many free apps have already been around a few years. Weight Watchers's online had its fastest growth while these apps were available. Online operating income went from $87 million in 2010 to $260 million in 2012.

This is what makes judging the threat posed by free apps so difficult. There are several things happening to Weight Watchers at once. One, there is an economic cycle. Most subscription based businesses for health, fitness, etc. are not operating at peak levels right now. Companies like Town Sports International (which owns a collection of gyms in major cities) are earning less today than they were in 2007. Weight Watchers's most expensive business – its monthly pass that goes for $43 a month – is performing below 2007 levels. There are company specific reasons for this. There may also be competitive reasons for this. However, there is no doubt that consumer confidence is also a factor.

Free apps should show up most obviously in pressuring the online business. Growth in the online business has slowed. The subscriber base online will shrink for the first time this year.

At the end of 2012, the then CEO of Weight Watchers, David Kirchoff, blamed some of this slowdown on free apps: “Our Weight Watchers Online advertising has done a great job over the past few years of creating awareness for losing weight online and driving trial of our online product by advertising the fact that you could lose weight successfully online. This worked well for us over multiple years, a time during which there was no meaningful competitive online alternative. Over the past year, however, there’s been an increase in proliferation of free applications, and Google Trends metrics indicate that consumer interest in these apps is up significantly this January. It’s now clear that the WeighWatchers.com awareness driving strategy that has been so successful at driving millions of people to WeightWatchers.com started losing some effectiveness roughly 6 months ago. We now need to shift gears to leverage the groundswell of people interested in weight loss mobility tools by communicating the full value proposition of Weight Watchers Online, and the behavior modification approach on which it’s based…what we’ve been seeing this January is softness in newer member recruitment in Weight Watchers Online but continuing strength in recruiting rejoins and continuing strength in retention.”

This is very bad news. But it is also completely consistent with what happens when a new service – a fad – appears on the scene. Weight Watchers’s attendance declined when low carb diets appeared. Attendance numbers dropped by similar amounts (about 14% in the U.S.) as they have done this past year. Retention and rejoins don’t decrease. First time membership does.

A new weight loss system sucks up all the “buzz” in the industry. Marketing is a huge part of what weight loss companies do. Investment in the weight loss business means marketing. Weight Watchers has a total of $216 million in property, plant, and equipment on its books. In comparison, it spends $344 million on advertising each year. Advertising is Weight Watchers’s real cap-ex.

Weight Watchers recently cut its marketing spend. That could be viewed as a negative. It would be if it was a long-term trend. But it is not a trend. It is simply a rational response to incredibly bad returns on marketing.

The question is whether this bad return on marketing is due entirely to free apps. The answer is no. Weight Watchers breaks down its results by region. The results for the U.K. and E.U. are very different. Attendance in the U.K. recently declined 20% while attendance in Europe was flat. The company expects single digit declines in European attendance over the next year while the U.S. will have “mid-teens” declines.

Regional executives run their own marketing. It is localized. They do not use the same spokespeople. Different regions often get very different results. The average obese woman in Europe is no richer, more confident, etc. than her counterpart in the U.K. Nor are free apps something unique to the U.K. Europeans use the internet too. The biggest driver of the difference in attendance by region is the effectiveness of local marketing. These huge disparities show that a lot of Weight Watchers’s results its driven by the effectiveness of its marketing rather than the presence of free apps.

Quan believes Weight Watchers will – within a few years – reach its previous peak operating income result. That was just under $550 million. Those investors and analysts who see free apps as a bigger threat, probably do not see that previous peak as a realistic goal within 3-4 years. Misjudging the likelihood of reaching and surpassing that peak within 3-4 years is the biggest risk to the investment case for Weight Watchers. The company is cheap compared to its previous high watermark for operating income. It is not especially cheap compared to estimates for next year’s operating income. So the key judgment is knowing which of those two numbers – the previous peak, or the expected results in 2014 – is the more “normal” number.

This will depend on the permanence of price competition from free apps. Will a less effective but free system take paying customers from Weight Watchers?

CONCLUSION: *Weight Watchers Needs to Reach Record High Operating Profit – On Record Low Share Count – by 2018*

Weight Watchers’ future is uncertain. But that does not mean it is unfavorable. With the benefit of hindsight, it is possible to see that Weight Watchers’ future has often been uncertain in the sense that it has been impossible to predict short-term trends. However, the company’s financial results have progressed steadily upward even when it faced challenges in its industry.

Concerns about free apps are speculative. They may be valid. However, knowing what harm free apps will actually do to Weight Watchers’ normal earning power in the future is difficult. There are several reasons for this.

The best illustration of just how speculative concerns about free apps are – how difficult they are to price into the stock – is provided by Weight Watchers’ 10-year financial results. In 2002, Weight Watchers had essentially one business. It ran meetings. People paid for each meeting they attended. Attendance had recently risen. The company was performing well in that core business. It also was part owner of a new website that had just been launched. This online business was completely insignificant in 2002.

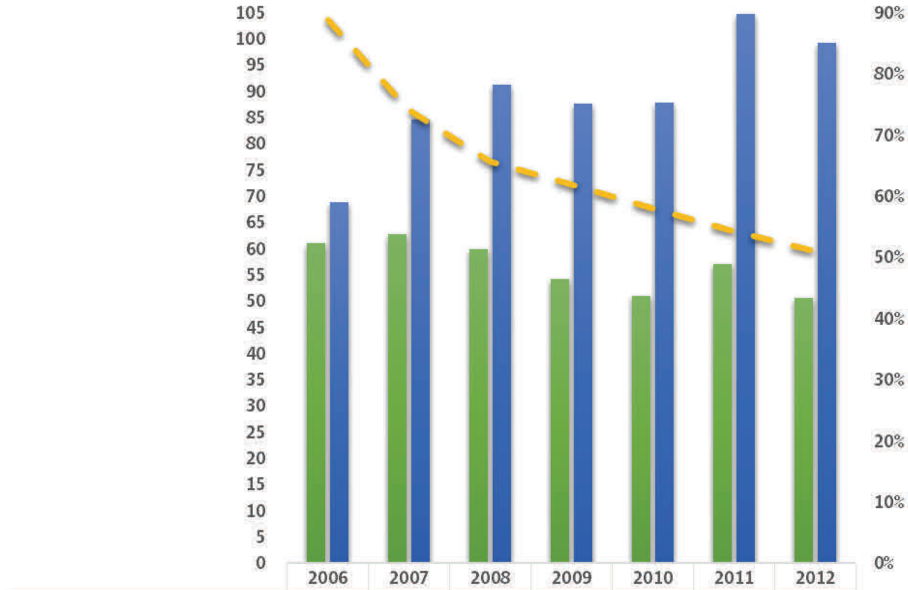
Over the next 10 years – from 2002 till today – Weight Watchers increased its earnings per share by 12% a year. During the same time, attendance at the meetings declined more than 7%. For every 100 people attending a Weight

Watchers meeting in 2002, there are now only 93. This number is expected to decline further in the year ahead. Yet there is no doubt Weight Watchers will – even at the very low attendance levels predicted for next year – earn more as a company than it did in 2002. Just as importantly, there is no doubt the company will have only half as many shares outstanding next year as it did in 2002. The result will be much higher earnings per share decade over decade despite a double-digit decline in meeting attendance over that same period.

The future is always somewhat unpredictable. In 2002, very few people could have predicted that Weight Watchers would be making most (51%) of its operating profit online. At the time Weight Watchers started its online business, the idea of charging for subscriptions on the web was very unusual. Weight Watchers was extremely successful charging for its website. In fact, when the New York Times decided to set up a paywall around part of its website, one of the models that company's management studied closely was Weight Watchers online.

The idea of making $260 million a year purely on member subscriptions at a website does not seem that odd today. But having 1.8 million paying customers – people who pay $19 a month for access – is a model that didn't exist in the early 2000s. That business model had very little to do with the existing meetings business Weight Watchers ran. The common connection was mindshare. It was the system and the brand. The Weight Watchers' program is effective. It has goodwill – mindshare – with obese women. It has worked in about 30 different countries. It has worked online and offline.

It is unclear whether Weight Watchers will have success in its new business to business channel. The company is in the same position of uncertainty it was in back in 2002. No one could have predicted how much the online business would be



	2006	2007	2008	2009	2010	2011	2012
Meeting Attendance	61	63	60	54	51	57	51
Meeting Paid Weeks	69	85	91	88	88	105	99
Weeks Attended/Weeks Paid	89%	74%	66%	62%	58%	54%	51%

From 2006 to 2011, meeting attendance declined 3% a year while weeks paid increased 9% a year

worth within 10 years. No one can predict how much – if anything – the business to business channel will be worth in 2023. It may not even exist then. It may be a complete flop. Many companies that tried to set up successful subscriber supported websites never managed to. Weight Watchers did. But that does not guarantee success in the business to business channel.

Weight Watchers uses its brand name in many different ways. It used to franchise out a lot of its meeting business. Today, 83% of the Weight Watcher system's worldwide attendance comes from company owned operations. Just like Coca-Cola, Weight Watchers has had success franchising out a lot of its system and owning much of the entire system. The value is in the brand. To the extent Weight Watchers can just own the brand, it can make money. It has managed to do that in several ways. Not all of them are tied to attendance.

Last year, Weight Watchers made $134 million from franchising and licensing. The company's brand name is licensed for use on more products than could possibly be listed. Examples include: Applebee menu items, Conair scales, Green Giant frozen vegetables, Progresso light soups, Yoplait light yogurt, Russell Stover chocolates. That is just in the United States. In the U.K., Finsbury Foods puts the Weight Watchers name on cakes and Walkers puts the name on biscuits ("cookies" in American English). There are additional licensees in the E.U., Australia, and New Zealand.

Investors may focus on attendance numbers. To some extent, they should. Attendance reflects engagement with the Weight Watchers brand. But, attendance is a means to an end. Profitably extracting earnings from the small number of obese women who are willing to pay for the Weight Watchers systems is what drives results.

A good example of how Weight Watchers can extract profit from its system without getting actual volume growth is the introduction of "monthly pass". In 2006, meeting attendance was 55 million Last year, it was 51 million. That means women are using Weight Watchers meetings 7% less. Simply put, the legacy meeting business had a 7% volume decline from 2006 to 2012. Interestingly, Weight Watchers didn't charge 7% less. Paid weeks were 68.8 million in 2006. They were 99.2 million last year. In fact, from 2006 till the peak in 2011, paid weeks rose 9% a year from 68.8 million paid weeks in 2006 to 104.8 million paid weeks in 2011. During that same time period, attendance actually declined about 3% a year. So while the actual use of Weight Watchers meetings was declining by 3% a year, the company was actually increasing its weeks billed by 9% a year.

This is an excellent example of how Weight Watchers actually makes money. It does not depend on constantly increasing attendance at any price. Instead, it tries to maximize the overall operating profit of the entire system through a combination of franchising, licensing, meetings, a website, and now a business to business channel.

Most importantly, Weight Watchers has been able to increase operating profit while decreasing share count. Over the last 10 years, meeting attendance – which was pretty much the company's sole business in 2002 – declined by 7%. Meanwhile, operating profit doubled and share count halved. So, the company roughly quadrupled earning power per share (EPS increased 12% a year) without any volume increase in its core business.

If operating profit – not attendance – can reach peak levels again in each of Weight Watchers' two core businesses (meetings and online) it will have operating profit of $650 million.

This is one of the numbers Geoff focuses on: "I try to look out 4 years. Do I think the meeting business can one day produce as much profit as it did at its 2007 peak? Do I think the online business can surpass its record operating profit from last year? Not in the next couple years. But, I believe both of those things are possible if we take the longer view and think about 2017 and 2018 rather than 2013 and 2014. How Weight Watchers gets to record operating profit by 2018 may not be clear. But I think it will do that just as it managed to increase profit on flat meeting attendance. So, I look out to 2018 and ask whether Weight Watchers will be making $650 million in operating profit. And I ask whether the share count will be lower. I think it will be making $650 million (assuming a normal economic climate). And I am certain there will be fewer than 50 million shares outstanding. Unless you assume Weight Watchers will trade at a single digit P/E ratio forever, that will result in a higher stock price 3 to 5 years from now."

Weight Watchers (NYSE: WTW)
Appraisal: $63.40

Margin of Safety: 29%

OWNER EARNINGS	(in millions)
2008 EBIT	$425
2009 EBIT	$357
2010 EBIT	$390
2011 EBIT	$546
2012 EBIT	$511
Post-Crisis (after 2007) EBIT	$2,229
5-Year Average EBIT	$2,229 / 5 = $446
Owner Earnings	$446

Business Value

Weight Watchers' business value is $5,796 million.

- Pre-tax owner earnings are $445.84 million
- Fair multiple = 13x pre-tax owner earnings
- $445.84 million * 13 = $5,796 million

Fair Multiple

Weight Watchers' business is worth 13x pre-tax owner earnings

- Quan thinks: "Weight Watchers is worth 20 times free cash flow"
    - Owner earnings compounded 6.7% over the last 7 years
        - Long-term growth is about 5%
    - 13x pre-tax owner earnings = 20x after-tax FCF
        - Using 35% tax rate
            - 13/(1-0.35) = 20

Share Value

Weight Watchers' stock is worth $63.40 a share

- Business value is $5,796 million
- Net debt is $2,214 million
- Equity value is $3,582 million
- $5,796 million - $2,214 million = $3,582 million
- Equity Value = $63.40/share
    - 56.50 million outstanding shares
    - $3,582 million / 56.50 million = $63.40

Margin of Safety

Weight Watchers stock has a 28% margin of safety.

- Business Value = $5,796 million
- Enterprise Value = $4,108 million
- Discount = $1,688 million ($5,796 million - $4,108 million)
- Margin of Safety = 29% ($1,366 million / $5,796 million)

	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBIT	EV/Owner Earnings
Medifast	0.89	1.18	9.21	13.65	13.65
Nutrisystem	1.06	2.28	36.38	552.06	552.06
Tupperware	2.16	3.23	12.05	17.75	13.49
Life Time Fitness	2.78	6.66	8.65	12.67	10.04
Town Sports	3.15	6.4	7.13	9.5	7.96
Minimum	0.89	1.18	7.13	9.5	7.96
Maximum	3.15	6.66	36.38	552.06	552.06
Median	2.16	3.23	9.21	13.65	13.49
Mean	2.01	3.95	14.68	121.13	119.44
Standard Deviation	1.01	2.46	12.26	240.92	241.86
Variation	50%	62%	83%	199%	202%
Weight Watchers (Market Price)	2.25	3.79	7.51	8.04	9.21
Weight Watchers (Appraisal Price)	3.17	5.34	10.59	11.34	13

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).