



POLLEIT & RIECHERT
Investment Management

Low-end disruption in fitness

- THE GYM GROUP -



WIDEMOAT Investing Summit 2017
Matthias Riechert
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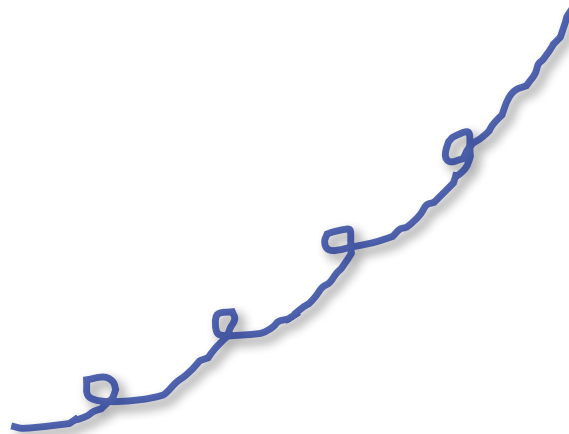
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Our mission: We are searching for *great businesses*



POLLEIT & RIECHERT
Investment Management

A “great business” has a number of elements (characteristics)
that result in...



... an ability to reinvest free cash flows at
high returns on incremental capital.



Summary

The Gym is a low-cost, no-frills gyms operator in the UK. It is rolling out a low-end disruption recipe and will likely compound for the next 4 to 5 years at high returns on incremental capital.

Name	The Gym Group plc (LSE:GYM)
Stock price on 27.6.2017	£1.92
Mcap	£246m
+net Debt	£4m
=TEV	£250m
P/E (LTM)	43x
TEV/EBITDA (LTM)	11.5x



But: P/Owner's Earnings estimate ~11x

CEO and Founder John Treharne and CFO Richard Darwin own 4.4% of shares.



Stock chart

Since IPO in November 2015 stock price went sideways. PE firms have recently exited.



Business Model



How do they make money?



Over 90% join online.
Avg. monthly
membership fee £14.30



No-frills, low-cost.
Example: Automatic
entrance with personal
PIN code



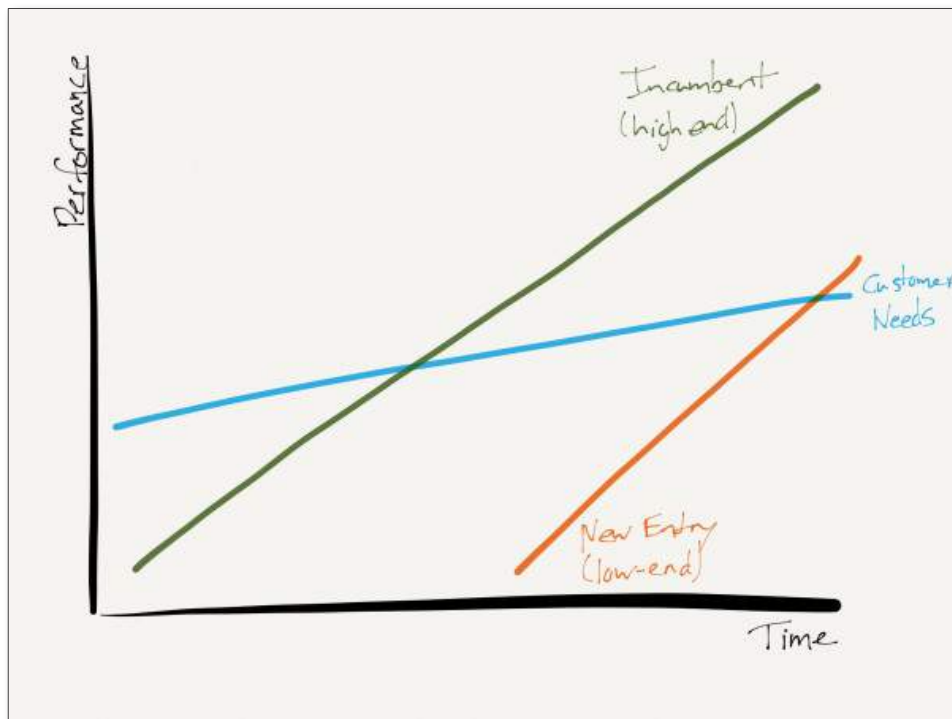
Average size 16,600 sqft. Cardio, free weights and
open class areas

>>> Simple, straightforward business with low-end disruption recipe.



The theory: Low-end disruption

Clay Christensen (Innovator's Dilemma) describes a process by which a product or service takes root initially in simple applications at the bottom of a market and then relentlessly moves up market, eventually displacing established competitors.



 **RYANAIR**
easyJet





Low-end disruption playbook for gyms

Not-to-do list



- Reception
- Pool, sauna, steam room
- Tennis, squash courts
- Spa, massage,
- Cafe, bar, family area
- 12-months-locked-in membership

= monthly fee ~GBP60-100

To-do list



- 24/7 opening hours
- Technology/Online membership managmt.
- Clean, nice atmosphere
- High quality equipment
- Personal trainer
- Simple, no fixed term

= monthly fee GBP14

Elements of a Great Business



The European market

The UK has ~9.7m gym members, growing at ~6%.

Fig. 2 – Total membership, membership growth and penetration rate of top 10 European fitness markets (2015)



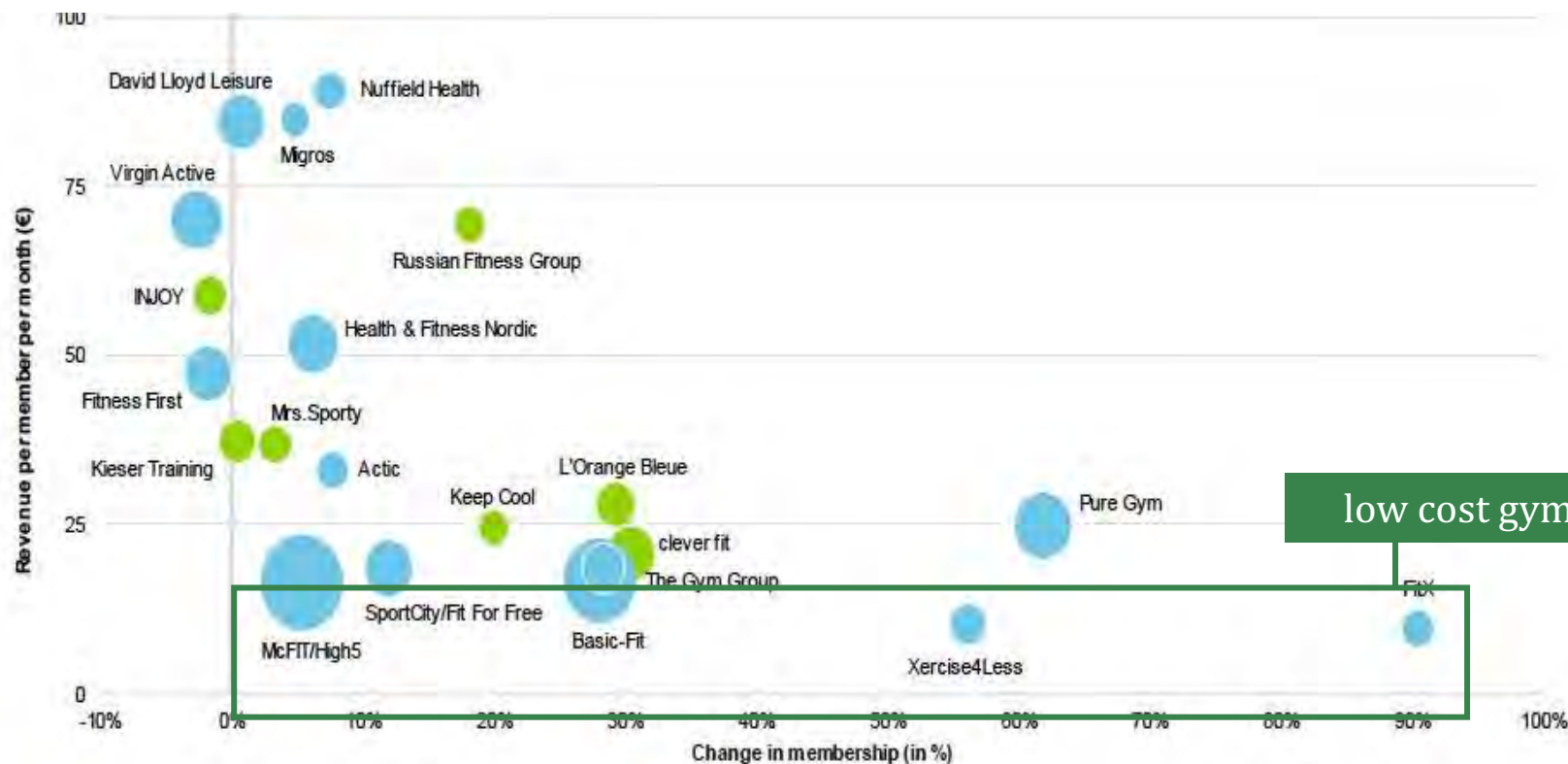
~6% growth

Bubble size represents total membership as of 2015



The European market

The fastest-growing fitness firms are low-cost operators.



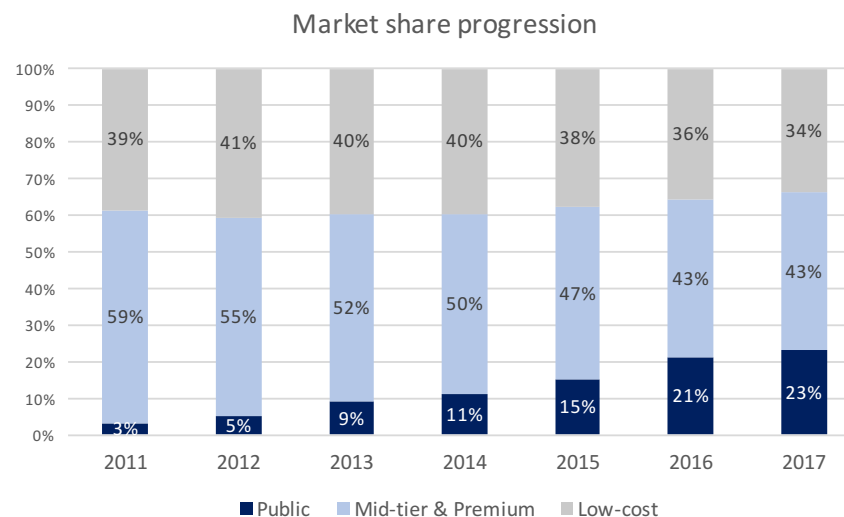
Notes: 1) Revenue figures for clever fit, INJOY and Mrs.Sporty, Change in membership for Basic-Fit as well as revenue and membership figures for FitX, McFIT/High5, SportCity/Fit For Free and Virgin Active based on professional judgement; 2) Migros figures only include Swiss business; 3) Nuffield figures do not include corporate fitness and wellbeing centres

Sources: EuropeActive/Deloitte, Company information



The UK market

Low-cost is taking market share from higher segments.



Source: Left: The Gym company presentation. Leisure Database Company. State of the UK Fitness Industry report (2017); Numis Research and Local Data Company



The UK market

Like with low-cost airlines, the top few are pulling away.



Source: The Gym company presentation. Leisure Database Company. State of the UK Fitness Industry report (2017)



Is there a large market potential?

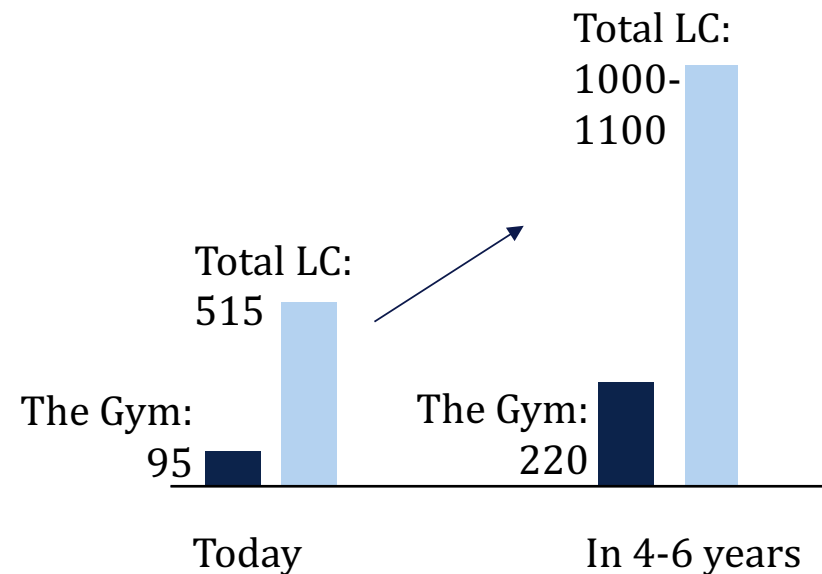
Clear trend: Land-grab opportunity of good locations for the next years.

Increasing demand:

1. Existing customers move down
(Low-cost market share 23% in the UK vs. 40-50% in Germany)
2. New customers enter
(over 30% of GYM customers have never used a gym before)



Room for 500-600 new low-cost gyms in the UK.



>>> *Strong signs of demand for the foreseeable future*



Value creation – customers

The Gym is significantly cheaper than traditional gyms and one of the cheapest low-cost operator.

Most important factors for customers:

1. Location
2. Price
3. Value for money

Net Promoter Score

2015 60.2

2016 62.2



Source: Company presentation. Net Promoter Score® is based on asking customers a direct question: How likely is it that you would recommend The Gym to a friend or colleague (0-10 scale)? The score is calculated by subtracting the number of detractors (0-6 responses) from the number of promoters (9-10 responses). Net Promoter Score is a registered trademark of Fred Reichheld, Bain & Company, and Satmetrix.

>>> *Clear value-for-money for customers*



Value creation – shareholders

Strong top line growth.

£'m	2016	2015	2014	2013	2012	15-16% change
Financial						
Revenue	73.5	60.0	45.5	35.7	22.2	22.6%
Group Adjusted EBITDA	22.7	17.0	14.7	11.8	6.0	33.4%
Group Adjusted EBITDA before POC	24.9	19.7	16.7	12.9	7.6	26.5%
Group Operating Cash Flow	24.9	18.6	16.5	14.8	9.6	34.4%
Group Operating Cash Flow Conversion	109.9%	109.4%	112.4%	125.5%	160.4%	
Expansionary Capital Expenditure	20.9	28.2	20.3	14.1	21.6	-25.9%
Net Debt	5.2	7.1	49.2	36.7	19.0	-27.5%
Operational						
Total Number of Gyms	89	74	55	40	32	20.3%
Total Number of Members ('000)	448	376	293	225	166	19.1%
Average Number of Members ⁽¹⁾ ('000)	429	355	271	212	135	20.8%
Average Revenue per Member per Month ⁽²⁾ (£)	14.29	14.08	13.98	14.06	13.78	1.5%
Number of Mature Gyms in Operation	55	40	32	16	10	37.5%
Mature Gym Site EBITDA	26.2	18.8	16.2	9.5	6.0	38.9%

1. Average number of members is calculated as the total number of members divided by the number of months in the period.

2. Average revenue per member per month is calculated as revenue divided by the average number of members divided by the number of months in the period

Source: The Gym company presentation.

>>> Has produced growing shareholder value but hidden by immature sites



Culture & Management

We like to invest with serial entrepreneurs. John Treharne has done it before: His first business was Dragons Health Club plc.

What is your focus?

"Low cost gyms. It's in our DNA."

Sense of ownership

All staff members are shareholders, gym managers think & act like owners

Capital allocation discipline

*"Our number one target is ROC, not number of clubs or members."
"I'm happy to be number two."*



The Gym headquarter
in Croyden

>>> *Evidence of great culture*



Does the business have barriers-to-entry?

75% of the market are traditional health clubs. Anecdotal evidence suggests that mid-tier gyms, such as David Lloyd, increase prices and flee upmarket.

“Disruption works because it is much easier to beat competitors when they are motivated to flee rather than fight.”

Clay Christensen

>>> Different culture and cost structure prevent traditional operators to compete



Does the business have barriers-to-entry?

But what about competition with other low-cost operators and potential new entrants?

Culture:

- Humility, learning, low-cost DNA, customer focussed
- Ownership mentality, empowering
- Capital allocation, ROC hurdle

Scale advantage:

- Lower cost (Example: Matrix equipment sourcing. Site cost reduced by 10%.)
- Two-location network: home and work

Local economies of scale:

- Local dominance. Similar to Aldi/Lidl/JDWetherspoon, competition depends on competitive behaviour of low-cost peers.



Does the business have barriers-to-entry?

Role model Easyjet.

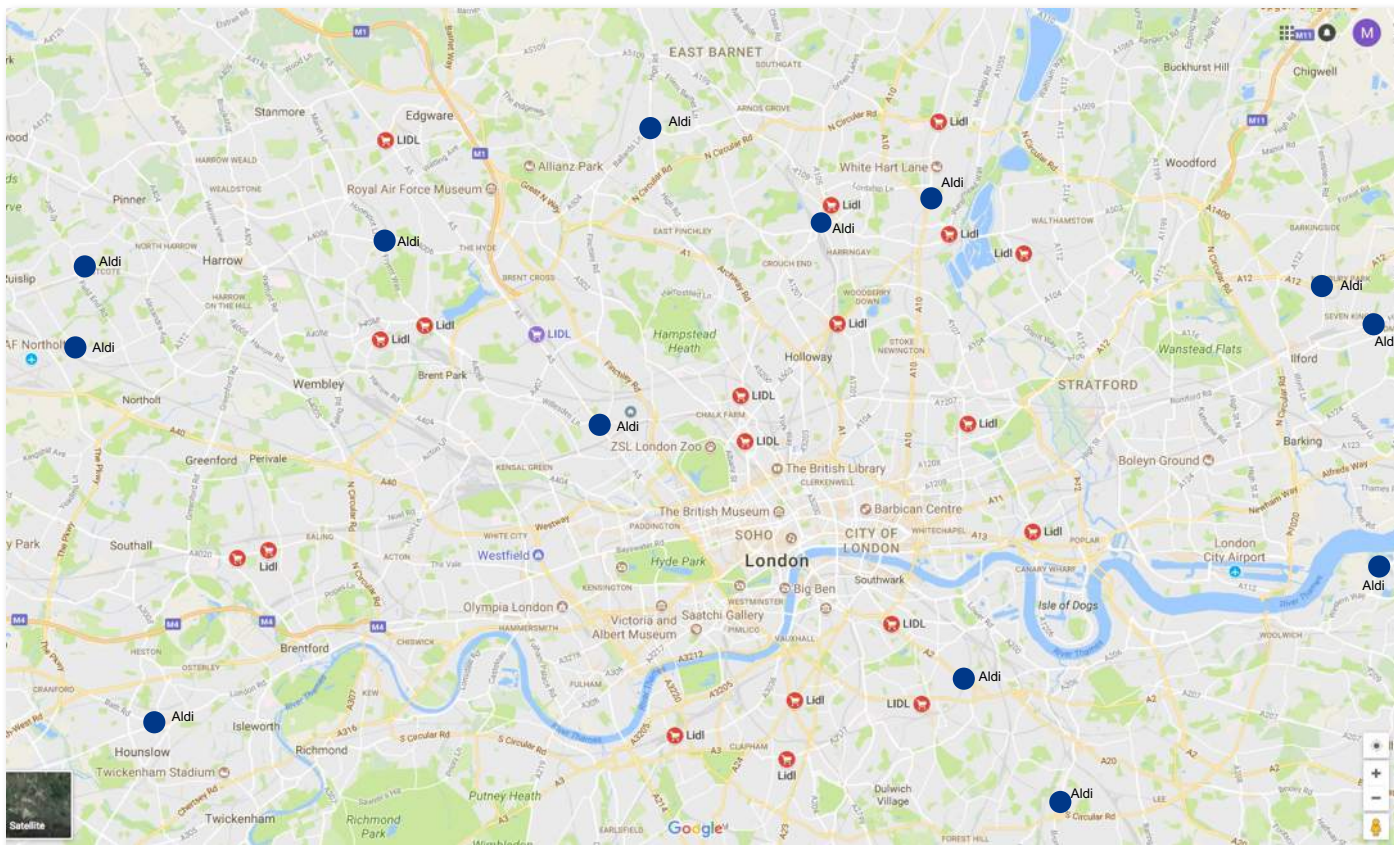


Source: Easyjet annual report 2016.



Does the business have barriers-to-entry?

Aldi and Lidl locations on central London. Rarely in direct competition.

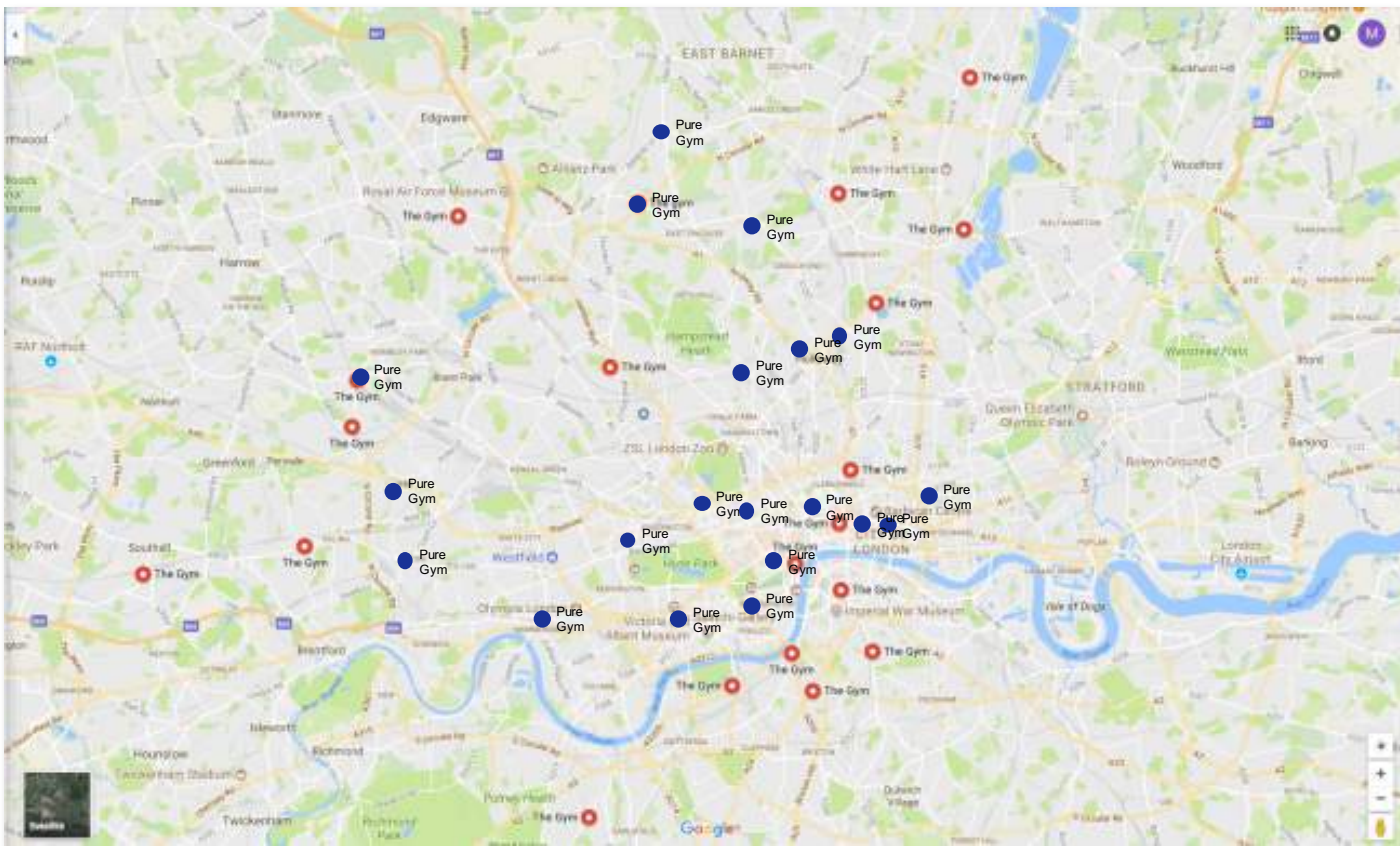


Source: Google Map Search



Does the business have barriers-to-entry?

Pure Gym and The gym locations in London.



Source: Google Map Search

>>> Location dominance, site location expertise and capital allocation discipline



Test questions: Disruptive Innovation

1. Is the DISRUPTOR offering simpler, cheaper, more reliable, more comfortable – but not necessarily more sophisticated products?



2. Is the DISRUPTOR targeting a new (or price sensitive) group of customers?



3. Does the DISRUPTOR have a different business model that allows for attractive returns and low prices?



4. Are incumbents able to flee upmarket?



5. Is the DISRUPTOR creating new barriers to entry?



Valuation



Unit economics

Estimated P&L of a mature gym.

Per mature gym	(£m)
Revenues	1.00
Gross profit	0.99
Fixed property costs	0.26
Marketing	0.04
Staff	0.07
Other Opex	0.15
EBITDA	0.48
(Maintenance Capex)	(0.08)
Contribution before central costs	0.40

After 5 years cardio equipment replacement (120k); after 7 years refurbishment (350k) plus overall maintenance (75k). Average per annum cost ~80k per gym.

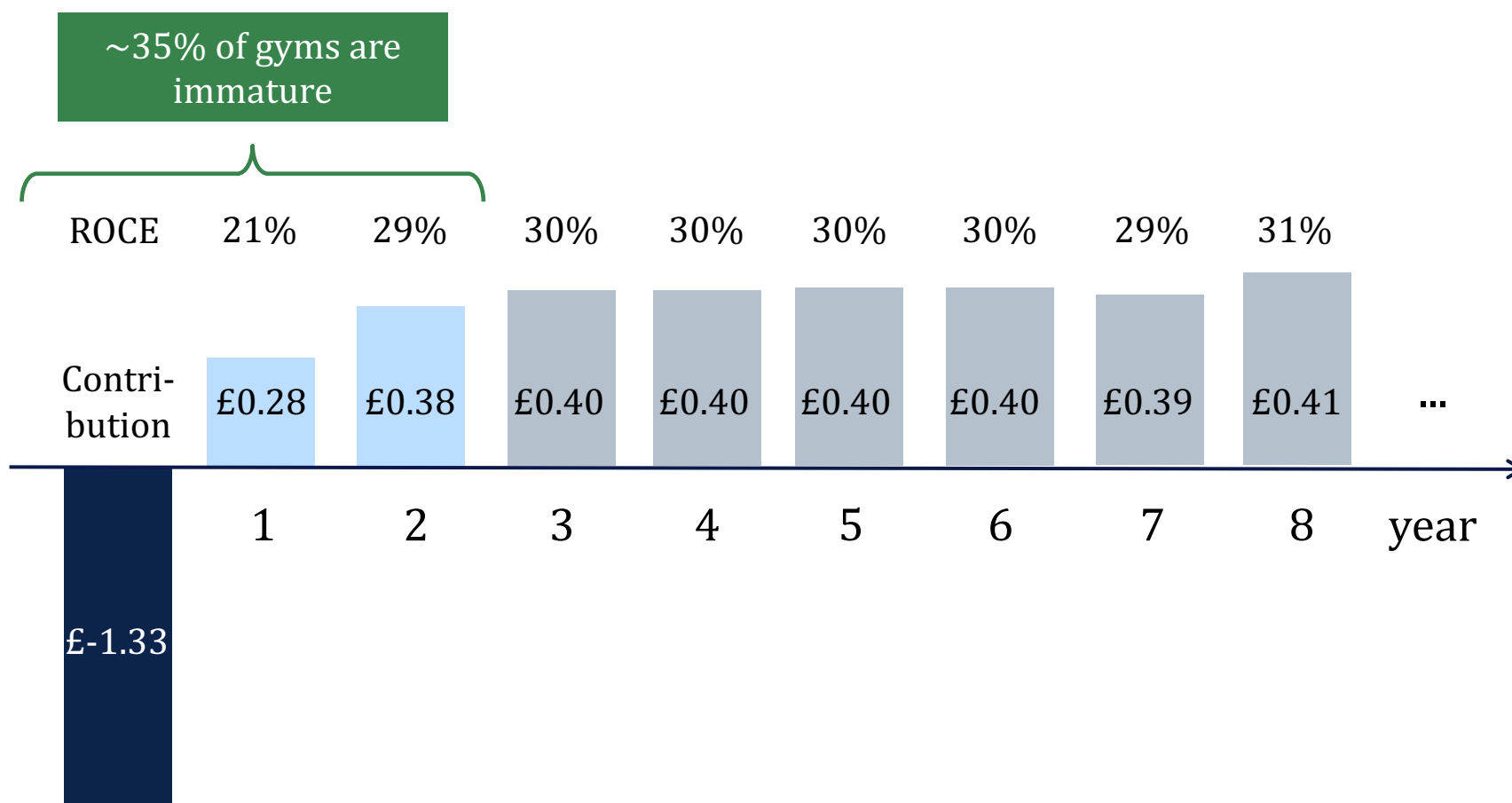
New gyms require £1.33m in Capex resulting in pre-tax ROIC of ~30%.

Note: Estimate based on company information (investor day 2017 slides) and conversation with the company.



Unit economics

Economic earnings stream of a gym built during the last 2 years.



Note: Own estimate based on company information and conversation with the company.



Owner's Earnings estimate

How much economic earnings would The Gym produce if it stopped investing in growth and only reinvested enough to maintain its competitive position in existing locations?

	2017	2018	2019
Number of gyms	95	95	95
Mix (immature/mature)	33/62	16/79	0/95
Contribution (£m)	34.7	36.4	38.0
Central costs (£m)	10.10	10.45	10.70
PBT (£m)	24.6	26.0	27.3
Tax (statutory UK)	19%	19%	18%
Owner's Earnings (£m)	19.9	21.0	22.4
OE multiple (vs mcap 246)	12.3x	11.7x	11.0x

On the back of the envelope:

Mature contribution of £0.40m
x 95 gyms = £38m. Subtract
central cost £8.4m, comp £0.9m
and interest £0.8m
=PBT £28m. Assume statutory
tax at 19%. That gives owner's
earnings of approx. £22m.

Reasons for difference to reported earnings:

1. 1/3 of sites are immature
2. Depreciation > refurbishment costs

Note: Own estimates. Contribution for immature gym £0.3m, for mature £0.4m. By definition estimating Owner's Earnings requires some guessing. Despite the imprecision I consider the Owner's Earnings figure more relevant for valuation purposes than GAAP earnings.



However, they are reinvesting!

More important than the number of new sites is the rate of reinvestment and the return on incremental capital. E.g. they could invest in more smaller gyms, but maintain the ROCE hurdle.

	2017	2018	2019	2020	2021	2022	2023
Total number of gyms	109	129	149	167	185	203	220
New gyms (<1yr)	20	20	18	18	18	17	10
Adj. PBT (£m)	29	34	40	47	52	58	64
yoy growth		20%	18%	16%	13%	11%	9%
Reinvestment (£m)	27	27	24	24	24	23	13
Reinvestment rate	93%	78%	59%	51%	46%	39%	21%
pre-tax ROC (Adj. PBT/Avg. Capital)	21%	21%	22%	22%	22%	23%	23%

Valuation in 2021:
PBT £52m minus 17% corp.
tax = £43m after tax
Assume a multiple of ~13x
= £556m (CAGR of 20%)



Note: Based on own estimates. Average invested capital includes PP&E at cost growing with estimates for reinvestments. See Annex for adj. PBT calculations.



Conclusion

The Gym has many elements of a great business. It trades at ~11x owner's earnings and will grow earnings at ~15% for the next 4 to 5 years with high returns on incremental capital.

To monitor over time:

Signs of

- (Un-)disciplined capital allocation (ROC hurdle)
- (Ir-)rational behavior of competition



What can be done better?

Coming out of the ownership of private equity, the board is strictly following UK corporate governance guidelines without explaining why it makes sense for long-term shareholders.

Examples:

- Typical UK plc remuneration package linked to EBITDA, EPS and relative TSR. Why not design long-term incentives linked to ROC - or better EVA?
- Why pay a dividend, albeit a small one, if you can reinvest at 30% ROCE?

>>> Potential for long-term shareholders to support management and board to think and act more like an “Outsider”.

That's all. Thank you.



Annex

Estimates	2017	2018	2019	2020	2021	2022	2023
Total number of gyms	109	129	149	167	185	203	220
Mature gyms (>2yrs)	74	89	109	129	147	165	183
New gyms (<1yr)	20	20	18	18	18	17	10
Contribution from mature	29.6	35.6	43.6	51.6	58.8	66.0	73.2
Contribution from immature	10.5	12.0	12.0	11.4	11.4	11.4	11.1
Total contribution	40.1	47.6	55.6	63.0	70.2	77.4	84.3
Central cost (incl. comp, interest, IT dep)	11.6	13.3	15.3	16.5	17.7	19.1	20.5
Adj. PBT	28.5	34.3	40.3	46.5	52.5	58.3	63.8
Tax (statutory)	5.4	6.5	7.6	7.9	8.9	9.9	10.8
Adj. NI	23.1	27.8	32.6	38.6	43.6	48.4	53.0
<i>yoy growth</i>		20%	18%	18%	13%	11%	9%

Note: Based on own estimates. Contribution for immature gym £0.3m, for mature £0.4m. Total contribution includes central cost, comp, interest and depreciation for IT. Growing at 15% until 2019, thereafter at 7.5%.



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