



Source: Eikon Thomson Reuters

Market data	
EPIC/TKR	GYM
Price (p)	208
12m High (p)	220
12m Low (p)	155
Shares (m)	128.5
Mkt Cap (£m)	267
EV (£m)	271
Free Float*	85%
Market	Main

Description

The Gym Group is the second largest operator of low cost gyms in the UK.

Company information

CEO	John Treharne
CFO	Richard Darwin
Chairman	Penny Hughes

www.tggplc.com

Key shareholders

Directors	5%
Soros	7%
Legal & General	7%
Threadneedle	6%
Fidelity	5%
Hargreave Hale	5%

Diary

29 Sep	xd interim div
Dec 18	Pre-close update
Mar 18	Prelims
Jun 18	AGM

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The author owns stock in The Gym Group

The Gym Group

Alternative valuation

Valuing high growth companies can be tricky. The cost of establishing growth tends to drag down current earnings, making the company look expensive on straight PE grounds. For a business like The Gym Group there is an alternative: valuing it on a per gym basis, not forgetting the value of future gyms. Using this technique, we derive a value of 320p per share. Alternatively, we find that the current share price assumes a 13% discount rate needs to be applied to future cash flows.

- ▶ **Strategy:** The Gym Group is a fast growing operator of low cost gyms in the UK. At the end of 2016 it had 89 gyms open. It plans to open 20 in 2017 and it has just announced the acquisition of a further 18 gyms from Lifestyle Fitness.
- ▶ **Low cost growth:** The growth in the UK fitness market is coming from the low cost sector with membership at both traditional private clubs and publicly run facilities largely static. Of the total 6,700+ gyms in the UK fewer than 550 are "low cost", where membership typically costs less than £20 per month.
- ▶ **Gym efficiency:** The Gym Group opened its first site in 2008 and has become the second largest player in the low cost segment to Pure Gym. It costs Gym group slightly less than £1.5m to open a new gym that should generate £405k of EBITDA in its third year. The company targets a ROCE in excess of 30%.
- ▶ **Risks:** In addition to generic corporate risks, the main threat that the Gym Group faces is, we believe, competition. There are many players in this market and the barriers to entry are not high but The Gym Group is an impressive operator that has honed its operations very efficiently.
- ▶ **Investment summary:** This is not a full report on The Gym Group and it is not a client of Hardman and Co. but we believe it is an interesting example of a company that benefits from looking at its valuation in a non-traditional way and where the valuation on a per outlet basis is particularly appropriate.

Alternative valuation

Trying to value a fast growing business like Gym Group with normal metrics – PER, DCF, price to free cash flow – is difficult: the faster they grow the more expensive they appear to be as pre-opening costs and initial lower profitability dilute the underlying profitability of the company. A business like The Gym Group, which has homogenous discrete units, can be valued in a different way: per gym. We believe this gives a more accurate picture of the financial strength of the business.

Valuing a gym

The gyms reach maturity relatively rapidly – we have assumed that in their third year of operation they are at full earning potential. In the pre-opening period all the costs are up front and then there are two years of sub-optimal revenue while membership grows on a largely fixed cost base. In cash terms the company often benefits from rent-free periods or discounted rents, but in P&L terms these benefits are spread over the length of the lease.

For the individual gyms we have started at the EBITDA line rather than revenue but in the table below we show how revenue is converted to EBITDA in the standard Gym Group model.

Typical individual gym profitability at maturity		
	£000	
Revenue	1,000	100%
Cost of sales	-10	-1%
Gross Profit	990	99%
Property costs	-255	-26%
Other operating costs	-255	-26%
EBITDA	480	48%

Source: The Gym Group

There is then the maintenance cost to consider. The Gym Group has been explicit about the cost and the timing of the large maintenance items, we have just guesstimated the timing of the smaller payments.

Gym Group seven year maintenance cycle		
	£000	Description
Year 1	0	
Year 2	10	General
Year 3	20	General
Year 4	20	General
Year 5	120	Cardio equipment and rebranding
Year 6	20	General
Year 7	350	Other equipment and site refurbishment
Total over 7 year cycle	540	Equivalent to c7% annual revenue

Source: The Gym Group and Hardman & Co Research

The cost of opening includes the fitting out costs, the equipment and the pre-opening marketing costs. Pre-opening marketing spend is typically £140k. Over the years the company has managed to reduce the cost of fully fitting out a gym from £1.5m to £1.33m and the cost of the seven-year refurbishment cycle from £630k to £540k.

These are benefits of scale and experience that provide a barrier to new entrants looking to enter the market. With the lower capital investment required, Gym Group can target slightly lower earning gyms and still achieve their 30% ROCE.

Cash flow

We now need to value the cash flow from a gym. For our base assumptions we have assumed 2% inflation and a 10% discount rate. If we were to assume higher growth we would be inclined to use a bigger discount factor. The older gyms make on average about £480,000 of EBITDA at maturity. The newer ones we are assuming return £405,000 in year 3.

Individual Gym Group cash flow years 0-7 (£000)								
Year	0	1	2	3	4	5	6	7
EBITDA	0	50	290	405	413	421	430	438
Capex	-1,470	0	-10	-20	-20	-120	-20	-350
Cash flow	-1,470	50	280	385	393	301	410	88
discount factor	1.00	1.05	1.15	1.27	1.40	1.54	1.69	1.86
DCF	-1,470	48	243	303	282	196	243	48
NPV to perpetuity pre-tax	2,524							

Source: Hardman & Co Research

Gyms that are already open fall into one of three categories: opening year, second year, third year or more. To value each category, we just exclude the earlier year(s) and move the discount factor along.

Gym value per maturity group			
Maturity	Year 3 EBITDA £000	Gross Value £000	Net Value £000
Mature gym	480	6,000	4,800
Y2 gym	405	4,658	3,726
Y1 gym	405	4,390	3,512
Pre-opening	405	2,524	2,019

Source: Hardman & Co Research

Unsurprisingly there is little difference in value once the opening costs are omitted as there are only one or two years of less than full profitability. The net present value of a gym opened by the Gym Group on these metrics is £2m; that is net of all investment both initial and ongoing maintenance.

We have ignored tax at the unit level and just applied an overall tax charge to the value of the gyms at 20%. We have also had to subtract the capitalised (and taxed) cost of the central function that we have estimated at £8.8m for 2017 up from £7.5m last year. We assume it grows in line with the percentage increase in number of gyms, reaching £14m in 2021 and capitalised at a 2% growth rate and 10% discount rate thereafter. It equates to £125m net present cost.

The Gym Group – Valuation on per gym basis

Number	Maturity	2016 EBITDA £000	Net Value £000	Total 2016 EBITDA £m	Total value £m
55	Mature gym	480	4,800	26.4	264
19	Y2 gym	290	3,726	5.5	71
15	Y1 gym	50	3,512	0.8	53
	Pre-opening	0		-2.7	0
89	Total at end 2016			30.0	387
75	Future gyms		2,019		120
164	Gym total				508
	Central costs			(7.3)	(125)
	Net debt				(4)
	Group value			22.7	379
	Group value per share				295p

Source: Hardman & Co Research

In our valuation table we show the value of the existing gyms and then look at only the next five years. We assume the company grows from 89 gyms (as at Dec-16) to a total of 164 gyms in 2021, opening 15 per year, which is at the lower end of the company's plans. Our valuation implicitly assumes the group then stops and just counts the cash as it comes in.

The group value comes in at 295p per share. If you exclude future gyms then it drops to around the current share price 201p.

Risks

This is not purporting to be a comprehensive report on the Gym Group so we are just accepting The Gym Group's analysis that all the growth in the gym sector in the UK is in the "low cost" segment, which represents a small fraction (less than 10%) of the whole market and thus leaves very substantial room for further growth.

There are obviously plenty of risks associated with any business like this. And the further you look out to the future the more the risks accumulate. Other than using a discount rate, our model implicitly assumes everything works perfectly smoothly.

Another way of using this valuation is to calculate what discount rate the current price is assuming. To get back to a price of 202p per share, you need to discount the future cashflows at 12.4%. With bond yields where they are this is a very substantial premium, in our view, for a relatively straightforward business.

The total value of the future gyms falls to just £72m under these assumptions.

Valuation of the Gym Group at 12.4% discount rate					
Number	Maturity	EBITDA £000	Net Value £000	Total EBITDA £m	Total value £m
55	Mature gym	480	3,825	26.4	210
19	Y2 gym	290	2,961	5.5	56
15	Y1 gym	50	2,736	0.8	41
	Pre-opening	0		-2.7	0
89	Total			30.0	308
75	Future gyms				72
164	Gym total				379
	Central costs			(7.3)	(115)
	Net debt				(4)
	Group value			22.7	260
	Group value per share				203p

Source: Hardman & Co Research

Acquisition

As we were writing this piece, the Gym Group announced a small acquisition of 18 gyms from Lifestyle Fitness for a cost of £20.5m. It plans to spend a further £5.4m on refurbishing them. The aggregate cost works out at £1.44m per gym, a figure not dissimilar to the cost of opening a new gym but with the advantage that these are already open and have revenue and members already.

Lifestyle Fitness gyms acquisition					
Number of gyms		Acquisition price £m	Refurb cost £m	All-in price £m	All-in per gym £m
10	Convert to The Gym	11.4	4.5	15.9	1.59
8	Lifestyle	9.1	0.88	10.0	1.25
18	Total	20.5	5.38	25.9	1.44

Source: Hardman & Co Research

If we were to value all the converted gyms at the full maturity valuation of £4.8m and leave the others at cost that would add, after the total investment, a net £32m or 25p to our valuation at the 10% discount rate. **Added to our 295p valuation that gives a 320p value for the enlarged group. It also pushes the implied discount rate at today's price up to 13%.**

Summary

On current consensus estimates – before any adjustment for the Lifestyle Fitness acquisition – of 7.5p and 9p per share for FY17 and FY18 respectively (source FT.com), Gym Group trades on a PE multiple of 27x falling to 22.5x using a 202p share price – the price before the announcement of the Lifestyle deal.

The problem with using this metric is that it is looking at only 74 of the expected 104 gyms open by Dec-17 operating at full maturity and completely ignoring the potential 15 or more to be opened each year into the future.

We believe that looking at the valuation of the individual gyms under The Gym Group management and the future growth prospects gives either a clearer view of the value of the business or the level of risk the market is attributing to the enterprise at the current share price.

Notes

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