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Insight



The UK fitness industry is under a growing mountain of debt, writes **David Minton**, which if not managed properly, threatens to become overwhelming

Debting away with it...

I never realised that my interest-only mortgage and private equity houses had so much in common.

I take on a load of debt, in the form of a mortgage, improve the property and assume the upside will be there for me when I come to sell. Historically the upside has worked for the majority in the UK.

Private equity houses effectively work in the same way. They look for companies where the (share) price doesn't reflect the underlying asset value, drive a hard bargain, convince a bank of the new business case, then take on debt to buy the company. Traditionally an improvement in trading and profitability enable the company to pay the debt charges and be groomed for re-sale asap. The upside enables the debt to be paid back and the private equity house to get profit or 'carry' out of the deal.

The system has generally worked well, in that banks and building societies tend not to burden people with a mortgage that would cripple them, long term. At the same time, private equity has found a constant supply of companies that have benefited from their 'turnaround' skill set.

But what happens when the banks and building societies provide loans to too many people who can't afford them and who start to default - it's now called 'sub-prime'. When too many private equity houses start chasing too few deals with too much money they end up with over valued assets loaded with debt. That could be - pride before a fall?

One consequence of consolidation in the fitness market is bigger levels of debt to service. If the debt was raised on inflated valuations of property (PropCo) and the operational company (OpCo) now has to service this enlarged debt, monthly membership rates could start to rise simply to meet the debt charges and with little regard for what the market can bear. A few of the trade buyers, but far too many of the non-trade buyers have purchased without any regard to the latent demand (LatDem), so who can be surprised when the business stagnates or goes backwards? Quantifying demand for the product helps either reinforce the valuation or ring early warning bells during due diligence.

Debt charges finally brought down the largest US fitness brand on 1 August 2007, when it filed for bankruptcy protection as part of a plan to restructure its mountain of debt. Chicago-based Bally Total Fitness has seen membership numbers drop across its 375 clubs (not including the two joint ventures or the 33 franchised sites) from 3,611,000 in 2005 to 3,555,000 in 2006, with revenues drop-

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ping to around \$758m, from \$807m in 2005.

Court papers show Bally listing \$396.8m of assets, against \$761.3m of debt. We know from press reports over the years that the company had been struggling for some time with debt. In 2005, when seven out of the ten shareholders were hedge funds who together controlled at least 43% of the outstanding shares, the company avoided a technical default that could have rendered what was then \$700m of debt immediately due and payable. The company at the time had just \$45m in cash.

If we cast our minds back to 2003, Bally announced a joint venture partnership with Holmes Place with the intention of introducing the Bally brand throughout western Europe. No clubs were ever opened under this partnership because the battle for control of Bally was raging back in Chicago then, and still continues to this day. At the same time Holmes Place was in denial about what was about to happen to its own share price. Holmes Place stock peaked at 370p in 1999 and in 2003, the same year as the 'partnership' with Bally, the company was sold for 25p a share. By this stage the heady expansion of Holmes Place had boosted net debt to £184.8m. In August 2007 Close Brothers European Debt Advisory Group advised Virgin Active on the raising of £249m (equivalent) of debt facilities to finance the acquisition of the UK business of Holmes Place's 48 clubs.

Our industry, like so many of us working within it, is mortgaged up to the hilt and so long as there's confidence in the market place that's just fine. When growth stops or -worse - when things start to go backwards, like at Esporta currently, that's the time when investors, funds, banks and debt providers start to wonder if this is just a blip or something more serious. Bell Leisure, the holding company of Esporta was placed in administration on 14 August 2007. At this stage the property needs to be re-valued; that will be twice in less than 12 months - nice work if you can get it! Perhaps this time valuations will take LatDem into account. Sadly operations

can be likened to rats, and a sinking ship will need to be re-built quickly. While the original under bidders re-visit their sums for the once proud Esporta, let's also look at the LatDem site by site.

On 2 August, as planned, Versailles Bidco was the successful bid vehicle of London & Regional Holdings (L&R) and Bank of Scotland Corporate for David Lloyd Leisure. At £925m, this is the largest deal so far in the fitness business but again it was the PropCo that drove it, not the OpCo or the LatDem. If we add in the £101.7m (or £201m including debt) for the original 14 sites of Next Generation, plus the one Odyssey, one Harbour Club and the purchase of the two Amida sites - for what a source close to the deal described as "loadsamoney" - we can see that for property developers L&R have quite an exposure to the fitness market.

Not all deals are backed up by a PropCo and the Harbour and Amida clubs were leasehold, like the record-breaking £22m that's been paid for a single site in Soho. Third Space has been sold to a management buy-out, backed by Graphite Capital. Graphite not only holds the distinction of being the most stable form of solid carbon ever discovered but also (probably) holding the most debt in a single fitness club ever. So do the new owners bring a new meaning to the third space, as in: home, work, and debt? As a former member I, along with countless students could relate to that.

Debt, of course, is everywhere. Search 'Debt' and Google brings back 181 million items in 11 seconds compared to 'Porn' with only 106 million. Put the two together and Pornbrokers takes on a whole new meaning. Consumer debt levels in this country have reached record levels of more than £1.3 trillion this year and have become a major economic concern in the light of a string of interest rate rises. The Insolvency Service confirmed a sharp rise in the number of people who filed for bankruptcy or took Individual Voluntary Arrangements, while the Financial Services Authority said that personal debt levels were among the biggest risks to financial stability in the UK over the coming year. We, like poor countries, learn to live with a debt burden. Africa, for example, spends four times more on debt interest payments than on health care. So, debt, I've decided, is like stress: a little is good for us, but too big a mortgage, or debt burden, could bring the house down.

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