

Work Project, presented as part of the requirements for the Award of a Master's degree in
Finance from the Nova School of Business and Economics.

Private Equity Challenge: Investment Committee Paper of Planet Fitness
Capital Structure

Benjamin Liermann (50604)

Work project carried out under the supervision of:

Inês Lopo de Carvalho

15/12/2022

Abstract

Planet Fitness is a market leading fitness studio chain and franchisor with over 2,324 stores in the US. It provides high and recurring cash flows, making it a good LBO target. 2022 EBITDA reaches 336\$M, exceeding pre-covid levels. The company offers value creation potential in internationalization through M&A, Greenfield possibilities, and further organic growth levers. Entry Multiple of 9.2x results in an EV of 3.1\$B. With 5.2x Leverage an LBO yields 4.0x Money Multiple and 26% IRR.

Keywords

LBO, Investment Committee Paper, Gym Chain, Private Equity, Value Creation

This work used infrastructure and resources funded by Fundação para a Ciência e a Tecnologia (UID/ECO/00124/2013, UID/ECO/00124/2019 and Social Sciences DataLab, Project 22209), POR Lisboa (LISBOA-01-0145-FEDER-007722 and Social Sciences DataLab, Project 22209) and POR Norte (Social Sciences DataLab, Project 22209).

I. Table of Content

1. Investment Committee Paper summary	3
1.1. Company Overview	3
1.2. Historic Financials	5
1.3. Market Overview	6
1.3.1. Trends and Forecast	7
1.3.2. Competitive Positioning.....	8
1.4. Investment Thesis	9
1.5. Value Creation	9
1.6. Business Plan and Forecast incl. Financials	14
1.7. Valuation	15
1.8. Capital Structure and returns	15
1.9. Exit Opportunities.....	16
1.10. Key Areas for Due Diligence	17
2. Capital Structure – Benjamin Liermann, 50604.....	17
2.1. Deal Structure – Sources and Uses.....	17
2.2. Debt	18
2.2.1. Debt structure.....	18
2.2.2 Types of debt.....	19
2.2.3. Pricing of Debt.....	21
2.2.4. Covenants.....	24
2.3. Equity.....	25
2.3.1. Equity Structure	25
2.3.2. Institutional Investment	26
2.3.3. Management Investment.....	26
Bibliography.....	28

1. Investment Committee Paper summary

1.1. Company Overview

Planet Fitness is the largest franchisor and operator of high value low price gyms, founded by Marc and Michael Grondahl in 1992 in New Hampshire, USA. The company is the market leader in the high value low price fitness sector with an expectedly 16.3 million members and 2,324 stores worldwide in 2022. The 233 corporate-owned and 2,091 franchised gyms are mainly located in the US, followed by a small share in Canada, Mexico, Australia, and Panama. At the beginning of 2022, Planet Fitness acquired one of its franchisees Sunshine Fitness (hereafter Sunshine Acquisition), to gain the team behind one of the best-performing franchisees of its network. Hence, 114 stores were acquired and shifted from franchisee-owned stores to corporate-owned stores, almost doubling the number of corporate-owned stores. Besides operating and franchising gyms, the company sells equipment to its franchisees in US and Canada as the third line of business. As contracted in the franchise obligations, franchisees must purchase the equipment exclusively from Planet Fitness (except internationally, as they buy equipment from approved vendors and Planet Fitness receives a commission). Planet Fitness acquires the equipment directly from suppliers at lower prices and sells it at a markup, providing a recurrent stream of income. The franchisees are obliged to stick to the mandatory renewal of equipment every 5 to 7 years to maintain the company's quality standards.

Hereby, the corporate-owned store revenue accounts for 44%, the franchise business for 39%, and the equipment sales for 17% of total revenues. The strongest EBITDA of 58% margin, however, is generated via the franchise model as it is characterized by a low level of fixed costs and focused on selling and licensing franchise agreements.

Furthermore, the company has demonstrated double-digit past growth rates. Total revenue approximately doubled from 430\$M in 2017 to 839\$M expected in 2022 while the EBITDA increased from 180\$M in 2017 to 337\$M in 2022. With this track record, the company has

outgrown the market by, on average, 17 percentage points year-on-year, demonstrating the company's strong capabilities. This is enabled by the four major pillars the business model is built upon: The high value low price strategy, the "Judgement Free Zone" Concept, high-quality equipment standards, and the attractive franchise structure. Firstly, the high value low price segment has increasingly gained popularity among gym goers as it offers, as the name implies, high-quality amenities at a low price point. The company offers its classic membership for a fee of \$10 per month. This fee has never been increased and is one of the lowest in the market. While it is acting as a flagship for the company, it has also been attracting new joiners ever since. However, a premium option, the Black Card membership, with an increased number of services available is offered for 22.99\$ per month. Secondly, by being recognized for the "Judgement Free Zone", Planet Fitness distinguishes itself by providing a non-intimidating environment that creates a space for "everyone" and not only the bodybuilding athlete. Thirdly, high-quality standards can be ensured by strict equipment renewal and purchase standards for its franchisees. This leads to high levels of customer satisfaction. Lastly, by offering an attractive franchise option with solid potential returns (an IRR of 17% over 10 years), strong brand awareness, continuous support, and an overall streamlined model, Planet Fitness has been able to grow its number of franchisee-owned stores with an 10% CAGR from 2017 to 2021. Currently, the company follows several strategies to attract new members such as further internationalization in New Zealand and Mexico or marketing strategies with memorable, and creative advertising. Moreover, it offers a free mobile app that entails selected features such as equipment tutorials, live workouts or digital gym check-in. Lastly, as ESG ratings are increasingly important, Planet Fitness has set up a strategy to mitigate the risk associated with a relatively weak current rating. The history of the company has demonstrated the capabilities of the executive team. Therefore, the combined more than 17 years of executive experience at Planet Fitness, will also pave the way for future growth.

1.2. Historic Financials

Planet Fitness has demonstrated solid member growth with a 2017-2022 CAGR of 9%. Furthermore, total number of stores increased consistently, starting with 1,518 in 2017 to 2,324 in 2022. This amount of store openings is mainly impacted by the store openings of Planet Fitness franchisees.

Total revenue grew with a 2017-2022 CAGR of 14%, already exceeding pre-covid revenue in 2021. Total revenue can be separated into three streams: Franchise revenue, corporate-owned store revenue, and Equipment revenue. Franchise revenue consists of royalty- and other fees (~70%), National Advertising Fund revenue (~20%), and commission income from vendors (~10%). Despite a slight decrease during covid, franchise revenue consistently grew in the past, exceeding pre-covid numbers already in 2021. This growth has slowed down in 2022 related to the sunshine acquisition. Due to this event, corporate-owned revenue more than doubled in 2022 as it is driven by the number of stores, which also doubled. Equipment revenue heavily suffered during covid due to related closures of stores and postponement of new equipment purchases. However, this segment already started to recover, reaching almost pre-covid levels despite the loss of 114 deliverable stores (sunshine acquisition).

Planet Fitness shows a strong EBITDA margin of 40% in 2022, achieving pre-covid levels. The strongest driver of the EBITDA is the franchise segment, which in 2021 made 72% of total EBITDA (Corporate-owned: 18%, Equipment: 10%). In 2022, the corporate-owned impact on EBITDA increased to 37% (Franchise: 56%, Equipment: 7%) due to the sunshine acquisition. Furthermore, the franchise segment itself has the highest EBITDA margin as pct. of franchise revenue (58% in 2022) as franchise costs are only consisting of NAF expenses.

In the years 2017 to 2019, Planet Fitness' net income rose from 17% to 21%. During Covid, the net income became negative due to the related closure of most operated stores. However, 2021 and 2022 show signs of recovery with margins of 11% and 12% respectively.

The Net Working Capital (NWC) has been negative in the past (2017-2022) and further decreasing in 2021 and 2022 (-80,802 \$M in 2022). This is driven by multiple factors. Firstly, Planet Fitness has an inventory-light business model. Revenues are achieved by delivering service instead of goods, which must be stored. Secondly, as opposed to low inventories are high deferred revenues. As many memberships are paid at the beginning of the year for a service, that will last the year, the revenue cannot be immediately recognized. So, the money is already received while the service wasn't provided. Those revenues must be deferred.

1.3. Market Overview

The US health club and studio market is currently valued at 33.3\$B¹ and has shown solid growth until 2019 before the covid crisis hit. Going forward, it is expected to grow at a similar speed. In other words, a 2008 to 2019 CAGR of 5.7% was estimated while 2022 to 2030 growth is projected with a CAGR of 5.8%². During the pandemic, things looked different due to several closures and restrictions majorly affecting leisure institutions such as gyms. The market dropped by approximately 58% in 2020. In the following year, the market was down by 22.5% compared to a pre-Covid level³. This growth trend also translated into the number of health clubs (31 thousand in 2012 vs. 41 thousand in 2019)⁴ and respective number of members which have increased by more than 14 million from 2012 to 2019⁵. But they did not only increase in absolute number but also as a share of the US population from 18.37% in 2012 to 22.48% in 2019⁶. The trend of increasing penetration is expected to continue.

¹ Proprietary Market Model

² Ibid.

³ Expert Interview, Rizzo, Nicholas, "Fitness Industry Statistics 2021-2028 [Market Research]."

⁴ Statista, "US Fitness Centers and Health Clubs."

⁵ IHRSA Media Center, "Total U.S. Health Club Membership by Year."

⁶ Proprietary Market Model

1.3.1. Trends and Forecast

Besides increased penetration, the fitness market is influenced by majorly five macro trends, all of which started pre-COVID and are generally anticipated to continue going forward. Firstly, customers become increasingly health concerned. Secondly, boutique studios gained popularity. They have grown with a CAGR of 6% year-on-year. Thirdly, the rise of wearables and new technology concepts largely influence customer fitness behavior. Fourthly, favorable changes in demography lead to an increase in the share of younger populations, i.e. 6-34 years, which is in other words a growth in the number of future gym goers. Lastly, customers increasingly appreciate high value at a low-price offering. This trend fuels the erosion of the mid-tier segment and buttresses the growth of value players such as Planet Fitness as these enter mid-tier offerings at attractive price points⁷.

The latest trend reveals that the health and fitness market can be further divided into four sub-segments: Community centers and clubs, studios, independents, and large chains. The large chains making up approximately 32% in 2022 themselves are usually split into corporate-owned and company owned which again are split into the three major segments⁸.

The major differentiator between the three segments is the price point. Low-cost players are characterized by starting fees lower than or equal to \$20 while premium players have starting fees of \$60 and beyond. Mid-Tier ranges in between. Hereby, Premium accounts for 10% or 1\$B, Mid-Tier for 30% or 3 \$B and High Value Low Price (HVLP), for 60% or 7\$B generate a combined market value of approximately 11\$B. Going forward, Premium and HVLP market revenues are expected to grow with a CAGR of 7.8% and 8.1% respectively. The Mid-Tier

⁷ IHRSA, "IHRSA Media Report 2021.", Expert Interview

⁸ Proprietary market model

segment is, however, expected to further lose share growing with a CAGR of approximately 5.5 percent⁹.

1.3.2. Competitive Positioning

Market competitors vary in scale and business model. However, considering current trends and developments, the rivalry between HVLP and mid-tier appears to be the fiercest. But also, online offerings widely gained popularity during the pandemic¹⁰. Nevertheless, Planet Fitness shows strong economics and established successful strategies to win in the competition for members but also franchisees.

Firstly, Planet Fitness holds a market share of approximately 57% of the HVLP segment while showing an above-average monetization per square foot of gym of 84\$. Hereby, the company benefits from a staff-light business model as well as cost-efficiency and leaves the major competition behind. Secondly, Planet Fitness has appropriate offerings matching the five key determinants of membership sign-up and retention: Price point, quality and retention, location, network, and complementary online offering and app. Especially the basic fee is the flagship of the company and has never been raised beyond 10\$ while the quality of amenities and customer satisfaction ratings are high¹¹.

Secondly, franchisees are especially attracted by five characteristics: A franchisor's reputation, the support offered, growth potential, cost, and profitability. The factors are especially given the HVLP segment. This combined with the strong profitability, support and reputation makes especially Planet Fitness stand out and an attractive option for franchisees.

All in all, Planet Fitness has built upon several successful strategies to win the market. Not only in terms of competition for members but also in terms of competition for franchisees.

⁹ Ibid.

¹⁰ ABC Fitness Solutions, "The next fitness consumer – 10 Key findings."

¹¹ Expert interview, company information

1.4. Investment Thesis

Planet Fitness qualifies as a promising target due to the attractive market it operated in, its proven business model, and its strong value creation levers and returns. The company is the market leader in the HVLP segment with a vast presence, especially in the US. With 2,242 stores in 2022 in the US only and 2,324, PF is the largest HVLP player in terms of units and revenue across the country. The second largest HVLP player is only one-seventh of its units. The company has strong brand recognition as an attractive franchisor and partner. Moreover, the company constantly outperformed the health club market growth year-on-year, and the trend is expected to continue. The HVLP segment especially is expected to grow stronger with a CAGR of approximately 8 percent¹² as customers highly value strong value proposition at low cost. Moreover, selling membership options brings predictable and recurring revenue income, which is beneficial for e.g. servicing debt payments. Lastly, strong value creation levers will yield a money-on-money multiple of 4.0x or an IRR of 26%. This is based on the scalable business model which can be further exploited by an increase in the number of gyms from 2,324 to 3,802 worldwide. However, most importantly strong value creation levers were identified that should yield the expected return focusing especially on the top line, bottom line growth, and financial structure.

1.5. Value Creation

Top-line growth will be achieved in four ways. Firstly, to further increase market share and penetration, organic growth is fostered by introducing measures to attract new members such as special marketing on social media or leveraging the Planet Fitness app. On the other hand, measures to increase revenue per member will be introduced such as price increases for the Black Card membership and focus on upselling i.e. to increase the share of Black Card members

¹² Proprietary market model

will be implemented. Secondly, Greenfield projects with a major focus on three areas in the US will exploit underrepresented areas in California, Florida, and New York. Thirdly, a new revenue stream will start in 2023, the extended Planet Fitness App. Lastly, international M&A in Germany and UK to kickstart internationalization. Although the focus is set on top-line improvements bottom-line improvements cannot be neglected. To fully exploit EBITDA margin potential, major improvements due to exploiting economies of scale to their fullest and small-scale projects to foster more specific improvements are proposed. This in the end will further enhance the value at exit.

The final lever block is CAPEX and NWC improvements. Decreasing maintenance CAPEX per store following the historical trend and boosting cashflows after an initial increase in IT CAPEX as a percentage of revenue. The increase in investments in the first years will boost revenue and EBITDA margin. Afterward, a decrease in reinvestment rate and focus on cash generation is planned closer to the exit year.

1.5.1. Organic revenue growth

Increasing revenue per gym is twofold. On the one hand, the average number of members should be further increased up to a threshold of 8.5 million. On the other hand, getting the most revenue out of a single member will further increase monetization per member beyond the capacity restriction.

Increasing the number of members per gym

Firstly, the proposed marketing strategy will especially focus on Generation Z as the future generation of gym goers. This includes the introduction of regular TikTok Challenges and cooperation with influencers. Hereby, Planet Fitness members participating in the challenge are eligible for a small goodie. Secondly, by introducing corporate fitness options, Planet Fitness can leverage the acquired knowledge e.g. from beneFit or Fit/ One to especially target the largest population of gym goers, the Millennials. As in Europe and the US, no large chain does

not offer classes, so it is proposed to introduce live classes for Black Card members. Starting with a test in Europe and a potential rollout across the US after a successful test. To stick to the cost-efficient and staff-light business model, classes will not be held by personal trainers live in the studios, but one personal trainer will be streamed into many local studios. This will attract new members and avoid a churn of members from potential targets while keeping costs low but the effect high. Moreover, small changes such as a limited number of bring-a-friend days for Black Card members should trigger the conversion of the guest brought to a real member. But also, the Planet Fitness App can be further leveraged to act as a gateway to a gym membership.

Increasing revenue per member

By introducing five measures to increase the share of black card members we expect to reach a share of approximately 68% by 2028. An average price increase to \$24.99 in 2024, the introduction of a free Black Card trial period for basic members and non-members should be introduced. Moreover, a minimum contract duration of 24 months will be linked to the Black Card option and will be combined with an attractive discounted lump sum payment possible for the whole period. Thirdly, regular pre-announced cooperation with partner companies should be implemented. Hereby, actions will be promoted as limited to create hype and trigger the decision not to wait and immediately to enroll. Recent cooperations such as the one with the new Amazon wearable were the first sign of success for PF and the cooperating party. Lastly, into crease the attractiveness of the Black Card membership compared to the classic option, the limited offerings for black card members only should be extended. This will on the one hand affect in-store options but also Planet Fitness App options.

1.5.2. Greenfield

New store openings will focus on the three areas of New York, California, and Florida as identified white spots and for strategic reasons. This is expected to yield an increased market share and higher-than-average potential in these gyms. New York is the state with the lowest

gym density per 100 thousand people which leaves sufficient room to easily attract new members. The potential in California is similar¹³. Moreover, as Planet Fitness already has the highest location share at this stage, the company can leverage its strong existing knowledge and presence. Also in Florida, Gym density is at the lower end. Additionally, the major US mid-tier player Anytime is more strongly represented¹⁴, making it a good place for Planet Fitness to keep up with the competition and eventually convert their members to new Planet Fitness following the erosion of the mid-tier trend.

1.5.3. A new revenue stream

During the global COVID-19 pandemic, Planet Fitness launched “United We Move” to provide free, live digital workouts to millions of people around the globe to keep people active, moving and engaged with the Planet Fitness brand¹⁵. This led to a strong increase in users of the free Planet Fitness App and currently approximately 6 million weekly users. However, the model is currently offered for free but offers high revenue potential. Therefore, the existing membership base and awareness lay the foundation to kickstart a new revenue stream in 2023 by broadening the offerings and meeting the demand of the post covid fitness community¹⁶. The app is forecasted to contribute 5% to total Planet Fitness EBITDA in 2028 with a revenue of approximately 62\$M annually and 14.3 million active users. The app strategy is built upon four major Pillars: the Freemium Model, Optimization for wearables and smart TV, community, and internalization of knowledge to be the 24/7 connection to the current members and new community acting as the perfect extension to the limited and cost-effective studio offerings. This will act as an effective presales tool or standalone membership.

¹³ Morris, Kathy, “THE 10 STATES WITH THE MOST GYMS (AND THE LEAST).”

¹⁴ ScrapeHero, “Number of Planet Fitness locations in the United States.”

¹⁵ Company information

¹⁶ ABC Fitness Solutions, “The next fitness consumer – 10 Key findings.”

1.5.4. Kickstart internationalization via M&A

Acquisitions in Germany and UK were chosen to become the starting point for further franchise openings across Europe. Europe itself is an attractive market worth approximately \$23 billion and 56.3 million health club members as well as a highly fragmented structure. Moreover, it is expected to outgrow the US market with a CAGR of 7.25% from 2021 to 2026¹⁷. The United Kingdom and Germany are the top two countries in terms of gym revenue making up together approximately a quarter of the European market. In both countries, low-cost gyms have been on the rise and increasingly gained popularity, so the average monthly dues paid by members in both countries are below the current US average (UK: \$48, Germany: \$44)¹⁸.

Target Selection Criteria

Potential targets were screened based on six criteria to ensure a strategic fit, reduce the risk associated with potential acquisitions and ensure that excess cash is sufficient to finance the deal as all deals are proposed to be paid in cash only. Small- to medium-sized gym chains with 10 to 50 gyms are targeted since smaller operators are not worth the effort. These clubs are cheaper and bear more potential for multiple arbitrage. Consequently, the proposed acquisition price should be below \$150 million, and the EV/EBITDA multiple should be below the planet fitness entry and exit multiple. As described prior, the target's geographical focus should be in the United Kingdom or Germany. Moreover, the business model should fit the high-value low price model of Planet Fitness with a similar target customer and high-quality standards that ensure a smooth transition of members to the rebranded gyms and avoid churn of existing members. Franchise experience is a plus but not required as the targets will be converted to corporate-owned gyms. Lastly, financial health and profitability are a prerequisite to not threaten Planet Fitness' margins. However, due to the substantially smaller size compared to

¹⁷ EuropeActive, & Deloitte, "European Health and Fitness Market Report 2022."

¹⁸ Ibid.; Statista, "Average membership fee per month for fitness clubs in Germany from 2014 to 2019."

Planet Fitness, it is expected that margins of targets are lower at acquisition but are expected to rise due to a successful post-merger integration. Especially target price, number of clubs and portfolio fit are the most relevant criteria.

Selected Targets

Based on the above criteria, three targets with a major focus in Germany and one target in the United Kingdom were selected. In total 85 locations will be acquired: 64 in Germany, 16 in the UK, 4 in Austria and 1 in Poland. The acquired targets will become new corporate-owned stores. These stores will act as well-functioning hubs in the respective countries and centers of knowledge. Further expansion will start with a franchise system and area developer contracts in these two countries and across Europe. The new acquisitions will bring know-how e.g. on corporate membership options, new online content can be acquired and new national talent.

The acquisition series will start with the largest German target Fit/One with 41 locations in 2024. This will be followed by the two German low-cost chains beneFit and World of Fitness (WOF) and the UK chain 24/7 Fitness in 2025 with 15, 13 and 16 gyms respectively. On average targeted locations are larger creating revenue upside potential per gym¹⁹. The timing of the acquisitions is on the one hand based on the forecasted cash availability. On the other hand, it is expected that the ramp-up period of the gyms will be finished in year three after opening or acquisition. Therefore, all acquisitions are expected to have fully realized potential until the planned exit in 2028.

1.6. Business Plan and Forecast incl. Financials

Revenue is increasing from 839\$M in 2022 to 1,950\$M until 2028. In the same period, EBITDA increased by 446\$M (138%) to 803\$M in 2028. The increase in EBITDA is mainly driven by greenfield (27%) and organic growth (27%). An increase in equipment revenue accounts for

¹⁹ Respective company websites

19% and the internationalization kickstart via M&A for 18%. The new revenue stream of the PF-App accounts for 5% of the revenue increase and EBITDA margin improvements for 5%. Free cash flow increases to 493\$M in 2028. To calculate the financial forecast, the key main revenue drivers were identified for each segment. For corporate-owned stores and franchise stores, these are mainly the number of stores, members per store, and revenue per member. Equipment revenue thereby is driven by franchise stores and (re)equipment costs per store. The app revenue is forecasted based on monthly downloads, percentage of paying users, and price per online membership. On the other hand, costs are mainly driven by revenue or the number of stores. CAPEX is mainly depending on stores in operations and store openings. Balance sheet items are either forecast through D&A and CAPEX or by a revenue-dependent driver.

1.7. Valuation

The valuation is based on the 2022 expected EBITDA as this accounts for the changes that occurred due to the sunshine acquisition and related increases in revenue and EBITDA while no more covid effects prevail. By applying the median past HVLP transactions EV/EBITDA multiple of 9.2x²⁰, which is accounting for the specialties of the HVLP segment, Planet Fitness is valued at 3.1\$B. This valuation and multiple will lay the foundation for the entry valuation. A DCF with a WACC of 8.18% was conducted as well, resulting from a levered historical 5Y monthly beta of 1.21, a cost of equity of 9.25%, and a 4.82% cost of debt based on a BBB rating²¹.

1.8. Capital Structure and returns

The total sources of the deal are separated into equity and debt. The optimal debt structure was analyzed, accounting for 52.8% of the Deal Value being split between senior and subordinated

²⁰Merger Market, Refinitiv Eikon, Capital IQ as of November 13, 2022

²¹ Bloomberg as of November 11, 2022

debt which equals 4.2x and 1.0x of the 2022 EBITDA respectively. While the subordinated debt is based on mezzanine financing, with a bullet payment in the 9 years horizon, the senior debt is structured in three tranches: Tranche A with amortization payments throughout the 6 years maturity equating to 1.2 x the EBITDA, Tranche B with a bullet payment in the 7 years' horizon amounting to 1.5x the 2022 EBITDA and, finally, Tranche C with a bullet payment as well of 1.5x the EBITDA, 8 years after the acquisition.

In terms of equity financing, 1,564,883\$ will be raised, equating to the remaining 47.2% of the Deal Value, and a multiple of 4,6x the 2022 EBITDA. This value is divided between two different segments: preferred shares, providing financing of 4.5x the EBITDA, and ordinary equity, with 0.2x EBITDA. Invested into the equity part are institutional investors (the fund) and the management. When exiting in 2028, the EBITDA is estimated to achieve 835\$M, and as we don't assume any multiple arbitrage, we result in an exit multiple of 9.2x and the subsequent Enterprise Value of 7,683\$M. At the exit, management returns add up to a Money Multiple of 24.2x or an IRR of 70%. Institutional investors yield 4.0x or 26% IRR.

1.9. Exit Opportunities

Due to the size and popularity of Planet Fitness, it is proposed to exit via an IPO. Although an IPO is highly dependent on market conditions, the past has shown that the fitness segment can be considered rather resilient, and Planet Fitness has shown strong growth and is expected to do so going forward. Moreover, the market highly values a scalable, well-functioning franchise system that is considered low risk²². As the second-best option, a strategic sale should be considered. Selected national and international competitors or market participants could be interested in horizontal, forward, or backward integration. These candidates are potentially willing to pay a strategic upside on the true value at exit. For example, LifeTime Fitness, a

²² Capital IQ, Merger market, Bloomberg, Company information

premium gym chain operator in the US, fit bit an international company selling budget-friendly wearables, or Life Fitness, a current supplier and global gym equipment manufacturer are proposed.

1.10. Key Areas for Due Diligence

The due diligence should mainly focus the legal and financial due diligence, followed by commercial, valuation, and exit. The legal part should mainly cover the contractual relations with the franchisees and the correctness as well as sufficient of the franchise disclosure document (FDD). The financial part should focus on a detailed split of SG&A and labor costs to further understand improvement levers as well as profitability analysis on gym levels for the same reasons. Thirdly, the commercial due diligence should further elaborate on and validate the attractiveness and adequate documentation of the Planet Fitness franchise system, the impact of contractual obligations on franchisee performance plus validating characteristics of the market and proposed targets. Lastly, exit and entry multiples should be verified via fair value opinions as multiples are one determinant of return potential. However, not only wrong multiples could have a negative impact on returns but also competition laws which could prevent a potentially profitable strategic sale.

2. Capital Structure

2.1. Deal Structure – Sources and Uses

For the deal, an entry multiple of 9.2x EBITDA is used. The EBITDA in 2022 is estimated to reach 336,533\$T, leading to an Enterprise Value (EV) of 3.1\$B. The costs of the deal, namely advisory-, banking, and due diligence fees, are expected to be 7%²³ of the EV, amounting to 217\$T.

²³ Expert Interview

To finance the amount of EV and fees, a total of 3,312,832\$T needs to be funded. This funding consists of an equity investment of the private equity fund as well as a significant portion of the debt. The debt is separated into different types, senior debt, and subordinated debt. As senior debt has the highest seniority, meaning it will be paid back first in the event of default, it is cheaper than subordinated debt or equity. Therefore, it is desirable to cover most of the debt with senior debt. The equity is separated into preferred shares and ordinary shares. Invested in the equity part are the investors of the private equity fund (Limited Partners) and the management of Planet Fitness. Therefore, both will participate in the returns achieved by the deal.

2.2. Debt

As a significant amount of debt is used for the deal, it is important to understand the debt structure, different types of debt used in the deal, and how it is priced.

2.2.1. Debt structure

Adding leverage to an investment has two sides: On one hand, it boosts the IRR for the investor, on the other hand, it makes the investment riskier. For banks as well as for investors it is therefore important, to find an equilibrium between risk and return. As a benchmark of maximum leverage for buying planet fitness, we chose 6x EBITDA. This is due to a paper published by the FED that comments on underwriting standards as follows: “Generally, a leverage level [...] over 6x total Debt/EBITDA raises concerns for most industries²⁴”. With this maximum leverage, there are different possible debt structures. Having in mind that additional debt might be used, instruments to help finance capital expenditures and acquisitions, as well as a revolver to provide liquidity in worst-case scenarios, a total amount of 5.2x leverage is considered. This accounts for 52.8% of the total sources or 1,749,972\$T. This will leave

²⁴ Federal Reserve,” SR 13-3: Interagency Guidance on Leveraged Lending.”

headroom of 0.8x add-on leverage during the investment period while not missing out too much on boosting the deals' IRR.

2.2.2 Types of debt

For the deal, different types of debt are used. This is common for deals of this size as more debt increases risk and therefore needs an adjusted debt instrument. Senior debt is often secured, meaning the debt is backed by assets of the company. The more assets are used as underlying security, the less can be used for further securitization. Therefore, senior debt usually does not account for the whole debt in an LBO, but unsecured financing is added (Subordinated debt).

Senior Debt

Senior debt accounts for 81% of total debt. It consists of three different tranches: Tranche A, B, and C.

Tranche A is the only amortizing debt and amounts to 403,840\$T, i.e. an EBITDA multiple of 1.2x. Its maturity is assumed to be 6 years, amortization is consistently rising over the 6 years starting with 5% of the total amount and ending with a 40% repayment in 2028. This amortization schedule leads to an average life of the facility of 4.45 years.

Tranches B and C amount to 504,800\$T, implying an EBITDA multiple of 1.5x each. The maturities of the tranches are 7 and 8 years respectively, and both are amortized with a bullet payment at the end of maturity.

Subordinated Debt

This debt is subordinated to the senior tranches, meaning in an event of default it would be paid back after the senior loan. Therefore, higher pricing can be expected. However, it is less risky than equity, positioning it between senior debt and equity. The debt instrument used for this deal as subordinated debt is Mezzanine debt. The maturity is assumed to be 9 years. As this maturity exceeds the investment period, the amount is paid back with the proceeds from the exit with a bullet payment. Total Mezzanine debt is 336,533\$T or 1.0x EBITDA.

Other instruments

To assure liquidity during the investment period and to fund further expansion to increase value, different other types of debt instruments are used.

Expansion CAPEX and Acquisition CAPEX facilities are implemented to support planned openings of new stores and acquisitions of gym chains in Europe. Both facilities have drawdown periods of three years and afterward repayment periods of three years. Therefore, the maximum amount needed for capital expenditures is calculated within the years of the drawdown period. The maximum expansion CAPEX needed is 78,963\$T while the maximum acquisition CAPEX amounts to 347,918\$T. It is assumed that both facilities will fund 50% of the maximum CAPEX needed. Both facilities use the full amount available for funding, resulting in a total add-on debt of 213,440 \$T, which is fully repaid in the years 2026-2028. This is useful as expansion and acquisition activities are reduced when approaching the exit year, so those cash flows are distributed over the whole investing period, avoiding strongly fluctuating cash flows.

As an additional instrument, a Revolving Credit Facility (RCF or Revolver) is introduced. Revolvers are useful in providing short-term liquidity and can avoid covenant breaches (e.g. cash cover). In the specific case of Planet Fitness, the revolver is used as a risk mitigation instrument. As currently there is a lot of uncertainty in the economy, which can also be seen in the debt market²⁵, it is important to be prepared for worst-case scenarios. To avoid liquidity problems and covenant breaches this instrument is installed. When modelling different crisis-scenarios (High interest rates, failed M&A approaches and another pandemic), the revolver proves its efficiency as even in worst cases it helps to hold a cash cover of greater than 1.0x.

²⁵ Expert interview

2.2.3. Pricing of Debt

For different instruments, different types of pricing can be expected. Senior debt is typically underlying a variable pricing while mezzanine interest is mainly fixed. As underlying rate for fixed rate margin, the 1 Month Term SOFR (01/23) is used. For the variable interest rates, the SOFR forward curve is used. SOFR stands for Secured Overnight Financing Rate and it is replacing the London Interbank Offered Rate (LIBOR). It finds great acceptance in the industry as JP Morgan states that the SOFR rate is its' "preferred alternative to USD LIBOR²⁶". The SOFR can be used as an interest benchmark for USD-derivatives²⁷. It is important to understand that the forward curve represents the current expectations for future interest rates, not actual future interest rates. Using forward curves as baseline of variable interest therefore it has to be treated carefully as it can deduct from the forward curve over time²⁸. To account for this risk, different SOFR rate scenarios are implemented, reaching from the original forward curve to the forward curve +300 bps each year ("High interest scenario"), using steps of +50 bps and +150 bps. +300 bps is our maximum stress-test, as interest rate caps are also used for the pricing of debt. In the case of an increase of +3pp the interest rate caps will hinder the total interest from rising further, showing the LBO with its highest possible interest rates. Debt derivatives like floors and caps are especially useful in times of economic uncertainty²⁹, as they protect lenders (floor) from missing out on yields due to low interest rates as well as borrowers from increasing interest rates. Furthermore, they help with estimation of future scenarios as a clear maximum can be modelled.

²⁶ JP Morgan, "Goodbye LIBOR, hello SOFR."

²⁷ Chatham Financial, "What is an interest rate forward curve?"

²⁸ Expert interview

²⁹ Expert interview

The base rate has a floor at 300 bps, protecting the banks from decreasing rates, and a cap at 600 bps. For the base scenario (SOFR forward curve), the floor is used in the years 2026 and 2027, where the SOFR rate is expected to be at levels of 298 bps. The cap is activated in two of the high interest scenarios, +150 bps in 2023 (SOFR would be at 604 bps) and in most years of the +300 bps scenarios.

Senior Debt

As stated above, senior debt is priced with a variable interest rate based on the SOFR. All interests on senior debt are cash interest payments. Tranche A is expected to have a margin of 400 bps as add on to the SOFR rate leading to a total interest rate of SOFR + 400 bps. This leads to an average interest rate of 7.38% throughout the investment period. As Tranche A is amortizing, interest payments continuously decline over the years.

For Tranche B, a margin of 425bps is assumed. This margin is slightly above Tranche A. Tranche B is considered slightly riskier than senior Tranche A which is why the pricing is increasing (in event of default Tranche A is covered first). For Tranche B the same floor and cap limits are applied. Tranche B has an average interest rate from 2023 to 2028 of 7.68%.

Tranche C is priced at a margin of 450 bps. It has an average interest rate of 7.88% and is floored and capped at the same level as Tranche A and B.

In total, interest on the senior debt of 604,603\$T is due during the investment period, assuming the base scenario. This amount can increase up to 807,680\$T for the case of SOFR + 300bps. This shows the strong impact of increasing interest rates and why it is important to stress-test the debt schedule for different scenarios and to make sure, that even with high interest rates debt can be repaid.

Subordinated Debt

Mezzanine debt is typically priced with a fixed interest rate. One reason for that is the ability of lenders to plan interest income accordingly. As Mezzanine debt has a higher maturity than

senior debt, predictable income is an important factor. Furthermore, interest on Mezzanine debt is separated into Payment in Kind (PIK or accrued interest) and a cash element. PIK interest is not paid in cash, but the amount is added to the existing balance of debt, leading to an increase in interest payments in the following year. For our LBO, a PIK interest rate of 5% is assumed as well as a cash interest rate of 9.5%. This interest rate exceeds those of the senior debt as it has a higher risk. Total cash interest of mezzanine during the investment period is 217,004\$T, while the total amount of PIK interest is 114,453\$T.

Other Debt Instruments

Other debt instruments consist of the expansion CAPEX facility, acquisition CAPEX facility and revolving credit facility. Those facilities are based on the short-term liquidity need of the company and therefore, the exact amount cannot be determined upfront. As the lender commits the maximal needed amount without knowing if it is actually drawn, a commitment fee is installed in addition to the interest rate. This fee has to be paid as a percentage of committed capital which is not drawn, as the lender receives interest on drawn capital and therefore, would miss out on return if capital is not fully used. To mitigate that risk, borrowers also pay interest on undrawn amounts.

Expansion CAPEX and acquisition CAPEX are priced quite similarly. Both have an assumed margin of 5% and a commitment fee of 25% of the margin, resulting in 1%. As both are priced with fixed terms, high interest rates will not have an impact on the pricing of these facilities. Total interest paid until 2028 for expansion facility and acquisition facility (including commitment fee) amounts to 10,630\$T and 43,547\$T respectively.

The revolver has an underlying margin of 300bps, the commitment fee is also 25% of the margin, resulting in 0.8%. As the revolver can be drawn over 6 years, the SOFR forward curve is used to calculate the interest base for each of the possible drawdown years. This makes it dependent on the interest rate developments and therefore relevant for the debt schedule stress-

test. In the expected Investment- and Bank cases, the revolver is not drawn at all, leading to a total payment of 3,375\$T only for commitment fees. This money can be seen as mitigation expense, as in crisis scenarios, short-term liquidity can be even more expensive, if the conditions were not agreed on upfront. To always comply with the cash cover, even in worst-case scenarios, and therefore always be able to pay the interests and debt repayments, the revolver is necessary.

Total interest payments of these three debt instruments are 57,553\$T, accounting for 7% of total cash interest paid over the investment period.

2.2.4. Covenants

Covenants are used by lenders as early warning signals of possible default. There are different types of covenants, controlling total debt levels, liquidity and the ability to pay interest and debt repayments. Breaches can lead to different consequences. As the lender may see an increased risk of default in the future, they may demand an immediate full repayment of the outstanding amount. Furthermore, the relationship between borrower and lender suffers, affecting future debt possibilities and prices. Therefore, it is a goal for both parties that covenants will not be breached.

For this LBO three different types of covenants are used. Firstly, maximum leverage, meaning total net debt / EBITDA. Secondly, interest cover, showing current EBITDA / Cash interest, and thirdly Cash cover, showing Free cash flow plus drawdown of facilities / total debt service (interest + repayment). Cash cover can be interpreted as the most important covenant as it clearly shows the ability to comply with necessary debt repayments. To propose certain covenant values, the bank case is used as the underlying case as it is a more conservative estimation of future company development and therefore has more upside potential with a lower risk of downside development. In addition to using the bank case, a headroom of 20% is considered, even further mitigating the risk of breaching covenants (for maximum leverage and

interest cover). Cash cover must always be equal to or exceed 1.0x, meaning that at least 100% of total debt service can be covered by the company's cash flow (including facility drawdowns). As a cash cover of exactly 1.0x leaves no room for potential downside, a more attractive goal for the company is to achieve a cash cover of at least 1.2x. Maximum leverage and interest covenants are variable, adapting to the expected development of the company's leverage and cash flows. As some debt is repaid during the investment period and cash flow, as well as EBITDA, is expected to grow, the covenants are growing, or, in case of maximum leverage are decreasing, with them. For the bank case as well as the investment case, no covenant breaches are expected. Furthermore, covenants are solidly complied with in different case scenarios like high interest rates or failed M&A attempts. Only in the case of another pandemic, covenants will be breached. This is unavoidable for extreme situations like the covid pandemic. For those situations, covenants would have to be renegotiated with the lenders, or expansion strategies (and therefore capital expenditures) would have to be adapted. Breaches of covenants in this scenario do not pose a major problem on the LBO as they are not only unlikely, but also banks had to be more adaptable as many companies would suffer from those conditions. Therefore, renegotiations and maybe even more debt to cover the liquidity shortage would be possible.

2.3. Equity

A significant portion to finance for the deal is provided by investors in equity. Majorly the equity is provided by the fund itself, a minor part however comes from the management of Planet Fitness. Equity is the most expensive part of deal financing as it carries the most risk. Limited partners expect high returns for investing their capital in private equity. For the deal, a sum of 1,562,860\$T of equity is used.

2.3.1. Equity Structure

For this deal, equity consists of two elements, preferred shares (Fixed Return Instrument) and ordinary shares. Preferred shares provide a predetermined return to the investors which is paid

before the ordinary shares. General managers (GMs) in a private equity fund earn most of their money with the so-called carry, an interest that is paid on the returns after the invested amount plus a certain rate has been paid back to the investors (through the preferred shares). This is called the hurdle rate. For the GMs, it is therefore important to reach or exceed this predetermined hurdle rate to earn money. After the preferred shares inclusive of the interest is paid back, investors get paid back the equity that is left from the exit via ordinary shares.

2.3.2. Institutional Investment

As mentioned before, most of the equity portion comes from the fund itself. In total, the entry value of institutional investors is 1,518\$M, separated into 1,476\$M of preferred shares and 42\$M in ordinary shares. That accounts for 97% of the total equity used in this deal. Investors can expect a return of 8% on the preferred shares, paid as a payment in kind interest. Furthermore, they participate in 78% of the returns generated on ordinary shares.

2.3.3. Management Investment

In private equity deals, it is also important to align the interests of the fund, the shareholders (limited partners), and the management. That's why different instruments can be used to incentivize management to perform to their maximum possibilities.

Sweet equity is an investment of Planet Fitness' management into the ordinary shares of the deal. That way, management participates in returns that exceed the payback of the preferred shares but loses their investment if preferred shares plus interest cannot be paid back. This motivates management to perform well. To make sure this is a real incentive, management has to invest a significant amount of money into sweet equity. For Planet Fitness, 200% of the management's annual cash compensation is reasonable as it is a significant cash amount to incentivize management performance. The sweet equity, therefore, amounts to 10,754\$T. For this investment, management receives 20% of the ordinary shares, which provides the possibility for significant returns on their investment.

In addition to the sweet equity investment, a management rollover is anticipated. As Planet Fitness' management did not only receive cash compensation but also equity stakes, they own 2.2% of Planet Fitness' shares³⁰. To increase incentives and decrease the equity that has to be provided by the fund, management will keep this 2.2% share in equity. With that rollover, the fund only has to buy 97.8% of the shares to achieve 100% ownership of the company which reduces the amount of money needed to fund the deal. The management is now also invested in the private equity deal as they own 2.2% of the equity invested (this investment is on the same level as the investment from the limited partners). Therefore, they do not only participate in the returns on ordinary shares, but now also own a portion of the preferred shares, receiving 8% payment in kind interest. The total amount invested via management rollover is 34,412\$T. All in all, management is assumed to invest 45,166\$T in the LBO and therefore own 2.9% of total equity. This investment helps to finance the deal, aligns the interests of management and private equity fund, and last but not least, enables management to participate in both, returns on preferred shares as well as returns on ordinary shares.

³⁰ Company information (SEC Filing 2022)

Bibliography

- ABC Fitness Solutions.” The next fitness consumer – 10 Key findings”. Accessed October 10, 2022. <https://www.ihrsa.org/publications/the-next-fitness-consumer-key-findings/>
- Chatham Financial.” What is an interest rate forward curve?”. Accessed October 21, 2022. <https://www.chathamfinancial.com/insights/what-is-a-forward-curve>
- EuropeActive, & Deloitte. “European Health and Fitness Market Report 2022”. Accessed November 13, 2022. <https://www2.deloitte.com/de/de/pages/consumer-business/articles/report-european-health-fitness.html>.
- EuropeActive, & Deloitte. “European Health and Fitness Market Report 2020”. Accessed November 13, 2022. <https://www2.deloitte.com/de/de/pages/consumer-business/articles/report-european-health-fitness.html>
- EuropeActive.” 2022 European Health & Fitness Market Report: Memberships and number of clubs grew in 2021”. Accessed November 10, 2022. <https://www.europeactive.eu/news/2022-european-health-fitness-market-report-memberships-and-number-clubs-grew-2021>
- Federal Reserve.” SR 13-3: Interagency Guidance on Leveraged Lending”. Accessed October 20, 2022. <https://www.federalreserve.gov/supervisionreg/srletters/sr1303.htm>
- Florida, Richard. “The Geography of American Gym and Fitness-Center Brands”. Accessed October 15, 2022. <https://www.bloomberg.com/news/articles/2019-01-10/the-geography-of-american-gym-and-fitness-center-brands>
- Florida, Richard. “Your Fitness Resolution Might Be Easier If You're Rich”. Accessed October 15, 2022. <https://www.bloomberg.com/news/articles/2019-01-08/fitness-centers-are-more-prevalent-in-affluent-areas>
- IBIS World. “Gyms & Fitness Centres in the UK - Market Size 2011–2029”. Accessed November 11, 2022. <https://www.ibisworld.com/united-kingdom/market-size/gyms-fitness-centres/>
- JP Morgan. “Planet Fitness Equity Report, Sep 2022”. September 2022
- JP Morgan.” Goodbye LIBOR, hello SOFR”. Accessed October 20, 2022. <https://www.jpmorgan.com/commercial-banking/insights/the-global-move-away-from-LIBOR>
- Morris, Kathy “THE 10 STATES WITH THE MOST GYMS (AND THE LEAST)”. Accessed October 15, 2022. <https://www.zippia.com/advice/states-most-gyms/>
- ScrapeHero. “Number of Planet Fitness locations in the United States“. Accessed October 16, 2022. <https://www.scrapehero.com/location-reports/Planet%20Fitness-USA/>
- Statista. “Number of health clubs in Europe in 2020, by country”. Accessed November 10, 2022. <https://www.statista.com/statistics/308831/health-club-amount-in-european-countries/>
- Statista. “Revenue of the fitness market in Germany from 2014 to 2019”. Accessed November 11, 2022. <https://www.statista.com/statistics/1044221/fitness-market-revenue-germany/>
- Statista. “Revenue of the health club industry in European countries in 2019”. Accessed November 11, 2022. <https://www.statista.com/statistics/308822/revenue-of-the-health-club-industry-european-countries/>

Statista." Number of health and fitness club members in the United States in 2019, by household income". Accessed November 11, 2022.
<https://www.statista.com/statistics/1244820/gym-members-income/>

Statista." Number of health clubs in the United States from 2008 to 2022". Accessed September 9, 2022.
<https://www.statista.com/statistics/244922/us-fitness-centers-und-health-clubs/>