Planet Fitness (PLNT) – Not As Fit As It Appears

As with most IPO's, Planet Fitness (PLNT: $16/share), home of the $10-a-month gym membership, is going public at a time when business is booming and sentiment is strong. It is one of the largest fitness centers in the country and boasts rapid store, membership, and revenue growth. Management and Wall Street tout plans to keep up the strong performance across all fronts by continuing to leverage the firm's franchise business model.

The stock gets our Neutral rating, and we advise caution when considering this IPO because:

1. Reported profits are overstated as PLNT exploits pre-IPO reporting loopholes that allow it to mislead investors.
2. Most of the future cash flow growth potential is already priced into the IPO price.
3. The business lacks the differentiation and barriers-to-entry needed to sustain growth

What You See Is Not What You Get From This IPO

The 13.5 million shares offered at IPO only have a 14% voting interest and 38% economic interest in the business operations of Planet Fitness. The remaining economic and voting interest will be split between previously-issued A and B shares and "holding" units owned by members of TSG Consumer Partners. Due to this corporate structure, the "holding" units and B shares, which can be converted to A shares at any time, are included when computing Planet Fitness' shares outstanding. This inclusion raises PLNT shares outstanding to over 98 million, greatly impacting IPO investors' share of the company.

Strong History Profit Growth Looks Unsustainable

Unlike many other recent IPO's such as Etsy (ETSY) or GoDaddy (GDDY), Planet Fitness actually makes money.

Over the past two years, Planet Fitness has grown after-tax profit (NOPAT) from $48 million to $72 million, which represents 50% growth year over year. NOPAT margin has increased from 23% to 26% and return on invested capital (ROIC) has improved from 8% to 12% over the past two years as well.

We question whether Planet Fitness' business model can sustain its impressive profit growth. The company derived 44% of revenues from the sale of gym equipment to its franchisees in 2014. These equipment sales are non-recurring as they occur only when new stores open, or every 4-7 years as equipment is replaced. With such a large portion of revenue brought in through these "quasi-one-off" items related to store openings, we feel it is likely that Planet Fitness will see its margins, and profits, contract as store growth slows.

Growth Goals Aren't Sustainable

Like profits, store growth has been impressive. New stores are opening at a 24% compounded annual growth rate (CAGR) since 2010 while memberships are growing at a 28% CAGR and revenues at a 32% CAGR.

However, the company's stated goal of 4000 U.S. based stores (from ~1000) appears unrealistically high for these reasons.

1. The market is very competitive and already highly penetrated. Planet Fitness faces competition from many other fitness centers including Anytime Fitness, Snap Fitness, and 24 Hour Fitness in addition to traditional higher end competitors Lifetime Fitness and Equinox Gyms. These five industry stalwarts operate a combined 4700 locations while Planet Fitness expects to operate 4000 alone. The International Health, Racquet & Sportsclub Association (IHRSA) estimates there are already over 34,000 fitness clubs in the U.S.
2. Planet Fitness' offering is undifferentiated. The current high-volume low-cost business model aims to grab as much market share as possible. The company only provides a limited set of workout equipment. Apart from discouraging weightlifters or "hardcore gym users", Planet Fitness' offering is not especially attractive in any way, except maybe price.

To put faith in Planet Fitness' continued store growth would imply it is able to grow locations well above the industry average (6% unit growth in 2014 according to IHRSA) while advertising an undifferentiated product in a highly competitive market. If Planet Fitness looks to differentiate itself in hopes of spurring further store growth, margins most likely must decline.

IPO Disclosure Loopholes to Be Aware Of

As with all IPO's, there are certain reporting loopholes that allow companies and their underwriters (who also happen to write most of the research) to make the offering seem better than it is.

1. Misleading "adjusted earnings": Planet Fitness' adjusted EBITDA metric overstates the company's profits because it removes management fees, IT systems upgrades, and costs to open new corporate stores from its total. We believe these are direct costs of operating the business and should not be removed.
2. Delayed release of critical information: The company chose to wait to release information critical to understanding the ownership rights of IPO investors until 7 days before PLNT is scheduled to begin trading. Planet Fitness filed their initial S-1 in late June, but this filing did not specify pricing and number of shares being traded because a reporting loophole allows them to exclude this important information as long as they file an amended filing later.
3. Reduced disclosure requirements: Planet Fitness qualifies as an "emerging growth" company under the 2012 JOBS Act. This qualification imposes less stringent disclosure requirements. The problems related to lack of disclosure were covered in detail in our recent Danger Zone report and increase risk for IPO investors in the long run.

Impact of Footnotes Adjustments and Forensic Accounting

In order to derive the true recurring cash flows, an accurate invested capital, and a real shareholder value, we have made several adjustments to Planet Fitness' 2014 income statement and balance sheet. The adjustments are:

Income Statement: we made $39 million worth of adjustments with a net effect of removing $35 million of unusual expenses. We adjusted $37 million related to non-operating expenses and $2 million in non-operating income.

Balance Sheet: we made $154 million worth of balance sheet adjustments to calculate invested capital with a net increase of $58 million. One of the largest adjustments made when calculating invested capital was the removal of $38 million (7% of net assets) related to excess cash.

Valuation: we made $520 million worth of adjustments with a net effect of $444 million. The largest adjustment we made to Planet Fitness' shareholder value was $87 million (6% of market cap) related to off balance sheet operating leases.

Valuation Is All About Margins

At $14 to $16 per share, Planet Fitness is pricing at a level that already implies significant profit growth based on what may be unsustainably high margins, as noted earlier.

Reports have pegged the average margin of fitness centers around 9% and competitor, Town Sports International (CLUB), has a pretax margin of 8%. Planet Fitness has been able to achieve such high margins in part due to spending less on personnel and collecting large, upfront payments from franchises in the form of equipment sales. However, Planet Fitness' valuation is built upon the idea that it can maintain such high margins, which as noted above, we feel is unlikely.

If we assume that Planet Fitness can maintain a pretax margin of 15%, well above industry average and is able to continue growing revenue at 30% compounded annually for the next five years, the stock is worth $14/share today. Looks like the best-case scenario is already priced in.

In a more likely scenario, if Planet Fitness' margin falls to the industry average of 9%, then the stock is only worth $6/share today – a 63% downside from PLNT's IPO price even if it can grow revenues by 30% compounded annually for the next five years.

Without closely reading S-1's and studying accounting rules, investors may not realize just how much risk they're taking.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

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ANSWER: They should not.

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Our Philosophy About Research

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1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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