Capital Reinvestment & Performance Considerations

The decision to spend money, or "reinvest", in updated facilities or new exercise equipment is never an easy one. Typically, membership prospects expect it, members request it, staff push for it, and investors / owners often resist it. Further, when is the right time to make such reinvestments? Perhaps most importantly, will the improvements generate more revenue or a return on investment?

Change is rampant in the health and fitness industry. Today, the industry continues to show signs of reaching maturity and diversification is evident on all fronts. There is prolific competition in virtually every market segment – "big box clubs", boutiques, specialty studios, cross-fit gyms, budget clubs, corporate facilities, hospital entities, online workout programs, etc. Quite simply, the challenge to retain and attract members has never been greater and organizations that want to be relevant into the foreseeable future must be committed to a path of continual improvement. Facilities, programming, services, and equipment have to evolve and present a fresh value proposition to survive.

Achieving differentiation in a crowded market is critical to success. As the centerpiece of health and fitness centers, one of the most recognized points of differentiation is facility design and offerings (multi-purpose, fitness only, aquatics, tennis, movement studios, small group training spaces, quality of finishes, etc.). Consumers also demand and expect quality exercise equipment that is current, offers variety, is plentiful, includes the latest entertainment features, and is of course in working order at all times. Thoughtful discussions regarding possible upgrades in these two areas should be undertaken regularly, as they likely offer a reasonable return on investment.

Outlined below are some considerations that may useful during planning / discussions:

- When was the most recent significant investment in new exercise equipment (not just a few replacement pieces)?

- Would a walk-through of all exercise equipment areas reveal any noticeably outdated equipment? Although most strength equipment can "last a lifetime" – it shouldn't. The condition of equipment speaks volumes about the "tired"/ outdated status of the overall facility.

- How much is the club currently spending per month on the repair and essential maintenance of older exercise equipment – primarily cardiovascular pieces? Are there cardiovascular units that are seemingly "out of order" on a consistent basis (even if repaired immediately)?

- Adopting a strategy of replacing a few pieces of exercise equipment at a time (usually cardiovascular selections) holds great value in ongoing customer satisfaction and member retention. This approach generates goodwill within the member community and sends a consistent message to users that "their" club is constantly reinvesting in the product offering. However, although this "benefit drip" helps retain existing members, it does little if anything to attract new members or maintain a competitive advantage in the marketplace. Periodically, it should be augmented with a major / noticeable equipment rejuvenation – generating a "wow" factor.

- Evaluating the "highest and best use" of available space in a facility should be an ongoing endeavor, balanced with proven trends in the industry. Analyzing usage patterns, capacity metrics, revenue generated per square foot, opportunity costs, and fit with the chosen value proposition, should all be considered.

- In recent years, there has been a renewed focus on customer / member satisfaction by most health and fitness facilities. Driven by the expansive proliferation of exercise options available to consumers, leading facilities are measuring and evaluating their customer service like never before.

    - *Listen 360* is a preferred vendor in the fitness industry that provides Net Promoter Score (NPS) customer feedback management survey services and analysis. They have found the following items are what loyal members care about most (see below chart). Conversely, an analysis of the top reasons "detractors" give for dissatisfaction includes **"poor or broken equipment"** at number two.

5 Things Loyal Members Care About Most
1. Friendly staff/ trainers/ instructors
2. Plenty of good quality equipment
3. Variety and schedule of classes/ programs
4. Clean facility
5. Good customer service

    - In the recent *IHRSA Trend Report*, health club members across the U.S. were asked, **"What keeps you coming back to the health**

club you currently belong to?" The fourth most frequent response was **"the variety of strength and cardiovascular equipment"**.

- Medallia is another preferred vendor in the fitness industry that provides NPS programs and analysis. Research of their collective facility subscribers data reveals there is a significant improvement in net promoter scores (overall customer satisfaction) immediately following **reinvestment in the facility and/or exercise equipment**.

- According to *IHRSA's Guide to the Health Club Industry for Lenders & Investors* a distinction must be made between "repairs and maintenance", which is an ongoing month-in, month-out operating expense at every facility, and "maintenance capex" which involves essential replacements of physical assets. The former appears on the income statement; the latter appears on the balance sheet. It is recommended that annual "maintenance capex" be set at approximately 4% of revenue or $4 per sq. ft.

  In addition, at least once every five years, a facility will need to expend approximately 10% of revenue to make market driven improvements, such as the latest in exercise equipment, updated locker rooms, a new small group training studio, or dedicated performance programming space.

  Then, once every ten years most facilities need a total overhaul/ reconfiguration if they wish to maintain market momentum and remain competitive. This once-a-decade total facility renewal can cost 20% - 30% of sales.

  Thus, over a ten-year period, total capex, i.e. maintenace capex plus improvement capex, will often, if computed on a straight-line basis, require a budget allocation of at least 6% per year.

- Research reported in *IHRSA's 2015 Profiles of Success: the Annual Industry Data Survey of the Health and Fitness Industry* found that "Investing in capital expenditures not only maintains the club; it can contribute to an increase in revenues and the bottom line". In addition, "The upper quartile of health and fitness centers that spent more on reinvestment reported significantly greater pre-tax earnings as a percent of total revenue and reported a much higher increase in revenues (see chart below). More detailed spending analysis broken out by club type and size is available in IHRSA's report.

Reinvestment & Performance	Top 25%	Middle 50%	Bottom 25%
Total Spending as % of Revenue	14.4%	5.7%	1.6%
Revenue Growth	14.5%	4.5%	2.5%
Net Membership Growth	7.1%	4.9%	2.5%
Rate of Member Retention	70%	69.5%	69.6%
EBITDA as % of Revenue	20.5%	14.9%	10.2%
Pre-tax Earnings as % of Revenue	8.9%	7.0%	5.4%

- To offset the costs of reinvestment, as well as ever-rising operating expenses, most leading facilities have developed a practice of increasing monthly dues on an annual basis. Typically these modest increases are 2% - 3% of the current dues rate.

- During the last decade, many health and fitness facilities have effectively borrowed an idea common in country clubs, which is to levee an "annual assessment improvement fee". Essentially a one-time annual fee, collected with the express intent of reinvestment in the facilities and equipment. These monies are used to make upgrades / new purchases and are communicated in general to the membership.

- *REX Executive Roundtable* members worldwide, including over 5,000 health and fitness facilities, meet regularly to collectively share best business practices. Many have successfully collected member annual assessment fees ranging from $19 - $59, with an average charge of $29.

Reinvestment in equipment and facilities is an absolute necessity in the health and fitness business. The exercise environment we live in continues to be so dynamic and fluid that productive change must be constant. Think about it. Just a few years ago, there were no; cross-fit gyms, barre studios, cycling studios, Orange Theory's, budget clubs (Planet, Anytime, Snap), or online group classes of all modalities. If maintaining a prominent position in the community of health conscious consumers is part of the organizations vision, providing a quality product is paramount. Shift happens … the response is what matters.