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SATS ASA (SATS.NO)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Sondre Gravir

Chief Executive Officer, SATS ASA

Good morning, everybody, and welcome to our presentation of the second quarter of 2022. My name is Sondre Gravir, the CEO of SATS, and I'm here today with Cecilie Elde, our CFO. We will, as usual, run a Q&A session on Teams 10:30 today to allow those of you who follow this presentation some more time to look into the report and numbers before we do Q&A. You will find the link to this Q&A session on our Investor Relations website.

We concluded the second quarter with 267 clubs and 671,000 members. Cecilie will come back to the financials in the financial section later in the presentation. A key objective for SATS is to increase the member base. This is important, both financially and for public health. The member development during the second quarter was slightly better than in a typical pre-pandemic second quarter, as we indicated in our first quarter presentation in early May.

Overall, the fitness market in the Nordics, as we see it, is not dramatically changed since before the pandemic. We would not be surprised, though, if the inflationary pressure and interest rate increases that we see around us affected the consumer behavior within our industry. So, we follow this closely but, at least so far, there are no signs of members trading down on their memberships.

However, what we see have changed is that those who were active before the pandemic, have become more active now, while those who worked out occasionally have reduced their activity level further. But on average, our members are more active than previously, a trend that is mainly driven by our younger members.

Going forward, our key focus is to increase the member base, which we will do through three levers. We will improve and optimize our existing clubs to facilitate for more members per club. We will deliver on the communicated greenfield pipeline. And we will continue searching for attractive consolidation opportunities.

The member base going out of Q2 2022 is in line with Q2 2019. Please note that the member development in 2020 and [ph] 2020 now (03:21), as we know, is highly affected by the pandemic and is neither suitable for comparison nor prediction going forward. But as you can see from both this quarter and Q2 2019, we typically lose some members going into December, a trend that is reversed when we head into the autumn. However, we manage to keep this net member loss at the minimum with a strong member development than in Q2 2019, primarily due to lower churn.

With the current market dynamics, as I said, it's important to follow the consumer sentiment and behavior. So far, we don't see any signs of members trading down. We have received many questions about whether we lose

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members to lower priced competitors, et cetera. And as you know, we have a low-cost operator within the [ph] SATS Group (04:23), Fresh Fitness, the biggest low-cost brand in Norway, where we have valuable insight into the development in low cost versus full service. As you can see, the full service operator, SATS developed better during the pandemic than the low-cost operator, Fresh Fitness, and the same is true for the second quarter of 2022.

A second valuable data point supporting that we don't see changes in consumer behavior is the development in up and downgrades of membership times, for example, related to group training or a number of clubs.

If we compare the first half of 2019, we see that not only have we increased the number of upgrades by 28%, but we have also reduced the number of downgrades by 23%. The overall churn rate is also reduced. Again, comparing the first half of 2022 with the first half of 2019, we see a 0.3 percentage point reduction in churn. And churn is a highly important metric for SATS as with all subscription models, and it's also very important from a public health point of view, because active members, in general, don't churn. The last fact point supporting this statement is the price adjustment we have implemented in Q1 and Q2 this year. This further proved the increased loyalty in the member base, resulting in lower churn than we have seen in similar price adjustments implemented previously.

Overall, the training habits, as we can observe are more or less the same as prior to the pandemic. However, there are signs of polarization. Looking at our own member base, hearing from competitors, seeing results from [ph] Virke Trening (06:24), and so on, we see that the members, who previously worked out sporadically, typically have reduced their activity levels, while the active part of the population, typically now are more healthier and more active than ever before. And a typical member who leaves SATS, leaves SATS for the sofa and not for the competitors, because they have become passive members. And this is a significant threat to public health, but the flip side of the coin is that it represents a great opportunity for SATS when it comes to reactivating these members. Further on, the increased activity level among the most active members increase the loyalty and reduces the probability for churn.

Looking at the total activity level, our members have visited us more frequently than in 2019 in almost all weeks during the quarter. This trend is, among others, driven by our younger members, who are working out on the gym floor, which has resulted in a slight reduction of the average visitor age by 0.7 years. This is clearly positive for SATS. If we can activate the young members and create joy of training and sustainable training habits early on, we lay a good foundation for the future. Member-based growth is a key driver for SATS to deliver improved financial results. We have strong marginal contribution from new members, given the relatively high share of fixed and semi-fixed cost in our cost base. Cecilie will cover this further afterwards.

Hence, continue to grow the member base is the number one priority for SATS going forward. And we are working along three parts to do this. First of all, we see a significant potential in optimizing our clubs to facilitate for dimensioned increase visit frequency in addition to growing the number of members per club. I will come back to this on the next slide. Further on, we will continue to grow the number of clubs adding new members, either through greenfield openings or through acquisitions, we have proven through the solid club expansion we have done during the past years.

As I said, by far, the most important lever from a financial point of view is to increase the number of members in the current club portfolio. And here, we have a strong potential, both to get back to the pre-pandemic level in the like-for-like portfolio, but also to continue to grow beyond that level. We still have a lot of available capacity in the network of clubs, and we can increase the capacity further by improving and optimizing the clubs. So, what are we doing to attract more members to our clubs to facilitate for more visits without members perceiving the clubs

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as full? We are using data from the actual usage of our clubs and the actual usage of equipment to increase capacity in the current network. We can improve the club layout. We can optimize the club design. We can optimize the equipment mix on the fitness floor. And only this year, we are doing major and minor upgrades of 63 clubs in the network. With this, we can facilitate for more visits and happy members in already well-established clubs.

An example of this, we have many examples, but one example is the optimization we have done at SATS Fagerborg here in Oslo. SATS Fagerborg was a club that we acquired in Q1 2019, and it's a good example how we use data and we use the cluster strength we have to optimize the offering. SATS Fagerborg is complementing the very well visited SATS Bislett and supporting the surrounding club cluster. And after analyzing the usage of the club based on SATS' internal perfect club approach, we changed the club layout, we optimized the gym floor, we optimized the equipment mix a few months ago, and after that, we have seen a 20 percentage point higher visit growth than the Oslo average.

We also, typically, in these clubs where we do this type of optimization, we see an improved member satisfaction, because the club is more attractive with better capacity and the right equipment mix, which is important as member preferences changes over time. In addition to improving the member base in existing clubs, we also grow and expand the network of clubs. During 2020, 2021 and the first half of 2022, we have added 38 new clubs to our club portfolio. Nine of these clubs are welcomed in 2022, of which half of them in Norway, and half of them in Sweden. And going forward, we have 19 new clubs signed, a strong confirmed greenfield pipeline.

The transaction of the seven acquired clubs from Bare Trening was successfully closed in early July, and six more openings are expected to take place during the year. We will execute on this strong greenfield pipeline, ensuring successful club openings and positive member development in these new opening over time. And then, in addition, we will continue the M&A track and searching for interesting consolidation opportunities, adding clubs to strengthen our already strong clusters.

And with that, I leave the word over to Cecilie for the financial section.

Cecilie Haugen Elde

Chief Financial Officer, SATS ASA

Thank you, Sondre, and good morning, everyone. Before we head into the financial section, it's important to note that the second quarter of 2021 was heavily affected by club closures and other pandemic-related restrictions. So, it has therefore limited comparative value. We will use the pre-pandemic second quarter of 2019 as a supportive benchmark in this review.

As we've shown previously, we have accelerated the club rollout during the pandemic and we have, since the beginning of 2020, opened net 28 new clubs. We have already signed the additional 19 clubs opening over the next two years and, more importantly, the equity raise we did in February enables continued club growth, as we now have the capacity to further tap into the attractive consolidation market through M&A.

So, the second quarter of the year is seasonally a period with a decline in the member base due to lower sales, as is the case this year, although somewhat lower than we usually see with a member decline of 15,000 in the quarter, compared to 21,000 in 2019. And over the last year, the member base has had a 10% growth, and it comes primarily from our like-for-like clubs, although, of course, acquired and maturing clubs continued to further the member recovery in the period.

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Member base at like-for-like clubs is close to full recovery after the pandemic period, lacking around 5% to reach 2019 level. And please note that we do not plan to include the split between like-for-like and maturing club as an integrated part of the quarterly reporting going forward, but we wanted to provide some more detail in this area at this time. So, overall, the total member base remains in line with 2019 at 671,000 members. And the growth has not come at the cost of lower prices, despite heavy campaigning throughout the last couple of years. We have been able to increase the underlying membership yield through our pricing strategy, consistently lifting prices, resulting in an 8% price progression over the last three years.

And our annual price optimization process to increase membership prices historically has been very successful, and we are constantly working on optimizing price levels in the member base to ensure fairness, and that all members pay the same price for the same membership access rights.

So, over several years, the experience is that there is significant resilience to such price adjustments. And concretely, we see that the annual adjustment performed late last year with effect as of January confirms the expectation of very low incremental churn. And the latest price adjustment increased prices with 2.3% and an additional price adjustment was recently performed with financial effect as of mid-third quarter. So, we expect a further lift of around 1% in prices.

Total revenues continue to grow up 2% versus 2019, and member revenue development has steadily improved quarter-over-quarter, as restrictions are eased, memberships are unfrozen, and after periods of solid membership sale from existing and maturing clubs. Member revenue is up 5% since second quarter of 2019, driven by an increase in yield. And the member revenue bridge on the right-hand side illustrates where we stand in terms of run rate revenues, compared to 2019. The average number of members after the second quarter was slightly ahead of 2019 and the strong yield development we have seen over the recent years improves revenues further with an impact in the quarter of NOK 62 million. So, despite the average member base for like-for-like clubs not yet being fully recovered, compared to 2019, yield improvements fully compensate for the gap in volume as revenues for like-for-like clubs are now returned to 2019 level. And also, discount periodization from campaigns from previous quarters impacts the quarter negatively with around NOK 14 million.

And to elaborate a bit more on the growth going forward. Our business model benefits from operating leverage, as cost base required to operate the current club portfolio is largely fixed, meaning that incremental membership revenue has a 90% drop-through to EBITDA for existing clubs. Therefore, as member levels for like-for-like clubs return and maturing clubs fill up with new members, this additional revenue growth flows more or less directly to adjusted EBITDA. Historically, our profitability growth has come from developing our mature club portfolio, increasing number of members per club. So, there is significant untapped earnings potential in the existing portfolio, closing the gap of 200 members per club, bringing the number of members back to 2019 level. And as Sondre represented, through club optimization, our mature like-for-like clubs still has capacity to continue to grow beyond the 2019 level in terms of average members per club.

Yield expansion will continue to improve profitability going forward and high demand for personal training and retail with solid margins is expected to continue to grow in the future. And as mentioned, since 2019, we have accelerated our rollout of new clubs, both through acquisitions and greenfields and the new clubs, obviously, add cost, negatively impacting profits in the short term. But as you can see on the right-hand side, the maturing clubs have lower average members than the like-for-like clubs, and new clubs added reduces the overall average in the ramp-up phase. On average, greenfield takes 6 to 12 months to reach breakeven, resulting in short-term drag in profits in the maturing phase of its lifetime. And it takes 12 to 24 months to reach maturity in terms of member and financial results.

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After the club closure in March 2020, significant efforts were made to reduce operating expenses, and variable and semi-fixed costs were taken down according to the reduction in activity level. With operations running normal, cost also returns to the normal level, which explains the increase from last year. Total operating expenses have increased by 3.3% annually since 2019, partly due to pure inflation, driven mainly by adding 28 new clubs to the portfolio. But in addition, the ramp-up of Mentra by SATS and utility cost drive the increase.

For like-for-like clubs, the annual increase is lower at 1.4% annually, mainly inflation-driven adjustments on rent-related costs and, of course, significantly increased electricity prices. This is partly offset by successful cost-saving efforts to compensate for the overall cost increase. And looking ahead, we expect, as stated last time, some inflationary pressure as we see increased prices [ph] on some of our inferred factors (20:29), especially electricity prices, plus also the other two of our main cost items, rent and salaries. And we estimate that the cost will increase around 4% to 6% on the like-for-like basis in the coming year. Price increases are expected to offset the inflation effect partially this year and entirely in 2023.

Given the spike in electricity spot prices, we want to give a brief overview of the utility cost, which makes up around 5% of our cost base, totaling NOK 44 million in the quarter. We have received a few questions about the seasonality of the electricity consumption, which is relatively evenly spread throughout the year. It's somewhat lower during the summer, but ventilation and cooling systems partly replace heating in the winter. The total utility cost increased by 14% per club, compared to 2019, while the electricity cost isolated increased by 40% per club. As an example, the spot prices in Oslo increased by 171% on average during the same period. But this increase is partly offset by both consumption reductions and other electricity cost elements like grid rent.

Adjusted EBITDA of NOK 83 million in the quarter is significantly improved, compared to last year and shows that EBITDA is on track to recovery. To summarize and to look ahead, profitability will improve going forward by member recovery and continued growth in like-for-like clubs, as well as yield expansion and other revenues; new and acquired clubs reaching 2019 average; and thirdly, further growth from already signed new clubs and future acquisitions. So, EBITDA is well on track to recovery and further growth.

Moving on to investments, maintenance CapEx has, through the pandemic, been lower than usual due to focus on cash preservation, less wear and tear on equipment due to reduced visits, and lower average age in the club portfolio overall. But we anticipate returning to a more normal level of maintenance of CapEx going forward at around 5% of revenues. We have a structured approach to club portfolio assessment to optimize the prioritization of investments based on club quality, competitive situation, and cluster strategy. And despite the pandemic, we have prioritized investing for the long term, both in technology team, systems and infrastructure, but also in club expansion. And as we've shown, we have a strong pipeline of new clubs opening and with the capital raise performed in February, we now have the flexibility to really tap into the attractive M&A consolidation potential, as Sondre described earlier.

Moving on to liquidity, we are in a well-controlled and satisfactory position, as we closed the second quarter with a cash balance of NOK 245 million and NOK 838 million in total liquidity. Operating cash flow for the second quarter is negative by NOK 66 million, mainly due to negative working capital effects, reflecting a normal seasonal settlement of deferred liabilities. SATS, in general, benefits from structurally negative working capital, driven by membership prepayments and follows the seasonality of the business overall. Working capital tends to be lower in November to May and higher in June to October, with accrued holiday pay paid out in June for the Norwegian employees affecting Q2 working capital significantly.

And now, ending this financial section with an update on net debt. The equity issue last quarter strengthened the balance sheet, reducing net debt to around NOK 1.5 billion. The increase in net debt from last quarter is partly

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due to the typical working capital effects as mentioned, as well as negative currency effects. We have historically shown solid deleveraging profile on the back of EBITDA growth and high cash conversion. And we expect to return to the same approach to deleveraging again, as we've done in the past.

And with that, I will leave the word back to you, Sondre.

Sondre Gravir

Chief Executive Officer, SATS ASA

Thank you, Cecilie. We are operating in fitness market that is recovering and growing. And our main priority, as we laid out going forward, is to continue to grow the member base, improving the number of members per club, which will drive improvements in profitability. We will execute on a strong greenfield pipeline and continue to acquire clubs to strengthen our clusters. From a public health point of view, the most important thing we can do is to activate our members to help them to succeed with their training. And growing the member base and help the members to become active is truly delivering on our vision of making people healthier and happier.

And then, before we conclude this presentation, I would like to inform about our first Capital Markets Day, which we will hold on October 28th, the same day as our Q3 presentation. We will come back to more details, but I just wanted to give you a heads up to save the date for now. And please remember, the Mentra by SATS app is never far away with fantastic cultures, fantastic classes, and programs.

So, with that, Cecilie and I will, on behalf of SATS, wish you all an active summer. Thank you.

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