14-Feb-2023

SATS ASA (SATS.NO)

Q4 2022 Earnings Call

CORPORATE PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Sondre Gravir
Chief Executive Officer, SATS ASA

Good morning, everybody, and welcome to our Presentation of the Fourth 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 in Teams today at 10:00, and you are all welcome to join in. You will find the link to this Q&A session on our Investor Relations website, satsgroup.com.

We are now halfway into a busy first quarter, but let's jump back to the final quarter of 2022. On the Q2 presentation, I said the following. We would not be surprised if the inflationary pressure and interest rate increases affected the customer behavior within our industry. So, we follow this closely. But at least so far, there are no signs of members trading down. And this is still true.

Our most important operational KPIs are all showing a promising development. Sales is strong and churn is overall in line with historical development despite price increases both for new and existing members. The financial result for Q4 is not satisfactory, but given the strong operational development, we are confident that the financial result will follow.

The profitability program announced on the Capital Markets Day in October is now well on track and is expected to yield the returns gradually throughout 2023 and all related extraordinary costs are booked in Q4 2022, as Cecilie will come back to. So, overall, the development is following the projections from the Capital Markets Day, both with regards to the profitability program, price adjustments and portfolio optimization.

We concluded the fourth quarter with 275 clubs and 721,000 members and Cecilie will come back to the financials later in the presentation. We grew the member base with 13,000 members in Q4 2022. Q4 2019 gives a quite good indication of a typical fourth quarter in terms of member growth. Hence, a growth of 13,000 members is very strong. The growth is a result of strong sales and then churn being in line with historical levels. Please note that the member development in 2020 and 2021 is highly affected by the pandemic and is thus neither suitable for comparison nor prediction going forward.

One of the operational KPIs that we pay the most attention to is number of workouts, both in total and per member. Active members are satisfied members, healthy members and loyal members. Overall, active members don't quit.

In Q4 alone, our members worked out impressively 10.5 million times in our clubs. That is an increase of 8% compared to Q4 2019. An average workout per paying member increased by 4% compared to Q4 2019. So, we get more members and they are more active.

This is a result of the megatrend around personal health in the society, but we also see that our communication measures are working. We have an important role to play when it comes to motivating our members and also helping them to create good new habits. The activity level is important for the financial sustainability of SATS, but also contributing to the UN sustainability goal number three, good health and wellbeing.

When only considering the members who have reached the World Health Organization's recommendation for physical activity at SATS, which is a pretty conservative estimates in other words, SATS members have, in the past 12 months, contributed to around 13,000 quality-adjusted life years, 13,000 extra years of living with good quality. That might be a bit hard to grasp, but it translates into around NOK 18.5 billion in socioeconomic welfare gain, which we are truly proud of.

With the current market dynamics, it is important for us to follow the consumer sentiment and behavior. We still don't see any signs of weakened consumer sentiment affecting our business. As highlighted, the membership sales have continued at a high pace and in the other hand, churn is on par with historical levels despite price increases.

We have received many questions about whether we lose members to, for example, low-cost operators, and with the low-cost operator within the SATS Group, Fresh Fitness, we have valuable insights into development in low cost versus full service. And 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 now for Q4 2022, as it also was for Q3 and Q2.

A third valuable data point is the development in up and downgrades of membership types. For example, whether it to group training or number of clubs you have access to. Compared to Q4 2019, we now have 22% more upgrades per downgrade. And this trend is driven by a demand for extended geographical access, meaning access to more clubs within our networks, and multi-club access is a strong competitive advantage for SATS with the extensive club network we have in our main clusters.

So in sum, all these important KPIs tells us that at least, so far, people seem to prioritize own health despite lower purchasing power.

After a period now of strong club growth, we are now focusing on optimizing our club portfolio, as we also presented during the Capital Markets Day in October. We have 10 new confirmed clubs in our pipeline for 2023 and 2024 and we will not add many new clubs to this pipeline going forward. Only very attractive leads or acquisitions will make it all the way.

When it comes to our existing club portfolio, we are closing some clubs and relocating others. Clubs with unsatisfying cash generation and no relocation alternatives, they are closed. This has especially been the case where the landlords have not been contributing to sustainable club financials through rent reductions or investment grants. And in these cases, we enjoy great benefits from our other clubs in the networks as we can move the members from exited clubs to other SATS clubs nearby.

And relocations are made to achieve better terms, investment grants or improved micro locations. We have done several relocations with good results in the past and will continue to relocate the club when that is the most attractive solution.

Another key focus area for us is to contract the high inflation with cost discipline. As announced on the Capital Markets Day, we have now initiated a range of measures to keep a sustainable cost base. And our cost base is, roughly speaking, divided into three: rent; salaries; and other costs. And the cost inflation is significant in all these three areas. Rent levels, salary and IT licenses are all increasing. And we are currently discussing our rental agreements with all our landlords, both on rental terms, the inflation adjustment of rent and also potential resizing or relocation of clubs. And so far, we are seeing positive results.

On the salary side, we have reduced the number of overhead FTEs, with the goal of reducing total overhead cost in relation to total revenues back to 2019 levels. And at clubs, we are continuing to improve operational efficiency and reduce the staffing without reducing the offering to our members.

And lastly, within other costs, we are, among other things, reviewing agreements and licenses, optimizing our general cost control and improving margins on PT and retail, especially IT licenses prices have skyrocketed as many companies around us are also experiencing. So, that is really an area we are working hard to address.

The way we see it, we have three areas of risks that could significantly change our financial performance compared to the plan we outlined during the Capital Markets Day. The first area being changed consumer behavior and weakened consumer sentiment. We are now leaving behind us a January with a record high visit level as we have also seen in Q4. So, people are visiting our physical clubs as ever before.

Further on, we have now delivered the Q3 and Q4 with record-high sales levels and the start of 2023 has also been positive. So, so far, we don't see any signs of consumer sentiments cooling down our business.

The second area has been around our ability to increase prices without exploding churn to compensate for the high cost inflation. We have now adjusted prices significantly for both new and existing members, which Cecilie will describe more in detail later on. And churn has not exploded or developed differently than expected. Sales has, so far in 2023, been strong, selling without discounts on new list prices.

And the third main concern has been related to the risk of costs escalating and especially electricity prices. In general, our cost base is being addressed as described on the previous slide. And with regards to electricity, we have now more visibility after having hedged around 60% of the estimated electricity consumption for the first half of 2023. So, overall, with what we know today, we are positive and confident on our development.

I will come back to the outlook, but, first, Cecilie will take you through the financials. Cecilie?

Cecilie Haugen Elde

Chief Financial Officer, SATS ASA

Thank you, Sondre, and good morning, everyone. In the following financial review, we are showing both 2021 and 2019 comparators where relevant. And we, for the last time, include 2019 to give a more relevant benchmark for the underlying scale and operating performance.

We have accelerated rollout of clubs over the last couple of years and have since the beginning of 2020 increased the portfolio with 27 clubs. We are closing the quarter with 721,000 members, which is at an all-time high after a period with strong sales and churn overall in line with historical levels. And over the last year, the growth in the member base of 8% comes both from acquired and maturing clubs, but most importantly, a strong recovery in the like-for-like clubs as can be seen on the right-hand side graph. And these like-for-like clubs now have returned to pre-COVID levels. The focus will be on improving overall members per club, filling maturing clubs to maximize profitability.

And an important lever to improve profitability is to increase prices. And in Q4 2022 and Q1 of this year, we have executed on our annual pricing strategy of adjusting prices for new and existing members. Cost has increased significantly over the last six months, and inflation adjustment of prices in the beginning of 2022 was made before inflation accelerated and thus set and based on an entirely different level. This created a lag in our price-driven revenue growth compared to cost increases.

So with the latest price adjustments, we are now mitigating the gap by doing three things: increasing list prices for membership and personal training with an average of 8% increase. We are inflation adjusting existing members according to the country-wise Consumer Price Index, which varies from 7.5% to 10.9%, and this took effect starting January of this year. And finally, price adjustments of member that for some historical reason have a membership price far below the current list price, which has an increase of up to NOK 100. So overall, about 50% of the members gets a price increase. And the remaining part of the members, those in binding and prepaid cash memberships, are not adjusted in this round.

But strong sales numbers come at a cost. And over the last year, we have invested more than usual in marketing, both promotions and campaigns, which temporarily affects yield negatively. But knowing that the market is not entirely back as the share of Nordic people are not yet fully back to an active lifestyle as they were before COVID, our priority has been to sacrifice short-term profitability to ensure that we gain market share in terms of members to secure a solid run rate out of 2022.

And while yield is negatively affected, the contractual price remains intact, increasing with 2% annually over the last years with the further ramp-up estimated now in Q1 2023 after latest adjustment. And this will mitigate the inflationary gap by an increase estimated to be around 6%. And it's worth highlighting that the 6% increase is only for the first quarter and the effect will be higher for the full year as new members enter the member base at higher list prices.

Total revenues continue to grow, up 8% compared to last year and 5% versus 2019. But member revenue has had an even stronger growth, increasing with 10% since 2019 after periods of solid membership sales from existing and maturing clubs, but also driven by an improvement in yield.

The member revenue bridge on the right illustrates where we stand as of revenues compared to 2019. And the yield improvements contribute to NOK 41 million in increase in revenues. And the member base has surpassed the 2019 level and improves revenues further with NOK 57 million in the quarter, but slightly elevated freeze levels and campaign impact from current and previous quarters continue to impact revenues negatively.

Historically, OpEx has increased with inflation, but has been partially offset by cost-saving efforts. And adding 27 clubs compared to 2019 is the main driver for the increase in the cost base as well as an increase in overhead, scaled to reflect strong growth ambition both for members and club expansion.

But over the last six months, the inflationary environment has resulted in cost increases on several of our input factors, adding pressure to our margins, especially energy cost continues to be higher than usual, up 41% versus 2019 to NOK 65 million in the quarter. And as a risk-reducing measure, we have hedged electricity price for around 60% of total estimated consumption in the first half of 2023. And this is to increase visibility and reduce exposure to what has become a highly volatile cost item.

And looking ahead, we expect continued inflationary pressure as we see continued increase on our input factors, especially energy prices as mentioned. Although for the next year, it seems to have come somewhat down compared to what we saw during the fall. And as Sondre mentioned, the cost base is addressed through a group-wide profitability program, which will gradually come into effect during 2023. And over time, we are aiming to counteract inflation with cost discipline and price increases.

Adjusted EBITDA of NOK 12 million in the quarter is temporarily impacted by the imbalance between cost and revenue inflation in 2022. Despite solid member growth, there is a lag in profitability improvement as cost has increased faster than our prices. Inflation adjustment of prices in 2022 was, as mentioned, made before the inflation really accelerated, while most of our factors were adjusted during the year.

With the latest price adjustment, we expect to mitigate the gap and see a rebalance within the end of 2023. And the initiated profitability program addresses the cost base, but results in extraordinary one-off cost in the quarter. It amounts to NOK 68 million, of which NOK 46 million affects adjusted EBITDA. And these are severance packages from downscaling the organization, related to write-offs from Mentra after rebranding to SATS Online and finally club closures as part of the portfolio optimization initiative, as described in the Capital Market presentation from October.

Maintenance CapEx has, throughout the pandemic, been lower than normal due to focus on cash preservation. But we plan to return to more normal levels of maintenance and upgrades CapEx in 2023 at around 5% of revenue. And we have a structured approach to portfolio assessment in order to optimize the prioritization of investments based on club quality and competitive situation and cluster strategy. And in addition to the specific club upgrades, we continuously upgrade our product portfolio in the important clusters. And upgrades and maintenance in the fourth quarter is driven by several major club upgrades. And we have a strong pipeline of 10 new clubs opening over the next year, but further expansion has been temporarily paused due to the current macroeconomic climate.

Then, moving on to liquidity, the key message here is that we are in a well-controlled and satisfactory position, as we close the quarter with NOK 345 million in cash on the balance sheet and NOK 404 million in an undrawn revolving credit facility. In our view, we are sufficiently funded to handle current operations as well as facilitating our communicated growth strategy. And in the fourth quarter, we are back to being cash generative with operating cash flow of NOK 50 million. And the ramp-up in member base and activity level, prepaid revenues from both membership and personal training result in a positive working capital effect, which is normal for the fourth quarter in the year. However, NOK 50 million of this effect is related to the extraordinary cost, where the majority of the cash effect is expected in 2023.

And now, ending this section with an update on net debt, the COVID-19 period resulted in significant losses, which have resulted in an increase in debt. Historically, we have shown a strong cash generation capability and stable cash conversion, resulting in a solid deleveraging profile. And in the short term, investments in club expansion will be limited, prioritizing reducing debt and leverage. And as reported previously, an addendum to the revolving credit facility was signed last year and included adjusted temporary covenants which will apply until the end of 2023. And the adjusted covenants set out quarterly minimum levels for liquidity and adjusted EBITDA. And the last one will come into effect as of the first quarter in 2023. And note that 2022 results will not constitute any part of the measured adjusted EBITDA covenant going forward.

And with that, I'll leave the word back to Sondre.

Sondre Gravir

Chief Executive Officer, SATS ASA

Thank you, Cecilie. 2023 have started on a positive note with strong sales and record-high activity level. We see promising results from the price adjustments with churn developing in line with expectations. And as highlighted on the Capital Markets Day, further additions to the club expansion pipeline are temporarily paused and club economics optimization is of high priority. The current plan will give us a modest club growth of four clubs in 2023. And our focus now is on growing the member base per club, contracting inflation with increased average revenue per member and cost discipline and improve our operational leverage. That was the outlook.

Thank you for watching and don't hesitate to contact Stine Klund on Investor Relations if anything isn't clear. And with that, both Cecilie and myself wish you a healthy and happy Valentine's Day.