

Turnaround at Bally Total Fitness?¹

By 1999, the 1996 spin-off of Bally Total Fitness (ticker BFT) from Bally Entertainment had all the elements of a classic turnaround story. Under the leadership of President and CEO Lee Hillman, stagnant sales and losses had been converted to rapidly growing sales and profits. With over 4 million members and 350 facilities, BFT had firmly established itself as the dominant player in the growing health club business. However, despite its apparent success, BFT was experiencing mixed reactions from Wall Street. After reaching an all-time high of close to \$40 in early 1998, BFT's stock price had dropped back into the \$20s. The initial drop in its stock price was prompted by concerns about BFT's accounting procedures that appeared in the *Wall Street Journal*:

The nation's largest health-club chain is getting worked over by skeptical investors, who quarrel with its accounting methods. The questions started at the end of July, when Bally Total Fitness Holdings reported an unexpectedly encouraging second-quarter profit of eight cents a share. The bulls credit new health programs and more than \$100 million of revenue from a successful installment-membership plan devised by the two former accountants who run Bally, Chief Executive Officer Lee Hillman and John Dwyer, chief financial officer. But bears don't believe in the turnaround of the previously none-too-healthy fitness centers. They cite puzzling changes in depreciation and gaps between cash collection and anticipated revenue. And they don't think Chicago-based Bally is keeping enough reserves for membership fees that may not be paid. If Bally's accounting was more conservative, "it would have lost significant amounts of money, instead of making eight cents" in the quarter, says money manager Blair Baker of Precept Capital Management in Dallas²

Related concerns continued to plague BFT's stock price into 1999. Short sellers continually targeted the stock, with 4 million shares shorted by the middle of 1999, representing over one-third of BFT's float and 20 times BFT's average daily volume. As a result, BFT's stock price looked cheap compared to its expected future earnings performance, as indicated below:

BFT: Earnings Growth and Related Pricing Ratios, 1999

	Last Five Years	This Year (Dec. 1999)	Next Year (Dec. 2000)	Next Five Years	Price/Earnings (Dec. 1999)	PEG RATIO (Next Five Years)
Bally Total Fitness Holding Corp	n/a	202.0%	49.6%	35.0%	14.2	0.4
Leisure and recreation services	2.1%	3.7	21.7	18.8	46.9	2.5
S&P 500	10.3	11.3	10.1	7.5	28.0	3.7

Source: Yahoo! Finance Website (1999).

Wall Street's sentiments about BFT also were reflected in its dwindling sell-side analyst coverage. From the beginning of 1998 through the middle of 1999, First Call indicated that sell-side analyst coverage

¹ This case was prepared by Professor Richard Sloan as the basis for class discussion, rather than to illustrate either effective or ineffective handling of a business situation. Copyright © 1999 by Richard Sloan.

² Extracted from "Bally Total Fitness' Accounting Procedures Are Getting Some Skeptical Investors Exercised," *The Wall Street Journal*, August 28, 1998. WALL STREET JOURNAL. CENTRAL EDITION [ONLY STAFF-PRODUCED MATERIALS MAY BE USED] by WALL STREET JOURNAL. Copyright 1998 by DOW JONES & COMPANY, INC. Reproduced with permission of DOW JONES & COMPANY, INC. in the format Textbook via Copyright Clearance Center.

declined from 6 to 3, while the consensus sell-side recommendation slid from 1.3 to 2.0. Merrill Lynch, who also happens to be BFT's primary investment banker, continued to be BFT's strongest sell-side supporter. Merrill analyst Seth Weber issued the following comments in response to continued criticism of BFT's accounting policies:

Shares of Bally Total Fitness have been under pressure on another negative report. In our view, the report had no new information and basically rehashed the same issues we addressed last year. We recommend investors particularly use any weaknesses in the stock as a buying opportunity . . . With respect to the report, it discusses BFT's membership growth, deferral accounting and cash flow—all issues we feel comfortable with.³

Details concerning BFT's business strategy and financial performance are provided in BFT's Form 10-K for the year ended December 31, 1998. This document is available as an online exhibit at www.lundholmmandsloan.com.

QUESTIONS

1. Evaluate BFT's business strategy, identifying the key success factors and risks.
2. Evaluate the appropriateness of BFT's revenue recognition policy with respect to financed memberships. Your evaluation should address
 - Whether the policy is consistent with GAAP.
 - Whether the policy is consistent with the underlying economics of the business.
3. Recast BFT's 1998 income statement assuming that BFT recognized (and had always recognized) membership revenues when cash was received from members. List any assumptions or approximations that you make. (Financials are available in Excel format at www.lundholmmandsloan.com)
4. Explain the major reasons for any differences between the original and recast financial statements. Do you think that the recast financial statements represent BFT's economic performance better or worse than the numbers reported by the company?
5. What actions would you advise BFT's management take in order to increase investor confidence in BFT's financial condition? What are the pros and cons of these actions?

³ Research comment on Bally Total Fitness Holding Corp., *Merrill Lynch*, September 29, 1999.