

PART 1 CASES

Case 1-1: Bally Total Fitness*

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In 2004, Bally Total Fitness was a leading firm in the U.S. health club industry. From a single, modest club in 1962, the company had grown to become—in management's words—the “largest and only nationwide commercial operator of fitness centers” in the United States.¹ Bally had faced its share of challenges as it rose to become a major health club operator, but the last couple of years had proven particularly difficult. Competition in its markets had intensified; Bally's stock price had collapsed; the company had restated earnings to the chagrin of shareholders; and the U.S. Securities and Exchange Commission had begun to investigate Bally's accounting procedures.

Under the direction of Paul Toback, CEO since December 2002, Bally had revisited its unique approach to pricing and selling health club memberships; boosted the accountability of club managers for profitability; launched new efforts to help club members meet weight-loss goals; altered its marketing message; and begun to strengthen its internal control systems. Toback and his team were committed to increasing the number of Bally members and maximizing revenue per member.² Would Toback's efforts restore Bally's battered stock price, stave off

companies that were rumored to want to buy the company, and enable Bally to remain a major player in the industry?

The U.S. Health Club Industry in 2004

Consumer Demand

Exercise gyms had long been a feature of the U.S. social scene. Indeed, the Young Men's Christian Association (YMCA) had offered basic gym facilities in many of its locations for 150 years. Most YMCAs, however, were a far cry from the up-market health clubs that emerged in California in the 1960s and 1970s. First seen as a fad, these clubs quickly took root and grew strongly for much of the 1980s and 1990s. By 2004, the U.S. health club industry took in revenue of \$14.1 billion. More than 26,000 health clubs operated in the United States, up from 6,700 two decades earlier, and these clubs claimed 41 million members, over 13 percent of the U.S. population (see Exhibit 1). Including non-members, nearly 60 million people used health clubs in 2002.³

Most industry observers thought that industry growth would continue as more and more Americans became concerned about their health and well-being. Two-thirds of the adult population were classified as being either overweight or obese in 2004—indeed, nearly one-third were classified as clinically obese—and the Surgeon General's office voiced concern about the impact this had on general levels of health. It was estimated that 300,000 Americans died annually of obesity-induced diseases.⁴ A recent survey showed that 37 percent of exercisers were motivated by a desire to control weight. The same survey categorized 17 percent of U.S. inhabitants as hard-core fitness participants; of these, two-thirds already attended health clubs. Another 63 percent of the population were viewed as “uninitiated believers”—convinced of the importance of exercise and eager to participate more in fitness activities; only 25 percent of these individuals attended health clubs, so uninitiated believers were seen as the prime targets for growth.⁵

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Exhibit 1 Number of Health Clubs, Memberships, and Core Members in the United States, 1987–2004

Year	Health Clubs, in thousands	Health Club Memberships, in millions	Core Health Club Members, ^a in millions
2004	26.8	41.3	17.4
2003	23.5	39.4	15.7
2002	20.2	36.3	14.6
2001	17.8	33.7	13.9
2000	17.0	32.8	13.5
1999	15.4	30.5	12.5
1998	14.1	29.5	11.4
1997	13.8	28.3	9.4
1996	13.4	26.2	NA
1995	12.6	24.1	NA
1994	12.4	25.2	NA
1993	11.7	22.9	8.2
1992	12.6	20.9	NA
1991	12.1	20.9	NA
1990	13.9	20.7	6.8
1989	13.0	20.9	NA
1988	12.4	19.5	NA
1987	11.8	17.3	5.3

Source: Compiled from American Business Information, Inc. as published in "The Scope of the US Health Club Industry," <http://cms.ihrsa.org/IHRSA/viewPage.cfm?pageId=804>, accessed November 2003 and November 2006; 2003 IHRSA/American Sports Data, Health Club Trend Report as published in "The Scope of the US Health Club Industry," <http://cms.ihrsa.org/IHRSA/viewPage.cfm?pageId=804>, accessed June 2004; IHRSA/American Sports Data, *Health Club Trend Report 1987–2002* as published in "Core Health Club Members 100 Days of Attendance," <http://www.ihrsa.org>, accessed June 2004.

^aA "core health club member" is a member who attended a club 100 days or more per year.

The decision to join a health club could be motivated by any of many factors: a desire to lose weight, to get in shape, to meet people, or to reduce stress, for instance. Tellingly, 22 percent of new members enrolled in January or February, when New Year's resolutions and holiday weight-gains were fresh.⁶ For customers joining a health club, the choice among clubs was swayed by a second set of factors: friends' recommendations, facilities available in each club, the cleanliness of a club, the friendliness of staff, fees, brand names, the persuasiveness of sales pitches, and club convenience, for example. On the dimension of convenience, industry observers felt that few customers would travel more than five miles to a health club.

Once enrolled, health club members varied in how often they visited their club. Usage frequency was bimodal, with 25 percent of members attending fewer than 25 times per year and 41 percent—the core users—attending more than 100 times per year. (See Exhibit 2.) The average frequency of attendance in 2001 was 92 times per year, up

from 71 in 1987, and the proportion of core users was on the increase.⁷ At the same time, attrition was a significant concern for health clubs: roughly 30 percent of members failed to re-enroll each year.⁸

Historically, most health clubs had targeted and appealed to 18- to 34-year-olds, but in the late 1990s, their popularity grew strongly among older consumers. By 2004, a wide spectrum of ages went to health clubs. Membership was weighted toward higher-income households. (See Exhibit 2.) And while many Americans were joining health clubs, it did not appear to be having a major impact on the number of people exercising regularly, which had remained stable at around 50 million for about 10 years. Rather, more of these fitness participants were choosing health clubs as their preferred location for exercising.

Activities, Facilities, and Equipment

Clubs varied in the activities and facilities they offered. Most provided gym facilities with aerobic and weight machines as part of their core offering. Some also had a swimming pool. These services were usually included in the basic subscription charge. In addition, clubs typically offered a wide range of extra services for additional charges, such as personal trainers. The mix of activities changed over time, based on changes in customer preference. The top growth activities offered by health clubs between 1998 and 2003 were Pilates training, elliptical motion trainers, and yoga.⁹

Most clubs purchased equipment from a small number of well-known producers such as Nautilus, Life Fitness, Cybex, Star Trac, Precor, and Techno Gym. Several lesser-known equipment producers also existed, but they tended to sell their products to home users. Equipment makers sought to introduce new and upgraded product lines on a regular basis.

Nautilus was the leading equipment maker in 2004. Incorporated in 1986, Nautilus sold fitness products to health clubs via a sales force and dealer network and to consumers via direct marketing and retail channels. Its commercial-strength product lines were sold under the Nautilus, Schwinn, and StairMaster brands. Each piece of commercial Nautilus equipment, priced between \$5,000 and \$7,000 before volume discounting, focused on a particular strength-building exercise. The Schwinn Indoor Cycling line offered classroom exercise bikes, for instance, while the StairMaster product line included stair climbers, stepmills, treadmills, and exercise bikes.¹⁰ Nautilus grew its sales and profits rapidly from 1998 to 2002, but 2003 was a difficult year for the firm: heightened competition and less effective advertising of its Bowflex home product line

Exhibit 2 Demographics of Health Club Users**Frequency of Health Club Attendance (percentage of all members)**

Days per Year	1987	2001
25	32%	25%
25-51	19	18
52-99	13	12
100+	31	41
Not reported	5	4

Health Club Users by Age

Age	Members, in millions		Compound annual growth rate (%)	Total population, in millions, 2001	Percentage of population enrolled, 2001
	1997	2001			
18	2.5	4.1	12.3%	50.7	8.2%
18-24	3.7	4.8	6.3	27.2	17.5
25-34	7.9	6.9	-3.6	35.9	18.9
35-44	7.2	6.9	-1.0	44.1	15.6
45-54	3.6	5.6	11.5	37.9	14.6
55+	3.4	5.6	13.1	55.2	10.2
Total	28.3	33.8		251.0	13.5

Core Health Club Members by Age (percentage of total)^a

Age	1988	1997	2001
18	4%	5%	7%
18-34	53	42	32
35-54	34	39	42
55+	9	14	19

Club Membership by Annual Household Income

Income	Percentage
\$25,000	11%
\$25,000-\$50,000	21
\$50,000-\$75,000	22
\$75,000+	46

Source: 2002 IHRSA/ASD *Health Club Trend Report*, as published in *IHRSA Trend Report 9* (October 2002): 4, and 10 (July 2003): 4, <http://cms.ihrsa.org/IHRSA/viewPage.cfm?pageId=801>, accessed July 2004.

^aA "core health club member" is a member who attended a club 100 days or more per year.

caused sales and income to decline for the first time in company history (Exhibit 3).¹¹

The total capital required to outfit a 40,000- to 50,000-square-foot health club was roughly \$1.5 million, with \$500,000 in equipment alone. It was also possible to open and run a club at a smaller scale. Nautilus estimated that it

would cost approximately \$144,000 to buy equipment for a 10,000-square-foot start-up.¹² Because equipment could be leased and facilities rented, a small operator could open a health club with \$25,000 to \$35,000 of upfront capital.¹³ New operators could also tap into an active market for used fitness equipment.

Exhibit 3 Nautilus Group Financials (in millions of dollars)

	For 12 Months Ending December 31,				
	1999	2000	2001	2002	2003
Total Revenue	133.1	223.9	363.9	584.7	498.8
Cost of Revenue	46.5	75.6	140.7	252.1	252.7
Gross Profit	86.6	148.4	223.2	332.6	246.1
Selling/General/Administrative Expenses	48.9	82.3	115.4	171.3	186.3
Other Operating Expenses	6.9	5.0	7.4	10.1	8.0
Operating Income	30.8	61.1	100.4	151.2	51.8
Net Income	20.3	41.6	66.6	97.9	34.4

Source: Data provided by OneSource[®] Business BrowserSM, an online business information product of OneSource Information Services, Inc. ("OneSource"), accessed July 2004.

Formats

Thousands of companies competed in the health club industry in 2004. The 50 largest firms accounted for 33 percent of industry revenue.¹⁴ (This was lower than the comparable figure for 90 percent of all industries in the United States.) Thirty-eight percent of health clubs were not-for-profit—run by the YMCA, a town, a church, or a university, for instance.¹⁵ Among for-profit competitors, common formats included the following:

- **Owner-operated clubs:** These clubs, operated by their owners, made up the majority of all health clubs. Many owners operated at just a single location. As the industry had grown, however, an increasing number of local, regional, and super-regional chains had emerged. The largest chains were Bally Total Fitness, with over 400 outlets, and 24 Hour Fitness, with over 300. Chains tended to centralize procurement, program design, marketing, finance, accounting, and collections, for instance.
- **Franchised clubs:** Under this format, a successful health club concept was franchised to multiple investors who paid a fee to operate a club under the franchise brand umbrella. In return, franchisees received professional advice and advertising support and enjoyed the purchasing power of a large chain. The largest franchises included Curves for Women fitness centers, with 8,000 locations; Gold's Gym, with more than 550 gyms in 25 countries and approximately 2.5 million members; and Lady of America's 1,000 fitness centers for women only.
- **Design and management companies:** These companies provided advice on how to set up health clubs and charged a management fee to operate them. They often worked for corporate clients including hotel chains,

hospitals, universities, and companies aiming to provide their employees with convenient exercise facilities. Many corporate-based fitness facilities were supported in part by company subsidies. Design and management companies included Health Fitness, which managed 390 corporate centers in 2004, and Fitcorp, which managed corporate fitness centers for 150 clients and 13,000 members.

- **Health spas:** This format combined a residential hotel with extensive health club facilities and sporting facilities. Examples included KSL Recreation, which operated seven luxury hotels and resorts in California, Arizona, Florida, Georgia, and Hawaii.

Firms distinguished themselves in part by the clientele they served. Some clubs, such as Gold's Gym and Gorilla Sports (acquired by Bally in 1998), offered no-frills gyms for serious fitness buffs. Others, such as The Sports Club Company and Wellbridge, targeted the social elite and operated a small number of upscale clubs in prestigious locations. Still others focused on women (e.g., Lady of America and Curves), amateur and professional athletes in training (e.g., Velocity Sports Performance), or children (e.g., My Gym Enterprises).

Firms varied significantly in their geographic scope. Thousands of owner-operated gyms had a single location. There were also many small regional health club chains such as All American Fitness Centers, Inc., with seven locations in Oklahoma, and much larger regional players such as Town Sports, with 130 full-service health clubs in New York City and beyond. Multi-state players included Bally in 29 states, 24 Hour Fitness in 16 states, and Wellbridge in 12, for example. These firms were dwarfed by the YMCA with its network of more than 2,500 outlets in all 50 states. Exhibit 4 lists the top health-club chains in the United States

Exhibit 4 Top Health Club Chains in the U.S. by Revenue

Company	2003		Employees	Sites in 2003 ^a			Members (000s)	No. of States Operated In	Listing	
	Corporate Revenue (\$MM)	Revenue Change from 2002 (%)		O	M	L				F
1 24 Hour Fitness	981	5	16,000	305			3,000	16; Asia	Private	
2 Bally Total Fitness	954	5	23,000	420			3,600	29; Mexico, Asia, Caribbean	Public	
3 Town Sports International, Inc.	343	7	7,500	127	2		350	8; Switzerland	Private	
4 LifeTime Fitness	257	32	7,500	34			250	9	Public	
5 The Wellbridge Co.	174	0	5,000	33	13		200	12	Private	
6 The Sports Club Co.	131	8	2,450	9	1		50	5	Public	
7 Equinox Fitness Clubs	117	21	2,700	21			NA	4	Private	
8 Tennis Corp. of America (TCA)	90	8	2,200	26	17		175	North America	Private	
9 Western Athletic Clubs	82	8	2,200	11			NA	2	Private	
10 Sport & Health Clubs	77	10	2,800		2	27	NA	3	Private	
11 Spectrum Clubs Inc.	75	10	1,600	21	1		NA	2	Private	
12 Club One	56	5	2,000	18	82		50	8; Canada	Private	
13 Leisure Sports Inc.	51	34	1,402	7			37	3	Private	
14 Gold's Gym International	50 ^b	5	2,200	37			2,500	43; 25 countries	Private	
15 East Bank Club	47	2	650	1			10	1	Private	
16 Fitness USA Supercenters	42	5	830	24			175	3	Private	
17 New York Health & Racquet Club	35	11	700	21			NA	1	Private	
18 Five Seasons Sports Country Club	33	2	1,000	7			NA	4	Private	
19 Lucille Roberts	32	5	680	49			NA	3	Private	
20 Health Fitness Corp.	31	13	3,000		334		200	41	Public	

Source: Compiled from "Top 100," *Club Industry's Fitness Business Pro*, July 1, 2004, http://www.fitnessbusiness-pro.com/nmg/fitness_top_31/index.html, accessed November 2004. Member numbers from companies' Web sites and headquarters.

^a O = owned, M = managed, L = leased, and F = franchised.

^b Corporate-owned only.

by revenue. A number of firms—including Bally, 24 Hour Fitness, Gold's Gym, and the YMCA—had also branched out internationally.

Pricing and Sales

Health clubs typically charged customers a one-time enrollment fee for joining a club and then a monthly subscription charge. A recent survey of clubs, conducted by an industry trade association, reported a median enrollment fee of \$150 and a median monthly charge of \$50.¹⁶ The surveyed clubs were larger and more upscale than the average in the industry, however, and fees varied widely around these medians. On joining, new members were usually committed to a minimum subscription period, most commonly a year. As noted before, approximately 30 percent of members dropped their membership after a year and 70 percent renewed. Some clubs asked their new members to commit for longer periods. For instance, Bally aimed to have all of its customers commit for three years, but this was generally unpopular with customers.

Most clubs included a number of services and facilities in the basic subscription charge and offered additional services for a fee. The non-dues fees generated from these activities made up 28 percent of total health club revenues in 2004. When asked in a survey to identify their five most profitable add-on programs, 50.5 percent of clubs listed personal training. Massage therapy, pro shops, aquatic programs, and tennis programs were each identified by 20 to 30 percent of clubs.¹⁷ The top quartile of clubs on a revenue-per-member basis generated a larger proportion of their revenues from non-dues services (more than 30 percent). They also enjoyed higher member-retention rates.¹⁸

Larger clubs and chains gave dedicated sales representatives the job of attracting new members. It was not uncommon for sales people to be paid entirely on commission and for the commission per new member to be a substantial fraction of the customer's enrollment fee. Clubs routinely ran promotions to win new members. In a recent survey, 75 percent of clubs reported that they had discounted enrollment fees in order to attract members, but very few had reduced their monthly fees.¹⁹ One reporter's experience with the sales process was typical:

When we called [the chain's club] in Atlanta on Dec. 31 [as a potential customer], the [sales] rep gave us a stern warning: sign up now, because rates were going to shoot up on Jan. 1; similarly, the Chicago [sales] rep told us the initiation fee was sure to jump to \$299, from \$49. But, when we called both clubs back on Jan. 2, the rates hadn't risen at all—in fact, they'd dropped in Atlanta. We were offered two years for the price of one and no initiation fee.²⁰

Exhibit 5 Club Operating Benchmarks in 2004

Financial performance	Thousands of dollars	Percent of total revenue
Revenue		
Dues	1,561	71.9%
Non-dues revenue	610	28.1
Total revenue	2,171	100.0
Expenses		
Payroll	934	43.0
Rent	402	18.5
Depreciation and amortization	237	10.9
Other ^a	475	21.9
Total expenses	2,048	94.3
EBIT	123	5.7
Operating statistics		
Number of members	3,019	
Indoor square feet	42,300	

Source: "Club Operating Benchmarks," <http://cms.ihrsa.org/IHRSA/viewPage.cfm?pageId=807>, accessed November 2006. Casewriter calculations.

^a "Other" expenses include advertising, sales commissions, utilities, insurance, training, overhead, etc.

Operations

Exhibit 5 shows the operating statistics and income statement of a representative health club, derived from the trade association survey mentioned above. (Again, the surveyed clubs were larger and more upscale than the average club in the industry.) Labor was the largest cost incurred by a club. Indeed, retaining a skilled, friendly, and motivated staff was considered a key challenge in the industry. A surge in the popularity of personal trainers had increased the demand for personnel in recent years, and large chains had responded by increasing their efforts to train trainers.

Contrary to the occasional depiction of the job in movies, working in a health club was decidedly non-glamorous work. It involved working long hours, being on the job precisely when most other people had free time, picking up towels in changing rooms, putting away equipment that patrons had left out, dealing with customers in a wide range of moods, and so forth. Motivating staff members to accomplish such tasks was not easy, and this made it challenging to manage a health club. Large chains had recently developed information systems to assist and monitor their club managers, but it remained unclear how effective such systems were.

Accounting and Control

In enrolling new members, health clubs took in one-time enrollment fees and incurred one-time customer acquisition costs. Accounting standards left club managers some latitude to decide when to recognize revenue and book expenses. A firm that recognized revenue relatively early could show inflated profits, especially if the firm were growing rapidly. Alternatively, a firm that spread its recognized revenue over the expected duration of a membership could find, perversely, that a fall in retention would cause revenue to be recognized earlier and profits to rise.

Trends

Industry analysts noted several key trends and growth opportunities for fitness clubs in 2004.²¹ They were expecting some companies would go public and others would consolidate. They were also predicting that studio-sized clubs (such as the Curves franchises) that required minimal initial financial investment would continue to flourish. Typically smaller than 2,000 square feet and lacking traditional club amenities (e.g., showers and lockers), studio-sized clubs were popular among consumers who valued their convenient locations. Pay-as-you-go pricing, which allowed customers to pay per visit, was also likely to become the norm at clubs.

In addition, many observers believed that health clubs would become more diverse as they catered to certain demographics or created niches for themselves. For example, the number of children and teenagers belonging to health clubs doubled between 1993 and 2003.²² Also, the prevalence of childhood obesity concerned many. Stephen P. Roma, CEO of WOW! Workout World, suggested, "The next great bonanza market has to be the kids. . . . When exercise, fun and results are tied together the kids will do it; this not only helps bring in them and their parents now, but builds a base for the future."²³ Analysts saw baby boomers as another "bonanza market": the number of individuals over 55 who belonged to health clubs increased 273 percent between 1993 and 2003.²⁴ Roma explained, "It would not surprise me to see specific, small fitness centers that cater to the 50-plus market and address the specific programming, supplementation and coaching needs of this type of population."²⁵

Finally, analysts felt that national concerns about obesity, desire for overall mind-and-body wellness, and consumer dissatisfaction with myriad diet programs portended great opportunities for the health club industry. Many clubs were responding to diet dissatisfaction by incorporating weight-management programs into their

portfolio of offerings. Also, more health-care providers and employers were expected to offer or subsidize exercise programs. However, there remained a gap between people's recognition of the importance of working out and their willingness to do it. Health clubs continued to try to bridge this gap.

Bally Total Fitness

Bally Total Fitness generated revenues of \$954 million in 2003 and was the largest publicly traded health club operator in the United States. Bally operated over 360 outlets in the United States and more than 50 internationally. Worldwide, it had 3.6 million members.²⁶

History and Scope

Bally traced its roots to the Health and Tennis Corporation, run by Dave Wildman. Wildman started to buy ailing gyms in 1962, expanding aggressively and acquiring dozens of brands. Financial performance was weak, however. In the early 1990s, as part of a diversification move, Bally Manufacturing, a gambling equipment company, purchased Wildman's chain and rechristened itself Bally Entertainment. The firm spun off its health club—Bally Total Fitness—in 1996 with Lee Hillman as CEO.²⁷

To improve performance, Hillman sold off outlets and rationalized Bally's brand portfolio. Nineteen clubs were divested in 1996 and 1997 in order to return the business to profitability. By the late 1990s, Bally began to expand again. In 1998, the company purchased two gym chains in northern California: the upscale Pinnacle Fitness and the no-frills Gorilla Sports. It added a 10-club Toronto chain in 1999 and a number of other chains in 2002.²⁸ By 2004, Bally had outlets in 29 states, giving it the broadest geographic distribution of any owner-operated health club chain in the United States. The expansion left Bally with considerable debt, including \$300 million of notes due in 2007.

Over time, Bally had developed an unusually broad range of products. Starting in the late 1990s, Bally's senior vice president for corporate development Paul Toback had introduced a line of Bally-branded nutritional products, including protein powders, energy drinks, snack bars, and vitamins. By 2004, these were sold in virtually all Bally clubs as well as 7,000 grocery and drug stores. Bally-branded products, including jump ropes, weightlifting gloves, treadmills, and stationary bikes, were produced by third parties and distributed via more than 8,000 retail stores. Retail counters in Bally's clubs offered Bally-branded merchandise and, in roughly half of its clubs,

made fresh nutritional drinks at a juice bar.²⁹ A Merrill Lynch analyst remarked about Toback: "He's been a champion at finding ways to drive revenues out of their existing membership base."³⁰ In a 2003 interview with *Club Business International*, Toback explained that Bally's non-club products plus its 6,000 personal trainers contributed \$150 million annually to the company's revenue.³¹

Bally had broadened its set of target customers over time. For many years, the company had defined its target as 18- to 34-year-olds of middle income. In the early 2000s, this was broadened to encompass 35- to 54-year-olds.³² The Hispanic community was also a new area of focus.

In December 2002, CEO Lee Hillman stepped down suddenly "to pursue new challenges and interests and to spend more time with his family."³³ Paul Toback moved into the top role. With an undergraduate degree from Stanford, a law degree from the University of Chicago, and administrative experience in the Chicago Mayor's office and the Clinton White House, Toback had joined Bally in 1997 as senior vice president of corporate development. Since 2001, he had served as Bally's chief operating officer. Upon taking the CEO role, Toback told the *Wall Street Journal* that he expected any changes to be "more evolutionary than revolutionary."³⁴

Pricing and Sales

The chain whose helm Toback took had long sold and priced memberships in a distinctive way. The list price of the enrollment fee ranged from \$49 to \$199, before any discounts, while monthly dues ranged from \$19 to \$39. Throughout its history, Bally had new members sign 36-month, legally binding contracts. New members could pay the entire 36-month liability upfront or, in effect, take out a loan from Bally to join the club and repay the loan over 36 months. The member was then legally liable to repay the loan. After 36 months, members could remain in the club by making a lower monthly payment—\$12 on average. Bally enjoyed member retention rates that were higher than the industry average.³⁵

The 36-month commitment, however, was a source of contention with some patrons. A number of members complained about cancellation requests that were not honored, the use of harassment or deceptive means to collect fees, and the unauthorized charging of credit cards or debiting from bank accounts. As a result, in 1994, the Federal Trade Commission required Bally to pay \$120,000 in civil penalties and to refund thousands of members' membership fees.³⁶ Complaints continued, and an active consumer Web site in 2004 brought attention to Bally's alleged abuse of customers. In response, Bally began to experiment with pay-as-you-go memberships.

Pay-as-you-go constituted eight percent of memberships in 2004, up from three percent in 2003.³⁷

Toback was eager to change the company's approach to member enrollment: "We want to exit our finance business. Because of the way that we sell memberships, we're essentially running two businesses—a finance company and an operating company. It's important for us . . . to begin to decouple those two businesses."³⁸

Operations

The typical Bally club was a 30,000-square-foot facility near a regional, urban, or suburban shopping area. It contained exercise equipment, free weights, and stretch areas. Only a few clubs included swimming pools or racquetball courts. Roughly 50 employees—including managers, instructors, personal trainers, sales personnel, and maintenance personnel—were involved in operating each club. In total, Bally employed 21,700 people at its fitness centers and 1,500 people at central locations. Centralized personnel supervised and supported club-level managers; processed memberships and collected membership fees; managed information systems; and provided support for accounting, human resource management, real estate activities, and legal matters.³⁹

In 2004, Bally was in the midst of two operational adjustments that Toback considered important. First, club-level managers were increasingly being asked to operate as general managers with responsibility for club profitability. In the past, incentives of club managers and regional supervisors had focused almost exclusively on sales figures. Under the new system, compensation packages were modified to include a component based on local profitability.⁴⁰

Second, Bally had launched in 2003 a "comprehensive nutritional and exercise program customized to an individual's unique metabolism."⁴¹ The program's objective was to offer consultation to members who had weight-loss goals and to construct for each member a tailored combination of an exercise regime, personal training, and an approach to diet and nutrition. In an effort to serve as a one-stop fitness resource for consumers, Bally had launched a line of nutritional supplements and meal-replacement items. Chief Marketing Officer Martin Pazzani commented, "We see a difference between fitness and total fitness. . . . We are evolving the company from gyms to a 'total fitness product and services' company. We have reformed the brand and position."⁴²

Marketing

Bally had also conducted an extensive survey to determine what kept people from the gym. According to Pazzani, "We learned that the [hard body] image turned everybody

off. . . . It was an impossible standard to meet. It was impossible to envision perfection, and people didn't want to go to the gym."⁴³ In response, the company constructed new ads: "hard bodies" were gone, replaced by people of various ages, sizes, and ethnicities who told how Bally's clubs had helped them reach their fitness goals.

Accounting and Control

During early 2004, while closing its books on the 2003 fiscal year, Toback and his team encountered a series of accounting and control problems. Bally's auditors resigned in March 2004; the SEC began to investigate its accounting methods in April; and the company was unable to report 2003 results until August 2004.

In those results, Bally management opted to change two accounting procedures. In the past, the revenue from members' enrollment fees had been recognized over the first 22 months of membership. Many members stayed for more than 22 months, however, so new procedures were adopted that matched revenue recognition to the actual retention patterns of members. The revenue recognizable when a member enrolled was capped by the cash that Bally received at that moment, even if the member signed a contract to pay more later. Second, the costs of enrolling a new member had, in the past, been booked over the same 22-month period. Under new procedures, such costs would be expensed as soon as they were incurred.

As a consequence of these changes, the 2003 results included a \$581 million charge for cumulative adjustments. Soon, the company faced lawsuits from shareholders who accused Bally of financial misrepresentation and fraudulent accounting practices.⁴⁴ The company announced that it would soon restate results from several past years; that it was finding a set of problems in past accounting methods and current financial control systems; and that it was exploring legal options against past officers, including former CEO Lee Hillman. It was unclear when Bally would be able to report 2004 results. See Exhibit 6 for Bally's financial results and operating statistics and Exhibit 7 for Bally's stock price over time.

Leading Competitors

YMCA

The Young Men's Christian Association was founded in London, England, in 1844 as a response to unhealthy social conditions in big cities at the end of the Industrial Revolution. It arrived in the United States in Boston in 1851, started by Thomas Sullivan, a retired sea captain. The YMCA had a long sports tradition. James Naismith invented

the game of basketball at the International YMCA Training School in December 1891. In 1895, an instructor who felt that basketball was too strenuous for businessmen invented volleyball at the Holyoke, Massachusetts, YMCA. Racquetball was invented in 1950 at the Greenwich, Connecticut, YMCA by a member who did not care for handball.

By 2004, the YMCA was the largest health club operator in the United States, although it was a community service organization and not a health club specialist. With over 2,500 locations—many of which offered exercise facilities—and operating in every state with a total volunteer staff of 570,000, the YMCA was an American institution. It served over 18 million members, half of whom were under 18 and half of whom were female. A not-for-profit organization, it consisted of 972 independent YMCAs and generated aggregate revenues of \$4.2 billion.⁴⁵ Each independent YMCA set its own membership fees, and some YMCAs based fees on an individual's or family's income.

Beginning in the 1980s, a number of private health clubs challenged the YMCA's nonprofit status. Pointing to the YMCA's construction of high-end fitness facilities in affluent communities, the private clubs argued that the YMCA should be required to pay taxes like other competitors. Indeed, as a result, the state government of Oregon withdrew the YMCA's nonprofit status at two Portland locations in 1988.⁴⁶

Gold's Gym

The first Gold's Gym was established in Venice, California, in 1965. A no-frills bodybuilding center, it was soon dubbed "The Mecca of Bodybuilding" and received international attention after being featured in the 1977 movie *Pumping Iron* starring Arnold Schwarzenegger. In the years that followed, Gold's Gym expanded by means of franchising. The organization maintained its bodybuilding tradition while incorporating other services such as group exercise, personal training, cardiovascular equipment, Pilates, and yoga.⁴⁷ In 2003, the company hired a new ad agency to lower Gold's "intimidation factor" and help it broaden its customer base to include more families and young people.⁴⁸ By 2004, Gold's Gym described itself as the largest coed health club franchise in the world with over 550 locations in 43 states and 25 countries and 2.5 million members.⁴⁹ Its members—the parent company claimed—shed more than 20 tons of body fat each day.⁵⁰

24 Hour Fitness

In 2004, 24 Hour Fitness generated more revenue than any other for-profit health club specialist. Founded in 1983 by Mark S. Mastrov, the privately-held company had

Exhibit 6 Bally Total Fitness Financial Results and Operating Statistics (in millions of dollars, except for member, employee, club, and state numbers)

	For 12 Months Ending December 31,									
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total Revenue	661.5	653.4	639.2	655.1	735.4	663.0	785.9	840.9	904.9	953.5
Cost of Goods	462.2	446.8	408.7	384.5	423.7	501.3	581.9	630.6	744.7	803.6
Gross Profit	199.3	206.6	230.5	270.6	311.7	161.7	204.0	210.3	160.2	149.9
Selling/General/Administrative Expenses, Total	177.7	143.8	151.4	209.1	230.8	74.9	80.4	81.3	87.6	95.0
Income before Depreciation and Amortization	21.6	62.8	79.1	61.5	80.9	86.8	123.6	129.0	72.6	54.9
Depreciation and Amortization	58.9	57.4	55.9	52.9	48.3	52.9	65.6	72.9	74.3	77.5
Non-operating Income	NA	-0.2	-3.1	13.2	22.7	61.8	63.7	61.3	50.0	72.5
Interest Expense	38.6	43.8	47.6	45.0	41.5	52.4	62.1	58.8	55.5	60.6
Income Before Tax	-75.9	-38.6	-27.5	-23.2	13.8	43.3	59.6	58.6	-7.2	-10.7
Provision for Income Taxes	-25.0	-7.2	-2.7	0.3	0.5	0.9	-19.0	-13.6	-4.2	51.5
Net Income before Extraordinary Items	-50.8	-31.4	-24.9	-23.5	13.3	42.4	78.6	72.1	-3.0	-62.2
Extraordinary Items and Discontinued Operations	NA	NA	5.7	-21.4	NA	-0.3	NA	-2.0	-1.5	-583.8
Net Income	-50.8	-31.4	-19.2	-44.9	13.3	42.2	78.6	70.1	-4.5	-646.0
Members (thousands)	NA	NA	NA	NA	NA	3,428	3,556	3,541	3,542	3,616
New members (thousands)	NA	NA	NA	NA	NA	NA	891	908	935	965
Employees	17,400	14,400	12,600	13,900	14,800	16,350	18,975	21,250	23,000	22,200
Clubs	332	325	320	320	330	370	385	405	412	418
U.S. States Operated In	27	27	27	27	27	27	28	28	29	29

Source: Thomson Research, accessed November 2004. Member, employee, club, and state numbers obtained from company 10-K reports (1994 to 2003), accessed via Thomson Research.

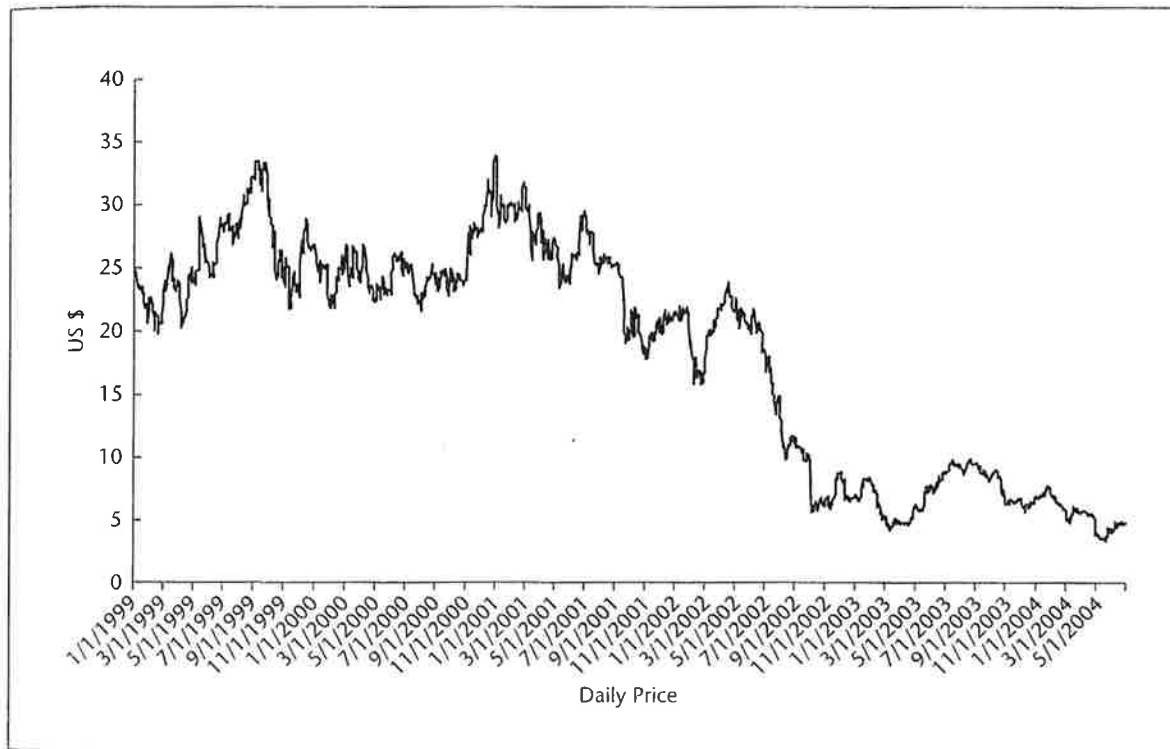


Exhibit 7 Bally Total Fitness Stock Price, January 1, 1999, to June 30, 2004

Source: Adapted from Thomson Datastream, accessed August 2004.

expanded organically and by acquisition, always aiming to be the “number one or number two player” in each local area.⁵¹ In 2003, 24 Hour Fitness operated 305 clubs in 16 U.S. states (primarily in the West and Mid-West) and 21 clubs in overseas locations; had 3 million members and 16,000 employees; and generated \$1 billion in revenues.⁵² According to Mastrov, the company aimed to serve the 87 percent of the public that did not already belong to health clubs.⁵³ In 2004, the company operated clubs with different formats—ranging in size from 10,000 square feet to 100,000 square feet—to meet the needs of different customers and markets. Enrollment fees and ongoing monthly dues depended on the type and location of the club in which a member enrolled. Patrons had the option of selecting “pay-as-you-go” month-to-month memberships or longer-term, prepaid ones. 24 Hour electronically deducted monthly dues from patrons’ checking or credit card accounts using an information technology infrastructure that was considered state-of-the-art in the health club industry.⁵⁴ Proprietary software also enabled 24 Hour Fitness to develop thousands of individualized, personal training and nutrition programs for its customers.⁵⁵

Curves International

A health club chain exclusively for women, Curves International billed itself as the largest fitness center franchise in the world in 2004, operating in the United States, Canada, Mexico, and Europe. Founders Gary and Diane Heavin opened the first Curves in Texas in 1992 and granted their first franchise in 1995. By 2004, 8,000 Curves units operated worldwide serving 2 million members. The company found its niche by targeting older women, those new to exercise, and women not comfortable in coed gyms. Curves outlets were small, contained no showers or mirrors, and were often located in strip malls close to residential areas. Franchises offered patrons a comfortable, supportive environment in which to perform Curves’s 30-minute circuit training using hydraulic resistance machines.⁵⁶

Conclusion

In late 2004, Paul Toback and his team at Bally faced a mixed situation. On one hand, Bally’s new marketing and operations efforts appeared to be yielding results. Bally

saw a surge in new memberships at the end of 2003 and during the first two quarters of 2004; indeed, during the second quarter of 2004, the number of new members increased 22 percent year over year. Total membership fees increased 15 percent during the same period.⁵⁷ On the other hand, competitive and capital-market pressures were

intense. TheDeal.com reported that a major shareholder was urging Toback to sell the company. TheDeal.com also reported that several private equity firms, as well as rivals such as 24 Hour Fitness, “could have interest in buying Bally.”⁵⁸

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