Fit for purpose

In a new series on competitive advantage, **Tony Grundy** charts the transformation of an ailing gym chain into a distinctive brand

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Matthew entered the health club market as a young man in 1997. He had a burning desire to help people to get fit while also having fun.

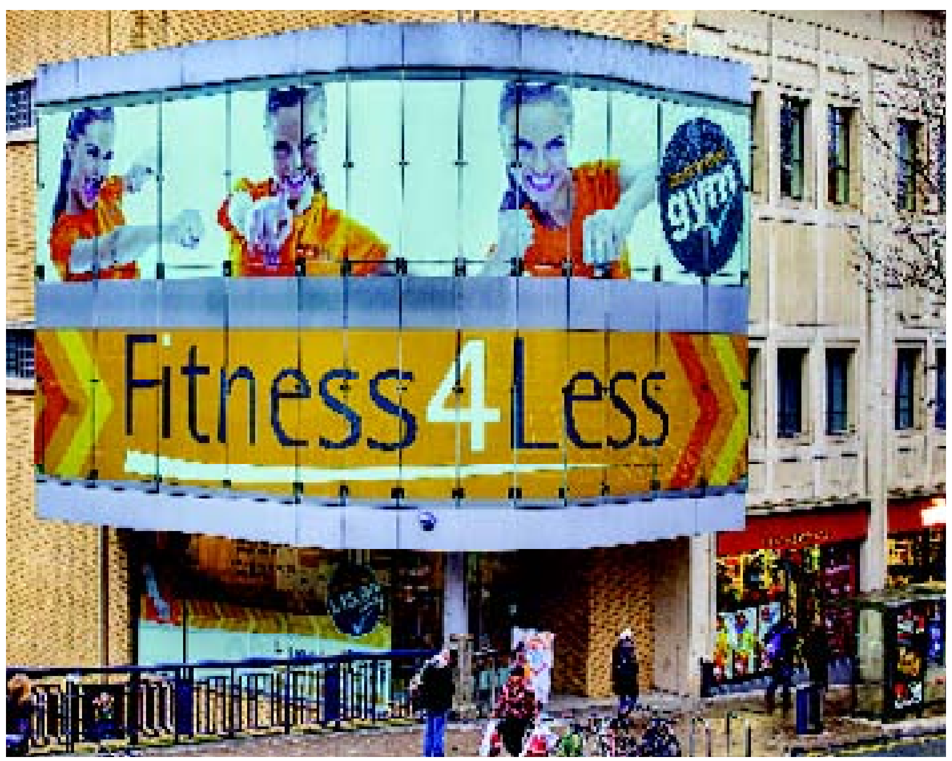
We first met through his company's auditors – I was running a programme for them called 'Developing Growth Advisers', and Matthew kindly offered to be a guinea pig for me to develop a case study so that the auditors could come up with interesting growth strategy options. He role-played not only for this programme but also for me as a visiting speaker when I was teaching at Cranfield.

At this time, Matthew was rapidly developing a chain of health clubs and wanted a brand and competitive strategy that was quite different from others in the market, so he had climbing walls, a women-only area, and more of a night club-type ambiance for the really vigorous exercisers.

The chain grew quickly, mainly in the South East. Levels of performance varied, with clubs such as London Bridge being stars, and some others, such as Bristol, having low profits. He successfully floated the business for £28m in 2000 on the AIM market, but after a short while, one of the investing institutions changed its investment strategy and dumped its shares, damaging the share price. The group also had significant debts, and central costs had grown faster than revenues and margins, putting some financial strain on the group.

In 2002 we ran some workshops with the board to see what deeper economies we could make in central costs, and a process of selective disposals was started. As a result of external financial pressure, there was a major reconstruction of the group, which left Matthew with around half a dozen clubs of mixed profitability.

Central costs then dropped to be unimaginably lower than the previous structure, and Matthew had now started to understand just how to execute a 'cost leadership' strategy (where you aim to have the lowest costs in the game, and therefore lower prices, but adequate quality).



Getting into shape

By 2007 the clubs were in much better financial shape, with half the original number of clubs, but otherwise there wasn't much growth. Then something big occurred – through strategic thinking.

Matthew and I were by then friends, and I had also joined his board as a non-executive director. Matthew said he was wondering what to do with the Bristol club, as it really struggled to make money – maybe he should sell it? I replied with something like: 'You may well be right: but in some ways it feels like giving up. You are a very competent operator, so what makes you think that there is anyone who could actually turn Bristol around if you can't? You would have to find someone who was gullible or deluded to take it off your hands and pay you for it. I don't think that you have exhausted the options for turning it around yet.'

Matthew took this on board and suggested that we use the 'strategic option grid' (see earlier articles) to generate and evaluate the options. I also suggested that we did some mindset dumping and imagine what an alien might do to produce a better model with more natural customer appeal and greater value generation.

In the next half hour or so, we came up with the basic elements of a newer and leaner business model. We sketched out our evaluation using the option grid on a serviette.

The core ingredients of that model were:

* having no sales force (a big cost driver was the high costs of customer acquisition) but setting the price point at a mere £15 a month (at a time when the price of an average club was around three times that), making a sales force irrelevant – word of mouth would do
* driving all bookings and sign-ups online
* finding economies in sourcing equipment
* negotiating down rentals, as we said the low-cost mantra had to reach every part of the club
* outsourcing some areas of administration
* removing the constant, wasteful presence of staff on the gym floor, supposedly there to stop people doing things against the rule-book
* maintaining 'friendliness' by not skimping on reception staff
* positioning the brand as Fitness for Less.

While not exactly an EasyJet strategy, the thought process behind it was very similar.

The results were impressive: within six months, Fitness for Less had migrated profitably to a highly cash-positive business model. This gained further momentum as time went on. While the club was a lot busier, many of the members were not such intensive users: as it was cheaper to join, the average frequency of visits was quite a lot lower than in the past.

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Over that period I joined the board too, and encouraged further development of the model to keep the clubs ahead, as I was acutely aware that it was going to be hard to defend against imitation. For example, a cheap lookalike club was set up close to a Fitness for Less branch in Birmingham. The price: only £10 a month. (So cheap that we wondered whether they would have to hire a security guard to make sure everyone had left in the evening, as it would work out at 35p a night to sleep there.)

There were some interesting strategic choices, such as finding new locations and developing a franchise model. We tried at all times to keep in our sights the need to come up with a cunning plan.

Interestingly, on one occasion when we all met in Bristol, I did some benchmarking of some competing clubs by asking about membership, and found them to be not obviously better, despite being much more expensive. They were, in the words of Professor Michael Porter of Harvard Business School, 'good competitors', as they hung on for prices that made Fitness for Less unbelievable value. When I walked round our own club, I found the reception helpful and friendly. Indeed, Matthew and the management team maintained a level of friendliness that surpassed that of competitors.

On a roll

Matthew continued to develop the business by:

* doing more franchise business
* converting his original core business to the business model and rebranding as Fitness4Less
* cutting costs further and achieving greater economies of scale
* improving cashflow, EBITDA (earnings before interest, taxes, depreciation and amortisation) and reducing gearing
* disposing of all underperforming clubs.

No doubt progress was helped through the impact of the recession. Even though this effect has now worn off, it created in the minds of most customers the thought that they can and should get value for money from their gym.

Looking ahead

Of course, the external environment hasn't stayed still and, as we all expected, imitators have emerged. Indeed this sector is now a substantial part of the UK fitness market – accounting for perhaps around 15% of it. So this raises questions about future growth drivers. For instance, will we see add-on extras that members are willing to pay for, as seen in the budget airline market – maybe offering the potential to adjust positionings within this strategic group? Or even a super-budget model, where you can only go to the health club on one fixed day of the week? Maybe this suggests another round of mindset dumping, future storytelling or both?

Learn the hard way

So why does this matter to Matthew? Well, he should perhaps be more concerned about economic value than short-term accounting profit. Two key value drivers are important here: sales growth rate and operating profit margin.

The value of Matthew's business will be driven not so much by some crude multiple of EBITDA but by the potential for sales growth rate (more sector growth, capturing greater sector share) and by strategies that also increase margin – set against a scenario of future demand, future competitive structure and Fitness4Less's future competitive edge. Otherwise the resulting value of the business will truly be based on the wrong kind of NPV (numbers prevent vision).

One of the biggest lessons from Fitness4Less is the need to learn from experience – however painful – and to be prepared to think totally differently. ■

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