

HKICPA Business Case Competition 2018

Supreme Fitness

Overview

Supreme Fitness ('Supreme') is a small company operating in the fitness sector in Hong Kong, listed on GEM of the Hong Kong Stock Exchange. It provides training space and equipment to 18,700 members through its network of ten fitness centres.

Supreme has two major revenue streams: monthly membership fees and personal training fees (individually tailored fitness programmes developed for members by personal trainers). In addition, a small amount of revenue is generated from sales of sundry items such as cold drinks, toiletries and 'Supreme Fitness' T-shirts from the fitness center front desks.

The business was founded 30 years ago by Frank Hau, who wanted to take advantage of the growing interest in health and fitness in Hong Kong at the time, and looked forward to growing Supreme into a global presence in the fitness market. In the early days of the company, Supreme was regarded as a new and exciting proposition, with its state of the art equipment and fitness centers in fashionable locations. Supreme's brand has a high level of recognition in Hong Kong, and its advertisements have been a familiar part of the landscape for many years, but Frank Hau's dreams of expansion have never been realized, largely because of a history of family disagreements on the way that the business should develop. As a result, the Supreme brand is unfamiliar in the rest of South East Asia.

The Hau family continues to own 66% of the shares in the company and remains keen to find ways for Supreme to grow its revenues, but consensus on future strategy is hard to achieve and various options are regularly discussed. Some family members argue for a low cost operation, while others believe that Supreme must invest more, expand into different areas and differentiate itself from the competition if it is to survive.

Organization structure and board of directors

Frank Hau, the company's founder, is now the company chairman. The current CEO is his brother, David Hau. The executive management team consists of the CEO, CFO Wendy Leung and COO Edward Hau (David's son). There are five independent non-executive directors. David thinks that the board has too many non-executive directors and blames them for what he sees as an habitual 'blocking' of strategic ideas for growth in the past, and a reluctance to take even the smallest risk. He is determined to change this mindset.

There is a head office in Hong Kong with 20 staff comprising the executive management team and a team of support staff including a financial manager, human resources manager, marketing manager and a small team of business analysts (which supports both the finance and marketing managers).

Market conditions

Supreme competes with both the large international gym chains and smaller domestic operators. In recent years, the Hong Kong fitness center market has become increasingly crowded and competitive, and profit margins have been squeezed. There are around 110 fitness clubs in the city, with approximately 940,000 members. The management team at Supreme believes that the current challenges are largely due to a combination of external factors including continued fears of global economic slowdown, and an apparent decline in willingness to pay high prices for health and fitness services.

Supreme has to a certain extent turned this to its advantage. Since many fitness center users are now unable, or unwilling, to pay high membership fees, Supreme has maintained its membership base by keeping its membership fees low to retain customers, and offering promotions to members. The company is also reviewing costs and capital expenditure, having taken the decision during 2017 to restrict expenditure on new equipment, maintain staff numbers at current levels and keep facilities relatively simple.

Management does acknowledge that without the resumption of regular and major investment in equipment and premises, Supreme could be seen as outdated in a very short time. It already finds itself at the lower end of the market, being unable to charge the high membership fees commanded by fitness centers offering swimming pools, modern equipment, specialty training and wellness programmes. There has also been concern expressed by some members and management that the equipment in some of the centers is not safe because of poor ongoing maintenance. In addition some centers are extremely crowded at peak times, putting pressure on center staff and affecting customer service standards.

When equipment breaks down entirely it is replaced. Equipment has been purchased mainly from the USA, but Supreme's major supplier has recently announced the establishment of a factory in Hungary, which will in future fulfill the orders placed by its customers in Asia. Aware that Supreme has put its investment programme on hold, the supplier has recently offered Supreme its own large discounts on future equipment orders from the new factory if they are placed before the end of 2018.

Recent work by one of the head office business analysts has shown that membership numbers are declining, and the COO, Edward Hau, believes that the market position of Supreme is no longer sustainable. He feels that the lower end of the market is unlikely to deliver financial success with the current strategy of low investment, crowded facilities and a limited offering. Edward argues that urgent remedial action needs to be taken to ensure a profitable future for the company. He has tried to persuade the rest of the board that a comprehensive refurbishment of the fitness centers and investment in new equipment will be needed in order to maintain profitability and improve the potential for growth in the business. Edward has been asked to present a stronger case for new investment, because David Hau is not convinced. He worries that the demand for fitness centers may have passed its peak and that other avenues need exploring. These conflicting views have caused considerable tension between David and his son Edward. However, both of them do acknowledge that there is a need for cost control.

A recent market research indicates a number of customer preferences for choosing fitness centers. Customers prefer centers offering wider range of fitness options in addition to traditional cardiovascular and weight training equipment. They appreciate centers selling health food and nutrition supplement as being a convenient choice after workout. They also prefer fitness center with global presence so that they can continue their workout under similar environment during both business and personal trip.

Staffing

With the market containing so many competitors, turnover of junior staff in fitness centers these days is quite high. Individuals move from Supreme to its competitors, often in search of a more modern working environment, and the median length of employment for new staff is currently about 18 months. Several years ago, following a critical report from a human resources consultancy drafted in to investigate problems with staff retention, Supreme introduced a bonus scheme for the achievement of certain targets, aimed at retaining its center managers, with the result that some of the longer serving managers are now on remuneration packages that are slightly above the industry average.

This situation does not extend to junior center staff - many center managers are saying that the company needs to provide more training to help develop a closer rapport between staff and members that will encourage members to stick with their training goals and maintain their memberships year after year. Some center managers would also like to see the company encouraging center staff to acquire personal trainer licenses of their own, as this would reduce the reliance upon freelance personal trainers to generate additional revenue. Many members of center staff have expressed enthusiasm for training in areas such as motivational psychology, as well as disciplines such as yoga or Pilates.

Services provided by Supreme

Each of Supreme's ten fitness centers operates with a center manager and around 15 members of staff who are on a shift system, so that five members of staff are on duty at any time. The centers are relatively compact, with each one averaging 2,000 square meters. All of the premises are leasehold, and each one receives a standard Supreme fit out which is capitalized as leasehold improvements.

Over the years some of the center locations have become more fashionable and prestigious. Operating fitness centers in these desirable locations has helped to some extent in maintaining Supreme's reputation with existing and potential members. Supreme has a simple gym format. It provides gymnasium space and equipment and standard fitness classes in an exercise studio. All centers are fitted out with cardiovascular equipment (exercise bikes, cross-trainers, rowing machines and step machines) and weight training machines. Members have access to use of the equipment, and are essentially left alone to get on with their workouts. Centre staff tend not to offer any advice, with their role limited to patrolling the center and making sure that nobody is using the equipment incorrectly and risking injury.

Membership of Supreme entitles an individual to gym access at any of the company's locations at any time during their opening hours, although on the Supreme database they will be linked to a preferred (usually their nearest) center. Membership contracts with Supreme obligate the member to pay monthly membership fees for a minimum of 24 months. Having signed a contract, members' are obligated to make payments for the full period. In addition to salaried employees, there are several freelance personal trainers operating at each fitness center. Members can arrange personal training sessions through Supreme. This can be done for individual sessions, or members can pay up front for blocks of ten sessions. Blocks of ten sessions are priced at the cost of nine sessions to incentivize members to purchase in this manner. Supreme pays 40% of the personal training fees received to the personal trainer when the sessions are provided.

Marketing

Marketing activity is controlled by Head Office. Expenditure has been cut in recent years, but the company invests in outdoor advertising and regards the fashionable locations of some of its centers as a key selling point for the Supreme brand. Recent promotional campaigns for these centers have focused upon benefits such as being able to 'Train where the celebrities live', 'Enjoy these unbeatable views' and 'Get fit in fabulous surroundings'. These messages are at odds with the dated appearance of the equipment and facilities inside some centers, and have helped to create some confusion over Supreme's brand image.

Unlike many of its competitors, Supreme's online presence is basic. Its website is limited to providing information on center locations, opening hours and fees. Members are not able to perform any transactions with the company online; they must set up their memberships and any personal training sessions in person at their local centers.

Financial performance 2017

The company is profitable. However, profits have been falling since 2015 and performance in 2017 has reflected the challenging market, with a fall in revenue of 5% and falling profit margin. This is blamed largely on the atmosphere of economic uncertainty, as Supreme has been unable to increase its membership fees in the current climate, membership numbers have dropped and operating costs have not fallen. Some directors on the board are optimistic that profit growth can be restored if the correct strategy can be found. Others argue that the company should take measures to reduce costs before the company pursues any growth targets.

Summary financial statements for Supreme for the three years ended 30 September 2017 are shown in Appendix 1.

Membership information for 2017 is shown in Appendix 2.

Performance of individual Fitness Centre is shown in Appendix 3.

Working capital

Most sales by the company are paid for by direct debit or credit card. On signing a membership contract the first month's membership is paid immediately, with the remaining 23 payments due on the same day of the next 23 months.

Members purchasing personal training sessions pay in advance when they arrange a session. If ten sessions are purchased these are also paid for up front.

In accordance with HKFRS 15, Supreme recognizes revenue in line with the provision of related services. Therefore memberships and personal training fees received in advance lead to the recognition of deferred income.

Cash, dividends and share price

Wendy Leung, the CFO of Supreme, is proud of the fact that the company is 'cash rich'. In view of the company's continued profitability and strong cash position, the board of directors has managed to sustain a policy of high dividend payouts. As major shareholders in the company, the Hau family strongly supports the high dividend payout policy. This has continued in 2017.

The company has 100 million shares of HK\$0.1 each in issue. The earnings per share for 2017 were HK\$0.163 (calculated as HK\$16.3m / 100,000,000 shares). The company's share price is currently HK\$4.08, down from HK\$5.29 one year ago.

Recent incident

One of the Supreme fitness centres is located on a busy street in the Central District. The location makes it extremely popular with the population working in that area.

Two months ago, the centre manager left Supreme for a competitor following an argument over his bonus payment, and what he perceived as his excessive working hours due to a lack of staff to cover all of the busy shifts. While Supreme is searching for a permanent replacement, Edward Hau appointed his daughter, Julie Hau, taking up the position during the interim period. The appointment was completed with very little assessment of her suitability, due to the pressure on putting an interim manager in place to maintain the operations.

The building is relatively old and it has been 10 years since last refurbishment. The board of Supreme have been aware for some time that this fitness centre, is in need of refurbishment. Edward Hau, the COO of Supreme, was in possession of several reports attesting to this, but with the pressures on costs, there is an unwillingness to undertake the investment required. Edward has been told several times at board meetings that investment will not be sanctioned without the preparation of a formal business case. This he has so far failed to produce, citing work pressures.

Last month, part of the ceiling collapsed in the centre, breaking both arms of a member who was using a rowing machine and injuring many others with rubble and broken glass. Several staff members were also badly injured. The ceiling has now been repaired and the centre is gradually getting back to normal operations.

This was a public relations disaster for Supreme. The neighbouring business has taken to social media pointing out that Supreme was aware of the risk some time ago. In response, Supreme destroyed all the related reports it received and has chosen to deny having any communication regarding the needs of refurbishment. Edward Hau has told his daughter Julie Hau to do the same or she will risk jeopardising her position at Supreme. Julie Hau agreed.

Appendix 1: Summary Financial Statements for the three years ended 30 September for Supreme Fitness Limited

STATEMENT OF PROFIT OR LOSS

Year ended 30 September	2015 HK\$m	2016 HK\$m	2017 HK\$m
Sales revenue	211.0	220.0	208.0
Staff costs	24.6	26.4	26.5
Outsourced labour costs	20.3	21.4	19.9
Occupancy costs	98.6	99.0	98.4
Depreciation	8.8	8.7	9.0
Advertising and marketing	3.0	5.2	4.5
Other operating expenses	<u>27.2</u>	<u>35.1</u>	<u>29.5</u>
Total operating costs	<u>182.5</u>	<u>195.8</u>	<u>187.8</u>
Profit before interest and tax	28.5	24.2	20.2
Interest payable	1.0	1.1	1.1
Interest income	<u>0.4</u>	<u>0.2</u>	<u>0.3</u>
Profit before taxation	27.9	23.3	19.4
Income tax expense	<u>4.5</u>	<u>3.7</u>	<u>3.1</u>
Profit after taxation	23.4	19.6	16.3
Dividends	14.2	11.6	11.6
Retained profit	9.2	8.0	4.7

Notes:

- 1 The majority of sales are by credit card or cash for the first month, and then direct debit from member bank accounts thereafter.
- 2 Staff costs comprise salaries and related costs for the 150 staff based in the ten fitness centres, plus 20 staff at head office.
- 3 Occupancy costs consist of rental costs and other operational costs associated with building occupation, such as utilities.

SUMMARY STATEMENT OF FINANCIAL POSITION

Year ended 30 September	2015 HK\$m	2016 HK\$m	2017 HK\$m
Non-current assets			
Leasehold improvements	87.0	91.7	95.9
Fixtures, fittings and equipment	5.0	4.2	3.0
Gym and other equipment	6.2	5.1	3.3
Total non-current assets	<u>98.2</u>	<u>101.0</u>	<u>102.2</u>
Current assets			
Inventory	1.8	2.1	2.0
Receivables	3.5	3.2	3.4
Cash	8.6	16.0	16.7
Total current assets	<u>13.9</u>	<u>21.3</u>	<u>22.1</u>
Total assets	<u>112.1</u>	<u>122.3</u>	<u>124.3</u>
Current liabilities			
Payables	16.5	15.2	14.0
Deferred income	9.0	9.5	10.0
Borrowings	25.0	28.0	26.0
Total current liabilities	<u>50.5</u>	<u>52.7</u>	<u>50.0</u>
Equity			
Share capital	10.0	10.0	10.0
Reserves	51.6	59.6	64.3
Total equity	<u>61.6</u>	<u>69.6</u>	<u>74.3</u>
Equity and Liabilities	<u>112.1</u>	<u>122.3</u>	<u>124.3</u>

Note: Borrowings represents a HK\$40m revolving credit facility from Supreme's bankers which has been agreed until 2019.

STATEMENT OF CASH FLOWS

Year ended 30 September	2015	2016	2017
	HK\$m	HK\$m	HK\$m
<i>Cash flows from operating activities:</i>			
Profit before tax	27.9	23.3	19.4
Depreciation	8.8	8.7	9.0
Net interest paid	0.6	0.9	0.8
(Increase)/decrease in receivables	0.2	0.3	(0.2)
(Increase)/decrease in inventory	(0.2)	(0.3)	0.1
Increase/(decrease) in payables	0.5	(1.3)	(1.2)
Increase/(decrease) in deferred income	0.3	0.5	0.5
Cash generated from operations	<u>38.1</u>	<u>32.1</u>	<u>28.4</u>
Net interest paid	(0.6)	(0.9)	(0.8)
Dividends paid	(14.2)	(11.6)	(11.6)
Income tax paid	(4.5)	(3.7)	(3.1)
Net cash from operating activities	<u>18.8</u>	<u>15.9</u>	<u>12.9</u>
<i>Cash flows from investing activities:</i>			
Acquisition of property, plant and equipment	(34.0)	(12.2)	(11.2)
Proceeds from sale of plant and equipment	8.5	0.7	1.0
Net cash used in investing activities	<u>(25.5)</u>	<u>(11.5)</u>	<u>(10.2)</u>
<i>Cash flows from financing activities:</i>			
Increase/(decrease) in borrowings	2.0	3.0	(2.0)
Net cash from financing activities	<u>2.0</u>	<u>3.0</u>	<u>(2.0)</u>
Net increase/(decrease) in cash and cash equivalents	(4.7)	7.4	0.7
Cash and cash equivalents at 1 October	13.3	8.6	16.0
Cash and cash equivalents at 30 September	<u>8.6</u>	<u>16.0</u>	<u>16.7</u>

Appendix 2: Membership and Revenue by Location

Year ended 30 September 2017

Revenue and members per centre

Centre	1	2	3	4	5	6
Members	1,496	2,431	1,870	1,309	2,618	2,244
Revenue:	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Subscriptions	11.2	18.2	14.1	9.8	19.6	16.8
Personal training	4.0	6.5	5.0	3.4	7.0	6.0
Sundry sales	1.4	2.3	1.7	1.4	2.5	2.2
Total	16.6	27.0	20.8	14.6	29.1	25.0
Centre		7	8	9	10	Total
Members		1,496	1,309	935	2,992	18,700*
Revenue:		HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Subscriptions		11.2	9.8	7.0	22.5	140.2
Personal training		4.0	3.5	2.4	8.0	49.8
Sundry sales		1.4	1.3	1.0	2.8	18.0
Total		16.6	14.6	10.4	33.3	208.0

*Membership at 1 October 2016 was 20,466. During the year, 11,357 new members joined Supreme Fitness and 13,123 memberships lapsed.

Appendix 3: Performance of Individual Fitness Centres

Year ended 30 September 2017

	Centre 1	Centre 2	Centre 3	Centre 4	Centre 5	Centre 6	Centre 7	Centre 8	Centre 9	Centre 10	Total
Centre size (sqm)	1,900	2,200	2,100	1,800	2,200	2,200	1,800	2,000	1,400	2,400	20,000
Members at 30.9.2017	1,496	2,431	1,870	1,309	2,618	2,244	1,496	1,309	935	2,992	18,700
Staff	12	18	16	13	19	17	14	13	10	18	150
Personal trainers	6	9	8	6	10	8	7	6	2	8	70

	Centre 1	Centre 2	Centre 3	Centre 4	Centre 5	Centre 6	Centre 7	Centre 8	Centre 9	Centre 10	Total
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
Revenue	16,640	27,040	20,800	14,560	29,120	24,960	16,640	14,560	10,400	33,280	207,997
Staff costs	1,872	2,808	2,496	2,028	2,964	2,652	2,184	2,028	1,560	2,808	23,400
PT costs	1,594	2,590	1,992	1,395	2,789	2,391	1,594	1,395	996	3,188	19,925
Occupancy costs	9,006	10,428	9,954	8,532	10,428	10,428	8,532	9,480	6,636	11,376	94,800
Advertising And marketing	360	585	450	315	630	540	360	315	225	720	4,500
Other operating expenses	<u>2,803</u>	<u>3,245</u>	<u>3,098</u>	<u>2,655</u>	<u>3,245</u>	<u>3,245</u>	<u>2,655</u>	<u>2,950</u>	<u>1,056</u>	<u>4,540</u>	<u>29,491</u>
Operating profit	1,005	7,384	2,810	(365)	9,064	5,704	1,315	(1,608)	(73)	10,648	35,881
<i>HO cost</i>											
<i>Allocations:</i>											
Depreciation	855	990	945	810	990	990	810	900	630	1,080	9,000
Head office staff costs	312	312	312	312	312	312	312	312	312	312	3,120
Head office occupancy costs	<u>360</u>	<u>360</u>	<u>360</u>	<u>360</u>	<u>360</u>	<u>360</u>	<u>360</u>	<u>360</u>	<u>360</u>	<u>360</u>	<u>3,600</u>
Profit before Interest and tax	(522)	5,722	1,193	(1,847)	7,402	4,042	(167)	(3,180)	(1,375)	8,896	20,161

Assumptions made by the business analyst:

Staff costs = number of staff at each centre × HK\$156k

PT costs = 40% of PT revenue

Head office occupancy HK\$3.6m, divided equally between the centres

Occupancy cost allocation = HK\$98.4m – HK\$3.6m for head office / 10 centres = HK\$9.48m average (adjusted for actual sqm at each centre)

Depreciation = HK\$9m / 10 centres (adjusted for actual sqm at each centre)

Head office staff 20 × HK\$156k = HK\$3.12m, divided equally between the centres

Advertising and marketing HK\$4.5m, divided between the centres according to number of members

Your Action

You are a Hong Kong Certified Public Accountant working in the Business Analyst Team under Edward Hau, COO. This morning, he showed the team below email.

Edward Hau is planning to have your team presenting the immediate next steps and a business proposal for improving company performance to Frank Hau, the Chairman and David Hau, the CEO.

The immediate next steps should also consider any applicable ethical requirements and a plan to restore the image of the Company.

They target to have a 15-page Business Proposal starting with an executive summary not more than 5 pages.

