KerrisdaleCapital

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ClubCorp Holdings, Inc. (MYCC)

Countering the Bulls

In the wake of our report on ClubCorp Holdings, several equity-research analysts have attempted to refute our arguments. Their notes focused on four major themes:

- The extent and nature of ClubCorp's capital expenditures
- The escheatment risk and tax implications of the company's membership deposit liability
- The track record of the company's acquisitions and their effects on consolidated ROICs
- The decade-long same-store revenue-growth track record we compiled

Below, we summarize all the substantive equity analyst responses we're aware of and explain why we think they're wrong. We continue to believe that ClubCorp is dramatically overvalued.

Maintenance Capital Expenditures

> *Argument #1 in defense of ClubCorp:* Several analysts reiterated their belief that "reinvention capital spending" is very different from "maintenance capital spending" and that, if we would just visit the clubs, we'd see this for ourselves. Most of the "reinvention" capex happens at newly acquired properties that ClubCorp invests heavily in to invigorate dues and membership growth.

We don't dispute that what ClubCorp labels "maintenance capital expenditures" and "reinvention capital expenditure" are qualitatively different. Maintenance capex is capex that has to be done at every club every year. Reinvention capex is capex that has to be done at every club every ten to fifteen years or, equivalently, capex that has to be done every single year at a significant percentage of clubs. From a consolidated point of view, every year will include a large dose of reinvention capex, and thus we *are* disputing that a proper assessment of ClubCorp's long-term cash flows can exclude reinvention capex.

As one illustration, the capital-expenditure disclosure in ClubCorp's 2014 10-K supports our view that so-called "reinvention" is actually a routine, never-ending process:

> For fiscal years 2007 through 2014, we have invested more than $480.0 million of capital to better position and maintain our clubs in their respective markets. This represents an investment of approximately 7.9% of our total revenues, for such period, to reinvent, upgrade, maintain, replace and build new and existing facilities and amenities focused on enhancing our members' experience. From 2007 through 2014, we "reinvented" 33 golf and country clubs…

ClubCorp added fewer than 10 net new golf clubs over the 2007-2014 time frame, yet it "reinvented" 33, showing that clubs that have long resided in ClubCorp's portfolio – not just new acquisitions – require periodic "reinvention." (In particular, none of the capex in this period pertained to the Sequoia golf clubs, which ClubCorp only purchased in the fourth quarter of 2014.)

In fact, based on our industry research, we believe that "reinventing" only 33 clubs in 8 years – which, given the size of ClubCorp's portfolio, implies approximately 25 years between successive reinventions at a given club – is unusually stingy. This apparent underinvestment (taking place during the years when ClubCorp was owned by the private-equity firm KSL) may have contributed to ClubCorp's historically anemic same-store growth. For instance, we estimate that, from 2005 to 2014, revenue per club only increased by a cumulative 10%, for an annualized growth rate of about 1%. At a portfolio level, there is little evidence that ClubCorp's approach to reinvention has ever driven unusually rapid growth.

Will ClubCorp's past reinvention activity at least grant it a reprieve from future capex, as one analyst has argued? We doubt it. Even with 33 clubs having been "reinvented" from 2007 to 2014 and another 19 in 2015 (mostly from the acquired Sequoia portfolio), about two thirds of ClubCorp's clubs haven't been "reinvented" in close to a decade. Soon enough, they too will need overhauls. We therefore don't expect a significantly lower level of reinvention or maintenance capex going forward.

> *Argument #2 in defense of ClubCorp:* Other private clubs are not comparable to ClubCorp because they don't have the same disciplined return hurdles. ClubCorp's pre-IPO maintenance capex is also irrelevant because part of it pertained to hotels that ClubCorp used to own.

Our capital-expenditure analysis was based in part on comparing ClubCorp clubs to industry benchmark data and to ClubCorp's own historical performance. Notwithstanding our critics' complaints, both comparisons are valid and informative.

First, while it's true that member-owned clubs don't have profit-driven return hurdles, ClubCorp still has to compete with those clubs and, in order to do so, must provide a similar (and frequently higher) level of services and amenities. Similarly, in the world of retail, Amazon may not have the same return hurdles or near-term profit targets as traditional, higher-margin brick-and-mortar stores, but that makes it *harder,* not easier, for such stores to compete successfully. Just as they must at least maintain parity with Amazon's features and benefits, ClubCorp must keep up with member-owned clubs, no matter what their economic motives.

Second, adjusting ClubCorp's historical capex to exclude hotel-related spending does not alter our conclusions; indeed, it's a factor we already weighed. ClubCorp's 2005 10-K informs investors that, "for 2005, we expended approximately $68 million in maintenance capital, and we anticipate spending approximately $69 million in 2006 for maintenance capital." Our analysis assumed that the resort operations spent 7-8% of revenue on maintenance capex

(conservatively *higher* than the 5-6% levels that high-end hotels and resorts typically guide to), leaving an estimated $50 million of maintenance capex tied to the golf and business-club operations.

With a golf-club portfolio that is now 60% larger than it was in 2005, ClubCorp management is guiding investors to a maintenance-capex level that is *lower in nominal dollars* than it was in 2005. It defies common sense. Meanwhile, simply scaling up the 2005 figure to account for the expansion of the portfolio and a modicum of inflation results in a maintenance-capex estimate of approximately $85-90 million, or about 8% of projected 2016 revenue.

More broadly, our view of capex is a synthesis of observations from many different sources, including interviews with club general managers, industry benchmark data, ClubCorp's own financial results, and ClubCorp's depreciation accounting. It is no coincidence that all of these methods arrived at the same conclusion: normal, recurring capital expenditures are in the range of 8-10% of revenues.

> *Argument #3 in defense of ClubCorp:* ClubCorp has provided multiple examples of new membership growth and above-average dues increases (at mid-single-digit to high-single-digit percentage rates) as evidence that reinventions drive growth.

A few individual examples of reinvention projects don't prove that reinventions drive overall growth. After all, ClubCorp reinvented a third of its portfolio in the eight years between 2007 and 2014 yet still only achieved meager same-store sales growth. Indeed, many ClubCorp analysts we've spoken with have admitted that, despite the stories they've heard about individual clubs, any effect is too small to be able to "point to it in the numbers." In the end, of course, the numbers, not the stories, are what count.

Membership Deposits

> *Argument #1 in defense of ClubCorp:* The company doesn't believe that membership deposits are escheatable back to the states and insists that it has robust legal arguments to defend itself. Additionally, the rating agencies don't treat membership deposits as true liabilities.

In our report, we ourselves quoted ClubCorp's 10-K disclosures asserting that the company does not believe that its members' refundable deposits are escheatable to the states. But the fact that many of the states in which ClubCorp conducts business have hired auditors to investigate these deposits is a good indication that the issue is not so cut and dried. If ClubCorp's case were so strong, why would it have to disclose ongoing audits for three straight years? We also put little stock in the rating agencies' assessment of the deposits; this would hardly be the first time that they underestimated the importance of contingent liabilities.

While we agree that large-scale escheatment is unlikely, our primary argument is that ClubCorp's current equity valuation leaves no room for error on this front. The downside risk is real, but investors aren't being compensated for bearing it. Indeed, our discussions with ClubCorp equity and debt holders have confirmed that, prior to our report, few had given the tail risks serious thought.

> *Argument #2 in defense of ClubCorp:* ClubCorp is paying taxes on the member deposits as they are amortized through the income statement. If the membership deposits are escheatable, then the company will get a tax refund. Overall, in the words of one firm, "ClubCorp has fully accounted for its tax liability as appropriate."

We never claimed that ClubCorp has failed to properly account for its deposit or tax liabilities. The problem isn't the accounting; the problem is stakeholders treating the accounting as pure fiction rather than a reasonable reflection of economic reality. Moreover, many analysts seem to confuse tax and accounting issues pertaining to the *discount* on ClubCorp's membership deposits (created because they're recorded as present value, not gross value) with those pertaining to the deposits themselves. Our understanding is that membership deposits are generally treated for tax purposes as the property of the members, not as income; indeed, historically, this advantageous tax treatment was a major motivation for clubs to use deposits rather than straightforward fees. The passage below, taken from a 2011 *National Law Review* article, details how such deposits stopped being seen as a boon:

> The club industry has dramatically changed its perception of refundable membership deposit structures for clubs. Once viewed as the preferred structure, refundable membership deposit structures are avoided like the plague.
>
> Under the traditional refundable membership deposit structure, a club charges a membership deposit to join the club, which is repaid in 30 years or after the member resigns or dies and the membership is reissued. … Membership deposits were hugely popular with for-profit club owners because of the income tax advantages and their popularity among potential members who liked the idea of getting their money back. Membership deposits are treated as debt, and therefore, club owners are not required to pay federal income tax on membership deposit proceeds. The result was that many club owners were able to raise huge amounts of funds, tax free, which the club owner was able to use for any purpose, including reimbursement for development, reserves or even distributions to partners. Although the membership deposits are debt, they were generally not viewed as regular debt in the valuation of clubs…
>
> The perception of membership deposit programs began to change in the early 2000's when resigned member sell lists grew [*i.e. attrition increased*]. … [P]rospective club purchasers, investors and appraisers began to view membership deposit[s as] debt, the same as any other unsecured debt. Club owners with significant membership deposit liability found that the amount of the membership deposit debt exceeded the value of the property, often limiting or even eliminating a club sale as an exit strategy. Many owners

of membership deposit clubs have resorted to bankruptcy or transferring the club property to their lenders to address the membership deposit debt problem.

In short, what many ClubCorp bulls regard as a non-issue has actually driven some of ClubCorp's peers into bankruptcy. They too had likely argued that it was all just meaningless accounting.

The Failure of ClubCorp's Acquisition Strategy

Argument #1 in defense of ClubCorp: Acquisitive companies usually see ROIC fall in the short run but then rebound and grow. If ClubCorp makes no further acquisitions, EBITDA and returns will ramp up significantly into 2018; ClubCorp is targeting $300mm of EBITDA by 2018, up from $233mm in 2015. This goal implies that the company will achieve its targeted return of 17% EBITDA to cash invested.

Pre-Tax Returns on Average Tangible Invested Capital (ROTIC)

(*$ in mm*)	2010	2011	2012	2013	2014	2015	
Operating profit*	$ 68	$ 62	$ 86	$ 76	$ 79	$ 89	
EBITDA − capex	92	83	100	86	86	84	
Average tangible invested capital**	**$ 1,023**	**$ 993**	**$ 970**	**$ 956**	**$ 1,082**	**$ 1,238**	
Pre-tax ROTIC, based on:							**Average**
Operating profit	***6.7%***	***6.3%***	***8.8%***	***7.9%***	***7.3%***	***7.2%***	***7.4%***
EBITDA − capex	***9.0%***	***8.4%***	***10.3%***	***9.0%***	***7.9%***	***6.8%***	***8.6%***

Source: company filings, Kerrisdale analysis

** Operating profit represents EBITA (EBITDA less depreciation).*

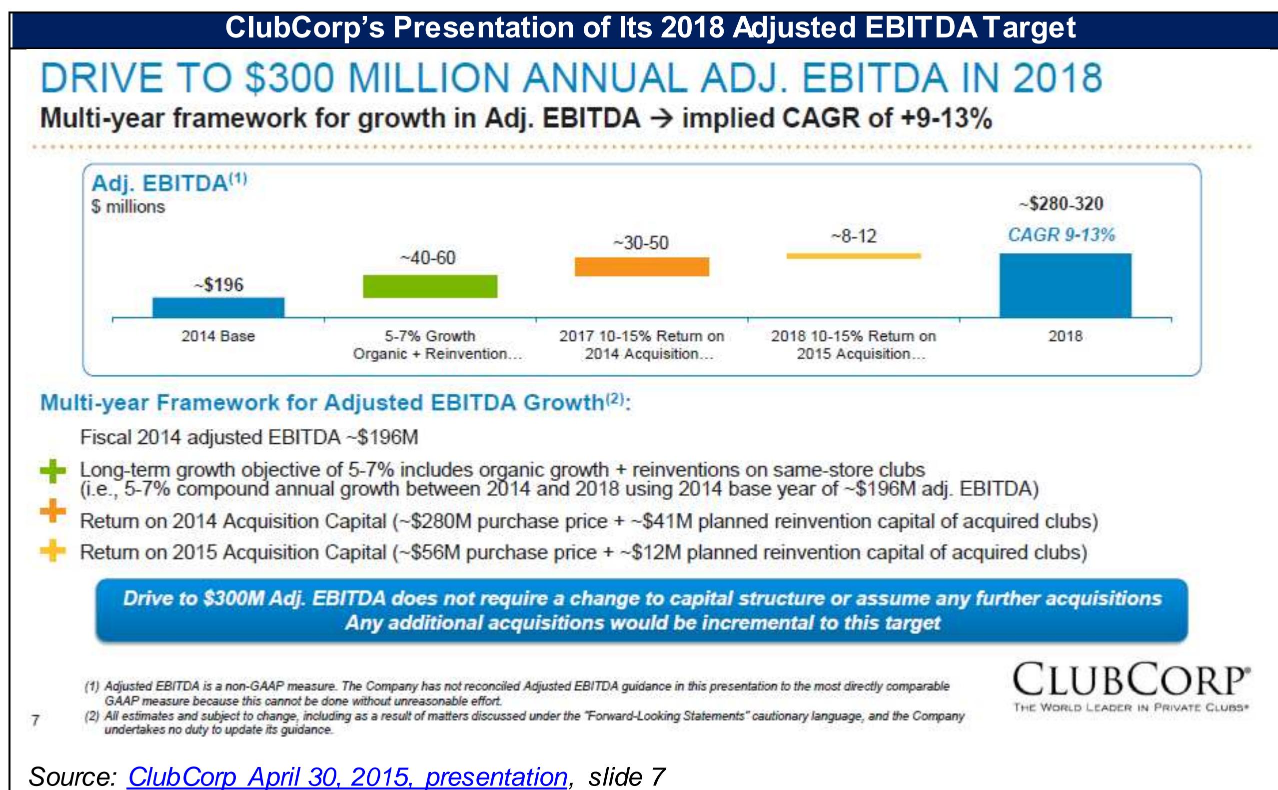
*** Tangible invested capital is adjusted for fixed-asset impairments and non-cash losses on disposition.*

One of the reasons that ROICs fall in the short run for acquisitive companies is that any goodwill and intangibles created in the deals inflate the invested-capital denominator. But we already adjusted for that factor in our report by primarily analyzing *tangible* invested capital, ensuring that we don't penalize ClubCorp for the premiums it paid historically. Even with that (arguably charitable) adjustment, ClubCorp's ROIC track record is poor. The table above also shows that returns on tangible invested capital were weak even before the large 2014 acquisition of Sequoia, showing that even the bolt-on acquisitions that ClubCorp did in 2010-2013, most of which were presumably fully integrated by year-end 2013, did little to enhance the company's returns on capital.

Regarding ClubCorp's $300mm 2018 Adjusted EBITDA target (introduced during the company's 2015Q1 earnings call), we note that, based on the company's own guidance, a majority of the EBITDA increase is expected to come from the company's 2014-year-end portfolio, with

assumed same-store sales growth for those clubs in the 5-7% range, a level that has not been achieved in any of the last five years. That guidance has also not changed in the year since the company introduced it and proudly noted that it assumed no further acquisitions. Yet it acquired three clubs in just the last four months, surely making its EBITDA target easier to hit without necessarily adding any economic value.

ClubCorp's Presentation of Its 2018 Adjusted EBITDA Target



Source: ClubCorp April 30, 2015, presentation, slide 7

ClubCorp's guidance also implies adjusted EBITDA to invested capital of only 12.5% on the Sequoia deal. After accounting properly for long-term maintenance capex, the pre-tax return falls to the mid-to-high single digits, close enough to the company's cost of capital to make the acquisition a wash, at best, in terms of shareholder value. Even if everything goes as planned for ClubCorp, the economics just aren't compelling.

> *Argument #2 in defense of ClubCorp:* Margins *have* expanded at the segment level, ~100bps for the Golf & Country Clubs (GCC) segment (in spite of a very tough year with 100-year storms) and ~200bps for the Business, Sports and Alumni Clubs (BSA) segment. Group-level margins have not increased simply because of $7mm of increased overhead costs related to being a public company and complying with the Sarbanes–Oxley Act.

ClubCorp Segment and Consolidated Adjusted EBITDA Margins, 2010-2015						
(*$ in mm*)	2010	2011	2012	2013	2014	2015
GCC Adjusted EBITDA margin	27.2%	27.5%	28.9%	28.7%	29.2%	29.2%
BSA Adjusted EBITDA margin	17.7%	19.0%	19.6%	19.0%	19.0%	20.3%
"Other" EBITDA as % of total revenue	(4.0)%	(4.2)%	(4.8)%	(4.6)%	(4.8)%	(5.0)%
Consolidated Adjusted EBITDA margin	***21.8%***	***21.8%***	***21.9%***	***21.7%***	***22.2%***	***22.2%***

Source: company filings, Kerrisdale analysis

As the table above shows, it's true that ClubCorp's segment-level margins have increased over the last few years. At the same time, though, centralized costs as a percentage of total revenue – what ClubCorp reports as "other" EBITDA – have increased at a pace that almost completely swamps the segment-level margin expansion. Of course, centralized costs are precisely the costs that – in a rollup model – should *fall* as a percentage of revenue, not rise. Once more we see that ClubCorp has, in net terms, gained almost nothing from scale.

Additionally, a quick glance at the above data indicates that, even at the segment level, over three quarters of the margin expansion took place between 2010 and 2012, when ClubCorp was still privately held and did not execute any major acquisitions. Just as the company's acquisition strategy began to ramp up in 2012-2013, margin expansion came to a halt, another indication that acquiring more clubs has not generated economies of scale.

Finally, note that the table above uses ClubCorp's own "adjusted" EBITDA figures, which already exclude many of the company's public-company and Sarbanes–Oxley costs.

Long-Term Same-Store Sales Growth

> *Argument in defense of ClubCorp:* It's not possible to compare the 2005 club portfolio to today's; there's been too much club turnover. Thus any long-term calculations drawing on 2005 same-store data are faulty.

The claim that the same-store clubs in 2005 and the same-store clubs in 2015 are not comparable because of turnover is simply wrong. ClubCorp has disclosed a detailed list of each of its clubs in every one of its 10-Ks, including the 2005 10-K. We've analyzed the datasets in each of the 10-Ks and found that, of the 159 clubs in the ClubCorp portfolio as of January 12, 2016, 88 were also in the ClubCorp portfolio at year-end 2005. Thus, of the 101 "same-store" clubs for which ClubCorp provides data in its latest 10-K, about 90% were also reported as same-store clubs in the 2005 10-K, making the comparison only slightly imperfect.

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