

Weight Watchers International, Inc. (NYSE:WTW), SHORT

April 26th, 2011

PointsPlus can't revive WTW

Tim Chen

Investment Thesis: Weight Watchers International (WTW) presents a short opportunity for MII because PointsPlus will underperform and fail to revive a declining membership base. In turn, revenues will suffer and the lack of cost-cutting opportunities will lead WTW to face strong liquidity issues.



Misperception: The launch of PointsPlus in November 2010, an upgrade to WTW's revolutionary weight-loss Points system introduced 13 years ago, means potentially more new customers. Because PointsPlus guides users toward a healthier lifestyle, those using the program will see more long-term benefits, experience faster weight loss, and be more likely to stay members for life.

Correction: The launch of PointsPlus comes with a subliminal agenda: it was a desperate measure to revive the membership base and generate revenues. In January 2007, majority-owner PE firm Artal Group convinced WTW to repurchase 19% of its total shares through a \$1.025B debt-financed tender offer, increasing WTW's debt from \$830M to \$1.8B. Since 2006, attendance has decreased by 16.5%, including the fact that from 2006-2008, WTW acquired multiple franchises, in turn "buying" attendance levels. Furthermore, WTW implemented the monthly pass (MP) program, in which members pay a rough 20% discount versus paying-on-the-go (PAYGO); however, members actually end up paying a premium because average monthly attendance is approximately 51%. These two key drivers, paid weeks based on attendance levels and growth of MP conversions have been used to sustain revenues in 2006. However, WTW now has few strong, large franchises to acquire to sustain inorganically attendance levels. Furthermore, PointsPlus will backfire because it eliminates previous switching costs and alienates current members, leading members back to the PAYGO model. Both will impair WTW's ability to generate revenues and therefore make timely debt payments.

Key Points

1. Declining attendee level undermine WTW's ability to generate future revenues
 - a. MP conversion growth may slow or decline as struggling members on PointsPlus switch back to PAYGO. WTW uses "average meeting fee per attendee" metric to show a 3.2% CAGR in meeting fees per attendee from 2006 to 2010. However, **the increase in this metric arises because not all members who purchase MP attend all the meetings for which they have paid.** As of 2010, MP revenues contributed to 76% of meeting paid weeks. According to management, **MP members attend 1.8x meeting per month and PAYGO members attend 3.0x meetings per month.** Furthermore, MP prices have not risen since 2006 and the market for MP is likely to be hitting a saturation wall given the low attendance frequency relative to PAYGO members. Furthermore, if members find PointsPlus difficult to maintain, they may convert back to PAYGO.
 - b. There is a lack of opportunities for inorganic growth. **From 2006 to 2010, total attendance in company-owned operations has declined 16.5%.** This is conservative given that the company aggressively acquired scalable franchises and counted those acquired attendees as growth as well as booked additional revenue (100% meeting fees rather than 10% royalties). There aren't a whole lot of franchises left that are scalable to acquire (17% are still franchised). WTW also has few cost-cutting opportunities. It currently outsources production of its products, pays low fixed costs for leased meeting areas, and pays its leaders near minimum wage.
 - c. To sustain in-meeting product revenues, **WTW is decreasing the sizes of its products but not the price.** Therefore, the member has to buy more. WTW's 2010 in-meeting product sales increased 3.6% from 2009 to \$260.5M and on a per attendee basis, global in-meeting product sales increased 10.3%. **But attendee levels are shrinking.** There will eventually be an inflection point where the rise in price will not lead to more product purchases but rather backlash from consumers.
2. The PointsPlus system eliminates switching costs and skews the perception of healthy foods
 - a. PointsPlus eliminates existing switching costs from Points. WTW's business relies on customers to buy into its weight-loss programs. The **new plan alienates current Points plan members** because it allots points based on a more complex formula that changes the weekly point system and point values of foods – **a new kind of math that requires a complete overhaul in recalculation of what had been ingrained.** Current members essentially become just as "new" as new members. Furthermore, PointsPlus completely replaces the old system. **Some people were drawn to the Points system by the idea that it was an anti-diet** because you could eat whatever you wanted as long as you gauged the portion, counted the points, and if necessary, sacrificed elsewhere. This was because the old system regarded all calories as the same: "if you ate 100 calories of butter or 100 calories of chicken, it was all the same. Now we know that is not the case." Says Karen Kovach, chief scientific officer of WTW and creator of both Points system formulas. The new system shifts consumers' perception of the plan into that of a diet; one member on the WTW forum states: **"I feel like I am being forced to 'diet,' and that is what I DO NOT WANT."** The new plan is harder than the old plan and therefore converting new members would be even harder. To make things worse, the two systems can't be mixed: **"Essentially we are retiring the Points plan,"** says Kovach, **"You can't mix the new system with the old one."** Resources on the website and other WTW products will be replaced by the new system alienating current members who are struggling with PointsPlus and possibly losing them. In turn, WTW's membership will continue to decline, hampering WTW's ability to generate future revenues.
 - b. Changing the points system changes the way people manage their points because of relative perception. According to a study done on WeightWatchers.com's by Elly Mc Nerney, an editor on WeightWatchers.com, members are struggling to meet their points target because the old system **allotted 18 points but the new system allots 29. That's more than a 50% increase.** For example, under the old program, a banana cost the same points values as a 100-calorie pack of cookies: 2. When the member realizes that under the new program bananas cost 0 points and the cookies 3 points, eating the banana becomes the

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<p>better choice because the member will still have the same amount of PointsPlus to spend as before. Although this choice emphasizes a healthier lifestyle, and does what PointsPlus was designed to do, members have actually stopped eating all snacks with PointsPlus values, even when they have points to spare. The second reason is because members are focusing entirely on “bargains.” Although foods have not changed, points have, creating a wider gap in perception of “what is healthy and “what is not”. Grain and starches are important to nutritional health but members are avoiding these because they have gone up in points. Instead of picking foods that give them a healthy, varied diet, members are picking foods that allow them to stash PointsPlus values. In turn, they are not losing weight on PointsPlus. Members may then find alternatives to weight-loss programs.</p>		
<p>3. An over-leveraged balance sheet, sensitive marketing spending, and lack of “real assets” undermine WTW’s value</p> <p>a. WTW may face liquidity problems in the near future. The company has a debt to equity ratio of -168%, a current ratio of 0.3, and debt leverage ratio slightly below 3.0x. While WTW is managing to pay off its short-term portion of long-term debt, if PointsPlus proves unsuccessful, operating income will be drastically impaired and WTW may be in financial distress. The company has strict debt covenants that prohibits a leverage ratio greater than 3.0 and WTW has been playing near the cliff. Any indication that WTW will break the covenant and be unable to pay off its debt will lead to backlash.</p> <p>b. WTW must periodically remind consumers of its programs and recent developments in order to retain and gain members. In Q2 2010, WTW launched a new initiative featuring Jennifer Hudson that focused on member experiences. The results have been disastrous: compared to prior year periods, Q2 2010 paid weeks and attendance declined 1.8% and 4.9%, respectively, while in Q3, paid weeks increased by 2.8% and attendance improved to a decline of 3.8%. Overall 2010 paid weeks decreased by 0.8%. Furthermore, although internet revenues grew by 21.8% and membership by 38%, this was a result of the introduction of PointsPlus and is not sustainable (see exhibit 1). Total daily reach is dropping back to early 2010 levels. 93% of weightwatcher.com’s visitors go to weightwatchers.com, rather than a subdomain, but the bounce rate is at 25%, meaning one in four visits contain a single page view. Those who do stay, however, spend roughly 7 minutes on the website. The data indicates that viewing trends on weightwatchers.com is moving back towards pre-2010 levels.</p> <p>c. An overwhelming amount of WTW’s assets are intangibles (5 year average: 71.8%). As of EOY2010, net intangibles totaled \$795.83M, of which, \$656.6M or 82.5% account for carrying values of franchise rights acquired globally. WTW claims in its 2010 10K that “...approximately 90% of the carrying values of our franchise rights acquired had fair value of at least three times their respective carrying amounts.” The value of franchise rights are calculated based on growth rates and future cash flows. This is a fluffy accounting measure and any negative impact on WTW’s brand or services provided (such as PointsPlus) may cause WTW’s “assets” to be impaired. There aren’t a whole lot of real, tangible assets in the company.</p>		
<p>Catalysts</p> <ul style="list-style-type: none"> • Violation of a debt covenant or inability to pay off short term debt. • Weak marketing strategy does not capture new members or motivate current members, continuing the decline in attendees. • Miss earnings 		
<p>How It Plays Out</p> <ul style="list-style-type: none"> • WTW misses Q1 or Q2 earnings due to inability to sustain revenues through PointsPlus and inability to revive a declining membership base. • WTW can’t generate enough cash flow to meet outstanding debt obligations, breaking debt covenants. • WTW is forced to cancel its dividend payments and Artal may force equity raising, franchising, or sales, which contradicts WTW’s current strategy. 		
<p>Risks / What Signs Would Indicate We Are Wrong?</p> <ul style="list-style-type: none"> • WTW Leaders are very successful at transitioning members to the new program and helping them stay disciplined. • 2010 Q4 Earnings call indicated declining membership base was due to consolidation of meeting network to focus on strongest members, leaders, and time slots. Through this re-organization, WTW is able to restructure itself from the inside and slowly propagate outwards once again with PointsPlus. • WTW shows no strong indication that it may default on its loans; PointsPlus is successful going forward and the company is able to pay off a substantial amount of its debt. • WTW renegotiates outstanding covenants or tries to work out financial distress out of court with creditors • If PointsPlus is able to increase meeting attendance levels and encourage members to stay on the program (see exhibit 2) 		
<p>Signposts / Follow-Up</p> <ul style="list-style-type: none"> • Prices of monthly passes, in-meeting products, and online registry. • Measure attendee level and membership base • WTW’s cash flow and ability to pay off short-term debt 	<p>Company Description: WTW is a global diet, nutrition, and weight management service provider which sells its products through meeting operations as well as online and to franchisees. WTW business is focused on key weight management systems and sales of branded consumables. WTW programs, management tools, and tracking tools are available on a subscription basis at Weightwatchers.com</p>	

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Exhibit 1

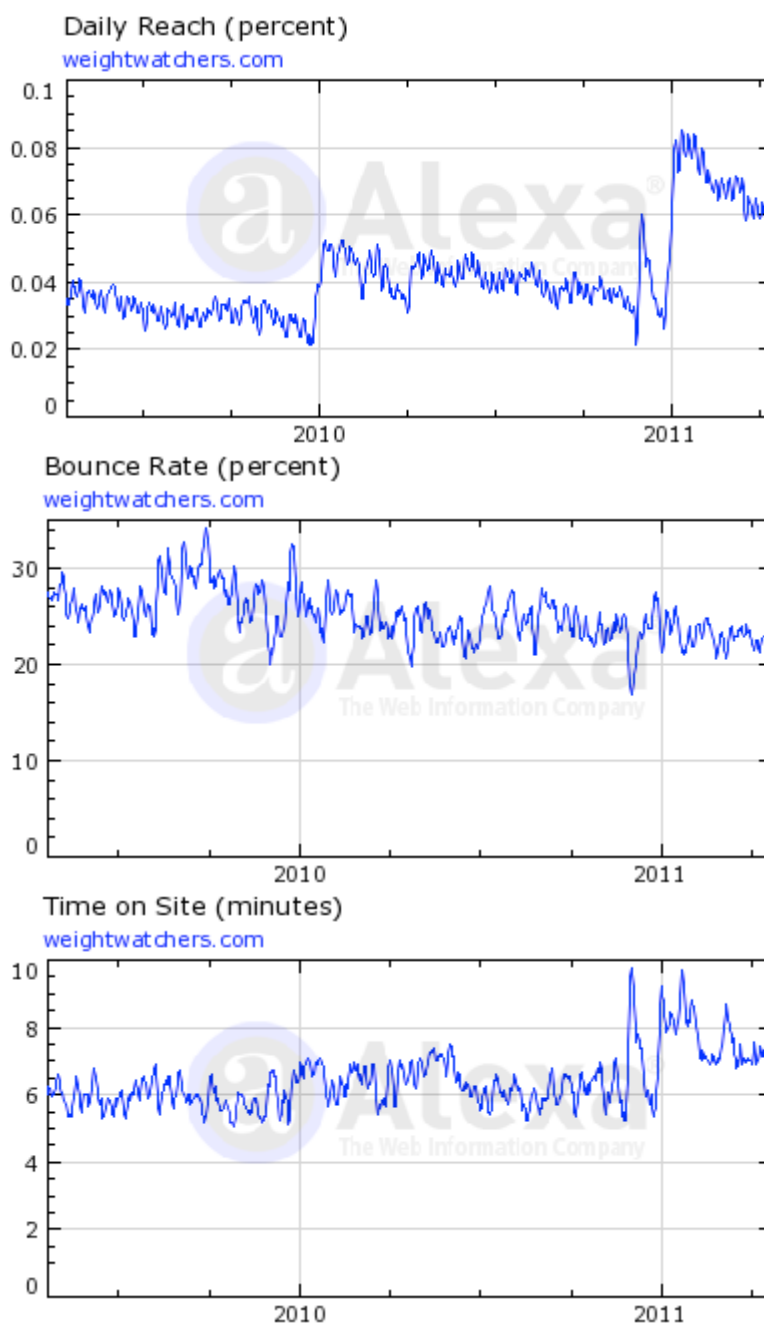


Exhibit 2

- Findings from a study done by Heshka et.al in weight loss with self-help compared with a structured commercial program (Weight Watchers was used in this study)
 - “The mean weight loss of Weight Watchers participants was 2.3 times more than the self-help group at one year, and essentially undefined at two years.”
 - Participants who participate in over 78% of the sessions maintain a mean weight loss of almost 10lb at the end of the 2-year study. After 2 years, 52% of the commercial group would lose enough to be considered experiencing “significant long-term weight loss.”**
- According to a study done by Dansinger, et.al in comparing four popular diets for weight loss –Atkins, Weight Watchers, Zone, Ornish, **Weight Watchers came in 3rd, with a mean weight loss of only 6.6lbs in 12 months. Adherence to the program was the main reason for “modest weight loss.” At the end of the study, 45% of the Weight Watchers’ participants had dropped out.** The most common reasons cited for discontinuation of the study were that the assigned diet was too hard to follow or not yielding enough weight loss.

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Exhibit 3: Analysis of Weightwatchers.com online community forum

An analysis of the top 20 hottest topics on weightwatchers.com indicates that topics about weight loss or Points Plus (most are negative reactions) are the most popular. While it is possible some members may post more than others in the topic, a topic's "popular" status is a proxy for how consumers feel. Also, there appears to be a problem with WTW's IT management of weightwatchers.com.

Type of discussion	Percent
Complaints about the forum/website	15%
Encouragement	20%
Confusion about Points Plus	45%
Other	20%

Thread Name	Started By	Date Created	Posts	Last Post
TWEAK THIS	lifetimemo	1/24/2011 6:34:41 PM	291	2/14/2011 3:42:11 PM by sugar~n~spice
How the PP vs Momentum debate game counting	wilderness2wander	2/8/2011 12:14:51 PM	166	2/25/2011 10:46:04 AM by louisstone
Going out on a limb here...	jas53787	2/17/2011 11:59:23 AM	164	2/18/2011 9:23:27 AM by luv2walk84
My 0.29 Worth	louisstone	2/14/2011 3:51:02 PM	159	4/16/2011 12:47:03 PM by homerun88
People struggling with PP: From WW CEO	emilyalie	2/10/2011 12:18:17 PM	149	2/13/2011 4:56:22 PM by losingbutt
OT: Jennifer Hudson on Oprah...ugh.what a waste	basilplant	2/10/2011 4:05:58 PM	127	2/16/2011 11:56:58 AM by dmacdots
new plan = disaster!	kate600	2/16/2011 8:00:03 AM	127	2/25/2011 4:46:36 PM by louisstone
How to deal with adult daughter and her weight/fo	taybi2	3/30/2011 12:16:36 PM	125	3/31/2011 6:50:25 PM by aknall
HO HO: WE'RE NUTS	psi336	2/17/2011 5:07:00 AM	120	2/18/2011 4:06:31 AM by llama.face
Board Pet Peeves	dramamama611	1/30/2011 9:39:52 AM	118	2/15/2011 7:43:47 AM by leblisa
MG Cafe	wildirishrose24	2/11/2011 6:07:56 PM	106	2/12/2011 8:23:00 AM by gramx8
MEAN BOARD FRIENDS	wildirishrose24	2/5/2011 5:46:36 PM	104	2/5/2011 10:37:58 PM by graveyardgirl
MG CAFE	lifetimemo	2/17/2011 5:30:56 PM	101	2/18/2011 12:57:50 PM by lpmssusan
I'm not trying to cause trouble...but	heatherrenee7094	1/24/2011 1:08:09 PM	100	1/30/2011 4:15:25 PM by aknall
9 weeks on new plan no loss	noceleryplease	1/22/2011 9:17:39 AM	99	1/27/2011 1:04:53 PM by noceleryplease
I hate Points Plus	pamd352	1/21/2011 10:49:48 AM	95	4/6/2011 11:06:12 AM by jillinea16
Debbie Downer reporting...	jaxx4694	1/21/2011 11:49:51 AM	94	3/5/2011 11:23:05 AM by jenrekudi
MG CAFE	lifetimemo	3/17/2011 5:34:42 PM	94	3/18/2011 7:58:58 AM by lifetimemo
who has gone ba	cathych19	1/22/2011 7:29:12 PM	93	2/12/2011 11:04:06 AM by barbara31655
HO HO: WE'RE NUTS	psi336	2/16/2011 5:43:25 AM	89	2/16/2011 8:46:11 PM by barefootgirl27

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Exhibit 3: VAR		
Janna Whearty Weightwatchers.com Forum Member	<p>"I had been on ww for about a year, and lost almost 50 lbs. I was going very slow, but steady and was very happy - the program was easy to follow and I was never hungry. When PP launched, I got completely discouraged, as most of the foods I was depending upon had gone up so much in points. I had it down to a science on the old program - I knew what I could and couldn't eat and now, I was starting over ... It sucks. I am starving constantly, I always go over points (and I never ever had to use weeklies before unless I was splurging on something special and even then only rarely) and despite the fact that I track religiously I have gained 6 lbs in two weeks. <u>I hate this, I feel completely lost and discouraged and like I need to find a new diet</u>"</p>	
Denise Ti Weightwatchers.com Forum member	<p>"I have been at my goal weight for almost a year now and have been on WW this time around for almost 2. <u>I lost my weight under the old points system and know it like the back of my hand. I also know the points values of all of my favorite foods by heart too and can track in my head each day. Now, WW has gone and changed the whole thing. I feel like if it ain't broke why fix it?</u> The old plan worked well for me and although I have tried to embrace the new plan I just can't. As far as I'm concerned the only good thin about it is the free fruit, lol. <u>But seriously how come we all get a minimum of 29 points? That's one thing my leader couldn't explain to us.</u> How some people who are still losing and people like me on maintenance could have the same number of points. <u>I also don't want to have to relearn all the points plus values now for my favorite foods and I can't calculate the points value in my head. Its too darn complicated if you ask me. What do you guys think?</u>"</p>	
Elizabeth Saunders Weight Watchers Facebook Group member	<p>I have tried the Points Plus program in good faith for three months now. On the old Points program, I lost 22 lbs in 2.5 months. While I agree that is a little faster than should be sustained long term, I have lost a grand total of 4 pounds in 3 months on Points Plus. It's like someone applied the emergency brake the minute the program changed. I have followed the PP program to the letter. In the first 16 days of March, I haven't dropped an ounce. <u>My leader tells me to focus on the weight I have already lost. She has absolutely no suggestions for identifying the problem.</u> I'm tracking. I'm following the nutrition rules. I'm exercising. Like mad. I don't want to focus on the weight I've lost. That is behind me. I'm looking forward. And going forward, PointsPlus doesn't seem to be working for me. Three months is long enough to "give the program time". While it's good to see that it's not just me, I also want a program that works.</p>	
Ellen Hookey Weight Watchers Facebook Group member	<p>Totally Agree Elizabeth!!! I decided tonight after my fiance and I have been doing WW since June on the Momentum plan and lost 60lbs and He's lost 106lbs that we were making the switch back....and as we were figuring everything out and pulling out old material....it was like a weight had been lifted....no pun intended...I already feel better just going back to what works...I felt awful tonight...<u>and all the leader keeps saying is keep trying....well I'm tired of trying for 3 months....they don't know what to tell people when PP doesn't work for them...</u></p>	
Facebook "WW meeting leader not up to date" forum topic	<p>"I was trying to talk to <u>my ww leader and she really doesn't grasp this new program</u> so its hard for me to understand..." – Marsha Farley "What our <u>leader told us is that NOTHING IS FREE.</u> The fresh fruits and most vegetables are 0 points. If you have too many of anything you need to count it." – Lynn Sirianni Morrison "... <u>our leader did not tell us that. She just told us they were a free food.</u>" – Lisa Christine Pearson "...but <u>my ww leader said only 2 pieces of fruit a day but shes pretty useless so I'm not sure.</u>" – Chloe Sams</p>	
Facebook "Worst customer service..." forum topic	<p>"I joined WW last month. I purchased the \$99 set of books and pedometer, points tracker... then they change the points system rendering my purchase USELESS. <u>I sent them an e-mail regarding a refund and I was told that I was ineligible. I am SUPER pissed off. I am ending my membership. I refuse to spend any more money on a company that doesn't respect it's customers.</u> I can't believe I fell for this crap." – Erin Barone "I totally feel you. I have 3 calculators (one at home, one at work and one in my purse), the books, and a scale that are absolutely no good now. <u>Let me tell you, I'm going to complain to my meeting leader and if nothing happens I'm ending my membership as well.</u>" – Kara Graff Hale</p>	
Jill Goodwin Palmer Weight Watchers member	<p>I just rejoined on April 21st. I came home totally confused and not understanding the new point system.... I do better going to the meetings because I know I have to weigh in. I find that other members are very helpful suggesting food that is low in points or keeping you motivated.... Where I go there is meetings every day, with different instructors. I would try out different ones to see who you like the best.</p>	
Andy Barker WeightWatchers Leader	<p>"It depends on your leader, but all of them will have had training on the new program and will have done the "Getting Started Session" talk at least a time or two with new members by now. If you've done Points before with WW, PointsPlus isn't too much different. The old Points were calculated by looking at the Calories, Fat, and Fiber. PointsPlus uses the Fat, Carbs, Protein, & Fiber to figure up the</p>	

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	<p>points. Also, the Facebook community is very helpful & supportive, so any questions your leader can't answer, you can probably find assistance from the friendly folks around here. Also, any leader worth their name badge would likely be willing to stay and go over any questions or difficulties you may have, and I say that as a leader myself =) I really hope you consider joining, but either way, I hope for success for your journey!"</p>	
Courtney Booth Weight Watchers member	<p>I am a lifetime member - Joined in August 2009 and continued to follow program even after hitting lifetime (although not as strictly). Ever since starting PointsPlus I have been gaining. I was never one to choose cookies over a banana, and am not into processed foods.</p> <p>It seems to me that the new program is great to encourage people to eat healthy - or "eat clean" as I call it. HOWEVER, I feel I have too many points. I am 5ft, and have the same points value as someone who is 5 inches taller than me - yet we are both supposed to lose?! Doesn't make sense to me.</p> <p>Thinking about calculating points for my fruits/veggies and lowering my daily point intake.</p> <p>Glad to see that I'm not the only one feeling this way - I feel like the odd girl out at my meetings.</p>	
Melanie Brede Dietician	<p>Nutrition science, like any field of research, is constantly being updated. Any given day, you may find news media reports of recently breaking research findings. In a more formal sense, the government releases the "Dietary Guidelines for Americans" update every 5 years (since 1990).</p> <p>In general, people quit diets when they find them unsustainable. Any number of reasons can cause this, such as schedule changes that interrupt meal prep, diet rules that are too rigid, inaccessibility of foods recommended on the diet, etc.</p>	
Michael Hertz WoodRogers Patent Lawyer	<p>In response to: "Weightwatchers.com bulletin boards police postings of its points value system, claiming its IP infringement. However, this is misleading, given that in the US, formulas alone can't be subject to patent protection due to <i>Gottschalk v. Benson</i>. Furthermore, the fact that WTW has not sued ConAgra Foods for labeling packages with Points values highlights the weakness of any trademark related"</p> <p>"WTW would have strong patent protection on its formula, if not, the program at large."</p>	
David Smith Corporate Finance Professor	<p>WTW doesn't seem like it is in strong trouble to pay off its debt (no news on Deal Pipeline), however, if PointsPlus negatively impacts revenues, it does appear that they may break certain debt covenants such as the one that states the debt leverage must be less than 3.0.</p>	

Exhibit 5

Expected Future Cash Flows	2010	2011	2012	2013	2014	2015
EBIT	\$ 356,000	\$ 366,680	\$ 377,680	\$ 389,011	\$ 400,681	\$ 412,702
- Taxes	\$ 113,208	\$ 116,604	\$ 120,102	\$ 123,705	\$ 127,417	\$ -
After-tax EBIT	\$ 242,792	\$ 250,076	\$ 257,578	\$ 265,305	\$ 273,265	\$ 412,702
+ Depreciation & Amortization	\$ 30,000	\$ 30,000	\$ 30,000	\$ 30,000	\$ 30,000	\$ 30,000
Gross Cash Flow	\$ 272,792	\$ 280,076	\$ 287,578	\$ 295,305	\$ 303,265	\$ 442,702
- Capital Expenditures (Δ GROSS Fi	\$ (11,000)	\$ (20,000)	\$ (20,000)	\$ (20,000)	\$ (20,000)	\$ (20,000)
- Change in Net Working Capital	\$ (348,700)	\$ (200)	\$ (200)	\$ (200)	\$ (200)	\$ (200)
Net Cash Flow	\$ 610,492	\$ 259,876	\$ 267,378	\$ 275,105	\$ 283,065	\$ 422,502
Terminal value						\$ 4,608,583
Expected Future Cash Flows		\$ 259,876	\$ 267,378	\$ 275,105	\$ 283,065	\$ 5,031,085
Discount Factor		1.08	1.17	1.26	1.36	1.47
PV of Expected Future Cash Flows		\$ 240,626	\$ 229,234	\$ 218,388	\$ 208,061	\$ 3,424,072
Enterprise Value	\$ 858,804					
Debt	\$ 1,365,080					
Cash	\$ 40,530					
Equity Value	\$ 2,906,510					
Shares outstanding (diluted)	73,000					
Equity Value / Share	\$ 39.82					



Last Trade 4/25/11:	\$78.59
Market Cap:	\$5.27B
52 week	\$24.47 - \$78.75
EV:	\$7.02B
P/E:	30x
EV/EBITDA:	16.74
Profit Margin	13.38%
Total Cash	\$40.53M
Total Debt	\$1.40B
Debt/Equity	-168%
Current ratio	0.35
Book value per share	-\$9.47

