KerrisdaleCapital

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ClubCorp Holdings, Inc. (MYCC)

Valuation on the Fairway, Fundamentals in the Rough

ClubCorp Holdings is a highly levered golf-course roll-up facing three profound challenges: a secularly declining end market, weak unit-level profitability, and no economies of scale. Founded in 1957 as a single country club in Dallas, ClubCorp now bills itself as "The World Leader in Private Clubs®," with a portfolio of 206 locations (including two in Mexico and one in China). But as ClubCorp has grown, golf has shrunken. Golf participation, golf rounds played, and sales of golf equipment have all trended down over the past decade, while the age of the average golfer has trended up. Though these demographic pressures strain the entire industry, ClubCorp suffers further from the nature of its competition: not-for-profit, member-owned clubs that strive not to maximize the bottom line but simply to provide a good experience. As these clubs plow any efficiency gains back into additional amenities for members, ClubCorp must keep up by way of its own continuous improvements, resulting in persistently high capital expenditures and weak returns. While the premise of ClubCorp's roll-up model is that greater scale leads to better returns, most golf-course costs are inherently local and thus difficult to centralize, as attested by ClubCorp's own mediocre earnings and stagnant margins.

For ClubCorp shareholders, these problems are amplified by the company's billion-dollar debt burden; at nearly 10x unlevered cash flow, it leaves the equity almost no downside support. Any economic hiccup impacting consumer discretionary spending could wipe out shareholders entirely. Yet despite its poor fundamentals and high leverage, ClubCorp shares offer investors just a 5% free-cash-flow yield – appallingly slender compensation for such massive risks.

ClubCorp's valuation has remained so rich partially as a result of the dearth of similar publicly traded companies; in this informational vacuum, management has successfully directed the market's attention to the most flattering financial metrics while glossing over the unpleasant long-term realities of the golf business. But our detailed industry research – including an analysis of benchmarking studies as well as conversations with more than a dozen golf-club general managers, many of whom compete directly with ClubCorp – reveals that low margins, weak membership growth, and a never-ending succession of capex projects are par for the course. Moreover, ClubCorp clubs appear to perform worse than average, with member attrition three times the industry median and anecdotal evidence of lax course maintenance and bad customer service. Informed by this bottoms-up research, our DCF model values ClubCorp equity at just $2.75 per share, 80% lower than the current price. But with such a fragile capital structure – and large contingent liabilities not captured in our base case – ClubCorp could easily be a zero. To those who are long shares: Fore!

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I. Investment Highlights

<u>ClubCorp's free cash flow doesn't justify its market cap</u>. Below we summarize ClubCorp's capital structure and run-rate free cash flow. With so much debt piled on top of so little earnings power, ClubCorp's equity won't get much; debt service and capital expenditures (necessary to keep club quality from rapidly decaying) together consume 75% of EBITDA, leaving little room for genuine growth initiatives or additional acquisitions. Indeed, free cash flow scarcely covers the dividend. Today, the market values ClubCorp's equity like a safe, stable bond; in reality, with $1 billion of debt outranking it and a multitude of fundamental flaws in the underlying business model, it's a highly risky asset that calls for a correspondingly high yield.

ClubCorp: Capital Structure and Cash Flow

	Value ($mm)
Capital structure	
Total debt	$ 1,116
Less: cash	(116)
Net debt	$ 1,000
Market cap	864
Enterprise value	$ 1,864
Run-rate cash flow	
EBITDA	$ 211
Depreciation	(110)
Cash interest expense	(62)
Taxable income	$ 39
Cash taxes	(14)
After-tax income	$ 25
Capex/depr. delta	17
Free cash flow	$ 42
FCF yield	4.8%

Source: company filings, Kerrisdale analysis
Note: Run-rate figures represent Kerrisdale 2016 estimates.

Our DCF model, which assumes a completely benign economic backdrop, values ClubCorp at just $2.75 per share, for 80% downside. A simple historical analysis produces a very similar result: since ClubCorp has only generated modest, mid-single-digit returns on invested capital – at or below a realistic estimate of its cost of capital – its enterprise value should approximate its $1.2 billion of net tangible assets. While this figure covers the debt, it leaves only ~$200mm for the equity – again leading to about 80% downside. Whatever the analytical framework, the conclusion is clear: ClubCorp's stock price has a long way to fall before it begins to approach fair value.

Golf is in the midst of a long-term secular decline. According to the National Golf Foundation, the number of golf participants in the US fell 22% from 2005 to 2015; the number of golf rounds played at private clubs likewise fell 17%. Demographics ensure that this decline is just beginning: golf participation among the critical 18-to-34-year-old age group has fallen 30% over the past two decades.

Golf's difficulties are not some passing fashion; they stem from the sport's fundamental qualities. Golf is expensive, difficult, and time-consuming in a world with a vast array of cheap and easy recreation options. Social change is also a headwind: gone is the era when the family patriarch could cavalierly leave his wife and children behind to spend a day golfing. In keeping with these trends, ClubCorp's revenue per club barely grew in nominal terms from 2005 to 2015 (and declined in inflation-adjusted terms), while average members per club was flat. ClubCorp's prospects for long-term organic growth are bleak.

ClubCorp's business model is inherently flawed. Some stagnant businesses can still generate high returns, but ClubCorp isn't one of them. There is a basic tension in the for-profit golf-course model: shareholders would like to wring as much revenue as possible out of each 18-hole course, but member satisfaction declines precipitously with any hint of crowding, capping the productivity of the capital employed. Moreover, in any geographic region, ClubCorp's clubs are just one choice among many, and competitors are often member-owned non-profits perfectly willing to operate at break-even. Our discussions with industry participants suggest that ClubCorp differentiates itself from the competition primarily by targeting lower-end customers and skimping on service, resulting in much higher attrition rates and greater sensitivity to economic downturns. But this strategy has not translated to strong revenue growth, margins, or returns on invested capital, all of which are consistently low.

Running private clubs is naturally capital-intensive; the golf courses, additional athletic facilities like gyms, clubhouse fixtures, parking lots, and other tangible assets all have finite life spans and require frequent renovations to maintain parity with competitors and justify even modest increases in membership fees. While ClubCorp management likes to bifurcate its capex into "maintenance" and "ROI" – implying that the latter is non-recurring and discretionary – our industry research belies this framing, showing that an annual capital budget of 7-10% of revenues – in line with ClubCorp's historical *total* capex but substantially higher than its purported "maintenance" spending – is necessary just to stay in place. Intense competition and high capital intensity are headaches in any sector, but, in a shrinking market like golf, they can be deadly.

ClubCorp's acquisition-driven growth strategy is a value-destroying failure. Like the retailer in the old joke, ClubCorp hopes to make it up on volume – transforming the golf-course business from dud to winner by simply buying and operating many courses. But, as industry benchmarking studies confirm, back-office and other readily centralizable costs represent a small fraction of the typical golf-course budget, while key line items like on-premise labor, facility maintenance, and local marketing are difficult to buy in bulk. There's no good reason to expect compelling synergies from a golf-course roll-up. Sure enough, ClubCorp's profit margins – whether measured using the company's own liberally adjusted version of EBITDA or more standard metrics – have been flat or down over the past five years, even as the number of clubs in its portfolio has grown almost 40%.

Given that ClubCorp generates mid-single-digit returns on *tangible* capital, paying a premium to net assets – as it has typically done in its acquisitions, resulting in $348 million of goodwill and other intangibles on its balance sheet – destroys economic value. A recent example is ClubCorp's large purchase of Sequoia Golf in 2014. We estimate that this deal generated a 7.7% pre-tax return on invested capital (including goodwill). Yet ClubCorp's last unsecured debt issuance priced at 8.25%, and credit spreads have widened further since then. This is a new twist on the proverbial 3-6-3 rule of old-fashioned banking (borrow at 3%, lend at 6%, and be on the golf course by 3 p.m.): borrow at 8%, invest at 8%, and own an extra golf course or three. Such a strategy expands ClubCorp's empire but destroys shareholder value.

Overlooked liabilities could wipe out ClubCorp's equity. In lieu of straightforward fees, some of ClubCorp's clubs have required *refundable* "membership initiation deposits"; after a long but limited time period, usually 30 years, members are entitled to get these funds back. Today such deposits exceed $700 million and are carried on ClubCorp's balance sheet at their present value of $357 million, of which $153 million is classified as *current* and could, in principle, come due at any moment.

Yet the market completely neglects this material liability (41% of ClubCorp's market cap and 200% of our base-case estimate of equity fair value) on the theory that few members have asked for their money back so far. Over time, however, something has to give. Either

- members do ask for their deposits back, resulting in a cash outflow large enough to significantly impair or even completely destroy ClubCorp's equity; or
- they don't ask for their deposits back, leading them to be classified as unclaimed property and remitted to the relevant state governments under escheatment laws, again draining cash; or
- they don't ask for their deposits back but ClubCorp somehow manages to evade the rules governing unclaimed property, thereby converting the deposits into taxable income and resulting in a multi-hundred-million-dollar tax bill over time – again, quite material relative to the magnitude of ClubCorp's equity.

While investors may give ClubCorp the benefit of the doubt as long as this liability remains largely hypothetical, any bad news could quickly alter perceptions. The long-term fate of ClubCorp's membership initiation deposits is just one more downside risk for a dangerously levered company with weak fundamentals trading at a high multiple of free cash flow.

II. Company Overview and Valuation

ClubCorp is a capital-intensive business with a long history of negligible organic growth and weak returns. Despite its low quality and high leverage, the company's equity currently trades at 21x our estimate of 2016 free cash flow. At a more reasonable enterprise valuation, ClubCorp equity would be worth 80% less.

ClubCorp: Capitalization and Financial Results

(*$ in mm except for share price*)

Capitalization	
Share price	$13.27
Diluted share count	65
Market cap	$ 864
Net debt:	
Term loan/revolver	$ 675
Unsecured notes	350
Mtges/capital leases	91
Total debt	$1,116
Cash	(116)
Net debt	1,000
Total enterprise value	1,864
EV/EBITDA	9.0x
EV/unlevered FCF	**18.3x**
Mkt cap/levered FCF	**20.7x**

Financial Results	2012	2013	2014	2015	2016
Revenue	$ 755	$ 815	$ 884	$ 1,053	$ 1,100
EBITDA	154	145	158	190	206
Capex	(54)	(60)	(73)	(105)	(94)
EBITDA − capex	100	86	86	84	113
Unlevered FCF	96	82	83	73	102
NOPAT	82	73	76	77	85
Acquisitions	$ 4	$ 16	$ 280	$ 59	
Golf clubs (#)	102	105	157	158	
Members	*82,719*	*85,397*	*117,212*	*121,228*	
City clubs (#)	49	49	50	49	
Members	*62,046*	*61,405*	*63,474*	*61,900*	

Source: company filings, Kerrisdale analysis

Note: cash and debt are pro forma for recent debt issuances. 2015 and 2016 figures represent Kerrisdale estimates.

ClubCorp runs two types of clubs: 1) golf and country clubs and 2) business, sports, and alumni clubs (known as "city clubs" in the industry jargon). Here we focus primarily on the golf-and-country-club business, which represents over 80% of ClubCorp's revenue and even more of its operating profit. Within this segment, ClubCorp owns and leases 143 clubs, manages 10, and participates in JVs tied to another 6, for a total of 159.

Though ClubCorp dates back to 1957, its current incarnation is fairly new. After years of being controlled by the Dedman family (related to the company's founder, Robert H. Dedman, Sr.), ClubCorp was acquired in 2006 by the private-equity firm KSL, which took the company public in 2013. At the time of its second IPO, ClubCorp had 105 golf and country clubs and 49 city clubs, the vast majority of which had been in its portfolio at the time of KSL's purchase. But the company has since embarked on a transaction spree; not a quarter has gone by that it hasn't acquired or sold a golf club. All this activity has obscured the basic reality that, as we aim to demonstrate below, golf clubs are simply bad businesses, with high capital requirements, intense competition, limited growth opportunities, and no pricing power. Making matters worse, golf as a hobby is itself in secular decline.

This industry backdrop informs our DCF analysis, summarized below, which values ClubCorp's equity at roughly $3 per share.

ClubCorp: Illustrative Kerrisdale DCF Analysis

($ in mm except for share price)

	Historical			Projected							
	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17	12/31/18	12/31/19	12/31/20	12/31/21	12/31/22	12/31/23
Total revenue	**$ 815**	**$ 884**	**$ 1,053**	**$ 1,100**	**$ 1,117**	**$ 1,134**	**$ 1,151**	**$ 1,168**	**$ 1,185**	**$ 1,203**	**$ 1,221**
% growth	*8.0%*	*8.5%*	*19.1%*	*4.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*
Gross profit	213	235	275	292	296	300	305	309	314	319	324
% margin	*26.1%*	*26.6%*	*26.1%*	*26.5%*	*26.5%*	*26.5%*	*26.5%*	*26.5%*	*26.5%*	*26.5%*	*26.5%*
% growth	*5.0%*	*10.4%*	*17.0%*	*6.1%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*
SG&A	64	74	83	80	82	83	84	85	87	88	89
% margin	*7.9%*	*8.4%*	*7.8%*	*7.3%*	*7.3%*	*7.3%*	*7.3%*	*7.3%*	*7.3%*	*7.3%*	*7.3%*
Growth	*41.3%*	*15.3%*	*11.8%*	*(2.8%)*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*
EBITDA	**149**	**161**	**192**	**211**	**214**	**218**	**221**	**224**	**228**	**231**	**234**
% margin	*18.2%*	*18.2%*	*18.3%*	*19.2%*	*19.2%*	*19.2%*	*19.2%*	*19.2%*	*19.2%*	*19.2%*	*19.2%*
D&A	72	81	104	110	112	113	115	117	119	120	122
% of revenue	*8.8%*	*9.1%*	*9.9%*	*10.0%*	*10.0%*	*10.0%*	*10.0%*	*10.0%*	*10.0%*	*10.0%*	*10.0%*
EBIT	**77**	**80**	**88**	**101**	**103**	**104**	**106**	**107**	**109**	**111**	**112**
% margin	*9.4%*	*9.1%*	*8.4%*	*9.2%*	*9.2%*	*9.2%*	*9.2%*	*9.2%*	*9.2%*	*9.2%*	*9.2%*
Interest	(84)	(65)	(71)	(63)	(63)	(63)	(63)	(63)	(63)	(63)	(63)
EBT	**(7)**	**15**	**18**	**39**	**40**	**42**	**43**	**45**	**47**	**48**	**50**
Unlevered FCF											
NOPAT (35% tax rate)			$ 82	$ 88	$ 89	$ 90	$ 91	$ 92	$ 93	$ 94	$ 95
Plus: D&A			104	110	112	113	115	117	119	120	122
Less: capex	(60)	(73)	(105)	(94)	(95)	(96)	(98)	(99)	(101)	(102)	(104)
% of revenue	*7.3%*	*8.2%*	*10.4%*	*8.5%*	*8.5%*	*8.5%*	*8.5%*	*8.5%*	*8.5%*	*8.5%*	*8.5%*
Unlevered FCF			**$ 81**	**$ 104**	**$ 105**	**$ 107**	**$ 108**	**$ 109**	**$ 111**	**$ 112**	**$ 113**
Discount rate	9.0%										
Terminal FCF multiple	11.1x										
Terminal value	$ 1,258										
PV of interim FCF	$ 598										
PV of terminal	631										
Intrinsic EV	**$ 1,229**										
Less: debt	(1,166)										
Plus: cash	116										
Intrinsic equity value	**$ 180**										
Implied EV / 2015 revenue	1.2x										
Implied EV / 2015 EBITDA	6.4x										
Implied EV / 2015 EBIT	13.9x										
Shares outstanding	65.1										
Implied share price	$2.76										
Current share price	*$13.27*										
Upside / (downside)	**(79)%**										

Source: company filings, Kerrisdale analysis

We assume that the company can permanently increase its EBITDA margins by ~100bps relative to its 2015 performance, but, with no track record of positive operating leverage, there's little reason to expect any ongoing additional margin improvement. With low long-term organic growth of 1-2% at best, consistent with its history, ClubCorp's unlevered cash flow of ~$100 million per year won't change much over time, and the vast majority of it will accrue to its creditors, not its shareholders. Given ClubCorp's macroeconomic sensitivity and junk-rated credit quality, we regard a 9% WACC as generous, and, in simple terms, a ~$100-million-per-year perpetuity priced at 9% just barely covers ClubCorp's debt balance, with little left over. (While we don't explicitly incorporate future acquisitions, we also believe that recent ones haven't created economic value; if anything, it's optimistic to ignore the likelihood of future value destruction from bad deals.)

Viewed through a slightly different lens, ClubCorp relies on its tangible assets – its greens, parking lots, kitchens, tennis courts, and so on – to generate profits. But its pre-tax returns on tangible assets are consistently mediocre at 7-9% (as discussed further below), implying that ClubCorp as a whole is worth little more than its tangible asset value. That value covers its debt but not much more, again implying tremendous downside for ClubCorp's share price. (Nor is it obvious that ClubCorp's carrying values are conservative; from 2010 to 2015, it recorded $82 million of cumulative asset impairments and losses on disposal.)

ClubCorp: Tangible Asset Value vs. Enterprise Value

	Value at 12/31/15 ($mm)
Total assets	$ 2,171
Goodwill/intangibles	(344)
Cash	(116)
Non-debt liab's excl. deposits	(522)
Noncontrolling interest	(10)
Net tangible assets	$ 1,178
Less: net debt	(1,000)
Value remaining for equity	$ 178
Implied share price	$ 2.73
Upside / (downside)	**(79)%**

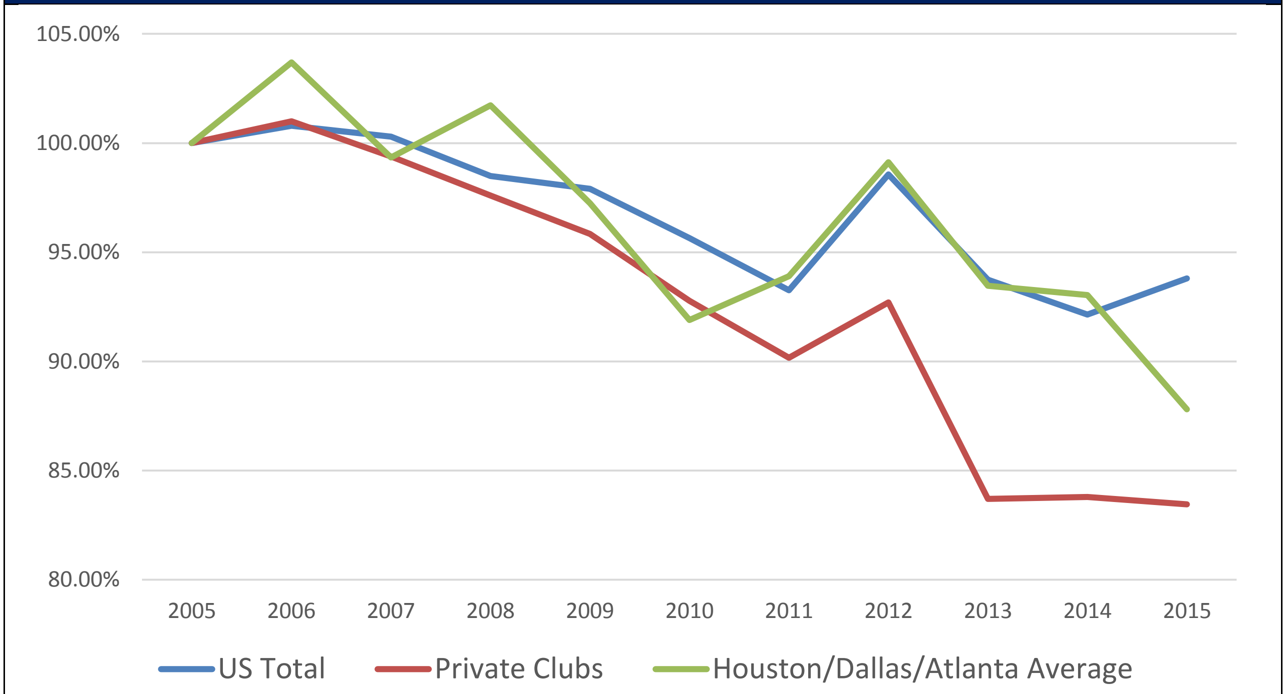
Source: company filings, Kerrisdale analysis

Moreover, the analysis above does not even contemplate the potential future refunding of ClubCorp's ~$700 million of membership initiation deposits, a liability to which ClubCorp itself has ascribed a present value of $352 million, even a fraction of which would dramatically impair the company's equity value. At its current 5% free-cash-flow yield, ClubCorp's market cap prices in either extremely low risk or high growth, but in light of the company's weak fundamentals and already daunting indebtedness, neither possibility makes sense. The stock should trade much lower.

III. Golf as a Hobby Is in Secular Decline

Over the past decade, the world of recreational golf has steadily gotten smaller and older. The data here are clear. To begin with, the chart below shows the number of golf rounds played per year (indexed to 2005 levels):

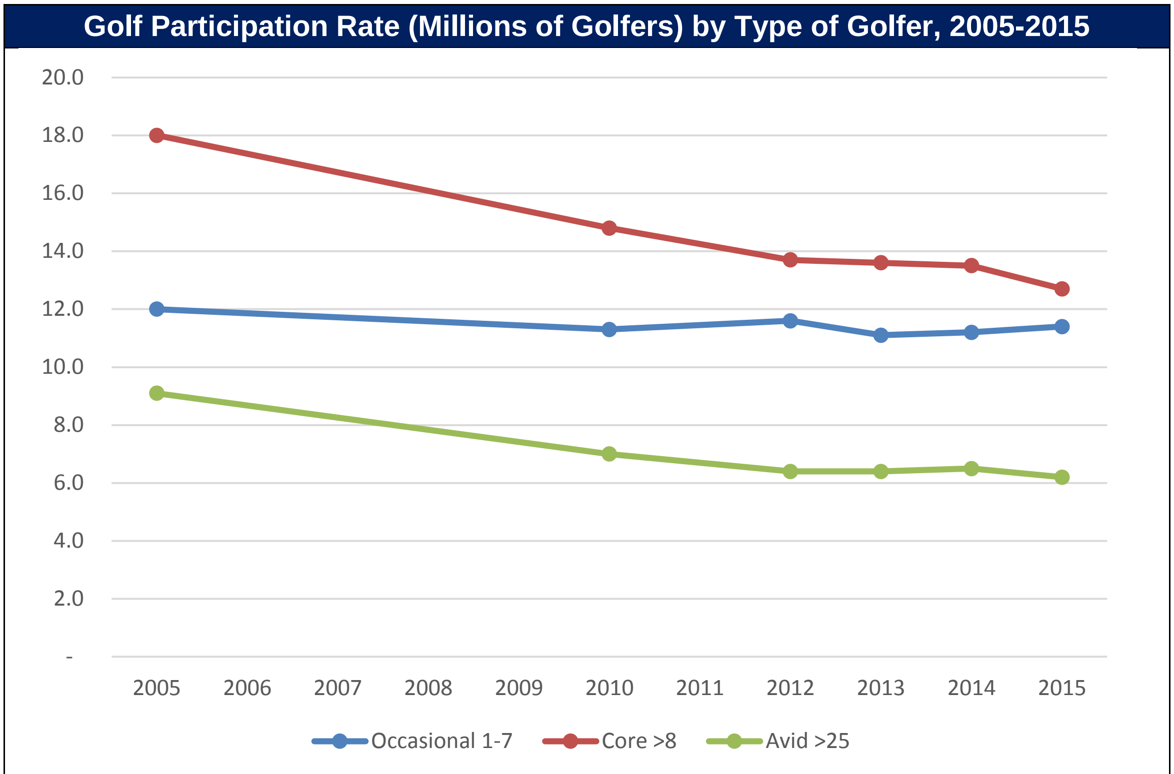
Golf Rounds Played in the US, 2005 to 2015 (Indexed to 2005)



Source: National Golf Foundation, Kerrisdale analysis

We include an average of the rounds played in the Houston, Dallas, and Atlanta metro areas given ClubCorp's disproportionate presence there. At least over the last decade, these areas have (very slightly) outperformed the overall national average – yet ClubCorp's own growth rates have actually been *worse* than the national average.

Golf's decline can also be seen in the participation rate: the number of people that take part in the sport with various degrees of enthusiasm.

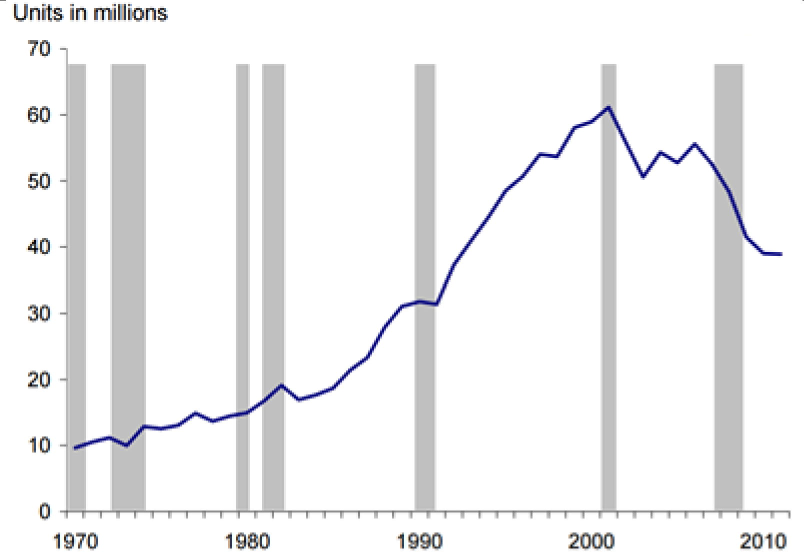


Source: National Golf Foundation, Kerrisdale analysis

Each line represents a different category of golfer based on average rounds played per year. Our discussions with golf-course general managers (GMs) confirmed that these high-level trends reflect on-the-ground realities: golf participation is down, and the proportional decline has been worse among more dedicated golfers, contributing to the underperformance of private golf clubs (which cater to frequent players) relative to public golf courses (which serve a broader audience).

Perhaps the simplest illustration of golf's decline is the following graph, showing the last 40 years of golf-ball unit sales, which peaked around 2000 and have since fallen by about a third:

Forty Years of Golf-Ball Sales

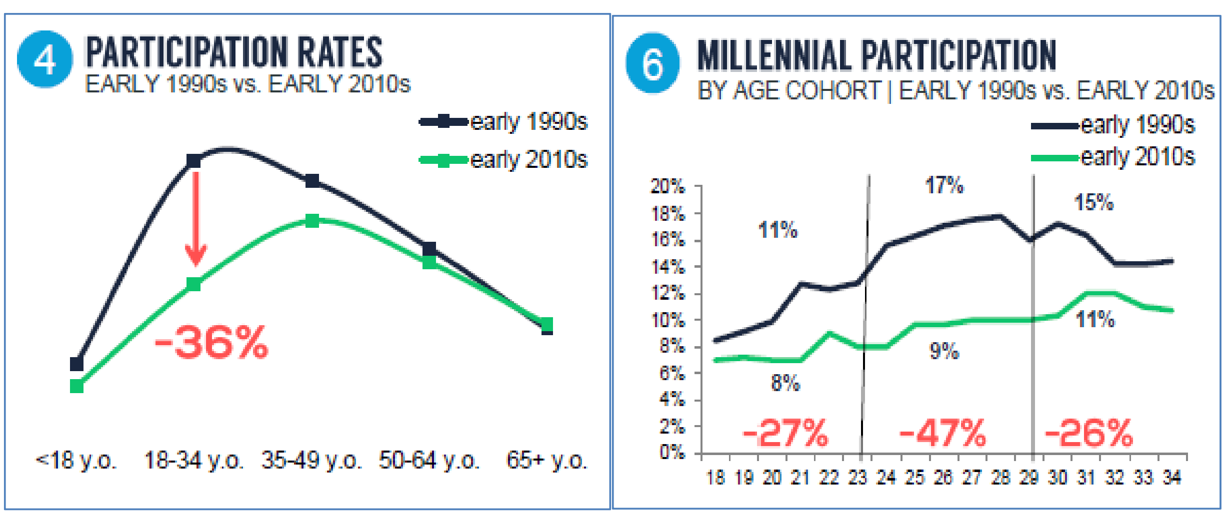


Source: National Golf Foundation

Note: gray bars represent recessions.

Even if golf is less popular than it once was, can it stabilize and grow again? Demographics make such an outcome highly unlikely. As the graphs below indicate, the age distribution of golfers has shifted toward elderly participants: while participation among those aged 50 or older has remained relatively flat, the crucial 18-to-34-year-old group – the key to golf's future – has shrunken dramatically.

Golf Participation by Demographic



Source: National Golf Foundation

Since 35-to-49-year-olds currently have the highest golf participation rate and spend the most money on the sport, the lack of interest on the part of their younger counterparts bodes poorly for golf-course owners like ClubCorp. As time passes, today's 35-to-49-year-olds will get older and participate less, but there will be far too few millennials to replace them – suggesting that golf's decline may even accelerate in the coming years.

What has driven golf's falling popularity? Conversations with golf-club GMs uncovered a variety of factors:

- The required time commitment. It takes four hours to play 18 holes. GMs almost all agreed that, in a culture characterized by short attention spans and the quest for instant gratification, four hours is a tough sell. Moreover, the affluent professionals who have historically constituted golf's key demographic actually work longer hours than before, compressing the time available for golf and turning a single round into a proportionally larger use of scarce leisure time.
- The high cost. Golf is expensive, and several GMs lamented that it has only gotten more expensive over time, outpacing the average worker's income.
- Social change. In the words of one GM, "It used to be that the husband could just take off on a Sunday morning and come back eight hours later after spending the day at the club with the boys." That era is long gone. Patriarchs are far less patriarchal, and, with both members of many couples working during the week, the weekend has increasingly become the main opportunity for families to be together, leaving less room for golf. While clubs have tried to appeal to families with more non-golf activities and amenities, like swimming pools (pushing capex ever upward), this strategy puts them in direct competition with a much larger universe of possible family activities.

These negative factors aren't fleeting; they're permanent. The golf business will continue to struggle and deteriorate for the foreseeable future.

IV. ClubCorp's Business Model Is Inherently Flawed

While a weak end market does not always make for a bad business, it doesn't help – and ClubCorp's financial results demonstrate that it has not transcended golf's challenges. The company's weak performance makes perfect sense: for-profit golf clubs can't grow much, face formidable competition, and require constant capital infusions.

Bounded Growth and Difficult Competitive Dynamics

At the level of the individual club, revenue growth has a tight upper bound, because there's a limit to the number of members and rounds of golf that a given club can support. As more members crowd into a fixed space, tee times become hard to get, and dissatisfaction and attrition rise. (Sell-side models that assume perpetual growth in same-store membership thus defy reality.)

Once clubs approach their capacity, the only way to increase revenue is to raise dues, fees, and food prices. The competitive landscape, however, is unforgiving. At a high level, there are three types of venues for golfers to choose from:

- Public and municipal courses. Of the 15,000 clubs in the US, approximately 11,500 – more than three quarters – are public golf courses. These courses typically focus exclusively on golf, eschewing frills like food, pools, and tennis courts. (ClubCorp itself manages 11 such facilities.) Given their relatively bare-bones approach, public courses generate ~75% less revenue than comparable private clubs.
- High-end, member-owned clubs. The vast majority of the 3,900 private clubs in the country are member-owned non-profits populated by the wealthy, with initiation fees ranging from $20,000 to $200,000 but low ($300-700) monthly dues. These clubs are far more than just places to golf; they're hotbeds of upper-class socialization and networking. Lacking a profit motive, member-owned clubs tend to invest their every last dollar in pleasing their members, which, coupled with their social status and the high sunk cost of initiation, leads to low churn and long waiting lists.
- Privately owned clubs run by ClubCorp and its peers. Clubs like ClubCorp's resemble lower-end knock-offs of member-owned clubs, with much lower initiation fees (zero to a few thousand dollars) but similar monthly dues. With a less affluent, less exclusive clientele, these clubs lack the social cohesion of their more authentic counterparts, resulting in minimal loyalty and higher sensitivity to price. Discounting (especially on initiation fees) is common, eroding any cachet and fostering bad blood between members who paid full price and those who didn't. According to club GMs we spoke to, members at for-profit clubs tend to resent any service cuts or subpar amenities, viewing them as corporate nickel-and-diming at members' expense.

In any given region, all three types of clubs coexist; if private clubs like ClubCorp's don't offer a competitive value proposition, golfers have other options, including much cheaper ones. Moreover, since neither public nor member-owned courses aim to make money, they generally limit price increases to whatever is necessary to cover rising costs. Private clubs aiming to raise prices at a faster pace risk losing members. In the long run, therefore, the typical private club can only increase its revenue at the rate of inflation.

These abstract phenomena take concrete form in ClubCorp's operating results:

Unit-Level Analysis of ClubCorp Golf Revenues ($mm), 2005 to 2015									
($ in mm)									
	2005		2009	2010	2011	2012	2013	2014	2015
Golf revenue	$ 512	...	$ 526	$ 521	$ 541	$ 580	$ 600	$ 627	$ 662
Total no. of golf clubs	91		96	96	95	100	100	101	103
Members/club	828		834	824	837	811	818	816	827
Revenue/club	$ 5.6		$ 5.5	$ 5.4	$ 5.7	$ 5.8	$ 6.0	$ 6.2	$ 6.4
Cumulative %Δ									14.2%
CAGR									***1.3%***

Source: company filings, Kerrisdale analysis

Note: "golf revenue" represents revenue at "Same Store Clubs" in ClubCorp's Golf and Country Club segment, which includes only clubs with a full calendar year of results under ClubCorp management for both the year shown and the prior year. Changes in the set of "Same Store Clubs" in each year lead to variations in overall averages.

The figures above, though as clean as we could assemble, are still muddied by certain acquisitions and dispositions. Nonetheless, the general trend is clear: the number of members per club is roughly flat over the course of a decade, while revenue per club has grown at just 1% per year on average – less than half the growth rate of the Consumer Price Index over the same period. (In fact, since public courses tend to generate much less revenue than private clubs and the share of such courses in ClubCorp's portfolio has declined over time, the revenue CAGR of the *private* clubs is likely even lower than 1.3%.)

Strikingly, after the last recession, ClubCorp did not regain its 2005 revenue-per-club average until 2011. By contrast, our conversations with GMs at non-ClubCorp clubs indicated that many were able to continue to increase dues and fees even during the financial crisis. We believe the difference boils down to customer loyalty: ClubCorp's for-profit model induces much higher churn than the industry average, giving the company little pricing power:

Membership Churn: ClubCorp vs. the Industry						
	2010	2011	2012	2013	2014	2015
ClubCorp	17.2%	15.9%	16.4%	16.3%	16.3%	17.0%
Industry median	4.5%	4.8%	4.9%	5.5%	5.5%	5.8%

Source: company filings, Club Benchmarking Inc., Kerrisdale analysis

During an economic expansion, higher churn is less problematic because replacement members are easier to find. In the wake of a recession, however, new members become scarce at the same time as old members tighten their belts – a double whammy, particularly considering ClubCorp's less affluent membership base. Over a full economic cycle, ClubCorp will likely continue to underperform its peers, who themselves struggle just to keep up with inflation.

High Capital Requirements

In our discussions with golf-club GMs, one topic that kept coming up was just how capital-intensive it is to maintain a private country club. Below we provide a (non-exhaustive) list of some of the biggest items in a typical club's capital budget:

A Typical Golf Club's Physical Capital

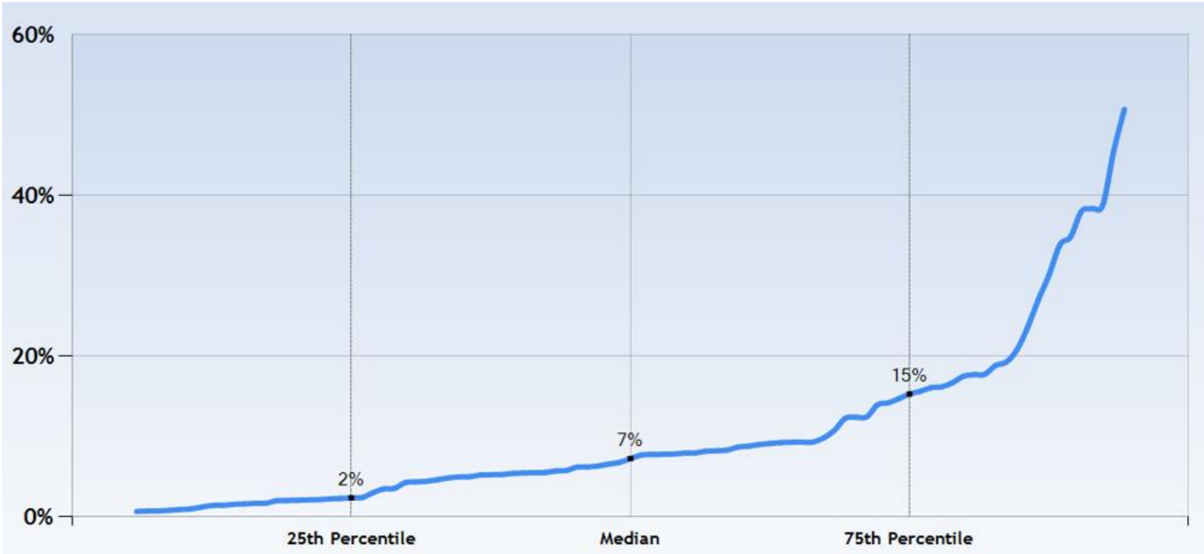
	Useful life (years)
Golf course	
Greens	10-15
Bunkers	7-10
Streams	3-5
Furniture, fixtures, and equip.	
Kitchen	7-10
Pool area	7-12
Other facilities	
Building exterior	3-5
Parking lots	10-12
Clubhouse (total reno.)	15-20

Source: Kerrisdale research

What's clear is that none of these facilities lasts forever, with average useful lives generally in the 10-to-15-year range (perhaps closer to the upper end given the disproportionate impact of very costly but infrequent clubhouse renovations). GMs almost unanimously agreed that ongoing capital maintenance and replenishment consume 7 to 10% of revenues over time, fluctuating in step with the availability of funds and the vehemence of member demands.

This level of capital intensity is consistent with the data set compiled by Club Benchmarking, a golf-club data provider that aggregates financial results and operating metrics from more than a thousand private golf clubs across the country. In that data set, average capex as a percentage of operating revenue was 9.2%, with a median of 7%:

Private Golf Clubs: Capital Expenditures as a Percentage of Operating Revenue, 2015



Source: Club Benchmarking Inc.

Importantly, our sources indicated that spending 7 to 10% of revenue on capex is just the cost of doing business – *not* an elevated level associated with special growth-oriented projects. To the contrary, it's the level of capex necessary to keep club quality stable while achieving what GMs often refer to as "annual cost-of-living increases" in club dues. What happens when clubs hold back on capex? GMs consistently answered that, while one might get away with restrained spending for, say, a year, a club's ability to consistently increase revenue in line with inflation depends on members' perceptions that the club is constantly updating its offerings and keeping things fresh. Skimping on capex ultimately leads to higher churn, lower loyalty, and reduced pricing power.

With this industry context in mind, we now turn to ClubCorp's historical capex trends:

ClubCorp: Historical Capital Expenditures ($mm)

	2010	2011	2012	2013	2014	2015
Total revenue	$ 688	$ 720	$ 755	$ 815	$ 884	$ 1,053
Gross depreciable PP&E	950	1,034	1,044	1,110	1,351	1,476
Capex	$ 43	$ 48	$ 54	$ 60	$ 73	$ 105
% of revenue	*6.2%*	*6.7%*	*7.2%*	*7.3%*	*8.2%*	*10.0%*
Average capex/revenue			***7.6%***			
Implied useful life (yrs)	*22.2*	*20.7*	*19.2*	*18.1*	*16.9*	*13.4*
Average implied useful life			***18.4***			

Source: company filings, Kerrisdale analysis

Over a multi-year period, ClubCorp's total capex-to-revenue ratio is roughly in line with its peers', although its steady increase from a lower level in 2010 suggests that the company's former private-equity owners were milking it for cash flow, with limited regard for long-term sustainability. Ultimately, though, capex had to normalize upward. By comparing the value of gross depreciable PP&E to the rate of capex, we estimate the implied useful life of the underlying assets, assuming that capex was actually high enough to fully replenish them. For years, however, ClubCorp's capex level implied that its assets only needed to be replaced on a ~20-year cycle. Based on the primary research summarized above, 20 years is unrealistically high; 15 years is more reasonable, consistent with the higher recent capex levels.

ClubCorp's depreciation accounting further confirms that a 15-year average useful life (corresponding to capex of about 9% of revenue) provides a good estimate of the capex required in the long term just to maintain the status quo:

Average Life of ClubCorp Assets

(*$ in mm*)	2010	2011	2012	2013	2014	2015
Gross depreciable PP&E	$ 950	$ 1,034	$ 1,044	$ 1,110	$ 1,351	$ 1,476
Depreciation expense	66	69	69	69	79	101
% of revenue	***9.6%***	***9.6%***	***9.1%***	***8.5%***	***9.0%***	***9.6%***
Capex	43	48	54	60	73	105
PP&E average life (years)						
Based on depreciation expense	**14.3**	**14.4**	**15.1**	**15.6**	**15.5**	**14.0**
Based on capex	22.2	20.7	19.2	18.1	16.9	13.4

Source: company filings, Kerrisdale analysis

Of course, depreciation figures are just a function of management estimates of average useful lives. But here the tacit message from management corroborates what we learned from external data and primary research: the key physical assets in the golf-club business last 15 years on average, and replenishing them consumes about 9% of revenue.

Why does this matter for ClubCorp investors? By focusing exclusively on adjusted EBITDA, many have overlooked the first-order significance of recurring capex, which dramatically reduces the cash flow available to equity. Management's breakdown of capex into "maintenance" and "ROI" categories seduces investors into regarding only the former as ongoing and the latter as temporary. Our findings, however, cast great doubt on the relevance of this distinction. However one chooses to label different individual investment projects, the fact remains that ClubCorp's recent capex has not been abnormally high; on average, it's been more or less exactly what any experienced outside observer would have predicted. In short, investors should regard essentially all of ClubCorp's capex as "maintenance" – recurring and necessary to preserve earnings power – to get a clear picture of long-run free cash flow.

For an entity like ClubCorp, constant reinvestment is especially important because tangible club amenities serve as the only draw. By contrast, member-owned clubs that serve as much as social networks as they do as sporting venues have greater leeway. Even with capex at industry-standard levels, ClubCorp loses members at three times the usual rate; below-average spending would only further impair the company's competitive position.

Low Returns on Capital

For ClubCorp, low growth, challenging competitive dynamics, and high capital intensity are interrelated problems, different facets of one central reality: golf is a bad business (which perhaps explains why most clubs and courses are *not* businesses). ClubCorp's track record of profitability bears this out:

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.*

Whether one looks at operating profit, which effectively assumes that maintenance capex is equal to GAAP depreciation, or actual historical capex (which we believe has been unsustainably low until recently), ClubCorp's average return on *tangible invested capital* is paltry. This measure doesn't incorporate the impact of taxes (low on a cash basis recently but likely to normalize in the future) or goodwill; since ClubCorp paid, for instance, a 25% premium to tangible book value for Sequoia Golf in 2014, its return on the capital deployed to actually obtain its current tangible assets is even lower than what is shown above. Even neglecting deal premiums, ClubCorp's returns look little better than its cost of capital, especially considering that as recently as December ClubCorp issued $350 million in unsecured notes with an 8.25% coupon. Raising money at 8% to invest it at 8% doesn't create shareholder value; it simply underscores the weakness of ClubCorp's business model.

V. ClubCorp's Acquisition Strategy Is a Value-Destroying Failure

One of the stated purposes of ClubCorp's aforementioned debt raise was to fund additional acquisitions. Throughout its history, ClubCorp has constantly bought up small, privately owned clubs and managed them from its corporate headquarters. The purported logic is that that it can offer economies of scale and industry best practices, and, given the large number of small-scale private-club operators in the US, most of which own just a single club, the runway for future growth is long.

Examining ClubCorp's financials, however, we find no evidence of economies of scale:

ClubCorp Margins: No Hint of Scale

(*$ in mm*)

	2010	2011	2012	2013	2014	2015
Revenue	$ 688	$ 720	$ 755	$ 815	$ 884	$ 1,053
Adjusted EBITDA	150	157	166	177	196	234
% of Revenue	***21.8%***	***21.8%***	***21.9%***	***21.7%***	***22.2%***	***22.2%***
EBITDA	135	131	154	145	158	190
% of Revenue	***19.6%***	***18.3%***	***20.5%***	***17.8%***	***17.9%***	***18.0%***
Unlevered FCF	86	69	96	82	83	73
% of Revenue	***12.5%***	***9.6%***	***12.7%***	***10.1%***	***9.4%***	***6.9%***
NOPAT	62	48	82	73	76	77
% of Revenue	***9.1%***	***6.7%***	***10.8%***	***8.9%***	***8.6%***	***7.3%***

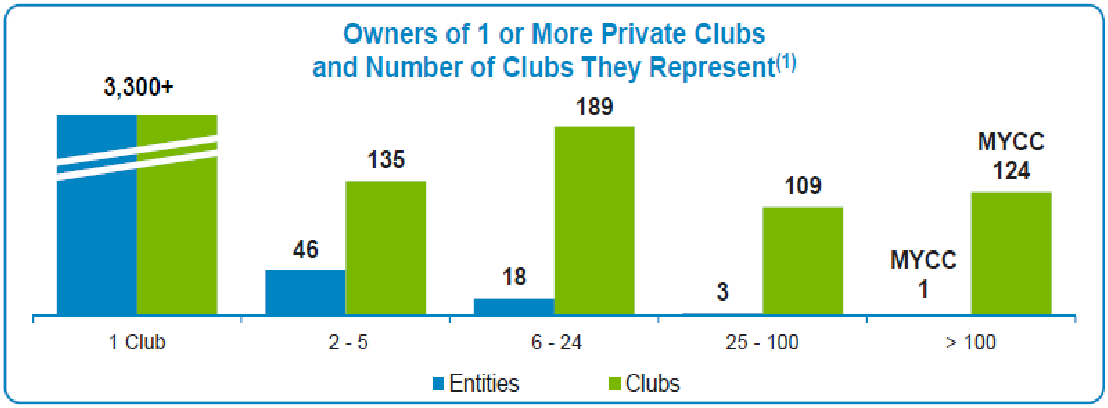
Source: company filings, Kerrisdale analysis

To be sure, revenue has grown substantially, almost entirely as a result of acquisitions, but even "adjusted" EBITDA – ClubCorp's preferred measure, which we regard as grossly inflated – has only managed to stay flat, while other margin metrics have actually *declined* as ClubCorp has expanded. As previously shown, returns on tangible capital also exhibit little correlation with size. The economies of scale that might justify ClubCorp's roll-up approach are nowhere to be found.

Indeed, there is little reason to expect such economies of scale. Few of the major costs of running a club lend themselves to centralization. Labor, which accounts for more than half of a typical club's expenses, is inherently local, as are construction, marketing, fertilizer, and so on. ClubCorp doesn't have much to work with.

Furthermore, the runway for future acquisitions isn't as long as ClubCorp would like investors to believe. Here's how ClubCorp frames the opportunity:

ClubCorp's View of Potential M&A



Source: ClubCorp [January 2016 investor presentation](), slide 12

In reality, however, very few of these clubs are up for sale to a corporate buyer. The vast majority are high-end, member-owned non-profits accustomed to lavish spending – a very different model than ClubCorp's. The members-*cum*-owners would never allow their beloved clubs to be taken over by a faceless profit-maximizer. Whatever the universe of clubs willing to sell actually is, it's a fraction of what ClubCorp suggests.

Of course, the ultimate test of any roll-up strategy is whether it generates returns in excess of the acquirer's cost of capital. Unfortunately, since ClubCorp's acquisitions have generally been small, we don't have enough detail to analyze the economics of most individual deals (although the previously discussed return-on-tangible-capital trends imply that ClubCorp's return on *incremental* capital employed has been low or negative). There is one major exception: the 2014 Sequoia acquisition, which was large enough to demand additional disclosure. ClubCorp paid $265 million, plus acquisition expenses, for Sequoia, whose key financial metrics it presented like so:

Sequoia Golf: Financial Metrics as Presented by ClubCorp

- LTM Revenue $98.4 million
- LTM Adjusted EBITDA(1) $24.4 million
- Pro forma Adj. EBITDA(1) $29-30 million due to anticipated cost synergies

Source: ClubCorp [August 2014 investor presentation](), slide 6

Even granting the legitimacy of ClubCorp's EBITDA "adjustments," ClubCorp paid ~13x pre-tax operating profit for Sequoia (assuming that maintenance capex is $7 to 10 million, in line with standard industry ratios). That equates to a 7.7% pre-tax return on invested capital. But with an unsecured debt cost of 8.25% – which is likely materially higher today, given the decline in

ClubCorp's stock price, along with the general widening of high-yield credit spreads – ClubCorp shareholders should not applaud such a purchase. ClubCorp's already sky-high leverage will impede its ability to make additional purchases, but, even if it scrounges up funding, its track record suggests that it will fail to create any value, and will likely destroy it.

VI. ClubCorp's Large Contingent Liabilities Pose Serious Risks

For the most part, the problem with ClubCorp is simply that the company's high leverage and structurally poor fundamentals make its equity free-cash-flow yield absurdly inadequate. However, there is a plausible scenario in which the outcome for ClubCorp shareholders is even worse.

The issue is membership initiation deposits. In lieu of straightforward fees, some of ClubCorp's clubs have required long-term refundable deposits whenever new members join. Members are entitled to eventually get every dollar of these deposits back, but only after a long period, usually 30 years after the membership starts. At the end of 2015, ClubCorp held a staggering $717 million in deposit liabilities owed to its members, which it carried on its balance sheet at a discounted present value of $357 million. These liabilities are so large that ClubCorp actually has negative tangible book value after taking them into account. But despite ClubCorp's contractual requirement to refund these deposits after the allotted time period, and despite their presence on the company's balance sheet, investors tend to ignore them, as we have in all of our foregoing financial analysis. After all, so far, few members have actually asked for their money back, as the summary below shows – despite the steady increase in the portion of the liability classified as current, i.e. due within 12 months:

ClubCorp: Membership Initiation Deposits

($ in mm)

	2010	2011	2012	2013	2014	2015
Membership initiation deposits:						
Current portion	$ 54	$ 70	$ 91	$ 112	$ 136	$ 153
Long-term portion	202	204	203	204	203	204
Total	**$ 256**	**$ 273**	**$ 294**	**$ 316**	**$ 339**	**$ 357**
Cash paid out for refunds	$ -	$ 0.4	$ 3.0	$ 1.4	$ 1.6	$ 1.5

Source: company filings, Kerrisdale analysis

If ClubCorp only ever has to pay out a few million dollars on a several-hundred-million-dollar liability, then it doesn't make much of a difference. But what about taxes? We believe that IRS rules generally treat the receipt of refundable membership deposits as a non-taxable cash inflow, on the theory that the deposits essentially remain the property of the members. (We sought clarity on this and related points from ClubCorp management months ago but never received any answers.) At some point, however, this theory becomes ridiculous. If ClubCorp gets to do what it wants with millions of dollars for decades and never really expects to pay anything back, then those amounts must ultimately be treated as taxable income, and ClubCorp will be on the hook for a material tax bill. (35% of a $352 million deposit present value equals $123 million.) If ClubCorp *does* actually refund a large portion of its deposits, the tax bill goes away, but investors should then regard the liability as just as real as ClubCorp's other borrowings, yet senior to ClubCorp's equity. Using our base-case valuation of $206 million for ClubCorp's equity, which does *not* contemplate the payout of its membership deposits, the present value of even a fraction of those deposits is so large that it would completely wipe out the equity and potentially even impair the debt.

While ClubCorp will likely try to ignore this problem for as long as possible, it might run into trouble with escheatment laws. These laws govern the status of unclaimed private property, like 30-year-old membership deposits. In Texas, for example – the home of more than 20% of ClubCorp's clubs –

> The unclaimed property law requires financial institutions, businesses, and government entities to report to the state personal property they are holding that is considered abandoned or unclaimed. … Property is turned over to the Comptroller's office annually when the owner's whereabouts are unknown and the property has been inactive on the books of the reporting company after the appropriate abandonment period has expired.

Despite this statutory requirement, ClubCorp contends in its 10-K risk-factor disclosures that it can somehow evade the escheatment laws via "complex" legal analysis (emphasis added):

> [W]e may be subject to various states' escheatment laws with respect to initiation deposits that have not been refunded to members. All states have escheatment laws and generally require companies to remit to the state cash in an amount equal to unclaimed and abandoned property after a specified period of dormancy, which is typically 3 to 5 years. **We currently do not remit to states any amounts relating to initiation deposits that are eligible to be refunded to members based upon our interpretation of the applicability of such laws to initiation deposits. The analysis of the potential application of escheatment laws to our initiation deposits is complex, involving an analysis of constitutional and statutory provisions and contractual and factual issues.** While we do not believe that initiation deposits must be escheated, we may be forced to remit such amounts if we are challenged and fail to prevail in our position.

It's difficult to take comfort in this vague and thoroughly hedged pronouncement, especially when ClubCorp goes on to note that the relevant authorities are already making inquiries:

> …[M]ost of the states in which we conduct business have hired third-party auditors to conduct unclaimed and abandoned property audits of our operations…[T]he audits have not been terminated.

Whether ClubCorp ends up refunding old membership deposits, escheating them to government agencies, or treating them as income and paying tax on them, any outcome has the potential to take a serious toll on the company's financial resources and do significant damage to its equity value. These risks may take years to materialize, but ClubCorp shareholders are receiving no compensation for taking them.

VII. Conclusion

There's a good reason that the overwhelming majority of golf courses in the United States are owned and operated by non-profit entities: golf is a bad business. It's extremely capital-intensive, and its unit-level growth is inherently limited. It's also in the midst of a decade-long decline that, based on demographic trends, will likely get much worse before it gets better. ClubCorp keeps doubling down (and levering up) on golf, but its mediocre returns barely cover its cost of capital, and its massive debt load puts it in a precarious position, especially when its low-loyalty, high-churn model is acutely susceptible to economic downturns. At some point, it will also have to face reality and crystallize its thus-far unrealized deposit liability. To those standing in the way of these fearsome risks in return for a bond-like 5% free-cash-flow yield, we remind them that it won't take too many bogeys to lose this game.

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