Association of Fitness Studios: Building a Business Plan

How to Build a Business Plan and Financial Forecast

"At AFS one of our biggest priorities is connecting our members so they can leverage the combined experiences of each other to maximize their growth potential."

– Josh Leve, Founder & CEO, Association of Fitness Studios

ASSOCIATION OF FITNESS STUDIOS

The Value of a Business Plan and Financial Forecast

As an entrepreneur, creating a business plan and documenting it provides clarity and direction to your vision.

By identifying your new studio's objectives, then building a plan to achieve them, it provides added insurance that you know where you are going and how you are going to get there.

A business plan tells potential investors that your venture is more than an idea or concept; it communicates to them that you are clear about what lies in front of you, and that you are fully prepared to meet the challenges inherent in developing a successful business.

> *"A business plan is a roadmap for success. For a studio owner, the business plan provides direction and clarity on who you are, where you are going, and how you will get there. For investors, a well thought out and documented business plan tells them that you know your business and what is required to achieve success."*
>
> – Stephen Tharrett, Co-founder & Partner, ClubIntel

Building a Plan for your Studio; Core Attributes of a Quality Business Plan

In a survey conducted by a Palo Alto software developer that involved approximately 3,000 firms, and reported in Small Business Trends, an online blog, the researchers discovered that firms that had a business plan were twice as likely to secure capital and grow their business. While the study may not be representative of every new business venture or reflective of any specific industry, what it does affirm is the importance of a business plan to achieving success with a new or existing business.

A business plan, especially for a new start-up business such as a fitness studio, must incorporate a financial forecast/projections which projects the revenues, expenses and cash flow for the business over a period of at least five years. The preparation of financial projections are an integral part of the planning process, and for many, if not most investors, the financial projections are the single most important document they consider. Without a financial forecast, even the best business plan will fail to generate enthusiasm from investors, or provide the entrepreneur a realistic picture of what stands before them.

- *Do your due diligence and understand the market dynamics.* The first step in the business planning process involves conducting the necessary research to understand local market dynamics and how your studio's concept or value proposition fits. Investors want to understand, as should you, the underlying business opportunity and how your concept can take advantage of that opportunity, assuming it exists. When facilitating your research, whether on your own or with the assistance of a professional you want to address the following issues.

    - *What are the needs of the local market and how well is it being served?*
      For example, if your studio concept involves offering integrative sports performance, you want to know if there is a demand for it in the market (number of middle and high school athletes, HH income, number of sports teams, etc.) and what offerings already exist (existing sports performance studios, clubs that offer sports performance services, programs offered by schools, etc.). It is also important to identify the leading competitors and how you will differentiate yourself from them.

    - *How does your concept or value proposition differ from what already exists?*
      It is important to you as the business owner, but also to investors, to understand how your concept differs from what already exists in the marketplace. Gaining clarity your concept's unique sales proposition and its implications for business success are critical.

    - *Obtain benchmark data on other studios and the industry in general.* It is vital for you to understand what the "norms" are in the industry as it pertains to market penetration, revenue generation, expenses, investments, etc. Investors need to have confidence that you understand the dynamics of the business and have addressed them in your plan. As the owner you need to understand these dynamics to assist in the development of your financial projections.

Once you have completed the research, document the key insights and their implications for your business.

- *Present your general business model*. Having completed your market research, your next step is to clarify the concept or business model for your studio. The business model is intended to provide an overview of your business vision. Typically, you would find the following set forth in this part of your business plan.

    - Concept overview
    - Description of your value proposition and how that makes it unique or different in the marketplace
    - Clarification of your core competencies; those things you do incredibly well and which separate you from the competition
    - Description of your mission, vision and values; the ultimate drivers of your success
    - Description of your core audience for clients and/or members

- *Begin with the end in mind*. Once you understand the dynamics of the market and clarify the business model, your next step is to establish short-term (one year), mid-term (two to three year) and long term business objectives (five year). These objectives frame the journey of your business providing a compass for the actions and strategies you will need to take. The pervading thought in the business world is to create a set of balanced long term objectives, meaning you have identified objectives that address the client and/or member perspective, the partner and employee perspective, the shareholder perspective and possibly the brand perspective. The objectives need to be simple, realistic (e.g., attainable) as well as measurable.

Examples of long term business objectives, by domain, for a fitness studio might appear as follows:

- *Client and/or member domain*
    - ✓ Acquire 100 paying clients that train on average twice weekly by the end of Year 1
    - ✓ Retain 90% of all new clients by the end of Year 1
    - ✓ By Year 3 reach 300 clients using the studio services twice weekly
    - ✓ Our clients will live and work within a 10-minute radius of the studio, be between the ages of 35 and 54 and have an average HH income of greater than $100,000.

- *Shareholder domain*
  - At the end of Year 1 achieve $250,000 in revenues with a net profit margin of 10%
  - Reach breakeven by Month 6
  - By Year 5 reach $750,000 in revenues with a net profit margin of 25%
  - Over the first five years achieve an annual return on invested capital of 15%
- *Partner/Employee Domain*
  - Hire only the best instructors, those certified by a nationally accredited organization and who have at least five years professional experience
  - Keep total payroll costs under 50%
  - Provide an annual continuing education benefit for each instructor of $300.

These are only examples of what an entrepreneur might identify as short-term, mid-term and long-term objectives for the business.

- *Identify an exit strategy*. Most entrepreneurs, especially those in the fitness industry believe they will never leave the business. Indeed, this may be true, but a wise business leader, especially one who may be dealing with investors, understands the relevance of identifying an exit strategy. An exit strategy describes how you, and your partners, if any, will cash out of the business sometime in the future. Your strategy should identify the most likely scenarios, as well as the expected financial outcome of an exit. For example, your exit strategy may be to sell to a larger more established fitness company (approach taken by Soul Cycle when sold to Equinox); sell to an employee of the business, or find other investors to purchase the ownership interests of a portion of the business.
- *Delineate your marketing and sales strategies*. No matter how unique and differentiated your business concept is, it all comes down to your story, and how will people hear about it. Investors and business partners want to know how you will reach out to your target audience; how you intend to provide a compelling message that drives purchase intent. The marketing strategies must be intimately linked to your business objectives and provide a clear understanding of the specific actions you will take. With each strategy you need to identify specific actions that the business intends to take to bring the strategy alive. Two examples of a marketing strategy and actions to support it follow.
  - *Strategy – Conduct quarterly direct mail campaign to targeted households.*
  - *Strategy – Establish social media sites to build studio audience*

- *Frame your financial model.* Provide a clear description of your revenue model as well as your approach to expense management. The model represents the core assumptions about how you will generate profitability.
- *Showcase your talent.* Include a Portrayal of the organizational structure and the relationships between the owners and the management team. Obviously if you are a one person team then this is not necessary. Make sure to include Biographies of the key players (founder, manger, top trainers, etc.). Highlight their education, certifications, work experience and reputation. If possible elaborate on their previous achievements.
- *Embellish the plan with supportive documentation.* To support your business plan and build confidence among potential investors, incorporate materials that demonstrate the points you make in the business plan. For example, to support pricing projections provide examples of how your competitors price. To support your marketing strategy you might incorporate examples of effective strategies used by competitors or by your previous firm. This section of your business plan allows you to demonstrate how well you know your business and how well you have planned for its success.

Creating a Financial Forecast for Your New Business

Once a business plan has been completed, the next step is to create a reliable financial forecast (financial proforma). As a start-up business you will want to create, at the minimum, a five year financial forecast; then once you are in business, generate an annual operating budget. No financial forecast will be 100% accurate, but the objective is to present a realistic projection of what you expect. So what goes into your financial forecast?

- *Key revenue and expense assumptions.* Your assumptions are the key drivers of your financial model. The more detailed your assumptions are, the more accurate your projections will be. Examples of assumptions you would consider for a fitness studio include:

Revenues

- *Average annual price point (dues) for a membership if your business model calls for memberships*. If you will have two categories of membership, one at $400 a year and another at $600 a year, you will need to calculate based on the projected membership levels what the actual average price point will be. If we take the aforementioned example and estimate we will have 200 members at $400 annually ($80,000) and 100 members at $600 ($60,000), then the average price point would be $466. Make sure to build in annual price increases, if nothing else multiply each year by the forthcoming year's projected Consumer Price Index (CPI)

- *Average price for each service you intend to offer*. For example if you will have three price points for individual training/classes and another for group training then you will want to establish an average price point for each. If for example you had two price points for individual personal training, $50 for personal trainers and $60 for master trainers and expected 40% of your clients to use the entry level trainers and 60% to work with the master trainers then you average price point would be $56. Make sure to build in annual price increases, if nothing else multiply each year by the forthcoming year's projected Consumer Price Index (CPI)

- *Membership capacity, if offering memberships, for each year*. Projections for membership capacity should be based on your market research. In general, if you are offering memberships, depending on whether you are a low cost operator, mid-market operator or premium operator you can expect suitable levels of membership capacity to be as follows:

  - A budget operator might allocate five square feet per membership. Thus, if you had 5,000 square feet you could accommodate 1,000 members.

  - A mid-market operator might allocate 10 to 12 square feet per membership. Thus if you had 5,000 square feet you could comfortably accommodate between 400 and 500 members.

  - A premium/exclusive operator might allocate 20 square feet or more per membership. Thus if you had 5,000 square feet you might not accommodate more than 250 and possibly as high as 300 members.

- *Fee based service usage.* In the majority of studios this is the primary source of revenue, and therefore calculating usage levels is critical to projecting revenues. There are several ways to create your assumptions. One approach would be to assume a certain percentage of members would use the services each month. For example if you had 500 members you could assume that 10% of those members (unique client users) would use an additional service each week and each of them would use it twice. Another approach, let's say if you don't offer memberships is that if you have 300 clients, that 20% would visit and pay for a service each day. While no standard exists for what percentage of members and/or clients will pay for a service, empirical data shows that you can expect about 10% of its members to utilize a fee based service each week and to use it an average of 1x to 2x a week. The best operators see 20% to 30% of clients and/or members utilizing a fee based service each week.
- *Rental fees and rental levels.* Some studios rent space to trainers. In this instance you would need to assume an average rental charge and a specific number of trainers you intend to rent to. Depending on the market, studios charge as little as $250 a month rent for a trainer to as much as $2,000 a month.

Expenses

- *Payroll.* If your intent is to have employees, then this will be your largest expense. Typically, trainers get 50% of the revenue generated. If your studio offers classes such as yoga, then possibly the instructor gets 25% of the class fees generated. Of course you could also assume a flat fee for providing training or teaching classes, which would require you to assume a certain number of classes are taught or a certain number of training sessions are provided. For your non-instructional staff (e.g., reception, cleaning, sales) you need to estimate the hourly rate and the number of hours they will work. Successful businesses typically keep their payroll expenses less than 50% of the revenues.
- *Contract labor.* Contract labor represents the staff, such as trainers and instructors who rather than employ, you retain as an independent professional and establish a fee for each service they provide. The easiest way to forecast this would be to assume they receive a given percentage of the revenue they generate. You can pay a higher percentage commission to contracted professionals than you can to an employee because you are not assuming the payroll costs associated with having employees. A word of caution; be conservative with this assumption and try to keep it around 50%.
- *Payroll costs.* This expense line only needs to be considered if you will have employees. For purposes of building a financial forecast you can stick to 16% to 18% of the total payroll.

- *Rent.* If you will be renting a studio, then this will likely be your second largest expense. When establishing your assumptions identify the square footage of your leased space, along with lease rate and common area costs (CAM) that the landlord is charging you. A word of advice, you want to keep your rental costs at 20% or less of your projected revenues.
- *Utility costs.* If you are renting space, then you need to factor in an assumption. The best approach is to identify the utility rates per square foot for your building. A prospective landlord should be able to provide this or you can seek out information from other operators, then multiple it by the square footage you will be occupying.
- *Other operating costs.* There are a lot of items that go into your operating costs, items such as internet expense, administrative costs (contracted bookkeeper or accountant), supplies, phone expenses, educational expenses, etc.). Since you are building financial projections, you can assume these expenses will run between 8% and 12% of your projected revenues.
- *Marketing costs.* Marketing costs typically run 2% to 3% of projected revenues, so if you want to make it easy on yourself you can use this as an assumption, otherwise it is best to work through your marketing strategy then establish a realistic assumption that will allow you to fulfill the marketing strategy.
- *Other cost assumptions to consider.* There are a host of other cost assumptions that need to be considered when preparing your financial projections. The most common ones include:
  - ✓ Property taxes (data easily found through the local government web site)
  - ✓ Principal and interests payments on any debt you plan to obtain.
  - ✓ Depreciation expense (cost associated with the loss in value of your business' fixed assets)
  - ✓ Insurance (general liability, property and professional liability)
  - ✓ Royalties if you are operating a franchise (standard percentage in the industry is 5% to 6% of projected revenues)

Building the Five Year Financial Forecast

Once you have established your financial assumptions, then it's easier to build on the financial projections. Unless you are a financial analyst or have a background in building financial projections, it is recommended that you retain a professional experienced in preparing financial forecasts. It is best if you build your assumptions into an Excel worksheet, since this will make

it easier to build out the forecast for the next five years. Most financial forecasts provide a column for the pre-opening projections and then a column for each of the first five years of operation. While we won't go through the process of building your forecast from your financial assumptions, we will share the core numbers and metrics that need to appear on your financial forecast to demonstrate to potential investors the viability of your vision.

- *Total revenues and revenue by category.* For each time period you want to show the overall revenues both by category (e.g., personal training, classes, retail merchandise), as well as the total revenues.
- *Total payroll costs.* If you intend to have employees then you need to provide the total cost. In addition, it is recommended that you show total payroll as a percentage of revenues, since this is a benchmark metric for the fitness industry against which investors may want to compare you.
- *Occupancy costs.* This represents the cumulative cost of rent and utilities. Some investors may want to see it broken out, otherwise you can combine them.
- *Marketing costs.* Most investors like to see this cost broken out so they can compare it against your marketing strategies and marketing assumptions.
- *Other operating costs.* This line reflects all the other costs associated with operating the business and include items such as insurance, supplies, internet, and general administrative costs.
- *EBITDA. This is earnings before interest, taxes, depreciation and amortization. Every investor in your business is going to want to know what the forecast is for EBITDA. They will also want to know your EBITDA margin which is the percentage of revenues that are retained as EBITDA. Good EBITDA margins range from 20% to 25% of revenues while excellent margins will be above 25% (starting in the 2nd year). If you own your facility rather than lease it, then the margins could be 10% to 15 % higher. In most start-up businesses, studios not being exempt, achieving a breakeven ($0 EBITDA) in year one is considered a success, while having a positive EBITDA would be considered excellent.*
- *Capital reserve.* Capital reserve represents the cash from the business you forecast to keep in the company to pay for the ongoing maintenance and improvements to the studio.

- *Depreciation, principal and interest*. These are important expenses that fall below EBITDA on a financial statement and can heavily influence the cash that can be extracted from the business.
- *Investments*. This represents the cash, whether equity or debt that will be put into getting the studio open. Investments typically include hard costs such as facility design costs, construction costs, equipment purchases and any start-up costs such as the creation of branding and marketing materials.
- *Net cash flow*. This represents the cash that after accounting for all revenues and all expenses that is available for distribution to the owner(s), whether an individual or group of owners.
- *AROIC (annual return on invested capital)*. Some investors prefer ROE or return on equity to return to AROIC. In the case of AROIC this reflects what percentage of the capital that investors put into the venture is returned in net cash flow distributions. ROE would be the percentage of the equity invested that is returned as cash flow each year. The capital invested can be larger than the equity invested since you may assume a bank loan to finance a part of the development. In this case the ROE will be a higher percentage than the AROIC. Investors definitely want to see returns in excess of 10%.
- *IRR (internal rate of return)*. This is a financial calculation that takes into account the equity invested, the value of the cash flow generated annually accounting for the net present value of money each year, and an exit at some point in the future (five to seven years). Typically investors like to see at least a 20% IRR over five years (exit or no exit), but there are some investor groups that like to see IRR's of 25% to 30%.
- *Pre and post money valuation*. This is a complicated calculation that reflects the true value of the business based on its value before investors get involved and then after the investors get involved and the business is sold. The calculation of valuation is best left to an experienced financial professional.

A business plan is a roadmap for success. For a studio owner, the business plan provides direction and clarity on who you are, where you are going, and how you will get there. For investors, a well thought out and documented business plan tells them that you know your business and what is required to achieve success. The budget represents the financial targets that can be expected if your business plan is followed.

As an entrepreneur it is essential to have a clear understanding of the revenues you can expect to generate, the costs it will take to achieve those revenues, and finally, how much profit you can expect. From an investor's perspective the budget provides them with a means to assess the level of risk and reward associated with their investment.