

# Weight Watchers Is Still A Value Trap

April 9, 2015

## What you will learn:

- The definition of a value trap
- How much I lost of Weight Watchers
- Why WTW is still a value trap
- The quantitative and qualitative checks showing the problems that WTW is facing

## The Definition of Value Traps

The dreaded type of investment that you want to buy.

Value traps.

I previously highlighted five characteristics of [value stocks and value traps](#).

Here they are again:

- Cyclical and/or overly dependent on one product
- Hindsight drives expectations
- Marquis management and/or famous investor(s)
- Appears cheap using management's metric
- Accounting issues

A value trap doesn't have to have all of those five points, but several do show up most of the time

One year ago, I sold Weight Watchers for a 40% loss and announced that [WTW was a value trap](#).

Thank God, because I could be sitting on an 80% loss if I held on.

Plus, I still see the company fit many of the value trap definitions above.

## The "Value" Story of Weight Watchers

- Overly depressed stock price
- Cheap relative to past performance
- EV/EBIT of 8
- P/FCF of 2.5
- ROIC sitting at 19%
- Most of the debt is long term debt
- Weight Watchers is still a profitable company able to generate free cash flow
- The Weight Watchers name is a well recognized brand

## **The Value “Trap” Story of Weight Watchers**

The above points are well known and if you just look at the numbers, then it's a very tempting investment.

Although the point about positive FCF comes up regularly, the recent year took the biggest hit. Positive FCF is better than no FCF, but with an interest expense that continues to increase, it will eat up into FCF further limiting the ability to invest into different areas like healthcare and fitness tech.

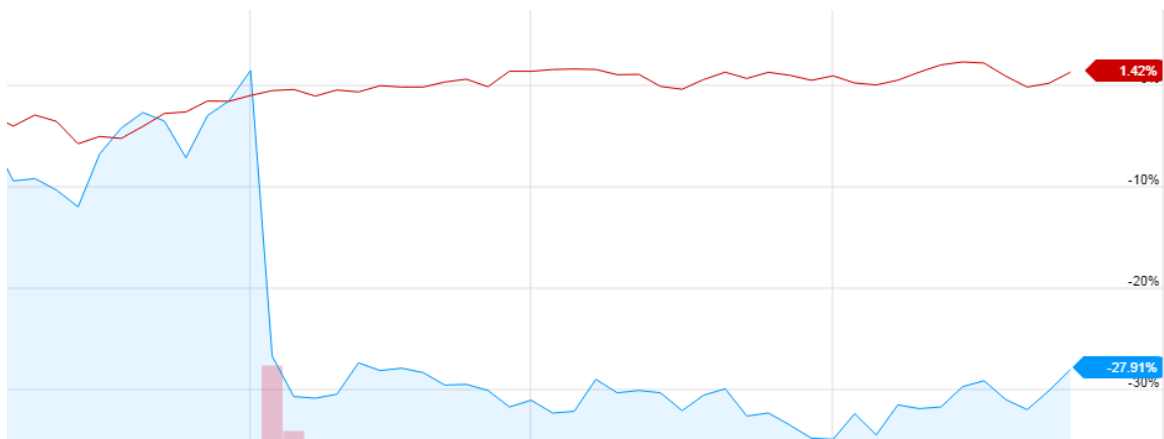
Then factor in the increases in capex required for Weight Watchers to get back on track to compete. Between 2005 to 2012, capex was \$31m at the peak, but in 2013 along, it hit \$62m and \$51m last year. Don't expect this number to decrease.

Although the above metrics can show how cheap Weight Watchers has become, I've learned the hard way that cheap can get cheaper.

It's a human tendency to be optimistic. It's part of our DNA because that's how we survive and the world continues to grow.

However, this tendency also spills over to investments.

We see a chart like this;



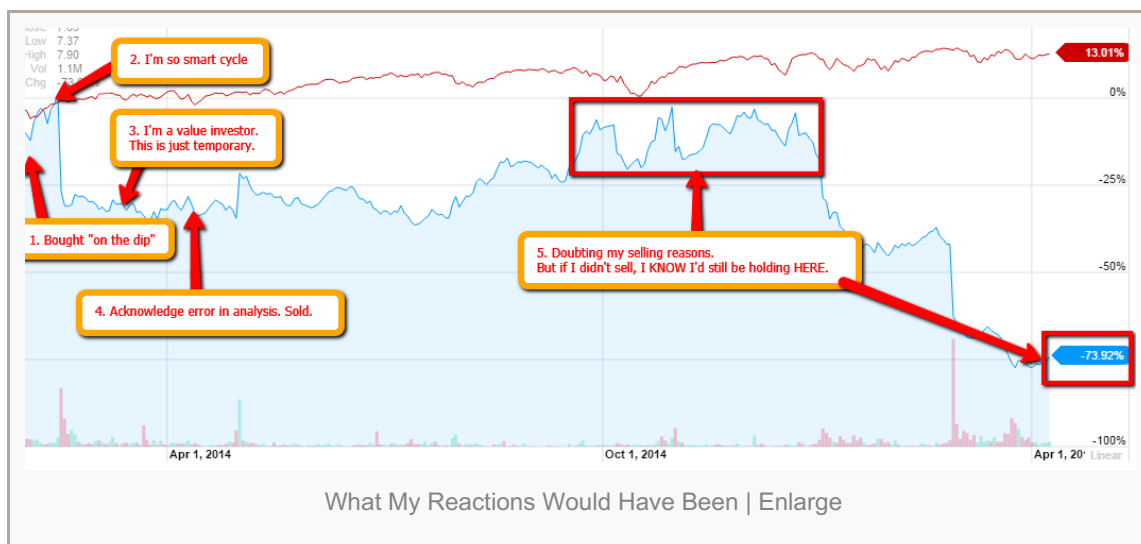
and think it can get better. That the stock has hit the bottom and will bounce back.

When in fact, it can easily turn out like this.



I know that this is in hindsight but I think about how I would have acted during the process from my initial position to today if I continued to hold.

Here's what I believe my reaction cycle would have been.



Cheap can definitely get cheaper.

Looking at the numbers now, it's much easier to see the problems that Weight Watchers is facing.

One of the easiest things to look for are declining margins.

Although gross margins of 54% is within the historical average of 55.5%, operating and net margins have taken a big hit at 20% and 6.7% respectively compared to 27% and 12% the prior year.

## Quality Checks

Here's another quick and easy method to check the quality of a company.

The **Piotroski score**, which is a grading system based on positive accounting trends, is down to 4. The lowest it's been in 10 years.

Piotroski Score								
Piotroski F Scores	2008	2009	2010	2011	2012	2013	2014	TTM
	5	5	8	9	6	6	5	4
Piotroski 1: Net Income	1	1	1	1	1	1	1	1
Piotroski 2: Operating Cash Fl	1	1	1	1	1	1	1	1
Piotroski 3: Return on Assets	0	0	1	1	0	0	0	0
Piotroski 4: Quality of Earning	1	1	1	1	1	1	1	1
Piotroski 5: LT Debt vs Assets	1	1	1	1	0	1	1	1
Piotroski 6: Current Ratio	0	0	0	1	1	1	1	0
Piotroski 7: Shares Outstandin	1	1	1	1	1	1	0	0
Piotroski 8: Gross Margin	0	0	1	1	1	0	0	0
Piotroski 9: Asset Turnover	0	0	1	1	0	0	0	0

WTW Piotroski Trend

## Cyclical & Overly Dependent on One Product.

The meetings are losing relevance each year and it's the biggest part of the company's revenue.

Wearables and fitness tech is gaining speed and Weight Watchers has to be ahead or on par with the competition.

The plan from management isn't going to be enough.

*We enter the 2015 winter season with two objectives, to significantly improve our marketing execution and to launch enhancements to our products. We were optimistic that new creative would be a driving force and the introduction of our coaching and expert chat support platforms would contribute to making 2015 the inflection point for our business.*

At this point, with the lag in Weight Watchers ability to innovate and become a tech company, it looks like Weight Watchers may be the next Motorola. A great company and product at the peak, but reduced to mediocrity and eventually swallowed by another company for it's intellectual property.

The move to healthcare is a good one and management is targeting this segment to bring in \$300m of revenue by 2019.

But is it too late?

In 2014, total revenue was \$1,480m with meeting fees making up \$744m. Approx 50% of revenues.

And here's a look at how meeting fees have been performing over 16 years.

Weight Watchers Historical Meeting Fees								
	1999	2000	2001	2002	2003	2004	2005	2006
Meeting Fees	266.2	283.5	415.7	520.7	607.2	629.1	681.1	723.1
% Change		6.5%	46.6%	25.3%	16.6%	3.6%	8.3%	6.2%
	2007	2008	2009	2010	2011	2012	2013	2014
Meeting Fees	880.7	908.1	817.5	819.6	990.3	934.9	851.6	744.6
% Change	21.8%	3.1%	-10.0%	0.3%	20.8%	-5.6%	-8.9%	-12.6%

WTW Meeting Fees since 1999

Last year saw the biggest drop in meeting fees in Weight Watchers public history.

So even if WTW could do \$300m in the healthcare segment, it will merely replace some of the lost revenue from the meeting fees.

The important metrics to watch for is whether the initial free 6 months offered to employees, will convert to paying customers.

If the cost to acquire each customer is too high compared to the lifetime value of such a customer, then it doesn't matter how much revenue they pull from healthcare.

## Hindsight Drives Expectations

When I bought WTW, I was a victim of hindsight.

Although Warren Buffett says that

*"In the business world, the rearview mirror is always clearer than the windshield"*

the quote can't be applied to every company.

Here's a perfect example of why it doesn't work.

From a strict numbers point of view and believing that management is capable of turn the company around back to its "norm", I can easily fool myself into thinking that WTW is currently cheap.

Assuming a 5yr growth rate of 0%, 9% discount rate and starting FCF of \$180m, I get a fair value somewhere around \$12.50.

The screenshot shows a DCF valuation tool interface. At the top, the company name "Weight Watchers International (WTW)" is displayed along with the date "4/9/2015". There are buttons for "Save as PDF", "Click to Watch Video Tutorial", "Enter Ticker", "Refresh", and "CLEAR". The main table contains the following data:

Shares Out.	M.O.S	Growth	Discount %	Terminal %	Select FCF
56.71	25%	0.0%	9.0%	2%	FCF
		0.0%			
Current Price	Fair Value	Buy Under	Actual M.O.S	52 Wk High	52 Wk Low
\$7.85	\$ 12.49	\$9.37	37%	\$29.84	\$6.71

Below the table, it says "WTW DCF Valuation | Enlarge".

But let's say I don't trust using a DCF as the single valuation method.

Even a EBIT multiples valuation method shows that the "norm" fair value is much higher than the stock price.

<b>Veight Watchers Internatio</b> <b>WTW)</b> '9/2015		Normalized Rev Period 3YR	Projection Normalized EPS	EPS \$2.98	%old scho Figures in Millions exce
Save as PDF					
Enter Ticker Refresh CLEAR		<b>Current Price</b> <b>\$7.85</b> M.o.S	<b>Conservative</b> <b>\$4.33</b> 0.0%	<b>Normal</b> <b>\$14.48</b> 45.8%	<b>Aggressive</b> <b>\$24.63</b> 68.1%
or Each Operating Segment (1)		Conservative	Normal Case	Aggressive	
ormalized Revenue Estimate (2)		1,210.0	\$1,210.0	1,210.0	
Manual Input for Revenue			\$1,210.0		
rojected Normalized Operating Margin (3)		23.8%	23.8%	23.8%	
perating Income Estimate (EBIT)		287.8	287.8	287.8	
aluation Multiple (4)		8x	10x	12x	
<b>estimate Value of Operating Segment</b>		<b>2,302.3</b>	<b>2,877.9</b>	<b>3,453.4</b>	
ash & Equiv on Balance Sheet		301.2	301.2	301.2	
Manual Input for Cash & Equiv					
Total Value of business + cash		2,603.5	3,179.1	3,754.6	
ass Total Debt		2,358.0	2,358.0	2,358.0	
Manual Input for Total Debt					
ass Off Balance Sheet Debt (5)		0.0		0.0	
ass Net Pension/Retirement/Workers Comp		0.0		0.0	
estimated Fair Value of Equity		<b>245.5</b>	<b>821.1</b>	<b>1,396.6</b>	
hares Outstanding		56.71	56.71	56.71	
urrent Price		\$7.85	\$7.85	\$7.85	
<b>estimated Fair Value per Share</b>		<b>\$4.33</b>	<b>\$14.48</b>	<b>\$24.63</b>	
largin of Safety		0%	46%	68%	
rice/Intrinsic Value Ratio (6)		1.8	0.5	0.3	

WTW EBIT Valuation | Enlarge

But that's the problem here.

Hindsight drives expectations and that's what happened and is happening with management.

## Marquis Management and/or Famous Investor(s)

*"When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact." – Warren Buffett*

Artal Group owns 52%, and a lot of faith and emphasis is placed that if Artal bought shares on the open market, it must be undervalued.

But Artal is also run by a person and people also make mistakes.

Placing too much trust and hope in a management team or big investor is just another way of

losing money.

I've been there.

Ultimately, the financial numbers tell the final story. It's so common for management to provide glamorous plans and convince shareholders that they know what they are doing.

But the numbers are the judge and right now, the verdict doesn't look good for Weight Watchers.