Off Wall Street

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New Rec: Tivity Health, Inc. (TVTY: $38.50) May 28, 2018

Position: Source of funds **Potential downside: 30%**

$MM	2Q18e	3Q18e	4Q18e	1Q19e	2018e	2019e
Revs	149.6	148.3	150.0	154.1	597.8	616.5
Adj EPS	0.52	0.53	0.49	0.48	2.03	1.92
Y/Y Gr	28%	16%	21%	-1%	22%	-6%
PE	n/a	n/a	n/a	n/a	19.0	20.0
Cnsns Rev	152.9	154.6	156.4	166.2	613.8	672.6
Cnsns EPS	0.53	0.57	0.56	0.57	2.16	2.43

Shares Out: 43.6 **Market Cap: $1.7B** **FYE Dec**

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Concept:
1. Growth of SilverSneakers (82% of 2017 revenue) is slowing, primarily due to share losses to UNH's pilot program, whose expansion should cause further SilverSneakers share loss.
2. SilverSneakers competitors offer fitness centers higher reimbursement. Fitness center managers are pressuring TVTY to increase payments per visit, which should impact margins.
3. TVTY is trying to grow revenue per eligible member by increasing visits to fitness centers and adding programs such as walking tracked by FitBit. These efforts should see little success.
4. TVTY's Prime Fitness program (15% of 2017 revenue) faces increasing competition from similar programs, and from low priced memberships offered by rapidly expanding PlanetFitness and other chains.

Summary: Tivity (TVTY), previously known as Healthways (HWAY), contracts with health plans to provide fitness center access, primarily to Medicare beneficiaries. In 2017, 82% of revenue came from SilverSneakers (SS), a program for Medicare Advantage (MA) and Medicare Supplement members, who enroll at no additional cost for access to a network of 14,000 fitness locations. These include chains (e.g., Planet Fitness), independent facilities, YMCAs, and adult daycare centers. Some facilities also offer branded SS fitness classes. Another 15% of 2017 revenue came from Prime Fitness, an out-of-pocket fitness network program for commercial health plan members aged 18-64. The remaining 3% of 2017 revenue came from its WholeHealth program, sold to health plans, that offers a network of chiropractic, acupuncture, and other alternative medicine services.

SilverSneakers (SS) has been in existence for over 25 years, first as part of Healthcare Dimensions, which merged in 2004 with Axia Health Management. In October 2006, Axia was sold to disease management company Healthways for $450M. By 2008, Healthways' disease management business was deteriorating rapidly, as health plan customers chose to insource the work. In February 2014, activist investor North Tide launched a proxy battle, won three board seats, and eventually succeeded in ousting the CEO. A new CEO came onboard in July 2016 and began to execute North Tide's plan to focus on SS. The population management business and Healthways brand name were transferred to privately-held Sharecare. The SS, Prime Fitness, and WholeHealth programs were retained by the company, which renamed itself Tivity Health.

SS is available to about 61% of Medicare Advantage members, a market that is growing 8% y-y. SS' market dominance is threatened by the staged rollout of a competing fitness center network by its own customer, UnitedHealth, which, we estimate, generated 25% of SS revenue (or 20% of total revenue) in 2017. This possibility should worry investors, since it seems a reminder of the fate of TVTY's previous disease management business. UnitedHealthcare (UNH), which has the #1 share in the MA market, launched its Optum Fitness Advantage network in two states in 2017 and in nine additional states in 2018. Today, we estimate Optum Fitness has 9% of the total MA market. Our research and discussions with industry observers suggest UNH is likely to roll out in another 11-14 states beginning January 1, 2019. North Tide also seems to have seen the writing on the wall, since it began selling its 11% position in TVTY shares in 1Q17, and owned just 1.6% of shares by the time UNH announced its nine state rollout in November 2017. North Tide now appears to be fully wound down, and its founder did not stand for reelection to TVTY's board on May 24, 2018.

We think this rollout is already impacting SS revenue growth, which slowed from 10% y-y in 2017 to 4% y-y in 1Q18. The company blamed flu and cold weather for this slowdown, but as we discuss, there may be more to the story. Bulls expect a reacceleration to 8% y-y growth for the full year 2018, in line with growth of the overall MA market, as the company increases enrollment and visits by eligible members. For 2019, bulls are modeling 8%-9% growth for SS, and do not appear to be including a further rollout for Optum Fitness in their estimates.

The senior fitness benefit market appears fully penetrated, meaning TVTY must take business from others to replace any lost UNH revenue. This could prove difficult. Humana (#2 MA share) already offers SS to nearly all of its plan members. In January 2018, Aetna (#3 MA share) dropped Silver&Fit in some areas to become a national SS account. This helped fill in some of the revenue lost from UNH's nine state rollout, but it also means there is no large client to convert in 2019 to offset revenue lost from UNH's likely continued Optum Fitness rollout. We expect SS revenue growth of 5.4% y-y in 2018 and just 1% y-y in 2019.

The introduction of Optum Fitness is not only taking MA members from SS, it also threatens to increase the cost of SS visits. TVTY pays fitness centers in its network about $3 for each member visit, capped at about eight visits per month ($24). Industry sources say that these rates have been static for many years. Fitness center owners are being offered rates of as high as $30-$32 per month by Optum Fitness and Silver&Fit, and are asking SS to increase reimbursement per visit. Thus far, there has been little sign of cost pressure in TVTY's gross margins, which were flat at 29% in 2016 and 2017, but we expect cost pressure to increase as Optum Fitness rolls out in more states.

Longer term, SS faces challenges because there is no proof that offering the benefit actually lowers health plan costs. As MA plans are squeezed by higher costs, they may look to shift dollars to spending that has been shown to lower costs. Industry participants tell us that UNH/Optum, with its superior analytic capabilities and formidable operating leverage, may be able to win fitness network business away from SS. We note that Optum already provides services used by non-UNH health plans, including utilization management and analytics services.

TVTY has tried a number of programs in an attempt to increase SS engagement, and thus revenue, from eligible members. Our discussions with industry participants suggest success has been elusive. For example, the company's Flex program is supposed to allow SS members to engage in certified instructor-led classes outside of the fitness center. Some of these classes are offered at adult daycare centers, which reach members that cannot make it to the gym. While the program looks interesting on paper, industry participants tell us that execution has been very poor. Sales managers are sometimes successful getting health plans on board with the concept, but observers say that management may not follow through with contracting for the site where it will be offered, or finding the instructors for the program.

TVTY will hold an investor day on June 1, 2018. It has promised to discuss new programs to improve member engagement. Many of these programs appear to be pilot stage. Industry observers tell us that so many pilots are underway that it will be difficult to measure success, if any. Even execution at the pilot stage appears to be a problem. For example, a FitBit pilot, designed to reward members for steps completed, was reported to have been pitched to Humana (HUM) several months ago. We were told that TVTY presenters were challenged to respond to HUM's questions about how the program would work, and did not have an adequate analytics plan to measure success. It will be interesting to learn if HUM or another plan has been willing to participate in a FitBit pilot.

TVTY's Prime Fitness program (aka Fitness Your Way) was 15% of 2017 revenue, and grew 22% y-y. Revenue increased 19% y-y in 1Q18, but benefited from a 16% price increase for new members on 1/1/18 ($29 per month from $25 prior). Unlike SS, health plan members must pay for this benefit out-of-pocket. For $29 per month (with minimum 3 month commitment and a $29 enrollment fee that is often waived), Prime Fitness members get access to a network of 10,000 fitness locations, primarily chains like Planet Fitness, LA Fitness, Curves, and Snap Fitness. As with the SS network, TVTY pays these gyms on a per visit basis with a monthly cap. We model double digit growth in line with the "street," but, as we discuss below, competition in the segment is very high. In addition, we note that in May 2018, TVTY is offering one month free in addition to a waived membership fee on its Facebook page (https://www.facebook.com/TivityHealthFitnessYourWay/). We do not see evidence of similar offers in 2017 or before. Perhaps higher prices are hurting enrollment.

On November 6, 2017, the day UNH announced the Optum Fitness expansion, TVTY shares declined 34% to $31.60. TVTY management released a statement that day maintaining the 2018 guidance it had offered on October 26, 2017, saying that it had anticipated UNH's change. The fact that had not shared this important news with its investors prior to UNH's announcement has of course triggered multiple shareholder lawsuits. Since UNH's announcement, shares have risen 22%, despite 1Q18 revenue of $149.9M, below consensus of $154.4M. Bulls appear optimistic that the company can increase enrollments and visits by eligible SS members, both during the rest of 2018 and into 2019. As mentioned above, the "street" does not appear to be modeling a further rollout of Optum Fitness Advantage.

The "street" expects $613.7M in revenue in 2018 and $672.6M in 2019, with EPS of $2.16 in 2018 and $2.43 in 2019. We model $597.8M in revenue for 2018 and $616.5M in 2019, with EPS of $2.03 in 2018 and $1.92 in 2019. TVTY currently trades at 16x consensus 2019 EPS. Our $27 future fair value estimate is based on a multiple of 14x our 2019 EPS of $1.92, below its current multiple of 16x. At our fair value price, TVTY's EV/2019 EBITDA multiple would be 10.3x versus its current valuation of 11.3x consensus. TVTY's FCF yield at our fair value price would be 6.8%.

Borrow information: TVTY

Supply Quantity	Short Interest	Available to Borrow	Date
16.5M	5.5M	10.1M	5.25.2018

Source: OWS/Prime Brokers Estimates

Background:

Tivity, based in Franklin, TN, was founded in in 1981 and went public in 1991 as American Healthcorp. It later changed its name to American Healthways, then to Healthways, and most recently to Tivity. Today, it has about 475 employees who maintain relationships with 63 health plan customers and with a network of 14,000 contracted fitness centers. We previously wrote about Healthways in 2006 (see OWS archives).

SS invented the senior fitness benefit market when Healthcare Dimensions started offering the program over 25 years ago. It gained market dominance in part by signing fitness centers to exclusivity agreements, blocking them from signing with competing networks. These agreements often also had one year post-termination non-compete clauses that also effectively blocked competing networks. That changed in June 2013, when TVTY settled anti-trust litigation brought by American Specialty Health. TVTY agreed to end its exclusive contracting, opening the door to the expansion of Silver&Fit, and ultimately to UNH's Optum Fitness Advantage.

In 2016, TVTY tried to maintain some degree of exclusivity for its branded SS classes by asking fitness centers to block attendance by non-SS members. The fitness centers, particularly YMCAs, rejected this move, with some dropping SS entirely. Fitness centers now openly market SS classes as available to all members, and over 175 YMCAs around the country are offering classes called EnhanceFitness, which are very similar to SS classes. In addition, Silver&Fit touts its program to health plans as giving members access to SS classes at a lower cost.

Health plans offering SS to their members pay TVTY a per member per month (PMPM) fee for each eligible member or for each member receiving services per month, with some plans paying a combination of PMPM and member participation fees (e.g., fee per fitness center visit). The company calls these "hybrid" customers, which is says accounted for 64% of eligible lives in 2018, up from 61% in 2016. Contracts vary widely, and company disclosure is scant, making precise modeling difficult. According to TVTY, only about 7% of SS eligible members are active users (6-7 visits per month), 14% are sporadic users, and 79% never use the benefit at all. TVTY positions this as a great opportunity, since it can increase revenue if it gets those already eligible for SS to enroll and participate more frequently.

TVTY pays participating fitness centers for each visit by a SS member. Most fitness center managers report that they receive about $3 per visit, with reimbursement capped at about eight visits ($24) per month. Participating fitness locations include YMCAs, independent gyms, Parks & Recreation departments, and lower cost chains like Planet Fitness franchises (not available in all locations), LA fitness, and Anytime Fitness. Notably, higher end chains like LifeTime Fitness (except some acquired locations that already had SS contracts) do not participate in SS. Industry participants tell us that health plans would like these fitness centers to be included, but SS is not willing to adjust its payment structure to win contracts with these chains. In some markets (e.g., Florida), TVTY also contracts with adult daycare centers and other locations to offer SS classes to seniors who may not be able to make it to a fitness center.

Today, over 80% the 19.1M Americans enrolled in MA plans have access to SS or a competing fitness network. We think this is full penetration, since the remaining 20% of MA enrollees are in smaller, lower quality plans that do not offer a fitness benefit. Enrollment in MA plans is growing at about 8% y-y, higher than the 3%-4% growth of the Medicare population. Market experts expect continued 8%-9% growth for several years, as more Medicare enrollees choose MA over Medicare Supplement insurance or no additional insurance at all. Only about 25%-30% of the 14.1M Americans enrolled in Medicare Supplement (Medigap) insurance have access to SS or a competing network. Unlike MA plans, Medigap plans do not receive quality bonuses from CMS to be used to pay for "extras" like fitness, dental/vision, or $0 copays. The Medigap enrollment population is growing about 3.5% y-y.

TVTY has the largest share of the senior fitness benefit market, with about 61% of MA members and 24% of Medigap members eligible to enroll in SS. The second largest player is American Specialty Health's Silver&Fit program, which we estimate has about 10% share. Industry participants tell us that many smaller plans do not sign exclusively with SS or Silver&Fit, since offering both gives them more negotiating leverage.

TVTY's largest customers in 2017 were UNH and HUM, which together generated about 38% of total 2017 revenue, and about 44% of SS revenue. Based on MA enrollment data, we estimate UNH represented 25% of SS revenue in 2017, while HUM represented 19%. Other important customers are Aetna (AET), Anthem, and independent Blue Cross Blue Shield plans.

About 15% of 2017 revenue came from TVTY's Prime Fitness program, a network of 10,000 fitness centers. Health plans market this program to their members as a discounted gym membership. Revenue for TVTY comes primarily from initiation and monthly membership fees paid directly by plan members with their credit cards. WholeHealth (3% of 2017 revenue) offers a network of chiropractic and other alternative care specialists that offer discounted services, and also utilization management and accreditation services. HUM appears to be the biggest customer of WholeHealth, with a dedicated 800 number for providers on its website. Cigna also has an 800 number, but that is only for services in Washington state and Oregon.

As we discuss below, we think it quite likely that UNH will further roll out its Optum Fitness Network in 2019, significantly impacting SS growth in 2019 and beyond. Given that UNH appears to be SS' largest customer, and that few MA plans exist that do not have SS or a competitor, it will be difficult for TVTY to replace this revenue. Moreover, we think the more generous payments made to fitness centers by Optum Fitness and Silver&Fit will lead to demands for higher reimbursement for SS visits, pressuring TVTY's margins. As shown in the table below, we think these challenges will lead to lower revenue, EBITDA, and EPS than the "street" expects.

Table 1: “Street” vs. OWS Estimates 2018-2019

$M	"Street" 2018e	OWS 2018e	"Street" 2019e	OWS 2019e
SilverSneakers	495.5	481.1	535.1	485.9
Prime Fitness	100.7	99.5	119.0	112.9
WholeHealth	17.5	17.2	18.4	17.6
Total Revenue	613.75	597.8	672.6	616.5
Adj EBITDA	141.4	134.4	157.7	127.6
Adj EPS	2.16	2.03	2.43	1.92

Y-Y change	"Street" 2018e	OWS 2018e	"Street" 2019e	OWS 2019e
SilverSneakers	9%	5%	8%	1%
Prime Fitness	21%	19%	18%	13%
WholeHealth	5%	3%	5%	2%
Total Revenue	10%	7%	10%	3%
Adj EBITDA	10%	4%	12%	-5%
Adj EBITDA Margin	23%	22%	23%	21%
Adj EPS	30%	22%	13%	-5%

Discussion:

1. UNH seems likely to continue rolling out Optum Fitness Advantage in 2019

TVTY’s 2018 10-K discloses the following about its relationship with UNH:

> “While we believe United Healthcare values the health benefits that SilverSneakers presents to its Medicare Advantage beneficiaries as well as the brand recognition of SilverSneakers among active seniors, United Healthcare may discontinue offering SilverSneakers to its Medicare Advantage beneficiaries in additional states in 2019 or 2020 within contractual limitations and/or may offer multiple fitness benefits, including SilverSneakers.”

TVTY management has not made any public prediction about the potential further rollout of Optum Fitness, but routinely discounts the threat, telling investors that the SS brand is so powerful that MA members will and actually have changed plans when it is not available. Bulls seem to have bought into this line of thinking, with one commenting on TVTY’s 1Q18 call that there was “some evidence to suggest that perhaps they're not winning as market -- as much market share in the areas where they insource.”

Our analysis indicates that UNH has rolled out Optum Fitness Advantage to about 34% of its total MA membership. Given this level of commitment, it is difficult to imagine that UNH would not continue the rollout, absent some negative impact to enrollments. As shown below, in the 11 states where Optum Fitness is the sole fitness offering for UNH MA members, UNH has either maintained or gained market share. Its MA membership grew 13% y-y in these states, versus 8% y-y growth for the market overall.

Table 2: MA Enrollment by State, April 2018

	UNH	All Other	Total
AZ	226,706	263,734	490,440
FL	483,760	1,453,432	1,937,192
KY	42,445	233,994	276,439
NJ	147,629	214,780	362,409
NY	354,373	1,068,078	1,422,451
OH	133,059	804,398	937,457
OK	40,610	96,408	137,018
OR	58,298	315,932	374,230
TX-excl DFW*	410,602	869,406	1,280,008
WA	139,941	277,037	416,978
WI	181,956	275,815	457,771
Total	2,219,379	5,873,014	8,092,393

*SS is still available to UNH members in Dallas-Fort Worth (Dallas and Tarrant counties)

Table 3: MA Enrollment by State, April 2017

	UNH	All Other	Total
AZ	210,829	255,289	466,118
FL	434,297	1,371,431	1,805,728
KY	38,684	215,428	254,112
NJ	133,123	196,811	329,934
NY	341,479	1,001,541	1,343,020
OH	107,717	761,653	869,370
OK	33,947	92,177	126,124
OR	50,484	307,135	357,619
TX-excl DFW	343,443	783,785	1,127,228
WA	102,263	262,518	364,781
WI	165,506	272,395	437,901
Total	1,961,772	5,520,163	7,481,935

Source: https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/MCRAdvPartDEnrolData/Monthly-Enrollment-by-State.html

Table 4: Y-Y Enrollment Change, UNH Market Share by State, 2017-2018

	UNH Y-Y change	All Other Y-Y Change	Total Y-Y change	UNH 2017 Share	UNH 2018 Share
AZ	8%	3%	5%	45%	46%
FL	11%	6%	7%	24%	25%
KY	10%	9%	9%	15%	15%
NJ	11%	9%	10%	40%	41%
NY	4%	7%	6%	25%	25%
OH	24%	6%	8%	12%	14%
OK	20%	5%	9%	27%	30%
OR	15%	3%	5%	14%	16%
TX-excl DFW	20%	11%	14%	30%	32%
WA	37%	6%	14%	28%	34%
WI	10%	1%	5%	38%	40%
Total	13%	6%	8%	26%	27%

UNH's success in gaining share in the Optum Fitness roll-out states mirrors the success it is seeing nationally, as well. As shown below, UNH grew its total MA enrollment 13% y-y from April 2017 to 2018. Only AET grew at a faster pace (20%), but off of a much lower base. Thus, SS faces a dual problem. Not only is it losing its largest SS customer, that customer is also the fastest growing MA participant, taking share from many of its smaller clients.

Table 5: MA National Enrollment by Plan, April 2017 and April 2018

	April 2017	April 2018	Y-Y chng	Net Change in Members	April 2018 Share
Aetna	1,395,511	1,669,655	20%	274,144	8%
Anthem	745,368	816,554	10%	71,186	3%
Centene	271,814	277,735	2%	5,921	1%
Cigna	383,375	373,221	-3%	(10,154)	2%
Humana	3,289,034	3,507,902	7%	218,868	17%
Molina	97,476	99,420	2%	1,944	0%
United	4,648,379	5,245,481	13%	597,102	25%
Wellcare	424,589	450,062	6%	25,473	2%
Other	8,322,012	8,588,908	3%	266,896	41%
Total	19,577,558	21,028,938	7%	1,451,380	100%

Source: https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/MCRAdvPartDEnrolData/Monthly-Enrollment-by-Plan.html

Numerous industry participants, including executives at fitness center chains, told us that they expect a further rollout of Optum Fitness in January 2019, with some mentioning rumors about an expansion into 11-14 more states. In 2017, the chatter about the 2018 expansion began in the summer, when UNH began signing up fitness centers in new states, and insurance brokers began getting details about new plan structures. We think this scenario is likely to repeat during the summer of 2018, with an announcement by UNH in October-November, coinciding with the 2019 Medicare Open Enrollment period (10/15/18-12/7/18).

2. Growth in SS eligible members is slowing, with the impact of UNH losses somewhat offset in 2018 by added AET members

Many MA and Medigap members are eligible for fitness benefits. We estimate that about 80% of MA members are offered the benefit, versus about 25%-30% of the Medigap population. As shown in the tables below, the total potential market for SS grew about 6% y-y in 2018. MA market consultant Gorman Health Group expects MA enrollment growth of 8%-9% in 2019 and 2020, with slowing y-y growth of Medigap enrollment (https://www.gormanhealthgroup.com/blog/the-outlook-for-government-sponsored-health-programs-in-2018/).

Table 6: SS Total Addressable Market, 2015-2018

	2015	2016	2017	2018
Total MA Lives	15.8	16.7	17.7	19.1
Total Medigap Lives	12.4	13.1	13.6	14.1*
Total Potential SS Lives	28.2	29.8	31.3	33.2

Sources: https://www.kff.org/medicare/fact-sheet/medicare-advantage/, CSG Actuarial
*OWS estimate

Y-Y chng	2015	2016	2017	2018
Total MA Lives	10.5%	5.7%	6.0%	8.0%
Total Medigap Lives	6.9%	5.8%	3.5%	3.5%
Total Potential SS Lives	8.9%	5.7%	4.9%	6.0%

As shown in the table below, TVTY reported a 6.8% y-y increase in SS eligible lives in 2018, 80 bp faster than the growth of its addressable market. However, in both 2016 and 2017, the number of SS eligibles grew 320 bp faster than the addressable market.

Table 7: SS Eligible Members (millions), 2015-2018

	2015	2016	2017	2018
MA members eligible begin period	9.1	10.0	11.0	11.9
Medigap members eligible begin period	3.3	3.4	3.6	3.7
Total SS eligible members begin period	12.4	13.5	14.6	15.6

Source: TVTY presentations

	2015	2016	2017	2018
MA members eligible begin period	9.6%	9.9%	10.0%	8.2%
Medigap members eligible begin period	6.5%	6.1%	2.9%	2.8%
Total SS eligible members begin period	8.8%	8.9%	8.1%	6.8%

Eligible member growth in 2018 has come from underlying growth in membership at existing accounts, and also from AET (#3 MA market share) converting from a regional to a national SS account. With HUM and AET now fully penetrated, there do not appear to be any other large accounts TVTY can convert in 2019 to make up for losses from a further expansion of its Optum Fitness network.

3. Increased revenue per eligible SS revenue seems unlikely to be enough to offset losses from a further Optum Fitness network rollout

TVTY is trying to increase enrollment of eligible members and visits per enrolled member to grow SS revenue 8%-9% per year, above the growth in the number of eligible MA and Medigap members. However, it does not provide investors with the metrics needed to determine how SS revenue generation might be changing (e.g., % of revenue from visits, % of revenue from PMPM).

The table below illustrates how we estimate the impact of the Optum Fitness rollout in 2018 and beyond. In our model, UNH's spending increases, but an increasingly large part of the spending goes to its own Optum program and SS gets less and less of a percentage of the total spending pie. We assume UNH's 2017 senior fitness spend was $114M, nearly all of which went to SS. In 2018, we expect this spend to increase 14% y-y (in line with 13% membership growth) to $130M, but 30% of this will be spent on its own Optum Fitness program, leaving $91M for SS. We expect SS revenue at other customers to increase 14% y-y to $390M, so total 2018 SS revenue would be $481M, up 5% y-y.

Table 8: OWS Estimates of Optum Fitness Rollout Impact on SS Revenue, 2018-2020

$M	2017	OWS 2018e	OWS 2019e	OWS 2020e
UNH Total Senior Fitness Spend	114.2	130.2	147.9	165.6
SS % UNH Senior Fitness Spending	100%	70%	33%	15%
UNH SS rev	114.2	90.6	48.6	25.3
Other SS rev	342.5	390.5	437.3	481.1
Total SS Revenue	456.7	481.1	485.9	506.4
Y-Y chng				
UNH Senior Fitness Spend	n/a	14%	14%	12%
UNH SS rev	n/a	-21%	-46%	-48%
Other SS rev	n/a	14%	12%	10%
Total SS Revenue	n/a	5%	1%	4%
UNH % Total SS	25%	19%	10%	5%

Source: OWS Estimates

In 2019, we assume UNH's total senior fitness spend again increases by 14% y-y (up more than the 8% growth of the underlying MA market due to market share gains) to $148M, but expect 66% of this to be spent on its own Optum Fitness network, leaving $49M for SS. We generously assume SS revenue at other customers to increase 12% y-y to $437M, so total 2019 SS revenue would be $486M, up 1% y-y. In 2020, SS growth improves to 4% y-y since the drag from UNH losses is nearly complete.

The sensitivity analysis in the table below illustrates our estimate of the best, average, and worst case scenarios for the further rollout of Optum Fitness in 2019. In the best case for TVTY, SS retains 50% UNH's Medicare fitness spend. In this scenario, SS revenue would increase 6% y-y versus the 8% expected by the "street." The average case, 1% SS growth from UNH, is used in our estimates and the table above. The worst case, only 20% of UNH Medicare fitness spend remaining with SS in 2019, would mean a 3% y-y decline in SS revenue.

Table 9: Sensitivity Analysis: 2019 UNH SS Spending Scenarios

	Best	Average	Worst
SS % UNH 2019 Fitness Spending	50%	33%	20%
UNH SS Revenue	73.9	48.6	29.6
Other SS Revenue	437.3	437.3	437.3
Total SS Revenue	511.3	485.9	466.9
Y-Y change SS Revenue	6%	1%	-3%

Source: OWS Estimates

4. Recent 1Q18 SS shortfall may not be made up in 2Q18-4Q18 quarters

SS revenue grew just 4.3% y-y in 1Q18, below the 8% y-y growth expected. Total revenue in the quarter missed "street" expectations by $4.5M. SS revenue growth was well below the 6.8% y-y growth in SS eligible lives in 2018. Reported visits were up 5.8% y-y, suggesting fewer visits per eligible member. However, since we do not know how eligibles are actually using SS, or how TVTY is compensated for these visits, it is difficult to know how lower visits might impact SS revenue.

Management blamed the miss on lower fitness center visits due to flu and cold weather. This miss surprised the "street," because management had given no hint that January and February were weak when it reaffirmed its 2018 guidance on its February 22 4Q17 earnings call. This lack of transparency seems to repeat the pattern illustrated by the company's silence on the Optum Fitness rollout until UNH's November announcement.

There may be other reasons for the 1Q18 miss. On January 9, 2018, TVTY announced a contract extension with HUM to provide SS through 2022. The existing contract was set to expire in 2020, so it is curious that the companies would sign an extension two years early. We wonder if HUM, knowing that TVTY was under pressure from UNH's insourcing, negotiated a lower fee for SS in exchange for the extension. AET, which had been offering SS in some areas and lower cost Silver&Fit in others, became a national SS customer in January 2018. AET likely switched members from Silver&Fit to SS in exchange for a lower overall per member cost. If these companies, and perhaps others, squeezed TVTY on SS pricing, revenue may remain below expectations for the rest of 2018.

TVTY did not disclose quarterly SS revenue in 2017, but we can estimate it based on other disclosed information. As show in the table below, in 2017 there appeared to be little seasonality to SS revenue, with nearly 25% of revenue recognized each quarter. However, industry participants report that senior gym visits mirror that in the general population: Highest in January (New Year's Resolutions) and March (getting ready for the beach), lowest in the summer, and then a bit higher October and November, before the holidays. The lack of seasonality in SS revenue in 2017 suggests that the large majority of revenue was paid on a PMPM basis, with only a small kicker from increased visits in 1Q17.

Table 10: Seasonality of SS Revenue

	1Q17	2Q17	3Q17	4Q17
Silver Sneakers Revenue	116.0	114.2	112.6	113.8
% of Total	25.4%	25.0%	24.7%	24.9%

Management tells investors that "hybrid" customers, for whom it receives both PMPM and per visit revenue, account for 64% of eligible lives in 2018, up from 61% in 2016. Even if TVTY is successful in increasing gym visits during the rest of 2018, we doubt that it would be enough to drive revenue growth from 4% y-y in 1Q18 to the 10% y-y in 2Q18-4Q18 needed to meet "street" expectations.

5. TVTY has suffered from customer insourcing before

There is precedent for the insourcing of TVTY services that should worry bulls. In 2008, the company (then known as Healthways), began to lose disease management customers. One of the first to leave was Blue Cross Blue Shield of Minnesota in May 2008, followed by Cigna in October 2011. Insurers said that insourcing disease management gave them more control over their members, and created more opportunities to collaborate with physicians. Another reason for insourcing was HWAY's inability to prove a positive ROI for disease management programs, at least at the prices it was charging.

UNH's rollout of Optum Fitness may be driven by similar factors. Using its prodigious analytic capabilities, Optum can combine member gym visit data and medical information to design outreach programs for at-risk populations. Industry participants say this outreach may be directed at physicians, rather than patients, since providers are thought to be in the best position to influence individual patient outcomes. For example, UNH could flag obese patients within a physician's practice, and provide incentives to physicians who are successful in encouraging more frequent gym visits, which could ultimately result in weight loss and lower health costs. If UNH can show a positive ROI for its Optum Fitness network, it may win business away from SS at other insurers, many of which are already using Optum's pharmacy benefit and utilization management services.

Industry participants report that, as was the case for disease management, the lack of proof that SS actually reduces health care costs presents a real long-term risk for the program. Today, plans will pay for SS without proof of a positive ROI because most pay for it with quality bonuses earned from CMS. These bonuses are paid to plans earning 4-5 quality stars from CMS based on effectiveness of delivery (e.g., percent of members receiving flu shots) and health outcomes. These plans receive a 5% bonus payment per member that must be spent on "extras" such as low/$0 copays, dental/vision, or fitness programs. In 2018, 73% of MA members were enrolled in plans rated 4-5 stars, which helps explain why about 80% of MA members currently have access to a fitness program (SS, Optum Fitness, or Silver&Fit). As MA costs increase, industry participants tell us it is likely plans will try to spend bonus dollars on extras that, unlike the SS program, are proven to actually reduce costs.

6. Gross margin compression seems likely as fitness centers seek SS visit reimbursement comparable to Optum Fitness and Silver&Fit

Our interviews with fitness centers suggest that both Silver&Fit and Optum are offering much higher reimbursement for senior visits than that offered by Tivity for SS. Instead of SS' $3 per visit fee capped at 7-8 visits a month ($21-$24 per month), Silver & Fit and Optum reimburse centers a set amount ($19-$32, depending on the center's basic membership rate) if a member visits at least once a month. At a Snap Fitness in Oregon, Optum pays $32 per month and Silver & Fit pays $30 per month, much better than this gym's $2.85 per visit/$22.80 per month cap for SS. TVTY says its average active member visits 6-7 times per month, but many visit just one or two times. Thus, from the fitness center perspective, the Optum Fitness and Silver&Fit payment models offer more potential upside.

Optum Fitness' payment structure was so attractive to Planet Fitness (~$22 per month for members visiting at least once a month) that it signed its first ever corporate agreement for a senior fitness benefit. In contrast, SS is offered at Planet Fitness locations at the discretion of the franchisee.

Industry participants report that fitness centers are increasingly pressuring TVTY to increase SS reimbursement to a level more in line with Optum and Silver&Fit. These requests are even coming in the midst of fitness centers' 2-5 year SS contracts. Some industry participants think that TVTY uses "creative" ways to increase payments to centers without changing payments per visit. This might include making charitable donations to YMCAs, and funding other programing at fitness centers, costs that would probably show up in SG&A.

Thus far, there has been little evidence of this pressure on TVTY's gross margin, which has been flat at 29% in 2016 and 2017. In addition to perhaps shifting some fitness center reimbursement costs to SG&A, TVTY has apparently dramatically reduced the number of staff supporting the fitness centers. We have heard, for example, that the number of staff managing the fitness network (e.g., handling visit reporting, contracting, quality control) has declined from about 100 in 2016 to just 35 today. If this is correct, over a network of 14,000 locations, this means each support person has gone from supporting 140 locations to supporting 400 locations.

We think the continued rollout of the Optum Fitness network, with its more generous reimbursement, could lead more fitness locations to look for higher reimbursement from TVTY. Given the deep staffing cuts TVTY has already made, it may become increasingly difficult for TVTY to offset higher payments with cuts elsewhere. TVTY may have to ramp staffing back up in order to compete more effectively with Silver&Fit, and perhaps even with Optum, should non-UNH health plans begin to consider a switch. We expect EBITDA margins to decline from 23% in 2017 to 22% in 2018 and 21% in 2019.

7. New programs unlikely to be successful

With growth in the available SS market slowing and UNH insourcing members, TVTY is looking to capture more revenue per SS eligible member by increasing enrollment and participation. On its 2Q17 call, management said that it had about 40 pilots underway in SS and Prime Fitness looking for ways to achieve this growth. It promised to provide "definitive participation statistics" from the programs after 2Q18, and said it expected 10-12 of these pilots to be fully integrated into its programs in 2018 "not at a cost that's going to erode margins."

Industry participants think that by trying so many pilots at the same time, TVTY risks being unable to determine which, if any, are having a positive impact. There also seem to be significant execution issues with the pilots. For example, the company pitched a pilot to HUM that uses FitBits to measure steps, which would allow TVTY to get paid for non-fitness center participation. We were told the presentation fell flat when TVTY could not answer basic questions about how the impact of the program would be measured. We also heard that another pilot might have even threatened SS members with suspension of their membership privileges unless they attended a minimum number of classes per month.

We may learn more about TVTY's SS pilot programs from the company's investor day, scheduled for June 1 in New York. We think it is unlikely that these programs would work, if only because TVTY is attempting what seems to be a Sisyphean task. As proved to be the case with disease management, we think it is unlikely that SS can change the behavior of the senior population in a meaningful way at a reasonable cost. The root causes of American's poor health are likely much more than a free gym membership can cure.

8. Prime Fitness faces significant competitive pressures

Prime Fitness was 15% of revenue in 2017, and grew 22% y-y. The program is marketed primarily through Blue Cross Blue Shield commercial health plans. BCBS members who enroll for $29 per month get access to a network of fitness centers, primarily YMCAs and lower cost chains such as Anytime Fitness, LA Fitness, Planet Fitness, YouFit, Crunch Fitness, and Curves. The program does not include popular higher cost gyms such as LifeTime Fitness and Equinox, or boutique yoga, cycling, rowing, cross fit, or other facilities.

TVTY reported 19% y-y growth for Prime Fitness in 1Q18, but much of this growth appears to have come from a 16% y-y price increase ($25 per month to $29 per month) for new members effective January 1, 2018. The company announced to some health plans that it would take this increase in mid 2018, so growth in 2H17 may have been driven in part by members joining ahead of the increase to lock in a lower payment. The "street" models growth of 21% y-y 2018 and 18% y-y in 2019. We model growth of 19% y-y in 2018 and 13% y-y in 2019, which could prove generous if TVTY's price increases drive potential customers to competitors.

Prime Fitness faces competition from similar programs. For example, American Specialty Health markets its Active & Fit Direct program, which costs members just $25 per month. Other competing fitness networks are available, including GlobalFit and International Fitness Network, which offer discounted memberships. In addition, Prime Fitness must compete with rapidly expanding chains within its own network. For example, Planet Fitness offers access to its own network of 1,565 locations for just $21.99 a month.

Many health plans offer fitness center fee reimbursement benefits that give members access to a much broader choice of facilities. For example, UNH will reimburse members $20 per month for a gym membership if they go to the gym at least 12 times a month. This means a member with a $10 per month Planet Fitness membership could actually make $120 per year for regular workouts. Other plans offer three months of paid fitness center membership per year, regardless of the monthly cost. Finally, the growth of other fitness network membership options such as ClassPass are competing directly with Prime Fitness for share of members' wallets.

9. WholeHealth is small, slow growing

TVTY's WholeHealth network generated about 3% of revenue in 2017, and seems to be growing in the low single digits. Its website lists 800 numbers for Humana and Cigna, which appear to be its largest health plan customers. The primarily purpose of the network is to provide discounted access for health plan customers to chiropractic, acupuncture, and other alternative medicine services. WholeHealth also offers health plans utilization management and credentialing services.

We model 3% y-y growth in 2018 and 2% y-y growth in 2019 versus the "street's" expectation of 5% y-y growth in both years.

10. Sustainable FCF much lower than CFO less capex

Management says it expects in excess of $100M in FCF in 2018, which it appears to calculate as CFO less capex. The company has significant NOLs that will be fully utilized in 2018, so we think it is more instructive to look at sustainable FCF (Net Income + Deprec/Amort – Capex).

In 2017, sustainable FCF was $59M. We model $84M in 2018 and $81M in 2019. Nearly all of the y-y cash flow growth in 2018 comes from one-time tax and interest expense benefits. Lower corporate taxes (from 42% in 2017 to 27% in 2018) add $12M to 2018 FCF, while lower interest expense (per company guidance) adds $7M.

The interest expense benefit comes primarily from the full amortization in 2Q18 of a $38.6M debt discount, saving the company about $2M in quarterly interest expense. In June 2018, the company will repay a 1.5% $150M cash convertible senior note with an existing line of credit. The company may be planning to use its cash flow to reduce the interest payments on this line of credit, which would be higher than the current 1.5%.

11. Recent results and guidance

TVTY reported 1Q18 revenue of $149.9M, lower than the $154.4M expected. EPS of $0.49 was in line. On its 4Q17 earnings call, management guided to 2018 revenue of $607M-$625M, EBITDA of $139M-$144M, and EPS of $2.12-$2.20. It reaffirmed this guidance on its 1Q18 call, despite the top line miss. The company does not provide quarterly guidance.

Management has also guided for 2018 $4M in depreciation expense, $8M in interest expense, a 27% tax rate, diluted shares outstanding of 43.5M-44.0M, free cash flow in excess of $100M (discussed above), and capex of $10M.

12. Financial assumptions

<u>SilverSneakers revenue</u>: Please see the detailed discussion of our assumptions in discussion point 3 above. We model 5.4% SS growth in 2018 and 1% y-y growth in 2019, as the Optum Fitness rollout takes away more of UNH SS revenue. "Street" models assume about 8.5% y-y growth in 2018 and 8% growth in 2019.

<u>Prime Fitness revenue</u>: We assume 19% y-y growth in 2018 as the company benefits from increased enrollments and the 16% y-y price increase for new members it took on 1/1/18. According to its Facebook page, this was the first price increase it took in five years. We assume it will not be able to increase prices further in 2019, so Prime Fitness growth will slow to 13% y-y. The "street" assumes about 21% y-y growth in 2018 and 18% y-y growth in 2019.

<u>WholeHealth</u>: We assume revenue continues to grow slowly, up 3% y-y in 2018 and up 2% y-y in 2019. The "street" assumes about 5% y-y growth in both years.

13. Valuation

TVTY shares trade at 16x "street" 2019 EPS. This is a discount to peers like HMSY (23x) and INOV (24x), likely due to investor uncertainty related to the UNH rollout.

We expect TVTY's multiple to compress further if our assumption that the Optum Fitness network continues to roll out is confirmed. Investors' level of concern regarding TVTY's future would increase. Our target of $27 is based on 14x our 2019 EPS. At our fair value price of $27, TVTY's EV/2019 EBITDA multiple would be 10.3x versus its current valuation of 11.3x consensus. TVTY's FCF yield at our fair value price of $27 would be 6.8%.

14. Risks

The primary risk to achieving our target price would be a decision by UNH to stop the expansion or to drop the Optum Fitness Network pilot. Other risks include higher Medicare Advantage membership growth than we expect, or acquisitions of non-SS health plans by those using SS. TVTY could be acquired by one of its health plan customers (e.g., HUM), or could merge with another company serving a similar client base (e.g., HMSY).

15. Financial projections

a. Quarterly projections

$M	1Q18a	2Q18e	3Q18e	4Q18e	1Q19e	2Q19e	3Q19e	4Q19e
SilverSneakers	121.0	120.8	119.1	120.2	122.2	122.0	120.3	121.4
Prime Fitness	24.4	24.6	25.0	25.5	27.3	27.9	28.4	29.3
WholeHealth	4.5	4.2	4.2	4.3	4.6	4.3	4.3	4.4
Total Revenue	149.9	149.6	148.3	150.0	154.1	154.2	153.0	155.1
Cost of services	108.3	106.2	105.3	106.5	112.5	111.0	110.2	111.7
SG&A	8.6	9.0	8.5	11.0	10.0	10.5	10.5	12.5
Deprec/Amort	1.1	1.1	1.1	1.1	1.2	1.2	1.2	1.2
Tot Op Expense	118.0	116.3	114.9	118.7	123.7	122.7	121.9	125.4
Op income	31.9	33.3	33.4	31.4	30.4	31.5	31.1	29.7
Adj EBITDA	33.0	34.4	34.5	32.5	31.6	32.7	32.3	30.9
Interest expense	(3.5)	(2.0)	(1.5)	(1.5)	(1.3)	(1.3)	(1.3)	(1.3)
Pretax income	28.4	31.3	31.9	29.9	29.2	30.2	29.9	28.5
Taxes	7.2	8.4	8.6	8.1	7.9	8.2	8.1	7.7
Net Income	21.2	22.8	23.3	21.8	21.3	22.1	21.8	20.8
EPS	0.49	0.52	0.53	0.49	0.48	0.49	0.49	0.46
Adj EPS	0.49	0.52	0.53	0.49	0.48	0.49	0.49	0.46
S/O	43.6	43.8	44.0	44.2	44.4	44.6	44.8	45.0

Y-Y change	1Q18a	2Q18e	3Q18e	4Q18e	1Q19e	2Q19e	3Q19e	4Q19e
SilverSneakers	4%	6%	6%	6%	1%	1%	1%	1%
Prime Fitness	19%	20%	19%	19%	12%	13%	14%	15%
WholeHealth	0%	2%	2%	2%	2%	2%	2%	2%
Total Revenue	6%	8%	8%	8%	3%	3%	3%	3%
Cost of services	6%	7%	11%	7%	4%	5%	5%	5%
SG&A	3%	10%	9%	10%	16%	17%	24%	14%
Deprec/Amort	40%	41%	25%	21%	9%	7%	7%	7%
Tot Op Expense	5%	8%	11%	5%	5%	5%	6%	6%
Op income	11%	8%	-3%	19%	-5%	-5%	-7%	-5%
Adj EBITDA	4%	8%	-3%	9%	-4%	-5%	-6%	-5%
Interest expense	-9%	-51%	-64%	-56%	-64%	-38%	-17%	-17%
Pretax income	14%	17%	5%	31%	3%	-3%	-6%	-5%
Taxes	-23%	-12%	-17%	-43%	9%	-3%	-6%	-5%
Net Income	37%	33%	17%	153%	0%	-3%	-6%	-5%
EPS	27%	28%	16%	148%	-1%	-5%	-8%	-6%
Adj EPS	16%	28%	16%	21%	-1%	-5%	-8%	-6%
S/O	8%	3%	1%	2%	2%	2%	2%	2%

% Total Revenue	1Q18a	2Q18e	3Q18e	4Q18e	1Q19e	2Q19e	3Q19e	4Q19e
SilverSneakers	81%	81%	80%	80%	79%	79%	79%	78%
Prime Fitness	16%	16%	17%	17%	18%	18%	19%	19%
WholeHealth	3%	3%	3%	3%	3%	3%	3%	3%
Total Revenue	100%	100%	100%	100%	100%	100%	100%	100%
Cost of services	72%	71%	71%	71%	73%	72%	72%	72%
SG&A	6%	6%	6%	7%	6%	7%	7%	8%
Deprec/Amort	1%	1%	1%	1%	1%	1%	1%	1%
Tot Op Expense	79%	78%	77%	79%	80%	80%	80%	81%
Op income	21%	22%	23%	21%	20%	20%	20%	19%
Adj EBITDA	22%	23%	23%	22%	21%	21%	21%	20%
Interest expense	-2%	-1%	-1%	-1%	-1%	-1%	-1%	-1%
Pretax income	19%	21%	21%	20%	19%	20%	20%	18%
Taxes	5%	6%	6%	5%	5%	5%	5%	5%
Net Income	14%	15%	16%	15%	14%	14%	14%	13%

b. Annual projections

$M	Restated 2016a	2017a	2018e	2019e	2020e
SilverSneakers	415.8	456.7	481.1	485.9	506.4
Prime Fitness	68.5	83.5	99.5	112.9	124.2
WholeHealth	16.7	16.7	17.2	17.6	18.5
Total Revenue	500.9	556.9	597.8	616.5	649.1
Cost of services	357.2	395.6	426.3	445.4	467.3
SG&A	39.5	34.3	37.1	43.5	45.4
Deprec/Amort	4.1	3.4	4.5	4.8	5.0
Restructuring	4.9	3.2	0.0	0.0	0.0
Tot Op Expense	405.7	436.6	467.9	493.7	517.8
Op income	95.3	120.4	129.9	122.8	131.3
Adjusted EBITDA	108.7	128.8	134.4	127.6	136.3
Interest expense	(17.2)	(15.6)	(8.5)	(5.0)	(5.0)
Pretax income	78.1	104.8	121.4	117.8	126.3
Taxes	21.9	43.6	32.3	31.8	34.1
Net Income	56.1	61.2	89.1	86.0	92.2
EPS	1.48	1.44	2.03	1.92	2.05
Adj EPS	1.40	1.67	2.03	1.92	2.05
S/O	37.6	42.5	43.9	44.7	45.0

Y-Y chng	2016a	2017a	2018e	2019e	2020e
SilverSneakers	15%	10%	5%	1%	4%
Prime Fitness	n/d	22%	19%	13%	10%
WholeHealth	n/d	0%	3%	2%	5%
Total Revenue	11%	11%	7%	3%	5%
Cost of services	12%	11%	8%	4%	5%
SG&A	11%	-13%	8%	17%	4%
Deprec/Amort	-41%	-17%	31%	7%	4%
Restructuring	n/m	n/m	n/m	n/m	n/m
Tot Op Expense	12%	8%	7%	6%	5%
Op income	5%	26%	8%	-6%	7%
Adjusted EBITDA	11%	18%	4%	-5%	7%
Interest expense	-4%	-9%	-45%	-41%	0%
Pretax income	7%	34%	16%	-3%	7%
Taxes	-25%	99%	-26%	-2%	7%
Net Income	29%	9%	46%	-4%	7%
EPS	22%	-2%	41%	-5%	7%
Adj EPS	15%	19%	22%	-5%	7%
S/O	4%	13%	3%	2%	1%

% Total Revenue	2016a	2017a	2018e	2019e	2020e
SilverSneakers	83%	82%	80%	79%	78%
Prime Fitness	14%	15%	17%	18%	19%
WholeHealth	3%	3%	3%	3%	3%
Total Revenue	100%	100%	100%	100%	100%
Cost of services	71%	71%	71%	72%	72%
SG&A	8%	6%	6%	7%	7%
Deprec/Amort	1%	1%	1%	1%	1%
Restructuring	1%	1%	0%	0%	0%
Tot Op Expense	81%	78%	78%	80%	80%
Op income	19%	22%	22%	20%	20%
Adjusted EBITDA	22%	23%	22%	21%	21%
Interest expense	-3%	-3%	-1%	-1%	-1%
Pretax income	16%	19%	20%	19%	19%
Taxes	4%	8%	5%	5%	5%
Net Income	11%	11%	15%	14%	14%

16. Financial metrics

	3/31/17
Debt	147.8
Equity	294.6
Tangible book	(69.1)
Current market value	1,679
Cash	38.8
EV	1,788

	2017	2018e	2019e
EBITDA	128.8	134.4	127.6
Capex	(5.9)	(10.0)	(10.0)
Surplus FCF (Net income + depr/amort - capex)	58.7	83.6	80.8
EV/EBITDA	13.9	13.3	14.0