

LIFE TIME FITNESS INC
Form 10-Q
November 04, 2004

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-Q

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2004

or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File No. 001-32230

Life Time Fitness, Inc.

(Exact name of Registrant as specified in its charter)

Minnesota
(State or other jurisdiction of
incorporation or organization)

41-1689746
(I.R.S. Employer
Identification No.)

6442 City West Parkway
Eden Prairie, Minnesota
(Address of principal executive offices)

55344
(Zip Code)

Registrant's telephone number, including area code: **952-947-0000**

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The number of shares outstanding of the Registrant's common stock as of October 15, 2004 was 33,759,882 common shares.

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LIFE TIME FITNESS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)

	September 30, 2004	December 31, 2003
	(Unaudited)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 17,009	\$ 18,446
Accounts receivable, net	2,623	1,217
Inventories	4,507	4,654
Prepaid expenses and other current assets.	7,673	6,977
Deferred membership origination costs	8,101	7,363
Deferred tax asset	2,669	5,368
Income tax receivable	4,034	2,547
	<hr/>	<hr/>
Total current assets	46,616	46,572
PROPERTY AND EQUIPMENT, net	460,888	379,193
RESTRICTED CASH	12,967	10,972
DEFERRED MEMBERSHIP ORIGINATION COSTS	6,079	5,942
OTHER ASSETS	12,731	10,667
	<hr/>	<hr/>
TOTAL ASSETS	\$539,281	\$453,346
	<hr/>	<hr/>
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current maturities of long-term debt	\$ 32,539	\$ 18,278
Accounts payable	4,608	6,171
Construction accounts payable	15,219	6,522
Accrued expenses	20,023	13,105
Deferred revenue	20,345	17,836
	<hr/>	<hr/>
Total current liabilities	92,734	61,912

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LONG-TERM DEBT, net of current portion	165,873	214,954
DEFERRED RENT LIABILITY	3,416	2,660
DEFERRED INCOME TAXES	24,002	23,196
DEFERRED REVENUE	11,050	11,667
	<u> </u>	<u> </u>
Total liabilities	297,075	314,389
	<u> </u>	<u> </u>
COMMITMENTS AND CONTINGENCIES (Note 7)		
REDEEMABLE PREFERRED STOCK:		
Series B redeemable preferred stock, \$.02 par value; 0 and 1,000,000 shares authorized, issued and outstanding, respectively		27,003
Series C redeemable preferred stock, \$.02 par value; 0 and 4,500,000 shares authorized, issued and outstanding, respectively		56,029
Series D redeemable preferred stock, \$.02 par value; 0 and 2,000,000 shares authorized, 0 and 1,946,250 shares issued and outstanding, respectively		23,133
	<u> </u>	<u> </u>
Total redeemable preferred stock		106,165
	<u> </u>	<u> </u>
SHAREHOLDERS EQUITY:		
Undesignated preferred stock, 10,000,000 and 2,500,000 shares authorized; none issued or outstanding		
Common stock, \$.02 par value, 50,000,000 shares authorized; 33,751,982 and 16,146,607 shares issued and outstanding, respectively	675	323
Additional paid-in capital	209,583	17,714
Retained earnings	31,948	14,755
	<u> </u>	<u> </u>
Total shareholders equity	242,206	32,792
	<u> </u>	<u> </u>
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$539,281	\$453,346
	<u> </u>	<u> </u>

See notes to unaudited consolidated financial statements.

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LIFE TIME FITNESS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
REVENUE:				
Membership dues	\$52,477	\$42,981	\$152,662	\$125,306
Enrollment fees	5,297	5,438	15,332	15,418
In-center revenue	18,178	14,068	52,836	40,742
	<hr/>	<hr/>	<hr/>	<hr/>
Total center revenue	75,952	62,487	220,830	181,466
Other revenue	3,233	3,540	9,114	8,416
	<hr/>	<hr/>	<hr/>	<hr/>
Total revenue	79,185	66,027	229,944	189,882
OPERATING EXPENSES:				
Sports, fitness and family recreation center operations	42,529	33,239	122,048	96,581
Advertising and marketing	2,838	3,059	9,292	7,929
General and administrative	4,302	3,547	15,852	14,145
Other operating	4,637	5,465	13,586	12,574
Depreciation and amortization	7,489	6,300	21,407	18,374
	<hr/>	<hr/>	<hr/>	<hr/>
Total operating expenses	61,795	51,610	182,185	149,603
	<hr/>	<hr/>	<hr/>	<hr/>
Income from operations	17,390	14,417	47,759	40,279
OTHER INCOME (EXPENSE):				
Interest expense, net	(4,285)	(4,850)	(13,346)	(14,320)
Equity in earnings of affiliate	257	205	778	518
	<hr/>	<hr/>	<hr/>	<hr/>
Total other income (expense)	(4,028)	(4,645)	(12,568)	(13,802)
	<hr/>	<hr/>	<hr/>	<hr/>
INCOME BEFORE INCOME TAXES	13,362	9,772	35,191	26,477
PROVISION FOR INCOME TAXES	5,458	4,118	14,428	11,157
	<hr/>	<hr/>	<hr/>	<hr/>

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NET INCOME	7,904	5,654	20,763	15,320
ACCRETION ON REDEEMABLE PREFERRED STOCK	<u>95</u>	<u>1,761</u>	<u>3,570</u>	<u>5,226</u>
NET INCOME APPLICABLE TO COMMON SHAREHOLDERS	<u>\$ 7,809</u>	<u>\$ 3,893</u>	<u>\$ 17,193</u>	<u>\$ 10,094</u>
BASIC EARNINGS PER COMMON SHARE.	<u>\$ 0.24</u>	<u>\$ 0.24</u>	<u>\$ 0.79</u>	<u>\$ 0.63</u>
DILUTED EARNINGS PER COMMON SHARE	<u>\$ 0.22</u>	<u>\$ 0.20</u>	<u>\$ 0.65</u>	<u>\$ 0.54</u>
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING BASIC	<u>32,533</u>	<u>16,098</u>	<u>21,628</u>	<u>16,058</u>
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING DILUTED	<u>35,385</u>	<u>28,144</u>	<u>32,177</u>	<u>28,381</u>

See notes to unaudited consolidated financial statements.

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LIFE TIME FITNESS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	For the Nine Months Ended September 30,	
	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 20,763	\$ 15,320
Adjustments to reconcile net income to cash from operating activities:		
Depreciation and amortization	21,407	18,374
Deferred income taxes	3,505	6,727
Loss on disposal of property, net	318	378
Amortization of deferred financing costs	1,137	700
Compensation related to stock options	213	
Tax benefit from exercise of stock options	733	
Changes in operating assets and liabilities	3,936	(2,217)
	52,012	39,282
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment (excluding non-cash purchases supplementally noted below)	(101,804)	(22,837)
Increase (decrease) in construction accounts payable	8,698	(323)
Proceeds from sale of property	1,249	21,942
Increase in other assets	(1,761)	(3,796)
Increase in restricted cash	(1,995)	(3,048)
	(95,613)	(8,062)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from long term borrowings	26,977	1,661
Repayments on long term borrowings	(65,292)	(11,746)
Payments for deferred financing costs	(1,061)	(2,579)
Proceeds from initial public offering, net of underwriting discounts and offering costs	80,653	
Proceeds from exercise of options	887	149
	42,164	(12,515)

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INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,437)	18,705
CASH AND CASH EQUIVALENTS Beginning of period	18,446	8,860
	<u> </u>	<u> </u>
CASH AND CASH EQUIVALENTS End of period	\$ 17,009	\$ 27,565
	<u> </u>	<u> </u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash payments for interest, net of capitalized interest of \$1,091 and \$1,015, respectively	\$ 12,549	\$ 13,561
	<u> </u>	<u> </u>
Cash payments for income taxes	\$ 8,786	\$ 3,477
	<u> </u>	<u> </u>
SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Property and equipment purchases financed through notes payable	\$ 2,954	\$ 19,111
	<u> </u>	<u> </u>
Property and equipment purchases financed through capital lease obligations	\$ 145	\$ 7,131
	<u> </u>	<u> </u>

See notes to unaudited consolidated financial statements.

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LIFE TIME FITNESS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of Life Time Fitness, Inc. (the Company) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary to fairly present financial position, results of operations and cash flows for the periods have been included.

These interim financial statements and the related notes should be read in conjunction with the annual financial statements and notes included in the final prospectus relating to the Company's initial public offering, as filed with the Securities and Exchange Commission (SEC), which includes audited financial statements for the three fiscal years ended December 31, 2003.

2. Initial Public Offering and Capital Stock

The registration statement filed in connection with the Company's initial public offering, as filed with the SEC, was declared effective on June 29, 2004. The Company's shares began trading on the New York Stock Exchange on June 30, 2004. The Company closed this transaction and received proceeds from the initial public offering on July 6, 2004. The initial public offering consisted of 11,385,000 shares of common stock, including the underwriters' over-allotment option of 1,485,000 common shares. Of the shares of common stock sold in the initial public offering, the Company sold 4,774,941 shares, resulting in proceeds of \$80,653, net of underwriting discounts and commissions and offering expenses payable by the Company of \$7,684. The Company used a portion of the net proceeds to repay amounts outstanding under its revolving credit facility and to repay a loan under its construction facility that the Company used to finance the development of its center in Plano, Texas. The Company expects to use the remaining net proceeds to finance its growth by opening additional centers.

As a result of the Company's initial public offering being declared effective on June 29, 2004 and the closing of the transaction occurring on July 6, 2004, the Company reflected a subscription receivable of \$75,420 in the equity section of its unaudited consolidated balance sheet at June 30, 2004. The accompanying unaudited consolidated balance sheet as of September 30, 2004 reflects the reclassification of the subscription receivable into common stock and additional paid-in capital.

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Basic earnings per common share (EPS) is computed by dividing net income applicable to common shareholders by the weighted average number of shares of common stock outstanding during each period. Diluted EPS is computed similarly to basic EPS, except that the numerator is adjusted to add back any redeemable preferred stock accretion and the denominator is increased for the conversion of any dilutive common stock equivalents, such as redeemable preferred stock, and the assumed exercise of dilutive stock options using the treasury stock method. A reconciliation of these amounts is as follows (share amounts in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
Net income	\$ 7,904	\$ 5,654	\$20,763	\$15,320
Less: accretion on redeemable preferred stock	95	1,761	3,570	5,226
Net income applicable to common shareholders	<u>\$ 7,809</u>	<u>\$ 3,893</u>	<u>\$17,193</u>	<u>\$10,094</u>
Weighted average number of common shares outstanding basic (a)	32,533	16,098	21,628	16,058
Effect of dilutive stock options	2,166	1,600	1,930	1,305
Effect of dilutive redeemable preferred shares	686	10,446	8,619	11,018
Weighted average number of common shares outstanding diluted	<u>35,385</u>	<u>28,144</u>	<u>32,177</u>	<u>28,381</u>
Basic earnings per common share	<u>\$ 0.24</u>	<u>\$ 0.24</u>	<u>\$ 0.79</u>	<u>\$ 0.63</u>
Diluted earnings per common share	<u>\$ 0.22</u>	<u>\$ 0.20</u>	<u>\$ 0.65</u>	<u>\$ 0.54</u>

(a) As of September 30, 2004, total common shares outstanding were 33,751,982

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The Company has stock option and incentive plans for employees, directors and consultants and accounts for these plans in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. If compensation cost for these plans had been determined consistent with Statement of Financial Accounting Standards (SFAS) No. 123, the Company's net income applicable to common shareholders, basic EPS and diluted EPS would have been reduced to the following pro forma amounts:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
Net income applicable to common shareholders basic:				
As reported	\$7,809	\$3,893	\$17,193	\$10,094
Pro forma	\$7,120	\$3,661	\$15,913	\$ 9,434
Basic earnings per common share:				
As reported	\$ 0.24	\$ 0.24	\$ 0.79	\$ 0.63
Pro forma	\$ 0.22	\$ 0.23	\$ 0.74	\$ 0.59
Net income applicable to common shareholders diluted:				
As reported	\$7,904	\$5,654	\$20,763	\$15,320
Pro forma	\$7,215	\$5,422	\$19,483	\$14,660
Diluted earnings per common share:				
As reported	\$ 0.22	\$ 0.20	\$ 0.65	\$ 0.54
Pro forma	\$ 0.20	\$ 0.19	\$ 0.61	\$ 0.52

5. Operating Segments

The Company's operations are conducted mainly through its sports, fitness and family recreation centers. The Company has aggregated the activities of its centers into one reportable segment as none of the centers meet the quantitative thresholds for separate disclosure under SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, and each of the centers has similar expected economic characteristics, service and product offerings, customers and design. The Company's chief operating decision maker uses EBITDA as the primary measure of segment performance. For purposes of segment financial reporting and discussion of results of operations, centers represent the revenue and associated costs (including general and administrative expenses) from membership dues and enrollment fees, all in-center activities including personal training, spa, café and other activities offered to members and non-member participants and rental income. Included in the All Other category in the table below is operating information related to nutritional products, media, athletic events, and a restaurant, and expenses, including interest expense, and corporate assets (including depreciation and amortization) not directly attributable to centers. The accounting policies of the centers and operations classified as All Other are the same as those described in the summary of significant accounting policies in the annual financial statements and notes included in the final prospectus relating to the Company's initial public offering, as filed with the SEC.

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Financial data and reconciling information for the Company's reporting segment to the consolidated amounts in the financial statements are as follows:

	Sports, Fitness and Family Recreation Centers	All Other	Eliminations(a)	Consolidated
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Three months ended September 30, 2004:				
Revenue	\$ 75,952	\$ 3,800	\$ (567)	\$ 79,185
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net income (loss)	\$ 8,293	\$ (389)	\$	\$ 7,904
Provision for income taxes	5,956	(498)		5,458
Interest expense, net	3,810	475		4,285
Depreciation and amortization	6,063	1,426		7,489
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
EBITDA	\$ 24,122	\$ 1,014	\$	\$ 25,136
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total assets	\$462,886	\$76,395	\$	\$539,281
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Three months ended September 30, 2003:				
Revenue	\$ 62,487	\$ 4,089	\$ (549)	\$ 66,027
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net income (loss)	\$ 6,370	\$ (716)	\$	\$ 5,654
Provision for income taxes	4,622	(504)		4,118
Interest expense, net	4,406	444		4,850
Depreciation and amortization	5,154	1,146		6,300
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
EBITDA	\$ 20,552	\$ 370	\$	\$ 20,922
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total assets	\$345,156	\$91,256	\$	\$436,412
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Nine months ended September 30, 2004:				
Revenue	\$220,830	\$10,832	\$(1,718)	\$229,944

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	_____	_____	_____	_____
Net income (loss)	\$ 25,354	\$ (4,591)	\$	\$ 20,763
Provision for income taxes	17,882	(3,454)		14,428
Interest expense, net	12,046	1,300		13,346
Depreciation and amortization	17,249	4,158		21,407
	_____	_____	_____	_____
EBITDA	\$ 72,531	\$ (2,587)	\$	\$ 69,944
	_____	_____	_____	_____
Total assets	\$462,886	\$76,395	\$	\$539,281
	_____	_____	_____	_____
Nine months ended September 30, 2003:				
Revenue	\$ 181,466	\$ 10,213	\$ (1,797)	\$ 189,882
	_____	_____	_____	_____
Net income (loss)	\$ 18,910	\$ (3,590)	\$	\$ 15,320
Provision for income taxes	13,710	(2,553)		11,157
Interest expense, net	13,192	1,128		14,320
Depreciation and amortization	15,095	3,279		18,374
	_____	_____	_____	_____
EBITDA	\$ 60,907	\$ (1,736)	\$	\$ 59,171
	_____	_____	_____	_____
Total assets	\$345,156	\$91,256	\$	\$436,412
	_____	_____	_____	_____

(a) Eliminations relate to the sale of the Company's nutritional products to its owned cafes.

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Changes in operating assets and liabilities, reflecting increases (decreases) in cash, are as follows;

	For the Nine Months Ended September 30,	
	2004	2003
Accounts receivable	\$(1,406)	\$ (805)
Income taxes receivable	(1,487)	507
Inventories	147	(764)
Prepays and other current assets	(696)	(1,816)
Accounts payable	(1,563)	(20)
Accrued expenses	7,162	1,406
Deferred revenue	1,023	(1,081)
Deferred rent	756	356
	<u>\$ 3,936</u>	<u>\$(2,217)</u>

7. Commitments and Contingencies

Litigation The Company is engaged in legal proceedings incidental to the normal course of business. Although the ultimate outcome of these matters cannot be determined, management believes that the final disposition of these proceedings will not have a material adverse effect on the consolidated financial position or results of operations of the Company.

Item 2.
**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**
Forward-Looking Statements

The following discussion may contain forward-looking statements regarding us and our business, prospects and results of operations that are subject to certain risks and uncertainties posed by many factors and events that could cause our actual business, prospects and results of operations to differ materially from those that may be anticipated by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those described under *Factors That May Affect Future Results* in this report. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. We undertake no obligation to revise any forward-looking statements in order to reflect events or circumstances that may subsequently arise. Readers are urged to carefully review and consider the various disclosures made by us in this report and in our other reports filed with the Securities and Exchange Commission (SEC) that advise interested parties of the risks and factors that may affect our business.

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The interim financial statements filed on this Form 10-Q and the discussions contained herein should be read in conjunction with the annual consolidated financial statements and notes included in the final prospectus relating to our initial public offering, as filed with the SEC, which includes audited consolidated financial statements for our three fiscal years ended December 31, 2003.

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Overview

We operate sports, fitness and family recreation centers. As of October 15, 2004, we operated 37 centers primarily in suburban locations across eight states under the LIFE TIME FITNESS brand. We commenced operations in 1992 by opening centers in the Minneapolis and St. Paul, Minnesota area. During this period of initial growth, we refined the format and model of our center while building our membership base, infrastructure and management team. We standardized the size, design and layout of our centers, which we refer to as our current model centers. Several of the centers that opened during our early years have designs that differ from our current model centers.

We opened six centers in 2001, five centers in 2002 and four centers in 2003. We have opened four current model centers in 2004 and plan to open two additional centers in 2004, one of which will be a current model center. Recently, we opened our fourth and fifth centers in the Texas market, located in Sugar Land, near Houston, on October 1, 2004, and Flower Mound, near Dallas, on October 8, 2004. Each of these new centers is 108,890 square feet. We plan to open six current model centers in 2005.

We compare the results of our centers based on how long the centers have been open at the most recent measurement period. We include a center for same-center revenue purposes beginning on the first day of the thirteenth full calendar month of the center's operation, prior to which time we refer to the center as a new center. As we grow our presence in existing markets by opening new centers, we expect to attract some memberships away from other centers already in those markets, reducing their revenue and initially lowering their profitability. In addition, as a result of new center openings in existing markets, and because older centers will represent an increasing proportion of our center base over time, our same-center revenue increases may be lower in future periods than in the past. Of the six new centers we have opened or plan to open in each of 2004 and 2005, we expect that four will be in existing markets in 2004 and four will be in existing markets in 2005.

We have three primary sources of revenue. First, our largest source of revenue is membership dues and enrollment fees paid by our members. We recognize revenue from monthly membership dues in the month to which they pertain. We recognize revenue from enrollment fees over the expected average life of the membership, which is 36 months. Second, we generate revenue, which we refer to as in-center revenue, at our centers from fees for personal training, group fitness training and other member activities, sales of products at our LifeCafe, sales of products and services offered at our LifeSpa and renting space in certain of our centers. Finally, we have expanded the LIFE TIME FITNESS brand into other wellness-related offerings that generate revenue, which we refer to as other revenue, including our media, nutritional products and athletic events businesses. Our primary media offering is our magazine, *Experience Life*. Other revenue also includes our restaurant located in the building where we operate a center designed as an urban executive facility in downtown Minneapolis, Minnesota.

Sports, fitness and family recreation center operations expenses consist primarily of salaries, commissions, payroll taxes, benefits, real estate taxes and other occupancy costs, utilities, repairs and maintenance, supplies, administrative support and communications to operate our centers. Advertising and marketing expenses consist of our marketing department costs and media and advertising costs to support center membership growth and our media, nutritional products and athletic events businesses. General and administrative expenses include costs relating to our centralized support functions, such as accounting, information systems, procurement and member relations, as well as our real estate and development team and other members of senior management. Our other operating expenses include the costs associated with our media, nutritional products and athletic events businesses, our restaurant and other corporate expenses, as well as gains or losses on our dispositions of assets. Our total operating expenses may vary from period to period depending on the number of new centers opened and the number of centers we have in the pre-opening sales and marketing phase during that period.

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Our primary capital expenditures relate to the construction of new centers and updating and maintaining our existing centers. The land acquisition, construction and equipment costs for a current model center aggregate, on average, approximately \$23.5 million, which could vary considerably based on variability in land cost and the cost of construction labor, as well as whether or not a tennis area is included. We perform maintenance and make improvements on our centers and equipment every year. We conduct a more thorough remodeling project at each center approximately every five years.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S., or GAAP, requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. In recording transactions and balances resulting from business operations, we use estimates based on the best information available. We use estimates for such items as depreciable lives, volatility factors in determining fair value of option grants, tax provisions and provisions for uncollectible receivables. We also use estimates for calculating the amortization period for deferred enrollment fee revenue and associated direct costs, which are based on the average expected life of a membership. We revise the recorded estimates when better information is available, facts change or we can determine actual amounts. These revisions can affect operating results.

Our critical accounting policies and use of estimates are discussed in and should be read in conjunction with the annual consolidated financial statements and notes included in the final prospectus relating to our initial public offering, as filed with the SEC, which includes audited consolidated financial statements for our three fiscal years ended December 31, 2003.

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The following table sets forth our statement of operations data as a percentage of total revenues and also sets forth other financial and operating data for the three and nine month periods ended September 30, 2004, and 2003.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
Revenue				
Center revenue:				
Membership dues	66.2%	65.1%	66.4%	66.0%
Enrollment fees	6.7	8.2	6.6	8.1
In-center revenue	23.0	21.3	23.0	21.5
	<hr/>	<hr/>	<hr/>	<hr/>
Total center revenue	95.9	94.6	96.0	95.6
Other revenue	4.1	5.4	4.0	4.4
	<hr/>	<hr/>	<hr/>	<hr/>
Total revenue	100.0	100.0	100.0	100.0
Operating expenses				
Sports, fitness and family recreation center operations	53.7	50.4	53.1	50.9
Advertising and marketing	3.6	4.6	4.0	4.2
General and administrative	5.4	5.4	6.9	7.4
Other operating	5.8	8.3	5.9	6.6
Depreciation and amortization	9.5	9.5	9.3	9.7
	<hr/>	<hr/>	<hr/>	<hr/>
Total operating expenses	78.0	78.2	79.2	78.8
Income from operations	22.0	21.8	20.8	21.2
Interest expense, net	5.4	7.3	5.8	7.5
Equity in earnings of affiliate	0.3	0.3	0.3	0.2
	<hr/>	<hr/>	<hr/>	<hr/>
Total other income	5.1	7.0	5.5	7.3
Income before income taxes	16.9	14.8	15.3	13.9
Provision for income taxes	6.9	6.2	6.3	5.8
	<hr/>	<hr/>	<hr/>	<hr/>
Net income	10.0%	8.6%	9.0%	8.1%
	<hr/>	<hr/>	<hr/>	<hr/>

Other financial and operating data:

Average revenue per membership	\$ 280	\$ 275	\$ 848	\$ 820
Average in-center revenue per membership	\$ 67	\$ 62	\$ 202	\$ 183
Centers open at end of period	35	30	35	30
Number of memberships at end of period	285,975	240,784	285,975	240,784

Three Months Ended September 30, 2004, Compared to Three Months Ended September 30, 2003

Total revenue. Total revenue increased \$13.2 million, or 19.9%, to \$79.2 million for the three months ended September 30, 2004, from \$66.0 million for the three months ended September 30, 2003.

Total center revenue grew \$13.5 million, or 21.5%, to \$76.0 million for the three months ended September 30, 2004, from \$62.5 million for the three months ended September 30, 2003. Same-center revenue grew 7.6% compared to the prior year quarter. Of the \$13.5 million increase in total center revenue,

70.5% was from membership dues, which increased \$9.5 million, due to increased memberships at new and existing centers.

30.5% was from in-center revenue, which increased \$4.1 million primarily as a result of our members increased use of our personal training, LifeCafe and LifeSpa products and services. As a result of this in-center revenue growth and our focus on broadening our offerings to our members, average in-center revenue per membership increased to \$67 for the three months ended September 30, 2004, from \$62 for the three months ended September 30, 2003.

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Enrollment fees, which are deferred until a center opens and recognized on a straight-line basis over 36 months, decreased slightly to \$5.3 million for the three months ended September 30, 2004, from \$5.4 million for the three months ended September 30, 2003. Our number of memberships (including pre-sale memberships) increased 18.8%, to 285,975 at September 30, 2004, from 240,784 at September 30, 2003. Enrollment fee revenue associated with new members at open centers was offset by a decreasing amount of recognized deferred enrollment fees as a result of our opening six new centers in 2001, five new centers in 2002, and four new centers in 2003.

Other revenue decreased 8.6%, to \$3.2 million for the three months ended September 30, 2004, which was primarily due to decreased revenue generated from sales in our nutritional division.

Sports, fitness and family recreation center operations expenses. Sports, fitness and family recreation center operations expenses totaled \$42.5 million, or 56.0% of total center revenue (or 53.7% of total revenue), for the three months ended September 30, 2004 compared to \$33.2 million, or 53.2% of total center revenue (or 50.4% of total revenue), for the three months ended September 30, 2003. This \$9.3 million increase primarily consisted of an increase of \$6.2 million in payroll-related costs to support increased memberships at new and existing centers and increased expenses to support in-center products and services, as well as having five centers in the pre-opening sales and marketing phase during the third quarter of 2004 compared to three centers in the pre-opening sales and marketing phase during portions of the third quarter of 2003. Additionally, occupancy costs increased \$2.5 million, including \$1.2 million in expenses related to a sale-leaseback transaction with respect to two of our current model centers that was entered into on September 30, 2003.

Advertising and marketing expenses. Advertising and marketing expenses were \$2.8 million, or 3.6% of total revenue, for the three months ended September 30, 2004, compared to \$3.1 million, or 4.6% of total revenue, for the three months ended September 30, 2003. As a percentage of total revenue and in aggregate dollars, these expenses decreased primarily due to more cost effective marketing campaigns at our centers.

General and administrative expenses. General and administrative expenses were \$4.3 million, or 5.4% of total revenue, for the three months ended September 30, 2004, compared to \$3.5 million, or 5.4% of total revenue, for the three months ended September 30, 2003. This \$0.8 million increase was primarily due to increased costs to support the growth in our membership and center base in 2004, as well as costs associated with being a publicly-held company.

Other operating expenses. Other operating expenses were \$4.6 million for the three months ended September 30, 2004, compared to \$5.5 million for the three months ended September 30, 2003. This \$0.9 million decrease was primarily due to lower costs associated with our athletic events and nutritional product businesses.

Depreciation and amortization. Depreciation and amortization was \$7.5 million for the three months ended September 30, 2004, compared to \$6.3 million for the three months ended September 30, 2003. This \$1.2 million increase was due primarily to depreciation on our new centers opened in the fall of 2003 and summer of 2004.

Interest expense, net. Interest expense, net of interest income, was \$4.3 million for the three months ended September 30, 2004, compared to \$4.8 million for the three months ended September 30, 2003. This decrease was primarily the result of a sale-leaseback transaction, which reduced our average debt balances, and interest income generated from the proceeds of the initial public offering.

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Provision for income taxes. The provision for income taxes was \$5.5 million for the three months ended September 30, 2004, compared to \$4.1 million for the three months ended September 30, 2003. This \$1.4 million increase was due to an increase in income before income taxes of \$3.6 million.

Net income. As a result of the factors described above, net income was \$7.9 million, or 10.0% of total revenue, for the three months ended September 30, 2004, compared to \$5.7 million, or 8.6% of total revenue, for the three months ended September 30, 2003.

Nine Months Ended September 30, 2004, Compared to Nine Months Ended September 30, 2003

Total revenue. Total revenue increased \$40.0 million, or 21.1%, to \$229.9 million for the nine months ended September 30, 2004, from \$189.9 million for the nine months ended September 30, 2003.

Total center revenue grew \$39.3 million, or 21.7%, to \$220.8 million for the nine months ended September 30, 2004, from \$181.5 million for the nine months ended September 30, 2003. Of the \$39.3 million increase in total center revenue,

69.5% was from membership dues, which increased \$27.4 million, due to increased memberships at new and existing centers.

30.7% was from in-center revenue, which increased \$12.1 million primarily as a result of our members increased use of our personal training, LifeCafe and LifeSpa products and services. As a result of this in-center revenue growth and our focus on broadening our offerings to our members, average in-center revenue per membership increased to \$848 for the nine months ended September 30, 2004, from \$820 for the nine months ended September 30, 2003.

Enrollment fees, which are deferred and recognized on a straight-line basis over 36 months, decreased slightly to \$15.3 million for the nine months ended September 30, 2004, compared to \$15.4 million for the same period last year. Our number of memberships (including pre-sale memberships) increased 18.8%, to 285,975 at September 30, 2004, from 240,784 at September 30, 2003. Enrollment fee revenue associated with new members at open centers was offset by a decreasing amount of recognized deferred enrollment fees as a result of our opening six new centers in 2001, five new centers in 2002, and four new centers in 2003.

Other revenue grew \$0.7 million, or 8.3%, to \$9.1 million for the nine months ended September 30, 2004, from \$8.4 million for the nine months ended September 30, 2003, which was primarily due to increased revenue generated from advertising sales in our media division.

Sports, fitness and family recreation center operations expenses. Sports, fitness and family recreation center operations expenses were \$122.0 million, or 55.3% of total center revenue (or 53.1% of total revenue), for the nine months ended September 30, 2004, compared to \$96.6 million, or 53.2% of total center revenue (or 50.9% of total revenue), for the nine months ended September 30, 2003. This \$25.4 million increase primarily consisted of an increase of \$16.5 million in payroll-related costs to support increased memberships at new and existing centers and increased expenses to support in-center products and services, as well as having six centers in the pre-opening sales and marketing phase during portions of the first nine months of 2004 compared to four centers in the pre-opening sales and marketing phase during portions of the first nine months of 2003. Additionally, occupancy costs increased \$5.9 million, including \$3.6 million in expenses related to a sale-leaseback transaction with respect to two of our current model centers that was entered into on September 30, 2003.

Advertising and marketing expenses. Advertising and marketing expenses were \$9.3 million, or 4.0% of total revenue, for the nine months ended September 30, 2004, compared to \$7.9 million, or 4.2% of total revenue, for the

nine months ended September 30, 2003. The

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\$1.4 million increase was primarily due to a national advertising campaign for our nutritional products, including a major U.S. magazine advertising placement, and as a result of the simultaneous pre-opening sales and marketing campaigns for centers opening in 2004. As a percentage of total revenue, advertising and marketing expenses decreased primarily due to more cost-effective marketing campaigns at our centers.

General and administrative expenses. General and administrative expenses were \$15.9 million, or 6.9% of total revenue, for the nine months ended September 30, 2004, compared to \$14.1 million, or 7.4% of total revenue, for the nine months ended September 30, 2003. This \$1.8 million increase was primarily due to increased costs to support the growth in our membership and center base in 2004, as well as costs associated with being a publicly-held company. As a percentage of total revenue, general and administrative expenses decreased primarily due to economies of scale achieved in shared service functions, including member relations, information technology and procurement, as our membership and center base expanded.

Other operating expenses. Other operating expenses were \$13.6 million for the nine months ended September 30, 2004, compared to \$12.6 million for the nine months ended September 30, 2003. This \$1.0 million increase was primarily due to branding initiatives related to our media, nutritional products and athletic events businesses.

Depreciation and amortization. Depreciation and amortization was \$21.4 million for the nine months ended September 30, 2004, compared to \$18.4 million for the nine months ended September 30, 2003. This \$3.0 million increase was due primarily to depreciation on our new centers opened in the fall of 2003 and the summer of 2004.

Interest expense, net. Interest expense, net of interest income, was \$13.3 million for the nine months ended September 30, 2004, compared to \$14.3 million for the nine months ended September 30, 2003. This decrease was primarily the result of a sale-leaseback transaction which reduced our average debt balances, interest income generated from the proceeds of the initial public offering, and our increased cash flows from operating activities allowing us to limit our borrowing during the first nine months of 2004.

Provision for income taxes. The provision for income taxes was \$14.4 million for the nine months ended September 30, 2004, compared to \$11.2 million for the nine months ended September 30, 2003. This \$3.2 million increase was due to an increase in income before income taxes of \$8.7 million.

Net income. As a result of the factors described above, net income was \$20.8 million, or 9.0% of total revenue, for the nine months ended September 30, 2004, compared to \$15.3 million, or 8.1% of total revenue, for the nine months ended September 30, 2003.

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Liquidity and Capital Resources

Liquidity

Historically, we have satisfied our liquidity needs through various debt arrangements, sales of equity to investors and cash flows from operations. Principal liquidity needs have included the development of new sports, fitness and family recreation centers, debt service requirements and expenditures necessary to maintain and update our existing centers and their related fitness equipment. We believe that we will be able to satisfy our debt service obligations and capital expenditure requirements through 2005 with available cash balances, including the net proceeds from the initial public offering, cash flow from operations, our committed debt facilities, through the extension of certain of our debt facilities, or by obtaining additional debt. We believe that we can satisfy our longer-term debt service obligations and capital expenditure requirements with cash flow from operations, by the extension of the terms of or refinancing our existing debt facilities, through sale-leaseback transactions and by continuing to raise long-term debt, although there can be no assurance that such actions can be completed. Our business model operates with negative working capital because we carry minimal accounts receivable due to our ability to have monthly membership dues paid by electronic draft and because we fund the construction of our new centers under standard arrangements with our vendors that are paid with proceeds from long-term debt.

Operating Activities

As of September 30, 2004, we had total cash and cash equivalents of \$17.0 million and \$13.0 million of restricted cash that served as collateral for certain of our debt arrangements. On July 6, 2004, we received proceeds of \$80.7 million from our initial public offering, net of underwriting discounts, commissions and offering expenses payable by us. On the same day, we utilized \$8.7 million of the net proceeds from our initial public offering along with cash received from monthly membership dues to repay all amounts outstanding under our revolving credit facility, with the exception a \$15.0 million term loan under the revolving credit facility. We also used \$8.9 million of the net proceeds from the offering to repay a loan under our construction facility that we used to finance the development of our center in Plano, Texas. We expect to use the remaining net proceeds of \$63.1 million from the offering to finance our growth by opening additional centers.

Net cash provided by operating activities was \$52.0 million for the nine months ended September 30, 2004, compared to \$39.3 million for the nine months ended September 30, 2003. The increase of \$12.7 million was primarily due to an \$7.3 million increase in net income adjusted for non-cash charges and increases in cash provided by net operating assets and liabilities.

Investing Activities

Investing activities consist primarily of purchasing real property, constructing new centers and purchasing new fitness equipment. In addition, we make capital expenditures to maintain and update our existing centers. We finance the purchase of our property and equipment by cash payments or by financing through notes payable or capital lease obligations. For current model centers, our investment has averaged approximately \$23.5 million, which includes the land, the building and approximately \$2.5 million of exercise equipment, furniture and fixtures.

At September 30, 2004, we had purchased the real property for the five new current model centers that we plan to open in 2004, two of which had already opened. In addition, we had purchased the real property for four of the current model centers we plan to open in 2005, and we had entered into agreements to purchase real property for the development of the remaining two current model centers that we plan to open in 2005.

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Net cash used in investing activities was \$95.6 million for the nine months ended September 30, 2004, compared to \$8.1 million for the nine months ended September 30, 2003. The increase of \$87.5 million was primarily due to capital expenditures for the construction of new centers and maintenance and updates to our existing centers. Total capital expenditures for the nine months ended September 30, 2004, totaled \$104.9 million. For the nine months ended September 30, 2004, capital expenditures for the construction of new centers totaled \$89.2 million and capital expenditures for the maintenance and updates to our existing centers totaled \$11.7 million. Additionally, in January 2004, we purchased a jet for \$4.0 million.

Financing Activities

Net cash provided by financing activities was \$42.2 million for the nine months ended September 30, 2004, compared to a use of \$12.5 million for the nine months ended September 30, 2003. The increase of \$54.7 million was primarily due to proceeds from sales of our shares during our initial public offering.

We have several secured credit facilities. We have a \$55.0 million revolving credit facility led by Antares Capital Corporation that expires on June 30, 2005. Availability under this facility is determined based upon a multiple of a variation of EBITDA as defined in the credit agreement. Additionally, we are restricted in our borrowings and in general under the revolving credit facility by certain financial covenants, including capital expenditure levels and maintaining leverage ratios, fixed charge and interest coverage ratios and a loan to value ratio. At December 31, 2003, the outstanding balance was classified as long-term debt in the accompanying consolidated balance sheets. As of September 30, 2004, we had \$15.0 million outstanding classified as a current-maturity of long-term debt, \$8.0 million in committed letters of credit and \$32.0 million available for additional borrowings under this facility. On July 6, 2004, we repaid \$24.4 million outstanding under this facility, using cash received from monthly membership dues and a portion of the net proceeds from our initial public offering.

We also have a \$75.0 million construction credit facility led by U.S. Bank, National Association. Pursuant to the terms of the construction credit facility, the lending group has committed to make up to seven individual loans, the purpose of which is to fund the construction costs related to completing the construction of certain centers. The current commitment to lend expires on January 1, 2006. Borrowings under this facility are limited to the lesser of 55.0% of the total land and construction cost, or 75.0% of the appraised value, of the specific centers currently under construction and are due and payable no later than three years from the closing date of each individual loan. As security for the obligations owing under the construction credit facility, we have granted mortgages on each of the specific centers that are financed by means of the construction credit facility. Funds are available only after we have first contributed our portion, which is approximately 45.0%, of the total project cost to the construction of the specific project and then only for reimbursement of project construction costs actually incurred. Interest accrues at a rate of prime plus 0.5%. At September 30, 2004, we had no outstanding borrowings and \$75.0 million available for borrowings under this facility. On July 6, 2004, the outstanding balance of \$8.9 million was paid off with a portion of our net proceeds from our initial public offering.

We have financed 13 of our centers with Teachers Insurance and Annuity Association of America pursuant to the terms of individual notes. The obligations under these notes are due in full in September 2011, and are secured by mortgages on each of the centers specifically financed, and we maintain a letter of credit in the amount of \$5.0 million in favor of the lender. The obligations related to 10 of the notes are being amortized over a 20-year period, while the obligations related to the other three notes are being amortized over a 15-year period. The interest rate payable under these notes has been fixed at 8.25%. The loan documents provide that we will be in default if our Chief Executive Officer, Mr. Akradi, ceases to be Chairman of the Board of Directors and Chief Executive Officer for any reason other than due to his death or incapacity or as a result of his removal pursuant to our articles of incorporation or bylaws. As of September 30, 2004, \$133.0 million remained outstanding on the notes.

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Factors That May Affect Future Results

If we are unable to identify and acquire suitable sites for new sports, fitness and family recreation centers, our revenue growth rate and profits may be negatively impacted.

To successfully expand our business, we must identify and acquire sites that meet the site selection criteria we have established. In addition to finding sites with the right demographic and other measures we employ in our selection process, we also need to evaluate the penetration of our competitors in the market. We face significant competition from other health and fitness center operators for sites that meet our criteria, and as a result we may lose those sites, our competitors could copy our format or we could be forced to pay significantly higher prices for those sites. If we are unable to identify and acquire sites for new sports, fitness and family recreation centers, our revenue growth rate and profits may be negatively impacted. Additionally, if our analysis of the suitability of a site is incorrect, we may not be able to recover our capital investment in developing and building the new center. For example, in 2002 we recorded an asset impairment charge of \$7.0 million related to our executive facility, which is located in downtown Minneapolis, Minnesota, and a restaurant that we operate in the same building.

We may be unable to attract and retain members, which could have a negative effect on our business.

The success of our business depends on our ability to attract and retain members, and we cannot assure you that we will be successful in our marketing efforts or that the membership levels at our centers will not materially decline, especially at those centers that have been in operation for an extended period of time. All of our members can cancel their membership at any time upon one month's notice. In addition, we experience attrition and must continually attract new members in order to maintain our membership levels. There are numerous factors that could lead to a decline in membership levels or that could prevent us from increasing membership at newer centers where membership is generally not yet at a targeted capacity, including market maturity or saturation, a decline in our ability to deliver quality service at a competitive price, direct and indirect competition in the areas where our centers are located, a decline in the public's interest in health and fitness, changes in discretionary spending trends and general economic conditions. In addition, we may decide to close a center and attempt to move members of that center to a different center or we may have to temporarily relocate members if a center is closed for remodeling or due to fire, earthquake or other casualty.

Delays in new sports, fitness and family recreation center openings could have a material adverse affect on our financial performance.

In order to meet our objectives, it is important that we open new centers on schedule. A significant amount of time and expenditure of capital is required to develop and construct new centers. If we are significantly delayed in opening new centers, our competitors may be able to open new clubs in the same market before we open our centers. This change in the competitive landscape could negatively impact our pre-opening sales of memberships and increase our investment costs. In addition, delays in opening new centers could hurt our ability to meet our growth objectives. Our ability to open new centers on schedule depends on a number of factors, many of which are beyond our control. These factors include:

obtaining acceptable financing for construction of new sites;

obtaining entitlements, permits and licenses necessary to complete construction of the new center on schedule;

recruiting, training and retaining qualified management and other personnel;

securing access to labor and materials necessary to develop and construct our centers;

delays due to material shortages, labor issues, weather conditions or other acts of god, discovery of contaminants, accidents, deaths or injunctions; and

general economic conditions.

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Our continued growth could place strains on our management, employees, information systems and internal controls which may adversely impact our business and the value of your investment.

Over the past several years, we have experienced significant growth in our business activities and operations, including an increase in the number of our sports, fitness and family recreation centers. Our past expansion has placed, and any future expansion will place, significant demands on our administrative, operational, financial and other resources. Any failure to manage growth effectively could seriously harm our business. To be successful, we will need to continue to implement management information systems and improve our operating, administrative, financial and accounting systems and controls. We will also need to train new employees and maintain close coordination among our executive, accounting, finance, marketing, sales and operations functions. These processes are time-consuming and expensive, will increase management responsibilities and will divert management attention.

The opening of new centers in existing locations may negatively impact our same-center revenue increases and our overall operating margins.

We currently operate sports, fitness and family recreation centers in eight states. As of October 15, 2004, we have opened four current model centers in 2004 and plan to open two additional centers in 2004. Four of these six openings in 2004 are in an existing market. With respect to existing markets, it has been our experience that opening new centers may attract some memberships away from other centers already operated by us in those markets and diminish their revenues. In addition, as a result of new center openings in existing markets, and because older centers will represent an increasing proportion of our center base over time, our same-center revenue increases may be lower in future periods than in the past.

Another result of opening new centers is that our overall operating margins may be lower than they have been historically. We expect both the addition of pre-opening expenses and the lower revenue volumes characteristic of newly-opened centers to affect our operating margins at these new centers. We also expect certain operating costs, particularly those related to occupancy, to be higher than in the past in some newly-entered geographic regions. As a result of the impact of these rising costs, our total center contribution and operating margins may be lower in future periods than they have been in the past.

Our debt levels may limit our flexibility in obtaining additional financing and in pursuing other business opportunities.

As of September 30, 2004, we had total consolidated indebtedness of \$198.4 million, consisting principally of obligations under construction and term notes that are secured by certain of our properties, borrowings under our revolving credit facility that are secured by certain personal property, mortgage notes that are secured by certain of our sports, fitness and family recreation centers and obligations under capital leases.

Our level of indebtedness could have important consequences to us, including the following:

our ability to obtain additional financing, if necessary, for capital expenditures, working capital, acquisitions or other purposes may be impaired or such financing may not be available on favorable terms;

we will need a substantial portion of our cash flow to pay the principal of, and interest on, our indebtedness, including indebtedness that we may incur in the future;

payments on our indebtedness will reduce the funds that would otherwise be available for our operations and future business opportunities;

a substantial decrease in our cash flows from operations could make it difficult for us to meet our debt service requirements and force us to modify our operations;

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we may be more highly leveraged than our competitors, which may place us at a competitive disadvantage;

our debt level may make us more vulnerable and less flexible than our competitors to a downturn in our business or the economy in general; and,

some of our debt has a variable rate of interest, which increases our vulnerability to interest rate fluctuations.

In addition to the amount of indebtedness outstanding as of September 30, 2004, we have access to an additional \$142.0 million under our credit facilities. We also have the ability to incur new debt, subject to limitations under our existing credit facilities and in our debt financing agreements. Furthermore, we have 13 centers financed by Teachers Insurance and Annuity Association of America that are subject to cross-default and cross-collateral provisions, which would allow the lender to foreclose on each of these 13 centers if there is an event of default related to one or more of these centers. If we incur additional debt, the risks associated with our leverage, including our ability to service our debt, could intensify.

Because of the capital-intensive nature of our business, we may have to incur additional indebtedness or issue new equity securities and, if we are not able to obtain additional capital, our ability to operate or expand our business may be impaired and our operating results could be adversely affected.

Our business requires significant levels of capital to finance the development of additional sites for new sports, fitness and family recreation centers and the construction of our centers. If cash from available sources is insufficient, or if cash is used for unanticipated needs, we may require additional capital sooner than anticipated. In the event that we are required or choose to raise additional funds, we may be unable to do so on favorable terms or at all. Furthermore, the cost of debt financing could significantly increase, making it cost-prohibitive to borrow, which could force us to issue new equity securities. If we issue new equity securities, existing shareholders may experience additional dilution or the new equity securities may have rights, preferences or privileges senior to those of existing holders of common stock. If we cannot raise funds on acceptable terms, we may not be able to take advantage of future opportunities or respond to competitive pressures. Any inability to raise additional capital when required could have an adverse effect on our business plans and operating results.

The health club industry is highly competitive and our competitors may have greater resources and name recognition than we have.

We compete with other health and fitness centers, physical fitness and recreational facilities established by local non-profit organizations, governments, hospitals, and businesses, amenity and condominium clubs and similar non-profit organizations, local salons, cafes and businesses offering similar ancillary services, and, to a lesser extent, racquet, tennis and other athletic clubs, country clubs, weight reducing salons and the home fitness equipment industry. Competitors, which may have greater resources or greater name recognition than we have, may compete with us to attract members in our markets. Non-profit and government organizations in our markets may be able to obtain land and construct centers at a lower cost than us and may be able to collect membership fees without paying taxes, thereby allowing them to lower their prices. This competition may limit our ability to increase membership fees, retain members, attract new members and retain qualified personnel.

Competitors could copy our business model and erode our market share, brand recognition and profitability.

We employ a business model that could allow competitors to duplicate our successes. We cannot assure you that our competitors will not attempt to copy our business model and that this will not erode our market share and brand recognition and impair our growth rate and profitability. In response to any such competitors, we may be required to decrease our membership fees, which may reduce our operating margins and profitability.

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We have significant operations concentrated in certain geographic areas, and any disruption in the operations of our centers in any of these areas could harm our operating results.

We currently operate multiple sports, fitness and family recreation centers in several metropolitan areas, including 14 in the Minneapolis/St. Paul market, seven in the Chicago market and five in the Detroit market, with continued planned expansion in other markets. As a result, any prolonged disruption in the operations of our centers in any of these markets, whether due to technical difficulties, power failures or destruction or damage to the centers as a result of a natural disaster, fire or any other reason, could harm our operating results. In addition, our concentration in these markets increases our exposure to adverse developments related to competition, as well as economic and demographic changes in these areas.

If we cannot retain our key personnel and hire additional highly qualified personnel, we may not be able to successfully manage our operations and pursue our strategic objectives.

We are highly dependent on the services of our senior management team and other key employees at both our corporate headquarters and our centers, and on our ability to recruit, retain and motivate key personnel. Competition for such personnel is intense, and the inability to attract and retain the additional qualified employees required to expand our activities, or the loss of current key employees, could materially and adversely affect us.

If our founder and chief executive officer leaves our company for any reason, it could have a material adverse effect on us.

Our growth and development to date have been largely dependent upon the services of Bahram Akradi, our Chairman of the Board of Directors, President, Chief Executive Officer and founder. If Mr. Akradi ceases to be Chairman of the Board of Directors and Chief Executive Officer for any reason other than due to his death or incapacity or as a result of his removal pursuant to our articles of incorporation or bylaws, we will be in default under the loan documents for our 13 centers financed with Teachers Insurance and Annuity Association of America. As a result, Mr. Akradi may be able to exert disproportionate control over our company because of the significant consequence of his departure. We do not have any employment or non-competition agreement with Mr. Akradi.

We could be subject to claims related to health or safety risks at our sports, fitness and family recreation centers.

Use of our centers poses potential health or safety risks to members or guests through exertion and use of our equipment, swimming pools and other facilities and services. We cannot assure you that claims will not be asserted against us for injury or death suffered by someone using our facilities or services. In addition, the child care services we offer at our centers expose us to claims related to child care. Lastly, because we construct our own centers, we also face liability in connection with the construction of these centers.

We are subject to extensive government regulation, and changes in these regulations could have a negative effect on our financial condition and results of operations.

Various federal and state laws and regulations govern our operations, including:

general rules and regulations of the Federal Trade Commission, state and local consumer protection agencies and state statutes that prescribe certain forms and provisions of membership contracts and that govern the advertising, sale and collection of our memberships;

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state and local health regulations;

federal regulation of health and nutritional products; and,

regulation of rehabilitation service providers.

Any changes in such laws could have a material adverse effect on our financial condition and results of operations.

We have introduced other business initiatives that may not be profitable.

In addition to our sports, fitness and family recreation centers, we have introduced other business initiatives in the areas of nutritional products, media and athletic events in order to capitalize on our brand identity and membership base. We have limited experience with these other initiatives and face significant competition against established companies with more retail experience and greater financial resources than us. We may not be able to compete effectively against these established companies, and these other business initiatives may not be profitable. In addition, we license from a third party the right to use the mark LIFE TIME in connection with our nutritional products, as well as the right to use certain ingredients of such products. These rights may be material to marketing and distributing our nutritional products. If these licenses are terminated for any reason, we may no longer be able to market and distribute nutritional products under the LIFE TIME FITNESS brand.

We could be subject to claims related to our nutritional products.

The nutritional products industry is currently the source of proposed federal laws and regulations, as well as numerous lawsuits. We advertise and offer for sale proprietary nutritional products within our centers, on the Internet and through selected national retail channels. We cannot assure you that there will be no claims against us regarding the ingredients in, manufacture of or results of using our nutritional products. Furthermore, we cannot assure you that any rights we have under indemnification provisions or insurance policies will be sufficient to cover any losses that might result from such claims.

If it becomes necessary to protect or defend our intellectual property rights or if we infringe on the intellectual property rights of others, we may be required to pay royalties or fees or become involved in costly litigation.

We may have disputes with third parties to enforce our intellectual property rights, protect our trademarks, determine the validity and scope of the proprietary rights of others or defend ourselves from claims of infringement, invalidity or unenforceability. Such disputes may require us to engage in litigation. We may incur substantial costs and a diversion of resources as a result of such disputes and litigation, even if we win. In the event that we do not win, we may have to enter into royalty or licensing agreements, we may be prevented from using the marks within certain markets in connection with goods and services that are material to our business or we may be unable to prevent a third party from using our marks. We cannot assure you that we would be able to reach an agreement on reasonable terms, if at all. In particular, although we own an incontestable federal trademark registration for use of the LIFE TIME FITNESS® mark in the field of health and fitness centers, we are aware of entities in certain locations around the country that use LIFE TIME FITNESS or a similar mark in connection with goods and services related to health and fitness. The rights of these entities in such marks may predate our rights. Accordingly, if we open any sports, fitness and family recreation centers in the areas in which these parties operate, we may be required to pay royalties or may be prevented from using the mark in such areas.

Our business could be affected by acts of war or terrorism.

Current world tensions could escalate, potentially leading to war or acts of terrorism. This could have unpredictable consequences on the world economy and on our business.

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Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not believe that we have any significant risk related to interest rate fluctuations since we have primarily fixed-rate debt. We invest our excess cash in highly liquid short-term investments. These investments are not held for trading or other speculative purposes. Changes in interest rates affect the investment income we earn on our cash and cash equivalents and, therefore, impact our cash flows and results of operations. As of December 31, 2003, and September 30, 2004, our floating rate indebtedness was approximately \$44.4 million and \$22.1 million, respectively. If long-term floating interest rates were to have increased by 100 basis points during the first nine months of 2004, our interest costs would have increased by approximately \$0.2 million. If short-term interest rates were to have increased by 100 basis points during the first nine months of 2004, our interest income from cash equivalents would have increased by approximately \$0.1 million. These amounts are determined by considering the impact of the hypothetical interest rates on our floating rate indebtedness and cash equivalents balances at September 30, 2004.

Item 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we conducted an evaluation, under the supervision and with the participation of the principal executive officer and principal financial officer, of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)). Based on this evaluation, the principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Not applicable.

ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

ITEM 5. OTHER INFORMATION

Not applicable.

Table of Contents**ITEM 6. EXHIBITS***Exhibits filed with this report*

Exhibit No.	Description	Method of Filing
3.1	Amended and Restated Articles of Incorporation of the Registrant	Incorporated by reference to Exhibit 3.1 to the Registrant's Form 10-Q for the quarter ended June 30, 2004 (File No. 001-32230)
3.2	Amended and Restated Bylaws of the Registrant	Incorporated by reference to Exhibit 3.1 to the Registrant's Form 10-Q for the quarter ended June 30, 2004 (File No. 001-32230)
4	Specimen of Common Stock Certificate	Incorporated by reference to Exhibit 4 to Amendment No. 4 to the Registrant's Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on June 23, 2004
10.1	Schedule of parties to Executive Employment Agreements	Filed Electronically
10.2	Fourth Amendment to Second Amended and Restated Credit Agreement dated as of September 30, 2004, by and among the Registrant, Antares Capital Corporation, JP Morgan Chase Bank, Mariner CDO 2002, Ltd., Merrill Lynch Capital, and M&I	Filed Electronically

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Marshall & Ilsley Bank

31.1	Rule 13a-14(a)/15d-14(a) Certification by Principal Executive Officer	Filed Electronically
31.2	Rule 13a-14(a)/15d-14(a) Certification by Principal Financial and Accounting Officer	Filed Electronically
32	Section 1350 Certifications	Filed Electronically

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, Life Time Fitness, Inc. has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on November 4, 2004.

LIFE TIME FITNESS, INC.

By: /s/ Bahram Akradi
Name: Bahram Akradi
Title: Chairman of the Board of Directors,
President and Chief Executive
Officer

By: /s/ Michael R. Robinson
Name: Michael R. Robinson
Title: Executive Vice President and Chief
Financial Officer

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31.1	Rule 13a-14(a)/15d-14(a) Certification by Principal Executive Officer	Filed Electronically
31.2	Rule 13a-14(a)/15d-14(a) Certification by Principal Financial and Accounting Officer	Filed Electronically
32	Section 1350 Certifications	Filed Electronically