

TOWN SPORTS INTERNATIONAL HOLDINGS INC

Form 10-Q

November 02, 2015

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Form 10-Q

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

For the quarterly period ended September 30, 2015

or

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

For the Transition period from to .

Commission File Number 001-36803

TOWN SPORTS INTERNATIONAL HOLDINGS, INC.

(Exact name of Registrant as specified in its charter)

Delaware

(State or other Jurisdiction of

Incorporation or Organization)

5 Penn Plaza (4th Floor)

New York, New York 10001

Telephone: (212) 246-6700

(Address, zip code, and telephone number, including area code, of registrant's principal executive office.)

20-0640002

(I.R.S. Employer

Identification Number)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ✓ No ..

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.:

Large accelerated filer ..

Accelerated filer ✓

Non-accelerated filer .. (Do not check if smaller reporting company)

Smaller reporting company ..

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes .. No ✓

As of October 27, 2015, there were 24,879,897 shares of Common Stock of the registrant outstanding.



Table of Contents

FORM 10-Q

For the Quarter Ended September 30, 2015

INDEX

Page

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

Condensed Consolidated Balance Sheets as of September 30, 2015 and December 31, 2014 1

Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2015 and 2014 2

Condensed Consolidated Statements of Comprehensive Loss for the three and nine months ended September 30, 2015 and 2014 3

Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2015 and 2014 4

Notes to Condensed Consolidated Financial Statements 5

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations 21

Item 3. Quantitative and Qualitative Disclosures About Market Risk 42

Item 4. Controls and Procedures 42

PART II. OTHER INFORMATION

Item 1. Legal Proceedings 43

Item 1A. Risk Factors 43

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds 43

Item 3. Defaults Upon Senior Securities 44

Item 4. Mine Safety Disclosures 44

Item 5. Other Information 44

Item 6. Exhibits 44

SIGNATURES 45

INDEX TO EXHIBITS 46

Table of ContentsTOWN SPORTS INTERNATIONAL HOLDINGS, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

September 30, 2015 and December 31, 2014

(All figures in thousands except share and per share data)

(Unaudited)

	September 30, 2015	December 31, 2014
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$88,286	\$93,452
Accounts receivable (less allowance for doubtful accounts of \$2,814 and \$2,511 as of September 30, 2015 and December 31, 2014, respectively)	2,428	3,656
Inventory	456	573
Deferred tax assets	533	724
Prepaid corporate income taxes	9,843	11,588
Prepaid expenses and other current assets	15,809	12,893
Total current assets	117,355	122,886
Fixed assets, net	206,255	233,644
Goodwill	1,055	32,593
Intangible assets, net	182	394
Deferred tax assets	217	—
Deferred membership costs	4,443	7,396
Other assets	12,454	12,920
Total assets	\$341,961	\$409,833
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>		
Current liabilities:		
Current portion of long-term debt	\$3,114	\$3,114
Accounts payable	5,422	2,873
Accrued expenses	28,927	26,702
Accrued interest	129	376
Dividends payable	173	291
Deferred revenue	43,657	36,950
Deferred tax liabilities	229	300
Total current liabilities	81,651	70,606
Long-term debt	295,394	296,757
Building financing arrangement	83,900	83,400
Dividends payable	123	211
Deferred lease liabilities	52,292	53,847
Deferred tax liabilities	577	11,999
Deferred revenue	1,571	2,455
Other liabilities	10,343	8,642
Total liabilities	525,851	527,917
Commitments and Contingencies (Note 12)		
Stockholders' deficit:		
Preferred stock, \$0.001 par value; no shares issued and outstanding at both September 30, 2015 and December 31, 2014		
Common stock, \$0.001 par value; issued and outstanding 24,879,897 and 24,322,249 shares at September 30, 2015 and December 31, 2014, respectively	24	24

Edgar Filing: TOWN SPORTS INTERNATIONAL HOLDINGS INC - Form 10-Q

Additional paid-in capital	(8,586	) (10,055	)
Accumulated other comprehensive (loss) income	(923	) 395	
Accumulated deficit	(174,405	) (108,448	)
Total stockholders' deficit	(183,890	) (118,084	)
Total liabilities and stockholders' deficit	\$341,961	\$409,833	
See notes to condensed consolidated financial statements.			

1

---

Table of ContentsTOWN SPORTS INTERNATIONAL HOLDINGS, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

For the Three and Nine Months Ended September 30, 2015 and 2014

(All figures in thousands except share and per share data)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Revenues:				
Club operations	\$102,119	\$110,956	\$318,748	\$339,600
Fees and other	1,645	1,565	4,736	4,521
	103,764	112,521	323,484	344,121
Operating Expenses:				
Payroll and related	42,889	43,994	135,886	133,329
Club operating	49,280	46,664	151,386	144,877
General and administrative	6,696	7,813	23,144	23,600
Depreciation and amortization	12,190	11,638	36,042	35,289
Impairment of fixed assets	12,420	—	14,571	4,513
Impairment of goodwill	—	—	31,558	137
	123,475	110,109	392,587	341,745
Operating (loss) income	(19,711)	) 2,412	(69,103)	) 2,376
Interest expense	5,204	4,519	15,562	13,927
Equity in the earnings of investees and rental income	(571)	) (580)	) (1,761)	) (1,820)
Loss before benefit for corporate income taxes	(24,344)	) (1,527)	) (82,904)	) (9,731)
Benefit for corporate income taxes	(2,338)	) (660)	) (17,066)	) (4,430)
Net loss	\$(22,006)	) \$(867)	) \$(65,838)	) \$(5,301)
Basic and diluted loss per share	\$(0.89)	) \$(0.04)	) \$(2.68)	) \$(0.22)
Weighted average number of shares used in calculating loss per share	24,654,267	24,301,677	24,554,390	24,251,682
Dividends declared per common share	\$—	\$—	\$—	\$0.32

See notes to condensed consolidated financial statements.

Table of Contents

TOWN SPORTS INTERNATIONAL HOLDINGS, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

For the Three and Nine Months Ended September 30, 2015 and 2014

(All figures in thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Statements of Comprehensive Loss:				
Net loss	\$(22,006 )	\$(867 )	\$(65,838 )	\$(5,301 )
Other comprehensive (loss) income, net of tax:				
Foreign currency translation adjustments, net of tax of \$0 for each of the three and nine months ended September 30, 2015 and 2014	(238 )	(364 )	(44 )	(253 )
Interest rate swap, net of tax of \$0 for each of the three and nine months ended September 30, 2015 and 2014, respectively, and (\$333) and \$193 for the comparable prior-year periods	(558 )	433	(1,274 )	(250 )
Total other comprehensive (loss) income, net of tax	(796 )	69	(1,318 )	(503 )
Total comprehensive loss	\$(22,802 )	\$(798 )	\$(67,156 )	\$(5,804 )
See notes to condensed consolidated financial statements.				

Table of ContentsTOWN SPORTS INTERNATIONAL HOLDINGS, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Nine Months Ended September 30, 2015 and 2014

(All figures in thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2015	2014
Cash flows from operating activities:		
Net loss	\$(65,838	) \$(5,301 )
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	36,042	35,289
Impairment of fixed assets	14,571	4,513
Impairment of goodwill	31,558	137
Amortization of debt discount	972	978
Amortization of debt issuance costs	588	443
Amortization of building financing costs	95	—
Non-cash rental income, net of non-cash rental expense	(2,694	) (4,913 )
Share-based compensation expense	1,187	1,563
Net change in deferred taxes	(11,519	) (23,567 )
Net change in certain operating assets and liabilities	12,961	(10,172 )
Decrease in deferred membership costs	2,953	930
Landlord contributions to tenant improvements	296	1,302
Increase in insurance reserves	689	760
Other	340	(60 )
Total adjustments	88,039	7,203
Net cash provided by operating activities	22,201	1,902
Cash flows from investing activities:		
Capital expenditures	(24,073	) (29,196 )
Change in restricted cash	(1,100	) —
Net cash used in investing activities	(25,173	) (29,196 )
Cash flows from financing activities:		
Proceeds from building financing arrangement	500	83,400
Principal payments on 2013 Term Loan Facility	(2,335	) (3,160 )
Debt issuance costs	(350	) (2,437 )
Cash dividends paid	(82	) (7,666 )
Redemption paid pursuant to the Rights Plan	(246	) —
Proceeds from stock option exercises	282	47
Tax benefit from restricted stock vesting	—	1,692
Net cash (used in) provided by financing activities	(2,231	) 71,876
Effect of exchange rate changes on cash	37	(229 )
Net (decrease) increase in cash and cash equivalents	(5,166	) 44,353
Cash and cash equivalents beginning of period	93,452	73,598
Cash and cash equivalents end of period	\$88,286	\$117,951
Summary of the change in certain operating assets and liabilities:		
Decrease (increase) in accounts receivable	\$943	\$(44 )
Decrease (increase) in inventory	118	(90 )
Increase in prepaid expenses and other current assets	(781	) (1,496 )



Edgar Filing: TOWN SPORTS INTERNATIONAL HOLDINGS INC - Form 10-Q

Increase (decrease) in accounts payable, accrued expenses and accrued interest	5,052	(4,612	)
Change in prepaid corporate income taxes and corporate income taxes payable	1,806	(6,166	)
Increase in deferred revenue	5,823	2,236	
Net change in certain working capital components	\$12,961	\$(10,172	)
Supplemental disclosures of cash flow information:			
Cash payments for interest, net of capitalized interest	\$12,981	\$12,741	
Cash payments for income taxes	\$88	\$23,552	
See notes to condensed consolidated financial statements.			

Table of Contents

TOWN SPORTS INTERNATIONAL HOLDINGS, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands except share and per share data)

(Unaudited)

1. Basis of Presentation

As of September 30, 2015, Town Sports International Holdings, Inc. (the “Company” or “TSI Holdings”), through its wholly-owned subsidiary, Town Sports International, LLC (“TSI, LLC”), operated 153 fitness clubs (“clubs”) and three BFX Studio locations. The clubs are composed of 105 clubs in the New York metropolitan market under the “New York Sports Clubs” brand name, 27 clubs in the Boston market under the “Boston Sports Clubs” brand name, 13 clubs (two of which are partly-owned) in the Washington, D.C. market under the “Washington Sports Clubs” brand name, five clubs in the Philadelphia market under the “Philadelphia Sports Clubs” brand name and three clubs in Switzerland. The condensed consolidated financial statements included herein have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). The condensed consolidated financial statements should be read in conjunction with the Company’s December 31, 2014 consolidated financial statements and notes thereto, included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014. The year-end condensed consolidated balance sheet data included within this Form 10-Q was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America (“US GAAP”). Certain information and footnote disclosures that are normally included in financial statements prepared in accordance with US GAAP have been condensed or omitted pursuant to SEC rules and regulations. The information reflects all normal and recurring adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the interim periods set forth herein. The results for the three and nine months ended September 30, 2015 are not necessarily indicative of the results for the entire year ending December 31, 2015.

Change in Estimated Average Membership Life

The Company completed the introduction of a new pricing model to a substantial majority of its clubs in the second quarter of 2015. As of September 30, 2015, approximately 80% of its clubs were operating under this new pricing model, with the remaining clubs principally comprising the Company's passport-only model. Prior to introducing this model, the Company tracked membership life of restricted members (primarily students and teachers) separately from unrestricted members. The Restricted Membership was discontinued as clubs transitioned and therefore the Company now aggregates all members for purposes of tracking average membership life. For the three and nine months ended September 30, 2015 and the full-year ended December 31, 2014, the average membership life was 22 months. The Company monitors factors that might affect the estimated average membership life including retention trends, attrition trends, membership sales volumes, membership composition, competition, and general economic conditions, and adjusts the estimate as necessary on a quarterly basis.

Initiation and processing fees, as well as related direct and incremental expenses of membership acquisition, which include sales commissions, bonuses and related taxes and benefits, are currently deferred and recognized, on a straight-line basis, in operations over the estimated average membership life or 12 months to the extent these costs are related to the first annual fee paid at the time of enrollment. Annual fees are amortized over 12 months.

## Table of Contents

### 2. Recent Accounting Pronouncements

In April 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2015-03, “Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs”.

This standard changes the presentation of debt issuance costs in the financial statements to present such costs as a direct deduction from the related debt liability rather than as an asset. Amortization of debt issuance costs will be reported as interest expense. In August 2015, the FASB issued ASU No. 2015-15, “Interest - Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements”. ASU 2015-15 clarifies that the U.S. Securities Exchange and Commission would not object to the deferral and presentation of debt issuance costs as an asset and subsequent amortization of debt issuance costs over the term of the line-of-credit arrangement, whether or there are any outstanding borrowings on the line-of-credit arrangement. These standards are effective for annual reporting periods beginning after December 15, 2015. The adoption of this guidance is not expected to have a material impact on the Company's financial statements.

In April 2015, the FASB issued ASU No. 2015-05, “Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 35-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement.” This ASU provides guidance to customers about whether a cloud computing arrangement includes a software license. If an arrangement includes a software license, the accounting for the license will be consistent with licenses of other intangible assets. If the arrangement does not include a license, the arrangement will be accounted for as a service contract. ASU 2015-05 is effective for interim and annual periods beginning after December 15, 2015. Early adoption is permitted. The Company is currently evaluating the effect this standard will have on its financial statements.

In January 2015, the FASB issued ASU No. 2015-01, “Income Statement - Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items.” This guidance eliminates the concept of extraordinary items from GAAP. As a result, an entity will no longer be required to segregate extraordinary items from the results of ordinary operations, to separately present an extraordinary item on its income statement, net of tax, after income from continuing operations or to disclose income taxes and earnings-per-share data applicable to an extraordinary item. However, the ASU does not affect the reporting and disclosure requirements for an event that is unusual in nature or infrequent in occurrence. This guidance is effective for interim and annual periods beginning after December 15, 2015. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The adoption of this guidance is not expected to have a material impact on the Company's financial statements.

In November 2014, the FASB issued ASU No. 2014-16, “Derivatives and Hedging” (Topic 815): “Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity, which provides guidance on identifying whether the nature of the host contract in a hybrid instrument is in the form of debt or equity”. This standard requires management to consider the stated and implied substantive terms and features of the hybrid financial instrument, including the embedded derivative features, in order to determine whether the nature of the host contract is more akin to debt or to equity. The ASU is effective for annual periods and interim periods with those annual periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance is not expected to have a material impact on the Company's financial statements.

In August 2014, the FASB issued ASU No. 2014-15, “Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern.” The standard requires management to evaluate, at each annual and interim reporting period, the Company’s ability to continue as a going concern within one year of the date the financial statements are issued and provide related disclosures. This accounting guidance is effective for the Company on a prospective basis for the annual period ending December 31, 2016 and is not expected to have a material effect on its financial statements.

Table of Contents

In May 2014, the FASB issued ASU No. 2014-09, “Revenue from Contracts with Customers”. The standard provides a single, comprehensive revenue recognition model for all contracts with customers and supersedes current revenue recognition guidance. The revenue standard contains principles that an entity will apply to determine the measurement of revenue and timing of when it is recognized. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. The new standard also includes enhanced disclosures which are significantly more comprehensive than those in existing revenue standards. In August 2015, the FASB issued ASU No. 2015-14, “Revenue from Contracts with Customers” (Topic 606): “Deferral of the Effective Date”, which defers the effective date of ASU No. 2014-09 for all entities by one year, to annual reporting periods beginning after December 15, 2017. Early adoption will be permitted for annual reporting periods beginning after December 15, 2016. The standard allows for either “full retrospective” adoption, meaning the standard is applied to all of the periods presented, or “modified retrospective” adoption, meaning the standard is applied only to the most current period presented in the financial statements. The Company is evaluating the impact of this standard on its financial statements.

## 3. Long-Term Debt

	September 30, 2015	December 31, 2014
2013 Term Loan Facility outstanding principal balance	\$305,949	\$308,284
Less: Unamortized discount	(7,441)	(8,413)
Less: Current portion due within one year	(3,114)	(3,114)
Long-term portion	\$295,394	\$296,757

## 2013 Senior Credit Facility

On November 15, 2013, TSI, LLC, an indirect, wholly-owned subsidiary, entered into a \$370,000 senior secured credit facility (“2013 Senior Credit Facility”), among TSI, LLC, TSI Holdings II, LLC, a newly-formed, wholly-owned subsidiary of the Company (“Holdings II”), as a Guarantor, the lenders party thereto, Deutsche Bank AG, as administrative agent, and Keybank National Association, as syndication agent. The 2013 Senior Credit Facility consists of a \$325,000 term loan facility maturing on November 15, 2020 (“2013 Term Loan Facility”) and a \$45,000 revolving loan facility maturing on November 15, 2018 (“2013 Revolving Loan Facility”). Proceeds from the 2013 Term Loan Facility of \$323,375 were issued, net of an original issue discount (“OID”) of 0.5%, or \$1,625. Debt issuance costs recorded in connection with the 2013 Senior Credit Facility were \$5,119 and are being amortized as interest expense and are included in other assets in the accompanying condensed consolidated balance sheets. The Company also recorded additional debt discount of \$4,356 related to creditor fees. The proceeds from the 2013 Term Loan Facility were used to pay off amounts outstanding under the Company’s previously outstanding long-term debt facility originally entered into on May 11, 2011 (as amended from time to time), and to pay related fees and expenses. None of the revolving loan facility was drawn upon as of the closing date on November 15, 2013, but loans under the 2013 Revolving Loan Facility may be drawn from time to time pursuant to the terms of the 2013 Senior Credit Facility. The borrowings under the 2013 Senior Credit Facility are guaranteed and secured by assets and pledges of capital stock by Holdings II, TSI, LLC, and, subject to certain customary exceptions, the wholly-owned domestic subsidiaries of TSI, LLC.

Borrowings under the 2013 Term Loan Facility and the 2013 Revolving Loan Facility, at TSI, LLC’s option, bear interest at either the administrative agent’s base rate plus 2.5% or a LIBOR rate adjusted for certain additional costs (the “Eurodollar Rate”) plus 3.5%, each as defined in the 2013 Senior Credit Facility. With respect to the outstanding initial term loans, the Eurodollar Rate has a floor of 1.00% and the base rate has a floor of 2.00%. Commencing with the last business day of the quarter ended March 31, 2014, TSI, LLC is required to pay 0.25% of the principal amount of the term loans each quarter, which may be reduced by voluntary prepayments. As of September 30, 2015, TSI LLC has made a total of \$19,051 in principal payments on the 2013 Term Loan Facility.

Table of Contents

The terms of the 2013 Senior Credit Facility provide for a financial covenant in the situation where the total utilization of the revolving loan commitments (other than letters of credit up to \$5,500 at any time outstanding) exceeds 25% of the aggregate amount of those commitments. In such event, TSI, LLC is required to maintain a total leverage ratio, as defined in the 2013 Senior Credit Facility, of no greater than 4.50:1.00. While not subject to the total leverage ratio covenant as of September 30, 2015 as the Company's only utilization of the 2013 Revolving Loan Facility as of September 30, 2015 was \$2,850 of issued and outstanding letters of credit thereunder, because the Company's total leverage ratio as of September 30, 2015 was in excess of 4.50:1.00, the Company is currently not able to utilize more than 25% of the 2013 Revolving Loan Facility. The Company will continue not to be able to utilize more than 25% of the 2013 Revolving Loan Facility until it has a total leverage ratio of no greater than 4.50:1.00. The 2013 Senior Credit Facility also contains certain affirmative and negative covenants, including covenants that may limit or restrict TSI, LLC and Holdings II's ability to, among other things, incur indebtedness and other liabilities; create liens; merge or consolidate; dispose of assets; make investments; pay dividends and make payments to shareholders; make payments on certain indebtedness; and enter into sale leaseback transactions, in each case, subject to certain qualifications and exceptions. In addition, at any time when the total leverage ratio is greater than 4.50:1.00, there are additional limitations on the ability of TSI, LLC and Holdings II to, among other things, make certain distributions of cash to TSI Holdings. The 2013 Senior Credit Facility also includes customary events of default (including non-compliance with the covenants or other terms of the 2013 Senior Credit Facility) which may allow the lenders to terminate the commitments under the 2013 Revolving Loan Facility and declare all outstanding term loans and revolving loans immediately due and payable and enforce its rights as a secured creditor.

TSI, LLC may prepay the 2013 Term Loan Facility and 2013 Revolving Loan Facility without premium or penalty in accordance with the 2013 Senior Credit Facility. Mandatory prepayments are required relating to certain asset sales, insurance recovery and incurrence of certain other debt and commencing in 2015 in certain circumstances relating to excess cash flow (as defined) for the prior fiscal year, as described below, in excess of certain expenditures. Pursuant to the terms of the 2013 Senior Credit Facility, the Company is required to apply net proceeds in excess of \$30,000 from sales of assets in any fiscal year towards mandatory prepayments of outstanding borrowings. In connection with the sale of the East 86th Street property, accounted for as a building financing arrangement, described in Note 5 – Building Financing Arrangement, the Company received approximately \$43,500 in net sales proceeds (after taxes, before giving effect to utilization of net operating losses and carryforwards) during the third quarter of 2014. Accordingly, the Company made a mandatory prepayment of \$13,500 on the 2013 Term Loan Facility in November 2014. In connection with this mandatory prepayment, during the year ended December 31, 2014, the Company recorded loss on extinguishment of debt of \$493, consisting of the write-off of unamortized debt issuance costs and debt discount of \$119 and \$374, respectively. To the extent the proceeds of the sale of the East 86th Street property are not reinvested, the Company may be required to use such amounts, other than amounts used in 2014 to repay debt, to pay down its outstanding debt, as provided under the terms of its 2013 Senior Credit Facility. Based on increased capital expenditures related to the building of new clubs and new BFX Studio locations, the Company does not expect to be required to make a payment at any time. In addition, the 2013 Senior Credit Facility contains provisions that require excess cash flow payments, as defined, to be applied against outstanding 2013 Term Loan Facility balances. The excess cash flow is calculated annually for each fiscal year ending December 31 and paid 95 days after the fiscal year end. The applicable excess cash flow repayment percentage is applied to the excess cash flow when determining the excess cash flow payment. Earnings, changes in working capital and capital expenditure levels all impact the determination of any excess cash flow. The applicable excess cash flow repayment percentage is 50% when the total leverage ratio, as defined in the 2013 Senior Credit Facility, exceeds or is equal to 2.50:1.00; 25% when the total leverage ratio is greater than or equal to 2.00:1.00 but less than 2.50:1.00 and 0% when the total leverage ratio is less than 2.00:1.00. The first excess cash flow payment would have been due in April 2015. The excess cash flow calculation performed as of December 31, 2014 did not result in any required payments in April 2015. The second excess cash flow payment is due in April 2016, if applicable. Based on the Company's unit growth projection and capital expenditures related to club renovations, the building of new clubs and new BFX Studio locations, together with its operating forecast, the Company does not expect there will be an excess cash flow payment required at that

time.

8

---

## Table of Contents

As of September 30, 2015, the 2013 Term Loan Facility has a gross principal balance of \$305,949 and a balance of \$298,508 net of unamortized debt discount of \$7,441 which is comprised of the unamortized portions of the OID recorded in connection with the May 11, 2011 debt issuance and the unamortized balance of the additional debt discounts recorded in connection with the first amendment and second amendment to the 2011 Senior Credit Facility. The unamortized debt discount balance is recorded as a contra-liability to long-term debt on the accompanying condensed consolidated balance sheet and is being amortized as interest expense using the effective interest method. As of September 30, 2015, the unamortized balance of debt issuance costs of \$3,127 is being amortized as interest expense, and is included in other assets in the accompanying condensed consolidated balance sheets.

As of September 30, 2015, there were no outstanding 2013 Revolving Loan Facility borrowings and outstanding letters of credit issued totaled \$2,850. The unutilized portion of the 2013 Revolving Loan Facility as of September 30, 2015 was \$42,150 and the available unutilized portion, based on the Company's total leverage ratio exceeding 4.50:1.00, was \$11,250.

On January 30, 2015, the 2013 Senior Credit Facility was amended (the "Amendment") to permit TSI Holdings to purchase term loans under the Credit Agreement. Any term loans purchased by TSI Holdings will be cancelled. The Company may from time to time purchase term loans in market transactions, privately negotiated transactions or otherwise; however the Company is under no obligation to make any such purchases. Any such transactions, and the amounts involved, will depend on prevailing market conditions, liquidity requirements, contractual restrictions and other factors. The amounts involved may be material.

### Fair Market Value

Based on quoted market prices, the 2013 Term Loan Facility had a fair value of approximately \$183,569 and \$221,964 at September 30, 2015 and December 31, 2014, respectively, and is classified within level 2 of the fair value hierarchy. Level 2 is based on quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets. The fair value for the Company's 2013 Term Loan Facility is determined using observable current market information such as the prevailing Eurodollar interest rate and Eurodollar yield curve rates and includes consideration of counterparty credit risk.

For the fair market value of the Company's interest rate swap instrument refer to Note 4 — Derivative Financial Instruments.

### 4. Derivative Financial Instruments

In its normal operations, the Company is exposed to market risks relating to fluctuations in interest rates. In order to minimize the possible negative impact of such fluctuations on the Company's cash flows the Company may enter into derivative financial instruments ("derivatives"), such as interest-rate swaps. Derivatives are not entered into for trading purposes and the Company only uses commonly traded instruments. Currently, the Company has used derivatives solely relating to the variability of cash flows from interest rate fluctuations.

The Company originally entered into an interest rate swap arrangement on July 13, 2011 in connection with the Company's previous credit facility. Effective as of November 15, 2013, the closing date of the 2013 Senior Credit Facility, the interest rate swap arrangement had a notional amount of \$160,000 and will mature on May 15, 2018. The swap effectively converts \$160,000 of the \$325,000 total variable-rate debt under the 2013 Senior Credit Facility to a fixed rate of 5.384%, when including the applicable 3.50% margin. As permitted by FASB Accounting Standards Codification ("ASC") 815, Derivatives and Hedging, the Company has designated this swap as a cash flow hedge, the effects of which have been reflected in the Company's condensed consolidated financial statements as of and for the three and nine months ended September 30, 2015 and 2014. The objective of this hedge is to manage the variability of cash flows in the interest payments related to the portion of the variable-rate debt designated as being hedged.

Table of Contents

When the Company's derivative instrument was executed, hedge accounting was deemed appropriate and it was designated as a cash flow hedge at inception with re-designation being permitted under ASC 815, Derivatives and Hedging. Interest rate swaps are designated as cash flow hedges for accounting purposes since they are being used to transform variable interest rate exposure to fixed interest rate exposure on a recognized liability (debt). On an ongoing basis, the Company performs a quarterly assessment of the hedge effectiveness of the hedge relationship and measures and recognizes any hedge ineffectiveness in the condensed consolidated statements of operations. For the three and nine months ended September 30, 2015 and 2014, hedge ineffectiveness was evaluated using the hypothetical derivative method. There was no hedge ineffectiveness for the three and nine months ended September 30, 2015 and 2014.

Accounting guidance on fair value measurements specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. These two types of inputs create the following fair value hierarchy:

Level 1—Quoted prices for identical instruments in active markets.

Level 2—Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.

Level 3—Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

The fair value for the Company's interest rate swap is determined using observable current market information such as the prevailing Eurodollar interest rate and Eurodollar yield curve rates and include consideration of counterparty credit risk. The following table presents the aggregate fair value of the Company's derivative financial instrument:

	Total Fair Value	Fair Value Measurements Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Interest rate swap liability as of September 30, 2015	\$2,568	\$—	\$2,568	\$—
Interest rate swap liability as of December 31, 2014	\$1,294	\$—	\$1,294	\$—

The swap contract liability of \$2,568 and \$1,294 are recorded as a component of other liabilities as of September 30, 2015 and December 31, 2014, respectively, with the offset to accumulated other comprehensive income (\$1,451 and \$1,215, net of taxes, as of September 30, 2015 and December 31, 2014, respectively) on the accompanying condensed consolidated balance sheet.

There were no significant reclassifications out of accumulated other comprehensive income during the three and nine months ended September 30, 2015 and 2014 and the Company does not expect that significant derivative losses included in accumulated other comprehensive income at September 30, 2015 will be reclassified into earnings within the next 12 months.



## Table of Contents

### 5. Building Financing Arrangement

On September 12, 2014, the Company completed the legal sale of its property (building and land) on East 86th Street, New York City, to an unaffiliated third-party for gross proceeds of \$85,650, which includes \$150 of additional payments to the Company. Concurrent with the closing of the transaction, the Company leased back the portion of the property comprising its health club. The Company expects to lease ("Initial Lease") the premises to at least March 2016 and then, upon at least 120 days notice from the purchaser/landlord, the Initial Lease will terminate and the Company will vacate the property while the purchaser/landlord demolishes the existing building and the adjacent building and builds a new luxury, high-rise multi-use building. In connection with vacating the property, the Company intends to enter into a new lease ("New Club Lease") for approximately 24,000 square feet in the new building for the purpose of operating a health club upon completion of construction by the purchaser/landlord. The term of the Initial Lease is 10 years, and at the end of this initial term, the Company has two options at its sole discretion to renew the lease; the first for an additional 10 year period and a second for an additional five year period (although the Company expects that the purchaser/landlord will exercise its right to early terminate the Initial Lease so that it may commence the construction of the new building). Under the Initial Lease (and New Club Lease if entered into), the purchaser/landlord has agreed to pay the Company liquidated damages if the new club is not available by a certain date. The latest date that the liquidated damages would begin to be paid would be April 13, 2020 and would continue until the new club is available. For accounting purposes, the nature of these potential liquidated damages constitutes continuing involvement with the purchaser/landlord's development of the property. As a result of this continuing involvement, the sale-leaseback transaction is currently required to be accounted for as a financing arrangement rather than as a completed sale. Under this treatment, the Company has included the proceeds received as a financing arrangement on its balance sheet. Except for payments under the Initial Lease and the New Club Lease, the Company does not expect to make any cash payments to the purchaser/landlord with respect to the building financing arrangement. The Company recorded a taxable (for federal and state income tax purposes) gain on the sale of the property and made estimated tax payments in September 2014 in this regard. In March 2015, the Company received the remaining proceeds held in escrow of \$500, which was included in the Company's cash flow statement for the nine months ended September 30, 2015 as a financing cash inflow.

As of September 30, 2015, the total financing arrangement was \$83,900, which is net of \$1,750 held in escrow for the Company's former tenant. Because the transaction is characterized as a financing for accounting purposes rather than a sale, the rental payments and related transaction costs are treated as interest on the financing arrangement. As these interest amounts are less than the interest that would be charged under a typical financing, the financing is characterized as an interest only financing with no reduction in the principal throughout the Initial Lease term until any continuing involvement has ceased. Until such time, even though the Company no longer has legal title to the building and the land, the building, building improvements and land remain on the Company's consolidated balance sheet and the building and building improvements will continue to be depreciated over their remaining useful lives. Similarly, the Company does not have a loan or borrowing arrangement with the purchaser/landlord but the building financing arrangement will remain on the Company's balance sheet until any continuing involvement has ceased. As of September 30, 2015, the net book value of the building and building improvements was \$2,865 and the book value of the land was \$986. As part of the transaction, the Company incurred \$3,160 of real property transfer taxes, broker fees and other costs which will be deferred and amortized over the term of the Initial Lease of 25 years, which includes the option periods. The net fees are recorded in Other assets on the accompanying condensed consolidated balance sheets as of September 30, 2015 and December 31, 2014.

Payments made under the Initial Lease, including rental income related to the Company's tenant in the building that was assigned to the purchaser/landlord, are recognized as interest expense in the underlying financing arrangement. Included in the table below is the Company's future lease commitment of \$750 per year under the remaining term of the Initial Lease, which includes the options periods and will be recorded as interest expense.

Table of Contents

12 months ending September 30,	
2016	\$750
2017	750
2018	750
2019	750
2020	750
2021 and thereafter	14,208
Minimum lease commitments	\$17,958

Not included in the table above are the cash rent portion of rental income related to the Company's former tenant in the building ranging between \$1,883 and \$2,617 per year through March 2028 and the amortization of the deferred costs of \$126 per year through September 2039, and such amounts will be recorded as interest expense (unless the purchaser/landlord exercises its right to terminate the lease before the end of the 10-year Initial Lease).

#### 6. Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist of cash and cash equivalents and the interest rate swap. Although the Company deposits its cash with more than one financial institution, as of September 30, 2015, \$75,558 of the cash balance of \$88,286 was held at two financial institutions. The Company has not experienced any losses on cash and cash equivalent accounts to date, and the Company believes that, based on the credit ratings of these financial institutions, it is not exposed to any significant credit risk related to cash at this time.

The counterparty to the Company's interest rate swap is a major banking institution with a credit rating of investment grade or better and no collateral is required, and there are no significant risk concentrations. The Company believes the risk of incurring losses on derivative contracts related to credit risk is unlikely.

#### 7. Loss Per Share

Basic earnings (loss) per share ("EPS") is computed by dividing net earnings (loss) applicable to common stockholders by the weighted average numbers of shares of common stock outstanding during the period. Diluted EPS is computed similarly to basic EPS, except that the denominator is increased for the assumed exercise of dilutive stock options and unvested restricted stock calculated using the treasury stock method.

For the three and nine months ended September 30, 2015 and 2014, there was no effect of dilutive stock options and unvested restricted common stock on calculation of diluted EPS as the Company had a net loss for these periods. As a result, the Company reported basic and diluted loss per share of \$0.89 and \$2.68 for the three and nine months ended September 30, 2015, respectively, and \$0.04 and \$0.22 for the comparable prior-year periods. If the Company had not been in a net loss position, there would have been anti-dilutive shares of 807,228 and 329,847 in the three and nine months ended September 30, 2015, respectively, and 366,417 and 383,956 in the comparable prior-year periods.

#### 8. Stock-Based Compensation

The Company's 2006 Stock Incentive Plan, as amended and restated (the "2006 Plan") in May 2008, authorizes the Company to issue up to 3,000,000 shares of common stock to employees, non-employee directors and consultants pursuant to awards of stock options, stock appreciation rights, restricted stock, in payment of performance shares or other stock-based awards. In April 2015, the Company further amended the 2006 Plan to increase the aggregate number of shares of Common Stock issuable under the 2006 Plan by 500,000 shares to a total of 3,500,000.

Table of Contents

Under the 2006 Plan, stock options must be granted at a price not less than the fair market value of the stock on the date the option is granted, generally are not subject to re-pricing, and will not be exercisable more than ten years after the date of grant. Options granted under the 2006 Plan generally qualify as “non-qualified stock options” under the U.S. Internal Revenue Code. Certain options granted under the Company’s 2004 Common Stock Option Plan, as amended (the “2004 Plan”), generally qualified as “incentive stock options” under the U.S. Internal Revenue Code; the exercise price of a stock option is equal to the fair market value of the Company’s common stock on the option grant date. As of September 30, 2015, there were 702,352 shares available to be issued under the 2006 Plan.

At September 30, 2015, the Company had no stock options outstanding under the 2004 Plan while the 2006 Plan had 849,866 stock options outstanding and 324,243 shares of restricted stock outstanding.

Effective December 31, 2014, the Company’s Board of Directors adopted a stockholder rights plan (the “Rights Plan”). Pursuant to the Rights Plan, the Board of Directors declared a dividend distribution of one preferred share right (a “Right”) for each share of Common Stock held as of January 12, 2015. Each Right entitled the holder to purchase one one-thousandth of a share of Series A Junior Participating Preferred Stock (the “Preferred Shares”) at an initial exercise price of \$15, subject to certain adjustments. On March 24, 2015, the Company entered into a nomination and standstill agreement (the “Nomination and Standstill Agreement”). Pursuant to the Nomination and Standstill Agreement, the Company agreed to redeem, effective immediately, the rights issued pursuant to the Rights Plan. Pursuant to the terms of the Rights Plan, the Company paid a redemption price to the holders of the rights equal to \$0.01 per right in cash, or \$246, on April 20, 2015.

**Stock Option Awards**

On August 19, 2015, the Company granted an award of non-qualified options to purchase 250,000 shares of its common stock to its Chief Operating Officer (“COO”) under the Company’s 2006 Plan. In addition to awards granted under the 2006 Plan, the Company granted its COO an award of non-qualified options to purchase 450,000 shares (“Non-Plan Options”) of its common stock. These Non-Plan Options were granted outside of any shareholder-approved plan as an inducement to accept employment with the Company. The options granted on August 19, 2015 shall vest in three equal installments on each of the first three anniversaries of the date of grant and have a term of five years. These options have an exercise price of \$2.61 per share, equal to the closing price of the Company’s common stock on the date of grant.

The Company calculated the expected term of stock options to be 3.50 years, which represents the period of time that options are expected to be outstanding. The risk free interest rate for periods within the contractual life of the option is based on the U.S. treasury yield in effect at the time of grant. The volatility is determined based on management’s estimate or historical volatilities of comparable companies.

The estimated fair value of the options as of the grant date was \$0.98 per underlying share. The fair value of the stock option award is estimated on the grant date using the Black-Scholes option pricing model with the following assumptions:

Grant Date	Risk-free Interest Rate	Expected Dividend Yield	Expected Term (Years)	Expected Volatility
August 19, 2015	1.05	% —	% 3.50	50.70 %

Total compensation cost, classified within payroll and related on the condensed consolidated statements of operations, related to stock options outstanding was \$28 for both the three and nine months ended September 30, 2015, versus \$61 and \$273 for the comparable prior-year periods.

As of September 30, 2015, a total of \$647 in unrecognized compensation expense related to stock options is expected to be recognized over a weighted-average period of 2.9 years.

Table of Contents**Restricted Stock Awards**

On August 19, 2015, the Company issued 300,000 shares of restricted stock to its COO ("Non-Plan RSA"). These Non-Plan RSA were granted outside of any shareholder-approved plan as an inducement to accept employment with the Company. The fair value of the Non-Plan RSA was \$2.61 per share, representing the closing stock price on the date of grant. These shares will vest in three equal installments on each of the first three anniversaries of the date of grant.

On March 2, 2015, the Company issued 207,000 shares of restricted stock to employees under the 2006 Plan. The fair value for these awards was \$6.68 per share, representing the closing stock price on the date of grant. These shares will vest 25% per year over four years on the anniversary dates of the respective grants.

The total compensation expense, classified within payroll and related on the condensed consolidated statements of operations, related to restricted stock was \$186 and \$714 for the three and nine months ended September 30, 2015, respectively, versus \$369 and \$1,045 for the comparable prior-year periods. In the three months ended September 30, 2015, the Company adjusted the forfeiture estimates to reflect actual forfeitures. The actual forfeitures experienced in the third quarter of 2015 differ from the Company's previous estimate mainly due to the termination of one of its executive management level employees in August 2015. The impact of forfeiture adjustment reduced stock-based compensation expense by \$191 for the three months ended September 30, 2015.

As of September 30, 2015, a total of \$2,175 in unrecognized compensation expense related to restricted stock awards is expected to be recognized over a weighted-average period of 2.8 years.

**Stock Grants**

In the nine months ended September 30, 2015, the Company issued shares of common stock to members of the Company's Board of Directors in respect of their annual retainer. The total fair value of the shares issued was expensed upon the date of grant. The total compensation expense, classified within general and administrative expenses, related to Board of Director common stock grants was \$445 and \$245 for the nine months ended September 30, 2015 and 2014, respectively. There was no compensation expense related to Board of Director common stock grants for the three months ended September 30, 2015 and 2014.

Total shares issued to members of the Company's Board of Directors during the nine months ended September 30, 2015 were:

Grant Date	Number of Shares	Price Per Share	Aggregate Grant Date Fair Value
February 2, 2015	35,764	\$6.85	\$245
March 24, 2015	31,845	\$6.28	\$200

**9. Fixed Asset Impairment**

Fixed assets are evaluated for impairment periodically whenever events or changes in circumstances indicate that related carrying amounts may not be recoverable from undiscounted cash flows in accordance with FASB guidance. The Company's long-lived assets and liabilities are grouped at the individual club level, which is the lowest level for which there are identifiable cash flows. To the extent that estimated future undiscounted net cash flows attributable to the assets are less than the carrying amount, an impairment charge equal to the difference between the carrying value of such asset and their fair values is recognized.

## Table of Contents

In the three months ended September 30, 2015, the Company tested its underperforming clubs and recorded an impairment charge of \$12,420 on leasehold improvements and furniture and fixtures at nine clubs that experienced decreased profitability and sales levels below expectations during this period. This charge was recorded within the Traditional Clubs segment. The remaining clubs tested that did not have impairment charges had an aggregate of \$22,712 of net leasehold improvements and furniture and fixtures remaining as of September 30, 2015. The Company will continue to monitor the results and changes in expectations of these clubs closely during the remainder of 2015 to determine if additional fixed asset impairment charges will be necessary.

In the nine months ended September 30, 2015, the Company recorded a total of \$14,571 fixed asset impairment charges compared to impairment charges of \$4,513 in the nine months ended September 30, 2014. The fixed asset impairment charges are included as a component of operating expenses in a separate line on the condensed consolidated statements of operations.

In determining the recoverability of fixed assets, Level 3 inputs were used in determining undiscounted cash flows, which are based on internal budgets and forecasts through the end of the life of the primary asset in the asset group which is normally the life of leasehold improvements. The most significant assumptions in those budgets and forecasts relate to estimated membership and ancillary revenue, attrition rates, estimated results related to new program launches and maintenance capital expenditures, which are generally estimated at approximately 3% to 5% of total revenues depending upon the conditions and needs of a given club. The fair value of fixed assets evaluated for impairment is determined considering a combination of a market approach and a cost approach.

### 10. Goodwill and Other Intangibles

Goodwill has been allocated to reporting units that closely reflect the regions served by the Company's four trade names: New York Sports Clubs ("NYSC"), Boston Sports Clubs ("BSC"), Washington Sports Clubs ("WSC") and Philadelphia Sports Clubs ("PSC"), with certain more remote clubs that do not benefit from a regional cluster being considered single reporting units ("Outlier Clubs"), the Company's three clubs located in Switzerland being considered a single reporting unit ("SSC"), and our BFX Studio ("BFX Studio"). As of September 30, 2015, only the SSC region has a remaining goodwill balance.

The Company's annual goodwill impairment test is performed on the last day of February, or more frequently, should circumstances change which would indicate the fair value of goodwill is below its carrying amount. The determination as to whether a triggering event exists that would warrant an interim review of goodwill and whether a write-down of goodwill is necessary involves significant judgment based on short-term and long-term projections of the Company. As a result of the significant decrease in market capitalization and a decline in the Company's current performance primarily due to existing members downgrading their memberships to those with lower monthly dues and new members enrolling at lower rates, the Company performed an interim impairment test as of May 31, 2015.

The Company's current year annual goodwill impairment test as of February 28, 2015 and the interim test performed as of May 31, 2015 were performed using the two-step goodwill impairment analysis. Step 1 involves comparing the fair value of the Company's reporting units to their carrying amounts. If the estimated fair value of the reporting unit is greater than its carrying amount, there is no requirement to perform step two of the impairment test, and there is no impairment. If the reporting unit's carrying amount is greater than the estimated fair value, the second step must be completed to measure the amount of impairment, if any. Step 2 calculates the implied fair value of goodwill by deducting the estimated fair value of all tangible and intangible assets, excluding goodwill, of the reporting unit from the estimated fair value of the reporting unit as determined in Step 1. The implied fair value of goodwill determined in this step is compared to the carrying value of goodwill. If the implied fair value of goodwill is less than the carrying value of goodwill, an impairment charge is recognized equal to the difference.

## Table of Contents

As a result of the May 31, 2015 interim impairment test, the Company concluded that there would be no remaining implied fair value of goodwill attributable to the NYSC and BSC regions. Accordingly, in June 2015, the Company wrote off \$31,558 of goodwill associated with these reporting units. The Company did not have a goodwill impairment charge in the SSC region as a result of the interim test given the profitability of this unit. The February 28, 2015 annual impairment test supported the recorded goodwill balance and as such no impairment of goodwill was required. The February 28, 2014 annual impairment test resulted in a goodwill impairment charge of \$137 associated with the Outlier Clubs in the nine months ended September 30, 2014.

For the May 31, 2015 and February 28, 2015 impairment tests, fair value was determined by using a weighted combination of two market-based approaches (weighted 50% collectively) and an income approach (weighted 50%), as this combination was deemed to be the most indicative of the Company's fair value in an orderly transaction between market participants. Under the market-based approaches, the Company utilized information regarding the Company, the Company's industry as well as publicly available industry information to determine earnings multiples and sales multiples that are used to value the Company's reporting units. Under the income approach, the Company determined fair value based on estimated future cash flows of each reporting unit, discounted by an estimated weighted-average cost of capital, which reflects the overall level of inherent risk of a reporting unit and the rate of return an outside investor would expect to earn, which are unobservable Level 3 inputs, and taking into account the firm offer. The discounted estimates of future cash flows include significant management assumptions such as revenue growth rates, operating margins, weighted average cost of capital, and future economic and market conditions. The estimated weighted-average cost of capital of NYSC and SSC were 9.2% and 11.2% as of May 31, 2015, respectively, compared to 13.3% and 13.9% as of February 28, 2015. Determining the fair value of a reporting unit is judgmental in nature and requires the use of significant estimates and assumptions, including revenue growth rates and operating margins, discount rates and future market conditions, among others. These assumptions were determined separately for each reporting unit. The Company believes its assumptions are reasonable, however, there can be no assurance that the Company's estimates and assumptions made for purposes of the Company's goodwill impairment testing as of May 31, 2015 and February 28, 2015 will prove to be accurate predictions of the future. If the Company's assumptions regarding forecasted revenue or margin growth rates of certain reporting units are not achieved, the Company may be required to record goodwill impairment charges in future periods, whether in connection with the Company's next annual impairment testing or prior to that, if any such change constitutes a triggering event outside the quarter when the annual goodwill impairment test is performed. It is not possible at this time to determine if any such future impairment charge would result. The estimated fair value of SSC was greater than book value by 65% as of May 31, 2015 and 84% as of February 28, 2015.

Solely for purposes of establishing inputs for the fair value calculation described above related to goodwill impairment testing, the Company made the following assumptions. The Company developed long-range financial forecasts (three years) for all reporting units and assumed known changes in the existing club base. Terminal growth rates were calculated for years beyond the five year forecast. As of May 31, 2015, the Company used discount rates ranging from 8.2% to 11.2% and terminal growth rates ranging from 1.0% to 3.0%. As of February 28, 2015, the Company used discount rates ranging from 13.2% to 13.9% and terminal growth rates ranging from 0.5% to 3.0%. These assumptions are developed separately for each reporting unit.

The Company's next annual impairment test will be performed as of February 28, 2016 or earlier, if any such change constitutes a triggering event outside the quarter when the annual goodwill impairment test is performed. The Company determined a triggering event did not occur in the three months ended September 30, 2015.

Table of Contents

The changes in the carrying amount of goodwill from December 31, 2014 through September 30, 2015 are detailed in the charts below.

	NYSC	BSC	SSC	Outlier Clubs	Total
Goodwill, net of accumulated amortization	\$31,549	\$9			

OUR TECHNOLOGY PLATFORM IS BASED SOLELY ON OUR PROPRIETARY DRUG DELIVERY TECHNOLOGY. OUR ONGOING CLINICAL TRIALS FOR CERTAIN OF OUR PRODUCT CANDIDATES MAY BE DELAYED, OR FAIL, WHICH WILL HARM OUR BUSINESS.

Our strategy is to concentrate our product development activities primarily on pharmaceutical products for which there already are significant prescription sales, where the use of our proprietary, novel drug delivery technology could potentially enhance speed of onset of therapeutic effect, could potentially reduce side effects through a reduction of the amount of active drug substance required to produce a given therapeutic effect and improve patient convenience or compliance.

Companies in the pharmaceutical and biotechnology industries have suffered significant setbacks in advanced clinical trials, even after obtaining promising results in earlier trials. Data obtained from tests are susceptible to varying interpretations which may delay, limit or prevent regulatory approval. In addition, companies may be unable to enroll patients quickly enough to meet expectations for completing clinical trials. The timing and completion of current and planned clinical trials of our product candidates depend on, among other factors, the rate at which patients are enrolled, which is a function of many factors, including:

- the number of clinical sites;
- the size of the patient population;
- the proximity of patients to the clinical sites;
- the eligibility criteria for the study;
- the existence of competing clinical trials; and
- the existence of alternative available products.

Delays in patient enrollment in clinical trials may occur, which would likely result in increased costs, program delays or both.

THERE ARE CERTAIN  
INTERLOCKING  
RELATIONSHIPS AND  
POTENTIAL CONFLICTS OF  
INTEREST.

In May 2008, the Company had entered into definitive agreements



for the private placement with ProQuest Investments II, L.P., ProQuest Investments II Advisors Fund, L.P., and ProQuest Investments III, L.P., collectively referred to herein as ProQuest, for an aggregate of up to \$4,000,000 in gross proceeds, in the form of secured convertible promissory notes with an interest rate of 10%, and warrants to purchase shares of the Company's common stock, referred to herein as the 2008 Financing. In May 2008, the Company sold securities in the initial closing of the 2008 Financing, resulting in the issuance of notes convertible into 5,000,000 shares of the Company's common stock, and warrants to purchase 3,000,000 shares of the Company's common stock. The sale of the notes and warrants resulted in gross proceeds to the Company of \$1,475,000, before deducting certain fees and expenses. In October 2008, the Company sold securities in the subsequent closing of the 2008 Financing, resulting in the issuance of notes convertible into 10,744,681 shares of the Company's common stock, and warrants to purchase 6,446,809 shares of the Company's common stock. The sale of the notes and warrants resulted in gross proceeds to the Company of \$2,525,000, before deducting certain fees and expenses.

In December 2009, the Company entered into an amendment agreement with ProQuest, whereby ProQuest agreed to convert the outstanding aggregate principal amount of all of their convertible notes and liquidated damages notes, in each case, plus accrued interest thereon, in an amount equal to \$3,657,517 into 23,237,083 shares of our common stock, \$0.001 par value per shares. Immediately

following such transaction, ProQuest's equity ownership in the Company consisted of (i) 29,504,653 shares of common stock and (ii) warrants to purchase 11,433,345 shares of the common stock at an exercise price of \$0.1888 per share.

In March 2010, ProQuest participated in the Offering, whereby ProQuest received 4,848,485 shares of our common stock and warrants to purchase 4,040,405 shares of our common stock.

As of June 30, 2010, ProQuest, directly and indirectly, of us, beneficially owns approximately 44% of our outstanding common stock (assuming full exercise of certain warrants held by ProQuest). As such, ProQuest may be deemed to be our affiliate. Mr. Steven B. Ratoff, our Chairman, President, and Chief Executive Officer, has served as a venture partner with ProQuest since December 2004, although he has no authority for investment decisions by ProQuest.

OUR BUSINESS AND REVENUE  
IS DEPENDENT ON THE  
SUCCESSFUL DEVELOPMENT  
OF OUR PRODUCTS.

Revenue received from our product development efforts consists of payments by pharmaceutical companies for research and bioavailability studies, pilot clinical trials and similar milestone-related payments. Our future growth and profitability will be dependent upon our ability to successfully raise additional funds to complete the development of, obtain regulatory approvals for and license out or market our product candidates. Accordingly, our prospects must be considered in light of the risks, expenses and difficulties frequently encountered in connection with the establishment of a new business in a highly competitive industry, characterized by frequent new product introductions. We anticipate that we will incur substantial operating expenses in connection with the development, testing and approval of our product candidates and expect these expenses to result in continuing and significant operating losses until such time, if ever, that we are able to achieve adequate levels of sales or license revenues. We may not be able to raise additional financing, increase revenues significantly, or achieve profitable operations

SOME OF OUR PRODUCT  
CANDIDATES ARE IN EARLY  
STAGES OF CLINICAL  
DEVELOPMENT AND SOME  
ARE IN PRECLINICAL TESTING,  
WHICH MAY AFFECT OUR  
ABILITY OR THE TIME WE  
REQUIRE TO OBTAIN  
NECESSARY REGULATORY

#### APPROVALS.

Some of our product candidates are in early stages of clinical development, such as our Duromist product candidate, and some are in preclinical testing. These product candidates are continuously evaluated and assessed and are often subject to changes in formulation and technology. The regulatory requirements governing these types of products may be less well defined or more rigorous than for conventional products. As a result, we may experience delays with our preclinical and clinical testing, and a longer and more expensive regulatory process in connection with obtaining regulatory approvals of these types of product candidates as compared to others in our pipeline at later stages of development. These delays may negatively affect our business and operations.

We may not be able to successfully develop any one or more of our product candidates or develop such product candidates on a timely basis. Further, such product candidates may not be commercially accepted if developed. The inability to successfully complete development, or a determination by us, for financial or other reasons, not to undertake to complete development of any product candidates, particularly in instances in which we have made significant capital expenditures, could have a material adverse effect on our business and operations.

#### WE DO NOT HAVE COMMERCIALY AVAILABLE PRODUCTS.

Our principal efforts are to obtain regulatory approvals for our product candidates and to license our product

candidates. We anticipate that marketing activities by our licensees for our two approved products will begin in late 2010.

There can be no assurances that our licensees will successfully market our two approved product candidates, or that such product candidates will become commercially available.

**WE DO NOT HAVE DIRECT CONSUMER MARKETING EXPERIENCE.**

We have no experience in marketing or distribution at the consumer level of our product candidates. Moreover, we do not have the financial or other resources to undertake extensive marketing and advertising activities. Accordingly, we intend generally to rely on marketing arrangements, including possible joint ventures or license or distribution arrangements with third-parties. Except for our agreements with Mist, ECR, BioAlliance, Par, Manhattan Pharmaceuticals, Velcera and Hana Biosciences, we have not entered into any significant agreements or arrangements with respect to the marketing of our product candidates. We may not be able to enter into any such agreements or similar arrangements in the future and we may not be able to successfully market our products. If we fail to enter into these agreements or if we or the third parties do not perform under such agreements, it could impair our ability to commercialize our products.

We have stated our intention to possibly market our own products in the future, although we have no such experience to date. Substantial investment will be required in order

to build infrastructure and provide resources in support of marketing our own products, particularly the establishment of a marketing force. If we do not develop a marketing force of our own, then we will depend on arrangements with corporate partners or other entities for the marketing and sale of our remaining products. The establishment of our own marketing force, or a strategy to rely on third party marketing arrangements, could adversely affect our profit margins.

**WE MUST COMPLY WITH  
GOOD MANUFACTURING  
PRACTICES.**

The manufacture of our pharmaceutical products under development will be subject to current Good Manufacturing Practices, or cGMP, prescribed by the FDA, pre-approval inspections by the FDA or comparable foreign authorities, or both, before commercial manufacture of any such products and periodic cGMP compliance inspections thereafter by the FDA. We, or any of our third party manufacturers, may not be able to comply with cGMP or satisfy pre- or post-approval inspections by the FDA or comparable foreign authorities in connection with the manufacture of our product candidates. Failure or delay by us or any such manufacturer to comply with cGMP or satisfy pre- or post-approval inspections would have a material adverse effect on our business and operations.

**WE ARE DEPENDENT ON OUR  
SUPPLIERS.**

We believe that the active ingredients used in the manufacture of our product candidates are presently available from numerous suppliers located in the U.S., Europe, India and Japan. We believe that certain raw materials, including inactive ingredients, are available from a limited number of suppliers and that certain packaging materials intended for use in connection with our spray products currently are available only from sole source suppliers. Although we do not believe we will encounter difficulties in obtaining the inactive ingredients or packaging materials

necessary for the manufacture of our product candidates, we may not be able to enter into satisfactory agreements or arrangements for the purchase of commercial quantities of such materials.

On December 28, 2009, DPT Laboratories became our contract manufacturer for Duromist, sildenafil citrate oral spray.

With respect to other suppliers, we operate primarily on a purchase order basis beyond which there is no contract memorializing our purchasing arrangements. The inability to enter into agreements or otherwise arrange for adequate or timely supplies of principal raw materials and the possible inability to secure alternative sources of raw material supplies, or the failure of DPT Laboratories, or Rechon Life Sciences to comply with their supply obligations to us, could have a material adverse effect on our ability to arrange for the manufacture of formulated products. In addition, development and regulatory approval of our products are dependent upon our ability to procure active ingredients and certain packaging materials from FDA-approved sources. Since the FDA approval process requires manufacturers to specify their proposed suppliers of active ingredients and certain packaging materials in their applications, FDA approval of a supplemental application to use a new supplier would be required if active ingredients or such packaging materials were no longer available from the originally specified supplier, which may result in manufacturing delays. If we do not maintain important manufacturing relationships, we may fail to find a replacement manufacturer or to



develop our own manufacturing capabilities. If we cannot do so, it could delay or impair our ability to obtain regulatory approval for our products and substantially increase our costs or deplete any profit margins. If we do find replacement manufacturers, we may not be able to enter into agreements with them on terms and conditions favorable to us and, there could be a substantial delay before a new facility could be qualified and registered with the FDA and foreign regulatory authorities.

FAILURE TO ACHIEVE AND MAINTAIN EFFECTIVE INTERNAL CONTROLS IN ACCORDANCE WITH SECTION 404 OF THE SARBANES-OXLEY ACT OF 2002 COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS AND OPERATING RESULTS. IN ADDITION, CURRENT AND POTENTIAL STOCKHOLDERS COULD LOSE CONFIDENCE IN OUR FINANCIAL REPORTING, WHICH COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR STOCK PRICE.

Effective internal controls are necessary for us to provide reliable financial reports and effectively prevent fraud. If we cannot provide reliable financial reports or prevent fraud, our operating results and financial condition could be harmed.

We are required to document and test our internal control procedures in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, which requires annual management assessments of the effectiveness of our internal controls over financial reporting. During the course of our testing we may identify deficiencies

which we may not be able to remediate in time to meet the deadline imposed by the Sarbanes-Oxley Act of 2002 for compliance with the requirements of Section 404. In addition, if we fail to maintain the adequacy of our internal controls, as such standards are modified, supplemented or amended from time to time, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002. Failure to achieve and maintain an effective internal control environment could also cause investors to lose confidence in our reported financial information, which could have a material adverse effect on the price of our common stock.

C O M P L I A N C E   W I T H  
CHANGING REGULATION OF  
CORPORATE GOVERNANCE  
AND PUBLIC DISCLOSURE  
MAY RESULT IN ADDITIONAL  
EXPENSES.

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new regulations promulgated by the Securities and Exchange Commission, or SEC, and NYSE Amex, or NYSE Amex rules, are creating uncertainty for companies such as ours. These new or changed laws, regulations and standards are subject to varying interpretations in many cases due to their lack of specificity, and as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies, which could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, our efforts to comply with evolving laws, regulations and standards have resulted in, and are likely to continue to result in, increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. In particular, our recent efforts to comply with Section 404 of the Sarbanes-Oxley Act of 2002 and the related regulations regarding our required assessment of our internal controls over financial reporting requires the commitment of financial and

managerial resources. In addition, it has become more difficult and more expensive for us to obtain director and officer liability insurance. We expect these efforts to require the continued commitment of significant resources. Further, our Board members, Chief Executive Officer and Chief Financial Officer could face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficulty attracting and retaining qualified board members and executive officers, which could harm our business. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, our reputation may be harmed.

#### WE FACE INTENSE COMPETITION.

The markets which we intend to enter are characterized by intense competition. We, or our licensees, may be competing against established, larger and/or better capitalized pharmaceutical companies with currently marketed products which are equivalent or functionally similar to those we intend to market. Prices of drug products are significantly affected by competitive factors and tend to decline as competition increases. In addition, numerous companies are developing or may, in the future, engage in the development of products competitive with our product candidates. We expect that technological developments will occur at a rapid rate and that competition is likely to intensify as enhanced dosage from technologies gain greater acceptance. Additionally, the markets for

formulated products which we have targeted for development are intensely competitive, involving numerous competitors and products. Most of our prospective competitors possess substantially greater financial, technical and other resources than we do. Moreover, many of these companies possess greater marketing capabilities than we do, including the resources necessary to enable them to implement extensive advertising campaigns. We may not be able to compete successfully with such competitors.

Accordingly, our competitors may succeed in obtaining patent protection, receiving FDA or comparable foreign approval or commercializing products before us. If we commence commercial product sales, we will compete against companies with greater marketing and manufacturing capabilities who may successfully develop and commercialize products that are more effective or less expensive than ours. Our competitors may be more successful in receiving third party reimbursements from government agencies and others for their commercialized products which are similar to our products. If we cannot receive third party reimbursement for our products, we may not be able to commercialize our products. These are areas in which, as yet, we have limited or no experience. In addition, developments by our competitors may render our product candidates obsolete or noncompetitive.

We also face, and will continue to face, competition from colleges, universities, governmental agencies and other public and private research organizations. These competitors are

becoming more active in seeking patent protection and licensing arrangements to collect royalties for use of technology that they have developed. Some of these technologies may compete directly with the technologies that we are developing. These institutions will also compete with us in recruiting highly qualified scientific personnel. We expect that developments in the areas in which we are active may occur at a rapid rate and that competition will intensify as advances in this field are made. As a result, we need to continue to devote substantial resources and efforts to research and development activities.

**LIMITED PRODUCT LIABILITY  
INSURANCE COVERAGE MAY  
AFFECT OUR BUSINESS.**

We may be exposed to potential product liability claims by end-users of our products. Although we obtain product liability insurance per contractual obligations, before the commercialization of any of our product candidates, we cannot guarantee such insurance will be sufficient to cover all possible liabilities to which we may be exposed. Any product liability claim, even one that was not in excess of our insurance coverage or one that is meritless and/or unsuccessful, could adversely affect our cash available for other purposes, such as research and development. In addition, the existence of a product liability claim could affect the market price of our common stock. In addition, certain food and drug retailers require minimum product liability insurance coverage as a condition precedent to purchasing or accepting products for retail distribution. Product liability insurance coverage includes various deductibles, limitations and exclusions from coverage, and in any event might not fully cover any potential claims. Failure to satisfy such insurance requirements could impede the ability of us or our distributors to achieve broad retail distribution of our product candidates, which could have a material adverse effect on us.

**EXTENSIVE GOVERNMENT  
REGULATION MAY AFFECT  
OUR BUSINESS.**

The development, manufacture and commercialization of pharmaceutical products is generally

subject to extensive regulation by various federal and state governmental entities. The FDA, which is the principal U.S. regulatory authority over pharmaceutical products, has the power to seize adulterated or misbranded products and unapproved new drugs, to request their recall from the market, to enjoin further manufacture or sale, to publicize certain facts concerning a product and to initiate criminal proceedings. As a result of federal statutes and FDA regulations pursuant to which new pharmaceuticals are required to undergo extensive and rigorous testing, obtaining pre-market regulatory approval requires extensive time and expenditures. Under the Federal Food, Drug, and Cosmetic Act, or FFDCA, as amended (21 U.S.C. 301 et. seq.), a new drug may not be commercialized or otherwise distributed in the U.S. without the prior approval of the FDA or pursuant to an applicable exemption from the FFDCA. The FDA approval processes relating to new drugs differ, depending on the nature of the particular drug for which approval is sought. With respect to any drug product with active ingredients not previously approved by the FDA, a prospective drug manufacturer is required to submit an NDA, which includes complete reports of pre-clinical, clinical and laboratory studies to prove such product's safety and efficacy. Prior to submission of the NDA, it is necessary to submit an Investigational New Drug, or IND, to obtain permission to begin clinical testing of the new drug. Such clinical trials are required to meet good clinical practices under the FFDCA. Given that our current product candidates are based on a



new technology for formulation and delivery of active pharmaceutical ingredients that have been previously approved and that have been shown to be safe and effective in previous clinical trials, we believe that we will be eligible to submit what is known as a 505(b)(2). We estimate that the development of new formulations of pharmaceutical products, including formulation, testing and NDA submission, generally takes two to three years under the 505(b)(2) NDA process. Our determinations may prove to be inaccurate or pre-marketing approval relating to our proposed products may not be obtained on a timely basis, if at all. The failure by us to obtain necessary regulatory approvals, whether on a timely basis or at all, would have a material adverse effect on our business. The filing of an NDA with the FDA is an important step in the approval process in the U.S. Acceptance for filing by the FDA does not mean that the NDA has been or will be approved, nor does it represent an evaluation of the adequacy of the data submitted.

**THE CLINICAL TRIAL AND REGULATORY APPROVAL PROCESS FOR OUR PRODUCTS IS EXPENSIVE AND TIME CONSUMING, AND THE OUTCOME IS UNCERTAIN.**

In order to sell our proposed products, we must receive separate regulatory approvals for each product. The FDA and comparable agencies in foreign countries extensively and rigorously regulate the testing, manufacture, distribution, advertising, pricing and marketing of drug products like our products. This approval process for an NDA includes preclinical studies and clinical trials of each

pharmaceutical compound to establish its safety and effectiveness and confirmation by the FDA and comparable agencies in foreign countries that the manufacturer maintains good laboratory and manufacturing practices during testing and manufacturing. Clinical trials generally take two to five years or more to complete. Even if favorable testing data is generated by clinical trials of drug products, the FDA may not accept an NDA submitted by a pharmaceutical or biotechnology company for such drug product for filing, or if accepted for filing, may not approve such NDA.

The approval process is lengthy, expensive and uncertain. It is also possible that the FDA or comparable foreign regulatory authorities could interrupt, delay or halt any one or more of our clinical trials. If we, or any regulatory authorities, believe that trial participants face unacceptable health risks, any one or more of our trials could be suspended or terminated. We also may fail to reach agreement with the FDA and/or comparable foreign agencies on the design of any one or more of the clinical studies necessary for approval. Conditions imposed by the FDA and comparable agencies in foreign countries on our clinical trials could significantly increase the time required for completion of such clinical trials and the costs of conducting the clinical trials. Data obtained from clinical trials are susceptible to varying interpretations which may delay, limit or prevent regulatory approval.

Delays and terminations of the clinical trials we conduct could result from insufficient patient enrollment. Patient enrollment is a function of several factors, including the size of the patient population, stringent enrollment criteria, the proximity of the patients to the trial sites, having to compete with other clinical trials for eligible patients, geographical and geopolitical considerations and others. Delays in patient enrollment can result in greater costs and longer trial timeframes. Patients may also suffer adverse medical events or side effects.

The FDA and comparable foreign agencies may withdraw any approvals we obtain. Further, if there

is a later discovery of unknown problems or if we fail to comply with other applicable regulatory requirements at any stage in the regulatory process, the FDA may restrict or delay our marketing of a product or force us to make product recalls. In addition, the FDA could impose other sanctions such as fines, injunctions, civil penalties or criminal prosecutions. To market our products outside the U.S., we also need to comply with foreign regulatory requirements governing human clinical trials and marketing approval for pharmaceutical products. Other than the approval of NitroMist and Zolpimist, the FDA and foreign regulators have not yet approved any of our products under development for marketing in the U.S. or elsewhere. If the FDA and other regulators do not approve any one or more of our products under development, we will not be able to market such products.

**WE EXPECT TO FACE  
UNCERTAINTY OVER  
REIMBURSEMENT AND  
HEALTHCARE REFORM.**

In the U.S. and other countries, sales of our products will depend in part upon the availability of reimbursement from third-party payers, which include government health administration authorities, managed care providers and private health insurers. Third-party payers are increasingly challenging the price and examining the cost effectiveness of medical products and services.

**LEGISLATIVE OR  
REGULATORY REFORM OF THE  
HEALTHCARE SYSTEM MAY  
AFFECT OUR ABILITY TO SELL  
OUR CURRENT AND FUTURE  
PRODUCTS PROFITABLY.**

In the United States and certain foreign jurisdictions, there have been a number of legislative and regulatory proposals to change the healthcare system in ways that could impact our ability to sell our current and future products profitably. On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act or PPACA, which includes a number of health care reform provisions and requires most U.S. citizens to have health insurance. Effective January 1, 2010, the new law increases the minimum Medicaid drug rebates for pharmaceutical companies, expands the 340B drug discount program, and makes changes to affect the Medicare Part D coverage gap, or “donut hole.” The law also revises the definition of “average manufacturer price” for reporting purposes (effective October 1, 2011), which could increase the amount of the Company’s Medicaid drug rebates to states, once the provision is effective. The new law also imposes a significant annual fee on companies that manufacture or import branded prescription drug products (beginning in 2010). Substantial new provisions affecting compliance also have been added, which may require modification of business practices with health care practitioners.

The reforms imposed by the new law will significantly impact the pharmaceutical industry; however, the full effects of PPACA cannot be known until these provisions are implemented and the Centers for Medicare & Medicaid Services and other federal and state agencies issue applicable regulations or guidance. Moreover, in the coming years, additional change could be made to governmental healthcare programs

that could significantly impact the success of our current and future products, and we could be adversely affected by current and future health care reforms.

25

---

OUR STRATEGY INCLUDES ENTERING INTO COLLABORATION AGREEMENTS WITH THIRD PARTIES FOR CERTAIN OF OUR PRODUCT CANDIDATES AND WE MAY REQUIRE ADDITIONAL COLLABORATION AGREEMENTS. IF WE FAIL TO ENTER INTO THESE AGREEMENTS OR IF WE OR THE THIRD PARTIES DO NOT PERFORM UNDER SUCH AGREEMENTS, IT COULD IMPAIR OUR ABILITY TO COMMERCIALIZE OUR PROPOSED PRODUCTS.

Our strategy for the completion of the required development and clinical testing of certain of our product candidates and for the manufacturing, marketing and commercialization of such product candidates includes entering into collaboration arrangements with pharmaceutical companies to market, commercialize and distribute the products.

Through June 30, 2010, we entered into strategic license agreements with: (i) Hana Biosciences, for the development and marketing rights in the U.S. and Canada which was subsequently sublicensed to Par for our ondansetron oral spray Zensana, (ii) Manhattan Pharmaceuticals, in connection with propofol, (iii) Velcera, in connection with veterinary applications for currently marketed veterinary drugs, (iv) BioAlliance Pharma SA, for the European rights for ondansetron oral spray Zensana, (v) Mist Acquisition, LLC, for the manufacturing and commercialization rights in the United States, Canada and Mexico

for our lingual spray version of nitroglycerine, NitroMist, and (vi) ECR Pharmaceuticals Company, for the manufacturing and commercialization rights in the United States and Canada for our oral spray formulation of zolpidem tartrate, Zolpimist.

Our success depends upon obtaining additional collaboration partners and maintaining our relationships with our current partners. In addition, we may depend on our partners' expertise and dedication of sufficient resources to develop and commercialize proposed products. For example, in November 2008, Par announced that it had completed bioequivalence studies on Zensana with mixed results and, as a result, it had ceased development of the product. Since such time, we have had numerous meetings and discussions with both Par and Hana regarding the development of Zensana. We cannot assure you that Par or Hana will perform under our license agreements.

We may, in the future, grant to collaboration partners, rights to license and commercialize pharmaceutical products developed under collaboration agreements. Under these arrangements, our collaboration partners may control key decisions relating to the development of the products. The rights of our collaboration partners could limit our flexibility in considering alternatives for the commercialization of such product candidates. If we fail to successfully develop these relationships or if our collaboration partners fail to successfully develop or commercialize such product candidates, it may delay or prevent us from developing or commercializing our proposed



products in a competitive and timely manner and would have a material adverse effect on our business.

IF WE CANNOT PROTECT OUR INTELLECTUAL PROPERTY, OTHER COMPANIES COULD USE OUR TECHNOLOGY IN COMPETITIVE PRODUCTS. IF WE INFRINGE THE INTELLECTUAL PROPERTY RIGHTS OF OTHERS, OTHER COMPANIES COULD PREVENT US FROM DEVELOPING OR MARKETING OUR PRODUCTS.

We seek patent protection for our technology so as to prevent others from commercializing equivalent products in substantially less time and at substantially lower expense. The pharmaceutical industry places considerable importance on obtaining patent and trade secret protection for new technologies, products and processes. Our success will depend in part on our ability and that of parties from whom we license technology to:

- defend our patents and otherwise prevent others from infringing on our proprietary rights;
- protect our trade secrets; and
- operate without infringing upon the proprietary rights of others, both in the U.S. and in other countries.

The patent position of firms relying upon biotechnology is highly uncertain and involves complex legal and factual questions for which important legal principles are unresolved. To date, the U.S. Patent and Trademark Office, or USPTO, has not adopted a consistent policy regarding the breadth of claims that the USPTO allows in biotechnology

patents or the degree of protection that these types of patents afford. As a result, there are risks that we may not develop or obtain rights to products or processes that are or may seem to be patentable.

Section 505(b)(2) of the FDCA was enacted as part of the Drug Price Competition and Patent Term Restoration Act of 1984, otherwise known as the Hatch-Waxman Act. Section 505(b)(2) permits the submission of an NDA where at least some of the information required for approval comes from studies not conducted by or for the applicant and for which the applicant has not obtained a right of reference. For example, the Hatch-Waxman Act permits an applicant to rely upon the FDA's findings of safety and effectiveness for an approved product. The FDA may also require companies to perform one or more additional studies or measurements to support the change from the approved product. The FDA may then approve the new formulation for all or some of the label indications for which the referenced product has been approved, or a new indication sought by the Section 505(b)(2) applicant.

To the extent that the Section 505(b)(2) applicant is relying on the FDA's findings for an already-approved product, the applicant is required to certify to the FDA concerning any patents listed for the approved product in the FDA's Orange Book publication. Specifically, the applicant must certify that: (1) the required patent information has not been filed (paragraph I certification); (2) the listed patent has expired (paragraph II certification); (3) the listed patent has not expired, but will expire on a particular date and approval is sought after patent expiration (paragraph III certification); or (4) the listed patent is invalid or will not be infringed by the manufacture, use or sale of the new product

(paragraph IV certification). If the applicant does not challenge the listed patents, the Section 505(b)(2) application will not be approved until all the listed patents claiming the referenced product have expired, and once any pediatric exclusivity expires. The Section 505(b)(2) application may also not be approved until any non-patent exclusivity, such as exclusivity for obtaining approval of a new chemical entity, listed in the Orange Book for the referenced product has expired.

If the applicant has provided a paragraph IV certification to the FDA, the applicant must also send notice of the paragraph IV certification to the NDA holder and patent owner once the NDA has been accepted for filing by the FDA. The NDA holder and patent owner may then initiate a legal challenge to the paragraph IV certification. The filing of a patent infringement lawsuit within 45 days of their receipt of a paragraph IV certification automatically prevents the FDA from approving the Section 505(b)(2) NDA until the earliest of 30 months, expiration of the patent, settlement of the lawsuit or a decision in an infringement case that is favorable to the Section 505(b)(2) applicant. Thus, a Section 505(b)(2) applicant may invest a significant amount of time and expense in the development of its products only to be subject to significant delay and patent litigation before its products may be commercialized. Alternatively, if the NDA holder or patent owner does not file a patent infringement lawsuit within the required 45-day period, the applicant's NDA will not be subject to the 30-month stay.

Notwithstanding the approval of many products by the FDA pursuant to Section 505(b)(2), over the last few years, certain brand-name pharmaceutical companies and others have objected to the FDA's interpretation of Section 505(b)(2). If the FDA changes its interpretation of Section 505(b)(2), this could delay or even prevent the FDA from approving any Section 505(b)(2) NDA that we submit.

**EVEN IF WE OBTAIN PATENTS TO PROTECT OUR PRODUCTS, THOSE PATENTS MAY NOT BE SUFFICIENTLY BROAD AND OTHERS COULD COMPETE WITH US.**

We, and the parties licensing technologies to us, have filed various U.S. and foreign patent applications with respect to the products and technologies under our development, and the USPTO and foreign patent offices have issued patents with respect to our products and technologies. These patent applications include international applications filed under the Patent Cooperation Treaty. Our pending patent applications, those we may file in the future and those we may license from third parties, may not result in the USPTO or any foreign patent office issuing patents. Also, if patent rights covering our products are not sufficiently broad, they may not provide us with sufficient proprietary protection or competitive advantages against competitors with similar products and technologies. Furthermore, if the USPTO or foreign patent offices issue patents to us or our licensors, others may challenge the patents or circumvent the patents, or the patent office or the courts may invalidate the patents. Thus, any patents we own or license from or to third parties may

not provide any protection against competitors.

Furthermore, the life of our patents is limited. Such patents, which include relevant foreign patents, expire on various dates. We have filed, and when possible and appropriate, will file, other patent applications with respect to our product candidates and processes in the U.S. and in foreign countries. We may not be able to develop additional products or processes that will be patentable or additional patents may not be issued to us. See also “Risk Factors - If We Cannot Meet Requirements Under our License Agreements, We Could Lose the Rights to our Products.”

**INTELLECTUAL PROPERTY  
RIGHTS OF THIRD PARTIES  
COULD LIMIT OUR ABILITY TO  
MARKET OUR PRODUCTS.**

Our commercial success also significantly depends on our ability to operate without infringing the patents or violating the proprietary rights of others. The USPTO keeps U.S. patent applications confidential while the applications are pending. As a result, we cannot determine which inventions third parties claim in pending patent applications that they have filed. We may need to engage in litigation to defend or enforce our patent and license rights or to determine the scope and validity of the proprietary rights of others. It will be expensive and time consuming to defend and enforce patent claims. Thus, even in those instances in which the outcome is favorable to us, the proceedings can result in the diversion of substantial resources from our other activities. An adverse determination may subject us to significant liabilities or require us to seek licenses that third parties may not grant to us or may only grant at rates that diminish or deplete the profitability of the products to us. An adverse determination could also require us to alter our products or processes or cease altogether any related research and development activities or product sales.

**IF WE CANNOT MEET  
REQUIREMENTS UNDER OUR  
LICENSE AGREEMENTS, WE  
COULD LOSE THE RIGHTS TO  
OUR PRODUCTS.**

We depend, in part, on licensing arrangements with third parties to maintain the intellectual property

rights to our products under development. These agreements may require us to make payments and/or satisfy performance obligations in order to maintain our rights under these licensing arrangements. All of these agreements last either throughout the life of the patents, or with respect to other licensed technology, for a number of years after the first commercial sale of the relevant product.

In addition, we are responsible for the cost of filing and prosecuting certain patent applications and maintaining certain issued patents licensed to us. If we do not meet our obligations under our license agreements in a timely manner, we could lose the rights to our proprietary technology.

In addition, we may be required to obtain licenses to patents or other proprietary rights of third parties in connection with the development and use of our products and technologies. Licenses required under any such patents or proprietary rights might not be made available on terms acceptable to us, if at all.

**WE RELY ON  
CONFIDENTIALITY  
AGREEMENTS THAT COULD BE  
BREACHED AND MAY BE  
DIFFICULT TO ENFORCE.**

Although we believe that we take reasonable steps to protect our intellectual property, including the use of agreements relating to the non-disclosure of confidential information to third parties, as well as agreements that purport to require the disclosure and assignment to us of the rights to the ideas, developments, discoveries and inventions of our employees and



consultants while we employ them, the agreements can be difficult and costly to enforce. Although we seek to obtain these types of agreements from our consultants, advisors and research collaborators, to the extent that they apply or independently develop intellectual property in connection with any of our projects, disputes may arise as to the proprietary rights to this type of information. If a dispute arises, a court may determine that the right belongs to a third party, and enforcement of our rights can be costly and unpredictable. In addition, we will rely on trade secrets and proprietary know-how that we will seek to protect in part by confidentiality agreements with our employees, consultants, advisors or others. Despite the protective measures we employ, we still face the risk that:

- they will breach these agreements;
- any agreements we obtain will not provide adequate remedies for this type of breach or that our trade secrets or proprietary know-how will otherwise become known or competitors will independently develop similar technology; and
- our competitors will independently discover our proprietary information and trade secrets.

**WE ARE DEPENDENT ON  
EXISTING MANAGEMENT AND  
BOARD MEMBERS.**

Our success is substantially dependent on the efforts and abilities of the principal members of our management team and our directors. Decisions concerning our business and our management are and will continue to be made or significantly influenced by these individuals. The loss or interruption of their continued services could have a materially adverse effect on our business operations and prospects. Although our employment agreements with members of management generally provide for severance payments that are contingent upon the applicable officer's refraining from competition with us, the loss of any of these persons' services could adversely affect our ability to develop and market our products and obtain necessary regulatory approvals, and the applicable noncompetition provisions can be difficult and costly to monitor and enforce. Further, we do not maintain key-man life insurance.

Our future success also will depend in part on the continued service of our key scientific and management personnel and our ability to identify, hire and retain additional personnel, including scientific, development and manufacturing staff.

**RISKS RELATED TO OUR  
COMMON STOCK**

**BECAUSE OUR COMMON  
STOCK IS LISTED ON THE  
OVER-THE-COUNTER  
BULLETIN BOARD, THE  
LIQUIDITY OF OUR COMMON**

**STOCK MAY BE IMPAIRED.**

On December 24, 2009, we announced that our common stock began trading on the Over-the-Counter Bulletin Board, or OTCBB. Our new ticker symbol on OTCBB is NVDL.OB. We filed Form 25 on December 14, 2009, voluntarily withdrawing our listing and registration from NYSE Amex LLC. The final day of trading on NYSE Amex LLC was December 23, 2009.

Because our common stock is listed on the OTCBB, the liquidity of the common stock is impaired, not only in the number of shares that are bought and sold, but also through delays in the timing of transactions, and limited coverage by security analysts and the news media. As a result, prices for shares of our common stock may be lower than might otherwise prevail if our common stock was traded on NYSE Amex LLC or another national securities exchange.

As of June 30, 2010, our net worth position was a deficit of \$5,835,000 and as of December 31, 2009, our net worth position was a deficit of \$4,341,000.

**WE ARE INFLUENCED BY  
CURRENT STOCKHOLDERS,  
OFFICERS AND DIRECTORS.**

Our directors, executive officers and principal stockholders and certain of our affiliates have the ability to influence the election of our directors and most other stockholder actions. As of June 30, 2010, management and our affiliates currently beneficially own, including shares they have the right to acquire, approximately 45% of the common stock on a fully-diluted basis. This

determination of affiliate status is not necessarily a conclusive determination for other purposes. Specifically, ProQuest has the ability to exert significant influence over matters submitted to our stockholders for approval. Such positions may discourage or prevent any proposed takeover of us, including transactions in which our stockholders might otherwise receive a premium for their shares over the then current market prices. Our directors, executive officers and principal stockholders may influence corporate actions, including influencing elections of directors and significant corporate events.

THE MARKET PRICE OF OUR  
STOCK AND OUR EARNINGS  
MAY BE ADVERSELY  
AFFECTED BY MARKET  
VOLATILITY.

The market price of our common stock, like that of many other development stage pharmaceutical or biotechnology companies, has been and is likely to continue to be volatile. In addition to general economic, political and market conditions, the price and trading volume of our common stock could fluctuate widely in response to many factors, including:

- announcements of the results of clinical trials by us or our competitors;
- adverse reactions to products;
- governmental approvals, delays in expected governmental approvals or withdrawals of any prior governmental approvals or public or regulatory agency concerns regarding the safety or effectiveness of our products;
- changes in the U.S. or foreign regulatory policy during the period of product development;
- developments in patent or other proprietary rights, including any third party challenges of our intellectual property rights;
- announcements of technological innovations by us or our competitors;
- announcements of new products or new contracts by us or our competitors;

- actual or anticipated variations in our operating results due to the level of development expenses and other factors;
- changes in financial estimates by securities analysts and whether our earnings meet or exceed the estimates;
- conditions and trends in the pharmaceutical and other industries;
- new accounting standards; and
- the occurrence of any of the risks set forth in these Risk Factors and other reports, including this prospectus and other filings filed with the Securities and Exchange Commission from time to time.

Our common stock is currently listed for trading on the OTCBB under the symbol “NVDL.OB” and was previously traded on the NYSE Amex LLC from May 11, 2004 to December 23, 2009. During the six-month period ended June 30, 2010, the closing price of our common stock has ranged from \$0.16 to \$0.29. We expect the price of our common stock to remain volatile. The average daily trading volume in our common stock varies significantly. Our relatively low volume and low number of transactions per day may affect the ability of our stockholders to sell their shares in the public market at prevailing prices and a more active market may never develop.

In the past, following periods of volatility in the market price of the securities of companies in our industry, securities class action litigation has often been instituted against companies in our industry. If we face securities litigation in the

future, even if without merit or unsuccessful, it would result in substantial costs and a diversion of management attention and resources, which would negatively impact our business.

BECAUSE THE AVERAGE DAILY TRADING VOLUME OF OUR COMMON STOCK IS LOW, THE ABILITY TO SELL OUR SHARES IN THE SECONDARY TRADING MARKET MAY BE LIMITED.

Because the average daily trading volume of our common stock is low, the liquidity of our common stock may be impaired. As a result, prices for shares of our common stock may be lower than might otherwise prevail if the average daily trading volume of our common stock was higher. The average daily trading volume of our common stock may be low relative to the stocks of exchange-listed companies, which could limit investors' ability to sell shares in the secondary trading market.

WE LIKELY WILL ISSUE ADDITIONAL EQUITY SECURITIES, WHICH WILL DILUTE CURRENT STOCKHOLDERS' SHARE OWNERSHIP.

We likely will issue additional equity securities to raise capital and through the exercise of options and warrants that are outstanding or may be outstanding. These additional issuances will dilute current stockholders' share ownership.

PENNY STOCK REGULATIONS  
MAY IMPOSE CERTAIN  
RESTRICTIONS ON  
MARKETABILITY OF OUR  
SECURITIES.

The SEC has adopted regulations which generally define a “penny stock” to be any equity security that has a market price of less than \$5.00 per share or an exercise price of less than \$5.00 per share, subject to certain exceptions. As a result, our common stock is subject to rules that impose additional sales practice requirements on broker dealers who sell such securities to persons other than established customers and accredited investors (generally those with assets in excess of \$1,000,000 or annual income exceeding \$200,000, or \$300,000 together with their spouse). For transactions covered by such rules, the broker dealer must make a special suitability determination for the purchase of such securities and have received the purchaser’s written consent to the transaction prior to the purchase. Additionally, for any transaction involving a penny stock, unless exempt, the rules require the delivery, prior to the transaction, of a risk disclosure document mandated by the SEC relating to the penny stock market. The broker dealer must also disclose the commission payable to both the broker dealer and the registered representative, current quotations for the securities and, if the broker dealer is the sole market maker, the broker dealer must disclose this fact and the broker dealer’s presumed control over the market. Finally, monthly statements must be sent disclosing recent price information for the penny stock held in the account and information on the limited market in



penny stocks. Broker-dealers must wait two business days after providing buyers with disclosure materials regarding a security before effecting a transaction in such security. Consequently, the “penny stock” rules restrict the ability of broker dealers to sell our securities and affect the ability of investors to sell our securities in the secondary market and the price at which such purchasers can sell any such securities, thereby affecting the liquidity of the market for our common stock.

Stockholders should be aware that, according to the SEC, the market for penny stocks has suffered in recent years from patterns of fraud and abuse. Such patterns include:

- control of the market for the security by one or more broker-dealers that are often related to the promoter or issuer;
- manipulation of prices through prearranged matching of purchases and sales and false and misleading press releases;
- “boiler room” practices involving high pressure sales tactics and unrealistic price projections by inexperienced sales persons;
- excessive and undisclosed bid-ask differentials and markups by selling broker-dealers; and
- the wholesale dumping of the same securities by promoters and broker-dealers after prices have been manipulated to a desired level, along with the inevitable collapse of those prices with consequent investor losses.

Our management is aware of the abuses that have occurred

historically in the penny stock market.

**ADDITIONAL AUTHORIZED  
SHARES OF OUR COMMON  
STOCK AND PREFERRED  
STOCK AVAILABLE FOR  
ISSUANCE MAY ADVERSELY  
AFFECT THE MARKET.**

We are authorized to issue a total of 200,000,000 shares of common stock and 1,000,000 shares of preferred stock. Such securities may be issued without the approval or other consent of our stockholders. As of June 30, 2010, there were 98,383,458 shares of common stock issued and outstanding. However, the total number of shares of our common stock issued and outstanding does not include shares reserved in anticipation of the exercise of options or warrants. As of June 30, 2010, we had outstanding stock options and warrants to purchase approximately 36.5 million shares of common stock, the exercise prices of which range between \$0.17 per share and \$3.18 per share, and we have reserved shares of our common stock for issuance in connection with the potential exercise thereof. As a result, as of June 30, 2010, 210,000 and 10,181,000 shares remain available for issuance under the 1998 Stock Option Plan and the 2006 Equity Incentive Plan, respectively.

To the extent such options or warrants are exercised, the holders of our common stock will experience further dilution.

In addition, in the event that any future financing should be in the form of, be convertible into or exchangeable for, equity securities, and upon the exercise of options and

warrants, investors may experience  
additional dilution.

31

---

See “Risk Factors - Our Additional Financing Requirements Could Result In Dilution To Existing Stockholders” included herein. The exercise of the outstanding derivative securities will reduce the percentage of common stock held by our stockholders in relation to our aggregate outstanding capital stock. Further, the terms on which we could obtain additional capital during the life of the derivative securities may be adversely affected, and it should be expected that the holders of the derivative securities would exercise them at a time when we would be able to obtain equity capital on terms more favorable than those provided for by such derivative securities. As a result, any issuance of additional shares of our common stock may cause our current stockholders to suffer significant dilution which may adversely affect the market.

In addition to the above referenced shares of our common stock which may be issued without stockholder approval, we have 1,000,000 shares of authorized preferred stock, the terms of which may be fixed by our Board. We presently have no issued and outstanding shares of preferred stock and while we have no present plans to issue any shares of preferred stock, our Board has the authority, without stockholder approval, to create and issue one or more series of such preferred stock and to determine the voting, dividend and other rights of holders of such preferred stock. The issuance of any of such series of preferred stock may have an adverse effect on the holders of our common stock.

SHARES ELIGIBLE FOR  
FUTURE SALE MAY

ADVERSELY AFFECT THE  
MARKET.

From time to time, certain of our stockholders may be eligible to sell all or some of their shares of our common stock by means of ordinary brokerage transactions in the open market pursuant to Rule 144, promulgated under the Securities Act of 1933, as amended, subject to certain limitations. In general, pursuant to Rule 144, a stockholder (or stockholders whose shares are aggregated) who has satisfied a six-month holding period may, under certain circumstances, sell within any three month period a number of securities which does not exceed the greater of 1% of the then outstanding shares of common stock or the average weekly trading volume of the class during the four calendar weeks prior to such sale. Rule 144 also permits, under certain circumstances, the sale of securities, without any limitation, by our stockholders that are non-affiliates that have satisfied a one-year holding period. Any substantial sale of our common stock pursuant to Rule 144 or pursuant to any resale prospectus may have a material adverse effect on the market price of our common stock.

LIMITATION ON  
DIRECTOR/OFFICER LIABILITY.

As permitted by Delaware law, our certificate of incorporation limits the liability of our directors for monetary damages for breach of a director's fiduciary duty except for liability in certain instances. As a result of our charter provision and Delaware law, stockholders may have limited rights to recover against directors for breach of fiduciary duty. In addition, our certificate of incorporation provides that we shall

indemnify our directors and officers to the fullest extent permitted by law.

WE HAVE NO HISTORY OF PAYING DIVIDENDS ON OUR COMMON STOCK.

We have never paid any cash dividends on our common stock and do not anticipate paying any cash dividends on our common stock in the foreseeable future. We plan to retain any future earnings to finance growth. If we decide to pay dividends to the holders of our common stock, such dividends may not be paid on a timely basis.

PROVISIONS OF OUR CERTIFICATE OF INCORPORATION AND DELAWARE LAW COULD DETER A CHANGE OF OUR MANAGEMENT WHICH COULD DISCOURAGE OR DELAY OFFERS TO ACQUIRE US.

Provisions of our certificate of incorporation and Delaware law may make it more difficult for someone to acquire control of us or for our stockholders to remove existing management, and might discourage a third party from offering to acquire us, even if a change in control or in management would be beneficial to our stockholders. For example, our certificate of incorporation allows us to issue shares of preferred stock without any vote or further action by our stockholders. Our Board has the authority to fix and determine the relative rights and preferences of preferred stock. Our Board also has the authority to issue preferred stock without further stockholder approval, including large blocks of preferred stock. As a result, our Board could authorize the issuance of a series of preferred stock that

would grant to holders the preferred right to our assets upon liquidation, the right to receive dividend payments before dividends are distributed to the holders of our common stock and the right to the redemption of the shares, together with a premium, prior to the redemption of our common stock.

SALES OF LARGE QUANTITIES  
OF OUR COMMON STOCK BY  
OUR STOCKHOLDERS,  
INCLUDING THOSE SHARES  
ISSUED IN CONNECTION WITH  
PRIVATE PLACEMENT  
TRANSACTIONS, COULD  
REDUCE THE PRICE OF OUR  
COMMON STOCK.

Since May 2005, we have entered into private placements and registered direct offerings whereby we sell large quantities of our common stock to investors. For example, on March 31, 2010, we sold 9,100,001 shares of our common stock at a price of \$0.165 per share to certain investors in a registered direct offering. The investors also received warrants to purchase 7,583,335 shares of common stock with an exercise price of \$0.25 per share

These holders of the shares may sell such shares, if such shares are registered or pursuant to an exemption from registration, at any price and at any time, as determined by such holders in their sole discretion without limitation. Any sales of large quantities of our common stock could reduce the price of our common stock. If any such holders sell such shares in large quantities, our common stock price may decrease and the public market for our common stock may otherwise be adversely affected because of the additional shares available in the market.

We cannot assure you of the prices at which our common stock will trade in the future, and such prices may continue to fluctuate significantly. Prices for our common



stock will be determined in the marketplace and may be influenced by many factors, including the following:

- The depth and liquidity of the markets for our common stock;
- Investor perception of us and the industry in which we participate; and
- General economic and market conditions.

As of June 30, 2010, we have 98,383,000 shares of common stock issued and outstanding and approximately 36.5 million shares of common stock issuable upon the exercise of outstanding stock options and warrants. In the event we wish to offer and sell shares of our common stock in excess of the 200,000,000 shares of common stock currently authorized by our certificate of incorporation, we will first need to receive stockholder approval. Such stockholder approval has the potential to adversely affect the timing of any potential transactions.

**WE MAY INCUR SIGNIFICANT COSTS FROM CLASS ACTION LITIGATION DUE TO OUR EXPECTED STOCK VOLATILITY.**

In the past, following periods of large price declines in the public market price of a company's stock, holders of that stock occasionally have instituted securities class action litigation against the company that issued the stock. If any of our stockholders were to bring this type of lawsuit against us, even if the lawsuit is without merit, we could incur substantial costs defending the

lawsuit. The lawsuit also could divert the time and attention of our management, which would hurt our business. Any adverse determination in litigation could also subject us to significant liabilities.

THE UNCERTAINTY CREATED BY CURRENT ECONOMIC CONDITIONS AND POSSIBLE TERRORIST ATTACKS AND MILITARY RESPONSES THERETO COULD MATERIALLY ADVERSELY AFFECT OUR ABILITY TO SELL OUR PRODUCTS, AND PROCURE NEEDED FINANCING.

Current conditions in the domestic and global economies continue to present challenges. We expect that the future direction of the overall domestic and global economies will have a significant impact on our overall performance. Fiscal, monetary and regulatory policies worldwide will continue to influence the business climate in which we operate. If these actions are not successful in spurring continued economic growth, we expect that our business will be negatively impacted, as customers will be less likely to buy our products, if and when we commercialize our products. In addition, the potential for future terrorist attacks or war as a result thereof has created worldwide uncertainties that make it very difficult to estimate how the world economy will perform going forward.

OUR INABILITY TO MANAGE  
THE FUTURE GROWTH THAT  
WE ARE ATTEMPTING TO  
ACHIEVE COULD SEVERELY  
HARM OUR BUSINESS.

We believe that, given the right business opportunities, we may expand our operations rapidly and significantly. If rapid growth were to occur, it could place a significant strain on our management, operational and financial resources. To manage any significant growth of our operations, we will be required to undertake the following successfully:

- We will need to improve our operational and financial systems, procedures and controls to support our expected growth and any inability to do so will adversely impact our ability to grow our business. Our current and planned systems, procedures and controls may not be adequate to support our future operations and expected growth. Delays or problems associated with any improvement or expansion of our operational systems and controls could adversely impact our relationships with customers and harm our reputation and brand.
- We will need to attract and retain qualified personnel, and any failure to do so may impair our ability to offer new products or grow our business. Our success will depend on our ability to attract, retain and motivate managerial, technical, marketing, and administrative personnel. Competition for such employees is intense, and we may be unable to successfully attract, integrate or retain sufficiently qualified

personnel.

If we are unable to hire, train, retain or manage the necessary personnel, we may be unable to successfully introduce new products or otherwise implement our business strategy. If we are unable to manage growth effectively, our business, results of operations and financial condition could be materially adversely affected.

**WE MAY BE OBLIGATED,  
UNDER CERTAIN  
CIRCUMSTANCES, TO PAY  
LIQUIDATED DAMAGES TO  
HOLDERS OF OUR COMMON  
STOCK.**

We have entered into agreements with the holders of our common stock that requires us to continuously maintain as effective, a registration statement covering the underlying shares of common stock. Such registration statements were declared effective on January 26, 2007, May 30, 2006 and July 28, 2005 and must continuously remain effective for a specified term. If we fail to continuously maintain such a registration statement as effective throughout the specified term, we may be subject to liability to pay liquidated damages.

## ITEM 6. EXHIBITS

### INDEX TO EXHIBITS

The following exhibits are included with this Quarterly Report. All management contracts or compensatory plans or arrangements are marked with an asterisk.

EXHIBIT NO.	DESCRIPTION	METHOD OF FILING
10.1*	Employment Agreement, dated June 9, 2010, by and between the Company and Craig Johnson.	Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on June 9, 2010.
10.2*	NovaDel Pharma Inc. 2006 Equity Incentive Plan (as amended and restated on April 20, 2010)	Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on June 10, 2010.
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed herewith.
31.2	Certification of Principal	Filed herewith.

Financial and  
Accounting  
Officer pursuant  
to Section 302  
of the  
Sarbanes-Oxley  
Act of 2002.

32.1 Certification of   Furnished.  
the Principal  
Executive  
Officer and  
Chief Financial  
Officer under 18  
USC 1350,  
Section 1330 as  
adopted,  
pursuant to  
Section 906 of  
the  
Sarbanes-Oxley  
Act of 2002.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NovaDel Pharma Inc.

Date: August 16, 2010 By: /s/ Steven B. Ratoff  
Steven B. Ratoff  
President and Chief Executive Officer  
(principal executive officer)

Date: August 16, 2010 By: /s/ Craig A. Johnson  
Craig A. Johnson  
Chief Financial Officer  
(principal financial and accounting officer)





ottom;border-bottom:1px solid #000000;padding-left:2px;padding-top:2px;padding-bottom:2px;padding-right:2px;">

Q1

Q2

Q3

Wholly owned clubs operated at beginning of period

160

160

161

156

160

156

156

152

New clubs opened

—

1

—

3

4

1

—

—

Clubs closed, relocated or merged

—

—

(5  
)

(3  
)

(8  
)

(1  
)

(4  
)

(1  
)

Wholly owned clubs at end of period

160

161

156

156

156

156

152

151

Total clubs operated at end of period (1) (2)

162

163

158

158

158

158

154

153

Includes wholly-owned and partly-owned clubs. Not included in the total club count are locations that are managed (1)by us in which we do not have an equity interest. These managed sites include three fitness clubs located in colleges and universities and eight managed sites.

(2)Excludes three BFX Studio locations.

23

---

Table of Contents

## Comparable Club Revenue

We define comparable club revenue as revenue at those clubs that were operated by us for over 12 months and comparable club revenue increase (decrease) as revenue for the 13th month and thereafter as applicable as compared to the same period of the prior year.

Key determinants of comparable club revenue decreases shown in the table below are new memberships, member retention rates, pricing and ancillary revenue increases (decreases).

	2014				2015			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	
Comparable club revenue	(4.7 )%	(4.5 )%	(4.5 )%	(3.9 )%	(3.5 )%	(5.4 )%	(7.1 )%	

The comparable club revenue declines experienced in 2014 are primarily due to the impact of membership declines.

We experienced an overall member loss of 13,000 in the year ended December 31, 2014. The decline in comparable club revenue for the nine months ended September 30, 2015 is mainly driven by lower membership revenue due to existing members downgrading their memberships to those with lower monthly dues and new members enrolling at lower rates under our new pricing model. The effect of existing members opting for lower dues and new members enrolling at lower rates was only partially offset by an increase in membership sales volume. In the nine months ended September 30, 2015, our total member count increased 55,000 compared to a decrease of 18,000 in the nine months ended September 30, 2014. We continue to consider pricing adjustments in order to increase revenue while also driving membership growth.

## Consolidated Results of Operations

The following table sets forth certain operating data as a percentage of revenue for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2015	2014	2015	2014	%
Revenue	100.0	% 100.0	% 100.0	% 100.0	%
Operating expenses:					
Payroll and related	41.3	39.1	42.0	38.7	
Club operating	47.5	41.6	46.8	42.1	
General and administrative	6.5	6.9	7.2	6.9	
Depreciation and amortization	11.7	10.3	11.1	10.3	
	107.0	97.9	107.1	98.0	
Impairment of fixed assets	12.0	—	4.5	1.3	
Impairment of goodwill	—	—	9.8	—	
	12.0	—	14.3	1.3	
Operating (loss) income	(19.0 )	2.1	(21.4 )	0.7	
Interest expense	5.0	4.0	4.8	4.0	
Equity in the earnings of investees and rental income	(0.5 )	(0.5 )	(0.5 )	(0.5 )	
Loss before benefit for corporate income taxes	(23.5 )	(1.4 )	(25.7 )	(2.8 )	
Benefit for corporate income taxes	(2.3 )	(0.6 )	(5.3 )	(1.3 )	
Net loss	(21.2 )%	(0.8 )%	(20.4 )%	(1.5 )%	

Table of Contents

Three Months Ended September 30, 2015 compared to Three Months Ended September 30, 2014  
Revenue (in thousands) was comprised of the following for the periods indicated:

	Three Months Ended September 30, 2015		2014			
	Revenue	% Revenue	Revenue	% Revenue	% Variance	
Membership dues	\$74,806	72.1	% \$84,377	75.0	%(11.3)	
Initiation and processing fees	3,373	3.2	2,886	2.6	16.9	
Membership revenue	78,179	75.3	87,263	77.6	(10.4)	
Personal training revenue	17,868	17.2	17,703	15.7	0.9	
Other ancillary club revenue (1)	6,072	5.9	5,990	5.3	1.4	
Ancillary club revenue	23,940	23.1	23,693	21.0	1.0	
Fees and other revenue (2)	1,645	1.6	1,565	1.4	5.1	
Total revenue	\$103,764	100.0	% \$112,521	100.0	%(7.8)	

(1) Other ancillary club revenue primarily consists of BFX Studio classes, Small Group Training, Sports Clubs for Kids, and racquet sports.

(2) Fees and other revenue primarily consist of rental income, marketing revenue and management fees.

Revenue decreased \$8.8 million, or 7.8%, in the three months ended September 30, 2015 compared to the same prior-year period, as a result of lower membership revenue partially offset by higher ancillary club revenue. Revenue decreased approximately \$7.7 million at our clubs opened or acquired prior to September 30, 2013 and \$3.1 million at clubs that closed subsequent to September 30, 2013. These decreases were partially offset by a \$2.0 million increase in revenue from our clubs that were opened or acquired subsequent to September 30, 2013.

Membership dues revenue decreased \$9.6 million, or 11.3%, in the three months ended September 30, 2015 compared to the same prior-year period primarily due to existing members downgrading their memberships to those with lower monthly dues and new members enrolling at lower rates, both as a result of the new pricing model. These decreases were partially offset by an increase in annual fees recognized of \$3.0 million. Beginning in the third quarter of 2014, new memberships charge an annual fee beginning on the first day of membership and on each annual anniversary date thereafter and are deferred and recognized, on a straight-line basis over 12 months. We continue to consider pricing adjustments in order to increase revenue while also driving membership growth.

Initiation and processing fees revenue increased \$487,000, or 16.9%, in the three months ended September 30, 2015 compared to the same prior-year period, primarily reflecting an increased amount of initiation and processing fees under the new pricing model associated with an increase in membership sales volume beginning in the third quarter of 2014. Our total member count increased 14,000 to 534,000 in the three months ended September 30, 2015 compared to a decrease of 9,000 in the same prior-year period. Initiation and processing fees are recognized into revenue over the estimated average membership life.

Personal training revenue increased \$165,000, or 0.9%, in the three months ended September 30, 2015 compared to the same prior-year period, primarily reflecting increased interest on our multi-session personal training membership products and an increase in overall membership level.

## Table of Contents

Other ancillary club revenue increased \$82,000, or 1.4% in the three months ended September 30, 2015 compared to the same prior-year period primarily driven by increased revenue from our BFX Studio classes, partially offset by decreased revenue from guest fees as guest fees are no longer charged in most of our clubs.

Comparable club revenue decreased 7.1% in the three months ended September 30, 2015 as compared to the same prior-year period. The price of our membership dues and fees decreased which was partially offset by an increase in memberships at our comparable clubs.

Operating expenses (in thousands) were comprised of the following for the periods indicated:

	Three Months Ended September 30,			
	2015	2014	% Variance	
Payroll and related	\$42,889	\$43,994	(2.5	)%
Club operating	49,280	46,664	5.6	
General and administrative	6,696	7,813	(14.3	)
Depreciation and amortization	12,190	11,638	4.7	
Impairment of fixed assets	12,420	—	N/A	
Total operating expenses	\$123,475	\$110,109	12.1	%

Operating expenses increased due to the following factors:

Payroll and related. Payroll and related expenses decreased \$1.1 million, or 2.5%, in the three months ended September 30, 2015 compared to the same prior-year period. Overhead and club expenses decreased \$2.4 million primarily associated with the initial results of our cost savings initiatives, including a headcount reduction. These reductions primarily occurred in September 2015. These decreases were partially offset by severance charges of \$954,000 in the 2015 period, including \$446,000 in separation obligations related to our former Chief Information Officer. (Note 14 - Separate Obligation to our condensed consolidated financial statements). In addition, personal training payroll increased \$307,000, which was related to an increase in personal training revenue.

Club operating. Club operating expenses increased \$2.6 million, or 5.6%, in the three months ended September 30, 2015 compared to the same prior-year period. This increase was principally attributable to the following:

Rent and occupancy expenses increased \$1.8 million in the three months ended September 30, 2015 compared to the same period last year principally due to the following:

Mature clubs expenses increased \$860,000 resulting from rent escalations.

Expenses associated with newly opened and future clubs and BFX Studio locations increased \$221,000.

In the three months ended September 30, 2014, we recognized \$2.9 million of gains related to the reversal of deferred rent in connection with leases terminated early which decreased rent and occupancy expenses in that period.

Offsetting the above increases were savings of \$1.5 million for closed clubs.

Lease termination penalties decreased \$641,000.

Electric utilities expense increased \$694,000 in the three months ended September 30, 2015 compared to the same prior-year period primarily as a result of rate increases, as well as the warmer weather and therefore higher electricity consumption.

Table of Contents

General and administrative. General and administrative expenses decreased \$1.1 million, or 14.3%, in the three months ended September 30, 2015 compared to the same period last year, primarily reflecting the initial results of our cost savings initiatives of \$1.7 million. The decrease was partially offset by increased general liability insurance expenses of \$581,000 associated with an increase in reserves for claims related to prior periods.

Depreciation and amortization. In the three months ended September 30, 2015 compared to the same period last year, depreciation and amortization expense increased \$552,000, or 4.7%, principally due to the addition of new clubs and BFX Studio locations during 2014 and 2015.

Impairment of fixed assets. In the three months ended September 30, 2015, we recorded a total of \$12.4 million fixed asset impairment charges at underperforming clubs. We did not have fixed asset impairment in the three months ended September 30, 2014.

Interest expense

Interest expense increased \$685,000, or 15.2%, in the three months ended September 30, 2015 compared to the same period last year, primarily reflecting the non-cash rental income related to our former tenant at the East 86th Street property. Because the legal sale of our East 86th Street property is characterized for accounting purposes as a financing rather than a sale, rental income related to our former tenant in the building that was assigned to the purchaser/landlord is treated as interest on the financing arrangement. We will continue to account for the rental income from this former retail tenant as interest expense until the tenant's lease is terminated. This was partially offset by a decrease in interest expense due to principal payments made on our 2013 Term Loan Facility.

Benefit for Corporate Income Taxes

We recorded an income tax benefit of \$2.3 million inclusive of valuation allowance and an income tax benefit of \$660,000 for the three months ended September 30, 2015 and 2014, respectively, reflecting an effective income tax rate of 10% for the three months ended September 30, 2015 and 43% for the three months ended September 30, 2014. For the three months ended September 30, 2015 and 2014, we have determined our income tax provision and benefit on a discrete basis since the potential impact of fluctuations in our forecast may have a significant impact on the estimated annual effective tax rate.

Table of Contents

Nine Months Ended September 30, 2015 compared to Nine Months Ended September 30, 2014

Revenue (in thousands) was comprised of the following for the periods indicated:

	Nine Months Ended September 30,					
	2015		2014			
	Revenue	% Revenue	Revenue	% Revenue	% Variance	
Membership dues	\$235,185	72.7	% \$260,571	75.7	% (9.7	)%
Initiation and processing fees	10,650	3.3	9,080	2.7	17.3	
Membership revenue	245,835	76.0	269,651	78.4	(8.8	)
Personal training revenue	55,527	17.1	52,857	15.3	5.1	
Other ancillary club revenue (1)	17,386	5.4	17,092	5.0	1.7	
Ancillary club revenue	72,913	22.5	69,949	20.3	4.2	
Fees and other revenue (2)	4,736	1.5	4,521	1.3	4.8	
Total revenue	\$323,484	100.0	% \$344,121	100.0	% (6.0	)%

(1) Other ancillary club revenue primarily consists of BFX Studio classes, Small Group Training, Sports Clubs for Kids, and racquet sports.

(2) Fees and other revenue primarily consist of rental income, marketing revenue and management fees.

Revenue decreased \$20.6 million, or 6.0% in the nine months ended September 30, 2015 compared to the same prior-year period, as a result of lower membership revenue partially offset by higher ancillary club revenue. Revenue decreased approximately \$18.0 million at our clubs opened or acquired prior to September 30, 2013 and \$8.8 million at clubs that closed subsequent to September 30, 2013. These decreases were partially offset by a \$6.2 million increase in revenue from our clubs that were opened or acquired subsequent to September 30, 2013.

Membership dues revenue decreased \$25.4 million, or 9.7%, in the nine months ended September 30, 2015 compared to the same prior-year period primarily due to existing members downgrading their memberships to those with lower monthly dues and new members enrolling at lower rates, both as a result of the new pricing model. These decreases were partially offset by an increase in annual fees recognized of \$6.2 million. Beginning in the third quarter of 2014, new memberships charge an annual fee beginning on the first day of membership and on each annual anniversary date thereafter and are deferred and recognized, on a straight-line basis over 12 months. We continue to consider pricing adjustments in order to increase revenue while also driving membership growth.

Initiation and processing fees revenue increased \$1.6 million, or 17.3%, in the nine months ended September 30, 2015 compared to the same prior-year period, primarily reflecting an increased amount of initiation and processing fees under the new pricing model associated with an increase in membership sales volume. Our total member count increased 55,000 to 534,000 in the nine months ended September 30, 2015 compared to a decrease of 18,000 members in the same prior-year period primarily due to the implementation of the new pricing model. Total initiation and processing fees collected in the nine months ended September 30, 2015 were \$10.0 million compared to \$8.3 million in the same period last year. Initiation and processing fees are recognized into revenue over the estimated average membership life.

Personal training revenue increased \$2.7 million, or 5.1%, in the nine months ended September 30, 2015 compared to the same prior-year period, primarily reflecting an increased interest on our multi-session personal training membership products and an increase in overall membership level.



Table of Contents

Other ancillary club revenue increased \$294,000, or 1.7% in the nine months ended September 30, 2015 compared to the same prior-year period primarily driven by increased revenue from our BFX Studio classes, partially offset by decreased revenue from guest fees as guest fees are no longer charged in most of our clubs.

Comparable club revenue decreased 5.3% in the nine months ended September 30, 2015 as compared to the same prior-year period. The price of our membership dues and fees decreased which was partially offset by an increase in memberships at our comparable clubs.

Operating expenses (in thousands) were comprised of the following for the periods indicated:

	Nine Months Ended September 30,			
	2015	2014	% Variance	
Payroll and related	\$135,886	\$133,329	1.9	%
Club operating	151,386	144,877	4.5	
General and administrative	23,144	23,600	(1.9	)
Depreciation and amortization	36,042	35,289	2.1	
Impairment of fixed assets	14,571	4,513	>100%	
Impairment of goodwill	31,558	137	>100%	
Total operating expenses	\$392,587	\$341,745	14.9	%

Operating expenses increased due to the following factors:

Payroll and related. Payroll and related expenses increased \$2.6 million, or 1.9%, in the nine months ended September 30, 2015 compared to the same prior-year period. Personal training payroll increased \$1.7 million which was related to the increase in personal training revenue. The increase also included \$2.5 million separation obligations related to the departure of certain executive officers and severance charges of \$546,000 associated with certain employees. These increases were partially offset by decreased overhead expenses and club expenses of \$2.2 million associated with a headcount reduction and other cost savings initiatives. These cost reductions primarily occurred in September 2015, reflecting the initial results of our cost savings initiatives.

Club operating. Club operating expenses increased \$6.5 million, or 4.5%, in the nine months ended September 30, 2015 compared to the same prior-year period. This increase was principally attributable to the following:

• Marketing expenses increased \$5.0 million in the nine months ended September 30, 2015 compared to the same period in the prior year principally due to increased advertising spend associated with the new pricing model.

• Rent and occupancy expenses increased \$2.6 million in the nine months ended September 30, 2015 compared to the same period last year principally due to the following:

Mature clubs expenses increased \$2.5 million resulting from rent escalations.

Expenses associated with newly opened and future clubs and BFX Studio locations had increased \$868,000.

In the nine months ended September 30, 2014, we recognized \$2.9 million of gains related to the reversal of deferred rent in connection with leases terminated early which decreased rent and occupancy expenses in that period.

Lease termination penalties increased  
\$230,000.

Offsetting the above increases were savings of \$3.6 million for closed clubs.

## Table of Contents

**General and administrative.** General and administrative expenses decreased \$456,000, or 1.9%, in the nine months ended September 30, 2015 compared to the same period last year, primarily reflecting the initial results of our cost savings initiatives of \$1.8 million, partially offset by increased general liability insurance expenses of \$425,000 associated with an increase in reserves for claims related to prior periods. In addition, in 2015 there was an increase in costs of \$200,000 associated with stock awards granted to the new members of the Board of Directors and \$699,000 associated with the changes to our Board of Directors and other related expenses.

**Depreciation and amortization.** In the nine months ended September 30, 2015 compared to the same period last year, depreciation and amortization expense increased \$753,000, or 2.1%, principally due to the addition of new clubs and BFX Studio locations during 2014 and 2015.

**Impairment of fixed assets.** In the nine months ended September 30, 2015, we recorded a total of \$14.6 million fixed asset impairment charges compared to \$4.5 million in the nine months ended September 30, 2014 all related to underperforming clubs.

**Impairment of goodwill.** As a result of the significant decrease in market capitalization and a decline in our current performance primarily due to existing members downgrading their memberships to those with lower monthly dues and new members enrolling at lower rates, we performed an interim impairment test as of May 31, 2015. We concluded that there would be no remaining implied fair value of goodwill attributable to the NYSC and BSC regions. Accordingly, in June 2015, we wrote off \$31.6 million of goodwill associated with these reporting units. The February 28, 2014 annual impairment test resulted in a goodwill impairment charge of \$137,000 associated with the Outlier Clubs in the nine months ended September 30, 2014.

### **Interest expense**

Interest expense increased \$1.6 million, or 11.7%, in the nine months ended September 30, 2015 compared to the same period last year, primarily reflecting the non-cash rental income related to our former tenant at the East 86th Street property. Because the legal sale of our East 86th Street property is characterized for accounting purposes as a financing rather than a sale, rental income related to our former tenant in the building that was assigned to the purchaser/landlord are treated as interest on the financing arrangement. We will continue to account for the rental income from this former retail tenant as interest expense until the tenant's lease is terminated. This was partially offset by a decrease in interest expense due to principal payments made on our 2013 Term Loan Facility.

### **Benefit for Corporate Income Taxes**

We recorded an income tax benefit of \$17.1 million inclusive of valuation allowance and an income tax benefit of \$4.4 million for the nine months ended September 30, 2015 and 2014, respectively, reflecting an effective income tax rate of 21% for the nine months ended September 30, 2015 and 46% for the nine months ended September 30, 2014. For the nine months ended September 30, 2015 and 2014, we have determined our income tax provision and benefit on a discrete basis since the potential impact of fluctuations in our forecast may have a significant impact on the estimated annual effective tax rate.

Table of Contents

## Segment Results of Operations

The following discussion sets forth our financial performance by reportable segment for the three and nine months ended September 30, 2015 and 2014. We present earnings (loss) before interest expense (net of interest income), provision (benefit) for corporate income taxes, and depreciation and amortization (“EBITDA”) as the primary measure of profit and loss for our operating segments in accordance with FASB guidance for segment reporting.

Clubs (New York Sports Clubs, Boston Sports Clubs, Philadelphia Sports Clubs, Washington Sports Clubs, and Swiss Sports Clubs)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Revenues	\$103,075	\$112,419	\$321,875	\$344,019
EBITDA	\$(6,094)	) \$15,690	\$(28,404)	) \$42,109

Three Months Ended September 30, 2015 compared to Three Months Ended September 30, 2014

Clubs revenue decreased \$9.3 million, or 8.3%, in the three months ended September 30, 2015 compared to the same prior-year period, mainly driven by lower membership revenue due to existing members downgrading their memberships to those with lower monthly dues and new members enrolling at lower rates under our new pricing model. The effect of existing members opting for lower dues and new members enrolling at lower rates was only partially offset by an increase in membership sales volume. These decreases were partially offset by an increase in annual fees recognized of \$3.0 million. Our total member count increased 14,000 to 534,000 in the three months ended September 30, 2015 compared to a decrease of 9,000 in the same prior-year period. We continue to consider pricing adjustments in order to increase revenue while also driving membership growth.

In the three months ended September 30, 2015, Clubs had an EBITDA loss of \$6.1 million compared with an EBITDA of \$15.7 million in the three months ended September 30, 2014, primarily reflecting increased fixed asset impairment charges of \$12.4 million and the decline in revenue.

Nine Months Ended September 30, 2015 compared to Nine Months Ended September 30, 2014

Clubs revenue decreased \$22.1 million, or 6.4%, in the nine months ended September 30, 2015 compared to the same prior-year period, mainly driven by lower membership revenue due to existing members downgrading their memberships to those with lower monthly dues and new members enrolling at lower rates under our new pricing model. The effect of existing members opting for lower dues and new members enrolling at lower rates was only partially offset by an increase in membership sales volume. These decreases were partially offset by an increase in annual fees recognized of \$6.2 million. Our total member count increased 55,000 to 534,000 in the nine months ended September 30, 2015 compared to a decrease of 18,000 members in the same prior-year period. We continue to consider pricing adjustments in order to increase revenue while also driving membership growth.

In the nine months ended September 30, 2015, Clubs had an EBITDA loss of \$28.4 million compared with an EBITDA of \$42.1 million in the nine months ended September 30, 2014, primarily reflecting increased fixed asset and goodwill impairment charges of \$41.5 million and the decline in revenue, as well as increased marketing expenses associated with our new pricing model.

Table of Contents

## BFX Studio

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Revenues	\$689	\$102	\$1,609	\$102
EBITDA	\$(856)	\$(1,060)	\$(2,896)	\$(2,624)

Three Months Ended September 30, 2015 compared to Three Months Ended September 30, 2014

BFX Studio's revenue was \$689,000 in the three months ended September 30, 2015, reflecting revenue of our three BFX Studio locations which opened in September 2014, March 2015 and June 2015. We currently plan to open one additional BFX Studio location in early 2016.

BFX Studio had an EBITDA loss of \$856,000 and \$1.1 million for the three months ended September 30, 2015 and 2014, respectively, primarily reflecting the rent and occupancy costs, start-up costs and overhead payroll for our three BFX Studio locations and one other location with leases executed and development underway.

Nine Months Ended September 30, 2015 compared to Nine Months Ended September 30, 2014

BFX Studio's revenue was \$1.6 million in the nine months ended September 30, 2015, reflecting revenue of our three BFX Studio locations opened in September 2014, March 2015 and June 2015. We currently plan to open one additional BFX Studio location in early 2016.

BFX Studio had an EBITDA loss of \$2.9 million and \$2.6 million for the nine months ended September 30, 2015 and 2014, respectively, primarily reflecting the rent and occupancy costs, start-up costs and overhead payroll for our three BFX Studio locations and one other location with leases executed and development underway.

## Liquidity and Capital Resources

As of September 30, 2015, we had \$88.3 million of cash and cash equivalents. Financial instruments that potentially subject us to concentrations of credit risk consist of cash and cash equivalents. Although we deposit our cash with more than one financial institution, as of September 30, 2015, \$75.6 million was held at two financial institutions. We have not experienced any losses on cash and cash equivalent accounts to date and we do not believe that, based on the credit ratings of the aforementioned institutions, we are exposed to any significant credit risk related to cash at this time.

Historically, we have satisfied our liquidity needs through cash generated from operations and various borrowing arrangements. Principal liquidity needs have included the acquisition and development of new clubs, debt service requirements, and other capital expenditures necessary to upgrade, expand and renovate existing clubs. In March 2014 and June 2014, we paid a cash dividend of \$0.16 per share. Any determination to pay future dividends will be made by the board of directors and will take into account such matters as cash on hand, general economic and business conditions, our strategic plans, our financial results and condition, contractual, legal and regulatory restrictions on the payment of dividends by us and our subsidiaries and such other factors as our board of directors may consider to be relevant. We believe that our existing cash and cash equivalents, cash generated from operations and our existing credit facility will be sufficient to fund capital expenditures, working capital needs and other liquidity requirements associated with our operations through at least the next 12 months.

## Table of Contents

**Operating Activities.** Net cash provided by operating activities for the nine months ended September 30, 2015 increased \$20.3 million compared to the same period last year, primarily related to the total change in cash flow from income taxes of \$31.0 million. Cash paid for income taxes decreased \$23.5 million mainly related to the legal sale of the East 86th Street property in 2014, which was treated as a financing arrangement for accounting purposes, but recognized as of the date of sale for Federal and State income taxes. Additionally, in the 2015 period we received an income tax refund of \$7.5 million. The increase in cash flows also reflected an \$13.5 million increase in cash collected for member enrollment in the nine months ended September 30, 2015 related to an increase in memberships sold. The increase in accrued payroll expenses generated a favorable cash flow variance of \$6.1 million in the nine months ended September 30, 2015 compared to the same period in 2014 principally due to timing differences in payroll payments. The increase in cash flows also reflected the timing of certain payments and collections made associated with our accrued expenses. These increases were partially offset by a decrease in membership dues collected of \$29.0 million in the nine months ended September 30, 2015.

**Investing Activities.** Net cash used in investing activities decreased \$4.0 million in the nine months ended September 30, 2015 compared to the same prior-year period. The decrease was primarily due to the decreased activity in the building of new clubs. The increase was partially offset by a \$1.1 million executive separation obligation related to our former Executive Chairman during the nine months ended September 30, 2015. Investing activities in the nine months ended September 30, 2015 and 2014 both included capital expenditures related to expanding and remodeling existing clubs, and the purchase of new fitness equipment.

**Financing Activities.** Net cash used in financing activities for the nine months ended September 30, 2015 was \$2.2 million compared to net cash provided by financing activities of \$71.9 million in the same period in 2014. In the nine months ended September 30, 2014, financing activities consisted of \$83.4 million in cash proceeds from the sale of the East 86th Street property, partially offset by \$3.2 million of real property transfer taxes, broker fees and other costs associated with the property sale. In addition, there was a decrease in cash dividends paid to common stockholders of \$7.6 million related to dividends declared prior to 2015.

As of September 30, 2015, our total principal amount of debt outstanding was \$305.9 million. This substantial amount of debt could have significant consequences, including:

- making it more difficult to satisfy our obligations, including with respect to our outstanding indebtedness;
  - increasing our vulnerability to general adverse economic and industry conditions;
  - limiting our ability to obtain additional financing to fund future working capital, capital expenditures, acquisitions of new clubs and other general corporate requirements;
  - requiring a substantial portion of our cash flow from operations for the payment of interest on our debt, which is variable on our 2013 Revolving Loan Facility and partially variable on our 2013 Term Loan Facility, and/or principal pursuant to excess cash flow requirements and reducing our ability to use our cash flow to fund working capital, capital expenditures and acquisitions of new clubs and general corporate requirements;
  - increasing our vulnerability to interest rate fluctuations in connection with borrowings under our 2013 Senior Credit Facility, some of which are at variable interest rates;
  - limiting our ability to refinance our existing indebtedness on favorable terms, or at all; and
  - limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate.
- These limitations and consequences may place us at a competitive disadvantage to other less-leveraged competitors.

## Table of Contents

We believe that we have, or will be able to, obtain or generate sufficient funds to finance our current operating and growth plans through the next 12 months. Any material acceleration or expansion of our plans through newly constructed clubs or acquisitions (to the extent such acquisitions include cash payments) may require us to pursue additional sources of financing. There can be no assurance that such financing will be available, or that it will be available on acceptable terms.

### 2013 Senior Credit Facility

On November 15, 2013, TSI, LLC, an indirect, wholly-owned subsidiary, entered into a \$370.0 million senior secured credit facility (“2013 Senior Credit Facility”), among TSI, LLC, TSI Holdings II, LLC, a newly-formed, wholly-owned subsidiary of the Company (“Holdings II”), as a Guarantor, the lenders party thereto, Deutsche Bank AG, as administrative agent, and Keybank National Association, as syndication agent. The 2013 Senior Credit Facility consists of a \$325.0 million term loan facility maturing on November 15, 2020 (“2013 Term Loan Facility”) and a \$45.0 million revolving loan facility maturing on November 15, 2018 (“2013 Revolving Loan Facility”). Proceeds from the 2013 Term Loan Facility of \$323.4 million were issued, net of an original issue discount (“OID”) of 0.5%, or \$1.6 million. Debt issuance costs recorded in connection with the 2013 Senior Credit Facility were \$5.1 million and are being amortized as interest expense and are included in other assets in the accompanying condensed consolidated balance sheets. We also recorded additional debt discount of \$4.4 million related to creditor fees. The proceeds from the 2013 Term Loan Facility were used to pay off amounts outstanding under our previously outstanding long-term debt facility originally entered into on May 11, 2011 (as amended from time to time), and to pay related fees and expenses. None of the revolving loan facility was drawn upon as of the closing date on November 15, 2013, but loans under the 2013 Revolving Loan Facility may be drawn from time to time pursuant to the terms of the 2013 Senior Credit Facility. The borrowings under the 2013 Senior Credit Facility are guaranteed and secured by assets and pledges of capital stock by Holdings II, TSI, LLC, and, subject to certain customary exceptions, the wholly-owned domestic subsidiaries of TSI, LLC.

Borrowings under the 2013 Term Loan Facility and the 2013 Revolving Loan Facility, at TSI, LLC’s option, bear interest at either the administrative agent’s base rate plus 2.5% or a LIBOR rate adjusted for certain additional costs (the “Eurodollar Rate”) plus 3.5%, each as defined in the 2013 Senior Credit Facility. With respect to the outstanding initial term loans, the Eurodollar Rate has a floor of 1.00% and the base rate has a floor of 2.00%. Commencing with the last business day of the quarter ended March 31, 2014, TSI, LLC is required to pay 0.25% of the principal amount of the term loans each quarter, which may be reduced by voluntary prepayments. As of September 30, 2015, we have made a total of \$19.1 million in principal payments on the 2013 Term Loan Facility.

The terms of the 2013 Senior Credit Facility provide for a financial covenant in the situation where the total utilization of the revolving loan commitments (other than letters of credit up to \$5.5 million at any time outstanding) exceeds 25% of the aggregate amount of those commitments. In such event, TSI, LLC is required to maintain a total leverage ratio, as defined in the 2013 Senior Credit Facility, of no greater than 4.50:1.00. While not subject to the total leverage ratio covenant as of September 30, 2015 as our only utilization of the 2013 Revolving Loan Facility as of September 30, 2015 was \$2.9 million of issued and outstanding letters of credit thereunder, because our total leverage ratio as of September 30, 2015 was in excess of 4.50:1.00, we are currently not able to utilize more than 25% of the 2013 Revolving Loan Facility. We will continue not to be able to utilize more than 25% of the 2013 Revolving Loan Facility until we have a total leverage ratio of no greater than 4.50:1.00. The 2013 Senior Credit Facility also contains certain affirmative and negative covenants, including covenants that may limit or restrict TSI, LLC and Holdings II’s ability to, among other things, incur indebtedness and other liabilities; create liens; merge or consolidate; dispose of assets; make investments; pay dividends and make payments to shareholders; make payments on certain indebtedness; and enter into sale leaseback transactions, in each case, subject to certain qualifications and exceptions. In addition, at any time when the total leverage ratio is greater than 4.50:1.00, there are additional limitations on the ability of TSI, LLC and Holdings II to, among other things, make certain distributions of cash to TSI Holdings. The 2013 Senior Credit Facility also includes customary events of default (including non-compliance with the covenants or other terms of the 2013 Senior Credit Facility) which may allow the lenders to terminate the commitments under the 2013 Revolving Loan Facility and declare all outstanding term loans and revolving loans immediately due and payable and

enforce its rights as a secured creditor.

## Table of Contents

TSI, LLC may prepay the 2013 Term Loan Facility and 2013 Revolving Loan Facility without premium or penalty in accordance with the 2013 Senior Credit Facility. Mandatory prepayments are required relating to certain asset sales, insurance recovery and incurrence of certain other debt and commencing in 2015 in certain circumstances relating to excess cash flow (as defined) for the prior fiscal year, as described below, in excess of certain expenditures. Pursuant to the terms of the 2013 Senior Credit Facility, we are required to apply net proceeds in excess of \$30.0 million from sales of assets in any fiscal year towards mandatory prepayments of outstanding borrowings. In connection with the sale of the East 86th Street property, accounted for as a building financing arrangement, described in Note 5 – Building Financing Arrangement, we received approximately \$43.5 million in net sales proceeds (after taxes, before giving effect to utilization of net operating losses and carryforwards) during the third quarter of 2014. Accordingly, we made a mandatory prepayment of \$13.5 million on the 2013 Term Loan Facility in November 2014. In connection with this mandatory prepayment, during the year ended December 31, 2014, we recorded loss on extinguishment of debt of \$493,000, consisting of the write-off of unamortized debt issuance costs and debt discount of \$119,000 and \$374,000, respectively. To the extent the proceeds of the sale of the East 86th Street property are not reinvested, we may be required to use such amounts, other than amounts used in 2014 to repay debt, to pay down our outstanding debt, as provided under the terms of our 2013 Senior Credit Facility. Based on increased capital expenditures related to the building of new clubs and new BFX Studio locations, we do not expect to be required to make a payment at any time. In addition, the 2013 Senior Credit Facility contains provisions that require excess cash flow payments, as defined, to be applied against outstanding 2013 Term Loan Facility balances. The excess cash flow is calculated annually for each fiscal year ending December 31 and paid 95 days after the fiscal year end. The applicable excess cash flow repayment percentage is applied to the excess cash flow when determining the excess cash flow payment. Earnings, changes in working capital and capital expenditure levels all impact the determination of any excess cash flow. The applicable excess cash flow repayment percentage is 50% when the total leverage ratio, as defined in the 2013 Senior Credit Facility, exceeds or is equal to 2.50:1.00; 25% when the total leverage ratio is greater than or equal to 2.00:1.00 but less than 2.50:1.00 and 0% when the total leverage ratio is less than 2.00:1.00. The first excess cash flow payment would have been due in April 2015. The excess cash flow calculation performed as of December 31, 2014 did not result in any required payments in April 2015. The second excess cash flow payment is due in April 2016, if applicable. Based on our unit growth projection and capital expenditures related to club renovations, the building of new clubs and new BFX Studio locations, together with our operating forecast, we do not expect there will be an excess cash flow payment required at that time.

As of September 30, 2015, the 2013 Term Loan Facility has a gross principal balance of \$305.9 million and a balance of \$298.5 million net of unamortized debt discount of \$7.4 million which is comprised of the unamortized portions of the OID recorded in connection with the May 11, 2011 debt issuance and the unamortized balance of the additional debt discounts recorded in connection with the first amendment and second amendment to the 2011 Senior Credit Facility. The unamortized debt discount balance is recorded as a contra-liability to long-term debt on the accompanying condensed consolidated balance sheet and is being amortized as interest expense using the effective interest method. As of September 30, 2015, the unamortized balance of debt issuance costs of \$3.1 million is being amortized as interest expense, and is included in other assets in the accompanying condensed consolidated balance sheets.

As of September 30, 2015, there were no outstanding 2013 Revolving Loan Facility borrowings and outstanding letters of credit issued totaled \$2.9 million. The unutilized portion of the 2013 Revolving Loan Facility as of September 30, 2015 was \$42.2 million and the available unutilized portion, based on our total leverage ratio exceeding 4.50:1.00, was \$11.3 million.

On January 30, 2015, the 2013 Senior Credit Facility was amended (the “Amendment”) to permit TSI Holdings to purchase term loans under the Credit Agreement. Any term loans purchased by TSI Holdings will be cancelled. We may from time to time purchase term loans in market transactions, privately negotiated transactions or otherwise; however we are under no obligation to make any such purchases. Any such transactions, and the amounts involved, will depend on prevailing market conditions, liquidity requirements, contractual restrictions and other factors. The amounts involved may be material.





## Table of Contents

### Financial Instruments

In our normal operations, we are exposed to market risks relating to fluctuations in interest rates. In order to minimize the possible negative impact of such fluctuations on our cash flows we may enter into derivative financial instruments (“derivatives”), such as interest-rate swaps. Derivatives are not entered into for trading purposes and we only use commonly traded instruments. Currently, we have used derivatives solely relating to the variability of cash flows from interest rate fluctuations.

We originally entered into our interest rate swap arrangement on July 13, 2011 in connection with our previous credit facility. Effective as of November 15, 2013, the closing date of the 2013 Senior Credit Facility, the interest rate swap arrangement had a notional amount of \$160.0 million and will mature on May 15, 2018. The swap effectively converts \$160.0 million of the \$325.0 million total variable-rate debt under the 2013 Senior Credit Facility to a fixed rate of 5.384%, when including the applicable 3.50% margin. As permitted by FASB Accounting Standards Codification (“ASC”) 815, Derivatives and Hedging, we have designated this swap as a cash flow hedge, the effects of which have been reflected in our condensed consolidated financial statements as of and for the three and nine months ended September 30, 2015 and 2014. The objective of this hedge is to manage the variability of cash flows in the interest payments related to the portion of the variable-rate debt designated as being hedged.

When our derivative instrument was executed, hedge accounting was deemed appropriate and it was designated as a cash flow hedge at inception with re-designation being permitted under ASC 815, Derivatives and Hedging. Interest rate swaps are designated as cash flow hedges for accounting purposes since they are being used to transform variable interest rate exposure to fixed interest rate exposure on a recognized liability (debt). On an ongoing basis, we perform a quarterly assessment of the hedge effectiveness of the hedge relationship and measure and recognize any hedge ineffectiveness in the condensed consolidated statements of operations. For the three and nine months ended September 30, 2015 and 2014, hedge ineffectiveness was evaluated using the hypothetical derivative method. There was no hedge ineffectiveness for the three and nine months ended September 30, 2015 and 2014.

The counterparty to our derivatives is a major banking institution with a credit rating of investment grade or better and no collateral is required, and there are no significant risk concentrations. We believe the risk of incurring losses on derivative contracts related to credit risk is unlikely.

## Table of Contents

### Building Financing Arrangement

On September 12, 2014, we completed the legal sale of our property (building and land) on East 86th Street, New York City, to an unaffiliated third-party for gross proceeds of \$85.7 million, which includes \$150,000 of additional payments to us. Concurrent with the closing of the transaction, we leased back the portion of the property comprising our health club. We expect to lease (“Initial Lease”) the premises to at least March 2016 and then, upon at least 120 days notice from the purchaser/landlord, the Initial Lease will terminate and we will vacate the property while the purchaser/landlord demolishes the existing building and the adjacent building and builds a new luxury, high-rise multi-use building. In connection with vacating the property, we intend to enter into a new lease (“New Club Lease”) for approximately 24,000 square feet in the new building for the purpose of operating a health club upon completion of construction by the purchaser/landlord. The term of the Initial Lease is 10 years, and at the end of this initial term, we have two options at our sole discretion to renew the lease; the first for an additional 10 year period and a second for an additional five year period (although we expect that the purchaser/landlord will exercise its right to early terminate the Initial Lease so that it may commence the construction of the new building). Under the Initial Lease (and New Club Lease if entered into), the purchaser/landlord has agreed to pay us liquidated damages if the new club is not available by a certain date. The latest date that the liquidated damages would begin to be paid would be April 13, 2020 and would continue until the new club is available. For accounting purposes, the nature of these potential liquidated damages constitutes continuing involvement with the purchaser/landlord’s development of the property. As a result of this continuing involvement, the sale-leaseback transaction is currently required to be accounted for as a financing arrangement rather than as a completed sale. Under this treatment, we have included the proceeds received as a financing arrangement on our balance sheet. Except for payments under the Initial Lease and the New Club Lease, we do not expect to make any cash payments to the purchaser/landlord with respect to the building financing arrangement. We recorded a taxable (for federal and state income tax purposes) gain on the sale of the property and made estimated tax payments in September 2014 in this regard. In March 2015, we received the remaining proceeds held in escrow of \$500,000, which was included in our cash flow statement for the nine months ended September 30, 2015 as a financing cash inflow.

As of September 30, 2015, the total financing arrangement was \$83.9 million, which is net of \$1.8 million held in escrow for our former tenant. The accrued interest on financing arrangement was not material at September 30, 2015. Because the transaction is characterized as a financing for accounting purposes rather than a sale, the rental payments and related transaction costs are treated as interest on the financing arrangement. As these interest amounts are less than the interest that would be charged under a typical financing, the financing is characterized as an interest only financing with no reduction in the principal throughout the Initial Lease term until any continuing involvement has ceased. Until such time, even though we no longer have legal title to the building and the land, the building, building improvements and land remain on our consolidated balance sheet and the building and building improvements will continue to be depreciated over their remaining useful lives. Similarly, we do not have a loan or borrowing arrangement with the purchaser/landlord but the building financing arrangement will remain on our balance sheet until any continuing involvement has ceased.

As of September 30, 2015, the net book value of the building and building improvements was \$2.9 million and the book value of the land was \$986,000. As part of the transaction, we incurred \$3.2 million of real property transfer taxes, broker fees and other costs which will be deferred and amortized over the term of the Initial Lease of 25 years, which includes the option periods. The net fees are recorded in Other assets on our accompanying condensed consolidated balance sheets as of September 30, 2015 and December 31, 2014.

Payments made under the Initial Lease, including rental income related to our former tenant in the building that was assigned to the purchaser/landlord, are recognized as interest expense on the underlying financing arrangement. Included in the contractual obligation table below is our future lease commitment of \$750,000 per year under the remaining term of the Initial Lease, which includes the options periods and will be recorded as interest expense. Rental income related to our former tenant in the building of approximately \$2.0 million and the amortization of the deferred costs of \$126,000 per year will be recorded as interest expense (unless the purchaser/landlord exercises its right to terminate the lease before the end of the 10-year Initial Lease).



## Table of Contents

### Contractual Obligations

As of September 30, 2015, our contractual obligations listed in the table below and payments due by period were as follows:

	Payments Due by Period (in thousands)				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Contractual Obligations (4)					
Long-term debt (1)	\$305,949	\$3,114	\$6,228	\$6,228	\$290,379
Interest payments on long-term debt (2)	73,281	15,333	29,462	26,816	1,670
Operating lease obligations (3)	602,754	90,057	161,824	133,365	217,508
Total contractual obligations	\$981,984	\$108,504	\$197,514	\$166,409	\$509,557

Notes:

(1) Principal amounts paid each year may increase if annual excess cash flow amounts are required (as described above). Excess cash flow was calculated as of December 31, 2014 and no payments are currently required in 2015 or any future period.

(2) Based on interest rates pursuant to the 2013 Term Loan Facility and the interest swap agreement as of September 30, 2015.

(3) Operating lease obligations include base rent only. Certain leases provide for additional rent based on real estate taxes, common area maintenance and defined amounts based on our operating results. Amounts include obligations under the Initial Lease related to the Building financing arrangement and does not include any amounts relating to the New Club Lease. See "Building Financing Arrangement."

(4) The table above does not reflect payments related to planned club closures and executive separation obligations to our former Executive Chairman, our former Chief Executive Officer and our former Chief Information Officer.

Refer to Note 14 - Separation Obligation to our condensed consolidated financial statements.

The following long-term liabilities included on the condensed consolidated balance sheet are excluded from the table above: income taxes (including uncertain tax positions or benefits), insurance accruals and other accruals. We are unable to estimate the timing of payments for these items.

## Table of Contents

### Working Capital

We had working capital of \$35.7 million and \$52.3 million at September 30, 2015 and December 31, 2014, respectively. Major components of our working capital on the current assets side are cash and cash equivalents, accounts receivable, prepaid expenses and other current assets, and the current portion of deferred tax assets. As of September 30, 2015, these current assets more than offset the current liabilities, which consist of deferred revenues, accounts payable, accrued expenses (including, among others, accrued construction in progress and equipment, payroll and occupancy costs), the current portion of deferred tax liabilities and the current portion of long-term debt. The deferred revenue that is classified as a current liability relates to dues and services paid-in-full in advance and fees paid at the time of enrollment and totaled \$43.7 million and \$37.0 million at September 30, 2015 and December 31, 2014, respectively. Initiation and processing fees received are deferred and amortized over the estimated average membership life of a club member and all annual fees are deferred and amortized over a twelve month period. Prepaid dues and fees for prepaid services are generally realized over a period of up to twelve months. In periods when we increase the number of members and consequently increase the level of payments received in advance, we would expect to see increased deferred revenue balances. By contrast, any decrease in demand for our services or reductions in joining fees collected would have the effect of reducing deferred revenue balances, which would likely require us to rely more heavily on other sources of funding. In either case, a significant portion of the deferred revenue is not expected to constitute a liability that must be funded with cash. At the time a member joins our club, we incur enrollment costs, a portion of which are deferred over the estimated average membership life or 12 months to the extent these costs are related to the first annual fee paid at the time of enrollment. These costs are recorded as a long-term asset and as such do not affect working capital. We believe our cash and cash equivalents and our 2013 Revolving Loan Facility, which had \$11.3 million of availability at September 30, 2015 based on our leverage ratio and utilization at that date, are sufficient to fund our operating, investing and financing requirements for the next twelve months.

### Recent Changes in or Recently Issued Accounting Pronouncements

See Note 2 — Recent Accounting Pronouncements to the condensed consolidated financial statements.

### Use of Estimates and Critical Accounting Policies

**Fixed and intangible assets.** Fixed assets are recorded at cost and depreciated on a straight-line basis over the estimated useful lives of the assets, which are 30 years for building and improvements, five years for club equipment, furniture, fixtures and computer equipment and three to five years for computer software. Leasehold improvements are amortized over the shorter of their estimated useful lives or the remaining period of the related lease. Payroll costs directly related to the construction or expansion of the Company's club and BFX Studio base are capitalized with leasehold improvements. Expenditures for maintenance and repairs are charged to operations as incurred. The cost and related accumulated depreciation of assets retired or sold, is removed from the respective accounts and any gain or loss is recognized in operations. The costs related to developing web applications, developing web pages and installing developed applications on the web servers are capitalized and classified as computer software. Web site hosting fees and maintenance costs are expensed as incurred.

**Long-lived assets,** such as fixed assets and intangible assets are reviewed for impairment when events or circumstances indicate that their carrying value may not be recoverable. Estimated undiscounted expected future cash flows are used to determine if an asset group is impaired, in which case the asset's carrying value would be reduced to its fair value, calculated considering a combination of market approach and a cost approach. In determining the recoverability of fixed assets, Level 3 inputs were used in determining undiscounted cash flows, which are based on internal budgets and forecasts through the end of the life of the primary asset in the asset group which is normally the life of leasehold improvements. The most significant assumptions in those budgets and forecasts relate to estimated membership and ancillary revenue, attrition rates, estimated results related to new program launches and maintenance capital expenditures, which are generally estimated at approximately 3% to 5% of total revenues depending upon the conditions and needs of a given club. If we continue to experience competitive pressure, certain assumptions may fluctuate materially. See Note 9 — Fixed Asset Impairment to our condensed consolidated financial statements.



## Table of Contents

In the three months ended September 30, 2015, we recorded a total of \$12.4 million fixed asset impairment charges. We did not have fixed asset impairment in the three months ended September 30, 2014. In the nine months ended September 30, 2015, we recorded a total of \$14.6 million fixed asset impairment charges compared to \$4.5 million in the nine months ended September 30, 2014. The fixed asset impairment charge is included as a component of operating expenses in a separate line on the condensed consolidated statements of operations.

Goodwill has been allocated to reporting units that closely reflect the regions served by the Company's four trade names: New York Sports Clubs ("NYSC"), Boston Sports Clubs ("BSC"), Washington Sports Clubs ("WSC") and Philadelphia Sports Clubs ("PSC"), with certain more remote clubs that do not benefit from a regional cluster being considered single reporting units ("Outlier Clubs"), the Company's three clubs located in Switzerland being considered a single reporting unit ("SSC"), and our BFX Studio ("BFX Studio"). As of September 30, 2015, only the SSC region has a remaining goodwill balance.

As of February 28, 2015 and February 28, 2014, we performed our annual impairment test of goodwill. The February 28, 2015 annual impairment test supported the recorded goodwill balance and as such no impairment of goodwill was required. The February 28, 2014 annual impairment test resulted in a goodwill impairment charge of \$137,000 associated with the Outlier Clubs in the nine months ended September 30, 2014.

As a result of the significant decrease in market capitalization and a decline in our current performance primarily due to existing members downgrading their memberships to those with lower monthly dues and new members enrolling at lower rates, we performed an interim impairment test as of May 31, 2015. The determination as to whether a triggering event exists that would warrant an interim review of goodwill and whether a write-down of goodwill is necessary involves significant judgment based on our short-term and long-term projections. As a result of the May 31, 2015 interim impairment test, we concluded that there would be no remaining implied fair value of goodwill attributable to the NYSC and BSC regions. Accordingly, in June 2015, we wrote off \$31.6 million of goodwill associated with these reporting units. We did not have a goodwill impairment charge in the SSC region as a result of the interim test given the profitability of this unit.

For the May 31, 2015 and February 28, 2015 impairment tests, fair value was determined by using a weighted combination of two market-based approaches (weighted 50% collectively) and an income approach (weighted 50%), as this combination was deemed to be the most indicative of the our fair value in an orderly transaction between market participants. Under the market-based approaches, we utilized information regarding the Company, the Company's industry as well as publicly available industry information to determine earnings multiples and sales multiples that are used to value our reporting units. Under the income approach, we determined fair value based on estimated future cash flows of each reporting unit, discounted by an estimated weighted-average cost of capital, which reflects the overall level of inherent risk of a reporting unit and the rate of return an outside investor would expect to earn, which are unobservable Level 3 inputs, and taking into account the firm offer. The discounted estimates of future cash flows include significant management assumptions such as revenue growth rates, operating margins, weighted average cost of capital, and future economic and market conditions. The estimated weighted-average cost of capital of NYSC and SSC were 9.2% and 11.2% as of May 31, 2015, respectively, compared to 13.3% and 13.9% as of February 28, 2015. Determining the fair value of a reporting unit is judgmental in nature and requires the use of significant estimates and assumptions, including revenue growth rates and operating margins, discount rates and future market conditions, among others. These assumptions were determined separately for each reporting unit. We believe our assumptions are reasonable, however, there can be no assurance that our estimates and assumptions made for purposes of our goodwill impairment testing as of May 31, 2015 and February 28, 2015 will prove to be accurate predictions of the future. If our assumptions regarding forecasted revenue or margin growth rates of certain reporting units are not achieved, we may be required to record goodwill impairment charges in future periods, whether in connection with our next annual impairment testing or prior to that, if any such change constitutes a triggering event outside the quarter when the annual goodwill impairment test is performed. It is not possible at this time to determine if any such future impairment charge would result. The estimated fair value of SSC was greater than book value by 65% as of May 31, 2015 and 84% as of February 28, 2015.





## Table of Contents

Solely for purposes of establishing inputs for the fair value calculation described above related to goodwill impairment testing, we made the following assumptions. We developed long-range financial forecasts (three years) for all reporting units and assumed known changes in the existing club base. Terminal growth rates were calculated for years beyond the five year forecast. As of May 31, 2015, we used discount rates ranging from 8.2% to 11.2% and terminal growth rates ranging from 1.0% to 3.0%. As of February 28, 2015, we used discount rates ranging from 13.2% to 13.9% and terminal growth rates ranging from 0.5% to 3.0%. These assumptions are developed separately for each reporting unit.

The valuation of intangible assets requires assumptions and estimates of many critical factors, including revenue and market growth, operating cash flows and discount rates. We will continue to complete interim evaluations of the goodwill by reporting unit if a triggering event exists.

**Deferred Income Taxes.** We had a net deferred tax liability of \$61,000 and \$11.6 million as of September 30, 2015 and December 31, 2014, respectively. We had a state net deferred tax liability of \$17,000 and \$3.3 million as of September 30, 2015 and December 31, 2014, respectively. As of December 31, 2014, we maintained and as of September 30, 2015 continued to maintain a full valuation allowance of our deferred tax assets.

### **Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains “forward-looking” statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding future financial results and performance, potential sales revenue, potential club closures, results of cost savings initiatives, legal contingencies and tax benefits and contingencies, future declarations and payments of dividends, and the existence of adverse litigation and other risks, uncertainties and factors set forth under Item 1A., entitled “Risk Factors”, in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2014 and in our other reports and documents filed with the SEC. You can identify these forward-looking statements by the use of words such as “outlook”, “believes”, “expects”, “potential”, “continues”, “may”, “will”, “should”, “seeks”, “approximately”, “intends”, “plans”, “estimates”, “anticipates”, “target”, “could” or the negative version of these words or other comparable words. These statements are subject to various risks and uncertainties, many of which are outside our control, including, among others, the level of market demand for our services, economic conditions affecting our business, the success of our pricing model, the geographic concentration of our clubs, competitive pressure, the ability to achieve reductions in operating costs and to continue to integrate acquisitions, outsourcing of certain aspects of our business, environmental matters, the application of Federal and state tax laws and regulations, any security and privacy breaches involving customer data, the levels and terms of the Company’s indebtedness, and other specific factors discussed herein and in other SEC filings by us (including our reports on Forms 10-K and 10-Q filed with the SEC). We believe that all forward-looking statements are based on reasonable assumptions when made; however, we caution that it is impossible to predict actual results or outcomes or the effects of risks, uncertainties or other factors on anticipated results or outcomes and that, accordingly, one should not place undue reliance on these statements. Forward-looking statements speak only as of the date when made and we undertake no obligation to update these statements in light of subsequent events or developments. Actual results may differ materially from anticipated results or outcomes discussed in any forward-looking statement.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our debt effectively bears interest at fixed and variable rates so that we are exposed to market risks resulting from interest rate fluctuations. We regularly evaluate our exposure to these risks and take measures to mitigate these risks on our consolidated financial results. We do not participate in speculative derivative trading.

Interest rates on borrowings for the 2013 Term Loan Facility are for one-month periods in the case of Eurodollar borrowings. Our exposure to market risk for changes in interest rates relates to interest expense on variable rate debt. As of September 30, 2015, we had \$305.9 million of outstanding borrowings under our 2013 Term Loan Facility of which \$160.0 million of this variable rate debt is hedged to a fixed rate under an interest rate swap agreement.

Changes in the fair value of the interest rate swap derivative instrument is recorded each period in accumulated other comprehensive income (loss). Based on the amount of our variable rate debt and our interest rate swap agreement as of September 30, 2015, a hypothetical 100 basis point interest increase would have increased our annual interest cost by approximately \$760,000.

For additional information concerning the terms of our 2013 Term Loan Facility, see Note 3 — Long-Term Debt to the condensed consolidated financial statements.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures: We maintain disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) that are designed to ensure that the information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and such information is accumulated and communicated to management, including the Executive Chairman and the Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Disclosure controls and procedures, no matter how well designed and operated, can provide only reasonable assurances of achieving the desired controls.

As of September 30, 2015, we carried out an evaluation, under the supervision and with the participation of our management, including the Executive Chairman and the Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures defined above. Based upon that evaluation, our Executive Chairman and Chief Financial Officer have concluded that, as of September 30, 2015, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting: There have been no changes in our internal control over financial reporting during the quarter ended September 30, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

**PART II. OTHER INFORMATION**

**ITEM 1. Legal Proceedings.**

On February 7, 2007, in an action styled White Plains Plaza Realty, LLC v. TSI, LLC et al., the landlord of one of TSI, LLC's former health and fitness clubs filed a lawsuit in state court against it and two of its health club subsidiaries alleging, among other things, breach of lease in connection with the decision to close the club located in a building owned by the plaintiff and leased to a subsidiary of TSI, LLC, the tenant, and take additional space in a nearby facility leased by another subsidiary of TSI, LLC. Following a determination of an initial award, which TSI, LLC and the tenant have paid in full, the landlord appealed the trial court's award of damages, and on August 29, 2011, an additional award (amounting to approximately \$900,000) (the "Additional Award"), was entered against the tenant, which has recorded a liability. Separately, TSI, LLC is party to an agreement with a third-party developer, which by its terms provides indemnification for the full amount of any liability of any nature arising out of the lease described above, including attorneys' fees incurred to enforce the indemnity. As a result, the developer reimbursed TSI, LLC and the tenant the amount of the initial award in installments over time and also agreed to be responsible for the payment of the Additional Award, and the tenant has recorded a receivable related to the indemnification for the Additional Award. The developer and the landlord are currently litigating the payment of the Additional Award and judgment was entered against the developer on June 5, 2013 in the amount of approximately \$1.0 million, plus interest, which judgment was upheld by the appellate court on April 29, 2015. TSI, LLC does not believe it is probable that TSI, LLC will be required to pay for any amount of the Additional Award.

On or about October 4, 2012, in an action styled James Labbe, et al. v. Town Sports International, LLC, plaintiff commenced a purported class action in New York State court on behalf of personal trainers employed in New York State. Labbe is seeking unpaid wages and damages from TSI, LLC and alleges violations of various provisions of the New York State labor law with respect to payment of wages and TSI, LLC's notification and record-keeping obligations. The Court has bifurcated class and merits discovery. The deadline for the completion of pre-class certification document discovery was December 31, 2014. On June 12, 2015, the plaintiff made a motion for class certification. On July 24, 2015, the court indefinitely adjourned the plaintiff's motion for class certification to allow the court to first decide a motion for sanctions by TSI, LLC against Labbe. TSI, LLC made that motion for sanctions on June 30, 2015. The motion seeks dismissal of Labbe's complaint, and reimbursement of certain of TSI, LLC's legal fees, on the ground that Labbe has not complied with his discovery obligations and the court's discovery orders. TSI, LLC's motion for sanctions remains pending. TSI, LLC has proposed a settlement offer and the parties are working towards a resolution of this matter. If the parties are unsuccessful in these settlement negotiations, TSI, LLC intends to continue to contest this case vigorously.

In addition to the litigation discussed above, the Company is involved in various other lawsuits, claims and proceedings incidental to the ordinary course of business, including personal injury, employee relations claims and landlord tenant disputes. The results of litigation are inherently unpredictable. Any claims against the Company, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time and result in diversion of significant resources. The results of these other lawsuits, claims and proceedings cannot be predicted with certainty. The Company establishes accruals for loss contingencies when it has determined that a loss is probable and that the amount of loss, or range of loss, can be reasonably estimated. Any such accruals are adjusted thereafter as appropriate to reflect changes in circumstances. We currently believe that the ultimate outcome of such lawsuits, claims and proceedings will not, individually or in the aggregate, have a material adverse effect on our consolidated financial position, results of operations or liquidity. However, depending on the amount and timing, an unfavorable resolution of some or all of these matters could materially affect our future results of operations in a particular period.

**ITEM 1A. Risk Factors**

There have not been any material changes to the information related to the ITEM 1A. "Risk Factors" disclosure in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.



Table of Contents

ITEM 3. Defaults Upon Senior Securities

None.

ITEM 4. Mine Safety Disclosures

Not applicable.

ITEM 5. Other Information

None.

ITEM 6. Exhibits

Required exhibits are listed in the Index to Exhibits and are incorporated herein by reference.

From time to time the Company may use its Web site as a channel of distribution of material company information.

Financial and other material information regarding the Company is routinely posted on and accessible at

<http://investor.mysportsclubs.com>. In addition, you may automatically receive email alerts and other information about the Company by enrolling through the "Email Alerts" section at <http://investor.mysportsclubs.com>.

The foregoing information regarding the Company Web site and its content is for convenience only. The content of its Web site is not deemed to be incorporated by reference into this report nor should it be deemed to have been filed with the Securities and Exchange Commission.

Table of Contents

SIGNATURES

Pursuant to requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

TOWN SPORTS INTERNATIONAL  
HOLDINGS, INC.

DATE: November 2, 2015

By:

/s/ Carolyn Spatafora  
Carolyn Spatafora  
Chief Financial Officer

Table of Contents

INDEX TO EXHIBITS

The following is a list of all exhibits filed or furnished as part of this report:

Exhibit No.	Description of Exhibit
3.1	Amended and Restated Certificate of Incorporation of Town Sports International Holdings, Inc. (incorporated by reference to Exhibit 3.1 of the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006).
3.2	Third Amended and Restated By-laws of the Company (incorporated by reference to Exhibit 3.2 of the Registrant's Current Report on Form 8-K, filed on September 17, 2014).
3.3	Certificate of Designations of Series A Junior Participating Preferred Stock of Town Sports International Holdings, Inc. filed with the Secretary of State of the State of Delaware on January 2, 2015 (incorporated by reference to Exhibit 3.1 of the Registrant's Current Report on Form 8-K, dated January 2, 2015).
4.1	Rights Agreement, dated as of December 31, 2014, between Registrant and Computershare Trust Company N.A., as Rights Agent (incorporated by reference to Exhibit 4.1 of the Registrant's Current Report on Form 8-K, dated January 2, 2015).
10.1	Letter Agreement with Gregory Bartoli, dated August 17, 2015 (incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed August 18, 2015).
10.2	Form of Indemnification Agreement for Directors.
10.3	Form of Non-Qualified Stock Option Agreement for Gregory Bartoli pursuant to the 2006 Incentive Plan, as amended.
10.4	Form of Restricted Stock Agreement for Gregory Bartoli.
10.5	Form of Non-Qualified Stock Option Agreement for Gregory Bartoli.
31.1	Certification of Executive Chairman pursuant to Rule 13a – 14(a) and Rule 15d – 14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a – 14(a) and Rule 15d – 14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Executive Chairman pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document



101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase