FINAL TRANSCRIPT

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LTM - Q2 2008 Life Time Fitness Earnings Conference Call

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CORPORATE PARTICIPANTS

Ken Cooper
Life Time Fitness - VP of Finance

Bahram Akradi
Life Time Fitness - Chairman and CEO

Mike Robinson
Life Time Fitness - CFO

CONFERENCE CALL PARTICIPANTS

Paul Lejuez
Credit Suisse - Analyst

Paul Swinand
Stephens Incorporated - Analyst

Ed Aaron
RBC Capital Markets - Analyst

Laura Richardson
BB&T - Analyst

Karen Howland
Lehman Brothers - Analyst

Greg McKinley
Dougherty & Company - Analyst

Hardy Bowen
Arnhold Bleichroeder - Analyst

Kathryn Thompson
Avondale Partners - Analyst

Tony Gikas
Piper Jaffray - Analyst

Tom Shaw
Stifel Nicolaus - Analyst

Sharon Zackfia
William Blair - Analyst

Michael Keara
Merrill Lynch - Analyst

Vivian Ma
Oppenheimer Companies - Analyst

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the second quarter 2008 Life Time Fitness earnings conference call. (OPERATOR INSTRUCTIONS.)

I would now like to turn the call over to your host for today's conference, Mr. Ken Cooper, Vice President of Finance. Please proceed, sir.

Ken Cooper - *Life Time Fitness - VP of Finance*

Thanks, Imogene. Good morning, and thank you for joining us on today's conference call to discuss the second quarter 2008 financial results for Life Time Fitness. We issued our earnings press release this morning. If you did not obtain a copy, you may access it at our website which is lifetimefitness.com. In a moment, Bahram Akradi, our Chairman and CEO, will discuss his thoughts on our second quarter and our underlying business trends. Following that, Mike Robinson, our CFO, will review our financial highlights.

Once we have completed our prepared remarks, we will take your questions until 11:00 a.m. Eastern time. At that point in the call, the operator will provide instructions on how to ask a question. I will close with the tentative date of our third quarter 2008 earnings call. Finally, a replay of the teleconference will be available on our website at approximately 1:00 p.m. Eastern time today.

I'd like to remind everyone that this conference call contains forward-looking statements and future results could differ materially from the forward-looking statements made. Actual results may be affected by many factors including the risks and uncertainties identified in this morning's earnings release and in our SEC filings. Concurrent with the issuance of our second quarter earnings results, we have filed a Form 8-K with the SEC. Certain information in our earnings release and information disclosed on this call constitute non-GAAP financial measures, including EBITDA. We have included reconciliations of the differences between GAAP and non-GAAP measures in our earnings release and our Form 8-K. Other required information about our non-GAAP data is included in our Form 8-K.

With that, let me turn the call over to our founder and CEO, Bahram Akradi. Bahram?

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Thanks, Ken. On behalf of all Life Time Fitness, I am very pleased to provide you with an update on our business. As I said in our last call, the current environment is challenging but doable. We saw further proof of our ability to perform in a challenging environment in the second quarter. Revenue was up nearly 19% and we delivered over 20% growth in net income. We exceeded our membership growth expectations and we continued to see strong dues growth. Both were ahead of our internal plan.

Mike will provide greater detail on our financial performance shortly. I would like to give you some color on a few items. First, as we have mentioned since we went public, we felt one of our greatest weapons in growing membership in a tough environment would be to use more direct marketing and lower enrollment fees. We have proven over the 16 years life of the Company and my 25 years in the industry that by using these levers, we're able to continue to deliver membership growth.

The first half of this year has been no exception. Specifically, in the second quarter we spent ten more basis points on marketing and reduced our enrollment fees. This has resulted in our 11.9% membership growth, which, as I mentioned before, was ahead of our 10% plan. Further, this positioned us very well to accomplish our goal of 13% to 14% membership growth in the second half of the year.

One important thing to add is that we continue to maintain our dues structure. We have not and do not plan to discount our monthly dues. In the second quarter, we completed the remodeling of four more of the seven clubs we acquired two years ago and held grand opening events for each one. While these clubs took more time and cost more money than our initial thoughts, I can comfortably say they are now amazing, healthy-way-of-life destinations we at Life Time Fitness are all so proud of.

And more importantly, our members' response has been absolutely great. I cannot wait until we can show you, our shareholders and analysts, these magnificent facilities. Now, with these facilities completed with better layouts, we will be able to attract more membership than originally planned. Also, with these four remodels, we have completed six of the seven remodel projects that we acquired from two years ago.

We also opened three of our prototype facilities with great success. The new member sign-up has been on-ramp expectation or better at each of these facilities.

In summary, for the second quarter, we have delivered our plan for remodel and new club openings, customer satisfaction, and we have achieved our financial and membership goals by using the known levers as I mentioned before.

Now looking in the future, I look for some near-term accomplishments. This quarter we will launch our new member communication program, our new LTF vision network, a new member connectivity program and our new Member Advantage value ad. We will grand open three new facilities and one remodeled acquired club. We will also continue to use the levers we talked about before to deliver our plans.

We are focused, excited, and confident we can deliver our objectives. Now, I would like to turn the call over to our CFO, Mike Robinson, who will provide more color on our financial performance to date. Mike?

Mike Robinson - *Life Time Fitness - CFO*

Thanks, Bahram. As Bahram indicated, we're performing well through the first half of the year. As I did in my last call, I'd like to start my comments with an update on our capital structure. In the second quarter, we brought in approximately $104 million of sub-4% variable rate funding. This included the increase in the borrowing availability of a revolver to $470 million from $400 million without changing the terms of the facility and a $34 million variable rate mortgage loan. These debt sources allow us to take advantage of the current low short-term interest rate environment and give us the flexibility to pay them down or lock in fixed rates in the future.

We are well positioned for additional capital. We've signed two letters of intent for sale leaseback financing, subject to customary closing conditions, totaling $160 million from two separate companies and we expect to close on these transactions in the third quarter. We expect these deals to be approximately P&L neutral with lease costs offset by reduced depreciation and interest expense. In addition, we're negotiating on mortgages on several properties. Completion of these transactions will fund the bulk of our 2009 financing needs.

Moving to our P&L performance for the second quarter, total revenue was up 18.7% from the last second quarter. This growth was due to several factors, including membership dues growth of 18.2%. We continued to see a positive gap between our dues growth and membership growth, which was 11.9% in the quarter or a 630 basis point difference. This gap continues to be driven by our price changes to either new or existing memberships over the past year or so.

In-center revenue grew by 22% in the quarter, again led by personal training. We continue to deploy new products, programs, and services, in each of our in-center businesses, which also support our growth. Highlights from our other revenue metrics include our second quarter same-stores were again in the low-end of our expected range. For the quarter, we generated a 3.3% increase in same-store sales and had a 2% decline on our 37-month mature same-store sales.

Year to date we generated a 3.8% increase in same-store sales and had a 1.9% decline in our 37-month comps. This continues to be driven by a softer spa business, especially massage, as well as some revenue loss at some of our lower demographic locations. In the second quarter, we had two centers enter the 13-month comp base and one center enter the 37-month comp base.

With respect to revenue per membership, we generated a 6.9% increase to $361 in the quarter. In-center revenue per membership increased in the second quarter to $107 or a 9.8% increase over the second quarter. Both are good indicators we are executing on our strategies and are at the high end of our expected range.

Moving to our margin analyses, the Company's operating margin remained at 20.7% for the quarter compared to the second quarter 2007. During the quarter, we improved our G&A margin by 110 basis points primarily driven by the leverage of a growing business, focused efficiency improvement, and the elimination of rent costs on our corporate office. As a reminder, we moved into an owned facility late in the fourth quarter 2007 from previously leased facilities.

Offsetting the G&A improvement was approximately ten basis points of increased spend in marketing and 90 basis points of increased center operation expense. Both of these cost increases were related to our member acquisition efforts in the second quarter. Our center operating margin decreased from 42% to 41.1% as a percent of total revenue for the quarter. As we make our way down the P&L, interest expense, net of interest income, increased to $6.9 million from $6.4 million last second quarter as we continue to grow our new center base and our average debt balances grow.

Our tax rate for the quarter was 40.5% and was 40.4% year-to-date. This slight increase in our tax rate is due to reduced stock option exercise activity resulting in a lower tax benefit. We expect our 2008 effective tax rate to be approximately 40%.

That brings us to net income for the quarter of $19.8 million, which was up 20.3%. Our net income margin for the quarter increased ten basis points to 10.3%. Total common shares outstanding as of June 30, 2008 were 39.6 million shares. Weighted average fully diluted shares totaled 39.3 million shares for the second quarter. We expect our total weighted average diluted share count for 2008 to be approximately 39.5 to 40 million shares.

Based on the 2008 second quarter weighted average share count, our diluted EPS for the quarter was $0.50, up from $0.44 in the second quarter last year, or 15%. As a reminder, the difference between our net income growth and our EPS growth is related primarily to the equity offering we completed in August 2007.

Moving to our operating data, the number of open centers at June 30, 2008 was 74, compared with 64 at June 30, 2007. Of the 74 centers, 42 are current model and 54% have been opened three years or more, which we classify as mature centers. As of June 30, 2008, we had approximately 7.3 million square feet, which is 16.7% greater than we had at June 30, 2007, when we had approximately 6.3 million square feet.

EBITDA totaled $57.4 million in Q2, up 18.4% from last second quarter. EBITDA margin decreased ten basis points from 29.9 to 29.8%.

Memberships at June 30, 2008 totaled 547,497, compared to 489,489 memberships last Q2, up 11.9%. This exceeded our expectations for membership growth, which was particularly pleasing since our attrition rate increased slightly to approximately 38%. We've seen a few more people leave our centers in the current environment, but at the same time we're seeing more people join. We've been able to offset increased attrition with new membership additions. In the second quarter, we delivered a net membership increase of over 26,000 memberships as compared to 15,000 memberships last second quarter.

We have changed our estimate for the average life of a membership from 36 to 33 months for new memberships starting in Q2 2008. This change resulted in a very minor increase in enrollment fee revenue of under $30,000.

Cash flow from operations totaled $105.7 million, up from $66.2 million in the first half of 2007. This 60% increase is driven by our EBITDA growth rate, an increase in deferred taxes related to accelerated depreciation on new assets placed into service, thanks to the economic stimulus package of 2008, and working capital control. In addition, there was approximately a $4 million cash use last year on the tax benefit for stock option exercises, which was not duplicated due to the low stock option exercise volume because of stock price being lower this year compared to last year.

Turning to the balance sheet highlights, the largest activity continues to be driven by our continued growth of new center construction. Cash outlays for capital expenditures for the first half were $235.6 million, which included approximately $168.4 million related to growth or the construction of new centers, $40.6 million for the gross cash costs of remodels of acquired clubs, and $26.6 million for maintenance of our existing club base and corporate initiatives.

To finance our growth, we will continue to use our strong operating cash flow debt and sale leasebacks. During the second quarter, our overall debt balance grew by approximately $92 million to $723 million as of June 30. This includes $429 million outstanding on our $470 million revolver. Our net debt to capital ratio increased during the second quarter to 53.9%. One other balance sheet variance to note is our working capital deficit grew $18.2 million to $139.2 million, driven primarily by growth in construction accounts payable and accrued expenses. Both are in line with our business growth.

Now, as it relates to our outlook for the rest of the year, we are reaffirming our guidance for 2008. We expect to open seven more centers in 2008 and finish the year with a total of 81. We expect three centers to open in the third quarter and four to open in the fourth quarter. Our next clubs to open will be in September in Rockville, Maryland; Houston, Texas; and Vernon Hills, Illinois, a suburb of Chicago.

Our revenue guidance is maintained at 19% to 22% growth, which equates to approximately $780 million to $800 million. We expect net income growth of 21% to 23%, which equates to approximately $82 to $83.5 million. This results in diluted EPS guidance of 16% to 18% growth, which equates to $2.06 to $2.09 per share.

Regarding our CapEx guidance, we maintain expectations of $440 million to $460 million in net cash outlay for the year. This includes approximately $370 million to $390 million for growth, which works out to approximately $35 million per club for the Class of 2008. It also includes approximately $35 million of maintenance CapEx on our existing club base and $30 million to $35 million of one-time remodel costs, net of leasehold improvement credit and asset sales for our recently acquired clubs.

During the second quarter, we saw very good but slightly lower revenue growth as compared to the first quarter. This was driven primarily by the 9.9% membership growth rate in Q1. With the sequential quarter increase of membership growth to 11.9% in the second quarter, we expect a top line growth increase as we move into the second half of the year. Additionally, we expect slightly lower operating margins driven by marketing and membership acquisition costs as we continue to drive membership growth and an increase in lease costs from the sale leasebacks we expect to close in the third quarter, which, of course, are offset by lower depreciation and interest costs.

For the third quarter, we expect revenue growth of approximately 20% and net income growth of approximately 20%.

As we stated in our last call, before moving to the Q&A session, I wanted to address a few items that have been posed as questions to us more than once via our many discussions with our investor base. First, why am I comfortable about securing financing that fits our needs in this environment? I think the quick response is we've got a strong balance sheet that's made up of great, well-located, income-producing assets. As a reminder, of our 74 open centers, we own 54 of which 32 are without mortgages with an asset value well in excess of $500 million.

These assets are attractive, especially as we continue to improve our model works. Like our operating environment, the credit markets are challenging. However, I hope that most of our recent transactions and terms are indicative that we have partners that want to work with us. I gain comfort in knowing we are working on many options with many institutions, and though it takes time, I see the progress.

Does your initial pricing -- second question, does your initial pricing of Florham Park, Vernon Hills, and City Center indicate lower returns? The quick answer is absolutely not. Our initial pricing for these clubs is to start individual dues at $89 per month. As we build the business plans for these centers, we looked at pricing at $59 and up. The key is to match price and capacity. The higher dues, the lower the capacity needed to achieve our returns. Starting at the low end of our Onyx pricing range does not alter that return scenario. What it does is allow for more initial membership base to jumpstart the ramp. From there we can either ramp to a specified capacity or raise dues and decrease capacity to be commensurate with the experience desired. The advantage we are in is that these are higher density areas and they allow us the flexibility to start at a good price point and build from there.

That concludes our prepared remarks regarding our second quarter 2008 financial results. We continue to be pleased with our performance. With that, we are happy to take your questions now.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS.) Your first question comes from the line of Paul Lejuez with Credit Suisse. Please proceed.

Paul Lejuez - *Credit Suisse - Analyst*

Good morning. Thanks. Mike, can you just maybe repeat what you said in terms of the financing that you had lined up? I just wanted to make sure I got that. And then my question for Bahram, just wondering if in this environment, Bahram, you're seeing any change in terms of the supply and the capacity across the competitive landscape? Are you maybe seeing some smaller fitness centers really start to struggle, maybe close, and if there are any particular regions where you think that might be that likely? I'd be curious to hear your thoughts there. Thanks.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Paul, those are two good questions. I'll let Mike take the financing, and I'll cover your question for me.

Mike Robinson - *Life Time Fitness - CFO*

In the second quarter, we closed $104 million of incremental financing. We have $160 million of sale leaseback financing under letter of intent, which we expect to close in the third quarter, and we are negotiating on several properties with mortgages.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Let me take you through the question you asked. Typically, during the prolonged tougher consumer environment, it takes maybe as much as a year or so for some of the clubs that are struggling to actually come to the grips that they want to close their doors or quit going through the struggle. We are seeing some of that around the country. Occasionally, we talk to those people to see if we can help them out in any shape or form by providing a place for their members. And I believe that because this tougher consumer environment has been longer than initially expected, I think we're going to see more of those starting to surface here in the next 6 to 12 months. And we're well-prepared to do what we can to benefit from it.

As far as being specific to a region, I can't tell you. We see it all over. It's not any one area versus another. Does that answer your question?

Paul Lejuez - *Credit Suisse - Analyst*

Yes. Thank you and good luck.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Thank you.

Mike Robinson - *Life Time Fitness - CFO*

Thank you.

Operator

Your next question comes from the line of Paul Swinand with Stephens Incorporated. Please proceed.

Paul Swinand - *Stephens Incorporated - Analyst*

Good morning. My question is on some of your connectivity initiatives. I know Bahram has talked about you can do a lot more, you need to execute better. As you increase your churn rate a little and you've got more new members, how do you run your connectivity programs and how is that actually reaching the members? And what metrics do you think that's going to impact?

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

That's a great question. What we have done is we provide a great experience to our members in the four walls of our clubs and we have been doing that. Our member communication in terms of connecting them properly to the areas of their interest has not been a very technologically modern approach and taking full advantage of the current technologies available through the web and the new way of communication between folks and customers, etc. And we've been really working on this, not the last three months. We've been working on this at least over nine to ten months and we're just really excited to get this launched.

It's not just the Web. It's not just the communication system. It's not just club within club. It's really the entire way that we are going to be doing business, how the clubs are organized once we launch this. So that whatever your interest level is, whether if it's tennis or basketball or cycling, if it's yoga, Pilates, whatever your interest is, we a have much, much more -- I mean, it's literally not evolutionary, it's revolutionary in the way it's going to change immediate connectivity with those customers about the areas of their interest. I just can't wait until you guys will actually be able to experience this. Within the next 90 days it'll be rolled out to all of our clubs. It's much harder to describe it because it's not a five-minute deal. Really, it is a complex system we are changing all around and we're pretty excited about that.

We also are launching our LTF Vision, which is our own television network of programming, which allows us to bring in a more dynamic and exciting program to our members and communicate important issues via our own production team that will communicate with them what's new, what's happening, what's hot, and do it in a very, very fast, exciting way that would really keep them engaged and want them to watch that TV screen.

Mike Robinson - *Life Time Fitness - CFO*

Paul, the metrics that we internally will be watching as keys to the success of this really come in three ways. They come in what we call Net Promoter Score, NPS, that really focuses on customer and customer satisfaction. And we would expect to see that continuing to move up. We're going to certainly look at the attrition or the churn rates, and then also we expect to see a continued growth in our in-center revenues of which some of this touches. And so we'll keep an eye on our in-center revenue growth and, in particular, are we delivering within the expected range in in-center revenue per membership growth, which we expect to be in the high single-digits.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Because the communication between us and the members in the areas of their interest is so natural that we will much better know what members are using, what interest points of the club, very, very accurately, which we haven't been able to do in the past.

Paul Swinand - *Stephens Incorporated - Analyst*

Okay.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Okay. Next question?

Paul Swinand - *Stephens Incorporated - Analyst*

Thank you.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Thanks.

Operator

Your next question comes from the line of Ed Aaron with RBC Capital Markets. Please proceed.

Ed Aaron - *RBC Capital Markets - Analyst*

Great. Thanks. Mike, just one question for you. The interest expense came in quite a bit lower than what I was expecting. Can you just give us if there was any capitalized interest in the quarter versus what that was last year?

Mike Robinson - *Life Time Fitness - CFO*

There's always some capitalized interest. It was not -- we capitalize interest on projects that are under construction. It was not significantly higher relative to last quarter. We really have benefitted, though, from a lower interest rate environment with our revolver. That's probably the biggest key there.

Ed Aaron - *RBC Capital Markets - Analyst*

Thank you.

Operator

And your next question comes from the line of Laura Richardson with BB&T. Please proceed.

Laura Richardson - *BB&T - Analyst*

Thanks. Question I've been wondering about for a while and especially when you talked about sale leasebacks being P&L neutral, why would you -- or maybe you are thinking about doing a lot more of these or what are the advantages to owning the 54 centers, especially in an environment where people are worried about leveraged companies? It seems like you could unleverage yourself pretty easily that way.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

That's a great question. This is Bahram. All along we told our shareholders that we like to own real estate for flexibility and giving us the equity in our company that gives us the ability to grow in just about any type of economic challenge. Basically, mathematically, when the interest rates were lower on the spread and the long-term financing, we were ahead by being able to do the mortgage financing at the P&L level. With the interest rates slightly higher for long-term mortgage, we are more P&L neutral and you are right on track. At this point, we have -- Mike, how many facilities do we have at the end of this quarter that will be owned?

Mike Robinson - *Life Time Fitness - CFO*

We own 54 --

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Right.

Mike Robinson - *Life Time Fitness - CFO*

-- of which 22 of them have a mortgage against them.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Right. And so we are talking about six of these right now?

Mike Robinson - *Life Time Fitness - CFO*

Yes.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

So after those six we still have 48 plus a bunch of facilities that are under construction that will open this year. So, we have a supply of facilities that they are complete cash flow positive and there are many different people interested in sale leaseback deal with us, so that's a source for us that we will utilize as necessary. So, you're right on track.

Laura Richardson - *BB&T - Analyst*

What would it do to the balance sheet, let's say, if you did the sale leaseback of everything you could possibly do?

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Well, it would be debt free and have capital in the bank and cash in the bank. So, ultimately, we will -- like I said, depending on the price of the stock, depending on the finance rates, and depending on the sale leaseback rates, we will do the appropriate thing. And we take the right measures to help the shareholders' value the best way we can do it and long-term success of the Company. We have those options ahead of us, and I emphasize as Mike had said, that's why we have no concern about having the ability to get the financing to grow the Company per our plan.

Laura Richardson - *BB&T - Analyst*

Okay. Just -- I'm going to ask one last follow-up on that because I'm still trying to -- like what is your average club worth if you sold it to someone?

Mike Robinson - *Life Time Fitness - CFO*

I don't have a current market value for every one of the clubs. I can tell you that obviously as we've gone through market appraisals on clubs, the clubs that we mortgaged late -- or in 2007, those appraisals came in at -- on average 110% to 130% above our cost. Other clubs -- certainly, the appraisals we are seeing come in above cost, in some cases significantly above cost. But, again, I don't have a specific market value.

Laura Richardson - *BB&T - Analyst*

Okay, and cost is what is sitting on your balance sheet?

Mike Robinson - *Life Time Fitness - CFO*

I'm sorry?

Laura Richardson - *BB&T - Analyst*

Cost's what's sitting on your balance sheet?

Mike Robinson - *Life Time Fitness - CFO*

Yes. Cost is what's sitting on our balance sheet.

Laura Richardson - *BB&T - Analyst*

Okay.

Mike Robinson - *Life Time Fitness - CFO*

That's correct.

Laura Richardson - *BB&T - Analyst*

Thanks a lot. Good luck.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Thank you.

Operator

Your next question comes from the line of Karen Howland with Lehman Brothers. Please proceed.

Karen Howland - *Lehman Brothers - Analyst*

Good morning.

Mike Robinson - *Life Time Fitness - CFO*

Good morning, Karen.

Karen Howland - *Lehman Brothers - Analyst*

Quick question. I know typically we'll look at growth of both members and dues on a year-over-year basis. However, if I look at it sequentially, it looks like your members accelerated or, excuse me, your member growth accelerated from the first quarter to the second quarter, but your dues enrollment and in-center revenue decelerated somewhat. Is that to do with the timing of the members coming on? Did most of them come in the latter half of the second quarter? Can you help me work through that?

Mike Robinson - *Life Time Fitness - CFO*

Yes, you're correct. It's timing and it's a comment that I made in the prepared remarks where we saw a 9.9% membership growth in the first quarter and an 11.9% growth in the second quarter. That takes that membership growth -- it takes a little while to work through the system. And so you saw a little bit of deceleration in dues growth and in-center revenue growth really built off of some of that first quarter activity. I also mentioned that I expect to see those line items of revenue increase a little bit as you work that membership growth that we saw in the second quarter, work that into and through the system. So, you are correct. It is timing.

Karen Howland - *Lehman Brothers - Analyst*

Okay. Thanks for clarifying that. And if I could ask just one quick follow-up about the financing. I was just wondering -- obviously, you got strong terms in the one that you announced last quarter. Was wondering if you were getting similar terms for the 160 that you'd -- for the 160, which I think you said were for six centers that you're expecting to close in the third quarter.

Mike Robinson - *Life Time Fitness - CFO*

Yes, I'm not going to get into specific terms on that, really for competitive reasons right now, but again, the statements that I've made is that we expect them to be relatively P&L neutral to incremental debt that we would place on the books at long-term rates. What we -- the deals that we struck in the second quarter are really taking advantage of lower short-term variable rates that give us a lot of flexibility as we move forward. Longer term rates, longer term interest rates we're seeing more in the 7% fixed range, somewhere in 6.5% to 7.5%, and so from a sale leaseback perspective, I'm comparing really to those types of interest rates.

Karen Howland - *Lehman Brothers - Analyst*

Okay. Thank you very much.

Operator

Your next question comes from the line of Greg McKinley with Dougherty & Company. Please proceed.

Greg McKinley - *Dougherty & Company - Analyst*

Yes. Thanks. Mike, could you talk to us a little bit more about center margin trends? I know you indicated in your comments that the stepped-up marketing efforts were going to dilute the margin outlook a little bit. What else is involved with that as we saw what may be a 40 or -- I'm sorry, 60 or 70-basis point decline in center margins sequentially? What are the other factors impacting that margin?

Mike Robinson - *Life Time Fitness - CFO*

Yes, the biggest driver for that is as we have been more aggressive in our enrollment fees, we take to the P&L immediately any sales commissions that we pay in excess of enrollment fees on a club-by-club basis. And so there are occasions where we will be paying out total commissions in excess of those enrollment fees. Those go to the P&L immediately. They come through the center operating line and that was really the largest effect that drove -- in fact, it was the effect that drove operating margins down in the second quarter.

Greg McKinley - *Dougherty & Company - Analyst*

So, up to the enrollment fee, those are deferred on the balance sheet, but in excess they're going to P&L?

Mike Robinson - *Life Time Fitness - CFO*

That's correct.

Greg McKinley - *Dougherty & Company - Analyst*

Okay. Thank you.

Mike Robinson - *Life Time Fitness - CFO*

You're welcome.

Operator

Your next question comes from the line of Hardy Bowen with Arnhold Bleichroeder. Please proceed.

Hardy Bowen - *Arnhold Bleichroeder - Analyst*

Hello. Bahram?

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Yes, Hardy? How are you?

Hardy Bowen - *Arnhold Bleichroeder - Analyst*

Good. In the tests that you've done with the connectivity programs, I'm presuming that the attrition rates do decline, at least in parts of the club where you can put these in?

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Of course we are seeing desired results, Hardy, at the test club. Our corporate store, if you call it, right here by Chanhassen corporate office, we have been rolling these programs out and focusing on all the things that we're going to roll out in the third quarter system-wide in all of our clubs. And the member satisfaction is incredible. Customers are connecting. In average, they connect to about five or six of the interest areas that we offer, about 36 to 40 of them. We really feel like this is a revolutionary change, Hardy, and I see it -- the collection of the programs we're introducing in the third quarter, middle to end of third quarter, to start providing real traction in the fourth quarter and so forth.

Hardy Bowen - *Arnhold Bleichroeder - Analyst*

Okay. Is your feeling about the -- I mean, obviously, the marketing programs have been extremely successful in creating more members. Is your thinking that you should continue on the same plan or do less or do more or what's the general thought?

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

In terms of building new clubs?

Hardy Bowen - *Arnhold Bleichroeder - Analyst*

In terms of marketing programs for new members.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

The marketing program, we're going to continue what we have been doing in the second quarter. As I have mentioned this before, it's a natural leverage you use with your enrollment fee and your initiation and your direct marketing. We can turn up the heat, bring in the traffic, generate more membership sales. During the times like this, you're going to see, as Mike mentioned as well, a little more people concerned about dollars and dropping out and you get more people coming in because we provide a fantastic, healthy way of life, family entertainment for very little money. They could cut out one trip, one vacation for the family, and save $1,500 or $2,000 in three, four days and use that money the entire year and show up in our pool decks in our facilities, the different type of programs we offer, two hours a day. So, and we see a significant amount of people coming in and offsetting those people who drop out for some other financial reasons that forces them to go out. So, we feel very comfortable that we can continue to deliver the membership growth that we have mapped out utilizing the new connectivity programs, new value ads, as well the old, traditional levers, which is initiation fee and marketing -- direct marketing.

Hardy Bowen - *Arnhold Bleichroeder - Analyst*

Okay. Sounds good.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Thank you so much.

Mike Robinson - *Life Time Fitness - CFO*

Thanks, Hardy.

Operator

Your next question comes from the line of Kathryn Thompson with Avondale Partners. Please proceed.

Kathryn Thompson - *Avondale Partners - Analyst*

Hi. Thanks. I have two quick questions, more on the cash flow statement and balance sheet. First, there was a -- deferred income tax on cash flow from operations increased from -- to roughly $8.9 million from $2.5 million last year. If you could just clarify the increase, and also, could you walk through the rationale of the classification of non-cash investing and financing activities at the end of your cash flow statement? Thank you.

Mike Robinson - *Life Time Fitness - CFO*

Sure. Sure. Deferred income taxes, as I stated in my prepared remarks, Kathryn, the economic stimulus package of 2008 calls for some accelerated depreciation on items placed on 20-year or less than 20-year asset classes for items placed in service in 2008. We obviously placed a significant amount of assets into service in 2008, and we are taking advantage of the economic stimulus package. That's a direct result of the economic stimulus package of 2008. We expect that to continue in the third quarter and the fourth quarter with those accelerated depreciation tax breaks. They don't change tax rate. They defer tax out, but they are a significant positive cash flow item for us.

Your second comment was on what are the non-cash items sitting in the cash flow statement.

Kathryn Thompson - *Avondale Partners - Analyst*

The footnote, the supplemental schedule.

Mike Robinson - *Life Time Fitness - CFO*

Yes. At any time, there are a number of items that are non-cash related. It could be timing of things in payables, meaning construction in payables. It really is not a cash item yet. The cash has not gone out the door, so that's just a disclosure on that and that looks at the change in that line on a year-over-year basis. We also have -- when we purchase something through a capital lease obligation, again, it's a non-cash item. The cash element of that, the lease payment, comes through the cash flow statement, but the purchase -- the long-term piece of that is really a supplemental disclosure on the cash flow statements because it's a non-cash element. So that's what those supplemental disclosures are for.

Kathryn Thompson - *Avondale Partners - Analyst*

Sure, yes. I guess it just jumped out because, as you said, on a year-over-year basis, you are comparing year over year and there was just a fairly wide discrepancy with two specific items and just so -- I wanted to get an idea. Is this something we're going to see more going forward so we can account for that on comps going forward? And so that's really why it jumped out, just because --

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Mike Robinson - *Life Time Fitness - CFO*

Well, it's -- on capital leases, it will really depend on some of our -- in this particular case, the significant majority of this is one land purchase that we looked at, looked at different alternatives, and ultimately decided on this approach that made the best approach and was the most cost-effective way for Life Time Fitness to acquire that piece of property. Ideally, we like to acquire property for cash right up front, but in this particular case, the seller did not want that and so we looked for other ways to structure it where we had control, ultimately, of the property and this is what we did. I can't sit here and say that that will happen -- that that will not happen in the future. It will just -- it will depend on specific circumstances when we're negotiating again, in this case, a land acquisition.

Regarding the purchase of property and equipment in accounts payable, that is really driven by the amount of activity that goes on in our construction group. As you can imagine, there's a lot of activity going on with the opening of 11 centers this year, and a significant amount of construction already underway for the openings in 2009.

Kathryn Thompson - *Avondale Partners - Analyst*

Okay. So, that would explain the difference between the $3.8 million and the roughly $18 million year over year?

Mike Robinson - *Life Time Fitness - CFO*

Yes. Yes, that's correct.

Kathryn Thompson - *Avondale Partners - Analyst*

Okay. Thank you.

Mike Robinson - *Life Time Fitness - CFO*

You're welcome.

Operator

Your next question comes from the line of Tony Gikas with Piper Jaffray.

Tony Gikas - *Piper Jaffray - Analyst*

Thanks. Good morning, guys. Just a couple quick ones. Bahram, maybe you could give us a little update on the progress with the cafes, and then, Mike, just a gross margin trend looking at 2009.

Mike Robinson - *Life Time Fitness - CFO*

Sure. Bahram?

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

I'll take you through the cafes. We are very pleased with the menu item changes, the bread changes, and all the different things we wanted to do and the execution at our test club, which is, again, the corporate office. The results are great. Customers are happy. I'm happy with what we're delivering in terms of quality, service, food, taste, and the nutritional aspects of it. We have not been able to roll that out as early as I wanted. We're just about ready. We just signed our deals to get the delivery of the products worked out so that we can make the bread, etc., and then have it delivered through the food service to all of the places across the country. So, while we are doing well with our cafes' same-store performance from this year to last year, the bulk of the improvement in the food is going to be realized in the second half of the third quarter and the fourth quarter. And I look very, very forward to the results of that. I believe that the customers will accept it much better, as they have in Chanhassen, Tony.

Mike Robinson - *Life Time Fitness - CFO*

Tony, your question on gross margins -- let me start with a comment on overall operating margins. Operating margins were flat in the quarter. As we look forward, we continue to see leverage that will come from our G&A business, not only this year, but as we go into 2009 and beyond. The biggest change to overall operating margins, and it affects directly the center operating margins, will be any lease costs that we put on the books on sale leasebacks. And so I expect that we will see some lower center operating margins as we move into certainly third and fourth quarter and until we would anniversary any of those lease costs that we would have on the books. I do not expect that that will drive any significantly lower operating margins, though, because of the leverage in G&A and the fact that we will have some lower depreciation expense also. And of course, you make up the rest of that from a lease perspective on the interest rate line.

Tony Gikas - *Piper Jaffray - Analyst*

Okay. Thanks, guys, and congrats on another successful triathlon event.

Mike Robinson - *Life Time Fitness - CFO*

Thank you.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Thank you, Tony.

Operator

Your next question comes from the line of Tom Shaw with Stifel Nicolaus. Please proceed.

Tom Shaw - *Stifel Nicolaus - Analyst*

Hey, guys. Just kind of a nitpicky question here. On membership count up 11.9%, is there any way of disaggregating the impact of the newly remodeled centers in the quarter?

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Most of the new remodeled facilities got done towards the very, very end of the quarter. So, that was not from the new remodeled clubs. We see the results of the new remodeled clubs increase helping the memberships in the third and fourth quarter, and then into the next year.

Tom Shaw - *Stifel Nicolaus - Analyst*

And that's the 13 --

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

What you saw was -- what you saw increased membership was just in the legacy clubs, lifetime clubs.

Tom Shaw - *Stifel Nicolaus - Analyst*

That's helpful. Thanks.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Okay.

Operator

Your next question comes from the line of Sharon Zackfia with William Blair. Please proceed.

Sharon Zackfia - *William Blair - Analyst*

Hi. Good morning.

Mike Robinson - *Life Time Fitness - CFO*

Good morning.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Good morning, Sharon.

Sharon Zackfia - *William Blair - Analyst*

I don't think anyone asked this yet, so I guess could you quantify -- you mentioned attrition has inched up a little bit more and I think it inched up a bit in the first quarter, as well, so where are you running now on annualized attrition and is that continuing to trend upwards?

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Actually, it's stabilized, as Mike said. It's about 38% right now. We believe that part of that is due to the increased activity and the membership price changes first half of the year accompanied with the economic factors and people coming in and having pressures. Like I said, we're getting more people coming in to join and more people -- kind of a little more agitated kind of effect as a whole in the entire club. But we don't expect it to continue to ramp up at all. We think it's going to be here or with the initiatives we're putting forward, it might actually go back down a little bit.

Sharon Zackfia - *William Blair - Analyst*

Okay. Can you quantify for us how much of that attrition increase was planned? I know there must have been some expectation as you were increasing dues.

Mike Robinson - *Life Time Fitness - CFO*

Yes, about one point of that was planned. So, we would've expected to be running in the 35%, maybe 35.5% to 36% range.

Sharon Zackfia - *William Blair - Analyst*

Okay. Thank you.

Operator

Your next question comes from the line of Michael Keara with Merrill Lynch. Please proceed.

Michael Keara - *Merrill Lynch - Analyst*

Hey. Good morning, everyone.

Mike Robinson - *Life Time Fitness - CFO*

Good morning, Michael.

Michael Keara - *Merrill Lynch - Analyst*

I have a question for Bahram. You guys have talked about rationalizing the membership base, obviously, with the dues increases over the past few years. I'm just curious, is that what's helping this -- clearly in this economy, in-center revenues of 22% versus last year -- I mean, what would that look like if -- I think you've always said to me, "I'd rather have a person willing to pay $50 or more for a gym membership as opposed to a person paying $35. Does that have a lot to do with the fact that this is what's driving this in-center business?

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

Well, it's part of it, not all of it. Our personal training business has been -- we're performing according to our plans and we had increases built into our plans for growth in there. Cafe is doing better than last year. Also, the aggregate -- as we have raised prices over the years, we don't immediately catch up all the old members to the full new price we're charging somebody new, and as people drop out and somebody else comes in, we're appraising the memberships. Somebody may drop out in a club where they were at $49 and now we're only selling $59. The $49 member is going out and $59 member is coming in.

Michael Keara - *Merrill Lynch - Analyst*

Right.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

So, not only we're getting the membership turned over, replacing that attrition, we're replacing the attrition with a higher price dues customer. Okay? So that combination of these things will work now. Your question is would we get this increase only if we raised the dues? The answer is no because part of our attrition has been because of the fact that we raised the dues. So, if we hadn't raised the dues, you would say that you would have a few more members. It probably would've been near the same.

Michael Keara - *Merrill Lynch - Analyst*

Okay. All right. What do you think attrition rates would look like if you had to -- I mean, I know you don't do it, but if you lock in people for a year or two contracts?

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

I don't -- I'm not even going to answer that --

Michael Keara - *Merrill Lynch - Analyst*

Don't even go there.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

-- because I -- philosophically, we think that's a very, very bad way of doing business with the customer. The customer should be at your club because you are keeping them satisfied and they want to be there, not because they're ankles are tied up to -- because of a contract. That is a fundamental difference. We do not agree with it whatsoever.

Michael Keara - *Merrill Lynch - Analyst*

Okay. All right. Thanks.

Operator

Your next question comes from the line of Vivian Ma with Oppenheimer Companies. Please proceed.

Vivian Ma - *Oppenheimer Companies - Analyst*

Good morning. Just a quick question, a follow-up on the attrition. Is there a salvage effort for those who are exiting? Do you -- at the time when the member is canceling, do you try to get them to stay or after a certain period of time, does someone call them back and see if they want to rejoin again?

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

We have always had plans to work with them. We have done things in the past. We have some new, improved initiatives, the way we're going to handle that and really not -- it is not directly in reaction to the change in the percentages right now. It's really more based on the fact that we think it's the right way of connecting to that customer and bringing them enough additional values that makes it even a more difficult decision for them to leave Life Time. We're pretty excited about what we're going to roll out in the next month. You guys will see it, and I think you'll appreciate it, as well as our members.

Vivian Ma - *Oppenheimer Companies - Analyst*

Thank you.

Bahram Akradi - *Life Time Fitness - Chairman and CEO*

You're welcome.

Operator

And you have no further questions at this time.

Ken Cooper - *Life Time Fitness - VP of Finance*

Thank you for participating. We look forward to reporting to you our third quarter 2008 results, which tentatively has been scheduled for Thursday, October 23, 2008, at 10:00 a.m. Eastern. For these and all other key dates, please see the events section within the Investor Relations section of our website. Thank you and good-bye.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Good day.