

Edgar Filing: SPORTS CLUB CO INC - Form 10-Q

SPORTS CLUB CO INC
Form 10-Q
August 08, 2006

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

FORM 10-Q

(Mark One)

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934 FOR THE QUARTER ENDED MARCH 31, 2006

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: 1-13290

The Sports Club Company, Inc.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction
of incorporation of organization)

95-4479735
(I.R.S. Employer
Identification No.)

11151 Missouri Avenue
Los Angeles, California
(Address of principal executive offices)

90025
(Zip Code)

Registrant's telephone number, including area code: 310-479-5200

11100 Santa Monica Blvd.; Suite 300; Los Angeles, CA 90025
(Former name, former address and former fiscal year,
if changed since last report.)

Indicate by check mark whether the registrant (1) has filed all reports required
to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934,
during the preceding 12 months (or for such shorter period that the registrant
was required to file such reports) and (2) has been subject to such filing
requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an
accelerated filer, or a non-accelerated filer. See definition of "accelerated
filer and large accelerate filer" in Rule 12b-2 of the Exchange Act. (Check
one):

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☒

Indicate by check mark whether the registrant is a shell company (as defined in

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Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Shares of common stock outstanding at July 31, 2006: 19,405,718

THE SPORTS CLUB COMPANY, INC. CONDENSED CONSOLIDATED BALANCE SHEETS December 31, 2005 and March 31, 2006 (in thousands, except per share amounts)

ASSETS

Current assets:

| | |
|--|--------|
| Cash and cash equivalents..... | \$ 10 |
| Marketable securities..... | |
| Restricted cash..... | |
| Accounts receivable, net of allowance for doubtful accounts of \$464 and \$484 at December 31, 2005 and March 31, 2006, respectively..... | 1 |
| Receivable from stockholder/related party..... | |
| Inventories..... | 1 |
| Prepaid expenses..... | 127 |
| Assets held for sale..... | 141 |
| Total current assets..... | 141 |
| Property and equipment, net..... | 60 |
| Goodwill..... | 7 |
| Marketable securities..... | |
| Restricted cash..... | 1 |
| Other assets..... | 1 |
| | ----- |
| | \$ 212 |
| | ===== |

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LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)

Current liabilities:

| | |
|--|--------|
| Current installments of notes payable and equipment financing loans..... | \$ 100 |
| Accounts payable..... | 2 |
| Accrued liabilities..... | 10 |
| Deferred revenues..... | 8 |
| Liabilities related to assets held for sale..... | 78 |

| | |
|--------------------------------|-----|
| Total current liabilities..... | 201 |
|--------------------------------|-----|

| | |
|---|----|
| Notes payable and equipment financing loans, less current installments..... | 18 |
| Deferred lease obligations..... | 7 |
| Deferred revenues, less current portion..... | |
| Minority interest..... | |

| | |
|------------------------|-----|
| Total liabilities..... | 228 |
|------------------------|-----|

Commitments and contingencies

| | |
|--|----|
| Redeemable Convertible Preferred Stock, Series B, \$.01 par value, 10,500 shares authorized, issued and outstanding at December 31, 2005 and March 31, 2006 (liquidation preference of \$14,098 and \$14,336 at December 31, 2005 and March 31, 2006, respectively)..... | 13 |
| Redeemable Preferred Stock, Series E, \$.01 par value, 20,000 shares authorized, issued and outstanding at December 31, 2005 and March 31, 2006 (liquidation preference of \$2,295 and \$2,351 at December 31, 2005 and March 31, 2006, respectively)..... | 2 |

Stockholders' equity (deficit):

| | |
|--|-------|
| Preferred Stock, \$.01 par value, 899,500 shares authorized at December 31, 2005 and March 31, 2006; no shares issued or outstanding..... | |
| Convertible Preferred Stock, Series C, \$.01 par value, 5,000 shares authorized, issued and outstanding at December 31, 2005 and March 31, 2006 (liquidation preference of \$6,490 and \$6,601 at December 31, 2005 and March 31, 2006, respectively)..... | 6 |
| Convertible Preferred Stock, Series D, \$.01 par value, 65,000 shares authorized; issued and outstanding at December 31, 2005 and March 31, 2006; (liquidation preference of \$7,556 and \$7,701 at December 31, 2005 and March 31, 2006, respectively)..... | 7 |
| Common Stock, \$.01 par value, 40,000,000 shares authorized; 21,074,717 shares issued and outstanding at December 31, 2005 and March 31, 2006. | |
| Additional paid-in capital..... | 96 |
| Accumulated deficit..... | (129) |
| Note receivable from stockholder..... | |
| Treasury Stock, at cost, 1,668,999 shares at December 31, 2005 and March 31, 2006..... | (12) |

| | |
|---|------|
| Total Stockholders' equity (deficit)..... | (32) |
|---|------|

\$ 212
=====

See accompanying notes to consolidated financial statements.

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Three Months Ended March 31, 2005 and 2006
(in thousands, except per share amounts)
(unaudited)

| | Three Months Ended March 31, | |
|---|---------------------------------|------------|
| | 2005 | 2006 |
| | ---- | ---- |
| | (Reclassified) | |
| Revenues: | | |
| Membership revenues..... | \$ 9,166 | \$ 9,779 |
| Products and services..... | 4,473 | 4,784 |
| | ----- | ----- |
| Total revenue..... | 13,639 | 14,563 |
| Operating expenses: | | |
| Club operating costs..... | 6,495 | 6,786 |
| Cost of products and services..... | 3,780 | 4,015 |
| Selling and marketing..... | 506 | 693 |
| General and administrative..... | 2,048 | 2,248 |
| Impairment charge..... | -- | 713 |
| Depreciation and amortization..... | 1,224 | 1,137 |
| | ----- | ----- |
| Total operating expenses..... | 14,053 | 15,592 |
| | ----- | ----- |
| Loss from operations..... | (414) | (1,029) |
| Other income (expense): | | |
| Interest, net..... | (1,168) | (2,280) |
| Other income..... | -- | 628 |
| Minority interests..... | (37) | (37) |
| | ----- | ----- |
| Loss from continuing operations before income taxes and income from discontinued operations..... | (1,619) | (2,718) |
| Provision (benefit) for income taxes..... | -- | -- |
| | ----- | ----- |
| Loss from continuing operations before income from discontinued operations..... | (1,619) | (2,718) |
| Income from discontinued operations..... | 375 | 47 |
| | ----- | ----- |
| Net loss..... | (1,244) | (2,671) |
| Dividends on Preferred Stock..... | 493 | 549 |
| | ----- | ----- |
| Net loss attributable to common stockholders..... | \$ (1,737) | \$ (3,220) |
| | ===== | ===== |
| Net income (loss) per share attributable to common stockholders - basic and diluted: | | |
| Discontinued operations..... | \$ 0.02 | \$ 0.00 |
| Continuing operations..... | (0.11) | (0.17) |
| | ----- | ----- |
| Net loss per share..... | \$ (0.09) | \$ (0.17) |
| | ===== | ===== |

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Weighted average number of common shares outstanding:

| | | |
|------------------------|--------|--------|
| Basic and diluted..... | 19,131 | 19,406 |
| | ===== | ===== |

See accompanying notes to consolidated financial statements.

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THE SPORTS CLUB COMPANY, INC. CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS Three Months Ended March 31, 2005 and 2006 (in thousands) (unaudited)

| | Three Months Ended March 31, | |
|--|---------------------------------|---------|
| | 2005 | 2006 |
| | ---- | ---- |
| | (Reclassified) | |
| Cash flows from operating activities: | | |
| Net loss..... | \$ (1,244) | \$ (2,6 |
| Adjustments to reconcile net income (loss) to cash provided by (used in) operating activities: | | |
| Income from discontinued operations..... | (375) | (|
| Depreciation and amortization..... | 1,224 | 1,1 |
| Related party costs settled with Common Stock..... | 316 | |
| Impairment charge..... | -- | 7 |
| Minority interests expense..... | 37 | |
| Distributions to minority interests..... | (37) | (|
| (Increase) decrease in: | | |
| Accounts receivable, net..... | (50) | (3 |
| Inventories..... | 75 | (|
| Other current assets..... | 5 | 3 |
| Other assets, net..... | 284 | (8 |
| Increase (decrease) in: | | |
| Accounts payable..... | (388) | (1,0 |
| Accrued liabilities..... | (1,878) | (5,2 |
| Deferred revenues..... | 444 | 5 |
| Accrued lease obligations..... | 286 | |
| | ----- | ----- |
| Net cash used in operating activities..... | (1,301) | (7,4 |
| Cash flows used in investing activities: | | |
| Capital expenditures..... | (461) | (3,0 |
| Marketable securities..... | -- | (14,9 |
| (Increase) decrease in restricted cash..... | (15) | (1,7 |
| | ----- | ----- |
| Net cash used in investing activities..... | (476) | (19,8 |
| Cash flows from (used in) financing activities: | | |
| Net proceeds from notes payable and equipment financing loans... | -- | 60,0 |
| Repayments of notes payable and equipment financing loans..... | (124) | (100,2 |
| | ----- | ----- |

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| | | |
|---|----------|---------|
| Net cash used in financing activities..... | (124) | (40,2 |
| | ----- | ----- |
| Net cash used in continuing operations..... | (1,901) | (67,5 |
| Cash flows from (used in) discontinued operations: | | |
| Operating activities - Net cash provided by..... | 441 | |
| Investing activities: | | |
| Net proceeds from sale of Clubs..... | -- | 68,8 |
| Capital expenditures..... | (104) | |
| | ----- | ----- |
| Net cash from discontinued operations..... | 337 | 68,9 |
| | ----- | ----- |
| Net increase (decrease) in cash and cash equivalents.. | (1,564) | 1,3 |
| | ----- | ----- |
| Cash and cash equivalents at beginning of period..... | 7,559 | 10,2 |
| | ----- | ----- |
| Cash and cash equivalents at end of period..... | \$ 5,995 | \$ 11,6 |
| | ===== | ===== |
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the period for interest..... | \$ 6,048 | \$ 5,3 |
| | ===== | ===== |
| Cash paid during the period for income taxes..... | \$ 195 | \$ 1 |
| | ===== | ===== |
| Supplemental disclosure of non-cash investing activity: | | |
| Notes receivable related to sale of Clubs..... | \$ -- | \$ 30,0 |
| | ===== | ===== |

See accompanying notes to consolidated financial statements.

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THE SPORTS CLUB COMPANY, INC. NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS December 31, 2005 (Audited) and March 31, 2006 (Unaudited)

1. Basis of Presentation

The condensed consolidated balance sheet as of December 31, 2005 derived from audited financial statements and the unaudited condensed consolidated financial statements for the interim periods ended March 31, 2006 and 2005, included herein, have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). The condensed consolidated financial statements should be read in conjunction with the Company's December 31, 2005, consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K (SEC File Number 1-13290). Certain information and footnote disclosures, which are normally included in financial statements prepared in accordance with United States generally accepted accounting principles, have been condensed or omitted pursuant to SEC rules and regulations for interim financial statements. The Company believes that the disclosures made are adequate to make the information presented not misleading. The information reflects all adjustments that, 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. All such adjustments are of a normal and recurring nature. The results for the

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three-month period ended March 31, 2006, are not necessarily indicative of the results for the fiscal year ending December 31, 2006.

In accordance with Emerging Issues Task Force Issue No. 87-24, Allocation of Interest to Discontinued Operations, interest was allocated to discontinued operations based on the interest on debt that was required to be repaid as a result of the disposal transactions. On January 13, 2006, the Company sold five of its nine sports and fitness Clubs (see Note 4 to the Company's condensed consolidated financial statements). The proceeds of \$80.0 million from the sale were required to be used to repay a portion of the \$100.0 million of Senior Secured Notes. Accordingly, the Company has allocated to discontinued operations 80.0% of the interest associated with the Senior Secured Notes. For the three-month period ended March 31, 2005, the amount of interest allocated to discontinued operations was \$2,476,000. Due to the relatively short period that the Company owned the Clubs during 2006, no interest was allocated to discontinued operations for the three-month period ended March 31, 2006.

2. Reclassification

2005 Reclassification

In December 2004, the Company committed to a plan and came to an understanding to sell six of its nine sports and fitness Clubs to an affiliate of Millennium Entertainment Partners (collectively with its affiliates "Millennium") for \$65.0 million. Accordingly, the Company reported the operating results of these six Clubs as discontinued operations and their assets and liabilities as held for sale in the consolidated financial statements included in the Company's 2004 Form10-K and March 31, 2005 Form 10-Q.

The condensed consolidated financial statements for March 31, 2005 previously reported the assets and liabilities of The Sports Club/LA - New York at Rockefeller Center as held for sale and reported the operations of this club as part of discontinued operations. In November 2005, the Company decided to retain ownership of this Club. Accordingly, the

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condensed consolidated financial statements have been revised to include the assets, liabilities and operating results of this club as part of continuing operations in accordance with Statement of Financial Accounting Standards No. 144, Accounting for Impairment and Disposal of Long-Lived Assets.

A reclassified condensed consolidated statement of operations for the three months ended March 31, 2005, reflecting the above reclassification is presented below. The amounts are in thousands, except per share amounts.

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Condensed Consolidated Statement of
Operations
Three Months Ended March 31, 2005

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| | As Reported ----- (unaudited) | Retained Operations ----- (unaudited) | As Reclassified ----- (unaudited) |
|--|--|--|--|
| Revenues: | | | |
| Membership revenues..... | \$ 7,837 | \$ 1,329 | \$ 9,166 |
| Products and services..... | 3,814 | 659 | 4,473 |
| | ----- | ----- | ----- |
| Total revenue..... | 11,651 | 1,988 | 13,639 |
| Operating expenses: | | | |
| Club operating costs..... | 4,431 | 2,064 | 6,495 |
| Cost of products and services..... | 3,218 | 562 | 3,780 |
| Selling and marketing..... | 418 | 88 | 506 |
| General and administrative..... | 2,048 | -- | 2,048 |
| Depreciation and amortization..... | 1,224 | -- | 1,224 |
| | ----- | ----- | ----- |
| Total operating expenses..... | 11,339 | 2,714 | 14,053 |
| | ----- | ----- | ----- |
| Income (loss) from operations..... | 312 | (726) | (414) |
| Other income (expense): | | | |
| Interest, net..... | (1,632) | 464 | (1,168) |
| Minority interests..... | (37) | -- | (37) |
| | ----- | ----- | ----- |
| Loss from continuing operations before income taxes and income from discontinued operations..... | (1,357) | (262) | (1,619) |
| Provision (benefit) for income taxes..... | -- | -- | -- |
| | ----- | ----- | ----- |
| Loss from continuing operations before income from discontinued operations..... | (1,357) | (262) | (1,619) |
| Income from discontinued operations..... | 113 | 262 | 375 |
| | ----- | ----- | ----- |
| Net loss..... | (1,244) | -- | (1,244) |
| Dividends on Preferred Stock..... | 493 | -- | 493 |
| | ----- | ----- | ----- |
| Net loss attributable to common stockholders..... | \$ (1,737) | \$ -- | \$ (1,737) |
| | ===== | ===== | ===== |
| Net income (loss) per share attributable to common stockholders | | | |
| - basic and diluted: | | | |
| Discontinued operations..... | \$ 0.01 | \$ 0.01 | \$ 0.02 |
| Continuing operations..... | (0.10) | (0.01) | (0.11) |
| | ----- | ----- | ----- |
| Net loss per share..... | \$ (0.09) | \$ -- | \$ (0.09) |
| | ===== | ===== | ===== |
| Weighted average number of common shares Outstanding: | | | |
| Basic and diluted..... | 19,131 | -- | 19,131 |
| | ===== | ===== | ===== |

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The condensed consolidated statement of cash flows for the three months ended March 31, 2005 presented elsewhere in this Form 10-Q has also been reclassified to reflect The Sports Club/LA - New York at Rockefeller Center as a continuing operation.

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3. Accounting for Stock-Based Compensation

Through the end of fiscal 2005, the Company measured compensation expense for stock-based incentive programs utilizing the intrinsic value method prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." Under this method, the Company did not record compensation expense when stock options were granted to eligible participants as long as the exercise price was not less than the fair market value of the stock when the option was granted. In accordance with Statement of Financial Accounting Standards ("SFAS") 123R, the Company disclosed the pro forma net income (loss) per share as if the fair value-based method had been applied in measuring compensation expense for share-based incentive awards. No share-based compensation cost was recognized in the Condensed Consolidated Statement of Operations for the three months ended March 31, 2005 for options granted under the Company's Stock Incentive Plans, as all unvested options granted had an exercise price equal to the market value of the underlying common stock on the date of grant.

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123R. This statement requires that the cost resulting from all share-based payment transactions be recognized in the Company's consolidated financial statements. In addition, in March 2005 the Securities and Exchange Commission ("SEC") released SEC Staff Accounting Bulletin No. 107, "Share-Based Payment" ("SAB 107"). SAB 107 provides the SEC's staff's position regarding the application of SFAS 123R and certain SEC rules and regulations, and also provides the staff's views regarding the valuation of share-based payment arrangements for public companies. Generally, the approach in SFAS 123R is similar to the approach described in SFAS 123. However, SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the statement of operations based on their fair values. Pro forma disclosure of fair value recognition, as prescribed under SFAS 123, is no longer an alternative.

In the first quarter of fiscal 2006, the Company adopted the fair value recognition provisions of SFAS 123R utilizing the modified prospective transition method, as prescribed by SFAS 123R. Under that transition method, compensation cost recognized during the three months ended March 31, 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Under the modified prospective transition method, results for the prior periods have not been restated.

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For the three months ended March 31, 2006, the Company recognized no non-cash share-based compensation costs as a result of the adoption of SFAS 123R. The effect of the change in applying the original provisions of SFAS 123 resulted in no change in reported net loss or reported loss per share, as shown below (in thousands, except per share amounts):

| | Prior to Application of SFAS 123R ----- | As per SFAS 123R ---- |
|---|--|-----------------------------|
| Net loss..... \$ | (3,220) | \$ (3,220) |
| Net loss per share - basic and diluted.... \$ | (0.17) | \$ (0.17) |

The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of SFAS 123R to options granted under the Company's stock option plans in all periods presented. The Company did not recognize any compensation expense related to the issuance of stock options in 2005. The effect of applying SFAS 123R resulted in no change in net loss and basic and diluted loss per share as shown below (in thousands, except per share amounts):

| | Three Months Ended March 31, 2005 ----- | Thre Marc ---- |
|--|--|----------------------|
| Net loss, as reported..... \$ | (1,737) | \$ |
| Deduct: Total share-based employee compensation expense determined under fair value-based method for all awards, net of related tax effects..... | -- | ----- |
| Pro forma net loss..... \$ | (1,737) | \$ |
| | ===== | ===== |
| Net loss per share-basic and diluted: | | |
| As reported..... \$ | (0.09) | \$ |
| Pro forma..... \$ | (0.09) | \$ |
| Shares used in computing net loss per share: | | |
| Basic and diluted..... | 19,131 | |

During the three months ended March 31, 2006, there were no shares granted, exercised or cancelled under the Company's stock option plans. At December 31, 2005 and March 31, 2006, there were no unvested options outstanding.

4. Sale of Assets

In December 2004, the Company committed to a plan and came to an understanding to sell six of its nine sports and fitness Clubs to an affiliate of Millennium Entertainment Partners (collectively with its affiliates "Millennium") for \$65.0 million. Millennium is the Company's largest stockholder and was the landlord at four of these Clubs. Accordingly, the Company reported the operating results of these six Clubs as discontinued operations and their assets and liabilities as held for sale in the condensed consolidated financial statements included in the Company's March 31, 2005 Form 10-Q (see Note 2 to

the Company's condensed consolidated financial statements). In November 2005, the Company decided to retain ownership of one Club and increase the sales price to \$80.0 million. The condensed consolidated financial statements included in the Company's March 31, 2005 Form 10-Q have been reclassified to reflect the decision to retain ownership of this Club (see Note 2 to the Company's condensed consolidated financial statements). On January 13, 2006, the Company completed the sale of five Clubs to Millennium for \$80.0 million. The Clubs sold include the Company's interest in Reebok Sports Club/NY and The Sports Club/LA in Washington D.C., Boston, San Francisco and the Upper East Side in New York. The Company's management agreement covering the Club in Miami was also terminated. The Company received \$50.0 million in cash upon closing the sale (before transaction related costs) and received two Notes from Millennium. The first Note of \$22.2 million was due and was collected on January 31, 2006. The second Note of \$7.8 million is due in 2013 and is secured by a pledge of the Series C and Series D Preferred Stock owned by Millennium and accordingly, the note receivable has been presented as a contra-equity item on the Company's condensed consolidated balance sheet. The Note is also guaranteed by an affiliate of Millennium. The net proceeds from the sale exceeded the carrying value of the net assets sold by approximately \$24.8 million. Millennium has two directors on the Company's board of directors, is a major stockholder of the Company and was the landlord at four of the five Clubs that were sold. Millennium is a related party, as defined by generally accepted accounting principles and by the United States Securities and Exchange Commission. Accordingly, the amount by which the net proceeds from the sale of the five Clubs to Millennium exceeded their carrying value has been classified as a capital contribution in the accompanying condensed consolidated financial statements.

Concurrent with the asset sale the Company entered into several ancillary agreements with Millennium. These agreements provide Millennium rights, subject to certain conditions, to use certain Proprietary Information and Trademarks for perpetuity in connection with their operations of the acquired Clubs. The Company also entered into a short-term Transitional Services Agreement with Millennium to assist them in certain areas to ensure an orderly transition in the operations of the Clubs. Both Millennium and the Company entered into non-compete arrangements, that restricts each party's ability to compete in the others primary territories. Millennium, as the owner of these Clubs, remains responsible for general management of each Club and the Company is not involved in the management of the sold Clubs.

The operating results of the five Clubs sold have been classified as discontinued operations in the accompanying statements of operations. A reclassified condensed consolidated statement of discontinued operations for the three-month period ended March 31, 2005 and a listing of assets and liabilities held for sale at December 31, 2005, follows:

The Sports Club Company, Inc.
Reclassified Condensed Consolidated Statement of Discontinued Operations
Three Months Ended March 31, 2005
(unaudited)

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| | |
|---|-----------|
| Revenues: | |
| Membership revenues..... | \$ 15,221 |
| Products and services..... | 7,763 |
| Management fees..... | 92 |
| Reimbursed costs..... | 1,450 |
| | ----- |
| Total revenue..... | 24,526 |
| Operating expenses: | |
| Club operating costs..... | 12,858 |
| Costs of products and services..... | 6,046 |
| Selling and marketing..... | 785 |
| General and administrative..... | 58 |
| Reimbursed costs..... | 1,450 |
| | ----- |
| Total operating expenses..... | 21,197 |
| | ----- |
| Income from operations..... | 3,329 |
| Other income (expense): | |
| Interest, net..... | (2,472) |
| Minority interests..... | (331) |
| | ----- |
| Income from operations of discontinued operations before income taxes..... | 526 |
| Provision for income taxes..... | 151 |
| | ----- |
| Income from discontinued operations..... | \$ 375 |
| | ===== |

Note: Depreciation expense ceased effective January 1, 2005 upon classification of the assets as "Held for Sale."

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Assets and liabilities related to assets held for sale consist of the following:

| | |
|--|------------------------------|
| | December 31, 2005 ---- |
| | (in thousands) |
| Assets held for sale: | |
| Cash and cash equivalents..... | \$ 2,105 |
| Accounts receivable, net of allowance for doubtful accounts .. | 1,316 |
| Inventories..... | 419 |
| Prepaid expenses..... | 444 |
| Property and equipment, net..... | 123,279 |
| Other assets..... | 286 |

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| | |
|--|------------|
| Total assets held for sale..... | \$ 127,849 |
| ===== | |
| Liabilities related to assets held for sale: | |
| Accounts payable..... | \$ 485 |
| Accrued liabilities..... | 1,897 |
| Deferred revenues..... | 15,469 |
| Accrued lease obligations..... | 58,796 |
| Minority interest..... | 1,723 |
| ----- | |
| Total liabilities related to assets held for sale..... | \$ 78,370 |
| ===== | |

5. Cash, Cash Equivalents and Restricted Cash

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. On March 31, 2006, cash and cash equivalents were \$11.6 million.

The Company considers cash, cash equivalents and other investments that are required to be held as deposits to satisfy certain governmental regulatory or Club security deposits as restricted cash. At March 31, 2006, the Company had \$3.1 million of both short-term and long-term restricted cash.

6. Marketable Securities

At March 31, 2006, the Company held \$3.8 million and \$11.2 million of short-term and long-term marketable securities, respectively. All marketable securities were classified as held-to-maturity and carried at amortized cost. The marketable securities consisted entirely of Governmental Agency Notes and Bank Certificates of Deposit. At March 31, 2006, the estimated fair value of each investment approximated its amortized cost and therefore, there were no significant unrealized gains or losses.

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As of March 31, 2006, the Company's marketable securities were classified as follows (in thousands):

| | Amortized Cost ---- | Gross Unrealized Gains ----- | Los --- |
|-----------------------------------|---------------------------|------------------------------------|------------|
| Short Term | | | |
| ----- | | | |
| Bank Certificates of Deposit..... | \$ 600 | \$ -- | \$ |
| Federal Home Loan Bank Bonds..... | 3,222 | -- | |
| ----- | | | |
| Short-term total..... | \$ 3,822 | \$ -- | \$ |
| ----- | | | |
| Long Term | | | |

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| | | | | |
|--|----|--------|----|-------|
| ----- | | | | |
| Federal National Mortgage Association Notes..... | \$ | 4,605 | \$ | -- |
| Federal Home Loan Mortgage Corporation..... | | 4,546 | | -- |
| Federal Home Loan Bank Bonds..... | | 1,999 | | -- |
| | | ----- | | ----- |
| Long-term total..... | \$ | 11,150 | \$ | -- |
| | | ----- | | ----- |
| Total..... | \$ | 14,972 | \$ | -- |
| | | ===== | | ===== |

7. Receivable From Stockholder/Related Party

Concurrent with the asset sale (see Note 4 to the Company's condensed consolidated financial statements), the Company entered into a short-term Transitional Services Agreement with Millennium to assist them in certain areas to ensure an orderly transition in the operations of the Clubs. Millennium is the Company's largest stockholder and was the landlord at four of the Clubs that the Company sold. Income of \$628,000 for the three months ended March 31, 2006 for such services are included as other income in the accompanying condensed consolidated statement of operations. During this transitional services period the Company paid and or incurred certain expenses for the sold Clubs on behalf of Millennium for which Millennium is to reimburse the Company. At March 31, 2006, this receivable from stockholder/related party was \$1,465,000.

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8. Notes Payable and Equipment Financing Loans

Notes payable and equipment financing loans are summarized as follows:

| | December 31, 2005 ---- | March 31, 2006 ---- (unaudited) |
|-----------------------------------|------------------------------|--|
| | | (in thousands) |
| Senior secured notes (a)..... | \$ 100,000 | \$ -- |
| Mortgage note (b)..... | 19,250 | 19,136 |
| Mortgage note (c)..... | -- | 59,828 |
| Equipment financing loans (d).... | 63 | 59 |
| | ----- | ----- |
| | 119,313 | 79,023 |
| Less current installments..... | 100,373 | 1,330 |
| | ----- | ----- |
| | \$ 18,940 | \$ 77,693 |
| | ===== | ===== |

(a) On April 1, 1999, the Company issued in a private placement \$100.0 million of 11 3/8% Senior Secured Notes due in March 2006 (the "Senior Notes") with interest due semi-annually. In May 1999, the Senior Notes were exchanged for registered Series B Senior Secured Notes (the "Senior Secured Notes"). The Senior Secured Notes were secured by substantially all of the Company's assets, other than certain excluded

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assets. The notes were repaid in January 2006 with a portion of the funds received from the sale of five of the Company's Clubs (see Note 4 to the Company's condensed consolidated financial statements) and from funds received from the new mortgage on The Sports Club/LA - Los Angeles (See (c) below).

(b) On June 12, 2003, the Company obtained mortgage financing in the form of a secured five-year promissory loan in the amount of \$20.0 million. The loan is evidenced by a promissory note that bears interest at a fixed interest rate of 7.25%; requires monthly principal and interest payments of \$144,561; is secured by the common stock and all the assets of Irvine Sports Club, Inc., the Company's wholly owned subsidiary that owns The Sports Club/LA - Orange County; and is guaranteed by the Company's Chairman and its Chief Executive Officer. The note requires The Sports Club/LA - Orange County to maintain a minimum operating income, as defined, or the Company will be required to establish a payment reserve account of up to \$607,000. As of March 31, 2006, the Company has maintained the minimum operating income. The note may be prepaid at any time without penalty or premium and requires a final principal payment of \$18.3 million on July 1, 2008.

(c) In January 2006, the Company secured a \$60.0 million mortgage note at The Sports Club/LA - Los Angeles. The note, which matures in January 2016, is secured by all the real estate and other assets at The Sports Club/LA - Los Angeles, bears interest at 6.48% per annum and requires monthly payments of \$404,375 which amortizes the loan over a twenty-five year period. Two of the Company's shareholders executed limited guarantees under which the lender has recourse to them in certain circumstances. The Company has agreed to indemnify these shareholders under certain circumstances for losses under this guarantee. In exchange for the guarantee, the Company pays each guarantor a fee equal to .75% per annum of the average outstanding principal balance of the loan. Such fees may be paid in Common Stock, cash or a combination thereof at the Company's discretion.

(d) The equipment financing loans are secured by furniture, fixtures and equipment. The amounts are generally repayable in monthly payments over four or five years.

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9. Consolidated Statements of Operations

Total revenue and total operating expenses consist of the following:

| | Three Months Ended March 31, ----- (in thousands) | |
|----------------------|--|--------------|
| | 2005 ---- | 2006 ---- |
| | (unaudited) | (unaudited) |
| Revenues: | | |
| Membership revenues: | | |
| Monthly dues..... | \$ 8,468 | \$ 8,990 |
| Initiation fees..... | 521 | 605 |

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| | | |
|--|-----------|-----------|
| Other..... | 177 | 184 |
| | ----- | ----- |
| Total membership revenues..... | 9,166 | 9,779 |
| | ----- | ----- |
| Products and Services: | | |
| Private training..... | 2,376 | 2,684 |
| Food and beverage..... | 1,088 | 1,149 |
| Spa services..... | 492 | 552 |
| Physical therapy..... | 314 | 267 |
| Other..... | 203 | 132 |
| | ----- | ----- |
| Total products and services..... | 4,473 | 4,784 |
| | ----- | ----- |
| Total revenue..... | \$ 13,639 | \$ 14,563 |
| | ===== | ===== |
| Operating expenses: | | |
| Club operating costs: | | |
| Payroll and benefits..... | \$ 2,718 | \$ 2,645 |
| Rent..... | 1,329 | 1,329 |
| Other operating costs..... | 2,448 | 2,812 |
| | ----- | ----- |
| Total Club operating costs..... | 6,495 | 6,786 |
| | ----- | ----- |
| Costs of products and services: | | |
| Private training..... | 2,006 | 2,222 |
| Food & beverage..... | 1,088 | 1,147 |
| Spa services..... | 442 | 474 |
| Physical therapy..... | 217 | 172 |
| Other..... | 27 | -- |
| | ----- | ----- |
| Total cost of products and services... | 3,780 | 4,015 |
| | ----- | ----- |
| Sales and marketing..... | 506 | 693 |
| General and administrative..... | 2,048 | 2,248 |
| Depreciation and amortization..... | 1,224 | 1,137 |
| Impairment charge..... | -- | 713 |
| | ----- | ----- |
| Total operating expenses..... | \$ 14,053 | \$ 15,592 |
| | ===== | ===== |

10. Net Income (Loss) per Share

Basic and diluted loss per share represents the net loss less Preferred Stock dividends divided by the weighted-average number of shares of Common Stock outstanding for the period. Diluted loss per share excludes the dilutive effect of potential common shares. For the three-months ended March 31, 2005 and 2006, there were 3,332,465 and 4,042,300 anti-dilutive potential common shares, respectively.

11. Series B Redeemable Convertible Preferred Stock

On March 18, 2002, the Company completed a \$10.5 million private placement of a newly created series of its redeemable convertible Preferred

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Stock. The Company received \$9.9 million in cash, after issuance costs, and issued 10,500 shares of Series B Preferred Stock, \$.01 par value ("Series B Preferred"), at a price of \$1,000 per share. The Company has the option to redeem any outstanding shares of Series B Preferred at any time and the holders may require the redemption of any outstanding shares of Series B Preferred on or after March 18, 2009 at a price of \$1,000 per share plus accrued but unpaid dividends. Dividends accrue at the annual rate of \$90.00 per share. Such dividends are cumulative but do not accrue interest and at the Company's option, may be paid in cash or in additional shares of Series B Preferred. The Series B Preferred may, at the option of the holder, be converted into shares of Common Stock at the rate of \$2.8871 per share, as adjusted for the issuance of Series D Preferred Stock in March 2004. At March 31, 2006, the Series B Preferred, including accrued dividends of \$3,836,000, was convertible into 4,965,536 shares of Common Stock. The conversion price will be adjusted downward in the event the Company issues additional shares of Common Stock at a price below \$2.8871 per share, subject to certain exceptions; and any such downward adjustment is subject to the prior approval of the American Stock Exchange. In the event of liquidation, the Series B Preferred holders are entitled to receive, prior and in preference to any distribution to common shareholders and pari passu with holders of the Series C Convertible Preferred Stock, an amount equal to \$1,000 for each share of Series B Preferred then outstanding. Since this series of Preferred Stock is conditionally redeemable it has been classified between stockholders' equity and total liabilities in the accompanying balance sheet.

The initial carrying value of the Series B Preferred was recorded at its sale price less costs to issue on the date of issuance. The carrying value of the Series B Preferred is periodically adjusted so that the carrying value equals the redemption value on the redemption date. The carrying value of the Series B Preferred will also be periodically adjusted for any accrued and unpaid dividends. At December 31, 2005 and March 31, 2006, the Series B Preferred carrying value consisted of the following (\$ in thousands):

| | December 31, 2005 ---- | March 31, 2006 ---- |
|---|------------------------------|---------------------------|
| | | (unaudited) |
| Initial fair value, sale price of \$10,500 | | |
| less costs to issue of \$592.....\$ | 9,908 | \$ 9,908 |
| Redemption value accretion..... | 324 | 345 |
| Accrued and unpaid dividends accretion..... | 3,598 | 3,836 |
| | ----- | ----- |
| Total carrying value.....\$ | 13,830 | \$ 14,089 |
| | ===== | ===== |

12. Series C Convertible Preferred Stock

On September 6, 2002, the Company completed a \$5.0 million private placement of a newly created series of convertible Preferred Stock. The Company received \$5.0 million in cash and issued 5,000 shares of Series C Convertible Preferred Stock, \$.01 par value ("Series C Convertible Preferred"), at a price of \$1,000 per share. Dividends accrue at an annual rate of \$90.00 per share. Dividends are payable when and as declared by the Board of Directors. Such

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dividends are cumulative, but do not accrue interest and at the Company's option, may be paid in cash or additional shares of Series C Convertible Preferred. Dividends are paid pari passu with dividends on the Series B Preferred. In addition, upon conversion any earned and unpaid dividends would become payable. The Series C Convertible Preferred may, at the option of the holder, be converted into shares of Common Stock at the rate of \$2.8871 per share, as adjusted for the issuance of Series D Preferred Stock in March 2004. At March 31, 2006, the Series C Preferred, including accrued dividends of \$1,601,000, was convertible into 2,286,377 shares of Common Stock. Upon conversion, any earned and unpaid dividends would become payable in cash or additional shares of Series C Convertible Preferred, at the Company's option. The conversion price will be adjusted downward in the event the Company issues additional shares of Common Stock at a price below \$2.8871 per share, subject to certain exceptions; and any such downward adjustment is subject to the prior approval of the American Stock Exchange. At the option of the Company, the Series C Convertible Preferred may be redeemed in whole or in part by paying in cash the sum of \$1,000 per share plus any earned and unpaid dividends. In the event of liquidation, the Series C Convertible Preferred holders are entitled to receive, prior and in preference to any distribution to common shareholders, and pari passu with holders of the Series B Preferred, an amount equal to \$1,000 for each share of Series C Convertible Preferred then outstanding, plus earned and unpaid dividends.

The carrying value of the Series C Convertible Preferred is periodically adjusted for any accrued and unpaid dividends. At December 31, 2005 and March 31, 2006, the Series C Convertible Preferred carrying value consisted of the following (in thousands):

| | December 31, 2005 ---- | March 31, 2006 ---- |
|--|------------------------------|---------------------------|
| | | (unaudited) |
| Initial fair value..... | \$ 5,000 | \$ 5,000 |
| Accrued and unpaid dividend accretion..... | 1,490 | 1,601 |
| | ----- | ----- |
| Total carrying value..... | \$ 6,490 ===== | \$ 6,601 ===== |

13. Series D Convertible Preferred Stock

On March 12, 2004, the Company completed a \$6.5 million private placement of a newly created series of Convertible Preferred Stock. The Company received \$6.1 million in cash, after issuance costs of \$428,000, and issued 65,000 shares of \$.01 par value Series D Convertible Preferred Stock ("Series D Convertible Preferred"), at a price of \$100 per share. The Series D Convertible Preferred was purchased by three of the Company's principal shareholders. Dividends accrue at an annual rate of \$9.00 per share and shall be paid prior and in preference to any dividends earned on the Series B Preferred, Series C Convertible Preferred, Common Stock or any other class of equity security that is junior to the Series D Convertible Preferred. Dividends are payable when and as declared by the Board of Directors. Such dividends are cumulative, but do not accrue interest and at the Company's option, may be paid in cash or additional shares of Series D Convertible Preferred. The Series D Convertible Preferred may, at the option of the holder, be converted into shares of Common Stock at the

rate of \$2.00 per share. At March 31, 2006, the Series D Preferred, including accrued dividends of \$1,201,000, was convertible into 3,850,500 shares of Common Stock. Each share of Series D Convertible Preferred shall

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automatically be converted into shares of Common Stock upon the consummation of a qualified public offering of Common Stock of at least \$50.0 million or if the closing price of the Common Stock for a period of thirty consecutive trading days exceeds \$6.00 per share and at least 150,000 shares of Common Stock have been traded during such applicable thirty day period. Upon conversion, any earned and unpaid dividends would become payable. The conversion price will be adjusted equitably in the event of any combination, recapitalization, merger, reclassification or similar transaction or issuance of Common Stock (or any instrument convertible into or exercisable for Common Stock) at a price per share less than \$2.00. Commencing on the sixth anniversary of the issuance of the Series D Convertible Preferred, the Company at its option may redeem the Series D Convertible Preferred in whole or in part by paying in cash the sum of \$100 per share plus any earned and unpaid dividends. In the event of liquidation, the Series D Convertible Preferred holders are entitled to receive, prior and in preference to any distribution to common shareholders and holders of the Series B Preferred and Series C Convertible Preferred, an amount equal to \$100 for each share of Series D Convertible Preferred then outstanding, plus any earned and unpaid dividends. The holders of the Series D Convertible Preferred are afforded protective rights that among other things restrict the Company's ability to incur debt or lease obligations, make investments or acquisitions, sell a Club leased from Millennium, issue any new class of equity securities, repurchase or redeem any equity securities, hire or fire the Chief Executive Officer, enter into any new line of business or change the primary line of business and issue options under the Company's stock option plans. The Company obtained all necessary approvals from the holders of the Series D Convertible Preferred for the sale of the Clubs to Millennium and for the mortgage financing of The Sports Club/LA - Los Angeles, on January 13, 2006 (see Note 4 to the Company's condensed consolidated financial statements). In addition, Millennium is entitled to designate two directors (at least one of whom must be independent) and the other two holders are each entitled to designate one director, to serve on the Company's Board of Directors.

The carrying value of the Series D Convertible Preferred is periodically adjusted for any accrued and unpaid dividends. At December 31, 2005 and March 31, 2006, the Series D Convertible Preferred carrying value consisted of the following (in thousands):

| | December 31, 2005 ---- | March 31, 2006 ----- (unaudited) |
|--|------------------------------|---|
| Initial fair value..... | \$ 6,500 | \$ 6,500 |
| Issuance costs..... | (428) | (428) |
| Accrued and unpaid dividend accretion..... | 1,056 | 1,201 |
| | ----- | ----- |
| Total carrying value..... | \$ 7,128 ===== | \$ 7,273 ===== |

14. Series E Redeemable Preferred Stock

On September 14, 2004, the Company completed a \$2.0 million private placement of a newly created series of Redeemable Preferred Stock. The Company received \$2.0 million in cash and issued 20,000 shares of \$.01 par value Series E Preferred Stock ("Series E Preferred") at a price of \$100 per share. The Series E Preferred was purchased by three of the Company's principal shareholders consisting of Kayne Anderson Capital Advisors, Rex Licklider and D. Michael Talla. Dividends accrue at an annual rate of \$11.375 per share. Dividends are cumulative, do not accrue interest and, at the Company's option, may be paid in additional shares of Series E Preferred. The Series E Preferred is not convertible into shares of the

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Company's Common Stock and, except as required by law, does not entitle the holder(s) to vote on matters brought before the Company's stockholders. At any time after May 31, 2006, provided the Company is legally able to do so, (i) the Company may, redeem all or part of the Series E Preferred for cash at the redemption price of \$100.00 per share, together with all accrued but unpaid dividends or (ii) the holders of at least 50% of the Series E Preferred may demand that the Company redeem all the shares of the Series E Preferred by paying the redemption price in cash to each holder of the Series E Preferred. Since this series of Preferred Stock is conditionally redeemable it has been classified between stockholders' equity and total liabilities in the accompanying balance sheet.

This initial carrying value of the Series E Preferred was recorded at its sales price. The carrying value of the Series E Preferred is periodically adjusted for any accrued and unpaid dividends. At December 31, 2005 and March 31, 2006, the Series E Preferred carrying value consisted of the following (in thousands):

| | December 31, 2005 ---- | March 31, 2006 ---- |
|---|------------------------------|---------------------------|
| | | (unaudited) |
| Initial fair value..... | \$ 2,000 | \$ 2,000 |
| Accrued and unpaid dividends accretion..... | 295 | 351 |
| | ----- | ----- |
| | \$ 2,295 | \$ 2,351 |
| | ===== | ===== |

In June 2006, as allowed under the terms of the Series E Preferred, the Company redeemed all outstanding shares in cash for the redemption price of \$100.00 per share plus any accrued and unpaid dividends.

15. Note Receivable From Stockholder

On January 13, 2006, the Company completed the sale of five Clubs to Millennium for \$80.0 million (see Note 4 to the Company's condensed consolidated financial statements). Millennium is the Company's largest stockholder and was the landlord at four of these Clubs. The Company received \$50.0 million in cash upon closing the sale and received two Notes from Millennium. The first Note of \$22.2 million was due and was collected on January 31, 2006. The second Note of \$7.8 million is due on January 13, 2013, and is secured by a pledge of the Series C and Series D Preferred Stock owned by Millennium. The Note is also guaranteed by an affiliate of Millennium. The Note bears interest at the rate of nine percent (9.0%) per annum and the interest shall accrue and be payable on the Maturity Date.

On June 14, 2006, the Company repurchased all of Millennium's Series C and Series D Convertible Preferred Stock and concurrently, Millennium prepaid the entire Note. Due to the terms and nature of the Note and to the Company's relationship with Millennium, the Company has classified the Note as a reduction of Stockholders Equity in the March 31, 2006 condensed consolidated balance sheet.

16. Litigation

The Company is involved in various claims and lawsuits incidental to its business, including claims arising from accidents. However, in the opinion of management, the Company is adequately insured against such claims and lawsuits involving personal injuries,

and any ultimate liability arising out of any such proceedings, whether insured or not, will not have a material adverse effect on the Company's consolidated financial condition, cash flows or results of operations.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our historical results of operations and our liquidity and capital resources should be read in conjunction with the condensed consolidated financial statements and related notes appearing elsewhere herein. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures. On an on-going basis, we evaluate our estimates and judgments that are based on historical experience and other assumptions that we believe to be reasonable under the circumstances. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements.

Overview

We are currently the operator of four sports and fitness Clubs located in the Los Angeles and New York metropolitan markets. Our Clubs are spacious, modern facilities that typically include spas, restaurants, fitness centers, swimming pools and basketball courts. Our Clubs, which are named The Sports Club/LA, are recognized as among the finest sports and fitness facilities in the United States.

Three of our four Clubs range in size from 90,000 to 140,000 square feet. Due to the size of these facilities and the additional amenities included in our Clubs, we spend significant amounts to construct a new facility. We compare the results of our Clubs based upon how long the Clubs have been open at the most recent measurement period. We categorize Clubs as either mature or recently opened. Mature Clubs are those Clubs at which we believe the membership levels have reached a stable level and based upon the amount of new membership sales and attrition, or the size of the Club, we do not believe a significant additional growth in the membership level will occur. Clubs are considered to be recently opened while the membership level is increasing. Three of the Clubs that we own are considered to be mature. The Sports Club/LA - Beverly Hills was opened in October 2003 and is now nearing its optimum membership level. Newly developed Clubs tend to achieve significant increases in revenues until a mature membership level is reached. Recently opened Clubs that have not yet achieved mature membership levels have operated at a loss or only a slight profit as a result of fixed expenses that, together with variable operating expenses, approximate or exceed membership fees and other revenues.

In 1999, we decided to expand The Sports Club/LA brand on a national scale. We issued \$100.0 million of Senior Secured Notes that were scheduled to mature in March 2006 and used the proceeds to construct six new Clubs between 2000 and 2004. We invested significant amounts of cash in the construction and operation of these new Clubs. Our operating performance and our liquidity were negatively impacted due to the initial construction cost and start up costs and the delay or failure of the Clubs to generate positive cash flows.

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During 2005, the operations of these new Clubs increased to the level where our operating cash flows were sufficient to cover our debt service and capital expenditure obligations. However, we were faced with the maturity of the \$100.0 million of debt in March 2006, so in December 2004, we decided to sell some of our Clubs and seek new financing of The Sports Club/LA - Los Angeles property. On January 13, 2006, we completed the sale of five of our nine sports and fitness Clubs for \$80.0 million. Concurrent with the sale, we completed a \$60.0 million financing of The Sports Club/LA - Los Angeles. Proceeds from

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these transactions were used to retire the \$100.0 million Senior Secured Notes. Following the sale, we continue to own and operate four Clubs: The Sports Club/LA - Los Angeles, The Sports Club/LA - Beverly Hills, The Sports Club/LA - Orange County and The Sports Club/LA - New York at Rockefeller Center. The operating results from the five Clubs we sold and the fees and costs associated with the Miami management agreement that has been terminated have been classified as Discontinued Operations in the accompanying condensed consolidated financial statements and in the other parts of this Form 10-Q.

We measure performance using key operating statistics such as initiation fees, monthly dues and ancillary revenues per member. We closely focus on new membership sales and the level of membership attrition at each Club. We also closely evaluate our expenses with an emphasis on controlling payroll costs. We use Club operating income, before depreciation expenses and rent expense as a means to evaluate the overall performance of an individual Club.

We have two primary sources of revenues. First, our largest source of revenue is from membership dues and initiation fees. We recognize revenue from dues in the month it is earned. Initiation fees are deferred and recognized as revenue on a straight-line basis over the membership lives of each Club based on each individual Club's respective average membership life. Secondly, we generate ancillary revenue from our membership within each Club. The largest of these revenues comes from individual private training. We also generate revenues from our spas, restaurants, childcare, sports programs and guest fees. Our total ancillary revenues for our continuing operations, represent 32.8% of total Club revenue and we believe that percentage is among the highest in the industry. We believe that membership levels are the primary indicator of a Club's ability to generate revenue. Therefore, we are consistently generating programs to market the Clubs to potential new members as well as striving to reduce our membership attrition rates. We believe our current attrition rate at the Clubs we still own of 28.9% is well below the norm in the industry.

Our direct expenses include costs to operate our Clubs. These consist primarily of payroll and employee benefits, rent and other occupancy related costs, supplies, repairs, costs of products sold and various other operating costs. A significant amount of these costs are fixed in nature.

General and administrative expenses include costs related to our centralized support functions such as accounting, information technology, development and our executive management. Costs associated with being a publicly owned company are also included in this category. Selling expenses include our advertising, marketing department and promotional costs associated with the generation of new memberships.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to

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make estimates and assumptions that affect the reported amounts of the assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We base these estimates and assumptions upon historical experience and existing known circumstances. Actual results could differ from those estimates. Specifically, we must make estimates in the following areas:

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Revenue Recognition. We receive initiation fees and monthly membership dues from our members. Substantially all of our members join on a month-to-month basis and can therefore cancel their membership at any time. The transaction in which we receive initiation fees may include free private training sessions. Under Emerging Issues Task Force 00-21, Revenue Arrangement with Multiple Elements, we determined that the initiation fees and private training sessions did not represent separate units of accounting. Accordingly, initiation fees and related direct expenses, primarily sales commissions, are deferred and recognized, on a straight line basis, over the average membership life. Effective in the second quarter of 2005, we started amortizing initiation fees over the membership lives of each Club based on each individual Club's respective average membership life. Dues that are received in advance are recognized on a pro-rata basis over the periods in which services are to be provided. In addition, payments of last months' dues are deferred. Revenues for services including private training, spa treatments and physical therapy sessions are recorded when such services are performed. Amounts received in advance are recorded as deferred revenues. Revenues from our SportsMed subsidiary are recognized when the services are rendered based upon the estimated amount to be collected.

Allowance for doubtful accounts. We provide a reserve against our receivables for estimated losses that may result from our members' inability to pay. We determine the amount of the reserve by analyzing known uncollectible accounts, economic conditions and historical losses and our members' creditworthiness. The likelihood of a material loss from this area is minimal due to our limited exposure to credit risk.

Lease Accounting. We record rent expense on facilities under operating leases. The aggregate rental obligation is expensed on a straight line basis over the lease term, commencing with the date when we take possession of the property. If the lease imposes a significant economic penalty not to renew an option period, we use the initial period plus the option period as the lease term. Rent incurred before the facility is ready for use is capitalized as leasehold improvements. Effective December 15, 2005, the Company adopted FASB Staff Position 13-1 Accounting for Rental Costs Incurred During a Construction Period, which requires rental costs incurred during construction be expensed.

Impairment of long-lived assets. The carrying value of our long-lived assets is reviewed annually and whenever events or changes in circumstances indicate that such carrying values may not be recoverable. We consider a history of consistent and significant operating losses to be our primary indicator of potential impairment. Assets are grouped and evaluated for impairment at the lowest level for which there are identifiable cash flows, which is generally at an individual Club. Through 2005, we evaluated our three New York City Clubs as a group since they were located in the same geographical area, were operated and evaluated as a group and memberships allowed the members to use any of the New York Clubs. Operating the Clubs as a group allowed us to compete more effectively with the local competition which also have multiple locations. Due to the sale of two New York Clubs, we now evaluate the remaining long-lived asset in New York on a stand alone basis. The determination of whether an

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impairment has occurred is based on an estimate of undiscounted future cash flows directly related to that Club or group of Clubs compared to the carrying value of the assets. If an impairment has occurred, the amount of impairment recognized is determined by estimating the fair value of the assets and recording a loss if the carrying value is greater than the fair value. At December 31, 2005, the evaluation of The Sports Club/LA - New York at Rockefeller Center resulted in an impairment charge of \$18.6 million. At March 31, 2006, the evaluating of The Sports Club/LA - New York at Rockefeller Center resulted in an impairment charge of \$713,000.

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Valuation of goodwill. We recorded goodwill in connection with our acquisitions of The Sports Club/LA in Los Angeles and Orange County, Reebok Sports Club/NY and SportsMed. We are required to evaluate goodwill on an annual basis or when certain events require us to reevaluate our goodwill. We performed the analysis, as of December 31, 2003, 2004 and 2005, and determined that our remaining goodwill was not impaired. No events occurred in the three months ended March 31, 2006, that require the Company to re-evaluate its goodwill.

Marketable Securities. At March 31, 2006, the Company held \$3.8 million and \$11.2 million of short-term and long-term marketable securities, respectively. All marketable securities were classified as held-to-maturity and carried at amortized cost. The marketable securities consisted entirely of United States Treasury Notes and other Governmental Agency Notes. At March 31, 2006, the estimated fair value of each investment approximated its amortized cost and therefore, there were no significant unrealized gains or losses.

Valuation of deferred income taxes. Valuation allowances are established to reduce deferred tax assets to the amount expected to be realized. The likelihood of material change in our expected realization of these assets depends on future taxable income, our ability to deduct tax loss carry forwards against future taxable income, the effectiveness of our tax planning and strategies among the various tax jurisdictions in which we operate and any significant changes in the tax laws.

Interest expense. In accordance with Emerging Issues Task Force ("EITF") Issue No. 87-24, Allocation of Interest to Discontinued Operations, interest was allocated to discontinued operations based on the interest on debt that was required to be repaid as a result of disposal transactions. On January 13, 2006, we completed the sale of five of our nine sports and fitness Clubs (see Footnote Note 4 to our condensed consolidated financial statements appearing elsewhere in this 10-Q). The proceeds of \$80.0 million from the sale were required to be used to repay a portion of our \$100.0 million of Senior Secured Notes. Accordingly we have allocated to discontinued operations 80.0% of the interest expense associated with the Senior Secured Notes. For the three-month period ended March 31, 2005, the amount of interest allocated to discontinued operations was \$2,476,000. Due to the relatively short period that the Company owned the Clubs during 2006, no interest was allocated to discontinued operations for the three-month period ended March 31, 2006.

Results of Operations

Several reclassifications have been made to the condensed consolidated statement of operations for the three months ended March 31, 2005, primarily due to our decision to retain The Sports Club/LA - New York at Rockefeller Center, as discussed in Note 2 to the condensed consolidated financial statements, in accordance with Statement of Financial Accounting Standards No. 144, Accounting for Impairment and Disposal of Long-Lived Assets. The following discussion that compares our results of operations is after consideration of such reclassifications.

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Comparison of Three Months Ended March 31, 2006 to Three Months Ended March 31, 2005.

Our total revenue from continuing operations for the three months ended March 31, 2006, was \$14.6 million, compared to \$13.7 million for the same period in 2005, an increase of \$924,000 or 6.8%. Revenue increased by \$549,000 at The Sports Club/LA - Beverly Hills primarily as a result of an 11.9% increase in membership between March 2005 and March

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2006 and to annual rate increases for dues and other ancillary services. Revenue increased by \$226,000 at The Sports Club/LA - New York at Rockefeller Center primarily as a result of a 7.9% increase in membership between March 2005 and March 2006 and to annual rate increases for dues and other ancillary services. Revenue increased by \$196,000 at The Sports Club/LA - Los Angeles and The Sports Club/LA - Orange County primarily as a result of dues increases and to higher ancillary revenues, mostly private training revenues. There was a decrease in revenue of approximately \$47,000 at our two SportsMed locations primarily due to decreased patient visits.

Our club operating costs and cost of products and services increased by \$526,000, or 5.1% to \$10.8 million for the three months ended March 31, 2006, versus \$10.3 million for the same period in 2005. Club operating costs and cost of products and services increased by approximately \$199,000, as a result of the increases in variable costs (mostly payroll, payroll related, supplies and other operating expenses) associated with the increase in membership and revenues at The Sports Club/LA-Beverly Hills. Club operating costs and cost of products and services increased by approximately \$348,000, as a result of the increases in variable costs (mostly payroll, payroll related, supplies and other operating expenses) associated with the increase in membership and revenues at The Sports Club/LA- New York at Rockefeller Center. Club operating costs and cost of products and services increased by approximately \$24,000 at The Sports Club/LA - Los Angeles and The Sports Club/LA - Orange County primarily due to increased utility and supply costs. There was a decrease in cost of products and services of approximately \$45,000 at our two SportsMed facilities due to a decrease in the number of patient visits.

Our selling and marketing expenses were \$693,000 for the three months ended March 31, 2006, versus \$506,000 for the same period in 2005, an increase of \$187,000 or 37.0%. The increase in selling and marketing expenses is primarily the result of not allocating various corporate level selling and marketing costs to Clubs that were sold (see Note 4 to our condensed consolidated financial statements). Prior to the sale we allocated certain corporate level selling and marketing costs to all nine Clubs that we owned. Once the five Clubs were sold we could no longer allocate these selling and marketing costs to the sold Clubs. We have been able to reduce our corporate level selling and marketing costs as a result of the reduced number of Clubs that our corporate sales and marketing department now supports, but due to the fixed nature of some of the expenses we have not been able to reduce our selling and marketing cost in proportion to the number Clubs sold.

Our general and administrative expenses were \$2.2 million for the three months ended March 31, 2006, versus \$2.0 million for the same period in 2005, an increase of \$200,000. Rent decreased by \$155,000 as a result of relocating the corporate office. Licenses and permits increased by \$77,000 primarily as a result of a City of Los Angeles business license required for the corporate administrative offices. The remaining increase in general and administrative expenses of approximately \$278,000 is primarily the result of not allocating various corporate level general and administrative expenses to Clubs that were

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sold (see Note 4 to our condensed consolidated financial statements). Prior to the sale we allocated certain corporate level general and administrative expenses to all nine Clubs that we owned. Once the five Clubs were sold we could no longer allocate these general and administrative expenses to the sold Clubs. We have reduced our corporate level employee headcount and have been able to eliminate other corporate level general and administrative expenses as a result of the reduced number of Clubs that we now support, but due to the fixed nature of some of the expenses we have not been able to reduce our general and administrative expenses in proportion to the number of Clubs sold.

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We incurred an impairment charge during the three months ended March 31, 2006, of \$713,000. This impairment charge consisted of the write down of fixed assets at The Sports Club/LA - New York at Rockefeller Center. The future estimated cash flows from this Club were not adequate to recover the net book value of its fixed assets. As a result, we were required to write down the fixed assets to their estimated fair value.

Our depreciation and amortization expenses were \$1.1 million for the three months ended March 31, 2006, versus \$1.2 million for the same period in 2005, a decrease of \$87,000 or 7.1%. Depreciation and amortization expenses increased by \$27,000, primarily due to capital additions made at The Sports Club/LA - Los Angeles and The Sports Club/LA - Orange County during 2005 and 2006. Depreciation and amortization expenses decreased by \$114,000 at the corporate office facility due to the relocation to a new smaller facility.

Net interest expense from continuing operations increased by \$1.1 million to \$2.3 million for the three months ended March 31, 2006, versus \$1.2 million for the same period in 2005. Due to the sale of the discontinued Clubs in January 2006, we stopped allocating interest costs on our \$100.0 million of Senior Secured Notes to our discontinued operations and this resulted in an increase in net interest expense from continuing operations of \$707,000. Conditions attached to the Senior Secured Notes prevented us from paying them off on the date we sold the discontinued Clubs and we did not pay them off until late February 2006. In January 2006 we entered into a new mortgage for \$60.0 million, secured by the assets of The Sports Club/LA - Los Angeles. Interest on this mortgage increased net interest expense from continuing operations by \$842,000. Net interest expense from continuing operations increased by \$156,000 due to guarantee fees incurred on the \$60.0 million mortgage. Two of our largest stockholders have personally guaranteed a portion of the mortgage and we pay them each a guarantee fee for this personal guarantee. Net interest expense from continuing operations decreased by \$594,000 due to interest income earned on the excess proceeds and notes receivable generated from the asset sale.

During the three months ended March 31, 2006, we recorded other income of \$628,000. This other income consists of transitional services fees charged the new owner of the five Clubs we sold in January 2006 (see Note 4 to our condensed consolidated financial statements).

We did not record any federal or state deferred tax benefit related to our consolidated pre-tax losses from continuing operations for the three months ended March 31, 2006 and March 31, 2005.

Our income from discontinued operations was \$47,000 for the three months ended March 31, 2006, versus income from discontinued operations of \$375,000 for the same period in 2005, a decrease of \$328,000. We sold these discontinued Clubs effective January 1, 2006, with a closing date of January 13, 2006. The income from discontinued operations of \$47,000 for the three months ended March 31, 2006 is the profit incurred during January 2006 related to these sold Clubs.

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After the income from discontinued operations and dividends on preferred stock of \$549,000 during the three months ended March 31, 2006 and \$493,000 during the three months ended March 31, 2005, our consolidated net loss attributable to common stockholders was \$3.2 million, or \$0.17 per basic and diluted share for the three months ended March 31, 2006, versus a loss of \$1.7 million, or \$0.09 per basic and diluted share for the three months ended March 31, 2005.

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Liquidity and Capital Resources

Liquidity

In 1999, we decided to expand The Sports Club/LA brand on a national scale. We issued \$100.0 million of Senior Secured Notes that were scheduled to mature in March 2006 and used the proceeds to construct six new Clubs between 2000 and 2004. We invested significant amounts of cash in the construction and operations of these new Clubs. As typically happens when a new Club is open, these Clubs operated at minimal or negative cash flows during their early stages of operation as their membership levels were increasing. Because of this, we did not have cash on hand to meet our interest obligations under the Senior Secured Notes and therefore, between March 2002 and September 2004, we raised \$24.0 million through four separate Preferred Stock issuances. During 2005, the operations of these new Clubs increased to the level where our operating cash flows were sufficient to cover our debt service and capital expenditure requirements. However, we were faced with the maturity of the \$100.0 million of debt in March 2006, so in December 2004, we decided to sell some of our Clubs and seek new financing of The Sports Club/LA - Los Angeles property. On January 13, 2006, we completed the sale of five of our nine sports and fitness Clubs for \$80.0 million. We received \$50.0 million in cash upon closing the sale and received two notes from Millennium. The first note of \$22.2 million was paid in cash in January 2006 and the second note of \$7.8 million was satisfied by redeeming Millennium's Preferred Stock in June 2006. The net proceeds from the sale exceeded the carrying value of the net assets sold by approximately \$24.8 million. Millennium has two directors on the Company's board of directors, is a major stockholder of the Company and was the landlord at four of the five Clubs that were sold. Millennium is a related party, as defined by generally accepted accounting principles and by the United States Securities and Exchange Commission. Accordingly, the amount by which the net proceeds from the sale of the five Clubs to Millennium exceeded their carrying value has been classified as a capital contribution in the accompanying condensed consolidated financial statements. Concurrent with the sale, we completed a \$60.0 million financing of The Sports Club/LA - Los Angeles. Proceeds from these transactions were used to retire the \$100.0 million Senior Secured Notes.

Following the sale, we continue to own and operate four Clubs. We believe our remaining consolidated operations will generate sufficient cash flows to cover our operating costs and debt service obligation for the next twelve months. At March 31, 2006, we have \$26.6 million of cash and marketable securities to fund our operations going forward.

We plan on spending more than the normal amount on capital expenditures at three of our Clubs during 2006. Normally, we would expect to spend between 3-4% of revenues on capital expenditures. This would approximate \$2.0 million per year. In 2006, we plan on replacing much of our cardio vascular and weight training equipment, carpeting, audio-visual equipment and lockers at these three Clubs as well as making other significant capital expenditures. Therefore, we have budgeted \$7.6 million for capital expenditures in 2006.

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We retired our Series E Preferred Stock in June 2006. We used \$2.4 million of cash to redeem the stock and pay the accrued dividends. At that time we also paid all accrued dividends on the Series B, C and D Preferred Stock as well as retired the Series C and D Preferred Stock owned by Millennium. This resulted in the retirement of an additional \$13.4 million of Preferred Stock and accrued dividends. We were required to use \$4.3 million of cash to make these redemptions since the amounts due to Millennium were offset against a Note receivable we had from them and a portion of the accrued dividends were paid by issuing additional shares of Series C Preferred Stock.

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Substantial funds are required to develop additional new Clubs. Our current debt levels make it difficult for us to secure the financing to develop additional new sites. Therefore we would expect any new Clubs to be structured as joint ventures, partnership agreements or management arrangements. We are currently pursuing several potential new Club developments that would be structured in that manner. This structure would allow us to expand our brand and receive an immediate earnings stream and cash flow, with the potential for additional profits, without making the significant capital investment required to develop a club without a partner.

Operating Activities

At December 31, 2005, our cash balance was \$10.3 million. In January 2006, we completed the sale of five Clubs, financed The Sports Club/LA - Los Angeles and retired our \$100.0 million Senior Secured Notes leaving us with \$26.6 million of cash and marketable securities at March 31, 2006. We believe we will generate positive cash flows from operating activities in the future.

Investing Activities

Investing activities consist of new Club development and expenditures to maintain and update our existing Clubs. Our Clubs are upscale and capital improvements are regularly needed to retain the upscale nature and presentation of the Clubs. A deterioration of the quality of the Clubs can lead to reduction in membership levels and lower revenues. In the first quarter of 2006, capital expenditures to maintain and update our Clubs, were \$3.1 million. We normally estimate that expenditures of between 3% and 4% of revenues, depending on the age of the Club, will be necessary to maintain the quality of the Clubs to our satisfaction. However, in 2006 we plan on spending approximately \$7.6 million in capital expenditures at our four Clubs. We plan to replace most cardio vascular and weight training equipment, carpeting, audio visual equipment and lockers at our three established Clubs and upgrade our management information systems and enhance our disaster recovery capabilities.

We currently have no definitive plans for new Club developments that would require our own capital. However, we are in preliminary discussion with several parties about the possibility of developing new Clubs under management agreements.

Financing Activities

On April 1, 1999, we issued in a private placement \$100.0 million of 11 3/8% Senior Secured Notes due in March 2006, with interest due semi-annually. The Senior Secured Notes were issued pursuant to the terms of an indenture agreement dated April 1, 1999 (the "Indenture"). The Senior Secured Notes were secured by substantially all of our assets, other than certain excluded assets. The Senior Secured Notes were repaid in January 2006 with the proceeds from the sale of five of our Clubs and the financing of The Sports Club/LA - Los Angeles.

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On June 12, 2003, we obtained financing in the form of a secured five-year promissory loan in the amount of \$20.0 million. The loan is evidenced by a promissory note that bears interest at a fixed interest rate of 7.25%; requires monthly principal and interest payments of \$144,561; is secured by the common stock and all the assets of Irvine Sports Club, Inc., our wholly owned subsidiary that owns The Sports Club/LA - Orange County; and is

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guaranteed by two of our major stockholders. The note may be prepaid at any time without penalty and requires a final payment of \$18.3 million on July 1, 2008.

In March 2004, three of our principal shareholders purchased \$6.5 million of a newly created class of Series D Convertible Preferred Stock in a private placement offering. The proceeds were used to pay the March 15, 2004 interest payment on our Senior Secured Notes and to provide additional working capital. In September 2004, three of our principal shareholders purchased \$2.0 million of a newly created class of Series E Preferred Stock in another private placement offering. The proceeds were used to pay the September 15, 2004 interest payment on our Senior Secured Notes. The Series E Preferred Stock may be redeemed at any time after May 31, 2006.

In January 2006, we secured a \$60.0 million mortgage note at The Sports Club/LA - Los Angeles. The note, which matures in January 2016, is secured by all the real estate and other assets at The Sports Club/LA - Los Angeles, bears interest at 6.48% per annum and requires monthly payments of \$404,375 which amortizes the loan over a twenty-five year period. Two of our shareholders executed limited guarantees under which the lender has recourse to them in certain circumstances. We have agreed to indemnify these shareholders under certain circumstances for losses under this guarantee. In exchange for the guarantee, we agreed to pay each guarantor a fee equal to .75% per annum of the average outstanding principal balance of the loan. At our discretion, such fees may be paid in Common Stock, cash or a combination thereof.

Contractual Obligations

The following schedule lists known contractual obligations (amounts in thousands) as of March 31, 2006:

| Contractual Obligations | Total | Less Than 1 Year | 1-3 Years | 3- Years |
|---|------------|------------------------|-----------|-------------|
| ----- | ----- | ----- | ----- | ----- |
| Mortgage note (1)..... | \$ 59,828 | \$ 874 | \$ 2,074 | \$ 2,3 |
| Interest on mortgage note (1)..... | 35,075 | 3,574 | 7,631 | 7,3 |
| Mortgage note (2)..... | 19,136 | 357 | 18,779 | |
| Interest on mortgage note (2)..... | 3,173 | 1,378 | 1,795 | |
| Equipment financing loans (3)..... | 59 | 21 | 38 | |
| Interest on equipment financing loans (3)..... | 9 | 6 | 3 | |
| Operating leases (4)..... | 49,311 | 5,519 | 11,298 | 11,7 |
| Minority interest (5)..... | 1,013 | 150 | 863 | |
| Redeemable Preferred Stock (6)..... | 16,126 | 2,296 | 13,830 | |
| | ----- | ----- | ----- | ----- |
| Total | \$ 183,730 | \$ 14,175 | \$ 56,311 | \$ 21,4 |
| | ===== | ===== | ===== | ===== |

(1) In January 2006, we secured a \$60.0 million mortgage note at The Sports Club/LA - Los Angeles. The note, which matures in January 2016, is secured by all the real estate and other assets at The Sports Club/LA - Los Angeles, bears interest at 6.48% per annum and requires monthly payments of \$404,375, which amortizes the loan over a twenty-five year period. Two of our shareholders executed limited guarantees under which the lender has recourse to them in certain circumstances. We have agreed to indemnify these shareholders under certain circumstances for losses under this guarantee. In exchange for the guarantee, we agreed to pay each guarantor a fee equal to .75% per annum of the average outstanding principal balance of the loan. At our discretion, such fees may be paid in Common Stock, cash or a combination thereof.

(2) On June 12, 2003, we obtained financing in the form of a secured five-year promissory loan in the amount of \$20.0 million. The loan bears interest at a fixed interest rate of 7.25%; requires monthly principal and interest payments of \$144,561; and requires a final principal payment of \$18.3 million on July 1, 2008.

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(3) Equipment financing loans are secured by our furniture, fixtures and equipment. The amounts are generally repayable in monthly payments over four or five years.

(4) We lease certain facilities pursuant to various operating lease agreements. Club facility leases are generally long-term and non-cancelable triple-net leases (requiring us to pay all real estate taxes, insurance and maintenance expenses) and have an average remaining term of 19.47 years, including renewal options which are included in the lease term, with the earliest lease expiration date of January 31, 2013. We are also obligated under lease agreements for six of our former Spectrum Club locations. We have subleased each of these properties to the buyer of these Clubs under sublease agreements which provide that all operating costs of these facilities be assumed by the new owners. Amounts due for Spectrum Club leases are excluded from this table.

(5) We own a 50.1% interest in the partnership that owns The Sports Club/LA - Los Angeles, and D. Michael Talla, our Chairman, beneficially owns the remaining 49.9%. We have the option to redeem Mr. Talla's preferred partnership interest for \$600,000, which expires on December 31, 2008. We have included the annual preferred distribution of \$149,700 to Mr. Talla in the above table for the next 2.75 years and the redemption amount is included in 2008 (Year 3).

(6) On March 18, 2002, we issued 10,500 shares of Series B Preferred Stock. The stock is redeemable by the stockholders on March 18, 2009. On September 14, 2004, we issued 20,000 shares of Series E Preferred Stock. The stock is redeemable by the stockholders after May 31, 2006. The amount of dividends payable on the redemption date is included in the above table.

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Impact of Inflation

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We do not believe inflation has had a material impact on our consolidated results of operations. We cannot provide assurance that future inflation will not have an adverse impact on our operating results and financial condition.

Seasonality of Business

Seasonal trends have a limited impact on our operations. We typically experience a slight increase in membership sales in the first quarter. Additionally, we normally experience a slight decrease in our revenues during the summer months at our New York Clubs due to lower membership attendance.

Forward Looking Statements

From time to time we make "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. Forward-looking statements include the words "may," "will," "estimate," "continue," "believe," "expect" or "anticipate" and other similar words. The forward-looking statements generally appear in the material set forth under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" but may be found in other locations as well. Forward-looking statements may also be found in our other reports filed with the Securities and Exchange Commission and in our press releases and other public disclosures. These forward-looking statements generally relate to our plans and objectives for future operations and are based upon management's reasonable estimates of future results or trends. Although we believe that our plans and objectives reflected in or suggested by such forward-looking statements are reasonable, such plans or objectives may not be achieved. Actual results may differ from projected results due to unforeseen developments, including developments relating to the following:

- o the availability and adequacy of our cash flow and financing facilities for our requirements, including payment of our mortgage notes,
- o our ability to attract and retain members, which depends on competition, market acceptance of new and existing sports and fitness clubs and services, demand for sports and fitness club services generally and competitive pricing trends in the sports and fitness market,
- o our ability to successfully develop new sports and fitness clubs,
- o disputes or other problems arising with development partners or landlords,
- o changes in economic, competitive, demographic and other conditions in the geographic areas in which we operate, including business interruptions resulting from earthquakes or other causes,
- o competition,
- o changes in personnel or compensation, and
- o changes in statutes and regulations or legal proceedings and rulings.

We will not update forward-looking statements even though our situation may change in the future.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

All of our current financing bears interest at a fixed rate and is not subject to interest rate risk. We are exposed to risk from a change in interest rates to the extent we are required to refinance existing fixed rate indebtedness at rates higher than those prevailing at the time the existing indebtedness was incurred. As of March 31, 2006, we had two mortgages totaling \$79.0 million due in July 2008 and January 2016 bearing fixed interest rates. A hypothetical increase in interest rates of 1% would increase our interest expense by approximately \$790,000 per year.

The fair value of our financial instruments as of March 31, 2006 is estimated as follows (in thousands):

| | | |
|--------------------------|----|--------|
| First Mortgage Note..... | \$ | 19,136 |
| First Mortgage Note..... | | 59,828 |
| | | ----- |
| | \$ | 78,964 |
| | | ===== |

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ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of disclosure controls and procedures.

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended, are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's ("SEC") rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures. Our internal control system is designed to provide reasonable assurance regarding the preparation and fair presentation of published financial statements. All internal control systems are designed based in part upon certain assumptions about the likelihood of future events, and, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation and may not prevent or detect all misstatements. Our management, including our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), has evaluated the effectiveness of our disclosure controls and procedures as of the end of the fiscal quarter covered by this Quarterly Report on Form 10-Q. This evaluation included a review of the steps management undertook in an effort to ensure that information required to be disclosed in its Exchange Act filings is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC. In light of certain material weaknesses in our controls and procedures described below, the CEO and CFO concluded that, as of the end of such period, these deficiencies have caused our disclosure controls and procedures not to be effective to enable us to record, process, summarize, and report information required to be included in our SEC filings within the required time period, and

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to ensure that such information is accumulated and communicated to our management, including our CEO and CFO, to allow timely decisions regarding required disclosure. As described below, we are taking steps to remediate the deficiencies in our control over the financial reporting process.

In performing its audit of our Consolidated Financial Statements for the years ended December 31, 2004 and 2005, Stonefield Josephson, Inc. ("Stonefield") noted a matter involving our internal controls that it considered to be a "reportable condition." A "reportable condition," which may or may not be deemed a material weakness, involves matters relating to significant deficiencies in the design or operation of internal controls that, in the auditor's judgment, could adversely affect our ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

The reportable condition that Stonefield considered to be a material weakness was that the Company was unable to process its financial information and present financial statements within a timely fashion. Stonefield's observation was summarized in its letters dated September 30, 2005 and May 5, 2006 to the Audit Committee of the Board of Directors.

In December 2004, the Company received a comment letter relating to the Company's Form 10-K/A for the year ended December 31, 2003 and Form 10-Q for the quarter ended September 30, 2004 from the staff of the SEC. One of the issues dealt with accounting for initiation fees under the provision of Emerging Issues Task Force ("EITF") No. 00-21. The eventual resolution of this issue contributed to the untimely filing of the Company's financial statements for the year ended December 31, 2004 and quarterly periods ended March 31, 2005 and June 30, 2005.

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The Audit Committee has authorized and directed management to devise and implement actions to address this deficiency and to enhance the reliability and effectiveness of the Company's internal controls over financial reporting and to provide reasonable assurance that our disclosure controls and procedures allow for the accurate presentation and timely filing of our financial statements. The Company's accounting personnel have reviewed their reporting and certification obligations under the Exchange Act and the Sarbanes Oxley Act of 2002, and have consulted with the Company's outside counsel with respect to those obligations. We have assigned a high priority to both the short-term and long-term strengthening of these controls and have identified certain additional measures, which we believe will address the conditions identified by our auditors as a material weakness, including the following:

- o engaging an accounting or financial consulting firm (other than the Company's independent auditor) to consult with the Company on accounting issues, including the interpretation of new accounting rules and releases promulgated by the SEC, the Financial Accounting Standards Board and other organizations, and the application of accounting principles to new transactions in which the Company engages;

- o reviewing the new FASB, EITF, SOP and other accounting rules and pronouncements. The review will assess each new rule or pronouncement; whether or not it amends or modifies an existing rule or pronouncement; its applicability to the Company or any transactions in which the Company has engaged, or proposes to engage; and the appropriate accounting ramifications of the new rule or pronouncement;

- o subscribing to selected professional publications that discuss new accounting rules and regulations applicable to reporting companies, and sending

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our senior accounting personnel to seminars and other presentations which focus on new accounting and financial disclosure rules and pronouncements; and

- o establishing an internal audit procedure to ensure that transactional recording, transactional review and adherence to applicable accounting policies and principles are observed.

Management believes that the foregoing measures will address the condition identified as material weaknesses by Stonefield. We will continue to monitor and evaluate the effectiveness of our disclosure controls and procedures and our internal controls over financial reporting on an ongoing basis, and are committed to taking further action and implementing additional enhancements or improvements, as necessary. We believe that these measures are reasonably likely to have a material impact on both our internal controls over financial reporting and disclosure controls and procedures in future periods.

(b) Changes in internal controls over financial reporting.

During the quarter ended March 31, 2006, the following changes occurred in the Company's internal controls over financial reporting (as those terms are defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting:

- o the Company has worked with an accounting firm (other than Company's independent auditor) to consult with on accounting issues;

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- o the Company has reviewed new accounting pronouncements to determine the applicability to the Company;
- o the Company has subscribed to professional publications that discuss new accounting rules and regulations;

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are involved in various claims and lawsuits incidental to our business, including claims arising from accidents. However, in the opinion of management, we are adequately insured against such claims and lawsuits involving personal injuries, and any ultimate liability, whether insured or not, arising out of any such proceedings will not have a material adverse effect on our consolidated financial condition, cash flows or results of operations.

Item 1A. Risk Factors

There have been no material changes from the information previously reported under Item 1A of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005, which Item 1A is hereby incorporated by

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reference.

Item 2. Changes in Securities

None

Item 3. Defaults upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None

Item 6. Exhibits

31.1 Certification of Rex A. Licklider pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Timothy O'Brien pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Rex A. Licklider 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 Timothy O'Brien pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

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

THE SPORTS CLUB COMPANY, INC.

Date: August 8, 2006

by /s/ Rex A. Licklider

Rex A. Licklider
Chief Executive Officer
(Principal Executive Officer)

Date: August 8, 2006

by /s/ Timothy M. O'Brien

Timothy M. O'Brien

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Chief Financial Officer
(Principal Financial and Accounting
Officer)

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EXHIBIT 31.1

CERTIFICATIONS

I, Rex A. Licklider, Chief Executive Officer of The Sports Club Company, Inc. certify that:

1. I have reviewed this quarterly report on Form 10-Q of The Sports Club Company, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures (as of the end of the period covered by this report based on such evaluation); and
 - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's third fiscal quarter in the case of this quarterly report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and;

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5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Dated, August 8, 2006

/s/ Rex A. Licklider

Rex A. Licklider
Chief Executive Officer

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EXHIBIT 31.2

CERTIFICATIONS

I, Timothy O'Brien, Chief Financial Officer of The Sports Club Company, Inc. certify that:

- 1. I have reviewed this quarterly report on Form 10-Q of The Sports Club Company, Inc.;
- 2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
- 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- 4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

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- (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures (as of the end of the period covered by this report based on such evaluation); and
 - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's third fiscal quarter in the case of this quarterly report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Dated, August 8, 2006

/s/ Timothy O'Brien

Timothy O'Brien
Chief Financial Officer

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EXHIBIT 32.1

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the quarterly report of The Sports Club Company, Inc. (the "Company") on Form 10-Q for the period ended March 31, 2006 filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Rex A. Licklider, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. (Section Mark) 1350, as adopted pursuant to 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(i) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

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(ii) The information contained in the Report fairly represents, in all material respects, the financial condition and result of operations of the Company.

/s/ Rex A. Licklider

The Sports Club Company, Inc.
Chief Executive Officer
August 8, 2006

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EXHIBIT 32.2

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the quarterly report of The Sports Club Company, Inc. (the "Company") on Form 10-Q for the period ended March 31, 2006 filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Timothy O'Brien, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. (Section Mark) 1350, as adopted pursuant to 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(i) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(ii) The information contained in the Report fairly represents, in all material respects, the financial condition and result of operations of the Company.

/s/ Timothy O'Brien

The Sports Club Company, Inc.
Chief Financial Officer
August 8, 2006

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