In the world of professional sports, Real Madrid Club de Futbol is royalty. During the 20th century, Real Madrid won thirty one Spanish La Liga titles, 17 Spanish Copa Del Rey Cups and the UEFA Champions League a record nine times. The iconic white jersey of ‘Los Galacticos’ has been worn by some of the greatest players of this generation, from Zinédine Zidane to current superstar Cristiano Ronaldo. A quick glance at the club’s trophy case should be all that is needed to declare that they are the most successful club in the world, but is this evaluation complete? While Real Madrid has always been a winning team, its financial strategy has put it amongst the world’s ten most indebted clubs. These ten clubs had a combined debt load of €4.08 billion in 2010, posing the question of whether financial health and on-field success are mutually exclusive.

Many shareholders invest in their favourite clubs to help them win, while the financial side of the operation becomes an afterthought. Winning is at the forefront for any sports team, but these clubs are also businesses and should be operated with consideration of shareholder value. The debt problem raises an important question in the footballing world: is the goal of a club to win games or to be profitable?

Breaking the Bank

The business model of a football club seems simple. Revenues consist of gate collections, television broadcasting fees, advertising and merchandise. Costs consist of player wages and operating expenses. The profitability of a club therefore depends heavily on its ability to generate fan interest. Clubs that cannot win are unable to attract fans that are willing to spend money.

A major use of cash, however, is missing from this model: player transfers. In football, rather than making trades, clubs purchase players from other clubs. In order to fund these acquisitions, many clubs take on an enormous amount of debt. FC Barcelona, arguably the most dominant club in the world today, follows this approach. In the summer of 2010, FC Barcelona broke the bank by purchasing David Villa and Javier Mascherano, pushing the club’s total debt figure to €442 million. This forced FC Barcelona to take out a €138 million bridge loan to finance its payroll this year, making profitability a nearly impossible goal. FC Barcelona had a net loss of €77 million in 2010, questioning the sustainability of its position atop domestic and international competitions. If the team continues to lose money, Barcelona may be unable to re-finance the debt needed to continue its aggressive transfer-market strategy.

Building a Winner

Financially successful clubs manage their value chain by making sound investments that follow both economic and football logic. However, the vast majority of European clubs disrupt their business models by investing in overvalued players and expensive management teams, without a feasible plan to recoup the investment. This overindulgence in debt has thrust many clubs into financial distress and has resulted in several teams changing ownership.
Footing the Bill

Chelsea FC, based in the south of London, England, has climbed to the top of the footballing world under the control of oil tycoon Roman Abramovich. Abramovich, whose net worth is approximately €4.53 billion, took over Chelsea in 2003 and promptly spent over €700 million in his first five years as owner. Although the club recently attempted to curb spending, Chelsea still suffered a €78.6 million operating loss in 2010. Interestingly enough, very little of Chelsea’s spending has been invested in the stadium portion of their value chain. Chelsea’s Stamford Bridge, with a modest 41,841 seats, the eighth largest in the English Premier League, has not been upgraded since Abramovich took over.

Across town in the north of London, 2006 marked the opening of Arsenal FC’s €533 million, 60,000-seat Emirates Stadium. As the second largest venue in the league, the stadium immediately increased revenue by €72 million annually. This strategy represents a fundamental contrast in resource allocation between Arsenal and Chelsea. While Chelsea has repeatedly sought out short-term solutions to improve its standing in the league, Arsenal has made longer term capital investments to drive incremental profit. This fiscal responsibility has paid off, as Arsenal posted an operating profit of €51.3 million in 2010, in stark contrast to Chelsea’s €78.6 million loss.

Arsenal also captures value from player development by taking a fundamentally different approach than its English rivals. Arsenal’s premier training academy not only helps to produce premier players that feed into the senior team, but also serves as a profit centre by nurturing young talent and selling players off through the transfer market. Arsenal’s strategy allowed them to fill its starting roster spots with Academy graduates such as Cesc Fábregas and Nicklas Bendtner, while selling talented graduates for a significant transfer premium—including the €5.7 million transfer of Ashley Cole to Chelsea and the €24 million transfer of Thierry Henry to FC Barcelona.
With premier players worth a significant transfer premium, smart clubs dangle these players on the transfer market in the hopes of capturing as much value from stars as they can while the players are at their prime. A successful training academy builds fan loyalty by allowing the fan base to follow young players from their developing years to their premier stage. In contrast, Chelsea fills most of its starting eleven with expensive players from the transfer market. Before Abramovich’s takeover in 2003, net spending on player transfers was €77.7 million. Since then, this figure has increased to a staggering cumulative €442 million, distorting the football transfer market and resulting in net losses every year since 2005 for Chelsea.

**Striking a Balance**

The success of business-savvy clubs like Arsenal must be analyzed within the context of their European competitors’ strategies. Among the European Elite, the ideal balance between profitability and winning is almost exclusively held by Arsenal. However, this begs a fairly obvious question: if Arsenal has proven that achieving this position is possible, then why have the other elite clubs not followed suit?

Before other teams can achieve Arsenal’s mix of profitability and league performance, clubs face a catch-22 that prevents scalable success in football. To win games, clubs must spend a substantial amount of money to field a strong team. Access to these funds, however, depends on on-field performance -- fans tend to spend more money to watch good teams. Since teams require fans’ financial support, they take on debt in an attempt to improve league results.

In February 2011, Chelsea spent €58 million on Fernando Torres, the fourth largest transfer fee of all time. However, clubs that regularly invest in superstar players suffer from diminishing marginal returns. While purchasing a high-profile player on the transfer market may lead to more wins and higher revenue, the next expensive transfer will often have fewer financial and on-field benefits. Arsenal realized this and instead chose to invest in long-term revenue-driving assets like Emirates Stadium. In this approach, Arsenal develops players from a young age and sells superstars when they become overvalued by the market. Rumours suggest that Arsenal will continue this strategy by selling Fàbregas to FC Barcelona for over €40 million this summer.

Although Arsenal has been good enough on the pitch to consistently qualify for the UEFA Champions League, it has never been dominant enough to win the tournament. Perhaps for this reason, its rivals are content with neglecting financial health to win championships. While the spending model of clubs like Chelsea and Barcelona has produced trophies and accolades, the clubs’ financial position are unsustainable in the long run.

**Opportunity Knocks**

Despite his tremendous business success in the oil market, Roman Abramovich is a perfect example of an owner who does not operate his club as a business. The problem with football’s dominant model of ownership is the risk of progressing down this slippery slope of indulgent player spending funded by unhealthy debt.

This raises the question of who can capitalize on the opportunity created by overindulgent owners who treat their teams as toys. In an era when financial and on-field performance are so tightly intertwined, the ideal owner must understand the complexity of the business, the role that winning plays and the optimal allocation of resources. Investing in player development, rather than player purchases, allows a smart owner to capitalize on the same transfer market that makes so many clubs unprofitable.

Arsenal has demonstrated that this model works both financially and on the pitch. This model represents an opportunity for owners who see beyond the glamour of owning a world-class football club and recognize the tremendous business potential. The current market structure could allow wealthy investors to capitalize on overindulgent owners. Arsenal will eventually reach the upper-echelon of European football on the strength of its prudent financial strategy and long-term focus on player development. Unlike its rivals, when Arsenal wins the Champions League, it will not need a loan to fund the parade.