



Cineplex Inc.: Is This Great Stock Worth the Inflated Price?

Description

There's a lot to like about **Cineplex Inc.** ([TSX:CGX](#)).

Billionaire investor Warren Buffett tells investors to look for a moat—a sustainable competitive advantage—when finding investment opportunities. Ask yourself this: If I spent the company's enterprise value trying to destroy it, could I do it? If the answer is anything but a definite no, it's time to move on.

Cineplex has a massive moat. It essentially owns the movie theatre business in Canada, commanding a 78% share of the box office in this country in 2015. Its largest competitor, privately held Landmark Cinemas, has just a 9% market share. A number of smaller competitors split the remaining 13%.

It's common knowledge that theatres don't make much on ticket sales with most of the gross going back to the movie studios. Profits come from the concession stand.

Cineplex has long since moved past selling bags of popcorn. The company's theatres have evolved into full-fledged entertainment destinations, featuring such things as full-service restaurants, arcades, and screens showing alternative programming. The company also makes additional revenue from selling premium experiences—think IMAX and Ultra AVX screens—digital signage for other companies, and through its SCENE debit and credit card partnership with **Bank of Nova Scotia**.

In short, Cineplex has done a terrific job leveraging the low-margin business of showing movies into all sorts of lucrative divisions.

The problem

The problem isn't with Cineplex itself. Management has done a terrific job.

The problem is valuation.

Cineplex shares are currently flirting with the \$50 level, which is right around its all-time high. That's a far cry from where shares were five years ago when they traded at less than \$25 each. That's a total

return of more than 113% during that time, excluding dividends.

Investors are obviously willing to pay up for a company with such great growth. In 2015 the company earned \$134 million on sales of \$1.37 billion, good enough for \$2.12 per share. That's a nice improvement over 2014 when it earned \$1.20 per share on sales of \$1.23 billion.

But those earnings were perhaps artificially propped up by the new *Star Wars* movie, which came out late in the fourth quarter. Analysts predict earnings will take a step back in 2016, coming in at \$1.98 per share, and 2017 is projected to be much better with earnings at \$2.37 per share.

At \$50 per share, that puts Cineplex at 25 times 2016's earnings and 21 times 2017's projected bottom line. That's expensive no matter how you slice it.

Things continue to get discouraging when we look at other valuation metrics. For 2015, the company generated just \$97 million in free cash flow. That puts the company at more than 32 times free cash flow. Additionally, the company only barely earned enough to cover its 3.1% dividend, at least from a free cash flow perspective.

The issue with paying an aggressive valuation is simple. If the company hits the growth targets the market sets out for it, everything is fine. But if it doesn't, there's significant downside potential.

If Cineplex loses its lustre and investors only assign it a 20 times earnings valuation—which is still more expensive than the market as a whole—it'll trade at approximately \$40 per share. That's a 20% haircut from today.

For shares to go higher, one of two things have to happen. Either earnings have to grow faster than expected or the company's multiple has to expand. And 25 times earnings is already expensive, so that leaves greater-than-predicted earnings growth. That could happen, but what if it doesn't?

CATEGORY

1. Dividend Stocks
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1. TSX:CGX (Cineplex Inc.)

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