Cineplex Inc.'s Big Question Mark

Description

Any time a company reports a 72% decline in quarterly profits, investors are right to take a second look at the numbers. **Cineplex Inc.** (TSX:CGX) attributed the drop in second-quarter income to a lack of box office hits relative to last year when there were three smash hits, including *Furious 7.*

In the movie business, if you don't have great content it's definitely more difficult to fill the seats. Just ask any struggling professional sports franchise what it's like to fill a stadium when everyone thinks your team stinks—they'll tell you it's an uphill battle that's hard to reverse.

It's for this reason that Cineplex has diversified its revenue streams, so it's not so reliant on the movie studios to keep the profits flowing. It would be easy to take CEO Ellis Jacobs at his word and leave the issue alone because he's definitely one of the best executives operating anywhere in this country.

Since Jacobs merged Galaxy Entertainment with the Canadian assets of Cineplex Odeon in November 2003 and then took the combined company public at $10 per share, Cineplex stock has appreciated by more than 400%. In comparison, the **iShares S&P/TSX Capped Composite Index Fund** is up 92% in the same period.

Now trading within 5% of its all-time high, I definitely don't want to be a buzzkill for Cineplex investors. However, there is a big question mark that shouldn't be swept under the rug. Let me tell you what it is; you can decide if it's a big deal or not.

Breaking down the MD&A

If you look at Cineplex's Q2 2016 Management Discussion and Analysis (MD&A), you'll notice that the company's largest expense against revenue is "other operating expenses," which represent 34% of the $338 million in total revenue in the quarter. In the same quarter in 2012, when the company generated 59.3% of its revenue from the box office compared to 48% today, "other operating expenses" were just 23% of the $264 million in total revenue.

Worse still, those expenses are rising at a much faster rate today than four years ago. In 2012 they increased by 1.8% year over year. In the second quarter this year they were up 28.2%, while total revenues decreased by 2.2%.

Does it make sense with declining revenues that expenses of any kind would be rising this fast? It's like alarm bells going off for investors who own retail stocks when they start seeing inventory levels rising faster than actual revenues. It might not be anything, but it's better to be certain.

So, what's causing the other operating expenses to increase so quickly? It's quite simple really.

On October 1, 2015, Cineplex acquired the remaining 50% of Cineplex Starburst Inc. (CSI)—one of North America's largest arcade game distributors—it didn't already own for $21.4 million. As a result, Cineplex now consolidates the operating results of the arcade game division. Prior to October 1, 2015, it put that information of its 50% interest in "share of income of joint ventures" on the income statement. As an equity investment, it didn't break out the revenue and expenses of the 50/50 joint venture.

In the second quarter, if you back out CSI's revenues of $24.6 million and $19.6 million in expenses, the other operating expenses line item increased by just 6.6% year over year and represent just 30.3% of its overall revenue, 370 basis points lower than reported.

Bottom line

There are two things to take home from this little exercise.

First, Cineplex's diversification strategy, although ongoing, appears to be working. And second, if not for CSI's second-quarter numbers, its exhibition segment, which includes CSI, would have been that much worse.

CATEGORY

1. Investing

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1. TSX:CGX (Cineplex Inc.)

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