Look Out Below With Cineplex Inc.!

Description

Chasing yield can be one of the most dangerous things to do during the latter stages of a bull market run; with equity markets approaching all-time highs when comparing valuations to earnings, steering clear of a company that has seen its share price correct by more than 30% can be a difficult thing to do.

Value investors looking to potentially cash in on a rebound value play with **Cineplex Inc.** (TSX:CGX) have noted that with a new slate of blockbusters on the horizon, and Cineplex's juicy dividend yield of 4.4%, playing a 2018 rebound may seem like a safe value bet in a market that saw "deals" disappear very rapidly in 2017.

Here's my take on why investors should forget Cineplex altogether and focus on other, more defensive sectors in 2018.

Sector-specific risks not abating

In my opinion, when considering Cineplex as a long-term investment, thinking about which movies were released in a specific quarter, or which ones are upcoming is far too short-sighted to make a long-term bet on the resurgence of the cinema business. While the previous two quarters for Cineplex may have been disproportionately disappointing, I believe the long-term risks related to a contracting cinema/movie/entertainment sector are very real and are likely to destroy the current economics of the cinema business, making businesses such as Cineplex much less appealing on a cash flow basis alone.

Owning a company with an effective monopoly on an industry or sector is great. If that sector begins to contract, however, investors will be at risk of catching a falling knife. With North America attendance numbers down approximately 5% year over year, the reality is, long-term fundamentals appear to be changing and are not being properly priced in to Cineplex at current levels.

I believe the company's recent forays into general entertainment offerings such as Rec Room, Playdium, and Topgolf may actually hurt earnings long term, as these businesses, in many ways, are aligned with the cinema business (i.e., potentially declining business models). An acquisition growth model is not one which is generally profitable long term, and, in my opinion, Cineplex should be focusing the vast majority of its resources on developing its online presence, not enhancing its brick-and-mortar footprint.

Fundamentals don't make sense

The company's debt-to-equity ratio stands at a whopping 85, and the company's current ratio is at 0.5, meaning the company has enough liquid assets to cover 50% of 2018 current expenses. Combine these numbers with negative levered free cash flow, a TTM price-to-earnings ratio of 36, and a razor-thin profit margin of 4%, and a more complete picture of the company's financial situation begins to surface.

Bottom line

The only reasonable way I see Cineplex growing is through acquisitions, and given the state of the company's balance sheet at present, it appears to me that the ability/prudence of such a strategy should be questioned by shareholders.

Cineplex is between a rock and a hard place, in my opinion. The undeniable long-term threat that home entertainment options, streaming services, and high-definition theatre-like options available to consumers in their living rooms provide to Cineplex should be forcing the company toward innovation in its online offerings.

Stay Foolish, my friends.

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