Why the Fall at Cineplex Inc. Is Only Getting Started

Description

Shares of **Cineplex Inc.** (TSX:CGX) recently fell by close to 4% in one day, as the Canadian movie company continues to struggle. Although many investors and fellow writers at the Motley Fool are very keen on this name, there remains a key challenge before this company can deliver results to investors.

Before talking about the reasons why this name may be going considerably lower, we first need to appreciate the positives of this unique asset. With a market capitalization of more than $2 billion, there are very few direct competitors in this space.

With what is clearly a unique asset, investors do not have to worry about the company going bankrupt.

Another aspect that makes this company seem like an attractive investment is due to the current dividend, which is in excess of 5% and is paid on a monthly basis. Although above average, investors may be in for a surprise if the company were to cut the dividend should it need to conserve cash.

But will the company need to cut the dividend?

For the first three quarters of the current fiscal year, the company paid dividends totaling $78.5 million out of bottom-line profits of $41.5 million and cash flows from operations (CFO) of $35.5 million. Clearly, something is not right. For fiscal 2016, dividends totaled $101 million, as net income came in at $78 million, and CFO was no less than $166 million.

As of the end of the third quarter, the company had cash on the balance sheet of almost $19 million, as the flow of popular movies slowed down significantly throughout the year. In spite of the release of *Star Wars* and *Jumanji* throughout the fourth quarter, the situation remains less than stellar, as investors now have high hopes for the coming quarter.

As we know from experience, however, high expectations can lead to large losses.

The reason that the pullback of Cineplex may only be getting started is due to the valuation of the company. At a share price of slightly less than $33, investors are receiving a dividend yield which may need to be cut should the business fundamentals fail to improve.

Currently trading at more than 40 times CFO (assuming we annualize the first three quarters of the year), investors are paying a significant price for each share. Given that the dividend payout ratio has jumped in the most recent year, the bull case becomes much more difficult to argue. With the expectation of a 5% dividend yield plus capital appreciation, many investors may be disappointed when shares of this Canadian gem pull back to a much more reasonable valuation. Hopefully, a dividend cut will be in the books by that point.

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