Cineplex Inc.: Is the Dividend Safe?

Description

A once reliable investment, Cineplex Inc. (TSX:CGX) has lost approximately 40% of its value over the past year. Canada's largest theatre chain is struggling to remain relevant with both customers and investors. The Cineplex conversation is dominated by two opposing views: investors who believe the company's business model is doomed to fail or those who believe that the company will rebound from its 52-week lows.

To add another layer of complexity, Cineplex is a Canadian dividend aristocrat, having raised its dividend for seven straight years. As the company has struggled, the sustainability of its dividend has come under greater scrutiny.

The company's current dividend growth streak started in 2010; it has a consistently announced a dividend raise along with its May dividend announcement. Its average historical dividend growth rate of approximately 4% is nothing to get overly excited about, but it currently yields a healthy 5.41%.

The most significant red flag is that the company's dividend payout ratio as a percentage of earnings is a whopping 151%, which means that the company is paying out more in dividends than it is earning. The ratio can be somewhat misleading, however, as earnings include several non-cash items, which aren't as important to dividends. It is also worth noting that the high payout ratio is nothing new for the company. In seven of the past 10 years, the company's payout ratio has been above 100%, reaching a previous high of 145% in 2014.

The sustainability of the dividend is far more dependent on a company's cash flows. There are two cash flow numbers that are important to analyze: operating cash flow (OCF) and free cash flow (FCF). OCF strips out non-cash items from earnings and refers to the amount of cash a company generates from its revenues. FCF takes it a step further and subtracts a company's capital expenditures. FCF tends to vary widely depending on the investments the company is making to expand its asset base.

Cineplex has invested heavily in new technologies and diversification initiatives over the past couple of years, which has led to a deteriorating FCF. In 2016 and 2017, total dividends eclipsed the company's FCF. Worse yet, FCF turned negative in 2017. The negative FCF is due in large part to a 66% increase in CAPEX. Although acceptable over the short term, it is not sustainable or good business practice over the long term. On a positive note, CAPEX is expected to drop by approximately 30% to $125 million in 2018, which means FCF should improve significantly.

After reaching a peak of $231 million in 2015, OCF dropped in 2016 and hit an eight-year low of $154 million in 2017. The good news is that dividends are fully covered by OCF with a coverage ratio of 1.4. The bad news is that this coverage ratio has been steadily decreasing for the past few years.

The dividend is safe — for now

I am firmly in the Cineplex bull camp, and I believe that its 40% drop in share price is overdone. However, even *I* can't ignore the red flags with respect to the company's dividend. In its most recent earnings' conference call, Cineplex President and CEO Ellis Jacob made a strong statement on the dividend: "Look, we've been a strong proponent of making sure our shareholders received the dividend, and we've done it since inception in 2003 when we went public…we are not deploying a cut." His words were in response to analysts' questions on the dividend and whether the company is implementing a new dividend policy, which may imply a dividend cut. Over the short term, I believe the company's dividend is safe, but its dividend growth streak is in danger. The company has recently been expanding and diversifying and has been burning through cash. While maintaining its dividend may indeed be a priority, raising the dividend is at odds with its growth plan.

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