3 Reasons You Shouldn't Be Afraid of This Stock

Description

There's no question that **Cineplex Inc.** (TSX:CGX) is experiencing the worst downturn it has seen in the past decade. To make matters worse, on May 2, Cineplex announced first-quarter earnings that were 34% lower than a year earlier.

There's no way to sugarcoat it: Cineplex is in a world of hurt. No fewer than four Fool.ca contributors have tried to make sense of the company's business since it announced earnings last week — and I'm about to make it a fifth kick at the can.

On April 28, prior to earnings, Joey Frenette, who is somewhat of a permabear when it comes to Cineplex, had this to say about its stock:

"Although I believe 'Cineplex: the amusements and entertainment company' will be successful over the long run, I think the stock will stand to get hit even harder as it gradually transforms itself," Frenette wrote. "At this point, you're still betting on a rebound in box office revenues over the short to medium term — a bet that I wouldn't make no matter how high the yield gets."

I'm a permabull

While Frenette is convinced that Cineplex is in the grips of a secular downtrend affecting the theatre business, I'm skeptical about his assessment for several reasons, not the least of which is the fact **Netflix, Inc.** (NASDAQ:NFLX) is said to be interested in buying movie theatres in New York and Los Angeles so its original productions can get Oscar nods.

"It seems Netflix would like to get some of its movies for Oscar contention or other types of industry awards," said Eric Handler, an analyst with MKM Partners who covers the major theatre chains. "They're trying to get credibility. Netflix took off when a couple of their own titles got nominated for Emmys. That lent credibility to what they're doing. If they can do that for various awards, that might raise the platform a little bit."

Whether you like it or not, the big studios still have a lot of clout in the movie business, and they all want their movies playing in theatres. It's been that way for 100 years.

Just as skeptics point to the demise of shopping malls — a fact that's patently false (yes, they are reconfiguring themselves) the movie-going experience is not going away.

That's the first reason you shouldn't be fearful of Cineplex stock.

The second reason you shouldn't fear Cineplex stock is its current valuation.

Fool.ca contributor Kay Ng recently came up with what I believe is the best explanation for the big decline of Cineplex stock: it was too expensive. Trading at 21 times cash flow in mid-2017, it's now trading for half that. Recent history has seen Cineplex trade between 9-17 times cash flow.

Overbought last summer, it's now oversold.

Which brings me to my last reason not to fear Cineplex

While movie attendance continues to flat line due to bad content, the company continues to grow both box office revenue per patron and concession revenue per patron, up 2.4% and 6.7%, respectively, in the first quarter.

It can't do anything about the lack of good content, but it can make more money off each patron. Until I see those two numbers drop for several consecutive quarters, I'd hardly call the situation urgent.

With its diversification efforts paying dividends — The Rec Room generated $16.1 million in revenue in Q1 2018 at a store level margin of 20.5% — the company, as I've said in recent articles, will look much different in five years than it does now.

If buying Cineplex stock last summer was a 10 out of 10 in terms of the likelihood that you were overpaying for the stock, it's now closer to five or even less.

At $28 per share, you should be a lot less fearful than when it was trading at $53 last summer.

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