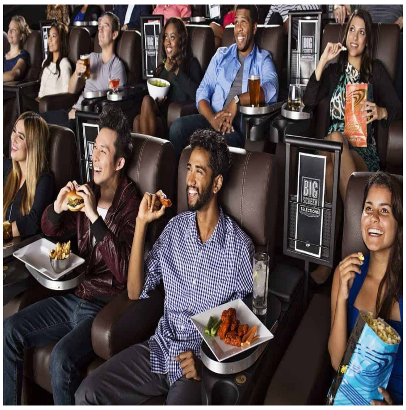

Why it's Time to Buy Cineplex Inc. (TSX:CGX) Before the Stock Turns a Corner

Description

Last year, I warned investors that **Cineplex Inc.** (TSX:CGX) stock was severely overvalued and listed a handful of headwinds that the company would be facing, none of which I felt Cineplex was prepared to deal with. Shares fell off a steep cliff right after the piece was published courtesy of an abysmal quarterly report delivered by Cineplex.

Fast-forward to today, and Cineplex shares are now down around 44% from the top at the time of writing. Of the four headwinds I noted in my previous warning, two still remain in full force: disruption from video streamers and the distaste of the public for unhealthy fatty concession stand snacks.

The other two headwinds: severe overvaluation and running into a growth ceiling, are still present. However, there's evidence that suggests these headwinds aren't as bad as they were when shares of Cineplex were at their peak.

Cineplex traded at near 40 times trailing earnings when I urged investors to offload their positions. Today, Cineplex shares are still quite rich, though not unreasonably so. The stock trades at 31 times trailing earnings and 25 times forward earnings; these P/E numbers are not at all indicative of a stock that's in secular decline. In fact, the valuation implies that growth is still alive and well.

This is true to an extent.

While the movie theatre business has hit its growth ceiling, Cineplex is positioned to grow its "general entertainment and amusements" business through the roof with intriguing concepts like Rec Room, Playdium, Topgolf and most recently, The Void, a virtual reality experience centre.

I'm a huge bull on the entertainment and amusements segment and would probably buy into an amusements spin-off if it ever happened. Management is tapping into experiences economy that I believe will be a massive success among young consumers like millennials, who value experiences over material goods versus that of the baby boomers.

Just have a look at some of the new concepts! I'm sure you'd agree that they make for a fantastic date night experience! For Q1 2018, amusement revenues grew 20.5% year over year, and as more amusement establishments are rolled out, I suspect an even higher magnitude of growth in the years ahead.

These amusement growth efforts will allow Cineplex to diversify from movie theatres over the long-term, but in the meantime, movie theatres will continue account for a majority of Cineplex's revenues, which is a problem for those thinking about buying shares today.

Movie theatres will be a drag but on the overall business, but the longer you intend to hang onto the stock, the less you'll need to worry about volatility at the box office.

Moreover, analysts have lowered the bar on box office expectations currently. They realize that no film is a guarantee of success at the box office anymore, so that leaves room for a possible upside surprise should the bleeding at the box office gradually be reduced.

Foolish takeaway

I've been a huge bear on Cineplex for quite some time now, but I'm finally ready to change my stance.

The movie theatre business is still in secular decline (attendance fell 9.2% year over year in Q1), but diversification efforts have shown tremendous promise, and over the next few years, I'm confident that newly erected entertainment establishments (Rec Room and the like) will offset any marginal weaknesses experienced at the box office.

Moreover, management has done a great job of cutting costs on the movie theatre side of the business and will begin to funnel ample amounts of cash into its "amusements" business.

I think management ought to reduce its dividend to accelerate the dilution of the box office segment; however, I don't think they will, as it would likely cause income investors to ditch the stock to the curb.

If you're an income investor, I have no problem recommending Cineplex at these levels. The 5.7% dividend yield is attractive, and if it's reduced, I think that's something to be bullish about as Cineplex attempts to stop the bleeding and return to the growth track.

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