How the Market Can Be Irrational About a Stock

Description

For a long time, **Cineplex Inc.** (TSX:CGX) was an excellent investment. From a recession low of $13 and change per share, the stock climbed for about 8.5 years and delivered annualized returns of about 20%!

A $10,000 investment in the stock transformed to +$47,500 in that period.

The stock offered a yield of as high as 9% during the recession. As it has maintained or increased its dividend per share, its dividend has been a key contributor to the stock's total returns.

Notably, the stock's price-to-operating-cash-flow ratio expanded from about four during the recession to about 21 by mid-2017. What's worse was that the company's operating cash flow per share actually declined about 24% in the 8.5 year period.

One explanation may be that Cineplex's share price moved steadily higher, and so investors believed that it was a quality stock offering a very safe monthly dividend.

So far, Cineplex has proven that its dividend is safe. However, since mid-2017, the stock has lost as much as half of its value.

Some folks might have recognized the elevated multiple Cineplex was trading at in 2014. However, the stock became more and more excessively overvalued for about 3.5 years since then before it came crashing down to the mean.

This shows how the market can be irrational about a stock for an extended period of time.

Where's Cineplex at now?

While Cineplex has a leading box office market share of nearly 76%, it has been investing in other areas of entertainment to reduce its reliance on theatre attendance, which has been falling since 2015.

Thankfully, Cineplex has some pricing power. It has been able to increase the spending of moviegoers from pushing out premium offerings such as VIP cinemas, UltraAVX, and D-BOX seating.

Additionally, unlike theatre attendance, its theatre food service revenue has seen much more stable growth. Specifically, the concession per patron saw a three-year growth rate of 5.6%. So, Cineplex is doing the right thing by expanding its food offerings, which now includes brands, such as Outtakes, **Pizza Pizza**, Tim Hortons, Yoyo's, Melt, Poptopia, and **Starbucks**.

Cineplex has partnered up with Topgolf. Over the next few years, Topgolf will be expanding into Canada. Its venues will be the destinations for entertainment, socializing, and golf in any season for any skill level. Cineplex will be managing the venues' day-to-day operations. The first Canadian location of Topgolf is expected to be in operation by late 2019.

To diversify from its box office revenue, Cineplex also aims to open 10-15 locations, respectively, of The Rec Room and Playdium. Five locations of The Rec Room are already in operation.

Investor takeaway

Previously, investors were complacent with Cineplex stock, which continued its steady climb despite shares becoming excessively overvalued in 2014. The market was irrational about the stock through mid-2017 by which time the stock came crashing back to reality — to a normal multiple.

Currently, Cineplex is reasonably valued and offers an above-average dividend yield of 5%. If the company executes well on its growth initiatives (Topgolf, The Rec Room, and Playdium), the stock can recover to +$40 per share over the next two years.

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