Income Investors: Is This Fallen Angel Due for a Bounce?

Description

The last time I looked at **Cineplex's** (TSX:CGX) stock, the shares had just taken a tumble. Once a favourite of Canadian growth investors, the company's shares have tumbled spectacularly in recent months. It has now fallen over 50% from its highs of around $53 a share to the paltry $24 a share it sits at this writing. Depending on your point of view, this could be either a fantastic time to enter the stock or time to avoid this big dividend payer.

The business strategy is intriguing

Cineplex has several positive attributes, beyond the dividend, that continue to draw would-be investors to the company. Cineplex operates as a near monopoly in the Canadian movie theatre space with over 75% of the box office market share. Given the expense and complexity of opening movie theatres, they have relatively high barriers to entry, which should keep many would-be rivals away.

Its diversified business model is also a draw. Its theatres offer different experiences, from IMAX and D-Box movies to the much-appreciated VIP theatres where adults can sit in comfort, drink some wine, and have a children-free experience watching the latest movies. New non-movie offerings like the Rec Room and Playdium are bringing in new revenues with new locations being added rapidly.

While this stock is not growing like gangbusters, it is still showing some forward momentum. Full-year revenues increased by 3.8% at the end of 2018 over 2017. Adjusted free cash flow increased 15.8% over the same period, boding well for dividends and eventual debt repayment. Net income decreased by 5.7% and theatre attendance decreased by 3.2%, though, which is a little disconcerting.

The dividend is plump at over 7% as of this writing, which is surely drawing income investor's eyes. The 10-year compound annual growth rate of the dividend is around 4%. While these raises are nice, at this yield level it may be a good idea to start putting some cash to work paying down debt.

What could go wrong?

So, with all these great product offerings, why has the stock fallen so hard? Well, it was very expensive, for one thing. Even at the current valuation of 19 times earnings and a price to book of more than two, it is difficult to make the argument that it is cheap. The stock had been priced for rapid growth, and when some weakness crept into its revenue, investors got spooked.

It also has a tonne of debt. Cineplex has a lot of initiatives on the go, and these initiatives cost money. In some cases, building a Rec Room in a city like Toronto or Vancouver can be extremely expensive, requiring the company to increase its leverage to acquire the land and build the site. There is a lot riding on the willingness of people to come to these places with their friends and family frequently.

Many investors are also starting to get spooked that there might be a recession on the horizon. If that occurs, and people start losing their jobs, it seems likely that cutting out discretionary spending on movie trips and Rec Room visits will occur. With all that debt on the books, Cineplex may come under pressure as people stop spending their discretionary income on entertainment. This is not a regulated utility; it is a company that depends on people wanting to show up at its sites and spend.

Should I buy this stock for income?

Cineplex has done a fantastic job diversifying its product offerings. It has a great dividend yield , and it has grown that dividend religiously over the years. This company is a contrarian play at the moment with potential, but it is not the lowest-risk yield you can find in Canada at the moment.

The two big danger signs for me are the risk of recession and Cineplex's debt load. The company depends on Canadians spending discretionary income at its sites, and Canadians are nearly tapped out. A recession is most likely on the horizon at some point, and that could be a difficult time for the stock. If you want to roll the contrarian dice, this could pay off over the next few years if everything comes up Cineplex. But do not think that this is a low-risk income play.

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Date
2025/08/27
Date Created
2019/03/13
Author
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