Why I’m Not Buying Cineplex (TSX:CGX) Stock Despite Its Massive Upside Potential

Description

The stock market has mostly recovered from the COVID-19 crisis, posting an impressive V-shaped recovery. There are still many hard-hit stocks that have not participated in the rally. Such stocks that could have a tonne of room to catch up in the next leg of this rally, which may be led by the first-half losers that have felt the full force of the COVID-19 impact.

Restaurants, hotels, airlines, cruise lines, fossil fuel producers, financials, and entertainment venues have taken on a brunt of the damage. If the coronavirus is eliminated within the next year, such stocks could stand to correct to the upside, leading the charge for the next leg of a broader market rally. Investors need to be very selective when it comes to battered COVID-hit stocks, though.

In times like these, a healthy balance sheet is vital

By having a strong preference for financially flexible firms with a solid balance sheet, one can steer clear of heavily-impacted firms that could suffer longer-term from the effects of limited financial flexibility amid this crisis. Firms with meagre liquidity positions and considerable amounts of debt weighing down the balance sheet could suffer from business erosion and potential insolvency the longer COVID-19 disruptions to cash flows persist.

There’s never been a better time to focus one’s analysis on a firm’s financial health and the state of its balance sheet. In some cases, the greater financial health of a heavily impacted firm may be more worthy than low traditional valuation metrics such as the price-to-earnings (P/E) ratio.

Indeed, it’s tough to gauge the extent of disruption that poorly-capitalized firms will face as a result of this crisis. Limited financial flexibility could cause a firm to forego growth opportunities and existing projects in the effort to conserve cash. Doing such could weigh on a firm’s ability to grow years after this pandemic ends.

Cineplex stock under pressure

Consider **Cineplex** (TSX:CGX), the Canadian movie theatre company that found itself between a rock and a hard place amid the pandemic. The number of bums in seats of its theatres nosedived, as COVID-19 shutdowns hit. With a meagre balance sheet and a considerable amount of debt on the balance sheet, the company is not only at risk of insolvency should this pandemic drastically worsen over the next year, but is also poised to pull the breaks on its promising growth initiatives.

Before the pandemic, the company was gaining traction with its non-theatre amusement businesses, which were to hold up better than the box office segment amid the continued rise of video streamers. Growing the firm's Rec Room, Playdium, TopGolf, and other non-theatre entertainment venues was a compelling way for Cineplex to regain its former glory as a dividend darling.

The COVID-19 crisis is likely to put the brakes on the firm's amusement diversification efforts as it looks to conserve cash in the fight for its survival. Cineplex is limited its spending on growth initiatives with annual capex to drop to $50 million, down from around $150 million. This reduction in spending could delay Cineplex's reincarnation for years — if it even survives this crisis.

Fortunately, the box office has reopened, and if all goes smoothly, the company could find itself free cash flow positive within the next two quarters. The company also raised over $300 million worth of capital, improving the company's liquidity positioning to an acceptable level. Still, growth expectations are now muted, and the company could find itself skating on very thin ice through the duration of this pandemic.

Foolish takeaway on Cineplex stock

Even with the recent box office reopening, I'm not a buyer of the stock because the insolvency risks are far too high, and the company's growth profile looks to be stunted as a result of its poor liquidity position entering this crisis. The much-anticipated live-action epic *Mulan* is also headed for a streaming debut on **Disney**+, which is more lost dough for Cineplex, which needs cash now more than ever.

Sure, there's significant upside in the name, but I'm going to enjoy the show from the sidelines, as Cineplex could feel the COVID-19 impact for years after the pandemic ends.

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