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HOORAY FOR HOLLYWOOD

For this month's article I would like to offer a new recommendation to replace the companies sold last year, and would also like to comment on recent distribution cuts by oil and gas trusts. This month's pick is Cineplex Galaxy Income Fund (CGX.UN-T).

Cineplex Entertainment, the operating company for Cineplex Galaxy Income Fund (Cineplex), is the largest film exhibitor in Canada, with 131 theatres with 1321 screens in 6 provinces representing around 70% of Canadian box office revenues. Cineplex Odeon is its brand for large urban centres while Galaxy targets mid sized markets. It also operates the Famous Players' theatres, which it acquired in 2005, and specializes in prominent sites in high traffic areas under such names as Coliseum and Silver City.

Why We Like It

Cinema going has historically been a resilient activity during times of economic downturn, as it is a relatively low cost outing which is one of the last activities that will be cut back, and indeed may benefit from "trading down' by consumers from other more expensive outings such as dinners or theatre. In fact, research by RBC Securities has shown that box office returns have shown little correlation to declines in the economy. Furthermore, while this defensive position is only as strong as the quality of the movies that are being released, 2009 has what looks like a strong slate of forthcoming releases which include the delayed sixth instalment of the Harry Potter series, a new Star Trek movie and a Transformers sequel. The recently released fourth quarter results for Cineplex showed unexpectedly strong attendance, record concession revenues and only slight signs of weakness in advertising, during a quarter when the Canadian economy fell into a recession.

Cineplex also has a clean balance sheet, a factor of great importance in these credit constrained times. Since making the Famous Players acquisition in 2005, which saw debt to Earnings Before Interest, Tax and Depreciation and Amortization (EBITDA) rise from 2x to 6x, it has used most of its excess cash flow after distributions to reduce debt, with the result that Debt to EBITDA has declined from 6x to 2.5x at present. Cineplex does not have a need for refinancing its existing debt until 2012, and has an undrawn $130m non-revolving credit facility available for any further acquisitions or capital expenditure in addition to its fully drawn $235m senior credit facility and $105m convertible debenture, all three of which do not mature until July and December 2012 respectively. Cineplex cannot exceed 3x Debt/Last 12 Mths EBITDA, and as end December 2008, the ratio stood at 1.88x.

Furthermore, RBC has calculated that Cineplex is generating sufficient free cash flow to enable it to increase its payout by 3% p.a. until 2011 and then would not need to cut its distribution even with the introduction of taxation from the beginning of that year. One of the reasons for this is that Cineplex has approximately $400m in tax pools for investments in capital equipment, property and other items generating tax credits, which will be available to be applied against tax, unlike many other business trust structures. While Cineplex did not announce an increase in distributions along with its strong fourth quarter results, the implied stability of its payouts between now and 2011, let alone after the introduction of taxation on trusts makes its especially attractive.

RBC's analysis of Cineplex's margins makes it apparent why this is such a suitable business model for the trust structure. While the estimated margin in 2009 on the box office (i.e. the actual showing of movies) is barely 2% ($9m on $524m of revenues), it is 36% on the concession sales of popcorn, soda and candy ($92m on $254m in revenues) and a remarkable 88% on ancillary activities ($83m on $94m in revenues), which primarily consists of advertising, as well as games arcades, gift cards etc. this give Cineplex a blended operating margin of 21%, and with increases in concession prices on June 1st 2008 and ticket prices on November 1st last year, these margins are not under threat. However, an important point to make in comparison with US cinema chains is that Cineplex has not relied on ticket price increases to drive the bottom line. Instead it has concentrated on attracting more patrons to its cinemas, including scheduling live events in High definition such as hockey games and opera performances, and particularly with its innovative Scene loyalty card programme. This gives members 10% off concession prices, helping increase overall spending at the concessions and free movie tickets once one has seen a number of movies. Scene now had 1.4m members from a standing start 2 years ago, and helps Cineplex track members' watching habits to enable them to target marketing efforts.

Risk Factors

As noted above, the quality of the movies being shown is the biggest factor in determining audiences in the cinema business, although the slate for 2009 appears strong. Movie attendance quarter to date in 2009 is down 4% compared to last year, although the first week last year included New Year's, and the weather has been worse. The national roll out of digital projection systems that began in 2008, with 84 digital projectors now installed in 46 theatres allows Cineplex to show 3-D movies at $3 extra per ticket on the 49 screens that have RealD 3D technology, but the revenues generated depend upon the amount and attractiveness of 3D films that are released and will cost Cineplex approximately $1.75m to install the 175 screens that have been agreed. Minimum wage increases in Ontario and Saskatchewan and more concession staff due to higher attendance in the fourth quarter saw expenses rise $1.9m and will likely reoccur this year. Media spending (advertising) is vulnerable to the economic downturn, and while it has only declined marginally in the fourth quarter (1.1%), advertisers are shortening their commitments, but given the ability of cinema to reach hard to attract teenage and young adult audiences, cinema advertising may hold up better than other media.

Recent Developments

On Friday 13th, the same day that the new 3D version of the movie was released, Cineplex released its fourth quarter and full year results. Revenue came in above expectations at $211m up 16% on a year on year basis with EBITDA up 40% to $36.1m. Attendance was up 17%, helped by a strong slate of releases such Madagascar 2, the James Bond release Quantum of Solace and the teen vampire movie Twilight. Combined with record concession revenues, up 21% to $61.4m, reaching $4.03 per customer (over $4 for the first time), this more than offset the slight decline in advertising. For the year, revenues were up 5.5% from $805m to $849.7m, as the success of the Batman movie The Dark Knight offset the deferral of the latest Harry Potter title while EBITDA was up slightly less (3.5%) from $140m to $144.9m. Distributions increased 5.1% from $1.18 per unit to $1.24 for a sustainable payout ratio of 67% and a yield of 8.9%.

Recommendation Buy Now for a sustainable yield from a defensive sector.

Energy Trusts Cut Payouts

The two oil and gas trusts that I recommended to Income Investor readers Canadian Oil Sands and Penn West, have both reduced their payouts in the last month, Canadian Oil Sands for the second time in two quarters. This is obviously disappointing, especially the latter trust, which has seen its payout reduced from $1.25 per quarter in the third quarter of 2008 to $0.15, but as noted when recommending energy trusts, their payouts will be dependent upon what the price of oil and gas is doing. Management is being prudent in ensuring that investors are not effectively receiving back their own money after fees through a return OF capital, but instead paying out the sustainable yield on the business activities. With the price of oil having fallen from U$147 per barrel in June last year to under U$40 per barrel, trusts are naturally reflecting the much lower price they are receiving, especially in the case of Canadian Oil Sands, which allowed its hedges to expire once it had finished the Stage 3 expansion project. Canadian Oil Sands is estimating its share of Syncrude’s production will average 115000 barrels per day against 105,900 in 2008 at a cost of $30.76 per barrel, assuming U$50 per barrel WTI oil. It will also spend $440m on its share of capital expenditures, which can be funded after distributions of $0.15 per quarter per unit by increasing borrowings modestly by $200m.

Penn West, which cut its payout from $0.34 per month to $0.23 in January, has hedged approximately 25% of its 2009 production at oil prices between U$80 and U$110 per barrel and C$7.88 and C$11.71 per mcf. It has also sold some non core assets to raise $150m to reduce debt, which it will do by the end of the first quarter, and cut its capital expenditure programme by half to $600-$825m, of which $250-325m will be spent in the first half on low risk projects as it waits for oil industry costs to follow the price of oil downwards. Enerplus and ARC Energy have also reduced their monthly distributions from $0.48 to $0.17 and $0.28 to $0.12 per unit, as the conventional oil and gas trusts adapt to a period of lower oil prices.