February 22, 2018

CINEPLEX INC.

TSX-CGX

Putting Cineplex Back on the Marquee

Recommendation	BUY
Current Price	C$31.53
Veritas Intrinsic Value	C$41.00
Market Cap ($ millions)	1,995.85
Yield	5.3%
Average 30 Day Volume (thousand shrs)	538.3
Float Shares Outstanding (million shrs)	63.3

Consumer Staples & Consumer Discretionary

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PUTTING CINEPLEX BACK ON THE MARQUEE

Since last August, when Cineplex reported Q2-2017 and posted a sixth consecutive quarter of declining year-over-year attendance, its stock has tumbled 40%. The question facing investors is whether Cineplex can reverse what appears to be a secular decline in movie attendance or at least overcome the negative momentum with diversification into other revenue streams. It is also up for debate just how much of Cineplex's recent troubles are due to last year's weak film slate, with 2017 North American box office declining by 2.7% versus 2016. For 2017, Cineplex achieved an EBITDA of $240 million, slightly higher than $234 million in 2016.

Over the next few years, we see Cineplex's core business to remain stable, with the 2018 film slate likely to be an improvement over a weak 2017. At the same time, Cineplex is cultivating several new revenue streams that should build out and diversify its earnings. Specifically, we expect:

- **Year-over-year growth in 2018 box office driven by Q2 and Q3 attendance:** With the next installments of Black Panther, Avengers and Jurassic World set to premiere, in February, May and June respectively, we see a high likelihood of 2018's box office exceeding lackluster 2017 results. While we expect North American box office in Q1-2018 to be roughly flat versus its prior year quarter, a strong slate of films over the remainder of the year should push North America's 2018 box office up 4% to 5% versus 2017. As a result, we see Cineplex posting 2018 EBITDA of $275 to $285 million.

- **Sustained revenue per patron growth based on premium offerings that target frequent moviegoers:** Over the past eight years, Cineplex has managed to raise its box office and concession revenues per patron at rates above inflation, defying headwinds from competing entertainment sources and navigating Hollywood's increasing concentration on fewer high-profile releases. We attribute Cineplex's pricing power to two factors: the company's continued investments in premium offerings (audio, 3D, VIP theatres, reclining seats, etc.) and a core set of frequent moviegoers that generate roughly half of industry sales. While we expect growth in revenues per patron to slow, we still see enough topline strength to mitigate negative trends in attendance.

- **Revenue diversification and growth via Cineplex's gaming ('P1AG') and amusement offerings ('Rec Room', 'Playdium'):** Building on Cineplex's arcade and entertainment complex business ('Player One Amusement'), management is now embarking on an expansion of its 'Rec Room' concept from five locations (including Playdium) to 20 to 25 over the next four to six years. We see an interesting comparable in the publicly traded Dave & Busters (D&B) chain, which has grown from 61 stores in 2012 to 105 today (2 in Canada), generated comp store sales growth of 19.5% from F14 to F16 and maintains EBITDA margins near 24%. With potential EBITDA margins of 17% to 20% for Cineplex's Rec Room concept and 12% to 15% for P1AG, we expect the company's amusement and leisure segment to make up 20% to 25% of overall EBITDA by 2023, up from 12% in 2017.

- **Consistent free cash flow generation and support for dividends:** Even though we take issue with Cineplex's estimates of maintenance capex, we still see a solid base of free cash flow over the next several years. We note that the company typically reports maintenance capex of $25 to $35 million per year representing 2% to 3% of revenues, while peers spend anywhere from 5% to 6%. Even assuming a more realistic maintenance capital assumption equal to 6% of theatre-based revenues, Cineplex is still likely to convert ~50% to 55% of its core EBITDA into free cash flow before growth.

Before growth spending, we expect free cash flows to reach $2.20 to $2.30 per share in 2018, giving Cineplex a FCF yield of 6.5% to 7.5% on its current share price. As a result, we think Cineplex shares look cheap as the company is better positioned than U.S. theatre chain peers, with a lower valuation multiple and potential annualized EBITDA growth of 8% to 9% over the next three years. We are initiating coverage of Cineplex with a Buy recommendation and an intrinsic estimate of $41.00 per share.

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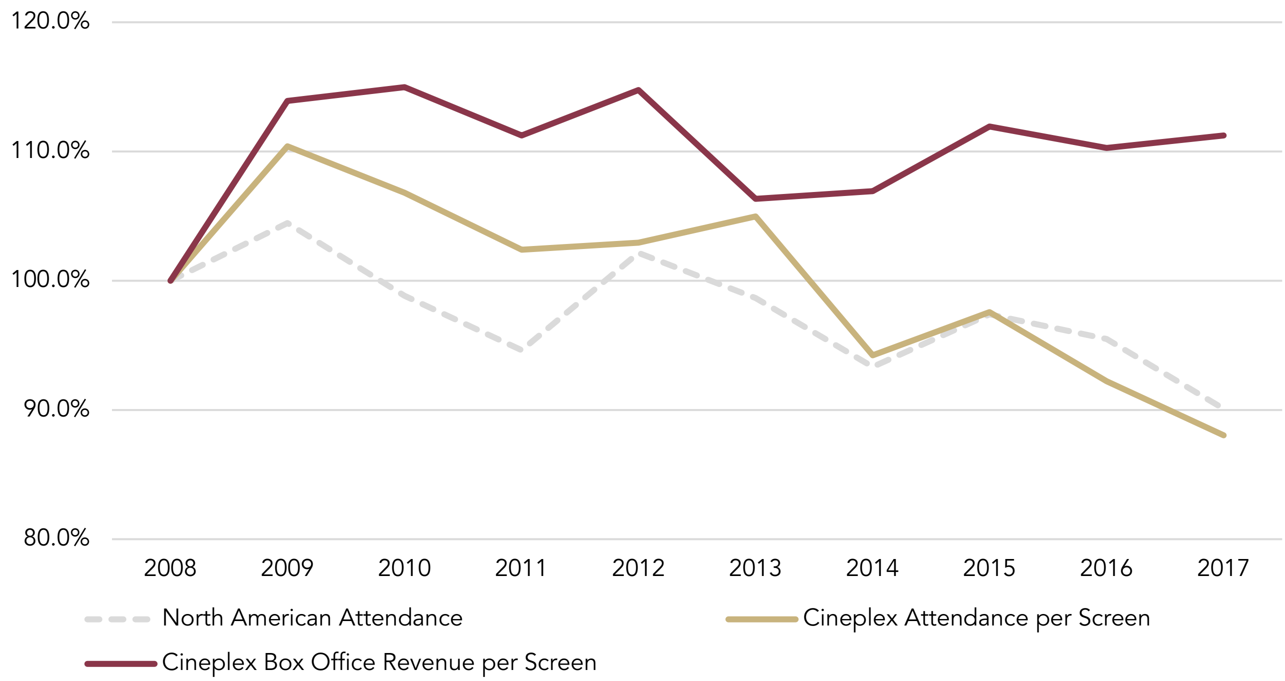
MOVIE ATTENDANCE: DEALING WITH A SECULAR DECLINE

Based on data from Nash Information Services, North American movie attendance, measured in terms of tickets sold, has generally declined every year since 2002, from 1.5 billion to 1.2 billion tickets in 2016. The declines have many roots including the proliferation of other entertainment options, at home streaming services, and a greater concentration of attendance in a narrower slate of films. We also note escalating movie budgets and premium formats have generally encouraged higher ticket prices, with the higher pricing likely having a negative effect on attendance by more casual filmgoers.

As shown in Figure 1, Cineplex's attendance per screen has generally moved lower in line with North American trends. With steady increases in revenues per patron, however, Cineplex has nonetheless been growing its box office revenue per screen since 2013:

Figure 1
Attendance vs. Revenues: Though Overall Attendance Has Been Decreasing, Cineplex Has Been Able to Maintain Revenues from Their Theatre Division

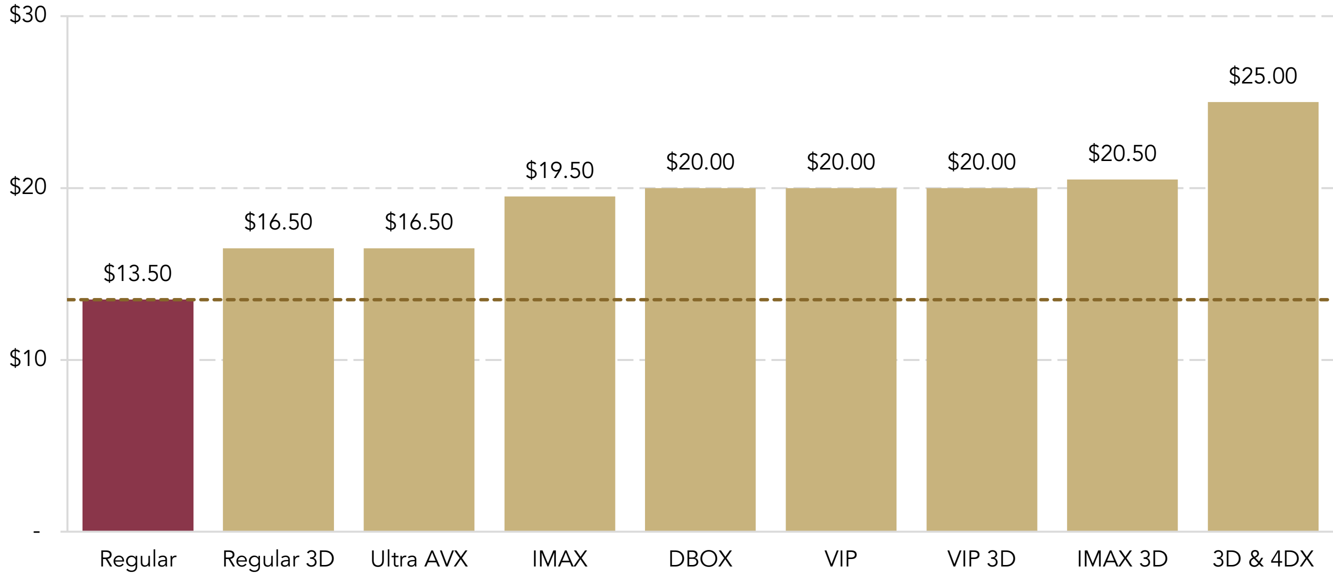


Source: Motion Picture Association of America, Cineplex, Veritas estimates

As shown above, while Cineplex's 2017 attendance per screen has fallen to 88% of 2008 levels, the company has managed to increase its box office revenues per patron by 26% versus that year.

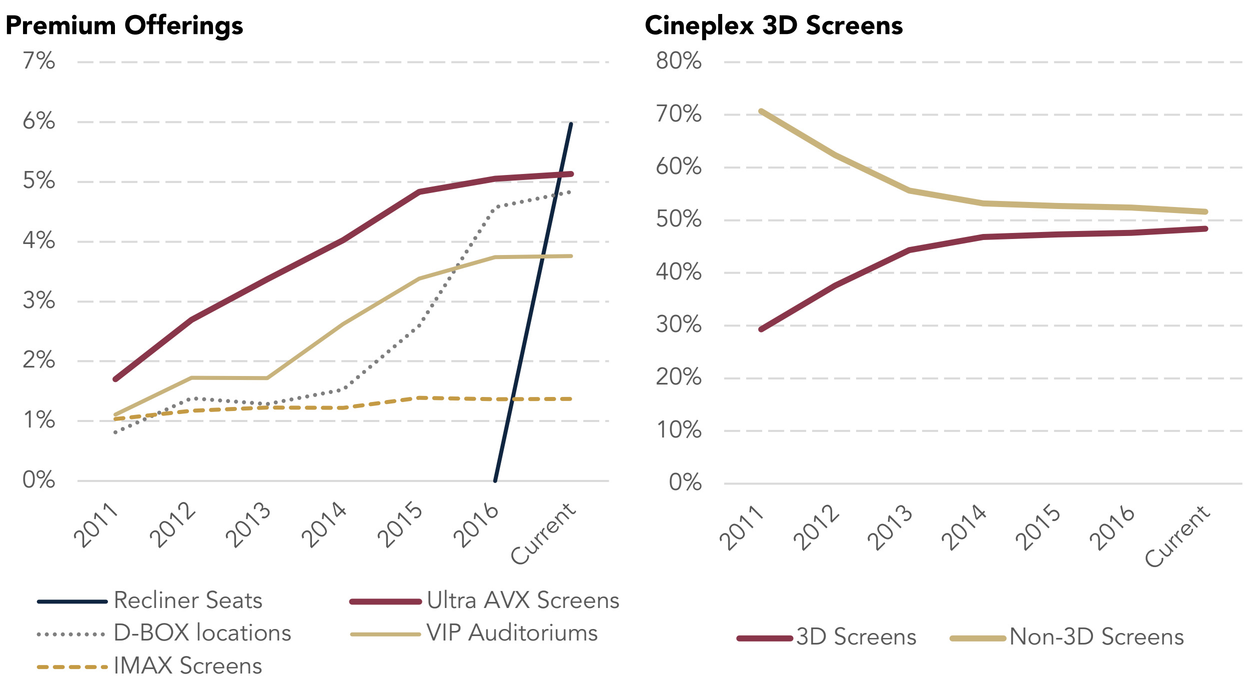
The chain has achieved the topline increase largely by raising its prices and delivering a range of premium formats and options, which we outline in Figures 2 and 3 (next page):

Figure 2
Cineplex Price Points for Various Movie Formats
Amounts in millions of Canadian dollars



Source: Stats Canada, Cineplex

Figure 3
Cineplex Screens with 3D / Premium Offerings: Shift to Premium Accelerating Post-2013
Amounts shown as percentage of total Cineplex screens



Source: Cineplex

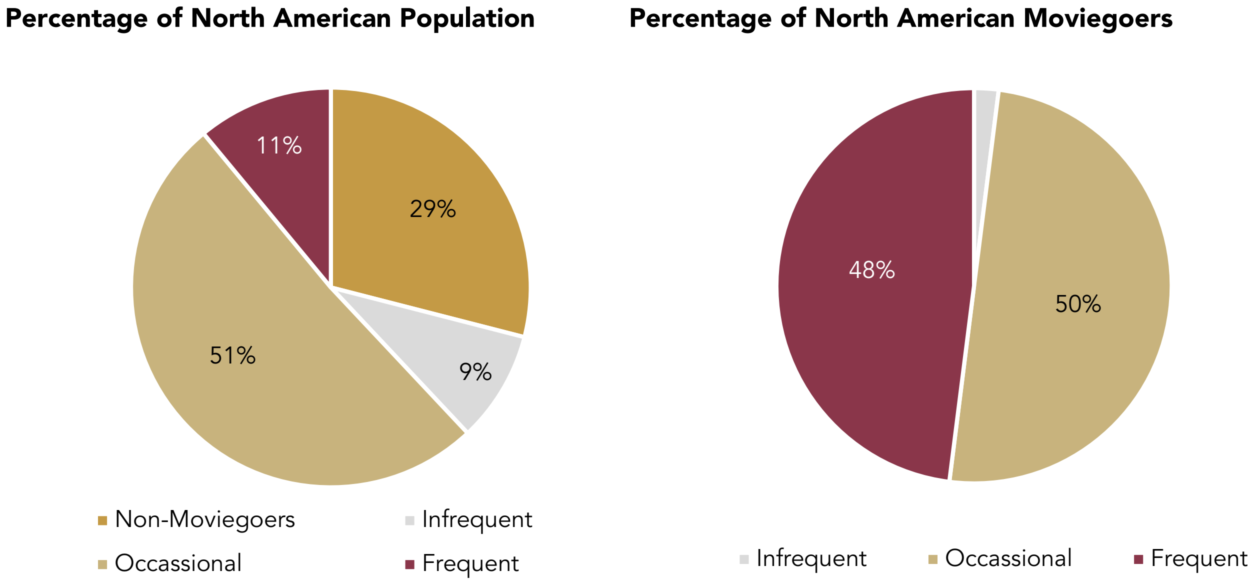
We note that just as Cineplex's roll out of 3D screens was reaching its peak in late 2013, investments in new premium offerings began to pick up, extending growth in revenues per patron up to the present. Once the new offerings are more broadly available, we would expect revenues per patron to level off or grow at a rate closer to inflation.

Faced with a narrowing market, Cineplex appears to be pursuing a strategy common to other mature industries: raise prices while introducing premium services, in the hopes that increasing revenues from core customers can offset underlying attrition. So far at least, the strategy appears to be working, which we attribute to the makeup of Cineplex's audience.

WHO ARE CINEPLEX'S CORE VIEWERS?

As we show below, Cineplex's pricing and premium format strategy appears well suited to the movie industry, where a small group of frequent moviegoers – defined as attending one or more movies per month – makes up close to half of industry attendance:

Figure 4
2016 Frequency of Movie Attendance Demographics



Source: Motion Picture Association of America

Cineplex's pricing and premium format strategy has worked well so far: since 2008, revenues per patron have grown at 3.8% CAGR versus Canadian CPI of 1.7%. The risk of raising prices, of course, is that it may eat into the attendance of occasional moviegoers – defined as those seeing less than one movie per month but more than one movie per year. These occasional attendees still represent half of industry attendance.

IS THERE STILL ROOM TO INVEST IN PREMIUM FORMATS?

Even given current attendance challenges, returns on theatre improvements can be attractive. As an example, in its 2018 presentation, competitor AMC noted that post-renovations, its theatres achieved an average increase of 57% in attendance and 225% in operating cash flow. Compared to 2015, the three largest American chains will have renovated up to 40% of their total seats by the end of 2018. Similarly, since 2015, Cineplex has refurbished or upgraded less than 10% of their locations showing room for improvement.

Cineplex has also devoted a substantial amount of resources to their VIP cinema concept. VIP cinemas focus on providing their customer a higher quality experience through a more intimate auditorium, larger food menu and full-service attendants. Consequently, Cineplex can charge a substantial premium for the additional services. Currently, with 17 locations and 63 auditoriums, VIP cinemas still represent a relatively small percentage of Cineplex's footprint. Even so, we think investments in this higher-service option will have noticeable effects on revenue per patron trends over the next few years. Management has committed to building an additional 6 VIP dedicated theatres by 2019.

Going forward, we think Cineplex still has room to advance its premium format strategy, allowing average prices to increase by 2.5% to 3.5% per year, closer to inflation. With the rollout of premium upgrades (e.g. VIP, IMAX, etc.) and attendance growing at VIP complexes, we also expect comparable increases in concession revenues per patron, driven in part by even higher ticket products (i.e. alcohol, meals). While we expect Cineplex to increase its traction with frequent moviegoers, overall attendance may continue to be weak as pricing crowds out some occasional moviegoers.

In the context of more marginal filmgoers, we think the quality of the film slate becomes that much more important to ultimate attendance figures. The good news, at least for 2018, is that we expect a better selection and pace of movie releases than in 2017.

Weighing the 2018 Film Slate

Before launching into an analysis of the 2018 film slate, we should first point out that box office predictions are fraught with uncertainty and 'surprise' results – even the movie studios, who are paid to manage budgets to results, still frequently lose money on individual films. At the same time, box office outcomes are highly correlated with three key drivers of performance:

- **Film budgets:** Of all the possible factors, the production cost of a film is the most predictive of box office results and audience approval ratings. Unfortunately, estimated budgets are only disclosed or confirmed after the fact. Even so, there are diminishing returns to increasing movie budgets (i.e. the relationship between budgets and box office is non-linear).

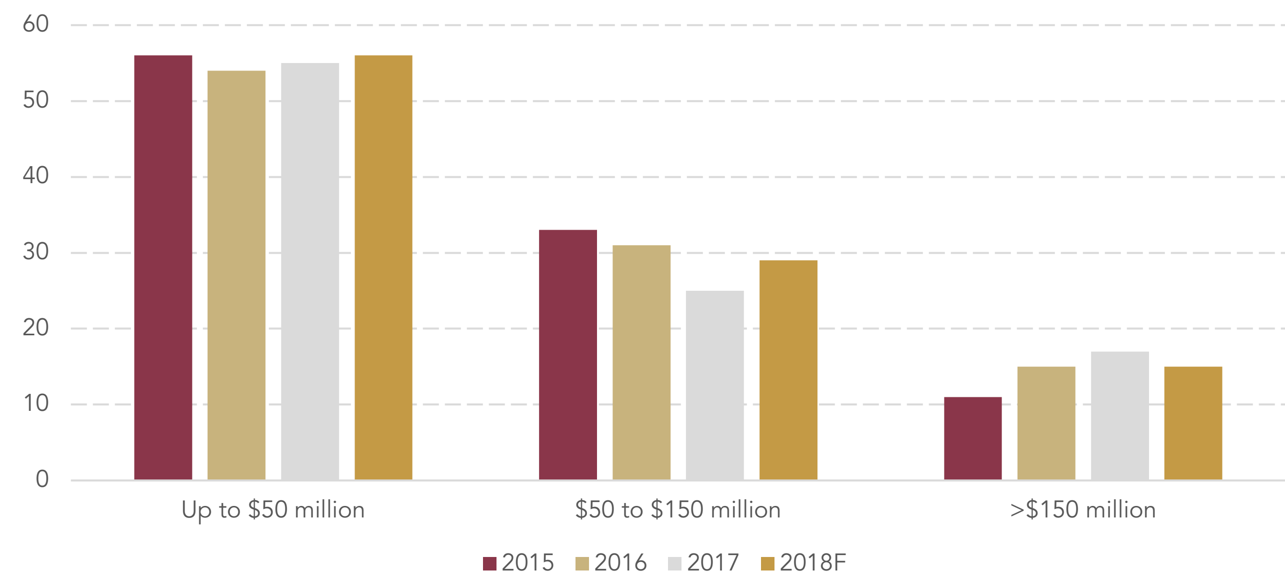
- **Sequels:** Much to the chagrin of many viewers and critics, sequels do tend to have a positive effect on box office, separate from a film's budget. In many cases, however, sequels return less relative to their budget than the preceding movie, which we attribute to mean reversion – i.e. the first movie in the vintage is often a 'sleeper hit' and an outlier versus its underlying budget, while the sequel behaves more predictably.

- **Genre:** Relative to budgets and sequels, which have an outsized influence on box office, the effects of genre are less significant. Two categories stand out, however, horror movies and animated features. We attribute this result to the fact that both genres are built on relatively different cost structures from most of Hollywood's film slate – horror movies tend to have lower budgets and more sleeper hits, while the cost of animated features varies in a narrower range than for typical films.

Even though these variables are quite predictive, we note that the variability of results around these factors can be very wide. Outside of the top 30 movies, predicting the box office for individual films very difficult.

Looking at 2017's budget distribution, we think it becomes clearer why last year's movie slate underperformed: with a larger share of movies with large budgets ($150+ million) and a smaller share of mid-level budgets ($50 to $100 million), the oxygen taken up by blockbusters crowded out many of the mid-tier movies (see Figure 5):

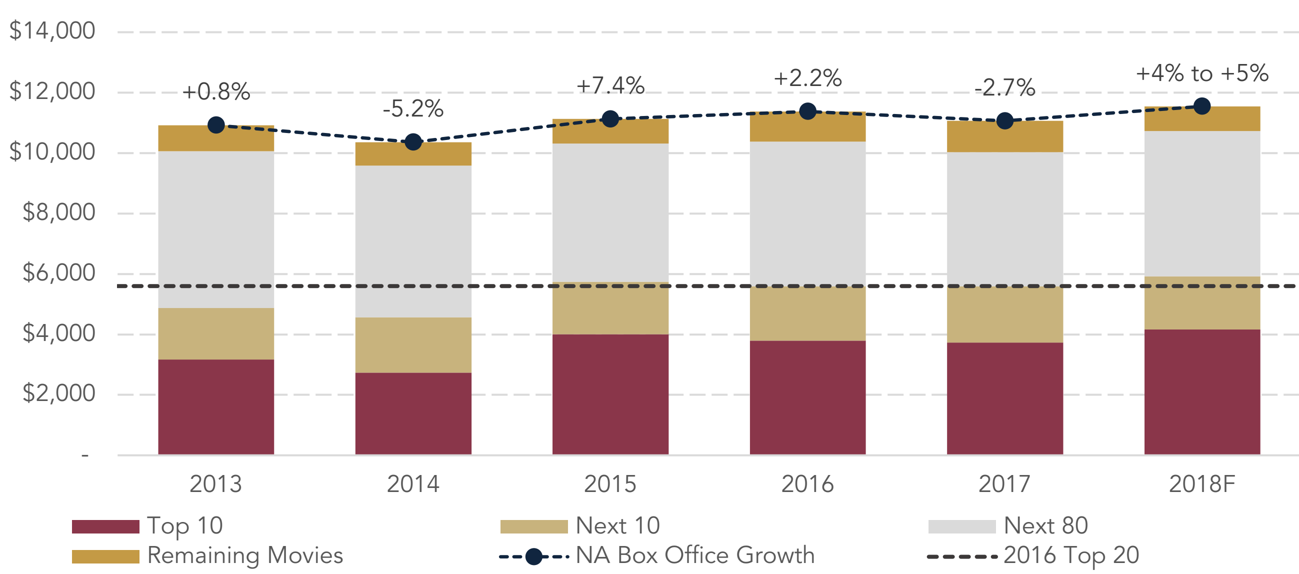
Figure 5
Top 100 Movies by Numbers
Amounts in number of movies



Source: Movie Mojo, Nash Information Services LLC, Veritas estimates

In Figure 6 below, we show that the top 20 movies of 2017 earned roughly the same box office as in 2016 and 2015. The Top 20 movies by box office earned $5,590 in 2017, flat versus 2016, while the next 80 movies earned $4,440 billion, down 7% versus the next 80 of 2016:

Figure 6
2018 Box Office Predictions Compared to Historical Averages
Amounts in millions of U.S. dollars

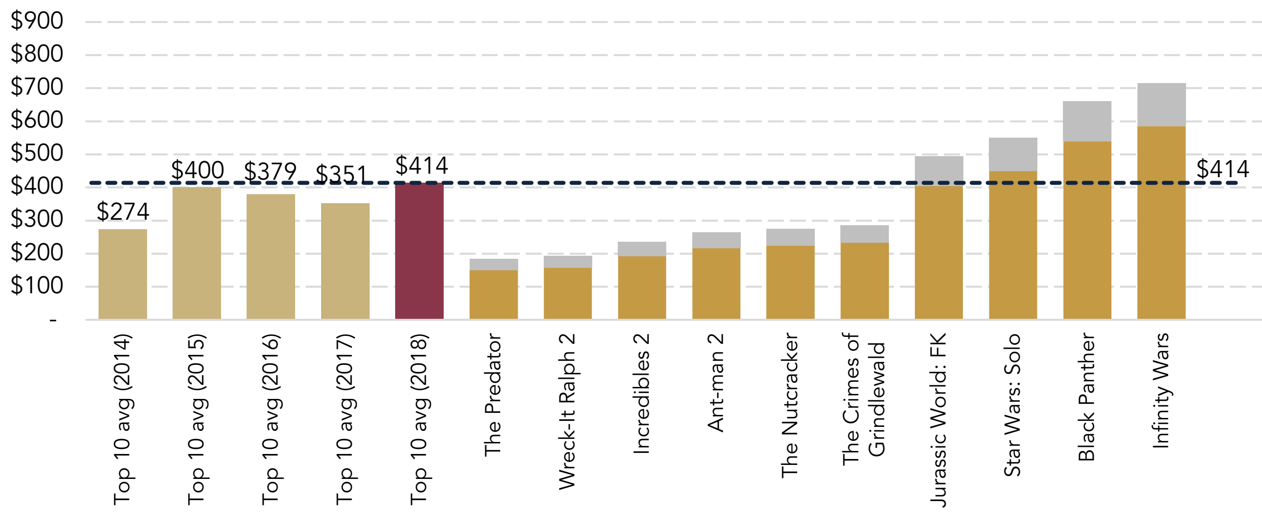


Source: Movie Mojo, Nash Information Services LLC, Veritas estimates

As illustrated, our expectation for an overall increase in 2018 box office extends from our view that mid-range movies, represented by the next 80 group in Figure 7, will perform better than in 2017. At the same time, we do not see much of a departure from prior years in terms of likely sequels, animated features or horror movies (see Appendix for recent trends).

Within our tier of Top 20 films, we note that 2018's largest 10 films by budget are likely to have noticeable effects on this year's individual quarters. In Figure 7, we illustrate 10 of the most anticipated movies of 2018 with our North American box office estimates for each. We also highlight that we expect the average take of 2018's top 10 movies to be higher than in 2017:

Figure 7
2018 North American Box Office Predictions and Historical Averages
Amounts in millions of U.S. dollars



Source: Movie Mojo, Nash Information Services LLC, Veritas estimates

As Figure 8 shows, we anticipate the greatest effects on individual quarters to come from Black Panther (February release), Jurassic World: Fallen Kingdom (June), Solo: A Star Wars Story (May) and Avengers: Infinity Wars (May), with the net result being that Q2 and Q3-2018 will likely experience double digit increases in year-over year box office. It should be noted however, that Q1-2018 looks to have a weaker year-over-year film slate as, even with Black Panther's impressive results, last year's sleeper hits set a high bar (Beauty and the Beast, Logan, Get Out).

Overall, we see a likely lift in Cineplex's attendance this year and a corresponding increase in its EBITDA to $275 to $285 million for 2018. Even though we see stronger results in 2018, we do not expect material growth in theater and media revenues in subsequent years, increasing the importance of Cineplex's efforts to diversify and build out its non-theatre revenues.

BEYOND MOVIES: CINEPLEX'S ONGOING DIVERSIFICATION STRATEGY

Cineplex has been looking to extend its brand beyond its core movie-exhibition business for some time now, with its earliest properties centered around its co-located arcade offerings. As far back as 2011, Cineplex acquired the third-party supplier of its arcade equipment and then, in 2012, it entered a joint venture with Starburst Coin Machines, a large distributor and supplier of arcade games. In 2015, Cineplex bought out its partner's interest in Starburst and rebranded the broader group of businesses to Player One Amusement Group (P1AG). While it has also made a small foray into e-gaming, through its purchase of World Gaming Network, the revenues have been largely inconsequential.

More recently, Cineplex's search for additional revenue streams has centered on 'entertainment complexes' that combine food and arcade offerings branded as 'the Rec Room'. It should be noted that Cineplex has some experience with these type of facilities through its ownership of the Playdium arcade brand under P1AG. In our view, Cineplex's Rec Room is far from an untested concept as it more or less mirrors the strategy pursued by U.S. restaurant chain Dave & Busters (D&B).

Dave & Busters is a well-established brand in the U.S. that offers a large format, theme restaurant/arcade offering, typically set up in 25,000 to 45,000 square feet locations, with individual locations serving large urban or suburban markets. The Dave & Busters (D&B) chain has grown from 61 stores in 2012 to 105 today (2 in Canada), generating comp store sales growth of 19.5% CAGR from F14 to F16.

In terms of customers, D&B reports that it attracts:

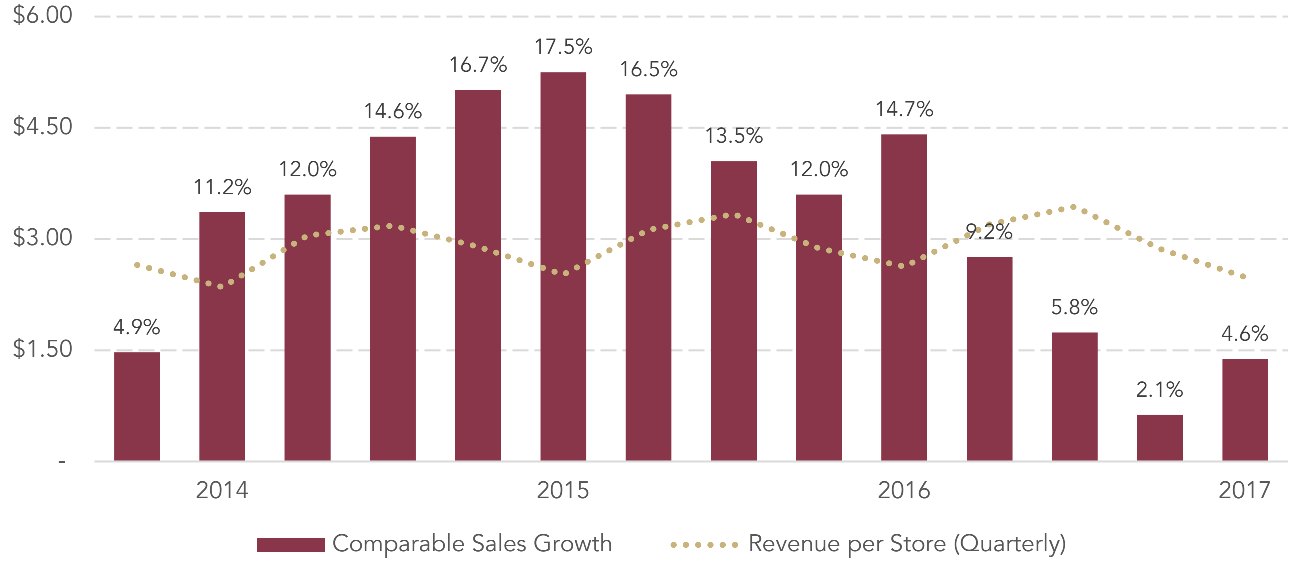
- Relatively balanced and younger demographics (age 21 to 39);
- Above average household incomes (US$75,000+);
- A strong following among families (~42% of revenues); and
- Off-peak use for corporate and special events (~10% of F2016 revenues)

D&B's average sales per location are impressive, at US$12 million, as is the stability of its EBITDA margins over time, at 23% to 25%. While D&B has two locations outside of Toronto, it has no plans to expand further in Canada, which has opened a potential opportunity for Cineplex.

While lower average household income in Canada could prove to be a limiting factor, so far, Cineplex has been careful to select markets that are above the national average for disposable income (Calgary, Edmonton and Toronto). Over the next four to six years, Cineplex expects to roll out 10 to 15 Rec Rooms in larger 40,000 to 50,000 square feet formats, as well as another 10 to 15 smaller 20,000 to 30,000 squarer foot formats with the latter likely to carry the Playdium brand. At $250 to $280 per square foot in construction costs, the large formats would require up front investments of $10 to $14 million (with Cineplex targeting $12 million), while the smaller formats would cost $5 to $8 million. The company plans to operate the restaurants under long-term leases.

As a point of reference, we note that D&B has been able to sustain strong sales growth as it has increased its footprint over the last four years, as illustrated in Figure 8 (next page):

Figure 8
Dave and Buster's Comparable Store Sales Growth and Revenue per Store
Amounts in millions of U.S. dollars



Source: Dave and Buster's

We note, however, that Dave & Buster's concentrates its locations on U.S. metro areas with the largest populations as summarized below:

Figure 9
Dave & Buster's Model: Largest Metro Areas with Multiple Locations Where Supported
U.S. Metro Statistical Areas and 2016 Census populations - amounts in thousands

Ranking of U.S. Metro Statistical Areas by Population:	Top 50	51-100	101+	All Locations
Number of U.S. metro areas with a Dave & Buster's	46	17	4	**68**
Number of metro areas with multiple locations	21	0	0	**21**
Average population per location	2,027	876	394	**1,783**

Source: Wikipedia, Veritas estimates

Unfortunately, the Canadian market offers fewer large urban targets for Rec Room locations, which we summarize below:

Figure 10
Estimated Potential Locations
Canadian Metro Statistical Areas and 2016 Census Populations - Amounts in Thousands

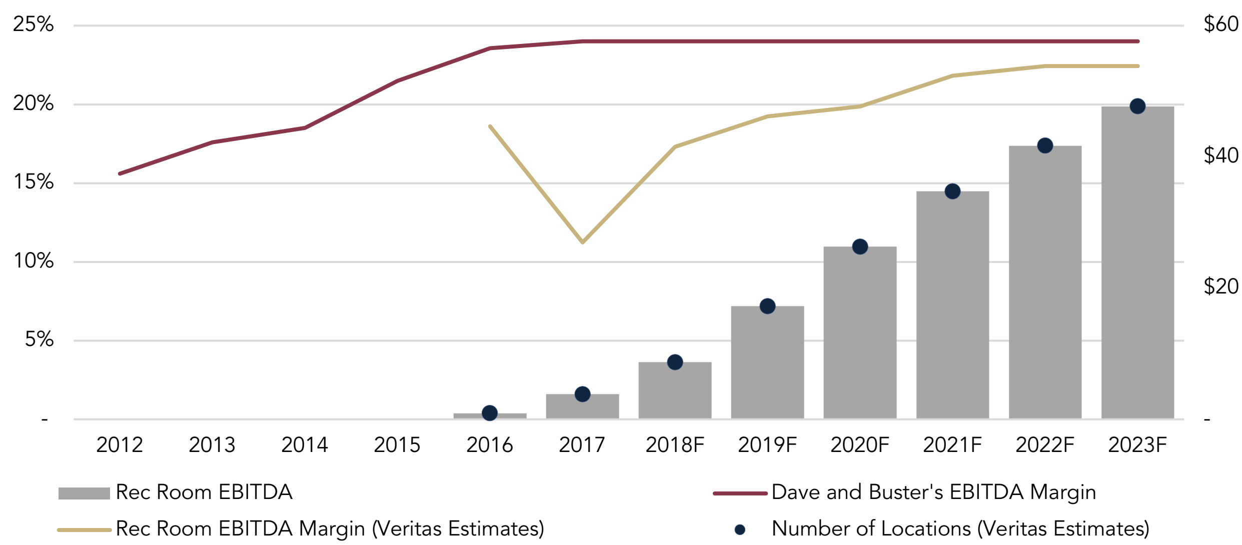
U.S. Metropolitan Statistical Areas by Population	Toronto, Montreal, Vancouver	Calgary, Ottawa, Edmonton	10 CMA's 300k to 900K pop.*	All Locations
Total population	12,490	4,038	5,230	21,758
Estimated potential locations	**9**	**4**	**10**	**23**
Implied population per location	1,388	1,010	523	946

** Quebec City, Winnipeg, Hamilton, Kitchener/Waterloo, London, Niagara, Halifax, Oshawa, Victoria, Windsor*

Source: Wikipedia, Veritas estimates

Assuming Cineplex achieves: first year sales of $9 to $11 million in its large format Rec Room locations; annual sales growth of 5% through year ten; and 20% EBITDA margins, the internal rate of return on its upfront cost of $12 million should reach 12% to 17% over the first ten years, with a pre-tax NPV of $1.9 to $4.7 million per location (9% discounting). Given a long initial payback period in our buildout scenario (5+ years), the longevity of each Rec Room's appeal becomes that much more important. In Figure 11, we show our assumed ramp up of Rec Room and Playdium locations and EBITDA margins over the next seven years:

Figure 11
Rec Room Growing EBITDA Metric and Projected EBITDA Margin
Amounts in millions of Canadian dollars

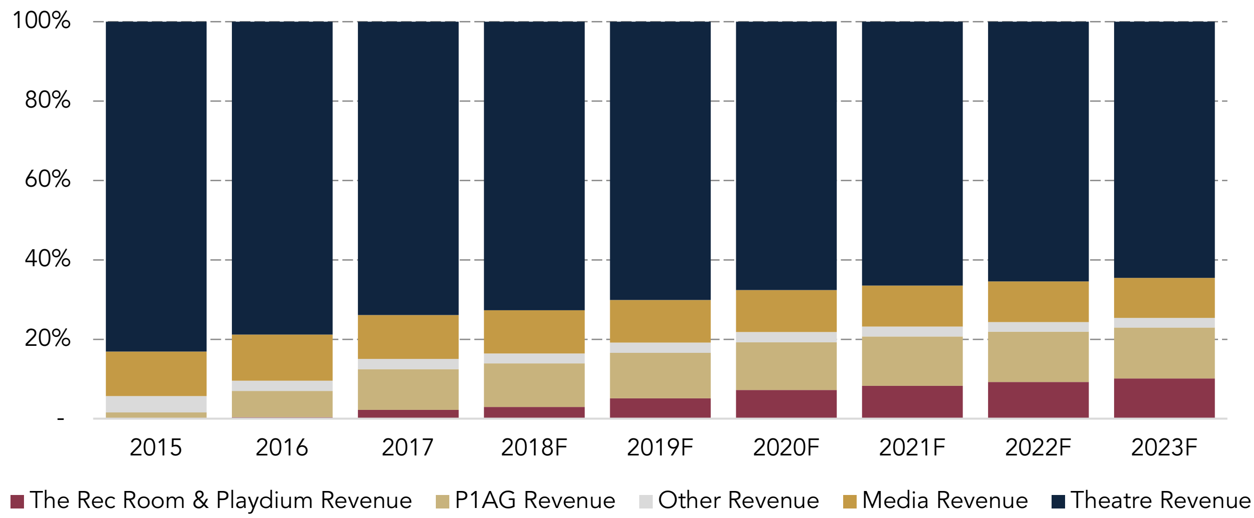


** Only historical numbers were used for Dave and Buster's margins*

Source: Cineplex, Dave and Buster's, Veritas estimates

As shown in Figure 12 (next page), if Cineplex's Rec Room strategy develops as we anticipate, the company's reliance on its core theatre-exhibition business would be greatly reduced over the next five to six years:

Figure 12
Cineplex's Share of Revenue by Category: Significant Decrease in Box Office Reliance



Source: Cineplex, Veritas estimates

The Rec Room buildout is likely to be funded by bootstrapping cash flows from existing locations, with the option to adjust the pace of expansion based on the performance of existing locations. As a result, we see relatively low risk to the Rec Room concept, with Cineplex's Rec Room/Playdium option worth $5 to $6 per share of our $41.00 per share intrinsic value.

We think it is important to point out that even if EBITDA for Cineplex's core theatre business remains flat, as we expect it to over the next several years, the cash flow produced, including P1AG results, supports upside from its current trading price near $32 per share. As we discuss in the next section, even adjusting for more realistic levels of capex to maintain Cineplex's core operations, we see the company generating a free cash flow of $2.20 to $2.30 per share over the next several years prior to any growth spending, which should fully support its current dividend of $1.68 per share.

A Closer Look at Cineplex's Reinvestment Profile

There is no denying that Cineplex's core theatre exhibition business is mature and offers little growth. Against this backdrop, however, it is strange that much of the company's disclosed capital spending is growth capital – on average ~50% of 2012 to 2016 its capital spending, adjusted for tenant inducements, and excluding growth spending in the media, amusement and leisure segments.

In our view, with underlying weakness in attendance, Cineplex's investments in premium formats is a more defensive measure than growth spending as it allows the chain to raise prices to offset declining ticket volumes. In addition, we view tenant inducements as a grey area – Cineplex receives funds from its lessors as compensation for upgrading facilities but some of these inducements may be offset by higher future rental rates, essentially shifting a maintenance-like expenditure into a future operating cost. Had Cineplex owned its own real estate, the tenant upgrades would have been capitalized and amortized.

As a final adjustment, we also deduct depreciation on 3D projectors held by Cineplex in its CDCP joint venture. By seeding capital to the JV to fund new 3D projectors, Cineplex has structured one of its key capital upgrades into a lease arrangement. We view costs associated with the 3D projectors much in the same way as Cineplex's premium format investments – necessary maintenance to shore up attendance. As a result, we deduct annual depreciation from the CDCP JV prorated for Cineplex's 78.2% ownership.

As we show in Figure 13, Cineplex's reported maintenance capex is a very low percentage of its theatre revenues, which we have adjusted to exclude non-theatre-based spending; reported maintenance capex averaged ~2.3% from 2012 to 2016. While dollars spent by peers are not perfectly comparable, U.S. chains averaged a much higher 5.0% to 6.0% of revenues over the same period. Once we adjust for Cineplex's investments in premium formats, its depreciation on 3D projectors and its tenant inducements, we find the company's spending is much closer to peers at 4.3% of theatre revenues:

Figure 13
Peer Comparison of CAPEX to Cineplex: Reported Maintenance CAPEX % Substantially Lower than Comparable Companies
Amounts in millions of Canadian dollars

Cinemark	2012	2013	2014	2015	2016	Average
Theatre revenues	**2,473.5**	**2,682.9**	**2,627.0**	**2,852.6**	**2,918.8**	
Capital expenditures*	115.8	125.0	140.0	199.3	237.1	
% of revenue	**4.7%**	**4.7%**	**5.3%**	**7.0%**	**8.1%**	**6.0%**
Regal Entertainment						
Theatre revenues	**2,820.0**	**3,038.1**	**2,990.1**	**3,127.3**	**3,197.1**	
Capital expenditures**	89.2	112.1	156.8	185.7	214.9	
% of revenue	**3.2%**	**3.7%**	**5.2%**	**5.9%**	**6.7%**	**5.0%**
Cineplex						
Theatre revenues* **	**1,078.8**	**1,148.2**	**1,191.9**	**1,306.2**	**1,319.7**	
Company disclosed maintenance capex	26.6	27.8	25.0	33.6	27.2	
Company maintenance % of revenue	**2.5%**	**2.4%**	**2.1%**	**2.6%**	**2.1%**	**2.3%**
Veritas adjustments to Cineplex maintenance capital						
Company disclosed maintenance capex	26.6	27.8	25.0	33.6	27.2	
Tenant inducements	7.6	5.4	4.2	1.6	4.9	
Premium formats	9.1	8.4	7.3	9.5	11.8	
CDCP JV – Dep'n on 3D projectors****	9.3	10.6	10.6	10.7	10.7	
Veritas adjusted maintenance capex	**52.7**	**52.2**	**47.2**	**55.4**	**54.5**	
Veritas adj. maintenance % of rev.	**4.9%**	**4.5%**	**4.0%**	**4.2%**	**4.1%**	**4.3%**
Adding full growth & acq. capital	88.4	74.9	107.5	97.2	107.0	
Full capex % of revenue	**8.2%**	**6.5%**	**9.0%**	**7.4%**	**8.1%**	**7.9%**

** Cinemark's capital spending estimate is based on company disclosed maintenance spending*
*** Regal makes no adjustment for growth capex but indicates all expenditures relate to its theater circuit*
**** Total Cineplex revenues less Rec Room, Digital Place-Based Media (non-theatre) and P1AG*
*****Disclosed CDCP depreciation adjusted to Cineplex's 78.2% ownership of CDCP*

Source: Regal Entertainment, Cinemark, Cineplex, Veritas estimates

As with Cineplex's premium format spending, there is an argument to be made that some of its growth capital, which includes building new VIP format theatres, may also be 'maintenance'. After adding the full amount of Cineplex's disclosed growth and acquisition capex, its adjusted total capital expenditures reach ~8% of revenues.

For the purposes of our valuation, we have conservatively assumed that Cineplex's core theatre businesses require maintenance capex equal to 6% of theatre revenues to sustain growth in per patron revenues at rates above inflation.

CINEPLEX OFFERS STRONG FCF EVEN AT OUR HIGHER REINVESTMENT RATE

As shown in Figure 14 below, even at our higher maintenance capital estimate, Cineplex's core business can generate strong free cash flows, averaging a FCF conversion rate of 50% to 55% of EBITDA:

Figure 14
EBITDA to Free Cash Flow Conversion: Stable Ability to Convert Free Cash Flows
In millions of Canadian dollars, except as noted

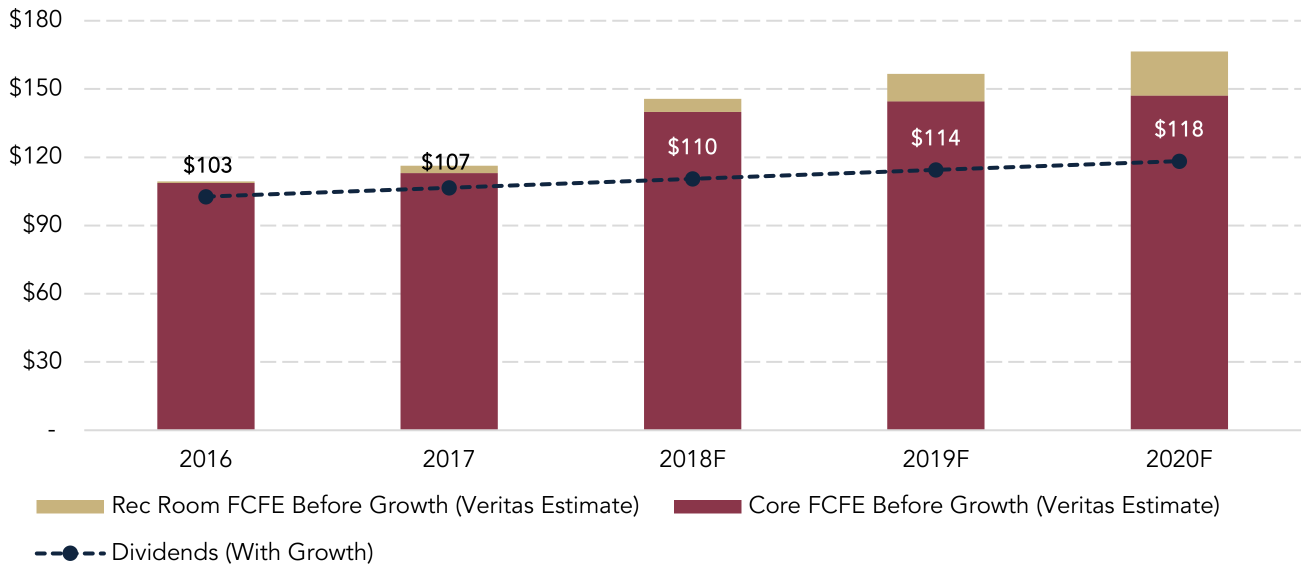
	2014	2015	2016	2017	2018F	2019F	2020F
A) Core EBITDA (excl. Rec Room)	**197**	**276**	**233**	**237**	**273**	**272**	**279**
Adjustments:							
Taxes	(21)	(37)	(31)	(27)	(32)	(37)	(41)
Other (e.g. interest, etc.)	(16)	(16)	(15)	(18)	(21)	(7)	(6)
Veritas estimated maintenance capex	(69)	(71)	(79)	(79)	(80)	(84)	(84)
B) FCF to equity from core business	**91**	**152**	**108**	**113**	**140**	**144**	**148**
(B/A) Adj. FCF conversion %	46.2%	55.1%	46.4%	47.7%	51.3%	52.9%	53.0%
FCF to equity per share*	**1.40**	**2.34**	**1.66**	**1.74**	**2.15**	**2.22**	**2.28**
C) Add: Est. Rec Room EBITDA	-	-	1	4	8	16	26
(A+C) Combined EBITDA	**197**	**276**	**234**	**241**	**281**	**288**	**305**

** Using diluted share count of 65.0 million shares at December 31, 2017.*

Source: Cineplex, Veritas estimates

Over our forecast horizon, we expect Cineplex's core free cash flows to range from $2.10 to $2.20 per share before growth capital. As we show below, the company's free cash flow growth is highly dependent on the roll out of its Rec Room plans:

Figure 15
Free Cash Flow Projections: Growth in the Gaming Business Will Allow Cineplex to Maintain Their Dividend
Amounts in millions of Canadian dollars



Source: Cineplex, Veritas estimates

As shown above, while Cineplex's 2017 payouts look stretched, we see the company's Rec Room offering as increasing future room for dividends.

As a final note, Cineplex's balance sheet leverage is creeping up, with Net Debt to trailing EBITDA likely to fall near 1.9x at 2017 year-end[1]. However, there is currently more than $150 million available on its revolving credit facilities, which we would expect the company to use to settle $107.5 million in convertible debentures maturing at the end of 2018. Even assuming the full amount of the convertibles is rolled over on credit, we estimate that Cineplex's Net Debt to EBITDA ratio is likely to rise to 2.2x, at most, well below an allowable limit of 3.5x (both using definitions under the facility). As a result, we do not currently see any refinancing risks or potential liquidity issues.

Earning a Better Review

After suffering a string of bad results in the past several years, we think Cineplex's business prospects in 2018 are likely better than the market anticipates, with the potential of a full Rec Room expansion not priced into its shares. We are initiating coverage on Cineplex with a Buy recommendation and an intrinsic value of $41.00.

[1] *Using covenant definitions on Cineplex's credit lines, the company's leverage ratio at September 30, 2017 was a relatively comfortable 2.05x versus a limit of 3.50x.*
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Appendix A: Tracking Cineplex's Payroll Expense

With one of Cineplex's largest expenses being theatre payroll, we expect provincial minimum wage increases to adversely affect the company in 2018 and into 2019. 80% to 90% of Cineplex's 13,000 employees are waged. Based on the geography of Cinemas, we estimate minimum wage hikes could increase the company's payroll expense by 8% to 10% in 2018 and 4% to 5% in 2019. This translates to a $10 to $15 million and $5 to $10 million reduction of cash flows YoY in 2017 and 2018 respectively, illustrated below:

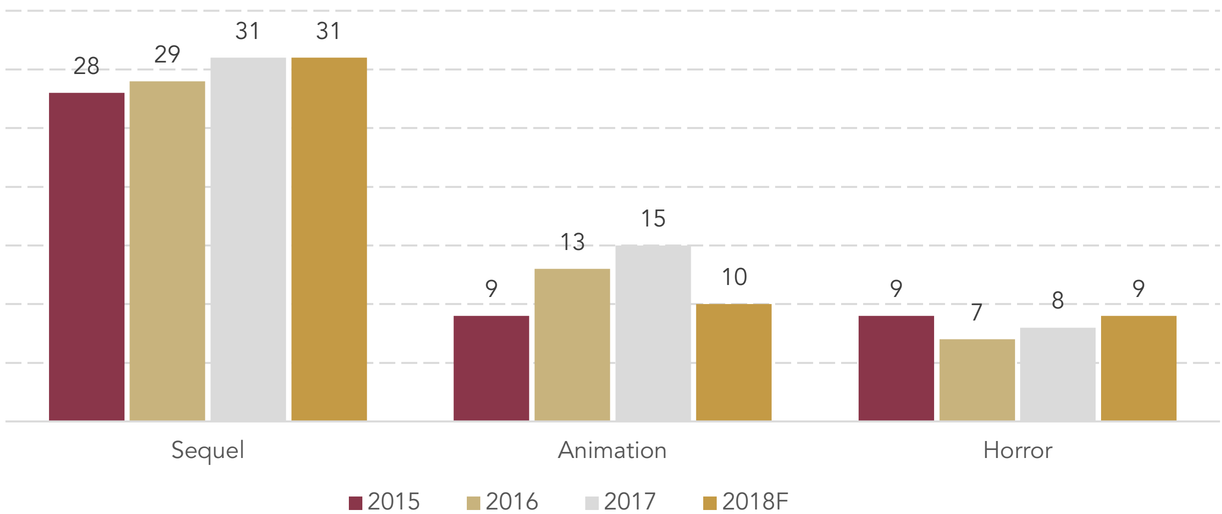
Figure 1
Expected Increase in Payroll Costs Due to Wage Hikes
Amounts in Canadian dollars

Number of Employees		13,000						
% on Salary		88%						
		Minimum Wage			% Increase in Minimum Wage		Weighted Change	
Province	# of Theatres	2017	2018	2019	2018 Δ	2019 Δ	2018 Δ	2019 Δ
AB	17	$13.60	$15.00	$15.45	10.3%	3.0%	1.1%	0.3%
BC	25	$11.35	$11.69	$12.04	3.0%	3.0%	0.5%	0.5%
MB	5	$11.15	$11.48	$11.83	3.0%	3.0%	0.1%	0.1%
NB	5	$11.00	$11.33	$11.67	3.0%	3.0%	0.1%	0.1%
NL	3	$10.75	$11.00	$11.33	2.3%	3.0%	0.0%	0.1%
NS	12	$10.85	$11.18	$11.51	3.0%	3.0%	0.2%	0.2%
ON	68	$11.60	$14.00	$15.00	20.7%	7.1%	8.6%	3.0%
PEI	2	$11.25	$11.59	$11.94	3.0%	3.0%	0.0%	0.0%
QC	20	$11.25	$11.59	$11.94	3.0%	3.0%	0.4%	0.4%
SK	6	$10.96	$11.29	$11.63	3.0%	3.0%	0.1%	0.1%
Total	**163**						**11.1%**	**4.7%**
Total 2018 change		9.8%						
Total 2019 change		4.2%						

Source: Cineplex, Retail Council of Canada

APPENDIX B: HOLLYWOOD RELEASES BY GENRE

Figure 1
Movies Releases by Genre: 2015 to 2018
Amounts in number of movies



Source: Movie Mojo, Nash Information Services LLC, Veritas estimates

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