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Stupid Investment of the Week

Commentary: Regal Entertainment Group gets two thumbs down

By Chuck Jaffe, MarketWatch
Last update: 3:49 a.m. EST Nov. 7, 2008

BOSTON (MarketWatch) -- Investors looking for gems in the ruins of the current market downturn typically rely on a few key criteria.

They want a business that can thrive in an economic downturn, a company with a leadership position in its industry, one that has lost enough during this year to be considered a bargain, and a high dividend payout to overcome the bumps and bruises of day-to-day volatility.

With that in mind, an investor might be attracted to Regal Entertainment Group (RGC) , the nation's largest operator of movie theaters.

Its stock price has been more than cut in half in the last year, pumping the current yield into double-digit range. Alas, dig beneath the surface on all of those issues, and you can see the stock still has a lot of negatives -- enough to make it Stupid Investment of the Week.

Stupid Investment of the Week highlights the flawed logic and beneath-the-surface issues that make a security less-than-ideal for the average investor. The hope is that showing where danger lies in one situation will make it easier for readers to uncover problems elsewhere. While obviously not a purchase recommendation, neither is this column intended as an automatic sell signal.

Action packed

In the case of Regal Entertainment, there is an obvious bullish case to be made right now.

Start with the economy, which is bad for many businesses but not necessarily a problem for cinema operators, as going out to the movies is likely to remain one of the cheaper ways for a night on the town. In Regal's case, the company's free cash flow has been relatively stable, which is important because there's a significant debt load to worry about.

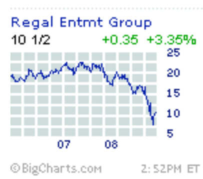
Then there's the company's huge collection of theaters, which give it an advantage in negotiating contracts with production companies and concession firms. And because Regal tends to build big complexes -- where it can leverage labor costs over many screens -- the company has the highest operating margins in the industry.

Next comes the yield, which now stands north of 12%, a nice cushion against any continued price erosion and particularly attractive when you consider that the stock recently dropped below $10 per share and most fair-value estimates stand at least twice that high, meaning any current buyer is getting the stock at what amounts to a half-off sale.

So much for the good news.

Cutting-room floor

You can start the bad news with a simple economic analysis, one which says that in current economic conditions, consumer discretionary stocks are in line to take a beating, particularly if they have an issue with debt.



Regal has a mountain of debt, close to $2 billion. While it's not coming due until 2011-- by which time the credit markets may be working properly and efficiently again -- there's no question that it's a big potential threat to the dividend. The debt load also could limit potential growth, whether through expansion or acquisition, and limit the company's ability to embrace certain industry developments such as Imax and 3-D theaters.

The debt might not be a threat to the dividend if everything was up to Regal, but theater operators don't control the quality of the films coming out, and so rely on someone else to pump up their revenues. While consumers may find movies a cheap date, that doesn't mean they'll pony up to see bad films.

Moreover, customers have no reason to be particularly loyal to any movie theater. If the same film is showing in two places, a consumer concerned about their pocketbook will go to the one that is closest (lowest gasoline cost) or that has the lowest ticket prices (lowest profit margin for the operator).

That same lack of loyalty can occur among studios. If a theater operator pushes for too sweet a deal from the studios, the producers can simply take their show up the road to the next company. Say goodbye to any power in negotiating film licenses.

And while an investor is buying shares in Regal, they're not actually getting a controlling interest in the company. That belongs to the Anschutz Co., which owns all Class B shares of stock, the ones with 10-1 voting power that give Anschutz more than three-quarters of Regal's voting control.

Said David Brady of Brady Investment Counsel in Chicago: "The shares are cheap, no doubt, and they pay a great big dividend ... but there are a lot of cheap [stocks] today without the without funky ownership structures."

While the stock is below fair-value estimates, its third-quarter profit fell by more than 45% from a year ago and was well-below analyst forecasts.

Nashville-based research firm New Constructs had Regal on its "most dangerous stocks" list for October, a month when the company's shares lost 18%, but has since moved the stock off that list and has given it a neutral rating.

David Trainer, New Constructs' president, said that Regal "must grow profits at 3.5% per year for each of the next 27 years to justify the current price." And while that might not sound like much, Trainer noted that the operating profit growth rate over the last five years averages a negative 3%.

Until that trend can be reversed, Regal looks like the kind of "good company, bad stock" situation that amounts to "a bargain in the making." It could still have further to fall -- especially if the dividend is cut -- and needs more health in the economy before it can live up to the potential that it appears to have at first glance.

Chuck Jaffe is a senior MarketWatch columnist. His work appears in dozens of U.S. newspapers.