Carmike Cinemas, Inc. (CKEC) Memo

Name: Tim Chen	College/School: McIntire '12	Year: 2

Financials/Model

- See Exhibit 3

Thesis / Key Points

- CKEC Faces Higher Costs, has Unsustainable Operating Cash Flow, and Low Equity Value
- CKEC operates in non-urban, small to mid-sized cities and thus doesn't face direct competition from larger film exhibitors such as Regal and AMC; however, patron incomes are likely to be lower. As of 2009, admissions are 67% of revenue, and concessions are 33%. Film exhibition costs rose 12% from '08 to '09 and 20% from 2005 to 2009. These costs vary with box office admissions and are accrued based on contracts with movie studios. The current trend in 3D will increase box office admissions, and movie studios will demand more to cover their production costs of 3D movies. Furthermore, CKEC has an exclusive contract with Coca-Cola through 2013; costs will rise 3.3% in 2010 as stipulated in the contract, and Coca-Cola has the option of increasing costs by up to 10%. To maintain a strong revenue stream, CKEC passes its costs on to the consumer by raising prices for films and concessions. While the average attendance per screen in 2005 and 2009 is roughly equal, CKEC's admission prices rose by 22% versus 17% on average according to the National Association of Theater Owners, and its concession prices rose by 16%. 3D surcharges provide a margin of safety for revenue but it won't last. To maintain lower 3D admissions, CKEC raises the price of its concessions. CKEC has a popcorn bucket promotion where the patron pays $15 for a bucket, and refills are $2.50 for all subsequent uses. This is a nasty strategy – how many patrons bring a bucket into a theater? CKEC then counts the cost of the bucket as concession sales. Higher concession costs and 3D admission costs – relative to 2D admission costs – mean patrons will likely forgo concessions, and eventually, if 3D admission costs rise, forgo 3D movies.
- CKEC has entered into multiple long-term agreements and leases without fully exiting current long-term leases. CKEC is on schedule with its debt repayments due 2013 and 2016, and has a 30mm revolving credit facility. CKEC sought Chapter 11 bankruptcy protection in 2000 after failing to make $9M in interest payments; it had $650M in debt. Although CKEC isn't currently facing bankruptcy risk, it pays back debt via operating cash flow, which is volatile due to the seasonal nature of the industry and unpredictability of the success of movies. Low operating cash flow means inability to renovate and maintain its theaters. Operating cash flow will decrease as a result of higher costs and lower share of revenue splits due to pressure from the movie studios industry. Furthermore, CKEC's bonus structure rewards managers for maximizing profits, which leads managers to forgo renovations, maintenance, and customer service. CKEC also converts sub-par quality and loss generating theaters into discount theaters and may later sell them to generate additional cash. CKEC closed 55 theaters and 286 screens from 2007 to 2009 and currently operates 20 discount theaters**.** In areas where real estate is readily available, there are few barriers to entry. In 2009, competitors entered markets where CKEC has 8 theaters with 78 screens. During the same period, CKEC closed 11 theaters and 70 screens. Since 2007, CKEC has forgone $15.7M in revenue from discontinued operations and has lost after-tax $4.2M from selling these operations.
- CKEC will increase the number of shares from 20 million to 35 million on May 17th in an effort to finance itself. From 2005 to 2009, assets have decreased by 38% and total stockholder equity by 95%, from $232.7M to $11.3M. Equity dilution will hurt EPS and make it harder for CKEC to beat future EPS estimates.
- Shrinking Revenue Stream

  Film exhibitors have two main sources of revenue – admissions and concessions. Most movie studios engage in sliding-scale contracts with theaters – the studio takes 100% on the opening weekend, 90% the second, and so forth. Theaters take the rest. Therefore, while a theater may sell-out on opening weekend for a highly anticipated 3D or 2D movie, the revenues go toward movie studios. CKEC and other theaters will have to depend on concession sales; however, with the ever increasing 3D ticket prices, a family of four paying $60 will likely forgo popcorn and cola. CKEC and other theaters are pushing for longer playing times at its theaters so they can increase revenue; however, movie studios are pushing for a smaller DVD release window, the time between the release of a film in theaters and to DVD. The theaters don't have strong negotiation power because movies oftentimes don't profit movie studios – showing movies at the theater itself is an advertising ploy for movie studios because movie studios gain most of its revenue from TV licensing and other downstream sales – rentals, DVD sales, etc. The release window has been narrowing over the past several years and currently averages 17 weeks; Disney is taking a bold move in pushing for 12 weeks with "Alice in Wonderland." With its number of screens decreasing and the DVD release window narrowing, CKEC's revenue stream is shrinking as opening week profits are taken by the movie studios and longer playing time of one movie on one screen forgoes the possibility of playing a new movie and generating stronger concession revenues.
- Dispute with Lionsgate

  CKEC, although it has local monopoly power in some areas, has damaged its reputation due to its recent dispute with Lionsgate over revenue sharing. CKEC decided to ban Lionsgate films at its theaters. While disputes between one theater and a studio are common, disputes like this one on a mass scale is very rare. In areas where CKEC has a local monopoly, patrons who want to see the newest Lionsgate film "Kick-Ass" are bitter at the establishment. In areas where it is economically practical to drive to a farther theater, patrons are doing so. Without CKEC's distribution channels, Lionsgate's "Kick-Ass" was still shown in over 3,000 screens, the fourth most in Lionsgate history. Lionsgate is also coming out with "SAW VII," one of its best performing series that grosses $67 million on average, and a highly anticipated summer action flick, "The Expendables," featuring Jason Statham, Jet Li, Sylvester Stallone, and Steve Austin. Many bloggers already rate the Expendables, a revisit of 1980s action films and directed by Stallone, as one of the top movies of 2010. Because Lionsgate was still able to promote its movies pervasively without CKEC's distribution channels, CKEC will lose attendance and revenues from these Lionsgate films. Furthermore, the dispute is of lower priority to Lionsgate as Lionsgate is currently trying to fend off Carl Icahn's hostile takeover bid.

Carmike Cinemas, Inc. (CKEC) Memo

- Monopolist Pricing and Cannibalization
  CKEC had the highest concession prices by a wide margin – sometimes 30% or higher. Furthermore, in areas where CKEC is a local monopoly, it charged $3.00 more for the Michael Jackson tribute, and is charging $2-$3 more for presale Iron Man 2 tickets nationwide. Its 3D surcharge also varies by demographics – it charges $3 in Farmville, but $3.50 in Charlottesville. CKEC exploits this power in areas where it has a local monopoly, knowing that patrons have nowhere else to go and must remain loyal. This sets CKEC in a bad situation if there is competition from local theaters. Local movie and bar or restaurant establishments, which provide for a better experience, and better food, have led to increased competition for CKEC. Furthermore, in areas where CKEC has more than one establishment, because theaters are managed locally, an incentive to distinguish itself to increase attendance will lead to cannibalization.
- Obsolete equipment
  CKEC entered a locked contract from 2005 to 2020 with Christie/AIX to install up to 2,300 2K digital projectors at $800 each and maintenance costs at an annual $2,340 per screen. However, the industry standard will soon be 4K digital projectors by Sony, which competitors such as AMC are currently installing. Christie/AIX does not have 4K technology. CKEC's competitive advantage from early investment in 3D is now next to none as most competitors have equal or more superior 3D systems. Impairments for 2008 and 2009 have increased due to accelerated depreciation on CKEC's 2K projectors but CKEC does not have the financial flexibility to get ahead of its competitors who have 4K projectors.

Misperception

1) After beating 2009 Q4 earnings estimates by $0.39/share, CKEC's stock price rose from $9.50 on the March 1st announcement date to $18.59 in less than two months. Bulls are encouraged by CKEC's 5x+ beat on EPS but this is CKEC's second time in 2.5 years posting a quarterly profit. Furthermore, analysts fail to take into account that 2009 was a year that featured nine $100M+ grossing films. Every research report on CKEC every quarter discusses exciting new films coming soon but they never say they will disappoint. Predicting attendance, cash flow and results isn't easy – it is seasonal and depends on the movies. This is a problem for CKEC, who leases over 74% of its theaters and enters into long-term non-cancelable lease agreements from 15-20 years. Because cash flows are unsustainable due to poor movies, CKEC, who exhibits increasing operating leases on its theaters, closed 55 theaters in the past four years.

2) The 3D movie novelty will eventually wear off and CKEC will suffer. 3D has only done well with "Avatar" and "Alice in Wonderland." Recent 3D movies, including "How to Train your Dragon," opened with a disappointing $43.7 million and dropped 33.7% in revenue in its second weekend. Although "Titans" opened with $64M, it cost the studio over $125M to make and over $50M to market. These other 3D movies have not been living up to the hype and cost movie studios more to make and may not be profitable in the long run. Movie studios may eventually turn away from the 3D trend. Furthermore, even if a 3D movie performs well on its opening weekend, it will likely gain high attendance the first few weeks, but most of the revenue goes to movie studios, not film exhibitors like CKEC. Avatar grossed over $2B in revenue and Alice in Wonderland, over $800M in gross revenue. These are exceptions whereas average 3D movies gross in the $100M to $200M range.

VAR

- See exhibit 1

How It Plays Out

I believe CKEC will beat Q1 earnings estimates, which will propel the stock price up artificially above $20. CKEC cannot sustain its momentum by relying on the novelty of 3D movies – as soon as movie studios realize not all 3D movies are as successful as Avatar, they will cut back on 3D production, leaving CKEC with excess capacity and an increasingly lower return on assets. 3D movies cost $10million more to make on average, than 2D movies. This excludes marketing costs, and the cost of 3D digital projectors for theaters. Although CKEC has equipped itself with multiple 2K digital projectors for 3D, the industry standard will soon be 4K. Furthermore, because CKEC relies on operational cash flows to finance its debt, one bad year in movies will set it further behind on its debt. This is exacerbated more by the lack of power in negotiation between film exhibitors and movie studios as movie studios seem to be able to command the industry – the irrational backlash against Lionsgate only makes CKEC worse off.

Risks / What Signs Would Indicate We Are Wrong?

- CKEC beats analyst estimates of $0.05 per share because of the long playing times of post 4th quarter hits such as "Avatar."
- New 3D movies (19 scheduled for release in 2010) will be just as successful as "Alice in Wonderland" or "Avatar."
- CKEC solves the dispute with Lionsgate in the near future and will see increased revenue from playing Lionsgate's movies.
- Movie studios strike a deal with film exhibitors for a fairer revenue sharing scheme that benefits film exhibitors.

Signposts / Follow-Up

- Pair trade with RealD, which filed for an IPO in 2010 – its technology was used in "Avatar," and it controls 97% of the 3D market.
- How will stockholders react to equity dilution?
- Relationship between Lionsgate and CKEC
- How certain highly anticipated 2010 movies perform at the box office on opening weekend and successive weekends
- Which studio is producing most of 2010's most anticipated films (research sequel average grossing revenues and predictions for opening weekend revenues)

Company Description

[CKEC] is a motion picture exhibitor in the US. The company owns 244 theaters with 2,277 screens located in 35 states. The company is located in small towns and cities. 2141 screens are equipped on a digital-based platform and 503 screens are equipped for 3-D. The company also operates 20 discount theaters. Box office admissions account for 67% of revenue and concessions and other revenues total 33%.

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(Exhibit 1)

VAR

- Survey results, Exhibit 2

  Data was collected from a sample of UVa Students (Fitzhugh-Dunnington residents. According to UVa, 1st year residence is placed at random).
- Professor Natasha Foutz

  Professor Foutz is a marketing professor at the McIntire Commerce School with a focus in the movie studios industry. I interviewed her with a list of in-depth questions particular to CKEC, movie studios, and theaters.
- The revenue sharing scheme between studios and theaters is usually via sliding scale. CKEC gains revenues from concessions during those early weeks.
- Studios sign individual contracts with different theaters, even within franchises. This is inefficient because theaters should be managed at a corporate level and not local – this could lead to cannibalization.
- Movie studios are focused on downstream (TV licensing, DVDs) revenues. TV licensing is the largest revenue source for movie studios; video rentals and sales are the cash cows. Studios have an incentive to shorten the DVD release window, whereas theaters want to encourage playing movies for longer because they earn revenue over time. Thus, theaters have weak negotiation power and are struggling. Many theater owners are selling their businesses and companies like Regal don't have the capital to expand into smaller markets. Many theater screens can't fill a full audience. Theaters are distinguishing themselves but at the same time this creates cannibalization.
- Most movies don't break even at the theater stage – this is purely advertisement. Movie studios need to keep good relationships with theaters; good advertisement leads to stronger licensing demands from TV companies.
- In the case of Lionsgate and Carmike, both have pushed each other into the lower corner of a prisoner's dilemma – both are losing. Large disputes on a mass scale such as this are very rare but between one theater and a studio is not.
- 3D is a trend – big name directors are committing themselves to make 3D movies. 3D movies are cheap or expensive depending on the technology; there is a trade-off with quality (risk). *However, 3D movies are of better quality with 4K projectors, which CKEC does not possess. 4D would require theaters to put in more money in renovating their theaters, money that CKEC does not currently have.*
- It is ridiculously difficult to get data on the film exhibition or movie studio industry – they guard them very well.
- Theaters will not go out of business just as radio didn't with the advent of TV
- Charley Li, Ross'10, individual investor

  Charley is an individual investor and a current student at Ross. He has interned with Lehman Brothers and Blackstone, and will be working with Goldman upon graduation.
- "Can't believe it doubled in the last two months…soared because the company's capital structure is better than it was previously from the restructurings they have initiated. I don't think bankruptcy risk is there anymore as it was last year…this is a highly volatile stock…"
- "Companies in this space deserve about a 20x P/E. On a 2010 estimate earnings of slightly under $0.50, the stock is trading at 35x P/E, which is overvalued. But for 2011, which estimates are a dollar in earnings, a 10x multiple would mean $20 per share."
- Christa Doerwaldt

  Christa is an UVa student from Winchester, VA. There were two Carmike Cinemas located near her hometown. Because a local movie and tap bar, with cheaper ticket prices, a better experience, and better food, was established, one of the Carmike theaters was shut down.
- Carmike in Charlottesville, VA

  Lack of customer service – phone menu details showings and concessions. Regal has a customer service representative. When I went to watch Avatar on opening day, there was one person selling tickets, the line was long, and no one was working concessions even though there were idle employees. Furthermore, the theater floors were littered with popcorn, the chairs were old and torn, and it wasn't stadium seating – which made watching 3D very uncomfortable.
- Customer Representative, Carmike HQ, GA

  The dispute with Lionsgate is on a mass scale not per-theater or per-market scale. The issue will be resolved indefinitely.
- Peter Wilkes, Lionsgate Investor Relations

  Cannot comment on anything at this time because of Carl Icahn's takeover bid.
- Rita Xia, UVa'10, Film Major

  Believes 3D is just a trend.
- Chrissy Regelski, UPC Cinematheque Director

  Non-profit organizations like us select movies from movie distributors, not the studios themselves. Carmike in Charlottesville recently changed management.

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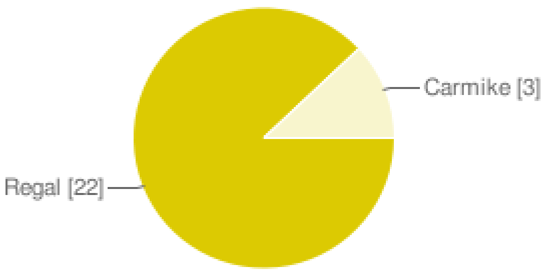
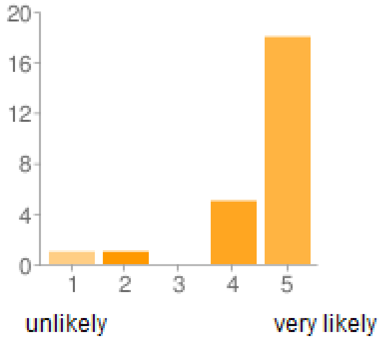
(Exhibit 2)
Survey Results

Would you watch a 2D/digital movie at Regal or Carmike?



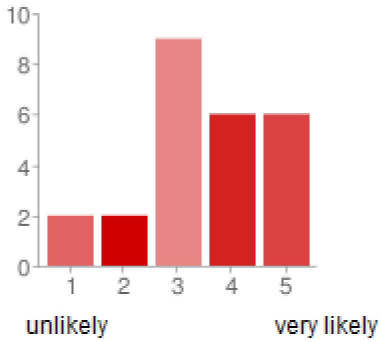
Regal	**22**	88%
Carmike	**3**	12%

If Carmike bans a movie you really wanted to watch from its theaters, how likely are you to drive to another theater 5-10miles farther away to watch it?



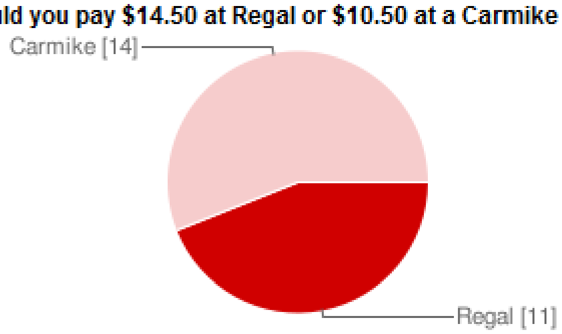
1 - unlikely	**1**	4%
2	**1**	4%
3	**0**	0%
4	**5**	20%
5 - very likely	**18**	72%

How likely are you to go back to Carmike if it previously banned a movie you really wanted to watch?



1 - unlikely	**2**	8%
2	**2**	8%
3	**9**	36%
4	**6**	24%
5 - very likely	**6**	24%

Would you pay $14.50 at Regal or $10.50 at a Carmike to watch a HIGHLY anticipated 3D movie?



Regal	**11**	44%
Carmike	**14**	56%

From the survey, important tables are listed above. Although students are likely to go to a different theater if the movie they want to watch is not playing at Carmike, most patrons are likely to go back to Carmike for future movies. However, if given the choice between Regal and Carmike, 88% of students prefer to watch a 2D movie at Regal. Most students would pay more to watch a highly anticipated 3D movie at Regal but less for casual one at Carmike. Other highlights are listed below, ratings are based on a 1-5 scale, 1 being very low, and 5 being very high. It is important to note that the sample was taken only from college students and thus does not represent all demographics.

	Carmike	**Regal**
Overall notion	*60% answered 3*	*64% answered 4*
Cleanliness, wear and tear, etc.	*52% answered 3*	*56% answered 4*
Movie watching experience	*56% answered 3*	*52% answered 5*

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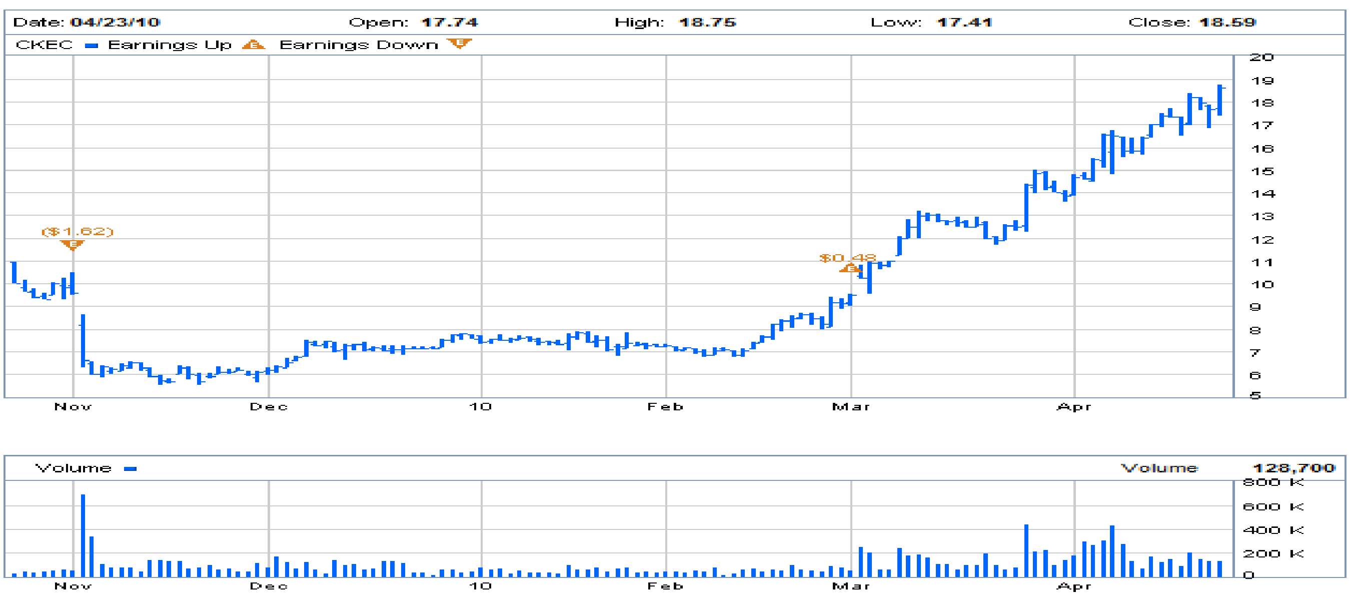
(Exhibit 3)

(4/23/10)	Price	52 Week Range	Market Cap
	$18.59	$3.92 - $18.75	$239.12M

ROE	-84.1%	Total Cash	$25.7M
Debt/Equity (TTM)	24.49	Long-term debt	$369.12M
Current Ratio	0.40	PE (TTM)	-14.86
Short Interest	5.54%	Days to Cover	3.3
TEV	$570.84M		

	2007A	2008A	2009A	2010E	2011E	2012E
Revenue ($mil)	482.06	472.68	514.72	*518.89*	*523.09*	*527.33*
Growth		-1.9%	8.89%	*0.81%*	*0.81%*	*0.81%*
EBITDA ($mil)	77	72	79	77.8	78.5	79.0
Margin	15.9%	15.2%	15.3%	*15%*	*15%*	*15%*
Est. EPS	-0.27	-0.18	-1.22			
Street EPS			-1.64	*0.69*	*0.94*	*1.00*
Multiples			-15.6	*20*	*20*	*20*
Price ($)			7.56	*28.99*	*21.28*	*20*

Historically revenue growth has been +0.81% (Fidelity).
CKEC traded at around 20x from 2003-2004; using this highly optimistic multiple, the current stock price is modest; however, I don't see CKEC jumping from -15.6x to 20x soon. Using a multiple of 10, prices are $14.49, $10.63, $10 for 2010E, 2011E, and 2012E respectively.



Management:
Insider Trading

Insider buying increased on March 3rd, 2 days after Q1 earnings report on March 1st, and before the surge in price. Management seems to believe the stock is undervalued.

Carmike Cinemas, Inc. (CKEC) Memo

Ideas for the Club

Meeting time: Wednesday is a common day for labs or discussions. Because it is a mid-week day, a lot of members have exams or papers due later on in the week (Thursday or Friday). I propose we move meetings to Friday afternoon, where we have the opportunity to look back on the week, and have the weekend as breathing space to discuss forthcoming events.

Group presentations: I know a few members, who are either friends or current residents of mine, who feel that there is a huge learning curve when it comes to stock pitches and thus rarely come to meetings. Although analyzing a company by oneself is in itself a huge experience, some members lack the motivation. I propose we allow new members to be able to work in pairs – this way they can build off each other, and become more motivated to pitch stocks. I used this technique back in my high school's investment club and it worked really well. Furthermore, this allows for more members to participate in pitching stocks each week.

Get to know management: I feel there are some members who feel excluded from MII because they don't know other members or the management really well. I propose there to be sessions once a month or so where MII members and management come together and get to know each other. This way, members become more motivated, excited, and will also help recruit future members.