VICTORIA MUTUAL Wealth MANAGEMENT

Company Analysis: Palace Amusement Company Limited (PAL)

VMWM Research and Stockbroking | December 31, 2019

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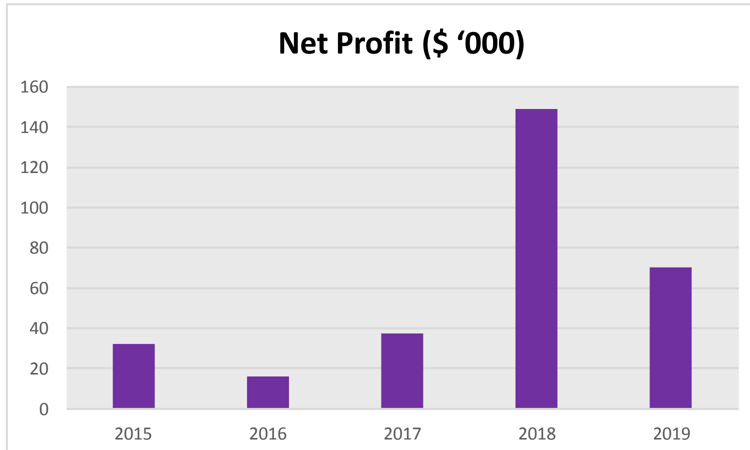
- Recommendation: SELL
- Price Target: $786.06
- Current Price: $2900.00 [1]

- Shares Outstanding: 1,437,028 units
- Market Value of Shares Outstanding: 4.167 billion[1]
- Financial Year End: June 30

ABOUT THE COMPANY

The Palace Amusement Company (1921) Limited and its subsidiaries are limited liability companies incorporated in Jamaica with its registered office at 1A South Camp Road. The Group operates cinemas locally and rents films to other cinemas. The company is a 65.95% subsidiary of Russgram Investments Limited which is also incorporated in Jamaica



FINANCIAL PERFORMANCE

($ '000)	2015	2016	2017	2018	2019
Revenue	915.8	909.2	990.1	1,163.0	1,112.6
Net Income	32.0	16.2	37.3	149.2	70.4
Total Assets	460.7	466.9	509.0	678.2	702.9
Net Profit Margin (%)	3.5	1.8	3.8	12.8	6.3

Outlook

We believe that PAL will maintain its profitability due to its experience and multiple revenue lines. However, its performance will be directly linked to the performance of the US film industry and its ability to produce movie 'hits'.

Projections and Valuations

We used a discounted cash flow model with a discount rate of 11.5% to arrive at our valuation of $786.06 per share. Therefore, we recommend PAL as a SELL.

Risks to Price Target

On the upside, if the film industry consistently releases 'hits' in the theatre then Palace will increase its revenue and therefore profit. However, if more film makers utilize alternative means of releasing films or the films released do not resonate with the Jamaican population then PAL could see its revenue falling below previous levels. Additionally, a significant downturn in the Jamaican economy can lead to a decline in revenue.

[1] As at January 3,2019

FINANCIAL PERFORMANCE

	2015	2016	2017	2018	2019	2019 Q1	2020 Q1
Revenue ($ '000)	915.8	909.2	990.1	1,163.0	1,112.6	269.4	370.0
Gross Profit ($ '000)	189.3	181.2	200.9	272.3	212.6	53.6	65.1
Net Profit ($ '000)	32.0	16.2	37.3	149.2	70.4	9.9	18.1
Gross Profit Margin (%)	20.7	19.9	20.3	23.4	29.1	19.9	20.7
Net Profit Margin (%)	3.5	1.8	3.8	12.8	6.3	3.7	4.9
Total Assets ($ '000)	460.7	466.9	509.0	678.2	702.9	645.4	741.6
Current Ratio (x)	1.42	1.60	2.11	1.51	0.81	1.15	0.91

FOR THE FIRST THREE (3) MONTHS OF FY2020:

The newly constructed cinema in Portmore began operations in this quarter which was the main cause of the 37.35% increase in growth in comparison to the same quarter in 2020. A slightly higher cost margin, 80.11% in FY2019 versus 82.41% in FY2020, led to only a 21.45% increase in gross profit from $53.6 million to $65.1 million. The company increased its profitability as the net profit margin increased from 3.69% to 4.9% translating to an increase in net profit from $9.9 million to $18.1 million.

In the first three months of its financial year, PAL increased assets by 5.5%, liabilities by 9.41% and equity by 3.98%. The increase in assets was due to continued increases in property, plant and equipment, inventories and receivables. This was partially financed by the company's cash. The remainder of the asset increase was financed by a 422.45% in long term liabilities from $7.5 million to $39.3 million. The increase in equity continues to be due to increases in the company's retained earnings due to the profit earned. The company's liquidity position improved slightly as the current ratio increased from 0.81x to 0.91x over the 3 months.

FOR THE LAST FIVE (5) YEARS:

Revenue for Palace Amusement is dependent on many factors including the number of appealing films release by the US film industry, customers' purchasing power and the level of crime in Jamaica. Changes in these factors have led to fluctuations in revenue for PAL, nevertheless, between 2015 and 2019, revenue has grown at a CAGR of 3.97%. Much of this growth is due to the increase in confectionary sales which increased at a CAGR of 7.22% over the period. Direct expenses as a percentage of revenue have remained relatively constant averaging 79.32% over the period which has allowed for growth in gross profit from $189.3 million to $212.6 million, or by 12.3%. Admin expenses have also remained a relatively constant percentage of revenue for the last 5 years averaging 17.3%. Net profit has increased from $32.0 million in 2015 to $70.4 million in 2019 after peaking at $149.2 million in 2018. The exceptional profitability in 2018 was due to 17% increase in revenues that year and slightly lower cost margins.

Assets have grown in the last 5 years by 52.56%. Asset growth was largely attributable to the construction of the cinema in Portmore that contributed to a 90.77% increase in Property, plant and equipment. The growth in assets was accompanied by a 28.17% growth in total liabilities and a 64.84% growth in total equity. The increase in liabilities was caused by a 37.63% increase in payables as all other liabilities declined in value. The increase in equity was due to the net income earned by the company which resulted in increased retained earnings. The liquidity of the company as measured by the current ratio fluctuated during the period ranging from as high as 2.11x in 2017 to as low as 0.81x in 2019. The current ratio compares the total current assets of the company with the current liabilities. A benchmark of 1x indicates that the company has exactly the amount of current assets necessary to take care of current liability obligations as they arise. The liquidity dipped below this benchmark in 2019 caused by a concurrent increase in payables and decrease in cash for that year. This represents an illiquid position and may pose difficulty for the company to finance its liabilities.

OUTLOOK:

Revenue will be dependent on the Hollywood movie Industry
PAL's revenue will be dependent on the international film industry and its ability to create films that entice the Jamaican audience. For example, in 2019 when blockbusters from the Marvel and DC franchise were released along with the remake of The Lion King, there would be an abundance of the Jamaican population that wants to watch these movies. In other years when films did not appeal to Jamaicans as much or less films were released, PAL earned less revenue that would have been expected.

Less movies coming to cinema as streaming services enter the market
The global movie industry is changing as streaming services such as Netflix and Hulu become more popular. These services, which were once known to stream previously aired television shows and movies, are now in the market of producing and releasing original shows and movies. As more film-makers flock towards these services through which they can release their work, instead of the traditional cinema, this will decrease the number of films that PAL has available to show and will therefore lead to a decline in revenue growth.

Growth to be Enhanced with the new location in Portmore
In July 2019, PAL opened its latest cinema in Portmore, St. Catherine. This cinema will allow a greater portion of the St. Catherine population to have access to a movie cinema as they would previously have to commute to Kingston to enjoy such. This is expected to account for much of the company's expected revenue growth within the next 2 years but will be accompanied by revenue reallocation. Revenue earned in the two Kingston locations from persons out of town, will now be redirected to the new location, reducing revenue in Kingston. The redistributed Kingston revenue will be accompanied by revenue from customers in St. Catherine who could not commute to Kingston to watch a movie.

INVESTMENTS POSITIVES:

- Has multiple revenue streams
- Does not have any competitors

INVESTMENT NEGATIVES

- Currently has low liquidity
- Revenue is dependent on the US Film Industry's performance

CONCLUSION

Over the past few years PAL has experienced volatile revenue and thus net profit due to the population's reception of the movies that it shows in theatres. This volatility is expected to continue especially as films are not being released using alternative means such as streaming services.

We used a discounted cash flow model with a required rate of return of 11.5% to arrive at our target price of $786.06. This price represents a 27.11% downside from current levels, thus we recommend PAL as a **SELL.**

SOURCES

The Jamaica Stock Exchange and PAL Quarterly and Annual Financial Reports

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