

A Tale of Two Movie Theaters¹

This case compares the financial statistics of two movie theater companies: one that defaulted on its debt and filed for bankruptcy in 2000 and the one that did not. Your task is to predict which company will ultimately be the one that declares bankruptcy. Until the solution of the case is presented, we will refer to the two companies as *Country Cinema* and *City Screens*.

THE MOVIE THEATER INDUSTRY

Attending a theatrical movie remains a thriving entertainment activity in North America, with ticket sales topping \$7.6 billion in 2000. While the number of movie attendees has declined slightly in recent years, the decline has been more than offset by increases in ticket prices, resulting in healthy year-to-year ticket revenue growth (see Figure 1). But despite the overall increase in sales, the movie theater industry has struggled in recent years. The number of screens has increased 34 percent since 1995, somewhat less than the total box office sales growth, but the cost of operating so many new screens has outstripped the increase in revenue. Multiplexes, theaters with eight or more screens, have become the industry standard, and megaplexes, theaters with at least 10 screens and stadium-style seating, have grown rapidly in popularity. While the multiscreen theater format offers many advantageous operating features—the ability to optimally match the theater size with the audience and a more evenly spaced demand for concession services—it also has required significant capital expenditures on stadium seating and state-of-the-art sound and projection equipment. The popularity of the new theater options has caused many older theaters to suffer, necessitating asset write-downs. Finally, the increased competition between screens has caused marketing costs to rise 54 percent since 1995 and shorter runs have raised the rental fees to distributors (which average about 50 percent of the total box office).²

TWO MOVIE THEATER COMPANIES

The two companies in this case are approximately the same size, each with approximately 2,800 screens as of fiscal 2000. For each company, ticket sales constitute approximately 65 percent of revenues, followed by concessions, which make up roughly 30 percent of revenues, with the remainder coming from video games and on-screen advertising. The two companies differ significantly in the size of town they operate in. *Country Cinema*, as we will call it, targets small to mid-sized communities. As of 2000, the management of *Country Cinema* believes it was the sole exhibitor in approximately 65 percent of its areas. In contrast, *City Screens* operates 69 percent of its domestic screens in the 20 largest “designated market areas” (as defined by Nielsen Media), as well as operating in certain large international cities.

	box office gross sales	average ticket price	attendance	# of screens	# of theaters	average screens/theater
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¹ Professor Russell Lundholm prepared this case as the basis of class discussion.

² First-run motion picture rental fees are generally the greater of (i) 70 percent of box office admissions, gradually declining to as low as 30 percent over a period of four to seven weeks, and (ii) a specified percentage (i.e., 90 percent) of the excess of box office receipts over a negotiated allowance for theater expenses (commonly known as a “90/10” clause). Second-run motion picture rental fees typically begin at 35 percent of box office admissions and often decline to 30 percent after the first week. (Source: 10-K of *City Screens*.)

1995	\$5494 M	\$4.35	1263 M	27805	7744	3.6
1996	\$5912 M	\$4.42	1339 M	29690	7798	3.8
1997	\$6366 M	\$4.59	1388 M	31640	7480	4.2
1998	\$6949 M	\$4.69	1481 M	34186	7418	4.6
1999	\$7448 M	\$5.08	1465 M	37185	7551	4.9
2000	\$7661 M	\$5.39	1421 M	37396	7421	5.0

Figure 1: North American Theater Statistics

WHO WILL DEFAULT: COUNTRY CINEMA OR CITY SCREENS?

From 1995 to 2000, both companies were expanding rapidly and changing over to multiplex and megaplex theater formats. And both were borrowing heavily to fund their growth and remodeling costs. But one company stumbles in the summer of 2000 and defaults on its loans. The summer season is traditionally the highest-volume period for movie theater attendance, but the summer of 2000 failed to deliver any blockbuster movies and attendance suffered. Consequently, one of the companies did not generate sufficient cash flow to stay within its loan covenants.

The detailed requirements of each company's loan covenants fill hundreds of pages, but the basic idea behind them is very simple. The covenants place limits on additional borrowing and on payments to equity holders. They also describe a number of financial health measures so that, if the company starts to get too sick, the bank can declare the loan in technical default. This makes the loan immediately due and payable in full, allowing the bank the opportunity to claim assets before they are all gone.

Two measures of financial health for Country Cinema and City Screens are the total leverage ratio, roughly defined as total debt/EBITDA before nonrecurring items, and the fixed charges coverage ratio, roughly defined as EBITDA plus rent/interest plus rent, where rent is the rent expense on operating leases and debt includes capital leases. At the time of the case, both companies were required to maintain the total leverage ratio below 6 and the fixed charges coverage ratio above 1.25. However, the precise definition of EBITDA differed between the two companies. The definition of EBITDA in the Country Cinema covenants was basically the traditional earnings before interest, taxes, depreciation, and amortization, and before any nonrecurring items such as gains/losses on asset sales or restructuring charges. For City Screens, the definition was more forward-looking, excluding the performance of theaters scheduled to close and extrapolating into the near future the performance of theaters that were recently opened.

REQUIREMENTS

Your task is simply to forecast which company you believe will default in the summer of 2000 and justify your prediction. It will aid your analysis greatly if you forecast the next year's financial statements for both firms. There are much data available to you. The case materials are as follows:

1. You can load the case data into *eVal* and examine the credit risk statistics at the bottom of the Ratio Analysis sheet. (Note: case data can be imported by going to the Case Data sheet in *eVal* and selecting the yellow block of data for the company, and then pasting this block of data into the yellow cells at the bottom of the Financial Statements sheet using Paste Special - Values from the Edit menu.) Note that the 1998 fiscal year end for City Screens is actually April 1, 1999.

The fiscal 1998 financial statements and excerpts from the MD&A for both companies are available as online exhibits at <http://www.lundholmandsloan.com>.

Please note: The exact definitions of the financial health measures given in the loan covenants for each company are extremely detailed, and you do not have sufficient information to reconstruct them. The details about the covenants given above and a general investigation into the financial health, risk exposure, and, most importantly, a forecast of the future for each company will be sufficient to guide your analysis.

COUNTRY CINEMA FINANCIAL RATIOS

Fiscal Year End Date	<u>12/31/1995</u>	<u>12/31/1996</u>	<u>12/31/1997</u>	<u>12/31/1998</u>
Analysis of Credit Risk				

Net Income to Total Assets	0.027	-0.015	0.033	-0.044
implied default probability	3.0%	5.5%	3.0%	5.5%
Total Liabilities to Total Assets	0.613	0.636	0.673	0.676
implied default probability	4.5%	5.5%	5.5%	5.5%
Quick Ratio	0.553	0.337	0.323	0.226
implied default probability	5.0%	9.0%	9.0%	9.0%
EBIT to Interest Expense	2.36	2.66	2.41	1.89
implied default probability	3.0%	3.0%	3.0%	5.0%
Inventory Holding Period	7.12	5.51	5.98	7.11
implied default probability	3.9%	3.9%	3.9%	3.9%
Annual Sales Growth	11.3%	17.0%	7.5%	5.0%
implied default probability	3.0%	3.2%	3.0%	3.0%
Average Implied Default Probability	3.7%	5.0%	4.6%	5.3%

Other Ratios

rent expense (from footnotes)	45,600	54,800	57,600	66,800
Fixed Charge Coverage	1.79	1.83	1.82	1.66
Total Debt/EBITDA (b/f non-recurring charges)	3.5	3.21	4.05	3.96

CITY SCREENS FINANCIAL RATIOS

Fiscal Year End Date	<u>3/28/1996</u>	<u>4/3/1997</u>	<u>4/2/1998</u>	<u>4/1/1999</u>
Analysis of Credit Risk				
Net Income to Total Assets	0.057	0.026	-0.031	-0.016
implied default probability	2.0%	3.0%	5.5%	5.5%
Total Liabilities to Total Assets	0.671	0.764	0.825	0.882
implied default probability	5.5%	7.0%	9.0%	9.0%
Quick Ratio	0.296	0.256	0.132	0.167
implied default probability	9.0%	9.0%	9.0%	9.0%
EBIT to Interest Expense	2.38	2.74	1.03	0.34
implied default probability	3.0%	3.0%	7.0%	7.0%
Inventory Holding Period	0.00	0.00	0.00	0.00
implied default probability	3.0%	3.0%	3.0%	3.0%
Annual Sales Growth	16.5%	14.4%	13.3%	20.4%
implied default probability	3.2%	3.0%	3.0%	3.2%
Average Implied Default Probability	4.3%	4.7%	6.1%	6.1%

Other Ratios

rent expense (from footnotes)	64,813	80,061	106,383	165,370
Fixed Charge Coverage	1.89	1.89	1.5	1.31
Total Debt/EBITDA (b/f non-recurring charges)	1.67	3.31	3.78	5.95

C A S E TWENTY