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THIS MONTH'S ISSUE

VIL EXCLUSIVE

Chuck E. Cheese Has More Upside Potential

By Jeff Sutton, ValueTree Investments

Finding a "50-Cent Dollar" is a value investor's dream. With CEC Entertainment valued at a 30-50% discount to other restaurants, it may be a dream come true.

To read Jeff Sutton's article, please click here.

Jeff L. Sutton, CFA

Jeff L. Sutton, CFA, is the founder of ValueTree Investments, LLC (ValueTreeInvestments.com), a Registered Investment Adviser in the state of North Carolina. ValueTree manages investment portfolios by selecting common stocks that we believe are trading at prices that represent significant discounts to our estimate of each company's long-term intrinsic value. Mr. Sutton graduated *summa cum laude* with two Bachelor of Arts degrees from Rhodes College, where he is a member of the Alumni Executive Board. He also earned an MBA degree from the Darden Graduate School of Business Administration at the University of Virginia.

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CEC Entertainment, Inc. (CEC) has more upside potential

Summary:
CEC Entertainment, Inc. (CEC) has more upside potential for several reasons. First, the stock is valued at a 30% to 50% discount to other restaurants, yet it has significantly better operating margins, and a stable stream of revenue and cash flow. At its recent price range of approximately $44 to $45 per share, CEC currently trades at a trailing P/E multiple of approximately 16x, which compares to a restaurant industry average of almost 22x. Next, the stock is priced at approximately 6x trailing EBITDA, while many restaurant peers sport multiples as high as 9x to 12x trailing EBITDA. And finally, a free cash flow analysis suggests that CEC should have an intrinsic value of at least $60 to $65 per share, implying that the stock could produce a sizeable return for investors over the next one to two year period.

The Business:
CEC Entertainment, Inc. (CEC) operates a national chain of over 500 restaurants under the Chuck E. Cheese's brand name that appeals to families with children between the ages of about two and twelve years old. CEC operates an extremely simple business model that focuses on two universal themes that are unlikely to change anytime soon. First, families like to eat meals together. And second, children like to play games.

In line with these two distinct themes, the company reports revenue in the following two categories: (1) food and beverage sales, and (2) entertainment and merchandise sales. Revenue from food and beverage largely consists of pizzas and soft drinks, whereas entertainment and merchandise revenue predominantly comes from the sale of tokens that children use to play arcade games located throughout each restaurant.

In recent years, increasingly more revenue has been generated by the entertainment and merchandise category than from food and beverage sales. This trend is encouraging, since entertainment and merchandise sales have a significantly higher profit margin than food and beverage sales. Moreover, several other operating metrics appear to be improving in recent years, and the company has renewed its expansion efforts.

Improving Operating Metrics:
The strength of CEC's business model has been proven over the last five years, when the company maintained an extremely stable stream of revenue and cash flow, even as the overall economy struggled. For example, CEC has consistently earned revenues between approximately $800 and $820 million every year for the last five years, which represents a 2.5% fluctuation in business operations over that time period, while many restaurants saw revenue declines of 10% or more from their highs in 2007 and 2008 to the lows of 2009 and 2010.

Although average revenue per restaurant has fallen by about 2% company-wide over the last two years, the company reports that the 27 restaurants it has opened over the last 5 years are generating almost 30% more revenue per restaurant than the company's older locations. This statement implies that each new restaurant is generating approximately $2.0 million in revenue per year, compared to the company's historical average of approximately $1.6 million in annual revenue per restaurant. Assuming this trend may continue with each new location that the company opens (it plans to open 13 to 14 new restaurants in 2013, and 12 to 15 new restaurants in 2014), suggests that CEC could add at least $35 million in total company revenue over the next two years, which is a 4% improvement over the level it has averaged for the last 5 years. Combining new restaurant openings with CEC's recent comparable store sales trends (which were positive 2.2% for the first half of 2013, and positive 0.8% for the first nine months of the year, compared to negative -2.5% for the last two years) implies that total company revenue could increase by as much as $65 million, or an 8% improvement over the company's 5-year average. Looking to the bottom line, a sustained improvement in CEC's average revenue per restaurant could allow the company to increase its cash flow from operations by approximately $17 to $35 million annually, implying an increase of 15% to 25% from current levels (cash flow from operations was $142 million for the trailing 12 months ended September 30, 2013).

In addition, in late 2012 the CEC management team announced a cost reduction program that can already be seen in the company's results. For example, reorganizing the prize categories that children can win from the company's arcade games, and adjusting its pricing strategy for both food and games, has yielded a 0.8% increase in consolidated gross margin over the last year. This improvement in gross margin comes in spite of a 13% increase in

the company's cost of cheese, a key ingredient in its primary menu item – pizza. To provide some perspective, a 0.8% increase in gross margin is significant, considering that CEC already has industry leading gross margins in excess of 85%, compared to the restaurant industry average around 70%. And due to fixed cost leverage, higher gross margins also translate into a significantly higher EBITDA margin that has been as high as 25% in recent years, compared to the restaurant industry average of about 12% EBITDA margins. According to my analysis, CEC's cost reduction program could add another $4 to $6 million in annual cash flow from operations over the next year.

CEC has been expanding its operations internationally through franchise partners. The company currently has 53 franchised restaurants, of which 19 are located outside of the United States. Two new franchised restaurants are currently under construction in Mexico and Saudi Arabia, and the company has authorized its international franchise partners to open up to 70 additional franchised restaurants over the next several years. CEC generated almost $5 million in revenue from franchise and royalty fees over the last 12 months ended September 30, 2013. According to my analysis, the continued success of CEC's international franchised restaurants could add at least $4 to $6 million more in annual revenue and cash flow over the coming years.

Risks:
On its most recent third quarter 2013 conference call, the CEC management team announced that the company's comparable store sales declined by approximately -2.1% during the third quarter, following six months of positive comp store sales growth of approximately 2.2%. The management team attributes the negative comp store sales growth in the quarter to two primary factors. First, a larger number of "G" and "PG" rated movies were released during the third quarter, and total box office revenue generated from these films increased by over 65% during the quarter. The CEC management team believes that popular children's movies can draw family entertainment budgets away from CEC restaurants. And second, the company's revenue generated from birthday parties declined by approximately -11% during the third quarter, and contributed about -1.5% of the total -2.1% drop in comparable store sales.

At the same time, management also stated that its comparable store sales trend has turned positive for the first four weeks of the fourth quarter of 2013. In addition, the company has adjusted its advertising message to address the slump in birthday party sales, and while this new advertising campaign has only been active for two weeks, reservations for new birthday party sales have rebounded sharply, and are now relatively flat compared to the same period last year. Nevertheless, if the third quarter slowdown does not correct itself for the remainder of the year, then the company's overall results could be impacted.

Favorable Valuation:
CEC deserves a higher valuation. The stock is valued at a 30% to 50% discount to other restaurants, yet it has significantly better operating margins and a stable stream of revenue and cash flow.

Over the trailing 12 months ended September 30, 2013, CEC earned approximately $821 million in revenue and $176 million in EBITDA, netted $2.72 per share in EPS, and generated about $142 million in cash flow from operations.

Starting with the company's trailing EPS of $2.72 per share, and applying an industry average trailing P/E multiple of approximately 22x suggests that the company's stock price could reach as high as $60 per share. Moreover, the company issued stronger than expected guidance for its fourth quarter 2013 results, in the range of $0.15 to $0.19 per share in EPS. Adjusting the company's earnings for the next quarter's results, suggests that CEC could earn approximately $2.92 per share in EPS for the full year 2013, which equates to a stock price of approximately $64 per share, if the company were valued at an industry average trailing P/E multiple. Similarly, applying an industry average trailing EBITDA multiple of 9x would suggest a stock price of $72 per share. And a free cash flow analysis implies a long-term intrinsic value of at least $60 to $65 per share, and possibly much higher as the company continues to grow.

To elaborate, my base case free cash flow analysis assumes that the company generated trailing cash flow from operations of $142 million, incurred maintenance capital expenditures of approximately $60 million (which assumes that about 20% to 25% of the company's restaurants are upgraded every year at a cost of approximately $500,000 per restaurant, which appears to be in line with historical averages according to my analysis), and is capitalized at a free

cash flow yield of 8%. This combination suggests that CEC generates maintenance free cash flow of approximately $82 million annually. If valued at an 8% maintenance free cash flow yield, which is in line with many other restaurant peers, then CEC should have an intrinsic value of approximately $60 per share.

It is important to note that the discussion about CEC's maintenance free cash flow, as highlighted in the previous paragraph, does not take into account the most recent shift in the company's capital expenditure program for updating its existing stores. On its most recent third quarter conference call, the CEC management team outlined a new strategy for its maintenance capital expenditures. Instead of updating its restaurants every 4-5 years, as appears to be the historical trend, the company will now attempt to update its existing restaurants approximately every 2 years. These updates will maintain a fresh and new feeling at all locations, and according to management's recent guidance, should cost significantly less than my original estimate for maintenance capital expenditures. For example, instead of spending approximately $60 million per year in maintenance capital expenditures, the CEC management team suggests that such updates should cost $27 to $29 million in 2014. For the purposes of my analysis, I have assumed that the company will update half of its existing restaurants every two years, at a cost of approximately $125,000 per location, which implies current maintenance capital expenditures of approximately $32 million per year. Taking the same approach, and using an 8% yield to capitalize CEC's $110 million stream of maintenance free cash flows (which consists of $142 million in trailing cash flow from operations, less $32 million in maintenance capital expenditures), suggests that CEC should have an intrinsic value of approximately $80 per share.

And finally, if the company's new restaurant growth and cost reduction program are included in free cash flow estimates, then maintenance free cash flow could increase from approximately $110 million on a trailing 12 month basis, up to at least $130 to $150 million by the end of 2015, which may imply a significantly higher long-term intrinsic value over the next few years.

Key Investment Highlights:

1. Industry leading margins – gross margin and EBITDA margin are significantly higher than peers.
2. Expansion opportunities – new restaurants opening domestically, and new franchises opening internationally.
3. Improving restaurant level operating metrics – new restaurants have had 30% higher volumes than older locations, and cost reduction program is improving profitability.
4. Stable revenue and cash flow generation – maintained consistent levels throughout the last 5 years, in spite of weak economy, and top line has begun to grow again.
5. Favorable valuation – trading at 30% to 50% below peer multiples, strong cash flow supports an intrinsic value estimate of at least $60 to $65 per share, and growth opportunities merit a much higher valuation.

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