Cedar Fair, L.P.
(Nasdaq: FUN)

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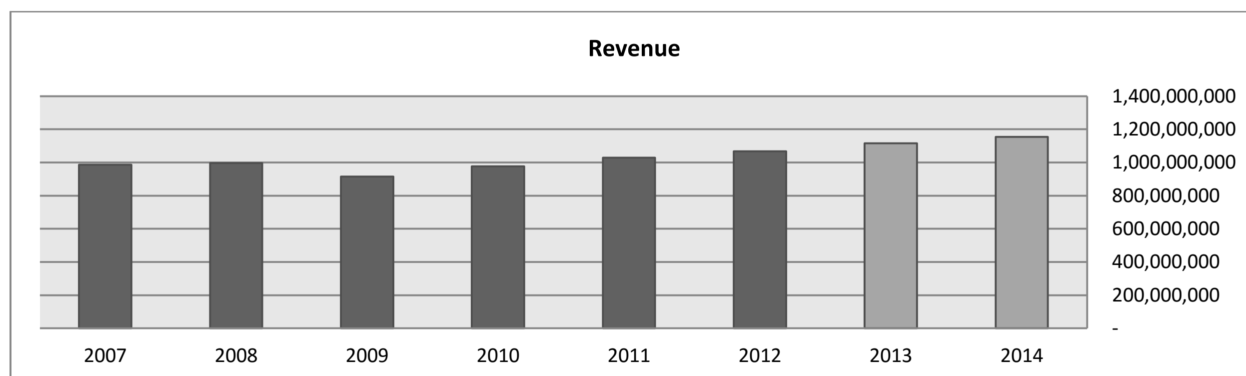
Introduction

Since the sale of Broyhill Furniture in 1980, the Broyhill family wealth has been managed to maximize income for shareholders, in a manner consistent with maintaining long-term purchasing power. Specifically, our investment objectives in order of importance are: preservation of capital, current income and moderate growth. Consequently, our research seeks to identify outstanding companies with sustainable competitive advantages, which offer the potential for full participation in up markets while mitigating the brunt of down markets through attractive dividends and consistent earnings growth. The result is a concentrated equity portfolio comprised of exceptional businesses judged to be competitively entrenched market leaders, trading at reasonable prices.

Ideal investment candidates have the potential to double over a three to five year horizon, as we seek to purchase shares at an equivalent discount to our estimate of intrinsic value based upon a company's normalized earnings power. This hurdle, combined with our quality mandate, tends to limit our investable universe, and as a result, we will often hold high cash balances in the absence of opportunity. But when we can find high quality businesses with defensive characteristics, high barriers to entry, and pricing power that are distributing cash to owners, we size them accordingly. We believe Cedar Fair (FUN) meets each of these requirements and recent weakness - driven by short term panic created by rising interest rates rather than long term fundamentals - has presented investors an attractive entry point to purchase shares, now yielding close to 6.5 percent.

Overview

The amusement park industry is a clear-cut and easy to understand business model, an attribute we seek in all of our investments. Cedar Fair owns and operates amusement parks and generates almost all of its revenues from the sale of tickets in addition to food & merchandise. Unlike peers in the leisure industry, FUN's revenues are incredibly resilient as its regional parks cater to recurring "day-tripping" visitors from the surrounding area rather than long-distance visitors to destination parks. As a result, the business enjoys a natural economic stabilizer during difficult times, as consumers cut back on more expensive vacations in favor of the value offered by amusement parks closer to home. We analyzed attendance records going back to 1990 and found only three instances where the industry's head count declined, but only a single period in which revenues fell year over year. In each of these instances, the recovery in the following year made up nearly all of the lost ground. This is a very good business.

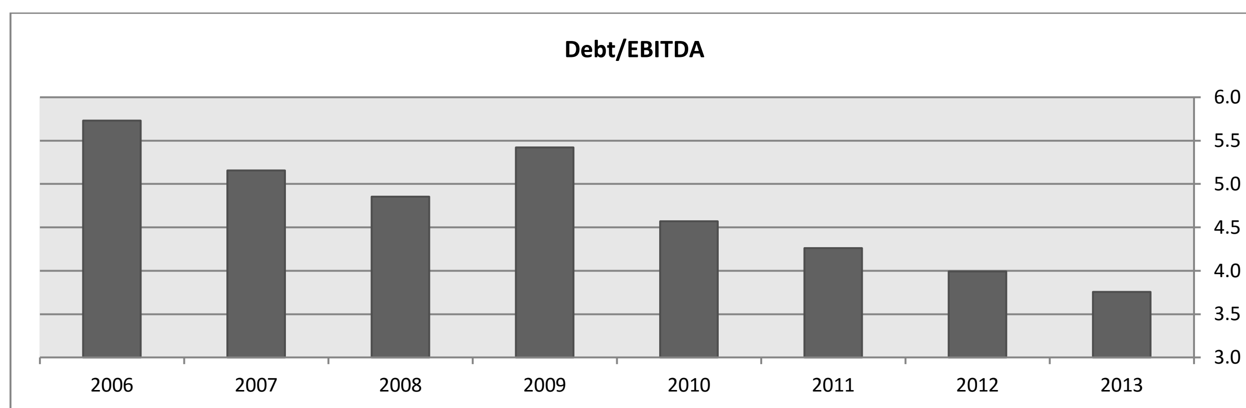


The amusement park industry is a highly concentrated, mature industry which benefits from high barriers to entry in the form of limited land supply, arduous zoning restrictions, and substantial capital requirements. With major markets already well served by established incumbents, new entrants have little hope of gaining ground with thrill seekers. We believe this competitive landscape provides Cedar Fair with significant economies of scale through its near monopolies of niche markets. Consequently, there has been zero growth in the number of amusement parks over the last decade. FUN management has previously commented that there has not been a successful new regional park built in the past three decades. Furthermore, we have yet to hear of any plans from Google to start building rollercoasters, on this planet (others may be up for discussion).

Financial Analysis

Given the maturity of the industry, attendance growth is unlikely to be a significant top line contributor. However, the industry has still managed to grow revenues at close to a 2% annual rate over the last five years. We use this as a starting point for sales growth in our model, although we believe FUN can further boost top line growth through a number of recent initiatives to improve pricing, reduce discounts and extend the season beyond the second and third quarter. Strategically, management is focused on enhancing the guest experience with premium product offerings, dynamic pricing and advance purchases (i.e. season passes, etc.). Given the company's fixed cost structure, incremental top line gains should ultimately drive higher margins and increased cash distributions to unit-holders. Again, we assume little margin expansion in our base case, but believe FUN has room to improve its stable, industry leading EBITDA margins by roughly 100 bps over the next three years.

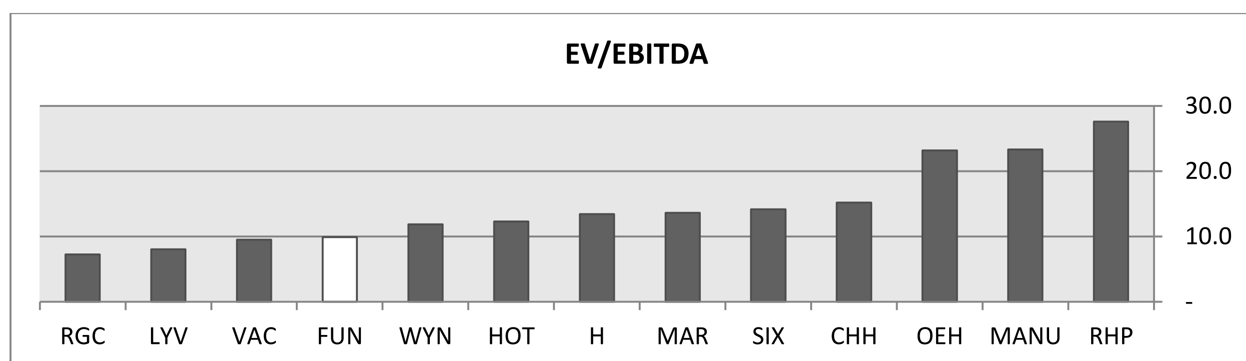
With only six analysts covering the stock, shares have been slow to rerate after the company suffered financial difficulties during the financial crisis. While this is an extremely capital intensive business – annual capital expenditures approximate 9% of sales – with a highly fixed cost structure, FUN generates very consistent cash flow which is largely recession-resistant. Consequently, management has been able to consistently deleverage its balance sheet since the crisis, leaving significantly more cash available for distribution while putting the company on a much stronger financial foundation. The resulting capital allocation story is the foundation of our investment thesis as the bulk of the company's cash flow can now be returned to investors rather than building new parks, acquiring competitors or paying down debt. Note that our estimates of cash distributions are reported in the final section of this report.



Finally, we believe FUN's core assets, located largely in "Middle America" are well positioned to capitalize from any economic benefit related to the potential for a domestic manufacturing resurgence. Admittedly, economic shifts of this magnitude are difficult to predict with a great level of confidence, so we have not accounted for any related gains in our estimates. That said, we do believe the evidence here is increasing. Note the steady increase in energy and transportation costs over the past decade and the more recent collapse in domestic energy prices driven by an unprecedented surge in natural gas supply. Natural gas was priced at $4 in the US in April versus $17 in Japan and Korea. We would also highlight the consistent increases in Chinese labor costs alongside of declining unit labor costs at home. Meanwhile, manufacturing GDP has grown at almost double the pace of overall GDP during the current recovery. As a result, manufacturing employment is growing at nearly twice the average rate in states like Ohio, where overall employment is near its prior peak. This bodes well for Cedar Fair's core markets as the majority of the company's EBITDA and flagship properties are based in the Midwest.

Valuation

The few analysts that cover the stock tend to value shares on a multiple of EBITDA. A quick look at FUN's peer group shows the stock trading well below the industry average. It appears that the market does not yet appreciate the safety of modern rollercoasters or the defensive characteristics of the relatively small and underfollowed amusement park industry. If management is able to achieve its long term goal of $450 million in EBITDA by 2016, and the market values FUN in line with its closest competitor, SIX, the stock would be trading at twice today's levels. We don't think either of these factors are unreasonable assumptions.



For our part, we view an investment in FUN in a similar context as MLPs, Utilities or REITs where the company's stable and growing cash flows are valued relative to the yields available in the current marketplace. In this respect, we believe the market's Pavlovian reaction to "tapering" has presented investors with a compelling opportunity to purchase FUN at a price which should generate a double-digit dividend yield on our estimate of normalized earnings power. This is not 1994 or 1975. If the Fed could create inflation it would. But it can't. Instead, inflation expectations have collapsed year-to-date, despite the mini-rally in yields, consistent with the pattern in 2010, 2011 and 2012. We have seen this movie before and each time, the surge in yields was followed by an even greater move lower. We don't expect anything different today as the multipliers between money and credit remain broken, and as a result, we are dependent upon low rates to keep the system alive.

Prudent investors looking for a little FUN stand to do quite well in this environment, as the market should continue to bid up the price of high quality, income generating assets. Based upon an estimated 2013 distribution of $2.50, the stock yields 6.25% today, which is quite attractive in a zero interest rate world, yet slightly below the company's 7% long term average yield.

Historically, the company has traded 200 basis points over treasuries, although admittedly this spread has varied greatly over time. Even still, we think this is an appropriate comparison and a good place to start for perspective. With this in mind, we can develop a range of fair value estimates based on normalized earnings power three years out. We assume top line growth of 2% to 4% given limited supply and competitive dynamics which should continue to benefit pricing. Growth at the low end results in margin compression over our forecast period while we estimate that better-than expected sales would drive increased profitability at the top end of our range, resulting in a 100 basis point increase in EBITDA margins. For each scenario, we assume various levels of annual debt repayment, deducting $25 million from distributable cash flow annually in our bear case and assuming all excess cash flow is available for distribution in our bull case. We also assume the company spends 9% of sales annually on capital expenditures and an additional $15 - $20 million of supplementary capital expenditures throughout our forecast period.

Bottom Line

The end result of this exercise is a range of estimates for 2016 Distributable Cash Flow, which we then discount by an additional 10% leaving management some wiggle room in distributing 90% of earnings power to shareholders. Our estimates here range from $2.25 on the downside to $3.50 at the high end. We note that our bear case on the stock assumes a lower level of distribution than the company is paying today, while our bull case is essentially in line with the low end of management's long term EBITDA guidance. In other words, we are being very conservative in our estimates. Finally, we capitalize our unit distributions at various rates to derive our fair value estimates. The results are quite compelling. Downside risk looks to be in the neighborhood of 10% after adjusting for anticipated distributions and assuming an 8% discount rate - nearly 200 basis points higher than today and almost 600 bps above treasuries. Conversely, in an extended environment of zero interest rates, we don't think a 4% yield is out of the question – FUN approached these levels in 2011-2012. Capitalizing our $3.50 distribution in this environment would result in returns in excess of 100% plus distributions. We understand this is a stretch for some, so our base case assumes a 6% distribution yield, roughly in line with today, and still produces almost 50% upside potential over our forecast period. Now that is FUN.

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