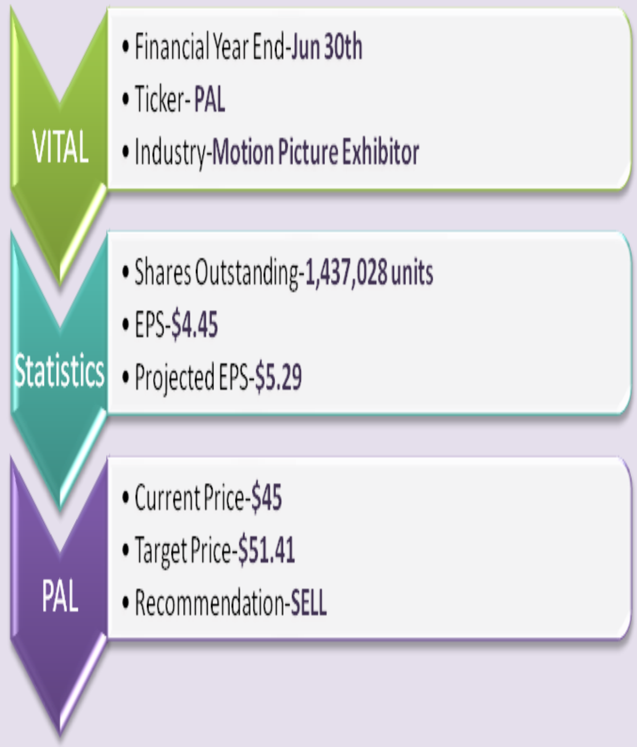
Company Overview

Palace Amusement is the dominant and only listed motion picture exhibitor in Jamaica. The company operates 13 screens across 4 cinemas - Carib Cinema, Palace Multiplex, Palace Cineplex and Odean Cineplex. Ticket sales account for the majority of revenues, and is supplemented by confectionery sales and film rentals. Recently, management has sought to augment growth and diversify revenues through screen advertising and corporate screening events.[1]



Introduction

With attendance and consequently revenues highly susceptible to the inconsistencies in movie quality, Palace's earnings have been very volatile. Despite its virtual monopoly on cinema operations in Jamaica, Palace has limited ability to absorb exogenous shocks considering; its position as a price taker from international film studios, the resulting limited ability to negotiate pricing for licenses, proliferation of piracy in the local market and intense competition for consumers' discretionary income. The company's historically thin margins reaffirm the vulnerability of its earnings. Notwithstanding this, continued FX stability paired with the digital evolution occurring within the industry, should assist in growing revenues over the medium term.

[1] Palace's profitability is heavily dependent on exogenous factors such as the quality of films released on the international market.

Board & Management Profile

Douglas Graham has chaired the board of Palace Amusement since 1998.[2] The board comprises 10 directors, with four full-time executives implying 60% are non-executive directors. A greater percentage of independent directors are preferred, as currently this is inconsistent with international best practice for corporate governance which recommends that 75% of the board be independent.

The top ten shareholders account for 84.2% of holdings, with the Chairman and connected parties combined accounting for 75.3%.[3] This concentrated holding of shares could adversely impact the rights of minority shareholders.

Professional Experience of Directors				
Independent	Finance	Cinema	Marketing	Legal
Elon Beckford	★		★	
Vincent Wong	★			
Ian Phillipson				★
Douglas Stiebel	★			
Hugh Levy				★
Christine McMorris	★			
Non-Independent				
Douglas Graham	★	★		
Scott Graham		★		
Steve Cooke		★	★	
Melanie Graham			★	

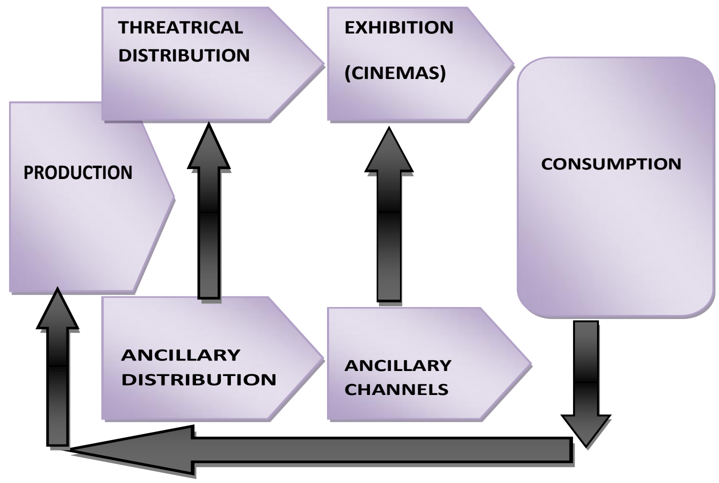
2 Douglas Graham is the owner of Russgram Investment Limited which also owns 62.05% of Palace Amusement Co.

3 Annual Report FY 2009/10

Industry Analysis

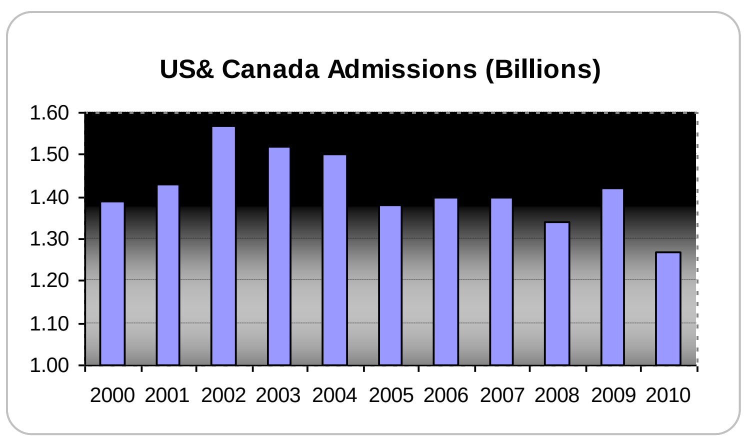
The value chain of the motion picture industry has three key areas: production, distribution, and exhibition. Cinema operators, who are on the final link, remain weak players given their limited ability to negotiate pricing and impact film quality. With so little leverage, earnings within cinemas are highly susceptible to changes in external forces. Further, revenues within the industry have been continuously challenged by piracy, resulting in approximately 30% leakage from the industry worldwide.[4]

Motion Picture Value Chain



The cyclical pattern of movie releases and earnings within the industry underscores the uncertainty inherent within the business, despite efforts to augment revenues through secondary channels such as confectionery sales and film rentals. However, the surge in 3D films since 2009 buoyed earnings both internationally and locally. Grossing at the US Box Office surged in 2009 driven by successful movies such as Avatar in 3D, Transformers and the Twilight Saga. Worldwide box office ticket prices increased an average 5% due to 3D films which bolstered earnings growth.

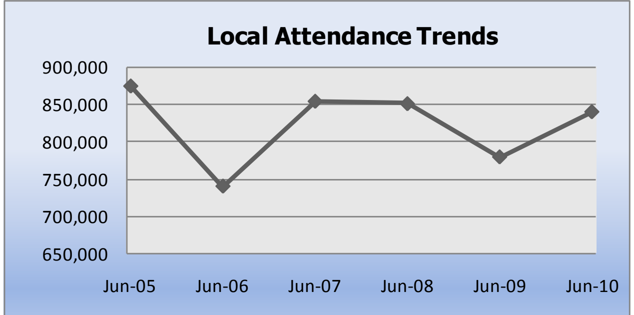
However, industry data for North America indicate that movie attendance in 2010 was markedly reduced at approximately $1.27Bn, the lowest attendance figure in 15 years. The increase in in-home entertainment such as computer games and home theatre systems as well as the narrowing window between movie and DVD releases also threaten long term patronage. Earnings also softened slightly against the background of weaker performance in traditionally high grossing months of May, November and December as the absence of another blockbuster and the underperformance of releases softened worldwide box office receipts. Further, international trends relating to the attendance of motion picture screening in the North America indicate a less than favorable outlook for attendance in 2011.



[4] Annual Report 2010

Box Office data indicate that "2011's gross-to-date is also down substantially from 2009 and 2008, and attendance is at its lowest in close to 20 years." [5]

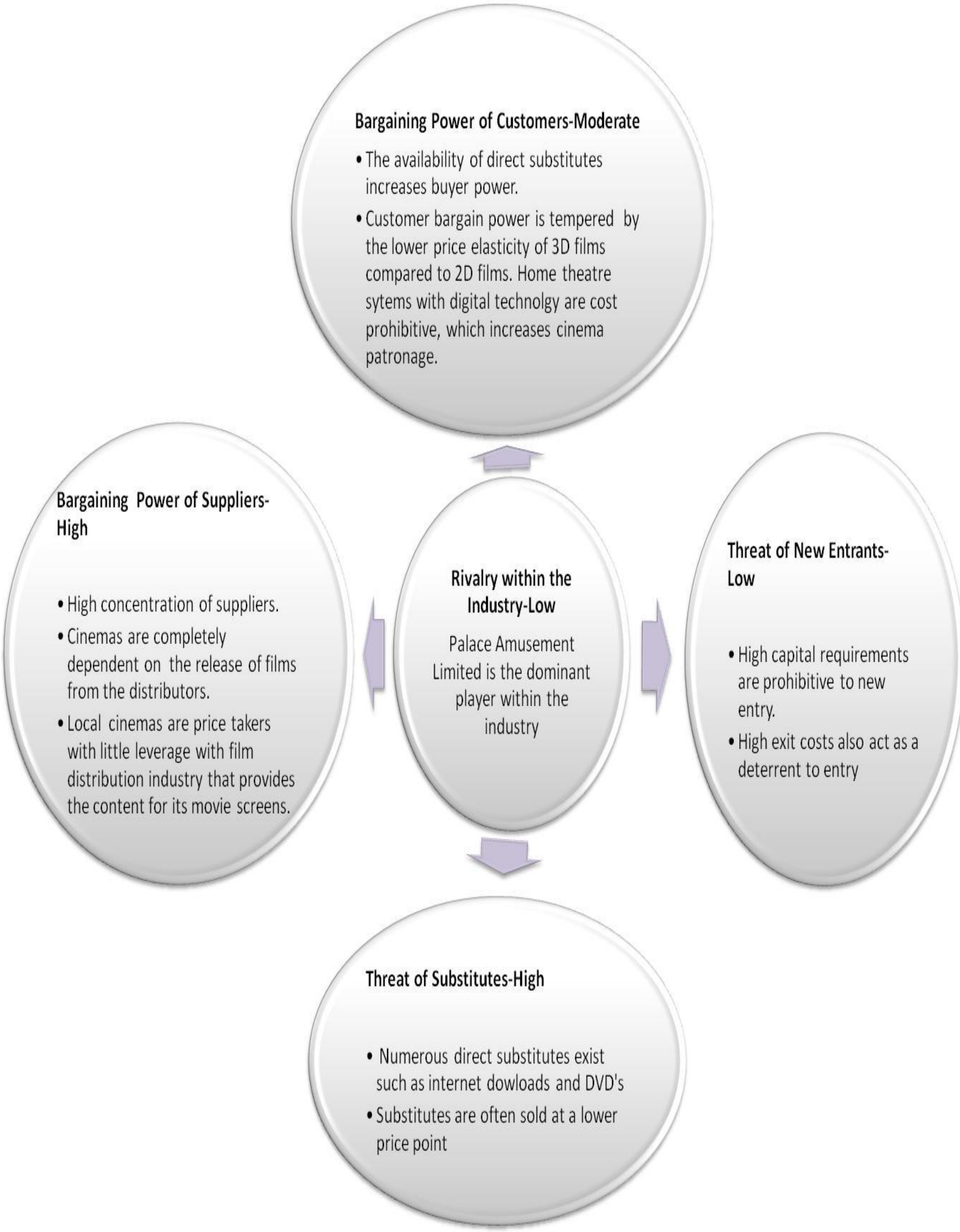
The local industry faces similar challenges with a significant decline in attendance. Local attendance figures have contracted from a high of 1.2Mn in 1994 to 840,541 in 2010 against the background of the proliferation of piracy. Pirated DVDs are markedly cheaper than movie tickets. Substitutes to cinema patronage such as computer games and other forms of entertainment along with declining consumer discretionary incomes have also challenged attendance.



	Jun-05	Jun-06	Jun-07	Jun-08	Jun-09	Jun-10
Series1	875230	740204	854676	851389	779641	840541

[5] Data obtained from Box Office Mojo- representative of figures up to January 28th 2011

Industry-Porter’s Five Forces



Business Strategy

Competitive ticket prices relative to other forms of entertainment underpins the company's pricing strategy and has limited the impact of the downturn in the economy on attendance. Through early week specials, Palace aims to buoy attendance during its low demand period as new movies are released mid week and revenues peak on the weekend. This strategy assists in smoothing out its cyclical weekly revenue pattern.[6]

Palace's secondary strategy is to diversify revenues through screen advertising, rental of cinemas for corporate special events/movie premiers and income from confectionery sales. The use of screen advertising prior the commencement of movies and during intermission is a distinguishing feature of the local market.

Guided by its mission to ensure that the cinema is the preferred option with the latest technology, the company has revamped its operations from analog technology to a phased implementation of digital 3D screens. 3D films are considered the way of the future and the competitiveness of Palace will depend on the speed at which it adapts to the new technology as well as the precision of its digital projections. 3D films have a lower price elasticity compared to 2D films and the company anticipates that the paradigm shift towards 3D technology will augment revenues.

[6] Movie specials are offered Monday's and Tuesday's

Qualitative Comparative Analysis

As the only listed motion picture screening company in Jamaica, the ability to assess Palace's performance against a local counterpart using financial metrics is limited. Marked differences in the size and scope of its business also limit financial comparisons with international players, and as such, a qualitative comparison was done. [7]

Qualitative Metrics	Palace Amusement	International Industry Players
Increasing threat from non-theatre players such as in-home theatre systems, concerts, plays and other alternative forms of entertainment.	✓	✓
Economies of scale through the creation of megaplexes which accommodates an average of 6.5 screens to a theatre with the scope of reducing labour and concession costs.	✗	✓
Augmenting revenues via diversification into international markets.	✗	✓
Absence of intra-industry competition.	✓	✗
Accelerated growth in digital screens.	✓	✓
Little pricing power with respect to contracts with film distributors	✓	✓
Box office receipts being the main revenue line, revenues supplemented through other media such as confectionery sales.	✓	✓
Piracy(internet downloads and illegal DVD sales)	✓	✓
High currency risks given the importation of films	✓	✗

Qualitative metrics, indicate similarities in 56% of variables, however Palace's limited ability to achieve economies of scale due to its small size minimizes the possibility of lower costs and healthier margins. Further, unlike its international counterparts, being limited to a relatively small market means Palace is unable to leverage international diversification to drive economies of scale and improve operating efficiency. This has challenged the company's growth prospects. Box office receipts jumped 58.2% from 2005 to 2009 in the Latin American market helping to boost revenues for major international players, while receipts grew by 29.1% locally. [8]However, the absence of significant intra-industry competition means that Palace has better pricing power and a captive market although this may be constrained by weak economic conditions.

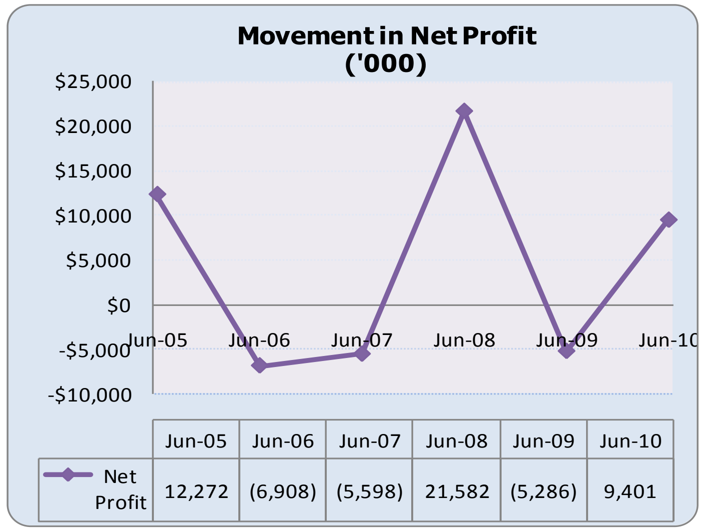
[7] International industry players refer to cinema operators in North America
[8] Theatrical Market Statistics 2009

SWOT

STRENGHTS	WEAKNESSES
• As the dominant player locally, Palace has some degree of power in setting prices without fear of competition from rivals. • Simultaneous showing of movies allow the company to maximize its revenues. • Phased implementation of Digital 3D screens facilitates viewing of growing number of 3D films. • Higher movie quality via digital projections boosts the theatrical experience. Value added services including on-line reservation increase the convenience to patrons.	• Uncertain business model - attendance is heavily dependent on movie quality and the timeliness of distribution - external factors over which Palace has limited control. • High fixed cost associated with the cinema business means margins are thin and vulnerable as Palace finds it difficult to offset falling revenues by reducing costs.
OPPORTUNITIES	**THREATS**
• 3D films are difficult to pirate, which gives Palace an advantage for these movies. Low penetration of home theatre systems with 3D technology due to the still high cost of such technology creates an opportunity for the company to showcase 3Dfilms. • Digital technology increases the possibility of alternative content such as sports events and concerts that can be carried live.	• Internet downloads and the inexpensive “bootleg” DVDs offer a cheaper alternative to cinema patronage. • Increase in film costs (80% of revenues) could push the Palace into a loss position given weak margins. • Higher electricity costs, given rising oil prices could further compress margins. • Film costs are susceptible to devaluation of the JMD against the USD given that it is imported. • The narrowing window between movie and DVD releases can potentially undermine ticket sales.

Historical Performance

Palace's earnings have been volatile since 2005. Despite efforts by the authorities to clamp down on illicit DVD sales, this substitute paired with internet downloads offer a cheaper alternative to cinema patronage. This has challenged the company's top-line and contributed to the sluggish movement in earnings. The company has also faced significant competition from non-theatre substitutes.



To offset costs, ticket prices have increased almost annually allowing for a consistent box office contribution of at least 60% of revenues. The surge in high grossing 3D films, such as Avatar, buoyed growth in attendance and revenue by 8% and 27.74%, respectively in 2010 underscoring the potential of a block-buster release to offset the impact of weak economic activity.

The high cost structure and the resulting razor thin margins have limited the company's ability to withstand any exogenous shocks to operating expenses. Direct expenses consistently accounted for over 80% of revenues, while since 2009 higher costs relating to 3D films compressed margins. The fragility of the company's operating and net profit margins is reflected by the volatility in profits, which increases the likelihood of losses. [9]A breakdown of Return on Equity (ROE) using the Dupont Analysis suggests that the volatility in the net profit margin due to the company's inability to control costs has been the main driver of changes in ROE given the relatively stable leverage ratio.

Dupont Analysis

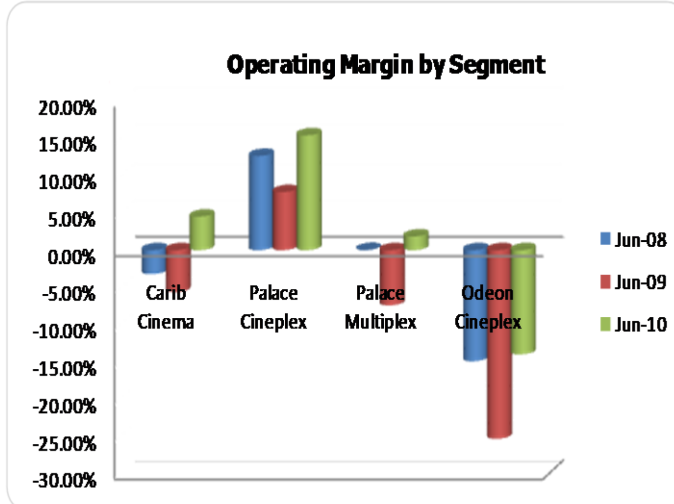
	Jun-05	Jun-06	Jun-07	Jun-08	Jun-09	Jun-10
net profit margin	3.24%	-1.95%	-1.35%	4.50%	-1.00%	1.39%
leverage	1.44	1.33	1.31	1.33	1.43	1.52
total asset turnover	1.07	1.14	1.38	1.43	1.52	1.76

[9] Total asset turnover: Sales/Total Assets

Segment Performance –by Cinema

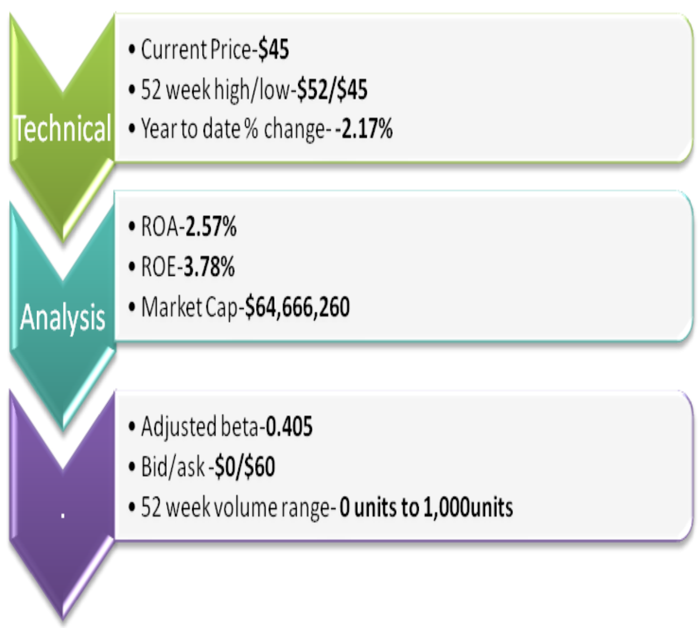
In the last three years, Carib cinema has generated the largest revenue flows and contributed the most to operating profits. However, anemic margins at this location are suggestive of higher operating costs.

Although contributing a lower proportion of operating earnings, Palace Cineplex has been the most profitable segment. Operating profit margin provides an indicative measure of profitability and margins are healthiest at this location. However, profitability indicators show that Palace Multiplex and Odean Cineplex are a drag on the company's performance due to high operating costs relative to revenues.



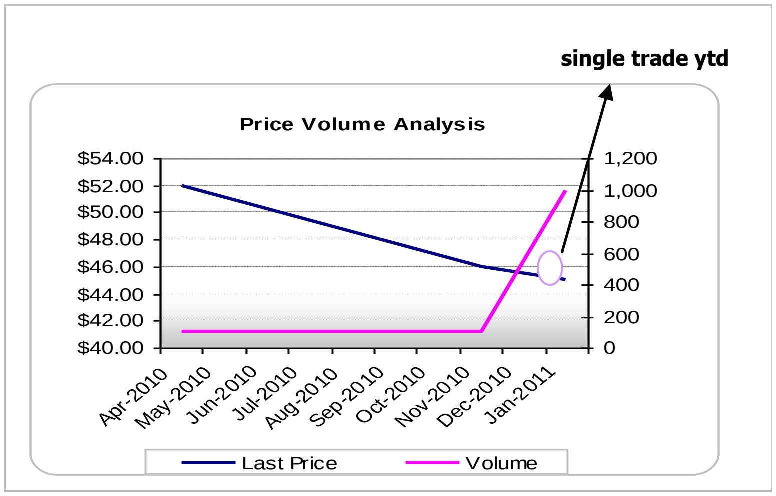
Technical Analysis

Since January 2010 the JSE Main Index has appreciated by 0.78%, outperforming Palace's share price which declined by 2.17%. With only 150 shareholders and the least number of shares issued on the JSE, the stock is extremely illiquid. With 84.2% of shares owned by the top ten shareholders, the remaining 15.71% free float limits active trading which impinges on shareholder's ability to realize a return once the stock is purchased.[10] This has contributed to the subdued movement in the share price.



[10] Top ten shareholders as at June 30th 2010

Since the start of 2010 Palace has traded only 3 times with volumes totaling 1,200 units compared to the market where on average volumes and numbers of trades are markedly higher. The stock's adjusted beta of 0.405 is the direct result of its infrequent trading which artificially reduces the level of volatility in the stock and lowers its standard deviation.[11]



Dividend Policy

High fixed costs and the need to invest to keep pace with technology means that Palace rarely pays dividends to shareholders. Dividends were paid twice between 2005 and 2010. Absence of a clear dividend policy limits the attractiveness of the stock because there are no steady cash flows to augment returns to investors.

H1 Earnings

Despite modest revenue growth, earnings were muted for the first half (H1) of the FY 2010/2011 due to higher operating expenses. Limited high grossing films and higher operating expenses in the second quarter resulted in net profit for H1 declining 45.3% to $6.3Mn (EPS: $4.45).

Revenues grew by 3.9% driven by higher box office receipts which accounted for 61% of revenues. Box office receipts increased 3.87% driven by higher priced 3D films and their relative lower price elasticity when compared to 2D films. Income from confectionery sales also recorded a modest increase (4%), while screen advertising rose 40% albeit from a small base. Screen advertising still accounts for a small percentage (4.7%) of total revenues.

Direct expenses increased at a slower pace when compared to revenues as the revaluation of the local currency helped to moderate expenses relating to film costs. As a result, gross profit margin remained stable at 17%, with gross profit at $62.9Mn.

However, Palace's operating margin deteriorated from 3.22% to 2.51%, reflecting higher administrative expenses. Administrative expenses were markedly increased (11.9%) when compared to the corresponding

[11] Asynchronous trading

period in FY2009/2010 given the implementation of a call centre geared at improving its customer service capabilities. Additionally, the 40% increase in finance expenses associated with the increased current portion of long-term liabilities further tempered earnings and margins.

Balance Sheet

Despite an enhanced fixed asset base given the phased implementation of 3D screens and other technological upgrades, Palace's asset base fell to $389Mn due to a decline in cash balances. The quick ratio declined from 1.44X to 1.04X. Shareholders' equity exhibited only a marginal improvement to $258Mn.

Earnings Projection

- Revenues are expected to grow by 10% to $743Mn helped by the anticipated release of 30 3D films in 2011, with the associated ticket price premiums augmenting revenues.[12] However, the historical volatility in attendance, the unpredictability of movie quality and the lower year to date grossing, is expected to moderate revenue growth.

- Operating expenses are expected to consume a significant portion of revenues in line with the historical average (80%) given the higher cost of 3D films. FX stability is expected to temper growth in expenses to $613Mn, contributing to a slight improvement in trading profit margin.

- Data to December 2010, indicate a marked reduction in cash and short term balances. With a significant reduction in money market rates paired with J$ stability, it is expected that "other income" will fall 40% to $9.7Mn.

- Higher administrative expenses are projected to significantly restrict growth in earnings, considering year to date expenses have already increased by 11%. Administrative costs are expected to increase 15% over FY2009/10.

- Consequently earnings should total $7.6Mn (EPS: $5.29) in FY2010/2011.

[12] J.P Morgan

Valuation

Residual Income (RI)

Palace Amusement's unstructured dividend policy and persistent negative free cash flows preclude the use of the Dividend Discount Model, the Justified P/E and Free Cash Flow valuation methods. The RI method was used since it uses book value and the company's ability to generate a ROE above its cost of capital.[13] A 19.70% cost of equity and conservative growth rate of 2% was applied to the model.[14]

	2011	2012	2013	2014	2015
Beginning Book Value	$176.20	$181.49	$186.88	$192.39	$198.00
EPS	$5.29	$5.40	$5.50	$5.61	$5.73
Dividend	0	0	0	0	0
Ending Book value	$181.49	$186.88	$192.39	$198.00	$203.73
Cost of Equity	19.70%				
Residual Income	-29.42	-30.36	-31.31	-32.29	-33.28
PV of Residual	-$24.58	-$21.19	-$18.26	-$15.73	-$27.80
PV of RI +Begining BV	$82.90				-$13.54

The estimated value of the stock is largely influenced by the company's high book value per share given the minimal number of shares outstanding. Palace has a negative present value of residual income because its relatively low profitability means that it is unable to generate a ROE above its cost of equity capital. This results in an intrinsic value of $82.90 which is significantly lower than its book value but a substantial premium above its current price. Although the RI model implies significant upside potential for this stock, it is unlikely that the stock will trade that high considering it rarely trades and the low probability of dividends to augment returns.

Price Multiples

The price to earnings (P/E) and the price to book (P/B) offer some insight into shareholders' sentiment regarding the stock. Investors' perception of the stock's illiquidity and its infrequent cash flows is factored into its price relative to earnings and book value. Using a trailing P/E of 9.72X applied to a forward EPS $5.29 yields a future price of $51.41.[15] Using a 5 year historical P/B of 0.26X against our projected book value per share of $181.49 yields a forward price of $47.19.

The P/B valuation gives a fair assessment of the stock's value, as the deep discount of the stock price relative to its book value accounts for the less optimistic prospects for cash flows and price appreciation. Palace has never traded close to its book value in the last five years which reaffirms the challenges in realizing returns from this stock.

---

[13] RI assumes that the existence *Clean Surplus Accounting* (ending book value of equity equals the beginning book value plus earnings, minus dividends), which holds in this situation given the stability in movement of financial securities that are charged directly to shareholders' equity.

[14] Given the distortions to the stock beta caused by its infrequent trading, a beta of 1 was used given the inherent risks in the company's earnings, the stock is assumed to be at least as risky as the market..

[15] Trailing P/E as at March 10th 2011

Deep discount of price relative to book

	Jun-05	Jun-06	Jun-07	Jun-08	Jun-09	Jun-10
Pice to Book	0.31x	0.19x	0.20x	0.28x	0.35x	0.30x

Recommendation

A **SELL** is recommended on PAL despite valuation methods yielding intrinsic values higher than the current price. The high illiquidity of the stock makes it unlikely that the stock will approach its fair value in short to medium term. The unlikelihood of realized capital gains and cash flows increases the opportunity costs of holding the stock. In fact, investors would likely fare better holding fixed income investments despite low market rates.

Outlook

Distribution trends show that box-office and consequently theater company performance will increasingly depend on a smaller number of blockbusters, advertising spending will rise and the timing of releases (and DVDs) will become a bigger issue for theatre operators.

Palace's limited control over film costs will keep costs elevated and the 3D evolution will further heighten operating costs and place greater pressure on margins. This could increase losses particularly if high grossing 3D box office hits fail to materialize in any year. However, anticipated FX stability for the remainder of the year should allow for some control over film costs. As such, Palace will need to grow other income streams to improve profitability. Disposal of unused properties could assist in augmenting cash flows.

With the prohibitive cost of digital home theatre systems, it is expected that Palace's leverage in exhibiting digital projections will continue in the short to medium term.

THE PALACE AMUSEMENT CO.

Company Analysis as at March 11th 2011

Appendix: Historical Performance

Table 7

Palace Amusement Profit & Loss Statement Financial Year End 30-Jun.	2005 Audited (JA$ 000)	2006 Audited (JA$ 000)	2007 Audited (JA$ 000)	2008 restated Audited (JA$ 000)	2009 Re-stated Audited (JA$ 000)	2010 Audited (JA$ 000)
OPERATING REVENUE	**378,202**	**355,148**	**414,727**	**479,866**	**528,906**	**675,638**
OPERATING EXPENSES	(310,282)	(293,363)	(332,403)	(405,267)	(469,336)	(565,649)
Trading Profit	**67,920**	**61,785**	**82,324**	**74,599**	**59,570**	**109,989**
Other operating income	47,654	36,137	18,750	39,903	42,966	16,170
Administration expenses	(94,055)	(98,474)	(92,619)	(79,496)	(106,565)	(107,994)
Other operating expenses	(5,119)	(5,483)	(2,850)	(4,681)	-	
Operating (Loss)/Profit	**16,400**	**(6,035)**	**5,605**	**30,325**	**(4,029)**	**18,165**
Financial (cost)/income, net	(9,047)	(3,631)	(3,636)	(1,976)	(2,686)	(4,322)
Share of Results of Assoc. Co's						
PROFIT BEFORE Exceptional Items	**7,353**	**(9,666)**	**1,969**	**28,349**	**(6,715)**	**13,843**
Exceptional items	-	-				
Profit after Except Items	**7,353**	**(9,666)**	**1,969**	**28,349**	**(6,715)**	**13,843**
Taxation	4,919	3,038	**(7,567)**	**(6,767)**	**1,429**	**(4,442)**
Profit After Tax.	**12,272**	**(6,628)**	**(5,598)**	**21,582**	**(5,286)**	**9,401**
Extraordinary Items						
Minority Interest		(280)				
Net Profit Attri. To Stkholders	**12,272**	**(6,908)**	**(5,598)**	**21,582**	**(5,286)**	9,401
Earnings per Stock Unit	**5.34**	**(4.42)**	**(3.83)**	**14.19**	**(3.51)**	**6.64**

Table 8	
Rf (20year bond)	11.45%
MRP	8.25%
Beta	1
Cost of equity	19.70%
Forecasted EPS	$5.29

References

Motion Picture Association of America: Theatrical Market Statistics 2009

Palace Amusement Annual Report 2005-2010

Stowe, John D.,Thomas Robinson, Jerald Pinto and Dennis Mcleavey.2002. "Analysis of Equity Investments:Valuation."

www.jamstockex.com

http://www.jamaicaobserver.com/entertainment/3D-movies-boost-cinema-attendance-in-Jamaica_8402597

http://boxofficemojo.com/news/?id=3038

http://boxofficemojo.com/news/?id=3059

http://www.wikinvest.com/stock/Cinemark_Holdings_(CNK)

Bloomberg

www.morganmarkets.com