Is CGI Group Inc. a Safe Place to Hide From the Market Weakness?

Description

In the last year, **CGI Group Inc.** (TSX: GIB.A)(NYSE: GIB) has not participated in the market rally. While the **S&P/TSX Composite Index** (TSX: ^OSPTX) has a one-year return of 10%, and the **S&P/TSX Capped Information Technology Index** (TSX: ^SPTTTK) has a one-year return of 19.2%, CGI saw a decline of -0.86%.

The reasons for this underperformance include the Obamacare debacle, the accounting concerns related to the $2.6 billion Logica acquisition, and concern that the company would not be able to maintain its margins. These concerns have thus far proved to be exaggerated, and with more and more quarters such as the last one, investors' fears, in my view, will be eased.

By contrast, the one-month returns show a different picture. The S&P/TSX Index has declined 8.1%, and the S&P/TSX Information Technology Index has declined 6.9%, while CGI has outperformed, with a 2.5% decline. Is this the start of a period of outperformance on the part of CGI? I believe this to be the case due to the following reasons.

Attractive valuation

Valuation on the stock is very attractive, trading at a P/E multiple of 15.5 times trailing EPS and a P/CF of 8.6 times. It is trading at 13.4 times 2014 expected EPS, which is expected to increase over 23% in 2014 and 12% in 2015. These EPS numbers do not include any acquisitions, which, now that the company has a much improved balance sheet, may be coming sooner rather than later. This would obviously provide upside.

Continued margin improvements should silence the doubters

It is clear that margins suffered with the Logica acquisition. After the acquisition, 2012 and especially 2013 EBIT margins were hurt. In 2013, the company's EBIT margin was 10.6% and they flirted with 8% at one point. But, the company has made significant margin improvements since then and is well positioned to continue to make improvements with the help of its size and breadth of offering. In the latest quarter, margins were back up to 12.8% after the restructuring program that saw the company spend almost $600 million to achieve $375 million in annual synergies.

Furthermore, there are opportunities for cross selling, and the company's plan is to increase sales of its IP software, which are higher margin revenue and "stickier". The company fully intends to take advantage of its newly expanded global distribution network.

Strong industry trends

According to global research firm Forrester Research, worldwide information technology spending is expected to grow 3.3% through to 2018 for a total spend of $2.2 trillion. Other estimates are calling for an almost 6% annual growth rate through to 2018. With CGI having achieved diversification across geographies, industries, and services, the company is well positioned to grab a significant piece of this pie. In the latest quarter, the United States accounted for 29% of EBIT, Canada accounted for 26%, the Nordics and Southern Europe accounted for 14%, and the rest was from the U.K, Asia Pacific, France and Central and Eastern Europe.

Further consolidation opportunities

CGI Group has been a consolidator in the IT industry and this has served to increase the company's global presence, its breadth of offerings, and its expertise. The company's most recent acquisition, the acquisition of UK- based Logica, was CGI's biggest acquisition to date. It effectively lifted CGI to become the world's fifth largest independent IT and business process services company.

The company's strong free cash flow generation leaves it well positioned to continue to be a consolidator, and execute its "Build and Buy" growth strategy. In the latest quarter, ended June 30 2014, the company generated free cash flow of approximately $300 million. This growth strategy targets growing organically through contract renewals and extensions, winning new contracts, smaller niche acquisitions, and if and when the time is right, bigger transformational acquisitions. We are seeing this strategy play out in the company's healthy backlog of $18.8 billion as of the end of the most recent quarter, and in the continued success at being awarded contracts.

Amid the market turbulence that we have seen lately, CGI Group stands out as a fundamentally sound, reasonably valued company that investors can expect will be an outperformer this year.

CATEGORY

1. Investing
2. Tech Stocks

TICKERS GLOBAL

1. NYSE:GIB (CGI Group Inc.)
2. TSX:GIB.A (CGI)

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Author
karenjennifer