This Stock Is up 1,121% in 5 Years: Can it Rise Even Higher?

Description

Since December 1, 2010, it's been good to be a **Constellation Software Inc.** (TSX:CSU) shareholder. The stock is up a mind-blowing 1,121%, rising from $46.50 per share to today's price of $571.

Needless to say, that's a great performance. It's the kind of increase that can affect a whole portfolio.

But what about the future? Does Constellation Software still have the potential to increase going forward? Let's have a closer look.

The bull thesis

One of the big trends in the stock market over the past five years has been the roll-up acquisition story. A company uses its size to acquire smaller competitors, adding the acquired company's products to its offerings. Over time, the growing company can use its clout to raise prices to existing customers, and it can easily gain clients because of its size and product offerings. It's much easier for a customer to deal with one big company than several smaller ones.

This model has gained popularity in several sectors, especially the pharmaceutical industry. It isn't hard for a sales force to offer a few additional drugs. And the cost savings achieved in condensing back-office duties can also be significant.

Like health care, software is another logical choice for this type of business model. There are hundreds of small- to medium-sized companies out there with just one or two products that do quite well in their niche. Constellation looks for companies that dominate a niche, have revenues of at least $5 million, and don't have the giants of the industry as direct competitors.

In 2015 alone, Constellation announced eight different acquisitions. A slower year in comparison was 2014, with only two companies acquired. A really exciting year was 2013 when the company made 18 different acquisitions. And this could even ramp up over time, since the company has increased the number of employees it has looking for deals.

Management knows there are challenges to building a conglomerate, and the company is taking steps to try and ensure it doesn't fall into some of the same traps that have ensnared other conglomerates. Management studies other comparable companies and commissions studies on certain things they're concerned about.

One thing Constellation has over its competitors is a focus on designing software for the public sector. In the first three quarters of 2015 it got $915 million in revenue from various North American governments compared to $411 million in business from the private sector.

Does the valuation matter?

It's obvious that there's still a lot of potential to consolidate the software space. After all, Constellation isn't the only company doing so; **DH Corp.** has a similar business model, and it's focusing on just software for the financial services industry.

The big issue with Constellation is valuation. The company currently trades at more than 60 times trailing earnings, even though it posted negative 5% organic revenue growth in the most recent quarter. Granted, currency fluctuations were the main culprit, but a company trading at 60 times earnings with only a little organic growth is troubling.

There's an argument to be made that the valuation doesn't matter. Constellation was never really an organic growth story; rather, investors like it because of the potential for more acquisitions. As long as it can buy companies at a greater return than its cost of borrowing, investors are happy.

But at the same time, valuation always matters, especially when a stock is trading at 60 times earnings. Analysts predict some pretty major growth in the next couple of quarters, which they think will be enough to boost earnings per share to $26 for 2016. That puts shares at a forward price-to-earnings multiple of 22 times, which is much more reasonable.

I'm skeptical that the company can post such great earnings growth over the next year, especially after considering the lack of organic growth in the latest quarter. If the growth doesn't come, the stock could easily head lower when disappointed investors lose their patience.

Constellation still has a great runway of potential ahead of it. I just don't like the valuation. Perhaps investors should try to be patient with this name and look to pick it up after a pullback.

CATEGORY

1. Investing
2. Tech Stocks

TICKERS GLOBAL

1. TSX:CSU (Constellation Software Inc.)

Category

1. Investing
2. Tech Stocks

Date
2025/09/12

Date Created
2015/12/01
Author
nelsonpsmith