Be Cautious With CGI Group Inc.

Description

CGI Group Inc. (TSX:GIB.A)(NYSE:GIB) retreated by 3.15% on August 2, 2017, following an underwhelming Q3 2017 earnings report and the announcement that the company is going to lay off 1,600 workers as it restructures its workforce.

The company

CGI is an information technology consulting, outsourcing, and integration solutions company based out of Montreal. The company is geographically diversified and has been a top pick of investors for its impressive bottom-line growth over the years.

To many investors, CGI is a great growth play which has delivered impressive capital gains of over 170% over the past five years. Although the company doesn't pay a dividend, many Canadians still flock to this stock for its price appreciation and exposure to the tech sector.

Software development is a high-margin business, and CGI has seen its gross margins surge over the last few years as the company shifted its focus on higher-margin projects. Although the software development and outsourcing market are expected to increase over the next few years, there are a few reasons to be cautious about CGI.

Great valuation, but what about the associated risks?

CGI trades at a modest 18 price-to-earnings multiple, which is substantially lower than the company's five-year historical average of 48.4. That seems like a great deal for a company that consistently delivers strong earnings growth with a high 17.73% return on equity (ROE), but one of the primary concerns is what appears to be slowing revenue growth and the potential implications of an economic downturn.

Slowed revenue, increasing margins

Although revenues have pretty much remained flat over the last few years, gross margins and operating margins have both jumped, which resulted in impressive earnings-per-share growth. Instead of boosting top-line growth, CGI is doing everything it can to cut costs to boost its earnings, but there's really only so much juice you can squeeze out of a lemon.

More recently, CGI announced it's cutting 1,600 jobs, and CEO George Schindler stated, "Nearly 80% of clients interviewed across every industry plan to increase or maintain their IT budgets — with significant increases for new applications and automation."

Although client's demands are changing, and the company wants to lower its dependance on outsourcing, I believe the wave of layoffs was to just another way to boost profit margins, which have taken a small 50-basis-point slip in Q3 2017 compared to the same quarter last year.

Bottom line

CGI is facing the pressure, and the management team is doing everything to keep its bottom-line growth solid. Unfortunately, I believe CGI may eventually hit a brick wall if top-line growth remains stagnant.

Personally, I'd avoid CGI, especially after the latest underwhelming quarter. Shares are reasonably priced though, so value investors keen on getting exposure to the IT outsourcing industry may want to consider buying shares on weakness.

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