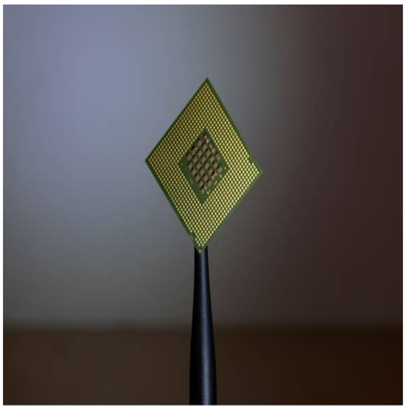

Constellation Software Inc. (TSX:CSU) Stocks Get Pummeled: Is it Still a Great Investment?

Description

If you've been following how growth stocks have fared on U.S. exchanges recently, you'll have noticed that the market is punishing stocks on any signs of weakness. Beating earnings may not be enough at a time when many sectors, like tech stocks, seem overbought.

The same tenacity is shaking up TSX growth names. Shares of **Constellation Software Inc.** (TSX:CSU), considered by many as a robust software company and darling investment, got hammered on Friday. At the time of writing this piece, Constellation stock was down 7.5%.

This price drop eclipses single-day poor performance over the last 300 trading days for this stock (nearly double the 3.7% drop on May 18, 2018). Ouch!

Constellation has been one of the best stocks of the year. There was frothier-than-usual volume in the days leading up to the Thursday, July 26th earnings report. I viewed this as a sign that shareholders were playing it smart and taking profits when they had the chance. No one predicted this kind of drop, though! It was a bit odd that the company choose to have **no** earnings call. Investor questions can instead be logged online for easier access. I have to admit, I don't mind this format.

Is Constellation still worthy of such a high price multiple after this quarter?

Constellation's bottom line was reported in earnings per share (EPS) of $5.75, missing estimates by 15%, as analysts expected the quarter to produce an EPS of $6.78.

On the top line, revenue came within target, missing the $753 million estimated by a mere $1 million.

Meanwhile, revenue was up 25% from Q2 2017. Constellation makes most of its money from ongoing contracts, both in private and public sectors. A notable highlight in the earnings report was a 56% increase in professional software services in the private sector. Consistent with the business *modus operandi*, Constellation also gobbled up more software companies through $43 million in acquisitions this quarter.

Reasons to be concerned about Constellation

- Sales were $3.1 billion in 2017, an impressive number. Yet year-over-year sales are actually slowing, from 32%, 12%, and then 9% from 2014 through to 2017. Don't let the percentages trick you, though. It is not possible to increase sales at the same pace without exponential sales growth. This is unrealistic to expect for a $22 billion market cap company. It ain't a small cap anymore!
- Current price-to-sales ratio of 9.1 is the highest it has been in 10 years.
- Some insiders were taking profits by selling shares in advance of the quarterly report. I don't view this as a sign of weakness, but, undoubtedly, this is a small factor in the price dump.

Take-home message

After a meteoric rise year to date, Constellation stock is correcting downward towards a 100-day moving average. With its wide business moat, strong revenues from both the private and public sector, Constellation deserves a high multiple.

Mat Litalien makes the point that this stock is good for millennial investors. I agree. The market is saying that a forward-looking price-to-earnings ratio above 30 may no longer be acceptable. Analysts seem to agree that Constellation could not keep up the rapid pace to match the investors hype that bid the stock up in the first place. One bad quarter will not sink this software ship; this is more of a reboot.

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