Is Constellation Software (TSX:CSU) Undervalued?

Description

The Andreessen-Horowitz team was right when they said “software is eating the world.” With the right talent, even a handful of engineers can build a business that solves a critical problem and scales swiftly.

The key word here is *scale*. Once the technology is created, it can be distributed for next to nothing and replicated at the click of a button. This allows software companies to create high-margin businesses that grow remarkably quickly.

Couple these businesses with great managers and a defensible moat and you have a stellar business. Back in 1995, venture capitalist Mark Leonard realized the potential of this new business model earlier than most. He created **Constellation Software** (TSX:CSU) to collect these stellar businesses.

Over the past 20 years, Leonard’s team has picked up over 300 companies including business solutions provider ACCEO Solutions Inc. (which it paid $250 million for earlier this year) and hospitality cloud solutions provider Multi-Systems, Inc. (MSI).

On its website, Constellation says it focuses on small or mid-sized teams that dominate a vertical with at least $5 million in revenue. They also look for experienced managers who’ve delivered 20% or more revenue growth over the last few years. By this standard, the potential acquisition universe includes 38,000 software vendors across 12 verticals.

To say that this strategy has paid off well for shareholders is an understatement. Since its initial public offering (IPO) in 2006, Constellation’s stock has multiplied 49 times. That implies a compounded annual growth rate of roughly 38% over a 12-year period.

Leonard wrote an annual letter to shareholders to share more details about the business. This year’s letter would be the last one published because the team is now wary of giving too much away to competitors.

“We believe that sharing our tactics and best practices with a host of Constellation emulators is not in our best interest,” Leonard said in his final letter. It’s an indication that the company faces tougher competition for acquisition targets. Probably from venture capitalists, private equity firms, hedge funds, and family offices.

Across the world, the valuation of technology companies of all sizes has reached record highs. There are more unicorns (startup worth $1 billion+) than ever before. There’s simply too much capital chasing too little innovation.

Nevertheless, Constellation’s proven track record of disciplined value investing coupled with the recent correction in tech stocks should give investors hope of attractive acquisitions in the near future.

As the stock is down along with the rest of the market, it’s a good time for investors to take a closer look. The stock trades at a price-to-operating cash flow ratio of 35.84. The company’s return on invested capital and organic growth has been 33% over the past year.

If you use operating cash flow instead of earnings for this holding company, the price-to-earnings (PEG) ratio is 1.086, which would imply that the stock is fairly valued at the moment.

Foolish takeaway

Constellation Software is an impressively stable compounding engine. Investors can be rest assured that the company’s management is investing prudently and delivering a handsome return on every dollar invested.

Despite the recent correction, the stock isn’t attractive enough for value investors; however, it may be priced fairly for growth investors. That said, this is a tech stock that deserves a spot on your watch list.

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