Is This Growth Stock Overvalued?

Description

Constellation Software (TSX:CSU) is one of the most expensive stocks on the Toronto Stock Exchange, currently trading at $928.17. There are good reasons why CSU's share value is so high. The software company has been a model of consistency since it first went public back in 2006. Consider, for instance, that the company's stock price has risen to its current price from $293 in January 2014. That is an increase of 216%.

The tech company's current price-to-earnings (P/E) ratio of 57.44% is worth noticing, however. A high P/E ratio typically means investors are paying more than they should for the company's earnings; in other words, it may be an indication that the company's stock is overpriced. Let's look further into CSU's financial performance and growth prospects to determine whether the company is worth its price tag.

Strong financial results

CSU posted very strong results in 2017, with increases in revenue, net income, earnings per share, and cash flow from operations from 2016. This upward trend in some of the company's most important figures continued this year. Its third-quarter earnings report showed a revenue increase of 19% year over year, while the company's adjusted net income and cash flow from operations increased by 26% and 17%, respectively.

The software company compares favourably to its competitors and the market. Over the past year, CSU outperformed its industry by providing a 21.7% return (compared to 8.7% for the software industry), and vastly outperformed the TSX whose one-year return to date is -2.80%. CSU has grown accustomed to such above-average performances. It is no wonder that its share value has soared on the heels of analysts' enthusiasm, many of whom even think CSU's historical performance is "too good to be true."

CSU's growth model

CSU provides software services to companies within the public and private sectors. The strength of CSU's relies on its ability to make astute acquisitions. The tech company is known for purchasing vertical market software businesses. CSU's latest acquisition was in January when it purchased Real Estate Digital LLC through one of its subsidiaries, Perseus Operating Group. This latest acquisition, which strengthened the company's presence in the real estate industry, is typical of CSU's business model.

Acquisitions do not necessarily create value for the acquiring company. Whether it increases shareholder value depends on several factors, including how the operation is executed. CSU has managed to make it a habit to acquire companies that have the potential required to be scaled within a chosen profitable sector. In doing so, CSU continually expands and diversifies its revenue base, thus making the company more profitable and less likely to succumb to large-scale financial woes.

Will CSU's stellar historical financial performance continue? The company has proven that its business model works. Investors have every reason to believe that CSU's management will keep purchasing profitable and scalable software companies. CSU's revenue and profit are expected to grow even more next year. If its future trend even vaguely resembles its growth since it first went public — which certainly looks very likely — CSU's P/E ratio is justified. Thus, the company's stock is probably not overpriced.

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