Is Canada's Top Tech Stock Worth the Price?

Description

Canadian tech stocks are a lot more industrial than their U.S. counterparts. Supply Chain and enterprise content management systems fail to attract the sort of attention America's FAANG stocks get, which means the sector is worth a look for sophisticated investors seeking promising niche stocks.

Perhaps the most underappreciated mid-sized tech stock in the country is **Descartes Systems Group** (TSX:DSG)(NASDAQ:DSGX). Waterloo-based Descartes provides on-demand software-as-a-service (SaaS) solutions focused on supply chain management and business security. The company dominates the Canadian market for specialized logistics software alongside rival **Kinaxis Inc.** (TSX:KXS).

According to Descartes, the global market for logistics is worth $4 trillion. Growth in international trade and the prevalence of online shopping should drive the need for further efficiency and automation in this market. In other words, the more people shop online and the more countries trade, the higher the demand for the company's platform.

Like Kinaxis, Descartes has a solid base of recurring income through long-term contracts with major corporations. Its core product, Global Logistics Network, is an extensive electronic messaging system used by nearly every stakeholder in the global supply chain.

The system currently serves 13,000 customers across 160 countries. The cloud-based messaging platform processes over 4.5 billion messages and manages more than 30 million shipping routes every year. In 2015, the company signed a deal with German business software giant **SAP SE** for access to the platform's data.

This sticky platform can be thought of as the iMessage of the logistics industry. That means it has durable network effects, which are difficult to replicate. This is the company's core competitive edge.

Management has been building around that edge with acquisitions. Since 2006, the company has acquired more than 41 different entities at a rate of three deals per year. This growth-through-acquisitions strategy has delivered a 273% return for shareholders over the past five years.

In its most recent quarter, the company generated US$70 million in sales, delivered a 34% earnings before interest, taxes, depreciation, and amortization (EBITDA) margin, and reported US$19.2 million in operating cash flow.

However, the stock is overvalued by nearly every measure. It trades at a current price-to-earnings (PE) ratio of 78, a forward PE ratio of 56, and a five-year estimated price-to-earnings-growth (PEG) ratio of 3.4. The company doesn't pay a dividend and has only US$35 million in cash and cash equivalents.

By comparison, the company’s most recent acquisition was for Visual Compliance at approximately C$330 million (US$250 million). Most of that purchase was financed by debt, which is likely to be the case for other acquisitions in the near future. The expected rise in debt and the above-average valuation could make this stock too risky for most investors.

Bottom line

The Canadian tech sector isn’t a fertile ground for bargain hunters. While Descartes trades at a valuation lower than most top tech companies, the price is still relatively high when adjusted for realistic growth opportunities.

However, the growth-by-acquisition strategy has delivered excellent results for shareholders in the past. If the strategy continues to deliver, the stock might be worth a closer look for investors willing to face the market’s volatility.

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