



3 Trends to Watch on Kinaxis Inc (TSX:KXS) After the Latest Earnings Report

Description

One of Canada's highly regarded tech growth stocks **Kinaxis Inc** ([TSX:KXS](#)) traded 7.75% lower on Friday last week after the company reported fourth quarter and annual financial results for 2018 after-market hours on Thursday, February 28.

The latest drop could be another opportunity to pick up more shares on the dip for investors bullish on the supply chain planning solutions provider's future prospects, but there are three developing trends that may cause a further weakness on the stock, which may require close monitoring going forward.

A slowing growth rate, declining margins, and potentially declining earnings quality are three important issues on Kinaxis that warrant a discussion today.

Slower revenue growth rate

As [previously highlighted](#), the company adopted some new accounting standards last year, including IFRS 15 that has caused some havoc on its top line growth and hampered direct comparability of 2018 results against 2017 figures. Management has made a stellar effort to report both post and pre-IFRS 15 numbers to aid comparability, but even after this adjustment, a worrisome trend is showing.

Kinaxis used to grow annual revenues by a three-year compound growth rate of around 24% per annum over the past five years, but growth has slowed over the past three years to just 19%. Year-on-year revenue growth peaked at 30% in 2015, fell to 27% the following year and slowed to a low of 15% in 2017 before a rebound to 16% last year.

It's reassuring that the company has given a guidance for a total revenue mid-point of US\$185.5 million for 2019 (post IFRS 15) representing a 23% sequential growth over last year's reported sales. Revenue visibility is very high for Kinaxis given the strong 100% plus retention rate in its subscriptions portfolio, there's an excellent chance of realizing this projected growth.

That said, a revenue miss or a downward adjustment to the issued guidance could greatly disappoint investors who have assigned a hefty earnings multiple to the stock price. Slower growth may attract a

valuation multiple contraction and cause a further fundamentals driven fall in the share price.

Weaker profitability margins

At 67% recently, Kinaxis' gross margin for 2018 significantly strayed from the near 70% reading that investors had become used to since 2014. The cost of revenue has increased as the company invested in new data centres and increased its head count to better serve a growing global client base, and it may take awhile before we see a rebound in this profitability measure.

The recent strong growth in the cost of revenue has the potential to soften as the company hits its capacity expansion targets. This cost component has some characteristics of a short term relatively fixed cost, which would give the company some operating leverage, so gross margins may start improving as the company continues to win new customer accounts.

That said, operating expenses grew faster than revenue last year, and the adjusted EBITDA margin declined to around 27% for 2018, down from over 30% in 2017.

Even worse, the company's 2019 guidance is for the adjusted EBITDA margin to shrink further to between 23% and 25% of revenue this year as expenses continue to grow faster than annual revenues. Shrinking margins are a serious concern that could result in an earnings multiple contraction and lead to a weaker stock price.

Declining earnings quality?

The company is still profitable, which is a good thing, but a massive 104% jump in trade and other receivables in 2018 raises some eyebrows and could be cause for concern.

Trade receivables constituted 37% of annual revenue last year, up from under 21% in 2017, which negatively affected operating cash flow last year and reduces the quality of the recently reported annual earnings.

Revenue growth accompanied by an increase in receivables may at times reflect earnings management, and investors may need to watch this development closely going forward.

Foolish bottom line

Slower growth and a margin contraction present a discouraging trend in a growth stock, and the near 8% plunge in Kinaxis stock after earnings on Friday is therefore a natural investor reaction.

Reported earnings were weaker, even after adjusting for the change in accounting rules, but there is new hope in the company's earnings guidance for this year. The company closed a number of new multi-year subscription wins during the fourth quarter of 2018 and these, and other wins during the year, may support desired growth and a return to price momentum on the stock.

Close attention should be paid on margins, cash flow and the quality of earnings going forward.

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