Contrarian Investors: Should This Beaten-Down Tech Stock Belong to Your Portfolio?

Description

At times, high-quality stocks do get beaten down either on market jitters of higher perceived risk, or on genuine news of underperformance that warrant a short-term price weakness. **Enghouse Systems** (TSX:ENGH) stock is down over 17% from its pre-earnings trading range on March 7 after reporting first quarter 2019 earnings. Could this be a good opportunity to buy the dip on this highly profitable sleepy giant?

A business with several income sources

Enghouse Systems is a developer and marketer of enterprise oriented applications software that operates through two business segments, the Interactive Management Group and the Asset Management Group.

The Interactive Management Group's products include customer interaction software and services designed to enhance corporate customer service like contact center communication systems, and the Asset Management Group serves telecom service providers, utilities and the oil and gas industry with products that include operations support systems, mobile value added services systems and data conversion systems and it also offers fleet management and communications solutions for the transportation, government, emergency services and security sectors.

Why did the share price tumble after earnings?

The company's Q1 2019 results disappointed.

After closing two new acquisitions in the Asset Management Group during the quarter, total revenue for the period grew a mere 1% over prior year sales to $86 million. The contribution of newly consolidated entities was almost totally offset by a worrying decline in licenses revenue in the Interactive Management Group

A negative growth trend has developed in the company's biggest revenue generating segment. Fourth-quarter 2018 revenues in the Interactive Management Group were down 7% from a comparable quarter in 2017, and this time Q1 2019 revenues from this segment were 10.2% lower than Q1 2018 numbers, with software licenses revenue down 15.25%.

Increasingly competitive cloud software providers are hurting the company's licenses sales model and **Microsoft'**s decision to abandon Skype for business in favour of Teams has resulted in a temporary dip in customer licences purchases as migration to the new platform goes underway.

Investors had reason to freak out, and shares tumbled.

However, historically the company's operating results have been very volatile due to timing of license sales, and the recent introduction of a new accounting standard IFRS 15, which requires more aggressive upfront revenue recognition on some term licenses that were previously spread over longer periods may even increase top-line volatility significantly going forward.

Can valuation recover?

Near-term weaknesses in license sales may continue for a while as the company adapts to an evolving business environment, but investors with a time horizon of three years or longer have very good chances of witnessing a strong share price growth on the ticker.

The company is growing, albeit mainly through acquisitions. Cash flow generation continues to be strong as operating cash flow grew 4.5% during the quarter. Cash flow is the life blood of any business, and the company is generating lots of it.

Further, we saw a 2.2% decline in the company's quarterly operating expenses. This happened even as two new acquisitions were consolidated during the period. Ongoing cost reductions may support increases in adjusted EBITDA margins and lead to earnings per share growth. This favours share price recovery.

Interestingly, there was a sharp 22% increase in deferred revenue at the end of the first quarter, which could imply a better revenue run-rate this year. Equity valuation may improve as revenue growth returns over the remaining three quarters of the year.

Time to buy?

Enghouse Systems remains a solid cash rich technology company whose businesses enjoy around 30% operating margins. It has grown its small yielding quarterly dividend by double digits in the past 11 years, which could make it a formidable income stock in the next five years. The latest dividend increase was by 22% this quarter.

Management feels this is the right time to make new acquisitions, and the company has a liquid cash position comprising 36% of its balance sheet that is available for deployment this year without any potential dilution to current shareholders. New acquisitions may bring back the mojo that investors look for, and buying the current dip could be a wise idea.

That said, there's a need for weak revenue lines to return to organic growth. Fresh acquisitions may not continue to mask deteriorating businesses for very long, and management may be forced to recognize some goodwill impairments later and this may hurt the share price.

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