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Is Constellation Software (TSX:CSU) Resilient to the Pandemic?

Description

The current COVID-19 crisis has made investors fearful about the safety of their investments. They have shifted to defensive stocks that are resilient to an economic downturn. Among tech stocks, large enterprise software companies are considered defensive because of their recurring revenue and stable cash flows. The biggest name in this segment is **Constellation Software** (TSX:CSU), which has an annual revenue of around US$3.5 billion and a market capitalization of over $30 billion.

Constellation is among the most diversified software companies

Enterprise application software companies like **Descartes Systems** and **Open Text** diversify themselves by offering their software to a wide range of customers across different industries. Constellation Software acquires many small companies that provide mission-critical software solutions to one or two industry verticals. It has not only a diversified customer base but also a diversified product portfolio.

Since its inception in 1995, Constellation has acquired over 260 vertical-specific software (VSS) providers, giving it exposure to over 120 niche end markets. It serves over 125,000 customers across 100 plus different markets across the globe. The company earns two-thirds of its revenue from the public sector, which includes government customers that are resilient to economic downturns. Its diversified portfolio and exposure to government customers help it mitigate the impact of an economic downturn.

The secret behind Constellation's high revenue retention

Constellation depends heavily on acquisitions for revenue growth. Even though acquisitions lead to customer attrition in the short term, the company has retained more than 90% of its customers in the last 10 years. The secret behind its high retention rate is the importance of its solutions to customers.

Constellation acquires VSS companies that serve a niche market, which means they do not have many well-funded competitors. Moreover, these companies offer mission-critical software that customers cannot remove. And switching to an alternative solution is expensive and time consuming. Hence, most customers continue paying fees to Constellation.

Fitch Ratings noted that Constellation's organic revenue fell 3% in the 2009 crisis, while other VSS providers' revenue fell double digits. Although Constellation has a resilient business model, it is not entirely immune to the COVID-19 pandemic.

Many of its customer industries that have been severely hit by the pandemic are cutting their IT costs by delaying or canceling software purchases or canceling ongoing software maintenance contracts. Fitch Ratings expects the current crisis to reduce Constellation's organic revenue by 10% in 2020.

Constellation focuses on ROE and cash flow

The pandemic has not stopped Constellation from acquiring new companies. An economic downturn creates attractive acquisition opportunities as many companies with good growth potential become cheap. In May, Constellation agreed to acquire Netherlands-based Topicus.com that has €100 million in annual revenue. This acquisition will help the Canadian firm mitigate the impact of COVID-19 on its 2020 revenue.

The company acquires VSS businesses, which it believes can achieve the highest ROE. These businesses generate high cash flows, which the company reinvests in new acquisitions, thereby creating a compounding effect on its returns. Its acquisition strategy helped the company increase its ROE from 10% in 2009 to 43% in 2019.

A healthy balance sheet is a sign of a good company

Acquisitions generally lead to high leverage. But Constellation makes bigger acquisitions on a standalone basis, in which its six operating subsidiaries raise funds for the purchase. This

Constellation has $216 million in net cash and $700 million in the undrawn credit facility, which gives it sufficient liquidity to withstand the crisis and undertake acquisition opportunities.

Foolish takeaway

Constellation's diversified customer base, high retention rate, healthy free cash flow, and liquidity has made it resilient to the pandemic. Like all defensive stocks, it is less volatile; because of this, it outperforms in a downturn and underperforms in an upturn. It rose 33% in the last year, outperforming the **TSX Composite Index**, which fell 5%. But it underperformed the **iShares S&P/TSX Capped Information Technology Index ETF**, which rose over 50%.

However, Constellation stock's stable returns give benefit in the long term. If you had invested $1,000 in this stock 10 years back, you would have earned $36,600.

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