



Better Buy: Enghouse (TSX:ENGH) vs. Constellation Software (TSX:CU)

Description

As COVID-19 took the form of a pandemic and disrupted several economies across the globe, several investors sold their stocks and flocked to defense stocks. Now, defense stocks are the ones that are not too sensitive to overall market movements.

In other words, a defense stock has a beta (a measure of market volatility) of less than one. Some software stocks emerged as defense stocks, as their recurring revenue brought visibility into future earnings. Shares of **Enghouse Systems** ([TSX:ENGH](#)) and **Constellation Software** ([TSX:CSU](#)) have a beta of 0.56 and 0.72 as they are [resilient to a market event](#). But a low beta doesn't mean the stock momentum is weak.

Enghouse is a smaller company with a market capitalization of \$3.4 billion, but it has a higher average trading volume of over 153,000. Constellation has a market capitalization of over \$32 billion, but it has a lower average trading volume of over 61,000.

The two stocks outperformed the market by growing around 20% year-to-date. Company-specific fundamentals are driving

Stock Returns	Constellation Software	Enghouse Systems	TSX Composite Index
Year-to-Date	19.0%	23.1%	-9.2%
1 year	31.9%	84.6%	-4.2%
5 years	187.0%	124.1%	3.8%
10 years	3640.8%	1266.8%	34.2%

The COVID-19 pandemic has a positive impact on Enghouse

Enghouse acquires software providers that serve verticals like contact centres, telecom, logistics, and geographic information systems. Its core vertical is contact centres from which it earns more than 50% of its revenue. Last year, it acquired video-conferencing vendor Vidyo and cloud-based video service

provider Espial.

These acquisitions benefitted Enghouse during the pandemic-driven lockdown as the trend of remote working trend gathered pace.

Enghouse's hardware and professional services segments took a hit as the lockdown postponed onsite installations and upgrades. The pandemic had a mixed impact on Constellation, which has exposure to many different verticals.

While some of its customer industries benefitted, some were

Company-specific fundamentals remain strong

Enghouse and Constellation depend on acquisitions to boost revenue. They acquire small companies and support them with their vast sales and marketing teams created through several acquisitions.

A portfolio of related software products under one umbrella allows cross-selling and offers enhanced customer support to existing customers. But the organic growth generated from cross-selling forms a small portion of their revenue.

The two companies focus on acquiring providers that generate high recurring revenue from maintenance contracts. In the case of Enghouse, it also earns recurring revenue from software services hosted on the cloud.

Higher recurring revenue improves profit margin and cash flows, which the two companies reinvest to fund new acquisitions. This reinvestment creates a compounding effect on their returns.

Between fiscal 2015 and 2019, Enghouse's revenue rose at a CAGR of 6.7%, but its adjusted EBITDA increased at a CAGR of 10.7%. Its adjusted EBITDA margin improved from 25% to 30% during this period. It has \$167 million in net cash, which gives it ample liquidity to undertake new acquisitions.

Constellation stopped reporting adjusted EBITDA from 2019 onward. Its revenue and adjusted EBITDA rose at a CAGR of 12.7%, and 16.8% between fiscal 2014 and 2018. Its adjusted EBITDA margin improved from 21% to 25%. It has US\$216 million in net cash, giving it ample liquidity to undertake new acquisitions.

Which is a better buy: Enghouse or Constellation

Both Enghouse and Constellation have low beta and strong fundamentals, which will help them withstand the crisis and continue growing through acquisitions. When deciding on which stock to buy, valuation plays an important role.

Enghouse is trading at 49 times its earnings per share, while Constellation is trading at 76 times its earnings. Enghouse is fairly valued, whereas Constellation is trading 36% above its fair value. From the valuation perspective, Enghouse is a better buy.

CATEGORY

1. Coronavirus
2. Investing
3. Tech Stocks

TICKERS GLOBAL

1. TSX:CSU (Constellation Software Inc.)
2. TSX:ENGH (Enghouse Systems Ltd.)

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