Enghouse Systems’s (TSX:ENGH) Q2 2020 Earnings Reassures Bulls

Description

Enghouse Systems (TSX:ENGH) stock made some big moves after it released record quarterly earnings. On June 5, the stock made a new high of $77, up 23% from its previous close, and then returned to mid $60s. The stock rose 9% during the week before the earnings release and 7% a day after earnings.

Similarly, **Constellation Software** stock rose 5% during the week before its earnings and 4.5% a day after earnings release on May 7. The stock continued to rally throughout the month.

Will Enghouse stock rally continue? It is essential to understand what it’s fiscal 2020 second-quarter earnings said about its future growth potential.

Enghouse’s earnings reflect its two-pronged growth strategy

Enghouse earns money by acquiring software companies that are complementary to its existing businesses. With these acquisitions, it aims to increase its recurring revenue stream from maintenance contracts and subscriptions of cloud-based services.

Over the years, it has built a diversified product portfolio and global market presence in four verticals, namely a contact centre, transportation, telecom, and geographic information systems.

Enghouse has adopted a two-pronged strategy of growing through acquisition and organically. These acquisitions are immediately accretive to its earnings. The company leverages its global sales and marketing teams to cross-sell products to its existing and newly added customers.

YoY Growth	Q2 2019	Q3 2019	Q4 2019

Revenue	4.7%	16.8%	27.4%
Adjusted EBITDA	7.0%	2.3%	21.8%
Adjusted EBITDA Margin	30.5%	27.7%	31.1%

In the last one year, Enghouse has acquired Vidyo and Dialogic, both of which support visual communications. It also purchased Espial that supports video services like IPTV. The timing of these acquisitions and the COVID-19 pandemic benefitted Enghouse.

The work from home culture increased demand for Vidyo's video conferencing products. Dialogic secured a significant order for software license

The incremental revenue from new orders and accretive revenue of the above acquisitions drove Enghouse revenue 58% year over year) to an all-time high of $141 million. This quarterly revenue will become the company's new normal unless a significant customer cancels its ongoing maintenance contract. Such revenue growth improved its adjusted EBITDA margin to 35%, the highest in over three years.

Enghouse's cash flows and balance sheet have reassured bulls of future growth

Enghouse collects the payments from licensing and maintenance contracts in advance and provides the services throughout the term of the contract. The new contact wins increased its operating cash flow by $37 million to $57.5 million in the second quarter of fiscal 2020.

The significant cash inflow increased its cash reserve to $168 million and equipped it with sufficient liquidity to undertake new acquisitions and invest in internal growth.

The company's recurring revenue brings visibility around its future cash flow, but it also faces the risk of cancellation of contracts. Some of its customers could be hurt by the pandemic and decide to delay or discontinue their maintenance contract.

However, the company reassured investors of its future cash flows by increasing its dividend per share by 23% at a time when many companies are slashing dividends.

Enghouse's stock rally could continue

Enghouse reported its most bullish quarterly earnings in over three years, and this earnings growth is likely to continue throughout fiscal 2020. Investors have priced in this growth.

The stock will continue to trade around $65 for some time, as all technical indicators are showing positive momentum. Its 50-day and 200-day moving averages have moved upward this year.

It is currently trading at 43 times its earnings per share — higher than the industry average of 34 times the earnings. The stock is a buy and hold for the long term as the incremental revenue from cross-selling, and accretive revenue from new acquisitions will continue to drive profits.

As the earnings variant in the price-to-earnings ratio grows, the stock's value will reduce. The market will correct the valuation by increasing the price variant.

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Date
2025/09/28
Date Created
2020/06/08
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