Converge Stock: A Severely Oversold Growth Bargain to Buy and Hold

Description

Converge Technology Solutions (TSX:CTS) is a young company that is just over six years old. Management has done a superb job in growing the business.

Acquisitions contribute to a big part of its growth. Converge has made 35 acquisitions in the last five years. As an IT services company that caters to the mid-market, it has been incredibly successful in its mergers and acquisitions strategy due to its cross-selling and integration capabilities.

Its products and services offerings include advanced analytics, application modernization, cloud solutions, cybersecurity, digital infrastructure, digital workplace, managed services, and IT talent recruitment.

From 2019 to 2021, Converge more than doubled its revenue and gross profits by 2.22 times and 2.14 times, respectively, while quadrupling its operating income by 4.33 times.

Here are its recent results. It reported so far for 2022, net revenue growth of 71% to $1.7 billion, adjusted EBITDA, a cash flow proxy, growth of 68% to $99.8 million, and adjusted earnings per share growth of 55%.

It sounds like a great company with a bright future, but why is the tech stock down so much?

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The small-cap stock fell almost 58% in 2022. The stock was close to fully valued at the start of 2022. The biggest reason it fell so much was because of the brutal capital tightening in 2022, during which the Bank of Canada raised the benchmark interest rate seven times. 2022 ended with a policy interest rate of 4.25%, up from 0.25% at the start of the year.

Higher interest rates don't affect Converge's balance sheet because it has no long-term debt. Unfortunately, a side effect of higher interest rates is the reduction of stock valuations. The company hasn't taken on debt to make acquisitions, but it has been using its common stock to raise capital for acquisitions. It's great to do so when the stock price is high. It's not so good to use this strategy to raise capital for acquisitions now that the stock has gone down so much.

What will it take for the stock to turn around?

A reversion to capital easing (that is, a decline in interest rates) would trigger a rally in stocks, particularly growth stocks like Converge. The company seems to think that this is not going to happen anytime soon, because in November, it began a strategic review process with the aim of maximizing shareholder value. This implies the company could be potentially looking for a buyer, although there's, of course, no guarantee that a transaction will take place.

The Foolish investor takeaway

It would be interesting to see the kind of growth that Converge could materialize without acquisitions. Buyers of the growth stock today who are patient could be handsomely rewarded. At $4.54 per share at writing, 14 analysts have a 12-month price target that suggests the stock is almost half off and could climb 93% in the near term.

I think both investors and management can exercise patience. The Bank of Canada might cut interest rates to counter a potential recession in 2023, which could drive a rally in the stock. If not, there's a better chance investors can materialize outsized gains over the next few years.

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Date
2025/08/12
Date Created
2023/01/10
Author
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