

EQUITY RESEARCH

August 10, 2022

Earnings Update

CONVERGE TECHNOLOGY SOLUTIONS CORP.

SMB Demand Robust Despite Macro Headwinds

Our Conclusion

Converge reported in-line Q2 results. The company continues to see supply chain disruptions in networking equipment, although expects the backlog could ease in Q3. While we regard the SMB customer base as a potential concern in a tougher macro environment, management noted a solid demand backdrop, with IT talent shortages driving demand among the SME client base. With M&A nearing management's annual target, we expect focus for the balance of the year to turn to integration and cross-selling. We retain our Neutral rating and increase our price target from \$7 to \$8.

Key Points

Backlog Impacted By Networking Delays: Supply chain issues – particularly for networking equipment – remain a drag, weighing on product and service delivery. CTS ended Q2 with a product backlog of \$507 million, up from \$472 million at the end of Q1. Encouragingly, \$375 million of the Q1 backlog was cleared in Q2, as the large majority of the Q2 backlog (\$410 million) was composed of new orders in the quarter. CTS also introduced a service backlog figure with results, with a backlog of \$71 million, up from \$45 million in Q1. Networking delays are also impacting the services backlog as onboarding is delayed until equipment is delivered. Lead times on networking orders remain unchanged, although management expressed optimism that the backlog could ease materially in Q4 as deliveries pick up, leading to stronger organic growth in the fourth quarter.

M&A Mostly Done For 2022; Focus On Cross-selling: CTS has acquired \$928 million in gross revenue YTD, approaching management's \$1B target. We expect the focus for the remainder of the year to be on integration, logo growth, and cross-selling. CTS has launched over 100 marketing campaigns across analytics, cloud, cyber, and managed services, targeted at the existing customer base and new customer opportunities. Cross-selling managed services is a priority, with managed services ARR finishing the quarter at \$115 million. Management had been targeting \$200 million in managed services ARR by year-end, a target we consider as challenging given M&A is largely finished for 2022. We also expect that the \$1B of acquired revenue planned for 2023 will be more evenly spread across the calendar year as CTS looks to show integration and cross-selling progress.

Capital Allocation And Increased Line Of Credit: Prior to the quarter Converge increased the size of its revolver from \$300 million to \$500 million (plus a \$100 million accordion) and received approval for an NCIB to buy back 5% of the outstanding float. We expect management to be active on the buyback as leverage would only increase to 0.5x run-rate adjusted EBITDA if the NCIB was fully exercised at an average share price of \$7. Management has noted that it is comfortable with leverage up to 2x.

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Neutral

CTS-TSX, Sector: Information Technology

Current Price (8/10/22): C\$6.99

Price Target (12-18 mos.): ↑ C\$8.00

Previous: C\$7.00

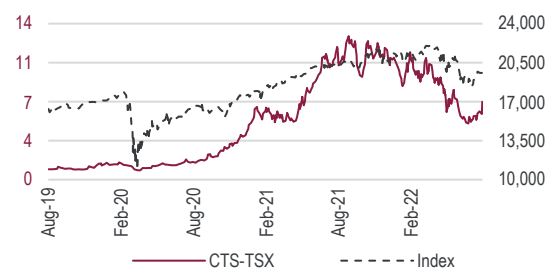
CIBC Estimates and Valuation

(Dec. 31)	2020	2021	2022	2023
Adj. EPS	0.25A	0.35A	0.51E	0.59E
Prior			0.48E	0.55E
Adj. EBITDA(mln)	60.5A	94.0A	149.2E	185.5E
Prior			144.8E	176.2E
Adj. EPS	Q1	Q2	Q3	Q4
2021	0.08A	0.08A	0.07A	0.12A
2022	0.10A	0.14A	0.13E	0.14E
Prior		0.11E		
Adj. EBITDA(mln)	Q1	Q2	Q3	Q4
2021	18.8A	21.7A	18.9A	34.7A
2022	29.6A	39.2A	39.0E	41.3E
Prior		34.7E	38.3E	42.1E
Valuation	2020	2021	2022	2023
P/E	28.3x	20.1x	13.6x	11.9x
EV/EBITDA	25.2x	16.2x	10.2x	8.2x
FCF Yield	NM	NM	NM	NM

Stock Performance and Key Indicators

Enterprise Value:	C\$1,525M	Shares O/S:	214.9M
Market Cap.:	C\$1,501M	Float:	197.9M
52-wk Range:	C\$5.04 - C\$12.85	Div. / Yield:	C\$0.00/0.00%

TSX Composite Index vs. CTS-TSX



(Source: FactSet)

All figures in Canadian dollars unless otherwise stated.

Please see "Price Target Calculation and Key Risks to Price Target" information on page 5.
For required regulatory disclosures please refer to "Important Disclosures" beginning on page 6.

Converge Technology Solutions Corp. (CTS-TSX) — Neutral

Price (8/10/22) C\$6.99 12-18 mo. Price Target C\$8.00

Sector: Information Technology

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Key Financial Metrics	2020	2021	2022E	2023E
Net Debt	74	(247)	(17)	101
Total Debt	139	1	242	442
Net Debt/EBITDA	1.2x	(2.6x)	(0.1x)	0.0x
Free Cash Flow	(15)	(191)	(204)	(109)
Sales Growth	37.9%	61.0%	57.2%	20.7%
Per Share Data	2020	2021	2022E	2023E
FCFPS	(0.15)	(1.01)	(0.94)	(0.50)
Adj. EPS Dil.	0.25	0.35	0.51	0.59
Wgt Avg # of Shares	103.0	185.8	214.9	215.3
FD Number of Shares	103.0	187.9	218.0	218.5
Income Statement	2020	2021	2022E	2023E
Revenue	949	1,528	2,402	2,898
Cost of Goods Sold	716	1,182	1,877	2,246
Gross Profit	233	346	525	652
Gross Margin %	24.56%	22.63%	21.84%	22.50%
Tot Operating Exp	178	255	378	467
Adj. EBITDA	60	94	149	185
Adj EBITDA Margin	6.4%	6.2%	6.2%	6.4%
D&A	21	36	66	69
Interest Expense	20	8	11	21
Pretax profit	(3)	24	49	91
Tax Expense	2	8	13	25
Adjusted Net Income	(4)	16	36	66
Adjusted Net Margin	(0.4%)	1.1%	1.5%	2.3%
Cash Flow Statement	2020	2021	2022E	2023E
Net CFO	52	87	50	114
Capex	(5)	(6)	(21)	(6)
Free Cash Flow	47	81	29	108
Balance Sheet	2020	2021	2022E	2023E
Cash & ST Investment	65	248	260	342
Goodwill	219	557	761	909
Total Assets	721	1,369	1,833	2,225
LT Int-Bearing Debt	6	0	50	250
Total Liabilities	619	720	1,147	1,473
Shareholders' Equity	102	649	687	752

Source: FactSet, Company Reports & CIBC World Markets Inc.

Company Profile

Converge has built out a network of regional IT Service Providers (ITSPs) that provide IT solutions into a sticky mid-market customer base.

Investment Thesis

1) Roll-up of under-capitalized ITSPs at attractive multiples with synergies; 2) Scale-driven operational and financial efficiencies; and, 3) Solid North American base with a successful entry into Europe.

Price Target (Base Case): C\$8.00

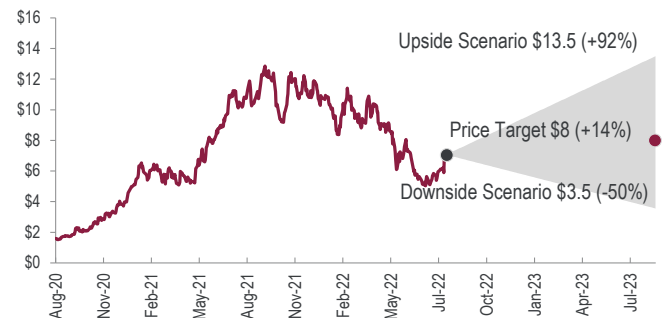
Our price target is calculated using 16% revenue growth, a 6.8% EBITDA margin, and a 9.0x EV/EBITDA multiple.

Upside Scenario: C\$13.50

Our upside scenario is calculated using 25% revenue growth, a 7.4% EBITDA margin and a 12.0x EV/EBITDA multiple.

Downside Scenario: C\$3.50

Our downside scenario is calculated using 10% revenue growth, a 6.0% EBITDA margin and a 4.0x EV/EBITDA multiple.



Financial Summary

Revenue By Segment: Converge reported net revenue of \$597 million, above consensus of \$583 million, driven by contribution from acquisitions. Product license revenue of \$492 million (consensus \$484 million; our estimate \$496 million) was up 75% Y/Y due to M&A, and service revenue of \$105 million (consensus \$89 million; our estimate \$92 million) was up 64% Y/Y due to acquisitions and cross-selling activity. Recurring revenue from managed services grew 100% Y/Y to \$115 million through the acquisitions of CBI as well as organic growth.

Gross Profit And EBITDA: Converge reported gross profit of \$133 million, in line with consensus and our estimate. Gross profit margin of 22.3% was 20 bps below consensus and 30 bps ahead of our estimate. Adjusted EBITDA of \$39.2 million was above consensus of \$38.4 million. EBITDA adjustment includes \$5.6 million in special charges and \$1.7 million in stock-based compensation expenses. Adjusted EBITDA margin as a percentage of net revenue was 6.6%, up 30 bps Y/Y, and adjusted EBITDA margin as a percentage of gross profit was 29.4%, up 160 bps Y/Y.

Cash Flow: Converge generated \$26.6 million in cash flow from operations in Q2 and free cash flow of \$21.1 million (up 14% Y/Y) after \$5.4 million in capex and lease payments. Converge's adjusted free cash flow metric (adjusted EBITDA less capex less lease payments) was \$33.8 million, up 83% Y/Y. CTS spent \$199 million on M&A in Q2/22, compared to \$96 million in H1/21. Converge ended the quarter with \$4MM in net debt.

Exhibit 1: CTS – Financial Summary, Q2/22 (\$MM, except per share)

	Q2/22			Q2/21	Y/Y %	Q1/22	Q/Q %
	Actual	CIBCe	Cons.				
Consolidated							
Net Revenue (\$MM)	597	588	583	345	72.8%	550	8.5%
Product License	492	496	484	281	74.8%	453	8.5%
Service	105	92	89	64	63.8%	97	8.5%
Gross Profit	133	129	131	78	70.2%	109	22.1%
Gross Margin	22.3%	22.0%	22.5%	22.7%	-1.5%	19.8%	12.6%
Adjusted EBITDA	39.2	34.7	38.4	21.7	80.4%	29.6	32.2%
EBITDA Margin (% Revenue)	6.6%	5.9%	6.6%	6.3%	4.4%	5.4%	21.8%
EBITDA Margin (% Gross Profit)	29.4%	26.8%	29.3%	27.8%	6.0%	27.2%	7.8%
Adjusted EPS	\$0.14	0.11	\$0.09	\$0.08	NA	\$0.10	NA

Source: Company reports, FactSet and CIBC World Markets Inc.

Exhibit 2: CTS – Changes To Our Model, 2021 - 2023E

	Net Revenues (\$MM)	Gross Profit (\$MM)	EBITDA (\$MM)	Adjusted EPS (\$)	CFO (\$MM)
2021	\$1,528	\$346	\$94	\$0.35	\$87
2022E					
CIBC Est. – New	\$2,402	\$525	\$149	\$0.51	\$50
CIBC Est. – Prior	\$2,395	\$521	\$145	\$0.48	\$44
Consensus	\$2,518	\$549	\$167	\$0.39	\$108
2023E					
CIBC Est. – New	\$2,898	\$652	\$186	\$0.59	\$114
CIBC Est. – Prior	\$2,754	\$620	\$176	\$0.55	\$117
Consensus	\$3,051	\$700	\$222	\$0.59	\$130

Source: Company reports, FactSet and CIBC World Markets Inc.

Environmental, Social and Governance (ESG) Metrics for CTS-TSX

CIBC ESG Metrics

Governance Metrics	2017	2018	2019	2020	2021
Insider Ownership	NA	NA	NA	NA	7.9%
Board Gender Diversity	NA	NA	NA	NA	33%
Separation of Chair & CEO	NA	NA	NA	NA	NO
Dual-class Ownership?	NA	NA	NA	NA	NO
Disclose ESG Data?	NA	NA	NA	NA	NO
Social Metrics	2017	2018	2019	2020	2021
CEO Comp./Mkt Cap*	NA	NA	NA	NA	\$0.9
Diversity Targets	NA	NA	NA	NA	NA
Women Managers	NA	NA	NA	NA	NA
Environmental Metrics	2017	2018	2019	2020	2021
Emissions Intensity**	NA	NA	NA	NA	NA
Net-zero Targets?	NA	NA	NA	NA	NA

*CEO Compensation is shown as per thousand dollars of market capitalization

**Emissions Intensity calculated as total emitted CO2e divided by million \$ of CAD revenue

Sustainalytics ESG Risk Rating

24.1

Medium Risk

Updated on
Mar 27, 2022

Momentum



Sustainalytics ESG Risk Rating Ranking

UNIVERSE	RANK (1 st = lowest risk)	PERCENTILE (1 st = lowest risk)
Global Universe	5766/14418	41st
Software & Services INDUSTRY	577/979	59th
IT Consulting SUBINDUSTRY	128/204	63rd

Sustainalytics Material ESG Issues

These are the Material ESG Issues driving the ESG Risk Report

Issue Name	ESG Risk Exposure Score Category	ESG Risk Management Score Category	ESG Risk Rating Score Category	Contribution to ESG Risk Rating
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CIBC Quantitative Scorecard

Within Sector			Within S&P/TSX Comp.		
Style	Rank	Delta	Style	Rank	Delta
Value	10	-1	Value	126	+118
Momentum	28	-9	Momentum	237	+207
Quality	16	0	Quality	91	+95
Market	24	0	Market	179	+181
Low Volatility	26	-3	Low Volatility	224	+218
Growth	8	0	Growth	48	+64

Note: Ranking out of 28 stocks

Note: Ranking out of 237 stocks

General Notes Behind the Quantitative Scorecard

Delta refers to the change in the ranking over the past month. Number of stocks "Within Sector" is defined by the number within the GICS. In the "Within S&P/TSX" category, we use all stocks in the S&P/TSX Composite. For detail on the Quant Factors included in each style above, please contact the CIBC Portfolio Strategy Team.

The table above is based upon quantitative, statistical, and mathematical analysis and is not intended to serve as a fundamental recommendation.

CIBC Technical Scorecard

Factor	TSM Score	Factor	TSM Score
TSM	-3	Momentum	D
Beta	1.74	MACD	C
Volatility	↔	Alpha (Sector)	C
Trend	↔	Alpha (Index)	D
RSI	Neutral		

General Notes Behind the Technical Scorecard

TSM: The Trendspotting Matrix uses technical factors to score uptrend durability.

Momentum and alpha metrics compare performance over one-month, one-quarter and one-year timeframes, outputting a rating from A to D.

Trend/Volatility metrics measure price deviations relative to underlying moving averages.

RSI is an oscillator that provides mean-reversion estimations.

MACD is a momentum indicator rated from A to D based off the strength of its signal.

The table above is based upon a technical methodology that examines the past trading patterns and trades and is not intended to serve as a fundamental recommendation.

Price Target Calculation

We derive our price target of \$8.00 by applying a 9x EV/EBITDA multiple to our 2023 EBITDA estimate based on the current capital structure. The 9x multiple is in line with hardware VAR peers.

Key Risks To Price Target

The primary risks to our price target include the following: 1) the company's ability to acquire ITSPs at a reasonable valuation; 2) increasing competition from other IT Solutions providers; 3) volatility in the global IT environment; 4) the company's ability to partner with leading technology providers; and, 5) the loss of key management or other employees.

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Neutral	NT	Stock is expected to perform in line with similar stocks in the coverage universe during the next 12-18 months.
Underperformer	UN	Stock is expected to underperform similar stocks in the coverage universe during the next 12-18 months.
Tender	TR	Shareholders are advised to tender shares to a specific offer as we do not believe a superior offer will materialize.
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Overweight	O	Sector is expected to outperform the broader market averages.
Marketweight	M	Sector is expected to equal the performance of the broader market averages.
Underweight	U	Sector is expected to underperform the broader market averages.
None	NA	Sector rating is not applicable.

Note: Broader market averages refer to S&P 500 in the U.S. and S&P/TSX Composite in Canada.

CIBC World Markets Inc. Price Chart

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Neutral	132	42%	Neutral	132	100%
Underperformer	8	3%	Underperformer	8	100%
Tender	4	1%	Tender	3	75%
Restricted	7	2%	Restricted	7	100%

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