

# EQUITY RESEARCH

August 9, 2023

Earnings Update

## CONVERGE TECHNOLOGY SOLUTIONS CORP.

The Integration Continues

### Our Conclusion

After completing 12 acquisitions in 2022, Converge is focused on the integration of recent M&A and cross-selling higher-margin offerings into the acquired customer base. We see upsell as a longer-term opportunity and expect near-term organic growth (1.8% in Q2) to remain depressed as hardware refresh cycles remain elongated. The weaker hardware demand has been translating into weaker working capital as payment cycles lengthen, especially in Europe. We retain our Neutral rating and \$3.00 price target. We see upside if Converge is able to execute on its organic growth and integration activities more quickly than anticipated.

### Key Points

**A Focus On M&A Integration:** Converge continues to focus on M&A integration, noting that the sales front office integration is largely completed in North America and back office integration is ongoing. Within Europe, neither integration has been completed and the companies continue to operate on a stand-alone basis. We expect adj. EBITDA margins to remain roughly flat Y/Y in F23, with \$15MM in cost savings from recent restructurings offsetting merit increases and several of the larger 2022 acquisitions' (TIG, European acquisitions) low-margin hardware businesses that will take time to transition to higher-margin services/software work.

### Organic Environment Remains Tough, But Pockets Of Growth:

Converge's hardware business remains depressed given the overall macro-environment and overbuying during the pandemic. Management noted public sector demand in Canada and Germany as particularly weak. This is being partially offset by AI demand (high compute clusters), with organic Product revenue down 4.4% in Q2. Services organic growth remained solid at 14.6% as customers look for improved efficiencies in the current environment.

**Working Capital Usage Increases:** Operating cash flow was negative \$9.6MM in Q2, driven by working capital usage of \$44.9MM. Management noted slower payment cycles, particularly in Europe and cautioned against looking at last year's cash flow as a guide given the number of acquisitions completed. Working capital usage has increased since the company's European deals, with positive working capital in F21 (\$7.6MM) versus negative working capital in F22 (\$77.2MM) and YTD (\$53MM). Management is implementing a number of changes and expects positive cash flow for the full year (CFO was \$87MM in F21 and \$41.6MM in F22).

**Buybacks Remain The Preferred Use of Capital:** Converge did not complete any M&A in the quarter and continues to view share buybacks as its best use of excess capital. The company executed on \$14.2MM in share buybacks in Q2 and renewed its NCIB with the quarter, allowing the repurchase of up to 10% of its public float. The company has ~\$250MM in available liquidity and leverage as per its credit agreement of 2.8x.

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.

Stephanie Price, CFA  
Analyst  
+1 416-594-7047  
Stephanie.Price@cibc.com

Scott Fletcher, CPA, CA  
Analyst  
+1 416-956-3229  
Scott.Fletcher@cibc.com

Sam Schmidt, CPA  
Associate  
+1 416-980-5448  
sam.schmidt@cibc.com

Neutral

CTS-TSX, Sector: Information Technology

Current Price (8/9/23): C\$2.90

Price Target (12-18 mos.): C\$3.00

### CIBC Estimates and Valuation

(Dec. 31)	2021	2022	2023	2024
Adj. EPS	0.35A	0.50A	0.52E	0.57E
Prior			0.51E	0.50E
Adj. EBITDA(mln)	94.0A	142.9A	169.1E	187.5E
Prior				182.4E

Adj. EPS	Q1	Q2	Q3	Q4
2022	0.10A	0.14A	0.10A	0.15A
2023	0.12A	0.12A	0.13E	0.16E
Prior		0.13E		0.13E

Adj. EBITDA(mln)	Q1	Q2	Q3	Q4
2022	29.6A	39.2A	31.0A	43.1A
2023	41.2A	41.5A	38.6E	47.8E
Prior		41.0E	42.3E	44.6E

Valuation	2021	2022	2023	2024
P/E	8.3x	5.8x	5.6x	5.1x
EV/EBITDA	10.0x	6.6x	5.6x	5.0x
FCF Yield	NM	NM	0.8%	15.2%

### Stock Performance and Key Indicators

Enterprise Value	C\$940M	Shares O/S:	209.0M
Market Cap.:	C\$605M	Float:	199.1M
52-wk Range:	C\$2.71 - C\$7.41	Div. / Yield:	C\$0.04/1.38%

### TSX Composite Index vs. CTS-TSX



(Source: FactSet)

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

Price (8/9/23) C\$2.90 12-18 mo. Price Target C\$3.00

Sector: Information Technology

Stephanie Price, CFA +1 416-594-7047 Stephanie.Price@cibc.com

Key Financial Metrics	2021	2022	2023E	2024E
Net Debt	(247)	262	338	275
Total Debt	1	422	530	730
Net Debt/EBITDA	(2.6x)	1.8x	2.0x	1.5x
Free Cash Flow	81	18	44	92
Sales Growth	61.0%	41.7%	20.2%	0.9%
Per Share Data	2021	2022	2023E	2024E
FCFPS	(1.01)	(1.95)	0.02	0.44
Adj. EPS Dil.	0.35	0.50	0.52	0.57
Wgt Avg # of Shares	185.8	213.1	208.6	208.8
FD Number of Shares	187.9	215.8	209.2	208.8
Income Statement	2021	2022	2023E	2024E
<b>Revenue</b>	<b>1,528</b>	<b>2,165</b>	<b>2,603</b>	<b>2,626</b>
Cost of Goods Sold	1,182	1,614	1,923	1,969
<b>Gross Profit</b>	<b>346</b>	<b>551</b>	<b>680</b>	<b>656</b>
Gross Margin %	22.63%	25.44%	26.13%	25.00%
Tot Operating Exp	255	414	515	469
<b>Adj. EBITDA</b>	<b>94</b>	<b>143</b>	<b>169</b>	<b>188</b>
Adj EBITDA Margin	6.2%	6.6%	6.5%	7.1%
D&A	36	75	107	108
Interest Expense	8	20	32	37
<b>Pretax profit</b>	<b>24</b>	<b>19</b>	<b>9</b>	<b>38</b>
Tax Expense	8	(4)	3	11
<b>Adjusted Net Income</b>	<b>16</b>	<b>23</b>	<b>5</b>	<b>28</b>
Adjusted Net Margin	1.1%	1.1%	0.2%	1.1%
Cash Flow Statement	2021	2022	2023E	2024E
<b>Net CFO</b>	<b>87</b>	<b>42</b>	<b>61</b>	<b>98</b>
Capex	(6)	(24)	(16)	(6)
<b>Free Cash Flow</b>	<b>81</b>	<b>18</b>	<b>44</b>	<b>92</b>
Balance Sheet	2021	2022	2023E	2024E
Cash & ST Investment	248	160	193	456
Goodwill	557	1,028	927	819
<b>Total Assets</b>	<b>1,369</b>	<b>2,249</b>	<b>2,116</b>	<b>2,321</b>
LT Int-Bearing Debt	0	0	530	730
<b>Total Liabilities</b>	<b>720</b>	<b>1,618</b>	<b>1,492</b>	<b>1,677</b>
<b>Shareholders' Equity</b>	<b>649</b>	<b>631</b>	<b>624</b>	<b>643</b>

Source: FactSet, Company Reports &amp; 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 undercapitalized ITSPs at attractive multiples with synergies 2) Scale drive operational and financial efficiencies 3) Solid North American base with a successful entry into Europe.

**Price Target (Base Case): C\$3.00**

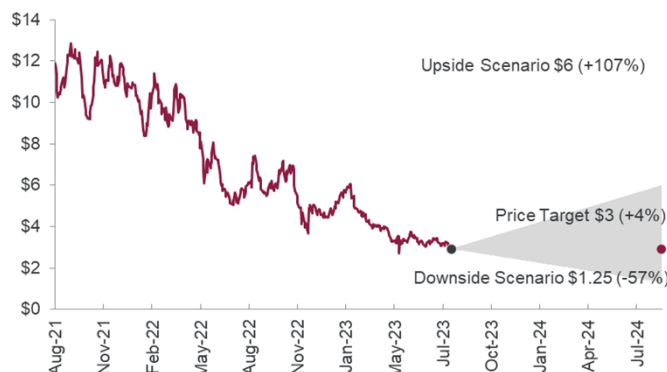
Our Price Target is calculated using 1% revenue growth, 7.1% EBITDA margin, and a 5.0x EV/EBITDA multiple.

**Upside Scenario: C\$6.00**

Our upside scenario is calculated using 5% revenue growth, 7.4% EBITDA margin and a 8.5x EV/EBITDA multiple.

**Downside Scenario: C\$1.25**

Our downside scenario is calculated using 5% revenue decline, 6.0% EBITDA margin and a 4.0x EV/EBITDA multiple.

**Scenario Analysis:**

## Financial Summary

**Q2 Results:** Net revenue of \$666MM beat consensus of \$641MM and our estimate of \$594MM, with gross profit of \$176MM also above the Street at \$168MM and CIBCe at \$149MM. Adjusted EBITDA of \$41.5MM was in line with both the Street and CIBCe (\$41.1MM/ 41.0MM). Backlog increased to \$448MM in Q2/23, down \$79MM sequentially.

**Cash Flow:** Converge had -\$9.6MM in cash flow from operations in the quarter, against \$26.6MM a year ago. The negative CFO was driven by -\$45MM of non-cash working capital changes vs. \$7MM a year ago. Cash on hand was \$78MM at the end of Q2/23, and borrowings under the company's global revolving credit facility were ~\$430MM.

### Exhibit 1: CTS – Financial Summary, Q2/22 – Q2/23

	Q2-F2023			Q2-F2022	Y/Y%	Q1-F2023	Q/Q%
	Actual	CIBCe	Cons.				
Consolidated							
Net Revenue (\$MM)	666	594	641	515	29.2%	678	-1.8%
Gross Profit	176	149	168	133	31.9%	172	2.4%
Gross Margin	26.4%	25.0%	26.2%	25.8%	2.1%	25.3%	4.3%
Adjusted EBITDA	41.5	41.0	41.1	39.2	6.0%	41.2	0.8%
EBITDA Margin (% Revenue)	6.2%	6.9%	6.4%	7.6%	-18.0%	6.1%	2.6%
EBITDA Margin (% Gross Profit)	23.6%	27.6%	24.5%	29.4%	-19.7%	24.0%	-1.6%
Adjusted EPS	\$0.12	\$0.13	\$0.12	\$0.14	-13.8%	\$0.12	2.6%

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

**Changes To Our Model:** We have updated our model to capture the Q2 results, with a flow-through to FY24 estimates. Our EBITDA estimates remain little changed.

### Exhibit 2: CTS – Changes To Our Model, 2022 – F2024E

	Net Revenue (\$MM)	Gross Profit (\$MM)	Adj. EBITDA (\$MM)	Adj. EPS	CFO (\$MM)
<b>2022A</b>	2,165	551	143	\$0.50	42
<b>2023E</b>					
CIBC est. – new	2,603	680	169	\$0.52	61
CIBC est. – prior	2,531	635	169	\$0.51	59
Consensus	2,614	680	175	\$0.49	111
<b>2024E</b>					
CIBC est. – new	2,626	656	188	\$0.57	98
CIBC est. – prior	2,552	638	182	\$0.50	86
Consensus	2,765	726	199	\$0.55	140

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

28.3 +4.2 Medium Risk

Updated on  
Jul 9, 2023

Momentum



## Sustainalytics ESG Risk Rating Ranking

UNIVERSE	RANK	PERCENTILE
	(1 <sup>st</sup> = lowest risk)	(1 <sup>st</sup> = lowest risk)
Global Universe	6651/15361	44th
Software & Services INDUSTRY	660/1063	62nd
IT Consulting SUBINDUSTRY	158/236	67th

## Sustainalytics Material ESG Issues

These are the Material ESG Issues driving the ESG Risk Report

Issue Name	ESG Risk Exposure	ESG Risk Management	ESG Risk Rating	Contribution to ESG Risk Rating
	Score   Category	Score   Category	Score   Category	

## CIBC Quantitative Scorecard

Within Sector			Within S&P/TSX Comp.		
Style	Rank	Delta	Style	Rank	Delta
Value	1	+3	Value	59	+48
Momentum	12	-2	Momentum	230	-11
Quality	6	+1	Quality	55	+57
Market	10	0	Market	188	0
Low Volatility	10	0	Low Volatility	219	+4
Growth	3	+4	Growth	38	+85

Note: Ranking out of 12 stocks

Note: Ranking out of 231 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	-4	Momentum	D
Beta	1.57	MACD	D
Volatility	↓	Alpha (Sector)	D
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 \$3.00 by applying a 5.0x EV/EBITDA multiple to our 2024E EBITDA estimate based on the current capital structure. The 5.0x multiple is in line with company's hardware VAR acquisitions

## Key Risks To Price Target

The primary risks to our price target include the following: 1) the company's ability to acquire ITSPs at 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; 5) the loss of key management or other employees.

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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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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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Tender	1	0%	Tender	1	100%
Restricted	4	1%	Restricted	4	100%

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