

EQUITY RESEARCH

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Flash Research

CONVERGE TECHNOLOGY SOLUTIONS CORP.

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Pre-releases Q4 Results That Are Below Consensus

Conclusion: Converge pre-released Q4 results that were below consensus. The midpoint of net revenue was 3% below consensus and the midpoint of adj. EBITDA 18% below. Adj. EBITDA margin (as a percentage of gross profit) was 25.2% at the midpoint, 340 bps below the Street. Backlog was up \$52MM sequentially to \$556MM, with company noting continued supply-chain challenges, specifically around networking gear. The press release did not mention the ongoing strategic review process. We will be looking for commentary around progress of acquisition integration, strategic review process, and additional details on lengthening sales cycle when the company releases full results on March 15, followed by a conference call on March 16.

Key Highlights

Q4 Results: The midpoint of net revenue (\$771MM) missed consensus, but came in above CIBCe (\$791.5MM/\$720.5MM), while midpoint gross profit of \$169MM came in below Street, but slightly above CIBCe (\$182MM/\$162MM). Adjusted EBITDA of \$42.5MM was 18% below Street and slightly above CIBC estimates (\$51.9MM/\$38.9MM). Backlog was up \$52MM sequentially to \$556MM, with management noting continued supply chain headwinds.

Revenue: Net revenue of \$771MM was 3% below consensus (\$792MM), driven primarily by supply chain challenges leading to networking gear delays in particular. The company also noted the sales cycle lengthening, with three of its largest year-end deals pushed into the first half of 2023. These two factors represent expected future revenue of more than \$90MM.

Profitability: Gross margin of 21.9% at the midpoint was 100 bps below consensus and down 100 bps Y/Y. Adj. EBITDA margins (percent of revenue) were 110 bps below the Street (down 140 bps Y/Y) and adj. EBITDA margins (percent of gross profit) were 340 bps below the Street. Converge noted a +\$10MM adj. EBITDA impact from revenue factors noted above and a slower-than-expected acquisition integration. Converge noted that it executed on delayed SG&A reductions in North America in Q4/22 and early 2023, which the company expects to drive over \$15MM in annual cost savings. We expect integration challenges could persist into Q1/23 as the company integrates \$1B of acquired gross revenue on its operating model. The company noted that ~\$8MM was invested in 2022 to build out a dedicated team to accelerate the integrations of its 19 acquisitions.

Cash Flow: Converge had \$28MM in cash flow from operations in the quarter. Cash on hand was \$159.8MM at the end of 2022, and borrowings under the company's global revolving credit facility were ~\$420MM. Despite its focus on organic growth and integration in H1, CTS recently signed a definitive agreement to acquire the remaining 25% stake in Rednet. This transaction is expected to be completed before the end of Q1/23.

Neutral

CTS-TSX, Sector: Information Technology
Current Price (2/14/23): C\$5.47
Price Target (12-18 mos.): C\$5.25

All figures in Canadian dollars unless otherwise stated.

Please see "Price Target Calculation and Key Risks to Price Target" information on page 2. For required regulatory disclosures please refer to "Important Disclosures" beginning on page 3.

Exhibit 1: CTS – Q4/22 Financial Summary

	FQ4/22		
	Actual	Consensus	CIBCe
Consolidated			
Net Revenue (\$MM)	\$765.3MM to \$777.6MM	792	720
Gross Profit	\$166.2MM to \$171.2MM	182	162
Gross Margin	21.3%-22.4%	22.9%	22.5%
Adjusted EBITDA	\$40.8MM to \$44.2MM	52	38.9
EBITDA Margin (% Revenue)	5.2%-5.8%	6.6%	5.4%
EBITDA Margin (% Gross Profit)	23.8%-26.6%	28.7%	24%

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

Price Target Calculation

We derive our price target of \$5.25 by applying a 6.5x EV/EBITDA multiple to our 2024E EBITDA estimate based on the current capital structure. The 6.5x 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 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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CIBC World Markets Inc. Price Chart

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