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CIBC CAPITAL MARKETS

EQUITY RESEARCH

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January 18, 2022 **Industry Update**

High Tech & Rising Rates

A Look At The Impact Of Rising Rates On Our Coverage

Sector:
Information Technology

Our Conclusion

With North American economies experiencing sustained elevated levels of inflation, the timing of central bank rate hikes has quickly moved to the top of the list of key equity market variables in 2022. Technology markets have been hit hard in recent weeks as it apparently has become clear that rate hikes are coming faster and more frequently than previously expected. As tech equities have sold off, we have been left wondering how much of the drawdown is warranted, strictly as a fallout from rising rates. To get a sense of the impact of rising rates on valuation, we looked at the impact of a 50 bps increase in the WACC used in our DCF-based price targets.

The exercise showed that the share price changes in our coverage since the TSX peaked on November 19 have, on average, exceeded the impact that a 50 bps increase in WACC would have on our price target calculations. This discrepancy is magnified in names trading at premium multiples, where declines in SaaS stocks have more than doubled the potential impact on our DCF valuations. We generally view this discrepancy as an opportunity for investors to add to positions, and see KXS and DCBO as attractive at these levels.

Conversely, mature software names whose outlooks are less tied to outsized growth have seen less of an impact from rising rates. We believe both GIB.A and LWRK are attractive defensive options as a shift away from higher-growth names continues.

Key Points

The limits of this exercise are clear, as equity prices reflect a number of variables in addition to discount rates. Additionally, the relationship between a rising rate environment and falling tech returns is hardly set in stone. Over the last 20 years, the correlation between 10-year treasury note yields and the S&P software index has not been uniformly negative: from 2016 to 2018, while 10-year yields more than doubled, technology stocks also saw gains of ~60%.

The recent pullback in technology names is more than likely a combination of related issues including rate concerns, profit-taking after a period of outsized gains, and a shift in sentiment from growth names to traditional value stocks, to list only a handful.

Keeping that in mind, we still see interesting takeaways from our look at rising discount rates. Some of our more mature software and services names have been less impacted by the recent selloff, as business models with solid margins, strong free cash flow, M&A potential and a limited reliance on outsized growth look attractive in the current environment. These names could potentially remain safer havens throughout 2022, as the impact and speculation around rising rates continue over the course of the year.

All figures in Canadian dollars unless otherwise stated.

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A Look At The Impact Of Rising Rates

The impact of a 50 bps increase to the WACC resulted in an average decline of 8.2% to our current DCF-based price targets. The 8.2% decline is 670 bps below the actual 15.0% average price decline in our coverage since November 19. This average is being skewed by price declines of greater than 15% in the SaaS Group (DCBO, DSGX, KXS), all of which trade at premium multiples.

A number of our business services and mature software names have performed better than or more in line with the implied impact of a 50 bps rise in rates, and names like GIB.A, LWRK may be attractive defensive options as a shift away from higher-growth names continues.

Exhibit 1: CIBC Software/Services Coverage - Impact Of Change To WACC, 11/19/21 - 1/18/22

Company	Price Decline (%) - Nov 19, 2021 Vs. Jan 18, 2022	Implied Change In PT With 50 bps Change In WACC	Delta (Actual Price Decline - Implied TP Decline)
Software & Systems			
Constellation (US$)	(6.0%)	(8.4%)	2.5%
Descartes (US$)	(22.9%)	(10.8%)	(12.1%)
Docebo, Inc. (US$)	(31.8%)	(7.9%)	(23.9%)
Dye & Durham Limited (CAD)	(4.3%)	(10.5%)	6.1%
Enghouse (CAD)	(18.0%)	(7.0%)	(11.1%)
Kinaxis (US$)	(32.3%)	(7.9%)	(24.4%)
Open Text Corporation(US$)	(9.7%)	(7.4%)	(2.2%)
Business Services			
Altus Group Limited (CAD)	(1.0%)	(9.4%)	8.4%
CGI Group Inc. (CAD)	(0.8%)	(7.1%)	6.4%
Converge Technology (CAD)	(24.4%)	(6.3%)	(18.1%)
Information Services Corp. (CAD)	(6.9%)	(6.5%)	(0.5%)
LifeWorks Inc. (CAD)	(3.4%)	(8.1%)	4.7%
Softchoice Corporation (US$)	(16.8%)	(8.9%)	(7.9%)
TIXT (US$)	(18.4%)	(9.0%)	(9.4%)
Average	(15.0%)	(8.2%)	(6.7%)

Source: FactSet and CIBC World Markets Inc.

We also suggest evaluating current valuation multiples against longer-term historical averages that include periods of higher inter rates. Consider Kinaxis, down 30% since November 19, is currently trading at 10.4x forward sales, a modest 7% premium to its five-year average of 9.7x. Over that same five-year period, interest rates and expectations around rates have exceeded current levels, lending some support to the idea that the selloff may be excessive.

Exhibit 2: CIBC Software/Services Coverage – Valuation Vs. Two- And Five-year Averages – January 17, 2022

Company	EV/Sales	2-Year Average	Δ	5-Year Average	Δ
Altus	4.24x	3.60x	0.64x	2.85x	1.39x
Constellation	6.09x	5.53x	0.56x	4.88x	1.22x
Docebo	10.24x	NA	NA	NA	NA
Descartes	13.18x	12.05x	1.12x	9.62x	3.56x
Dye & Durham	5.23x	NA	NA	NA	NA
Enghouse	4.28x	5.53x	-1.26x	4.79x	-0.51x
CGI Inc.	2.25x	2.29x	-0.05x	2.18x	0.06x
Information Services	2.85x	2.67x	0.19x	2.66x	0.19x
Kinaxis	10.36x	12.16x	-1.80x	9.66x	0.70x
LifeWorks	2.19x	2.59x	-0.39x	2.45x	-0.26x
Open Text	4.17x	4.44x	-0.27x	4.16x	0.02x
TELUS International	3.56x	NA	NA	NA	NA
Average	**5.72x**	**5.65x**	**0.07x**	**4.80x**	**0.92x**
Median	**4.26x**	**4.44x**	**-0.19x**	**4.16x**	**0.10x**

Source: FactSet and CIBC World Markets Inc.

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