

# EQUITY RESEARCH

March 23, 2022

Earnings Update

## CONVERGE TECHNOLOGY SOLUTIONS CORP.

Executing To The Plan

### Our Conclusion

Converge reported Q4 results that were at the top end of its pre-announced range. The company is continuing to execute to its plans, with management noting a pipeline of seven M&A deals that are expected to close in H1/22. Converge is seeing strong demand for managed services offerings, although supply chain issues are expected to persist in the first half of 2022. We are factoring in \$300 million in M&A spending in 2022 and foresee upside if Converge can execute on additional acquisitions. We retain our Neutral rating and \$11 price target.

### Key Points

**Q4 Final Results:** Converge reported net revenue of \$505 million and gross profit of \$116 million, both at the top of the pre-announced ranges (\$497.5 million-\$504.5 million/\$114 million-\$116 million, respectively). Gross profit margin of 23% was in line with the pre-announced mid-point and adjusted EBITDA margins of 6.9% were 20 bps above the mid-point, but down from 8.1% in Q4/20 given acquisition integration efforts.

**Acquisition Pipeline Solid:** Converge remains confident in its target of acquiring \$1 billion in revenue in 2022. Year to date, we estimate that Converge has acquired ~\$250 million in revenue, primarily through the acquisition of PDS. Management notes a strong M&A pipeline of seven near-term prospects (three in North America/four in Europe). We expect that the European expansion will focus on Converge's traditional hardware VAR targets as the company looks to build out its customer footprint. Higher-value managed services acquisitions are more likely in North America as Converge looks to hit its target of \$200 million in managed services ARR by the end of 2022.

**Supply Chain Disruptions Expected To Persist In H1:** Converge continues to contend with supply chain disruptions, with backlog increasing \$100 million sequentially to \$350 million in Q4. The delays are primarily on the networking equipment side, with orders delayed by roughly six months. This implies that orders in Q1 will be filled in Q3, suggesting that the disruptions could begin to be resolved in the second half of the year. That being said, management was somewhat cautious on the resolution, noting that there could be disruptions from COVID-19-related lockdowns in China.

**Organic Gross Revenue Growth Of 10% In 2021:** Converge noted organic growth in 2021 of roughly 9.6%. The company calculates organic growth based on invoiced (gross) revenue and includes companies that Converge has owned for at least three months. We see the addition of this metric as a positive data point. However, given the netting down of certain revenue lines, we look forward to future disclosures around organic gross profit growth.

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**Neutral**

CTS-TSX, Sector: Information Technology

Current Price (3/23/22): C\$10.66

Price Target (12-18 mos.): **C\$11.00**

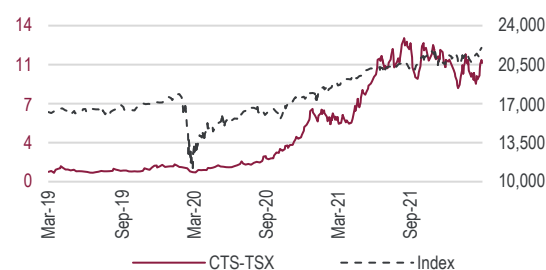
### CIBC Estimates and Valuation

(Dec. 31)	2020	2021	2022	2023
Adj. EPS	0.25A	0.35A	0.38E	0.43E
Prior	(0.05)A	0.12E	0.40E	0.45E
Adj. EBITDA(mln)	60.5A	94.0A	148.9E	173.3E
Prior	59.4A	88.2E	150.7E	174.8E
Adj. EPS	Q1	Q2	Q3	Q4
2021	0.08A	0.08A	0.07A	0.12A
Prior	0.02A	0.01A	0.02A	0.07E
2022	0.08E	0.09E	0.09E	0.11E
Prior	0.10E	0.10E		0.10E
Adj. EBITDA(mln)	Q1	Q2	Q3	Q4
2021	18.8A	21.7A	18.9A	34.7A
Prior				28.8E
2022	32.8E	36.2E	37.3E	42.6E
Prior	37.3E	38.0E	35.7E	39.7E
Valuation	2020	2021	2022	2023
P/E	43.2x	30.6x	28.2x	24.7x
EV/EBITDA	30.9x	19.9x	12.6x	10.8x
FCF Yield	NM	NM	NM	NM

### Stock Performance and Key Indicators

Enterprise Value:	C\$1,870M	Shares O/S:	197.0M
Market Cap.:	C\$2,100M	Float:	198.1M
52-wk Range:	C\$5.09 - 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 4. For required regulatory disclosures please refer to "Important Disclosures" beginning on page 5.

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

Price (3/23/22) C\$10.66 12-18 mo. Price Target C\$11.00

Sector: Information Technology

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Key Financial Metrics	2020	2021	2022E	2023E
Net Debt	74	(247)	15	204
Total Debt	139	1	51	251
Net Debt/EBITDA	1.2x	(2.6x)	0.1x	0.0x
Free Cash Flow	(15)	(191)	(262)	(189)
Sales Growth	37.9%	61.0%	43.7%	16.4%
Per Share Data	2020	2021	2022E	2023E
FCFPS	(0.15)	(1.01)	(1.35)	(0.97)
Adj. EPS Dil.	0.25	0.35	0.38	0.43
Wgt Avg # of Shares	103.0	185.8	191.7	192.1
FD Number of Shares	103.0	187.9	194.3	194.7
Income Statement	2020	2021	2022E	2023E
Revenue	949	1,528	2,196	2,555
Cost of Goods Sold	716	1,182	1,669	1,942
Gross Profit	233	346	527	613
Gross Margin %	24.56%	22.63%	24.00%	24.00%
Tot Operating Exp	178	255	378	440
Adj. EBITDA	60	94	149	173
Adj EBITDA Margin	6.4%	6.2%	6.8%	6.8%
D&A	21	36	48	48
Interest Expense	20	8	(1)	9
Pretax profit	(3)	24	102	117
Tax Expense	2	8	29	33
Adjusted Net Income	(4)	16	73	84
Adjusted Net Margin	(0.4%)	1.1%	3.3%	3.3%
Cash Flow Statement	2020	2021	2022E	2023E
Net CFO	52	87	44	117
Capex	(5)	(6)	(6)	(6)
Free Cash Flow	47	81	38	111
Balance Sheet	2020	2021	2022E	2023E
Cash & ST Investment	65	248	36	47
Goodwill	219	557	809	1,061
Total Assets	721	1,369	1,574	1,957
LT Int-Bearing Debt	6	0	50	250
Total Liabilities	619	720	852	1,151
Shareholders' Equity	102	649	722	806

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 drives operational and financial efficiencies; and, 3) Solid North American base with a successful entry into Europe.

### Price Target (Base Case): C\$11.00

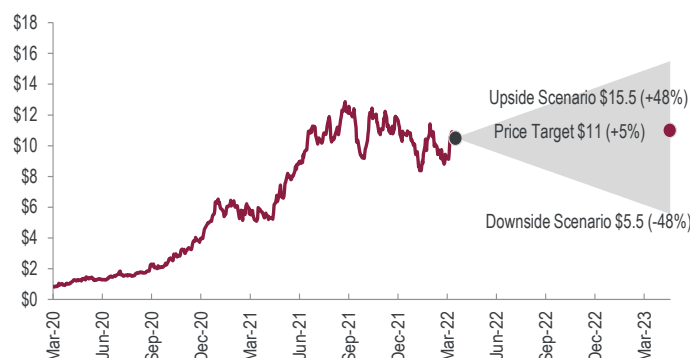
Our price target is calculated using 16% revenue growth, a 6.8% EBITDA margin, and an 11.0x EV/EBITDA multiple.

### Upside Scenario: C\$15.50

Our upside scenario is calculated using 25% revenue growth, a 7.4% EBITDA margin and a 14.0x EV/EBITDA multiple.

### Downside Scenario: C\$5.50

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



## Financial Summary

**Revenue By Segment:** Converge reported net revenue of \$505 million, at the top end of the pre-announced range of \$497.5 million-\$504.5 million. Product license revenue of \$413 million (consensus \$395 million; our estimate \$408 million) was up 71% Y/Y on acquisitions, and cloud revenue of \$92 million (consensus \$68 million; our estimate \$80 million) was up 90% Y/Y due to growth in managed services. Recurring revenue from managed services grew 56% Y/Y to \$22 million through the acquisitions of ExactlyIT and Rednet as well as organic growth.

**Gross Profit And EBITDA:** Converge reported gross profit of \$116 million, compared to the pre-announced range of \$114 million-\$116 million. Gross profit margin of 23% is in line with the implied gross margin at pre-announcement. Adjusted EBITDA of \$34.7 million was also at the high end of the pre-announced range of \$32.1 million-\$34.8 million, inclusive of \$2.6 million in special charges and \$1.1 million in stock-based compensation expenses. Adjusted EBITDA margin of 6.9% is down 120 bps Y/Y, driven by the acquisitions of primarily lower-margin hardware resellers.

**Cash Flow:** Converge generated \$17.9 million in cash flow from operations in Q4, with a cash conversion of 52% from adjusted EBITDA. For the full year, Converge generated \$87 million in cash flow from operations, for a cash conversion of 93%. CTS deployed \$261 million towards acquisitions (net of cash) in 2021, compared to \$44 million in 2020.

### Exhibit 1: Converge Technology – Financial Summary, Q4/21

	Q4/21			Q4/20	Y/Y%	Q3/21	Q/Q%
	Mid-point	CIBCe	Cons.				
Consolidated							
Revenue (\$MM)	505	488	489	290	74.4%	367	37.5%
Product License	413	408	395	241	71.3%	290	42.6%
Cloud	92	80	68	48	90.0%	78	18.4%
Gross Profit (\$MM)	116	117	113	71	63.4%	84	38.4%
Gross Margin	23.0%	24.0%	23.1%	24.5%	-6.3%	22.8%	0.6%
Adjusted EBITDA (\$MM)	34.7	29	32	23.4	48.4%	18.9	84.0%
EBITDA Margin	6.9%	5.9%	6.5%	8.1%	-14.9%	5.1%	33.8%
Adjusted EPS (\$)	\$0.12	\$0.07	\$0.06	\$0.01	NA	\$0.02	NA

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

**Changes To Our Model:** Our full-year estimates are roughly unchanged, although we have adjusted the seasonality somewhat to reflect a slower Q1 given continuing supply chain delays.

### Exhibit 2: Converge Technology – Changes To Our Model, 2021 - 2023E

	Net Revenues (\$MM)	Gross Profit (\$MM)	EBITDA (\$MM)	Adjusted EPS	CFO (\$MM)
<b>2021</b>	\$1,528	\$346	\$94	\$0.35	\$87
<b>2022E</b>					
CIBC est. – new	\$2,196	\$527	\$149	\$0.38	\$44
CIBC est. – prior	\$2,227	\$534	\$151	\$0.40	\$91
Consensus	\$2,288	\$553	\$172	\$0.42	\$129
<b>2023E</b>					
CIBC est. – new	\$2,555	\$613	\$173	\$0.43	\$117
CIBC est. – prior	\$2,582	\$620	\$175	\$0.45	\$116
Consensus	\$2,613	\$655	\$219	\$0.54	\$162

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

## Price Target Calculation

We derive our price target of \$11.00 by applying an 11x EV/EBITDA multiple to our 2023 EBITDA estimate based on the current capital structure. The 11x multiple is in line with software resellers and IT Services 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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