Company Overview

CGI Inc. is an end-to-end IT and business consulting company that works across multiple countries. They mainly provide high-end IT and business consulting as well as handling outsourced systems integration services. They cover the full spectrum of technology, delivering solutions in digital strategy, architecture, design and development, and other aspects of the IT and business functions.

*Competitive Advantages –* Their driver of continued growth comes from their three main competitive advantages; *Intellectual Property* solutions, deep industry expertise, and applied innovation. CGI has over 175 co-innovated business solutions that drive change and innovation within the companies that they service. The company is an expert in the IT sector and related industries and can therefore provide evolving solutions for clients and organizations. The company has been running for 40 years and has proven track records of their ability to transform business and the power of their replicable, scalable and measurable deliverables allowing clients, existing and new, to be confident in their ability to provide applied innovation.

*Strategy­* – The company’s strategy derives from four main pillars; 1) winning, renewing and extending contracts, 2) securing new, large outsourcing contracts, 3) metro-market acquisitions and 4) transformational acquisitions. Pillar one and two are drivers of organic growth whereas three and four are growth through acquisition, particularly through geographic expansion, enhancement of current services and broadening of client relationships. The company hopes to execute this strategy through a combination of client proximity and a strong global delivery network.

*Competitive Environment* - The company competes against a multitude of competitors ranging from niche companies performing specialized services to global service providers and large consulting firms. All the competitors aim to provide some or all of the services provided by CGI. Factors distinguishing the competitors are based on 1) depth and breadth of industry and technical expertise, 2) consistent, punctual, and well-priced delivery of solutions regardless of where the client performs business, 3) cost of services and the associated value provided for the cost, 4) breadth of digital IP solutions, 5) ability to deliver practical innovation and measurable results, 6) variety in terms of delivery of solutions, including global services, onshoring services and nearshoring service and 7) local presence and strength of client relationship . CGI is able to compete on a global basis because they are able to provide end-to-end solutions while competing with scale, reach, and capabilities required by client and their enterprise.

Forecasted Financial Statements

The valuation of the company derives from a projection of the company’s performance and status in the next five years. To do this, we first had to project a three-statement model, including the statement of earnings, the statement of financial position and the statement of cash flows. Please refer to Figure \_\_ in the appendix for the projected statements. In order to project the statements, we had to first derive the income statement for the following 5 years.

*Statement of Earnings* – To project the statement of earnings, we first had to project the revenues using historical data. Revenues was comprised of two main sources of income; management of IT and business functions, the company’s IT arm, and systems integrations and consulting, the company’s consulting arm. We determined historical growth over the past 4 years – 2.53% and 5.31% respectively – and used these trends to project the revenue into the next 5 years. We realized that the growth in 2018 was inconsistent in relation to 2017 and 2016, perhaps due to the increased acquisition activities, and decided to take that into account when estimating growth. Expenses were mainly a function of sales, excluding D&A and interest. D&A was driven estimated using a three-year moving average percentage of sales while interest expense was driven by the weighted average interest rate on long-term debt and the projected debt amount still owed, which will be explained in the statement of cash flows. We used these projections to determine the net earnings for years 2019-2023. These figures were then used in the statement of cash flow, which then altered the statement of financial position.

*Statement of Cash Flows and Financial Position* – The statement of cash flows was more difficult to estimate. Although cash from operations were affected by the statement of earnings, the other figures were more difficult to project as there was limited information regarding the method with which the company used cash. We decided to use a moving average for the majority of cash flow statement items in with the exceptions being D&A and proceeds from PPE. D&A is a function of sales as the company requires more assets to maintain the revenue growth. The same goes the case for proceeds from PPE. Therefore, both these items are a function of the moving average of the items as a percentage of the subsequent sales for that year. In regards to business acquisitions, this figure most certainly needed to be a function of sales, yet, it was difficult to determine how many acquisitions the company would have to partake in order to drive revenue and therefore was a moving average for the years where acquisitions became a strategy, 2017-2018. These line items directly affect a particular line item in the statement of financial position and therefore the statement of financial position was a function of the statement of cash flows.

*Assumptions* – These projections are subject to the assumptions made and are therefore sensitive to the assumptions. The forecasts are based on historical averages and relative proportion to the sales of the given year. The forecasts do not consider material changes in the future that may stem from technology, unforeseen competitors and other disruptive forces. The projections are subject to the changes in the economy as well as the availability of companies to acquire, a driver of growth. These should be considered when analyzing and understanding the projections.

Valuations

The valuation methods used included a discounted cash flow as well as a multiples approach.

*Discounted Cash Flow* – The discounted cash flow was a valuation method that was heavily subject to the projected financial statements. Using the projected income statement, we were able to determine the projected net earnings for each period. Adding back non-cash expenses; depreciation, and deducting the net change in working capital, we were able to deduce the unlevered free cash flow for the period. We then had to determine the weighted average cost of capital for the company in order to find the present value of the cash flows. Through market data, we were able to determine a 10-year Bank of Canada bond return of 2.7%, a TSX composite return of 7.9% and a beta for the company of 0.79. Using this, we were able to find the cost of equity using the CAPM approach; a cost of equity of 6.81%. Using the weighted average cost of debt of 3.81%, the tax rate of 23.99% and the implied D/EV ratio of 78.3% and E/EV ratio of 21.7%, we were able to find a WACC of 3.74%. using this WACC, we discounted the cash flows using the mid-year discount to arrive at the present values, the summation of which equaled roughly $2.14B. The terminal value was a function of the WACC and a growth rate that was determined by evaluating the historical inflation rate. We found an inflation rate of 2.5% and used this as the perpetual growth rate. A sensitivity is also provided to indicate the effect on the valuation if the growth rate or WACC were altered by ± 0.5% and ± 1% under figure \_\_ in the appendix. The values ranged from a low of $33.41 and a high of $632.05 with negative values for the following WACC and Terminal Rates; 2.74% and 3%, 2.74% and 3.5%, 3.24% and 3.5%, respectively. These negative values are due to a growth rate that exceeds the required rate of return, a phenomenon that doesn’t generally occur. As seen from the highs and lows, it can be seen that the value of the company is very sensitive to the assumptions and estimates made.

*Multiples Valuation* – We decided to use a multitude of exit multiples to determine what the value of the firm would be in 2023. These multiples included the P/E ratio, EV/Sales ratio, EV/EBITDA and EV/EBIT. The competitors analyzed were a multitude of tech and tech/consulting companies. CGI Inc. falls on the 25th percentile of its competitors for all the ratios analyzed. By projecting these ratios to the 2023 figures, we were able to produce estimates of the company’s projected enterprise value for 2023, ranging between $21B and $98B. By adjusting for projected Cash and Cash Equivalents and Debt, we found an equity value ranging from $21B to and $98B with an implied price ranging from $85.86 per share and $391.65 per share. This shows that our valuation using the discounted cash flow is reasonable and that the two methods show that the firm is undervalued in the eyes of the markets.