Calian Group Ltd. Research Report
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Instructions

(i) The report is part of the application for the 2022 Summer Investment Intern at Burgundy Asset Management Ltd.

(ii) Jeremy Lin is a Master of Financial Economics (MFE) Candidate at Western University.

(iii) Readers can find my detail models on my **Github**:

https://github.com/linhao142857/HAO-LIN. The file name is **CGY financial models** and has no password.

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1 Introduction

- Calian is a Canadian small-cap company, whose business operates through four segments, including Advanced Technologies, Health, Learning, and Information Technology. The firm has a very strong Q3 performance, mainly due to increasing demand for high-quality medical service and mobile hospitals. According to the most recent Q3 management forecast, the 2021 revenue is expected to be 500 to 525 million. Adjusted EBITDA is 49 million to 52.5 million, and adjusted net income is 34.9 - 38.2 million. Calian is trading at $64.84 on Aug 27, 2021, with a market cap that is around 730 million.
- I conduct a qualitative analysis, DCF analysis, comparable company analysis, and sensitivity analysis for the firm. I issue a **SELL** recommendation to the stock due to high uncertainty on health and advanced technologies sectors, and to the revenue growth relies heavily on acquisitions and the volatility of Canadian dollars.

2 Qualitative analysis

2.1 Business model

- Calian achieved stable revenue growth via diversification through 4 different sectors and continuous innovation. Advanced Technologies division provides infrastructure and technical solutions to Aerospace, Satellite, Wired & Terrestrial Wireless, AgTech, and Nuclear industries. In the learning sector, Calian delivers courses and custom training solutions including analyzing, designing, developing, implementing, and evaluating the effectiveness of clients' training. The firm also conducts risk assessments and develops customized training and emergency plans for various public and private clients. IT & Cyber Solutions deliver value to many of the nation's top companies and federal and provincial governments by combining market-leading technology, proven expertise, and a proven resilience-based business model. Finally, Calian supports over six million patient visits per year at over 180 clinic locations across Canada. Its health solutions include COVID 19 Response, Clinical and Nursing Services, Psychological Services, and Medical Property Management.

2.2 Competitive advantage

- A big portion of Calian's revenue is from governments (e.g. DND, Canadian Armed Forces), which is considered relatively stable and reliable. Calian's engineering, nuclear and technical solutions teams are some of the most highly sought experts in their fields. The firm's instructors are experts in adult education and skilled in teaching both in-class and scenario-based formats. Few organizations have the in-house depth, experience, and capabilities in the IT sector to deliver projects like upgrading, migrating, and implementing enterprise software in the Cloud on their own. Calian Health is one of Canada's largest national health services organizations with a network of over 2,400 healthcare professionals in over 60 categories. With the acquisition of Alio and Allphase, Calian has added clinical research and patient support programs to its health offerings.

2.3 Company management

- Before taking Calian's CEO role, Kevin served as Calian's Business and Technology Services Division President for over 4 years. He also spent more than 10 years at IBM as a Partner in Global Business Services prior to joining Calian[1].

- On average, Calian's division leaders in each sector have over 15 years of experience in their respective fields.

2.4 Revenue Analysis

- Notwithstanding challenges presented by the COVID-19 pandemic, CGY's business performed well in 2020 and has continued this positive trend thus far in 2021. 2021 Q3 represents a new high for the company in both gross margins and adjusted EBITDA. Health revenue growth continues to be strong. This was the result of strong growth in CGY's current contract delivery across Canada, including services that range from testing, vaccine support, and general health care services.

[1] Kevin Ford Linkedin: https://www.linkedin.com/in/kevin-ford-5426948/

- IT also achieve tremendous growth (46%). And it was primarily driven by acquisitive revenue from EMSEC and Dapasoft. The latter was the biggest acquisition in the firm's history.
- With 23% revenue growth, Learning also demonstrates the contributions from acquisitions, along with the resumption of business which was impacted significantly in the prior year due to COVID-19 restrictions and stay-at-home orders.
- Advanced Technologies was the only sector that achieved only single-digit revenue growth. Increased costs for travel and quarantine, availability of trained staff, and delays in the material are responsible for the increased costs. Of course, the volatility of the Canadian dollar is always an influencing factor for margins on new work in the Advanced Technologies segment to the extent that work is denominated in foreign currencies.
- Looking ahead, I remain constructive on the company's outlook. Specifically, I expect CGY to continue to deliver organic revenue growth, improve operating margin (supported by growth in acquisition activities over time, but remain stable after 2022).
- Looking ahead to the last quarter of the year, I expect the closure of testing centers and a drop in overall hospitalizations as COVID cases fall. The pressure on the hospitality segment should continue easing through the rest of the year.
- The firm did a great job on revenue diversification. According to the Q2 conference call, 53% of CGY's revenue came from the Canadian government, comparing to 69% previously. However, this posing a challenge for revenue growth and gross margin improvement, as I expect there will be fewer government contacts coming in when both Canada and the US are re-open.
- The CEO expects that M&A activities will continue to be the key driver for Calian. The firm has completed more than 7 acquisitions during the past 12 months, including CTS, Tallysman Wireless, Cadence, InterTronic and Dapasoft.
- Since improving margins and organic growth are achieved through acquiring companies that are healthy and efficient, there might not be that many target companies for Calian to acquire in the future. Hence, I believe the strong growth of revenue and profits is less likely to maintain for 2022 and after.

3 DCF analysis

- I project the 2021E financial statements based on the released Q3 result. As Kevin outlined in the conference call, the projected revenue for 2021 would be 500 to 525 million, so I picked 512.5 million. I expect revenue growths will be 10% for 2022, and slightly converging to 2% after 2025. For the fiscal year 2021, many of my assumptions are computed by Q3 financial statements because Q3 is a good representative of the entire year. These assumptions include gross margin, SG&A in the percentage of revenue, prepaid expense in the percentage of SG&A, dividend payout ratio, average tax rate, depreciation rate.

- To project working capitals (e.g. Account Receivable, Work in process, and Inventory, Account Payable), I calculated the historical days of each item and form my forecast accordingly. These numbers are eventually converting back to the historical level.

- The weighted average cost of capital (WACC) is 9.06 % in my models. The cost of debt is estimated by lease obligation interest expense and other interest expense in Q3, which is 3.5%. The debt to capital ratio was found through the TD Securities Research site. Cost of equity was estimated by CAPM, with a risk-free rate at 1.71% (Canadian long-term bond yield). And beta that I choose is 0.86, which was founded on Yahoo Finance. The risk premium in CAPM was estimated by the Ibbotson-Chen model[2], which is 11.69%. Lastly, I add a 3% SMB premium to CAPM. The final cost of equity was 13.29%.

- With the above assumptions, I use FCFF analysis because the firm has high D&A expenses. According to Q3 report, no preferred shares are outstanding as of June 30, 2021. So I believe this will stay the way it is from July to September. The target share price is $63.18 at the end of fiscal 2021. The stock is traded at $64.84 on Aug 27. Hence, I issue a SELL recommendation.

4 Comparable company analysis

- REFINITIV Stock Reports gave a list of comparable companies. But I only include IBI Group Inc.(IBG), GDI Integrated Facility Services Inc.(GDI), K-Bro Linen Inc.(KBL), Waste Connections Inc.(WCN), Ritchie Bros Auctioneers Inc.(RBA), and Telus International Cda Inc.(TIXT). Because these firms have either similar market cap or debt to capital ratio. KUT and XX are excluded due to negative earnings (hence negative P/E ratio) and extremely low market cap. Similarly, AIM was not included due to the negative EV/EBITDA ratio. DNTL has a very large EV/EBITDA ratio due to negative earnings and extremely low EBITDA.

- CGY is expected to trade at 48.26x P/E and 18.32x EV/EBITDA [3] at the end of the fiscal year 2021, whereas its peers are expected to trade at 29.89x and 17.57x respectively.

[2]According to Ibbotson Chen model, Equity risk premium = [(1+EINFL)(1+EGREPS)(1+EGPE)-1.0]+EINC - LTGBY, where EINFL = Expected inflation, EGREPS = Expected growth in real earnings per share, EGPE = Expected growth in the market P/E ratio, EINC = Expected income component

[3]Management indicating Adjust EBITDA will be 49 million to 52.5 million at the end of fiscal 2021. So I choose the average, which is 50.75 million

- With the above higher P/E ratio and expected EPS of $1.32, the target share price based on relative valuation is $63.53. Therefore, I conclude that **CGY is relatively overvalued** comparing to its peers.

- Please noted that small-cap industrial companies have unstable share prices and earnings. Hence the above ratios and analysis in my model are subjected to fluctuations.

5 Sensitivity analysis

- I tested the target share price at different terminal growth rates (from 1% to 3%) and different discount rates (from 7% to 11%).

- The results are consistent with the above analysis. That is, unless Calian could significantly improve its long-term growth prospective or significantly change its capital structure (namely, more debt, and lower WACC), the stock remains overvalued, in my opinion.

6 Key risks to target price

- Key risks to our target price include weakness in the demand for, supply of, and/or value of used equipment; competition; weakening economic activity; currency volatility; acquisition integration; the potential for losses on guarantee contracts and outright purchase agreements; incidents or circumstances that might taint the company's reputation for fair dealing or commitment to the unreserved auction process; and FX.

7 Reference

- Calian Group Ltd. annual and quarterly reports: https://www.calian.com/investor-resources/

- TD Securities Equity Research reports

- Insider News and Knowledge (INK) research report

- Quantitative Equity Research Report, released on Aug 13, 2021, 21:15 UTC

- REFINITIV Stock Reports Plus released on Aug 12, 2021

- Yahoo Finance