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Short sellers bet against CGI Group Inc as cash questions cling to tech firm

By Nicolas Van Praet

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MONTREAL – Plenty of investors on the New York Stock Exchange have bet against CGI Group Inc. this year, despite the overwhelming buy recommendations Canada's biggest tech company enjoys from brokerage analysts.

But the reason is not the company's role in the botched rollout of healthcare.gov in the United States. At the heart of short-selling activity on CGI shares are questions surrounding its accounting, which are clinging to the company like an unwanted pest.

New York hedge fund manager James Chanos, who famously shorted Enron Corp. before it went belly up in 2001, took a bet late last year against CGI shares. Among his arguments is that the company is using book-keeping conventions to boost earnings.

Although it's not the dominant view, others share that thesis. In Canada, perhaps the loudest CGI skeptic is **Michael Yerashotis** at **Veritas Investment Research** in Toronto. The analyst estimates that the Montreal-based IT outsourcing company has made as much as \$1.1-billion worth of accounting adjustments following its purchase of U.K.-based Logica in 2012 that may subsequently flow back into its reported earnings without a matching increase in its cash position.

The result is that investors could have a more optimistic picture of the company's finances than what's warranted, he says. Second-quarter earnings CGI reported last week have not changed his view.

"We continue to believe that the company's earnings will ultimately come down to meet its cash flow," **Mr. Yerashotis** said Monday. "Earnings expectations are too optimistic."

He says investors should base their decisions on future cash flow rather than earnings, which have benefited from adjustments.

Given that CGI's integration plan for Logica is mostly done, the analyst doesn't see the potential for a significant surge in cash flow for the foreseeable future. As a result, he has cut his estimate for CGI's sustainable earnings before interest, taxes, depreciation and amortization to \$1.3-billion - about 30% lower than the consensus analyst estimate for fiscal 2015 as of April 30.

By many measures, CGI's second quarter earnings last week were stellar. The company beat consensus estimates on revenue, earnings per share and EBITDA. Cash flow from operations before the impact of integration payments was about \$890-million on a trailing 12-month basis.

Investors applauded the results and pushed up the stock 4% on reporting day.

However, **Mr. Yerashotis** says that after adjusting for a couple of significant working capital fluctuations over the past two quarters, CGI's current gap between earnings and cash flow has only slightly improved sequentially. Meanwhile, the company's shortfall from Veritas's own cash-on-cash analysis, which compares pre- and post-acquisition cash flow, has widened considerably to \$525-million in the last quarter.

No one is suggesting CGI is breaching any International Financial Reporting Standards or breaking the law. The argument is only that the company's earnings don't tell the whole story.

CGI rejects the premise that its book-keeping is aggressive.

"We've done a lot of these acquisitions and [having a gap between earnings and cash] is a normal thing in the integration period because we're disbursing cash to restructure the operations," CGI chief executive Michael Roach said in a recent interview.

He said the company's expectation is that as it rolls off the remaining cash being used for restructuring and as revenue collection speeds up further, the cash position will increase.

"Unfortunately, I can't disprove a negative here," Mr. Roach said. "I just have to kind of produce the cash."

At that point, the accounting question will fall off, he said.

"There's still concern out there" in the market about CGI, said another analyst who asked not to be named. "The final verdict? We're not there yet. We're still going to need a few quarters to resolve these issues."

Meanwhile, many of CGI's major institutional shareholders have continued to add to their positions through the debate, Mr. Roach said. "We have not had major churn in the stock."

Pension fund manager Caisse de dépôt et placement du Québec, one of CGI's largest investors with a roughly 19% stake, has said it is "not convinced" there is an issue with the company's fundamentals.

"When we look at a company like CGI, what we see is a very talented management team in an interestingly contra-cyclical sector, that's in the process of expanding on a global basis," Caisse CEO Michael Sabia said Feb.26. "Long term, [that's a] pretty good bet."

In Toronto trading Monday afternoon, CGI shares fell 2.6% to \$38.06.