Oct 21, 2014

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VALUE RESEARCH

CGI GROUP INC.

TSX: GIB.A

Bargain Currently; but what's the next step?

BUY

CMP C$37.56

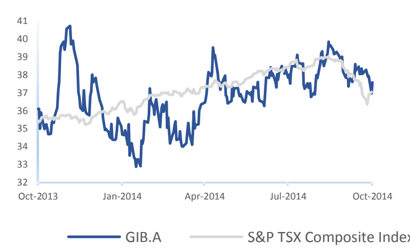
Target Price: C$45

Market Cap (mm C$)	11674
Shares Outstanding (mm)	310.8
Float	88.10%
Avg. 3M Daily Vol. (mm)	0.59
52 Week Price Range (C$)	32.71 - 41.47
Dividend per Share	0
Price to Book	2.4x
Beta	0.25

EPS (C$)	
2013A	2.28
2014E	2.97
2015E	3.37

PE	
2013A	16.47x
2014E	12.65x
2015E	11.15x

Share Price Performance



Investment Thesis: The Logica acquisition has created tremendous opportunities for CGI in the European outsourcing space. With the build and buy strategy succeeding once again, we believe that Europe will be the key catalyst for improving revenues and margins, supported by stable growth from the U.S. and Canada. We expect the acquisition to have a positive impact on free cash flow generation and translate into EPS accretion. In our opinion, another acquisition in a relatively untapped market could be the next material catalyst for future earnings growth. Complementing these drivers is a rising global demand for IT services coupled with CGI's superior operational execution capabilities that provide the base for our recommendation. We recommend a BUY at current price with a target of C$46.5.

Key Highlights:

Positive outlook on IT Services: With increasing GDP growth forecast for US and Europe, corporate and government IT spending is also expected to increase significantly by over 5% in coming years. A shift in corporate IT spending and increase in IT complexity faced by companies is likely to drive the business in the near future. Given the proactive management and growing IP resources at its helm, we believe that CGI is well positioned to benefit from the improving industry trends.

Successful integration of acquisitions: Time and again CGI has proved its superior integration capabilities by benefitting from its successful acquisitions with its 'build and buy strategy'. The integration of Logica is nearly finished and we expect the restructuring efforts to contribute to higher margins and revenue growth.

Margin expansion: There has been strong margin improvement in European operations. We believe that margins will continue to expand going forward due to run-off of negative and low margin projects, organic expansion in India and renewed emphasis on high margin project selection across Europe.

Solid FCF may lead to new drivers: Lack of visibility over Free Cash Flow is dwindling and there are clear signs that cash conversion will hit the pre-Logica period levels. With expected FCF of over $1B in FY14, we believe that CGI will look to position itself for an acquisition in coming periods. We believe that such an acquisition will lead to higher EPS accretion and will drive further re-ratings.

Favorable Industry Trends

There has been a recent wave of corporate spending on new digital technologies known as SMAC (Social, Mobile, Analytics, Cloud). The boom in the use of big data and analytics is just one example where companies are forced to become smarter and quicker or risk being left behind by their competitors. There is some debate on the impact of these trends on traditional IT services, however in the medium term, we believe that IT services companies like CGI are well positioned because:

1) Shift in technology will boost demand for innovative IT services, which will provide cross sell opportunities.
2) Shift in IT spend from traditional services is likely to be reinvested in other areas in IT services. As the complexity of IT needs grow, firms will continue to invest in IT support and services.

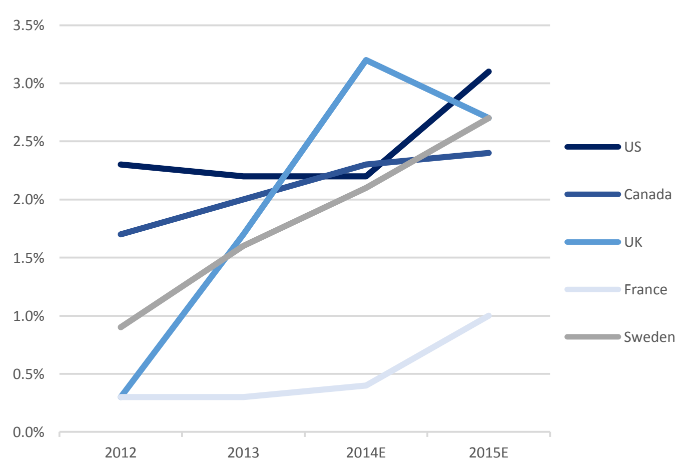
The Industry is currently going through a trend of vendor consolidation as well, which will benefit larger firms like CGI as it provides end to end IT services for its clients.

IT spending is expected to increase at a CAGR of 5% going forward, an increase from 2% CAGR in 2008-2012. This trend is supported by improving macroeconomic indicators in CGI's key markets.

Macroeconomic Tailwinds: Recovery on Track

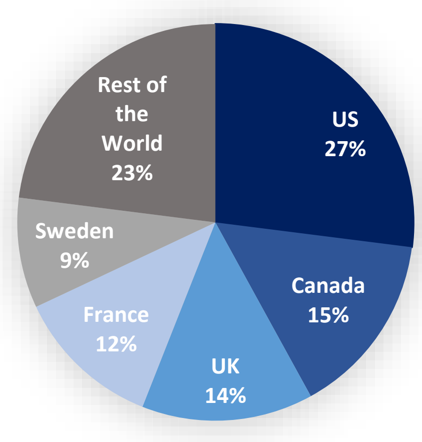
As the U.S. and Europe continue their recovery through 2014 and 2015, corporate IT spending is expected to increase in 2015 and 2016 as well. The following chart shows the GDP growth trends for some of the key markets for CGI:

Exhibit 1: GDP Growth



Source: IMF

Exhibit 2: Revenue Share



Source: Company Data

GDP growth will lead to increased business activity and in turn, further growth opportunities for CGI in the services sector. The U.S. and Canada are expected to continue on their present trajectory for a strong recovery. The UK and Sweden are also expected to improve whereas France is expected to have a weaker comeback from the slump.

The economic prospects for Europe are especially important as CGI now derives over 50% of its revenue from this geography. Business momentum in Europe appears to be improving as reflected by the recent TTM book-to-bill of

1.13x. There has been a slew of high-quality bookings in the previous quarter including: Michelin, Post North, and the European Commission, Volvo, and EDP.

Build and Buy Strategy: The Success Story

CGI has an established track record of extracting synergies from acquisitions and has continued to successfully implement its 'Build and Buy' Strategy. This strategy focuses on organic growth in existing markets and taking an opportunistic but disciplined approach to acquisitions by making 'The right acquisition at the right time and the right price'. CGI has expanded throughout North America and Europe by three key acquisitions: (1) U.S. based American Management Systems in 2004; (2) Stanley Inc., a U.S. Federal IT provider in 2010 and; (3) Europe based IT service provider Logica in 2012. CGI has been successful in integrating acquired assets by controlling costs and therefore increasing margins and benefitting from the acquired IP software portfolio. Historically, the margins for CGI have decreased post acquisition but have improved quickly in subsequent periods.

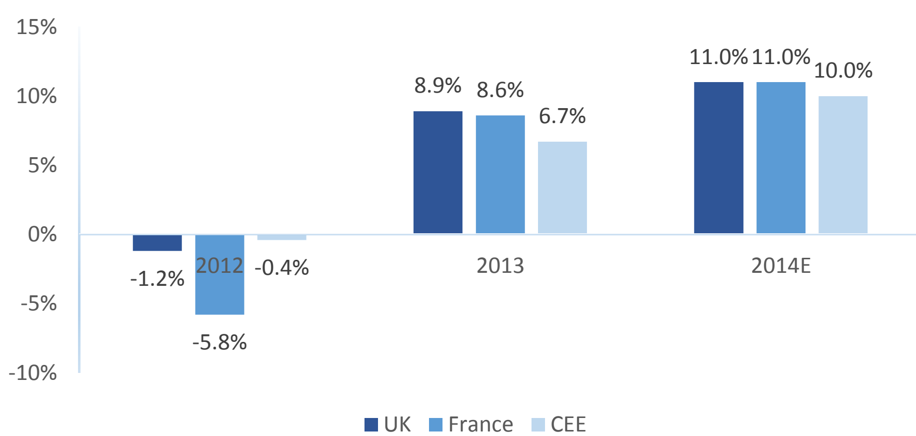
Improving Margins: The 'Build' Part Of The strategy

Successful execution of the 'Build and Buy' strategy will require strong organic growth in the U.S., Canada and Europe. CGI generates 27% of its revenues from the US and of that total, 50% is from the Federal Government and agencies. Momentum in the public sector space has stalled since 2010 due to budget pressure, sequestration and a backlog of bidding contracts. Meanwhile, CGI also suffered from negative publicity due to problems with the Healthcare.gov website rollout. However, we believe that due to CGI's long term and wide ranging relationship with the Federal Government and a higher likelihood of a pickup in Federal funding, there will be little impact on CGI's performance.

In Q3 FY14, CGI was able to improve margins by 230bps to 14.6% as compared to last year, on the back of addressing the challenges in the delivery of state contracts and on license sales. Still, CGI is yet to break into the U.S. corporate market in any meaningful way and will be on the lookout for a suitable acquisition to kick-start the process in the future.

Canada is another core market for CGI characterised by stable trends and high margins. Canadian margins were up 260bps to 21.8% in Q3 FY14 as compared to last year due to a healthy mix of high quality revenue contracts and improved resource utilization.

Exhibit 3: European EBIT Margins



Source: Company Data

Europe has a lot of potential for margin improvement, especially after the completion of the Logica acquisition. CGI has been able to draw upon its previous integration expertise and has driven an increase in European segment margins from 6.3% at time of the Logica acquisition to 12.7% in Q3 FY14. This improvement in margins is sustainable as it has been driven largely by a reduction in Logica legacy headcount by 12% and other cost control efforts. Margins in Europe are expected to improve as CGI completes the process of pruning less profitable contracts and concentrates efforts to attract higher quality revenue. These efforts are already bearing fruit in the UK where the revenue mix is now of much higher quality as evidenced by an increase in margins to 13.1% in Q3FY14 as compared to 10% in Q3FY13. Hence, we see potential for solid post integration profitability across European markets by 2015.

CGI also intends to expand its existing delivery network in India to shore up outsourcing resources which will further boost margin growth in the future.

Free Cash Flow: Spending It Wisely

CGI has an excellent track record of converting earnings to free cash flow. As integration with Logica is in its final stages and integration costs are diminishing, visibility around cash flows is increasing. With an expected FCF of 1B+ in FY14, we believe that CGI will spend it on a mix of acquisition and buyback along with organic expenditures, specifically in Canada and India. We believe that use of this cash will be a key driver for the company in near term.

Management has indicated its intention to choose organic growth and acquisitions over repayment of debt and dividends. It has explicitly said that it may consider increasing debt. This indicates the confidence management has for the future growth prospects of CGI. Also, locking in a lower rate for long term debt in a contractionary monetary environment would benefit CGI in the long term.

Management has also previously used share buyback as a method to deploy cash. The current share price as compared to global peers is undervalued by a significant margin. We believe that this could be a good opportunity for the management to repurchase shares and increase ROE, since accretion due to share buyback will be greater than accretion due to reduced debt.

However, potentially the biggest catalyst for future earnings growth is CGI’s next acquisition. Taking into account the above actions, we feel that CGI is in the process of positioning itself for another acquisition. We believe that the target will likely be a U.S. company with a strong software IP portfolio, which will help CGI to break into the U.S. commercial IT services market. This will provide a hedge against the overreliance on Federal Government contracts in the U.S. market and further opportunities to grow market share. This will eventually lead to higher EPS accretion and possible re-ratings in the future.

Valuation:

On the basis of strong margin expansion, synergetic benefits, possible share buyback and acquisitions due to higher free cash flow, we believe that CGI has a greater potential for possible re-ratings in the upcoming year. In our opinion, the market has not fully factored in these drivers into the current price. We believe that CGI is undervalued in comparison to its peers in US, Europe and India. Our valuation target is based on a blend of forward PE and EV/EBITDA multiples.

Valuation Metrics	FY14E	FY15E
Revenue (mm C$)	10690	11224
EBITDA (mm C$)	1764	1908
EPS (C$)	2.97	3.37
P/E	12.6	11.1
EV/EBITDA	8.03	7.42

Target Price Calculation	
CMP (C$)	37.56
EV (C$)	14164
EBITDA FY15E (mm C$)	1908
EPS FY15E (C$)	3.37
PE Multiple (Expected)	14.26
EV/EBITDA Multiple (Expected)	8.67
Target Price (C$)	**46.5**

Company	FY 15E		Next 2 Yr. Est. EPS Growth
	EV/EBITDA	P/E	
Cognizant Technology	11.07x	17.77x	14.20%
Infosys Ltd.	12.34x	17.77x	13.20%
Tata Consultancy Services Ltd.	16.78x	22.29x	15%
Atos SE	6.32x	12.37x	-18%
Leidos Holdings, Inc.	9.53x	15.08x	6%
Booz Allen Hamilton Holding Corp.	9.42x	15.81x	0.30%
Open Text Corp.	10.88x	13.55x	11.70%
Cap Gemini S.A.	7.15x	14.39x	11.60%
Computer Sciences Corp.	4.16x	13.21x	13.30%
Accenture plc	8.68x	16.22x	7.60%
Average	**9.63x**	**15.85x**	**7.49%**
CGI	**7.40x**	**11.15x**	**21%**
CGI Target (10% discount to average)	**8.67x**	**14.26x**	-

Global IT peers are currently trading at an average 15.9x FY15E EPS, whereas CGI is trading at 11.2x despite a higher expected EPS growth rate for next 2 years of 21% for CGI vs 7.5% for its peers. With a conservative framework we value it at 14.2x FY15E EPS, a 10% discount to its peers. CGI is currently trading at 7.4x FY15E EV/EBITDA. We expect a conservative target EV/EBITDA of 8.7x, a 10% discount to its global peers which are trading at an average of 9.6x. This blend leads to a target price of C$46.5.

Risks:

Economic Condition: CGI depends heavily on the general business activity of the economy in its key markets. If the economic recovery in the U.S. and Europe is derailed, book to bill ratios will decrease, revenue growth will slow down and margins will fall which will directly impact the company's cash flows.

Acquisition and Integration: We believe that CGI is slowly positioning itself for an acquisition which presents its own risks and challenges. If CGI does not correctly value the acquisition or fails to integrate it successfully, it will have an adverse impact on the long term growth of the company. CGI's stellar track record of the 'Build and Buy' strategy and previous M&A discipline mitigates this risk to a large extent.

Client Concentration: CGI derives a significant portion of its revenue from the U.S. Federal Government and its agencies. A material change in the level of business with CGI would have an adverse impact on cash flow and hard to replicate in the near term. The recent Healthcare.gov rollout is an example of the catalyst that could lead to such a situation. However, we believe that the strong and in depth relationship with the Federal Government along with an excellent delivery record (barring the above incident) will help mitigate this risk.