Converge Information and Communications Technology Solutions, Inc. [PSE:CNVRG]

CONVERGE ICT SOLUTIONS INC.

Thursday, October 15, 2020

Initial Public Offering

Reference: Japhet Louis O. Tantiangco

OUR TAKE

Converge Information and Communications Technology Solutions, Inc. [CNVRG] will offer 1,505,273,510 shares with an overallotment option of 225,791,026 secondary shares priced at P16.80 each. Approximately 90% of the estimated net proceeds from primary share sales of P7.712 billion are earmarked for capital expenditures while the remaining are for general corporate purposes.

We are neutral on Converge ICT. While we see the company benefitting from its nationwide expansion plan together with the data service industry's advantageous position amid the economy's shift to the new normal, we still see CNVRG as overvalued relative to its peers. At the same time, Concerns are appearing with its profitability ratios, with margins and return on asset and equity declining in the recent years.

Nonetheless, we do not discount the possibility of a short run appreciation in its share price brought by excitement towards the company and its prospects. With this however, managing your trading risk is a must.

INVESTMENT NARRATIVES

Upside

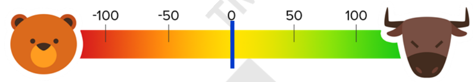
- **Industry advantage:** The shift of the economy towards the digital space where more business activities and transactions are done online due to the COVID-19 induced new normal is seen to put the data service industry at an advantageous position.
- **Residential Segment Opportunities:** The utilization of work-from-home setups and online classes amid the new normal is seen to boost the residential space's demand for data services.
- **Fast Paced Growth:** CNVRG's Revenue and Net income have been growing with a compounded annual rate of 69% and 49% respectively.
- **Outperforming peers:** CNVRG's EBITDA and Net margin have fared better than the fixed-line segment of the telecommunication duopoly PLDT and Globe in 2019.
- **More room for growth:** the company still has a lot of space for growth as it has yet to expand in the Visayas and Mindanao region while strengthening its foothold in the Luzon area.

Downside

- **Declining margins:** Gross, operating and net margins have been decreasing in the recent years with net margins extending the decline in the 1st half of 2020 as production and financing costs increase rapidly.
- **Diminishing returns:** Return on equity has been going down in the past 2 years as the company's asset efficiency in generating revenues and cost efficiency declines.
- **Expensive valuation:** CNVRG's price-to-earnings ratio is far higher compared to the incumbent telecommunication duopoly.
- **Tighter competition:** Telecommunication/data service players are expected to expand networks further and employ more competitive strategies amid the growing opportunities in the market.

CNVRG

NEUTRAL



SUMMARY OF THE OFFER	
Offer Price	P16.80 per share
Primary Offer Shares	480,839,941
Secondary Offer Shares	1,024,433,569
Overallotment Option	225,791,026 Secondary Shares
Total Offer Shares (Without Overallotment Option)	1,505,273,510
Total Offer Shares (With Overallotment Option)	1,731,064,536
Offer period	October 12 - 16, 2020
Outstanding shares (Post-IPO)	7,526,294,461
Market capitalization (Post -IPO)	126,441,746,944.80
Institutional Offer	1,053,691,310
Trading Participant Allocation	301,054,800
Local Small Investors Allocation	150,527,400
Minimum subscription	500 offer shares, in multiples of 100 shares.
Estimated total net proceeds (without overallotment option)	P24.361 billion
Estimated total net proceeds (Assuming full exercise of overallotment option)	P28.054 billion
Estimated net proceeds from primary shares	P7.712 billion
Estimated public float without Overallotment Option (Post-IPO)	20%
Estimated public float with Overallotment Option (Post-IPO)	23%
Lead Underwriters	BPI Capital Corporation and BDO Capital & Investment Corporation
Listing date	October 26, 2020

COMPANY PROFILE

Founded by Mr Dennis Anthony Uy and Ms. Grace Uy, Converge Information Communications Technology Solutions, Inc. is a provider of fixed broadband internet service, catering both the residential and enterprise segment. Aside from this, Converge ICT also provides private data network solutions, cloud and colocation services, and other connectivity solutions to its enterprise customers. It has over 35,000 kilometres of fiber network that stretches from the northernmost to southernmost part of Luzon as well as a fiber distribution and last-mile network that covers over 200 cities and municipalities across the island. It currently operates in the Ilocos region, Cordillera Administrative Region, Central Luzon, National Capital Region, Calabarzon, and Bicol.

According to Media Partners Asia (MPA), Converge ICT has the largest high-speed fixed broadband operator in the country, by high-speed residential fixed broadband subscriptions, with a 55% market share as of the end of 1st half of 2020. It also has the fastest growing fixed broadband operator in the country, with its residential business gaining a 56.6% market share of new subscriptions from January 1, 2018 to June 30, 2020, and its enterprise business growing at 3.6 times the market between 2016 and the last 12 months ending in June 30, 2020. Its network has already reached approximately 4.1 million homes covering 28% of households in Luzon (based on 14.4 million households as of December 31, 2018 as per MPA).

Board of Directors	
Jose Pamintuan De Jesus	Chairman, Independent Non-
Dennis Anthony H. Uy	CEO, Founder and Executive Director
Maria Grace Y. Uy	President, Chief Resources Officer, Founder and Executive Director
Amando M. Tetangco Jr.	Independent Non-Executive Director
Roman Felipe S. Reyes	Independent Non-Executive Director
Francisco Ed Lim	Non-Executive Director
Saurabh Narayan Agarwal	Non-Executive Director

Source: Company Website, https://www.convergeict.com/

USE OF PROCEEDS FROM PRIMARY SHARE SALES

Use of Proceeds	Estimated Amount (In Million PHP)	Estimated Timing of Disbursement
Capital Expenditures	6,941.00	2021 - 2022
General Corporate Purposes	771.20	2021 - 2022
Total	**7,712.20**	

Source: Converge ICT Solutions, Inc. Final Prospectus

Capital Expenditures

About 90 percent of the net proceeds from primary share sales will be utilized for capital expenditures to accelerate their Fiber network rollout. Converge ICT plans to is to deepen the reach of its network in its existing markets in Luzon (Go Deep Strategy) andto go nationwide by establishing new markets in Visayas and Mindanao (Go National Strategy).

Outside Plant Equipment - About 60 to 80 percent of the net proceeds from the primary share sales will be used for not electrically powered network equipment needed for the construction of its end-to-end Fiber network. In particular, the net proceeds will be used for purchase of Fiber-optic cables, construction of domestic backbone and distribution networks, installation of network access points and ports, and investments in international bandwidth capacity on major international connectivity networks.

Inside Plant Equipment - About 10 to 20 percent of the net proceeds from the primary share sales will be used for electrically powered network equipment including dense wavelength division multiplexing equipment and routers for activating the network build out

Other Property, Plant, Equipment and Intangible Assets - About 10 to 20 percent of the net proceeds will be used for other investments including customer premise equipment, general Information technology investments, and related office equipment.

General Corporate Purposes

Approximately 10% of the net proceeds are intended for general corporate purposes including working capital requirements. This includes Plant, property, and equipment repair and maintenance, and funding unexpected increases in inventory requirements.

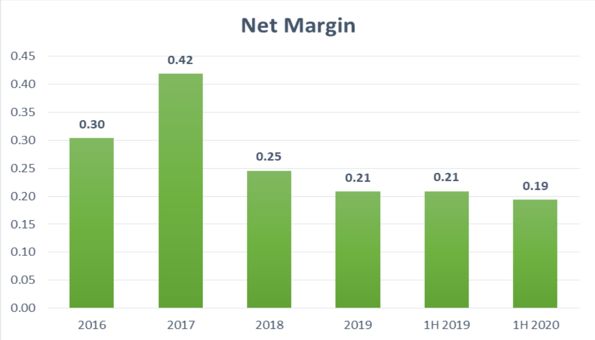
FINANCIAL ANALYSIS

In Million Php	2016	2017	2018	2019	1H 2019	1H 2020
Revenues	1,894.00	2,940.20	5,054.60	9,139.50	3,942.40	6,489.90
Cost of Services	(654.70)	(1,049.90)	(2,328.50)	(4,440.70)	(1,900.20)	(3,018.10)
Gross Profit	1,239.20	1,890.30	2,726.10	4,698.80	2,042.20	3,471.80
General and Administrative expenses	(279.70)	(441.90)	(912.70)	(1,414.80)	(636.50)	(1,076.70)
Provision for impairment of trade and other receivables	(80.90)	(77.60)	(124.90)	(529.90)	(229.30)	(324.30)
Unrealized fair value loss on financial asset at FVTPL	-	-	-	-	-	(40.60)
Other income (loss), net	(293.20)	(72.20)	51.10	18.30	(26.50)	114.40
Operating Income	585.40	1,298.60	1,739.70	2,772.30	1,150.00	2,144.60
Financial Costs	(4.80)	(11.20)	(70.60)	(275.10)	(136.70)	(347.30)
Profit before taxes	580.70	1,287.40	1,669.10	2,497.30	1,013.30	1,797.30
Income tax expense	(6.30)	(56.90)	(427.50)	(592.50)	(188.50)	(538.60)
Net Income	574.40	1,230.50	1,241.60	1,904.70	824.70	1,258.70
Other Comprehensive Income	-	1.60	8.50	45.20	27.10	(19.40)
Total Comprehensive Income	574.40	1,232.10	1,250.10	1,949.90	851.80	1,239.30

Source: Converge ICT Solutions, Inc. Final Prospectus

The growing fixed broadband market in both the residential and enterprise segment of the country coupled with the firm's expansion of its fiber network has led to a strong revenue performance with its compounded annual growth rate from 2016 to 2019 reaching 69%.

- Revenues from the residential segment grew at a compounded annual rate of 94.7% from 2016's P861.5 million to 2019's P6,353.90 million. Contributions from the enterprise segment on the other hand rose at a compounded annual rate of 39.2% from 2016's P1,032.5 million to 2019's P2,785.6 million.
- CNVRG's Residential business base has already surged from 73,633 subscribers in 2016 to 731,563 subscribers as of June 30, 2020. Enterprise business base on the other hand has grown from 4,292 subscribers in 2016 to 10,498 subscribers as of June 30, 2020.
- In the 1st half of 2020, the new normal set by the COVID-19 pandemic has propelled the demand for fixed broadband data services helping CNVRG sustain its topline performance. Revenues grew 64.6% y/y to P6,489.9 million.



Gross profits have grown at a compounded annual rate of 55.9% from 2016 to 2019. Gross margins have been declining however from 0.65x in 2016 to 0.51x in 2019 resulting from the fast increase in the firm's cost of sales. In the 1st half of 2020, gross profits jumped 70% y/y to P3,471.80 million due to the high revenue levels. Gross margins stood at 0.53x, higher than the same period last year's 0.52x but lower than its last 3 years average of 0.57x.

Operating profits have risen at a compounded annual rate of 67.9% from 2016 to 2019. The rapid increase in cost of sales and operating expenses led to a decline in operating margins from 2017's 0.44x to 2019's 0.30x. In the 1st half of 2020, operating profits grew 86.5% y/y to P2,144.60 million with operating margins improving from the same period last year's 0.29x to 0.33x. This was still lower however compared to its last 3 years average of 0.36x.

Net income has surged at a compounded annual rate of 49.1% from 2016 to 2019. Similar to operating margins however, net margins have started declining from 2017's 0.42x to 0.21x in 2019 amid the fast increase in overall expenses. In the 1st half of 2020, net income jumped 52.6% y/y to P1,258.70 million. Net margins however have declined to 0.19x from 1H of 2019's 0.21x. This was also lower compared to its last 3 years average of 0.29x.

BALANCE SHEET

In Million Php	2016	2017	2018	2019	1H 2020
Cash and Cash Equivalents	316.40	420.50	476.70	6,233.00	8,982.10
Current Assets	1,086.30	1,661.80	3,630.90	11,204.00	15,171.60
Non Current Assets	1,733.60	3,372.30	9,025.30	19,955.40	26,209.80
Total Assets	2,819.90	5,034.10	12,656.10	31,159.50	41,381.50
Short term debt	31.60	278.30	1,583.50	1,453.40	831.90
Current Liabilities	543.30	1,357.90	6,608.50	10,160.50	11,104.50
Long term debt	221.40	348.10	1,232.50	8,226.50	11,423.50
Non Current Liabilities	285.70	449.80	1,439.10	8,831.20	12,304.00
Total Liabilities	829.00	1,807.70	8,047.60	18,991.70	23,408.50
Total Equity	1,990.90	3,226.40	4,608.50	12,167.80	17,972.90

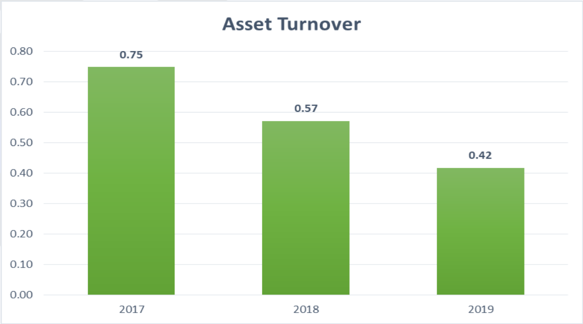
Source: Converge ICT Solutions, Inc. Final Prospectus

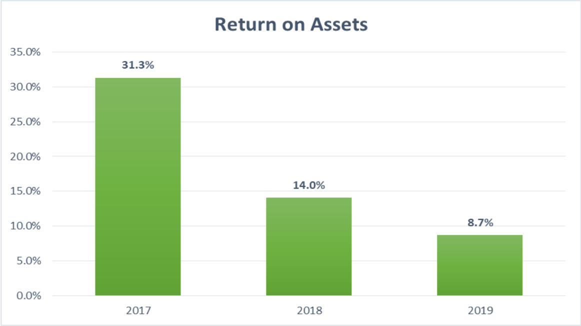
The company's current assets rose by 35.4% to P15,171.60 million from end-2019 to 1st half of 2020 driven by the 44.1% increase in cash and cash equivalents to P8,982.10. Its current ratio in the 1st half of 2020 stood at 1.37x, higher than end-2019's 1.10x and the 2017 - 2019 average of 0.96x. This shows that the company has ample liquidity to meet short-term obligations, mitigating liquidity risks.

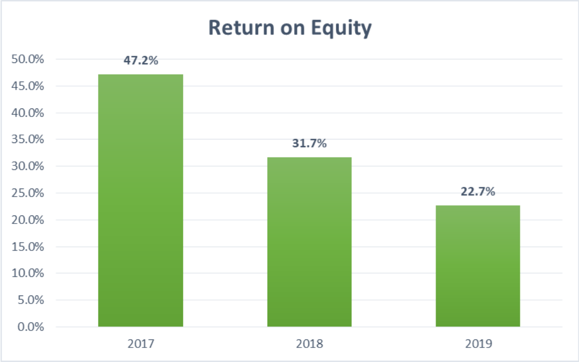
The company's total assets have been growing at a compounded annual rate of 122.7% from 2016 to 2019. From end-2019 to the 1st half of 2020, total assets grew by 32.8% to P41,381.50 million. Of this, 49% is from the company's net property, plant, and equipment. The company's asset turnover has been declining from 2017's 0.75x to 2019's 0.42x indicating that the company is becoming less efficient in generating revenues out of its growing assets. Return on assets have also been on a downtrend from 2017's 31.3% to 2019's 8.7% indicating that in the past three years, CNVRG's assets have been receiving declining net income returns on a per Peso basis.

In the 1st half of 2020, CNVRG's total debt rose by 26.6% from end-2019 to P12,255.40 million. Debt to asset ratio declined from end-2019's 31.3% to 29.6% but still higher compared to the company's 2017 - 2019 average of 21.9%.

The company's return on equity has been decreasing from 2017's 47.2% to 2019''s 22.7% indicating that the company has been generating less net income returns to the shareholders' investments on a per Peso basis. The downtrend in CNVRG's return on equity was caused by its declining efficiency in generating revenues out of its assets (asset turnover), and its fast increasing costs that have lowered its net margin.







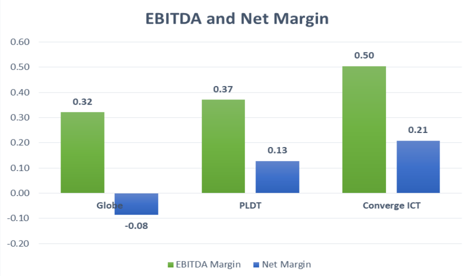
AGAINST THE DUOPOLY

In 2019, PLDT Inc. led the three in terms of Revenue, Earnings before interest, taxes, depreciation, and amortization, and net income received. Globe on the other hand, lagged in terms of bottomline, recording a net loss of P3.2 billion for its wireline segment.

In Million Pesos	Globe	PLDT	Converge ICT
Revenue	37,636.10	89,406.00	9,139.50
EBITDA	12,096.17	33,162.00	4,609.30
Net Income	(3,196.71)	11,421.00	1,904.70

Converge ICT vs. Globe and PLDT's fixed line segment (2019)

In terms of margins however, Converge ICT led the three with its EBITDA and net margin recording 0.50x and 0.21x respectively. Globe remained at the bottom with its EBITDA margin at 0.32x and its net margin at –0.08x due to the net losses recorded. Based from this data, Converge ICT has been more efficient in managing cost compared to the duopoly, allowing it to derive more earnings for every P1.00 of revenue.



	Common Outstanding Shares	Share Price	Market Capitalization	2Q 2020 EPS (TTM)	2Q 2020 PE Ratio TTM	FY 2020 Projected EPS	2020 Projected PE Ratio
Converge ICT Solutions, Inc.	7,526,294,461	16.80	126,441,746,944.80	0.32	52.50	0.35	48.64
Globe Telecom, Inc.	133,432,727	2,050.00	273,537,090,350.00	161.99	12.66	158.06	12.97
PLDT Inc.	216,055,775	1,310.00	283,033,065,250.00	104.44	12.54	109.89	11.92

GLO and TEL's share price based on October 9, 2020 closing, market capitalization and PE ratio computation are based on the said prices. Converge ICT's 2nd Quarter Trailing 12 Month EPS computation does not include preferred shares to be converted to common and new shares to be issued on IPO.

As observed, Converge ICT's market capitalization at P16.80 stands at P126.44 billion which is close to the half of Globe and PLDT. Currently, Converge ICT is serving only the Luzon market whilst the Telecommunications duopoly have already expanded nationwide. Also, CNVRG is focused on the fixed broadband sector while Globe and PLDT are operating in both the mobile and fixed-line segment.

Meanwhile, the share's projected price-to-earnings ratio for 2020 is at 48.64x which is about 4.1 times of PLDT's and about 3.8 times Globe's projected price-to-earnings ratio. Given this, CNVRG is considered relatively overvalued.

FORECASTS

In Million Php	2017	2018	2019	2020	2021
Revenues	2,940.20	5,054.60	9,139.50	15,444.36	26,847.32
y/y growth	55.2%	71.9%	80.8%	69.0%	73.8%
Gross Income	1,890.30	2,726.10	4,698.80	7,327.16	11,509.87
y/y growth	52.5%	44.2%	72.4%	55.9%	57.1%
Operating Income	1,298.60	1,739.70	2,772.30	4,655.53	7,125.26
y/y growth	121.8%	34.0%	59.4%	67.9%	53.0%
Net Income	1,230.50	1,241.60	1,904.70	2,840.30	3,753.69
y/y growth	114.2%	0.9%	53.4%	49.1%	32.2%

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Rating Definitions:

BUY - More than 15% upside base on the target price in the next 9-12 months

HOLD - 15% or less upside or downside in the next 9-12 months

SELL - More than 15% downside base on the target price in the next 9-12 months

TRADE - A potential 10% and above short-term upside base on entry price and selling price.