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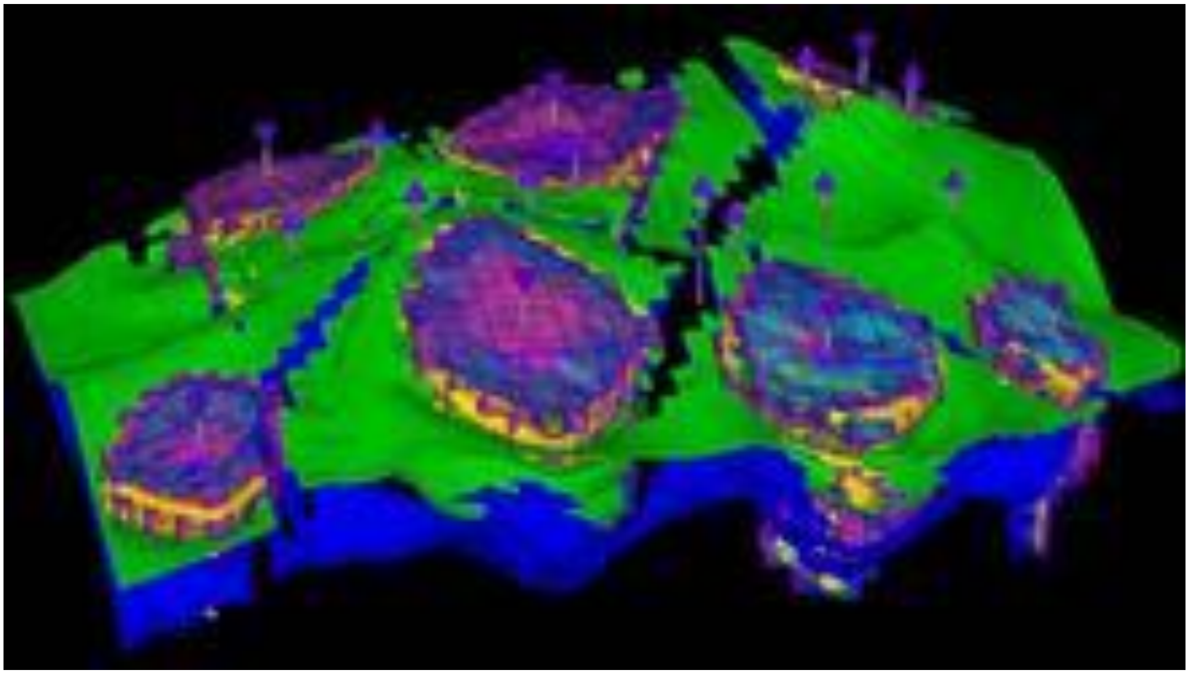

Energy downturn drags high-growth software stock into bargain bin

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The mere association with oil and gas companies has been reason enough for investors to target Computer Modelling Group Ltd. The software company's shares have been battered amid the energy downturn, even outpacing the declines posted by the broader Canadian energy sector.

But Computer Modelling is not an oil company.

"It gets grouped in with more cyclical businesses, but with the high recurring revenue it has, it's going to be a lot more stable," said Don Walker, portfolio manager at Hesperian Capital, which owns shares of the company.

Considering Computer Modelling's mitigated exposure to commodity prices, the recent selloff makes for a compelling entry point into a stock that very rarely goes on sale.

The Calgary-based company is one of the few providers of reservoir simulation software. Oil and gas companies use these products to run production scenarios and maximize recovery.

As the industry has come to rely more on complex extraction methods such as hydraulic fracturing to develop less accessible resources, costs and development time have risen.

That means Computer Modelling is pegged to a high-growth segment, as unconventional drilling becomes more prevalent.

"We continue to like the long-term market opportunity – unconventional oil production represents less than 10 per cent of total production, but accounts for 70 per cent of the world's oil reserves," Industrial Alliance analyst Steve Li said in a recent note.

Additionally, within its small group of competitors, Computer Modelling is a market leader. "They're the go-to guys in terms of any complicated reservoir model," said Jerome Hass, a portfolio manager at Lightwater Partners, which also owns shares of the company. "That's a nice niche to be in."

The key to the company's stability is its revenue model. Licensing its software to oil and gas companies, more than 75 per cent of Computer Modelling's sales are pegged as recurring, Euro Pacific analyst Amr Ezzat said in a note. "This provides for exceptionally high top-line visibility as we estimate customer renewal rates at [more than] 95 per cent," Mr. Ezzat said.

Growth has come fast and steady. Its top line has consistently risen at about 20 per cent a year, its profit by 25 per cent.

"It's a very well-run business, it has about the most revenue visibility in Canada, but you were paying for it," Mr. Walker said. On a near-uninterrupted rise for about 10 years, the stock peaked at $15.74 in May, when its trailing price-to-earnings ratio pushed past 40 times.

An inflated valuation made Computer Modelling vulnerable to profit-taking once a selloff began, Mr. Walker said.

The spark came from the company's first-quarter results, which fell short of expectations despite substantial year-over-year revenue growth. But flat earnings spooked shareholders, Mr. Walker said.

Oil prices peaked the following month, and later dropped off precipitously, which increased concerns over Computer Modelling's ability to maintain high growth.

"When their customers are going through a hard time, it's natural for people to be concerned," Mr. Hass said. "But I don't think we're at the point where people are going to cancel subscriptions because it's such a valuable tool."

Nevertheless, Computer Modelling's stock dropped by 36 per cent over five months, bottoming out at $10.06 in October. Based on forecasted earnings for the company's fiscal year ending March, 2016, the stock now trades at a P/E of about 24.

"The recent pull-back in Computer Modelling's shares represents a rare buying opportunity relative to its historical upward share-price trajectory," BMO Nesbitt Burns analyst Michael Mazar said in a recent note. He rates the stock "outperform" at a price target of $19. The average target among all the analysts covering the stock is $14.56, representing a 36-per-cent premium over Friday's closing price of $10.70.

The current share price is much more attractive for a company with superior growth prospects, Mr. Walker said. "You could probably buy a starter pack in this position, and pick and choose your spots later on as sentiment ebbs and flows."

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