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Why is this 'screaming buy' so heavily shorted?

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CGI Group founder and chairman Serge Godin, left, and chief executive Michael Roach get set to start of the company's annual meeting Wednesday, February 1, 2012 in Montreal. (Ryan Remiorz/THE CANADIAN PRESS)

CGI Group Inc. is a Canadian success story, but it's one of the least popular stocks south of the border – and Obamacare is only part of the tale.

The Montreal-based company is easily Canada's most valuable tech company, with an $11-billion market capitalization that's nearly as large as the next two concerns combined. The provider of computing services to big customers such as governments rose steadily until last fall, when it was revealed that its U.S. division was a major player in creating the error-plagued Obamacare website.

The stock is off its highs, and advocates are calling this a buying opportunity – a "screaming" one, according to least one of its owners, quoted earlier this month in The Globe and Mail.

But while most of the sell-side analysts have rallied around the stock, there are plenty of people on the other side of this trade. And it's worth taking a look at what they're considering.

CGI, which also trades on the NYSE, was easily the most heavily shorted stock on a U.S. exchange at the end of March using a measure called the "days to cover ratio." That compares the number of shares shorted – sold by people betting the stock will fall, and they can profit by buying it later – and comparing it to the stock's normal trading volume.

CGI's 21 million shares sold short wouldn't crack the top 50 on an absolute basis. But it would take 94 days of trading, at its average U.S. daily volume of just under 225,000 shares, to cover that short position. No other stock in the U.S., on the NYSE or Nasdaq, required as many as 70 days.

Now, this particular statistic may exaggerate CGI's disfavour among investors: It came at a time of particularly low volume for the stock on the NYSE. At the same time, CGI shares traded about three times as often on the TSX. Using a different, higher volume number would drive down this days-to-cover ratio to more normal, yet still pessimistic levels.

However, it's worth noting that the absolute number of shares shorted is up by 24 per cent in the two months since we included CGI on a list of heavily shorted Canadian companies in a February column.

This suggests, dare I say, that the healthcare.gov fiasco, which faded from headlines as time passed, may not be the sole explanation of the current pessimism about CGI.

Instead, it may be that questions initially raised about CGI's accounting last year are gaining traction. In August, Vox brought its readers the concerns of analysts at ***Veritas Investment Research*** in a column headlined "CGI: A different view of a tech superstar." ***Veritas*** analyst ***Michael Yerashotis*** raised questions about a number of accounting decisions CGI made as it acquired European company Logica.

Mr. Yerashotis believed CGI would be able to add more than a billion dollars to its reported earnings over the next few years without a corresponding increase to the company's cash position. (To be clear, he is not suggesting the company is violating International Financial Reporting Standards, much less doing anything illegal.)

Since ***Mr. Yerashotis'*** report, analyst Bryan Keane of Deutsche Bank downgraded CGI to a "sell," citing "aggressive accounting [that is] not driving free cash flow." In December, Newsweek reported that noted short-seller James Chanos, who made his reputation by shorting Enron, had taken a large short position in CGI, citing accounting reasons in addition to the Obamacare fallout.

Asked about it today, ***Veritas' Mr. Yerashotis*** says growth in CGI's U.S. government-contracting business is far less significant than progress on the Logica acquisition. "I agree that healthcare.gov drew attention to CGI south of the border, but the accounting issues causing the significant gap between cash flow and earnings are currently the most hotly debated matters among informed investors," he says. "I also believe it is correct to say that weak cash flows post-acquisition have reinforced the negative thesis."

CGI spokesman Lorne Gorber declined to speak at length, given CGI's upcoming earnings report next Wednesday, but reiterated comments from last year: CGI followed accounting standards relevant to companies filing with the U.S. Securities and Exchange Commission; the bulk of the analyst community rejects the accounting criticism; and, over time, the amount of cash the company reports will drive the shares.

If you are indeed a believer in CGI, the current negativity is, in a way, a good thing: When short sellers get it wrong, and companies surprise with positive news, the shorts get "squeezed" into buying the stock to cover their short positions. That sends the shares even higher. If, of course, CGI really is a "screaming buy."