# **Constellation Software Inc.**

#### TO OUR SHAREHOLDERS

As a rule, I prefer to use these letters to write about our business, not our stock. And while I'll start off focusing on the business, I think it is worth devoting some ink to what I think I've learned about managing our stock.

In Table 1, we've updated the Constellation ("CSI") metrics to include the 2011 results. The definitions of Adjusted Net Income, Average Invested Capital, ROIC and Net Revenue appear in the Glossary at the end of this document.

Table 1

	Adjusted Net Income (a.)	Average Invested Capital	ROIC	Organic Net Revenue Growth (YoY)	ROIC + Organic Net Revenue Growth
2001	7	69	10%	b.	b.
2002	2	71	2%	6%	8%
2003	22	83	26%	11%	37%
2004	13	84	15%	9%	24%
2005	17	101	17%	18%	35%
2006	26	123	21%	8%	29%
2007	33	154	22%	1%	23%
2008	54	195	28%	5%	33%
2009	62	256	24%	-3%	21%
2010	84	325	26%	-2%	24%
2011	140	394	36%	7%	43%

- a. Historical figures restated to comply with revised definition.
- b. Not Available

Note: 2010 and 2011 information is presented in accordance with IFRS

2011 saw a very significant increase in Adjusted Net Income compared with 2010. The 68% growth in 2011 Adjusted Net Income far exceeded revenue growth, which was 22% for the year. The rapid growth in Adjusted Net Income was partly a function of the recovering economy: Organic Net Revenue Growth was 7% in 2011 versus -2% in 2010. My sense is that our managers were reticent about adding staff and incremental expense (particularly for long term initiatives) while we were involved in the strategic review process ("Process"), and hence the improved Organic Net Revenue Growth drove improved operating margins. Adjusted Net Income growth also outstripped revenue growth because our investment in acquisitions in 2011 was less than half that in 2010. We tend to have lower operating margins in years when we actively acquire because some of the acquisitions are not very profitable when initially purchased. During the Process our managers were instructed to stop making acquisitions in new verticals. In addition some of the time and attention that might otherwise have been used for acquisitions was diverted into preparing for and responding to potential acquirers of CSI. I anticipate that our acquisition pace will recover somewhat in 2012.

Our Average Invested Capital increased by only 21% during 2011, much lower than our ROIC. The difference is accounted for by the \$2.00/share annual dividend that we paid in 2011. The company has recently adopted a new dividend policy and paid a quarterly dividend of \$1.00 per share immediately

following the end of our first quarter. Because of the new dividend policy, we anticipate that Average Invested Capital will grow at a much lower rate in the coming decade, than it has in the past.

ROIC in 2011 was 36%. I believe that the Process created a focus on short-term profitability that detracted from our investment in long-term initiatives and from acquisitions that would generate attractive (but sub 36%) ROIC's. I expect to see our ROIC decrease in the coming decade as margins moderate and we deploy more capital.

Organic Net Revenue Growth recovered to 7% in 2011. I believe that this was a post-recession bounce. We don't expect organic growth to continue at this pace over an extended period.

We use the sum of ROIC and Organic Net Revenue Growth as the best single metric for measuring the short-term performance of our low asset intensity software businesses. For 2011, CSI's ROIC plus Organic Net Revenue Growth was 43%, a spectacular performance that we would be hard pressed and illadvised to try to repeat.

When short term results (such as our 68% growth in 2011 Adjusted Net Income) seem unusually good, it is worth examining other measures of intrinsic value that are not as subject to short-term swings. In Table 2, you can see that CSI's Maintenance Revenue grew 24% in 2011, slower than in most prior years. If you believe that intrinsic value is closely correlated with Maintenance Revenue, and factor in our unchanging share count, then arguably CSI's value per share incremented very satisfactorily... though perhaps not at the pace that our Adjusted Net Income growth would suggest.

Table 2

	2006	2007	2008	2009	2010	2011
Maintenance Revenue (US\$MM)	116	142	193	252	340	422
Growth from:						
Acquisitions	17%	11%	24%	27%	28%	15%
Organic Sources						
a) New maintenance	15%	10%	10%	8%	8%	8%
b) Price increases	5%	8%	9%	3%	6%	6%
c) Attrition - Lost Modules	-2%	-2%	-3%	-3%	-3%	-2%
d) Attrition - Lost Customers	-4%	-4%	-4%	-4%	-4%	-3%
Total Organic Growth	14%	12%	12%	4%	7%	9%
Total Maintenance Growth	31%	23%	36%	31%	35%	24%

Growth in Maintenance Revenue due to acquisitions slowed to 15% in 2011 and is expected to slow further in 2012 due to the unusually low amount of our acquisition investment in the last half of 2011. Longer term, we will be satisfied if the company generates 10% Maintenance Revenue growth from acquisitions, though it is conceivable we could exceed this number if we succeed in improving the efficiency of our acquisition process.

The organic growth in Maintenance Revenues edged up to 9% in 2011. We were particularly pleased to see customer attrition decrease to 5.5% in 2011 from 6.7% the previous year. One note of caution with regard to the organic and acquired Maintenance Revenue growth numbers... while the analysis in Table 2 foots to our reported Maintenance Revenue for financial reporting purposes, the individual components reflected in this table are generated by examining and categorising thousands of records. This analysis isn't perfect, but I believe it is a fair illustration of the trends in our maintenance base and, ultimately, the trends underlying the intrinsic value of our business.

A couple of years ago we added some GAAP/IFRS metrics to our regular letters to shareholders, which we've updated in Table 3.

In 2011, revenue per share increased 22% and cash flow from operating activities per share increased 28%. The growth in cash flow from operating activities cannot outpace revenues ad infinitum. I expect these two growth rates to track each other more closely in the future.

Having had the chance to review the tables, I hope you'll join me in thanking the CSI employees for a wonderful decade. It is a rare company that consistently increases its per share financial fundamentals by 25% or more for such an extended period.

Table 3

	Total Revenue per Share		Cash Flow from	Total Share Count	
		YoY △		YoY △	
2000	3.00		0.06		19,439
2001	2.95	-2%	0.48	729%	19,284
2002	3.22	9%	0.43	-11%	19,342
2003	4.16	29%	0.74	72%	19,428
2004	5.49	32%	0.59	-20%	19,891
2005	8.11	48%	1.21	106%	20,392
2006	10.01	23%	1.36	12%	21,065
2007	11.47	15%	1.62	19%	21,192
2008	15.60	36%	2.96	83%	21,192
2009	20.67	32%	3.85	30%	21,192
2010	29.92	45%	5.06	32%	21,192
2011	36.49	_22%	6.49	28%	21,192
CAGR *		25%	_	30%	

<sup>\*</sup> Cash flow CAGR calculated from 2001. It is 53% if calculated from 2000.

Note: 2010 and 2011 information is presented in accordance with IFRS

Moving on to the "manage the stock versus manage the company" issue... I used to maintain that if we concentrated on fundamentals, then our stock price would take care of itself. The events of the last year have forced me to re-think that contention. I'm coming around to the belief that if our stock price strays too far (either high or low) from intrinsic value, then the business may suffer: Too low, and we may end up with the barbarians at the gate; too high, and we may lose previously loyal shareholders and shareholder-employees to more attractive opportunities.

In previous letters (for instance, the 2008 letter to shareholders), I've talked about how important long-term oriented employees, customers and shareholders are to both our strategy and organisational design. A long-term orientation requires a high degree of mutual trust between the company and all of its constituents.

We trust our managers and employees and hence try to encumber them with as little bureaucracy as possible. We encourage our managers to launch initiatives, which in our industry, often require 5 to 10 years to generate payback. We are comfortable providing them with capital to purchase businesses that won't be immediately accretive, but that have the potential to be long-term franchises for CSI. We nearly

always promote from within because mutual trust and loyalty take years to build, and conversely, newly hired smart and/or manipulative mercenaries can take years to identify and root out. We incent managers and employees with shares (escrowed for 3-5 years) so that they are economically aligned with shareholders. In return we need and want loyal employees... if they aren't planning to be around for 5 years, then they aren't going to care much about the outcome of multi-year initiatives, and they certainly aren't going to forego short-term bonuses for long-term profits.

When a company is put on the block, employees worry, and trust erodes. It isn't hard to imagine their concerns: Will the current long-term oriented compensation plans be changed? Will independence be constrained? Will their boss be fired? Will they have to fire some mandated percentage of their long-term employees? Should they embark on attractive initiatives which will lose money in the short-term? Why do major shareholders want to sell and is there something daunting in the future that the major shareholders see?

Customers rely on us to provide them with the tools to keep their businesses operating efficiently and adapt their information systems to evolving best practices within their industry. They also begin to question their relationships with the company when a potential sale is announced: Will pricing change? Do they need stronger agreements to protect themselves? Will they be dealing with different employees? Will the company have significant debt if it is sold? Will the company continue to invest in its solutions?

And long-term shareholders begin to question their commitment to the company: Is the board exploring a sale because they are concerned about the long-term prospects for the company? Has the company been "optimised", and hence should shareholders sell now before the fundamentals plateau?

Our employees, customers and long-term shareholders endured 9 months of these Process related uncertainties last year. There's no doubt in my mind that the Process hurt the company's prospects. However, the ironic and perverse result of the Process, was that our short-term profits improved, acquisition investment slowed, cash piled up and the board was able to institute significant dividends, all of which seems to have contributed to a greater than 70% increase in our stock price over the last 16 months. The stock price increase effectively scuttled the chances of selling the entire company to a financial buyer, while at the same time allowing our two major shareholders to sell some shares at prices which they felt were closer to intrinsic value.

When we announced the Process, I asked a number of our sophisticated long term shareholders (other than the two major shareholders) for their estimate of the intrinsic value of the company. I was surprised by their answers (they seemed high to me), but assumed that they were just trying to put a high sticker price on the company in the event of a sale. During the course of the ensuing year these investors have significantly increased their stake in CSI at ever-increasing prices. This vote of confidence achieved two things: Firstly, it made me accept that the company was likely undervalued when the Process started. It also convinced me that we have the nucleus of a group of competent long-term oriented shareholders who can provide the stable ownership which will allow us to prosper. A respected investor told me, "You end up with the shareholders you deserve". I'm hoping that's true.

There is a nuance to "stock price management" that may be unusually important to CSI. For nearly all companies, when their stock price gets too low, there is the potential for a "Process", and obviously we are no different. However, when CSI's stock price gets too high, I think we have the potential to lose our most valuable cohort - our senior managers. Most of these employees have been with us for many years. Most of them started out as operators. They've refined their operating chops, learning best practices from their peers and from their own experiments. As vertical market software business operators, I'd say they are amongst the most talented available (and I'm uniquely qualified to be a connoisseur of such talent). They also have another skill, one that is incredibly rare: they respect and know how to deploy capital to

generate high rates of return. Glancing at our ROIC+Organic Growth stats, it is evident that our senior managers consistently generate rates of return in excess of 25% on the capital that they deploy. As investors you'll know that this is wildly difficult to achieve. How do we keep these multi-talented managers? Hopefully we provide an environment that is fulfilling, colleagues that are both challenging and entertaining, and work that is meaningful. We also pay them well. They are all millionaires many times over, with much of their net worth invested in unescrowed CSI shares. If they don't think that CSI shares will generate high rates of return, they need only sell their shares and use their unique skills to deploy and manage their capital. And because the average business that we buy costs something less than \$3MM, nearly all of these managers could be in business for themselves very quickly.

I've always tried to avoid having CSI's shares trade at too high a price. Many members of the board were conscious of the opposite problem. I think we all now acknowledge the importance of managing our stock into a price range where we neither invite another Process, nor encourage our employee shareholders and long-term investors to liquidate their holdings. I don't think it will be difficult to keep our stock price marching in lock-step with the intrinsic value of our company. The board and I just have to be conscious of doing so.

We will be hosting the annual general meeting on Thursday May 3rd. Many of our Directors and Officers and a number of our senior managers will be in attendance. We look forward to talking about our business and answering your questions. With our increasingly broad institutional and retail ownership, I'm hoping for a record turnout. I hope to see you there.

Mark Leonard President Constellation Software Inc. May 2<sup>nd</sup> 2012

# Glossary

Effective Q1 2008, the term "Adjusted Net Income" is derived by adjusting GAAP or IFRS net income for the non-cash amortization of intangibles, future income taxes, and charges related to appreciation in common shares eligible for redemption (a charge that we no longer incur now that CSI's common shares are publicly traded). Prior to Q1 2008, Adjusted Net Income was derived by adjusting GAAP net income for the non-cash amortization of intangibles and charges related to appreciation in common shares eligible for redemption. The computation was changed to include future income taxes since the majority of future income taxes relate to the amortization of intangible assets, and thus are being added back to more closely match the non-cash future tax recovery with the amortization of intangibles. All previously reported Adjusted Net Income figures have been restated in the table above to reflect the new method of computations. We use Adjusted Net Income because it is generally a better measure of cash flow than GAAP or IFRS net income and it is closely aligned with the calculation of net income that we use for bonus purposes.

"Average Invested Capital" is based on the Company's estimate of the amount of money that our shareholders had invested in CSI. Subsequent to that estimate, each period we have kept a running tally, adding Adjusted Net Income, subtracting any dividends, adding any amounts related to share issuances and making some small adjustments, including adjustments relating to our use of certain incentive programs and the amortization of impaired intangibles.

"ROIC" represents a ratio of Adjusted Net Income to Average Invested Capital.

"Net Revenue". Net Revenue is gross revenue for GAAP or IFRS purposes less any third party and flow-through expenses. We use Net Revenue since it captures 100% of the license, maintenance and services revenues associated with CSI's own products, but only the margin on the lower value-added revenues such as commodity hardware or third party software.

#### Forward Looking Statements

Certain statements herein may be "forward looking" statements that involve known and unknown risks, uncertainties and other factors that may cause the actual results, performance or achievements of CSI or the industry to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. These statements reflect current assumptions and expectations regarding future events and operating performance and speak only as of the date hereof. Forward looking statements involve significant risks and uncertainties, should not be read as guarantees of future performance or results, and will not necessarily be accurate indications of whether or not such results will be achieved. A number of factors could cause actual results to vary significantly from the results discussed in the forward looking statements. These forward looking statements are made as of the date hereof and CSI assumes no obligation to update any forward looking statements to reflect new events or circumstances except as required by law.

### Non-GAAP/IFRS Measures

Adjusted Net Income, Adjusted EBITDA and Organic Revenue Growth are not recognized measures under GAAP or IFRS and, accordingly, shareholders are cautioned that Adjusted Net Income Adjusted EBITDA and Organic Revenue Growth should not be construed as alternatives to net income determined in accordance with GAAP or IFRS as an indicator of the financial performance of the Company or as a measure of the Company's liquidity and cash flows. The Company's method of calculating Adjusted Net Income, Adjusted EBITDA and Organic Revenue Growth may differ from other issuers and, accordingly, may not be comparable to similar measures presented by other issuers. Please refer to CSI's most recently filed Management's Discussion and Analysis for reconciliation, where applicable, between the IFRS, GAAP and non-GAAP/IFRS measures referred to above.