

# Constellation Software Inc.

## TO OUR SHAREHOLDERS

Table 1 contains non-IFRS metrics for Constellation Software Inc. (“CSI”). The definitions for these metrics appear in the Glossary at the end of this document. Unless otherwise indicated, all dollar amounts are expressed in millions of U.S. dollars. Several of the statements included below constitute forward looking statements and should not be read as guarantees of future results. See “Forward Looking Statements”.

Table 1

	Adjusted Net Income (a)	Average Invested Capital	ROIC	Organic Net Revenue Growth (YoY)	ROIC + Organic Net Revenue Growth
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 (b)	84	325	26%	-2%	24%
2011	140	394	36%	7%	43%
2012	172	491	35%	2%	37%
2013	207	585	35%	4%	39%
2014	274	739	37%	3%	40%

(a) Historical figures restated to comply with revised definition.

(b) 2010 and subsequent year information is presented in accordance with IFRS

Adjusted Net Income (“ANI”) increased 32% in 2014, and average ANI growth per share over the last five years has been 36%. This is an impressive but unmaintainable performance. The ubiquitous “*Past performance is no guarantee of future results*” disclaimer really does apply in this instance.

Our shareholders’ Average Invested Capital grew 26% in 2014. This, in conjunction with a slower acquisition pace, allowed us to reduce our overall debt from \$477 million on Dec. 31, 2013 to \$295 million on Dec. 31, 2014. I am not comfortable using short term debt or long-term debt with highly restrictive covenants to finance the parent company.

2014 ROIC, at 37%, was the highest we’ve ever achieved. In a well-managed, organically growing vertical market software business, less tangible assets tend to be required over time, hence you would expect to see increasing ROIC’s. In CSI’s case, there are a couple of countervailing factors: Our cash tax rates are likely to increase over the next few years, and we are willing to make acquisitions that generate IRR’s that are much lower than 37%. Even if new acquisitions track according to plan, they will nearly always depress our overall ROIC to some degree. If we are successful in deploying large amounts of capital, ROIC could drop sharply for a time.

CSI’s Organic Net Revenue Growth was 3% in 2014, below our long-term average but better than GNP growth. We’d like our Organic Net Revenue Growth to be higher.

We achieved a very high combined ratio (the sum of ROIC and Organic Net Revenue Growth) of 40% in 2014. If we had to pick a single metric to reflect the growth in the intrinsic value of our businesses, this is the one that we'd choose.

Table 2 parses our Total Maintenance Revenue Growth into organic and acquired, and further divides the organic growth into its components. We made a very large acquisition (TSS) in late 2013, which contributed to another year of rapid (40%) Total Maintenance Growth in 2014. One very important caveat about Maintenance Revenue as presented below: it is a gross number... i.e. it is not net of third party costs. For instance, if we have a business which incorporates third party databases or development tools and/or utilises third party hosting, the Net Maintenance Revenue received by CSI may be far less than the gross.

Maintenance Revenue growth due to acquisitions was 33% in 2014. Based upon the acquisitions that we completed in 2014 and those done year to date in 2015, we anticipate far slower acquired Maintenance Revenue growth in 2015.

Table 2

	2006	2007	2008	2009	2010	2011	2012	2013	2014
<b>Maintenance Revenue (US\$MM)</b>	<b>116</b>	<b>148</b>	<b>193</b>	<b>252</b>	<b>337</b>	<b>417</b>	<b>510</b>	<b>725</b>	<b>1015</b>
<b>Growth from:</b>									
Acquisitions	17%	11%	21%	27%	26%	15%	15%	34%	33%
Organic Sources									
a) New Maintenance	15%	9%	9%	7%	8%	8%	8%	10%	10%
b) Price Increases & Other	5%	8%	8%	3%	6%	6%	5%	5%	5%
c) Attrition - Lost Modules	-2%	-2%	-3%	-3%	-3%	-2%	-2%	-2%	-3%
d) Attrition - Lost Customers	-4%	-4%	-4%	-4%	-4%	-3%	-4%	-5%	-5%
Total Organic Growth	14%	11%	10%	3%	8%	9%	7%	8%	7%
Total Maintenance Growth	31%	23%	31%	31%	34%	24%	22%	42%	40%

The Total Organic Growth in Maintenance Revenue was 7% in 2014. Lost module attrition nearly doubled in 2014, primarily due to newer acquisitions.

SaaS revenues are becoming increasingly important to us: Our 17 "SaaS'y" businesses (those where SaaS revenues are over half of total revenues and where our customers do not host their own applications) now constitute 13% of Maintenance Revenues. This is up from less than 1% of Maintenance Revenues five years ago. In addition, most of our traditional (i.e. non-SaaS'y) businesses have some SaaS offerings of add-on or core products, so I'd guess that SaaS revenues overall are now almost one fifth of our total Maintenance Revenues. The SaaS'y businesses also have higher organic growth rates in recurring revenues than do our traditional businesses. Unfortunately, our SaaS'y businesses have higher average attrition, lower profitability and require a far higher percentage of new name client acquisition per annum to maintain their revenues. We continue to buy and invest in SaaS businesses and products. We'll either learn to run them better, or they will prove to be less financially attractive than our traditional businesses - I expect the former, but suspect that the latter will also prove to be true.

A note of caution with regard to the organic and acquired Maintenance Revenue growth numbers... while the totals in Table 2 are materially the same as our Maintenance Revenue for financial reporting purposes, the individual components reflected in this table are generated by examining and categorising tens of thousands of records. The complexity of the analysis is compounded by the movements in foreign exchange and transactional revenues (which are currently categorised in "Price Increases & Other"). We are working

to improve the accuracy of the underlying data so that we can better manage this critically important part of our business. For the time being, we believe that the data presented is a fair illustration of the trends in our maintenance base.

Table 3 contains some metrics that we started to present a few years ago in response to a request for GAAP/IFRS information.

In 2014, revenue per share increased 38% and Cash Flow from Operating Activities per Share (“CFO/Shr”) increased 55%. We don’t aspire to grow revenue per share at this sort of rate in the future nor do we think that the growth in CFO/Shr will be able to consistently outpace revenue per share.

Table 3

	Total Revenue		Cash Flow from Operating Activities		Total Share Count
	per Share	YoY Δ	per Share	YoY Δ	(000's)
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
2012	42.05	15%	6.83	5%	21,192
2013	57.13	36%	10.40	52%	21,192
2014	78.77	38%	16.11	55%	21,192
CAGR		31%		39%	

Note: 2010 and subsequent year information is presented in accordance with IFRS

We hope that shareholders are as proud of our last decade’s performance as we are.

A quick observation before we leave the discussion of Maintenance Revenues and cash flows. In assessing CSI’s value, it is tempting to look at cash flows after tax, interest and capex as the “real” return on shareholders’ capital. However, you should only do that if you can convince yourself that the underlying (mostly intangible) assets of our businesses are not deteriorating. The analysis of Maintenance Revenues in Table 2 is designed to give you some tools to assess the health of those intangible assets. If Maintenance Revenue continues to grow organically, there’s reason to believe that our intangible assets are not deteriorating. A nice byproduct of isolating the Organic Growth in Maintenance Revenue, is that you can also see how much Maintenance Revenue has been acquired and compare that to the amount spent on acquisitions.

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Last year I asked the board to reduce my salary to zero and to lower my bonus factor. CSI had a great year, so despite those modifications, my total compensation actually increased. This year I’ll take no salary, no incentive compensation, and I am no longer charging any expenses to the company.

I’ve been the President of CSI for its first 20 years. I have waived all compensation because I don’t want to work as hard in the future as I did during the last 20 years. Cutting my compensation will allow me to lead a more balanced life, with a less oppressive sense of personal obligation. I’m paying my own expenses for

a different reason. I've traditionally travelled on economy tickets and stayed at modest hotels because I wasn't happy freeloading on the CSI shareholders and I wanted to set a good example for the thousands of CSI employees who travel every month. I'm getting older and wealthier and find that I'm willing to trade more of my own cash for comfort, convenience, and speed ... so I'm afraid you'll mostly see me in the front of the plane from here on out.

I love what I'm doing, and don't want to stop unless my health deteriorates or the board figures it's time for me to go. We have an impressive board. I trust them to determine when I'm no longer adding value as the senior executive in the company.

I recognise that some of our directors, shareholders and employees have, or are going to have, misgivings about this arrangement. I'm still planning to do the work that I've always done: acquisitions, monitoring, best practice development, investor relations and financing. I'm just not going to do the weekends, all-nighters and a constant grind of 60 hour plus weeks that characterised my earlier career. Keep in mind that CSI has an unconventional organisational structure, and we seem to have prospered to date without a lot of centralised command and control. While I may not be travelling as much as before nor putting in as many hours, CSI has lots of seasoned and accomplished managers at the Operating Group level who have become far better coaches, culture bearers, and hypothesis generators than I ever was.

One of the results of this compensation change is that I get to side-step the agent-principal problem. My compensation for being president is now tied solely to my current ownership of CSI shares. In essence, I'm your partner in CSI, not your employee. I like the feel of the partner relationship a whole lot better.

I'm currently campaigning for a couple of changes in emphasis at CSI, and I'm hoping that my new "partner" status will lend me increased credibility as I make the case for those changes.

First, I'd like CSI to experiment with modifying its employee bonus program. The idea is to make any such changes totally optional from the employee's perspective, so that there is no loss of trust. My experience with long-term compensation programs is that they require many years of consistent application before employees believe in them enough to make the short-term / long-term trade-offs necessary in the software business. The objective of the compensation plan changes will be to allow our newest generation of employees to build wealth more quickly. In a zero sum game, whatever incremental compensation we deliver to these employees will come out of the hides of shareholders, mine included. The trick, of course, is to make sure that we aren't operating in a zero sum environment. There's reticence in the organisation about "fixing" an existing bonus program that isn't obviously broken. I'm trying to convince our managers and directors that pre-emptive change is worthwhile.

Second, I'd like to over-capitalise the company with reliable capital. We've had poor results with this tactic historically. In 1999, we raised a \$60 million second round of equity capital. We didn't end up using the capital for several years, and eventually our investors insisted on a special dividend to return some of it. The good news was that we maintained our investment discipline despite holding "excess cash" for many years and we acquired a second institutional investor to help balance out our shareholder group. The bad news was that our employee shareholders suffered more dilution than was necessary. Why is a historically bad idea worth trying a second time? Currently, we're using debentures to build our long term capital. The debentures are less costly than our second round equity financing, and they will only be a net cost to shareholders if CSI is unable to deploy the capital at attractive returns in a reasonable time-frame. Our confidence is growing that we can compete effectively with Private Equity firms for larger vertical market software company acquisitions. This feels like a much bigger opportunity for capital deployment than the market in which we've historically played, and is not a market where we can finance the "equity" portion of transactions from our revolver. Of course, what may appear to be prudent funding when it leads to excess

cash of \$100 million, may appear to be foolhardy funding if it has \$1 billion floating around in our coffers. And therein lie the seeds of debates that I'm sure our board will be having for years to come.

While we are on the capital raising topic, Jamal has presented our lead bank with a draft agreement for a new revolving line of credit that is more reliable: one with less restrictive covenants, and with room and flexibility enough to allow us to buy significant businesses (or pieces of businesses) during a recession. We are hopeful that our existing banks and perhaps some new ones will find the proposal attractive.

Shareholders sometimes ask why we don't pursue economies of scale by centralising functions such as Research & Development and Sales & Marketing. My personal preference is to instead focus on keeping our business units small, and the majority of the decision making down at the business unit level. Partly this is a function of my experience with small high performance teams when I was a venture capitalist, and partly it is a function of seeing that most vertical markets have several viable competitors who exhibit little correlation between their profitability and relative scale. Some of our Operating Group GM's agree with me, while others are less convinced. There are a number of implications if you share my view: We should a) regularly divide our largest business units into smaller, more focused business units unless there is an overwhelmingly obvious reason to keep them whole, b) operate the majority of the businesses that we acquire as separate units rather than merge them with existing CSI businesses, and c) drive down cost at the head office and Operating Group level.

I find that some of our shareholders confuse CSI's strategy with that of our business units. While there are terrific moats around our individual business units, the barrier to starting a "conglomerate of vertical market software businesses" is pretty much a cheque book and a telephone. Nevertheless, CSI does have a compelling asset that is difficult to both replicate and maintain: We have 199 separately tracked business units and an open, collegial, and analytical culture. This provides us with a large group of businesses on which to test hypotheses, a ready source of ideas to test, and a receptive audience who can benefit from their application. More quickly and cheaply than any company that I know, we can figure out if a new business process works. This sort of ad hoc experimentation doesn't require enormous systems or the peddling of a new dogma to the unreceptive. It requires curious managers at a few dozen business units and a couple of clever analysts to plausibly test if a process works. Once a new best practice starts working within CSI, wide access to benchmarking information tends to rapidly breed emulation. We've found a few other examples of high performance conglomerates built around the idea of continuously refining their business processes and then driving ever more acquired businesses up their business process learning curve as quickly as possible.

When CSI was much smaller, we used to run annual offsite meetings. Working on the curriculum for one of the offsites, I asked our academic advisor about game theory. He said "tit-for-tat, that's pretty much all you need to know". That clever but unsatisfying explanation eventually led me to the book and article that I'm recommending this year - [The Evolution of Cooperation](#) by Robert Axelrod, and a related journal article<sup>1</sup> (jointly, "EoC"). EoC is a short and accessible introduction to the prisoner's dilemma game. Google Scholar has 28,000 scientific citations for the original EoC article in the journal *Science*, so I'm not going out on much of a limb by recommending it. Despite that, it doesn't seem to get much coverage in the business press.

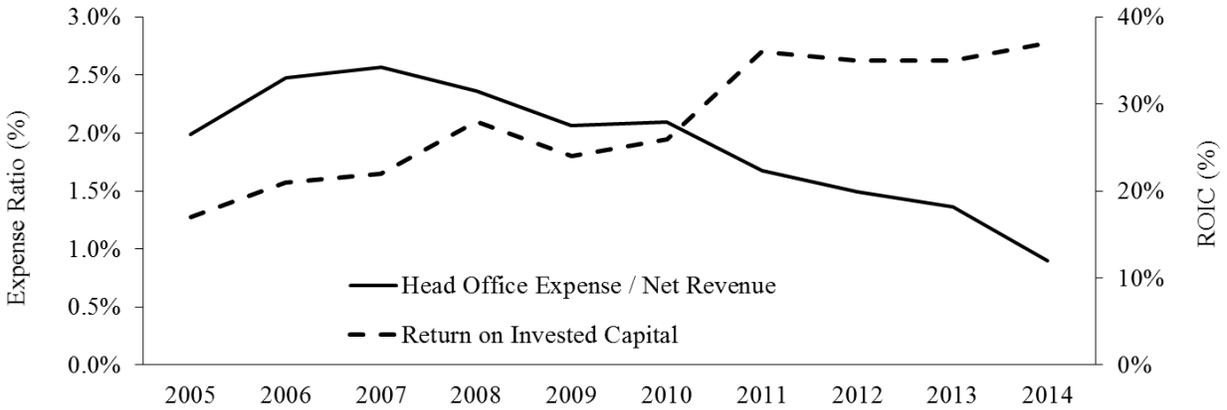
EoC has provided me with models for thinking about a number of business problems. Perhaps the best way to illustrate that the sort of reciprocal trust advocated by Axelrod can be profitably applied in a business, is

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<sup>1</sup> "Launching The Evolution of Cooperation": Axelrod, *Journal of Theoretical Biology* April 2011

to look at some statistics from CSI's history. In Chart 1, you'll see that our head office expense as a percent of Net Revenues has halved from 1.9% in 2005 to 0.9% in 2014 while ROIC has increased from 17% to 37%. Clearly trust trumped central bureaucracy in our case.

Chart 1



If you ask me about “hierarchical bullies” at our Annual General Meeting, I’ll be happy to give you another example of how EoC helped clarify my thinking in a practical application at CSI.

We will be hosting the annual general meeting on Thursday, April 30<sup>th</sup>. Many of our Directors and Officers and a number of our employee shareholders will be in attendance. We look forward to talking about our business and answering your questions. We hope to see you there.

Mark Leonard  
President  
Constellation Software Inc.

April 6<sup>th</sup>, 2015

## 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” 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. “Maintenance Revenue” primarily consists of fees charged for customer support on our software products post-delivery and also includes, to a lesser extent, recurring fees derived from software as a service, subscriptions, combined software/support contracts, transaction-related revenues, and hosted products.

## Forward Looking Statements

Certain statements in this letter may contain “forward looking” statements that involve risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Company or industry to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Words such as “may”, “will”, “expect”, “believe”, “plan”, “intend”, “should”, “anticipate” and other similar terminology are intended to identify forward looking statements. These statements reflect current assumptions and expectations regarding future events and operating performance as of the date of this letter. 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. Although the forward looking statements contained in this letter are based upon what management of the Company believes are reasonable assumptions, the Company cannot assure investors that actual results will be consistent with these forward looking statements. These forward looking statements are made as of the date of this letter and the Company assumes no obligation, except as required by law, to update any forward looking statements to reflect new events or circumstances. This report should be viewed in conjunction with the Company’s other publicly available filings, copies of which can be obtained electronically on SEDAR at [www.sedar.com](http://www.sedar.com).

### Non-GAAP/IFRS Measures

Adjusted net income and Organic Net Revenue Growth are not recognized measures under GAAP or IFRS and, accordingly, shareholders are cautioned that Adjusted net income and Organic Net 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 and Organic Net 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.