

Constellation Software Inc. - Chief Financial Officer at Constellation Software

Interview conducted on April 06, 2022

Tegus and Constellation Software have partnered to compile a primer of commonly asked questions on the business. All questions are answered by Jamal Baksh, Constellation Software's Chief Financial Officer.

This call is a one-on-one conversation with a company's management team, facilitated as part of Tegus' corporate access program. The contents have been reviewed by the company and any material information is publicly available. A version of this transcript can also be found on the firm's investor relations website.

Tegus

Jamal, thank you for taking the time today. If we just dive in, can you start out by giving us a 3 to 4-minute overview of Constellation Software, how the business is organized, the size of the business, the end markets that you serve, and how you grow?

Chief Financial Officer at Constellation Software

Constellation is an acquirer of vertical market software companies that provide mission-critical solutions to the customers that utilize our software. We manage, build and grow these businesses and never sell. Our goal is to generate a rate of return on each of these investments at or above our hurdle rates.

We operate in over 100 different verticals. Our largest verticals are transit and health care. But even those verticals can be subdivided so there's no one business unit within Constellation that is material to the company.

The corporate structure has evolved and scaled over time. For the first 10 years of Constellation, most of the activity around M&A was done from the head office. The team would go out and source companies to buy. Once acquired, the team would understand the operations, learn ways to improve operations and take these best practices and share them across the businesses.

During the first 10 years, the team made 6 larger platform acquisitions and these individuals reported directly into head office. We soon realized that we couldn't manage the portfolio of businesses from head office and that the universe of VMS software companies was much, much greater than we had originally anticipated.

So the firm pushed down some of the responsibility of M&A sourcing to the individuals that we refer to as operating group heads. Head office retained the authority to approve any of the acquisitions that were made. Over the next 10 years, each of the operating groups started to make acquisitions and became very proficient in doing that. Eventually, we decided to let the operating group heads approve M&A transactions up to \$20 million.

Today almost everything that we're buying can be approved by the operating group heads. The 6 operating groups have become conglomerates of vertical market software companies, or essentially mini-CSI's.

These groups are now getting to a size where they can't do all of the M&A from their respective head offices so they are pushing down that responsibility to the portfolio managers that are reporting to the operating group managers. The same way that head office originally retained the authority to approve acquisitions, the operating group heads retain the authority to approve most of these acquisitions. Over time that will likely change and you will have something like 50 mini-CSI's. That is how we have scaled and are able to continue to deploy more and more capital.

Tegus

Capital allocation is such a core competency to the organization, as you just described. You talked about one of the guardrails, which is a certain dollar amount that folks can approve acquisitions below. But what are some of the other heuristics or guardrails that you think about as you think about building an organization where capital allocation is such a core competency?

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Chief Financial Officer at Constellation Software

We are a very metric-driven organization. There are core metrics around the core departments of the organization as well as other metrics, like growth rates and how different cohorts are doing versus other cohorts.

We have base rates around all the businesses that we have acquired. When a team is putting together a forecast for a potential acquisition and modeling out cash flows from the business, we can overlay those forecasts against a subset of CSI-owned companies that may have similar characteristics to the target business.

This allows us to get comfortable around forecasts for a potential acquisition. And hence, our ability to achieve the returns that we say we're going to achieve is quite high.

Tegus

Great. So once you make this acquisition or these many, many acquisitions, what happens with the teams? How do you integrate them? What's the model of how you work with so many businesses across the holding company?

Chief Financial Officer at Constellation Software

Back in the day, it was head office working with these teams. Now it's portfolio managers working with these teams. Our mantra is all about decentralization and autonomy.

However, there is an expectation that the businesses we acquire apply the best practices that we have learned over the years. The level of involvement from current CSI employees with a new management team will depend on the complexity of the needed changes.

For example, we acquired TSS back in late 2013. It was a large, organization with a sophisticated management team. Head office and the operating group managers were the de-facto integration managers that worked directly with TSS to describe CSI's best practices. If we are buying a very small \$2 million karate club software business, then it's probably going to take a single integration manager from a small and related business unit.

Tegus

As you think about the major drivers of the business, sure, there's acquisition, there's also a real free cash flow growth story over time with margin expansion, how do you think about the next 5 years, how you focus on different levers for growth, how those might be different than what you focused on in the past?

Chief Financial Officer at Constellation Software

We have always had a focus on organic growth. Our maintenance organic growth number has been pretty stable at 4% for years and, prior to that, was around 5%.

It declined when we made a large investment in the U.S. health care space. And we knew that those businesses would have negative organic growth. And they continue to have about 100 basis point negative impact on CSI.

Maintenance organic growth has been very stable. We'd like it to be higher but I don't know what the maximum long-term organic growth rate could be considering how diversified we are. There are always going to be verticals that are negatively impacted by the environment like the housing crisis or COVID. I would expect organic growth to sort of stay around that 4%, 5% on the maintenance side, while on the license and professional services side organic growth could be quite lumpy.

We have started a vertical market software venture capital fund. I think some people misunderstand its objective. We are hoping that it will catalyze some larger organic growth initiative investments at CSI.

VMS Ventures will only invest if it foresees funding a business with at least a \$10 million per annum revenue potential. The majority of the business units within Constellation are smaller than this. If you are a CSI employee and you come up with an idea for a new initiative that can create a \$10 million opportunity, and you are operating within a business that has less than \$10 million in revenues, it would be very detrimental to your business' bonus pool in the early years of the initiative. This is because we bonus business unit employees on the return on invested capital and then get a "growth kicker" for the business

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that they're a part of. Under the current plan, if ROIC does not exceed 5%, then growth has no impact.

With VMS Ventures, if an entrepreneur in a smaller business unit comes up with a larger idea, we can take it either partly or entirely out of the current business and fund it through VMS Ventures. The entrepreneurs and the sponsoring business unit receive equity in the initiative and, if the business takes off and is successful, their equity investment could be very valuable. It's a different compensation model than the current CSI bonus plan.

Tegus

Really great insight, thanks. You talked, as part of that, about how management is incentivized based on growth and return on invested capital. How would you describe the culture of Constellation broadly, especially given that the business is so decentralized?

Chief Financial Officer at Constellation Software

We are a conglomerate over 1,000 business units and we do allow these businesses to run autonomously. There is no one culture across Constellation. But the common thread across the organization would be that desire for autonomy and the appreciation of our decentralized model.

Tegus

You're really unique in that you don't have stock-based compensation. Can you talk more about the philosophy behind that?

Chief Financial Officer at Constellation Software

There's a couple of reasons. One, we designed our plan so that the full expense of any compensation flows through the P&L. We don't like stock options as the P&L impact is not reflective of what the true expenses are. We also want people focused long term. We don't want employees focused on driving up the price of the stock so that options can be in the money.

We pay bonuses based on growth and return on invested capital, but there's a large component that gets withheld. We take that cash and we buy shares in the open market in an employee's name and he or she is restricted from selling the shares for an average of 4 years. We have 6,000 - 7,000 employee shareholders now so we still have the benefit of employees being actual shareholders.

Tegus

Yes. If we turn back to growth, one thing that Mark's talked about in his 2021 shareholder letter was that you're evaluating areas beyond vertical market software. What's been the driver of that? Can you speak more to what areas may be attractive?

Chief Financial Officer at Constellation Software

We were sitting on a lot of cash at the beginning of 2020. We had a pipeline of acquisitions and we didn't believe we could deploy all the capital, so we decided to return it to shareholders. We did a special dividend of around \$500 million.

Our shareholders don't want us to return capital as they'd much rather we invest it. We knew we had a couple of other levers to pull. One was lowering the hurdle rate for larger-size acquisitions and the other was deploying capital outside of VMS. So we decided that before we return capital again let's put a concerted effort into these two other initiatives.

We did lower the hurdle rate on larger acquisitions, ones with an equity check greater than \$100 million. I believe we have dropped it as low as we're willing to go. Mark also started to put some effort around investing outside of VMS.

In terms of where or will we be able to invest outside of VMS, I'd just say it's going to be extremely difficult to find an area where we can invest large amounts of capital outside of vertical market software.

I tell investors, I would not factor that into any modeling that you're doing for the company. Some of our team put some effort

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in and I can't disclose what they were, but there were a couple of ideas that came up, and we followed through on it and they didn't end up coming to fruition. I would say, it's going to be difficult to try to find something that hasn't been tapped into before, where we're going to be able to invest large amounts at very high rates of return.

Tegus

You had talked about this buildup of cash on the balance sheet. You've been able to make a few substantial acquisitions recently, been able to deploy some of that cash in addition to the special dividend. How do you think about the sustainability in terms of ability to deploy capital against what you've done in recent history, in 2021 and early 2022? And do you think that is sustainable? Do you think that's a floor going forward?

Chief Financial Officer at Constellation Software

We will never give guidance on what we think we're going to deploy. I would say for the smaller-size acquisitions, we're continually trying to improve that process. We're adding more and more leads to our database. We're nurturing those leads and developing better relationships. Hopefully, we'll see more of these businesses when they're ready to sell.

For all the larger acquisitions we've made, there was something specific about it that made us the preferred buyer. If you've got a growing business, highly profitable, that private equity is highly interested in, because of their business model, it's going to be very difficult for us to compete because they sell in 3 to 5 years, where we hold for life.

The fact that we did one this year does not mean we will do another one next year. But on the smaller sizes -- again, I can't provide guidance -- but if we've been able to do about 100 in the last couple of years, I would hope that we'd be able to continue to do 100 small ones going forward.

Tegus

You talked about competition with private equity. With the amount of dry powder in the market, the fact that many private equity firms, growth equity firms are coming down-market to acquire smaller businesses, how do you see the competitive environment from a capital allocation standpoint impacting that ability to continue to do 100 a year? Do you find yourself in more competitive processes relative to 5 or 10 years ago?

Chief Financial Officer at Constellation Software

We're still not seeing private equity come down to \$5-million-revenue-type businesses. Maybe if they're rolling up an industry, they might go that low.

There are, however, companies that try to emulate the CSI model, and we refer them as copycats. Hence, we try to keep a lot of our detailed internal information close to our chest, so it makes it more difficult for them to copy us. But the expectation is the competition from those businesses will increase over time.

Tegus

Yes. Helpful. We've heard that attracting and retaining talent is really a top of mind across Constellation. Do you see wage inflation aggravating that situation at all?

Chief Financial Officer at Constellation Software

Not really. We can adapt if wage inflation's higher, we can pay higher and hopefully, we can adjust the prices where possible.

I think the bigger concern might be the ability to work from home. Many of the companies we own are in small, remote cities and people like that because they don't have to commute downtown.

In Toronto, for example, we have some of our businesses that are out in the suburbs. Now if there is a downtown Toronto company they want to work for and they can work from home, they don't have to deal with that commute into the city. So that is a bit of a concern. We are not seeing a great resignation or anything across CSI, but it's something we're keeping on

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Attrition is something that we definitely keep our eye on since employees are the key to Constellation. We're not seeing any major attrition at the more senior levels. We have seen some turnover or unfortunate turnover maybe at some of the more junior levels. But for more of our longer-term employees, we're not seeing that as a concern.

Tegus

You talked about the ability to pass price increases along to customers. What is Constellation's view of pricing increases? Is that something that's institutionalized? Is that made at a business unit level?

Chief Financial Officer at Constellation Software

Our whole mantra is customers for life. So we don't want to be seen as gouging our customers or putting a huge hike and driving attrition. Like I said, we own thousands of businesses and they all have their own customer contracts. Those decisions are left to the business units.

Once we acquire a company, we're doing a lot of analysis around pricing to understand whether or not the product is priced correctly and where it should be priced. And in some cases, there might be some price increases put through as a result of that analysis.

Tegus

Got you. I'd love to turn to talking about Constellation's capital structure. Can you talk a little bit about the capital structure today?

Chief Financial Officer at Constellation Software

It's a pretty healthy balance sheet. We've never issued any equity. Rather, we IPO-ed to give liquidity to our PE shareholders and none of those proceeds came to Constellation. We have a \$220 million debenture and we have an undrawn \$700 million revolver.

That's at the CSI level. We're not opposed to debt. It's just that, we can't deploy the capital that we have at the rates of return we require so there's no need to take on additional debt. Where you do see some debt, is I think about \$400 million or so of ring-fenced debt.

Our hurdle rate is an equity hurdle rate. And we have, for years, allowed the use of debt to improve that return on equity. So the first levered deal we did was the TSS acquisition back in 2013, and there's been a handful of others since.

All of those debt facilities are ring-fenced so they only have recourse against the assets of the business that they were used to acquire. And there's a couple of reasons we do that. One, it de-risks CSI. The lender will have to deal with that management team to negotiate if things go south, which none of them have.

And then it really forces that management team to think through whether or not or how much debt they want to take on. If all of this debt was just theoretically put in place and handled by CSI, that wouldn't force management teams to make those tough decisions.

Tegus

You talked about those management teams making that decision. Is the ability to take on debt allowed at that business unit level?

Chief Financial Officer at Constellation Software

The Board needs to approve larger transactions. But decisions around when and how much debt you want to take on have historically been made by the management teams that are putting it in place. The Board has not overruled any of those.

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Tegus

How did you think about spinning out Topicus? What was the thought process there? Why spin it? And can we expect to perhaps see more spinouts or other ways of returning capital to shareholders over time?

Chief Financial Officer at Constellation Software

Mark had mentioned at an AGM that he saw the future of Constellation as being many of these spinouts. But how we had talked about it was more about spinning off a vertical and doing it in conjunction with an acquisition.

This is a theoretical example. But let's just say transit, which is one of our largest verticals, had one of their largest competitors become available for sale. We could combine the 2 together, spin it off and have a transit-focused software company.

When Topicus B.V. came available for sale. If we were able to acquire it the same way we acquire other companies, we would have. The sellers however wanted the Topicus brand to live on and there was also a valuation gap in terms of what they were looking for the company.

Robin came up with the idea of using the spin concept for the Topicus acquisition. Now what was great was TSS was already a ring-fenced entity. So the structure lent itself to this acquisition.

I don't foresee us spinning off operating groups. I do, however, think that we could spin off verticals in the future, again, in conjunction with an acquisition.

Tegus

Does size pose a challenge to continually generating high ROIC? I think your point just now on Topicus was that rationale had nothing to do with just becoming a lot larger business, but it facilitated a transaction. But more broadly, is the large size that Constellation is now growing to making it difficult to generate higher ROIC?

Chief Financial Officer at Constellation Software

I think there is still a lot of room to increase the amount of capital we deploy at high rates of return. We're generating just over \$1 billion now. And the reason why I believe we could still deploy more is because of a metric we also track called our coverage ratio.

We have a database, the last time we publicly disclosed its size we said there were 40,000 opportunities in it. And we're constantly adding more. What we do for our coverage ratio metric is we look at the number of businesses that were sold in a given quarter, and for those businesses that are also in our database, we calculate how many of those transactions we were aware of.

And what we're finding is we are not aware of close to 70% of the transactions, even though the company was in our database, and we supposedly had a relationship with the company. And what it showed us is that there's a lot of businesses that are in the database that we don't have relationships with.

We have done a great job -- if you think of the database as a sales funnel -- of adding leads to the funnel. But we haven't had time to fully nurture them and turn them into real relationships. We are focused on how we improve that coverage ratio from, let's say, 30% to something higher.

I don't think it will ever get to 100%, but could it get to 60%? Maybe. And if it does, hopefully, we could deploy twice as much capital.

Tegus

When you announced the special dividend in December of 2020, how did you think about a dividend versus a buyback? You referenced earlier that Mark has always said that the stock is overvalued, yet in the intervening 16 months, Constellation has performed quite well.

Chief Financial Officer at Constellation Software

If you go on our website, we have a Q&A on the topic. Mark has responded to questions about buybacks, and you can get his opinion of why he's not a fan of buybacks.

Tegus

What questions have I not asked about Constellation that I should have?

Chief Financial Officer at Constellation Software

I don't think you've missed anything. It's impossible to understand Constellation by trying to understand all of the businesses that we run and verticals that we operate in. We are almost like an investment company. We just happen to invest in private vertical market software companies.

From a valuation perspective, it's how much capital can we continue to deploy at high rates of return and then what the underlying organic growth is of those businesses. I think those are the key things you need to understand to decide whether or not it's a solid investment.

Tegus

Great. Thank you so much for the time.

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