SELECTED INVESTOR QUESTIONS RECEIVED THROUGH FEBRUARY 20, 2019

(Relating to the special dividend)

Question

Now that CSI has announced a special dividend, could you please elaborate on your thinking behind the decision. You've talked a bit about the pros and cons of retaining capital vs returning it to shareholders in the past (via special dividends or buybacks, which you aren't a fan of). I'm curious what prompted the decision now. Is this a signal at all about capital deployment, or do you feel like you have such good access to capital (with the new bigger revolving line of credit and the possibility of issuing more debentures and the ever growing FCF coming in) that the excess ~$400m was simply superfluous? Should we read into this that there are no elephants in the pipeline, or that if you were to do one, you'd want to lever it up anyway and wouldn't require that much cash.

Response

The dividend is clearly a signal about capital deployment. If we thought that we could deploy this capital at high rates of return, we would have kept it.

ML

Question

While your team of capital allocators at CSI is able to deploy capital at a ROIC of 25% to 30%, a good fundamental investor might hope to generate 10% to 15% CAGR if he does a good job. This is far from the 25-30% CSI is able to generate, and in between, it seems to us that lowering CSI's hurdle rate in order to deploy more capital might be a better use of cash than returning it to shareholders. We would be curious to have Mr. Leonard's thoughts about the opportunity cost investors incur when receiving such a dividend from a high ROIC generating company such as CSI?

Response

This has been a perennial discussion topic with the board.

I used 3 ideas to make the case for maintaining hurdle rates to our board this quarter: Hurdle rates are magnetic, our performance has been exceptional despite (and perhaps because of) our high hurdle rates, and if we deploy our capital at the "cost of capital" then there are no exceptional returns to share with employees in the form of bonuses.

We have only our own experience to go on when it comes to changing hurdle rates. We've noticed that when we increase or drop the hurdle rate, all of the expected returns on our new acquisitions seem to increase or drop, respectively, in lock step with the new hurdle rates. We summarise this with the phrase "hurdle rates are magnetic". I'd be interested to hear if others have had a similar experience or if they've found any academic studies on the topic.

It is rare to find acquisitive companies that generate high rates of return on invested capital. I did a study for our managers and directors in the most recent board package. I found a half dozen public companies out of 4000 had done as well or better than CSI with an acquisition strategy during the last decade. All of them were operating on a smaller scale than CSI. If you know of any acquisitive companies that have done well by deploying capital at 10% or 15% ROIC's for long periods, we'd be pleased to study them and try to learn from them.

I had no qualms recommending to the board that we leave the hurdles where they are and send excess capital back to shareholders.

ML

Question

I had a question about Constellation's special dividend. What drove the decision to pay out the $20/share dividend - and why was the $20 amount decided upon? Mark has debated the merits of buybacks and special dividends with excess capital for a while, and the press release spoke about returning excess capital, but what was the straw that broke the camel's back? Was it just that the cash balance surpassed $500 million for the first time? The special dividend (plus regular dividend) will sharply reduce the existing cash balance; is this because management expects F19 cash flows to largely cover the cost of F19 acquisitions? Or is this more on the view that CSU will become more levered (at least on a net basis) to optimize its capital structure? Thank you for answering these in advance.

Response

As mentioned previously in the Q&A responses, capital allocation is a perennial topic for our board discussions. This quarter I got the sense that the board hit a tipping point. There were a number of factors. We had excess cash. We are deploying more capital in the vertical market software sector, but don't see dramatic growth this year unless competition slackens. One of the directors mentioned that they were disappointed with my efforts to find new avenues for investment (outside of vertical market software), and that we should apply more effort. I don't disagree, but that is unlikely to reduce our cash meaningfully in the short term. Those factors seemed to combine to make this the right time to pay a special dividend.

Perhaps dividends are perceived as a failure… but to my mind, they are less of a failure than sitting on excess cash.

ML