SELECTED INVESTOR QUESTIONS RECEIVED THROUGH OCTOBER 9, 2018

Question
Is the traditional moat around software shrinking as 1) absolute development/compute/storage/ distribution costs fall, 2) startup costs become increasingly variable vs. fixed (e.g. pay-per-drink compute/storage offerings like AWS and increased availability of developer tools/APIs), 3) capital has become more aggressively available and 4) product distribution via the internet/SaaS model has become cheaper, easier and faster, with lower switching costs? Is the current reality of software a lower moat business now versus the days of deeply entrenched, costly to create, costly to install/sell/service/customize, multi-product suites of the past like SAP/ORCL?

In a related question - could this mean the niche TAMs that Constellation operates in that historically were illogical to compete in ("not worth it") are more 'at risk' going forward given software development and distribution seems to be much easier, cheaper and more variable now than it was ten years ago?

Response - Mark:
There's little doubt that the cloud + amortised payment models + single instance multi-tenant software (let's call this technology/economic model "SaaS" for the purposes of this response) has significantly lowered the up-front costs of equipment for new SaaS entrants, has the potential to both speed up and lower their costs of development and customer acquisition, and has attracted huge amounts of capital to finance the creation of new SaaS products. As to your related question, I think smaller TAM's (TAM is venture capital speak for "total addressable market") are more viable today than ever before if start-up capital is available. The "if" is important, as new SaaS products consume a lot of up-front cash.

Over the entire value chain and over long periods of time, it isn't clear to me how much value will be created by the move to SaaS. Nor is it clear to me how the value created (if any) will get shared amongst clients, their software vendors and the cloud hosting companies:
If SaaS players consistently compete for new clients based on low prices, then the clients will likely be the largest beneficiaries of the platform change;
If the big three cloud vendors use the pricing leverage provided by the proprietary development and infrastructure management tools that they offer to developers, then they may get to extract a large portion of the benefits from the platform change;
If new name client acquisition costs are rational and the cloud vendors don't succeed in materially raising developers' switching costs, then perhaps software vendors who make the platform transition will also get to participate in the benefits of the move to SaaS.

I think the demand for SaaS (as defined above) amongst clients will be based upon their budgets and the desired "proprietaryness" of their software and data. Nearly all clients would like to have custom developed enterprise-wide software suites tailored to their chosen business processes and strategy. Those with really deep pockets will want to keep their proprietary data and processes private.

Many more clients will not be able to afford custom software and their own IT infrastructure, and hence will take pre-packaged software that is either highly configurable or allows for customisation. They may or may not want this hosted in the cloud.

The clients with the smallest IT budgets need to accept software with little or no customisation, and it will almost certainly be hosted in the cloud.

SaaS is ideal for customers who have strict financial constraints, and hence is an existential threat to vendors of on-premise legacy software solutions selling into the low-priced software segment. I believe that legacy solutions with browser and smart phone based user interfaces will remain the dominant solution in the mid-tier market for many years to come. True SaaS solutions strike me as unlikely to replace a significant portion of large custom-developed solutions in my lifetime.

On a more pragmatic note, the organic growth or contraction of CSI's recurring revenues and free cash flow should give you a pretty good sense of the impact on CSI of new SaaS entrants.

I asked Barry Symons who runs our Jonas Operating Group to provide you with an example from his portfolio. His response appears below. I think you'll get a sense of how his incumbent club software business fortified their moat in the face of technological disruption and potential new entrants.

Mark L.

Response - Barry:

Thanks for the question(s), below would be our thoughts:

On the moat issue, I think economic theory would say that if you have a business/industry that can produce above average returns for extended periods of time, intelligent people and capital will find ways to get into the industry and thus over time increase the competitiveness of the business/industry and by definition probably reduce the size of the moat. We are seeing some of the effects of the points you raised, however, I also believe that these are not changing at rapid speed (as we have witnessed so far) and thus if we are paying attention and responding appropriately we can defer their impact (materially speaking) for a very long time.

Specifically to the 4 items you mention there is no doubt that they have the potential to reduce the size of the moats we have, but we are actively working on things to counteract these threats. A great example of this would be the club market, which is one of our larger verticals. When we first entered the club market back in 2003 (via acquisition of Jonas) we were not the market share leader and we did not have a "complete" enterprise product but we saw lots of potential. Over the last 15 years in the face of the challenges you mentioned we have managed (at least in my opinion… I am sure our competitors may feel a bit differently) to not only maintain the size of the moat but in fact expand it:

1) We continued to invest in new name sales as we were seeing great traction and the economics were compelling (we measure our sales & marketing investment relative to long term value of the customers acquired)
2) We realized that we needed to have more of an enterprise-wide offering: our mantra has always been to try to be the one stop shop for all our clients' software / technology needs. Thus we built or purchased the products we did not have and began selling them back to our base of clients to truly have an enterprise product. This makes our offering to our customers even more valuable and thus reduces their desire to leave us for the competition.
3) We acquired some of our competitors to strengthen our position in the market.

4) We paid attention to changing trends in the market and developed solutions our clients would one day need… hopefully before they needed them. Since 2003 many things have evolved and changed and we have responded accordingly such as:
   a. Websites – just having a web presence
   b. Interactive websites – allowing the club members to actually utilize the website for booking tee times, event sign up, court booking, review their statements etc.
   c. Member communications – email marketing and text messaging modules that did not exist in 2003.
   d. Payments – back in 2003 the club world was pretty much all invoice and check. That has transitioned tremendously and we have built the solutions to help our clients embrace digital payments.
   e. Mobile computing – as things transitioned we moved our product to our clients' and their members' smartphones – first with responsive designs and then with club specific mobile apps.
5) We evolved how we delivered our products to our clients – back in 2003 we literally shipped our clients CD's for every update that was needed (and we used to have huge Fed Ex bills) we evolved to digital downloads and have moved to having a cloud based offering for those who no longer want to host the product on site at the club.

There are many other changes I could go on about but the key message is each of these changes are things we have to respond to that give us the opportunity to deepen our moats if done properly.

I think in the end as long as we are producing above average returns there will be threats to our moats we need to deal with. However, if we are actively watching our KPI's on things like: Customer Satisfaction, Attrition Rates, Win Loss percentage etc. we can hopefully course correct before any threat becomes overly material.

Finally, specific to the second question about "not worth it", I am sure some of the 4 items you mention have some impact, but in each of our verticals there is still a very large barrier to entry to get in the game and while the 4 items you mention make it a bit easier to build a base product, the evolutions that happen (as noted in the club example) constantly increase the size of the base product, offsetting some of the attacker's advantages. At the same time the majority of the markets we serve are not rapidly expanding so the "size of the prize" is not growing significantly. Further, no matter what changes in the 4 items mentioned, the pain of switching a mission critical enterprise application is still high. No matter how fast and cheap computing power becomes people do not like to change things that are working well unless the upside to the change is extremely compelling. Thus I think for the majority of our markets the "not worth it" comment continues to hold and that is evidenced by the limited number of new competitors we see in the majority of our verticals.

Hopefully the above gives you comfort that we are constantly thinking about these threats and doing our best to manage our shareholders capital in intelligent ways. I know we have made mistakes in the past and I am sure we will make many more in the future but if we respond quickly, rationally and intelligently we can hopefully maintain if not grow the size of our moats in a number of our stronger verticals while gracefully reducing our presence and investments in those where we have lost our edge.

Barry Symons

Question

There are a number of successful companies who count the culture they have created as part of their moat or competitive advantage. Many of us shareholders believe CSU is one of those companies. However, could you elaborate on this where CSU is concerned and how important do you this the CSU culture is in the ability to drive solid shareholder returns longer term.

Response

Page 2 of http://www.csisoftware.com/wp-content/uploads/2018/07/QA-July-25-2018-Final.pdf answers part your question... at least from my perspective. If there's a more specific corporate culture-related query, don't hesitate to send it in to the Q&A website.

I'm leery of corporate culture. The popular business press has touted it as a tool to improve corporate performance for decades. I find it a fuzzy concept (values, beliefs, and?) and a bit threatening. Actively promoting "correct corporate culture" has vague overtones of brainwashing and the cult-like expectation of acquiescence. I won't accept a set of values and beliefs that are foisted upon me, and I would not expect others to accept them, either.

I think we have lots of different sub-cultures and more than our share of heretics at CSI. Some of these sub-cultures will thrive, and some will fail. The cultures that are successful are likely to propagate their values and beliefs by example and by selection. With that sort of evolutionary process at play, my sense is that we don't need to be preaching corporate culture from head office.

Mark L.