

CONSTELLATION SOFTWARE INC.

TO OUR SHAREHOLDERS

One of our directors has been calling me irresponsible for years. His thesis goes like this: CSI can invest capital more effectively than the vast majority of CSI's shareholders, hence we should stop paying dividends and invest all of the cash that we produce, even if it means lowering our hurdle rates.

I used to argue that we needed to maintain our hurdle rates because dropping them for a few marginal capital deployments would cause the returns on our entire portfolio to drop. The evidence supported my contention, so we kept the rates high for small and mid-sized vertical market software ("VMS") acquisitions and made very few exceptions for large VMS acquisitions. The by-product of that discipline has been a perennial inability to invest all of the cash that we generate.

What have we done with that excess free cash flow available to shareholders ("FCFA2S")? Historically, we have paid three special dividends, and for the last decade we have also paid a regular quarterly dividend.

I have stopped arguing. I have converted, and with the fervour of the newly converted, I am busy demonstrating my new-found faith.

The obvious first step is to stop special dividends in all but the most compelling circumstances. That decision was made by our directors at Friday's CSI board meeting. We have maintained the quarterly dividend for now, but if we are successful in finding better uses for our FCFA2S, the quarterly dividend will also be sacrificed.

We will continue to invest most of CSI's FCFA2S in small and mid-sized VMS acquisitions at our traditional hurdle rates. Our Operating Group Managers have done a spectacular job of growing CSI's market share of acquisitions within this portion of the VMS sector, without succumbing to the siren song of increased centralisation, bureaucracy, and control. Most of these businesses are blessed with big moats and long-tenured employees and customers. The Operating Groups provide a low overhead environment where autonomy, collegiality, and shared knowledge are the cultural norm, and good people thrive. I am incredibly proud of what they have accomplished.

At head office our original objective was to be "good perpetual owners of VMS businesses". Our success forced us to delegate that task to the Operating Groups. Head Office now needs to become a "good steward of our investors' capital". To that end, we are working on two initiatives: 1) increasing the number of very large VMS businesses (i.e., those requiring multi-hundred-million-dollar equity cheques) that we pursue, and 2) developing a circle of investing competence outside of the VMS sphere.

For many years, we have tracked large VMS acquisition prospects as a separate segment of the market. We have invested less than 10% of our FCFA2S in this segment, making only three large VMS acquisitions during our entire 26 year history.

Between 40 and 70 large VMS businesses are sold each year. The vast majority of these transactions are marketed to prospective buyers by less than a dozen major merger and acquisition ("M&A") brokers. Over the last five years, we were aware of about 80% of the large

VMS businesses that were sold, but their brokers only invited us to participate in 16% of the sales processes.

We are building a small, dedicated team at head office to pursue large VMS acquisitions and to work with M&A brokers. If we drop our hurdle rates for these acquisitions, I believe that competent and diligent M&A brokers will include us in more auctions.

Most of our competitors maximise financial leverage and flip their acquisitions within 3-7 years. CSI appreciates the nuances of the VMS sector. We allow tremendous autonomy to our business unit managers. We are permanent and supportive stakeholders in the businesses that we control, even if their ultimate objective is to eventually be a publicly listed company. CSI's unique philosophy will not appeal to all sellers and management teams, but we hope it will resonate with some.

If we are successful in acquiring one or two large VMS businesses per annum, then I anticipate that CSI's return on investors' capital will decrease, but we will not have to return any of our free cash flow to shareholders.

In parallel with our established and growing small and mid-sized VMS practise and our nascent large VMS practise, we are trying to develop a new circle of competence. We are seeking attractive returns, a sustainable advantage, and the ability to deploy large amounts of capital outside of VMS. That will require highly contrarian thinking and is likely to be uncomfortable in the early going. Hopefully, we have built enough credibility to warrant your patience as we explore new and under-appreciated sectors.

Mark Leonard
President
Constellation Software, Inc.
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