

Constellation Software Inc. - Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

Interview conducted on May 10, 2023

Tegus and Constellation Software have partnered to share an in-depth conversation on Constellation's ESG focus. This conversation is between a current Topicus shareholder and Lawrence Cunningham, long-time shareholder and Vice Chairman of the Board of Directors of Constellation Software and current board observer.

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.

Cunningham would like to emphasize that the views expressed in this interview are his own views and not necessarily those of Constellation or its directors or officers.

Tegus Client

Do you mind giving a quick background and how you found your way to Constellation's Board?

Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

It was 2016, and the Board was doing a search, while also debating whether Constellation, this big sprawling organization, had a culture or not. Coincidentally, I had written a book a year or two before on Berkshire Hathaway's culture.

My name popped up on both points. Mark Leonard, Constellation's President, asked me to do a brief culture study of Constellation to produce some information on their debate. I did. It was very well received. The board then asked me to join as a director, which I did.

In 2019, Mark Leonard, as the board's Chairman, asked me to serve as Vice Chairman of the Board. Duties are internally helping to shape the board agenda and externally engaging with institutional investors. Last summer, Mark Miller, CEO of Constellation's Volaris Operating Group, asked me to do a deeper culture study just on that group.

Mark Miller had noticed that Volaris is as large today as Constellation was at the time of my earlier study. His team was having their own version of that debate about culture. So I did an even deeper dive on that which is proving to be very valuable to the Group. One side-effect is the study was so broad that it put me outside the limit of the technical definition of "independent director."

In order to maintain a majority of independent directors on Constellation's Board, I didn't stand for election this year. But independence concepts and board configurations change and I'd be happy to rejoin at any time. I would add that I've been a shareholder throughout that time with a meaningful portion of our family's net worth in the stock.

Tegus Client

Congratulations on picking a winner. It's been a great stock to own and a pretty high-quality story. It doesn't seem like there's the accounting games that exist in quite a bit of tech companies, stock-based compensation, non-GAAP onetime expenses. All of these things are just to feel like they're an anathema to that Constellation culture.

We will start with an ESG-related set of questions. Do you mind talking about your involvement in

Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

The concept of ESG has no fixed or stable meaning. Ever since the UN invented it in 2004, it's been taken in innumerable directions. Lately, it has also assumed a political dimension. The concept is therefore freighted.

In its best sense, ESG is about protecting against externalities—E around greenhouse gas emissions, S on protecting employee wellbeing and customer care, and G assuring business administration to promote related practices.

Historically, such goals are embedded in the operation of Constellation and percolate up and down through its numerous portfolios and decentralized business units. As such, as a corporate board member, a director is responsible for oversight of these topics.

But as a formal matter, when Mark asked me to be Vice Chairman, part of that was to engage with institutional investors and asset managers who were increasingly focused precisely on ESG topics. I have participated with the CFO and other directors in such engagement year round.

Constellation also has developed more data of interest on these topics for publication on its website, led very capably by Jeff Bender, CEO of the Harris Operating Group. In accordance with Constellation culture and practice, the data are generated at the business unit level; when aggregating them, the company is very careful to take the time to present reliable information rather than simply publishing whatever is at hand in response to requests.

Tegus Client

If I think about ESG, personally, I care mostly about things around like mining operations, pollution, organizations that can mistreat their workers. How would you say that ESG for a software company can either be done right or can be done wrong? And how serious is that dividing line?

Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

I don't think that our businesses discriminate against customers in those ways. I think our software is potentially used by businesses in every industry, sector, and professional services group, including mining. I understand that proponents of some versions of ESG object to the existence of certain industries or sectors, such as tobacco, gaming, alcohol, or perhaps mining. At Constellation, we don't discriminate that way.

On the other side of the ledger, we also have significant businesses that contribute to reducing greenhouse gas emissions. One of our largest businesses is in the public transit sector, the Modaxo portfolio within the Volaris Group. A smaller business of ours creates software to support the renewable energy sector. But I am not aware of any company policy that discriminates for or against lawful businesses.

Tegus Client

Yes, I think my question was more around what kind of factors would make it so that a software company has not operated in an ESG conscious way. And what have been changes at Constellation during your journey there and before you joined to try and be more ESG sensitive?

What does that transition path look like to aspirationally become best-in-class?

Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

I am not sure what best in class would be when it comes to ESG, given the absence of both definition and reliable measurement. Companies may be best in class by some measure but produce abundant negative externalities.

I don't think Constellation aspires to be best in class in ESG, but rather to empower its business unit

managers with the autonomy they need to operate their businesses in the diverse settings where they operate. With operations in more than 100 countries, each business unit faces different challenges and opportunities in terms of environmental protection, employee well-being and diversity, and governance structures. All these intangibles have always been important in business.

That said, to highlight one point about the overall Constellation footprint, the various business units and operating groups do use a number of data centers across the world. Some data centers have sizable carbon footprints and emit large metric tons of greenhouse gasses. Reducing Constellation's contributions, all the operating groups have been increasingly migrating to the cloud. That results in far less energy use, directly and indirectly, as operators of those cloud-based services tend to prioritize using renewable energy.

Constellation operating groups and business units have active programs about mental health, psychology, nutrition and similar investments in employees. Again, I don't think these programs are designed to win awards for best in class but are adopted for intrinsic reasons: they are the right way to treat people, improve the quality and productivity of the workforce, and reduce health problems and costs. These are old-fashioned business ideas that predate the ESG movement.

Tegus Client

So if ESG makes good business sense, like trying to be good by your employees, being aware of the carbon footprint that you have as a company, what do you think the blockages are for companies that when you look at them, that are not doing that great of a job with it? When you've encountered and kind of formed a critical view of other companies, just what are attributes and kind of pushback that you would encounter?

Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

I think over the past 3 or 5 years, as the ESG movement became so overwhelming, directive mandatory and politicized, some companies may react negatively, especially those who have long lived by the ancient values that originally undergirded the UN's ESG concept. The power of the ESG movement has led some to hijack it for their own agenda, which has led to the backlash against it. Most companies want to focus on their businesses and not get caught in the crosshairs of ESG battles. .

Tegus Client

Yes. Personally, I agree with you. It's painful. There was a high-profile ESG review of Tesla -- with Tesla towards the bottom and Exxon up top or something. Whoever is making that somewhat strange decision to put Tesla towards the bottom and somebody else above them, I don't know, it just seems weird.

The rating methodology, as you were saying, it seems like there's a level of kind of politicization. It does feel odd. But if you were to say the lessons to be learned by the folks who actually like need to change, what are those lessons like, really look and feel like?

There has to be a point that's trying to be communicated by instituting regular reporting. A core of truth. It seems like a change was needed.

So if you were to rewind 20 years ago, when you were studying corporate culture, the lessons that have been learned, what would you say that some of those big lessons that have been learned and that still need to be learned by some companies that maybe haven't pulled their head out of the sand to understand. Just help me again understand what is the core that should be welcomed and maybe isn't actually fully welcomed by all companies today?

Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

I don't know that some companies have their head in the sand. I think companies have been extremely responsive to what has been an extremely intense political movement. I cannot think of particular companies that are not responding, even though they are facing overwhelming and often conflicting pressures.

I think the real problem is that there's so much pressure that companies release data that isn't vetted and

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make statements that become misleading. The result is called green washing, which is presenting a company as more ecological than it is, or pinkwashing, which is portraying a company as more gender diverse or committed than it is.

The system needs to return to a sense of balance and an appreciation that the UN's original conception of ESG would have been recognized by Ben Franklin. One hurdle is that at this point there is an enormous amount of money to be made in ESG. Millions of people make their living from it: the standard setters, rating agencies, statistical firms, NGOs, law firms, accounting firms, consulting firms, auditing firms, regulators and many others.

Tegus Client

Yes. I don't want the tone of my questions to indicate that I disagree with anything that you're saying because everything that you've said just now, I 1,000% agree with. So don't misunderstand me. We're on the same side on this. Let me talk about in a Constellation context with 1,000 subsidiaries independently run in different vertical groups.

How do you go about defining culture in an organization like that? Is there a culture or when you do a random sampling, which I actually have done in a business context, how has that felt? What are commonalities? I'm super curious about your experience, given that's such a depth of focus for you.

Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

Culture is an intangible characteristic that probes the norms, behaviors, and expectations of a group or subgroup. In the case of a company like Constellation, the challenge is that you have layers:

- a large umbrella, the parent company, with little operations but with iconic leadership and rich history
- encompassing operating groups, each led by a different personality in diverse vertical markets, of different sizes, histories, organizational structures
- each in turn divided into multiple portfolios, each in turn with their distinctive profiles
- each of those portfolios comprised of hundreds of separate business units, each with their leadership, history, geographies, products, customers, employees etc.

The question: is there one culture, one thousand cultures or some other number? The common answer from surveying hundreds of people within the organization, is there is both one culture and a thousand cultures, there is a culture of cultures, a culture within cultures. Each business unit has a culture, each portfolio has a culture, each group has a culture and yes, there is one enveloping Constellation culture.

Across Constellation, there are pervasive attributes modeled and shared across the rest, featuring such norms or beliefs as autonomy and decentralization, employee empowerment and customer centricity, along with best practices and performance standards. There is belief that business operators in specific verticals and locales—tech in Israel, automotive in Brazil, transport in South Africa, health care in Canada—knows best how to cater to its customers and nurture its employees than a centralized body in a city far away. At the same time, there is a data-based conviction about the performance metrics of successful software companies that transcend verticals or geographies.

And the aggregate and long-term consolidated performance results speak to the value of this mode, which has been quite successful.

Tegus Client

It sure has. It really has. Yes, that level of kind of delegating down in the organization for Constellation is on the one hand wonderful, that trust-based system has worked. And that is a culture that does percolate all the way down. The way it percolates -- it's impressive. It's really impressive. And congratulations for being able to work your way up and witness it really firsthand.

So that's truly a unique organization. Berkshire, to some degree, has had that, right? And you studied Berkshire before, but Constellation it feels like it took it to entirely another level, just in terms of the number of companies, right?

Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

Yes, that's a great point. Many companies believe in autonomy, value human freedom and judgment and prefer to let people closest the decision to make it rather than having a central board or senior management telling everybody what to do. It's not a majority of companies that operate this way, but I aware of 50 to 75.

But exactly how the value is embraced and operationalized differs. For instance, each has its own way of assuring accountability. They may have playbooks of best practices and performance benchmarks. They may have intensive upfront screening tests and/or intensive training programs. Companies may have tailored incentive and compensation programs to support the autonomous culture.

In general, however, employees and leaders performing to expectations tend to get the green light of maximum autonomy while those in the yellow or red get more coaching, oversight, or direction.

Tegus Client

How do you think about times when change is needed? For instance, there have been a few large technology waves, the move to cloud, kind of on-prem to cloud has been disruptive for the legacy firms. You can see legacy software company, flat SaaS company growing was 40% now, who knows. We're in a weird environment.

That is a trend and now increasing implementations of AI, generative AI, things that, to some degree, can require retraining of people and different ways of doing things. How do those kind of "hey, this is happening, get on it now, so you don't get left behind" issues percolate when you've got such a highly decentralized organization?

Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

Yes. Great question. I think one of the geniuses of Constellation's organizational structure is that most good ideas come from the people closest to the problems, usually business units rather than from headquarters.

When someone detects the waves or trends such as you reference, they can act more nimbly, even pro-actively, on customer care, product innovation, employee training or recruiting. The culture of best practices in turn transmits these early detections and responses to other business units and groups.

The process begins informally and may ultimately be incorporated into formal training programs. Each Constellation operating group runs academies or a university that collates knowledge, including around metrics, best practices and the latest learnings. The genius bubbles up from the bottom and spreads around, rather than being delivered from the top.

In the case of ESG, they share ideas on questions such as how to cut down your use of water, paper, plastics? How do you cut down travel? How does a carbon offset purchase work for your off-site? How do you develop a successful employee well being program?

No one at headquarters is sending these memos down. No one even at the operating group is, typically. It's this business unit manager saying, they form workers' councils and they have customer advisory boards and they're getting this learning from amongst themselves.

Tegus Client

Would you agree that it's more through informal channels, the dissipation of best practices around how to implement some generative AI chatbot into the software. Would there be formal programs, corporate funds to propagate that throughout the company.

Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

It can be all of the above. Ideas can come from anywhere and they can be codified in any form or they can be transmitted in any form. And so sometimes it's just informal conversations between people in the same business unit or across portfolios. Eventually, some ideas or practices gel and are turned into a case study or a training module at one of the academies or universities.

The culture is one of curiosity and sharing rather than rigidity and overconfidence. The Constellation annual meeting, held recently, illustrates. One manager said "we haven't succeeded because of intellectual superiority. We've succeeded by learning from the businesses we acquire and their people." Another said, "we make lots of mistakes, but always try to learn from them." Mark Leonard was asked about the quality of forecasting within the organization and he replied that "we're very good on average but terrible in the particular case."

Another thing about culture is a culture tends to attract and keep people who fit into that culture and to repel others. At Constellation, if you're not curious, if you're not innovative, if you're not willing, if you're not a self starter, you are likely to be frustrated and soon enough move somewhere else. If you thrive in such a setting, you'll love it and stick around. It's also critical to be long-term and patient, to build knowledge as well as wealth gradually. If you want to make a million dollars fast this place is probably not for you.

Tegus Client

That was actually going to be my next question because with the energy around Silicon Valley to produce the next Bill Gates and some attention even internally in Constellation to try and create a venture arm. The question, at a big company, how do you pay people to truly engage hard and try to swing for the fences?

That's been the technology game, at least outside of Constellation, these moonshot bets that go to \$1 billion, that quintessential unicorn, which is antithetical to how Constellation has worked.

In that backdrop where sometimes people do want to swing super hard for the fences, you have a company like Constellation that is very bottom line oriented and doesn't have that many kind of like ultra-fast-growing unicorns inside of it. How does Constellation perceive that world? And effectively, what I'm asking is the uber-incentivization of somebody who is willing to go to the mat and work 25 hours a day.

Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

The umbrella culture may not include that kind of moonshot attitude. But that doesn't prevent business units from creating opportunities like that or idea factories like that. And many of them do. In addition, Mark Leonard recently incubated VMS to entice those with such big ideas. So Constellation people with those aspirations do have a place to pursue their dreams. And while I'm not in the investment advisory business, I have been a buyer of Constellation shares throughout my tenure here and expect I will continue to be satisfied with these decisions.

Tegus Client

It's a unique attribute, especially in vertical market software, which has a degree of longevity versus like in the horizontals, you can get disrupted pretty quickly, right? It wouldn't necessarily work if you're in the social network innovation industry to try and consolidate these things.

Certainly, the fragmentation of the end use cases. For me, that's one of the things that I found refreshing about the Topicus TSS merger, that at Topicus there was also a bubbling up of ideas.

It is an idea factory and it was a well-run company, right? So you apply best practices once you've got an idea that works, and I found that to be compelling enough so that we established a fairly meaningful size position right at the time that it was spun out.

I do like the idea that we're going to try and grow stuff, and if it doesn't work, at least we tried, right? Because that practice, I think, is important, it keeps you growing. It keeps you aggressively trying. Anyway, that is at least how I ended up being a Topicus shareholder...

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Lawrence Cunningham, Vice Chairman of the Board of Directors of Constellation Software

When Constellation acquired TSS in 2014, many of its leaders and managers understood the Constellation model, but a lot of them did not. Dutch business culture is \different from that of North America, more top down and buttoned up. It took a while, but those who believed in the Constellation model doubled down on it while those did not eventually left.

The company embraces autonomy, decentralization, best practices, long-term thinking and the rest. But of course it also maintains its Dutch culture—and its business units retain their particular culture. This is a good example of the value of decentralization for ESG purposes. For example, TSS has a strong women leadership program. The support helpful or necessary to help women advance in leadership positions differs across geographies, and the programs TSS has developed reflects the regional situation that differs from what's best in other locales from Australia to Pakistan

Tegus Client

Yes. That was great. That was a really nice hour. Thank you so much again for taking the time.

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