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## Return on Investment

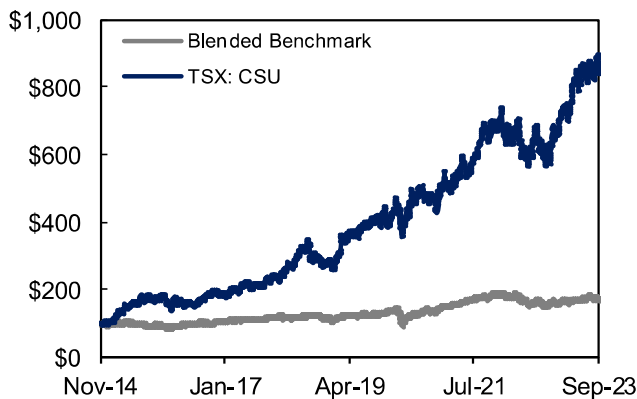
Current Share Price	\$2,804.07
Target Price	\$3,075.00
Dividend Yield	0.20%
Implied Return	10%
Conviction Rating	2

## Market Profile

52-Week Range	\$1,827.33 - \$2,905.40
Market Capitalization (\$mm)	\$59,422
Net Debt (\$mm)	\$2,453
Enterprise Value (\$mm)	\$61,876
Beta (5-Year Monthly)	0.83

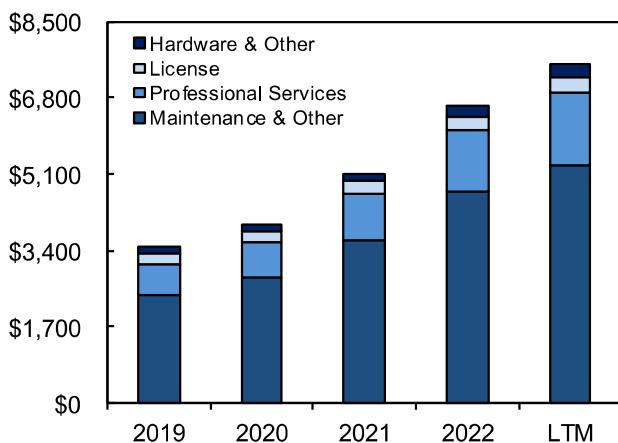
Metrics	2023E	2024E	2025E
Revenue (US\$mm)	\$8,145	\$9,463	\$11,010
EBITDA (US\$mm)	\$2,020	\$2,517	\$2,973
EPS (US\$)	\$30.59	\$41.63	\$50.02
EV/EBITDA	22.1x	17.7x	15.0x

## Holding Period Trading Performance (Indexed to \$100)



Source: S&P Capital IQ

## Figure 1: Segmented Revenue Mix (US\$B)



Source: Company Filings

Constellation Software

## Business Description

Constellation Software Inc (TSX: CSU) is a leading acquirer, manager, and builder of vertical market software (VMS) businesses, which delivers tailored software solutions to customers. These companies operate across various markets, including agriculture, utilities, and real estate. CSU focuses on acquiring companies with strong historical ROIC values, robust FCF profiles, and promising growth prospects. The Company's portfolio is organized into six operating segments: (1) Harris Computers, (2) Jonas Software, (3) Lumine Group, (4) Perseus Group, (5) Vela Software, and (6) Volaris Group. These segments oversee more than 600 companies and serve 125K users in 100 markets globally.

## Industry Overview and Growth Strategy

The software industry is projected to grow at a five-year CAGR of 1.6%, driven by the continued adoption of digital transformation. The industry is dominated by firms focused on growth by acquisitions, allowing companies to achieve economies of scale through efficient IT infrastructure and cost synergies. As a large-scale software consolidator, CSU competes with Descartes (TSX: DSG), Enghouse (TSX: ENGH), and OpenText (NASDAQ: OTEX). VMS-based companies often have lower penetration rates and lower churn, which deters new entrants. This is amplified by the fact that once a client adopts a VMS solution, there is extremely low churn, as clients will experience high switching costs. Furthermore, customer reliance on CSU's products provides stable and recurring revenue. The Company's growth relies on its extensive expertise of executing acquisitions and successful integration of smaller VMS businesses. CSU has made 62 acquisitions as at Q3 2023, on track to meet its five-year average.

## Operating Group Updates and Spin-Offs

CSU has six distinct operating segments, each managed by an operating group manager. These managers invest capital to generate returns at or above the investment hurdle rates set by the President and Board of Directors of CSU.

**Harris Computer Systems:** In May 2022, Harris purchased Allscripts' (NASDAQ: MDRX) Hospitals & Large Physician Practices segment for US\$727mm, enhancing its digital health offerings.

**Jonas Software:** In September 2023, Jonas Software acquired 4GL Solutions, a specialized ERP software provider for the metals industry, to enhance its portfolio of over 140 global companies.

**Vela:** Vela acquired GreatSoft in August 2023, enhancing its offerings for accountants with an R&D focus and expansion into Africa and global markets, backed by a strong client base.

**Volaris:** In September 2023, Volaris acquired RAF Technology, a leader in AI-optical character recognition for postal and logistics sectors, bolstering its software portfolio of over 190 companies.

**Perseus:** In September 2023, CSU acquired Black Knight's Optimal Blue for US\$700mm, a mortgage secondary technology marketing leader. This complements its existing portfolio of 800 companies.

**Total Specific Solutions (TSS):** TSS acquires leading European VMS software providers and was spun off during the Topicus (cont.)

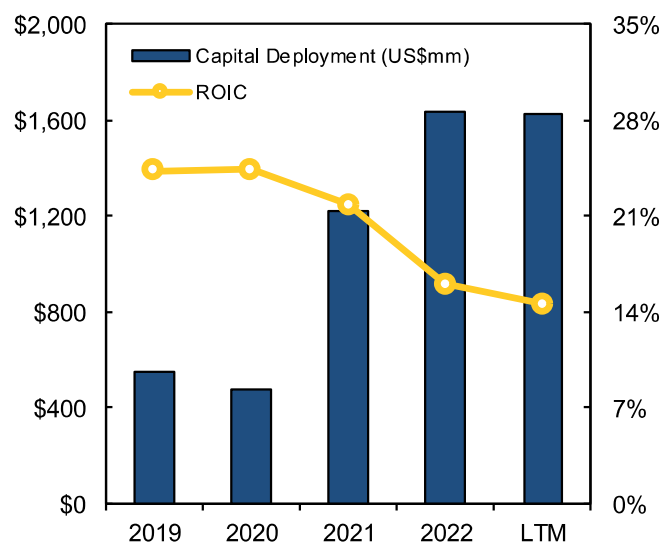
**Figure 2: Decentralized Business Model**



CSU operates 600+ companies. As of September 2023, CSU has spun-off two business units, Topicus (CVE: TOI) in January 2021 and Lumine (CVE: LMN) in March 2023.

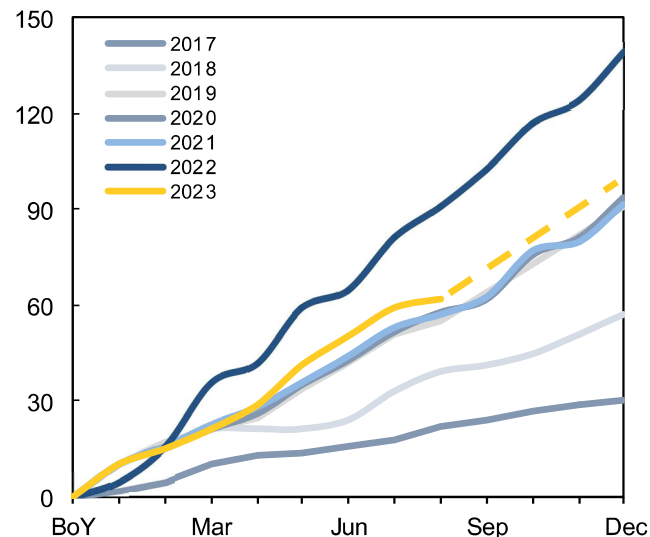
Source: Company Filings

**Figure 3: LHS Capital Deployment vs RHS ROIC**



Source: Company Filings, S&P Capital IQ

**Figure 4: Cumulative Acquisitions by Month**



Source: CPMT Estimates, Street Research

Acquisition in December 2020. Both entities now trade under Topicus.com (CVE: TOI) and oversee 160+ companies.

**Lumine Group:** A part of Volaris and a subsidiary of CSU, acquired 100% of WideOrbit Inc, a U.S. media VMS provider, for US\$490mm. In March 2023, the combined entity was spun out of the Company and operates as a separate entity as Lumine (CVE: LMN).

**Mandate Fit**

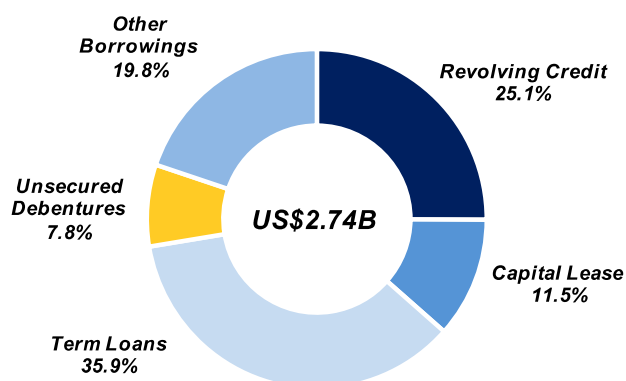
**Quality Management:** Since 1995, CSU has been led by its founder and President, Mark Leonard. CSU operates through a decentralized model, creating individual business leads for each division, with an average CEO tenure of 17 years across its six operating units. In addition to experienced leadership, the Company exercises a unique long-term incentive compensation plan. Rather than committing to stock-based compensation, CSU buys its shares in the open market and pays them to employees as a bonus. Executive officers must invest 75% of bonus into common shares and are restricted from selling these shares for an average of four years. NEO compensation is broken down as follows: cash bonus (10%), salary (20%), bonus to be used to purchase common shares (33%), and bonus withheld at source for tax purposes (37%).

**Competitive Advantage:** CSU’s competitive advantage lies within its expertise in M&A execution, especially in an industry with low penetration and chum. Its decentralized M&A structure and large track-record of VMS M&A allows the Company to engage in post-acquisition reviews and utilize mutually exclusive collectively exhausting modelling (MECE) to evaluate transactions. CSU’s valuation methods utilize four probably-weighted scenarios, enabling a single hurdle rate for different-risk investments. Using reliable base rates from numerous past acquisitions, the Company consistently applies MECE methods across investment opportunities. The Company’s targets small, specialized VMS businesses, which avoids competitive bidding processes. Acquisition targets continue to function independently from CSU’s operating segments, which has proven to be a successful business model as it accelerates targets’ management decision-making. Moreover, the Company’s proprietary acquisition target database has experienced substantial growth from ~1K in 2006 to ~45K currently. The Company estimates that 30% of its acquisitions are converted from its database.

**Strong Balance Sheet:** CSU maintains a conservative capital structure of 96.9% equity and 3.1% debt, which is in line with peers. The Company’s financial strength is reflected by its investment-grade of BBB from Moody’s. This is justified through its consistent FCF growth, stable business model, and disciplined capital allocation strategy. CSU holds a 1.4x Net Debt/EBITDA ratio, above the Company’s three-year average of 0.6x due to its recent engagements in larger acquisitions. This is still lower than OTEX’s Net Debt/EBITDA of 2.6x, while DSG and ENGH have a cash surplus compared to debt. Considering CSU’s tendency to finance larger acquisitions through debt, the Company’s recent debt issuances move signals an intent to increase cash reserves for future M&A.

**Growing Free Cash Flow:** CSU’s growing FCF generation has allowed it to continue conducting M&A, having completed over 62 acquisition YTD. The Company has grown FCF at a 24.7% CAGR since 2017, driven through accretive M&A. Although CSU has had significant M&A in past years, the Company lowered its hurdle rate from 30% to 20% for purchases larger than US\$100mm in 2019 to increase acquisition opportunities. This is reflected through CSU’s recent larger deals such as Altera, Optimal Blue, and Wide Orbit for US\$727mm, US\$700mm, and US\$490mm, respectively.

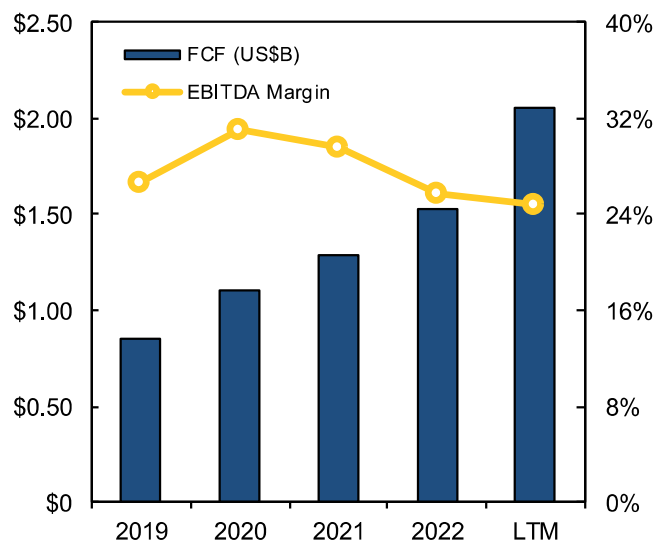
Figure 5: Q3 2023 Debt Composition



In August 2023, CSU announced up to \$700mm of its Series One Unsecured Subordinated Floating Rate Debenture. This is at a rate of "Inflation + 650 bps".

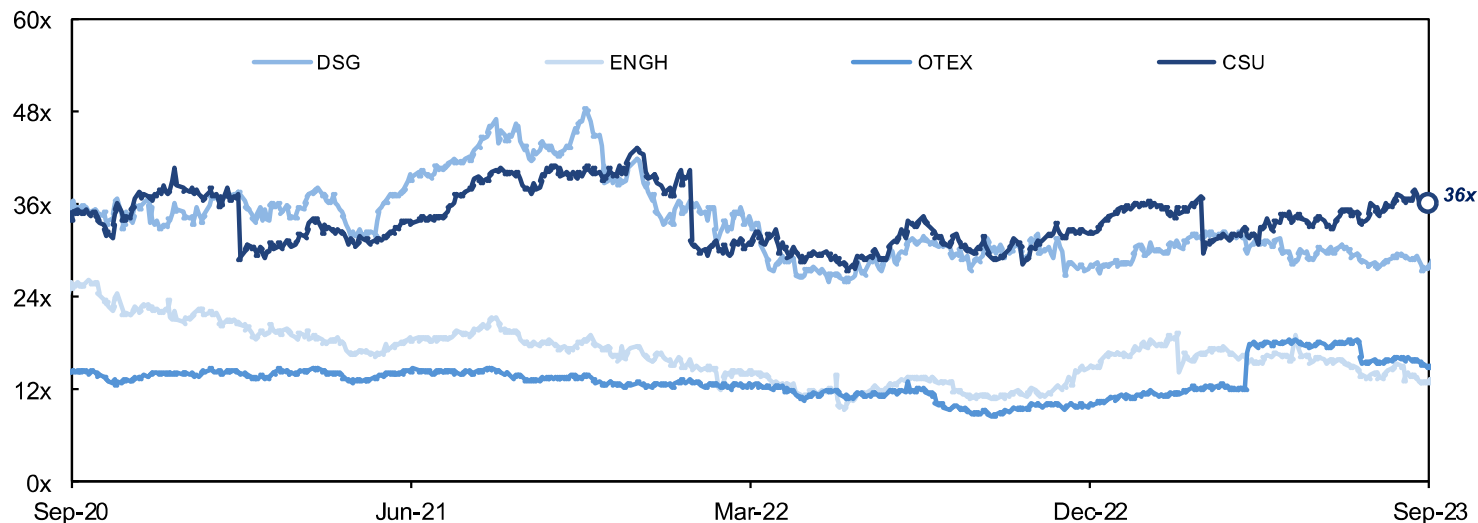
Source: FactSet, S&P Capital IQ

Figure 6: LHS Free Cash Flow vs RHS EBITDA Margin



Source: Company Filings, S&P Capital IQ

Figure 7: NTM EV/EBITDA vs Peers



Source: S&P Capital IQ

Risks

**(1) Ability to Sustain Margins:** CSU's inorganic growth strategy relies heavily on its ability to execute accretive M&A. The software industry has seen a notable increase in industry consolidation over the past few years. Deal values have a 17.2% CAGR since 2014, when the CPMT entered a position in the Company. As the market becomes more saturated, CSU may experience difficulty in sustaining its margins. This is seen in the Company's ROIC, which declined from 27% in 2018 to its LTM value of 15%.

**(2) Investment Hurdle Rate:** Total software transaction value has decreased 52% YoY as of Q1 2023. This decrease in deal value highlights increased competition. Shareholders are concerned about the Company's ability to meet its investment hurdle rate of a ROIC of 20%. In 2022, CSU deployed ~US\$1.6B on 139 acquisitions, shifting its strategy towards acquiring larger businesses. Mr. Leonard emphasized that this strategy would decrease ROIC but is necessary to become appropriate stewards of investor capital, indicating difficulty in executing M&A that provide historical returns.

**(3) Future Debt Issuances:** CSU recently issued a \$284mm unsecured debenture despite having an initial target of \$700mm. Its interest rate is tied to the Canadian All-Items CPI plus 6.5% and will mature in 2040. The persistence of the current inflationary environment will drastically increase interest expenses. This uncertainty regarding a recession may exacerbate financial strain, lower credit ratings, and lead to unfavourable future financing terms.

Investment Thesis and Valuation

CSU was valued at US\$3,075 using an eight-year DCF with a WACC of 8.84%. The terminal value was determined through the Gordon Growth method, using a 3.00% terminal growth rate.

The CPMT maintains confidence in CSU's ability to pursue accretive VMS M&A despite concerns surrounding its investment hurdle rate and sustenance of margins. The CPMT believes that the Company possesses an outstanding business model due to its capacity to finance most its acquisitions using cash, thereby maintaining low levels of debt and consistently generating FCF. Due to its steady stream of recurring revenue generated by its highly adhesive software products, CSU will persist in generating cash flow and engaging in acquisitions, even in a high interest rate environment, as demonstrated by its acquisition performance in the H1 of 2023.