

KAI SPOTLIGHT

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Company Spotlight



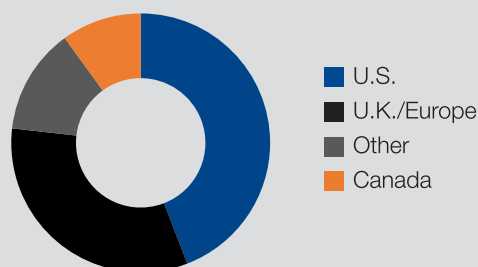
CONSTELLATION
SOFTWARE
INC.

While Constellation Software Inc. (CSI) may not have the household recognition some of our other technology portfolio companies enjoy, it is unquestionably a remarkable global success story hailing from Canada. Established in 1995 in Toronto, Constellation Software began its journey under the guidance of Mark Leonard who continues to serve as the company's president. A former venture capitalist, Leonard identified the untapped potential in acquiring, stewarding, and expanding smaller, profitable software companies that catered to niche, or "vertical", markets.¹ While CSI was established in Canada and maintains its headquarters here, it is a global company as only about 10% of CSI's annual sales are generated from Canadian operations. Meanwhile, the U.S., U.K., and European operations collectively contribute to approximately 77% of CSI's annual sales. This geographical revenue distribution demonstrates the global reach of CSI's business operations.²

Constellation Software Inc. Revenue by Geographic Segment³ Millions USD

U.S.	2,923
U.K./Europe	2,161
Other	876
Canada	661

6,621



To better understand what we believe is a key structural advantage for CSI, it is important to understand the difference between vertical and horizontal software. Vertical software, as the name implies, is software that is designed for a specific industry or sector. It caters to niche markets, providing software solutions that are highly specific to a particular industry. This unique focus is reflected in CSI's current operating divisions. Three of its main divisions are: Volaris, which offers software catered to the Agricultural and Bio-Sciences sectors; Harris, serving Utilities, Healthcare, and various other areas of the Public Sector; and Perseus, which delivers specialized software for Homebuilders and the Specialized Manufacturing sector. In each case, the software provided is tailored to meet the unique needs of a specific industry, which we believe underscores the "mission-critical" nature of CSI's vertical software offerings.^{1,4,5} In contrast, horizontal software is designed to be industry-agnostic, providing software solutions that are applicable across multiple industries. For example, Microsoft's Office software bundle (Excel, Word, Outlook, etc.) provides productivity tools that can be used by businesses or individuals across any industry.

The vertical markets CSI caters to often have unique industry-specific needs that are not adequately served by generalized horizontal software. Our view is that horizontal software companies benefit from customer switching cost advantages, however we believe CSI's vertical market strategy has even higher customer switching costs and thereby elevated customer retention rates. Due to the high degree of specialization and integration within customer operations, switching to a different software provider can be costly, time-consuming, and risky for CSI's clients. These high switching costs act as a natural barrier to competition. Furthermore, the specialized nature and smaller size of the vertical markets CSI serves often means less competition compared to broader horizontal markets, further enhancing CSI's competitive position.

From our perspective, CSI's durable business model has been instrumental in driving powerful financial performance. The company's business model, which combines mission-critical tools for customers, recurring software subscription revenue, and high customer retention has led to stable profit margins. CSI's durable business model, in combination with its compelling capital allocation strategy of acquiring profitable, cash-flowing vertical market software companies has generated a 5-year average return on invested capital of 22.5%.²

By successfully navigating the landscape of vertical software markets and through skillful capital allocation, Constellation Software has built a resilient business with a remarkable track record of value creation for shareholders. We maintain our confidence in the company's business model, capital allocation strategy, and the executive team led by Mark Leonard. As we look ahead, we are confident in CSI's ability to further leverage its competitive advantages and continue generating shareholder value into the future.

¹Constellation Software website, Overview and Management Team pages (July 2023) ²S&P Capital IQ, KAI Asset Management analysis (July 10, 2023) ³Based on 12 months ending December 31, 2022, S&P Capital IQ, KAI Asset Management Inc. analysis (July 2023) ⁴Constellation Software website, Our Companies page (July 2023) ⁵Constellation Software, *President's Letter* (2018) | © KAI Asset Management Inc. (KAM) 2023. KAM is a Portfolio Manager and Exempt Market Dealer registered in the provinces of Manitoba, Saskatchewan, British Columbia, Alberta, and Ontario. The firm is also registered as an Investment Fund Manager (IFM) in the provinces of Manitoba and Ontario. This communication is directed only to persons resident in those jurisdictions. The information contained herein is for general information purposes only and does not constitute an offer or solicitation of securities, managed account services, or advice on any specific security. The opinions set out herein are effective as of the date of publication and the authors do not undertake to notify the reader of subsequent changes. Certain general or market information contained herein has been obtained from sources believed to be reliable however KAM cannot guarantee their accuracy. Any opinions expressed in this newsletter are just that, and are not guarantees of any future performance or returns. 230713