GRANT'S
INTEREST RATE OBSERVER®
Vol. 34, No. 23c Two Wall Street, New York, New York 10005 • www.grantspub.com DECEMBER 9, 2016

Past Performance, Inc.

Good news you shout from the rooftops, bad news you mumble in a footnote. Constellation Software, Inc. (CSU on Toronto), the most successful Canadian company you've never heard of, isn't one for shouting. *Grant's*—to anticipate—is bearish on it.

Constellation, which the equity market values at C$12.6 billion ($9.5 billion) and at 46 times trailing GAAP earnings per share, is the largest listed software company in Canada. Vertical market software (VMS) applications are its stock in trade. They range from the exotic to the pedestrian. One Constellation application can manage a transit system. Another runs a karate club.

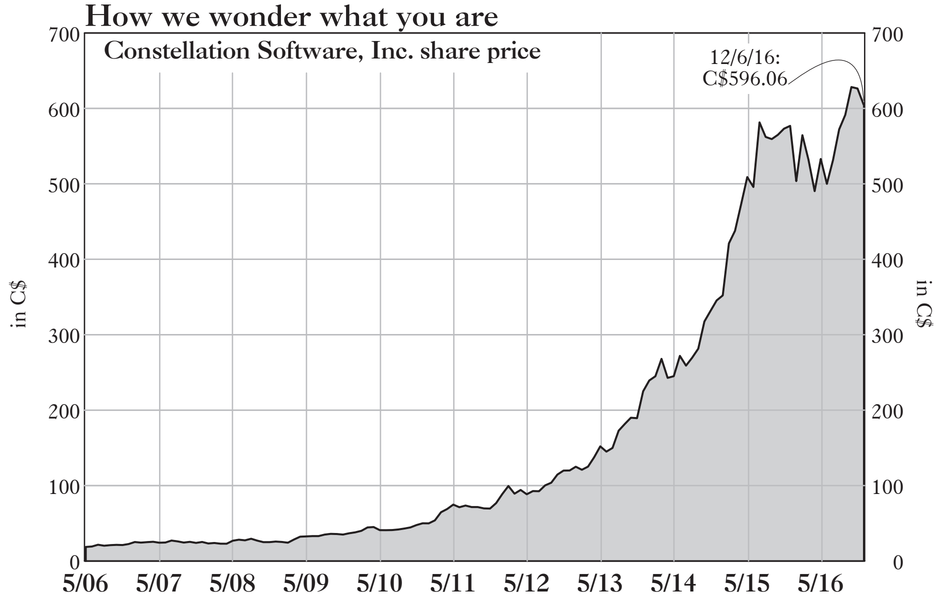
President and chairman Mark Henri Leonard, 60, founded Constellation in 1995 to roll up an atomized VMS industry. He has subsequently acquired 300-odd software businesses whose output is sold in more than 75 distinct niches, or "verticals." Transit and healthcare are the largest, and second largest, of these verticals. No one vertical constitutes more than 10% of revenue and no one customer or product is deemed material from a financial-reporting standpoint.

Constellation went public in May 2006 when its private-equity sponsors could find no other takers for the stock they wanted to unload. The share price has subsequently jumped by 34-fold on the back of growth rates that border on the supernatural. Since the IPO, revenue growth has compounded at a 26.4% annual rate. Return on invested capital, which has averaged 30%, reached 38% in 2015. Constellation finances most of its acquisitions with the cash it earns in operations. Nevertheless, debt—net of cash plus minority interests—amounted to $110.8 million as of Sept. 30. Fitch rates the debt triple-B-minus, meaning investment grade, barely.

Constellation is a company of few words. It spares its public even such details as the names of its smaller acquisitions. A press release hails the major deals, but silence greets the minor ones. And because Constellation makes lots of little acquisitions, i.e., those of less than $10 million, and because the small fry furnish the principal source of parental growth, the stockholders have no clear picture of what they actually own.

Maybe the front office reasons that knowledge avails even the best-informed Constellation investors little. Why, then, bother to disseminate it? You can—almost—see the point. In 2011, the aforementioned private-equity sponsors, who still held 51% of the stock, wanted an exit. They prevailed on management to find a strategic buyer. None stepped forward, at which point the board instituted a quarterly dividend of $1 a share, which continues to be paid. Between the formal cessation of the search for a taker, on Jan. 3, 2012, to the present day, the Constellation share price has vaulted by 640%, though it did so without the impatient PE investors, who sold at the conclusion of the strategic review. So much for foreknowledge. And so much for fancy information. "Nobody knows

How we wonder what you are



source: The Bloomberg

anything," to quote the screenwriter William Goldman.

Nevertheless, it would be nice to know a tiny bit more than management seems prepared to divulge. Thus, colleague Evan Lorenz asked Jamal Baksh, the Constellation CFO, to describe two or three recent acquisitions and explain what attracted management to them. "I can't disclose that to you if I am not disclosing that to the public," Baksh replied. "So," as Lorenz comments, "mum's the word on the little stars that constitute the big Constellation."

Constellation has six reportable business units, about which it keeps its own counsel. Management provides financial information based on binary customer type only: "public" (local, state and federal governments) and private. They contribute two-thirds and one-third of the top line, respectively. Last year, the United States delivered 54% of Constellation's revenues, Europe and the UK 29%, Canada 12% and parts unknown 5%. U.S. dollars are the company's reporting currency.

"Maintenance revenue," meaning recurring revenue, is the kind of income that Constellation strives to acquire, build and nurture. Software-as-a-service, transaction-related revenues and hosted products are examples of the type. In the third quarter, maintenance revenue chipped in 66% of the total.

If his fans insist on comparing him with Warren Buffett, Leonard doesn't discourage them (nor does he encourage them; the Canadian financial press can't seem to get a word out of the publicity-shy entrepreneur). He models himself after the chief of Berkshire Hathaway in letting his acquired companies go their own way. In fact, he encourages them to compete with each other.

Through long experience, says Baksh, management knows what works in the software industry and how to impart these best practices to its hundreds of acquirees. That said, decentralization is the essence of Constellation's management style. On the third-quarter earnings call, Leonard either could not, or would not, hazard a guess as to how much the average price of the company's software had risen so far in 2016. Pricing decisions, he said, are made "down at the individual business-unit level." Of course, Constellation is ultimately one company, and it falls to the CFO, Baksh, to consolidate more than 250 unique profit-and-loss statements every three months for quarterly reporting purposes.

Constellation Software, Inc. revenues
all figures in $ millions

	3Q16	3Q15	pro forma adjustments	adjusted 3Q15	calc. growth %	reported growth %
Public Sector	368.1	317.5	39.0	356.5	3.3	4.0
Private Sector	177.5	142.8	30.0	172.8	2.7	2.0
Total	545.6	460.4	69.0	529.4	3.1	4.0

source: company reports

Constellation stands taller on Toronto's Bay Street than analyst ratings alone would suggest (two buys, eight holds and one sell, according to Bloomberg). The analysts have penciled in year-over-year growth in revenue and adjusted EPS of 13% and 18%, respectively, for 2017. To quote Blair Abernethy, of iA Securities: "We believe Constellation has the opportunity to continue to drive material revenue growth and steadily scale its operations over the next five years. However, at current stock-price levels we are maintaining our Hold rating." Constellation changes hands at 24 times trailing adjusted EPS (and, as noted, at 46 times trailing GAAP EPS). Short interest constitutes 1.2% of the float.

The relative paucity of short sales suggests that the bullish view on Constellation is the majority one. The correct (we submit) minority case features these essential points: Competition in the software business is hotting up; competition to acquire desirable software businesses is likewise intensifying; Constellation's disclosure falls well short of de minimis, a fact which means that investors must trust rather than know; and Constellation may be too big to match its historic feats of expansion, though shares are priced as if it will.

As to the suspicion that Constellation has outgrown its familiar story, management sends mixed signals. On the one hand, it boasts of possessing a list of 30,000 VMS acquisition prospects. It says that it's ramping up to buy 100 new businesses a year, compared with the 31 it landed through the first nine months of 2016; the 31 cost $139.6 million. That compares, coincidentally, to 31 acquisitions in all of 2015; they cost $247.7 million.

On the other hand, on the third-quarter call, Leonard admitted that the quality of potential acquirees has deteriorated: "Initially, you have companies that are absolutely bullseye-type companies; they meet all of our criteria. And over time, as you build up pressure to increase the number of suspects in the funnel, you end up with increasingly marginal suspects. So the quality of what we've added in 2015 and 2016 is probably nowhere near as good as it was back in the day."

Maybe Leonard was thinking of Market Leader, a maker of software for real-estate agents that Constellation purchased last year from Zillow for $23 million. "Shrinking" was how Zillow characterized Market Leader on the eve of the sale. Or perhaps Leonard was recalling Springer-Miller Systems, another 2015 acquisition, the previous owner of which, Par Technology Corp., had classified it as a discontinued operation at the time of its sale. Both Springer-Miller, a vendor of hospitality-related software for which Constellation paid $16.6 million, and Market Leader had been money-losers under their respective prior managements. Constellation thinks of itself both as a value investor and a fixer-upper of broken businesses. It will have an opportunity to work its remedial talents in the pair of acquisitions just mentioned.

(Howard Leung, analyst for Veritas Investment Research, had spotted the Market Leader and Springer-Miller transactions and voiced his concerns about them almost a year ago. Leonard seemed to write his 2015 letter to shareholders in response to Leung: "Our acquisition mix in 2015 was . . . unusual," the president said. "We acquired some large, high-margin but shrinking businesses with attractive tax characteristics and higher than normal profitability resulting in consolidated EBITA/revenue margin reaching record levels." But neither Market Leader nor Springer-Miller fit the bill of "higher than normal profitability"—each, indeed, was estimated to be generating negative EBITDA before it joined the Constellation fold.)

"It's difficult," Lorenz observes, "to get a full understanding of Constellation's existing book of business. In fact, Constellation's 2015 Annual Information Report devotes more space to its acquisition process than to its products. (Attention, would-be acquirees: Purchase criteria are enumerated at www.csisoftware.com/about-us/being-acquired, a web page that includes Leonard's email address and phone number.)

"Besides having no clear idea of what Constellation owns," Lorenz proceeds, "an investor can't know whether that book of business is growing or contracting, excluding acquisitions. There's no disclosure of how much the businesses that the company owned a year ago grew in the current period. This lack of disclosure is important for two reasons. First, Constellation maintains that it typically buys fast-growing VMS providers and then jacks up the prices on the acquired software. That is to say, recent deals should skew higher reported pro forma growth. Second, whether or not Constellation's existing book of business is expanding also determines whether the company's non-GAAP earnings metric is a better measure than GAAP figures. The biggest adjustment to the non-GAAP number is the elimination of amortization expense for acquired intangible rights, i.e., the value ascribed to acquired software and brands. If the businesses Constellation purchases are shrinking, then the amortization is the real expense required to buy additional VMS providers in order to keep revenue flat. If the businesses are indeed thriving, then the amortization expense is an artifact of acquisition-related accounting.

"In the third quarter," Lorenz continues, "amortization expense fell by 11%, to $42.7 million, despite intangible assets increasing by 3% year over year, to $999 million. In the company's management discussion and analysis (MD&A) report, the following explanation is offered: 'The decrease in amortization expense is primarily attributable to an increase in the average remaining life of unamortized acquired intangible assets as at September 30, 2016 compared to September 30, 2015.' I asked Baksh to note what the average useful life changed to and why the change was made. He declined to answer.

"In some cases," Lorenz goes on, "the pro forma numbers that Constellation provides simply don't add up to the reported organic growth rates. The third-quarter MD&A report stated that public sector, private sector and total company organic growth was, respectively, 4%, 2% and 4%, measured year over year. Constellation also gives the dollar amounts needed to adjust third-quarter 2015 revenues to calculate third-quarter 2016 pro forma organic rates. Based on these figures, organic growth for the public sector, private sector and total company was 3.3%, 2.7% and 3.1%, respectively, in the third quarter, again measured year over year. The fact that reported and calculated growth rates for public, private sector and total company growth differ by 0.7%, 0.7% and 0.9% cannot be explained by a rounding error. Either the stated growth rates in the MD&A are wrong or the revenue adjustments the company gave to adjust third-quarter 2015 revenues are wrong.

"The fact that Constellation's financial reports are internally inconsistent raises an important concern," Lorenz proceeds. "As noted, the company does not integrate acquisitions. Nor does it address in any coherent way the critical question of whether the business is growing in the absence of price increases. You start to wonder if Constellation has adequate financial controls to monitor and audit its sprawling collection of VMS business units."

Lorenz queried Baksh on whether "organic growth" includes price increases from acquisitions.

BAKSH: The other thing is, we do get more benefit from acquisitions: Many acquisitions are underpriced when we buy them. You are able to get a correction in the first couple of years. Once it is corrected you get more in line with a sort of 3%–4% price increase. In acquisitions that number would come down.

LORENZ: In 2015, you had 15% growth from acquisitions. Does that include price increases on the acquisition base, or do price increases from acquisitions go into the price increases from organic sources?

BAKSH: Acquired growth is just the dollars you acquired. If you put an increase on top of that, that goes into. . . .

LORENZ: That goes into organic growth?

BAKSH: Yeah.

LORENZ: So, organic growth would include price increases from acquisitions?

BAKSH: Correct.

In the three months till Sept. 30, EBITDA as a percent of sales dwindled by 0.2% to 26.7%. It was the first year-over-year decline in margins since the second quarter of 2014. This decrease is all the more curious on account of a drop in expenses on R&D, sales and marketing, measured as a percent of sales, by 0.6%. It's odd for a company that claims to generate organic revenue growth *and* price increases to suffer negative operating leverage.

In the absence of information, one shouldn't dogmatize. Then, again, in this case, information seems to be withheld. One is curious to know, for example, whether, ex-acquisitions, Constellation's business is contracting or expanding. It had better be expanding, given the rise of cloud computing and app-based solutions and given the evident decline in a key measure of health for maintenance-software growth. Days deferred revenue, i.e., deferred revenue divided by daily sales, is that measure. It has fallen to 80.7 days from 84.3 days between the third quarters of 2015 and 2016. Excluding deferred revenue from acquisitions, deferred revenue days would have fallen to 73.3 days in the third quarter of 2016. (American investors may be especially skeptical of this line item because U.S. GAAP requires buyers to write off most of their acquired deferred revenue for accounting purposes.) Call us, then, doubtful about growth.

What does the digital world have to say about Constellation? On the recruiting site Glassdoor.com, the company earns 3.8 out of five stars based on 13 reviews, while Microsoft Corp. garners four stars on a slightly larger sample size—14,006. "First-class people with a strategy that has proven to be extremely successful," chimed in a former Constellation hand on Oct. 22. "Too decentralized, poor oversight of each business unit," complained a current employee on Sept. 10.

But search under Constellation Software's business units on the same site, and you'll find more reviews and more negative opinions. The company's Jonas Operating Group gets an average of 2.5 stars in 16 reviews. The Harris Operating Group achieves 3.3 stars in 53 reviews, including this one, dated Dec. 15, 2015: "[Harris Local Government] low employee retention, management valuing recognized revenue over customer and employee satisfaction, and an aging stable of software products don't make for a bright future for HLG employees or prospects." On Nov. 16, an in-house critic contended that Market Leader had not improved on Constellation's watch: "The product is very dated and not competitively priced, lots of cancels and unhappy customers."

A complaint by a former employee in the Harris Group anticipated many of the concerns that we raise here: "Focused almost entirely on quarterly numbers. No long term strategy. Concentrates on milking existing clients for every last cent. Talks about respect, gives none. Pay raises are few and far between. Infrastructure is non-existent. Relies on spreadsheets instead of integrated technologies. Can't keep numbers straight half of the time."

In Canada, Constellation's founder and president is held in a level of esteem commensurate with the parabolic rise of the Constellation share price. Notable, then, is Leonard's expressed intention to move away from the company he built. "I have waived all compensation because I don't want to work as hard in the future as I did during the last 20 years," the founder told the shareholders in 2014. "Cutting my compensation will allow me to lead a more balanced life, with a less oppressive sense of personal obligation." Nobody at *Grant's* is a psychiatrist, but we are going to venture that that is a kind of retirement announcement.

Over the past 12 months, insiders, on balance, have sold shares worth C$1.5 million in the open market.

A postscript: S.F. Nicholson, writing in the *Financial Analysts Journal* of July/August 1960—a time of keen interest in growth stocks—studied the returns on 100 common stocks over 11 time spans from 1939 to 1959. What he found, as Benjamin Graham paraphrased his conclusions, was that "the stocks selling at the lowest multiples showed much more appreciation than the stocks selling at the highest multiples and that the individual issues which showed losses during these periods or which showed relatively little appreciation were predominantly in the high-multiple groups."

Observed Nicholson himself: "Many investors have apparently underestimated the importance of reasonable price-earnings relationships." *Plus ça change*.

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