KANBRICK

April 5, 2022

Dear Partners,

Like the leaders who inspired the practice of our annual letter, we view writing as an opportunity to reflect; share our thoughts, learnings, and approach; and improve. We are humbled that you are reading this, and our hope is you will find at least a kernel of value. This marks our second year at Kanbrick, though this year we elected not to release our letter on April 1st: We'll leave those traditions to wittier fools.

Twelve months seems like an eternity in terms of COVID, inflation, macroeconomics, growth stock valuations, and geopolitics. The world has changed dramatically several times over; the observation that there are weeks when decades happen rings especially true now.

Yet there are some things that remain constant. People want to do meaningful work and have a positive impact, create a better future for their families, and achieve their potential. In many ways, these motivations were the catalysts for Kanbrick: Our purpose is to empower people and organizations to reach their full potential. This spans helping people grow and develop in their careers, building companies that create value for their customers and employees, and delivering great results so our partners can achieve their missions. We know we hit the lottery to have this opportunity in the United States, where capitalism has driven immense growth in our standard of living over the last 100 years, supported our national security, and provided the sparks for the American dream. And our approach is distinct from the many fish in the private equity sea. We think in decades, not quarters; believe great companies are built by people — not in spreadsheets; and focus on building companies that compound long-term value vs. "flipping deals" faster than McDonalds turns its burgers.

<u>Let's Build Together</u>

During our time leading a business as CEO and CFO, we saw a gap in alternatives and resources for the leaders of mid-sized companies. We created Kanbrick for people looking for something different; the option we wanted for our own families. The name Kanbrick is a nod to our shared experience growing up in family businesses in Kansas and our belief that great things are built "brick by brick" — day by day, little by little, through hard work, discipline, and integrity.

While building a great business takes years, selling it only happens once. Our best advice to owners certainly runs counter to the prevailing wisdom of other advisors: Continue to hold your business as long as it is right for your family. Selling does not make you wealthier, but it will shift the form of your wealth, perhaps enabling you to accomplish other goals, like diversifying your assets, finding a partner for growth, or preparing for succession. Unfortunately, many of the business owners we know well have had regrets after selling their companies to a strategic partner or a private equity firm.

At Kanbrick, we are business builders. Rather than maximizing our investing pace, we aim to partner with 1-2 exceptional companies per year. Just like Ted Williams mapped out the strike zone into 77 segments and waited for his pitch, we are focused on finding the right pitch for us. While auctions work great for cattle, we seek to work with owners who view their business as their baby and thus desire a long-term home and partner to help grow the business versus a spot on an ever-accelerating 3-year treadmill. Just as renters and owners treat a house differently, the same is true for companies. We think having a long-term time horizon incentivizes very different actions – such as investments in people and culture – than business renting and flipping. Our hope is that Kanbrick can be the long-term home of choice for family- and founder-owned businesses that have the following characteristics:

- Industry: Consumer, Business Services, and Manufacturing / Distribution
- Size: Up to $50M of EBIT
- Location: Headquartered in North America

If you or someone you know are thinking through this decision, we would welcome the opportunity to confidentially discuss the company and the right decision for the owner, family, and business. We promise to help think through different options (even if it doesn't include Kanbrick) while being responsive and maintaining confidentiality.

After we make an investment, we focus on building for the long-term. While we'll never understand a business as well as the founder or owner, we've found that the combination of our outside view, partnership mindset, and the Kanbrick Business System help accelerate what is possible. The Kanbrick Business System is a hands-on approach we've built from working across dozens of companies that tackles the biggest issues facing mid-size companies. Our first acquisition, Thirty-One Gifts, exemplifies this approach. We are proud of everything the team accomplished during a turbulent 2021. Last summer, we hired Camelle Kent as our CEO, and she has done an exceptional job continuing the inspiring legacy of Thirty-One Founder Cindy Monroe. The last year demanded navigating COVID and handling supply chain disruptions, all while refreshing our brand and product portfolio (including a new sustainable fabric line) and investing in our field, team, and culture. And if you need some durable, functional, and fashionable utility totes, bags or home organization products, each with a host of personalization options, check out the website or better yet connect with a local consultant who can give you personalized tips and recommendations.

The truth is that while there is a glut of resources for startups and enterprises, from accelerators to books and podcasts, to help leaders think through scaling and other challenges, there are far fewer such opportunities for mid-size companies. We created the exclusive invitation only Kanbrick Community to help fill this gap.

In 2021, we launched our flagship Build with Kanbrick program, a selective, free, three-month offering designed to help owners or CEOs of $50-$500M revenue companies accelerate long-term growth. In general, we found that most companies – including ours – have similar opportunities and challenges across attracting and developing talent, strategic planning, KPIs, allocating capital, creating a cadence to manage the business, and managing digital transformation. We had two successful cohorts in 2021 and just launched our third cohort in 2022. With more than 100 incredible applicants to date, one of our biggest challenges has been selecting participants. Our initial cohorts in 2021 included a fantastic set of businesses led by strong leaders: American Fence Company, American Hip Institute, Chirp, Cotopaxi, Martori Farms, NeoLife, SET Environmental, Three Ships, Tommy Gate, and Truck Centers. We just launched our 3rd cohort, which includes Biggby Coffee, Evoke Medical, Rep Fitness, Solberg Manufacturing, and Total Care Clinics. These 15 businesses represent a diversity of industries and geographies, and it is an honor to partner with them. We would welcome applications for our Fall 2022 cohort at Kanbrick.com/build.

Beyond our flagship Build with Kanbrick program, the Kanbrick Community helps bring together owners, CEOs, and executives of mid-sized companies for shared learnings. We recently started in-person Coffee Chats and will be hosting our inaugural Kanbrick Summit for members of the Kanbrick Community in April. Beyond events, we share our learnings to our email subscribers through content like our Annual Letters and white paper topics like Strategic Planning.

In addition to events, we are always looking for exceptional leaders and people to join us as board members or as leaders within our businesses. Birds of a feather flock together, and this is a chance for continuous learners to connect, learn, and grow together.

For our part, we know our own team and reputation is critical to our success. Kanbrick's culture is purpose-driven, entrepreneurial and meritocratic, with an emphasis on empowerment and accountability. We act like owners, focus on getting better every day, live with integrity, and win together. We are humbled to have a great team, including a couple of new additions over the last year. And we are always looking for exceptional people to join us, including in the following roles:

- Executives: We know firsthand how hard it is to run a business. Leaders at our companies get to think long-term and be empowered to act like owners, while also having the broader resources and support network of Kanbrick
- KBS Team: Our growing KBS team takes a hands-on role assessing business and driving value in partnership with our managers. The KBS team offers a great opportunity to get your hands dirty making an impact and to learn the ins and outs of managing a business
- Board Members: We are continuously seeking world-class board members – a few near-term focus areas include Marine, Enthusiast Brands, and Home / Commercial Services
- Investment Team: We are expanding our investing team and are currently hiring analyst through senior level roles. This is a great role for a long-term thinker who wants to combine investing and operating in a growth focused culture

We believe people decisions are the most important decisions, and much like the jeweler grades gems on the 4 Cs (i.e., cut, color, clarity, carat) we look to for a combination of 3 Cs in people: capability, character, and culture. It is magic to find alignment across all three, and if you or someone you know are interested in working with us, please reach out at build@kanbrick.com.

<u>Thoughts and Learnings</u>

"My hunger is not for success, it is for excellence. When you attain excellence, success naturally follows." – ***Coach K***

Winning in sport is the result of blood, sweat, and tears — often outside of the spotlight. Business requires a similar commitment to mastery. Connected to our belief that great companies are built brick by brick is our insatiable appetite for excellence. Success demands discipline, hard work, and a commitment to getting better every day. Reading, thinking, and reflecting are a key part of our process, and while we realize how much there is to learn, below are a few thoughts on topics that we think are relevant today (one note is we don't cover results or investment ideas for competitive reasons).

<u>Mid-Sized Companies: Mo' Money, Similar Problems</u>

We love working with midsized companies. They have achieved meaningful success, are the bedrock of the economy, have talented and passionate employees, and numerous opportunities to grow their impact. We often are asked about the challenges mid-sized companies face. In building businesses, we typically see the most opportunities in five key areas:

- People – attract, develop, and engage the right people
- Strategy – define the source of competitive advantage (i.e., how to win), determine where to play, and identify initiatives to drive the value creation flywheel
- KPIs – develop success metrics across the business and move to a mission mindset built on empowerment and accountability

- Capital Allocation – build a spending plan to fund the strategy and invest in growth, while also embedding capital allocation in the culture
- Execution – create a daily, weekly, and monthly cadence to problem solve and drive the business

Yet most business advice targets start-ups or large Fortune 500 companies. In practice this means key topics go uncovered, like how to build a great strategy without hiring McKinsey; create KPIs to manage the business; transform digitally when you have a spaghetti web of legacy systems; or attract and retain high-quality talent without a smoothie bar or massive stock option packages. We originally planned to launch a curriculum on these topics just for Kanbrick companies; however, we think we can better live our purpose of empowering people and organizations to reach their full potential by sharing more broadly, through programs like Build with Kanbrick, our Kanbrick Community, and our business content.

<u>Capital Allocation</u>

As long-term investors, we think a lot about capital allocation (in fact, last year our book recommendation was *The Outsiders,* a fantastic read on the subject) because how we invest today determines how we live tomorrow. The financial industry revels in using fancy words and confusing acronyms like EBITDA and IRR, but capital allocation at its most basic level is picking where to invest. This transcends business and applies to governments, communities, and individuals. For example, future GDP (and thus standards of living) are ultimately a function of our capital stock, labor, and technology. Examples like Singapore's remarkable transformation under Lee Kuan Yew show how high return investments in areas like education and rule of law grow productivity and standards of living, while there are countless examples of pork projects and bridges to nowhere that detract from growth. At the individual level, building problem-solving skills will pay future dividends while "investing" in junk food won't. Compounding – the very powerful but continually underestimated force – leads to geometric differences in results over time. For example, $100 invested at 20% vs. 2% over 1-year results in $120 vs. $102. While an $18 difference isn't huge, if your timeline is 50 years, then this gap widens to $910,044 vs. $269 (3381x difference with the 2% return almost certainly losing money on a real basis). They key is finding and making the 20% investments and avoiding the 2% (or worse) decisions.

At Kanbrick, we think about capital allocation across 3 levels. First there is company selection. As long-term investors, it is especially important for us to invest in companies with high returns on capital, a moat to protect these returns, and large opportunities to reinvest in growth. Great companies reward patient long-term investors. Second is allocating free cash flow within a business to capital expenditures, R&D, acquisitions, dividends, and share buy-backs. The third and often overlooked area involves the buckets of cash spent prior to free cash flow. In a 10% cash flow margin business, 90% of net revenue is covering costs like salaries, product costs, technology systems, facilities, working capital, etc. While many of these decisions are small, ultimately these choices add up and determine the destiny of a business. Just as importantly, this bucket offers an opportunity to empower people across the organization to make better decisions by embracing principles like acting like an owner or using simple decision guides like targeting 5x revenue return on new commercial investments. Putting capital allocation in tangible terms that everyone can understand helps ensure everyone is using the same measuring stick when making decisions.

It is incredible when all three spin together in a compounding value creation flywheel. Companies like this are true unicorns. If you find one, hold on tight because they are exceedingly rare and able to deliver exceptional returns. One classic example is ABC Capital Cities beginning in the 1950s under the leadership of Tom Murphy and Dan Burke.

The broadcast and publishing company benefited from a "moat" that supported significant value creation from the 1950s to 1980s (e.g., return on equity averaged ~19% in the 10 years prior to the 1985 merger with ABC). [1] Capital Cities had attractive reinvestment opportunities – including acquiring new broadcast stations – and it was able to realize untapped potential in these businesses by reducing costs, empowering talented people, and creating a culture of ownership (ideas that are all core to KBS). A few of our favorite nuggets include:

- Only painting the sides of a building that faced the road. This is a true-life example of acting like an owner and being frugal on things that don't drive customer value or employee experience
- Focusing intensely on finding and empowering the right people vs. centralized control. ABC Capital Cities has countless examples of this, and this mission mindset grounded in empowerment and accountability is key to our approach. We believe people decisions are the most important decisions yet are often overlooked. Although the economics of spending $1M on capex are very similar to paying someone $100K per year in perpetuity, the capex decision tends to require bales of complex analysis while hiring processes often make the DMV look organized

Capital Cities is a compounder, and rewarded its shareholders accordingly; after going public in 1957, the stock appreciated 23% annually through 1985. Compounders continue to exist in the wild today — Danaher and Constellation Software are modern examples. We seek to emulate this intense focus on capital allocation. It drives a virtuous flywheel by ensuring people understand the business economics, allocating capital to high return areas that drive growth, and ultimately creating more opportunities through growth (both more cash to deploy and opportunities for people to take on expanded roles).

Other Musings

Our approach of investing and building mid-sized businesses felt disconnected from the exuberance of meme stocks and Wall Street in 2021. We aren't macro investors, but much like it behooves the frog to have a thermometer for any warming pots of water, it is helpful to monitor key factors in the macro economy including interest rates, inflation, employment, and GDP growth.

Last year's letter noted our concern that growth stocks were particularly exposed to a change in interest rates given they are primarily valued based on large hoped-for cash flows many years in the future. Clearly, we are seeing more inflation today and the market is reassessing valuations accordingly. We don't think we can predict inflation, but the growth of the money supply is significant. According to the St. Louis Federal Reserve Bank, the M2 money supply increased a staggering ~35% from March 2020 to December 2021. Governments can print money – and as the global reserve currency, the U.S. has special status in this regard – but money is a medium of exchange which is different from wealth that is tied to what is produced by the real economy. Printing 2x the money doesn't make everyone 2x richer, and the inflationary impact is becoming apparent.

Beyond inflation, we've been thinking through the implication of a number of other trends. One area we are monitoring closely is the shift to goods vs. services during COVID. Just like you can't expect an exceptional growing season to repeat every year, we expect a reversion to occur, although the magnitude and level will vary by business (e.g., the desire to travel and explore isn't going away). Another interesting topic is the growth in private market valuations, especially in the venture and growth space. Headlines tout the army of unicorns joining the 3 comma-plus club; however, structural protections such as liquidation preferences and IPO rights often create complexities where new money is much more like a bond with an attached option.

[1] Capital Cities' Capital Coup – Fortune Magazine April 1985.

This makes determining the fair value of each tranche of equity quite complex and sensitive to assumptions in options pricing models like Black Scholes. And in many cases, we expect the true equity value is different than the headline number. Rather than sharing a bunch of math, we think a simple example illustrates this well: Buying common equity is very different than investing in a senior note with the option to convert to equity. Yet bulletin board valuations dominate the news, and this topic raises questions around how earlier stakes are valued (e.g., how does a mutual fund with private market exposure value existing shares following a new fundraising valuation) and how employee options are being presented and priced.

We often get asked about investing from friends and family, and over the last year we've seen a rise in speculation under the guise of investing, which is similar to having a friend who goes to the local riverboat casino to "invest." While both speculating and gambling can produce great payoffs and a sea of endorphins, heartbreak is almost sure to eventually follow. Memes and social media are modern inventions, yet our underlying human psychology hasn't evolved much since the Tulip mania of the 1630s. And the siren song of promoters has just become more sophisticated at separating investors from their wallets (and Odysseus surely would have found it easier to get tied to the mast of a ship than to lock himself out of his own brokerage account). We are focused on investing in private companies but many of the principles endure across public markets. With the legal disclaimer this is not investing advice and doesn't address the important topic of asset allocation (the late, great David Swensen's seminal work *Pioneering Portfolio Management* is a great read on this topic), a few of the key observations that we have shared with friends and family include:

- Beating the Market. Consistently beating the market is hard even for the best professional investors (and market timing is even more challenging). Unless you have the skill, time, and temperament, borrow Jack Bogle's: Just buy index funds month by month. While you don't have the great stock to talk about around the water cooler, you'll most likely have much better long-term results. If you do decide to actively invest, the below points are especially relevant
- Valuation. Ultimately the value of a business is grounded in the cash it produces and interest rates not the near-term enthusiasm of the crowds. Or as Benjamin Graham famously noted, in the long-term the market is a weighing machine not a voting machine
- Speculating vs. Investing. Investors think about holding a piece of a business that will grow in value over time while speculators hope to find another buyer regardless of fundamentals. Just like in musical chairs, eventually the music stops and buyers disappear. We prefer finding companies that offer some margin of safety instead of hoping to find an empty seat
- Understand Incentives. Charlie Munger talks about the superpower of incentives. Over the last year many new issuances were frequently shrouded in lofty projections and idealistic visions of democratizing access to unproven but potentially world-changing companies. Peeling back the incentives reveals a modern reincarnation of *Where are all the Customer's Yachts?* where promoters generally get huge paydays for getting deals done and shareholders are left holding the bag for sub-par performance
- Know Thyself. Temperament is key to investing and social media exasperates fear of missing out (FOMO), availability bias, and envy which in turn lead to poor decisions. If it seems too easy, then it probably is. Few people get rich quick, and just as the media doesn't cover lotto losers, it's a lot more exciting to write about the one in a million dart thrower vs. the millions of people who lost money. Decision making and outcomes don't always perfectly align and sometimes there is joy in missing out

At some level as a species and individuals, if you aren't learning, you're dying. We always appreciate reading recommendations and try to pay it forward each year with a few of our favorites. This year we have three that are relevant for investors and operators:

- *Superforecasting: The Art and Science of Prediction* by Tetlock and Gardner: This book shares lessons for improving forecasting including the use of base rates

- "The Psychology of Human Misjudgment," a lecture by Charlie Munger: Munger's lecture is a masterclass in cognitive biases and how to improve decision-making. Find it online or in the excellent compilation *Poor Charlie's Almanack* edited by Peter Kauffman
- *Lessons from the Titans: What Companies in the New Economy Can Learn from the Great Industrial Giants to Drive Sustainable Success* by David, Copeland, and Wertheimer: A deep dive showing the compounding power of business systems in industrials

We love to read and would welcome your book recommendations as well!

Looking Ahead

The last few years are a reminder of how much we don't control, the challenges in predicting the future, and that hard things are indeed hard. In 2019, few (if any) forecasts included a global pandemic, rising inflation, and war in Ukraine. Rather than predict the future, our approach has been to take a long-term view and build organizations that can evolve faster than the outside environment. We know there will be challenges and opportunities ahead and are excited about the journey to build exceptional companies with amazing people. We'd welcome the opportunity to work together – whether as part of the Kanbrick team, joining our family of exceptional businesses and the people who run them, or growing and learning together.

Sincerely,

Tracy Britt Cool

Tracy Britt Cool | Brian Humphrey