KANBRICK

April 1, 2021

Dear Partners,

We have long admired shareholder letters from respected investors and leaders like Warren Buffett, Jamie Dimon, and Jeff Bezos. While we can't match their leadership or insights, we can at least embrace the same medium. We launched Kanbrick one year ago on April 1, 2020, and this is our inaugural letter, in which we'll plan to discuss our results, learnings, and future goals. For competitive and regulatory reasons, we won't cover specific investment performance or ideas.

As we were planning to launch Kanbrick early last year, we had no idea what 2020 had in store. COVID-19 has been devastating, and our thoughts are with the countless people who lost loved ones or have been impacted by the virus and the ensuing economic crisis. Yet 2020 was also a year of inspiration -- during some of these toughest moments, we saw people put others first and persevere.

At Thirty-One Gifts, the business we acquired in July 2020, our team members and consultants inspired us daily in countless ways — from becoming at-home teachers to ensuring our distribution center continued to deliver to finding new opportunities to help customers. Despite the challenges, the ingenuity, compassion, and progress shown this year make us optimistic and confident about the future. It also makes us grateful, and we thank our team and the many others who have made significant personal and professional sacrifices and endured countless challenges over the course of this unprecedented year.

What We're Building

Kanbrick's purpose is to empower people and organizations to reach their full potential. Our goal is to compound long-term intrinsic value by buying, building, and growing great businesses. The name Kanbrick is a nod to our shared experience growing up 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. This is in our DNA, and we lived this every day growing up and working in our family businesses – farming for Tracy and cabinetry for Brian.

Again and again over the years, we have seen a special kind of business owner who is looking for a long-term home for their company — a partnership that would not only preserve, but also enrich their legacy. Core to our approach is our hands-on experience building companies as CEO (Tracy) and CFO (Brian). Leading a company is very different than sitting in a board room, and we know firsthand the joys (and challenges) of running a business. Great companies are not built in spreadsheets, and we create value through building enduring companies vs. financial wizardry and loads of debt. We built Kanbrick to offer an alternative to traditional private equity through a combination of our:

- Long Time Horizon: Great businesses are rare, and we think it makes sense to hold and build great businesses for the long-term vs. selling them every 3-4 years. We empower our teams to think about building an enduring business for decades, not quarters.

- Operating Experience: As noted above, we are both investors and operators with hands-on experience building companies. Some things can only be learned through experience, and we believe our experience as operators makes us better investors and vice versa.
- Focus on People and Culture: We have lived in a special culture and are guided by our purpose of empowering people and organizations to reach their full potential. We believe in doing the simple things like keeping our word, living our core values, and working hard as a team. At Kanbrick, we act like the partner we would have wanted for our family businesses.

While building a great business takes years, selling it only happens once. Our best advice to owners may be counterintuitive – continue to hold your business as long as it is right for your family. Selling will 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 or private equity firm. We want to be the 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 are thinking through this decision, we would welcome the opportunity to confidentially discuss your business and the different options to find the right decision for you, your family, and your business.

Year in Review

We launched Kanbrick a year ago, just as COVID was spiking for the first time and transforming our lives. This was undoubtedly a challenging time to launch, but we think in decades, not quarters, and we are proud of all that we accomplished to build our foundation. We are thankful to our families, team, friends, and countless partners for their support over the last year.

We believe everything starts with team and having the right people in the right roles. We have been humbled by the interest in joining Kanbrick. Our 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 actively hiring for our Kanbrick Business System (KBS) team to oversee the implementation of our value-creating playbook across our businesses. This is an amazing opportunity to have an immediate impact, learn and grow, and work in a critical role. If you have interest in working with us, please reach out via our website.

Our long-term approach, experience as investors and operators, and track record working with exceptionally respected companies continues to resonate with business owners. The combination of these three factors is unique – we think all good strategies need to be differentiated, hard to replicate, and create value – and we are very focused on building the best long-term partnership for companies.

We are especially excited to have partnered with Thirty-One Gifts and its Founder Cindy Monroe in July 2020. Thirty-One Gifts is a quintessential story of American entrepreneurialism in action: Cindy launched the business from her home 17 years ago and bootstrapped the company with incredible energy and limited initial capital. In addition to selling bags, storage products, and accessories that customers love, Thirty-One has a wonderful purpose, strong brand and history, and amazing group of independent consultants. Our goal is to strengthen the sales field, brand, and product so that Thirty-One consultants can continue to grow their businesses, especially digitally. The team accomplished a great deal since our investment, and we look forward to continuing to build the business for years to come.

When we were serving as CEO and CFO, we were constantly seeking to learn and grow, yet felt there was a dearth of easily accessible resources for mid-sized companies. We want to change that at Kanbrick by building a community of owners, operators, and investors through content, programs, and events. So, in early 2021, we launched a new program called Build with Kanbrick that is designed to drive value in participating companies, compound our learnings, and build our reputation among mid-size companies. The 3-month program focuses on helping CEOs, founders, and owners tackle some of their biggest challenges and opportunities. Many start-ups have access to accelerator programs, but there is little that supports more established businesses. We were excited to consider dozens of strong applications for 5 spots in our first spring 2021 cohort, which is currently underway. If you'd like learn more about future cohorts, please visit our website at www.kanbrick.com.

Thoughts and Learnings

One of our core values is "get better every day." We believe reflection is vital to continuous improvement and wanted to share some key learnings and reflections across several investing and operating topics. These insights synthesize our own experience as well as learnings from others. At the outset, we should note that each topic is inherently complex, so a few paragraphs are admittedly inadequate. We also stay away from macro predictions like foreign exchange or interest rates – our Magic 8 ball hasn't been helpful, and, despite years of searching, we have yet to find a crystal ball.

Purpose, People, and Performance

Studying the history of business provides a number of insights and based on our research and personal experience we believe the combination of Purpose, People, and Performance drives results. This three-legged stool is rarer than a four-leaf clover – most companies only focus on one or two areas and few deliver on all three.

Everything starts with People. As we continue to shift from a physical asset to an intangibles-based economy, we believe the importance of attracting, developing, and engaging incredible people will continue to grow. Lots of companies say people are their most important asset but few really back this up by prioritizing people and culture.

Too often firms overly focus on incentives – proper incentives are necessary but not sufficient (and as the Wells Fargo situation shows, improper incentives are dangerous). Other key components include defining your critical roles, ensuring you have the right people in these roles (which unfortunately often requires difficult decisions), having a rigorous hiring process, supporting a robust talent management process, and creating clear decision rights that enable empowerment and accountability. More broadly, we embrace Daniel Pink's idea of creating cultures that combine autonomy, mastery, and purpose. We know this is true in our case – we want to learn, grow, and have an impact.

Purpose answers the question of why we exist. Contrast the countless generic purpose statements focused on shareholder value with that of Starbucks: "To inspire and nurture the human spirit – one person, one cup and one neighborhood at a time" or Nike's intention "to bring inspiration and innovation to every athlete in the world." Purpose and its cousins vision and core values define an organization's reason to exist, what they want to achieve, and their fundamental beliefs. These components should be exciting, enduring, and authentic, and are generally found by looking within and engaging with employees, customers, and other key stakeholders.

Performance is the third leg of the stool. To achieve its ambition a business must execute and deliver results. High-performing companies have a well-defined strategy, clear goals and accountabilities, and a process to manage performance on a daily, weekly, and monthly basis. Danaher is tremendous in this area: They have a robust strategy process, clearly deploy goals across the organization, and embrace daily management and problem solving to drive results.

Delivering on People, Purpose, and Performance is hard – companies are complex adaptive systems with lots of moving parts. This is where a business system can be invaluable. A business system is a holistic approach that focuses on creating long-term value by aligning people, process, and culture to strategy. For example, in the Kanbrick Business System (KBS), we have four key pillars: People, Operating System, Operational Excellence, and Growth. KBS breaks down siloes and connects the organization. For example, KPIs cascade from the strategy, people receive training on problem solving to achieve their goals, new hires are assessed on problem-solving skills, and incentives reward achieving KPIs. Business systems are hard to implement – it takes years to ingrain them in a company, which deters investors focused on quick wins to flip a business in a few years. However, Danaher and Toyota are both examples of long-term value creation through a business system. At Kanbrick, we strive to use our business system to align People, Purpose, and Performance and create enduring companies that get better every year.

<u>Margin of Safety: An Operational View</u>

Ben Graham coined the term margin of safety to refer to buying a stock at a discount to its intrinsic value. While we are value investors by training and temperament, we have found the mindset equally valuable in running companies and everyday life. Evolution engrains us with overconfidence (implicitly the pros outweigh the cons), and margin of safety is a useful concept to mitigate this. Once you embrace this mindset, the tactical applications are endless. A couple that we've found valuable include:

- Requiring new initiatives to earn well above our cost of capital. For example, if our target return is 15%, then we generally look to invest in projects returning >25% vs. 15.1% (and aim to find projects with 10x return potential / significant option value). Returns analyses are highly sensitive to assumptions, and this helps us avoid the marginal projects and reduce the desire to "make a few teaks" to move from 14.9% to 15.0%.
- Constructing our annual plan. If setting out on a 100-mile road trip, then you'd want more than 100 miles worth of gas (especially if you're traveling through western Kansas where gas stations are rarer than cows). In annual planning, we typically seek to have expected initiatives with at least $1.50 of expected growth for every $1.00 in the budget as we know not everything will go as planned.

Beyond the tactical applications, leaders should think deeply about margin of safety or resiliency in their organization. The crucible of capitalism craves efficiency – customers always want better products faster and at lower prices – and the dust heap of history is littered with formerly iconic firms such as Polaroid and Blockbuster. The tradeoff is often in reduced resiliency and flexibility. COVID is another reminder that we can't predict the next crisis; however, we know dark clouds and stormy seas will appear again in the future.

As Warren Buffett has said, "when the tide goes out you see who is swimming naked," and reacting in the moment is challenging. The adage to "Be Prepared" is a more sound approach. From using prudent leverage to reducing supply chain vulnerabilities, it is important to understand key enterprise-level risks and ensure you are comfortable with your positioning. This isn't possible to get perfect because everything is a continuum and involves tradeoffs. Philosophically, we believe it is important to create businesses that can survive a large shock (Federal Reserve-style stress tests are a great tool for this) and evolve faster than the environment. And this isn't just a business issue; our electricity, food supply, climate, and other critical infrastructure all seem to be overly focused on short-term efficiency. While many investors look to run a 3-year sprint, we are running a marathon and are comfortable leaving some gas in the tank (and giving up some short-term gains) to ensure we can finish mile 26 strong.

Moats

While "moat" has become a trendy word tossed around by countless companies, finding a strong moat or competitive advantage in the wild is rarer than it seems. The best businesses have high returns on capital, significant reinvestment opportunities (at high rates), and a moat that keeps others from competing away that combination. Moats and sources of competitive advantage evolve and erode over time. Newspapers used to have an enviable moat, but we all see how the water there has dried up.

This is often tied to technology paradigm shifts and new platforms that occur over decades – electricity changed the basis of competition in manufacturing, and railroads fundamentally altered distribution – and it is clear digital technology and the internet are rapidly changing the current competitive landscape. If 2020 showed us anything, it is that the rate of change is accelerating, barriers to entry are falling (e.g., the cost of starting a business today vs. in 1999), and technology is enabling new business models that disrupt incumbents. The list of fallen stars is long, ranging from Kodak to countless retail stores. In fact, the consumer products / retail world provides a case study of this reality. Over time, distribution has evolved from catalogs to department stores to Wal-Mart and specialty retail and now Amazon and e-commerce. Historically brands were developed through national advertising – which required significant scale – and by gaining widespread distribution through large retailers. The internet has fundamentally changed this dynamic – online ads allow small businesses to advertise to target customers, and virtual shelf space is infinite allowing startups to quickly get distribution via Amazon or their own website. While the internet has unlocked countless Shopify and Amazon brands that wouldn't have been economically feasible in another era, some things remain the same. Unit economics still determine long-term success and attention, acquisition, and loyalty remain key. Similar changes are happening across other sectors and industries.

We are often asked how to navigate this increasingly complex environment. There is no simple answer, but we think a few things can be helpful. As investors, our focus is staying in our circle of competence and to also invest in businesses that we feel reasonably confident have a 10+ year runway (e.g., tech with a 1-year product cycle is too hard for us). On the operating side, we think it is critical to ensure leaders of businesses have a clear understanding of the strategic positioning, macro trends, threats, and opportunities. Equally important is creating an organization that can respond to these changes and evolve faster than the market (e.g., run experiments to test and learn, shorten planning cycles, and incorporate the voice of the customer). Much like other paradigm shifts, the internet and digital are moving beyond "technology" companies to impact every business and every industry, which requires a shift in approach and mindset to survive.

Other Observations

While we don’t make macro predictions, we have a few observations in the current low-rate, high-stimulus environment. First, it seems to have distorted incentives and market signals. For example, the Fed has flooded the system with liquidity due to COVID. This has helped challenged businesses survive and stave off restructuring, but the long-term impact of this is unclear. Lower rates also increase business valuations and asset prices, while numbing investors to potential risks.

This is magnified for companies whose value is primarily dependent on large future cash flows (e.g., $100 in 10 years is worth ~$91 today at 1% discount rate vs. ~$39 today at 10% discount rate). While many early-stage and growth investors are presumably valuing businesses based on option value (which can be massive in a network effects or winner-take-most market as evidenced by Facebook or Google), eventually each business’ value must be anchored in the cash it produces.

To roughly illustrate this using a simple example, if a company is worth $1B (a unicorn) and its investors want a 10% return, then this could be achieved by $50M in cash flow that grows 5% a year in perpetuity or $100M a year in annual cash flow with no growth. This is no small feat, and the requirements only increase as the cash is consumed by near-term operating losses. Far out and less certain cash flows are also relatively more sensitive to a rise in inflation or interest rates, which could result in more valuation compression. We aren’t sure what the future will hold; however, we do think there are likely a much broader range of potential outcomes than generally contemplated.

Lastly, we often get asked about book recommendations, so with our inaugural letter, we will start with one of our favorites for investors and operators alike: *The Outsiders*, by Will Thorndike. This book was published in 2012 and chronicles eight unconventional CEOs who generated significant value. If you haven’t read it, pick up a copy. And if you have already read it, read it again. Twice.

If you are interested in learning more about Kanbrick, please sign-up for our email list at www.kanbrick.com and we’ll share our Annual Letters along with other occasional thoughts and insights.

Looking Ahead

As we enter 2021, we are focused on building Kanbrick for decades to come. Our goal at Kanbrick is ambitious — we want to be the world’s best business builders by empowering people and organizations to reach their full potential. We believe outstanding people united by a shared vision can accomplish amazing things (and history has countless supporting examples of this). We’ve already begun building an exceptional team and family of businesses – please reach out if you’d like to join us.

We wish you and your families health and happiness in 2021.

Best,

Tracy Britt Cool

Tracy Britt Cool | Brian Humphrey