KANBRICK

April 18, 2023

Dear Partners and Friends,

As we exit an "easy money" era of low interest rates, unicorns as common as corn, and the attendant hoopla, we've had a recurring thought: It is supposed to be hard. Charlie Munger put this more bluntly:

"It's not supposed to be easy. Anyone who finds it easy is stupid."

Yet easy money seems to have created the mindset that everything should have a giant red Easy button, making this current moment a hard pivot for many. But doing something great is hard. The grind and process are relentless, and others are always trying to catch you and eat your lunch. Yet it's in spite — or maybe because — of these challenges that the quest for full potential is inspiring. If we look, we can see examples of this all around, from Patrick Mahomes gritting (and limping) through a sprained ankle to lead the Chiefs to a Super Bowl victory; to TSMC's foundries using photolithography to print 5-nanometer chips (for comparison, your fingernails grow approximately 1 nm per second, and a piece of paper is 100,000 nanometers thick); and NASA overcoming seemingly insurmountable obstacles to launch the extraordinary Webb Telescope after 20 years of work by 20,000 people. The extraordinary happens every day, too, and we are inspired by the countless examples of our team members balancing the herculean tasks of tackling challenging problems, innovating for our customers, and caring for children or sick family members.

Kanbrick was created to embrace the opportunities borne out of challenges by empowering people and organizations to reach their full potential. Our name 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. At our core, we are business builders focused on:

(1) Acquiring high-quality companies in growing markets
(2) Accelerating their growth by pairing the tools, principles, and resources of the Kanbrick Business System with a long-term mindset
(3) Attracting and empowering exceptional people

Kanbrick offers founders and owners a differentiated option: We think in decades not quarters, know great companies are built by people, not in spreadsheets, and have rolled up our sleeves to run companies vs. spending all our time in the cheap seats of the board room. Our core values of living with integrity, acting like an owner, getting better every day, and winning together serve as our compass.

We are honored and humbled to work with our many exceptional partners – from coworkers to customers to investors – across Kanbrick. As we reflect on the past year and look forward to the opportunities ahead, we want to provide you with an update on our progress and share broader thoughts on our approach to building Kanbrick.

Year in Review

"A journey of a thousand miles begins with a single step" – Lao Tzu

Progress often feels like lots of small steps (both backwards and forwards) in a muddy field at night. Reflecting over the last year, we have many learnings and are proud of everything our team accomplished. We welcomed two impressive businesses, Marine Concepts and JM Test Systems, to the Kanbrick family, which totaled nearly 900 team members at the end of 2022. These were important milestones – but culturally, we avoid celebrating check writing in favor of celebrating value creation. While it is impossible to capture everyone's contributions across Kanbrick, below are a few highlights from the last year:

- In June 2022, we invested in Marine Concepts in partnership with its founder Randy Kent. This partnership was driven by our shared vision to build an aftermarket marine enthusiast company. Randy founded Marine Concepts over 15 years ago when he developed a patented high-end boat cover system that simplifies the process of covering and uncovering your boat. Randy knew the business could scale into a leading platform for boaters, so he sought a partner for the journey — but he didn't love the traditional options out there. The company checked our boxes of being a good business with the opportunity to accelerate growth through geographic and product line expansion. We brought on CEO Terry McNew, who previously took MasterCraft Boat Company public, and Terry and the team hit the ground running by improving our production capacity and launching a new dealer program. A shameless plug, but if you know of any aftermarket marine products that customers rave about, then we'd love to chat. Or if you disdain the hassle of covering your boat, we've got you covered too

- JM Test Systems, which offers a range of mission-critical services including calibration, rental, field services, and distribution, joined Kanbrick in February 2023. We own the business in partnership with the Morrison family, who started the company 40 years ago. They share our long-term vision, building on the company's four decades of reliability with a first-class team of folks who are committed to ensuring the world runs accurately and safely for our thousands of customers. We are currently working hand-in-hand growing the core business and seeking acquisitions in calibration services and rental. Referrals welcome!

- Our Kanbrick and KBS team grew to 10 people plus several part-time specialists. From reviewing new potential investments to building our Kanbrick Community to refining the Kanbrick Business System, our entrepreneurial team lives our values and embraces our mission. We are actively hiring for a few roles including Chief People Officer / VP of Talent, Kanbrick Business System Lead, and several spots on our investing team. Learn more or apply at our website

- We also began using AI at Kanbrick — although this letter was still written by flawed humans — and are thinking through how it will fundamentally transform our work of building great companies. In 20 years, we expect to look back at the last year as AI's iPhone moment. The experience of ChatGPT is magical, and we believe we are in the very early innings of AI's takeoff. Historically, technology platform shifts have taken decades (e.g., building railroads or laying broadband cable); however, we expect the digital nature of AI to accelerate its impact. We anticipate advances in AI will reshape how we identify new companies, conduct analysis, monitor performance and identify value-creation opportunities (and open a host of ethical considerations). Similar opportunities will also exist within each of our companies — much like digital has rewritten the operating playbook of the last 20 years. AI hopefully will allow us to focus on the uniquely human aspects of our work such as building great partnerships with families and founders, thinking deeply about our most challenging problems, or managing change as we accelerate growth

- The power of creating win-wins and the belief that people build great companies are core to our philosophy. We strive to do this in a number of ways, including the Kanbrick Community, a like-minded group of business leaders and owners. A few of our key initiatives:
    - We launched our 4th and 5th cohorts of Build with Kanbrick, a free accelerator for mid-sized companies. We're proud to have worked closely with 25 companies and have had over 250 applicants to the program to date. The testimonials on our website will give you a better sense of the program and value than we can directly. For example, Daniel Sturman, the Co-founder and CEO of Evoke Medical Care, called the program "the most efficient and beneficial professional learning experience of his career." We are now taking applications for our fall cohort
    - In addition to the Build with Kanbrick program, we are hosting our second annual invitation-only Kanbrick CEO & Owner Summit for over 40 owners and CEOs in May. Our first event last spring was a great success – we had a tremendous group of leaders attend, and the overall net promoter score (NPS) was 92
    - Later this fall, we'll be launching our first annual Business Builder Event in Nashville. This will be a larger multi-day event focused on business builders – the leaders of mid-size companies who power our economy. We've long admired how events like the Allen & Company conference at

Sun Valley foster deep connections, and our goal is to bring together closely held middle market firms with $10M-$500M in revenue. If you are interested or want to nominate a strong leader for the event or Kanbrick Community, then email us at build@kanbrick.com
    - Lastly, we are always looking for exceptional outside board members and leaders. Serving on a Kanbrick board provides the opportunity to shape the trajectory of growing companies, work with committed and passionate teams, and participate as partners in value creation (plus have some fun). Similarly, we always enjoy connecting with world-class leaders and executives looking to build enduring companies as part of Kanbrick

- Many of our best relationships come from referrals, and we are excited to launch a formal referral program. The program is simple: If you refer us to a new platform company that we invest in, then we'll provide a referral bonus and the potential opportunity to co-invest in the business (the actual amount will depend on company size). All we need is an email or phone introduction, and then we'll take it from there. For more details on the program[1], you can reach us at build@kanbrick.com

Building Together

We believe the world doesn't need another private equity firm, but mid-sized companies do need a long-term partner focused on helping them fulfill their potential. Unfortunately, many of the owners we know well have had regrets after selling their companies to a strategic partner or a private equity firm, where the primary focus is realizing synergies (i.e., cost cuts) and maximizing short-term returns. That's why, three years ago, we founded Kanbrick.

While building a great business takes years (and lots of sweat, tears, and stress), selling it only happens once. This is why we counsel folks to hold onto your business as long as you can — counsel that often runs counter to the prevailing wisdom of Wall Street or those in the business of flipping businesses. After all, selling does not make you richer, but it will shift the form of your wealth, and enable you to accomplish other goals, like managing succession issues, finding a partner for growth, or diversifying your family's portfolio.

Auctions work great for cattle, but our goal is to partner with 1-2 special owners and families each year who view their companies as family versus a commodity. They care deeply about their business, its people, and its future success. After making an investment, we become partners. We're proud that all of the owners we've worked with have maintained significant equity stakes, and we work together to accelerate growth and help the company reach its full potential. Scott Morrison, the CEO at JM Test Systems, described his family's thought process as:

"Kanbrick was the clear choice given their long-term perspective, experience building businesses, and focus on partnering with family- and founder-owned businesses."

It is an honor to work with strong founders and owners. If you or someone you know are thinking through this decision, we would welcome the opportunity to confidentially discuss the business and the right decision for you, your family, and your business. We promise to help think through different options (even if it doesn't include Kanbrick) while being responsive and maintaining confidentiality. For our part, we typically focus on high-quality companies with the following characteristics:

- Industry: Consumer, Business Services, and Manufacturing / Distribution
- Size: Greater than $5M of pre-tax profit
- Location: Headquartered in North America

[1] Our lawyers wanted us to note that the full terms and conditions are available upon request and defined in our Referral Agreement (e.g., company must not be in auction process or already have relationship with Kanbrick). There is no obligation to make payments under the program except pursuant to the terms and conditions of a Referral Agreement signed by a participant and Kanbrick LLC. The payment of any amounts under the Referral Agreement is subject to applicable law and the terms and conditions of this program may change at any time at Kanbrick's sole discretion. The referral program is not for licensed brokers.

A few specific focus areas in 2023 include franchisors, value-added distributors, and niche commercial services. In addition, Marine Concepts is looking for aftermarket marine acquisitions, and JM Test is seeking businesses in the calibration services space.

Beyond partnering with great companies, we are building an ecosystem of exceptional people united by a growth mindset and passion for building enduring businesses that empower people to reach their full potential. If you fit this mold, then please get in touch. As mentioned above, we have a variety of opportunities to engage with the Kanbrick Community including our Business Builder Event, CEO & Owner Summit, Build with Kanbrick program, operating partner and board member roles, executive roles within our companies, and opportunities on the Kanbrick central team.

Thoughts / Musings

"An investment in knowledge pays the best interest" – Ben Franklin

Our strategy is not predicated on predicting the future (or even focusing on macro, for that matter) and instead rests on finding niche companies with moats led by exceptional people. We aim to deal with uncertainty by having a margin of safety and emphasizing adaptability versus the perfect forecast. That said, the macro environment matters, and we aim to monitor its temperature and the implications for our companies.

The last year has seen a reversal of the boom times of costless capital, SPACateers hawking their wares, and a cacophony of promoters fleecing Main Street investors with tokens and meme stocks. We felt out of place in this world of digital tulips and welcome a return to more sensible valuations and less focus on leverage and financial engineering. At the same time, we remain concerned about how the mix of easy money, macroeconomic challenges, and distorted incentives impact the real economy. After all, interest rates set the price of money, and raising rates – especially following a ~10-year period of low rates – decreases the prices of assets and changes the resource allocation equation across the economy.

We are deeply skeptical of prognosticators – the volume of media production means someone is almost certainly right, but more due to luck vs. skill (and if you had the skill, the rational play would be to run a macro fund vs. being a talking head on news programs). As we entered 2020, no one was predicting COVID, the war in Ukraine, supply chain challenges coupled with inflation, questions around bank stability, and the acceleration of AI. Too often risk management is either attempting to perfectly forecast the future (good luck!) or assiduously mapping out all the previous lighting strikes and avoiding those places. We prefer the more prudent approach of staying inside during a thunderstorm, even if it means missing out on the latest bandwagon. As Howard Marks points out, the challenge is that many more things can happen than do.

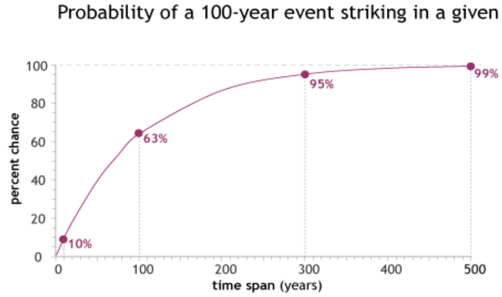
If history is a guide, the rapid Fed tightening after years of printing money will continue to ripple through the broader economy with unpredictable and likely negative consequences. For example, the rule of thumb on bond prices is a 1% change in interest rates multiplied by the bond's duration in years equals the approximate change in value of the security. In December 2021, the 10-year Treasury rate was ~1.5% vs. ~0.3% for a 1-year Treasury; thus, the risk was that for every 1% increase in interest rates a 10-year bond would lose 10% of its value. Not a great risk-return, especially given rates were unlikely to move down, leaving all of the exposure on the downside. Locking up capital in long-duration bonds wasn't really safe; however, banks like SVB had large deposit inflows and marched into this sort of trade. Perhaps a good sign that it was a bad bet was that nearly every American homeowner was eager to take the other side of the deal by locking in 30-year mortgages at under 3% in 2021.

Cars – a microcosm of the economy – are another example of the cascading impact. Rising rates make used cars (an asset) worth less, decrease the value of existing fixed rate car loans, and increase the cost of buying a new vehicle (which in turn should decrease demand). It also changes the economics of investing in things like new EV production facilities. More broadly, the economics of investing for future growth have changed. For example, venture and growth capital bet heavily on the option value of startups with far-off hopes of cash flow, and these valuations have come crashing back to reality (e.g., $100 in 10 years is worth ~$91 today at 1% discount rate vs. ~$39 today at 10% discount rate). In many ways these investments were partially a derivative bet on interest rates staying low, especially compared with companies generating cash flow today.

Mixing high leverage with increasing rates and the accompanying decline in asset prices is a dangerous brew waiting for a catalyst, and we think other areas of concern include commercial real estate (where headwinds include post-COVID utilization changes), highly leveraged companies with floating rate debt, and growing federal debt levels. We expect the next few years to be interesting for Kanbrick – we don't rely on extreme leverage, valuations are returning to more normal levels, and many owners are tired from tackling all the challenges over the last 3+ years.

We remain bullish on America – with our unique competitive position and resources. And yet we also have tons of untapped potential in countless areas where politics is a roadblock to progress. The current state of the relationship between the U.S. and China also remains concerning with numerous geopolitical and economic consequences that will define the decades ahead. Government should also work to address some of the larger, global risks that are often easy to ignore, hard to hedge, and nearly impossible to manage at the individual level – nuclear war, pandemics, large-scale cyberattacks, and dystopian AI. Even at a 1% aggregate likelihood per year, this implies a 63% chance it will happen over the next 100 years, as shown in the below NOAA chart.

Probability of a 100-year event striking in a given amount of time



TIME SPAN years	PROBABILITY % chance
1	1
5	5
10	10
20	18
50	40
75	53
100	63
200	87
300	95
400	98
500	99.3
800	99.97
1000	99.996

Source: NOAA (https://www.climate.gov/media/7853)

We are proud to support mid-sized businesses that are the backbone of the American economy. Business owners often ask us how we would value their company and the corollary of how to increase this value. There are lots of good resources on valuation math, the nuances of DCFs (e.g., calculating weighted average cost of capital, projecting cash flows by years, assuming changes in return on capital over time, etc.), so we'll focus more on the practical vs. academic calculations here. Mathematically, the value of a company is the summation of all future cash flows discounted back to today.[2] Breaking this down there are 3 main components:

- Today's cash flow
- The cost of capital or discount rate which is a function of the quality of the business (size, scale, durability), debt / equity mix, and interest rates (which we can't realistically impact)
- The growth (or decline) in future cash flows – with the caveat growth only creates value when returns on capital are greater than the cost of capital

In our view, the best businesses have high returns on capital, significant opportunities to invest at high rates, the ability to sustain these investments over time, and a moat to sustain / protect these cash flows. These trade at "high earnings multiples," which captures the combination of the above factors. If we invert this, a lower-quality business will have low returns on capital (in this case, reinvestment actually destroys value if returns are below our cost of capital) and the inability to sustain itself without significant investment.

[2] There are a number of good resources on this including Aswath Damodaran's work and presentations available on the NYU Stern website

This is a bit abstract so let's make it more tangible. Let's say you own a local plumbing business that makes $1K per year. If you assume a 20% cost of capital and no growth, then your business is worth $5K or ($1/20%) or a 5x multiple. To increase your valuation you have 2 levers: grow cash flow or decrease your cost of capital.

Let's say over the next 5 years you grow your business's cash flow to $2K by entering new geographies, adding new technicians, and improving your margins and net working capital turns. Your new valuation would be $10K or ($2/20%), which is a 2x increase. If additionally you assume that your cash flow growth will continue at 5% going forward, then your valuation would be about $13.3K or $2/(20%-5%), an increase of 33% over the no growth valuation. Similarly, if your discount rate or cost of capital declines to 15% given the business is now larger and more diversified, then the valuation would be $20K or $2/(15%-5%).[3] There is obviously lots more nuance and complexity, but this is a good directional guide. We are always glad to share our thoughts on valuation and value creation for your business directly.

Closing

There is rarely a higher return investment than in growing our own knowledge, skills, and capabilities (perhaps family and health). This doesn't require expensive classes or seminars – between books, the internet, and conversations with others there is a field full of wisdom waiting to be harvested. Having young kids is a constant, humbling reminder of how complex the world is and how poorly we understand it. Take a recent conversation on how airplane engines work that ended after two whys: They produce thrust and this is the result of combining fuel and oxygen in the turbine – not particularly impressive especially given the turbine is one of our key prime movers.

Just like we aim for our companies to compound value, compounding one's own skills can have an incredible impact over time. In the spirit of shared learning, a few of our favorite books over the last year include:

- *Chip War: The Fight for the World's Most Critical Technology* by Chris Miller: a great historical, economic, and political look at the chips that underpin modern society and are shaping the geopolitical environment of today
- *Multipliers: How the Best Leaders Make Everyone Smarter* by Liz Wiseman: leadership book on how leaders are the output of their teams, and the best leaders find ways to amplify or multiply their team's impact
- *Lessons from the Titans: What Companies in the New Economy Can Learn from the Great Industrial Giants to Drive Sustainable Success* by Scott Davis, Carter Copeland, Rob Wertheimer: examines lessons and successes of industrial companies via different case studies with great learnings on business systems

Email us at build@kanbrick.com if you would like our full reading list or sign up on our website for our email distribution list to stay updated on Kanbrick.

Thank you for your support and partnership as we build Kanbrick. Life is full of challenges and opportunities and part of the beauty is embracing the journey. We remain committed to taking a long-term approach, building resilient organizations that can adapt to an evolving world, and embracing the grind as we pursue excellence. We are fortunate to work with an exceptional group of partners and blessed to have incredible family and friends.

Best,

Brian Humphrey   Tracy Britt Cool

[3] Typically the discount rate or cost of capital would decline as the business grows and has more stability and diversification (e.g., new geographies, more technicians, etc.), but for illustrative purposes we showed the change in cost of capital happening upfront