SHIFT
CAPITAL

February 2021

Letter to our stakeholders:

Building Alpha

In our previous letters, as you may have noticed, we have strived to substantiate our positioning in the Brazilian Venture Capital landscape. First, we have outlined our critics towards a hard to assess approach of the local industry regarding risk-reward decision making. This would mostly reflect on a lack of in-depth analysis of the fundamentals and unit economics of early stage companies and seemingly unreasonable valuations of such cases. Later, in our December remarks, we have highlighted aspects of our unique positioning, describing how our investment in Skelt and Paketá reflect our (i) fundamentalist approach, (ii) risk assessment, (iii) value-add/risk management, proving to be (iv) clear follow-on assets with very exciting risk-reward balance.

By now we have gone through more than 2,000 companies in our pipeline and analyzed more than 1,000, while observing entrepreneurs striving to create long term competitive advantages. At this point we believe we have consolidated our understanding of what we have called "Risk Oriented Venture Investing". This would be our industry's parallel to Value Investing, or a fundamentalist approach.

Nonetheless, it's safe to say anyone would like to compare themselves with Berkshire Hathaway. But simply criticizing high valuations or large rounds doesn't quite get it. What we have been looking for is how to define "Alpha" for this asset class and how we could build ours. In this letter, we try to assess what Alpha means in Venture Capital and its conflict with the Power Law-based returns theory – which affirms that wide diversification is the strongest way of ensuring Alpha.

First, a quick intro on the subject (if you are familiar with the concept, feel welcome to jump to the next session):

Widely known by investment professionals, Alpha can be defined by the investor's ability to generate better risk-adjusted returns in comparison to the market, in his own asset class. It can be theorized by a simple equation:

$$Return = alpha + beta * market\ return$$

The "Beta" represents portfolio's adherence to market returns. A Beta larger than 1 means that the portfolio provides an amplified return, when the market performs well, and an amplified loss, when the market performs poorly. On the other hand, a Beta lower than 1 means the portfolio is "resilient" in comparison to the market, and its movements are less intense than the market's. At the end, it implies correlation to market's movements (a negative Beta would imply negative correlation, but that is rare).

The "Alpha", as an addition to the returns that are correlated to the market, represents portfolio's added risk-adjusted returns, or returns that do not depend on market's movement. It is the value that an investor can create, regardless of markets. Important to mention that "value added" does not necessarily mean increased absolute returns, but increased risk-adjusted returns. That is, capability to generate same returns, with less risk, or more returns, with same risk, or even less returns than the market, with even less risks.

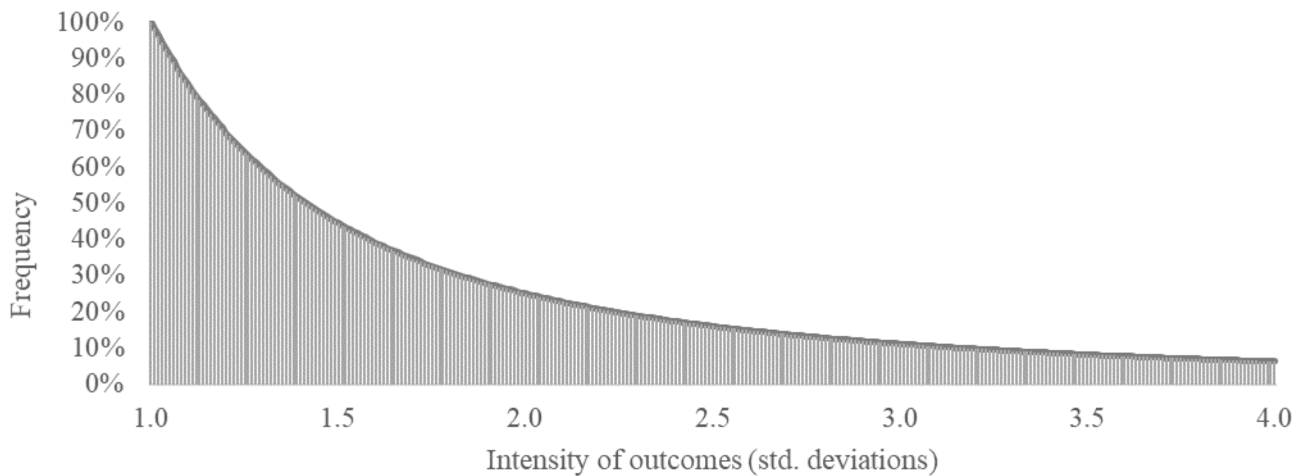
Much has been argued about the real significance of Alpha, given market's efficiency hypothesis, that attest market's ability to price assets to their real value, at any time. While this may be true for asset classes where information is widely available, such as public equities (yet reality often shows otherwise), this is not true for private markets and categories where skill is predominant, and information is asymmetrical.

The power law suggests that VC is a predictable industry, where one should diversify extensively to enjoy optimal Alpha

For a long time, we have heard that the VC industry follows a Power Law-shaped curve of returns. That inference has been made after funds returned multiple times initial contribution, driven by a single or a couple extremely successful deals. Those were memorable occasions for the industry, where funds like Sequoia, a16z

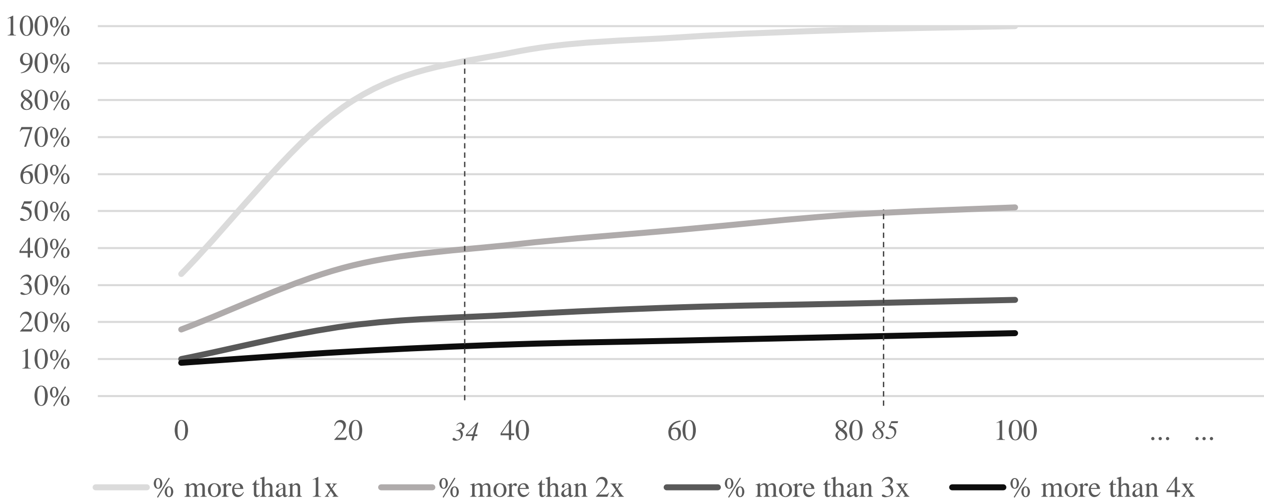
(also known as Andreessen Horowitz), Kleiner Perking, USV and other industry behemoths hit 50x + returns in companies such as Google, Apple, Facebook, Dropbox, WhatsApp, Walmart and Alibaba, propelling their funds to exceptional returns. To support such inference, researches have used public data from accelerators, angel and seed funds, and the conclusions have endorsed the Power Law-based returns for the asset class.

Example[1] of a "Power Law" distribution of outcomes



The Power Law draws a curve with a very long tail, suggesting that despite very uncommon (less than a 5% chance of occurring), extreme outcomes exist. If taken by heart, the theory suggests that the larger the sample, the larger are the chances of hitting extreme outliers, or "home runs". According to general research, VCs have a 2% chance of hitting those, implying that they must have at least 50 companies to enjoy a solid probability of finding those. Conclusively, funds generate incremental Alpha (risk-adjusted returns) as they get more diversified. An interesting study by the venture capitalist Jerry Neumann, published in his blog, using credible algebra and Monte Carlo simulations to estimate portfolio returns according to diversification levels, provided very interesting conclusion in this sense. His data supported the argument that as more diversified the fund is, more predictable its returns:

Probability of exceeding benchmark return according to portfolio size



According to the data:

- To exceed 1x his investment, with a 90% probability, an investor needs a portfolio of at least 34 companies;
- To exceed 2x his initial investment, 50% of the time, an investor needs a portfolio of at least 85 companies;

Notes
1: The formula for the line is: p(x)=Cx−α, where α (alpha) defines the shape of the power law and C is a normalization constant to make the total area under the curve sum to 1

- If you have a portfolio of 40 companies, that is, a mid-range portfolio of a Series A fund:
    - You will meet or exceed 1x initial investment 92% of the time.
    - You will meet or exceed 2x initial investment 44% of the time.
    - You will meet or exceed 3x initial investment 24% of the time.
    - You will meet or exceed 4x initial investment 16% of the time.
- If you make 1,000 investments you have a 95% chance of at least doubling your capital, and if you make about 15,000 you have a 95% chance of at least tripling your capital;
- If you make 1,000,000 investments, you have a virtual certainty of making 4 times your initial capital.

This analysis infers that diversification is indeed a driver of precision in returns and Alpha. On the other hand, implies that VC is a predictable industry, if you diversify enough. If we were to finish this letter right here, this would certainly be a great win to the current common-sense. However, historical performance data shows huge dispersion in returns, indicating that this theory is not important, or investors have not followed it so far, when producing great returns.

The Power Law suggests predictability, nonetheless, the VC industry is highly unpredictable

Cambridge Associates, one of the main references in alternative assets and owner of a vast database on investment returns, has compiled the below data that explains the skewed return distributions from emerging asset classes (explained by the existence or absence of Alpha in such markets).

Average Annual Manager Returns by Asset Class (2008 - 2018) – US only

Fund Type	Bottom	Top	Manager median	Dispersion from median
Global ex US Equity	2%	8%	4.5%	3.9%
Emerging Markets	1%	8%	4.0%	4.7%
US Small Cap Value	8%	15%	11.0%	3.4%
US Small Cap Growth	9%	16%	12.0%	4.2%
US Large Cap Growth	8%	14%	11.0%	2.6%
US Large Cap Value	6%	13%	9.5%	2.8%
Core/Core Plus Bonds	4%	6%	5.0%	1.8%
Average dispersion from median				*3.3%*
Absolute Return	3%	12%	6.0%	5.4%
Hedge Funds	0%	13%	5.0%	7.5%
Global Real Estate	-7%	27%	12.5%	15.2%
Global Private Equity	-5%	32%	11.0%	21.2%
Global Venture Capital	**-8%**	**46%**	**13.0%**	**33.3%**
Average dispersion from median				*16.5%*

As seen above, Venture Capital returns are much more skewed than other categories. The top 5% managers generate up to 46% IRR, with a 33% dispersion from the median of the group, while other managers lose money. This is evidence that there is, indeed, strong Alpha in the asset class. Contrary to the Powers Law's evidence of predictability in Venture Capital, managers seem not to care for predictable returns, seeking Alpha and differentiated returns (or failing in the attempt and generating losses).

While historically an Alpha category, recent changes in VC have inhibited the main value levers

Although the Power Law implies that wide diversification is the main driver of Alpha, managers seem to bet on this only for Seed funds. Historic behavior and returns of managers from Series A onwards have shown that they seek to produce their Alphas through a mix of concentration, picking better and investing early. Although holding 20+ assets, famous funds have concentrated 10-15% of allocation in one single company through subsequent rounds / follow-ons, to maximize allocation in assets where their comfort is greater.

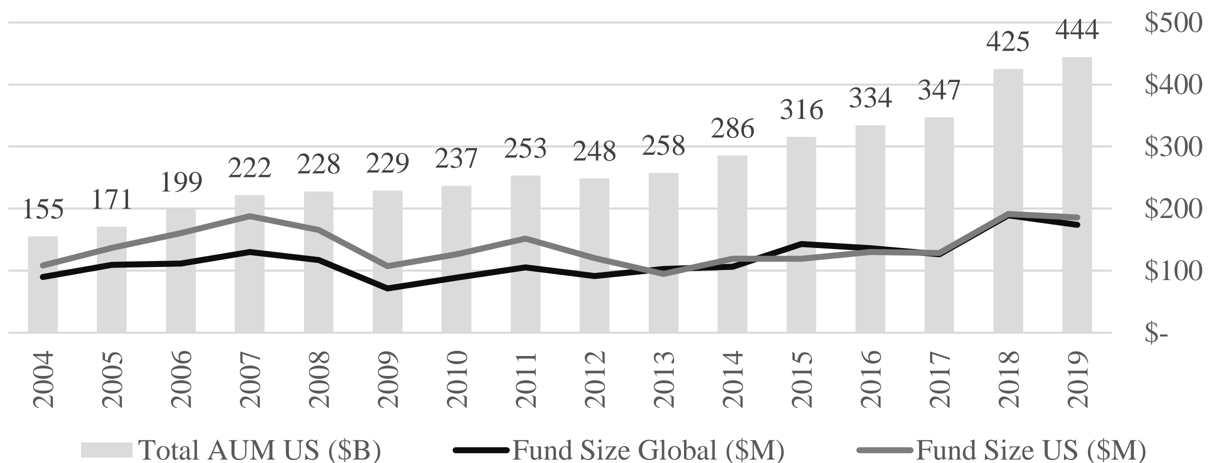
This means that, historically, diversification has worked more as an option than a strategy per se. By investing in dozens of companies, funds create a vast portfolio applicable to receive follow-on investments and concentrate in the probable winners.

In the first vintages and the most iconic venture capital period of 1995-2010, first movers enjoyed information asymmetries and competitive advantages to source better and pick better. With scarcity of capital, these funds were able to invest early, at lower valuations, in the company's journey and obtained outstanding returns.

However, three trends have caught our attention, that are substantially *shifting* market dynamics and will change industry's Alpha, with strong impact in the most recent vintages and the ones to come:

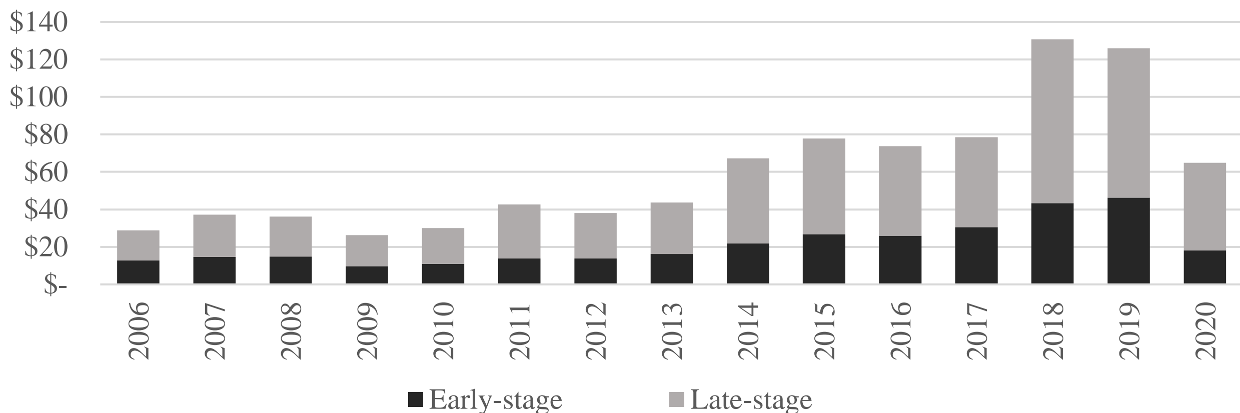
- First, **the category has been growing rapidly**. US VC industry alone posted an AuM of over $444 billion, experiencing a fast growth pace (CAGR 2004-2019 of 7.2%), and presenting $120 billion of dry powder in 2020, almost equivalent of 2004's total AuM. Still, the class represents only a third of the buyout category and poses significant room to grow further in an LP perspective.

  US VC industry AuM and avg. fund size – (U$ billions for AuM and U$ millions for Fund Sizes)



  As the class grows, it turns into **late-stage funding** rather than early-stage, offering very different return prospects than returns once enjoyed by early investors. While late-stage used to represent ~50-60% of the total industry, it now represents over 70%, driving the industry towards more predictable rounds with larger capital allocation. By 2006, roughly 20% of dollars went to investments of $50 million or more, and that figure was closer to 60% in 2019.

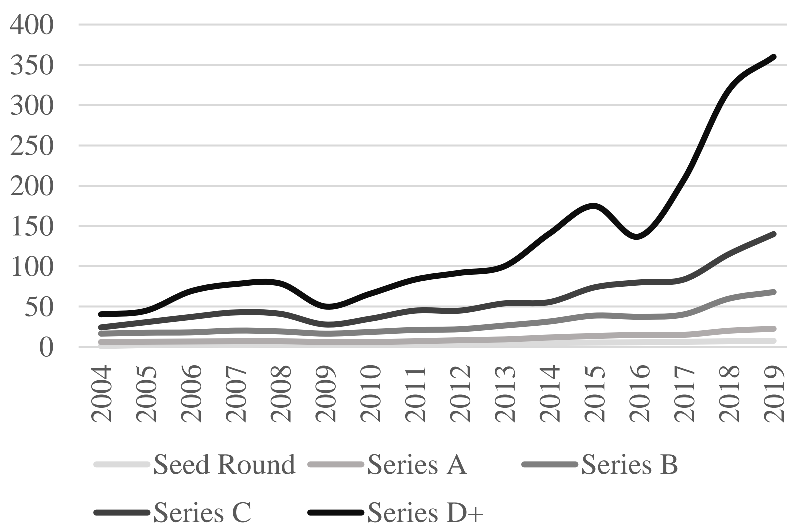
Early-stage vs Late-stage deal value – (U$ billions)



- Second, the top funds upped their game and **increased their fund-sizes**, decreasing their ability to generate Alpha through concentration. In these new and larger funds, managers are obliged to (i) diversify widely in order to allocate large sums of capital in early-stage companies, or (ii) turn to late-stage funding and settle for different return prospects. In addition to increased diversification (and reduced concentration; and Alpha), the increasing size of funds cause another negative trend: as the manager diversifies, he is unable to support companies and select better investments by cherry picking, reducing his Alpha even further.
  Average fund size reached an all-time high in 2018, reaching almost U$200 million. However, if we take a closer look into industry's 100 largest GP's, this number is over U$500 million, in some cases reaching a billion. Allocating such large amounts of capital in an industry that is distinguished by early-stage investing is a significant challenge – and raises the question whether VC has sufficient capacity (that is, the ability of the fund to grow without losing Alpha) to maintain returns as funds grow immensely.

- Third, and perhaps a result of the two points above, the **increasing competition** for deals have caused **valuations to surge sharply** in the last 10 years, representing huge changes in market dynamics. Seed funds were used to buy into U$1M rounds back in the day. Those are now priced at U$7.5M (similar trend in other rounds). Such price variation makes historical data for expected returns barely representative.

Valuation by stage of financing (U$ million)



Series	15-year increase
Seed Round	7.5x
Series A	3.8x
Series B	4.1x
Series C	5.8x
Series D+	8.9x

These three developments (industry's sharp increase in AuM; broad valuation increase; expanding fund sizes turning to late-stage rather than early-stage funding) have drawn us to two main conclusions:

1) As the VC market grows, becomes more crowded, competitive and accessible, the historical asymmetry-based leverages that allowed managers to build Alpha will be less and less available. **Managers would gradually be forced to build new Alpha-generation strategies**. At this point managers may turn back to Neumann's thesis and rely on diversification as their main Alpha.

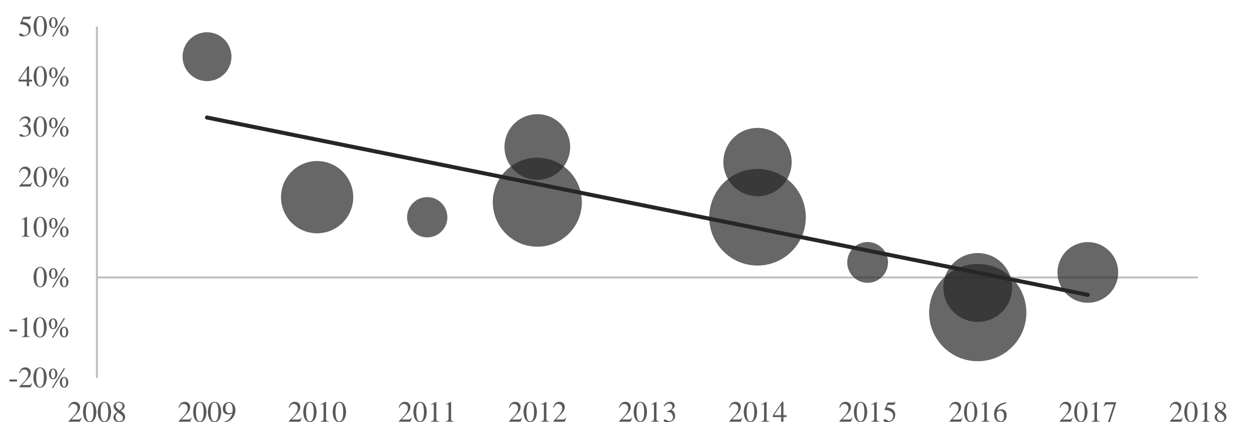
2) **Nonetheless, market-related returns are certainly going down**. Especially as early-stage valuations hit their peaks, Neumann's one million-company portfolio would certainly not meet the 4x return which has once been possible. Even though a "follow-on cherry-picking strategy" may add Alpha, large funds' allocation pressure combined with the higher valuation chain reaction in follow-on rounds put strong pressure on marginal returns.

More recent VC vintages have left the old days almost "artistic" approach to investing – the banner held by our industry's giants such as Sequoia, Accel, Bessemer and others, who valued utmost their ability of scenting the tendencies that shape our global community and foreseeing the future of tech. Currently you are more likely to hear approaches such as "industry coverage", "dry-powder-driven growth", "unicorn-driven fund returns", all of which reflect thesis based upon larger funds, larger checks (and valuations) and power-law based performances (by looking at the present VC landscape in Brazil, we would point out that conclusion #1 seems to already be in course).

Although lacking specific data on the newest VC vintages, especially because these funds have not yet been divested, it is possible that VC is trending towards a more Beta-like industry. There is very little argument in favor of VC's increasing capacity of funds, while managers continue to increase fund sizes and LPs to support it in search of premiere capital allocation. For LPs, the issue relates to our conclusion #2, whereas the trend of current VCs will provide diminishing returns if compared to old successful vintages..

The chart prepared by Crunchbase on a16z returns, supports the argument:

A16z's internal rate of return per fund, according to fund size and vintage year, net of fees



It shows a clear trend of diminishing returns as fund increase. Important to mention that a16z is still one of the dominant players in the industry, and it is possible that this curve represents the broader trend in the industry's top quartile of fund performers, for their newest fund vintages.

Deep dive on value levers VCs have been exploring to maintain Alpha

Historically, as an investment category becomes too crowded, too large, with declining information asymmetries and rising competition, maintaining Alpha becomes a challenge. This trend was first seen in Public Equities, with the advent of technology and broad information availability. Than it was also noticed in the Private Equity (buyout) market. The asset value of the class grew 3x faster than public markets and managers became more

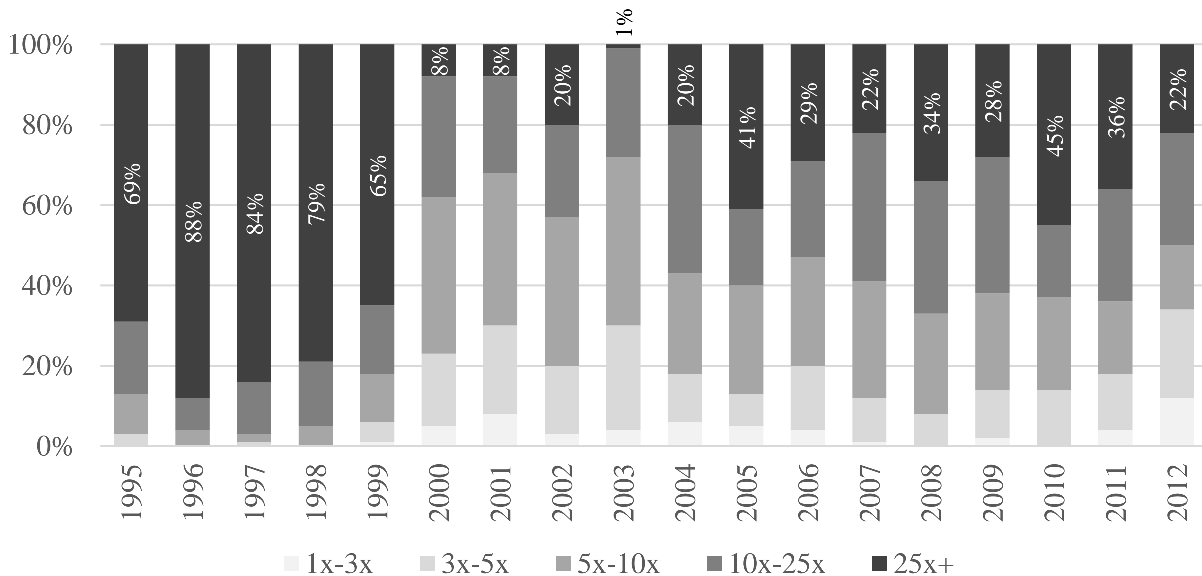
sophisticated, but returns did not follow. As the class became mainstream and progressively crowded, even as absolute skill among competitors increased, relative skill decreases and the difference between the best and the average shrunk (reducing manager's Alpha). This is defined as the "paradox of skill" and is present not only in investing, but also in sports, business, arts, etc. We sense we will be noticing it more and more in VC.

Owing to significant changes in the industry, the old tools for superior value generation in VC have been constrained, and value levers have *shifted* drastically. The old description of Alpha in the industry now seems too generic and not assertive for the new cycles to come. While assessing the future of the category, we have compiled a few trends we believe will be imperative in VC for developing Alpha in the new market dynamic:

I) Average deals instead of huge outliers – weakening Power Law-shaped returns.

As valuations and competition increase, it is progressively harder to hit investments that produces outlier returns (25 times initial capital), and the new vintages are compounding fund gains from deals that yield 3 to 25 times capital invested, rather than from extreme outliers. As the industry matures, information and deal flow become more widely accessible and arbitrages become less common.

Return profile of the 100 top deals in mature vintages



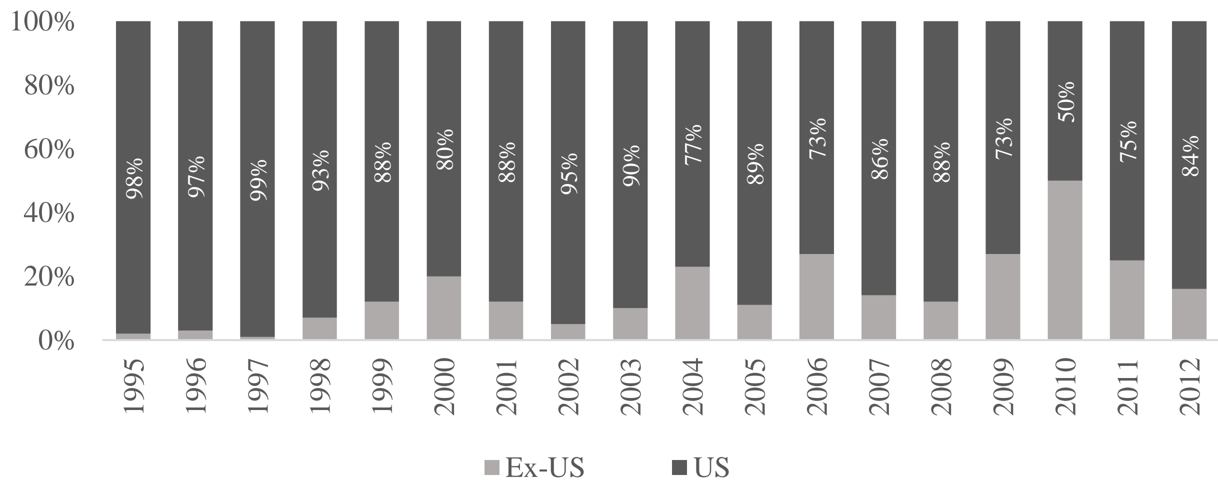
Especially after the "internet bubble" in the 2000's, top deals' returns have *shifted* to more normalized ones.

II) Non-US deals increasing participation in returns.

Europe, China, LatAm and other emerging markets are in a clear trend to increase their share in industry's returns. As those are underexplored markets, there is plenty of value to be generated by digitalizing consumption, enterprises, provide IT infrastructure, healthcare, and education. And those produce huge gains. In addition, valuations are probably lower than in the US, where competition for top deals is fierce.

Cambridge Associates research narrows the top 100 deals by initial investment year. Although it may not seem representative, in the time horizon under analysis (1995-2012 for initial investments), the 100 top US deals are responsible for a minimum of 72% of total industry's returns and a maximum of over 100%, due to industry's skewed returns and high rates of failed investments.

Deal representativeness in industry’s 100 top deals – US vs Ex-US

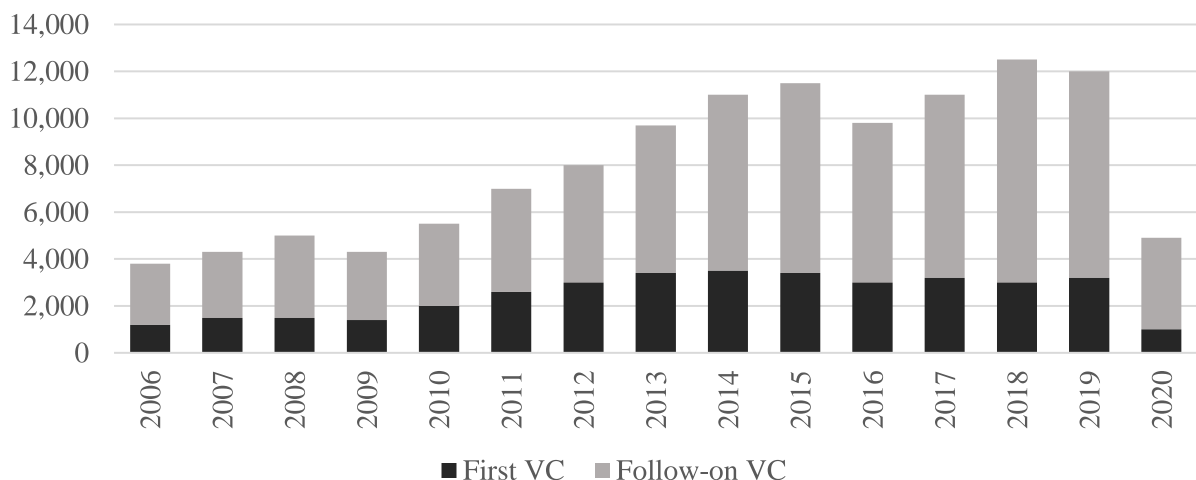


This trend indicates that Venture Capital will more and more become an international business, with funds increasing exposure to cross-border deals, seeking differentiated returns. That is already perceived in Brazil, with an increasing participation of international funds in local deals. Yet, their lack of knowledge in the local business environment is a strong inhibitor, especially when investing in early-stage companies.

III) Strong follow-on activity.

As the funds and the industry grow in volume, wide diversification becomes a necessary evil. However, managers try to offset their large portfolios through aggressive follow-ons in their most prominent companies. In this sense, investing in Seed and Series A is not manager’s main strategy for generating returns, rather is their attempt of creating options to make aggressive follow-on investments and allocate their huge funds, seeing early-stage diversification as a means to an end, rather than the end itself.

First funding vs follow-on funding – # of deals in US



As the industry develops, follow-ons are becoming predominant over the totality of deals. Those generally provide good risk-adjusted returns, but lower absolute ones, and are manager’s instrument for concentration.

IV) Specialization.

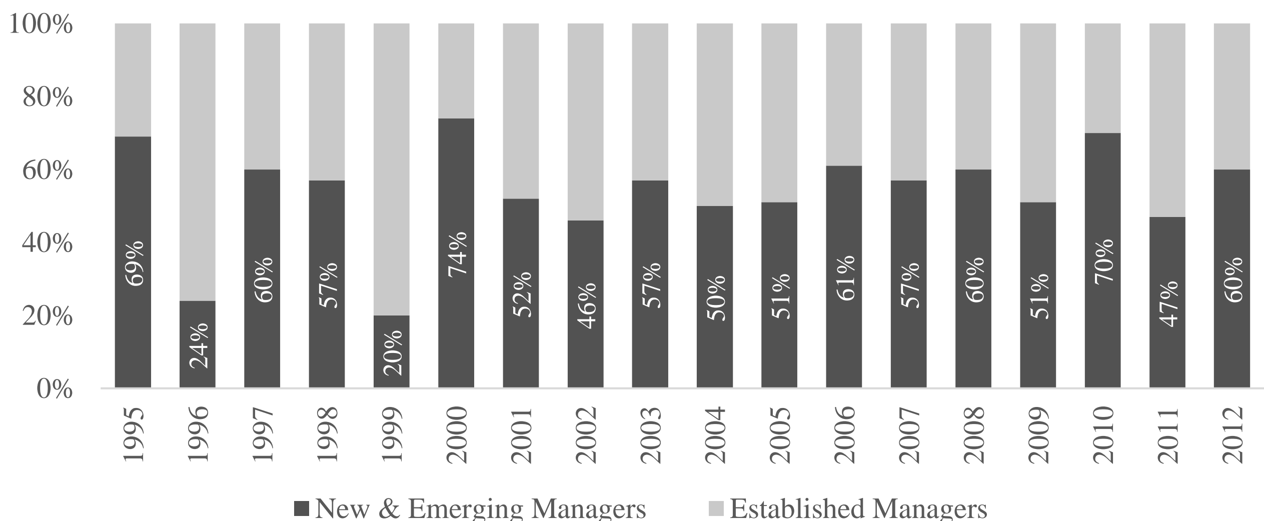
It is only natural to believe that there is a movement of further specialization of VC firms, at a firm or partner level. This move was noticed in other more mature categories, such as public equities, buyout, and debt. As competition increases and Alpha decreases, managers specialize in search of value added. In the US alone, there are over 18,000 VC backed companies, compared to 3,600 publicly traded businesses and 7,600 private equity-backed. With such a large and increasing company population, remaining agnostic becomes a huge challenge. The case supporting specialized VCs defends that deep sectorial knowledge, results in deep understanding of the challenges, value levers and the environment in which the startup is in. By specializing, VCs can assess value faster and better, and develop a deep network of colleagues in specific verticals, offering knowledge transfer, benchmarking, shortcuts and exits. Specialist VCs also have a premium deal flow driven by their niched positioning and are able to develop competitive edge against established generalist competitors. There are studies that show a softer competition in niched VC industries, if compared to generalist markets. In niche markets, the value added and the rules are clearer to the players, resulting in a more balanced environment with more intense collaboration. In a game theory of their own, outcomes tend to be more positive than in generalist markets – and returns tend to follow.

Thoma Bravo, Silver Lake and Vista Equity in tech, Charlesbank and L Catterton in consumer are examples of greatly executed specialization capable of maintaining competitive positioning and high returns. In VC, the trend has been spotted mainly in SaaS, Biotech and Healthcare, but it is expected to expand to all sectors.

V) New managers consistently among top performers.

New and emerging managers are consistently among the top managers, contrary to the assumption that large funds have unfair advantages. Emerging managers also will hold important edge, such as the ability to concentrate capital as funds are smaller, increased skin in the game as they are still conquering their space in the industry, and frequently sectorial or geographical edge. Provided their small fund sizes and structure, it is easier for emerging managers to specialize in specific sectors, enabling standpoint IV above.

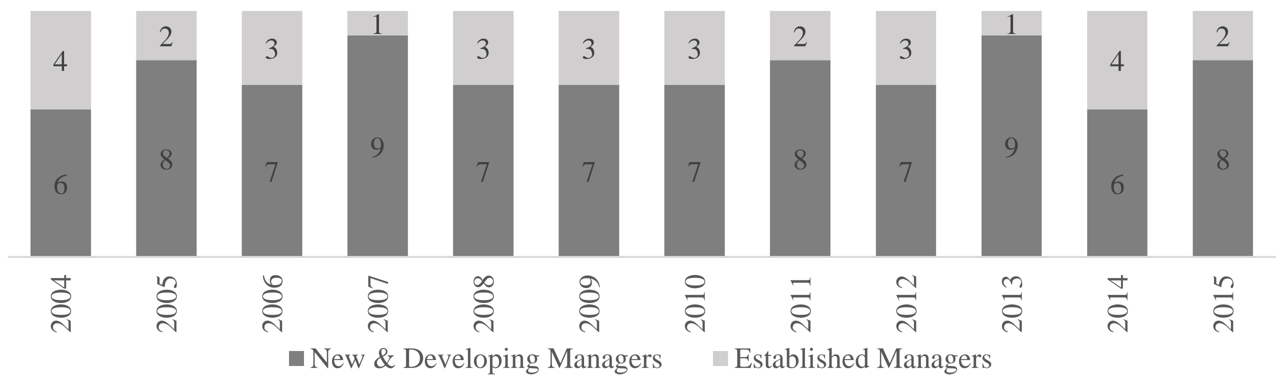
New and developing vs established managers participation in top 100 US deals



From the 100 top investments in any given year, new & emerging managers respond to 50% to 70% of value created, contrary to the idea that super funds dominate the best investments and returns.

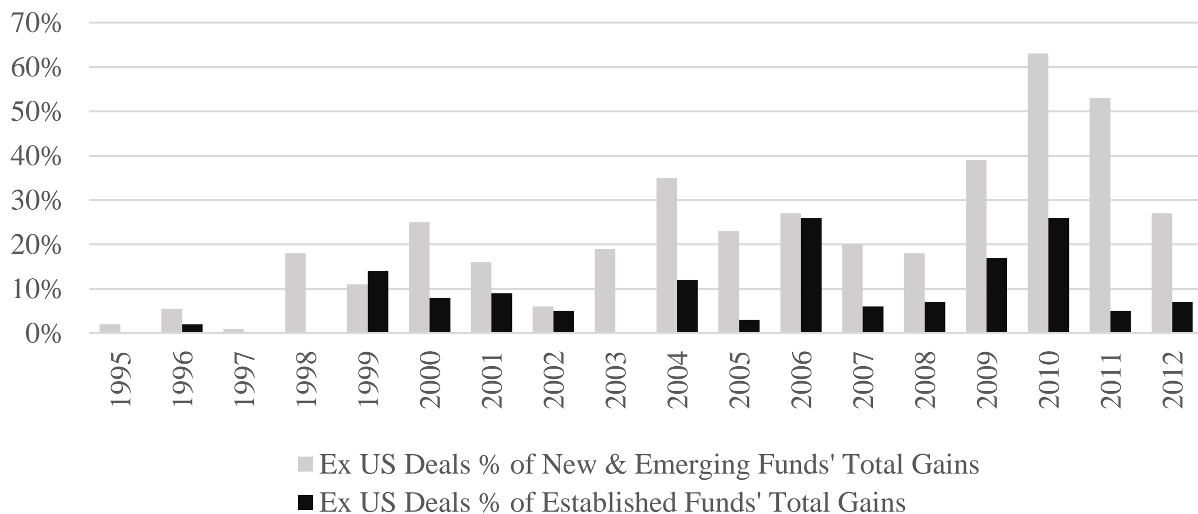
As a result, emerging managers are consistently among industry's top performers.

New and developing vs established managers – top 10 US VC funds per vintage based on net cash-on-cash



Another inclination in favor of emerging managers is that most of the Alpha produced in non-US countries is being captured by new & emerging managers. In the most recent vintages, over 50% of their fund returns was produced with emerging markets deals, while in established funds, this number has been much lower and increasing in a slower pace. It is not that easy to internationalize competitive edge in Venture Capital, yet emerging and underexplored markets are one of the main sources for alpha generation – being captured by emerging managers instead of established ones.

Ex-US deals representativeness in established vs new & emerging fund returns



VI) Developing value added platforms.

With the expanding competition, VCs are developing internal teams, know-how and playbooks to assist early-stage companies with several challenges of company building. This trend is happening in both small & emerging managers as well as with established players, denoting that competition is present for all managers, in all segments of the industry, despite scale advantages. Often called "Platform Teams", "Specialists" or "Applied Ventures", those teams are responsible for adding value in areas that are common to nearly all startups: talent, marketing, technology, etc. This movement became more tangible in the last decade, with players such as Sequoia, First Round Capital, Accel and most recently (and with great emphasis) a16z becoming very vocal about it. Still, these models are still in their early years, and have much to develop, adapt, and prove in terms of value proposition to both attract great founders and generate tangible value added in portfolio companies.

Shift's endeavor to build Alpha

It is clear to us that Alpha will become more and more scarce in the industry. The rapid increase in AuM, driving the expansion of fund sizes, intensifying competition and valuations, boosting information availability, and producing wide diversification, added to the limited capacity of funds in the asset class, are factors leading our conclusion to this end. Return will tend to the mean, which is also going down, and Alpha building will be key in steering consistent performance and separating the winning firms from the average ones in the cycles to come.

Since we founded Shift Capital in 2017 we have watched these *shifts* in the industry as they unfolded, both locally and globally. This has contributed to us developing our "contrarian" behavior, forging our culture, even radical to some, which is now being supported as data becomes available. In essence, it has always been about building Alpha. Rationally speaking, Shift's investment culture has developed the following Alpha blocks:

I) Earning money the way we feel is right.

Shift's "Zero/Thirty" fee structure that aligns our managers' interests with our investors' and pushes our team onto a long-term search for investment excellence, in opposition to industry standard, where fund managers tend to accommodate as their AuM grows. The business tends to *shift*, from asset picking to asset allocation, as we have discussed it in our August letter.

But why does that happen? To us, it reflects the business model itself. Managers are not growing AuM proportionally to skillset/capacity. With time, skill becomes secondary to fundraising. It is simply because that is how the model makes money. Assets under management, and not performance. To us, this is how severe the difference between Zero/Thirty and Two/Twenty may reflect on an investment culture.

When building the strategy for their next fund, the manager first determines his target AuM based on what he believes to be capable of raising with LPs. Then, he should ask: At this fund size, what is the average capital deployment rate per month during the investment period? Based on average deal size, what is the number of monthly deals per Portfolio Manager? Do we have enough PMs to deal with this demand? Given our expected investment ratio (deals invested over deals analyzed), how many new deals sourced and analyzed per month? How many man-hours deployed to complete the standard deal analysis before investment committee? What are the resulting man-hours required per month? Are man-hour requirements aligned with team size and capability? How did these KPIs perform during our last fund's investment period? Does the historical performance data support the deal team size being projected? Do I have enough PMs and seasoned team to meet the analysis and support standards I require? And so on. But sometimes these questions are not properly addressed. In these cases, there is either no process in place and managers will freestyle investment decision deal by deal, or they have not thought about this before going into fundraise (Softbank's Vision Fund I analysis by 7 Global Capital is quite elucidative in this sense). In a performance-based model, AuM may only grow when we are certain to match allocation challenges to skill capacity, because raising more money is only worthy if we can allocate with good performance prospects (otherwise, it is a risk). As an illustration, Shift's investment team is currently 9 members strong (and growing). And we do not have a fund in place, yet.

As we previously mentioned, studies show that new or emerging managers are usually top among performers. We argue that this proven reality is totally related to the long term biases the standard "Two/Twenty" business model poses to the successful manager. In the long-term, the manager will rush into fundraising without asking all the proper questions simply because raising capital is too sweet of an incentive and becomes easier with time. With the right set of incentives, we believe it is possible to maintain that "new investor spirit" for much longer. When earning the right way, priorities are often in the right places.

II) Stay true to our analytical nature, find the right investment stage to maximize value, trust and respect our processes above all else.

Venture is a risk-taking business. But not all risks are equal. As VC gets more crowded and competitive, speed becomes one of the main drivers of investment decision. Risks tend to be overlooked or underrated. To us, speed is only as valuable as it can be combined with our analysis. We have built a process focused on risk recognition and an assessment framework of downside potential, in balance to upside. We train ourselves and our team to differentiate and label risks, and we tend not to invest in risks we cannot map-out, understand and quantify.

Note that this would also imply on a reduced appetite towards Seed investments, given that MVP stage risks are naturally harder (or unfeasible) to quantify. This is true. Not so long ago we would spend countless hours and dozens of memo pages on Seed deals only to realize we would not reach the desired conclusions. Therefore, Seed investing at Shift is highly opportunistic, exclusively into cases where we believe to have profound information and very high conviction. Seed is a different game where statistics, diversification and industry coverage (industry related thesis with multiple invested companies) are imperative.

When building their strategies, most VC managers come across this “Seed/Series A” divide. We have been astonished to notice how many VCs have not realized how much these two differ from each other – and it is not only about check size. Strategies are so different that may only be reconciled when Series A is derived (follow-ons) from Seed portfolio. Either that or the fund would need different processes entirely and even different teams with different expertise. This discussion speaks to how little managers ponder about their own business models and question themselves about investment focus, strategy, underlying assumptions of their models, unique capabilities and – as a result – **how to build their own Alphas**. If you are an investor to multiple VC funds (and you have hanged in there reading this letter so far), we would recommend you contrast VC manager’s strategy between Seed and Series A investments.

At Shift, we understand our Series A focus derives from staying true to our analytical nature. Because we believe this is the investment stage where the value of in depth-analysis maximizes returns. Deals have enough variables to make them very risky (and highly rewarding), but risks can be quantified and measured enough to offer high levels of conviction. That is why we must respect the process above all else.

III) Investing less is a natural reflex of our model. Capital concentration must be a strength.

Analyzing longer and deeper, with a lower investment ratio than industry average, also means we allocate capital in a slower pace. It does mean we are less efficient in deal making, but we hope to be times more effective. Our team also tends to compensate that with longer working hours once we believe to have found a deal – when it happens, and it is a real rare thing – the team gets so excited you can almost feel the rush. Thus, our work intensity is more comparable to an investment bank than to a regular VC firm.

Nonetheless, investing less, at a same AuM basis, necessarily implies more capital concentration per deal than our peers. And that is just great! When an investment is approved after 3 different stages of analysis with an average of over 100 slides built by the investment team, 2 or 3 different committees, a final voting among the managing partners, at the current rate of less than 0.3% of total pipeline, we are confident that’s a good deal.

Thus, we usually face a different problem which is that our level of conviction in every deal is greater than the available check size (we would have invested at least 2x more in Skelt and 3x more in Paketá, our latest deals, at the same conditions we closed those rounds). Many times, it is even larger than our ability to fundraise at our current *Club Deal* structure.

We turn capital concentration into an advantage by two different methods. **The first**, we are relentless on understanding use of proceeds and accompanying the execution of our companies’ budgets. We help

entrepreneurs define and measure KPIs consistently, on a regular basis, in order to assess the effectiveness of capital allocation. What we hope for is to avoid a very recurring problem, that is overcapitalized early-stage companies spending capital unwisely, ineffectively, and burning massive rounds much faster, with worse results, than they would do if only fundraising had been smaller. In opposition, the culture we try to relay to our founders is that capital is always scarce, and that effective spending metrics are the best indicators of a strong and sustainable business. That also does not mean our companies don't grow. They should grow more effectively in bottom-line economics while sustaining top-line KPIs and metrics. It's just good management. **The second** approach to using concentrated capital to our favor is also the following Alpha block:

IV) We manage risk through hands on support and interventions.

This Alpha block comes from the mapped-out risks, flaws and value levers which we identified during our deep-dive investment process. We tend to identify opportunities and issues that are often not addressed in the company's business plan. Having theses levers clearly outlined to the founders will help target these untapped opportunities. An example was Kovi's seed round, our first VC investment, in which we clearly identified a high-level risk of car supply shortage at a certain point of the growth curve, because we had analyzed larger competitors which had already faced that problem at a certain point. We proposed a car-sourcing project which required, among other things, part of our investment into hiring an experienced car supply professional (Fernando Ribaldo is today one of the senior executives at Kovi, director of car supply, and joined the company right after our investment).

We firmly believe that, to become a truly effective investor, one must personally feel the reality and harshness of the daily life of the entrepreneur. Therefore, our investment team is also responsible for proposing and implementing such value-add projects themselves, once accorded by the founders. In Mimic's investment, our analyst who set out to assist the company in the 2020 strategic planning ended up hired by them to roll-out the project and remains an enthusiastic member of their team until now. As team members go back and forth between portfolio companies, they increase sectorial knowledge and front-line experience, fundamental tools for better assessing potential and risks during analysis process. It's a virtuous cycle in which investments are better selected and portfolio companies are better assisted.

V) Never rely exclusively on passive, network-based pipeline. The best investments are usually actively sourced.

It's quite common to listen to our peers saying that VC is a game of "access". It implies that top entrepreneurs will always pick a handful of investors and you need to have the right connections and be at the right places, at the right time, if you want to be part of these highly desired deals. That is indeed a reality. But the underlying assumption here is that the most coveted deals are also the best ones. That is where we tend to differ. At Shift we usually call these "hyped" investment opportunities the "Faria Lima Pipeline" (Faria Lima Avenue is where most of the financial market is based at in São Paulo). Though it is important to have access to these deals, as you can imagine, valuations tend to be high. Many times, too high.

In 2020, approximately 70% of Shift's pipeline has been generated actively. We have sourced in search engines such as google, social networks such as Instagram, walking around the streets and looking at interesting businesses (The Coffee was found like that). We develop and improve techniques to identify the deals no one is looking for, even before the founder himself is looking for capital. Our active pipeline increased 117% from 2019 to 2020 and we hope to keep up the pace.

With that we can find better investment conditions, under-the-radar markets with less professionalized competitors, profit-driven, bootstrapped entrepreneurs who value every dollar we might invest in them. **We**

take companies into VC and that may also turn them into more liquid assets and in turn more profitable deals.

As we enter 2021, we feel confident that our ever-improving Alpha blocks are being reassured day by day, and are starting to generate competitive edge. To us, building Alpha is about thinking beyond investments. It is about asking ourselves questions of purpose, capabilities, strategies and future. It is about conceiving the principles of an ever-improving investment culture and imbuing every team member with a constant desire of reaching excellence. With the right set of values in place, building Alpha is the nature of our business, less dependent on any individual and resultant of a constant, collective effort. With this in mind, this year we expect to launch our first discretionary investment vehicle: the Shift Alpha Fund I. We have named it as a constant reminder of what we envisioned since the founding days of Shift Capital and hope you will support us in this new and exciting chapter that we write.

Sincerely,

Bernardo, Fernando & João

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