November 2021

Letter to our stakeholders:

Back to Basics

A VC walks into a bar.

The bartender asks: "What will you have, sir?"

The VC: "Hmm… What everyone else is having."

We start this letter with a humorous provocation received from a dear friend. The VC category grows faster than ever. This industry behaves such as a marketplace: where opportunities (companies) are matched to capital providers. This marketplace, as of now, is very trendy, with plenty of supply and demand – perhaps too much.

In this vibrant environment, almost everyone gets a match. Good or bad. Right or wrong. There is no sanity check – the cycles are long, and mistakes are incentivized, supported by a culture where missing shots is part of the game. **The measure of success becomes how many matches you got, and in which high profile deals you participated, instead of which ones you got right**. The frequent questions are "how many deals you made" or "did you get into XYZ deal?" or even "what is your AuM", instead of "how much value did you create?" or "how consistent has your portfolio proven to be?" or even "what is your investment philosophy?". Sometimes we even catch ourselves biased by such unsound questions. As of now, a major force in the industry is FOMO – *what everyone else is having* – which makes the following discussions a must.

After 4 years on the road, we got many things right and others wrong. It is clear now that the best weapons we got to deliver consistency in decision making are our processes and investment philosophy. We have been focusing on those since the beginning, and these efforts finally gave origin to our first *investment manual*, that solidified our accumulated learnings into a document to assist us and our team in analysis process and decision making.

This letter will be based on our manual, on the investment philosophy, processes and methods behind it, the painful process to create it and how it has been helping us in every way.

What does investment philosophy mean for Venture Capital

With the intense flow of capital, managers (such as ourselves) often neglect their own investment philosophies – or don't bother to have one. This subject seems like that odd conversation…reserved for the old school, too outdated for the "new times". You will rarely find it in VC round tables.

Investment philosophies should be a super relevant topic in VC. Even more than in other asset categories. Here is our thinking:

i) **VC is long term**. Decisions made today will show results many years from now. Learning by mistake will take very, very long.
ii) **VC is very diversified**. Too much diversification incites (and hides) unnecessary mistakes.
iii) **Yet, returns are concentrated**. Even with diversified portfolios, returns are very concentrated.
iv) **VC's generally have little influence in their invested companies**. Most value comes from the investment decision, based on opinions formed prior to investing. And not during portfolio support.

In practice, a VC will make an investment decision today; this decision will have many biases, such as FOMO, peer pressure, personal relations with founders, ego, etc.; the processes to this decision will be soft, after all, it is ok to make a few mistakes in VC (there is presumably little information and diversification is a focal driver of returns); after the investment decision, very little influence will be applied into the company, and execution will depend solely on the founders; results will be seen 5 or 10 years afterwards; **after the full cycle, the VC will realize that <u>most results came from a single right investment decision</u>, and it may or may not have compensated for all the bad ones**; if those results are not satisfactory, the VC doesn't have to make a big deal of it – because VC is private.

If you look at Public Equities and Hedge Funds: investment decisions are put to test day by day, quarter by quarter; the manager can mitigate poor decisions or changes in scenario by calibrating positions or setting up structures to limit losses; the manager has liquidity and time to test, adjust and repeat so he can work on improvements on decision making and philosophy along the way.

If you look at Private Equity: the manager has influence and power to mitigate poor investment decisions by adjusting the company; the asset class has many decades of statistical data on what works and what does not.

If you look at VC, none of that is applicable, especially in Latam where the category is still of young age. A VC's philosophy (initially based on hypotheses) is the only north to guide decision making. Sure, it isn't that effective in the short term, because those hypotheses will take long to mature. But setting up an investment philosophy is the only way to put hypotheses into paper and iterate them along the way, in an ever-improving process.

A Venture Capital's investment philosophy is the main tool to bind investment managers' reasoning along market cycles and prevent them for falling into the seductions that the investment profession has to offer, keeping them from getting too biased and incur in unnecessary mistakes. In a hot and trending market such as the VC industry today, our perception is that this discussion is even more important. When (and if) the hype stops, the ones with strict philosophies and processes will be safe. Those without, probably won't.

Taking into perspective: how the current VC dynamics changes old school investment philosophies

In our last letter we dove deep on how the VC industry is evolving, its rocket speed AuM growth, the sharp increase in valuations, new methodologies, and tools for creating sustainable *Alpha*. VC has become a very dynamic category, marked by huge risk tolerance, diversification, and speed. This all must be considered for designing philosophies. What we found out is that the main ideas from the great old school investment philosophies are still applicable but must go through significant adjustments.

Business nature has changed. The vast majority of VC backed businesses follow an asset light logic, where assets are intangible and hard to put a value on. Brand, intellectual property, technology, and networks are the main assets of the current days and do not present a linear, obvious behavior. Nurturing those assets takes time and money, with very long payback periods, but their financial returns can be timeless, lasting for decades. To face those investments, a company needs much external equity capital to sustain years of negative cash-flows, and to obtain that capital, it needs to grow fast, with or without mature (profitable) assets. But why spend millions to create those assets, and market them prematurely and unprofitably, instead of building them slowly, funded with profitable revenues from clients?

On the one hand, VC has facilitated new companies' success by shortening time-to-market, innovation cycles and speeding up their growth. On the other hand, it has destroyed barriers to entry in most markets, making <u>speed a primordial pillar of a new venture's success</u> – at the expense of strong cash investments to develop assets and sustain unprofitable growth. These features have transformed the traditional logic of doing business and with it, created the need for more modern investment philosophies.

In our quest to understand what makes a winner VC-backed company, it was Adhemar, Kovi's founder, who provided us our first great spark: venture is a game of unfair advantages. To rise to a dominant position in a competitive market, you need to use VC in your favor to build the strongest unfair advantages, in the shortest window of time. Those are: disproportionate amounts of capital to innovate faster and faster and endure many years of unprofitability to create the best assets (products, growth momentum and network effects);

connections, access to top talent, references and support that will facilitate execution. We had heard it before, but never with the sort of logic that he presented – and that made us think for weeks. This sort of advantages, added to a great founding team, may be a recipe of success in this new world.

Looking with this perspective resulted in a non-obvious investment decision, that was backing Kovi for their Series Seed. At that time, the company had minimal gross margins, terrible working capital conditions, was addressing a not so large market (the one of ride-hailing drivers) and had a very weak balance sheet in an industry where strong balance sheet and efficient capital structure are clear competitive advantages. But Kovi had fantastic unfair advantages to quickly take it to the next milestones of their business plan: a superior tech platform, capital, support, connections, momentum, and a solid founding team capable of executing in top speed, attracting and retaining top talent. Once it got to the next milestone, everything would start to make sense – margins would go up following Kovi's scale and efficiency gains, working capital cycle would reverse as supply power would gradually shift from suppliers to Kovi and balance sheet would strengthen as capital raise and creativity (merits of a great team) would play their role. Once it got there, Kovi would benefit from solid economics, its great assets (tech/product, team, capital, know-how and network) to launch correlated innovative products to expand addressable market and grow even faster.

Now the thinking seems easy. But visualizing it back then was a huge effort. The conditions of the company and business model when we backed them for their Series Seed were contrary to all mantras of the old school investment philosophies. Now, while we back them for their Series B, we see a completely different company that is much more adherent to what we would call a *great company*. Capital efficiency, scale and scope gains, operational improvements and new markets are central to their Series B investment thesis. **Getting the company to this point was only possible due to Kovi's fantastic unfair advantages. The company's narrative is fully anchored in an aggressive VC-backing strategy and indeed much different from a traditional old school company, with execution speed as a central pillar of its success.**

Forming conviction in this investment thesis took us some *science* to bring numbers to the hypotheses, but also took a great deal of *art*, in form of vision, creativity and confidence to visualize the company's future and its probabilities. Making the *art* part of the decision-making criteria into something more tangible is essential to any modern investment philosophy, and our daily struggle.

Our own philosophy: Back to basics

Drawing our philosophy was a tremendous hardship. Especially because we started Shift, and have been as of today, a SPV (special purpose vehicles) business model. Meaning that our capital is tailor-made deal-by-deal and has no priorly set return expectations, or benchmarks. This, added to the fact that we can see value in many opportunities, created an uncertainty in our investment framework and an urgent need to work on our philosophy. We could see ~3x cash-on-cash opportunities in many companies, more than we could handle. 3x in a 3-to-5-year window is a good investment (a little over 30% IRR). **This made us realize that (i) not all returns are the same, when taking risks into account and (ii) our philosophy should drive us to the best investment opportunities, instead of only good ones.**

All philosophies start from **what you want as an investor** (*the output*). **In our case, we set to prioritize what we call *risk adjusted returns*. Meaning that we will never look isolated into return expectations. That is how we start to incorporate opportunity costs to our investment decisions.** With this in mind, we produce our base-case projections for the target company, considering all features of the business model: expected growth, economics, scale, efficiency and scope gains and its intrinsic and extrinsic risks. And Risks, to us, are everything (events and probabilities) that can negatively impact our base-case scenario.

Our projections will produce expected returns, in terms of cash-on-cash and IRR. Projections in early-stage investing are nothing more than a theoretical exercise. There are infinite possible outcomes for returns and our projections seek to produce a base-case scenario where risks are controlled and there are great probabilities that the actual result exceeds our case. Derived from our own experience of over 1,500 conversations with companies and 100 complete analysis processes, there seems to be enough opportunities with minimum 7x base-case cash-on-cash returns in 5 years of holding period, given our current allocation appetite. As the market *shifts* (valuations, number of companies, tailwinds, and headwinds) and our appetite for allocating capital in VC changes, this theoretical target may change as well. After finding balance in our base-case and drawing expected returns, with high degree of conviction, we watch close for potential upsides. **Our philosophy does not seek homerun returns at all risks from an initial standpoint, but values unpriced triggers for additional upside, even though they are unlike to effectuate. Cases with unpriced potential upsides will enable us to have outstanding expected value at no additional risks and little chance of failure – hence, optimal risk adjusted returns**.

The desired output is rather simple: (i) well-balanced risk-adjusted base-cases; (ii) conviction on a 7x cash-on-cash expected return – that shall yield a gross IRR north of 45%; and (iii) many unpriced additional upsides. If those three outputs are respected, we will have a meaningful chance to produce a winner portfolio in terms of returns, with mild risks.

After setting output goals, we got to the hardest part: setting standard guidelines towards **what we qualitatively seek in a company**. Those intrinsic (company) and extrinsic (market) features (together, ***the inputs***) will serve to assess a company's quality but also to design our base-cases, that will produce ***the outputs***.

"Team, market, product". It is a maxim that apparently leaves little room for mistakes in early stage investing. On the contrary. Those broad topics are full of nuances, contexts and perspectives and not diving deep on each one of them is the utmost source of mistakes.

Starting from this traditional VC analysis framework, we dove deep and elected a few pillars that are central to our analysis, and, hence, to our investment manual. We worked on each one of them, taking many references from the traditional value investing frameworks, and found out that most of the thinking is indeed applicable to VC. **We went *back to basics* in a theoretical immersion, making adaptabilities from the old theories into more modern ones, and the results have been exciting. We point below the main learnings so far**:

In case you want to skip the next chapter and go straight to conclusions of our analysis framework, click here

***

> ***Market / industry:*** there is plenty of nuances here. A "large market" seems too generic to us. Instead of a large market, we look for an attractive one. It can mean many things: that the market is large with slow incumbents; that the market is incipient but is being formed in a rapid pace with no clear winners yet; that the market is transforming in the next years due to innovation, technology or cultural aspects and share will be up for the taking; or even that the market is small, niched, and the company's product is so good that it is a hero and a probable winner in this small market, serving as great launch platform to new correlated markets. All of those may produce excellent risk-adjusted results.
>
> There is also the case of internationalization. Brazil has recently proven the case of being a great launch platform for companies addressing Latam or global issues. This changes the reference for market sizes since a multi-country approach may unlock new addressable markets. Although internationalization is not an obvious play, it has been added to our market sizing methodologies.
>
> Ultimately, we will expect to reach an addressable market in the company's maturity where *upside is virtually unlimited.* Through market, scope, or geographic expansion.
>
> ***Team:*** probably the hardest part of investment analysis. There is no consensus on what a great team means in early-stage investing. What we try to do is divide "team" into skills. Execution capabilities, market knowledge, fundraise/commercial and vision. Ideally, we look for all those skills into one person. That would assure great leadership and consistency for the company going forward. Co-

founders should add to execution capabilities, but vision, market knowledge and fundraise/commercial skills should be present in one protagonist.

Then we try to assess if this team is the right one for the challenge. For instance, if the challenge is to disrupt and transform a market through hardcore innovation, that will incur in tremendous cash losses and strong adversities in the first years, the team should be stronger on vision and fundraise capabilities. On the other hand, if the challenge is to grow a direct-to-consumer brand with solid economics and capital efficiency, the team should be strongest in execution capabilities and market knowledge. Frequently we see outstanding founders with an Ivy League MBA degree, that are not the right fit for the market or the challenge.

From start, we assess skill deficits in the founding team. In case they exist, we search for ways to tackle this before investing: sourcing new executives for the company or separating enough stock option pool to attract and retain C-level talent. We know that there are very few “complete” teams and that great investment cases may appear in a team that is under maturation.

And, as a final validation, we look for skin in the game. A successful founder must have the right drivers for creating a business. Only then he will be able to overcome the adversities and show resiliency in times of crisis. Creating a business in Latam has recently become trendy, and we see many founders with the wrong drivers, or little personal risks invested in the business. In these cases, investors will be bearing those risks alone, which may create meaningful misalignments.

Business model & product: the company may be attacking the problem through a new business model, a product innovation, or a mix of both. We prefer to analyze both together and look at problem-solution-fit through the same lens. This session of our analysis provides major inputs in regards of thesis’ quality.

We will look for a business that is defensible in the future through some sort of lock-in, network effects, scale and financial efficiency, a new business model or a product that is much better than competitors’. Ideally it will have few variables (we generally don’t support businesses that are too complex, exception to those where complexity put together huge barriers to entry) and be scalable in terms of technology and processes. Regarding product, it must be better or different than competitor’, highly innovative and durable in time – with the potential to exist and evolve for decades (this point will also relate to founder’s vision). It is important to take into perspective that in early-stage investing, one must be able to visualize business model and product into the future and evaluate feasibility. Because often the business is still incipient and much of the product’s features will be live in some years. The product vision must be coherent to the team’s skills, market dynamics and global benchmarks in case they exist.

For product and business model analysis, we will rely on a few tools to search for evidence supporting our (or founders’) initial hypothesis. Those tools are vital steps to a more scientific approach of product and business model analysis – topics that are too qualitative and frequently based on opinions, not facts. Some tools we use are SWOT and PORTER analysis (with grading systems), web scrapping, data crunching, traffic, client interview, testing, google trends, and several others.

Another edge of business model analysis we learned to value is go-to-market. It will relate to marketing strategy, client acquisition, revenue model and capital allocation. It is not as simple as it seems and the way a company chooses to tackle a market may be the sole distinction between a winner and a looser. In general, founders that know the market by experience tend to choose better go-to-market approaches.

Operations & traction: this part is more straight forward. Since the companies are still early-stage, the main KPIs must support the overall narrative of the business case, including product and business model hypothesis, but may or may not deliver solid results just yet. It is hard for late-stage / public equity investors to look at early KPI’s and visualize those into the future. It was a long learning curve for us. Experienced early-stage investors know exactly what they are looking for in a venture’s early KPI’s – knowing that desired results will vary according to market and go-to-market approaches (marketingled, sales-led, product-led and other strategies). The main sign we search for is product market fit, through client satisfaction, traffic, purchase, repurchase, conversions, engagement, referrals, churn / revenue retention and upsell. Prior to drawing conclusions, this data and KPIs will need to be treated and posed into cohorts to highlight behavior along time, organic *vs* inorganic. This analysis will ultimately serve to attest management's domain of the main operational challenges, execution capabilities, efficiency of current strategies and to further understand the market. For example, if the company targets a niche market, figures such as conversion rate, client engagement and organic behavior must be higher, since network effects come faster; on the other hand, if market is huge and go-to-market is not addressing a specific niche, data analysis may show how costly it will be to build network effects in such large market.

Financials: the main objective of our financial analysis is to understand how company's financials will behave in time as the main assumptions of the business model mature – mainly growth, margins, recurrence, breakeven, capital efficiency, cash generation, and cash needs. Ultimately, we will value businesses that have the potential to pose strong operational leverage, resulting in good margins (pre-growth investments). Those businesses will have enough cash generation to invest into their own growth or in innovative assets, in the long term. With those financial indicators in place, there are great chances that the company will present long-term double-digit growth, with compounded shareholder returns.

The key here is to adjust traditional profitability metrics to high-growth asset light companies, where assets are intangible and investments are accounted in the company's income statement, rather than balance sheet. For instance, looking at EBITDA before marketing investments and R&D provides more insights on operational leverage, as well as looking at ROIC adjusted for those non-balance sheet investments. **In the VC-backed world, growth and momentum are a company's lifeline – businesses that grow slow will eventually get overrun. Therefore, if a company is investing much of its cash generation into its own revenue growth and in intangible assets, a zero EBITDA is great. In fact, it is desirable.**

Unit economics and LTV / CAC are great proxies for profitability – but are never enough. Our case against looking solely to unit economics and LTV / CAC for financial assessment of an early-stage business is that those work great for SaaS companies, although not that great for other businesses. Depending on the methodology, it will drive wrong conclusions. We have adapted those for different client behavior – for instance, for early-stage consumer (consumer brands, consumer health, consumer education, consumer fintech), given the company's short period of sales (typically one to two years until they reach Series A), we built a LTV based on the long term trend of the company's sales cohorts obtained by non-linear regressions. This trend is applied to both the current and the projected unit economics to provide more precise recurrence estimations for the LTV calculations, as well as to topline build-up for the financial modelling.

We have found no other way to create comfort than to model the whole financials of the business so we can comprehend breakeven, operational leverage and cash dynamics – elements we cannot address by looking solely to unit economics. All modeling will come with *bear*, *base* and *bull* scenarios, adding feasibility and risks to businesses' main assumptions and establishing the main pillars for return assessment. Whenever we feel discomfort with an assumption, we will draw sensibilities and stress tests those to better understand risks and insert those into the scenarios.

Risks: it is essential that we assess returns only after creating a strong opinion on risks. Our return assessment must take risks into consideration to create risk-adjusted investment scenarios. The main obstacle here, that we are enduring to overcome, is how to create comparable *base-cases* among investment opportunities when risks are very different from a company to the other – and in essence hard to quantify. Our financial projections for two given companies should have the same amount of conservatism or aggressivity, as well as the same amount of embedded risks – producing risk adjusted *base-case* return expectations.

What we did to settle this is standardize our criteria for *base-cases*: it should not carry any binary probability of success or structural risk. Ideally, it should not depend on further capital raising (although this is not applicable for seed investing and to founders with great track record of fundraising) and no major changes to business model and product, considering only products with clear market-fit.

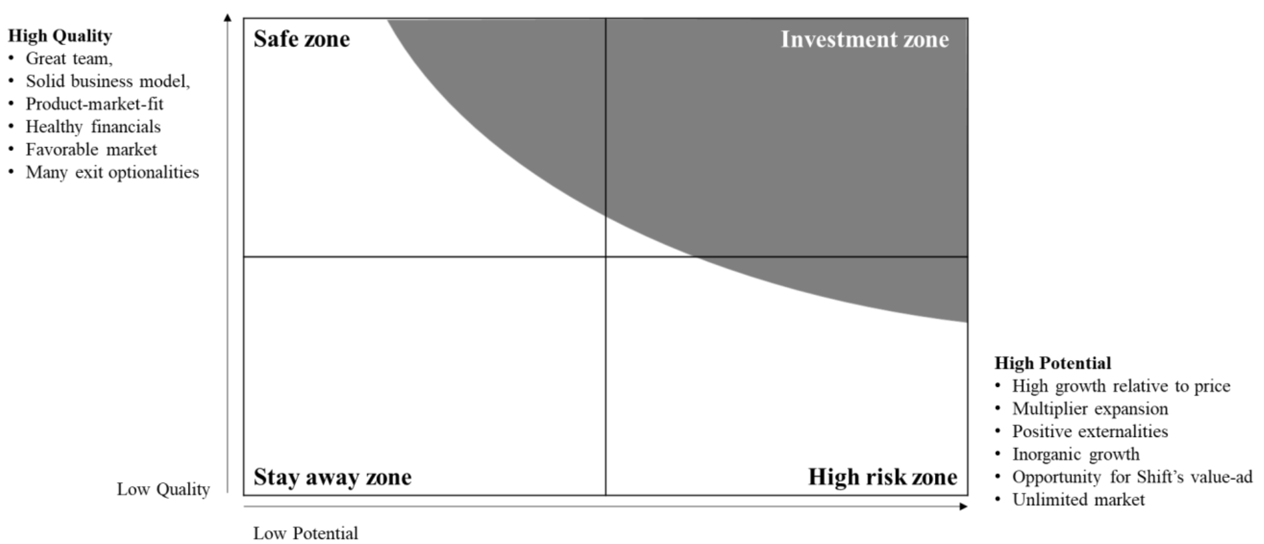
The best way we found to think about risks in early-stage companies and understanding if our case is conservative or aggressive is looking at it from the following perspective: starting from our base-case, <u>what could not go right</u>. In this framework, you point the main events, with probabilities and impacts, that could bring value down from its base-case. For instance, technology adoption, product development, regulation change, network effects, scope gains, etc. The output of this analysis is a waterfall of things that must go right so the company may achieve the *base-case* scenario, and the final probability to it. For instance, if you have 5 of such risks, with a 50/50 probability, and a 50% impact, you will have a final probability of 3% that this case goes right, which may represent that the *base-case* is way too aggressive and must be adjusted.

Return assessment: our process of measuring return expectations starts with well-designed, standardized risk-adjusted financial projections (bear, base and bull), that follow similar criteria for all the investment opportunities. Those will set the initial step for return measure. Then we assess exit optionalities, probable exit multiples and ideal investment time horizon (typically 5 years). Every scenario will have its return expectations, execution challenges and feasibility and its own embedded risks, producing a gross expected cash-on-cash and IRR. When the investment committee is comfortable with the company's base-case returns, we dig into potential upsides, and on how large those can be – but do not consider them into our scenarios at an initial standpoint.

***

Our whole analysis is supported by a field diligence, boots on the ground, testing products and speaking with direct and indirect competitors, industry leaders, customers, suppliers, and other stakeholders to obtain more granular information on market dynamics, market sizes, go-to-market, product and business model adherence, team reputation and so on. This approach has produced notorious results to us, ruling out unreputable founders, pointing failed go-to-market strategies and cutting market size estimations. Or, in other cases, affirming our initial assumptions to further support our convictions.

The end game of our analysis is (i) producing qualitative perceptions that position the company into its degree of *quality* and (ii) creating standardized return expectations, that grant the thesis with its degree of *potential*. **Together, quality and potential will be the two definitive factors for our decision-making process**.



One of the major differences of our philosophy is that we look <u>deeply</u> to quality and potential, developing a level of understanding and conviction that is unusual for a VC. This provides us with much more input for decision making and allows us to make non-obvious investment decisions, knowing that very few companies are high-quality and high-potential from a first look (and, as a consequence, their rounds are very competitive and overpriced). For instance, Shift will have investment cases that are high quality companies, with mid-potential, knowing that they present excellent risk-adjusted perspectives. On the other end, we will support a company that has mid-quality but great potential, knowing exactly what is missing and working on solutions by being hands-on. This is only possible if we understand, in depth, those features (quality and potential) of the target company to have strong conviction for a risk-adjusted base-case that provides an excellent risk-reward balance, despite not being optimally positioned in terms of quality or potential. The easy way, frequently chosen by most VCs, is to look at companies broadly, and bet only when potential is great at a first look.

Ultimately, we will always prioritize quality over potential, as we have more analysis capabilities and less probability of error on the first. We will choose to focus on *what we know* rather than on the many assumptions behind what we don't know, balancing the *art* and *science* parts of our decision-making equation. We feel that the industry, especially in early stage investing, tends to think it is mostly *art.* That is probably the reason why venture investors do not focus on their investment philosophies. Trying to reason with *art* is indeed a major challenge.

Although we succeeded in our first draft of the philosophy, processes, and frameworks, we expect many changes to happen in the next years as we acquire more experience and statistical significance. We are sure that our first fund will also contribute to this end. It will be interesting to contrast these initial steps to our philosophy revisions afterwards.

Our philosophy and the market progression

Since 2019, we have been experiencing great tailwinds in the Latin American VC industry, with increasing capital flow, heated M&A activity, and sharp multiplier expansions. The outstanding results of our portfolio companies have been positively influenced by it, as well as all Latam VCs' portfolios. It is very hard to separate our results (and industry's results) between what is attributable to the firm's own *Alpha* generating capability and what is attributable to market tailwinds. What we know for sure is that this investing season may not represent the following seasons to come.

We have tried to understand the macro behavior of the industry to better adjust our investment philosophy to market shifts and found out that our skills to this end are very limited. Trying to determine at what moment we are in relation to a hypothetical cycle would be an inglorious task, and the object of a new study involving global economics and geopolitics, which we are not yet prepared to undertake. However, be prepared for a reversal (from tailwind to headwind) is the least a mindful investor should do.

Looking back to our investment decisions and portfolio companies, we can infer that our philosophy has two strong value propositions to this objective: it is naturally prepared for a market reversal, although we don't pretend to know when and if it will happen, and it is naturally different from the standard of the Venture Capital industry, therefore, more uncorrelated.

Our philosophy has served us to many ends beyond returns

As you may know, we have investment committees. The whole industry has (on different formats and styles). At the beginning, it was very difficult to discuss investment opportunities in our committees – when we did not know exactly what we were looking for. When this is the case, it is a game of storytelling: if the investment manager is skillful enough to tell a compelling story, the investment feels right and is supported by the committee; and when he is not that skilled, he will just say “you have to hear it from the founder” and let the founder do the selling work.

After the painful process of drafting the first steps of our philosophy, and as soon as it became legitimate among our team members, our committees became a game of consistency rather than storytelling. We knew exactly what we were looking for. It became a virtuous cycle, where decisions are more rational, have high levels of conviction and are easier to make. **By the way, having high conviction in decision making feels great. It is great for our team, that feels incentivized with coherent horizontal decisions and processes. It is great for the founders, that have full unconditional support from our whole team. And it is great for our internal processes that get legitimized and improved, based on solid pillars of values, culture, and consistent decision-making.**

Our philosophy also assisted us to communicate with our investors, building a single understanding on how we think and what we seek in our investments. It is central to our positioning and differentiates us from the market. With the positive feedbacks we have been receiving, our philosophy has also helped us build confidence in our thesis for the next chapter of our story, the Alpha Fund I.

Sincerely,

Bernardo, Fernando & João