SHIFT CAPITAL

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Letter to our stakeholders:

*Activist minority shareholder*

The recent market downturn has made us think and discuss the private investment market *Modus Operandi*, specifically in Venture and Growth Capital. During the past cycle, these categories were marked by syndicated capitalization rounds, diversified corporate ownership, and passive investors, likely due to the collateral effects of a bull market. That incurred in a dispersed dynamic of power among minority investors and a balance that was, in practice, very favorable towards the founding shareholders. We remember how the theme of "governance" sounded bad in discussions with founders in the previous stage of the cycle. With "bargaining power" highly concentrated in the founders' hands, these could choose to associate with more passive investors with few control mechanisms. Perhaps due to a lack of criticism of that founders' cohort, which was experiencing its first bull market, they attributed great value to investors of this kind. The recent Dynamo's letter (part of our weekly readings), *dispersion and control*, helped us refresh our memories and foster debate about this theme – even though it discusses the public market, which shows distinct dynamics and challenges.

This topic is **very** relevant to the current moment. The established "institutions" in the financial markets and the "brakes"/risk control mechanisms are tested during a bear market. In the ongoing stage of the cycle, we will perhaps have the first significant test of the market's safety tools for Brazilian Venture and Growth Equity. Our guess for the result is not good (although this is not the central theme of this letter, and we avoid any prediction in that sense).

If you have been following the Brazilian Private Equity industry for more than ten years, you have probably heard the anecdotes about how difficult it is to be an active minority investor in the Brazilian market, mainly because of the legal, cultural, and emotional difficulties that involve the relationship between a founder and an active investor. In this letter, we go deep into the governance of a minority investor, not only explaining its importance, but detailing our *modus operandi*, exposing how we see the different pathways of influence on a company and, therefore, making it possible to build the desired governance while being a minority investor. As we have already argued in previous letters, **the fact that we are active investors plays an essential role in the way we manage risks, which is a central component of our investment philosophy** (in the Building Alpha letter, we detail our components of value generation – we strongly recommend reading it for those not familiar with our investment philosophy).

In our strategy, we seek the **risk management** capability adopted by traditional Private Equity firms, combined with the **potential** of a company led by a visionary founder. We will not extend ourselves to the benefits of having or not having a controlling stake in a company since we believe this matter deserves its own letter. We will detail in greater depth our strategy's challenges and our main learnings so far. Executing this strategy is a complex task and requires several understandings before an investment decision, contributing to our slow pace of capital allocation. Our opinion, exposed in this and other letters, is a set of learnings. As is in any good investment activity, it is constantly evolving, meaning that there are past decisions incompatible with what we stand for here.

**The best type of influence is not imposed; it is built**

There are different ways to influence decision-making in a firm, which are challenging in the form of minority partners. However, as an *active minority investor*, we must first ensure enough influence over the invested company. Each way of making interventions and influencing has its purpose, being more or less advantageous depending on the situation. Those ways are (i) legal rights, (ii) trust, and (iii) argumentation. **Exaggerating one kind of influence can harm the corporate relationship and impact the other forms of it. On the other hand, the lack of power almost always leads to information asymmetry** – where the entrepreneur can provide only the minimum legally required information – transmitting only a tiny fraction of a company's reality, creating obstacles to decision-making. Or, information *reporting events* can become a "sales pitch" rather than an honest discussion about the business' health. Thus, extreme clarity about how to build influence effectively in the condition of minority investors is an essential enabler for our investment strategy, which makes this theme so crucial for us.

i) Influencing by legal rights

**Legal rights** are typically pre-established when a partnership is built and are usually defined in the shareholders' agreement. These rights, granted to us as investors, usually in the form of vetoes or voting rights on specific issues, ensure that the entrepreneur acts independently within the basic scope of trust. The main advantage of this type of influence is its legal character, which guarantees essential influence assuredly but is restricted to what was defined at the time of the investment (affected by the investor's negotiating ability). These rights become even more limited regarding a minority investment with less bargaining power. **The abusive use of the legal mechanisms in the shareholders' agreement can lead to conflicts within the partnership, impacting the relationship between the investor and the invested company**. Therefore, using or even mentioning clauses from the contract should always be a measure of last resort. Nevertheless, we have a list of rights we do not give up in a negotiation to ensure a minimum level of interference that we consider appropriate for our investments. We need to act prudently, from negotiating our rights to choosing when to exercise them – which happens only when alternative forms of influence have been exhausted entirely and when dealing with high-risk issues to a thesis.

Finally, it is essential to note that well-defined legal rights **do not guarantee high information symmetry**. At this growth stage, entrepreneurs have much flexibility to report whatever they want – especially when it goes beyond the scope of accounting/auditing. **Board meetings, when poorly managed, end up becoming reporting meetings instead of discussions on how to create value**, inhibiting the investor's ability to identify and act on problems/opportunities. Governance is an intrinsic part of the management of any company, but its mechanisms are highly susceptible to failures when not complemented by other forms of influence.

ii) Influencing by trust

**Trust** is the belief in loyalty. The alignment of interests is so high that a decision made unilaterally is always, or almost always, the optimal decision for all parties. This form of influence is mutual and fundamental for exercising other influencing methods. Only through trust can we exercise the third type of influence: argumentation. For example, if we do not have the trust of an entrepreneur and try to convince them to follow a particular path through argumentation, our words will naturally have little value. The entrepreneur's trust in us is also crucial for reducing information asymmetry, as the lack of it often leads them to hide problems and engage in selective communication.

On the other hand, if we do not trust an entrepreneur, we will rely on using legal rights more frequently, for legitimate reasons or due to insecurity, leading to potential corporate conflicts.

Therefore, we understand that building a relationship of **mutual** trust between the entrepreneur and the investor is critical. **Our role here is to ensure that entrepreneurs have faith placed in us *as quickly as possible***. However, as in any relationship between people, trust takes time to be built – based on our experiences, it takes something between 12 and 24 months for the bridge to be made. But it only solidifies thoroughly after some necessary experience lived together that required engagement from both parties (such as a period of declining revenue or margin compression), with a successful outcome due to the good attitude of both the entrepreneur and investors.

It is a delicate subject as the **excess of confidence** can lead to errors driven by negligence, so it should not be considered the only form of influence. The trust's main objective is to bring fluidity to the other forms of influence: legal rights and argumentation. Without this element in the relationship established, it is unlikely that a minority investor will be able to generate value other than money for the trajectory of a company. **Knowing how to build and manage trust as a minority shareholder is the first and most crucial step to execute what we propose: managing risks as a Private Equity firm while investing in extremely visionary founders in high-growth stages**.

iii) Influencing by argumentation

**Argumentation** is using the debate to convince others that a particular viewpoint is correct. Properly using this method creates alignment among different parties in a company and tends to lead to the most logical path. That helps to avoid imposition and, consequently, reduce conflicts – which makes it the **primary and most effective form of influence**. We take this method very seriously because, in an ideal partnership, almost everything should be resolved through it. The best entrepreneurs see the debate as essential to building a business. Since we are also susceptible to biases, we often bring in-house discussion points between investors and invested companies to conduct sessions that assess whether we have a rational conviction. After all, this is the only way to mitigate our tendencies. However, **a logical debate between investor and entrepreneur is not always easy. The main reason is its high dependence on personal and organizational paradigms, combined with the highly interpretive nature of business challenges,** making it difficult to understand different viewpoints and making the argumentative process grueling. That leads many investors to avoid this procedure. **Therefore, to ensure that the argumentative process through debate works best, it is necessary first to ensure that the bridge of trust has been built and has solidified**.

**Learnings from a few years of investing, operating, and advising**

Some key learnings were essential to clarify how to **build influence over a company as a minority investor**. Identifying and establishing these learnings within our culture makes us more capable of executing our strategy as active minority shareholders. We will describe some of them below.

i) Hard work is the main trust-building driver

The fact that we are active investors and operators has been the main lever for building trust in recent years. It is well known that entrepreneurs attach great value to our track record as business operators. And, when we use this expertise to humbly help solve their company's problems without demanding anything in return, simply by aligning shareholder and company interests, we build trust. This often involves doing more than what is expected of us – and more than what is common in the "market". Several episodes come to mind, such as when we allocate Shift's talents in companies to solve significant problems, when we conduct roadshows to raise equity or debt for our portfolio companies, or when we conduct business development projects to unlock new opportunities for them. These stories circulate in the market and are a way of positioning Shift as a reliable hands-on investor. We believe that this reputation will help us, in the long run, to build bridges of trust in increasingly shorter periods, improving our governance.

ii) Transparency since the first contact is non-negotiable

As previously pointed out, trust brings fluency to an argumentation process and reduces the need for coercive means to influence a company. We give much importance to the level of transparency we perceive from the first interaction with an entrepreneur. We evaluate everything from how data is presented, to minor "unharmful" omissions, to judge whether it is appropriate to form a partnership with the founder. An excellent executor can take action without assessing risks accordingly and present unclear forms of communication when pressured for growth. That can hide the actual situation of a business and inhibit our ability to influence constructively. Therefore, **the process of influencing a company begins at the first moment we have contact with the entrepreneur**. At this stage, the main goal is to analyze the feasibility of building solid bridges of trust and dialogue.

iii) Vision alignment ensures the expected output

After understanding that we are facing potential business partners, alignment is the second point to be validated. Entrepreneurs with very different visions from ours on how to operate a business, even if successful, will create frequent strategic divergences and require us to exhaustively use argumentation to the point of creating conflicts. A classic mistake in the Brazilian middle-market Private Equity is when an investment manager identifies the lack of alignment before establishing a partnership but decides to proceed with the investment by believing that the legal rights will be sufficient to ensure alignment.

Investing in a good company with a good entrepreneur but with a divergence of vision will almost always be a stressful process where the return will not compensate for the risks taken. Therefore, we value entrepreneurs with a prudent capital allocation vision aimed at the business's longevity, with a strategic vision and business philosophy similar to Shift's, even if it does not result in the fastest growth or the highest potential. It is essential to note that we validate alignment not only by what is said to us but also by past actions of the entrepreneur that demonstrate their natural way of operating. After the cycle reversal, it has been common to hear speeches about cash generation and capital preservation from entrepreneurs whose attitudes do not correspond to this speech.

We have learned that a fundamental step in the analysis process is discussing the business plan and use of proceeds, where we have our first opportunity to influence the company's trajectory positively. If successful, this step ensures vision alignment and is essential to building trust.

iv) Avoid syndicated rounds

The *bull market* and low-interest rates situation in recent years, marked by an abundance of “adventurous” capital and new entrants in the Venture, Growth, and Private Equity categories, with the very active presence of “syndicated rounds” and co-investments, has created a somewhat unique corporate structure when compared to companies that have not followed the infamous "*VC Track*". Most of these investors assume that few companies will be responsible for most of their returns. They believe this asset category’s “return premium” should be very high, supporting higher-risk decisions. Their inexperience in these cases leads them to seek quick returns without considering that building a company takes time. This paradigm is little compatible with our investment philosophy. In companies with this context, influence through argumentation becomes much more challenging to implement.

Another incompatibility we sometimes face is the excess of confidence by investors in the entrepreneur, especially in these diversified corporate structures, which makes them highly inclined to support any decision with little reflection on the pros and cons. **As our philosophy is divergent from most of the growth/venture investors, we carefully consider the figure of "syndicated rounds" and diversified corporate structures, prioritizing companies in which we can be the focal point of influence to simplify the argumentation process and bring our paradigms of risk, management, and operation, even as minority investors**. After some time, we understand that the ideal business partnership comprises more than entrepreneurs with good execution capacity and well-capitalized co-investors. The ideal scenario is painted when everyone has similar "investment schools".

v) Small and active Board

Recently, we have realized that Boards of Directors are an outdated and highly inefficient institution for growth businesses. In this type of company, which is usually unfamiliar with governance rituals, the Board Meeting is unproductive and usually brings little additional value to the business. No wonder why entrepreneurs avoid it.

At Shift, we took some time to perfect our participation in boards. Board meetings are undoubtedly the best forum to build trust and influence if well-executed. First, we understand that it is necessary to avoid at all costs these meetings from becoming "accountability" forums. This is an exhaustive process for the entrepreneur. After 4 or 5 sessions of this type, the bond of trust and the investor's ability to influence decisions will certainly be weakened. Therefore, the forum must necessarily have pre-work and the "accountability" material must be sent before the meeting so that the investor can read it beforehand. The first few moments of the meeting then become a forum to clarify doubts about the pre-work material and financials, and the second and longest part of the meeting becomes a brainstorming session for strategy, problem-solving, and business development, creating space for the investor to generate constructive value for the business. **Ultimately, this value generation by the investor, bringing solutions and resolutive ideas, will contribute to solidifying the trust bond.**

After the board forum, we never exempt ourselves until the next meeting. We act as project managers (PMOs), piloting and demanding the initiatives raised and agreed upon in the forum. This usually ensures greater execution capacity for the founding entrepreneur, whose time is limited.

To accelerate the construction of trust, we usually initiate a relationship with an invested company with more frequent Board forums, monthly or bimestrial, which maximizes our learning curve about the company and the entrepreneur, allowing us to generate value more quickly and frequently. **Growth companies are very dynamic, and an investor who participates in forums only quarterly will often be outdated, inhibiting his ability to generate strategic value**. Additionally, we do not support a board with more than five members. For a company in the growth stage, there is simply no need for that. A large board will only inhibit the creation of trust among members and bring confusion to the strategy and decision-making process. In general, we prefer a board of 3 members until the company reaches a management maturity and governance capable of supporting a larger and more bureaucratic structure, knowing that the entrepreneur can always consult with references and industry leaders informally without having to inflate a Board for it (we strongly suggest this).

vi) The best of the two worlds

In a recent chat with Alexandre Cruz, co-founder of Jive Investments and a friend, we commented that we have an "identity crisis" installed at Shift: we do not fully fit in the PE category or the VC. This happens because we prefer to extract the best of both worlds regarding target-company profile and governance.

When it comes to company profiles, we prefer high-growth companies with good unit economics that don't necessarily translate into EBITDA and cash generation (alluding to the typical VC strategy) but that have a conservative risk profile, revenue robustness, product, economics, and revenue quality (alluding to the PE strategy). We can only invest in high-growth companies with PE's conservatism due to our governance style. We invest at a slow pace, seeking to have a stake, influence, and governance that guarantees high defensibility. We extract the best from both investment schools... **the well-established governance and risk assessment from the PE's playbook and the well-established tolerance for a dynamic growth environment from a VC's playbook**.

Another lesson we learned from both investment schools, where we chose to absorb the best of each, concerns power dynamics in a partnership. While the entrepreneur works for the investor in the PE school, in the VC school the opposite happens. We understand that a healthy business partnership should have no clear hierarchy definition. For trust building and alignment of interests, the investor must fully understand that the entrepreneur does not work for them but for himself. In practice, breaking this paradigm is more complex than it seems, involving two players with big egos: the entrepreneur and the typical financial market investment manager.

## Challenges for the current state of the private company market

With the recent capital shortage, we are already seeing companies that were once highly capitalized facing difficulties or even ceasing to exist, especially those that failed to adapt to the new reality. Interestingly, most of these cases have pulverized ownership structures, with funds holding a more significant share than the founders. Sometimes, an individual fund has a more influential position than the original shareholders. **Companies under stress, where investors are more relevant shareholders than the operators, create a significant misalignment of interest, especially during challenging bear markets, since most of the risk lies with the investors. In contrast, the direction of the company still rests with the founders**. In environments like this, there will undoubtedly be greater demand for control by the funds, who will test their governance mechanisms and techniques, which have been neglected for several years and are still underdeveloped (in Brazil's Venture & Growth markets). Investors who were once acting from a distance will be forced to come closer and build influence. The successful ones will be those with an excellent ability to build trust bridges, allowing the implementation of value-building initiatives and interest alignment, reducing risk.

Some crucial questions that lingered in our heads throughout the past bull cycle will be answered during this new phase:

i) Does the "American" governance style implemented through offshore structures and Delaware legislation work for Brazil?

ii) Is passive capital, in the American model of Venture and Growth, an option for the Brazilian market?

iii) Will diversified shareholder structures and huge boards overcome the turbulent phase in building companies?

iv) And finally, what is the *actual* mortality rate of young companies?

We understand that the bull market euphoria will be replaced by demand for transparency, governance, and alignment, requiring companies, entrepreneurs, and investors to mature quickly. This phase of the cycle will be crucial to raising the standards of professionalism in the Brazilian Private Equity market (including Venture, Growth, and middle market PE) in the process of creative destruction that, in our opinion, the market needs.

*Sincerely,*

*Bernardo, Fernando & João*