SHIFT CAPITAL

December 2020

Letter to our stakeholders:

Risk-oriented venture investing: attempt, reflect, adjust & repeat

Dear stakeholder,

Despite the COVID-related speed bumps, this has been an excellent year for Shift. Not only for the achievements made, but mostly for the hypothesis and thesis validations. The challenging year, detailed in our last memo, added to the results obtained, allowed us to reflect even more on Venture investing and our business.

Leading Shift's way

During this year, the main achievements we accomplished were the two lead investments concluded in the second half. Coming from a few co-investments with top-notch funds in 2019, we were eager to apply our methods and learnings into lead investments of our own. While patiently seeking the right opportunities, we finally executed.

The story behind our Skelt Brands deal is worth detailing. Beauty and Personal Care is a sector which we have studied and prospected since Shift's early days, but so far had not found a brand, strategy and team which truly excited us. Skelt was a product of our active prospection strategy - one of our analysts found it through Instagram and brought it to our weekly pipeline review. We had never heard of self-tanning and the market did not seem large enough, but the digital footprint and product design were the reasons we decided to entertain a first meeting with no expectations. Our first impression of the entrepreneur was mesmerizing: solid bootstrapped growth curve, strong unit economics and a second brand, Creamy, that had recently launched, with huge potential. Our analysis concluded that both brands were well positioned to capture growth during and after COVID. Creamy, in particular, was addressing a very promising category, skincare, through a unique low-cost, brand focused approach (direct to consumer). After a few months of intense analysis, interactions, and diligence, we knew that this was an investment case – but faced adversity as the founder was not fundraising and knew nothing about Venture Capital. Through patience, resilience and value added, we proved him that it was highly strategic to partner with Shift and 8 months after our first meeting, the deal was concluded – in very promising terms.

This reinforced our hypothesis that active prospecting is certainly the most effective strategy to finding high quality assets, with considerable value-based opportunities that generally provide better risk / reward prospect, given that such companies are totally under the radar. This was Shift's first lead investment and a Series A, which we now consider to be our sweet spot. In addition, we proved that our creativity in deal making allows us to capture hidden opportunities. This deal required consolidation of brands and companies, *captable* restructure, incentive plans and strict governance.

It is important to mention, however, that **there is no free lunch**. As we understand it, this was a high-potential investment due to (i) great & tangible growth potential and (ii) solid deal terms. However, the company is not completely prepared to grow at accelerated rates. While these are intuitive founders with outstanding brand and product skills, the trade-off is the lack of systematic planning, processes, tools and team, which are typical to the regular Brazilian real economy companies. In weighing those trade-offs against points i) "growth" and ii) "pricing" above, the risk is certainly worth taking, but will require much hands-on intervention from Shift's team. By now, our team is already engaged in creating (together with the founders) the 2021 business plan, managerial controls, action plans, key hires, supplier assessment (R&D, Public Relations, and product partners) among other tactical insertions.

It is safe to say that few VC investors would have been able to make such investment decision. The regular VC playbook has more rigid criteria that fends off the Brazilian “flavor” of opportunities. That is also because few professional investors have such an intensive real economy approach to investing, truly willing to deep dive into operational challenges to de-risk investments.

What we expect is that the capital and support provided will be key in driving the company’s growth, and most importantly, structuring period. With 12 months of Shift’s investment period, the company should be in a very privileged condition in terms of (i) brand & portfolio, (ii) financials / unit economics and (iii) structure, being able to attract more capital to enjoy rapid growth. We have an intensive journey ahead and are excited with it.

Shift also led Paketá’s Series Seed. Along the three years studying the fintech credit market, in rare occasions we were able to find sustainable businesses. The credit industry has important (and challenging) fundamentals that must be combined to form the backbone of a healthy long-term business. To name a few: 1) origination capacity and distribution channels with controlled cost of client acquisition and adverse selection mitigants; 2) harvest of loans with unit economics that pay the cost of capital, with the correct pricing and model supporting the credit approvals; 3) the right combination of collection methods and collaterals to manage default; 4) to have the correct funding structure and partners to provide the capital and grow with profitability (instead of having a large portfolio with poor returns). In Paketá we found a great team of 3rd time entrepreneurs with proven track records developing a technology that could unlock a very large market. We have monitored the company closely since March 2020 and saw the founders bringing together the important pieces of the business (team, tech, product, partners and credit). The several validations that the team surpassed along these 8 months of analysis have shown us that this was a Seed round with a few greatly appreciated Series A fundamentals. An interesting arbitrage.

Risk-oriented growth investing

One of the hypotheses that matured along this year is Shift’s risk-oriented investing approach. It is widely known that venture capital is a diversification business. Indeed, the very skewed returns calls for some level of diversification to broaden the chances of hitting outliers. However, if taken by heart, this “wide diversification theory” (sometimes associated to the “Power Law”) can cloud manager’s decision-making processes. By raising large Series A / Series Seed funds and over-diversifying (perhaps as a consequence of the large funds), the manager undermines his / her ability to make a fundamentalist analysis over the specific assets and, hence, “sprays” capital – in a manner which is often called “spray and pray” and justified as an investment strategy supported by the “Power Law”.

Throughout the year we confirmed one of our fundamental understandings of the VC industry, that when the Power Law / Spray and Pray thesis is embedded in a VC firm’s culture, managers become not only psychologically prepared to lose money – which is a natural part of the business – but also subject to strong decision-making biases. This model allows for suboptimal, rushed processes (spraying) and very high-risk tolerance (praying), hence justified by the wide diversification theory, in which investment mistakes are justifiable as long as you keep your portfolio “wide enough”. Globally, this strategy has worked in some cases, but our understanding is that in Brazil, statistics do not support it yet, and the inherent challenges for entrepreneurship in the region require different strategies. Locally, this is a belief rather than a science.

In this sense:

- Large funds require wide diversification
- Wide diversification allows for poor decision making and superficial analysis, supported by the inconsistent use of investment theories
- Large portfolios result in poor monitoring / little risk management
- Poor monitoring / little risk management results in information asymmetries and higher failure rates

Shift's capital concentration approach attempts to address those issues through better risk recognizing (analysis) and better risk management (support). That is only possible by having a more concentrated portfolio and hands-on operation. We define it as <u>risk-oriented growth investing</u>, in contrast to the current VC investment culture.

Venture is, by nature, a high-risk category. We have worked hard to crack it by bringing a few value-investing fundamentals to early-stage growth-investing. It is certainly not obvious. Our thinking goes as follows:

- Capital concentration allows for better analysis and risk recognition
- Real economy / investing based on sectorial affinity improves our risk assessment and value-added
- Smaller portfolio allows for better monitoring / risk management and less information asymmetries
- Resulting in <u>less risk</u> and better follow-on investments

With this year's results, the thesis appears to be paying off, but the trade-off remains: we invest less. 2020 was a year of two new investments and one follow-on, a significantly lower activity than our peers. We always tell investors that it is important for us (and them) to understand <u>which</u> and <u>how much</u> **risk** we are buying on each investment case. In VC investments, risks are rarely the same. By comparing risks, it gets easier to analyze the cases relatively and pick the best ones.

Super tasty, probably bitter

This year made clear that growth investing is a trend. Due to (i) low interest rates worldwide and (ii) an atypical year that attested growth companies as noncyclical, decorrelated and maybe resilient, capital is more than ever looking for growth. That has tremendous impact on valuations. In public markets, the equity risk premiums have decreased, and, therefore, valuations increased sharply.

We feel this is also true for private markets. An increasing number of asset managers targeting the category, added to the lower required returns, and proved resilience of the asset class, results in increased valuations for private growth-oriented companies. We believe these new valuations are the "new normal" in private investing and that those EBITDA-based transactions from our Investment Banking years are no longer the norm. Next year will probably be, as 2019 was, a year of high valuations in private markets. This means that investors must be extra careful because there is less and less price arbitrage, and skill will be imperative to generate returns. In private investing, skill means three things: choosing better, negotiating better, and adding more value along the journey.

In an extra hot industry, the challenges are significant. The long cycles and steep fail rates of the category mean that overpaying today may result in a bitter future for those that have an increased appetite for it. Therefore, to find greater risk-adjusted returns, active prospecting is increasingly important and hands-on support is a great tool to have in hand. As the category grows, we try to remain faithful to a few principles, and contrarianism must get into the game:

<u>Large amounts of money aren't made by buying what everybody likes. They're made by buying what everybody underestimates</u> - *Howard Marks*

Our year was marked by much active prospecting. Our pipeline management has worked amazingly well and that is key to relative analysis and better investing. The charts below provide a summary on this matter:

Passive vs Active prospecting

Number of meetings taken with new ventures:

Intentionally removed for confidentiality purposes

What we expect

Next year will be a year to consolidate and repeat. Consolidate our culture, our companies, our positioning, and processes. With a growing and improving team, better access to deal flow and capital, we expect to increase our investing output – new investments made with our unique DNA.

2021 will also be a year to better test our hands-on / value added approach. As we concluded our first lead investments, we will have significant influence in our invested companies to test, validate and adjust our value approach. We will strive to be a "modern board of directors", focusing on brand, growth, business development and company structure (people, processes, controls, capital structure) rather than the typical control freak board looking in the rearview and inhibiting creativity.

In short, this will be a year of intense execution. The main hypotheses have been tested, the processes are working fine, and the team is ready for it.

Sincerely,

Bernardo, Fernando & João