



Quarterly Update Newsletter

October 15, 2018

Hello everyone,

Welcome to the first quarterly update for Verdo Capital! Thank you for your interest in this pursuit - I am determined to make this successful and will inevitably rely on you all to get there.

Verdo was launched on July 15, 2018, hence the weirdly timed update. Hopefully there aren't too many of these, but I am prepared if there are. If I'm nothing else, I'm persistent. My goal with this is twofold. First, I aim to provide you with useful updates about my search as it progresses. Second, I hope to keep myself accountable and goal-oriented while executing the search.

I have structured the update into two main sections: Summary and Gory Details. The labelings should be self-explanatory. There is also an appendix that contains other useful information - in this installment, it includes details about our mission and values. I make sure to review this with any new team member during onboarding. I find it critical to success.

As with everything, feedback is much appreciated. I tend to come at everything I do with an operator's view of the world. If there are items of particular interest, particularly as investors or advisors, please let me know that. Alternatively, if things are useless, I'd prefer to not waste my time - so let me know!

All the best,

A handwritten signature in blue ink, appearing to read "Eric Hsu", with a long, sweeping underline.

1. Summary

1.1 Search Update

0 LOIs -- 6 offers -- 64 Seller Calls

| Quarterly Update Summary | | | | Quarterly Update - As % of Total | | | |
|--------------------------|-------------|--------|-------------|----------------------------------|-------------|---------|-------------|
| Funnel Steps | Proprietary | Broker | Grand Total | Funnel Steps | Proprietary | Broker | Grand Total |
| Leads | 2456 | 120 | 2576 | Leads | 100.00% | 100.00% | 100.00% |
| Contacted | 1536 | 120 | 1656 | Contacted | 62.54% | 100.00% | 64.29% |
| Reply | 191 | 55 | 246 | Reply | 7.78% | 45.83% | 9.55% |
| Positive Reply | 38 | 54 | 92 | Positive Reply | 1.55% | 45.00% | 3.57% |
| Conversation Complete | 15 | 49 | 64 | Conversation Complete | 0.61% | 40.83% | 2.48% |
| Offer Made | 1 | 5 | 6 | Offer Made | 0.04% | 4.17% | 0.23% |

With ~14% of the search behind me (assuming a two year window), I feel cautiously optimistic about performance in the first quarter. I had no personal benchmark, only anecdotes of other searchers, and I feel pretty good about this first attempt. There are means to improve and be more effective, but this was a positive start. The funnel metrics have proven invaluable to helping me identify where to focus my efforts on improving the process.

I find that I am really enjoying the search process so far. Sure, there are days that are more challenging than others, but overall, it is fun. There is a certain thrill when a big campaign goes out and some of the replies start to trickle in. I quickly got over the pang of anxiety when a seller replies that they never want to hear from me ever again. Going through the sale process with my father and the family business last year has been really helpful in establishing trust and rapport with sellers right out of the gate.

Another finding is just how opportunistic I am in this process so far. I find myself getting really excited about the situation more so than exactly what the company does. You'll see there is a very wide range of opportunities that I have bid on thus far. In each, I found myself getting excited about certain aspects of the opportunities - it was so driven by context. I have not fully figured out what that means for me, the search, or the business. Any ideas?

Six offers went out the door on a variety of companies, including:

(In order of my general excitement about the offer)

1. **Traffic Equipment Distributor** - Under contract with strategic buyer
 - a. I loved this business. Recently replaced it's main supplier, so sales took a dip, but this was enduringly profitable in a nice niche with significant fragmentation.
 - b. Learned: Meet the seller as quickly as possible, despite objections from intermediaries - only way to establish a bond.
2. **IP Translation Service** - Negotiating Offer
 - a. Specialized Japanese → English translations for patent filings. Decentralized network of translators. Doing just over \$1mm SDE annually. Huge margins, very

niche player with big growth upside. Concerns about the depth of key management, as two of the three are founders who would likely transition out.

- b. Learning: In progress
3. **Safety Training for Construction Workers** - Under contract with strategic buyer
 - a. The first offer I made. Less cyclical than most businesses tied to building/construction due to OSHA requirements and recertification requirements. Bid very conservatively due to human capital risks.
 - b. Learning: Negotiate more on structure than on price to be successful. Speak directly to the seller, not the intermediary.
4. **Dental Lab** - Seller passed expecting higher price
 - a. Large (over \$2mm in revenue) lab with premium pricing. Interest here was largely in a roll-up strategy of the many mom-and-pop dental labs that are out there with no succession plan.
 - b. Learning: Put an offer on paper, even if the intermediary discourages you from doing so - they have a fiduciary responsibility to present it to the seller and you never know what might happen.
5. **ABA Therapy Company** - Seller passed expecting a higher price
 - a. ABA was an early target industry. I liked the double bottom line aspect of such a business. The reality of the industry, particularly in this geography, hit quickly. There are very few targets with adequate scale in the geo area I'm targeting. This one in particular was a new company (<2 years operating, and a \$400k EBITDA run rate, but growing quickly)
 - b. Learning: Need to address the 'paying for past performance vs. future performance' more quickly - this seller was growing the business quickly and wanted a value based on future potential, not the work he put in.
6. **Contract Manufacturer** - Negotiating Offer
 - a. Machining and assembly specialist. Strong bench of management able to stay in place and continue to run the operations. Working capital dynamics are the biggest challenge/opportunity. 3x current EBITDA could be freed up in free cash flow if the company ran at industry working capital benchmarks for inventory, receivables, and payables.
 - b. Learning: How to (hopefully) explain what a working capital adjustment is and why it's needed in a deal to a reluctant seller.

The sourcing efforts were supported by my interns. Each has a stated weekly quota of 125 qualified leads. So far, this goal has been achievable in slow weeks, but hard to hit when school work is competing for time. In all, I've had 7 interns up to this point, with 6 currently working for me. My first masters level intern started last week. We are currently getting together as a team twice a week in a modest office space that I secured a mile from UC Berkeley.

1.2 Personal Update

Everything on the homefront is going well. Aanika started pre-school in September. After a bumpy couple of weeks to start, she seems to really be loving it. The school is located right down the street from our house, so getting her there on time is possible, if not likely. lyla continues to develop right before our eyes. She recently crawled for the first time. She has a nanny-share with an older boy from across the street. I've already sat him down to tell him the ground rules for hanging out with my daughter. Practice makes perfect! Haha.

Sheela continues to thrive at Slack. She now leads all of the global enterprise marketing efforts for the company. News reports have them eyeing an IPO in Q1 of 2019. She's doing a magnificent job balancing all of that responsibility while staying really engaged with the girls and me. We both find tremendous joy in parenting and being together as a family. Both Aanika and lyla really help keep us centered when things get hectic.

Personally, for me, I continue to spend some extra time doing carpentry projects around the house. lyla's room was the last project for me on nights and weekends. Tiling the guest bathroom is up next.

2. Gory Details

In this section, I will go into the details on a few different pieces of the search so far.

2.1 Details of Offers

| Company | EBITDA (\$,000) | Offer (\$,000) | Pros | Cons |
|-------------------------------|-----------------|------------------|------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------|
| Traffic Equipment Distributor | \$792 | \$4,000 5.05x | - Historical EBITDA averaged \$1.3mm - Enduringly profitable - Niche business in fragmented industry | - Lost primary supplier last year, hence hit in revenue and EBITDA |
| IP Translation Service | \$1,010 | \$5,011 5.00x | - Includes \$800k in cash and receivable - Niche business in fragmented industry | - Two founders will leave of three person key mgmt team |
| Safety Training | \$655 | \$2,100 3.20x | - ~33% EBITDA with good ops leverage - Obvious growth opportunities available | - All-time high rev LY - High human capital risk - Requires deep specialization |
| Dental Lab | \$781 | \$2,000 | - Bigger than most labs | - Products priced at a |

| | | | | |
|-----------------------|---------------------|--------------------------------------|---------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------|
| | | 2.56x | at \$2mm in rev - Clear roll-up strategy | premium vs. Glidewell (huge competitor) |
| ABA Therapy | \$408 annualized | \$1,300 3.18x | - Asset light, high growth therapy provider - Primed to grow geographically - Key team in place | - Very short history, but scaling quickly - Still quite small - Owner not willing to take note or risk future |
| Contract Manufacturer | \$704 | \$5,133 7.29x 4.20x excl WC | - Offer Incl. \$1.88mm in net working capital - 4.2x offer on cash flows when adjusted for working capital | - Heavy working capital requirements - Owner started with \$16mm price, including \$4mm of real estate |

Overall, reflecting on the offers, it is clear that I lowballed a few of them. Hindsight is 50/50, but it is important to keep that in mind with future deals, especially ones like the Traffic Management Distributor.

2.2 Companies in the Pipeline I Like

Are there any of these that pique your interest as an investor/advisor? Why?

- Global Educational Competitions
 - Creates "real-world" experiential learning opportunities by connecting students and educators with global brands to complete challenges defined by the brands.
- Trade Show Internet Provider
 - Provider of networks and connectivity to trade shows and other events/venues.
- Background Check Specialist
 - Background check provider, including speciality income verification processes with the IRS
- Cyber Security Firm
 - Cyber insurance broker with additional services aimed at helping businesses prevent and manage security breaches if/when they do occur.
- Niche Manufacturer
 - Injection molded ceramics. High customer concentration, but huge variety of applications in many industries. Lots of extra capacity. Minimum labor costs to produce, reducing overseas competitive advantage

2.3 Metrics

| Metric | Brokered | Proprietary | Grand Total | Goals | % of Goal |
|--------------------------------------|----------|-------------|-------------|--------|-----------|
| % of Quality Leads (Valid to Total) | 99.2% | 77.3% | 78.1% | 95.0% | 0.0% |
| % Contacted (of Valid) | 100.0% | 62.5% | 64.3% | 100.0% | 64.3% |
| % Replied (of Contacted) | 45.8% | 12.4% | 14.9% | 2.0% | 742.8% |
| % Positive Reply (of Contacted) | 45.0% | 2.5% | 5.6% | - | - |
| % Conversation Complete (of Replied) | 89.1% | 7.9% | 26.0% | 30.0% | 86.7% |
| % Offer Submitted (of Conversations) | 10.2% | 0.1% | 9.4% | 20.0% | 46.9% |
| % LOI Submitted (of Offers) | - | - | - | 33.0% | - |

Positive response rates seem in line with what I've heard from other searchers at 2.5%. The proprietary contact rate is a metric that is lower than I would have wanted, but due to concerns about spam, I have been slow to ramp up outreach efforts.

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2.4 Lessons Learned

- Speak directly with the seller as quickly as possible
 - The times I have not been able to speak with or interact with the seller, I cannot differentiate myself, tell my story, or establish rapport with the seller. This makes a material difference in how my offer is received. Despite all the efforts by brokers, I must continue to be creative in how I can get in front of sellers.

- It is nerve wracking to go to a 'new' part of the process, but the second time it's much easier and more familiar.
 - I was closest to an LOI with Turner Safety. In doing so, I felt the nerves of actually signing an LOI and what that meant. It caused some great but hard conversations with Sheela, an honest assessment about how serious I really was about the opportunity, and facing the reality of having to invest hard earned money in diligence. That being said, each subsequent time, it was a lot easier to get there. I imagine that it will be similar for fundraising, lender conversations, diligence, etc.
- Get support, especially from activities outside work
 - Sheela, family, and some personal interests outside of the search have helped keep me centered by giving me outlets outside of work, especially when some days have been particularly hard.
- It's a marathon, but it goes quickly
 - It's hard to believe the first quarter is done. It seems like three months, but it did happen quickly. There is no rush, but I cannot be complacent or waste precious time, either.

2.5 Goals for next quarter

1. Buy a business
2. Submit 9 offers to businesses that meet my criteria
3. Source 5,000 valid leads

What else would you like to see in this update as a friend, advisor, operator and/or potential investor?

Appendix

Our Mission

“To identify, acquire, and operate a business in Northern California with untapped potential”

The mission is what we aim to achieve, regardless of the time horizon. It focuses and inspires our efforts.

Our Five Values

These five values are at the core of how we behave. Achieving a goal and our mission is of critical importance, but the manner in which you achieve that goal is just as important. Culture is not a buzzword that you implement with powerpoint slides and all-hands meetings - it is how you behave every day, even when nobody's looking.

| | |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------|
| Persevere | Anticipate and Act |
| Adversity is inevitable - don't shy away from it. Embrace it and beat it. Constraints breed the best solutions. | Move quickly as a proactive problem solver to address issues and capture opportunities. Prefer action over analysis. |
| Own the Result | Measure Everything |
| Strong opinions are loosely held. Use available information, vocally disagree, but commit. Be proud of your success and humble in your failure. Act with integrity. | You don't know what you can't measure. Data leads you to truth, but you will have to use your judgement along the way. |
| Have Fun! Life is too short not to | |