

Operator-Led Private Equity at Ethos - Erik Brooks

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SUMMARY

Eric Brooks, co-founder of Ethos Capital, discusses his journey into private equity, emphasizing the importance of operator involvement in investment processes. He highlights the shift from traditional private equity approaches to a model that integrates seasoned executives to enhance decision-making and company performance.

- *Management meetings often feel heavy; breaking through this barrier is crucial for effective communication.*
- *Ethos Capital focuses on durable business models and operates with a unique cadence of one deal per year.*
- *The firm employs seasoned operators to enhance the investment process, leading to deeper insights and better decision-making.*
- *Brooks emphasizes the importance of building relationships based on trust and collaboration between Ethos partners and company management.*
- *The firm's operational system is designed to integrate various skill sets, allowing for a more nuanced approach to sourcing and diligence.*
- *Ethos aims to invest in companies with no expiration date, focusing on long-term growth and sustainability.*
- *Success is defined not only by financial returns but also by team satisfaction and the overall organizational culture.*
- *Brooks values creativity outside of work, particularly through cooking, and credits mentors for shaping his investment philosophy.*

You would be sitting in a management meeting. If I'm asking a management team questions, there is this heaviness that exists. You try and break through, but just naturally exists where the management team, okay, here come the private equity folks and the private equity folks walk in like, okay, here's the management team. The weight exists. You break through that and try and connect. Even in the best scenarios, my asking questions is a little bit of an interrogation. asked in the nicest, most open way, it's still definitionally a bit of an interrogation. When FO would run the management meetings, it was a conversation. It was FOD saying to the head of sales, when I ran business services for IBM in the Middle East and Africa, I noticed in some countries it was important for you to show up with multiple products. In other countries, they really wanted you to specialize. I see you've set yourself up geographically. Tell me a little bit more about some of the reasons you decided to do it that way. That's two people speaking Portuguese to each other and I speak Spanish. I'm getting a lot.

There's a level of depth. There's a level of understanding. The information you get back is different. I know that because I've sat in hundreds of management meetings. sitting in those meetings listening to f conduct them and the answers that were being shared by the management team were just different better they were deeper then

add on to that my interpreting the information is different than somebody who's been a CEO or a CIO or a CRO listening to the answers and interpreting it the quality of that interpretation is going to be better we don't make anything in our business we don't make glasses we don't cars. We don't make cups. Our input to the process is not glass or metal. It's information. If the questions are better, then the information you're going to be getting is better. If you get better information, you have somebody who is more knowledgeable in interpreting that information.

Hopefully, you're making better decisions. Better decisions lead to better results over time. I'm Ted Sides and this is Capital Allocators. My guest on today's show is Eric Brooks, the co-founder and managing partner of Ethos Capital, a middle market private equity firm built to bring seasoned seuite operators into every aspect of the investment process. Eric's experience prior to founding Ethos in 2019 spanned privatizations in Eastern Europe, value investing at Bowpost, and 20 years at Abri Partners. Our conversation covers Eric's path to private equity, lessons learned about risk, the importance of betting on people, and the evolution in his thinking that led to forming Ethos. We then cover Ethos's focus on durable business models, one deal a year cadence, operating system to evaluate and improve companies, and an investment example that brings it all to life.

Before we get going, summer's in the air and with that comes summer vacations and out of the office email responses. At the beginning of the year, I pledged to my team that I'd respond less rapidly to emails while traveling. So, I started writing entertaining out of the office emails every time I'd be away from my computer. There was one about ditching my cell phone for a day at the masters with no chance I'd respond, just like it ought to be. There was another about not responding because I was attending Will Gera's unreasonable hospitality summit, which created some cognitive dissonance for me, knowing that I wouldn't respond while allegedly learning how to see others better. And there was yet another about attending Milin with the recognition that anyone getting the response would probably see me before I responded anyway. Now many of these out of the offices increased my email count when I got back with a positive response about my reply. That caused me some confusion about whether I should reply to their reply to my reply to their email. One thing I learned from the exercise is we really don't have to reply to email when it comes in. Knowing that others know I won't respond reduces my peopleleasing angst. That's especially true when I get interrupted, like while listening to an episode of Capital Allocators. So, if you're listening, ignore your email for a while. And if you do grab your phone to send an email, you may just want to reply that you're engrossed in the latest episode and need some time to thoughtfully reply. Yeah, that works for me. Thanks so much for spreading the word.

Please enjoy my conversation with Eric Brooks. Eric, so fun to do this with you. >> Indeed. I've been looking forward to it. >> Why don't you give me a little bit of a hint of growing up and the path that led you to where you are today? >> I wish I had a more exciting story. My background was magnificently Norman Rockwell. It was two parents that loved each other and a sister, a great school, friends. Those kinds of childhoods give you the benefit of stability and security, confidence in yourself. Very formative and important and lucky. As you grow up, as you move through that though, you don't learn the hard stuff.

You don't come out with a lot of scars. You don't come out with a lot of lessons learned. You come out confident and strong, feeling good, which that would be wonderful. I did have sort of a cold shower of reality when it was

time for me to go to college. Growing up in that environment, I thought everything happened automatically. You go to a great school, you get great grades, you work hard, and everything just happens. I tried to make my parents proud, as we all try and do. Applied to every Ivy League school. It was my parents dream in life for their firstborn son to go to an Ivy college. When I got rejection letters from every single one of those schools, you can imagine over a 48 hour period of time opening envelopes. That was not a great couple of days in the Brooks family. It was a real wakeup call for me that things don't just happen automatically. I went to another school, spent my entire experience there, doing nothing other than trying to get the best grades that I possibly could. So much so that I would literally go to two of the same class in the same day. Econ 101, the first version of that would happen at 9:00 in the morning. Then there was another 2:00 session of the same class which I would then show up to just to make sure that there wasn't something that I was missing in the class that might have been overkill. It was good imprinting on how to make sure that you understand that you've got to do everything you possibly can to make it work.

>> What happened from there? >> I had a fantastic experience at Brown. graduated, moved to New York City, worked at DJ, then got a job at Apex Partners, came back to Harvard Business School, worked for Seth Clarin at the Bowpost Group while I was there, which was a transformative experience. I was injected with the DNA of value investing and thinking about risk in that way. After graduating from business school, I spent some time in Eastern Europe in the mid to late 90s. Ran around Ukraine and Kazakhstan and Russia and the Baltics participating in the privatizations of what was happening over there in that part of the world. That was a lesson in humility, risk, experiencing a completely different worldview. You can imagine picking somebody up and planting them in Dnipro Petrosk or Nijni Novograd in 1996 trying to convince people that you should buy their companies. It was a magnificent, exciting, terrifying period of time where I had the opportunity to work with David Swenson, Julian Robertson, and Andrew Golden who were investors in our fund at the time. Then also meet with people that had spent five seconds of their life thinking about how to make money at the company they were running. Their job was not to be profitable. Their job was to deliver sugar or toilets or whatever it happened to be on time. That was an incredible experience. It was an awakening for me to understand the relationship of risk and return. It was the first time in my life that I was putting capital to work.

Felt responsible for doing so. lived through a period of time where things went nowhere but up. It was buy a dollar for 10 cents, watch it go to 80 cents over a period of four or five years. When that happens, as a young man, you think you're a genius. You think you're the one who has invented fire. Then all of a sudden when the emerging market tsunami washes across that part of the world and your 70 cents on the dollar goes to 4 cents on the dollar. You recognize that it was not your genius.

In fact, it was the circumstances but that that is inherent in the risk of putting capital to work in a place where you can make seven or eight times your money. Having developed a net worth over that period of time and then seeing that go back to zero with a two-year-old daughter, spending three weeks a month sleeping in places that didn't have hot water in my clothes. Definitely not the Four Seasons or the AMA. This is rough.

Lots of stories about going to show up at an auction to buy a company, getting a call in the middle of the night. We think it'd be better if you didn't come to the auction tomorrow. No. Hi, this is Peter. How you doing? It was

literally don't come tomorrow. Those kinds of experiences frame your worldview on what it's like to do business in that part of the world. What did it mean when someone said don't come to the auction tomorrow?

>> That meant that somebody that was connected in a certain way had an idea that they wanted to own that company. They did not want somebody getting in the way of that. What I would do is thoughtfully pack my bags in the morning, go back to Moscow. Discretion is the better part of valor. You have to pick your battles. When it blew up, you viscerally feel like you spent all these years working for something. You have a young child. You're not seeing them or your wife. I knew that that part of the world was going to come back. My value investing DNA had incredible confidence in the magnitude of the opportunity, but I didn't know if it was going to come back in a couple of years or a couple of generations. To my good fortune, I had met Roykov, who's one of the founders of Abri, right before I went to business school. Royce had become a real mentor to me over that six, seven-year period of time. Timing in life is everything. I was having lunch with him in New York one day. I was having him listen to me go through my thought process of what I was thinking of doing, what I possibly was considering coming back or staying.

In the middle of that conversation, he looked at me and said, "Would you be interested in coming back to Boston and joining me at Abri?" That was the lightning bolt. I looked at him and I said, "Yes, that sounds great. I would like to do that." His response was, "Wonderful. let me come back with a proposal salary and a title and compensation package. I said yes. I don't care. This is not a decision about how much my salary is or what my title is or what the carry is. I'm with you.

I'm all in with you cuz you're one of the smartest people of the highest integrity I've ever met. Those have been my best decisions in life. Betting on people, making decisions to partner with people. That was the beginning of the next 20 years. Going into Abri with the lens of you want to be around the right people. You'd experienced value investing, a certain type of riskreward alongside of Seth, the privatization of Eastern Europe, a wildly different type of volatility within a riskreward and then something different that Royce had started at Abri. I'm curious how you thought at that part of your life about what investment strategy or type of investing most resonated for you. Different people have different skill sets. One of the superpowers you can give to your friends and your kids is the recognition of what are you great at with the combination of what do you love to do? It's hard to find those things. I wouldn't tell you I felt like I found my thing until I joined Abby. The investment strategy made sense to me. Over the next decade or so, I got to see and participate and learn in the execution of an investment strategy which is develop the strategy.

You need the people, processes and systems in order to do it well. They had in the early days really established that and were disciplined in executing it. >> What was that strategy? It was sector specialization at its very beginning. Andrew and Royce were the two senior partners at Bank Consulting running their media practice. Their strategy when they left was we know more about these businesses from a consulting perspective than anybody else. Let's use that knowledge and expertise rather than getting paid a consulting fee to put capital to work and take on that risk ourselves. It was media and communications for a long time. Invest in businesses that you understand the underlying business models and strategies in a wrapper of what are the business model characteristics that we're looking for. Say stable, predictable, recurring revenues, high barriers to competition.

Being disciplined about that filtered the noise out of the system. For a long time that space media communications was very stable and things change in the last decade. How do you think about investing in a sector when outside influences change the dynamics of what looked like a very stable business that may not be going forward. I've lived through a variety of evolutions in media in particular, but let's think about media as technology enabled content. In the beginning, analog media was print, radio, TV. As the digitization of content started to work its way through the economy, there were other business models that had media-like characteristics that were showing up in other places, healthcare or business services. The way I think about picking sectors or finding opportunities is trying to look at the business model, the nature of the customer set through the lens of we don't want to invest in a business that has an expiration date.

Some things change, some things don't. Customer service, that is a forever thing. It doesn't matter what business model you're in. Technology changes. Finding business models and trying to stay at the forefront of the thinking of where is this going? And what's the velocity with which it's happening has given us the ability to pick business models that are durable. The nature of what the business model is is not dependent on things that you could see changing quickly. Giant air quotes based on where we are today given AI. The pace at which the game is changing in a lot of different areas has fundamentally changed. That's the big difference. In your 20 years alongside Andrew and Royce, what did you see evolve in the business? The organization and the investment philosophy grew as we added more people in a healthy way.

Thinking about media as technology enabled content enabled us to expand into business services. Establishing a knowledge set and a way of growing your partnership. One of the best parts about building your own is everybody's inculcated in how you think about risk and return business models and the things that we want to do as opposed to trying to create an organization from scratch and hiring a whole bunch of folks. That was the strategy. Hire young people right out of investment banking.

Spend the next 10 years training them how to be a partner. That creates a great culture. It worked magnificently well for a long time. After a long period of time, you decide to set up ethos. What was the decision process that led you to leave Aubry and go out on your own? Life is unexpected. A wonderful accident bumping into my partner Fahada. When I was at Abby, we invested in a company. There was part of that company called Vicado which was an enterprise software business that automated the financial aid processing function for post-secondary schools here in the US. I met FOD when I originally made that investment. He was the CEO founder of that business. Fast forward I got to know FOD one of the most magnificent human beings I've ever met. We sell his business to Oracle. This was 2015/16.

I had noticed we were finding the market to be much more competitive that the competitive dynamics had changed in a way. It seemed like people were paying higher and higher prices being disciplined investors. That was uncomfortable. I was trying to think about what ways could we enhance our competitive advantage. Royce used to say versions of I want to play soccer on a field tilted towards the goal of my opponent. Private equity firms are organizations that take a long time to change. It's not a hedge fund where maybe over 6 months you can rotate your positions and move into something else.

If you own a company, you're going to own it for a while. If you want to buy a new company, it's going to take you a while to find and execute that. In thinking about how we could establish some new enhanced competitive advantage, one of the things that I was working on was this idea of bringing operating knowledge into the private equity model. Operating knowledge in the form of people that had literally been CEOs, CIOs, senior executives at companies, the people that build and run these companies. We brought FOD in as an investment partner. It was revelatory, terrifying, exciting. It was in a matrix way red pill, blue pill. I took the red pill. You can't unsee the things that you see when you sit in a management meeting with somebody that has been a CEO of three companies. The process of doing that with fi as an equal partner.

By the way, this was not he was part of the deal team and advising me. This was you're the left brain, I'm the right brain. We are making decisions together about whether or not to do this deal. You would be sitting in a management meeting. If I'm asking a management team questions, there is this heaviness that exists. You try and break through, but just naturally exists where the management team, okay, here come the private equity folks and the private equity folks walk in like, okay, here's the management team. The weight exists.

You break through that and try and connect. Even in the best scenarios, my asking questions is a little bit of an interrogation. Asked in the nicest, most open way, it's still definitionally a bit of an interrogation. When FOD would run the management meetings, it was a conversation. It was fi saying to the head of sales, "When I ran business services for IBM in the Middle East and Africa, I noticed in some countries it was important for you to show up with multiple products. In other countries, they really wanted you to specialize. I see you've set yourself up geographically. Tell me a little bit more about some of the reasons you decided to do it that way. That's two people speaking Portuguese to each other and I speak Spanish. I'm getting a lot.

There's a level of depth. There's a level of understanding. The information you get back is different. I know that because I've sat in hundreds of management meetings. Sitting in those meetings, listening to fi conduct them, and the answers that were being shared by the management team were just different, better, they were deeper. Then add on to that my interpreting the information is different than somebody who's been a CEO or a CIO or a CRO listening to the answers and interpreting it. The quality of that interpretation is going to be better. We don't make anything in our business. We don't make glasses. We don't make cars.

We don't make cups. Our input to the process is not glass or metal. It's information. If the questions are better, then the information you're going to be getting is better. If you get better information, you have somebody who is more knowledgeable in interpreting that information. Hopefully, you're making better decisions. Better decisions lead to better results over time. In that moment, when he's the person you're working with, as you described, he's a special human being. How do you know the difference between an operator asking those questions and fi in particular being the one who's asking those questions?

>> I've been with enough managers over time sitting on boards. You can interpret the information and you hear the information coming back. Understand that everybody has their different style of how they do that. somebody that was a head of sales asking another head of sales in a different way could be antagonistic. It could be competitive. It could be not received well. Implicit in your question is is there a certain kind of operator that

would be effective in that seat asking those questions I think the answer is very much so. That seat is not a seat for every kind of operator to sit in because you have to be open. You have to be non-threatening. You have to be collaborative. You have to give off all of those personal qualities in order for the person that you're talking to to give you back the information and the energy in a way that's going to be really useful.

>> Once you took the red pill, sat with him for a couple years, and felt like this was an important thing to do, what was the next step? >> It was easy and unbelievably difficult at the same time. It's difficult because you spend 20 years working with people and these are your dear friends and you've been to their weddings, kids births and birthday parties. Emotionally and personally very difficult, intellectually very easy. What I had come to realize that I needed to do with FOD was create something completely new.

Not something that could be retrofit in any way, shape or form. It was a recognition that Abby was a three Michelin star French restaurant serving 300 people a night. I wanted to build with f a 12 seat three Michelin star omic aca restaurant in the basement of the Tokyo subway system. What we were planning on doing was so fundamentally different it became easy to say let's go do this. What was the this that became ethos?

>> At its essence, it was trying to scale Eric and Fi. The chemistry and the magic and the complimentary skill sets, all of those things that helped us be a great team to do what we were doing together. How do we scale that? How do we put a group of people together that have a similar mindset, have a similar vision for the world? How do we convince a whole group of operators to come join a private equity firm? That was no small task. Every partner at Ethos is somebody that FO or I have known for at least a decade. That's how we approached it.

Let's go to the people that we know, that we have relationships with, that we've worked with, that we know personally, and bring a team in that has the skill sets that we need in order to make great private equity investments. That's what we did. We literally created a matrix of functional skill sets and industry skill sets that we were looking for. reached out to our colleagues and friends to put that group together. That was the easy part. People were so excited because what we were talking about doing felt very different to folks. The hard part was the executing.

That was harder than I thought it was going to be. >> In that matrix of the functional roles and the industries, what were the boxes that you felt? every functional box that you would have in a company, sales, finance, go to market, technology, HR, design, etc. We wanted to make sure that when we went to look at a company, we had people that were deeply knowledgeable seuite executives in every important area that you would want in any business that you were going to own.

The sectors of focus for us are the sectors that we spend a lot of time thinking about. They're driven by macro themes. We started the firm thinking about finding businesses that are participating in parts of the economy where there's a huge wind in the sales pushing that forward. Digital infrastructure risk and resilience where you don't necessarily have to worry yellow pages. Is this an industry that I'm not sure how long this is going to be around? We want business models that are accelerated by what's happening.

Then you go a level deeper. What are the specific business ideas within each of those areas within digital infrastructure? You could have cyber security is protecting digital infrastructure. You could have the domain name system which is your digital identity as it exists. Then you identify specific business models. What are those business models that we're particularly drawn to that we think are most interesting? Those were financial services, supply chain, digital identity and infrastructure, risk and resilience.

>> Once you had gotten the people on board, what made it so hard to execute? >> The process of building something completely from scratch was an exciting intellectual exercise. We sat down. Fi said to me, FOD's an engineer by training. We are going to engineer and develop an operating system for every part of what you do in the private equity process. We're going to sit down and if I showed you our ethos operating system, it would look like a Swiss clock of gears. What do you do in the sourcing process? What happens? Who does it? Who do you talk to? How long does it take? What are the skill sets necessary for it? When you do diligence on a deal, who does it? How long does it take? What skill sets? Etc. We mapped out and designed all of the different functions. Then we said, "Okay, what are the skill sets that we need organizationally to do that?" We brought the people in with our investment team and our partners who are operators. Then we spent time working with everybody to walk them through the process of what needed to happen when the investment team. That's pretty clear, but you would be surprised when you're integrating operating executives into a sourcing process. You really want them involved.

Or you're integrating operating executives into a diligence process. Somebody who is chief revenue officer might never have done diligence on a company from the mindset of what is this organization look like? What's the SWAT analysis on this particular thing? The hard part was creating something from scratch that incorporated and melded these two different but complimentary skill sets of people who are building and running companies to people that are analysts at evaluating companies and the risk associated with an investment. That was very difficult. There are a lot of spaghetti stains on the walls at Ethos.

Figuring out how to do that and do it well. >> What did you figure out that worked? The most important part was we came to appreciate that not everybody has to be good at everything up and down the organization. In your traditional private equity firm, someone joins as an associate. They do models and then they get promoted to senior associate and they're focusing on the models, but they're managing the regular associates that are doing the models and the vice president. You work your way up the chain, but you have to have been really good at everything to move all the way up to becoming a partner. We've completely deconstructed that mindset.

When you become a partner at a private equity firm, you really have to be a mile wide and an inch deep because you have to be good at all of these different things. Working with bankers, brokers, lawyers, accountants, reading financial statements and credit agreements and purchase and sale contracts and finding deals and diligence and deals on and on and on. What we've done at Ethos is we've recognized that not everybody has to ultimately be great at everything an inch deep and a mile wide. What we've done is created an organization of people that in some ways are an inch wide and a mile deep. Recognizing that not every partner who was an operator has to be great at deal sourcing or has to be great at diligence at working with a company once we own them. Everybody has different skill sets, different talents. Our recognition that let's lean in, celebrate and focus

on the things that people are great at. Building the organization with that mindset of giving people the opportunity to do the things they love to do and the things that they're great at creates a system for us of better performance and a group of individuals that are psyched and happy to be doing what they're doing. What does the team look like today?

>> We have 16 partners who are former suite executives who are involved in everything that we do. They are sourcing, doing diligence, and they're helping companies. Not everybody's doing everything, but everybody is welcome and involved to the extent that they want to be. That process changes the front end on our deal teams. A typical deal team at Ethos will have a dozen people as opposed to just a partner, a principal, a vice president, and maybe an associate because we're adding five or six or seven of those operating folks into the deal process itself. We have one deal team, which is a bit unusual in an organization that has almost \$6 billion of capital under management. We're only looking to do about a deal a year. We are very concentrated. Some people like that, some people don't. We're pistachio ice cream. It's either your favorite or you might go into anaphylactic shock, but it works with our model because we have to spend a tremendous amount of time working with the companies that we invest in. That's the whole idea is buy great companies, hopefully make them greater. That investment team spending a lot of time with those operators. We have full back office admin, one investment team stack and then we have 16 partners who are bring operating expertise into what we do.

>> By background, those 16 suite partners, what's the spread of what they've done in the past before they joined ethos? >> It's a magnificent popperri of industries and experiences. It is Disney, The Gap, Forbes, Google, Verizon, Brinks, you name it, across the spectrum. A lot of the wonderful surprises that result from them having that variety of backgrounds come in unexpected ways. I'll give you an example. There was a business that we were looking at. One of our partners comes from the world of education. We were looking at this company that provided administrative support services within the healthcare universe. These were people who would help doctors record things. We're looking at this company. We're doing diligence for every deal that we do. We have two moments in time on the front end and the back end where we have these rounds where every one of the partners is involved in helping us on the front end develop we call them acceleration vectors ideas for us to have impact on the company. On the back end after we've identified all those ideas and diligence them which ones do we have confidence in? When we were doing this one deal this was a business in and around healthcare. His partner in education looked at the company and said, "They're a school. How is this a school?" He said, "They recruit people to come in. They train them over a period of time, then they place them in jobs. That's a school."

Nobody had thought of the business in that mindset because we were thinking about it as a business service. His perspective on it's a school gave us a tremendous number of ideas on how we could do a much better job on the recruitment phase during the education part of teaching them how to do this thing that they needed to learn how to do, how you automate some of that, how you become more efficient at it. In our modeling, in our base case, that was 500 basis points of margin. You would never have expected this is executive who comes from the world of education would have anything really to contribute about this business in and around healthcare services. Those ideas happen all the time. When you bring this group of people together, how do you work as an organization? The conversations you have, the decisions you need to make.

>> Back to our operating system, a deal team is created once an idea comes in that is vetted. That deal team creates this analysis that is shared with the organization. We have built from scratch our own AI powered operating system. We have these 16 partners in different locations that need to look at information asynchronously. Everything that we do at ethos feeds into our data lake then is run through our knowledge graph in a very diadical transparency kind of way. Every email, Slack, calendar invite, every note, every file that gives everybody access to information in a real time way to stay upto-date and on top of what's happening. When we get together, everybody's fully briefed and up to speed and can stay so on a regular basis throughout the whole course of the transaction. Once we own the company, similarly, this continues.

>> What are the positives and negatives of targeting one deal a year? >> The negative would be if you get it wrong, having a zero and a fund of five, that math is slightly problematic. The opportunity for us to be incredibly focused and precious with our time is something that FO and I have taken away from past experiences to try and dial in the effort of the organization. All we have is time thinking about how we source most efficiently, how we diligence most efficiently. We have four companies at the moment. You can imagine the amount of firepower that you can put onto those four companies with 16 executives. This is a purpose-built by design strategy on the concentration of ownership that feeds into directly how we spend our time. You can be much more selective in your deal sourcing.

What makes it to the we're going to spend time on this? We probably dig deep on no more than six or seven companies a year. In 2024, we didn't do a deal. That's just fine. Another underappreciated characteristic of this kind of model is that we don't have to do three deals a year. We don't need to have 15 companies in a portfolio. If we don't do a deal in a year, that's just fine. The calm and the patience that that brings to the organization elevates the decision-m makes us more selective about where we're spending our time because we don't have to. What does that do to the business model of ethos?

That's a different construct than the way most private equity firms run. Raise a fund, maybe raise a bigger fund. by design being concentrated has worked out well so far in thinking about how we grow the organization. That's very important to think about because as we continue to increase the size of the organization, you go from fund one to fund two to fund three. Is it we're doubling fund sizes and doubling deal sizes? Are we doubling fund sizes and keeping the deals the same? Doubling the organization? All of these things create risk in some way, shape or form if you're changing the model. One of the things that we've designed from the front end is while we are incredibly strict about what runs the gauntlet to become an ethos company on all the characteristics, the one place that we are flexible is in deal size. We've made equity investments of hund00 million. We've made equity investments of \$500 million. Our limited partners are folks that like to co-invest. What that means is I can go from fund one to fund two to fund three and keep doing deals that are within the guard rails of the characteristics that we're looking for at ethos without having to change the organization in the double the number of people or double the size of the deals because everything else grows organically. Our team will grow organically. We will promote associates to senior associates to vice presidents to principles to partners.

The investment team will continue to expand at that kind of organic rate. With 16 partners, we have a lot of capacity there. We have a lot of room to continue to grow within the operating dynamics of the existing

partners that we have. By design, we have dramatically overbuilt for ethos as we created the company from scratch. We overbuilt it on purpose to be able to grow into the next 5, 10, 15 years of doing hopefully strategically the same thing over and over and over again. This is a pattern recognition business model with that degree of lateral seniority with 16 partners. You mentioned the associate can go to senior associate BB. What does it look like underneath that partner level to be able to execute what you're trying to do? We have one investment stack of individuals in the most traditional way. We didn't appreciate the amount of support that we were going to have to provide to that senior level executive as we do what we do. My experience was I know what it takes to do a deal. I have an investment team and we can do all of that stuff. When you're doing so much more than what you normally did, turns out you do need some more support. One of our partners nominated Steam Gold to be the partner of the operating executives. He now is the person responsible for all of the things that we do with our partners to create impact to hopefully accelerate these business models. Underneath Stephen, we've hired some other folks who are operators whose experiences are not investment professionals but come from the world of operations. We are one team that is extremely important in everything that we talk about and the way we work together. It is not the investment team and the operating team.

This is one organization with complimentary and different skill sets working together within that operating support system. We are building out principal, vice president, associate. They're just different skill sets than somebody who's grown up in the world of financial modeling and deal diligence. I'd love you to walk through an example of one of those four businesses. gives some color to how all this comes together from the sourcing all the way through to improving the business. One company that we owned is a business called Identity Digital. Identity Digital is the largest owner of what's called a tople domain name. The top level domain name is what comes after the dot.com is the largest tople domain name in the world. About 173 million.com registrations. body and I in our sourcing methodology originally said digital infrastructure what's an effective business model that benefits from that the DNS system the domain name system because it is literally people's digital identity let's go out and meet all the companies that own top level domain names we spent a bunch of time running around meeting with the founders and the executive teams of these different businesses identified one that we thought was particular ly attractive.

Went and met with the original founder of the business, the venture capitalists that had supported that founder and were able to convince that group that they should sell us a majority of the business because of the ideas that we had that we were going to be able to accelerate and grow the business. >> What was it about the business that made it the most attractive in that mix? >> The business model itself is literally your digital identity in the world. both the company and the individual. At Ethos, you can't connect with us unless you go to ethoscap.com or unless Ted is sending Eric an email at my email address. Everything is attached. All of the work that we do, all of our communications, everything happens under this rubric of the DNS system. It is the identity system across which everything travels on the internet. The business model is the most missionritical part of a company's identity. We don't exist without it. It costs on average for this company's domain names \$30 a year. We spend more on coffee, soda, and pens individually than we do on our digital identities. It is absolutely mission critical. It costs almost nothing, as close to zero as you can get. Customers renew with statistical probability that is the highest I've ever seen based on vintage cohort. The business has ebidal margins in the '60s is growing topline double digit has 98% free cash flow conversion very much like VeraSign for example almost a mirror image sourcing that took us over a year from the time we originally sort of met the founders to when we made our first

investment.

The diligence process is it's a great business. Now what are you going to do? What's your impact? What are your acceleration vectors that are going to accelerate this business? The process that we then run through is back to the round tables. We have to believe when we do that that there are 20 or 30 ideas that people have. We break those out into three categories. Strategy, market, and operations. Within each of those, there are categories underneath it. When I say 20 or 30, it's illustrative in that not all of those are good ideas.

Sometimes we go through that process and we'll have four or five. If we only come up with four or five ideas and it's not an ethos company, there's no alpha in our participating in throwing our resources into the business. It's got to have a lot of ideas. We call that down into a prioritized list of five to seven. That's really where we're spending our time once we own it. That's the traditional ramp of finding a business, doing the diligence, and the team that you have doing the diligence on that one. Probably had eight of our partners on that deal. Once we own it, we have 10 of our partners actively participating in that company now that we own it on a go forward basis, helping them think about pricing, how to expand their channel, helping them do M&A, helping them figure out how to improve the profitability of the business through their cost structure, how to work with their customers in different ways.

>> What went into winning that deal? Without question, the most important part of winning that deal was our ability to convince ourselves and the sellers that we had something to add. We had a perspective and the skill set to help them do something that they weren't doing themselves. Every deal that we've done so far, the sellers have stuck around in a significant way. That is a commonality that I anticipate will continue on a go forward basis because if somebody's selling a business and they just want the highest price, they're not going to value what we bring to the party in the same way. What went into winning that deal was first convincing ourselves that this was a business model that could be a one of five in a fund that it had the downside protection. Everything that we do has to start with what is the durability of the business. If you say, "Eric, how do I lose money in this deal?" My answer has to be some kind of black swanish intellectual exercise, the probability of which I would assign a single digit, but probably under 1% hopefully. Back to the math of you don't want a zero.

Convincing ourselves about the durability was the beginning, but then it was establishing what can we do to this business? walking the owners of that business through our vision for how we could make it better, faster, stronger, smarter, them wanting to participate in that story going forward. >> In your period of ownership so far, what's worked and what hasn't? >> That was the first investment that we made. The first thing that we learned, all of our analysis on the front end proved to be accurate. I wouldn't tell you there's anything on the front end that I feel like we missed. durability, profitability, growth characteristics, all of those things. Our process of how we work with management teams to help them execute and implement these ideas that we develop together with them was overinflated in my mind. The complexity of that, the process of getting the management team on board in a way that they owned it. Because there's one thing to say, "This is an amazing idea. Of course, let's go do this. Then you close the deal and everybody has to meet their quarterly Ibata hurdles and everybody has a day job. You show up with five or six great new ideas. Who's doing it?

Learning how to give management the resources that they need. One of the things that we've done is leaned in and enhanced the management teams of the businesses that we've owned to give them the resources to do some of these things because it's unrealistic to assume that someone's going to do their day job and all of these great things. That was one place where there were a lot of learnings. Another place was the speed with which this could happen. When we develop these ideas, they're narrowed down through something we call our fit methodology, which is feasibility, impact, and timing. How easy or difficult is this going to be? If it works, what's the impact, and how long is it going to take? We did not have that process keenly developed and dialed in up until a couple of years ago. There were a lot more ideas that worked their way through to the management team that didn't work. We wasted time. We wasted effort. We burned political capital.

Getting much better at doing that was helpful. The third thing is kicking stuff out quickly. If it doesn't work, kill it fast. That's a common lesson in life. In this situation, you have people who are operators who will will it to work. These are people who fix problems, who make things work. Getting our partners to recognize that if something isn't working, it's not a failure to walk away. The failure is continuing to spend time on something that you're never going to get to work because there are all these other ideas that we have.

All of these other things that we're working on that we don't build into our base cases. If any of them work and we hit our base case, then there's alpha in a system of hopefully asymmetric risk that we've created in the original base case. When it comes to taking the ideas, having your partners go and work with the companies, how do you think about being on the ground in the company alongside the executive team that already exists? Part of the design upfront is making sure that everybody both at the company and then our partners have a cleareyed view for how that relationship works. The amount of time that an ethos partner is spending at the company is bespoke and situation specific. If it's helping somebody redesign a pricing strategy, that's a different amount of time than if it's somebody helping a company figure out how are we going to completely change your debt structure from a sofur plus 625 unit deal that we're paying 10 12 on into a securitized assetbacked loan that we're going to pay a fixed 6.8% and save \$50 million a year. That's a complicated thing where you have to completely redesign the legal structure of the company and create bankruptcy remote subsidiaries, backup serer agreements, go meet with the rating agencies. That's almost a full-time effort. That is something that we did for this company, identity digital, where we had three of our partners working a lot of their time just trying to execute that one thing as opposed to another situation where they might just be meeting monthly to talk about how to change the channel strategy a little bit differently. Each situation's specific. There's an alchemy to the relationship that is unbelievably subtle and important. If you show up as an ethos partner to a company, are you ethos? Are you the company? Are you going to tell what I'm telling you to the board? What's the information flow here? Where's the trust? We've made it very clear and our partners are great at executing this which is the relationship that the ethos partner has with their counterpart at the company is a sacrosanked cone of silence trust relationship where the only information that's coming out of that is the information that those two people have agreed are coming out.

There's obvious stuff that we're sharing operationally. They have to believe that that's a relationship of trust, that they can share their insecurities and problems and issues and when stuff goes wrong, can you help me fix this? There aren't going to be the negative repercussions that you might imagine would come from a different kind of relationship. When you put in all of this time and effort to one deal a year, the resources you're

deploying to help these companies grow, how do you think about exiting? We want to buy businesses with no expiration date. The way we think about exiting is based on what is the incremental rate of return that we think we can generate from owning a company for another year. It is an active decision to own a company. It is not a passive decision. If you own something, then you are choosing to buy it at the price that you are carrying it. You should be thinking about everything that you own through that lens. We put so much work into these companies that I would tell you that the real evidence of financial performance doesn't really show up for probably two or three years. Sometimes we pull Ebida dot down. We're conservative in how we lever these businesses up front because we never want the operating strategy of a business to be dictated by the capital structure. I've made that mistake before. Exiting for us is driven by what do we think the incremental rate of return is on owning the business for another year. If it's below our base case, then we should probably sell it.

>> As you put all this together, how do you define what success looks like? >> There are lots of components to success. I could tell you that success is ultimately what's the rate of return we're generating on our investments. How are the portfolio companies doing? Are we hitting our base cases? Are people in the organization happy? Is the turnover low? Are we raising money? There are lots of components to what does success look like? Personally, success is am I having fun? It is hard work. If all of those things are working together in a way that people are coming to work excited, motivated, and ready to tackle the new day. That is evidence of enough of those things working in tandem that the organization is successful. Having seen lots of examples of that, I know what success doesn't look like and I know what it does look like. Eric, I think with that, I want to turn to a couple closing questions we can wrap up.

What's your favorite hobby or activity outside of work and family? >> I love to cook. I love to turn on some music. turn everything else in the world off and get creative. My experience with friends of mine that are in our industry, it's usually some creative outlet. I just love to cook. >> Which two people have had the biggest impact on your professional life? Royce Shedkoff. Royce really taught me how to invest. I'd never met anybody that could distill complex situations more quickly and more accurately. Royce could look at a situation and identify what are the three most important things that we need to figure out here. We all know folks who goes through that analysis paralysis exercise. Let's run the model 50 different ways because there are 250 basis points here. I tell all of my partners, I am not 500 basis points smart, let alone 250 basis points smart. Royce taught me how to step back.

What's the most important part of this business model? What are the risks associated with that? Professionally, he'd be that mentor for me. The other person I would tell you would be my partner FOD. FOD has taught me grace, the ability to step back, think about things with perspective, calm, not let fear get in the way of your decision-making process. He has made me a better investor but a better person as a result of that. My favorite poem is If by Kipling to be graceful was F's gift to me.

>> All right, our last one. If the next five years are a chapter in your life, what's that chapter about? >> I feel like I'm at the starting line. The gun just went off and how unbelievably lucky and excited I am to be at the beginning of something new. What a gift having done this for a long time to be with a group of people with a strategy and a mission. We called it ethos for a reason to create something new to do with a group of people that

are all equally excited. The next 5 years is the gun just went off and this is new beginnings.

>> Eric, thanks so much for taking the time sharing the story. >> Thank you, Ted. It's been a pleasure. Thanks for listening to the show. If you like what you heard, hop on our website at capitalallocators.com where you can access past shows, join our mailing list, and sign up for premium content. Have a good one and see you next time. All opinions expressed by TED and podcast guests are solely their own opinions and do not reflect the opinion of capital allocators or their firms.

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