2022 ANNUAL LETTER

15 YEARS IN THE TRENCHES OF SMB ACQUISITIONS AND OPERATIONS

PERMANENT EQUITY

"When somebody congratulates Amazon on a good quarter, I say thank you. But what I'm thinking to myself is those quarterly results were actually pretty much fully baked about three years ago."

– Jeff Bezos (2017)

Our posture in 2020 and 2021 of patience, conservatism, emphasis on good decision-making, and long-term focus bore fruit in 2022 with a record year of investment, tremendous progress in building Permanent Equity for scale, and good financial results despite a tepid market and some tough situations. There's often a disconnect between how things feel and how things are. Our relative returns were phenomenal this year, which goes to show that the real economy wasn't as bad as financial markets would indicate.

In 2022, we invested $46M of equity from our second fund across two deals, bringing our total investment in that fund to $83M of $300M. Interestingly, this year's investment total is nearly identical to the amount we invested out of our first fund and roughly 10X what we had invested prior to that. Scale is certainly non-linear.

We reinvested in our own business and hired six new team members. With those new hires and some self-reflection, we reorganized the firm (more on that later). We started writing a new book about SMB operations, which will hopefully be released mid-2023. And after a long search and many false starts, we began renovating another historic home down the street in Columbia, MO, for our expanding team.

All told it was a year of significant progress, despite some serious setbacks.

15 Years In

2022 marked the 15th year of operations for Permanent Equity. And my goodness have 15 years flown by. Many days have been long, but the years have felt shockingly short.

I had no plan when I started what became Permanent Equity, little money, hardly any wisdom, and a heck of a lot of desires. I knew I wanted to be "in business," but didn't know what business. I knew I wanted to make a lot of money and have people praise me, but didn't know how to make money or why I felt the need to be praised. I started something, which promptly failed, then started a few other things that did, at best, okay, before (accidentally) buying my first business with an SBA loan.

Since then, I've learned a humbling amount from failure – the art of knowing what not to do.

I learned how not to be a friend, a husband, or an employer. I discovered how not to start a company and how not to buy one. I figured out how not to hire and fire, and I learned how not to lead. I repeatedly learned the difference between EBITDA and earnings and cash flow. I spent money lavishly on inconsequential projects and wishful thinking. And, I learned how not to enjoy the ride.

The truth is that Permanent Equity shouldn't be what it is, but for an unexpected and abundant grace that has marked my life. My mistakes and shortcomings and failures, which deserved nothing but ruin, have been miraculously weaved into a beautiful tapestry of people and purpose and learning. We are blessed to be a blessing, and often that blessing comes from insights you can only gain in hardship.

Just this year, my small family suffered three deaths, one of which was a miscarriage. It feels awkward to talk about the topic of a miscarriage – it's deeply personal and painful, and often goes unsaid, especially by men, in the midst of the passing, "How ya doing?," of which the only proper response seems to be, "Good."

Not many people are good when they answer, "Good." Now after someone says, "Good," I try to follow up with, "No really, how ARE you doing?" More often than not, the second answer is very different. Pain grows in darkness and flees from light. We're all battling something, and battles aren't won alone.

On the business front, we were forced to do our first large-scale portfolio company layoff, something I hoped we'd never do. We repeatedly lost great opportunities to what felt like irrational behavior, which just means we don't understand. We had a heck of a time fighting inflation and margin compression across our companies. None of that felt like a blessing, but I've learned to trust that it is.

Faith is hope in things unseen. Thankfully, the longer I live the more I realize that unseen things are, by far, the best places to put my hope.

In business, ultimately all the pain and success and learning trickle down into concrete numbers, and those numbers get distilled into returns. It had been a while since I took stock of how we've done through the years, because frankly it doesn't matter day-to-day or even month-to-month, especially since we're not fundraising. And, as I said in last year's letter, the results take care of themselves if we focus on the process.

For years we didn't talk publicly about our returns. It felt voyeuristic and unnecessary. But by sharing, I hope to encourage others to take the almost completely irrational plunge into buying and building SMBs. There are far more sellers than capable buyers, and that needs to change. Despite the brutal difficulty, it is possible to do well for yourself, your investors, and your employees, to work at the intersection of purpose and profit, to simultaneously do good and do well.

System-wide, Permanent Equity and its portfolio of companies employ over 700 full-time people and have a little less than $350M of annual revenue. To date, we (individually and on behalf of our funds, PE I and PE II) have invested $133.4M and received back $65.9M in cash returns. For the period beginning with the firm's purchase of our collection of pool-related companies in 2015 and ending at the beginning of 2023, this represents a 29.1% cash on cash IRR across the system as a whole (i.e. including acquisitions made by the firm and on behalf of the funds). Notably, this does not account for any underlying asset appreciation.* Although our funds are GAAP audited and we believe all of our assets are reasonably marked, we don't think highly of marked returns. Until you can buy beer with it, it's not real.

Those are dollars we expect to earn from things like waterproofing, selling airplane parts, and fence-building. That said, I anticipate our cumulative IRR to trend down over time as we start dragging a bigger anchor of capital, but hopefully that's offset by improvements in judgment, skills, and systems.

**If you go back farther, the returns improve, but those previous investments aren't as analogous to what we're doing now. We are well aware of the rules we are supposed to follow so we are going out of our way to be conservative in the data points shared.*

Conservatism + Humility

I've always had the attitude, enthusiastically shared by the team, that the more inherently risky the activity, the more it pays to be conservative. Volatility can be a wonderful thing if you're able to withstand it. All businesses are loosely functioning disasters, some of which happen to make money. And, typically, the smaller the business, the more loosely it functions. All businesses lack something, and small businesses typically lack many things, which is why almost all small businesses stay small.

So if our goal is to partner with small and medium-sized businesses, it's important that Permanent Equity is able to mitigate some of the inherent risks by being what they're typically not. They're able to take more risk because they're backed by our strong balance sheet. They can carry less costly expertise because we can supplement it. They get better pricing because of our relationships and heft. They get access to world-class talent and expertise because of our network.

For all the benefits of conservatism, that mentality usually comes with the tradeoff of slow, steady plodding, hopefully towards prosperity. But by pairing portfolio company volatility with Permanent Equity conservatism, the partnership becomes symbiotic and positive sum. Portfolio companies get stability and Permanent Equity gets growth.

Our commitment to conservatism has been put to the test the past few years. While we watched more aggressive approaches seemingly get rich in crypto, tech, and leveraged buyouts, we stuck to our knitting – building, making, and fixing real things in the real world – despite the lower headline returns. And while others took advantage of low rates to use cheap leverage to pay higher valuations for lower quality assets, we continued to use no debt and not adjust our underwriting. For a team that is set up to handle up to 8 transactions per year, it ended up being a heavy lift to close two.

It's not an exaggeration to say that if we had done things differently we could have easily done dozens of deals and invested $500M+ in the past three years. We would only have needed some looser underwriting paired with some spreadsheet magic. As a reminder, it's not hard to do deals. It's hard to do good ones.

But it feels like that test is behind us and tough decisions, which felt brutally restrictive at the time, are now obvious. This is not to say that more aggressive approaches aren't without merit or that we were right all along. Rather, it's that the biggest risk to any investment approach is thesis creep, and steering clear of it is significantly more difficult than it seems. When the things you don't do are working well, it's hard not to want to do something different.

Conservatism is ultimately the pursuit of humility, with a nod to the lessons of history, cherishing the hard-earned wisdom of our forefathers. Thousands of years and billions of lives can instruct us. We can learn from their mistakes and triumphs. We emulate their principles and their courage to stand firm, despite the whims of popular culture.

We are committed to humility in the types of companies we pursue, the price we pay, the assumptions we make, the use of debt, and how we operate post-close, all enabled by humility in how we raise capital. A 30-year time horizon, a 10-year investment period, and a tightly aligned, novel fee structure give us the incentives and fortitude to hold out, even when temptation abounds. We aim to do just fine in the best of times and do even better when things get rocky, and sleep well regardless.

It's easy to get swept up in comparison – a stupid game of anxiety that wins a stupid prize of envy. Plus, it's usually a false comparison. Publicly available information is often outdated, inconsistent, or straight-up fabricated. Short-term performance is an unreliable predictor of long-term success. There are many ways to play the game. And, the only thing we have a shot at controlling is ourselves. We take a conservative approach, and that ain't gonna change.

Private Equity vs. Permanent Equity

The phrase "private equity" makes me cringe. It's loaded with decades of well-deserved baggage, and inside that baggage is dirty laundry. Which is why when someone asked me the other day when I knew I wanted to be in private equity I replied, "I'm still not sure."

Owners are leery of everything but the fat check they get, and they often get quickly sideways post-close. Executives expect longer hours, decisions coming from on high and new forced systems, and an "or else" attitude. Employees are terrified of layoffs, benefit cuts, or relocations. Suppliers brace for the letter demanding lower prices, more lenient payment terms, and faster on-demand delivery. Customers watch for cut corners, lower customer service, and major changes. Communities hold their breath in anticipation of losing jobs and/or the demand of government freebies.

The playbook is simple, and it works… for the investors… for a while.

I've never considered myself a private equity guy, or even a finance guy — I didn't go to an Ivy League school, can barely open up Excel, never worked at another financial firm, and have never even taken a finance class. And yet, I do lead a firm that buys equity stakes in small private companies. So yes, Permanent Equity is a private equity firm. But, how we go about it is so different that, for most people, labeling us "private equity" creates more confusion than clarity.

Private equity and Permanent Equity couldn't be more different. Debt is the lifeblood of private equity, while Permanent Equity doesn't touch it. Many cut, relocate, and replace. We try to understand, support, and honor. They're looking to be partners for just long enough to make changes and sell to someone else.

We look forward to building trusted partnerships and decades of sturdy growth together. Conventional models charge fees regardless of performance. We work for free until cash hits our investors' accounts.

Private equity has been an incredible driver of wealth, both for investors and the partners. And, in many ways, Permanent Equity operates inversely. As one institutional LP asked a few years back, "So, you're telling me the opposite of private equity is going to return more than private equity?"

Yessir. That's the idea.

Here's the story we at Permanent Equity tell ourselves that helps us focus on paying reasonable prices, sustaining long-term ownership, and using no-to-low debt:

The math behind traditional lower-middle market PE isn't complicated, at least historically. You buy $10M of annual cash flow for $100M, put $20M of equity into the deal, and use $80M of 5% debt. All goes well over a 3-5 year timeframe – you grow bottom line earnings a little, pay down the debt, and sell it to someone else for an expanded multiple. You share in the total return, minus cost of debt and your cost of equity.

Now, do the same exercise with interest rates at 8-10%, a challenging operating environment, and few buyers willing to pay up for your spiffed up asset. The math doesn't just get challenging; it stops working.

Word on the street is that almost no deals done in the last three years by traditional private equity pencil out in today's environment. That means that if the current circumstances don't improve, or if they get worse, the industry detonates. That's something almost unthinkable a mere nine months ago. And, it was predictable under these circumstances. Loose monetary policy is a helluva drug.

I have no idea where rates are going, or when there will be a war, or when the political winds will shift. The future is unknown and unknowable. What I do know is that small businesses face a constant barrage of challenges that makes consistently generating profit a mythical feat. Even non-cyclical businesses will get embroiled in lawsuits, go through difficult leadership changes, lose key customers, and have any number of "one-time" headwinds that always seem to be recurring.

At Permanent Equity, we keep the math simple – buy $5M of cash flow for $20M-35M using all equity. Build trust with the leadership team through genuine care, thoughtfulness, and humility. Work hard to understand where we may help. Then, go to work. If we screw up, which happens, we have the margin of safety to correct it and learn. Over time, the companies get more profitable and find more profitable opportunities to reinvest, compounding capital pre-tax and pre-fee. Everything we can't spend responsibly to help the companies we send out to investors via distributions.

The companies build and investors share in a steady stream of cash flow. It's a win-win. And, there's zero pressure to sell and ring the cash register, because the cash register rings regardless. In fact, Permanent Equity has yet to sell an investment, choosing instead to provide liquidity to retiring owners on an as-needed basis.

Highest-and-Best Use

We're constantly advocating for highest-and-best use. The concept is simple – each person has gifts and should use them. Some of those talents are more pronounced than others. Everyone can experience maximum joy and productivity when they align themselves with their highest-and-best use. Simple enough and easy to do, right? Not so fast.

All businesses hit a ceiling of brute force, and almost always because of underutilized talents. It's the point at which hard work, focus, and grit is no longer capable of providing growth. It's when the systems and attitude produce diminishing returns, despite maximal effort. Everything feels hard, all the time, and progress reaches a standstill at best.

The challenge, especially for the owner/CEO, is self-awareness. When an organization starts, it's pure chaos. There are no systems, little if any revenue, certainly no profits, and no margin for error. Everyone has to do everything, and everything is urgent. No one has the time to sit down and ponder the deep questions of life, let alone translate those answers into the workplace. The founder is the head salesperson, manager of the warehouse, accounting manager, lead engineer, primary recruiter, and chief problem solver. The helter skelter reality of the early days often becomes the norm… and time passes. This is how you find companies decades old that are still run like a startup, at a great toll on the team, and carrying with them the impossibility of scale.

Wisdom comes from experience, and experience almost always comes through suffering. I know this, because I've seen it over and over again. And, I have lived it.

I've seen $15M free cash flow businesses that have owners who haven't taken more than a day or two off in literally their entire careers. Can you imagine the personal toll, let alone the limits placed on the business? And yet, they're still successful, at least by any financial measure. Owners like this are true freaks of nature – high intelligence and high drive, with the stamina of the Energizer Bunny. And, they're impossible to replace when they leave or inevitably break.

And if I'm being honest, which is painful to say, I've held back Permanent Equity by my inability to properly self-assess, set up systems, and give up control. Something about cobbler's sons and shoes. While I'd talk regularly with sellers about their highest-and-best use, I was unreflective about my own. I'd tell myself that my need for control was helpful because I had the judgment and institutional knowledge. And, deep down, I also have trust and ego issues. As a side note, that's exactly what I hear from sellers too. Deception always lacks awareness. Blind spots are called that for a reason.

This year I spent quite a bit of time trying to walk my talk, including seeking counsel from wise friends, reading around the topic, and dreaming about what would be ideal for me and Permanent Equity. I largely retreated from social media and engaged the professional help of a couple counselors. Some of it felt cringey and self-indulgent. Other parts felt wheel-spinny. But occasionally, there were breakthroughs.

Thankfully, what I found isn't the mid-life crisis that makes for a good movie. I'm not growing out my hair, getting tatted up, and moving to Tibet. My big revelation is that I love Permanent Equity and want to work for the rest of my career doing what I already do – helping family-owned businesses transition ownership and grow into the future.

God-willing, I plan to double down on using my gifts to help Permanent Equity prosper. I just want to do more of what I'm good at and less of what I don't enjoy and others can do better. Here's what I wrote to the team when we made the following announcements internally:

> *We preach to our portfolio companies that sturdy scale comes from finding highest-and-best-use, starting at the top. This is an effort for me to do the same. I enjoy, believe I'm gifted at, and think it benefits the organization for me to deal-make and deal rescue, help uncover talent, investors, and opportunities, and explore new initiatives.*
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> *My intention is to be more engaged, not less. We have a rare opportunity to build something big and enduring, on our terms. And, to help a lot of families along the way. I love Permanent Equity, plan on being here the rest of my career, and want to work alongside you all until I'm put out to pasture.*

New Structure, New Faces

With regards to the reorganization I alluded to, as of January 1st, Tim Hanson (previously our CFO) and Mark Brooks (previously a Managing Director) are now Co-Presidents of Permanent Equity. Tim has been promoted to serve as President and Chief Investment Officer and Mark as President and Chief Operating Officer. Both have been tremendous contributors to the success of the business, and I believe their best contributions are yet to come. Functionally, Tim now leads our investing efforts and Mark our portfolio company and firm operations. You may remember that both Tim and Mark relocated to join Permanent Equity, and it's my hope that more continue to do so as we seek to build a world-class investment firm in mid-Missouri.

To that end, the team they lead has expanded significantly this year, with six new additions. I discussed four of them in the mid-year update. Here's the rundown on the other two:

Nicole Galloway, CFO

Most of the world knows Nicole as the whip-smart, dynamic, and no-nonsense Missouri State Auditor and runner up for Governor. And, I can assure you she's all that. There's a reason why she was discussed by cable news personalities for White House appointments and higher office. But I know Nikki as a kind, caring, and thoughtful friend of 15 years, with potentially the best laugh in the world. We originally met in grad school at the University of Missouri and became great friends, along with Jon Galloway, who eventually became her husband.

The minute I saw Nicole's announcement that she was retiring from politics, I sent her a text congratulating her and asking for lunch. A couple weeks later we met up, and I wasn't shy about telling her why.

There just aren't that many people in the world who have her financial knowledge and experience, combined with work ethic, leadership skills, and integrity. Nikki is a former college athlete with degrees in math and economics, as well as an MBA. She's a CPA and a Certified Fraud Examiner. She started in public accounting auditing Fortune 500 companies, then worked in-house at a large insurance company before becoming Boone County Treasurer, where she managed a $100M investment portfolio and issued all general obligation and revenue bonds for the county. She served as secretary and treasurer of the Missouri Technology Corporation, helping invest in entrepreneurs to create jobs for Missourians. Eventually, she led a staff of 115 in her state-wide role as Missouri State Auditor.

As CFO, Nikki leads all finance, accounting, and auditing for Permanent Equity and our portfolio companies.

Spencer Butcher, Vice President

You never know who's going to walk through your door, and that's what happened this summer when Spencer visited Columbia with a group of investors from Atlanta. Spencer had been hired to help these investors develop their deal flow for a roll up of adjacent firms. He immediately caught my attention for his thoughtful approach, articulate vision, and winsome demeanor. Prior to that engagement, he led a team of business development professionals for a large family office focused on software investing. When the investors chose an alternative path, Spencer was freed up and agreed to come on board to lead outbound efforts for Permanent Equity. As I told Spencer then, we have been blessed with abundant in-bound opportunities, but have never been able to figure out how to approach sellers. Perhaps it's a function of comfort? It's hard to gear up to hunt when steaks are lobbed over the fence. Figuring it out is now his job.

New roles and faces are working towards our ability to better serve our growing family of companies. 2022 led us to two new partnerships:

New Investment – AdAdvance*

One of our favorite concepts in investing is the "value curve" – quality of investment on the X-axis and price on the Y-axis. Almost all investors, including us, started on the bottom left corner, because price is the easiest thing to detect. Often, the question in that area is, "Is it cheap?" As you move towards higher quality, price tends to rise, but non-linearly. The need for skill increases, because assessing quality is infinitely more complex than analyzing an income statement and balance sheet. As you move up the curve, the opportunity presents as a proper analysis of quality paired with a price that doesn't appreciate it.

Things are almost always cheap for a reason, with some obvious defect or risk. If it's cheap, it's usually because the business model is suboptimal. Sometimes this looks like capped upside, unlimited downside, as is the case, for instance, with construction sub-contractors. If a project goes perfectly, you know how much you'll make. Of course, things never go perfectly. How much could you lose if a project really goes south? That's limited only by the bankruptcy protection laws and is why construction firms often transact at low multiples of earnings.

On the other end of the spectrum is software, which is now widely recognized as the best business model. It's infinitely scalable with nearly 100% operating leverage and 100% gross margin. This hasn't always been the case, but it's now also often priced accordingly. In the past, we didn't seriously consider most software-based businesses, both because we lacked the proper skill and because of price. But as we've gained more experience and added talented team members who come with technical backgrounds, we're starting to look at more business models that mix in software. With that said…

We're excited to announce our investment and partnership with the team at AdAdvance. It's a different style of investment for us. The Duluth-based team specializes in Amazon-oriented advertising and sales optimization, using custom-developed software. They're technically excellent, with a proprietary code base to prove it. And as Amazon has grown as an ad platform, demand for their offerings has exploded.

Matt and Joe are the founders, a developer and an organic chemist by trade, respectively. They set out looking for an investment partner to support scaling, but did not want to lose their culture, value proposition, or autonomy. They have a long runway as operators, are independently successful, and didn't have to do anything, providing the ultimate relationship test.

A tech-based marketing firm is certainly a shift for us, but beyond the headline, there are a lot of similarities. Quite honestly, Matt and Joe had questions about our interest and potential fit at first. But the more we talked, the more the fit became obvious. They know and love what they do, and have built a team in kind. What they need to accelerate growth is familiar to us, and to virtually all businesses at their stage – more robust systems, talent recruitment, business development, and help scaling.

We're thrilled to be their partners and are excited about the road ahead, even in the winter months. Rest assured, we're also investing in appropriate gear for ice fishing.

If your brand invests in advertising, we'd love to help you start a conversation with AdAdvance. They work with both e-commerce sellers and general brands looking for reach. Ping us and we'll get you routed appropriately.

**This was reproduced from our mid-year update.*

New Investment – Ace Fence

Ace Fence is our newest acquisition, a Dallas-based fabricator and installer of residential fencing completing around 100 fences a day in only three counties. Pam and Larry Little founded the company out of their garage (literally) in 1977 and have grown it for 45 years. As they looked to take steps back from the business, they were concerned with fit above all else – maintaining the company's culture, reputation, performance, and independence for the long-term. From the first time we connected, it felt like an obvious partnership. We shared a lot in common, from a focus on faith and family, to a love of football and a distaste for debt. Ultimately, we shared a vision for what Ace Fence could be for the next 45 years.

If there was ever a "classic" Permanent Equity deal, this might be it. For what we love, it checks all the boxes. It's a low capital intensity, high cash conversion manufacturer masquerading as a construction business. The average employment tenure is measured in decades, and their customer relationships are no different. They do great work, on time and on budget. They're important to their suppliers, with great relationships and meaningful buying power. We like the leadership team, and, fortunately, they like us too. They do such great work that their customers have been asking them to expand into new markets.

And like many homegrown companies, there are opportunities for improvement. The accounting system needs to be refreshed. The talent recruitment methodology can be improved. The physical footprint has grown out of need. Most processes are still paper-based. And they've done virtually no marketing, ever. While we're not in any hurry, we see tremendous opportunities to better serve our customers, and to serve more of them over time.

Remember, good fences make good neighbors, especially in Texas. So if you live in the DFW area and are looking for a new fence, give them a shout. The only challenge is that they're currently on about a 5-month wait.

Gratitude

As I write this letter, the overwhelming feeling I have is gratitude.

I'm grateful for the people God has put in my life and for their costly investments in me.

I'm grateful for all those who have chosen to take this ride with us, including our investors, employees, leadership teams, vendors, customers, and communities.

I'm grateful for the place I live and all the places I get to visit.

I'm grateful for getting another trip around the sun in this fragile meat suit.

I'm grateful for the incredible adventure known as Permanent Equity, and what a wild adventure it has been.

Cheers,
Brent