Investor Letter - 1st Half 2022

Introduction

The last 2 years have been uncommonly striking for the Brazilian and global stock markets. The pandemic and the subsequent resumption of the global inflationary scenario led the market to extreme and antagonistic points of view regarding risky assets - particularly high growth ones.

Throughout the first half of 2020, after the onset of the pandemic, investors migrated their positions to technology/innovation assets in an impressive way – the magnitude of this movement was possibly surpassed only by the American internet bubble around two decades ago.

The exorbitant valuation levels for high-growth assets were justified through great creativity, with investors abandoning traditional value metrics (Price/Earnings, for example) and resorting to metrics focused only on revenue growth, or even in the simplistic assessment of potential market size (TAM – Total Addressable Market).

During this euphoria, little attention was given to these companies' current - or even potential - profitability. Even less attention was given to the hyperaggressive accounting practices reporting “adjusted”, or supposedly recurring, earnings of businesses with enormous profitability challenges. Moreover, little attention was paid to the high level of several companies’ cash burn rate without the slightest prospect of the situation being reversed. Such combination did not strike us as generally favorable for investments in high-growth companies.

Our bewilderment towards the massive exaggerations taking place in the stock market was described at length in our 2H2020 investor letter. We highly recommend re-reading that letter, now with the benefit of knowing how those valuations evolved in the past year. It is, as always, an honest description of our challenge to understand the price movements throughout 2020.

Some excerpts from our 2020 letter:

“Since Oceana’s inception in 2008, we have witnessed very few moments in which our investment philosophy was challenged at this level by the market.”

“(…) we spent the entire year feeling as if going against the tide.”

“As an inside joke, we started saying that the market is pursuing a new class of assets, which we call GAUP (growth at unreasonable prices).”

“By the end of 2020, these metrics also proved not to be capable of justifying several assets’ pricing. Therefore, the market turned more broadly to the TAM (Total Addressable Market). In other words, it does not matter if the company is tiny or even if, after considerable growth, it will still have minimal income over the next 3 or 5 years, as long as its TAM and potential market share for the next 10 years are massive.”

“Considering current pricing, for some of these companies we see a fair value of less than 20% of their current market value when considering less constructive scenarios.”

“Our greatest reflections when trying to price high growth/tech assets usually isn’t revenue growth per se, but whether that growth will deliver long-term profitability. For several disruptive assets, we observe market projections of increased profitability and profit in the medium term that appear to us to be entirely unrealistic.”

“Market dynamics with an extreme focus on growth have been our biggest challenge. Our perception of the market has never been so different from what appears to be the consensus.”

It might seem like a long time ago, but it was a little over a year when we released this letter, in Feb.21. What seemed like a long-lasting trend, possibly spanning several years, turned out to be an excessive euphoria that was soon met with a significant and due correction. The dimension of this correction can be seen below.

Stock	Performance last 12 m	Drop vs All Time High
MGLU	-88%	-89%
STNE	-86%	-91%
MELI	-57%	-66%
BIDI	-92%	-92%
LWSA	-77%	-83%
PAGS	-80%	-83%
VIIA	-77%	-82%
ENJU	-89%	-94%
WEST	-75%	-81%

As of July 14th 2022.

Some IPOs that were carried out at exceedingly high prices currently trade at market values below their net cash position. As an example, Banco Inter, after having a 92% drop, started trading below its book value, with a market now focused on the lack of profitability in 2022 in view of the credit card operation probable losses.

Some well-respected technology companies ended up having their net cash position representing around 45% - 50% of their market value. It was a substantial correction that naturally created some one-off opportunities. Yes, we can now say we are able to find margin of safety in some technology companies - this was inconceivable a little over 12 months ago.

Our portfolio is still focused on traditional companies with stable businesses, high return on capital, strong cash generation and greater predictability. However, tech/high-growth companies are no longer negligible in our portfolio. The quality of our investor base allows us to act counter-cyclically, buying when most of the market is selling.

Oceana's investments in technology companies, even if modest in relative size to other positions, came as a surprise to some of our investors. We correctly did not board the tech company fad in 2020/2021. Why, then, invest now? Our answer, as always, is to reinforce that our investment philosophy has remained the same since 2008, focused on acquiring assets that offer a margin of safety for our investment. What has changed recently – and to a great extent – are these assets prices. We believe that the same asset can be a speculative investment or an investment with a proper margin of safety, depending on the price at which it is acquired.

It doesn't take an optimistic TAM analysis to invest in a technology company that trades significantly below its net cash value. Nor an optimistic assessment of the value per user for a bank that trades below its book value. We must refrain from believing in absolute truths. Both high-growth assets and short-term cash-generating assets can be good or bad investments. Again, it is the price we pay that gives us the margin of safety to invest.

“I am of the view that any stock is a buy at one price, a hold at other price and a sell at a higher price. What that means is that risk is related to what you pay, not just to what you buy”

Seth Klarman, Harvard Business School interview, June 2022

In a recent Oaktree Capital podcast, Howard Marks shed light again on the problem of classifying investments as “growth” or “value”. He mentioned some excerpts from his most popular letter to date, “Something of Value”, in

which the manager has a conversation with his son, Andrew, now an investor focused on high-growth companies. The excerpts are highlighted below:

“My Extensive discussions with Andrew led me to conclude that the focus on value versus growth doesn´t serve investors well in the fast-changing world in which we live.”

“My belief, especially after some deep reflection over the past year... is that the two should never have been viewed as mutually exclusive to begin with.”

Howard Marks, Something of Value

Discipline and Focus

The investment discipline that Oceana maintained during the euphoria period prevented us from suffering disproportionate losses in the subsequent period. Maintaining that discipline is never easy. Being part of the consensus is always more comfortable, and few consensuses were as strong as the investments in technology companies in early 2021 in Brazil.

But not only regarding our investment discipline over the recent years did we maintain a different mindset from most other asset managers in Brazil. We also differed in the way we conducted Oceana´s development as a business.

There is no absolute truth about which is the best business strategy for an investment management firm. The path chosen by Oceana is a result of our convictions, which is not necessarily better or worse than other possible paths.

One of our convictions is that it is very difficult to simultaneously carry out multiple changes in an asset management firm, including creating new investment strategies, without losing focus and investment excellence. Evolutions can happen over time, but major changes or changes on multiple simultaneous fronts create an important challenge for any firm.

Over 2020/2021 we observed several managers in Brazil simultaneously embracing multiple challenges, being worth mentioning: (i) a rapid growth in AUM; (ii) adjustment to the investment strategy to better embrace opportunities in technology; (iii) launching new business initiatives, such as private equity and venture capital.

> (i) AUM growth creates important complexities that require an adjustment period for both the investment management and research structures. This is the reason we believe AUM should be managed along the way, and any growth should happen in a paced manner. Definitely that is not what we saw in our industry in the 20/21 biennium.
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> (ii) Adjusting the management philosophy to better capture opportunities in technology requires effort and relevant changes, often including the displacement of analysts to a new sector and/or new hires. These are also processes that need to mature over some time.
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> (iii) Opening new business fronts brings new challenges. Conceptually, we agree that the philosophy of value investing in public equities can be applied to private investments (private equity and perhaps venture capital). However, the challenge of adapting the internal structure and team should not be overlooked. New internal capabilities must be developed, and there is an important cost in moving analytical capacity to the new private investment area – a cost hardly overcome by any potential synergy gains between public and private investments.

Once again, the path chosen by each company is unique and there is no absolute right or wrong paths. If, on one hand, simultaneously embracing the above challenges offers advantages – among them a short-term financial gain

to the investment managers – on the other hand, it can bring management difficulties that should not be overlooked. The speed at which each change or addition is addressed is often the key to the problem.

In a time when many investors demand a sustainable (ESG) approach from invested companies, focusing less on short-term gains and more on the companies' sustainable characteristics in relation to its many stakeholders, it's important to take a hard and honest look inside our businesses to avoid overlooking an important stakeholder: our LP investors.

Next, we will bring updates on some of our most relevant investments.

Once again, we would like to thank our investors for your trust and long-lasting partnership.

Aliansce x BrMalls Merger

The merger between Aliansce and BrMalls was finally approved, creating the largest shopping mall company in Brazil. As mentioned in our last letter, we believe that a larger scale greatly benefits the shopping mall operation, especially due to the following factors:

1. G&A dilution;
2. Greater bargaining power when dealing with tenants, enabling rent gains;
3. Scale gains in contracting suppliers, diluting condominium costs;
4. Greater capacity/scale to invest in technology, offering omnichannel solutions to shopkeepers in a more agile way than competitors;
5. Greater scale of the media business, making the product more attractive for advertisers;
6. Greater liquidity in listed shares;
7. Better ability to attract talented people.

The pricing difference between public and private markets in the Brazilian shopping mall sector draws our attention. The NewCo – the company resulting from the merger – is trading at a price level that represents a 2022 Cap Rate (shopping malls Operating Profit/Enterprise Value) of around 15%, while private transactions have been taking place at much higher prices. As an example, Shopping Uberlândia was sold by BrMalls in March 2022 at a Cap Rate of 6.7%. The average Cap Rate on most recent transactions in the sector was around 8%.

If we applied a conservative cap rate of 9% to NewCo, the company would be valued at around BRL 20 B, a potential appreciation of around 110% over current market value. In our view, this distortion should be exploited by management through the sale of assets in the private market, especially less productive/dominant malls.

Utilities

In the first half of this year, we have increased our exposure to the utilities sector. For different reasons, we had opportunities to invest with a good margin of safety in three companies that are highly exposed to power generation: Eneva, Auren and Eletrobras - these last two were already in our portfolio and we increased our positions.

Eletrobras: in 2020 we saw a good asymmetry that justified the investment, but we set up a relatively small position due to the state-owned company governance risk and the binary event that was the possibility of the privatization not going through. We waited for the capitalization, which would be big enough to increase our position with less

risk, given that the company would no longer be controlled by the government, and in the primary offering in June/22 we increased our investment in the company.

Auren: the company was originated from the merger of CESP with its controllers' assets (VTRM), resulting in a more robust power generator, with an even more diversified portfolio of hydro, wind, and photovoltaic projects and, in our assessment, a lower governance risk. The opportunity to invest in Auren occurred in virtue of some factors that affected the company throughout 2021: (i) the delay in the indemnification of the *3 irmãos* power plant due to the need to replace the legal process expert; (ii) the elevated *IGPM (*General Market Price Index*)*, significantly increasing the company's pension fund's liabilities and; (iii) a highly unlikely hydrological scenario (worst hydrology in the last 100 years followed by the best hydrology in the last decade) making it hard for the company to deliver good results in recent quarters. These factors combined drove away some investors, creating the opportunity to increase our investment with a good margin of safety.

Eneva: the opportunity arose with the end of the Urucu negotiation process, when the company stopped pricing this asset's potential value and started pricing only existing assets, leaving the different value generation fronts as optionalities not yet priced in. We started our investment on this occasion and increased our position by subscribing to the capital increase carried out on June 22.

Despite all three companies being very exposed to power generation, we assess very specific value creation situations for each one of them. Eletrobras is a case of turnaround, and we believe that only a small improvement in efficiency is embedded in the current share price. Eneva, in turn, tends to create considerable value over time, reinvesting its strong cash generation in integrated thermoelectric generation assets that offer a return well above their cost of capital. Finally, Auren is a poorly priced asset, that does not need to carry out a turnaround or generate value over time through reinvestments to justify a higher share price than the current one. In this case, some signs of prudent reinvestment, payment of dividends and/or a settlement of the 3 *irmãos*' indemnification imbroglio may be enough to draw prices closer to the implied value we are considering.

The increase in these positions raised our exposure to the long-term energy price, given that Eletrobras and Auren have a large part of their energy uncontracted. Our analysis considers a possible energy price range for the long run, and by stressing our valuation models, the resulting implicit prices are closer to the lower band of the range. Therefore, we believe that there is a high margin of safety in investments.

Renner

After many years closely monitoring one of the best managed retail companies in Brazil, but without a comfortable valuation, we were finally able to make a significant investment in Renner, which track record needs no introduction.

In our view, the company today stands in a very distinguished position for several reasons: (i) strong balance sheet, with a BRL 1.9 B net cash, at a moment of high interest rates and of great fragility in the apparel retail sector; (ii) significant market share gains over time; (iii) a gradual increase in profitability after a high investment cycle and; (iv) an omnichannel operation with increasing integration between in-store and online retail, which gives it an important competitive advantage over online-only competitors.

During the pandemic, Renner stepped up its investments in the online channel, carrying out in 2 years the investments planned for the next 5 years. This naturally caused a lower operation efficiency, and from 2019 to 2021 the company had its retail EBITDA margin drop from approximately 18% to 9%. This relevant margin drop raised two important questions regarding the case: (i) what will the normalized operating margin level be from now on; and (ii) how challenging will it be to maintain the operational consistency and the market share gains observed so

far, since the playing field now also encompasses an online market, with a different competitive environment which is less known to the company.

Although the online expansion was not very efficient at first, now the company is beginning to capture cost efficiencies and dilute expenses due to its greater scale. This is already reflected in last quarters' results. In addition, inventory turnover has been much more agile, which has benefited the markdown level and, consequently, the company's gross margin - something quite relevant in the fashion industry.

We recognize that the challenges the online market is facing are not negligible, but now, relying on a much more robust operation, Renner strengthens its competitive edge. The growing logistics integration between stores and ecommerce operations provides efficiency gains in freight and shorter delivery time for the online deals, in addition to a lower markdown for in-store retail.

A simple metric to illustrate the attractiveness of the valuation is the current 2023 Price/Earnings ratio which, even conservatively, with margins well below the 2019 level, is around 14x, considerably below the company's historical average.