OCEANA investimentos

Investor Letter 2019

Over the past 4 years we have seen a significant bull market in Brazil. Since January 2016 the Ibovespa Index has soared by approximately 170%. R$ 100,000 invested then would have turned into R$ 270,000 by the end of 2019. Significant bull markets are not uncommon in stock markets worldwide, although what fuels price appreciation naturally varies from country to country. Some dynamics present in these cycles are common across the board, especially those regarding investor behavior and risk perception. We believe valuable lessons about risk management may be learned by studying such cycles, as well as investor behavioral patterns, so we decided to address this theme in this letter. We believe these to be important considerations for any investor.

Before we start, a word of caution: despite our letter's focus on risk, our intention is not to paint, in any way, a pessimistic picture of the opportunities we see today in the Brazilian stock market. Even though we do notice some stocks being traded higher than we would consider appropriate, inadequate for investment, we still see a reasonable number of stocks being traded at interesting prices, offering enough margin of safety. This is no different to what is usually seen on the Brazilian stock market, with exaggerated valuations on "trendy" stocks and excessive discounts for "out-of-fashion" stocks.

Defining risk

The conceptual simplification created in academia in the 1950's (Markowitz) and refined in the 1960's with the development of CAPM (Sharpe, Linter), adopted the volatility of an asset or portfolio as its best risk metric. According to this simplification, the higher its volatility, the higher its risk. Academics needed ann objective metric that could fit their models and also be measured historically, as well as be forecasted. Volatility proved itself to be the ideal candidate, since other risk metrics did not present such properties.

In line with the movement introduced by academia, on the following decade most investors started accepting the definition of risk as being the volatility of an asset or portfolio. It was simple, comfortable and elegant, plus it brought psychological comfort for its preachers and users. If anything went wrong, at least some Nobel prizes gave credibility to the approach.

At Oceana, we have a quite different perspective on the nature of an investment's risk. There are several different risks associated with an asset, and volatility is one of the least important ones. As part of our daily practice, it is common for us to decline an investment for various reasons, but never because its price might sway too much in the future.

An example might be useful. Let's imagine that a certain stock price falls 50% due to a crisis in that specific sector in some other part of the world. In Brazil, however, the sector happens to be performing very well, going through a different part of the cycle. Moreover, we notice that that company's ability to generate returns has not been affected, despite the large drop in its stock price. If we use stock volatility as a risk metric we will conclude that, after a 50% slump in price, risk has risen materially. Is this reasonable? It is now possible to buy the same stock for half its previous price. Does it make sense to consider it riskier paying half the price for the same asset, with the same return outlook?

At Oceana we tend to see an asset's volatility as a potential source for investment opportunity. Companies are priced daily by the market. We can ignore market pricing or act on it, buying or selling stock. If a stock is more volatile, we will see an increased level of fluctuation driving prices both up and down. This provides us with increased opportunities to act on prices we believe to be unreasonable. When dealing with a less volatile stock, this kind of opportunity, by definition, will be rarer. In other words, an asset's volatility, in addition to not being equal to risk, can be an ally to those investors oriented by a value investing approach.

Given that we do not believe in volatility as an asset's sole risk metric, how do we perceive risk at Oceana? Risk for us is, above all, the possibility of permanent loss of capital. When we decide not to invest in an asset, we do so essentially because we see a significant chance of permanently losing money on that investment.

The possibility of permanent capital loss on stocks is not necessarily due to companies' weak fundamentals. If bought at discounted prices, even stocks of companies with more fragile fundamentals might have enough margin of safety and prove themselves to be excellent investments.

The possibility of permanent loss is also not necessarily associated to crises. In fact, this possibility is higher at moments of market euphoria, when stock prices are irrationally high. During these moments investors tend to become overly optimistic, stories of significant growth opportunities gain volume in the market – especially regarding companies that have been recently outperforming – and the margin of safety for prudent investments usually disappears. With inflated stock prices, anything that might go wrong, either with companies, with the economy, or with the perception of risk by investors, can lead to significant losses.

The "invisible" benefit of managing risks on upturn cycles

At Oceana, over the past 11 years we have used the same strict investment philosophy: we invest in companies focusing on the margin of safety of each investment. We observe each asset's potential returns in different scenarios, giving more weight to the less optimistic ones, especially to understand what that company's value and its cash flow could be in an adverse scenario. Does the company keep generating cash under a challenging environment? Does it have the capacity to pay its debts in the event of a crisis?

A superior ability to manage risk is not something that is highlighted during times of market prosperity and growth. We do not see asset managers being rewarded for avoiding risks that did not materialize. Risk is an invisible element, noticed and understood only when negative events occur. Only the losses themselves are observable, not the possibility of losses, however probable or asymmetrically negative they might be. Such is the nature of risk; it is one of the hardest elements to be adequately measured by investors. Absence of loss is not in itself evidence that a portfolio was prudently constructed, it only indicates that potential losses did not materialize.

Since permanent capital loss risk is hard to be measured ex post – we only see clearly what has already happened, and not what could have happened – during very optimistic cycles, good risk managers can be seen as too conservative, outdated, or as not having a good understanding of the current market opportunities. It is key to understand that, even when not materialized, risks have been present, in greater or smaller scales. Hard times will inevitably come, market euphoria will make way for depression, and stock prices being traded at unreasonably high levels will eventually be corrected.

Therefore, even if constantly present during times of market prosperity and growth, good risk management will only be adequately appreciated when the growth cycle comes to an end. Let us borrow an excellent example from Howard Marks' book "The Most Important Thing", which has inspired part of the concepts described in this letter. A house may be well built and resistant to earthquakes. On the other hand it might be poorly built, and in this case it will certainly collapse during an earthquake, even if a mild one. But it will only collapse if hit by an earthquake. We will only be able to assess the quality of the house once an earthquake has happened.

Current Market Environment

During the most recent market cycle in Brazil, we observed some patterns repeating themselves that are typical of bull markets. The reasons for this are very comprehensible, some of which we mention below:

i. Inflated prices for assets with positive earnings "momentum".

The perspective of economic activity growth, such as lower financial expenses, creates a positive outlook for companies in different sectors of the economy. If we add a favorable funding environment for M&As, plus record stock market inflows driven by interest rate cuts in Brazil, a very favorable scenario for increases in stock prices in Brazil is created.

Despite the appreciation movement being perfectly rational and comprehensible, the intensity of the movement might be exaggerated in some cases. In our view, exaggerations seem present especially in sectors facing notable improvements on earnings, accompanied by potential value generation via M&A. It is a moment during which investors are focusing on the perspective of growth in companies' profits rather than on the value effectively paid by growth.

This phenomenon is not observed exclusively on the Brazilian stock market. Other value investors around the world have observed the same characteristic on different markets, as may be seen below in a passage in the latest letter by Bill Nygren's, Oakmark's manager:

"Although the formula P=P/E x EPS highlights that estimating future P/E is just as important as forecasting EPS, investors typically alternate being obsessed with one factor and then the other. The collapse of the tech bubble in 2000 was a time when investors stopped paying higher and higher prices for the fastest growers and quickly pivoted to low P/E stocks. And today, just like during the height of the tech bubble, analysts are focusing much more on a company's earnings than on the company's appropriate P/E multiple. It's not the analysts' fault. After all, their job is to earn commissions from their clients, and today, most of their clients are paying them to focus on earnings predictions."

This is a typical characteristic of bull markets. There is no such thing as excessive prices for companies with strong profit growth perspectives. It becomes ever more common to see investors justifying an investment by arguing that: "the investment is not attractive, but with escalating profits the stock has no reason to fall".

In our understanding, some specific sectors, which are worth mentioning, would currently fall under this rationale:

- Toll road concessions. We agree with the market regarding the probable improvement of highways traffic as a result of GDP growth, which combined with a decrease in expenses, tends to lead to better results for companies in this sector. We also agree with the idea of additional value potentially being generated as a result of the next concession auctions. However, our view is that there might still have been an exaggeration on certain stocks' price action in this sector, since there are cases where in order to justify the current market value it would be necessary to generate tens of billions Brazilian Reais in future acquisitions.

- Vertically-integrated healthcare operators. These are good companies, with significant growth potential, whether organic or via acquisitions, that generate value for stockholders (given the high degree of synergies and efficiencies attained). Besides, we believe that a model of vertically integrated operators is beneficial in the current context of the Brazilian healthcare market, with higher potential for market share expansion. However, once again, market price movements may have been excessive. Currently, this sector trades at multiples close to 50x its forecasted earnings and it is a sector which demands regulatory capital. Additionally, this was a sector that has already gone through a material consolidation process. Since their respective IPOs, Hapvida bought 1.219 M users (53% of their base at the time of the IPO) and GNDI 1.017 M users (48% of their base at the time of the IPO). The big potential acquisitions have already taken place, and only medium and small players remain on the market. Value generation is even more questionable when we consider these companies current valuations, with Hapvida being worth approximately BRL 50 B and Intermedia close to BRL 42 B. In order to justify current market prices, it would be necessary to see future acquisitions generating values of tens of billions of Brazilian Reais.

- Real estate development and construction. The scenario of plunging interest rates is a fantastic propeller for the construction industry. A significant drop in loan rates and instalments creates an enormous potential demand for real estate. This effect not only boosts sales volume but may also raise housing prices. The probable higher prices, combined with new launches built on land previously bought at lower prices (before the sector's recovery), are likely to create excellent returns over the next 2 years. However, we have doubts regarding this sector's capacity to maintain elevated returns (which is currently forecasted/priced by the market). It is a pulverized sector, with diseconomies of scale, low entry barriers, capital intensive and that has presented a considerable difficulty in delivering good results over the past decade.

Besides, since the 2nd half of 2019, developers, optimistic with the economic recovery perspective (and maybe satisfied with their assets' pricing) started working on raising funds for the expansion of their businesses. In 2019 alone, around BRL 5.5 B were raised, most of it being allocated on the same thing: purchase of land in the city of São Paulo. For 2020, the deal pipeline is very robust, forecasting new financing rounds adding up to more than R$ 5 B, with resources once again mostly designated to the purchase of land in the city of São Paulo. We see this movement with great concern. For us, it is possible that the greatest beneficiaries of this movement will be the landowners, not the developers.

ii. Attention to revenue growth and less attention to earnings.

In optimistic environments, it is natural for the average investor to worry less about returns and companies' cash generation and to increasingly focus on revenue growth, or on the number of clients, or even on the possibility for the creation of and "ecosystem" in a distant future. After all, in an optimistic environment it is possible to wait longer for revenue growth to turn into profit, even if this path is not clear. Currently, we see investors' forecasted yield increase for some sectors with considerable skepticism, especially in face of the increased competitive conditions ahead. We will now explore two examples of sectors that fit this profile.

- E-commerce. These are mainly quality companies, with enormous focus on innovation, that have been providing constant and startling progress on operating standards, delivering products/services ever more rapidly, developing robust platforms, enhancing their physical/on-line integration (omnichannel) and providing a wider variety of products.

These are companies that have been reporting high growth, on a market with great potential. Today, e-commerce penetration in the overall Brazilian retail market is 7%, compared to 14% in the USA and 22% in China[1]. Given the improvements in service level that have been happening, we expect that this channel will continue to increase its relevance in the overall retail market and continue to report significant growth rates.

The enormous challenge facing this sector worldwide has been to combine growth and profitability. This challenge is greater for countries where several players have simultaneously become relevant, as has been the case with Brazil.

On markets concentrated in only a few dominant players such as the American market, led by Amazon (around 40% of market share[2] versus 6% by the 2nd largest player), or the Chinese market, led by Alibaba (with over 50% of market share and only 1 other relevant player– JD), the possibility of increasingly profitable operations seems more reasonable, especially if the market share is maintained or increased. However, the reality for fragmented markets seems to be different.

In Brazil, 3 players have already become very relevant: Mercado Livre, B2W and Magazine Luiza. Given the degree of capitalization, scale and leverage, these players will most likely continue to be relevant for many years to come. In addition to these players, there is also a risk of a more significant entry by Amazon in Brasil. Until now, Amazon's presence in Brazil has been shy, but the company has already started to show an increased intensity for its operations, entering the "1P" segment (keeping inventory of its own merchandise), with a continuous increase of SKUs and with the launch of Amazon Prime. Other smaller e-commerce players have also planned more aggressive moves, as is the case of Via Varejo and Carrefour, but it is still too early to assess whether these players will be successful.

Considering this competitive scenario and in search for balance between growth and return, e-commerce companies have reinforced their marketplace operations ("3P") – in principle more profitable operations due to being commission-based and for generating cross-selling options of services still not offered. Over the past 3 years, "3P"'s share of total e-commerce went from 25% to 50%, and our expectation is for this percentage to continue rising considerably. It is worth observing how returns will develop in the future, as most companies continue to stride in the same direction ("1P" -> "3P"), and there is no significant difference between their strategies. At the same time, this movement brings new challenges, since companies have an increasing need to migrate from a single platform model, with focus on

[1] Source: Euromonitor. Data excluding *cross border effect (*goods sold for consumers in other countries or acquired from other countries) and auto sales. [2] Source: Emarketer.

customers, to two-sided platform models, with focus on offering the best value proposal not only for customers, but also for sellers.

Two sided platform models are intermediary ecosystems with two different user groups that mutually benefit, thus creating a network effect and a virtuous cycle. In a competitive environment, companies that choose to follow this model need to find ways to attract not only their traditional clients (i.e. end-users/buyers), but also a new target audience (i.e. sellers). Looking to win this race, e-commerce companies have been choosing to use subsidies to attract both target audiences, as for example the subsidized fulfillment services and free shipping. These subsidies naturally make achieving profitability even more challenging.

This new environment also requires platforms to adapt in order to meet sellers' needs, which vary according to their profiles. We have observed increasing offers of technology, logistic and payment services, among others. Despite the possibility of these services being additional ways of monetization, the current competitive environment has pushed these solutions to be offered freely as a way of attracting sellers, bringing incremental expenses to the platform and increasing the challenge monetizing these initiatives.

We believe the expansion rate in this market will maintain a solid level, but it is unlikely for the Brazilian market to consolidate in a similar way to the American or Chinese markets. The most likely scenario might be an environment with 4 relevant players in 5 to 10 years, and this fragmentation is not ideal for generating high returns on capital. The path to profitability in Brazilian e-commerce companies may prove to be more challenging than many believe.

As a reference, a supposed combined entity of Magazine Luiza, B2W and Mercado Livre would have a market value of BRL 270 B, and, based on Bloomberg's profit consensus, a multiple Price/Earnings of 580x for 2020E, and 200x 2021E (it is not possible to estimate this for 2019, since a combined loss is likely to be reported). These elevated multiples would be even bigger if we consider Oceana's earnings forecasts, which are materially lower than market consensus especially due to aggressive accounting practices used by these companies. We acknowledge that the Price/Earnings metric is no longer used by the market for this sector, and maybe it is not appropriate for a sector going through such an important growth, but this metric offers a general idea of the increase in earnings necessary to justify current price levels for these assets.

- Fintechs. Fintechs have been expanding considerably their client base, bringing forth an enormous risk for incumbent Brazilian banks, which still operate with enormous profitability if compared to global standards. This higher profitability, expressed, among other things, by high tariffs charged by incumbents, creates a substantially favorable environment for the entry of new players with distinguished value propositions.

By our estimates, the existing fintech installed app base exceeded 50 million in a short time. In terms of number of users, we estimate today that the bigger players in Brazil are: Nubank, MercadoPago, PicPay, PagBank, Banco Inter, Ame Digital and Neon, all having more than 2 million installed apps each.

The astonishing progress of the fintechs, along with a more aggressive tone played by our Central Bank regarding fostering competition and even intervening in the sector's value chain, establishing and reducing fees for the financial system, creates an even less benign environment for incumbent banks. This scenario led to an important adjustment within our portfolio allocation, with a reduction of our structural position on the big private banks throughout 2019.

This shift in our view of incumbent banks does not mean that we believe fintechs in Brazil are currently a good investment. Up to now, low fees or financial incentives have been able to attract clients but have not, however, resulted in adequate profitability. A possible outcome for this new setting would be lower returns for incumbents and new players, with the consumers as the benefited party. Since fintechs present low or even negative profitability, what remains for the investor is believing in non-audited data supplied by companies themselves, or on subsidiary data, e.g. traffic, number of app downloads, or client satisfaction indicators.

However, the absence of return has not kept the market from establishing a metric to value fintechs. The global metric of US$ 1,000 per client was promptly and broadly applied. We find it difficult to accept this metric, especially given the fact that the same client is worth US$ 1,000 for different players, given that the typical digital customer is connected to more than one fintech.

Besides, as several players continue to increase their online client base with very similar proposals, we believe that the path to profitability might be much more challenging than some might think.

iii. Lemmings uncovering the route to gold.

Typically, when the capital market reaches a consensus regarding a certain asset class it becomes overvalued, usually leading to the assets' underperformance during the subsequent period.

At Oceana, after 11 years of employing a contrarian approach it is safe to say that we feel less and less uncomfortable to be pulling away from market consensus. Our level of discomfort as a result of our different/unique views and approaches is never non-existent since it is intrinsic to human nature to want to stick to standards. However, such concerns continue to decrease year after year, as our investment philosophy continues to deliver good results.

Every time we pull away from the accepted consensus in a drastic way, as was seen in 2018/2019 and is now notably happening again in early 2020, we are at risk of being branded "dinosaurs" that still have not grasped how to adapt to the "new market reality". The new reality changes over time... It has been technology by the end of the 90's, investing overseas, focusing mainly on political analysis, and now it seems to be the new economy and focus on growth, with less attention to cash flow generation.

Future results will, as always, define whether we will be seen as disciplined, or dinosaurs.

It is important to clarify that there are moments during which investing alongside market consensus may bring good results for a considerable amount of time. When there is a strong inflow towards equities, as is now being observed, "trendy" stocks receive an important additional flow. After all, the considerable flow into funds that own these stocks naturally generates an almost passive purchase of such assets.

This tendency may endure while the strong inflow is sustained. It is a movement that needs to be respected, but also understood so as not to create false expectations about what works in the medium run when investing in stocks.

Conclusion

Over the past years we have seen an extremely positive investment environment, in which our strict approach of risk management and downside protection focus might have seemed less important. We understand this perception, but continue to believe that, despite it seeming “useless” or “overly-cautious” at times, it is what guarantees solid results to our investors in the long run. In our experience, risk management proves itself to be even more important when it is ignored by the market.

Up to now our team has been very successful in finding good investment alternatives with low risk of capital loss. However, the challenges we will continue to face are not small. As stocks rise, these challenges increase, and in order to overcome them we need to continue to deliver a superior job in selecting stocks. This will only be possible if we maintain the pillars that led us this far: a differentiated team, with low employee turnover, solid investment philosophy, in-depth and well executed company analysis, strong internal culture, increasingly robust processes, and a focus on constant improvement.

We remain optimistic and inspired to continue delivering good returns to our clients.