OCEANA investimentos

Investor Letter - 2nd Half 2022

Introduction

The past few years have been marked by extreme price movements in the Brazilian stock market. In March 2020, the pandemic caused a rapid and pronounced drop in virtually all risky assets prices. After the downturn, with the help of unprecedented stimulus, a period of great euphoria began that lasted until the end of the 1st half of 2021. The dynamics of this period of euphoria were thoroughly explored in our last investor letter.

In mid-2021 Brazil entered a new market cycle marked another strong price correction of risky assets. A simplistic analysis of the Bovespa index price movement during this period does not provide the accurate understanding of the magnitude of the price movements that we saw in some sectors. Stocks in the retail, consumer, shopping, technology, healthcare, education, and transportation sectors had significant price drops that are not clear by looking at the Bovespa index because the Ibovespa currently has a relevant portion of commodities exporters in its composition – around 35% of the index – and these commodities companies performed well in the last 18 months.

This price movement can be divided into two parts: the first part should be seen as a simple correction of excesses, which is natural after a cycle of exuberance, a topic widely explored in our last investor letter; the second part, on the other hand, was mostly caused by a sharp deterioration of the fiscal and macroeconomic outlook in Brazil. These two movements combined have brought stocks in the Brazilian market to an attractive price level, but with a macroeconomic backdrop that is quite challenging.

This is a familiar environment for us. Unfortunately, crisis have been a constant in Brazil. Since Oceana's founding, 15 years ago, we have gone through numerous occasions like the current one, in which we found ourselves navigating in environments with apparently discounted assets but challenging macroeconomic backdrops.

Time and experience are important allies in turbulent times. One thing is to do theoretical historical analysis of past crisis; another entirely different thing is to have, as a team, steered an investment strategy and firm throughout different crisis.

Crisis and Opportunities

"We worry top-down, but we invest bottom-up"- Seth Klarman

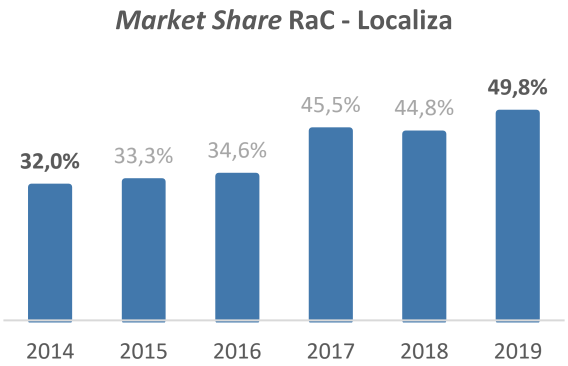
After the strong price movement we recently observed, an important doubt remains with investors: are stock prices really attractive or will a more challenging macro scenario - whether due to Brazil growing less, higher debt costs, or potential regulatory changes - significantly impact companies in a way that today's apparently cheap valuation will prove to be an illusion? Once again in Brazil this seems to be the main question to be answered by investors.

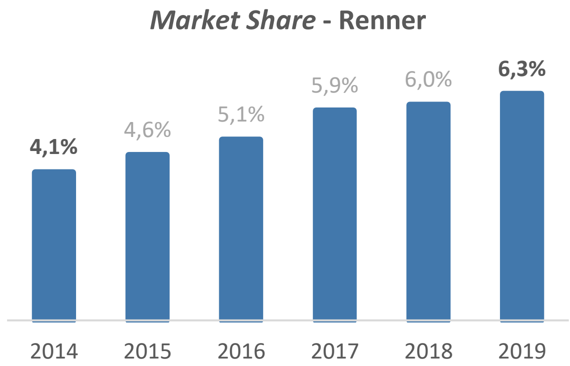
In our experience, during times of crisis, the market tends to generalize negative effects to different sectors of the economy, giving excessive weight to the macro scenario and political-economic issues, while at the same time, underestimating the positive second-order effects that can be generated during crisis by companies that have clear competitive advantages.

Companies that lead their sectors, with competitive advantages and solid balance sheets, tend to deal with turbulent periods better than their peers, and emerge with significant benefits for their long-term competitive positioning. Among the many benefits, we highlight the potential gain in market share that can be captured in moments like these. Less competitive and more leveraged direct competitors find themselves, due to rough waters, forced to significantly retract their operations through the release of working capital and/or through a rapid increase in their product prices, thus offering the sector leader an "easy", profitable, and possibly sustainable market share gain. In fact, depending on the degree of consolidation of each sector during the crisis, it is possible to observe higher profitability in a short period of time, due to lower competition in the sector. The largest oligopolies are formed during crisis.

The substantial value generated by dominant players in challenging environments has been observed in various past crises in Brazil. For example, between 2014 and 2016, some companies showed significant market share gains through organic growth, a trend that persisted for some time. In the car rental sector, the worst period of economic crisis in recent years was a catalyst for a very impressive market share gain in the Rent-a-Car (RaC) segment by

Localiza, with the company going from 32% market share in 2014 to 50% in 2019. A similar effect occurred with Renner during this period, with the company going from 4.1% market share in apparel retail in 2014 to 6.3% in 2019.





One of the key points for correctly evaluating the dynamics that are likely to occur in a sector during a crisis is having a deep understanding of the competitive environment of the sector and a correct understanding of the financial situation of competitors, both listed and non-listed companies. Analyzing these factors is never simple. It is an analysis that is only possible through a lot of fieldwork, which naturally demands a reasonable effort from the analysis team.

We believe that the competitive advantage of some companies in our portfolio have been increasing considerably over the past few years. This can be very powerful for the profitability of these companies in the medium term. Naturally, a slower growth in Brazil may impact these companies, but these are companies with clear competitive advantages and solid balance sheets, important levers that can allow these companies to generate a lot of value for shareholders in more challenging environments.

Below we highlight some companies that we believe deserve attention at the current moment.

Car Rental

Brazil’s lower economic growth and higher interest rates are factors that undoubtedly have a negative impact on the growth of the car rental sector. In addition to this impact, the results of 2023 will possibly be under pressure by an increased fleet depreciation.

Nonetheless, Localiza's competitive advantage evolution compared to its competitors in the sector is notorious. The company's current competitive position is the most favorable since its IPO in 2005.

Part of this competitive advantage comes from the scale that the company has achieved as a result from the merger that took place in December 2021 between Localiza and the second most relevant company in the sector, Unidas. The resulting company from this merger has now an impressive 70% market share in the Car Rental (RaC) segment.

In addition to the scale gain derived from the merger, a strategic mistake made by one of its competitors may bring even more benefits to Localiza in the near future. Movida, the only relevant remaining player in the sector, acquired a significant number of cars at a time when discounts offered by OEMs were low. Consequently, Movida increased its net debt to R$11.5bn, compared to a company´s market value of R$ 4.0 billion. Currently, this debt has a cost of over 130% of the CDI (Brazilian interbank deposit rate) and the high financial burden has hit Movida at a delicate time, with results being severely impacted by an increase in the economic depreciation of its fleet. We believe that Movida will be forced to shrink its fleet, which in turn will result in an opportunity for Localiza to expand even more its penetration and, later, its profitability.

Apparel Retail

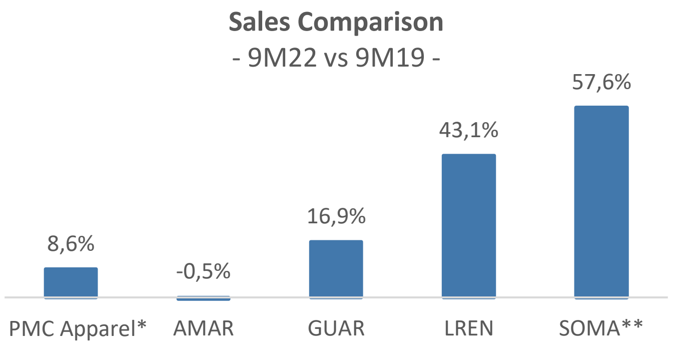
Due to an unfavorable macroeconomic scenario and an expectation of weak results for the 4th quarter, impacted by colder temperatures and weaker sales during the World Cup, the apparel retail sector recently saw significant drops in stock prices. As a result, Lojas Renner and Grupo Soma are now trading at very attractive Price/Earnings ratios of around 13x for 2023, near historical lows. Structurally, we continue to see both companies well positioned to maintain significant market share gains.

Renner is benefited from its solid balance sheet, with a strong net cash position and consistent execution, while many of its competitors are weak, with high levels of debt and restricted access to credit (deteriorated by the Americanas episode). Also, most of the competitors currently face high levels of default on consumer´s credit, which is an important sales lever in the mass apparel retail market. As an example, Marisa has recently started its judicial recovery process. In times of crisis that Renner stands out the most. We see the current situation as very favorable for the company to consolidate its position and expand its competitive advantages.

"Renner has always grown during moments of crisis. The differential lies in the product, its development, in the speed of this development, in the level of service provided in-store, and in prices." José Gallo, former CEO and current Chairman of the Board of Lojas Renner in a 2015 interview.

Grupo Soma has a solid portfolio of brands focused on the A/B public, a segment that has proven to be more resilient in the current macro scenario. The group's main brands, Farm, Animale, NV, Maria Filó, and Foxton, are benefiting from weaker competition in a market that is still highly fragmented. As a reference, the brand with the largest market share in its segment is Farm, which holds 8% of the addressable market in Brazil. The group’s other brands have between 3-5% of the market, making it possible for continued consolidation of this market in the coming years.

Additionally, we do not believe that an improvement in Hering's operations is reflected in the current stock price. Our fieldwork indicates significant improvements in the customer experience in physical retail stores, with better assortment, lower stockout levels, and better service. The new megastore format for Hering has shown encouraging signs, with positive feedback from shopping centers, a 5pp higher sales conversion rate than the network average, and higher average spending per customer due to increased time spent in-store.



*PMC Nominal Sales Revenue for the Textiles, Apparel, and Footwear category.
**SOMA Organic revenue in Brazil (excluding NV and Maria Filo, acquired in Oct20 and Feb20, respectively).

Banks

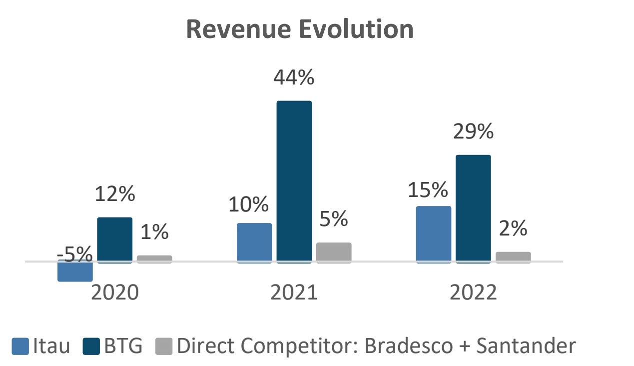
The competitive edge created by some large Brazilian banks in recent years is noteworthy. The increasing dominance of Itau and BTG Pactual in many segments in a short period of time is impressive. We believe that their improved business management is translating into differentiated results that are expected to endure in the medium term.

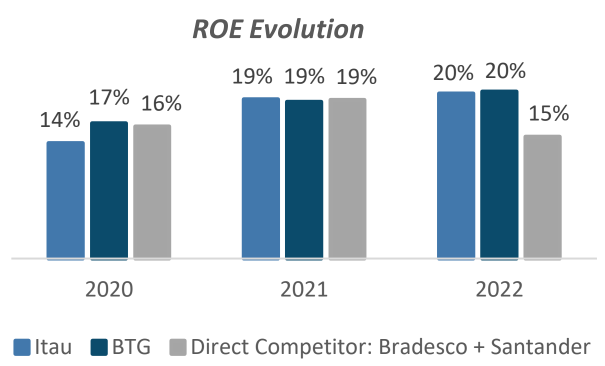
Itaú’s case is worth a special mention. After Milton Maluhy became CEO in 2021, we saw a significant change in perception about top management among employees at different levels and areas in a large and established company, which it's rarely seen. Our fieldwork led us to a pleasant surprise: the positive feedback about the new management is generalized, indicating a more present, dynamic, and much more capable management to motivate the business structure. When we compare this to the feedback we gathered from two to four years ago, from a less present, slower, more hierarchical management, the impression we have is that we are looking at two different companies.

The e-NPS, which measures employee satisfaction at the company, is at 88 points, the highest historical result. This has translated into greater customer satisfaction, with the bank's global NPS increasing by 20 points in just 4 years. This is an impressive change for an organization of this size and in a relatively short period of time.

BTG, in turn, has always been a reference for its partnership model, which promotes long-term alignment between employees and shareholders. Even though the bank has increased its staff by almost 90% in the last 2 years, BTG has managed to maintain its culture and business excellence, while expanding its lines of business beyond its core business, resulting in revenue and ROE growth above the industry average.

The evolution of both banks, combined with a set of important mistakes made by their direct competitors, is creating a relevant gap in the competitive positioning in the sector, translating into a differentiated performance in both revenue growth and ROE expansion.





The poor performance of the sector due to the probable (or almost certain) loan loss related to Americanas created a good opportunity for us to increase our stake in both banks.

Technology

The performance of the stocks in the technology sector has been more often driven by emotion and speculation than fundamentals. The comparison between prices at the peak of euphoria and current ones is striking. Price declines of 90% are not uncommon.

Although the stocks of virtually all companies in the sector have suffered, the impact of the crisis tends to be very distinct amidst them. As already mentioned, the health of a company's balance sheet is a crucial variable during a crisis. Currently, either by luck or competence certain companies are overcapitalized, while others are fragile and dependent on new capital injections, in a particularly delicate moment due to the bigger scarcity of venture capital funding.

A company with a strong balance sheet may have a significant advantage now, as it will encounter many of its competitors weakened. If well managed, this advantage can be translated into easier and/or less costly growth in the coming months or years. At the peak of the boom, both online advertising costs and labor costs were strong detractors of the results of the companies in the sector. We believe that, due to weaker demand, these costs will be lower and thus the gain of market share will be cheaper.

Today, we hold small positions in some well-capitalized technology companies. Many of them are trading at prices below their liquidation value - something that seemed unimaginable during the euphoria period just eighteen months ago.

Pulp

We have a very distinct view of what appears to be the market consensus regarding the pulp and paper sector, with our position in Suzano standing out.

Currently, there is a pessimistic view in the market regarding Suzano due to two main factors: (i) the probable decline in the price of pulp from its currently high levels, and (ii) less attractive multiples in the 2023/2024 biennium due to strong investments in the Cerrado project, which add debt and will only translate into more significant earnings generation in 2025.

This more negative view allowed us to increase our position in Suzano at levels we consider quite attractive.

We agree with the view that current pulp prices are above normalized levels and should therefore fall. However, we believe that the intensity of the decline may be less than expected by the market. The consensus today indicates a long-term price expectation for pulp of USD 550/ton, a price that is in line with what we use in our projections. However, there has been a strong cost inflation in the industry, and this cost inflation, in our view, may offer a higher price floor for pulp.

The sector's cost inflation was around USD 80/ton in the period from Jan-Sep 2022 compared to Jan-Sep 2019. However, Suzano did not experience this cost inflation, as its costs decreased by around USD 35/ton in the same period. This was due to several factors, including: (i) the company's more productive forestry assets; (ii) its higher level of integration compared to competitors; (iii) the smaller average radius of its forests; and (iv) the devaluation of the Real. This cost differential compared to the sector was very significant and is expected to increase as the Cerrado project enters full production.

Suzano's increasing cost differential compared to other companies in the sector creates a very significant structural profitability cushion. Here, as in the examples in other sectors mentioned in this letter, we are observing an increase in the competitive differential that is not being properly appreciated by the market.

The investment in Suzano has an additional attractive factor, which is, in our opinion, the stock price being based on an excessively short-term market view. As the company invests in the Cerrado project, debt increases without a corresponding increase in earnings. Since the project will only start production in mid-2024, the earnings impact will only be adequately reflected in 2025. Naturally, the simplistic EV/EBITDA calculation remains inflated until the project's completion, and free cash flow will be limited in the 2023/24 biennium, as cash generated by operations is being invested in the expansion project.

The numbers that the market is currently observing are depressed by the temporary effect of investing in a project with a high IRR and that generates a lot of value for shareholders. These numbers are not very important in our view. What is more important for us is that once the project is completed, we see a recurring FCF Yield of over 15% using long-term price assumptions that we consider conservative.

Final Remarks

We understand investors' concerns about a more challenging macro environment, with potential worse prospects for Brazil. It is a legitimate concern, as it could indeed impact the growth and/or profitability of companies in different sectors.

However, we believe that the long-term success of our investments is much more closely linked to the individual capabilities of each of the companies in which we invest, rather than the evolution of the country. We understand that the majority of companies in our portfolio, due to their capabilities, are expanding their respective competitive advantages over their competitors and are likely to consolidate market share over the next few years, an effect that can prove very powerful for shareholder returns.

The Brazilian stock market has many successful stories, despite the mediocre evolution of the country.