Investor Letter 1st Half 2023

Introduction

In this letter, we explore in greater detail a crucial aspect of our approach to investment analysis: evaluating how investees allocate capital.

When considering a new investment, it is crucial that we conduct a detailed appraisal of the business, its competitive position, suppliers, financial position, the caliber of its management team, its governance structure, and other aspects. Equally vital is assessing the business's capital allocation strategy. From our experience, this latter consideration is often overlooked by investors.

The way a company allocates its capital can be the difference between the success and the failure of an investment. Consistently well-executed capital allocation has the potential to generate substantial shareholder value over time. Companies that excel at this are often referred to as *compounders* — or businesses that multiply their value manifold. Conversely, poor capital allocation can erode economic value and make financial management significantly challenging. For instance, an ill-advised acquisition can lead to integration challenges, loss of focus, and financial management challenges, all the more so when too much risk is taken in the acquisition.

A forward-looking assessment of a business's capital allocation practices is a key challenge for Oceana's analysis and management team. These assessments look at numerous variables and involve significant effort. The first step is, of course, evaluating the company's historical capital allocation — a painstaking but not overly complex task. Considerably more intricate is the assessment of other intangible factors, such as: (i) the opportunities the company has for future capital allocations; (ii) the position of potential competitors vying for the same assets and market space; and (iii) financial discipline and incentives for executives, the board of directors, and controllers. When it comes to controllers specifically, it is often the case that their objective is not necessarily to maximize shareholder value. Although conflicting incentives are more prevalent in some state-owned enterprises, they are not uncommon in private businesses as well, where at times the size of the company holds more importance than it should for the controller or executive body. In these cases, economic rationale and shareholder returns are sacrificed for the misguided incentives of certain controllers or executives.

Any forward-looking assessment of a company's capital allocation is a laborious, complex exercise often involving an inherent degree of subjectivity. In these assessments, the time that analysts have spent tracking a company can make a difference by providing the opportunity to observe people's — executives' and directors' — behavior across different market cycles.

Over the nearly fifteen years since Oceana's inception — we turn 15 years old in October — our investors have benefited from investing in companies that have demonstrated successful capital allocation, generating substantial shareholder value. In many of these businesses, the value created through sound capital allocation has been so significant that, even after substantial stock-price gains, these companies have continued to offer an adequate margin of safety, justifying our continued investment.

"The ideal business is one that earns very high returns on capital and that keeps using lots of capital at those high returns. That becomes a compounding machine." - Warren Buffett

Regrettably, there have also been instances where our investees made misguided and undisciplined capital allocations, resulting in significant losses for shareholders. When this happens, it is important that we conduct a sober assessment of what went wrong. Mistakes are an inherent part of the process — demanding a 100% success rate would mean no company invests a cent for the rest of its existence. But it is crucial to evaluate whether these mistakes may have been caused by misguided incentives, a lack of financial discipline, or inadequate governance in the board of directors and executive body.

To illustrate the importance of sound capital allocation, we will now discuss selected examples from our investments. We will address instances where sound capital allocation moves generated substantial shareholder value, as well as moves that ultimately proved to be the wrong ones — either because they eroded economic value or introduced additional complexity without a clear economic benefit. We will explore examples from Equatorial, Aliansce Sonae, and Vibra.

Equatorial

We began investing in Equatorial over a decade ago when its market cap was around BRL1 billion — merely a fraction of its current — and staggering — BRL36 billion market cap. The company remains an important part of our portfolio, and the success story behind this investment offers useful food for thought.

Equatorial's success can be largely attributed to the exceptional composition of its management team and board, adept at both steering the company towards operational excellence and making effective capital allocation decisions over time. Its executives have consistently demonstrated their ability to allocate capital strategically in a way that has created enormous value over time. Some of the management team's key differentiators include:

(i) Expertise in turning around complex assets, enabling them to acquire electric utilities in markets with limited competition.
(ii) Swift decision-making in situations where prospective returns appeared highly favorable, as exemplified in the transmission auctions of 2016-17.
(iii) Smart financial engineering that enabled the company to acquire diverse assets over time, preparing it to navigate adverse market conditions.
(iv) Financial discipline, with responsible capital allocation resulting in returns consistently surpassing industry averages.
(v) An in-depth understanding of industry regulations, enabling the company to navigate regulatory frameworks effectively. This has positioned Equatorial at the industry forefront for efficiency and allowed it to capitalize on regulatory arbitrage in generation.

The company's management capabilities provide a structural competitive advantage that, due to its qualitative nature, cannot be precisely captured in prospective modeling but has historically translated into significant value creation for the company.

Some of the most significant milestones in Equatorial's timeline were in the power distribution segment. Initial acquisitions included CEMAR (Maranhão) and CELPA (Pará), which are now its most mature concessions. More recently (2019), the company expanded its portfolio with the acquisitions of CEPISA (Piauí) and CEAL (Alagoas) from Eletrobrás following the privatization of its distribution businesses. 2021 saw the addition of CEEE-D (Rio Grande do Sul) and CEA (Amapá), also as a result of privatizations. Finally, in 2022 it acquired CELG (Goiás) as part of the sale of Enel.

Looking back, two common threads stand out in its acquisitions of distribution utilities: (i) with the exception of CELG, all acquisitions were done through auctions, in which Equatorial bid independently, and (ii) turnarounds were completed faster than either the market or the company anticipated. These aspects illustrate the company's operational excellence, with its ability to operate concessions considered unattractive by other industry players while delivering results that surpassed expectations.

Currently, we still see acquisition opportunities in the distribution segment across two primary fronts: (i) inefficient companies struggling to remain solvent; and (ii) portfolio repositioning by multinational corporations — particularly European companies prioritizing major capital allocation opportunities closer to home, reflecting their decarbonization commitments.

Beyond acquiring distribution utilities, the company has proven itself to be nimble and adept at making targeted moves in other segments when market conditions present opportunities. A prime example is its foray into the transmission segment during the 2016-2017 auctions. Once again, Equatorial capitalized on a scenario of low competition, generating substantial value for shareholders. More recently, the company has entered the sanitation and renewables sectors.

We conducted an exercise to estimate the returns on the company's different capital allocation moves, factoring in both realized outcomes and our future projections. Our conclusion is that in the distribution segment, since the acquisition of Celpa, the company has consistently delivered capital allocations with leveraged returns exceeding 15% in real terms. In the sanitation and generation segments, in which it was a relative newcomer, Equatorial generated returns in the high teens. In transmission, the company seized an excellent market opportunity, achieving a return higher than 20% — one that, even when adjusted for risk, was notable.

Given its stellar track record, we are confident the company can continue to generate value in the distribution segment — which offers promising opportunities in the coming years — or in other segments, as they have successfully done in the past.

"We believe that when the right talent meets the right opportunity in a company with the right philosophy, amazing transformation can happen." - Reid Hoffman, founder of LinkedIn

Aliansce Sonae

Exchange-listed shopping mall companies in Brazil have always been recognized for the quality and resilience of their assets but have not particularly been acknowledged for creating value through sound capital allocation. A case in point is the significant number of successful capital-allocation moves that Aliansce Sonae has made in the last five years.

Following the announcement of its merger with Sonae in mid-2019, Aliansce's share price had a substantial gain. At year-end 2019, the company seized a highly favorable market opportunity and issued shares at a cap rate of 6.5% (annual income measured by net operating income (NOI) divided by the investment). The resulting deleveraging has paved the way for future consolidation moves.

During the Covid-19 crisis in 2020, shopping-mall stocks dropped significantly, and Aliansce used its deleveraged balance sheet to buy back shares at very depressed prices — approximately 40% lower than the capital increase level in 2019.

In 2022, still benefiting from having the most deleveraged balance sheet in the sector, Aliansce merged with BrMalls, in what became the most transformational play in its history. The merger involved a cash payment of BRL1.2 billion, at approximately a 12.5% cap rate. It was, in our view, an excellent move at an adequate price. The newly formed company now has a more well-rounded shopping mall mix that is more resilient than Aliansce Sonae's previous portfolio, as well as offering significant G&A synergies. We believe that the Board and CEO did a stellar job in concluding the transaction at attractive price levels.

The new company formed by the merger with BrMalls became more leveraged. To return to more suitable/conservative leverage levels, Aliansce's management has responded effectively over the past 12 months by divesting from several less-dominant malls in its portfolio at attractive price levels (~BRL1.5 billion at around a 9% cap rate).

Aliansce Sonae has successfully leveraged existing distortions between the public and private shopping-mall markets to generate immense value for shareholders. There were some occasions when Aliansce sold assets at a more attractive cap rate than its shares were trading at, and others when it issued shares at a lower cap rate than the private market would pay for its assets.

More recently, Aliansce took another significant step with the introduction of a minimum dividend policy offering a 50% payout, generating predictable shareholder returns by providing a substantial payout in a historically predictable sector.

While we have adjusted our position due to strong share price gains, we remain highly confident in the company's management.

Vibra

In February 2021, Vibra appointed a new CEO with extensive experience from the electric utility sector. Just over six months after his arrival, in October 2021, Vibra announced a transformational acquisition, venturing into a new sector with the acquisition of a major renewable energy platform, Comerc.

The company — once viewed by the market as a cash cow, with predictable operational cash flow translating into robust dividend streams — ventured into a new segment with a sizable market. This eroded the balance-sheet space for dividends and exposed the company to the challenges of the distribution segment, which had faced a string of turbulent years.

While we understand that this was part of the company's strategy to position itself for the energy transition, we question the speed and return at which this was implemented. The company's abrupt entry into the segment at a return lower than the cost of capital, compromising a significant portion of its balance sheet, was a move we believe to have been misguided. Even more surprising to us was the brief due diligence process. We believe this showed a certain level of weakness in governance, along with a significant increase in balance sheet risk due to higher leverage.

It is our view that the capital allocation process for an asset outside the company's core activity requires a higher standard of diligence than usual, given the knowledge gap most executives and board members have about the new business. We did not observe this enhanced due diligence in this transaction, let alone a return that would compensate for the risk of a fast-tracked process that was more susceptible to misjudgment. We estimate a return close to 8% in real terms on the acquisition of Comerc, a level below the company's cost of capital.

In July 2022, the then CEO of the company and the main advocate of the acquisition resigned, increasing the sectoral knowledge gap in the company shortly after its landmark entry into the renewable energy segment. It was undoubtedly a suboptimal sequence of events.

However, we believe that there are ways to mitigate the less-than-optimal capital allocation. While we accept the argument that there are synergies to be captured between Vibra and Comerc in the trading and distributed generation segments, we are not convinced of the strategic benefit of maintaining regular generation assets within Vibra. Conventional generation assets represent just over 50% of the company's total value. Given that it operates as a generator without the flexibility afforded by energy trading, we believe the potential synergies with Vibra are limited. In our opinion, carving out this segment could help alleviate the adverse effects of this capital allocation.

More recently, the company proposed a substantial capital increase of BRL10 billion. While we acknowledge the argument that some level of flexibility is necessary and desirable, we are uneasy about voting in favor of such extensive flexibility for the company, considering that: (i) it has in the recent past made a significant capital allocation move with returns below its cost of capital; (ii) while we recognize that the sub-optimal capital allocation decision was made by the previous management, the current board and executive leadership have too short a track record to judge whether we can expect sound decision-making in the future; and (iii) since the entry of the new chairman, communication has become more restricted, making it challenging to understand the long-term strategy of the company's new management.

We voted against the proposed capital increase, but the majority of shareholders dissented from our position. We have been wrong on numerous occasions throughout our 15-year history, and in this instance, we hope to be proven

wrong once again.

Currently, despite still trading at attractive price levels, Vibra holds a less significant position in Oceana's portfolio.

Conclusion

The importance of capital allocation decisions cannot be understated. Companies can create a lot of value through strategic capital allocation, becoming genuine *compounders* and lucrative investments over many years. On the flip side, companies can erode shareholder value through misguided acquisitions or capital allocation missteps over time.

Predicting future capital allocation is an ongoing exercise. We have seen undisciplined companies transform into effective capital allocators, whether through the introduction of new personnel, revamped processes, or an openness to innovative ideas. Conversely, we have seen good capital allocators become complacent or take excessive risks following a streak of successes. Valuation is an ongoing process, and in response to new developments, our assessment of companies can always change.

Once again, we wish to thank our investors for their enduring partnership and the trust they have placed in Oceana.