

# Brazil From a Value Investor's Perspective



# Summary

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- 1. Taming Inflation – a tale of 15 years**
  - a. Where we are coming from**
  - b. Where we could be headed**
  
- 2. Key strategies that worked for us**
  
- 3. Three investment ideas for the next few years**

# Taming Inflation: A tale of 15 years

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**Recent Brazilian macro economic history can be divided in three phases:**

**1. Initial efforts to curb inflation (Jul/94-Dec/98)**

- Artificially overvalued currency peg
- Very high real interest rates
- Growing current account deficits and foreign exchange debt
- Lower inflation boosts investment and productivity

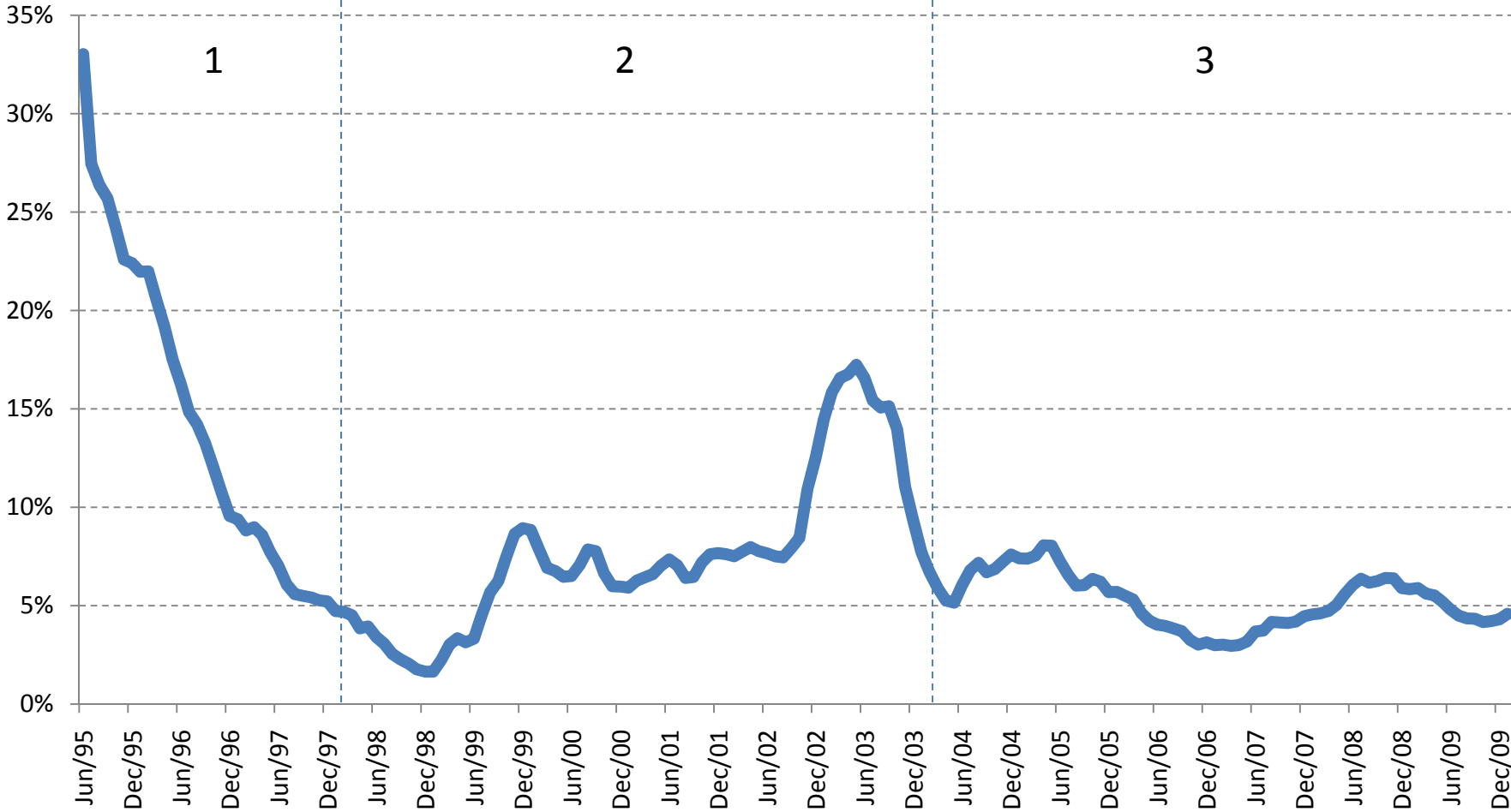
**2. Fixing the collateral damage (Jan/99 – Dec/03)**

- Extended period of undervalued currency
- Beginning of interest rate and sovereign debt reduction cycle
- Improved current account and foreign debt
- Poor economic growth (subdued investment and productivity)

**3. New growth cycle takes shape (04 - ??)**

- No foreign exchange debt / lower overall sovereign debt
- Currency back to “normal” / lower interest rates
- Growth in credit penetration
- Formalization, investment and productivity break out.

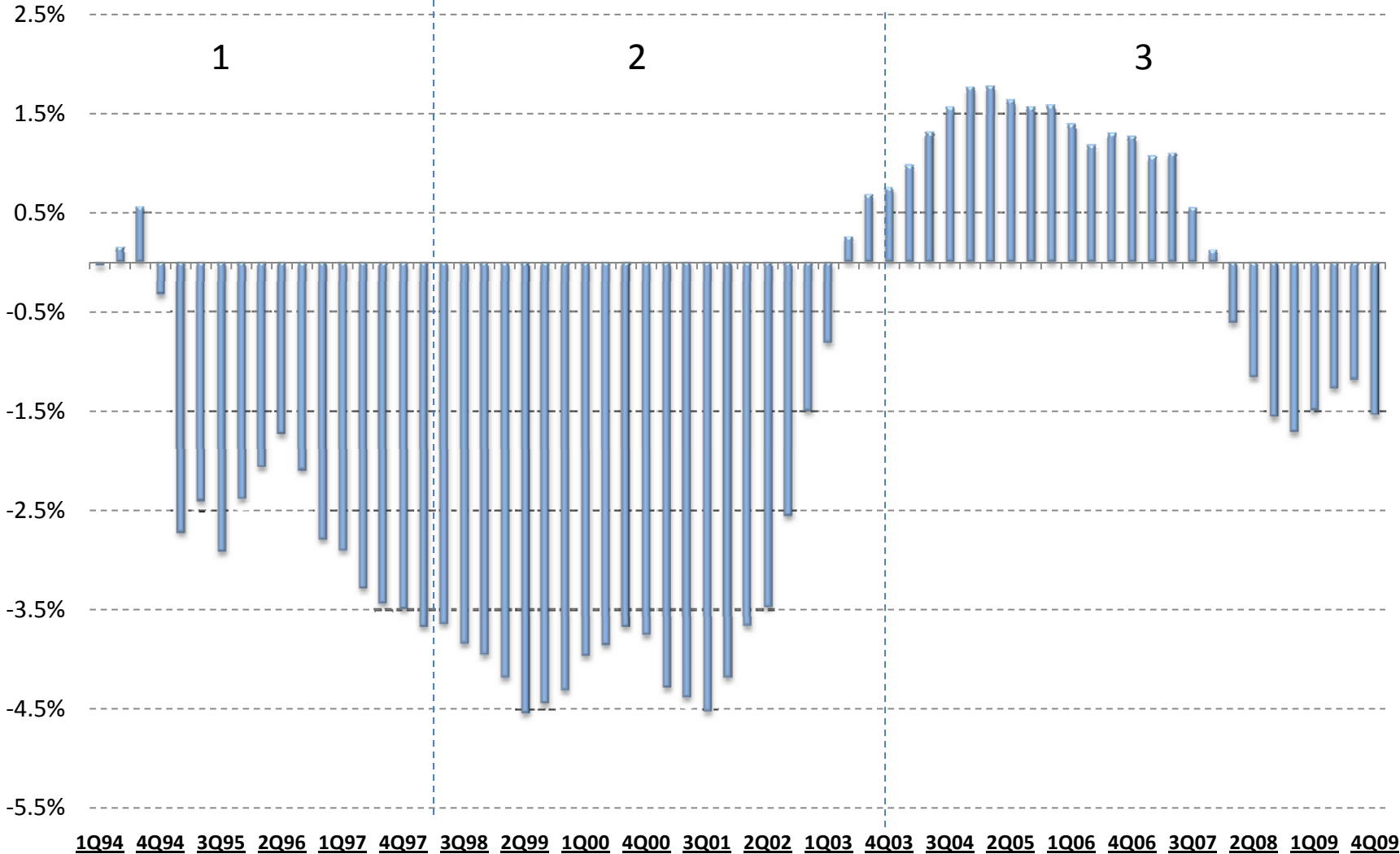
# Where we are coming from: Inflation Index (IPCA) - TTM



Source: IBGE



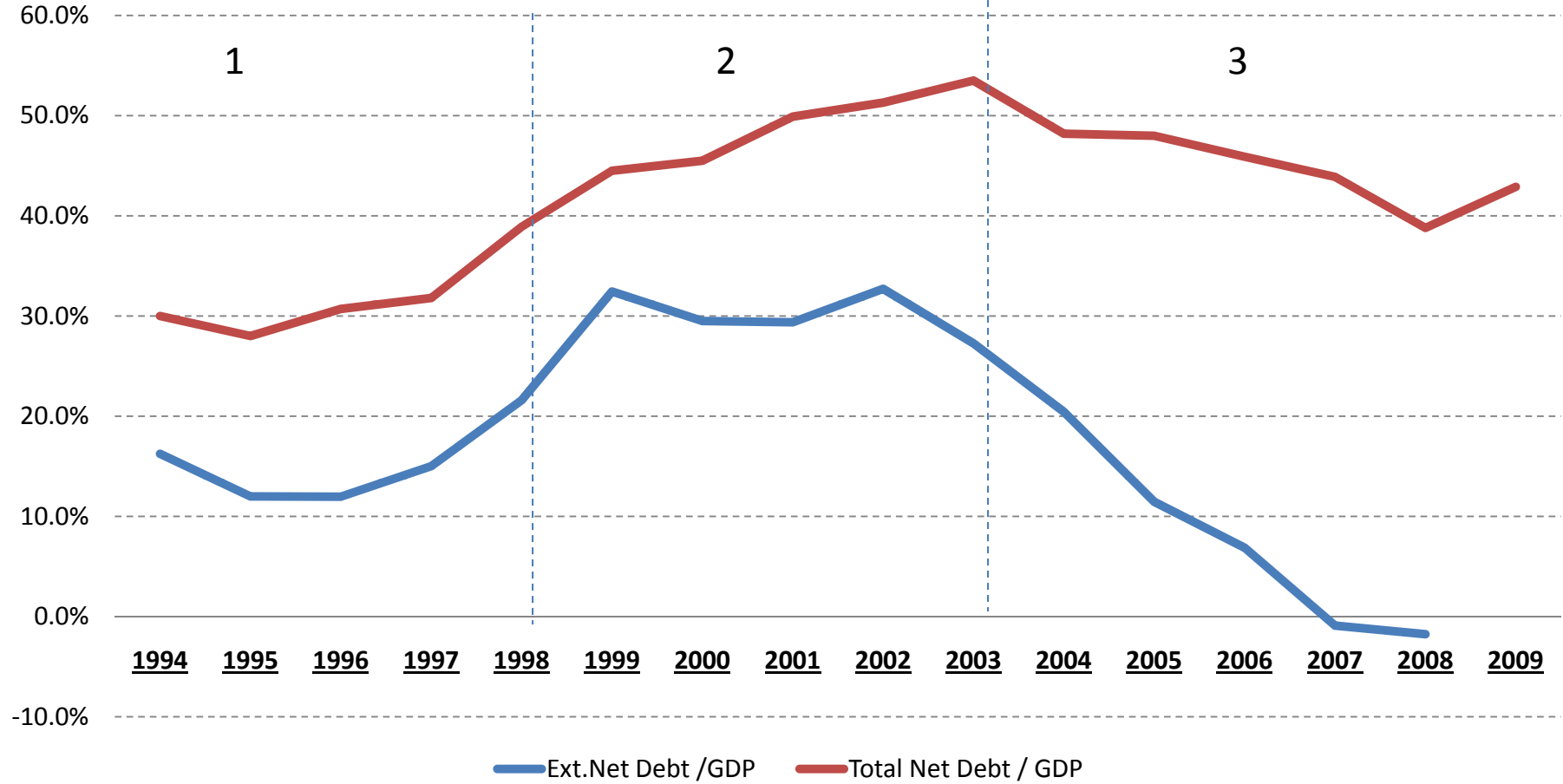
# Where we are coming from: Current Account (as % of GDP)



Source: Central Bank of Brazil



# Where we are coming from: Government Debt (total and external)



Source: Central Bank of Brazil

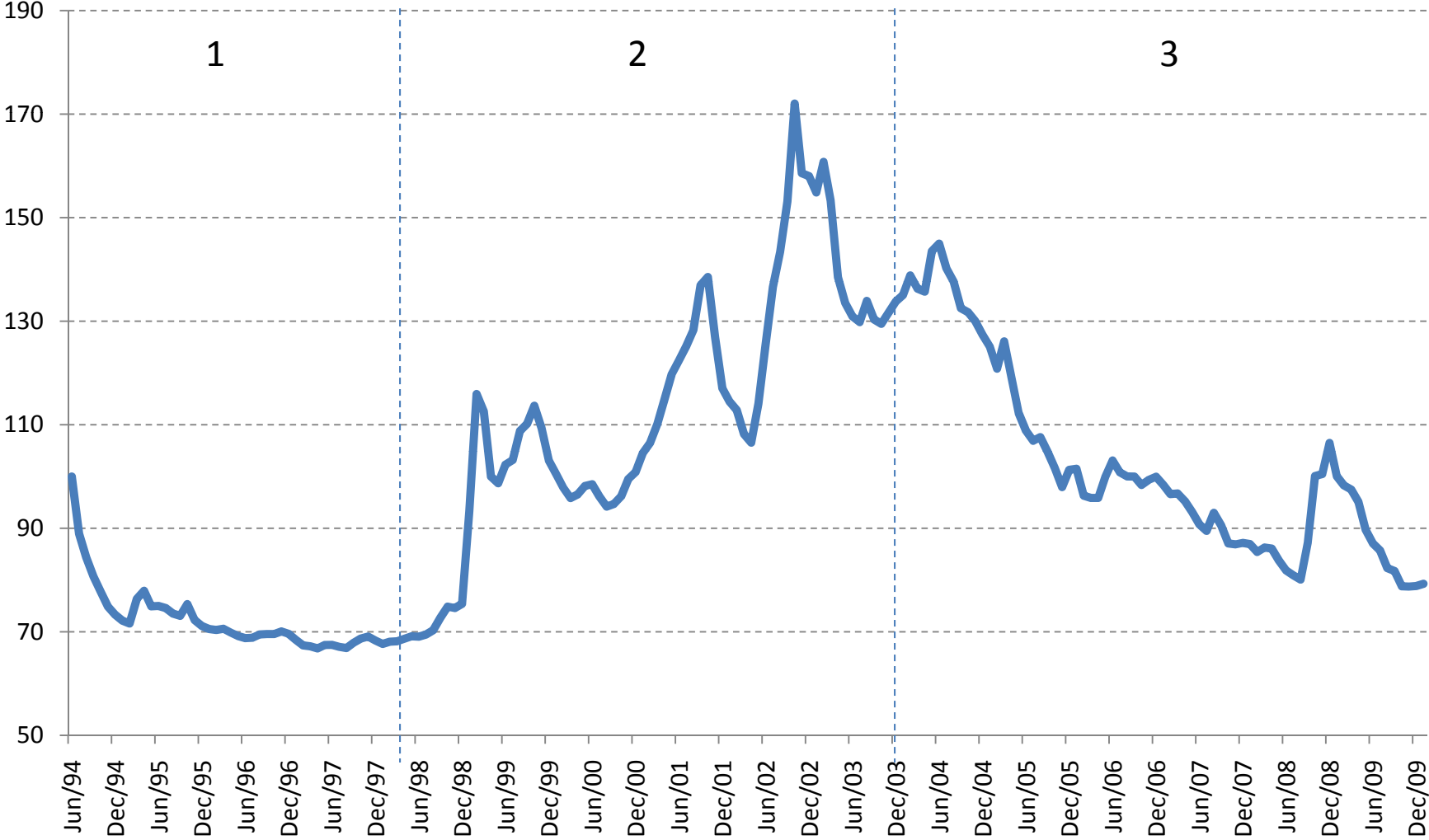


# Where we are coming from: Interest Rate (SELIC – Overnight rate)



Source: Central Bank of Brazil

# Where we are coming from: FX – BRL/USD, adjusted for inflation

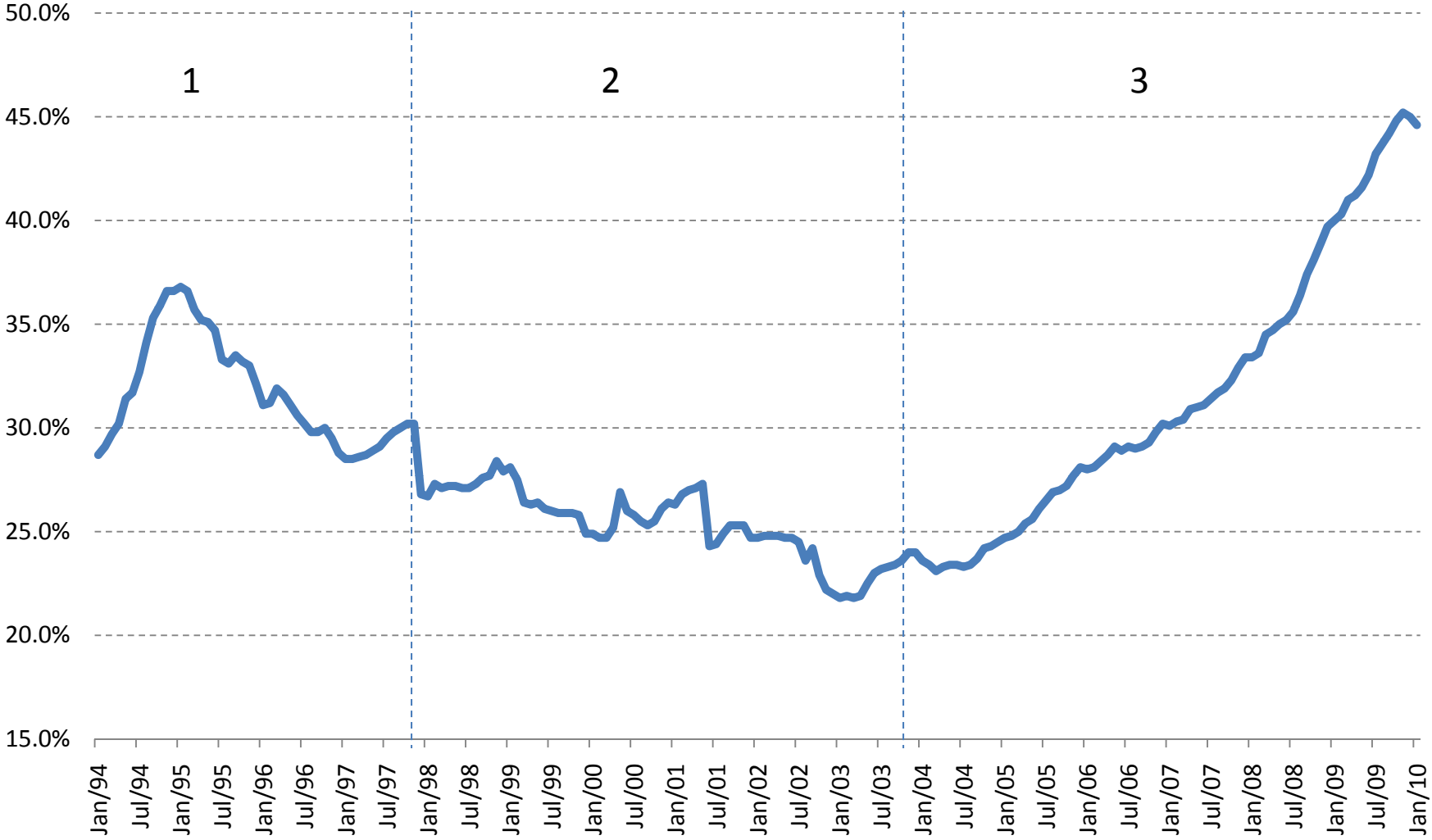


Source: Central Bank of Brazil





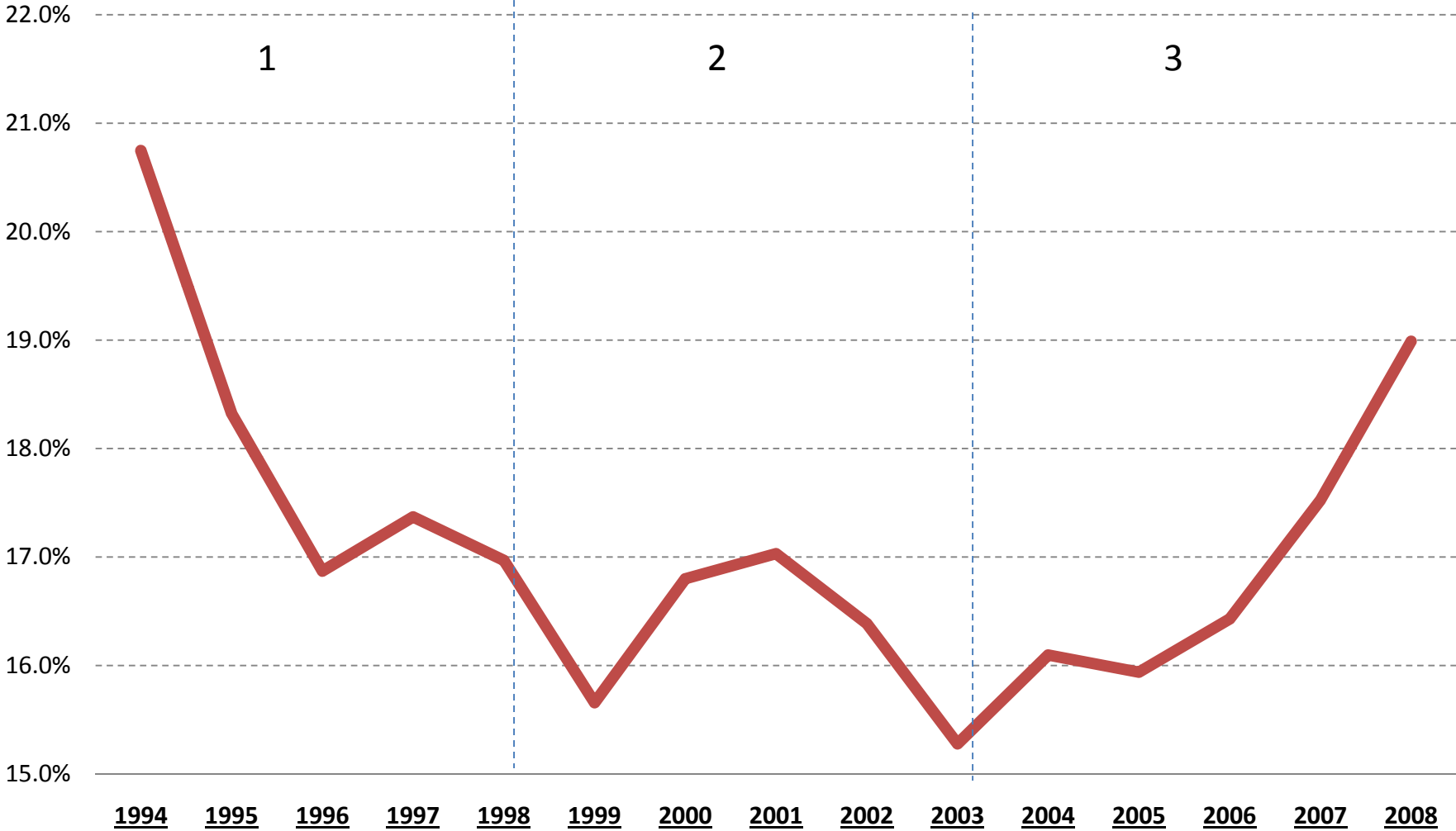
# Where we are coming from: Total Credit/GDP



Source: Central Bank of Brazil



# Where we are coming from: Fixed Capital Investment / GDP



Source: Central Bank of Brazil

## Where we could be headed

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### Having dealt with the severe macro economic imbalances...

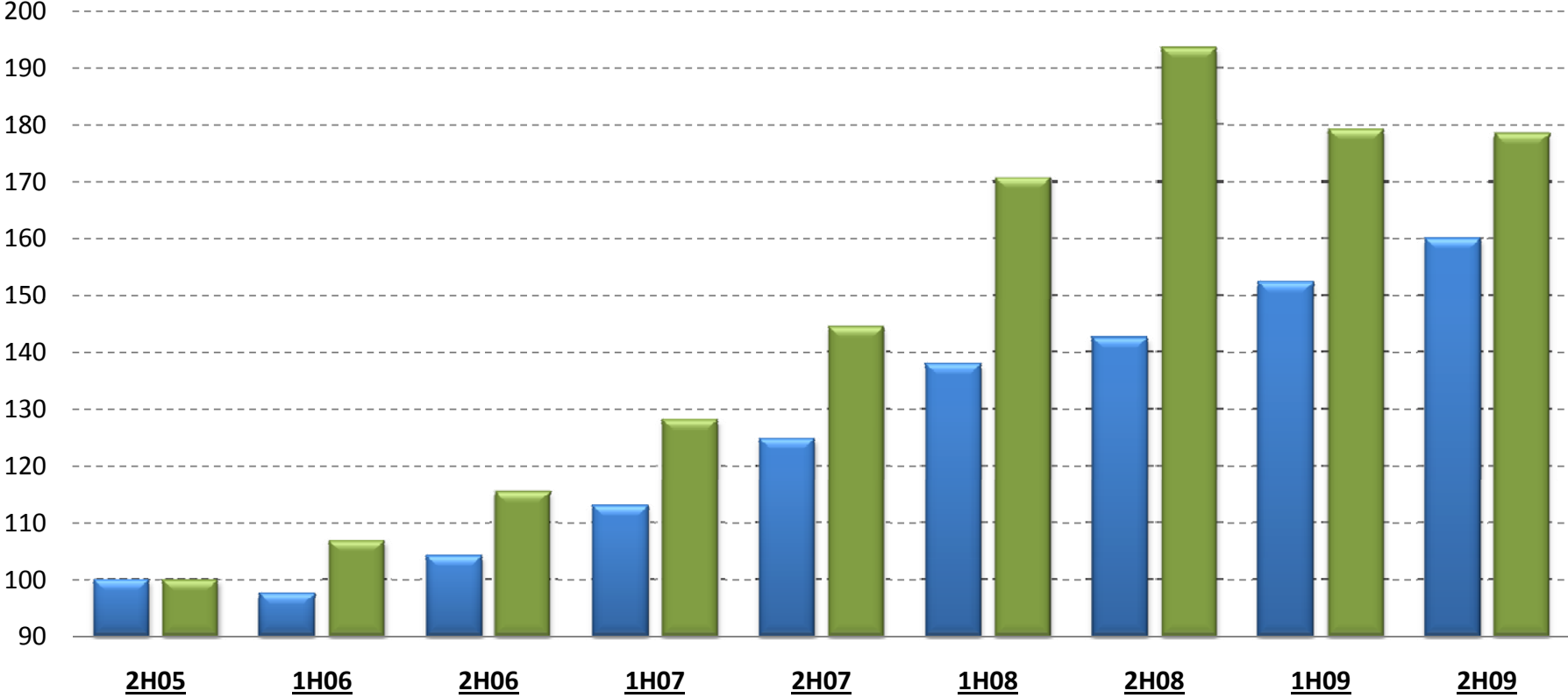
- External accounts in order
- Sovereign debt under control
- Inflation normalized
- Well developed and stable banking system



### ... a new set of variables will play a key role in the future

- Tax evasion is plummeting / formal job market growing
- Capital markets are becoming deeper
- Productivity is well-positioned to take-off

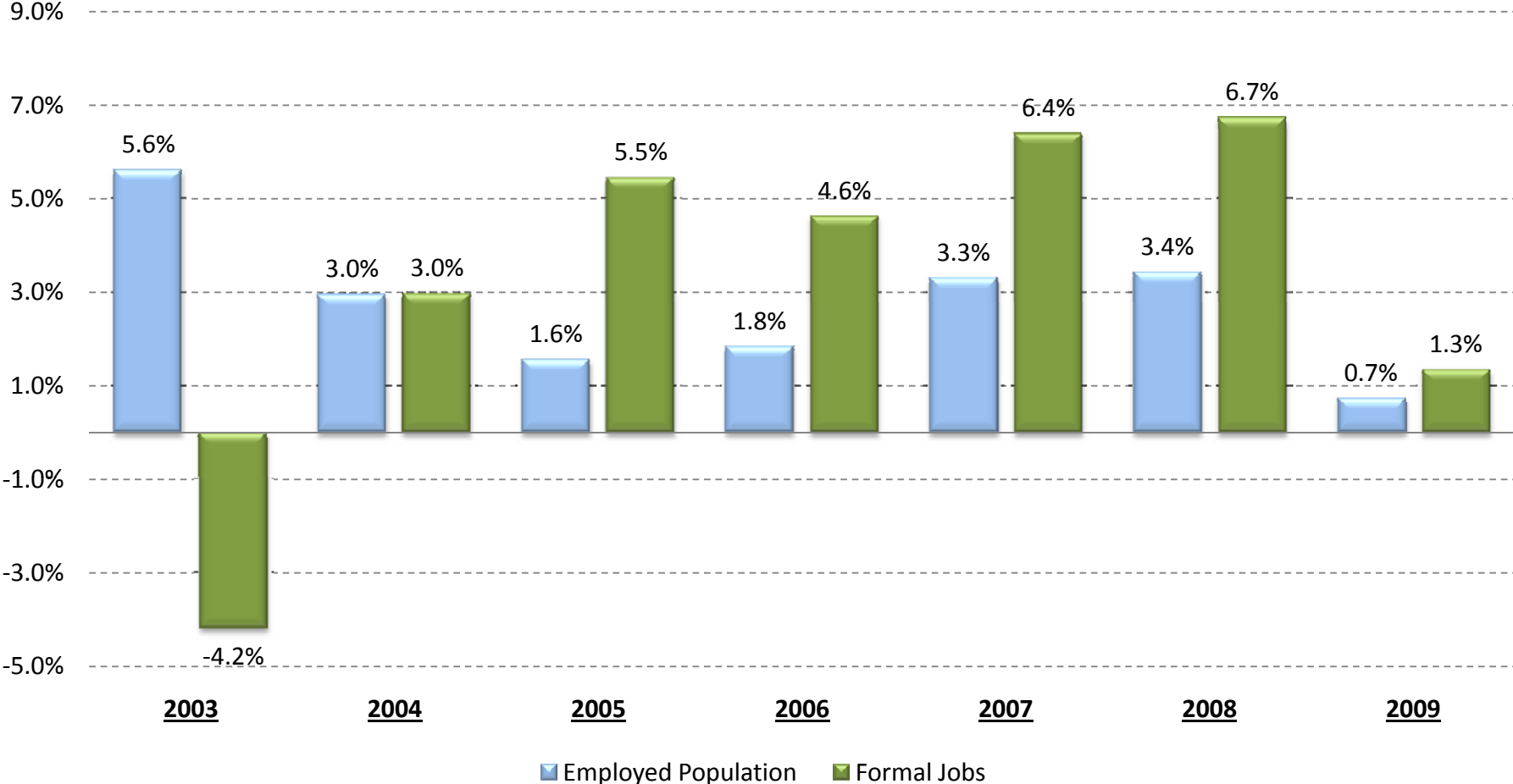
# Where we could be headed: Retail Sales in São Paulo x VAT collection



Source: CONFAZ and IBGE

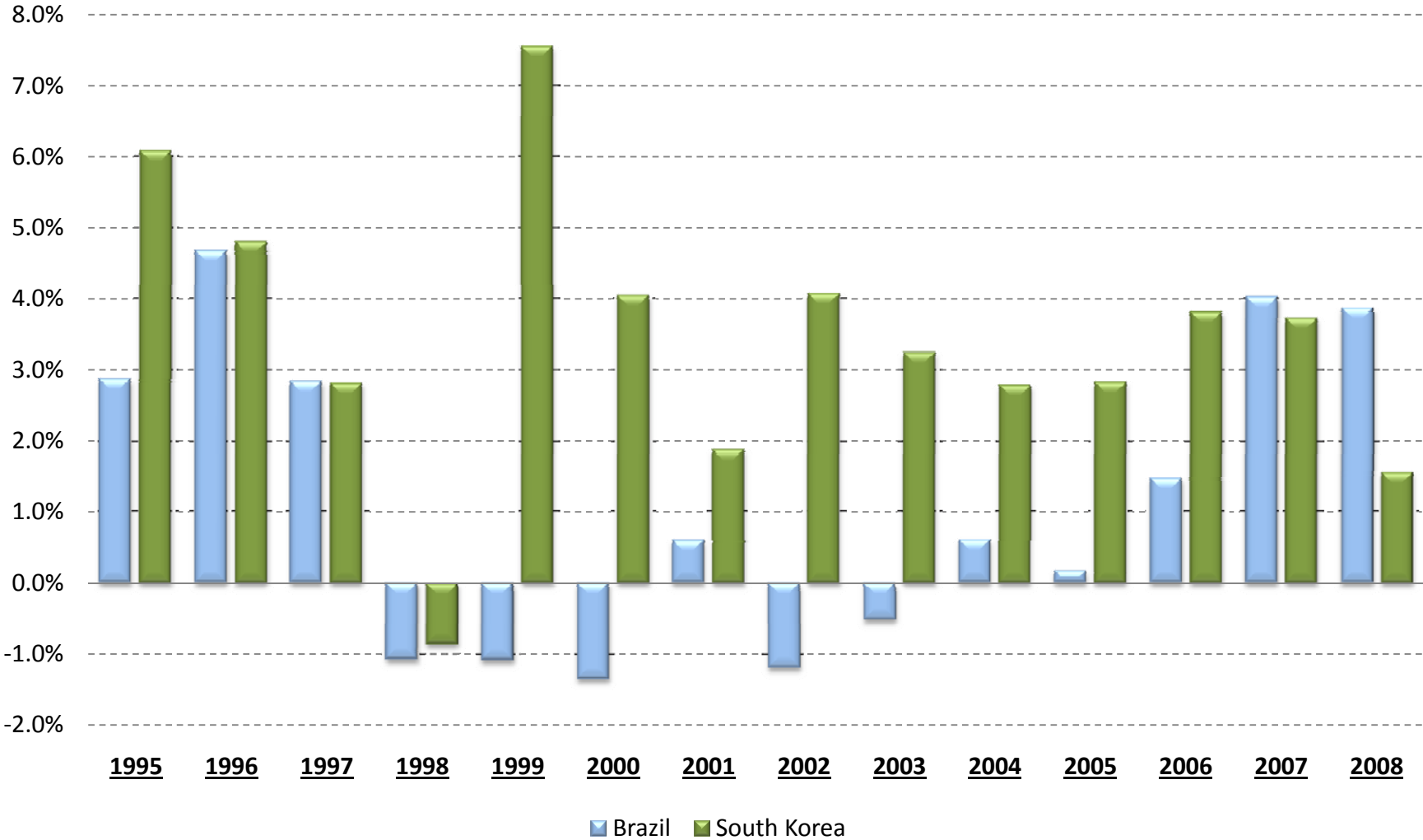
■ Retail - SP   ■ VAT from Retail SP

# Where we could be headed: Growth of Employed Population x Formal Jobs



Source: IBGE

# Where we could be headed: Change in Productivity Index (Brazil x Korea)



Source: International Labour Organization



## Where we could be headed: Dramatic changes in Capital Markets

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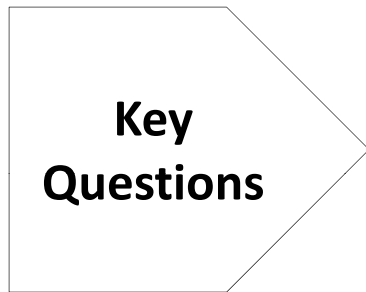
**Capital  
Markets  
Recent  
Changes**

- **More than 100 companies went public in 5 years (less than 10 in previous 15 yrs)**
- **At least another 50 issued secondary public offerings**
- **Almost BRL 200 billion (USD 100 billion) were raised**
- **Ownership and corporate governance have made significant strides**
- **Brazilians are developing an equity ownership culture**
- **Market for BRL denominated corporate debt is emerging**

## Key strategies that worked for us

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But, what does it all mean for a long term equity investor?



- How different is it to invest in equities in this environment?
- Should we think about businesses differently?
- Does it pay to be long term oriented?



## Key strategies that worked for us

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Through the years, selective stock picking paid off:

- Competition trumps growth
- Dominance over distribution makes for the deepest moats
- Understand the macro but don't over emphasize its importance
- It pays to think long term when everybody else is momentum-driven
- Good businesses may turn out to be bad investments if interests are misaligned

**So, it's not so different after all**

## Three investment ideas for the next few years

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### Common characteristics:

- **Privileged competitive position**
- **Benefiting from the macro economic trends**
- **Managed by competent and trustworthy people**
- **Trading at reasonable valuations**

# TOTVS

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## Company Highlights

- Largest ERP software provider in Brazil
- Focus on small and mid-sized enterprises
- 40% market share in Brazil. Over 60% in core markets (less than 250 employees)

## Market Cap

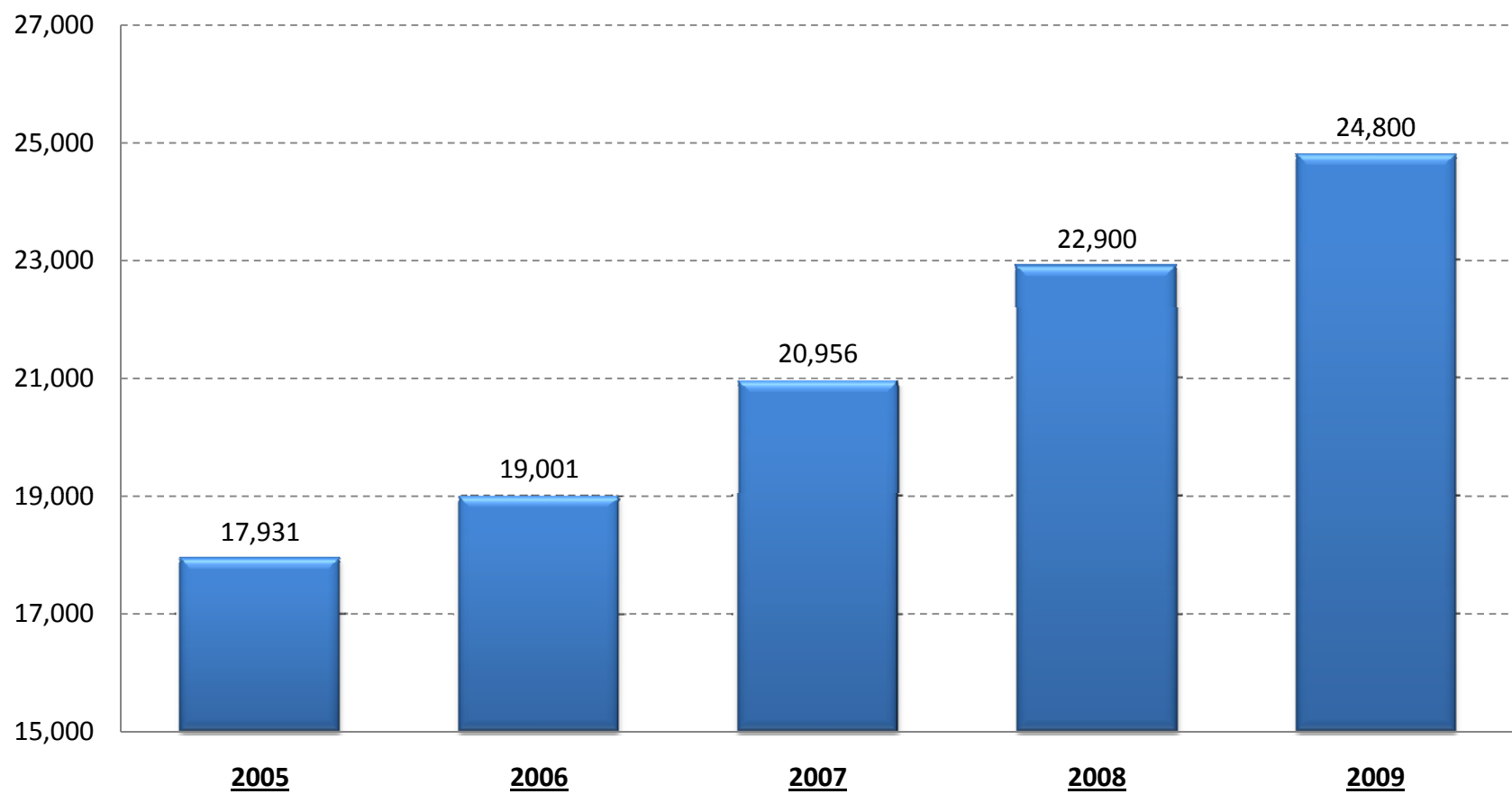
R\$ 3.6 billion

## Value Creation Drivers

- Significant barriers to entry in distribution/sales/implementation
- More than 450,000 companies with revenues larger than US\$ 8 million and less than 250 employees
- Penetration of ERP software below 8%
- Trend towards formalization (less “tax flexibility”) accelerating growth in penetration

## TOTVS: Fast Growing Active Client Base

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Source: TOTVS

# Ultrapar

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## Company Highlights

- Conglomerate that controls 2<sup>nd</sup> largest fuel distributor in Brazil
- Over 5,000 gas stations operating under Ultra's brand name ("franchisees")

## Market Cap

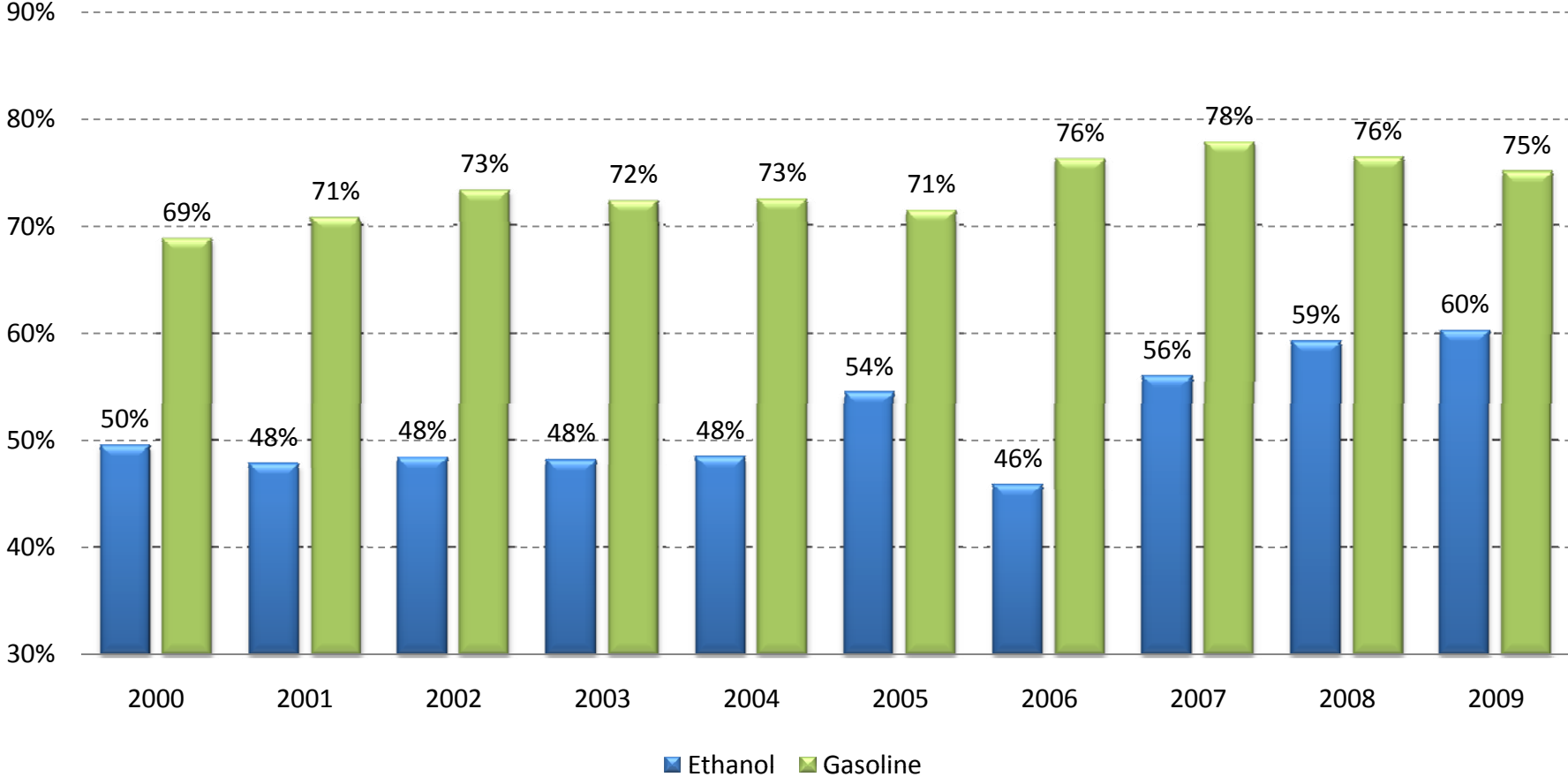
R\$ 12 billion

## Value Creation Drivers

- Formalization driving margins and market share
- Auto ownership driving volume growth
- Gas stations located in key areas with dominant micro-regional market share
- Possible spin-off / divestment from other less attractive businesses

# Ultrapar: Larger Players (Sindicom) retaking market share

## Sindicom / ANP total fuel consumption



Source: SINDICOM

# Banco Itaú

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## Company Highlights

- Largest financial institution in Brazil (by market cap)
- 10<sup>th</sup> largest in the world by market cap and 1st by ROE
- Dominant market share in key segments (consumer finance, credit card, mid-size companies)

## Market Cap

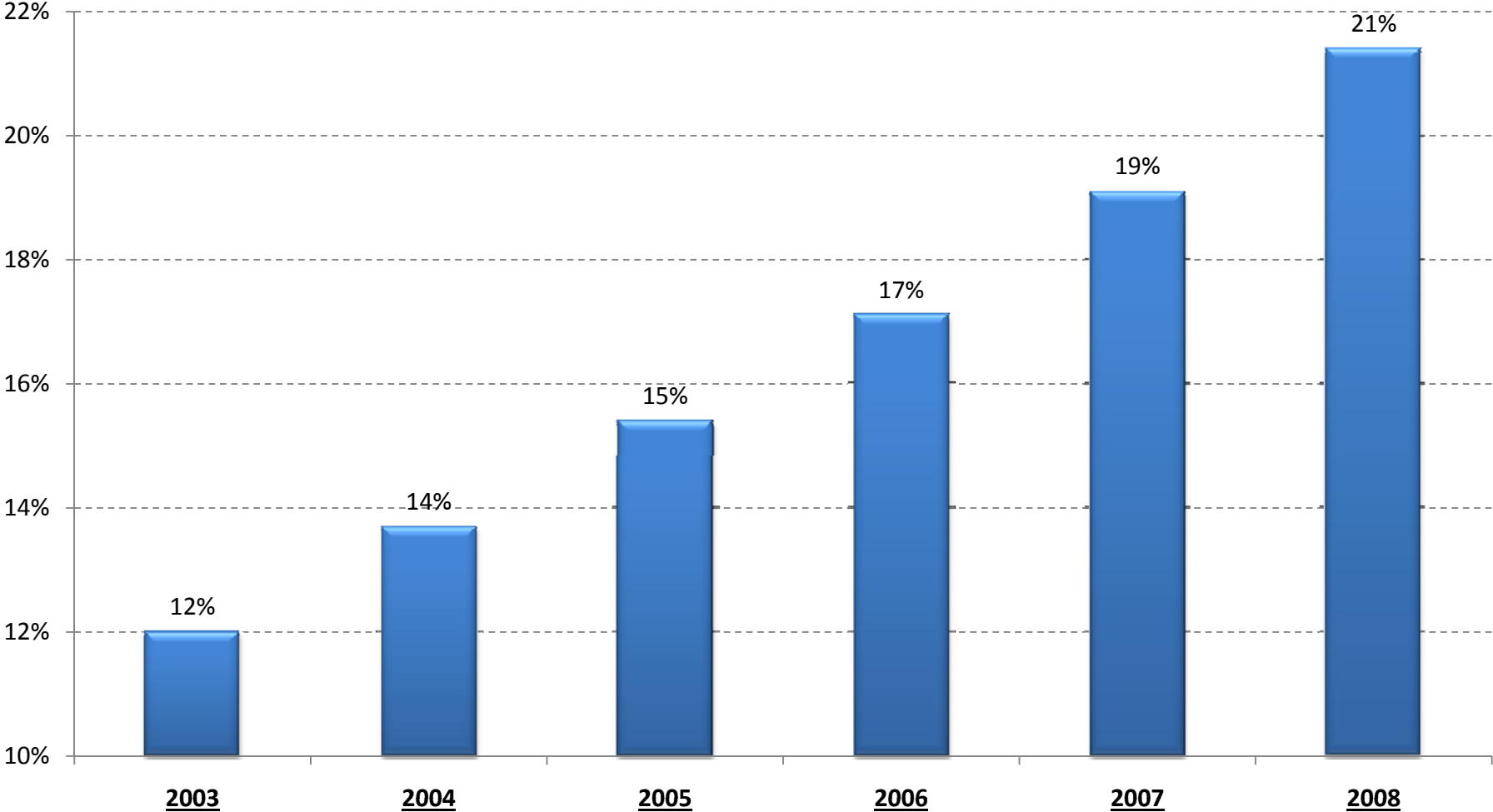
R\$ 165 billion

## Value Creation Drivers

- Exceptional management team
- Solid capital base (BIS ratio of 15%)
- Credit penetration growing fast (lower interest rates + formalization)
- Strong barriers to entry deriving from highly verticalized business model
- Partnerships with 350 retailers for issuance of credit cards
- 6 banks control 80% of the market
- Large part of profitability from transactional/franchise business (cards, asset management, fees)

# Banco Itaú: Credit cards are a major source of growth

## Credit card usage as % of family consumption



Source: Central Bank of Brazil



## Banco Itaú : A final note

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- Brazilian banks performed very well during the crisis and have emerged stronger
- Among many reasons, we think one should be singled out:
  - **STATUTORY DIRECTORS, BOARD MEMBERS AND CONTROLLING SHAREHOLDERS OF BRAZILIAN BANKS HAVE THEIR ENTIRE NET WORTH AT STAKE IF THEIR BANKS FAIL. ALL THEIR PERSONAL ASSETS ARE FROZEN FOR THE DURATION OF THE LIQUIDATION PROCESS AND MAY BE USED TO COVER ANY SHORTFALL. THERE IS ALSO A TAIL OF 12 MONTHS**
- **Would the excesses in the banking industry in the US and Europe have happened if this rule had been in place?**