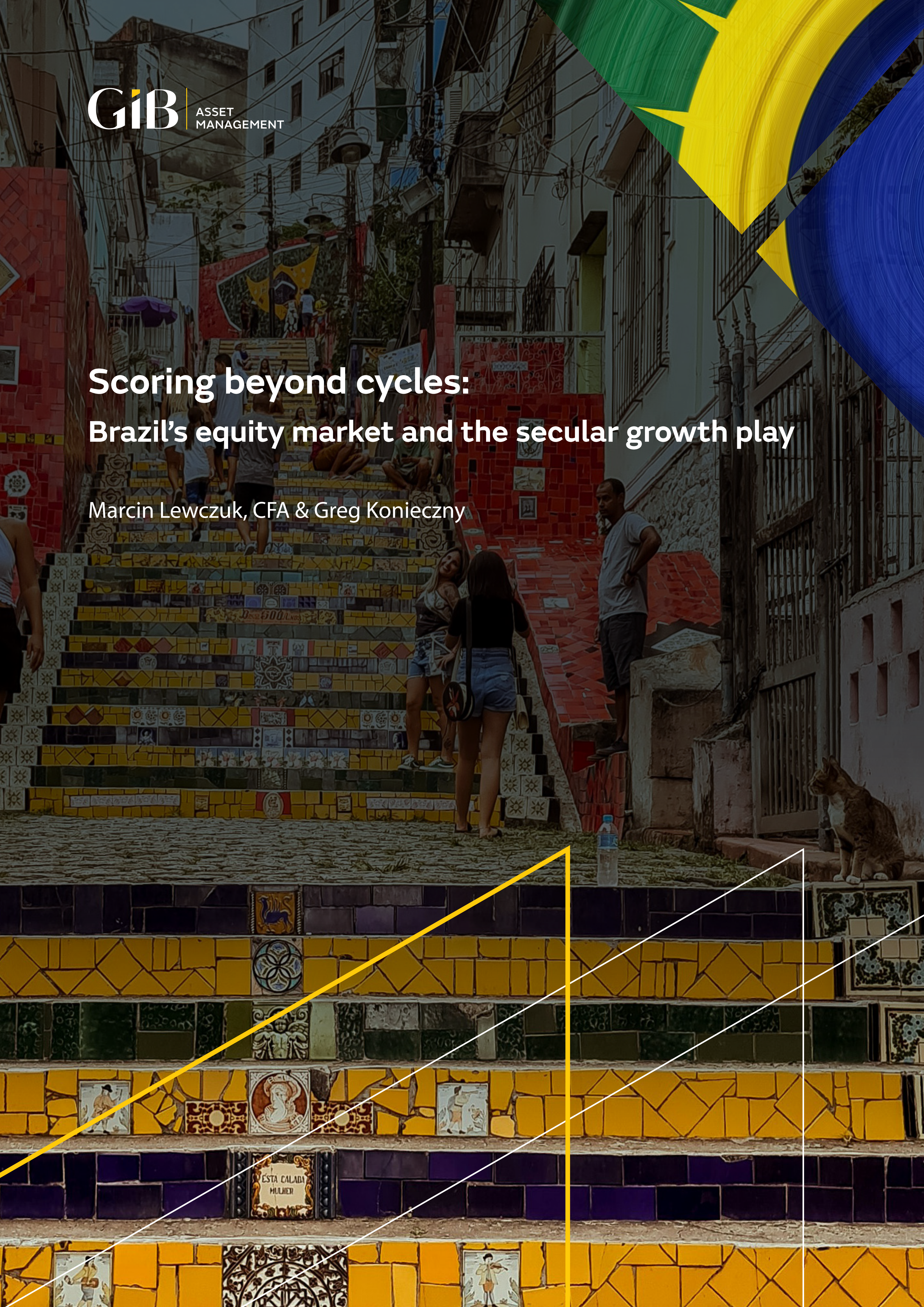
GIB ASSET MANAGEMENT



Scoring beyond cycles:

Brazil’s equity market and the secular growth play

Marcin Lewczuk, CFA & Greg Konieczny

Scoring beyond cycles:
Brazil’s equity market and the secular growth play

Executive Summary

- **Re-rating case**: Brazil's market, often undervalued and mistakenly seen as commodity-focused, is actually a thriving hub for growth in digitalization, e-commerce, software, and green technology.

- **Re-rating drivers**: Lower cost of capital, significant valuation discount and exceptional market profitability, set the stage for robust medium-term performance.

- **Fiscal reform impact**: Overlooked progress in fiscal reforms indicates a positive shift. Although short-term volatility is expected, it opens the door to long-term benefits and improves global risk perceptions.

- **Active engagement opportunity:** Brazil stands out with transparent, high-quality management teams eager for value-creating initiatives. This openness offers unmatched engagement prospects for investors like us.

From the pitch to the market: Uncovering Brazil's undervalued equity champions

Touching down in São Paulo, we were immediately swept up in the electrifying buzz of the Palmeiras vs. Sao Paulo derby and the vibrant anticipation of Carnival—a perfect prelude to our deep dive into Brazil's undervalued equity market.

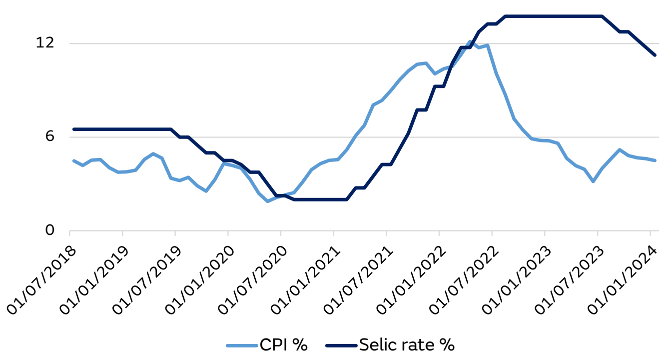
In our dialogues with local companies, a compelling comparison emerged: the transformation of iconic football clubs like Flamengo and Palmeiras into models of professionalism mirrors the metamorphosis of Brazil's equity market. Gone are the days when it danced solely to the rhythm of commodity cycles. Today, it is driven by a more complex beat, offering a rich tapestry of investment opportunities in booming sectors like financial technology, renewable energy, and software, all steered by management teams.

This evolution from volatility to predictability, from a commodity-centric past to a diversified future of secular growth, showcases the Brazilian equity market as an attractive, yet undervalued, arena for investment. It's a marketplace where innovation and resilience are the driving forces, much like the football clubs that have climbed up to global prominence through rigorous governance, financial discipline, and strategic planning.

Brazil unbound:
The compelling case for market re-rating

Inflation control and interest rate reductions: The outlook for Brazil's economy in 2024 is optimistic, with inflation under control and indicators pointing towards further reductions. Market participants now forecast a 3.8% inflation rate for 2024, suggesting growing confidence in the potential for Brazil's reference interest rate (Selic) to reach single digits by year-end. The expected reduction in the Selic rate to 9.0% by the end of 2024, from the current 11.25%, signals a positive impact on company earnings and overall economic activity.[1]

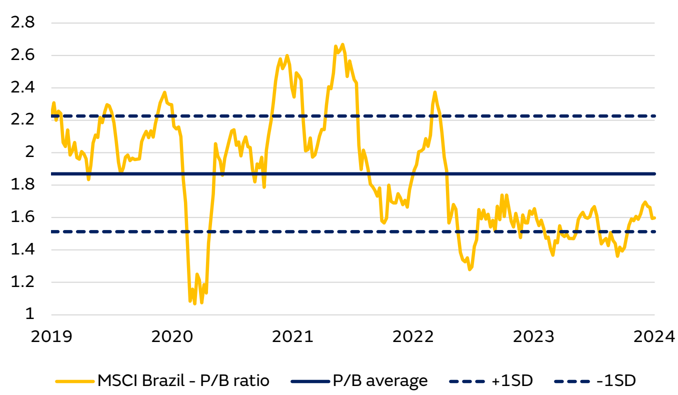
Chart 1: Brazil inflation vs. interest rates (Selic) – potential for near-term rate cuts[2]



Undervalued market with top-tier profitability

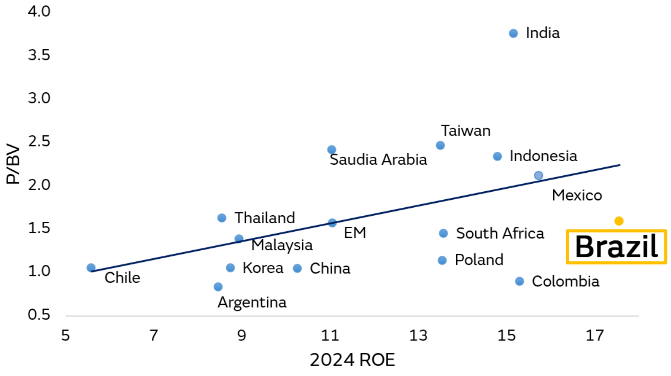
It may come as a surprise to many that Brazil boasts one of the highest Return on Equity (ROE) figures across emerging markets. Despite this impressive and improving profitability, Brazilian stocks remain significantly undervalued, trading close to one standard deviation below their 5-year price-to-book (P/B) average. Even when excluding the heavyweights in the energy and metals sectors, such as Petrobras and Vale, Brazilian equities are still priced at a modest 9.9x forward price-to-earnings (P/E) ratio. This combination of low valuations against the backdrop of strong macroeconomic fundamentals, notably robust trade flows, coupled with decreasing inflation and cost of capital, presents Brazil as an intriguing investment proposition. We are optimistic that this unique combination positions the Brazilian market for a strong performance in 2024 and beyond.

Chart 2: Brazil market valuation: A standard deviation below 5-year average amid rising ROE profile[3]



[1]Bloomberg, GIB AM Analysis (2024)
[2]Bloomberg (2024)
[3]Bloomberg (2024)

Chart 3: Undervalued Despite High ROE: Brazil's Position in Emerging Markets[4]



Capitalising on Brazil's revolution: Our portfolio's dive into digital and green futures

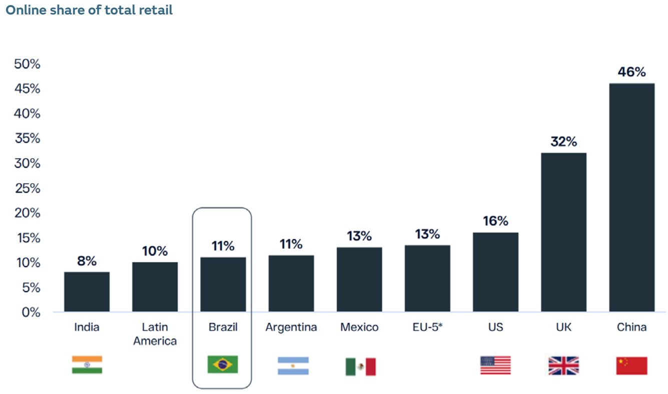
Innovations in financial services: Brazil outshines even the most developed nations with its forward-thinking financial technology sector. One of our holdings, a leader among digital banks, serves nearly 90 million customers with minimal physical infrastructure, leveraging remote work to ensure operational efficiency. This strategy has resulted in an exceptional Net Promoter Score (NPS) over 90, demonstrating unparalleled customer satisfaction and operational profitability.

Thanks to its cost advantage and superior user experience, the bank is now expanding beyond credit cards and consumer loans to penetrate markets that have historically been dominated by legacy players, including the payroll loan sector. We believe that with a clear cost advantage and a vast addressable market, the company will be able to continue reinvesting capital at high rates of return for the foreseeable future. In the longer term, our team strongly believes that the bank will be able to penetrate markets outside Brazil, where technological advancements and a customer-centric culture will enable it to thrive in new markets.

Empowering E-Commerce: During our visit to Brazil, we engaged directly with the management and operational teams of a pioneering provider in the online ecosystem for small and micro merchants, sharing a business model with notable similarities to the well-known Shopify. Given that online retail in Brazil is significantly less saturated than in other global markets, we're optimistic about firm's potential to capitalize on this growth opportunity.

The company is dedicated to enhancing the operational efficiency of small merchants with innovative solutions.

Chart 4: Brazilian e-commerce penetration is still very low comparing to other countries[5]



One standout feature we explored during our visit was the company's courier and logistics aggregation tool, which grants its customers access to shipping rates that are up to 70% less expensive than typical market prices.[6] This tool exemplifies business' competitive edge, as it directly addresses and alleviates common operational challenges faced by merchants, thereby fostering a strong loyalty among its user base. Such strategic advantages not only solidify the company's position but are instrumental in increasing the average revenue per user (ARPU) over time, by creating a substantial moat around its ecosystem and enhancing customer retention.

Strategic cooperation: ERP Software meets banking. Another exciting development within our portfolio is the ERP (Enterprise Resource Planning) software business we hold, that has entered into a joint venture with one of Brazil's largest banks. This collaboration is a prime example of how two distinct entities can leverage their competitive advantages to create a more robust offering for their clients. Their ERP software business possesses a complex understanding of its clients' financial standings, business models, and cash flow trends. This knowledge is incredibly valuable to the banking partner, enabling it to tailor its loan pricing with greater precision and efficiency. By doing so, we believe that in the future the bank will be able to offer competitive credit financing solutions to small and medium-sized enterprises (SMEs), benefiting from the low-cost funds it has access to.

[4]Bloomberg (2024)
[5]Company investor presentation; Atlantico (2023)
[6]Company investor presentation (2023)

Advancing green technology and EV: During our visit to the one of the world's largest production facilities of our industrial sector investment, we had the opportunity to observe firsthand the manufacture of electric motors and transformers. The degree of vertical integration was remarkable at every stage of production. Historically, the company's remote location in Brazil necessitated a vertically integrated model; this necessity has since evolved into a significant competitive advantage on the global stage. Through vertical integration, the company has achieved cost efficiency, enhanced speed of production, and superior customization capabilities, which have collectively spurred its global market share growth consistently over the years.

Notably, approximately 40% of the world's electric energy consumption is attributed to electric motors,[7] highlighting the critical role of research and development (R&D) and efficiency improvements in the global decarbonization effort. We believe that the demand for advanced technology in this area will continue to rise, as customers increasingly prioritize sustainability. Moreover, the company is poised to benefit substantially from the expansion of electric vehicles (EV) in Brazil, with its offerings in electric traction powertrains and charging stations set to drive further growth. We anticipate these developments to be key growth catalysts for the company in the coming years, aligning with global trends towards cleaner energy and transportation solutions.

Driving change:
Our engagement on governance, capital allocation and sustainability

In the landscape of emerging markets, the Brazilian market stands out for its exceptional entrepreneurial management teams and innovative business models. The openness of these entities to value-enhancing improvements aligns well with our dual-pillar investment approach, which focuses on uncovering high-quality, yet undervalued companies, and collaborating with their management to suggest improvements that could potentially enhance business value.

Our recent visit allowed us to concentrate on three critical areas of engagement:

Corporate governance: We aimed to enhance the structures of Boards of Directors, with a particular focus on promoting independence and diversity. Such improvements are pivotal for fostering more robust decision-making and ensuring that a wide range of perspectives are considered at the highest levels of company leadership.

Capital allocation: Recognising the opportunity presented by market volatility, we encouraged certain companies to optimize their balance sheets. Strategies such as implementing share buyback programs to acquire undervalued shares and allocating shares for long-term management incentives, were presented as means to unlock shareholder value and incentivize sustainable company growth.

Sustainability: We advocated for the integration of Environmental, Social, and Governance (ESG) frameworks into corporate strategy. Establishing long-term ESG objectives and linking these to management's variable compensation is essential in aligning the interests of the company with broader societal and environmental goals.

The receptivity and willingness of Brazilian companies to delve deeper into our suggestions have been encouraging. This proactive engagement, combined with the strong fundamentals of the businesses we invest in, reinforces our optimism about the investment potential in Brazil. Our efforts in governance, capital allocation, and sustainability is not just about enhancing business value in the short term. It also contributes to long term compounding power of the business and reduction of implied cost of capital.

Final reflections:
The unseen depths of Brazil's Carnival and equity market

Regrettably, we had to catch our flight back from São Paulo, leaving a day before the official start of the Carnival, missing the chance to witness the full spectacle of this cultural extravaganza firsthand.

[7] https://blogs.sw.siemens.com/simcenter/electromagnetic-motors-are-the-worlds-biggest-energy-consumers/

The Brazilian Carnival, often seen by the outside world as merely a vibrant spectacle of fun and festivity, holds a much deeper cultural significance than its exterior suggests. This annual event, rich in tradition and history, is a great expression of Brazil's diverse cultural heritage, showcasing the intricate tapestry of its society. Much like the Carnival, Brazil's equity market suffers from a superficial misperception. It is frequently viewed through a narrow lens as cyclical and commodity-driven, a reflection of the country's historical economic drivers, without recognizing the depth and breadth of opportunities it presents nowadays.

However, much like the Carnival, where the global audience may overlook the cultural aspect in favor of the spectacle, the Brazilian equity market's deeper value proposition remains underappreciated by investors. These very misconceptions create a fertile ground for investors to uncover and capitalize on the true value of Brazilian companies.

Contact

info@gibam.com

T: +44 (0) 20 7259 3456

Follow us: