A Week in Brazil – Entering the Kingdom of Monetary Sobriety

In June 2022, we spent a week in Brazil meeting companies across sectors as well as economists, entrepreneurs, local fund managers, investors and artists and have returned with a variety of insights into challenges and opportunities. But what impressed us the most was the level of digitalisation and the significant improvements in the ease of doing business for entrepreneurs.

São Paulo appears to be waking up from hibernation - streets are bustling, restaurants are crowded, high-street retailers appear busy, hotels are occupied. The city of 22 million inhabitants - the largest in the southern hemisphere - presents a disproportionate distribution of wealth: a modern, affluent front and an impoverished backyard with over 40,000 homeless. Technology and digitalisation have taken full control of public life (we did not need any physical currency!) - even on the flea markets payments are made digitally, museum tickets can only be purchased via the internet, Uber drivers and food delivery services are omnipresent.

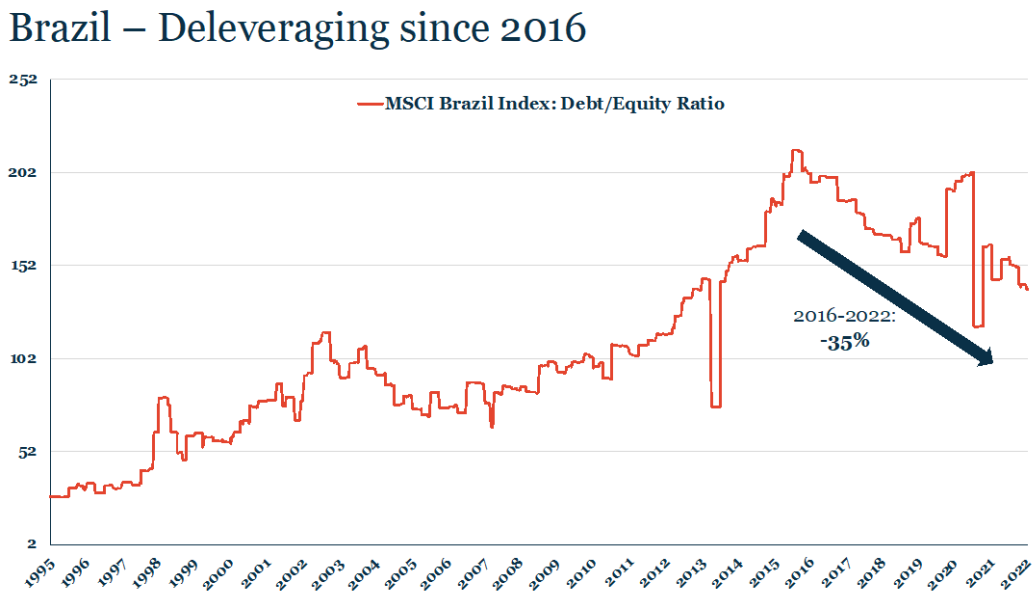
The pandemic has had two very palpable effects: 1) e-commerce and digitalisation have gone viral, and 2) demand for real estate in the non-urban areas has jumped, accompanied by a spur in renovation activities. Another noticeable change is the improvement in the ease of doing business for entrepreneurs. The government has reduced bureaucracy and it now takes less than a week to start a new business, versus months before. It is far easier to conduct transactions such as land or property sales, which used to be a long and complicated process.

One important observation was that no matter whom we spoke to, “politics” is not (yet) at the top of people’s minds. There is visible frustration with both presidential candidates which has led to political apathy. But there is confidence in the fundamental checks and balances, the powerful and free media landscape and the independence of the judicial system and central banks. We expect the debate to heat up towards August as the country moves closer to the general elections in October.

During our trip we were looking for answers to these key questions:

1) What is the macroeconomic situation in Brazil?
2) Can the elections lead to a further deterioration of consumer confidence?
3) How vulnerable are the banks and the private sector to the rate hikes?
4) What has driven the value destruction in the stock market? (e-Commerce businesses have been facing enormous deratings recently)
5) Most importantly, how are our portfolio companies performing in this environment?

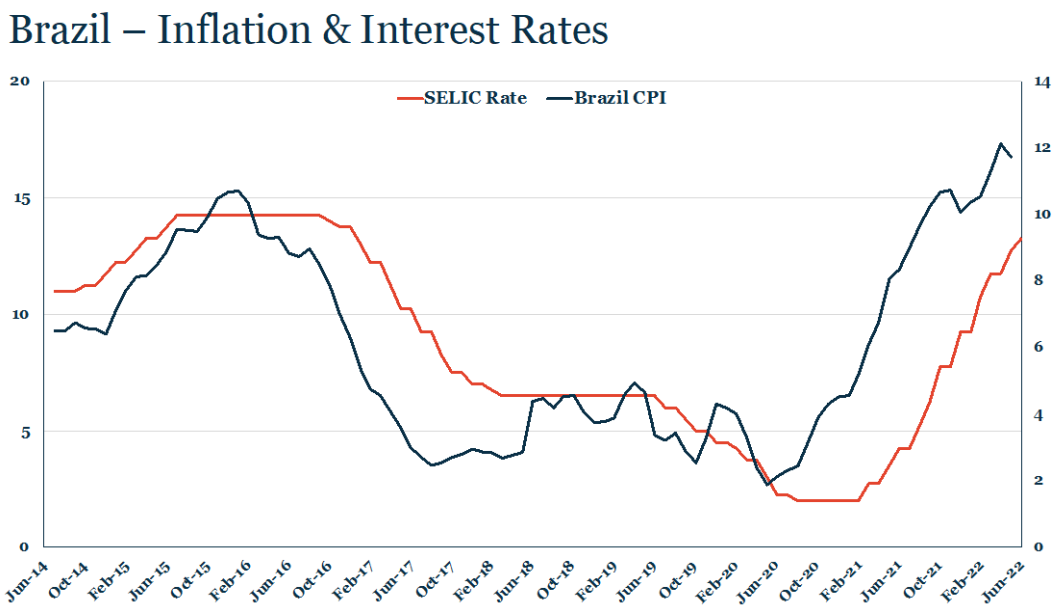
1) First of all, Brazil had to deal with a hefty recession in 2015/16 which caused a prolonged cycle of deleveraging which makes Brazil far more defensive today. A vast number of private sector companies went through a phase of cleaning up their balance sheets; large enterprises like Petrobras have reduced debt by over 30%.



Source: Bloomberg

2) The key risk for Brazil today is less related to the war in Ukraine or the Fed's monetary policy, and more driven by domestic debt levels with interest rates now above 13%, as well as commodity prices as the country remains a key exporter of various commodities.
3) The spike in inflation in Brazil has caused a rapid and almost unprecedented rise in the SELIC rate (Brazilian Federal Funds Rate) from a low of 2% back in March 2021 to

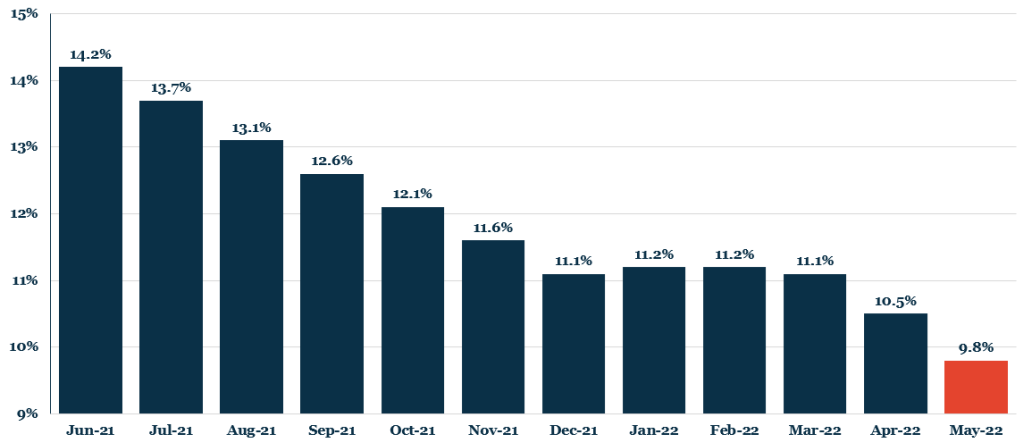
currently 13.25%. With these measures, Brazil is leading the tightening cycle globally. The country has been through 16 months of tightening compared to 4 months in the US!



Source: Bloomberg

4) The sharp increase in commodity prices in Brazil has led to a demand shock. Farmers have enjoyed an extraordinarily large dividend from the current prices and have gone on a spending spree.
5) Unemployment - which had jumped from 11.5% at the beginning of 2019 to over 15% at the height of the pandemic - has now for 11 consecutive months fallen to 11.2%. This is the lowest since February 2016 and a clear indicator that the private sector is normalising to pre-pandemic levels.

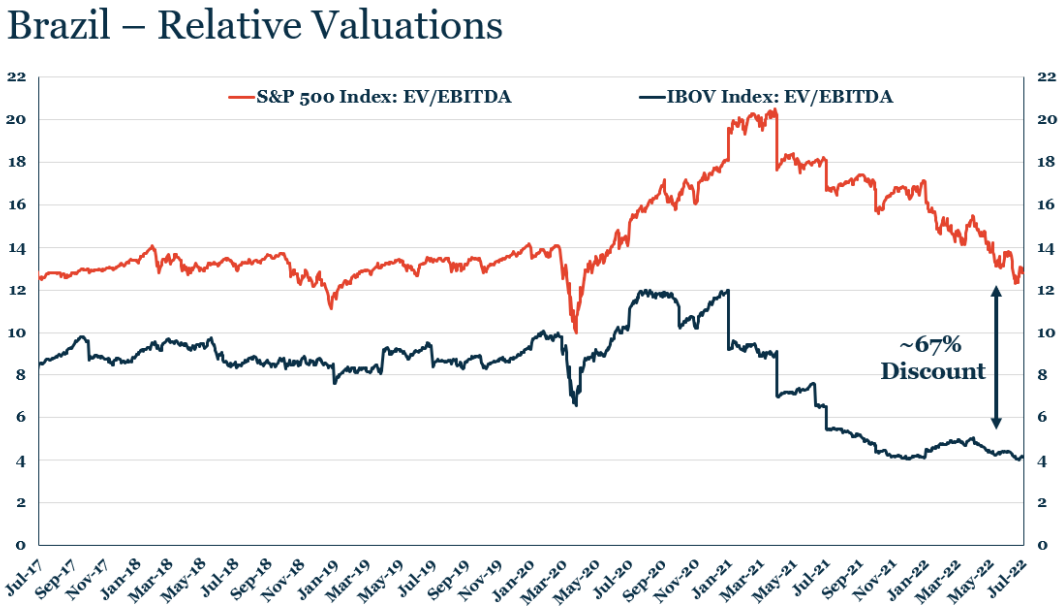
Brazilian – Monthly Unemployment Rate



Source: Bloomberg

6) Foreign reserves of USD 355bn and debt/GDP below 60% as well as strong export performance support the general macroeconomic conditions in Brazil.

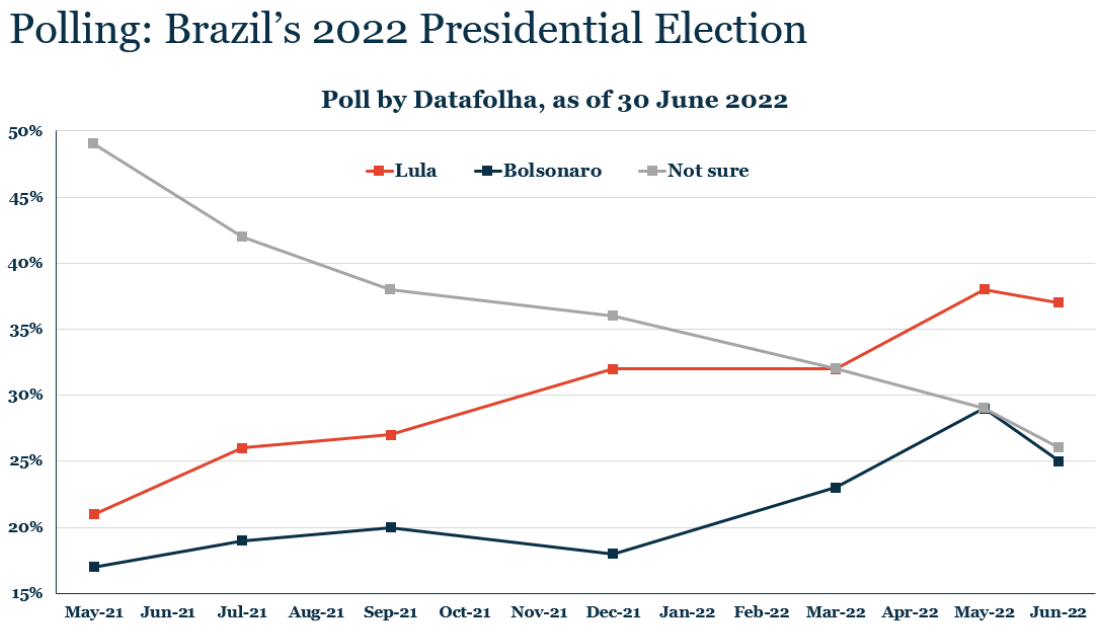
We are expecting the monetary measures to take effect and slow down consumption over the coming months. Twenty twenty-three will probably be a difficult year for Brazil, with higher cost of funding, elevated inflation and subdued growth. However, the stock market has priced this in accordingly and is now offering reasonable valuations. At the same time, the currency looks reasonably valued. Low external debt serves as a strong support in this period of uncertainty.



Source: Bloomberg

Politics and Elections

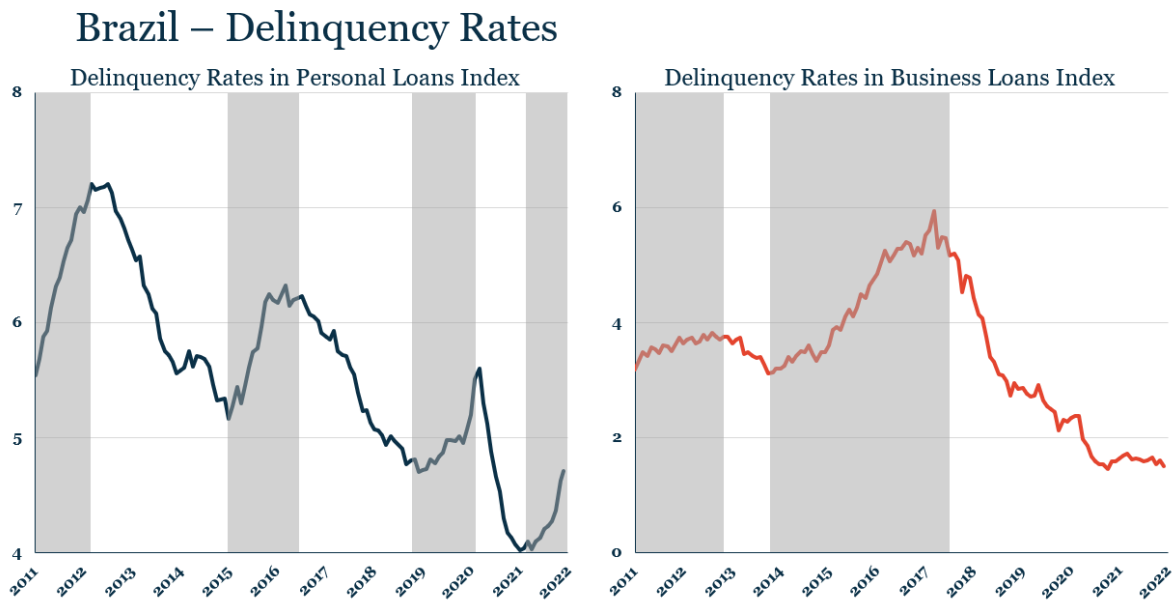
We talked to various stakeholders about the upcoming elections to understand the current sentiment. The country appears polarised. While the poorer regions tend to favour the former union leader, ex-convict, and former president (2003–2010) Luiz Inacio Lula da Silva (76), the more affluent regions and the agricultural lobby support the incumbent and ex-military officer Jair Bolsonaro (67). However, almost everyone we talked to appeared unhappy about both candidates. Bolsonaro has failed to win wider support due to his radical stance against minorities, and his mishandling of the Covid-19 pandemic ("it's just a flu"). The many positive and business-friendly reforms introduced during Bolsonaro's tenure - including the progress on privatisation (i.e. the $ 6-7bn Electrobras privatisation) - are hardly ever spoken about. All in all, while both candidates have very different political agendas, we believe that neither will harm the economy nor introduce policies that would considerably strangle Brazil's economic development. Even if Lula were to win, he probably would not have a majority, so the risk of radical changes is contained.



Source: Bloomberg

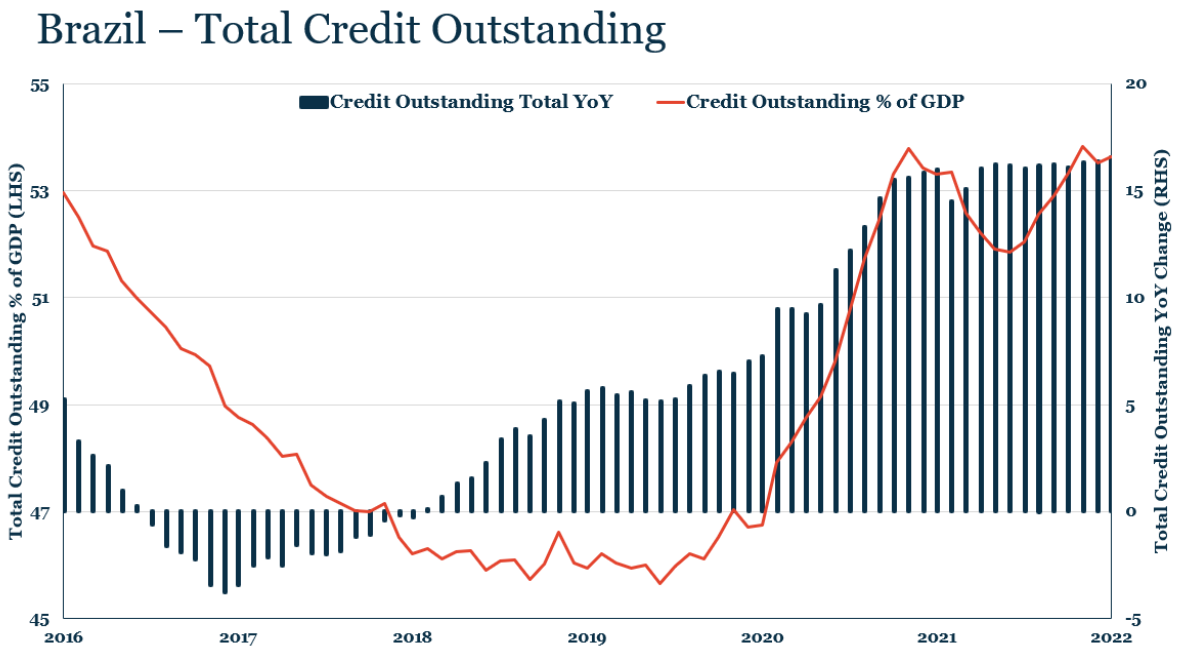
Banks and Private Sector Debt

It comes as no surprise that asset quality has been deteriorating in Brazil, as interest rates shot up and inflation increased. The government's social assistance program - which injected BRL293bn into the economy during the pandemic, three times the historical average of social assistance - has contained delinquencies.



Source: Bloomberg

The debt service ratio has jumped from 22% in 2018 to 28% today, which is rather concerning in view of the reduction in real wages. But we need to put the data into perspective: Brazilian (private) banks are well managed, with low NPL levels of less than 3% and particularly low corporate NPLs of less than 1.5%. Loan growth has been slowing significantly and is now below nominal GDP. While there is a risk of further tightening, the wider consensus right now points to a gradual reduction of the SELIC rate into 2023. The recent hikes sharply increased the cost of funding for the private sector. However, private companies have relatively low leverage compared to previous tightening cycles. Nonetheless, we need to monitor the impact on private households and the delinquencies resulting from the rate hikes very carefully. Furthermore, the monetary tightening could cause a recession of some form.

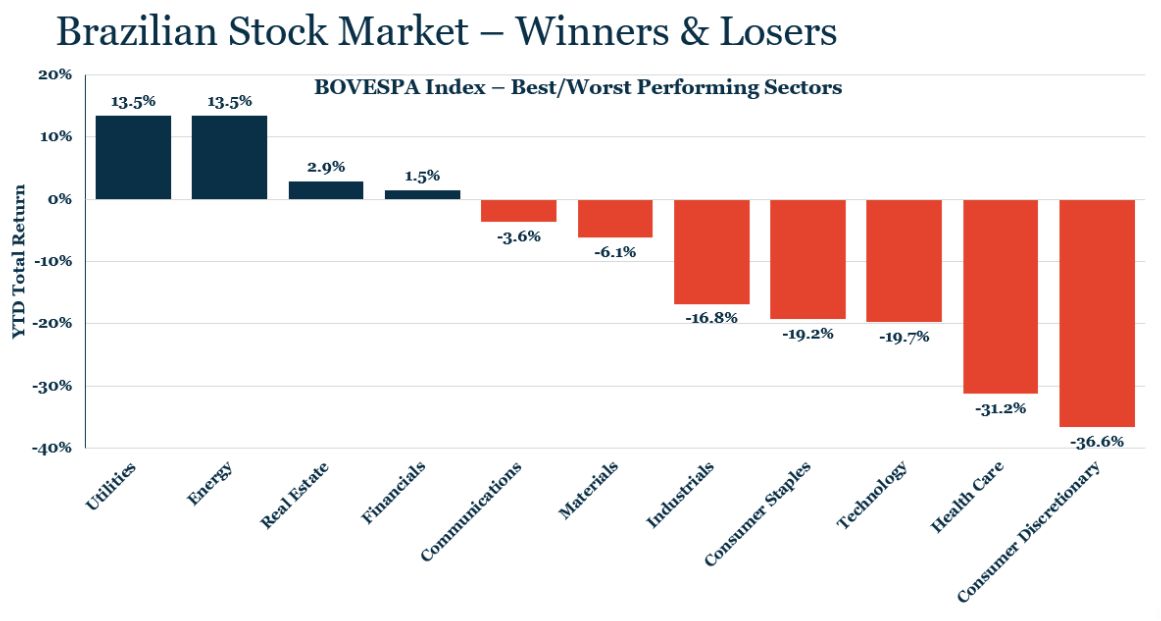


Source: Bloomberg

The Stock Market

Not surprisingly the winners of the Brazilian stock market this year were utilities and energy, driven by spiking commodity prices. The losers were consumer discretionary, health care and technology. Retail and eCommerce have been particularly hard hit on the back of worries about rising interest rates and the cost-of-living crisis. Brazilian retail company Magazine Luisa fell by as much as 67% YTD. After a strong start into the year the stock market has had a difficult time - it is down 6% (in BRL) YTD. With interest rates at double digits, investors can

just leave their money in the bank. On a positive note, our trip did confirm our view on Brazilian companies. They are often well-managed, highly innovative and have a strong edge. They have been unfairly punished by the general sentiment and macro-outlook. However, they are in a good position to perform strongly when the recovery sets in.



Source: Bloomberg

Our Portfolio Companies

Over the week, we visited several companies operating in different sectors, such as health care, IT, software, fintech, education, pharmaceutical, retail and banking. As TOTVS is one of our larger holdings, we summarise our takeaways from our meeting with the CEO, Dennis Herszkowicz, and his IR manager, Sergio Serio.

TOTVS is the largest technology company in Brazil specialised in the development of business solutions for companies of all sizes. More recently, it is being transformed into a leading fintech operator.

Sergio and his team had prepared a very hospitable reception. When you enter the open, well-designed TOTVS offices you can almost feel the positive working culture and creative energy that drives innovation in this company. Sergio gave us TOTVS's perspective on the current situation. The company operates across different sectors and has a good insight into how their customers are coping in this environment. He said they were seeing low levels of

debt across the corporate sector (their client base) and stable delinquencies. He felt that the interest rate hikes had been well digested by the economy and added that he would only start worrying if the US went into deep recession or local rates were to spike to over 20%. However, neither of these scenarios are his base case.

The backbone of the company is the enterprise resource planning (ERP) software and TOTVS has a dominant market position in this segment in Brazil. Partially aided by deregulation, but also through technological capabilities, TOTVS has ventured into new areas, as clients have sought additional solutions from them. Growth and diversification were achieved organically and through acquisitions. A good example is the recent purchase of RD Station in early 2021. This acquisition is in line with TOTVS's aim of broadening its product portfolio from enterprise resource planning systems to management tools and systems in the fintech space. RD Station's CRM system is already being used by TOTVS's core customer base: Brazilian SMEs. Beyond boosting customer loyalty, an enhanced presence in the business performance space creates more customer lifetime value. Synergies from the existing client bases of TOTVS and RD Station through cross- and up-selling products are expected to enhance performance.

As it is broadening its client offering, TOTVS has reorganised its sales force to reflect this. This has already resulted in over 1,000 clients buying their new fintech products. The fintech joint venture with one of the largest private banks in the country - Banco Itaú - not only lowers cost of funding, but also limits TOTVS's overall risk from lending activities.

The core risk for TOTVS now seems to be on the execution side of the business. To profit from the potential efficiencies and synergies resulting from the recent joint venture and acquisitions, TOTVS needs to execute on post-merger integration process of RD Station with a strong focus on creating synergies between the different sales teams.

Overall, the company is more diversified than ever before and enjoys a unique position with its dominant market share and fast-growing business with 40% annual growth!