NOTES FROM THE ROAD: BRAZIL

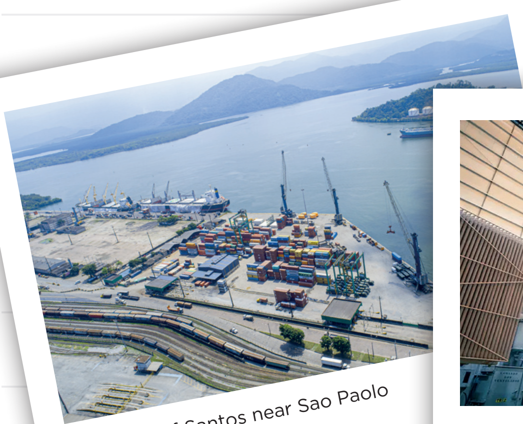
COMGEST

January 27 2020 BRAZIL

A Postcard From: Comgest's GEM team

During the past few months, members of the Comgest Emerging Markets Team travelled to Brazil, a country which has seen significant volatility in the past 30 years in both economic and financial market terms, culminating recently in the deepest recession the country has endured in over 100 years. This postcard sets out to document our major findings – both at the broad top-down level but of course mostly through the lens of individual companies – and should, by extension, help explain our current positioning.

Previewing our conclusion, now is an exciting time to be invested in Brazil. The country is at an important juncture where the opportunity to dictate its own trajectory lies much more in its own hands than has been the case for some time. This is being helped by a benign external environment with low interest rates internationally and decent, albeit moderate growth. With limited exports to GDP, at 12.5%[1], we believe Brazil is relatively immune to the slowdown in global trade, while at the same time having the ability to make important domestic reforms. Although it doesn't enjoy the tail-winds of the high commodity prices of the 2000s, it does have other factors supporting it, including a social backdrop seemingly in favour of change as witnessed by the rejection of 14 years of government by the leftist Workers' Party (PT). The extent to which this can be converted into structural reforms, together with the increasing application of technology



City Port of Santos near Sao Paolo

WEG – a global manufacturer and supplier of electric-electronic equipment

Sao Paolo – Brazil's economic and financial centre

[1] Source: Brazil Ministry of Economy

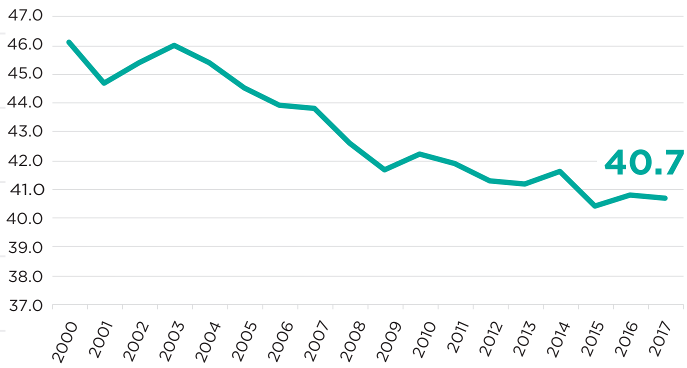
to improve efficiency, will help dictate the growth potential over the coming years. A cyclical recovery in both GDP – together with several potentially secular trends – could lead to one of the more positive phases in Brazil's development. Allied to this, we are seeing a strong company profits recovery, in particular in the Brazilian stocks held in our Global Emerging Markets and Latin America portfolios[2], with decent top line recovery but especially stronger EPS growth as companies benefit from the operational gearing awarded by their recent cost cutting and the output gap.

In total we have held over 100 company meetings since September 2019, many at senior management level, and would categorise our findings into 4 broad segments:

- **New Policy Direction and Reforms**
- **Economic Recovery** – not just a return to mean
- **Increasing Confidence in the Stock Market;** the switch from fixed income
- **Leapfrogging** – The Influence of **Technology**

For stock pickers such as ourselves, the Brazilian market has been rewarding in the short-term. However, standing back and one can see that the ratio of profits to GDP, at 40.7% in 2017 *(Figure 1)*, remains depressed while the domestic ownership of equities is still below its long-term average.

Figure 1: The Evolution of Company Profits as a % of GDP



Source: Cidades.ibge.gov.br; data period: 2000 – 2017

At the same time, we believe the opportunity-set is changing as entrepreneurship is rekindled by recovering growth, new technologies and liberalisation while the stock market is increasingly being used as a real option to raise capital, indicative of companies' desire to both invest as well as improve their balance sheets in anticipation of a pick-up in growth. Meanwhile the prospect of structurally lower interest rates is leading to a significant shift of assets into the equity market by domestic investors.

We hope you enjoy travelling with us.

A BRIEF HISTORY LESSON

'This time is different' is a perennially used, worn phrase to describe Emerging Market countries that pursue poor policies, experience recessions and are then forced to undertake domestically unwanted reform measures. Nowhere more so than in Brazil has this been the case over many decades. It is worthwhile, therefore, taking a few steps back to 'another time' in order to appreciate the current changes taking place.

Brazil was a poster child for bad economic policies in the 1980s that ultimately resulted in the debt crisis. Rampant inflation, which peaked at 6930% in 1990[3], had the consumer picking up the bill. Then Minister of Finance (later to become President), Fernando Henrique Cardoso introduced the Real plan in July 1994. With a linkage to the US dollar, it worked. The economy stabilised while inflation declined from 916% in December 1994 to 22% by December 1995.

[2] Comgest's representative accounts of the Global Emerging Markets Equities Composite and Latin America Equities Composite, respectively. The representative accounts discussed are managed in accordance with their respective Composite since the Composite's inception.
[3] Source: Brazilian Institute of Geography and Statistics (IBGE)

The 2000s were Brazil's boom years, effectively off the back of the commodity 'super-cycle', the country benefited from China's insatiable appetite for all forms of commodities thanks to its vast, high quality iron ore reserves and its position as the world's number one soybean producer.

In some ways the peak was obvious: the front-page picture of the Economist, in November 2009, of Christ the Redeemer in Rio de Janeiro taking off, indicating the positive outlook for the Brazilian economy. It appeared that Brazil under President Lula's PT government had broken the boom/bust cyclicality of the past. During his administration, approximately 45 million people had been lifted out of poverty and into the middle class, helped by the Bolsa Familia subsidy programme.

In 2011, the popular PT president Lula then handpicked his successor, Dilma Rousseff, and exited at the top. She pursued the same policies with even more vigour.

It was – certainly in part – a mirage. The proceeds from the commodity boom, instead of being saved or invested, had been spent. It seemed that Brazil had cleverly sidestepped the effects of the Global Financial Crisis (GFC) but in reality, the government had used (and would continue to do so for some years) state lending institutions to not only cushion the blow from the GFC, but to actually stimulate excessive growth and consumer spending through discounted lending. For example, the State development bank, the BNDES, saw its loan book grow from USD 50bn in 2005 to USD 270bn, or 15% of GDP, in early 2015! To put this in context, in 2005 the IMF had credit outstanding of USD 57bn. The biggest government bank, Banco Do Brasil (BdB), saw total assets rise from USD 58bn in 2002 to USD 555bn by 2012. This situation is now being unwound, with the BNDES' loan portfolio back to USD 121bn and BdB's assets at USD 400bn. We recently attended a conference in New York, where the President of the BNDES confirmed that BRL 30bn of the bank's assets in publicly listed equities would soon be sold, enabling the bank to focus on its strict development bank goals.

The crash was inevitable as Brazil could no longer afford its debt and sustain its economic policies. During the boom, the household loan to income ratio rose from 18% in 2005 to 40% in just 5 years[4]. It peaked at 47% in 2016.

Beneath this turbulent surface, something even more sinister lurked: A massive, Latin America wide corruption racket, centred on Brazil, the ruling PT Party and Petrobras, the State oil company. The size is still incalculable but estimates of the value in restitution via leniency agreements are USD 12.4bn. It involved many companies, politicians and individuals, and had spread to various other Latin American countries. Once exposed, it would lead to the impeachment of Dilma Rousseff in 2016, indirectly bring down her replacement, Michel Temer, as well as the toppling of other governments in the region, such as in Peru (and even involve the death of an ex-President of Peru). The scandal was so large and dramatic it has now been turned into a Netflix series.

Temer's term in office was a short 2 years, but in that time, he passed the first part of an important two-stage reform agenda, namely establishing a limit on government spending and consequently capping the budget deficit.

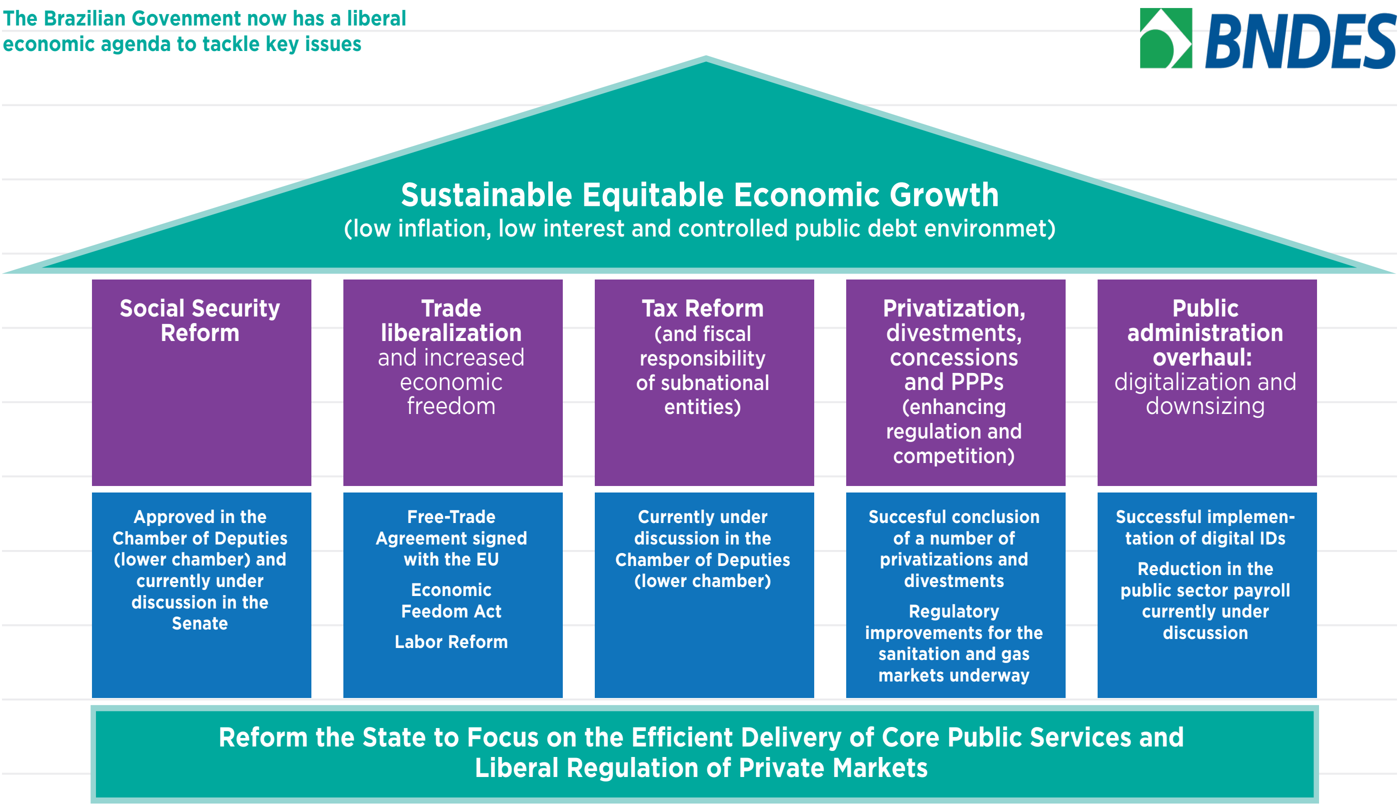
[4] Source: Brazil Central Bank

In many ways, from an investment perspective, this is where the Brazilian story gets interesting. The investigation by the judiciary, spearheaded by Judge Moro, began small. It soon snowballed. And it came to prove that various Brazilian State institutions, such as the judiciary, were not only robust, but active and healthy. And the population responded, particularly in the south-eastern cities, with massive demonstrations demanding a less corrupt and more equitable society, allied to political reform.

The consequence has been the election in 2018 of an otherwise little-known Congressman, with 28 years of experience, called Jair Bolsonaro, who spent just BRL 1.6m virtually all on social media to win. In contrast, Dilma Rousseff in her 2014 election campaign spent BRL 300m, almost all on television (we address the increasing influence and usage of technology later in this document). Bolsonaro's agenda appeared, at least in Brazilian terms, right wing, with primary goals being anti-corruption, an improvement in Brazil's fiscal position and the withdrawal of the State from much of the economy. Bolsonaro appointed Paulo Guedes, a respected economist and co-founder of the investment bank BTG Pactual, as his Minister of the Economy, with a large and market positive schedule of economic reforms *(as shown in Figure 2)*.

NEW POLICY DIRECTION AND REFORMS

Figure 2: New Economic Agenda: State Reform and Economic Liberalisation



Source: BNDES (Brazilian Development Bank)

At the heart of the current government's economic policies is the idea that the state should retreat, through a combination of deregulation, privatisation and fiscal rectitude, to leave space for the private sector to grow. This is seen as being key to increased investment and rising employment and thus to greater national prosperity. Consolidated public sector expenses represent 49% of GDP, excluding State-Owned Enterprises (SOEs). However, such a shift might not immediately result in faster GDP growth. The removal of legislative red-tape, tariffs, subsidies and other intervention should however create opportunities for the private sector to grow over time.

Investors' focus has been on the passage of the Social Security reform, the key part of which has been reform of State pensions. Social security payments consumed 45% of the primary government expenditures (excluding debt service) budget and has been growing at 4.3% p.a.[5] Without reform, the projected Gross debt/GDP ratio would hit an unsustainable 92% by 2027. With the recently passed reform, allied with a minimal 1.6% primary budget deficit, the figure should stabilise a little below the current 79% by 2027 (all figures assuming 2.2% average GDP growth and average real interest rates of 2.8%). Bolsonaro's government has successfully navigated this legislation to a conclusion whereby the substantial part of the original proposal has been passed, with BRL 738bn of potential savings in the next 10 years. It is a fundamental, although insufficient, condition for fiscal rebalancing. Considering how diluted most legislation has tended to be when passing through the Brazilian Congress, this is a major achievement.

Historically, the passage of one such major piece of legislation would satisfy the Executive. However, the list of reforms being presented is impressive. Added to the pension reform, the government is also proposing to reform the Civil Service, profoundly altering civil servants' income and careers at the federal, state, and municipal levels as well as clarifying rules for SOEs' employees. 22% of total Federal Government expense is payroll. The expected savings could amount to BRL 300bn over 10 years[6]. Most savings would depend on the government not replacing civil servants retiring in the coming years. Keep in mind that roughly 50% of current federal government civil servants will likely retire in the next 10 years, according to Bradesco BBI.

In addition, significant privatisations and sale of State assets are being pursued. The government has already raised BRL 96bn (USD 22bn)[7] in the first 10 months of the new administration. The state controls 47 companies directly and 101 companies indirectly. Petrobras, after being at the centre of the Lavo Jato (Car Wash) corruption scandal, is being rapidly 'de-risked' with an ongoing sale of assets both internationally and domestically. Downstream assets such as fuel stations and refineries (USD 16.8bn worth) are in the process of being sold, while foreign companies are being encouraged to invest in the Exploration & Production (E&P) sector. This is raising standards via competition as well as generating much needed revenue for the government.

The electricity sector, with the SOE Eletrobras at its centre, is also being privatised and even previously sacred sectors like the State banks are being considered, with talk of Banco do Brasil, the largest bank, being partially privatised. This is all in addition to the USD 35.5bn of asset sales which have already taken place since 2015 or pending regulatory approval in 2019.

[5] Source: Itau BBA
[6] Source: Itau BBA
[7] Comgest's representative accounts of the Latin America Equities Composite and Global Emerging Markets Equities Composite, respectively. The representative accounts discussed are managed in accordance with their respective Composite since the Composite's inception.

However, the government has not been focusing solely on improving its fiscal situation. It is also attempting to deliver on its campaign promises by passing through Congress various pro-growth initiatives such as the Sanitation and Telecommunications Bill (passed), an effort to raise basic infrastructure investment and provide a well-structured environment for that.

Infrastructure is an important sector where the government can outsource projects. Brazil's pipeline of road concessions is estimated at BRL 159bn for over 24,000 km of roads considering Federal and State concessions[8]. To put the dire need of more roads in Brazil in context, paved roads account for 12% of total roads: In Mexico the figure is 38% and in India 54%. The public sector manages 90% of all roads with 65.8% of these deemed to be only good to terrible compared to 81.9% of concessionaires' roads viewed as good to great. Federal government investment in roads, due to such tight budgetary constraints, has more than halved since 2011 to 0.11% of GDP. Already this government has auctioned concessions for the operation of 12 airport terminals, port terminals and railroad concessions, raising BRL 5.7bn. In 2020, 8 highways, spread across Brazil, with total investments expected to reach BRL 47bn, are expected to be auctioned, according to the Infrastructure Ministry. We have had direct contact with CCR multiple times in 2019. **CCR**, the largest quoted toll road and urban mobility concession operator (and a long standing holding in our Global Emerging Markets and Latin America portfolios[9]), is in a prime position to benefit from this, especially considering that the balance sheets of the major competitors are stretched. In H1 2020 a further BRL 5bn of capex in metro lines will be auctioned and CCR is likely to be the only bidder[10]. All tallied, the company could win Federal road projects summing to BRL 30bn in investments in the coming 3 years, equivalent to 42% of total concessions, putting into context the scale of potential opportunities and how limited competition might be. Besides this, CCR is owed various amounts from the government of Sao Paolo, which, because that government has admitted liability but is unable to reimburse CCR, is likely to be paid in extensions to existing road concession: a situation highly favourable to the company.

Moreover, in 2020, Congress is due to ease capital requirements for banks, such as allowing banks to lend money backed by the FGTS (a mandatory savings fund), which according to the Ministry of the Economy, could unleash BRL 100bn of potential lending over four years, stimulating consumption. Separately, the government is proposing to formalise into law the independence of the Central Bank (CB). Although the CB currently operates in an autonomous fashion, to have its independence legislated is a further sign of the government withdrawing its influence to the benefit of technocratic professionals.

Finally, there is a proposal for a major reform of the byzantine tax structure in Brazil[11]. The proposal is far reaching, effecting the various levels of VAT, income and Federal taxes, taxation on dividends and the potential for a financial transaction tax. The government's goal is to lower production tax and raise capital gains tax, rather than increase the overall tax burden, so effectively redesigning the origin of tax: bear in mind that Brazil's tax burden at 33.6% of GDP is high, especially for a developing country. According to the World Bank, Brazil ranks at 109 out of 190 countries in the Ease of Doing Business assessment: much of this is due to the complicated and ever-changing tax system, in which Brazil ranks 184 out of 190. Brazilian companies spend a total of 1,958 hours per year just to pay taxes. Only Bolivia and Venezuela in South America exceed this while only 4 sub-Saharan countries rank lower than Brazil. We believe even marginal

[8] Source: Itau BBA
[9] Comgest's representative accounts of the Global Emerging Markets Equities Composite and Latin America Equities Composite, respectively. The representative accounts discussed are managed in accordance with their respective Composite since the Composite's inception.
[10] Source: Itau BBA
[11] Source: Itau BBA

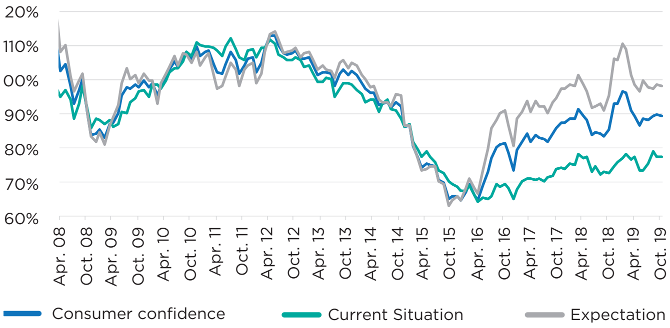
tax reform would boost productivity. All this may seem like a political wish list, but the record to date, and all within under one year of tenure, suggests that the Bolsonaro government is exceeding expectations.

ECONOMIC RECOVERY

In the 15 years following the turn of the century, Brazil (and other Latin American economies) experienced an extended period of socio-economic progress. According to the OECD[12]:

"The share of the population living in poverty dropped from 43% to 24% between 2000 and 2015. In addition, measurements of well-being beyond income, such as health, education and equality issues, have significantly improved. The percentage of the population earning USD 10-50 per day (2005 purchasing power parity), considered a benchmark for the middle class, rose from 21% in 2000 to 35% in 2015.

Figure 3: Consumer Confidence, Consumers views of the Current Situation and Their Expectations, since April 2008



Source: B3 – Data period: April 2008 – November 2019

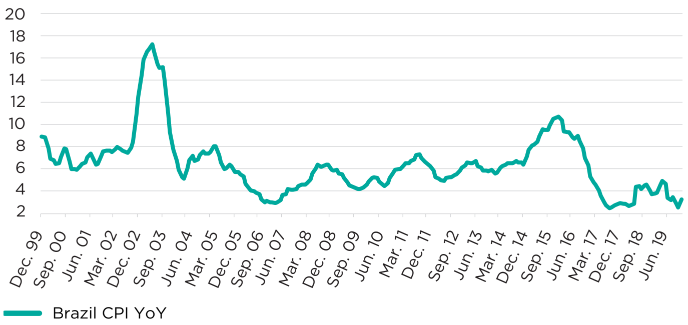
As such, the rise of the middle class in Latam has been one of the major positive socio-economic transformations of recent times. This has given way to a new consumer class with more sophisticated needs and greater expectations in terms of goods and services. It has also brought new challenges and opportunities to the region's public and private sectors."

As covered above, there has in Brazil's case been some lapse in this trend since 2015, yet our many recent meetings with Brazilian companies have revealed an increasingly upbeat mood about the economy and the effects the ongoing upswing will have on companies' sustainable profitability, particularly those focused on the domestic economy and its consumers. Indeed, the effect of the reforms past and coming, as described above, are generating a long-awaited pickup in confidence. For example, consumer confidence rose nearly 6% y/y, to 87.7 in October 2019[13] *(Figure 3)* while retail sales growth was up 4.8% y/y in September 2019. Business confidence hit its highest level since 2016 on a 12-month moving average basis in November. The decline in interest rates to a level that is unprecedented in Brazil's modern history, from 13.75% at the end of 2016 to 5% now, in addition to the aforementioned reforms, is supporting such optimism.

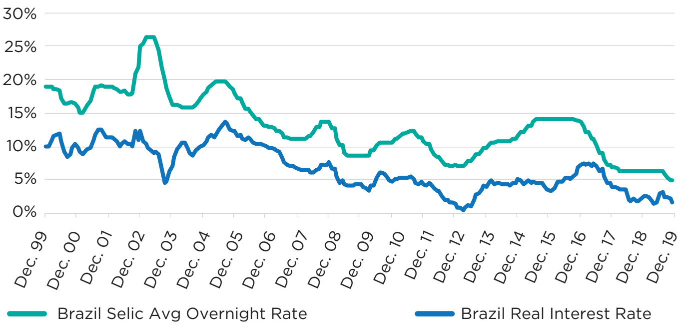
The story behind this includes the historically low level of inflation *(see Figure 4)*, at 2.54% as of October 2019, which looks like it will remain low given an output gap of –4.4%, capacity utilisation at 75.9% and unemployment still at 12%. Where employment has been increasing is in the knowledge industry. From the company contact we have had, it is clear that demand for skilled individuals, especially in the IT space, is close to leading to a shortage.

[12] Source: Organisation of Economic Cooperation and Development
[13] B3 and BTG Pactual

Figure 4: Long-Term Inflation



Real Interest Rates



Source: LH chart - IBGE (Instituto Brasileiro de Geografia e Estatistia); RH chart - Banco Central do Brasil; data period 31/12/1999 – 30/11/2019

This highlights the ongoing need to "skills upgrading" in Brazil, a long-standing trend which should benefit our investee company **Cogna** (previously **Kroton**), whom we last met with in Q4 2019. Cogna is the leading education company in Brazil with 10% market share in on-campus and close to 30% in distance learning. The company has outgrown the sector thanks to a clear vision, innovation, large investments in standardisation, in content and in technology. Growth (Comgest forecasts 5-year CAGR[14] EPS at 13.4% until 2024) should be sustained by a still low penetration of post-secondary education and geographical expansion in campuses and distance learnings. Additionally, with the acquisition of Somos, the leading primary and secondary education group in Brazil. Cogna increases its presence in K12, buying a new avenue of growth in a low competitive environment.

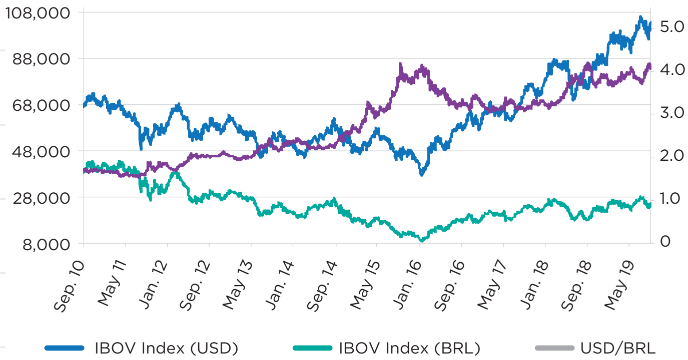
Meanwhile Foreign Direct Investment (FDI), a measure of confidence of foreign companies in Brazil's future, remains high at USD 70.3bn as of September 2019, representing 3.9% of GDP[15]. Consequently, Brazil's basic balance (Current Account + FDI) has remained solid for 20 years and is 1.8% of GDP as of September 2019.

Taking all of the above into account, we believe that the economic backdrop in Brazil within which private companies can operate is more stable and hence predictable.

Putting *Figure 4* charts in the context of the equity market is revealing and one of the reasons for our optimism *(see Figure 5)*. With the requirement for external funding minimal, price stability greater than ever and hence interest rates expected to stay low and probably even decline further, there exists the probability of further increases in GDP and earnings which are still in the process of recovering.

Turning to a company held in our Latin America portfolio[16], we last met with Lojas Renner in Q4 2019. With over 35% of the apparel market being informal, combined with pent up demand after the recent recession, **Lojas Renner** is well positioned to

Figure 5: Ibovespa Performance in USD and BRL, and the USD/BRL FX Rate, since 10/09/2010



Source: IBGE instituto Brasileiro de Geografia e Estatistia; data period: 10/09/2009 – 09/09/2019

[14] Compound Annual Growth Rate
[15] Source: Itau BBA
[16] Comgest's representative account of the Latin America Equities Composite managed in accordance with its Composite since the Composite's inception.

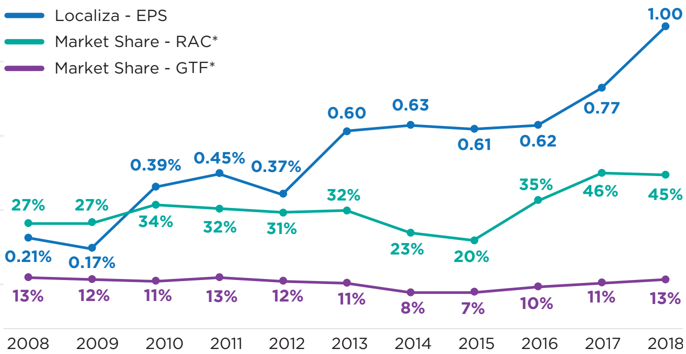
benefit from this improvement, being the largest clothing retailer in Brazil, but with only a 5% market share. CAGR 5-year revenue growth is projected to be 14% with 18% 5-year CAGR EPS growth. Renner has emerged from Brazil's downturn stronger than the competitors (more than 41,000 clothing and footwear stores closed from 2014 to 2017). Management has built a moat around its franchise via intelligent IT spend that is already differentiating them; a big part of their capex is in digitalisation and in the omnichannel, mostly to improve the level of service, faster supply chain responsiveness, a more efficient consumer financing structure and stronger product development and planning. Our meetings reminded us how Renner has invested heavily in IT and R&D, spending twice as much as Guararapes, its nearest competitor, at BRL 184m in 2018, or 2.2% IT&RD capex as a % of revenues, compared to BRL 88m, or 1.2% IT&RD capex as a % of revenues.[17]

We think this strategy makes sense. Online sales currently represent 5% of Renner's total and the company believes that it will be 10% in 5 years (like Inditex). Due to the complexity of the Brazilian market, many foreigners have entered and left (such as GAP and Forever 21) while Zara has been in Brazil for 20 years and has only opened 50 stores (compared to being in Mexico for 5 years and opening 300 stores).

The recent Central Bank directive for retailers' financial businesses to become formal banks adds another element to the Renner story. Currently, consumer financing represents 20% of Renner's EBITDA, while the official number of issued cards is 31.9m as of 3Q19. As credit penetration picks up and financial penetration becomes more sophisticated, Renner has the opportunity to increase the contribution from its financing arm, as well as in time cross sell more products to its customers. A sophisticated data base accumulated over many years means Renner is well positioned to target sales and offerings to its customers, who made 74.8m transactions in the last 12 months.

The recovery in the economy should also help the EPS growth at **Localiza,** the leading car rental company in Brazil, which Comgest forecasts to grow at 19.4% CAGR over 5 years. Localiza, which we met with various times in 2019, is a good example of a focused company which through intelligent investment by high quality management has created a moat around its franchise despite car rental historically being a sector with low barriers to entry.

Figure 6: Localiza – Evolution of Market Share and Profitability



Source: ABLA, Localiza and Bloomberg; data period 2008 – 2018
*RAC= Rent a Car segment; GTF=Fleet Management segment
*Methodology changed in 2016

As can be seen in the above chart, Localiza has increased its market share during the crisis from its historical average of low 30s%, to mid-40s%. This is close to 3x its nearest competitor, Movida. At the same time, although it saw a decline in market share in 2014 and 2015, the company increased its EPS growth despite Brazil suffering its worst recession in 100 years; a testament to its careful cash conversion cycle management. Roughly 40% (as of 2018) of the car rental market is informal, which is rapidly being replaced by formal companies. A key feature of our meetings was a discussion of how Localiza has differentiated itself through investing in IT, enabling it to ensure the right car is in the right place at the right time and at the right price throughout Brazil. More recently an agreement with Uber (Brazil is Uber's largest market globally) means that Uber drivers are highly likely to rent cars from Localiza. There is now a Localiza app where Uber pays the rental cost from the

[17] Comgest's representative account of the Latin America Equities Composite managed in accordance with its Composite since the Composite's inception.

commission before paying the driver, on a weekly basis. This not only locks in Uber with Localiza but also reduces the risk of Localiza not being paid.

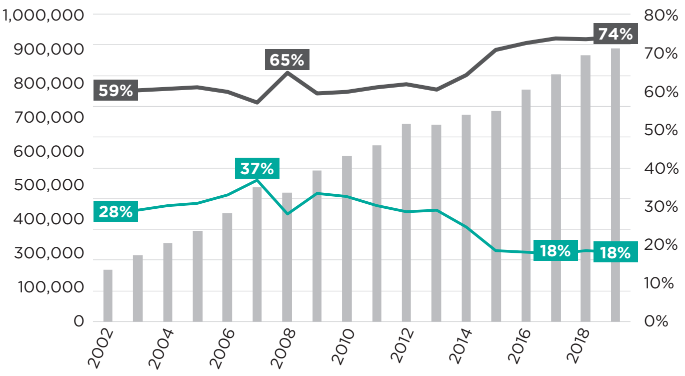
THE DOMESTIC FIXED INCOME TO EQUITY SWITCH

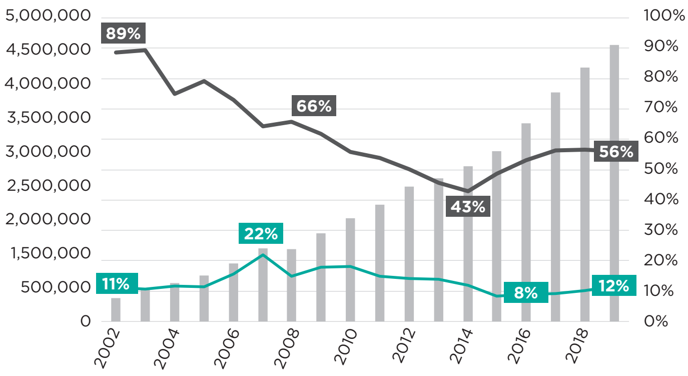
Confidence in the economic recovery and the ability of listed companies to benefit from this, allied to the ongoing and unprecedented decline in interest rates, is leading domestic investors to increase their allocation to Brazilian equities. This is a key and important trend that we believe is likely to be sustainable for an extended period.

While foreigners have been taking money out of Brazilian equities (equating to BRL 11.5bn in the year to 27-Nov-2019, according to JPMorgan), domestic investors have been making significant equity investments, funded from fixed income holdings. Much of this has gone into new issuance, which in H1 2019 amounted to USD 12.5bn [18], as companies both lower their cost of capital from more expensive bank debt and raise capital in anticipation of investing for growth.

Allocation to equities, however, remains at low levels and although for mutual funds the percent in fixed income has receded in the past few months, it remains above 50%, while for pension funds their fixed income allocation remains close to historical highs *(see Figure 7)*. Thus, the potential remains significant.

Figure 7: The Evolution of Pension and Mutual Fund Investment Allocations in the Past 17 Years





Source: Abrapp, Anbima, Bradesco BBI

B3, which is also held in our Global Emerging Markets and Latin America portfolios [19], is a major beneficiary of this shift. The company is a de-facto monopoly on almost all financial products trading, clearing and post trading services in Brazil. Besides traded instruments, B3 is also the platform for OTC derivatives, banks CDs (certificates of deposit) and loans and liens registration. Revenues are growing 18.7% y/y, driven by equities and equity instruments which rose 25.6% y/y and represent over 40% of total revenue. ADTV [20] y/y has expanded from BRL 11.2bn in the first 9 months of 2018 to BRL 16.5bn ADTV for the first 9 months in 2019 *(Figure 8)*. As the Brazilian financial markets develop and financial penetration expands, the use of more

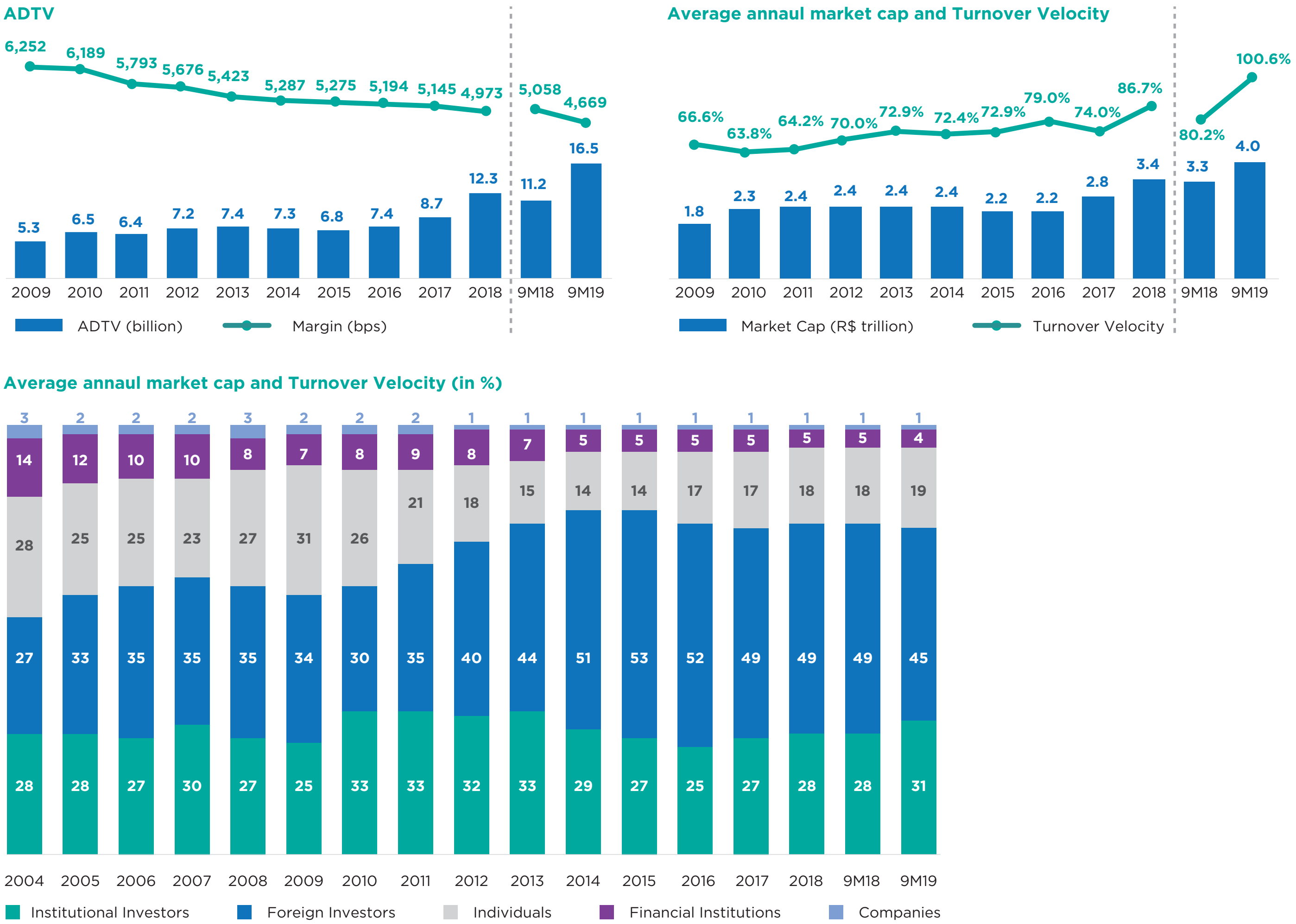
[18] Bradesco BBI
[19] Comgest's representative accounts of the Global Emerging Markets Equities Composite and Latin America Equities Composite, respectively. The representative accounts discussed are managed in accordance with their respective Composite since the Composite's inception.
[20] ADTV: average daily trading volumes

complex instruments will also increase. As such, management explained to us how it is likely that revenues derived from FX and interest rate derivatives, which grew 7.6% in Q2 2019, will continue to increase, while B3's technology and data service revenues, which are currently 11.5% of total revenues, are also likely to grow. It will not be just companies using these instruments. B3's strategy is to actively encourage domestic investors, as opposed to corporates and banks, with its 'Tesoro Directo' platform. The increase of a domestic institutional investor presence bodes well for market stability as well as valuations, particularly as the historically preferred alternative of bonds are trading close to all-time highs.

Corporate Credit to GDP is only 47.4% and with interest rates declining to 5% or lower, this debt becomes cheaper to service, opening up scope for an expansion of credit.[21]

Brazil's market capitalisation to GDP is a paltry 46%, which is actually a decline over 10 years, from 98%. This compares favourably with India at 90% and China at 71%.

Figure 8: Brazil – Listed Equities



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	9M18	9M19
Companies	3	2	2	2	3	2	2	2	1	1	1	1	1	1	1	1	1
Financial Institutions	14	12	10	10	8	7	8	9	8	7	5	5	5	5	5	5	4
Individuals	28	25	25	23	27	31	26	21	18	15	14	14	17	17	18	18	19
Foreign Investors	27	33	35	35	35	34	30	35	40	44	51	53	52	49	49	49	45
Institutional Investors	28	28	27	30	27	25	33	33	32	33	29	27	25	27	28	28	31

Source: B3; data period: 2004 – H1 2019

[21] Source: Itau BBA

THE RISING INFLUENCE OF TECHNOLOGY

It is clear from the many company meetings we have held, with both listed and unlisted companies, how much and how rapidly technology is transforming the corporate and consumer landscapes in Brazil. Being a nation of close to 200 million people, Brazil is an exciting destination, and in many ways ahead of regional competitors, as companies invest in IT eco-systems, thereby reducing infrastructure hindrances and costs which have until now held back the growth of companies. To put Brazil in context, it is the third largest user of Facebook globally, one of the largest users of WhatsApp and, as mentioned, the number 1 market for Uber in terms of rides.[22]

Many of these companies are benefiting from the late starter theory, gaining market share rapidly at the expense of outdated technology and business practices. Smart use of algorithms and data are enabling food delivery, financial, transportation and even medical companies to undermine what were until recently strong and established franchises. Some are responding in kind, but many could lose market share and profitability, meaning that they run the risk of obsolescence. We expect the technology gap and the adaptability of companies to become increasingly stark in the near future.

A company we met in Sao Paolo in October in the healthcare sector was **Dr. Consulta** (unlisted). This company has developed sophisticated algorithms that enable a consumer diagnosis and prescription to be determined without visiting a physical doctor: it has, according to the company, a success rate of 75–85%, better than the average GP, and this is only improving with time as it is adopted more widely and fed more data. According to the company, doctors who use Dr. Consulta's algorithms are 40% more productive. It is addressing the elevated cost of healthcare in Brazil, the shortage of doctors and clinics and could lead to a degree of de-hospitalisation. The barriers to entry keep rising as it is adopted more widely, thereby bringing greater efficiency by linking the customer with the doctor and using technology in an intelligent fashion.

Elsewhere, consumers are increasingly benefiting in different ways too, such as from the shorter delivery times for products in ever more distant parts of the country. Unlisted companies such as **Rappi** and **Loggi,** both of whom we visited in October 2019, are encouraging this trend with their delivery services. Online retailers are finding considerable surplus capacity in local logistics networks, empowering local distributors, with integrated micro carriers fulfilling the last mile. With 4G covering 90% of the population, online retail is in its early stages of development. 80% of the population has access to and uses decent online services. In general, we have been left impressed with the progress made by several companies in integrating technology in their businesses. In the consumer sector, **Localiza, Natura** and **Lojas Renner** are noteworthy, while **Atacadao** has a very convincing strategy for food e-commerce.

The influence of technological progression is also being felt in the industrial space. **WEG**, one of our holdings[23], and with whom we met in Q4 2019, is a world-class global manufacturer of motors and turbines and is a strong example of an industrial company applying innovative solutions to its processes. Recent data that shows electric motors represent 45% of all electric energy consumed worldwide (EEMODS/2019) and the fact that WEG manufactures 70,000 electric motors per day means that it can play an important role when one considers that every electric motor is a potential Internet of Things (IoT) connection. By monitoring electric motors, WEG monitors what drives an industry. WEG's plans towards advanced areas of technology are based on the evolution of IoT as an element of productivity, control and automation of

22 Source: BTG Pactual

23 In the portfolios of Comgest's representative accounts of the Latin America Equities Composite and Global Emerging Markets Equities Composite, respectively. The representative accounts discussed are managed in accordance with their respective Composite since the Composite's inception.

industrial activities, electric energy and electric mobility. WEG has a fast and effective domain of electric motors' IoT engineering and sensing technology, with a simple, but powerful, smart IoT sensor for diagnosis and monitoring of electric motors. This has now been expanded into smart meters for power consumption. In addition, the company has an innovative IoT platform with codeless development resources for dashboards, analytics and information that allow customers to create a web-based IoT environment which is mobile, robust and low-coding. This has created an ideal platform for data output collected from WEG's IoT devices and smart equipment (e.g. electric motors, drives, solar generation and electric vehicle charging stations). Next, WEG uses a software that allows, besides managing IoT devices status, insights and controls associated to manufacturing and not only managing equipment's status and health. WEG has created a favourable ecosystem to follow new trends in IoT systems and its forthcoming consolidation to wireless technologies and LPWA (low power wide area communication), with the acquisition of a leader in designing solutions with 5G technologies, manufacturing gateways and transmitters with this technology. The ultimate aim is to have a solution combining hardware and software for different industries, generating revenues from both of them.

But perhaps the biggest and most exciting changes are to be seen in the financial services space. A large number of new 'fintechs' are challenging the incumbent banks, in particular in the non-lending space. These companies are enabling small retailers to transact without using cash, to have a 'wallet' whereas historically they would never have been considered as eligible for a bank account. Money transfers, availability of credit, insurance and getting a mortgage among many areas where new companies are offering user friendly services to consumers, at cheaper prices than were historically available. Technology is also transforming credit scoring, which itself is leading to large sections of previously unbankable people being able to have a bank account and access credit. The incumbent banks, especially **Banco Itau** and **Banco Bradesco,** who are spending large amounts on technology themselves, are being forced to respond. They are trying to be more user friendly, digitalise their product offerings, lower fees and the cost of credit and consider those who were previously ignored. Yet with profitability at historically high levels from a global perspective, they may face risks to the downside.

Among the challengers, we met with several newly listed companies:
PagSeguro and **Stone**, which are two recent entrants in the merchant acquiring space: both companies have ambitions to expand their financial offerings to include banking. **Linx** and **TOTVS** are direct providers of financial solutions. **Linx** started successfully offering its client base Linx Pay: an integrated acquiring service, initially partnering with **Rede,** an incumbent. Linx intends to launch a series of services in order to grow the business: lately, they have made partnerships with AME digital, **B2W's** wallet and **MercadoPago** to enable their clients to accept QR code payments without having to download each app. They are becoming a QR code integrator and have launched a service to pay their clients payroll on a digital account with a prepaid card. **TOTVS** also announced its intention to launch a techfin solution to facilitate working capital loans to its client base of SMEs. At this point, payments in Brazil is probably the most competitive sector and the incumbent **Cielo** and Itau's **Rede** have both suffered significant market share loss and margin pressure. As seen in other oligopolistic sectors, both companies had become complacent, leading to rising customer dissatisfaction while they maintained their high margins, creating an environment ripe for competition. Interestingly, a company like **Stone** is taking share mostly from **Cielo** by offering a better customer service and so far not by reducing prices.

The same dynamic can be clearly seen in the banking sector, where both **Banco Itau** and **Banco Bradesco** are suffering on their fees and commission businesses, affected by competition in payment and upcoming competition in asset management but also in the traditional banking business of lending (even if, in the short term, we suspect that this might be offset by a pickup in lending volumes if the economy continues to recover which would mask the impact). Fundamentally, historically high profitability is encouraging new entrants. The banks are responding, with **Itau** initiating open architecture offerings in both asset management and insurance, in addition to a new service, called Iti, which is aiming to offer a payments solution in the micro finance and SME space with a digital wallet. This product receives money via an app to the digital account. In time, it could offer credit once the client has built a respectable history. Both Itau and Bradesco are investing heavily in digital services.

In the direct lending space, other new, unlisted companies such as **Creditas,** whom we visited, are offering asset backed mortgages, often to those who have been previously unbanked. Likewise, a visit to unlisted **Agibank** revealed a bank which offers personal loans, insurance and online banking services, focusing on the older generation of income categories C, D and E, with loans of up to BRL 4,000 per month. Both of these new financial organisations are digital and, although relatively small at present, are pointing the way to a redefinition of the financial services landscape. So even in lending, increased competition has arrived and is forcing better and quicker service and lower prices for customers.

All this is being encouraged by the regulator, in this case the Central Bank, by lowering barriers to entry, regulating against excessive fees and charges, and fostering competition in an increasing variety of financial services.

As we can see, almost regardless of the industry, the ability to regenerate and revitalise the relationship with the consumer through technology is quite clear and is happening despite the overall level of economic temperature. As smartphones have found their way into all social categories, the ability to service current customers better (as illustrated by LINX, TOTVS and Lojas Renner) or to expand the addressable market by reaching new customers (Mercado Libre, PAG Seguro, Localiza) is exciting. This use of technology is also reaching the industrial (WEG) and business service segments of the economy – and presumably as 5G enables internet-of-things more consistently to be deployed, this trend will only be enhanced. That may then represent a moment when Brazil experiences a structural leap forward. From our vantage point as stock pickers, it represents welcome new opportunities both for existing names to extend their growth paths as well as for new names to enter our universe.

To conclude, and with an eye to history, much has changed for the better in Brazil from an investment perspective. As with many other emerging economies, progress is never a straight line, but with the benefit of hard learnt lessons, willingness on the part of the political class and the population and the exciting changes that flow from technological developments, the outlook for Brazil is brighter and more stable than has been the case for many years.

January 2020

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