## "QUIEN NO ESPERA VENCER, YÁ ESTÁ VENCIDO"[1]

*There was once a worker on a platform in the North Sea who woke up with the alarming noise of a big explosion. Surrounded by smoke and fire, he had to make a quick decision: Wait for death without trying anything, or risk a jump into the icy water, hoping for an improbable rescue.*

It was in a little more elaborated version of this allegory that the recently-hired Nokia CEO, Stephen Elop, started a letter[2] to all of the enterprise's employees, showing in semi-apocalyptic fashion the actual moment of the company: "Nokia, our platform is burning".

The mass production of mobile phones during these last 20 years raised Nokia to a global leadership position with a market share estimated in 40% in 2007. After years of success, the company did not attend important changes in the market. The lack of agility in getting adapted to technological changes, together with the arrival of smart phones and Chinese cell-phones made it lose ¼ of its market participation in only 3 years.

The new CEO, a former executive from Microsoft, took over on September 2010. Realistic, he insisted on sharing with his public the company's main problems, and made it clear that "a jump from the platform" would be necessary, in order to keep the company in "survival-mode".

We were very surprised by his sincerity to report such an adverse moment. Realistic (or pessimistic) executives are very rare. The business process is not usually linear, but consists in continuous experiments until some positive result is achieved. An executive from the '80's, being questioned by a young talent about what would be the secret toward increasing one's success, answered: "If you want to increase your success rate, double your failures". Executives that arrive at the most relevant positions are, at large, a consequence of this type of process.

An optimist is always looking for new projects and developing ideas without fearing failure ("I have not failed, I have successfully found 10.000 ways that do not work"[3]). The search for partners to put up capital in the enterprise, the acquirement of loans in banks and the persuasion of suppliers/partners, among others, requires a big technical talent, but mainly commercial astuteness. The idea has to be very well sold to put everybody on board. The pessimist does not even take the first step.

## "DREAM IN A PRAGMATIC WAY"[4]

Optimism is usually contagious and is certainly responsible for most big business improvements. People who do not look for new products, markets, ways of attending clients, among others, will hardly survive competition in the long-run. In these cases, even companies with stable cash-flow generation, negotiating at low multiples, can become awful investments. That's why the challenge is to choose companies/executives that, albeit their innate optimism, do not endanger the company's survival if a certain project is not successful. Investors must take into account that certain variables, such as delays in

[1] *La victoria de Junín* - José Joaquin de Olmedo
[2] *http://www.ft.com/intl/cms/s/0/37ecf3fe-3432-11e0-993f-00144feabdc0.html#axzz1T7ap2rJu*
[3] *Thomas Edison*
[4] *Aldous Huxley*

execution, budget increases, lower than expected demand, and increase in operational costs, (to name a few) make a huge difference in the real return of the investment.

After several years of strong economic growth, people's tendency is to pay little (or much less) attention to the possibility of negative outcomes. The IPO fever transformed dreams, projects and their future cash flows into real money, granting space to the most optimistic entrepreneurs and executives. Executives evolved with the market and currently know exactly what market-participants want to hear in order to guarantee cheaper financing and maintain their shares as well-priced as possible (which is important for option-based compensation schemes, retention and attraction of talents, and as a strong exchange currency for acquisitions). Therefore, they will focus their message on a more positive scenario either because, they really think there is a very low probability of things getting worse, or because they want to monetize their assets as quickly as possible, before the scenario deteriorates.

It is interesting to note that the market does not always require a larger discount for a new project and/or an entrepreneur with little or no track-record. Maybe this happens because it is impossible to compare the ex-post outcome with the ex-ante promise. "Start-ups" know that the first few months are fundamental for a business' long term survival and that's why they focus on small realizations which are easy to show to the market. The important thing is to overcome short-term expectations, even if they are insignificant compared to the actual conclusion of the project.

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In a merger/acquisition it is easy to get persuaded and misled by promised synergies and the possible ramp-up of the acquired companies' incomes. We rarely see an announcement of this kind go by without a big surge in the stock's price. After all, we have several examples of companies that strengthened their markets, generating expressive returns to their shareholders. On the other hand, most of these cases are not well succeeded, but their stories end up being forgotten by the market.

Empirical evidence suggests that most mergers do not succeed in reaching expected profits because of culture shocks, difficulty to cope with many different products, among several other reasons. Many businesses that do not make any economic sense are promoted by bankers, lawyers and consultants, who end up being the main beneficiaries at the cost of shareholder value-creation. If, on one hand, it is easy to calculate ex-ante how much will be saved in buying supplies, it is difficult to estimate the investments needed for systems and process integration, client overlap, cannibalization between brands/stores, just to mention a few of them.

## "SON, IF YOU REALLY WANT SOMETHING IN THIS LIFE, YOU HAVE TO WORK FOR IT. NOW QUIET! THEY'RE ABOUT TO ANNOUNCE THE LOTTERY NUMBERS"[5]

We do not intend to judge the merit of each player, when they are just defending their specific interests. Entrepreneurs, executives and investors possess quite different visions and objectives. This does not mean that the relationship between players is not extremely relevant, but it is necessary to judge each one independently.

[5] Homer Simpson

Skepticism protects investors from determinate risks. On the other hand it also discourages them from investing in big ideas that could transform the world and present “stratospheric” returns. The possibility of multiplying capital by a big factor will always generate a big commotion. It is precisely for this reason that gambling is such a popular game, even though it presents such a negative expected value. It is not because you know someone that won the lottery that you have to buy a ticket yourself (and also, it is not because all your friends decided to create a group and buy several lottery tickets that you have to participate, in fear of being the only person who is not going to win). The same is true about someone who invested in a very risky project and multiplied his capital by a big factor. How many others lost a lot in similar bets and did not go around announcing their losses?

An excess of optimism in executives and entrepreneurs can be important to a national-economy. But it also can present very bad long-term results to an investor who is willing to risk a big portion of his capital in businesses which can have a residual value if things do not happen exactly as expected. In the end, we admire entrepreneurs and business executive’s optimism, but we have to try hard not to be too influenced by them.

Thanks for your confidence,

Atmos Capital