## "YOU CALL IT MONOPOLY, I CALL IT ENTERPRISE"[1]

Success stories of entrepreneurs are teeming with fantasies. The best-seller section of airport bookstores are replete with fairy tales of the idealist that struck it rich and now only desires what's best for society. Initially it is possible that a passion to develop and deliver a quality product or service exists. However, in the few businesses that do survive, the initial growth phase usually triggers an addictive desire to keep increasing profits unboundedly. At this point in time, customer experience is forgotten and the entrepreneur's focus (now playing a businessman's role) shifts to "creating a toll on the only bridge in town". To impede the emergence of new entrants, anything goes, even patenting rounded corners[2].

In theory, one of the goals of a developed society should include the deterrence of large market concentrations. However, such an objective can culminate in an undesired level of government intervention. Moreover, personal agendas within a government might lead to the persecution of earnest entrepreneurs, instead of dealing exclusively with the so-called "robber barons"[3]. The United States dealt with this process in a very competent manner. In the late nineteenth and early twentieth century the country passed rules and regulations[4] that successfully dismantled companies controlled by some highly-regarded businessmen, amongst which we can name John D. Rockefeller and John Pierpont Morgan. The absence of such reforms could have irreparably harmed the productivity of that society whilst still in its infancy.

On the other hand, developing countries often flirt in a promiscuous manner with powerful, politically-oriented businessmen. A less educated society, a state that actively manages business development and a weak foundation of civil rights seem to be some of the reasons behind this phenomenon. The explicit mingling between the state and the business community has never been strongly opposed in these locations. Especially in Brazil's case, it's easy to identify periods of time where the government's visible hand influenced the creation of specific big business groups.

This characteristic built concentrated markets and untouchable oligopolies that marked the formation of the Brazilian economy from as early as the beginning of the twentieth century. The state and its subsidiaries, such as public banks and regulatory agencies, have continually tried to accommodate and protect the position of such groups. It is no wonder that our stock market is so "anemic" in terms of the number of companies listed. It seems quite shallow to place all of the blame on historically high interest rates.

[1] Phrase commonly attributed to John D. Rockefeller, referring to his position in the process that split up Standard Oil (*"Standard Oil Co. of New Jersey v. United States"*, 1911)

[2] Here we are referring to the attempt made by Apple to bar Samsung's growth in the smartphone segment patenting a rectangular design with rounded edges for electronics. The following article presents an interesting discussion of the current state of validity of such patent: http://fortune.com/2015/08/19/apple-patents-rounded-corners/

[3] Robber Baron is a pejorative term used to describe a particular group of American businessmen from the late nineteenth century. It is typically used to describe the empire-building businessmen of the time, who utilized an enormous amount of "brute force" (in the broadest sense) to accumulate their fortunes

[4] Such as the "Sherman Act" of 1890 and Theodore Roosevelt's trust busting of the first decade of the twentieth century

## “BECAUSE THINGS ARE THE WAY THEY ARE, THINGS WILL NOT STAY THE WAY THEY ARE”[5]

Capitalism is essentially cyclical in nature and we are currently undergoing yet another wave of concentration in profits and income, especially in developed economies. The expanded utilization of sophisticated management software tools, fewer barriers among nations, low interest rates (facilitating mergers and acquisitions), increasingly relevant network effects[6] and an ingenious tax planning that transfers profits to regions with lower corporate tax rates, can be named as some of the reasons behind this fact. In turn, while large companies have expanded their markets, low-skilled workers have started to compete globally. It is not surprising that an increase in inequality in the developed world has ensued.

One positive consequence of market concentration is that initially the gains attained through economies of scale and the dilution of fixed costs tends to generate “above-normal economic profits”[7] that allow for meaningful re-investment and thus leverage growth. However, even though this dynamic can be effective for a determinate period of time, the more concentrated the economy, the greater the long term risks. An erroneously executed decision or the abuse of power enacted by a single agent can generate negative impacts on the entire system. If the intention is to foster growth in a long time horizon, one must not rely on the goodwill of people, but on a system that encourages competition.

The stimulus for innovation - perhaps a society's greatest long-term value-generating mechanism - is lost in less competitive environments. Furthermore, even when productivity gains do materialize, they are generally not passed on to consumers in the form of discounts or improvements in the quality of products. Under these circumstances, Peter Drucker’s maxim that states that "the only function of a company is to create and maintain a customer”, becomes irrelevant.

In contrast, in competitive markets, in addition to the continual search for innovation, there is also a greater propensity for companies to maintain a good relationship with every participant in its value-chain. Through natural selection, only the employees and executives that understand these requirements end up surviving. Any attempt to abuse power, whether over customers, suppliers or employees, tends to revert in a loss of market share and, consequently, in lower returns for shareholders.

True competition gives little importance to titles, insignia, or to past achievements. Even Walmart, a symbol of the American retailing establishment, was recently forced to announce an increase in employee wages and had to realize aggressive investments in e-commerce in order to keep up with Amazon’s innovative pace. During Walmart’s investor day, the company's CEO declared, "to deliver results to shareholders, we first have to win over consumers and associates." Statements of this sort are often empty and devoid of an actual commitment, but with the metaphorical “knife under its throat”, for Walmart it is a question of “doing or doing”.

Another great example of the benefits that competition can bring for the common good is the transformation we're seeing in the American beer industry. Due to growth of independent breweries, AB InBev needs to reinvent itself to try to maintain its relevance in this market. The old management model based on the exercise of dominance through the channels that the Brazilian and Mexican oligopolies allow (two relevant markets for the company), loses force in a regulatory environment that encourages competition. In the “three-tier system”[8], it is harder to execute a strategy where one helps a bar owner in the acquisition of refrigerators or pressures said bar

[5] Bertolt Brecht, German playwright of the early-to-mid twentieth century

[6] A product or service presents network effects when its utilization by any new user increases its usefulness to other users

[7] Profits that vastly exceed a sector’s benchmark cost of capital

[8] The most common distribution system in the U.S. whereby beer producers can only sell their products to wholesale distributors who, in turn, sell the products to retailers. Retailers are the only ones that can sell to end customers. In Brazil, where such regulatory framework is nonexistent, the beer producer can deliver and sell the product directly to the retailer

owner so that exclusively the company's brands are offered at points of sale. The old measurable and quantitative variables that have always been the company's main directives need to make room for less tangible elements. Recently, the company even changed its "dream" to include the term *"bringing people together"*. The old mission statement simply declared they wished to be *"the best beer company in a better world"*: "*(...) One of the reasons why people come to us, why they use our products is when people get together. So this whole idea that we want to build the best beer company by doing what, by bringing people together for what, for a better world (...) We're changing some of our commercial codes to make sure that every time we sponsor something that people feel better about themselves and their lives after. So if they go to a music festival, we want to do it in a very responsible way, so when they leave, they have great memories and they want do it again. And the neighborhood where the festival took place will welcome us again next year. So that's the idea, to really make an impact, a positive impact in the communities that we live and serve, so we can have a long-term business as opposed to anything else. So that's the idea.*"[9]

When competition results in a supply of goods/services that is broad, fragmented, and high-quality, "consumer sovereignty" modifies the behavior of even the most aggressive of capitalists.

## "EVEN THOUGH I WANT TO, I WILL NOT FOOL MYSELF / I KNOW YOUR STEPS / I SEE YOUR ERRORS / THERE IS NOTHING NEW / WE ARE STILL THE SAME"[10]

The commodity boom of the last decade brought to Brazil an abundance of resources that facilitated a robust credit stimulus to a number of sectors. As a result, with the prospect of a large increase in consumption, many companies and investors prioritized the country. Multinational companies obsessed with growth invested unjustifiable sums in marketing. This process was bolstered by a huge amount of global liquidity. Private Equity funds and the capital markets as a whole made significant investments in "greenfields" and expansion projects without much discretion. During this phase of increased demand only a few players were able to achieve an effective growth in economic profits. The competitive scenario made it difficult to profitably capture market share and keep prices growing in line with inflation. The most clear-cut example of this was the real estate market whereby a flood of capital forced an explosion in the number of launches. In this case, solely landowners and construction laborers enjoyed the benefits of the sector's expansion.

The current economic crisis and Brazil's diminished reputation in the global financial arena can decelerate further competitive gains for a prolonged amount of time. In a certain way, memories of the 80's (Brazil's so-called "lost decade") return with a bitter taste. During that period, the country faced low economic growth and an increase in inequality due to the regressive nature of the "inflation tax". However, as cynical as it may sound, this period is often remembered with a certain nostalgia by some then established businessmen (mainly from the industrial segment).

Recently, the Brazilian banking sector has started to resemble the old days. Over the past five years, the public banks, turbocharged by the ideological bias of the "new economic matrix"[11], decreased prices aggressively in pursuit of greater market share. Today, as a result, they operate with over-leveraged balance sheets, and can no longer count on a controlling shareholder that has used up all of his ammunition. At the same time, the private

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[9] This phrase was extracted from AB InBev's 4Q14 conference call. It is the CEO's response to a question from an analyst about the recent change in the company's "dream"

[10] Translated excerpt from the song *"Meu Erro"* ("My Mistake") by Brazilian band *Os Paralamas do Sucesso*. Composition by Herbert Vianna

[11] This is the title commonly ascribed to the worker's party (PT) heterodox economic policy that was assumed after the 2008 global financial debacle

sector starts to be cleansed of competition as international banks sell their local subsidiaries (such as HSBC) or simply reduce their appetite for market-share due to a top-down determination from the parent-company (as is the case of Santander). A well-behaved oligopoly is reborn, leaving a somber outlook for the country.

Most executives and investors have a certain fixation with pursuing sectors and companies with high revenue growth potential. The problem is that over the long-haul the focus should rest on increasing economic profits and therefore, factors such as the amount of allocated capital and a sector's competitive dynamics need to be held in the highest of regards. For example, in areas with less growth potential, competition for market share tends to decrease[12]. In such situations, oligopolies are strengthened and the capacity to pass on prices and exert power over other stakeholders is more easily executed.

It is important to mention that it would be very naive, though supposedly sophisticated, to desire unfavorable economic conditions for the nation. Although such situations can bring benefits to certain business groups over extended periods, at the outset, they tend to destroy large amounts of wealth. In the short to medium term, it is necessary to recycle a huge amount of misallocated capital and overcome the difficult task of reducing *"quasi-fixed*" costs. This is a very slow process, especially in an inflexible economy that punishes its entrepreneurs with very high transaction costs associated with firing workers and closing businesses. Depending on the depth of the crisis and the systemic effects that will follow, even market leaders may not escape unscathed.

## "THERE IS ONLY ONE REALLY SERIOUS PHILOSOPHICAL QUESTION, AND THAT IS SUICIDE"[13]

Much has been written about Brazil's low growth potential. However, we should remember that the past few years were contaminated by a series of bad policies and incentives, such as what seemed like an endless supply of subsidized credit, which naturally led to a big misallocation of capital. With less government interference and a simple agenda of economic liberalization Brazil could have grown at much higher rates. Symbolical of our backwardness is the fact that the country is not a free-trade zone even amongst its own states.

Political complexities aside, it is worth mentioning that a country with such a small amount of capital allocated to infrastructure should not have much trouble attracting interest to PPP's[14] and public concessions in a free market. Greater investment in this sector would free up relevant bottlenecks and boost the economy.

It will not be easy to recycle all of the capital that has been misallocated over the past few years. The difficulty of reversing this cycle amidst a troubled and economically fragile political environment requires an even greater focus on capital preservation. However, adverse economic times tend to result in reduced competition, and hence, a positive outlook for the companies that survive. Under such conditions, investments made in these assets at attractive multiples can lead to a very interesting compounding of capital.

Independent of the discussion above it is important to remember that, in the long run, a concentrated market that lacks innovative ruptures, and where there are no IPOs (or where IPOs are spin-offs of revenue-streams of existing businesses) to fund the growth of new companies, is simply a rent-seeking market. In other words, it does not contribute anything for the improvement of society's capital allocation process or economic growth. Its sole

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[12] The inverse of the described effect is known as "boom market price war". This phenomenon is profoundly studied by game-theoreticians and industrial-organization experts. For more, see: Julio J. Rotemberg and Garth Saloner. *A Supergame-Theoretic Model of Price Wars during Booms. The American Economic Review, Vol. 76, No. 3*. June 1986

[13] Albert Camus, French writer and philosopher of the twentieth century

[14] Public-private partnership. Agreement where the private partner assumes a commitment to provide a service to the public administration in exchange for a regulated financial return

function is to make the rich, richer. If this dynamic is sustained it will be difficult to argue against progressive tax hikes for the wealthy and large corporations.

**"Cause I'm the taxman / Yeah, I'm the taxman / And you're working for no one but me"[15]**

The dialogue below was extracted from a work by Antoine Rault entitled Diable Rouge (Red Devil). The supposed conversation took place during the reign of Louis XVI.

The conversation between the characters, Jean-Baptist Colbert (minister of the State and Economy under Louis XVI) and cardinal Jules Mazarin (who served as the prime minister of France), although clearly fictitious, serves as a warning of the times we live in.

Colbert: To find money, there comes a time when tinkering around no longer works. I would like for you as Superintendent to explain how we can keep spending when we're in debt up to our neck.

Mazarin: When one is a mere mortal and drowning in debt, one goes to prison. But the state? That's different. One cannot throw the state into prison. So, it continues to take on new debt. Every state does that.

C: Really? You think that is the case? And how do we do that when we've already created every tax imaginable?

M: We'll create others.

C: We can't tax the poor more than we are right now.

M: Agreed, that would be impossible.

C: So, the rich?

M: No, not the rich. They would stop spending. A rich man who spends money helps to keep hundreds of poor people alive.

C: So, what do we do?

M: Colbert, you have the mind of a chamberpot! There are people who are between the two, neither rich nor poor. They work dreaming of being rich and dreading becoming poor. Those are the people we must tax, more, and more, always more. The more you take from them, the more they work! They're an inexhaustible resource. They are the middle-class!

We no longer live in an absolutist regime or a dictatorship. A whopping level of disparity between socioeconomic classes (large business owners on one side and the middle class on the other), sustained over time in a democratic regime where even competitive capitalism is somewhat frowned upon by society, can be quite dangerous even for well-established companies.

In the long-term, growth depends on competition. This in turn is the number one enemy of economic profits. If sustained, the current dynamics of low growth in an uncompetitive economy in which each group defends its own set of privileges will in no time push us over the cliff towards collective suicide.

[15] Excerpt from the song "Taxman" by British band *The Beatles*. Composition by George Harrison