Atmos CAPITAL

"HOW MANY PEOPLE ARE TRAPPED IN THEIR EVERYDAY HABITS: PART NUMB, PART FRIGHTENED, PART INDIFFERENT? TO HAVE A BETTER LIFE WE MUST KEEP CHOOSING HOW WE ARE LIVING"[1]

An old story tells of a certain night, when the village's rabbis were debating into the early hours about God's existence. After a long discussion, they reached the feared conclusion that God does not exist. Everyone went to sleep, exhausted and disappointed with the discovery. At dawn, one of the rabbis left his room and was surprised to see one of his peers conducting the traditional morning liturgy. Thus, he asked: "Didn't we conclude that God does not exist?" Equally baffled by the question, the other rabbi answered: "What does God have to do with it?"

When habits get incorporated into our daily lives, they rapidly become as natural as the air we breathe. In investing, just as in any other arena, they influence processes and results. The dangerous part of this equation, which presents itself most often after a favorable investment period, is to underestimate nature's randomness and believe that success can be explained by faithfully performed customs.

Internally, we nurture the habit of attributing a disproportionate weight to eventual negative scenarios. Of the last 10 investment traps in Brazilian companies, we must have encountered at least 50. In a phase of the investment cycle that overlapped with an awful moment for the country[2], this feature demonstrated itself positive and we managed to obtain a good performance both from an absolute point of view as well as relative to market indices.

During this period, avoiding big mistakes was more important than finding successful investments[3]. After all, companies with unsustainable business models are proven infeasible relatively quickly when there is no excess capital to fund their big dreams.

It would be comfortable to continue following mental and cultural habits that have worked thus far. But will our mental framework of risk aversion keep working in an economic cycle more conducive to business development?

"THE ONES WHO GO BROKE IN THIS SITUATION ARE OF TWO TYPES: THE ONES WHO KNOW NOTHING AND THE ONES WHO KNOW EVERYTHING"[4]

Attention to faulty business models is, by definition, a relevant trait in avoiding big investment mistakes and, consequently, compounding capital over time. However, an exaggerated skepticism that repeatedly questions the long-term outlook of companies may lead to a laggard performance in case the consensus of economic stability materializes during the upcoming years. Under these circumstances, the ultimate beneficiaries will be those investors with a higher appetite for risk.

To further complicate our task as fund-managers, four years into the biggest economic crisis in Brazil's recent history, the long list of companies in intensive care has played the role of educating the market about the dangers of investing in vulnerable businesses. Presently, every analyst equipped with a basic quantitative filter is capable

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[1] Albert Einstein
[2] Which virtually overlapped with our fund's inception date in October 2009
[3] Despite the common criticism that all Brazilian funds hold the same positions, we managed to differentiate ourselves in positions in which the fund did not invest. As examples we can cite the following "non-investments": X-group companies, pre-MP579 electrical utilities, real estate from 2013 to 2015 and a myriad of IPO's that went very wrong
[4] Henry Kauffman, former director of now-defunct U.S. investment bank Salomon Brothers

of pinpointing which Brazilian companies are really well run, have a stable cash flow and a management that values rational capital allocation. Given that the examples of this type of business in our stock exchange are extremely limited, their prospective returns have become very depressed and homogeneous. Therefore, the rebalancing of the portfolio between traditional, high quality names has become a more complex activity when compared with the fund's early years.

The need to adapt to the new scenario forces us, at least temporarily, toward a higher exposure relative to our average levels since the beginning of the fund. We also find opportunities in riskier companies that we avoided throughout the last cycle of capital destruction, even though we comprehend that investing in these businesses adds to the portfolio a higher level of volatility than we have gotten used to in the past few years. We expect to be adequately rewarded by the potential upside in case a more optimistic scenario materializes. If previously we only saw risks, currently we see some risk of being positively surprised.

As presented in the tale at the beginning of the letter, the continued repetition of a comfortable habit can eventually be quite blinding. The only antidote to this situation is constant reflection at each step.

"UBER, THE WORLD'S LARGEST TAXI COMPANY, OWNS NO VEHICLES. FACEBOOK, THE WORLD'S MOST POPULAR MEDIA OWNER, CREATES NO CONTENT. ALIBABA, THE MOST VALUABLE RETAILER, HAS NO INVENTORY. AND AIRBNB, THE WORLD'S LARGEST ACCOMMODATION PROVIDER, OWNS NO REAL ESTATE. SOMETHING INTERESTING IS HAPPENING"[5]

In 1898, a group of intellectuals gathered in New York to discuss the future of the major cities over the next 100 years[6]. In that distant time, the city already pulsated with entrepreneurship and innovation as the first elevated passenger railway, subway and skyscrapers were being constructed.

The team of specialists, after a short and confusing conference[7], reached a somber conclusion. In the prior 80 years, New York had jumped from 60 thousand to 1.2 million inhabitants. Even with slower growth in the future, one wondered how all the people would be able to walk around the city. Horses, which constituted the main means of transportation, were a problem at the time. They left an enormous trail of dirt on the streets and represented a serious health hazard. The number of dead horses removed from the streets was colossal. The outlook was bleak. The city was bound to become a large open sewage and, at the turn of the century, would be completely destroyed.

What the specialists failed to comprehend was that, in a few years, the popularization of the automobile would revolutionize the transportation dynamics of every major city. Obviously, other problems would arise from the accelerated population growth, but the city did not collapse into a pile of dirt.

Scientific discoveries are embraced by society and then implemented into our daily lives when they pass the difficult test of large-scale economic viability. These advancements are widely discussed and even anticipated. The hard part is to be able to reflect on all the dimensions and assess the non-primary effects.

During the period that has become known as "post-war stability", and grounded in the respective ascension of the middle class, a technological rupture influenced a virtuous cycle which allowed for the strengthening of big consumer brands. The birth of the television and its immediate rise to the center of family life created national

[5] For more details, see the following: https://goo.gl/WAW42H

[6] For more details, see the following: https://goo.gl/NfCToh e https://goo.gl/tEj6bP

[7] The conference had been planned to last 10 days, but as the first three did not produce any practical result, the participants started to give up and leave in droves

franchises that inserted themselves into popular culture. An entire industry created in Madison Avenue would for decades dedicate itself toward devising an algorithm that could influence consumer desire. Concern with product quality was far from a priority. The consumer, with hardly any option at the point of sale, and furthermore programmed to desire famous brands, became a type of dream-client.

In this process, franchises built on high margins were widely capable of passing price increases on to consumers. Amid this environment, Warren Buffett and Peter Lynch put the teachings of Phil Fisher[8] to the test, obtaining extraordinary results by buying "great companies at fair prices."[9]

As an exercise, assuming a real discount rate of 6%, a business that raises its prices 1% above inflation for a long period, even in a scenario of constant margins, deserves a P/E multiple about 20% higher[10]. Not to mention that a company that passes real price increases on to its clients, with a minimum of discipline, tends to widen margins through time. In this case, results are increased without significant marginal investments, and on top of that fixed expenses are diluted, meaning that the company can pay shareholders (via buy-backs or dividends) all of the cash flow produced in the year, whilst it generates capital appreciation exceeding the 1% real revenue growth. Consumption industry darlings such as Coca-Cola, Pepsico, P&G, Kraft and Unilever were built under these extraordinary circumstances.

During a long period of prosperity, the world was charmed by the western lifestyle and these large multinational companies enjoyed for decades the power of their brands at home and abroad. A global marketing strategy was capable of impacting homogenously different consumers in cultures that were, theoretically, quite distinct.

The past few years bear a certain similarity with the post-war events that boosted these companies and allowed the creation of true behemoths. The difference this time is that the old winners look like they are now the prey. The digital revolution, which in the beginning would apparently just change the way we buy and receive our products, starts to interfere in unexpected issues. Traditional retail is not the only target of this transformation.

The capacity to invade and conquer markets without the need to spend large sums of capital has become commonplace. Technological advances created conditions for the development of the platform-company concept. These businesses enable direct interactions between producers and consumers and are totally open, with a participative business model that connects entire ecosystems. They are responsible for setting rules and conditions for the new market and, as they gain scale, they also create a new supply that fuels a dormant demand untapped by almost any analog player. This is every capitalist's dream. This rise has already jolted legacy businesses such as the taxi industry, brick-and-mortar retail, hotels and the traditional media[11].

The large consumption companies and their brands, until recently untouchable, can no longer hide. Who could have guessed 10 years ago that Gillette, from 2010 to 2016, would have its market share in the United States slashed from 70% to 54%[12], and that this year it would be forced to promote a large-scale price reduction after decades of above-inflation increases? Or that Amazon, in a short time span, would launch its own brand to quickly conquer 30% of the online battery market?

The mediocre product hiding behind a strong brand, dependent solely upon a mass marketing strategy and access to a point of sale, is now competing in a wild environment. User reviews are the libertarians' utopia, imposing a radical transparency on the process. Large companies, which historically exerted their influence over the traditional media as the main advertisers, lost control of the process. From a marketplace and online marketing

[8] For more information, consult the book "Common Stocks, Uncommon Profits", Phil Fisher
[9] "It is better to pay a fair price for a great company, than a great price for a fair company." - Warren Buffett
[10] Considering an unleveraged capital structure and comparing against a company whose prices only keep up with inflation
[11] For more details, see the following: Platform Revolution (Geoffrey Parker, Marshall Alstyne, Sangeet Choudary)
[12] Data according to a recent WSJ story. For more details, see the following: https://goo.gl/pSH9sA

platform, new products can arise from anywhere. In an interconnected environment permeated by fast-learning algorithms, the client's journey was never this well controlled.

In this ecosystem, the level of investment to make a brand well known plunges alarmingly, and scale is no longer a critical element. Incidentally, we already see companies born online such as Bonobos and Warby Parker that later added the offline experience competently. Brick-and-mortar stores become marketing expenses, strengthening the brand and speeding expansion. It is curious that even without expertise in physical retail they show a differentiated consumer experience, visibly superior to the existing retail businesses in their respective segments. In this case, the freedom of inexperience and the lack of decades-old, deep-seated habits, are an upside.

Voice technology also changes how one interacts with the brands. When ordering a product through Alexa[13] the experience related to packaging, pricing strategy and shelf position is disrupted. Billions of dollars spent to impact an entire generation of consumers are being destroyed. Surveys already demonstrate that search for brand-name products, either on Google or Alexa, have been declining quickly. Amazon, with all the knowledge it has about its clients, will be capable to quickly suggest the best offerings based on criteria such as taste, habits and price, while attributing little weight to the brand factor[14].

Currently, over 50% of U.S. online consumers start their product search inside Amazon itself[15]. It has topped traditional search engines such as Google, even though it still holds a timid presence in the gigantic food industry[16]. It will be no surprise if, in the coming years, a relevant chunk of trade and marketing expenses at consumer goods companies are earmarked to the online retailer.

In China, the concept is even more advanced. Alibaba has already opened 13 Hema-brand neighborhood supermarkets. It perfectly incorporates the new integrated retail concept, which aggregates logistics, data, online and offline experiences[17]. The service starts with the download of an app, which is already connected to the company's payment method. Within a three-kilometer radius, deliveries are made in 30 minutes and clients can buy traditional brands as well as fresh products from small producers. The experience is different from everything we have witnessed. All the items are easily scanned inside the store and delivered at the most convenient location for customers. As the database is built, the possibility of influencing the consumer's decisions grows exponentially.

In terms of capital allocation, the era of buying companies with strong brands, and then sitting in the shade waiting for returns to mount may be ending. However, due to the low level in interest rates and the outlook for mergers, the multiples of large consumption companies have reached all-time highs. It should be noted that in many cases we are witnessing 0% price increases in nominal terms (a 2% decrease per annum in real terms) while volumes also decline. Even if we assume constant margins[18] and ignore the volume decline, lagging behind inflation should bring down the fair multiple of a company in the United States from about 20x earnings to, at most, 12x[19].

If this company trades at a much higher multiple due to the possibility of buying companies at 15x earnings after synergies, risks persist. The positive mathematical effect from the decline of the traded company's multiple may generate a short-term appreciation of its stock. However, even a slew of mergers with businesses at lower

[13] Alexa is the virtual assistant Amazon launched in 2014. Through artificial intelligence algorithms, it is possible to carry out voice-controlled tasks such as playing music, making phone calls and, of course, buying Amazon products

[14] Argument by NYU professor Scott Galloway. For more details, see the following: https://goo.gl/VW8d4c

[15] Source: Bloomberg Technology - https://goo.gl/Cisg7Y

[16] With the increased presence in the food segment, intensified after the acquisition of Whole Foods, another retail segment may be impacted

[17] For more information, see the film inside the following link: https://goo.gl/13rcJe

[18] Optimistic premise taking into account that these companies have heavy fixed-cost structures

[19] Taking into account that the real price decreases of declining businesses will be sustained over time, and using the premises listed previously: (i) 6% real cost of capital and (ii) stable companies raising prices by 1% p.a. in real terms

multiples will hardly lead to long-term investment returns above the cost of capital if the acquired companies also feature real price decreases over time. Only mergers with high quality companies at significantly lower multiples (<12x) carried out in large scale, or extremely leveraged acquisitions of companies at 15x tied to long-term funding at very efficient costs will have the potential to effectively generate value in the long run.

This new competitive dynamic, already waged outside of Brazil, should be the subject of reflection at least as a cheap crystal ball. Brazil is not a country for amateurs. Tax and logistics-related complexity always shielded the big national groups and, historically, competition could only be initiated inside the protected local market via institutional acts. But the world has changed. The digital segment zooms fast and will cause a big impact on those who do not adapt. Entities such as unions or industry-specific lobbies are not capable of protecting their rich markets from this threat, which does not respect borders.

"DOUBT IS AN UNCOMFORTABLE POSITION, BUT CERTAINTY IS AN ABSURD ONE"[20]

In the 1990s, Stanford professors Jim Collins and Jerry Porras wrote the excellent book "Built to Last," which shook the corporate and investment worlds. They presented a thorough study on the characteristics that permeate lasting businesses but are absent from the losers' DNA[21]. *Winners and losers*, in a very American style.

The ideas were exposed in a clear and educational manner, backed by curious examples and solid data. The classic playbook of business schools, which are at the heart of the large international consulting companies. Readers were thrilled by the fact that the "winners'" principles required neither vast amounts of capital, nor NASA scientists. Any individual with common sense, focus and energy could create a "Built-to-Last Company" and be rewarded eternally.

In the following decade, at least half of the companies depicted in the book failed miserably, likening the study's statistics to a simple coin toss.

Excessively elaborated explanations developed in hindsight are simply conjectures. In this sense, we prefer to think about the history of business through a simpler heuristic: long cycles followed by ruptures. Normally, these changes disrupt companies, management styles and corporate theories.

There is an enormous fascination in identifying built-to-last companies. As long-term investors, they represent in our subconscious the pot of gold at the end of the rainbow. Even without admitting it, the research effort is always directed at finding the perpetual toll bridge on the only road to heaven. But the comfort provided by a monopoly and its permanent "winner's inertia" may create a certain arrogance and disrespect for future uncertainties. Society's capacity to seek innovation and alternative ways to solve chaos is minimized. This process usually upsets the table of winners and losers.

Trying to guess which companies will come out victorious from this transformative process is an inglorious, perhaps useless task. But turning a blind eye to what we are seeing can be lethal. Maintaining a fund-management style that only sees quality in perfectly priced, stable incumbents may be the functional equivalent of shorting disruption, just as this phenomenon presents itself indiscriminately. One could be copycatting the 19th century intellectuals who, looking out toward the future, only saw manure.

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[20] Voltaire
[21] Or even the runners-up