Atmos CAPITAL

"IF DATA IS THE NEW OIL, THEN CHINA IS THE NEW SAUDI ARABIA"[1]

Mission, purpose, manifesto, culture, disruption, ecosystem, ping-pong, chef, vegan, agile, squad. Silicon Valley culture has presented the world with a new way of doing business. Executives from across the globe visit the region as a tourist attraction. As if drinking water from the source will enable them to enter a portal into a universe of transformation.

Silicon Valley is the result of a Cultural Revolution that took place in the 1960s. The counterculture sowed by the hippie movement validated an ideology that proclaimed novelty as an end in itself. This view worked as a gravitational force for innovators in the following decades and ended up mixed with a nerd culture arisen from the explosion and democratization of personal computers. In this environment, serving the good of humanity before turning in a profit became a dearly held concept. As a result, values such as corporate purpose and mission emerged, agglutinating the necessary stamina to address supposedly impossible tasks.

The world has dubbed the changes birthed in Silicon Valley as the Technological Revolution. A new version of the Industrial Revolution, much like England's in the 18th century as well as several Western countries' in the mid-19th century. Historically, these periods were followed by economic growth and exponential gains in productivity and wellbeing. At first the new technology monopolizes and concentrates financial gains, creating disproportionate wealth. Then, with the technology democratized - often through antitrust regulation - it spreads globally, transferring gains from private pockets to the society at large. In the analogic world, the period between the explosion of creativity and the amortization of its benefits was longer. It usually took a rather long time for the playing field to be leveled and for execution to become the main instrument of differentiation.

The contemporary idyllic Silicon Valley presents instances of arrogance. The obsession with innovation has made the entrepreneur believe that instead of building a business, his project should involve the elaboration of a work of art. The *virtuoso* must isolate himself to create a masterpiece, as though humanity depended on it. Since this culture was *avant-garde* and a springboard for gigantic businesses, there is a certain embarrassment in copying ideas, products and processes. On the other hand, China has witnessed the birth of a model of technological implementation that is much more like original capitalism: competitive, profit maximizing, purposeless, aiming to serve consumers' dearest wishes - whatever they may be.

There is a cultural difference between the West and the incipient Chinese ecosystem. Western thinking traditionally sees China as a protected market for national champions picked by the centralizing State. It couldn't be more different. China's success in the digital era stems from an ardent capitalist process, where imitation is acceptable and competition only ends when competitors are exterminated. Agile, smart and practical entrepreneurs are being created, and they might just be China's secret to cashing in on the Artificial Intelligence Era before everyone else. Not to mention that the Chinese work ethic places American hippie-geeks - who worship lifestyle as the epitaph of a successful career - at a significant disadvantage[2].

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[1] Kai-Fu Lee, former CEO of Google China and founder of the Chinese venture capital fund Sinovation Ventures. Much of the reflections in this section were inspired by his latest book: *AI Superpowers: China, Silicon Valley and the new world order*

[2] The traditional practice at Chinese startups is centered on a work routine defined as 9/9/6: 9:00 a.m. to 9:00 p.m., 6 days a week

The adoption of new technologies is better executed in this fast-paced dynamic of unabashed copycatting, that does away with ideology and collides ideas against each other on a daily basis. Despite being deemed inferior by Western peers, this culture supports a greater movement of online to offline integration.

A good example of the effects that this model of cutthroat competition can have on society was demonstrated in the war between discount coupon companies that became popularly known as the "Thousand Groupon War." The habit of organizing groups to negotiate prices was common in China well before the smartphone boom. Without technological resources, consumers used to gather in person to bargain with suppliers of products and services. However, with the arrival of mass connectivity and the birth of Groupon in the U.S. in 2008, it did not take long for the offline culture to migrate online. The war for market share quickly took epic proportions: From 2010 to 2011 as many as 5,000 companies emerged in this new segment. Initially, not even the major operators were able to reach a positive bottom-line.

After a fierce war, two competitors survived: Dianping and Meituan. Meituan started out as an exact copy of Groupon. Even its web site's layout and colors resembled the American peer's. However, the company succeeded in converting the huge user-base generated by the original line of business into food-delivery sales and from there expanded its assortment to a host of different retail categories[3]. Meanwhile, Dianping was launched as a kind of Chinese Yelp where users could post comments and ratings for restaurants. The company forayed into the discount-coupon market during its boom and after the bubble burst returned to its original vocation, verticalizing its activities to provide delivery services.

Having survived the long-lasting war for market share in the seductive collective-buying sphere, both companies adapted their models to more sustainable segments and ended up merging their operations in 2015. The resulting company capitalized on the previously acquired clients to launch new verticals for products and services. Showcasing it's ability to cross-sell, Meituan Travel[4] currently carries out about 45% of hotel bookings in China[5], having dethroned the pioneer CTrip[6], which maintained itself conservatively concentrated in its original vertical. Despite a winding road and all the burnt cash, the violent competition made for a positive impact on the survivors. Meituan-Dianping is currently worth an estimated USD 40 billion, approximately 8x more than the market value of Yelp and Groupon put together. In this case, the copycat turned out better than the original version.

China has been crossing the bridge between the 20th and 21st centuries in accelerated manner. Conditioned on an internet adoption process that boomed through the use of smartphones, the first SuperApps are born, integrating hundreds of millions of people in a single platform. They consolidate food orders, personal and collective communication, online games, payments and the mass services market. In this process, real world data is amassed in scale and assimilated in real time by the verticalized winning businesses, resulting in a data lake that is much richer than the likes and search terms collected by Western companies. Equipped with this data the Chinese companies hone their solutions, enter and leave markets pragmatically, shape their clients' purchasing preferences and deepen their connective links to all of their consumers' day to day needs.

[3] Currently about 20 million people use the app on a daily basis
[4] Integrated travel platform, launched officially at the beginning of 2017
[5] There's a nearly 80% overlap between the company's hotel client base and its food segment client base
[6] Interestingly, Neil Shen, manager of Sequoia in China and a cofounder of CTrip, was the only participant in the initial investment rounds both for Dianping and Meituan through Sequoia funds. He is presently the independent director of CTrip and is on the board of Meituan-Dianping

"BRAZIL! / LAY BARE YOURSELF / I WONDER WHO BANKROLLS / OUR MISERY"[7]

China's evolution in the 21st century demonstrated how quickly an emerging country can adopt transformational technologies in the digital era, as long as it accepts the march towards a meritocratic capitalist system.

In Brazil, this Schumpeterian process seems to be in its infancy. One of the benefits of being a capitalist in an underdeveloped, commercially insulated country is that changes tend to be slower. Capital scarcity, bureaucracy, excessive regulation and tax and logistics issues are barriers to new companies. However, the convergence of physical processes towards virtual ones and the creation of a market willing to fund new businesses leaves the incumbents in a state of alert.

After a long hibernation, finally Brazil's entrepreneurial ecosystem woke up a few years ago. There are new companies upending the establishment based on modern corporate cultures and access to capital. XP Investimentos, Banco Inter, Stone, Arco Educação and 99 Taxi are a few examples. The gigantic, sluggish multinationals that in the past suffered while attempting to gain market share in Brazil are presently better represented by the major technology powers. The advance of Google and Netflix over the traditional media monopoly held by Grupo Globo, despite its economic hegemony and disproportionate political clout, is a picture of this reality.

On the opposite side, we see some established companies conceding that the world is undergoing significant changes and trying to develop better practices to the local reality: shopping malls teaming up with new online-based logistics players, traditional retail names betting on the omni world, established software companies generating new business units such as payments and the banks themselves going digital and shrinking physical presence.

Despite the correct direction, there are significant nuances that set apart desire and experience. We have recently been surprised by the incapacity of the established acquirers to stem the entry of competitors born mostly from well-told ideas and narratives, that didn't originally possess significant product differentiation. At a given moment, there was a chance to crush the new competitors but incumbents simply weren't capable of sacrificing short-term profit. Maybe they were even willing to do so, but institutional lethargy stood in the way.

The bloating and lack of lubrication in traditional structures make any change an insurmountable challenge. Legacy systems, which in the past provided sizable scale advantages, have become a burden, a cost that the new entrants simply do not bear. The capacity to lure talent is also hindered at the older companies: it is currently deemed preferable to chase a dream at a new company than to work for a fixed wage in a "pointless" position.

Darwin taught us that survivors are those capable of adapting. However, when the ecosystem undergoes a very drastic change only a few individuals from the old environment own the right adaptive resources to keep prospering. In the end of the day, dinosaurs that are wary of their potential risks of extinction are still dinosaurs.

[7] Excerpt of the song "Brasil" Written by Cazuza, George Israel and Nilo Romero

PERSPECTIVES

"THE PAST DOES NOT RECOGNIZE ITS PLACE. IT WANTS TO BE PRESENT"[8]

When asked whether we are optimistic about the country's future, a phrase by the immortal writer Cony[9] instantly comes to mind: "the optimist is ill-informed." However, after witnessing one of the most recessive cycles in Brazilian history, it is reasonable to be at least more constructive. This is a consensual outlook among local investors nowadays. It is important to note that, despite the inherent charm of being a nonconformist, the consensus proves itself right most of the time.

Even though we held on average about 25% in cash during the fund's first eight years, since last year we have parked a negligible amount in short-term government securities. Contrary to past years when we used to earn high real returns in floating-rates fixed income, today the picture is different. The cost of not being invested in equities rises sharply under such a scenario.

We are long-term allocators in the asset class "Brazilian Equities". We believe it will be a good generator of returns over time. Therefore, portfolio construction should follow an inverted logic: if we have no strong reason not to be invested, we will be long a relevant part of the portfolio. Our low allocation from 2009 to 2016 came from a very negative perception of the economic cycle. An uncommon situation when one looks at long historical periods. Sometimes, this position leads to misperceptions pertaining to our basic characteristic as investors: are we a bottom-up or top-down firm? We like the position postulated by Seth Klarman[10]: "we worry top down, but we invest bottom-up." Our investments will always be made based on a deep scrutiny of companies (bottom-up), while understanding that sharp recessive cycles destabilize the economy, affecting businesses' micro fundamentals. The departure of a populist, left-leaning regime is traumatic. The necessary re-basing of an artificially created demand eliminates the wellbeing frailly conquered by society. A few years are necessary for all the poorly allocated capital to be absorbed.

We definitely do not incorporate a naive view that Brazil will finally fulfill its prophetic destiny of becoming "the country of the future". Budgetary efficiency must be greatly improved, either through potential reforms of items that subsidize affluent families and consume a lot of resources (pension reform), or a productivity shock in the government sector, or even to a smaller extent via better checks and balances on corruption. However, shrinking bureaucracy to levels seen in civilized countries looks like an extremely challenging task. It would be a huge illusion to expect that the adjustment in the country's public finances will be made only via spending cuts and not through traditional tax increases.

Nevertheless, on a more positive note: regarding fiscal policy, exponential functions typically auto-correct. One either chooses to balance accounts, or else they explode. Contrary to our neighbor Argentina, Brazil was several times on the brink of the abyss, but never dared to jump off. Perhaps due to our bulkier institutions, or simply due to the strong presence of a self-interested political center that is convergent with the nation's economic wellbeing during periods of social chaos.

Since the beginning of former president Dilma's second term, which was concluded by president Michel Temer, progress has been made in trying to bring spending closer to revenues. After the irresponsible testing of all the

[8] Mário Quintana. Brazilian poet and journalist
[9] Carlos Heitor Cony. Brazilian journalist and writer, member of the Brazilian Academy of Arts and Letters since 2000
[10] Founder of Baupost, one of the greatest investors of the 20th and 21st centuries

chapters in the “economic heterodoxy textbook”, disguised under a cloth of “new developmentalism”, economic agents regained discipline and shifted to an extreme of orthodoxy.

Amid this context, a huge recovery potential becomes noticeable in the private sector. Companies’ and families’ de-leveraging has already happened. Nothing like a severe winter to challenge inertia. The big adjustment in costs and expenses made by businesses in the name of survival proved surprising and may bear interesting fruit as the economy picks up. Furthermore, on top of all this, for now competition seems weak, both because multinationals withdrew from the country and will be slow to return, and because several homegrown competitors were forced to leave the game.

On the other hand, one must be wary of false opportunities and traps along this new cycle. Despite potential growth and the supposedly interesting carry that accompanies it, the digital revolution may mercilessly kill sluggish incumbents. Even if the impact that accrues from this is slow, the market tends to anticipate such movements. Segments with gigantic profit pools are coveted prey. It should be noted that the secret to compounding returns throughout time is not brilliancy, but rather avoiding significant mistakes. Cielo, which for many years was one of the fund’s top positions, yielding excellent results, initiated a very accentuated value-destruction cycle with the recent inflow of fiercer competition. Other relevant (and perhaps related) industries within the Ibovespa index may follow suit.

A popular joke recalls that a Frenchman, an Englishman and a Russian were admiring the stunning painting of Adam and Eve in the Garden of Eden inside the Vatican Museum. The ironic Frenchman was the first to expose his opinion: “They must be French. They are naked and eating fruit.” Promptly, the Englishman replied like a Lord: “Clearly they are English. Observe how polite they are. The man is courteously offering the woman a fruit.” With a bang, the red-cheeked Russian swiftly ended the discussion: “They are certainly Russian! They have nothing to wear, nothing to eat and they think they are in paradise.”

Like the Russian, we still do not have much to dress or eat, but nevertheless have started to feel closer to paradise. This is a dangerous feeling given the number of uncertainties in the microeconomic plain and the difficult path toward the approval of unpopular structural reforms. One should always recall that the cemetery of local investors is full of men loyal to the *status quo* or who believed too much in Brazil.