"FOR HERE I AM SITTING IN A TIN CAN, FAR ABOVE THE WORLD. PLANET EARTH IS BLUE AND THERE'S NOTHING I CAN DO"[1]

Catastrophic events are often interpreted through the lens of immediate suffering – a consequence of the human obsession with fixating on specific moments and treating them as permanent. This applies as much to tragedy as to fortune. "*There is nothing either good or bad, but thinking makes it so*."[2]

The pandemic brought about by the SARS-CoV-2 virus will not be quickly forgotten. It will be thoroughly documented and studied, both from a scientific and sociological perspective, and the findings will have long-lasting impacts on society.

While a clichè comment, it is true that in four months the world witnessed a technological transformation that could have taken four years. Observing the behavior of businesses and consumers during this time was like watching a movie in fast-forward motion. Businesses that adapted quickly to the new circumstances or that were already well-positioned to face the challenges brought by the pandemic harnessed beneficial short-term effects. This allowed for their fast-paced growth and gave them the impression that they were on an unabated journey to paradise.

However, even though some companies had the opportunity to "front-load" their growth, competitors who under regular market circumstances would not have been able to attract resources (especially if the digitalization trend had followed its regular course), also capitalized themselves.

If companies were subjected to the Marshmallow Test[3], the desire to grow rapidly in the short-run at the expense of greater competition in the future would be analogous to the desire of eating one marshmallow immediately instead of eating two marshmallows after waiting 15 minutes. Slower growth in a less competitive market tends to generate greater value over time. Even if companies redirect all marginal momentary profits toward strengthening their moats, a capitalized competition might be capable of counterbalancing these short-term advantages.

As investors, we are tasked with the complex responsibility of interpreting these effects amidst the current whirlwind, aspiring the necessary wisdom to distinguish between signal and noise. At risk of being misled by a reflection that validates preconceived convictions, we attempt to lay out our thoughts in this letter.

"I WANT TO STAND AS CLOSE TO THE EDGE AS I CAN WITHOUT GOING OVER. OUT ON THE EDGE YOU SEE ALL THE KINDS OF THINGS YOU CAN'T SEE FROM THE CENTER"[4]

Humanity was built upon local narratives. Most recently, the advance of communication allowed for the formation of global narratives. The subsequent effect is an enormous homogenization of myths.

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[1] Excerpt from David Bowie's "Space Oddity.

[2] Quote from a conversation between Hamlet and his childhood friends Rosencrantz and Guildenstern, in Act 2, Scene 2 of Shakespeare's Hamlet. This quote can also be found in our 22nd letter, but remains incredibly pertinent as we collectively face this difficult moment.

[3] For more, see https://bit.ly/39vUDDa

[4] Kurt Vonnegut, American writer.

The financial markets are a part of this movement, and increasingly global mandates have led to a search for similar theses across continents. In Latin America we are witnessing a proxy to this race, with the benefit that in developing countries the themes draw inspiration from the two largest markets in the world, namely those of China and the USA.

The emergence of timely and sophisticated narratives, the growth of ETFs and passive investing, and finally, the fear of missing out following a decades-long bull market (driven by low interest rates) create a cycle that feeds on itself and elevates the capitalization of the new behemoths. This in turn leads to a reduction in these companies' cost of capital and, consequently, a solidification of their competitive advantages. It is a self-fulfilling prophecy bolstered by execution and strategy.

Transposing this dynamic to the Latin American market strongly boosts the few local publicly listed names that are labeled as "technology" companies. The correlation between these securities and their global peer-group, despite the acutely different geographic locations and market characteristics, is impressive.

In the real world, it is rare to find companies that manage to profit ~0.1% of the GDP of the markets in which they operate. Apple, for example, one of the companies with the highest sales and margins in the world, profits approximately ~0.1% of the GDP of the markets in which it participates. Assuming a generous multiple of 30x Earnings, one will find that companies worth ~3% of GDP should be extremely rare. In Brazil, where the banking system is notoriously oligopolistic, the largest banks profit approximately 0.15% of GDP above their cost of capital, and the market capitalization in excess of book value is around ~1% of GDP. As an upper bound we can look at China, where the Alibaba and Tencent ecosystems combined represent around ~10% of GDP, and there is a tremendous dominance in various services. Tencent owns the Chinese versions of WhatsApp and Facebook (WeChat Moments), gaming platforms, a digital wallet, in addition to enabling hundreds of thousands of third-party "mini apps" that offer a multitude of online and offline services under one ecosystem. Although the sum of the market values of platforms operating in Brazil point to a similar direction, the competitive dynamic seems utterly incomparable. It is worth noting that the market value of the local units of Google and Facebook jointly represent something between 2 and 4% of Brazilian GDP, given the relevance of both companies in the country. Furthermore, Brazil's high discount rate and its overall lower economic growth when compared to the US and China - as well as to much of the developed world - should also lower the relative valuations of companies operating exclusively in the region.[5]

"EVERYTHING IS RELATIVE; AND ONLY THAT IS ABSOLUTE"[6]

The "relative valuation technique" has been utilized instinctively since the days of the Persian markets to value goods and assets. The consumer, frightened after asking for the price of a good in the first stall of the bazaar, nonetheless proceeds to enter the second stall with a false perception that he is speaking to independent sellers. And on he goes, until he eventually opens up his wallet confident that a great deal has been negotiated.

When valuing businesses that do not currently generate cash flow to shareholders, it is easy to fall into the trap of the seductive merchant, now disguised as a visionary entrepreneur or legendary investor. In this endeavor, one risks losing touch with more fundamental frames of reference.[7]

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[5] With the exception of companies participating in sectors still poorly penetrated and with relatively uncompetitive conditions.

[6] Auguste Comte, renowned French philosopher.

[7] For more, see Coherent Arbitrariness: Duration-sensitive pricing of hedonic stimuli around an arbitrary anchor, by Ariely, Lowenstein and Prelec.

E-commerce reigns as one of the "digital" segments with the highest levels of comparability across continents[8]. However, akin to physical retail, the differences in the competitive dynamics between regions could not be more distinct.

The American market incorporates unique competitive characteristics, driven by historical motivations. Even though Amazon competes digitally with one of the largest and most admired players in the retail space, - Walmart, - it has obtained the safe-conduct with investors to make everyday "Day 1". Betting on a long game, the company constructed the notion that short-term profitability was unnecessary, inverting the traditional logic of retail and placing the customer in first place, ahead of any other considerations. Taking advantage of the exponentiality of a digital economy with significant network effects, they leveraged the power of demand aggregation[9]. Finally, when fixed assets were already considered anachronistic to the point of being perceived as liabilities, Amazon defied consensus and built a logistical last mile that put to shame even the leading pure-play logistics companies.

Today, Amazon is responsible for ~8% of all retail in the US[10] and ~40% of e-commerce. It faces practically no competition in its business model. Comparatively, Walmart boasts a larger share of overall retail sales but has a significantly smaller share of online sales. In recent years, only Shopify emerged as a real alternative to Amazon's aggregation model. Its modern approach and support of the DTC retail ecosystem consolidates the company as a possibility for small and medium-sized retailers that aim for a more personal relationship with their customers. Rapid adherence to this value proposition has allowed Shopify's platform to quickly reach a GMV superior to $100 billion.

In Brazil, there are four leading companies competing directly in the online retail sphere. However, the competition is characterized by a high dispersion of strategy and execution. Mercado Livre has established itself as the number one player in this market, with approximately 2x the sales and 5x the volumes of the second largest player, a significantly more advanced proprietary logistical system, and a specific focus on the long tail, in which competitive dynamics are in theory more favorable. Amazon, the fifth largest online retailer in the country, is the fastest growing and already a relevant player within the market. In fact, Amazon's subsidiary in Brazil has a share of the online market that rivals that of Walmart in the US. As for the other players, they find themselves at a crossroads, incapable of rising to a leadership position, and operating in an environment permeated by high fixed costs, little product differentiation, and cheap and abundant capital available to be spent on logistics and CAC.

To intensify the competition, other aggregators[11] have noticed the Brazilian retail industry's dependence on credit as an opportunity to build a new business vertical. Unlike Amazon in the US, no company in the Brazilian e-commerce segment seems to have built a loyal customer base. It is worth noting that the relationships with clients that the new entrants to the financial sector boast seem somewhat more resilient than those created by the local marketplace businesses, since it is much more laborious to switch to a new bank or wallet than to switch from one shopping platform to another.

Recently, the equation for valuing growth assets began to attribute high revenue multiples to businesses that consistently present double-digit growth and have a long runway ahead, in turn the result of a huge TAM. In the case of businesses with long-term pricing power, we are unable to falsify the hypothesis that this is indeed the correct method of valuing these companies.

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[8] After all, in the West, rarely does one see the development of social platforms or search engines that contain 'local characteristics.'
[9] By turning all cost streams into revenue streams, Amazon has been plugging in several features to reduce the churn of its customer base over time. Of particular note is Amazon Prime (and its sub-unit, Prime Video), which currently has ~150M global subscribers.
[10] GMV US 2020: ~$320B.
[11] Like fintechs and SaaS companies.

As aforementioned, Bezos pioneered the strategy of reinvesting all recurring operating income with the objective of financing future growth, in the form of a virtuous and continuous cycle. This seems the correct direction within a competitive framework in which the winner captures the bulk of the profit pool, (especially when evaluated ex-post).

However, this logic is reversed in more competitive business environments. If this is the case when it comes to the Brazilian e-commerce market, one risks a continuous re-investment cycle where there is a lot of growth, the customer benefits, but little, if any, economic value accrues to investors. A modern day wealth transfer program from "tech" investors to consumers.

(In Billions of dollars)	EV (29-03-2021)	Gross Profit (2020)	EV/Gross Profit	g Gross Profit 2017-2020**	Region	GDP Region	EV/GDP
JD	115	15,8	7,2x	29%	China	14.726	0,8%
B2W	5	0,6	9,2x	29%	Brazil	1.445	0,4%
Amazon	1.565	152,8	10,2x	32%	EU, US and others	40.189	3,9%
Amazon	1.565	152,8	10,2x	32%	EU, US and others*	33.149	4,7%
Alibaba	561	40,0	14,0x	26%	China	14.726	3,8%
Magazine Luiza	22	1,5	15,2x	28%	Brazil	1.445	1,5%
Pinduoduo	151	5,8	25,9x	240%	China	14.726	1,0%
Mercado Livre	69	1,7	40,1x	57%	Latam	3.635	1,9%
Sea Ltd.	100	1,3	74,3x	149%	Southeast Asia	2.975	3,4%
Shopify	123	1,5	79,8x	59%	EU and US	36.554	0,3%

** To calculate these addressable GDPs we used the same proportion of revenue Amazon has in their most penetrated markets: USA, UK and Germany*

*** Last three years growth calculated in local currencies (except Sea Ltd. which reports their revenues in dollars and Mercado Livre whose financials were converted to brazilian reais for simplification)*

[12]

"TIME IS THE CRUELEST FORCE OF ALL"[13]

We struggle with a daily fight between antagonistic feelings that fluctuate from an exaggerated skepticism to a short-sighted optimism. From the discipline to pursue a north star that minimizes significant losses but also respects the exponential character of hidden optionalities, which are so characteristic of this new economy.

The intelligent investor must be thoughtful and sober. He/she should not indulge in extremes, and should constantly pursue an even-tempered mindset. The price one is willing to pay for any given asset, however spectacular, should have clear-cut limits. Those who survive over the long-haul usually understand the concept of finiteness.

The mechanics of falsificationism require that growth hypotheses be permanently checked. The automation of projected levels of growth usually catalyze delusions in "perpetuity." When a valuation implies the need for unusual share gains or successful expansions into new verticals, the added risk to obtain a decent return over the next 10 years becomes an exercise of questionable expected value.

When evaluating a business with low penetration and consequently high growth prospects, such as digital commerce, the level of current multiples arouses a certain vertigo in investors. A multiple of ~3x the annual GMV - considering a long-term stabilized operating margin of 5% on said GMV - implies in a structural multiple ranging from 75 to 90x earnings depending on the tax rate that is utilized. Ignoring the creation of new businesses or

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[12] Source: Atmos Capital.

[13] Cixin Liu, Chinese writer.

verticals, this analysis would imply[14] that the market leader in Brazil is expected to witness a real GMV growth of ~20% per year[15] for ten years, eventually reaching a market share of ~20% of total retail sales[16]. Such market dominance has never been experienced by any player in a mature market. However, this is a short-sighted mathematical exercise that seeks for impossible precision. It would be naive, if not slightly arrogant, not to leave room for the optionalities of a business model that is still in its early innings and run by an extremely capable management team. For instance, conquering a new vertical that adds ~500 Bps to the potential long-term margin would completely nullify the logic described above.

Edmund Burke[17] warned against one planning for the future while looking at the past. However, it is difficult to resist searching for historical examples that can inspire reflections and resonate with the present moment. An investor who had become excited at the prospect of associating with Bill Gates at Microsoft right after his meteoric rise to the top rankings of the Forbes list circa 1998 would have enjoyed a real return of approximately 9% per year (at the date this letter was written). Merit of a company that relentlessly defended its market, and continued to be creative and wild in the search for other valuable verticals that are synergistic to its original core product, such as Azure[18]. However, patience would have had to be an essential characteristic of this investor. Between 1998 and 2012, his capital would have remained stagnant in nominal terms. Fourteen years are considered a blip in the construction of history, but are an eternity for the investor with clients that look at daily NAV fluctuations. "*What is smart at one price, is stupid at another*."[19]

Purchasing fast horses under the illusion that they are unstoppable catalyzes a feeling of omnipotence in the buyer. Investments with positive statistical frequency generate comfort, but it only takes a few days of significant corrections to make them mediocre.

PERSPECTIVES FOR A POST-COVID REALITY

In Ernest Hemingway's "The Old Man and the Sea," the reader is immersed in the adventures of the old fisherman Santiago in his fight to catch the largest fish of his life. After months of failing to catch any fish at all, Santiago feels challenged by his younger counterparts. He sets out towards the open sea of Havana to prove that he is still a capable and vigorous fisherman. Eventually he is able to hunt down an enormous fish and ties it to his vessel to return to the mainland. Believing he had won the battle, he is suddenly attacked by a group of sharks that slowly destroys and devours the meat of the fish that is tied to his boat. The story is about the struggle for survival and the tensions between nature and man; between perseverance and luck, or lack thereof. Santiago and his tenacity are a symbol of the man who is "destroyed but never defeated," in Hemingway's words.

Brazil has been fighting for a long time. It has survived a limp democracy, seven institutional coups since its independence, successive crises with its main commodities, an industrialization process induced by an inefficient and undisciplined state, a period of hyperinflation that followed the 1970's "economic miracle", and even the Workers' Party's rudimentary attempt at a New Keynesianism that left substantial economic scars.

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[14] In order to obtain a cost of capital of ~7.5–9.5% per annum, assuming a terminal multiple of 30xE at the end of the tenth year.

[15] With total retail growing in the same velocity as GDP, at ~2.5% p.a

[16] To simplify, we assume homogeneous growth across all regions.

[17] Renowned 18th century Irish economist, philosopher, and parliamentarian.

[18] Despite its late entry into the Cloud Computing sector.

[19] Warren Buffet.

Following all of that, the country also witnessed a second impeachment in the recent re-democratization process, an investigation to fight endemic corruption, and a president secretly recorded by the main crony-capitalist of the last cycle. The past decade was lost, economically and politically speaking, and productivity, the main driver of per capita growth, continuously declined.

As if by a work of fate, or perhaps the competence of a selfless few, a reformist wind blew recently like a breath of fresh air. Important structural reforms such as the labor reform were implemented, as well as a new sanitation framework, a new bankruptcy law, a new SOE law, a government-expenditure cap, among others. Additionally, the government progressed with new privatizations and concessions and directed the dreamed-of social security reform, which was finalized in the government of a caricaturistic populist president.

Within this context, we had been ushered toward abandoning our skepticism and looking at the horizon through a more constructive lens. In a scenario of structurally low interest rates and a cyclical recovery right at our doorstep, the adventure of investing the entire portfolio in long-duration locally-denominated assets seemed like a wise decision.

2020 has left its marks on the history of humanity and of capital markets. The credit for the economic recovery goes to the speed with which governments swiftly implemented policies aimed at preserving demand and jobs. And in the public health crisis, the positive "unknown unknowns," as explained in our penultimate letter[20], came, among several other manifestations, through the low transmission of the virus via surfaces, which allowed for the minimum normalcy necessary for the functioning of the economy.

Globally, in the beginning of this post-crisis period, low growth emerges as an argument in favor of a potential asset bubble. Are valuations of 25-30xE justifiable in a world where economic growth is sustainably low? This questioning seems short-sighted. After all, anemic interest rates permeate the economy, largely as a consequence of this timid growth. In a complementary way, listed corporates represent a fraction of the global economy that may continue growing at elevated rates while they gain market share over less structured players. Further, it is interesting to note that, despite the market's recent high, the spread between the S&P's structural FCF yield and the 10-year US Treasury yield remains quite high at ~5%.

Moving forward, we expect to see a monetary policy that is slightly contractionary, as well as efforts to migrate to more aggressive fiscal policies. Deflation and negative real interest rates should be removed from the public policy menu. Governments are likely to increase spending without immediate tax offsets, under the warning that exaggeration or a loss of control over the narrative could lead to inflation. Within this framework, we could expect a certain degree of asset deflation, partially reversing the last ten years of "low goods and services inflation" and "high asset inflation".

Nonetheless, if the U.S.long-term interest rate settles at a controlled level - which seems to be the base case - Brazil may see the light at the end of the tunnel, despite all of its notorious medium-term issues. Like the old Santiago, Brazil is tired of battles, surrounded by starved sharks, and looking toward the coast in an attempt to bring the entire fish to the mainland. We are still hoping that when we dock at the port we will move away from Hemingway's ending and toward a less somber epilogue, in which we are able to retain some of the fish's meat and not just its skeleton.

In face of such uncertainty, we maintain our discipline in search of growing companies, operating in difficult - but not hostile - competitive environments, and whose market values do not incorporate the perfection expected of the supposed winners of the current paradigm. We have also been seeking an elevated degree of decorrelation between

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[20] Letter 22.

theses, as well as investment cases with more endogenous than exogenous levers. In the dispute between long-duration assets, Brazilian stocks still offer real returns above the 4% granted by long-term government bonds.

Quality assets collected in a portfolio with the characteristics delineated above should pave the way for achieving an attractive return without incurring disproportionate risks.