



Vinci Mosaico FIA Quarterly Letter

March 2021

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Investment in technology: the future is not what it used to be.

In August 1995, the Netscape¹ browser IPO shed light on the revolutionary potential that the internet would bring to people's lives and to the business world. After about a quarter of a century, just think about the relevance that smartphones, online shopping, and social networks have in our daily lives to have a small evidence that this prophesied revolution, in fact, occurred.

Likewise, the winds of innovation radically transformed the business landscape in this period. In 1996, the five largest companies in the world, in terms of market value, were: General Electric, Shell, Coca-Cola, Nippon Telecom and Exxon²; they were all representatives of what we came to call the "old economy". The current snapshot is utterly different. The biggest corporate titans of the globe today are: Apple, Microsoft, Saudi Aramco, Amazon, and Alphabet (Google)³. With the exception of Aramco, all are technology companies and two of them had not even been created in 1996.

Here in Latin America, we are rehearsing a replay of that same movie. Today, Mercado Libre, who has its shares traded on Nasdaq, is already the second most valuable company in the region, with a market value of R\$ 420 billion⁴. Meanwhile, Magazine Luiza, worth R\$ 130 billion, joined Ibovespa's top 10 companies, starring among commodity producers and banks, which previously dominated this list for decades.

However, it is worth questioning: will Brazil, in fact, become a breadbasket for technology companies?

We believe so. Mostly because the key purpose of a startup is to solve consumers' challenges through the use of technology. Not surprisingly, there are plenty of challenges and opportunities for improvement in Latin America, and a good part of the solution involves making smarter use of the resources we already have. This context fits like a glove for a country like Brazil, where savings and investment are restricted.

To make our argument more tangible, think about how Uber got our fleet of cars more efficient (since it used to stay idle for the longest part of the day), while helping people get around. Another emblematic case is that of Nubank, which did not need a single physical store to reach a 35 million customer base (a number similar to that of Itaú!)⁵ and finally brought an uncomplicated banking alternative, with less fees and better service than the incumbents.

¹ Netscape was one of the first internet browsers. Its IPO was a great success; the price of its shares more than doubled on the first day of trading. This operation is taken as a starting point in the internet boom of the 1990s.

² Source: Book *Blitzscaling*: The lightning-fast path to building massively valuable companies, Reid Hoffman, 2018.

³ Source: <https://companiesmarketcap.com/>.

⁴ Source: Jornal Estado de São Paulo, 27/Apr/2021.

⁵ Source: www.nubank.com.br.

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In addition to the huge demand for better services and products, Brazil has a consumer base especially adherent to the use of apps. There are 240 million⁶ active smartphones in the country (more than one per inhabitant) by a population that is among the world champions in terms of time connected to the internet. Finally, we have a huge contingent of 40 million informal or unemployed labor force, many of whom believe that the opportunities created by these online platforms, such as working as a delivery-boy at Rappi or a seller at Mercado Libre, are a welcome source of income.

In this context, since 2017, Brazil created 16 unicorns⁷ (i.e., startups valued at more than US\$ 1 billion). Currently, the country occupies an honorable eighth place in the ranking of countries with the most unicorns⁸.

On the other hand, enough challenges still remain for Brazilian startups. Bureaucracy, the complexity of tax and labor rules and the “Brazil Cost” are old acquaintances of the brave local entrepreneurs. However, there is an even bigger problem for our young tech companies: the shortage of skilled labor, especially programmers. While Brazilian colleges graduate 300 thousand natural science bachelors a year (i.e., science, engineering, and mathematics), India graduates 2.5 million and China 5 million⁹. We hope that market forces, over time, will take care of this distortion.

An important success factor for the Brazilian startups cycle is a Venture Capital (“VC”) industry willing to finance these projects. Ten years ago, there were practically no such investor of this type in Brazil. However, the abundance of global liquidity and the success stories among Brazilian startups (such as 99 taxi, the first national unicorn) started to change this game. Currently, there is a vibrant VC industry in the country and its main exponent is the Japanese conglomerate Softbank, which announced in 2019 the creation of a US\$ 5 billion fund to invest in Latin American startups. In addition to capital, these VC funds are contributing a lot in terms of management and networking.

Equally important were the successful exits of a series of investments through IPOs on the stock exchange. Up until 2019, tech company listing on the Bovespa were very rare, but since then 9 startups successfully listed and, in 2021, the sector became the leader in the number of IPOs.

For us, as for so many other value investors trained in Benjamin Graham's margin of safety primer, great mental flexibility is needed to analyze investment in technology companies, which are usually valued at a multiple of revenue whilst profit is a distant promise.

Nonetheless, it is fair to state that current accounting does not reflect the true value of these companies' main assets, which are investments in improving the platform and client base,

⁶ Source: Época Negócios and Vinci Partners.

⁷ Source: [Os 16 Unicórnios brasileiros em 2021 \(poupardinheiro.com.br\)](https://poupardinheiro.com.br/os-16-unicornios-brasileiros-em-2021/).

⁸ Source: [Unicorns by country 2021 | Statista](https://www.statista.com/chart/1000000/unicorns-by-country-2021/).

⁹ Source: [Chart: The Countries With The Most STEM Graduates | Statista](https://www.statista.com/chart/1000000/chart-the-countries-with-the-most-stem-graduates/).

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usually registered as mere expenses in the result. A great example to illustrate this point is Mercado Libre, which was already a profitable company by 2016, when it decided to reinvest its profit in initiatives such as free shipping and cash back in order to obtain a larger and more recurring customer base at the same time as it encouraged the use of its digital wallet. The company's profit actually evaporated, going from US\$ 145 million in 2016 to a loss of US\$ 37 million in 2018. However, Mercado Libre became an even more valuable company with this move. Its shares went up tenfold since then, while the number of users grew by an average of 48% p.a. and the value transacted through its digital wallet multiplied by 2.5 times, reaching US\$ 20 billion in 2020¹⁰.

Another major challenge in the analysis of technology companies comes from the fact that many of them do not have a clear path to profitability. It is then up to the analyst to believe that that company, after years of enchanting customers and often burning a lot of cash in the process, will find creative ways to make money. Google, for example, was born as the best search engine on the internet in 1998, but only started to profit in 2001, after the creation of *AdWords*, an auction system where advertisers competed for each word to be searched by the user for a space at the top of the page¹¹.

Now shifting to growth strategy, the value investor also needs to tear up its manual when it comes to analyzing technology companies. Inspired by Warren Buffett's *franchise business*, we are used to looking for companies that gradually replicate their success formula, steadily conquering territory and never living beyond their means. That is how GEICO, Berkshire's auto insurer, which uses direct selling without a broker to offer cheaper policies, took second place in the American market in 2013, almost eight decades after it was established¹².

Among the greatest success stories of the Brazilian stock market in recent decades are many companies with this characteristic of gradual growth combined with profitability, such as Ambev and Lojas Renner. They fit perfectly with the concept created by Stanford business professor and best seller, Jim Collins, called the twenty-mile march, alluding to the story of the two explorers who formed competing expeditions to reach the South Pole in 1911, Roald Amundsen and Robert Scott. While Amundsen set an advance limit of 20 miles a day to avoid exhaustion of his team, Scott put pressure on his team to finish first. In the end, Amundsen's expedition reached the South Pole first and Scott's died on the way¹³.

Startups, on the other hand, tend to do the opposite of Amundsen and seek to grow as quickly as possible, even if this consumes a lot of cash, take their employees to exhaustion and quality of service is left to a second plan. Behind this strategy is the concept of *Blitzscaling*, created by

¹⁰ Source: [Overview | MercadoLibre, Inc.](#)

¹¹ Source: Book - In the Plex de Steven Levy, 2011.

¹² Source: Warren Buffett's Letters to Berkshire Shareholders, year 2013.

¹³ Source: Book - Great by Choice, by Jim Collins and Morten T. Hansen, 2011.

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entrepreneur and startup investor Reid Hoffman¹⁴, in which many of the segments hit by startups are in situations where the winner takes all, or takes most¹⁵.

Examples of companies that have achieved this dominance include Facebook, which is practically a synonym to social networking, and Uber, the global benchmark for ride-sharing apps. In both cases, companies have benefited greatly from the so-called network effect, in which the arrival of a new member greatly increases the value of the network to others. Aware of this, Uber tends to enter new markets giving subsidies to customers. This stimulus to demand attracts a large number of drivers from that city to the platform. The more drivers available, the better the customer experience; and, thus, a virtuous circle is created towards market dominance.

But how do you know if all of that cash and energy consumption is going to be worth it? In fact, there are no guarantees in this bold strategy. However, the analysis of some factors can give clues regarding the pay-off of this bet.

It all starts with the product/market fit, which means doing the exercise of finding out if the company is in a good market and has a product capable of satisfying it.

Accordingly, it is crucial to determine the size of the addressable market and if it is large enough to justify the undertaking. Here, it is worth reminiscing Jeff Bezos brilliance. Bezos started Amazon as a “mere” online bookstore but always envisioned the company as “*the everything store*”. Such vision materialized into what today is one of the largest retailers in the world (trillion-dollar addressable market!) ¹⁶.

In addition, when analyzing startups, it is essential to understand the relationship between the cost of acquiring a new customer (CAC) and the value that this customer is expected to bring over the course of their relationship with the company (Lifetime Value - LTV) ¹⁷. A good LTV / CAC ratio can bring confidence that the cash burn from rapid expansion of the customer base is justified, given how much the company is expected to profit from each new consumer. Another important point is to check the behavior of different cohorts of customer over time, in order to understand whether old consumers are losing attendance and whether the engagement of new customers is more or less intense than usual.

However, more than any numerical analysis, what really counts for a startup to be victorious is its management team. It is not just a matter of intelligence and curriculum, equally important

¹⁴ Reid Hoffman was LinkedIn's co-founder and participated in PayPal's creation.

¹⁵ Source: Book - Blitzscaling: The lightning-fast path to building massively valuable companies, Reid Hoffman, 2018.

¹⁶ Source: Book - The Everything Store: Jeff Bezos and the Age of Amazon, by Brad Stone, 2013.

¹⁷ CAC can be calculated by dividing sales expenses (advertising, commissions, etc.) by the number of new customers. LTV, on the other hand, is calculated through the annual gross profit per user, multiplied by the average time that a user is expected to remain as a customer. This average time is obtained as follows: 1 / retention rate, with the retention rate being calculated based on the company's customers in a given year and seeing what percentage of them remained as a customer in the following year.

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is resilience (bad news and frustrations are a constant in this game), adaptability (listening to divergent opinions, learning from mistakes) and the ability to bring in and retain talent.

The biggest chances of success for startups are in situations where there is less competition, something that can be derived from a regulatory or technological barrier that is about to fall. XP Investimentos, for example, was born in the same year as the regulation for independent investment agent was approved (2001) and had the guts to form a network of third-party distributors, while its competitors were concerned with the labor risks of this strategy¹⁸. Netflix, on the other hand, is a fantastic example of crossing the technological barrier. The company started with the fragile business model to offer subscriptions for the delivery of DVDs at home in 1997, but betting on Moore's Law¹⁹, already dreamed that as soon as broadband networks evolved enough (something that took more than a decade), the company would be among the pioneers in offering streaming services.

The world is experiencing a particularly effervescent time for innovation for two reasons: smartphones and cloud computing. Smartphones have allowed the mass creation and adoption of a series of applications that make consumers' lives easier. Cloud computing, then again, allowed a vast reduction in the startup cost of a new company, by discharging entrepreneurs from the need to buy a large chunk of server infrastructure and software licenses (now available in the subscription model).

Another component that made investment in technology an especially fertile ground is the extremely low level of interest rates over the last decade, which is the result of structural issues, such as the aging of the world population, and circumstantial issues, such as the 2008 sub-prime crises and European in 2011. The pursuit for satisfactory returns in this context has increasingly led investors to risky and long-term investments.

Finally, the most relevant stimulus for technology companies was the COVID-19 pandemic. Quarantines around the world accelerated consumers adherence to digital fronts in many years and made it possible to break regulatory taboos, such as electronic prescriptions for medicines, distance consultations, digital registries, etc.

All the above points led technology companies to have a very strong appreciation in recent years, especially in 2020. While the Nasdaq index rose 44% in the last year, the CQQQ (ETF of the main technology companies in China) appreciated by 57% in the same period²⁰.

However, it would be natural to expect that technology stocks would not perform prominently in the short term. This is because last year's strong revenue growth is expected to impose a high basis of comparison for these companies in 2021, while expecting a gradual normalization

¹⁸ Source: Book - Na Raça: Como Guilherme Benchimol Criou a Xp e Iniciou a Maior Revolução Do Mercado Financeiro Brasileiro, by Maria Luíza Filgueiras, 2019

¹⁹ Concept created by Gordon Moore in 1965 that said that the processing capacity of computers should double every 18 months.

²⁰ Source: Bloomberg

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of mobility as the world population is vaccinated. As a result, activities of the old economy (such as physical retailers) are expected to regain some of the lost ground.

Furthermore, interest rates around the world began to rise from the hyper stimulatory levels that reached a peak during the pandemic, given the vigorous recovery of the world economy and the recent rise in commodities. Growth companies tend to be more affected by higher interest rates.

Additionally, there are two supplementary challenges that are particular to investing in technology companies.

First, choosing the winning company is more significant in the technology sector than it is in most of the other traditional sectors. For instance, if we decide to invest in a steel company or a large Brazilian bank, the assertiveness of our bet will be much more tied to the head and tail winds for that industry rather than the quality of the company's management (see chart below). But if we decide to invest in a social network, it is important that it is the next Facebook and not a MySpace or Orkut. The same network effect that makes the winner take all or most, leaves a series of losers along the way. Netscape²¹, which we mentioned at the beginning of this letter, is one of the most emblematic examples of this ruthless dynamic.

Performance of Large Brazilian Banks: High Correlation²²



²¹ Netscape, which reached 90% market share among browsers in the early years of the internet, was overtaken by Microsoft's Internet Explorer, which started offering it for free within the Windows package. Netscape ended up being bought by AOL and submerged irrelevance in the 2000s.

²² Source: Economática.

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Second is the risk of bubble. As the cash generation of most startups is a distant promise, the calculation of their fair values is much more subjective than that of a traditional company. Therefore, moments of great enthusiasm, such as the one we are currently experiencing, deserve special attention. It is worth remembering the example of Microsoft, which reached a market value of US\$ 475 billion in 1999, at the height of the “.com era”. After the bursting of the internet bubble in 2000, it took 15 years for the company's shares to return to 1999 levels²³.

Currently, in the Vinci Mosaico portfolio, the only representative company in the technology sector is Totvs; leading Brazilian company in ERP and that is becoming a great technology platform, after its recent acquisitions of Techfin (Supplier) and Business Performance (RD Station).

However, many companies in our portfolio have an important part of their business inserted in the context of technology/startup, despite having an origin in the old economy. Examples of these are BTG Pactual's initiatives in the area of fintech (such as BTG digital and credit for small businesses) and the startup that is being created within Tenda to use a new constructive method for low income (the off-site construction).

Finally, despite the short-term and inherent risks to the sector, we believe that technology companies will be the great source of Ibovespa's value creation in the next ten years, in line with what happened in the USA and China during the last decade. Therefore, it will be crucial for our long-term performance that we become increasingly “bilingual”, that is, as fluent in growth equity as we are in value investing.

Respectfully yours,

Vinci Equities Gestora de Recursos Ltda.

²³ Source: Bloomberg.

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VINCI MOSAICO PORTFOLIO ANALYSIS

Vinci Mosaico FIA net returns compared to Ibovespa

Annual Historical Net Return

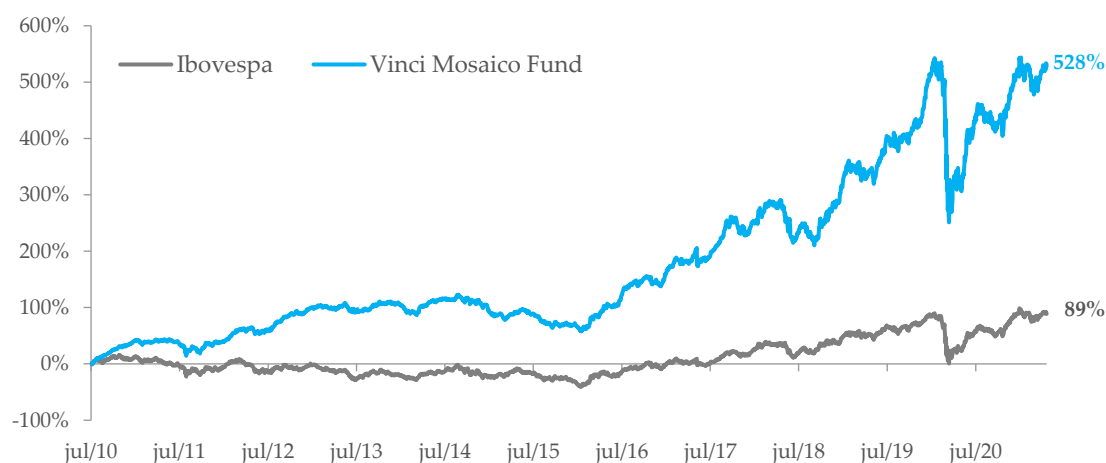
In R\$	2010*	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Vinci Mosaico Fund	38.7%	-0.2%	43.2%	5.6%	-1.9%	-16.2%	44.9%	40.6%	14.8%	49.5%	3.5%
Ibovespa	10.1%	-18.1%	7.4%	-15.5%	-2.9%	-13.3%	38.9%	26.9%	15.0%	31.6%	2.9%
p.p. above Ibovespa	28.6%	17.9%	35.8%	21.1%	1.0%	-2.9%	6.0%	13.7%	-0.2%	17.9%	0.6%

2021 Monthly Net Return

In R\$	Jan/21	Feb/21	Mar/21	Apr/21	2021*	ITD**
Vinci Mosaico Fund	-3.0%	-3.2%	4.0%	3.1%	0.8%	527.6%
Ibovespa	-3.3%	-4.4%	6.0%	1.9%	-0.1%	88.8%
P.P. above Ibovespa	0.3%	1.2%	-2.0%	1.2%	0.9%	438.8%

* Until April 30th, 2021

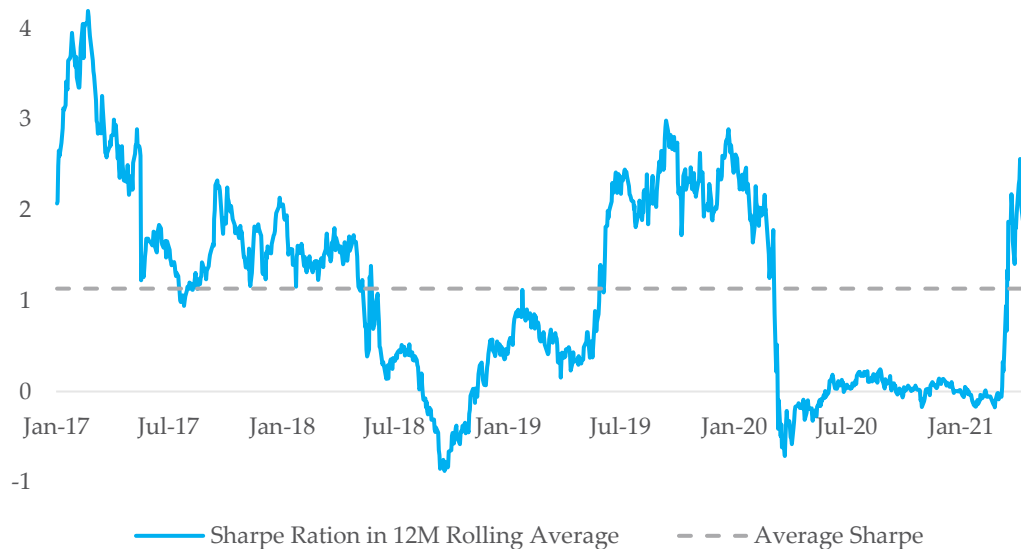
** Since inception: July 12th, 2010



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Vinci Mosaico Fund Sharpe Ratio 12M Rolling Average



Vinci Mosaico Fund Maximum Drawdowns Compared to Ibovespa

