INVESTMENT LETTER

NOVEMBER 2022

Emerging Markets' (EM) returns have been frustrating for the last decade or so. That's so well known it has even become cliched. At the same time, Developed Markets' (DM) returns have beaten every analyst's rosiest expectation, only making the comparison worse.

There are abounding reasons for this gap: political instability fueled by populist leaders who have not conducted necessary reforms; generalized corruption leading to the depletion of national reserves and over-investing in negative yielding infrastructure projects; sub-optimal institutional framework; costly and inefficient legal systems; and a general backdrop of regulatory instability.

All of this contributed to disappointing growth. Whilst DM economies boomed, blessed with decreased cost of funding and no FX volatility risk.

This has more than understandably led international investors to ask: "**why bother invest in Emerging Markets?**". However, before we make a final statement on the subject, let's look at some complementary data.

Companies invested in by private equity and alternative managers have a very different profile than that of the overall economy. The edge of these managers lies in identifying promising companies and helping them unlock value after investing. Beyond that, one of the reasons that compelled investors into EMs was the fact that excellent management practices should, theoretically, be even more impactful given the generalized inefficiency in these countries, hence generating outstanding returns.

We analyzed a cohort of 239 companies invested by private equity managers in Brazil from 2008-2017 and compared their financial performance with private equity-backed companies in the US for the same period to test the hypothesis that Brazilian investments underperformed their peers in DMs. Oddly enough, Brazil-based companies, on aggregate, posted Revenues and EBITDA CAGR of 17.8% and 18.9%, respectively, versus 6.6% and 6.7% from US-based companies (Cambridge Associates, 2019).

Revenue and EBITDA CAGR for private equity investments between 2008-2017

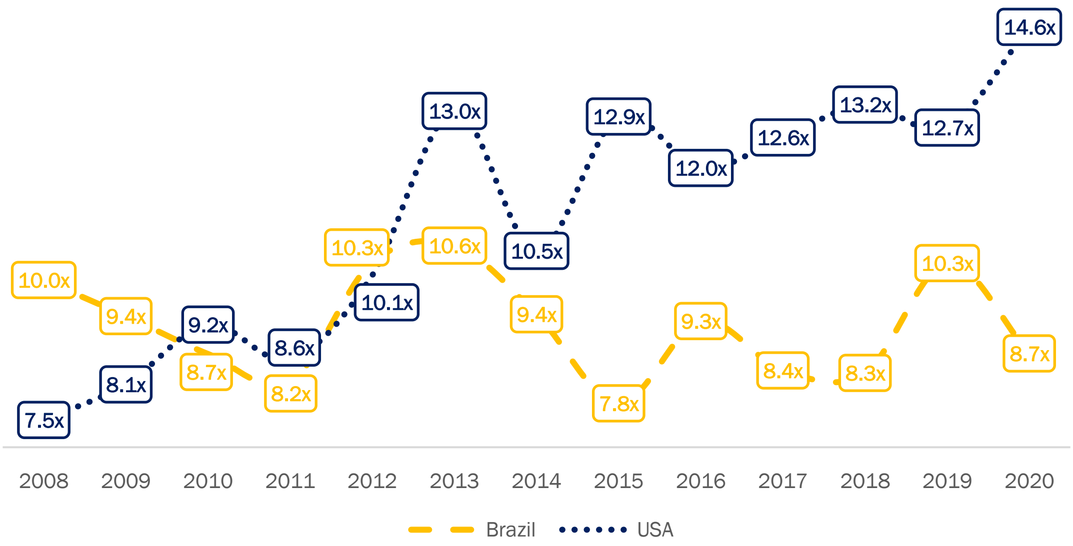
	Revenue CAGR	EBITDA CAGR
Brazil	17.8%	18.9%
USA	6.6%	6.7%

Source: Spectra Investments and Cambridge Associates

The initial conclusion was that the sluggish GDP growth for Brazil (EM) versus robust growth in the US (DM) might not have been the main driver justifying the return differential. Despite all the instability in the Brazilian economy, with GDP growth averaging 1.6% between 2008-2017, managers identified interesting companies and helped them expand regardless of the adverse scenario. Furthermore, it is also arguable that the relative efficiency of the US market makes it harder for portfolio companies to grow at a fast pace (on average).

After analyzing the relative financial performance, we then looked at average entry prices for at the 8-10x EV/EBITDA range, in the US it skyrocketed, going from 7.5x to 14.6x during the same period.

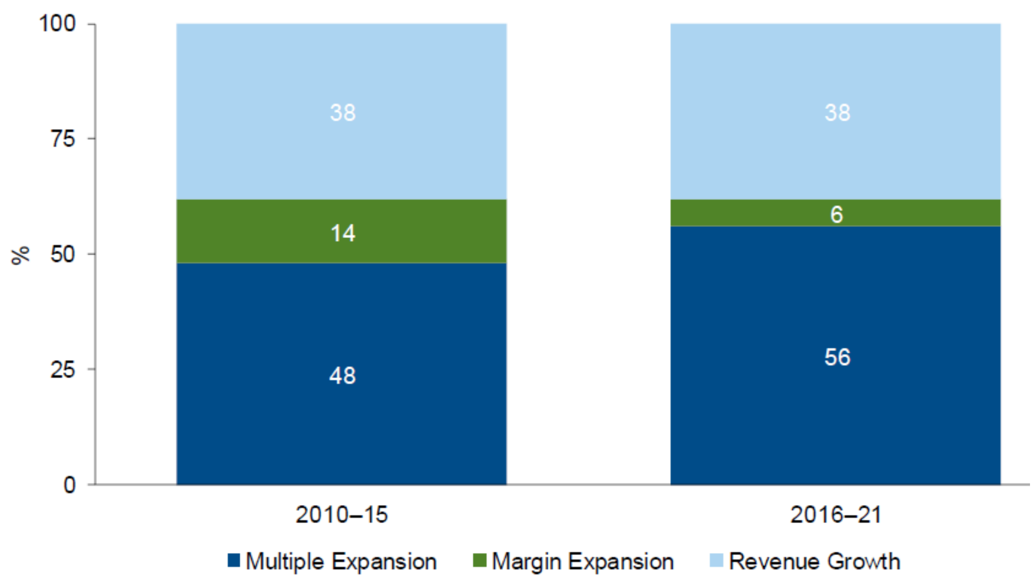
EBITDA Entry Multiples (LTM)



Source: Pitchbook, Fusões&Aquisições, KPMG

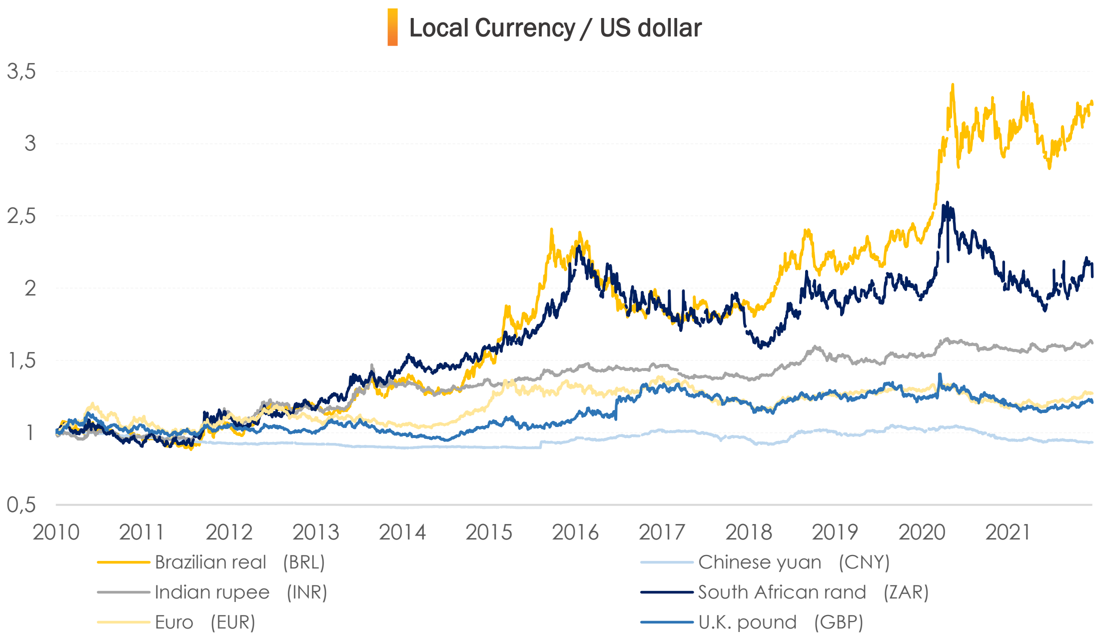
On average, entry prices were more attractive in Brazil than in the US. Thus, this could not be an explanation for the return differential. However, if you assume that entry prices are equal to exit pricing, something interesting shows up: we came across a study recently published by BCG that shows that more than half of the total return generated by PE managers in the US was attributable to multiple expansion. PE returns in the US over the last decade would have been a meagre 7% if this phenomenon weren't so favorable (data on returns in the US from Cambridge Associates).

Median Value Creation by Year of Exit



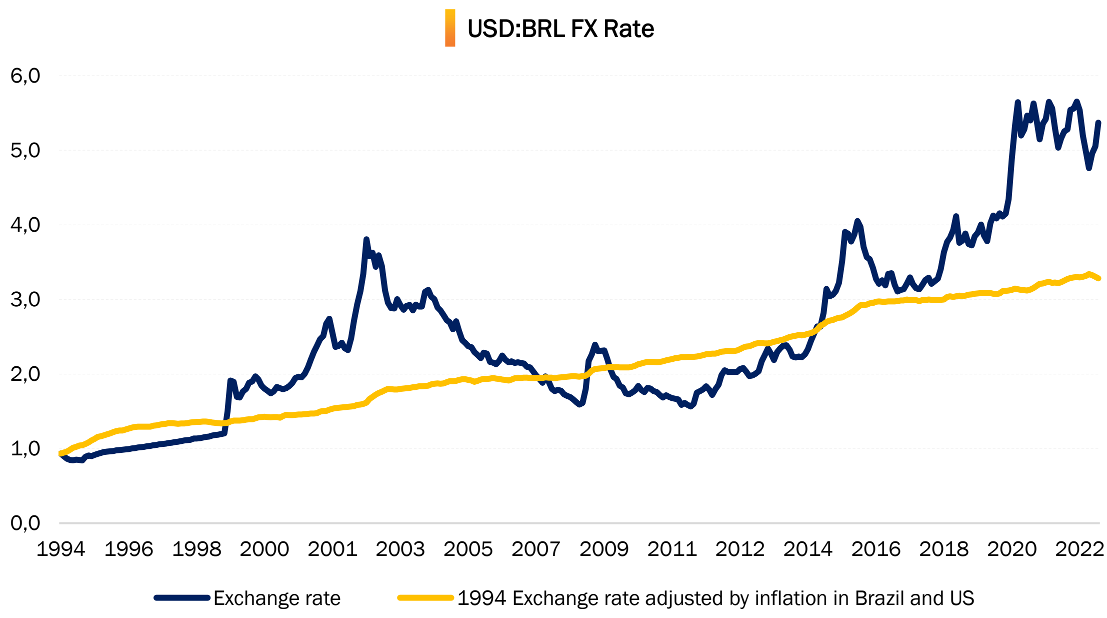
Source: BCG

Lastly, we land on the inevitable FX topic. EM currencies, especially the Brazilian Real, have lost a lot of value over the past decade and experienced an equal amount of volatility.



Source: IMF

Nevertheless, if we take a longer-term perspective, we notice that these swings rotate alongside a mean. As predicted by basic economics, in the long run, the inflation differential between the two countries explains the difference in FX. Let's look at the BRL against the USD since 1994.



Source: IBGE and FED

Since 1994, the Brazilian Real was overvalued for 40% of the time and undervalued during the remaining 60%. The last period of undervaluation lasted 8.5 years, while the most recent period of overvaluation took 7.6 years. We are at the beginning of the 7th year of an undervaluation phase and FX cycles seem to be extremely long. Furthermore, it seems counterintuitive that a devaluation period would last forever, based on the graph above and general cyclicality. That said, it's virtually impossible to predict when this correction will occur.

Therefore, our conclusion is that multiple expansion and FX overvaluation are the two main variables that explain the return differential between the US and Brazil. Let's conduct a simple back-of-envelope calculation to see if this theory holds.

Private equity net returns in the US have been circa 16% per year over the last decade (Cambridge Associates, 2022).

We will now compare this to an expected return using the following assumptions:

1. Multiple expansion has been about 30% for deals with an average industry holding period, which equates to 5 years;
2. Assets were bought with approximately 50% leverage;
3. EBITDA growth was 6.7% p.a. and;
4. Funds charge 2/20 in fees.

This calculation brings us to a staggering 17.4% net IRR. Numbers from this exercise are obviously not precise, but the message is clear: most of the net IRR came from simply surfing the Quantitative Easing (QE) wave.

Let's now compare this to Brazilian private equity net returns. Average returns for the past decade have been 15.2% in local currency and 5.1% in USD.

1. There has been no multiple expansion;
2. Assets have been bought with 10% leverage;
3. EBITDA growth was 18.9% p.a.;
4. Funds charge 2/20 in fees;
5. Assets suffered an average 11% FX depreciation p.a..

Our calculations return a net IRR of 16.9% in Brazilian Reais for those assumptions and a net IRR of 8.3% in US Dollars. Quite similar to the actual returns, an indication that this back-of-the- envelope calculation makes sense.

Assumptions	Private Equity in US	Private Equity in Brazil	
EBITDA Growth p.a. in local currency	6.7%	18.9%	
Holding period	5	5	
Multiple expansion during holding period	29.4%	0%	
Leverage	50%	10%	
Management Fees	2%	2%	
Carry	20%	20%	
Currency devaluation p.a.	-	11.7%	
	US Dollars	Brazilian Reais	US Dollars
Gross IRR	20.8%	20.4%	9.8%
Net IRR	17.4%	16.9%	8.3%
Gross IRR without multiple expansion	12.0%		
Net IRR without multiple expansion	9.5%		

All in all, it is clear to us that the bulk of underperformance in Brazil compared to the US stems not from sluggish growth, but multiple expansion in Developed Markets and capital outflows from Emerging Markets.

Moreover, it seems that both factors are related to a single root cause: Quantitative Easing. Excessive printing of money in DMs has led to low interest rates and asset price appreciation. Good returns in these markets have attracted investors to park their money there, creating an inflow of capital and, thus, FX appreciation.

Our conclusion is that Brazilian private equity managers could exploit the inefficiency of the markets, choose good companies, and grow them at a fast pace. QE lowered the cost of debt and is one of the reasons for multiple expansion in the US and currency devaluation in EMs. Those factors were crucial to explain the difference in private equity returns between the US and EMs during the last decade, but this might change.

Now, what happens from here? Will Developed Markets keep benefiting from indefinite multiple expansion and FX gains or shall we witness some sort of reversion to the mean? Will EM managers keep on posting above average operational improvement compared to DM managers? Those questions, and not whether GDP will grow, or which politician will be elected, seem to be the big questions related to portfolio construction in Developed x Emerging Markets.

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