Stewart Investors

Brazil

Recent history in Brazil has seen a push towards identifying and weeding out the linkages between corporate and political networks that have intertwined over decades to breed a culture of impunity.

The ongoing investigations under Operation Lava Jato continue to uncover steadily the scale of the kickbacks and fraudulent nature of numerous corporate contracts across sectors, with federal prosecutors seeking to recover approximately USD12 billion from those implicated. These attempts at justice and reform, however, are still very much in their infancy in the long road to truly addressing a political and corporate nexus where systemic corruption has become endemic. This was the backdrop to a trip to the country in August 2019, where meetings with management teams repeatedly reiterated the crucial nature of investing alongside stewards who demonstrate competence, integrity and humility.

As a team, we constantly try to challenge our conceptions about franchises and their stewards and as such, we spent some time during this trip with a few companies that we have not met in some years, revisiting our views about them.

> **“If there is a lack of machines, you can buy them; if there is no money, you can borrow some; but people you can neither buy nor borrow, and motivated people are the basis of success.**
>
> Eggon João da Silva, co-founder of WEG

A couple of the companies we met looked quite attractive on paper, with little debt on the balance sheet, growing fast, and with decent profit margins. However, further research into the founders of these businesses revealed quite a different story. We came across a regulated business whose founding family also owned a media and publishing entity in the North East of Brazil, where the links between political influence and business can sometimes be even more explicit than the rest of the country. Another example we came across was a company with dominant market share in their sector that has been found to be channel stuffing[1] twice in the past five years, and whose founder-Chairman and the former CEO have both recently resigned as part of an investigation into bribery charges.

These instances highlight the simple but essential fact that every founding family is not made equal, and emphasize the need to continue to be extremely rigorous where we look to invest clients’ capital. We continue to believe that management teams and founders that build franchises through political connections, those that do not treat all stakeholders appropriately, or demonstrate large risk-taking appetites might, at some point, disadvantage minority shareholders as well.

In today’s world of casino capitalism[2], having a patient steward at the helm gives companies the tangible advantage of being able to withstand short-term pressure from aggressive competitors funded by deep pockets.

We came across this in Brazil during our meeting with Raia Drogasil, the leading drugstore chain in the country. The company was formed through the merger of Droga Raia and Drogasil, two strong brands who have a century of history and experience behind them, with the founding families continuing to own close to 32% of the company.[3]

Over the years, management have proved themselves time and again to be able to execute just the right balance between growth, via new store openings, and consistent profitability. Attracted to a profitable, consolidating industry, recent years saw a number of risk-happy competitors entering the market and rapidly opening new stores. However, with neither the history nor the experience of what running drugstores entails, the most exuberant of these new entrants are now heavily debt-laden, loss-making, closing stores, and looking for opportunities to exit the business.

During two years of aggressive competition, the stewards at Raia demonstrated the ability to unwaveringly stick to a strategy that has served them well for a century, taking slower short-term growth in their market share rather than sacrificing their solid balance sheet to match the risk appetites of their competitors. They are now picking up the fruits of this long termism, with a range of consolidation opportunities to choose from as competitors depart and market shares gradually shift their way.

Another example where the patience and long-term vision of the stewards has been essential to the business is WEG. Set up in the 1960s, WEG, named after the initials of the founders – Werner Voigt, Eggon da Silva and Geraldo Werninghaus – produces electric motors. They are one of the few globally competitive industrial companies to come out of Brazil, challenging the likes of ABB, Siemens and Emerson across the world.

The vision of these stewards to take an evolutionary approach to building out the business internationally has seen the company go from a predominantly domestic business in the 1980s to 34% of products being exported in the 2000s to 30% of products now being produced and sold abroad, with another 30% being exported from Brazil. Slow but steady vertical integration is one of their main advantages, allowing them to maintain both flexibility and a competitive cost structure by setting up manufacturing much closer to customers. Above all else, they have shown a consistent adherence to their mission of continuous and sustainable growth while maintaining simplicity. This continues to be seen in their core focus on a business they have proved themselves in over the decades, a conservative balance sheet maintained to take advantage of opportunities when competitors suffer and disciplined capital allocation.

Having a family behind a company is no automatic guarantee of returns, and trying to find and back true family stewards is a key part of our jobs as active investors. We believe that these stewards provide long-term competitive advantages in the form of the patience to build sound businesses over decades, the resilience to overcome short-term setbacks and the institutional memories not to get carried away, both in times of elation or gloom. In a world where corporate time horizons continue to shrink, we remain on the lookout for these stewards managing durable franchises with structural growth tailwinds.

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[1] Channel stuffing is a deceptive business practice used by a company to inflate its sales and earnings figures by deliberately sending retailers along its distribution channel more products than they are able to sell to the public.(Source: Investopedia)

[2] An economic system driven by speculation rather than long-term investment.

[3] For illustrative purposes only. Any fund or stock mentioned in this presentation does not constitute any offer or inducement to enter into any investment activity nor is it a recommendation to purchase or sell any security. Companies mentioned herein may or may not form part of the holdings of Stewart Investors.

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