letter: November, 2021

Investing in growth stocks at good valuations and the SBF Case

mar asset management

I. Current Market Context

The original idea of this letter did not include a cyclical commentary on the stock market. However, after the strong *sell-off* of the last four months, we will start it with some comments on the recent price action in Brazil.

The main indexes and some stocks suffered the following price corrections between July and October of this year:

/ Ibovespa: -18%
/ Small Caps Index: -26%
/ Retailers and Shopping Malls Basket: -38%
/ Real Estate Basket: -40%
/ Top 15 Large Caps: -11%
/ Small Caps Basket (113 companies with current market value less than or equal to R$10bi): -33%

The Brazilian stock market lost more than R$600 billion in market value in the same period in which practically no company reported its results. The main reason among market agents is an expectation of a strong macroeconomic deterioration and the need for a higher interest rate level to contain the escalation in inflation.

If we look at companies with lower market value and liquidity, the correction was even stronger. The risk premium demanded for the illiquidity increased significantly and reflects the pessimism on long term results of these companies.

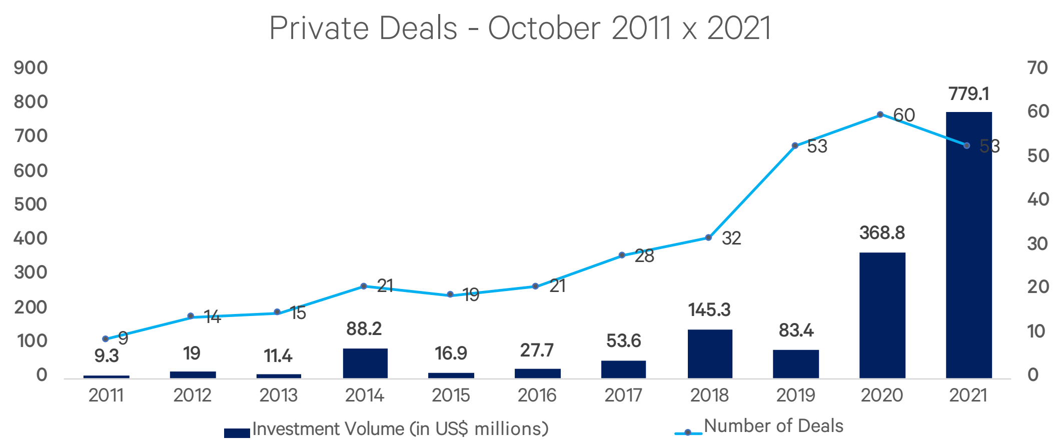
At the same time, investments in private companies reach record levels. In 2021, the amount invested in startups in Brazil already is three times greater than the pre-pandemic level, surpassing countries such as South Korea and Indonesia, and greater than the combined investments of Russia, South Africa, Turkey and Nigeria.

Without judgment of value on the quality of each company, these are, by definition, illiquid assets that demand a strong growth for many years ahead, and so, their valuation should be very sensitive to long-term interest rates. Still, it's not uncommon to hear about people “giving up” the stock market to focus on Venture Capital.

As an example of this robustness, we had the following funding rounds (out of more than 140) in the last four months:

- **Quinto Andar:**R$670m round at a valuation of R$28bi (it would be among the 40 largest companies on Bovespa if it were listed).
- **Nuvemshop:** R$2.8bi round at a valuation of R$17bi.
- **Justos:** R$200m round for an *insuretech* still in the pre-operational phase.

And as we can see in the chart below, the amount invested in October 2021 alone was twice as much in 2020 and 10x higher than in 2019.



Source: Distrito - Report Inside VC Outubro 2021

Many of these companies offer disruptive products and/or business models and will probably become giants in the near future. But this discrepancy between private and public companies valuation draws our attention. Most likely, Brazil is not the VC wonder world nor the horror that public equities investors expect.

In recent months, a series of SPACs were structured to buy private companies and list them on the stock exchange. We dare to say that the moment, in fact, is to set up PIPE funds[1] and invest in companies already listed, with a proven track record, transparency in numbers and even with a wonderful growth avenue ahead. Softbank is the only player that has made a move in this direction, recently increasing its participation in Inter.

Macroeconomic and political issues are common in emerging countries such as Brazil, but it is worth remembering that many public companies were built exactly in this volatile and chaotic environment. Although it is hard to anticipate the end point of this correction and, even at the risk of incurring additional mark-to-market losses before an improvement in sentiment, we understand that with due diligence, there are listed companies with attractive risk-return ratio in a longer term investment horizon.

In order to find such opportunities, we remain faithful to our investment process that closely resembles private equity investors. We make a deep analysis as if we were to become controllers and perpetual shareholders, but with the benefit of market liquidity to divest if the thesis proves wrong or even if the market price fully anticipates our assumptions. Below you will find more details about our philosophy and a practical example of how we think when investing.

II. Our process to invest in the stock market

GROWTH VALUE INVESTORS

As investors we are in constant search for knowledge. This path leads us to a permanent construction of an investment philosophy that best fits our risk profile.

1 Private Investments in Public Equities

In addition to our hands-on experience, between mistakes and successes, we devote considerable time to an extensive bibliography. From Ben Graham, with Mr Market and cigar butts, passing by, obviously, the Warren Buffet and Charlie Munger duo, Seth Klarman, Bill Ackman, to the latest influence of great *forward thinkers* such as Mark Andreesen (and all the a16z publications) and Scott Galloway. There is also the privilege of counting on more than 100 letters and countless conversations with our friends at Dynamo and others who have consolidated themselves over the last few years as the best equity investors in Brazil. But what comes out of this mix of references? How do we think about our process of finding good investment opportunities?

We consider ourselves *value investors*. This, however, is a much broader definition than it seems.

> *"Long ago, Ben Graham taught me that "Price is what you pay; value is what you get." Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."*

Warren Buffett – 2008 Berkshire Hathaway Letter

Value investing is believing that, at some point, the market price of a company will converge to how much it should really be worth, its intrinsic value. Ben Graham and David Dodd had introduced the concept in the 20's with the idea of buying companies at low multiples to its current profits. With the dissemination of the theory, investing in stocks just because its price to earnings ratio is low can mean a *value trap*. The change of business models has also made the balance sheet analysis more complex, since the competitive advantage of many companies is more related to their *off-balance* intangible assets than to its capitalized assets. The arduous task of determining the intrinsic value of a company has come to a much greater portion of "futurology".

For some, it derives from a complex spreadsheet that contains numerous variables with a relevant influence on the result. We prefer to deploy this tool as reality check and not as the main factor of an investment. The intrinsic value is closer to an range than to an exact number. We then spend much more time understanding the business idiosyncrasies, the people behind it and the value generation drivers. As a result of this imprecision, we seek companies with relevant upside potential and that can significantly grow its profit over the years, giving us the margin of safety that we consider important when investing.

A company's long-term sustained growth is a consequence of its decision-makers' capital allocation strategy. Investing in current operations, building new verticals, developing new technologies, acquiring other companies, repurchasing shares or paying dividends are most of the options available. We seek to invest in leaders capable of performing this role with above-average quality. Companies with such characteristics provide a type of investment much less dependent on trading and timing, with the potential to compound our investment at high rates of return for many years.

The sweet spot is when we find companies that are on the verge of entering a growth path not yet priced by the market. They are companies that, for example, have assets not yet monetized or competitive advantages that could sustain growth above expectations. In general, these are stocks with multiples that seem fair to more short term oriented investors.

That's the direction we have been heading as value investors in recent years: the *growth mindset*.

> *"I call myself a farmer. Wall Street is flooded with hunter – people who try to go out and find the big game. They fell it and bring it back, and there's a huge feast and everything is fabulous, and then they look for the next big game. I plant seed and then I spend all of my time cultivating them."*

Tom Russo – Rich, Wiser, Happier

SEARCHING FOR GROWTH COMPANIES AT INTERESTING PRICES

For new technologies, never tested, venture capital has been present for centuries. It was so with the Portuguese caravels in 1400, as the Italian bankers funded their construction and the first expeditions in search of new territories. In the 19th century, the industrial revolution was followed by an rapid development of the financial market. Railways, a technology that disrupted canals as a form of continental transport, were financed by famous houses such as the Rothschilds and J.P. Morgan.

Currently, the Venture Capital industry provides capital, knowledge and “patience” for new technologies. In Brazil, this still recent phenomenon has the potential to change the dynamics of many businesses in the coming years. Following them closely also helps us know where not to invest, since, in the first moment of a major disruption, it is easier to identify the losers than the winners. And with these new technologies reaching maturity we will have more and more companies (the winners) raising capital in a IPO for a second phase of growth, less riskier than the first (but with lower return too!).

Here we find some examples of companies that were able to achieve a sustainable growth after going public.

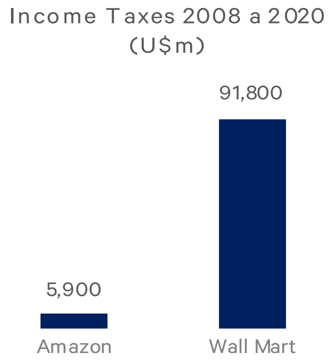
Around ten years ago, the newly formed Raia Drogasil (a merger of Droga Raia with Drogasil), traded at very high multiples to current profitability, and looked “expensive” to many investors. However, those who bought its shares compounded capital at 25% per year during this period, multiplying their investment by more than nine times. Whoever realized how big was the addressable market for a well-run drugstore (a new “technology”) with a superior business model to “mom & pops” peers, and focused on its operational growth drivers, made a lot of money despite the high volatility of its stocks (there were some 20% or more drawdowns). Ten years later, the company has tripled its stores footprint and increased its EBITDA by 6 times.

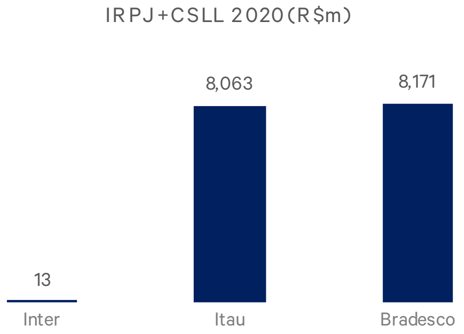
Another great example of capital allocation is Equatorial. We've been company shareholders since way before starting Mar and still own it. In this case, anyone who considered only existing assets would hardly invest in the company. It was vital to understand the ability of its management team and the board of directors to deploy the generated cash in new opportunities, transforming an electricity distributor into a capital allocation platform.

Value generation via capital allocation is usually underestimated by investors, especially those short term oriented, who prefer to receive dividends rather than face the risk of reinvestment. In 2012, Equatorial was worth less than R$2Bi with R$0.56Bi of EBITDA. Today it is worth R$25bi with R$5Bi of EBITDA, without paying a cent in dividends beyond the minimum required by law. It now owns a portfolio of six distribution companies, more than 2 thousand km of transmission lines, 1GW of renewable energy assets with an extensive pipeline of projects. And we believe the company is just starting a new act with its recently acquired sanitation concession, a segment undergoing a process of privatization and still in its early stages (potential market of R$1tri in capex).

We seek to go deep in sectors that undergo structural changes. At times like these many companies end up mispriced as the market does not have yet an insight into the future of the sector. In this direction, the digitalization of the economy and the massive use of smartphones broke down important barriers for some business to grow. The capital need to gain distribution has reduced significantly, which has freed up budget for more robust investments in other areas such as service quality and product development. Most of the companies founded in the digital world have business models superior to their incumbent competitors. This type of business disruption is repeated from time to time with the surge of new technologies. We can go back to Vasco da Gama and his trip to India, which created an ocean route from Europe to Asia that significantly cut the cost of logistics for spices. As a result, the price of pepper in Portugal decreased from 80 cruzados a portion to 30, even so, representing a 10x mark-up of what the Portuguese paid for it in India.

Back to present day, the retail banking business was radically affected by the "new technology" that enabled competitors to have a brutally lower cost curve. In addition, the market appetite for a high growth narrative gave them a very low cost of capital (equity) and even a tax "arbitrage" in a sector with very high corporate tax rate in Brazil (challengers do not generate profit!). In its last follow on, in June 2021, Inter raised R$5.5bi, valued at R$50bi. Despite the valuation of tens of billions of reais, the company generated no profit and paid R$13m of IRPJ+CSLL (federal corporate taxes) in 2020, while Itaú paid R$8bi. It reminds us of Amazon's path in the US, which has become a $1.5 trillion company paying virtually no federal taxes.





Source: Companies Reports, Mar Asset Management

The digitalization of financial services thesis has been part of our portfolio since 2019, via Inter and BTG Pactual, both responsible for a significant contribution to our results. In the case of BTG, there is a very interesting combination, since the "legacy" business profits (wholesale and investment bank) provide a floor to its valuation and work as funding for building the new retail banking vertical.

In the group of high-growth companies there are also those with assets not yet fully monetized (or *hidden assets*). We believe that the SBF Group, owner of the sporting goods retailer Centauro, and Fisia, a distributor of Nike in Brazil, shows this characteristic.

We will dedicate the next 19 pages to do a *deep dive* into a growth opportunity within the group that exemplifies our approach to an investment thesis.

It is important to note that this is a thesis that well portrays the characteristics we seek when investing in a company: (i) a profitable and growing "legacy" business, with well-built competitive advantages (Lojas Centauro); (ii) a very capable operational team under the leadership of a CEO, Pedro Zemel, with a focus on superior capital allocation; (iii) a new growth vertical with relevant potential and important assets already built (Nike Brasil); (iv) founder and controlling shareholder, Sebastião Bonfim, with a succession already well done and long-term alignment; and, (v) market prices that do not yet reflect the identified opportunity to generate value.

If we do any type of multiples screening, SBF would not be among the “cheapest”, trading at a multiple of current profits of more than 14x EV/EBITDA (ex IFRS-16) or 37x P/E 2021[2]. Even so, we understand that its market cap of R$5.1 billions is much lower than what we see as its intrinsic value.

III. Why do we see value in the SBF Group?

The sporting goods retail is highly pulverized in Brazil. Its big share of independent stores reminds us of the drugstore industry in the case of Raia Drogasil. The expansion of the Centauro store network and the strengthening of its digital channel, mainly through an integrated omni-channel experience, provide a good path to profitability growth. We see the SBF Group as the main candidate for a consolidator in the segment, with room to double the revenue of Centauro stores in the next 5 years.

However, what makes the story even more compelling is the recent deal with Nike Inc.

2 Closing values of October 2021.

We disagree with the market's consensus view of the distribution contract between Nike and SBF as something similar to a wholesale representation of an international brand, just as Vulcabrás has Under Armour and Mizuno in Brazil.

The SBF Group was hired by Nike Inc with a main goal: to develop the brand's retail channel (Direct-to-Consumer) in the country. The strategy involves transforming nike.com.br into a relevant ecommerce, leveraged by the group's infrastructure, and opening its own stores.

If the execution succeeds, the two assets (Centauro and Nike Brazil) will be hardly separable. The model will look more like a Nike master franchisee in Brazil than a representative who sells products to multi-brand stores via its showroom. In this case, it will make sense to give some perpetuity value to this asset, significantly increasing the intrinsic value of SBFG3.

In addition, we believe that under a first class management team in retail, Nike's potential in Brazil is much greater than its current size. People are exposed to the Nike brand many times a day and practically throughout their whole lives, regardless of social class, as a consequence of a lot of capital deployed in extraordinary branding globally. **It seems to us that the Nike brand in Brazil already has an goodwill so well built that it should be much larger than a company with less than R$3billion of revenue per year. It is a matter of increasing distribution and assortment, which comes with good execution.**

Under our assumptions this combination can worth something north of R$5bi in market value. Just a "contract", at first sight, but one that could double SBF shares.

In order to understand this opportunity we find usefull to deepen the research on Nike global operation and its branding and product investments.

NIKE, Inc.

Needless to say that the Nike brand is widely known to those who read this letter. But we cannot say the same for its recent business dynamics (if this is the case, we suggest skipping this session). Over the past ten years, led by Mark Parker and John Danahoe, their business model has undergone an ambitious transformation in the way it relate to its consumers, both in channel, branding and product.

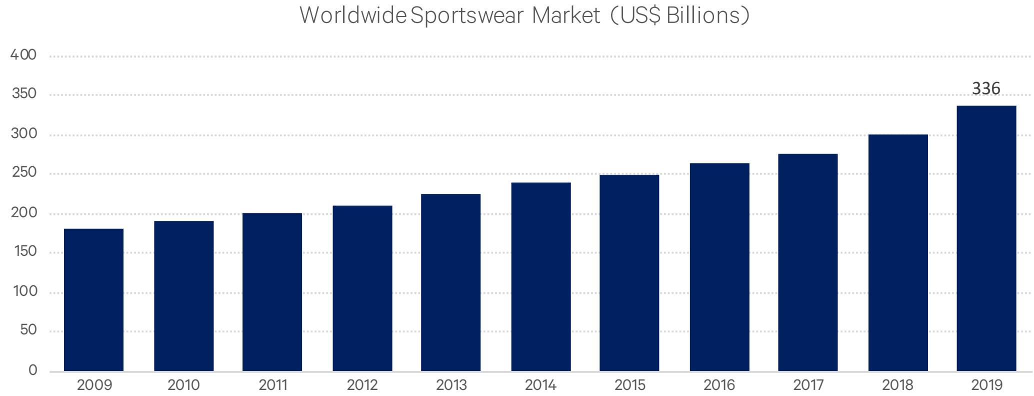
Nike's history is marked by the remarkable stubbornness of its founders and their obsession with the dissemination of a corporate culture essentially based on innovation, brand building and consumer focus.

Co-founded by Phil Knight and Bill Bowerman in 1962 in the city of Portland, Blue Ribbon Sports, embryo of what would later become NIKE, Inc. (NYSE: NKE), began as an exclusive distributor of the Japanese Tiger running shoes group Onitsuka Co. – now known as ASICS – in the USA. Today it has become the largest global sportswear and footwear brand, with one of the most recognized logos in the world and ended its last fiscal year with revenues close to US$45 billion and a market value[3] of US$265 billion.

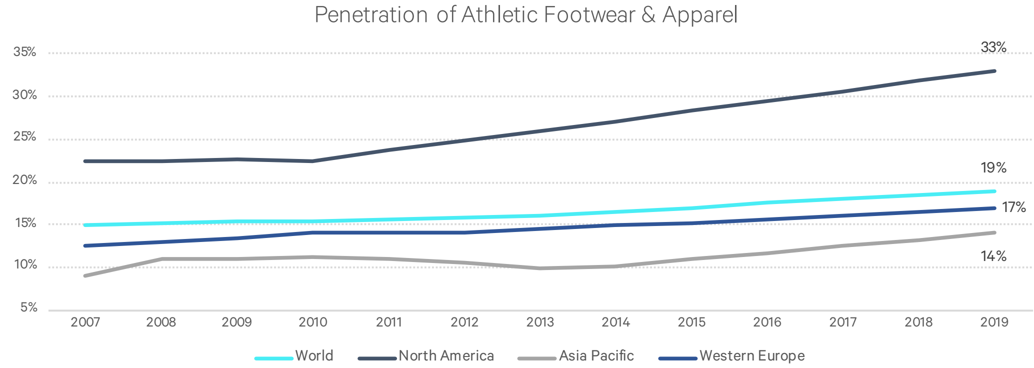
As a starting point in understanding Nike Inc's recent trajectory, let's take a look at the apparel and footwear industry around the world.

The global clothing and footwear market represented around US$1.8 trillion in 2019, of which US$336 billion comes from the sports segment. The combination of a secular trend of a healthier lifestyle and a more casual dress code ("Athleisure Lifestyle"), has led to a structural gain of share by this segment. At different magnitudes, this change has been occurring in several regions, even before the pandemic, as we can see in the following charts.

3 Fechamento de Outubro de 2021.



Source: Euromonitor, Bernstein Analysis, Mar Asset Management



Source: Euromonitor, Bernstein Analysis, Mar Asset Management

> “And we’ll set a new expectation for style, creating a new aesthetic to wear in all moments of their lives. To the consumer, there is no trade-off between sport and style. We know that more than half of the athletic footwear and apparel is bought for non-sport activities, and we have even more room to grow in this market.”

Mark Parker, Nike, Inc. Executive Chairman

The Covid-19 outbreak accelerated these trends and made the work from home option almost a rule. Who hasn't had a Zoom meeting with someone using a Nike shirt in the last few months? How many companies do we know that started to adopt "sneakers" as dress code (or if it is a start-up, the hoodie)?

The consequence of this behavior change is relevant for the industry. The addressable market of sports brands converges more and more to the apparel retail as a whole!

We can affirm that one of the biggest winners of the industry in recent years was Nike. This success could not be attributed to just one, but multiple factors, with years of execution consistency. And for building a brand of such relevance everything begins (and ends) with innovation.

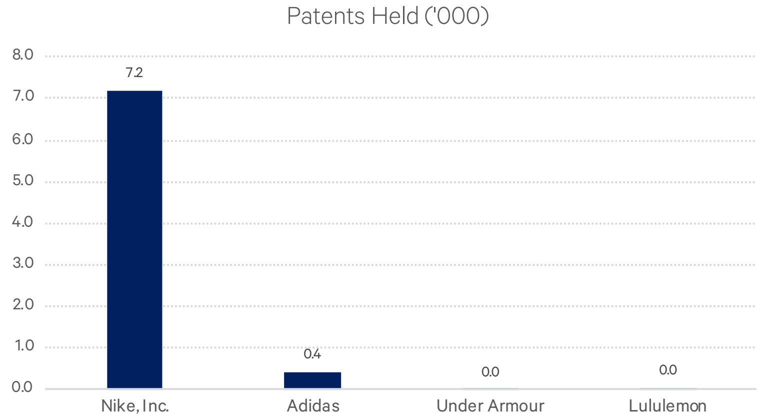
> "At Nike, innovation is a mindset. It drives how we think about efficiencies, about reducing our impact and how we invest in relationships with consumers"
>
> Mark Parker, Nike, Inc. Executive Chairman

Nike's innovation DNA permeates every step of its value chain. From the research and development of a new product and its manufacturing process, as well as its distribution and communication with the end customer, its innovation mindset is imperative and advocates towards the construction of brand equity and its *consumer oriented* value proposition.

Nike has a long track record of massive investments in R&D. Proprietary intelligence is a combination of inputs and data from athletes and other high-performance professionals with designers, engineers and, of course, users. The recently inaugurated Lebron James Innovation Center[4] is a synthesis of this culture, a 70,000-square-meter laboratory to develop new products.

As a consequence of this long track record of investments and focus on R&D, Nike has become the third largest patent owner in the USA, with more than 7,000 patents, substantially greater than any competitor in the sportswear and footwear segment in the world.

4 https://lebronjamesinnovationcenter.nike.com/



Note: Based on the number of patents signed between 1976 and March/2018.
Source: US Patent and Trademark Office, Bernstein Research, Mar Asset Management

One of the greatest insights by Phil Knight was, from the beginning, to invest in sports endorsements: marketing through sponsorships and partnerships with athletes and/or sports entities. The rationale is simple: it is the fastest way to accelerate product innovation, via feedback from athletes, and increase *brand awareness*.

The strategy began in the 1970s with track athletes and currently includes individuals and groups of the most diverse types of sports. Personalities such as Michael Jordan, LeBron James, Rafael Nadal, Ronaldo, Cristiano Ronaldo, Tiger Woods, as well as new generation athletes, such as the Olympic medalist Rayssa Leal, a Brazilian skater, are examples of athletes sponsored by Nike.

Sponsorships also extend to collectives, for example leagues such as NBA and NFL, or sports teams such as Chelsea, Barcelona and Corinthians. The Brazilian National Soccer Team itself – sponsored since 1995 – is a part of this select group.

The consequence is to have a group of individuals and aspirational collectives, with global reach, advocating in favor of Nike. Putting in numbers, if Nike were a country in the Tokyo Olympics, it would be the leader in medals, totaling 226, of which 85 gold. A powerful tool to show the Swoosh.

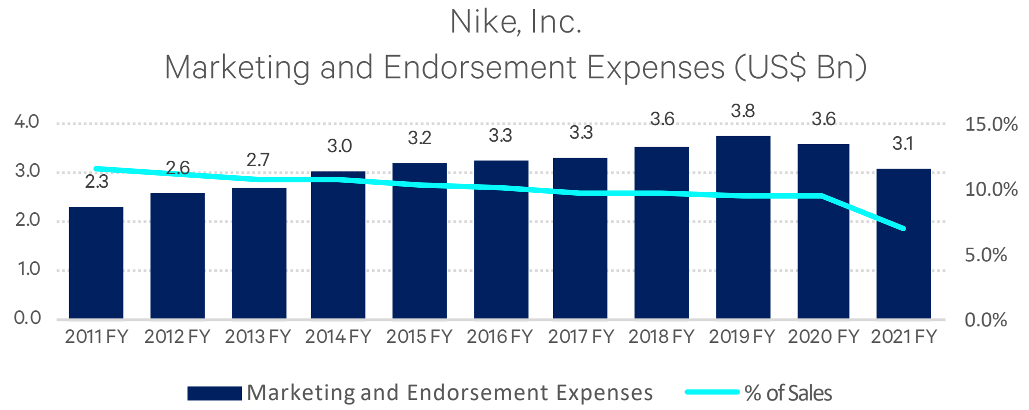
"Nike has a personal relationship with the greatest athletes for every sport from every corner of the world. And we partner because it's the fastest path to innovation, and together, we create the future of sport."

Mark Parker, Nike, Inc. Executive Chairman

However, the Nike brand equity not only derives from the athletes who it sponsors, but also from its positioning per se. The brand is widely known for its strong identity and very successful, and sometimes brave, marketing campaigns. **Today, we can consider Nike as a leading-edge brand, connected to the new generation and respected for its bold branding.**

As an illustration, for the 30th anniversary of the slogan "Just Do It", Nike launched a campaign against racism, in which it praised the NFL quarterback, Colin Kaerpernick, who refused to kneel during the national anthem in protest of violence against black people in the country. Another example was the positioning in favor of the protests of NBA athletes in the Black Live Matters movement and the commitment to donate US$40 million to support initiatives against racism. It is usual to see very inclusive and diverse campaigns.

This successful marketing and branding investment, which totals US$3.5 billion a year, represents a relevant competitive advantage, enhanced by the scale. Just by making use of its robust balance sheet it is possible to finance a great number of athletes and/or iconic sports institutions, as well as global marketing campaigns. As an example of the Nike brand reach, today there are more than 1 billion people digitally connected between the brand's social media and sponsored athletes and teams.



Source: Nike, Inc. disclousures, Mar Asset Management

> *"Our whole strategy is around speed and scale, getting faster in the creation of our product, getting faster in the manufacturing of our product and getting our product more quickly to our consumers."*

Eric Sprunk, Nike, Inc. Former COO

Through a strong brand, Nike is able to offer a wide assortment covering all categories, a wide price point range, and practically have all age groups in its client base. What other brand wears babies, teenagers, adults and the elderly?

Taking the North American market as an example: it is possible to find on nike.com, whether in the footwear or clothing segment, a wide range of products at the price of US$20 to US$40 as well as US$200 to US$300. Even more interesting, if we go to the "sneakers" market, as in the marketplace stadiumgoods.com, we can find U$10,000 products.[5]

Even before becoming a reference in brand and product, Nike innovated by being one of the pioneers in globalizing its supply chain, which was extremely important to reach the current scale. In its manufacturing footprint, Nike has 535 factories and 70 distribution centers around the world. China, Indonesia, Vietnam and Cambodia concentrate more than 60% of clothing and 95% of footwear produced.

However, a number of factors have caused a reversal in recent years, bringing the manufacturing chain closer to its end market. The need to serve a more demanding and subject to faster trend changes consumer makes an Asian supply chain lead time too long to serve the American market. Nike has been investing more in suppliers in the Americas and started new partnerships, such as the combination with Tegra Global, from private equity Apollo. The recent global supply chain disruptions should intensify this effort.

5 https://www.stadiumgoods.com/en-us/shopping/jordan-shoes?pageindex=1&sort=price&sortdirection=desc

The path paved by the company in recent decades and its structural competitive advantages built strong foundations for the next great growth cycle even for a consolidated company.

Nike's first 50 years of growth – as well as the vast majority of consumer brands – were sustained by the wholesale business, which allows for a wide products distribution with limited use of capital. However, it's a channel with limited retail price control, brand positioning and, by definition, the interaction with the end customer is outsourced. **In mid-2010, Nike made public a change of strategy and the growth opportunity through the Direct-to-Consumer ("DTC") channel and digital initiatives.**

The DTC consists of physical stores and digital channels directly operated by Nike. Unlike the wholesale, it is a more capital-intensive channel but, on the other hand, it allows you to capture the full retail price.

Thus, a sale on the DTC channel generates a higher gross margin and, if well operated, a higher contribution margin versus the wholesale. And, no less important, it ensures control of brand positioning and consumer data, thus generating a virtuous cycle. Enhanced by the membership model, the channel provides a deep data lake that subsidizes improvements in R&D, manufacturing, distribution, CRM, among others.

> *"In this fiscal year, we met the goal we set at our last Investor Day around membership of full year early and now have more than 300 million NIKE members... In this engaging membership experience fuels a virtuous cycle, feeding insight to product creation, inventory optimization and more, knowing and serving our members drives greater competitive separation."*

John Donahoe – CEO, Nike Inc – FY20 Q4

In 2017, after the first wave of growth of the channel, the strategy was intensified with the so-called "Consumer Direct Offense", turning the wheels to explore this road.

Ten years on we can already say that Nike was successful in executing this strategy. The DTC sales penetration went from 15% in 2011 to 37% today and the goal is to reach the 60% penetration mark, being 2/3 via

Digital, in the medium term. China is a highlight, where the DTC already reaches 46% of the total sales.

It is also worth mentioning that this increase was incremental to the company's revenue, since we did not see a significant cannibalization of the wholesale channel.

The unparalleled acceleration of consumer digitalization, as an effect of the covid-19 pandemic, was a game changer for Nike. Digital channels boosted yet another major leap in DTC penetration and led the company to report record growth and profitability in its last fiscal year[6]. This digital leap shows the first signs of being structural, since in the last fiscal quarter, even with physical retail revenue returning to pre-pandemic levels, digital sales still grew at rates above 10%.

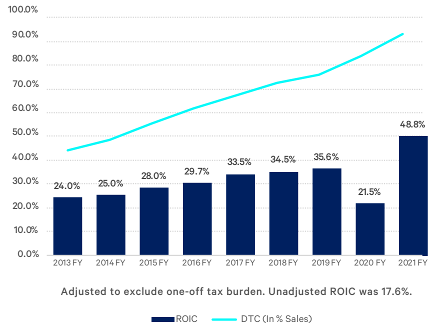
Questions also arrived as to whether, despite a higher contribution margin, the return on invested capital by the DTC would be higher than the wholesale channel. But as Nike expanded exposure to DTC, the company's consolidated ROIC went from 24% to almost 50%.

Some of this expansion is non-recurring because of temporary savings due to the uncertainties generated by the pandemic scenario. However, it represents a clear sign of capital allocation opportunities at more attractive levels of return.

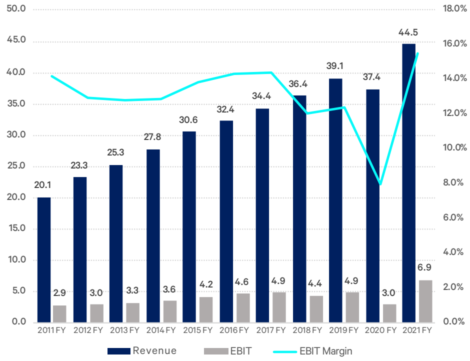
A continuous increase in return on capital and prospective scenarios of higher growth were a powerful combination to Nike's valuation as its multiple expanded from ~15x EV/EBITDA to ~30x EV/EBITDA and its stock multiplied by 7x in 8 years!

6 Nike Fiscal Year 2021 – June 2020 to May 2021.

Nike, Inc.
Return on Capital (ROIC, %)



Nike, Inc.
Revenue and EBIT (US$ Bn)



Source: Nike, Inc. Reports, Mar Asset Management

Nike's successful history around the world gives us an strong indication of the opportunity in Brazil. First, SBF will take advantage of all this investment in branding and product innovation made over so many years. Also, SBF can leverage from Nike insights of the global DTC building experience.

We wonder if it is possible to replicate it in Brazil despite years of operational underperformance versus other countries. However, as we will explore in the following pages, we understand that in the hands of an excellent retailer, Nike Brazil can finally take off.

NIKE BRAZIL AND GRUPO SBF

Nike started its operations in Brazil in 1988. Its business model was entirely in wholesale until the opening of the first Nike Store in 2008, located in the Pinheiros neighborhood in São Paulo.

As discussed, Nike Inc.'s DTC strategy has proved very successful in the vast majority of the countries in recent years. Brazil is among the exceptions. In order to identify the reasons, we need to understand the country idiosyncrasies of the last decade.

Nike began the aggressive roll out of its strategy in 2010. That year Brazil was on the cover of The Economist, its GDP grew 7.5% (the third highest global rate, after China and India) and the country had won the bid to host both 2014 World Cup and 2016 Olympics. Of course, as a result, Nike investments in the country accelerated, ramping up from a single store in 2008 to more than 50 in 2016. It seemed the right strategy.

Timing couldn't have been worse. Brazil entered a deep economic crisis in the following years, that led to a business contraction and Nike decided to reduced it size in the country since then. There was an massive overhead reduction, the stores were closed, and the DTC strategy totally adapted to this new reality. As an example: Nike's ecommerce was outsourced to another firm (Infracommerce); the stores became franchises and not integrated with its ecommerce; and its commercial app was not even launched. Over time, the country was completely out of priority. At its Investor Day in 2017, the company presented its 12 focus cities and none of them were Brazilian (Key Cities: Mexico City, Seoul, Paris, Beijing, Shanghai, London, New York, Los Angeles, Berlin, Tokyo, Barcelona and Milan).[7]

Finally, in early 2020, when the Brazilian operation accounted for just over 1% of total global revenue[8], and Brazilian GDP in dollars was nearly half of what it was in 2010, Nike Inc announced that it was changing the country's business model (as well as in Argentina, Chile and Uruguay) from subsidiary to distributor. The partner for Brazil was the SBF Group.

It is interesting to observe how SBF is a non-obvious choice. Nike chose to leave its brand in the hands of a retail company with no history of own branded product management. Totally different from others like Mizuno and Under Aurmour, both today under the management of Vulcabrás (owner of the Olympikus brand) and focused on wholesale.

7 "We are focused on creating this marketplace in 12 key cities and 10 key countries. These cities are the sharp points of our strategy, because they're the center points of change. This is where change is most accelerated. Everything comes together in the city. It's where the shift starts and the expectations continue to elevate. Today, our cities are driving such accelerated growth, they're outpacing the rest of our business. In other words, NIKE has created a local business on a global scale." – Nike Inc Investor Day 2017

8 On the Chinese Single Day of 2020 (11/11), Nike had digital sales of more than U$500m, that is, in 1 day it sold practically what it sells throughout the year in Brazil. Another interesting piece of evidence about the country's irrelevance to the company.

This decision revels a preference in choosing a partner with a good execution track record in retail, to focus on the DTC strategy so successful around the world. It is worth mentioning that, in recent years, Centauro was selected as a Key Account in the global rationalization process of the wholesale channel by Nike, where they started to exclude certain multi-brand stores and to give preference and exclusivity of assortment to others.

For Argentina, Chile and Uruguay, the negotiations did not advance with the Axo Group and Nike continues to seek a new operator. If SBF is successful in Brazil, it is expected that it will become a strong candidate to be chosen for these countries as well.

Although announced in January 2020, the transaction was completed only in December due to the pandemic, and 2021 is the first year under SBF management. **The group did not pay any goodwill for the operation buying R$1bi of inventory to become the brand distributor in Brazil for the next 10 years, renewable under some conditions**[9].

The Nike's Brazilian operation had gross revenues of R$2.6 billion: 70% wholesale, 20% outlet, and only 10% on its ecommerce. **As we anticipated, we believe that this is a very mispriced asset by the market and that it should generate a lot of value for shareholders over the next few years**.

We see two key drivers: (I) a successful execution of the brand's DTC channel in Brazil; and, as a result, (II) relevant gain of market share by Nike.

Starting with the latter.

Nike is one of the brands with the highest awareness in Brazil, belonging to a select group that reaches different social classes in the most diverse regions, such as Havaianas, Natura, Coca-Cola and Mcdonalds.

9 5 years for stores and 10 years for wholesale and website.

Research on the brand is limited to observing its size in relation to the sporting goods market in the country, a big misunderstand. Its true addressable market is much larger, closer to that of apparel, given the behavior trend addressed previously and the company's own evolution of assortment and positioning. Unlike Havaianas, which currently tries to monetize its brand with products other than sandals, Nike has long invested and developed lifestyle products that fit on several occasions other than sports. It is not a bet; **it is a consolidated strategy with products very well accepted by consumers**.

In this sense, to understand its potential size in Brazil, it seems more appropriate to compare Nike with other clothing brands with high awareness and distribution , such as Renner, which has a gross revenue of R$11bi[10], while Nike sales *(sell out)* is around R$5bi in 2021. Just as comparison, in the U.S. Nike is the leader, with sell out of U$ 27bi, well ahead of the second, Old Navy, with around U$7.4bi.

Of course, there are several challenges to achieving such scale, whether they are brand building, assortment, or distribution. But what we would like to draw attention to is that in Brazil, it seems to be more a matter of operational execution than brand building. It is exactly where we believe the SBF Group and a "spin off effect" with more focus and alignment can quickly make a difference.

In line with the global strategy, the path to greater distribution is to build the Direct-to-Consumer channel in Brazil, which today is relatively small.

The nike.com.br ecommerce sold R$260m in 2019 and was limited to a reduced supply of products with low investment in working capital, often leaving the inventory color and size grid incomplete and losing sales. The low capital deployed on this initiative was also perceived in the timid digital media budget, in the very small ecommerce team and in the outsourcing of ecommerce operations to Infracommerce.

10 Receita Bruta da marca Renner líquida de cancelamentos e devoluções

The business potential in the hands of a good and result oriented operator looks huge to us. Some of the drivers that the SBF Group can provide are:

- / Intelligence and good practices in purchasing digital media. The Centauro ecommerce revenue is close to R$1bi.
- / Centauro's omnichannel (benchmark in the industry), using the existing logistics network and the 200 stores with 1,200 m2 on average.
- / Tax incentives synergies on Distribution Centers.
- / The Group's 400 people developers team.

The first signs of an improved execution can already be seen during this first year. By increasing inventory coverage, minimally expanding assortment and investing more rationally in digital media, we expect the ecommerce to triple its sales compared to 2019. Those were low hanging fruits. The second step will come in 2022, after integrating systems, as the Nike ecommerce will be able to fully use Centauro logistics network. In addition to improving the delivery service, we expect the ecommerce conversion to increase significantly when customers realize that they can buy from nike.com.br and eventually return it in the existing 200 Centauro stores.

In the long term, it will be clear how important it is to have a dedicated local technology team. By not being dependent on Nike Inc's priorities list, where Brazil is at the end of it, the business gains agility to implement important operational improvements. We expect Nike's (and snkrs) commerce app to be launched next year after the development of an open microservice platform that enables big synergies between Centauro and Nike. The app is extremely important to increase engagement, sessions, and to reduce the cost of activating the base and client experience frictions. No wonder a relevant part of the global success of the digital strategy can be attributed to the Nike app.

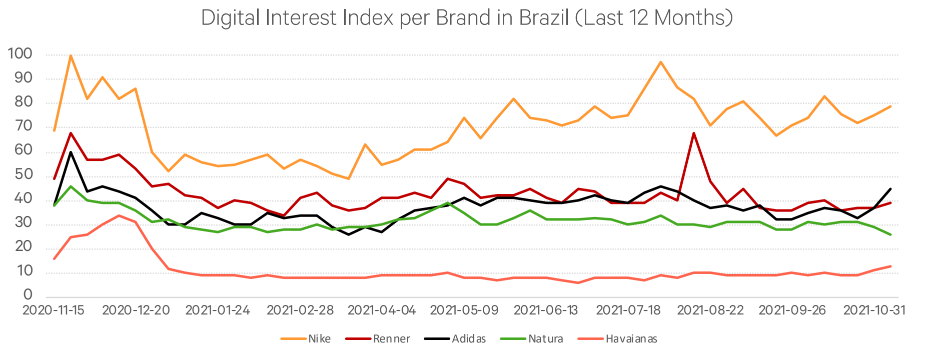
> *"As I said earlier, our owned digital business has more than doubled over the past few years to over $9 billion and at the center of our digital ecosystem is our suite of apps, which in Q4 reflected over 40% of our owned digital business."*

John Donahoe – CEO, Nike Inc – FY20 Q4

The expected operational improvement leads us to believe that Nike's digital sales potential in Brazil exceeds R$1.5 billion in a few years ahead. We like to look at Renner as one of its benchmarks, a brand with half of Nike's digital "interest"[11] (see chart below), and that, after investing in its ecommerce operation, and accelerated by the pandemic trends, increased its digital sales from R$400m in 2019 to R$1.2bi in 2021[12].

11 We define "digital interest" as the result of the search on google for brands according to google trends.

12 Mar estimates of Gross Revenue.



Source: Google Trends - https://trends.google.com.br/trends/explore?geo=BR&q=nike,renner,adidas,natura,havaianas

The DTC strategy will only be complete after the roll out of Nike's own stores. This is another front that SBF does not need to start from scratch. In addition, of course, to Nike brand being capable of generating instant customer flow to stores, Nike Inc has been developing several innovative store formats in recent years. Today there are four different ones in operation: Nike House of Innovation, Nike Rise, Nike Live and Nike Unite.

"At Nike, we focused on what consumers were telling us and stayed true to our belief of serving them completely. It's a concept that began 25 years ago when we opened our first flagship store. We didn't wait for an industry trend or shift. We believed we could reinvent retail by making it experiential, by elevating the power of our brand and by bringing storytelling to shopping in a way that other retailers hadn't done."

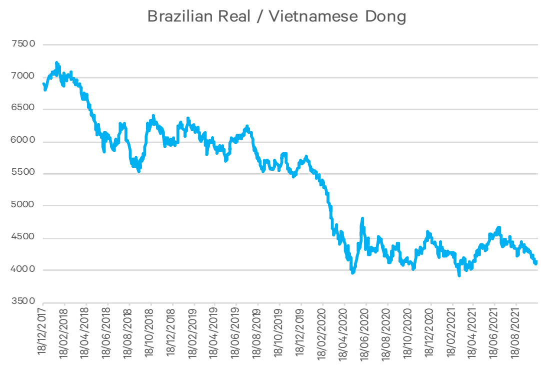
Heidi O'Neil, President of Nike Direct

The first store to be open by SBF will be one of the Nike Rise[13] concept, a store model that delivers an immersive digital experience in a 800m2 area costing R$4m on average capex.. These are stores with a 25%+ estimated return on invested capital. With the increase of Nike stores footprint, we believe that the assortment beyond footwear should gain

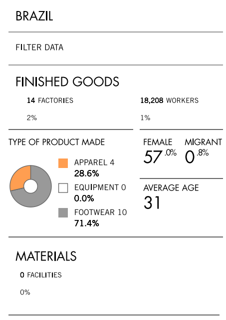
13 https://news.nike.com/news/nike-rise-retail-concept

more relevance. There is a big pent up demand for Nike women's apparel and lifestyle in Brazil, categories that drove DTC around the world.

We know that the assortment expansion faces some challenges and the main one is the exchange rate. There is a consensus within the SBF Group that it will be necessary to persuade Nike to the nationalization of some products manufacturing. Brazil already has some authorized suppliers such as Grupo Dass, Paquetá, and Hering, totaling 14 factories[14]. With the exchange rate devaluation and the global effort to bring the supply chain to the Americas (as in the case of Tegra, previously mentioned), we believe that SBF will have some success. The first step has already been taken, Nike will manufacture the Pegasus line in Brazil, a global best seller with a more complex product model and a higher *price point*.



Source: Bloomberg, Mar Asset Management



Source: http://manufacturingmap.nikeinc.com, Mar Asset Management

The nationalization effort will be linked to the DTC strategy success. The more SBF shows that there is a pent up demand for Nike products in Brazil, the greater will be Nike Inc's willingness to increase local production. We believe that the mix of domestic vs imported could significantly change if the Brazilian Real remains at current level, taking local manufacturing from 30% of total in 2019 to about 60% in a few years.

14 http://manufacturingmap.nikeinc.com/

In summary, we see a high return capital allocation opportunity for the SBF Group on Nike's retail channel. The combination of a strong brand with excellent products creates a relevant intangible asset to be monetized by increased distribution. We expect that in ten years Nike Brazilian operation will have more than 100 owned stores (funded by SBF balance sheet) and a R$2bi ecommerce fully integrated into Centauro's logistics network.

Income Statement - Nike Brasil in R$ millions	**2019E**	**2025E**	**2030E**
Sell Out	**4,420.0**	**7,688.8**	**10,964.8**
Gross Revenue	**2,600.0**	**5,160.6**	**7,738.0**
Wholesale	1,820	2,528	3,227
Digital	260	1,444	1,844
Stores	520	1,188	2,668
% DTC Channel	30.0%	51.0%	58.3%
Sales Tax and Deductions	-600	-1,148	-1,759
Net Revenue	**2,000.0**	**4,012.5**	**5,979.1**
Cost of Goods Sold	-1,490	-2,564	-3,590
Gross Profit	**510.0**	**1,448.3**	**2,389.5**
Gross Margin	25.5%	36.1%	40.0%
Selling and Royalties Expenses	-510	-962	-1,433
EBITDA	**0.0**	**486.4**	**957.0**
EBITDA Margin	0.0%	12.1%	16.0%

Source: Mar Asset Management

In turn, after years of mishandles and losing money, Nike Inc would have a very profitable operation (by sales royalties and products mark-up), albeit in a different model from the most of its global business. Under our assumptions, the relationship between SBF and Nike could become of a master franchisee, similar to other business models such as global restaurant chains, McDonald's and Burger King, or Coca Cola bottlers.

So, we end with the following question: how much should a Nike master franchisee be worth after executing such a successful strategy of revenue expansion and profitability? 10x Ebitda? 15x? **We would be talking about something between R$5bi and R$7.5bi of additional EV by 2025**.

Also, what externalities would such execution bring? By showing that you are able to build distribution for well-established brands, why not increase your ecosystem by doing the same for, as an example, a soccer team? A simple view for the next steps of a company that presents itself as a sports ecosystem and is willing to deploy capital in new growth fronts through the newly created Corporate Venture area.

FINAL COMMENTS

Companies like SBF are those we hope to be shareholders for a long time.

Companies with long term oriented controlling shareholders, operational excellence, and mastery and willingness to deploy the firm's resources on new market opportunities.

In 2019, SBF raised capital through an IPO to fund the growth of Centauro stores, and consolidate a still fragmented multi-brand retail of sporting goods.

In 2020, it again accessed the market to finance a new growth vertical through Nike Brasil, still in the middle of a pandemic.

Of course, there are execution risks, but the challenges are all within the company's *circle of competence*. The first one consists of making the national *roll out* of the Centauro operation, already consolidated, and tested. The second, monetize the Nike brand in Brazil.

With its eventual success we see ways for new opportunities to be identified, continuing the virtuous cycle.

mar asset management

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