

Investor Letter

2nd Quarter 2023

*"How does it feel,
To be your own,
With no direction home,
A complete unknow."*

Excerpt from the song "Like a Rolling Stone" by American singer-songwriter Bob Dylan.

The SFA EAC FIC FIA – BDR LEVEL I Fund closed the 2nd quarter of 2023 with a year-to-date return of 16.69%, outperforming its *benchmark* Ibovespa benchmark, which returned 7.61%.

Período	SFA EAC FIC FIA – BDR Nivel I	IBOVESPA	CDI
2T23	24,78%	15,91%	3,15%
YTD	16,69%	7,61%	6,50%
Últimos 3 anos	27,81%	24,23%	26,22%
Últimos 5 anos	113,72%	62,29%	40,38%
Desde o início	301,29%	120,70%	139,36%

A trend that has captured our attention is the growing impact of narratives, particularly since the pandemic. These narratives have driven abrupt and often extreme movements in asset prices. It is not news to *players* in the financial market that narratives, amplified by fear and euphoria, influence prices — however, recently this dynamic has accelerated, confronting investors with challenges such as the global pandemic, inflation at very high levels, and a large-scale military conflict.

We can cite several examples of these movements, both in the macroeconomic and microeconomic scenarios. From a macro perspective, in 2022 there was a consensus that inflation was out of control, evoking the inflationary spiral of the 1970s in the United States. However, the consensus has now shifted, with many forecasting that inflation will return to the 2.00% target without major complications.

Over the past year, we experienced the fastest and most aggressive interest rate hiking cycle in the United States in the last 40 years, and there is an ongoing debate about whether we can decelerate without feeling the full effects of such restrictive monetary policy — a prospect we view with considerable skepticism.

Brazil faced similar dilemmas. At the start of the year, market participants were operating in a climate of chaos, which drove the prices of publicly listed companies to levels completely inconsistent with the value those companies actually generate. Naturally, some companies suffered for legitimate reasons, but that is precisely our work at SFA: to seek good businesses at attractive prices. This typically occurs when no one wants to buy those companies. In this context, it is essential that we distinguish between temporary and permanent problems.

The Meta case illustrates well the fleeting nature of market perceptions. Despite being one of the most widely analyzed and closely followed companies in the world, we saw its market capitalization surge 243% from its prior-year low. A year ago, the market was forecasting the company's decline due to TikTok; today, it is regarded as a leader in artificial intelligence (AI).

Indeed, the AI theme has become central to investors worldwide, and SFA is no exception. While we believe this technology is transformational, the low degree of visibility regarding who the structural winners will be, combined with a reduced margin of safety, presents challenges for long-term investors such as ourselves.

The global and local outlooks are murky, but it is precisely in moments like these that our investment philosophy and process prove their worth most clearly. Over the past 10 years, we have navigated the most diverse market regimes, always acting in accordance with our convictions and maintaining focus on what truly matters in investing.

We continue to hold a balanced portfolio, with cash to take advantage of opportunities that are already beginning to emerge. In addition, we continue to maintain some *hedgies*, operating them dynamically so they do not become a mere cost center.

In this quarter's letter, we discuss how we evaluate companies and provide a retrospective of our investment in Sinqia.

*"There's a lady who's sure, all the glitters is gold,
And she's buying a stairway to heaven."*

Excerpt from the song "Stairway to Heaven" by British band Led Zeppelin.

Let's Talk About Company Valuation

The world's greatest fortunes have been built by investing in great companies. Great companies create tremendous value. A company creates tremendous value when the return on its operating profit exceeds the cost of the invested capital. When we invest, we are buying the future. Investors seek companies that may not necessarily have created value in the past, but that are primarily capable of generating value over a long future period. An investment in a company with a high return on invested capital, with its profits reinvested at high rates of return, is capable of multiplying the invested capital many times over the years.

We believe we can deliver excellent results to our unitholders by identifying and investing in great companies over long periods of time. Through both successes and mistakes, we want to remain invested for a considerable length of time in a small number of companies that possess the characteristics we seek and understand well. The key is to hold a small position when we are wrong and a larger position when we are right. To use a fashionable word, identifying companies with strong management, governance, and robust competitive advantages is part of our analytical framework.

To maximize our returns, there is one more important variable: price. We maximize results and minimize errors by buying a great company when the market price, for various reasons, does not reflect its value creation potential — or, in plain language, we want to buy good companies that are cheap. To distinguish between value and price, we employ *valuation* techniques that provide us with the necessary margin of safety to size our positions. It is about *valuation* that we want to speak in this letter.

We are very critical of our own processes and working methods. There are many difficulties in evaluating a company correctly. We consider the art of *valuation* to be important. Value discovery is a crucial, but not the sole, component of analyzing a company. We place greater emphasis on the process than

on the output of the *valuation*. For SFA, the *valuation* tools serve to show us the value creation perspective of an investment, rather than to pin down a price target for a stock. Indeed, we are entirely opposed to the notion of a company having a price target. We even doubt that such a price target truly exists, because for us, investing is an infinite game. Buying or selling a stock at a price target can be a trap, since the valuation exercise to arrive at a price is sensitive to many variables that are sometimes unimportant from a business perspective, and can turn *valuation* into a true black box where bias ends up being the predominant factor driving a stock from buy to sell, or vice versa.

A price target gives a static, budget-like view of *valuation*; a company is a living organism, not a financial project. A common mistake when valuing a stock by price target is failing to correctly account for a business's

investment cycle, and despite appearing scientific, there is a great deal of subjectivity in any *valuation*. After all, we often impose a linear perspective on a world that does not operate linearly. When conducting a price-target valuation, we are projecting how much we can earn if we buy a stock at the screen price, ascribing a finite horizon to the investment. And in our experience, reviewing past reports from various market analysts, the price target is more of a moving target. We frequently encounter two types of errors in market research: companies that appreciated far more than the *target price* projected, and companies that never reached their target. For this reason, at SFA we use approaches different from the traditional discounted free cash flow to evaluate the potential return of an investment. In our way, we put our philosophy first — our search for value, not for *upside*.

The paper "M&M"

From a theoretical standpoint, it is correct to say that the value of any investment today is the present value of its future cash flows discounted at a rate that reflects the opportunity cost of capital. The discounted free cash flow method is the most widely used method among fundamental analysts to value a stock. Many analysts like to believe that this is what separates the professional analyst from the rest, which, in our opinion, is far from the truth.

The foundations of the discounted free cash flow method were laid in 1961 in the article "*Dividend Policy, Growth and the Valuation of Shares*", in the *Journal of Business* by professors Franco Modigliani and Merton H. Miller, the famous "M&M." The paper attempts to prove that free cash flow is the operating cash flow available to creditors and shareholders — the cash flow "free" for distribution to the company's capital providers. Thus, under the assumption that the firm is entirely equity-financed and does not reinvest its earnings, they demonstrate that the discounted free cash flow determines the value of a company.

But, as American baseball legend Yogi Berra, known for many famous quotes, once said: "In theory, there is no difference between theory and practice, but in practice there is." The problem with the free cash flow method arises in practice. Theoretically, the greater the free cash flow during the projected period, the higher the value of the company. In simplified terms, every cash inflow is considered positive and every cash outflow is negative for the present value of the firm. This can be erroneous from a value perspective, because generating future value requires making investments. An investment the company makes is initially a cash outflow; therefore, we must correctly account, within the estimated cash flow period, for the maturation of that investment. We must also consider that past investments eventually lose their effectiveness in terms of return on invested capital. In practice, when building a cash flow projection, it is common in many market analyses to find no explicit distinction between mature investments and those still maturing, nor whether the projected cash flow correctly captures the investment cycle. Furthermore, it is necessary to properly distinguish between operating and investing activities, not least because accounting definitions of investment and operations often do not reflect the economic reality of a business. In the end, a projected cash flow becomes a mixture of cash inflows and outflows with no distinction between mature investments, those still maturing, and necessary reinvestments — and it concentrates into a single number on the spreadsheet both operating and investing activities, such that the enterprise value derived is often the result of an algebra that bears no correspondence whatsoever to the actual value of the business.

When we compare the actual free cash flow vs. the projected free cash flow from most analyses we find in the market, we observe that actual cash flows are far more volatile and different from projections, which tend to be more stable and generally growing. From a practical standpoint, we can reduce to two the problems that we believe most often lead to valuation errors, giving *valuation* by the discounted free cash flow method a false sense of precision:

Investment and business/economic cycles: Nature and business operate in cycles. We find in many market projections that business investment cycles are frequently disregarded. Many companies are in a

growth phase, and the return on investments being made is not correctly reflected in the cash flow growth during the estimated period. Or, most commonly, we encounter projections where companies' cash flows grow exponentially and miraculously without the need for investment. Another common problem is anchoring to the current business cycle: when a company or sector is in a downturn or upturn, it is common to project the continuation of the current cycle, causing us to miss buying opportunities or fall into a value trap.

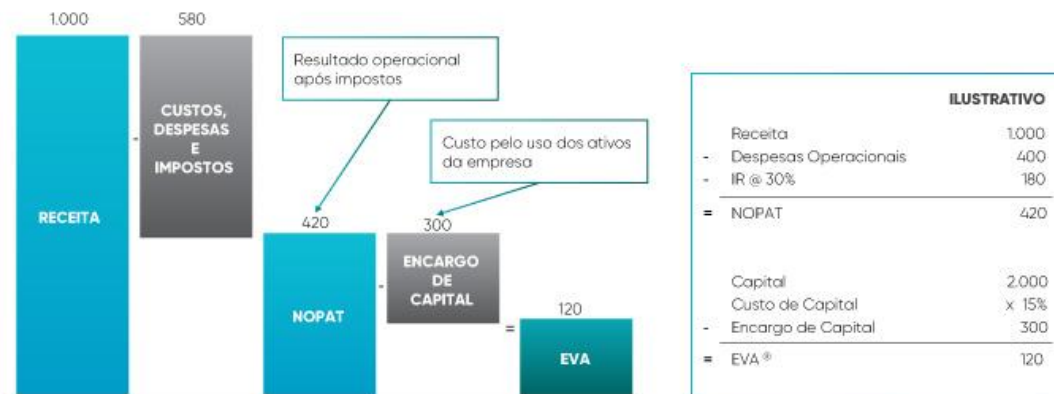
Terminal value: Terminal value, or value in perpetuity, is an essential part of *valuation* using the discounted free cash flow method, accounting for between 50% and 80% of the estimated value. Terminal value extends beyond the projected cash flow period, typically 10 to 20 years. It is truly a portion of value that is extremely sensitive to assumptions about cost of capital and growth — assumptions that are often applied to the last projected cash flow year, effectively assuming that after a 10-year projection period, the company has reached full maturity and that last year becomes the baseline for a mature business. This circles back to the prior problem: a part of value so important that business and investment cycle assumptions are entirely ignored, and cost of capital and growth assumptions beyond a 10-year period are not meaningfully discussed.

In our view, the greatest utility of *valuation* in analyzing a company is to show the value construction of a company, not merely to determine its value. We always want to analyze a stock from an investment perspective, which amounts to viewing a company as a living organism that makes and executes investment decisions. The primary role of *management* of a company is to allocate capital and obtain a return on that capital through the most efficient execution possible in pursuit of value creation. In practice, the present value of cash flows places excessive emphasis on the company's operating performance and does not allow for a deep discussion of the required capital, the investment cycle, and the expected return on the company's decisions. This makes *valuation* by discounted free cash flow a black box of value. For this reason, we consider other *valuation* methods more interesting.

Measuring Value Creation

We use EVA as a measure of a company's value creation in a given period. As we have discussed in prior letters, EVA is a measure of economic profit — a measure of value generation by definition. EVA is positive when operating profit covers the cost of capital. EVA is a more comprehensive measure than EBITDA, which is widely used by market analysts. As a curiosity, EBITDA was created by legendary Wall Street investor John Malone, who developed it after realizing that EPS (*Earnings per Share*) said little about a company's appreciation potential. However, quoting legendary investor Charlie Munger — who probably never opened an Excel spreadsheet in his life and tends to be quite direct in his comments — "EBITDA is bulls*** earnings."

EVA = Lucro Operacional menos um Encargo pelo Uso do Capital



- O EVA contrapõe o resultado operacional com o Capital que foi utilizado para gerar o resultado
- Foco no resultado operacional e na eficiência/disciplina de Capital
- EVA nada mais é do que uma forma de medir a geração e valor, o chamado lucro econômico

EVA	EBITDA
Receita líquida	Receita líquida
(-) Custos	(-) Custos
(=) Lucro bruto	(=) Lucro bruto
(-) Despesas operacionais	(-) Despesas operacionais
(=) EBITDA	(=) EBITDA
(-) Depreciação	
(=) Lucro Op. antes de impostos (EBIT)	
(-) Imposto de renda	
(=) Lucro Operacional (NOPAT)	
(-) Encargo de capital	
(=) EVA	

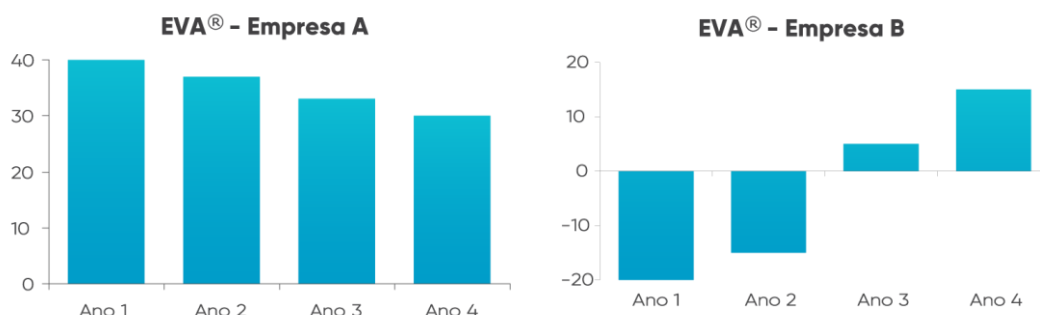
$$\text{EVA} = \text{Lucro Operacional Após Impostos} - \text{Encargo de Capital}$$

$$\text{EVA} = \left(\text{ROIC} - \text{WACC} \right) \times \text{Capital}$$

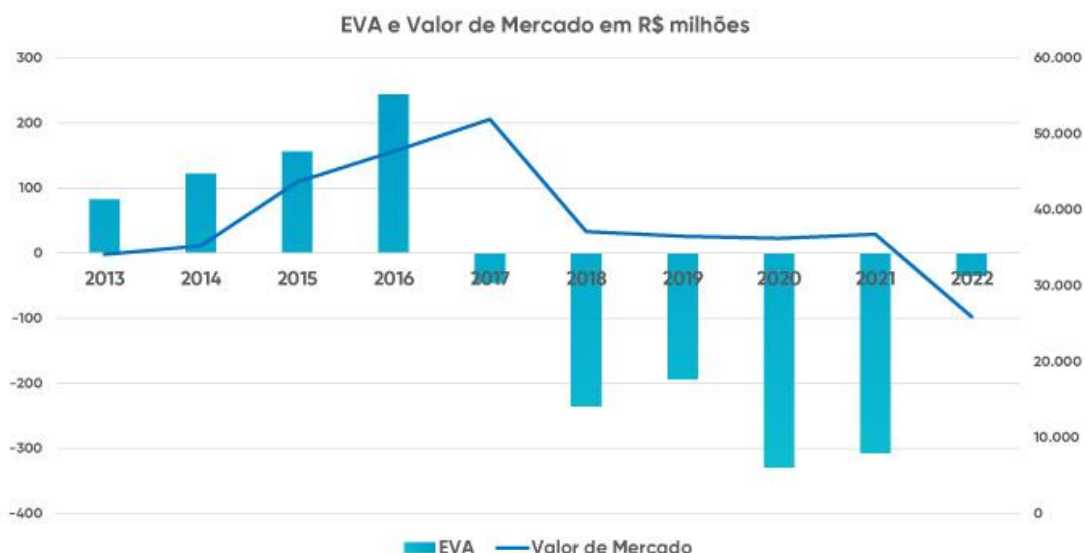
$$\text{Spread EVA} = \text{ROIC} - \text{WACC}$$

Retorno sobre o Capital
Custo Ponderado do Capital

Again, value-creating companies have a return on invested capital greater than the cost of that capital. Knowing past value creation is important, as it can say a great deal about the future, but EVA alone is only a measure of past value generation and does not indicate whether the company will continue to create value. It would be very easy for investors to simply invest in companies that historically delivered high returns on capital. But there is no free lunch: when we invest in a company, we are acquiring its capacity to generate EVA in the future, not just its past EVA. Companies that create value today may destroy value tomorrow, making for a poor investment. Companies with high returns on capital are typically widely followed and well priced, making value discovery harder — that is, it is more difficult to buy at a price with an adequate margin of safety. To speak about the future, beyond qualitative analysis, the role of *valuation* is important, and through EVA we can build valuation methods that serve as alternatives to discounted cash flow. In the illustration below, Company B would likely have been the better investment in Year 1.



As a real-world example, we have a Brazilian industrial conglomerate that until 2016 delivered high returns on capital. After several poor capital allocation decisions and structural changes in its sector, it began delivering negative EVA, and its share price followed the EVA decline. Those who invested in this company in 2016 based on its historically high return on capital ultimately suffered losses. An important lesson: past high returns are no guarantee of future EVA:



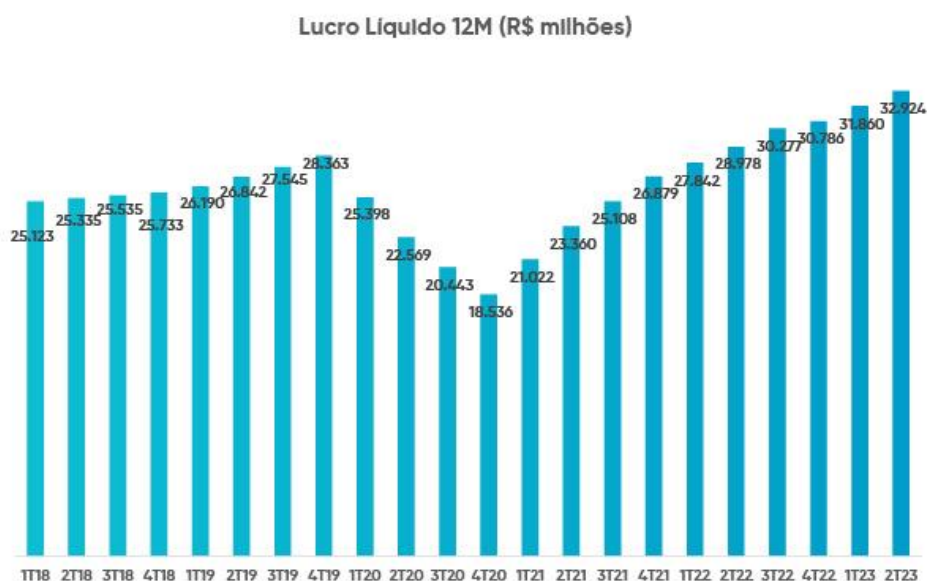
EVA vs. accounting measures

Many executives believe that their companies' share prices will be rewarded by the market if the company delivers a mysterious combination of earnings, revenue growth, cash flow, dividends, stock liquidity, customer and employee satisfaction, and good governance practices — metrics that are typically used in their performance evaluations for bonus payments. Over our ten years of existence we have spoken with many executives, and to our surprise, not all of them have a precise understanding of their mission to create value

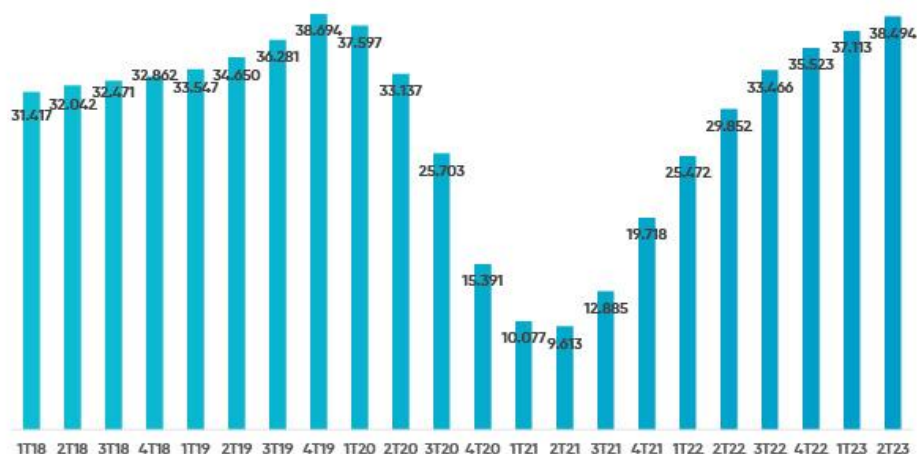
for shareholders. Many executives believe that by delivering earnings growth they are delivering what shareholders want. Of all the measures cited above, accounting earnings may well be the one most likely to lead to value traps. It is tempting for an executive, in pursuing earnings maximization, to cause the company to invest capital inefficiently, and despite achieving an earnings increase, value may not necessarily have been created for the shareholder — because the return on that investment, however positive, was still below the cost of capital. In other words, the company delivered earnings growth but with negative marginal EVA.

Earnings growth does not always mean value creation. To illustrate this, we recently sought to explain the behavior of an investment in our portfolio that, despite record earnings, seems unable to reach a record share price level. Is it simply market pessimism?

When analyzing a large Brazilian bank, we noticed that its earnings in 2023 surpassed the pre-pandemic peak, and yet its share price has not recovered to 2019 highs. Beyond the investor perspective, we sought to understand whether there was any fundamental justification for the *underperformance*. And we found the answer in what we seek to demonstrate: earnings growth is not the same as value creation growth. We observed that the bank, in order to produce more earnings, deployed more capital and did not generate more EVA than it did in 2019. What is our view on this? Does it mean the company was careless with capital? Not necessarily — it simply reflects the current reality that the financial sector is more competitive today and requires greater investment to achieve higher returns than in the past, but it illustrates that growing earnings is not the same as growing value.



EVA 12M R\$ milhões



Accounting is not finance. Analyzing a company by earnings growth is a trap. Accounting performance is not the same as economic performance. Additionally, accounting has changed considerably over the years, creating room for many subjective manipulations, which necessitates adjustments to arrive at true economic profit. However, something we believe will never change in accounting rules is the correct distinction between operating and investing activities. Accounting was originally created to provide information to creditors. Therefore, the accounting result serves to show whether a company generates sufficient profit to service its debt, and the balance sheet serves to show whether a company has sufficient free assets to serve as collateral.

Since we use financial statements as the basis of our analysis, we must adapt accounting to economic reality.

Below is a framework assembled by finance professor *Stern School of Business*, Aswath Damodaran, author of numerous books on *valuation*:

The Balance Sheet

Assets		Liabilities	
Long Lived Real Assets	Fixed Assets	Current Liabilities	Short-term liabilities of the firm
Short-lived Assets	Current Assets	Debt	Debt obligations of firm
Investments in securities & assets of other firms	Financial Investments	Other Liabilities	Other long-term obligations
Assets which are not physical, like patents & trademarks	Intangible Assets	Equity	Equity investment in firm

The financial balance sheet

Assets		Liabilities	
Existing Investments Generate cashflows today Includes long lived (fixed) and short-lived (working capital) assets	Assets in Place	Debt	Fixed Claim on cash flows Little or No role in management Fixed Maturity Tax Deductible
Expected Value that will be created by future investments	Growth Assets	Equity	Residual Claim on cash flows Significant Role in management Perpetual Lives

Source: Aswath Damodaran, NYU Stern

Example: Some accounting "manipulations" used by *management* of a company to boost earnings without translating into value creation (EVA growth). We find these "tricks" even in reputable companies. This year we analyzed a large U.S. technology company that employed several devices to increase earnings, but when we calculated EVA, value creation had actually declined. In this particular case, the depreciation life of its assets was extended from 5 to 6 years, reducing its depreciation expense for the period without substantial justification, while its competitors use something closer to 5 years for the same type of asset.

Change in Useful Lives of Our Server and Network Equipment

In January 2023, we completed an assessment of the useful lives of our servers and network equipment and adjusted the estimated useful life of our servers from four years to six years and the estimated useful life of certain network equipment from five years to six years. This change in accounting estimate was effective beginning in fiscal year 2023 and the effect for the three months ended March 31, 2023 was a reduction in depreciation expense of \$988 million and an increase in net income of \$770 million, or \$0.06 per basic and \$0.06 per diluted share.

Intangible Assets

To illustrate that accounting does not reflect the economic and financial reality of a company, accounting concepts do not correctly separate operating activities from investing activities. The growth of the so-called *big techs* (companies such as Meta, Google, Amazon, Microsoft, Apple, and Netflix), companies with global dominance that appreciated significantly on the stock market. *big techs* do not hold many tangible assets such as manufacturing facilities, machinery, and equipment, but they invest considerable capital — and this capital is not in the traditional form recognized by accounting. The high returns of these companies come from intangible assets such as brand, patents, regulation, and innovation, which are harder to value and do not appear explicitly on their balance sheets. Using EVA, we can adjust the financial statements and, in a single metric, better distinguish operating activity from capital deployment, including intangible capital.

An important adjustment we make is what we call the cash-to-economic basis adjustment. This adjustment refers to expenditures incurred and recognized in a given period but that carry economic benefits over more than one period. As examples of this adjustment, we can cite some SG&A expenses that actually carry an economic effect, such as:

- Advertising and marketing;
- Research and development;
- Quality programs;
- Training;
- Brand development (excluding brand maintenance);
- Process improvement;
- Exploration expenditures.

From an economic perspective, this adjustment aims to treat expenditures that generate benefits over several years as investments in the business.

In this way, the cost of capital is charged against them, which avoids discouraging outlays that increase future value creation capacity but reduce accounting profit in the period of disbursement.

Advantages of the adjustment: Emphasizes long-term focus by treating these expenditures not only as disbursements but also by their future benefits. Does not encourage short-term spending cuts in periods of difficulty, as the current period's EVA depends more on the amortization of prior-period expenditures.

Disadvantages of the adjustment: May diverge from short-term cash needs. Deciding which expenditures should be capitalized can be arbitrary.

Considerations: Establish rules for which expenditures may be capitalized, aiming to encourage correct decision-making for business success. Determine the capitalization and amortization period. The degree of control that *management* has over these decisions.

Tratamento Contábil	Ajuste
DRE Despesas são deduzidas do lucro no período em que foram incorridas.	NOPAT O NOPAT é impactado pela amortização da despesa capitalizada.
Balanco Patrimonial Como as despesas diminuem o lucro, elas indiretamente diminuem o Patrimônio líquido.	Capital O saldo das despesas capitalizadas é incluído no Capital como um investimento.

Example of marketing expenditures:

Tratamento Contábil		Ajuste	
Ano 4		Ano 4	
Receitas	150	Receitas	150
Despesas operacionais	(90)	Despesas operacionais	(90)
Despesa de marketing	(35)	Amort. da desp. de marketing	(30)
EBIT	25	NOPBT	30
Impostos (40%)	(10)	Impostos (40%)	(12)
Lucro líquido	15	NOPAT	18
Ano 3 Ano 4		Ano 3 Ano 4	
Ativo circulante	150	Ativo circulante	150 175
Passivo circulante	(100)	Passivo circulante	(100) (110)
Ativo circulante líquido	50	Capital de giro líquido	50 65
Ativos fixos	100	Ativos fixos	100 100
		Desp. de mktg. Capitalizado	75 110
		Amort. de marketing acum.	(47) (77)
Ativos líquidos	150 165	Capital operacional	178 198

Ao invés de deduzir a despesa de marketing em um ano, esta despesa é capitalizada e amortizada em 3 anos.

A despesa de marketing da DRE é substituída pela amortização da despesa de marketing no NOPAT.

	Ano 1	Ano 2	Ano 3	Ano 4	Ano 5	Ano 6	Ano 7	Ano 8
Despesa de marketing (DRE)	(21)	(25)	(29)	(35)	(37)	(39)	(41)	(42)
Amort. de marketing (NOPAT)	(7)	(15)	(25)	(30)	(34)	(37)	(39)	(41)
Ano 1	(7)	(7)	(7)					
Ano 2		(8)	(8)	(8)				
Ano 3			(10)	(10)	(10)			
Ano 4				(12)	(12)	(12)		
Ano 5					(12)	(12)	(12)	
Ano 6						(13)	(13)	(13)
Ano 7							(14)	(14)
Ano 8								(14)
Marketing capital. bruto	21	46	75	110	147	186	227	269
Amort. de marketing acum.	(7)	(22)	(47)	(77)	(111)	(148)	(187)	(227)
Capital	14	24	28	33	36	38	40	42

A despesa de marketing capitalizada e a Amortização de marketing acumulada são incluídas no Capital.

R&D Example:

Segundo o tratamento contábil a Despesa de P&D não é capitalizada e o Capital continua o mesmo.

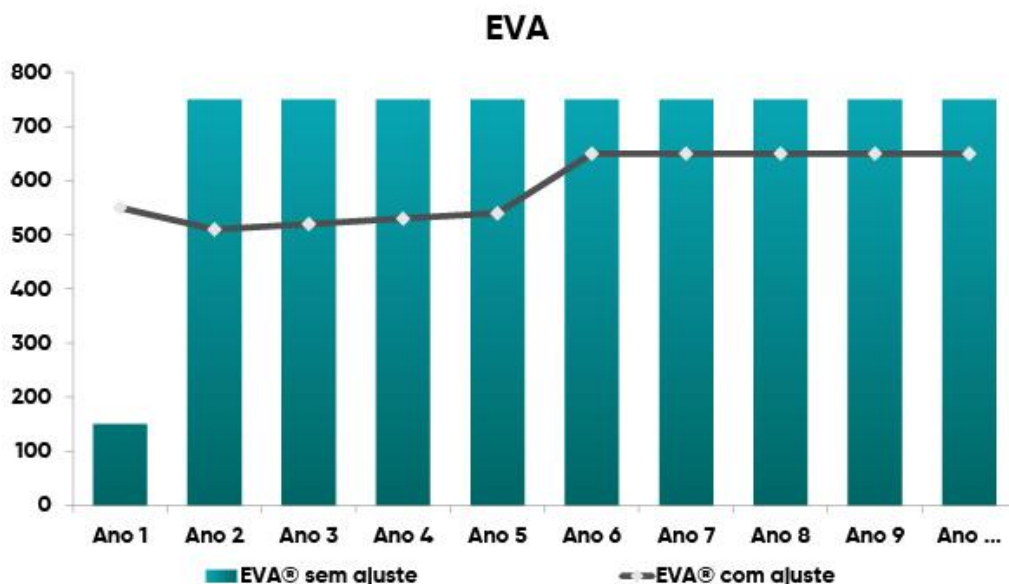
	Ano 0	Ano 1	Ano 2	Ano 3	Ano 4	Ano 5	Após
Receita		2.000	2.000	2.000	2.000	2.000	2.000
Custos		(1.250)	(1.250)	(1.250)	(1.250)	(1.250)	(1.250)
Despesa de P&D		(500)	0	0	0	0	0
Amortização de despesa de P&D							
NOPAT		250	750	750	750	750	750
Capital de giro líquido	300	300	300	300	300	300	300
Imobilizado líquido	700	700	700	700	700	700	700
P&D capitalizado líquido							
Capital operacional	1.000	1.000	1.000	1.000	1.000	1.000	1.000
Custo de capital		10%	10%	10%	10%	10%	10%
Encargo de capital		(100)	(100)	(100)	(100)	(100)	(100)
EVA® não ajustado		150	650	650	650	650	650
Fator de desconto	1,00	0,91	0,83	0,75	0,68	0,62	6,21
EVA® descontado		136	537	488	444	404	4.036
Valor Presente dos EVA®	6.045						

Note que o EVA varia muito do Ano 1 para o Ano 2, embora a performance operacional tenha permanecido a mesma.

Com o Ajuste, a Despesa de P&D é capitalizada e amortizada em 5 anos.

	Ano 0	Ano 1	Ano 2	Ano 3	Ano 4	Ano 5	Após
Receita		2.000	2.000	2.000	2.000	2.000	2.000
Custos		(1.250)	(1.250)	(1.250)	(1.250)	(1.250)	(1.250)
Despesa de P&D							
Amortização de despesa de P&D		(100)	(100)	(100)	(100)	(100)	0
NOPAT		650	650	650	650	650	750
Capital de giro líquido	300	300	300	300	300	300	300
Imobilizado líquido	700	700	700	700	700	700	700
P&D capitalizado líquido		400	300	200	100	0	0
Capital operacional	1.000	1.400	1.300	1.200	1.100	1.000	1.000
Custo de capital		10%	10%	10%	10%	10%	10%
Encargo de capital		(100)	(140)	(130)	(120)	(110)	(100)
EVA® ajustado		550	510	520	530	540	650
Fator de desconto	1,00	0,91	0,83	0,75	0,68	0,62	6,21
EVA® descontado		500	421	391	362	335	4.036
Valor Presente dos EVA®		6.045					

O mais importante é que o valor presente dos EVA é o mesmo nas duas metodologias.



An important note: capitalizing R&D expenditures is not forgiving the expense. The amortization of R&D capital flows through as an expense in operating profit, like any other investment, and a capital charge is levied on the capitalized R&D expenditure. EVA treats R&D as if it were an investment.

Intangible assets matter more in some sectors than in others, where tangible assets are more important. Therefore, if we observe that a *big tech* is cutting R&D and marketing expenditures solely to deliver higher accounting earnings, we should view this move with great caution, as the company may be sacrificing its future value creation.

Adjusting financial statements to arrive at EVA is an excellent analysis from the value investor's perspective. For the creditor, however, intangible assets generally do not serve as collateral.

Decomposing the Value of a Company

So, EVA is very useful for accurately measuring past value creation — but how do we use EVA for *valuation* of a company?

EVA is entirely consistent with the theory that a company is worth its future free cash flow brought to present value. The present value of the discounted free cash flow equals the present value of the EVA estimated in that same cash flow. The following is a numerical example:

EVA	"Free Cash Flow" – FCF
Vendas	Vendas
- Custo de Produção	- Custo de Produção
- Depreciação	- Depreciação
- Despesas Operacionais	- Despesas Operacionais
- Impostos	- Impostos
= NOPAT	= NOPAT
Capital Líquido de Amortização x Custo de capital	Invest. no Capital de Giro + Invest. em Capital Imobilizado
= Encargo de Capital	= Investimentos
NOPAT - Encargo de Capital	NOPAT + Depreciação - Investimentos
= EVA	= FCF Fluxo de Caixa Livre

Premissas	Ano 0	Ano 1	Ano 2	Ano 3	Ano 4	Ano 5
NOPAT	\$0	\$84	\$324	\$324	\$324	\$324
Capital de Giro Imobilizado Líquido	200 1300	300 1040	300 780	300 520	300 260	0 0
Capital	1500	1340	1080	820	560	0
Investimento Líquido	1500	(160)	(260)	(260)	(260)	(560)
Custo de Capital	12%	12%	12%	12%	12%	12%

Método do Fluxo de Caixa Descontado:

	Ano 0	Ano 1	Ano 2	Ano 3	Ano 4	Ano 5
NOPAT	\$0	\$84	\$324	\$324	\$324	\$324
- Investimento Líq.	1500	(160)	(260)	(260)	(260)	(560)
= Fluxo de Caixa	(1500)	244	584	584	584	884
x Fator de VP (@12%)	1.00	0.89	0.80	0.71	0.64	0.57
= VP dos FCF	(1500)	218	466	416	371	502
Soma dos VPs FCF	\$472					

Método do EVA:

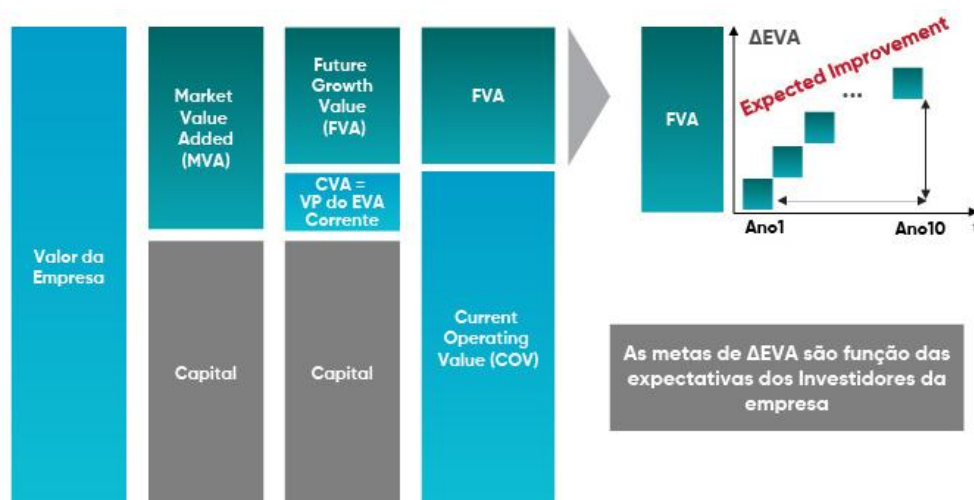
	Ano 1	Ano 2	Ano 3	Ano 4	Ano 5
NOPAT	\$84	\$324	\$324	\$324	\$324
Capital	1500	1340	1080	820	560
- Encargo de Capital	180	161	130	98	67
= EVA	(96)	163	194	226	257
x Fator de VP(@12%)	0.89	0.80	0.71	0.64	0.57
= VP dos EVAs	(86)	130	138	143	146
Soma dos VPs EVA	\$472				

With EVA, we have an entirely different view of *valuation*.

Following the logic above — that a company is worth its discounted free cash flow at present value, and that this value is equivalent to the invested capital plus the present value of future EVAs — we can decompose the value of a company.

Every company has invested capital, and that is where we begin our analysis. Part of a company's value is the capital invested in it. The value attributed above and beyond that capital is equivalent to the value creation of the invested capital and future investments. Beyond invested capital, a company's value is formed by the perpetuity of the current recurrent value generation and the present value of the incremental future value creation.

We can therefore decompose the value of a company into three components:



Capital: Capital invested by the company (working capital, fixed assets, and intangibles).

MVA (Market Value Added): What is attributed to the company's value above and beyond the capital invested in it.

CVA (Current Value Added): Perpetuity of the current EVA, assuming that this EVA is recurring and predictable.

COV (Current Operating Value): Value of current operations. Equivalent to capital + CVA. Value of the capital and the present value of the EVA that this capital produces on a recurring basis.

FVA (Future Value Added or Future Growth Value): Expectation of value. Incremental EVA brought to present value.

By decomposing the company's value in this way, we gain a better business view than that offered by the discounted free cash flow method, because we more explicitly account for a business's capital allocation. That is, we consider the invested capital, the capital required for business maintenance and growth, and we can estimate how much and at what rate this capital needs to be remunerated to justify the company's value. A different approach to projecting cash flow, albeit with the same result.

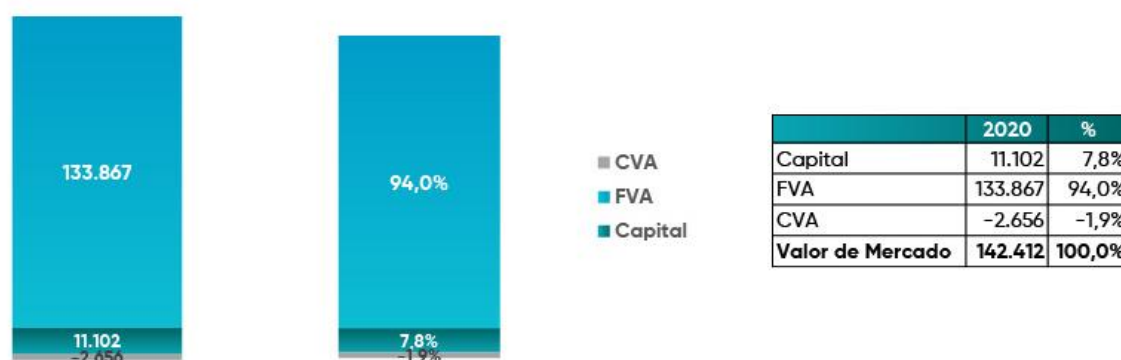
Beyond better understanding the components of a company's value, the above approach gives us a better sense of margin of safety. By considering FVA as the value of incremental future EVA, FVA can be translated as the expectation of a company's value creation — in other words, how much 'promise' is embedded in the *valuation*, with the remainder being the more 'concrete' value to assess, which is Capital and CVA representing the perpetuity of the current recurring EVA.

Examples:

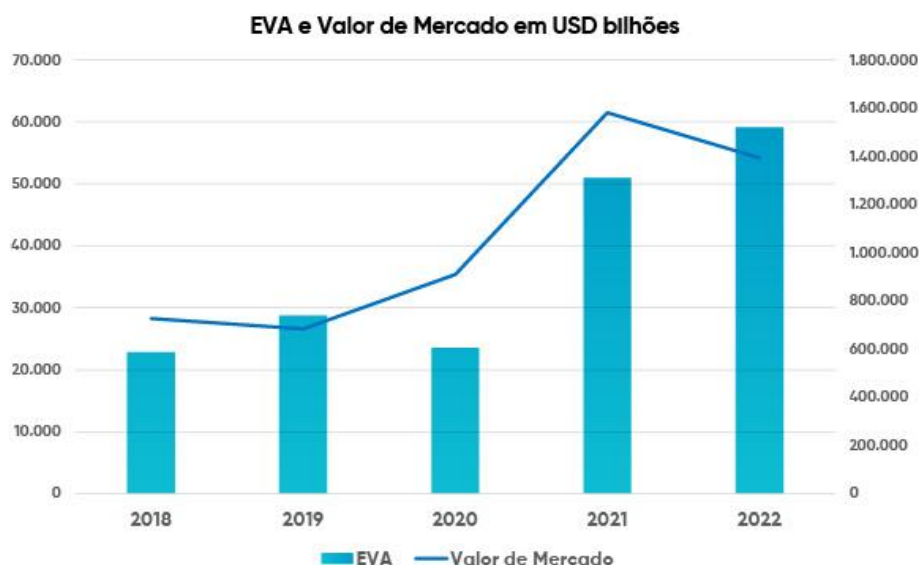
- Sometimes, in the world of investing, knowing what not to invest in is just as important as knowing what to invest in. A great example of this is a large Brazilian retailer whose market capitalization in June 2021 was R\$142.4 billion and in June 2023 was valued by the market at R\$33.7 billion, representing a decline of -76.3% in its share price. Despite the numerous qualitative aspects of this company praised by analysts at the time, we always questioned whether the market was correctly valuing it. Despite the FOMO (*Fear Of Missing Out*, in Portuguese, the fear of missing out on an investment opportunity), we chose the rational path.

In 2021, this company's invested capital was R\$11.1 billion, representing 7.8% of its market capitalization. Furthermore, the current EVA was negative at -R\$260 million. The FVA (*Future Value Added*) that we calculated for this company at the time was R\$133.8 billion — in other words, 94.0% of its market capitalization was expectation of future EVA growth. Even more strikingly, 94.0% of its market value was 'promise.' In our view, a significant increase in EVA over the following years would have been required for this promise to materialize. It was an expensive investment, particularly for a company that requires substantial working capital to grow. In fact, two years later, the promise not only failed to materialize but its EVA became even more negative.

For those who lived through that period, it is well known that many analysts were able to justify this company's market value and, beyond that, justify a price increase using the discounted cash flow method. This leads us to the conclusion that discounted cash flow can justify any price, while *valuation* using EVA gives us a more rational sense of value.



- There are also cases where the ‘promise’ more than materializes. *big techs* American big techs were the main protagonists of the rally in the S&P over the last 10 years. Many may even claim it is a bubble, but in fact, *big techs* American big techs are the companies that have created the most value in the world, exponentially. Taking the example of one *big tech*, in June 2018 its market capitalization was USD 727.6 billion and in June 2023, USD 1,487.6 billion — its shares nearly doubled in 5 years. The FVA of this company in June 2021 was USD 314.2 billion, equivalent to 51.3% of its market capitalization. In other words, 51.3% of its market value was ‘promise’ and reality exceeded expectations. Its EVA grew at a rate of 27% per year, and the current EVA is approximately 20% of the June 2018 FVA. It would have been easy to be skeptical at the time, but the company in fact delivered far more than expected.



- We might therefore conclude that we have a margin of safety if we buy any company at a price below the value of its invested capital. This assertion is not true, because a company may be destroying value — that is, it has negative EVA, and that EVA may remain negative to the point that value destruction erodes all invested capital. Or worse, a negative EVA in the future means operating profit does not cover the cost of capital, including the cost of debt. For a leveraged company, this can represent a serious problem. In 2016, many companies in the real estate development sector were trading below the book value of their assets, which proved to be a value trap. Subsequently, many of these companies filed for bankruptcy protection. Below is an example of a real estate company that filed for bankruptcy in 2016, in which its capital was well above its market capitalization. Even so, it was not a good investment.



Multiples

The finance world loves multiples. Multiples are easy to use and useful because they allow the comparison of different companies regardless of size, sector, or geography. In our critique, multiples perform pricing, not value measurement — they merely provide a relative price view. We believe multiples are most often used indiscriminately, as, beyond relying directly on accounting measures (enough criticism of that), few question what growth and return on capital are embedded in the multiples. Multiples can be decomposed into value parameters, and we find it more interesting to analyze market multiples in this way:

$$\text{EV / sales} = \frac{\text{ROIC} - g}{\text{ROIC} \times (\text{WACC} - g)} \times (1 - T) \times M$$

$$\text{EV / EBITDA} = \frac{\text{ROIC} - g}{\text{ROIC} \times (\text{WACC} - g)} \times (1 - T) \times (1 - D)$$

$$\text{Price to earnings} = \frac{\text{ROE} - g}{\text{ROE} \times (\text{COE} - g)}$$

$$\text{Price to book value} = \left(\frac{\text{ROE} - g}{\text{ROE} \times (\text{COE} - g)} \times \text{ROE} \right) \text{ or } \frac{\text{ROE} - g}{\text{COE} - g}$$

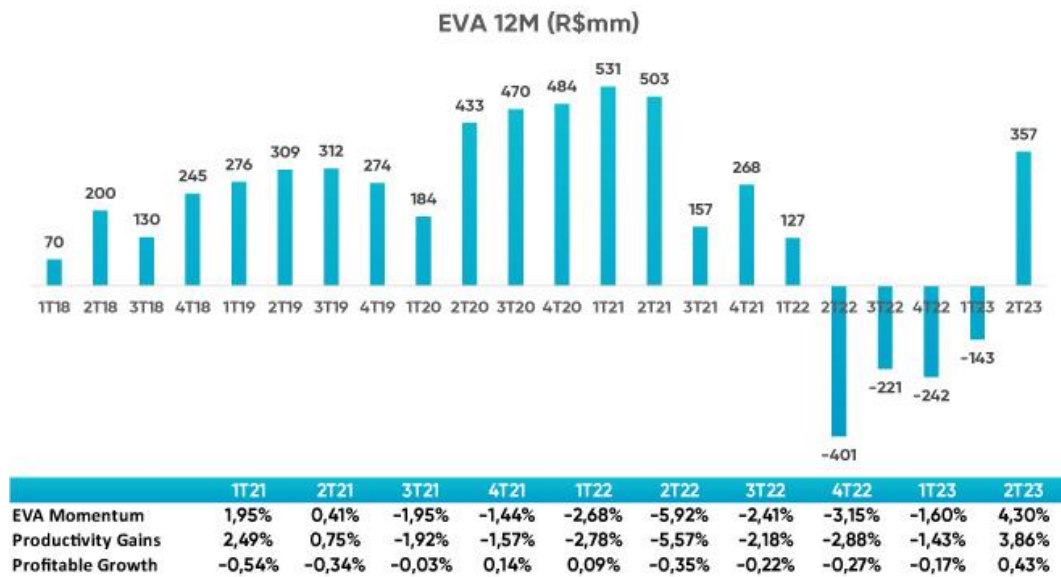
Por exemplo, o P/E (*Price-to-Earnings*), widely used as a pricing measure, is more useful when discussed in the manner above — what ROE (Return on Equity) and growth are embedded in the market price if we pay a given multiple of earnings for the company. Is it consistent with the past? Is it consistent with other companies in the sector? Is it possible to deliver the same historical ROE and growth (*g*) in today's world? From our investor perspective, these questions are less hollow than using P/E to claim a company is cheap simply because its multiple is lower than that of its nearest competitor.

But our point here is not to criticize the most widely used market multiples. We want to show that we can construct *ratios* and EVA multiples that bring the same practicality of placing different companies on the same dimensionless scale.

EVA Multiple:

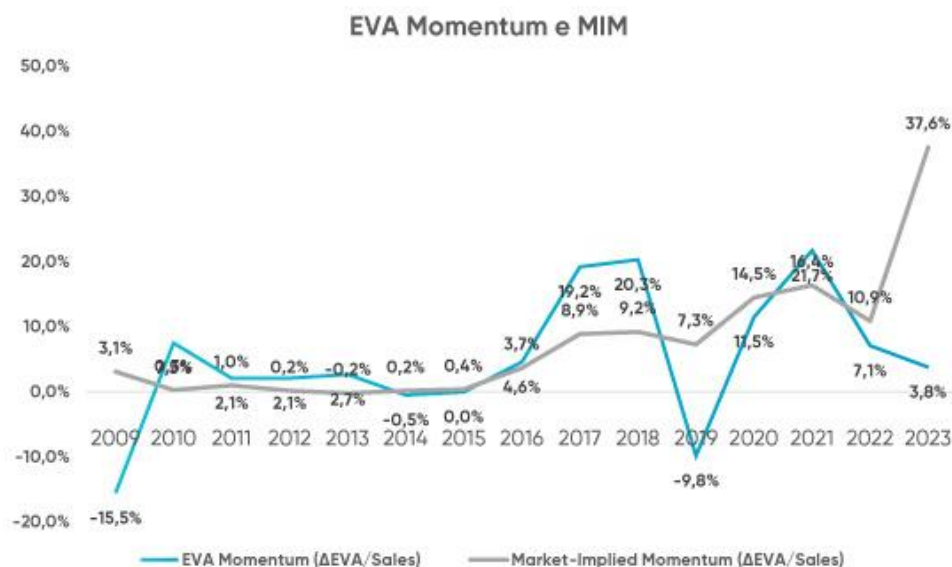
EVA Multiple	Definition	Traditional measures	Benefits of the EVA multiple
EVA Momentum	ΔEVA/Prior Period Revenue	Revenue growth, earnings, EBITDA and EPS	EVA growth is the most important measure of value creation
EVA Margin	EVA/Receita	Gross Margin, EBITDA Margin, ROE	EVA margin consolidates operational efficiency and capital allocation
Market-Implied Momentum (MIM)	EVA growth implied in the share price	Consenso EPS, P/E, EV/EBITDA	MIM is a more reliable measure of market expectations

As an example of the use of the above metrics, let us apply them to a market-leading insurance company:



In this example, the company was an excellent investment that, due to cyclical factors, began delivering negative EVA as claims ratios rose, and its shares declined. In our opinion, it was a buying opportunity at the time, as structurally the company possesses competitive advantages to return to positive EVA as claims normalize. Using the EVA multiples, we can conclude from the above analysis that the company recently created value through the reduction of its claims ratio to historical levels. In other words, its EVA Momentum was positive (it recovered EVA) with productivity gains, most explicitly in 2Q23, and its shares reacted positively.

In another, more recent example, a manufacturer of GPU cards used by *gamers*, miners, and Artificial Intelligence processing has its shares extremely valued on the stock market due to the *hype* of Artificial Intelligence. The MIM (*market implied momentum*) of this company is 29.2%, meaning that over the next 10 years this company needs to deliver the equivalent of 29.2% of its revenue in EVA improvement each year — and historically its EVA Momentum has been well below that level, while statistically, S&P companies deliver around 1%. Will the promise materialize?



*And then one day you find,
Ten years have got behind you,*

*No one told you when to run,
You missed the starting point."*

Excerpt from the song "Time" by British band Pink Floyd.

Case Sinqia

And of course, after discussing *valuation* at such length, we think it makes sense to share what we saw in Sinqia, a relevant position in our portfolio that recently went through an *M&A* transaction.

SFA invested in Sinqia at its IPO in 2013 and held the position for 10 years. Sinqia's shares appreciated as the company's performance improved. Over this period, the shares multiplied 11 times, equivalent to an annual return of 28%, outperforming both the IBOVESPA and the CDI.

During its 10 years as a listed company, Sinqia led the *software* financial segment in Brazil and grew substantially. In 2012, its revenue was R\$46 million, rising to R\$616 million in 2022. Additionally, the company's EBITDA grew significantly, with the margin expanding approximately 10 percentage points.

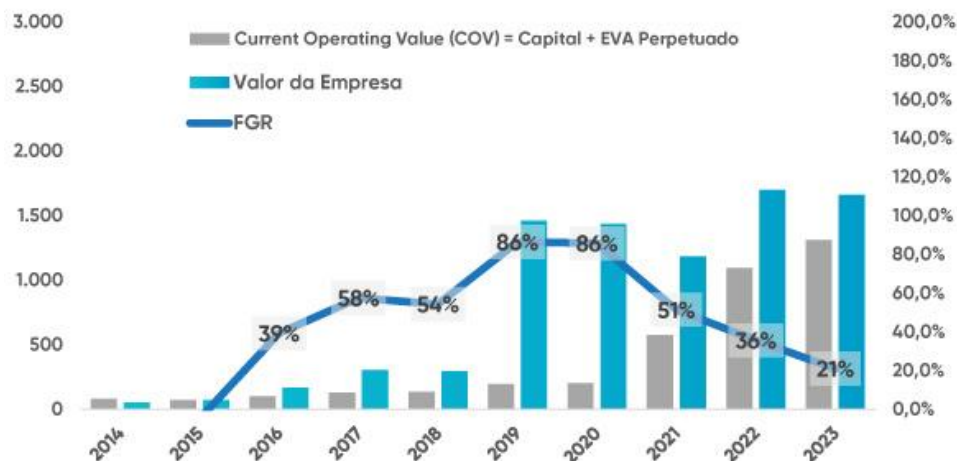
When we invested in Sinqia in 2013, we focused on three aspects:

- 1. Clear investment thesis** - Sinqia had a solid and recurring business model, already leading the *software* sector for financial institutions.
- 2. Competitive advantage** - The company enjoyed a competitive advantage due to high switching costs to competing products and a successful acquisition strategy, reflecting efficient capital allocation.
- 3. Competent management** - Led by Bernardo Gomes and Luciano Camargo, the company had (and continues to have) effective management and a young, committed team.

In recent years, however, the stock had been "moving sideways," and when we looked at the numbers, the *valuation* seemed significantly discounted, given our knowledge of the sector and our comfort with the company.

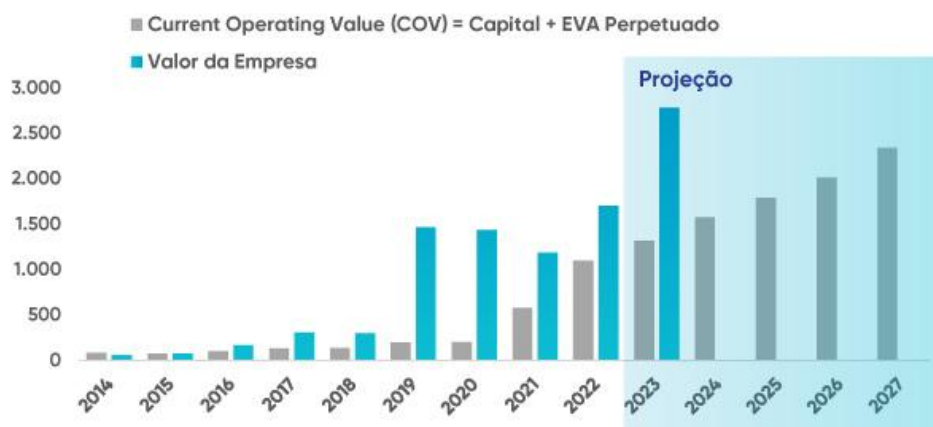
Below, the numbers as they stood with Sinqia @R\$14.50 at the start of the year:

- Notably striking was the fact that the "Enterprise Value" was nearly equal to the COV (invested capital + perpetuated EVA).
- This implied a very low FGR (*Future Growth Rate*), as the screen price was already close to the company's operational value. The FGR is calculated as **FVA (*Future Value Added*) / Enterprise Value**.



Sinqia @R\$14.50 (Jan 2023) - Very low future value; enterprise value was nearly equal to COV (operational value).

Looking at these numbers, we also observed that the company had excellent potential (with very reasonable assumptions) to create significant value, nearly doubling its COV (operational value) in a few years. This strongly indicated that the Enterprise Value should "react," with shares repricing to reflect the company's operational performance, serving as a "*floor of valuation*".



Sinqia underwent a transaction and was absorbed by Evertec in a deal valued at approximately R\$2.5 billion. Every story has an end, including investment stories. We are convinced that time is a variable that closes the *gap* between value and price. This is what we at SFA call "temporal arbitrage."

We must emphasize that we are business investors. We invest in companies that we believe are capable of generating profits above the cost of capital for many years, resulting in true wealth creation, and we make a daily reflection and judgment between value and the screen price of stocks.

Therefore, even though the takeover at R\$27.19 per share represents a gain of 81.5% in 2023, we believe Sinqia is still well below the price we consider fair. We believe monetization of a business should occur after the full growth potential has been exhausted or when the company is priced well above its intrinsic value. In Sinqia's case, we believe neither condition was met.

Below, we illustrate how the *gap* closed after the proposal, when we look at the company's FGR.



Conclusion

We use alternative methods precisely because of the empirical evidence accumulated by our partners, who have many years of combined experience analyzing *equities*. We believe the *valuation* methods used by SFA can minimize errors and maximize successes. We are confident, as demonstrated above, that we are fully aligned with value theory and with the primacy of technical rigor.

Beyond the methods mentioned above, we typically use three or four different *valuation* methods to have a more rigorous analysis of a company's value formation and how much we pay for it. Our mission to seek value runs through our extensive investigative and qualitative analysis, as well as our quantitative and *valuation* analysis, to justify our investments.

We thank you for your trust,

SFA Investimentos Team

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