LUXOR

INVESTIMENTOS

Investors Letter

September 2023

Manager's Message

The year 2023 has been intense, and we are already in the last quarter of another tumultuous year. Fortunately, we have navigated well through this environment so far, and we are confident that our course is correct. The world is changing, which makes our task particularly complex. The consistent and widespread capital gains we have seen in recent years may not be repeated in the future. In this context, the performance of our portfolio will be essentially determined by our ability to identify the companies that will succeed in this new cycle. More than ever, we are focused on this pursuit. At the same time, we hope that the future will bring peace and progress to humanity.

1. Update on Performance and Portfolio Adjustments

From March 2023, when we wrote our last letter, until the end of September, Mangalarga returned +9.75% in US dollars (5.3% in Brazilian reais).

The majority of this performance was attributed to our equity portfolio, while multi-market funds made a negative contribution, and we recognized some losses in illiquid investments.

Regarding the portfolio, since then, we have marginally reduced the allocation of capital to equity, as many companies returned to trading at high capitalization levels as the market regained its optimism.

Additionally, we have added two new cases to our equity portfolio - Suzano and GE - and reinvested in Airbnb, a company from which we divested in early 2022. On the other hand, we divested from Intuit, a company in which we have been investors for the last 4 years and which has delivered excellent results. In this letter, we will present our investment thesis on GE, sharing our case analysis process.

Luxor Mangalarga FIC FIA	
Period	Return % (a.p. in R$)
2023	+6.35%
12 months	+0.97%
36 months	-0.06%
60 months	+54.36%

2.The General Electric Case

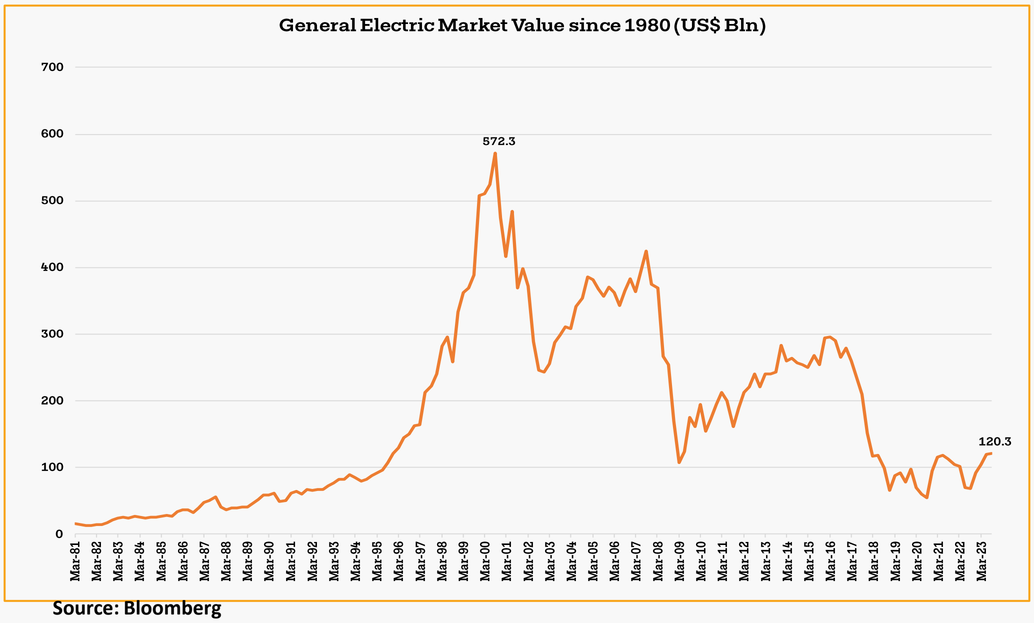
2.1 Motivation

General Electric is an iconic company. Founded in 1892 through the consolidation of Thomas Edison's lighting companies, the great entrepreneur and inventor responsible for transformative innovations for humanity, such as the incandescent light bulb, video camera, and phonograph. Moreover, it was one of the first 12 companies to join the Dow Jones in 1896 and one of the most successful corporate stories in the United States, delivering extraordinary returns to its shareholders for over a century.

However, since the departure of its famous CEO, Jack Welch in 2000, the company went through a long period of severe turbulence, involving issues ranging from accounting problems to a serious lack of strategic and operational direction that cast doubt on the survival of one of the greatest corporate icons in the U.S.

In many aspects, GE had gradually incorporated many elements that we consider detrimental to a company's success: a degenerated culture, questionable accounting and corporate practices, and a lack of clarity in its purpose and value generation strategy. In this context, this massive conglomerate lost 90% of its market value: from $500 billion at the turn of the millennium to less than $50 billion in 2020.

The story of such a spectacular downfall of one of the world's most successful companies did not escape our notice. After the departure of Jeff Immelt, who initiated a cycle of profound reforms within the company in 2017, we began to follow the case. Corporate restructurings are very complex processes, especially in companies as large and long-standing as GE, a conglomerate with enormous business units in various sectors. However, the prospect of rebuilding this company with a remarkable history of excellence and innovation inspires optimism and positive expectations for long-term investors.



Source: Bloomberg

2.2 The Turning Point

It was in mid-2017 that the plan for the reconstruction of GE began to take shape, with the replacement of Jeff Immelt by John Flannery as the new CEO in charge of spearheading the restructuring that GE so desperately needed. As soon as he took the helm, John focused his efforts on profound changes, including executive team changes, reforms to the board of directors, the company's culture, its cost structure, and its competitive strategy. Notably, the prominent figure invited to join the new board was Larry Culp, the former CEO of Danaher, a company that we admire and have been investors in since 2013. For a long time, Danaher had been seen by GE executives as a successful conglomerate model and held up as a counterpoint to the management challenges faced by GE. The arrival of Larry Culp on the board led us to believe that the intention to transform the way GE operated was genuine, and, most importantly, that the cultural change that the company so desperately needed could indeed be effective.

2.3 New Directive

Flannery has been concerned with revitalizing the company's culture and pride since his arrival. In one of his early speeches as CEO, he stated: “GE is a company that matters to the world. For one hundred and twenty-five years, we just tackled the biggest challenges the world faces. So light, flight, health – these are the absolute underpinnings of the modern world. It’s always been this mix of sparks of innovation with just sheer determination to succeed. It’s been a company that does things, solves things, lines things out, sweats the details. The harder the better; bring it on. That’s been the essence of the company, affecting the world for over a hundred years. It’s always been a culture of meritocracy, compliance and integrity. There is a passion and love for the company inside like you can’t imagine. And the world is fundament-tally going to run on the back of GE. It’s going to move on the back of GE, it’s going to heal, babies are going to be born on the back of GE.”

Even with the new strategic direction, Flannery was dealing with the catastrophic consequences of the Alstom acquisition, as well as the collapse of the energy division and the emergence of hidden billion-dollar liabilities in the insurance division. As a result, there was an urgency for more drastic measures to prevent the collapse of GE. It was then, in December 2017, that he announced the company's restructuring plan, known as the "Eisenhower Document”. Essentially, the plan defined the establishment of a new, smaller, and completely renewed board, a strict reallocation of corporate expenses with a focus on cost reduction. Finally, the CEO announced the end of an era – GE would be dismantled: "Our current structure does not maximize the value of the businesses, assets, and underlying technologies we possess."

It was the acknowledgment that the conglomerate model built over many years would come to an end.

The GE of the future would be an efficient company focused solely on its aviation, energy, and healthcare businesses, led with rigor, excellence, and transparency – "Three complementary businesses with excellent growth prospects," according to Flannery. In June 2018, the new board would authorize John to proceed with the Eisenhower Plan.

2.4 The New GE

Despite Flannery's key role in conceiving the GE restructuring plan and initiating its implementation, the company continued to struggle to improve its practices and deliver disappointing operational results, especially in the energy unit. As a result, in October 2018, the last - and most significant in our view - element of the new GE emerged: Larry Culp was appointed as the new CEO, with a blank check to implement in the company all the cultural and operational excellence elements that made Danaher, an industrial conglomerate similar to GE, one of the most successful corporate cases in recent history. During his 14 years as CEO, Danaher's market value multiplied by 5x, generating a 14% annual return for its shareholders.

Larry accepted one of the biggest challenges of his professional life when he took the helm of GE. At that time, the company's debt stood at $133 billion, 8.2x its EBITDA, and with $112 billion in revenue, GE reported a loss of $867 million. In his first meeting with investors, Larry announced the recognition of $22 billion in losses related to Alstom and reduced the dividend to nearly zero (from $0.12 to $0.01 per share). Furthermore, Larry soon began to dictate how the Eisenhower plan would be implemented under his leadership. Soon, GE would sell the Biopharma division of the Healthcare unit to Danaher for $21 billion, its stake in Baker Hughes, and also sell the profitable part of GE Capital - responsible for aircraft leasing - to Aercap for $30 billion, in addition to other smaller business units. All the cash from the divestments was used to pay down debt, which decreased from $133 billion to only $23.5 billion - 2.6x its EBITDA.

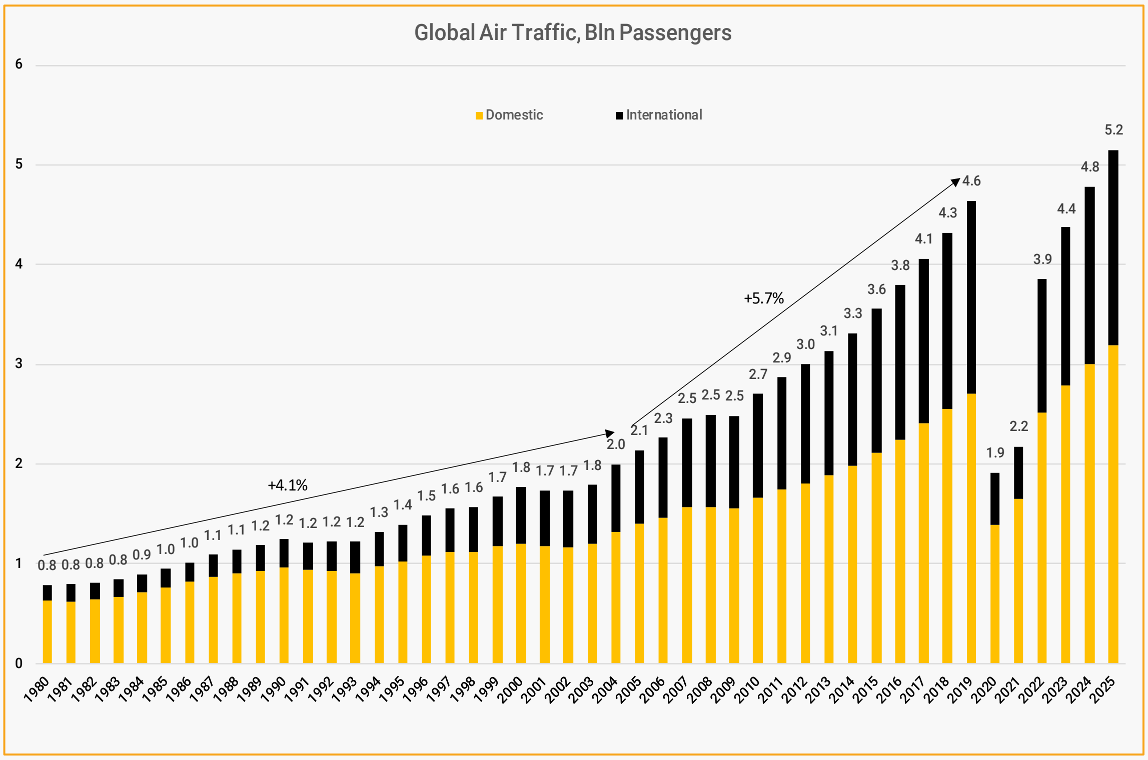
After this reorganization, what remained of the company was a GE consisting of three businesses: Healthcare, Energy, and Aviation. In early 2023, the Healthcare business was separated, and in early 2024, we will see the conclusion of the last chapter of this company restructuring process, which will be the spin-off of the Energy segment, leaving only the Aviation business. According to Culp, these operations mark the "transformation of GE into a more focused, simpler, and stronger industrial company

2.5 Why do we consider GE Aerospace an excellent business?

GE Aerospace is, in our view, the crown jewel - the leading supplier of turbines for commercial flights - with over 70% market share in narrowbody[1] aircraft and over 50% in widebody[2] aircraft. The turbine business is driven by a trend of people increasingly using air transportation, with high recurring revenue, few competitors, and evidence that GE holds a deep competitive advantage derived from its technological leadership in building these equipment and the high development costs associated with them. Therefore, we believe this business possesses elements associated with a successful enterprise.

a) Secular Trend

The number of air travel in recent decades clearly reflects the secular trend fueling the aviation market's growth. As travel becomes more affordable, and more routes become available, more people take to the skies. Consequently, the overall air transportation market grows on average at 1.5 times the global GDP growth. According to Boeing, the global fleet of commercial aircraft is expected to double in the next 20 years. Additionally, the democratization of air travel and environmental concerns have largely driven the demand for more efficient aircraft and engines, creating more opportunities for companies like GE. Given this scenario, it is estimated that the total aircraft turbine market will triple by 2042 with an annual growth rate of 4%.



Source:IEA - International Energy Agency

[1]Narrowbody | Aircraft suitable for shorter-haul and regional routes.
[2]Widebody | Aircraft suitable for longer international and intercontinental flights.

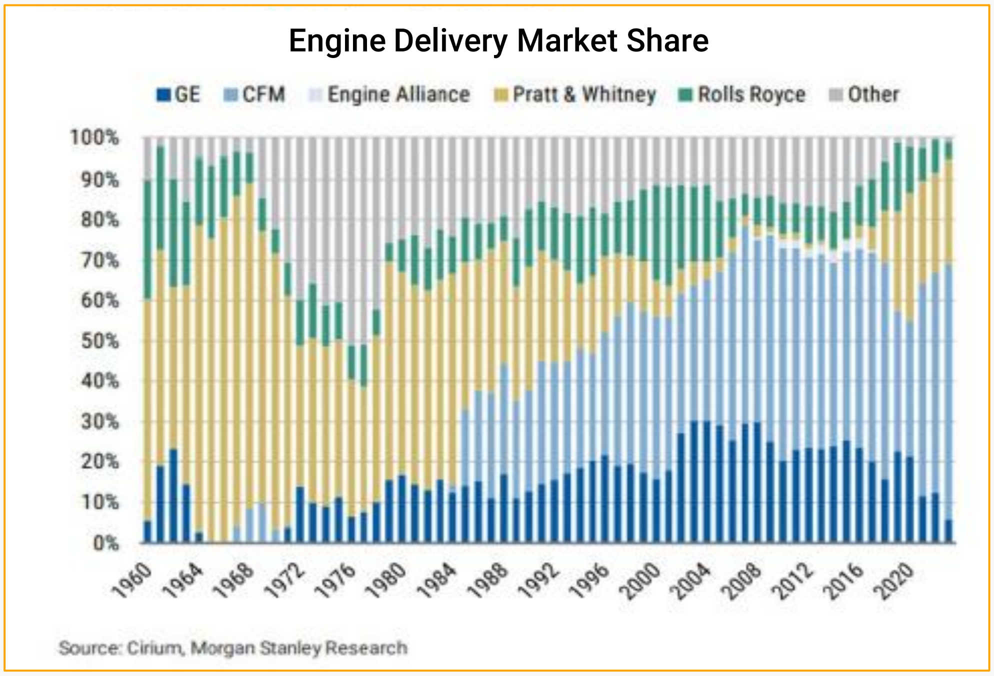
b) Competitive Advantage

The excellent competitive position of GE in this market is another fundamental element of our investment thesis in GE Aerospace. First and foremost, it's worth mentioning that this is an extremely concentrated industry where GE competes directly for the best commercial agreements with only two more players - Rolls Royce and Pratt & Whitney. The business is favored by very high barriers to entry, as you are dealing with aircraft turbines - a highly technologically complex and slow and expensive development component. For example, Pratt & Whitney, GE's primary competitor in narrowbody aircraft, spent about $10 billion to develop its new GTF engine in a 20-year project. Furthermore, even among its peers, efficiency and durability indicators position GE as the technological leader in the market, and its market position is evidence of this fact: GE is the sole supplier of engines for the 737 and equips over 80% of 787 jets and 60% of A320 aircraft.

As a result, when considering the CFM engines, a joint venture between GE and Safran, its market share currently reaches 70%.

c) Recurring Revenues

Moreover, the structure of the commercial aircraft engine market brings recurring revenue and a service component to the business that enhances the operation's margins, reduces capital intensity, and provides revenue predictability for the company, contributing to cost efficiency both operationally and financially. It happens that 70% of the value that GE derives from the sale of a turbine does not come from the sale of the equipment itself, as the margin on the sale is low or even negative. Most of the value from the sale of the turbine comes from the exclusivity that the company holds in maintaining the equipment. Due to regulation and safety considerations, all engine maintenance and spare part replacement services are performed by GE itself.



d) Larry Culp and cultural transformation

Looking within the company itself, we consider the cultural transformation being implemented at GE by Larry Culp, based on his highly successful experience at Danaher – which is also a large American industrial conglomerate – a fundamental element for the success of this management change. Larry joined Danaher in 1990 and became CEO in 2000, remaining in that position for 15 years. It was during this entire period that he absorbed the philosophy of the DBS – Danaher Business System. The DBS has three basic pillars - growth, lean, and leadership - which represent a focus on growth and improvement, operational efficiency, and knowledge-based leadership by setting good examples. These are all characteristics that were lacking at GE and, if effectively incorporated into the company's daily operations, can make the new GE a much more innovative company aligned with the interests of its shareholders than before.

e) Company value and margin of safety

Lastly, we consider the stock price still attractive despite the significant appreciation in 2023. Currently valued at $120 billion, GE is trading at a multiple of approximately 30 times the 2023 earnings and 25 times the 2024 earnings, which doesn't appear to be a bargain. However, considering a revenue growth of 8-10% for the coming years and potential margin gains resulting from operational leverage, we expect an EPS growth of 21% by 2028 and an expected return on investment in the range of 10 to 12% over that period.

3. *Intuit`s divestment*

We invested in Intuit in 2019, attracted by its leading position in the tax preparation and small business accounting software market (TurboTax and Quickbooks), as well as an admirable corporate culture focused on customer obsession, innovation, and self-disruption. Since then, we have achieved a gain of nearly 100% on our investment, driven by the company's excellent results.

However, some uncertainties are beginning to weigh on our assessment of the company's future. On the consumer side, the U.S. government's revealed intention to modernize the IRS infrastructure and automate the individual income tax filing process, along with potential competition driven by AI innovations, have raised concerns about the evolution of TurboTax pricing.

In the corporate segment, our discomfort arises from Intuit's own success – market saturation of Quickbooks may impact future growth in the segment. Additionally, the company's challenges in delivering the expected results from recent acquisitions have led us to question the strategic rationale of these operations. Finally, recent changes in the senior executive team have also caused some discomfort regarding the company's path.

All these factors have reduced our confidence in the speed and sustainability of the company's future growth, while the current company's valuation leaves little room for error in management execution. Therefore, we have decided to divest from the company for now and observe the development of this story from the outside. We still love the business and corporate culture, but we need to see a less restrictive price and better clarity about the future of this story.

4. The Investment in Suzano

Responsible for nearly 30% of the world's short-fiber cellulose production and possessing a fantastic Brazilian business history, Suzano is a leader in the lowest cost per ton of production in the world - a fundamental competitive advantage in a commodity market. This prominence is largely due to its favorable geographic location, along with important and well-executed decisions by the company's executives. Brazil, where all the company's factories are located, is a very fertile environment for eucalyptus production in terms of both yield and production cost. The decision to integrate the entire paper production supply chain has optimized production costs and strategic coordination for the business.

We have great admiration for its history and founders. David Feffer, the company's Chairman, represents the third generation of the family that built and established Suzano. His grandfather, Leon Feffer, was a Ukrainian immigrant who, in the 1920s, sold a bit of everything in the country to make a living. In 1924, he founded Suzano, initially trading in paper. Years later, he invested everything he had (even his wife's jewelry) to open the first factory, marking the beginning of a prosperous family business trajectory. For all these reasons, we have a great deal of trust in the company's management, and the recent implementation of its new factory (Project Cerrado) reinforces our belief in the company's growth prospects at a challenging time in the pulp industry cycle, where market prices are trading below the industry's marginal cost. A combination of very favorable factors for us to initiate a position.

CONCLUSION

Investing is a fascinating activity. It combines the intellectual challenge of capital allocation with the emotional challenge of live with market risks and fluctuations, all while navigating a daily avalanche of information that, at first glance, appears equally - and extremely - relevant, but is rarely as defining as the headlines suggest. This becomes especially challenging when the world is indeed in a time of change, as it is now.

Until the pandemic event, we lived through a very prosperous cycle of technological development and globalization, where many new companies emerged and established themselves, generating widespread capital gains. Since then, the world has entered a different phase. Geopolitical conflicts, inflation, high interest rates, and political instability are factors that make the environment much more complex. Companies will have to adapt their business models, reinvent their supply chains, and navigate a distinct global environment. Understanding who the big winners will be on this new playing field is a significant part of our current challenge.

The good news is that we continue to believe that good companies managed by competent and committed leaders can adapt. Furthermore, we believe that with diligent study and monitoring of the companies we invest in and the environment in which they operate, we can adapt to this new reality and navigate all these changes. By doing so, we will capitalize on the success of these business stories over time. We may not be able to control or prevent the rocking of the boat, but with the right course, patience, and resilience, we will reach our destination.

Sincerely,

LUXOR INVESTIMENTOS