Absoluto Partners

+55 21 3554-8151
contato@absolutopartners.com.br

Dear investors,

It is always hard deciding where to start a first letter. After 20 years of working at the same firm, where we were very content, we decided it was time to move on to a new journey and pursue a dream we have had for a while now. We experienced much along the way – the prospect of leaving a familiar home for a new one, countless conversations, (a few) anguishes, trepidation – but above all the will to build something we had always dreamed of. Something more than what we had built thus far. This, ultimately was the driver behind the inception of Absoluto Partners – a desire to build something from the ground up and based on the principles and values we believe in. This is what we want to focus on in our first letter with you: how we envision Absoluto Partners and what we value and practice during our day-to-day. We invested a great deal of time discussing these principles, and we are confident that every minute of these reflections and conversations will be fundamental to the way we operate our business for the next 10, 20, 30 years and beyond.

We would also like to take this opportunity to profoundly thank all of those that helped us in the formation of Absoluto Partners: our investors, who joined us on and contributed to our new journey; executives of our invested companies and fellow fund managers, old friends whom, through this process, we have come to admire even more. Our long conversations and interviews were fundamental to the formation of our firm and principles. Thank you all.

Before we dive into our principles and values practiced here at Absoluto Partners, we would like to emphasize the two main drivers behind our decision to build something that is truly ours:

EXCLUSIVE DEDICATION TO MANAGING THE FUND:

This was a fundamental factor in our decision. When we reflected on what we would aspire to do over the next 30 years, we realized it was to immerse ourselves in the evaluation and understanding of the businesses we cover. We are investors first and foremost, this is our passion, drive and brings us accomplishment.

ALIGNMENT:

The desire to concentrate significant amounts of our own capital in companies we know deeply and that we judge to be our best investment ideas. We have a strong conviction that this alignment is fundamental to true investing. The same alignment which we look for in our portfolio companies should be applied in our own practice.

Beyond these drivers, what motivates us is the chance to build something our way – with the principles and values that we believe are fundamental to building a long-lasting, enduring business. Our adherence to these principles is what will ensure our business' longevity.

And what principles are these? Ownership, teamwork, grit, meritocracy and work ethics.

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OWNERSHIP | TEAMWORK | GRIT | MERITOCRACY | WORK ETHICS

OWNERSHIP:

At Absoluto Partners we value an ownership mentality. This can mean many things, but if we were to choose one, it is a mindset of always doing what is best for the firm first, putting team before individual. It means we roll up our sleeves and we do the hard work required. It means we perform duties that are not necessarily outlined in our job description. As a matter of fact, we do not believe in "job descriptions." Here we want everybody to feel and behave as owners.

Ownership is a habit, a way of living and dealing with the hard decisions and challenges that will inevitably face us in the years ahead. It must be cultivated, encouraged and grown every day.

TEAMWORK:

Here we do not believe in over-emphasizing individual attribution. Our central investment theses will always come from a process of collective collaboration and intensive discussion, and the best arguments will ultimately prevail, independently of who they come from. We believe in the power of the team, because only through teamwork can we fully leverage the unique knowledge, experiences and backgrounds of our team members. It is through continuous and iterative interactions that we believe the best investment decisions will be made.

GRIT:

We believe perseverance and resilience are the key attributes to obtaining superior long-term results – these are the qualities which allow individuals to reach their full potential, independently of natural gifts or talent. Grit means maintaining one's determination and motivation for long periods of time, no matter the challenges encountered, allowing for superior and consistent results in the long run. We believe grit is one of the best indicators of future success, more so than talent or an above-average IQ. Having grit means to never be satisfied, it is something that drives us to continually do better and that will always keep us out of our comfort zone.

MERITOCRACY:

Meritocracy is the core of our evaluation and compensation philosophy. We measure our members' adherence to our cultural values and investment process, always on a medium to long term horizon. We discourage short term and individualist behaviors.

WORK ETHICS:

Integrity, simplicity, humility and hard work are the characteristics we look for. Adherence to our values is imperative and non-negotiable and inform all our actions, both inside and outside our company.

Regarding our annual letter, we intend to update you on our business and, when appropriate, share thoughts and discussions we judge to be impactful to our portfolio. Thus, in our first investor communication we will touch on the ongoing transformations within Brazil's financial sector, many of which are shaped by technology disruption.

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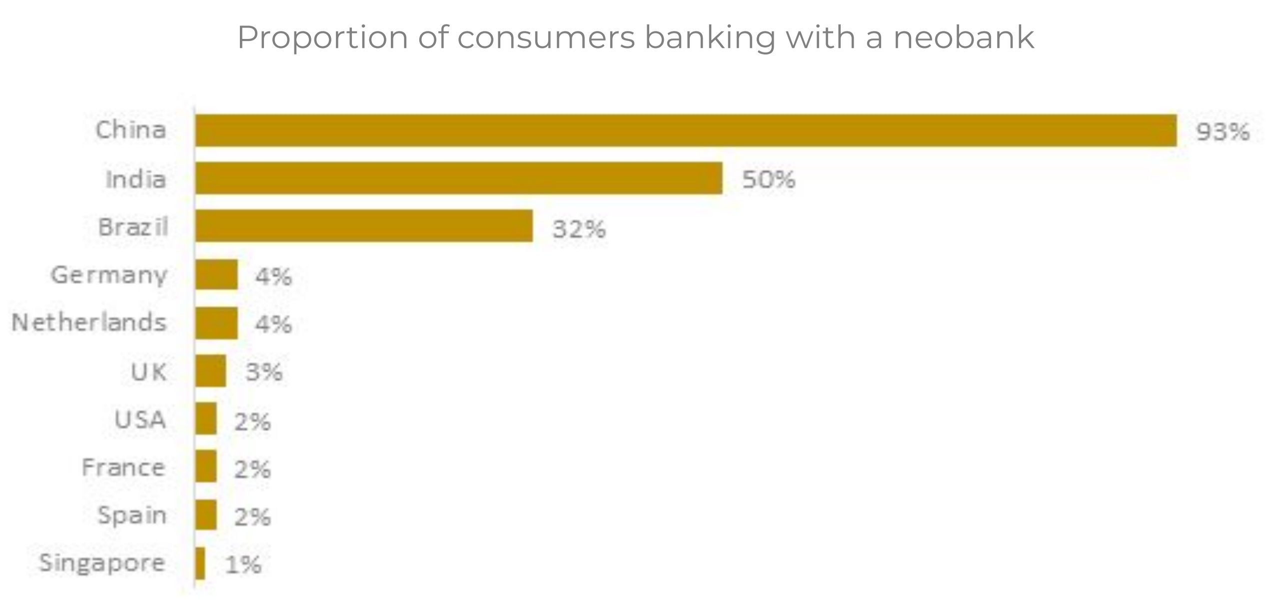
Impact of technology in the financial sector

Numerous aspects of our everyday lives are undergoing rapid technological transformation. Examples include how we commute to work, consume media, book travel reservations, all activities that have been transformed by new business models made possible through rapid technological innovation. Technology is often the driver of disruption, enabling significant improvements in customer experience and/or cost efficiency relative to prior business models.

It is interesting to observe that such transformations are still barely visible in the financial sector. As an example, in the United States, United Kingdom and Germany, home to some of the most valuable digital banks in the world (Chime, Revolut, Monzo, N26), the market share and performance of traditional banks have not yet been significantly affected. Even in China, a global benchmark for digital payments innovation, fintechs went after areas of the market not traditionally focused on by the main banks (who historically served large public companies). The success of fintechs in China has not been at the expense of traditional banks; on the contrary, they have benefited from partnerships with them.

In Brazil, we are starting to notice more concrete signs of the impact of digital banks and payment companies on the financial system. According to the research company Kantar, 32% of traditional banks' clients also have an account with a digital bank, compared with only 4% in Germany, 3% in United Kingdom and 2% in the United States. In addition, 9% of consumers have their main bank account with a digital bank. The transformation of the financial system is being led not only by digital banks, but also by the rapid expansion of companies with disruptive business models in acquiring, asset management, digital wallets and many others.



Source: Kantar - Future finance from bricks to clicks: the impact of neobanks so far

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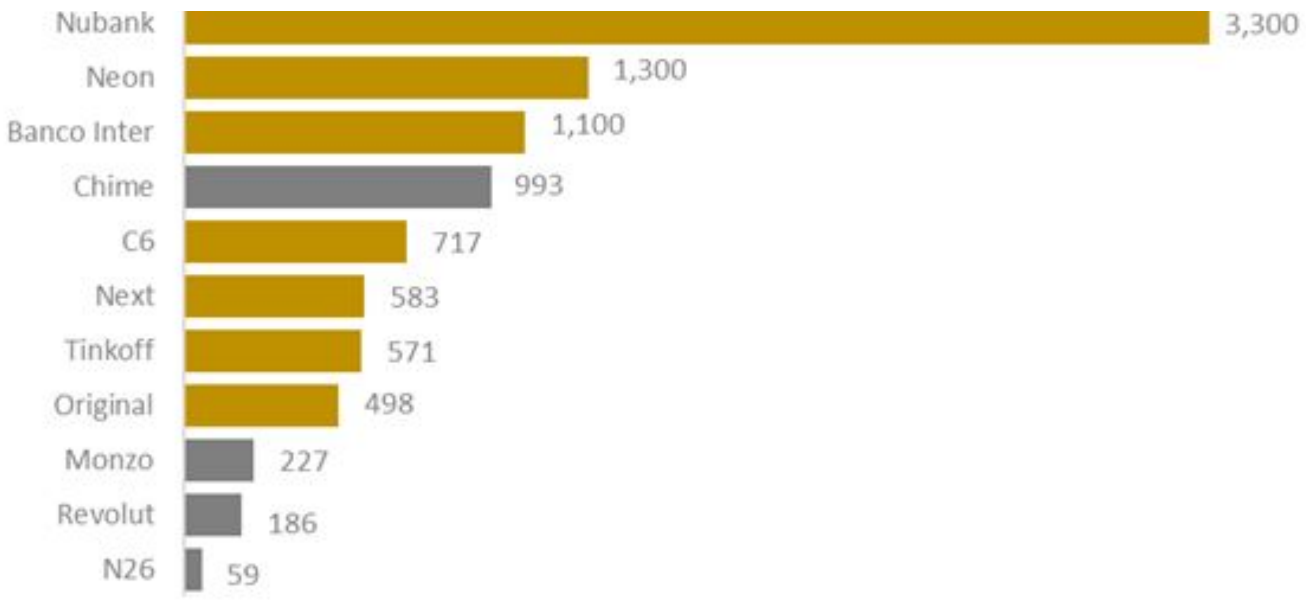
Brazil has various characteristics that may explain its vanguard position in digital payments adoption, and which may pave the way for a more profound disruption of the banking sector. First, Brazilian society is characterized by “collectivism” and consequently high engagement in social media and smartphone usage: Brazilians spend on average 9 hours and 29 minutes connected to the internet (behind only the Philippines) and 4 hours and 45 minutes on mobile internet (behind only Thailand and the Philippines). Another interesting datapoint is the ~70 million active Whatsapp users in the country, of whom >80% access it at least once every hour. Additionally traditional banks have a reputation for overcharging and underserving clients, and along with an obsolete credit rating system leaves 63.4 million people out of the banking system (the underbanked), this all makes for a very conducive environment for disruptors.

Neobanks (000’s downloads in dec/19)



Source: Similar Web, Absoluto Partners
The number of downloads are only from the countries that the respective companies began..

David and Goliath

The newcomers have certain advantages over the incumbents, despite being nascent business models. Fintechs typically employ a microservices-based architecture, in which the underlying technology is divided into defined building blocks (vs “monolithic”), which provides more flexibility, scalability and agility. The programming language, database management systems and modern hosting infrastructure used by fintechs are also important differentiators that incumbents are effectively unable to match. This modern backbone results in (i) more agility for rapid implementation/testing of features, (ii) better user experience for clients in digital channels (mobile app) and (iii) leaner cost structure, allowing for better pricing.

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The corporate culture of these newcomers is also an important differentiator, characterized by flat structures, employee ownership, rapid decision making, collaboration between employees, and a mission-driven approach to running their businesses. Customer-first focus is another important advantage – by virtue of having started with no customers (unlike the traditional banks), it is imperative for these companies to focus first and foremost on customer needs in order to gain share. As a result of these characteristics, newcomers are often more efficient and able to better attract and retain talent – from graduates of the best colleges to highly sought-after software engineers.

Traditional banks, in turn, have weaknesses that are naturally exploited by the newcomers. Legacy IT systems developed decades ago, based on outdated programming languages and monolithic architectures, are the main obstacles preventing them from competing effectively with the more innovative fintechs. These outdated architectures result in slower response times and inflated cost structures, making it difficult to price competitively. Despite sitting on an abundance of data, incumbents often have trouble leveraging that data to improve the customer experience, due to their outdated IT systems. Therefore, they are only able to view their business in terms of "products" or – at best – "channels", and not in terms of "customers". Having a true view into the customer would allow them to offer more relevant and targeted products, services and pricing to customers – something the fintechs are doing aggressively.

In addition, since competition was historically restricted to just a few large incumbents, the banks had no incentive to serve customers well. Hierarchical and risk-averse corporate structures mean traditional institutions move slowly in response to competitive changes – a dynamic illustrated well in the acquiring sector. Due to the factors mentioned above, banks have a negative public image, which has created a willingness among many individuals to try out and use alternative solutions and competitors.

With all that said, the banks do still have some things in their favor. The size and quality of their customer base is at a scale that no newcomer can hope to match in the short term. The product offerings breadth is still unmatched by most fintechs. The robust balance sheets are unique. The data, despite banks not being able to fully leverage it, is still a competitive advantage, especially for extending credit. Despite their negative reputation for customer service, they are known for financial solidity and trustworthiness, which are still deciding factors for some customers. These factors may ensure a longer timeline for them to adapt to this new competitive environment.

What could be at imminent risk?

The main revenue streams for banks are checking account fees, debit and credit card issuance, merchant acquiring and asset management. Of these, the only one that has so far seen meaningful deterioration from new competition is merchant acquiring – which provides a very clear case study on the impact of disruption. The power of superior customer service and better technology, translated into a more convenient platform and combined with fintechs' other competitive advantages outlined above, have had a greater impact than imagined on the unit economics of the traditional acquirers and paved the way for significant market share gains in the Brazilian retail market in just a few years.

+55 21 3554-8151
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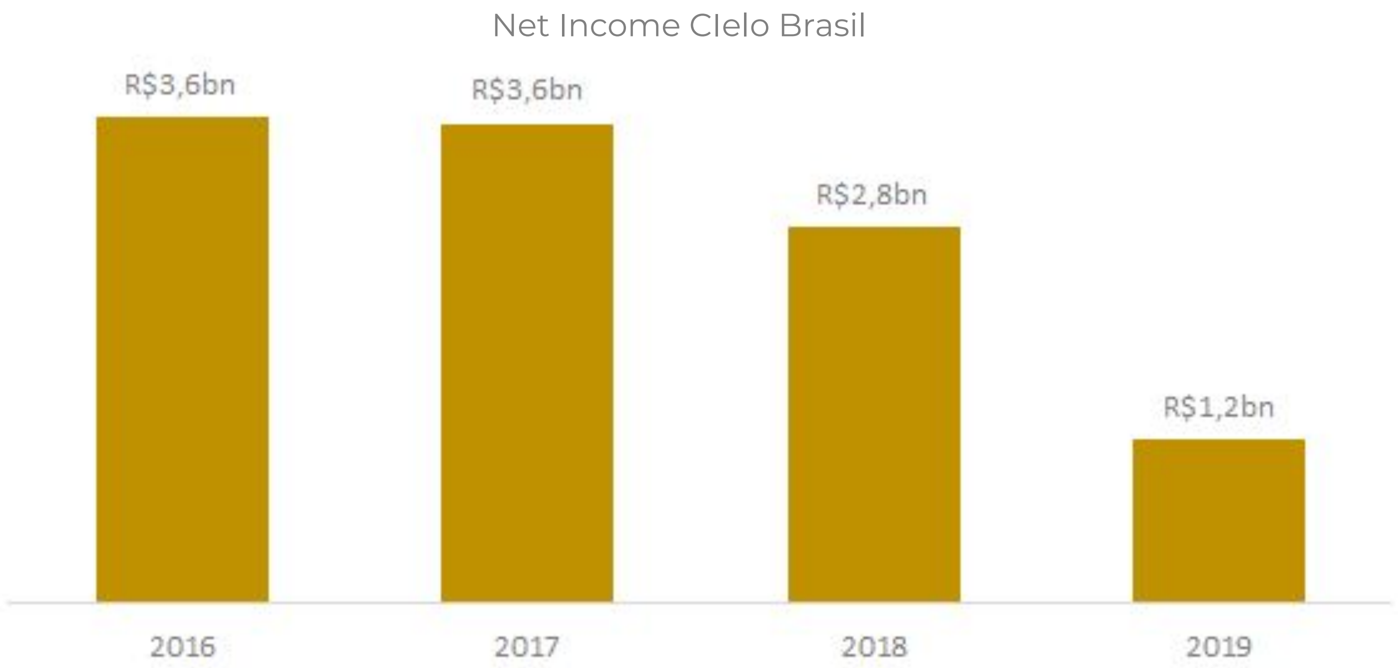
This loss of market share in some of the most lucrative segments of the market, combined with pricing adjustments, resulted in a material deterioration in the incumbents' financial performance, as portrayed in the graph below.



Source: Companies data, Absoluto Partners
(*) Considers only the acquiring subsidiary of Cielo (Cielo Brasil).

The value proposition offered by incumbents in the acquiring sector was proven fragile once new alternatives became available, mostly given the incumbents' high prices and weak customer service. An inflection point was reached in the beginning of 2018, when the main newcomer in the middle-market segment achieved 10% market share and caused a tipping point in the industry. The incumbents reactively adjusted swiftly – with fee reductions, salesforce hiring, and improvements in their platform – but it was too little too late, and not enough to stem the market share losses driven by better technological solutions and a superior customer proposition offered by disruptors. Further, recent data continues to show record high net adds for the newcomers.

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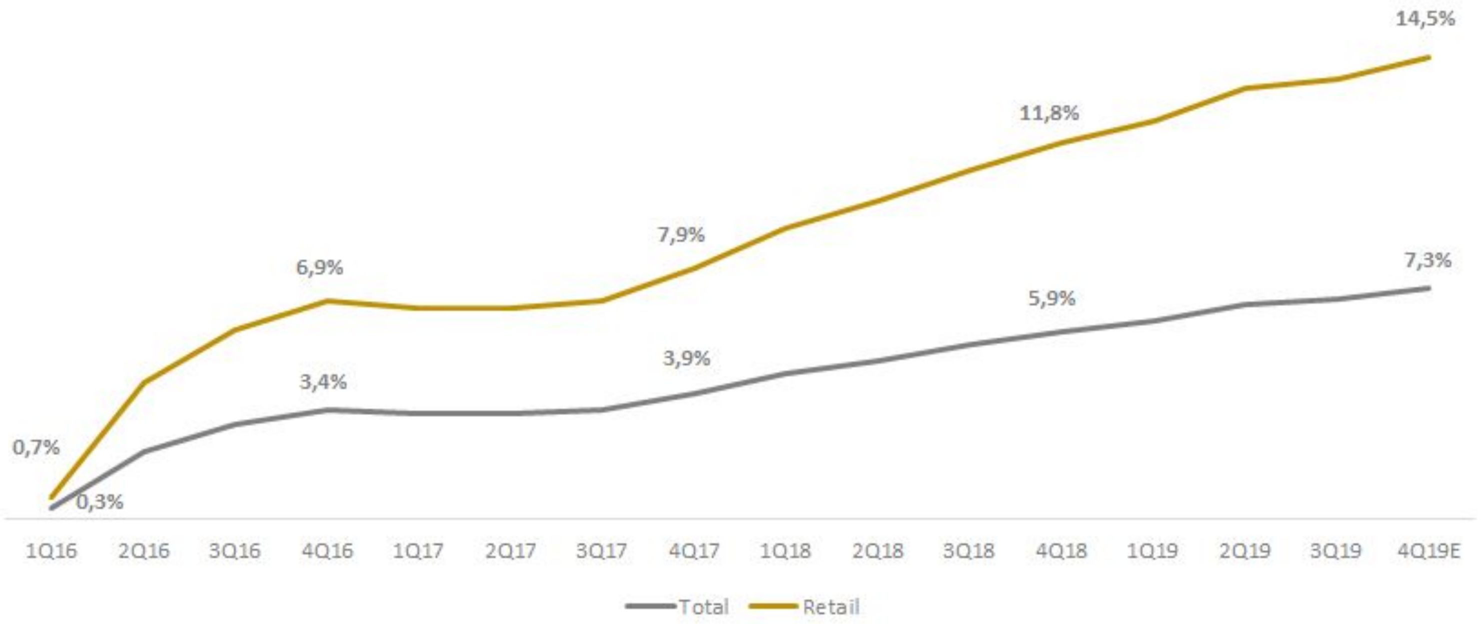
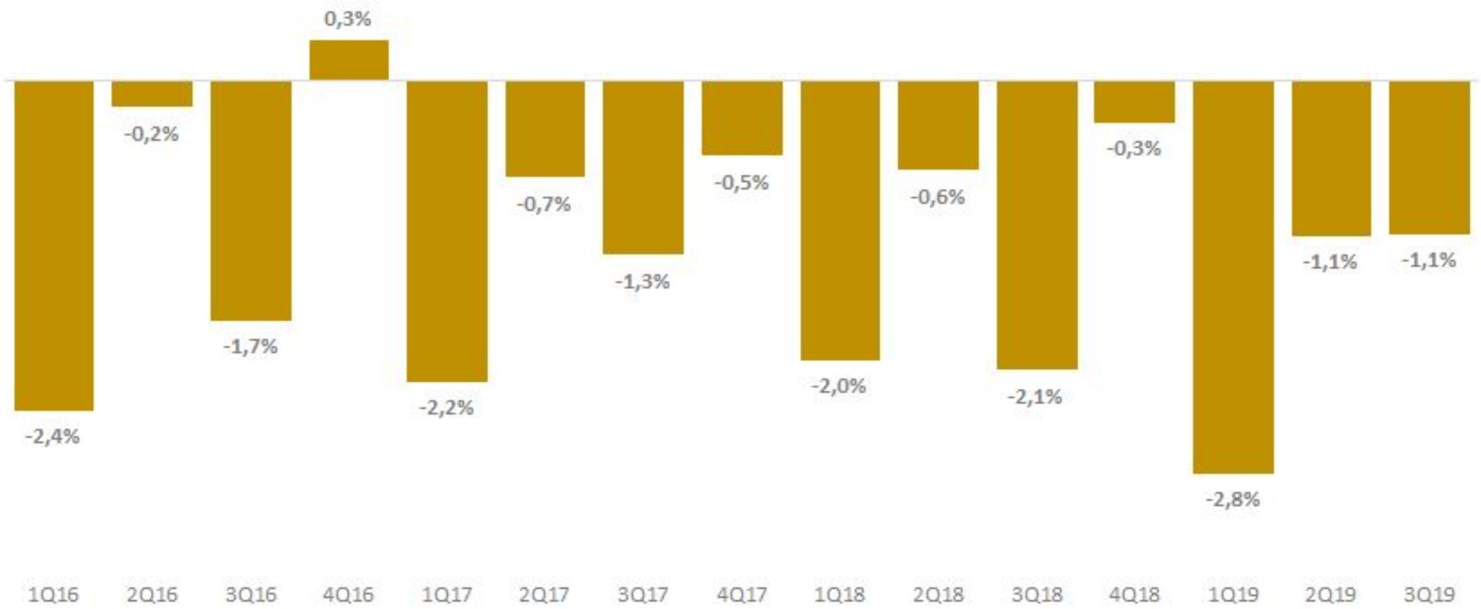
Market share Stone



Source: Companies data, ABECS, Absoluto Partners
(*) Forecast for the market segmentation based on discussions with other acquirers.

Sequential delta of market share of the incumbents

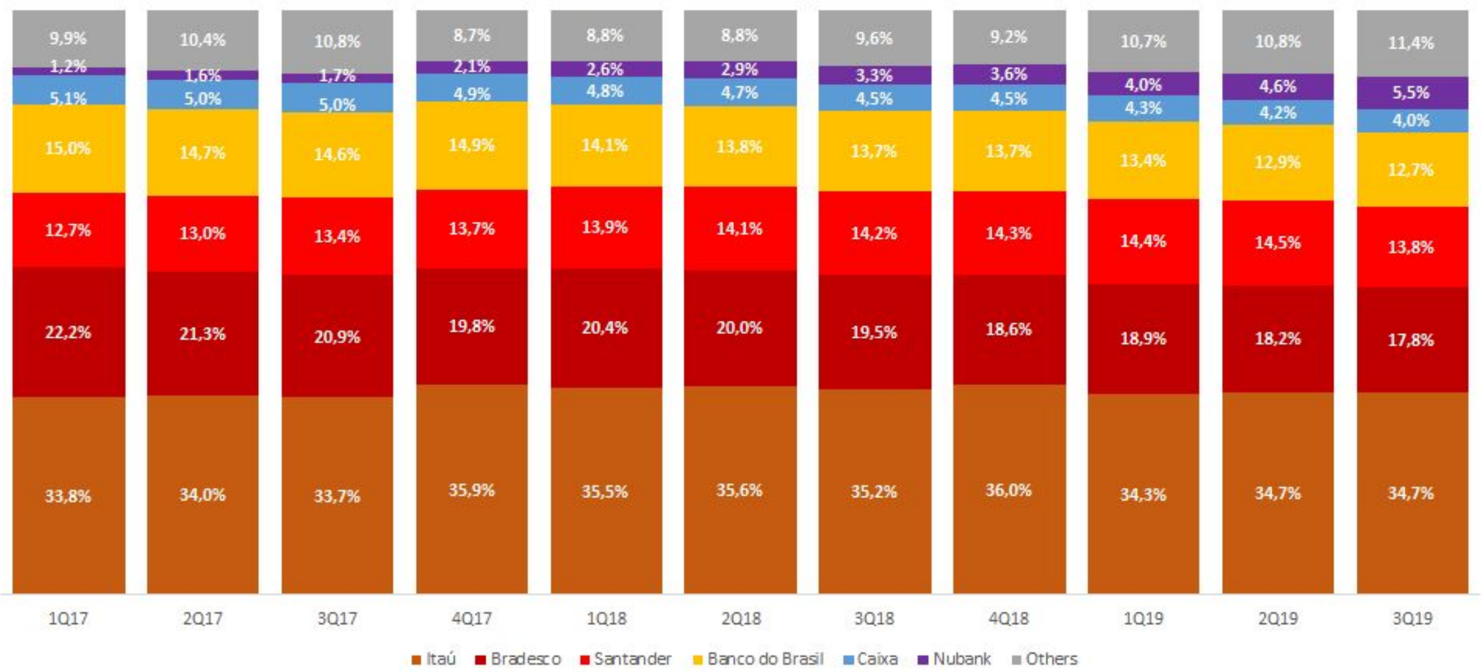


Source: Companies data, Absoluto Partners

+55 21 3554-8151
contato@absolutopartners.com.br

The card issuance segment is also topical given a very relevant disruptor. Nubank now has 5% market share and is gaining around 0.75pps each quarter, driven by the quality of its services and attractive pricing (no annual fee). In contrast, we estimate the annual fee from the main private banks in Brazil to be above R$100 per cardholder. We estimate that around half of this amount is returned back to customers in the form of rewards. In response to a new pricing environment, the banks have responded by chasing after the “platumization” movement (i.e. offering premium cards) in an attempt to stem the overall deterioration within payments; however, even if they are able to temporarily mitigate this revenue compression by increasing the interchange rate, it is a limited benefit and increases regulatory risk. The continuing growth acceleration of the technology companies, helped by regulatory changes (such as automatic debit), should result not only in the loss of clients for the traditional banks, but also drive pricing pressure on traditional banking products. Nubank’s market share will likely reach double digits in the beginning of 2021, which, based on the acquiring case study, should provoke a more visible reaction from the incumbents.

Market share TPV credit cards

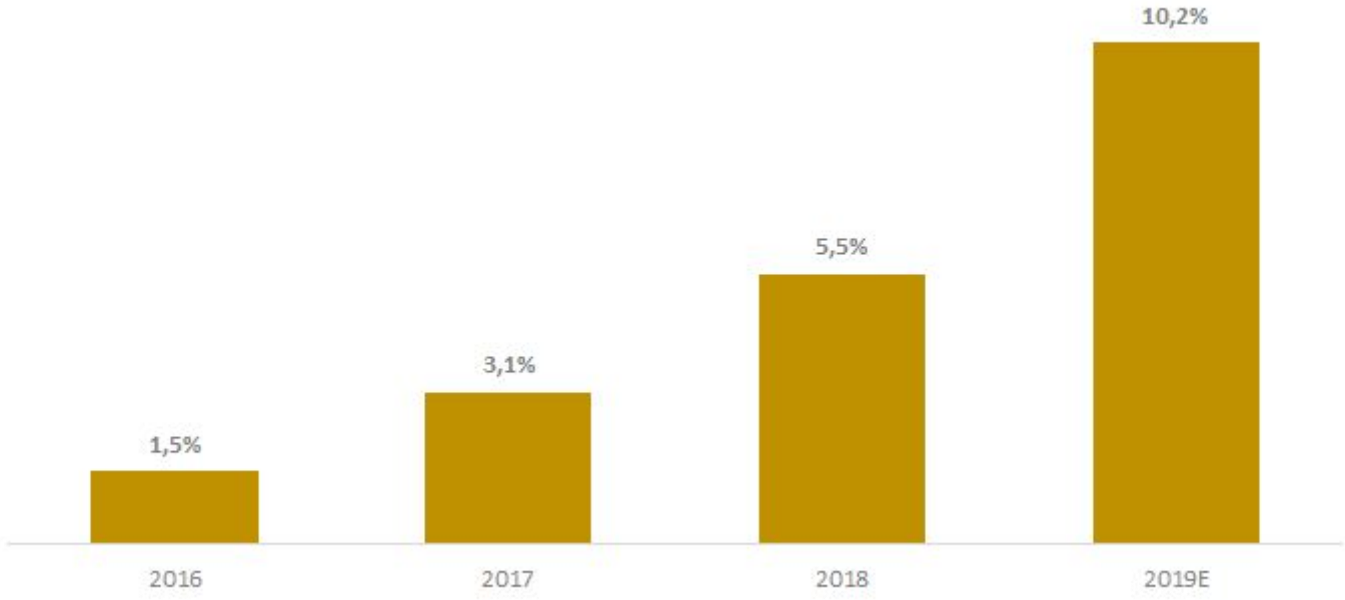


Source: Companies data, ABECS, Absoluto Partners

+55 21 3554-8151
contato@absolutopartners.com.br

The asset management market is also undergoing rapid transformation. XP Investments has already reached 10% of the retail investment market and, like its acquiring and credit card peers, continues to rapidly take share. As an illustration of this trend, net new money from the funds managed by the 5 biggest Brazilian banks was negative in 2018 and the top 5 banks represented only 30% share in 2019, while in 2017 and previous years this number was around 80%. In contrast with other disrupted segments in Brazil, within investments the representation of traditional banks is still well above that of developed markets peers – independent investment platforms only account for 10% of assets under custody in Brazil, while in European countries this number is around 65%, 87% in the United States and virtually 100% in the United Kingdom. With mostly less-sophisticated products and less competitive fees, incumbents will be increasingly challenged by the new SELIC rate levels. This will result in CDI backed funds with administration fees of 1% - accounting for more than 50% of the main pension funds in Brazil – having an expected return below 80% of the CDI. In a hypothetical scenario, if the banks set a cap of 0.5% on the administration fees of their fixed income funds, we estimate an impact of 1% to 2% to their net income.

Market share XP



Source: Companies data, Absoluto Partners
(*) Market forecast based on data from ANBIMA and SUSEP.

The revenue stream from collection fees (i.e., bank slips, covenant accounts and tax collection) will also feel pressure in the upcoming years. Although a much less relevant revenue stream, collection fees account for around R$2 billion of revenue per year for each of the main private banks. The most immediate threat comes from digital banks themselves issuing bank slips at discounted prices, while the traditional banks charge up to R$10. Additionally, one of the regulator's objectives is to make the process of paying utilities, telephone and electric bills more flexible and enabling customers to pay freely at any financial institution, leading to a better customer experience and pressuring this revenue stream for the traditional banks.

The new platform by FEBRABAN, in turn, will likely encourage companies to issue "bank slips" instead of "covenant accounts", migrating to a model where bilateral agreements are no longer relevant and, therefore, eliminating a key barrier for the digital banks. Also, the instant payment platform, promoted by the Brazilian Central Bank, may replace some of the transactions made by traditional "bank slips". The revenue streams from TED and DOC, generally included in the checking account revenue stream and corresponding to hundreds of millions of reais for the big banks, will also likely be negatively impacted by this platform, which will be more cost-competitive compared with current prices.

Finally, the revenue stream from checking account offerings will also be pressured by the exponential success of digital banks, given their "freemium" business model. Customers that don't use many products from the banks – while they may not be the most profitable – have a greater propensity to migrate to alternative banks as they are less dependent on the incumbents. These solutions could come from fintechs that were initially positioned as digital banks, or from one-product companies that may gradually increase their offerings. Also, the creation of the payment account enabled the offering of financial services by newcomers, as it has in its scope similar products as a banking account, but with a lower observance cost.

Additionally, an increasingly digital environment and gradually more conducive regulation enables a much more fluid account opening process, lowering the costs and barriers for consumers to try out other platforms. The deepening of customer relationships with the so-called "neobanks" will naturally occur as customers familiarize themselves with these new business models. Indeed this may gain increasing traction as newcomers continue to introduce new functionalities, made possible by their internal software development teams and facilitated by the removal of regulatory barriers (such as automatic debit and withdrawal), to the point that it eventually makes sense for a customer to discontinue their relationship with an incumbent.

The insurmountable obstacle, for now

The main area of banking that remains resilient (to date) is credit. Robust balance sheets, extensive databases and expertise gained over decades has resulted in a fine-tuned model that may protect traditional banks for the time being. None of the hundreds of fintechs have a credit offering on the same scale as the traditional banks, with fintechs as a whole having only originated ~some billion reais in 2019. Successful players who originally focused on other products (such as acquiring, card issuing, investments) have recently started credit offerings, and even though they are growing exponentially, these are still only in the hundreds of millions – effectively irrelevant considering the national loan balance for individuals is R$2.0 trillion. Credit offerings are also very important for maintaining a close relationship with SMB clients, mitigating some of the negative pressures on service revenue streams discussed above.

On the other hand we question whether the banks' balance sheets alone are enough to sustain customer loyalty. The seamless process (vs. bureaucratic traditional banks) relationships with fintechs and using their products should result in at least a partial withdrawal from traditional banks, even for credit customers, as niche players are often able to offer better pricing in specific segments.

Even if the credit offering business proves to be more resilient, profitability could significantly downtick if the trend in service revenues continues, as these revenues are ultimately most important in driving high returns for banks (in contrast to solely focusing on net interest margin.) Additionally, the ongoing accumulation of data by newcomers, the increasing use of non-structured data, recent regulation from the Direct Credit Society of Central Bank (SCD) and the Personal Loan Society (SEP), and the increase in data sharing due to the "cadastro positivo" and open banking, should all gradually contribute to increasing credit portfolios for the newcomers in the medium term, eventually weakening this "fortress" of the banks.

The regulators' role

The Central Bank has played a decisive role in incentivizing competition in the financial system. Restrictions in the acquiring industry began to be eased in the early 2000s. In 2013, the Central Bank officially became the payments regulator. A year later, they obliged companies to share their receivables book. In 2015, they demanded the creation of a centralized "grid for liquidation". In 2016, CADE and the federal government became more proactive, imposing interoperability between PIN pads and allowing price differentiation (surcharge). Afterwards, regulation of the Chamber of Receivables was enacted. The evolution of regulation, while at first glance only gradual, played a crucial role in the profound changes that occurred in the acquiring sector as players had to adapt to the new rules, and with change disruptors emerge. Similar changes are starting to be introduced in the banking sector, that while also seem timid at first glance, may create similar tipping points in other revenue streams in the near future.

+55 21 3554-8151
contato@absolutopartners.com.br

A few years ago, with the worst of the economic crisis past us and the banks surviving the most stringent stress tests, the incentive to promote competition by Regulators was greater than ever. Initiatives responding to complaints about the level of interest rate spreads from banks became even more important to the regulators once the problem of high interest rates was addressed. In 2016, the Central Bank introduced the BC+ agenda, with the aim of collecting literally hundreds of initiatives to make the financial system more efficient and credit cheaper. The most recent administration has intensified its efforts, renaming the agenda to BC#. As a result, the process of opening a checking account was made easier and the "cadastro positivo" (more credit friendly scoring) finally became a reality. The Central Bank established a cap for the interchange rate on debit cards and on overdraft interest– events that were seen as unlikely years ago, reinforcing the seriousness of this subject.

Many advancements in the regulatory framework have at the time passed unnoticed and subsequently proven to be transformational. The payment accounts, for example, was created in 2013 and only gained momentum years later, allowing for the execution of most banking functionalities: withdrawal, bill payment, issuance and payment of credit and debit cards and money transfer. Assets in a payment account are deposited in a specific account in the Central Bank or in public titles, providing security for customers and making this account option very competitive. In this case the regulator's monitoring costs decrease significantly. The main restriction is that the payment accounts can't be used to fund credit offerings.

The next steps on the regulatory agenda appear to be even more important than the previous ones. Open banking, which is in public hearing in the Central Bank and will have its first implementation phase this year, has the potential to expand access to various financial participants to valuable data used for credit modeling. This data was previously only available to the banks, therefore eliminating one of their main competitive advantages. This innovation may spur a new wave of specialized financial services offerings – and the experience of Brazilians in the past few years shows that newcomers focused on specific niches tend to offer better services, prices and gain acceptance very rapidly with the Brazilian consumer, which are tech savvy and early adopters. The instant payment platform promoted by the Central Bank will also launch in 2020, impacting the revenue streams of payments and money transfer businesses. More recently, the regulator expressed its interest in addressing two other key limitations for the digital banks: access to the physical assets of the incumbents, and restrictions on paying bills in automatic debit. In June of 2020 the Central Bank will announce the second phase of the BC# Agenda, with a new bundle of measures that should encourage even more competition in the financial system.

Tying this into our investment process

To summarize, in the next few years we expect to observe an ongoing dispute between incumbents, backed by their extensive base of clients and product offerings; and fintechs, backed by their disruptive technology and more attractive value proposition. In addition to this dynamic, it will be interesting to observe the variety of reactions from each of the individual incumbents, illustrated by the dichotomous performance of service revenues already observed from the incumbent banks.

Even though we recognize that it is difficult to exactly anticipate how the next stages of competition between the incumbents and the newcomers will unfold, we have conviction that the new players will dictate an increasingly important role in the national financial system. We have closely followed these ongoing dynamics since 2017, and aim to reflect them in our portfolio through investing in companies that we believe to be the best positioned in this environment – never in a thematic way, but as always in accordance with our rigorous, bottoms up investment process and principles.

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ABSOLUTO PARTNERS FIC FIA I ("Fund")

December 2019

Absoluto Partners
+55 21 3554-8151
contato@absolutopartners.com.br

PERFORMANCE

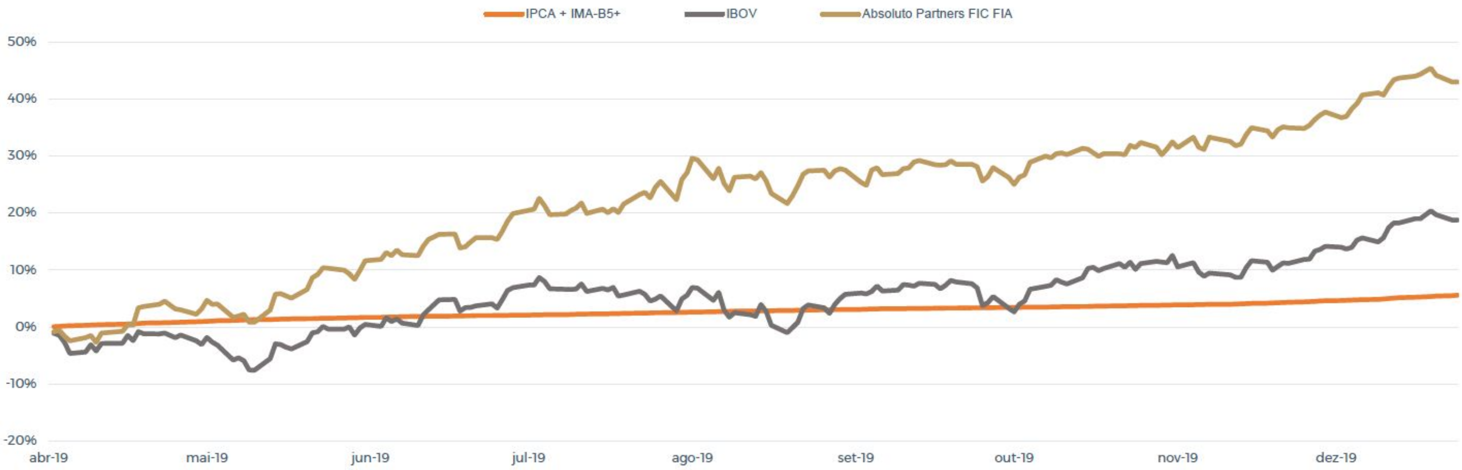
	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	YTD
FIC FIA				4.51%	5.53%	4.85%	6.04%	3.88%	0.89%	2.30%	2.64%	5.95%	42.97%
IPCA + IMAB 5+				0.76%	0.78%	0.44%	0.47%	0.49%	0.36%	0.40%	0.56%	1.17%	5.56%
IBOV				-1.04%	0.70%	4.06%	0.84%	-0.67%	3.57%	2.36%	0.95%	6.85%	18.77%

ABSOLUTO PARTNERS FIC FIA I:
AUM: R$ 402,646,093

ABSOLUTO PARTNERS FIC FIA I:
AUM (monthly average): R$ 222,745,848

ABSOLUTO PARTNERS MASTER FIA:
AUM: R$ 3,397,402,774

PERFORMANCE



Performance calculated since the start of the fund, 04/08/2019, having a change in 08/12/2019 of the Fund Manager to Absoluto Partners Gestão de Recursos Ltda.
The indexes IMAB 5+ and IBOV were only used as a reference for the analysis. The performance fee of the fund is calculated over the IPCA + IMAB 5+.

EXPOSURE MARKET CAP %

Exposure Market Cap	% AUM
R$ 0 to 10 bi	6.9%
R$ 10 to 20 bi	2.0%
Above R$ 20 bi	89.8%

LIQUIDITY

ADTV of assets	% AUM
0 to R$ 15MM	0.0%
R$ 15MM to R$ 50MM	1.9%
Above R$ 50MM	96.8%

CONCENTRATION

# of companies	% Portfolio
Top 5	45.8%
Top 10	74.4%
Top 15	91.2%

Service providers of the fund

Manager: Absoluto Partners Gestão de Recursos Ltda
Administrator: BTG Pactual Serviços Financeiros S.A. DTVM
Custodian: Banco BTG Pactual S.A.
Auditor: Ernst Young
CNPJ (Fund): 32.738.755/0001-84

Investment conditions

ANBIMA category: Ações Livre
Management fee: 1,85% a.a.
Performance fee: 15% above benchmark
Benchmark: 100% IPCA + IMA-B 5+ variation
Initial investment: R$200.000,00
Minimum subsequent orders: R$10.000,00
Application conversion: D+1

Redemption conditions

Minimum redemption: R$10.000,00
Time limit for redemption: 14:30
Redemption time frame: D+60
Redemption liquidity: D+62
Quota: End of day quota
Income tax: 15% tax over the nominal returns

Autorregulação ANBIMA
Adesão Provisória

Objective: The Fund has as its objective to allocate at least 95% of the Asset Under Management (AUM) of ABSOLUTO PARTNERS MASTER FIA ("Master Fund") through fundamentalist analysis and investment in companies that have proven sustainable growth, in order to provide for our quota holders, in the medium and long term, gain of capital of their investments, primarily in the stock market, without the necessity of following any correlation with stock indexes.
Target audience: Fund exclusively directed for investments from qualified investors, as specified in the terms of CVM Instruction n° 539/2013.