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Dear investors,

As 2023 comes to a close, we believe the market environment today reflects many of the dynamics we described in our last letter – a challenging global macro environment with U.S. interest rates reaching 40-year highs, and meaningful uncertainty surrounding the new presidential administration in Brazil. At the same time, company valuations already more than reflect this scenario, and it's important to highlight something we feel is often overlooked: high discount rates also reflect investors demanding a higher margin of safety; and the more uncertain the environment, the higher this margin tends to be.

We believe 2023 is possibly just the beginning of a multi-year normalization cycle. The rapid increase in global interest rates since 2022, exacerbated by excessive pandemic-era government stimulus, has finally shown signs of stabilization. Furthermore, supply chain normalizations have enabled easing of commodity prices and input costs across the board. Domestically, we have already seen the beginning of an interest rate cut cycle towards more reasonable levels. Together, these macro "ingredients" create the backdrop for strong performance for each of our portfolio companies in the coming years, enhancing the underlying idiosyncratic tenets of each investment thesis.

At Absoluto Partners, we continue to strive for excellence and the ongoing improvement of our investment process. We have reached our fifth year, growing and maturing as a hardworking, cohesive team that enjoys working together. It is gratifying to see the signs of our philosophy and culture already taking hold even in our youngest team members.

In this letter, we revisit the Brazilian Financial Sector, whose transformation we consider to be one of the most relevant business dynamics in the country today. While in our last letter we focused specifically on Nubank, whose differentiated cost structure has been paramount to its success, we use the same lens to explore the incumbent banks' current operating situation.

We believe and seek to illustrate within that changes in competitive and regulatory dynamics in the last few years have structurally reduced retail banking earnings power to such a degree that a complete overhaul of the traditional banking model is now necessary. A critical part of this process will require aggressive cost reductions across the board, with an intensity far higher than what we have observed in recent years. We therefore envision that this topic and its implications will become top of mind in industry discussions very soon.

THE FUTURE OF RETAIL BANKING

In our very first letter from 2019, we shared our perspective on the Brazilian Financial Sector. We had at that time seen a reshuffling of the merchant acquiring sector, which had already started to leave scars and lessons for the country's main incumbent banks. We believed that disruption would not stop there and would extend to other financial services, such as investments, credit cards and consumer banking.

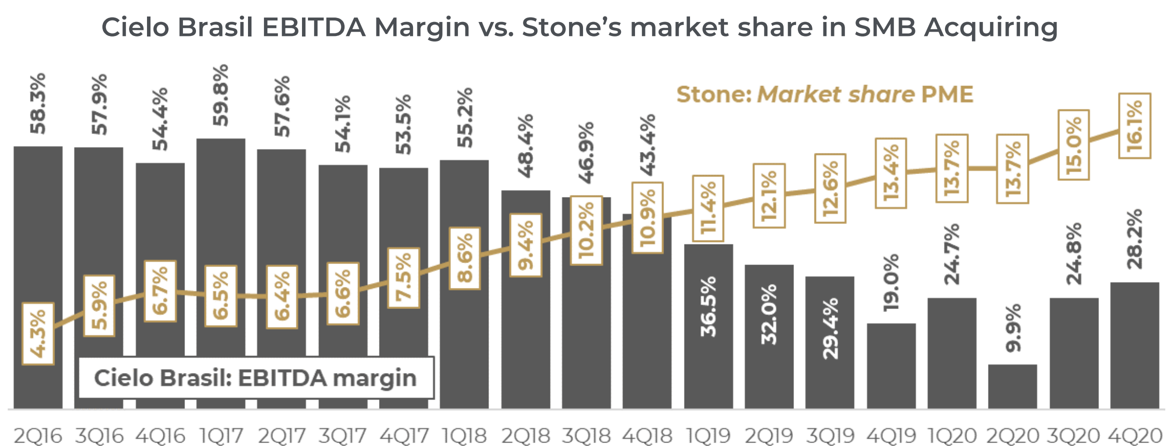
Looking back, we realize that these sectors' transformations have been even faster than we had initially anticipated. The COVID-19 pandemic catalyzed the digitalization of society, an atypically low interest rate environment through 2021 accelerated the reallocation of household savings and new entrants were able to offer superior services and attain levels of scale previously unimaginable. Moreover, regulatory changes materially curtailed the profitability of certain incumbent bank products, such as account overdraft and payroll loans.

It has therefore become clear to us that we are at a turning point for the entire Financial Sector in Brazil. **We estimate that the ROE for retail banking is now below 10%, down from 20% to 30% in recent years.** The situation is even more dire for banks that have a higher concentration of low-income customers, where profitability may very well be in negative territory. Even though this scenario may be *partially* explained by transitory headwinds facing the industry, namely where we are in the credit cycle, we believe that a series of structural headwinds far outweigh the transitory ones. To return to reasonable levels of profitability, **we estimate the banks will need to reduce their existing cost base by an unprecedented 20% or more**. In turn, this will accelerate the transformation of the Brazilian Financial Sector even further.

In this letter, we will first address several competitive and regulatory pressures which have led to a significant compression in sector returns in recent years. After, we will detail the extent to which the banks will need to cut costs to make up for said compression – unlike in the past, pricing power will no longer be an option in what has become a very competitive market.

Slowly, then suddenly

As mentioned above, the first retail banking segment that underwent structural competitive changes was merchant acquiring, whose contribution to the private banks'[1] net income fell from high-single digits to low-single digits[2]. In our 2019 letter, we commented how "the ground began to shake" more visibly when Stone reached around 10% market share in the SMB segment (which is the main profit pool of the acquiring industry). At that scale Stone's success could no longer be ignored, as given Stone's exponential growth it quickly became clear that continued inaction on the part of incumbent banks would lead to increasing market share losses. Perhaps more importantly, Stone's unit economics disproved skeptics and confirmed the disruption was sustainable. New entrants were now to be taken seriously, and it was time to act: first in late 2018 with Cielo reducing prices to new customers by 30%, and later in early 2019 with Rede eliminating charges for pre-paying receivables on purchases not made in installments. As shown below, when incumbents started to take action, what was at first a gradual deterioration in profitability in the acquiring sector suddenly accelerated.



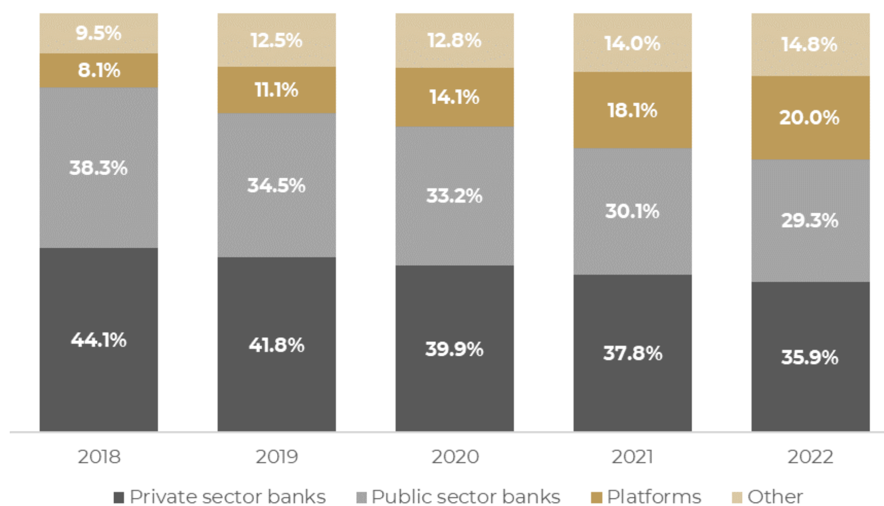
Sources: Absoluto Partners, Company Filings

[1] Throughout this letter, we refer to "private banks" as the aggregated results of Itaú Unibanco, Bradesco and Santander Brasil.

[2] Cielo Brasil (Cielo's merchant acquiring segment) went from 6.0% of Bradesco's net income in 2017 to only 1.3% in 2022. Furthermore, in 2017, Rede represented 10.4% of Itaú Unibanco's profit (ex. Amortization of acquisition intangibles, net of taxes), while today, although no longer publicly available, we believe it represents only a fraction of this amount.

In recent years, new entrants in the investments, credit card and personal banking sectors have also achieved double digit market share. Analogous to what we observed in merchant acquiring, changes in the competitive environment in these sectors have similarly ushered in accelerated urgency to transform, and have pressured earnings for incumbents, which we detail below.

The challenger **investment platforms** crossed the 10% market share mark in assets under custody at the end of 2019, mainly due to the success of XP. Given the exponential growth of the new entrant, incumbents, who previously only distributed their own investment products, gradually started distributing third party products, reduced fees on traditional products and increased yields on retail banking account savings products. These changes not only compressed unit economics, but were ultimately not enough to stem the tide of clients shifting their assets to other platforms.

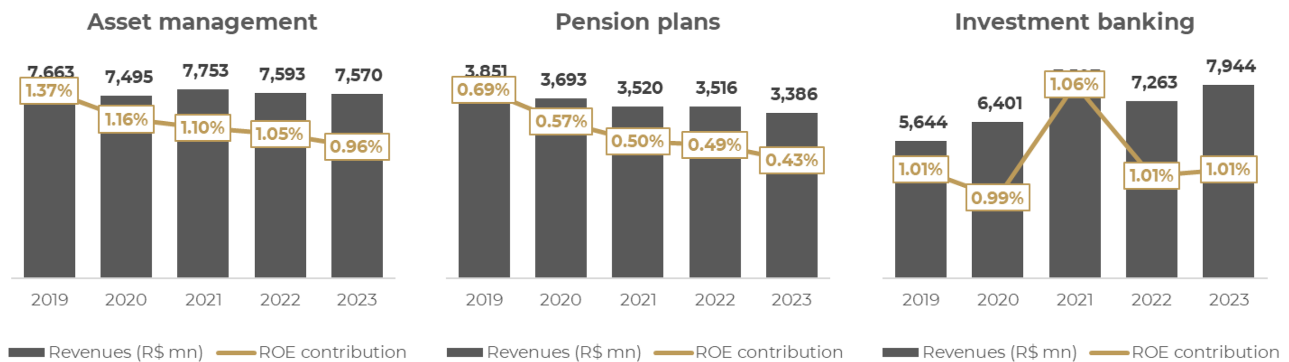


Sources: Absoluto Partners, ANBIMA, Company Filings.

The disruption in investments has implications for several of the incumbent banks' profit pools. These include, among others, cost of funding, asset management fees, pension plans and investment banking. The combined revenue of the 3 largest private banks in asset management and pension plans has been flat to down since 2019, resulting in a 70bps ROE compression. Meanwhile, cost of funding for time deposits for one of the private incumbent banks, whose financial disclosure allows us to make a rough estimate, has deteriorated nearly 10 percentage points from pre-pandemic levels (from ~65% to ~75% of the CDI base rate). On the other hand, investment banking, despite market share losses for the private banks, has been more resilient, bolstered by a favorable industry environment.

Asset Management, Pension Funds and Investment Banking Revenues[3]

(R$Mn and as % of Equity)



Source: Absoluto Partners, Company Filings.

While the flow of redemptions experienced by incumbents has somewhat moderated, we believe this will continue to be an issue for the foreseeable future. In the last two years, while the “micro” has been difficult with the continued growth of independent platforms, the “macro” has been favorable to these players given the increase in interest rates and the surge in savings accounts post-pandemic. Incumbent banks have further attempted to defend their critical deposit bases from outflows by increasingly launching tax exempt products. However, these tailwinds are now abating: monetary policy is already become expansionary, household savings are normalizing to lower levels and collateral availability for asset backed tax exempt products are dwindling (eg LCA, LCI and LIG)[4].

It is interesting to observe how different incumbent banks have reacted to the evolving backdrop. While some have been investing in improving their investment platforms through initiatives like increasing product breadth and segmenting client relations in order to partially mitigate the deteriorating competitive environment, others have reverted back to strategies which we consider unsustainable. For example we are starting to witness, yet again, the launching of CDI related funds whose high fees are disproportional to the product’s low risk profile, resulting in clearly inferior products for clients relative to other platforms.[5] While such practices may temporarily relieve top line pressure, offering an inferior value proposition to customers simply presents another opening for challenger competitors to differentiate themselves and continue to poach clients in the long run.

[3] Asset Management revenues disconsider revenues related to consortia administration, which is generally included under the same line item in disclosed financial statements from the banks. ROE contribution is calculated based on revenues and the marginal tax rate.

[4] As an example of this product, we highlight the fund “Bradesco Renda Fixa Simples Automatico of R$6Bn since Jan/2021 whose investor base has increased by 139k during this period The fund charges 1.5% performance fee for a product which basically mirrors the CDI base rate.

[5] The balance of LCI (letters of credit for real estate) and LIG (letters of credit guaranteed by property) as a % of Itau Unibanco’s real estate portfolio increased from 23.8% in 2019 to 87.1% in 3Q23; those of Bradesco increased from 53.2% to 74.7%; those of Santander Brasil from 66.3% to 87.9%.

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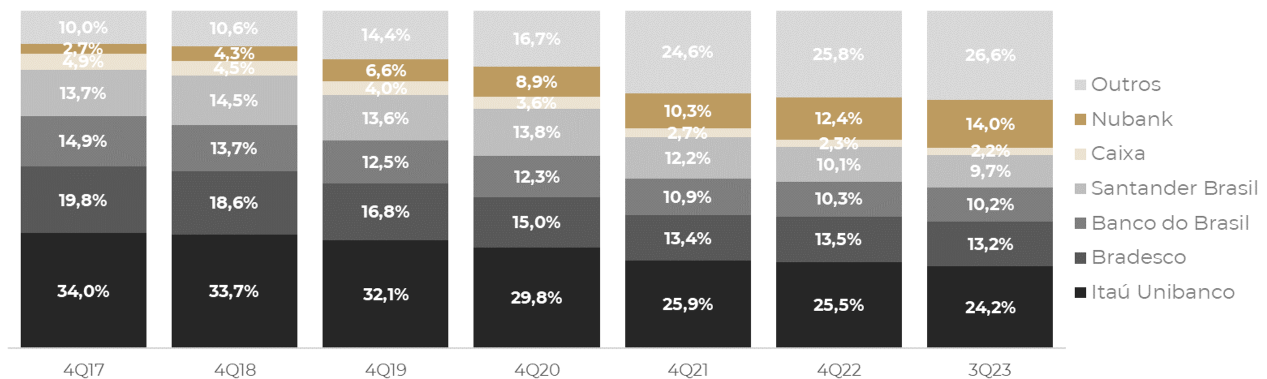
In the **credit cards issuing** segment, Nubank crossed 10% share of TPV in 2021 as shown in the graph below. At this time, incumbent banks began responding more aggressively in this segment, originating new cards at an unprecedented velocity. As we mentioned in our 2022 letter, this strategy quickly backfired. The root cause was a long-standing but ultimately incorrect belief that the success of the neobanks was due to an "open sea" strategy, in which they successfully extended credit limits to non-banking customers. In reality, some of the neobanks were successful because their superior customer experience enabled them to earn their place as the primary banking relationship ("principality") for many incumbent banks' customers. In fact, today principality is widely recognized as a determining factor in successful credit extension..

Market share of credit card TPV



Source: Absoluto Partners, ABECS, Company Filings.

We believe the next reaction to the change in the competitive environment will consist of accelerating the waiving of annual credit card fees. In fact, we have already observed such fees falling by over 15% since 2019, while the banks' equity has increased nearly 30% during the same period, significantly reducing its contribution to ROE. It is worth noting that even after this contraction, credit card annual fees still contribute between 5% and 10% of the incumbent private banks' pre-tax profit, representing a meaningful threat to the future profitability of the sector. Importantly, when competition drives *price reductions* (as opposed to simply *market share losses*) it has a particularly material impact on profits with top line pressures dropping straight to the bottom line, resulting in acute operating deleverage.

Additionally, in the last few years, the significant growth of the credit card industry (21.4% 2018-2022 CAGR) has partially masked the effect of market share loss on incumbent banks' numbers. In 2023 the market backdrop changed however, with industry growth decelerating substantially – and we believe the pace of origination should continue to be modest in the coming years given today's heightened level of household debt. The deceleration of credit origination not only exposes incumbent banks' structural headwinds more clearly, but could even exacerbate them – as companies seek to show growth in their quarterly numbers even in a weaker environment, they might be tempted by imprudent competitive behaviors which would worsen the profit headwinds noted above. We have already seen evidence of this in the merchant acquiring sector, with one of the largest acquirors noting the market deceleration is generating more cannibalization between players.

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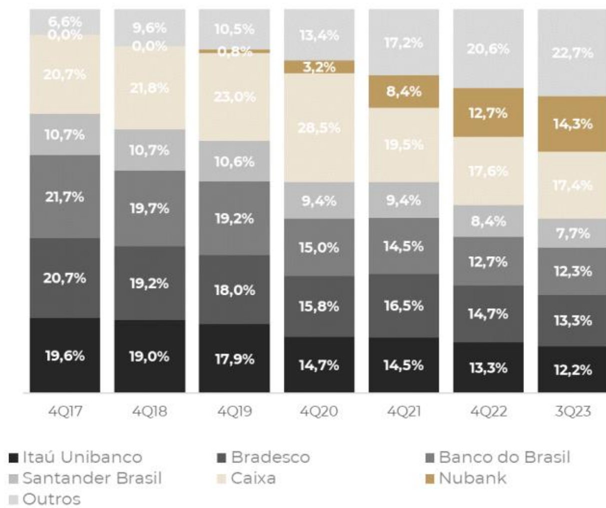
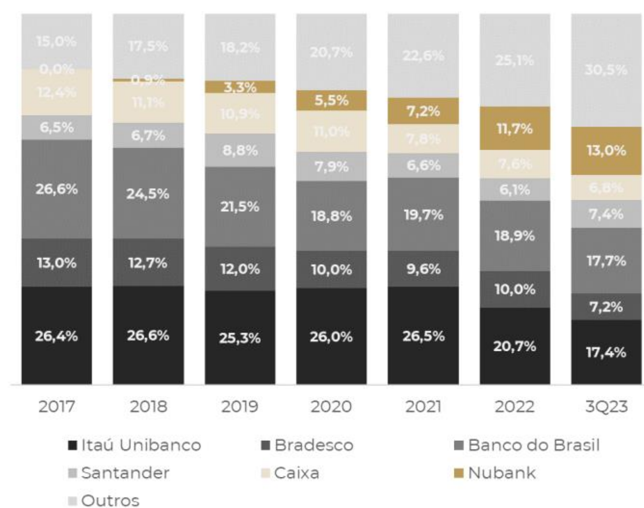
Fees from **consumer banking accounts** have likewise been steadily pressured over the last few years. As a proxy we can look at market share of debit card TPV (since this taps customers' account balances directly) as well as market share of current account deposits.

Debit Card TPV Market Share [6]



Sources: Absoluto Partners, ABECS, Company Filings.

Current Account Balance Market Share [7]



Sources: Absoluto Partners, ABECS, Company Filings.

Lastly, we also believe that the market share of PIX "Keys" (used to enable PIX for a given bank account) is also a relevant indicator of principality, given PIX's tremendous success and relevance in Brazilian consumer payments today, and therefore the propensity of customers to register the main Keys (CPF, cellphone number, e-mail) with their preferred banking partner. The charts below illustrate that incumbent banks' market share of these main registered PIX Keys is less than 10%.[8] Moreover, their share is even lower when only considering the flow of *newly created* keys, indicating ongoing market share loss. When evaluating PIX transaction volume, we also note neobank relevance versus the incumbents, as the Brazilian Central Bank recently noted 40% of the number of PIX transactions were received by payment institutions[9].

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[6] We estimate Bradesco's Debit Card TPV assuming TPV / customer similar to that of ITAU Unibanco.

[7] We include in our analysis the Nubank deposits that we estimate are not invested in the "caixinhas," or denominated savings yielding accounts. Money simply left on current account balance is invested in RDBs and is therefore classified as a time deposit despite having a current account deposit functionality. This analysis also include ITAU Unibanco international deposits, which pollute the interpretation of market share, although the data point is relevant when evaluating inter-year trends.

[8] Every Brazilian has the ability to register four different PIX keys: CPF, Celphone number, e-mail and a fourth "random" key chosen at the customer's discretion. We exclude this fourth key given that we believe customers choose the first three for their primary banking relationships.

[9] Numbers taken from the "Relatório de Gestão do Pix" from November and December 2022. We prefer to use number of transactions vs. TPV in this analysis given B2B transactions are much larger than C2C and C2B and the data does not distinguish between the two. BB, which we believe is dominated by the incumbent banks, represents ~40% of PIX TPV and only ~3% of number of transactions.

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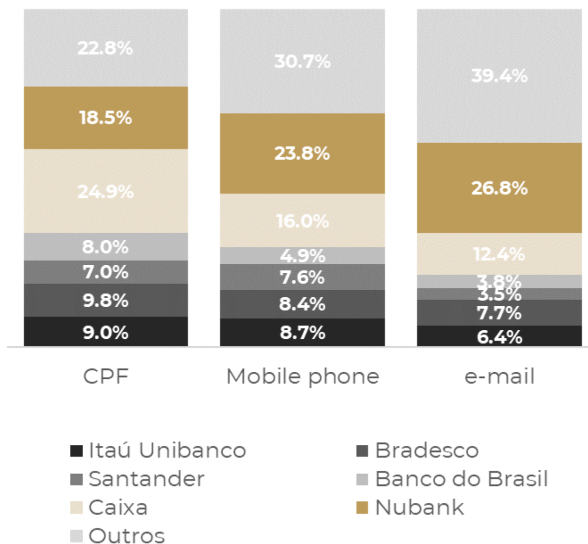
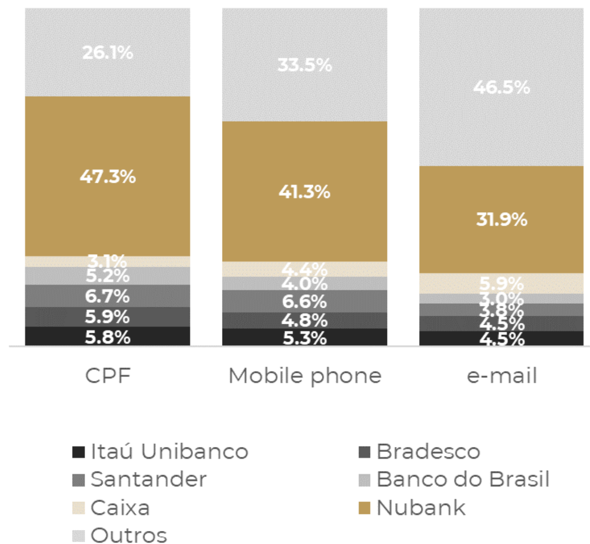
PIX “Keys” Market Share



Sources: Absoluto Partners, ABECS, Company Filings.

PIX Key Net Adds Market Share, 3Q23

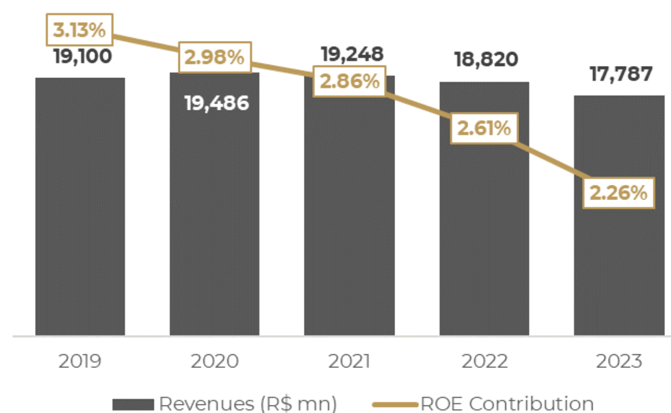


Sources: Absoluto Partners, ABECS, Company Filings.

Given the current market share trends and implication for principality dynamics illustrated above, we believe it will be increasingly difficult for incumbents to justify charging account fees to customers, who have become increasingly digitalized and savvy when it comes to assessing different bank account options. As an example, 45% of individuals who use the app of either Itaú Unibanco, Bradesco and Santander now also have Nubanks' app installed, up from 25% at the end of 2019 according to third party data. The overlap suggests that more and more clients of incumbent banks are experimenting with solutions from new entrants, in turn making it harder to charge for current account services given the increasing availability of fee-exempt solutions.. We estimate the decline in current account fees have already created an 80bps headwind to incumbent banks' ROE in recent years, and should only worsen in the coming years.

Current Account Fees [10]

(R$Mn and as a % of Equity)



Source: Absoluto Partners, BCB, Company Filings.

[10] Current account fees reported by the private banks include: Fees charged not only to individuals, but also to business accounts which have gained increasing relevance. Business account fees are more resilient given the competitive environment around B2B banking has not escalated as much and PIX has proven to be an additional monetization lever, which is not the case for C2C our C2B Pix transactions.

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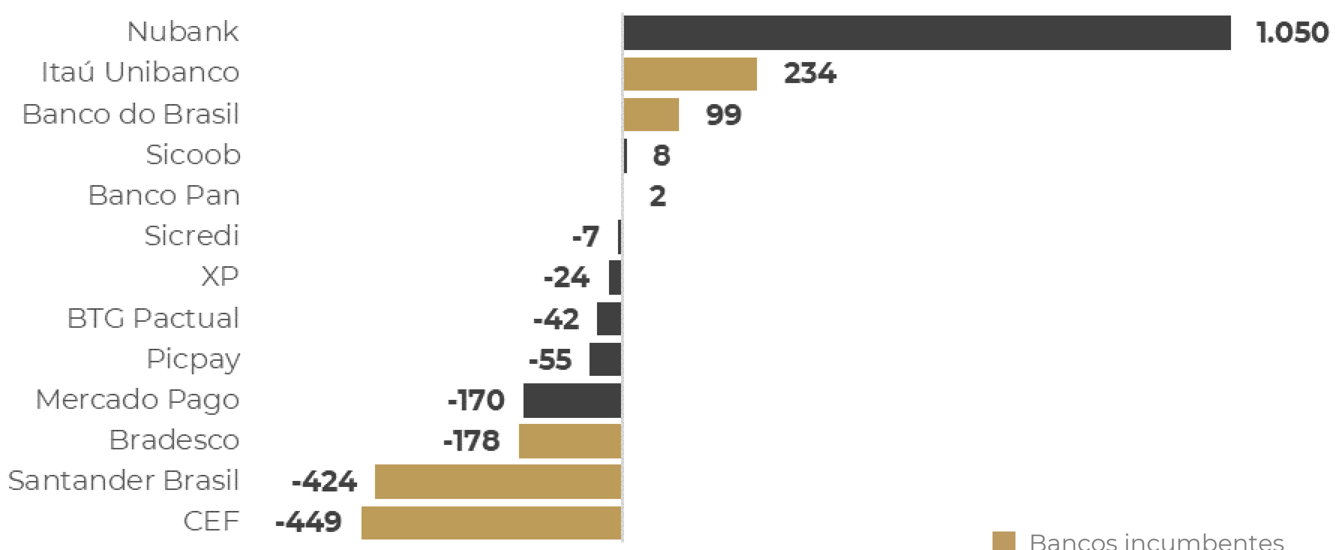
New Threats on the Horizon

In addition to the aforementioned headwinds, we believe "Open Finance", where Brazil is increasingly viewed as a global benchmark, could further spur competitive pressure. The initiative is still fairly new, with bank and customer adoption only ramping in the second half of 2022. The number of user approvals to share banking information increased from 14 million in early 2023 to 27 million as of October 2023, indicating early traction. The Payment Initiation Mechanism[11] is still in its infancy and has not been very successful so far, with many financial institutions still in test phase. The last proposed phase of Open Finance, related to investments, recently started at the end of September of this year and holds the promise of optimizing client portfolios, especially for less sophisticated investors.

Easier comparison between products and the ease of moving money across different accounts could heighten pressure on several important business lines. For example, new entrants will soon be able to send push notifications to customers, highlighting the returns they could expect for a given investment product were they to switch from their incumbent bank, and migrate the account with just a few clicks through the Payment Initiation Mechanism. Put simply, Open Finance should help accelerate the secular shift of client assets away from incumbent banks to other platforms with better or simpler products, and the initiative has been much more effectively leveraged by the neobanks than the incumbents. The Central Bank even believes that individuals will eventually begin using financial services aggregator apps, allowing them to select the best products across banks in one place. In this environment, charging customers excessive fees on products such as credit cards and checking accounts becomes even more untenable.

Number of "Net" Data Sharing APIs through Open Finance in Oct/2023
(receipts – transmissions; millions of consents)



Sources: Absoluto Partners, Open Finance Brasil.

[11] The Payment Initiation Mechanism permits individuals to move money from any given financial institution through the app of any other institution with whom they already have a banking relationship; This is part of Open Finance, which in general terms, allows customers to share their financial data across their different banking relationships.

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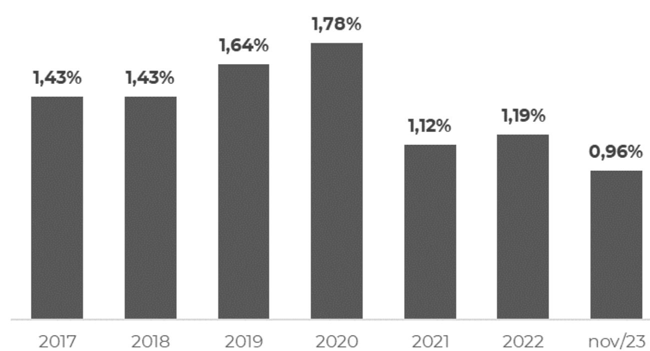
There are still a few other business lines that might also begin to migrate over to challengers from incumbent banks. For example, Nubank today already originates 20% of "clean credit" personal loan volumes vs. 11% in 2022 and 7% in 2021. More recently, Nubank also launched digital, direct to consumer asset-backed personal loans, and other players have similar initiatives. It is worth mentioning that clean credit and asset-backed personal loans are one of the incumbents' largest contributors to NII, at around 30%. As new entrants achieve scale here, we should start to see a similar pressure begin to build as we have seen in other areas — slowly at first, then suddenly.

Disaggregating Profitability Deterioration

In addition to the competitive headwinds, regulation has already played a prominent role in compressing overall profitability in the Financial Sector. The Central Bank's influence has been felt both indirectly, by facilitating new entrants and therefore spurring competition, and more directly by specifically limiting profitability of certain products – for example caps on debit card interchange (Oct/2018) and account overdraft interest charged (Jan/2020), and the extinction of "overhedge" (Jan/2021)[12] were all structural profitability inhibitors. Likewise, the introduction of PIX (Nov/2020) organically drove compression in TED and DOC bank transfer fees (and even eliminated them in some cases). The Brazilian Congress also increased bank income taxes to 45% (Mar/2020) vs. 40% in 2019.[13] Finally, the Conselho Nacional de Previdencia Social has imposed caps on spreads in asset-backed payroll loans, which have been compressing for quite some time now.

Spread on Asset Backed Loan Origination via INSS[14]



Sources: Absoluto Partners, Conselho Nacional de Previdência Social.

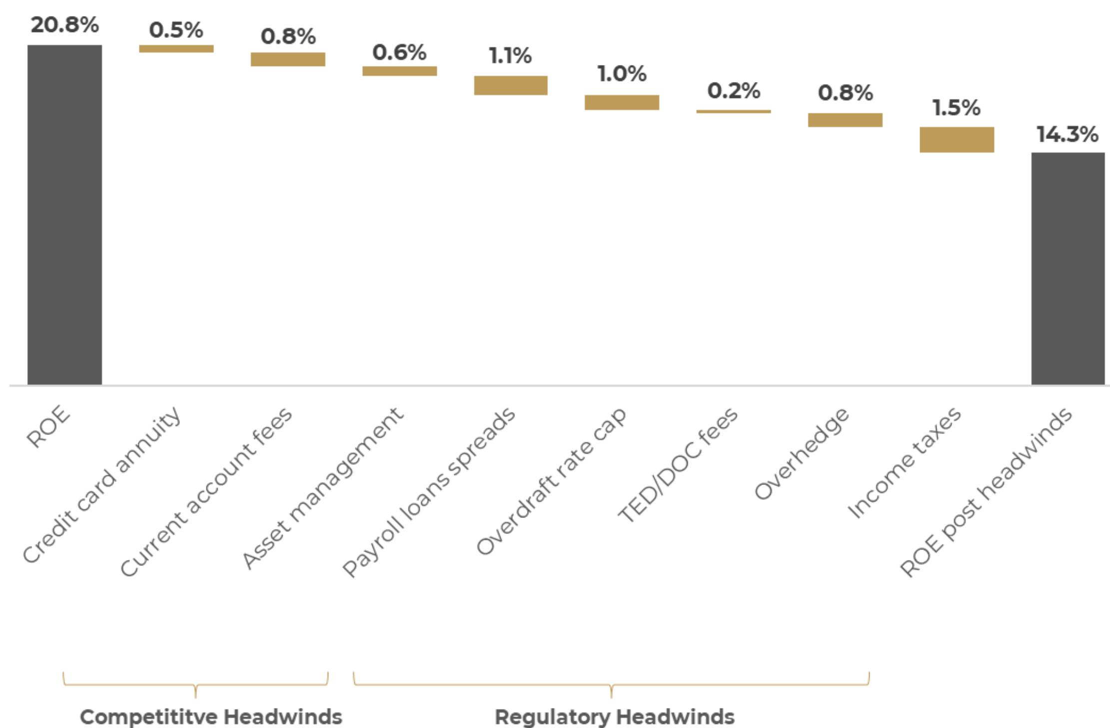
[12] The extinction of overhedge was phased, with 50% of the arbitrage eliminated in Jan/2021 and 50% in Jan/2022. Overhedge resulted from not taxing FX hedging of bank's shareholders equity denominated in foreign currencies, while the impact of FX on shareholders equity was to be taxed. As a result, the amount necessary to hedge was far superior (up to ~1.9x) than the amount effectively hedged such that the FX impact on net income was neutral. The banks therefore benefited from a gain on the spread between CDI and this FX hedging delta over shareholders equity in foreign currency, incentivizing them to allocate the maximum amount possible of their shareholders equity in USD. This practice was banned after MP930/2020.

[13] The tax rate of social contribution over net income (CSLL) of the banks was increased temporarily from 15% to 20% between Dez/2025 and Dez/2028, returning to 15% in Jan/2019. In Nov/2019, Congress again approved the increase of the rate to 20% beginning at the end of Feb/2020

[14] Spread of asset backed payroll loans for retirees in the INSS system is estimated by taking the difference between the maximum rate by the Conselho Nacional de Previdência Social and the 2 years forward interest rate curve.

Taking into account the various competitive and regulatory pressures detailed above, we believe that between 6% and 7% of incumbent banks' ROE has been structurally impaired in just the last few years. In the graph below, we present an exercise illustrating where we view the banks' 2019 net profit excluding revenue lines listed above which we deem no longer viable on a go-forward basis. For lines that have only been partially removed from the P&L, such as annual credit card and bank account fees, we consider their present contribution instead of 2019 actuals. Furthermore, we have not considered all of the headwinds mentioned throughout this letter, such as market share losses in different products.

ROE Evolution of Private Sector Banks[15]



Sources: Absoluto Partners, Company Filings

While we believe the above analysis directionally illustrates the structural profitability headwinds faced by incumbent banks, this is of course not an exact science. We understand there are some misconceptions as it relates to the banks' profitability compression. While we concede that some players are indeed suffering from transitory factors during this stage of the cycle, such as credit quality and pressured ALM[16] results, we firmly believe that this decline in profitability is predominantly recurring in nature and that the majority of the ROE detractors listed above will not be recovered going forward. As transitory headwinds begin to abate, we think the banks will start to run out of excuses, as reported profits will remain low and the aforementioned structural headwinds will become more apparent, surprising many stakeholder and requiring a more thorough re-examination of the incumbents' strategy. In fact, we believe that recent changes in top management at one of the largest private banks is a testament to this dynamic.

[15] In the customer bank account detractor line from ROE, we remove the contribution of TED/DOC in order to avoid double counting with PIX's impact.

[16] ALM (Asset and Liability Management) results are negatively correlated with declines in the SELIC interest rate, as a relevant part of this business has assets mainly in fixed interest rates, while the liability side is based on floating rates. Certain banks eliminate this exposure via hedging.

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What Now?

For a few years now, the commonly accepted wisdom has been that the banking sector would offset any challenges with fee increases or by widening spreads to the consumer – indeed that has often been the case historically. In other words, the sector is viewed as having strong pricing power and thus returns on equity have tended to converge to historical levels. Today however the situation is quite different, given that the underlying headwinds are competitive and structural, rather than cyclical in nature. Regulatory actions have an even more pronounced impact given banks can no longer simply raise prices. In other words, we will no longer see mean reversion in incumbent banks' ROE as we have in the past.

Since pricing is no longer a tool, banks will have to rely on cost reduction to offset these various pressures. In our last letter, which we entitled "It's About the Cost," we detailed how Nubank's principal competitive differentiation lay in its leaner, more efficient cost structure, which has now become a threat to the incumbent banks. Nubank's annual cost base is around R$10Bn, while that of Itaú's retail banking unit (which we consider to be the most efficient among the incumbent banks) is closer to R$40Bn.[17] Despite NU having only a quarter of Itaú's cost base, both banks have a similar number of customers, while Nubank has nearly 2x the account holders of Itaú.

"We believe Nu's investment thesis can be defined as a "cost play" rather than a "revenue play" – its success comes from capturing a share of the revenue pool at significantly lower incremental cost than incumbents. This unit economic cost advantage is then passed through to customers, allowing Nubank to offer more attractive prices and a significantly differentiated value proposition, which in turn drives market share and creates a virtuous cycle."

Absoluto Partners, It's about the cost, Annual Letter, 2022.

This situation we're seeing in the retail banking segment reminds us of a similar dynamic we observe in the commodities sector. New entrants are the "lowest cost producers", enabling them to offer a lower price for the same product than the incumbents. These lower prices are then translated into scale gains. Hence, the "high cost producers" are ultimately unable to match these lower prices, leaving their business models more vulnerable to economic cycles and even the risk of being competed out of the market altogether. Reducing cost, therefore, becomes a matter of survival.

[17] 3Q23 numbers annualized. Itaú's retail banking operation does not consider asset and wealth management and investment banking, whose revenues can sometimes be tied to retail baking distribution and are business units which Nubank has exposure to as well, albeit much more limited. Nubank's cost base includes Mexico and Colombia operations, which comprise 20% of the company's full time employees.

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To quantify the magnitude of cost cuts necessary to recover the sector's lost profitability, we start with the cost base of the three main private banks which is around R$150Bn. Considering their pre-tax income stands at around R$85Bn, every 1% of cost reduction drives nearly 2% increase in net income. In other words, a 5% reduction in costs would lead to 1 percentage point of ROE impact on average for the sector. **Assuming 6 percentage points of structurally impaired ROE as our baseline (detailed above), the implied level of necessary cost cuts is on the order of 20-30%.** A herculean task.

As a starting point, the material reduction in foot traffic to traditional bank branches presents opportunities for efficiency. We have recently heard from various executives at the different incumbent banks that foot traffic is down ~50% and transactions at bank tellers are down ~90% in the last two years alone. In theory, the lower need for physical touch points in an increasingly digital world allows for significant optimization of today's branch footprint, without any meaningful consumer backlash.

The flipside is as digital banking becomes more prominent, the quality of the digital experience will become central to attracting and retaining customers. This trend favors digitally native neobanks who offer a superior app user experience. Moreover, reducing the branch footprint removes a legacy competitive advantage the banks had, especially among those segments of the population that still value physical interactions with their banks. Closing bank branches should stimulate digitalization even further, driving a virtuous cycle where branches become less and less important.

While large scale branch closures will be a key part of cost cutting initiatives, this lever alone will not be sufficient to right size the cost bases. For instance, we estimate that the direct cost of operating a bank branch is on average R$1Mn-2Mn annually, comprised mainly of up to two administrative employees, rent and depreciation, security and funds transportation (we are not considering client facing roles in this analysis, as we assume they continue serving customers through digital channels). **Therefore, depending on the bank, the potential cost reduction attributable to bank branches represents only 5-15% of the total incumbent bank cost base, which while an important step, is insufficient to reduce today's cost base by an adequate amount.**

The private banks have already talked to the importance of bank branch efficiency for several years, with the number of branches declining ~20% since 2019. Their overall cost base, however, has not followed this trajectory – in fact the private banks' cost base has increased 12.7% since 2019, which although below cumulative inflation of 27.8% over the same period, is not even close to a nominal reduction. It is therefore necessary to look beyond the "low hanging fruit" of branch closures.

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Additionally, reducing the cost to serve faces various challenges. Firstly, a majority of incumbent banks' employee bases are unionized, and therefore require annual salary increases above inflation and make layoffs more difficult. Banks also face several labor and civil lawsuits which have become recurring cost items. Let's not forget banks will still have to continue to invest just to compete in the increasingly digital operating environment we find ourselves in, illustrated by Itau's nearly R$4Bn annual capex wit technology. On a related note, the banks have begun to capitalize various R&D investments which will lead to elevated amortization expenses in the coming years.

Safe to say, a cost base overhaul of this magnitude will not be without its complications. Given the urgency to cut cost, banks run the risk of cutting into the "meat" of their business and impacting the customer experience. Given the risk of impacting operating results, there will likely be a degree of inertia as well – and we believe certainly players may choose to "kick the can down the road", accepting inferior returns in the meantime.

Given the challenges of these tasks, it will be especially important to appropriately align management incentives with longer term results and to arm them with the ability to take the necessary actions. If not, indiscriminate cost reduction could diminish the banks' competitiveness, resulting in further losses in market share, profitability, and lead to even further need for cost cuts in the future. This risk is exacerbated by the increasingly competitive environment, with neobanks gaining ever more scale and entering even more relevant incumbent bank profit pools, where they are underpenetrated today.

The Issue of Low and Middle Income Segments

The issues above are not felt uniformly across the banking sector. Competitive pressure and the urgency to cut cost is particularly acute in the low and middle income retail banking segments, where neobanks have achieved an outsized level of success. We believe profitability erosion has been outsized in these segments, specially low income, while high income, SMB and wholesale banking have proven more insulated. Related, we have seen a much sharper decline in the profitability of non-account holders of the incumbent banks, where there is no principality advantage, and such customers also over-index to lower income tiers.

Itaú discloses a more detailed picture of its retail and wholesale banking operations, which enables us to examine the subject closer. While wholesale banking ROE (ex.Latam) grew from 20-25% through 2019 to 30-35% today, retail ROE fell from 30-35% through 2019 to 15-20% today. Removing SMB results from the retail banking number, we estimate that the ROE for retail banking for individuals has been below 10% since the beginning of 2022. Within this number, we estimate a still favorable ROE for high income clients, which in turn implies a worse, potentially negative return for middle and low income customers. It is worth remembering that Itaú has the highest profitability among the private banks, meaning the other banks could possibly be seeing even worse results in retail banking.

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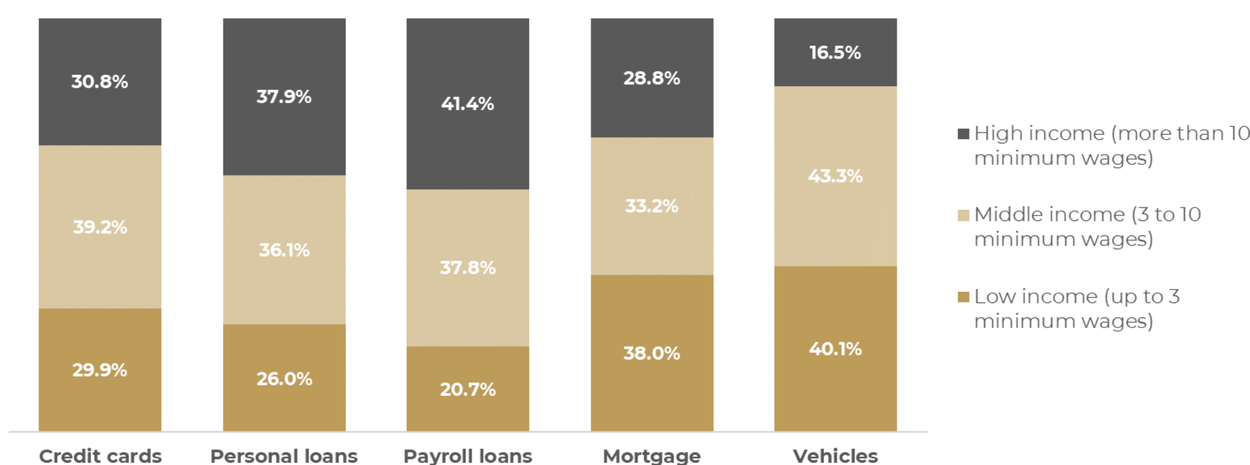
For context, the middle and low income tiers of retail banking are very meaningful to the incumbent banks' overall credit portfolio, with low income (defined as 1-3 minimum monthly wages) representing over 35% of the portfolio and middle income (3-10 minimum monthly wages) over 40%. Both these segments still benefit from soon to be extinct practices, such as charging account and credit card fees.

Credit Portfolio Mix of Brazil's Largest Banks, by Income Segment



Sources: Absoluto Partners, BCB.

We therefore believe that there is an even greater urgency for change within the low and middle income segments of the incumbent banks' businesses. Given the size of these operations within the banks, as well as their relevance to the overall cost base, we should see transformational changes in the banks as a whole.

Implications for Our Investment Process

In summary, we believe that the changes in the competitive and regulatory environment detailed above, and the accompanying impact on the entire financial sector's profitability outlook, will result in the incumbent banks embarking on inevitable cost cutting at an unprecedented level. These structural changes should prove to accelerate the transformation of the entire Financial System, impacting several different groups:

I. Incumbent banks with higher exposure to low- and middle-income segments face the delicate balancing act of reducing cost to serve while simultaneously avoiding a further decline in the value proposition to customers. The near elimination of physical bank branches should accelerate the digitalization of banking, which plays to the neobanks' strengths.

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II. Incumbent banks with larger exposure to high income and wholesale banking operations, although they should also face pressures, should be more resilient. As a result we may see an increasing divergence between each player's operating results – until recently we have seen less disparate returns across companies, but now management competence, use of technology and operating excellence among the different companies will be more important than ever.

III. Digitally native banks should benefit from the accelerated digitalization of traditional banking, which plays well to their competitive advantages. The transformation of retail banking, including the reduction in the number of branches and the upending of the current customer service model, especially for lower and middle income customers, affirms the digitally native bank as the superior business model. This alone is a victory for the neobanks.

IV. Wholesale banking operations and investment platforms should also benefit from the increasing shift to digitalization, which has allowed a more level playing field when it comes to cost of funding. Furthermore, the reduction of banks' physical presence may lead to a weakening of incumbents' client relations. On the other hand, the issues prevalent in retail banking could eventually generate increased pressure on other resilient business units to deliver revenue growth for the banks. For example, this could lead to higher competition and a compression in spreads within wholesale credit.

V. Traditional retailers also possess consumer finance verticals, which help consumers pay for goods. These might be impacted by the issues discussed above, especially given the difficulty these consumer finance operations have in obtaining banking principality (also important for credit performance). While many of the retailers' lower and middle income customers used to only access credit for purchases through the retailer's own consumer finance operation, neobanks offer often superior solutions that result in a stickier banking relationship. In addition, as the digital banking experience becomes more robust, the advantage of stores as physical touch points with the consumer increasingly diminishes, just as with bank branches.

As mentioned in our 2019 letter, we remain vigilant following all these changes in the Financial Services landscape. We have sought to reflect this in our investment portfolio, preferring companies that are relatively better positioned in light of the ever fluid environment – never thematically, rather organically through the course of our bottoms-up investment process.