NORTHCAPE CAPITAL

Global Emerging Markets

# A Letter from Brazil…

During our recent visit to Brazil, we observed that industry consolidation is enhancing pricing power and returns for a select group of high-quality companies on our Approved List, even as the broader macro environment remains challenging. Persistent underinvestment in infrastructure and constrained public finances continue to temper the outlook, leading us to remain selective in our Brazilian exposure and to maintain a higher allocation to Mexico, where the fundamentals are more compelling.

In December, the Northcape EM team travelled to Brazil to visit companies and meet with analysts and political and economic experts. We met companies in São Paulo and Rio de Janeiro. Unfortunately, our plans to travel to Navegantes were thwarted by travel disruptions, which laid bare the poor state of Brazil's infrastructure (more on that below). In this write-up we focus on:

- How industry consolidation is improving pricing power and returns on capital for our Brazilian holdings,
- The causes and implications of Brazil's prolonged underinvestment in infrastructure, and
- Why we favour Mexico over Brazil from a macro perspective, reflected in our significantly higher portfolio weighting to Mexico.

## Industry consolidation is driving price power and higher return for Brazil's market leaders

Corporate meetings in Brazil reaffirmed the trend we have observed across the emerging markets: ongoing industry consolidation in a higher cost-of-capital environment is allowing market leaders to take share from weaker, second-tier players. This dynamic was evident across our key Brazilian holdings.

### MercadoLibre – scale, stickiness and consolidation at work

MercadoLibre (Northcape EM Approved stock) is Latin America's leading e-commerce and fintech platform, supported by a large and engaged user base and an integrated ecosystem spanning marketplace, payments and logistics. Its market leadership is underpinned by scale, a strong logistics network, a broad product offering, and deep integration between payments and commerce, reinforced by a first-mover advantage.

MercadoLibre's continued investment in logistics has improved delivery times and service levels, strengthened the user experience for both buyers and sellers, and increased platform stickiness – further entrenching MercadoLibre as the default regional platform as weaker competitors struggle to keep pace.

After reducing free shipping eligibility from BRL $79 to BRL $19 (AUD ~$5), MercadoLibre has been more competitive in lower-value items (where rival Shopee has historically been strong), while also lifting utilisation across its network. The pressure on the competition of this move is becoming evident, with Shopee raising its service fees for individual sellers from BRL $5 to BRL $7 (AUD ~$2) per item sold early in 2026 – highlighting the strain on smaller players as scale economics increasingly matter.

MercadoLibre's management indicated that competitive responses from Amazon in Brazil, announced in 4Q25, have had limited impact.

Amazon's decision to reduce fulfilment fees has not materially shifted seller behaviour, as merchants remain reluctant to allocate inventory to a platform with only modest ~10% market share. By contrast, MercadoLibre's dominant ~40% share and dense fulfilment network underpin high seller stickiness that competitors have struggled to replicate, even with significant investment.

Despite strong growth in recent years, e-commerce penetration in Latin America remains relatively low and well below more developed markets, leaving a long runway for growth. In a consolidating market with high fixed costs, MercadoLibre's scale, logistics density, and ecosystem breadth position it to continue taking share while reinforcing its pricing power and returns over time.

## Rede D'Or – a scale winner in a consolidating healthcare market

Rede D'Or (Northcape EM Approved stock) is Brazil's leading private hospital operator, with a network of nearly 80 hospitals nationwide. Hospitals are becoming increasingly capital- and technology-intensive, creating a growing barrier to entry that favours scale players like Rede (see Exhibit 1). Smaller hospitals are often unable to invest in advanced medical equipment and digital infrastructure, which is steadily driving both doctors and patients toward larger hospital chains like Rede.

Brazil's hospital market remains highly fragmented. The average hospital has around 30 beds and is often privately owned by a doctor or family, while meaningful efficiency gains tend to emerge above 100 beds, with the most efficient hospitals operating at up to ~500 beds.

**Exhibit 1:** Tour of Rede's Copa Star hospital in Rio de Janeiro (Source: Northcape Capital)


We heard from Rede's management team how the economics of consolidation are extremely compelling. As Brazil's largest purchaser of medicines and medical equipment, Rede benefits from meaningfully lower procurement costs than its acquisition targets, which typically translate into a material margin uplift post-acquisition. Further efficiencies are realised through scale and centralisation, with Rede's overhead structure substantially leaner than that of smaller hospital groups.

Rede's scale is also reinforcing its pricing power. Smaller hospital chains and standalone hospitals are often not strategically important to leading health insurers and are therefore forced to offer discounts to gain access to insurer panels. In contrast, Rede's scale and network breadth make it a core partner for insurers, supporting structurally better pricing and bed utilisation.

Rede D'Or also benefits from Brazil's constrained public finances. The country faces a chronic shortage of hospital beds, while the government lacks the fiscal capacity to meaningfully expand public healthcare infrastructure, increasing reliance on the private sector and maintaining relatively light regulation.

Australian readers may associate private hospitals with high-income earners, but in Brazil the addressable market is far broader. Given the poor quality and capacity constraints of the public healthcare system, private hospitals serve much of the formally employed population – ranging from President Lula to school teachers.

Despite its scale, Rede still holds only around 5% market share in a large and gradually consolidating market. With demand supported by one of the fastest-ageing populations in emerging markets, we believe the company remains well positioned to compound returns through continued consolidation, its scale-driven cost advantages, and sustained pricing power.

### America Movil – structural winner of Brazilian telco consolidation

America Movil (Northcape EM Approved stock), whose Claro unit is a close #2 mobile operator in Brazil behind Telefónica's Vivo. Brazil represents around 20% of America Movil's overall revenue and EBITDA.

Since 2020, the Brazilian telecom market has consolidated from five players to three, following Claro's acquisition of Nextel and the subsequent break up of Oi, whose assets were acquired by Vivo, TIM and Claro in 2022. This consolidation has materially improved industry discipline.
The result has been steadily rising ARPUs, expanding EBITDA margins, improving returns on capital, and lower churn across the remaining incumbents. When we met with Vivo's management in São Paulo, they highlighted that the more rational market structure should support mobile ARPU growth remaining above inflation over the medium term.

Meanwhile, pricing remains highly affordable – monthly mobile ARPUs in Brazil are roughly equivalent to a McDonald's meal or a few coffees – while demand has proven resilient, with consumers often prioritising mobile bills ahead of other utilities like electricity or gas.

The consolidation dynamics are set to extend into fixed broadband, where over 1,000 small operators remain. In a higher cost-of-capital environment, many of these sub-scale players are increasingly financially constrained. America Movil management noted that rising interest rates are beginning to pressure weaker operators, accelerating share gains for the well-capitalised market leaders such as Claro and Vivo.

### Itaú Unibanco – prioritising sustainable returns over headline market share

The picture is more nuanced investment thesis for Itaú (Northcape EM Approved stock). While Itaú remains the country's largest bank by assets, the sector has been disrupted by the rapid and aggressive expansion of Nubank in recent years. Importantly, outsized market share gains in banking do not always signal strength – they can reflect growth in lower-quality or economically unattractive segments.

Nubank has been the primary share gainer in the retail segment, growing from a niche challenger to over 100 million Brazilian customers in a short period of time. This expansion has coincided with a sharp increase in the number of credit cards in Brazil, rising from around 200 million in 2019 to more than 400 million today, equivalent to roughly four cards per creditworthy adult.

Incumbent banks view this credit expansion, particularly in lower-income cohorts, as structurally unsustainable. Nubank's aggressive approach has prompted Itaú to deliberately scale back exposure to this segment, with management telling us, "It is not a sustainable dynamic." Bradesco echoed this view, noting that Nubank is "playing another game" – prioritising rapid customer and balance sheet expansion over near-term asset quality discipline. Both banks believe that the rapid build-up of credit card debt among lower-income consumers will ultimately result in higher delinquencies, and the debt service ratio of Brazilian households has increased to 30%.

As a result, market share gains in isolation are not a sufficient measure of success. In banking, long-term value creation depends on disciplined underwriting, stable funding, and sustainable returns – areas where incumbents like Itaú are focusing on protecting profitability rather than chasing growth at any cost. Indeed, Brazil's leading lender has maintained an ROE in excess of 20%.

## Infrastructure: A tale of two cities

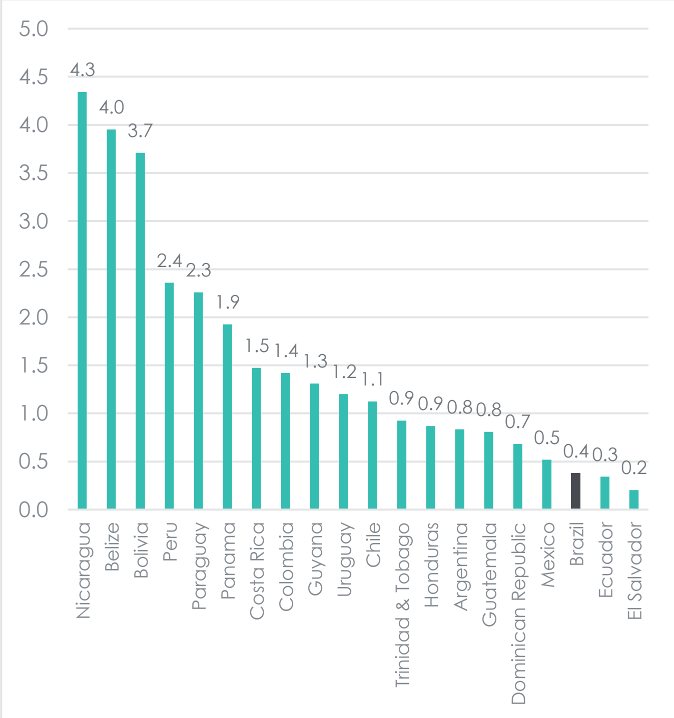
In last month's newsletter, we highlighted the profound transformation in India's physical infrastructure over the 18 years we have been visiting the country. This progress reflects a sustained national commitment to investment – with India now spending around 4% of GDP on infrastructure – which is increasingly supporting productivity gains, through improvements in urban mobility, and lower logistics costs.

On each visit to India's major cities, we continue to encounter new projects that are reshaping travel patterns and easing long-standing bottlenecks. In Mumbai alone, our team's November trip allowed us to see firsthand the benefits of the Sambhaji Link, the expansion of the city's metro network, and ongoing upgrades to airport and road infrastructure that are materially improving connectivity across the metropolitan area. Shortly after our visit, the city's second airport, Navi Mumbai International Airport, was opened.

In contrast, São Paulo's infrastructure appeared largely unchanged to members of our team returning to the city for the first time in more than six and eight years, respectively.

This observation is borne out by the data, which shows that Brazil has long underinvested in its infrastructure. While the country has modestly increased total infrastructure spending in recent years to around 2% of GDP, public sector investment remains exceptionally low at approximately 0.4% of GDP – higher only than Ecuador and El Salvador among countries in Central and Latin America (see Exhibit 2). This is a strikingly low ranking for the region's largest economy, particularly when set against India's materially higher and more sustained investment effort.

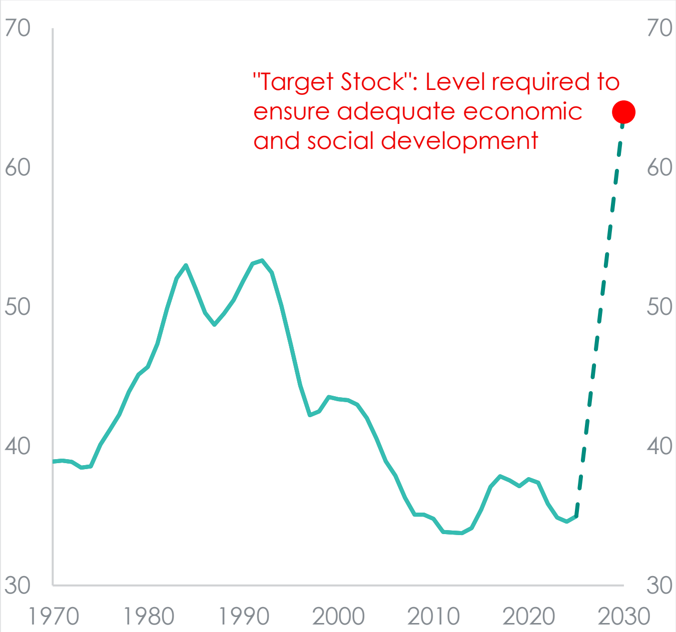
**Exhibit 2:** Public investment in infrastructure (% of GDP) – 2019-23 average (Source: Infralatam)




The core constraint here is the rigidity of Brazil's public finances. With around 90% of the federal budget pre-committed to wages, pensions, and transfer payments, there is little left over for discretionary spending on infrastructure investment.

As a result of more than three decades of underinvestment, Brazil's infrastructure capital stock has been in secular decline since the early 1990s and has remained stuck in a 35-40% of GDP range since the mid-2000s – well below the level required to sustain productivity and long-term economic and social development (see Exhibit 3). This prolonged underinvestment has significantly aged Brazil's infrastructure base, with a large share of existing assets now 30-40 years old. Reflecting this deterioration, the bulk of Brazil's current infrastructure spending is absorbed by maintenance rather than growth: in 2024, an estimated 62% of total infrastructure investment was required simply to offset depreciation of existing assets, limiting the economy's ability to meaningfully modernise or expand its infrastructure stock.

**Exhibit 3:** Brazil's capital stock as a % of GDP (Source: Carta de Infraestrutura, Inter B)




### First-hand experience of infrastructure fragility

We experienced the consequences of this underinvestment directly during what was intended to be our final day in São Paulo. A storm the previous day, driven primarily by elevated winds rather than extreme rainfall, triggered widespread disruption across the city.

Power outages were extensive, reflecting an electricity network heavily reliant on above-ground transmission. As a precaution against damaged lines, large areas of the city were taken offline. The loss of power quickly cascaded into water supply disruptions, with pumping systems unable to operate.

São Paulo's transport networks were also materially affected. Fallen trees blocked several major roads, leading to severe congestion. Although we were able to reach meetings within a concentrated area of the city (albeit one corporate had to meet us in a shopping mall as the power in their building was out!), it took our driver more than three hours to return home.

The disruption extended to air travel, with flight delays and cancellations persisting for several days and ultimately preventing our onward travel to Navegantes for a company visit. São Paulo's Congonhas Airport, opened in 1936 and only incrementally upgraded since, was visibly strained by the disruption (see Exhibit 4).

Taken together, these experiences underscore a broader structural issue: decades of insufficient investment have left Brazil with an ageing and brittle infrastructure base, with limited redundancy. This fragility acts as a persistent drag on productivity and resilience, and stands in sharp contrast to EM peers that have prioritised infrastructure as a foundation for long-term growth.

**Exhibit 4:** Travel chaos at Congonhas Airport (Source: Northcape Capital)


### Brazil vs. Mexico: A divergent macro and political outlook

Brazil is Latin America's largest economy and carries the highest weighting in the MSCI EM index. Despite this, the Northcape EM strategy has long maintained a materially higher allocation to the region's second-largest market: Mexico. As at 31 January, Mexico accounted for 26% of the portfolio, compared with 7% for Brazil. While the rationale for this positioning is multifaceted, the following section highlights some of the key factors, incorporating insights from our recent on-the-ground visits to both markets.

We would remind readers that our country weightings are not set top-down. Rather, they result from the interaction between our sovereign risk assessment – which determines each market's unique cost of capital – and our bottom-up company modelling. Within this framework, we find Brazil offers a number of businesses that continue to generate strong free cash flow even in a high-rate environment (as profiled above).

### 1. The Brazilian election outcome remains uncertain

Based on our discussions with experts and companies in Brazil, it is too early to call the Brazilian election. While some private-sector participants and analysts had hoped a right-wing candidate could unseat Luiz Inácio Lula da Silva, thereby alleviating concerns about Brazil's public debt-to-GDP trajectory, the political landscape remains fluid.

The incumbent president remains reasonably popular, as the Brazilian economy has managed to 'muddle through' with real GDP growth of 2-3% since Lula commenced his current term at the start of 2023, and both inflation and unemployment are nearing 5% – both relatively low levels by Brazil's standards.

Denting the right's prospects in the run-up to Brazil's 2026 presidential election is the continued shadow of former president Jair Bolsonaro's legal troubles. Bolsonaro remains barred from holding office, limiting his ability to campaign directly, while public opinion toward the Bolsonaro family remains sharply divided following the January 2023 attacks on government institutions in Brasília.

In response, Bolsonaro has endorsed his eldest son, Senator Flávio Bolsonaro, as the Liberal Party's presidential candidate. While Flávio's candidacy preserves the family's influence on the right, it also complicates efforts to unify the conservative bloc, particularly as figures such as São Paulo governor Tarcísio de Freitas have signalled they are unlikely to run. Experts we consulted in December viewed de Freitas as a more "pragmatic" option for the right. Current polling suggests Flávio currently lags President Luiz Inácio Lula da Silva, though the race remains far from settled, and the right retains a sizeable, motivated voter base heading into the campaign.

By contrast, political certainty is much higher in Mexico with President Claudia Sheinbaum set to remain in power until 2030.

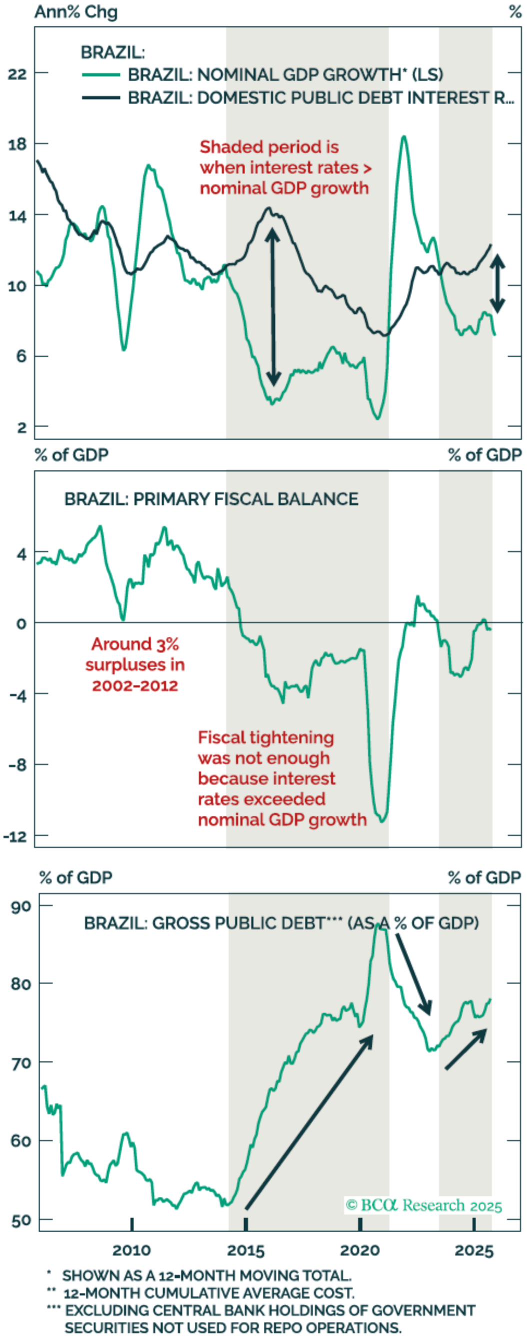
### 2. Brazil's fiscal dynamics are materially worse than Mexico's

Brazil has one of the highest public debt-to-GDP ratios in emerging markets, at around the mid-70% range, compared with around the mid-40% range in Mexico. Successive Brazilian administrations have failed to stabilise this debt burden – thwarted by adverse debt arithmetic which is reinforced by structural political constraints.

For any highly indebted country, stabilising the debt ratio requires either sustained and sizable primary surpluses, and/or nominal GDP growth running meaningfully above borrowing costs. Exhibit 5 shows that neither condition has been met since 2014 in Brazil, explaining the persistent upward drift in the country's debt ratio, outside of a brief period in 2021-22 when nominal GDP surged amid pandemic area fiscal stimulus and a commodity price boom triggered by the war in Ukraine.

Today, the gap is unfavourable. Nominal policy and borrowing rates remain around 13%, while nominal GDP growth is closer to 7%, implying a large and persistent interest-growth differential. This gap is unlikely to close organically given Brazil's structurally weak productivity growth and reversing demographic tailwinds, both of which cap the economy's growth potential.

**Exhibit 5:** When interest rates are above growth, Brazil's public debt-to-GDP ratio rises (Source: Central Bank of Brazil, BCA Research)




Under reasonable assumptions (real growth of around 2% and real borrowing costs of roughly 5%) economists estimate that Brazil would need to run primary surpluses of roughly 2-3% of GDP on a sustained basis simply to stabilise the debt ratio. This looks unrealistic, particularly amidst an election cycle and in a fiscal system where around 90% of spending is effectively fixed, leaving very limited scope for discretionary adjustment.

Thus, Brazil's public debt dynamics remain structurally pressured, and neither the current administration nor a future market-friendly government is likely to deliver the scale of adjustment required to materially change the outlook.

In contrast, Mexico has a much stronger fiscal starting point and far more benign debt arithmetic. Public debt stands at around 46%, and its fiscal policy has been orthodox, even through recent political transitions. The Mexican government is expected to run small primary surpluses in each of 2025 and 2026, which is forecast to be sufficient to stabilise, and potentially modestly reduce, its debt ratio given the country's lower borrowing costs.

### 3. Mexico's external position is structurally stronger

Mexican external accounts are strong, with the current account and trade balance broadly in balance. The economy's external resilience is underpinned by improving trade dynamics and sustained FDI inflows, driven by the near-shoring trend and Mexico's deep integration with the US economy. As global firms reconfigure supply chains away from Asia, Mexico has emerged as a primary beneficiary due to its geographic proximity to the US, preferential trade access, and established manufacturing base. Mexico also enjoys among the lowest effective US tariff rates.

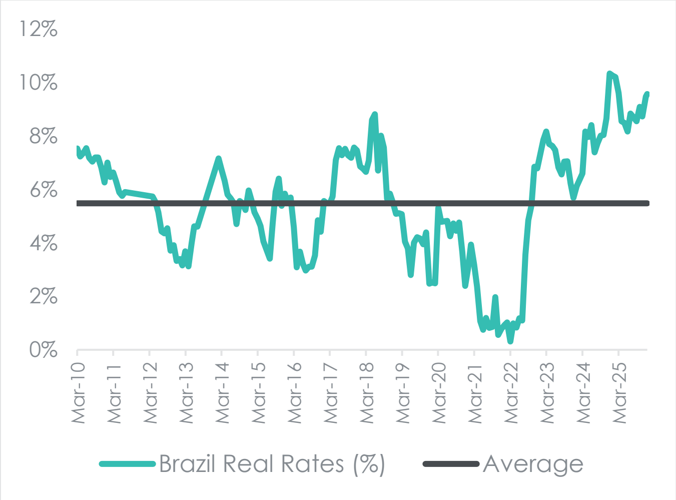
By contrast Brazil's current account deficit, at around 3%, is one of the larger in EM, leaving the Brazilian Real highly vulnerable to external shocks and foreign capital outflows. Because Brazil is running both a large external deficit and a widening fiscal deficit, it must keep interest rates high to attract foreign capital.

### Why are we still slightly overweight Brazil?

Despite the ongoing macro and political headwinds, the Northcape EM strategy remains selectively overweight Brazil. This reflects our view that a small number of high-quality Brazilian businesses are materially undervalued, even after applying our very high Brazilian cost of capital to account for elevated country risk.

Further, we note that real interest rates in Brazil remain near record highs – approaching 10% versus the long-run average of ~5.5% (see Exhibit 6), reflecting a prolonged period of restrictive monetary policy aimed at anchoring inflation expectations, and preserving central bank credibility. Whilst nearly every other major central bank commenced easing in 2025, the Brazilian central bank continued to hike taking the Selic rate to 15%.

**Exhibit 6:** Brazil's real interest rates are near historic highs (Source: Bloomberg Finance LP)




Given bond yields in Brazil currently sit at 13-14%, Brazilian domestic investors are materially underweight local equities, with capital instead allocated to fixed income. As the CFO of Brazilian stock exchange B3 lamented to us in São Paulo, "it is unfair competition…why bother buying stocks, even if they are undervalued, if you can buy a risk-free asset paying real rates of 8%?"

Thanks to the Brazilian central bank's strong independence, inflation has eased to 4.3% as of December 2025 – a historically low level. While this remains above the formal target, companies we met in Brazil view current inflationary pressure as low, and the central bank is expected to resume interest rate cuts this year.

As Brazilian domestic fund managers typically operate with absolute return hurdles linked to real interest rates, a sustained decline in real rates could prompt a sharp rotation out of fixed income and into equities, resulting in a continuation of the re-rating of the market from the early 2025 lows. We note the Brazilian market has one of the strongest correlations to lower rates among emerging markets.

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