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The main positive contributions in 2017 came from investments in Berkshire Hathaway (+21.6% in 2017), Itaúsa/Itaú (+37.8%), Amazon (+55.9%), Alphabet (Google, +35.6%), B3 (+40.9%) and Wells Fargo (+13.2%). Additionally, there were minor contributions from Apple (+48.5%), Danaher (+20.0%), Energisa (+50.5%), Anheuser-Busch InBev (+9.7%), Thermo Fisher (+35%), Goldman Sachs (+7.7%) and Nike (+24.7%).¹ The last three positions have already been closed.

One of the few detractors – the only significant and by far the largest – was Panvel. After rising by a hefty 132.2% in 2016, shares fell by 40% in 2017, resulting in a negative contribution of 6.3%² to IP-Participações during the year.

PANVEL (DIMED)

Despite the drop in 2017, Panvel has appreciated by 39% in the past two years. The stock price volatility contrasts with the stability of the business, which has been recording consistent and improving results.

As mentioned in previous reports, the lower liquidity and share price volatility, although an inconvenience, do not prevent us from participating in the evolution of the business. Panvel is a high quality asset with highly predictable results and a long runway for growth over the coming years. Moreover, there is always the possibility that the low liquidity may be mitigated in the future.

IP-Participações' cumulative returns in 2016 and 2017 were 64.4%. Hypothetically, if we could smooth out

the effect of Panvel's stock volatility during those years, the fund would have risen by 28.2% in 2016 and 28.2% in 2017, instead of 49.3% and 10%, respectively.

The good news is 2018 starts with shares trading at a rather attractive level. At R\$400 per share, the company trades at an estimated sales multiple of a mere 0.75 for 2018 – assuming real sales growth will remain in line with the company's results of recent years.

PORTFOLIO

Given the strong share price gains in the last months of 2017, we continued to trim some positions – not without some hesitation.

It has been a pleasure to watch and participate in the value creation of remarkable companies such as Alphabet (Google), Amazon, Itaúsa/Itaú, Berkshire Hathaway, Danaher, B3, Energisa, among others. On the other hand, in some cases, prices have been moving ahead of value. How can one solve this dilemma? Selling is not without its risks. Imagine the bitter regret of investors who were shareholders of Berkshire Hathaway, Amazon, Ambev, Souza Cruz or Itaú 10 or 20 years ago but decided to sell their shares because they became “too expensive”.

Our most common and costly mistake over time has been to prematurely sell investments in extraordinary businesses. The truly exceptional companies often positively surprise us and create more value than we – and a large share of the market – are able to anticipate.

¹ Returns in USD for companies abroad and in BRL for companies in Brazil.

² Total contribution of common and preferred shares.

Over the years, we have adjusted the frequency of our most significant reductions to occur only when market prices truly offset this “risk”.

At the end of the day, we seek balance. As markets show increasing signs of over-heating, our conservative temperament tends to prevail. We have slowly trimmed some investments, increased the funds’ cash and spent slightly more on hedges preparing for a bigger market downturn.

We do not make investment decisions based on macro concerns but, as long-term investors, we are aware that markets are cyclical and are subject to shocks every so often. As such, it is useful to try to “take the temperature” of current market conditions.

Some signs:

- 2017 was the S&P 500’s 9th consecutive positive year. And what a year: +21.83%.
- Nearly a decade of monetary stimulus from the world’s main central banks, with negative real interest rates and some trillions of U.S. dollars injected into the markets.
- Funding costs for companies from developed countries are at a historic low. Bad businesses with access to cheap capital. Bombs ahead?
- The Swiss National Bank manages a portfolio of nearly US\$800 billion in bonds and stocks. Reports

income of US\$55 billion in 2017 – approximately 8% of Switzerland’s GDP.

- A Japanese entrepreneur raises US\$70 billion for a US\$100 billion fund to invest in disruptive technologies – and is already planning another one.
- According to research³, a little over three in every ten workers in South Korea have already “invested” in some type of cryptocurrency.
- Daily variations of 5%, 10%, 20% and even 30% in cryptocurrency prices.
- Over US\$600 billion in market cap for the dozens of cryptocurrencies.
- A Sports bra company changes its name to “The Crypto Co” and shares rise from US\$10 to US\$575, reaching over US\$10 billion in market value, only to fall by 98% to US\$11 in the next few days.
- Art prices reach new records and paintings are sold for hundreds of millions of dollars.
- Most emerging market stock indexes trade near maximum historical levels.

The above message is loud and clear: the world has been swimming in liquidity for a while, with direct and indirect impacts to asset prices. And this will possibly begin to unwind. The Fed has already started to increase interest rates, removing liquidity from the markets. The European Central Bank indicates a similar

³ <https://news.bitcoin.com/31-of-south-korean-workers-are-cryptocurrency-investors/>

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path for 2018. If the ample liquidity had such positive effects on asset prices, how strong will the headwind be if this situation is reversed?

On the other hand, Trump's tax reform will boost results of U.S. companies. This is good news for our investments in Berkshire Hathaway and Wells Fargo, not only given the lower taxes they will incur but also the possible secondary effects from the reform (slightly higher interest rates?). In any case, we are not convinced these tax cuts are sustainable in the long term and are therefore cautious about factoring this benefit into our estimates.

Our investments in Brazilian companies, such as Itaúsa/Itaú, Energisa, B3 and M. Dias Branco continue to report good results and trade at reasonable prices. Nevertheless, we continue to tone down our enthusiasm as we face the country's harsh reality. There is still a lot to be done to put the country on the right track – many risks and uncertainties that will not vanish in the short term – which, in most cases, is not reflected in prices.

CONCLUSION

Despite the slightly more cautious tone of this report, we are pleased with our investments. One of the advantages of investing in truly top-tier companies is that they are accustomed to overcoming obstacles.

Below, we discuss in greater detail one of the companies that has been part of our fund for several

years: Danaher.

* * *

DANAHER

“When I heard, I said Dana-who? We all had misgivings. A US company with no experience in medical instruments; if they bought us, what could they possibly add? All the prejudices about American management style surfaced; brash, political, short-term view, only interested in profits. I heard about the Danaher Business System and thought, this might be real, or it could just be a public relations stunt. We were in for a big surprise.

They took much the same approach as the rest, but a number of things stood out. First, they wanted to talk to customers; this made a lot of sense to us. Then, they insisted on walking the floor of our factories. This we couldn't understand. What did they know about manufacturing medical equipment? We also saw Danaher's CEO, Larry Culp, take a very intense and personal interest in the details of our business. And then there were the questions; endless questions; ten times more than anyone else. The level of due diligence was impressive.⁴

Peter Kürstein, CEO of Radiometer – a company acquired by Danaher in 2003

Some of our clients have the same reaction when we mention Danaher: “Dana-who”? Although unknown to many, its products are often present in people's lives – mostly indirectly, as we will see later on.

⁴ Source: HBS Case Collection – Radiometer, 2013. <https://www.hbs.edu/faculty/Pages/item.aspx?num=47742>

In this report, we decided to share more on Danaher's business model and explain why we invest in the company. Danaher offers a rare combination of positive attributes: (i) businesses with high barriers to entry, (ii) fairly non-cyclical, (iii) a powerful culture of operational excellence, (iv) ownership mindset, (v) good opportunities to reinvest capital (through M&A) and (vi) low succession risk.

But what is Danaher? Like Ultrapar and Berkshire Hathaway, Danaher is a holding company that owns several businesses. However, unlike the previous examples, Danaher's portfolio is concentrated in the scientific and technological fields – products and services that carry a high degree of intellectual property.

Currently, Danaher generates US\$18 billion in revenue

and US\$2.8 billion in net income,⁵ employs 62,000 people and is valued at approximately US\$69 billion.

The holding company is organized into five business platforms, each of which branch out, on average, into four independently managed companies. Each of these businesses is ranked first or second in terms of market share in their respective segments. They are also B2B businesses, essentially catering to specific niches, with low fixed and working capital requirements⁶. Virtually all cash surplus generated by these companies is converted into new acquisitions for the group, in a model similar to Berkshire's.

As shown below, Danaher's five platforms are: Life Sciences, Diagnostics, Water Quality, Product ID and Dental.



⁵ Adjusted by the amortization of intangible assets from past acquisitions. Figures reported in 2017.
⁶ The company's conversion of adjusted net income to cash flow is approximately 100%.

We will not waste our readers' time describing all these companies, but we highlight below some features of their exceptional business models:

- **Most businesses fit the razor-razorblade model, which increases customer loyalty.** Take the case of Beckman Coulter, part of the Diagnostics platform. A blood test taken at a clinic will likely be processed by a Beckman machine. As clients acquire Beckman's equipment, they also purchase the reagents sold by the company to process the exams on a regular basis.
- **The complexity of some production processes hinders the ability to switch suppliers:** The production of biopharmaceuticals, such as vaccines and monoclonal antibodies, requires the use of sophisticated microscopic porosity filters in several stages of the production process⁷. Danaher is the market leader in the supply of these filters through its subsidiary Pall Corp. Given living organisms are an extremely complex product, both the medicine and the production process must be patented and approved by regulatory agencies, which provides important barrier to entry.
- **Nearly 2/3 of Danaher's portfolio is focused on the health sector, which benefits from a long-term growth trend:** An example is Radiometer, mentioned at the beginning of this report, which is a leading supplier of equipment and reagents

for an arterial blood gas (ABG) test. An ABG test checks for severe problems, such as respiratory insufficiency or hyperventilation, and quickly indicates whether the patients' metabolism and blood pH are at adequate levels. Other Radiometer equipment allow hospitals to make quick tests to discover whether patients are prone to heart attacks, for instance.

- **Products are indispensable and represent a small share of the total cost of services or products offered by its clients, which favors higher margins:**
 - Danaher is the world's second largest supplier of dental products and services. Many instruments and materials used by dentists are supplied by Danaher's subsidiaries, including dental drills, restorative material, implants, braces, fluorine, patient chairs and imaging equipment, among others. Unlike hospital materials, which account for a large share of hospital costs, dental materials account for less than 10% of a dental clinic's operating costs.
 - As with other major brands, Coca-Cola, which has several bottling companies and suppliers worldwide, needs to ensure that all soda cans are manufactured in the same shade of red, regardless of the location. To do this, it outsources the control and specification

⁷ The filters remove all the residues inside the cellular structure, leaving only the molecules necessary to fight the disease in question.

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of this process to two Danaher subsidiaries: Pantone and X-Rite. It is an important task for the brand, but with an insignificant impact on the final cost of the product.

In addition to these excellent businesses, Danaher has another important competitive advantage: the Danaher Business System (DBS), the company's management system. DBS is nothing more than a compilation of best corporate practices – a manual on how to efficiently manage a business.

DBS was born with Japanese DNA, inherited from the Toyota production system. At a time when Japan was running circles around the U.S. in terms of manufacturing productivity, Danaher decided to copy them and embrace concepts such as lean manufacturing and kaizen (continuous improvement). Over time, it disseminated these tools to other areas in the organization. It created a strong culture, heavily based on facts and data. For Danaher managers, DBS is the company's main asset and competitive advantage.

With DBS, Danaher's formula has been repetitive: "acquire good niche businesses, apply the DBS system and improve operating results over the years". The Radiometer acquisition is a good example: its operating margin jumped from approximately 20% in 2003 to 30% in 2017, while both revenue and market share growth accelerated.

DBS even provides methodologies on integration and efficiency gains designed to instruct employees

of newly acquired companies. One example is a tool called "value stream mapping". In the first two weeks following the acquisition of Radiometer, for example, the company's 40 main executives were divided into five groups. Each group was asked to analyze the steps in the production process and supply chain of one of its products, and discuss potential inefficiencies. As Peter Kürstein describes, the outcome was unexpected:

"I was truly amazed; my component took 18 days to go through the plant and yet it only took 21 minutes to make. There was waste everywhere! By laying out the process so everyone could see what was going on, we could dramatically reduce the number of production planners and information systems and just get the job done. We took the cycle time down from 18 days to 4. I was born again lean! I see waste everywhere now."⁸

Can a management system be an irreplaceable competitive advantage? What about all the business and strategy books that say otherwise? Don't the management systems of other conglomerates have a comparable level of excellence? There are certainly other companies in the world doing similar things – making intelligent acquisitions and improving operating performance. What makes Danaher special?

A significant difference lies in its origin. Danaher created DBS two years after its inception, in 1986. The company's history is intertwined with the history of its management system. DBS was born from the need to survive at a time when the businesses held by the

⁸ Source: HBS Case Collection – Radiometer, 2013. <https://www.hbs.edu/faculty/Pages/item.aspx?num=47742>

founders – Steven and Mitchell Rales – were of inferior quality than the current ones. The first business to be transformed by DBS was a truck brake company⁹ held by the group. If Danaher had not been efficient or productive in its first years, it would not have been able to become the value creation machine it is today.

In stark contrast to DBS, the vast majority of other management systems were born after the company had already reached critical mass. They arose from different needs: organize the company, extract efficiency gains from acquisitions and develop a standard for integrating future ones. The most famous systems we know – the Honeywell Operating System, United Technologies’ Achieving Competitive Excellence and Thermo Fisher’s Practical Process Improvement – all share these characteristics.

Given its distinct origins, Danaher was able to capitalize on two differentiating factors: depth and standardization.

Depth: As a system launched over 30 years ago, depth is an evident feature of DBS. Among other systems, focus typically lies on productivity gains and higher margins – usually by applying concepts broadly disseminated by consulting firms worldwide.¹⁰ On the other hand, at Danaher absolutely everything is based on DBS methodology and process: HR, sales, logistics, R&D, working capital management, budget control, strategic planning, leadership training, problem solving, learnings from management mistakes,

among others. DBS even includes training on the best approach of potential target companies – a technique called *cultivation*. After acquiring many companies, Danaher’s leaders know that price is not always the key variable to close a good deal.

Standardization: Even with a large number of distinct businesses, all of Danaher’s factories have an operational harmony guided by DBS. A manager of a Water Quality subsidiary is able to understand how a Diagnostics factory operates. All the main flowcharts, management reports and KPIs¹¹ are strictly homogeneous. Obviously, other conglomerates also standardize certain processes, but the habits and legacies of the acquired companies often coexist with current management models.

Another important feature of DBS’s cultural standardization is the presence of senior executives at *gemba*, which in Japanese means “where the work is done”¹², and may be the factory floor, the call center or the R&D workspace. In order to comply with DBS, executives must be present where execution takes place, rather than in their offices.

The core tenet of Danaher’s culture was cleverly described by a former executive officer of the company:

“Danaher is not a corporation. It is a federation of companies operating in a decentralized manner, with leaders managing business under the DBS mantra. Local

⁹ Jacobs Manufacturing Company

¹⁰ Accenture, McKinsey, BCG, Bain, etc.

¹¹ Key Performance Indicator.

¹² Also “the place where virtue or truth can be found”.

managers have autonomy to manage their businesses (and even acquire smaller companies), but everything has to be planned, managed and monitored under DBS."

As such, DBS also aims to achieve a productive balance in what is one of the inevitable dilemmas in large corporations: the conflict between centralized and decentralized decision making.

Every company knows that excessive centralization may lead to bureaucratization and can alienate the front office staff. On the other hand, too much freedom at the business end may result in loss of control and productivity. Large conglomerates, such as GE and ABB, have already made such mistakes: the first erring on the side of centralization and the second on the side of decentralization. As it has ingeniously resolved this with the DBS, Danaher is much more efficient.

Depth, standardization and balance between the center vs. periphery make DBS a unique value creation system and a very tough asset to replicate.

Moving on to the bad news

Throughout Danaher's history, mainly under the management of former CEO Larry Culp, the company skillfully focused its M&A potential on truly outstanding businesses in resilient segments that offer long-term structural growth. In 2015, under the management of current CEO Tom Joyce, the company made another good decision by splitting into two: (1) the current Danaher, focused on the scientific and technological businesses; and (2) Fortive, aimed at

businesses with a more industrial profile.

After the spin-off, Danaher's business became less cyclical, with 65% of revenue coming from consumables (repeatedly purchased by clients) and only 35% from equipment sales. Taken in isolation, this is great. The problem is that exceptional business niches often feature other exceptional companies. Since the superior business characteristics serve all companies, it is not easy to steal market share from incumbents. The new Danaher – scientific and technological – has more businesses in which it is the second largest player than the first.

In the Life Sciences platform, for instance, Danaher faces fierce competition from the main player in the sector - Thermo Fisher – especially for acquisitions. In Diagnostics, Roche is the market leader and has been recording better results than Danaher over the last few years. In the Dental platform, the company competes with a major player, Sirona Dentsply, and two resourceful niche players – Straumann (leader in dental implants) and Align Technology (and its revolutionary Invisalign corrective braces).

Lastly, China's growing importance is both a risk and an opportunity for Danaher – and health equipment suppliers in general. Although it accounts for only 10% of consolidated sales, the Chinese market has represented nearly 1/3 of Danaher's marginal growth. As a result, any macro bumps in China may hurt the company's figures. On the other hand, the market size and demographic trends offer a great long-term opportunity. The risk, in this case, seems more cyclical than structural.

Unleash Potential

But after all, what is Danaher?

From all the answers to this question, the most insightful came from a former executive of the company: *“Danaher is like a ‘United States of companies’ and the U.S. Constitution would be something equivalent to DBS”.*

While the U.S. Constitution is a set of rules meant to

unleash human potential¹³, DBS and Danaher consist of a system designed to unleash business potential. Who would have thought that operational excellence and execution could be lasting competitive advantages?

To conclude, below are some figures that show Danaher’s impressive development.



¹³ As noted by Warren Buffett in Berkshire’s 2016 Annual Report.

MISCELLANEOUS

“A bull market is like sex. It feels best just before it ends.”

– **Warren Buffett**

“Cash is like oxygen. When you don’t need it, you don’t notice it. When you do need it, it’s the only thing you need.”

– **Warren Buffett**

“Bitcoin, art, wine, equities, credit... you name it. Everything is one way up. And there’s huge distortions taking place and it’s all in the name of this 2% inflation target. And when you get a misallocation of resources, it really hinders growth over the longer term.”

– **Stanley Druckenmiller**

“Early Americans, we should emphasize, were neither smarter nor more hard working than those people who toiled century after century before them. But those venturesome pioneers crafted a system that unleashed human potential, and their successors built upon it.”

– **Warren Buffett**

“As we pursue our objective of becoming the most-innovative and lowest-cost manufacturer of the products we offer, we are seeking a market position with each product that is either first, second, or within a very distinctive market niche.”

– **Danaher 1986 Annual Report**

“The response to metrics is as important as the numbers. If an operating review shows green on all 20 monthly objectives, we know we probably have an issue. The objectives weren’t tough enough. And if they’re red on 10 out of 20, the way the team responds matters. You don’t want them to view it as OK, but you don’t want them demoralized, either. You want them to rise to the challenge, adopt stretch objectives, and seek to improve.”

– **Tom Joyce, CEO of Danaher**

“You can walk up to a visual board on the shop floor in any Danaher business, and the metrics have the same labels: safety, quality, delivery, cost, and inventory. You can look at progress against clear targets — monthly, weekly, and daily cell-level targets. With that kind of visibility and transparency in performance, it’s easy to call it the way you see it. You can start a discussion by saying, ‘Based on the data, we’re not making progress.’”

– **Tom Joyce, CEO of Danaher**

“We might say to a company leader, ‘You don’t know us, but we’re interested in this space, and one day, if you think of selling your business, please talk to us. We have a long-term point of view and would like to stay in touch over time.’ That’s proven to be a very powerful tool. At any point, we’re probably cultivating 200 companies that aren’t for sale today. We’ve cultivated some companies for 10 years. When they’re ready to sell, they’ll often come to us because they know we’re interested and they understand how we operate.”

– **Daniel Comas, CFO of Danaher**



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