Constellation: Management Report 2Q16

Long Only Performance	Fund (USD)	MSCI Brazil (USD)
1H16	49.84%	46.50%
Annualized return since inception	12.87%	3.12%

In the first semester of 2016, the Constellation LO fund was up 49.84%, compared to 46.50% for the market. It is a surprisingly positive performance, as our portfolio tends to be more conservative. Stock picking made the difference, with our long term holdings performing really well. There were definitely macro tailwinds (Beta) in these last few months, but most of our companies performed well based on their own internal dynamics. This makes us very happy, as the quality of the Alpha was good, and we believe, sustainable.

Given the president's impeachment and the remarkable performance of the Brazilian markets, we have been asked a lot about Brazil's political and economic situation. We would like to address some of them in this letter, in a Q&A format.

Q: Did things really improve that much to justify a 50% rally?

One must consider that after a 4-year bear market, valuations were at the lows of their historical range and earnings were also cyclically depressed. With a new pro-market government in place, long term rates fell almost 400 bps, the currency appreciated 20% and growth expectations improved. In addition, on the global front, commodity prices stabilized, expectations of a FED interest hike were postponed and emerging markets in general performed well. Brazil performed better, but the global backdrop also helped. The truth of the matter is that 400 bps lower rates have a significant impact on the economy, corporate earnings and valuations. Therefore, we believe the performance was more than justified indeed.

Q: What are the chances of Dilma coming back? When will this issue be resolved?

Almost nil. Dilma coming back would be very bad for the economy and the remainder of her term would be a disaster. This would deprive her party from the "Coup" rhetoric and the poor economy would make it hard for the Workers' Party to be successful in the 2018 elections. Some say that even her party doesn't want her back. The final vote in the Senate should occur by the end of August.

Q: Will the new Government be able to push all the needed reforms?

Probably not. Brazil was on an economic collision course. The growth of the fiscal deficit pointed to an unsustainable debt to GDP ratio in a couple of years. Social security, tax and labor reforms are in order. These will probably only happen with a new elected government in 2018/2019. In the meantime, we'll probably get a light version of these reforms. Not enough to put the country on a high growth path, but enough to avoid disaster and to improve expectations. We'll also get some quick wins through micro reforms, which will make a big difference in some sectors.

Q: Aren't valuations for the so called "quality companies" stretched?

For some of them, on an historical basis, yes. Looking forward, maybe not. We believe that after years of cutting costs most leading companies are much leaner and have a stronger competitive position (some of their weaker competitors are getting out of business). When the economy improves, earnings could significantly surprise on the upside. We see an average annual IRR of 20.6% for our portfolio; attractive enough in a world of low interest rates.

There are also some "late cycle" companies that happen to be in more cyclical sectors, but are very high quality. These definitely offer very attractive upsides if the economy improves. In summary, we are almost fully invested and see interesting opportunities.

Q: What will you do if there is a rotation to state-owned or lower quality names in Brazil?

With the new government, some former non eligible companies may get back to our radar screen. We'll look at them with caution. We still believe the Brazil story in equities is that of long term investing in strong compounders (volatility will kill you if you think short term). These companies have been gaining market share because of their strong balance sheets, barriers to entry and management. Some of these are the global leaders in their industries regarding return on capital and they may underperform sometimes, but their performance has been consistent over time. Raia Drogasil, which we will discuss in more detail, has been a good example.

Q: Finally, how is your business?

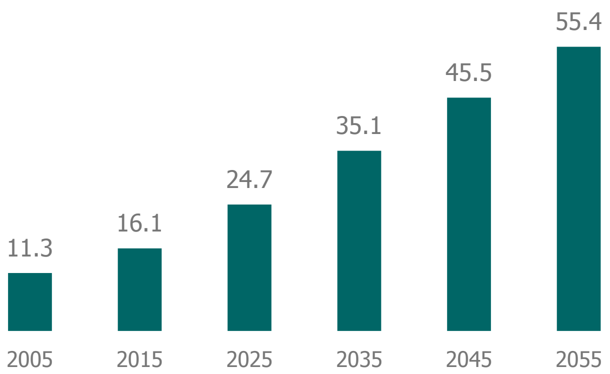
We do spend an above average time managing our people and keeping our clients informed. Our AUM has been stable and we have had no senior turnover in almost 10 years and we believe the team is excited with the prospects of new interesting stories and IPOs.

As you know, our main focus is on stock picking and what excites us is participating in the compounding growth of superior business. The best performing one in our portfolio this year is Raia Drogasil.

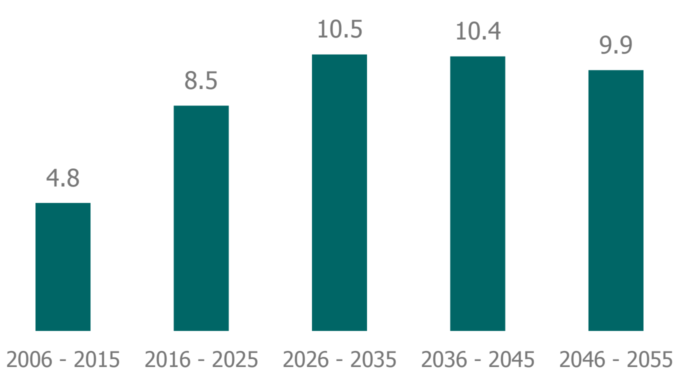
Raia Drogasil was created in 2011, after the merger of Drogasil and Droga Raia, and became the largest drugstore chain in Brazil. Both companies were excellent in their own way: the former had very well structured processes and was particularly well positioned within the elderly population; while the latter was more innovative and consumer-driven. Raia Drogasil merged these different capabilities into a single company, creating a very successful dual brand strategy.

Demographics is a key growth driver for drugstores. Seniors – defined as people older than 65 years - spend 3x more with pharma products than the average population, and 7.5x more than people younger than 25 years old. Brazil is getting older: from 2005 to 2015, 4.8mn seniors were added to the population. In the next 10 years, there will be 8.5mn more seniors, almost 2x the increase of the past 10 years. Going further, in the next 30 years, it is estimated that this demographic group will triple.

Senior population in Brazil (millions)



Addition of seniors in Brazil (millions)



Source: IBGE

Pharma demand is very resilient, and should remain so in the future. Combining population growth, aging, and inflation, we estimate that the Pharma market in Brazil will be 3.3x larger in 10 years. Given its position, we expect Raia Drogasil to outperform the industry.

Market Share in the Brazilian drugstore segment is very fragmented. The top 5 drugstore chains account for only 30% of sales, while the small independent players account for 86% of the stores, but only 47% of sales. These independent players represent a large opportunity: they don't have scale, they lack a complete mix in the stores, and they struggle with the formalization of Brazil's economy. We expect a long and continuous consolidation of this market by the largest players and we see Raia Drogasil as the company best positioned to benefit in this process.

"What was the concept? ***Simply this: the best, most convenient drugstores, with high profit per customer visit.*** *That's it. That's the breakthrough strategy that Walgreens used to beat Intel, GE, Coca-Cola, and Merck.*

In classic hedgehog style, Walgreens took this simple concept and implemented it with fanatical consistency. It embarked on a systematic program to replace all inconvenient locations with more convenient ones, preferably corner lots where customers could easily enter and exit from multiple directions." - Jim Collins, Good to Great: Why Some Companies Make the Leap...And Others Don't

Raia Drogasil is replicating a similar concept in Brazil. As for location, corners and real estate with parking space cost a lot more than comparable areas nearby for a reason: they attract more customers. Despite the higher costs, Raia Drogasil focuses in these kinds of locations for its stores because of its ROIC driven approach. Not surprisingly, 70% of its stores have parking area. Raia Drogasil's revenue per store is 11% higher than the industry's 2nd best (DPSP - Drogaria São Paulo), which facilitates expense dilution – from store pharmacists to expansion managers – and weakens competitor's stores in the same area.

Raia Drogasil added 495 drugstores since the merger in 2011, averaging 116 new stores per year. In the next 5 years, we expect this number to grow to around 200 new stores per year. More important than the number of new stores, quality is key: maintaining high revenue per store in the expansion is essential to sustainable barriers to entry.

Due to the acceleration of store openings, Raia Drogasil's sales expenses have increased, standing at 19.6% of sales. Nevertheless, this still represents 300 bps less than the industry's 2nd best (DPSP) at 22.6%. This difference, in this segment, is indeed material. By itself, 300 bps is more than DPSP's net margin of 2.5%.

"Leaving the question of price aside, the best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return." - Warren Buffett, 1992 Shareholder Letter

Raia Drogasil is another good example in this sense. Their expansion is unparalleled in its industry. It focuses its capital allocation on organic growth, fully controlling the quality of its expansion. We estimate that BRL 2.8bn will be invested in the next 5 years, approximately 70% of the company's earnings, at an estimated ROIC of 30%. Because of the conversion of 100% of earnings in cash and the unlevered balance sheet, these investments will be fully funded by operating cash flow. In sum, Raia Drogasil has a rare combination: a large set of opportunities and the capability to deploy a substantial portion of its earnings at a high ROIC.

In the past 10 years, Raia Drogasil grew its revenues 6x (from BRL 1.5bn to BRL 9.4bn). Despite this, they still only represent 11% of the market. In São Paulo – the largest market in Brazil, with 27% of total pharmacy sales – Raia Drogasil derives 60% of its revenues and has a 22% market share, leading to significant local economies of scale.

Revenue addition since 2011 was BRL 4.3bn, which is the approximate revenue of the 3rd largest player – Pague Menos. In the next four years we estimate an addition of BRL 8.4bn in revenues, 20% more than the current largest competitor, and we expect EBIT addition of BRL 700mn, 2.6x DPSP's EBIT in 2015.

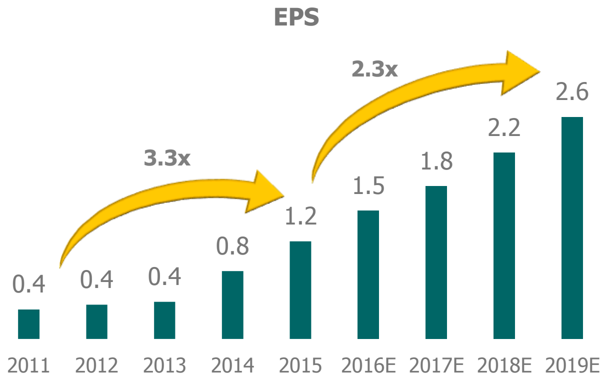
BRL millions	Revenues 2011	Revenues 2015	Revenue addition	Revenue growth (2015 - 2011)	EBIT 2011	EBIT 2015	EBIT addition
RaiaDrogasil	4,547	8,898	4,351	96%	119	501	382
+SP DROGARIA SÃO PAULO	4,452	7,004	2,552	57%	144	273	130
PagueMenos	2,783	4,787	2,004	72%	211	217	6

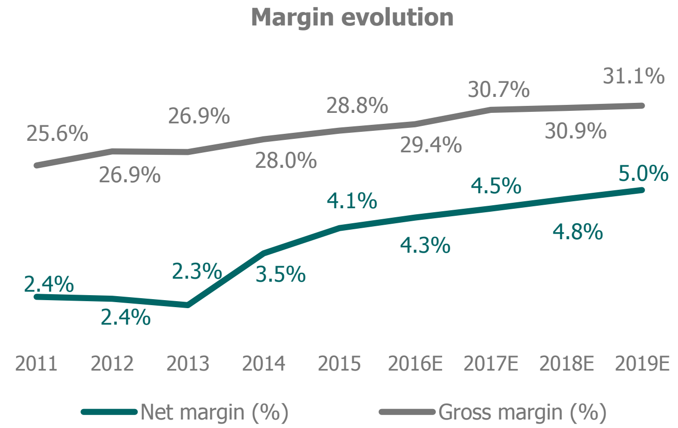
Source: Company's financial reports

The table shows the largest and best prepared players to reap the benefits of the consolidation to come. But we can see that profitability can be pressured if the expansion process is not well structured. Up to now Raia Drogasil has been delivering the best combination of growth and profitability improvement by far and we expect this trend to continue.

Scale and gross margin increase have been key factors for Raia Drogasil's profitability improvement. As for scale, given that the company will keep adding more stores with higher sales per store, its size gap vs competition is likely to continue widening– thus we expect profitability to improve further in absolute and relative terms.

As for gross margin, there has been a 320 bps improvement since the merger, higher than the 160 bps net margin gain in the period. In addition of its purchasing power, due to its strong expansion, there are 35% of stores still maturing, which could add around 1% net margin when they mature in up to 2 years, a 25% EPS addition.

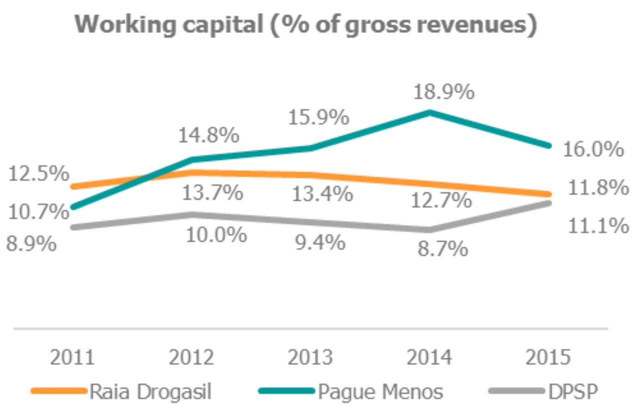


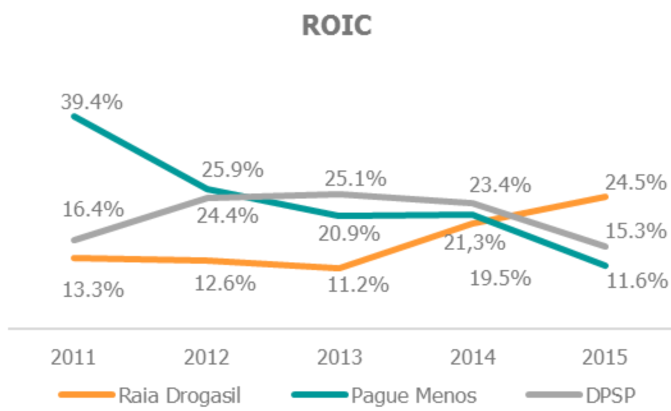


Source: Raia Drogasil's financial reports & Constellation's estimates

The integration of Droga Raia and Drogasil took 2.5 years to be completed. After its logistics and front-and-back end systems were merged, the company directed more resources to store expansion and store productivity.

More than 50% of Raia Drogasil's SKUs have only one or two items in the store. That is, while the addition of one item to their inventory may represent a 50% increase, a one item shortage may cause a lost sale. Running this tight ship is a tough challenge - but we can see working capital and ROIC improving materially as Raia Drogasil is constructing an expansion process with tight working capital management. We believe this trend will continue.





Source: Raia Drogasil's financial reports & Constellation's estimates

Raia Drogasil is working on a project with a customer science company aiming to maximize sales per customer. Because of the very high penetration of Raia Drogasil's loyalty program, 85% of sales, they have a unique source of information to work with. Personalized offerings, faster and better service, and better mix management should keep pushing sales per visit, further enhancing Raia Drogasil's differentiation.

Drugstores have been the best performing segment in Brazil's retail market in the past decade, but growth definitely does not imply a high ROIC. Raia Drogasil's performance has been a highlight not only among retailers in general, but also among drugstore players. Since the merger, we saw large players in the same industry in need of corporate and debt restructuring – demand tailwind was there, but that was just part of the scenario. We understand that the management team is key to understand Raia Drogasil's stellar operating outperformance.

The company's board of directors and executives have a long track record in the industry. Six of the nine directors represent the group of shareholders who controls Raia Drogasil, holding 40% of the company – they were shareholders of Droga Raia or Drogasil and have been tied by a shareholder agreement since the merger in 2011. The nine executives average 13 years working at Raia Drogasil, and have been leading the team who delivered the outstanding results of the past decade.

It is very difficult to find a company with both a strong competitive position and clear tailwinds in its market. Raia Drogasil has those characteristics and also a management team focused on executing a straightforward strategy, which mitigates risks for its investments in the very large consolidation opportunity ahead.

As Brazil ages, its senior population will increase their demand for Pharma products - only a well-positioned company, with operational excellency, strategic store locations and profitable expansion strategy will be able to navigate this scenario and seize the best of this opportunity.

We believe Raia Drogasil has all these attributes. Because of this rare combination, we have an unusual conviction on the potential of its earnings growth - it will likely be a compounding machine for many years.

We value your relationship and the trust you have placed in us by investing in Constellation. Our investor relations team will be glad to answer any further questions.

Sincerely,

Constellation Team

Constellation Fund SPC Equities Class – Long Only

Fund Objective

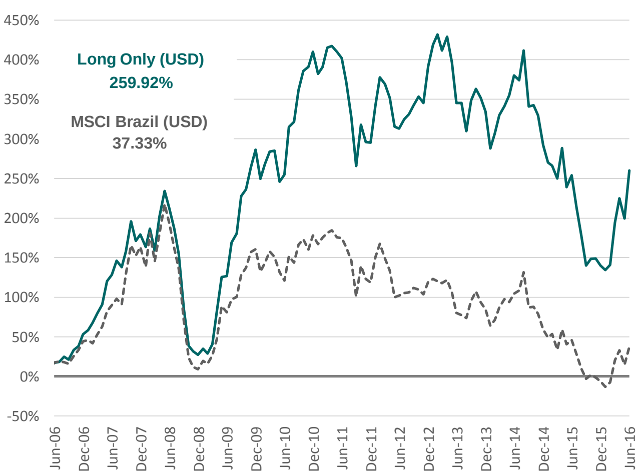
The fund's objective is to provide sophisticated investors with superior risk-adjusted returns by investing in stocks at the Brazilian Stock market through a rigorous research driven "bottom-up" fundamental approach, while carefully attempting to control portfolio risk and transaction costs. The fund does not intend to track market indices and is generally invested 80% to 105% of the NAV. Leverage is rarely used and we attempt to avoid excessive concentration.

Share Appreciation (Net of all fees and audited by KPMG)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Fund YTD	MSCI Brazil YTD	Fund Since Incep.	MSCI Brazil Since Incep.
2005												2.45%	2.45%	-0.96%	2.45%	-0.96%
2006	12.28%	4.59%	1.81%	12.98%	-13.71%	-1.74%	0.87%	5.37%	-2.81%	9.94%	3.77%	10.64%	49.33%	45.80%	52.99%	44.39%
2007	3.43%	6.07%	7.08%	6.20%	15.43%	3.71%	7.66%	-3.21%	8.31%	14.71%	-8.38%	3.03%	82.52%	79.99%	179.22%	159.89%
2008	-5.66%	8.81%	-9.70%	16.76%	10.62%	-6.76%	-8.13%	-13.70%	-27.40%	-24.95%	-5.06%	-3.36%	-55.75%	-56.06%	23.55%	14.21%
2009	5.88%	-4.40%	9.14%	29.69%	23.55%	0.65%	18.58%	4.21%	16.85%	2.64%	8.23%	6.14%	203.31%	128.62%	274.75%	161.10%
2010	-9.52%	5.32%	4.32%	0.30%	-10.20%	2.60%	16.98%	1.52%	9.54%	5.25%	1.07%	3.91%	32.09%	6.81%	395.01%	178.88%
2011	-5.48%	1.73%	5.06%	0.36%	-1.39%	-1.62%	-5.92%	-9.51%	-14.43%	14.36%	-5.27%	-0.24%	-22.57%	-21.59%	283.28%	118.68%
2012	11.85%	8.14%	-1.81%	-3.72%	-7.99%	-0.62%	2.85%	1.50%	2.50%	2.61%	-1.82%	10.47%	24.53%	0.34%	377.23%	119.42%
2013	5.52%	2.44%	-3.79%	3.44%	-6.10%	-10.33%	-0.05%	-7.95%	9.47%	3.18%	-2.41%	-3.89%	-11.71%	-15.79%	321.35%	84.76%
2014	-10.66%	4.85%	5.67%	2.69%	3.07%	5.48%	-1.21%	7.94%	-13.82%	0.38%	-2.96%	-8.76%	-9.74%	-13.74%	280.31%	59.38%
2015	-5.53%	-1.12%	-11.02%	10.92%	-7.34%	4.39%	-11.38%	-11.42%	-11.38%	5.27%	0.24%	-3.53%	-36.84%	-41.18%	140.20%	-6.26%
2016	-2.37%	2.65%	22.21%	10.41%	-7.82%	20.21%							49.84%	46.50%	259.92%	37.33%

Long Only Performance

(Equities Class vs MSCI Brazil – Since Inception)



Exposure (Delta Adjusted)

Sector	% NAV
Financials	28.16%
Consumer Staples	21.51%
Utilities	11.46%
Infrastructure	8.28%
Consumer Discretionary	7.98%
Services	7.49%
Education	6.09%
Homebuilders	2.65%
Healthcare	2.00%
Industrials	0.08%
ETFs/Ibovespa	-2.75%
Total	**92.95%**
Exposure to BRL	**98.86%**

Value per Share (Net of all Fees)

As of June 30th, 2016	410.7597

Number of Positions

Stocks	23

Sector Attribution (Month)

Outperformers	% NAV
Financials	2.85%
Utilities	0.87%
Services	0.82%
Underperformers	**% NAV**
Industrials	-0.01%

Overall Strategy Liquidity (1/3 of Average Daily Traded Volume)

Tenor	% Exposure
1 Day	33.06%
1 Week	83.52%
1 Month	97.96%

Market Capitalization

>USD 10 bn	43.61%
>USD 1 bn and <US$10 bn	44.54%
<USD 1 bn	4.80%
Total Equity Exposure	**92.95%**

Main Characteristics

Inception Date:	November 30, 2005.
Initial Investment:	US$ 100,000
Subsequent Investment:	US$ 50,000
Subscriptions:	Last Business Day of the month.
Redemptions:	Available series: monthly with 3 months prior notice.
Payments:	Three business days after the redemption day.
Advisory Fee:	1.0% per annum.
Incentive Allocation:	10% of the profit paid annually or upon redemption.
Net Asset Value:	Daily net of advisory fee.
AUM of the Strategy:	USD 664,964,578.60

Risk x Return Profile (Since Inception – Net of all Fees)

Annualized Return	12.87%
Annualized Ibovespa USD Return	0.88%
Annualized Standard Deviation	31.90%
Ibovespa USD Annualized Standard Deviation	47.70%
# of Positive Months	74
# of Negative Months	53
Best Monthly Return	29.69%
Worst Monthly Return	-27.40%
ISIN:	KYG238261112