Constellation: Management Report 2Q17

Long Only Performance	Fund (USD)	MSCI Brazil (USD)
1H17	12.70%	2.82%
Annualized return since inception	12.98%	4.17%

In the first semester of 2017, the Constellation Long Only Fund was up 12.70%, compared to 2.82% for the market.

For equity managers, it is very important to separate the signal from the noise. Although there has been a lot of noise recently in Brazil, our scenario has not changed much. Using the Austrian Economic Cycle Theory as a backdrop, we believe Brazil is entering the recovery phase of the cycle. After years of recession that led to very low inventory levels, consumer deleveraging and falling inflation, interest rates are collapsing from 14.25% in 2016 to an estimated 8.00% in 2018. Lower rates will have a massive positive effect on the economy, earnings, credit availability and on portfolios (shift to riskier assets). The first quarter of this year was the first, after some years, in which we saw earnings recovering YoY.

There is a disclaimer to be made. There are probably managers in India, South Africa, Mexico and other Emerging Markets saying how great their countries are. After all, all these markets have been performing pretty well. We should not forget that the global liquidity and search for yield play a big role in the remarkable performance of all these markets, as well as Beta plays a big role in the performance of managers.

Brazilian markets would be doing even better if it wasn't for the political crisis. Much has been written and speculated about Temer's fate. We don't know the outcome of this imbroglio. Actually, the main risk of the political crisis is it delaying the cyclical recovery. The pivotal moment will be next year's presidential elections. It is too early to know who will run for president. We are quite optimistic in the political cycle as well. After 2 terms of Fernando Henrique Cardoso (center) and 3 terms of leftist presidents, we expect a more conservative president this cycle.

During all this noise, we focused on the fundamentals of our businesses and avoided big changes. We did adjust the portfolio a little though, to a more defensive bias. The dream of every portfolio manager is having a portfolio of totally idiosyncratic investments, no Beta risk. This is almost impossible, especially in Emerging Markets. That said, we believe Fleury, Alupar, Energisa and Rumo are more idiosyncratic than average and have their own robust dynamics. Rumo is among our top 5 positions and several clients have been asking for an update on the story. Here it is.

Back on track

Our investment thesis in Rumo is based on the great operational turnaround that is being executed by the best team in the industry. Rumo is the largest logistics company in Brazil, has structural competitive advantages and operates as a monopoly in a market where demand is well ahead of supply, and where Rumo's solution is the customer's first choice. After many years of underinvestment and mismanagement, the owners and management of Rumo changed in 2015. The new team restructured the company's balance sheet in the next year, a crucial move to unlock value, which allowed us to become shareholders.

Given that Rumo is a "new" company, although in a mature and well-known sector in the Brazilian stock market, it is very important to understand the history of the creation of the new Rumo, and then talk about the great operational transformation that the company is going through and finally, to understand why we invest in Rumo.

Rumo was created in April 2015 with the merger of ALL and Rumo Logística. Company's history is far older, beginning in the 1990s, when Brazil's government privatized several companies and sectors that were running in deficit. Brazil's rail network was privatized in 1997 and was the birthplace of ALL, a private company owner of Malha Sul, a railroad concession in the southern region of the country operating with a net loss of BRL 62mn and tight operating margins of 9% in 1997. As one might imagine, there was a lot of value to unlock with the privatization. After 4 years, the company became profitable, and in 10 years increased its operating margin from 9% to 47%, delivering a net profit of BRL 173mn in 2006. It was an interesting decade for the company and the sector.

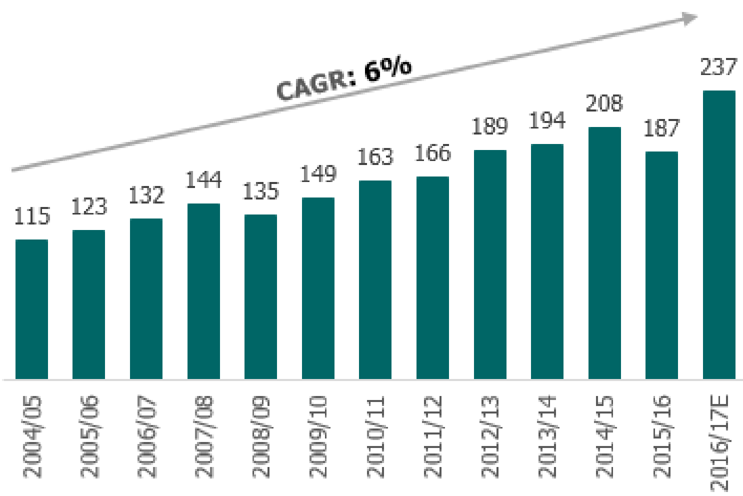
In 2006, ALL purchased Brasil Ferrovias to consolidate the sector and become a mandatory player for customers wishing to transport cargo from the countryside to ports in the south and southeast. The acquisition of Brasil Ferrovias placed ALL in the country's main grain export corridor, as the owner of the railroad linking the main grain producing regions of Mato Grosso and Mato Grosso do Sul to the port of Santos. Strategically, the acquisition made a lot of sense. However, the size of the turnaround challenge was far greater than initially imagined, and ALL's second decade of operation was the opposite of its first.

Difficulties with the turnaround of the acquired operation coupled with a complicated balance sheet situation in a capital-intensive business made it clear that ALL investment decisions were destroying value. For example, to raise cash to invest in its own assets, ALL entered into business agreements with many of its customers. All these agreements had commitments to increase capacity and deliver high levels of service at great onus if the company failed to meet the commitment (as happened in most cases). The facts mentioned above combined with the difficulties that ALL faced with the Ministry of Transportation and the regulatory agency (ANTT) due to the years of underinvestment, led to a perfect storm in 2014: unhealthy relationships with customers, suppliers, regulator (ANTT), granting power (Ministry of Transportation), and the entrance into an arbitration process with a relevant client that had invested more than BRL1bn in its assets in exchange for capacity in the rail network that was not being delivered. This relevant client was Rumo Logística, a logistic operator of great success, considered the benchmark of its industry.

Rumo Logística, a subsidiary of the Cosan group, was created in 2008 as an independent rail operator focused on sugar export logistics. Under the leadership of Julio Fontana (CEO), well-known in the rail sector for having led the MRS railroad since 1997 and turning it in the most efficient operation in the country, Rumo represented the new mindset in the rail sector: efficiency and hands on operation. More than BRL 1bn of investments were made (Rumo invested in ALL's rail network to receive discounts on rail freight) with returns of 20-25%. The company became the success story for investors, customers and, above all, the regulatory agency (ANTT). For this reason, when Rumo and ALL entered the arbitration process mentioned above in 2015 due to noncompliance with commercial contracts, it seemed that a bad outcome for ALL was inevitable. However, the longer it took to reach an agreement, the more harmful it was for both companies. This process culminated in the merger of the companies, where Rumo's shareholders accounted for 65% of the combined business, and ALL shareholders had 35%. The new company was born in April 2015, after the CADE (Brazilian Antitrust Authority) and the regulatory agencies approved the deal. This marked the end of an era in the Brazilian rail sector. In May 2016, the new Rumo fixed its balance sheet, rolling BRL 3bn in debt, raising BRL 2.6bn in equity and putting into practice a very promising investment plan. At this time, Rumo became a significant position in our portfolio.

The Rumo that we know today has 12,000 km of rail concessions connecting Brazilian ports in the south and southeast of the country. These ports are responsible for 80% of the country's soybean and corn exports, and concentrate a relevant share of the pulp and sugar exports. Rumo has 4 port terminals and 36 logistics terminals spread along its rail tracks. Since the main grain producing regions are distant from the ports (~1,600km), railroad is the most efficient logistics solution. However, today half of the exports volume in the south and southeast of Brazil is transported to the ports by truck and only the other half is transported by railroads. The explanation for this split is the lack of capacity in the railroad system. Rumo is competing with a much worse transportation alternative from an economic point of view. It’s just a matter of time and capacity expansion before Rumo absorbs the demand that is already there.

Brazil's grains production (tons mn)



Brazilian grain crop has delivered strong and consistent growth over the last decade and it should continue to grow in the coming years. On top of that, it is interesting to note that Rumo's volume growth depends more on the market share gain of railway vs trucks than on the growth of agribusiness in general. On top of that, there is potential for value creation in other types of cargo. For example, Brazil is the biggest exporter of eucalyptus pulp and it has been expanding its production in regions that can have structural demand for Rumo's transport. Fuel distribution can also be important for Rumo as the sector is facing a lot of dynamism since the implementation of Petrobras's new price policies in October 2016. When a specific cargo does not have the appropriate shape or volume to be transported in bulk, a container is used. It is staggering that not even 5% of container transportation in the country happens in railways – there is tremendous potential to be explored in this segment.

To take advantage of all this potential, Rumo needs to increase its capacity with investment and a good management team. Rumo's seasoned team is delivering the volume growth and operational margin improvements. They brought back to the company the operator perspective, client partnerships and asset optimization. As the client begins to trust the railroad, he tends to hire more rail than road transportation beforehand, thus increasing Rumo's capacity utilization.

On top of the dilution of costs and better control of operations, the company has also been growing its capacity by buying new locomotives and wagons. A new locomotive consumes less diesel and has a higher average speed, allowing higher asset turnover, higher capacity and lower costs. As a typical case of operational leverage, when volumes grow, earnings grow much more. This is exactly what this company is trying to do, invest BRL 7bn with a 18-20% return (per our estimates), allowing volumes to grow 8-10% YoY and EBITDA to grow 18-20% YoY for the next five years. This should result in recurring earnings of around BRL 1.5bn.

Rumo has BRL 3bn in cash and its debt has been renegotiated at its capitalization in 2016, making its cash position sufficient to cross a potentially challenging scenario in debt markets. An important part of the company's investment plan is the financing plan in which BNDES (Brazilian Development Bank) is one of the long-term financing options for Rumo.

A good business, with a seasoned team, great assets and attractive opportunities to add value – this strong combination is what makes us confident on Rumo's investment case.

Regarding housekeeping, Rafael Sales after 10 years of contributions to the portfolio and the business, is starting a new chapter in his life. Rafael left Constellation on May 2017 to become Executive Vice President of Aliansce, one of our invested companies, where he will oversee all executive directors and work directly with the founder, Renato Rique, on a succession plan. We believe this is a terrific opportunity for Rafael's career, one difficult to miss. For this reason, we are happy for him and wish him well in his new endeavor. As a final note, we don't plan to hire any replacements, but rather empower people from our team that have been with us for so many years, covering all the companies that Rafael oversaw.

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