

Constellation: Management Report 3Q14

Long Only Performance	Fund	Ibovespa in USD
YTD:	+ 1.54%	+ 1.40%
Last 12 months:	- 1.73%	- 6.14%
Annualized Return since inception:	+ 17.89%	+ 4.73%

Long Short Performance	Fund
YTD:	+ 1.58%
Last 12 months:	+ 0.36%
Annualized Return since inception:	+ 8.01%

Dear Investors,

The presidential election in Brazil is finally over. Dilma Rousseff, the current president, has been chosen to run the country for another four years. This has frustrated much of the business community which had hoped for deep reform in the country and a more market friendly scenario with higher growth.

After a very tight race (tightest decision since 1955), it would be reasonable to expect a very negative reaction in asset prices, given that, in the past few months, market’s volatility was tightly correlated with elections expectations. When Dilma was up in the polls, the market was down and vice versa.

With financial news being dominated by the elections, one could expect a very negative hangover in the market after Dilma's victory. Although, after just one day of down market (the Monday that followed the elections), the market returned and is practically flat on the month. This post-election optimism seems to be a response to the statements made by the president following her victory, where she has been showing signs of a government more aligned with the business community. This new commitment was put to work just three days after the elections, when the central government announced a hike in rates, lowering inflation expectations and long term rates. This move addressed one of the main concerns among Brazilian economists, investors and businesses.

During this period of market turbulence, we did not make relevant changes to our portfolio. As we mentioned in our last letter, the businesses we own are less affected by changes in government. A change in leadership would have been great for the valuation of our companies, which suffer today from low growth and high interest rate expectations. We cannot count on drastic changes in the short term: some companies will continue to do well (maybe less than their full potential) and our job will continue to be finding these businesses that are more protected and run by talented management teams, instead of counting on stronger tailwinds and a more favorable macro scenario.

Performance

The long only fund was practically neutral on the 3rd quarter, up 0.48% in BRL. On the other hand, due to the devaluation of the BRL, the offshore fund was down -8.11%. Year to date, the fund is +4.86% in BRL and +1.54% in USD – as of the end of September.

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In this last quarter, the main performance contributors were Itaú, Abril Educação and Embraer. As for the underperformers, they were Cosan and Cielo.

As some of you were not able to attend our annual meeting, we thought this letter would be a good opportunity to discuss one of the investment cases presented in the conference – Linx.

Investment Update – Linx

The story behind our investment in Linx started five years ago when we still had a relevant position in Totvs. Whilst performing our field research to identify other players in the software business, we met Linx and its management.

Back then, Linx was already the leading software provider for the retail sector though there was not enough data available to analyze the other players in this segment. Today Linx dominates with over 30% of the market share of retail software, far ahead of its main competitors, representing the sum of 2nd to 5th place of the players in this market.

The company also counts on a robust business model with recurring revenues adjusted for inflation. This not only facilitates the capture of new costumers (low initial investment), but also results in a rare resilience of revenues – 80% of Linx's revenues are recurrent.

- Competitive Advantages

The consistency of strategy is a strong characteristic of Linx. They have a clear focus – software for retail – which helps the company when making capital allocation decisions, reinforcing their competitive advantages.

“Competitive advantages are invariably market-specific. They do not travel to meet the aspirations of growth obsessed CEOs.” – Bruce Greenwald, Competition Demystified

Developing a fortress within a niche market, with scale and specialization, is a proven method to building barriers to entry and acquiring sustainable competitive advantages. The software business is a vast universe with different product segments, client sizes and technologies.

Linx's revenues today are around 20% of the leading software provider in Brazil, Totvs. However, in the retail vertical, Linx is the incontestable leader. They have built this fortress by positioning itself even more dominantly among apparel retailers. In our field research, we heard different store owners referencing Linx as the standard solution. We estimate their market share to be over 60% in this niche market.

Linx's focus translates into an exceptional ROIC of more than 60% - it is our understanding that this figure will continue to be high for a long time. In the long run, delivering high ROIC consistently has a powerful compounding effect. In our analysis, we consider this to be more relevant than short term multiples.

Establishing these recurring revenues as soon as possible automatically aligns Linx with its customers – the earlier the implementation, the better. This is a model that reinforces revenue resilience. In order to generate a high NPV customer retention must be high.

Considering recent retail activity in Brazil, we can highlight two segments that have consistently outperformed: malls and franchises. Linx's software has a strong presence in both. As we see these segments growing faster than traditional retail, Linx should follow and deliver strong growth.

Linx increases its revenues every time one of its clients opens a new store. When Hering, Renner, Lojas Americanas, Restoque or Arezzo expand their number of stores, additional recurring revenue streams are generated for Linx. Therefore, top line growth is linked to the expansion plan of clients' brands, not the sales volume of each individual store. These five companies cited above opened 1,266 new stores on the past four years and we expect them to open another 1,178 in the next four.

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We interviewed a franchisee of one of the largest apparel retailers. When we inquired about her monthly spending with Linx's software, she said "I do not remember. I spend more with our office messenger". A basic plan costs BRL 300 per month and this is the plan chosen by the franchisor.

One critical point that led to our investment decision in both Linx and Tavs was the high barriers to exit to its customers. It is common to hear retailers not fully satisfied with the software they use. But it is uncommon to hear them saying they would change providers because of that. In Linx's case, even clients that transitioned to large ERP systems (i.e. SAP) did not switch their point of sale software.

This combination of customer captivity and ability to invest more than competitors in software designed specifically for retailers is powerful. We believe this is essential so that Linx can continue to deliver high ROIC in the long run.

- Consolidating the market

In 2010, BNDES became the first external investor in Linx, accelerating the consolidation of the retail software market. Even with dilutions that grew the amount of shares by 2.4 times, EPS expanded 20% per year from 2008 to 2013. This growth in EPS was pushed by an estimated organic revenue growth of 18% per year. We expect Linx to keep growing revenues organically by around 15% per year for several years.

Through this consolidation process started in 2009, Linx acquired 18 companies investing BRL 450 million. This was done focusing on the retail sector but adding technologies, know-how and geographies. We estimate the return on this aggregate invested capital to be 18% in 2015, demonstrating their diligence in acquisitions.

- Opportunity in micro businesses

Reaching the approximately 2 million points of sale across the country poses a complex challenge to companies. This is an important reason to why no player has been able to capture this segment in large scale.

In June 2014, Linx partnered with Cielo, the leading acquirer in Brazil. They announced a JV offering a simple solution to this market – thus leveraging Cielo's already established distribution network of roughly 1.4 million. We believe this JV can be larger than Linx today, adding 30% value to our base case scenario for the company.

Conclusion

We hope that the definition of leadership in our country for the next four years will bring a less turbulent scenario than the one we saw this year. This will help us in our projections and studies of Brazilian companies. It will be interesting to see the operational results reported by our companies at the end of this year. We shall comment this on our next letter.

It is also with great satisfaction that we announce that Eduardo Dumans and Alexandre Bagnoli, members of our investment team, became partners at Constellation. They are welcome to our partnership and we are proud to share their success.

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

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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.

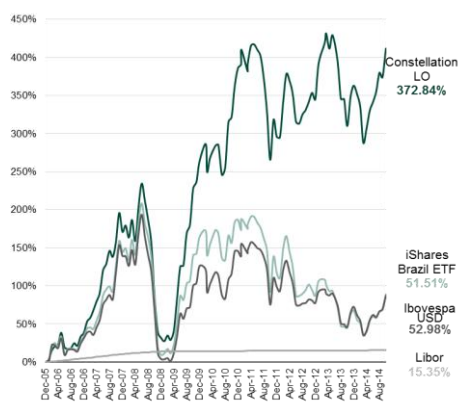
Share Appreciation (Net of all fees and audited by KPMG)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	Since Incep.
2005												2.45%	2.45%	2.45%
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%	52.99%
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%	179.22%
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%	23.55%
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%	274.75%
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%	395.01%
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%	283.28%
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%	377.23%
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%	321.35%
2014	-10.66%	4.85%	5.67%	2.69%	3.07%	5.48%	-1.21%	7.94%	-13.82%				1.54%	372.84%

Exposure (Delta Adjusted)

Sector	% Long NAV
Financials	20.80%
Education	19.54%
Consumer Staples	14.45%
Services	12.68%
Fuel Distribution	7.92%
Utilities	4.13%
Energy	3.38%
Metals & Mining	2.32%
Industrials	2.12%
Homebuilders	1.66%
Consumer Discretionary	1.61%
Infrastructure	0.98%
IBOV/Options	-3.17%
Total	88.43%
Exposure to the BRL	95.60%

Constellation (net of fees) vs. Ibovespa vs. ETF



Number of Positions

Stocks	22
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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:	US\$ 989,637,365

Value per Share (net of all fees)

As of September 30th, 2014	488.3472
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Sector Attribution (month)

Outperformers

	% NAV
Industrials	0.25%

Underperformers

	% NAV
Financials	-2.49%
Fuel Distribution	-1.40%
Services	-0.84%

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

Annualized Return	17.89%
Annualized Ibovespa USD Return	4.73%
Annualized Standard Deviation	31.80%
Ibovespa USD Annualized Standard Deviation	47.70%
# of Positive Months	66
# of Negative Months	40
Best Monthly Return	29.69%
Worst Monthly Return	-27.40%
ISIN:	KYG238261112

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Constellation Fund SPC Class B - Long Short

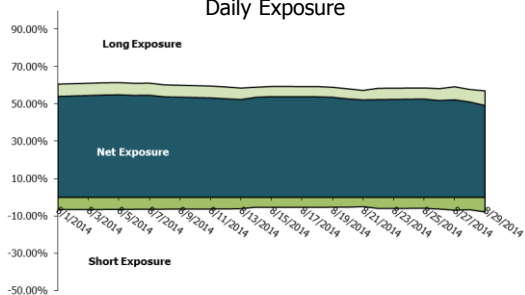
Fund Objective

The fund's objective is to provide sophisticated investors with superior risk-adjusted returns in any market environment. To achieve the objective, the fund employs a classic long/short equity strategy by investing in stocks at the Brazilian Stock Exchange, while carefully attempting to control portfolio risk and transaction costs. Our stock selection is based on rigorous research driven "bottom-up" fundamental analysis.

Share Appreciation net of all fees (* Performance of Long Short Class A until Nov 04, Class B onwards.)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	Since Incep.
2002 *												2.27%	2.27%	2.3%
2003 *	0.97%	1.00%	1.11%	1.65%	-0.29%	0.68%	0.25%	3.10%	2.92%	1.45%	4.71%	1.60%	20.81%	23.6%
2004 *	3.52%	0.22%	0.26%	-1.99%	-0.79%	0.58%	0.68%	3.38%	2.70%	0.67%	-0.09%	8.37%	18.52%	46.4%
2005	6.13%	4.90%	-3.81%	-2.86%	0.50%	1.55%	-1.49%	1.26%	9.20%	-2.11%	4.48%	2.51%	20.76%	76.8%
2006	6.61%	1.20%	-0.38%	8.68%	-3.72%	-1.03%	0.57%	3.67%	-1.85%	0.89%	0.53%	3.42%	19.46%	111.2%
2007	0.85%	3.13%	2.76%	0.87%	5.00%	-0.28%	2.90%	-2.10%	2.54%	3.43%	-4.58%	2.70%	18.18%	149.6%
2008	-1.77%	-0.57%	-3.92%	1.47%	2.45%	-2.11%	-2.67%	-4.32%	-5.36%	-7.55%	-1.10%	-2.39%	-24.88%	87.5%
2009	-0.15%	-1.01%	2.03%	3.69%	4.19%	0.32%	6.20%	1.11%	7.73%	2.45%	2.34%	2.40%	35.75%	154.5%
2010	-2.83%	1.74%	0.93%	-0.04%	-3.60%	0.75%	6.23%	0.95%	3.23%	1.35%	0.75%	1.12%	10.74%	181.9%
2011	-1.56%	0.03%	1.78%	-0.19%	-0.94%	-2.22%	-2.08%	-3.28%	-3.82%	1.66%	-1.61%	-0.54%	-12.19%	147.52%
2012	3.12%	2.66%	-0.62%	-2.03%	-2.57%	-0.59%	2.33%	0.01%	0.58%	0.86%	-2.46%	5.80%	6.96%	164.75%
2013	3.04%	1.87%	-2.26%	2.13%	-3.98%	-5.91%	-0.13%	-6.29%	5.55%	3.29%	-1.31%	-3.08%	-7.60%	144.63%
2014	-7.01%	3.31%	4.05%	1.94%	1.90%	2.73%	-1.44%	5.61%	-8.51%				1.58%	148.50%

Daily Exposure



Sector Exposure (Delta Adjusted)

Sector	Long	Short	Gross	Net
Financials	12.6%	0.0%	12.6%	12.6%
Education	10.7%	0.0%	10.7%	10.7%
Consumer Staples	7.1%	0.0%	7.1%	7.1%
Services	6.7%	-1.4%	8.0%	5.3%
Fuel Distribution	4.3%	0.0%	4.3%	4.3%
Energy	3.7%	0.0%	3.7%	3.7%
Utilities	2.8%	0.0%	2.8%	2.8%
Homebuilders	3.6%	-2.1%	5.7%	1.5%
Metals & Mining	1.4%	0.0%	1.4%	1.4%
Industrials	1.0%	0.0%	1.0%	1.0%
Consumer Discretionary	2.6%	-1.9%	4.5%	0.8%
Infrastructure	0.5%	0.0%	0.5%	0.5%
Etf's/ibov/options	0.0%	-2.6%	2.6%	-2.6%
Total	57.0%	-7.9%	64.9%	49.0%
Exposure to the BRL				48.40%

Total Portfolio P/L (Gross of Performance Fee)

	Jul14	Aug14	Sep14	2014
Longs	0.11%	5.44%	(4.56)%	3.06%
Shorts	(0.22)%	(0.35)%	0.42%	(0.14)%
FX/FX Options/Fixed Income	(1.17)%	0.70%	(4.26)%	0.58%
Equity /Index Options	0.03%	0.02%	0.09%	0.12%
Others Expenses	(0.19)%	(0.20)%	(0.20)%	(1.68)%
Total	(1.44)%	5.61%	(8.51)%	1.58%

Number of Equity Positions

Long	22
Short	4

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

Tenor	Long	Short
1 Day	79.2%	100.0%
1 Week	94.9%	100.0%
1 Month	100.0%	100.0%

Main Characteristics

Inception Date*	November 30, 2004.
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:	3 business days after the redemption day.
Advisory Fee:	2.0% per annum.
Performance Fee:	20% of the profit paid annually or upon redemption.
Net Asset Value:	Daily net of advisory fee.
AUM of the Strategy:	US\$ 117,181,465

Value per Share (Net of all Fees)

As of September 30th, 2014 **208.0424**

Market Capitalization

	Long	Short
>US\$10 bn	27.5%	2.5%
>US\$ 1 bn and <US\$10 bn	25.0%	3.2%
<US\$1 bn	4.5%	2.1%
Total Equity Exposure	57.0%	7.9%

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

Annualized Return	8.01%
Annualized Standard Deviation	10.70%
# of Positive Months	70
# of Negative Months	48
Best Monthly Return	11.14%
Worst Monthly Return	-8.51%
ISIN:	KYG238261039

* Annualized T-Bill 90 daily return.

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