Constellation: Management Report 3Q16

Long Only Performance	Fund (USD)	MSCI Brazil (USD)
3Q16	6.14%	11.37%
YTD	59.05%	63.15%
Annualized return since inception	13.18%	1.77%

In the 3rd quarter of 2016, the Constellation Long Only fund was up 6.1%, compared to 11.4% for the market. Year to date the fund is up 59.1%. The main event in Brazil this quarter was the final vote of Dilma Roussef's impeachment by the Senate, confirming the change in political leadership for the next two years. In this letter we'll focus on our view that Brazil is at the trough of three cycles: political, economic and earnings.

The pick-up in the political cycle

"This country, with its institutions, belongs to the people who inhabit it. Whenever they shall grow weary of the existing Government, they can exercise their constitutional right of amending it or their right to dismember or overthrow it." – Abraham Lincoln

"The economic infrastructure determines the political superstructure" - David Ricardo

In 2002, after 12 years of right-wing oriented governments, Brazil, not surprisingly voted for Lula, giving the "left" a chance. Lula started his term on a conservative note and everything seemed to be going well. During Lula's 2nd term, things started to go south and then Dilma's mismanagement of the economy threw Brazil into deep recession.

After 13 years of left governments and a deep recession, it is time to change once again. The new government has a pro-market bias and is well aware of what needs to be done in terms of macro and micro reforms.

In 2018 there will be presidential elections and there are always fears of a fallback to the left. In that respect, the recent municipal elections give us hope of a positive outcome. In São Paulo, the largest city in Brazil, a business man with a pro-market platform had a huge win. It is still early and a lot of things can happen in 2 years, but we believe voters are smarter and more conservative than people think and should opt for a more pro-market candidate in the next election. A pick up in the economy will be very important for the 2018 election, and this brings us to the economic cycle.

The pick-up in the business cycle

"The business cycle refers to the periodic highs and lows in the economy as measured by gross domestic product, unemployment, consumer demand, housing activity and other indicators. The four phases of a business cycle are recession, recovery, growth and decline. The recovery phase of the cycle usually begins with falling interest rates, and continues with increases in demand and employment, which leads to economic expansion.

Low interest rates

Business recoveries usually start in a low interest-rate environment. The central bank typically lowers short-term interest rates during a recession, which is the business cycle stage that immediately precedes a recovery.

Demand growth

More disposable income for individuals and more free cash flow for businesses usually mean higher demand for products and services. Factories restart production, which increases demand for components and raw materials. The magnitude of the increase determines how quickly economic expansion resumes.

Job creation

Companies resume hiring when they can project future sales with some certainty. Businesses normally resume investments in anticipation of consumer demand, which usually means additional hiring. As more people return to the workforce, spending increases, which increases demand and the recovery continues. However, if companies are uncertain about future demand, they may postpone their hiring plans, or hire only on a part-time or contract basis.

Economic expansion

The final stage in the recovery phase is expansion, in which the economy records consecutive quarters of GDP growth. Unemployment levels gradually decline and the stock market trends higher."

For a recovery to start, an improvement in consumer and business confidence is needed. In Brazil, we saw the trough in both indicators in August. Both turned positive in the last few weeks. In terms of the economic backdrop, we believe Brazil is in a different cycle than other major markets. The Central Bank will start lowering rates this month and from this quarter on, the economy should start growing on a yearly basis. From an investors' perspective, an easing cycle tends to be favorable for risky assets, a tailwind for equities. "Never fight the Fed".

Source: FGV

One caveat, consumer recovery will be slow. Unemployment will stay high for a while and consumers and companies are still levered. But the trend in growth is definitely up.

The pick-up in the earnings cycle

Regarding companies' earnings, in addition to better sales growth, we expect significant margin expansion. Given the severe recession in the last few years, companies in general have been cutting costs and running leaner structures. There is also significant spare capacity available.

Source: National Confederation of Industry

Once sales pick-up, margins will expand and earnings will surprise on the upside. Lower rates should also be an additional help on the financial side of income statements.

Therefore, all in all, we believe Brazil will be dancing to a different tune than most of the world for the next 3 years. There is a lot of uncertain and hard work to be done but, if successful, could lead to a sustainable bull market.

In the short run there is a lot of work to be done in Congress. After the strong rally in Brazilian assets this year, markets are currently in waiting mode. Given the fragile fiscal backdrop, reforms are needed to avoid the debt to GDP ratio to spiral out of control. The milestones markets will be watching are:

1. The voting of the mandatory government expenses ceiling. We expect this to be approved until the end of the year. The first votes carried out during Temer's interim presidency suggest that he can rely on votes from his coalition. Average adherence to the government orientation has been very high even among parties not represented in the administration.

2. Current inflation coming down and expectations for future inflation getting closer to the target. These should happen in the next few months and should be pivotal for the beginning of the easing cycle in Brazil. We expect the Central Bank to start cutting rates in the next meeting, by the end of October.

3. With the approval of the debt ceiling and expectations of lower rates, international flows to Brazil could accelerate.

4. In the first semester of 2017 the government should send the proposal for the much needed Social Security reform. This is going to be an uphill battle, but we believe a light version will go through, enough to stabilize expectations for a while.

5. By the end of next year, the 2018 presidential elections will come into focus. The first round in elections for mayor have just finished, with big wins for pro-market candidates and losses for the PT party, a potentially good sign for 2018. As in other parts of the world, Brazilians are tired of traditional politicians and after 13 years of leftist presidents, we believe there is a big possibility for a cyclical change to the right.

6. In the next few days the 3Q16 earnings season begins. No news expected. Earnings will still be sub-par. As mentioned above, we expect earnings to improve only next year, helped by the beginning of the economic recovery and lower interest rates.

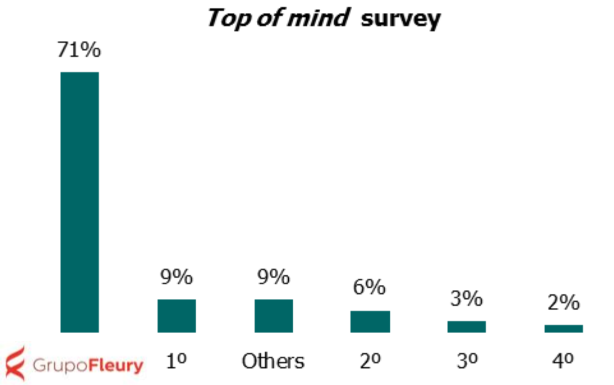
Regarding the portfolio, there were no major changes this last quarter. We are very confident with our current positions, mostly idiosyncratic investments. The book is well balanced between: (1) defensive compounders, (2) companies that benefit from lower interest rates and a stronger economy, and (3) companies that will benefit from internal improvements. There is one common thread though, good businesses run by good capital allocators we trust. Fleury is a good example of such a company.

Fleury

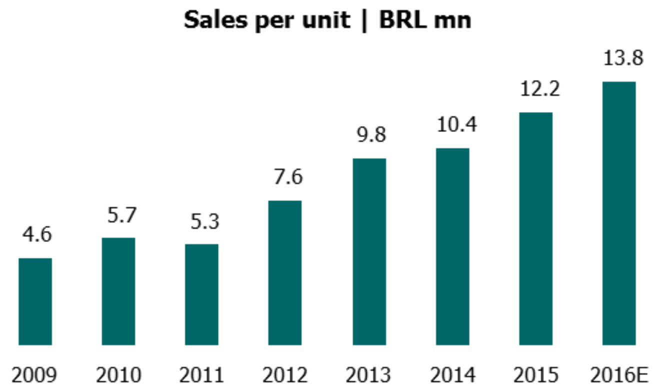
We have been covering the healthcare diagnosis industry for over 12 years and have already invested in Fleury in the past. Due to a series of decisions made by the previous management team, we decided at one point to divest from the stock. Last year we became impressed with the company's new management team and the results they started delivering. The corporate governance structure also improved after private equity fund Advent International invested in the company and joined the board. As a result, we became interested again.

Fleury is the leader in the premium segment for healthcare labs in Brazil. Just like Raia Drogasil, which we mentioned in the previous letter, Fleury also benefits from the country's aging population (more exams). Aside from demographics, the company also reaps rewards from the resiliency of the premium segment and its strong relationship with the medical community through its 90 years of existence. In addition to the sector's favorable trends, Fleury's internal dynamics also improved in the last few quarters driving returns to increase substantially. We believe this is just the beginning of a revenue growth story coupled with strong margin improvements.

The healthcare diagnosis business has all essential elements of a *compounder*. There are high barriers to entry, it is scalable and it has low volatility with attractive returns. Among the barriers to entry we highlight Fleury's strong brand. As Fleury became known for its quality among the doctors, it generated a virtuous cycle. According to recent polls, 71% of doctors mention the company as the most reliable laboratory. As more doctors recommend it, more patients use Fleury. This effect is clear when we see that sales per unit more than tripled since the IPO (2009).

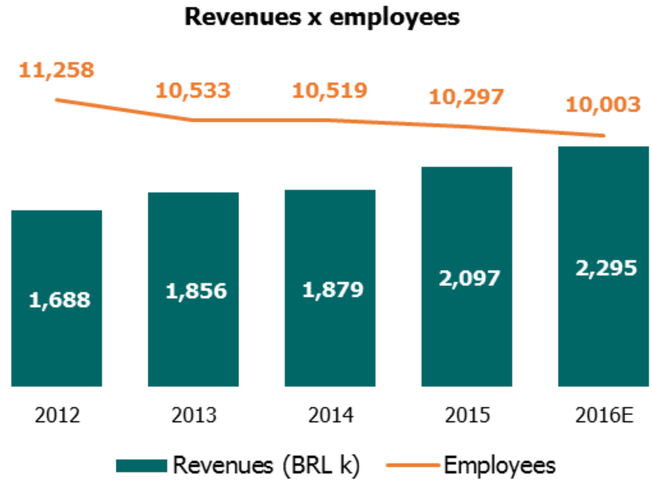


Source: Top of mind



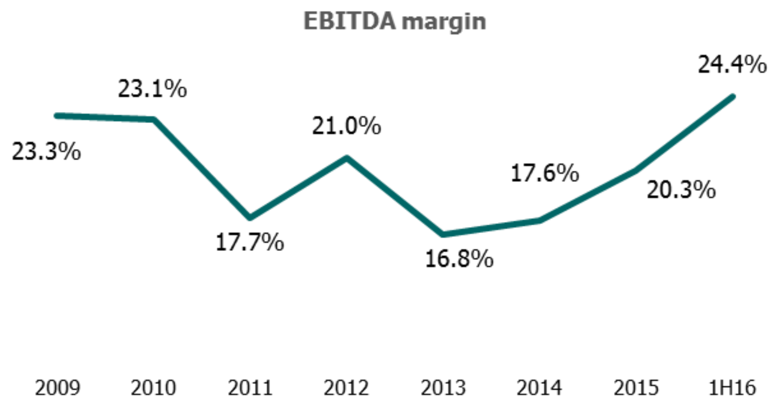
Source: Fleury's reports and Constellation's estimates

Another highlight in this case is scale. With advancements in technology and its centralized diagnostics centers, Fleury benefits from its operational leverage. Since the company finalized its last acquisition in 2012, we noticed that the number of employees fell while revenue grew 36%.



Source: Fleury's reports and Constellation's estimates

Despite the positive dynamics of the Healthcare Industry and specially the diagnosis segment, Fleury had reduced profitability during a number of years (2009-2013), due to: 1) geographic expansion into areas that were less explored by the company and with less knowledge; 2) Increased exposure to the image diagnosis business; and 3) changes in key people in the C-suite. Given such a scenario, Fleury decided to revisit its growth strategy and, in 2014, under a new management, the company returned to its origins and dedicated more focus on the clinic diagnosis for the premium segment, with greater focus in the São Paulo area. The operational improvement these last few years involved the development of better internal controls, shutting down non-profitable units, a stricter selection of the health insurance plans it partners with, widening the portfolio of clinical tests, plus other initiatives. With such efforts, the company quickly started to see positive results, with a margin gain of 700bps, surpassing historical levels of return.



Source: Fleury's reports

The improvements delivered so far are substantial and we believe that we are in the beginning of a cycle where, not only revenues should grow, but margins should continue to expand, all due to the very positive dynamic the company has today. When we combine a strong brand, a defensive business, high barriers to entry and a talented management team with a strong focus on return, we remain enthusiastic with our investment. We project that the company has the capacity to grow earnings at around 20% per annum for the next few years, making it a great *compounder*.

As a final word, we would like to remind our investors that we will be holding our annual meeting October 20th. We are delighted to have the presence of several important speakers, including 3 CEOs of our invested companies and Paulo Guedes, one of the most regarded economists in Brazil, with a unique ability to combine an analysis of the local and global economies with deep knowledge of the markets. Moreover, we will also have the presence of key people from the Government to talk about the infrastructure and privatization agenda, an important engine for future growth.

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