Constellation: Management Report 3Q17

Long Only Performance	Fund (USD)	MSCI Brazil (USD)
3Q17	22.08%	23.00%
YTD	37.58%	26.48%
Annualized return since inception	14.58%	5.90%

In the 3rd quarter of 2017, the Constellation Long Only fund was up 22.1%, compared to 23.0% for the market. Year to date the fund is up 37.6% and the market 26.5%.

"It's essential to remember that just about everything is cyclical. Cycles always prevail eventually. Nothing goes in one direction forever. The most dangerous thing is to insist on extrapolating today's events into the future.

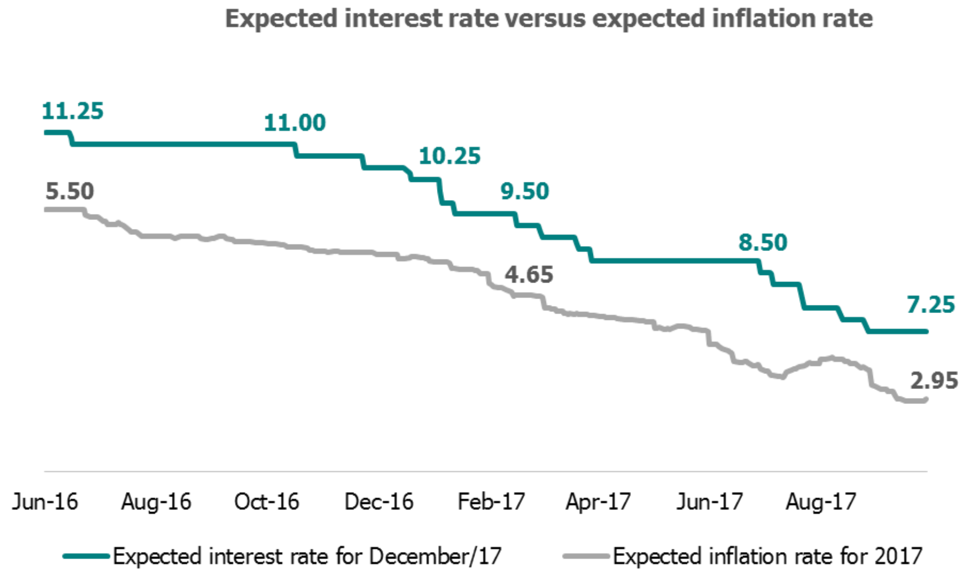
- Rule number one: most things will prove to be cyclical.

- Rule number two: some of the greatest opportunities for gains and losses come when other people forget rule number one."

- Howard Marks, "The most important thing".

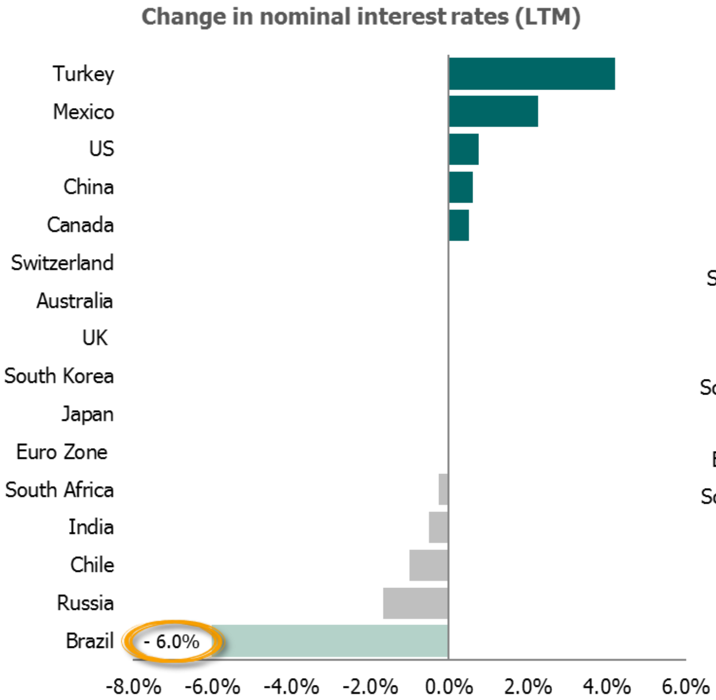
Cyclicality has been a recurring theme in our last few letters, and we continue to see signs which confirm the expected, but not consensual, economic rebound. This process has been fueled by the impressive cut in local interest rates, which went from 14.25% to 8.25%, a 600bps cut.

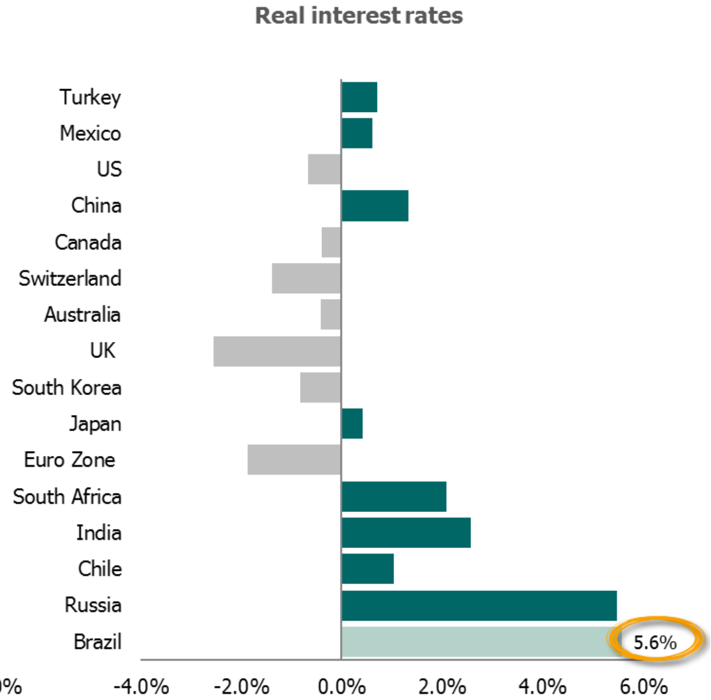
As illustrated in the chart below, this cut was much larger than what the market initially expected and as inflation continued to surprise downwards, there might be room for the Central Bank to take rates to new lows.



Source: BCB Focus report.

To put into perspective how massive this cut has been, we decided to compare how the Brazilian Central Bank's (BCB) move fared against other major economies. Considering the last twelve months, the Brazilian Central Bank has been by far the most dovish central bank. Furthermore, it is interesting to highlight that despite Brazil having presented the largest nominal interest rates cut, it still boasts one of the highest real rates among the main economies as inflation has also been tumbling. Therefore, we believe there may be room for the rate to fall below 7.25%, which is in line with the market's current forecast.





Source: Central Banks.

As there is still a significant volume of idle capacity in the economy, both in terms of production capacity and labor, this should allow rates to stay lower for longer. This is unprecedented in the Brazilian economy and the dimension of the impact is still challenging to forecast. Throughout this letter we will shed some light on what we have already been observing in the economy and the companies in our portfolio.

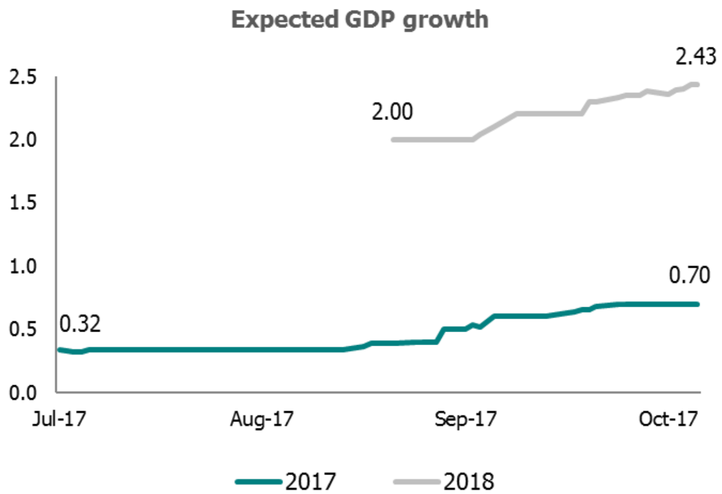
We believe it is insightful to see how several leading activity indicators have been developing. The shaded green cells mark when each respective indicator started to show a recovery trend. As can be noticed, confidence indices were the first leading indicators. Afterwards, the positive momentum started to spread out and has been observed in a broad range of sectors, as the economy distances itself from the political imbroglio.

	2016				2017								
Economic indicators	**1Q**	**2Q**	**3Q**	**4Q**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**
YoY growth													
Industry confidence index	-9.3%	5.2%	17.5%	13.1%	14.2%	15.5%	19.0%	16.8%	17.0%	9.0%	6.0%	7.6%	5.7%
Consumer confidence index	-11.7%	-7.3%	15.4%	17.9%	17.0%	17.0%	25.1%	26.6%	19.6%	13.2%	6.6%	1.9%	3.7%
Light vehicle production	-25.8%	-14.3%	-12.6%	13.5%	18.0%	41.0%	18.9%	10.6%	41.6%	14.8%	17.6%	45.5%	39.4%
Corrugated box shipment	-5.9%	0.6%	-0.3%	-4.5%	5.4%	3.3%	6.8%	-4.2%	6.0%	2.8%	3.0%	8.9%	6.2%
Real wage bill	-4.2%	-4.0%	-3.6%	-2.1%	-0.4%	0.8%	0.9%	1.3%	1.0%	2.4%	3.1%	2.7%	n.a.
Truck production	-35.1%	-12.1%	-14.4%	-4.3%	7.8%	-0.1%	5.1%	13.5%	42.1%	22.0%	36.2%	62.9%	56.8%
Mall foot traffic	-0.4%	-1.5%	-2.8%	-2.1%	-0.7%	-1.3%	0.6%	3.4%	0.1%	0.0%	1.6%	1.6%	4.4%
Real food retail sales	-5.2%	-6.6%	-4.1%	-2.0%	-0.6%	1.0%	-0.4%	9.5%	4.3%	7.9%	9.0%	11.4%	n.a.
Industrial production	-11.5%	-6.4%	-4.9%	-3.1%	1.8%	-0.4%	2.0%	-4.2%	4.4%	0.9%	2.9%	4.0%	n.a.
Unemployment	10.1%	10.8%	11.7%	12.6%	13.0%	13.0%	12.9%	12.9%	12.8%	12.7%	12.6%	12.5%	n.a.
Fuel consumption	-4.2%	-3.2%	-2.5%	-5.0%	1.1%	-4.9%	2.0%	-5.6%	2.1%	2.4%	1.7%	1.1%	n.a.
Total credit concession	-13.9%	-12.5%	-13.6%	-11.7%	2.5%	-10.5%	3.4%	-5.1%	3.9%	3.7%	2.7%	5.0%	n.a.
Heavy vehicle traffic	-5.8%	-4.0%	-7.1%	-7.0%	-2.3%	-4.9%	-0.7%	-8.3%	4.0%	-0.8%	3.1%	5.1%	4.3%

Source: ONS, ABPO, ABCR, Anfavea, IBGE, FGV, ABRAS and iFlux.

As a result of this trend, the underlying earnings of the companies in our portfolio have been increasing consistently, and surpassing market expectations. The recurring pattern which can be observed, is that operating profits have been growing at a faster pace than net revenues due to operational leverage; and net earnings have been growing at an even faster pace due to financial leverage.

The path to full recovery will likely be a long and arduous one, with eventual setbacks. Nevertheless, we do believe we are further down the path today, than we were earlier this year. As a matter of fact, economists have been consistently reviewing their GDP forecast for 2017 and 2018 as they update their models with the most recent data.



Source: BCB Focus report.

In the following paragraphs, we will describe how this inflection point of the economy is manifesting itself in a few of the companies in our portfolio.

- **CCR** is very well positioned for the cyclical rebound due to the high quality of its assets which are located near to the main economic centers in Brazil. This, combined with its high operating leverage, will have a noteworthy impact on the company's bottom line. We have already started to see the impact of traffic growth (which had been declining since 3Q14) on CCR's earnings, with a LTM net margin expansion of 400bps in 2Q17. We expect that a healthy traffic growth coupled with lower interest rates and the ramp-up of non-toll road assets, on which CCR invested roughly BRL 5bn (12% of its market cap.) in the past 3 years, will translate into average earnings growth rate of ~45%YoY in 2017/2018.

- **Rumo**'s results will continue to be boosted by its internal dynamics, characterized by a high exposure to agribusiness and grain exports growth, which have been strong in 2017 and should achieve an all-time high during the 2018 harvest. Moreover, Rumo's management has been delivering on eliminating operational bottlenecks and increasing efficiency, which has translated into a EBITDA margin expansion of ~300bps in 1H17. This environment coupled with a quick deleveraging confirms our positive view for Rumo, which has recently completed an accretive capital increase of BRL 2.6bn, in which we participated.

- **Localiza** is a great example of a company that became stronger during the crisis. In 2014, the competitive scenario in the car rental business started to become fiercer due to Movida's strong growth, which pushed down prices in the industry, consequently leading to flat profits until 2016. During this period, Localiza invested in technology and pricing intelligence, while at the same time reducing its cost base. With the stabilization of the competitive scenario, Localiza is now reaping the benefits of these internal efforts, increasing EBITDA by 20% and net profit by 25% in 1H17. As it is mostly a fixed-cost business, we expect to see the effect of operational leverage materializing, as industry demand is growing at a robust rate. In addition, financial leverage should also benefit earnings, given that a large part of the debt is indexed to variable rates.

- **Iguatemi** has been one of the best performing malls over the last years, despite the severe financial crises faced by the country. The company's portfolio proved to be extremely resilient, posting positive same store sales every single quarter, translating into an average growth rate of 4% since 2015. During this period Iguatemi also reduced costs and expenses, which led its EBITDA margin to expand from 72% in 2014 to 78% in 2016. As the company's newer assets continue to ramp-up, we expect this trend to continue, while also benefiting from the reduction in interest rates as nearly 80% of their debt is linked to variable rates.

- **Fleury** delivered 25% growth in its top line during the two-year period between 2015 and 2016. This happened while health plans lost 2.4mn clients, a 5% loss. The National Regulatory Agency for Private Health Insurance and Plans (ANS) data show that, after a long hiatus, in August, 70,000 clients were added to the system. Given Fleury's very strong brand awareness among the medical community, we see it very well positioned to capture even more growth in a scenario with net additions in the private health system.

- Apparel sales in Brazil had declined -11% from 2014 to 2016. In this same period, **Renner** grew retail sales 23.2%, while **Guararapes** grew 13.6%, both gaining significant market share. Despite the economic headwind, both companies kept moving, investing to improve their logistics network, increase labor productivity and open more stores. Year to date, Renner is growing retail sales 12.8% YoY, while Guararapes is growing 10.3%, and we see both companies well prepared to benefit from a healthier consumer environment, capturing strong operating leverage.

- **CVC** expanded total bookings by 13% through 2015 and 2016, while GDP contracted 7.2% in real terms during the same period. The company expanded its store base, created financial solutions to its clients and made selective acquisitions to accomplish this remarkable result. Consumer spending is now recovering, with consumer leverage below 2011 levels, and we still see CVC widening its moat by continuing to expand its store base, and rolling out its omnichannel strategy. We expect CVC to keep outgrowing its competition and delivering EPS growth significantly above net revenues.

Although the recovery has started to be more widespread, it's important to highlight that our thesis of strong companies getting stronger continues to play out, as the companies in our portfolio continue to materially outperform their respective sectors. Overall, while GDP has accumulated a nominal growth of 6% in 6M17, our portfolio delivered a consolidated EPS growth of 24% during the same period.

Overall, we believe our companies are well prepared to accelerate their growth, which will lead to further outperformance of their operating profits versus their revenues, as they have become leaner and more efficient over the past years. This is something we already had incorporated in our numbers coming into 2017, which we believed was our variant perception. Looking forward to 2018, despite the street having started to revise their models, incorporating a more positive scenario, we believe there are still cases in which an anchoring bias continues to lead the market to project lower earnings than what we believe is achievable.

To be able to have a superior view and to continue to be ahead of the curve, our team dedicates relentless efforts to talk to as many industry players as possible, public and private. So far, this year we have carried out more than 940 meetings, which have been confirming a more constructive view, with more companies inclined to resume expansion plans.

Despite the strong rally seen this year so far, it’s important to remember that the opportunity cost has also been falling sharply. For example, if at the beginning of the year Company A had an estimated nominal IRR of 20% and the interest rate (forward curve) was 14%, then the equity premium was 6%. If the same company now has a nominal IRR of 14% and the interest rate is 8%, then the equity premium remains the same 6%. Looking at our portfolio, the equity premium is currently at 6% which is exactly in line with its historical average.

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