Constellation: Management Report 4Q16

Long Only Performance	Fund (USD)	MSCI Brazil (USD)
2016	53.92%	67.25%
Annualized return since inception	12.38%	4.07%

In 2016, the Constellation Long Only fund was up 54%, compared to 67% for the MSCI Brazil in USD. It was a unique year and the first one we ever underperformed the market since our inception. Even though we are not focused on mimicking the index, it is never nice to underperform. Our investors had a very decent return though and are still way above the market since our inception, with much lower volatility.

Last year the Brazilian market was positively impacted by the performance of Petrobrás, Vale and global cyclical stocks. We consider most of these companies below average businesses and they underperformed sharply in the last few years as businesses and stocks. We currently do own Petrobrás as the company went through profound changes in "ownership" (new government), management, capital allocation and pricing policies. It is a much better business now. We have no conviction on Vale or other cyclicals yet.

We had big wins in our portfolio last year. Rumo more than doubled since the offering in the 1st Quarter. BM&FBovespa, our largest position, was up 90% in USD. Fleury and Raia Drogasil were up 190% and 112% in USD respectively. Overall, there were no relevant mistakes. Avoiding big mistakes is one of the things we spend most time on.

Business-wise, Constellation had a very good year: (1) we recovered the assets we had lost in 2015, (2) we moved to JP Morgan as our administrator (we believe we are now the only Brazilian manager able to accept unlimited ERISA investors), (3) we had net subscriptions in our funds, (4) we launched a very successful Special Opportunities fund (concentrated in our less liquid best ideas) and (5) we had two junior additions to the team and no one senior left.

The Constellation Challenge, an equity research competition we created in 2014, was a big success among undergrads with more than 300 individual participants from over 30 universities in this year's edition. We are thrilled that there is a new generation of students who enjoy doing research and investing. As a result, we have also benefitted from a record number of applications for our trainee program. We proudly believe Constellation is the equity manager with the highest recall among undergrad students in the best universities in Brazil.

After years of a tough market environment, morale in Constellation is high and we are all excited with potential new IPOs and clients we expect for 2017. It is going to be a very interesting year.

Last year was one of big changes in Brazil. The impeachment process of Dilma Rousseff, albeit dramatic, was very good news. We believe that the country was "blessed" that the new president, former vice-president Temer, will not run for reelection and therefore is willing to address the tough issues a politician would usually not address. It is worth noting some big wins in less than 6 months as president Temer:

1. Appointed probably the best economic team in decades;
2. Built a strong majority in Congress;
3. Changed the management teams of all big state-owned companies. The most relevant of them was Petrobrás. The company is selling non-strategic assets, implemented a market based pricing policy, eliminated subsidies and significantly improved its cash flow;

4. Had Congress approve a spending cap bill, which is a big step for fiscal stabilization;
5. Sent an ambitious Social Security reform to Congress, which we expect to be watered down to some extent but to be approved in the Lower House in the 2nd Quarter;
6. Proposed a modern high school reform in Brazil.

Markets soon realized Brazil was changing. The BRL appreciated 20%, the MSCI Brazil was up 67% in USD terms, the sovereign risk premium fell 43% and most importantly, inflation is converging to the target, paving the way for the most significant interest rates adjustment in big economies in the world. We expect interest rates in Brazil to fall from the current 13.75% to 10.00% by the end of the year.

Our base scenario that 3 cycles are turning in Brazil is even stronger now. Brazil is turning the **political cycle**, which is positively impacting the **economic cycle** and will improve earnings in an exponential way (operational and financial leverage) turning the **earnings cycle** up as well. It is going to be a bumpy ride up though. There will be significant volatility (Trump and the political process in Brazil) potentially leading to investor's second guessing from time to time. But the underlying collapse in interest rates and improvement in earnings will be a strong support for the market and should not be forgotten during the inevitable short term corrections. "Never fight the FED".

In regards to businesses some very important economic policies improved in 2016, but the benefits have not been felt by the companies in general. Consumers and businesses are still levered and we should start to see improvements from this quarter on. However, 2016 was not a bad year for our companies. Some remarkable examples:

Raia Drogasil opened 200 new stores, increased market share from 10.6% to 11.8% and grew total sales area at 15%. We expect sales to have grown organically 25% for the year with earnings benefitting from economies of scale, growing 36%, a BRL 120mn net income addition, more than the absolute net income of the 3rd largest player in Brazil. Not bad in a recession. Raia Drogasil is an example of the strong companies growing stronger during crises in Brazil.

BM&FBovespa announced the merger with Cetip, creating a regional power house and raising huge barriers to entry for new competitors in the market. The combined entity will be a dominant vertically-integrated player in all asset classes. The "new" BM&FBovespa will earn revenue in every trade, registration and custody of all types of securities in Brazil (derivatives, equities, currency and fixed-income instruments). In addition, BM&FBovespa continued to progress in the clearinghouse integration project, launching new promising products (e.g. inflation future contract) and acquiring stakes in other Latin American stock exchanges (Mexico, Colombia and Chile) throughout the year. It was a very eventful year for the company.

For 2017 the focus will be on integrating with Cetip. We expect to see the regulatory approval in the first half of the year. We understand that with the economic cycle turn, BM&FBovespa is one of the companies best positioned to deliver strong operational results.

Rumo restructured its balance sheet with a very successful new equity offering in the 1st Quarter, it rolled-over short term debt and is addressing new funding. Furthermore, the new management team improved operations, hired experienced personnel in the railway sector, implemented internal incentives towards creating a long-term culture and is engaging in important investments in the company's infrastructure and rolling stock. This will increase Rumo's efficiency, increase capacity and dilute costs.

For 2017 we expect Rumo's levered balance sheet to benefit from lower interest rates and an all-time high corn and soybean crop (record volume). It is also important to highlight the favorable regulatory environment that is being built in the sector and should translate into higher returns and, potentially, into the signing of the extension of Malha Paulista's concession term to 2058. This will be an important milestone for the company to continue to implement its ambitious investment plan, resulting in high-teens operational growth rates in the years to come.

Fleury (medical diagnosis) continued to grow revenues and margins. We expect sales to have grown 11% for the year and EBITDA margin to have improved >300bps, reaching the highest levels of profitability ever. After two years of re-organizing the company and extracting value from current operations, the management team is now ready to expand the business, a process that already started to take place in 2017.

Aliansce acquired a stake in Shopping Leblon, one of Rio de Janeiro's best performing assets, while also strengthening the company's balance sheet through a very successful private equity offering. Despite being a private offering, the company was able to bring a new relevant shareholder with extensive knowledge in real estate. For 2017 we expect Aliansce to benefit from lower interest rates as the company shifted a large portion of its debt to floating rates.

Multiplan presented yet again a year of good growth, a reflection of its dominant position. Also, after years of focusing almost exclusively on green and brownfield projects, it went on a buying spree at the very end of 2016. Multiplan was able to take advantage of its strong balance sheet to buy small stakes in some of their best performing malls from partners that were under financial stress and were forced sellers. This year Multiplan already announced a relatively small additional private offering that will allow them to continue seeking accretive acquisitions.

In sum, last year most of our businesses strengthened their competitive positions widening their moats. Quoting Warren Buffett:

"Every day, in countless ways, the competitive position of each of our businesses grows either weaker or stronger. If we are delighting customers, eliminating unnecessary costs and improving our products and services, we gain strength. But if we treat customers with indifference or tolerate bloat, our businesses will wither. On a daily basis, the effects of our actions are imperceptible; cumulatively, though, their consequences are enormous.

When our long-term competitive position improves as a result of these almost unnoticeable actions, we describe the phenomenon as 'widening the moat.' And doing that is essential if we are to have the kind of business we want a decade or two from now. We always, of course, hope to earn more money in the short-term. But when short-term and long-term conflict, widening the moat must take precedence. If a management makes bad decisions in order to hit short-term earnings targets, and consequently gets behind the eight-ball in terms of costs, customer satisfaction or brand strength, no amount of subsequent brilliance will overcome the damage that has been inflicted."

Given the lackluster environment in Brazil in the last few years the number of "investable" stocks was very limited. The overlap among managers was therefore significant. In the new scenario for the next years several companies that were not "interesting" in a recession become eligible. We also expect a large number of IPOs in new and growing industries. It is going to be an intense 2017 for our research team. We are prepared.

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