Constellation | Management Report 1Q18

Long Only Performance	Fund (USD)	MSCI Brazil (USD)
1Q18	11.32%	12.47%
Annualized return since inception	14.72%	6.50%

In the first quarter of 2018, the Constellation Long Only fund was up 11.32%, compared to 12.47% for the MSCI Brazil. The main contributors were our investments in Suzano and Localiza. There were no major losses, but Rumo and Ultrapar detracted from our performance.

The Brazilian investment backdrop is auspicious: inflation is under control; interest rates are at the lowest level in a decade and should stay low; the economy is slowly picking up; earnings of the best companies are growing double digits. We expect this positive backdrop to continue over the next few years.

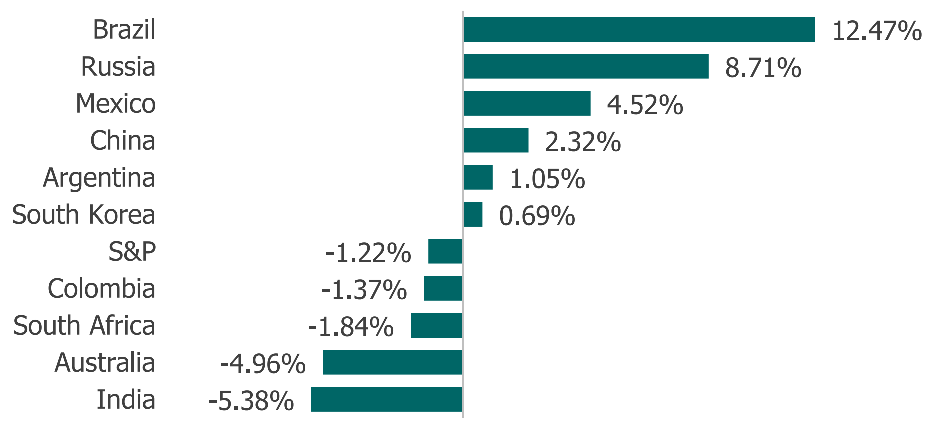
Collapsing interest rates are having a profound impact on local investors. They were used to making 1% per month in short-term government bonds. Now, if they want to maintain a similar level of return, they will have to increase exposure to riskier assets in their portfolios. Quite frankly, most of the money is going into local macro hedge funds. Although these funds tend to focus on bonds and rates, they also invest in equities. Speaking of which, we are seeing record inflows into equity mutual funds by individual and institutional investors – one of the reasons for Brazil's sound recent performance.

Fund Flows (per Asset Class)	1Q18 (BRL mn)
Equities	*7,100*
Macro Hedge Funds	26,700
Long Short	(193)

Source: Anbima.

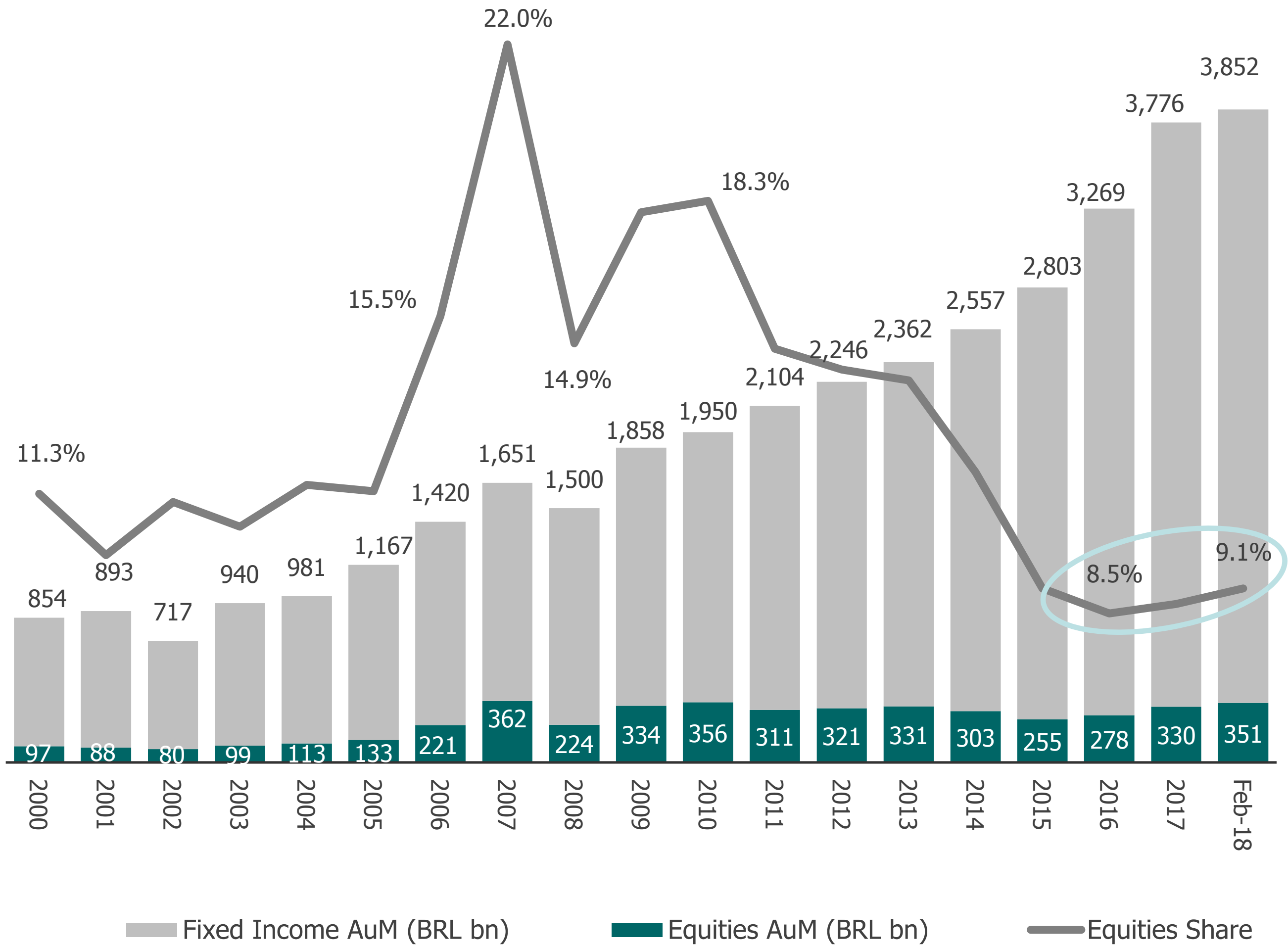
When one looks at the relative performance of Emerging Markets, Brazil stands out.

Performance 1Q18 (USD)



Source: Bloomberg.

Despite massive inflows, most investors are still underweight equities, as the graph below demonstrates.



Source: Anbima.

The apparent calm on the surface does not reflect the sweat and tears in most portfolios when it comes to stock picking. The Brazilian equities story is no longer about value – it is about growth, as it has truly always been. Businesses that survive here have wide moats, strong balance sheets and investment in growth. Organic growth in the good times, and acquisitions of weaker competitors in the bad ones. In fact, that is one of the main conclusions of "Sucesso Made in Brazil," written by my good friend, Martín Escobari, and Harvard professor Donald N. Sull. Winning Brazilian companies are the ones that benefited from crises by acquiring their competitors and consolidating their industries.

As reflected during the Brazilian market rebound over the last two years, value tends to dominate the first leg of the bull market. Attractive value plays are still out there, yet most companies now need to deliver growth to justify valuations. The ones that do not deliver the expected growth are being severely punished, as the examples below show (we do not own any of these stocks below, by the way).

Company	Return YTD*	Observations
BRF	-34.0%	Weak 4Q17 earnings coupled with governance issues and a leverage of 4.4x Net Debt/EBITDA.
Hering	-22.1%	Weak sales volume, below estimates, with SSS shrinking 1.1% in 4Q17.
Qualicorp	-28.0%	Slower than expected client growth, losing 5% of 4Q17's initial base and -12% in 2017.
Ser	-43.7%	Frustration with the recently announced growth plan. Estimates for 1S18 reflecting -13% in onsite business, despite campus expansion. Margin contracted 12% 4Q17 (YoY).
Kroton	-25.8%	Challenging long-term growth and margin dynamic (-5.1% 2017 EBITDA ex-financing and provisions).

**Until 19.04.2018; Source: Bloomberg, Constellation and Companies' Reports.*

We are always extremely diligent in our research process, and one of our key concerns now is not losing money by overpaying for growth, nor by overestimating earnings. Mistakes may go unpunished during the first leg of the bull market, when flows lift all boats and lower quality companies' stocks outperform. Well, that phase is over. There may be an equity bubble if the October presidential election outcome is favorable, but stock picking is no longer playing second fiddle to the macro picture.

Investors will need to be more diligent in choosing managers, and managers will have to work harder. I must confess that life is tougher at Constellation these days. We are not only triple checking the fundamentals and operational performance of our business, but we are also analyzing new companies that will be "IPOed" or that were recently "IPOed". In that respect, we promoted André Lima – one of our most talented young assistant analysts – to full time analyst.

Finally, we present some highlights in our portfolio, as well as a detailed analysis of Localiza.

Suzano & Fibria

After years of speculation, a merger between Suzano and Fibria was announced on March 16th. Most impressive is how Suzano, valued at BRL 26 bn that day, acquired 100% of Fibria for BRL 35 bn, given that BRL 29 bn will be financed by new, pre-approved debt. The transaction's structure is another critical point: Suzano will pay BRL 52.5 per stock (corrected by the CDI, Brazil's interbank lending rate), plus 0.4611 of Suzano's stocks, which equals BRL 10 on the announcement day. Therefore, the upside of higher pulp prices, synergies and goodwill will be mostly captured by Suzano's shareholders. We estimate that the NPV of the operational synergies represent about BRL 10 bn and the goodwill another BRL 3 bn. Since pulp prices have stayed persistently high, the company should go through a rather accelerated deleveraging process, quickly transforming the debt into equity for the shareholders. We remain optimistic with the pulp market for the following years, given the lack of new capacity entering the market, while consumption should grow consistently.

Energisa

Since our first investment at its re-IPO in July of 2016, we believed that 2018 would be a very special year for Energisa. The reality has since proven to be better than initially expected. Positive regulatory themes (regulatory WACC and technical details of tariff revisions for power distributors) were approved at the beginning of this year, as we anticipated. The company's strong management has improved all operational indicators: energy loss, better frequency and shorter duration of power cuts. A heating economy has propelled energy consumption to nearly 5% in the first quarter. We expect the combination of these positive factors to drive strong profit growth for Energisa this year.

Rumo

Our constructive outlook on the company continues to improve, especially in the beginning of 2018. During the first semester, agribusiness should reach a new milestone in Brazil – another record high soybean crop. Considering a significant soybean stock from last year's record crop, Rumo will have a substantial volume to transport this year. Another important part of our investment thesis continues to evolve: positive results from the investment plan, with new services initiating this month of April (i.e. fertilizer transportation between the port of Santos and Mato Grosso), aside from the capacity increase and cost reduction already reflected on the company's results.

Petrobras

The company's main value drivers are further underlined in 2018 with strong deleveraging, better corporate governance, constructive commodity prices and pro-market management decisions. Given BR Distribuidora's IPO (the last major asset sale in December of 2017), we expect significant divestments of pipelines and oil fields to continue playing out. When we combine the selling of assets with strong results driven by better commodity prices and rational product pricing, we expect to see Petrobras delivering a healthy free cash flow and reaching a leverage below 2.5x Net Debt/EBITDA by year-end. Corporate governance continues to improve as well. In the beginning of this year, the company improved its fuel pricing policy – one of its main milestones and the third major change since its inception in 2016. In addition, studies for a new dividend distribution policy have been announced.

Localiza

"So we think in terms of that moat and the ability to keep its width and its impossibility of being crossed as the primary criterion of a great business. And we tell our managers we want the moat widened every year. That doesn't necessarily mean the profit will be more this year than it was last year because it won't be sometimes. However, if the moat is widened every year, the business will do very well…"
– Warren Buffet, in Berkshire's 2000 annual meeting

Localiza's story began in 1973 with six used and financed Volkswagen Beetles and a small agency in the center of Belo Horizonte. In the beginning of this journey, the founders envisioned growing throughout the Northeast, avoiding stronger competition in the South and Southeast. Once they successfully took their first step and gained a larger scale, they began expanding nationally. After a few more years of solid execution, Localiza became leader in the car rental market.

In the beginning of the 1990's, the company started building a chain of franchises – a less capital-intensive strategy to quickly gain capillarity. At the same time, Localiza created a certified pre-owned (CPO) store. It was a strategic decision that proved to be right, as competitors still have not been able to replicate this model as successfully. At the end of the 1990's, they created the fleet rental division, a synergetic business to their car rental operation.

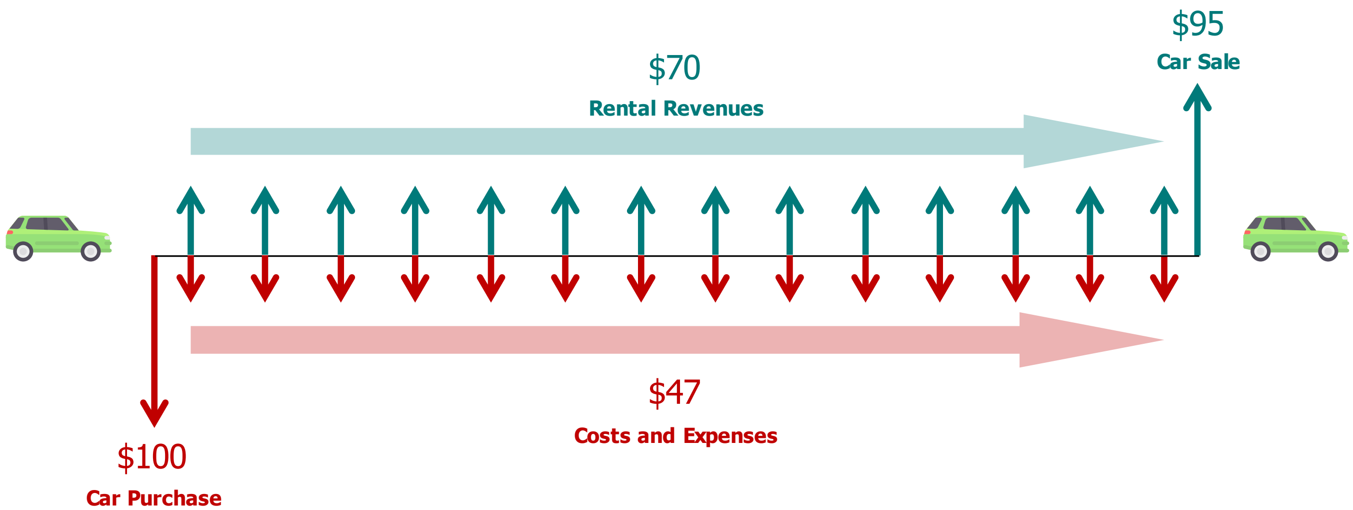
In 2005, Localiza was listed on the stock exchange with a market value of approximately BRL 760 mn. The company's revenue during this period was BRL 850 mn with a total fleet of thirty-two thousand cars.

It currently has a fleet of 194K cars (6.1x larger than the fleet at IPO) and 517 agencies in the country, greater than the sum of the second and third largest competitors, even when considering the merger between Locamérica and Unidas. It is the only company in the sector in Brazil with returns above the cost of capital, being the most profitable globally. Localiza's market value today is BRL 18 billon, equivalent to that of Hertz and Avis combined.

BRL mn - 2017	Localiza	movida rent a car	locamerica / unidas
Net Revenues	6,059	2,468	2,815
Rental Revenues	2,591	1,018	1,473
Net Profits	561	66	133
ROIC before Taxes	18.4%	8.2%	11.5%
Fleet size ('000)	194	76	111
# of agencies	517	183	265
Market Value	18,680	1,522	3,505

Source: Companies' reports.

There are three stages in the car rental business: the purchase of the car, the rental and the used car sales. Below, we provide a simplified flow chart of the process. Car rental has a one-year duration, while fleet rental has a three-year duration.



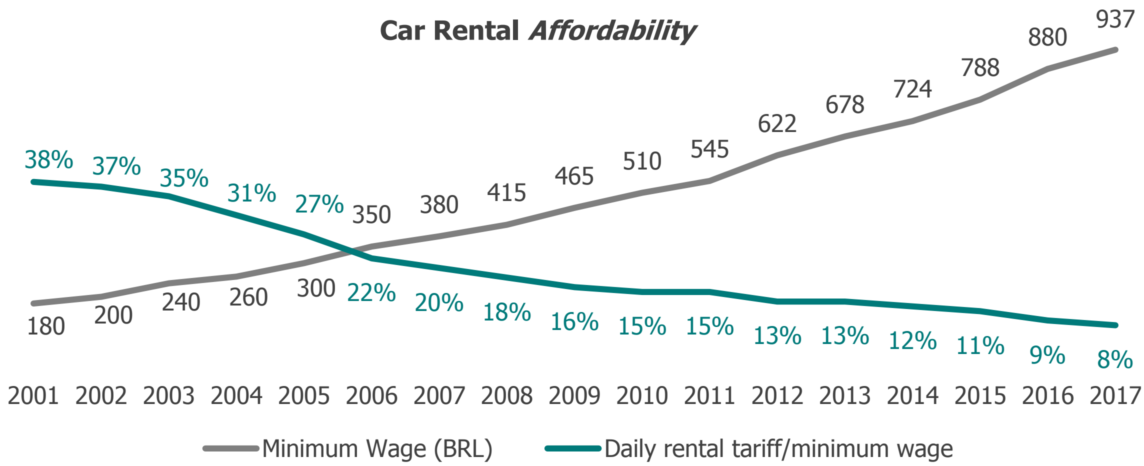
Source: Constellation.

The first phase of the cycle is the car purchase, with either proprietary or third-party cash. This activity is capital intensive. Since Localiza is the most financially robust company of the sector, it has the lowest cost of capital. It also has scale – another critical factor in obtaining a greater discount with automakers. As Localiza represents about 10% of sales of the five largest automakers in the country combined, it enjoys the best purchasing conditions.

The second phase of the cycle is car rental. It entails innumerous details, controls and robust processes to ensure a consistent level of operations. Thus, strong execution discipline and vast experience are critical competitive advantages here. To further illustrate, Localiza must process fines that customers may have received; implement car licensing and tax payments; control spare keys; clean and ensure check-ups are followed through; control each car return; maintain excellent customer service; and prepare the cars for sale. The operation has a relevant fixed cost structure. We estimate around 50% of costs and expenses are fixed, underlining the importance of scale.

Last, but not least, selling used cars well is essential to renovating the fleet and to repeating the entire operational cycle. Thirty years ago, the company built the chain of CPO stores, which today is one of its main pillars. With direct sale to the final customers, the price of the sold car is higher compared to the alternative of selling to a wholesaler, which generates more capital to be reinvested in the purchase of cars. We estimate that the concentration of used car selling via own stores increments the company's profits in approximately 7%. In addition, having their own chain brings greater brand recognition in the CPO market and creates an inventory buffer for Localiza (if the company cannot fully attend the spikes in car rental demand, cars on sale can be dislocated to the rental operation). During this phase – once again – Localiza has competitive advantages, counting on a chain of CPO stores twice as productive as the average of its two major competitors. It is worth mentioning that this phase of the operation is pivotal, given that erring on the price will compromise the rest of the cycle.

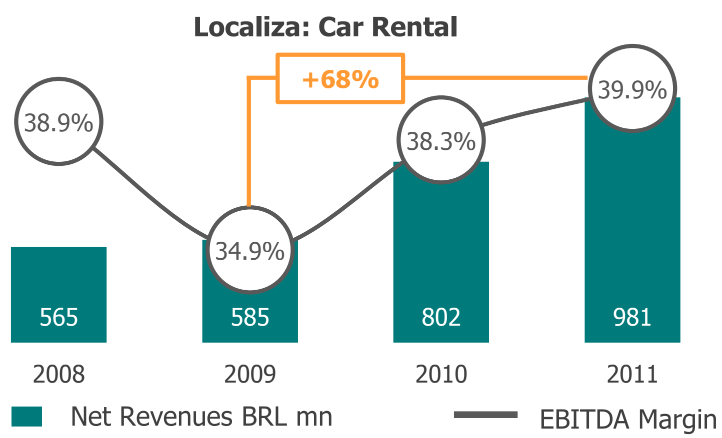
Thus, Localiza has competitive advantages in all its operational phases, given that it is the only one capable of delivering returns above its cost of capital in Brazil. These advantages have stimulated a positive feedback loop over time: the economies of scale are in part shared with clients (the daily prices as percentages of the minimum wage have fallen consistently over time, making car rental even more accessible), pressuring the profits of players with less scale that continuously deliver returns below their cost of capital. The car rental sector has a high barrier for lucrative growth – only Localiza has trespassed this critical mass.



Source: Localiza and Constellation.

One of the qualities we search for in our companies is the capacity to reinvent themselves when faced with adversity, as well as a culture of excellence. Localiza's story has a few episodes that highlight the team's execution capacity.

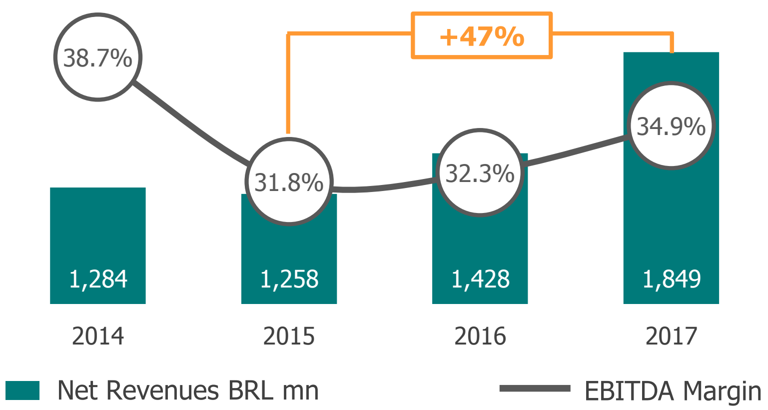
In 2009, while Brazil faced economic deceleration and falling GDP, the company dealt with smaller demand and smartly decided to use the time to review internal processes and increase operational efficiency. In the following years, revenues grew 25% per year, gaining expressive market share (approximately 6% over two years) and strong operational leverage – EBITDA went from BRL 245 mn in 2009 to BRL 460 mn in 2011.



Source: Localiza and Constellation.

Another striking example was in 2015, a year in which the competitive scenario grew fiercer. The company, once again, maintained its operational discipline and searched in-house, investing in greater competitive intelligence, people and technology. They implemented a more dynamic pricing model, varying its prices according to demand, car availability and competitive intensity (like airline companies do). When it comes to people, they opened more space for juniors and reinforced some abilities that gained importance in the last few years: marketing, technology and statistics. In the technological front, new digital applications were launched aiming at improving the customer experience. The result was a jump in growth with strong margin expansion over the last two years, proving that the strategy was a success. Between 2015 and 2017, they added to the company more than the equivalent of Movida’s fleet and EBITDA.

Localiza: Car Rental



Source: Localiza and Constellation.

This most recent wave of aggressive competition (which occurred between 2015 and 2016) left scars on two of its main competitors – one of them is facing internal operational challenges, a result of extremely aggressive growth, leaving no appetite for further expansion. This player is still highly leveraged at almost 4.5x Net Debt/EBITDA with returns on invested capital 5% below its cost of capital. Another competitor was sold and is currently involved in the integration process. Therefore, Localiza is in a privileged position to capture the demand growth associated to the country’s economic recovery, given a benign competitive backdrop.

Therefore, Localiza is a dominant platform prepared for growth and market consolidation. The company is a rare combination of extremely experienced leaders (with over 40 years in the sector), alignment, and sustainable competitive advantages across its operations. We understand that the company has a great avenue of growth going forward and opportunity to deploy capital at attractive rates for a long time, generating value for its shareholders. It is a typical case of operational and financial leverage driven by profit growth. We estimate an annualized return of 15% throughout the next three years.

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