Constellation | Management Report 2Q18

Long Only Performance	Fund (USD)	MSCI Brazil (USD)
2Q18	-26.67%	-26.37%
1S18	-18.37%	-17.51%
Annualized return since inception	11.63%	2.08%

In the second quarter of 2018, the Constellation Long Only fund was down 26.67%, in line with the MSCI Brazil. Year to date the fund is down 18.37%, while the MSCI Brazil is down 17.51%. In fact, currency depreciation has had the largest impact this year. The Real devalued 17.62% in the quarter, 17.18% year to date.

Last quarter was one of the most eventful in the last few years, leading to negative repercussions in the markets. Globally, there was geopolitical noise, uncertainty regarding US monetary policy change, and currency crises in Turkey and Argentina, to name a few. In Brazil, we dealt with the truck drivers' strike impacting this year's expected GDP, malaise concerning the Brazilian presidential election, and speculations as to whether Brazil should raise interest rates.

Yet what really changed after all? There are two factors we must surely consider. To begin with, there is a less favorable global environment for risky assets. We are not alluding to a crash, but to weaker market tailwinds and beta, as well as weaker fundamentals (i.e. Turkey and Argentina). As mentioned in our last quarterly letter, stock picking and alpha generation have become crucial now more than ever. Another factor to consider is how the shift in global appetite for risky assets hit Brazil at the worst moment during the truck drivers' strike. It is still premature to measure the impact of this combination on the Brazilian economy and, most importantly, on the fund. Consequently, GDP growth, interest rates and company earnings over the next few quarters remain nebulous. Despite some stocks having fallen 30% from their highs, we have only lowered our earnings expectations on average 5% to 10% - a less pessimistic projection than consensus.

Accordingly, we steer away from pure macro plays, focusing instead on secular growth trends, whether that be sectorial or company-driven. Some investors tend to believe emerging markets are about value investing. They look for cheap assets, as if they were in an apparel outlet store, where it is common to buy items that either do not fit or are not needed. I myself have done better buying quality stuff I do need at fair prices. Emerging markets are about buying quality companies investing in growth, either organically or through acquisitions. Below, we highlight a few:

Lojas Renner

Lojas Renner is the leading apparel retailer in Brazil with the best execution. It emerged from the recession much stronger than its competitors, reflecting the investments made in its stores, its distribution infrastructure and its financial services business. The company's strong competitive position, coupled with greater real estate availability, has provided diverse opportunities to accelerate expansion and market share gains. Consequently, in 2017 Renner increased its sales area by 12%, net revenues by 15% and earnings per share by 17%, while Brazil's apparel sales grew only 6%, according to IBGE.

The first quarter of 2018 has also proven to be auspicious, with revenues growing 15% and earnings per share increasing 58%, compared to the same quarter in 2017. Credit business improvement, new logistics system expansion and more favorable FX hedge on imported products should drive similar top line growth through the rest of the year. Despite the deceleration and reduction of growth expectations in several segments of discretionary consumption, in general we look for Renner to deliver revenue growth and earnings per share expansion of around 12% and 20%, respectively.

CVC

CVC is the largest tour operator and travel agency in Brazil, having built a unique competitive position over the last three years. The following drivers put the company in a favorable position to organically gain market share and acquire competitors: informational advantage obtained by operating across all travel segments; economies of scale with its suppliers; a solid balance sheet; as well as exclusive product offering and financial solutions.

When GDP contracted 8% in real terms between 2015 and 2016, the company's Leisure segment grew organically 10% in nominal terms, while the sector itself contracted 4%. In 2017, CVC grew 17% in the same segment, compared to 8% for the sector.

In the first quarter of 2018, consolidated bookings increased by 12% and earnings per share by 36%, compared to the previous year's quarter. We expect CVC to end 2018 with consolidated bookings growth greater than 12%. Considering the operating leverage and synergy of recent acquisitions (Trend and Visual), we estimate 30% earnings per share expansion in 2018.

Mercado Livre

Mercado Livre (MELI) is the leading e-commerce company in Latin America with Brazil generating more than 70% of the company's cash flow. By 2017, MELI already had 27% of e-commerce market share – compared to 19% of its largest competitor. It is expanding that gap by systematically improving its consumer experience with greater payment solutions, as well as faster and more reliable delivery alternatives.

The platform's massive strengths allow the company to explore other forms of monetization, such as Mercado Pago, its fintech division, that is now offering new payment and financing solutions to sellers and consumers. These initiatives both increase the platform's perceived value and create new profit pools with enormous potential to be exploited.

In 2017, MELI delivered 57% sales growth in Brazil in BRL, capturing 66% of the total market growth of 17%. In the first quarter of 2018, sales increased 71%. Despite the upheavals caused by both the post office price increase in March and the truck drivers' strike in May, we believe that MELI will continue to grow more than 50% per year in Brazil in BRL, expanding its leadership and creating value in complementary initiatives, such as fintech.

Suzano & Fibria

The companies in the pulp and paper sector continue to benefit from a very favorable backdrop with tight supply and robust demand. On the demand side, we have seen strong growth in China, with total import volumes growing 3% during the first five months of 2018. The greatest surprise, however, has been on the supply side: unexpected maintenance stoppage was unexpectedly high in the first semester, reaching 500-600 thousand tons, versus an expectation of 300-400 thousand tons for the entire year. As a result, we have seen very resilient pulp prices.

The aforementioned scenario, combined with a more depreciated BRL, caused both Suzano and Fibria to deliver distinctive results in the first quarter of the year. Suzano's EBITDA grew 80% YoY, while Fibria's grew 183% YoY. Additionally, Suzano's acquisition of Fibria has been progressing smoothly, with the US Federal Trade Commission approving the transaction without restrictions, and the transaction being filed at the Brazilian anti-trust authority earlier this month. Our two key reasons to invest in the sector, therefore, stand solid. We remain optimistic with the positive supply and demand environment, as well as with the highly synergistic transaction (at least BRL 10 bn in synergies).

Iguatemi

Iguatemi is one of the leading shopping mall companies in Brazil with a high-quality portfolio that has been amply validated over the past few years. Despite the crisis during this period, it has delivered consistently increasing revenues and controlled delinquency rates. Iguatemi's business is resilient and is able to increase rents above inflation – that is why we like it.

In spite of modest revenue growth in recent quarters, we see further acceleration looking forward over the following years due to higher inflation and gradual reduction in store discounts. In fact, if Iguatemi eliminated all discounts, revenue growth would almost equal an additional mall, without any investment. Furthermore, we expect the company's deleveraging and lower interest rates to propel results in 2018. In the first quarter of 2018, Iguatemi delivered 30% FFO growth YoY, as financial expenses represented only 17% of revenue against 28% in the first quarter of the previous year. For the following quarters, we expect this dynamic to continue.

Rumo Logística

Our investment thesis in Rumo, the largest logistics company in Brazil, remains intact. Management, which has been leading the company for three years, continues extracting value from the combination of Rumo's former assets with rail operator ALL. Its robust investment plan is also being well-executed. After an exceptionally strong 2017, the company continues to perform well in the first half of 2018. EBITDA is expected to grow roughly 20% YoY from both volume and margin gains, due to the capacity increase that is in line with the investment plan, allowing the company to expand operating margins.

Rumo's investment plan is necessary to meet the large freight demand that exists in Brazil, especially for grain transportation from the countryside to ports. The best logistical solution is the railroad, which currently does not have enough capacity to meet all of the demand. Therefore, we see promising conditions for the company to post EBITDA growth of at least 15% per year over the following three years.

Energisa

Energisa is a power distribution company covering 19% of Brazil's territory. Since our first investment in the company in July 2016 (re-IPO), we projected 2018 as a very special year for the company. It has, so far, been the case due to positive tariff revisions in important concessions: Mato Grosso, Mato Grosso do Sul and Sergipe. Not until 2020 will Energisa have to worry about a new tariff revision to redefine its regulatory targets – a time frame that significantly reduces the risk of our investment thesis.

In addition, the company's management team continues to improve its operation, reducing energy losses, as well as duration and frequency of power outages. Energisa also continues to analyze growth opportunities through M&A and greenfield projects. Considering only the current assets of the company, we believe that Energisa will be able to grow profits by 19% per year over the next three years.

Localiza

Localiza is an exceptional car rental platform, larger than the sum of its second and third largest competitors and the only company in the sector that delivers returns above its cost of capital. It is a rare combination of highly experienced, aligned leaders with sustainable competitive advantages in all stages of the vehicle rental business: Localiza's cost of capital is at least 2 p.p. lower than that of its competitors; it purchases cars at a greater discount due to its unmatched scale (on average, 4% cheaper); it sells used cars at a better price (almost 8% higher, net of store maintenance costs); and it dilutes its fixed costs because of its scale.

In the last two years, the company has opened a large execution gap, growing more than one Movida (second largest company in the sector) in fleet and EBITDA. Localiza should continue to be the sector's highlight, capturing a significant portion of growth, while being the main market consolidator. For example, after car rental volumes increased 35% in 2017, we expect this year's growth to be above 25%. Combined with operating leverage, Localiza should present a profit increase of around 30%. The first quarter of 2018 has proven that they are well positioned to achieve this.

B3

B3 is the dominant exchange platform in the Brazilian financial market – a business with high barriers to entry and solid returns. Cetip's integration is in its final stretch and from now on the focus will be on launching new products, aiming to increase the platform's network effect and reinforcing the company's competitive advantages. After Cetip's acquisition, B3 has a more diversified and resilient revenue profile, and all of which have been accelerating. For instance, equities and derivative volumes are at record-high levels, lending keeps accelerating and vehicle sales continue to recover. Thus, we expect EBITDA to increase around 30% YoY this year.

Itaú

Itaú has the best banking franchise in Brazil, and is consistently the most profitable in the industry. Last year marked the beginning of the cyclical earnings recovery, and we expect this trend to continue. Itaú's credit origination is growing 20% YoY, improving the loan portfolio dynamic. In addition, after forming a large reserve cushion for loan provisions, Itaú will have less need for doing so, which will be an important profit growth driver for the year, translating into a high shareholder payout. We expect a dividend yield of 8% for 2018, unique for a quality asset like Itaú.

Shifting gears, after the sharp recent correction in stock prices and currency, we have been seeing inflows by our international investors, proving once more that our client base is mostly counter-cyclical.

As a final note, we would like to congratulate our former partner, Rafael Sales, who is now officially the CEO of Aliansce. Rafael has been doing a great job at the company and we are happy investors in the business.

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