

## MANAGEMENT REPORT 3Q18

LONG ONLY PERFORMANCE	FUND (USD)	MSCI BRAZIL (USD)
3Q18	0.42%	6.17%
YTD	-18.03%	-12.07%
ANNUALIZED RETURN SINCE INCEPTION	11.43%	2.39%

In the third quarter of 2018, Constellation Long Only fund was up 0.42% and -18.03% YTD, compared to MSCI Brazil's 6.17% and -12.07%, respectively. The Real's 22.30% devaluation this year is the main detractor weighing on the MSCI's performance. In fact, the anticipation of tighter global liquidity going forward has dragged Emerging Markets and their currencies, with Turkey and Argentina having suffered the most.

Despite the challenging year for Brazilian stock pickers, we remain constructive, as companies have faced significant price corrections while maintaining positive fundamentals. Most higher quality companies are down 20% to 30%, yet the Ibovespa is flat. GDP growth uncertainty surely does not help. A stronger USD, however, has benefitted commodity producers and Petrobras, players with a relevant weight in the index. Thankfully, the businesses we invest in continue doing well.

Let's first address the big elephant in the room: the Presidential elections' impact on the markets. We have been investing in Brazil for 30 years and we have seen it all. Over the last decades, we have seen interest rates range from 6% to 50% per year; the currency range from 1.10 to 4.60; three vice-presidents taking office; and several different parties in power. We have experienced the Mexican, Asian, Russian, Brazilian, Nasdaq, Brazilian again, Subprime and Brexit crises. During all those years, certain companies thrived. Among them: Localiza, Itaú, Weg, Porto Seguro, Ambev and Lojas Renner. These companies share some characteristics: management with an owner's mentality, strong balance sheets, sector leaders and consistent investment in business growth. For example, the UOL group recently listed PagueSeguro – a USD 10 billion company "created" during the crises years.

COMPANY	PROFIT GROWTH 2007-2017
RAIA DROGASIL	41% a.a.
MERCADO LIVRE	39% a.a.*
LOJAS RENNER	18% a.a.
EQUATORIAL	17% a.a.
LOCALIZA	11% a.a.

\*Brazil's operating performance

SOURCE: CONSTELLATION

We have no doubt that plenty of entrepreneurs will continue growing their businesses and generating significant value in either scenario, a Left or Right government. It is our job to find these people, invest in them and nurture a client base that is willing to stay for the long term to reap superlative returns. We believe that one of these businesses is Energisa.

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## ENERGISA

Energisa is one of the largest and most highly regarded companies in the Brazilian electric power sector. With a market cap of BRL 11 billion, it operates eleven distribution concessions and two transmission lines. A family-owned company with a strong results-oriented culture, Energisa is admired for knowing the formula for transforming bankrupt operations into state-of-the-art ones. The company is at the forefront of its sector consolidation for a reason, creating a lot of value for shareholders. It is also an important investment for Constellation since its re-IPO in July of 2016. Knowing its story is central to understanding our investment thesis, for Energisa only needs to continue executing what it already knows to continue generating strong returns.

Controlled by the Botelho family since its foundation in 1905, the company was born in the town of Cataguases in the state of Minas Gerais. During nine decades, it developed and operated generation projects in the electric power sector, until the government offered a great growth opportunity in the 1990's: the privatization of electric distributors.

Brazil had a peculiar moment during that decade when many government-controlled and -administrated sectors were privatized. Many transformational stories took place, as good management and smart capital allocation made all the difference for companies previously considered bad ones.

With an exhausted system that yearned for new investments and efficient management, the state-owned electric power distributors entered the list of eligible assets for privatization. Energisa knew how to take advantage of this and in the beginning of the 2000's, already operated the distributors of the states of Paraíba and Sergipe in the Northeast of Brazil, aside from managing numerous other small generation and distribution operations.

Distribution is a complex segment in the electric power sector. It may appear to be simple at first: a distributor needs to deliver electric power to residential, commercial, industrial and governmental consumers in an efficient manner (correct tension without interruptions), and to charge for this service.

Diverse motives, however, make this business extremely challenging. It is exposed to a relevant portion of the sector's default, as the company is responsible for charging clients for its own service, as well as for the service of transmitters and generators. Electricity loss is one of the largest sources of value destruction. It derives from customers who find ways to cheat the measurement device of volume consumed, thus stealing electricity. Moreover, the distributor is fined when there are electricity supply interruptions. Heavy rains in urban areas tend to be an aggravation, as the supply is often interrupted due to falling branches and trees on wire posts. Evidently, there are innumerable challenges to overcome.

Because of that, the privatization era in the 90's sought not only to reduce elevated debt, but also to foment resourceful management amongst electric power distributors. It provided Energisa a strategic opportunity to become a relevant player in the Northeast.

In Paraíba, Energisa established an emblematic track record. It went from a loss of BRL 94 million in 2000 to a profit of BRL 270 million in the second quarter of 2018 (accumulated over the last twelve months). Paraíba was awarded the nation's best distributor, according to the sector's association's most recent ranking. The good work done in Paraíba has been replicated in the operations of Energisa's other distributors.

Between 2000 and 2002, the company's team focused on financial and regulatory issues. It made an emergency capital expenditure to rescue Paraíba's operations from years of incompetent management. Between 2003 and 2009, the team focused on combatting electricity losses – the greatest source of value destruction, as aforementioned. It did so by implementing two programs simultaneously with the support of a proprietary software. The initiatives, which regarded increased fiscalization and delayed payments, were crucial to elevate the distributor's profitability level. At heart, it is conceptually simple, yet tough to execute, and more so to maintain. Finally, from 2010 until today, the company continues delivering in Paraíba more of the same: efficient management investing in asset, as well as electric power volume sales, growth to expand margins.

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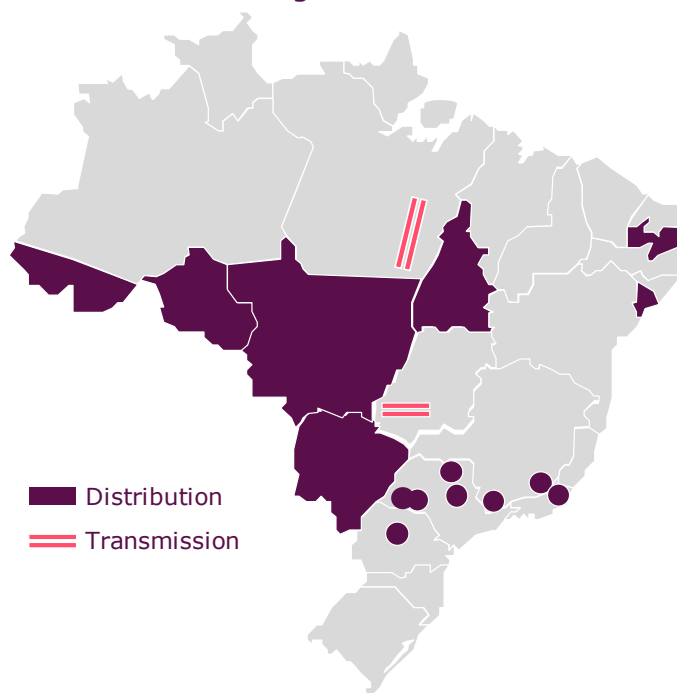
In 2014, Energisa made another strategic acquisition that tripled its asset and consumer base. The group expanded its operations to the states of Tocantins, Mato Grosso and Mato Grosso do Sul, which are important growth potential regions for Brazil's agribusiness. Energisa's efficient management style has propelled average annual growth of 20% EBITDA in Mato Grosso and Tocantins. There is still much value to extract from the companies acquired in 2014.

Energisa also has a track record in electric power generation. The company developed and acquired around 488 MW of capacity in the last 10 years, both in thermoelectric and small hydropower plants, investing in this segment only when returns are deemed worthy. In 2015, big international players sought M&A opportunities in Brazil, substantially elevating the valuation of electric generation assets. Energisa took the opportunity to divest from the segment with a BRL 2.5 billion deal. The capital was reallocated to the distribution segment when they acquired the distributors of Mato Grosso, Mato Grosso do Sul and Tocantins.

In 2018, Energisa made an offer to acquire control of Eletropaulo, a distributor of the metropolitan region of São Paulo. This time, the initiative attracted additional competition. There was another offer on the table 77% higher than the one made by Energisa. The valuation did not make sense and Energisa exited the dispute.

In the third quarter of 2018, the federal government initiated a new cycle of privatizations: the distributors of the states of Rondônia, Acre and Piauí. All of them are highly leveraged and extremely inefficient. Without competition, Energisa won the bid for the distributors from Rondônia and Acre. We hope that soon two more concessions shall be privatized: Amazonas and Alagoas. This would finalize this year's privatization cycle.

**Energisa's Presence**



SOURCE: ENERGISA

Given the complexity, it does not come as a surprise that there is low competition for inefficient assets. They are distributors with negative EBITDA, contingency problems, strong labor unions, high frequency of service interruption and an elevated amount of electricity stealing. Energisa's know-how is crucial in transforming these distributors as state-of-the-art operators. For this reason, privatization auctions for inefficient distributors drive away competition and have a low selling price, which places Energisa in a favorable position as the main sector consolidator.

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Therefore, Energisa is a value creation platform in the electric power sector. There is a lot of potential to extract from the eleven distributors the company operates, as well as from future auctions of generation, transmission and distribution companies. Without considering new projects or acquisitions, we believe Energisa can grow a 24% annual EBITDA over the next three years, doubling profit during the period. Our expected return in the investment is 82% over the next three years.

Finally, we would like to point out a few highlights of other portfolio companies during the third quarter:

## CVC

CVC announced three new acquisitions, taking an important step in its expansion strategy. The acquisition of Esferatur, announced in mid-August, further strengthens its leadership in the corporate segment and increases its sales to almost three times as that of the second largest player. The other two acquisitions, Grupo Biban and Ola Translántica – announced in the beginning of September – marked the beginning of CVC's international expansion. With both acquisitions, the company is already the third largest player in Argentina, which is responsible for almost 40% of international arrivals in Brazil and is one of the most important destinations for Brazilian tourists.

## ALPARGATAS

Alpargatas sold 22.5% of its operations in Argentina, with the option to sell the remaining 77.5% in two years. This operation was suffering with the volatile economic backdrop, as well as with the changes in local import tariffs, which certainly demanded careful attention from the company's management. Its sale will free financial and human capital to be reallocated to its sandals business, which is Alpargata's strategic focus.

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**

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