MANAGEMENT REPORT 4Q18

LONG ONLY PERFORMANCE	FUND (USD)	MSCI BRAZIL (USD)
4Q18	23.61%	13.83%
2018	1.33%	0.08%
ANNUALIZED RETURN SINCE INCEPTION (11/30/05)	13.01%	3.48%

In 2018, the Constellation Long Only Fund rose 1.33%, compared to 0.08% for the MSCI Brazil. The investment thesis we established three years ago is playing out as expected. It is based on the evolution of four cycles: (1) the **political cycle** shifting to more market-friendly politicians; (2) the **economic cycle** upturn with lower interest rates and credit expansion; (3) the **earnings cycle** boosted by companies' operational and financial leverage; and (4) the **market cycle** driving greater demand for equities when considering the aforementioned factors and how local and international investors have the lowest Brazilian equity allocation in decades.

Foreigners are wary of President Bolsonaro, as they haven't figured him out yet. With a more market-friendly government in power, investors shall be surprised by the new economic team's accomplishments. Paulo Guedes, the Minister of Finance, is my former partner and a long-time friend. Mr. Guedes is one of Brazil's savviest and most committed Austrian School economic liberals.

The current global market environment does not help international investors' appetite either. Nevertheless, Brazil is embarking on an economic recovery, while most other countries are facing a downturn. It is a matter of time before flows begin. This constructive market view is relatively consensual among Brazilian managers; therefore, stock-picking shall be the main alpha driver going forward. We at Constellation are prepared to work much harder, as (1) all our businesses face disruption to some extent and (2) how overwhelming the number of IPOs and new companies/industries coming to the market will be.

Regarding our companies, 2018 was a great year. In this quarterly letter, we briefly comment on the operational performance and share our perspectives on the main portfolio positions.

ITAÚ

We continue believing that Itaú is the best banking franchise in Brazil, consistently delivering the highest profitability in the industry. In 2018, it was no different. The bank is going through a profit acceleration cycle, as it strengthens credit origination and focuses on segments with greater spreads (such as credit for individuals and small and medium-sized businesses), thus boosting revenue growth. The consumption of a portion of the loan loss provision that Itaú built over the past few years will contribute to next year's earnings as well. Given the credit portfolio's low growth during the recent crisis, the bank accumulated excess capital. It was mainly allocated to the purchase of a stake in XP (Brazil's largest investment product distribution platform), dividends and buybacks. In fact, Itaú delivered a roughly 6% dividend yield in 2018 – a high level for such a quality asset.

B3

As predicted, B3 has strongly benefited from the economic recovery, generating strong revenue growth and greater profit expansion (thanks to its operating leverage). Equities average daily trading volume rose 41% in 2018. Hypothetically, if we extrapolate the average daily trading volume in 4Q18 to 2019, B3 would already have a 25% growth rate versus the 2018 average. After successfully concluding the merger with Cetip, the management team is now focusing on creating an extensive map of new products (some of which have already been launched) to strengthen its platform’s network effect. Going forward, we remain optimistic with the investment case, which shall benefit from several factors: (1) cyclical profit recovery of listed companies; (2) credit portfolio growth; (3) active corporate debt market to finance investments; (4) greater vehicle financing; (5) greater risk appetite and equities asset allocation; and (6) increase in the volume of new issues, both follow-ons and IPOs. We see B3 well-positioned to continue delivering distinctive results in this scenario.

MERCADO LIBRE

It was another strong year for Mercado Libre, which grew GMV (Gross Merchandise Volume) by 40% to BRL 23bn in Brazil (USD 12.7bn in total operation), accelerated the progress of its logistics solutions, and reinforced its financial services offering on Mercado Pago. We estimate that BRL 6.8bn of GMV was added in 2018 (versus BRL 6.3bn in 2017), which represents a sum larger than that added by B2W, Magazine Luiza and Via Varejo online combined. We expect the company to continue materially increasing its one-to-two-day delivery and adding relevant new product categories, which should strengthen the frequent buyer behavior.

The financial services segment grew even more. In Brazil, the TPV (Total Payment Volume) of MPOS (Mobile Point of Service) is expected to end 2018 with an annualized BRL 10bn (equivalent to PagSeguro's machines), and more than BRL 20bn in 2019. This is the fastest growing segment in financial services, where total TPV is expected to reach USD 30bn by 2019. Furthermore, it has reinforced its e-wallet offering with additional services, such as sweep accounts, which should continue attracting new users.

We see Mercado Libre strengthening its platform’s network effects with the opportunity to plug in new profitable services. It is a marketplace with good NPS (Net Promoter Score), more loyal buyers and a more effective advertising opportunity (higher margin revenue line). The strategy of having a relevant e-wallet can also attract third-party financial products. Credit is a natural product offering for a platform with thousands of small sellers, whether it be conceded by Mercado Libre itself or by third parties. Given the evolution of these different business segments, we estimate that the platform can be worth USD 27bn in three years and provide an expected total return of 80% in USD.

IGUATEMI

Iguatemi is a company with a portfolio of high-quality assets, extreme resilience and a robust balance sheet. It delivered an EBITDA CAGR of 6% p.a. and FFO CAGR of 16% p.a. between 2015 and 2018, despite GDP falling an accumulated 5% during the same period due to Brazil’s sharp recession. This was possible thanks to the company's disciplined cost control, which increased the EBITDA margin from 73% to 78% and led to a significant deleveraging of 3.6x to 2.7x Net Debt/EBITDA. In addition, Iguatemi’s agile move migrating a large portion of its debt to CDI versus TR allowed it to capture more efficiently the fall in interest rates during this period.

In 2019, we believe that the company will continue to deliver strong results, given the following factors: (1) reduction of rent discounts than were granted over the last few years; (2) rent leases adjusted by a higher inflation; (3) continued deleveraging and exposure to a lower CDI; and (4) market sentiment improvement propelling the inauguration of new expansions and multi-use projects, as we have already seen in 4Q18, when it inaugurated a commercial building next to one of its malls.

RUMO

Rumo began an ambitious investment plan in 2015 with its merger with the rail operator ALL. Since then, it has delivered strong results with the operational turnaround, such as an EBITDA CAGR of 18% p.a. Rumo made some important deliveries yet again last year, completing almost half of the investment plan established four years ago. We expect the second half of the investment plan to be completed over the next three years with projected EBITDA growth of 15% p.a. and profit growth of 30% p.a. In addition to the existing portfolio’s attractive returns, good investment opportunities can be unlocked with the new government’s proposal to accelerate infrastructure investment in partnership with the private sector. There are at least two mapped projects that could be unlocked: the federal auction of the Norte-Sul Railroad and the extension of Rumo's Malha Norte Railroad. These investment possibilities could add a lot of value to Rumo.

ENERGISA

Energisa is a platform of value creation in the electricity sector. Since our first investment in the company in July 2016, its performance has lived up to our expectations. Management has done a lot of work improving the assets acquired in 2014, when the company's size tripled by buying three large distributors (states of Mato Grosso, Mato Grosso do Sul and Tocantins) and a pool of small operations. The job well done generated an EBITDA growth of around 30% in 2018. In addition to strong organic growth, the company continued making acquisitions in the distribution sector by winning the privatization auction of distributors in the states of Rondônia and Acre. We expect Energisa to continue delivering great results by executing a turnaround in the acquired distributors and leveraging growth opportunities in new mergers, acquisitions and infrastructure auctions.

LINX

Deriving from its original, resilient and extremely dominant business of ERP (Enterprise Resource Planning) and POS (Point of Sale), Linx created two new business segments that drove the excellent performance of its shares in 2018. In fact, both have been instrumental to our investment case. The first segment is Linx Digital. Benefitting from the 40% market share in the physical world of POS and ERP, Linx Digital now connects retailers to omnichannel – the next big wave of retail growth that serves as junction between on- and offline. The second segment is Linx Pay, which was released after much time reflecting and working on its development. It is Linx's equivalent of a fintech with a privileged position in the acquisition segment. Linx Pay provides a low customer acquisition cost and introduces technology to an industry typically lacking this type of initiative. Through its three major business segments, we estimate that Linx will be able to triple earnings per share over the next four years, generating tremendous shareholder value.

RENNER

Renner is the leader in Brazilian apparel retail and has the best execution capacity. It emerged from the recession much stronger than its competitors, reflecting the investments made in its stores, distribution infrastructure, push-pull strategy and financial services business. In 2018, the company is expected to deliver a 6% sales growth and a 13% consolidated net revenue growth, driven by strong SSS performance. Due to its operational and financial leverage, we estimate a 27% earnings per share growth amidst the sector's meager 1% apparel sales growth. Renner's solid annual performance contributes to our thesis that the company should continue gaining market share, as it has been doing since its re-IPO in 2005, going from 2.3% to approximately 6.5% today.

In addition, the company announced the succession plan of its current president José Galló after 27 years of brilliant work. Fabio Faccio will take over in April after 20 years at the company. The transition has been extremely well-handed, and Fabio has our confidence to continue driving the structural market share growth, thus increasing profits about 20% p.a. for the next few years.

LOCALIZA

Localiza continued strengthening its market dominance in 2018, adding three times more to its fleet than the sum of its two main car rental competitors. It is also the only company in the sector to deliver returns above its cost of capital. Localiza's car rental segment doubled in size over the past three years and has a distinct daily volume growth (approximately 40% last year), further increasing its competitive advantage. We believe the company's segment can double in size again in up to four years, capturing a significant portion of the sector's growth and acting as a major industry consolidator.

CVC

CVC has built a formidable competitive advantage in Brazil. Its organic market share growth shall be driven by the following factors: (1) informational advantage of operating in all travel segments; (2) scale with suppliers; (3) solid balance sheet; (4) unique product offering; and (5) financial solutions. Additionally, 2018 was an important year for the company. It made three acquisitions, implemented a new organizational structure, accelerated the digitalization process, formed a new board of directors and executed its succession plan. It marked the end of Luiz Eduardo Falco's successful cycle and the beginning of Luiz Fernando Fogaça's work as the new CEO. We estimate that last year CVC was able to grow reservations organically around 11% and earnings per share around 27%. Looking forward, we expect the company to capture the synergies of its acquisitions in 2017 and 2018, participate in the acceleration of Brazil's leisure and corporate tourism market and grow profits more than 20% p.a. over the next few years.

OUR BUSINESS

Managing an equities-only asset management business may appear to be very profitable and relatively easy ("it's just beta"). However, many underestimate how demanding and costly it is, while overestimating the role beta plays. Perhaps some managers got away with mediocre performance in the past, made a lot of money and didn't care to properly manage the firm. Maybe some still do, but today this business has some additional challenges:

a. Scale, as costs have increased tremendously between technology, compliance, risk management, and people.
b. Strong management skills to attract and retain talent.
c. True commitment to client value-added propositions, for there are a plethora of actively managed and passive investment alternatives, while clear attribution analysis is also widely available.
d. Transparency, as there is no hiding behind secret sauces or black boxes.

Clients must acknowledge these challenges as well and understand that excessively squeezing a manager hinders the business's viability and talent retainment. At Constellation, we experience these challenges every day and dedicate a significant amount of time towards engaging and motivating the team.

OUR CLIENTS

In 2018, we were fortunate enough to have net inflows that strengthened and diversified our investor base. Long-term clients are one of our core pillars. Last year, we organized four major events: our first annual meeting in NYC; our annual meeting in São Paulo with record attendance; our first education day with renowned HBS professor Boris Groysberg in São Paulo; and our participation at Expert XP, the world's largest investment conference. The Investor Relations team did a great job.

We are currently at an AUM sweet spot. The team will now focus on restricting growth, while helping to improve and diversify our client base. This is critical, as having too large of an AUM places the manager in a fragile position. After all, we prefer to be antifragile, as advocated by the author Nassim Taleb.

OUR TEAM

Constellation Challenge is Brazil’s largest investment case competition for college students. Last year, we reached a record of 1,100 applicants. The quality of the participating Brazilian students is outstanding. We met and hired our most promising interns and young professionals through the Challenge, forming Constellation’s best-ever team of young analysts to date. The heat is on for the oldies.

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