MANAGEMENT REPORT 1Q19

LONG ONLY FUND (EQ Class I)	FUND (USD)	MSCI BRAZIL (USD)
1Q19	8.91%	8.22%
ANNUALIZED RETURN SINCE INCEPTION (11/30/05)	13.47%	5.68%

In the first quarter of 2019, the Constellation Long Only Fund was up 8.91%, compared to 8.22% for the MSCI Brazil in USD. The companies that most contributed to the fund performance were Mercado Livre and B3, and the largest detractors were CVC and Bradesco. The quarter started with a strong rally, which later stabilized amid political turbulence. The Social Security reform is being closely followed as Congress initiates negotiations for its approval. We believe it is not a matter of whether it will pass, but rather how diluted the final version will be.

Our constructive scenario for Brazilian equities is actually founded on earnings growth acceleration, propelled by companies' operational leverage and the economy's cyclical recovery. The expected average EPS growth for our portfolio this year is 23.0%, with a 3.0% dividend yield. In 2020, we expect further EPS growth of 19.0%, as well as a 3.5% dividend yield.

The latest earnings season (4Q18) was auspicious for our portfolio companies. Most delivered the expected EPS growth. These are some highlights:

BANKS

After a four-year streak of lackluster dynamics, credit is expected to grow 10% this year. Bradesco, Brazil's second largest private bank, should lead the pack. Its credit portfolio has a nationwide profile and large exposure to the SMEs segment, which suffered the most during the recession and is poised for a stronger recovery. On top of this, the bank still has a tailwind from loan loss provisions normalization and synergies from HSBC Brazil acquisition. These factors combined should lead to a strong earnings growth over the next years.

B3

Equity volumes grew nicely last year, expanding 41%. The other business lines are also showing strong growth, reinforcing our thesis that the company is highly exposed to the Brazilian cyclical recovery and combined with a powerful operational leverage, will continue to deliver robust earnings expansion. As a side note, B3 is on-track to launch new products to improve its ecosystem and increase its network effect. Thanks to new management it is quickly becoming a client-centric company.

LOCALIZA

Brazil's dominant car rental company continues to outgrow the sum of all its main competitors and continues to widen its business moats. In addition, it has been investing in new technology platforms to improve client experience and strengthen its competitive position. The combination of a great team with a large and fragmented addressable market makes us believe that it will continue to generate value throughout the upcoming years.

ENERGISA & EQUATORIAL

The consolidation of last year's acquisitions began during the 4Q18. Equatorial acquired Cepisa in the Northeast, while Energisa acquired Ceron and EletroAcre in the North. An update on the initiatives of these operations indicates that they are on the right track. Both companies reported results in-line with our expectations, with

Energisa being the main highlight in the distribution sector with strong operating results deriving from high volume growth and increased efficiency in its main operations.

PETROBRAS

Despite a dramatic decline in oil prices in the 4Q18, Petrobras was able to deliver consistent results, keeping a critical pillar of our investment case intact: deleveraging. In the last quarter of 2018, ND/EBITDA was at 2.3x, below the company's guidance of 2.5x, and the lowest figure since the peak of 5.3x in the 3Q15.

RUMO

The company reported strong results again in 4Q18 due to successful investment plan execution and a premium footprint exposed to the agriculture business that had a great performance in 2018. In addition to the ongoing investment plan, Rumo is evaluating an increase in capex related to a more positive view on market dynamics and growth opportunities. The North South Railway concession auction, which took place in 1Q19, is an example of an available opportunity that Rumo seized. In this case, there was low competition (only two participants) in a strategic asset that offers great potential for synergy and market protection for Rumo's current assets.

ESG, NPS & DIVERSITY

Switching gears to our investment process, we would like to share three recent and evolving initiatives that we believe will help us find long term winners. We are adding NPS, ESG and Diversity to our investment process.

It is proven that companies that are more customer-centric perform better in the long run. **NPS** (Net Promoter Score) is one of the best indicators to that effect. But it is not only about measuring customer satisfaction. What we are trying to identify are companies that use NPS as a strategic tool, like performance reviews, compensation and product choices. And it all has to start with the C-suite. If the CEO doesn't care for the customer or does not walk the talk, it won't work.

"NPS provides the litmus test for how well we are living up to our core values—it is the first screen I look at when I boot up my computer each morning." - Walt Bettinger, CEO of Charles Schwab.

Companies with high NPS scores have more loyal customers, which means more promoters than detractors, therefore spend less on advertising and, most of the times, have a more engaged workforce. The way we incorporate NPS in our analysis is understanding what kind of company we are looking at: one that is honest and values its customers, or one that is just concerned with short term profits. NPS scores are more relevant in certain industries (education e.g.) than others. But even in monopolies they matter. The worse the service a monopoly provides – and that is mostly the case – the higher the risk of disruption. The first step for an investor is to start asking the NPS question to management. The answers will give interesting insights on what kind of person/ company you are talking to and partnering with. In addition, companies that provide a superior service to their customers have a lower risk of being disrupted.

The same goes for **ESG**, Environmental Social and Governance. Intuitively we always knew that companies with higher ESG standards, as a group, perform better in the long run. In a recent study our research team found that a portfolio of high ranked socially conscious companies in Brazil delivered a 13.3% p.a. better return in the past 5 years than a portfolio of low ranked stocks. So why isn't it obvious that we all should focus on ESG?

In emerging markets, the challenge for portfolio managers is the scarcity of investment opportunities compared to developed markets. In addition, highly rated ESG businesses sometimes can be perceived as "boring". Portfolio managers tend to like "sexy" companies, the ones that usually rally in the fourth inning of a bull market. We prefer to call them "mermaids". They look cheap and interesting, but they are just "enchanting" you with their siren songs as they will make you wreck your ship.

Interestingly, the more we studied the subject, the more questions we had. As a start we created a proprietary rating system. We selected several metrics and each analyst rated their companies accordingly. The distribution of ESG ratings tends to follow a bell curve. Some companies are obviously compliant like Natura. Others are obviously bad, but most stay in the middle. If they are between the low and middle of the range of the group, we limit the sizing. Vale and Petrobras are the best examples of companies with a lower allowed exposure than the liquidity of their shares would initially permit. Companies well rated in ESG can have a higher exposure in the portfolio.

We applied to become signatories of PRI (*Principles for Responsible Investment)* and decided to publish our ESG rating criteria in our website (Constellation ESG Framework). The factors we are monitoring are:

ENVIRONMENTAL

- Energy consumption and efficiency
- Resource and waste recycling
- Air pollution (e.g. carbon emission)
- Biodiversity preservation
- Safety nets against disasters
- Conscious employees

SOCIAL

- Employee engagement and turnover
- Employee education development
- Talent attraction
- Employee health and safety
- Customer relations
- Local community protection

GOVERNANCE

- Shareholder rights and alignment
- Executive compensation alignment
- Board independence, expertise and pay
- Accounting practices (e.g. aggressiveness)
- Solid internal processes and controls
- Related party transactions
- Transparency and accountability
- Dual-class structures

In the end, we expect to accomplish four things:

1. Improve performance in the long run.
2. Reduce the risk of the portfolio.
3. Have an impact on our companies making them more aware of ESG issues.
4. Constellation as a company and as a team, be more socially conscious.

There is a risk of this becoming a here-today gone-tomorrow initiative. We need our LPs to be engaged in this issue with us. We want you to ask questions to our analysts. The more questions you ask, the better for us. And the more we ask, the better for our companies. It will be a long and fascinating learning journey for all of us.

Regarding **Diversity**, we see it not only as a social mission, but also as an important tool for companies to make better decisions and better know their customers. From a leadership point of view, having a diverse group, with different skills and backgrounds ads to the decision-making process and understanding of the client-base. We were talking to the chief innovation officer at a big European multinational consumer goods company and his point was that roughly 20% of his clients in America are Latino, 15% black, 60% women and 20% low income. Most of his board and leadership team are white affluent men. They may have very little understanding of their clients' needs.

There is another aspect to diversity which relates to Constellation's business. We strongly believe that there is no gender difference in how well prepared one is to be a successful investor. However, sometimes men may be blind sighted by their excessively high egos and lack the required patience to invest long term. Having said that, we still need to work to increase diversity in our business as well.

In the end, you entrust us your money because you expect us to have a superior risk adjusted performance and we strongly believe that all the three issues contribute to that. Being conscious to client and social issues, and really walking the talk is paramount for companies to not only have a superior long-term profitability, but also to survive in a challenging and disrupting environment. This applies to Constellation as a business and team as well.

CONSTELLATION CHALLENGE

As we mentioned in our last letter, we are proud to lead the largest equity research competition in Latin America, the Constellation Challenge. This initiative has been consolidating through the last five years, proving to be an essential tool to improve the company's awareness and recruiting efforts. From Constellation's research team of 11 people, 5 were hired through the Challenge. We believe we now have the most talented young investment team in our history, which motivates and puts sound pressure on the senior members of the team. The Competition's positive impact goes well beyond our own firm. Since 2015, there have been roughly 3,000 students participating, from 100+ universities, contributing to one of our main pillars at Constellation: our commitment to sharing knowledge with others.

In 2019 we decided to expand the Challenge internationally and reached 24 universities in the United States and 1 in Britain, in our first international edition. In April, we held the final presentation from the best groups at the Brazil Conference at Harvard & MIT, where a group of students from Poli-USP and FGV-EAESP was named the winner for 2019. We will continue to expand this initiative to maintain our main competitive advantage: a small group of talented individuals with an owner's mentality, who are passionate about investing.

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