In this investor letter, we will present a brief summary of investment cases that were relevant in our portfolios during the first semester of 2015. We will also offer some comments on the current shorting environment and arbitrage opportunities in Brazil.

Banks (Itaú/Itaúsa)

Our structural view of the banking sector remains positive, in light of the arguments presented in previous letters, but we understand that for 2015 the risk of short-term volatility is higher.

In 2014, we saw the recovery of fees and spreads, combined with more a controlled credit default environment and – despite the low growth of the credit-portfolio – a more strict control of expenses. Good results in services revenues ensured a 30% increase in profit, with a corresponding expansion of 300 bps in Itaú's RoE – which reached 23% this year.

For 2015, we expect that the growth in the credit-portfolio will continue to be modest, but that fees and spreads will remain in a positive trend. Banks should benefit from a hike in Selic (Brazilian bank's overnight rate) and a more benign competitive environment, given the capital constraints faced by government-controlled banks and the government's fiscal effort. At the same time, expense control remains a priority for Itaú, which – despite high inflation – still has room for efficiency improvements.

On the other hand, we believe that the risk of credit default has increased. The combination of a weaker economy and specific sectors suffering significant strains (for example, oil supply chain and infrastructure) increases expressively the risk of losses in the credit-portfolio. Since the middle of last year, we have seen Itaú anticipate its provisions for losses from credit default. This anticipation of provisions can help mitigate the investment's risk of short-term volatility in the upcoming quarters. We have also noticed that the bank has revised the expected expenses with provisions for 2015, and are now more consistent with the market's more pessimistic expectations. Nevertheless, this movement has not expressively reduced the analysts' profit projections, as it has been offset by higher spreads and fees practiced by the market. In this scenario, the bank also revised its expected net interest income for 2015. The net effect of these revisions (higher provisions and higher fees and spreads) was virtually null – that is, the same result is expected but in a way different from originally forecasted.

We understand these factors, related to the year of 2015, as risk factors that could cause short-term volatility and that need to be closely monitored. They are issues that may significantly affect the bank's profit this year (by increased expenses on loss provisions), resulting in a possible share price movement on a 12-month horizon. Nevertheless, we do not believe that these impacts can bring permanent and significant impact to Itaú's value.

Another aspect worth mentioning is that, in our opinion, the discussions regarding expected operational performance and valuation comparisons (especially set against historical and international standards) have dismissed, to some extent, the importance of the bank's non-credit business. It is evident that credit activity is core to the bank and therefore deserves great attention. However, we believe that sometimes the market loses some perspective on the relevance of Itaú's other sources of revenue and profit. At the 2014's last quarterly earnings conference call, Itaú highlighted an interesting point: in 2014, just over half of its profit came from activities unrelated to traditional credit. These activities – insurance and services, including credit cards – generated a RoE of over 40%. They are not immune to an adverse economic cycle, but should show greater resilience while requiring less capital.

For these reasons, we are comfortable with the operational aspects and competitive dynamics of Itaú. However, we must emphasize that there are exogenous risks to the bank's operation that cannot be overlooked, namely:

i. Increased Social Contribution: Recently, we have seen increased social contribution (from 15% to 20%), and some predisposition in favor of further increase (to 25% or 30%).
ii. End of the Deductibility on Interest on Equity payments: there have been growing rumors regarding the end of the deductibility of interest on net equity payments; this assumption is not completely discarded by the government.

Although both points (i and ii) are significant and tangible risks – the increase of the social contribution from 15% to 20% seems to be irreversible – we believe that the structure of the banking sector in Brazil, concentrated and with high entry barriers, favors the reestablishment of profitability to a level such as the one previous to the tax increase. The current conjuncture, in which government controlled banks need to raise capital through increased profitability, is quite favorable to reinstating profitability levels. In a context of rising interest rates, we believe that banks should pass-on to customers any tax increases. With regard to the eventual end of the net equity payment deductibility, we believe that the banking sector is one of the few that will be able to recover its level of profitability in a reasonable horizon.

iii. Economic Plans Trial: After a wait of nine months, the appointment of Luiz Fachin as STF (Supreme Federal Court) minister should bring back the discussion and economic plans trial. There is still great uncertainty surrounding the hearing, for example, should the new minister be prevented from partaking in the trial (he has acted as a lawyer in cases related to the same issue, which could make him ineligible to preside over the trial), the scope and amounts involved, among others.

We understand that all these issues should generate some volatility and uncertainty surrounding the banks' stock price.

Having said that, we believe Banco Itaú to be an investment case with more risks in 2015 than in 2014 but that also presents all the aforementioned merits and is trading at a P/E of 7.7x earnings (2016) with a real IRR of 11.5-12% – in our view, a very attractive investment.

BVM&F

After a significant decline in its stock price due to a more negative outlook of the traded volume on Bovespa, BVM&F reached very attractive price levels during the first half of 2015. The attractiveness of the investment becomes even more evident if taken into consideration CME stocks held by BVM&F (which have appreciated significantly, especially in Brazillian Reais terms).

Throughout the first semester, the shares appreciated from approximately R$ 9.50/share to R$ 12.00/share, hence we reduced part of the position. Nevertheless, we still see the company trading at a P/E ratio of approximately 13.5x (2016), or 11.5x earnings excluding its stake in CME. At the current stock price BVM&F embeds a real IRR of 12-12.5%. To put into perspective, after recent appreciation, most of the world's listed stock exchanges are trading at P/E ratios on average around 18x (2016).

We believe that an eventual sale of the CME stake could act as a key catalyst for BVM&F's stock price. Given the relevance of the stake for the company and the less strategic importance of the partnership today (since the PUMA Trading System was concluded), we understand that selling this stake would aid the price correction for BVM&F's stock. This has been a plea of many shareholders.

Nevertheless, the investment in BVM&F brings a significant impending risk related to a notice of infraction regarding the use of goodwill amortization for fiscal purposes (more on this below). While we understand that the likelihood of loss is low, the potential value of this loss is high. Further negative news on the topic are to be expected at some point this year.

About the notice of infraction: The goodwill originated from the Bovespa/BM&F merger is being amortized (in the fiscal Statement of Income for the year, but not in the corporate Statement of Income) since 2008, creating a fiscal credit for the company. In 2010, the Brazilian IRS, who understood that the goodwill deduced in 2008 and 2009 could not be deducted for income tax calculation purposes, enforced regulatory action against the company. In 2013, the CARF (Board of Tax Appeals) voted 4-3 (Chairman of the CARF has a casting vote, he is an IRS representative) in favor of the infraction. The total amount, including the fine and interest, is around R$ 800MM. The company will appeal to CARF and, if unsuccessful, will go to a common court of justice (1st instance, 2nd instance and potentially higher courts) in order to ensure what they understand to be their legal rights. The company is still subject to new notices related to additional goodwill amortizations from 2011 up until 2017 (end of the amortization period).

In a scenario where the company can no longer amortize goodwill, the company could increase dividend payments through interest on net equity in order to reduce the impact on the income tax calculation. Still, the possibility of this benefit could have an impact of R$ 1 billion (owed + interest + penalties for the period of 2008 to 2009) to R$ 4 billion (worst case = total loss, net result of an increase in the interest on net equity payments), this for a company whose current net worth is around R$ 21 billion. In this context, the rumors of a potential end of the deductibility of interest on net equity payments (as previously mentioned) contributes to the investment case's risks.

Cielo

After a significant appreciation of Cielo's share price over the first semester of 2015, we reduced our position as the margin of safety of the investment diminished. Nevertheless, we still see a good risk/return tradeoff in Cielo's investment case. We believe it is a high quality company (business + management), in a "competition-protected" sector with tremendous growth potential. There are some regulatory and governance risks, but the overall outlook is positive.

The payment card industry should continue to grow as the penetration of electronic payment methods increases. Cielo's scalability and its controlling shareholders (large Brazilian banks) practically guarantee that the company will have a privileged position to benefit from this growth.

More recently, Cielo entered into a joint venture with Banco do Brasil, in which it will manage the Ourocard operations in exchange for a compensation based on the interchange fee received by the bank. From a strategic point of view, it is not the most noble of activities (transaction processing), but its compensation is very attractive (the interchange rate does not suffer the effects of competition and has been preserved for a long time). In addition, there is room in the joint venture for new customers and improvements in the business' efficiency.

The main risks are associated with (changes in) regulation, irrational competition (by Redecard and GetNet) and corporate governance (the controlling shareholders – Bradesco and Banco do Brasil – are its main suppliers, with distribution via banking channels).

Thus, we have a moderate risk investment case, protected against inflation (compensation is a percentage of the transacted volume), and trading at a P/E ratio of 18x (2016), with an real IRR of around 9.5% – a relatively interesting value proposal in a context of uncertainty but with a limited potential for a significant change in the stock price level.

Equatorial

Equatorial is another investment that has substantially appreciated in the semester. Currently, we see a real IRR in the order of 9.5%, in a defensive sector with below average risks, with some relevant options for value creation. The company has good governance, excellent execution and a great capacity to navigate the regulatory process.

We see good growth potential with shareholder value creation through the acquisition of Eletrobrás' power distributors in the north and northeast of Brazil, which are running deficits. Given the company's execution history and its proven ability to conduct successful turnarounds, we believe that future acquisitions represent an important value creation lever for the company.

If these acquisitions do not happen, we believe Equatorial will again begin paying high dividends and will negotiate at a somewhat lower real IRR, more in line with the sector, offering still some room for appreciation.

Education Basket

In March, we began to build relevant position in the education sector. After sharp drop in stock prices, we have identified education companies offering interesting margin of safety, even considering pessimistic scenarios regarding the continuity of the FIES (Higher Education Financing Fund, government sponsored) program.

Despite the challenges in thoroughly measuring the impact of FIES in education companies, our investment thesis englobed three key points:

1. We believed that the student intake decrease in the first semester of this year would be less dramatic than the market consensus. The main thesis behind this was associated with enrollments' low growth in private

colleges/universities after the arrival of FIES. Our understanding is that the program was much more important for profitability and reduction of evasion/default in private higher education institutions, than for intake and enrollment growth. That said we understood that the first semester's student intake would probably positively surprise the market.

2. We believed that (i) the shared disciplines initiatives, (ii) the greater use of distance learning within classroom courses and (iii) an increase of number of students per class in non-freshman classes, would lead to profit growth in 2015.
3. We acknowledged that the competitive advantage of the listed education companies, in relation to smaller companies in the industry, continued to expand. After a series of conversations with the non-listed education companies, we better understood the competitive edge of the large and listed company, especially after changes/restrictions on student loans. We have noticed huge difficulties in the adaptation of small education companies to the new market dynamics and an extremely fertile setting for M&As, likely leading to a larger number of smaller players being put up for sale. Of the many factors that assure the larger education companies' competitive advantage, the following are worth mentioning: more efficient use of teachers; shared service centers; marketing capability; brand awareness; and technology for distance education.

After price recovery in recent months, we have reduced the position to a little less than half the size of the original position. This reduction was also motivated by the consumer confidence indexes' deterioration – factor that could significantly affect the student intake in the second half of 2015.

Other Investment Cases

In addition to the aforementioned investment cases, we have positions of some relevance in Brazil Foods, Lojas Americanas, Qualicorp (latest increase) and Queiroz Galvão Exploração de Petróleo.

Also noteworthy is the reduction of our exposure to the construction industry. This reduction was due to both the increase in share value (reducing the margin of safety of the investment) – in the case of Gafisa –, and as a function of deteriorating fundamentals (both operational and governance) – in the case of Even. We currently have low exposure to the sector, with greater relevance to intra-sector relative value positions. For this specific sector, we believe the market has been improperly pricing the construction companies' different leverage levels, creating interesting opportunities.

Brief comments on shorting and arbitrages

In recent years, the stock market's biggest 'winners' were quality and defensive companies. There had indeed been an excellent investment opportunity in the past, but as these stocks appreciated, we observed a progressively smaller margin of safety. Now, after significant appreciation, we see many of these defensive stocks priced to perfection, trading at multiples of 20x earnings or above, offering excessively compressed return levels (based on IRR observed in our DCF models).

This appreciation to a higher-than-fair level is natural in all market cycles. These cycles are usually well determined by these distinct phases: initially, contrarian investors observe an exceptional opportunity – typically in out of fashion industries or companies –; next, a new wave of investors follows this new trend, providing price appreciation, and thus the investments become less out of fashion; finally, in a third phase, every other investor follows to buy the stock (or similar) simply because it is what has worked in recent years without any rational reason easily explained by numbers, focusing on qualitative discussions. We have a growing impression that we are currently in the third stage of this cycle with respect to Brazilian defensive stocks, and in this context, we see progressively clearer shorts opportunities. Obviously, this observation is a generalization, which like all generalizations has its exceptions. It is the case of Lojas Americanas and Cielo, companies in which we still hold long positions – in smaller exposures than we have had in the past – although they are considered to be defensive stocks.

The difficulty in opening short positions in well-priced defensive stock is primarily due to the operational characteristics of the underlying companies. Some stocks have indeed surprised in regards to their operational resilience, while others seem to be suffering less from operational impact because of a temporal effect (late cycle). We are closely following this trend, and believe that some defensive stocks will offer interesting short opportunity in the second half of this year. We will continue acting with caution in this strategy as long as stronger catalysts are not identified.

Finally, in relation to arbitrage positions, after a long period of few opportunities, some "classical" arbitrage opportunities are once again offering good asymmetry. Today we have five arbitrage positions in the portfolio that fit this case.