Oceana Investimentos

Investor Letter – YE 2017

1. OVERVIEW OF RESULTS

After a long negative period for the Brazilian stock exchange, 2016-2017 witnessed a dramatic rebound. We are pleased that our RoR of invested capital has far outpaced the markets not only during this time period of the last 2 years, but also since inception of the fund.

Going back to 2011 to 2015, the market presented significant challenges for stock investors, as the Ibovespa index fell in nominal terms -37.45%. Despite the challenges the general investor faced during that time span, our strategy focused on the margin of safety of investments has generated a great deal of value for our investors. The focus on buying solid assets, in which we observe adequate returns in the various possible scenarios we model (and not only in an optimistic scenario – which is common in moments of euphoria), proved successful, especially in the face of an accelerated economic deterioration scenario in Brazil.

As simplistic as it may seem, buying quality assets at an appropriate price can generate excellent returns even in more adverse economic scenarios. Perhaps the biggest challenge of this strategy is to avoid the various pitfalls along the way, be it the competitive disruptions that fall upon various sectors, undisciplined business competitors, accounting tricks that embellish sub-optimal businesses, conflicts of interest, low quality of the company's executive team, overhyped projects…, just to name a few.

The subsequent period, between 2016-2017, presented a very different dynamic, as the Ibovespa rallied +76.25%. In theory, roaring bull markets should be positive for stock investors, but a little less favorable to our investment strategy, which has a much greater focus on risks than in the return potential of each investment. Moments of euphoria are times when lower quality companies present the best performances and highly leveraged stocks multiply in value. In this kind of environment, it is natural our investments should present a less impressive performance. Add to that the fact we have a portion of the portfolio in cash. In times of market exuberance, this combination of factors brings challenges to the conservative strategy implemented by Oceana.

As can be seen however, we have performed very well, actually even better that we expected given the roaring market, from an absolute and alpha-driven perspective. In particular, our stock picking was very successful during this period. Looking back at 2017, we were able to find good opportunities in various sectors during the year: electric utilities, financials, homebuilders, consumer names, malls, education and health. The heightened volatility during the year helped, as this presents a favorable backdrop to our search for distortions in the market. It is also worth pointing to the maturity of our analysis team, a factor that certainly has contributed to our results.

The “first generation” of the analyst team (essentially the original partners) have been working together for over a decade. The "second generation" of analysts have been together now for about 5+ years, and the team is showing excellent dynamics as we work together as a larger group. The maturity of the team has been making a difference, and that brings plenty of optimism ahead as we look forward.

As we have mentioned several times in the past, investing is a business of people. Perhaps our biggest challenge is to keep a cohesive team which is motivated, engaged and aligned with the ownership of the business over time: easier said than done. It is by no means trivial the balance sought between the constructive friction and competitiveness needed for our business to keep pressing forward, compared to establishing an enjoyable environment where individuals work as teammates. We feel that we are doing a good job at this, witnessed by our returns coupled with our low employee turnover.

2. Closing of our local BRL funds

In our year-end letter of 2016, we emphasized the importance that the size of the funds has in considering the ability to generate differentiated returns for our investors. In October 2017, we reached an AUM level which made it prudent to take a pause in bringing in new capital. We chose a course of action where we would not witness a dramatic influx of capital upon our closing, which required that we send notice of the closing of the products on the day it occurred. We believe this has preserved our excellent current investor base, as we did not take in outsized capital at the close.

We are currently only taking in subscriptions in our "offshore" products, as we look to complement our existing local investor base with more non-Brazilian entities. We will follow the same discipline with regard to the growth of offshore funds we have shown in the past. There is not an unlimited supply of capacity, and it is critical we err on the side of caution when raising capital, so we can execute our investment strategy and generate alpha for all our investors.

3. Sector Cyclicality

The evolution and cyclicality of the different sectors of the economy takes place in a fairly uniform pattern over time. In times of extreme adversity for any given sector of the economy, the companies in those segments tend to naturally retreat, pull back on investing and decrease their operations. On the other hand, in times of euphoria for that sector, we see these same companies accelerate their investments and enter a phase of expansion for their business. As this growth is usually replicated simultaneously by several companies in that sector, the effect ends up being a significant impact on the future profitability of the overall sector, forming well-defined expansion cycles which are followed by contractionary periods. This dynamic repeats itself frequently and is observed over a wide range of sectors in the economy.

The euphoria in a given sector typically is triggered by a recent surge of revenue growth and operational profits, as they emerge from cyclical lows of the past. This accelerating growth as a company or sector emerging from the cyclical lows causes two important consequences: (1) greater optimism of companies looking forward – directly correlated with the recent past; (2) greater capital availability to invest – as good recent results drive a reduction in leverage. When this improvement of results is combined with the possible realization of a strategic event before seen as unimaginable (i.e. a potential IPO of a private company or a PE-takeout), the problem is typically compounded by greed.

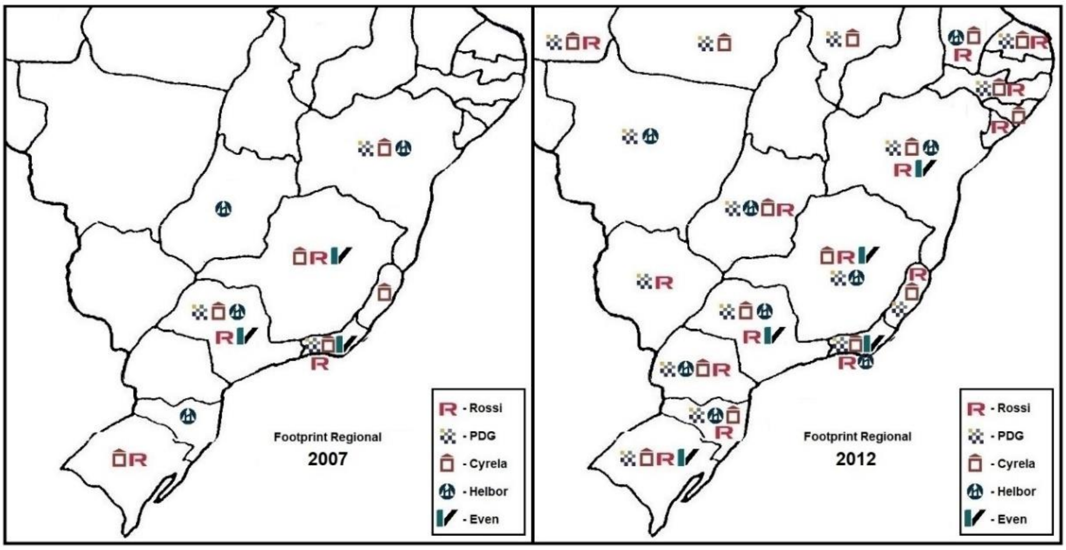
Looking at a company-by-company basis, during these phases of euphoria it is common to see an acceleration of investments to levels that are unsustainable, either due to the lack of execution capacity given the pace of the expansion itself, by the lack of qualified people to manage this new expansion, or due to the lack of diligence of growth prospects during the euphoria, among several other potential reasons. Periods of euphoria tend to be seen as times when greed overcomes fear, when the brave are seen as winners while conservative operators are seen as people without entrepreneurial vision. It is also a time when, in hindsight, irresponsible capital allocations are setting up for (potential) future losses to shareholders.

In times of euphoria in a particular sector, it is extremely important to observe the effect of the sum of the simultaneous investments of the various companies. At that given time, investments that may make sense from an individual company's point of view, may in fact prove disastrous when considering the investments of competitor companies in the sector. An accelerated expansion of several market players at the same time may bring adverse consequences, such as ruthless pricing behavior, competition for raw materials or employees, cannibalization of sales, among others. There are plenty of examples in which extremely negative repercussions were witnessed after this short period of accelerated expansion during a market euphoria. Below we will talk about two clear cases of excessive euphoria in specific sectors that happened in the past, and also highlight another example which we believe may be currently unfolding.

Homebuilders

The homebuilding sector underwent a strong wave of optimism between 2005 and 2008, a period that witnessed 20 IPOs in the sector. At that moment, virtually all of the companies promised accelerated growth and regional diversification. This willingness to grow was driven by good results in previous years, and also was demanded by risk-seeking investors.

In the maps of Brazil below one can notice the evolution of the footprint of several operators contrasting 2007 to 2012. As can be seen, the expansion took shape very broadly and aggressively. Some homebuilders practically doubled their footprint, such as Even, which went from 3 to 5 states, and Helbor, which expanded from 4 to 8. Even more impressive were the expansions of Cyrela, which went from 6 to 16 states, Rossi, from 4 to 15, and PDG, from 3 to 16 states.



Source: Empresas

The investors, euphoric with the recent achievements of the companies, paid enormous multiples for the assets of the developers. By investors pricing into their models high levels of growth and rising margins due to scale benefits, the market eventually paid multiples over 3x the book value of certain homebuilders.

Unfortunately, the strategy adopted by individual companies ended up significantly cannibalizing the overall industry returns. As the developers did not have an adequate structure outside their operations in their existing footprint (i.e. in 2007), they started to outsource the management of the construction and land purchases to local partners to advance their future growth. The very fast pace of expansion caused: (1) many of the local partners to see themselves overwhelmed with the amount of projects; (2) the land became more expensive, compromising the future profitability of the business/projects, and; (3) there soon arose a shortage of supplies and suppliers, as well as large competition for manpower. The result was a high number of cost overruns, undisciplined landbank purchases at excessively high prices, and an eventual dramatic drop in the profitability of the industry.

This decline of profitability of the homebuilders can be observed in the table below. As can be noted, the level of destruction of shareholder value was brutal and the companies that expanded most were those which eventually saw the most impairment of value (i.e. examples of Rossi and PDG).

ROE Averages	2006-2009	2013-2016	ROE Declines
Cyrela	18.7%	9.0%	-51.9%
Even	15.5%	8.1%	-47.7%
EzTec	14.1%	19.5%	38.3%
MRV	14.7%	11.7%	-20.4%
Helbor	14.5%	10.2%	-29.7%
Tecnisa	10.0%	3.2%	-68.0%
Gafisa	7.6%	-3.2%	-142.1%
Direcional	26.6%	9.1%	-65.8%
PDG	12.4%	-36.0%	-390.3%
Rossi	9.0%	-31.0%	-444.4%
Average	**14.3%**	**0.1%**	**-99.6%**
Median	**14.3%**	**8.6%**	**-40.2%**

Source: Empresas

Faced with the magnitude of losses incurred due to the accelerated growth, most of the developers decided to return to their original markets, typically São Paulo and Rio de Janeiro, considerably shrinking in size. Today, expansion and diversification are seen by the market much more cautiously than before. The same investors who used to applaud company growth, now demand more focus from the operators in the sector. The deterioration of multiples was also evident during this last cycle: while in the euphoric times the average P/B was 2.1, today it is only 0.7.

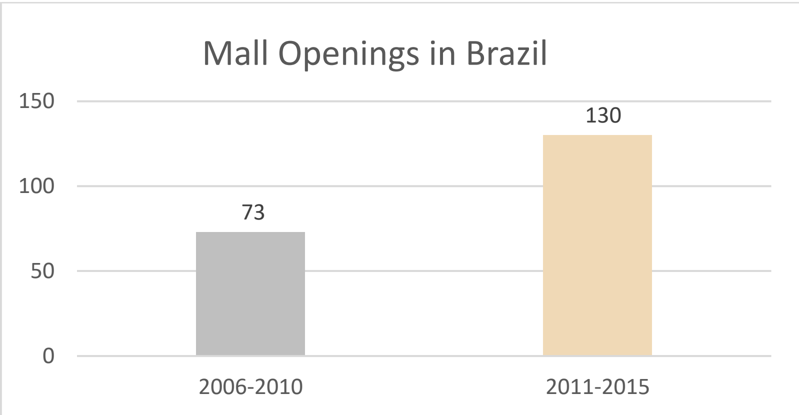
	Cyrela	Even	EzTec	MRV	Helbor	Tecnisa	Gafisa	Direcional	PDG	Rossi	Average	Median
P/B 2007	3.7	2.7	1.1	2.8	1.2	1.6	1.3	1.5	2.1	2.7	**2.1**	**1.9**
P/B YE 2017	0.9	0.6	1.4	1.2	0.5	0.6	0.5	0.5	0.0	0.5	**0.7**	**0.6**

Source: Empresas

Shopping Malls

The shopping mall industry also experienced a time of strong expansion from the boom-years of 2011 to 2015. During that time, most of the mall operators had bold expansion plans, theoretically warranted by the growth of consumer indicators springing to life. Consumption penetration metrics and gross leasable area (GLA) per occupant, associated with a low cost of capital, were often the necessary ingredients for such growth plans to be realized.

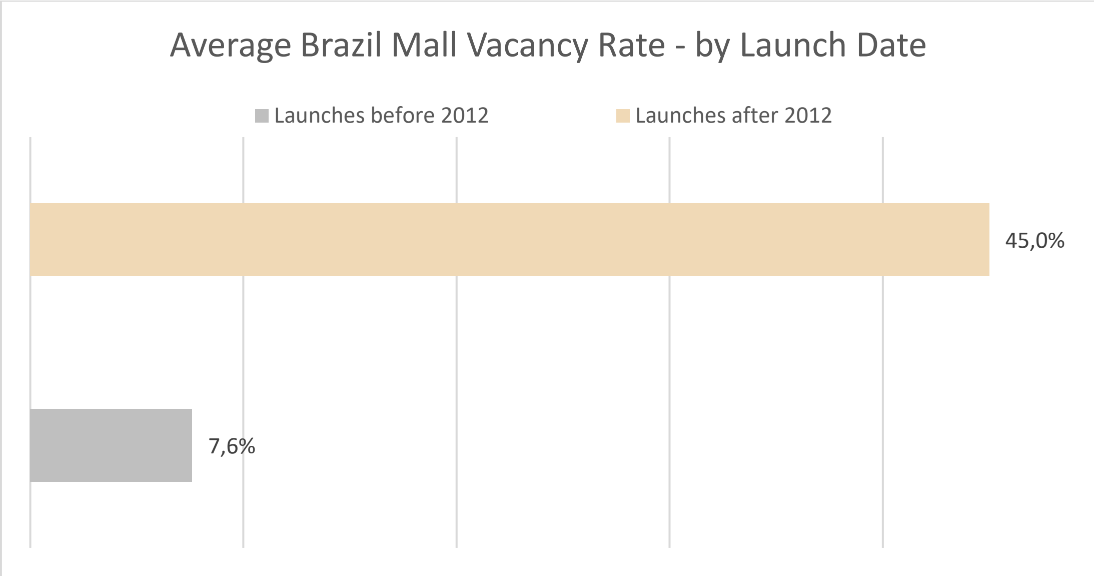
With the acquired resources and the shareholders' backing during that period, the sector began to expand at a rapid pace. When we look at the expansion rate of malls from 2006 to 2010, compared with the period from 2011 to 2015, one can notice that the expansion rate almost doubled.



Source: Abrasce

Many of these new openings took place in inner cities, where the local economy could not support high levels of expansion. At various times we witnessed the following phenomenon: the mall operators were correct in their initial assessments of the region’s demographics, especially income level growth and potential for sales, however they ended up being wrong about how aggressive their competitors would be in terms of their expansion plans in that region. Once they started to break ground, these mall operators needed to continue with the completion of their projects, given the invested capital and expectations of their investors, even in the face of other projects being built simultaneously by their competitors in the region.

The eventual reality of a high-competition scenario with a challenging macro environment resulted in a catastrophic effect on the new shopping centers. With the excess of GLA, retailers had more options for their expansion plans and, in the face of the crisis, postponed or cancelled such plans. The combination of the two factors caused the demand for new projects to be far below what was expected, resulting in high vacancy rates.



Source: Ibope Inteligência, datapoints as of April 2016

During the time of accelerated expansion, it was common to observe a particular company claiming that its competitors were behaving irrationally. In turn, those competitors accused the other of said irrationality. Each player naturally defended their own expansion project, claiming that time would prove them the "ultimate winner" in the long run.

There are still many cities where these problems are far from resolved. Take the case of Sorocaba, a city located on the outskirts of São Paulo, which is emblematic of the problems discussed. The city, which had 3 shopping malls in 2012, witnessed 5 new openings from 2013 to 2015. Malls were opened with 90% vacancy rates, coupled with a fall in occupancy levels at the existing old malls, confirming a strong cannibalization in the local market.

However, it is worth pointing out that, unlike the homebuilders industry, we have been able to observe successful expansions in the shopping mall sector. Often such expansions are in regions where the companies have been working for a long time and have deep knowledge of the market and local competition. By prioritizing such regions/projects, we have seen companies managing to maintain their dominant profile by expanding their portfolio, thus generating value for shareholders.

Drugstore

As we evaluate the problem in the shopping mall and real estate sectors, we naturally have the benefit of accessing all the data and, in particular, the results at our disposal. The prudent question though is: does having a profound understanding of what happened in the past allow us to anticipate future problems in specific sectors where profitability has not yet been impacted?

Of course, when it comes to prospective analysis, there are always doubts. However, some sectors present dynamics that we have seen before and raise our antennas to be on high alert for potential impending problems. As an example, we see this playing out now in the drugstore industry, which has us questioning the future dynamics of the sector.

Before we analyze the sector as a whole, it is important to talk a little about the behemoth of the sector, Raia Drogasil (RD), which today represents a market value of almost $10 billion USD. RD is a company that has earned its elevated market value. RD has a team of distinguished executives and has produced over time an excellent history of results. Not only has it delivered an impressive evolution of revenue and margins, but RD has been able to expand its operations, with sustainable market share gains along with an improvement in its return on invested capital (ROIC).

Given its history of great success, RD stock today trades at a P/E multiple of more than 55x (according to our estimates). The market clearly is rewarding RD for all of the positives it has attained in the past, and has also extrapolated this success going forward. The market is claiming to justify this multiple of 55x with the strong growth of expected profits for the coming years.

Of course, the market price climb of RD has not gone unnoticed by the other companies in the sector, nor by private equity participants. Glimpsing the possibility of their business being valued at similarly higher levels (if they could replicate the success RD has had), the vast majority of competitors within the industry have recently decided to accelerate their own respective expansion plans. This development can be seen in the expansion plan of the sector companies for the 2017 to 2018 period. From 2014 to 2015, the selected chains shown below averaged 468 stores/year of growth. Already in the 2017 to 2018 period, they have opened/announced a rate of 789 stores/year. In addition, the trend seems to be accelerating even more looking beyond 2018.

Expansion plans of the major drugstore operators

	2014	2015	2016	2017E	2018E
RD	135	156	212	212	240
DPSP	150	130	100	140	140
Pague Menos	90	100	146	170	200
Panvel	14	26	38	50	50
Extrafarma	28	31	61	100	100
Araujo	15	17	20	40	40
Nissei	15	20	20	30	30
Onofre	0	0	-12	7	17
Venancio	5	4	7	6	6
Total Openings	**452**	**484**	**592**	**755**	**823**

Source: company reports, and Oceana estimates/analysis

In addition to the acceleration of the expansion of almost all industry players, we also are seeing regional stores entering new areas geographically. In particular, we have observed some competitors with more aggressive expansion plans for the São Paulo region, exactly where RD has been a dominant player.

There are always market winners in the face of competition (we believe that RD will be one of them given its quality), and others who are less-prepared to grow will fail, destroying much value over time due to the acceleration in outlays during their expansion phase. We are skeptical that those smaller regional players trying to succeed in dominant areas of RD, like São Paulo, will have much success in the long-term. That said, it is worth pointing out that the drugstore sector has very distinctive characteristics then that of the homebuilders and shopping centers. It is important to note that:

1. **Secular growth drivers:** We believe that the foundations that sustain the growth of the drugstore market are robust. The growth of the drugstore market is sustained by the ageing population, and a secular demographic trend that should positively impact the sector's revenue for more than a decade.
2. **Greater ease of contraction:** A pharmacy can be built in a smaller time period, less than 1 year, and it only requires an investment of R $1 -1.5 million per store, while a real estate/shopping mall project could take 4 to 8 years and require an investment of hundreds of millions. At a time when companies meet a deterioration of the fundamentals of the sector, the contraction is naturally faster in the drugstore industry. Real estate projects already started (which have often incurred much of the investment) will follow with relevant investments until their conclusion. The drugstore networks, in comparison, can reverse their expansion plans very quickly.

Because of the caveats mentioned above, we believe that the acceleration of the expansion in this sector will generate a much smaller and less durable impact than the one observed in the real estate and shopping center segment. However, some impact will be had and we expect it will create some short-term disruptions (opportunities).

It is natural to anticipate greater competition for locations, qualified people and customers (via more competitive prices or higher marketing spending). In an environment like this, the risks of pressure on same store sales (SSS) and on the profitability of the sector should not be discounted, especially for the 2018-2019 timeframe, in which a series of industry players are simultaneously accelerating their expansion plans.

Due to its superior execution, financial discipline, and quality of the store operations, we have difficulty in stating to what degree RD will feel the impact of the upcoming dynamics, or whether it will be able to maintain its dynamics of market share gains leveraging its operational efficiency. However, we understand that the environment will be more challenging in the coming years, and that this theme should be monitored closely as it may present opportunities to generate alpha.