We are currently undergoing a very particular investment environment in Brazil. The current dynamics of the economy is presenting challenges of different magnitudes to different companies and sectors, and the proper understanding of this dynamic will tend to define the success of investment decisions for the next few years.

Even though the deterioration of Brazil's GDP seems to be a consensus in investors' minds and valuations, as of the second half of 2015 we noticed a new dynamic playing out for Brazilian companies: a substantial deterioration on the credit market, meaning massive challenges for leveraged companies as they approach maturity/amortization of their debts.

The increase in spreads charged by banks in such a short time is impressive. We have seen companies that run stable and relatively unleveraged business observing the spreads charged increasing threefold. Spreads increasing from 150 bps to over 450 bps are common. This dynamic, coupled with prospective higher interest for the coming years, has resulted in a complex combination for the companies. The interest rates for Jan/21 jumped from 12.5%, in the first half of 2015, to levels of 15.5% to 16% by year-end. Of course, the curve embeds a series of assumptions/risks and does not necessarily correspond to future reality. Nevertheless, based on simple arithmetic, adding the effects of higher spreads to the prospective higher interest rates, we observe a 600 bps difference in the nominal cost of debt projected for the next years. This change happened in less than 6 months, amidst an environment where most sectors of the economy show deteriorating results.

It is always a challenge to assess whether the increase in spreads charged by banks in Brazil is more of a cyclical or a structural effect. Our view is that several factors point to a more lasting/structural effect, the main being:

1. Artificially high credit supply resulting from the policy adopted by government-controlled banks.

   After the 2008 crisis, guided by a government induced economic policy of promoting consumption, public banks increased their credit supply. While Itaú and Bradesco increased their credit portfolio by an average of 11% per annum from 2008 to 2015, *Banco do Brasil* (BB) and *Caixa Econômica Federal* (Caixa) grew 19% p.a. and 35% p.a., respectively. In 2008, BB and Caixa credit portfolios combined were 30% smaller than Itaú and Bradesco combined. In 2015, these portfolios were <u>60% **larger** than the portfolios of Itaú and Bradesco</u>.

   This growth cycle took place when private banks deemed lending costs as artificially low and in turn, they decided not to follow the government-controlled banks, causing them to lose market share. We understand that prices during this period were not sustainable (it is worth noting that BB and Caixa ended this cycle with extremely high leverages – with asset to equity ratios of almost 20x versus around 12x for Itaú and Bradesco). This level of leverage, measured also by their capital ratios, significantly limits the growth potential of BB and Caixa. A future increase in spreads is the most obvious maneuver to reestablish their capital ratios (higher spreads = more profit, with same assets = increased BIS ratio).

2. Retraction of the private banks.

   Overall, we have seen private banks with a much more cautious speech, indicative of a smaller appetite for credit – for example, the 2016 guidance of Itaú and Bradesco points to a credit portfolio growth of 2 to 3%. As a backdrop to this is the expectation of rising unemployment and consequently the deterioration of private individual credit loans, as well as a challenging macroeconomic environment for small and medium companies. In the large corporates segment, so far, the spreads charged in the near past have shown to be insufficient to compensate for losses (past and future) because of the macro environment (or, more specifically, the commodities prices collapse) and the effects of the *Operação Lava Jato* (federal investigation of corruption involving some large companies and the government).

   Banking sector executives support this thesis. Itaú is particularly pessimistic with the scenario unfolding for Brazil and has shown a high-risk aversion in recent years. At the same time, Bradesco, following the acquisition of HSBC (still pending approval by Brazil's regulators), will tend to focus on deleveraging its balance sheet over

2016/2017. This context leads us to believe that it is very unlikely to see an increase in these banks' risk appetite over the next 12-18 months.

This disruption of the credit market brings more obvious negative effects on leveraged companies, significantly increasing their financial expenses, harming their results and ultimately threatening their solvency. We believe that much of the market has still not adequately incorporated in their projections this new credit environment – for example, we see many sell side projections underestimating companies' financial expenses. In short, we believe that we are experiencing a particularly hostile environment for leveraged companies. In this context, we are being especially cautious when evaluating companies with high leverage.

Kroton and Equatorial

A tighter credit environment affects leveraged companies the most, but it also tends to favor, in the medium term, solid and unleveraged companies. These companies can rely on an extremely favorable environment for market share gains, either growing organically or through acquisitions of weaker players that find themselves lacking alternatives. Companies with differentiated management and little leverage in their balance sheets may have a great potential to generate value to shareholders. In several cases this is currently being underestimated by the market.

We believe that our portfolio has two investments that are in a unique position to take advantage of this environment: Kroton and Equatorial. Both are, in our opinion, the best performing companies of their respective sectors, with low leverage and within an environment where many competitors are struggling. Despite the challenges of pricing these opportunities, they should definitely not be overlooked.

In the case of Kroton, the company has significantly higher operating margins than its peers. Based on discussions with several smaller competitors it is possible to identify a margin differential of twofold. This efficiency gap, combined with a highly successful track record of acquisitions, and a balance sheet free of debt (when its cash is adjusted to consider the sale of Uniasselvi), enables Kroton to enjoy an exceptional environment to generate value through acquisitions. We believe that competitors in a situation of negative operating cash flow, in this extremely difficult time to roll over debts, should become more open to takeover bids considering multiples at reasonable levels. In addition, Kroton is opening this year 232 new DL centers (Distance Learning) and deploying DL Premium (DL for engineering and nursing courses) in over 50 centers. These initiatives should promote an important growth and strengthen competitive advantage in the DL segment both by increasing its scale and by pioneering in several regions that had no access to undergraduate courses. Another source of Kroton's diversification is the Blended Learning – DL courses mixed with classroom sessions – which gained strength with the accreditation in about 60 in-classroom centers. Blended Learning is one of the company's tools to keep its student base growing without compromising profitability in a low-income environment. Despite a reduction in the students' monthly payments in the Blended Learning modality, EBITDA/student ratio has been preserved due to the lower costs with faculty and occupation. This modality tends to be an important competitive tool to accelerate the consolidation of the market through market share gains.

In the case of Equatorial, as we observe the turnarounds conducted in Cemar and Celpa and the degree of efficiency that Equatorial reached in Cemar, we see it as the company with the best turnaround credentials in the industry.

In Cemar, since the beginning of the restructuring process, the cost per customer was reduced by 21% and losses reduced by 41% leading to an increase in EBITDA/customer by 79% in real terms. Quality indicators also showed significant improvement in the same period, where duration and frequency of the power outages were reduced in approximately 70%.

In Celpa, we believe that Equatorial will also be successful, with possibly more immediate improvement, considered the learning curve they had in Cemar and the similarity of the challenges on the several fronts of the turnaround. It is already possible to notice a reduction in operating costs per customer of 29% in real terms, a significant improvement in quality indicators and a reduction in losses from 35% to 31.2% from Sep/2012 until the end of 2014. Note that the incentive to reduce losses is always higher shortly after the tariff review cycle (Celpa's last review was in Jun/15).

In addition to generating value in the turnaround process of these companies, we believe that new acquisition opportunities may arise both in Eletrobrás group's distribution companies and in other utilities industry assets. There are several leveraged firms seeking to sell assets and few unlevered players ready to seize the opportunities that might arise. Equatorial's low leverage – amongst the smallest of the sector – brings flexibility to the company to acquire assets in the coming years.

Private Banks: Itaú and Bradesco

Considering the rupture observed in the credit environment, we could not fail to mention its different effects in two of our funds' key investments, the large private banks: Itaú (through Itausa holding company) and Bradesco.

This is possibly the most complex of our funds' themes and has generated some interesting discussions.

The complexity comes from the significant challenge of estimating with any degree of certainty the level of default to be expected in the biennium 2016/2017. The short-term default level, which in the current context is decisive for the performance of stocks in the short run, is a difficult variable to pinpoint, especially due to the significant drop in Brazil's GDP and because of bank secrecy, which prevents a more detailed disclosure by banks with respect to specific transactions and their collateral levels. This naturally brings much uncertainty to the performance of the shares during the year of 2016.

When we look at the investment from the perspective of its fundamentals and its intrinsic value, it is not difficult to conclude that the big private banks are undervalued. The banks' long-term value becomes even clearer when we separate the value of their services business (which includes credit card processing, insurance and other services) from their credit business. Their business have been benefiting over time by an improvement in their competitive position, given the significant consolidation undergone in the banking industry in Brazil. The reduced availability of credit by public banks, as well as the risk aversion of the major private banks are creating a shortage of credit supply, which in turn causes credit portfolios to be repriced, a movement that will positively influence the profitability in the medium term of these banks. Taking a longer-term look, several positive vectors seem to appear.

That being stated, we believe that the discussion around the large private banks boils down to investment horizon. For investors with short-term horizon, the investment is extremely uncertain/risky especially because of the doubts regarding defaults, but for long-term investors, it tends to be very successful.

It is not the first time, nor will it be the last, that an investment will offer opposing views for different investment horizons. In such cases, interesting discussions arise with divergent views and high degree of conviction in both directions.

Cielo

The change in the credit environment also significantly affects other positions in our portfolio, Cielo being one of them. About one third of the company's results comes from pre-payments to merchants. In an environment of credit scarcity, it is natural to have an increase in the spreads charged and in volumes. This helps provide resilience to the company's results, amid the cooling down of the credit card industry.

It is important to note, however, that Cielo has suffered with the increased perception of its governance risks. These risks have always been there and only now, the market identified them as being more tangible. It came as a surprise to the market the drop in the revenue's yield (revenue/transactions volume) in the results for the fourth quarter of 2015. Cielo explained that this decrease was caused by several factors; the most important being an increase in compensation transferred to banks (the company reports its revenues already net of this compensation). Since Bradesco and BB are not only Cielo's controlling shareholders but also two of their major suppliers (both responsible for the commercial distribution of Cielo, a crucial part of the business), the potential for governance conflict has surfaced and caused great discomfort to the market. Following this, rumors poured that these same controllers would be examining the acquisition of Elavon's Brazilian operation, one of Cielo's competitor. Both banks did not deny the rumor, at first maintained a 'we don't comment on rumors' posture that after changed to 'we analyze every opportunity'. Until the speculation has been cleared up, Cielo's shares should remain under pressure.

Relative Value

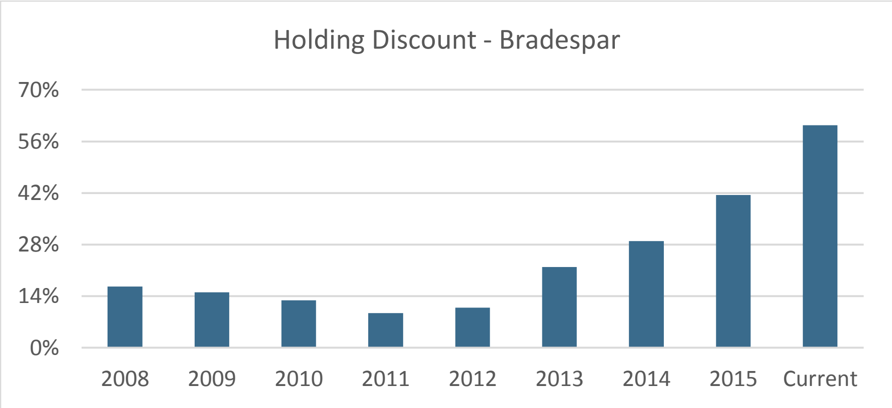
Regarding relative value investments, considering the movement observed throughout 2015, the share-class arbitrage strategy undeniably stands out, especially with respect to holding discounts and disparity between common and preferred shares of the same company.

We chose to further discuss the situation of Bradespar's holding company discount given the relevance of the investment in the funds.

Each holding typically has a "fair" discount, which takes into consideration the costs of the holding company, capital allocation risks, tax inefficiency, as well as the risk of dilution in cases of capital increase, among other risks. There is no rule of thumb for calculating the fair discount, as each holding will have its specific characteristics.

Large deviations from the fair discount have always been traded by the funds, and we have achieved extremely consistent results in this particular strategy over the last 10 years. In 2015, we have observed some major disruptions in the discount levels and for the first time the funds suffered an annual loss in the arbitrage strategy.

One of the relative value losses that the fund incurred originated from the Bradespar arbitrage, whose holding discount developed as seen in the chart below:



The holding company discount went from an average under 15% in the period between 2008-2013 to the 60% currently observed.

This movement happened due to a number of factors, amongst which stand out:

1. Vale's shareholders agreement expires in April 2017, if not renewed, Bradespar will no longer be one of Vale's controlling shareholders, and Previ (Banco do Brasil's pension fund) will solely control the company. There is a growing fear of part of the market that Bradespar may have to pay Previ a high price for the renewal. Assuming this price is exorbitant, it would destroy the holding company discount, and on top of that, it would leave Bradespar in an undesired leveraged situation. To simplify, a BRL 500 million payment (40% of Bradespar's current market value) would take the holding discount from 61% to 52%. A payment of unreasonable amounts, speculated by some players in the market, could nullify the potential returns of the investment.

   We do not believe in extreme scenarios, especially since the renewal of the agreement seems to meet the interests of all parties involved – including Previ, that if were to become the only controlling shareholder would have much more difficulty in blocking government interference. This scenario would also increase governance risk, possibly negatively affecting Vale's share price, which today is the main asset in Previ's portfolio, and in turn would cause significant losses to their books. Considering that the renewal of the agreement is in the best interest of all involved, we have trouble believing the renewal price would be of disproportionate amounts. We believe that the renewal of the agreement will most likely come at a moderate burden, of less than BRL 500 million.

2. A secondary risk to the investment would be a capital increase, either because of Vale's capital constraint, where Bradespar would have to follow the increase to maintain its position in the control block, or because of Bradespar's own capital constraints. Under any case the holding discount would be significantly reduced.

   In relation to Bradespar's leverage, we understand the situation to be relatively comfortable, especially when we consider that, in addition to Bradespar's investment in CVRD of about BRL 3.5 billion (market value), Bradespar holds an investment in CPFL of BRL 880 million and a bullet loan of BRL 980 million maturing only in mid-2018, at a cost of 105% of CDI (Brazilian Interbank Deposit). Despite this relative comfort, we have actively advocated for Bradespar to sell their stake in CPFL, in order to practically completely deleverage the holding company's balance sheet. When we look at its net debt to asset ratio, we arrive at a comfortable level of 25%. As a comparison, the ratio of Gerdau is 45%, even after its capital increase, and today negotiates with a holding discount of around 5%. It is interesting to note the difference in risk perception of the market in both situations.

   Regarding Vale's leverage, we consider it to be an important risk factor to the Bradespar investment. A significant capital increase in Vale's common shares, followed by Bradespar's capital increase to remain in the control block, could significantly dilute the discount. We understand that, given the recent developments in commodity prices, especially the price of iron ore, Vale's path will be very sensitive, especially during the pre-operating period of the Carajás' expansion (S11D), where disbursement of capex without operational counterparts has been ongoing. The biennium 2016/2017 tends to be a more difficult period for the company, which still has the Mariana catastrophe pending.

   In a scenario of capital shortage, new share issues certainly presents itself as an interesting alternative; however, we understand Vale will most likely resort to selling premium assets or issue preferred stock-convertible debenture. A capital increase of common shares in large magnitudes would be a problem for the controllers, especially for Previ. Their portfolio is overexposed to those shares and they have been clearly focused in divesting, so for that they would require a major capital injection to maintain control, the opposite direction of their needs. We, therefore, understand that a substantial capital increase in common shares would in fact be the last alternative to the controlling shareholders.

Despite the investment's risks, at the current holding discount of 60%, we see very few scenarios in which the funds would incur permanent capital loss. A 60% discount is simply too big, with a lot of margin of safety. We believe that the major catalyst for the investment to converge to its fair value will be the renewal of the shareholders' agreement, which we believe should happen between May and October of 2016. We find it hard to believe that this uncertainty will be extended beyond 2016.