Our funds had a strong performance in the first half of 2016. On top of positive developments in some of our invested companies, the funds benefited from two other factors:

1. High market volatility:

   During times of high volatility, as experienced in the first half of the year, we tend to benefit by taking advantage of short term irrationalities of market participants and intense sector rotations.

   Usually, when a major macroeconomic shift occurs, certain decisions that might make sense for an investor from a macro point of view end up making much less sense when we factor asset prices into the equation. Maintaining a value perspective during extreme market shifts tends to benefit our investors on a medium to long term basis.

   This dynamics can be exemplified by BVMF´s (BVMF3, the Brazilian stock and derivatives exchange) investment case. In 2015, we bought BVMF shares at around R$9.0/share, when it was trading at ~9x forward earnings (adjusted for the stake held on CME). In other words, at a time when the market was supposedly convinced that trading volumes would remain depressed for the next decade, the market was offering us a great asset, with strong cash flow and a net cash balance sheet, at an extremely attractive price - a price that offered a significant margin of safety.

   A year has passed, and with the political changes observed, market participants again showed a high level of certainty, but this time in the opposite direction. They now believe that negotiated volumes on the Brazilian stock exchange will grow sustainably over the next decade, taking BVMF shares to a price of almost R$18.0/share at the end of 1H16, and a 12-month forward P/E of ~19x.

   Such extreme mood swings always amaze us and have constantly benefited our funds over time. This benefit is naturally amplified in times of increased volatility.

   Today we no longer hold a stake in BVMF, as we do not see a large enough margin of safety.

2. The mean-reversion of some share-class and holding company arbitrages:

   After a challenging 2015 for share-class and holding company arbitrages, in 2016 we saw a return to more rational discount levels. The irrational behavior seen last year negatively impacted our arbitrages performance. However, that resulted in interesting opportunities, especially considering the distortions observed at the end of last year. Those distortions ended up benefiting us significantly this year. Among them, we highlight Bradespar (BRAP4) arbitrage, which was explained in detail in our last investors´ letter.

   Market exaggerations often generate some losses in the short term, but these losses tend to be more than offset over longer periods of time.

   We will further discuss share-class arbitrages with more specific examples later on this letter.

   Before we move on to the fund’s main contributions/positions, it is worth mentioning the departure of one partner/analyst, Daniel Arditti. He was focused on the commodities sector over the last several years and his departure led us to a deep reflection on our effective competitive advantage within this sector. Commodities has been a very challenging sector for us, not only from a performance point of view, but also from the benefits generated when adjusting for the time allocated to the sector by the research team. As we joke internally, every day is a new day for a thorough commodities discussion. There are always relevant China-related news, exchange rate fluctuations, or new information about commodities prices in various parts of the world. Having said that, we have discussed if a possible new hire (that would keep the research team in seven people) should focus on commodities or on strengthening sectors that have generated consistent performance over time. We will probably do the latter.

Fund's performance contribution and key holdings:

1. **Utilities: Equatorial and Transmissão Paulista**

Equatorial (EQTL3):

In our last investor letter we talked about Equatorial, highlighting its efficiency and quality of the management team, as well as its potential to generate value through acquisitions of inefficient companies and execution of successful turnarounds. At each successful turnaround delivered by Equatorial, as evidenced at Cemar and partially at Celpa (ongoing), our confidence about the continuous value creation through acquisitions increases.

The stock performed very well over the first semester, up more than 40%. This was due to two main factors: (1) good reported earnings, especially in the 4th quarter; (2) increased expectation of value generation through acquisitions, especially with Eletrobrás' agenda to privatize its inefficient power distribution utilities in the north and northeast of Brazil.

The new government, despite being in office for only over a month, is taking significant positive measures in the utilities sector. Among them, we highlight the appointment of highly regarded market executives for key positions in the Energy Ministry (MME), EPE and Eletrobrás, and the preparation to sell power distribution utilities currently under Eletrobrás, having rescheduled the first auction (Celg) for August. We see the sale of Celg and six other distribution utilities controlled by Eletrobrás to be great value creation opportunities for Equatorial due to: (1) Equatorial's ability to raise ROIC above the regulatory WACC, through cost and commercial losses reduction; (2) asset base increase through investments with low risk of being discarded by the regulator and above cost of capital returns. Additionally, we understand that some private distribution utilities have high probabilities of being sold, and we see few potential buyers. In this environment with many acquisition opportunities and low competition for assets, we believe that Equatorial should be able to generate new value creation fronts.

We reduced slightly more than half of our position at the end of the semester due to the price appreciation, and the consequent reduction in the margin of safety of the investment. That said, Equatorial remains a relevant position in our funds, offering an adequate (but not huge) return and with significant optionalities ahead.

Transmissão Paulista (TRPL4):

Transmissão Paulista was an important performance contributor in this semester. We began to build our position late last year. The stock had limited liquidity at the time, and the sale of a significant stake in the market created an opportunity for us to start investing. It caught our attention that a power transmission company was trading at that time at around an 11.5% real internal rate of return to shareholders. The transmission business in Brazil has predictable and pretty much fixed revenues, with low default risk. In addition, the operating costs are low and margins are high. The business risk lies in the pre-operational phase of the power line build up.

The company holds substations and power lines that are almost 100% operational, being therefore a low-risk investment that should trade at a much lower risk premium compared to long term inflation-linked government bonds. The main variable that justified the existence of such a high premium was the uncertainty on the amount and timing of the company's indemnification for RBSE (Basic Network Existing Systems) assets, which was reverted to the State at the end of 2012. The amount the company could receive was of major relevance to the investment case.

Throughout the last semester, there were some developments that increased our confidence on the indemnification monetization: (1) recurrence of failed new transmission lines auctions organized by the government (absence of bidders due to the indemnification uncertainty); (2) Eletrobrás' financials deterioration – the company is entitled to the largest amount of indemnification among the transmission companies. We monitored closely both events, with frequent interaction with the companies, ministry and regulatory agency.

At the end of April, the Energy Ministry published a decree setting the general rules of RBSE indemnification, indicating the horizon, payment method, and especially the interest that should accrue in the indemnification, which led to a higher present value than expected by the market. This was critical for the strong repricing of Transmissão Paulista shares (since we started buying the stock it has appreciated around 50%).

After the strong stock price increase, we began to see the company trading at more coherent internal rate of return. However, we see potential catalysts that might add considerable value to the company, and that lead us to maintain ~50% of the position we had before the Energy Ministry decree: (1) interruption of the contribution to the pension plan of employees of the State control period, which we believe should be a burden of the State of São Paulo; (2) winning new transmission projects in upcoming auctions. It is important to highlight that at the last new transmission projects auction held in April, the projects estimated real equity returns were double-digits. On the other hand, there is a risk of capital gains tax burden over the indemnification (even if partial), despite the fact that conceptually it doesn´t make sense to tax the indemnification, and that ANEEL's (regulator) technical area is apparently not favorable of the capital gains tax.

2. Real Estate: Direcional (DIRR3) and Gafisa (GFSA3)

Direcional was an important performance contributor to our funds in the first semester. The investment opportunity derived essentially from the difference between the way the market evaluates a homebuilder (developer) and how we evaluate it internally.

Typically, the market has a greater focus on the income statement, and metrics such as the ROE of a specific year, while we have a greater focus on the homebuilders´ balance sheet.

Very briefly, we don't love the developing business. We understand that it is a business with limited returns, typically long cycles, some leverage and significant tail risk. Having that in mind, we always seek to acquire assets in the sector that trade at substantial discounts to their intrinsic or economic value.

This strategy, in spite of making sense in theory, as the companies´ assets are relatively liquid (when compared to a factory), many times does not work for different reasons, among them, we highlight:

- Leverage: the cash flow has a more uncertain timing than the market believes. It depends on: the pace of sales, transfers to the banks (in Brazil, the homebuilder receives about 70% of the cash flow from a unit's sale only after the transfer to the bank materializes), the amount of sales that comes from finished units, among other factors. Due to these factors, counting on the money before it is received can be dangerous. This is the main reason why we stay away from over leveraged homebuilders.

- Shareholder's Equity can be a good or bad value reference: the balance sheet holds assets that have historical costs as reference, but many times the liquidation value of the assets is lower. In addition, administrative costs reduce some of the value that would be generated over the years. In other words, in some occasions, the equity value does not reflect the economic value of the assets. From this perspective, it is crucial to understand the assets listed on the balance sheet. Last, it is worth noting that the higher the leverage, the greater the risk of misunderstanding the balance sheet – another reason to stay away from highly leveraged companies.

- Capital Allocation: if we are buying an asset at 20% or 30% of its book value, even if we have made the correct analysis of the balance sheet and leverage, the capital allocation may destroy the investment case. If a homebuilder has proper capital allocation discipline, as the assets on the balance sheet turn into cash (or into good investments), we benefit, given the asset's discount level. On the other side, if a developer continues to invest in low return assets over time, the potential cash flow that would hypothetically return to us may be diluted over time. As a result, it is critical for the company to have good capital allocation.

In Direcional, we found an interesting combination of: (1) an asset that traded below 30% of book value; (2) one of the least leveraged homebuilders of the sector; (3) management and controlling shareholder that we believe to be aligned with minority shareholders' interests. Our most significant stock purchase was at around R$3.50 per share, when the stock traded at ~30% of its book value. At that time, we believed (and still do) that the company had adopted the correct strategy: a significant reduction of their exposure to the middle income business and a focus of the investments on its low income segment.

The low income business has some very positive features: (1) it has low-cost funding; (2) an associative credit system, in which the transfer to the bank is made before the construction begins, which reduces the working capital and drives sales cancellations to almost zero; (3) shorter construction cycle, which also reduces working capital.

We expected the company would generate significant cash on the back of delivering previous projects. Since the low income business does not demand significant working capital, we expected this cash flow to be distributed to us through dividends. In companies trading at a fraction of its book value, the dividend distribution generates a disproportionately positive effect for shareholders. Take for example a company with a market cap of R$ 500m and a book value of R$ 2bn (i.e. trading at 25% of book value). Assuming that it distributes only 10% of its equity, or R$ 200m, it would generate for shareholders a very significant dividend yield of 40%! The higher the market value discount vis a vis its shareholders equity, the greater the potential of this monetization.

After the stock appreciated to a level close to R$ 6/share, we reduced substantially our position. Currently, our position is about 25% of the original size. It is a small holding, but given our perception of the company´s management quality and controlling shareholder alignment, we will continue to monitor it closely.

As Direcional was increasing in value and our position was being reduced, we found another investment opportunity among homebuilders: Gafisa.

After several years of low returns, Gafisa posted very weak results on the 1st quarter of 2016 from an income statement point of view (however it is worth noting, the company generated cash) causing Gafisa's shares to depreciate substantially, offering an interesting investment opportunity. Throughout June, we bought a considerable number of shares at R$ 1.85/share, a price equivalent to 22% of its book value. Gafisa has a leverage slightly higher than Direcional, but still acceptable.

Gafisa has basically three business units: (1) Gafisa segment: medium/high income; (2) Tenda segment: low income; (3) Alphaville segment: horizontal lot development.

Alphaville, the largest horizontal lot developer in the country, is an asset in which Gafisa has a 30% stake. Nearly 3 years ago (Jun/2013), Gafisa sold 70% of Alphaville to private equity funds Blackstone and Patria (a local private equity fund in which Blackstone holds a 40% stake). At the time of the transaction, Alphaville was valued at R$2bn, or 300% of its book value. Since Gafisa sold only 70% of Alphaville, it received R$1,4bn and maintained its 30% stake, worth R$600m. Currently, Gafisa as a whole, including its three segments, is valued at R$750m.

Tenda targets the low income, a segment that we are very familiar with because of our previous investment on Direcional. As mentioned before, we see the business of low income as a good business as long as the funding dynamics remain unchanged. However, given the risk of changes in the low cost funding dynamics, we are cautious on perpetuating good returns in the low income companies in the long run, though we don't expect any disruption in the short/medium-term.

Gafisa segment, which bears the company's name, is its most problematic business. Medium/high income is a challenging business, in which the cycle is longer, and the return has proved to be very low over time, especially when we adjust for the incurred risk. In this segment, we argue in favor of the company maintaining a low level of new developments (focusing only on projects that have high profitability and margin of safety) and to seek converting its assets into cash (as far as possible, of course). This is a segment in which we see little business value, but a lot of value on the balance sheet, where there are R$ 1.6bn worth of equity that we would like to see turning into cash over time. In this case, the benefit of the equity conversion into cash and later dividends would be similar to what we described for Direcional, especially given the high discount of Gafisa to its book value.

Perhaps the biggest investment risk is the capital allocation discipline in the Gafisa segment (medium/high income). This risk is relevant, but it is minimized by recent history, as the company has been able to make a downsizing of Gafisa structure, as well as taking advantage of moments when the market presented good opportunities to make aggressive share buybacks. Furthermore, the controlling structure favors rationality. A local hedge fund holds about 20% stake. In addition, it is important to mention Pátria that holds more than 5% of the company. We bought about 3% stake in Gafisa.

One optionality of the investment is a potential M&A. As we mentioned, private equity funds acquired 70% of one of Gafisa´s business segment (Alphaville) for R$ 1.4bn. Gafisa´s current market cap of ~R$ 750m - or eventually 2x this value for a possible offer to buy the whole company - could represent a cheap way for a strategic investor to buy the remaining 30% stake on Alphaville and still grab an asset with high scale for a fraction of its fair value. We wouldn´t discard this hypothesis while Gafisa is trading at such a deep discount to book value.

3. Education:

The education sector was favored by the potential merger of Kroton (KROT3) and Estácio (ESTC3), a deal that could unlock significant value through synergies. This corporate event benefited both stocks and our funds.

As mentioned in our last letter, we expected Kroton to keep generating value through M&A over time:

> "This efficiency gap, combined with a highly successful track record of acquisitions and a debt free balance sheet (when cash balance is adjusted to the sale of Uniasselvi), offers Kroton an exceptional opportunity to generate value through acquisitions."

Despite what we wrote in the last letter, we were not expecting a relevant M&A in the short term. Kroton's offer to acquire Estácio was a pleasant surprise this semester.

We believe there is a high probability of the deal being closed, especially due to the high overlap of the companies shareholders base. Observing Estácio shareholders, 44% of the total also have a relevant stake on Kroton (based on the lastly updated shareholders base). Observing exclusively shareholders´ interest, we figured that the tendency would be to approve the deal favoring somewhat Estácio vs. Kroton, considering the economic stake held by each shareholder in each of the companies.

Despite the risk of the transaction not being closed, it is important to understand the potential of both assets combined. With the deal closed, the combined company will have a high internal rate of return to shareholders as well as attractive consolidated multiples, especially if we deduct the present value of synergies (conservatively estimated) from the market cap.

Considering synergies before they materialize is always a risk, but in the case of Kroton, the several successful acquisitions (including the largest and latest – Anhanguera) and the quality of its management team minimizes this risk. Assuming the deal conclusion, we believe that the new entity will offer two interesting characteristics to investors: it will combine growth potential with high dividend distribution, a combo that may lead to further multiples re-rating.

We keep seeing Kroton as a very well run company with significant competitive advantages in a regulated and still fragmented sector. Therefore, we expect the company to continue generating value to its shareholders over time.

4. Other significant contributions:

Among other important contributions in this first half of the year, we highlight banks – Itaúsa (ITSA4) and Bradesco (BBDC4) – and Cielo (CIEL3). We commented on both cases in our last letter. Both continue to be important holdings to our funds.

5. Arbitrages:

As we mentioned in our last letter, 2015 was characterized by some irrationality among several holding discounts. Below we highlight a quote from our last letter regarding Bradespar (BRAP4) and Metalúrgica Gerdau (GOAU4), two holdings being evaluated on a completely different way by the market:

> "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."

That is, at that time, we saw two different holding situations, with some leverage risk, but with completely different holding discounts. Bradespar trading with a holding discount of 60% while Metalúrgica Gerdau traded at a 5% discount. Obviously, each case had its own specifics, but the holding discount gap between both arbitrages was far too wide.

Fortunately, we managed to take advantage of both opportunities. The Metalúrgica Gerdau discount expanded to more reasonable levels of 30%, while Bradespar´s dropped to ~37%. After the above mentioned performance, we sold our Gerdau vs Metalúrgica Gerdau arbitrage, while considerably reduced our position in Bradespar vs. Vale and CPFL, as the margin of safety declined.

Going back to see some details of our Bradespar arbitrage, a few factors are noteworthy.

Given the wide gap between the holding price of Bradespar and the sum of the parts of the stakes it held, we took that opportunity to build a very relevant position for the funds, and even had to announce in February that we reached more than 5% of the company's total preferred shares.

Due to our relevance in the company, and believing it to be of great importance for the investment case, we decided to take a more active stance. First, we sent a letter to the board suggesting the sale of CPFL shares held by Bradespar in order to pay down its debt and turn Bradespar into a pure holding company being solely part of Vale´s controlling block, without other assets and free of debt. We believed this would reduce the holding discount. Later, we elected, along with another minority shareholder, a board member, Mr. Eduardo Parente.

Despite our governance effort, we ended up holding this relevant Bradespar position for a shorter than expected time. The holding discount reduced too fast, which potentially will lead our governance efforts to benefit other shareholders even more than our funds.

For more details about Bradespar arbitrage, we recommend reading our last semester letter.

About arbitrage and relative value operations in general, one last important point is the improvement of the stock loan market as a whole throughout the first half of 2016. The significant decrease in borrowing rates seen in several stocks over this semester is noteworthy. After two years working with an extremely difficult stock loan market, the recent trend is certainly encouraging for our short and relative value operations. Since this is a very recent event, it is difficult to evaluate whether this dynamic will consolidate. We will certainly follow up with updates about this topic over our next letters.