"When we think we've had a good year, our investors should ideally agree with us" - Seth Klarman

It´s easier to agree a year was good when returns were positive, but we should always keep in mind that there are years in which not losing money may be considered an excellent result. We believe our funds had a good year in 2016 – especially when taken into consideration the dynamics of the Brazilian market during the year.

This was an year in which less predictable (or riskier) stocks performed outstandingly well: Vale3 + 98%, Petr3 + 98%, Elet6 + 148% e Bbas3 + 99%, and the challenge of delivering good results without significant directional exposure to these companies was substantial.

As mentioned in our first semester investor letter, the high volatility throughout the year was beneficial to our funds. In times of high volatility and excitement, we usually identify distortions between asset prices and underlying securities value more often. Overall, we have been successful in not distracting our analysis from factors that we see as short-term noise, and we have profited from the irrationality and extreme sector rotations by picking investments with a large margin of safety. Last semester we wrote about our investment in BVMF to exemplify this effect. As we constantly repeat, volatility is a great ally of the value investor.

Investment Philosophy - Focus

Investing in a country like Brazil is a constant challenge, given the continuous change in macro variables and a constantly shifting political landscape. Especially in recent years, we found ourselves in a highly volatile financial environment. Naturally, each investor chooses the strategy they believe is the most effective in dealing with this challenge/opportunity. Different methods are valid: some investors focus on asset selection through fundamental analysis (our choice); others prefer to focus on forecasting the macro scenario for the next few years (we are more skeptical); another approach is to identify different asymmetries in the many possible scenarios; others employ a more active trading strategy (quantitative methods or others); amongst others.

Regardless of the chosen method, we believe that two main concepts should guide investors:

1. It´s imperative for the investor to conduct an honest self-analysis to evaluate whether he or she actually has a competitive advantage in the intended strategy/method.
2. It is important not to make many changes in the investment philosophy over time. The underlying premise is simple: after 10 or 20 years applying the same strategy, certainly the investor will not make the same mistakes he made when he had less experience.

In light of these two concepts, we have kept a safe distance from some new trends which good part of Brazilian investors have followed.

There are examples in the Brazilian investment industry in which the expansion/modification of manager's investment scope brought positive results, but there are far more examples where this stretch has generated poor results. Around 10 years ago, many long-only value investors decided to enter the long-short strategy, perhaps without having a clear competitive advantage on it. In this same period, we watched some macro-oriented managers hiring equity analysts focused on bottom-up research, with these new analysts competing for capital in the same investment vehicles their macro teams were managing. We have also seen public-equities focused managers dive into the private equity sector. There has been a clear trend of Brazilian managers increasing their investment scope over time.

More recently, especially in the last three years, a good part of the public-equities focused managers in Brazil have expanded their investment scope on two major fronts: greater macro/political focus and/or greater geographic diversification, adding more international assets to their portfolios.

It´s still early to evaluate whether these new trends will turn out to be successful. Some will be more successful than others, and probably, the extent of their success will be related to the time in which these changes has been carried out by each investor. Rather than trying to guess the future, it is important to us to be clear with our investors about the path we have chosen, and to keep them aligned with the strategy we will continue to employ at Oceana.

Our choice continues to be to invest in companies that show significant distortions between its share price and intrinsic value. We keep on believing that the best strategy for capital preservation is to invest in companies we know well, and do so at prices that offer a large margin of safety. We also understand that our competitive advantage lies in investing in companies operating in Brazil. Here we know the companies, the regulatory environment, the consumer preferences, the controlling shareholders and executives' backgrounds, our rights as minority shareholders, and we have very good corporate access. Moreover, we will keep on stating our inability to predict the next macroeconomic movement.

In 5 years, we may be seen as disciplined for having kept focus, or as dinosaurs who weren´t able to adapt to changes. Without a doubt, our funds performances will be decisive for this conclusion.

The choice to remain adherent to our original investment philosophy is due to our belief that the expansion of our investment scope would considerably dilute our competitive advantage. The effort we employ to keep our team and processes aligned with our original investment philosophy is significant. The constant political news flow in Brazil, or the possibility of investing in American capitalism icons, such as Coca Cola, Apple or Google, tend to seduce the majority of young analysts (and also many not so young). It is a conscious effort within Oceana to maintain the culture, strategy and discipline of the investment team over time.

Strategy Capacity

Throughout our last letters, we gave examples of our approach in dealing with the high volatility of the Brazilian stock market. In this context, it is worth emphasizing the limitations that we must observe in order to remain efficient in our approach. If, on one hand, the high uncertainty and the market volatility in Brazil favors the value investor (offering significant distortions between asset prices and intrinsic values), on the other hand our market unfortunately still has a limited liquidity. With this in mind, it is important to reinforce that the Fund size matters, and a lot, when it comes to our ability to exploit the opportunities generated in times of stress.

This concept, despite being present in most managers' sales pitches, is usually ignored when managers start growing their assets. Often, the idea of short-term financial gain is dominant in the managers' decision to grow their funds. As a well-known fact to our investor base, we understand that being conservative with our strategy's sizing is critical to our performance in the long run.

The benefits of having our strategy's properly sized has already proven important at various points in Oceana's history. A good example is the Gafisa (homebuilder) investment case. As mentioned in our last Investor Letter, "we bought a considerable number of shares at R$ 1.85/share, a price equivalent to 22% of its book value". At the time, our understanding was that the sum of the parts was undervalued by the market. Gafisa operated in 3 segments: (1) Gafisa segment (medium/high income); (2) Tenda segment (low income); And (3) Alphaville segment (allotment). When we evaluated independently the three segments, we observed an aggregated value considerably above the market value.

Following the IPO announcement of one of these segments, the Tenda subsidiary, which made it clear to the market the existence of "hidden value" within Gafisa, the shares appreciated considerably. We sold most of our position at prices between BRL 2.5 and BRL 2.9/share, as the margin of safety narrowed (we now hold close to 15% of our original position).

Although we were not anticipating at the time of our shares sale (though we considered a risk), Tenda's IPO failed, and the company was partially sold to a private equity group and some of Gafisa's minority shareholders, at approximate 0.45x book value (a price significantly lower than the potential IPO indicated). The outcome was somehow disappointing to us, and the combination of Tenda's IPO failure and the weaker than expected financial results, led the stock price to a level slightly above R$2/share. Due to this sequence of events, even though prices came again close to our original investments' price, the deterioration in the company's fundamentals made we refrain from buying the stock again. We continue to monitor Gafisa closely.

More important than the evolution of the Gafisa case is to demonstrate the importance of adjusting the size of our investment in light of new facts and prices. Market volatility can be a great ally of the value investor, but as long as the investor has the right size to take advantage of market opportunities. A much larger position in Gafisa (due to a higher level of assets under management), would have narrowed our options - we could certainly have sold part of the position, but possibly not enough to ensure the same positive outcome for the Funds. Long-term performance relies on proper, conservative, strategy sizing. Gafisa is just one of several examples that could be used to illustrate this concept.

To our investors, we emphasize our commitment to maintain the same AUM growth discipline in the future as we have over the last 10 years.

Shopping Malls

Historically, when analyzing the shopping malls sector, we have always been concerned about having a good understanding about the financial health of the retailers of such malls. In the short run, the financial health of retailers may diverge from the financial health of the mall, but in the long run they tend to be highly correlated.

The retailers' situation often can work as a predictive tool on how the mall’s financial results will behave in the coming years. The fieldwork required to understand the situation of retailers is an arduous work, but doing so can offer significant benefits, especially during times of drastic improvement or deterioration of the retailers' situation.

By the end of 2011, after a consumption boom in Brazil that had led, for several years, to strong sales growth, retailers on average were doing very well financially. This indicated a high probability of strong rental adjustments in upcoming years, potentially generating good revenue growth for the malls. After checking with several small retailers, we noticed an even greater aggressiveness by the malls than we initially imagined. Readjustments of 30/40% above inflation were common.

Given that the average retailer's rental contract length is 5 years, a relatively long time elapses until the mall captures the full benefits of favorable renegotiations with the retailers. As these benefits are attained progressively as retailers contracts’ expire, the impact on malls' profits on the year following the aggressive renegotiations is limited, but over longer periods the impact is significant. Our studies indicated at the time rental adjustments considerably above the retailers' sales projected growth over the following five years. The impact of these adjustments on the intrinsic value of the shopping malls was very incisive.

This dynamic, together with the fact we saw very attractive internal rates of return, compelled us to build up positions in some shopping mall companies at that time. This investment proved to be successful, bringing positive results to the fund over its following years.

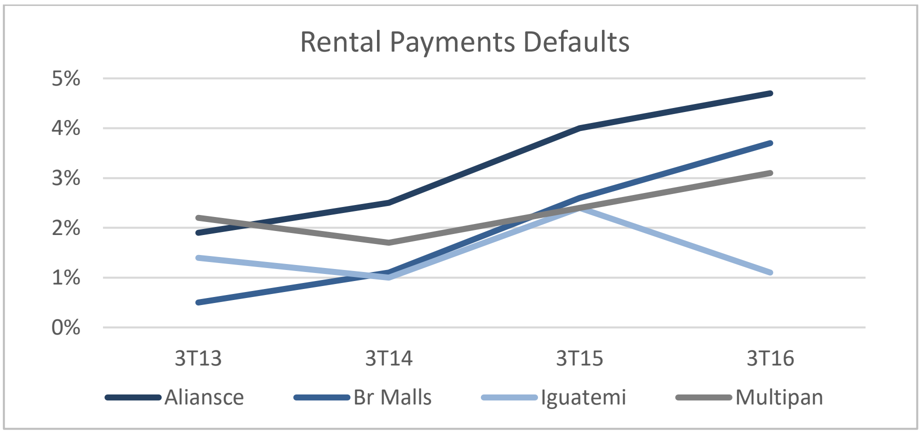
This was the reality observed in the shopping mall sector until mid-2014, when the sector started facing a crisis of severe proportions. With the macroeconomic scenario deterioration that followed, retail sales decelerated significantly, leading to nominal sales declines for retailers in several malls. This deterioration affected retailers of different malls in different ways: today, for example, we see dominant malls focused on upper class customers with more resilient sales than regional malls or the ones targeting middle class customers.

Amongst the listed malls companies (see table below), the challenge of maintaining sales in recent years is clear, with sales evolution well below inflation. It is also possible to note the difference in performance of retailers in different malls: Aliansce (ALSC) and BR Malls (BRML), with greater exposure to middle class customers, had worse performance than Iguatemi (IGTA) and Multiplan (MULT), which are focused on upper class customers.

Annual Sales per m² Occupied		
	2014	2016E
Aliansce	BRL 12,843	BRL 12,288
Var. Biennium		-4.3%
Br Malls	BRL 14,233	BRL 13,880
Var. Biennium		-2.5%
Iguatemi	BRL 18,296	BRL 19,485
Var. Biennium		6.5%
Multiplan	BRL 17,523	BRL 18,067
Var. Biennium		3.1%
Consumer Price Index		
Var. Biennium		17.6%

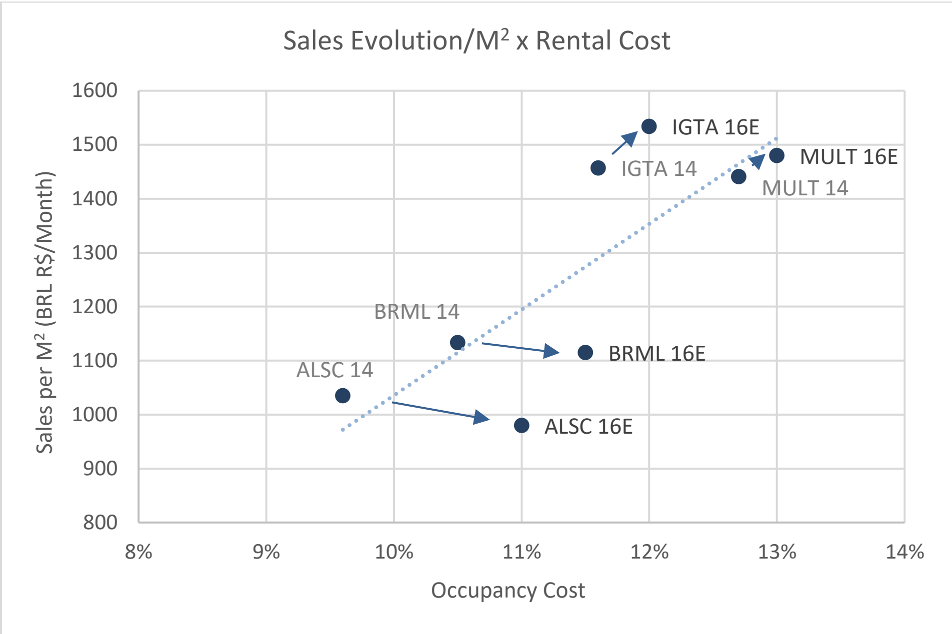
Although sales deterioration takes time to appear on the mall's balance sheet (a similar rationale to the one observed in 2011 – even though the effect on the malls is quicker on the downward movement), it is possible to observe the beginning of some new trends: (i) retailers at malls with a greater focus on middle class customers have been increasing their rentals´ discount levels; (ii) rental payments' default rates in malls exposed to middle class customers have been increasing more than in malls exposed to upper class customers. Usually, an unfavorable sales dynamic can result, in the mid-term, in one (or the combination) of the three events: increase in vacancy; increase in rental default payments; increase in discounts offered by the malls to their tenants.

The chart below demonstrates the rental payments defaults evolution of the listed malls in Brazil. Even though this trend is on its initial phase, it is possible to notice a less troublesome evolution of default in the case of Iguatemi.



Data source: Cias listadas

The combination of sales evolution per square meter and rental cost is something we watch closely. In theory, the greater the retailers' sale per square meter, the greater should be the rental cost of the mall that the retailer can afford. Often, a retailer with exceptional sales in a dominant mall can afford to spend up to 20% of sales revenue in rental costs, while another retailer with very weak sales in an inefficient mall is not sustainable even at a zero rental cost. Looking at both data together may indicate potential financial imbalances of the retailers. The chart below indicates some relevant trends:



Data Source: Listed companies; Oceana.
IGTA – Iguatemi; MULT – Multiplan; BRML – Br Malls; ALSC – Aliansce

Taking the cases of Br Malls and Aliansce, whose malls are focused mainly on middle class customers, we can observe a nominal drop in sales over the last two years and, at the same time, an increase in rental costs (+100Bps in BRML and +140 in ALSC). In Iguatemi and Multiplan cases, focused on upper class customers, we see a nominal increase in sales with a marginal increase in occupancy cost (+20Bps in IGTA and +40Bps in MULT). In theory, Aliansce and Br Malls retailers are further away from an equilibrium – indicated by the dashed line – and currently face greater challenges.

As previously mentioned, the impact of increases or drops in sales is appropriated by shopping malls on a slow pace, because of the nature of its rental contracts maturities. Given this fact, we believe that the malls with retailers struggling more today with sales decreases and increases in occupancy costs will have difficulty over the next years to deliver solid results. In the case of an improvement in the macro scenario, we believe the withdrawal of discounts in rental costs will be first seen in malls in which retailers are healthier.

We currently hold a single position in this sector through Iguatemi (IGTA), which is priced at an attractive internal rate of return and offers a good margin of safety. Observing only the short-term multiples, we see a modest discount compared to other companies in the industry, but over a longer horizon, we believe that the gap on its operating performance relative to peers will surprise most of the market. We understand that Iguatemi retailers currently are, on average, a lot healthier than the sector's average, indicating the company has a better financial perspective than many of its peers. In addition, when compared to other listed companies, Iguatemi has no exposure to the state of Rio de Janeiro, a region that may be further impacted by a severe fiscal crisis that is affecting the state.

Relative Value:

In 2016, we generated good results in relative value postitions, with special emphasis on pair trades, share-class arbitrages (more than offsetting the 2015 losses) and inter-sector value distortion trades.

Looking at 2017, we started the year with a lower level of arbitrage opportunities, but with a higher and growing level of pair trade opportunities, especially in financials, shopping malls, utilities and real estate sectors. Of course, the market is dynamic, and this picture can change a lot throughout the year, but we entered 2017 with some optimism regarding the pair trades opportunity set.

As stated in our last letter, we noted an "improvement of the stock loan market as a whole throughout the first half of 2016." The lending market remained relatively healthy throughout the second half of year. A well-behaved stock lending market is helpful for generating results in the long short strategy. We´ll continue updating our investors about this theme in our upcoming letters.