On Cycles and Equitas

In our first letter after a year without sending out our monthly commentary, we would like to present our view of the cycles we have been through, as well as our outlook for the cycles that are about to begin. In the first part of this document, which will form the backdrop for the subsequent narrative, we will briefly explain how our thoughts about the development of economic and political cycles we face have evolved. Subsequently, we will focus on Equitas' trajectory, how we are positioned and our view of the future.

The Political Cycle

2016 marked the end of a populist cycle that had dominated domestic politics for the previous 13 years. The PT administration mostly stuck to its plan during its many phases, which, later on, made its demise fairly predictable. However impossible it was to anticipate the timing and sequence of events that led to former President Dilma Rousseff's downfall, the approaching shift in Brazil's political cycle seemed clear to us back in 2015. Brazil's recent populist adventure began in 2003 with the arrival of a new and charismatic leader who took power in the face of distrust from many economic agents. He adopted an orthodox economic policy formula, maintaining a combination of fiscal discipline while isolating the Central Bank from political pressure and steering monetary policy in a credible direction. After experiencing a period of robust economic growth, in former president Lula's second term, there was a possibility and even temptation to loosen certain variables in this equation, one of which is fiscal discipline, that were not part of a traditional populist formula.

When the economy began to show signs of slowing during Dilma's administration, she aggressively deployed a populist economic formula in an attempt to maintain economic activity at what were, in the circumstances, unsustainable levels. The effects of fiscal and monetary indiscipline started to appear with rapid growth in public debt and a lack of inflationary control, while the economic measures implemented by the former president began to have a catastrophic effect on market mechanisms. In 2014, former president Dilma was at risk of losing her mandate in the upcoming elections. Cornered, she invoked her Leninist training and resorted to a series of aggressive communication tactics that increasingly divided the population into opposing factions, diverting attention away from her problems to end up with a narrow victory at the polls. By burning her bridges and ending any possibility of dialogue with her opponents at the beginning of her second term in 2015, the former president committed what we then believe was "political suicide" and would later mark the end of a populist cycle. No matter how correct this path might have been, her attempt to redirect the economy using an orthodox formula she

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had previously vilified during her campaign proved to have intense short-term recessionary effects that would leave her party without a “centerpiece” to unite the party at the following elections, further undermining the core of her already weakened Congressional caucus. We believe it was these circumstances that led to the former president’s downfall.

Although the end of the populist cycle was predictable, the sequence of events that took place in 2016 was something we could not foresee even in our wildest dreams. Whatever the risks of any future impact Operation Car Wash might have on the current political framework and the uncertainties surrounding the 2018 elections, our view is that conditions could hardly be better for starting a new and long-lasting economically conservative cycle. A president with the right view of the situation, who is willing to push ahead what are considered to be “unpopular” structural reforms, with a short term in office, with no “obligation” to seek re-election and ample support from Congress, seems to be a very promising combination. Even if we examine the president’s personal characteristics, whatever he may lack in charisma and the ability to communicate with the masses, which would weaken his chances in the future presidential election, he makes up for with political prowess. This trait has been crucial in leading discussions with legislators in order to obtain approval for substantive constitutional amendments. Looking at the PEC (Constitutional Amendments) spending cap, which brought with it a deep transformation in federal budget planning, it took exactly 6 months to push the bill through, compared with the average 20 months it took to pass PECs during the FHC, Lula and Dilma administrations. The controversial Social Security reform backed by the Temer administration began its path through the legislature when the Lower House’s Justice and Constitution Committee voted to accept the bill in just 10 days, burning through a phase that would, on average, usually take 4 months.

One of the current administration’s most promising characteristics is the quality of the team created to formulate and execute economic policy. In our job as analysts, we usually give great importance to the human factor, which normally has a significant impact on the performance of any company we invest in. A skilled management team is capable of making a huge difference in terms of creating value over time. Looking at the current economic team, it is hard to imagine one that could be better structured with such highly skilled individuals in each of their particular areas. Besides the individual technical quality, every networking opportunity we have had with members of the new team has given us the impression their goals are aligned and their decision-making is coordinated, something which is particularly important in order to overcome bureaucratic hurdles and was missing during the previous administration. We believe the contrast in quality and competence between this particular team and that of the previous administration is something that even the general public will notice. These factors heighten our belief that we have passed an inflection point in the political cycle and that we are entering a new more economically conservative cycle.

Can the 2018 elections substantially alter this landscape?

We do not intend to make predictions about the elections, which is a murky business at best. We believe the 2018 elections pose an obvious risk to the momentum advances that started in 2016. Until then, everyone investing in Brazil will be keeping a weather eye on the political landscape. Nevertheless, it is comforting to note that the focus is changing on issues close to the hearts of many Brazilians. Until recently, economically conservative ideas were not widely accepted outside small, elite circles in Sao Paulo and Rio de Janeiro linked to the financial markets. However, these ideas recently started to attract the attention of mass media outlets and to generate broader debates throughout society. Certain themes that were once redolent of an outdated and reactionary elite that was trying to protect its own interests, at the expense of social well-being, are now spreading among groups of young middle-class people, like the MBL. After years of being popularly tagged as “fraud” during PT campaigns, “privatization” is once again a motif for several presidential candidates. In a sense, the results of the 2016 municipal elections confirmed this trend. The 2017 performance of mayors elected on an economically conservative ticket could further strengthen these values. The way the short-term economic cycle is unfolding, which suggests 2018 will be an electoral year with inflation close to target, interest rates lower than they are now and some degree of economic growth, should boost this trend and benefit the candidate who can cast him or herself as an advocate of current economic policies. It is always theoretically possible for a charismatic figure with a populist approach to pop up and change the current political landscape. Additionally, the progress made by Operation Car Wash makes it hard to identify possible candidates at such an early stage. However, it seems the stage is set in a way that would greatly benefit a candidate who stands for economically conservative ideas, who can still channel anti-PT sentiment, which is still very much alive, and who has not been knocked out of play by Operation Car Wash.

The Economic Cycle

Despite this sharp change in direction in the political cycle, there has been no clear evidence of an inflection point in the economic cycle during 2016. There was a mild improvement of some leading indicators and sequential data stabilized, although the level of economic activity remains extremely depressed. We believed we might see an upturn at the start of the fourth quarter of 2016, but the scale of the damage and disorder caused by years of blatant interference with market mechanisms points to a slower and more painful recovery. The positive economic news counterbalancing this has been the start of a rapid drop in inflation which, alongside efforts to center expectations over futures indices, has paved the way for the Central Bank to begin a monetary loosening cycle that could extend through 2018. Even if economic activity has taken longer than we expected to react, a series of leading indicators from December 2016 and January 2017 (ex: cardboard production for packaging, industrial output, electricity

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consumption, road transport, consumer and business confidence indexes, rebuilding the steel inventory, credit, real estate demand, increased demand for short cycle products from manufacturers of capital goods, such as WEG) suggest this economical cycle may already have reached its inflection point. At the outset of this recovery, the farming industry should provide an additional boost to economic activity in rural areas, especially as the soy and corn that are now being harvested in Brazil's Center-South region are expected to produce bumper crops, which could result in a 16% increase in real incomes for farmers compared with 2016, a year marred by the effects of El Niño.

How can all this affect equity investments?

Without trying to define timings or foresee trajectories, we believe the alignment of the political and economic cycles that is currently taking shape appears to be very favorable. Right now, continuing to pursue a structural reform agenda and reducing historic distortions, such as the BNDES' performance, will create a path that will allow us to normalize interest rates and bring them down to a more civilized level and rebuild a long yield curve of prefixed interest rates in BRL. In addition to creating the structural conditions to increase long-term private sector investment, this process will have a significant and positive impact on risky-asset prices in Brazil. Overlapping this, the inflection point in the economic cycle, which is naturally shorter, should gradually boost activity throughout 2017, which, as things stand, will disproportionally affect companies' profits.

As we go about our day-to-day business, we have been able to see companies that we follow try to protect profitability during the extensive economic downturn by attempting to increase efficiency. Nearly all of these companies have deployed some sort of initiative to cut costs and increase productivity and some have undergone deep restructuring processes, leading to improved governance practices. Companies whose efforts to increase efficiency did not stand out are, generally speaking, those that already had a corporate culture focused on continuous productivity gains and, therefore, were better equipped to face the downturn and were much less affected by the deteriorating macroeconomic landscape.

In most cases, the recent crisis also helped industry leaders increase concentration, expand market share and capitalize on their respective competitive differentials. A while ago, we heard a very simplistic view from a businessman we know that defines the recent dynamic very well. He used to say that he perceived his sector's competitive environment as a queue of companies facing an abyss and, from time to time, the queue was pushed a little further forward. He said his only concern was ensuring that his company was always at the back of the queue. The deep recession in Brazil was a gigantic push toward the abyss for many players, while others were left barely hanging on. As economic activity recovers, albeit gradually, companies that were able to come through this challenging period in a healthy financial

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position and stronger market position will probably enjoy favorable competitive environments, where they will find opportunities for growth and increased profitability.

The combination of more efficient structures with high operating leverage and a brighter competitive environment should lead to a significant jump in profits for many of the companies we analyze. **We see potential growth of 25% in average annual profits over the next 3 years for companies in our portfolio.** Although potential profit growth is only partially reflected in market analysts' forecasts, once profits starts to increase, this should boost these companies' stock prices. There is also the possibility capital costs will decrease as well as potential for a long-term decline in interest rates, which points toward a potentially huge jump in value for medium and long-term investors.

How could the external scenario affect this landscape?

The way events are evolving and political debates in many key economies suggest xenophobic and nationalist leaders are gaining strength. Despite the hysteria of the American liberal media and its tendency to mock and magnify the histrionics of Donald Trump, in our opinion, the American presidential election has been the biggest evidence of this trend so far. Only after Trump's inauguration in 2017 will the world be able to see how this will affect the global economy and its relative prices. Today, it seems certain the United States is moving towards reducing its involvement in international trade, renegotiating commercial agreements and, possibly, promoting economic growth through fiscal stimulus and an increase in infrastructure investment. With the American economy moving towards full employment, the most probable outcome will be a momentary boost for the economy, bringing higher inflation and interest rates. The impact of these policies on the total productivity of production factors is still very unclear. Setting the new American president's rhetoric aside, some of his initial decisions, such as approving the construction of two oil pipelines previously vetoed by the Obama administration, seem to indicate he will take a more practical approach to issues that could have a direct impact on the US economy. The intensity with which decisions are taken and their ensuing consequences still pose a huge question mark. So far, the only thing we know for sure is that the Trump administration will produce a vast amount of material for comedians and talk-show hosts.

If Trump's policies really do result in a substantial increase in long-term US interest rates, it could create a less favorable scenario for commodity prices, for currencies in emerging countries and for countries that are most vulnerable to foreign capital flows. Higher interest rates would raise the Brazilian interest rate "floor" during a convergence towards international parameters. In any event, because our starting point is so high, we believe that even if US interest rates return to near historical levels (prior to the 2008 crisis), there will still be a major opportunity for a decline in our long-term interest rate curve as the domestic reform agenda progresses. In other words, this will depend much more on us than them.

Looking at the possible effects a protectionist surge could have on the international trade and global growth, we see a scenario that includes some risks that could also develop into great opportunities for Brazil. Over the past two decades, as the globalization movement intensified, commercial agreements were established, free trade zones created and production chains integrated, Brazil remained among the world's most closed economies. Since 2010, the world has seen a proliferation of bilateral commercial agreements and the number of existing agreements rose from 255 to 352. Due to what turned out to be a misplaced gamble on the evolution of multilateral agreements, Brazil remained on the fringe of this process. In 2016, the sum of our imports and exports accounted for 18.8% of GDP, compared with an average 60% of GDP in emerging countries and 38% of GDP in emerging countries in Latin America. This means Brazil is now the most closed country of all emerging economies and, in 2015, was ranked as the G20 country with the most closed economy by the World Chamber of Commerce. For many years, our foreign policies focused on attracting allies to pursue the puerile objective of guaranteeing Brazil a seat on the UN Security Council. Today, as commercial agreements and international partnerships are constantly renegotiated and redefined, Brazil can take advantage of the decision to reorient our foreign policy, which now appears to be pursuing more practical and mundane objectives such as opening up new markets for our products. A recent speech by British Prime Minister Theresa May during the World Economic Forum in Davos highlighted this opportunity. In her speech outlining the UK's stance on post-Brexit international trade, Theresa May said she was pleased countries such as Brazil had taken an interest in establishing commercial ties with the UK.

Where are we?

In short, for the first time in many years, we can see an environment in which we can outline a highly promising scenario for equities in Brazil as the cycles that have recently reached an inflection point evolve and which, as they have only recently begun, could last a relatively long time. However, there are still risks that deserve careful monitoring. The possibility of: (I) implications from Operation Car Wash destabilizing the Temer administration, affecting its ability to push ahead with the reform agenda; and (ii) Donald Trump's policies leading to a significant increase in risks across the geopolitical landscape, are the most vivid examples of issues that could have a material impact on how an investment-positive scenario might unfold. In any event, we believe the considerable attention these issues have been getting from market participants could lead to a healthier investment scenario. It is in moments of "clarity" that feelings of elation can lead to asset overpricing, making these assets highly vulnerable to unmapped, but ever-present risks.

At this stage, the reader may have noticed that we see cycles in almost all of the trajectories we observe. We mistrust forecasts that are based on the indefinite continuity of apparently unidirectional trends, which is a very common practice among investors and analysts and drives the constant fluctuation between euphoria and depression. This is the basic structure of the mindset we have adopted in the processes we use to analyze scenarios, industries and companies. Translating this to our day-to-day corporate analysis in search of good investment opportunities, we always focus on identifying and understanding how each element that helps generate value at a company is positioned from a cyclical standpoint. Indeed, all of these elements follow a cyclical pattern; it is up to the diligent analyst to understand them. Some of these potential elements are: (I) a favorable economic cycle; (Ii) a brilliant group of executives or CEO; (Iii) modern and efficient production assets; or (iv) a successful product portfolio; these are a few examples of elements which tend to follow a short cycle, but that could momentarily lead to strong value generation while they exist. The lifespan of any impact these factors' have on a company's results is usually overestimated. A few potential value-generating factors enjoy longer cycles, such as: (i) demographic shifts; (ii) the power of a brand to attract a particular group of consumers; (iii) a distribution structure that offers improved access to consumers; (iv) scale, which provides cost advantages. Nevertheless, a shift in consumer habits, technological disruption and the emergence of new players tend to challenge the continuity of these longer-lasting cycles. That is why there are only rare examples of companies that deliver consistent performance for more than one or two decades. What this small group has in common is a corporate culture focused on excellence and efficiency, leading the company to constantly and persistently try to bolster its differentials and, by doing so, lengthen the duration of beneficial cycles. They are also concerned about identifying and preparing themselves for future cycles that could alter the group of factors enabling their ability to generate value. These examples are used as a benchmark for our portfolio choices and business decisions.

Equitas

After telling the reader how we view the current scenario, we will present an analysis of Equitas' trajectory up until now, as well as our future plans and challenges.

2016 was an extremely important year for us. Equitas completed a decade as an investment fund manager and began a new cycle. We faced major challenges, started reaping the rewards of past choices and, above all, solidified our conviction that, little-by-little, we are building a solid foundation for a long and prosperous future.

Ten years ago we began our journey as fund managers in a very unusual way. We believed our professional and academic experience, alongside a few specific nuggets of knowledge, would put us in a strong position to navigate the investment environment that was then starting to take shape as the

Brazilian economy grew and capital markets matured. With the benefit of hindsight, when we look back, we now believe that apart from our belief in our analytical and competitive differentials, we were driven by an optimistic view of our chances of success and a certain naivety about the challenges we would face - factors that commonly assail entrepreneurs when they make decisions. Unlike many of our peers, we were not coming from other asset management firms, did not have previous experience in fund management and did not even have experienced mentors to back us up. Despite our extensive search for references in literature and observable examples, we did not have close examples that would show us the ropes. Therefore, our first years was mainly of trial and error. This was apparent not only in our main activities, but also in our decisions on how to develop the fund management company and how to build an environment that would support the standout performance from the type of investment we wanted to do.

Even without this previous experience, in many of our issues and decisions we were able to quickly adjust course and find the right path. When addressing other, more structural issues that were tougher to change, the aftermath of some initial decisions, which were proven to be wrong, ended up affecting our activities for a very long time. This initial learning curve was marred by a scatter-gun approach and too much time and energy spent on course changes and initiatives that ultimately contributed little to our long-term development. However, it was during this period that we went through the process of building the basis of a team that would unite behind a long-term outlook and cemented our understanding of our differentials and how to translate them into a robust and efficient investment process. It was also then that, almost spontaneously and without any master plan, we began forging our own culture, which is now the cornerstone for our team and our company's development. It became clear over time that a few structural decisions made during our ramp-up period, such as shareholder structure, internal governance rules, focus and investor base development, would later hamper our growth.

For example, when we decided we needed to build an investor base, we believed we needed to build one that understood our investment strategy, trusted in our management capabilities and was aligned with our investment horizon from the outset. We still feared that our lack of an investment track record at the time might mean we would take quite some time to build such a highly qualified base that was aligned with us. We also believed it would be important for our development if we could prove our ability to manage significant volume of AUM. That is why we opted to expand our catchment area in order to include every funding pool that we possibly could. Backed by stellar performance from our funds, we attracted an uneven investor base, with a high percentage of people who disproportionately valued recent performance. We were lauded by those who were enchanted by our performance but they were not concerned about trying to understand what we were actually doing. Despite our unease with what we saw as an abnormal situation, a combination of (i) a self-imposed pressure to continue surfing the

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"crest of the wave" and meet unrealistic expectations, (ii) a lack of discipline, and (iii) a certain amount of overconfidence meant the quality of our investment decisions deteriorated between the end of 2012 and 2014. We went through a period of anxiety as we searched for a dwindling number of good investment opportunities, threw a wider net at the expense of analysis depth, shortened our investment horizon and increased our portfolio turnover as we jumped from one idea to the next. We "lowered the bar" when choosing our investments and incurred atypical risks. The outcome was temporarily mediocre performance - similar to share indices that were also performing poorly at the time - and unfulfilled expectations.

Our growth on such a fragile platform allowed us to invest in infrastructure (risk and management support systems) and to develop the team, although it also brought instability as our performance lost its luster. This instability undermined our most valuable and qualified investor base, one that knows us and follows us closely and understands the frailty of an exclusively performance-driven relationship. Since then, we have been through an ongoing process of analyzing past experiences and reviewing every aspect of our business which could, under certain conditions, influence the quality of our analysis and decision-making process. During 2015, we made several decisions that were hard to implement but had a significant structural impact, such as discontinuing long-short market neutral strategies, redefining our shareholder structure and adopting new internal governance rules. These actions aimed to preserve and showcase the core management team that was responsible for our past performance, allowing it to focus on operations, align the investment horizon with our investor base and align our long-term interests.

With the benefit of over 10 years' experience and having experienced the consequences of both right and wrong decisions, we have built up a series of convictions and drawn up a list of open-ended questions that we will only be able to answer as our experience grows.

One of our most significant convictions is that we do not see our activities at Equitas as just work - i.e., a means of obtaining financial compensation that may be more or less attractive depending on each person's "opportunity cost". We are driven by a mutual commitment and common goal to build a robust and long-lasting organization where we are able to work in an exciting, enjoyable and rewarding environment throughout our entire working lives. Knowing each other's flaws and virtues, we share common values, appreciate each person's role within the company and create more value together than any of us could individually. We trust in everyone's commitment to the group and their willingness to work hard and diligently, even under challenging circumstances that require significant personal sacrifice. We also believe that we are capable of producing exceptional (risk-adjusted) returns by deploying a consistent investment strategy focused solely on our unique approach and governed by a well-defined process. Beyond focus and discipline, we believe that differentials come from producing in-depth analysis of companies within a limited universe, which is only possible using a very wide range

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of evidence and information obtained through hard work and persistence. We also believe that results from analyses that are done properly only become differentials when they are subjected to scrutiny and debate in an environment that holds ideas to be more important than seniority and encourages different viewpoints in order to reach robust and consensual conclusions. We are confident that our strategy is only efficient if it is applied over a medium/long-term horizon (2-5 years) and that incredible short-term performance usually says more about changes in the risk profile of a particular investment than the quality of the original investment decision. That is why this is not the right strategy for someone who plans to race their competitors or any given market index. We need the mindset of a marathon runner who understands his qualities and limitations and can gradually build results, but avoids competing with sprinters who might take the lead early on but run out of steam as the race progresses.

Specific knowledge about investment opportunities and about decision-making processes creates a collective memory that will eventually become one the organization's main assets, although this accrual depends on keeping a close-knit team together. However well a team performs, maintaining its performance requires constant evolution. For that to happen in an investment business, we need to maintain an environment that values self-criticism, where people trust one another and feel they can honestly and openly evaluate their own mistakes. Despite the importance of preserving a stable core, the constant evolutionary process also depends on the capacity to absorb new knowledge and experience from people who join the group over time and bring fresh impetus to our discussions. Lastly, we believe that, in order to build the organization we want, we will make decisions that will eventually result in a slower growth of our assets under management.

In addition to these many challenges and convictions, we also have several short, medium and long term questions. These are questions that drive us to think about the path ahead and for which, as yet, we have no answers. We have questions about how we will be able to balance maintaining our corporate culture and doing things our own way while still wanting to bring new team members aboard. We also question how we can ensure the workplace remains an exciting and rewarding environment for each and every one of us in the long run, bearing in mind that people evolve at different speeds and levels and circumstances can change over time.

As for the issues that could directly influence our short-term fund performance, we are dissatisfied with our fund's return profile. Since Equitas Selection launched in 2010, we have had to face an extremely challenging market environment, where the many elementary mistakes that were made running the Brazilian economy created major headwinds for the stock market. During this period, we also had to deal with and overcome our own internal issues. Nevertheless, the fund accrued returns of 209%, equivalent to 19% per annum. Although this performance is likely among the top 1% of equity investment managers, we are still dissatisfied with our past experiences and the externalities they caused. We are focused on improving our returns adjusted for actual and perceived risks. Although we know there is no "silver bullet" and that the road to success will require many small adjustments across several areas, we believe in our ability to minimize short-term losses without giving up much of the potential our investment strategy has to generate long-term returns.