Letter 14 – 2015

Studio Investimentos

For the sixth year running we are sending our annual letter to inform you of the outcome of yet another year's activities at Studio. As in previous years we will discuss both the positive and the negative aspects of the year's performance. We are glad to say that after the disappointments of 2014 we have learnt a great deal and have emerged stronger and more mature.

The Brazilian economy ended 2015 more fragile than even the most pessimist analysts had forecast at the beginning of the year. Even so we achieved significant success (Studio 30 returned 10.4% and Studio FIC 5.9%) with notable alpha generation when compared to the performance of the stock market indices (Ibovespa returned -13.3% and IBX -12.4%).

Thus, as we have frequently stated, we continue to be convinced of our capacity to achieve high returns in the long term, adhering to the fundamentals of company analysis and always seeking investment alternatives which justify the opportunity cost of the money, while avoiding the traps of labels that come in and out of fashion, such as *small cap*, *value*, *dividend*, *fully invested* etc..

Assets under management totaled R$356 million at the end of 2015, invested by over 500 clients. Since its inception, on November 25, 2009, the Studio FIC FIA has returned 63.6%, compared to -36.2% of the Ibovespa and -15.9% of the IBX indices.

Performance

In the following paragraphs we will discuss the main positions that positively impacted the fund's returns, as well as the two positions that affected it negatively.

Equatorial

Equatorial was both the portfolio's largest position and the best performer during the period.

As we discussed the company at length in our 2014 letter, this section is limited to an overview of what occurred during the year and what we expect for the future.

At the end of 2014 we mentioned four possible upsides for the investment: 1) continued increase of Cemar's operational efficiency; 2) advances in Celpa's turnaround; 3) Celpa's tariff revision; 4) acquisitions of new distributors.

Both Cemar and Celpa's operating results continued to improve, and Celpa's tariff revision was better than we originally forecast, as the regulatory asset base was higher than expected. Tariff revisions occur once every four years and represent one of the major risks for electric power distribution companies, and, consequently, once the process has been successfully concluded, the company's operational risk is substantially reduced.

Only the last item was disappointing. No distribution company was sold in 2015, and once again, the process of the sale of distributors owned by Eletrobrás was delayed. The sale of Celg has been scheduled for the first quarter of 2016, and Eletrobrás continues to insist that it will go on to sell the others.

The challenging fiscal environment of the federal and state governments, combined with the new regulations for concession renewals approved this year, which require improved service quality and financial leverage targets to be met in order to maintain the concession, constitute two new sources of pressure for the sale of poorly performing state companies.

Until the beginning of 2015 only the distribution companies owned by Eletrobrás were on the list of possible sales. But with the two new variables quoted above, combined with the unfavorable economic and credit conditions, we believe that the number of distribution companies that will be put up for sale may well be larger.

Another important development in 2015 was the reduction in the risk of rationing caused by the drastic reduction in the demand for energy resulting from the weak performance of the economy. The large volume of rainfall since the beginning of the rainy season is a further positive factor (for hydroelectric plants). These factors point to a scenario of energy reserves for the coming years which will allow for a reduction in part of the tariff increases of the last few years.

Looking forward, we forecast an improvement in Celpa's commercial losses as it achieves the regulatory targets in 2017, the main task still unfulfilled in the turnaround, and we have not included additional efficiency gains in Cemar and Celpa. We believe that there was a significant reduction in the risk of the company during the year for three main reasons: lower risk of energy rationing, completion of Celpa's tariff revision and greater confidence in the company's capacity to conduct turnarounds (after almost completing its second turnaround process with enormous success). Even with premises that do not take into consideration the possible upsides of further operational improvements and new acquisitions, our assessment is that the return on investment is still very good compared to the risk. With the pleasant surprises of 2015, we foresee similar returns for the investment at the beginning of 2016 as we did at the beginning of 2015.

The likelihood of Equatorial making future acquisitions is increased by the fact that, after the crisis in the sector and in the country, the company is one of the few distributors that has maintained its financial capacity intact.

Industries – Tupy, Mahle Metal Leve and Marcopolo

As we emphasized in our last letter – "searching for a new equilibrium" – vehicle sales in Brazil had been negative since the beginning of 2015. Between 2003 and 2013 sales for both light and heavy vehicles had increased on an unprecedented scale, as a result of falling interest rates, extended financial deadlines and increased wages. During this period the market was further boosted by government subsidies such as reduction of IPI (Industrial Production Tax) in the case of light vehicles, and in the case of heavy vehicles the adoption of the PSI (Investment Sustainment Program) with interest rates subsidized by the National Development Bank (BNDES).

For these reasons we expected the sales of vehicles in Brazil to fall considerably further in 2015. Despite this, we remained positive about the prospects for a few companies in the industrial segment which could benefit from the devaluation of the real which resulted from the country's structural fiscal deficit and deteriorating terms of trade caused by the drop in commodity prices. With this in mind we increased our position in Tupy, which we had held since the company's public share offering in October 2013, and initiated a position in Mahle Metal Leve in April last year.

70% of Tupy's revenues come from the external market, above all North America, and for this reason the company represents an interesting option for taking advantage of the gains in competitiveness of Brazil's industrial sector. In addition to its revenues in strong currency, the company's operational leverage, resulting from the fact that most of the costs of its Brazilian plants are in reais[1], represents a good opportunity for higher returns. Nevertheless, the domestic market was extremely difficult for Tupy in 2015, with the volume of sales falling by around 30%, while on the external market, sales in the off-road segment (construction, mining and agricultural machines) fell by around the same amount. With the end of the commodities 'super cycle', Caterpillar's mining equipment segment, one of Tupy's important clients, has seen a considerable drop in sales over the last two years.

[1] 60% of the company's total production is in Brazil.

Meanwhile the agricultural machinery sector in the United States is going through a fallow period after a period of high investments in the renewal of machinery by farmers during recent years. As a result the total volume of Tupy's sales in its annual statements for 2015 will likely be 10% down on the previous year. On the other hand, its revenues should increase by 10%, helped by the favorable exchange rate, and EBITDA by around 20%, even with the extra expenses resulting from the implementarion of the SAP system.

We continue to be encouraged by the company's prospects, and forecast that 2016 will be a good year, despite the continued deterioration of the markets mentioned above. Nevertheless, the unfavorable domestic market is unlikely to have much effect, as Brazilian sales represented less than 20% of the company's revenues in 2015 and vehicle production in the country is already considerably lower. Furthermore, sales in the off-road segment are likely to fall less than in 2015. The rest of the segments in the company should continue to present good prospects, with the continued recovery of the nonresidential construction segment in the United States, which increases the sales of class 3-7 trucks, Tupy's most important segment, and with the progress in its new contracts with Ford's Nano motor and Audi/VW's EA-888, which will ramp up in 2016. All of these factors, combined with a favorable exchange rate and lower CAPEX disbursement, as the main organic investments were made over the last five years, makes Tupy's valuation very attractive - we see the company trading at 13% of the FCF yield for 2016.

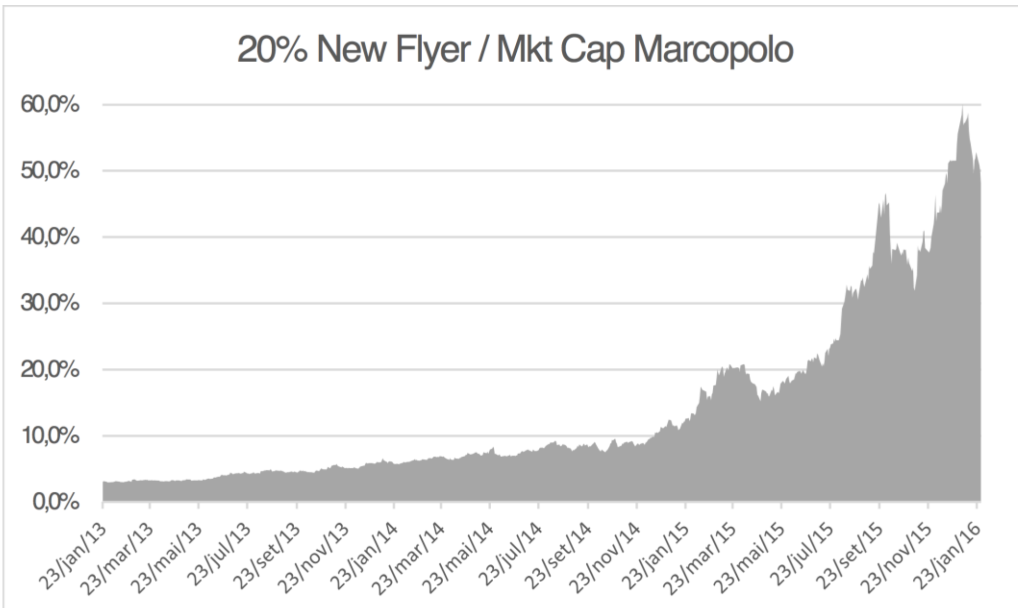
Mahle Metal Leve also appeared to be protected against further declines in the domestic market, as its revenues from sales to Brazilian auto manufacturers (OEM segment) represented only 35% of its total revenues in 2014. A further 26% came from the sale of replacement parts on the domestic market, which has held up much better, as sales in this segment are related to the maintenance of vehicles that are already in use, and are always more stable. The remaining 39% came from sales to the external market, where the company was able to benefit from the favorable exchange rate, increasing its sales in reais and its operational leverage, since a relevant portion of its costs are denominated in Brazilian Reais. However, the company faced certain challenges that offset some of these positive effects: one of these was the increase in the cost of electric energy. In addition to the overall increase due to the higher energy development account (CDE)[2] and other higher charges for the sector (including an increase of 30% in electricity bills for industrial consumers), the company's contract for the supply of energy to its main industrial plant expired during a period when rationing appeared imminent, so that the new contract was negotiated on less favorable terms. Even with these challenges, and with the sharp drop in the production of vehicles for the domestic market, the company managed to increase its share of the Brazilian market and its exports benefited from the favorable exchange rate. As a result the company's revenues increased by 7% during 2015, which was a difficult year, and EBITDA by almost 11%. Going forward, we believe that the company will increase the volume of its sales on the external market due to the opportunities for new contracts resulting from its considerable operational competitiveness.[3] Despite these ongoing favorable prospects, after the strong performance of the company's shares in 2015, the current share price offers a lower margin of safety for which reason we have concentrated our investments in the industrial sectors in Tupy and Marcopolo.

We have been monitoring Marcopolo for years. The positions we held in the company between 2009 and 2010 made a positive contribution to the fund's performance. After four years of exceptional results the effects of the drastic decline of the domestic market began to make themselves felt and the environment became more competitive. As a result the company's shares fell by around 75% in relation to the price at the end of 2013. Last October, when the company's shares had already fallen by 50% since the beginning of the year, we initiated our position. With the drop in the sale of buses on the local market in 2015 (a decrease of around 40%), revenues from the domestic market are likely to represent less than 50% of the company's reported revenues (according to IFRS). If we were to consider the proportionally consolidated revenues of its holdings in joint ventures and affiliates (such as New Flyer), the percentage of its revenues from the Brazilian market falls to below 30%. We consider that the company has great potential to regain markets that it lost during the period when the exchange rate was very unfavorable

[2] Energy development account.
[3] Mahle, which operates from Germany, channels orders to its most competitive subsidiaries. Among these, Mahle Metal Leve is at a considerable advantage due to the favorable exchange rate.

(2007-2014) and to optimize its productive structure in Brazil, closing some of its work posts and production lines to adapt to a weaker market.

Abroad, New Flyer, of which Marcopolo acquired 20% in January 2013, performed well. Since then the company has successfully consolidated its position on the heavy duty transit bus market in the United States and recently acquired a major player in the North American motor coaches segment. Since Marcopolo acquired its holding in New Flyer the value of the company has increased by 165% in Canadian dollars, or 270% in Brazilian Reais. With the drop in the value of Marcopolo' shares during this period, it's 20% holding in New Flyer, which in January 2013 represented just 3% of the company's market value, now represents 50%. Although we do not believe that the company will sell its stake in the short term, without doubt it represents an important liquidity buffer.



We believe that the company will considerably improve its results in 2016, helped by a more favorable exchange rate that will both improve the results of its international operations and aid in reconquering new export markets through its Brazilian operations. Furthermore, we consider that there will be interesting opportunities through the more efficient use of the company's industrial assets by a reduction in its fixed costs.

Cielo

The third company that most contributed the fund's performance in 2015 is one already very well known to Studio. The companies of the credit card acquirer sector were the subject of letter which we sent in 2012 (Cielo and Redecard), and were also mentioned as among the greatest contributors to the fund's performance in our 2011 and 2013 letters.

In this last letter, we reiterated our opinion that the immense difficulties of entering the sector would prevent the emergence of rival companies and ensure the maintenance of Cielo's high returns, as long as any structural conflict between its two controlling shareholders, Bradesco and Banco do Brasil, remained dormant.

During the two years that have gone by since making this assessment we have received no indicators to make us feel uneasy about the controllers, but have continued to monitor them closely. There has been no lack of opportunities for them to act: neither of the controlling banks utilized the creation of Elo, the acquisition by Cielo of a credit card processing unit owned by Banco do Brasil, and the enormous opportunity presented by the anticipation of receivables, to shift returns from the acquiring operation owned by Cielo to their powerful banking retail operation.

Although there has been little reason for our confidence in the relationship between controlling and minority shareholders to be affected, the new regulatory environment has led us to elevate the risk of investing in the company. In this recent development we feel that decisions taken in mature economies such as the United States, the European Union and Australia may influence Brazilian regulators towards adopting unorthodox measures.

At the II International Seminary of Arrangements and Payment Institutions organized by the Central Bank last November, our concerns were reinforced when we heard the details of how all these countries had directly intervened in the formation of tariff prices (above all interchange) and we noted that the Brazilian Central Bank had invited only representatives of the authorities who had been responsible for such interventions to give the presentations.

Since the opening of the acquiring market and the end of exclusive control in 2010, little has changed in the basic characteristics of this industry. Cielo and Rede continue to maintain between 80 and 90% of the market, the segment continues to be highly profitable and the price for the end client has not fallen (with the exception of a few specific cases).

The position of the two dominant players in this segment (Cielo and Rede) is so strong, that the regulator will have to be extremely creative in order to transfer the potential benefits of a more competitive market to the end clients (the retail outlets), such as lower prices, a better quality service and more frequent innovations etc.. Even if a pricing cap mechanism were introduced, the resulting potential fall in profits could be offset by utilizing other products and tariffs.

At the end of 2015 we concluded that the investment risk of interventionist measures by the Central Bank had not been adequately priced, and consequently we substantially reduced our position in the company. We shall continue to closely monitor the sector, and Cielo, in the hope of a future opportunity to increase our position with an adequate margin of safety.

Grupo Pão de Açúcar

There are two types of mistakes we always try to avoid in our analysis and stock picking process. On the one hand we cannot be over concerned with minor details of the companies while overlooking the larger picture, either sectorial or of the economy as a whole. But on the other we must be careful to avoid choices that are based entirely on a more macro vision that ignore companies' characteristics and idiosyncrasies. This is delicate a balance for which there is no fixed recipe.

We initiated an investment in the Grupo Pão de Açúcar (GPA) motivated by our view that we would have a very bad year for the economy, and particularly for the retail sector. The investment in the group represented a safer port of call as three quarters of its business is in food retail, a segment that traditionally shows considerable resilience. The company's strong position in the sector, with retail outlets that are better located than those of its competitors, should mean that it continues to increase its market share in the sector, of which 50%, according to our estimation, is still in the hands of minor players.

The devil, as we described below, is in the details.

The group's retail food segment did not perform well, losing part of its market share to other major players. The reasons for this poor performance are still not entirely clear, but we can present a few hypotheses. After the departure of Abílio Diniz many members of the company's management were replaced and this overhaul may have affected the operation. Another possible explanation is that after the company was taken over by the Casino, a policy was implemented to increase gross margins and reduce expenses. Initially this increase in margins was positively assessed by investors, which saw the move as a reduction in the "excesses" of the previous management, but with the drop in sales we began to understand that the economies made had led to a reduction in the quality of service and less competitive prices, resulting in clients shopping elsewhere. A third explanation is the improvement in the operation of the group's major competitor, Carrefour, which after several years of challenges has been performing well, with renovated stores and a more assertive retail policy.

Another explanation for the group's poor performance is the concentration of its retail activities in hyper and supermarkets, which have been losing their share of the market. There is a worldwide tendency for greater polarization in the retail sector. On the one hand, shops which offer little personalized service and lower prices, such as *Cash & Carry* (wholesale retail) in Brazil and *Hard Discount* abroad, and on the other local shops which more convenient, with higher prices and more personalized service. Strange as it seems, this tendency is accentuated during times of economic crisis. This is easy to understand in the case of *Cash & Carry*, which offers lower prices, but local shops also offer a convenient alternative where shoppers can avoid unnecessary purchases. We estimate that 75% of the group's food business is in hyper and supermarkets.

The durable goods operation (Via Varejo – physical shops, and Cnova – online) was severely affected by the poor performance of the economy and was responsible for an even greater drop in EBITDA in 2015. Our view of the durable goods business has always been very negative as the segment, as well as being extremely competitive, has been overstimulated in recent years. It forms part of a group of segments which we believe will be "searching for a new equilibrium", as we discussed in our letter 13.

Despite the fall in EBITDA for the group's durable goods being much more significant – it will probably be around 50% in 2015 – our main disappointment is the food business, whose EBITDA will probably fall by "only" 10%. This was our greatest mistake.

We ended by unwinding our investment, after losses of 25%, considering that the company will have to invest more in prices (reducing gross margins) and in its service (increasing expenses) to attract consumers back to its stores. We recognized that our original hypothesis of the resilience of the food business was unsound in such a competitive market, where the form of retail outlets is undergoing a process of change, putting pressure on the profitability of this company with its thousands of stores. It is true that the revenue dynamic was considerably more defensive than that practiced in other sectors of the economy, but margins were under pressure and negatively affected cash generation.

After we undid our position, around the middle of the year, the group's shares fell by 40% as a result of worsening operational margins, the increase in the corporate governance risk and the general deterioration of the economy. Shortly after our exit, the controlling shareholder, Casino, undertook a corporate restructuring with the aim of distributing cash flow to the parent company, which is excessively leveraged. For this purpose it sold a holding in the Grupo Pão de Açucar to its Colombian affiliate Exito, at a very high valuation, obliging Exito's minority shareholders to buy part of its holding in the GPA, reducing even further the balance of interests within the company.

It's extremely poor operational performance, above all in Brazil, added to the fact that the company is dangerously leveraged, has left Casino in a very delicate financial situation, which may lead to further decisions which are in conflict with the interests of minority shareholders or strategically damaging in the long term, with the decision to maintain higher margins when it should increase its investments to maintain its strategic position. For this reason we continue to be reticent about investing in the company again.

Bradesco

Our position in Bradesco was one of the most negative contributions to the fund in 2015. Currently, we believe that the banks present a compelling valuation and as such are one of our main investments in the fund. We initiated a small position in July, since when specific facts occurred which led to the bank performing significantly worse than its principal rival – a difference of around 20%.

The main reason for this was that on August 3 Bradesco announced its acquisition of HSBC for U$5.2 billion. The implicit valuation of the acquisition was significantly higher than that of Bradesco, which at that moment was trading at 1.4x P/B (Price to Book) whereas HSBC, which had considerably lower returns (ROE) than the purchaser, was being purchased at 1.7x P/B. Furthermore, it later transpired that Bradesco had not protected itself with an exchange hedge, and after the devaluation of the Brazilian Real from R$3.38 to R$4.00 the valuation of the acquisition was even worse, reaching 1.9x P/B.

We believe that there were two further factors that contributed to the poor performance of the shares. It was given out that the bank had not made provisions for a possible default by Sete Brasil; however, it should be stressed that in the third quarter Bradesco, like Itaú, greatly reinforced its provisions to a level of over 200%. Finally, the results for the third quarter showed a loss of R$4.0 billion in overseas private securities, generating further unease in the fixed-rate portion of the bank's portfolio.

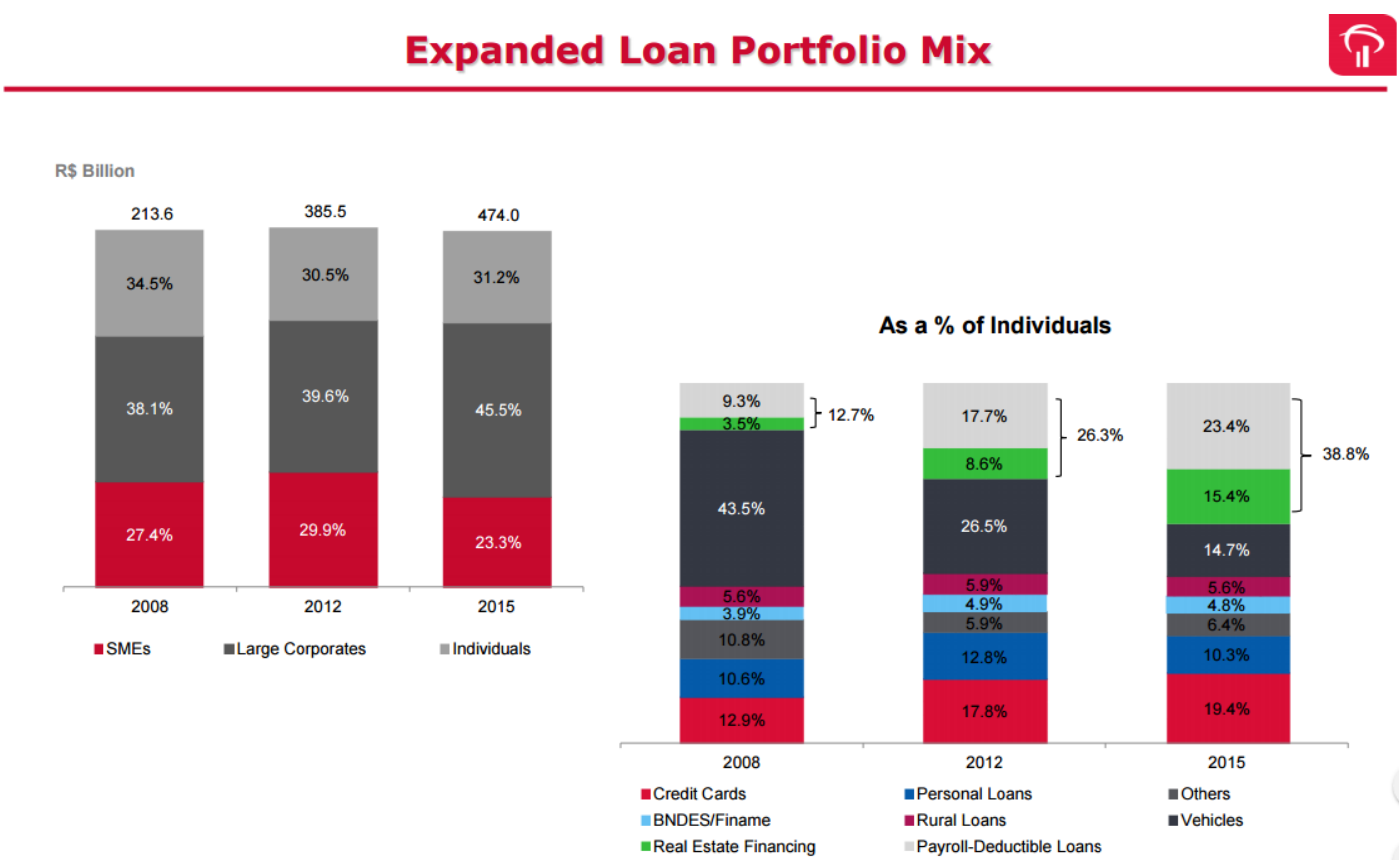
Today Bradesco is trading at 1.2x P/B, already offsetting its loss of value due to its acquisition of HSBC. Thus, despite the specific risks, we believe that the valuation of Bradesco is sound, considering the current context, and as a result we increased our position at the end of November.

Our position in Bradesco has increased our previous investments in the Brazilian banking sector, which for a long time were restricted to Itaú. In the letter which we published on the fund's performance in 2014, we stressed that the best contribution to the fund during that year came from our position in Itaú. However, the privately owned banks performed very poorly in 2015, with a fall of 10% in the case of Itaú and of 30% in the case of Bradesco.

We understand that the economic situation of the country is rapidly deteriorating, and we are of the opinion that it would be impossible to isolate the operational performance of the country's two main banks from what has been happening in the economy during the last few quarters. However, unfavorable situations can produce good investment opportunities in solid companies, with resilient operations, first-class governance and leading positions in their respective sectors, which is unquestionably the case with both Banco Itaú and Bradesco.

In addition to the valuation of Bradesco, discussed above, we believe that Itaú, trading at 1.3x P/B, already has a very high margin of safety, even within a context where quarterly results with no positive surprises are still to be presented.

Although the presentation of poorer results will come as no surprise to us, executives in both banks have been working for a number of years to try to minimize the effects of the deterioration of the economy on their operations. As can be seen in the graph below, Bradesco's credit portfolio has been significantly modified, moving towards safer credit operations and lower default rates.



Furthermore, for more than three years, Itaú and Bradesco have adopted a slow and selective expansion strategy for their credit portfolios, making room for significant growth in the market share of the state owned banks, whose participation in the sector is now large enough to reduce the concentration of potential losses in the privately owned banks

Finally, we cannot overlook the high level of cumulative provisions in the financials of Itaú and Bradesco for 2015, which both demonstrate a very high level of coverage against default.

We are certain that 2016 will be a very troubling year. Nevertheless, we have decided to maintain a significant position in Itaú and Bradesco, as we believe that the current share prices of these two excellent companies offer a rare investment opportunity.

Conclusion

We would like to reaffirm our complete commitment to the search for good investments. After a very difficult year in 2015, the forecast is for the economic and political situation in the country to continue to deteriorate and affect the corporate environment in 2016. Nevertheless it is during such times of unfavorable conditions and negative tendencies that the stock market produces good opportunities.

Few businesses have favorable prospects of increasing their sales or margins. We continue our search for resilient companies with sustainable businesses which are adequately priced for the current risk scenario. We are convinced that some of them will come out of the crisis with a stronger competitive position. Nevertheless, the unpredictability of the duration and intensity of the adjustments that we are undergoing make the risk we see for the companies crossing this uncertain period extremely relevant in our analysis.

History shows us that avoiding major permanent value losses significantly contributes to long-term cumulative returns. Thus, under the current extremely difficult circumstances, we are particularly focused on avoiding companies that, due to financial or operational leverage, depend on the recovery of the economy in order to survive.

Thank you for your confidence and we wish you an excellent 2016.