2016 Letter

Studio Investimentos

2016 can best be described in a single word: volatility. Nevertheless, despite the constant economic difficulties, the year ended better than it had begun. Differently from our conservative approach adopted during the past recent years, the fund's prospects are now looking brighter – as evidenced by the considerable increase in its risk exposure. We strongly believe that better years are coming. Our net exposure – including hedge adjustments - in January 2016 was 55%, which increased to around 80% by the end of the year.

In addition to the increased exposure, It is important to mention the changes in the profile of companies invested in our portfolio. We reduced investments with exposure to the dollar, seeking opportunities in companies that can directly benefit from the improvement in Federal Government administration and from a domestic market rebound.

The change in expectations for the country's future was evident from the sharp rise of the Ibovespa (38.7%), after six straight years of accumulated decline. Despite a portfolio concentrated in resilient companies with low leverage, the Studio 30 rose 26.9%, which, in our opinion, is a fair result considering the high risks related to the unpredictable development of the political situation in the country. It is also important to highlight our culture of focus on capital preservation.

The relatively low risk to which the fund was exposed throughout the year can be better understood by our analysis below of the leading positive results achieved in 2016. As always, we also provide an analysis of the year's two worst investments.

Assets under management by Studio totaled R$467.3 million in 2016, invested by more than 500 clients. Since it was started on 25 November 2009, the returns since inception of Studio FIC FIA have totaled 104%, compared to a drop of 11.3% during the same period of the Ibovespa Index.

Performance

In the paragraphs below we give details of the main positions that positively affected the fund's profitability in 2016, as well as the two positions which affected it negatively.

Equatorial

It's great source of satisfaction to us to report the results of the third straight year of our investment in Equatorial. As in 2015, the company's shares made the most positive contribution to the fund in 2016. The dream of any equity analyst or manager is to find well-run companies in attractive sectors which provide consistent returns in the long term and end up by generating spectacular compound results. This was the case with Equatorial. Since our first investment in 2012, the increase in the share value has been almost 300%, while the Ibovespa remained unchanged. After the initial work of getting to know the company, the time involved in monitoring its performance has been considerably less than in most of our other investments, and this, in our view, confirms the quality of its management. Solid companies with solid strategies in general change little. Not that this indicates less work by the company, on the contrary – its management has consistently surprised the market in a positive way – but it certainly means less work for us.

2016 was the first year since our investment in 2012 in which the results of Cemar and Celpa were worse than we had expected, basically due to the poor performance of the economy and the consequent increase in non-payment by consumers. The disappointment, however, was less than in the large majority of companies that we cover, and we continue to believe that these negative results will be reverted with the improvement in the economy and with the issues already addressed by the current administration.

Although it was another disappointing year regarding to acquisitions of new distributors, in November the company surprised us with a strong presence at the transmission auction. This initiative was extremely sound as the projects offer higher returns and lower risk, as ANEEL (National Energy Agency) was under pressure due to the amount of auctions that have attracted no interest over the last few years and by the need to expand Brazil's transmission network. Further, the competition was limited due to the high leverage of the national players, by the lack of construction companies to carry out the work (consequence of the 'Car Wash' corruption investigations and economic difficulties), and by the absence of international bidders. The company's transmission activities will represent a third of its cash generation when fully implemented between 2019 and 2020.

From the point of view of value generation, the transmission auction was the great event of the year. For us the projects represent nearly 15% of the company's value. It is evident that after the share's performance of 62% in 2016, the return on the investment is currently more limited. Even so, we still find the shares' risk/return ratio attractive. We continue to monitor the company closely, with a critical eye, aware that companies are organisms in constant transformation, but still with the expectation that the combination of good business managed by good people works in our favor.

Itaú and Bradesco

In our end-of-the-year letter last year, we discussed at considerable length the factors that we believed lay behind our investment in Bradesco, having been one of the worst performers of the year.

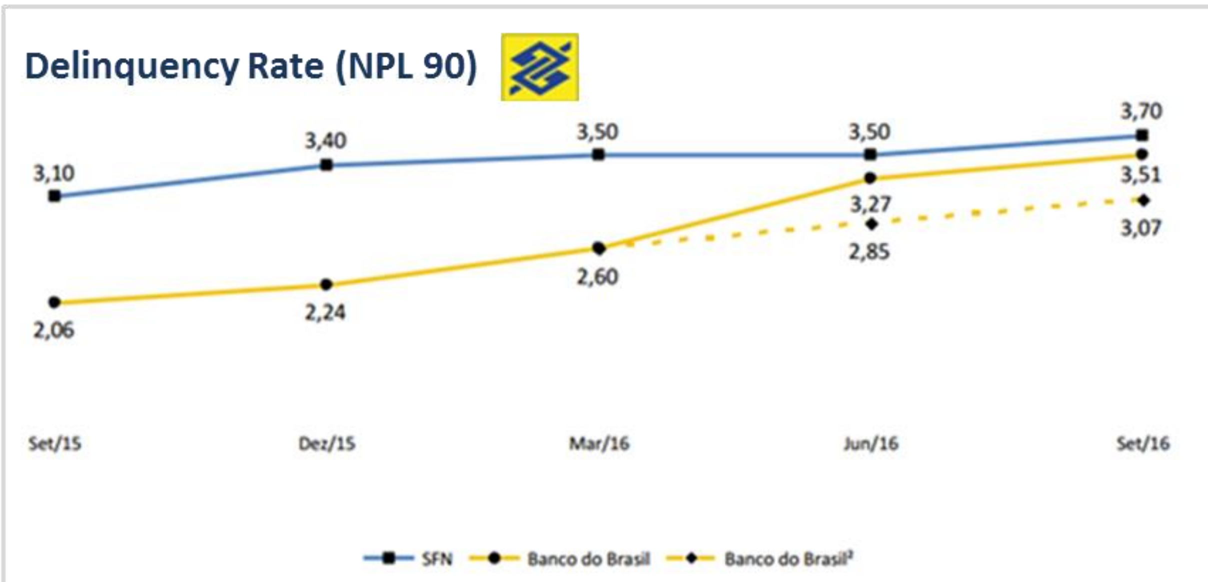
We commented at the time that it was very difficult to foresee the effect of the deteriorating economic situation: whether there would be signs of a change in direction, or even factors that could propel growth. Even so, we were struck by the level of valuation at which both Bradesco and Itaú were trading at the end of 2015.

We stressed in the letter: "Today Bradesco is trading at 1.2x P/B already adjusted by its loss of value due to the acquisition of HSBC. Thus, despite the specific risks, we remain comfortable with Bradesco` s valuation, considering the current context, and as a result we increased our position at the end of November".

Many things happened during 2016, most of them completely unforeseeable at the time of writing our end-of-the-year letter for 2015. The effect of the impeachment and the improvement in the expectations of economic agents for the future cannot be overlooked: they were extremely important factors in the remarkable positive performance of banks in the fund´s portfolio over this year.

Despite the improvement in expectations following the changes in Brasília, the performance of the economy was even worse than it had been forecast at the beginning of the year. The figures for GDP, which have not yet been published, are likely to show a contraction of 3.5%, with a devastating effect on the results of the majority of companies.

In the financial sector, it is precisely the quarterly results reported by both Bradesco and Itaú that provide evidence of the resilience of both companies, as well as the enormous gap between their results and those of the state-owned banks. As we emphasized in our last letter, strategies for growth in credit and the search for safer credit lines were diametrically opposed, with the large non-state owned banks on the more conservative side and Caixa Econômica and Banco do Brasil (state owned banks) on the other.



As can be seen from the graph above, the delinquency rate in the National Financial System (SFN), which registers the consolidated data for all banks operating in Brazil, rose by around 20% (3.1 to 3.7). In the case of Banco do Brasil, the rate rose by 75% (from 2.06%) in just 12 months.

Within this context, Bradesco and Itaú showed their ability to continue to generate ROE at a level of 20% a year, whereas BB progressively saw the delinquency rate on its portfolio compromise its provision expenses, which could not be sufficiently offset by the spreads. Recently, the bank had to re-evaluate its returns guidance to around 7% to 8% this year.

Despite the considerable appreciation during 2016, we continue to invest in both Bradesco and Itaú. We believe that the competitive environment is very favorable and that the normalization of provisioning levels may lead to good results, even before any significant economic recovery.

Alpargatas

The third positive contribution in 2016 was Alpargatas. We have monitored the company closely since the fund was set up and discussed it in our 2011 letter, at the time of our first investment. Our interest has always been motivated by the quality of the Havaiana sandals business, which represents almost the entire company's value. Our current investment started in 2014, around the time of the opening of the new sandal factory in Montes Claros, Minas Gerais. The investment was focused on the more than 50% increase in production capacity in a new, more productive factory, which would led to a cascading effect in the company's revenues and profitability.

To put the investment in context, let us go back a few years in the company's history. As we said in 2011, the Havaianas brand has existed since 1962 and underwent a process to position the brand in a more premium way between 1993 and 2001. After this the company experienced two periods during which its profitability increased considerably. The first of these was in 2005, when the then governor of Paraíba, Cassio Cunha Lima, transformed the ICMS tax relief program into a law. This led to the concentration of sandal production in the state, bringing enormous productivity gains and reduced the amount of tax paid by the company. The second period was between 2006 and 2010, when the company implemented a successful process of increasing the overall added value of its product mix.

2010 was a spectacular year for Alpargatas, as well as for a number of other Brazilian companies. There was considerable economic growth driven by the increase in consumption, which led to rising revenues and greatly improved margins. But a series of serious setbacks began to occur in 2011. In 2008 the company had decided to delay the construction of its new plant due to the international financial crisis. However, as the crisis didn't affect Brazil intensely, by 2010 the company had already reached its maximum capacity for sandal production. Also, between 2010 and the end of 2013, the price of rubber, the company's main production cost, rose considerably; at the same time, the raw material cost of the company's main rival increased less, making it difficult to incorporate its higher costs into the retail price for Havaianas. Furthermore, wages, the company's second largest expense, were significantly affected by the considerable increase in real terms, as was also the case with companies all over the country. Within this context it became much harder to increase revenues, market share declined and the EBITDA margin was reduced from 17% in 2010 to 12% in 2013.

We believed that the beginning of production at the new plant and the greater cost stability would result in a return to profitability for the company after 2014; in our opinion there was a repressed demand for *Havaianas* as a result of the lack of production capacity in 2010. Not only was the cost per sandal produced at the new plant between 10% and 20% lower than at the old one in Paraíba, but the new plant also freed up the old one to concentrate on the production of simpler products, overstretching its capacity less. This should have led to improved productivity. However, this was not what happened in 2014. One of the risks that we had foreseen actually occurred. The delay in the ramp-up of production was longer than expected and there were a series of other problems, including high staff turnover and technological problems with the new machinery exclusively developed for Alpargatas for rubber injection. Thus the new operation ended up reducing total profitability, with the EBITDA margin falling from 12% in 2013 to 10.6% in 2014. Furthermore, the slowing down of economic activity which badly affected the sports footwear business in 2014 continued to negatively impact the company's results for the subsequent years.

Despite the disappointment of the first year we decided to maintain the investment. In our view our original thesis still made sense, and at the same time we noted a change in the company's speech.

In the past the strategic narrative had been more directed at growth and the acquisition of companies and brands. But at the beginning of 2015, after the appointment of a new CFO, the company's narrative changed to one more directed at the recovery of profitability, generation of cash flow and the improvement of internal procedures and controls. They began to propose disinvestment in deficit-producing activities, with a greater focus on their core business. This was just what we had hoped to hear from them. From the middle of 2015 our investment strategy appeared to begin to work. Havaianas started to gain market share and solutions for the problems of the new plant were underway, aiding the beginning of the recovery of the profitability of the sandal business. In 2015, the Topper, Rainha and Tavex operations were sold off – this last a worldwide denim manufacturer – and the license to operate Timberland in Brazil was discontinued. All of these operations, in addition to negative EBITDA, occupied a disproportionate amount of management time. In addition, the company began the disinvestment of its Argentinian operation.

In 2016 we saw a continuation of the process described above, with a new variable. At the end of 2015, Camargo Corrêa, the previous controller, sold the company to the J&F group. The process was fast and we believe that J&F took almost the whole of 2016 to get to know the company better. Camargo, as a controller, had always kept its distance from business, delegating a great deal of power to management for the definition of strategy. In addition, the board, made up of representatives from Camargo, used to make few demands for results.

From the outset our assessment of the change in controller was a positive one. The knowledge we had acquired on the way J&F operated in other companies left us optimistic – a company with an owner, with a meritocratic culture, dynamic, and which surrounds itself with competent executives. We believed this kind of competence should clear the way for the creation of value that we always believed the Havaianas business have.

A good example of this was provided during the APIMEC (Investment Professionals' Association) meeting last December. After several years without publishing its long-term guidance, and failing to meet the goals of those published in previous years, the company committed itself to an EBITDA margin between 19% and 21%, with the volume of sandals increasing to over 320 million pairs in 2020. To put this in perspective, in 2016 we estimate that the EBITDA margin will be 13.8%, with sales of 240 million pairs. However, we now believe that the demands and the incentives for meeting its targets will be greater and that, due to the size of the challenge, management is likely to continue focused on core business (mostly sandals), distancing itself from its acquisition strategy, which in the past has left the market uneasy and been widely criticized.

The last point worth noting is the company's share structure. At the moment the company has preferred shares (with no voting rights or tag along) and common shares. Camargo had been planning to sell the control of the company for several years and thus resisted unifying the two classes of shares. We believe that J&F is a long-term investor, which is an incentive for unification. In addition, after the public share offering of the common shares, J&F owns 54% of Alpargatas, more than the 44% previously owned by Camargo, which allows it to maintain the majority of shares in the event of unification of share classes.

For the reasons given above we expect to see a process of considerable growth over the next few years, driven by sandal exports and, above all, the increased profitability resulting from the operation of the new plant at full capacity and the full commitment of the management on meeting the targets for 2020. In addition, we believe it is probable that all the shares will be converted into preferred shares, which should improve visibility, liquidity and growth in the share price.

The company is only at the start of the process described in the paragraph above, and, if it's successful in its strategy, we will see a considerable increase in the share value, which will not only reflect higher profits (the target for 2020 is for a net profit CAGR of over 20%) but also trade at higher multiples. Currently the share is trading at 13x earnings for 2016.

Suzano

During the year, the exchange rate behaved very differently from what we and other market agents had expected. This was due to the abrupt change in the political situation from March onwards, which culminated in the impeachment of Dilma Rousseff.

At the beginning of 2016 the exchange rate was 3.98 R$/US$, with the expectation of further devaluation; but by the end of the year the dollar had fallen 18.3% against the real. As 100% of Suzano's revenues are in dollars, or indexed in the mid-term to the currency, but only 20% of its costs are in dollars, the exchange rate has an enormous effect on its operational leverage. If the price of the real were to increase by around 23% as it did in real terms, the company's operational result would shrink by around 35%, presuming all other assumptions continued unaltered.

Nevertheless, it's worth noting that the price of hardwood pulp also decreased more sharply than we had expected. We had already foreseen a price decrease for the commodity in 2016, as it ended 2015 virtually unchanged, with the price in dollars stable despite the considerable increase in the strength of the currency during the year. Strong demand from China helped to explain pulp price stability during 2015. However, in the following year, with the start-up of the Klabin's Puma Mill in March, and with the imminent start-up of the APP OKI Mill in Indonesia, the Chinese took advantage of the prospect of increased supply to reduce its inventories to minimum levels. As a result, the price of pulp fell 24%[1] between October 2015 and March 2016. It was only at the end of the year that the delay in the beginning of production at the APP Mill forced the Chinese to revise their pulp inventory to more normalized levels and prices rose by 10% compared to their lowest value in October.

We disinvested in Suzano shares in July, re-evaluating the investment within the context of the exchange-rate scenario and adopting somewhat more conservative assumptions for pulp prices, even though we had already projected significantly lower prices than those at the end of 2015.

Despite the recent pulp price recovery, we still believe in a challenging scenario for the next two years. We foresee an imbalance between supply and demand with the start-up of new pulp mills whose joint production capacity amounts to almost 10% of global supply in a period of less than 12 months. Therefore, we believe that prices will decrease significantly, forcing out the less competitive players.

The pulp and paper sector is one where Brazil has natural competitive advantages and one where there is increasing global demand. However, industry players still lack supply discipline. Over the last few years we have noted that in all the periods of price-recovery, players promptly approved expansion projects. We expect that further mergers and acquisitions in the sector will help to moderate the additional supply coming into this market and leverage the profitability of the industry, opening the way for the more competitive players to achieve higher returns on invested capital.

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[1] Price of bleached hardwood kraft pulp delivered in China.

Tupy

Like Suzano, Tupy's operational leverage is greatly affected by the exchange-rate. As a little over 40% of the company's revenues come from its Brazilian exports, even though contractual clauses allow for a part of the exchange-rate costs to be passed on to the end-price, the company nevertheless has to absorb a significant share of the exchange rate variation. Added to this, all the company's Brazilian operational costs and expenses are in Reais and its operational margin is low (EBITDA margin in 2015 was 17.4%), making it extremely vulnerable to a potentially weaker dollar. Even after the contractual clauses mentioned had been triggered, allowing for the partial transfer of losses from higher exchange rates to the end-price, we still calculated that the company's EBITDA would shrink by 25% in a recurring mode after the almost 20% appreciation in the exchange rate last year.

Furthermore, during periods when the Real appreciates against the dollar, the impact tends to be greater, as there is a gap of around three months before the trigger clause is activated.

Even with these considerations, the results reported by the company last year were still disappointing, as the real exchange rate level was not very different from that of the first semester of 2015.

It should be noted that in November, with the surprise election of Donald Trump in the United States and his protectionist speech, which even includes the possibility of renegotiating NAFTA, a further variable of uncertainty was added in the case of this investment. As nearly 40% of Tupy's production is in Mexico, the final destination of which is almost entirely the United States, there is now the question of how a possible renegotiation of NAFTA would directly affect Tupy's Mexican operations.

There are, however, attenuating factors. Firstly, it should be noted that there is no longer any large-scale iron foundry in the United States to meet American demand for blocks and motor heads. The supply comes entirely from Mexico, Brazil and Europe. Therefore, a tax rate that is high enough to incentivize greenfield investment in iron casting, which has experienced a process of declining capacity around the world over the last few years, appears unlikely to us. Recently there has been talk about the possibility of the Trump government introducing a system of border adjustments, which would allow for the deduction of the cost of raw materials produced in the US from US income tax, but not the cost of imported ones. This would probably burden the productive chain of the American assembly plants which import raw materials from various parts of the world. We consider it unlikely that there will be investments in the construction of iron foundries in the USA due to these new tax regimes. As to the renegotiation of NAFTA, we believe that this is likely to affect products for which the member countries of the block receive special trading conditions, which does not appear to be the case of iron foundries. For example, the United States levies no import tax on the raw cast-iron products which Tupy exports from Brazil (80% of its production) and an import tax of just 3% on machined products (20% of production). Thus we do not believe that Mexico have the advantage of more favorable trading conditions than those of other trading partners in the sector. All things considered, we think it is more likely that Tupy's Mexican operations will not be directly affected by possible protectionist measures currently being considered. Nevertheless, Tupy's clients may have to, at least partially, revert the migration process of the production of automobiles and auto-parts from the USA to Mexico. In this scenario, Tupy would stop sending the products it manufactures to major assembly plants in Mexico, sending them instead to plants in the United States.

Despite its weak operational performance in 2016, we have maintained our investment in the company. We believe that the volume increase due to additional new contracts, added to the improvement in the company's costs with the operational optimization plans for its plants, will be important factors in the recovery of the company's margins during 2017.

Conclusion

2016 was certainly a turbulent year which saw major transformations. So much occurred in such a short time that it seemed as if we were living through several years in one. The near future continues to be full of uncertainties. Notwithstanding, we would like to emphasize that we continue with renewed motivation in the construction of a balanced portfolio, adapting to the opportunities of the current scenario, but without being exposed to excessive risks.

Despite the painful process that the Brazilian economy went through over the past two years, this new government appears to be more aware and better prepared to face the country's real problems. We also see a more mature society to discuss the reforms that can no longer be delayed. It's important to note that this reforms always involve a hard debate as they are seen as affecting people's 'rights', conceded by an overgenerous Constitution. This is a moment of great importance for the economy, offering a historic opportunity to eliminate the enormous distortions created by recent governments and to implement urgently needed reforms,such as the social security reform. It presents us with a unique opportunity for a large and sustainable reduction in interest rates, rapidly bringing them into line with international levels.

Brazil is better prepared for the obstacles which the coming years will present. We have leaders of unquestionable quality directing the process. Along the way we will have to cross a few rickety bridges and be careful not to fall into any traps, but the journey will help us to mature and to prepare Brazilian society for the new challenges of the modern world.