BOGARI
capital

BOGARI VALUE

Investor Letter 26, Quarter 2 2013 – Contingencies

Bogari Value FIC FIA is an investment vehicle focused on equity investments in Brazilian public companies. The fund's objective is to provide its clients with long-term capital appreciation by investing in companies whose stocks are trading at a substantial discount to intrinsic value.

Portfolio Performance

Up to Q2 2013, Bogari Value's performance was up **+0,3%**, versus Ibovespa negative return of **-22.1%**.

Since inception,[1] our total return was 1,183%, compared to 19% from Ibovespa. During this period, our NAV per share appreciated to BRL 1,283 from BRL 100.

Below is our performance through December 31st and for the year to date 2013:

	Annual Performance		
Year	**Bogari**	**Ibov**	**Outperformance(%)**
2013	**-0.3%**	-22.1%	+21.9
2012	**25.1%**	7.4%	+17.7
2011	**-0.5%**	-18.1%	+17.6
2010	**29.5%**	1.0%	+28.5
2009	**122.0%**	82.7%	+39.3
2008(1)	**-20.1%**	-41.2%	+21.1
2007(1)	**278.8%**	43.7%	+235.2
2006(1)	**18.7%**	11.4%	+7.3

	Accumulated Since Inception		
Year	**Bogari**	**Ibov**	**Outperformance(%)**
2013	**1,182.8%**	18.9%	+1,164.0
2012	**1,186.5%**	52.6%	+1,133.9
2011	**928.4%**	42.1%	+886.3
2010	**933.3%**	73.6%	+859.7
2009	**697.8%**	71.8%	+626.0
2008(1)	**259.3%**	-6.0%	+265.3
2007(1)	**349.6%**	60.0%	+289.6
2006(1)	**18.7%**	11.4%	+7.3

The Brazilian Equity Markets remain extremely challenging. The Ibovespa slumped in H1 2013, strongly influenced by the collapse of Eike Batista's "X Group" of companies.

So far, we have been able to achieve our goal of holding up during heavily bearish markets, having managed to stay flat during the period. We were preparing for a significant correction early this year, as noted in our previous letter.

We expect for the near future more volatility once (1) Federal Government is not being successful in stimulating the economy and (2) China is starting to decelerate, which will likely impact commodity prices and exchange rates.

In general, our investor letters are organized by sections, the first section being dedicated to update our performance, followed by a brief update on the portfolio, and lastly a section dedicated to general topics, related to companies or the general economy, which we believe to be worth sharing with our investors.

On the following pages, we will discuss contingencies and their impact in our investment analysis.

Portfolio Commentary

During this semester, we took advantage of market dislocations to start new positions that we had been studying and increasing holdings in others that we have been carrying for quite some time in our portfolio.

We are particularly excited with some of those new purchases because some of those companies had been ignored by the markets, but we believe they are near an inflection point and will soon start to present better operational results.

We know markets are very dynamic and we acknowledge that the companies' past success is not a guarantee of future performance but we believe most of the companies in our portfolio present strong competitive advantages to keep growing and creating value to its shareholders.

Our largest holdings however, have remained unchanged over the past few months. Itausa remains our largest position. The bank is still on course to reduce the risk of its credit loan portfolio avoiding competition with state owned banks, and we should see this strategy move more clearly reflected in the operational figures throughout the year. One point to watch is the growth of their loan book, which becomes more challenging as the economy falters.

Cemig, another large position in our portfolio, has completed the review of its distribution concession. The outcome was a somewhat below market expectations, due to a lower regulatory net asset base recognition.

[1] The vehicle was founded in 1 Nov 2006 as an investment club. On July 8, 2008 it was transformed into Bogari Value FIA and in 26 Oct 2012 in Bogari Value FIC FIA.

For us it was not a surprise, and indeed it was quite expected to happen as companies overstate their investments' capitalization in order to increase the odds of having the highest possible net regulatory asset base recognized (similar to a private negotiation). Despite this disappointment, cost reduction programs are on track and we should see better results in the coming quarters.

However, the most important value driver in the investment case nowadays is the litigation regarding the three hydro power plants whose contracts expire in 2-3 years as the Federal Government does not recognize that Cemig has the right to renew the contracts under the current economic conditions.

Cemig decided to challenge the Federal Government in the Courts as it understands its contracts are completely different from all others.

Cemig obtained an injunction allowing it to operate the Jaguara hydro power plant until the ruling. In our view, the case is interesting precisely because we are not paying for this plant. If the outcome is positive, the impact in value will be relevant. The asymmetry seems very interesting since we are paying a fair price and getting a free option.

Cielo, another relevant position in our portfolio, keeps taking advantage of industry's secular growth prospects, experiencing double-digit growth, both in credit and debit card transaction volumes. In addition to that, Cielo is very well positioned to navigate the current inflationary pressure enviroment, as a big portion of its revenues is inflation protected.

Regarding competition, we do not foresee any irrationality, be it from incumbents or from newcomers that are indeed, growing at a much slower pace than planned.

On the regulatory front, the Central Bank is now the new regulator of the industry and we do not expect any material changes. In fact, we do believe the relationship tends to be fair and predictable, as CB is recognized for its very technical and balanced decisions.

Lastly, Kroton is a relevant position that we now hold in our portfolio for the second time.

We have been experiencing a strong demand for undergraduate courses boosted in recent years, by FIES, a student loan program remodeled by the Federal Government in 2010 (much lower interest rates and a much larger grace and amortization period). And Kroton has been very successful in taking advantage of this tailwind, giving them even more scale, helping management to speed up their financials goals.

In addition to industry's favorable scenario, Kroton has announced last April a merger with Anhanguera, becoming the largest educational group in Brazil and one of the largest in the world by numbers of students.

The deal makes a lot of sense in terms of footprint (Anhanguera has a stronger presence in São Paulo state and Kroton in Central and Southern Regions) and expertise (Kroton has accelerated Distance Learning while Anhaguera has focused its attention on the traditional model)

As we like to reinforce in our letters, we keep diversifying our holdings (our largest position is currently 7% of AUM and top 5 combined are less than 30% of AUM) and maintaining high liquidity, holding a 30% cash-position and being able to sell 90%+ of our holdings in 5 days.

We continue to hold good assets in our portfolio, at compelling valuations and interesting perspectives for the next few years. In case of a stronger market correction, we are prepared to take advantage of that event.

About Contingencies

Contingencies are duties/liabilities or rights/assets originating from past actions whose side effects can materialize in the future, usually materially affecting a company's financial situation.

Contingencies are outside a company's control but affect equity value once a provision is recognized against book value. As most contingencies are liabilities and as its impact is negative for equity value, we will focus our discussion on the liability side.

Contingencies vary a lot in size and nature, the most common ones being related to (1) labor and social security matters, (2) tax matters, (3) civil matters or (4) environmental matters.

Labor contingencies are related to former employees and contract labor claims. **Social Security** contingencies arise both from intentionally lower collection of payroll taxes and/or pension fund deficits.

Tax contingencies usually relate to different interpretations regarding the origin and methodology of a tax liability.

Civil contingencies relate to all kind of litigations against the enterprise claiming moral and/or material hazard.

Lastly, **Environmental** contingencies arise when the company's activities cause material damages to the environment.

How Contingencies Arise

Before going further on this topic, we would like to take a step back and discuss how contingencies arise within a corporation. Contingencies depend on three factors: (1) business complexity (regulated services are more sensitive due to quality compliance requirements), (2) corporate culture (risk averse investor or risk taker) and (3) companies' size (naturally the bigger the companies and their client bases, the more exposed they are to contingency risk.

It is worth noting that Brazil is a challenging country to do business in. Our legal system is complex, bureaucratic and too often extremely biased towards the consumer.

For different companies, contingencies' nature may vary, depending on its business environment. For instance:

- Big Retailers and Banks dealing directly with millions of individuals, are more exposed to civil claims and collective litigation.
- Service providers such as telecom and tour operators who deliver a product whose outcome is more abstract than a physical product. Additionally the consumption of said service may be continuous, resulting in a longer relationship with clients thus more exposed to frustration and litigation risks.
- Labor intensive companies are exposed to labor litigations, due to complex and onerous labor laws in Brazil.
- Regulated companies, such as telecom and electricity distribution must comply with regulations and in case of failure, penalties will be issued.

Nevertheless, all companies regardless of their industry, have a challenge to be up to date with changes in social security and tax acts and their frequent amendments. According to a Doing Business survey, Brazil is the last country on the list for ease of filing corporate tax returns[2].

Besides business complexity, contingencies are directly related to the corporate culture and how risk averse management may be. Risk averse companies tend to be orthodox in the way they interpret and comply with the laws. Therefore, we should expect to see fewer contingencies on their books.

On the other hand, a risk-taking corporate culture will most likely ignore a legal obligation if there are worthy economic gains. Such culture may lead to very negative effects. Leadership behavior ends up being a proxy for corporate culture, and bad examples have effects which trickle down the company's hierarchy.

Equity value destruction might be multiplied when management team's incentives are short-term oriented. In such case, the benefits of flaunting a rule or regulation are usually immediate, whereas their economic consequences will only arise in the future, since fines and legal costs may take years before hitting the balance sheets. In this scenario, management will focus on immediate gains, and not long-term value creation. In a publicly-traded companies, management and current shareholders are benefitted at the expense of future shareholders, since the shareholder base will naturally see some turnover. This is a case of agency cost with a temporal bias, where a future shareholder will suffer the consequences of past management and shareholders.

However, even in the absence of an aggressive short term oriented remuneration package culture, the lack of accountability, affecting especially state owned companies in Brazil, can be just as detrimental, once decision makers will never be financially responsible for bad decisions causing millions, and sometimes billions in losses.

In a nutshell, the bigger and the more complex a company is and the worst its corporate culture, the higher the risk the company will lose money in the future with contingencies.

How companies are impacted

Contingencies are recognized on the balance sheet if: (1) there are unpaid obligations related to past events, (2) the likelihood of disbursement is real and (3) the amount due can be properly estimated. The timescale may encompass months or years.

Assessing the likelihood of a disbursement is not an easy, or an objective exercise. It will always depend on management's prior experiences and the accurate and fair opinon of specialists.

Technically speaking, accounting norms suggest three categories for contingencies:

1. Likely: When there is a high chance of disbursement,
2. Possible: When there is a chance of disbursement but not very likely, and
3. Remote: When the probability of any kind of disbursement is very low.

According to accounting standards (CPC 25) provisions must be constituted only when a disbursement is likely, in other words, being recognized as a loss in the income statement and a liability in the balance sheet.

If contingencies are classified as possible, there is no need to immediately recognize it in the balance sheet but it must be presented in an explanatory note. In the case of a remote possibility, neither a provision, nor its disclose is necessary.

Every single contingency must be reassessed quarterly in order to reflect the best estimate up-to date. In case a contingence is not so likely anymore, provisions may be reversed.

In our view, what really matters is the economic impact of a contingency and how it can materially impact equity value.

Every day, companies are dealing with clients, suppliers, government authorities, employees and other stakeholders. Decisions are being made every minute and occasionally, negative consequences may arise. When both parties are private, problems tend to be negotiated, so companies do not need to recognize contingencies on their balance sheets. However, when the counterpart is a public body there is no flexibility, since lack of compliance automatically causes a consequence. Therefore every legal challenge escalates into

[2] DOING BUSINESS, Paying Taxes. www.doingbusiness.org

a contingency, even though there might not be an immediate impact on the balance sheet or cash flow

Contingencies affect companies in three dimensions: (1) in terms of cash management, (2) in terms of credit restrictions and (3) in terms of human resources management

Financially speaking, the cash effects vary for each legal dispute. Some require collateral (cash, insurance policies or letter of guarantee), others do not. To underwrite an insurance policy and/or letter of guarantee it will usually cost the company between 0.5-3.0% of the total amount at stake in the litigation. Alternatively, companies can put real estate as collateral..

In terms of credit restrictions, the more collateral is tied in legal disputes, the less will be available to offer for banks and consequently, credit will be more scarce and costly.

And in terms of human resources management, the more legal disputes the company is involved in, the bigger the legal department expense will be. On the other hand, if the company underestimates the size and quality of the legal department, its savings may be negated.

Finally, if the ruling is unfavorable, the company must finally disburse the amount of cash due and write the provision off. It is worth noting that net income will not be affected, as provisions were recognized previously. What we notice is the market very often does not pay attention to these expenses, as we will see in the following sections.

How the stock market value contingencies

Equity analysts quite often do not put so much effort in understand the nature of contingencies as they do when understanding revenues breakdown, margins, cash flow, market growth and competition. And the reasons are:

First, it is not easy to assess the negative impact of a contingency because it always depends on both the likelihood of the event to happen and the size of the liability it generates. As we see it, probability is something subjective, evaluated case by case, so we must trust insiders' judgement, and the size of liabilities are not always an exact number once each judge can define different penalties for different claims.

Second, the number of claims and contingencies a certain company will face can vary annually. Except for large legal cases - as the one Vale is facing right now regarding foreign profits and tax evasion, estimated at up to BRL 30bn - contingencies are part of ongoing business, happening on a regular basis (mainly labor and consumer related ones), allowing analysts to roughly estimate their amounts.

Despite often being volatile and hard to estimate, contingency costs are recurrent and should be considered in a rigorous assessment of a company's values. However, in reality, due to the difficulties mentioned here, the markets tend to overlook at least part of their impact.

For us, the flaw lies on the assumption that contingencies are non-cash and non-recurring expenses. For us, this is a conceptual error, causing an overestimation of target prices.

In practice, what we observe from sell-side analysts is that they usually consider contingencies as a one-off event, ignoring the fact that new contingencies will arise in the future. Their models therefore deviate from reality since companies may not always be able to translate profits into free cash flow, because of contingencies payment.

The above happens because the payment of contingencies affects the variation of the business' real working capital, and therefore shows up on the cash flow demonstrations. This variation, when plugged into the models of sell-side analysts, does not consider the cash effect of contingencies because, usually only a few variables such as stocks, receivables, and suppliers come into account in the calculation of working capital. The projections end up therefore not showing on the income statement, either as an ordinary expense, or as working capital, where its cash effect appears in the accounts.

If we take a closer look at private transactions, buyers carry out a diligence processes in order to understand both the size and likelihood of current contingencies to materialize and the risk of contingencies arising in the future. Even after the due diligence process, it is common to define in a contract that all claims related to previous management will be due to the former owners.

We find it very peculiar that the process to assess equity value in the public markets should be different from the one used in the private markets. In some cases we could observe what we call a valuation paradox. Ignoring the existence of contingencies (current and future ones), some assets are very cheap, but when considering all contingencies they become expensive.

We dare to go further and state that some companies in our equity market would be worth zero in a private transaction, because the volume of contingencies is so large that no cash flow would be left for the shareholders. Yet, as if by magic, some of these companies are worth many millions, and sometimes, even billions of BRL.

Practical consequences for our investment process

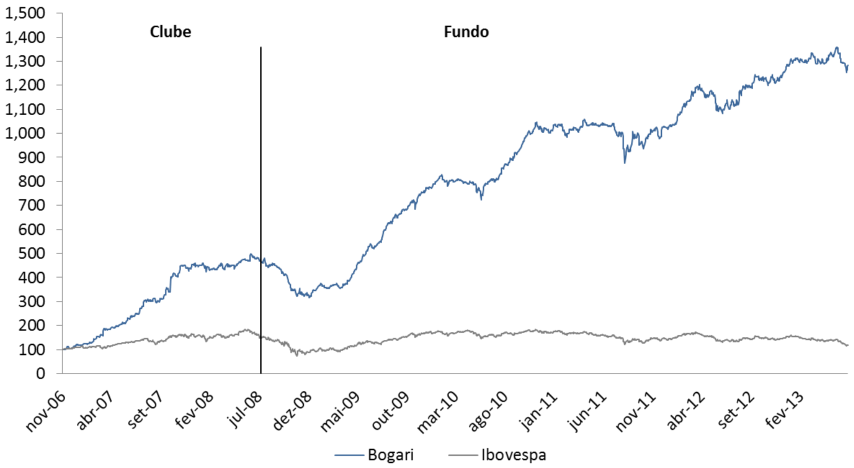
As we are more conservative by nature, most of those assets end up being, in our point of view, more expensive for us than for the markets, once they are improperly valued due to an improper assessment of of contingencies impact equity values.

If the market did not ignored those cash burns and priced assets properly, they would be more reasonably priced, eliminating the paradox of contingency.

Thank you for your trust and support.

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2013	Bogari	1.2%	0.9%	-0.4%	1.2%	0.4%	-3.6%							-0.3%
	Ibov	-2.0%	-3.9%	-1.9%	-0.8%	-4.3%	-11.3%							-22.1%
2012	Bogari	5.9%	5.9%	2.2%	0.0%	-6.0%	1.1%	4.3%	2.0%	2.6%	-0.4%	1.7%	4.1%	25.1%
	Ibov	11.1%	4.3%	-2.0%	-4.2%	-11.9%	-0.2%	3.2%	1.7%	3.7%	-3.6%	0.7%	6.1%	7.4%
2011	Bogari	-2.0%	0.7%	2.1%	0.3%	0.0%	-0.9%	-2.9%	-2.1%	-1.9%	4.2%	0.8%	1.5%	-0.5%
	Ibov	-3.9%	1.2%	1.8%	-3.6%	-2.3%	-3.4%	-5.7%	-4.0%	-7.4%	11.5%	-2.5%	-0.2%	-18.1%
2010	Bogari	0.0%	0.0%	-0.4%	-0.7%	-0.1%	1.2%	8.7%	4.4%	6.7%	4.8%	0.3%	1.7%	29.5%
	Ibov	-4.6%	1.7%	5.8%	-4.0%	-6.6%	-3.3%	10.8%	-3.5%	6.6%	1.8%	-4.2%	2.4%	1.0%
2009	Bogari	-1.2%	5.5%	-0.9%	21.3%	12.3%	5.1%	15.1%	7.3%	4.0%	3.0%	8.7%	4.2%	122.0%
	Ibov	4.7%	-2.8%	7.2%	15.6%	12.5%	-3.3%	6.4%	3.1%	8.9%	0.0%	8.9%	2.3%	82.7%
2008(1)	Bogari	-3.6%	3.9%	-1.2%	3.1%	2.5%	2.2%	-7.3%	-0.8%	-12.9%	-13.0%	-0.6%	7.8%	-20.1%
	Ibov	-6.9%	6.7%	-4.0%	11.3%	7.0%	-10.4%	-8.5%	-6.4%	-11.0%	-24.8%	-1.8%	2.6%	-41.2%
2007(1)	Bogari	9.4%	25.7%	14.4%	9.7%	16.3%	13.9%	11.3%	3.3%	8.8%	28.6%	0.6%	2.4%	278.8%
	Ibov	0.4%	-1.7%	4.4%	6.9%	6.8%	4.1%	-0.4%	0.8%	10.7%	8.0%	-3.5%	1.4%	43.7%
2006(1)	Bogari											5.1%	12.9%	18.7%
	Ibov											5.0%	6.1%	11.4%

Valor da Cota Bogari(1) x Ibovespa
(Nov/2006 - Jun/2013)



(1) O veículo foi fundado em 1/11/2006 como um clube de investimento. Em 8/7/2008, foi transformado no Bogari Value FIA e em 26/10/2012 no Bogari Value FIC FIA. O Patrimônio Líquido médio do fundo nos últimos 12 meses foi de R$ 214 milhões e o atual é de R$ 306 milhões. A rentabilidade nos últimos 12 meses foi de +16,7%.

Fund Information

Administration	BNY Mellon Serviços Financeiros DTVM S/A	**Investment NAV**	T+1 (business days)
Investment Management	Bogari Gestão de Investimentos Ltda.	**Redemption NAV**	T+30 (calendar days)
Distribution	BNY Mellon Serviços Financeiros DTVM S/A	**Settlement**	T+33 (30 calendar days + 3 BDs)
Custody	Banco Bradesco S.A.	**Management Fee**	2.175% (Max.: 2.5%)
Auditor	KPMG Auditores Independentes	**Performance Fee**	20% of return exceeding the benchmark – Ibovespa (with high watermark)
Minimum investment	R$ 30,000.00	**Anbima Code**	212962
Minimum balance	R$ 30,000.00	**Anbima Classification**	Ações Ibovespa Ativo
Minimum transaction	R$ 10,000.00	**Pricing**	Closing
Maximum initial invesment	R$ 20 million	**Notice**	9hs to 14hs
Target Audience	General Investors		

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