

**BOGARI VALUE**

Investor Letter 27, Quarter 4 2013 – Image

Bogari Value 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 is trading at a substantial discount to intrinsic value.

**Portfolio Performance**

By year-end 2013, Bogari Value FIC FIA return was **+4.5%**, versus Ibovespa negative return of **-15.5%**.

Since inception<sup>1</sup>, our absolute return was 1,244%, compared to 29% from Ibovespa. During this period, our quota (NAV/quota) appreciated to R\$1,344 from R\$100.

Set forth below are our results through December 31<sup>st</sup> and for the year 2013:

Ano	Annual Returns		Outperformance (%)
	Bogari	Ibov	
2013	4.5%	-15.5%	+20.0
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 <sup>(1)</sup>	-20.1%	-41.2%	+21.1
2007 <sup>(1)</sup>	278.8%	43.7%	+235.2
2006 <sup>(1)</sup>	18.7%	11.4%	+7.3

Ano	Accumulated since Inception		Outperformance (%)
	Bogari	Ibov	
2013	1,244.0%	29.0%	+1,215.0
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 <sup>(1)</sup>	259.3%	-6.0%	+265.3
2007 <sup>(1)</sup>	349.6%	60.0%	+289.6
2006 <sup>(1)</sup>	18.7%	11.4%	+7.3

The Brazilian Equity Market ended up being much more challenging than expected in 2013. The Bovespa lost 15.5%. On the one hand, we were satisfied with our positive performance of 4.5%, outperforming Ibovespa Index by 2000 bps. On the other hand, we recognize that part of that outperformance is due to Bovespa's poor methodology, helped by the collapse of "Group X" stock prices. In our Q2

2013 letter (# 26), we drew up some comments about the macroeconomic scenarios and the likelihood of going through some challenging times. We were slightly wrong. The world seems to be recovering from 2008 and Brazil is getting worse. Fortunately, we repositioned ourselves in order to anticipate the economic downturn. For this year, we do not expect anything different. We do foresee a volatile period ahead, as we will have elections that can bring tail risks depending on which candidate is the winner.

In case of reelection, we would be more skeptical at first and would rather wait and see how the current Government will reorganize our finances to put the economy back on track.

On the other hand, if the opposition party wins, public equity markets in Brazil would likely soar, as investors would pay in advance believing better economic policies would be adopted.

In our overall point of view, assets are fairly priced. However, as we consider that business in general might embed a higher risk now than in the past, we tend to think assets prices could go down a little more in order to adjust for a new risk-reward reality.

Nonetheless, despite our natural skepticism we are getting more optimistic in the beginning of the year.

In general, our letters are organized in sections, the first one being dedicated to a performance update, the following one to comments on relevant positions and key findings and, the last section, is normally reserved for general topics, related to companies and markets which we believe might be worth sharing with investors.

On the following section, we will discuss our investment case of BB Seguridade and our thoughts on the worsening of Brazil's image in the world and its consequences for our economy.

**Comments on our Portfolio**

During 2013 we did not undertake any major changes in our portfolio. Core positions have remained the same: Itaúsa, Cosan, Cemig, Equatorial, Cielo and Qualicorp. The novelty was BB Seguridade, which we will talk more about shortly.

<sup>1</sup> The vehicle was founded in 1 Nov 2006 as an investment club. In 8 July 2008 it was transformed into Bogari Value FIA and in 26 Oct 2012 in Bogari Value FIC FIA.

Once again, we were able to prevent permanent losses this year. The few negative contributions we had to our performance were concentrated in small-sized positions, some of them we are still learning more about. On the flipside, we were successful once again in choosing our core positions, contributing positively to our performance, bearing low risk of permanent loss.

Our cash position was very important in a year that most of the assets' return underperformed the fixed income benchmark (CDI). We were very diligent in our few purchases this year, waiting for some stress period in order to buy good assets at attractive prices.

In the last few weeks, we have seen a market correction and we might increase our exposure to equities very gradually in order to enjoy this buying opportunity.

As we like to emphasize in all investor letters, our portfolio continues to be well diversified. The top position is just 8% of AUM and the top five represent less than 32% of AUM. In terms of liquidity, we are still holding a lot of cash and cash equivalents (31% of AUM) and are able to liquidate 90% of our AUM in 6 days.

We believe we still hold a well-balanced portfolio, with good assets, at good prices and good future prospects in order to keep increasing shareholder value for the following years. Moreover, the high cash position we hold will allow us to enjoy better entry points in the near future, as soon as the market goes dips.

## BB Seguridade

BB Seguridade was formed after the spin-off of the insurance and pension fund assets from Banco do Brasil (BB). Its major competitive advantage is directly related to the distribution channel's exclusivity.

The reason why Banco do Brasil has decided to spin off those assets was the necessity to capitalize the bank, allowing BB to keep the same strong growing pace presented in the past few years. The way chosen to cope with this objective was spinning off the company and making its **IPO** in April 2013.

For the controlling shareholder (the Federal Government) the IPO was a good deal in the short term due to high capital gain taxes collected from BB and the avoidance of raising new **capital**. For BB, we consider there is no strategic reason to justify this move.

BB Seguridade is a holding company investing in the following operational companies:

- BB Mapfre SH1 (75%): Individual, Farmer and Credit Life ("Prestamista") insurance  
**(ROAE 9M13: 25%)**

- Mapfre BB SH2 (50%): Property and Casualty insurance (mainly vehicles and general liability)  
**(ROAE 9M13: 8%)**

- Brasilprev (75%): Pension Fund  
**(ROAE 9M13: 47%)**

- Brasilcap (67%): Premium Bond  
**(ROAE 9M13: 48%)**

- IRB – Brasil RE (20%): Reinsurance

- BB Corretora (100%): The exclusive broker allowed to sell all insurance products at BB branches.

It is interesting to note that although BB Seguridade holds a high economic interest in each insurance company it does not have a controlling stake in any of them. The reason being, to avoid the restrictions all state-owned companies are subjected to by law.

All segments are very profitable but SH2, where BB holds the lowest economic interest among all businesses.

The Brazilian insurance industry presents a secular growth prospect driven by low penetration and still young population (very low % of GDP), mainly in the individual and pension fund segments.

Some insurance segments are growing even faster due to strong micro trends, as the Credit Life segment helped by real estate credit growth as well as premium bonds which have been growing quite well in the last few years.

In addition to all the sector's tailwinds, BB Seguridade has a lot of room to grow on its own since BB's client base is underpenetrated when compared to its private peers. Another point in favor of BB Seguridade's case is BB's intention to accelerate service fees growth and insurance is definitely a good product to reach this goal.

Although the insurance companies are profitable, on average, the most valuable asset, that makes BB Seguridade investment case unique, is BB Brokerage. All insurance policies taken by BB clients must be sold exclusively by BB Brokerage. For each BRL100 earned in commission fees, BB Brokerage pays BRL 15 to BB, making BRL 85 in gross profit.

As BB Seguridade's cost structure is very lean, Ebitda margins are very healthy, helped a lot by BB Brokerage. Currently, BB Seguridade ROAE 9M13 is 34%, but when we exclude BB Brokerage, ROAE 9M13 goes down to just 14%.

We like BB Seguridade's business model: asset light, high return on invested capital, and growth, allowing the company to distribute almost all profits as dividends and keep growing.

However, we do recognize that the related party contract is the main risk for the case (risk of permanent loss). One single change in the terms of the contract could increase COGS materially and consequently negatively affect operational margins forever and generate a lower future return on equity.

The 20 year contract between the related parties guarantee to BB Seguridade the exclusivity of the distribution channel and defines the parameters that determine the remuneration due to BB. Nonetheless, it does not establish any clause and penalty for early termination.

In order to reduce the inherent conflict of interest, BB Seguridade created a related party committee responsible for approving any changes in this contract, reserving the power of veto for the independent board member. It is a good response to protect minorities' interests although we do not rule out the possibility of any changes in the future.

Roughly, BB's channel remuneration is defined by the contract as a function of:

- (1) Sales Force's time dedication
- (2) IT system required
- (3) Any other indirect cost related to cost sharing

We consider as normal to observe in the long run some pressure in COGS, as we do expect managers' salaries to increase. We also consider as normal some volatility in the results, as occasionally managers could need to dedicate more time and effort to sell BB Seguridade's products and/or use more shared services, increasing indirect costs.

So far, results have fluctuated within a very comfortable range. Revisions in the cost structure agreement are expected to occur over the time. The risk is more on the size of the adjustment that could materially affect long-term profitability.

Defining one general methodology to rule the cost allocation is always complex and subjective. Results could range as wide as one can imagine. Moreover, even with the existence of a related party committee and the right to power of veto, changes are possible and reasonably justified.

However, in the short-term, we truly believe it is in BB's best interest not to change anything in the contract, keeping all the efforts directed towards growing the company and creating even more value to equity shareholders.

BB still holds 66% of equity interest on BB Seguridade and that can be one avenue to strengthen its balance sheet with no requirement for capitalization. To succeed in this strategy of spinning-off other assets (ie: BB Credit/Debit Cards) we restate that governance policy must be strong and protect minorities' interests.

As we mentioned in the beginning of the letter, we will have general elections this year. If the opposition wins, we do not know how the company could be materially affected, as it is normal to expect that BB's board of directors would be reshuffled and perhaps the strategy that has been carried out in the last few years may change. The major risks here would be a lesser focus on insurance sale and the relationship between BB and BB Seguridade Brokerage

We are aware of those risks and we do monitor these relationships as closely as possible but we do consider the expected return on our investment to be adequately adjusted for the risks mentioned earlier.

## Brazil's Image

### Ibovespa

Along 2013, the debate about changing Ibovespa Index methodology was quite intense and at a first glance, results were good.

Unfortunately, it took too long and the change could not prevent Ibovespa Index's strong drop in 2013 helped a lot by OGX and MMX collapse.

Ibovespa Index's methodology must be very strong in terms of academic theory, reliable to investors' eyes and flexible enough to mitigate tail events' impacts.

Ibovespa Index is the major reference to Brazilian Equity Market. More than just a number, it has an institutional role of communicating in an easy and simple way how risky the Equity Market is being perceived by investors (local and foreigners). It influences investor's mood and ultimately is responsible for promoting Brazilian Equity Market growth.

A strong decline as the one we had in 2013 does not help at all to attract new investors to our Equity Market, reduce current capital allocation and make new issuances much more challenging.

In a nutshell, it is extremely important for our Brazilian Equity Market to have a strong and reliable index, helping us to promote adequately to investors the attractiveness of our country. The change took too long to materialize, but it is positive.

### The Federal Government's Role

In the following paragraphs, we will try to expose examples of how Brazil's government makes little effort to keep a good image of the country abroad. This applies both to Getulio Vargas' 1932 provisional government, as well as Dilma Rousseff's 2010 democratically elected government.

This sad inheritance shows its face on the Brazilian Capital Market as the government's inability and unwillingness to manage investors' expectations contributes to increase risk perception and, consequently, the cost of investing in Brazil.

This weakness is amplified when compared to the US Federal Reserve's disciplined and serious conduct in communicating issues which may affect investors' risk perception.

In showing an example from 1932 we illustrate that, unfortunately, strengthening Brazil's institutional reputation was never a priority for our governments, past or present.

## The 1932 Brazilian Olympic Campaign

Lira Neto, author of Getulio Vargas' biography, based on the book "1932: Uma Aventura Olímpica na Terra do Cinema"<sup>2</sup>, briefly described Brazil's participation in Los Angeles' 1932 Olympic Games.

"The economic crisis [Great Depression] made it impossible to undertake significant investments in preparing a delegation. Part of the travel expenses to Los Angeles would be funded by sales of commemorative stamps, and special editions of a daily sports newspaper. The bulk of the costs, however, would be paid with the proceeds of 55,000 bags of coffee from government stockpiles, shipped in the hold of the Itaquicê, the ship taking the delegation to the games. The transaction would be carried by the Olympic delegation itself, during the stops enroute to their destination. A tell-tale sign of the makeshift nature of the enterprise, the ship was denominated a warship, in order to evade international customs restrictions. Two mock-cannons were installed on the deck where the athletes carried out their morning exercises. If the ruse was successful, the Itaquicê would be exempted from heavy tariffs.

Some days later, however, the ship was retained by the Panamanian authorities for suspected smuggling. Following embarrassed wired requests for apologies from the Brazilian government, the trip resumed, but with waning prospects to find buyers for the coffee. With the global crisis, Brazil's main export had lost its appeal. The question was how to pay for the athlete's stay in the Olympic village. Only 67 out of the 82 – those who could pay their own bills, or had at least some chance of winning a medal – were allowed to disembark. The rest sailed onwards to San Francisco, in the hope of finally selling their cargo. It did not work. In the end, the athletes-cum-travelling salesmen returned home with no medals, and piles of coffee in the cargo hold.

## The extension of transmission and generators' concessions

A little over a year ago, the Brazilian government published the now infamous MP579, whose objective was to define the renewal of the concessions of electricity transmission, generation and distribution expiring by 2017. The government's plan was to transfer part of the electricity cost reduction to society, as a result of lowered taxes for the sector, and the end of amortization of plants which had been in operation for many years, and therefore were paid off.

With the benefit of hindsight, we may concur that the process was disastrous, based on good intentions and terrible execution. And perhaps the greatest motivation for reducing the cost of electricity was in fact to force inflation under control.

However, not even this objective was achieved, as with the low level of the water reservoirs at the hydro power plants, it was necessary to dispatch the expensive gas-fueled power

plants to avert the risk of electricity rationing. The cost reduction in energy generated excess demand precisely at the moment when no spare capacity was available. The final result was that electricity bills dropped less than expected, and this year and next we will have to pay the bill for this more expensive power coming on the grid. The poor rain season has been forcing the System National Operator (ONS) to fully dispatch thermal plants, much more expensive, neutralizing price reduction's effect.

Interestingly, like in the case of the 1932 Olympic campaign, we can note the lack of interest by government to create a positive image of Brazil.

During the process of concession renewal, the government proposed moving the renewals forward. The government proposed renewing the concessions for a further 30 years, at a lower rate than previously. The case from the government was that rather than being an imposition, this was a deal offered to the concession holders. A low amount in exchange for the renewal. Not renewing would equate to keeping the existing contracts unchanged until expiry.

Like other companies, Cemig did not accept the renewal terms proposed by the government and it decided to go to court in order to guarantee the maintenance of its three main hydropower plant concessions (Jaguara, São Simão and Miranda).

The first one to expire was Jaguara (Aug,2013). Cemig followed exactly all the legal steps required but the Ministry of Energy denied all requirements alleging that according to the new law, the deadline for renewal had now expired.

We are not here advocating the cause's merit (judges are much more prepared than we are to do so). We do find fault in with the manner the whole process was conducted. One could expect the new rules would not apply to concession-holders not interested in accepting the new terms. That would be common sense, however, that was not the interpretation of the Ministry of Energy.

Apparently, it is not in our governments' best interest to build relationships based on confidence with its stakeholders. And, unfortunately, history tends to confirm this is the rule, not an exception. If Brazil really aims step up to its aspirations in the international arena, it is mandatory to radically change the way it conducts and communicates its actions.

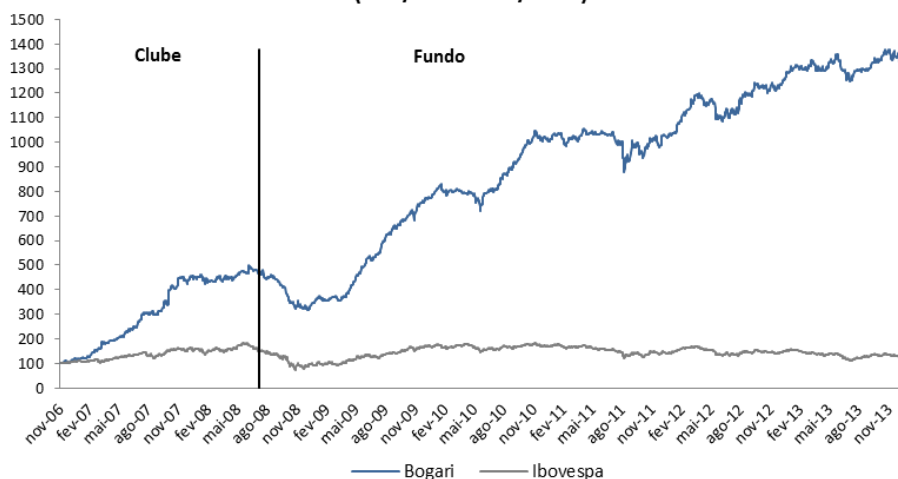
Thank you for your trust and support.

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<sup>2</sup> PETRIK, T. (2008). *1932 - uma aventura olímpica na terra do cinema*. Rio de Janeiro, RJ: PTK Livros.

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2013	Bogari	1.2%	0.9%	-0.4%	1.2%	0.4%	-3.6%	0.8%	0.4%	2.1%	3.7%	-0.7%	-1.5%	4.5%
	Ibov	-2.0%	-3.9%	-1.9%	-0.8%	-4.3%	-11.3%	1.6%	3.7%	4.7%	3.7%	-3.3%	-1.9%	-15.5%
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 <sup>(1)</sup>	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 <sup>(1)</sup>	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 <sup>(1)</sup>	Bogari											5.1%	12.9%	18.7%
	Ibov											5.0%	6.1%	11.4%

Valor da Cota Bogari<sup>(1)</sup> x Ibovespa  
(Nov/2006 - Dez/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\$ 289,4 milhões e o atual é de R\$ 331,0 milhões. A rentabilidade nos últimos 12 meses foi de +4,5%.

## Fund Information

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

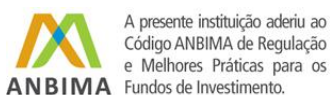
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