



## BOGARI VALUE

### Investor Letter 29, Quarter 2 2015 – Words vs Actions

Bogari Value is an investment vehicle focused on publicly traded equities of Brazilian companies. The Fund is long-term oriented and focuses on identifying price distortions between asset values and their trading prices.

## Our Performance

As of the end of June, we have had a performance in BRL of +4.94% against the benchmark, Bovespa's +6.15%.

Since its inception, the Fund has had an accumulated performance of +1,335% compared with +33% for the Bovespa.

Annual Returns			
Year	Bogari	Ibov	Difference (%)
2015	4.9%	6.1%	-1.2
2014	1.8%	-2.9%	+4.7
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	-20.1%	-41.2%	+21.1
2007	278.8%	43.7%	+235.2
2006	18.7%	11.4%	+7.3

Accumulated Since Inception			
Year	Bogari	Ibov	Diference (%)
2015	1335.4%	32.9%	+1.302.5
2014	1319.9%	37.0%	+1.282.8
2013	1244.0%	29.0%	+1.215.0
2012	1186.5%	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	259.3%	-6.0%	+265.3
2007	349.6%	60.0%	+289.6
2006	18.7%	11.4%	+7.3

The year 2015 got off to a post-election pessimistic start, followed by a strong upswing in the stock markets, buoyed mainly by foreign investors. The upturn was facilitated by the new Finance Minister, who's been doing a good job, considering the task at hand.

More recently, the stock market has been gradually falling, perhaps confronted by the country's harsh economic reality, which has been showing a constant deterioration in all its indicators. This year so far looks similar to 2012, where we observed a sharp rise, followed by a correction.

The index however does not tell the whole story. The equity market currently looks split between two groups: high quality companies, which appear well priced, and companies of lesser quality or size, which appear to be cheaper. With the former, one is paying for safety during a time of uncertainty, and for the latter, companies whose results are affected by the crisis, are being penalized.

In this scenario of uncertainty, we understand it makes sense to invest in high quality companies. However, we believe it doesn't make sense to overpay in such cases. Our portfolio currently has larger, more robust, and more liquid companies, delivering adequate returns. Once we have better definition on the state of the political and economic situation, and more adequate purchasing prices, we will be able to take advantage of the opportunities. In this manner, we shall be planting the seeds which will potentially provide excellent returns over the next years.

Our investor letters are divided between a commentary on performance, the current section, a brief update on the portfolio, and one or more themes we deem worthy of commenting on.

In this issue, we will explore discrepancies between words and actions of government in Brazil.

## Brazil

The beginning of the newly reelected government was challenging, as expected. The big news was the government's embrace of a more rational, orthodox economic approach. Joaquim Levy – a household name from the capital markets – was appointed Finance Minister, and has shown an incredible aptitude for perseverance.

However, the transition from a clearly populist stance, to a market-friendly one bears curious characteristics. The disparities between what was said during the presidential campaign and the actions taken post-elections have been creating odd situations. The government is not doing what it says, and cannot say what it does, hence the disconnect between its words and actions.

This lack of coherence between speech and action is not exclusive to this government. Former president Fernando Henrique Cardoso (FHC) has used this technique many times during his government. It looks however, as if FHC knew Machiavelli better than the current government.

The discrepancy between saying and actually doing something, along with a lack of planning, prevents the

government from setting out a clear plan to make the necessary adjustments to the economy. In comparison, FHC knew that unpopular measures should be taken swiftly and popular ones, evenly spread out. The “fiscal packages” were fairly common during his governments, as the objective was to implement painful measures in one fell swoop. The current government however, prefers to discuss and implement the measures one at a time.

The advantage of the “packaged” measures is that they allow the stakeholders in an economy to have a holistic view of the intended reforms, giving the impression that there is a “light at the end of the tunnel”. As the saying goes, “Better a horrible end than an endless horror”.

The second advantage comes from the political dynamics of negotiating all measures with Congress at once, rather than every one of them separately as is currently the case. A politically fragile government, where the ruling coalition – or what’s left of it – struggles to support the measures due to its ideological legacy, can cause these negotiations to drag on for too long.

Currently the government is selling the idea that predictability is key, but does not stick to it. As of the end of June, little has been actually implemented, whilst every day news and rumors on new taxes and government cuts appear. It is very hard to create predictability in this manner.

Such dynamics are bad for our investments, as the disconnect between theory and reality has important consequences in the investment decisions of companies.

A good example is the changing rules of the government’s student loans program, FIES. Keeping in mind that the government’s new slogan is “Educating Homeland”, FIES was widely valued and companies in the educational sector had made bets accordingly. However, on December 29, 2014 the government unilaterally changed its own rules, including for instance, its payment schedules to these companies. With the new proposal, the amounts would no longer be transferred monthly. Instead, they would receive 8 out of the 12 monthly instalments, with no estimate of when the other 4 would be received. This was the actual content of the ordinance from the Ministry of Education and Culture.

It is easy to understand the frustration for educational companies, which heavily invested in their businesses, ramping up capacity and making acquisitions, only to have the government surprise them on the second to last day of the year without prior discussions with any of the stakeholders, and declaring that only two thirds of the previous applicable amounts would be paid. As an example, on December 19, Anima announced it was purchasing Whitney’s operations for BRL 1.1bn, under the assumption that the rules in place would be maintained. It is not surprising that the deal was subsequently cancelled in April 2015.

Clearly, the rules for FIES had to be changed, since its first iteration relied on a populist, unsustainable model. As is normally the case, one does not dispute the merits of the measures, but rather the form in which they are being

announced or implemented. This process of destruction of expectations and value in the educational sector was very similar to the effects of the rules which gravely damaged the financial health of the electricity sector in 2012.

Unfortunately, the principles of lack of respect towards the risk-taking entrepreneurs is too ingrained in the popular culture, and our politicians are a reflection of the people.

Additionally, we can speculate that our President’s admiration for one of her predecessors, Getúlio Vargas, influences the way she runs the nation. Getúlio, probably the greatest Brazilian politician of the 20<sup>th</sup> century, believed that time solved a large part of the problems. He liked to say: “Leave it as it is, to see what it will end up like”. One cannot argue it is a wrong concept, but it should be used with restraint.

During the time when Getúlio ruled, in the 1930s, there was no internet, or mobile phones. The information flowed more slowly, and in a controlled manner. Markets were not electronic and interlinked as they are today, and economic knowledge was not as developed and tested. Therefore, at present times one must act. Inaction generates a vacuum of uncertainty in the markets, and in politics a space which is being aptly occupied by an ever more ambitious and assertive coalition party, the PMDB.

We are closely watching the political changes taking place. From proposed laws to postpone the mandatory retirement of Supreme Justices, to the reelection of the President of the Lower House of Congress, to political reforms, which may all take unexpected turns. As convenient as those reforms may be, they may create often undesirable precedents for a young democracy like Brazil’s.

## Portfolio

The positions in our portfolio generally change little over time, and 2015 was no different.

**Itaú** continues to post good results, and is reaping the benefits of changes to its credit portfolio over recent years, focusing on less risky loans with higher collateral. As expected, government-owned banks are less aggressive and spreads in general are on the way up. However, we have recently had unexpected events which may cause relevant losses to the banking system as a whole. There are several large companies being investigated under the recent Petrobras corruption probe. Naturally, these companies have outstanding loans with the largest Brazilian banks and those loans may not be repaid if there are further problems arising from the investigations. Another point of concern relates to oil-related businesses which are being affected by the problems with Petrobras as well as falling oil prices.

Furthermore, Brazil’s growth figures are expected to be worse than predicted at the end of 2014. We can’t predict exactly how this drop in economic activity will impact delinquencies, and the resulting losses for Itaú. In reality, not even the bank can draw a precise estimate of what will happen, but they have been preparing by increasing

provisions over the recent quarters, and being more conservative in approving new loans.

Additionally, news of tax increases have been putting pressure on banks. The increase in CSLL [Social Contribution on Net Profits – a tax] from 15% to 20% and the possible abolition of JCP [Interest on Shareholder's Capital – a tax break] may reduce Itaú's profit in the short to medium term. However, as the Brazilian banking system is quite concentrated, it is likely that the higher cost will be passed on to clients, through increases in spreads and charges.

The big news on **Cielo** has been the announced partnership with Banco do Brasil, through a joint-venture company called Cateno, to handle some back-office processes for the bank's cards. Cielo will invest BRL 8.1bn and will own 70% of the joint venture. The price seems fair, and if Cielo can increase efficiency on Banco do Brasil's card operations – which we expect to happen – there will be good value generation for the company. Moreover, we view this as a healthy revenue diversifier since this joint venture's revenue will basically come from the interchange fee from Banco do Brasil's cards.

On the other hand, the macro picture is likely to hamper credit and debit card transaction volumes in 2015, dampening Cielo's growth prospects. Despite the company having largely captured the expected increase in inflation for the year, the drop in economic activity has had an impact on transaction volumes. However, this also brings increases in the volume of prepayment of receivables to merchants, making up for lost revenues due to lower transaction volumes. Cielo has been benefitting from this trend with increasing prepayments of receivables and higher rates.

**Cosan** finally saw the approval of the merger between logistics operator ALL and Cosan's logistics arm Rumo by the Brazilian antitrust authority. As anticipated, the approval took place without significant restrictions to the operations of the new company. The next step will focus on the disposal of unprofitable sectors, and renewing the concession of the remainder of its rail network. To achieve this, it should be submitting a new investment plan, aiming for a significant increase in capacity.

The fuel distribution arm should continue presenting consistent results with good margins, despite the expected lower growth due to the challenging economic scenario. The growth in the number of refueling stations through rebranding should make up for slower sales.

The greatest surprise for the sugar and ethanol concerns of Cosan was the pronounced drop in crude oil prices. Despite

the fact that gasoline prices are controlled in Brazil, and are not following international prices in the short term, one can expect prices to converge in the medium to long term. Should low oil prices endure over the long term, it would be increasingly harder for ethanol to compete with gasoline, affecting demand in Brazil for the former, and in turn further affecting prices for sugar. Since prices for both crude and gasoline have already somewhat recovered, and the Real has devalued significantly, this risk might be averted. However, this only corroborates our opinion that investing in commodity sectors carries a high risk, and we must be very careful in our estimates.

Comgás – Cosan's natural gas distribution business – continues to undergo a tariff revision process, which is taking longer than expected. This could be a positive factor however, considering that gas consumption volumes are low due to incentives for curbing water consumption currently in place in São Paulo. With this new perspective of lower consumption, the regulator's projections should be more realistic and conservative than they would have been last year.

On **Equatorial**, a great risk we were foreseeing has seen its chance of materializing greatly reduced, since the probability of energy rationing this year seems to have been reduced to practically zero. This was helped by the rains which partially replenished the country's reservoirs, but is mainly the result of a lower demand for electricity due to the stagnant growth of the economy.

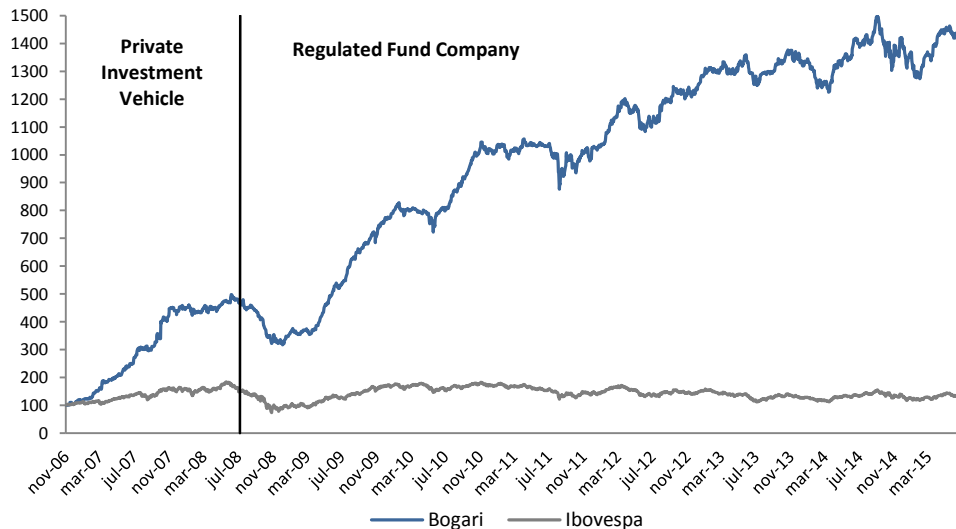
Other news was the preliminary result of the cycle of tariff revisions, where the regulator proposed a WACC of 8.09%, well above what had been previously signaled, and also above market expectations. With this, we had lower risk and stronger return, making Equatorial one of this year's top performers in our portfolio.

As we like to remind the readers of our investor letters, the Fund's portfolio remains adequately diversified. Our largest position represents around 11% of the portfolio, and the top 5 positions 40%. Our cash holding is high: beyond 33% of cash (and equivalents), over 90% of our portfolio can be liquidated within 7 days. We continue to hold good assets at adequate prices, with good perspectives for the coming years. Additionally, we are prepared to take advantage of a possible correction in the markets.

Thank you for your trust.

## Monthly Returns

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2015	Bogari	-6.9%	6.9%	2.7%	3.6%	-2.1%	1.1%							4.9%
	Ibov	-6.2%	10.0%	-0.8%	9.9%	-6.2%	0.6%							6.1%
2014	Bogari	-5.9%	-0.5%	3.4%	1.7%	1.5%	4.1%	0.2%	6.5%	-7.7%	1.1%	1.9%	-3.7%	1.8%
	Ibov	-7.5%	-1.1%	7.1%	2.4%	-0.8%	3.8%	5.0%	9.8%	-11.7%	0.9%	0.2%	-8.6%	-2.9%
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%

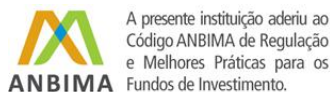


(1) Bogari Value was launched as a regulated private investment vehicle in November 1, 2006. In July 8, 2008, the vehicle was converted into Bogari Value FIA.

## Main Fund Characteristics (Brazilian Onshore Vehicle)

<b>Administrator</b>	BNY Mellon Serviços Financeiros DTVM S/A	<b>Subscription</b>	T+1
<b>Manager</b>	Bogari Gestão de Investimentos Ltda.	<b>Redemption</b>	T+30
<b>Distributor</b>	BNY Mellon Serviços Financeiros DTVM S/A	<b>Settlement</b>	T+33
<b>Custodian</b>	Banco Bradesco S.A.	<b>Management Fee</b>	2.175%
<b>Auditor</b>	PricewaterhouseCoopers	<b>Performance Fee</b>	20% over Ibovespa (w/ high watermark)
<b>Minimum Investment</b>	R\$ 30,000.00	<b>Anbima Identifier</b>	212962
<b>Minimum Balance</b>	R\$ 30,000.00	<b>Classification</b>	Equities Ibovespa
<b>Minimum Transaction</b>	R\$ 10,000.00	<b>NAV</b>	Close of Business Day

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