

BOGARI VALUE

Investor Letter 30, Quarter 3 2015 – Telecom Industry in Brazil

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 intrinsic asset values and their trading prices.

Our Performance

As of the end of September, we have had a performance in BRL of 1.1% against the benchmark, Bovespa's -9.9%.

Since its inception, the Fund has had an accumulated performance of +1,253% compared with +13% for the Bovespa Index over the same period.

Annual Performance			
Year	Bogari	Bovespa	Difference (%)
2015	-1.1%	-9.9%	+8.8
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	Bovespa	Diference (%)
2015	1,252.9%	12.8%	+1,240.1
2014	1,267.9%	25.2%	+1,242.7
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	259.3%	-6.0%	+265.3
2007	349.6%	60.0%	+289.6
2006	18.7%	11.4%	+7.3

Over recent months, equity markets in Brazil dropped as the economic crisis takes hold. Economic forecasts already point to a deepening recession in 2015 and 2016. To make matters worse there is no relief on the political side, since the frustrated attempts to enact much-needed measures to tackle the budget deficit are a consequence of the government's loss of grip on the political situation. As for the structural adjustments aimed at fostering long-term growth, they are currently not even on the agenda.

With so much uncertainty, expectations for companies' results are not good, and we expect to see worsening operational results on the balances until at least the early part of next year. Consequently, companies have cut

investments and reviewed their costs in a bid to maintain profitability in this challenging environment. These defensive actions do not help to contribute with a way out of the downward spiral of economic contraction.

Within this scenario, we have been able to achieve one of our objectives, which is to have substantially smaller declines when markets plunge. We see some high-quality companies trading at attractive valuations, even when worsening economic conditions have been priced in. We understand however, that the situation may worsen before improving and therefore our strategy has been to incrementally buy assets with a better risk-return ratio, increasing our equity exposure as prices improve.

Our investor letters are divided between sections, starting with 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 discuss the development of the telecom industry in Brazil.

Portfolio

The economic slowdown has been greater than expected, which does not bode well for credit growth or its quality at Itaú. With increasing levels of unemployment, we should see an increase in NPLs for the "Individuals" segment. However, the improvement of recent years in the mix of its loan book leaves the bank better prepared than previously, since its portfolio is now more exposed to lower risk credit such as mortgages and payroll-deductible loans.

In the "Companies" segment (which includes Corporates and SMEs), we see a potentially bigger problem with some of the larger companies, such as cyclical, and those whose names are linked to the Petrobras corruption scandal. The bank has prepared for potential losses, having increased its historical provisioning levels, and having already built up excess provisions in its balance sheet. It is, however, difficult to quantify when and what the loss will eventually be. What we know so far from our simulations is that even if we project high losses over the coming years the bank still holds a great deal of value.

Besides the increase in NPLs, the bank has been on the receiving end of government measures to increase tax revenues, with some tax increases such as the "social contribution on net profits" (CSLL) up 5% for the next 3 years and capped the prevailing tax rate for interest on shareholder's capital at 5%. Despite having partly reduced

potential profits of banks, these measures had a smaller negative impact than initially anticipated.

For **Cielo**, we see a different dynamic from previous years across its lines of business having a positive impact on the company's results. On the one hand, the economy and consumption in Brazil have decelerated, leading to transacted volumes increasing below inflation in the short term. On the other hand, the same challenging conditions mean merchants require more working capital, therefore increasing demand for prepayment of receivables. Fees for prepayment of receivables have been increasing, leading this line of business to make up for the lower volumes of debit and credit card transactions.

On the regulatory front, the capture of transactions from smaller credit card brands through any acquiring network is being rolled out on a trial basis, and next year we should see one POS being able to capture transactions from all card brands. Despite this translating into a potential reduction in the number of POSs, we believe the impact will not be so relevant as commercial establishments typically hold several POSs to process transactions simultaneously, as well as a backup to minimize the risk of a lost sale due to network issues.

Cosan share prices have suffered throughout the year, mainly due to uncertainties in some business lines such as Sugar & Ethanol, and Comgás. On the other hand, the fuel distribution business remains stable, with good returns, despite suffering somewhat from the economic deceleration.

The Sugar & Ethanol business has been positively impacted by various policies implemented by the government throughout the year (rise of gasoline-specific tributes, increase in the proportion of anhydrous ethanol in gasoline, increase in sales tax in some states), leading ethanol to become more competitive versus gasoline, and increasing demand for the former. With the recent increase in gasoline prices by Petrobras, this trend has been accentuated, and it is now possible that stocks run out during sugarcane's off-season. Ethanol and sugar prices have risen accordingly, improving profitability at sugar mills. The scenario seems favorable for the next few years, with tight supplies for sugar, and ethanol being increasingly competitive as a fuel.

Meanwhile, Comgás still awaits its 5-year tariff revision process, which is delayed by almost 18 months. Once the process is finalized, we should have better visibility on the levels of the company's return on investment.

We have not had many news at **Equatorial**, with its turnaround in operations in the state of Pará still ongoing, and good results in the state of Maranhão. With the economic slowdown, we should see slower growth in demand for electricity. However, the two states in which the company owns concessions have more residential characteristics, and therefore should be somewhat less impacted by falling demand.

As we always like to point out in our investor letters, our portfolio remains adequately diversified. The largest holding makes up around 10% of the Fund's assets, and the top 5

positions combined account for 40%. Liquidity is high: besides holding around 33% of cash and equivalents, we are able to convert over 90% of the Fund into cash within 7 days. We are holding good assets, at adequate prices and good perspectives for the coming years. Additionally, we believe we are prepared to take advantage of a possible devaluation in equity markets in Brazil.

Telecommunications

The current shape of the telecommunications market in Brazil is essentially the consequence of three waves of development. Telephone lines were inaugurated in Brazil in 1877, when the emperor Dom Pedro II demanded the installation of telephone lines between his palace and the residences of his ministers. Between the late 19th century and the mid-1970s, the development of telephone services followed a fragmented and disorderly path. There was no development plan, technical standards, or any other form of planning. By the mid-1960s, there were more than 900 companies operating in the sector.

The 1960s saw the beginning of the structuring of this industry. The Brazilian Telecommunications Code was implemented, the Ministry of Communications, and Telebrás were created. This also marks the beginning of the State-controlled development model, which was in place between 1970 and 1995. Under this framework, Telebrás owned a local exchange carrier for each of the Brazilian states. This model served its purpose, allowing for a reorganization of the fragmented phone services industry through a policy of development of the industry and technical standardization. As a consequence, service levels were significantly improved.

From 1995, the industry entered a new phase. Many factors acted as catalysts to a significant number of changes: the global momentum for privatization of state-owned companies; the end of AT&T's monopoly in the US; the financial difficulties Brazil was going through then; and the development of new technologies. Thus, under the leadership of Telecommunications Minister Sergio Motta, a few years later Brazil no longer had a monopoly in the telecom industry. The General Law for Telecommunications was approved as the new regulatory law governing the industry and, finally, the privatizations took place in 1998.

At the time when the new regulations were laid out, specific focus was given to some aspects: increase of the infrastructure through investment incentives; competition; affordable rates; and a stable regulatory base aimed at generating predictability in order to reassure private interests. That model had an important limitation: it was designed based on technology available at the time, and therefore would need to be revised as new technology became available. Notwithstanding, the regulatory changes were a great success.

We may divide the post-1995 period in two sub-phases. First, with the establishment of the national infrastructure, many players took part in the process of privatization, acquiring the

existing companies as well as new licenses to operate fixed and mobile phone services throughout the country. During this phase, massive infrastructure investments were made by all the groups in order to facilitate the offering of services.

The second phase was marked by the consolidation of those regional players, forming the four biggest groups operating in Brazil today: Vivo, Claro, Tim, and Oi.

The market did not evolve exactly as intended by the design of the regulation. Fixed line services, for instance, saw competition from mobile phones, since both offer voice services, as well as competition from calling services via internet (VoIP).

Fixed lined operations went through some of the business world's most dramatic changes over the last few decades. What had been a natural monopoly for almost 100 years started being subjected to fierce competition.

To have an idea of how the face of this competition has been changing, we may look at how the numbers for each type of service has evolved over time. In 1995, there were 13.3m fixed lines and 1.3m mobile lines in operation in Brazil. In 2014, there were 45m fixed lines, and 281m mobiles lines. While the number of fixed lines tripled during this period, mobile line numbers rose 200-fold!

The most interesting part is the fact that this point is currently almost irrelevant, because we find ourselves already on the next phase of telecom evolution. With further developments of messaging services and VoIP (WhatsApp, for example), smartphones, wireless data, and integration of broadband and WiFi, voice services have been decreasing significantly in many markets. Telecom services are migrating massively towards data, be it wireless or broadband. What we are starting to see globally is a migration to a model where one contracts access to data, including unlimited voice calls.

Herein lies part of the problem with telecoms in Brazil. The regulatory framework, as noted earlier, has been developed around 1995, and designed based on the technology available at the time. However, the way in which the market developed did not follow the original design. The framework has been somewhat updated over time, but no significant overhaul was made to bring it up to today's requirements. The existence of this legacy regulation creates distortions for some players.

The most important regulatory distortion is the existence of requirements for those companies that used to hold public concessions. Public concessions stem from the concept of a natural monopoly held by fixed line communication services in the past. As mentioned earlier, fixed line voice services had been a natural monopoly for almost 100 years. Despite the potential technological advances already apparent at the time when the new regulatory framework was designed, the concept of natural monopoly persisted in the definitions of the requirements concession holders had to fulfill. Such a concept only makes sense when there is a monopoly in place. This concept has survived the elaboration of the regulatory framework and remained a contractual obligation of concession holders like Oi and Vivo, which places a

significant burden on these players. Examples include public payphones, the requirement for universal fixed line service to any locality with a minimum population in Brazil, maximum deadlines for connection and maintenance of those services, and broadband access for public institutions, among others.

The fixed line market worked with a system of strong cross subsidies between clients and services. Companies holding concessions would make money in urban centers with high client density and made little money, or even losses, in other areas. With technological changes and greater competition for services in high-density urban centers, the source that paid for other locales was reduced. This is a natural dynamic, since new entrants tend to focus their efforts on the most profitable markets. For concession holders, the picture became gradually deteriorated, since they had to contend with the requirements of a monopoly while having strong competition in their most lucrative markets.

The dynamics of new technologies created yet another phenomenon: the standardization of telecom services did not happen via fixed line, but rather through mobile services. With comparatively low installation costs, the benefit of mobility for clients, and possibility of pre-paid usage with no monthly commitments, any person could have access to some kind of phone service at an accessible cost. Having understood these changes, the concession holders have aligned themselves to the changes in trend and behavior by starting to offer mobile phone services as well. At the same time, they still had their legacy requirements to offer fixed line services in any locality within their concession areas.

The industry then discovered that the more services a client would buy, the better their loyalty and the cost of serving that client was diluted. Therefore *bundles* have come into play: initially there were *triple play* bundles, consisting of mobile, broadband and fixed line services, but soon got augmented to *quad play*, with the addition of pay-TV.

The four biggest groups which managed to consolidate telecom operations in Brazil have done so through alignment of geographical presence and ease of providing bundled services.

Of the two original concession holders still in existence today, the Spanish group Telefonica has been noted to look for high quality assets. At first, they have focused on developing broadband services based on their legacy fixed line networks. In 2006 they bought the operations of Abril's TVA pay-TV operations, which was not a game-changing acquisition. At the same time, their partnership with Portugal Telecom in Vivo managed to consolidate some of the best mobile phone operations around. In 2010, when the offering of *triple play* became unavoidable, the Spaniards bought the remaining shares in Vivo, and merged its operations with Telefonica. Finally, in 2015 they bought GVT, a newer and lighter platform – technologically speaking – which has been very successful at attracting clients through its superior broadband offering. Therefore, the company now boasts a high quality mobile network, high capillarity of fixed and broadband services in the State of São Paulo, and a good

technological platform in the main Brazilian cities thanks to GVT.

The second concession holder, Telemar initiated its mobile operations in 2002, intensified its broadband offering and chose to acquire in 2008 another player with similar operations, but lack of geographical overlap, BrT, to form the company which is known today as Oi, a national platform of fixed and mobile phone services. Subsequently, they joined forces with Portugal Telecom in 2013, but the alliance was short-lived, since the imperatives of financial survival put an end to the union.

Claro, owned by Carlos Slim's America Movil, also consolidated a mobile phone services platform through the acquisition of companies who had acquired licenses during the tender of "Band B" during the privatizations. They acquired Embratel in 2004, which held a concession for long distance services and a considerable portfolio of corporate clients. In the same year, they acquired cable-TV operator NET, perhaps their most important acquisition. NET has enabled Claro to aggressively grow their broadband services by using the company's existing coaxial cable infrastructure. The combination of the two companies enabled Claro to offer a good nationwide mobile network, as well as a good corporate portfolio, and a substantial pay-TV network which allows the offering of fixed line and broadband services in the country's main cities. NET also generated a significant differential to the group, since it enables Claro to have the best *quad play* service bundle offerings in the market.

Italian group TIM has consolidated another platform of mobile services. A few years later, with the need to incorporate broadband services in their offerings, TIM bought two companies which own fiber optic networks in the main cities, as well as long distance services – Intelig and Atimus. However, mobile services still represent a high percentage of their earnings, possibly leaving the company vulnerable over the long term.

The tendency of the consumer market is to select bundles of converging services. Experience in markets outside Brazil shows that the future lies in offering fixed and mobile data access which will be used to deliver internet, voice, and video.

Which company would be best positioned in the Brazilian market? Since the four main players have a national mobile platform, this aspect does not offer a distinction. What makes a company more interesting or less so is the kind of platform it has, and its ability to deliver the service bundle most suited to each client's needs.

Vivo possesses a greater technological advantage through its more consistent nationwide network, good capillarity in São Paulo, and a good growth-enabled nationwide platform through GVT. In terms of bundles, its weakness lies in pay-TV, therefore the current rumors that Vivo would like to purchase Sky's operations in Brazil could be founded.

Claro possesses the greatest competitiveness in terms of bundles, due to the scale and capillarity of its pay-TV offering

through NET. However, their network is somewhat more complex than Vivo's since NET operates with coaxial cable – a technology which differs from the rest of Claro's network – and uses an in-house system to manage its pay-TV business. The streamlining process of the offering has been slower than expected, however it is possible that the merger of the two companies, which took place in 2014 enables a greater operational integration.

Besides its mobile network, Oi has a legacy network of fixed lines which is not simple. Because it is an old network, with nationwide coverage and part of a concession, it comes with a high operating cost, which will also impose a significant investment in infrastructure modernization. Maintaining the legacy fixed line system hampers the elaboration of service bundles. Additionally, Oi has the same challenges as Vivo and TIM in terms of pay-TV.

As for TIM, besides its mobile network it has a more limited fiber optic network, and therefore a considerable shortfall in its ability to deliver bundled services. Despite having a modern network, it is limited in size and scope as it does not have a relevant pay-TV offering.

In short, despite having made large (and often expensive) acquisitions, Vivo has managed to build the best platform in Brazil, which can be further improved through the acquisition of Sky. Claro, having made disciplined acquisitions (NET standing out as the most successful example), also boasts a good mobile network, the best pay-TV solution, but a complex integration of its platforms. Oi is in a delicate situation, needing to focus on its high leverage, as well as attempting to adjust the new proposed industry framework, since under the current proposed legislation its business model is not viable. TIM, meanwhile, is financially sound, but its strategic model is fragile as it fails to deliver what its clients want over the long term.

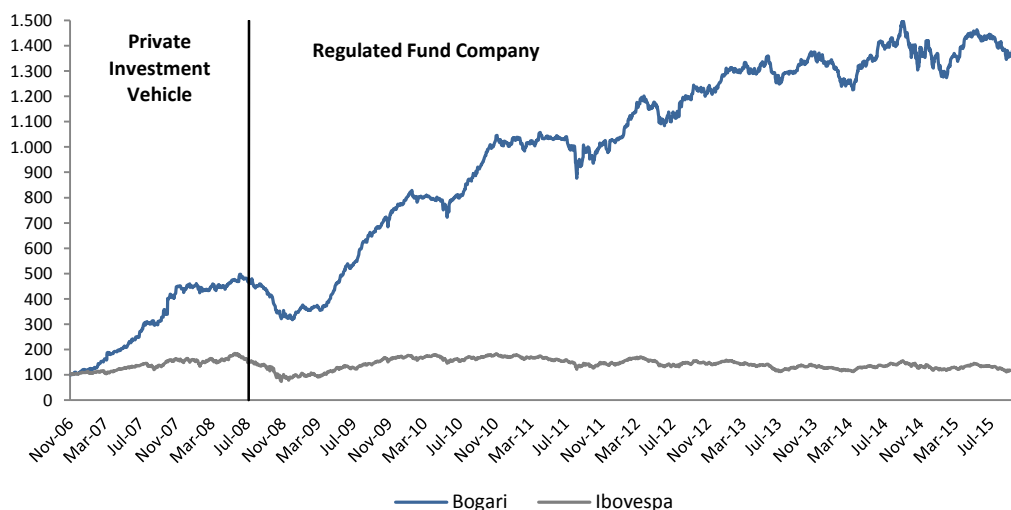
As it stands, there is a tendency that Vivo and Claro eventually dominate the market over the long term, as they are most responsive to their clients' needs. A merger between TIM and Oi would increase the odds of another viable player in the long term. However, the merger of operations in such a transaction would be difficult to execute (mainly due to the complexity of Oi's network and operations), with a large risk for value destruction, even if the legislation ultimately passed is favorable. If such a merger were indeed to take place, Vivo and Claro would benefit in two ways: firstly through reduced competition and ensuing increase in scale and margin of each player, and secondly with the resulting company focusing its efforts on the operational execution of the merger, leaving the market under less intense pressure.

We believe Vivo is a good vehicle to participate in this process, as it is the best company in a sector which is set to see increases in the returns of its players because of the current events.

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%	-1.6%	-3.3%	-1.0%				-1.1%
	Ibov	-6.2%	10.0%	-0.8%	9.9%	-6.2%	0.6%	-4.2%	-8.3%	-3.4%				-9.9%
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 ⁽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%

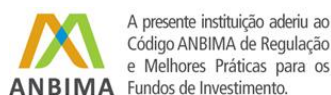


(1) Bogari Value was launched as a regulated private investment vehicle in November 1, 2006. In July 8, 2008, the vehicle was converted into Bogari Value FIA.

Main Fund Characteristics (Brazilian Onshore Vehicle)

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

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