BOGARI capital

BOGARI VALUE

Investor Letter 31, Quarter 1 2016 – Brazilian Railways

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 March, we have had a performance in BRL of +8.9% against the benchmark, Bovespa's +15.5%.

Since its inception, the Fund has had an accumulated performance of +1,392% compared with +25% for the Bovespa Index over the same period.

	Annual Performance		
Year	**Bogari**	**Bovespa**	**Difference (%)**
2016	**+8.9%**	+15.5%	-6.6
2015	**0.2%**	-13.3%	+13.5
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**	**Difference (%)**
2016	**+1,391.9%**	+25.4%	+1,366,5
2015	**+1,270.6%**	+8.6%	+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

A far as Brazil is concerned, 2015 turned out to be much worse than expected by the markets. The political crisis, coupled with the government's paralysis deepened the economic contraction well into 2016. Additionally, the country is going through the difficult process of impeaching a democratically elected president.

If on the one hand, we have positive expectations concerning the adjustments to the economy, on the other hand we will be forced to live through every single day of this painful period. Financial markets have already adjusted the prices of a number of assets, based on the expectations of changes ahead. However, we are still going through a recession, and many questions remain on how a new government would be able to tackle the economy and put it back on track.

As usual, we try to keep our portfolio conservative, with low risk of permanent losses. We took advantage of the market correction during the first quarter to increase our exposure to high quality assets. However, due to the rapid reversal of expectations – mostly due to China and the increasing possibility of the impeachment of Dilma Rousseff – we witnessed a sharp rise in equity prices, curbing our efforts to reduce the cash in our portfolio.

We are now waiting to see either more attractive prices or less uncertainty before we deploy more capital. We are sure of one thing, however: ousting the current government is the best course of action. In spite of its challenges, it prevents further value destruction from taking place. The main issue with populist governments is that often they only come to an end when the country goes bankrupt. And that, we must avoid.

Our investor letters are broken down into sections, starting with a commentary on performance – the current section – a brief update on the portfolio, followed by one or more themes we deem worthy of commenting on.

In this issue, we will discuss railways in Brazil.

Portfolio

Despite seeing a considerable drop in GDP in Brazil during 2015 (-3.8%), public companies as a whole managed to adjust their operations, and did not post significant drops in their results. This year however, the story should be different as there is no longer much room to cut costs, and the economy remains weak.

At **Itaú** we should see a drop in profits, mainly as a consequence of worsening credit defaults. This trend is normal during periods of economic contraction, but estimating the amount of losses to be provisioned remains a challenge. Whereas the changes in the profile of the credit book mitigates part of the problem, this is the worst recession the country has ever been through. In any case, we do not expect a significant impact to Itaú, which should remain in a strong competitive stance and well positioned to take advantage of the next cycle of growth in Brazil.

At **Cielo** we should see a repeat of 2015, with strong results for prepayment of receivables making up for weak transacted volumes. The noise around regulation has increased: pro-competition measures are being analyzed by the Competition Regulator (Cade) and the Central Bank. Nevertheless, we are still confident the company will maintain a strong competitive position relative to its peers. An upcoming test will be the actual opening to capturing transactions of every card issuer by its competitors, which should effectively happen by the end of this year.

Cosan has posted a substantial improvement of its results in Sugar & Ethanol. Hydrated ethanol prices saw a large improvement due to increased domestic demand and sugar prices have risen due to an expected tightening of global supply. One of the companies under Cosan's umbrella, natural gas distributor Comgás saw a significant improvement to its capital structure due to a large payment of dividends. Furthermore, part of this dividend was used in the rights issue of Rumo/ALL, allaying concerns over the company's level of leverage.

As for **Equatorial**, we keep watching the turnaround of Celpa, its electricity distributor in the northern state of Pará, which has so far been very satisfactory. Demand for electricity in the northern states of Pará and Maranhão, where Equatorial operates, has been resilient. There is also a possibility for the company to acquire new concessions over the next few years.

As we always like to point out in our investor letters, our portfolio remains adequately diversified. The largest holding makes up around 11% of the Fund's assets, and the top 5 positions combined account for 32%. Liquidity is high: besides holding around 33% of cash and equivalents, we are able to convert over 90% of the Fund into cash within 8 days. We are holding quality assets, at adequate prices and with good prospects for the coming years. Additionally, we believe we are prepared to take advantage of a possible devaluation in equity markets in Brazil.

A Look at the Railway Sector in Brazil

Our Motives for Discussing the Theme

We have been following the ALL (presently merged with Rumo) investment case since its IPO, having never felt compelled to make an investment. The reason being that in our understanding the asset presented four characteristics that we typically avoid in our capital allocation decisions: (1) recurring necessity for large volumes of investments; (2) high operational complexity; (3) history of conflicts with regulatory authorities; (4) challenges to align shareholders' and managements' interests, as goals have always been skewed towards prioritizing the short term as opposed to the long-term horizon of expected returns for this industry.

However, as shareholders of Cosan since 2011, we have spent some time analyzing the company, at first to understand the pre-merger dynamics between Rumo and ALL, and subsequently to understand the future of this asset under its new management at Cosan.

Despite not being particularly fond of ALL's business model, we did not initially question its ability service the sugar-hauling contracts agreed with Rumo without affecting its finances and operations. We began questioning this ability throughout our investment in Cosan and, in retrospect, we can say the contract between the companies was asymmetrically in favor of Rumo, which helped to expose ALL's fragile financials.

The solution was to merge the operations of Rumo and ALL, which took place in May 2014. For risk mitigation purposes, Cosan's share in this new company was split into a new vehicle – Cosan Logistica – which is a separate entity, but also controlled by Cosan Limited. Under this new arrangement, had we invested only in Cosan S.A. we would not need to concern ourselves with Rumo/ALL. However, whenever possible, we seek to invest in the vehicle carrying the largest discount, taking into consideration issues such as liquidity, voting rights, fiscal inefficiencies, etc. In this particular case, we invest both in the holding company, Cosan Limited, and in the operating entity Cosan S.A. The former has always been the cheapest vehicle, but carries lower liquidity and we therefore split our holdings across both companies.

We continued to follow ALL's performance, and were already convinced that its post-merger value excluding Rumo was close to zero. This was due to the difficult task of generating sufficient cashflow to support the heavy investments it committed to execute in order to compensate for past underinvestments and to support future growth. Also to be taken into account, its financial commitments towards its debt, licenses and leases. Our understanding is that ALL was comparable to Telemar [the privatized phone company which later became Oi], due to its operational and regulatory complexities, high requirements of maintenance capex, and delicate financial situation, worsening year after year. To put it better, ALL was Telemar on rails.

The question at the time was whether it was worth investing via Cosan Limited – thus being exposed to Rumo/ALL – or simply through Cosan S.A. avoiding such exposure. Since the discount has always been excessive, ascribing ALL a value of zero – or even below zero – would still justify an investment into Cosan Limited.

During early 2016 the asset's price effectively converged to near zero, leading us to ponder whether the new, post-rights issue Rumo/ALL case could be a sign of an inflexion point in the history of this asset. And, for some reason, whether it could be seen under a more inspiring outlook for value and sustainable generation of cash flow for its shareholders over the coming years.

We are not suggesting that we will attempt to bring here a definitive answer to these questions, but rather to encourage a reflection which may recur over the coming years. We acknowledge the strategic value of some assets (physical rail network) owned by Rumo/ALL and its irreplicability. However, the fact is that over the last two centuries, the history of railways the world over is littered with bankruptcies, high subsidies, and extremely low return on invested capital. Lest not forget that in Brazil the situation is further aggravated by a structural shortage of cheap capital.

We have structured this part into the following sections: (1) a brief history of the railways sector in Brazil; (2) the privatization process; (3) new government initiatives to reduce the costs of logistics; (4) from theory to practice, the current challenges to reduce the costs of logistics in Brazil, and; (5) the operational impacts of the new investments in Rumo/ALL.

A Brief History of the Railways Sector in Brazil

Railways in Brazil started in the middle of the 19th century, under Emperor Dom Pedro II, driven by the need to more efficiently export the coffee produced in the provinces of Rio de Janeiro, São Paulo, and Minas Gerais. This was followed by commuter lines in the main urban centers. The first rail projects were elaborated by the British and financed by British venture capitalists and sometimes by local businessmen, among whom the illustrious Irineu Evangelista de Souza, the Baron of Mauá, Brazil's most prominent entrepreneur at the time. Following the first wave of expansions, the railway companies in Brazil saw the same fate as the Baron of Mauá: utter bankruptcy, with the railways being either abandoned or taken over by the State.

New forays into railways only gained momentum again from the start of the 20th century, led by the network's inland expansion drive in the state of São Paulo, and the construction of the Vitória-Minas Railway whose concession would be transferred in the early 1940s to Vale (then called Companhia Vale do Rio Doce). From the second half of the 20th century, Brazilian railways entered a period of decay, losing out to highways, chosen as the favored mode of transport in Brazil since the time of President Juscelino Kubitschek.

As a result of decades of neglect and underinvestment, by the end of the 20th century Brazil's rail network was mostly laid to waste, forcing the State to privatize almost all the network until then operated by State-owned companies RFFSA and FEPASA.

The Process of Privatization of Brazilian Railways

The worsening fiscal stance of Brazil in the 1980s accelerated the decay of railway operators, rendering them insolvent and incapable of investing in the maintenance of their physical assets.

In order to address Brazil's fiscal crisis and enable the sector to resume investments, during former President Fernando Henrique Cardoso's first mandate, the government promoted a large-scale program of privatizations of railways between 1996-1998. The main participants in this process were the large Brazilian pension funds, and private equity funds, among which GP Investments.

Under private management, the sector had a new lease of life: productivity indicators rapidly rose (253 Mton of freight transported in 1997 vs 445 Mton in 2007), accident rates dropped (75 accidents per million train kms vs 14 in 2007) and investments picked up (BRL 500-600mln/year in 1997 vs BRL 2-3bn 10 years later).

The cycle of revitalization in the sector culminated in the creation of the National Agency for Terrestrial Transportation (ANTT in Portuguese) in 2001, which would be in charge of overseeing and regulating the sector.

The process consolidated the capital markets as financial backers of heavy infrastructure investments, both in debt as well as equity. A landmark of this new chapter in the history of the sector was the IPO of ALL – then controlled by GP Investments – which enabled the company to fund its expansion, consolidation of the industry and renewal of the rolling stock throughout the following decade.

New Cost-Cutting Initiatives in Brazil

The second mandate of former President Lula (2007-2010), and the first mandate of President Dilma (2011-2014) were characterized by the resumption of the developmental school of thought, with the State as the great architect and financial backer of large infrastructure projects in Brazil. The objective, in theory, was to foster competition and reduce the costs of logistics in the country (mainly for exports).

In order to reach these objectives, two large initiatives became fundamental pillars of this process:

(1) The launch of the Growth-Acceleration Program (PAC), later followed by the Logistics Investment Program (PIL) focusing on reviving investments in railways, with a specific focus on the North-South Railway, where ground was first broken as far back as the 1980s and aims to connect the São Paulo network to northern Brazil's ports.

(2) Deliberations over a new regulatory framework aimed at ending operational monopolies of the network, enabling any participant to operate freight trains upon payment of a toll, much in the same way as highways.

The expected effect would be to enable a steep reduction of logistics costs, since the government would heavily subsidize tolls on these new railways, and large freight operators would also be able to vertically integrate their operations. These would in turn put pressure on the rail operators' current margins. As one might expect, despite supposedly attractive financing rates (70% of the project financed by the BNDES at 100bps over the low long-term interest rate, "TJLP"[1]) private capital shunned those projects as it would entail accepting government risk on the receivables without the backing of the National Treasury as a counterparty, seen as the minimum acceptable requirement.

On the regulatory front, in spite of discussions being held at length, no practical solutions were implemented to date. There was a formalization of the roles of the Independent Rail Operator and Infrastructure Coordinator. Furthermore,

[1] Currently 7.5%, as opposed to base rate Selic at 14.25%

the obligation for the regulator to draw a 15-year investment plan for each concession holder was established.

Plans were also put in place in order to set quality targets and a new method for tariff reviews every five years, to be adjusted by inflation and deflated by a productivity factor (similar to the model used in electricity distribution).

In theory, the concept of distinguishing the business models between those who manage the infrastructure, and those who operate on it makes sense as it stimulates competition. In practical terms, however, the set-up requires high levels of government subsidies over decades, something not viable in the country's present fiscal climate.

From Theory to Practice: Reducing the Cost of Logistics in Brazil

We acknowledge that good ideas were formulated during this period, but fell short due to the practical challenges of implementation: time, cost, and complexity. Current fiscal restrictions prevent us from moving forward with the idea of a new regulatory model (open access), whose viability relies intrinsically on heavy government subsidies.

However, there are ways to achieve large gains in reduction of logistic costs without changing the regulatory framework. Export costs can be improved simply by increasing competition between the different existing modes of transport.

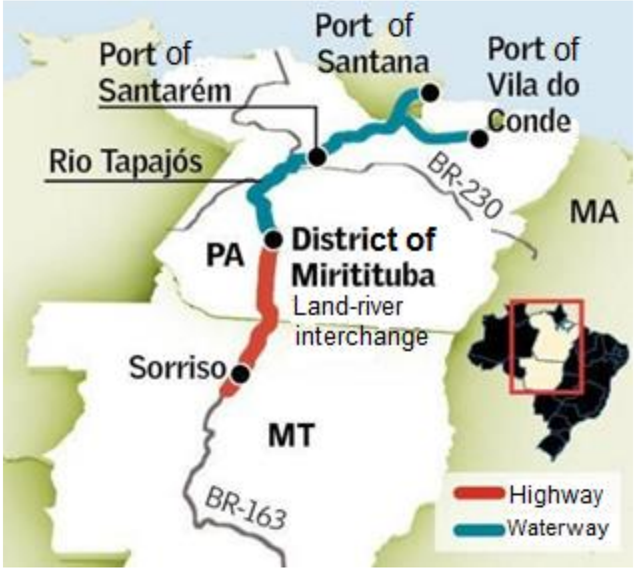
More specifically, the Midwest region – accountable for the bulk of export growth – has suffered for decades from the absence of competing modes of transport in order to offload its production of grains to Europe and Asia.

Therefore, reinforced by this scenario of severe fiscal restrictions, it would seem more productive and cheaper for the government to focus on a few initiatives of high immediate impact. For example, developing the ensemble of investments we call the Northern Corridor (see map) appears to be an initiative with high returns and low execution complexity.

The Northern Corridor would enable year-round navigation of the Amazon River Basin, a better land access (road and rail) to the intermodal freight terminals, and new operations at private ports in the Vila do Conde region. Potentially, its completion could make viable new, cheaper logistic alternatives to shipping agricultural exports from the Midwest regions to the Northern region of the country. This new corridor has the potential to transform the logistics of exports in Brazil, shortening the freight cycles to Europe and Asia.

In order for this scenario to actually take place, efforts should concentrate on finishing sealing the BR-163 highway, which cuts through the Mato Grosso region and reaches the southwest region of the state of Pará. This would enable greater volumes to reach the private terminals in the region of Miritituba, and subsequently offloading freight through the ports of northern Pará.

At a later stage, alternate routes could be upgraded, like the North-South Railway reaching the Port of Vila do Conde and the Tocantins Araguaia waterway.



Source: Valor Econômico

The New Northern Corridor and Risks for Rumo/ALL

The investments in logistics discussed in the previous section are not new concepts – many have been discussed for decades. However, a new corridor would compete directly with current operational assets of Rumo/ALL. And because it is a capital intensive business, this scenario could considerably impact the company's profitability.

The success of the Rumo/ALL business plan depends in short, on two key factors:

(1) Successful negotiations for the renewal of concession contract, with the devolution of at least part of the uneconomic sections of the network (West and South), and keeping the profitable sections (Santos-Paranaguá corridor).

(2) Ability to maintain its competitive advantage intact, sustaining the high operating margins of the Mato Grosso-Santos corridor, presently accounting for 70-80% of the company's Ebitda).

With regards to the success of the ongoing renegotiations of its contracts, we estimate the company should reach beneficial terms by signaling its compromise to invest in the existing network. This model of renewal of terms through investment commitments was successfully carried out for some port concessions.

As for Rumo/ALL's competitive advantages, we believe that the prospect of transporting freight through the northern ports is a real threat to the company's market share, and its current margins on the Mato Grosso-Santos corridor.

On the one hand, we share the same belief underlying Rumo/ALL's business plan, where Brazil's agricultural exports will continue to grow, mainly through the addition of new arable land – where Brazil has an unmatched competitive advantage. On the other hand, we are somewhat more skeptical with respect to the rate of this growth in production, meaning it could be possible that investments in new capacity both from Rumo/ALL and the Northern Corridor coming online around the same time could create a gap between the supply of logistical infrastructure, and demand for these services.

Some high-level numbers below illustrate the competitive potential of the Northern Corridor:

- The state of Mato Grosso (MT) exported 29 Mton of soy and corn in dry bulk in 2015 (35% of Brazil's production). China and other countries in Asia accounted for 55% of those exports.
- Of the 29Mton of soy and corn grains exported by MT in 2015, half passed through the port of Santos.
- Considering only the competition by currently operational terminals operated by Bunge/Amaggi, ADM, and Hidrovias do Brasil, the increase in capacity in the Vila do Conde area is over 10 Mton, attaining up to 18 Mton within the next 5-10 years. This translates into almost 2/3 of the volume currently exported by MT.

The logistics route through the north of Brazil offers potential savings of 20-30% for producers of the regions of Sorriso (MT) and Lucas do Rio Verde (MT) compared to the cost of bulk exporting through the port of Santos.

As a simple theoretical exercise, considering a hypothetical scenario where half of the volume of soy and corn transported by Rumo/ALL to the port of Santos (~6 Mton) is sensitive to this new logistic alternative, and that the Ebitda margin of the Rondonópolis-Santos is around 55% (~BRL 80/ton), potentially maintaining the volumes by cutting prices of rail freight as mentioned earlier (20-30%), could represent a permanent loss of BRL 180-270mln/year (10-15% of Ebitda in 2015).

There are many scenarios which may well arise from the consolidation of this newly inaugurated alternative logistic route. If, on the one hand, the new Northern Corridor will be an important sponsor of the growth of new areas of agricultural production, creating new demand for transport services to ports, on the other hand the offer should exert competitive pressure on Rumo/ALL, affecting both volumes and operating margins.

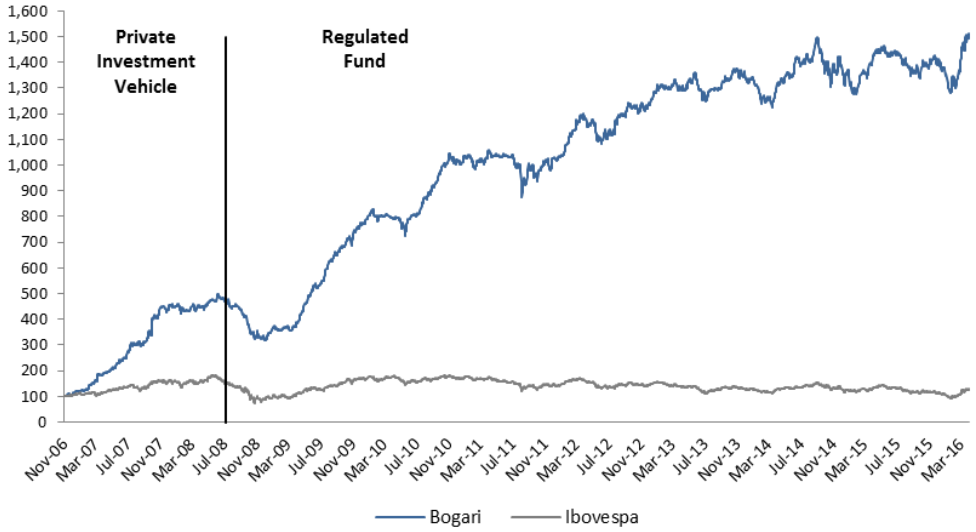
From an intellectual point of view, we consider this to be an interesting and challenging case, due to its layers of complexity and uncertainty. For now, we understand that our small indirect exposure to this asset, through Cosan Limited, is adequate. All the more so because we are paying a sum very close to zero for Rumo/ALL.

Thank you for your trust.

Monthly Returns

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2016	Bogari	-1.9%	3.3%	7.5%										8.9%
	Ibov	-6.8%	5.9%	17.0%										15.5%
2015	Bogari	-6.9%	6.9%	2.7%	3.6%	-2.1%	1.1%	-1.6%	-3.3%	-1.0%	2.0%	0,9%	-1.6%	0.2%
	Ibov	-6.2%	10.0%	-0.8%	9.9%	-6.2%	0.6%	-4.2%	-8.3%	-3.4%	1.8%	-1.6%	-3.9%	-13.3%
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%

Bogari Price(1) x Ibovespa
(Nov/2006 - Mar/2016)



(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	Deloitte Touche Tohmatsu	**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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