BOGARI capital

BOGARI VALUE

Investor Letter 32 – Strategic vs Financial Controlling Shareholders

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 June, we have had a performance in BRL of +13.7% against the benchmark, Bovespa's +4.4%.

Since its inception, the Fund has had an accumulated performance of +3,034% compared with +57% for the Bovespa Index over the same period.

	Annual Performance*		
Year	Bogari	Bovespa	Difference (%)
2017	+13.7%	+4.4%	+9.3
2016	+34.3%	+38.9%	-4.6
2015	2.9%	-13.3%	+16.2
2014	4.3%	-2.9%	+7.2
2013	11.3%	-15.5%	+26.8
2012	33.9%	7.4%	+26.5
2011	3.4%	-18.1%	+21.5
2010	39.2%	1.0%	+38,2
2009	145.4%	82.7%	+62,7
2008	-19.2%	-41.2%	+22.0
2007	278.8%	43.7%	+235.2
2006	18.7%	11.4%	+7.3

	Accumulated Since Inception*		
Year	Bogari	Bovespa	Difference (%)
2017	+3,034.2%	+57.5%	+2,976.7
2016	+2,655.7%	+50.8%	+2,604,9
2015	+1,951.3%	+8.6%	+1,942.7
2014	+1,892.6%	+25.2%	+1,867.4
2013	+1,811.0%	+29.0%	+1,782.0
2012	+1,617.7%	+52.6%	+1,565.1
2011	+1,183.1%	+42.1%	+1,141.0
2010	+1,140.6%	+73.6%	+1,067.0
2009	+791.5%	+71.8%	+719.7
2008	+263.3%	-6.0%	+269.3
2007	+349.6%	+60.0%	+289.6
2006	+18.7%	+11.4%	+7.3

*Gross of Fees

The past 18 months have seen many changes in Brazil. At the onset of 2016 we had a perspective of a worsening economy and a government that seemed unable to change this situation, much less to pass any effective measures in the congress.

We have witnessed the second presidential impeachment in recent history in Brazil, giving start to a sharp turnaround in the country. With a first-rate economic team and a more politically shrewd government, many measures were quickly implemented aiming at stabilizing and kick starting the economy. These included the approval of a spending cap by the government, improved governance in State-controlled companies, changes to oil exploration laws, approval of new labor laws, and the State pensions reform seemingly well underway. Inflation is currently under control and we are going through a monetary easing cycle, with a significant drop in interest rates.

However, the period of calm under Temer did not last long. Following JBS' pleas bargain revelations, we now have a weaker government with less political ammunition to tackle the reforms in their original form.

Despite all the political uncertainty, we believe there is a clear path towards economic recovery. With the continuation of economic reforms, a controlled inflation and falling interest rates are achievements that help consolidate an outlook of improving economic activity. Consequently, we remain positive on the dynamics of earnings and constructive with regards to public equities in Brazil.

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 the differences between companies whose controlling shareholders are either "Strategic" or "Financial".

Portfolio

Following a GDP drop of over 7% in two years, companies as a whole were forced to make significant adjustments in order to survive. We have observed a generalized reduction in personnel, renegotiated rents, reduced staff benefits, various administrative cost cuts, i.e. the companies have done everything they could to survive the abrupt drop in demand.

With this situation, we have an interesting paradox where the recession weakened the financial health of the companies, leading many to bankruptcy, but also making the surviving ones even stronger operationally. With companies now more efficient, any incremental increases in demand for its products or services may lead to a significant recovery in margins. This greater operational leverage should be coupled with a considerable reduction in financial expenses, due to falling interest rates and spreads, leading to a substantial increase in profits for companies. It should not be uncommon to see profits more than doubling in the next few years.

Considering the scenario of important changes in Brazil, our portfolio has undergone some changes, but remains with banks as the largest holdings, in this case Bradesco and Itaú. The worst of defaults seems to have passed, for companies and individuals alike. As we mentioned in an investor letter of 2015, we expected a scenario of increased defaults and losses at the banks, but nothing affecting their competitive stance. This was exactly what happened, with a drop in profits which was not significant. For the next few years their competitive stance is very healthy, with an increasingly concentrated market, and with State-controlled banks lacking the strength to be more aggressive. We expect Bradesco and Itaú will manage to capture more extensively the growing demand for credit.

In the electricity distribution sector, we have acquired a stake in Energisa, following its “re-IPO”. We already knew the company well, through the analyses of our investment in Equatorial, but Energisa has some interesting attributes. The controlling group is a family with extensive experience in the sector. In 2014 the company made a significant acquisition: the assets of Grupo Rede, which are the electricity distributors of the central states of Mato Grosso, Mato Grosso do Sul and Tocantins. Currently the company is focusing on the turnaround of these operations. With a track record of acquisition and integration of several other electricity distributors, we believe the company will deliver good results over the coming years.

Another relevant position in our portfolio currently is Guararapes. It is perhaps the greatest example of a company that comes out stronger from the recession. There was a sequential drop in productivity (sales per sqm) in its stores over the last 3 years, but the company implemented several cost-cutting measures during this time. Among the initiatives we can highlight: optimization of sales staff numbers instore; enhanced collection development process; creation of new displays instore; establishment of a new automated distribution center, allowing for individualized replenishment of stocks (push-pull). Furthermore, there was an increase in categories available instore, with the addition of perfumes and mobile phones. With these initiatives, despite lagging in various aspects behind Renner – the sector’s benchmark – Guararapes should present a significant improvement in profitability, bigger than its peer who suffered less during the financial crisis.

As we always like to point out in our investor letters, our portfolio remains adequately diversified. The largest holding makes up around 8% of the Fund’s assets, while the top 5 positions combined account for 30%. Liquidity is high: we are able to convert over 90% of the Fund into cash within 12 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.

Strategic vs Financial Controlling Shareholders

An aspect we have been observing in the public markets in Brazil throughout the years is that efficient strategic players tend to operate companies better than those with a financial bias do.

Before delving any further into the discussion, we must define what we mean by efficient strategic player, and player with a financial bias. We have defined the former as a group that has been acting for a long time in an industry by managing a company – as a controlling shareholder or not – and possessing extensive knowledge in this sector. Generally, these are originally formed by individual entrepreneurs or family groups who were successful in the industry. As for a player with a financial bias, we see this as a group which considers the investment in a certain company with the primary objective of having a good return on investment over a not very long time frame – the biggest representative of this group are private equity firms.

We have chosen to discuss this theme because it regularly takes a prominent space in our process of evaluating investment opportunities. The objective of this analysis is not to point towards a definitive conclusion on the subject, much less to indicate the characteristic of the controlling shareholder as a definitive parameter for the performance of a company – the subject is too complex and subjective to be generalized. Our goal is to reveal how the profile of the controlling shareholder relates to key attributes for the operational performance of a company and how this question is reflected in our investment decisions.

We have described below some examples taken from the Brazilian markets in order to illustrate some concepts we will be presenting further ahead.

The list does not aim to be comprehensive – there are examples in other industries we have omitted which follow the same concept. Although there are exceptions, examples in different sectors suggest an edge in companies controlled by strategic players. These companies present superior operational consistency through time, allowing a strengthening of their competitive stances. Consequently, these companies are currently perceived as being stronger by the markets. However, the story of each of these companies have their own idiosyncrasies.

We have examples like Ambev, Lojas Americanas and Equatorial, which were built by financial players and today are seen as references by the markets. In cases like Ambev and Lojas Americanas, we have witnessed the transformation of financial players into strategic players, which is rare and therefore difficult to predict.

Industry	Strategic	Financial	Notes
Homebuilders	- Cyrela - Eztec - Helbor	- Brookfield - PDG - CR2 - Viver	- Capital intensive business - Winners are family-controlled businesses with long history in the sector
Shopping Malls	- Multiplan - Iguatemi	- Brmalls	- Strategic players have better capital allocation on expansions and higher commitment to maintenance capex
Telecom	- Telefônica - Claro	- Oi	- Strategic players committed to maintenance capex with low returns in the short term, but fundamental due to technological changes
Education	- Kroton - Ser Educacional	- Anhanguera - Estácio	- Better knowledge of the sector by strategic players, reflected by better operational efficiency
Retail	- Renner - Guararapes - Lojas Americanas - Hering	- Restoque - Inbrands (unlisted)	- Among the strategic players, there is undeniably a discrepancy in operational efficiency, however the focus on the long term and knowledge of the sector enabled their survival
Electricity Distribution	- Energisa	- Equatorial	- Energisa is the industry's efficient strategic player - Equatorial is an exception, a case to be studied in the future
Consumer	- Ambev - M.Dias Branco	- BRF	- Ambev: where the financial player became strategic, also an exception
Sugar & Ethanol	- São Martinho - Raízen	- Odebrecht Agroindustrial (unlisted)	- Strategic players who know the sector dynamics and take coherent long-term decisions - Financial player, product of a consolidation of similar operations
Car Rental	- Localiza	- Unidas	- Strategic player more efficient
Drugstores	- Raia Drogasil	- BR Pharma	- Efficient strategic player, with expertise in integrating acquisitions

As for Equatorial, we have a company which developed a solid culture of success, operating in a regulated sector, where the interests of shareholders and society are aligned. In electricity distribution, this alignment is a result of the economics defined by the regulator, where more investments in the regulatory asset base generate higher returns for shareholders. This has been enabling the company to remain efficient with a good outlook for the future, despite the financially-biased shareholder undergoing transitions.

Coming back to the central point of this analysis, what analogies can we draw between the difference in performance of the companies and the controlling shareholders' profiles? What in a strategic player's management leads to superior results? Alternatively, what elements or biases may be present in a financial player's management that may undermine a company through time?

In our understanding, the reasons stem from three main elements highlighted in this discussion: industry knowledge, time horizon, and focus on short-term cash flow generation. These elements often come into play simultaneously, leading to distinctive decision pathways. "Strategic" companies tend to have a deeper knowledge of the industry, normally work with an extended time horizon, and understand the importance of allocating capital in low-return projects that are important over the long term. That way, their chances of identifying and prioritizing the critical strategic elements of a certain industry are higher.

Alternatively, "financial" companies deliberately (or not) tend to prioritize the short term due to their investment horizons, and often also due to their inability to measure the significance of strategic aspects for the business' long-term competitiveness. Even greater is their difficulty to make decisions that are not clearly supported by financial analysis. It is natural that this difference in the decision-making process, over long periods, would lead to discrepancies in the competitive stance of a company, with consequences in its operational dynamics.

These differences in alignment of time horizons, knowledge and focus on short-term cash flow generation may be observed in a series of critical aspects of a company such as:

- *Investment Policy*: Investments which are necessary to strengthen competitive advantages, but do not present a visible financial return are more likely to be neglected by financial controlling shareholders. Likewise, financially appealing investments may be approved without careful evaluation of execution risks which are more naturally visible to the strategic players with ample sector knowledge. Financial players have a particular handicap with regards to maintenance capex. This aspect is amplified in industries requiring high levels of maintenance. Since the marginal reduction in maintenance capex does not affect operations in the short term, the formula appears to work at first. However, sometime later the company starts to suffer consequences like outdated plants (production, transportation, power or telecommunications), obsolete equipment with lower productivity and unsatisfactory service level. Unfortunately, such cases have occurred in Brazil over the last few years, with financial players gaining on their investments and the companies deteriorating dramatically years later.

- *Transformation of the Industry*: Industries undergoing significant changes to their competitive dynamics – due to new technologies or new players – require complex business decisions. Relinquishing the status quo in order to back a new model is very difficult because as a rule, the new model cannibalizes the existing one, which accounts for the company's profits over the short term. Strategic investors have greater chances of success during such a transition period due to their better understanding of the industry's trends and their focus on the long term. Additionally, financial investors struggle to allocate capital to projects that generate uncertain profits over the long run at the expense of more immediate profits.

- *Cost Management*: Financial players carry a higher risk of undermining a company's competitive stance by employing an overly aggressive focus on cost management. Short-term pressures for profits may lead to cuts that ultimately jeopardize the business, such as the deterioration in the quality of the product, service levels, or an increased risk of reaching a breakdown in the company's operation. While the company's profits may substantially increase over the short term, its long-term competitive stance is compromised.

- *Mergers & Acquisitions*: Strategic controlling shareholders tend to be more cautious in this aspect. Once again, the difference in posture may be related to knowledge and time frame. A financial controlling shareholder is more likely to engage in a corporate operation for the wrong reasons than a strategic player is. Frequently, M&As may be viewed as a shortcut to profits and synergies may be overstated, obfuscating long-term questions like strategic rationale and corporate culture, for example.

- *Organizational Culture/Compensation Policy*: Financial players are more likely to adopt compensation policies which are not aligned with the long-term objectives of the company. Once again, short-term pressures lead to aggressive compensation packages, anchored on schemes rewarding shorter-term profits. Worse yet, aggressive management models and inadequate compensation policies may create a corporate culture which is focused on the short term, where beating annual metrics takes precedence over the long-term development of the company. In strategically-focused companies it is more common to find policies attuned to the long-term interests and, as a consequence, a more stable management team with more extensive experience with the company.

At Bogari we have a special focus on understanding the profile of the controlling shareholder. While there is no dogma on the subject, in light of the points raised thus far we have a clear preference for companies under a strategic controlling shareholder. As always, when it comes to investing there is not a definitive parameter, but we consider this matter to be a significant factor in the risk analysis of an investment. All things being equal, the risk of running into a gradual deterioration of its competitive stance seems higher to us in a financially biased company. The more complex a business, the bigger the risk associated with the controlling shareholder's profile. Historically, this preference is reflected in our results.

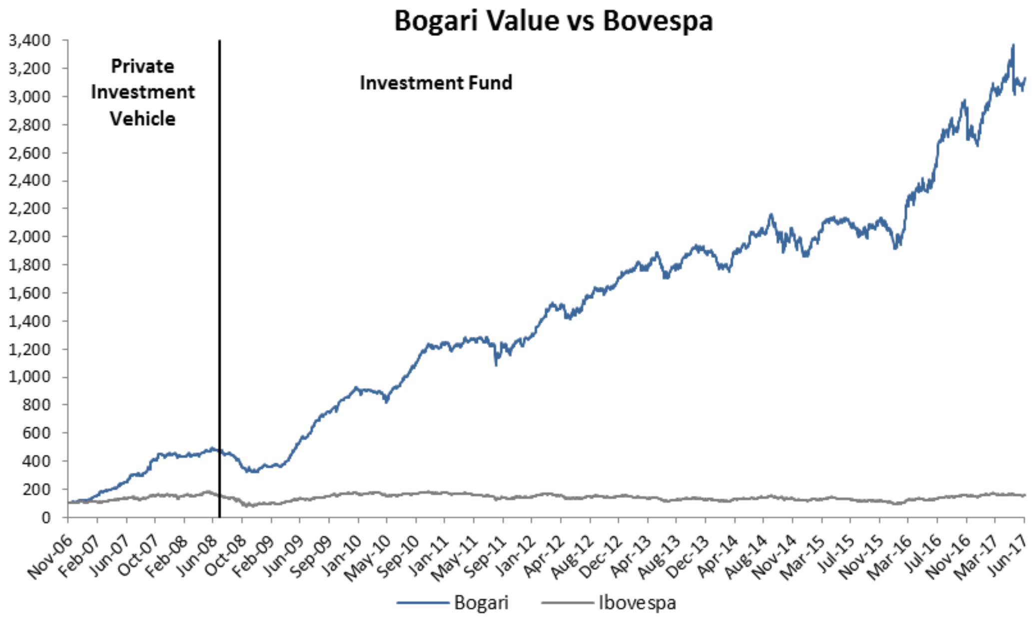
We have not had – to date – significant losses in situations arising from issues pertaining to financially-biased controlling shareholders – most likely as a consequence of appropriate risk assessment and demanding an adequate price for the asset. At the same time, we have accumulated significant gains investing in companies boasting strategic controlling shareholders – often these gains are simply due to the company's operational coherence, which enabled it to post outsized returns to its stock. Other times they were a result of the opportunities where we benefitted from investing at prices where the advantages of the strategic controller were being neglected by the markets, due to short-term obstacles transiently impacting the profits of these companies.

For all the points presented here, we prefer companies "with an owner", often in spite of a controversial controlling shareholder. That way, we can count on a seasoned specialist taking strategic long-term decisions, enhancing the probability of success over the life of our investment.

Thank you for your trust.

Monthly Returns (BRL – Gross of Fees)

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2017	Bogari	6.2%	4.3%	1.5%	3.9%	-3.2%	0.6%							13.7%
	Ibov	7.4%	3.1%	-2.5%	0.6%	-4.1%	0.3%							4.4%
2016	Bogari	-1.8%	3.5%	9.7%	2.9%	-1.3%	7.5%	9.2%	1.9%	-1.2%	8.3%	-6.3%	-1.2%	34.3%
	Ibov	-6.8%	5.9%	17.0%	7.7%	-10.1%	6.3%	11.2%	1.0%	0.80%	11.23%	-4.6%	-2.7%	38.9%
2015	Bogari	-6.7%	7.1%	3.4%	3.4%	-1.5%	1.4%	-1.4%	-3.1%	-0.8%	2.3%	1.1%	-1.5%	2.9%
	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	-5.7%	-0.3%	3.6%	1.9%	1.7%	4.4%	0.4%	6.7%	-7.5%	1.3%	2.0%	-3.5%	4.3%
	Ibov	-7.5%	-1.1%	7.1%	2.4%	-0.8%	3.8%	5.0%	9.8%	-11.7%	1.0%	0.2%	-8.6%	-2.9%
2013	Bogari	2.1%	2.3%	0.1%	1.9%	1.6%	-6.0%	2.0%	1.2%	3.4%	3.9%	-0.1%	-1.4%	11.3%
	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	6.8%	6.4%	3.3%	1.1%	-5.1%	1.6%	4.7%	2.3%	2.5%	0.5%	2.1%	3.9%	33.9%
	Ibov	11.1%	4.3%	-2.0%	-4.2%	-11.9%	-0.3%	3.2%	1.7%	3.7%	-3.6%	0.7%	6.1%	7.4%
2011	Bogari	-1.8%	0.9%	2.7%	1.3%	0.7%	-1.0%	-2.7%	-1.9%	-1.7%	4.4%	1.0%	1.8%	3.4%
	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	1.1%	-0.1%	-0.8%	-0.5%	0.1%	3.4%	9.0%	6.1%	6.9%	5.7%	1.5%	1.7%	39.2%
	Ibov	-4.7%	1.7%	5.8%	-4.0%	-6.6%	-3.4%	10.8%	-3.5%	6.6%	1.8%	-4.2%	2.4%	1.0%
2009	Bogari	-1.0%	5.8%	-0.8%	22.1%	15.9%	7.1%	17.5%	8.4%	3.2%	3.8%	8.9%	4.9%	145.4%
	Ibov	4.7%	-2.8%	7.2%	15.6%	12.5%	-3.3%	6.4%	3.2%	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%	-7.2%	-0.6%	-12.8%	-12.8%	-0.4%	8.1%	-19.2%
	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											5.2%	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%
Auditor	KPMG Auditores Independentes	**Performance Fee**	20% over Ibovespa (w/ high watermark)
Minimum Investment	R$ 50,000.00	**Anbima Identifier**	212962
Minimum Balance	R$ 50,000.00	**Classification**	Equities Ibovespa
Minimum Transaction	R$ 10,000.00	**NAV**	Close of Business Day

Rua Jardim Botânico, 674/523 | Jardim Botânico | Rio de Janeiro - RJ | Tel 55 21 2249-1500
www.bogaricapital.com.br
BNY Mellon Serviços Financeiros DTVM S.A. (CNPJ: 02.201.501/0001-61)
Av. Presidente Wilson, 231, 11º andar, Rio de Janeiro, RJ, CEP 20030-905
Telefone: (21) 3219-2500 Fax (21) 3974-2501 www.bnymellon.com.br/sf
SAC: sac@bnymellon.com.br ou (21) 3219-2600, (11) 3050-8010, 0800 725 3219
Ouvidoria: ouvidoria@bnymellon.com.br ou 0800 7253219