

**BOGARI VALUE**

Investor Letter 23, Quarter 3 2012 – Electricity Sector

Bogari Value FIA is an investment vehicle focused on equity investments in Brazilian public companies. The fund's objective is to provide its clients with long-term capital appreciation by investing in companies whose stocks are trading at a substantial discount to intrinsic value.

**Our Performance**

Up to August 2012, Bogari Value's performance was +15.7%, against Ibovespa's +0.5%.

Since inception<sup>1</sup>, our total return was +1,090%, compared to +43% from Ibovespa. During this period, our NAV per share appreciated to BRL 1,190 from BRL 100.

Year	Annual Performance		
	Bogari	Ibovespa	Outperformance(%)
2012	15.7%	0.5%	+15.1
2011	-0.5%	-18.1%	+17.6
2010	29.5%	1.0%	+28.5
2009	122.0%	82.7%	+39.3
2008 <sup>(1)</sup>	-20.1%	-41.2%	+21.1
2007 <sup>(1)</sup>	278.8%	43.7%	+235.2
2006 <sup>(1)</sup>	18.7%	11.4%	+7.3

Year	Accumulated Since Inception		
	Bogari	Ibovespa	Outperformance(%)
2012	1,089.8%	42.9%	+1,046.9
2011	928.4%	42.1%	+886.3
2010	933.3%	73.6%	+859.7
2009	697.8%	71.8%	+626.0
2008 <sup>(1)</sup>	259.3%	-6.0%	+265.3
2007 <sup>(1)</sup>	349.6%	60.0%	+289.6
2006 <sup>(1)</sup>	18.7%	11.4%	+7.3

The shape of the equity markets has not changed much in the past two months. What we wrote in our last letter still stands, therefore we decided to restate it below:

*"In the past few months, markets have continued to follow the path of uncertainty..."*

*We continue to seek assets with an asymmetry in risk-return, i.e. with a low probability and intensity of a drop. We maintain our caution with regards to the deployment of capital in the fund, as we believe it is not unlikely there will be better opportunities for buying assets through the course of the year.*

*Notwithstanding, our portfolio continues to hold good assets at adequate prices and we believe that staying the course on our strategy – which translated into smaller drawdowns and consistently positive performance – should bring us good returns in the long run."*

In general, our investor letters are organized by sections, the first section being dedicated to update our performance, followed by a brief update on the portfolio, and lastly a section dedicated to general topics, related to companies or the general economy, which we believe to be worth sharing with our investors.

In this issue, we will comment on the electricity sector in Brazil.

**Portfolio Commentary**

Throughout the year, we gradually sold assets which have significantly increased in value and buying assets with better asymmetry. We are currently analyzing various companies and revisiting others, but we have not yet significantly increased our equity exposure.

Following the release of second quarter's earnings, we have had confirmation that the Brazilian economy was decelerating.

Itaú's earnings had no surprises, with reduced provisions towards NPLs. We are seeing great pressures on government-controlled banks to reduce spreads, but we believe privately controlled banks will not follow this pattern with the same intensity. Apparently, the privately controlled banks will only follow the rates insofar as to keep competitive, waiting for the government banks to run out of steam. The latter – with weaker balance sheets – should not hold the pace of accelerated growth in loans for too long. Itaú is doing its homework: improving its efficiency and focusing in lower risk products. Therefore, next year we should see lower growth compensated by lower provisions due to this improved vintage in credit. In some years we will probably see privately controlled banks that are stronger, and government ones recapitalized.

Grendene confirmed its trajectory of recovery and sales growth. Despite the second quarter generally being the softest in the year, the company posted strong sales volumes domestically and one of its highest margins for the quarter. The positive trend should continue for the remainder of the

<sup>1</sup> The vehicle was founded on 1 Nov 2006 as a private investment vehicle. On July 8, 2008 it was transformed into Bogari Value FIA.

year, with the company benefitting from a potential recovery in retail sales as a whole.

Brasil Insurance posted significantly better earnings than the previous quarter, showing a recovery in the issuance of new insurance premiums. Acquisitions – another pillar for growth – still falls short of expectations, but it is possible it will pick up pace and the company can attain its goal of BRL 200mn in acquisitions in 2012. Brazil Insurance’s challenge has been organic growth, but given the insurance sector is displaying good growth, the company should at least match the pace of the market.

Kroton posted good numbers, continuing its gradual improvement in margins. New student intake has happened mostly via the federal government student loan program (FIES), which translates into smaller delinquency and dropout rates. Distance learning is benefitting from the fact that new programs are being held back by the regulator, which has been doing overarching work in adjusting the standards of this type of operation. However, we expect competition in distance learning will intensify, putting pressure on the company’s future earnings. The sector is going well, and Kroton in particular is one of the stocks which have risen the most this year.

As we like to emphasize in our letters, we like to keep our portfolio adequately diversified. Our largest position is currently 9% of AUM and top 5 combined are around 30% of AUM. We maintain high liquidity, holding a 30% cash-position and being able to sell 90%+ of our holdings in 5 days.

We continue to hold good assets in our portfolio, at compelling valuations and interesting perspectives for the next few years. Additionally, we are positioned to take advantage of a potential market devaluation.

## Electricity Sector: Intention, Form, and Risk

And our president has defined the principles of renovation of generation, transmission and distribution concessions which have expired between 2015 and 2017...

The theme is rich, interesting and very technical, therefore as usual, we will try to be concise and to keep it simple, avoiding to overstretch ourselves.

The Brazilian electric system is subdivided between generation, which generate electricity; transmission, which brings the electricity from the generating plants to the consumption centers; and distributors, which receive this electricity wholesale and take them to retail consumers.

Due to Brazil’s physical dimensions and its potential in hydro power generation, the development of the sector happened in a centralized manner. In the past, the federal government, through Eletrobrás, has coordinated and executed investments in large hydroelectric plants and in the integrated transmission system in order to direct this electricity to the consumer centers. Additionally, it was responsible for a centralized dispatch system in order to

coordinate and maximize generated power as a whole. Regional companies – mostly with government-controlled capital – retained responsibilities for distribution to end consumers. Little by little some of these companies started to invest in generation and transmission assets, in order to support their local economies – the main ones being Cesp, Cemig and Copel – which acquired relevant generation assets.

With a reduced investment capability from the states, the government-backed model weakened and various assets were privatized. However, contrary to the telecom sector, sales of assets started in 1995 without a regulatory framework in place. The same year, the General Concession Law was approved, dictating that concessions had to be bid for. The following years, the regulatory framework for the sector was developed giving rise to the current model in 2004. The transition between the old and new models, based in concessions, had some adjustments. Specifically, for the electric sector, another law was used to regulate the concessions of services that had been in place, extending or awarding another 20-year terms to assets already in operation.

Those concessions which were awarded the 20-year term following the General Concession Law of 1995 will be expiring between 2015 and 2017. The subject is not new and its parameters are fundamental to generate predictability for the sector. For this reason, over the last few years, an intense debate involving representatives of the main stakeholders (concession holders, industries, other consumer segments, and the government) has been taking place.

The main alternatives discussed for the renovation of the concessions were: reducing as much as possible the price of electricity generated by the older plants, passing this benefit on to society, or adopting a model of marginal cost of expansion of the system. The final choice was the first option.

In adopting this alternative, and additionally trying to reduce other taxes in the sector, a choice was made to try to tackle a structural problem in Brazil: the high cost of electricity to consumers. For energy-intensive sectors this is very beneficial as it reduces the cost per unit of the products generating more competitiveness, which is very positive as it contributes to reducing what is commonly known as the “Brazil cost”. On the other hand, by reducing the expense of household consumption, the use of residential electricity is stimulated for a marginal price that does not reflect the marginal cost of expanding the system. However, the result is undoubtedly a very positive measure.

A change of this magnitude generates consequences in the markets that we must try to understand. If, on one side of the equation, society benefits, on the other, concessions and, indirectly equity markets can suffer with these measures.

Electricity tax cuts have a relevant impact on final consumers, but marginal for the concessions since these merely acted as collecting agents on behalf of the Government.

The change in electricity prices sold by the generators and the reduction in permitted transmission revenues may have a considerable economic impact for the companies. According to the guidelines released, assets whose concessions expire between 2015-2017 which are fully depreciated. At their renovation, may not be remunerated for depreciation or cost of capital. Concession holders would have been eligible to receive amounts pertaining to – “among others” – costs of operation and maintenance of the assets. Assets which have not been fully depreciated shall be indemnified by the Federal Union according to a set of criteria established by the regulator, Aneel, or would continue to be remunerated until the term of depreciation (a rule that was not widely divulged). Since there are too many pending details, there will be an intense debate on how tariffs and compensations will be calculated.

Some comments are necessary. First, despite the fact that the transfer of amortization benefits to the society being a positive factor, it is likely that some injustices have been committed. In transmission, Cemig has assets which were built in 1999, which should not have been included in the general rules defined by the package, since its regulatory base had been revised in 2009. As for generation, there are concessions held by Cemig, Cesp and Eletrobrás containing a significant share of non-depreciated assets. In this case, the debate lies on whether or not there has been a prior non-onerous renewal of concessions, since the procedure had been happening for similar assets<sup>2</sup>.

Secondly, the calculation of indemnity values of assets reversible at the end of the concession term has always been a contentious issue, be it for telecoms or others. In one way or another, the debate has been avoided due to its complexity and the high sums involved. Now the matter will be debated and a precedent will be set for future cases. Chances of legal challenges are high and, depending on their outcome, may interfere in the perception of risk in investing in Brazil.

Third, management of the assets post renewal should, in theory, be a remunerated service. However, this was not announced and is not explicitly provisioned for in the text of the Provisional Measure. Therefore, we have trouble understanding the motivation for a group's willingness to manage an asset which, despite having zero economic and book-keeping value, has a replacement value of many millions. Especially considering there will be quality and availability demands placed on the operator. This topic will no doubt have to be discussed at length and possibly, this service would turn into a reasonably attractive business. Otherwise the government will risk having to nationalize the concessions and manage the assets, which is not good, or an ill-intentioned group will accept managing the assets in order to obtain unorthodox advantages, which is even worse.

What is curious is the fact the text of the Provisional Measure 579 is more flexible than its earlier announcement.

Therefore, it may be possible to negotiate a tariff which remunerates non-depreciated assets and, even if trivial, an amount for management services.

In general, it seems the initially leaked highlights seemed worse than what was finally announced, both through the Proposed Law, as well as the need to negotiate language which is acceptable to Congress. Sometimes, due to immaturity, Brazil still believes someone will work for free, and what we see in the end is a greater cost to society<sup>3</sup>. In conclusion, the intentions were good, but the form was bad, somewhat more radical than what was prudent and necessary.

There is still a lot of number-crunching to be made, and much discussion around the issue. It is most likely that in time, common ground will be reached, turning the business marginally attractive to the current concession-holders.

With regards to the public markets, what is almost unbelievable is that in spite of the uncertainties over the concession renewals, few analysts and investors believed that the most severe solution proposed by the government would actually be the chosen one. In the end, the least likely and highest impact scenario took place.

As we know, human beings tend to be optimistic and perpetuate the *status quo*, which in this case is represented by the renewal of the concessions at similar conditions to the original contract, as was usually the case.

Additionally, assets with a good track record of paying dividends, and presenting low volatility in their accounts appear to be stable and low risk, which makes them popular investments.

By breaking with these expectations, the government caused a strong correction in the sector, simply because part of the economic value that was previously taken into account in valuation models of those companies – perhaps equivocally – no longer existed.

This is a clear illustration of the premise that risk is relative. From the point of view of share volatility and operational results, the risk of companies in the electric sector should be low. Such is the case that it is common market practice to assign a lower discount rate for these companies.

Additionally, consistent dividend payments by those firms lead some investors to believe such assets have an economic value above reality. The fact is that evaluating regulated companies seems like an easy task, but it is not. The reason being, that the logic of asset value is tied to regulations, and to definitions made by the conceding authorities, and not to any multiples, such as dividend yields.

On principle, we use the purchase price of a share as the main risk mitigator. In this case, we did not see a discount in the price of assets, as they already priced very low returns. In other words, the assets were expensive. It is possible that

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<sup>2</sup> The renewal of the hydroelectric planta t Serra da Mesa of Furnas on April 30th 2014 – a little over 4 months prior to Provisional Measure 579.

<sup>3</sup> A reminder to our readers of the case of road concessions in 2008, where toll rates offered were extremely low, but what we have seen as a result were few investments and improvements to the operations.

an expensive asset becomes even more expensive, or that it's operational performance is so good as to justify paying a premium. However, we do believe that in the majority of cases the risk is not worth bearing.

What we have seen in the case of the electric companies was that, since they were mostly priced above their real

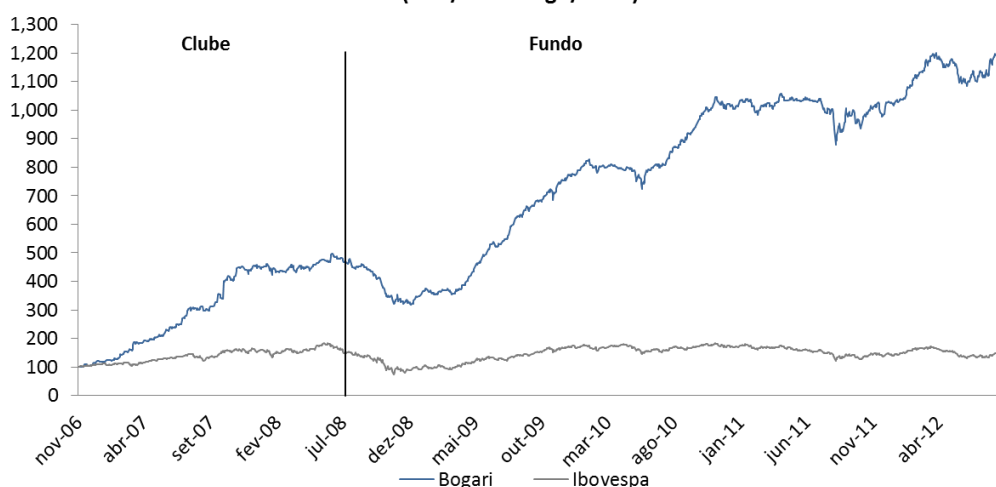
value, the change in expectations adjusted the prices in the market. For many investors, it is possible that this loss was a permanent one.

Thank you for your trust.

## Monthly Returns (BRL – Net of Fees)

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2012	Bogari	5.9%	5.9%	2.2%	0.0%	-6.0%	1.1%	4.3%	2.0%					15.7%
	Ibov	11.1%	4.3%	-2.0%	-4.2%	-11.9%	-0.2%	3.2%	1.7%					0.5%
2011	Bogari	-2.0%	0.7%	2.1%	0.3%	0.0%	-0.9%	-2.9%	-2.1%	-1.9%	4.2%	0.8%	1.5%	-0.5%
	Ibov	-3.9%	1.2%	1.8%	-3.6%	-2.3%	-3.4%	-5.7%	-4.0%	-7.4%	11.5%	-2.5%	-0.2%	-18.1%
2010	Bogari	0.0%	0.0%	-0.4%	-0.7%	-0.1%	1.2%	8.7%	4.4%	6.7%	4.8%	0.3%	1.7%	29.5%
	Ibov	-4.6%	1.7%	5.8%	-4.0%	-6.6%	-3.3%	10.8%	-3.5%	6.6%	1.8%	-4.2%	2.4%	1.0%
2009	Bogari	-1.2%	5.5%	-0.9%	21.3%	12.3%	5.1%	15.1%	7.3%	4.0%	3.0%	8.7%	4.2%	122.0%
	Ibov	4.7%	-2.8%	7.2%	15.6%	12.5%	-3.3%	6.4%	3.1%	8.9%	0.0%	8.9%	2.3%	82.7%
2008 <sup>(1)</sup>	Bogari	-3.6%	3.9%	-1.2%	3.1%	2.5%	2.2%	-7.3%	-0.8%	-12.9%	-13.0%	-0.6%	7.8%	-20.1%
	Ibov	-6.9%	6.7%	-4.0%	11.3%	7.0%	-10.4%	-8.5%	-6.4%	-11.0%	-24.8%	-1.8%	2.6%	-41.2%
2007 <sup>(1)</sup>	Bogari	9.4%	25.7%	14.4%	9.7%	16.3%	13.9%	11.3%	3.3%	8.8%	28.6%	0.6%	2.4%	278.8%
	Ibov	0.4%	-1.7%	4.4%	6.9%	6.8%	4.1%	-0.4%	0.8%	10.7%	8.0%	-3.5%	1.4%	43.7%
2006 <sup>(1)</sup>	Bogari											5.1%	12.9%	18.7%
	Ibov											5.0%	6.1%	11.4%

Valor da Cota Bogari<sup>(1)</sup> x Ibovespa  
(Nov/2006 - Ago/2012)



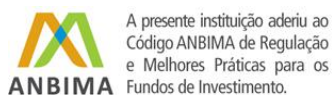
(1) Bogari Value was launched as a regulated private investment vehicle in November 1, 2006. In July 8, 2008, the vehicle was converted into Bogari Value FIA

## 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>	KPMG Auditores Independentes	<b>Performance Fee</b>	20% over Ibovespa (w/ high watermark)
<b>Minimum Investment</b>	R\$ 50,000.00	<b>Anbima Identifier</b>	212962
<b>Minimum Balance</b>	R\$ 50,000.00	<b>Classification</b>	Equities Ibovespa
<b>Minimum Transaction</b>	R\$ 10,000.00	<b>NAV</b>	Close of Business Day

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In order to comply with applicable law, all investors must provide to the administrator copies of their identification documents prior to investing in the fund.



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