BOGARI
capital

BOGARI VALUE

Investor Letter 33 – Post-Crisis Recovery

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 +5.4% against the benchmark, Bovespa's +11.7%.

Since its inception, the Fund has had an accumulated performance of +3,748% compared with +114% for the Bovespa Index over the same period.

	Annual Performance*		
Year	Bogari	Bovespa	Difference (%)
2018	5.4%	11.7%	-6.3
2017	32.5%	26.9%	+5.6
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 (%)
2018	3,748.3%	113.8%	+3,634.5
2017	3,551.9%	91.3%	+3,460.6
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 year 2017 and the beginning of 2018 saw a continued recovery of the Brazilian stock market, despite the mishaps along the way. The stock market, as it always does, anticipated the impact of the improvement of the economic environment in the country, with the approval of reforms, improved governance in state-owned companies, controlled inflation and a significant drop in interest rates. At the end of the year, we saw several indicators showing an actual recovery. Corroborating this scenario, company earnings have also shown significant improvement.

Despite the significant rally, the outlook for public equities is still good for 2018. Looking at the micro side, i.e. our analyses of the companies, we see relevant improvements in results, which should continue to support the good momentum for stocks. As this topic is extensive and quite interesting, we have decided to use this specific letter to explain why we remain optimistic about the prospects for companies over the coming years.

However, there are still some important risks. This year we have presidential elections where the candidates are still undefined and, so far, we do not know how the political forces will gather. So far, it seems likely a reformist government will win and carry on with the current economic policies. If, on the one hand, the most important reform – of State pensions – has not yet been approved, on the other hand there is a belief that the next government, whatever it may be, will do so. However, we expect turmoil along the way, which is natural in such an open electoral race.

A second risk is the current global economic scenario. Despite robust growth, movements in the US and China can have major impacts on Brazil. With excess liquidity worldwide and renewed appetite for risk, significant volumes of capital are flowing to emerging markets and, consequently affecting Brazil. It is hard to say how for long these flows will continue, but they have been quite beneficial to the stock market as seen in the first quarter of 2018.

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 talk about the post-crisis recovery of companies.

Portfolio

The main positions of the portfolio have not changed much recently, but we have an extensive pipeline of opportunities and new analyses. We already have smaller, newer positions that are good candidates for becoming relevant positions in the near future.

Energisa has become the largest position in our fund recently. The investment case was based on: (i) turnaround of the acquired operations of the Rede Group, (ii) strong investment to increase the regulatory base of these companies and (iii) deleveraging. There were also some

optionalities such as: taking minority interests in the acquired subsidiaries; new acquisitions of distributors and new generation and / or transmission projects. This case was still based on the fact that the company was managed by what we call an "efficient strategic player", as discussed in our last letter (issue #32). When we invested in the company during its re-IPO, we were very clear on what to expect for the development of the company – the case developed better than expected.

The results of the Rede Group distributors acquired in 2014 showed great improvements: the tariff revision was exceptional (with the recognition of the regulatory base) and the debt is under control. Some of the optionalities also materialized, such as the acquisition of minority interests in the distributor of the state of Mato Grosso, which was made at an attractive price. With this, the company has delivered consistent results and the market, recognizing this, started to price the company on another level, giving it a seal of "quality" similar to what it attributes to Equatorial, one of its peers. We still see improvements ahead and a risk-adjusted return on the company.

Another company that has delivered good results is Guararapes. The internal changes in the company are having an effect and the profitability of the business is increasing. After the implementation of the replacement of stores per unit sold (push-pull), the results have been encouraging. Gross margin seems less pressured by markdowns, sales grew at a healthy pace and working capital declined significantly. With the resumption of the economy, we expect the company to continue to improve its results.

With regard to banks, our scenario of normalizing risks in their portfolios and loosening of credit lines and less competitive pressure from public banks seems to be occurring. This should lead to continued good growth in profits for banks over the coming years. However, stock prices are anticipating part of this future improvement and as a result, we have reduced our holdings.

As we always like to point out in our investor letters, our portfolio remains adequately diversified. The largest holding makes up around 9% of the Fund's assets, while the top 5 positions combined account for 28%. Liquidity is high: we are able to convert over 90% of the Fund into cash within 13 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.

Post-Crisis Recovery

Although markets have already risen considerably in the last 18 months, we remain generally excited, with the usual caution. This enthusiasm comes from a set of micro and macroeconomic factors that affect the operations of companies, supported by a flow of capital that is only now beginning to occur. Undoubtedly, the positive vectors associated with improvements outstrip the negative ones in the most likely scenario. In this context, the most crucial point for our investment process is understanding some of the factors that affect each of our companies during this post-crisis phase. In general, the main aspects to be understood can be grouped in: (i) competitive dynamics / market share evolution; (ii) reduction of expenses and gain in operating efficiency, (iii) deleveraging and reduction of financial expenses.

Competitive Dynamics

Brazilian society as a whole has suffered greatly from the almost 10% per capital GDP during the crisis. Individuals lost their jobs or saw their incomes reduced and, consequently, had to make deep cuts in their budgets. Companies went through a similar situation and many failed to survive, closing their doors and leaving the market altogether. Most of those managing to navigate the crisis have had to make deep spending cuts and downsize. These two effects – the mortality of competitors and the consequences of spending cuts – have significantly affected the competitive dynamics of the markets.

At the end of the crisis, companies that have survived and maintained their capacity to generate revenues will benefit doubly. First, from the growth of the economy as a whole and second through market-share gains, assuming they have prepared for it. Economic growth, on average, affects companies proportionally to their markets, industry and geography. Competitive dynamics, however, vary according to the set of decisions taken by companies in each of these local markets. The effect in each sector will depend on the number of players that will continue to operate in the market and the decision taken by each company on how to reduce its spending structure.

Cutting expenses is not an obvious process as it can generate unwanted effects. If on the one hand it increases profitability in the short run, on the other hand it can generate a loss of revenue potential during the recovery phase. The ideal is to cut costs without affecting the company's ability to generate value.

For example, we assume that a retail company has a network of stores and manages to cut costs by reducing its store expenses, either renegotiating the rent or reducing its staff by redesigning processes. When it comes out of the crisis, with the return of demand, its revenue and margins will be higher, benefiting company earnings. Another solution would be for the company to reduce the number of stores by closing down the ones with poor results. Although this decision generates a gain in the short term by reducing its losses during the crisis, during the recovery its capacity to generate results will be stunted, because it will have lower sales potential.

Therefore, the quality of the expense cuts will affect the performance of each company during the recovery phase, depending on how their capacity to generate revenue was maintained. Below are a few concrete examples:

- Leading apparel retailers gained 10% market share due to the closure of competitors' stores. As a rough estimate, let's imagine that there were 100 stores with equal sales spread throughout the country before the crisis. Due to the severity

of the crisis, nine stores shut down. As a consequence, the market share of the surviving companies grows around 10%, since those sales were redistributed among the survivors. Thus, with sales recovering, survivors will sell proportionally more than before.

- Several infrastructure service providers have left some markets, both because they have gone bankrupt and because they have reduced their geographic footprint. Once again, let us imagine that in a certain city there were four infrastructure service providers of equal size, where their "fair share" would be 25%. If one of them closes its subsidiary, the remaining services are redistributed among those who have survived, raising their "fair share" to 33%. Therefore, the market with three participants generates a better competitive and financial equation than one with four participants, as there will be a greater use of local assets and a greater dilution of overheads.

In short, the survivors came out stronger from the crisis, as they will have a larger market share than previously. Moreover, their revenue growth will benefit both from this effect and from the growth of the economy as a whole.

Efficiency Gains

Another effect of the strong adjustment that companies have made in recent years has been a greater level of operational efficiency. This may have been due to gross margin gains or SG&A reductions. In any case, the sum of this improvement generates an important operational leverage for the companies. This means that for any given revenue growth there will be an even greater increase in EBITDA.

As each company and sector has different cost allocations, for simplicity's sake we will comment on the reduction of expenses (costs and expenses) as they are variable (or semi-variable) or fixed, relative to revenue. In general, we can say that the companies had no qualms in cutting costs. Every expense was reevaluated – there were no sacred cows or taboo subjects. Among the variable (or semi-variable) expenses, there were operational gains from the reduced use of resources and the renegotiation of unit values of these resources, generating higher margins.

In general, all companies tackled workforce reductions, reductions in average wages through the dismissal of more expensive personnel and contracting of cheaper personnel, reduction of benefits (including healthcare plans), renegotiation with suppliers, cancellation of software licenses, reduction of promotional and marketing expenses, etc. On the other hand, gains in productivity by achieving more with less was also favored. Again, to illustrate some of these measures, below are some examples:

- Education companies have made a strong effort to dilute the semi-variable cost with teachers. To do so, they increased classroom sizes, adjusted the course curriculum, and began to rely more on distance-learning resources.

- Retail companies renegotiated with their merchandise suppliers, sought rent reductions with shopping malls, and reduced staff.

- Banks continued their process of closing branches, reduced staff, renegotiated with suppliers, etc.

A practical case in our portfolio is Guararapes. Throughout the crisis it has implemented various initiatives to increase operational efficiency. It reduced the number of employees in stores, from 38 to 48 m^2 / employee; implemented the replacement model by SKU (push-pull) significantly reducing store inventory; implemented improvements in store models; reinforced the planning and processes for new collections. The company's 4Q17 result has already demonstrated the potential for efficiency gains and operating leverage: the company's revenue grew 9%, while its (adjusted) EBITDA increased 32%.

In summary, companies were more efficient, with a large capacity to improve results in terms of operating leverage, regardless of the speed of revenue growth.

Reduction of Financial Expenses

Reductions in financial expenses have occurred in a very strong way for three reasons: reduction of interest rates and inflation, spread and leverage. The average base interest rate dropped from around 14% in 2016 to 10% in 2017 and less than 7% in 2018, down nearly 30% each year. The spread paid by companies has also been dropping consistently in the past year. The main reason is that companies are accessing the capital market directly, raising funds via debentures (tax exempt or not), and receivables certificates at much lower costs. Even borrowing costs at traditional banks have been dropping significantly. Finally, leverage was also reduced. Companies have worked hard to increase their results (EBITDA, for example), generate cash, demobilize assets, and adjust their capital structure.

An interesting example is Energisa. In 2014, when the company purchased the Rede Group, it issued simple debentures to the tune of BRL 1.5 bn. In 2016, prior to its re-IPO, it negotiated with BNDES a set of debentures at a time when the capital market was practically closed to companies. Part of these debentures are simple and others have a right to convert into shares of the company. The simple debentures were negotiated with BNDES at a rate of CPI + 9% pa. However, in 2016, Energisa did not comply with its covenants and the compensation was increased to CPI + 10.25%. By way of illustration, the inflation rate in 2016 was 6.28%, which took the nominal financial cost of this instrument to 16.53% pa.

With the reopening of capital and operating improvement of the group companies, Energisa returned to the capital market, raising increasingly cheaper debt. In 2017, for example, it issued debentures at an average cost of 105% of the base interest rate p.a. (swap), currently equivalent to a 7.1% p.a. In this example, there was a marginal saving of 57% in the financial cost of debt.

This example of Energisa is not unique, companies as a whole are benefiting from improved credit and deleveraging conditions, boosting their cash generation.

As a consequence of the 3 factors mentioned above – the improvement of the competitive dynamics / market share evolution; reduction of expenses and gain in operating efficiency and deleveraging with reduction of financial expenses – we have a number of companies well positioned to present a solid improvement in results in the coming years.

To illustrate the impact of these factors on corporate profits, we will use a hypothetical example of a company A. We assume that this company operated in the year 2016 with a depressed profit because of the crisis. Considering a growth in its market of 2% per year, and a market share gain of 5% per year, the company's revenues grow in the order of 7% pa.

With the effect of operating leverage – assuming in this case 80% of fixed costs – much of the revenue is translated into EBITDA. Thus, EBITDA growth is much higher than that of revenue (~20% vs. 7%). At the same time, the effect of reducing financial expenses further boosts profit growth. In this example, with the company having an initial leverage of 2x Net Debt / EBITDA, and debt costing 100% of the base rate, the financial expense falls by half in two years. With that, the ultimate effect for the company is that its profit doubles in two years, even with modest revenue growth.

	2016	2017	2018
Market	100,000	103,000	106,090
Growth		3.0%	3.0%
Mkt Share	10.0%	10.5%	11.0%
Net Profits	10,000	10,815	11,670
Growth		8.1%	7.9%
Ebitda	2,500	2,945	3,413
Ebitda Margin	25.0%	27.2%	29.2%
Growth		17.8%	15.9%
Financial Expenses	-700	-497	-340
Interest Rate	14.0%	9.9%	6.8%
Profit	990	1,418	1,830
Growth		43.2%	29.1%

Figure 1: Hypothetical example of the impact of a modest resumption of growth in demand, combined with efficiency gains, market share, and falling financial expenses.

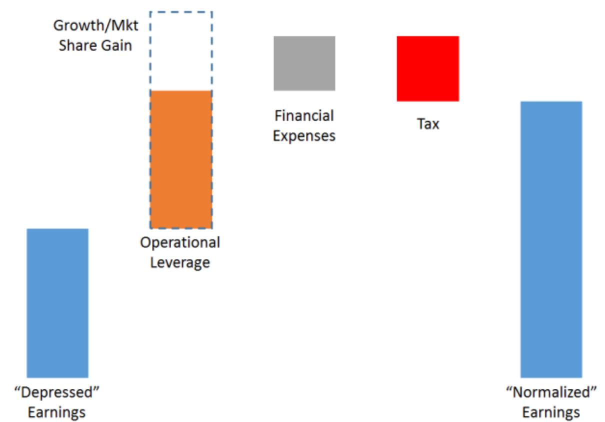


Figure 2: Impact of operational leverage and reduction of financial expenses on the normalization of profits.

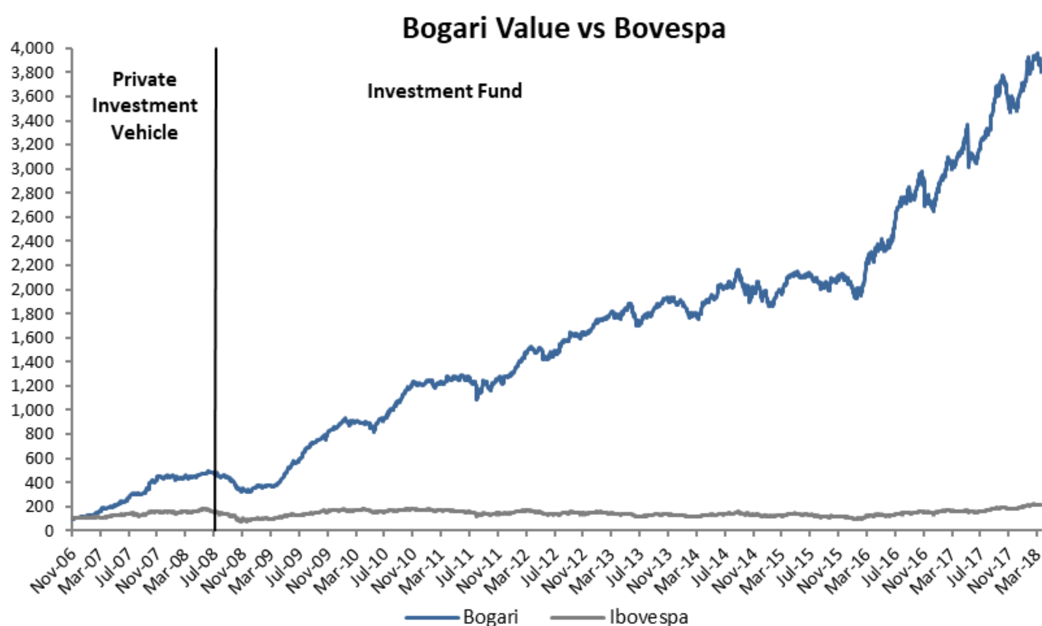
Coupled with this strong improvement in the fundamentals of the companies, we also have potentially a strong flow of capital coming to the stock market. The drop in interest rates to record lows mean that there is greater demand for assets with better return potential. As investors in general are at a lower than average level of equity exposure, we should see further inflows into the asset class over the next few years. Thus, the flow of investment in shares will be supported by the significant improvement in the fundamentals of the companies, giving sustainability to the valuation of the assets.

We believe that several companies in our portfolio will benefit from the recovery factors we have described. Additionally, as stock prices tend to follow the fundamentals of companies, we are excited about the current outlook.

Thank you for your trust.

Monthly Returns (BRL – Gross of Fees)

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2018	Bogari	6.7%	0.2%	-1.5%										5.4%
	Ibov	11.1%	0.5%	0.0%										11.7%
2017	Bogari	6.2%	4.3%	1.5%	3.9%	-3.2%	0.6%	4.2%	5.8%	5.4%	-0.5%	-3.2%	4.1%	32.5%
	Ibov	7.4%	3.1%	-2.5%	0.6%	-4.1%	0.3%	4.8%	7.5%	4.9%	0.0%	-3.1%	6.2%	26.9%
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	Bogari Gestão de Investimentos Ltda.	**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

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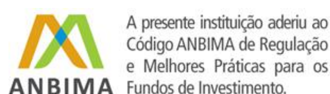

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