Brazil: Structural reforms are moving on surprisingly fast, anchoring long term debt dynamics and tackling fiscal deficits

Looking at our June 2016 letter and at what happened since then, one needs to acknowledge the positive developments in Brazil. Most importantly, the confirmation that Temer's economic response has focused on structural reforms and privatizations. The tax increase debate has taken a back stage. Temer used his unpopularity and Brazil's deep recession to approve unpopular measures. Two constitutional amendments as well as four important laws were approved. The two constitutional amendments ultimately provide more flexibility in the government's budgeting exercises by loosening the earmarking system (DRU) and by capping expenses, untying the current indexation mechanism (PEC dos Gastos). The other measures are linked (a) to governance practices in state owned enterprises (director nominations, compliance), (b) to providing visibility to electric concessions (concession renewal mechanisms, regulatory agencies) which should ultimately facilitate their privatizations (inc. the state concessions that have been federalized) and (c) to enabling Petrobras to skip its obligation to participate with a 30% stake in all pre-salt projects. Micro measures were as well taken in order to improve the business environment (bureaucracy, credit card spread mechanisms). Twenty two other projects are in the pipeline for the Congress and the Senate to approve. A labor reform has been drafted providing flexibility in wage negotiations (between unions and employers versus the CLT law) and in enabling shorter working days and lower salaries.

A sense of urgency and rationality has emerged. The country is somehow being governed now. The impact of the recession on over-leveraged households and corporations together with the lifting of all kind of subsidies and a strong currency enabled inflation expectations to be anchored. Forward real interest rates have converged to below 6%. A cyclical recovery is underway, but for it to be sustained we need to have the pension reform approved and to watch the ongoing negotiations between the Federation and the States (debt renegotiation and fiscal austerity/privatizations at state level).

The BRL may seem overvalued (it appreciated against the USD) but trade balance robustness, current account trends and FDI resilience should keep BRL strong for the foreseable future. Interest rate differential with the US still provides ample room

Victoire Brasil Investimentos
Rua Olimpíadas, 200, 7º Andar
Vila Olímpia - 04551-000
São Paulo, Brazil
Phone: + 55 11 4872 4040
www.victoireinvest.com

for further reduction without worrying about the currency, in our view. The Presidential Elections in 2018 may provide more upside than downside risks from where we stand today. Visibility is extremely low as the Lava Jato gears up but in our opinion there is probably no space and no names at sight that can revert any of what has been done by Temer's team.

If things move on according to plan, forward real interest rates have room to shrink further to 400 bps and nominal interest rates could reach 8.5% in nominal terms by the end of 2017.

Trump´s election and the embedded contradictions in his program (fiscal policy, US yields, USD trend, protectionism rhetoric) have a limited impact on Brazil and the region (except Mexico) overall. China trade channel present the largest downside risk for South American exports. Authorities in the region are looking inward, doing their homework in order to insulate their countries from what Trump election could mean for the world economy (or any surprises on the European front).

On Corporate Governance ('CG') & State Owned/Controlled Enterprises: Regulatory and CG Upside risks

Over the last 6 months, the alignment in vision between the executive power (and Brazilian pension funds), the renovated regulatory agencies and new management in SOEs was a structural game changer in our point of view and may be the most important shift when looking at relative stock performances. Upside risks in Corporate Governance in specific sectors such as Utilities, Concessions, in the Energy & Mining industry, in the Banking sector should mean over time stronger operating and earnings and better shareholder alignment and Board accountability. Tariff liberalizations, transparent and rational pricing policies, capital discipline, risk management procedures, Board structures and accountability, pro-market orientation (shareholder rights, consolidation of share classes, etc) improve visibility and all point to guarantee business sustainability. Re-ratings have a cyclical tilt but in the sectors, we believe that re-rating have a more structural tilt to it as corporate governance practices improve.

Banco do Brasil's and BNDES's rational attitude should stop capping interest rate margins (in a highly consolidated industry, bringing in the private sector) and should help remove subsidized long term credit lines bringing back market forces to existing long term credit mechanisms (TJLP) eliminating automatic indexation and most importantly improving monetary transmission.

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Petrobras new pricing policy provides visibility for its operating margins, momentum to its deleveraging story and alleviates the burden of future investments, when capital discipline is paramount.

Concessions renewal clauses and new privatization scheme (Grant fee payment instead of reverse auction) would help privatizations of state/union owned toll road concessions. Rail and airports models are being sweetened to attract investors.
New management/boards at Eletrobras and its subsidiaries as well as new governance practices should help it restructure its indebtedness by privatizing specific stakes in distribution, transmission and generation. With states and municipalities at the brink of bankruptcy, the Federation is asking for cost cutting initiatives as well as the sale in Water & Sewage Concessions and helping them modeling the regulatory framework for those assets.

Recently, Vale confirmed that controlling shareholders (inc. pension funds) are discussing consolidating its "dilutive" share classes structure. A single share class with equal shareholder rights are strong pro-market orientation signals. This is being discussed today after all the organizational changes they implemented over the last 6 months, the cost cutting initiatives and divestments new management has made. The recent uptick in metallic commodities helps.

LatAm ex-Brazil

LatAm political cycle shows a change in paradigm. New governments in Argentina and Peru (besides Brazil) and new developments in Venezuela points to a trend away from a populist rhetoric. Post Trump election, the region is looking inward to solve its challenges strong drive for structural reforms such as: indexation, budget, tax, pension, labor reforms. A recent uptick in metallic commodities and oil price stabilization should be beneficial for the region.

In Mexico, in particular, economy is expected to slowdown in 2017 as interest rates moved up and budget cuts weigh on domestic demand. The sharp Peso depreciation and gasoline price liberalization will exert upward pressure on inflation. Interest rates should move up in tandem with US rates. As long as protectionism does not materialize, higher growth in the US is good news.

For Argentina, a recovery of economic growth is expected in 2017 as the adjustments will pay off. Currency depreciation, energy tariff adjustments are now behind us. Mid-term elections in October 2017 will provide extra help from the tax amnesty program. Normalized access to global capital markets may reduce currency uncertainty. Inflation outlook is benign (depending on wage negotiations) but should not meet the government target. There may be a positive impact of the potential MSCI reclassification to EM this year.

In Chile, subpar growth and inflation has been persistently high, remaining above the 4% ceiling of its Central Bank. Presidential elections become critical for investment decisions. Both potential candidates are considered market friendly. Inflation expectations are converging below target (currency strength and unemployment ticking higher).

In Colombia, the twin deficits in current account and fiscal balance together with higher US rates could lead to some currency depreciation. The upcoming tax reform is critical and they face the risk of losing investment grade. Inflation should fall gradually as well as interest rates.

In Peru, the technical-oriented cabinet, the pro market President and the structural reform agenda (dealing with informality and productivity) bodes well for GDP growth. Despite the fact that the economy is still very dependent on copper, domestic consumption should be the driver. Interest rates are likely to stay unchanged over the year.

On Portfolio Construction

The alignment between the portfolio construction influenced by style factors vis-à-vis the economic outlook allowed the long short strategy to deliver a strong rebound during the last semester.

As we described on the semiannual report, our portfolio construction discipline privileged leverage (operational and financial), lower rate-sensitive and companies that will improve their profits on a rebounding economy to the detriment of a defensive portfolio having safer value attributes such as resilience, strength of dividend yield, foreign assets or export-orientation that we began 2016.

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Regarding country exposure, as long as the scenario cleared and the perspective improved for Brazil, our Net Long Exposure increased along the year, reaching 70%+ on its peak in July. For Mexico, despite the stretched multiples, we have been Net Long on the country on the first half of 2016 taking advantage of the strong earnings momentum faced by the consumer sector as well as some exposure to some high conviction names as a Long in **Ienova** and Short in **America Movil**. The Trump election and its effects on Mexico, however, led us to revert our exposures and build a Net Short position on the country. In Argentina, the improving scenario, increasing liquidity and valuations justified a Net Long exposure kept during the year, basically through Longs in **Banco Macro** and **Pampa Energia**. Exposures in Colombia and Chile was also held through Longs in **ISA** and **Concha y Toro** and Short in **CCU**.

Sector-wise, the largest positive contribution came from Utilities, especially from the Water & Sewage sector. We consolidated our exposure with two names: **Copasa (Minas Gerais)** and **Sanepar (Paraná)**. We see tariff adjustments & reviews kicking in on the back of rational ROAs and regulatory largest upside risk, following years of non-economic decisions (large investments with sub-par returns and tariff freezes). Water & Sewage is a service in Brazil that did not keep up with better living standards, and municipalities are obliged to provide the deeply needed service at the same time they face severe financial stress, paying the way for more market participation in the sector. We believe there is upside risk in our valuation metrics on regulatory grounds but would not like to overpay for future growth.

The second largest positive contribution came from Commodities, especially from the Long **Petrobras** we kept up to November. During this period, the stock outperformed (60% in BRL). We owe this re-rating due to a profound shift in risk perception, prevailed by the great improvements the company presented in management and corporate governance. We understand that a significant value gap was closed during this period but we do not discard Petrobras as an interesting investment case that can continue to perform relatively well having triggers on the debt level front (improve in case BRL appreciates) and new divestments (BR Distribuidora).

Additionally, the Longs on **Ser Educacional** and **Banco do Brasil** as well as the Shorts on **Natura** and **PDG** also positively contributed to the portfolio. On the LatAm front, we highlight the Long position in Pampa Energia (Argentina) and the Short in **Liverpool** (Mexico).

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Ser Educacional anticipated the sector cool down adopting a series of internal procedures back in 2015, so the challenging past years could be confronted by the company without margin contraction, keeping its sound balance sheet and open to several growth opportunities that were presented by then. In our point of view, the company has at this stage less dependency on the FIES system for new intakes and is consolidating its distance learning strategy that should help operational leverage. Technology/System investments are gaining relevance in that sub segment and M&A should be expected. The stock was one of our core Long holdings during 2016 (4.7% on average) and we continue invested in 2017. We consider its current valuation levels attractive (10x PE 2017) due to the great execution skills of the management that presented solid results over the last quarters.

We built up a Long position in Banco do Brasil back in June, highly concentrated (4.4% on average during the period) and which we still hold during 2017. This holding is part of our banking sector exposure, which fundamentals are based in strong growth of profits which are yet not incorporated to their multiples. We expect spreads to widen in the banking sector as competition and pricing behavior is expected to remain rational (BBAS, BNDES, CEF). NIMs could further widen as liabilities get re-priced before assets and lower SELIC rates means lower cost of equity. We expect a re-rating of the sector that would account for the value of future growth. We expect NPLs to peak (with some potential write offs still in the coffin) and see technology (and capital discipline) as having for the first time ever a deflationary impact in their cost base. Also, Banco do Brasil trades close to book value, presenting great re-rating potential in a structural way (not consider into our conservative valuation).

On the Short Book, Natura still faces considerable structural challenges, losing competitiveness over its portfolio and losing ground over the last years (market share down from 15% - 2010 - to 11% -2015) to Unilever, Procter & Gamble, L'Oreal and especially to O Boticário. Its margin contraction and the de-rating suffered as consequence are here to stay in our opinion as the direct-selling business model is not a growth driver anymore and the shift to new retail formats will take some time to mature. We began our Short on Natura back in 2015 but increased considerably on March 2016, keeping this position to our current portfolio.

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The Short in PDG during a brief period on November was our largest positive contributor on the Short Book as the stock fell 30% in BRL terms during this period. The homebuilder faces a serious solvency problem with difficulty in honoring its debt service, even after successive renegotiations with its major creditors. The level of properties in stock still does not show signs of reduction, since the gross sales are totally annulled by the high level of cancellations. The stockholder value should tend to zero, since not even debt holders will have the expected return on their capital. However, as its legal recovery plan request event approaches, we have chosen to zero the position given this can bring a lot of volatility, and depending on the agreement, any residual value for the shareholders may represent a very large upside on a highly depreciated market cap value.

The largest negative contributor to the Long Book was **Alliar**, a concentrated position that we held for a short period of time. Problems related to the IPO process, the strong performance of its main listed peer added to a herd effect ended up leading to strong selling pressure. Although we see value in the case, we thought it was more prudent to zero the position and wait for more concrete triggers over the next few quarters, maintaining exposure in the industry through **Fleury**. We think Fleury delivered most of the front end homework as YTD results have shown. Systems, processes and procedures have consolidated. The right sizing effect (geographical) should help consolidate operating margins above 3rd quarter`s. Free cash flow has turned positive for two quarters in a row, deleveraging and dividends are consequences. We welcome Advent`s hands-on approach and leadership in managing the business and believe that their main challenge is to grow without eroding margins. Organically this can be a challenge, although the company seems well prepared for the next growth cycle. M&A could be also an option. In all cases, we are happy to pay for the value of future growth.

Regarding positions outside Brazil, we have been holding Pampa Energia since December 2015. The position reflects our positive view towards Argentinean Equity Market and its possibility to being upgraded from Frontier Markets to Emerging Markets, as well as the expected economic rebound in 2017, which will bring a positive investment perspective. Pampa Energia is an integrated electricity company which can benefit on different fronts, namely gas production (supply shortage), generation (increase in tariffs), and also transmission and distribution opportunities, not to mention Petrobras Argentina's integration. The stock performed +27% (in USD) during last semester, and we still see plenty of additional upside on the name.

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We built a Short on Liverpool right after Trump's election, that remained on the portfolio only during November. Although the market reaction to the US election was strong, we found there was still downside risks to be captured, as the valuation of the company was still embedding a premium with P/E multiples at the high-20's level. Our current view for the Mexican universe remains on the negative side, with interest rate increases hampering consumer spending, dollarized COGS pressuring operating margins, and still overvalued stocks in some cases. Liverpool however was zeroed after its price correction, down 20% in dollar-terms.

Our Business

In February 2016, André Caminada was appointed, by the Board, CEO of Victoire Investment Management, the holding company that bonds our two investment companies and coordinates support services including investor relations. Since then Mohamed Mourabet and Priscila Simon no longer act in any management committees (HR and Budget). Their sole responsibility will be investment management. André's attributions of research and portfolio management have been re-directed to Mohamed, assisted by the investment team. This decision enables leadership and accountability over the firm's long term strategy. Over the last quarters, initiatives targeted efficiency gains in technology, CAPEX and human resources mainly in support services. While improving the team's productivity by investing in our research platform, we intend to add resources in research.

Taking into account market characteristics (number of listed opportunities, normalized liquidity patterns, market cap, segments etc), we decided to consolidate all our Long Only strategies of the commingled funds (Small Cap, Selection and Equity Income) into a single flagship strategy that we named Brazil Focus and will have the MSCI Brazil SMID as hurdle rate. Compliant with capacity studies, the strategy seeks to capture the best investment ideas irrespective of market cap within the liquid spectrum (ADTV above USD 1 million).

The changes have been carefully considered and, in our opinion, are in the best interests of our investors. Consolidating the vehicles enables us to provide a single Long Only strategy fully aligned with our existing institutional mandates, benchmark agnostic and concentrated and encompasses the small cap liquid opportunities.

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