Back to Basics

During the first quarter of this year, we decided to consolidate all our Brazilian and Latin American strategies into a single one, the existing LatAm Long Short Equity which was the first strategy we launched back in 2004 when Victoire was established. This is quite a landmark for our firm as it will bring us back to our essence and will guide the firm in the decades to come. A single strategy is what we longed for - based on the correct understanding of the investable universe for public equities of the region and the intrinsic market inefficiencies we are able to exploit on an absolute return basis, by building high conviction exposures based on in-depth and in loco research, sensitive to capacity with a team oriented investment process. Over the coming weeks our investment vehicles will be merged into the LatAm Equity Strategy with a view to provide a single investment strategy for both onshore and offshore investors. We want to share the following conclusions and convictions always having our clients' best interest in mind when we look at public equities in the region:

Mapping the Investable Universe - Implications

Having spent the last three years focusing on the importance of managing our capacity within a challenging environment (for listed opportunities in Brazil and LatAm), with liquidity shifts (domestic interest rates), outright recessions or decelerations for overall corporate profits, but also top down regulatory developments and corporate governance improvements, mapping the investable universe and its imbedded limitations took a central stage:

<u>Being irrespective of market cap and targeting a wider universe are paramount</u> – the whole region (from Mexico to Argentina) has close to 200 listed liquid opportunities (including US listings), having Brazilian names representing half of this universe. Our investable universe does not provide enough room or spectrum, to segregate between strategies, market cap, and specific tilts and so on. Investing in this region should seek absolute returns independent of style tilts and geographic limitations. Our playing field are these 200 companies and we trust our investment process can segregate the wheat (longs) from the chaff (shorts); We have been working on the LatAm ex-Brazil front over the last 4 years: our team have had more than 500 research meetings per year, 100 of them in Argentina, Mexico and Chile.

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A solid understanding of the capacity and size of the strategy is a key component of the Portfolio Manager ability to successfully manage it. Any framework to manage liquidity should take into account two components: (i) the ability of the strategy to meet redemptions at any time but also (ii) the ability of the PM to find attractive opportunities to extract as much alpha as possible. No need to write that capacity and repeatability work hand in hand (we are not in the asset gathering business). Looking at our investment universe, a liquidity of USD 1 million per day is a good threshold providing us with a USD 750 million capacity. These limits enable us to concentrate into our highest convictions without losing sight of liquidity limitations.

The absolute return orientation and its capacity sensitivity within a wider investment universe are behind our belief that short-selling can generate positive returns as much as long exposures. They can extract additional alpha (extending active risks for those looking at the universe with "active management eyes") amplifying desired risk exposures and improve information ratios. Shorts deliver positive returns on their own rights: each exposure needs only to be considered stand alone on its own merits and not a hedge to some sort risk. Exposure to volatility, to directionality (Beta) or any other Active Risks (size, liquidity, yields leverage, etc.) vis-à-vis equity market indexes (MSCI LATAM or any other) take a second stage in the portfolio construction process.

One Single Strategy means One Single Mindset

Having a single investment strategy brings alignment in everything we do, in day-to-day activities as well as portfolio construction and research deployment. The first strategy of the company, our DNA, the one in which we based the inception of this company and has been run by the team for the last 13 years, with a proven investment framework and track record. The one strategy that extracts as much alpha as possible from our investment process, team orientation and capacity limitations and that resonates into our client portfolios in a uniform manner. No distractions and no restrictions, absolute return only aiming to translate our proven investment process into performance.

We invite you to contact our team should you need any further detail or clarification about the merge process and its timeline.

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LatAm Scenario

The first half of 2017 was a quite turbulent nevertheless positive period for Latin American equities, especially Brazil.

The global environment of low yield, sustainable growth, weaker USD and higher commodity prices helped emerging market assets.

Regionally for LatAm, GDP reacceleration and earnings growth momentum mixed with political instability/uncertainties set the tone.

Since the end of 2016, Brazil was facing a very positive trend in terms of economic and political developments. Both consumer and business confidence levels have been moving up consistently. Inflation were coming down, interest rates being cut, reforms under way and the first signs of economic recovery were close to the horizon. In May, however, the country was taken by surprise by the alleged involvement of President Temer in corruption scandals, which triggered a sharp correction in the local assets. Despite nothing concrete was indeed proved by now, it led Temer and his government to a more fragile condition. Approving the much needed and unpopular pension reform, in its current format, may prove extremely challenging in this new environment, which increases the challenges for Brazil to regain its fiscal equilibrium.

Even though the current political crisis could have a negative impact on the speed of the economic recovery, this should be partially offset by the surprisingly lower inflation environment which is already and will continue to lead nominal and real interest rates to new lows. Given the level of operational and financial leverage of the Brazilian companies, earnings growth in Brazil in the next couple of years will be substantial and may support equity market appreciation.

For **Mexico**, after a critical 2H16, with Trump election and several uncertainties from NAFTA negotiations, growth and inflation to local elections, the worst seems to be behind us. Despite one of the richest valuation in EM, the scenario is very constructive, with stabilized inflation suggesting that interest rate cycle has ended, resilient GDP, double-digit credit growth, robust consumption, stronger currency, improving external accounts, optimistic views towards the upcoming NAFTA renegotiation process and recent positive electoral outcome.

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Despite the market disappointment related to the delayed MSCI upgrade decision, the improving fundamental story for **Argentina** is still in place. Economic rebound continues and is broadening and key policy changes, such as those in the energy sector, are highly sustainable. Mid-term elections in October, however, represents a risk. Despite unlikely, the return of Cristina Kirchner to the Presidency would not be welcomed by the market.

Chile is still facing weak economic growth but November Presidential elections may lead to a more friendly business environment for 2018, supporting market performance. In **Peru**, the effects of the El Niño floods should negatively impact the Peruvian economy in 2017, but a recovery is expected in 2018 on infrastructure and mining investments. In **Colombia**, GDP growth remains sluggish but may be helped by the easing cycle and the infrastructure program.

Portfolio & Performance

As we have previously discussed, for the past year our portfolio construction discipline has been privileging leverage (operational and financial), lower rate-sensitive and companies that could generate more earnings on a rebounding economy. Country-wise, we kept net long exposures in Brazil, Mexico and Argentina and close to neutral exposures to the other countries in the region.

During the first half of 2017, our largest positive contribution to performance came from the Utilities Sector, basically from the long positions on **Pampa Energia** and **Copasa**. **Pampa** is one of the portfolios core positions, held since the end of 2015 and was the largest single contribution to the portfolio this year. In USD terms, the stock appreciated 179% since we build the position and 69% in the first half of 2017. There were several developments during this past few months, from the Argentinean government extending its subsidies to gas producers through 2021 (subsidies had been expected to end this year) to a new regulatory framework for distribution, in addition to positive regulatory asset base calculation and tariff reviews. On a normalized approach, we see further upside potential generated from growth opportunities in generation, lower Argentina risk and potential for further oil and gas output growth.

The second largest contribution came from the Consumer Sector, namely in longs such as **Fleury, CVC** and **Ser Educacional** and shorts such as **Cielo** and **Valid**. **Fleury**, which provided the

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largest return, continue to deliver an exceptional execution. The company is successfully implementing an ambitious growth plan, while simultaneously maintaining high levels of profitability based on operating efficiency, while also generating cash and increasing ROIC. **Ser Educacional** is also a positive highlight. The company will continue growing organically in both on-site and distance learning (the sector was benefited by an increased flexibility in the distance learning segment) as well as through acquisitions (the recent equity offer will provide enough funding for M&A).

Is it worth mentioning also the contribution of the long position in **Mercado Libre**. The company continues to deliver impressive growth rates and to benefit from its operating leverage. The free shipping campaign launched last month in Brazil may boost GMV growth and market share gains as it did in Mexico during this first half of 2017. The company is well positioned to take advantage of the secular and structural e-commerce opportunity in LatAm and its current valuation is justified by scarcity value, growth and returns profile.

On the short side, one highlight would be **Natura**. Despite succeeding in growing its international operations, the company keeps facing challenging conditions in its core market, direct sales in Brazil. The company has been struggling in the past couple of years with management, innovation and market share loss. During the last semester, the stock went up strongly support by the rumor of the M&A involving Body Shop. After announcing the EUR 1 billion acquisition, however, the market realized the size of the integration challenge that should be conducted at the same time they try to regain its path in the domestic operation and the stock went back to trade at a more depressed valuation. At this point we see limited downside and decided to close our short position.

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