



JARDIM BOTÂNICO INVESTIMENTOS

JBI Focus Letter #16

January 2015

2014: AN ATYPICAL YEAR?

'We probably are trying too hard at what we do. More than that, no matter how hard we try, we may not be as important to the results as we'd like to think we are. But I also hope to persuade you that that's not all bad.'

Dean Willians, Trying Too Hard, Keynote Speech Financial Analysts Federation Seminar, 1981 – alerting to the risks of getting bogged down in the analysis of too many variables.

We ended the year with a fall of 31.2% in the fund's NAV in US dollars. This was a particularly difficult year where, in retrospect, we misread some signs. Paradoxically, it was also a year where one of the main tenets of our investment philosophy proved right: not investing in state-owned companies. We are very disappointed with this result but it also serves to evaluate what did not work and, more importantly, reaffirm the main aspects of our investment philosophy.

1. Despite the frequent comparison, we do not follow any market index when constructing our portfolio. We do not believe that a company's market capitalization is a relevant indicator of how good its business is or how well it is managed. In fact, many companies that are included in different market indices fail our governance test. These companies are summarily excluded from our investment universe since they do not follow minimum criteria in terms of ethical standards and the protection of minority shareholders.
2. Our strategy depends to a large extent on two factors: independence of analysis and patience. Stock prices tend to fluctuate around companies' intrinsic value (based on

fundamentals). Purely speculative short-term factors may significantly affect this trend, only leading to convergence over longer periods. Hence, to generate above average returns, we must focus on long-term fundamentals, trying to seize opportunities momentarily available in the market and being patient enough to wait until stock prices reach what we consider to be a company's fair value.

3. We see risk as the possibility of permanent capital loss. We target companies that have solid competitive advantages, are well managed and trade at a discount to their intrinsic value based on fundamentals. Our objective is to generate absolute returns over long periods, minimizing the risk of permanent losses.
4. Good governance is the basis of all our decisions. We dismiss companies that do not abide by minimal standards of ethical conduct. When we invest in a company, besides looking for good returns, we are in a way also supporting how controlling shareholders, managers and employees conduct corporate affairs. We do not trade governance for upside potential. Irrespective of a company's expected returns, we will not make an investment if a company does not comply with adequate governance and ethical standards.

The year was dominated by intense short-term events and a continuous deterioration in the economy domestically. Extreme reactions to local

issues, as elections and the Petrobras corruption scandal, dominated the news and are still feeding market speculation. As value investors with long-term objectives, we cannot be influenced by this type of scenario, despite the disappointment (we hope temporary) with results. We believe recent performance does not reflect the value potential of our invested companies. In this regard, experience shows that it is precisely in those moments when volatility and short-term speculation prevail that long-term investors find the best opportunities to generate above-average returns.

In any case, it is not because we had a bad year that we will blame the market's irrationality for it. After all, this is a variable we always have to work with. It is equally important to review the decisions taken during the year to fully understand what did not work as expected and, more importantly, the reason for this mismatch in expectations.

When we build our portfolio, we select our best ideas, weighing positions according not only to our confidence in the investment case but also considering the diversification of risk factors that each investment brings to the portfolio. In this sense, although our investment limits may be considered generous for some (max. 20% per stock and 40% per sector), we have rarely been close to them. However, sector diversification not necessarily entails risk diversification. In a crisis, companies from apparently different sectors, such as real estate and steel, may follow, and indeed followed, similar patterns.

Even if we always aim for the appropriate diversification in the portfolio, this was not an effective mechanism of risk dilution given the magnitude of the year's events. In hindsight, it became clear that what seemed to us like a reasonable exposure to the infrastructure sector, was

too aggressive in a context of economic slowdown, worsened by corruption investigations affecting the main construction companies in the country. As bottom up investors, we leave to portfolio companies the task of appropriately reacting and adapting to changes in the macro outlook. We do not spend much time projecting economic variables but we try to understand how each company reacts to scenario changes. Still, it is not enough to invest in the best, if they are all in the same boat when navigating turbulent waters.

Mills was the portfolio company most severely hit by the political-economic scenario in 2014, being responsible for over a quarter of the fund's performance. That is why we believe it is important to share our views on what caused such a fast and sharp downturn in the stock price and, most importantly, our expectations for the company in the mid and longer term.

The company released weak results in the first half of the year, with ROIC reduction initially caused by the conclusion of a large number of projects in the Heavy Construction division, leading to a higher than usual demobilization of equipment. In Real Estate, the conditions were not ideal either, but still the company was managing to grow, recovering margins and ROIC. As for Rental, it remained as the division with better prospects.

At the time, the results did not look odd to us and we saw the close to 40% reduction in share price in the year (in BRL) as an opportunity to increase our allocation in the stock from 6% to 8%. However, 3Q14 results came worse than expected. Uncertainties surrounding the presidential elections had delayed the start of many infrastructure projects, while the slowdown in economic activity had a strong impact in the Real Estate division, reducing considerably the launch of new developments. On top of that, unplanned provisions and a general

increase in delinquency levels were also detrimental to results. The market immediately penalized the stock that was down 35% (in BRL) in November alone.

To complete this 'perfect storm' scenario, Mills is being hurt by the side effects of the Petrobras scandal, since all construction companies under investigation are among the company's clients. As a result, the sector has virtually stopped and doubts remain over the resumption of infrastructure projects and delinquency levels in the next quarters.

We have been in constant talks with the company (CEO, directors and main shareholders) to understand the consequences of this inactivity and, in particular, how management is reacting to this new scenario. It is worth pointing out that Mills has a great flexibility in terms of CAPEX requirements and expects to reduce its investments to minimal levels in 2015 (probably below R\$ 60Mn from an average of R\$ 340Mn in the last 5 years). The company is also implementing several measures to rationalize the use of equipment in both the Real Estate and Heavy Construction divisions, expected to result in higher cash generation in the next quarters. Regarding the Petrobras investigations, less than 15% of Mills' revenues depend, directly or indirectly, on the companies involved. As for the exposure to the Oil & Gas sector, it represents less than 5% of revenues. The company has also announced a share buyback program of up to 5% of its share capital in response to the fall in price in recent months.

We also like the fact that a significant amount of the management's compensation is linked to the company's operational results and stock performance. Variable pay is calculated based on the EVA methodology (*economic value added*) – no bonus will be distributed this year – and most stock options are now out of the money (with strike prices close to R\$26/ share).

Short-term prospects remain uncertain and the company's greatest challenge will be to manage delinquency rates until infrastructure investments are resumed. Mills seems fit for the task: leverage ratios are at comfortable levels (1.5x net debt/EBITDA and 6.3x interest coverage measured by EBITDA/interest expenses) and cash flow is positive.

We believe the long-term fundamentals that led to our initial investment in the company's IPO remain unchanged:

- In Heavy Construction, in spite of the fiscal adjustment under way and the impacts of the corruption investigations, we believe infrastructure investments will remain as a top priority. BNDES estimates R\$1.7 trillion will be invested in the sector from 2014 to 2017, a 32% rise in the amount deployed from 2009 to 2012. Even if investments are only partially executed, it is still a relevant investment plan. Mills is a market leader in this segment and has a current backlog 1.5x times larger than last year's.
- In Real Estate, the country has a housing deficit of around 5 million homes, while mortgage loans represent 10% of GDP, a low level when compared to other emerging economies. Household indebtedness remains stable at 22%. Once real estate developers manage to normalize inventory levels, Mills will be well positioned for the recovery cycle given its strong ties with the main players (listed and not-listed) and expertise in infrastructure works - a relevant skill in a sector where qualified professionals are sparse and a higher degree of industrialization looks like an obvious solution. Moreover, the company plans to tap

new markets, such as light industrial and sewage.

- In Rental, the use of aerial work platforms in Brazil remains very low. The utilization of this sort of equipment is expected to rise, given the market's growth potential (15% penetration in Brazil compared to 50% in the US, 60% in Japan and 80% in the UK, just to name a few).

Mills is also a market leader in this segment.

The stock is currently trading at historical lows, below its IPO price in 2010, even though revenues have doubled since then and EBITDA is 2.4x higher. For us, this discount looks excessive, as it considers a scenario of full disruption in investments, which appears to be unreasonable. The company is clearly suffering with short-term expectations, but considering its leadership, management quality and financial strength, we believe it can recover ROIC, keeping cash flow positive via CAPEX reduction and control of delinquency rates.

Finally, the market's current volatility is also creating opportunities and we have added new positions to the portfolio. They were all in our radar screen for a long time and we expect these new names to bring more diversification to the fund in a moment of greater uncertainty in the macro front domestically and abroad. As a result, we finished the year with cash at 8.5% and 20 companies invested.

Going back to our initial quote, we aim to avoid at all costs the trap of trying too hard at what we do and losing focus on efficiency. We want our analysis to be clear and objective. We are not interested in making projections right on target, but rather on fully understanding investment risks and how each company will behave under different market conditions. To take advantage of opportunities that appear out of speculative scenarios also allows us to secure a margin of safety when buying new assets, certainly our biggest protection against uncertainty.

To conclude, we would like to end with another quote, this time from Benjamin Graham, considered by most the father of value investing:

'In the short run, the market is a voting machine but in the long run it is a weighing machine.'

That is to say, in the short-term the market simply differentiates between popular and unpopular contestants, like in an election. In the longer run, however, it becomes a weighing machine, allowing investors to assess *'the substance of a company'*. The message is clear: if you are investing for the long term what matters is a company's operational performance and the management quality, not the market's erratic opinion on its short-term prospects.

DISCLAIMER

*The offer and sale of shares of the Funds in certain jurisdictions may be restricted by law. Access to this document or use of the services or information provided herein is prohibited by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law, rule or regulation. *This document is not destined to investors with residence in Brazil. The Offshore Funds may not be offered, sold, redeemed or transferred in Brazil. *Participating shares of the Fund may not be sold, transferred or delivered to any person, corporation or other entity that is deemed to be a resident of The Cayman Islands or Brazil. The Funds are not listed on the Cayman Islands Stock Exchange and are accordingly prohibited from making an invitation to the public in the Cayman Islands. *No registration statement has been filed with the United States Securities and Exchange Commission or any State Securities Authority with respect to the offering of shares in the Funds. * The shares in the Funds have not been and will not be registered under the United States Securities Act of 1933, as amended (the "Act"). *Shares in the JBI Focus Brazil Fund Ltd. may only be offered, sold or otherwise transferred directly or indirectly to any United States citizen or resident or to any corporation, partnership, trust or other entity chartered or organized under the laws of any jurisdiction in the United States of America, its territories or possessions in private placements exempt from registration pursuant to regulation D of the Act. *Shares in the JBI Focus Brazil Fund Ltd. may not be offered or sold within the United States or to any US Person. **"Public" for these purposes does not include any exempted or ordinary non-resident company registered under the Companies Law or a foreign company registered pursuant to Part IX of the Companies Law or any such company acting as general partner of a partnership registered pursuant to section 9(1) of the Exempted Limited Partnership Law or any director or officer of the same acting in such capacity or the trustee of any trust registered or capable of registration pursuant to section 70 of the Trusts Law. *Past performance does not guarantee future results. Before subscribing for the shares, each prospective investor should carefully read and retain the Fund Prospectus and Regulation. *This document is published exclusively for the purpose of providing information and conferring transparency to the management carried out by Jardim Botânico Partners Investimentos Ltd. (JBI), is not the Offering Memorandum of JBI Focus Brazil Fund Ltd. and is not to be considered as an offer for the sale of Shares of the Fund or of any other security. *Before subscribing for the shares, each prospective investor should (i) carefully read and retain the Offering Memorandum of the Funds and the relevant Supplement or Annex in respect of the portfolio and/or class of shares; (ii) consult with his/her/its own counsel and advisors as to all legal, tax, regulatory, financial and related matters concerning an investment in the Funds. *JBI takes no responsibility for the accidental publication of incorrect information, nor for investment decisions taken based on this material. *This is a preliminary document and certain aspects of the information contained herein may change as a result of discussions with potential qualified investors. *Este documento não se destina a investidores residentes no Brasil. *As cotas do JBI Focus Brazil Fund Ltd. não são registradas na CVM e não podem ser oferecidas, distribuídas, resgatadas ou transferidas no Brasil.