Tarpon GT Public Equities: quarterly update

The strategy posted a positive 2.96% return in the 4Q17 while the Ibovespa Index ended with a positive return of 2.84%. Our portfolio showed consistent performance and our companies continued to deliver sound results. With investments in quality companies trading at a significant discount to the market average, we believe we are well positioned to continue generating positive returns. Since the relaunch of the strategy, the portfolio has posted a net return of 60.5% against 25.7% of the Ibovespa.

One of our investments' highlights in the quarter was the addition of a new position in the homebuilding sector: Trisul. The company has presented a very interesting entry point (0.5x book value, 47% discount to the sector), as a large shareholder fully divested during the quarter. We built an intermediary position, 7.5% on the average.

Trisul is a traditional homebuilder, with more than 30 years of experience, operating mainly in the São Paulo region. The company struggled during 2010-2014, but was able to do a successful turn-around/ back to basics strategy since then. More recently, the company is presenting encouraging results as its net sales in 3Q17 reached the highest quarterly level of the past 6 years and its most recent launch sold 86% of its units in just 4 days. For these reasons, we saw in Trisul an interesting risk-return opportunity, not only because it is a solid company that directly benefits from the economic recovery of Brazil, mainly from the increasing consumer confidence, employment, income, and lower interest rates, but also because it trades at a significant discount to our estimates of intrinsic value.

In addition, in the 4Q17, we added one new company to the portfolio and divested from one case whose investment thesis had matured. We remain very focused on the investments pipeline, which is very promising in terms of new ideas and their potential upsides.

Finally, we re-opened the local fund to new investors and remain confident that we have the right team to continue sourcing attractive investment opportunities and leveraging on our experience in the Brazilian Stock Market.

Preference for Quality Businesses:

As mentioned in our previous letters, we have been implementing an investment strategy that's not only based in investing in stocks at attractive valuations, but also in companies with potential inflection points and above-average business quality. In this letter, we would like to expand our thoughts in which business characteristics we take into consideration in our quality assessment, giving more clarity on what we view as its key components: (i) return on capital; (ii) operational predictability and resilience; and (iii) growth potential. As you will notice, some topics are overlapping, making the whole analysis much more valuable than the sum of the parts.

Return on Capital

"The ideal business is one that earns very high returns on capital and that keeps using lots of capital at those high returns. That becomes a compounding machine." Warren Buffett

Return on capital is one of the best indicators of business quality because it measures the effectiveness of companies' capital allocation decisions, attributes a quantitative value for the company competitive positioning, and shows the company's capacity to generate intrinsic value.

Companies with high return on capital, particularly at low prices, can be very special investment opportunities. When these companies can reinvest some or all their profits at high return rates, they can be even more valuable investments - the so called "compounding machines". In these special cases, we don't have to rely only on the market recognition to generate value throughout the years.

Maintaining high returns on capital requires high barriers and competitive advantages that protect returns from other players. Therefore, identifying what these competitive advantages are and understanding their sustainability in a dynamic environment is key to our investment process. Some examples of sustainable competitive advantages that are harder to be replaced by competitors are: network effect, customer switching costs, structural cost advantages and intangible assets (e.g. brands and regulatory assets).

In the analyses, we must be very careful to not mistake some nice-to-have business/organizational features with truly competitive advantages. For instance, greater size, good products, experienced management team and better execution all matters, but are recurrently mistakenly considered as sustainable, while in the most cases these features do not create long-term competitive advantages, as they can be replicated or disrupted by the market over time.

The key metric we use to evaluate the rates of return of the companies among the different sectors and industries in our hunting ground is ROIC (Return on Investment Capital). In our view, return metrics should be a proxy for the cash return from each monetary unit invested by a business, despite of the capital structure and accounting practices. We believe that ROIC is a good metric toward achieving this.

Numerous market studies have shown that companies that generate intrinsic value throughout the cycles are those able to deploy capital with returns above their cost of capital. Moreover, companies that can sustain ROICs at the range of high teens trough time are usually good businesses and potentially attractive opportunities.

In most of the cases, the greatest challenge in evaluating a new company lies on the fact that future incremental returns on capital may differ dramatically from historical levels. The expansion or the reduction of one company's return is a great contributor to share price return. For instance, a company with higher historical return but with declining marginal ROIC tend to underperform another company with historical low returns and improving additional ROIC. Our capacity to point out situations like these will have a great contribution to our strategy's return.

Finally, we've been recently seeing that in the context of the Brazilian economic cycle recovery, higher returns are in a pathway for improvement and, at the same time, our cost capital is paving it´s way for compression, providing excellent opportunities for shareholder´s value generation. In recent years, due to the challenging macro scenario, many companies started pursuing initiatives targeted at reducing margin gaps and becoming more efficient. Operating leverage is also on the spotlight as many industries are at a cyclical trough and some are expected to recover at a faster fashion, benefiting from higher asset turns and higher operating margins. Therefore, we still believe there are several appealing investment opportunities, especially when we move to companies with less coverage, such as mid and small caps. As the great investor Peter Lynch once said, "Big companies have small moves, small companies have big moves."

Operational Predictably & Resilience

"If investing is entertaining, if you're having fun, you're probably not making any money. Good investing is boring."
George Soros

Good investments, as well as good businesses, are – most of the time – boring. Good businesses usually do not bring many surprises – even though the positive ones are very welcome – and, except in extraordinary situations, won't let you lose a night of sleep. Therefore, quality business for us presents those traits, which can be named as resilience and predictability of operating results.

Resilience and predictability are not random, they are generated by structural competitive advantages and strong business models, enabling companies to quickly adapt to cycles, market changes and even disruption, while maintaining operating margins, profits, and preserving assets, people and overall brand equity.

Warren Buffett, who also appreciates this kind of business, when investing in the chewing gum maker Wrigley, said it best: *"I look for businesses in which I think I can predict what they're going to look like in ten to fifteen years time. Take Wrigley's chewing gum. I don't think the internet is going to change how people chew gum."* We have a similar mindset. For instance, Sanepar (water and sewage utility company) and Alupar (energy transmission utility company), just to mention some of our holdings that couldn't be in more predictable-stable businesses.

Our approach to identify this kind of business starts not only from our proprietary database, but also from our experience investing in different companies and sectors. For us, the key metric to analyze is operating margins predictability. Comparing across different companies in different industries and diverse time frames, we found a high correlation of this metric, with strong competitive advantages and, consequently, business quality.

Lastly, we highlight that we do not have any ambition of being able to make precise predictions of how a business will do in the future. We believe this uncertainty is an important part of the game. However, by having a lower margin of error in our estimates when projecting those more stable businesses, the implicit investment risk is reduced, therefore, enhancing the investment risk-reward attractiveness.

Growth Potential

"It's true that growth often has a positive impact on value, sometimes one of spectacular proportions."
Warren Buffett

Predicting long term growth potential is among the most challenging aspects of the investment analysis. While many analysts spend great time building next quarter estimates for growth, we view as much more important to the investment thesis – as well as difficult to gauge – potential rates of growth over the long run.

Opportunities for growth maximize the benefits derived from high returns on capital. Such opportunities may come from cyclical or structural market growth, market share gain in existing markets, geographical expansion or mergers and acquisitions. Whichever the growth strategy, they all come with uncertainties, leading us to prefer companies with proven track record and companies that are following a path that has already been pioneered by other companies in other segments or markets.

We believe that sustaining growth in the long run is not possible without reallocating resources and there is a strong correlation between higher return on capital and higher future earnings growth. In our view, a stable, above average return profile is a good basis for better earnings growth predictability. Furthermore, the key metrics we use to evaluate growth potential are: (i) historical growth rates and current trend of the company and its industry; (ii) the company's track record of capital deployment; and (iii) the expected marginal returns.

Finally, we see important secular growth trends taking place in Brazil (such as rapid demographics shift). We can name some underpenetrated sectors and a wide range of them that are ripe for consolidation over the next decades. These trends provide additional complexity to the analyses but offer a fertile hunting ground.

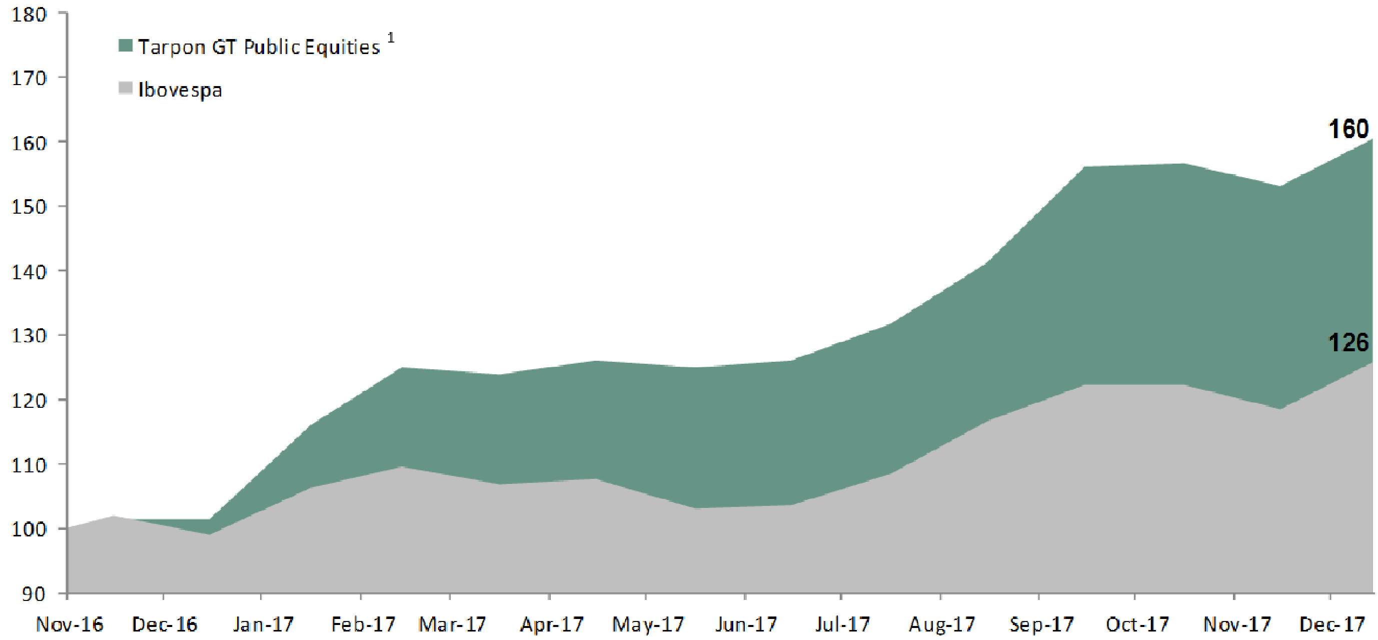
Conclusion

We hope that this letter provided some color and some interesting insights about this amazing and broad topic of Business Quality. In summary, quality businesses are those with structural and sustainable competitive advantages that enable them to generate high returns, grow more and be more operationally stable/predictable. Potential investments will present some of these features – the more, the better. Moreover, it is crucial to understand the whole industry context and economic cycle, build independent quantitative and qualitative assessments, and analyze the quality of the accounting practices and corporate governance to really be capable to benefit from the opportunities that the market offers, from time to time, to invest in good quality businesses at discounted prices.

Best regards,

Tarpon GT Public Equities
www.tarpon.com.br

Performance Since Relaunch



(1) Performance is net of pro forma fees. The returns were calculated using the gross returns of the strategy, discounted by the average fees of the Tarpon GT Public Equities Fund (management fee of 1.25% per year and performance fee of 20% of the excess returns above the Ibovespa Index).