<u>Nebraska Capital - Seventh Investment Report – April, 2018</u>

It has been a good time since we last wrote an Investment Report, in March, 2017. During this period a lot has been going on in macroeconomics and politics, both of which we follow, but our current investees are more resilient to these forces than most other businesses. Meanwhile, we have been studying a lot. We have made some marginal changes to our portfolio, including a "complementary" investment in a new company, Coelce, as well as a new investment in two peer companies, Smiles and Multiplus, which we will cover in another report to be issued shortly. These investments prove that there is absolutely no need for us to stretch beyond our circle of competence to put cash to work at favorable odds. Neither do we need to look for investment cases supported by short term macroeconomic "beliefs". But, to begin with, let's see what has been going on at Itaú and Equatorial.

<u>Itaúsa (38%)</u>

In March, 2016, we wrote:

"*<u>Finally, to close on Itaú we must mention a particular source of risk</u>. The bank is controlled by two entrepreneurial families and managed accordingly. When its mangers see a strategic path they go for it decisively… Overall we like both this alignment with controllers and managers' willingness to do what is needed - they are also decisive to acknowledge mistakes and act to correct them.*"

"*<u>Itaú already has about 10% of its equity in Latin America, the most relevant country by asset size being Chile, where a merger with the local CorpBanca is about to get completed</u>. Itaú will put an additional US$650.00 million in the merged company and will have slightly more than 1/3 of the business, with controlling power because of an agreement with CorpGroup, which will owns 1/3 of the shares… <u>Itaú has likely paid a high price to get scale into those markets</u>…"*

<u>"Both Itaú-Chile and CorpBanca are relatively new entrants to the retail market</u> - most of their assets are still in loans to large companies, funding comes mostly from large clients/institutions, loans surpass deposits, credit losses have been very low for more than a decade, and ROA cannot get much beyond 1%. <u>In summary, a really different bank from what we have as shareholders in Brazil."</u>

Putting it into a few words, we could see that Itaú was generating huge amounts of excess capital and that acquisition opportunities in Brazil would be rarer going forward; in addition, we were skeptical on that recent transaction in Chile. The numbers on the next page speak for themselves. Santander and Banco de Chile are two dominant retail banks in that country; they hold competitive positions similar to the one that Itaú has in Brazil. The Chilean economy has decelerated since 2015 and Itaú's management has been taking actions to de-risk and restructure its operations there, both of which impact short term results; nonetheless, the numbers depict a clear difference between true retail banks and "wholesale" (or midway) ones, something that is usually just clear when tougher times arrive. Quoting Buffett: *"it is only when the tide goes out that you discover who's been swimming naked"*.

We don't bring this subject here to argue that Itaú's merger with CorpBanca was a bad decision. We totally understand that management opted to spend a relatively small amount of capital to test the waters in a new market, to see how its management techniques would work out there. Moreover, short-term results are inconclusive and it is almost certain that Itaú will deliver much better numbers in Chile in the future. We brought this up to contextualize management's caution and rationality, especially in light of the new dividend policy.

Itaú has recently announced that it will pay out as dividends (which don't face income taxes in Brazil) all of the capital it generates beyond what is necessary to grow the bank, keeping a Common Equity Tier 1 ratio of 13.5% (Basel III,

fully-loaded). Hence, management has signaled that, despite their strategic views on international expansion, they are going to proceed with much care regarding capital allocation. We really like that, especially the caution with paying premium prices for assets that will (at least) take many years to become premium.

In Ch$ million	Itaú CorpBanca		Itaú CorpBanca	
	Consolidated*	Chile	Consolidated*	Chile
	2017	2017	2015**	2015**
Average Loans (gross)	20,714,812	15,968,940	21,201,431	16,097,381
PTPP	408,223	309,789	676,554	447,377
% of loans	2.0%	1.9%	3.2%	2.8%
Credit losses	367,694	228,370	217,654	90,110
% of loans	1.8%	1.4%	1.0%	0.6%
Average Tangible Equity	1,808,194		1,700,248	
loans/equity	11.5		12.5	
Profit before taxes	40,529	81,419	458,900	357,267
% of loans	0.2%	0.5%	2.2%	2.2%
Pre-tax ROE	2.2%		27.0%	

* Includes Colombian operations.

** Pro-forma for the merger.

*** PTPP: Profit before taxes and provision for credit losses.

In Ch$ million	Santander	Santander	B. de Chile	B. de Chile
	2017	2015	2017	2015
Average Loans (gross)	27,466,173	24,085,293	25,412,535	22,916,462
PTPP	1,020,081	941,136	926,029	923,789
% of loans	3.7%	3.9%	3.6%	4.0%
Credit losses	299,205	413,694	234,982	303,062
% of loans	1.1%	1.7%	0.9%	1.3%
Average Tangible Equity	2,906,791	2,626,238	2,962,370	2,612,466
loans/equity	9.4	9.2	8.6	8.8
Profit before taxes	720,876	527,442	691,047	620,727
% of loans	2.6%	2.2%	2.7%	2.7%
Pre-tax ROE	24.8%	20.1%	23.3%	23.8%

Meanwhile, in Brazil, passing through our worst economic crisis ever:

Itaú*	2011	2012	2013	2014	2015	2016	2017
Recurring Profit (R$ MM)	14,641	14,043	15,836	20,619	23,832	22,150	24,879
Dividends	4,394	4,518	5,095	6,635	7,304	10,000	17,557
Equity (year end)	71,347	74,220	81,024	95,848	106,462	115,590	126,924
ROE	22.3%	19.4%	20.9%	24.0%	23.9%	20.3%	21.8%
Brazil's GDP	3.97%	1.92%	3.00%	0.50%	-3.77%	-3.60%	1.00%

* Consolidated numbers; 97% of profits came from Brazilian operations in 2017.

As explained in our recent Annual Letter, we cannot highlight enough the resiliency of Itaú's business model. This is something that is hugely important for us at Nebraska. We are not here trying to pick the stock that will do better in the short run in case our country's economy really bounces back; rather we are here to allocate capital in companies that will produce real wealth over the long run, trying to exploit Mr. Market's moods to get great entry points into those firms, and always bearing in mind those risks to which people seem to just care about when they appear.

We won't take more of your time repeating ourselves on Itaú's economics in Brazil. But, we couldn't help bringing one more table:

2017 (R$ Billion)	Itaú	Bradesco	Santander	Banco do Brasil
Credit Portfolio (yearend)	593.7	492.9	348.0	681.3
of which Latin America	145.6			
Equity (yearend)	126.9	110.5	58.9	98.7
CET1 (Basell III)*	13.5%	11.9%	13.6%	10.2%
Profit	24.9	19.0	9.9	11.1
ROE	21.8%	18.2%	16.9%	11.8%
Profit / Credit	4.2%	3.9%	2.8%	1.6%
ex Latin America	5.4%	3.9%	2.8%	1.6%

* Itaú: fully loaded, after extraordinary dividends and acquisitions to be completed.

Itaú's new dividend policy was very well received by most shareholders. There is a negative side to it though: it is not a surprise to anyone, but as time goes by, Itaú is becoming a more and more mature company. We own Itaú through the holding company Itaúsa, whose policy has always been to pass along all of the bank's dividends and that is unchanged. The discount at the holding level is about 20%, even disregarding the equity that Itaúsa has in other companies. This is more than enough to offset some tax inefficiencies, which Itaúsa has historically covered with share issuances.

As commented in past reports, Itaúsa's management is looking to diversify a little from the bank. Over the last year, the holding has acquired a controlling stake in Alpargatas (the owner of Brazil's famous Havaianas sandals) and a minority stake (with the Canadian giant Brookfield being the major partner) in a pipeline company spun-off and sold by Petrobrás. Those two investments together represent less than 4% of Itaúsa's net worth (by market value, of which the bank is still close to 95%). We understand and live well with the fact that, over time, Itaúsa will do some share issuances (in which we will be forced to participate as they are done at huge discounts) to raise cash to pay down debt taken for those acquisitions. And, a few more similar deals may come along. We believe the likelihood of value destruction is very small as management is focusing on established businesses with good returns on equity.

We have recently sold some Itaúsa's shares in order to raise cash for the investments commented on the introduction; but that was almost irrelevant since we had spare cash for most of the purchases. When we last wrote, on March, 2017, Itaúsa was trading at only 1.7x book value (disregarding Itaúsa's equity in companies other than the bank), and we highlighted that a little more than a year before that the multiple was a very depressed 1.2x, because of Mr. Market's irrational panic. As we write this, the multiple has come to about 2.4x, closer to a fair value for such a high quality business. Having roughly 40% of our fund in Itaúsa throughout this period, we are almost sure that Nebraska was the asset manager that generated the most value (relatively to the fund's size) to its clients with Itaú over this timeframe. That was done without running any risk of permanent capital loss (something that cannot be said about many stocks that have also boomed in the period, but whose underlying businesses are "fragile" to say the least). Furthermore, and this is the main point here, we are certain that there are at least a handful of competing asset managers in Brazil that understand Itaú's intricacies better than we do (this is not to say we don't understand them quite well too); we strongly believe that our good (and differentiated) outcome with Itaúsa is due to our businesslike approach to investing.

Equatorial (13%)

"We are not here to build an empire" – from Equatorial's CFO, Eduardo Haiama, in December, 2016.

You may remember that in December, 2016 we wrote a report exclusively to praise Equatorial's participation in the least competitive auction for transmission projects in Brazil for years, if not decades. We finished that report with the same quote reproduced above, believing that Equatorial would avoid becoming just one more big, mediocre utility holding. In that auction, Equatorial was the biggest winner, offering on average a 12% discount to the annual permitted

revenues (which had been calculated with as much margin of safety as ever and with a very healthy WACC by the regulators), and committing to invest about R$4.0 billion, for great rates of return on equity. Early in 2017 Equatorial could win one more project at similar economics in another auction. And, in August the company announced the acquisition of an existing transmission line for R$550.00 million (when considering the stakes of both ex-owners, one of which signed on more recently), with good rates of return as well.

Then, in December, 2017 the government held another big auction. Today, we would like to praise Equatorial's management even more than we did in 2016 for what they did <u>NOT</u> do. The company did not win a single project in December's auction.

Below we have translated some phrases from an article that appeared on the newspaper *Folha de São Paulo* on the day of the auction:

Folha de São Paulo (December 15, 2017):

"The dispute was fierce...

With the result, the average discount reached 40.46%... the highest to the sector since 2011…

… ten minutes before the beginning of the auction, about 200 people still waited to enter the building, and many stayed outside."

<u>Cemar (27%) and Coelce (5%)</u>

Old time readers are likely tired of our explanations about why Cemar is such a good company (regulation through benchmarking, badly managed peers…). We are not going to repeat all of that here. Every time we find Cemar's shares available at good price, we buy them, but the liquidity is low and those opportunities are getting scarcer. As we write this, Cemar is trading at about 1.6x equity (disregarding working capital, which is relevant and generates finance and fee income on receivables). Despite being extremely under leveraged at the moment, Cemar generates so much efficiencies over regulatory targets that we see it delivering returns on this equity of about 20%, compared to the regulator's 12% cost of equity, both in real terms (above inflation). The company has just passed by its fourth regulatory review, and we already have good visibility on the fifth cycle for the sector; in other words, as long as Cemar keeps doing its homework well, its returns will keep very healthy for at least another seven years, and likely for much longer. As an icing on the cake, there is still good growth on invested capital into the future, as Cemar is in one of the country's most underdeveloped regions.

Nebraska's first investment in electricity distribution companies was in Coelce, back in 2011. It was a small investment, supported by a high dividend yield; but it was this small investment that led us to dig much deeper into the regulation, untangle it, look at peers, and eventually find Equatorial. We have now come full circle.

Coelce is very similar to Cemar. Both operate distribution networks in states located in the country's Northeast region, and both are amid the most efficient firms in the sector. Coelce's results are often used by ANEEL (the regulatory body) as targets for other companies, especially the company's low level of electricity losses. We have built our stake in Coelce in two chunks; the first in May, 2017, right after our stock market took a big hit as an audio of our President talking with the head of the meat-giant JBS about allegedly dirt schemes was released, and the second, more recently, in March, 2018 after the company released some confusing numbers for its fourth quarter results, leading the stock to another drop. The valuation that we paid implies a discount of about 30% to Cemar's current valuation just mentioned. So, why can we buy such a nice regulated natural monopoly that has historically delivered great results at such discounted prices? We have two clues, besides the simple "Mr. Market" explanation:

1- Coelce is going to pass through its fifth regulatory cycle in April, 2019 (more likely this will be delayed, as always, because the company is one of the firsts into each new cycle). Since the company went through its last regulatory review, our country has suffered a huge recession that leads to a much more complicated environment for utilities (people stealing more energy, defaulting more often, etc.); this, combined with lower consumption per client, leads to regulatory targets for operating expenses and energy losses that are (in this last year of the fourth cycle) likely as hard as they get for this company (but Coelce is still beating the targets when you combine all of them into a final bottom line effect). Moreover, Coelce has invested tons of money in its network over the last four years, much above depreciation. If electricity consumption were growing fast, that would not be a factor, but it is clear that current rates are not enough to compensate the company for its invested capital (at regulatory WACC) – this is naturally going to be corrected by the upcoming regulatory review.
2- Coelce is controlled (74%) by the giant multinational utility ENEL, which has done some failed efforts to buy minority shareholders out. Unlike Equatorial, ENEL is not public traded in Brazil, and Coelce's individual disclosures have been getting thinner and thinner – it is almost impossible to communicate with the company at this point. Analysts have left the company aside, and dividends are below what they should be (with the caveat that recent levels of capital expenditures might explain a more conservative capitalization, which today is similar to Cemar's). We pay great attention to all of this, and we prefer a "relatively" more expensive Cemar because of Equatorial's governance and management team, as well as more consistent results; nevertheless, just as Cemar, Coelce, by its charters, cannot be anything else but the electric distribution company of its state, Ceará – in other words, either it is well managed and pay excess capital out to shareholders, or it is worth less for both us and ENEL.

Coelce's shares have much more liquidity than Cemar's, but are not very liquid either. We see those two investments together, along with Equatorial, regarding our exposure to the sector and risks. When we think about our concentration in the sector, we have in mind three big themes:

1- We have structured Nebraska so that our interests are hugely aligned to our clients', who, in turn, provide us stable, long term capital.
2- The regulation for distribution companies in Brazil is very settled and consistent at this point, going into the fifth cycle already, with ever increasing visibility and transparency throughout the process. In addition, those businesses are highly resilient to macroeconomic forces.
3- Cemar and Coelce are extremely cheap – those who follow utilities in the U.S., for example, know that similar companies there trade above two times book value; and that is without them being able to deliver returns superior to their regulatory cost of equity.

We appreciate your attention,

Nebraska Capital April, 2018