# <u>Nebraska Capital - Sixth Investment Report - March, 2017</u>

As announced in our latest Annual Letter, in this report we are going to focus on Itaú, our largest holding (at 38%, through the holding company Itaúsa) and the banking sector. But, before moving on to this topic, we want to highlight an important change in our portfolio. In previous reports we have made it clear how much we appreciate both Equatorial and Cemar. We have said that Cemar's shares are thinly traded and that we acknowledge that its shareholders are not going to participate in (likely) accretive inorganic growth that Equatorial may have; however Cemar's valuation implies a large discount to Equatorial's and Cemar is Equatorial's oldest holding, operating at full speed in terms of efficiency and profits. Over the last months we had the chance to buy a good lot of Cemar's shares and we just could not let it pass. The company now represents 26% of our fund (and Equatorial another 14%), up from 16% at yearend. On the other side we sold almost all of our stake in Vivo (we didn`t have enough cash to buy all of the Cemar`s shares we wanted); as hinted in previous reports we were increasingly questioning ourselves on this investment, especially in light of the changes in the company since we first invested (namely GVT's acquisition).

Electricity distribution firms in the U.K. (where our regulators look for inspiration), as well as in the U.S., are allowed to earn good returns on equity capital, and are worth anywhere from 1.5 to 2.5 times regulatory equity. The economic value of these assets in Brazil should not be much different, unless our economy (or our government) takes a "Venezuela-route" (in which case, by the way, most businesses would lose a lot value, not only regulated ones). We believe that Cemar's current market capitalization would be a fair valuation in case the company was just "average", or reasonably managed. But Cemar is not reasonably managed; it is very well managed, and operates in a regulatory framework that strongly favors efficiency. The company currently makes almost two times regulatory returns, and we don't think this edge is going to decrease fast - to the opposite, this should be a slow process, if and when it begins. Moreover, Cemar's regulated asset base continues to grow at strong rates.

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## <u>Itaúsa (38%)</u>

*<u>"Profitability is more important than market share"</u>* - Paulo Caffarelli, CEO of Banco do Brasil - commenting on his bank's 2016 results.

This quote, from BB's CEO, summarizes a good deal of the message we intend to pass here.

In our first investment report, from April, 2015 we wrote:

(1) *"<u>Rational decisions, by the way, is the name of the game for future high returns on equity</u>. According to Itaú`s management (and not a surprise for whoever studies the business in developed economies), <u>the bank's highest returns are not on providing loans, but rather on a wide array of services</u>, such as the credit card ecosystem (issuing, acquiring, servicing), fees, insurance products, investment banking, and others."*

(2) commenting on Itaú's strategic moves since 2011: *"Besides BMG, Itaú has made other nice deals, such as acquiring 50% of Redecard (its acquiring arm) that it did not already own and Citibank`s long established card issuance business in Brazil, Credicard, expanding Itaú's leadership in the segment."*

(3) *"Meanwhile, government controlled banks expanded their balance sheets, attracted the clients Itaú and Bradesco rejected and pushed their leverages to new highs. Between 2011 and 2014, private and foreign banks kept their combined credit/GDP ratio stable at about 27.5%, but public banks pushed their loan balances from 21.4% to 31.6% of GDP. The consequence of all this was their own weakening, which is well represented by the fact that Banco do Brasil had to let go part of its profitable insurance arm and, more recently, part of its card business - despite the benefits of privatizing those good businesses, the bank itself has become a company with weaker economics."*

Later, in March, 2016, before the impeachment of our previous President and thus in the eye of the hurricane (Brazil's current crisis), we had a report solely dedicated to Itaú, in which we argued that:

(1) the bank's profit before taxes and provision for loan losses (PTPP) was ample and supported by earning streams from service businesses, concluding that Itaú was ready to pass through almost whatever storm Brazil's economic environment could bring; specifically we wrote:

*"Itaú's credit portfolio is diversified and geared towards low-loss-variance loans enough as to give us peace of mind regarding the bank's PTPP-power to surpass drastic scenarios (much worse than what management draws for 2016). But don't get us wrong, losses occasionally rising by a factor of 2, or even 3, times is still a possible scenario in this discussion."*

(2) businesses with large and sustainable moats are worth multiples of book value regardless of macro-economic scenarios (apart from Venezuela-like situations). Further, we noted that, between 1997 and 2015, Itaúsa, through dividends and equity growth, had delivered a real annual return of 17.5%, versus 7.7% for the CDI (risk free interest rates) and that, although it was impossible to pinpoint the size of the edge going forward, every sensible businessman that understands about banks in Brazil could see it would continue to be substantial; and we concluded that Itaúsa's shares were a great investment at that time, as they were trading at about 1.5x book value (already up from 1.2x a few months before, when we were as much invested in it).

As I write this, our arguments from 2016 seem to have become commonplace. Itaú has delivered nice results in 2016, with a net profit of R$22.0 billion (down only 7% from 2015), and management has said that expenses with loan losses are going to fall between 30% and 40% in 2017 (although the bank is likely to consume part of the additional provision booked late in 2015) - this is a much more relevant improvement than what competitors have guided, showing the results of Itaú's actions on its credit portfolio since 2011 (on which we have commented in previous reports). Over the last twelve months, Itaú's shares (ITUB4) are up 43% and Itaúsa's (ITSA4) 37% (without considering dividends). The discount at the holding company has expanded due to market concerns regarding Itaúsa's disclosed interest in acquiring a controlling stake in BR Distribuidora - more about that later. Anyway, we are happy to say that our Itaúsa's shares still trade at only 1.7x book value.

Given that we don't like to take your time with easily available thoughts, we are going to resume commenting on the competitive environment, with which we began this letter (Mr. Caffarelli's phrase and our writings from 2015).

First of all, we need to remember that we live in a country with a quite concentrated banking system, in which three private banks (Itaú, Bradesco, and Santander), along with two government controlled ones (BB and Caixa), dominate retail banking, from business loans to payment services. Moreover, our government is constantly short of capital, with the same being true for the banks it controls. And, Brazil's capital markets are quite under-developed, for a variety of reasons that would require a full letter. Hence, point number one: Brazil's economy unquestionably needs Itaú, Bradesco, and Santander's balance sheets.

Point number two: our banking system is constantly forced, by groups of interest within our society, into one sort or another of cross subsidies. To exemplify, we force banks to direct their lowest-cost funds to specific types of credits (residential mortgages, rural...). Moreover, some groups that can scream louder (or can spend more money on that) end up getting hidden subsidies in the form of cheap loans (besides directed lines) from government controlled banks - the third table below, with BB's losses on its loans to businesses, displays a good evidence.

All of this creates a completely disturbed competitive environment, from which a well-managed bank (Itaú) can profit handsomely. Given its size and importance to our economy, Itaú cannot simply opt out of any particular segment within banking, but it can expose itself more or less to specific parts of it. The third table below will make it crystal clear that BB makes tons of money on its relationships with individuals (perhaps it has the "easiest" banking business in Brazil in that niche, with a lot of government employees who default little and yet pay high rates for loans, besides using a lot of services), whereas it pass along most of these earnings as "subsidies" to other groups of clients. This strategy didn't come out of the blue, rather, it was conceived and successfully implemented by our governments during the 2000's - it was the only way they could make those louder voices happy without breaking the bank.

However, too much of a "good" thing can only go so far. During this decade (2010's), the subsidies within government controlled banks got so large that their profitable parts could not bear the burden anymore. As we wrote in 2015, while Itaú directed capital and efforts to those businesses in which our government "forced" banks to be quite profitable (credit-cards, insurance...), BB and Caixa did the opposite. The results are appearing now. Moreover, our democracy may advance somehow (we hope so), but we don't see it changing as much as to modify the way our banking system works in any meaningful way - the country has just barely put its nose out of the water and we are already seeing the government "facilitating" things for some groups (namely the construction industry, through a renewed boost to residential mortgages at Caixa).

Before moving on, all of the above does not mean we don't see our banking system advancing. Better regulations around secured loans can really bring defaults and interest rates down, regardless of structural changes in the competitive environment. Digitalization can lead to expenses cuts, with similarly downward effects on interest rates, and enable more people to access the system. We could go on, but the message is given: Itaú and its peers will continue to benefit our economy, given minimally reasonable conditions to operate. Also, we cannot fail to remember that our largest private banks have not even come close to need a government bail-out during the severe crisis we are passing through in Brazil, a remarkable stability that we regard as a substantial benefit to our economy.

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"*We gather what we seed.*" - Brazil's folk saying.

(1) Profit before taxes and provision for loan losses (PTPP), ROE and Basel III:

| In R$ billion | Itaú* 2015 | Itaú* 2016 | BB** 2015 | BB** 2016 |
|---|---|---|---|---|
| A - PTPP | 55.60 | 54.90 | 32.40 | 35.30 |
| B - Provision for loan losses | (19.00) | (24.20) | (20.00) | (27.00) |
| A/B | 2.93 | 2.27 | 1.62 | 1.31 |
| ROE | 23.9% | 20.3% | 13.0% | 7.5% |
| Basel III Core capital*** | 13.6% | 14.0% | 8.2% | 9.6% |

* Itaú's numbers are pro-forma for the acquisition of CorpBanca (Chile).
* Itaú's loan losses include impairment of corporate securities.
** PTPP Adjusted for minorities` share in subsidiaries, which are mostly service-businesses.
** BB's numbers differ from what we showed in previous reports due to acounting changes in consolidation.
*** Itaú is fully loaded, BB is not.

(2) Itaú's source of profits:

| Itaú - Net Income per Segment - R$ Billion | 2015* | 2016 |
|---|---|---|
| Services and insurance | 14.10 | 13.60 |
| ROE | 33.9% | 39.5% |
| Credit and trading | 9.60 | 6.40 |
| Credit | 8.10 | 5.30 |
| ROE | 13.3% | 9.4% |
| Excess capital | 0.10 | 2.10 |
| ROE | 10.1% | 9.9% |

* Adjusted pro-forma for the merger with CorpBanca.

(3) BB's lending business - cross-subsidies:

| In Billion R$ | Average credit portfolio | Spread | Provision for Loan losses 1* | Provision for Loan losses 2* | Net spread |
|---|---|---|---|---|---|
| Individuals | 186.00 | 22.10 | (6.30) | (5.31) | 16.79 |
| Businesses | 330.00 | 14.60 | (20.40) | (17.18) | (2.58) |
| Rural | 178.00 | 8.60 | (1.80) | (1.52) | 7.08 |

* Loan losses 1 are before recoveries, as disclosed by the bank.
* Loan losses 2 are our accounts allocating recoveries pro-rata to losses, which is likely unfair with the Individuals segment, given that recoveries are usually larger (relatively) there.

About the numbers on table (3) it is important to mention two things: (a) the spread by loan segment is given by the bank and brings into consideration the specific cost of funding, in other words, the rural segment gets almost all of the benefits of the cheapest sources of funding; and (b) it is very probable that relationships with businesses have more non-interest expenses than income, thus, being nice, looking just at the R$2.58 billion loss above and allocating 40% of BB's equity to this segment, we can say that the segment's results in 2016 were R$9.5 billion below a 20% pre-tax return on equity that shareholders could reasonably expect - for a bank that had an overall pre-tax result of R$8.3 billion this drawback is impressive.

As shareholders of a well positioned competitor, we could not be more pleased with BB's numbers, as well as with its CEO's comments, which, in our opinion, just clarify a direction that BB would necessarily need to take, sooner or later. Rest assured, though, there will be a time when BB's leaders will be loud about gaining market share again, sooner or later.

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Before closing, we have a few words about capital allocation, first on Itaú, and second on Itaúsa:

(1) With a return on equity above 20% and a huge Basel ratio, Itaú is certain to generate much more capital than what organic growth in Brazil will require, regardless of both whether inflation really falls to below 5% (as forecasted by many) and whether economic growth resumes. Management has just announced a change on the bank's dividend policy, increasing the payout range from 30-35% to 35-45%. For 2016 the actual payout was 45%, but, although the credit portfolio is barely going to grow in 2017 (according to the bank's guidance), management did not commit on that percentage for the following years, opting instead to retain flexibility.

We applaud the decision to increase the payout (dividends are not taxed in Brazil), but, as we wrote in 2016, we acknowledge that, by investing in Itaú, we have chosen to partner with two of the country's most successful and entrepreneurial families, which are likely to opt for growth instead of dividends whenever that makes economic sense - <u>economic sense</u> being of paramount importance here.

Our previous report on Itaú brought some thoughts on management's decision to merge its small Chilean subsidiary with CorpBanca, allocating an additional US$650.00 million in cash in the process to get a little more than 1/3 of the combined entity (Itaú-CorpBanca) and gain managerial control. We are not going to repeat ourselves here, but we see this deal with skeptical eyes, as Itaú has bought into a bank that has a very different competitive position in Chile than what Itaú, itself, has in Brazil.

Such as Itaú-Chile before the merger, CorpBanca was not amid the leaders in retail banking in its home country (nor in Colombia where it has a smaller presence) - the combination itself cannot bring relevant improvements to these competitive positions. The fact that Itaú-CorpBanca's recurring net profit in Chile (pro-forma) fell by 75% in 2016, along with a loss in Colombia and a 2% consolidated ROE for the year, shows how weaker the bank's economic value is as compared to that of the Brazilian bank in which we decided to invest - Itaú, in Brazil, has passed through a much tougher economic storm with a 7% decrease in earnings, and a ROE above 21%; moreover, the profits of the dominant retail banks in Chile have barely varied between 2015 and 2016.

That said, we understand that CorpBanca was a small deal for Itaú and that it gives management the opportunity to test its managerial capabilities in two important countries in Latin America, Chile and Colombia. In both of these countries, as well as in many others in the region, there are great retail banks with dominant positions and quite profitable operations; but taking control of such firms will certainly require much larger capital commitments.

Given its controllers' disclosed ambitions for Latin America, we see a good likelihood that, sooner or later, Itaú will announce a larger deal in the region. As the bank's shares appreciate (though still far from being a good currency in our opinion), and as other countries in the region pass through some troubles (think Mexico and its currency losing value for example), this probability increases. Over the years we have developed a good confidence in Itaú's management and its capital allocation capabilities; but, having not seen relevant ventures out of Brazil so far, we cannot reach a definitive conclusion that anything management does will be good (at least in terms of processes, as outcomes in businesses are subject to some uncontrollable forces, as we all know).

(2) Itaúsa is the holding company of the Egydio de Souza Aranha family. As of December, 2016, the entity had 95.6% of its total investments (of R$47.00 billion) in Itaú. In other words, its other investments (namely a controlling stake in Duratex) are almost irrelevant and are not requiring additional capital, thus we simply disregard them when deciding to invest in Itaú through the holding. For decades Itaúsa has been just a conduit, paying out the bank's dividends to its shareholders (adjusting, through small share issuances, to some small tax penalties). The company has no financial leverage. However, perhaps the fact that the bank is generating much more capital than it needs, along with Brazil's economic crisis creating some opportunities in other sectors, has led Itaúsa to announce it may increase its investments in other businesses to 10% (from the current 4.4%).

Specifically, Itaúsa, along with the holding company of the Moreira Sales family (its partner in Itaú), has disclosed an interest in acquiring a 33% controlling stake in Petrobras's fuel distribution arm, BR Distribuidora. Petrobras is expected to auction-off this stake as part of its restructuring process. According to market news, the stake could command an equity value of about R$10.00 billion; Itaúsa's share would be half of that, and management has hinted it could use some combination of leverage and equity to finance it.

Fuel wholesale has become a great business in Brazil after a large consolidation/restructuring process that took place during the 2000's. Currently three players, Ipiranga and Cosan, besides BR, dominate the field. Many say opportunities for profit enhancements are plenty at BR, and this is likely the reason why many suitors have appeared. Itaúsa's managers argue that in their favor they have both the fact that they are buy-and-hold shareholders, and their local expertise.

Anyway, the specifics of a potential BR deal are not the most important thing for us at this moment. The fact is that we did invest in Itaúsa because of the huge holding discount and thinking that, according to a decade-long practice, nothing else of relevance would happen over there. Obviously, we also trusted that its controllers and managers would not destroy value. Since the company announced the interest in BR, the discount (ITSA4 to ITUB4) has widened from about 21% to 25% (giving zero value to assets other than Itaú), which means either that the market has already priced in BR's acquisition as a certainty and total disaster, or, more likely in our opinion, that the slightly strategic change at Itaúsa has alienated part of its previous shareholders, who used to see it the way we did and got scared away. To scare us away, however, much more is needed than a disclosed interest in making a relatively small investment in a good asset.

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To finish, we replicate some lines of our recently disclosed Annual Report, about Roberto Setubal (in the context of his retirement as Itaú's CEO):

*"He took the position in 1994, when the Brazilian banking sector was still quite fragmented, and has created a machine, with a winning culture, that has transformed itself into the largest bank in the country, the most profitable (amid the big retail ones), and, certainly, the best managed of all. During these 23 years, Itaú's average return on equity was 23.7%, and its shares have gained 24.7% annually, with dividends reinvested."*

We appreciate your attention,

Nebraska Capital March, 2017