Nebraska Capital - Fifth Investment Report - December, 2016

Our portfolio has barely changed since mid-2015; that is worth highlighting given all the volatility in Brazil's stock market during this period. As explained in previous reports, we always felt our core investments were well positioned to pass through (or even benefit from) the economic turmoil, because of their strong competitive positions and healthy balance-sheets. We believe that, in the long-run, being right on these assessments (and avoiding overpaying to get into new investments) will pay off quite well, and that those are the kind of judgments we are able to do. We just leave trying to anticipate trends to others.

Since we last wrote, in June this year, the operating performances of our main companies have not brought relevant novelties - Itaú, Equatorial and Vivo are doing well, especially when compared to their competitors. Nevertheless, Equatorial`s entrance into the transmission segment is worth a few pages.

Equatorial (14.6%) and Cemar (13.8%):

As we always like to remind readers, Equatorial is a holding company that owns 96.5% of Celpa and 65.1% of Cemar, both of which are regulated companies that distribute electricity. Equatorial's stake in Cemar was acquired in 2004 and this subsidiary is currently operating at "full speed". Celpa was acquired late in 2012 and is still in a turnaround process, with good results so far. We have been acquiring Cemar's shares slowly for years as they have low liquidity. Recently, we had to return money to some investors and decided not to sell Cemar, opting instead to sell a little more of Equatorial's shares and keep our combined exposure to the two companies steady. Although we have written extensively about Equatorial and Cemar on our last report, we are dedicating a few pages to Equatorial once again as, for the third time in its twelve-year history, the company has made a major capital allocation decision.

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> "*In addition, we own positions in non-traded securities of Dow Chemical, General Electric, Goldman Sachs, Swiss Re and Wrigley with an aggregate cost of $21.1 billion and a carrying value of $26.0 billion. We purchased these five positions in the last 18 months. Setting aside the significant equity potential they provide us, these holdings deliver us an aggregate of $2.1 billion annually in dividends and interest."* (Warren Buffett - Berkshire Hathaway's 2009 Letter)

During the deep crisis through which the U.S. economy passed in 2009, Berkshire's thriftiness, patience, conservatism, preparedness, and rationality, which express themselves in the form of a strong balance sheet, paid out, not only to its shareholders, but also for society at large. Fast forward to 2016, Brazil is in a severe crisis, investors are afraid to put cash to work, and, specifically, its electric transmission infrastructure is lacking. This time, Equatorial's characteristics that resemble those of Berkshire came to the rescue. We are happy to be shareholders in a company like this.

In Brazil, transmission lines are planned by ANEEL (the country's regulatory body for electricity) and submitted to a bidding process in which many qualified companies participate and the one offering the lowest annual revenue, to be adjusted for inflation and gained over a 30-year period, wins the auction. Building those lines is a not rocket-science, to the contrary, it is usually outsourced under fixed-price contracts. It is that simple; in a "flat" world, it would be impossible to make great investments in this sector, but, then, it would be very unlikely for the companies that Buffett mentioned in the lines above to need to borrow money at such high interest rates as well.

Last October, 28, ANEEL offered 24 transmission projects for bids. Equatorial won the concessions to build and operate seven of those - in three of which it was the only bidder. The company has committed to invest almost R$4.0 billion over the next five years. The government, through ANEEL, had been trying to auction off these projects, which are essential to link new hydro and wind power plants to the grid, for months without success, and had improved the premises underlying the maximum allowed revenues twice to a point in which the economics became quite attractive as the table below should clarify. It's worth noting that, although Equatorial's prior focus had been on distribution, a segment in which management capabilities have a higher value and the regulation is more compelling in our opinion, the company's entrance into transmission did not come as a surprise to us; managers had been saying that they could invest in both generation and transmission if the economics were compelling and execution risks were low.

Sniffing out opportunity, Equatorial had done its homework. It had hired some professionals, had made its analyses, and went to the auction with agreements over building costs with major construction firms. In previous transmission projects, companies have had issues with environmental licenses and this still remains a risk; but this time not only the contracts' terms passing responsibilities for delays in this area to the government are clearer, but also the period to bring the lines into operation is much longer, providing an extra margin of safety, as well as some upside, both of which are also seen in other aspects of this latest auction.

Equatorial is likely to finance between 50% and 70% of construction costs with debt, an usual leverage ratio in this kind of projects. The government's bank, BNDES, is going to provide subsidized debt (which is barely subsidized these days) for approximately 20% of costs. The benefit of this leverage, nevertheless, is already considered on ANEEL's maximum allowed revenue, as well as on any competitor's bid. In other words, the more BNDES-debt the government offers, the worst the economics of the project in our opinion, as this only decreases the entrepreneur's margin of safety, as well as his ability to differentiate himself by obtaining market-debt at a lower cost than his peers could do.

According to the company, and to our calculations, Equatorial's current cash balance and dividends from Cemar and Celpa should be enough to finance the equity portion of the projects it won - not that we would be unhappy to provide new capital for attractive deployment. To close this first part, despite Equatorial's strong team regarding finances and regulation, as well as the projects' layers of margin of safety, we should remember that this is the company's first adventure into transmission, and that risks are far from zero.

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"A hasty person eats raw (food)." - Brazilian proverb.

Until recently, transmission auctions had been dominated by government-controlled companies, such as Eletrobras and Copel, as well as foreign multi-nationals, such as Abengoa. Vast amounts of capital were committed to the sector between 2006 and 2013; the table below brings data from just a few auctions.

Auction date	Sep-11	Dec-12	May-13	Nov-14	Oct-16
Premises for Annual Allowed Revenue					
Cost of equity (Real return)	9.9%	9.4%	9.4%	10.5%	11.1%
Equity / (Equity + Debt) *	36.5%	36.5%	36.5%	41.0%	79.3%
Real cost of BNDES-debt	4.7%	3.8%	3.8%	3.3%	8.9%
WACC	5.6%	5.0%	5.0%	5.6%	10.0%
Initial Annual Allowed Revenue (R$ millions)	340.00	450.00	452.00	432.00	2,416.60
Effective Annual Revenue (winning bid)	263.80	350.20	398.00	377.00	2,124.87
Average discount	22%	22%	12%	13%	12%
Largest winner		Abengoa	Abengoa	Eletrobras	Equatorial
Equatorial's bid:					
Initial Annual Allowed Revenue					815.15
Effective Annual Revenue					718.52
Average discount					12%
Calculations for illustrative purposes; assumes one year of planning, four years of construction, 25 years of revenues (as if these were the contractual terms in all of the auctions), debt amortization in 15 years, full tax rate, and the following:					
1- Construction costs, leverage and cost of debt the same as in the projects, but Effective Annual Revenue:					
Real rate of return on equity	6.2%	5.7%	7.6%	8.5%	9.6%
2- Leverage and cost of debt the same as in the projects, but Effective Annual Revenue and costs overrun of 10% on capex:					
Real rate of return on equity	5.0%	4.5%	6.1%	7.0%	8.6%
3- Construction costs and cost of debt the same as in the projects, but Effective Annual Revenue and leverage as follows:					
Equity / (Equity + Debt)	36.5%	36.5%	36.5%	36.5%	36.5%
Real cost of additional debt (NBK`s assumption)**				9.0%	9.0%
Real rate of return on equity	6.2%	5.7%	7.6%	8.6%	10.8%

* Leverage assumption considering subsidized BNDES-debt only.

** For illustrative purposes only.

Despite not drastically different regarding ANEEL's premises for cost of equity, we can clearly see that previous auctions were not only more competitive, but also much riskier than the last one. It is much safer to offer a 12% discount on maximum revenues with a 21% implied leverage than bidding the same discount with a 63% leverage assumption. Moreover, the risk is lower when your economics aren't hugely dependent on timely accessing a heavily subsidized debt from a bureaucratic bank. Equatorial had not even participated in previous auctions - they really don't like raw food over there.

Novak Djokovic, with his "gluten-free, as-raw-as-possible diet", would say eating raw food isn't a bad thing (and we can't argue against his recent results), anyway, you got our point with the proverb above. Moreover, we would add that (forgive us Djoko) eating raw food causes indigestion as both Abengoa and Eletrobras are under serious financial distress, the former in a "Chapter 11" in Brazil, and stayed out of this last auction. Proverbs can be a really nice source of wisdom.

The table above gives you some idea about the real rate of return on equity that Equatorial may get from its transmission investments, which don't scratch the company's capacity to pursue other acquisitions as they demand little in terms of human-capital. And, there is another plus that could add almost 200 bps to these returns: investments in the North and Northeast regions of Brazil, where most of our projects are located, have a 55% benefit on Income Taxes - though the full use of that is not so simple as the benefits must be reinvested in those same regions.

To close, bringing the concept back from our last report, Equatorial's "antifragility" seems to have paid off as the company has contracted to make incremental equity investments representing roughly 15% of its current market capitalization (assuming 50-70% leverage) under an attractive risk/reward proposition. As a final caveat, there is one particular thing we don't like about transmission projects: over the long-term, they generate a lot of free cash flows, which, without management intervention, bring the holding company's leverage significantly down. Yes, we really meant it. Whereas well managed electric distribution companies offer shareholders a guaranteed high level of capital expenditures under healthy regulated returns "forever", cash flows from transmission subsidiaries must find their destinies each year (the country will need additional investments in transmission lines, but incumbents have no edge on that, instead, new auctions will take place; and replacement/marginal capital expenditures within the same lines are irrelevant). Under these conditions, looking at the experience of most other electricity holding companies, the institutional imperative (coming back to Warren Buffett) tends to act, "forcing" managers to allocate capital even at mediocre projects so that their "empires" don't shrink. The usual high leverage level of the sector further amplifies this issue. We hope to be around way beyond Equatorial's transmission projects get to this long-term "problem"; and we really hope the company's current management team (or at least its culture) not only stays around, but also holds on to its rationality - it will not be easy.

"We are not here to build an empire." - A few days after we had written this piece, Eduardo Haiama, Equatorial`s CFO, said that on a conference call with investors. We had heard similar phrases from him before.

We appreciate your attention,

Nebraska Capital December, 2016