LIS Value FIA 2 Years Anniversary

LIS Value FIA completed 2 years in March. Although 2018 has been a troublesome year so far (as we predicted in our last letter), the performance of these years, term we deem the minimum appropriate to gauge the consistency of the fund's results, has been notable. Despite the strong result, it is not the return itself that stands out, but the way it has been achieved, which we understand is most important to our investors

The levels of risk assumed to achieve these returns have been well controlled, which is a mandatory healthy practice for our investors.[1] First, our return has not been built through very risky, concentrated bets that went well, nor has it been affected by extraordinary one-time events that benefitted the portfolio.

Much to the contrary, the investments that comprise our portfolio, created through diligent analysis of each company, and supported by our risk measurement and control tools, were made with relatively small positions and high levels of cash, while also carrying the costs of hedging, which naturally impact returns, but are an important tool to protect the portfolio against negative high impact, unpredictable events.

In the end, we are very happy with the disciplined execution of our processes and the conservative risks taken in our portfolio, two factors that are determinant for the construction of good and sustainable returns for our fund in the long term.

Processes – Portfolio Model

Given the importance that processes have on portfolio management, we would like to use this letter to explain briefly one of our most important tools. The purpose here is to open our doors and show to our investors how our decision-making works, so our fund can be judged by more than the return track record – specifically in the short-term, when results usually are misleading when evaluating the quality of our investments.

The tool mentioned above is one we internally named "portfolio model". What it does, basically, is defining the exposure of each stock we invest in in the portfolio, while also pondering our cash and hedge positions. There are three main variables that influence the output of our tool: the quality of the underlying company, our trust in the management and controlling group, and the existing margin of safety. The cap to the maximum exposure in a stock is defined, mainly, by how much we would lose if we are mistaken, or if negative events for the company unfolded, given that our major concern is always protecting the capital of our investors.

Our cash position has a very relevant role, both for controlling risks of permanent loss of capital and for allowing us to have firepower to be aggressive when opportunities arise. We don´t treat our cash position as residual – leftovers after we have allocated what we deemed appropriate into stocks. We use an active policy in cash management, with a well-defined process. In it, we define the amount of cash by calculating the total risk of loss from our portfolio – a sum of the individual risk for each investment. Every time the consolidated risk rises above our predefined

[1] Despite being more important than the return itself, generally the levels of risk taken by investment funds are not revealed to investors until it is too late. At LIS, we put effort into doing exactly the opposite: being conservative at taking risks while being transparent on how we run things.

parameters, we increase our level of cash in order to bring our worst-case scenario potential loss within prudent levels for the portfolio.

This process creates a counter-cyclic dynamic to our portfolio. When stock prices are going up, the potential losses of each investment also increase, *ceteris paribus* (i.e., assuming there are no changes to the worst-case scenario because of improving economic conditions). Consequentially, our cash position will also go up, and the opposite happens in bear markets. In the pendular nature of the market, we will typically be heavily allocated in stocks in situations of severe disparities between price and value – planting the seeds of future returns – or, during bull markets, nicely protected in cash – diluting eventually market corrections and having liquidity to seize available bargains.

On top of all these practical applications of our portfolio model, we believe that its´ biggest value is in the fact that it contributes to mitigating the cognitive biases to which we are exposed, since it relies on well-defined and long discussed premises. Thus, for example, the Portfolio Model will avoid the market mood to interfere with the investment decisions – a very common trap given human predisposition of following the herd, being the social animals that we are.

An integral part of our investment philosophy is in the continuous and disciplined execution of allocation and risk control processes. We understand that these traits – execution and discipline – are paramount advantages we have that create value for our investors.

"We don't have to be smarter than the rest. We have to be more disciplined than the rest."- **Warren Buffett**

In fact, during these first two years we have been putting effort into further improving our tools and processes built since the conception of the fund. Certainly, we will continue working towards refining our decision-making, supported by one of our pillars: having a team that has been working together for over a decade, accumulating hits and mistakes over that time span.

"Go to bed smarter than when you woke up." - **Charles T. Munger**

Investment in Unipar

The investment in Unipar started in February 2017, and was concluded during the first semester of this year, bringing outstanding results to our portfolio. The company had been developing a long and troublesome history as a listed company. When we first invested, only a handful had some understanding of what was going on in the company, given its´ very low levels of negotiation and overall less-than-inspiring situation.

Its controlling shareholder was being targeted by a corruption investigation, the company was proceeding with acquiring a competitor with a long history of poor results and a very stressed balance sheet, and, mainly, the controlling group had started the process of trying to take the company private by offering a very low price for the stocks being negotiated in the local market.

Nevertheless, as we dug deeper in our analysis, it became clear that investing in Unipar bundled several features any investor would like to find (quality and price), besides having some characteristics that alleviated the apparent risks.

Unipars´ business, the production of chlorine and caustic soda, has a profile of strong and resilient cash flow generation with low need for investments, presenting characteristics of a natural monopoly. The controlling shareholder, stuck with lawsuits and under pressure for the offered price to take the company private, was forced to step back. Furthermore, among the

minority shareholders was a well-known activist, Mr. Luiz Barsi, which had all the reasons to defend the rights of other minority shareholders. The company being acquired – Solvay-Indupa – was having a long streak of financial losses mainly due to an overleveraged balance sheet, consequence of poor management by its previous owner – this became clear with the quick recovery in results after Unipar took over and renegotiated its debt. Lastly, the price for which the stocks were being traded in the stock exchange, anchored by the standing public offer to take it private, offered a massive discount when compared to our conservative estimations of its value – very attractive, after all.

Put shortly, we concluded that the risk/return profile of the investment was strongly asymmetric – from the good side, we were investing in a good company at very attractive prices; from the bad side, if we failed in cancelling the attempt of taking it private, the price we would receive for our stocks would be only slightly lower than what we had paid (low downside potential).

Our understanding was that the controlling shareholder was hurting other investors by offering a price that was very distant from what the company was worth. We then focused efforts, along with other shareholders, to gather enough shareholders to reject the offer. This rejection would be viable given the rules of CVM[2] that, if more than 1/3 of the free float voted against the offer, it would be considered void, and the company wouldn´t be allowed to be taken private.

Our fiduciary duty and the chance to contribute with the organization of minority holders by exposing the problems with the offer led us to participate in articles and interviews explaining the difference between the offered price and what we considered to be its fair value. We also contributed with Mr. Barsi in writing a letter to investors that detailed the absurd assumptions used to calculate the price offered by the controlling shareholder to take the company private.


OPA da Unipar Carbocloro deve fracassar

Em carta, Barsi e a Lis Capital defendem que o valor justo na OPA deveria partir de R$ 20 (ou R$ 25 sem o ajuste dos dividendos). Na prática, o investidor acabou defendendo um valor ainda mais alto e habilitou suas ações para o leilão a R$ 30 cada. Segundo a Lis Capital, apenas ajustando a taxa de desconto (que considera o custo da dívida e o de capital próprio) utilizada na conta, o valor da empresa chega a R$ 2 bilhões, contra R$ 706 milhões do valor indicado no laudo. Para o acionista Jorge Briby Junior, o controlador deveria propor termos mais favoráveis, já que os investidores esperam ter retorno adequado após os ajustes recentes na gestão da empresa.

Valor ECONÔMICO

OPA? Que OPA? Small cap vive rali de 30% às vésperas do pregão que poderia marcar sua saída da bolsa

Na mais recente carta, Barsi e a Lis Capital argumentam por que a oferta deveria ser de pelo menos R$ 20,00 por ação (ou R$ 25,00 sem descontar os dividendos).

Em um exercício simples de valuation, eles demonstram que somente mudando a taxa de desconto (custo da dívida e custo do capital próprio) adotada no laudo do Santander, em meados de 2016, o valor justo chega aos R$ 25,00 por ação (ou R$ 20,00 ajustado). Ao InfoMoney, a Lis Capital comenta que essa diferença deve-se pela queda significativa no custo de capital, em meio à queda vista na Selic durante nesse período. Veja abaixo os cálculos:

InfoMoney

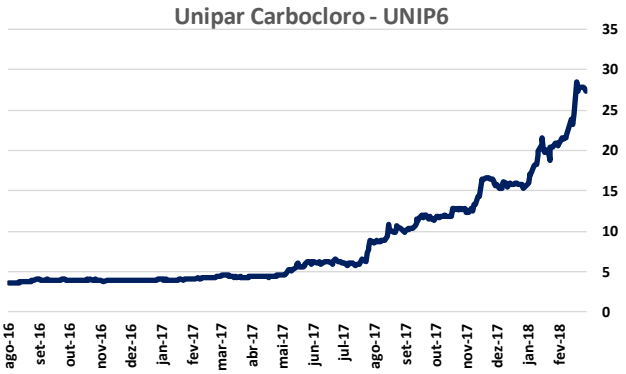
O PRÓXIMO EMBATE DOS GEYER

POR QUE OS MINORITÁRIOS DA UNIPAR CARBOCLORO SE RECUSAM A ACEITAR O PREÇO DA OPA DE FECHAMENTO DE CAPITAL

Gestor da Lis Capital, Tito Ávila observa que o preço oferecido no laudo está subestimado, pelo fato de as taxas de desconto aplicadas sobre o fluxo de caixa futuro da Unipar não serem condizentes com a atual realidade. "Quando o Santander elaborou o laudo, o cenário macroeconômico estava mais indefinido e o custo de capital era mais alto", avalia o gestor. Não foi por acaso que nesses últimos 12 meses as ações da Unipar subiram na bolsa, e para um patamar superior aos 7,50 reais da OPA. No dia 6 de junho do ano passado, data da divulgação do segundo laudo do Santander, as ações UNIP3 valiam 6,67 reais e as preferenciais classes UNIP6 e UNIP5, R$ 6,10 e R$ 6,06, respectivamente. Já em 12 de junho deste ano, o preço chegou a R$ 10,35, R$ 9,54 e R$ 10,62.

CAPITAL ABERTO

In the end, we gathered a much higher level of rejection than 1/3 of the free float, cancelling the offer. With that anchoring gone, the company´s stock started rallying. We started investing when the price of the stock was around R$ 4, and we sold our position when the price reached our fair value estimations, under our traditionally conservative approach, around R$ 30 (ex-dividends), accumulating an impressive 550% return to the fund in little less than 1 year.



[2] CVM - Comissão de Valores Mobiliários – is the Brazilian SEC

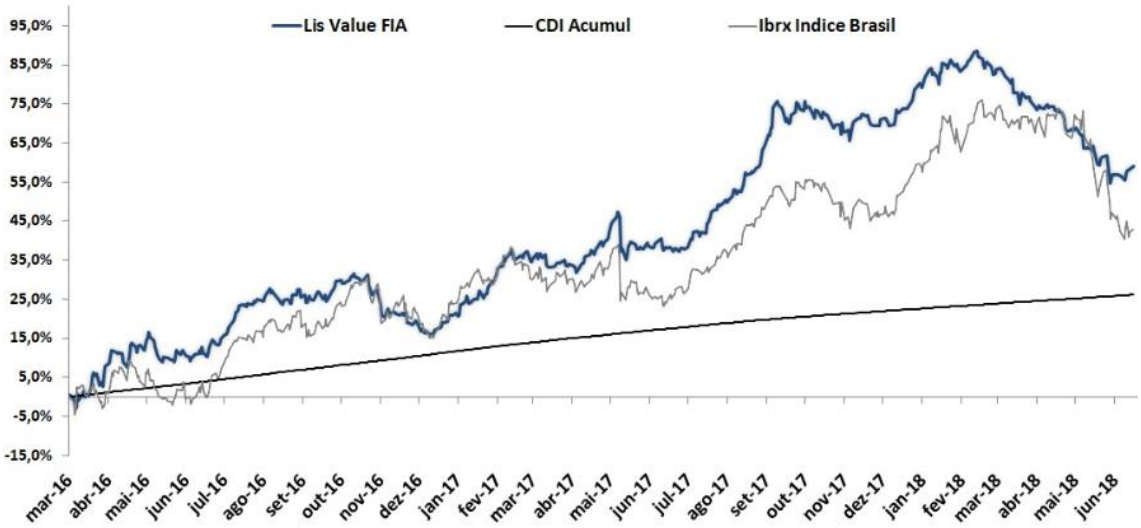
Current Conditions

The year started well for the Brazilian stock exchange, but it didn´t take long for expectations to quickly turn around, as expected in years of federal elections. The Market doesn´t deal well with uncertainty, and usually responds with exaggerated corrections. It is not hard to imagine such a nervous dynamic to aggravate as we draw closer to the election, at least until we have a clearer picture of the election results.

In any way, as mentioned in previous letters, the recurrent instability in the economic situation of Brazil spreads to our stock market. Our economic downturns frequently are shadowed by the ghost of government fiscal irresponsibility, as is the case this time and once again.

That is why our investment strategy doesn´t ignore our historic-economic reality. Much to the contrary, our investment philosophy and our risk management tools try to simultaneously protect our portfolio while exploiting the opportunities that arise amid the instability. Paradoxically, we can´t stress enough how often the worst times of a crisis, when fear takes control of the market, become the best times to put money to work.

With that said, our portfolio is well structured, with good amount of cash and hedges, to protect itself from further corrections and seize opportunities that already arise and may multiply if the fear intensifies or even if an unfavorable result to the election occurs. Observing how the fund has behaved since the market downturn steepened in May, it can be seen how our protection mechanisms, specifically the out-of-the-money puts for the Ibovespa index that expire after the election, have been instrumental in shielding the fund as market conditions deteriorate further. We expect, with some level of confidence, that this dynamic will hold or even increase the more the Ibovespa index suffers in the upcoming months, given the consistency and discipline we try to sustain when executing our protection and risk management policies. It is worthwhile to mention, as explained in our previous letters, that we use hedges to protect the fund against high impact negative events, and therefore their results must be analyzed within an appropriate timeframe.



"Cash combined with courage in a time of crisis is priceless" – **Warren Buffett**

Knowingly, short-term returns for investments in stocks depend a lot on arbitrary events, like market mood changes. Therefore, it is of utmost importance to have a clear distinction between

short-term results and the quality of the processes that sustain the portfolio decision-making. Sometimes, these two may take opposite directions, but, in the long run, they invariably converge, separating the diligent investor from those who got lucky. In the short term, one must be able to endure pain when others are giving up on the game. That is how the best seeds for future returns are planted.