

LETTER 1 – INVESTMENT CASE: LONG-SHORT IN BRADESPAR-VALE

March, 2020

Dear investors,

In this memo, we share with you an unorthodox arbitrage investment that we held between 2018 and 2019 and that generated excellent results for us. It is a good example of using risk-return asymmetry in the investor's favor.

The trade consisted of buying Bradespar shares combined with selling Vale shares.

Bradespar is a publicly traded *holding company* founded by the controlling group of Grupo Bradesco with the purpose of investing in exchange-traded assets and diversifying the Group's capital.

After selling its entire stake in CPFL Energia in December 2017, Bradespar's only remaining portfolio investment was Vale, a company in which it has been a shareholder since its privatization. Bradespar thus became, in practice, a means of investing indirectly in Vale.

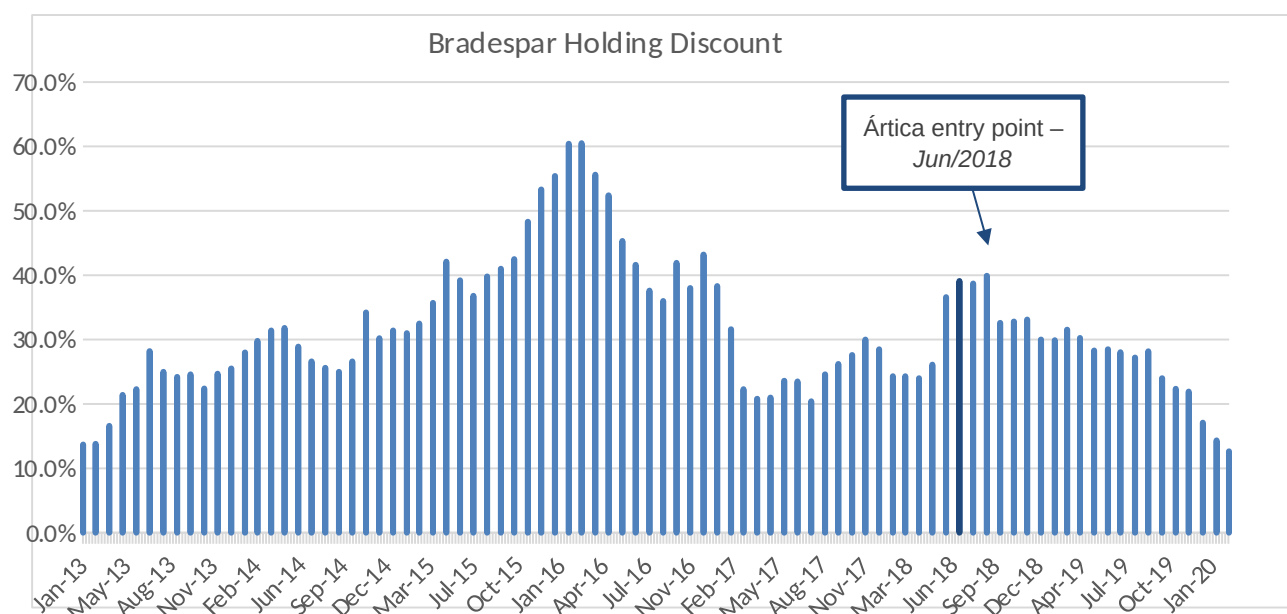
As is common in similar cases (observed in Gerdau - Metalúrgica Gerdau, Itaú Unibanco - Itaúsa, Iguatemi - Jereissati Participações, among others), Bradespar trades at a discount to its NAV – i.e., it is worth less on the stock exchange than the market value of its stake in Vale. This discount is called the *holding company* discount, and it exists because the intermediate vehicle – the *holding company* – adds an extra layer of uncertainty to the asset, since it can use the proceeds from its investment (dividends, interest on equity and sales of shares in the market) at its own discretion, and may even allocate them to low-return activities, destroying value for its shareholders.¹

In general, the *holding company* discount observed in similar cases hovers around 20% of NAV, which can historically be observed at Bradespar.²

In 2018, the *holding company* discount widened because of a lawsuit brought by Elétron, a company of the Opportunity Group (owned by businessman Daniel Dantas). The dispute was already 11 years old and concerned a lawsuit filed by Elétron against Bradespar and Litel. In May 2018, the court ratified an expert report that set compensation for Elétron of R\$4.4 billion, of which Bradespar would be responsible for half.

¹ NAV: *Net Asset Value*. It indicates the market value of the assets less the market value of the liabilities.

² The peak in the *holding company* discount observed in the chart (between 2013 and 2016) occurred because of the approaching end of Vale's Shareholders' Agreement, which was due to expire in 2017. However, the Agreement was renewed and the discount returned to levels close to 20% in 2017



Source: Bradespar, Ártica analysis

The news caused Bradespar's *holding company* discount to widen considerably (the discount reached as much as 40%, as shown in the chart above). In our view, the increase was exaggerated: even assuming a scenario in which Bradespar bore 100% of the contingency, i.e., R\$4.4 billion, the adjusted discount would still be 23.5%, above the historical average of 20%. For us, this would be the worst possible scenario.

In R\$ billion <i>Values as of Sep/20/2018, date of the last increase in the position</i>	Optimistic scenario	Probable scenario	Pessimistic scenario
Value of Bradespar's stake in Vale, net of Bradespar's other liabilities (A)	19.6	19.6	19.6
Value of the liability related to the dispute with Elétron (B)	0.0	2.2	4.4
Bradespar's market value (C)	11.6	11.6	11.6
Holding company discount ($D = 1 - C / (A-B)$)	39.2%	32.8%	23.5%

To capture this opportunity, our investment needed to be positioned on the basis of Bradespar's *holding company* discount, capturing the value as the discount returned to historical levels. The way we found to structure this trade was through a *long-short*: we went *long* Bradespar (BRAP4) and *short* Vale (VALE3), so that losses generated by the appreciation of VALE3 would be offset by gains from the appreciation of BRAP4, and only the relative movement between the prices of BRAP4 and VALE3 would affect our investment – an important point, since we did not want to bet on the absolute direction of these stocks (which prevented, for example, a capital loss for Arcádia after the Brumadinho accident, when Vale's shares fell more than 24% in a single day).³

The fact that it was a *long-short* gave the investment an interesting feature, as it did not require large amounts of capital, since we used the proceeds from the sale of VALE3 to buy BRAP4. In other words, it was not necessary to withdraw funds from other assets, or even from cash, to invest in the thesis.

³ *Long*: investing in a stock (gains occur when the stock appreciates); *Short*: betting against a stock (gains occur when the stock depreciates). *Long-short* strategies are used for investments in which the thesis is the relative change in the value of the assets, not their absolute change.

We built the position between June and September 2018, when the *holding company* discount hovered around 39%, until we reached the maximum limit allowed by Arcádia's bylaws.

Since then, Bradespar, Litel and Elétron have ratified an agreement under which they agreed to total compensation of R\$2.8 billion, well below the initial R\$4.4 billion, split equally between Bradespar and Litel (R\$1.4 billion each).

Litel sought to recover from Bradespar in court the R\$1.4 billion it had paid but, more recently, in December 2019, a court decision was announced rejecting this claim.

This news had a positive impact on the discount, which fell from 39% to the current level of 13% (in February 2020). The narrowing of the discount generated an excellent result for Arcádia – a total return of 91.2% on the capital employed, which represents an annualized return of 47.7% through February 2020.⁴

The remaining question is the following: what would happen if the *holding company* discount had widened instead of narrowing? Although the trade could have shown a negative result “on paper,” in practice it was only a matter of time before the discount narrowed, since the market tends to correct significant value dislocations over time. And we had enough time to wait because, since we had bought Bradespar “cheap,” the dividends received on the *long* position exceeded the cost of maintaining the *short* position – in other words, we were effectively being paid to wait and make money!

The case described above illustrates an alternative way of achieving a differentiated return combined with very low risk exposure. This type of investment serves as an important complement to the portfolio and becomes even more attractive in *bull market* periods, when it becomes increasingly difficult to find good stocks at reasonable prices on the stock exchange.

To make investments like this one, it is necessary to be alert to the opportunities the market offers, and to exercise the same skills of common sense and analytical capacity that are naturally required for more traditional stock investments.

⁴ As of 02/28/2020

Historical cumulative return⁵

Indicators:

Current net assets:

R\$76.5 million

12-month average net assets:

R\$56.5 million

Cumulative return:

1,003.3%

12-month return:

20.4%

36-month return:

519.6%



	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year		Since inception	
													Arcádia	Ibovespa	Arcádia	Ibovespa
2013	-	-	-	-	-	2.2%	6.7%	(5.2%)	8.8%	8.3%	(1.0%)	(0.3%)	20.2%	8.2%	20.2%	8.2%
2014	(4.5%)	2.9%	2.2%	(0.9%)	4.2%	7.7%	1.2%	0.9%	(1.2%)	(1.2%)	6.2%	(1.7%)	16.0%	-2.9%	39.4%	5.0%
2015	(4.4%)	(3.6%)	3.4%	5.1%	1.3%	(4.2%)	(10.6%)	(2.9%)	0.2%	(8.7%)	0.5%	3.5%	-19.7%	-13.3%	12.0%	-8.9%
2016	(9.7%)	2.8%	20.9%	4.7%	1.8%	(0.7%)	16.1%	7.8%	(0.3%)	(1.0%)	1.6%	0.6%	50.3%	38.9%	68.3%	26.5%
2017	2.0%	3.7%	1.4%	2.6%	20.4%	1.7%	27.9%	9.4%	8.7%	8.9%	14.1%	(1.2%)	151.7%	26.9%	323.7%	60.5%
2018	22.1%	23.9%	0.8%	2.4%	29.7%	(8.4%)	7.9%	5.1%	(7.8%)	6.5%	(4.7%)	0.9%	98.8%	15.0%	742.3%	84.6%
2019	10.7%	(1.7%)	(3.4%)	(1.2%)	(5.7%)	(1.5%)	3.6%	1.0%	(7.8%)	14.0%	0.5%	25.0%	33.1%	31.6%	1,021.5%	142.9%
2020	2.7%	(4.2%)	-	-	-	-	-	-	-	-	-	-	-1.6%	-9.9%	1,003.3%	118.8%

⁵ Arcádia began on June 27, 2013 as an “investment club” and, on September 27, 2019, it was converted into an “equity investment fund.” Returns shown from inception as a club on June 27, 2013 through February 28, 2020