

INVESTMENT CASE: BIOTOSCANA GROUP

October, 2020

Dear investors,

For this month's letter, we will share a recent case from Arcádia: the investment in Grupo Biotoscana (GBT).

GBT was a relevant investment in the portfolio from mid-2019 until we exited the position in August 2020, when the company launched a tender offer to delist from the stock exchange. The investment lasted a little over a year and appreciated 29%, compared with 6–8% for the Ibovespa over the same period.

This is an interesting case because we divided it into two phases with distinct analytical characteristics. The first phase covered the period from our entry until October 2019, when it was officially announced that control of the company would be sold. In this phase, the analysis of the investment was more focused on the company's fundamentals, similar to the other analyses we carry out. The second phase covered the period from October 2019 until our exit in August 2020. In this second phase, the investment had the characteristics of an arbitrage.

Below, we detail our investment process in the company, with an emphasis on the arbitrage phase.

Company background and initial investment:

Grupo Biotoscana (GBT) markets high-complexity medicines to treat diseases such as cancer, AIDS and Hepatitis C. The company originated from a project to consolidate the sector in Latin America, promoted by the private equity fund Advent. Four companies were acquired to form the group: Biotoscana (Colombia, 2011), United Medical (Brazil, 2014), LKM (Argentina, 2015) and DOSA (Argentina, 2017).

Unlike other pharmaceutical companies, GBT has a business model that requires little investment in R&D. Rather than developing drugs, the company buys marketing licenses for medicines from international pharmaceutical groups that lack distribution strength in Latin America. Once the licenses are acquired, the company is responsible for obtaining the regulatory approvals required for each medicine, as well as for its distribution, marketing and after-sales.

When well executed, the company's business model allows for high returns, combining the purchase of licenses for good molecules at attractive prices with a low need for research investment. There are, however, two problems with the model. The first is that the company owns only the marketing license for the drug for a specific period, and not the drug itself. The company therefore always runs the risk that the pharmaceutical companies will not renew the licensing agreements. The second is that the adoption cycle of the molecules can be quite long. After acquiring a molecule, the company takes an average of 1–2 years to obtain the necessary regulatory approvals and a further 5–6 years of product maturation until it is widely adopted by the market and reaches its peak sales potential. It is therefore possible for the company to make investments whose results take years to begin showing up in its financial statements.

These problems converged into very poor share performance in the two years following the IPO. The company went public in 2017 at R\$26.50 per share and was trading close to R\$7.00 in 2019, a 73% decline.

The main reasons behind this decline were: (1) the IPO price assumed the execution of a very challenging business plan; (2) in 2018, GBT lost an important medicine contract that represented 15% of its revenues (the contract was with Actelion and was not renewed after the company was acquired by Johnson & Johnson); and (3) Argentina (an important region of operation for GBT) entered an economic crisis, which did not help the company's results. The drop in the share price left the company discredited by the market and, in our assessment, provided a good entry window.

Chart 1 – GBT share price and key milestones (part 1)



Our main reason for believing the stock had become cheap was that GBT had a pipeline of recently launched molecules with enormous sales potential, which were still in the maturation phase and had no significant impact on the company's results. It was a thesis that would take longer to materialize, but one that we believed offered an excellent margin of safety and, for that reason, we decided to make the investment. This was phase 1 of the case.

Post-acquisition analysis:

A few months after the investment, the sale of control of GBT to the Canadian group *Knight Therapeutics* was announced. In fact, we had already considered this possibility in our initial discussions, given that M&A deals are quite common in the sector and Advent was already reaching 8 years since its initial investment, so the timing for its exit was near.¹

In situations like this, the need to shift the focus of the analysis becomes clear. Instead of seeking to understand the fundamentals and prospects of the business, it becomes more important to understand the characteristics of the transaction and its impact on minority shareholders. In particular, the problem becomes finding the fair price of the share today, given the following variables: (1) the probability that the transaction will

¹ Investments made by private equity funds have an average holding period of 5 to 7 years.

in fact be completed; (2) the transaction price and, consequently, the price that will be paid to us, the minority shareholders; and (3) the time frame for that payment to be made. Below, we detail each of these variables:

1. Probability of closing the transaction: Here, our M&A *background* gave us an edge in the analysis. In situations like this, after the transaction is announced, it is common for certain conditions precedent to have to be met before the deal is completed. Common conditions precedent are:

- a. Approval from antitrust authorities: In this case, since Knight had no presence in Latin America (GBT's region of operation), the transaction did not need to be submitted to *antitrust* authorities, which eliminated this potential risk.
- b. Obtaining financing: Financing the transaction can be an important bottleneck in some cases, but it was not a risk in this one. When the transaction was announced, it was stated that it would be financed with Knight's own cash, and upon reviewing the company's balance sheet, we saw that it had more than enough resources to complete the transaction, even in an adverse scenario, which is what happened with the Covid-19 crisis.
- c. Approval from important company stakeholders: This point could have been critical, since GBT had commercial relationships with several pharmaceutical companies that owned the drugs licensed by the company, and they would probably have to approve the sale. However, based on our experience, we considered it unlikely that GBT and Knight would announce the transaction if such approvals could not be obtained.

Besides the transaction being completed, we also had to make sure that we, as minority shareholders, would also benefit from the sale. In this case, protection for minority shareholders was guaranteed by GBT's bylaws, which established *tag along* rights for minority shareholders on the same terms as the controlling shareholders. In other words, in the event of a sale of control, the buyer would have to extend the offer made to the controlling shareholders to all other shareholders of the company.²

2. Price paid to minority shareholders: The proposed price was R\$10.15 per share, to be adjusted by the Selic rate until the date the delisting was completed. Incidentally, this was very close to what we conservatively estimated as the intrinsic value of the business in our internal analyses.³

3. Payment timing: As for the payment timing, the history of similar transactions in Brazil shows that the delisting process takes between 8 and 12 months after the acquisition of control is completed. We therefore expected the transaction to be concluded between July and November 2020.

Summing up the three points above, we had the scenario of a transaction with a very high probability of being completed, with a practically guaranteed payment of R\$10.15 per share (adjusted by the Selic rate) in a relatively short period. It was up to us to monitor the share price in the market and determine the best moments to increase or reduce the position.

An opportunity to increase the position appeared in March 2020, during the period of greatest uncertainty caused by the Covid-19 crisis. At the time, the stock was trading as low as R\$9.00 and we saw a clear asymmetry in the market. Considering the R\$10.40 that was received in August 2020, we were facing an opportunity that allowed for a 16% return in 5 months, which corresponds to an annualized return of 41% per year. This compares with a Selic rate of 4.25% at the time. We made a significant investment, and the position came to represent up to 20% of the portfolio.

² *Tag along* is a protection mechanism for a company's minority shareholders. It guarantees these shareholders the right to sell their stake in the company if it is sold to a third party.

³ In the material fact announcing the delisting, the company presented two options to minority shareholders. The first was a fixed price of R\$8.77 plus variable installments paid over 3 years that could reach a total of R\$2.16, and the second was a fixed price of R\$10.15 per share. We chose the second alternative and, for simplicity, it is the one we focus on in the text.

Within a short time, the distortion was corrected and the stock went back to trading close to R\$10.00, delivering a quick return with a very low level of risk to Arcádia.

Chart 2 – GBT share price and key milestones (part 2)



Result:

As mentioned at the beginning of the text, the investment in GBT appreciated 29%, compared with 6–8% for the Ibovespa over the period.

In our opinion, this case offers two important lessons. The first is that the market can overreact to bad news about a company, to the point that the company becomes discredited and a buying opportunity emerges. The second is that, when properly analyzed and understood, delisting situations can provide excellent arbitrage opportunities that offer an attractive level of return with a low level of risk. At Arcádia, we are always monitoring the market in search of such situations.

Fund characteristics

ARCADIA FUNDO DE INVESTIMENTO DE AÇÕES (the “Fund”), managed by Arcádia Participações e Gestão de Recursos Ltda., is an equity investment fund regulated by CVM Instruction 555/2014.

Target audience

The Fund is intended exclusively for qualified investors (under CVM Instruction 554/2015) seeking long-term-focused returns.

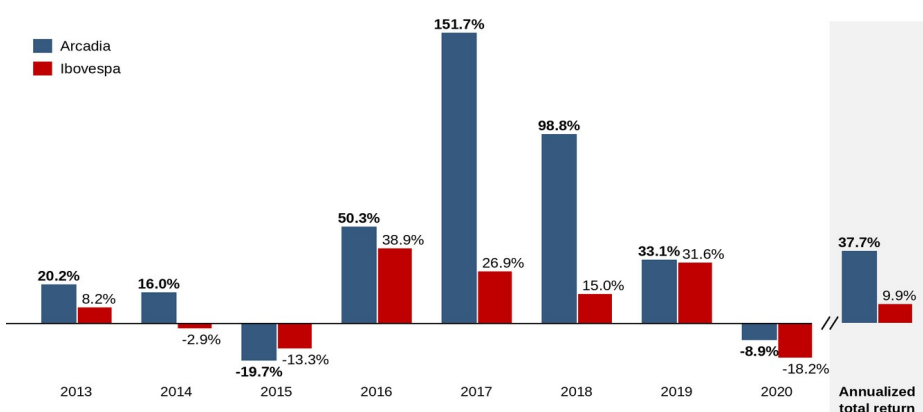
Fund objective

The Fund's objective is to provide its unitholders, over the medium and long term, with capital gains by investing its resources primarily in the stock market, without pursuing a high correlation with any specific equity index available.

Current net assets	R\$ 85.8 million
12-month average net assets	R\$ 74.3 million
Cumulative return	922.0%
12-month return	30.5%
36-month return	195.9%
Fund assets held by partners	58.2%

ANBIMA classification	Equities (Free)
Manager	Arcádia Participações e Gestão de Recursos Ltda.
Administrator / custodian	BTG Pactual Serviços Financeiros S.A. DTVM
Minimum investment	R\$ 100.0 thousand
Additional investment	R\$ 1.0 thousand
Minimum balance	R\$ 50.0 thousand
Management fee	2% p.a.
Performance fee	20% of excess return over the Ibovespa (high-water mark)
Subscription conversion	D + 1 (business day)
Redemption conversion	D + 89 (calendar days)
Settlement	D + 1 (after conversion)
Taxation (income tax)	15% of gains upon redemption (no come-cotas)

Annual return



Monthly return

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year	Cumulative
2013	Arcádia	-	-	-	-	-	2.2%	6.7%	(5.2%)	8.8%	8.3%	(1.0%)	(0.3%)	20.2%	20.2%
	Ibovespa	-	-	-	-	-	(11.3%)	1.6%	3.7%	4.7%	3.7%	(3.3%)	(1.9%)	8.2%	8.2%
2014	Arcádia	(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%	39.4%
	Ibovespa	(7.5%)	(1.1%)	7.1%	2.4%	(0.8%)	3.8%	5.0%	9.8%	(11.7%)	1.0%	0.2%	(8.6%)	(2.9%)	5.0%
2015	Arcádia	(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%)	12.0%
	Ibovespa	(6.2%)	10.0%	(0.8%)	9.9%	(6.2%)	0.6%	(4.2%)	(8.3%)	(3.4%)	1.8%	(1.6%)	(3.9%)	(13.3%)	(8.9%)
2016	Arcádia	(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%	68.3%
	Ibovespa	(6.8%)	5.9%	17.0%	7.7%	(10.1%)	6.3%	11.2%	1.0%	0.8%	11.2%	(4.7%)	(2.7%)	38.9%	26.5%
2017	Arcádia	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%	323.7%
	Ibovespa	7.4%	3.1%	(2.5%)	0.7%	(4.1%)	0.3%	4.8%	7.5%	4.9%	0.0%	(3.2%)	6.2%	26.9%	60.5%
2018	Arcádia	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%	742.3%
	Ibovespa	11.1%	0.5%	0.0%	0.9%	(10.9%)	(5.2%)	8.9%	(3.2%)	3.5%	10.2%	2.4%	(1.8%)	15.0%	84.6%
2019	Arcádia	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%	1,021.5%
	Ibovespa	10.8%	(1.9%)	(0.2%)	1.0%	0.7%	4.1%	0.8%	(0.7%)	3.6%	2.4%	1.0%	6.9%	31.6%	142.9%
2020	Arcádia	2.7%	(4.2%)	(24.8%)	8.0%	0.2%	6.7%	9.9%	(2.9%)	(0.2%)	-	-	-	(8.9%)	922.0%
	Ibovespa	(1.6%)	(8.4%)	(29.9%)	10.3%	8.6%	8.8%	8.3%	(3.4%)	(4.8%)	-	-	-	(18.2%)	98.7%

* 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 on June 27, 2013 through September 30, 2020



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Additional analysis



Max drawdown Arcádia: 30%
Max drawdown Ibovespa: 39%



Max drawdown Arcádia: 34%
Max drawdown Ibovespa: 47%

	Arcádia	Ibovespa
Volatility – since inception	24.9%	26.4%
Sharpe – since inception	1.21	0.16
Sortino – since inception	2.26	0.25
Correlation (Arcádia vs Ibov) – since inception	0.35	-
Volatility – 12 months	30.3%	43.4%
Sharpe – 12 months	1.50	0.12
Sortino – 12 months	2.17	0.17
Correlation (Arcádia vs Ibov) – 12 months	0.73	-

Rolling 3-year returns



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