

São Paulo, July 31th 2014

Dear Investor,

During the first half of 2014, the Mosaico FIA (local Brazilian vehicle) appreciated 3.10% while the Bovespa index rose 3.22%. Since the fund's inception in July 2010, through to the end of June 2014, the average return of the Mosaico FIA was 21.4% p.a. versus an average fall of 4.2% p.a. in the Bovespa.

We recently heard an insightful phrase from a large investor. He said: "Currently everything in Brazil is doing bad, except for the stock market".

This phrase fits well with the curious moment in which we live. On the one hand we are seeing the economy deteriorate (the expected GDP growth for 2014 fell from 2.4% at the beginning of the year to 0.9% currently). On the other hand the Brazilian stock market has been rising strongly, in July alone it rose 5%.

The backdrop to this apparent paradox is the increased chance of an opposition victory in the upcoming presidential elections. In the view of many, this would be a chance to tackle the fundamental problems of our economy, these being excessive and rising public expenditure, government intervention and low investment.

The stocks that have benefited most from this change in the political outlook are the State controlled companies. Petrobras has risen 19% this year (11% in July alone) and Banco do Brasil, 18%. Behind this movement is the expectation that, in the event of an opposition victory, the political interference in these companies will decrease. As examples, Petrobras is helping to contain inflation (the price of gasoline is at least 15% lower than it should be) and the state-controlled banks have pursued an aggressive policy of granting credit.

Besides this, the most liquid stocks have been the channels by which flows of capital from foreign investors have come back into the country. The foreign net inflows have nearly tripled so far this year and this explains, in part, the gap between the performance of the Bovespa (+ 8% YTD) and the Small Cap index (down 6% in 2014).

Meanwhile, in the real economy consumption has slowed, sales of high-ticket goods such as automobiles and real estate have plummeted. The industrial segment is suffering from a drop in demand, inventory adjustments and an exchange rate that is apparently overvalued. Even electric utilities, a traditionally defensive sector, have been hampered by price manipulation from the government.

As a consequence of this, investors have fled to the few sectors that, contrary to the wider economy, are showing good growth in profits, such as Education and Finance. However, the strong appreciation of these companies left them with little margin of safety.

Despite market's prognosis, we are not qualified to predict the outcome of elections and gauge the odds that a new government will be able to significantly change the direction of the economy. We have remained cautious and followed our approach to capital preservation. As we explained in our last letter, we have a diversified portfolio,

exposed to various different sectors and with a significant cash position (currently 17%).

Nevertheless, there is an interesting opportunity in front of us. Many small-caps have fallen significantly so far this year and seem to have already priced in adverse scenarios for the coming years. We are studying several potential new investments and recently added a new company in our portfolio. It is clear to us that small-caps fundamentals will benefit as much as their more liquid peers, were the direction of the economy to really change.

A good example of the opportunity found in small-caps is the case of Tempo Participações, which we added to our portfolio at the end of last year and is currently our largest holding, with a 13% weighting in the fund.

We managed to build our position in Tempo at a very attractive valuation, taking advantage of the fact that the company is little known by the market (no sell-side coverage), is small, with a very concentrated shareholders base and has low liquidity (just BRL 260,000 per day). What attracted us in the company is the fact that it was undergoing a profound reorganization, which has generated significant value for its shareholders.

But ultimately what is Tempo Participações? Tempo is a financial services holding company which went public in 2007. It was founded and steered by one of the largest private equity funds in Brazil. The initial idea was that they should group together different business that had synergies with end consumers, service providers and clients (mainly insurance companies) through an aggressive acquisition program.

Since the start of operations in 2000 until 2013, the company made 16 acquisitions and was present in 5 core businesses: (i) Home Care (home hospital services), (ii) Health Services (technological and administrative services to health plans), (iii) Health Insurance, (iv) Dental Insurance (v) Assistance (outlined below). As a result of this intense inorganic growth process, the combined company had a wide range of activities and, in some cases, even competed with its customers.

As might be expected, the company struggled to organize and create relevant competitive advantages in many of its markets. In the following years it had a large turnover rate, with three CEOs during this period. The complexity in managing so many activities meant that the company did not present consistent results.

Then, in late 2013, after a long period trying to seek synergies between businesses, the company decided to change course and started a process of selling off certain assets. Over 6 months, the company successfully divested from its units in Actuarial Risk (Health and Dental Insurance) and Health Services. They will receive approximately BRL 350 million for the assets sold. These funds will add to net cash of BRL 120 million held by the company at the end of the first quarter.

By our calculations, following the completion of the divestments and payment of taxes, the company's cash position should represent 60% of its current market cap of BRL 700 million.

In our opinion there is a big chance that the cash will be returned to investors. This is because almost half of the shares are in the hands of large investment funds, which



have a clear vision of opportunity cost. These same funds supported the recent divestment process and approved in the past the distribution of the proceeds that were initially designated for acquisitions.

But are the businesses that remain interesting? After this divestment process we will be shareholders of two businesses: Assistance and Home Care. Home Care is a small business within Tempo, focused on a specific niche and is in the process of being reduced further in its scope.

The 'Assistance' business (Tempo USS) is an excellent business, despite being largely unknown. The average return on capital (ROIC) for this unit has been around 40% in recent years. The business is essentially a service provider, giving support services for vehicles, homes, travel, people and others. The company is a market leader with a market share estimated at 34%. Major customers include insurance companies, some automakers, retailers and credit card companies. In this sector, Tempo USS has over 20 years of experience and has one of the largest networks of coverage in Brazil, with 20,000 outsourced service providers, who are responsible for emergency or other services for its customers.

Tempo is the only independent company in its field while its main competitors belong to insurers. The lack of conflict of interest has allowed the company to gain market share with insurers that are not vertically integrated. In addition, the company recently entered into direct sales agreements with retailers that helped boost its revenue, which grew 26% in Q1.

As we have been increasing our participation in the company, we have intensified both our proximity to the company, and our knowledge of its competitors and customers. Our perception is that with the simplification of the company structure, the management team has been more focused on the Assistance business, something that has been very well received by everyone within the scope of its business.

Currently, we see the company with (i) a return and growth significantly higher than the market average, (ii) low risk (given their high cash levels) and (iii) trading at just 4.0 X EBITDA (2015). We believe that Tempo is an excellent allocation of our capital.

We look forward to hearing from you and would be very happy to answer any questions you may have.

Best Regards,

Mosaico Capital



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