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IP-Participações	04
Alphabet	05
AB Inbev	07
Miscellaneous	15
Performance	17
IP-Participações Class	18

IP-PARTICIPAÇÕES

As discussed in previous reports, Fed's decision to unwind its balance sheet and remove market liquidity would have ramifications on general asset prices. In recent months, these impacts have become more evident. The fear that followed the rise in the 10-year Treasury rate troubled many markets. On our part, we only have reasons to celebrate.

These situations can be distressing for those who invest attempting to foresee market movements. For those investors, if opportunity costs (interest rates) rise, market prices must fall. Investors who believe this is the beginning of a longer cycle of increasing interest rates often attempt to anticipate market trends and sell assets before prices drop even further. These investors will not only miss more attractive asset prices but may also take permanent losses in untimely sales.

On the other hand, investors focused on absolute long-term returns view any market shake-up as a blessing. If projected cash flows of invested companies, assuming reasonably accurate estimates, already indicated attractive returns before the share price drop, logically, future returns should increase as shares cost substantially less. For exceptional companies, trading at decent prices, a 1% or 2% increase in interest rates – after a significant stock price decline – would not make additional purchases unattractive.

As previously stated, markets are cyclical and subject to shocks every now and then. It is helpful to

understand the rationale of other market participants, but our primary concern is never to anticipate macro trends or the shocks themselves. Our primary concern is to be prepared. We want to anticipate which companies can create value on their own merits, with consistency, and who can take advantage of future adverse scenarios.

PORTFOLIO

The recent shake-up in the American market was most welcome. The drop in share prices, combined with the consistent growth of individual businesses created excellent opportunities to use part of the cash we had been storing in previous quarters.

We initiated two small investments: Facebook and Charter. These are businesses for which we've held particular admiration and which suffered significant price declines for reasons we believe to be temporary. We'll further comment on these cases in future reports.

We significantly reduced our investment in Amazon after the more than 30% share price increase in 2018. We choose to still participate in its impressive evolution, however, with a smaller position.

In Brazil, our key investments — Itaú/Itaúsa, Energisa, and B3 — were reduced after significant increases given the euphoric beginning of 2018. More recently, following a period of greater complacency with the uncertainties in upcoming elections, risks have finally

started to reflect on asset prices. While shares of state-owned, cyclical and lower-quality businesses soared following a decompression of the economy and the appreciation of certain commodities, some companies within our universe have returned to more reasonable valuations.

We metaphorically compare our funds to little bonsais. There are no shortcuts to good results: it takes careful cultivation alongside much energy and dedication.

The recent performance of our fund tells a somewhat limited story about our investments. The investment optimizations, although conservative, are constant. This year, the dispersion in returns within our portfolio positions has been higher than average, which allowed us to make interesting adjustments. Increased volatility, coupled with the ability to quickly allocate capital in opportunities both in Brazil and abroad, gives us the flexibility to increase potential returns. It is a privilege to be able to restrict ourselves to truly outstanding companies. Over time, this improves the quality of the businesses in our portfolio and, consequently, safely increases our funds' performance.

We believe we are well positioned to face whatever looming scenario. To successfully navigate market turmoil, nothing beats a portfolio of strong, profitable businesses that grow, generate cash, and trade at reasonable prices — in addition to a very comfortable cash cushion.

In this report, we will comment on our investments in Alphabet (Google) and Anheuser-Busch InBev.

ALPHABET

In our 2Q17 report, we explained the rationale for our investment in Alphabet, the holding company for Google. Since then, the company's rhythm has remained strong. In the second half of 2017, growth accelerated to 23% per year and has continued so through the first quarter of 2018. Even the US search business, its most mature, has sustained growth rates of around 20%. Such growth is boosted by YouTube, which we estimate to be at 30% per year, and segments such as Google Play (apps), Hardware (Google Pixel smartphone) and Cloud, which together grow at 40% per year. A spectacular performance for a company with annual revenues of over US\$100 billion.

In Search, by far its most significant segment, Google has innovated to reduce friction and become more valuable and integrated for users and advertisers. An example is the recently announced Shopping Actions, an e-commerce solution that permits users to add products from different vendors to a single shopping cart, directly from the search page. Only a single payment is necessary and free delivery is offered above a minimum purchase amount. The advertisement fee is calculated as a percentage of sales and not by clicks, allowing Google to capture more of the transaction value. Another example is the evolution of Google Hotel Ads, a solution that

IP-PARTICIPAÇÕES

compares hotel prices between various websites, including Expedia and Booking, and encourages hotels to advertise directly on Google. The result has been a gradual strengthening of hotels versus online travel agencies (OTAs), once again letting Google capture more value.

Margins, on the other hand, continue to compress. The reason for this is that the currently fastest growing businesses (YouTube, Hardware, and Cloud) have structurally lower margins when compared to Search. The fact that search is increasingly used on mobile devices, in which the company must pay manufacturers (such as Apple) to maintain Google as their standard search engine, does not help. Nevertheless, its annual recurring gross profit has grown in the 17-20% range. The net income has been evolving at similar levels when deducting recurring expenses in proportion to revenues.

Sundar Pichai (CEO) and Ruth Porat (CFO) continually remind investors that Alphabet's objective is not to expand margins but to increase profits in absolute terms. Thus, investors should expect strong investments to enable future growth, through research and development, marketing or investments in fixed assets (CAPEX). In the first quarter of 2018, CAPEX reached US\$7.3 billion, half to expand offices and facilities, and the other half to increase the company's computational capacity to manage processing-intensive services, such as artificial intelligence (AI). Sometimes, such numbers frighten the market and

allow us to increase our position at attractive prices. We see no problem with investing heavily towards the future. Quite the contrary — Alphabet is positioned to lead and extract enormous value from AI technology, which is hardware intensive by nature.

For example, its self-driving car initiative Waymo is no longer just theoretical. In Phoenix, Arizona, Waymo is piloting a 100% self-driven transportation service.¹ By the end of 2018, it will be available to the city's residents. Waymo's cars have amassed 9 million kilometers in test-drives and are at the forefront of the technological race to become truly functional and secure. The goal of the company is to have fully automated vehicles, not just on well-signaled roads and other more straightforward situations, as do the Tesla cars today. The argument is that people do not know how to operate with partial autonomy safely. Tests indicate that users quickly become too reliant on the automated system and get distracted. A system that works 95% of the time but can surprise the driver in critical situations can be more dangerous than no autonomy at all. In recent cases, such as the cyclist being run over by a self-driven Uber car, and the fatal accident of a Tesla client when crashing into a wall, the driver's distraction was critical and seems to confirm that full autonomy is the correct path. Waymo is one of Alphabet's Other Bets, does not generate significant revenues, and is not considered in our valuation calculations. Its development gives us hope that the Other Bets may not be a waste of capital after all.

¹ <https://www.youtube.com/watch?v=B8R148hFxPw>

The greatest risk to our investment lies in potential regulation, especially antitrust. Last year, the company received a €2.4 billion fine for its product price comparison solution in Europe. The decision is under appeal while the company complies with the demands from the European Commission. This discussion may still not be over for Alphabet, as well-organized lobbying groups are exerting public pressure for an even more favorable solution for them. They want Google to direct users to their websites, free of charge, something difficult to defend legally.

The Android issue is more delicate. Alphabet is being investigated for non-competitive practices, such as requiring from manufacturers the pre-installation of the Google Play Store, Search, Maps, and YouTube on all smartphones. The company has sought to resolve the issue with the European Commission, but we would not be surprised if there were other substantial fines along with specific conditions for the commercialization of Android products. One possibility may be to prevent Google from enforcing smartphone manufacturers to adopt all of their apps at once, letting users choose each app individually. Another possibility is the creation of a competing app store. Either way, Alphabet would lose its bargaining power with manufacturers and could have higher acquisition costs for Search traffic. Such scenarios must be considered. However, we believe the services offered by Search, Maps, YouTube and the Play Store are leaders on their own merits and not by mere

imposition. Therefore, we think this scenario can ultimately be managed by the company.

Alphabet trades, according to our estimates, at approximately 20x its 2018 recurring net income. We remove net cash from the company's market value and capitalize (rather than expense) the Other Bets. The current price is quite attractive for a business with such growth prospects, and thus we increased our position during the first months of the year.

ANHEUSER-BUSCH INBEV (ABI)

ABI's business model is attractive in numerous ways. The beer business is reasonably predictable, generates strong cash flows, has the potential for organic growth and has a small risk of suffering from technology shocks (especially in developing countries). In addition, ABI has a massive market dominance (generating around 30% of global beer volumes and almost 50% of the industry's profits), and a talented, well-aligned management team with an enviable execution track record.

In recent years, our investment in the company ranged from a small to medium position. Recently, a combination of factors gave us an opportunity to increase our stake.

Over the last five years, ABI's share price appreciated only 20%, while the S&P 500 climbed 84%². The main drag was the 9% drop in earnings per share between 2012 and 2017, due to: (i) the lack of organic

² Closing price on 04/30/2018 (adjusted by dividends).

IP-PARTICIPAÇÕES

volume growth, primarily a result of the economic recession in Brazil, (ii) the devaluation of emerging market currencies, generating a negative cumulative impact of approximately US\$6.6 billion on EBITDA, (iii) the increase in debt from 1.9x net debt/EBITDA to 4.7x in the period due to the SAB Miller (SAB) acquisition, and (iv) the shareholder dilution from this same acquisition.

In 2018, ABI's market capitalization fell by about 10%, from US\$210 billion to US\$189 billion³, following the increase in long-term Treasury yields, a general decline in the prices of global consumer goods companies, and a few company-specific concerns.

We believe some concerns may have been exaggerated and the company-specific risks are indeed manageable. For example, recently, many investors have questioned the ability of the culture employed by 3G Capital's partners to encourage innovation and create organic growth at both ABI and Kraft Heinz. We see these situations distinctly: different businesses, in different regions, with different teams and thus have different future perspectives. Although ABI has not grown organically in the last five years, the company is now better prepared to grow following the acquisition of SAB.

The decline in US beer volumes, which peaked in 2008, also causes concern. Since this is the most profitable and cash-generating region for ABI, a rupture

could cause significant operational deleverage and jeopardize the company's ability to maintain its dividends and/or manage its debt. The Budweiser and Bud Light brands, which account for roughly 60% of volumes, have been suffering from worsening competition. The volumes of these brands have dropped 5.8% and 6.5%, respectively, during the first four months of 2018⁴. On the other hand, the Super Premium category, which accounts for approximately 15% of volumes and has high margins (i.e., Michelob Ultra), grows at double-digit rates, helping to offset the declines of the more popular brands. We believe that, over the next few years, the change in mix will result in smaller reductions in revenues than expected. In any case, the region has been losing its relevance within the company over the years given its relative performance and some strategic acquisitions. In 2012, the United States represented 38% of total EBITDA, while in 2017 this number fell to 26%.

Another issue is debt. From 2015 to 2016, after the completion of the SAB acquisition, net debt increased from US\$42 billion to US\$108 billion and concluded 2017 at US\$104 billion. There are three critical risks regarding this increase in debt: (i) the risk of a normalization (increase) of global interest rates, (ii) refinancing risk and (iii) the risk of a mismatch between the cash flows denominated in multiple currencies and the mostly (90%) Euro and US dollar-denominated debt. Albeit these risks, a few points are

³ Closing price on 04/30/2018.

⁴ Source: Nielsen. Data as of 04/21/2018.

comforting: (i) 93% of debt is fixed with an average cost of 3.7% per year, (ii) over 60% of outstanding debt will begin to be amortized only in 5 years, long enough for the company to grow its business and improve its net debt/EBITDA ratio, and (iii) the company's cash flow is higher than its net income due to its negative working capital.

Where will growth come from?

Despite the risks discussed above, ABI can deliver sustainable growth in the upcoming years, for the following reasons:

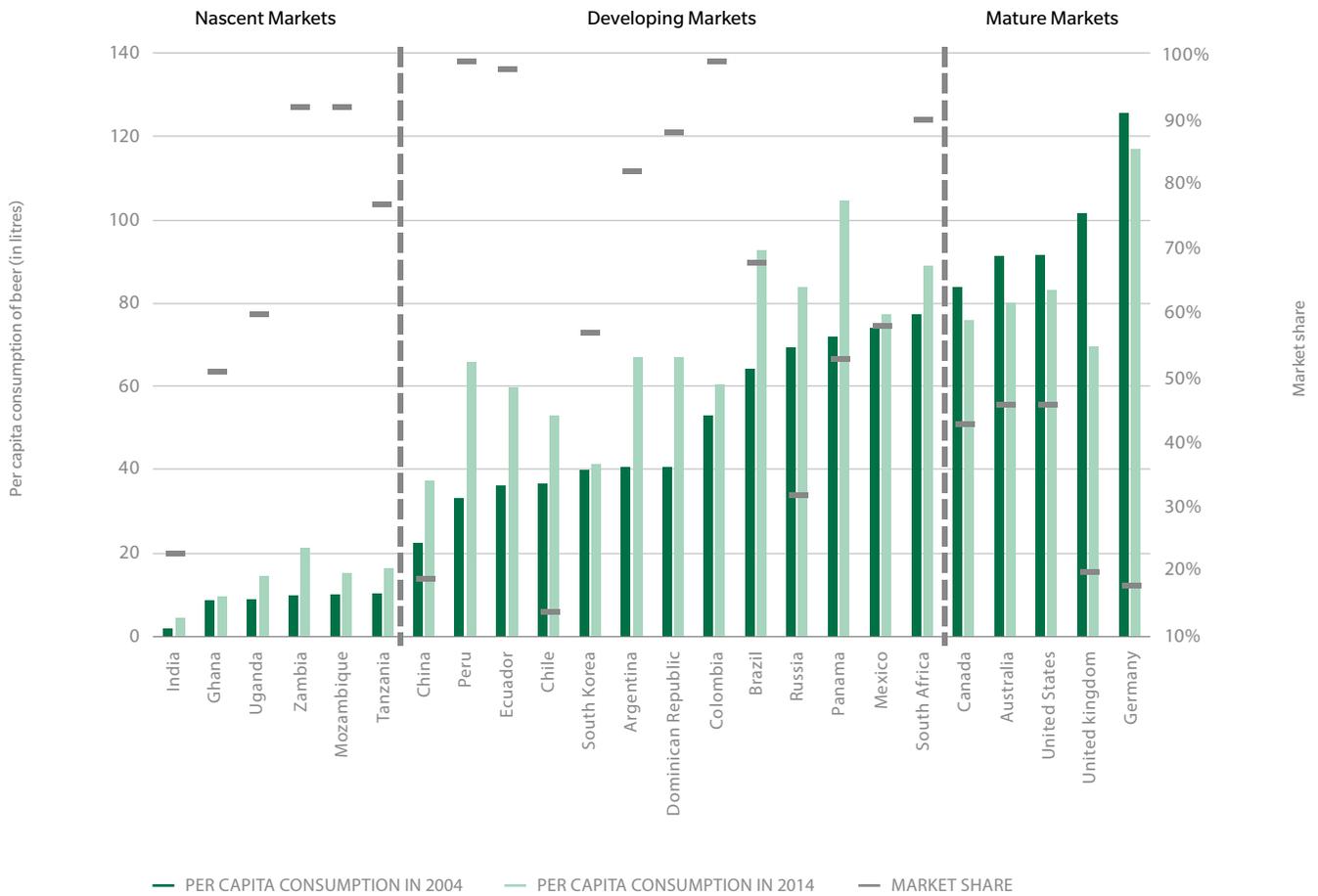
Firstly, ABI is currently more geographically diverse and has greater exposure to growing economies. The beer market in mature regions, such as the United States and Western Europe, is no longer growing. In these markets, beer has been losing market share to spirits and wine, and breweries have directed their

production to more premium brands to keep revenues stable. On the other hand, the beer market still grows in regions such as Colombia, Mexico, China and Africa due to populational growth, increased disposable income, increased beer consumption per capita and market share gains from informal beverages. The acquisition of SAB brought not only access to growing markets but also access to regions with elevated market shares, thus facilitating operational improvement and the expansion of its global brand portfolio.

The chart below illustrates the evolution of beer consumption per capita, by country, between 2004 and 2014 and ABI's current approximate market share in each region. The combination of a growing market with dominant market share is killer. In 2018, a little over 70% of ABI's volume will come from nascent or developing markets.

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BEER CONSUMPTION PER CAPITA (LITERS) AND MARKET SHARE BY COUNTRY



Source: World Health Organization. Only the population above 15 years is considered. Data for South Korea, Peru, Tanzania, Mozambique, and Zambia are from 2013. Data for Uganda and Ghana are from 2011. Market share data are Jefferies estimates for 2016.

Secondly, management’s commitment to generate organic growth is greater than in the past. By integrating SAB, ABI perfected its growth model by combining the best management practices from both companies. All to align the company and generate growth according to each region’s particularities.

SAB was known as a “market maker” while ABI was a “market taker.” Given the elevated market shares in its central regions, (>90% in Colombia, Peru, Ecuador and South Africa), SAB developed a growth model known as the category expansion framework. This framework organizes expansion strategies for a portfolio of brands, considering the specific characteristics of each region, such as the market’s maturity curve, the company’s level of dominance and the segments with higher growth trends. ABI, in turn, organized its expansion strategies based on individual brands, rather than regional portfolios, which generated some energy dissipation. The adoption of the framework will allow ABI to compete in all major segments, anticipating changes in consumer behavior and

avoiding being behind the curve, as was the case with the craft beer phenomenon in the United States.

ABI formally adopted the category expansion framework in March 2017. Consequently, each regional president developed a three-year growth plan for its brand portfolio, implemented in early 2018. Conversations with former SAB employees indicated that ABI’s more risk-taking culture could accelerate the brand portfolio strategy: *“SAB was quite a risk-averse business, so there were many cases where we were too afraid to trial things, whereas ABI is very open to trialing things. From that perspective, I think that could be a nice change in culture that could actually drive growth.”*

Additionally, in recent years, the company modified its incentives to better align executives with the company’s organic growth. Historically, variable compensation was based on four metrics: EBITDA, cash flow, operating costs and market share. In 2014, the operating costs metric was replaced by total revenue growth and, in 2016, they were all replaced by a balance of revenue growth and cash generation.

EVOLUTION OF PERFORMANCE METRICS FOR EXECUTIVE VARIABLE COMPENSATION

2011- 2013	2014- 2015	2016- 2017
EBITDA Cash Flow Operating Costs Market Share	EBITDA Cash Flow Total Revenue Growth Market Share	Balance between: Revenue Growth and Cash Generation

IP-PARTICIPAÇÕES

ABI also created three stock option programs to boost organic growth⁵:

- **2020 Incentive Plan:** Created in December 2015 for 65 executives. 4.7 million options with their value subject to a target net revenue until 2022⁶.
- **Long-term Stock Options Plan:** Created in December 2017 for 50 executives. 18 million options with their value subject to an annual organic EBITDA growth rate target until 2024.
- **Incentive Plan for “Disruptive Growth”:** Created in December 2015 for executives in the innovation department. They receive stock units based on a minimum return rate of their projects.

The last stock option plan granted for a specific purpose was in 2008 and 2009 when approximately 100 ABI executives received 33 million options with their value subject to the company’s ability to reduce its debt levels to 2.5x net debt/EBITDA by the end of 2013. The company ended 2013 at 2.3x.

Multiple other factors will further help sustain growth in the medium-term, such as the remaining synergies from the SAB integration (US\$1 billion remaining), the roll-out of ABI’s global brands (Budweiser, Stella Artois, and Corona) to SAB legacy regions⁷, the increasing

penetration of premium brands in the portfolio over time and, lastly, new acquisitions – albeit with much smaller relevance than past acquisitions.

ABI versus Ambev

A small part of our ABI investment is through a long position in ABI and a short position in Ambev. Over the past year, Ambev had a significant price-to-earnings (P/E) multiple expansion while ABI’s multiple compressed, differing from historical standards, as illustrated in the chart below:

HISTORICAL P/E MULTIPLES (NEXT 12 MONTHS)



Source: Bloomberg (Best PE Ratio – Blended 12m FY)

⁵ In addition to these three plans, there is another a stock option plan granted for the integration with SAB.

⁶ Target revenue is US\$100 billion and can be achieved through acquisitions.

⁷ In 2017, the global brands represented circa 17% of volumes and almost 20% of revenues. In 2017, their revenues grew 9.8% (vs 5% of the total portfolio). Over half of volumes and revenues originate outside their native markets. In 2017, the global brands grew 16.8% outside of their native markets, accelerating from 2016. The native markets for Budweiser, Stella Artois, and Corona are United States, Belgium, and Mexico, respectively.

Ambev's shares currently price in high expectations for volume recovery and margin improvements. Considering such recovery in 2018, Ambev still trades at around 26x P/E, a significant premium not only to ABI but to other global consumer goods companies. This implies that ABI, excluding Ambev, trades at a

more exciting valuation level, of about 17x P/E, while having similar EBITDA growth prospects.

The difference in valuation between the two companies and their main geographical contributions to EBITDA are illustrated below:

KEY CHARACTERISTICS FOR ABI, AMBEV, AND ABI (EXCLUDING AMBEV)

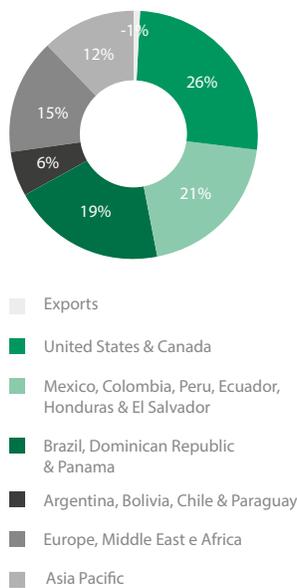
2018 ⁸ (in U\$ billions)	ABI	Ambev	ABI (excluding Ambev) ⁹
Revenue	58,0	14,9	43,1
EBITDA	23,8	6,8	17,0
Tax Rate	24%	20%	
Consolidated Net Income	11,6	4,2	7,4
Minorities	-1,9	-0,2	-0,2
Net Income	9,7	4,0	7,2
Market Capitalization	189	106	123
Net Debt	102	-3	105
Net Debt/ EBITDA	4,3x	-0,4x	6,2x
Price/Earnings	19,5x	26,4x	17,1x

⁸ ABI holds 61.9% of Ambev's capital. Market capitalizations as of 04/30/2018. Considers an average FX rate of R\$3.45.

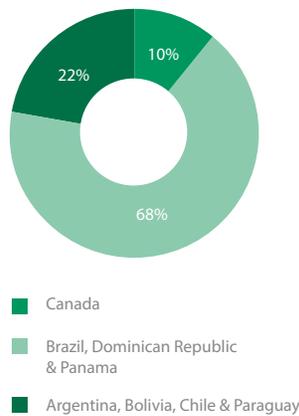
⁹ Values calculated as ABI minus 100% of Ambev. Market capitalization considers ABI minus 61.9% of Ambev.

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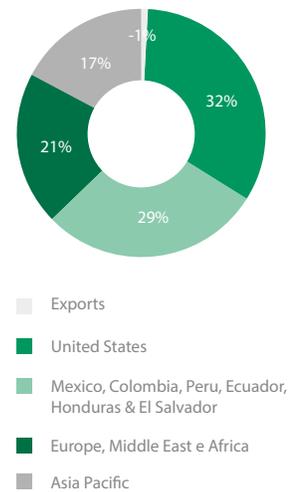
EBITDA 2018 - ABI



EBITDA 2018 - AMBEV



EBITDA 2018 - ABI (EX-AMBEV)



Source: ABI. Smaller countries may not have been specifically mentioned.

The excessive optimism on Ambev's operations creates an opportunity to invest in the rest of ABI's businesses at more interesting prices. Furthermore, as the Brazilian beer market is already reasonably mature, it is difficult to foresee long-term volume growth above other developing markets within ABI's portfolio.

4 → 6 → 8 + 4 Equation

In a broader horizon, we believe ABI can grow revenues at 4% per year, EBITDA at 6% per year (through

operational excellence and ongoing improvements), and profits at 8% per year, given the debt deleverage. Along the way, we shall receive dividends of around 4% of the company's current market value. We may even see potential acquisitions fostered by the 'dream big' culture. Overall, this is a good value creation equation in a low-risk business run by competent people.

MISCELLANEOUS

“Yes, excessive automation at Tesla was a mistake. To be precise, my mistake. Humans are underrated.”

— **Elon Musk**

“Excuse me. Next. Boring, bonehead questions are not cool.”

— **Elon Musk**

“I haven’t the faintest idea how Elon Musk will turn out, but he has a considerable chance of success and considerable chance of failure. He seems to like it that way.”

— **Charlie Munger**

“At Waymo, we are not just building a better car, we are building a better driver. And that driver can be used in all kinds of applications, like ride hailing, logistics, personal cars and connecting people to public transportation. We see our technology as an enabler for all of these different industries. And we intend to partner with lots of different companies to make this self-driving future a reality for everyone.”

— **John Krafcik**

“Building a culture of high standards is well worth the effort, and there are many benefits. Naturally and most obviously, you’re going to build better products and services for customers – this would be reason enough! Perhaps a little less obvious: people are drawn to high standards – they help with recruiting and retention. More subtle: a culture of high standards is protective of all the “invisible” but crucial work that goes on in every company. I’m talking about the work that no one sees. The work that gets done when no one is watching. In a high standards culture, doing that work well is its own reward – it’s part of what it means to be a professional. And finally, high standards are fun! Once you’ve tasted high standards, there’s no going back.”

— **Jeff Bezos**

“The second best business to invest in is the one that generates lots of cash flow. The best is the one that has an exceptional ability to spend that cash flow well.”

— *VC Investor*

“Yesterday’s successes often hinder progress. Successful people are the most difficult people to change.”

— *Jack Ma*

“We’re in an unprecedented situation in history in the sense that nobody knows what the basics about how the world will look like in 20 or 30 years. Not just the basics of geopolitics but what the job market would look like, what kind of skills people will need, what family structures will look like, what gender relations will look like. This means that for the first time in history we have no idea what to teach in schools.”

— *Yuval Noah Harari*

“U.S. cigarette consumption has dropped 44% since 1981. Altria stock is up 71,000% since 1981. Investing is hard.”

— *Morgan Housel*

Brian Chesky (CEO of Airbnb) to Jeff Bezos: “Jeff, what’s the best advice Warren Buffett ever gave you?”

Bezos: “[I asked Warren,] your investment thesis is so simple... you’re the second richest guy in the world, and it’s so simple. Why doesn’t everyone just copy you?”

Buffett: “Because nobody wants to get rich slow.”



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