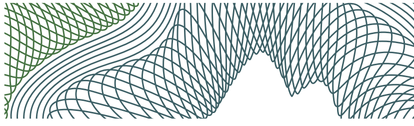


LEBLON
EQUITIES

Leblon Letter 3

3rd quarter 2009

www.leblonequities.com

We are happy to bring you our third quarterly Leblon Letter. It aims succinctly to give you our forward view on subjects that affect our investment decisions, and we once again hope it will be of interest.

We believe your participation, with criticisms, suggestions – or even words of encouragement – is essential for our success.

Thanks and regards,

Leblon Equities

SEA STILL ROUGH; SHIP MOVING – SLOWLY – IN THE RIGHT DIRECTION

We continue to be cautious on the global economy. The problem of the excessive indebtedness of economic agents (mainly the banks) in the US and Europe continues to exist – and may even have been worsened by the liquidity assistance offered by governments. Instead of forcing a painful, but final and fast, adjustment, in which debt would be converted into equity, governments decided to just continue rolling over the central question of deleverage. The dance hall is still going up in flames, but at least the crowd is now moving towards the exit in an ordered line, which can be good for those who are at the front of the line, but will certainly produce a lot of victims. The ideal outcome would have been an attempt to put the fire out once and for all. But no: the banks with problems (to avoid, politely, the word "failed") are slowly capitalizing themselves "via the market" while presenting balance sheets graced with a reasonably strong dose of cosmetics. Summing up, for as long as there is not a final solution that more or less evaporates the value of present stockholders' holdings, giving control of the business to holders of debt, we will be in a stock market that is highly volatile or unstable, only buying time in the hope that "locomotives" such as China, India or Brazil succeed in producing sufficient global growth for the level of underlying decay of the "rotten assets" to be slightly reduced. At any moment, the crowd might perceive that there is not enough space for all of them in the surviving equity, and we might, yet, have another stampede.

Globally, companies' reported second quarter results that were better than expected. This supported the performance of stock prices, but had a lot to do with accounting rules that had been eased so as to make it possible for the global banks not to appear to be insolvent – something which is not likely, in our view, to be kept up forever. The Explanatory Notes will not go unperceived for very long.

FINALLY, BRAZIL AS A SAFE HAVEN …
– AND CANDIDATE FOR THE NEXT BUBBLE?

In spite of this view, which is potentially negative for the performance of stock markets in the developed countries, there is an increasingly strong perception that Brazil may continue to come out of all this rather well (in our last Letter we gave our reasons for this). Interest rates continue to fall, and the Real continues to appreciate, foreign direct investment continues to be high, and for the first time in many years the volume of private debt exceeds the volume of public debt. Moreover, Brazil's IPO market is on a roll again, with the largest offering on the planet (Visanet) in 2009. Summing up, we have an increasingly normalized capital market, giving wings of inspiration to entrepreneurs' spirits – which is, at the end of the day, what makes economic growth improve.

In our view, if there was something positive in the last 12 (or 24) months of global crisis, it was the strengthening of global investors' view that Brazil really has achieved a change of level in relative terms. In the global context Brazil is ceasing to be seen as a "high beta" country and, together with China, taking on something of a spotlight position in the global assets allocation, as a safe haven (low beta). For Brazil, promotion to this position of safe haven for long-term international capital has an enormous impact on the flow of investment, due to the relatively small size of its stock market. Added to this global capital inflow is a reallocation of local capital, due to the fall in local interest rates to historic lows. The result is an explosive combination of flows, which could continue to feed a strong relative rise in Brazilian stock prices, even in the context of falling share prices around the world.

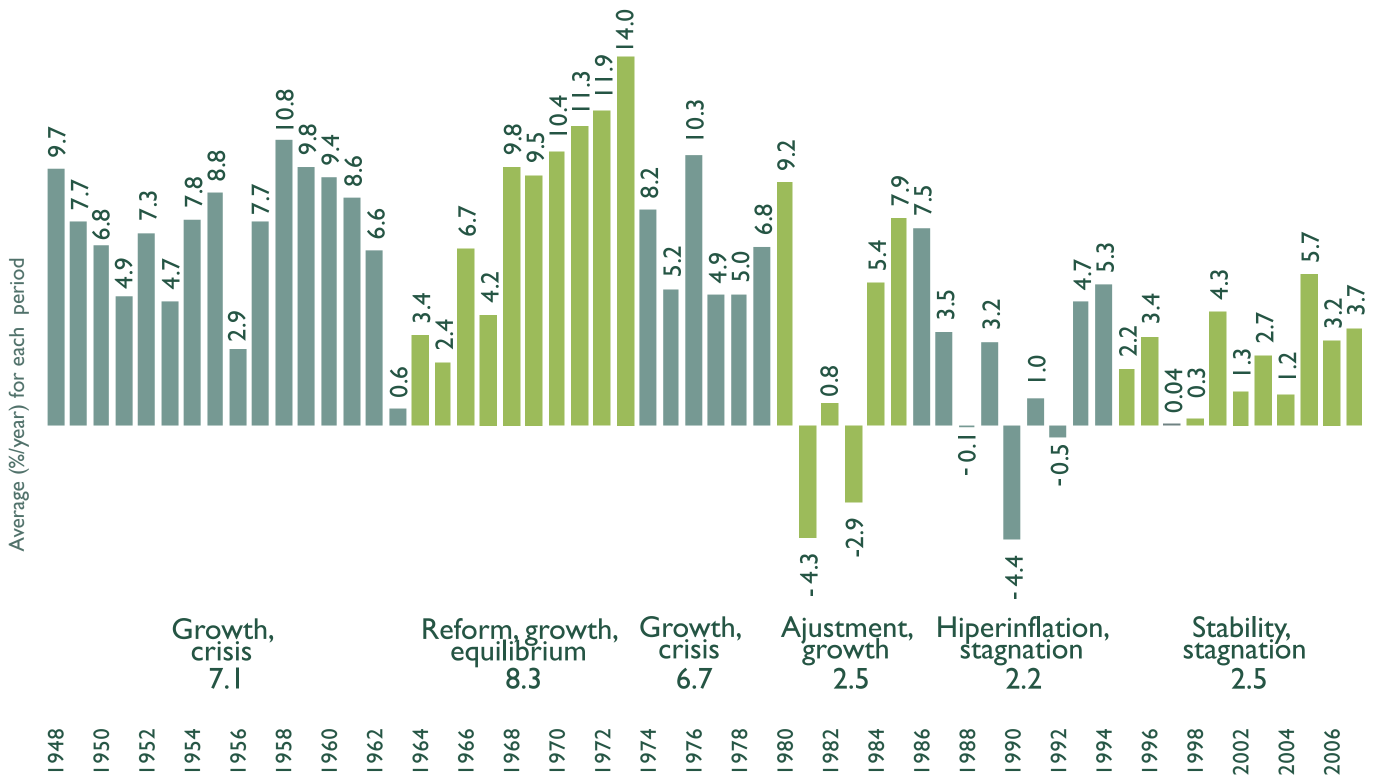
Looking at possible underlying factors, although we agree with the view that China is indeed a long-term structural "locomotive" affecting the scale of global demand, we do think that the strong appreciation of some metal commodities will not be sustained in the short and perhaps even in the medium term. What has happened in the last two quarters seem to us to be much more a rebuilding of inventories over the whole production chain than a return of global demand to its pre-crisis patterns. This is especially true in the durable consumer goods production chain (cars, white line, etc). China has, historically, operated as an extremely opportunistic buyer of commodities, building stocks at moments of crisis and then immediately ceasing to buy. If this game is repeated, we might be about to see moments in which the prices of these commodities falls, which could negatively affect several of the most liquid shares on the São Paulo Stock Exchange – whose Bovespa index is extremely concentrated in mining and steel.

For the first time in history China has pushed Germany aside as the world's largest exporter, and displaced the US as the largest importer of Brazilian products. This growing economic connection between China and Brazil has a significant impact on long-term world demand for Brazilian products (principally farm products, but including energy (alcohol from sugarcane), increasingly a "sub-product" in the farm sector). The scale of this structural transformation (like the one that took place between Brazil and Japan in the 1970s "Brazilian miracle" period) will have a profound impact on the value of Brazilian assets, which we believe could rise at higher rates than those currently forecast by market consensus, for many years ahead.
The level of prices of Brazilian assets does, indeed, have to change, due to an improvement in the fundamentals, since we will likely have a globally low interest rate for several years, and potential market growth higher than the one currently projected.

THE BAD NEWS (OR: THE OPPORTUNITIES?)

In spite of all this "optimism", on our part, about Brazil's relative potential, we have a few cogs in our DNA that are stubbornly skeptical, and don't allow us to achieve quite the level of "calm" that these thoughts might indicate. Brazil's problems, if not minimized or solved, will continue to produce growth rates lower than potential, unnecessarily in the range of 4% to 5% p.a. instead of 5% to 7%. As an illustration, an extra 2% in the long-term growth rate could mean an increase in the potential fair-value P/E of 20% (not to be ignored, especially in a world with near-zero interest rates).

Chart I: Brazil: annual GDP growth rates, 1948-2006



Source: IBGE

In spite of all the fair winds, in Brazil the state continues to be a heavy burden and, at least up to the present moment, there is not the least indication that the political process (in the form, perhaps, of the 2010 presidential elections) will create the conditions, or a consensus agenda, for the necessary reforms – to deal with Brazil's agenda of serious structural defects:

(1) Taxes are currently around 40% of GDP (vs. 15% in China or Russia).

(2) Low investment capacity of the state (only 3% of GDP), since the cost of the public machine consumes almost all tax effort inefficiently. As a result, infrastructure (principally, logistics – e.g. highways, ports and airports) is falling to pieces, removing companies' competitiveness.

(3) An extremely complex tax system, cumulative and regressive, removing competitiveness from exporters – and from the sphere of legality. Informal employment is at a level around 50% of the economy (according to a study by McKinsey consultants), mainly due to the enormous burden of taxes and other mandatory charges on salaries (instead of on profits).

(4) Extremely inefficient educational and health system, reducing social mobility, and taking a large bite out of productivity gains and international competitiveness.

(5) A State social security system based on partition rather than individual personal accumulation (or even a mixed system), which atrophies the capital markets, reduces the system's efficiency and does not motivate growth in the savings rates (reducing the investment rate).

(6) An expensive and inefficient political system (which de facto has no party loyalty, and is immensely skewed in its representativeness – e.g. election of a congressman for São Paulo State requires many more votes than one for a State with smaller population).

A political agenda of structural reforms to attack these problems could function as a catalyst that would transform the potential Brazilian bubble that is on the horizon into an increase in value with more structural long-term fundamentals – and then, who knows? – when the Chinese engine slows down a little, Brazil might make an even more significant contribution to global growth.
For the first time in the last 25 years the coming electoral process will be seen as an opportunity, and not a risk. For this reason, correctly, the cost of capital in Brazil is, slowly, converging to the level of "responsible" countries, such as justifies a structural rise in share prices.

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