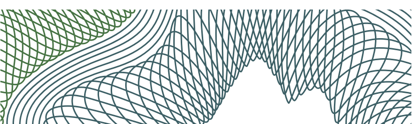

LEBLON
EQUITIES

Leblon Letter 8

3rd Quarter 2011

www.leblonequities.com.br

It is our pleasure to share our eighth Leblon Letter. Once again we hope this channel of communication will be of interest, and succeed in conveying our opinion on important themes affecting our investment decisions.

Thank you and regards,

Leblon Equities

Part I – 3 Years of Leblon Equities

It is our pleasure to share our eighth Leblon Letter, coinciding with our third birthday. On birthdays people usually assess the year, in some way. We thought we would focus this Letter on a look at our first three years – assessing our development as a company, and then some of the things we may have got right (or wrong) in following our strategy – spotlighting on a few individual investments.

In our first **Leblon Letter**, we spoke a little about our identity – our "DNA" – and what we intended to bring to the market as fund managers centering 100% on Brazilian equities. We don't claim to have developed any specific superior model, but we have sought – we think successfully – not to deviate from the main concepts and principles that we presented in that first Letter.

In the 3 years, our team has hardly changed; we have continually improved our way of working together, and added new partners to the original founders. We were 12 people, when we began, in September 2008. Now we are 21, including 10 of those 12. And as for the "pillars" that sustain our investment policy decisions – the ideas that we believe should make the company sustainable over the long term and the principles that guide our investment decisions – we have frankly gained additional confidence in them. We haven't (of course) come through 3 years without making our share of mistakes, but we can award ourselves a considerably positive performance sheet.

A Short Look Back

On September 30, 2008 we launched two local (onshore) funds: Leblon Ações, a long-only fund, and Leblon Equities Hedge, based on long-short strategies. This we did basically with injection of funds from the company's founding partners. For reasons only too well known, that moment for the market was very different from the context in which we had worked to structure the company, hire people, and discuss our business plan: it was a much more challenging market in which to start a fund management business that needed to attract funds, and grow, perform well and offer opportunities to that group of 12 people.

That last quarter of 2008 was a moment of extreme uncertainty on the market´s outlook – and even more so on companies' fundamentals. Looking back, the decision to be 100% invested as fast as possible now seems obvious – when you look at the appreciation of Brazilian assets in 2009 – but anyone who lived through the angst of that time knows it was not quite that simple to take investment decisions in those weeks and months. Having the opportunity to choose with care, we concentrated our investments in companies that we knew well, and which in our opinion offered an attractive opportunity in that environment of extreme uncertainty, and we were able to buy for prices we judged to be significantly lower – with a safety margin – than fair valuation for their assets. Curiously, in September 2008 the Bovespa index was between 55,000 and 50,000 points (it went much lower before the strong gains of 2009) – which is not too far from what we see today. On the other hand, in this period our Leblon Ações fund (local long only vehicle) has made a gain of approximately 88%, net of all costs, and the Leblon Equities Hedge fund (local long short vehicle) has gained approximately 72%. This 3-year perspective, much more than the performance of the most recent quarter (which we discuss in detail in the last section of this Letter), makes us increasingly confident in the pillars of our investment strategy.

The present moment in the equities market to some extent reminds us of the environment in 2008, in our initial months – though there has been nothing on the scale of the Lehman Brothers' bankruptcy and its consequences. Today, too, there is no easy opinion on "where the market is going", and for this reason we have invested more

time in understanding where companies are going, and what is reflected in the prices of their shares. Overall, more recently we have found opportunities to invest in companies that we have been studying for some time, but for which we had not previously found the price right. We have also had opportunities to build positions in companies that we see as very high quality assets, in which we have invested in the past, but which were expensive. We continue to invest without any prejudice as to size of the company or sector, ready to work on a longer than average time horizon. We have had the opportunity to discuss cases of investment with a long maturity date, such as Springs Global (**Leblon Letter 5**, November 2010), in which we are still invested, or Globex (**Leblon Letter 7**, July 2011), which we have now sold.

In the portfolio of our long only fund we have companies that we judge to be excellent, and others that we know are not on the same level of quality, either in the nature of their business or in their governance. In both cases, however, we are invested because we believe that there is a significant difference between the market value and the value of the assets, and that this difference is susceptible to being corrected by certain events or trends that we see as being feasible on a reasonable time horizon. Whenever possible, we will be acting either to help these events happen, or to help the company be in a position to benefit from such developments – or both. At the same time, we may have short positions in the value Hedge fund, in companies of extremely good quality, but which we believe are trading above their fair value.

In **Leblon Letter 6** we discussed some benefits of investing also in unlisted companies – private equity activity – very much because of the knowledge that this has enabled us to build, and continue to build, about companies and sectors. This experience is reflected over time in continuously improving investment decisions in our liquid funds. Our investment in Mills was a good example: we discussed our investment thesis for that company in detail in Leblon Letter 6 of February 2011. Similarly, our holding in a retail company, though unlisted, gives us a very valuable contact with the "real world".

A summary of results of this strategy over these three years gives a very positive picture. The 2% position that our funds took in Mills in 2009 has now been 100% sold[1], giving a return that we regard as very attractive (net returns of 118% in the offshore vehicle, compared to a flat Ibovespa in dollars in the period), but also left us with a valuable "legacy": a good knowledge of the markets in which Mills operates, which helps us in assessing and valuing companies that operate at other points in the chain of the infrastructure and construction sectors.

Over these 3 years we have analyzed several other potential private equity investments, and we think that this was an excellent investment of our research time. Leblon is the manager of the private equity fund that owns a holding in BR Home Centers (BRHC), a home improvement retailer with 18 stores in 6 states of Brazil (and the federal district), and one of the five largest companies in that sector. We were already investors when the merger of Casa Show and TendTudo created BRHC in June 2010, and we are now on the company's advisory board, accompanying its management in close-up view, which gives us an opportunity to enrich our knowledge of retailing in Brazil.

In the next section we write a little about one of the fund's most significant positions – Brasil Foods – and one of our intermediate-scale positions (Banco Panamericano).

1. We are still shareholders in our public equity funds.

BRF – Brasil Foods

This is one of the largest positions held by Leblon Equities Fund today, and was responsible for the biggest positive contribution to the fund's performance in third quarter 2011. Brasil Foods has been one of the fund's principal positions since the beginning of 2010, jointly with other significant investments, such as Mills, Saraiva, Wilson Sons and Aliansce, made in that period. In 2011 we have had the opportunity to manage this position more actively, taking advantage of moments of uncertainty – for example, expectations on the outcome of the decision on the merger by the Brazilian competition authority (CADE) – to increase our position in the company. The stock price of Brasil Foods rose by approximately 24% in 2010; and in 2011, to October 13, it had risen a further 25% (approximately 20% of that rise being in the third quarter).

In our view the association of these two companies, to form Brasil Foods, in 2009 was a truly transformational event of the type that happens very infrequently in the life of any company, and this case caused us to look more deeply at businesses that we had been following for a long time. The merger reinforced some of the main elements of investment thesis: (a) a solid competitive position, with a strong presence in the domestic market and a portfolio of products and brands that is difficult to replicate, plus exports being a significant proportion of total sales; (b) opportunities for significant expansion in the company´s operating margin in the medium and long term; (c) scope, over the long term, for an increase in the size of the market that the company addresses globally, through diminishing barriers to its products; and (d) attractive potential stock price upside when market prices are compared to our valuation of the assets.

We don't have specific or specialist knowledge about Brasil Foods' principal export markets, but we try to keep updated on the subject and the main trends. In Brazil, the advantage of availability of land and water continues to be a significant differential from other producing countries, and we make a comparison with large consumer markets that have been trying to implement policies of self-sufficiency in proteins, often with heavy programs of subsidy for local production. Some experts argue that several such programs have a structural limit, and sooner or later reality shows the need to return to imports as the sole means of supplying their domestic demand. One such analysis noted the example of China and soy: before 1995, China was one of the largest exporters of soy, and now it is one of the world's largest importers and consumers. This reflects not only the need to feed a population of 1.3 billion, but also gradual reduction in the relative profitability of planting of grains, compared to other cultures such as fruit and vegetables, in turn also reflecting reduction of the area able to be cultivated.

The Brasil Foods merger not only made a structural change in the business and its market, but also resulted in the company entering the Novo Mercado, and a diversification in its investor base. Today it has diffuse control: the six largest stockholders own some 35% of the total capital, including a group of pension funds who hold 28%. In 2010 its net revenue was R$ 22.7 billion, 8% more than in 2009, with Ebitda of some R$ 2.6 billion, Ebitda margin of 11%, even in a scenario of appreciation of the Real and increasing commodity prices, and profit of R$ 806 million. Revenue in the first half of 2011 was R$ 12.3 billion, 16% more than in first half 2010, with Ebitda margin already close to 13% (up from 10% in first half 2010). Leverage at the end first half 2011 was still low, with debt/Ebitda just slightly above 1.0x.

The uncertainty surrounding CADE's final decision on the Sadia–Perdigão merger brought a lot of volatility to the stock price in the first half of 2011, and at certain moments we took advantage of price reductions to increase our position. Clearly we could not foresee the final result, but our analysis of the possible results and their impacts still gave us a reasonable safety margin, especially at prices below R$ 26 per share. CADE gave its final decision on

July 13, approving the merger, imposing a commitment (called TCD) undertaking for a number of measures by the company. This information has of course been published in the company's Material Announcement, but it's worth mentioning some of the points of that commitment undertaking – also noting that they have no effects on the company's operations in the export market:

(a) Disposal of a portfolio of brands that are less significant compared to the brands such as Sadia, Perdigão and Batavo.

(b) A single joint disposal of all the goods and rights related to 11 production units, with industrial processing capacity of 730,000 tons/year, including the portfolio of contracts with integrated producers of poultry and pork that provide the supply of those units.

(c) Disposal of all the goods and rights related to the 8 of the 2 companies' total of 40 distribution centers.

(d) Suspension of use of the Perdigão brand name in the Brazilian market, for periods varying between 3 and 5 years, for certain products, which according to the company accounted for approximately one-third of the sales of the Perdigão brand in 2010.

(e) Suspension of use of the Batavo brand for 4 years for products that are also sold under the Perdigão brand, and other products listed in the undertaking.

As well as suspension of use of the brand names in certain product categories, the TCD imposed certain measures of specific performance such as, for example, not using any of either company's other brand names, or names derived from them, in these categories; and limited the company's ability to make exclusivity agreements with points of sale while it is in force.

According to the company, the assets that are to be sold represented approximately 8% of 2010 total sales, and 13% of 2010 domestic market sales, or a total of R$ 1.7 billion; and 74% of them were prepared or processed products. It is worth noting that the 2010 sales of the output of these assets to be sold represented some 65% of their capacity, so that the purchaser could be able to reach an even higher level of sales, as well as naturally investing in increasing these units' total capacity. As for the brands and products suspended, these represented approximately 2010 sales of R$ 1.2 billion, or 6% of total sales and 9% of domestic market sales – almost entirely in prepared/processed products. The total volume of sales affected by the undertaking as a whole in the prepared/processed segment, based on 2010, is R$ 2.5 billion, representing almost 30% of the total of 2010 sales in this market segment (we include meats and other products).

The approval of the merger, on its own, was a highly positive event, but while on the one hand the overall numbers do not seem to be deeply significant (only 13% of 2010 sales were impacted by it), the undertaking has an important impact on the company's operations when we look at the domestic market alone and, more specifically, the market segment of prepared/processed products. It also commits the company to: maintain investment in marketing of the brands that are the subject of the sale; maintain their market share; maintain the operational conditions; and maintain jobs in the units to be sold. There are operational and market positioning challenges ahead.

In any event, we see the opportunities arising from implementation of the TCD as more significant than the risks. It was extremely important that the company kept ownership of the Perdigão brand and the right to market certain categories under that brand – as a result that brand is not completely withdrawn from the market over this period of 3 to 5 years, and it is still worth investing in it. Similarly, the presence of the Batavo brand in the dairy products

market was not affected by the agreement. The sale of the assets could generate proceeds of more than R$ 1 billion, and although there is scope for additional leverage in the current balance sheet, the company may seek to make new investments.

In our opinion, Brasil Foods' current stock price of R$ 33 (market cap. R$ 29 billion) incorporates a scenario of moderate growth and a modest improvement in operational margin in the medium and long term; and this seems to us to be conservative. A sensitivity analysis of the discounted cash flow model for the company indicates that, using a discount rate of 10% in real terms, we can justify this market capitalization with a growth in revenue of 10% for 5 years from 2012 (adjusted for the effect of the measures imposed by CADE), 8% per year in the 3 subsequent years and zero revenue growth in 2020, with Ebitda margin at the same level as in first half 2011. This DCF uses several other assumptions and this exercise is only a simplification, but it illustrates that the market seems not to be pricing any significant transformation in the business. In our opinion, however, such a transformation could happen, either through growth – with increased opening of the markets for its exports; or through improvement of operational margins, resulting from an effective integration of the structures of the two companies and additional scale gains. At the present market valuation, the stock is trading at approximately 20x last 12 months' earnings, and EV/Ebitda of approximately 10x. These multiples are not low, but at the same time they don't incorporate any expectations of out-of-the-ordinary growth, in our opinion. We continue to accompany developments subsequent to the final CADE decision, and we believe that as from now it will be possible to have more objective discussions with the company on the additional opportunities that can be explored for efficiency gains.

Panamericano – Two moments, two investment stories

Our current investment in Banco Panamericano is an intermediate-size position in Leblon Equities Fund, and in some ways can be described as our second experience as investors in that company. Our investment in this stock made the second biggest contribution (after BRFS3) to the fund's performance in the first 9 months of 2011. In this note, we first talk about the reasons for the present position, and then look at our previous background history with this company.

The share price of R$ 6.16 (at the close of September 2011) values Banco Panamericano at approximately R$ 1.5 billion, or 110% of its consolidated book value (we will refer to the consolidated figures, which are more conservative than the individual figure presented by the bank). Although this is a significant value reference, principally in relation to a book value that has been "updated" by capital injections recently, the most important factor in our opinion is that this bank is trading at a very attractive price compared to its capacity for generation of profits in the medium term.

Banco BTG Pactual currently owns 51% of the voting shares and 37.6% of the total capital, while the Federal Savings Bank (CEF, or "Caixa") has 49% of the voting stock and 36.6% of the total capital (through its subsidiary Caixapar), bought from the previous controlling stockholder in 2010. As a consequence of the recent change in the bank's control, there have been profound changes in management and governance. The Board of Directors and the Executive Board were completely reformulated, with executives from BTG Pactual now controlling the key areas.

We see the 2 shareholders as both aligned with the creation of value in the long term: for CEF, to justify its initial investment – after the loss of market value that followed the discoveries of "accounting inconsistencies" – and for Pactual, to achieve a turnaround after its acquisition of control at a moment of difficulty: today it has some of its

own partners 100% dedicated to Panamericano. At the same time, we see this "division of control" as a healthy structure in relation to the various potential transactions with related parties, including those explicitly defined in the document referred to as the Operational Cooperation Agreement, signed between Panamericano and CEF for a period of 8 years.

In June 2011 Panamericano had assets of R$ 12 billion, a lending portfolio of R$ 7.0 billion – and some major challenges ahead of it. The profitability of the assets in its balance sheet is low, the result of a process of origination of questionable quality in the period that came before the disaster of 2010. The bank's management is redesigning processes, working with new models of credit, without the bank ceasing to function, and this alone is not a trivial task. The bank's operational costs are high for the present structure of assets, and investments are being made to reformulate several areas. This combination results in operational losses, as in 2Q11, when it posted a consolidated loss of R$ 25 million – the bank does not sell significant parts of the loans originated but we see opportunities for significant changes in this scenario: growth of assets of better quality with lower origination costs, gradual reduction in funding costs, and higher productivity. The markets in which Panamericano operates are significant, and there are opportunities in credit markets that still represent only a small percentage of its portfolio, such as lending to small and medium-sized companies.

In Itaú Unibanco, for example, the vehicle financing portfolio is approximately R$ 60 billion. Although the figures are not totally comparable, the Central Bank data show a total lending portfolio for acquisition of vehicles in the financial system of approximately R$ 160 billion. Some medium-sized banks have significantly reduced their operation in this market segment, and some large banks, such as HSBC, have taken the strategic decision to leave the financing market for non-clients altogether. This is a significant market, with fewer competitors than 4 years ago, and which in our opinion presents the opportunity for origination of potentially very profitable assets.

In the operational agreement between Pactual and CEF, CEF undertakes to acquire credits originated by Panamericano, assigned without recourse, up to a limit of R$ 8.0 billion, as well as interbank transactions with a lending limit of R$ 2.0 billion. In a scenario in which Panamericano "uses" 100% of this limit made available by the CEF, it would have access to R$ 10.0 billion for financing its balance sheet. Its funding from time deposits was R$ 3.0 billion in June, still less than its total of R$ 4.7 billion in December 2010, or R$ 5.1 billion before the problems identified. We believe that it has an opportunity to recover the previous level of funding, and to increase it, with lower funding costs than those that existed previously. With the control by two large-scale institutions, we believe that it might be able to work with more leverage than the average of medium-sized banks.

If 50% of the agreed CEF "capacity" were used, plus R$ 3.0 billion of additional time deposits, this would make R$ 8.0 billion available to the bank, which had R$ 12.0 billion in assets at the end of the second quarter of 2011. Just to simplify the analysis: with R$ 20 billion in assets and the potential for a return on assets between 2.0% and 2.5% – which we still judge to be relatively conservative for the nature of the business – the bank would have potential to generate profit between R$ 400 and R$ 500 million, and a potential market value, seen even conservatively, of R$ 3.0 billion – in our opinion – which is more than double its present market value. This does not seem to us to be a scenario for 2012, but one which could be attained in 2 or 3 years without any exaggerated aggressiveness that might put the solidity of the balance sheet at risk. It's true that today the bank does not have capital to reach this level of assets, but retention of earnings over the next 2 years could "finance" this growth, without the company needing to come to the market to increase its net equity.

But it was not always thus…

At the end of 2008, we had the opportunity to build a position in shares of Panamericano that was relevant (for the size of the fund at that moment), and that investment gave the fund a significant return over 2009. While on the one hand we cannot say that this bank was one of the group of companies that is a model of excellence in its sector of operation, that first investment was made when the shares were trading at a fraction of book value (which we discovered later not to be entirely "real", but it was still a reference point for value). We believe that the bank had some franchise value due to its operation in an important niche of the consumer financing business, while at the same time the Central Bank provided an arsenal of instruments to minimize the effects of the crisis of confidence on the liquidity situation of smaller-scale financial institutions. The risk-return ratio of the investment seemed to us attractive, and during 2009 we reduced our investment significantly, leaving the position completely in 2010, when the shares reacted very positively to the announcement of the investment by CEF. At that moment, the shares were trading at more than 1.5 times book value, it was a different game and we could no longer see an adequate risk-return (we saw little space for a change of level of multiples), and a limit for potential improvement of ROE).

Those were good decisions – up to that moment; but a little further ahead, in a movement that was less happy than the previous ones, we invested again, and suffered a major hit with the forced recapitalization resulting from the so-called accounting inconsistencies that revealed an urgent need for injection of cash. As the shares fell, after trading above R$ 10, and came close to a premium on book value that we considered low (10–15%), we began to invest again, based on some simple assumptions. First, we judged that the combination of a good franchise on the asset origination side, with the support of the CEF, had changed the competitive position structurally (with the possibility of a better offer of products and more competitive funding), and with it the bank's capacity for generation of profits in the medium term. The CEF became a significant stockholder (49% of the voting shares, 20% of the preferred shares), and the 2 institutions signed an Operational Agreement for sale of products in their distribution channels. The CEF had all the interest, economic and political, in making this investment/partnership work. As with the first investment, this was one of the fund's intermediate-size positions, but one that generated a perceptible negative result over November due to the significant fall in the shares following the announcement of the "accounting inconsistencies", which continued until the bank lost approximately half of its market capitalization.

Well, with that fait accompli – the damage was done – we took the decision to buy a little more at the price that was equivalent, in our view, to approximately 50% of book value, after the rescue and capitalization transaction agreed with the controlling shareholder. Ironically, the discovery of such a large-scale fraud, and consequent destruction of market value, left the CEF no alternative but to dive deeper into the solution of the problem, with injection of people and possibly funding to save its investment. The purchase of control of the bank by BTG Pactual provided an injection of confidence which without a doubt was important for the recovery of the bank's market value. In retrospect, we can always find reasons that would have led us not to invest in the bank, but at the same time, the combination of the value of the bank's franchise and the CEF as a significant stockholder were factors that in our view mitigated the investment risk as we saw it. The performance of the shares of Panamericano since we made the investment in 2010, shortly before the events of October, up to today, is slightly better than the performance of Itaú Unibanco which is, without doubt, an asset of "higher quality".

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