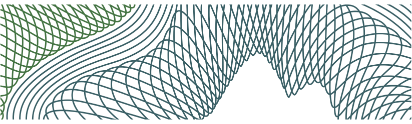

LEBLON
EQUITIES

Leblon Letter 9

4th Quarter 2011

www.leblonequities.com.br

It is our pleasure to share our ninth 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

Introduction

Few investors will look back to 2011 with nostalgia.

It was an unsatisfactory year for Brazil's stock market. For most companies, there was no deterioration in their fundamentals on a scale to explain the plunge in their market value. Nor were industry multiples especially high at the beginning of the year. The Brazilian economy performed reasonably well in a global context marked by a continuous flow of Armageddon-type news out of Europe and an incipient US recovery that only began to take shape as the year was coming to an end. In our view, 2011's truly defining features for the Bovespa were foreign-investor outflows and risk aversion in general.

In the year Leblon Equities Fund had a negative performance of 22%, and Leblon Value Hedge Fund was down 11%. If we exclude the performance of HRT (and we will explain the reasons for such exercise further down), Leblon Equities Fund would have fallen 14%, while Leblon Value Hedge Fund would have fallen 3%. The Bovespa Index fell 27% in USD in the year.

We are not happy with our results for 2011 – though we are clearly aware that enduring a few years of negative performance can be an inherent consequence of our philosophy of seeking high returns over the long term through an approach that looks for material distortions between the price and value of assets, without any particular concern for maximizing consistency in the short term.

We believe that when the market is looked at through longer time windows, companies' fundamentals prevail over temporary effects of risk aversion and financial flows. In this longer view, the market tends to recover some rationality, and the prices of good assets tend to converge to their intrinsic value.

Numerous Brazilian companies have started 2012 at attractive levels. According to Bloomberg, the Bovespa Index is trading at 9.4 times 2011 earnings, with a dividend yield of 4%, and expected earnings growth of 14% in 2012 and 12% in 2013. The Leblon Equities Fund portfolio offers an upside of nearly 50% on a DCF basis and using a discount rate of 10% in real terms.

From a micro viewpoint, several industries stand to benefit from interesting opportunities for consolidation. Despite the lack of a broad, substantial tax reform, we think the gradual and continuous improvement of tax collection system (inspections, tighter controls) tends to reduce the advantage of small informal businesses over the long term – resulting, in several sectors, in scale becoming a more important variable, which tends to accelerate consolidation, potentially generating value in the long term. Larger and more capitalized companies tend to be the winners in this process. We are also under the impression that the government, putting ideology aside, is committed to the privatization of certain infrastructure assets such as highways and airports – a movement that we believe will be very positive for the economy as a whole.

In the following pages, we will discuss our investment in UOL; the plunge in the HRT stock price; and the position in Coteminas we now manage.

Part I

UOL

Given the choice, we would prefer UOL continued to be a listed company. Apart from the historic scarcity of media companies on the Brazilian equity market, we believe UOL was about to go into what may likely be its best phase since its IPO in terms of operations and results.

Unfortunately, UOL's controlling shareholder, Folhapar, shared the same view and decided to make an offer to buy out the interests of minority shareholders. An intense negotiation process ensued, as there was a material difference between the price proposed by Folhapar and the perception of value on the part of the minority shareholders.

The public offer auction was finally held on December 29, and Folhapar acquired the equivalent of 96.4% of the shares that were the subject of the offer (UOLL4), for R$ 19.50 per share, for a total of R$ 338 million. The funds managed by Leblon Equities sold their shares, concluding an investment that we had begun in August 2010. We see the result of the process as satisfactory; and the rise in UOL's stock price in 2011 (approximately 46%) made an important contribution to the performance of Leblon's funds.

As we were saying, the minorities takeout process started months before and demanded a lot of time from the minority shareholders, who did not agree with the price initially offered. On July 26, 2011, Folhapar first announced its intention of making a public offer for UOL's shares at a maximum price of R$ 17 per share. This would have valued the company at R$ 2 billion. On October 9, Folhapar increased this offer price by approximately 12%, to R$ 19, plus an adjustment by the Selic rate from October 7 to the date of payment. This change was the result of a negotiation process between a group of 10 minority shareholders – led by Leblon Equities – and the controlling shareholder, in which the minorities pushed for a revision of the price to a level that better reflected the Company's value.

We first invested in the stock of UOL in August 2010, when we acquired a position amounting to 2% of the funds at an average price slightly above R$ 10 per share. This price valued UOL at R$ 1.2 billion. In the first nine months of 2010, UOL reported profit of R$ 95 million, on Ebitda of R$ 136 million, with net cash of R$ 490 million at the end of the third quarter. An aspect that stood out was UOL's success in maintaining revenue from subscriptions at a surprisingly high level, and one that was still very significant for the company as a whole. The nine-month figures indicated that this revenue would probably be at the same level at the end of 2010 as at the end of the previous three years (in nominal terms, but still better than we expected to see based on the nature of the business). At the same time, the revenues from advertising and other businesses were already greater than the revenues from subscriptions, and had grown by a significant 39% in the first nine months of the year. New services were created (such as the *PagSeguro* online payment system); software companies were acquired, and the company was already operating in the market of data centers and web hosting through partnerships with two other companies, offering hosting plans, management of email and construction of sites.

At that point UOL had been maintaining healthy operational margins (Ebitda margin above 20%), and a high return on capital invested, and it still had a balance sheet that made it possible to make new investments and acquisitions, allowing to diversify its businesses even further. In spite of the restraints imposed by the stock's low liquidity, and the difficulty of achieving a very complete understanding of the economics of the various businesses in which UOL operated, our assessment at the time was that it deserved additional research time on our part, because we might be looking at an interesting investment opportunity. Our view was that the market's valuation of UOL incorporated

a very low growth expectation. In December 2010, UOL acquired Diveo for R$ 693 million plus an additional R$ 19 million as a guarantee deposit against potential adjustments. Diveo provides services such as data center and web hosting (already offered by the UOL Host division), and software services. In our view, this acquisition changed UOL's business mix for the better (boosting its growth outlook and the scope for better margins); showed that the market for IT services had become important in UOL's strategy; and, finally, meant that UOL had found a use for the accumulated cash in its balance sheet, in a transaction that seemed to add value. UOL had maintained a high net cash position since its 2005 IPO, when the company was valued at approximately R$ 2.2 billion.

During the first quarter of 2011, we researched the company further and came to the view that the fair value for the stock was above R$ 20 per share, indeed closer to R$ 25 in a more positive scenario. The market price, at R$ 13–14, represented an interesting opportunity, in our opinion, and at the end of March 2011 our position in UOL was as much as 5% of the Leblon Equities fund. With the shares' appreciation after the announcement of the public offering, the investment in UOL rose in value to represent 6% of the fund in July. The controlling shareholder's intention of delisting UOL surprised us, even though the company was not giving any signals that it would improve communication with the market, especially in relation to its strategy – and at the same time the price was considerably below what we believed to be the Company's fair value. At that moment we decided to approach other UOL shareholders and began a negotiation with the controlling shareholder, presenting our valuation of the Company and attempting to obtain a price that would be closer to that valuation. Although R$ 19 per share did not in our view reflect all of UOL's potential, the 12% price increase at a time when the market was undergoing high uncertainty (the Bovespa Index fell 14% over the period of the negotiation), and the public offer gave instant liquidity to one of the fund's more significant positions.

HRT

A wise old saying from Brazil's mineral-rich state of Minas Gerais can be translated: "In elections and in mining, it's the outcome that does the defining".

Indeed, it is still early to say whether we are right or wrong in our investment thesis for HRT, since the company is at a very early stage of its exploratory campaign, in spite of the "disaster" scenario currently built into the stock price. Still, given the stock's extremely weak performance in recent months, this may well be the best moment for us to explain our investment thesis, our clear difference of opinion with the market, and what we expect from now on.

When we made our initial investment in February-March 2011, there was a rather long list of reasons attracting us to HRT: the quality of the people in its management team; this group's track record over years of work at Petrobras and other oil and gas companies; the alignment of interests between this team and the Company's shareholders; and a reasonably firm valuation compared to other listed, pre-operating oil companies.

We allocated 3% of the fund at a price level of R$ 1,700 per share, which was equivalent to paying an EV[1] of US$ 0.72 per barrel of oil equivalent (Boe).

Clearly our timing in starting to build the position was unfortunate, and the damage caused to the short-term performance of the fund was considerable. Fortunately, however, this damage so far has not proven permanent, and we do not feel discomfort with the fundamentals that led us to buy the company in the first place. After all, in spite of everything, none of those variables has changed significantly.

1 *Enterprise Value* = Firm Value

In April 2011, with the end of the lockup period for the investors that had financed the startup of HRT's operations in a private transaction about a year before the IPO, the stock price fell to R$ 1,300. At that moment, HRT had already succeeded in increasing its risked resources from 6.6 billion to 7.9 billion boe in just a few months (compared to 2.1 billion at the time of the IPO), and our analysis indicated a minimum value for the stock of R$ 800 in a pessimistic scenario, and R$ 3,000 if the winds were in favor. The risk/return seemed reasonable, and we increased the position as a percentage of the funds' NAV from 3% to 9%.

A simple storm, however, gave way to some serious turbulence. From that moment to date the stock has fallen by around 70%, as a result of developments which may perhaps have the potential to reduce the quantity of HRT's risked resources in the Solimões basin by 7.2% – that is to say, by 20% of the oil that was expected from that region[2] – namely the lower than expected results of the initial exploration campaign on the Solimões River, and the HRT1 well in particular, announced by the company in September 2011.

The share price débâcle reduced our portfolio's HRT exposure from 9% to 4% at the end of 2011. The reduction would have been greater if we had not made additional acquisitions at an EV of approximately US$ 0.10 per boe, so that today, in spite of all the depreciation, our quota holders' exposure to HRT[3] is at its highest since we began to invest in the company. At the same time, the potential future damage is limited to the total of just over 4% of our funds' total NAV that is invested in HRT.

The start of HRT's exploration campaign in the Solimões was less successful than the scenario indicated by its founder and CEO, Marcio Mello, a man whose belief in his business is matched only by his eloquence in communicating to others the scale and quality of HRT's assets.

Inviting investors to an organized visit to the Solimões basin in a conference call in the first quarter of 2011, Marcio said he hoped shareholders would be able "get their hands dirty with light oil" at the location when they got there, within a few weeks. Unfortunately, the campaign faced enormous operational problems (although in line with what is expected to happen to any prospecting effort deep in the jungle); and so far – at least up to the present moment – only natural gas has appeared instead of oil.

It seems to us that the market is penalizing the Company more than is necessary, perhaps because of the insecurity generated by a result that was weaker than expectations – just as, inversely, a better than expected result can often cause an overshoot in the price of assets of this type.

HRT's exploration campaign in the Solimões is only at its initial phase. It has drilled only four wells so far, of an estimated target of at least 40 by the end of 2013. In Namibia, where HRT has 85% of its risked resources, it plans to start a process to sell a minority stake in its concessions in the second quarter of this year, an operation that could recalibrate the fair price of those assets and put the company in a more comfortable situation from the point of view of its capex.

Today, our conservative scenario for HRT indicates a stock price of R$ 685, which is equivalent to the sum of its present cash position and a value for the Solimões basin at the price paid by TNK-BP – attributing zero value to the assets in Namibia. In our base scenario the stock is worth R$ 1,250, which is the sum of the cash, Namibia (at the valuation paid for UNX) and the Solimões (at the valuation paid by TNK-BP). As a comparison, at R$ 410 (the closing price of 2011), HRT was trading at an EV/boe of R$ 0.10, compared with R$ 6.80 for OGX.

2 This assumes a write-off of 100% of the oil certified by D&M in the HRT-2 and HRT-3 wells, and also 13 million boe less in HRT-1.

3 Number of shares in HRT, divided by to the total number of quotas in all the funds.

Perhaps this is an appropriate moment for a quote from J. Paul Getty when asked the secret of his success: "Rise early, work late, strike oil." For HRT, only the last element is not yet in place – but we expect that might be not too far away.

Coteminas

Three of the largest Brazilian pension funds have trusted us with the management of a holding equivalent to 22% of the voting stock of Coteminas. The sum of these positions in Coteminas – owned by Previ, Petros and Funcef – is approximately R$ 50 million. Management of this interest, which began in November, is being executed through an exclusive fund, without any direct relationship to Leblon's other vehicles, set up with a minimum duration of four years and the objective of generating value and liquidity for the shares.

Coteminas is currently valued at approximately R$ 400 million, which is equivalent to 30% of its book value. It owns 68% of Springs Global (SGPS3), its principal operational asset (it also controls Cia. de Tecidos Santanense). Springs is a significant position in our funds, and we have written about it in detail in Leblon Letter 5, back in November 2010. Our history as long-term investors in Springs, our knowledge about the company and proximity to its shareholders and executives were important factors in the process that led to our selection as managers of this Coteminas position. Our own goal in seeking to manage these holdings is in line with our objective of collaborating in the business of the companies in which we have a significant economic interest through our funds. Not only do we see Coteminas as an interesting investment from a "value" point of view, but its position as the controlling shareholder of Springs results in the management of 22% of its capital being important for the other funds managed by Leblon, creating synergy in terms of the time invested in managing this position.

In the long term, we believe that for the potential value of Coteminas to be recognized, a series of steps are necessary, and a more active role by the minority shareholders could play a decisive role. One question that comes up, for example, is the stockholding structure of the companies, which today is very complex. Springs is listed in the *Novo Mercado*, but Coteminas and Santanense are not. Coteminas is a direct shareholder of Springs, and also a direct and indirect shareholder of Santanense. We believe that some form of rationalization of this structure could create more liquidity for the shares.

In terms of strategy, Springs is going through a very important phase, making significant investments in a retail distribution channel. These investments began with the acquisition of MMartan in 2009, and now have been enlarged to include the opening of a chain of Artex stores and the start of a business to franchise that brand. In our view, the success of this strategy could be a transforming event for the company, potentially generating huge value for shareholders. We believe that our holding in the capital of Springs (4.5% of the total capital), combined with the significant position in Coteminas, will help us become even closer to the controlling shareholders and the executives, which will allow us to closely follow the execution of this strategy.

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