



LEBLON
E Q U I T I E S

Leblon Letter 12

3rd Quarter 2012

www.leblonequities.com.br

It is our pleasure to share our twelfth 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

This *Leblon Letter* – our 12th – coincides with the fourth birthday of our local funds, Leblon Ações (long only) and Leblon Equities Hedge (long short). With the various successes and mistakes, good years and less good years, the overall return of these four years has been very positive, and makes us confident for the years to come...

Over the period (up to September 28, 2012) the Leblon Ações fund (long only, local vehicle) has returned 115.3%, net of all fees, which compares to 19.5% for the Ibovespa and 28.6% for the IBX Index. The Leblon Equities Hedge Fund (long short, local vehicle) has returned 76.5% in the same period, net of all fees, compared to 48.2% for the CDI (Brazilian Overnight Interest rate). The offshore vehicles started in November 28, 2008. Since inception, Leblon Equities Fund has returned 185.7% and Leblon Value Hedge Fund has returned 57.8%.

We are now a team of 20 people, of whom nine are partners and 10 are directly involved in research, analysis and investment management. The five founding partners (Pedro Chermont, Marcelo Mesquita, Pedro Rudge, Bruno Pereira and Felipe Claudino) are still in the company; we have admitted three new partners from the team (Victor Uébe, Laura Tostes and George Earp); and in 2012 we contracted our ninth partner (Eduardo Castro).

Our team has never been so strong, skilled and cohesive as it is now. The younger members are maturing by the day, and actively contribute to the research, analysis and investment management. The recent hires, and the natural evolution of their predecessors, increase the team's level of seniority. Today six partners of Leblon Equities are on the Boards of Directors of companies we invest in.

After four years we feel secure in stating that our investment philosophy has been widely disseminated and consolidated inside the company. We make investments oriented by the companies' value, and we seek high returns over the long term, with low risk of any permanent loss of capital. To meet this objective, it is natural that we will have to face higher volatility, and what may sometimes be seen, by some as, "inconsistency" of results in the short term. When appropriate, we practice "Collaborative Activism", in the companies we invest in, which includes having a seat on their Boards of Directors. We seek to be catalysts of change. We do not believe, basically, in statistical approaches to risk management. The concept of a safety margin (knowledge plus conservatism) is the basis of our process of risk management. We have quantitative rules for liquidity and exposure, to minimize the risk of any extreme events.

We have made heavy investments in these recent years, and today we are fully confident that our team, our infrastructure and our IT systems are among the best in our sector.

Looking back at our first four years: 2008 - 2012

In this *Leblon Letter* we will make a slightly wider review of what we have done (and not done) over these four years, in terms of the investments made by the funds. Some of our important investments have been the subject of more detailed analysis in previous Leblon Letters – among them: Brasil Foods, Mills, Aliansce, BHG, Lojas Renner, and UOL. Hence we had not included them in this present Letter.

Over the length of this text, we have sprinkled some quotes from *Warren Buffet*, which we are able to relate, in one way or another, to our investments. In the middle of putting together this *Letter* you are now reading, we arrived at the conclusion that one of the most difficult of these teachings, in general, in this one:

'The truly big investment idea can usually be explained in a short paragraph' **Warren Buffet**

In general our investment philosophy puts up certain obstacles to investments in companies producing commodities, sectors that are regulated or very capital-intensive, and initial public offerings (IPOs). In spite of this, we are not prejudiced and, if the price is right, these 'negative' characteristics can be more than offset. Over these first four years, we have indeed made investments with very good returns in several companies in these categories: Cetip and Aliansce (IPOs); Satipel and Fosfertil (producers of commodities); and Wilson Sons and Santos Brasil (capital-intensive/regulated).

Some companies in commodities

The Satipel of 2008 is now part of Duratex. This was an investment with a very positive return for the Leblon Ações fund, and one of our great successes in a "new" company, when compared to the majority of the companies in the portfolio at that time. We knew the business in which Satipel operates, through our analysis of Duratex, and although we had no specific great admiration for the production of wood panels, our attention was attracted by the fact of its being well managed, operating in a market with a good long-term growth outlook and opportunities for consolidation, and also being valued well below what we could see, in a realistic scenario, as fair value. It had some clear opportunities ahead of it, such as migration of part of its production to a more up-to-date and efficient plant; it was in the final phase of a significant investment cycle, and even so it had a low level of leverage. We discussed the subject of consolidation of the sector, and in June 2009 Satipel announced its merger with Duratex, giving more backing strength for a recovery of value than was also reflecting the significant improvement of the market as a whole. We disposed of the investment in Satipel after the rapid rise in its share price – it contributed 4 percentage points to the performance in 2009, qualifying as a good investment in the world of quasi-commodities.

Fosfertil PN had a longer life in the portfolio of Leblon Ações, in spite of us having not written very much about it. At the end of 2008 it was a significant percentage of the fund, and we reduced our position to zero only at the time of the offer made by Vale in 2011. In our opinion the investment was justified by relatively basic considerations. Fosfertil did not have businesses that we could exactly call complex. Its value was pretty much specified by the price of a small group of materials, and we did not have very aggressive assumptions for finding much potential for appreciation. The market that it operates in was quite highly concentrated, and very unlikely, in our opinion, to experience any kind of rupture. The downside seemed to be quite limited, and we allowed ourselves to be excited by the fact that Vale had stated an interest in assets in the fertilizer business. In January 2010 Vale announced acquisition of a controlling stake in Fosfertil, but the complete saga of this investment, for us, was only to come in 2011, when Vale announced its offer to buy all of Fosfertil's preferred (PN) shares. Fosfertil contributed with 3.5 percentage points to the performance over the period.

The examples of Satipel and Fosfertil illustrate the flexibility needed by a bottom up investor. We have always said that we have a certain difficulty investing in commodities companies because, in most cases, they don't have a sufficient safety margin, and we are a little uncomfortable with a valuation where a single variable makes the difference between investing too expensively or too cheaply. But sometimes the figures add up, and if there is limited downside, then, yes, we may invest.

Investing in IPOs

We invest in IPOs infrequently, due to the difficulty of forming an opinion about a company, its businesses, people and value in the short space of time that a typical IPO process offers. Aliansce and Mills (both discussed in previous *Leblon Letters*) are two companies which for us are not in this situation, due to the opportunity that we had to understand them both well before their stock exchange debuts.

Cetip was another similar case (we had analyzed it for a possible investment when it was still unlisted). We invested not at the bookbuilding stage, but a few months later. The high P/E was not an insurmountable obstacle, due to the profile of strong cash flow, the outlook for growth in the medium and long term, and the considerable entry barriers for new competitors. Today it looks like many investors have overcome the initial prejudice on the company and the sustainability of its business. Leblon Ações remained invested during 2010, and sold its last position after an appreciation of approximately 100% in R\$, at a market valuation that did not offer a safety margin. Cetip contributed 3 percentage points to our funds' performance over the period. Shortly afterward, the acquisition of GRV helped increase Cetip's value to R\$ 8.0 billion, compared to R\$ 6.8 billion today. Over the period, we maintained a short position in the Leblon Equities Hedge fund, and subsequently we took another long position, although small.

Capital-intensive and regulated sectors

In the second quarter of 2009, we made an investment in Wilson, Sons, and for a period (though a short one), until the IPO of Mills at the beginning of 2010, it was the largest position in Leblon Ações fund. We also invested in Santos Brasil in 2009, just after the investment in Wilson, Sons. Although both companies can be "pigeonholed" as logistics/infrastructure, they are quite different businesses. Wilson is a company with assets and strategic operations in its market that range from tugs to operation of port terminals and shipyard. When we first invested, it had a market value of approximately R\$ 800 million, net debt of R\$ 30 million, invested capital of close to R\$ 900 million and investments planned for the following years that added up to almost its market value. It has the capacity to finance its investment at a very attractive cost of debt, due to the government incentives for the sector it operates in, and was returning an ROIC of nearly 15%. In short: it was possible to project some significant generation of value. We disinvested only at the end of 2010, with a return of 3.7 percentage points for the Leblon Ações and Leblon Equities Hedge in the period.

Santos Brasil has a similarity to Wilson, Sons, which is the strategic value of its principal asset (the Santos Container Terminal, or *Tecon*), which represented a clear competitive advantage, even though that asset was the subject of a concession contract. When we invested, the market value of Santos Brasil was R\$ 1.8 billion, or approximately 50% of its present market value. The multiples (price/book, P/E and EV/Ebitda) were not exactly low, but it was possible to find significant appreciation potential even without aggressive assumptions. The imbroglío involving the stockholders at the time was a point of attention, and risk, for the business, but this was an acceptable risk, in our view due to the potential return. We captured a significant part of the potential for appreciation, and sold the last part of our position in early 2011. We accepted some governance risk, provided it was able to be offset by significant returns.

Two companies, with interesting characteristics: Strategic assets, and good returns on invested capital. But the attractiveness of these investments could be very different, over time. When we initially invested in Wilson, Sons its market valuation was lower than the capital invested in the business. At present, the market value added to the net debt is close to R\$ 3.0 billion, the capital invested is around R\$ 1.8 billion, and we are unable to see scope for

ROICs that are much above the company's historic average. Although we would categorize it in general as a "like", the value equation has become less interesting. We may invest in businesses that have a high demand for capital, provided there is space for good returns on the capital invested.

'Over time, it is hard for my invested money to earn a much better return than the underlying business's returns on invested capital' **Warren Buffet**

The "inevitability" of mistakes...

In 2012, the average number of daily trades on the Bovespa was an impressive 700,000. Each presupposes the existence of a buyer and a seller. Thus we could say that every day, in Brazil alone, 1.4 million investment decisions are taken of which hundreds of thousands are wrong decisions. These are the "mistakes".

The buyer believes that the share is worth more than the price it is being sold for; the seller thinks the share is worth less than the price it is being bought for. In most cases, in most cases one of them is wrong. In the Bovespa example, the number of "wrong decisions" is not exactly 700,000, because there are situations where both the buyer and the seller can be right – for example, different investment horizons, tax reasons, etc.

Over the first four years of our history, we have also made our share of mistakes. They are inevitable and – such is life – we go on making them. In our opinion the important factor is to know how to identify them, since, counterintuitive though it may seem, we can gain by making mistakes; we can even lose by doing something right; and reflecting on our mistakes, we can create mechanisms to minimize their frequency and intensity.

Identifying the mistake is not trivial. We tend to think that making a mistake means losing, but that is definitely not the case. If someone proposes us a win/lose payment ratio of two-to-one on a heads-or-tails bet, we should in principle accept this bet because, in statistical terms, the "expected value" is positive. If we lose, it does not mean that the decision to accept the bet was wrong: it means we took the right decision, but we were not lucky.

HRT

We made two mistakes with HRT, that have so far cost us about 10 percentage points in the performance of Leblon Ações fund and Leblon Equities Hedge fund:

1) When we made the first investment in the company (3% of the funds), our calculation of the statistical "expected value"¹ was not properly based. We had attributed reasonably well-chosen probabilities for the positive and negative scenarios, but the expected return that we assumed for the negative scenario was not very conservative. Also, our assessment of the safety margin was based on the valuation of "comparable" companies, and turned out to be fragile. We got it wrong. *A posteriori*, we can say that the party that sold the shares at that moment got it right.

2) After the initial fall in the price of the share, we refined assumptions, deepened our diligence and gained a significant degree of confidence in the case – without being unaware of its risks. The stress scenario was now mapped, and we understood that in the case of the exploration campaign being unsuccessful, the downside would be big. However, our assessment was that the statistical expected value was considerably positive, and we increased

¹ Probability of the occurrence of scenario A (optimistic) multiplied by the expected return on scenario A, added to the probability of the occurrence of scenario B (pessimistic) multiplied by the expected return on scenario B.

the position to 9% of the funds. That is a significant position, although smaller than the largest positions (over 15%) that our funds had in the past held in companies such as Mills and Saraiva. After we increased our holding in HRT to 9% of the funds, there was a succession of negative events. The downside scenario was beginning to show itself, and the market was pricing that alternative. The share fell 80% after the results from the first 10 wells drilled, in an exploratory campaign of about 30 wells, were lower than expected. Although we have not revised the initial conclusion that (statistical) expected value of the second investment in HRT (when we increased to 9%) was positive, the size of the position proved to be inappropriate because it left us without much ammunition and conviction for a reaction (i.e. to buy more) after the share had fallen 80%. But what is the situation if, after we had bought 9% of the fund in HRT, the positive scenario materializes and the share triples in price? Had this happened by now, we would probably be called geniuses; but we would, even so, have taken a decision that was not the right one in relation to the size of the investment.

As a consolation, we have the fact that we have learnt a lot from this added experience. As well as this, which is a subjective consideration, we have an objective one: due to not having sold a single share in the company, we have preserved the potential return for the fund's more patient unit holders if the exploration campaign turns out to be a success – a possibility that cannot be ruled out. While on the one hand we could recover a significant part or even all of the loss on HRT so far, the future loss is limited to the present 2.5% of the fund's portfolio that is invested in HRT.

Springs Global: Complacency? - or the hidden cost of low liquidity?

In the cases of Saraiva and Lojas Renner, we have made significant changes in the proportion of both in the fund's portfolio, while our position in Springs was much less "managed", a reflection of the stock's very low liquidity. At the end of October 2008, Springs was trading for R\$ 2.66 – practically the same price as today, after having reached approximately R\$ 6 at the beginning of 2010. We have maintained a position of around 6–7% of the Leblon Ações fund in Springs during this period. What has happened since 2008, and what was the central point of the "error" in maintaining this position? We have written about this investment in previous *Letters*, but we now return to it briefly.

The textile industry is not exactly the sector where one frequently finds excellent companies, but in Springs we have seen a company that is very well positioned in this difficult market, largely because of its scale and its low production costs. At the end of October 2008 its market valuation was less than R\$ 300 million (at that time a fraction of its book value, which was supported by significant real assets), and we saw scope for an operational restructuring that could create a significant increase in its profit margin: it looked like one of the good investments that the market offered in its vast list of companies trading below fair price. Along the way, many situations evolved: the market in which Springs operates continued to be very difficult; its idle capacity grew; the businesses outside Brazil suffered tremendously; the price of cotton took off; some significant losses were accumulated, and the debt reached very high levels. In 2006 through 2008 the company accumulated a loss of some R\$ 950 million. 2009 was not exactly good, in spite of a net profit of R\$ 40 million, but the process of adjustments (in the size of the company and in its internal structure) continued over the two subsequent years, with a loss of almost R\$ 480 million, of which R\$ 321 million came from operations being discontinued. The sales revenue of its continued operation totaled R\$ 1.8 billion in 2011, compared to R\$ 2.1 billion in 2010. In 2006 it had total revenue of R\$ 5.5 billion. These figures give an idea of the scale of the adjustment that Springs has gone through.

Springs and its stockholders have not had an easy life over the last five years. It would be incorrect to say that our confidence in the investment thesis remained unshaken during that time. We questioned ourselves continually about the investment. In parallel to all the negative factors listed here, we gradually perceived a much greater propensity on the part of the company to take hard decisions about the business (partly, naturally, because of the economic and business context). These included closing of capacity, sale of assets, and repositioning in its principal markets. Its entry into retailing with the purchase of MMartan in 2009 was a very good sign, and we assessed the investments in the Artex project as promising. We have always been aware that the investment in Springs would take a long time to mature, but we can certainly say now that this period is passing faster than we initially expected. Perhaps the greatest lesson was: never doubt that what is already difficult could get even worse... We cannot rebuild our portfolio for the past years but when we look at Springs today we have a much more promising combination – of: (a) actions taken that are capable of substantially improving the results; (b) improvement of governance, to a high level of quality; and (c) greater proximity of Leblon to the company and its managers. We would risk saying that the future of this investment now seems to us much more attractive. In a scenario that we see as realistic, our position in Springs would be capable of generating a nominal internal rate of return of 12%, based on the initial date of the investment in 2008 and the target price for 2014. The optimistic alternative shows an IRR of 20%. The challenge that presents itself now is to make the strategy of vertical integration in retailing work – this is not at all something simple, but it has great potential.

*'We can be very patient. No matter how great the talent or effort, some things just take time:
You can't produce a baby in one month by getting nine women pregnant'* **Warren Buffet**

Lojas Renner and Valid: Selling too early. Mistake or Discipline?

In 2009 we were priding ourselves on having bought Lojas Renner below R\$ 10 per share, as soon as our funds were launched. It was perhaps our trader's first buy order. Even better: We sold nine or 10 months later, with a gain of 100%, in 2009. However, even better would have been to stay invested for another nine, 10, 12, 15 months... near the end of 2010, Renner was trading for R\$ 63 a share, and is now at R\$ 72, having traded below R\$ 40 in this interval. It is a very well-managed company, that we have known for a long time, in a business with enormous medium-term growth potential (both organically, and in terms of growth by acquisitions). Retail is not an easy business; so if we see a very good operation, the tendency is to invest. Some lessons: avoid paying an exorbitant price for the share; have some flexibility to manage the position as and when there are significant oscillations in price, and distances from fair value; never cease to monitor and follow the business; and make a critical evaluation as to whether there is any structural rupture ahead. But to stay invested is generally a good decision. For other companies in the portfolio, this same strategy has had very significant results: examples are Mills, Brasil Foods and Aliance. After our little "slip" in timing with Renner, we invested in it again in the first quarter of 2011.

*'Retailing is a tough business... In part, this is because a retailer must stay smart, day after day.
Your competitor is always copying and then topping whatever you do. Shoppers are meanwhile beckoned
in every conceivable way to try stream of new merchants. In retailing, to coast is to fail.'* **Warren Buffet**

*"In allocating capital, activity does not correlate with achievement.
Indeed, in the fields of investments and acquisitions, frenetic behavior is often counterproductive."* **Warren Buffet**

We made our first investment in Valid in the first quarter of 2009 when it was still known by its “non-Brazilian” name, Abnote (American Banknote). We had known it since its IPO. It is relatively unique, in that it operates in a range of businesses as different as producing credit cards, SIM cards for mobile phones and identity cards. For quite some time after its IPO, most analysts found it hard to “pigeonhole” as part of an identifiable sector, and probably partly for this reason it was rarely on most of the market’s radar screens. That was not entirely fair, in our opinion, since it had some very interesting aspects, which included the capacity to adapt to constant changes in the demand from its principal clients, and a solid relationship with them. It was a small company, but important in its market, managed by competent people, with a track record of profit and good returns on invested capital. A company that had earned money from the business of printing checkbooks, and migrated to the business of cards, accompanying all the technological changes, has its merits.

When we invested, we judged that its fair value, in reasonable scenarios, was between R\$ 20 and R\$ 25 per share, and this was reflected in the history of the investment for Leblon Ações fund— we sold the last part of our position just above R\$ 20. When we invested, it was trading at R\$ 10–11: its value incorporated practically no growth, and assumed low operational margins for the long term which we saw to some extent as pricing the risk that one of its products might disappear. In the fourth quarter of 2009 we perceived the surprise over the abrupt fall in sales of public phone cards as a warning light, but we stayed in. Over 2011 we gradually reduced the investment; and we did not capture the brilliant performance of 2012. Today the company is worth just over R\$ 2.0 billion, compared to approximately R\$ 500 million at the beginning of 2009, and R\$ 1.2 billion when we got out of our last position. In this particular case, we are inclined to say that this decision is better classified as discipline than error

Leblon Equities Team

Pedro Chermont – pedro.chermont@leblonequities.com.br
Marcelo Mesquita – marcelo.mesquita@leblonequities.com.br
Pedro Rudge – pedro.rudge@leblonequities.com.br
Bruno Pereira – bruno.pereira@leblonequities.com.br
Felipe Claudino – felipe.claudino@leblonequities.com.br
Eduardo Castro – eduardo.castro@leblonequities.com.br
Laura Tostes – laura.tostes@leblonequities.com.br
Victor Uébe – victor.uebe@leblonequities.com.br
George Earp – george.earp@leblonequities.com.br

Fernanda Pacini – fernanda.pacini@leblonequities.com.br
Rafael Streva – rafael.streva@leblonequities.com.br
Miguel Galvão – miguel.galvao@leblonequities.com.br
Pedro Gonzaga – pedro.gonzaga@leblonequities.com.br
Leonardo Vazquez – leonardo.vazquez@leblonequities.com.br
Paola Padula – paola.padula@leblonequities.com.br
Diana Ventura Rabello – diana.ventura@leblonequities.com.br
Luiz Senos – luiz.senos@leblonequities.com.br
Jayme Azevedo – jayme.azevedo@leblonequities.com.br

Leblon Equities Gestão de Recursos Ltda. (“Leblon”) does not sell nor distribute shares of investment funds or any other security. The content of this document has been prepared solely for informational and transparency purposes to the management carried out by Leblon and is neither intended, nor should be considered, as an offer to sell, or as a solicitation to acquire shares in any investment fund or any other security. The content of this document is solely for the use of the recipient and shall not be reproduced, distributed, published, copied or disseminated to others, except with prior and express written permission. Past performance does not guarantee future results. Investments in the Funds are not guaranteed by Leblon or any other service providers to the Funds, any insurance mechanisms or the Credit Guarantee Fund of Brazil (FGC). Leblon takes no responsibility for investment decisions taken based on this material. Access to this document or use of the services or information provided herein is prohibited by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law, rule or regulation..
