Leblon Letter 19

2nd Quarter 2014

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It is our pleasure to share our nineteenth 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

The table below shows Leblon Equities Funds' performance in 2Q2014, during the year and since inception (November 28, 2008):

	2Q2014	2014	ITD
Leblon Equities Offshore Funds			
Leblon Equities Partners Fund	6.4%	0.6%	158.6%
Leblon Value Hedge Fund	0.2%	-10.5%	38.1%
Benchmarks			
Libor	0.4%	0.8%	3.8%
MSCI	5.7%	7.8%	47.1%
Ibovespa in US$	8.4%	9.8%	53.9%

Second Quarter 2014

Both of Leblon Equities' funds had a positive performance for this year's second quarter.

After being the great factor responsible for our negative performance in the previous quarter, Saraiva (SLED4) – our largest position in the fund – was the top contributor for the funds' positive performance in this quarter. SLED4, which is currently 17% of our portfolio, rose 21% in the quarter, contributing to an overall gain of approximately 3 percentage points. At the opposite end of the performance scale, Springs, which had a drawdown of 38% in the quarter, contributed negatively with 2.6 percentage points.

Elections

For us at Leblon Equities, as fundamentalist long-term investors seeking opportunities where a company's management has a major protagonist role in the creation of value, moments like the present one, in which the macroeconomic environment dominates the market's imagination due to the approaching Presidential elections, are a challenge. They are challenging because macroeconomic aspects dominates the debate and our clients and the market in general seem to forget that, like people, each company has its own particular (if not unique) characteristics, and each one's manner of interaction with its 'environment' is not uniform. The debate assumes a black-or-white aspect, and over the short-term stock prices can vary (some more and some less, it is true) reacting basically to opinion polls on the election. At these moments, talking about companies almost seems to be irrelevant – but in our opinion and investment philosophy, it is not. If one wins, it is better to stay out of Brazilian equity; if the other wins, then it is better to be in. One or zero. Black or white. In the short-term this may even have some truth in it, but in the long term, this is not our belief.

We have no doubt that people are as important as, or more important than, institutions or processes – both at the micro and macro level. We are not arguing over the idea that for companies it makes no difference who wins elections. Since our focus is on the human individual – as the protagonist of change and transformation – it would be incoherent from us if we did say so. However, what intrigues us – and this is something that also creates good investment opportunities – is the fact that many people, especially at these times, pull back from the micro questions, as if they had suddenly become irrelevant, and focus only on the macro.

The macro view does of course have its value, and its influence on price. Brazil risk, for example, affects all businesses by increasing or reducing the cost of capital of projects, somewhat as rain on the track slows down Formula 1 racing drivers. However, what many seem to forget is that in these moments of rain on the racing track, the gap between the great and the regular drivers, in terms of their abilities and capacity to perform, is highlighted. When there is a macro hurricane (or storm), the vulnerable is weakened, and the opportunities for consolidation increase.

In the long term, it is in these moments of crisis, or of difficult short-term predictability, that the good companies take the opportunity to make major strategic moves. And it is because we believe firmly in this thesis that we can knowingly shift our concentration from the presidential election and focus our energy on our continuous quest, which at this time is for well-priced shares that may emerge as more interesting after the outcome of this event, which, although it is important, we cannot control or predict.

Most of us know or remember that the 1980s and 1990s were extremely challenging from the macro point of view in Brazil, but it was in that period that the strength of the major champions of today was being forged, as they prepared themselves to be able to make significant moves in the times of plenty that followed. Those who took a position on Ambev, Itaú, Bradesco, Gerdau, Ultra and Natura, to name only a few high-profile and well-known cases, did not regret it.

It would be good, of course, if it was possible to buy or sell assets while having certainty about the result of the elections, but this, of course, is not in the realm of the possible. What is possible is to be invested in companies that are capable of continuing to grow and increase their profitability independently of who happens to be doing the job of President of Brazil at the time. It is difficult, but it is possible. When we are invested in these companies, we may be close to short-term turbulence, but those who seek significant long-term returns need only to fasten their seat belts and wait for the storm to pass.

Market risk and cycles

This month we have had the privilege of reading 'Letter No. 21' by Turim, a well-known wealth manager based in Rio de Janeiro. This letter made some well-structured remarks on the theme of "market risk, and cycles" in its analysis. We would like here to plagiarize (as a form of compliment) a little of what was said in that letter, summarizing some thoughts of the great American manager Howard Marks (Oaktree Capital). We share a lot of his vision:

"What is risk? The academic discipline of finance traditionally teaches that risk is equivalent to volatility – that is to say, standard deviation of returns. But risk in reality is a much more complex subject, and extremely difficult to quantify in any single metric. Marks believes that what investors are really concerned about is loss of principal, so he adopts the view that the best way to think of risk is as the possibility of permanent loss of capital. In this, he aligns closely with the school of "Value Investing", focus on the difference between price and value, and rejection of volatility as a measure of risk – and thus does not distinguish risk and return as completely dissociated concepts.

In his book, Marks quotes a phrase of Elroy Dimson: "Risk means that more things may happen than in fact will happen." This phrase greatly illustrates a key concept: probability is different from outcome (that is to say, in probability theory jargon, from the event).

The fact of risk meaning that there are alternative scenarios that may occur, but that only one of them will in fact materialize, results in an important corollary that passes unnoticed by the majority of people: **One cannot judge the quality of a decision by its outcome alone. On its own, the return – and especially the return over short periods of time – tells us very little about the quality of an investment decision".**

Marks is skeptical when one is talking about forecasts. From his point of view what is important is to understand the present – taking the pulse of the markets and acting in accordance with that. The majority of people makes efforts to adjust their portfolios based on what they think is ahead, in the future. At the same time, however, most people would admit that the visibility of the future is not very good. And for this reason, Marks suggests responding to the present reality, and its implications, rather than expecting the future to clarify itself.

We can never know where we are going, but **it is good for us to have an idea of where we are.** That is, if we cannot see the beginning, duration and end of cycles, it is essential that we should **make an effort to understand where we are in the cycle**, and to act accordingly. To understand the investment mood is fundamental, the function of **making inferences about the 'psyche' of the participants in the market.** Marks tries to classify this 'psyche of the markets' in a practical way, suggesting three stages of optimistic (bull) markets, and three stages of pessimistic (bear) markets. Here are his three stages of bull markets: (1) when few people believe that things will get better; (2) when the majority believe that improvements are in progress; and (3) when everyone is certain that everything will always get better. His three stages of a bear market: (1) when some people believe that the situation will never be so good; (2) when the majority recognize that things are getting worse; and (3) when everyone is convinced that things can only get worse."

Within this model, we at Leblon Equities today have no doubt that we are in a "pessimistic" market, between level 2 and 3. When we talk to investors, the perception of most of them is that things are getting worse, or can only get worse. Thus, in Marks' concept, we are very close to a good moment to buy risk assets in Brazil.

Results in 2Q14
(for the five largest positions in our funds)

The performance of the companies that belong to our portfolio in the second quarter of 2014 was very goodand, in general, higher than market expectations. In spite of the perceptible slowdown in economic activity in the quarter, our investments in retail companies, or those exposed to the sector such as **Aliansce Shopping Centers**, saw their sales grow by significantly more than the average growth rates of their competition. Same-store sales of the **Pão de Açúcar Group** were up 9.5%, same store sales for **Saraiva** were up 12%, and the consolidated growth of SSS in the shopping malls of Aliansce was 9%.

Itaúsa, the parent holding company of **Banco Itaú,** published a result higher than market expectation, with ROE of 20%; **Cetip,** in spite of a declining rate of revenue growth, maintained a solid performance and its fourth quarter profit was up 9% year-on-year (YoY). In our view the second quarter of 2014 strengthened and supported the thesis that it is in the more difficult moments that the good operators stand out, and widen the gap that separates them from the mediocre. As Warren Buffet's once said, "you only find out who is swimming naked when the tide goes out".

Saraiva

17% of our funds' NAV, with a market cap of R$ 500mn (@ R$19 / share)

Saraiva's consolidated net revenue in the first half of 2014 was R$ 1.1 billion, up 10% from the first half of 2013. Consolidated adjusted Ebitda in the first half was R$ 87mn, 14% higher than in first half 2013. Adjusted net profit in the half-year, at R$ 34mn, was 34% higher than in first half 2013. In its retail sector, the physical store chain returned sales 17% up year-on-year (YoY) in the six months, with 12.2% YoY growth in same-store sales (SSS). A highlight for the publishing company was Ebitda 57% higher, at R$ 29mn, in the half year. On February 13, 2014, Saraiva announced a share buyback program, and by June 30 had purchased 1,081,300 preferred shares (SLED4) and 400 common shares (SLED3) representing an aggregate 3.8% of their total capital. Saraiva successively concluded a plan for contracting of a new financing line with the BNDES to raise R$ 629mn in loans to finance the company's investment program up to 2016, and in the process lengthened its debt profile and replaced more expensive debt.

Itaúsa

10% of our funds' NAV, with a market cap of R$ 53bn (@ R$ 8,69 / share)

Recurring net revenue in the second quarter (2Q14) was R$ 1.78bn, 30% up from 1Q13. In the half-year, profit was 24% up from 1H13. This was primarily due to the growth in profits of Itaú Unibanco. ROE of the holding company in 2Q14 was 20%, the same level as in the first quarter of the year. In the first six months, Itaúsa's ROE was 4.4 percentage points higher than in first half 2013. The stock is trading at 1.6 times book value and 8 times expected 2014 earnings, and in our calculation the stock's upside is around 24%.

Aliansce

7% of our funds' NAV, with a market cap of R$ 2.9bn (@ R$ 17,96 / share)

Sales in Aliansce's malls in 2Q14 were up 22.4%, YoY, and up 21.7% in 1H14. Same-store sales were up 9.0% in the second quarter. This was the sixteenth consecutive quarter in which same-area sales (SAS) grew by more than same-store sales. The successful changes of stores and the improvement of mix resulted in same-area sales growth of 9.7%, YoY, in the quarter. Same-store rentals (SSR) and same-area rentals (SAR) were both up 8.6% (YoY, in the quarter). Total occupancy rate at the end of 2Q14 was 97.1%. Aliansce's net revenue in 2Q14 was R$ 123.2mn, or 14.1% more than in 2Q13, and its net revenue in the first half was R$ 240.4mn – or 13.7% higher than in 1H13. Adjusted Ebitda was R$ 91.1mn in the quarter, and R$ 170.7mn in the first half – these two figures being respectively up 15.1% and up 14.7% YoY. Adjusted Ebitda margin in the second quarter was 73.9% – or 0.6 p.p. above that of 2Q13.

On June 14 of this year Aliansce signed an agreement to sell an indirect stake of 16.66% in the Santana Parque Shopping mall to CPPIB and GIC, for R$ 48.3mn, cash. This sale price could increase to R$ 53.3mn depending on the mall's performance in the 12 months following completion of the transaction. Based on the mall's expected 2014 NOI, the sale value results in a cap rate of 9.1%, or 8.3%, price-adjusted. If we value the total portfolio of Aliansce using the same cap rate of 8.3%, the fair value of the stock today would be R$ 24.30 per share, indicating 34% upside in relation to the closing price at June 30, 2014.

Pão de Açucar

7% of our funds' NAV, with a market cap of R$ 27bn (@ R$ 102.99/ share)

Total net revenue was up 13.4%, in the quarter, and SSS was up 9.5% YoY. Adjusted net profit was up 26.3%, and net margin was improved by 0.3 p.p. – also all YoY.
The growth in revenue got its boost from the performance of food retailing (Pao de Açúcar, Extra and Assai), and Nova Pontocom. The organization opened 116 stores in the last 12 months. Adjusted Ebitda was up 21.1% YoY, at R$ 1.155 billion. Adjusted Ebitda margin was 7.6%, or 0.5 p.p. higher than in 2Q13 – reflecting gain in margin at Via Varejo (Casas Bahia and Ponto Frio), and also in Multivarejo.
Our discounted cash flow forecast for Pão de Açúcar gives a fair value of R$ 131 – which would indicate potential upside of 27% from the closing price on June 30, 2014.

Cetip

6% of our funds' NAV, with a market cap of R$ 8.2bn (@ R$ 31.45 / share)

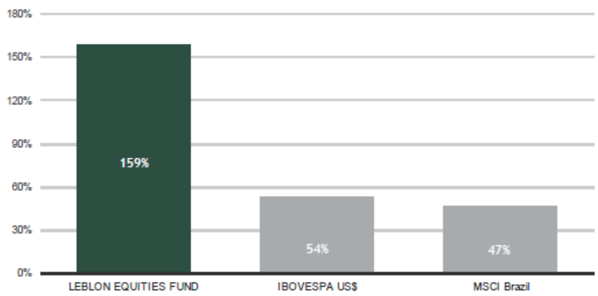
Total gross revenue in 2Q14 was R$ 292.3mn, or 8.0% more than in 2Q13 – and 1.7% more than in 1Q14.Gross revenue of the Securities Unit was R$ 190.3mn in the second quarter, up 8.5% from 2Q13, and 2.4% more than in 1Q14. Gross revenue of the Finance Unit, at R$ 102.1mn in 2Q14, was 7.2% higher than in 2Q13, and up 0.3% from 1Q14 – in spite of the retraction of 1.0% in the number of vehicles financed.
Net revenue, at R$ 243.5mn in 2Q14, was up 6.4% from 2Q13, and 1.8% higher than in 1Q14. Adjusted Ebitda in the second quarter was R$ 172.1mn, up 2.9% in comparison to 2Q13, and up 2.1% from 1Q14. Adjusted net profit, at R$ 134.8mn in the second quarter, was 5.4% up from 2Q13, and 1.1% higher than in 1Q14.
Our DCF forecasts give a fair valuation for a share of R$ 36 – this represents potential appreciation of 14% from the closing price of June 30, 2014.

Leblon Equities Fund

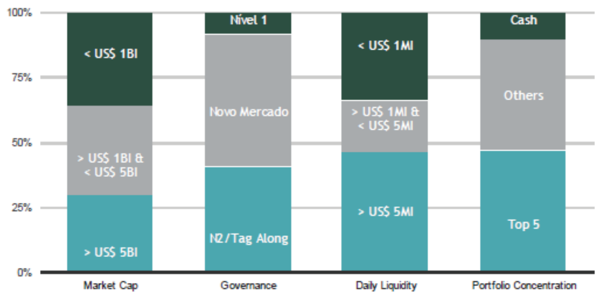
In the second quarter of 2014, Leblon Equities Fund posted a positive return of 6.4%, net of all fees, which compares to a gain of 8.4% in the Ibovespa index measured in US dollars. Year to date, the fund is up 0.6% and the Ibovespa USD is yielding 9.8%. Since inception, the fund has returned a gain of 158.6%, while in this same period the Ibovespa USD is up 53.9% The fund's annualized return since inception is 18.8%.

In this quarter, the Fund's largest gains came from positions in Saraiva, Wilson Sons, Cetip and Itaúsa. Losses came from positions in Springs, BHG, Oi, Aliansce and Duratex. Changes in the quarter include: new positions in Anima, Petrobras call options and Duratex. We have divested of IdeiasNET, increased the positions in Pão de Açúcar and Natura and we have also decreased the positions in Wilson Sons, Cetip, Itaúsa and Lojas Renner.

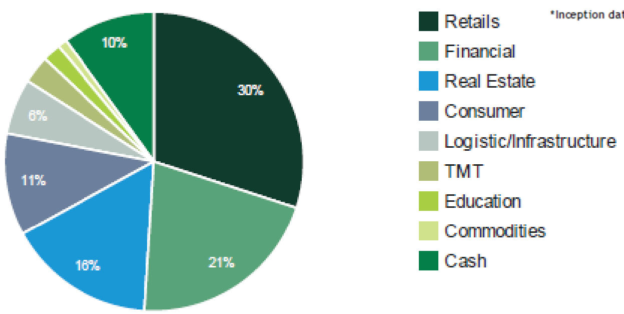
PERFORMANCE US$ (SINCE NOVEMBER 28TH, 2008)



RELEVANT INFO - EQUITY PORTFOLIO (JUNE 30TH)



SECTOR BREAKDOWN (JUNE 30TH)



RETURNS

Last 12 months returns (US$)			
Period	Leblon Equities Fund	Ibovespa US$	MSCI Brazil
June 14	3,81%	5,48%	5,09%
May 14	1,17%	-0,88%	-2,04%
April 14	1,31%	3,64%	2,66%
March 14	3,02%	10,38%	10,73%
February 14	5,15%	2,79%	3,21%
January 14	-12,76%	-10,70%	-10,77%
December 13	-1,48%	-2,60%	-4,84%
November 13	-7,88%	-8,36%	-6,82%
October 13	2,49%	4,95%	5,73%
September 13	10,45%	11,35%	12,14%
August 13	-7,47%	0,09%	-2,43%
July 13	-4,05%	-1,68%	-1,57%
12 Months	-8,29%	12,70%	8,82%
ITD (Until 06/30/2014)	158,64%	53,90%	47,06%

Annual returns (US$)			
Period	Leblon Equities Fund	Ibovespa US$	MSCI Brazil
2014 (until 06/30/2014)	0,56%	9,79%	7,76%
2013	-18,24%	-26,29%	-18,68%
2012	18,85%	-1,42%	-3,50%
2011	-21,55%	-27,26%	-24,85%
2010	21,17%	5,59%	3,78%
2009	144,67%	145,16%	121,25%
2008*	13,81%	2,44%	0,79%

Annualized returns			
Period	Leblon Equities Fund	Ibovespa US$	MSCI Brazil
1 year	-8,29%	12,70%	8,82%
2 years	-0,82%	-5,26%	-3,33%
3 years	-9,21%	-15,49%	-13,04%
4 years	-0,43%	-8,09%	-5,75%
5 years	6,80%	-1,76%	-1,31%
Since Inception*	18,76%	8,11%	7,23%
Volatility since inception*	21,83%	30,97%	30,46%

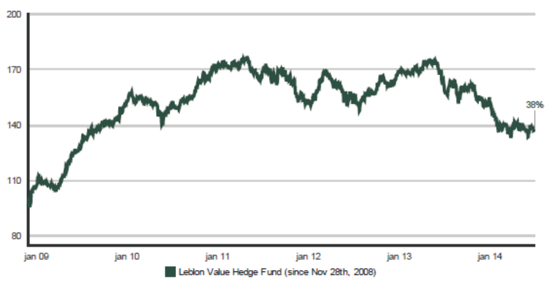
*Inception date of the fund 11/28/2008

Leblon Value Hedge Fund

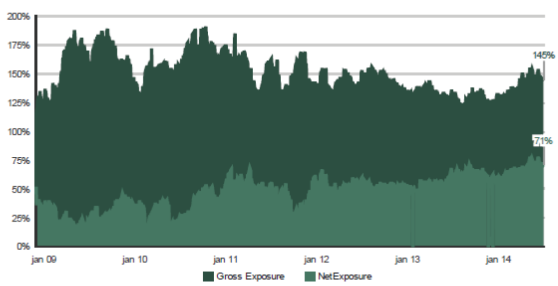
In 2Q2014, Leblon Value Hedge Fund had a return of 0.2% net of all fees, compared to a gain of 8.4% on the Ibovespa index measured in USD and +5.7% of the MSCI Brazil index. Year to date, the fund is down 0.6% compared to a gain in the Ibovespa in USD of 9.8% and +7.8% in the MSCI Brazil. Since inception, the fund is up 38.1%, compared to +53.9% of the Ibovespa index in USD and +47.1% of the MSCI Brazil index. The annualized return since inception of the fund is 6.0%. Average gross exposure in the quarter was 147%, and average net exposure approximately 71%

In this quarter, the funds' gains were in the look bong, which mirrors Leblon Equities Fund's portfolio. The losses came from Springs and other short positions. Gross exposure of the fund in the quarter increased from 143% to 145%, and net exposure also increased, from 66% to 71%. In the Leblon Value Hedge Fund, changes in the long book during this quarter were the same as the ones made on LEF's portfolio. Additionally, we have opened two new short positions and zeroed the short in Ioschpe Maxion, Brasil Pharma and the pair trade Direcional x MRV.

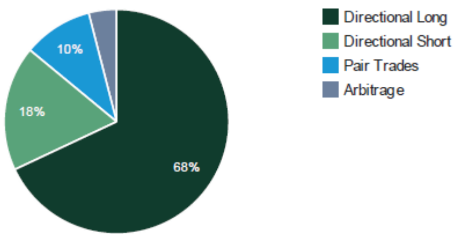
PERFORMANCE US$ (SINCE NOVEMBER 28TH, 2008)



GROSS AND NET EXPOSURE



STRATEGY BREAKDOWN (JUNE 30TH)



RETURNS

Last 12 months returns (US$)			
Period	Leblon Value Hedge	Ibovespa US$	MSCI Brazil
June 14	0,91%	5,48%	5,09%
May 14	0,03%	-0,88%	-2,04%
April 14	-0,72%	3,64%	2,66%
March 14	-2,40%	10,38%	10,73%
February 14	0,99%	2,79%	3,21%
January 14	-9,35%	-10,70%	-10,77%
December 13	-0,61%	-2,60%	-4,84%
November 13	-4,10%	-8,36%	-6,82%
October 13	1,80%	4,95%	5,73%
September 13	2,37%	11,35%	12,14%
August 13	-3,79%	0,09%	-2,43%
July 13	-1,85%	-1,68%	-1,57%
12 months	-16,0%	12,70%	8,82%
ITD (until 06/30/2014)	38,14%	53,90%	47,06%
Annual returns (US$)			
Period	Leblon Value Hedge	Ibovespa US$	MSCI Brazil
2014 (until 06/30/2014)	-10,45%	9,79%	7,76%
2013	-8,65%	-26,29%	-18,68%
2012	10,30%	-1,42%	-3,50%
2011	-10,53%	-27,26%	-24,85%
2010	11,98%	5,59%	3,78%
2009	43,35%	145,16%	121,25%
2008	6,61%	2,44%	0,79%

Annualized returns			
Period	Leblon Value Hedge	Ibovespa US$	MSCI Brazil
1 year	-16,00%	12,70%	8,82%
2 years	-5,01%	-5,26%	-3,33%
3 years	-6,48%	-15,49%	-13,04%
4 years	-2,17%	-8,09%	-5,75%
5 years	1,45%	-1,76%	-1,31%
Since Inception*	6,02%	8,11%	7,23%
Volatility since inception*	11,91%	30,97%	30,46%

*Inception date of the fund 11/28/2008

PERFORMANCE ATTRIBUTION (JUNE 30TH)

Directional Long	3,72%
Pair Trade	0,22%
Non-Equity Hedges	-
Arbitrage	-0,52%
Directional Short	-1,03%
Cash + FX Hedge	-1,17%
Expenses	-0,31%
Total	0,91%

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