LEBLON
EQUITIES

Leblon Letter 6

February 2011

www.leblonequities.com.br

Here, with satisfaction, is our sixth Leblon Letter. Once again we hope this channel of communication will be of interest, and succeed in succinctly giving you our forward view of the themes affecting our investment decisions. For our success, your participation – with criticisms, suggestions, and even words of encouragement – is vital.

Thank you and regards,

Leblon Equities

“*Investment is an act of arrogance.*” – Seth Klarman*

The phrase above is inspired by the notion that buying or selling a share or a company carries with it an intrinsic implication that the counterparty is incapable of knowing, understanding or judging the information that is out there in the market place.

(If I am buying – then it’s because I think it’s good…)

(But then if it’s good –why is the other party selling?)

Klarman has another interesting phrase:

“ *…the bad news about value investing: value investing itself has never been more popular. Fans of Warren Buffett fill a sports stadium when they flock to Omaha in May for the Berkshire Hathaway annual meeting.* “

In a world, and a country, that is increasingly overcrowded with value investors, how – on earth – can one hope to differentiate?

In defining our own strategy, we start with two basic principles,:

1. **Knowledge, understanding** and **judgment** precede the investment decisions of value investors: The greater one’s capacity to know, understand and judge, the better will be one’s performance in the long term.
2. The overpopulation of investors is not uniform in all the niches of the market. It’s easier to stand out in less populated niches than on overcrowded beaches.

Our strategy is to maximize *knowledge* and *capacity to understand*, and, also: to look more closely. When possible, from inside. As owner, member of the board of directors, executive, or simply as a collaborative investor.

Our strategy for maximizing capacity for *judgment* is to look at “everything”. Listed companies, unlisted companies, liquid, illiquid. Large caps. Small caps. Government owned companies. Private companies. Everything that’s possible in Brazil, and, indeed, anything that might serve as an example for some other situation elsewhere in the world.

Our strategy for avoiding investor overcrowding – which reduces opportunities – is to frequent more deserted beaches. To look at what no one looks at. To buy what no one wants.

The pillars on which we aim to build our performance in the long term are: i) the strategy of looking, simultaneously, at public and private companies with an active, and collaborative attitude; also being on the board of some companies; ii) the diversity of our team, with their widely differing and complementary experience; and iii) to look in “places that are different”.

We have been sitting on the boards of both listed and unlisted Brazilian companies for more than ten years now. To sit down beside the various controlling stockholders and members of the board of directors of companies has been a unique learning experience. Discussing, criticizing and collaborating, from the position of partners and directors, in

*Source : Original Sentence “*We regard investing as an arrogant act; an investor who buys is effectively saying that he or she knows more than the seller and the same or more than other prospective buyers.*” Autor Seth Klarman – Portfolio Manager of The Baupost Group, Inc the defining of long-term strategies, origination and allocation of funding, management compensation, communication with the market, etc., makes us more able, every day, to analyze the strategies and decisions of other companies.

To have had experience as executives of companies facilitates the capacity to know, understand and judge the executives of the companies in which we invest. Having experience in structured transactions and IPOs – and having taken part in a significant proportion of the IPOs that have taken place in the last eight years in Brazil – gives one an agility to understand and judge the capacity of the new companies that are coming to the fore every day.

There is no optimal allocation of time between public or private companies. When we visit a non listed retailer, with a view to acquiring a stake, we are at the same time increasing our knowledge about CBD, the listed company that is Latin America's largest retailer. When we take part in a meeting of the board of CBD, we increase our understanding of the sector and we expose ourselves to a rich mosaic of knowledge and competencies, which will be vital to us in other private equity investments. For Leblon's research and management team, there is no one time dedicated to private equity and another time devoted to "public equity". It is all part of time dedicated to our business, which is: analysis of companies and management of investments.

To have a team looking at both public and private companies is a powerful tool, one that is little used by most managers. In a country such as Brazil, where a significant part of the economy is still outside the stock exchanges, it is a crucial skill and allocation of time to accompany and analyze what is happening in the universe of private companies – and especially important and successful to do so in the role of a *potential investor*.

To interact only with public companies, with access to information that has already been "digested" by the market, circumscribed the capacity to make the most appropriate analyses of companies' strategies and results. Clearly, private companies are available for anyone who wants to talk to them, but if one positions oneself as a possible partner, investing and taking a seat on the board, whether of a public or a private company, this allows one to achieve a level of understanding, knowledge, and judgment that in our conception is incomparable. Knowledge, understanding and judgment – these are the things that in the long term will help construct the mental mosaics used in evaluation of investments by the whole team.

We bring together various experiences in our team, which is made up of a rich mixture (skills in management, research, analysis, governance, representation on boards of directors, capital markets, M&A, legislation and trading). This diversity forms an amalgam that has the capability to know, understand and judge in a way that is differentiated, and "outside the box", in a significant number of investment cases.

The basic raw material of the fund management business is: information. Information generates knowledge – and develops understanding; and makes possible the judgment that will lead to the final product: investment decisions. We believe that the wealth and relevance of a team's proprietary information substantially improves if the group of analysts dedicates itself to researching both the universe of public (listed) shares, and also unlisted – private equity – shares.

In our opinion, the cost (in the short term) of a larger coverage universe is in reality the source of a major long-term benefit in terms of the quality of what it does for the thinking, comparisons, intuition, deduction and analysis that goes in the minds of our team.

Investment Cases

MILLS

Mills is one of Brazil's largest providers of specialized engineering services, and the leader in supply of formwork for concrete, and tubular scaffolding. It also operates in industrial services (access equipment, industrial painting, thermal isolation), and equipment rental. It is present in the major projects – in infrastructure, residential and commercial construction, and industrial maintenance and assembly. Its services include planning, design and implementation of temporary structures for building construction (including formwork and shoring for concrete work, and scaffolding), industrial services (access, painting and isolation for construction and maintenance of industrial plant), motorized access equipment (aerial work platforms, telescopic handlers), and specialized technical assistance and labor.

In its 58 years of history, Mills has developed a relationship with most of Brazil's biggest and most active companies in heavy construction, residential and commercial building, and the industrial sector. By providing services in a consistent, punctual and reliable manner with quality, obeying rigorous safety rules, it has won a strong reputation.

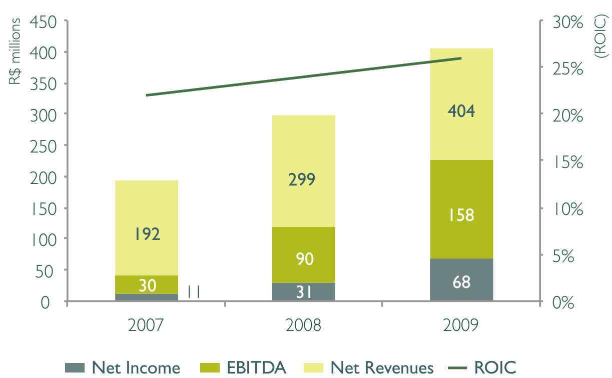
We believe the sectors where Mills operates will grow strongly in the coming years, due to a number of factors: (i) macroeconomic fundamentals that favor more availability of credit in Brazil; (ii) significant investments in infrastructure projects, financed with funding from the federal government's Accelerated Growth Program (PAC), estimated at R$ 504 billion; (iii) the federal government's *My house, my life* construction program for low-income family homes – creating investments of R$ 34 billion; (iv) the voluminous investment necessary for the 2014 soccer World Cup and the 2016 Olympic Games – currently estimated at R$ 110 billion; and (v) the need for significant investment in various sectors of Brazilian industry, including oil and gas, and petrochemicals.

Some of Mills' competitive advantages: i) Leadership in a market with nationwide scope and significant scale; ii) the capacity to offer innovative, quality engineering solutions and equipment, rapidly; iii) credibility and long-term relationships with clients; iv) proven capacity to allocate capital, achieve synergies with acquired companies, and grow profitably; and v) a unique culture reinforced by an experienced management team, and by the commitment to best corporate governance practices.

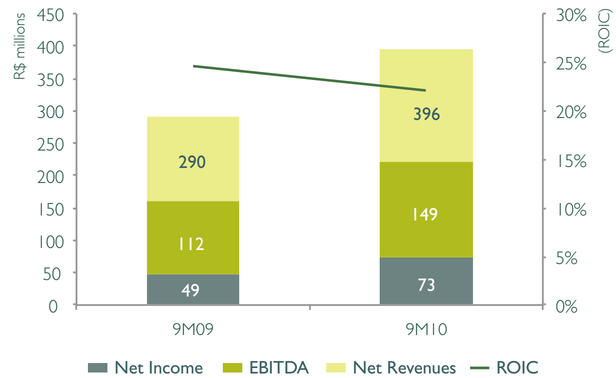
The focus on provision of services of quality and innovative solutions, allied to its competitive advantages, have enabled Mills, in recent years, to achieve high rates of growth with growing margins and high return on capital invested.

(*) Source: Company Prospectus

Chart 1: Revenues, Ebitda and Net earnings – Growth & ROIC, 2007–2010.



Source: Company Prospectus



Source: Company Presentation (3T10)

In 2009, a private equity fund managed by Leblon Equities acquired approximately 2% of the total capital of Mills, in a private transaction with the company's controlling stockholders. After the transaction, one of the partners of Leblon Equities took a seat on the company's board.

The negotiation with the controlling stockholders of Mills was oriented by the mutual desire to be partners. The negotiation on the entry price became a matter of secondary importance, due to the small percentage of the company that we were acquiring, and the perception that the union of the expertise of collaborative investors with the corporate expertise of Mills' entrepreneurs would be a combination that would benefit the process of generation of value for the company. The company was planning to make its IPO in 2010 and saw, in Leblon Equities, a partner capable of contributing both to the IPO process and also to its new phase as a listed entity.

The IPO took place in April 2010, priced at R$ 11.50/share, approximately 45% higher than the entry price of the Leblon private equity funds. In spite of the strong appreciation in the short period of time, we believed the IPO valuation was significantly below the company's fair value. At R$ 11.50/share it was being valued at EV/2010e Ebitda of approximately 6x. This multiple was significantly low for a company that had grown its Ebitda at a rate of 130% per year over the period 2007–2009, with average return on invested capital (ROIC) of 24% in the period.

This perception led us to double our investment in the company. Mills became the principal position of our public equities funds (Leblon Equities Fund and Leblon Value Hedge Fund), representing just over 10% of the funds' portfolio.

At the time of the IPO we already knew the company very well, we had full trust in the controlling stockholders, and strong confidence in the capacity of the executives. There was clearly an asymmetry of knowledge and understanding between Leblon and the other investors in the market. This asymmetry gave us enough conviction to become one of the biggest buyers of stock at the company's IPO, and the fund that bought the largest stake at the IPO as a proportion of its own assets under management.

The case of Mills is a classic example of the synergy between private equity and public equity. As a result of having known this asset for longer, we were able to take a decision to increase the investment significantly at the moment of the IPO, in a way that was rapid and secure.

Mills was the principal positive contributor to the performance of the funds of Leblon in 2010.

Cetip

We looked at **Cetip** for a possible investment before it went public, and we saw a major potential for appreciation. Cetip is a direct beneficiary of the reducing trend in Brazilian interest rates over the long term, and the growing sophistication of the local fixed income and derivatives markets, with the introduction of new instruments. The potential of the secondary market for fixed income securities, which is incipient in Brazil, is enormous. And while the annual turnover of the Bovespa (volume traded/assets in custody) was 69% in 2009, Cetip's was almost insignificant, at less than 1% (**).

At that initial time we were unable to invest resources of our private equity funds due to lack of funding, but we had done the diligence. Cetip's IPO took place just over six months after we had completed that diligence and decided not to go ahead with the private transaction. The IPO took place at a price higher than we considered reasonable for building a position in our public equities funds, but the performance of the shares in the following weeks provided a good entry opportunity. We invested approximately 5% of the fund in November 2009; by the end of 2010 these shares had appreciated by 65%. We completed our sale of the position in October.

Cetip is one of the ten positions that most contributed to the performance of the funds in 2010 (***).

Our Short on Redecard and Cielo

The fact that we have products with the three strategies – long only, equity hedge and private equity – has resulted in our having more opportunities to extract value from the knowledge generated (both in long and short positions).

In Leblon Value Hedge Fund, one of the highlights of the year was two short positions in which the "private world" had helped us to gain a differentiated assessment, and to make the correct analysis.

One of our investments in private equity is a home improvement retailer, **BR Home Centers**. Our position as investors in the company, initially in **Casa Show**, where we had a controlling position, and subsequently as minority shareholders of **BRHC**, after we had negotiated the merger with TendTudo, enabled us to accompany closely, in some cases while seated at the negotiation table, how the market changed rapidly for the credit card acquirer companies **Cielo** and **Redecard.** We were able to have a clear perception of the change in the competitive environment, and how the business transformed completely after the ending of the exclusivity agreements between the credit card brand-name cards and the acquirers. The market's expectations were clearly out of date and did not reflect the new reality.

(**) Source: Bovespa and Cetip

(***) Source: Leblon Equities

Our direct monitoring, as investors of private equity in a company that traded and negotiated with **Cielo** and **Redecard**, of the process of change in the dynamics of the Brazilian acquiring market was a determining factor. This position gave us a clearer perception of the speed and scale of the impact of these changes.

We kept a short position in the two companies as 2010 progressed, and we significantly increased this short position in September 2010.

The Leblon ValueHedge Fund benefited from the 17% fall in Cielo and the 24% fall in Redecard in the period.

Our funds:

	LEBLON EQUITIES FUND	IBOVESPA in USD
Jan-11	-2.2%	-4.35%
2011	-2.2%	-4.4%
2010	21.2%	5.6%
2009	144.7%	145.2%
2008*	13.8%	2.4%
ITD	229.9%	153.6%
Annualized Returns	73.5%	53.7%
ITD Annualized Volatility	22.4%	35.6%
12M Annualized Volatility	18.6%	27.2%

*Inception Nov 30, 2008

	LEBLON VALUE HEDGE FUND
Jan-11	0.56%
2011	0.6%
2010	12.0%
2009	43.4%
2008*	6.6%
ITD	72.1%
Annualized Returns	28.5%
ITD Annualized Volatility	11.0%
12M Annualized Volatility	9.0%

*Inception Nov 30, 2008

For more information about our funds, see attached fact sheets.

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