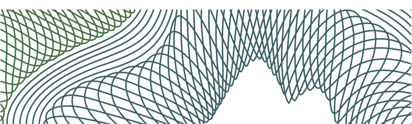

LEBLON
EQUITIES

Leblon Letter 10

1st Quarter 2012

www.leblonequities.com.br

It is our pleasure to share our tenth 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

Along with the firm recovery in Brazilian equities in the first quarter of 2012 – with the Bovespa Index up 14%, the IBX50 up 11%, and the SMLL Small Cap Index up 21% – there were much more significant rises in some of the positions in our portfolio.

The market's weakness in 2011, especially the fall in the second half of the year, had always seemed to us to be exaggerated when compared with the changes in the fundamentals – and we took the opportunity to increase our exposure to some companies. Later, with the gains of this first quarter of 2012, we made some tactical alterations to our portfolio, reducing positions in some companies that we cared for, but which were no longer offering the same level of upside potential. See comments below.

These last 12 months have been a time of significant changes in Brazilian stock prices, apparently reflecting sharp shifts in perception regarding the risk of equity investment. In our view these changes of sentiment had little direct relationship with the reality of the value of companies.

Oscillations in price without justification in the fundamentals, typically indicate an investment opportunity, especially when one is armed with an understanding of the main factors that actually determine a company's value.

It seems to us, that these significant price swings were largely dictated by doubts about medium and long-term growth.

In our view when determining the value of a company, it is harder to have a high level of confidence in choosing a long-term growth rate, or deciding at what point in time to start the perpetuity assumption, than to arrive at an appropriate rate for discounting of cash flows, or even to project certain assumptions for the next two to three years.

During internal discussions about valuation we pay particular attention to the importance of the long-term variable, to understand where we might be wrong, and to get an in-depth view of the sensitivity of a company's value to it, and also for what long-term growth rates are implicit in the present market value. Our general perception from this has been that using the relatively common assumption of a long-term growth rate equal to expected GDP growth can be potentially dangerous in valuing companies, and result in underestimation of the opportunities in some markets.

For example, in our opinion the opportunities in the retail segments which are still far from mature, can provide high growth for a long time, so that P/E multiples that might in other sectors be considered "high", such as 20x or more, become justifiable.

One good example is Lojas Renner.

At the end of 2011 it had 167 Renner stores, plus a pilot Blue Steel pilot store and 30 Camicado stores, recently acquired. In our projections, we assume that in the year 2020 it will have 400 Renner stores (selling area growing at CAGR of 9%, following a CAGR of 12% in the last five years) and 166 Camicado stores (CAGR of sales area 21%, after a CAGR of 9% in the last five years). In this scenario the target price is close to R$ 75/share.

Without losing sight of the safety margin that we demand when we invest, there comes a moment when we ask ourselves a why-not question: why are we not projecting 500 Renner stores and 300 Camicado stores? Renner has, historically, executed its growth strategy well, has a strong balance sheet, and has had attractive levels of return on capital invested. Today there are 432 shopping malls in Brazil, and expectation of another 42 by the end of the year – we envisage this rate of expansion being maintained for several years.

Looking at Camicado, it seems to us to be the more scalable model, by a considerable margin. Also, even with all the differences between the two countries (per capita income, geographical income concentration, infrastructure) it's interesting to note that JC Penney, at its peak, had more than 1,300 stores in the United States. Is there a good reason why we should not consider something a little closer to this number?

Another interesting example is Aliansce, one of the country's leading shopping mall companies.

When it was listed, in 2010, it had a portfolio of 13 operating shopping malls, and two under construction – a modest number compared to the opportunities offered by the sector. Two years later, it has a portfolio of 17 assets in operation, some of them with expansion projects already opened, two more under construction, and increases in its equity interest in some of the assets that it owned at the time of listing. Even after a very successful expansion, with development of new assets, that we see as strategic, we believe it still has strong opportunities for investment ahead.

When discussing long-term scenarios, the most natural trend is to assume a certain speed of development of new assets that is close to that of the recent past – representing the company's proven capacity for execution. On the other hand, a company's recent past may have suffered constraints that may be weaker, or absent, in the future – for example, limited access to capital, or a more modest consumer market.

What is the potential value of the company if its portfolio of assets reaches 100 shopping malls, with proportional growth in GLA and returns on capital similar to those achieved so far? Since the IPO, with the appreciation of almost 100% in the value of the shares of Aliansce, we have looked in depth at our valuation of Aliansce giving more emphasis to this question, and, with increased confidence in the capital allocation decisions made by the company's management, the "option" of reaching a portfolio of 100 good shopping malls becomes, in our view, a feasible and important consideration in valuing the company.

A similar line of thinking can be engaged in for several companies in various sectors, and although we all know that the path to the long term is not always an even one (profits can oscillate significantly, and the stock price even more so), this approach indicates to us that we can remain invested for a longer rather than a shorter time in several of the good companies that we know.

On the following pages we discuss (1) our investment in BHG, and (2) the main changes in the Leblon Equities Partners and Leblon Value Hedge funds' portfolios.

Part I – BHG

We have been invested in BHG since the beginning of 2011, when we participated in an R$ 85 million capital increase by private subscription at R$ 18.5 per share, which enabled us to build a firm position, though minor in terms of our total fund, at a price that we thought attractive, in a stock with extremely low liquidity.

Since that investment, BHG's stock price has grown by approximately 19% (with the Bovespa Index down 1.5% over the same period).

We have accompanied this organization since the beginning of 2009, when the former Invest Tur (which had listed in 2007) absorbed LAHotels S.A. (a company controlled by GP Investimentos), and the BHG that we know today began to be formed. Although we had some strong reservations about Invest Tur's business model and governance, the change in control involved in the absorption, and expectations of a radical review of the company's activity, made us put in some time to gain a better understanding of the scenario.

When the capital increase took place, BHG was at the beginning of a growth process which we believed had the potential to generate a lot of value in the long term, and had begun a period of substantial improvement in its financial results.

At the subscription price, the company was valued at approximately R$ 650 million, close to book value. On the one hand, this book value contained a land bank that had come from Invest Tur, which in our view was not likely to be easy to realize; at the same time it did not reflect the market value of the hotel assets. Taking into account the opportunities that we perceived for growth and improvement of returns, and some considerations about the value of the portfolio of hotels with EV/Ebitda multiples in a certain range, gave us quite strong comfort for investing at that level of valuation.

Today BHG is one of the largest hotel chains in Brazil. At the end of 2011 it had a portfolio of 20 hotels of its own, managed 15 other hotels and held a minority interest in three, operating in 14 Brazilian States and the Federal District. Its main sources of revenue are the income from its own hotel rooms, sales of food and beverages, events, and the fees paid by owners of the hotels it manages. It has an exclusivity agreement for South America with Golden Tulip – a chain created in Holland in the 1960s, which today has 200 hotels in 40 countries, with three main brands: Royal Tulip (Luxury), Golden Tulip (higher quality) and Tulip Inn (economical).

The business has a similarity with other real estate businesses such as shopping centers or investments in office/commercial buildings: combination of a yield on the asset and variation of the value of the asset over time. It does not have the predictability of revenues that other real-estate-based businesses enjoy from long-term rental contracts; but the low predictability and potential volatility of the "one-day contract" inherent in the hotel business, enable it to manage prices more actively.

With acquisitions and strong organic growth, BHG reported net revenue of R$ 186 million in 2011, 50% more than in 2010, which in turn had grown 61% from 2009.

From 2009 to 2011, the Ebitda generated by the hotel business (i.e. before the cost of the holding company and expenses related to the land bank), came close to quadrupling, with Ebitda margin expanding by 12 percentage points. Consolidated Ebitda reversed from negative in 2009 to R$ 24 million positive in 2011, with Ebitda margin of 22.5% (and a clear improvement trend, with 26% in the second half).

The main operational metrics of the hotels have shown consistent improvement, attesting to good management of the assets. Return on capital invested, even excluding the value of the land bank in the balance sheet, is still very low, but we see potential for significant improvement in the long term, especially through: (i) further scale gains; (ii) investment in greenfield projects providing higher leverage of own capital; and (iii) growth of the business of management of hotels for other owners.

BHG has advanced on all these fronts. Its acquisitions since 2009 have significantly diluted the expenses of the holding company (administration, and the functions of support and control) from 28% of net revenue to 11% of net revenue in 2011. We see space for further reduction. There have been important transactions since the 2011 results, such as acquisition and operation of five hotels in Belém, which will expand the number of owned units and rooms managed. Also in the management business, BHG signed contracts to take over management of one new hotel in Belo Horizonte, to be opened in 2013, another in Goiânia, already in operation, and to buy the Solare Group, which manages seven hotels in São Luis in the State of Maranhão. Its purchase of the Rio Palace in Rio de Janeiro, currently operating under the Sofitel brand, awaits a decision by the courts – and would be an important addition to the portfolio.

As part of its strategic planning, BHG plans to create 40 hotels of the "selected services" standard (Tulip Inn brand), over the next five years, for business users in regions where economic growth contrasts with a low supply of hotel rooms. Eight projects have been announced so far, four of which are under construction, and the company expects to start the others in 2012. Development of all of these projects could call for capital of between R$ 800 million and R$ 1.0 billion. With leverage of up to 60%, and bringing in equity partners while keeping a share of control, BHG could in our assessment make these projects feasible with approximately R$ 100 million of its own capital, significantly expanding the management business.

The land bank legacy from Invest Tur continues to be a challenge, since it does not fit into a strategy of growth in hotels centered on business users; but we must recognize that BHG has been creative in the ways in which it has sought to realize part of the value that is still in its balance sheet. The cost of maintenance of these sites has been substantially reduced since 2009, and BHG has succeeded in making some creative agreements such as, for example, selling part of a project in Bahia in exchange for some units (rooms) in a hotel that is in development and which it will manage. A contract has even been signed for wind farms to generate power on one of the largest properties, in the State of Ceará, on Brazil's Northern Atlantic shore.

BHG has yet to prove its capacity for execution of greenfield projects, and we have some concern on the level of investment that can be made in the sector over the coming years, with a possible risk of supply demand mismatch in the medium term. At the same time, BHG has greenfield projects outside the locations that are currently being most targeted in advance of near-future events (the Soccer World Cup, the Olympics), and we believe the supply of hotels in Brazil, even in important cities, is still far from its potential.

In our scenarios for valuation of BHG, we believe the present portfolio of operational assets, under what we judge to be relatively conservative projections, justifies its present market value, and indeed that some recent transactions, such as the acquisition of the Solare Group, provide potential for more addition of value. We believe the market is attributing little or no value to the business of development of new hotels, nor to the land bank, not even to recent transactions, and for these reasons we continue to be positive on the investment. If on the one hand, the safety margin that we had when we invested at close to book value is not the same as it was, today we have a lower execution risk, and more clarity about the growth opportunities.

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