LEBLON
EQUITIES

Leblon Letter 11

2nd Quarter 2012

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It is our pleasure to share our eleventh 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

A rapid change in investor sentiment about Brazilian equities in 2Q12 resulted in a 24% fall in the Ibovespa index in dollars in the quarter. As we noted in our Leblon Letter 10 (1Q12), the 17% rise in the index in dollars in the first three months of the year, and even more significant rises in the prices of some specific shares, surprised us, and led to some changes, mainly tactical, in our portfolio.

The correction – which began as early as the first 10 days of April, and accelerated in May – gradually created opportunities for allocation of a significant part of the cash position of the Leblon Equities Fund, which had remained high during the first three months of the year.

We increased the fund's position in several companies that were already in its portfolio at the beginning of the quarter, but we also revisited others, finding good combinations of price and fundamentals in some companies we had held in the past, and which are now back in the portfolio. As a result, the fund closed the quarter with less than 5% of its assets in cash – this compares to 21% at the end of March, and 15% at the end of December; and is a lower level than the average for the whole of 2011. It's worth reiterating that the fund's cash position is a function of the opportunities that we find (or not, as the case may be) to invest in assets with high potential for appreciation, and does not have any correlation with any wider view of the market as a whole.

We have never been so close to the companies that we invest in as we are today.

Partners of Leblon Equities currently participate on the boards of Saraiva, Mills, Springs Global, Coteminas – which is a small position of the fund but has Springs Global as its main asset – and Cambuci. These investments, combined, represent some 30% of the portfolio of the Leblon Equites Fund and the Leblon Value Hedge Fund.

The main goal of our participation on the boards of these companies is to contribute, with ideas and experience, with the objective of generating and releasing value for all shareholders. Acting as "owners" whose interests are truly aligned with the interests of these entrepreneurs in the long term, we believe that we are helping increase the value of these companies. In our opinion, this constructive engagement as partners is an effective strategy for maximizing the value of these investments, which in the long term tends to be translated into significant gains for our funds.

We see the time dedicated to the role of a board member as a fundamental part of the research process of analysis of a company and of sectors. If on the one hand having a seat on the board results in some reduction of liquidity for the fund's position, due to the legal restrictions on trading the stock at certain moments, at the same time it brings a differentiated level of knowledge about the company and its business, which provides a fundamental advantage for investment decisions. This is a trade-off that we are very comfortable in accepting.

During the second quarter of 2012 we slightly increased the position in Saraiva; we slightly reduced the investment in Mills, due to the strong increase in its stock price in the period; and we increased our position in Springs Global, as part of that company's recent capital increase. The three largest investments of Leblon Equities Fund (other than its cash position) remain the same. At the end of June they represented 29.3% of the fund, compared to 26.4% in March. Lojas Renner has replaced HRT as one of the fund's 5 largest positions (this reflects relative performance, and also the increase in the size of the position in Renner). These top five stocks together accounted for 41.0% of the portfolio at the end of the quarter, an increase of 1.2 percentage points from the end of March.

At the beginning of April, Springs Global published a material announcement with the terms of a proposal for a corporate reorganization, involving Coteminas and other companies of the group. The proposal set out a series of events which could lead to Coteminas migrating to the Novo Mercado, and included a capital increase at Springs of up to R$ 169 million. It also specifies: measures to optimize the management structure of the two companies, and improve their governance and investor relations; a review of Springs Global's business in the United States; and release of the company's industrial assets in Brazil. We see this group of measures, once they are fully implemented, as very positive for the business and governance of the two companies. Since that Material Announcement, Springs has announced the sale of one of the brands that it owned in the US, and the hiring of a new CFO and investor relations officer. Springs' capital increase was completed on July 10, 2012. All these steps are important, but execution of the strategy of expansion in the retail sector continues to be central for generation of value in the long term, and this is an area that requires special attention – as we commented in our Leblon Letter 5, of November 2010.

We believe that 2012 will continue to be a challenging year for investment in equities – as it has been so far, and indeed as was true for 2011. We do not know what Europe has in store for us for the coming months, nor, indeed, for the coming years, but it is difficult to believe that there will be an avalanche of good news that might in some way "save the market". We're also aware of the challenges that Brazil faces when we think about sustainable growth in the long term; it seems to us that 2012 will likely be a year of only reasonable economic growth (although that is certainly not something so terrible in the present global scenario). On the other hand, we are positive about the opportunities where we have invested, and about the strategies of our long-only portfolio as a whole – the success of which does not depend on any specific trend, sequence of events or macroeconomic movements.

We refer to a few cases:

Saraiva, in spite of the challenges that it faces in its most relevant markets, due to the constant changes in technology and in the behavior of its clients, succeeded in growing revenues in its retail business (Livraria Saraiva) – the physical stores + saraiva.com – by 23% per year, on average, over the three-year period 2009 to 2011, and improved its Ebitda margin after the negative pressure resulting from the purchase of Siciliano. Its publishing company, Editora Saraiva, has produced average revenue growth of 15% per year since 2006; it maintains a significant market share in purchases by the government as part of the so-called PNLD program, and has also invested in digital content and learning systems. Although the return on invested capital has fallen in recent years, we see significant upside potential at current market prices. We also think that the company has a strategic value which cannot be left out of account.

The real estate broker Lopes is another case: we keep our position in this company as one of the intermediate-size investments of the long-only strategy. If on the one hand Lopes suffers in the short term from the effect of a slower pace of new launches by the large-scale real estate developers (which are not currently going through the best of phases), we expect this effect to be temporary, and not to cause damage to Lopes's balance sheet, nor any other significant structural problem – such as the developers themselves are suffering directly. We see Lopes as very well-positioned in the secondary real estate market, with a very solid pillar in its strategic long-term alliance with Itaú, and we do not see the value of that alliance as completely priced into the share. There are many long-term positive trends that favor Lopes business. The growing number of new Brazilian families keeps up the demand for new real estate properties. The increasing stock of homes leads to a potentially higher turnover of these assets, thus positive for the secondary market;also, the greater availability of real estate financing (in spite of some noise in the short term) is now a permanent aspect of this sector in our view. These factors strengthen the real estate brokerage business, which continues to have only a reduced need for capital.

Another case in the real estate world: MRV. This is our only position in a homebuilder, and we have invested time in gaining deeper knowledge of this company. The difficulties faced by several companies in this segment of the market (both those with controlling shareholders that are experienced in the development market, and those, large or small, that are not in that category) remind us that there is always the possibility of being negatively surprised. This is of course one reason why we always invest with a certain margin of safety. We believe that we have bought MRV at prices which implied little or no growth, and which did not incorporate margins any better than the (weak) margins of 1Q12.

More recently (before the end of 1Q12), we invested in Estácio, in the education sector, and we now once again have DASA in the portfolio (it was an intermediate position in the fund in 2009). In both cases, we saw important structural changes happening, both in the business and in their governance, which in our view were not totally reflected in the value of both stocks.

Another new position for the long-only strategy has been Itausa, the performance of which has suffered negative effects from the results of Itaú. Itausa is quite a well-known story, widely followed by the market, but as we have already commented in Leblon Letter 7 (July 2011), we had some difficulty in finding significant upside potential investing at the P/E and Price/book levels that had predominated since 2010. Today we see a different scenario, and a more appropriate risk-return ratio for taking a position in the company, even if only an intermediate one.

As a result of our recent changes, as well as our more active participation in the business of the companies that are our core positions, we see the portfolio of the Leblon Equities Fund as being well diversified, both in terms of sectors and in terms of the variety of their investment theses. We see room for a significant increase in the value of the portfolio as a whole (a function of our target prices for each investment), indicating a potential attractive return – and this is even more true in a scenario in which lower interest rates seem to be increasingly the norm. The current "moment of doubt" on the Brazilian equity market is curious from at least one aspect – its limited similarity with other previous moments of accentuated uncertainty. The shares of the good companies with a strong positive outlook have returned some positive performance, while those that are going through an adverse experience have seen their market value converging to fairer levels. There is some differentiation – it is not as if everything is violently rising or falling at the same time. Since this differentiation of performance is not always justifiable, this aspect of the market's behavior also helps us to find ideas for the short portfolio of the Leblon Value Hedge fund.

Organizational update

As of June this year, we have a new partner: Eduardo Castro.

Eduardo brings with him important experience in the retail sector, particularly in retailing-commerce business, in which he has made a distinguished contribution at Nova Pontocom, of the Pão de Açúcar group, and at the specialty online perfume retailer Sack's. He was the COO of Nova Pontocom, an outstanding Brazilian online retail company with revenues of R$ 3.5 billion in 2011 – holding and operating the brands casasbahia.com, pontofrio.com and extra.com. We believe Eduardo will be able to make a significant contribution to our investments in the sector. In April this year, he was elected to the Board of Directors of Saraiva. He has now become Leblon's ninth partner. At the beginning of 2012 we had already made George Earp the eighth partner, and Laura Tostes and Victor Uebe became partners at the beginning of 2011.

In the next section we make a few comments about the performance of the funds.

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