LEBLON
EQUITIES

Leblon Letter 13

4th Quarter 2012

www.leblonequities.com.br

It is our pleasure to share our thirteenth 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

2012 was a good year for the funds managed by Leblon Equities.

[redacted]

The five top individual contributions to the fund's performance added up to approximately 20 percentage points of the year's performance. The highlight is Mills (MILS3), which has been one of the fund's most significant investments since its IPO in 2010. The chart below shows our investment in Mills.

Source: Perform It System (Leblon Equities)

Lojas Renner, Estacio, Saraiva and Lopes were other stocks that had positive contributions to the fund's performance – we have commented on theme in prior Leblon Letters, as they are positions the fund has held for a long time. On the other hand, although these are relatively "old" positions, our decision to increase the fund's exposure to Mills, Renner and Lopes at the end of 2011, taking the opportunity of very attractive prices, turned out to be a correct one. The investment in Estacio – one of the fund's new positions of last year – was made before the end of the first quarter of 2012, and the fund captured a good part of its strong price rise. Other investments that had an important contribution to the performance were Aliansce, Hypermarcas and MRV, all of which have been the subject of detailed analysis in our Leblon Letters.

Leblon Value Hedge Fund had a positive performance of 10.3% in 2012, net of all fees. The year did not provide good performance from some of the fund's most important short positions, but the long book, some specific arbitrages, and some of the smaller individual short positions did make a positive contribution.

We continue to be confident on the potential of the fund's main positions, but we are also attentive and diligent in relation to the assumptions that define, for us, the value of these assets. Undeniably, some companies are trading at a price close to what we consider to be their fair value, and for this reason we may make some adjustments of a more tactical nature to the portfolio during 2013. It is always worth remembering that in most cases, when a company is trading at what we consider to be its fair value, its projected cash flow still offers a real rate of return of between 8% and 10%, a level that is increasingly acceptable in terms of the reality of assets in Brazil. At the same time, we see some important positions of the fund still far from this level, notably Saraiva (even after a gain of 28% in 2012) and Springs Global (down 8% in 2012). In both cases, the way forward to achieving a stronger valuation is not uncomplicated, but the potential is significant.

We spoke briefly about Saraiva in Leblon Letters 4 (2Q10) and 11 (2Q12), but in this letter we give it proportionately more space.

We have been investors in Saraiva since the inception of the Leblon Equities funds in 2008. Over this period it has continued to be one of our funds' largest investments, constituting a varying percentage of their NAV: a maximum of 17% in February 2009 and a minimum of 5% in February 2010. Currently the stake is 11% of the total NAV of the funds.

From September 2008 to April 2012, the stance of Leblon Equities as a shareholder in Saraiva was relatively passive, with interactions limited to quarterly meetings with the company's executives and shareholders. In 2012 we began to change this approach, operating more actively together with the company, seeking to collaborate in subjects that we considered fundamental for increasing its value and the perception of that value by other investors.

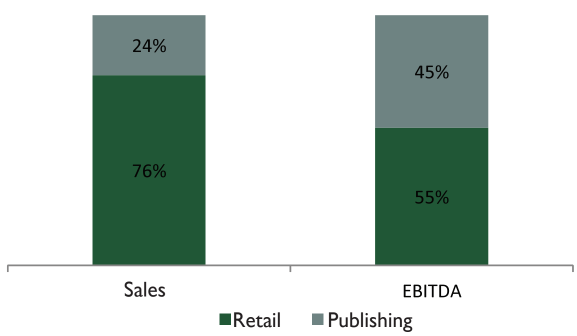
In April 2012 Leblon Equities led a group of investors that elected Eduardo Castro to Saraiva's Board of Directors. He took his seat on Saraiva's board in June 2012, and in the same month became a partner in Leblon Equities, with the principal remit of managing the investment in Saraiva. Eduardo has an operational profile that is very complementary to the profile of Leblon's other partners. Until June 2011 he was a partner (founder), and Executive Director for Operations of Nova Pontocom, a company of the Pão de Açúcar Group, owner of the Ponto Frio.com, Casasbahia.com and Extra.com retail chains.

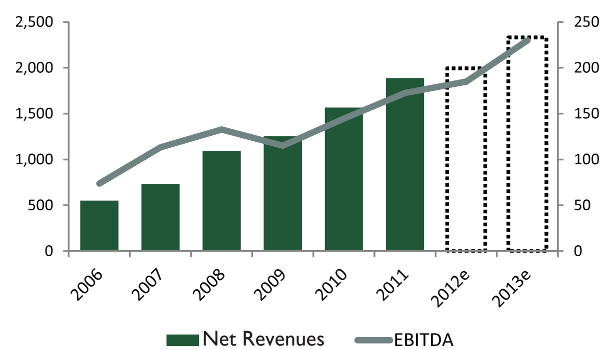
In this brief time of intense activity, Eduardo has dedicated some 3 to 4 days a month to Saraiva, while we have principally stimulated debate and questions on the its operational performance, its future ambitions as reflected in its annual budgets and long-term planning, and the way its executives are assessed, remunerated and held accountable. In spite of its long-term track record of growth and profitability, we believe that it has been less demanding with its managers than it should be, and that its global and individual targets have not been challenging enough. As well as these more subjective aspects, we have sought to make a contribution in operational subjects, such as Livraria Saraiva's move to a new Distribution Centre in Cajamar, replacing the two currently in operation, and several subjects related to the operation of its e–commerce (www.saraiva.com.br). We have received feedback from other shareholders and board members, and also from the managers themselves, saying our contribution has been valuable.

Saraiva's stock (SLED4) is trading well below the price of a profitable and growing business. At the end of December 2012, its price per share of R$ 25 valued it at R$ 680 million. On our estimates, this represents, for 2012, P/E of 8 and EV/Ebitda of 5.4 – figures that are respectively 73% and 62% below the average for comparables[1] traded on the Bovespa.

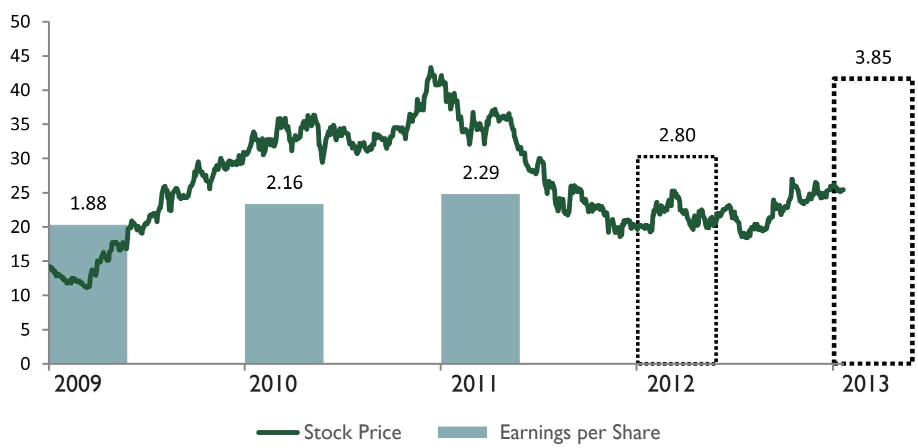
[1] Source: Market Consensus Bloomberg (05/02/2013). Companies: Abril Educação, Guararapes, Lojas Renner, Cia. Hering, Pão de Açucar, Lojas Americanas, B2W, Lojas Marisa, Arezzo, RaiaDrogasil and Magazine Luiza.

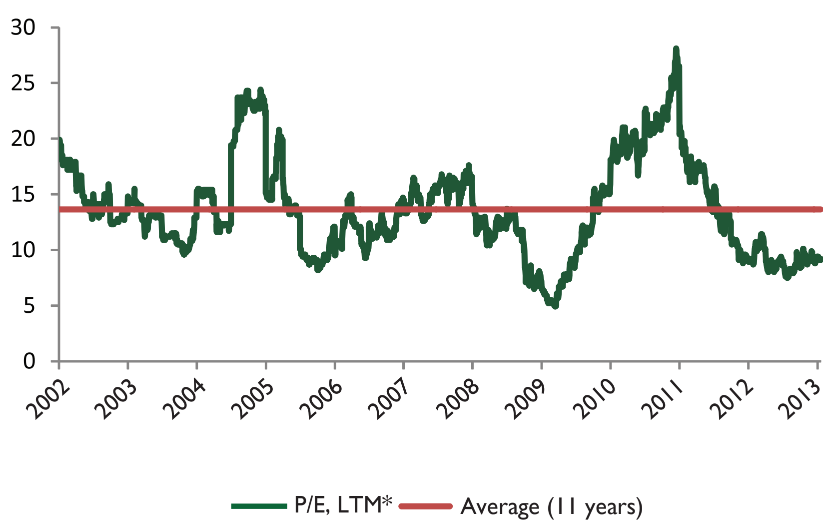
We expect Saraiva to post total 2012 net revenue of more than R$ 2 billion from its Publishing and Bookshops operations. The publishing operation, Editora Saraiva, has a leading position in the Brazilian market, particularly in teaching and technical books, in which it has a market share of some 15%. Its learning systems now have approximately 150,000 students, and went into breakeven last year. Saraiva has a high ROIC, of 25–30% over the years 2009–2011, and produces strong cash flow. The retail operation – Livraria Saraiva – now gets some 40% of its sales revenue from Internet sales, and operates 102 stores, with approximately 55,000m² of selling area. The two charts below shows some of Saraiva's financials.





This good performance, the strengths of the two businesses, and an earnings growth outlook for coming years have not been accompanied by strength in the stock price. As the two charts below show, market capitalization reached just below R$ 1.1 billion at the end of 2010, but this all-time high was followed by a strong decline, not recovered even by the appreciation of 2012; and P/E is now well below the historic average, in contrast to most listed Brazilian retailers and consumption stocks:





* Market capitalization devided by net earnings of the last 12 months.

Out of the list of possible explanations for this major distortion, we highlight two:

(i) insufficient and not very proactive communication with the market, leading to a low level of coverage by sell-side analysts – resulting in the stock remaining very little-known; and

(ii) expectation of changes in the business model and the competitive environment, resulting from the spread of e-books and the arrival of Amazon in Brazil.

One of the fruits of our activity on Saraiva's Board is that better communication with investors has become a priority for its CFO and Investor Relations Department. Indeed, part of the 2013 bonus for people in these areas of the company has been linked to targets for the number of top-tier financial institutions covering the stock. The table below illustrates how backward Saraiva is in this aspect, compared with companies of a similar size.

Company	Ticker	Sector	Liquidity (R$ k/day)	Market Value (R$ million)	Sell-side Coverage: (# of top-tier banks*)
BR Insurance	BRIN3	Financial Services	8.474	2.000	7
BHG	BHGR3	Real Estate	560	841	6
Profarma	PFRM3	Retail/Distribution	2.712	572	6
Magazine Luiza	MGLU3	Retail	9.706	2.348	5
Technos	TECN3	Consumer Goods	1.920	1.901	4
IMC	IMCH3	Retail	23.316	2.392	3
Unicasa	UCAS3	Retail	1.171	720	3
Time for Fun	SHOW3	Entertainment	1.143	521	3
Locamerica	LCAM3	Capital Goods	1.414	786	2
Valid	VLID3	Financial Services	9.730	2.302	2
Saraiva	SLED4	Retail	1.451	710	1

Source: Economatica and Bloomberg

The movements of Amazon, a heavyweight competitor for any segment of retailing – especially due to Kindle's strength and the transformation it has wreaked in the US market – are being observed. What has happened to Barnes & Noble – one of the companies affected by the changes in publishing and bookshops in the US – also sends out a message of caution.

From 2005 to the end of 2012, B&N's market value fell from US$2.2 billion to US$800 million. It increased sales in 2011, and managed to stabilize EBITDA margin after 5 consecutive years of decline, but is not yet back in profit. It currently has revenues of US$7 billion, operating 689 stores, a web retailing platform, an e-bookstore with 3 million titles, and sales of its proprietary Nook e-reader.

Without losing sight of differences in scale, there are significant distinctions between the two companies, that show Saraiva to be in a competitive position that is less vulnerable to the changes that have transformed the US market. The table below illustrates some of these differences. The dynamics of Saraiva's growth today are more positive; books are already a lower proportion of total sales than in B&N; and Saraiva's e-commerce is already a much more significant proportion of total revenue.

	Barnes & Noble	Saraiva
E-Commerce (% of Sales)	~10%	~40%
Books (% of Sales)	>75%*	~40%
Same Store Sales (06-11 Average)	-1,1%	13%
Sales CAGR (06-11)	6,5%	35%
Language/Contract Barriers	No	Yes

*Leblon Equities Research Estimates

We believe that two of the factors needed for a consistent appreciation in Saraiva's stock price are: (i) more efficient communication with investors; and (ii) continuous operational improvement, in the increasingly competitive business environment. As far as possible we believe we have made a contribution as shareholders and "hands-on" members of the Board of Directors. We believe our investment, today, has a good margin of safety, since Saraiva's present market cap implies expectations of falling margins, and zero growth, using a discount rate of 10% p.a. above inflation – a scenario that seems to us to be significantly conservative, and basically improbable. On a more reasonable scenario – that does not even assume that the stock will trade at the same multiples as the "comparable" companies mentioned above – the calculations we have made indicate an upside for Saraiva's stock in the order of 100%.

Equipe Leblon Equities

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.galvão@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

Fernanda Avelino - fernanda.avelino@leblonequities.com.br