

LEBLON
E Q U I T I E S

Leblon Letter I

Ist quarter | 2009

www.leblonequities.com

It is with great satisfaction that we bring you our first *Leblon Letter*. This quarterly channel of communication aims to give you our forward outlook for the main themes affecting our investment decisions. Meanwhile, our *Monthly Report* will be more retrospective and explanatory. With these two instruments, we hope thus to remain always fully “on the same page” as our clients. For us, communication with clients is of the essence. We believe your feedback – criticisms, debate, suggestions – will add value for all of us. With total transparency as a key tool in seeking to be correctly understood by yourselves, we aim to create a relationship that lasts and continues to have growing value over time. This first Leblon Letter also talks a little about what we expect to make of Leblon Equities in the future.

Thank you and regards,

Leblon Equities

Our “DNA”

Leblon Equities is a group of experienced professionals, from various origins, who are complementary to each other. This produces a “DNA” that is very much something of their own, both in investment strategies and in the company’s governance. We have unshakable faith in the partnership model in which the executives are the principal shareholders, and all the employees have their compensation linked to the company’s profitability. We believe that the greater the dispersal of equity, the greater is the sustainability of the business (our principal objective). A sustainable business should not depend on specific individuals. The guiding principle should be, in our view, that competent professionals attract and maintain competent professionals, resulting in the business perpetuating itself.

The basic raw material of the fund management business is information. Its final product is investment decisions. To build a competitive advantage it is vital to have a team of high-quality analysts. And one of our points of differentiation is our belief that the value and significance of proprietary information improves substantially if the team of analysts is researching the universe of both listed and non-listed (private equity) investments.

Our investment process is based on five pillars: knowledge, judgment, relationship, collaborative attitude and risk management.

- (1) Knowledge: Profound knowledge of and familiarity with the sectors of the economy, the companies and the people involved.
- (2) Judgment: Assessment of the information and of the knowledge, with good sense, and a capacity for careful critical analysis, not without the appropriate degree of skepticism.
- (3) Relationships: In our view, long-term relationships create more value than short-term ones.
- (4) Collaborative attitude: We aim to have a relationship of collaboration with the companies in the marketplace – our aim is that entrepreneurs should consider us desirable partners in their processes of transformation and growth.
- (5) Management of risks: We also adopt a qualitative approach. We have a focus on the concept of a margin of safety, not using excessive leverage, and creating and maintaining appropriate levels of liquidity.

We are long-term investors, and we have a vision that is often contrary to that of the majority (the so-called market consensus). Our analysis and research allocates an important weighting to understanding the motivations of the people who control or manage businesses: the incentives that guide them, and their long-term projects. We seek to be attentive to the dynamics of a sector, or between sectors, which influence companies, and also to international experiences that can help us not to repeat mistakes, and even show us new ways forward. And we talk with clients, suppliers, competitors, and, if possible, employees (both happy and unhappy), of the companies we analyze.

We are unprejudiced. We may invest in any sector; but we apply certain guiding ideas. For example, we prefer cases where the significant variables in generation of value for a company are more under the control of the managers of the business than dependent upon external events – which will most often be macroeconomic factors. We tend to prefer companies that are less known to the market, where there is a probability that the asymmetry of information may be greater, creating perhaps a greater opportunity of extraordinary gains.

As our principal tool for valuing companies we use discounted cash flow. We use multiples of comparable companies basically as a secondary, or reality check.

All significant investments made by our funds have to undergo a test by our criteria of **margin of safety**. This means not only that there must be a considerable distance (discount) between the price of the shares in the market and the value of those shares as measured by our discounted cash flow, but also the degree of security that one can assume in relation to our projections and forecasts. We prefer secure investments, in established companies, with clear outlooks for returns and profitability, and competitive advantages that will guarantee their survival, preferably in perpetuity. Our concept of margin of safety also demands that we should be relatively conservative in our projections, assumptions and forecasts – for example giving special attention to questions such as the risk of changes, or unexpected events, in the stockholding structure, or management's capacity to adapt to changes in the competitive scenario.

Our analysis has a strictly bottom-up focus. That is to say, in our consideration of a company its individual characteristics will always have more importance than those of the overall environment. This focus can lead us sometimes to invest in excellent specific cases in sectors that may themselves be problematic, or low-growth. The converse is not the case: we do not make any investments solely on good logic for a sector, or for any generalized theme.

This approach, however, does not prevent us from looking for the best investments within certain major investment themes. Those that hold some attraction for us are: (1) declining Brazilian interest rates: Though these are still incredibly high on a worldwide comparison, there is a very significant expansion of lending and indebtedness, of both companies and consumers, in progress, and we believe contrary to what is happening currently in the rich countries that this factor will continue to maintain and strengthen the growth of the banking and real estate sectors; (2) with the failure of the state's investment capacity and governance to deal with the modern complexities of the sectors of education, health and logistics infrastructure, in our view these areas will be increasingly served and dominated by private companies; (3) a significantly large middle class is coming into being in Brazil, with the gradual reduction of the incredibly bad income distribution that the country has had for so long; (4) per capita income is increasing, broadening the potential reach of the consumer market, and creating demand pressure for consumer goods and services; (5) Brazilian farming production is enormously competitive, making possible a great expansion of that sector; (6) Brazil is undergoing a transformation into a major producer of oil, generating high demand for companies supplying services and infrastructure.

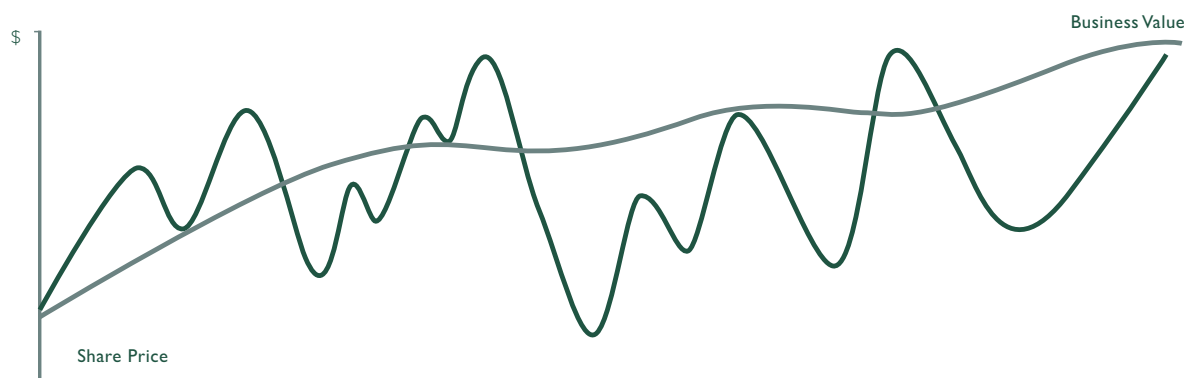
On value and price

Our analysis is concentrated on the variables that influence the formation of **value** of the companies over the long term. Variables that have a determinant weighting in our decisions on a company include competitive advantage, capacity to generate cash over the long term, the company's sustainability, the profile of its stockholders, the managers' capacity for execution, and alignment of interests between all stakeholders. We start from a simple observation: that the scale of variations in the **prices** of shares is much greater than the scale of the oscillations in

companies' fundamental **values**. Over the long term, correlation between a company's quality and the performance of its shares is very high; but in the short term, this correlation is low. The mismatch between formation of value in the long term and formation of prices in the short term creates investment opportunities for long-term investors who have the discipline and patience to wait for companies' stock prices to converge toward their intrinsic value.

The formation of **prices** of shares in the daily activity of the market is in part determined by variations in the behaviour of market participants. Usually this behaviour is influenced either by short-term events (quarterly results, current multiples, fashionable sector views, etc.), or by issues of a transitory nature that are difficult to predict (e.g. capital flows). While the majority of investors concentrate on anticipating movements of prices, and guessing when and why shares will begin to rise or fall, the strategy of Leblon Equities when making an investment can be summed up as buying good companies for prices that guarantee us a reasonable margin of safety, monitoring the development of the value of companies over the length of a cycle of investment, and waiting patiently for the price of the shares to converge towards their intrinsic value.

Chart I Business Value x Share Price



In certain situations, if we take an active stance in relation to invested companies this improves the risk-return ratio of the investment. In most of the illiquid investments that we make, we adopt an active stance in our relationship with the company. We exercise the rights legally belonging to significant stockholders – such as, for example, a seat on the Board of Directors, or on the Audit Board. In some cases, we become parties to a stockholders' agreement. Some positive results of an active stance can be: significant increase in knowledge of the company; and the capacity to influence its development – which means making an active contribution to the process of formation of value. A negative aspect is a possibly significant reduction of the liquidity (usually already low) of these investments, reflecting the significant scale of the investment position as a percentage of the company's total shares; and also the legal restrictions incumbent upon “insiders”. We practice what we could call “collaborative activism”, since we believe that the union of investors' financial expertise and the business expertise of entrepreneurs is a powerful tool in the process of generating value. We do not believe in “hostile” activism as an efficient path to creation of value in the long term in Brazil. Control by a single controlling stockholder or stockholding group is intrinsic to the stockholding structure of the majority of Brazilian listed companies, and the position of that stockholder or group is protected by the presence of two types of shares (common and preferred – ON and PN), or in some cases by the presence of obstacles – going by unlikely names such as “poison pills” (or even “shark repellants”) – in the Bylaws that are

impossible to remove, or overcome. As a result of this, the controlling stockholders have the guaranteed right to orient their companies' business, and to choose the managers, and there is no real possibility of minority stockholders re-orienting a significant aspect of the business approach, even if the company is being badly managed.

As a result, a deep understanding of the motivations and interests of the controlling stockholders of the companies that we invest in is a central element in our analysis. If there is alignment of interests between the controlling and minority stockholders, the window of opportunity is open for the practice of "collaborative activism".

We assess on a case-by-case basis whether it is appropriate to adopt an active stance, and we weigh whether the benefit of directly influencing the process of formation of value compensates for the cost of a reduction in liquidity.

In general, when we make active investments we follow certain parameters:

Control	Significant minority groups, or shared control.
Track record of results	We prefer profitable companies to companies undergoing restructuring.
Moment in the cycle	We prefer listed companies, or non-listed companies at pre-IPO phase, to small scale unlisted companies, or companies at pre-operational phase.
Managers	We prefer companies that are well managed, rather than the prospect of making changes in management.
Pricing	IRRs of at least 20% above inflation.
Sector	We are flexible to invest in any sector.

Our funds

Leblon Equities manages three investment funds, with local and offshore vehicles, that offer three strategies: Long Only; Equity Hedge; and Illiquid Shares (Private Equity and PIPEs*).

Our objective is: high returns, with low risk of a permanent loss, in the long term. We believe success in implementing our investment philosophy requires the building of a base of investors that is appropriate to the profile of the assets in which we are investing, that is to say, investors with a long-term horizon, able to permit us to invest in a counter-cyclical manner.

Risk management is concerned with minimizing permanent losses of capital. We do this by demanding a significant margin of safety in our investments; by not using excessive leverage; and by controlling the level of liquidity in accordance with the structure of redemptions of our funds.

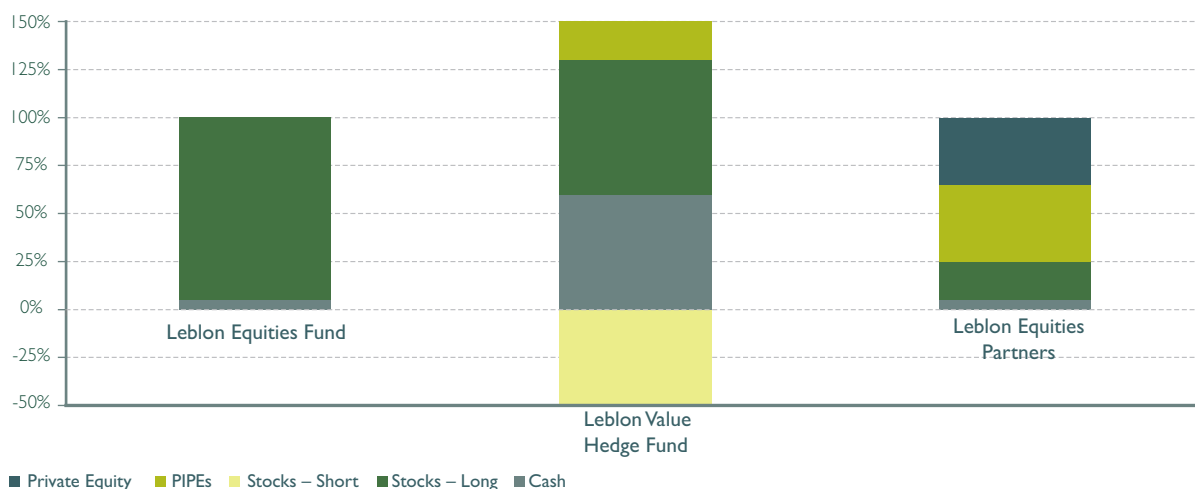
Consistency: We are not concerned with short-term volatility, nor with consistency of performance on a monthly basis. We are not disposed to exchange high long-term returns for low volatility in the short term. We consider it impossible to combine these three factors: (1) high long-term returns, (2) low risk of permanent loss; and (3) great consistency in the short-term. To reach our long-term objective, we are prepared to do without apparent short term consistency.

Hedging: Two of our funds – Leblon Equities Fund (*Long Only*) and Leblon Equities Partners (*PIPEs and Private Equity*) will not have an active hedge policy, and their net exposure to equities is likely to vary between 70% and 95%, in accordance with opportunities. These funds do however have the freedom to invest opportunistically in buying “insurance” for their portfolios. Typically this “insurance” will be direct or synthetic purchase of put options on shares or share indexes.

Leblon Value Hedge (*a Hedge Fund*), on the other hand, has an active hedging policy and uses various instruments such as short selling of shares and indexes, direct or synthetic buying of put options, and sale of call options, and may also use non-equity instruments for general protection of the fund.

The chart below illustrates a typical breakdown of our funds:

Chart 2 Typical portfolios



* Private Investments in Public Equities. (Arranged purchases by qualified investors of blocks of shares, usually at a discount, to raise capital.)

Our view of the crisis

Our opinion on the current scenario is built from the close contacts that we have with the companies we monitor, follow and invest in. For Brazilian GDP growth in 2009, we note that at present our sentiment is more pessimistic than the market consensus. We believe the interest rate at the end of the year will be lower than generally expected, since the Central Bank will have to be more concerned with the strong risk of economic slowdown than with the risk of inflation.

If on the one hand forecasts of earnings are likely to continue to fall, on the other hand the discount rate to be used to calculate the present value of cash flows to stockholders is also likely to fall. Who wins from this situation? For answers we need to analyze case-by-case, and in accordance with our bottom-up approach.

One other significant variable adds complexity: the exchange rate. We believe that in the long term, the Real will appreciate against the Dollar, or at least against a basket of international currencies, in spite of Brazil being a strong exporter of commodities with falling prices and volumes. This is because, in relative terms, we believe Brazil will very likely be one of the countries that least suffers from the global crisis. Its relatively closed economy, which made it grow by less than the world average in recent years, now functions in its favor. Today, we see American investors obliged to sell assets all over the world to pay domestic debt, making the Dollar appreciate. In the long term, however, investors in Asia and the Middle East will increasingly perceive the uncertainties of investing in U.S. assets, leading them to diversify over the rest of the world, benefiting flows to Brazil and to other emerging countries that have done their homework in the recent decades of successive crisis.

We believe that the global crisis, which in fact began more than a year ago, is still very far from being settled. Governments are battling to anaesthetize the patient with enormous injections of capital into insolvent companies. All the liquidity that the central banks make available to the banks does not reach companies because the crisis is not only one of liquidity, but one of confidence in companies' capacity to support economic depression while they have strong indebtedness in their balance sheets. The most complex part, which will be deleverage of the system, transforming debt into capital, and the subsequent exit by governments from private companies, is still far, far away. The post-operative phase, for the patient, will also be a long and uncertain one, because there has never been a similar situation of such proportions that has produced any type of experience that those currently conducting the process can make use of. The American consumer will have to save, to pay debts, and this will likely cause a permanent reduction in the level of demand for many products – and we believe this will be a qualitative change and not only a quantitative one. This change will make many business structures unfeasible – and the chain reaction effect will generate doubts as to the capacity for contracts to be honored, in general. In various production chains, we are already seeing companies assuming the role of banks, financing suppliers and clients – which increases the risk of the system even further.

In spite of this relatively pessimistic view of the situation as a whole, we believe that the prices of various Brazilian shares already reflect sufficient uncertainties to make the returns over longer periods very attractive. Given the opportunity cost of the alternatives, the risk-return ratio of long-term investments in certain shares in Brazil today is something quite out of scale to many of the opportunities seen over, say, the last decade in Brazil.

Crisis is opportunity

Today we think that: (1) The value of listed companies, on average, is more attractive than that of private equity (Chart 3); (2) Companies with businesses oriented toward the domestic market are more attractive than exporters (Chart 4); (3) Companies with lower market capitalization are cheaper than the larger companies due to the liquidity premium demanded by investors (mainly international) (Charts 5 and 6); (4) The controlling stockholders of companies that have recently floated their shares are open to find solutions for the present pricing of their shares, opening windows of opportunities for PIPEs (Charts 7 and 8).

The return embedded in stock prices in Brazil is at record levels, if the opportunity cost of the alternatives is considered. Chart 3 shows the changes in P/E (Price/Earnings) of a representative universe of companies over the last decade. Although these are still numerically above the "low of 2002", we believe that the market is more depreciated today than it was then. The P/E in 2002 was 4, but the opportunity costs were significantly higher. At that time, the projected real interest rate for the subsequent five years was around 20% per year. Today the P/E is 6, while the opportunity cost for the long term is 8% p.a. above inflation, and falling rapidly. As well as the prices of shares on average being attractive, the present dispersal between valuations is extremely high. The crisis has also not spared even some good companies with businesses that are relatively protected against the reach of the crisis itself.

Chart 3 Public Equities vs Private Equities

Brazilian public equities P/E ftm



Sources: UBS (listed companies), Leblon Equities (private equity estimates).

Although it is difficult to bring together precise information on changes and developments in the valuations of the privately-held companies, empirically one observes that the trading multiples of these companies are not very volatile over time, and have a strong correlation with the level of risk-free returns over the long term.

It can be said that transactions involving unlisted companies take place, in general, at valuation levels (multiples) that are relatively close to the value of those companies determined by discounted cash flow. This is because those transactions take place between players that know the business (the vendor – a controlling stockholder or founder; and the purchaser – a strategic investor or a financial investor who would usually carry out profound due diligence); and these transactions take a significant time to be completed (on average, say, six months), allowing for adjustments in the formation of the final price, as the degrees of knowledge held by the vendor – initially greater – and the buyer converge closer to equality.

On the other hand, in transactions in shares that take place daily on the stock exchange, parts of companies are transacted between sellers and buyers who are, on average, much less informed participants than in transactions involving non-listed companies. This low availability of well-processed information results in price formation being less correlated in the short term with the real value of companies, and more susceptible to the moods of participants – which are strongly influenced by short-term events.

These phenomena tend to cause the difference between valuations of listed and non-listed companies, at moments such as the present – of extreme lack of confidence in the future – to reach levels that are extremely favorable for investment in listed companies. At moments of euphoria, such as those that the market experienced in 2006, 2007 and the start of 2008, the reverse is true. Based on this understanding, it becomes fundamental for the investor with a long-term profile to be flexible to invest in both listed and unlisted companies, in accordance with the balance of opportunities – which, at the present moment, markedly favors investment in listed companies.

Exporters vs. domestic companies

Chart 4 shows the changes in relative valuations between companies with business oriented to the domestic market and companies that export commodities. Trading at multiples close to those of commodity exporters, the companies oriented toward the domestic market appear to us to be much more attractive at the present moment, since the visibility of results is greater and the risk is lower than in commodity exporting companies, whose products are likely to suffer a further fall in demand and price due to the slowdown of the economy. In spite of the strong consolidation that has taken place over the last 10 years in sectors such as iron ore, history shows us that the corrections in these movements are inexorable, and their magnitude, usually, is proportional to the amplitude of the preceding upward movement.

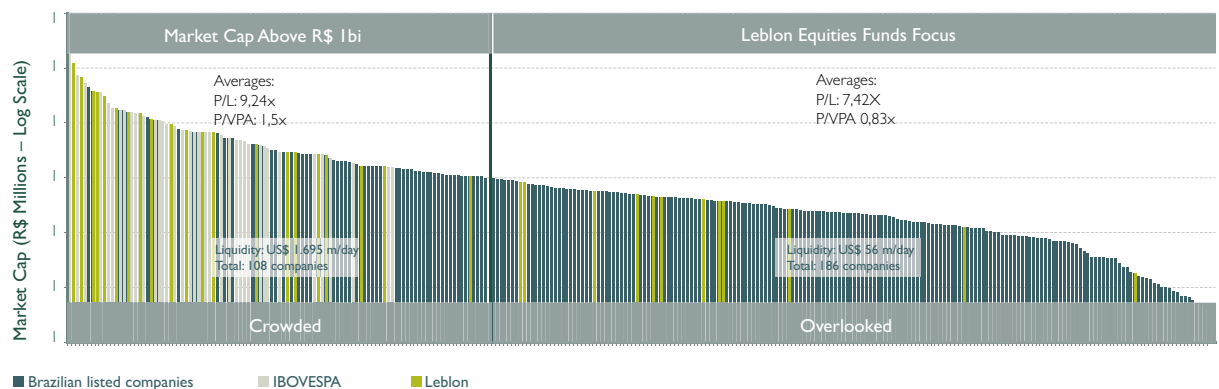
Chart 4 Domestic valuations at historical lows relative to Commodities.



Source: UBS

The international crisis has considerably increased liquidity premiums all over the world, and Brazil has been no exception. Small cap* stocks are trading at a significant discount to large caps in spite of their outlook for growth. The recent wave of IPOs in Brazil, in which the majority of shares were bought by foreign investors, are currently trading, on average, for prices 60% below their IPO launch prices. This opens a significant window of opportunity for the PIPE mode of investment, for several reasons: 1) attractiveness to the purchaser: the market price is an important signpost for these transactions; 2) attractiveness for the seller: controlling stockholders of recently-listed companies, after capitalizing themselves and their companies, may want to revisit their listed-company plans – at present they seem to us to be open to receiving collaborative long-term stockholders who, with a small-scale holding in the total capital of the company (e.g. 10%–20%) could help them in the task of bringing their company back to better pricing levels.

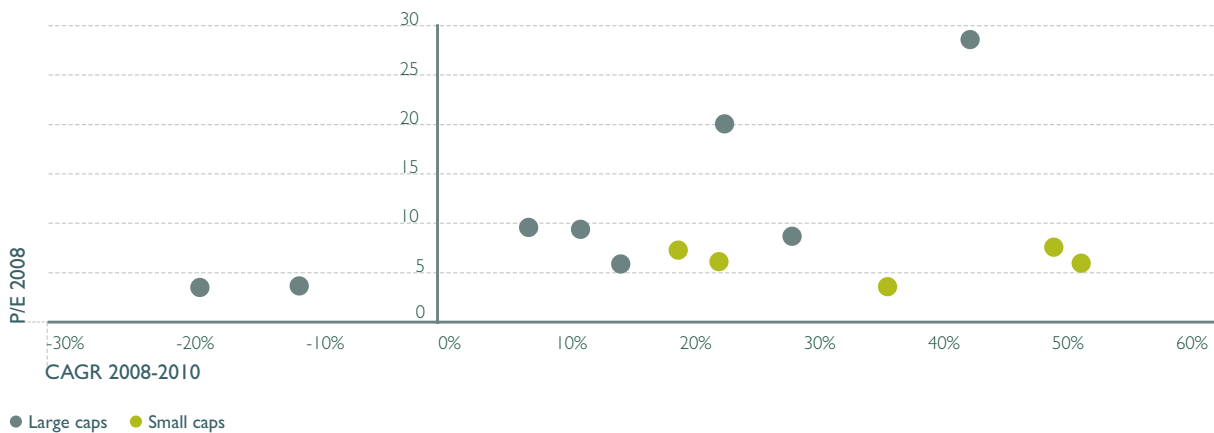
Chart 5 Small caps vs large caps valuations – High liquidity premiums



Source: Economática

* Companies with market value below US\$1 billion.

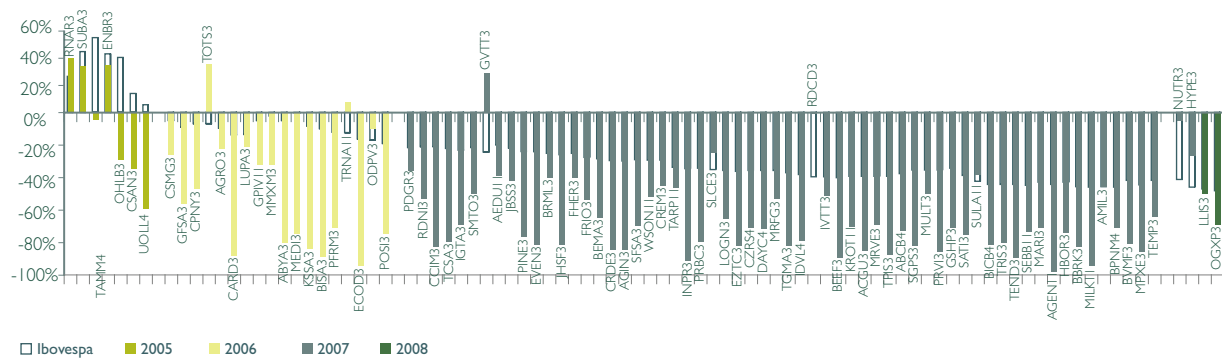
Chart 6 Large Caps x Small Caps - Earnings Growth Prospects



Sources: Economática and Leblon Equities

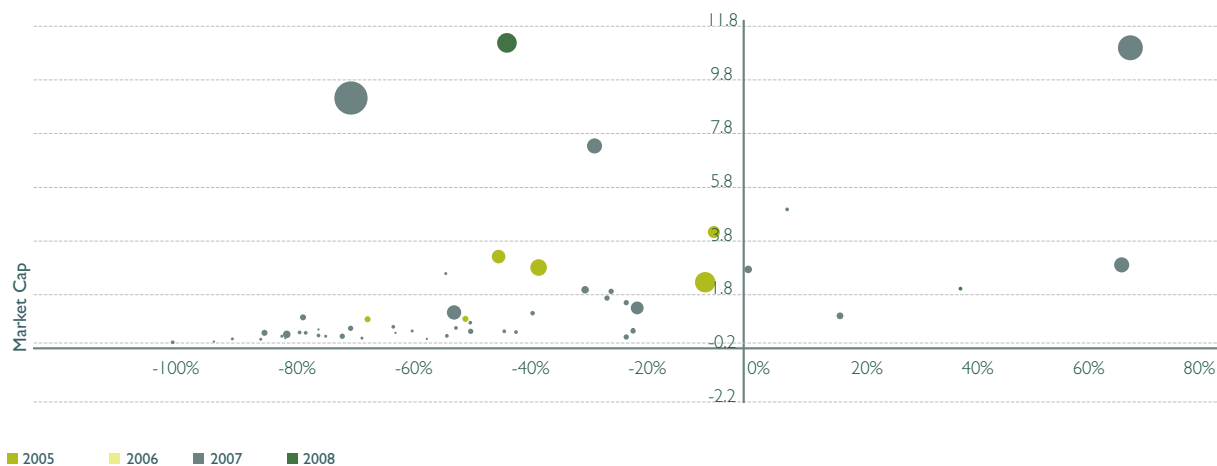
PIPEs

Chart 7 Performance since IPO x Ibovespa



Source: Economática

Chart 8 Small caps IPOs have generally underperformed larger IPOs



Source: Economática

* Sizes of the dots are proportional to the liquidity of the shares

Investment case

BicBanco (BICB4)

BicBanco is Brazil's twentieth largest bank, in terms of assets (Source: Brazilian Central Bank, September 2008), with more than R\$ 13 billion in total assets and a lending portfolio of approximately R\$ 9.7 billion. It is specialized in lending to the segment known as the middle market. In September 2008 it was the seventh largest Brazilian private sector bank, by assets, and the largest of the small and medium-sized banks listed on the Bovespa. Until the third quarter of 2008 it was maintaining strong expansion of its lending assets, sustained by the growth of the Brazilian economy and its activity focused on the middle-market segment, which has shown one of the strongest rates of expansion of recent years. It was founded in 1938, and has been under the control of the same group since that date, having operated mainly as a regional bank, concentrating in the Northeast (until the 1980s, when it began to operate nationwide).

Its lending portfolio shows a reasonable degree of diversification by product (it has trade finance operations on a significant scale, and working-capital and overdraft products), as well as being diversified by geographical region and by economic sector. It also has relatively short tenors (in September 2008 approximately 40% of the lending portfolio had maturities less than 90 days). It carried out an IPO in October 2007, increasing its capital by R\$ 500 million, after a capital increase by its stockholders of approximately R\$ 400 million. This boost to capital was important in giving it an additional safety margin to support the growth in lending that had been shown until that time; proved to be crucial for facing the challenges presented by the financial turbulence of the second half of 2008; and also gives it an advantage in the more challenging context of 2009. Throughout the process of strong growth of lending in the last three years, it has maintained a good return on equity, and solid levels of credit quality and operational efficiency. The challenges produced by the financial crisis of late 2008 are not small, and BicBanco went through this period of accentuated stress, like various other banks, with a reduction of deposits and difficulty in renewing external lines, being forced to adopt a much more conservative stance in lending. Risks it now faces are from: possible effects of the expected economic slowdown, such as in lower liquidity since the end of last year; and on the quality of its lending portfolio, and results.

When we initially analyzed BicBanco as an investment opportunity, its market value was close to R\$ 500 million, representing approximately 30% of its book value on June 2008, and approximately 1.2 times its profit for the second quarter of 2008, annualized. Starting in September, and more accentuatedly in October of 2008, we know that the market began to value financial companies based on a scenario that included a high risk of insolvency. The market value of BicBanco reflected this scenario which, even if not totally impossible due to the tight moment that banks around the world were going through, seems to us improbable due to the structure of its balance sheet and all the measures taken by the Central Bank to increase the liquidity of the banking system. Also, the market's valuation of BicBanco, when measured by the multiples referred to above, was the most negative of all the small and medium-sized banks listed on the Bovespa. Attributing a low probability to the scenario of insolvency and even a meltdown of the Brazilian banking system, we judged that the risk-return ratio on the investment was attractive at the time.

The charts below show the relationship between return on equity (ROE) and Price/Book value ratio (P/B) for the universe of small and medium-sized Brazilian banks listed on the Bovespa, based on prices of October 24, 2008, when we began to analyze the shares of BicBanco as a potential investment, and based on more updated prices

(close of January 9, 2009). The banks are identified by the trading tickers of their preferred shares, and the size of each image on the chart represents each bank's respective market value on the date.

Chart 9 Market capitalization at October 24, 2008

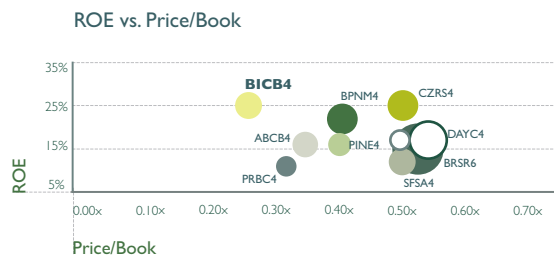
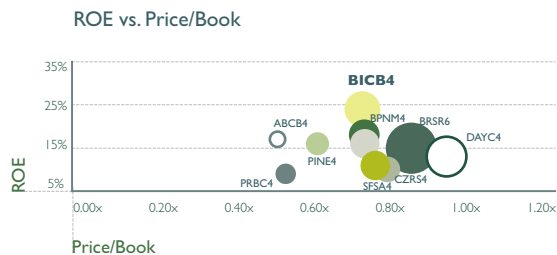


Chart 10 Market capitalization at January 9, 2009



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