

ALL THAT GLITTERS IS NOT GOLD

There is an old American maxim that says: “Why dig for gold – just make and sell shovels”

At the end of the nineteenth century, after gold was discovered in California, there was a mass migration to the region. Unlike other gold sites in the world, the metal was very close to the surface, and therefore easy to reach using simple tools and a good work ethos. In addition to the prior facts, given that the state had just effectively become a part of the United States, its laws and institutions were not yet established and gold belonged to whoever found it first. Indeed, this was the nearest one can get to a true “free market”.

The intensification of this kind of search brought a wave of miners searching for their dreams into the region, but only the first ones, luckier and more courageous would accumulate some wealth. Easily accessible gold was quickly exhausted, but the dream was not easily forgotten. New and more challenging areas, less abundant in the precious metal, continued to be searched.

While all the aforementioned events took place, peripheral products and services with a more limited supply became increasingly important. The prices of several basic items such as simple tools and water rose quickly. Some entrepreneurs took advantage of this opportunity to tackle the needs of the population that emerged in the region, leaving behind several businesses that continue to exist until today. Companies like Levi’s (selling jeans with high durability and pockets for tools) and Wells Fargo (financial services) were created during this period.

In Brazil, more specifically in Ouro Preto, we had our gold rush. The discovery of gold in that region also created a historical odyssey that ended in the most ironical way possible: miners starved to death with their pockets full of gold.

THE RUSH FOR LAND

The market for Real Estate developers’ IPOs was extremely heated between 2005 and the beginning of 2008. During this period, more than 20 companies went public in the stock-market, raising almost R\$20bn in primary offerings, with a growth expectation for the four biggest companies in the sector: Cyrela , Gafisa, PDG and MRV – which implied an increase of almost 5x in revenues, going from only R\$3.7bn in 2007 to almost R\$17bn in 2011. The high expectations, based on the emergence of “fiduciary alienation”, the fall in interest rates and the huge housing deficit in the country, seemed somewhat unrealistic to the more skeptical.

After four years, the optimists were proven to be correct. In fact, Brazil witnessed an explosive growth in the real estate market. It is expected that these four companies will produce over R\$20bn in revenues in 2011, higher than what was expected for the year back in 2007. Yet, not

one of these companies' stocks showed a better performance than the CDI from 27/07/2007 (the date of MRV's IPO, - the last company of this group to go public) until the end of 2011. MRV was the company with the best performance in the stock market during this period with an appreciation of 6% per annum, and the worst, Gafisa, lost 72% of its total value. In the case of the smaller, less capitalized companies, the numbers are even worse. Many of them were "left behind along the way", being bought at prices significantly lower than those at which they came to market.

This happened despite all the government intervention. The public sector acted strongly in the real-estate markets in the middle of the 2008/2009 crisis, creating incentives like the "Minha Casa, Minha Vida" program in 2009 (translated quite literally as "My House, My Life"). In fact, this program demonstrated how expectations many a time diverge from reality. The idea of a "guaranteed demand" generated in the first moment, hope of a low-risk investment. But reality showed itself to be quite different, with land inflation and construction costs affecting significantly the margin and return of a high proportion of projects under the program, not to mention the constant challenges to try to overcome CEF's ("Caixa Econômica Federal") bureaucracy.

Even though the real estate market did not generate value to most investors, the growth of investment in the sector was extremely important for the country, allowing increased access to new homes for many people and generating income to a vast number of workers.

BRAZIL-FROG TURNED INTO A PRINCE

The moment experienced by the Brazilian capital-markets over the last few years possesses some characteristics of a "gold rush". If, on one hand it attracts an excess of capital and generates a substantial rise of competition in some sectors (for instance, Real-Estate), on the other hand it creates big winners and contributes to form a generation of entrepreneurs who, in the past, were under-supplied with means to finance themselves.

Herring's case is emblematic on the winner's side. Until 2006 the company suffered with an excessive debt that did not allow necessary investments for the company to reposition itself. Herring was a company of R\$200-300mn in market value, repressed by lack of capital, which succeeded to finance itself through a public offering of shares after its migration to the "Novo Mercado" (translated literally as "New Market"). No other source of capital would have been possible. After investing these resources in the operation, the company was transformed into one of the most admired businesses in the country, and generated an enormous amount of value, recently reaching roughly R\$7bn in market value.

Economic growth, abundance of capital, good governance and strong institutions generate many opportunities, but good results are not available for everybody. In these moments of euphoria, capital is not allocated in an efficient way and tends to be used without much discretion.

Multinational corporations, with their big markets already stagnated, need to justify to their shareholders a more pro-active attitude for growth. Brazil, despite its structural problems, possesses rules and institutions that are clearer than its emerging-market peers. With an enormous consumer market, the country transformed itself naturally into an attractive target, and alongside this fact, BNDES and new private equity funds seem to have infinite sums of capital at their disposal right now.

Abundance of capital tends to reduce marginal returns and make the process of value creation more strenuous, even more so when a big competitive differential does not exist. Nevertheless, it is difficult to encounter analyst-projections which incorporate decreasing margins as a consequence of more arduous competition, which should eventually materialize in the long run. Not to mention that margins in Brazil are already some of the highest in the world in most sectors, and our products, the most expensive.

The miner's example has already taught us that it is not enough to run where everyone is going, utilizing the same tools. The pot of gold does not seem to be available to everyone, when they all go to the same place.

YEAR 2011 AND PERSPECTIVES

Despite Brazil's having "turned into a prince", we've advanced very little in terms of our rules and institutions over the last few years. Looked at from above, the bridge seems to be ready and secure, but its foundations are still fragile. The challenges for a high and sustainable growth, going forward, are still significant. What we saw in the last few years might have been caused largely by the Chinese-induced commodity boom.

The year of 2011 illustrates well this situation. We had a shortage of labor in almost every one of the economy's sectors (specially in the homebuilding segment), logistic difficulties, pressures on managed prices due to an increase in the IGP-M, among others. After two atypical years (2009-stagnation and 2010-very high growth), 2011 showed that our actual reality continues to be of moderate growth only. The high expectations in the beginning of last year led companies and consumers to invest in their operations and contract high levels of debt. This scenario of cost pressures and weaker than projected demand, added to the challenging environment in Europe and uncertainties related to economic growth in the USA and China led to lower than expected results for most companies in Brazil. Generally, the investors fled the most heterodox cases and reduced their risk appetite, rewarding stable companies with a strong competitive position and a high exposure to consumption in Brazil. For instance, Hering draws our attention, possessing today practically the same value as Abercrombie and Fitch.

The year that begins presents lower growth expectations and margins than the beginning of 2011. Moreover, the loosening of monetary policy and expansion of government spending may result in a significant acceleration in the second half of 2012. Considering also the fact that companies are more cautious in relation to their internal costs, this year's results tend to be better than last year, and may result in an upward revision of projected profits. Even in this case, the majority of shares related to the domestic market would continue negotiating with

significant premiums to what we consider reasonable. This follows mainly because we believe that important risks still exist, such as higher inflation in 2013, uncertainties related to Europe, and in the medium term, the effect of increased competition given the high amount of capital entering the country.

Our strategy for this year begins very similar to last year. Our main positions continue concentrated on big banks and credit card acquirer companies negotiating with a reasonable discount when compared to the local market. In sectors most exposed to competition, we have focused our attention on those companies that have already anticipated this trend and whose shares have already shown relevant corrections and started to present a good entry point. And finally, we still continue balancing some opportunities with good potential for return but with a slightly higher risk, with our cash position.