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PORTFOLIO HIGHLIGHTS

I. Duratex

Duratex is the leader in the market for wood panels, metal fittings and vitreous chinaware. After posting good results in 2010, it frustrated the market in the following year after facing difficulties. As a result, in late February 2012 the stock traded at R$9.60, down by 43% compared to the record high of R$16.90 on September 3rd, 2010.

The dismal performance of 2011 stemmed from conjuncture-related factors (cost pressures and weak demand). Competition turned fiercer in the wood division as competitors sought to increase market share in an effort to offset the weaker demand, which led to a drop in prices. In addition, the higher cost of resin, labor and wood put a drag on margins. As for Deca (the division of vitreous chinaware and metal fittings), sales volume was good but margins fell due to a rise in costs (especially labor and copper) and to a change in the company's product mix, with a vitreous chinaware-making plant acquired in the Northeast region. The margin for vitreous chinaware is lower than that for metal fittings, and the products from this new operation are aimed at the so-called C and D low-income brackets, with lower prices and margins. This acquisition bodes well for Deca because it commands roughly 40% of the market for vitreous chinaware and metal fittings, or almost 90% when we look at just the top two income brackets, a segment with no room for further growth.

Expectations for an improvement in the performance of the company in 2012 (greater demand due to cheaper credit, low unemployment rate and rising incomes) combined with a battered stock lured us into setting up a position in March 2012, given that we already liked the business as well as the increased alignment of interests between the officers and minority shareholders following the merger with Satipel in 2009. Two members of the board of directors are from the Seibel family, including Salo Seibel, the chairman and former CEO of Satipel for many years. He deeply knows the business of wood panels and is active in the company's day-to-day operations.

In line with our optimism for the year 2012, Duratex presented good results in the first half of the year, higher than expected by the market. Demand recovered in the wood segment, buoyed by government measures to spur consumption. Fixed costs were also diluted, allowing margins to expand. Back to Deca, the division kept benefiting from the good performance of the construction industry, operating near capacity. Also, we believe that the tax breaks announced by the government will help the company maintain a good performance in the second half of this year.

In the past 10 years, the market for panels grew three times as fast as the GDP growth and we expect this trend to continue. This market has been consolidating since 2000, and just three major producers lead the current cycle of output expansion (2011-2013). A 20% capacity increase is forecasted. In the previous cycle (2006-2010), nine producers invested towards expansion, raising industrial output by 80% (which sent prices tumbling). In 2012, output is stable compared to 2011, which vouches for certain price increases.

For 2013, as new capacity comes on line, we expect prices to stabilize.

The Deca and wood panel segments profited from the sharp growth enjoyed by the residential construction industry in the past few years. Between 2007 and 2011, the Bovespa-listed real estate developers grew on average 14.5% per year (by number of units launched). Considering a lag of about three years between launch and delivery and that Duratex products are used just in the final phase of construction, we still expect healthy growth in the coming years linked to the delivery of these units.

We are confident in this investment case, even considering that the stock has rallied since we started the position. Duratex is the market leader and a cash generator that is lightly leveraged (Net Debt / EBITDA = 1.4x), and it features competitive advantages such as strong brands and the fact that it is an integrated company. The combination of increased credit availability, lower interest rates and tax breaks for the furniture and construction industries should boost the company's sales.

II. Metalúrgica Gerdau

The Fund has invested in Metalúrgica Gerdau since its inception in September 2005. The fundamentals for investing are unchanged: (i) leader in the production of long steel in Brazil, a market with few competitors, (ii) low competition from imported products, (iii) favorable position in negotiations with suppliers, (iv) distribution / logistics widely established by the company, making up a barrier to the entry of new competitors, (v) competent managers, (vi) high exposure to infrastructure and construction industry, two sectors with excellent long-term prospects in our opinion, regardless of short-term macroeconomic movements.

The relationship between raw material suppliers and long steel producers is substantially different from that seen in the case of flat steel. Regarding the latter, a stable raw material (iron ore) favors the supplier, given the concentration on about four large producers worldwide. In the case of long steel, Gerdau buys from an extremely scattered scrap market.

Another advantage for the company is its distributor network, creating a barrier to the entry of new competitors. In addition, Brazil's strained logistics rarely allow imported products to leave the port of arrival.

2011 was a tough year for the steel industry, marked by the classic double-whammy of weak demand and pressure from raw material prices, coupled with an unfavorable exchange rate. The company's Ebitda margin fell from 16.5% in 2010 to 13% in 2011, reaching 10%-11% at the end of that year. Demand has improved in 2012, led mainly by the construction industry, lower cost pressures and a favorable exchange rate. The operations in the United States (35%-40% of sales in 1H12) have also recovered gradually.

The company, through its subsidiary Gerdau S.A., which leads the local market (42% market share), should benefit from the more than R$133 billion in infrastructure projects (ports, energy plants, railroads, pre-salt oil and more) slated for the next 20 years. Also, the per capita steel consumption in Brazil, at 140 Kg/inhabitant, is still 30% below the world average.

We chose to make our investment in Metalúrgica Gerdau, the parent of Gerdau S.A., because we understand that the 15% discount to the parent company does not make sense. Despite a history of Ebitda margin near 15-20%, we used more conservative premises in our model (13%), which still allows us to project an attractive upside potential for the stock. Moreover, we did not factor in the possibility of selling the company's mineral assets, which amount to nearly 2 billion tons of iron ore. Some analysts believe that these assets can reach as much as 20% of Gerdau's market value.

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