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INVESTMENT CASE – FLEURY

Fleury is a provider of diagnostic medical services (image and lab exams) through 200 care units and 29 hospitals. We have been following the company since its initial public offering in December 2009. From the IPO until mid-2012, the stock price rose 70% and from this point dropped over 20% within a few weeks, opening an interesting entry point. At that time, the market was too concerned with Fleury's decline in organic sales growth and the lower number of new jobs created in the country.

The Brazilian health sector has favorable long term perspectives. Job creation has risen significantly in the last 7 years, achieving a record 2.5 million net positions in 2010 and 1.2 million in 2012. Employees usually receive health plan benefits, which made the number of people covered by private plans grow 5.3% p.a. (2003-10) raising the coverage from 18% to 25% of the Brazilian population. Another important aspect is the shift of the Brazilian population pyramid towards a higher percentage of elderly people (ages over 60). Today they represent about 10% of the population and it is expected to reach 30% by 2050. Research shows that older people demands 3 times more medical exams when compared to middle-aged individuals.

In addition to favorable macro and social trends (e.g. higher employment, more private plans, aging population), we believe that better operational results will also come from investments in new care units made in 2011 that are now maturing (usually takes two years for units to reach revenue targets) and synergies from past acquisitions. In 2011, Fleury acquired the largest player in the state of Rio de Janeiro, Labs D'or, which should result in a better sales mix (Labs provides a

higher percentage of imaging exams) with higher margins. All considered, we believe the company can generate 10% growth in revenues (compared to 18.7% growth in 1Q12 vs. 1Q11) and higher EBITDA margins - from 18% to 20% or higher - in 2013.

The stock is down 15% this year (until end of April), following: (1) the announcement of record investments (US\$ 150Mn), mostly in the addition of units in the highly competitive São Paulo market; (2) three competitors (Hospital Einstein, Sírio e Libanês and Hospital do Coração) aggressive investment plans in diagnostic medical services; and (3) the sale of shares by some of the controlling shareholders, with more possibly to come.

Following the market reaction, the company has been holding meetings with investors and analysts to clarify the expansion plan. From the US\$ 150Mn announced, only part of it - US\$ 110Mn - will in fact be used for unit expansions covering 2013/2014, which does not differ much from the amount invested in 2011/2012 (US\$ 83Mn). The focus on the brand *Fleury* (concentrated in São Paulo) is justified by its higher margins and still pent-up demand, offsetting part of the concern with new competitors. Important to mention also that Fleury has been one of the few companies in the sector able to renegotiate prices to cover inflation costs.

Management is fully aware of the competitive challenges, but we can highlight that in 2012, when the diagnostic sector grew 7% and GDP expanded by only 0.9%, Fleury grew organic revenues by 12%. We believe the market has still room for other players and Fleury is taking the right steps to capture the growing

medical services demand with its recognized quality service.

Considering the many members of the holding company (mostly retired doctors), we see the sale of some of their positions as a natural consequence of liquidity needs, but with limited impact on the stock price.

We estimate the company is negotiating at a 30% discount to its fair value (based on conservative parameters), which we see as unjustified for a quality business, run by managers with large experience in a sector with positive long term trends.

AMAZON AND THE BRAZILIAN PUBLISHING MARKET

As investors in Saraiva and to better understand the publishing market competitive environment, we have recently talked to one of the company's competitors about the likely impact of the arrival of Amazon in Brazil.

Printed books: in most countries, cover prices are set by publishers, with retailers applying whichever discount they wish. That arrangement has given Amazon a significant advantage when compared to bookstores, as it offers bestselling books with an average discount of 40% in the US. In only a few countries, as France and Germany, the sale price is fixed.

In Brazil, sale prices will likely drop in the next few years as Amazon is expected to enter this market in 2013 (the company has been selling only digital books). Even though the attention is turned to e-books, price wars involving the sale of printed copies are the ones to worry about as they may be stronger and more damaging to competitors.

Big online retailers buy books from publishers with around 50% discount from their cover price. However, especially in the case of bestsellers, store discounts are so aggressive that profit margins are virtually nonexistent. A good example is what happened with the *Da Vinci Code*. Sold by R\$40 in stores it could be bought for R\$21 online, even though retailers had paid R\$20 for a copy. Retailers were always blaming one another,

claiming they were not the first to offer a price reduction.

The publisher we spoke to managed to get a verbal agreement with the biggest online retailers (Saraiva and B2W), limiting the possible discount of a book's cover price to 25%. Under these conditions, the *Da Vinci Code* could not be sold online for less than R\$30. The company also implemented a system to detect who is the first to reduce prices and if the 25% limit is breached. This way, it can have a certain control over the actual discount.

However, with Amazon entering the market, we believe discounts will become harder to control. As we said before, the agreement with online retailers has been mainly verbal with no written guarantees. Besides, Amazon is entitled to sell books for whichever price it wants since it has already bought and paid for them. It is extremely unlikely for Amazon to accept any interference from publishers on this matter.

Hence, we see Amazon's entry in this market as a threat to the maintenance of prices at current levels. Nonetheless, we still believe physical stores will play an important part in the purchase experience and that sales area is likely to grow in the country over the next years. Education and employment levels in Brazil have never been so high and they are expected to remain high for

years to come. Competition is growing but so is the consumer market.

Summing up, even though book prices may fall, we expect sales to grow over the next years and physical stores to remain profitable.

E-books: when Amazon launched Kindle in the US five years ago, the average price for a book was US\$25 and the company usually paid half of that price for a digital version. Still, even at a US\$12.50 average cost, Amazon would sell them at a loss for US\$9.90. At first, publishers did not mind the practice, but once Amazon started to eliminate most of its competitors, there were concerns that it would be able to set prices on its own. But, this scenario didn't unfold, and the reason was Apple. When Apple entered the market, it established a new kind of relationship with publishers, based on so called *Agency Contracts*. Under this agreement, publishers are responsible for setting e-books' retail prices, while Apple (the agent) is entitled to a 30% share of the value. Prices were not allowed to go above US\$15 and publishers were required to give Apple the same conditions given to other retailers. That allowed publishers to force Amazon to offer similar terms and, as result, retail prices increased from US\$9.90 to around US\$13.00.

In the beginning of 2012, the US Department of Justice, possibly influenced by Amazon, filed a lawsuit against Apple and five publishers accusing them of forming a cartel and colluding to increase e-books prices. Three of the publishers have already agreed to settle with the Department of Justice, allowing Amazon to restart offering

discounts on books published by them. In the EU, where a similar lawsuit was filed in 2011, Apple and four other publishers reached an agreement in December 2012. They will allow retailers to reduce the price of e-books, offering discounts for a period of two years. They will also lift for five years the contract clause forbidding publishers to sell e-books for a lower price than Apple.

In Brazil, Amazon started to approach local publishers in 2009 but they were reluctant to sign an agreement with the retailer, given Amazon aggressive discount policy, which could harm the operations of Brazilian players, similar to what happened in the US. Hence, they started to put in place a defense strategy where seven publishers (Sextante, Rocco, Objetiva, Record, Novo Conceito, LP&M and Planeta with 45% market share of fiction and non-fiction segments) established a company called Digital Books Distributor (DBD) in 2010.

In the end of that same year, Saraiva launched its digital store and the agreement with publishers also followed the *Agency* model. Publishers would sell e-books at a 35% discount to Saraiva, which in turn could offer up to 20% discount of that suggested retail price. Moreover, e-books could not be sold for more than 70% of the price of printed copies. Following Saraiva, other retailers have also launched their online stores and signed agreements with DBD with similar conditions. Amazon agreed to these terms in 2012, but was limited to 5% discount to publishers' suggested retail price, instead of 20%. The discount reduction

was then established for all retailers, as standard clauses are similar across contracts.

The main local players in the Brazilian e-books market are Saraiva, B2W, Nova.com and Livraria Cultura. They are joined by the following global players: Amazon, Apple and Google.

As we can see, Brazilian publishers are today more protected on their e-books sales than on printed copies. And in order to increase the share

of e-books on total book sales (currently 0.5%), e-reader devices must become more accessible. Some competition has already started, with Livraria Cultura recently launching Kobo for R\$399 and Kindle available for sale at a suggested price of R\$299. For most Brazilians though, they are still very expensive. But we have reasons to expect that further technology developments and new entrants will reduce product prices and allow a substantial increase in e-books sales.

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