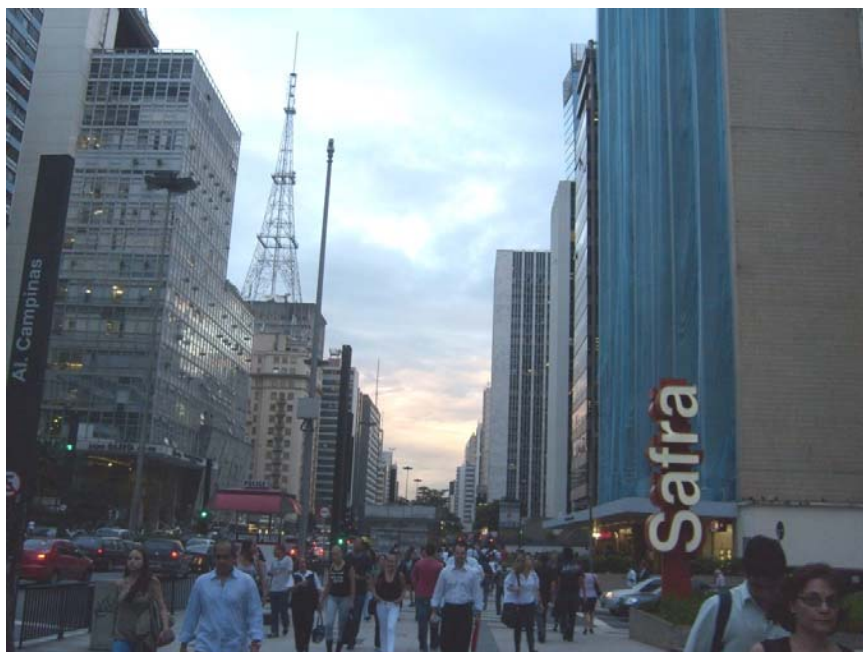


Classical Insights -- Emerging Markets

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Emerging Markets Bullet Points February 5, 2009



Avenida Paulista, Sao Paulo

I was in Sao Paulo earlier this week and the place looked better than I've ever seen it: clean air, clean streets, new construction, new-ish cars, warm weather and almost no one living on the streets. I met with five real estate developers, two banks and a few other firms. The homebuilders were the highlight of the trip: the stocks are down so much that you could just *liquidate* the companies and come out way ahead. The homebuilders also trade cheap on a 2009 EPS basis.

Brazilian homebuilders

Name	ticker	Share Price	52-wk hi	% down from 52-wk hi	Liquidation value/share	% upside to liquidation	Our 2009 EPS	Our 2009 P/E
Agra	AGIN3 BS	1.72	11.35	-85%	3.36	95%		
Camargo Correa	CCIM3 BS	2.37	10.94	-78%	4.60	94%	0.85	2.8
JHSF Particip.	JHSF3 BS	1.77	9.57	-82%	3.76	112%		
Tecnisa	TCSA3 BS	3.08	9.9	-69%	8.60	179%	1.01	3.1
MRV	MRVE3 BS	11.59	45.48	-75%	16.50	42%	2.43	4.8

Sources: Bloomberg, company guidance, Churchill Research estimates

Top points:

Homebuilders' earnings are destined to rise sharply in 2009 -- even if they don't sell one more house or apartment. This improvement will be a function of partial-completion accounting. A developer "sells" an apartment when somebody writes a check for it. But the sale only shows up as "revenue" on the income statement in stages, as the construction process moves along. Most of the companies I met have huge profit backlogs -- i.e. earnings that are guaranteed to move to the income statement (almost always within the next 30 months).

One would *think* these profit backlogs would be reflected in the current share prices of the homebuilders, but some of the managements I spoke with said investors generally don't

understand homebuilder accounting in Brazil. Thus, the positive news flow on earnings in 2009 could come as a positive surprise to many.

You could just liquidate every one of these companies and come out ahead. And most are very liquid. Here is the calculation the companies do in determining their value:

- + Cash
- + Value of landholdings if sold today
- + Profits on units already sold (but not totally finished)
- + Value of inventory (units not yet sold)
- Cost to complete projects under construction
- Debt
- = Liquidation value.

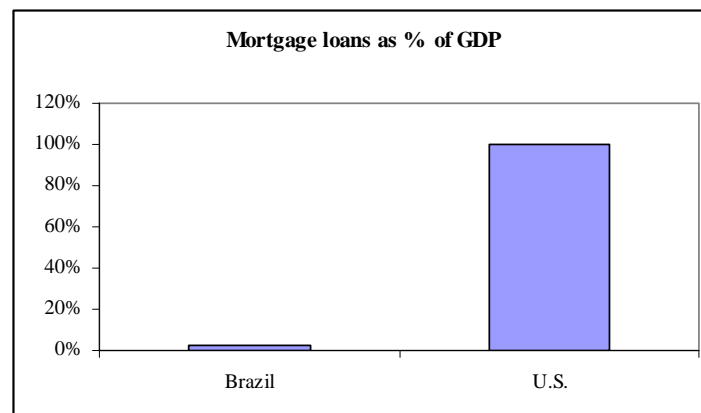
In most cases, you'd get a 50% increase on the stock just from doing this (at least in theory – you'd have to pay layoff costs, etc.)

The entry-level segment is the place to be right now, because subsidies offered by government agencies for entry-level home mortgages are keeping activity strong in this segment. Management at MRV Engenharia, which builds only entry-level houses and apartments, said business *sharply improved* in January. MRV was the only company to say that. Government subsidies now make it possible for a lower-income person to get a 20-year mortgage at 8% per year. That would have been unheard of five years ago.

The main reason developer stocks imploded late last year was that apartment and home sales fell off a cliff in October and November (down 30-50% from foregoing levels in many cases). Buyer confidence plunged with the falling Bovespa and the weakness in the real. That said, the sales slowdown doesn't drastically impact the true economic value of the homebuilders. As noted above, the value of the firms lies in their tangible assets, cash, and the bright long-term prospects for the industry. Many of the homebuilding stocks can double or triple when the pace of apartment and home sales picks up again.

The Brazilian mortgage market is really in its infancy:

- The mortgage market in Brazil has 1/40th the depth of the U.S. mortgage market. Mortgages in Brazil are equal to 2.4% of GDP. In Mexico the figure is 13% and in the U.S. it's 100%.



- The number of mortgages outstanding today in Brazil is the same as in 1980. Brazil's mortgage industry has been stagnant for three decades;
- Four years ago you couldn't get a five-year mortgage. Now 25-year mortgages are readily available. As terms lengthened over the past few years, monthly installments fell by 50% for the same size loan.

Two big legal changes in 2004 made housing development a much more viable business:

- a) Bankruptcy law was changed so that developers could repossess houses and apartments directly from parties that default. (Previously they had to go through banks, which was a big hassle.)
- b) Safeguards for home buyers were improved. Beginning in 2004, every real estate project was set up as a separate legal entity. Thus, if a developer were to go bankrupt, the buyer would not be hurt.

These two changes made developers more willing to start new projects and buyers more willing to buy them. In step with these changes, there was an explosion in new real-estate lending.

Brazilian developers have lived through the craziest economic environments known to man: 80% monthly inflation, step-function devaluations, total cessation of all bank credit. They've seen it all. Most are conservatively run as a result (although AGRA got into trouble and had to do a massively dilutive equity offering). Most developers ASSUME bad things will happen and structure their balance sheets accordingly. Most have low debt. In fact, it's fair to say that the entire residential housing industry (and much of the banking system) is structured around the expectation that a credit implosion could come at any time. Apartments here are virtually all pre-sold. The developers often acquire land not with cash, but with the promise of cash-flow participation in the project.

There are a variety of risks (mostly near-term) facing the homebuilding sector:

- a) Unemployment is rising. Fear of job loss has been a major factor depressing sales. Hopefully, layoffs will ease in coming months. That said, Brazil is to some extent hostage to exogenous developments;
- b) Homebuilders tend to sell their receivables upon completion of any given project – and the discount on the receivables has risen as creditworthiness of buyers has weakened;
- c) The homebuilders may record losses on land writedowns. Land prices in Sao Paulo doubled from 2005-2007. They are down 15% from the peak and could fall more. Most homebuilders have some cushion here, though, because they bought much of their land before prices ran up. Also, land is still inexpensive relative to other global capitals;
- d) It's cheaper to rent than buy for the middle- and upper-income segments.

Here are a few quotes from managements:

- “This global turmoil doesn't need to get better in order for Brazilian home sales to rebound -- it just needs to stop getting worse.”
- “There were too many launches in the high-income segment.”
- “When the market was hot in 2007 and all the homebuilders were doing IPOs, we felt we had to do one too in order to remain competitive.” (I heard that one twice.)
- “I bet some of these homebuilders wish they'd never IPO'd.”
- “We don't know if we'll have credit available here in Brazil.”
- “People don't buy land here for investment. They buy for a place to live. That's why prices aren't collapsing.”
- “This slowdown is just temporary. There is huge pent-up demand for housing in Brazil. Credit for end consumers is still there. The terms didn't get shorter and the interest rates didn't go up. As soon as the first round of layoffs is complete and consumers regain confidence, things will get better.”

We'll be adding MRV and Tecnisa to the EM portfolio (and may add Camargo later). *Turning to MRV:*

MRVE3 BS -- 11.59

Sales and earnings

	2007	2008e	2009e	2010e
Launches (BRL mln)	1200	2533	2250	2750
Pre-sales		1500	1750	2400
Sales (BRL mln)	384	1103	1600	1840
Sales growth		187%	45%	15%
EPS	0.15	1.70	2.43	2.96
Cash flow	0.16	1.73	2.47	3.01
FCF	0.06	1.36	2.03	2.49
Cons. EPS		1.91	2.45	2.49

Target price & valuation data

Our 12-mo. target	22.17	(based on 7.5x 2010 EPS)	
Upside to target	91%		
Mkt cap (BRL mln)	1,576	EV (BRL mln)	1,653
P/sales (2009e)	0.99	EV/sales (2009e)	1.03
P/E (2008e)	6.8	EV/EBITDA (2008e)	6.2
P/E (2009e)	4.8	EV/EBITDA (2009e)	3.8
P/E (2010e)	3.9	EV/EBITDA (2010e)	3.3

cash flow defined simply as EPS + depreciation. FCF defined as cash flow - capex.

The most upbeat homebuilder I met with was MRV Engenharia, which makes low-end, entry-level homes and apartments. The average selling price of one of its units is about US\$54,000, and some sell for less than \$35,000. MRVE is on track to earn 1.70 reals/share in 2008, which puts it on a trailing P/E of 6.8x. But earnings will rise sharply in 2009, just based on completion of pre-sold units. MRVE is trading at 4.8x our 2009 EPS and 3.9x our 2010 EPS (which assumes a gradual return to economic normalcy but nothing spectacular).

MRVE was founded in 1979 and has focused on entry-level homes for its entire 30 years of operation. It operates in 63 cities. MRVE is vertically integrated (it's both a developer AND a construction company). This vertical integration helps MRVE control costs and keep more margin. MRVE did an IPO in late 2007. Management owns 10% of the shares.

MRVE's buildings are simple: Many structures are four floors high or less and thus don't have elevators. They are made of concrete block (and they look fine).

At 11.59 reals/share, MRVE is trading below its book value of 12.50/share – and its book value is below its NAV (due to profit backlog). We figure NAV is about 16 reals/share.

Sales fell off a cliff in October (down 30-35%). November was a little worse, December a little better, *but January showed a sharp bounceback*. The key factor here is that MRVE's customers benefit from well-funded Federal mortgage subsidies for low-income buyers. These subsidies allows for monthly payments below \$200 – and even below \$100 -- for many homes.

Management said it will be cutting its launches this year to between 2 and 2.5 billion reals (down from 2.53 billion in 2008). We assume pre-sales rise to 1.75 billion in 2009 (from 1.5 billion), chiefly because the firm will have a lot more inventory to sell. The following year, 2010, is a bit of a wildcard but we assume business continues to improve (i.e. pre-sales rise to 2.4 billion reals).

Gross margins have been stable over the years at around 40-41%. We don't see why that needs to change. (Raw material costs have declined for builders, and interest rates have declined for low-income buyers.)

MRVE, like nearly all homebuilders, benefits from a low tax rate – as low as 7%. However, taxes are applied on sales (not revenues) so published tax rates will show up as being higher than 7% as long as sales are growing (because sales precede revenues by 1-2 years).

MRVE has a slight net debt position (about 150 million reals).

We are valuing MRVE at 7.5x our 2010 EPS estimate of 2.96 reals/share, or 22.17 reals. That would imply 91% upside from the current share price.

TCSA3 BS -- 3.08

Sales and earnings

	2007	2008e	2009e	2010e
Launches (BRL mln)	1000	1500	1500	1700
Pre-sales	472	1000	1000	1400
Sales (BRL mln)	338	505	1000	1100
Sales growth		49%	98%	10%
EPS	0.21	0.38	1.01	1.38
Cash flow	0.21	0.40	1.03	1.41
FCF	0.19	0.35	0.96	1.32
Cons. EPS		0.89	1.74	2.28

Target price & valuation data

Our 12-mo. target	9.66	(based on 7x 2010 EPS)
Upside to target	214%	
Mkt cap (BRL mln)	448	EV (BRL mln) 578
P/sales (2009e)	0.45	EV/sales (2009e) 0.58
P/E (2008e)	8.2	EV/EBITDA (2008e) 8.2
P/E (2009e)	3.1	EV/EBITDA (2009e) 2.4
P/E (2010e)	2.2	EV/EBITDA (2010e) 2.2

cash flow defined simply as EPS + depreciation. FCF defined as cash flow - capex.

Tecnisa is another attractive homebuilder and it probably has greater upside potential than MRV (given its much-lower EV/sales ratio). Like MRV, Tecnisa is vertically integrated -- it does its own construction & development and much of its own sales. Interestingly, Tecnisa is the market leader in *internet* sales (25% of total sales). Like MRV, Tecnisa has been in business 31 years. That long history is very helpful during these tougher times.

Tecnisa is more up-market than MRV (its average selling price is US\$110,000) – *but it has been moving down-market quickly*. Its average selling price has come down from \$180,000 three years ago. That is probably a function of the availability of government subsidies for low-income mortgages, as well as tightening terms for higher-end mortgages.

Tecnisa's revenues should double in 2009, as the firm finishes up projects launched in 2007 and 2008. We are assuming flat pre-sales for 2009, which should be a fairly low hurdle given that launches rose 50% in 2008. The strength of pre-sales in 2009 will determine launches, and thus earnings, in 2010 and 2011.

Tecnisa should have an 8%+ yield in 2009, and potentially higher in 2010. The stock is listed on the Bovespa's Novo Mercado, where one of the requirements is that a firm pay out 25% of earnings in dividends. So, if Tecnisa earns 1.01 this year, its dividend would be at least 0.25 reais/share.

The risks with Tecnisa are a) writedown of landholdings (which management mentioned as a risk), b) serious lack of clarity on when middle-market home and apartment sales will rebound.

Still, we think these shares make sense just on liquidation value alone. The firm's book value is 800 million reais, to which one would need to add profit backlog, profit to come from projects under construction, and land appreciation. So the NAV could be closer to 1.4 billion reais – 2.3x the enterprise value.

CCIM3 BS -- 2.37

Sales and earnings

	2007	2008e	2009e	2010e
Launches (BRL mln)		1000	1000	1400
Pre-sales		1100	900	900
Sales (BRL mln)	230	597	686	755
Sales growth		159%	15%	10%
EPS	0.05	1.00	0.85	0.95
Cash flow	0.07	1.08	0.94	1.06
FCF	(0.07)	0.94	0.78	0.86
Cons. EPS		1.11	1.47	2.74

Target price & valuation data

Our 12-mo. target	5.71	(based on 6x 2010 EPS)
Upside to target	141%	
Mkt cap (BRL mln)	259	EV (BRL mln) 238
P/sales (2009e)	0.38	EV/sales (2009e) 0.35
P/E (2008e)	2.4	EV/EBITDA (2008e) 2.1
P/E (2009e)	2.8	EV/EBITDA (2009e) 2.0
P/E (2010e)	2.5	EV/EBITDA (2010e) 1.8

cash flow defined simply as EPS + depreciation. FCF defined as cash flow - capex.

Camargo Correa Desenvolvimento builds both residential and commercial buildings (including office towers) -- and it's quite cheap on an EV/sales basis (0.34x). Like Tecnisa, it has been moving aggressively down-scale the past two years. Its average residential selling price last year was \$78,000 – down nearly 50% from two years earlier. In fact, some of its houses sell for as little as \$26,000. CCDI has its own construction company for low-end residential, but tends to partner with other construction firms for bigger ventures. Earnings in 2008 benefited from a one-off gain on sale of an office-tower.

CCDI has several big projects in the works:

- a) Caieiras – CCDI has purchased a gigantic piece of land in the town of Caieiras, 12 miles north of Sao Paulo. The parcel is the size of 700 football fields. A train runs adjacent to the land, and the commute time to downtown Sao Paulo is just 45 minutes. CCDI's plan is to double the size of Caieiras, via the construction of up to 20,000 lower-income units, with price tags below \$87,000.
- b) Avenida Paulista – CCDI has a 50% stake in what it terms “the most famous piece of land in Brazil,” located on Avenida Paulista between Pamplona and Campista. There is currently a parking lot on the site. CCDI is planning to develop a shopping center/office building there, in conjunction with Cyrela, a leading Brazilian developer. Heavy capex doesn't start for 18-24 months, though.
- c) Via Olimpia (Sao Paulo) – CCDI plans a \$400 million mixed use project on this land. It's currently in the design/approval stage.

CCDI is harder to model than MRV or Tecnisa. The firm's revenue is lumpier due to the office-building component, and its presence in several different market segments makes forecasting margins difficult. Our forecasts are well below consensus, as we expect sales and launches to slow considerably in 2009 due to weakness in higher-end residential and (probably) commercial. Plus, there is the risk of land-bank writedowns.

That said, CCDI is interesting because it is cheap on a price/NAV basis and has a fairly big operation for its market cap. Also, its flagship projects look interesting. We're going to value it at 6x expected 2010 EPS. The discount to Tecnisa and MRV reflects the greater difficulty in modeling the firm.

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