

Classical Insights -- Emerging Markets

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Emerging Market Bullet Points March 31, 2009

Brazilian homebuilders

Name	ticker	Share Price	52-wk high	% down from 52-wk high	EPS estimates		P/E	
					2009e	2010e	2009e	2010e
Tecnisa	TCSA3 BS	3.44	9.90	-65%	0.99	1.59	3.5	2.2
MRV	MRVE3 BS	13.71	45.48	-70%	2.35	2.98	5.8	4.6

Sources: Bloomberg, Churchill Research estimates

Business is improving for Brazilian homebuilders -- and the stocks remain quite cheap:

* MRV Engenharia just raised its guidance for 2009 pre-sales, and the firm continues to sell nearly everything it makes prior to completion. (Only 2% of its inventory is finished units.)

* Tecnisa has already sold 41% of its Q4 2008 launches -- and these are *middle-income units*, which don't qualify for government mortgage subsidies.

* Homebuilders' earnings are destined to rise sharply in 2009 -- even if they don't sell one more house or apartment. This is due to 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 (and most of it shows up at the end).

* 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. Brazil is bouncing back fairly quickly from the credit crisis because it's still largely a cash economy.

* You could just liquidate these companies and come out ahead. Tecnisa's NAV is 1.2 billion reals, but its enterprise value is 640 million reals. In MRV's case, the discount to NAV is smaller (roughly 25%) because the low-end homes in which it specializes have become the hot part of the market in the wake of big new government mortgage subsidy programs.

Top risks to homebuilders would be: a) another leg down in the global financial crisis (which would have a knock-on effect in Brazil), b) a crash in commodity prices, or c) a decline in margins from increased competition.

Turning to MRV ...

MRVE3 BS -- 13.71

Sales and earnings

	2008	2009e	2010e	2011e
Launches (BRL mln)	2533	2250	2750	2750
Pre-sales	1544	1900	2400	2400
Sales (BRL mln)	1111	1600	2000	2400
Sales growth		44%	25%	20%
EPS	1.70	2.35	2.98	3.78
Cash flow	1.78	2.43	3.06	3.86
FCF	1.41	1.99	2.55	3.34
Cons. EPS	1.91	2.29	2.36	2.61

Target price & valuation data

Our 12-mo. target	23.85	(based on 8x 2010 EPS)	
Upside to target	74%		
Mkt cap (BRL mln)	1,865	EV (BRL mln)	2,145
P/sales (2009e)	1.17	EV/sales (2009e)	1.34
P/E (2008)	8.1	EV/EBITDA (2008)	8.1
P/E (2009e)	5.8	EV/EBITDA (2009e)	5.2
P/E (2010e)	4.6	EV/EBITDA (2010e)	4.1

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

MRV Engenharia, Brazil's leading maker of low-end homes, raised its guidance for 2009 pre-sales during its recent Q4 conference call. MRVE3 stands to benefit directly from a recently-announced increase in government subsidies for lower-end mortgage borrowers. We are tweaking our EPS estimates slightly for 2009 and 2010 and also introducing a new estimate for 2011. MRVE is trading at 5.8x our new 2009 EPS and 4.6x our 2010 EPS. Here are the estimate changes:

	was	is
2009e	2.43	2.35
2010e	2.96	2.98
2011e	--	3.78

Source: Churchill Research estimates

The new target of 23.85 reals/share (was 22.17) is based on an 8x multiple to expected 2010 earnings (was 7.5x). The increased P/E multiple reflects the improving outlook for low-end home sales and our expectation that 2011 will be a good year. Our EPS estimates aren't rising, though, because we've reduced our gross-margin estimates a tad in the wake of new accounting rules. Also, we're now assuming 25 million reals/year in land writedowns for both 2009 and 2010.

Earnings in Q4 2008 were 0.37 reals/share, below our forecast of 0.43 reals/share. Much of the difference is due to introduction of new accounting rules for the sector in Q4, which negatively impacted numerous line items, particularly gross margin.

However management recently said its pre-existing 2009 guidance for pre-sales (1.6 to 2 billion reals) is now low, because the government loan-subsidy program is likely to boost sales. We are thus raising our estimate for 2009 pre-sales to 1.9 billion reals (was 1.7 billion). Pre-sales in Q4 2008 were weak-ish (298 million reals, or about 1.2 billion annualized). Business is stronger now than it was three months ago (management said pre-sales recovered sharply in January).

Our model assumes flat gross margins through 2011 (at Q4 2008's level of 38.5%). Management said it expects flat EBITDA margins this year, and our gross margin estimate is informed by that forecast. Conceptually, operating margins might be able to rise a bit due to economies of scale at the SG&A level (as rising pre-sales turn into rising sales).

Our forecast for rising revenues and earnings may seem ambitious, but for Brazilian homebuilders *today's pre-sales are tomorrow's sales*. That's how accounting works in this sector. The delay between pre-sales and sales can be 6-24 months. So, if MRV pre-sells 1.9 billion reals this year (no reason to think they can't) it should be able to post 2 billion in sales in 2010.

Turning to Tecnisa ...

TCSA3 BS -- 3.44

Sales and earnings

	2008	2009e	2010e	2011e
Launches (BRL mln)	1500	1600	1900	1900
Pre-sales	1015	1300	1600	1600
Sales (BRL mln)	494	1000	1350	1600
Sales growth		103%	35%	19%
EPS	0.52	0.99	1.59	2.03
Cash flow	0.54	1.01	1.62	2.07
FCF	0.50	0.95	1.53	1.98
Cons. EPS		1.66	2.28	1.48

Target price & valuation data

Our 12-mo. Target	11.12	(based on 7x 2010 EPS)
Upside to target	223%	
Mkt cap (BRL mln)	500	EV (BRL mln) 639
P/sales (2009e)	0.50	EV/sales (2009e) 0.64
P/E (2008)	6.7	EV/EBITDA (2008e) 14.8
P/E (2009e)	3.5	EV/EBITDA (2009e) 3.5
P/E (2010e)	2.2	EV/EBITDA (2010e) 2.3

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

Tecnisa management was surprisingly upbeat on its Q4 conference call last week, saying 41% of its Q4 2008 launches have already been sold. Of the seven projects it launched in Q4, six are meeting or beating expectations. That's pretty impressive given that TCSA concentrates on mid-range units. Low-end units constitute only about 10% of the firm's inventory, but management may introduce more of these to take advantage of the government's new mortgage subsidy program.

We are raising our 2009 pre-sales forecast to 1.2 billion reals (was 1.0 billion) based on the good start to the year. We're also raising our 2010 pre-sales forecast to 1.5 billion (was 1.4 billion).

Our *revenue* forecast for 2009 remains unchanged at 1.0 billion, but our forecast for 2010 revenues rises to 1.35 billion (was 1.1 billion), chiefly as a function of higher expected 2009 pre-sales.

Our new EPS estimates are as follows:

Changes to Tecnisa EPS estimates		
	was	Is
2009e	1.01	0.99
2010e	1.38	1.59
2011e	--	2.03

The 2009 forecast falls slightly due to the impact of new accounting rules and our expectation that TCSA will take land writedowns of 30 million reals. These negatives are partially offset by a slightly higher gross margin forecast (36%, up from 35%) and an increase in our expectation of net financial gain (i.e. interest on down payments from customers).

Pre-sales slightly exceeded our forecast in Q4 (259 million reals). It's not much of a stretch to get from the Q4 annualized rate (1.04 billion reals) to our 2009 forecast for pre-sales (1.2 billion).

Revenues should more than double this year (to 1 billion reals), in the wake of sharply-higher pre-sales in 2008. One of the benefits of higher revenues this year will be improvement in the SG&A margin. TCSA is vertically integrated, so it has been paying salaries on a beefed-up level of internal staff for more than a year – yet only now will it start to see sharply-increased revenues on its income statement. Thus, we expect SG&A as a percentage of sales to fall to 18% in 2009, from 27% in 2008. That will be a key driving factor in pushing earnings upward to 0.99 reals/share in 2009, from 0.52/share in 2008.

For 2010, earnings can rise sharply again, due to a further 35% increase in revenues and further reduction in SG&A (to 15.6% of sales).

Bottom line: TCSA is much cheaper than MRV on a variety of measures: price/sales, EV/sales, P/E and price/book. The risk with TCSA is that it sells higher-priced units, and hence would appear to be more vulnerable to economic weakness. However, that's not proving to be a problem at the moment. TCSA is selling its mid-range units just fine. If this trend continues, TCSA shares could really move. This was a 10-real stock less than a year ago – and it was a 15-real stock 20 months ago. Our target of 11.12 reals/share would could be met fairly readily if the firm gets close to our 2010 EPS estimate.

Turning to Arcosanti ...

On Friday I visited Arcosanti, the futuristic (for its time) brainchild of Italian architect/philosopher Paolo Soleri. Located north of Phoenix, Arcosanti is looking a bit down at the heels these days – *but the principles that Soleri put forth are being adopted by emerging-market homebuilders all over the world.* The tour confirmed for me (again) that EM homebuilders are showing the way when it comes to creating new spatial arrangements for human living. Soleri coined the term “arcology” to connote a merger of architecture and ecology. He envisioned huge, city-like arcologies that would house thousands of people in a highly energy-efficient way. Residents would work and shop right where they lived. Soleri (who is still alive) detests suburbs, believing them to be alienating, depressing and wasteful.

As I toured Arcosanti I recognized many of the elements I had seen in three of the EM developers with whom I’ve met over the past three months, JHSF Participacoes, Bakrieland Development and CC Land. All three mix residential, office and commercial spaces in their projects – and they do it in *scale*.

Three Arcosanti-esque developers

JHSF Participacoes	JHSF3 BS	Brazil
Bakrieland Dev'p	ELTY IJ	Indonesia
CC Land	1224 HK	China

What Soleri couldn’t fully achieve at Arcosanti, these developers have done in real life (or almost, anyway). Soleri visualized Arcosanti housing 5,000 people, but today it houses just 50-100. The complex is supported largely by the sale of Soleri windbells, which the residents make on site. By contrast, EM developers such as those noted above are creating mixed-use projects that in some cases really do house thousands of people – just as Soleri hoped for.

However, there is one key difference between Arcosanti and these developers’ projects: Arcosanti was envisaged as a self-contained *culture*, as well. Residents are meant to (and do) live somewhat communally. There is a common cafeteria where many of the residents eat. I had dinner there. There are regular meetings to discuss community affairs, and there are plenty of parties as well. But the recession may soon force a change on the Arcosanti ethos: Windbell sales are down, and there is a debate among residents as to whether to rent out space to outsiders, who would live at Arcosanti but work elsewhere and not necessarily be part of the “family.”

This gets to the core of the issue: Is it even possible to sustain a consciously-organized life/work community on any kind of scale in a global, wired economy? From a philosophical standpoint, Soleri’s vision for Arcosanti closely mirrors Plato’s and Heidegger’s conception of the ideal city: Work and spirit are unified and all citizens worship the same god (literally or figuratively). It’s tough to achieve that now, for a variety of reasons. Ironically, the closest approximations might be sprouting up from the *work* side of the equation. For instance, Googleplex, outside of San Jose, sprawls over 26 acres and includes a gym, laundry rooms, two swimming pools, a volleyball court and 11 cafeterias. It would be a fairly small change to include some condominiums on site as well. If that were to occur, Googleplex would be getting close to the Soleri vision.

Would Soleri be disturbed by the notion of a capitalist enterprise being the organizing force behind an expanded (with condos) Googleplex? I don’t know. It would disturb *me*, actually, since there would be a certain risk of fascism in the arrangement. Yet on this point, Soleri might prove flexible: He was born in 1920 and thus came of age in Italy in the 1930s, under Mussolini. He tells stories of riding around Italy on his bike in the ‘30s carrying far-out architectural drawings. The cops would stop him and he’d have to explain his crazy blueprints. There is a certain risk of fascism within the Arcosanti model itself, I think. The whole point is to pack people in to small spaces, leaving the surrounding land open. But what if people don’t want to be packed in to small spaces? What if they want McMansions? What then?

Given the high value we place on personal freedom, any movement toward more communal living arrangements is almost sure to be driven by people who find them either more fulfilling or

cheaper. On either ground, we could easily see greater embrace of Arcosanti-esque living arrangements in coming years. In fact, one would have to expect it.

There has also been a subtle shift in thinking on ethical philosophy in recent years that is likely to encourage more experiments in communal living: The “veneer theory” of morals has been largely discredited. This theory holds that people are, at root, selfish and evil, and that only acculturation makes them moral. This view held sway for a good part of the 20th Century and played a role in motivating people to move to the suburbs. (Fewer strangers means fewer crazy evil people.) But veneer theory has been largely discredited in recent years, in part due to the experiments with apes performed by Dutch primatologist Franz de Waal. If people fear the intentions of strangers less, they will likely be more open to experimenting more with communal living arrangements.

Bottom line: Mixed-use real estate developments are likely to continue to increase in appeal in coming years, and a number of emerging-market developers are well-positioned to take on more of these projects.

The Classical Insights EM portfolio holds MRV, Tecnisa and Bakrieland.

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