

FCL*Capital*

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Banking on a new financial order

Few business activities inspire so much excitement, anger, frustration and envy as investment banking. With this reality in mind, the focus of this letter will be to briefly explore the state of investment banking in the world and Latin America and discuss the reasons behind our investment in BTG Pactual.

Since the ancient world, merchants have used a separate institution to trade currencies from one city to another, to store their excess savings, to facilitate exchanges and payments, and above all, to intermediate savers and those who want or need to incur in debt. This institution is what we call a bank.

From the middle ages, the more specific figure of the investment banker started to develop, financing business ventures, expansions, giving credit and risking their own - to this day called "proprietary" capital. Some say it started during the great navigations, period when investment-banking activity really saw the light of the day.

By the middle of the 18th century, when London was the sole financial capital of the world, several prominent houses like Hope & Co., Baring Brothers and Morgan Grenfell, at that time called merchant banks, were alive and thriving.

As globalization started to emerge, the banks began to finance commerce and trade in an international scale. The merchant-banking model crossed the Atlantic and served as the inspiration for the financial firms founded by prominent families in what was the emerging market of those days - the United States. The structure and activities of early U.S. firms such as JP Morgan & Co., Goldman Sachs and Drexel & Co. at first reflected those of their European counterparts and included financing new business opportunities through raising and deploying investment capital.

These major financial firms did not limit themselves to investment banking, establishing themselves in a variety of other financial businesses including lending and deposit taking. The stock market crash of 1929 and ensuing Great Depression caused the U.S. government to reach the conclusion that financial markets needed closer regulation in order to protect the financial interests of average Americans. This resulted in the separation of investment banking from commercial banking (the Glass-Steagall Act of 1933).

The firms on the investment banking side of this separation - such as Morgan Stanley, Goldman Sachs, Lehman Brothers and First Boston - went on to take a prominent role in the underwriting of corporate America during the postwar period. ⁽¹⁾

This is an important distinction because when New York bankers took the lead in the investment banking world, the model changed somewhat, from the old European "merchant" model of risking their own capital, to a service business, ready to offer underwritings, equity deals, swaps and other financial instruments tailored for their clients.

To this day, the heart of the U.S. investment banking operation is the service to institutional clients, specially the so-called FICC (fixed income, currencies and commodities), with proprietary capital used in either a supportive role or even worse, in a short term and speculative manner as tragically seen in this past decade. In other words, a century ago investment banks became black box client services and ceased to be proper investment houses

1- Several excerpts taken from Wikipedia and the book "A Practical History of Financial Markets" by the CFA Institute.

Big changes in the model occurred in the 20th century, but a new wave of huge changes started in the beginning of the 21st century: with the advent of the 2008 financial crisis, the whole investment banking model went through its most dramatic revision, incurred by its regulators, investors and partners in the past 100 years.

It is not in the scope of this letter to analyze in huge detail all the transformation that this industry is currently going through, but to summarize very superficially the combination of a more conservative capital structure, as demanded by regulators and the so called "Basel III Accord", with slower capital markets activity and a more conservative business conduction in general would, in the minds of many analysts, if not kill the whole model for good, at least wound it permanently. Perhaps we'll see the prized ROE's (Return On Equity) fall dramatically and consistently from the 15%-20% that the major institutions were used to, down to much less exciting levels of around 10%-15%.

Moreover, this is before even factoring the many ethical and philosophical issues raised around the activity, from the supposed high level of paying of the banks' partners to questions about how these franchises dealt with their clients before the crisis hit. ⁽²⁾

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André Esteves' story is one of the most well known in Brazilian capitalism and already the stuff of legend. He first entered the scene in the 80's as a humble IT assistant for Pactual bank, a respected brokerage and investment-banking operation founded by the legendary banker and former Garantia partner Luiz Cesar Fernandes. Somehow, he was able to rise through the ranks of the partnership, build himself a reputation as an ace trader and eventually become a partner himself.

That was only the beginning. Esteves steadily gained his place at the forefront of a new generation of ambitious and aggressive young partners at Pactual. When Luiz Cesar Fernandes experienced financial difficulties in the 1990s due to unsuccessful business ventures outside of the bank, Esteves and his partners were able to buy Fernandes' shares at discounted prices and effectively take control of the bank. About this fact, Fernandes famously claimed that he "always knew Esteves was so ambitious that if it ever came to this, he was ready to sell his mother to gain wealth".

Then a couple of definitive transactions changed Pactual drastically. In 2006, UBS AG purchased Pactual, creating "UBS Pactual", the division of UBS in Latin American countries. André Esteves became CEO of all of UBS' Latin American operations. The reported purchase price was \$3 billion, about three times Pactual's book value, which is a widely used metric when it comes to investment banks and financial companies.

For a year, Esteves worked as global head of fixed income in London and some speculated that he could someday be UBS CEO. However, he had other plans and it is widely speculated that he tried to team up with fellow super investor Jorge Paulo Lemann to buy UBS's worldwide control during this period.

The plan died, and he decided to return to Brazil to start a new business from scratch. He contacted fellow Pactual partners telling them it was time to get back to work and to the financial markets. In other words, it was time to get "Back to The Game".

2 An interesting take can be seen in the Book "Why I left Goldman Sachs" by Greg Smith.

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On April 19th 2009, in a remarkable turn of events, BTG acquired UBS Pactual. The international financial crisis was in full rage and all any international investment bank could talk about was having access to liquidity, deleveraging, selling non-core operations and other assets.

When the transaction was finalized in September 2009, Pactual was bought back for the same \$3 billion, but this time at the fire sale price of one time its book value, resulting in the creation of BTG Pactual. With the acquisition, the partners who left the bank in 2008 reunited with the partners who decided to stay on at the institution throughout the period following the bank's sale to UBS.

The newly formed institution clearly had very ambitious plans: In December 2010, they issued US\$1.8bn in capital to a consortium of renowned international investors and partners, representing 18.65% of BTG Pactual. Finally, in 2012 BTG Pactual had its IPO, raising R\$ 3.65 billion in the Brazilian Bovespa.

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A year after BTG Pactual's IPO, FCL Capital started to buy some of its shares on the market. BTG Pactual is already around 5% of our fund's AuM, a position that is still slowly rising. We are building our position for the long term, we are not betting in a strategic event (we very rarely ever do that). In general, we tend to buy more when shares are especially depreciated and therefore have not rushed to buy too fast.

Combined Adjusted Revenues (unaudited) <i>(in R\$ million, unless otherwise stated)</i>	Full Year	
	2011	2012
Investment banking	377	448
Corporate lending	366	564
Sales and trading	1.012	1.517
Asset management	507	1.190
Wealth management	150	202
Principal investments	181	2.338
PanAmericano	(52)	(244)
Interest and other	661	802
Total revenues	3.202	6.817

After many meetings, conference calls and a reasonable work on the companies' numbers and actions, two things are worth highlighting in the knowledge we built so far about the bank. One is a mistake (in our opinion, of course) that we think many investors are making by attempting to compare BTG to its peers outside of Brazil, and two is the humbleness and feet on the ground that the management is showing.

False peers and a different model

We could summarize the critiques made by the sell side (and most other Brazilian asset managers) to BTG Pactual as follows:

- It may seem cheap, but all investment banking companies in the world deserve to be cheap, since they are facing so many problems.
- It may be cheap, but it is more expensive than, say, Goldman Sachs on a Price-to-book value basis.
- It deserves low multiples since it depends a lot on principal investments, a notoriously volatile business.
- It is growing too fast and may face problems in the future.

We will try to address all these concerns.

First, we firmly believe BTG is being packed and compared wrongly. It is true that investment banking in the G7 will not be as profitable an activity in the future as it was in the past, therefore they require cautious valuation. However, BTG is in a completely different ship and that is not only because it is in Brazil. In fact, what we see behind BTG's emergence is a return to the old "merchant banking" model of a century ago that was all but forgotten by the leading U.S. investment banks:

While Goldman and JP are modern investment banks with its full service approach, especially dependent on the so-called FICC (fixed income, currencies and commodities) trading on behalf of its clients, BTG, in a much nostalgic way, is a return to the old model when the house bet its own capital in the ideas and businesses of its clients. You can see most of its areas, like credit and private equity, in this context.

% of Revenue in 2012	Goldman Sachs	BTG Pactual
Sales and Trading for institutional clients	54.7%	17.4%
Principal Investments	0%	34.3%

Therefore, if the comparisons with Goldman or Credit Suisse seem out of context, the argument that it is a risky business deserving a discount is doubtful. Much of the vogue is caused by the sell side covering the bank these days, and in a lazy way, practically translating what everybody wrote about the US investment banks in the past few years, which really has to be taken with a grain of salt in our opinion.

First, to be rigorous in our analysis, we should carefully analyze the numbers in each of the different businesses inside BTG's principal investments' umbrella – global markets, merchant banking and real estate. Some of them, like real estate operations and some of its consumer business such as Brazil Pharma (BPHA3), actually receive very high multiples from the market. Nevertheless, when put inside BTG's umbrella, for some reason, analysts seem to think of them as risky businesses, which deserve to be trading cheap.

	Brazil Pharma	BTG Pactual
P/E 2014 (Estimate)	16.00	6.44

To be fair, we do think that the liquid proprietary desks, like the global macro and equity desks deserve low multiples. If we do the math to access the percentage each of these businesses

represent within BTG and include the banks' solid operations of asset management, wealth management and so on, there's no reason to think that this is not a premium operation deserving premium multiples.

Especially when we bring in the fact that all of its businesses have great perspectives, we are unable to see any reason why its future profitability should be smaller than in the past, unlike BTG's developed world peers.

Company	ROE in 2012
BTG Pactual	28.7%
Goldman Sachs	10.7%
Credit Suisse	10.0%
J.P. Morgan	8.2%
UBS	5.1%

Looking to the future, we can only think that with the development of Brazil's capital markets, BTG seems like a natural leader to surf this wave and maintain a very high return on capital, through its investment banking, principal and asset management operations.

The IPO duopoly

In the months our BTG research took place, we were especially interested in finding out the power of the bank's franchise. We were already convinced that the dominant thesis of a significant discount that any investment bank should suffer in its multiples should not apply in BTG Pactual's case.

By then our interest only grew as we studied the complex web of relationships. Access, capital and expertise in a non-trivial market like investment banking in Brazil is something very difficult to replicate, something competitors (Goldman Sachs, Morgan Stanley) with timid operations in Brazil's underwriting markets could attest.

M&A 2010-13 (Dealogic)

Institution	Volume (US\$bn)	# Deals	Mkt Share (%)
BTG Pactual	95.0	199	25.6
Credit Suisse	87.8	106	23.6
Rothschild	78.3	46	21.1
Itau BBA	76.3	154	20.5
Bank of America	63.1	46	17.0

ECM 2010-13 (Dealogic)

Institution	Volume (US\$bn)	# Deals	Mkt Share (%)
Itau BBA	9.6	51	13.5
BTG Pactual	8.9	46	12.5
Bradesco BBI	6.6	35	9.2
Bank of America	6.2	20	8.7
Credit Suisse	5.7	36	8.0

The grassroots phase of our investment analysis is always a very important step for FCL Capital, but in BTG's case, it was dramatic. For several weeks, we were dedicated to be in touch with employers, clients, partners and competitors to access the value of the franchise and its business model. One particular fruitful conversation took place in the early days of 2013 with an executive whose company had gone public a few years earlier in the Brazilian market.

At first, he was very angry about the high fees proposed by the investment bankers to go through with the operation. But then, he realized it was his company going public, an once in a lifetime occurrence, and after several contacts he found out a fact that only two firms in Brazil can really claim to be the top dogs in the IPO market: BTG and Itaú BBA, with Bradesco BBI being a distant third.

Unlike, say, the U.S. or UK markets, many particularities take place in Brazil, and foreign competitors cannot seem to find a way to really get in. He started to feel afraid that he would not get the price he wanted if he didn't go through with either BTG or Itaú BBA. At first he pondered forgetting the whole thing but then he went ahead and ended up selling shares to the public in 2010. He chose BTG Pactual.

Regarding its principal investments, after several visits and conversations, we judge that BTG was able to build a team that has knowledge, passion, discipline, vision and experience; a rare and fantastic mix. All this packed in a winning business culture.

Not a premium valuation

When BTG was founded in 2008, its CEO was already a billionaire and many of its partners multimillionaires. What's more, Esteves had just got back from a year in London and bought back Pactual at firesale prices due to the international financial crisis.

It would seem almost obvious for a smart businessperson that it was an auspicious time to build a global investment bank. After all, the global leaders in investment banking were all shaking and some of them falling. Certainly many old spots and positions were ready to be taken. André Esteves himself said in an interview he gave at the time that "building a global investment operation in Brazil a decade ago would seem either crazy or impossible. Now I would even say it is an additional charm".⁽³⁾

BTG obviously is not lead by small-minded people. They opened offices in New York, London and Hong Kong, mostly to support Latin business-accessing world markets but also with local teams and global hedge fund operations, and recently opened its first large infrastructure fund for Africa. For the most part however, this house has been amazed; I would even say puzzled by how much BTG's management has their feet on the ground. A quick look at the banks homepage reads "Latin America's investment hub".

In fact, instead of trying to build a global operation BTG very quickly became Latin America's investment bank. With its leading position in Brazil a definitive spot was taken when in 2012 BTG bought the Chilean brokerage company Celfin, a leader in the fast growing markets of Chile, Peru and Colombia. With a leading position in Brazil, Argentina and Celfin on board, Esteves himself admitted that the only piece still lacking to "complete the game" was a large acquisition in Mexico, the region's second biggest market.

We don't think yet that the dream of a global investment operation was forgotten. It is too soon to tell. These amazing and young investment bankers did a lot in only five years. Either way, it is a win-win situation. Latin America will be the region (alongside Asia) where capital markets will develop the most in the next decade or two. BTG, as the region's leader will certainly maintain very high returns on invested capital (a metric we at this house specifically have a deep interest in), so if they remain a Latin operation, they will have a great future and can be one of the most promising investments in our equities portfolio.

3 Valor Economico 22/04/2009

On the other hand, of course, they can become a global operation, after assuring their Latin America leadership position and sky would be the limit. However, we are not counting on it in our projections. It would only be an unforeseen bonus.

Surely, the global U.S. and European operations are still wobbly, especially with Basel III and new regulations by the U.S. congress on the horizon. Either direction seems promising. Investing in this sector has been a permanent challenge for our team, with its inherent complexity, qualitative factors and permanent change.

Keeping our guard high, we can attest that we would feel comfortable with either direction. A more predictable and shorter payoff with very high returns on capital on the horizon or a longer shot with possibly extraordinary rewards. Either way, we are talking about an investment with a great margin of safety. Which way do we go from here? Only time will tell.

Performance

During the third quarter of 2013, FCL Equities' shares appreciated 4.15%, worse than Ibovespa's performance of 10.81% but comparing favorably with the CDI's performance of 2.05%.

Our performance in the first nine months of 2013 was of -1.86%, comparing favorably with Ibovespa's performance of -14.3% (always in Brazilian real).

Our compounded annual performance since the inception of FCL Capital investment club in April 3rd 2007, our most important internal metric of performance assessment, was of 17.65% in September 30th 2013, once again comparing favorably with Ibovespa's annualized performance of 2.33% and CDI's performance of 10,19% in the same period.

Date	FCL Capital	Ibovespa	CDI
3Q 2013	4.15%	10.81%	2.05%
9M 2013	(1.86%)	(14.80%)	5.62%
Compounded Annual Return*	+17.65%	+2.33%	+10.19%

(*) – Since FCL Capital investment club was established in 04/03/07.

About FCL Capital

FCL Capital is an independent investment company, focused on portfolio management, free from conflicts of interest and multiple objectives that has for a mission the preservation and multiplication of its investors' capital, through a thorough financial analysis. Our goal is to generate absolute returns, staying solid and consistent through good and bad periods of the economic cycle.

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