

FCL*Capital*

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Promising Waters

In our April 2013 letter, we took the time to tell our investors about our Equities fund's two brand new strategic stakes: Direcional Engenharia, a Belo Horizonte extraordinary low income real estate company and also a cabotage semi pre operational business called Log-In Logística (LOGN3:bz).

While we remain very happy with Direcional, we decided to use the opportunity this letter presented to discuss in detail our opinions, framework and expectations regarding our investment in Log-In.

First of all, it is important to say, Log-In is an unusual investment for us. In our permanent search for alpha, we had never acquired a stake in a business that could be considered, to a large extent, still in a pre-operational phase.¹

While Log-In listed its shares in 2007, in a process somewhat overlooked by the financial press and a large part of the Brazilian sell side, it has been experiencing profound modifications since then. Therefore, it could still be called a pre operational company, with the sole exception of its port handling business, which is diminishing in importance.

Log-In is at the heart of a nascent and growing industry and it has an exciting history, thanks to an aggressive investment plan that costs close to zero. However, let us not get ahead of ourselves, and start from the beginning.

In June 2007, when subprime was still supposed to be a minor problem, the Brazilian stock market was experiencing a major boom. Dozens of companies rushed their IPO plans and a few business people became billionaires in the process. It had been two years since Eike Batista had listed his mining company in the Bovespa stock exchange and a year before his oil company went public. Somewhat unfit in this whole process was Log-In Logística's IPO.

Log-In was then a subsidiary of Vale, Brazil's giant mining company. Vale is still the company's largest shareholder with a 35% stake, but there is an ongoing discussion about when Vale will sell its stake. Log-In is small and unnecessary in Vale's giant and global portfolio while Vale, which once was Log-In's sole customer and the purpose of its existence, is now just another client and not even the company's largest.

In the IPO prospectus, Log-In stated that it was the "first and only logistics company in Brazil that offers integrated "one stop shop" solutions for the port handling and door-to-door transport of containers by sea or rail" and exposed its R\$ 1.3 billion investment plan which included upgrading its terminal handling operations and building new ships for its cabotage, transport between ports in the same country, operations.

Interestingly, it was not until page 18 in the prospectus that the company lists, among its risks, the real reason why Log-In is such an unique investment alternative: under a 1997 Brazilian law, "Companies that operate in the cabotage industry in Brazil are currently granted a subsidy for the maintenance, expansion or acquisition of vessels bearing the Brazilian flag".

¹ Inevitably, we pride ourselves for being in the minority of brazilian asset managers that never acquired a single share in any company of the so called "X Group", even when it was at the top of its hype.

Funds are raised through the AFRMM, a tax of 10% on coastal shipping freight, paid by coastal freight customers and deposited in the FMM, for use by cabotage companies operating in Brazil

In other words, this means that thanks to the government will to build a shipping and cabotage industry in Brazil, Log-In can raise money to build its ships (through BNDES), and be reimbursed of the interest with money from the AFRMM, which is immediately incorporated to the company's EBITDA.

In other words, this amounts to a giant CAPEX program with an effective cost of zero, an almost unique situation in the world's stock markets. If it sounds too good to be true, well, it is, with a few caveats.

The first caveat: why so few competitors took advantage of this incredible benevolence as much as Log-In? The answer, in large part lies in the fact that it is very hard to contract a good shipyard to build ships in Brazil.

Even with the lure of the AFRMM, Aliança, a global shipping company with operations in Brazilian cabotage, and therefore one of Log-In's competitors, had to import four ships from abroad because it just could not find anyone suited for building four new ships in Brazil.

Estaleiro Ilha, the shipyard contracted by Log-In, is operating in full capacity for the next few years to deliver Log-In's orders. So in our eyes this got even better, a company being subsidized in a promising industry, with limited or restricted new competition, because no one can build ships in Brazil and be subsidized in quite the same way.

The only piece still missing to our analysis was demand. Is cabotage a promising industry in Brazil?

Brazil has always been a nation by the sea. Its capitals before Brasilia were Salvador, a seaside metropolis in the country's northeast region, and Rio de Janeiro, where this house is located, and which to this day rule the world when the subject is beach culture, with all its surfers and beauties.

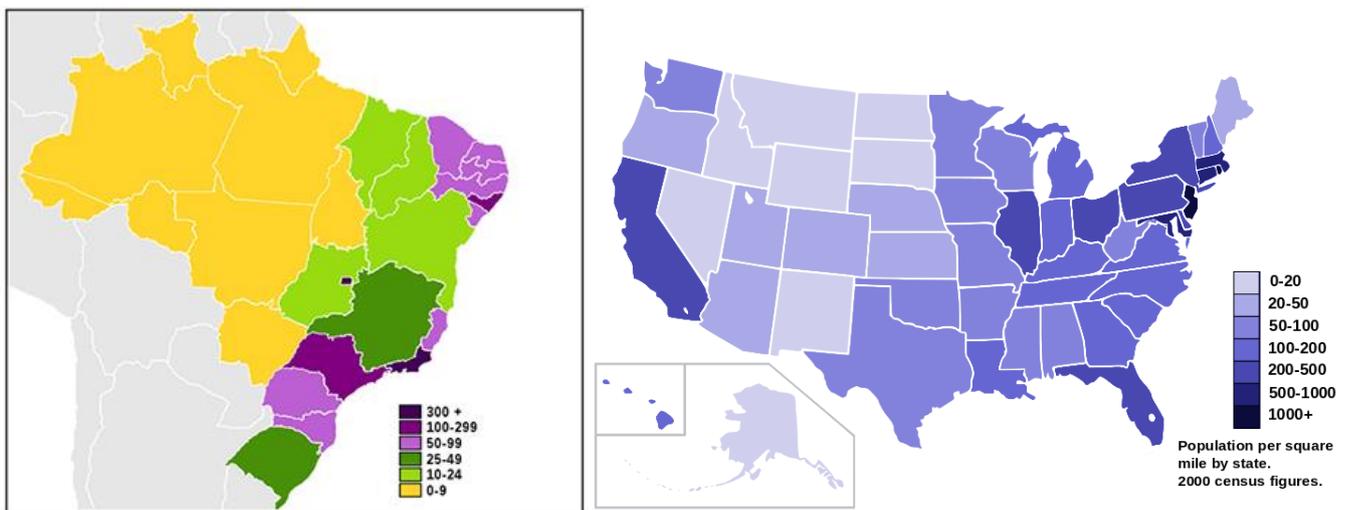


The odd thing is that Brazil's level of cabotage within the transportation matrix of the country is

extremely similar to, for example, the US, despite the fact that its population dispersion and economic density is completely different. The nation's ports and commerce of primary products have always been the economic heart and soul of the country.

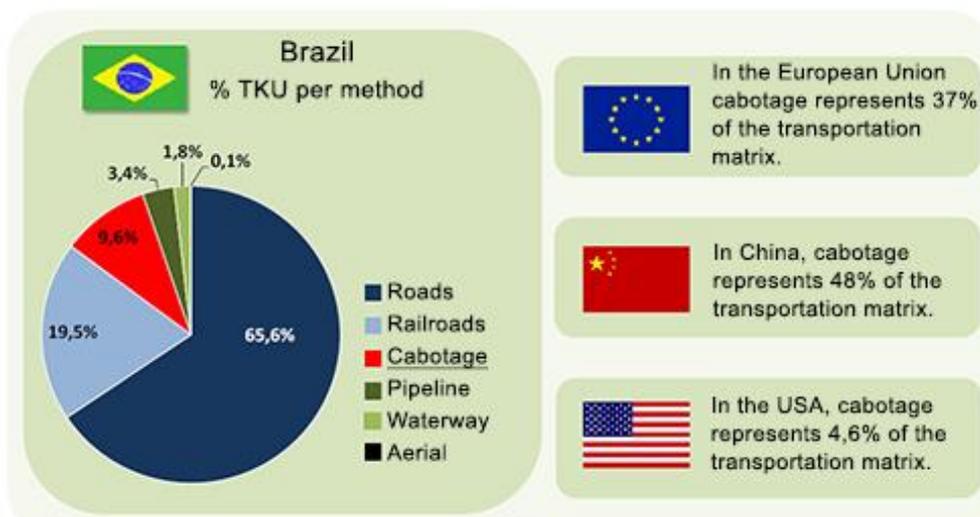
Thanks to statist regulation, terrible infrastructure, red tape, the huge amounts of investment necessary and other constraints, Brazil's internal distribution of goods have always had a completely different composition than logic and efficiency would suggest.

Overall, of the country's 200 million people, more than 80% of its population lives less than 200 kilometers (around 125 miles) away from the sea. This is funny because almost any Brazilian has the image of their own country in mind as of a huge country, when in reality, practically all the population and economic activity is situated in a relatively small part of the territory. This is a stark contrast with the USA, where economic activity and population are extremely dispersed.



Population density in Brazil per km² and population density in USA per square miles. Source: Wikipedia.

A crazy conundrum was historically developed in the country. If almost everyone in Brazil lives by the sea and if practically all economic activity is also located close to the coast, why are the goods inside Brazil moved mostly by road and not by the sea?



Transportation matrix utilization. Source: ILOS, Instituto de Logística e Supply Chain.

There are always many explanations for complex problems, but we wouldn't be very far from the truth if we attributed this particular problem to a mix of terrible port infrastructure, cultural reasons and the lack of a shipping industry in Brazil. Issues that are already being tackled respectively by "Lei dos Portos" (Port Law), "Lei do Motorista" (Driver's Law) and, rightly or wrongly, by the institution of AFRMM and the industry's subsidies.²

All of this has led us to believe that Brazil may be poised, in the next few decades, to a profound change in its goods' transporting model, with road transportation increasingly ceding space to more efficient models, especially cabotage. As a good industry leader, and maybe because of the huge space occupied now by road transportation, Log-In has been focused not on gaining market share within the cabotage industry, but on leading the change of the Brazilian transportation matrix from a mainly road focused model to a more cabotage centered one.

Warren Buffet once noted that if an investor was to pick a very promising industry that was poised to grow in the 1950's, airlines, possibly the industry that subsequently offered the worst returns to investors, would be the investor's top pick. His point was that being in a promising industry was not enough, and not even the main job of an investor. Instead, we should look to companies that have a "moat" as well as an established and difficult to replicate competitive position.

Log-In offers us a few unique characteristics that we as investors constantly look for, such as a free high return CAPEX (thanks to the AFRMM), growing demand, leadership in an industry of very limited supply (the good side of the logistical nightmare that is ship building in Brazil³), limited and rational competition, accelerating growth, and so on.

As value investors, what is our take on the company's multiples? We have been exposing our thesis through our past few letters that we believe the Brazilian market has been experiencing what we started to call a "quality bubble". Burned by the X fiasco, by the emerging markets' sell off and the risk of adverse climate in general, a very high premium is in place for anything that is already generating yield, is highly predictable and, I dare to say, boring.

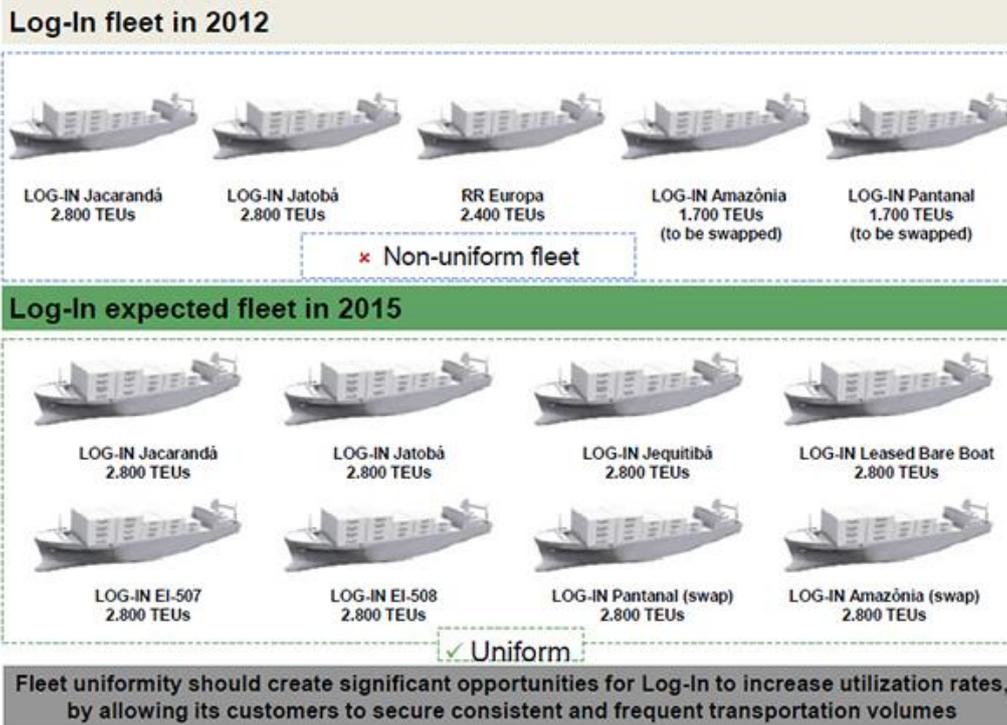
Log-In has showed almost flawless execution in its growth plan until now, if we forgive the delay that Estaleiro Ilha S.A. (Eisa) experienced in delivering the new ships, but is, as we said, still ramping up its operations

If we do the math, things gets really interesting. Investing is obviously an inherently probabilistic activity. We never know anything for sure. Many things could go wrong, such as Eisa continuously delaying the delivery of the four remaining ships, more supply entering the market and, more crucially, the government could change its mind about the subsidies to the industry. But if things remain as they are, it is almost a license to print money for the company.

Going back to the Dodd-Graham concept of margin of safety, we have a reasonable buffer already in place. If the world freezes and the AFRMM is revoked tomorrow, Eisa goes away for some obscure reason and Log-In is left with zero growth for eternity, the company would already be priced around a reasonable range in our estimates, assuming the reasonable hypothesis that AFRMM for already contracted ships remains in place.

² It will not be in the scope of this letter to discuss our political views, if the AFRMM and other subsidies should or should not take place in Brazil.

³ It is important to remember that many countries, including Brazil, forbids foreign ships to operate cabotage between their ports, which mixed to the fact that it is very hard to arrange for ships to be built in Brazil, leaves Log-In in a unique competitive position.



Log-In's expansion plan will raise its fleet capacity from 11.400 TEUS in 2012 to 22.400 TEUS in 2015.

Log-In is cheaper in fact than many mature and low growth companies. And to cite Buffett once again, we agree with his take that the distinction between growth and value is pure rubbish, as growth is nothing more than a component in the value of a stock. That being said, one way to look at it is to treat any growth that Log-In may experience with its low cost CAPEX as a cheap option, that could be worth a lot more than the whole company is worth now.

| | 2010 | 2011 | 2012 | 2013 (E) |
|-------------|------|------|------|----------|
| Net Revenue | 621 | 659 | 718 | 780 |
| EBITDA | 79 | -27 | 113 | 180 |
| EV/EBITDA | 16.3 | - | 15.4 | 11.0 |

LOGN3 - Stock Evolution



Log-In Logística Event Timeline, 2007-2013

| | |
|------------------------|---|
| 2007 | Log-In's public IPO. |
| 2008 | The ship Log-In Amazônia becomes operational. |
| 2009 | Log-In borrows from BNDES in order to expand Terminal Vila Velha. |
| 2010 | The ship Log-In Jatobá becomes operational; Bauxite transportation deal with Alunorte ; Log-In starts organizational restructuring. |
| 2011 | Focused in cabotage, Log-In sold to Vale its Trem Expresso railroad assets; TVV expansion is completed. |
| 2012 | Changes in law increases the benefit Log-In gets from AFRMM. |
| 2013 | "Driver's Law" is created; Cabotage finally becomes Log-In's most revenue-generating business. |
| 2014 & 2015 | Log-In awaits the completion of two more ships with 2.800 TEUS transportation capacity each. |

An additional push came this past year with a couple of recent laws. The so called "Lei do Motorista", which increases the amount of rest required by drivers, amongst other changes, making transporting goods by road more expensive and the "Lei dos Portos", which introduces new liberalizing rules for the country's ports.

Cabotage may be an indirect beneficiary of both, since it depends on adequate port infrastructure and therefore benefits from more competition in that area as well as from more expensive road transportation, as a substitute service. But the market reaction was to penalize Log-In due to the decrease in revenues its port operations were going to experience due to the changes. We were happy to see that the part of the business that really matters, cabotage, would be benefited.

It is not going to be a simple transition to navigate towards a different logistics model in Brazil. Log-In is after all, trying to arbitrate one of the Brazilian economy's main deficiencies. We know it is not trivial and are certainly not with our guard down when it comes to this investment, that in many ways is a little outside our core circle of competence. That said, it is, overall, a huge opportunity to explore one of FCL's main competitive advantages: our ability to access a longer time horizon than most investors, where the market is especially less efficient.

The irony is that in our traditionally contrarian ways, it is the first time we seriously entered a business whose main outlook was in the future and not within our core competence of finding obvious value plays buying cheap, good and stable businesses. It happened when the market, burned down by over hype on some wrong bets, started to behave beyond skeptical, not believing in things that were already before its eyes.