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BR Foods: A divergent opinion

Frequently, investors and peers mention that we have a unique portfolio. Some fund of funds' managers tell us that for most companies and cases, they could almost by heart repeat the case behind the investment, due to the number of times managers mention these companies among their top positions.

While it is not our aim to be different for its own sake, our distinct portfolio is a consequence of our business proposition. The world doesn't need one more investment manager having an opinion about companies like Petrobras, Vale, Exxon or Apple. Also, it is in our framework (as stated in our [annual report](#) last month) to seek market niches that are less efficient and/or less looked upon. And this certainly includes neglected companies that are not currently the darlings of Brazilian asset managers.

While holding stakes in companies that are not currently loved by our peers is not the ideal situation to put us in the center of attention in cocktail parties, we deeply believe it is in our investor's best long-term interest. That being said, we have discussed in our past letters many of our investment cases, including the ideas that turned out to be mistakes and value traps.

Now, in our first 2014 monthly letter we feel that it is time to discuss a company that is a frequent topic of our conversations. Not because we hold it in our portfolio, but because we do not. Being a top position amongst Brazilian independent asset managers nowadays, we frequently have to answer "Why don't you have BR Foods in your portfolio?" This letter summarizes the reasons we gave in many previous conversations with our investors.

A good company, but a flawed thesis

First of all, we have been avid watchers of BRF for many years now. Before we first opened our investment club back in 2007 we were already investors, and during the 2003-2007 Brazilian bull market, the major personal position of our manager was Sadia, the company that merged with Perdigão to form BRF in 2010. We held our short position in Odontoprev noting that one of our favorite Brazilian equity houses, Dynamo, was a major shareholder. This time around, even though we are not short in BRF, we encounter a similar situation with Tarpon being a major BRF shareholder. Nonetheless, we feel that much of the market may be embarking in a flawed thesis.

Below, a summary of a few points brought up by the sell side and most of the shareholders:

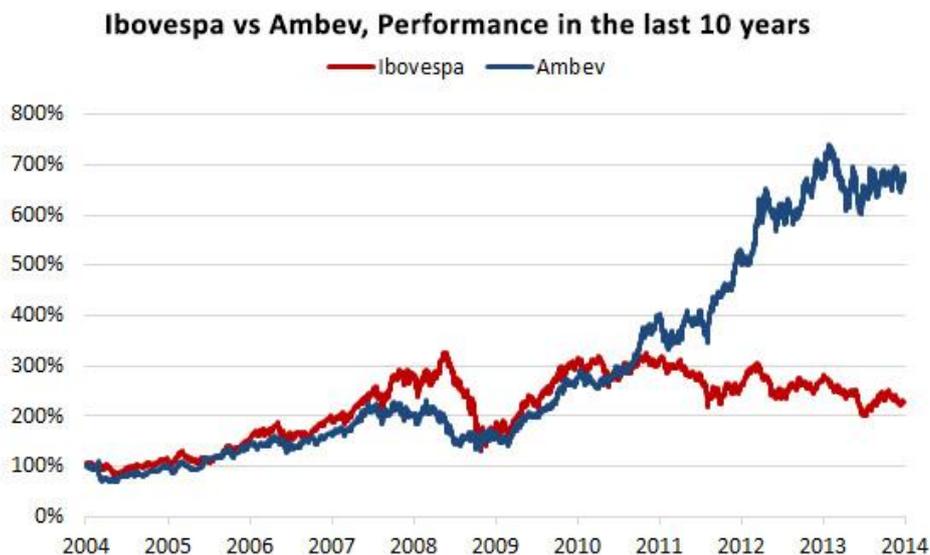
- a) The company is well placed to be a Brazilian global champion;
- b) The shares may seem pricey, but they are cheaper and have lower multiples than, say, Ambev, and in time they could converge to this higher level of multiples. They are on their way to becoming a blue chip company;
- c) The shares should not be compared to commodity food companies like Marfrig or Minerva, but to global premium-brand giant food companies like Nestle, because that is the direction the company is going.

¹ Although Cade only approved the merger in 2011, Sadia and Perdigão have been operating as a single company since the year before, so for the purpose of this letter we will consider 2010.

We admire BRF as a company and we would love to hold it at lower multiples, especially because we judge to have a competitive advantage, since we were Sadia shareholders and still know a few plants, operations and some of its people very well. That being said, we disagree with all of the above cited points and do not hold the stock, for reasons we discuss below.

Myth 1: BRF is not a new Ambev

The similarities are indeed astonishing. Two rivals that have been battling for market share and leadership for many decades finally undergo a merger, joining strengths to conquer the world. The same story could be applied to both the creation of Ambev back in 2004, with the merger of Brahma and Antarctica, as well as BRF in 2010 when Sadia and Perdigão joined forces. Being the great Brazilian success story of the past decade, and having surpassed Petrobras as the country's largest company by market capitalization, no wonder investors dream about finding the next Ambev.



The bad news: Ambev's story is really unique and although there are some similarities between the two stories, we are convinced that there are many more differences. First of all, beer is not meat and processed food. A big merger is never a trivial thing. Certainly, when the Garantia Partners bought Antarctica from the foundation that was the major shareholder, many processes and people had to be replaced². But when we talk about a nonperishable inventory, synergies and scale on distribution is faster and easier to achieve than in the case of the Sadia-Perdigão merger.

It is easier to consolidate the beer market in any country than the food market. Indeed, Jorge Paulo Lemann reportedly said once that a reason they were first interested in Brahma is that they "looked all over Latin America and in most countries, the richest person was the beer guy. These guys couldn't be all geniuses".

As is now understood, the real entry barrier for beer lies in the distribution channels coupled with the gigantic brand awareness and premiums. In the food business on the other hand, there is a lot more fragmentation, and brand premium is less relevant, especially outside of Brazil. Sadia has long been a major exporter, but the only region where there is brand awareness is the Middle East, and even there, for different products and on a smaller scale than on its home market.

² As can be read in the book "Sonho Grande" (Big Dream), still unpublished in english.

Production and consumption have to be better coordinated, since the time and distance from production to end consumption is usually smaller and crucial. The major synergies are not in the processes (something the Garantia partners have always mastered) or in the distribution, but in the comparative advantages in the production phase, unless we are talking about the high-end brand products which are not a relevant share of BRF's mix.

AMBEV operational performance, 2004-2007				
	2004	2005	2006	2007
Revenue (R\$ Millions)	12,007	15,959	17,614	19,648
Δ Revenue YoY	+38.27%	+32.91%	+10.37%	+11.55%
Gross Margin	47.71%	48.87%	53.46%	53.56%
EBITDA (R\$ Millions)	4,000	5,988	7,369	8,311
Δ EBITDA YoY	+51.94%	+49.71%	+23.05%	+12.79%

BR Foods operational performance, 2009-2013 (E)					
	2009	2010	2011	2012	2013 (E)
Revenue (R\$ Millions)	15,906	22,681	25,706	28,517	31,260
Δ Revenue YoY	+39.61%	+42.60%	+13.34%	+10.94%	+9.61%
Gross Margin	22.72%	24.42%	24.76%	21.83%	25.08%
EBITDA (R\$ Millions)	389	2,145	2,685	2,232	2,683
Δ EBITDA YoY	-63.93%	+450.83%	+25.15%	-16.87%	+20.20%

We understand the anchoring many Brazilian managers have made when they looked at Ambev's success and inferred that this new merger would bring a similar value creation. But, over the years, having known Sadia profoundly and looking in-depth at BRF's operations and strategic plan, we are increasingly confident to say that investors searching for the same pattern will be disappointed.

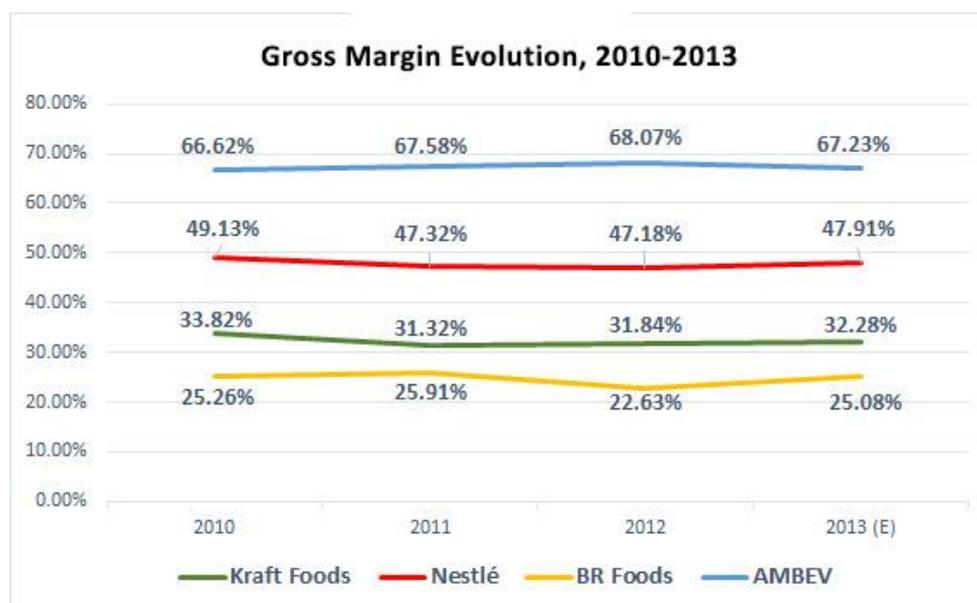
Four years have already passed since the merger. Over time, we have seen many other houses put faith in the dream that BRF is the new Ambev. Indeed, a quick tour through most Brazilian asset managers will show that this is still the top position in most equity house portfolios. Below, some data behind both cases:

Multiples at Time of Merger		
	P/E	EV/EBITDA
AMBEV (2004)	34.81	11.92
BR Foods (2009)	29.72	13.13

Myth 2: Premium brands

The second myth regarding BRF is that when we focus on its multiples and sales growth, we are looking at it the wrong way. The company is undergoing, its many fans would say, a deep transition towards being a global premium brand, so to compare it to, say, Minerva or Marfrig, would be comparing McDonald's to a French bistro.

So we did a simple exercise. We compared BRF's gross margin to Nestle and Kraft Foods, two global premium food brands. The comparison is not flattering. Not only the Brazilian company's margins are consistently and significantly lower, but they are not, in any way, converging to the global players



Also, the company is not becoming more global. In fact, we miss the old Sadia focus on having at least 50% of its sales abroad. In many ways, we used to regard Sadia as a better company than the result of its merger with Perdigão, with vast diseconomies of scale, complexities, multiple objectives, cultures and products.

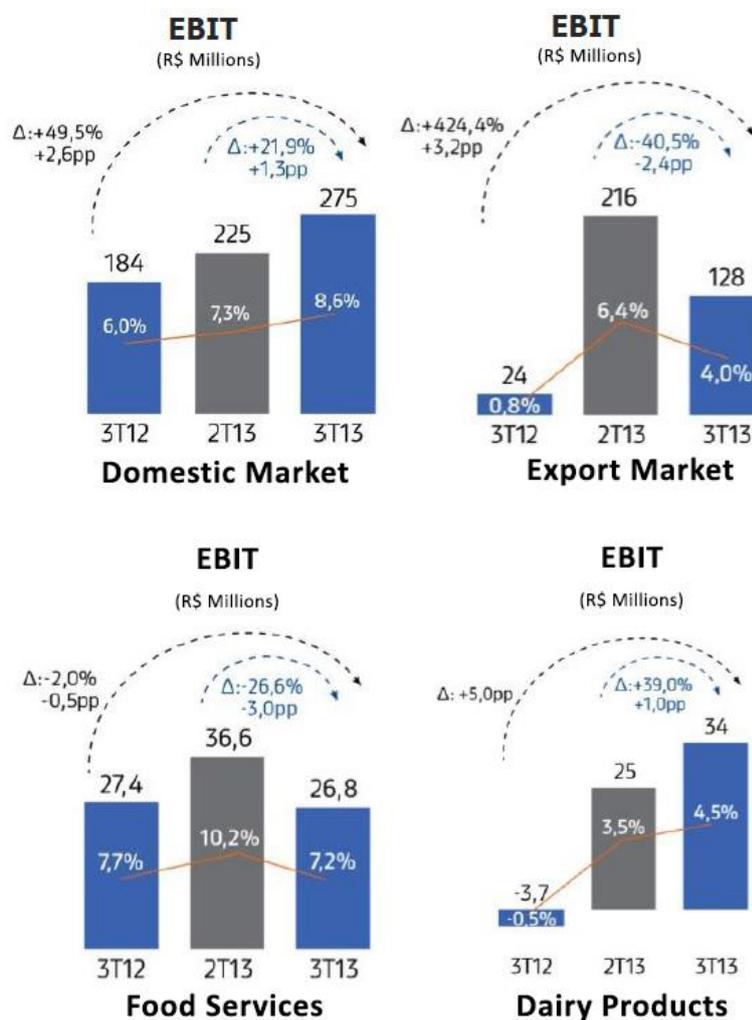
BR Foods – Performance of Sales Abroad		
	Revenue (R\$ Millions)	% of Total Revenue
2010	9.166	40.4
2011	10.287	40.0
2012	11.126	40.8
2013	12.135 (9M13 annualized)	43.7

But it gets a lot worse than that. One dilemma we already knew from the Sadia days is that as the percentage of sales outside of Brazil grows, the margins tend to decline. It's not really complicated: since BRF's branded and industrialized products are mostly sold in Brazil (with few significant exceptions) and the company is trying to grow abroad - where commoditized products dominate the company's sales mix - as the sales abroad grow, its margins should decline further.

We are not saying that the company shouldn't try to grow abroad. Mathematically speaking, after multiple exercises projecting the company's expected sales' growth abroad, we couldn't, even stretching a lot our margins expectations, come even close to what most analysts are estimating (fast sales growth abroad combined with stable to upwards margin trajectory).

We tried hard to obtain more information regarding margins per product, but the company does not disclose these numbers. It does disclose EBIT margins, both internal and external. As expected, external margins have been significantly and consistently lower.

EBIT by activity (BR Foods)



Making simple inferences, it is hard to imagine that they will someday converge. While the internal market sales are basically of processed products (the branded high margin ones), the external market sales are still more than 80% of non-processed products, despite the company's efforts.

DOMESTIC MARKET	THOUSAND TONS			R\$ MILLION		
	9M13	9M12	ch. %	9M13	9M12	ch. %
In Natura	308	331	(7)	1,816	1,584	15
Poultry	207	228	(10)	1,104	914	21
Pork/beef	101	102	(1)	713	671	6
Processed	1,098	1,233	(11)	6,860	6,808	1
Other sales	267	334	(20)	715	644	11
Total	1,673	1,897	(12)	9,392	9,037	4

EXPORT MARKET	THOUSAND TONS			R\$ MILLION		
	9M13	9M12	ch. %	9M13	9M12	ch. %
In Natura	1,506	1,571	(4)	7,604	6,709	13
Poultry	1,306	1,349	(3)	6,240	5,382	16
Pork/beef	200	222	(10)	1,364	1,326	3
Processed	323	269	20	2,049	1,518	35
Other sales	55	9	529	55	8	617
Total	1,884	1,849	2	9,708	8,234	18

We could be wrong. The company could create powerful brands abroad in addition to the well regarded brand Sadia, already in parts of the Middle East, but it is very far from trivial and most importantly, we don't see many synergies between this vision and the company's current low margin product mix abroad.

Myth 3: Global competitive advantage

The third and last myth in our opinion comes from the vision that BRF is a natural global champion. We do not see in this company the clear and sustainable competitive advantages that we see, for example, in Minerva, discussed at length in our last annual report.

It is important to say that this letter should not be misunderstood. We think BRF is a great company and we hope its management can turn the tables around. We are not short on the company and are not considering going short in the near future. This letter is solely an attempt to answer once and for all a question we hear very frequently: "Why don't you like BRF?"

A special comment must be made regarding Abílio Diniz, the company's new chairman. He has built a retail empire for a reason. He is a unique businessman and therefore the company is in great hands. We spent a great amount of hours listening to presentations and reading the company's material and it increasingly seems that Abílio's work is already being felt throughout the company.

Overall, however, we see BRF as a huge company with both strong and sustainable competitive advantages and significant stumbles. A few business segments are quite successful (all of them in Brazil), like its chester and tender products. In the other hand, other segments like its milk division are performing poorly.

Most importantly, it been tough to create powerful brands or pursue significant acquisitions outside of Brazil, a path we think should be considered due to the company's financial firepower.

One thing we dislike is its size. It was easier to have exposure to the "good" niches when the companies were separate. We have been asking ourselves in the past few months if we are being nostalgic, since we were shareholders back in the Sadia days. But being as impartial as we can in our analysis, we think the company is too big, too diverse, too unfocused and few parts of it really have sustainable competitive advantages, let alone global competitive advantages as its enthusiasts believe.

BR Foods vs Minerva – Ratio Comparison		
	BR Foods	Minerva
EV / EBITDA	13.22	6.25
Price / Earnings (Estimate)	16.98	8.22
Price to Sales	1.21	0.32
EBITDA Margin	10.69	10.41

Let's be honest: BRF in reality is two different companies: a high margin internal market's oriented brand and a commodity exporter, just like Minerva or JBS. Investors are extrapolating and paying the price of a full brand-oriented BRF, when this will not be the reality in the foreseeable future (within the next decade, at least).

Investors have sometimes a high margin fetish and pay high multiples for companies that say they are "trading up" or becoming more "brand oriented". Behavioral finance would say this is assimilation. Investors are members of the elite, and they pay more for companies from which products they consume.

Looking at the big picture, it is hard to disagree with the argument that Brazil is very competitive selling meat abroad and these companies' shares trade very cheaply. That is why we hold Minerva, and is one of the reasons why we held Sadia back then.

It is, however, very easy to deny the notion that BRF does not have a single iota of competitive advantage regarding its global brands compared to the global food giants, as was shown above. We just don't see a global champion arising here. We see a very expensive stock of a good quality company.

We wish all the best to BRF's new management. If they turn things around and a new Brazilian global champion is born, it will make up for a great story. But for now, at least for us, we see it as just day dreaming. We do not see anything that shows us that this vision will be a reality any time soon, if ever. We see BRF maintaining its strong position in different Brazilian industrialized food markets and continuing to be a commodities food exporter. All in all, not a terribly different company than it is now, maybe a little less confuse and more efficient.