

# FCL*Capital*

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## **A portfolio for a changing world**

First of all, let's be honest: the so talked about Santander's research note, advising clients that the Ibovespa should rise or fall in the short term depending on Dilma Rousseff's ratings (i.e Ibovespa should fall every time Dilma rises) was nothing more than the obvious truth: the market would like to see the current administration lose its job.

Why is that so? Apologizing beforehand for stating the obvious, the current administration's interventionism, constant change of rules, disregard for private investment and so on made the market reach the conclusion that almost any administration would be better than the current one.

That being said, we do not possess any competitive advantage in knowing how the Brazilian election will turn out. It would be beyond the scope of our mandate to speculate about the electoral process and to buy, for example, Petrobras' options expecting the opposition to win.

We are not denying that it is possible for some investors to make money this way. We are just stating that we do not have superior knowledge on the electoral process and therefore would not add value to our investors by trading this way. What we have been doing this past year is exactly what we do every year: we work on building a portfolio of businesses that:

- a) Are reasonably predictable;
- b) Are misunderstood or neglected by the market;
- c) Are attractively priced;
- d) Contain good optionalities<sup>1</sup> not yet properly priced by the market;
- e) Are well placed to endure a possible devaluation of the Brazilian currency and maybe able to profit from it.

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<sup>1</sup> Uncertain events and developments that could alter the situation of the business. They are part of the range of possible outcomes and are not currently, in our opinion, being adequately priced by the market.

It seems like a tall order, but the fact is that the current uncertainty and short term focus is precisely the kind of scenario that usually allows us to build a portfolio like this. Therefore, the cash portion of our fund has been decreasing this past year, from around 10% of our AUM to less than 4% as we write this letter.

Let's review our portfolio in light of the quest to find these five characteristics:

**a) Reasonably predictable and well placed to endure a relatively slow Brazilian and global economy.**

Our first search is for reasonably predictable companies. It does not mean avoiding cyclical companies altogether. It means we are searching for companies that do not depend too much on a specific event or outcome and are not too exposed to a possible negative event.

That is why we are not buying Petrobras' shares: they depend on a single specific positive event (Dilma's loss in October) for their outperformance and even if it happens, there is no guarantee that the company's shares will have sustainable outperformance afterwards.

Looking at our portfolio, we seem to pass the test: most of our companies have a majority of their revenues in dollars or other strong currencies, meaning that in a possible economic shock and consequent devaluation, they would be able to keep their earning power relatively stable.

Also, the cyclicals in the portfolio (Braskem and Gerdau) are not too dependent on an economic pick-up in Brazil - Gerdau depends basically on a return to profitability of its US operations and Braskem on the ramp up of its Mexican project.

The other companies we are invested in are agnostic when it comes to the electoral cycle and have a low dependency ratio of the economic activity in Brazil. We are not stating that they would not benefit from an economic pick-up, but they are clearly less exposed than, say, the average retailer.

Those companies are providers of essential and inelastic goods (Minerva), suppliers of services to the government (Direcional) and, in general, companies that would benefit from Real's devaluation or theses that are so specific that the general economic situation is almost irrelevant to them (Log In and Heringer).

## **b) Misunderstood by the market.**

Frequently, when we screen for potential investments, we look for companies that are mistakenly included in a peer group where they do not belong, or situations where the market overestimates a possible risk or underestimates a possible favorable option - the contraries can also be the case when looking for good short-selling opportunities.

Direcional for example is in our opinion wrongly compared with other real estate and construction companies. Since most of its business derives from the Minha Casa Minha Vida governmental project, it does not face any of the issues and risks other construction companies face, such as clients' defaults or the long term construction cycle.

Direcional is better understood when seen as a service company: it is hired to build projects and therefore it has completely different risks and competitive advantages than regular real estate companies.

Another example is Heringer, which is seen (unfairly, in our opinion) as a company that adds little to no value to the fertilizer's value chain, getting very low multiples as a result. The insiders and players in the industry have a completely different view and just gave the company a valuation that is over four times what the market is currently pricing, as we have shown in our last monthly letter.

## c) Attractively priced.

Price / Earnings 2015 Estimate	
Braskem	8,18
BTG	7,39
Direcional	4,68
Gerdau Metalúrgica	10,77
Fertilizantes Heringer	6,27
Log-In Logística	10,66
Minerva	8,26
FCL Equities' Average	8.19
Ibovespa	10,79

*Source: Bloomberg.*

## d) Contains good optionalities not yet properly priced by the market.

As our investors know, Minerva has been for the past year our fund's largest position. This position in particular illustrates very well item "d" because the company has a series of optionalities that together give color to our thesis and provide, in our opinion, an outstanding risk/return situation.

We expect an income growth in emerging markets. A series of analysis have shown consistently across the world that as people climb the income ladder, some goods (like rice) experience a decrease in consumption (due to substitution to other goods) and some goods experience a huge increase. Beef consumption in particular is a type of good extremely responsive to growth in income and urbanization.

It is interesting to note that in the past couple of years, Hong Kong, which is frequently used as a trading hub for mainland China, came out of nowhere to displace Russia as Brazil's leading beef importer according to ABIEC data.

Then, something we were not even expecting happened: mainland China approved Brazil as an official supplier - which can be particularly profitable with the current fast food chains' supplier

crisis and food consumption insecurity that China is facing according to several recent media reports.

We think that with the current change of dynamics in China (less emphasis on investment and infrastructure and more on personal consumption and income growth), the global winners of the next decade will no longer be companies like Vale or Rio Tinto, but companies like Minerva, that supplies goods that increase in demand due to an urban and richer population.

There is also the fact that Brazil keeps gaining market share in the global beef market, due to the country's natural competitive advantages like scale and the absence of climatological problems like the droughts currently experienced in the US and Australia, etc.

Finally, the internal dynamics of the industry are favorable: Minerva is the most efficient Beef producer in the most efficient market, also gaining internal market share among Brazilian producers and exporters.

There is a chain of positive optionalities at a very cheap price and limited downside. Everything could go right, but even it does not happen, we see several factors currently not yet adequately priced by the market, since they will not take place before the election or in the next 12 months. We also take advantage of the occasional short-term focus in Brazil.

Our other companies also have positive optionalities that we don't think the market is adequately pricing, like the return to normal profitability in the US operations in Gerdau's case, a possible strategic buyer in Heringer's case, a change in the Brazilian transportation matrix in Log-In's case and the Mexican shale gas project in Braskem's case. Minerva is our largest position because we think we understand its positive optionalities and are able to access the risks a little better than in most cases.

What about negative optionalities, our investors could ask. After all, the world doesn't change only in positive ways. Several trends can affect businesses in negative ways, like the recent lifestyle changes, with an increasing number of people in wealthy places in the US

and Europe becoming vegetarians or changing their habits to a healthier diet.

Our answer to this question remains the same: people tend to think too much about the highest end of the financial spectrum. For each American or European consuming less beef in the next couple of decades or so there will be at least ten people in emerging markets trading up from a simpler diet to a beef-heavy diet. Most people in the planet are simply several degrees below in the process.

**e) Well placed to endure a possible devaluation of the Brazilian currency and maybe profit from it.**

Our top three positions - Minerva, Braskem and Gerdau - would all profit asymmetrically from a hypothetical Brazilian Real devaluation, their EBITDA would grow a lot more in terms of percentage than the fall Real's market value. They have, after all, revenues mainly in us dollars and costs in Brazilian Real. This also means that in times of risk aversion our portfolio should endure better than most, since devaluations often happen in these moments.

Our portfolio has been called by an investor "pro-Dilma" and the above mentioned facts are the reason why: if there's a relevant capital flight, we have decent hedge holding companies that would profit from the fall of the Brazilian Real. As we said before, one of the beauties of investing in stocks is that you can have any kind of bet, strategy or opinion as long as you pick the right companies with the right framework.

It is not in the scope of our mandate to make aggressive macro calls, but obviously, even from a micro perspective, we think that holding companies able to keep their earnings' power is an important insurance policy for our investors. We fear that investors in Brazil seeking the comfort of the CDI or other fixed income securities may risk having a diminished buying power, at least in dollar terms over the next few years.

Going back to "a)", predictability, we are happy to state that all of our theses stand still after the election, no matter who wins. In our

opinion, the best we can do for our investors is position our fund in a way that is agnostic to the electoral calendar.

Of course, we know that if Dilma wins, we will probably do very well on a relative basis (better than most), but not so well in an absolute basis. If Dilma loses, the contrary might be true, but the most important thing: whatever the result, we can still check these five boxes for each of our companies and are comfortable holding them. It requires discipline and patience to not speculate with the current uncertainty and possibilities that the election results bring to Brazil, but in the long term we think our investors are better served by this approach.