

FCL*Capital*

Annual Report | 2014

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1-Performance Chart

FCL Capital - Performance	
Year of 2014	(25.88%)
Since FCL Equities Fund's Inception (22/1/2012)	(23.11%)
Since FCL Capital Club's Inception (03/04/2007)	+125.41%
Since 22/11/2012, Annualized	(11.73%)
Since 03/04/2007, Annualized	+11.00%

2- Operational Environment

As our investors know very well, 2014 was a tough year for our fund. Through the course of this annual report we will discuss the reasons for the bad results we had in the past year, a general assessment of the investment environment in Brazil right now, and why we are not overly concerned about the recent underperformance. In fact, we are still very sure our investors will enjoy substantial outperformance

compared to the major indexes, like the Ibovespa and the Brazilian CDI over the long term.

Interestingly, volatility, if endured with prudent risk control and occasional underperformance are the price to pay if any investor is to stand out from the crowd. That being said, we think the worst is behind us.

Starting by the macro picture, 2014 ended the same way it started: with several points of worry and uncertainty. The good news is that the US recovery seems to be on firmer ground than at any other time since the financial crisis. On the other hand, the Eurozone looks fragile and has two great worries keeping Mario Draghi, the ECB chairman, awake at night: the possible advent of deflation due to the fragile economic situation, and a possible rerun of the Eurozone crisis with a member (probably Greece) exiting.

Meanwhile, the third great pillar of the world economy, China, is engaged in a complicated act of juggling. The Chinese leadership wants (and needs) to put the country's economic model at a more sustainable footing, with more emphasis on consumption and income growth and less dependency on investments, leading to lots of overinvestment, malinvestment and overcapacity, but at the same time it is still very afraid of letting growth falling too much too fast. So far, it has done a reasonable job but we still think lower growth is needed for a real and faster rebalance to emerge.

In the Brazilian domestic front, the big event was the reelection of Dilma Rousseff for a second term - a fourth consecutive PT's term. While this certainly entails more of the economic irrationality, patrimonialism, distortions and complications that a PT administration entails, there are some good news. The government seems to have realized that its policies put the country in stagflation, with zero growth and high inflation and in a tacit admission of its

own incompetence appointed Joaquim Levy, an economist more associated with the opposition as the new finance minister.

He will have a very tough job, inheriting a fiscal situation that not only has deteriorated a lot but also has many rigidities, complications and this is before even mentioning the so-called creative accounting, which just means calling an expense an asset and not considering it and expense. Also, the country has a (still) overvalued exchange rate), it is losing competitiveness and already lost a good part of its business people's optimism.

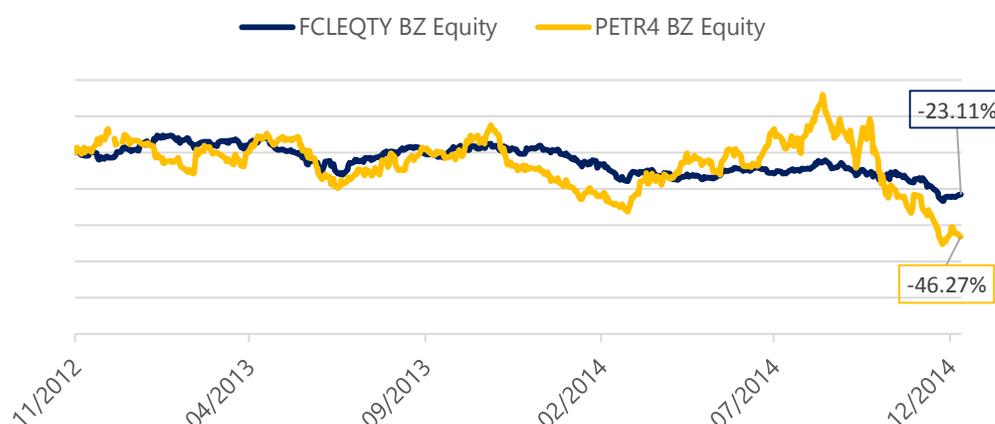
So why are we still confident? Three reasons:

- 1) As we discussed before, bullishness on a country is not really related to bullishness on specific companies of the same country. Therefore, there are still amazing opportunities in the Ibovespa after the terrible price falls of 2014.
- 2) Brazilians have a tendency to do the right things when they need to and when they are under pressure, while doing dumb things when the world helps them. Therefore, the government is already showing signs of being more responsible. It will never be a business friendly administration (what would you expect? The current president was a former socialist guerilla leader...) but we are quite confident that the current pressure that the Brazilian private society - the media, the executives, and so on - has built will lead the current administration to do a better job than in the first four-year term.
- 3) Everything is relative and everything has a price. The good consequence of bad performance in 2014 is that our portfolio is a lot cheaper than a year ago. Even more importantly, the share prices of the companies we have stakes in are a lot lower but the fundamentals of these companies are even

better than a year ago. So 2014 was not a bad year when it comes to the results of the companies we have investments in, only to the shares of these companies. This is usual in bear markets, as is the opposite when the times are good. But this makes us optimistic for the next year as we will show in the next section

In this already convoluted scenario, the Petrobras scandal obviously had a negative carry effect in the whole market, because it put in question the credibility of the country as a whole. Specifically in the Ibovespa, and we are not saying this because we had a bad year, irrationality set the tone. It was a year when (with obvious exceptions) good investors lost money and some people who did not know what they were doing made money.

FCL Capital vs Petrobras, Since Fund's Inception (22/11/2012)



Most of our portfolio holding went down, like Minerva (-13.92%) Metalurgica Gerdau (-51.71%) and Braskem (-16.67%), and we will talk about each one of them later in this report. However, what caught our attention was that, while obviously in any given year some stocks go up or down a lot because of fundamentals and good news, the current climate of short termism, fear and irrationality in the Brazilian stock exchange made some bizarre facts.

We don't own the following stocks that we are about to mention, are not thinking of buying them, and have never owned them at any point, so there's no hidden agenda here, but observe a stock like Mills Engenharia (MILS3:BZ), which is a company that leases and provides machinery and support equipment for the construction industry.

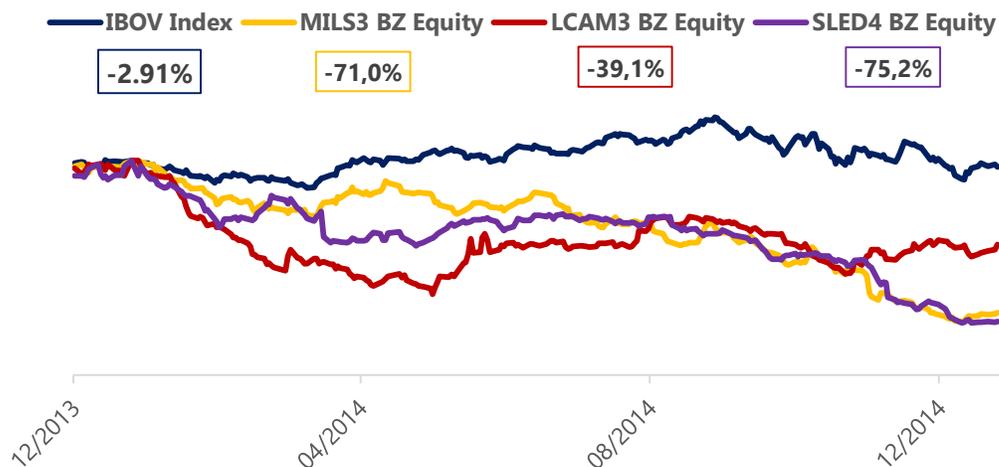
We think it is a decent company. This past year was reasonably tough for them: revenues were flat, EBITDA will probably end the year down close to 10% and earnings down more than 30%, but its business and prospects remain intact. The stock went down more than 70%, and its market cap is less than a third than it was just a year ago.

Or Saraiva, which has seen revenues up, profits up and EBITDA up, all of them significantly, only to see its stock decline more than 75%, or Locamerica (LCAM3:BZ), which had revenues, cash generation and profits up, while its stock ended the year at roughly half the level it started 2014.

Obviously, all of these companies face specific challenges and problems. However, we do think this divergence between their numbers and their share prices is an indication of the current market overreaction on both ways: a few specific loved companies while all the rest faces declining share prices no matter their results.

Once again, we don't own these companies, but observing them were instructive for us, because we could see the giant swing in mood investors have, especially in an emerging market like Brazil. In addition, since profits are up and share prices down, we can be more confident of the prices we are currently paying for our shares and that a rebound in the Brazilian market should not be too far away.

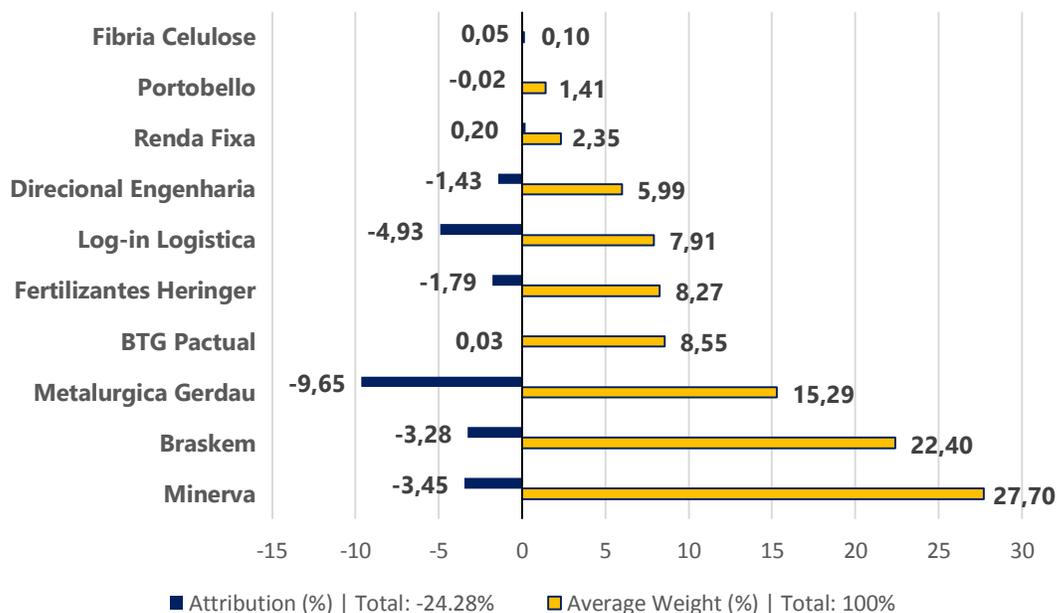
Performance in 2014



3-Portfolio & Performance Attribution

Over the course of 2014, one recurring theme happened to our investments: profits up and share prices down. Even for long-term investors this is an annoying phenomenon.

FCL Capital Portfolio Attribution in 2014



As we can see in the chart above, mainly Metalurgica Gerdau, Log-In Logística and Minerva impacted the performance in 2014, but almost every position fell in price. In the past year, we have stated the reasons for being bullish in these companies and although we frequently revisit their respective thesis and our framework about them keeps evolving, we continue to be very optimistic about their prospects. In this section, we take a quick glance at how they performed in the past year and their perspectives

Minerva (BEEF3) – Participation in 2014		
Return: -13.91%	Average Weight: 27.70%	Attribution: -3.45%

Minerva (BEEF3) – Key Figures		
	Last 12 Months	Year of 2013
Revenue	6303	5456
EBITDA	646,1	551,4
Adjusted Net Income	-230.8	-314.3

Comments: As our investors know, our long term thesis in Minerva is that international meat consumption in general and beef in particular will grow exponentially in the next few decades on the back of Asian and Chinese growth and changing dynamics, with more emphasis on consumption and family income (i.e. less iron ore, more meat).

Our thesis remains intact and at least in our view the company had a great year, with year over growth of more than 20% in revenues and record cash generation. The market however seems nervous about the current high price of cattle and the lower price of oil that makes consumption in countries like Venezuela and Russia (important buyers of Brazilian meat) suffer.

We think the recent price decline is a great entry point for long-term investors who want to take advantage of this secular trend and have

not sold our shares. We honestly don't see any reason for the shares to have dropped as much as they did, especially considering that China has just allowed once again Brazilian cattle imports and that the USA and Australia, traditional competitors, face chronic and severe drought problems.

Braskem (BRKM5) – Participation in 2014		
Return: -13.46%	Average Weight: 22.42%	Attribution: -3.28%

Braskem (BRKM5) – Key Figures		
	Last 12 Months	Year of 2013
Revenue	45,865	40,969
EBITDA	5,467	4,799
Adjusted Net Income	765.1	507.0

Comments: Braskem, like Minerva, also posted record results. The next year will be very important since this is when the new Mexican project will come online, bringing the company's results to a new level. We consider the company one of the cheapest in the Ibovespa index and it continues to trade at significantly lower multiples than virtually any other major petrochemical company in the world.

In addition, the company benefits from the dollar appreciation (100% of its revenues are in US dollars) and the lower oil price, since it is a major naphtha consumer. However, the market chose to focus on the current economic weakness of the country, that hurts its industrial consumers, the possibility of an energy crisis in Brazil and the more risk averse environment in general.

Gerdau (GOAU4) – Participation in 2014		
Return: -50.79%	Average Weight: 15.29%	Attribution: -9.65%

Since Gerdau was the main contributor for the fund's negative performance in 2014, we will discuss it a bit lengthier.

It is not hard to see why the shares have fallen: Brazil's economic performance clearly disappointed and this made the company more vulnerable to lower demand from its clients, while Brazil's over appreciated exchange rate helped imports on the other side. Meanwhile, the market is still not making a proper sum of the parts valuation: the U.S. assets, which represent almost half of the company clearly are not valued anywhere near a pure U.S. based steel maker would be.

While we agree that the economic situation in Brazil will remain difficult, it is important to observe that Brazil represents less than half of the company's operations when counted based on where the demand comes from. Besides the us operations Gerdau has a significant presence in countries like Colombia, Chile, specialty steel operations and Iron ore exports so once again it is important to note that a Brazilian company , even one from a cyclical industry like steel is not necessarily as affected by a downturn in the Brazilian economy as one could expect.

The numbers seem to prove our thesis: Gerdau has shown resilience and we think that in 2015 most of its operations, especially the U.S. long steel division will outperform and help the company to show record numbers.

Buying Gerdau shares is a great way to protect against a devaluation in the Brazilian real. In fact, one of the major problems the company has faced competition with Turkish and Chinese steel imports is diminishing precisely because of the lower level of the Brazilian exchange rate, not to mention a possible increase of exports from brazil and the higher level (when translated to reais) of profits in the us operations.

In the first week of 2015, Gerdau has rallied because, thanks to the real's decline, the company was finally able to increase long steel prices in the domestic market.

BTG Pactual (BBTG11) – Participation in 2014		
Return: 4.95%	Average Weight: 8.57%	Attribution: 0.03%

BTG Pactual (BBTG11) – Key Figures		
	Last 12 Months	Year of 2013
Book Value	18,176	16,091
Adjusted Net Income	3,328	2,882

Even in a challenging year, BTG was able to keep its roe close to the 20% level and post record profits. We think BTG is a better investment opportunity than the major retail banks like Itaú. It has a similar level of ROE even in a negative economic environment. The upshot is that when the cycle turns, its ROE will probably be far superior to the retails banks' since these are less dependent on the landscape in Brazil, an advantage of having cyclical results.

BTG took an important step in its internalization process, buying BSI, a traditional wealth manager located in Switzerland. If the principal operations and investment bank divisions improve their performance, we could see ROEs close to the 25% mark next year.

Fertilizantes Heringer (FHER3) – Participation in 2014		
Return: -24.1%	Average Weight: 8.27%	Attribution: -1.79%

Fertilizantes Heringer (FHER3) – Key Figures		
	Last 12 Months	Year of 2013
Revenue	6,817	5,428
EBITDA	332	267
Adjusted Net Income	49.0	-33.9

Overall Heringer had a transformational year. The company keeps growing quickly in terms of volume and revenue, although we would like to see the high EBITDA and revenue numbers to be more thoroughly translated in cash to the shareholders.

An important Moroccan phosphate producer, OCP international, acquire a 10,5% stake in Heringer for roughly five times the share price trading in the Bovespa. We share some of the market concerns regarding the company administration quality, but think its shares are overly depreciated, especially in a sector where Brazil has clear comparative advantages.

Next year will be make it or break it for this investment: either the company will deliver significant cash generation or our thesis will prove mistaken. The good news is that we are not far away from finding the truth.

Log-In Logística (LOGN3) – Participation in 2014		
Return: -58.54%	Average Weight: 7.90%	Attribution: -4.93%

Log-In was also a negative contributor for the performance of the fund in 2014. Still, our main thesis stands - in a continental country where almost all the population and economic activity takes place not far away from the coast cabotage (transporting goods from one port to another by sea and not by truck) will be a very noble and important industry and Log-In will be its leader remains intact.

We will not deny that the company faced a very important setback in 2014 - the temporary closure due to financial problems of EISA, the shipyard where are the four company's ships are being built.

Our team was personally two different times in EISA, to monitor the building progress of the ships, and while construction is going slower than we would like, the good news is that is once again marching ahead.

In this *annus horribilis* that was 2014 everything that could go wrong did, and we always knew that problems in EISA were the only risk to our thesis. Hopefully, things are now back on track and we still think Log-In has a brilliant future ahead.

Direcional Engenharia (DIRR3) – Participation in 2014		
Return: -28.26%	Average Weight: 5.99%	Attribution: -1.43%

We bought shares in Direcional at very cheap prices and they got cheaper. The only reason we could find for this is that at the last instance, the government is the main client of the company, and some investors are forecasting financial problems for the government.

We will explain in the next section where we discuss the case behind Direcional, even if everything goes wrong for Brazil in the next few years, we think social programs are the only story the government can plausibly tell so they will remain sacred. We do not see a change for the Minha Casa Minha Vida program in the future.

Portobello & Fibria

Portobello (PTBL3) e Fibria Celulose (FIBR3) – Combined Participation in 2014		
Return Portobello: -5.09% Return Fibria: 8.33%	Average Weight: 3.76%	Attribution: 0.03%

These are two smaller stakes still evolving in our fund as our team gather knowledge and evidence about the companies. We will probably talk about them with more depth in the future, but to sum it up, Portobello is a play on consolidation, a leader in a slow growing industry of ceramic coatings. There are signs it may even buy the second largest company in the industry, resulting in a sort of “Ambev of ceramics in Brazil”.

Fibria is almost a repeat, with some caveats, on our Minerva thesis: an industry where Brazil has a comparative advantage and where we can surf on the secular trend of Asian urbanization and growth of income, since the consumption of toilet and hygienic paper skyrockets when nations like China, India and the rest of Asia start to get richer.

4- Case: Direcional

We would like to take the opportunity this annual report presents to further review a company we have already been discussing with our investor for the past year: Direcional Engenharia.

Direcional, as our investors know, is a leader in the Brazilian real estate sector focused in lower income families. It is the largest player in the so-called Faixa 1 (band 1) of the Minha casa Minha Vida housing project, where the Brazilian federal government buys and subsidizes the purchase of habitation units for thousands of Brazilian families.

One of the main strengths of the company, in our view, is that this model allows for Direcional a completely different cash flow cycle, with much shorter receivables than traditional real estate companies. In fact, we would make an even further point: at least when considering its Minha Casa Minha Vida projects, Direcional is not really a real estate company, but a services company that builds for a specific purpose, and therefore has no default risk, low financial exposure, and so on.

Over the past year, we would argue that our thesis and our assumptions have proved to be correct. Direcional was able to keep (if not improve) its profitability despite a very weak economic environment. It did not have any major problems, unlike some traditional real estate players.

Despite this fact, the shares have performed very badly in the Brazilian stock exchange. The market is not really in the mood to access the reality of each single company. It simply decided that it should sell real estate companies and Direcional suffered just as much as all the rest.

The market seems to be worried about the exposure of the company towards the Brazilian federal government. According to this line of thought, since Brazil can face a financial and fiscal crisis, every company and program that depends on the government could face trouble. We already stated in the past the reason we do not agree with this reasoning: social program are the only venue were the government could plausibly defend its record. We do not think a serious discontinuation of any social federal program is in the cards, especially a popular and well-approved program like Minha Casa Minha Vida.

Despite this fact, investors heavily sold the shares throughout the year and at the time of this writing they are at an almost insane level

of cheapness: well below book value and at four times this year's earnings according to the Bloomberg Consensus

Direcional – Ratios in 2014	
Price to Book Value	0.69
Price / Earnings	5.71
Dividend Yield	8.36%
Price to Cash Flow	2.63

We expect a new phase of the Minha Casa Minha Vida program to launch in the not distant future. This next table is one of the most important when accessing the Direcional case in our opinion:

Level 1	Contracted Units	Direcional	Share %
MCMV1 & 2	1.586.409	84.065	5%
MCMV1	482.741	7.391	2%
MCMV2	1.103.668	76.674	7%

➔ +500 bps

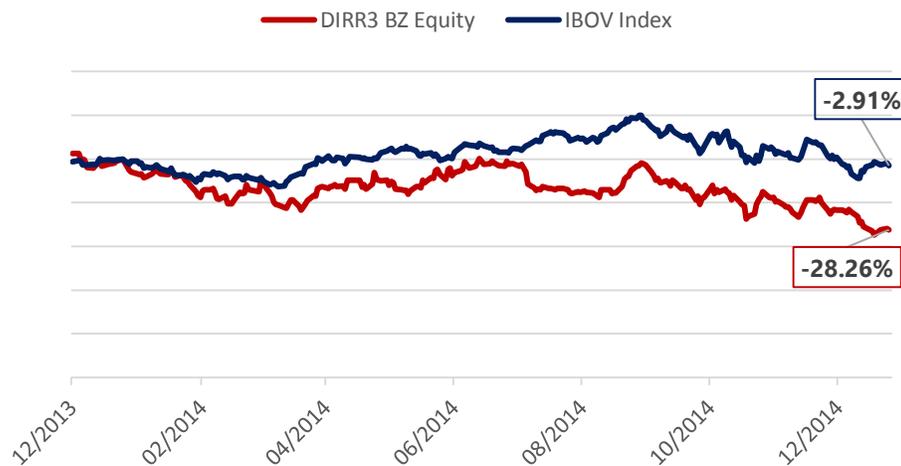
Source : Ministério do Planejamento, Orçamento e Gestão 05/28/2014

When the Minha Casa Minha Vida program was first announced years ago, there was a gold rush that is typical of a new opportunity, where thousands of companies from every corner of the country rushing in to be part of the program, many of which without the financial capacity or the expertise and vocation to be a low cost supplier.

Over time, as anyone would expect, many went burst, while others simply decided that the program was not a good opportunity. Meanwhile, Direcional has always been a natural leader with many comparative advantages, such as a unique construction method, utilizing a scale that allows the company not to enter any construction site with less than a thousand units.

The result was that over time, the company was able to grow its market share, from 2% during the phase 1 of the program, to 7% during phase 2, and we are quite confident that the company may show double-digit market share for the just announced phase 3 that will begin shortly.

Direcional vs Ibovespa, Performance in 2014



5- The two frontiers of the 21st century

We would like to end this report on a more positive note. More specifically, we will end this report discussing while we are still very optimistic about the world economy prospects for the next few decades and, crucially, this explains part of our long term bullishness in global stock markets.

We have been criticized in the past for being stock market bulls, in their worlds, optimistic investors. We do not deny this accusation, even though we are bearish in many short-term factors - Brazil's economic situation for example- over the long term these irresistible forces will make the world march forward.

Call them the two main drivers, the two frontiers of the 21-st century. These two forces will shape the world and the stock markets for the remaining of our work lives. The first one, innovation, will determine how fast the frontier, the very edge of the planet's economic evolution, will march forward.

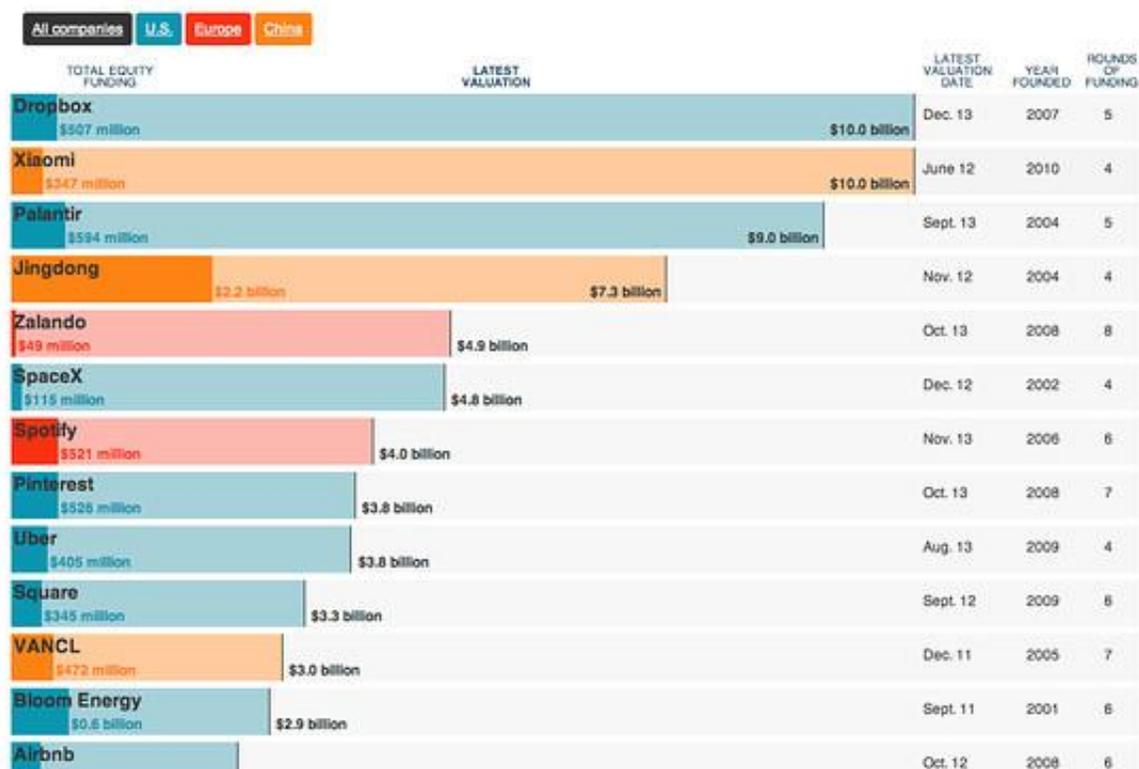
The second one, urbanization, the so called "catch up process", will be even more important for the planet's overall economic growth, because most people live very far away from the frontier, and this catch up process will diminish the difference between those who live close to the frontier (like us and northern European citizens) and the rest.

5.1- U.S. Productivity, Innovation and the Silicon Valley

The first drivel for the world's future economic growth is the increase in long-term productivity. There has been a lot of debate (as this house has issue a monthly letter about the subject) if productivity in the rich world in the future will be as good as in the past.

We stand in the optimistic camp: there are so many amazing innovations in the world's labs today that we really think human ingenuity, creativity and capacity to build amazing new companies is almost endless.

Among all the worlds innovation clusters, clearly on stands out: with its openness to talents from all over the world, unconformity spirit, excellent universities, hyper developed financial and venture capital markets, meritocracy and tolerance for risk and failures, the region south of San Francisco, universally called Silicon valley, has a clear leadership.



Obviously, it is very difficult to call which startups will be the huge winners of the future, but the goal of this report is humbler: to simply state and understand that no matter that, the pipeline of amazing new companies coming to market is not doing to dry up in the future¹.

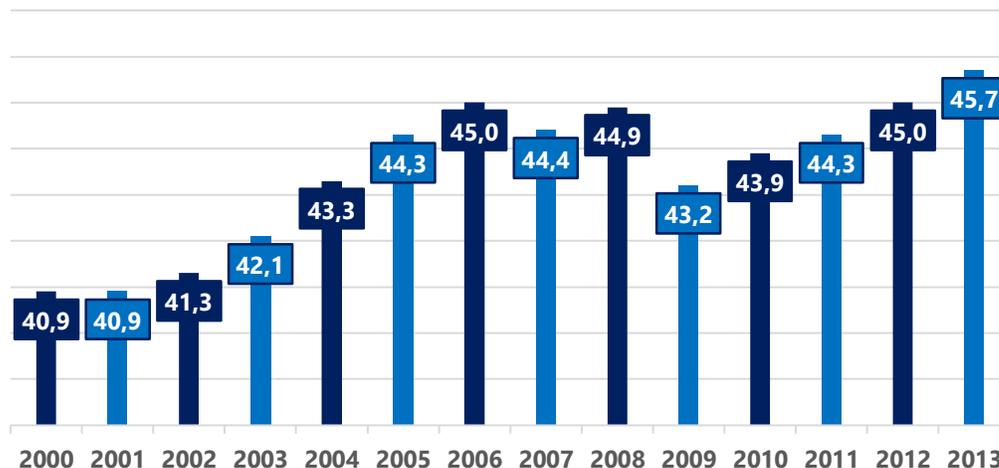
Why does innovation matter so much? Because advancements in technology (in a broad sense that also count infrastructure, education, and so on) are ultimately what drives productivity and this in turns drives long-term GDP growth.

The USA can still be considered the “frontier economy” in this sense. Even though there are richer countries than the US, like Switzerland or Singapore, none of them are big enough or important enough to

¹ *A more difficult discussion is if the public or private markets will accrue these gains, since companies lately are keeping private for longer. Anyway, for purposes of human and economic advancement, this is irrelevant.*

be considered the “base” in an assumption where every other single national economy could be considered a percentage of the U.S. levels in GDP per capita.

American GDP per Capta Evolution, in Thousands of Dollars



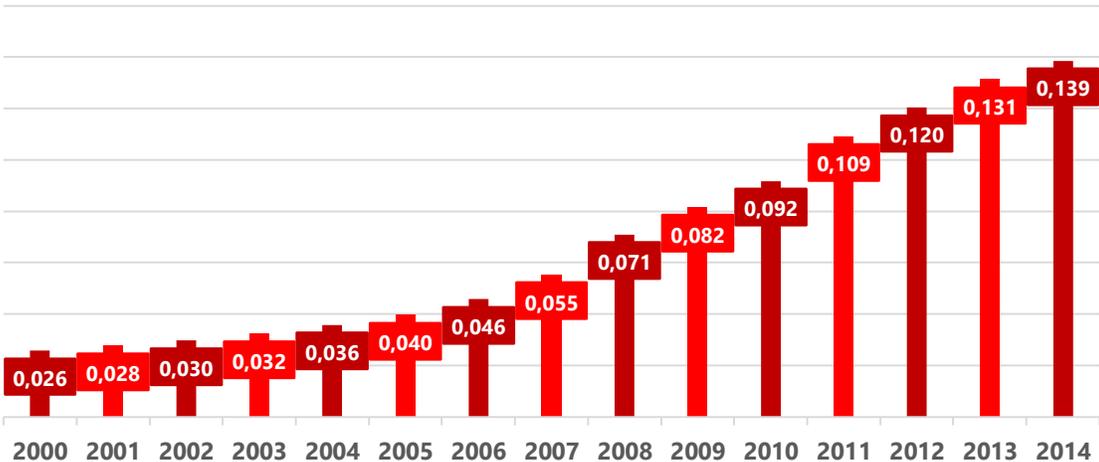
5.2- Urbanization & the Chinese catch up process

The second and last driver of economic growth is just as fascinating. Asia has always been the continent where most humans live. So the fact that this part of the globe is catching up (i.e. its levels of GDP per capita are approaching those of rich countries) is certainly the most important economic aspect of our times, alongside the internet.

To state in other terms, the numbers are on China’s (and in the distant future India’s) side. Since its population is over four times America’s population, fact is that arithmetically, if China rises from its current GDP per Capita of around U\$ 8.000 to a level close to the one enjoyed today by, say, Portugal (around U\$ 21.000) then it would have an economy with the size of the USA and the Eurozone combined. To put it in other terms, if China reaches this level then the economic axis of the world will clearly have shifted.

Can China reach a level of GDP per capita of U\$ 20.000 in the next 20 years? It seems clear that it can. The few examples of nations that quickly rose to developed level status in the past century were most East Asians, like South Korea, Japan and Singapore, all of them with high levels of savings, empathy's on education and a strong work ethic.

China / USA GDP per Capta Ratio Evolution



When adjusted for purchase power parity then this historical shift already happened. Since the Renminbi is still significantly cheap, 2014 market the first year since 1872, when the U.S. overtook Britain that the title of world's largest economy in purchase power parity terms changed hands.

As we stated in our past letters, many of our investment touch in one way or another in the china growth story and its recent change in focus from overinvestment (less iron ore or steel) to more consumption and growth in family income. That benefits Minerva, Fibria and even BTG, which provide wealth management to Asian clients through its recently acquired Swiss brand BSI.

To go back to where we started, we think these two secular trends, innovation and advancement of level of GDP per capita in the US and catch up and urbanization in China are the main thesis behind FCL's bullishness in stocks as an asset class for the next few decades.