

# FCL*Capital*

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## **FCL: Past and Future**

This is our 8-year anniversary letter. As usual, a few reflections.

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It was a sunny day in mid-2011. I was coming back to Brazil after living for a while in New York City and there was a consensus: Brazil was booming. In one of its most iconic covers, The Economist magazine painted a flying statue of Christ the Redeemer, with the title "Brazil takes off".

Inside the financial circles in New York City, every fund manager i met not only had a surprisingly good knowledge about the country's financial markets and its main companies, but also was actively interested in increasing its knowledge and exposure to the country.

When I came back, the optimism I could sense from outside gave way to something completely different: a hysteria, a sense of self-righteousness, certainly fed by a leftist government, but also that had found its place inside of the Brazilian psyche. After all, after so much time being considered a laggard, now it was Brazil's time to shine.

No critique was well received. No reasoning was needed to believe that the country was the future. The announcements from the government were all similar and they went more or less like this: "this Anglo-Saxon way of doing business and believing too much in laissez faire capitalism is wrong. We, a left wing government from Latin America know a better way, and the financial crisis proved our point"<sup>1</sup>. And the worst part: the population really believed in it.

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<sup>1</sup> The Brazilian way of doing things, of course, involved choosing the champions, increasing consumptions and expenditures, lying and cooking the books to

One thing I've learn is that every time a person, a company, or a country think it can do no wrong, it is just superior to everyone else, bad things are about to happen. Being wrong and knowing it has always been the way we improve as human beings after all.

One of the most frightening conversations, the week I was back was with a taxi driver - they are, after all, the voice of the population, the personalized collective imagination.

## **Taxi Driver**

- So, you were living abroad, right.

## **Me**

- Yeah.

## **Taxi Driver**

- Wow, poor guys. Things are really bad for them, the Americans, the Germans... Brazil is the one to come out stronger from the crisis.

## **Me**

- Wait, do you really think that right now the average German or American is worse off than the average Brazilian?

## **Taxi Driver**

- Yes. You just have to look at the TV or read the news!

He did think that. The government had convinced him as much. Like Eike Batista, a person who can be accused of many things but not of

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exclude expenses and other tricks we are still discovering every day. However, this is all a topic for another letter.

not being an amazing salesperson recently said, "Brazil was in love with Brazil"<sup>2</sup>.

The Ibovespa was hovering around 63.000 points, but thanks to an overvalued exchange rate, it was at double the level it is now, in dollar terms. It was more expensive to buy an apartment in Rio than Manhattan.

I was shouted at many times both in family and friends gatherings as in financial conferences when I argued, including in this very space of our management letters, that this bubble was also going to pop. Brazil was indeed in love with Brazil and when things are good people just do not want to hear the bad news.

Meanwhile, clouds were gathering: government expenses (as always) were going through the roof and increasing exponentially, a series of dumb mistakes in economic management, like bad coordination of expectations, distortions, dirigisme and so on were starting to harm the economic activity and hurt companies profitability.

In my twitter account, I posted:

**FernandoAraujoFCL @FernandoRJ · 22 Oct 2011**

*Bolha imobiliária, ufanismo, reformas paradas. O Brasil precisa urgentemente de uma nova crise para colocar as coisas nos eixos.*<sup>3</sup>

The good news is that finally, the crisis I was calling for has come. It could not have happened any other way. We produced this crisis. It is ours.

Psychologists always say that the first step to solve any problem is recognizing the problem exists. Brazil has grown a lot in the past

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<sup>2</sup> As can be read in Eike's most recent interview for Valor Economico

<sup>3</sup> "Real Estate bubble, blind patriotism, frozen reforms... Brazil urgently needs a new crisis to put things in perspective."

year. The sense of superiority and self-righteousness vanished. Brazil is in a bad shape and at least the king admits it is naked.

On the other hand, while we were right about the fact that this crisis would come, our defenses just did not work. We focused our bets in companies that have exposure to foreign currencies (because we had seen that the real was overvalued) and specific ideas that we judged not too dependent of the economic environment.

The first group of companies, mainly Minerva, Braskem and Gerdaul had its performance harmed because it was seen as a proxy for the economic environment. We do think that this group will reemerge, once results start to come in, with increased profit margins, thanks to the new level of exchange rate and despite the bad economic environment.

The second group, on the other hand, performed terribly because it is mostly composed of small caps, and small caps as a whole were decimated in the past couple of years in the Brazilian stock exchange. We have been reducing in the past month this exposure to this second group, not because the prices went down ( this should never be a reason) but because stressed situations made the companies perform, in some cases, differently than we would expect.

As Warren Buffet once said, we violated Noah's rule. We had foreseen the rain, but didn't built a good enough arc. That being said, it is the future we are excited about and want to focus in this letter.

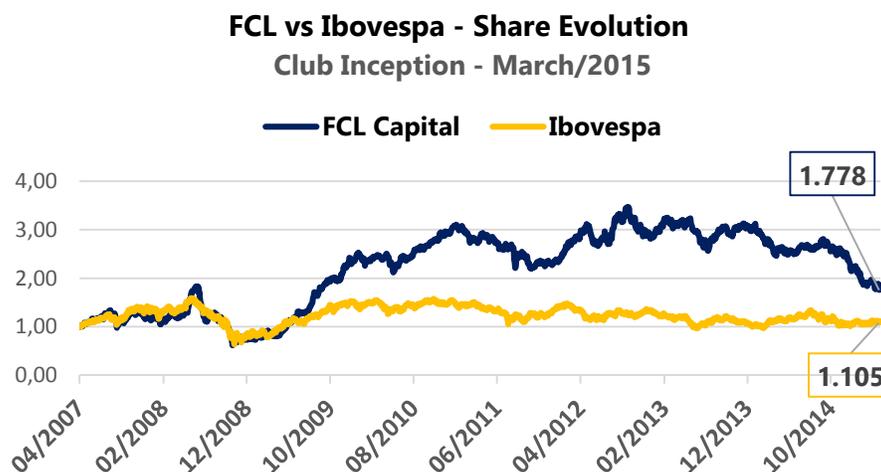
One of our main thesis when we founded our company was that in time the Brazilian economy and financial markets would converge with what happens in more developed markets. In other words, it made a lot of sense being a Brazil based equity fund if you believed that in time the Brazilian economy would show a greater level of sophistication, more mature markets, and consequently, a group of more numerous, more diverse and better quality companies listed in the Brazilian equity markets.

This thesis, just like some of our investments, has proved to be at least in part a mistake.

It is still quite probable that Brazil's economy will over the next few decades grow faster than the US Economy (after all, the country is only at around a fifth of the us levels of GDP per capita so there's a lot of catching up to do.) Considering population growth, it is virtually certain that Brazil will grow quite faster than Europe. It is a given and there is no merit in that.

Therefore, a good part of our "founding thesis" still stands: over time, the Brazilian economy and financial markets will exhibit a level of sophistication a bit more similar than what we see in some major markets today. On the other hand, it now seems that the process will be slower than most people originally thought, and with a few stop and go processes along the way.

Our job as investment managers is to keep evolving. Since we are celebrating 8 years of existence, and are approaching a decade of life, we would like to reflect on what we think was the greatest success we achieved so far and the search that will take place in our second decade for becoming better investors:



The success is that we could easily outperform our main benchmark, the Ibovespa index, by doing exactly what we promised we would do: looking for specific undervalued opportunities in the Brazilian markets. When aggregating the results of our club with the current incarnation, FCL equities, we were able to achieve a 77% accumulated return, against about 10% of the Brazilian index over the same period.

On the other hand, when it comes to protection against downturns and the optimal allocation of capital, which is our ultimate goal, we still think we have a lot of room for improvements.

We are becoming better investors with time. This much is a fact. Apart from that, this house, unlike most, has always been fanatic for finding the perfect structure and alignment with its investors<sup>4</sup>.

So what will the next few years look like?

Of course in this business, where predictability and sticking to our mandate counts so much, transitions should be very slow and careful.

First, what will always remain the same: we will always be a value investment house, focused and concentrated on relatively few investment opportunities and trying to be as aligned to our long-term investors as possible. In addition, we believe in a single vehicle structure.

Unlike many other asset managers, we will never institutionalize our investors. Our vehicle may change but as long as possible we will try to maintain just one single investment vehicle, where our money will be tied with our investors' money. That being said, we do foresee 3 avenues of evolution for FCL in the next few years:

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<sup>4</sup> As we said in the past, we think this is the most underappreciated competitive advantage in our business

- 1. A fund that searches for opportunities instead of equities;**
- 2. A global fund I instead of Brazil based;**
- 3. Very long term focused instead of stock fund liquidity;**

## **1) Opportunities instead of equities.**

Over time, we realized that what we are good at is finding specific long-term investment opportunities.

A few insights all but guarantee we will have a good year. Traditionally, we focused almost exclusively in equities, and this will always be our main focus, since we believe that our time is better spent researching the micro, the reality of each company, since it is harder to have an edge about macro events, especially for a small company like ours.

However, over time we think it is only logical to look at the capital structure of companies as a whole and a few specific opportunities that may present themselves, without drifting from our mandate as equity value investors.

We do believe there are synergies in this approach - we do not lose time with macroeconomic considerations and research, like for example gathering knowledge about commodities when investing in a commodity business, or, crucially, when we look at companies as a integrated capital structure rather than just at the owner's capital which is the equity side.

We do believe this approach, which we had from the start, allows us to be better equity investors and more complete and better able to understand the risks and rewards whe we choose to make equity or other kinds of investments.

## **2) Global Instead of Local**

Since the beginning, our mandate has been to allocate 90% of our capital in the Brazilian stock market and the remaining abroad. Due

to practical and operational difficulties, we never really made significant investments outside of the Brazilian market, and this has harmed greatly our performance over time—there were several instances where we compared specific Brazilian companies with their international peers or even the Brazilian stock exchange as a whole with other exchanges, and found better opportunities abroad.

Even with many important and legitimate considerations regarding competitive advantage and specialization of focusing in a single market, we are convinced that to be a complete investor, to be better able to balance risks and rewards, and, to enjoy the best risk adjusted returns possible, we have to look at the world as if it were borderless.

The good news is that gradually, Brazilian legislation is becoming more flexible. Starting in July 2015, funds like ours will be allowed to allocate up to 20% of their capital abroad, and this increase will allow us to be able to dilute the operational costs in a way that finally makes sense to allocate capital in specific opportunities overseas.

A possible future change in legislation and in our bylaws could make it theoretically possible to invest up to 100% abroad.

Obviously, knowledge is everything in investing. Brazil will probably remain our focus for many years to come since over time we have gathered so much specific knowledge about the companies we cover here. Looking abroad will be over time more useful, when comparing companies in Brazil with their peers, when accessing risks, currencies, competitors and opportunities. The direction is clearly for internationalization even if we remain unsure about the speed this will take.

Over the past months, our team has started carefully gathering information, knowledge and contacts and the fruits of this work are starting to arrive: we finally made our first investment in a company that has its headquarters outside of Brazil.

As it is frequently the case, we only announce our investments after our position has reached the size we judge convenient for our

portfolio so our investors should stay tuned about this new beginning in our investment process.

Obviously, an added benefit is that internalization, when looked from a portfolio perspective, can mitigate risks like the ones we faced in the past year: political risks, being stuck in a low growth economy, being exposed to a falling currency, and so on. The good news for our investors is that if everything goes according to plan, this will be the last Brazilian crisis that has such a dramatic impact on our returns, since we plan to be more diversified in terms of jurisdictions in the future.

### **3) Something between an Equity Fund and a Private Equity Fund**

The third and last avenue of internal growth for FCL is a direct consequence of the first two. Our specialization is in finding specific opportunities and since we will increasingly look globally for the best possible risk adjusted returns, a natural consequence is that over time, our fund should gradually have less liquidity, from the current d+ 12 days of redemption to a model that may be closer to a hybrid of public and private equity investing.

As in the first two cases, this gradual change will allow us to increase the universe of coverage and possibilities, focusing across jurisdictions, asset classes and degrees of liquidities all in the name of maximizing long-term adjusted returns.

Some investors may not feel that this level of liquidity is well suited for them, and clearly, they will be able to redeem their investments long before we make any changes. For the ones who remain, we believe more opportunities will open, since we could look at many possible investments, especially in PIPEs and private companies that our mandate does not allow us today.

In short, this house is as obsessed as ever about having the best possible performance, being the most aligned it can with its investors and above all, in improving every day. We thank all our investors that trusted us with their capital, insight and partnership in these first eight years and hope the next ones will be even better.