

FCL*Capital*

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In the mid-1980s, the area of Los Angeles consisting of Hollywood and its surroundings was already on steep decline compared to posher parts of California. According to Wikipedia and most biographical accounts, the keyboardist of an irrelevant local hard rock band called The Hollywood Roses was contacted by a friend, from another irrelevant band called the LA Guns. He was searching for a vocalist. Apparently, no one had bothered to audition for the job in the first place.

By most rational accounts, most would not have bet their money in the success of the band that was being born. Hard rock and heavy metal were already entering a secular decline in popular taste. The members were so edgy and so not worried about commercial success that the first name they considered as a band was "AIDS". Cases of drug addictions and breaking the law by the band members were rampant, before, during, and after the band's formation. Finally, the songs were heavy, had lengthy play times and were full of offensive words.

In the end however, unable to find a proper name and , possibly, unwilling to spend much time thinking about it, the band members only decided to merge the titles of the two bands. From the ashes of the LA Guns and the Hollywood Roses, Guns N' Roses were born. The following year, their first album, called "Appetite for Destruction" was released and it would eventually sell 30 million copies. To this date, it is the most successful debut album released by any band in the world ever, including the Beatles and the Rolling Stones.

At FCL Capital, we spend a vast amount of time trying to understand winning cultures. What are the specific set of circumstances, people, luck and surroundings that give birth to miracles like Microsoft, Google, Apple or Ikea? Can the winning cultures that took place in these companies be predicted and

foreseen? Even more importantly, can we possibly dream of installing a culture of excellence like this in our own company? Can we at least identify the key differentiators before other people realize the company is unique and gain an edge on our investments?

We started the letter by discussing the origins of Guns N' Roses, a remarkable example of a culture of excellence because a single fact has always scared me. After almost unbelievable fame and fortune, on a scale very few bands have ever experienced, the two main band members, the vocalist Axl Rose and the guitarist Slash fell on very bad terms. No matter how much fans around the world dream of a reunion, the two of them haven't spoken since 1993. So far, nothing out of usual for rock bands.

The band was formed when they were a group of drug-addicted nobodies. To this day, Slash is considered by many music critics and lovers, including myself, as the best player ever to touch in an electric guitar. When the band split, Guns N' Roses were already worldwide famous. Axl had millions of dollars and huge resources to spend in search for a replacement.

He had all the contacts in the world. He could run auditions that would attract thousands of musicians from around the world dreaming of playing in Guns N' Roses. Hell, if he wanted, he could even start a reality show only to look for a replacement, Donald Trump style.

Still, if we compare the guitarist Guns N' Roses had before any money and fame with any guitarist the band could attract when it had thousands of times more resources, as any Guns N' Roses fan will tell you, it is not even a contest.

This can only mean one thing: it is not that Slash has always been the best in the world - although he certainly has always possessed enormous talent – but maybe the band itself made him become so good.

Maybe it came from the way the band worked, not from how good he was in the first place for the band. In other words, maybe there were unique elements, internal greatness or some unique winning culture that allowed him to shine. Something hard to replace and to explain that the band had when they were together, despite all the apparent lack of effort.

The same challenge often happens to companies who want to replace a star CEO. It seems counterintuitive that it is easier for a startup with almost no resources to find the right person than for companies with billions in revenue¹. On the other hand, every soccer fan knows about the team that is the “best on paper” and has all the stars but gets a beating on the field. Why?

Maybe people are looking at this the wrong way. Maybe some founders like Steve Jobs and Richard Branson were so good exactly because of their companies and the culture they had, and not the other way around. They created, but most importantly, they and their teams flourished inside winning cultures.

Even if we look at history, although human IQ and intelligence is obviously spread equally on average around the world usually there has been places where unique results were achieved. The

¹ As Apple famously learnt when the company fired Steve Jobs in 1985.

Greeks, while living above rocks 2000 years ago, wrote about everything we still are today. Then the Romans, the Portuguese, the British, all the way to the Americans in the past century, and (just maybe) the Chinese in the next century.

The search for winning cultures is at the core of value investing for a firm like this house that searches for amazing companies with well-protected “moats” to use a Warren Buffet phrase. It is obviously very difficult to know beforehand when we are witnessing greatness, when a group of people, be they part of a company, a basketball team or anything else are destined to do amazing things. Overall, judging but all the evidence and cases we could think of, we would say winning cultures share at least three key traits:

- 1) Their people are not in a project, they are in a mission.**

Remember the words Steve Jobs used to lure Pepsi executive John Sculley to come work at Apple “Do you want to sell sugary water for the rest of your life, or do you want to come with me and change the world?”

He really believed in this, so did the people at Google, Ikea and so many amazing places. They are on to grander things not only to make some money

- 2) They do things their way, not caring about what everyone else is thinking or even wanting.**

And,

3) They are, due to luck or ingenuity, in the middle of a unique set of circumstances that allow them to achieve unique results.

You can find this third trait in one of our largest holdings, Minerva. It is a well-known fact that cattle production follows a few basic rules. You have to achieve scale and have vast land resources. It is fundamental that you have access to cheap water. Good climate conditions help. Therefore, looking at the supply side, it is almost impossible that South America will not gain market share in this market from the rest of the world. In fact, even more than that, the supply of the rest of the world combined will not even increase: all marginal demand will be supplied by South America.

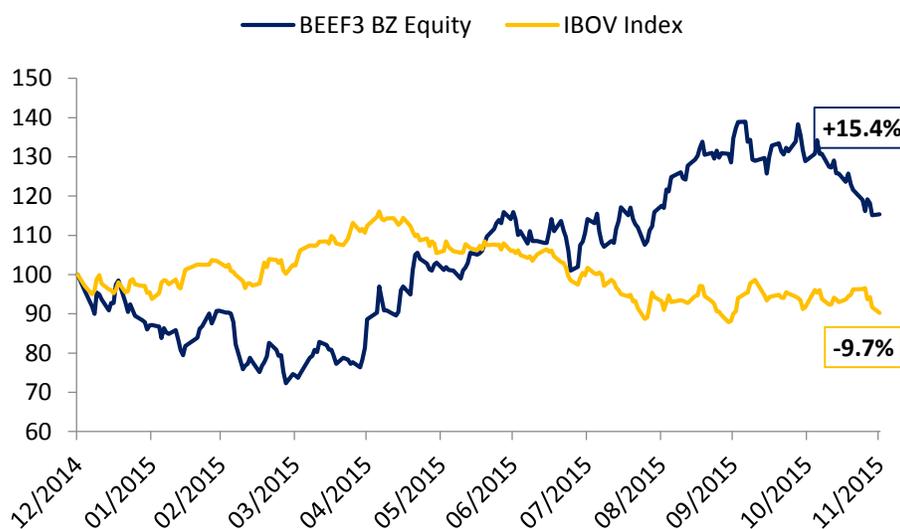
So far, this would not be a unique set of conditions. A beautiful little known fact is that 80% of Brazilian cattle is used for domestic consumption. It is slaughtered on the thousands of small mom and pop slaughterhouses that exist in Brazil. Largely, the big three, Minerva, JBS and Marfrig are in a different market. The remaining 20% of cattle production is a completely different matter. To borrow the words of a cattle breeder we know, it is a “cozy club” with the big three having a disproportional share.

The implications of this are fascinating: Brazil is in deep recession, possibly heading for a depression. Meanwhile, Brazilian beef exports will boom in the next few years. Since 80% of demand is domestic, the price of the cattle that is bought by the “big three” will be responsive to the depressed domestic demand, not the booming exports that are a small share of the total market.

Hence, players inside the “cozy club” will have disproportional gains and the dollars they will earn abroad will constitute an abnormal profit no one else outside the club will be able to earn².

In other words, the big three, and especially Minerva, will pay a low price for cattle since the economy will be in recession - and cattle price is 80% of Minerva’s costs of goods sold. Meanwhile, thanks to a depreciated domestic currency and booming exports market for Brazilian cattle abroad, the company’s margins will skyrocket.

Minerva vs. IBOVESPA, Year to date



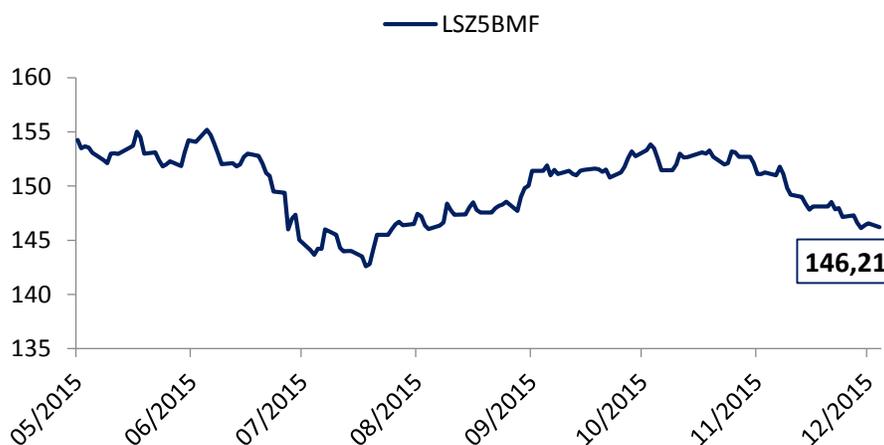
This is, we think, what Warren Buffet would call a moat. This unique set of circumstances is hard to replace. The right place and right time. This is a winning environment. We think Minerva is, just like

² In a recent meeting between cattle breeders and the slaughterhouses a common complaint was the little interest by the big three to reward breeders according to gains they would have exporting the production : [Link](#)

Guns N' Roses was in Hollywood in the 1980s, in the middle of an environment

where abnormal results can be achieved.

Cattle Price, 2015



In our May 2015 letter, we disclosed our investment in Apple and did not hide our discomfort with the fact that this was one of the best-covered and best-known companies in the world. It is certainly not common for any investor to find an edge and to realize something no one else had realized in a company like Apple, we said, and that is the main reason we tend to invest in emerging market small caps like Minerva and Log In.

Our letter even proposed several possible reasons for the "Apple discount" and why such an amazing company could be traded at a price that seems far away from efficient.

A recent interview to CNBC by one investor we really admire, called David Tepper, himself an Apple shareholder was really illuminating:

"I own it, so I am going to say it is great and everything else. It is a low multiple. You guys were talking about it earlier today, I think. Listen, I would agree with some of those things. It is always going to have a lower multiple because there is something that – it is still a device (read: a hardware) company, even though people think it can't be replaced, something could come along. We have seen it over time and things happen. I think it is a cheap stock. It does have a lot of Chinese exposure for its growth, which is a bit of a problem. But the multiple is low so i can deal with it."

- David Tepper, on Apple³.

In other words, Tepper was justifying Apple's low multiple because in contrast with companies like Netflix and Oracle, which are in essence service companies and have recurring revenues, Apple is a "device company" (although an amazing one) so it should have multiples comparable to, say, HP or Lenovo.

Empresa	EV / EBITDA	Price to Free Cash Flow
Apple	6,14	9,65
Hardware Companies		
Sony	5,57	9,49
Hewlett Packard	5,90	7,49
LG	5,13	-
Service Companies		
Netflix	118,04	-
Oracle	8,87	14,30
SAP	13,57	30,03

³ Watch the video: [Link](#)

Recently, a Goldman Sachs piece of research had ample repercussion in the market. It was a “buy recommendation” for Apple’s stock on the basis that Apple was becoming a services company. Goldman estimates the current ARPU (Average Revenue Per User) of Apple being \$ 42 but this number could jump almost fourfold in the medium term to \$153 even before the new “iPhone upgrade program” which we discussed in our past letters.

In fact, this research only goes in hand with what Apple bulls have been arguing for ages. Carl Icahn for example, has long argued that the market “doesn’t understand Apple” and that it was “not a hardware company, but an ecosystem”.

One famous event in Steve Jobs life was his fight to keep Apple a “closed system”. Apple lost the PC wars with Microsoft because it kept insisting that it would control the full experience, from software to design. Then with computer’s evolution, this once again became feasible and profitable. Apple didn’t change its ways. Then Android came along with a more open platform. Apple continued insisting on being a full package experience, with all its pros and cons.

Keep this in mind when judging which multiple Apple should trade at. If we take Apple’s trailing 12 month EBITDA and multiply it by the difference in multiples between the two sets of companies, we notice that this is not a trivial discussion. This is quite literally a trillion dollar question. Is Apple an ecosystem or a very good devices company?

We think you may come with a different answer depending on how unique you think Apple’s winning culture is. If an investor thinks this is a race for having the technological edge than probably Apple is a hardware company and like all hardware companies will

lose its edge someday. If, on the other hand, you think everything Apple has created, its history, its marketing and the passion it inspires is unique, than it is possibly a closed ecosystem.

One of the most powerful forces in the universe and in markets alike is reversion to the mean. Sooner or later what went up must come down and vice versa. The only exceptions are the companies with very strong moats. Even reversion to the mean can be battled if you have a powerful unique culture.

The search for unique cultures, like most things in life is a lot easier to spot when looking at the past. Everyone would have loved to invest in Apple when Steve Jobs was building unique things. Everyone should have bet that Garantia, with its meritocracy, would change Brazilian capitalism and its partners were destined to do amazing things.

A winning culture is not easy to spot early on or even decades later. Investing is not supposed to be easy, like Charlie Munger once said: "If you think it is easy, than you are stupid".

Above all, even the few people, like Bill Gates, Michael Jordan or Slash, that were creators of amazing and unique winning cultures, certainly have the sense that even them, as incredibly talented as they are, will probably never do such amazing things again.

Jordan went on to become a mediocre baseball player. Microsoft nowadays is considered a “has been” in the fast changing world of technology, although with some still very profitable businesses.

But it is Slash’s acceptance of this reality that amazed me the most. After the very public disagreements between him and Axl Rose and his subsequent departure from the band, he released a few very successful rock albums, and, amazingly, he formed a band with former members of Stone Temple Pilots, another rock band, called Velvet Revolver.

A few years back, i was in a bookstore in New York City when his autobiography was just released. A few weeks before Velvet Revolver’s debut album had just went platinum, meaning; it sold more than a million copies in the USA alone. Think about this for a minute. Very few bands achieve such level of success. For Hard Rock bands, selling more than a million copies would be something more than 99.9% of musicians could only dream of. But Slash knew that compared that what had already happened in his life, nothing would be too much.

And so I opened the first page of his book from the shelves of the bookstore and read the first page:

“Thanks to my loving family. And to all Guns N’ Roses fans everywhere, old and new, without their undying loyalty and limitless patience none of this would ever matter”.

For a musician who had just started a new band that released a platinum album debut, a glory almost all musicians on Earth could only dream off, the first page of his autobiography, the story of his

life, started with a thank you note and apart from his family, the only thing he cared to thank for were the Guns N' Roses fans.

He certainly knew deep down, just as someone who knew Steve Jobs, as someone who worked at Garantia's golden years that you may even see amazing things, but there are amazing things and then there are unique things. Our search as investors is for this second, more select group.

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