

FCL*Capital*

Annual Report | 2016

1. Performance

FCL Equities Performance in 2016

Year of 2016 (in USD)	10.28%
Year of 2016 (in BRL)	-9.38%
Since Fund Inception (22/11/2012) (in BRL)	-24.89%
Since Club Inception (03/04/20007) (in BRL)	124.84%

2. Operational context

The performance of our partnership in 2016 can be framed and seen in a different manner depending on the way we look at it: on the face of it, 2016 was a very bad year, especially in relative terms, since FCL Equities ended the year down 9,38% in Brazilian Real against an excellent performance of +38,93% of the Ibovespa Index.

The reason for this outcome is very straightforward: as we stated in our 2015 monthly letters, we had taken a strategic decision to progressively increase our fund and our partnership exposure to international assets and companies. This strategy worked brilliantly in 2015 when amid the devaluation of the Brazilian currency we were able to present performance in Real above our peers. The reverse happened in 2016: with the Real appreciating in value, our positions in Brazilian exporters and international companies when translated to the appreciating real, experienced decreases in prices.

The interesting thing is that this happened even with the fact that we correctly predicted that the Brazilian currency would appreciate in value in our 2015 annual report:

Excerpts from our 2015 annual report:

..`We had long argued that that the true value of the Brazilian Real should be something around R\$ 3.40 or R\$ 3.50 per U.S. dollar. The interesting thing is that we remain with this conviction, although the real went from roughly R\$ 2.50 per dollar to R\$ 4.00 per dollar in this period. Therefore, we went from being very bearish (against the consensus) in the Brazilian Real to being cautiously bullish (once again very much against the consensus).`

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The reasons cash had a significant increase (in our portfolio) through the year of 2015 were: 1) Our lack of confidence in Brazilian assets, while our bylaws still limited our maximum exposure of investing abroad; 2) Our lack of ability of finding good undervalued Brazilian securities that we judged had enough attractive risk reward opportunities in the face of the current Brazilian economic and political crisis; 3) The rushed sale of our position in BTG Pactual which with a dramatic turn of events (see our comments on BTG Pactual) forced us to liquidate our position in a rushed manner and therefore increased our cash exposure; 4) Finally, Our bullish call in the Brazilian Real against the US dollar. Since just holding cash yields in Brazil a 7% risk free inflation adjusted return (besides any potential exchange rate gains) and since we foresee a medium-term appreciation of the Brazilian currency against the American one, just holding cash at these levels of yield present a good risk return opportunity of appreciation, without incurring unnecessary risks of derivatives or other financial instruments.

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We did hold a larger than usual portion of the fund in cash denominated in the Brazilian currency, as we said we would, but in the end this successful and profitable position wasn't enough to offset the decrease in share prices in our Brazilian exporters, especially Fibria and Minerva as we will see ahead in this report.

Performance in USD:



■	S&P 500: + 8.97%
■	FCL Equities Fund: + 10.08%
■	Brazilian Selic (accumulated) : + 37.52%
■	Ibovespa: + 71.69%

Overall, the 2016 results showed us the inconsistency of our value proposal: we strive to reach results in dollars but with a fund structure, assets and risk profile still largely in Brazil, the result was a performance that could be considered reasonable if we compare our fund to international peers but clearly subpar if we were talking about a Brazilian domestic equity fund. Something had to give. Either we would allocate 100% of our fund to international assets, as has always been our intention, or we should measure ourselves in the domestic currency and against Brazilian benchmarks and peers.

The good news is that with the conversion of our main vehicle to a new structure called FCL Opportunities starting in early 2017, such internal conflicts will no longer exist: our benchmarks and assets will be international and the Brazilian assets inside the fund will exist only to add in terms of the dollar performance and not vice versa as has been the case. In other words, we will be an international fund with Brazilian local knowledge, as has always been our dream and not a Brazilian fund with some international exposure that could add or subtract to its performance.

3. Management Diary - Portfolio & Performance Attribution

Over the course of 2016, the biggest contributor to our fund performance was undoubtedly Braskem - its shares have appreciated 24% in Brazilian real and almost 51% in dollar terms. All in all Braskem contributed to more than nine percentage points if our fund shares were measured in Real in the year of 2016 and more than fifteen points if our shares were measured in dollars.

Braskem was discussed many times before in our letters including one from just a couple of months ago where we discussed and explained the reasons for the positive recent stock price performance, for a deeper analysis please refer to our November 2016 monthly letter.¹

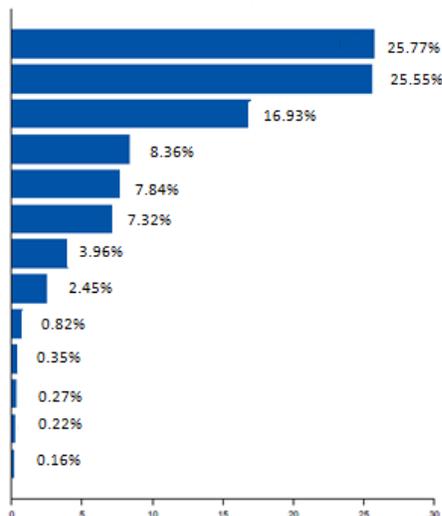
Our second largest hit this past year was Match.com if we measure it on an Internal Rate of Return basis. Match was the theme of our May 2016 letter.²

1 November Letter
http://www.fclcapital.com/publicacoes/FCL%20Capital%20Monthly%20Letter_November%202016.pdf

2 May Letter
<http://www.fclcapital.com/publicacoes/FCL%20may-16%20letter.pdf>

Performance in USD

Average weight

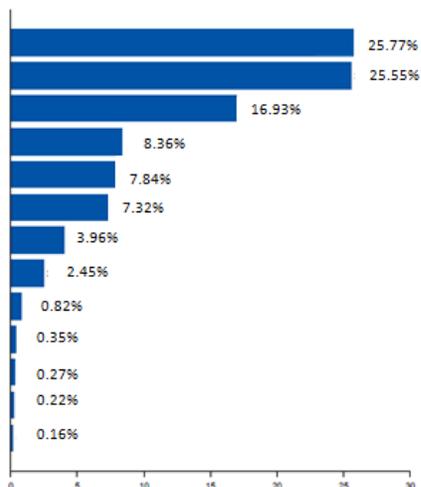


Contribution



Performance in BRL

Average weight



Contribution



Our second largest contributor on a money weighted basis however was our already mentioned position in LTNs and other Brazilian governmental fixed income securities that gave a combined contribution of 1.2 performance points in real and almost three percentage points in dollar, thanks to the effect of the appreciating Brazilian currency added to the normal income from the securities.

On the other hand, our two biggest losers were Fibria, which subtracted more than eight percentage points of performance in Real and six points in dollar performance and Regus, which robbed us four points in dollar performance and five points in Real.

Fibria's decline was largely due to macro reasons: the company's value is derived largely from two basic variables: the price of pulp, the commodity it sells to its clients worldwide and the dollar level against the Brazilian currency (it is a dollar play since its costs are in real and revenues in dollar)

Exactly for this reason, we like the company: it is a great way to hedge against a rise in the American currency. Unfortunately, the company faced a perfect storm this past year with a rising Brazilian currency against the dollar and a declining price of pulp at the same time.

Fortunately, we already see this tide turning: the Brazilian currency seems to have found its natural level. Meanwhile, the comfort of being the world's lowest cost producer is knowing that if things are reasonably bad for you, your competitors are in total distress. And prices seemed to have indeed found their floor and are now rising again amid news of cancelled pulp projects worldwide in response to abysmal prices.

FOEX Price of Pulp for delivery in China



Mid Price	532.33
High on 01/19/16	582.41
Average	517.35
Low on 10/11/16	484.50

Regus

As for Regus, once again macro factors dictated the fate of the share price of a company that has not faced any single major issue that could explain its tepid performance. One big unforeseen event seems to have dictated its fate this past year: Brexit.

Of course, a natural human instinct is to deny mistakes claiming the original investment thesis was sound. But so far we have not seen any justifiable reason to think the current upward trajectory of profits and revenues this company is experiencing will change with Brexit.

Full annual results will come out soon and we will look for clues about where the future is heading for this business, which we are so passionate about and which was also the subject of one of our past letters.

Our portfolio turnover is usually very low but it never completely stops to gradually change. We are very excited about new positions we are currently researching that could show a lot of promise for our investors in future years.

FCL Capital top 5 largest positions 31/12/2016

Braskem	30.40%
Minerva	26.43%
Fibria	14.51%
Brazilian Government Securities	11.19%
Us Dollar cash position	10.09%

Minerva

Minerva entered 2016 being our largest position but this past year proved uneventful for the company. Our thesis and optimism about Minerva is very public and very consistent - we hold its shares among our top 3 positions for at least five years now, since our FCL Investment club days. The bad news is that once again Minerva's management seemed more preoccupied with growth - its revenues went R\$ 4 billion in 2011 to around R\$ 10 billion in 2016 than with cash generation, repayment of debt and shareholder value.

That being said, the company was able to change its bonds from more expensive, to cheaper lines and the business environment is changing for the better - cattle costs in Brazil are finally falling once again, the currency is now stable and the domestic consumer market should start to recover. Furthermore, with the recent boost in oil prices, important consumers like Egypt, Venezuela and Iran could increase its purchases.

LSA cattle costs in real



Last Price	144.50
High on 02/04/16	167.04
Average	153.58
Low on 12/20/16	144.00

The story behind Minerva is one of growth ahead- supported by its management and the country’s natural competitive advantages and one of deleveraging that will bring an extra layer of returns to its equity shareholders.

However, with the Brazilian currency appreciation, the company was penalized by investors (since 70% of its revenues are exports) and Minerva subtracted a couple of points from our performance in real.

Dufry

Dufry is increasingly becoming, at the time we write this letter a core position, being upgraded from a not so large one a year ago. We are becoming increasingly excited about the company, its possibilities and its management.

Having become a clear global leader with the purchase of World Duty Free, 2016 was a year of consolidation and deleveraging for Dufry, so it could stabilize its same store sales, eliminate redundancies and then grow again.

We would love to see a big Asian acquisition - Lotte or Louis Vuitton's DFS would be perfect and make us very excited. Being a dominant player in Europe and Latin America and a very relevant one in North America, Asia is the last frontier for the company to be the single global consolidator in the world Duty Free Market -The AB Inbev of its sector if you will.





Albemarle

Albemarle is a new position and a still very small one we have been researching and exploring in the past few months. Historically, the company has been a specialty chemicals company with important applications and different sectors but increasingly it is becoming the world leader and consolidator in a commodity that is possibly the most promising one for the 21st century: Lithium.

Lithium is an ancient element that found new applications in the past few decades. Its use in glass and ceramics is still the largest one, but increasingly its use in batteries, from smartphones and other electronics too. Crucially, it is expected that its use in electric cars will change its dynamic.

Albemarle is the largest Lithium producer in the world and basically controls production with three other relevant players. Its lithium

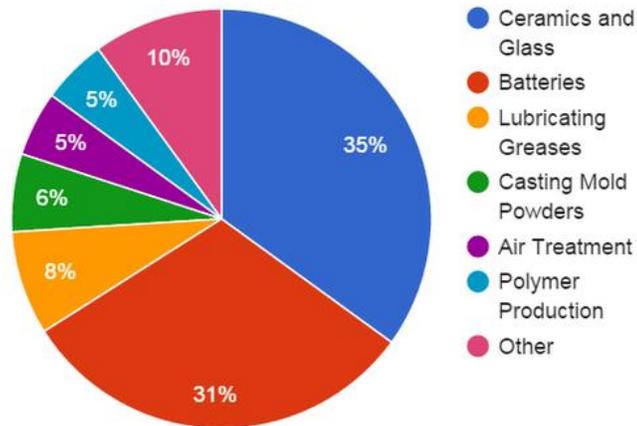
segment is fastly becoming dominant inside the company. Meanwhile, Lithium demand, even without considering the most optimistic projections for adoption of electric cars may exceed supply for the remainder of this decade.



Economist.com

Lithium carbonate price. Source: The economist

2014 Global Lithium Production and End-Uses



Lithium by end use

4. Sum zero

Although this house has always been shy about publicity, this manager decided to open an exception and be part of Sumzero, to be in contact with allocators who might find useful in a partnership like the one we have at FCL and also to be in contact with fellow stock pickers who love discussing investing ideas. Most importantly of all, we think this process helps us refine our investment thesis to the benefit of our investors.

To those of you unfamiliar to Sumzero, it is fastly becoming a kind of Facebook.com for stock investors. A place where investors publish their own zealously guarded investment ideas, with the hope that those ideas will be reviewed and criticized by fellow investment managers and money allocators.

Sumzero was founded by the Winklevoss brothers, who famously claim that Mark Zuckerberg stole their idea for Facebook.com. A brief report about the importance of the platform can be found at the latest edition of the Wall Street Journal's Baroon's magazine: <http://www.barrons.com/articles/facebook-for-stockpickers-1482555902?shareToken=std898750d87b248079397265223926f06>

Throughout the past year, this manager published five investment ideas on Sumzero, all of them important positions for our fund: Minerva, Braskem, Regus, Dufry and Match.

The publication date for each idea and the performance in US dollars since date of publication can be found at <https://sumzero.com/pro/user/12457/research/ideas>

Idea	Publication date	Return since Publication date
Minerva	29/09/2015	-7.50%
Braskem	12/2/2016	108%
Regus	15/03/2016	-15.70%
Dufry	5/4/2016	8.30%
Match group	6/6/2016	29.50%

Since the month of October, we have been among the top managers as judged by the combined return of investment ideas in the past 12 months, and in December, we were placed in 18th place among the 13.000 or so equity analysts with published thesis in Sumzero.

https://sumzero.com/pro/members/rankings#your_rankings

5. New products and future - part 2 (continuing from last year)

The last piece of our 2016 annual report is a direct continuation of the past piece in our 2015 annual report: the reasons and objectives of our reorganization and the discontinuation of our FCL Equities fund, that will give place to two new structures.

To summarize very briefly:

- FCL Equities trapped us into investing only up to 20% of our assets outside of Brazil, a situation we found to be suboptimal since the fund strives for dollar returns and a lower risk profile than the one provided by being fully invested in Brazilian equities.

- Our first attempt was to simply convert the fund and adjust its bylaws but we couldn't since inside our Equities fund we have non-qualified investors and according to Brazilian regulation only so called high net worth individuals can have full access to vehicles with full international exposure.
- At the same time, as a matter of loyalty for those who believed in us since the beginning we didn't want to simply ``kick out`` those investors not able to be part of the new international vehicle
- Our solution was to terminate FCL Equities and create two new structures: the first one will be called FCL Opportunities and it is basically a continuation of where FCL Equities left - a fund that invests mostly in equities and takes a long term view, fundamental bottom up approach. With the difference it will be able to invest all its capital in international opportunities, while retaining its DNA of deep local emerging markets knowledge.
- The second structure will be called FCL Hedge and will have a lower risk profile than FCL Opportunities. It will invest at least 80% of its assets in Brazil, at least at the start, and will be a natural home for our non-qualified investors. It will focus mostly on government bonds and corporate credit situations with a somewhat shorter horizon and lower risk return matrix.

After a lot of search, we are satisfied with the solution encountered.

We end this annual report, as always, excited about the news possibilities and most of all thankful for all our investors and friends who believe in our work. A happy 2017 to us all.

Sobre a FCL Capital

A FCL Capital é uma gestora de recursos sediada no Rio de Janeiro, cujo objetivo é maximizar o retorno de seus investidores. A FCL tem como nicho principal, mas não exclusivo, investimentos em empresas abertas, listadas em bolsa de valores (posições compradas e vendidas nos mercados acionários). Para saber mais sobre nosso trabalho, entre em contato conosco ou acesse nosso website: www.fclcapital.com.

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