FCL*Capital*

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If an alien spaceship descended on Earth around 100.000 years ago, and spotted our ancestors among the plants, rivers, oceans and rocks, there could only be one certainty about homo sapiens: our species, back then, was completely unremarkable.

We were definitely not the strongest, fastest, far away from being the most resistant and not obviously much more intelligent than the other mammals around, but even more importantly: we were completely ill suited for the challenges around us.

Our species lived and died in fear. We were cornered, mostly living in scattered caves in Africa, dealing with an ice age, afraid of predators and dying from diseases, unable to conquer the planet around us and vanishing from Earth. Because of so many terrors, we were dying in droves. At one remarkable time, that has been increasingly documented in recent years [1], maybe our low point as a species, there were probably just a thousand or so of us left on Earth. In other words, we were an endangered species, on the brink of extinction.

Then, a few coincidences happened. The climate got a little bit more hospitable for us. Out of necessity, we decided to split in small bands

1 http://news.nationalgeographic.com/news/2008/04/080424-humans-extinct_2.html

and some of us fortunately made it somehow. Our language and methods, like division of labor, suddenly started to develop and proved to be useful game-changers.

We became, over time, by far, the dominant species of the planet. In the year 1804 AC our population, which had once fallen to a thousand, reached the milestone of a billion people and most living longer and healthier lives than ever before.

If it took so many millennia to reach a billion, in only 127 years, with the advent of vaccination, the population doubled again to 2 billion individuals. The planet was already ours: intercontinental travelling, goods crossing the oceans in ships, and so forth. Then only 33 years to reach 3 billion in 1960. Today the population stands at 7.4 billion and it is predicted to reach 10 billion by mid century.

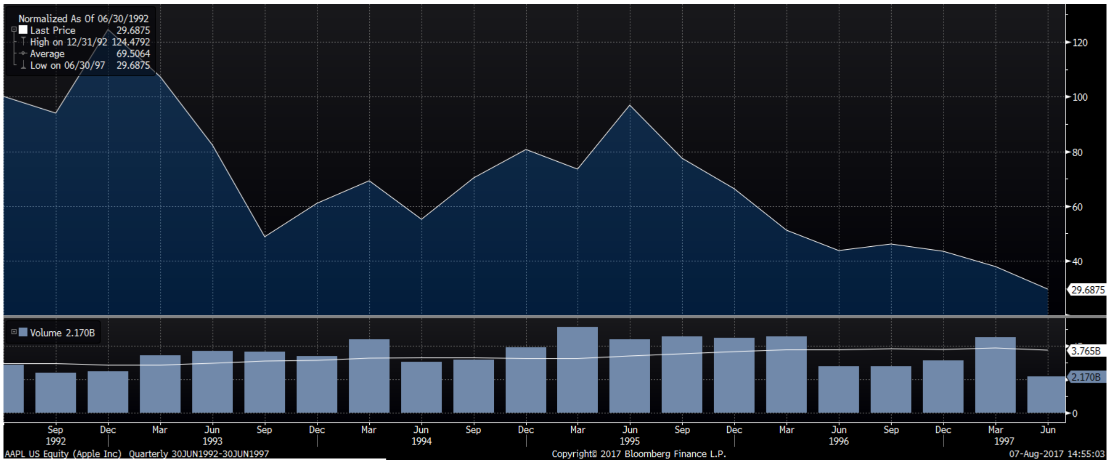
This letter is dedicated to the theme of foresight. It is about our permanent search as an investment company for ‘’signs of success’’ How could a smart alien species, 100.000 years ago tell that ours would be the dominant species in this planet, molding it according to our desires? Likewise, how can an analyst, a businessperson, an investor, spot early on, who will be the winners of the next 10 years in the investing universe? The tides are, as we all know, always changing, but where are they going after all?

Our first conclusion: signs of real success are amazingly hard to spot. When Franz Kafka, according to many, the greatest fictional writer of the 20th century was falling ill and about to die at the young age of 40 due to tuberculosis, he asked his best friend Max Broad to burn everything he had written. He never really had achieved any fame or literary prizes. Some of his works were read out loud by an inebriated Kafka to friends at dinner parties who mostly laughed at crazy themes like "Metamorphosis". Even Kafka himself didn´t think he deserved to be remembered. So he gave Broad this task. And in fact it is believed that Kafka himself burnt more than 80% of his lifetime work. The 20% remaining, that the whole world now knows thanks to the fact that Broad disobeyed his best friend´s last wish, are enough to make him one of history´s greatest writers by general consensus.

Or, in a history closer to our financial landscape universe, this amazing piece about a humbled company called Apple, who in 1998 was verging on bankruptcy, a stuff of laughs after having miserably lost the software and PC wars with Microsoft. It was a defeated entity, that, as a last desperate attempt after its management more or less admitted defeat in reviving the company, brought back its founder that was still respected in nerd cycles but was never seen as a serious businessman.

That was the stock price for apple in the 5 years preceding the Steve jobs comeback.

Chart 1 – Apple 1992 to 1997



Normalized Price as of 06/30/1992	
Last Price	29.9875
Highest in 12/31/1992	124.4792
Average	69.5064
Lowest on 06/30/97	29.6875

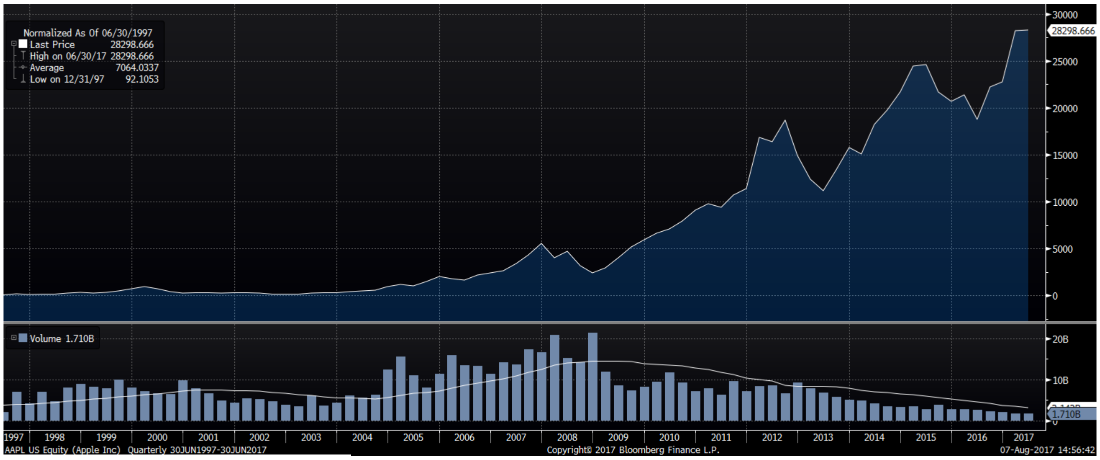
And that was what Michael Dell, back then possibly the most respected and followed leader in tech, frequently the cover of business magazines, had to say in 1997 about Steve Jobs comeback:

''What would I do? I'd shut it down and give the money back to the shareholders. Apple is beyond saving''.

In other words, one of the most respected tech leaders of the 1990s thought Apple was unsavable and the best that could be done was to sell the remaining assets while they were there, shut down the company and give what was left back to shareholders.

And that was what happened in the following 20 years.

Chart 2 – Apple 1997 to 2017



Normalized Price as of 06/30/1997	
Last Price	28298.67
Highest in 12/31/1992	28298.67
Average	7064.034
Lowest on 06/30/97	92.1053

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So where does our roadmap for figuring out winners from losers begin? As value investors, coming from the Dodd-Graham tradition, a first general principle would be helpful and come soon enough: before trying to guess the future, be humble enough just to focus on outguessing the competition. In other words, you don´t need to nail how things will turn out to be , just profit from the delta, the actual difference, between collective expectations and how reality turns out to be.

Principle 1 - It´s not about guessing, it´s about the delta between reality and expectations.

Going back to our homo sapiens in African caves example, certainly, no one could have guessed how successful we would turn out to be as a species in this planet. But probably, even 100.000 years ago, very strong signs were already there that, if we indeed survived, we would probably be a more interesting species even than other chimps. We already had rudimentary tools and language, we already had traces of a more sophisticated society. No one could guess the extent of our success just like very few could guess the extent of the success of Apple in 1997, or Microsoft in 1986, but a "long short" between humanity and the chimps just like educated guesses about different situations in the market can be made where the participant has a competitive edge.

A more humble framework would be to start from the "market" as understood by the collective perspective and go from there. We could paint this "market map" in four possible directions;

1. *You think things are improving and everyone is optimistic - Be alert.*
2. *You think things are getting worse but everyone is optimistic - It may be time to reduce your positions.*
3. *You think things are getting worse and everyone is also pessimistic - Focus on possible turning points.*
4. *You think things are improving but everyone is pessimistic - Time to be a contrarian and buy.*

Principle 2 - It´s less about demand than supply, it´s less about the industry than about competitive advantage inside the industry.

As all market participants know, finance is an activity that in order to survive one has to stay humble. Two industry performances this house has always been fascinated about are cigarette companies in the 21st century and airlines in the last quarter of the 20th century.

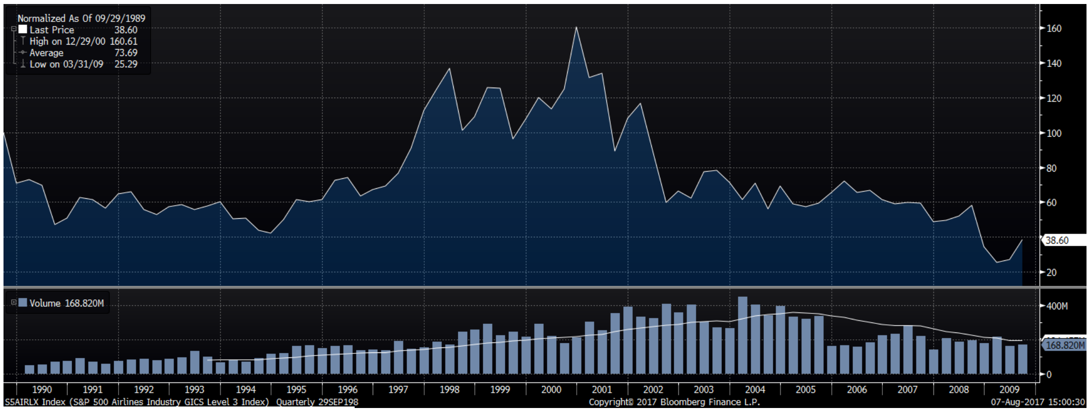
Many mid 20th century financial commentators were ecstatic about airlines and apparently, with very good reason – they were back then what internet companies are right now: the new economy, where the growth opportunities lie. The rationale was that over time more people would travel in planes all around the world. The planet would become smaller.

And here is the interesting thing: they were right! Over the years, the airline industry aggregate sales exploded as hundreds of millions of people started flying for business and holidays.

But what happened to the individual companies stock prices? They were one of the worst industries of the century, delivering negative returns across the board to investors.

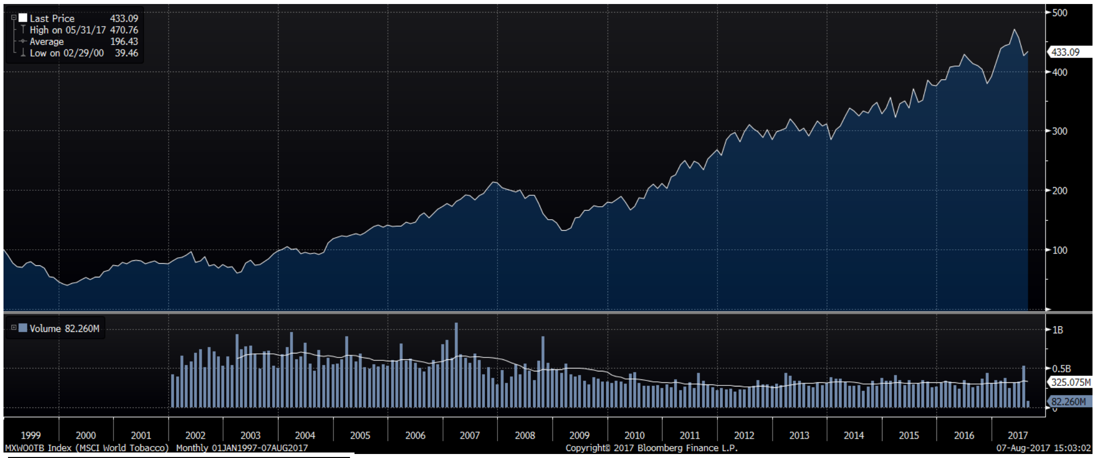
Cigarettes on the other hand at the turn of the century, were already thought to be a dying industry: fewer people smoke now, especially younger consumers. Governments came up with ever more aggressive restrictions. Yet, despite declining sales, stock performance was exceptional.

Chart 3 - Airlines in the last quarter of the 20th century



Normalized Price as of 09/29/1989	
Last Price	38.6
Highest in 12/31/1992	160.61
Average	73.69
Lowest on 06/30/97	25.29

Chart 4 – Cigarette companies in the 21st century



Normalized Price as of 06/1999	
Last Price	433.09
Highest in 12/31/1992	470.76
Average	196.43
Lowest on 06/30/97	39.46

How to start to untangle this charade?

First, it seems clear investors think too much about demand and not enough about supply. They project sales and tend to assume an industry´s competitive situation will remain static. But it should be obvious that over time, growing industries will attract competition. So a more important task would be to think about how strong is a particular company´s position of strength inside an industry. This, coupled with good management and sensible allocation of capital can be a great cushion even in declining industries. On the other hand, aggregate sales growth won´t be of much use if it has to be divided with new entrants in an industry.

And so it has happened with airlines. Over time, the industry´s terrible dynamics, from its low marginal costs coupled with high fixed costs and its permanent overcapacity generated by new entrants assured that, since no single company, with a few local exceptions, had a permanent competitive advantage, no company could earn a long term economic profit.

Cigarettes were almost the perfect flip side: the industry kept its discipline, giving back its excess cash to shareholders since there was no huge need for capex. Few new entrants ventured in the space. The industry became more consolidated. In short, a great environment, despite falling sales!

And since we have a habit of going back to Omaha in our letters, it is never too much to remember that among Warren Buffet's preferred targets were regional American Midwestern trailer companies and retailers, that were certainly located in uninspiring industries, but that possessed huge competitive advantages to fend off new competitors in each one of them and that could therefore keep earning economic profits.

Principle 3 – “Invert, always invert”

Charlie Munger, one of our major heroes, is frequently credited with this expression but actually, a quick internet search tells us that it was first used by Carl Gustav Jacobi, a 19th century mathematician.

Basically, this principle tells us that whenever we face a particularly hard problem, it might be useful to look at it from a different angle. How about to invert, change signals and since we can´t find the best possible outcome, to dream what would be the worst possible outcome so we can avoid it? As Charlie Munger says, “all I want to know is where i am going to die so I will never go there”.

Also, it might be useful to look at the problem backwards, and major mathematical advancements were made when people started tackling problems this way.

In the word of business, looking at problems backwards can be particularly insightful. For example: if someone wants to someday be a billionaire, a reasonable place to start is to investigate the world´s billionaire lists and study what those people did, what they didn’t do, and how.

In the world of stock investing, since we want to pick winners, It can´t hurt to look and study who the previous winners were and what were investors thinking about them at the time. And surprisingly, very few analysts devote any time to this interesting task.

So we repeated this exercise as we usually do at this house, since it brings fresh insights every time. We looked for every single stock that generated total annualized returns (share price appreciation plus dividends) greater than 25% per year over the last 10 years on average, in North American, European, Asian or BRICs stock exchanges in the basic resources, consumer and tech sectors (roughly, our investible universe).

In total, only 172 companies made the grade. It is important to have in mind that 25% annual compounded returns is a very high bar, especially in a decade (2007-2017) where global stock exchanges did not have a particularly strong performance.

Among these 172 elite companies, there are 39 Indian companies, 33 Americans, 27 Chinese, 22 Japanese, 20 Europeans (including Turkey and Russia), and maybe not surprisingly, considering the terrible decade the country has just faced and the dismal performance of the Brazilian market, zero Brazilian companies listed in the Bovespa stock exchange.

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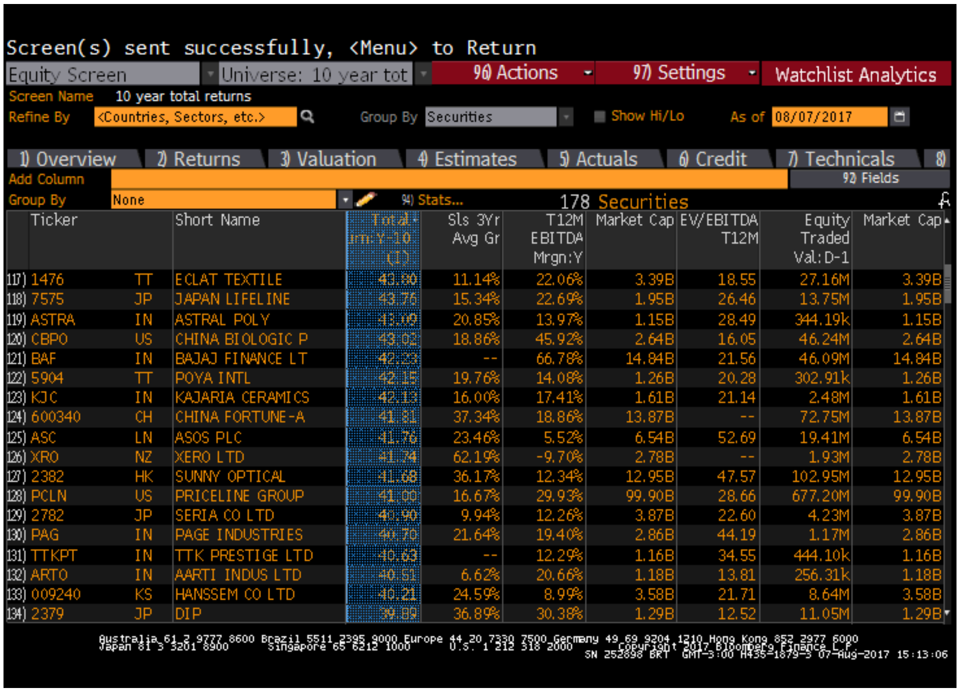
Chart 5 - The winners



	Ticker		Short Name	Total Rtn:Y-10 (I)	Sls 3Yr Avg Gr	T12M EBITDA Mrgn:Y	Market Cap	EV/EBITDA T12M	Equity Traded Val:D-1	Market Cap
117)	1476	TT	ECLAT TEXTILE	43.80	11.14%	22.06%	3.39B	18.55	27.16M	3.39B
118)	7575	JP	JAPAN LIFELINE	43.76	15.34%	22.69%	1.95B	26.46	13.75M	1.95B
119)	ASTRA	IN	ASTRAL POLY	43.09	20.85%	13.97%	1.15B	28.49	344.19k	1.15B
120)	CBPO	US	CHINA BIOLOGIC P	43.02	18.86%	45.92%	2.64B	16.05	46.24M	2.64B
121)	BAF	IN	BAJAJ FINANCE LT	42.23	--	66.78%	14.84B	21.56	46.09M	14.84B
122)	5904	TT	POYA INTL	42.15	19.76%	14.08%	1.26B	20.28	302.91k	1.26B
123)	KJC	IN	KAJARIA CERAMICS	42.13	16.00%	17.41%	1.61B	21.14	2.48M	1.61B
124)	600340	CH	CHINA FORTUNE-A	41.81	37.34%	18.86%	13.87B	--	72.75M	13.87B
125)	ASC	LN	ASOS PLC	41.76	23.46%	5.52%	6.54B	52.69	19.41M	6.54B
126)	XRO	NZ	XERO LTD	41.74	62.19%	-9.70%	2.78B	--	1.93M	2.78B
127)	2382	HK	SUNNY OPTICAL	41.68	36.17%	12.34%	12.95B	47.57	102.95M	12.95B
128)	PCLN	US	PRICELINE GROUP	41.00	16.67%	29.93%	99.90B	28.66	677.20M	99.90B
129)	2782	JP	SERIA CO LTD	40.90	9.94%	12.26%	3.87B	22.60	4.23M	3.87B
130)	PAG	IN	PAGE INDUSTRIES	40.70	21.64%	19.40%	2.86B	44.19	1.17M	2.86B
131)	TTKPT	IN	TTK PRESTIGE LTD	40.63	--	12.29%	1.16B	34.55	444.10k	1.16B
132)	ARTO	IN	AARTI INDUS LTD	40.51	6.62%	20.66%	1.18B	13.81	256.31k	1.18B
133)	009240	KS	HANSSEM CO LTD	40.21	24.59%	8.99%	3.58B	21.71	8.64M	3.58B
134)	2379	JP	DIP	39.89	36.89%	30.38%	1.29B	12.52	11.05M	1.29B

As for sector, the most represented were packaged foods and pharmaceuticals each with nine different companies, ahead, believe it or not, of internet software, which had eight.

There is just one thing we know for sure: the winners in the 2017 - 2027 cycle will mostly be very different. Possibly, with a different mix of countries and sectors. That being said, the future doesn´t repeat the past but it does rhyme. So are there any general insights we can have from our list?

1) **Winners are usually smaller than the average company**

This should come as no surprise and serves as vindication for this and many other houses efforts to focus on small cap companies. Small caps are not only less followed by the financial community, which allows their price to diverge further from their intrinsic value (in financial parlance, they are in a less efficient market) but also, as smaller companies they tend to be younger and growing faster than the average.

There are of course exceptions in our list: Amazon (U$ 479 billion in market cap) and Tencent ($ 379 billion were the largest companies in our elite ‘’above 25% compounded returns universe’’. But this should come as no surprise: even being big they were able to grow very fast. Overall, the median market cap in our 172 winners was just $ 3 billion, and even this figure is biased upwards because we excluded results with caps bellow $ 1 billion

2) **Winners have rising sales**

This should also be expected but note we are not talking about promising industries. Instead we are talking about companies that individually were able to grow, and many of them even in declining industries, gaining market share and dominating the competition.

Overall, our median 3 year sales growth was a very fast 18% per year, with very interesting observations in traditional industries, like Domino´s Pizza (50,61% average sales growth in the past 3 years), Geely, the Chinese car company (30.87%) and Mastercard (9% annual sales growth).

Going back to the tendency of small caps to outperform that this house is a proponent of, above average sales growth was exactly the reason some specific large companies were able to make the list, like Amazon (average 22% sales growth) , Netflix (average 26% sales growth) and Priceline (16% ssales growth).

3) Winners usually surpass expectations

Going back to the initial theme, to enjoy long term above average performance, it is obviously important to surpass expectations. Even if a company enjoys robust future growth, if all this growth is already discounted in the stock prices, no abnormal returns will be experienced. This was the case with several tech stocks at the turns of the millennium, like Cisco and Microsoft, which had market caps close to half a trillion dollars each and turned out to not be good investment opportunities in the following years thanks to the inflated expectations.

That being said, over the very long term, sustaining growth is clearly more important than the multiple. Companies that had what seemed like very inflated multiples many years ago, like Amazon, Google and Netflix, proved that those seemingly absurd multiples were in fact cheap because of the fast growth experienced.

At the same time, a list like this destroys several fancy thesis and fads from money managers, like only investing in high margin companies with strong brands. Overall, the median Ebitda margin in the elite universe was 20,95%, higher than average but nothing out of ordinary and many companies had average margins in the single digits, like Amazon (9,05%) and Asos (5,32%).

4) Leveraged companies

An interesting addition, made by the work of several insightful market researchers, is that usually, up to a point, leveraged companies outperform. This could seem surprising at first glance, since leveraged companies may be more fragile than the ones with strong balance sheets.

But at the same time, almost by definition, a leveraged company is one that holds a large amount of asset per dollar of equity. Since equity, through shares are the tradable part of a company´s capital, if things go right and the company is able to grow, thrive and pay down its debt, leverage will have a magnifying impact.

So bottom line, you should definitely be careful, but at the same time, look for fairly leveraged companies to outperform

5) Market conquerors

This one seems to be one of the most common occurrences in our list. Overall the winners are less about average companies in thriving industries and much more about the ultimate winners in particular, however uninspiring industries. It´s like each subsector of the economy had to send a representative. No single industry is overrepresented. Even, in fast growth industries, like the internet. Only the ultimate winners are there but not the average Joes.

6) Well managed

Finally, what is certainly the most common observation, over the very long term, probably nothing is more important than good management, who will guide the company through sales growth and sensible capital allocation decisions. Without good management almost nothing else, like industry or business opportunities matter.

So how a roadmap for future alpha seekers would look like? Which are the steps to take in this “Game of Thrones” of companies, to pick the ones that are the elite, in other words, the future crop just like these 172, that could be said to sit at the “Iron Throne” of stocks?

First, look for a market that is not in a bubble and trading at sensible multiples. They don´t really need to be dirty cheap, just not crazy for the reality to surpass expectations.

Then, spend less time thinking about which sectors in the economy are going to thrive and more about which companies are going to conquer their respective markets.

Once you think you have a good framework about how a particular industry works, look for the winner, think if the company has good management, will enjoy sales growth (industry growth might attract competitors, only valuable with high barriers to entry), instead, look for market share gains that seem sustainable.

Finally, it will help if the company is fairly leveraged, aggressive in the right amount and has a viable roadmap for market domination. Also, obviously luck will play a part.

A final advice, if picking a winner seems excruciatingly hard, just like in Westeros, it is even more difficult to stay at the top and not be decapitated, than to get there in the first place.

FCL Team

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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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