

FCL*Capital*

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A tour of two centuries, four continents and their realities when it comes to investing

1 - The USA

If the 20th century could be described by the work of one entrepreneur, in the humble opinion of this house, this entrepreneur should be Walt Disney.

We will explain our choice: the 20th century was undoubtedly, the American century. And the American century's foundation was consumption by American middle class.

In this nation of millions of immigrants, the idea was that name and past shouldn't matter as much. Instead of having an important surname, in America you could reach noblehood or something similar through your own effort and some good luck. Especially after the second world war, to an extent that was unprecedented for the rest of the world.

For the first time so many people could have a ticket to join "the dream": a house in the suburbs, a car, home appliances, entertainment, and so forth. The hierarchical ideas of the old world, with their titles and customs and etiquette seemed to be from another planet. A large mass of people was rising. They were hard working, pragmatic and with eyes on the future. They had careers to focus on, kids to raise and, especially, goods and services to buy. Consumption by post war American baby boomers certainly shaped the century. Their culture, values and desires shaped the following decades. That was when we first saw malls, the car revolution, suburbanization and blue chip companies.

If we visit one of Walt Disney's famous thematic parks, in California or in Florida, it is easy to realize how the idea behind those family-oriented playgrounds molded the century: first, you need to drive into a long and wide highway, probably built during president Eisenhower's Interstate highway system in the 1950s to actually get to the park. Until recently and since the car revolution in the Eisenhower years, the US was by far the world's largest car market and it is telling that Disney was betting this trend would continue: except for overseas tourists, the vast majority of visitors to the parks to this day get there using their own cars.

But that's only the start: After you park your car in a very spacious parking space (another sign of unprecedented affluence since most American family cars would soon be SUVs) and buy tickets and other souvenirs (unprecedented business practices, affluence and consumption power with total disregard to very deep aspirations) you are allowed in. Though and though a very uniquely American experience and deeply attentive to the ways of a class of people that would very clearly mold the 20th century.

In making his investments in parks and hotel complexes Walt Disney was certainly betting on a few things: a federal government that would bring the infrastructure, on a scale and speed not seen before anywhere else and only now, 50 years later, would be surpassed by China's urbanization.

He was also dreaming of a formidable middle class of anxious American parents, that, with their puritan values, would bring their children to have family style fun in their simple, clean, and affordable parks.

Finally, he was a pragmatic person: no deep thinking, no soul searching: the American century reflected this young nation's ways: simple to the point, all-American materialism¹. Hot dogs, French fries, milk shakes, and certainly no nudity, alcohol, Picasso paintings and renaissance art. Simple, basic and with unprecedented scale. That was the essence of the American dream that his company captured and profited from.

To sum it up, it is hard not to argue that the basic characteristics that made Walt Disney's parks in California and Florida so successful were also the characteristics responsible for the very dawn of the American century.

The American middle-class families in the late 1950s probably didn't know it then: but while having their shakes and burgers between rides at Space Mountain or the Pirates of the Caribbean, they were at the peak of American leadership: the US GDP was almost half of the global total at that time.

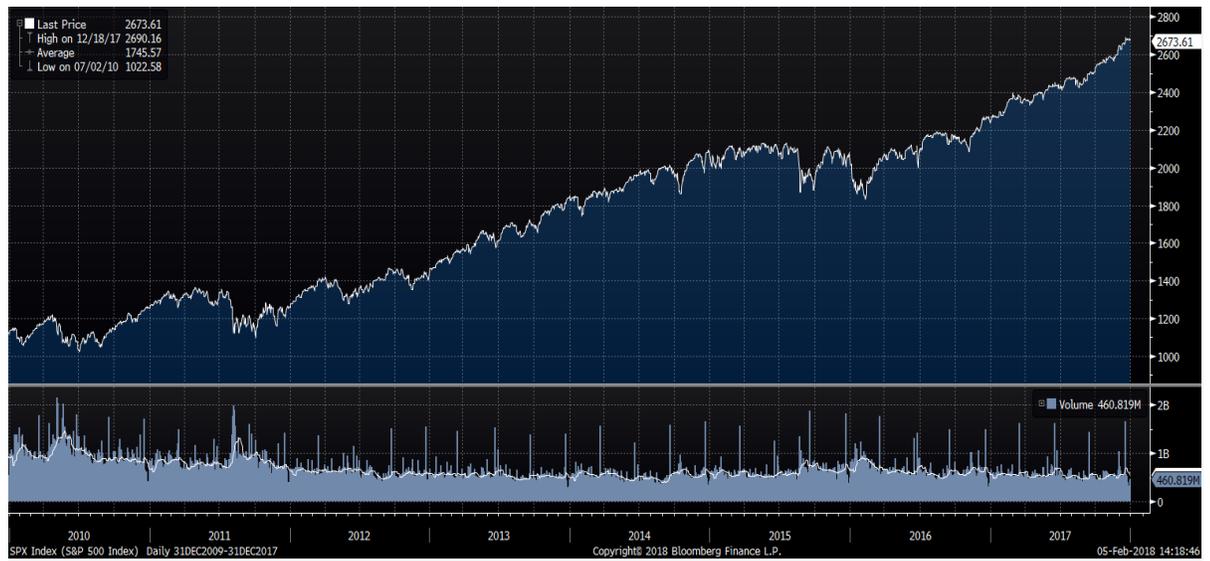
Fast forward to 2018. Donald Trump is on the news daily, or to put it more correctly, on Twitter, stating that the basic premises behind 20th century America: integration, tolerance, optimism, disregard for the past, need to be revised. There is bitter division and the US is clearly a fractured country, even showing some signs of sickness and disintegration, with vitriolic movements on the left and right.

Slowly, compared to a country that had as its consensus freedom, search for prosperity, rule of law, and integration, it seems that the very consensus of American society is crumbling.

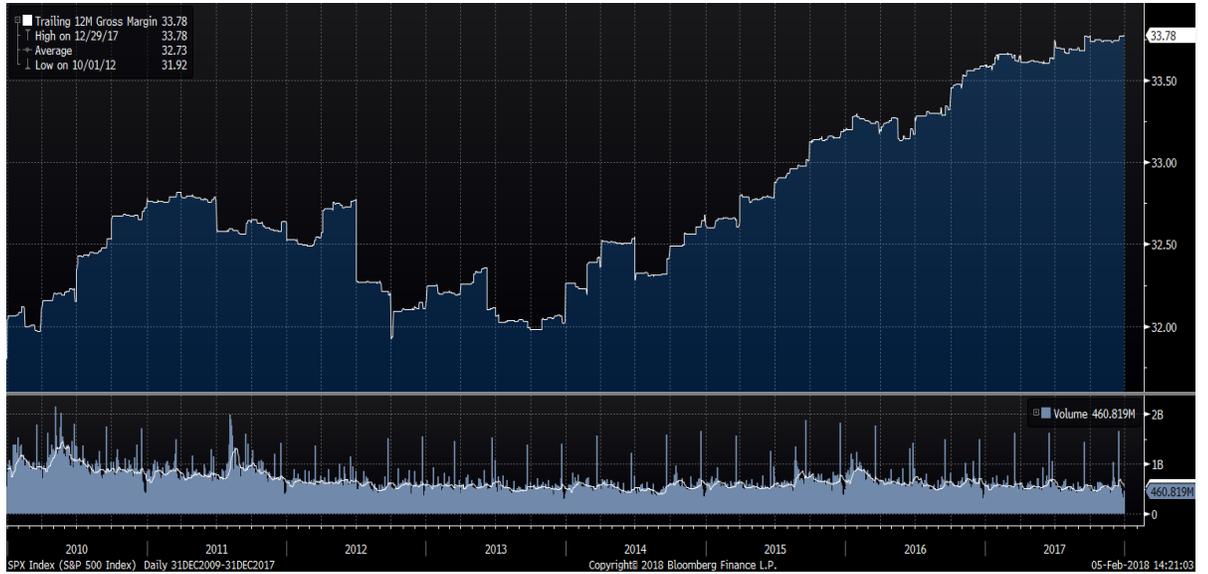
¹ It is true that nowadays, Cable channels, especially ESPN form the majority of Disney's earnings, but that was not the case during the middle of 20th century that is the scope of this letter

As for Disney itself, a company owing its prosperity to the car revolution and the American middle class seems almost bizarre when we remember that millennials are increasingly uninterested in even having cars in the first place and that the American society is becoming increasingly unequal and the American dream so distant to many of its citizens.

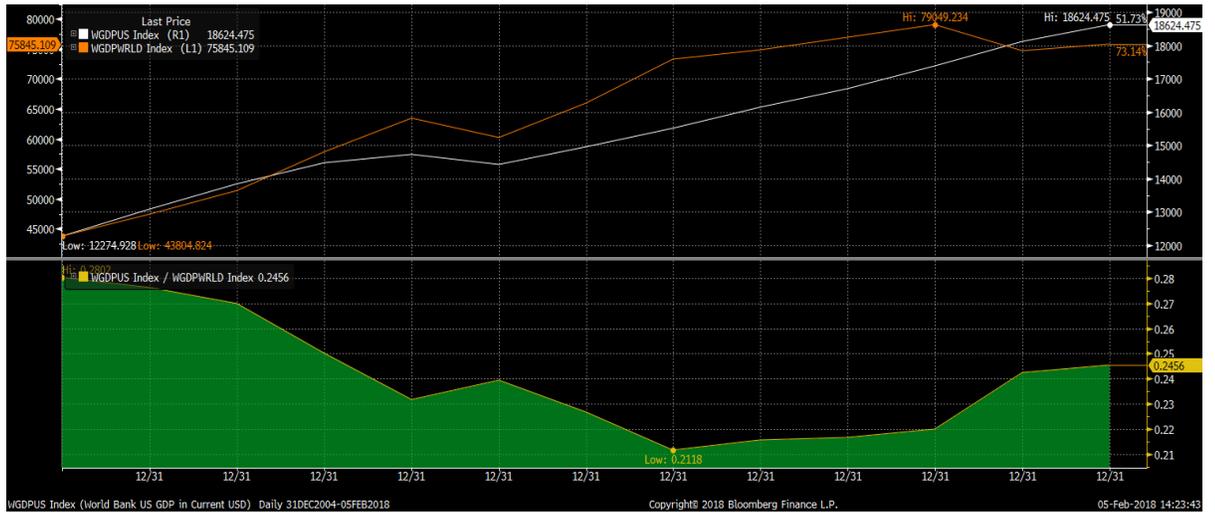
But since the mission of this house is to search for investment opportunities, it is fair to ask: is this a bad thing? Or is this true? A quick glance at American markets doesn't seem to concur with our statements.



SPX index, January 1st, 2010 - December 31st, 2017



SPX Index Gross margins – 2010 -2018



US share of total Global GDP



US total exchange market capitalization as share of world total

A lot of ink has been spilt lately on why global equity markets and particularly American markets are showing so much exuberance. Especially in the face of these shaky times.

Surely, there is a confluence of factors: the most synchronized global growth in a decade, interest rates that, even with the current spike we are experiencing, are still on very low levels and help to decrease the cost of capital, tax cuts passed by the current white house administration and so forth. But that is not the whole story.

Part of the reason lots of financial analysts argue that equity markets should come down is that margins are at an all-time high (see chart 2) and surely, they should converge back to their historical mean levels.

We will argue this might not happen for some time. And that part of the reason margins and consequently American equity markets are so high is that, to put crudely, the US is beginning to resemble a Latin American country in some aspects.

2 - Brazil & Latin America

Brazil, as we all know, is a vast market, full of promise and opportunities but at the same time with a very complicated business environment.

The bad news is that this situation prevents the country from climbing up the ladder towards developed status.

The good news, and this has been the case for decades, while also being a dirty secret of every Brazilian fund manager, is that this situation of high and complicated taxes, sclerotic business environment, sudden change of regulations, etc. works like a man from heaven to avoid new entrants and competition for Brazilian incumbent companies.

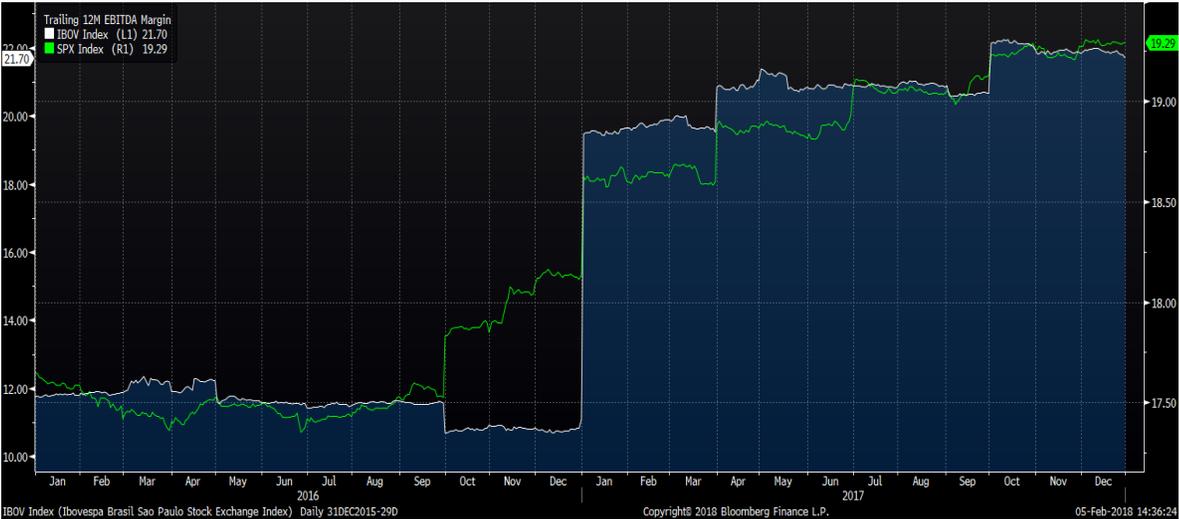
In other words, the Brazilian economy operates under a lower level of investment than otherwise would be the case and a higher level of return on assets for its elite companies. For our investments in Brazil, this basically means they have a lot less competition and consequently higher margins and returns on capital than would otherwise be the case in a more efficient economy.

To stay in one very recent and public example that appeared on Brazilian media. It is now well known that with the success of Renner, Brazil's most distinguished fashion retailer in the past decade, several international chains, especially Gap, tried to enter the market. No wonder. Brazil seems inviting: an upper middle-income country of 200 million citizens, not involved in wars and with western habits.

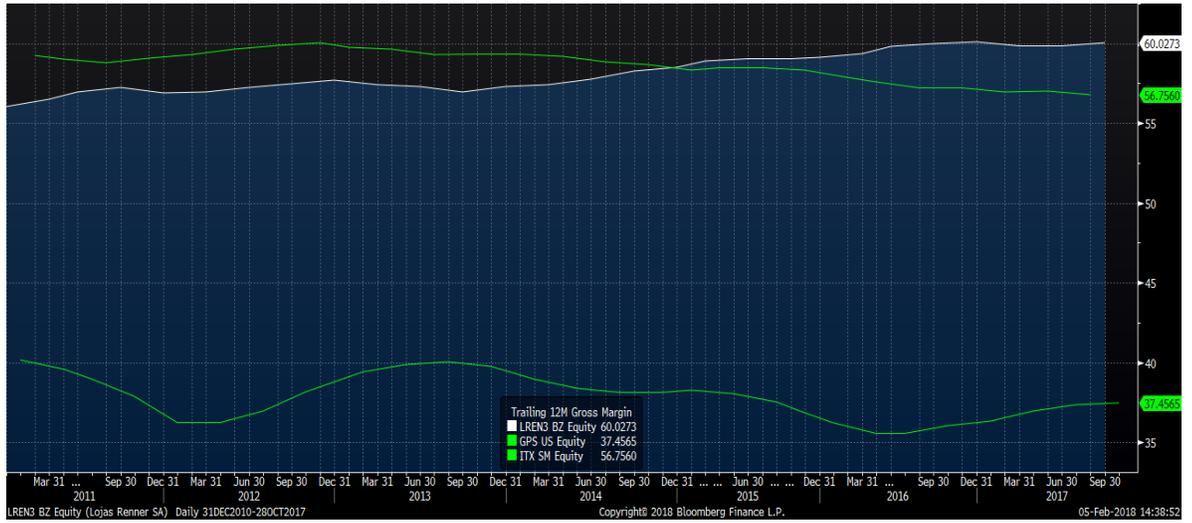
But once they realized the complicated environment and how difficult it would be to operate in it, they backed off. And they are not alone: Brazil is the only remaining BRIC without an Ikea store. Despite having a strong

coffee culture and being by far Latin America’s largest market, it received its first Starbucks coffee store after Chile, Colombia and Mexico. And examples abound.

That, in the opinion of this house, will continue to be Brazil’s story: a low growth middle income country that will nonetheless, due to its size and idiosyncrasies, continue to bring some of the most amazing value creation opportunities in the next few decades (also due to the Starbucks delay and Brazil’s high margins, several local coffee chains flourished for more than a decade). Also, low economic growth didn’t stop amazing stories like Natura, Renner and Braskem in the past, and certainly low growth won’t stop new entrepreneurs to adding to this list of successes in the future.



Bovespa gross margins vs SPX gross margins



Renner margens brutas (em azul) vs Inditex e Gap margens brutas



Ibovespa (em azul) vs SPX 2005 - 2018

Of course, we are not saying the US will become just like Brazil or any other Latin country in the next few decades. There is still an ocean of difference in every conceivable measure of business friendliness, openness to competition and access to markets, not to mention talent, know-how and access to capital and business practices between them. But what matters is the change in direction.

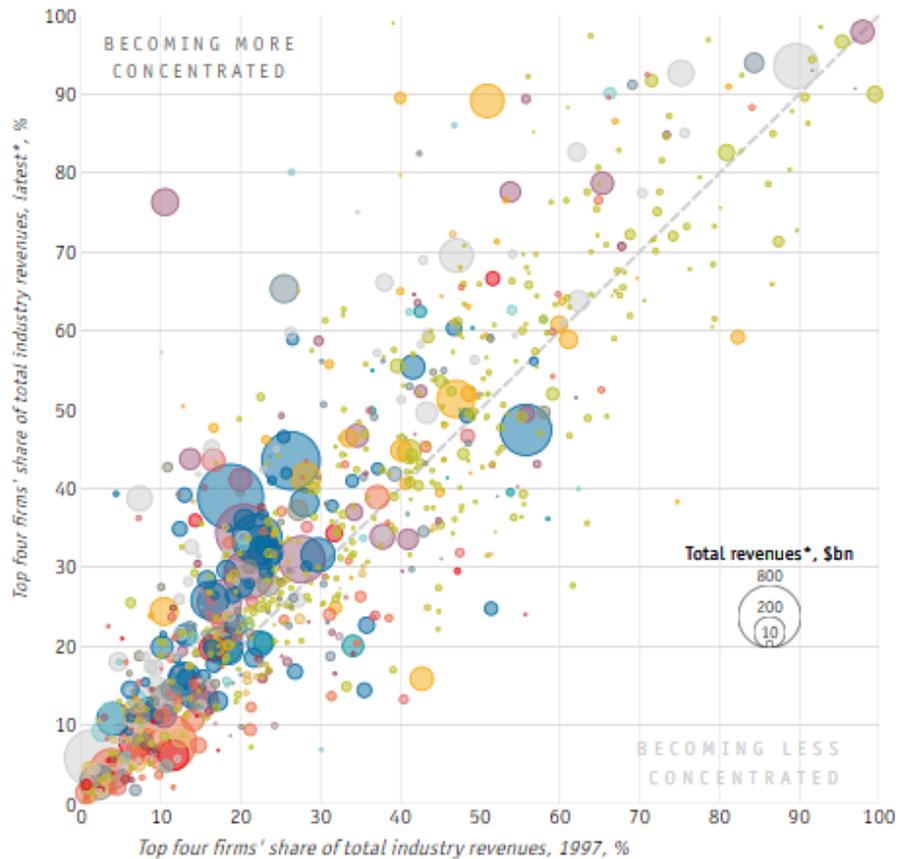
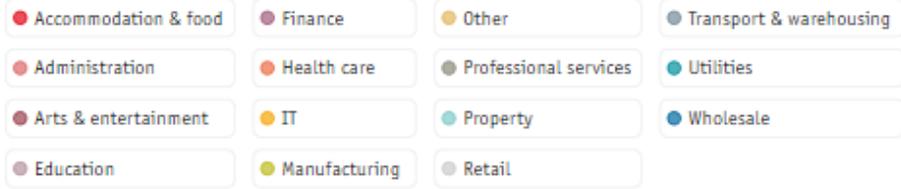
US ease of doing business - America slipping

Topics	DB 2018 Rank	DB 2018 DTF	DB 2017 DTF 🕒	Change in DTF (% points)
Overall	6	82.54	82.55	↓ 0.01
Starting a Business	49	91.23	91.23	..
Dealing with Construction Permits	36	75.77	75.74	↑ 0.03
Getting Electricity	49	82.14	82.14	..
Registering Property	37	76.80	76.80	..
Getting Credit	2	95.00	95.00	..
Protecting Minority Investors	42	64.67	64.67	..
Paying Taxes	36	84.13	84.08	↑ 0.05
Trading across Borders	36	92.01	92.01	..
Enforcing Contracts	16	72.61	72.61	..
Resolving Insolvency	3	91.07	91.18	↓ 0.11

Level of industry consolidation US

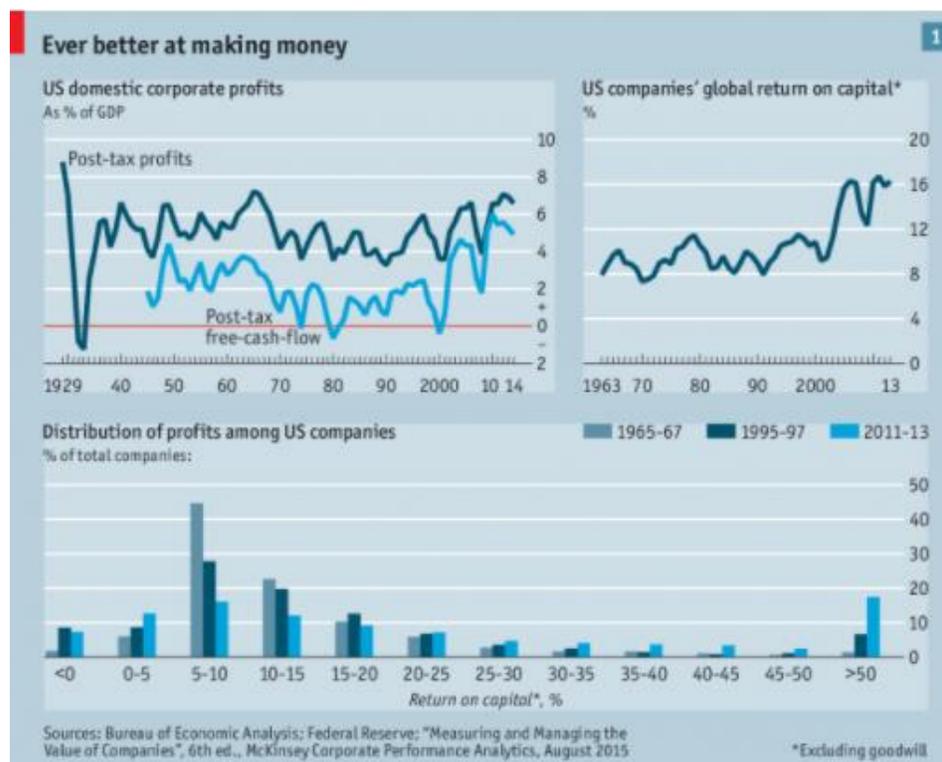
A widespread effect

Top four firms' share of total industry revenue, %
893 industries, grouped by sector, United States



Sources: US Census Bureau; *The Economist*

*Latest available, 2007 or 2012



America, due to a few reasons, is cozying up to monopolies and barriers to entry. Its regulators were relatively calm in face of industry consolidation in the past couple of decades, for correct and incorrect reasons and its politicians are marginally less supportive of free trade, especially when dealing with a rising china, then in the past.

The result is that the level of consolidation, barriers to competition and consequently the levels of profitability in almost every sector of the American economy is exploding.

This is a new reality for the US. But it has been a reality for Latin America and other less developed markets for generations. While American commentators marvel at how some companies like Amazon, Facebook and Google “own” their markets, in Latin America complete dominance of a single or even multiple relevant sectors of the economy by a single group

is a common occurrence. And naturally the level of profitability of these groups is off the charts.

To this house this new environment of “Latinization” of the US economy brings problems as well as opportunities. Our two largest holdings in the US are clearly, in our view, owners of some of their respective markets: Match.com is the undisputed leader in online dating and according to media reports is currently in negotiations for buying Bumble, its last remaining indecent competitor. Gannett meanwhile, owns many of the single newspapers in lots of American small and medium cities.

So, to put it short, the gradual and partial transformation of the US from a vibrant, low margin, high competition country into a stagnant, low competition, high margin one, is generally very positive for incumbent businesses like the ones we are invested in. It will mean lower GDP growth eventually but also higher ROICs and ROEs for our invested companies there.

3 - Asia

For over a century the planet’s most sophisticated economy was also its largest. But there is no reason why it should normally be this way. In a few years’ time, China will be the world’s largest economy. At the same time, for the foreseeable future, the US will remain, by some distance, the worlds most sophisticated economy: it will have the most vibrant and efficient stock markets in New York City; Silicon Valley will remain the most important center of innovation; Universities in Boston and California will continue to lead the world and its companies will remain the best managed and most competitive. We are not disputing that.

We feel not many investors are mentally prepared for this transition. It was very straightforward during Wald Disney’s days: in hindsight you

should have bet everything in the gradual rise of wealth in America and its middle class. You should have bought Disney, Walmart, Coca Cola, and countless companies that American consumers and later on people overseas turned to when they wanted to join “the dream”.

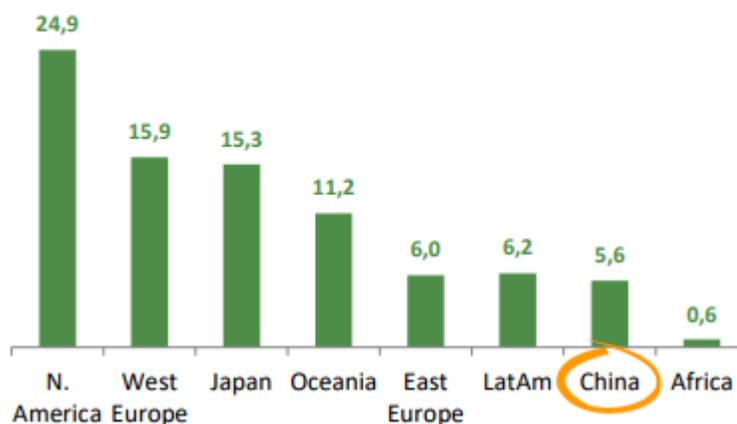
But while it is true that the US will remain the most dynamic and sophisticated economy, it is no longer true that its market will carry the most significant and rewarding opportunities. Due to their sheer size, the 21st century will have a different story and the most astute investors will have to bet on a new reality to find similar rewards.

This house believes that the story of this century is the global economic convergence, led by china and the BRIC countries and helped by technology. Just like in the 1950s there were a new phenomenon in the world, the emergence of hundreds of millions of Americans with their cars and looking for entertainment and a place in the American dream and this took the global commodities and financial markets by storm and changed them forever, now there are three billion people in the BRICs that also want a place in the sun and in their own way will want to consume, will want to travel, to have access to goods and services. And due to their number, even though their economies won't be the most sophisticated in this century, they will bring with them the most rewarding opportunities.

As examples of investments in our Opportunities fund, we would mention Anta, a Chinese sportswear company which this house believes might rival with Nike in market value in a couple of decades and Fibria, a Brazilian pulp company that serves Asia's increasingly affluent consumers that are becoming more westernized when it comes to hygiene.

Per Capita Consumption of Tissue by World Region⁽³⁾

(Kg/capita/year)



But things get even better: for all the investors (including this house) who would love to get back to a time when the Graham-Dodd disciples were beginning their careers in 1950s and there were huge opportunities ahead (Walmart hadn't been founded, Coca Cola was a regional company in Atlanta, Ray Kroc hadn't started flipping burgers) and even most importantly, back to a day when the market was not so efficient and a smart investor could literally see \$100 notes flying without anyone picking them (no Bloomberg terminals and at your disposal insightful research papers and lots of obvious winners), well, the rise of the BRICs brings not only a new market with unprecedented scale (even when compared to the US and Europe) but due to the fact that for the first time in more than a century the largest economies will not be the most sophisticated ones, those markets will not have for the next couple of decades the same level of sophistication and efficiency that the US market currently enjoys.

This is literally the best of both worlds for investors. And this is the premise our Opportunities fund was built upon. To search for the promising global opportunities.

The focus on BRIC countries has therefore three main reasons: first, due to their size and growing incomes, we believe this is where most huge

stock opportunities will be in the 21st century, just like the most promising ones in the 20th century were related to the rise of the American middle class in companies like Walmart, McDonalds and Coca Cola. Second, because this is our “home turf” and this house believes it has a comparative advantage when it comes to these markets. And finally, because one of our founding mottos is looking for asymmetric, inefficient markets, where it is easier to stand out. We like asymmetric competition, where the game is rigged in our favor, and we don’t believe super-efficient developed markets, for the most part, are the places to look at. The American markets have 55 analysts trying to outsmart one another on exactly how many cents GE will profit next quarter. The Bric countries will command larger economies without anything similar.

In the 20th century investors either had to venture in emerging and frontier markets which were small and unreliable and brought only comparatively small opportunities or deal with the efficiency and high level of financial competition in the US and Europe. Not anymore.

China, India and Brazil will have not only some of the largest companies that will define the century, but also it will be easier for making money in them as investors, than if they were in developed markets. The numbers of sell side analysts, resources, research papers, coverage and even interest will continue to be lower than for American companies. This is why we think investing in BRICs and companies related to them are the most promising opportunity in global equity markets this century.

For the first time since global equity markets were founded by Dutch merchants and as the title of “financial capital of the world” passed first to the British and then to the Americans, this will be the first time the largest economies, carrying most opportunities, will not also be in the same place as where most sophisticated investors looking for them are. And this in our view should bring a new paradigm when it comes to global investing

Company	Mkt Cap	Number of Sell-Side Analysts
McDonald's	134	37
Fogo de Chão	0,4	8
Nike	108	39
Anta	13	41
Google	761	12
Tencent	535	49

4 - Europe

Europe to us sits somewhere in the middle of this framework. It's market is somewhat less efficient than the American one and on the other hand it still has some of the most global and fantastic companies around. When we look at the mandate of our house, to search for the best BRIC related opportunities, no wonder some the ideas that our Opportunities fund has a stake in, like IWG, Pandora (a company to which China is increasingly relevant) and Dufry, are located there. Some of the best entry points to the BRICs are, counter intuitively, in the old continent.

5 - Back to the USA

Finally, back to where this intellectual "global search for context and opportunities tour" started, and after yet another "on the road" tour visiting companies and investors in New York City, combined with some sparse events of fun in the middle, this manager was left with the conclusion that it is still hard not to see that so much put this country on a league of its own in the past 100 years. And at the same time, depending on which interpretation an investor wants to have, it is also easy to see signs of decadence and the dusk of the American century.

To be worried, we would advise buying admittedly overpriced tickets to see Hamilton on Broadway. There, between the hip hop tunes, a global minded entrepreneur will be reminded how much this country owes to its founders: they were building a new system from scratch with the right instincts and principles: equality before the law, freedom of commerce, a sense that opportunity and the best days lie ahead that would serve as a call to arms to disillusioned entrepreneurs around the world who would flock to its ports in New York City and elsewhere in search for a better life.

Then and now there were dominant voices trying to close the border, raise taxes and tariffs, disrupt the status quo. But at least then in the end the right instincts mostly prevailed.

Hard not to be scared by the contrast with current days when as ever, people are anxiously trying to close the border, are suspicious towards the ones with different looks or religions, want to rig the game and tilt it against free trade and responsibility. What is scarier now is that this reasoning is finding friendly ears in the current executive administration.

For reassurance, however, we would advise one of the many amazing restaurants in town where chefs like Dan Barber and Thomas Keller took everything that was already amazing the Europeans did before them and reached new highs with imagination, creativity and a sense that ingenuity and search for something new would keep guiding them forward. Or even a visit, in the west side of Manhattan, to the scary and amazing Sleep no more.

Phantasmagoric, polemic and edgy, it symbolizes everything that is amazing about American entrepreneurship: a multi-racial and multinational cast guides participants, that are themselves protagonists in a horror story. A reminder that American ingenuity and entrepreneurship is far from extinguished.

For the sake of planet, let's hope a rising Asia, a stagnant but sophisticated Europe, a struggling Latin America that can keep counting with American entrepreneurship to keep molding trends and showing the way ahead in this global journey in search for investment ideas.

FCL Team.

Sobre a FCL Capital

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Relacionamento com Investidores

fcl@fclcapital.com

info@fclcapital.com

Avenida das Américas, 500 - Bloco 3

Sala 125

Rio de Janeiro / RJ - Brasil

CEP: 22640-100

Telefone: (55) (21) 3268-7918

www.fclcapital.com

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