

FCL*Capital*

February

“No one wants to die. Even people who want to go to heaven don't want to die to get there. And yet death is the destination we all share. No one has ever escaped it. And that is as it should be, because Death is very likely the single best invention of Life. It is Life's change agent. It clears out the old to make way for the new.”

Steve Jobs, during the famous Stanford Graduation speech, 2005

FCL Thesis: Fu Shou Yuan

There are going to be many winners in the next few decades out of China if this really turns out to be, as it is increasingly likely, a Chinese century.

Our thesis this month is about one of the corners of the Chinese boom which this house thinks is among the most overlooked. But first, a little bit of history.

In 1979, communist China was a very different country than it is today: back then the major fear among its rulers was that harvests wouldn't be enough to feed its many people and mass starvation and social unrest would result. At the same time, one thing that is frequently forgotten by westerners: Confucius values, one of the few constants in Chinese culture in the past few millennia, assured a level of resignation about what was to come. Confucianism after all puts a holistic emphasis on the whole, on society above the individual, on harmony above unrestricted change, on values and norms above individualism.

Confucius said thousands of years ago:

"Let the ruler be a ruler,
The subject be a subject
The father be a father,
And the son be a son,
As it should be"

So, what was about to come was the Chinese one child policy. In a society governed by a control-freak communist party, that was back then living on mass poverty and fearing unrest from population growth and famine, the policy was implemented, and with a few exceptions, no couple was allowed to have more than one child.¹

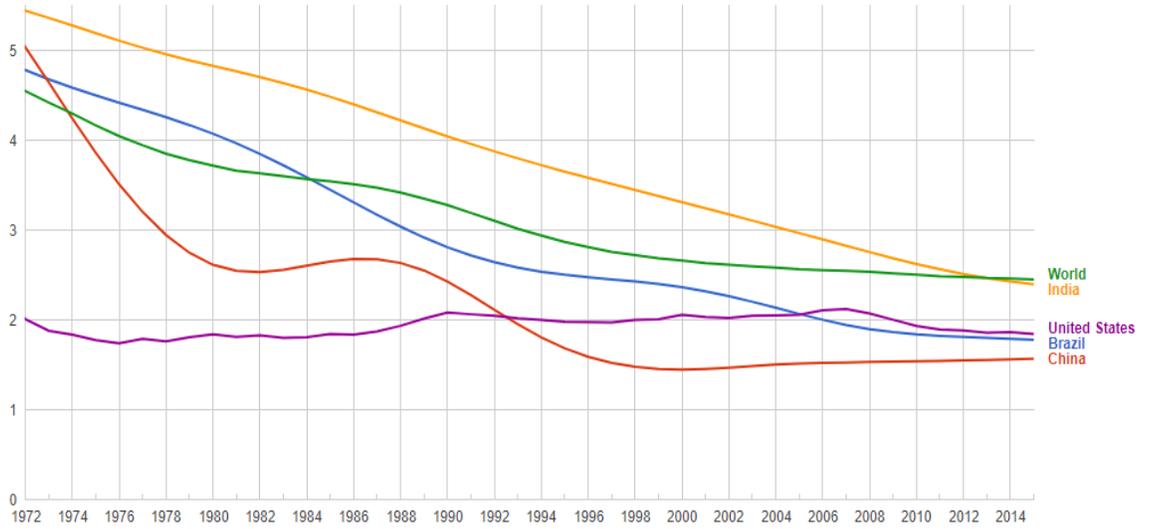
It is a matter of great debate, beyond the scope of this thesis how successful and well timed the policy was. Some say it prevented 400 million births. It had as side effects a skewed sex imbalance (due to abortions of baby girls on the countryside) and amazingly for a country that was still below middle income level, an incredibly low fertility rate.

Demographics, interestingly, is one of the most predictable parts of the future: with reasonable certainty we can foresee a country's population well into the future.

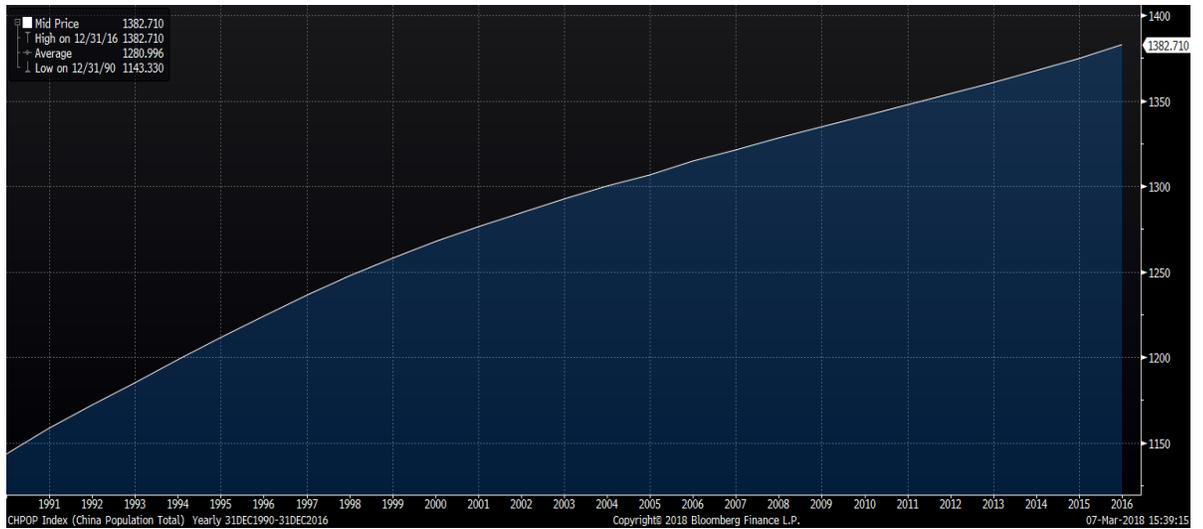
The fact is that, with the advent of the one child policy, combined with the astonishing opening and development of the Chinese economy, which led to a huge internal migration from the countryside to cities, increase in levels of literacy and ambition and busier lives, the fertility rate in china dropped markedly.

¹ The policy was gradually relaxed and nowadays two children per couple are permitted in most circumstances.

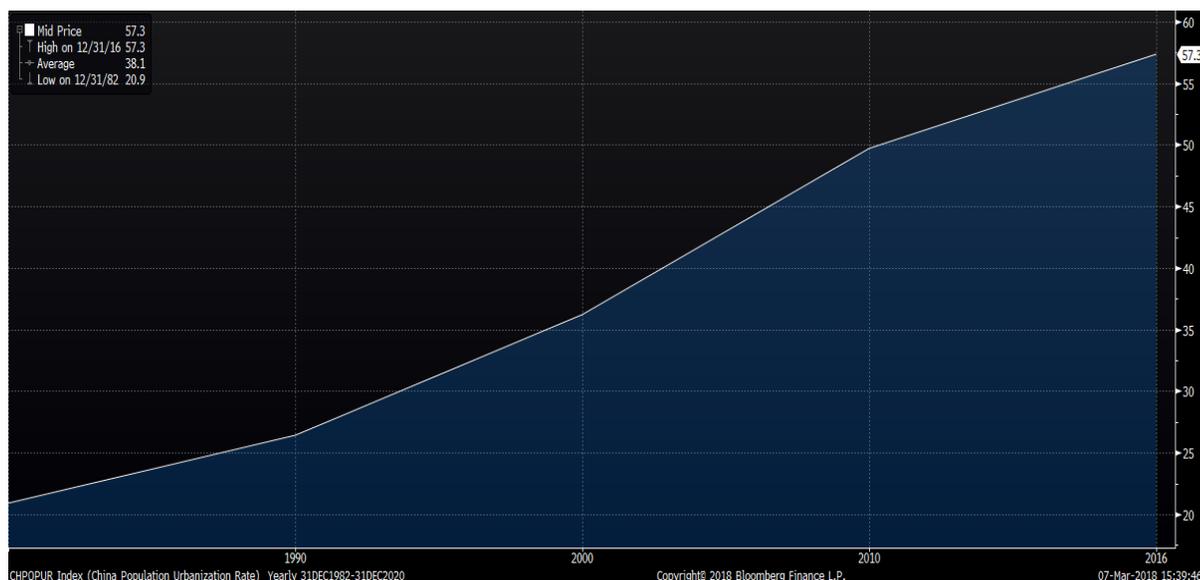
Fertility Rate



Chinese Population



Chinese Urbanization Ratio

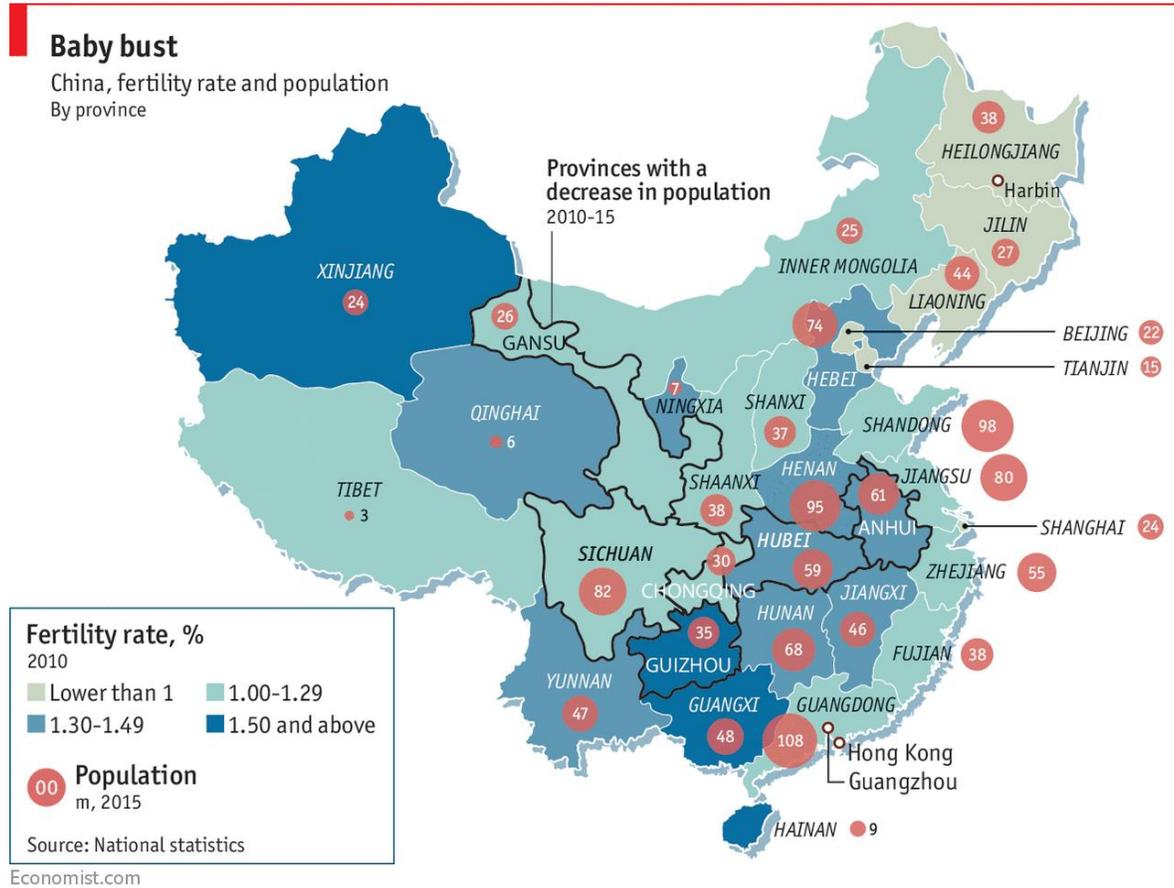


It is a well-known fact that 2.1 is the so called “replacement ratio” for a population, which is the number of babies the average woman has to have for the population to remain constant over the long term (since some children die before reproducing and two people are needed to conceive a child).

China is not only drastically below this level (though still higher than, say, Japan) but some parts of the country have an average level below one. Chinese women are increasingly leading busy work lives, and many are opting not to have children at all.

One direct consequence of a low fertility ratio: a population that over time gets older. In fact, some Chinese bears a camp this house does not belong to, even speculate that “China might get old before it gets rich”.

The Economist: China map - Fertility rate per region



Often when it comes to investing as in much of life, the obvious things are the ones people refuse to see. Thousands of investors, including us, are constantly looking for opportunities in Chinese consumption, Chinese finance, tourism, and so on.

Fu Shou Yuan is the leader and consolidator of one of what we think will be the biggest growth industries in China in the next few decades. It is the country's largest private death care provider.

First of all, every culture disposes its dead people in different ways. In china and the east, last rituals and funerals are a huge part of tradition. A generation later from “one child policy” was implemented, many of those millions of only-childs left their elderly parents in the countryside, got rich in the big cities and when they hear one of their parents passed away, they will want, with the help of their rising income, to have a beautiful and respectful ceremony for their elderlies.²

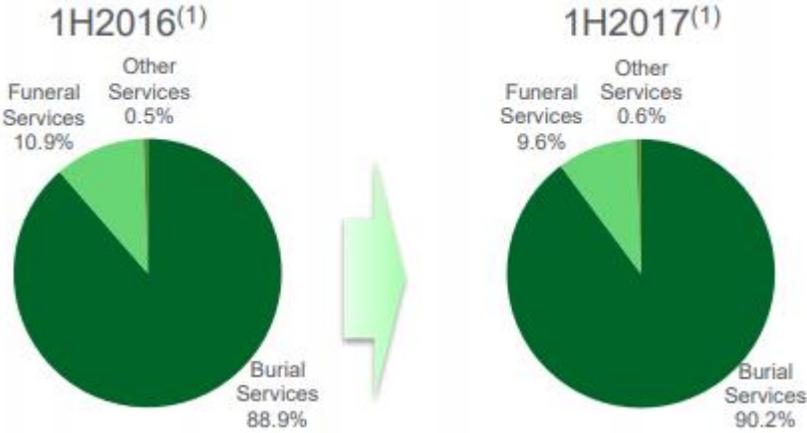
Fu Shou Yuan was founded in 1994 and it is nowadays the largest death care provider in China and a leader in an industry that is still mostly provided by inefficient state-owned cemeteries.

Overall the company owns and operates several important cemeteries throughout the country, provides funeral services, owns and maintains crematory machines and takes care of cemeteries landscapes.

In 2014, sensing the market opportunity and needing capital to consolidate this market the company listed shares on the Hong Kong stock exchange.

Overall, the company is still scratching the surface of this market’s potential: in 2016 it opened two new cemeteries in Anyang and Hebei and acquired a third one in Luoyang. In 2017 it acquired and opened several new properties and now the group serves 17 different cities in 10 provinces. Three new projects were also under construction by the company.

² <https://youtu.be/MvdXcb0V900>



Overall, we see this not only as a high margin, fast growth industry that is ripe for professionalization and consolidation but one that flies “under the radar” and is simply not noticed by most investors and businesspeople. The result is a massive opportunity for Fu Shou Yuan.

Risks

So, what are the risks of this marvelous and surprising growth story. As usual there are a few, which we judge are worth facing:

- a. A possible increase in government intervention.

Recently the company has been making agreements with local Chinese provinces to operate and even build and then provide services for cemeteries. The company seems to enjoy healthy relations with officials. But as always, in a communist dictatorship, we should be careful about a possible change of heart. Funerals and cremations are a huge part of Chinese cultural and a basic necessity of life. If the government feels the company is getting too powerful and profiting too much it might intervene.

On the other hand, in a highly fragmented, traditional industry that is still largely controlled by the state, we judge this risk low. On the contrary, the government might welcome handling the burden of those services to a private provider.

- b. “Under the ground services”

The Chinese are not going to be the leaders in this century for nothing. They are a remarkably entrepreneurial population. According to some sources, some funeral agents in properties owned by Fu Shou Yuan have been running clandestine operations, notably in Chingqin, where they were using a newly built government facility near the cemetery to provide

funerals. In a remarkable turn of events, the company is trying to take this facility to their side and cooperate with local authorities.

Over the long term we judge that increase in incomes will drive formalization and help with sector consolidation.

c. An increase in competition?

So far, Fu Shou Yuan itself is the new entrant against a large incumbent that is the state sector at the local level in China. The company is growing because it is able to provide better, faster and cheaper service than the government.

We do think competition might increase but what this house thinks might mitigate this risk is the very nature of this sector: just like some internet services, the death provider market is, to a large extent a “winner-takes – all” market, because many cities only have one or two cemeteries and even a huge city like Shanghai, with some 20 million people is really a collection of different regions, some of them with cemeteries that enjoy near monopolies in their part of the city.

Moreover, it is a capex intensive business that like private equity funds has a j curve: large upfront costs. We think death care industry in China might resemble something like this in 20 years: a huge private consolidator in Fu Shou Yuan, local governments still providing services in many smaller provinces and a cluster of regional private players competing with Fu Shou Yuan but none with its size.

Barriers to entry

In a recently released research report, the Asia-pacific team of JP Morgan noted that the company has been able to successfully raise prices and attribute this to an economic pickup. We disagree.

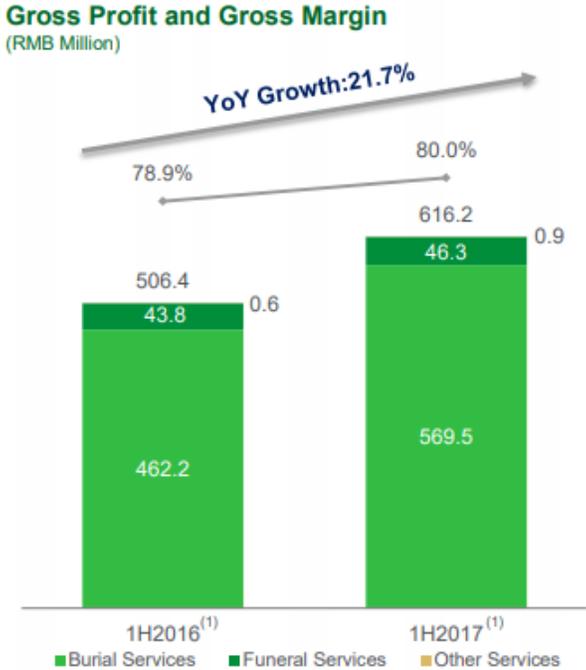
We think death care providers operate similarly to a one newspaper town or a toll bridge: once established and if there is no direct competition, they can raise prices faster than income rises since we are talking about a very inelastic good. In Chinese tradition family members tend to be buried together and in many first, second and third tier Chinese cities land is getting increasingly scarce and valuable. Overall, we disagree with most analysts take that this is a low barrier of entry industry.



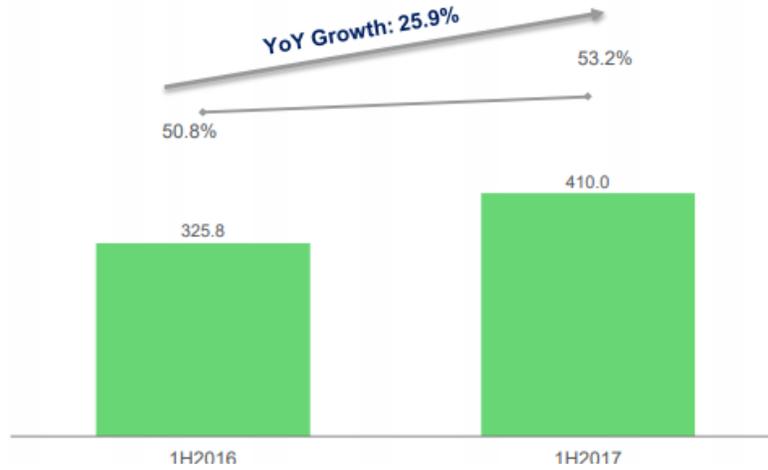
Financials

Over the past few months this house has been spending a consistent amount of time learning about funeral practices, habits and the death care services industry in Asia. And even more time digging information about Fu Shou Yuan. Its unique history, its properties, its management, legal documents and most importantly, its financials.

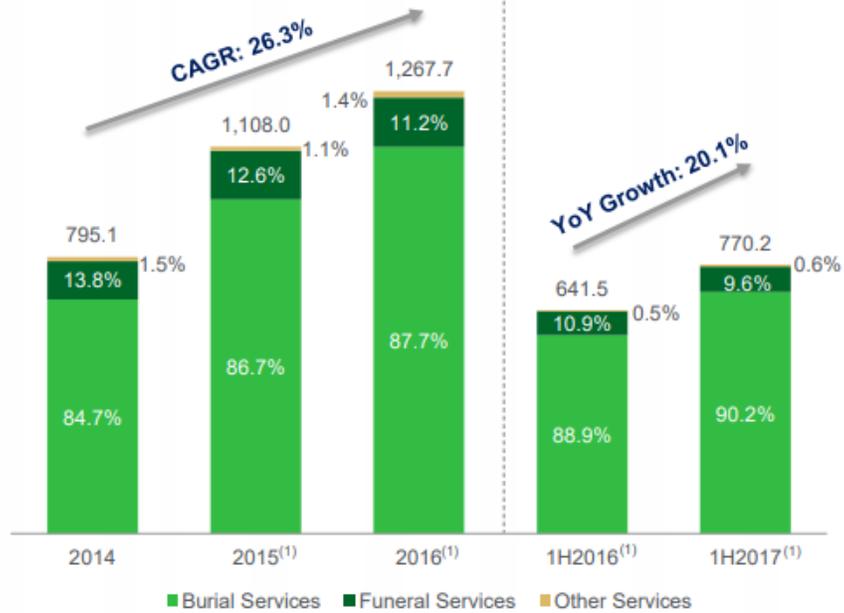
The first thing that clearly stands out and, in our minds, lay rest to the thesis of “low barriers to entry and high competition”, are its margins. And this was achieved with year over year growth consistently above 20%.



EBITDA and Margin⁽¹⁾ (RMB Million)



Revenue (RMB Million)



But there is more: the company is underleveraged, having positive net cash, which presumably will be used in further acquisitions and expansion. And a true cash cow. And with enough to pay a reasonable dividend.

Free cash flow over the years

2014	271,2
2015	288,8
2016	429
2017 (last 12Months to june 30th)	531,1

Multiples 2018

EV / EBITDA	15,39
P/E Ratio	30,57
Free Cash Flow Yield	4,30%

After trying many methods, we came with some reasonable projections for the future of the business:

1. We guess growth will slow to 15% per year in the 2018-2021 period and grow in perpetuity after that (a very conservative assumption)
2. We think the margins will stay where they are
3. We think the positive net cash will go to zero with acquisitions and capex expansion
4. We judge a 4% free cash flow yield a reasonable multiple that the market will likely demand in 2020 for the company and discounted this value back to the present day. This multiple is in line with the current, in our opinion, discounted valuation.

Overall even in this scenario we would get an upside of 25% from the current share price

But there are a series of potential optionalities to consider in this case:

- a. Increase in partnership with local governments that could cement the company's national expansion.
- b. Use of net cash to buy smaller competitors and enter new markets.
- c. Further increase in margins due to Chinese rising incomes, expanding market for the industry and formalization of the sector.
- d. Further gain of market share from government inefficient providers, continuing the current positive trend.

Conclusion: death as a growth industry

This house frequently holds one of the least correlated portfolios with virtually any other investment company. We can be many things but due to our inclination and unique traits we are certainly not a "closet beta" company.

In this permanent search for unique ideas and differentiated alpha we came across this interesting company. After a few months of preliminary research and checks around the turn of the year of 2018 we started buying shares and Fu Shou Yuan is now something north of 3% of the portfolio of our Opportunities fund.

We are still learning about the growth opportunities ahead, the risks and the management team but we already think this is a compelling risk reward opportunity and a company that sits right in the middle of our comfort zone: neglected (or simply shunned), with a clear and straightforward growth avenue ahead and selling at reasonable prices.

FCL Team

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.

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

Auditoria



Custódia



Regulamentação



Administração



Advertência jurídica: Esta carta é publicada somente com o propósito de divulgação de informações almejando dar transparência aos nossos investidores e não deve ser entendida como uma oferta de venda do clube de investimentos FCL Capital ou de qualquer valor mobiliário nela citada. As opiniões e estimativas citadas nesta carta são considerações feitas até o momento da publicação e podem mudar sem nenhum anúncio ou aviso prévio. Performance passada não é garantia de performance futura. Fundos de investimentos não possuem garantia de seu administrador, do gestor, ou qualquer mecanismo de seguro de fundos. As performances exibidas são sempre líquidas de taxas de administração e performance, mas não do imposto de renda devido pelos cotistas. Para maiores informações favor acessar o Portal Educação Financeira da ANBIMA "Como Investir" (www.comoinvestir.com.br)