

# FCL*Capital*

November 2018

## Fleury

### 1 – Introduction

After a rocky October, which was the theme of our last monthly letter and where virtually all risk assets world wide experienced heavy pressure, November was a recovery month for our funds.

FCL Opportunities shares appreciated 5,69% in Brazilian real and 1,93% in US dollars respectively while FCL Hedge appreciated 2,04% in Brazilian real.

As for our strategy, we continue to look for opportunities related to the rising middle class and consumption society in China and India, and deep value opportunities in Russia.

As for our home country, Brazil, since we are not inveterate long term bulls in the economic development of the country (except for a few specific sectors) we tend to look for companies that either ride of Brazil's relative advantages (as in the case of Minerva) or the ones that try to explore the country's economic deficiencies and arbitrate them away.

In the latter camp, Estacio, one of Brazil's largest education companies in a country still sadly apart from its peers in the fact that a surprisingly low share of its population reaches the university level, will surely be the theme of one of our future letters.

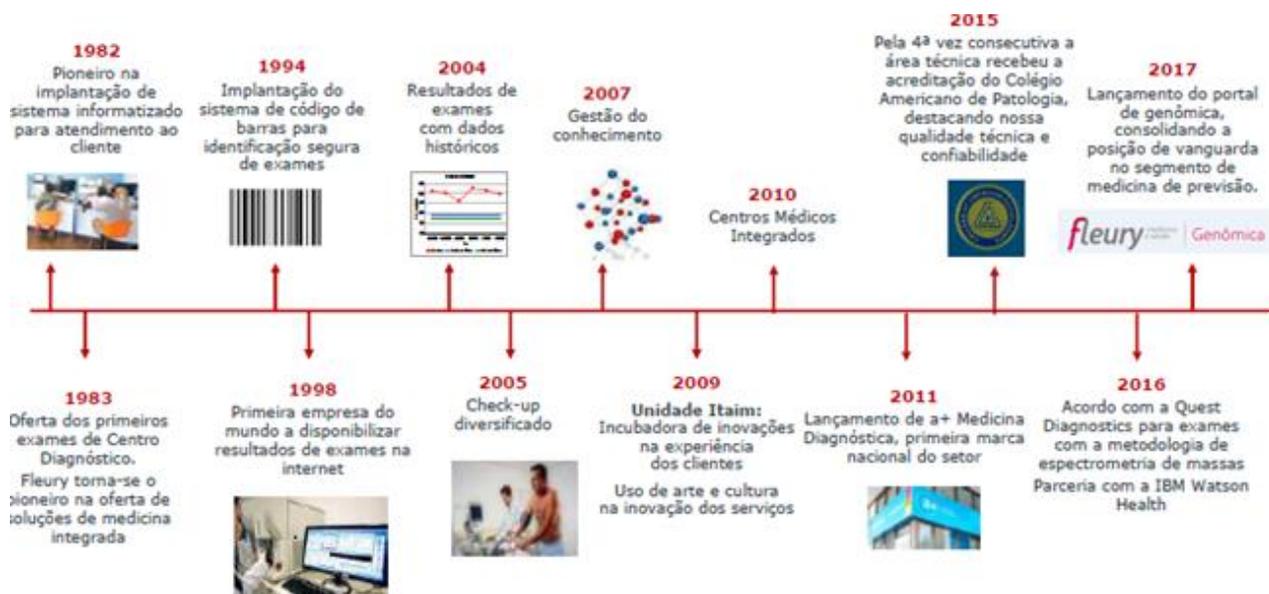
But this month we decided to focus and expose to our investors our thesis behind a company that is an important investment of both of our funds: Fleury.

We hope you like it and as always feel free to write us with any questions or considerations behind our thesis.

## 2 – The business

Group Fleury was founded more than 90 years ago in São Paulo, Brazil's business capital, and is today a leading medical diagnosis company in the country.

All in all, Fleury has 168 diagnosis centers, including 22 centers in hospitals, has almost 9.000 employees, including 2.000 physicians and has delivered more than 63 million medical tests in some 3.500 formats.



Over decades, Fleury became plausibly the most respected brand in medical diagnosis in Brazil, especially among the higher income segments of the population and started a natural process of consolidation in the traditionally very fragmented Brazil's medical diagnosis industry.



Among the company's competitors are Diagnosticos da America (DASA) and a few vertically integrated companies, like Intermedica.

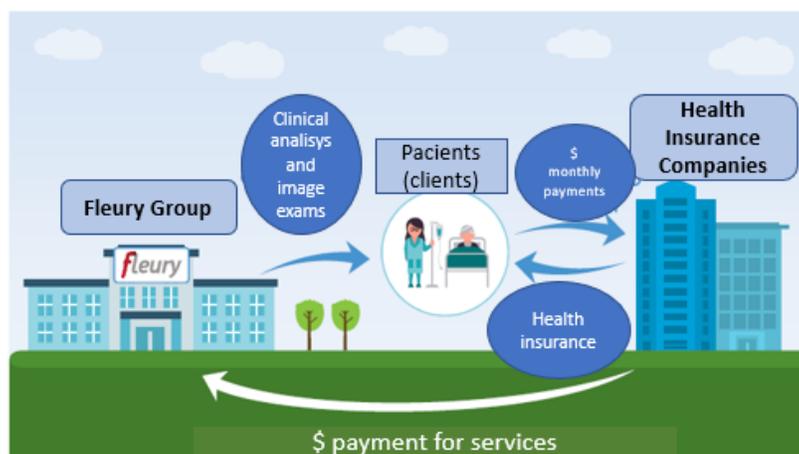
Part of our thesis comes from this house's belief that Fleury has the best and most sustainable long-term model to ride the sector's growth.

DASA delisted from stock exchange in the past few years and after the controlling shareholder's tragic and sudden death in 2017<sup>1</sup> is currently being managed by his son. Our channel checks and some anecdotal evidence suggest things are not going smoothly: according to Brazilian press<sup>2</sup> the young founder decided to leave the chairman's post and let professional executives run the company.

As for Intermédica, which has the distinction of being a vertically integrated company, unlike Fleury, part of the reason we prefer the latter is exactly the relative lightness, speed and focus of its business model.

In Fleury's case, patient wise the system usually works like this: there are private health plans, like Amil and Unimed where clients pay monthly or annual fees in exchange for improved (as compared to public) care.

Once a need for laboratorial test emerges, the client will make an appointment for one of Fleury's facilities (or one of its affiliated brands like Felipe Mattoso in Rio) and the company will be reimbursed by the health plan.



<sup>1</sup> DASA's owner was Edson Bueno, also Amil's founder and an important businessperson in Brazil  
<sup>2</sup> <https://www.istoedinheiro.com.br/pedro-bueno-deixa-o-cargo-de-ceo-do-laboratorio-dasa/>

In Intermédica's case, the company tends to run both test centers and hospitals. Currently Intermédica had its IPO and enjoyed higher multiples than Fleury exactly due to its vertical integration. So why don't we like this integrated model?

The answer lies in the sector's long term growth outlook as we will see soon. Brazil is currently the world's third largest healthcare market and its population is on the verge of experiencing rapid age increase. While there are undeniable advantages in the integrated model pioneered by Intermédica, especially in terms of costs, we also think Fleury's model provides specialization, stronger brands (both nationally using the Fleury flagship brand and with its regional brands) and above all flexibility to chase faster growth. At the same time, we doubt in the continent sized country like Brazil any company will be able to rapidly exploit market opportunities with the heavy investment that a verticalized model entails.

We are skeptical that any vertically integrated model company will be able to keep pace with what should be a fast-growing industry in the next few years without further capital increases.

Fleury meanwhile is freer to chase growth in the one part of the value chain it knows best: medical diagnosis. And it is increasingly becoming the undisputed leader in the industry.

Date	Buyer	Acquired Company	Value Paid (R\$m)	Valuation	Specialty	Location
Sep-17	FLRY	Serdil	29.8	6x EV/EBITDA	Imaging Services	Rio Grande do Sul
Apr-12	PARD	CEMEDI	n.a.	n.a.	Imaging exams	Minas Gerais
Oct-12	PARD	Progenética	n.a.	n.a.	Genetics and personalized medicine know-how	Rio de Janeiro
Dec-12	PARD	Digimagem	n.a.	n.a.	Imaging exams	São Paulo
Dec-12	PARD	Biocod	n.a.	n.a.	National paternity test leader	Minas Gerais
Jul-13	PARD	Diagnóstika	n.a.	n.a.	Anatomic pathologic tests	São Paulo and Rio de Janeiro
Jul-13	PARD	Padrão	n.a.	n.a.	Clinical analysis	Goiás
Dec-16	PARD	Centro de Medicina Nuclear Guanabara	n.a.	n.a.	Genetics and imaging tests	Rio de Janeiro
Oct-17	PARD	Ecoar	15.4	n.a.	Imaging Services	Minas Gerais
Nov-17	PARD	Laboratório de Análises Clínicas Humberto Abrão Ltda.	37.0	n.a.	Clinical analysis	Minas Gerais
Nov-16	AALR	Multilab	9.0	5x EV/EBITDA	Clinical analysis	Mato Grosso do Sul
Mar-17	AALR	Multiscan	92.0	7x EV/EBITDA	Imaging Services	Espírito Santo
Oct-16	DASA	Laboratório de Análises Clínicas Gilson Cidrim Ltda	n.a.	n.a.	Clinical analysis	
Dec-16	DASA	Leme Laboratório de Endocrinologia e Metabologia da Bahia	n.a.	n.a.		Bahia
Jan-17	DASA	Salomao Zoppi	600.0	n.a.		São Paulo
May-17	DASA	Laboratório Médico Vital Brasil Ltda	n.a.	n.a.		
Jun-17	DASA	Laboratório Médico Santa Luzia S.S.	n.a.	n.a.		
Oct-17	DASA	MOB Laboratório de Análises Clínicas Ltda.	n.a.	n.a.	Clinical analysis	Santa Catarina

Source: Company reports and J.P. Morgan.

### 3 – The industry

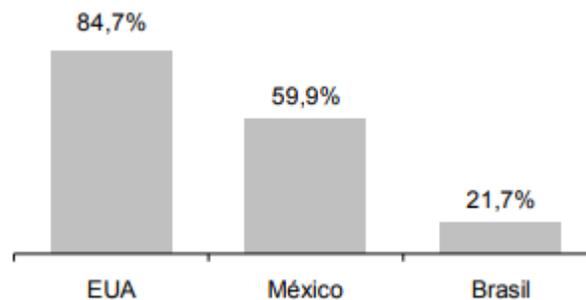
According to DATASUS (Brazilian Health Ministry Database) there are over 21 thousand individual diagnostic units in Brazil, with the four largest being DASA, Fleury, Alliar & Hermes Pardini. The absence of vertically integrated players is one more evidence of this house's thesis about being unenthusiastic about the idea.

All players are enjoying health growth due to a confluence of reasons:

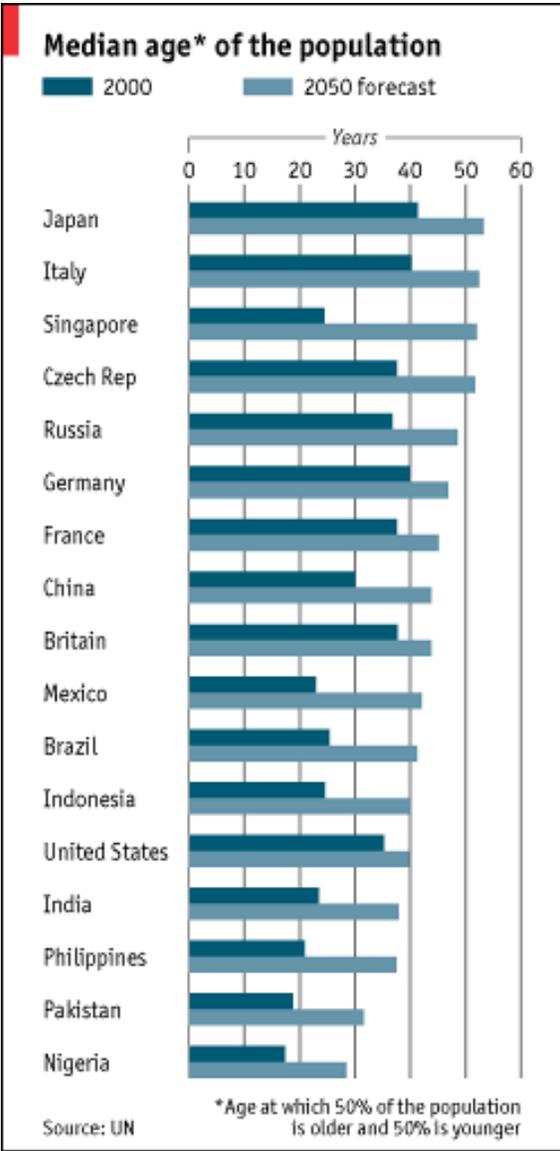
a. The lack of adequate public health care in the country and the consequent massive market gain of private health coverage.

b. Brazilian middle class rising income and the consequent demand and necessity to have a private health plan and subsequent access to Diagnostic Units. There is still a long road ahead since the private access to health plans is way below Mexico and the US.

**Percentage of population with private medical care**



c. Brazilian fast pace median age increase of the population. In fact, probably contrary to general perception both inside the country and abroad, Brazil is one of the fastest ageing societies on earth.



The confluence of all of those factors means that even if the Brazilian economy continues to enjoy lackluster growth in the next few decades, with rates between 2% and 3% like in the recent past, this house feels comfortable making the call that the healthcare sector in general and the private diagnosis sector in particular (once you add the fact that medicine is increasingly information and exams driven) will experience robust growth. To put it in other words, every piece comes together to ensure that even if Brazil continues to disappoint, healthcare in Brazil will be a fast-growing corporate oasis, able to experience rates of growth we usually associate with China and not Latin America.

Not surprisingly, M&A has been rampant in the past few years and should continue to be since overall the sector is still very fragmented with many regional and local operators.

So, a fast-growing sector, the best management in the industry, amazing economics, a sound business moat, strong brands, what is not to like?

#### **4 – Risks & downside protection**

As usual, this house's team spent some time brainstorming and mapping all the worst-case scenarios for Fleury. After some head scratching, here are a few of the worst we thought of:

- Fleury's specialized model could turn out to be incorrect and the vertically integrated companies, like Hapvida could gain share.

While this thesis has some proponents, we outlined over the scope of this thesis our disagreement to this view. That being said, as we were writing this letter Fleury signed the purchase of a small Rio de Janeiro based ambulatorial company. Something closer to the truth won't probably be as binary as presented: it will be a spectrum of strategies, with Fleury more specialized on medical diagnosis and some companies more vertically integrated. We suspect quite a few different models could thrive.

- Brazil's economy could crash

While this would obviously be very negative for the company, apart from utilities we would be very hard pressed to name a more defensive company than Fleury.

Over time the company has shown a smaller beta than the market and very predictable operational numbers. Granted a severe Brazilian recession would be a negative, but if you need to invest in Brazilian equities this company is one of your best safe harbors.

- A change of regulations

Brazil as we all know is an emerging market and frequently susceptible to change of laws and regulations. While this could affect the company there are two very important caveats:

1. The country 's new government is making all the right noises and seems eager to jumpstart the country's growth and respect contracts and the rule of law, a positive surprise in our opinion.
2. Fleury operates in a relatively less sensitive corner of the healthcare market than compared, to say, private health plans and even drugstores. Even a change of government probably won't bring many changes to the operational framework of diagnosis operator since they are a subcontracted part between patient and medicals plans. The conflicts and quarrels tend to happen between those later two and usually not with laboratory operators.

## **5 – Valuation**

Fleury is clearly a premium company. While the company has been in our radar since the founding of this house due to its strategic location, industry and prospects, over the past couple of years, with the de-rating in its multiples we decided for the first time ever to really dive into what makes this company and its numbers unique



**Fleury, performance in BRL, 2018 (January 1st=100)**

	Estimate:2019 A	Estimate:2018 A	Current/LTM	Original:2017 A	Original:2016 A
For the period ending	2019-12-31	2018-12-31	2018-9-30	2017-12-31	2016-12-31
Market Capitalization			6,506.37	9,318.25	5,601.15
- Cash & Equivalents			889.77	671.83	406.81
+ Preferred & Other			0.00	0.00	0.00
+ Total Debt			1,376.66	1,054.92	832.02
Enterprise Value			6,993.26	9,701.35	6,026.37
Revenue, Adj	2,957.50	2,663.20	2,591.75	2,383.01	2,096.11
Growth %, YoY	11.05	11.76	11.51	13.69	10.62
Gross Profit, Adj	997.33	892.28	789.55	736.08	601.05
Margin %	33.72	33.50	30.46	30.89	28.67
EBITDA, Adj	783.27	705.64	676.81	621.51	481.92
Margin %	26.48	26.50	26.11	26.08	22.99
Net Income, Adj	380.40	345.20	337.95	322.48	227.98
Margin %	12.86	12.96	13.04	13.53	10.88
EPS, Adj	1.22	1.10	1.04	0.99	0.73
Growth %, YoY	11.11	10.50	-0.11	36.36	99.21
Cash from Operations			601.09	529.61	513.87
Capital Expenditures	-240.29	-264.29	-284.51	-295.59	-183.98
Free Cash Flow	299.34	288.20	316.59	234.02	329.89

Overall, we find Fleury trading at 18x this year's forecasted earnings, around 10x its EV/Ebitda multiple and, even at a consolidation and investment phase, an almost 5% Free cash flow yield.

Although not ridiculously cheap by traditional standards, we find those numbers very justifiable and compelling for the rarity that Fleury is: a high

growth company in a low growth economy, with relatively low operational risk (not too dependent on the economic situation or commodities prices as is so common in Brazil) and with double digit annual growth rates ahead.

Those numbers compare favorably with international peers ( we did some comparison tests and Fleury not only is cheaper by most measures but also with a higher expected growth rate) and with national peers like Hermes Pardini (with its scale and history in our minds Fleury should command a premium in its valuation and it does not. Especially since it is already a corporation and with a lot less key man risk in a sector still typically controlled by founding families).

## 6 – Conclusion

This house thinks that Brazil will eventually find the road of growth again. But even if it does not Fleury should continue to thrive, like it did during the past three years: during the country's worst economic crisis, it grew its revenues by more than 40%, earnings by more than 100% and Free cash flow by more than 25%.

Several companies should take advantage of Brazil's macro demographic trends: the country is becoming wealthier and especially older in a fast pace.

We like Fleury's position in the sector with the added advantage that it is relatively immune to economic downturns and regulatory voluntarism.

We started buying shares earlier this year for both of our funds and Fleury is now an important position.

Like in biblical stories, in financial markets there is a time to plant and a time to harvest. This past year saw a severe bear markets for our target markets (emerging market related stocks) so it was naturally a time to plant. We hope in 2019 and the subsequent years Fleury and other ideas in our portfolio will start giving the fruits of their harvest for our investors.

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](http://www.fclcapital.com).

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