

FCL*Capital*

April 2019

Context - Still dreaming of BRICs

One of the most frequent topics on conversation and enquiries this house receives from our investors and friends concerns the global investment context in general and in particular whether the four countries that function as our main focus - Brazil, Russia, India and China - should still be viewed as a cohesive and functioning group (the one that captured global imagination with Jim O'Neil's "Dreaming of BRICs" Goldman Sachs' paper back in 2001) or should just be accepted as four particular and troubled stories.

As we write this letter Brazil is still mired in a lukewarm economic recovery after years of recession, India is in the fourth of a seven round intense electoral dispute, Russia still faces sanctions from the US, and China is in a very complicated - and we will add, crucial for the global economy - transition from an investment heavy capital intense growth model to a consumption and urbanization driven one.

Also, according to financial news, Europe is a complete mess (Brexit, Italy's permanent mess and vast menu to choose from) and the US might be the only bright spot with not brilliant but at least passable economic circumstances in the global financial system.

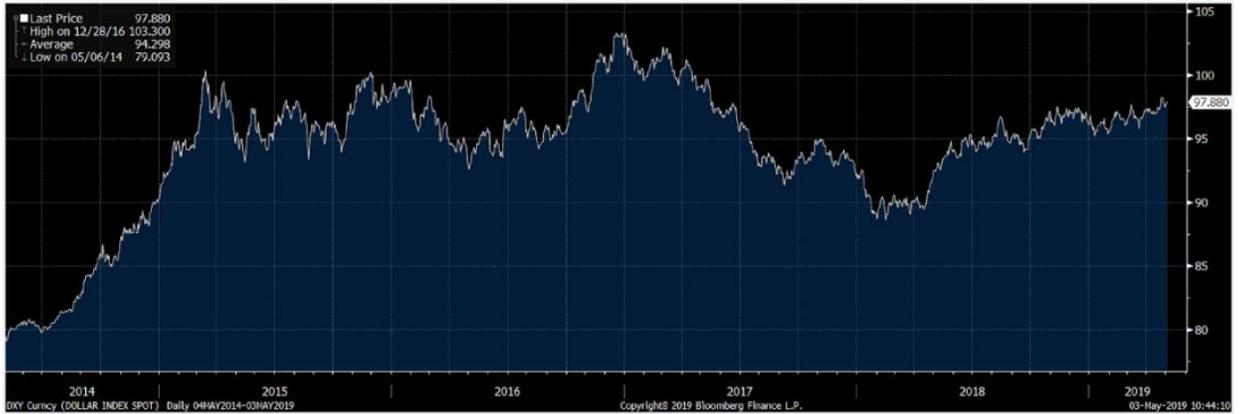
We will take this letter to examine those claims in detail and to give an updated assessment of how this house is currently thinking about the markets we operate in.

The US and the superstars

Starting by the so-called bright spot of the global economy, US markets and especially its currency have clearly been apart from the rest in the past few years.



S&P500 vs Ibovespa, China's CSI300, FTSE ALL World Index, January 1st, 2010-April 30th, 2019



DXY dollar index , past 5 years

This house feels significantly more pessimistic about the long-term prospects of the planet's most important and sophisticated economy than most. We delineated our reasons in length in some of our past letters but

in short, we think the US is, very gradually, going through a process of “Latinization” with the following characteristics:

- Less competition in most economic sectors (a positive for our portfolio companies).
- Lower level of overall capex and investment by companies.
- Lower level of trust and cooperation in society.
- Growing inequality and rigged economic opportunities.
- Lower immigration and long-term economic growth.

But if we had to summarize all of our findings in one, it would be this:

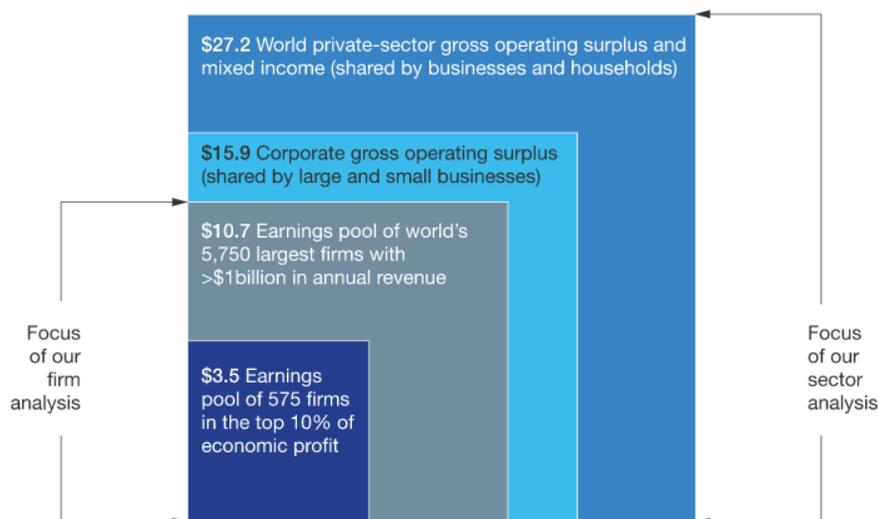
A growing and progressive tendency for most of the rewards to be concentrated in the top places, sectors and companies.

In fact, Mckinsey just released a fascinating economic report called “Superstars: The dynamics of firms, sectors, and cities leading the global economy” which we recommend to our readers. Its main conclusion is that the rewards for the winners in the global economy, and very especially in the US, were increasingly skewed.

For this house, these finding makes intuitive, if puzzling sense. The winner-takes-all phenomena can be seen in companies, where a handful of titans, like Apple, Google, Alibaba and Netflix, take the lion’s share of the global economic profits. Startingly, Mckinsey’s report finds that 80% of global economic (as opposed to accounting) profits accrue to just 10% of companies.

Superstar firms account for about 13 to 15 percent of global surplus and 22 to 25 percent of corporate earnings.

World gross operating surplus and share accruing to corporations as EBITDA,¹
\$ trillion, 2014–16 (3-year average)



¹Gross operating surplus is an economic measure that represents the income earned by capital. It is calculated as gross value added less compensation of employees and taxes on production and imports. Earnings before interest, tax, depreciation, and amortization expenses (EBITDA) plus R&D expense is the closest corporate financial proxy for the economic measure of gross operating surplus. See Peter Chen, Loukas Karabarbounis, and Brent Neiman, "The global rise of corporate saving," working paper number 736, Federal Reserve Bank of Minneapolis, March 2017. Corporate earnings pools are estimated based on EBITDA margin and R&D expenses relative to total revenue pools in each category. EBITDA margins of 12.6%, 14.3%, and 18.1% and R&D-to-sales ratios of 3.0%, 4.9%, and 7.0% used for firms in McKinsey's corporate-finance data set, firms with >\$1 billion in annual revenue, and firms in top 10% of economic profit, respectively.

Source: IHS; Organisation for Economic Co-operation and Development; Corporate Performance Analytics by McKinsey; McKinsey Global Institute analysis

Likewise, superstars' effects can be seen in sectors where finance, technology and, to a lesser extent, pharmaceuticals swallowed almost all talent, ambitious people and entrepreneurship all over the globe.

Finally, winners takes all effect can even be seen in places themselves and helps explain Donald Trump's election in one side of the Atlantic and Brexit in the other, where those who felt they were falling behind in the social packing order of their respective societies clearly voted to be noticed and annoy the elites.

While many places are clearly left behind by globalization, some clusters of talent and energy shine brightly, like the San Francisco bay area and its unicorns, Boston and its Ivy League colleges, London and its multiculturalism (still) , Berlin and its vibe, Hong Kong, Singapore and Shanghai and their promise, and probably still shining above everywhere else, New York City.

On a country level, winner takes all will define the 21st century with an incumbent superpower in a restless mood when finally faced with a more formidable and rising challenger in what this house thinks is a misguided (by American politics and society) zero sum mindset.

As we approach the twilight of American dominance, first in business and finance and eventually, probably in the second half of this century, in culture, media and society, it might be wise to contemplate what a run it was.

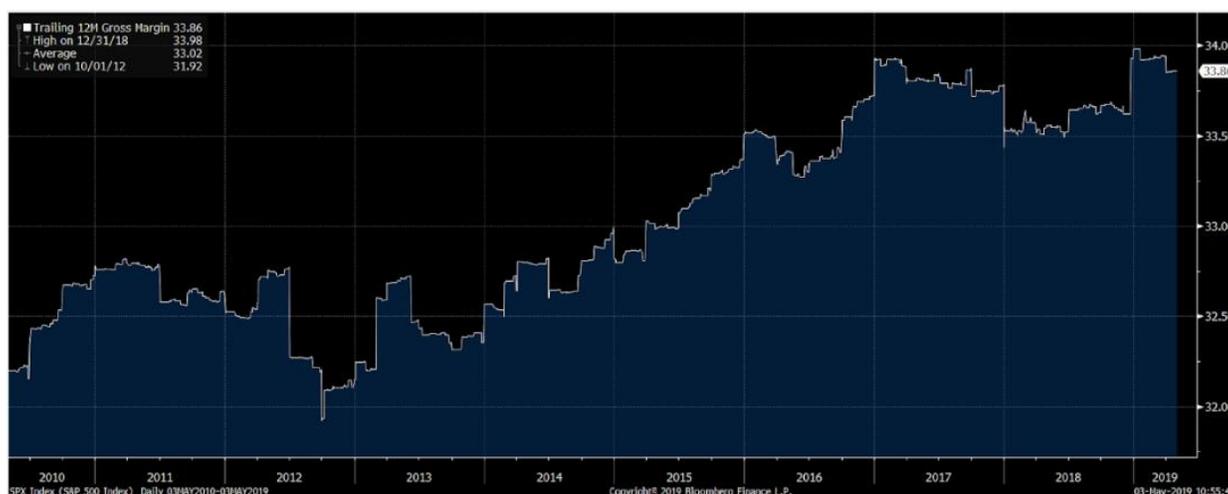
Since it became the world's largest economy on Purchase Power Parity, probably overtaking Britain around 1872, and especially after world war II, we lived in an American shaped world. To walk around New York City especially between streets 40 and 60 in midtown Manhattan, where the decisions that shape global markets take place or simply enjoying the evening in places like the Metropolitan Museum or the Lincoln Center and their marbled entrances named after their benefactors (the Henry Kravis or Stephen Schwarzmans of the world) is to live in present-day House of Medici. And just like we go to Uffizi Gallery in Florence nowadays to contemplate their past greatness, future generations in centuries to come will come to relics of this time to contemplate the greatness of the American era that is now exiting the stage for the next act: China and Asia.

Overall, we still think the US might be the country, alongside China and Brazil, that will provide the biggest number of potential future ideas and investments to our Opportunities Fund. There are so many historical and secular natural advantages for its companies that for the remainder of our

lifetimes it might be to US markets that the world will look first. They have the dollar, the FED, New York City, the English language, a series of procedures and business behaviors that became global benchmarks, the list of advantages the US has is still huge.

Also, if we are right on our hypothesis, a somewhat slower growth environment combined with less competition and higher barriers to entry will even increase US market returns in the medium term. We suspect this might already be happening and S&P500 margins keep defining predictions that they will fall back from their current sky-high levels.

All in all, we think this might be an economic environment where we know how to navigate: we were raised in Brazil, with its cozy cartel's monopolies and regulations after all.



S&P500 companies aggregate gross margins: trending upwards

If we had to summarize: the US will disappoint economically and its valuations might come down in a one-off effect, but its markets and also a diminishing number of great companies might decouple and prosper. We hope Match, our longtime US investment and also some other more recent US investments in our Opportunities fund will be among them.

A newer investment we haven't had the chance to discuss in this space, XPO, is a leader and consolidator in the courier delivery and logistics business. Part of this house's thesis is that a champion in this sector will be able to be profitable, grab market share from rivals and above all, surpass the loss of its major customer, coincidence or not, also a champion in another sector, that you, dear reader, might be familiar with - Amazon.com.

Europe

It is hard to avoid the thought that Europe will gradually play a diminishing role in the global economy and global affairs. It has a decreasing share of the planet's economy, capital flows and population.

That being said, Europe still matters a lot: it is home (even without adding up Non-EU area) to some 25% of the planet's economic output. It has areas of excellence in diverse sectors and some of the globe's wealthiest spots, like Switzerland and Norway.

Gradually, the investment ideas from our Opportunities fund that are located in Europe converged to the continent's strong spots, like the intersection between tourism and fashion that underpins our investment in Dufry, and scale and access to natural resources in the case of our investments in Russia, like the fertilizer company Phosagro.

To retain its prominent role in the global economy, this house thinks only 3 possible alternatives are available to Europeans:

- 1) a significant increase in immigration from Africa, Asia and the Middle East (unlikely to happen in a very large scale due to political reasons,

2) A revival of Eurasia and its notion of a single big continent where Europe's destiny will increasingly be tied to Xi Jinping's Asia (also unlikely to happen with the necessary speed) and

3) An increasing role as the planet's "playground" since with rising affluence, Asians will need a place to spend and have fun.

To this last point we think Europe might have a shot of playing a significant role. Europeans were able to convince the rest of the world that they are the judges and arbitrators of good taste and fashion trends and Louis Vuitton Bags, Cristal champagne and San Pellegrino water bottles around the globe would attest. Meanwhile cities like Paris, London and Barcelona continue to attract the planet's imagination and infatuation.

We think most investments this house will make in Europe over the next years and decades might have as background this notion outlined in point 3.

Gradually the notion of Europeans as arbitrators of good taste and decency took hold. Fairly or not, for a continent that through part of its history exported wars and colonialism, Europe is seen nowadays as the globe's most civilized part. Companies like LVMH, Graff, Hermes, Club Med and so many others profit from the notion that Europe, its cuisine, its destinations and its cities are where the world should be seen, how to world should dress itself, what the world should eat and drink.



Chart: LVMH shares in Euronext Paris

Asia and the new world order

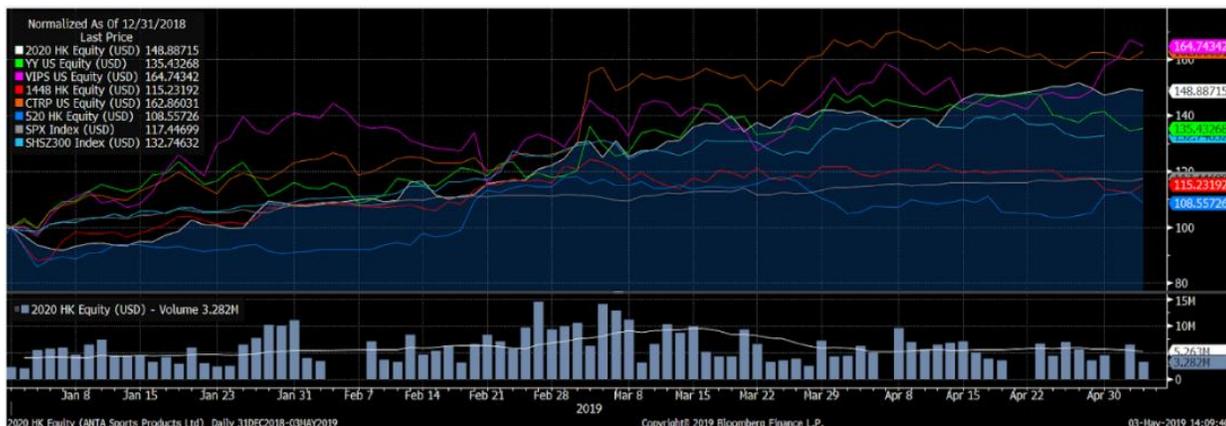
We won't go back in length about why we think Asia will increasingly be, in the 21st century, the epicenter of economic activity. In short, we think that just like the 20th century witnessed an unprecedented consumer scale with 300 million Americans enjoying high living standards, we will witness something even greater with 3 billion Asians reaching middle class status or higher. Fortunes will be made, and opportunities will abound.

Overall, our Chinese investments try to take advantage of this new Asian consumer society this house foresees or new business models that were not thought about by the west.

Our major Chinese investments at the time of this writing are:

- Anta, China's largest sports manufacturer.
- YY, a leading internet streaming and game streaming service.
- Vipshop, China's third largest shopping portal after Alibaba and JD.

- Fu Shou Yuan, a consolidator and leader in China's death care and burial services.
- Ctrip, China's largest travel portal.
- XiabuXiabu, a large hot pot restaurant chain.



FCL Opportunities Chinese investments vs S&P500 and China's CSI300 stock index, YTD, USD.

Why is Asia so crucial? To put it very crudely, economic output is productivity times the amount of work hours a place has. And the number of work hours is obviously the result of the number of people in a society. Asia is simply the place where more than half of humanity lives.

True, demography is not destiny. At least not always, as economists remind us. But is that really so? As a recent Free Exchange column on The Economist magazine puts it¹, there are certainly worse methods of predicting very long-term rates of economic output than ones simply based on population size.

¹ - <https://www.economist.com/finance-and-economics/2019/04/17/where-growth-is-concerned-is-population-destiny>

For most of humanity, demography was indeed destiny until the great divergence, with the industrial revolution, first in Holland, then the UK and finally the US put this concept to rest. Now, this house believes there is some evidence that with the advent of hyper globalization and diffusion of information, divergence will weaken, and convergence will be back in vogue at least in several parts of Asia, if not in Africa and Latin America.

Finally, size is not only an advantage when it comes to economic output per se, but also in the scale and efficiency of companies. It is undeniable that many American companies have used scale at their advantage when competing with European companies and their fragmented markets. Banking might be the most obvious example in recent times where US investment banks left their European counterparts in the dust since the advent of the 2008 financial crisis.

Brazil and Latin America

Finally, to our home market.

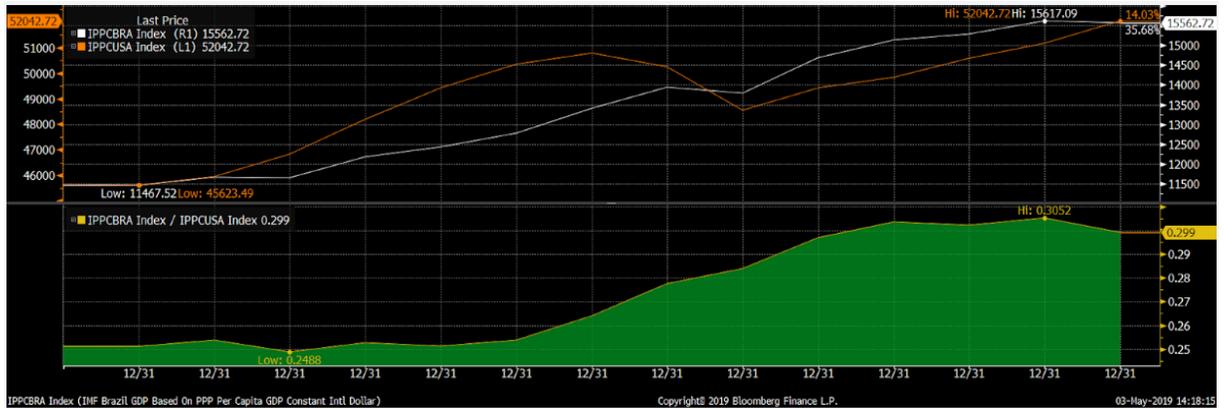
Brazil, in our view, has two very different dramas. One very much in the media nowadays, is its fiscal situation, that showed an almost unbelievable deterioration in the past decade due to an over generous and lax pension system coupled with a prodigal and inefficient Brazilian state. A succession of pension reforms (the current one, if approved being only the first) are surely necessary for the country not to fall in an economic abyss of rising net debt and budget deficits.

The second drama, less discussed, is the complete incapacity of the Brazilian economy to keep up with growth rates of the rest of the developing world (let alone Asia's). This happens because it is a nightmare to do business in Brazil and Latin America in general. High taxes, corrupt

bureaucrats, low social trust, inefficient logistics and infrastructure, low skilled workforce, low investments in R&D and many other factors.



Brazil Budget Deficit



Brazil as a share of US GDP per capita at Purchase Power Parity

The result is that, even if the complete mess caused by a possible insolvency is avoided due to the currently discussed pension reform (a reform that is so dramatically needed that calling it a necessity is an understatement) we would still be long term bears in Brazil: Latin America in general and Brazil in particular is a part of the world that is being left behind, to put it crudely.

That being said, its size and its competitive advantages in agribusiness and commodities, its islands of excellence and its best entrepreneurs assure that fortunes will still be made in Brazil, and avoiding a major collapse, this boom and bust cycle that has characterized the country since its founding in 1500 should keep going.

Overall, our Brazilian ideas happen when exploring the country's competitive advantages: Minerva and Fibria being the current prime examples. The country's specific circumstances: Estacio (low levels of education and graduation rates) and Fleury (rapidly ageing population) are the two major examples currently in our portfolio.

We do think that if a decent pension reform is approved in Brazilian congress, there is space left for Brazilian assets, especially its stock market but also its bonds, to rally. Fingers crossed for that.

FCL team.

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