FCL*Capital*

August | 2017

Thesis: Betting on Fogo

1. **Background**
2. **Our take: a look at the history of the “rodizio” origins**
3. **Valuation: discrepancy between price and value**
4. **Risks, considerations, mitigators and why we differ from the consensus**
5. **The future of Brazilian style barbecue**

1. Background

Every culture has a few of its dishes and offerings that were able to conquer the globe, because of its uniqueness or superiority that makes them stand apart from the rest. Food is after all, the greatest form of culture. In a world where we can see the Armanis and Tiffanies of the world looking just the same everywhere, food is possibly the last thing that is still largely hidden and about to be discovered by “foodie” globe trotters everywhere.

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Life wouldn’t be as enjoyable if we were not able to travel, if not physically, at least in spirit for the duration of a dinner to places like Japan, every time we order a sushi, Barcelona (sangria), California (burger and shake) , France (the whole haute cuisine and wine experience), Thailand, India, and so many others.

The success of new and exotic cuisines in cities everywhere, the increase of interest in food, where it comes from and how it’s made, the phenomenon of the “celebrity chef” and the popularity of series like “Chef´s Table”, all attest that people are salivating to discover and learn more about food. Unsurprisingly, new concepts on the whole food spectrum pop up with astonishing speed, from street food and fast food chains to upscale Michelin-starred establishments

When it comes to Brazilian food, if we consider açai and pão de queijo as side orders, it is undeniable that, increasingly, the churrasco style rodizio meat dinner is what people around the globe think of when they think about Brazilian food.

This is due to a few historical facts. The region that comprises the southernmost state of Brazil, along with Argentina and Uruguai are probably home to the best, most abundant and cheapest meat in the world. It is no accident that this region has the highest per capita consumption of red meat in the globe. Accessibility plus quality made this part of the local culture.

Chart 1: Average yearly meat consumption in pounds

Country	Per Capita
Uruguay	124.2
Argentina	120.2
Hong Kong	114.3
USA	79.3
Brazil	78.9

There is a lot of dispute about where lies the origin or rodizio style churrasco. Most people accept that its commercialization began in Rio Grande do Sul state, in the south of Brazil, during the 1960s, with humble origins of truck drivers as customers who would stop on the roadside to enjoy lunch. Since demand would peak at a few times during the week and then vanish, a small establishment called Tia Maria would impose a system of “espeto corrido” or rushed steak, with the notion that, since it didn´t have the capacity to prepare all the orders from all the tables, it would instead make all tables share the meats prepared from the grill, first in trays and then is metal sticks as it is still used today.

One of its earliest customers was a humble truck driver named Jandir Caumo who would later on become the founder of Estrela do Sul and Oasis chains, based mostly in Rio de Janeiro.

But it is also known that the real story of churrasco began centuries before, with Christian missionaries and early settlers that would grill the meat in holes dug in the ground (that´s where the name “fogo de chao” (“fire in the ground”) comes from.

Over time, the traditional open air ‘’gaucho’’ style churrasco became a cultural hallmark of southern Brazil.

That being said, while it is true that for decades most Brazilians have been used to eating “churrascos”, no single chain has been able to globally capitalize on its success.

Sure, a few entrepreneurs, most of them Brazilians living abroad, opened mom and pop ‘’rodizio style’’ establishments around the world.

Brazilian style churrascaria in the UK.

But so far, the Brazilian barbecue phenomenon has been more similar to sushi, where no single entrepreneur or chain was able to grab a globally significant market share, as it is the case with hamburgers, coffee and pizza where huge empires were born.

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The first Fogo de Chao was established in 1979 by two brothers called Ari and Jair Coser. It was an original concept since its founding. While most “churrascarias” were still focused on serving drivers at roadsides, the brothers decided to go “upmarket” and opened their place at the center of Porto Alegre, Rio Grande do Sul. In 1986, in another bold move they opened a restaurant in Moema neighborhood in Sao Paulo, Brazil´s business capital.

In 1997, attending a passionate request from an American business visitor, who was marveled at the concept, the brothers took their boldest step and opened a restaurant in the city of Dallas, Texas and entered the American market.

From these bold steps, the brothers embarked on a fully professionalized management system, still a rarity in Brazil these days and back then something almost unheard of for a medium sized company.

Several new inaugurations across Brazil and the US followed, including its first Rio de Janeiro restaurant, and finally, in 2016, its beautiful New York City flagship.

Then in 2006 a new chapter began: GP investimentos, one of the leading players in Brazilian private equity that can trace its roots back to its founding in 1993 by the now universally famous 3G partners (Jorge Paulo Lemann, Marcel Telles and Carlos Alberto Sicupira) bought a stake in the company with an eye on its continuing expansion in the US market.

From then on, its path of expansion seems to be steady: the chain usually adds between 1 and 2 new restaurants per year in Brazil and 3-4 restaurants in the US. Its Return on invested capital is, with a few exceptions, on a class of its own among its industry.

Chart 2 : ROIC Fogo de Chao compared

Unique Operating Model Drives Best-in-Class Financial Results

	FOGO DE CHÃO	Full-Service(1) Average	FOGO DE CHÃO Advantage
Average Unit Volume(2)	$7.8M	$4.5M	$3.3M higher
Labor Costs	23.0%	32.7%(3)	965bps lower
Restaurant Contribution Margin(4)	29.8%	19.4%	1,037bps higher
Net Income Margin	8.5%	4.2%	434bps higher
Cash-on-Cash Returns(5)	51.7%	29.9%	2,178bps higher

Note: Represents FY 2016.

Source: Company filings

(1) Includes BBRG, BJRI, BLMN, CAKE, CHUY, DFRG, DRI, RUTH and TXRH.

(2) Reflects median average unit volume of full-service competitors

(3) Excludes DFRG and RUTH labor costs as they are not reported separately

(4) Defined as 2016 Average Unit Volume * 2016 Restaurant Contribution Margin / Target Investment Cost.

As the cycle of its fund neared the end, GP Investimentos completed a secondary sale to Thomas H Lee partners in 2012, further linking the company´s future to the American market. In 2015, Fogo debuted in the Nasdaq Stock exchange. Thomas H lee has been gradually reducing its share in the company to the current 60.4% as its fund cycle also nears the end.

The first very interesting thing to notice is how a few coincident ingredients: some instability in the ownership structure, a certain investor´s saturation with the hole casual dining sector and the pure lack of knowledge from investors and the general public about the company combined to produce the fact that: despite Fogo being a unique and promising concept, and despite the fact that it kept growing and improving its numbers over the years, it kept remaining cheaper in the market.

If we look at the evolution of Fogo´s share price and results, it seems clear that the few investors keeping a close eye on the company were mostly satisfied. It´s just that the company could not surpass a general lack of excitement, and interest in the company and the sector as a whole after being burnt by stories like Chipotle and others.

Chart 3

Fogo	Market Cap USD	Ebitda	EV/Ebitda
2015	425.5	49.8	8.54
2016	404.8	55.1	7.34
2017 2q	354.4	53.9	6.57

This house has been following Fogo almost since its founding. We judge the company to have unique attributes, a strengthening brand, excellence in service and several hard to replicate qualities and market positions. In may 2017, as Thomas H Lee announced a follow on share offering, Fogo´s shares dipped around 20% as the market feared an overhang in shares and excessive supply that could further depress the share price.

We started building a position.

For this house, Fogo is probably the greatest example of what we try to do: our international fund looks for companies able to profit from the growth of emerging markets, particularly BRIC countries, while ideally with G7 levels of governance. Fogo is a Brazilian story, able to explore emerging markets consumer growth and emerging markets business concepts still unknown to many American and European investors while at the same time, with the processes and governance of an American company listed in the Nasdaq. Fogo, while having Brazilian roots also has its headquarters and most of its senior management in Dallas, Texas.

It is for us the best of both worlds: American governance combined with proprietary informational knowledge most American investors would find hard to get, since the company´s suppliers, founders and competitors are still mostly in Brazil.

But first things first, let's look at why we think Fogo is Unique.

2. Our take

As most investors know, there are a few concentric circles when it comes to being right or wrong about an investment thesis.

On the outer circles, meaning an investor´s miss, there are low quality companies that were acquired at high multiples. Those are possibly the most costly investment mistakes.

Getting close to the bullseye circle, there are low quality companies that were acquired at cheap prices. Probably the investor will lose a lower amount of money on those, since the low entry price will act as a buffer but eventually, the low quality will prevail unless the investor is able to ''time'' the market.

Closer still to the bullseye are high quality companies acquired at high prices. Unfortunately, even if the numbers keep improving, a too high price will likely avoid an adequate return on capital.

Finally, a great company acquired at low price. That´s the bullseye of equity investing.

We believe Fogo is a great company that for a few coincidences (inattentive sell side, change of ownership, slow environment for casual dining and consumer discretionary spending in general) became a great investment opportunity.

Talking about its attributes:

The brand: If we look at 47 restaurant chains found on a quick stock screening on the US markets using a Bloomberg terminal, Fogo has one of the highest potentials for being a world class global brand someday. Running through every name on the list, we find the obvious already global champions (Starbucks Coffee, McDonalds, Domino´s Pizza), we find a long tail or regional chains (Zoe´s Kitchen, Habit, Denny´s, Jamba Juice) and maybe with the sole exception of Shake Shack, we find no other name still in its early days of expansion where we see full potential of becoming a global brand.

Chart 4

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Name	Market Cap	Market Cap	EV/EBITDA T12M	BEst P/E BF12M	FCF Yld	Rev - 5 Yr Geo Gr:Q
			<Enter Filter>			
Investable Universe (47)	6.84B	6.84B	28.68	26.56	1.72%	3.97%
31) CHEESECAKE FACTORY INC/TH	1.84B	1.84B	6.26	13.81	7.81%	4.63%
32) BJ'S RESTAURANTS INC	604.78M	604.78M	6.42	16.44	2.24%	8.04%
33) BRINKER INTERNATIONAL INC	1.48B	1.48B	6.79	9.46	13.53%	2.44%
34) CHUY'S HOLDINGS INC	305.15M	305.15M	7.19	16.70	1.82%	16.87%
35) ARCOS DORADOS HOLDINGS IN	1.92B	1.92B	7.56	23.88	3.67%	-1.67%
36) BUFFALO WILD WINGS INC	1.53B	1.53B	7.69	18.47	7.44%	16.24%
37) BLOOMIN' BRANDS INC	1.56B	1.56B	7.85	11.50	3.05%	1.15%
38) DEL FRISCO'S RESTAURANT G	282.06M	282.06M	7.87	16.59	0.78%	10.28%
39) POTBELLY CORP	276.38M	276.38M	8.23	31.82	-1.09%	
40) CARROLS RESTAURANT GROUP	390.51M	390.51M	8.27	43.75	-3.89%	19.04%
41) BOJANGLES' INC	484.69M	484.69M	8.43	15.37	8.50%	
42) J ALEXANDER'S HOLDINGS	143.28M	143.28M	8.52	11.43	-3.02%	
43) DINEEQUITY INC	685.39M	685.39M	8.65	8.54	10.84%	-6.48%
44) FOGO DE CHAO INC	351.53M	351.53M	8.78	13.04	5.44%	
45) DAVE & BUSTER'S ENTERTAIN	2.09B	2.09B	9.08	18.42	3.35%	13.81%
46) SONIC CORP	956.18M	956.18M	9.19	16.93	2.92%	-2.90%

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Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2017 Bloomberg Finance L.P.
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But here is the interesting fact: this is certainly not the Street´s opinion. While Fogo has shown, during the past few years' hard climate for casual dining, very resilient growth that put it in the top quartile of average sales growth in its industry (earning, in our opinion, the merit of being thought of as a possible high flier) Fogo also trades at multiples in line with its regional, low growth peers.

This confluence of top quartile industry growth with multiples in line with regional, low growth chain and a clueless, inattentive sell side is what makes, in our eyes, Fogo de Chao a unique opportunity in the American consumer discretionary landscape right now.

Chart 5: Highest 3 year average sales growth among 47 restaurants, US


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Name	Market Cap	Market Cap	EV/EBITDA T12M	BEst P/E BF12M	FCF Yld	Rev - 5 Yr Geo Gr:Q
Investable Universe (47)	6.84B	6.84B	28.68	26.56	1.72%	3.97%
31) AMERICAN RESTAURANT PRTN	4.53B	4.53B	567.46		13.77%	6.18%
32) BRINKER INTERNATIONAL INC	1.48B	1.48B	6.79	9.46	13.53%	2.44%
33) DINEEQUITY INC	685.39M	685.39M	8.65	8.54	10.84%	-6.48%
34) BOJANGLES' INC	484.69M	484.69M	8.43	15.37	8.50%	
35) CHEESECAKE FACTORY INC/TH	1.84B	1.84B	6.26	13.81	7.81%	4.63%
36) RUTH'S HOSPITALITY GROUP	579.90M	579.90M	9.51	17.06	7.52%	1.10%
37) BUFFALO WILD WINGS INC	1.53B	1.53B	7.69	18.47	7.44%	16.24%
38) DENNY'S CORP	766.47M	766.47M	11.44	19.25	7.31%	1.49%
39) BIGLARI HOLDINGS INC	371.47M	371.47M	12.82	79.10	7.13%	-0.40%
40) DARDEN RESTAURANTS INC	9.85B	9.85B	11.27	17.34	6.11%	-0.42%
41) CRACKER BARREL OLD COUNTR	3.48B	3.48B	9.43	16.14	5.74%	2.88%
42) FOGO DE CHAO INC	351.53M	351.53M	8.78	13.04	5.44%	
43) DUNKIN' BRANDS GROUP INC	4.63B	4.63B	14.46	20.18	5.18%	4.91%
44) ELXSI CORP	140.43M	140.43M	44.84		3.90%	-0.78%
45) STARBUCKS CORP	77.23B	77.23B	14.48	23.04	3.76%	11.44%
46) RED ROBIN GOURMET BURGER	753.04M	753.04M	10.18	17.88	3.71%	7.21%

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Chart 6:

3. To build our proprietary model for the future of Fogo, we compared Fogo with its investible universe of 47 restaurant chains the US:

Median American restaurant chain:

Market cap: $ 794M
EV/Ebitda: 10.21
PE Ratio: 18.62
Free cash flow yield: 3.08%
Sales growth (2012-2017 period): 2.8%
Sales Growth (2017-2022 period): 3%
PEG Ratio: 6,42

And then we compared to our Fogo assumptions.

To come up with our Fogo numbers, we made some minor adjustments to the market consensus as any analyst could get in a Bloomberg Terminal. Roughly, our adjustments allowed for the fact that we think over the medium term the company´s same store sales will trend back to an average of 3% in the 2017-2022 period and the company Joint Venture opportunities with its middle eastern partners is not yet recognized by the market. But all in all we decided to be conservative and didn´t tweak the consensus numbers too much.

So how did we get to our target price? We used an average of the PEG ratio, the Free Cash flow yield and the EV/Ebitda ratios and compared to the industry´s average to reach our target price.

Fogo de Chao Proprietary FCL Capital Estimative:

Market Cap: $ 355M (less than half the median US restaurant chain)
EV/Ebitda (2017): 7.8 (24% discount to the median US chain)
PE Ratio (2017): 12.67 (32% discount to median US chain)
Free Cash Flow Yield (2017): 8.45% (almost 3x the median US chain)
Sales Growth (2012-2017 period): 8.51%
Sales growth (2017-2022 period) (FCL estimative): 3%
Adjusted average (2012-2022) sales growth: 5.75%
PEG Ratio: 2.20
PEG Ratio Upside: 6.42/ 2.2: 191%
EV/Ebitda upside: 10.21/7.8: 30.89%
Free cash flow upside: 8.45 / 3.08: 174%

FCL target upside for FOGO: 132%

4. Risks

As the months progressed in our research about Fogo, we talked with a few customers, suppliers and competitors. Admittedly, there are worse company research field trips than enjoying a feast at one of Fogo´s locations.

Many of our concerns were gradually addressed or diminished, as our framework about the company progressed. Bellow we list a few common Fogo usually perceived risks and what we think are their respective mitigating factors:

Risk 1: The general slow retail environment in the US warrants a low multiple for the company.

Everyone is watching the so called “retail carnage” taking place in the US, supposedly because of online retail increasing penetration, and scratching their heads, including us.

Granted, many traditional retail companies will have their business models challenged and some of them indeed deserve low multiples.

That being said, we would be hard pressed to think of a company more immune to online disruption than Fogo: it is not only a dining experience, which can´t be put on an APP, but even delivery services wouldn’t work to bring Fogo´s experience to one´s home (you can´t bring gauchos with their sticks to your home using *Delivery Hero* or *Spoon Rocket* after all. Also, Fogo will never be disrupted by the Amazons of the world.

On the contrary, there is convincing evidence that one thing millennials want to focus on is experiences, things that couldn't be bought on your smartphone. Which takes us to the next "risk".

Risk 2: The healthy dining trend may derail the company expansion

Life is full of contrasts. Interestingly we think this trend may even help Fogo surpass some indirect competitors.

As it is, people are indeed eating healthier foods on their day to day lives. This is a great thing, knowledge is power and consumers are making smarter choices.

But there is one interesting thing about Fogo: its business model rests not on heavy users - daily consumers that eat at one of its establishments every day, but on occasional goers, that are seeking an experience. This is why after all the company´s numbers are seasonal, and tend to grow on festive occasions.

Going to Fogo is an event and we think that once consumers want to indulge they will seek a over the top, premium experience like Fogo, instead of one of the many "casual dining" chains. Note that while Fogo patrons usually engage in a "one off" occasion, usually for birthday or business events, casual dining chains are more dependent on repeat customers.

Risk 3: Fogo´s Return on invested capital stands on a class of its own in the industry and could fall back to its competitors level

There are many small pieces that make a new Fogo restaurant more profitable than the average opening in the industry. Among them: lack of direct competitors, lower labor costs per customer than the industry average due to reasons we will further explain, higher margins than the industry average, superior procurement due to its standalone position in the industry and so on. However, we would like to further advance another point: the superior ROIC as it stands today only reflects the already opened restaurants in Brazil and the US.

Its new and promising Joint Venture with Middle Eastern partners, where Fogo will invest practically no capital, will yet start to bear fruits. If successful, this model could be replicated to other regions and elevate the company´s profitability to new levels.

We consider this one of the major free options the company´s stock currently holds.

Chart 7: Fogo’s Growth Plan

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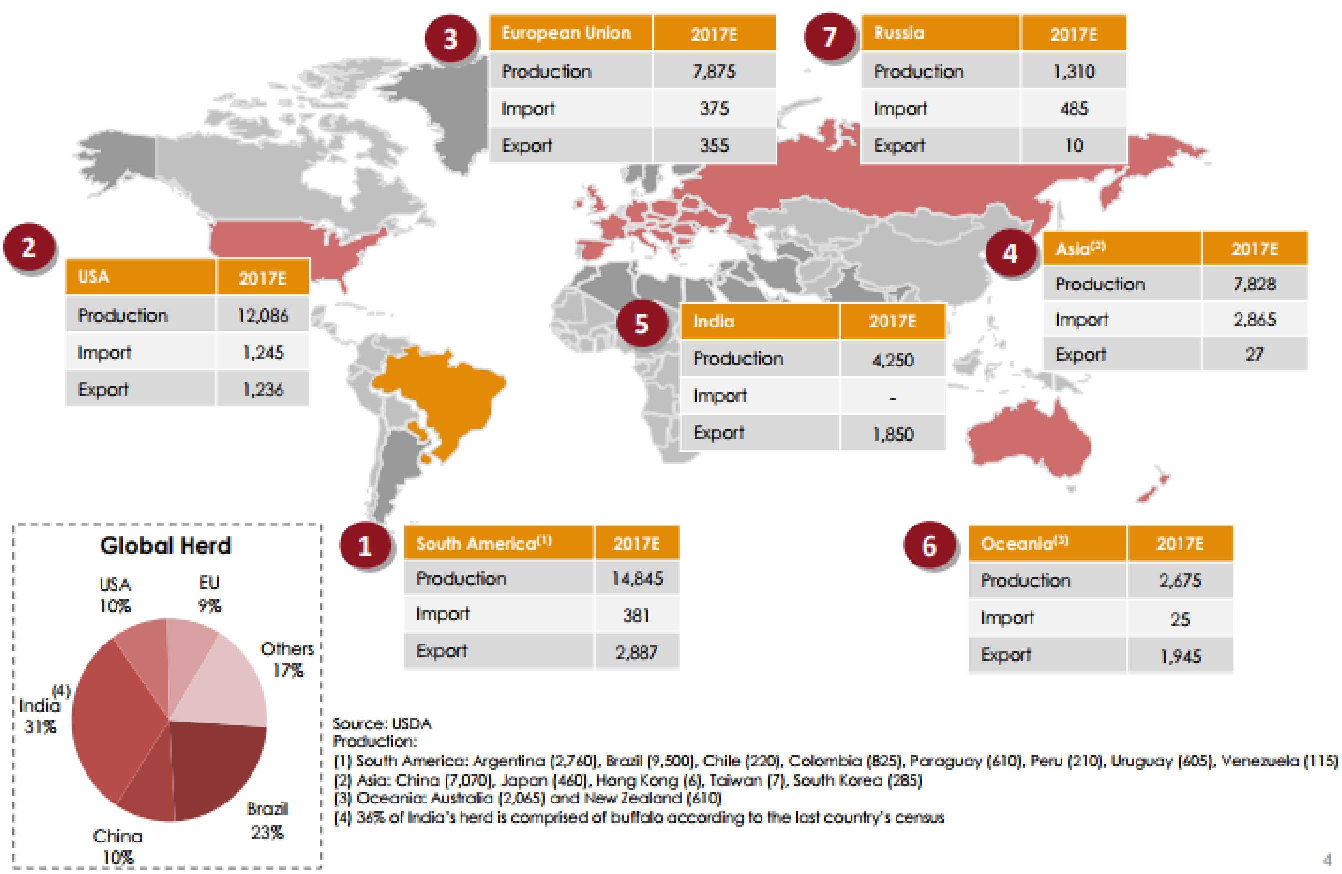
Risk 4: The company´s margins could suffer with an increase of meat costs.

There are advantages of being a bi-national company. Brazil is becoming, in fact, the biggest meat exporter in the world.

Chart 8: Global Beef Market



Source: USDA
Production:
(1) South America: Argentina (2,760), Brazil (9,500), Chile (220), Colombia (825), Paraguay (610), Peru (210), Uruguay (605), Venezuela (115)
(2) Asia: China (7,070), Japan (460), Hong Kong (6), Taiwan (7), South Korea (285)
(3) Oceania: Australia (2,065) and New Zealand (610)
(4) 36% of India's herd is comprised of buffalo according to the last country's census

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Being born in Brazil and still holding some key management positions in the country, our original intuition was that Fogo could have in place a Brazilian meat purchase process completely different from its American competitors.

After talking with a few channel checks our suspicions were confirmed. Basically, there are two ways a company could compete with Fogo:

- Opening an upscale steakhouse and using American meat, which has great quality but is way more expensive than Brazilian meat, leaving it at a cost disadvantage compared to Fogo while having the same level of quality.

- Using Brazilian meat but being further away in the chain of buyers and sellers. In other words, becoming an importer, instead of a company with a local foot on the ground, and without the same kind of relationships with Brazilian meatpackers, which will guarantee that Fogo has a cost advantage.

Risk 5: Labor costs are increasing in the US

- That´s a different surprise of the “rodizio” model: it is actually less labor intensive than virtually every other food retail chain. Since ‘’gaucho’’ servers will go from table to table and also help with some preparation in the kitchen, this model is less demanding in labor than even many fast food joints.

A nice exercise is to compare labor costs across the industry as a multiple of sales. Fogo de Chao is a positive outlier in this metric.

5. The future of Brazilian style barbecue

What is the future of “rodizio” style steakhouses? Could consumers as further away as Dubai, Texas, Shanghai and Paris someday be enjoying Brazilian steaks served to them in Fogo´s sticks?

It is a long shot at this moment for sure. But also an investment idea that seems incredible on a risk reward perspective: even if its ambitious plans don´t bear fruit we would then hold a company on the top quartile of its industry in terms of sales growth and margins and the bottom third of valuation multiples.

Fogo has many of the attributes that make a company unique: a brand that resonates with its customers, an experience seen as premium, a distinctive nature that puts its company on the rarefied field where it could claim it is on a “mission”, and also clear, reasonable growth prospects ahead served to our plate at a reasonable valuation and a very risk mitigated case.

Fogo is one of the companies that may be useful for really long term portfolios: it could slowly but surely fulfill its mission. It is the kind of company this house enjoys: while it will never top tables of high flying stocks, it can, Instead, become a king of compounding, delivering year after year record numbers.

Like one of Fogo´s chorizo steaks or spicy sausages, what’s not to like?

FCL Team

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