FCL*Capital*

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www.fclcapital.com

Illations

Since a few merchants started trading under a buttonwood tree in 1792, giving birth to the New York Stock Exchange, much has been learned about the investment world. Over time, a legion of investors and thinkers, from Benjamin Graham, John Templeton, Warren Buffett, Copeland, Damodaran, to George Soros, Henry Kravis, Jorge Paulo Lemann, and so many others, gave their contribution to the knowledge we have today.

More and more, the art of investing is becoming the science of investing. But there is still a long way to go. There is much more to learn than we have learned in these past centuries, and I am pretty certain that two fields will have special attention in the 21st century: behavioral investing and applied accounting.

They are wild frontiers: unlike, say, bond theory or equity valuation, they are new, fresh, and still in their infancy. And they bring new insights and takes. The first is a frequent topic of discussion in our monthly letters: it analyses the biases that human investors have when allocating capital. The second searches for hidden clues and signals (especially frauds) in financial reports. And, funnily enough, these two new fields help us explain to our investors two of our most recent investments: Log-In Logistica & Direcional Engenharia.

They also show, in our opinion, that most foreign investors only scratch the surface when it comes to the Brazilian stock market. When they look for a "hidden small cap", they end up buying a stock that is neither a small cap, nor hidden and also, doesn't have any value discount in it. But this is a story for another day. For now, we'll go back to the two "wild frontiers" of investing, and our two new positions in our portfolio

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Somewhere in the middle of 2007 I started to feel worried about the Brazilian stock market levels. The Ibovespa index had multiplied its value five times in the previous four years, and as everything that rises fast, it started to attract attention of retail investors. It became impossible to go to a gym, or a barber, or a bar in Brazil without overhearing how someone had "made a killing" on the stock market.

The talk was about when Eike Batista would surpass Carlos Slim as the world's richest man. A giant bull market does many crazy things. We had written extensively in those days about how expensive the market was and the subsequent crisis made we change our strategy for good, from a long only structure to the long biased form our "equities" fund now adopts, which offers our investors a new layer of protection in downturns.

One of the most impressive events of the 2006-2008 euphoria was the IPO fever. Basically, due to institutional appetite for Brazilian assets, many stocks showed significant appreciation in the first few days of trading.

[1] There are many good books about this amazing subject but we consider "Behavioural Investing" (2007) by James Montier to be the most useful.

[2] A fascinating use of applied accounting was the shorting of HP's stock by the australian hedge fund Bronte Capital. They knew Autonomy was a fraud because unlike most software companies, its balance sheet had a high level of receivables.

A group of “flippers”, specialized in booking a large order in the book building process only to unload it at a profit in the first day, quickly emerged. Many pre-operational ideas or semi-pre-operational ideas raised billions of dollars. We know today, a large part of them had very dubious quality, to say the very least.

This house, due to its natural inclination of seeking value, investing in solid ideas and searching for capital appreciation, has always had a deep reservation about paying upfront for an idea that could materialize and be very rewarding in the future. We may have let pass a few good opportunities thanks to this temperament, but we don’t regret this decision. And this may be the main reason why we have never invested in anything “ending with a letter X” in the Brazilian stock market. And few investment houses in this country can say the very least.

They also show, in our opinion, that most foreign investors only scratch the surface when it comes to the Brazilian stock market. When they look for a “hidden small cap”, they end up buying something like Natura, Renner or Anhanguera.

In short, a stock that is neither a small cap, nor hidden and also, doesn’t have any value discount in it. But this is a story for another day. For now, we’ll go back to the two “wild frontiers” of investing, and our two new positions in our portfolio.

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When the inventory of all the sins committed in the 2006-2008 financial euphoria was made, certainly in the pantheon of sinners, was the construction sector. When we took the time to research a few articles from that period in time (this old habit of checking what people said in the past) it became almost laughable how wrong most analysts’ projections were and how off the mark most company managements were.

In one interview, Tenda’s founder compared his company to Habib’s, the popular fast-food chain, and said that since Habib’s made possible for everyone to enjoy Arab food, why couldn’t Tenda do the same with real estate? A new world of perpetual growth and high margins was envisioned by many. A paper can never complain.

Rushed projections, false premises, crazy extrapolations ad infinitum, and one important account characteristic made everything worse: the accounting standards most constructors revenue is recorded using the percentage of completion methods (i.e. recording the revenue as the building is being built), became a perverse incentive.

Most managers, some in bad faith, some not, built a lot, in a hurried manner, and as investors saw quick growth, the stocks went up, making these same managers pocket millions of dollars in bonuses, tied to the stock price.

Now several of these companies are in a terrible financial situation due to this perverse incentive. As we said, some applied accounting could have worked wonders for investors. And we have to give credit to the few who raised the point that this could happen, as it did.

Construction has a long term cycle. When the budgets of many projects were proven to be very grossly understated, companies had to raise additional capital to conclude its projects. To make everything worse, real world problems like lack of labor, rise in the cost of materials, delays and defaults soon emerged. Investors had been fooled once again.

As Benjamin Graham once put perfectly, Mr. Market is a manic depressive. Sometimes he is on a roll, in too good a mood for his own interests. Sometimes, all is gloom. Being burned by the siren song of pre-operational stories, investors' natural reflex was to avoid at all costs everything that didn't yield, anything not tangible. Everywhere they could once again be fooled.

And so pre-operational companies all suffered. And one of the classic investors' biases, the tendency to believe in stories and package groups of sometime unrelated elements to make everything understandable took place.

12 month comparison: Log-in Logística vs HRT vs OGX vs LLX – Source: Bloomberg

Log-In Logística is a cargo handling company. Due to a relatively unknown government incentive program, the money used to build cargo ships in Brazil can be reimbursed to the company, utilizing the so called "AFRMM". If this sounds too good to be true, it is. The company can finance its CAPEX at essentially zero cost.

And there's more: the shipbuilding company in charge of Log-In Ships, essentially the only one able to deliver this kind of order, is in full capacity due to the company's orders. Recently the company's main competitor had to import two ships instead of building them in Brazil and utilizing the same program due to this fact.

Log-In Logística – Ship Investments

Year	# of Ships	TEUS*
Acquired in 2008	2	1.700
Acquired in 2011	2	2.800
Under construction – Ready in 4Q13, 2Q14 & 4T14	3	2.800

*- *Twenty-feet Equivalent Units* – Ship cargo measure

Instead of promises made during the euphoria years, Log-In is already in business (although with rented ships and therefore lower margins) and has a feasible plan. It is not trying to sell a story to make somebody rich in a IPO: Vale is the biggest shareholder and even if the CAPEX plan doesn't go though, the company won't be terribly expensive.

With the plan going through, we think the company is ridiculously cheap. But unlike the other Brazilian pre-operational cases, this is not a fabricated company made up by some investment banker: it has real demand and a reasonable plan. But investors usually do stupid things when times are good and equally stupid things when in retreat.

Log-In Logística – Fleet Evolution

Year	# of Ships	Avg. Age of Ships	TEUS*
2007	2	12	1.700
2012	2	4	2.800
2015 (E)	3	3	2.800

*- *Twenty-feet Equivalent Units* – Ship cargo measure

Having said that "we shall not drink the water" of pre operational companies in Brazil, we had to swallow our words due to this extraordinary case: a leading company, in a strategic sector, being subsidized by the Brazilian government and in a high entry barrier environment.

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When our equity analyst Gustavo Prado first told me about a "remarkable construction company from Minas Gerais called Direcional" as a long idea for our fund I didn't want to hear any of it. Wasn't he aware of all the problems the sector was going through? Weren't we proud that we didn't do at FCL, unlike other houses, those foolish things? And weren't those same perverse incentives still in place? Why would this one be any different?

In many ways, in fact, Direcional was away from its peers. First, its timing for the IPO was a little late and it had to receive a private equity investment before going public. But there was a lot more indeed.

So much more, that we truly don't even consider Direcional a construction company in the traditional sense, anymore.

If we go back to the classic "Competitive Advantage" book by Michael Porter, we see that he believed in two ways for a company to surpass its competitors: a superior product or a lower cost of production. Due to an unbelievable method - relentless focus, industrial internal production of materials, no-third party labour, industrial scale construction, not entering in a project with less than a thousand units and so on -, they can in fact claim the title of one of the world's most innovative construction companies and they evidently pass the scale and the lower cost it brings to their customers.

Video - Direcional Method (Click to watch)

In the past few years, Direcional became the biggest player in the "Minha Casa Minha Vida" ("My Home, My Life") Faixa 1 segment, accounting for 4% of the whole project in Brazil. Many companies got burned trying to sell to this segment, and most are just giving up. Direcional, on the other hand, is firing up, and this sector is becoming each day more important for the firm than the traditional incorporation business.

So in our view, since there's very little demand risk (it is a governmental program) Direcional is almost becoming, in essence, a construction procurement company. That is, we are just not in the same sector, and therefore not governed by the same rules and thinking of companies like Rossi and Cyrela for better or worse. We are not even claiming that this is a good thing. But we do think investors are making a mistake packaging Direcional alongside these companies.,

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When Gustavo finally convinced me to take, for the first time, an honest look at Direcional, I was marveled. "This is a great company", I said. It was 3 PM and I didn't leave my table until almost 9 PM still trying to learn more about its model. We are still in learning mode, still wanting to learn more about its method, its construction sites, etc. and therefore our position is still very small.

But we can already say that Direcional is not only on a totally different business but its management in our eyes has a totally different credibility level than most of its peers. There is no "optimistic budgeting", inflated VGV and praying for default levels to stay in line. There's a service being offered (to the government) and therefore money in the end. With the additional fact that if they do the service in an ultra-innovative, cheap and efficient way, their margin will consistently be the best in the class, as in fact is the case.

Direcional: Evolução da Receita e Lucro Líquido – Fonte: Financial Times

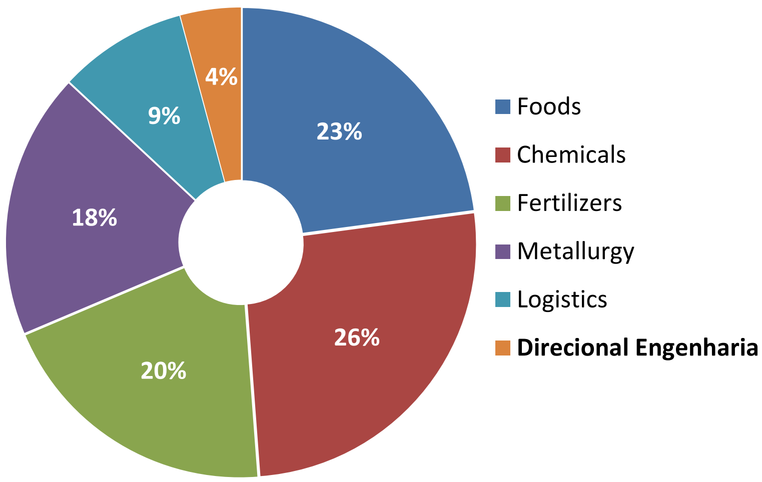
If someone told me a year ago that today we would be invested in a semi-pre-operational company and in a real estate business, I would have certainly laughed.

As it happens, this house and especially this manager is as prone to the mistakes exposed by behavioral investing and by applied accounting than many others. But over the past year we have certainly grown as investors in opening our minds to new possibilities, without letting the guard down for one second in our obsession for risk control and limited downside.

We like to call these two companies the "2013 vintage" of FCL's investments. We have deep expectations this vintage will grow to be one of our fund's most valuables over time.

FCL Equities Composition	
Long	103,91%
Short	(4,70%)
Cash	(2,28%)
Net Long	**96,93%**

FCL Equities - Setorial Exposition



About FCL Capital

FCL Capital is an independent investment company, focused on portfolio management, free from conflicts of interest and multiple objectives that has for a mission the preservation and multiplication of its investors' capital, through a thorough financial analysis. Our goal is to generate absolute returns, staying solid and consistent through good and bad periods of the economic cycle.

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