FCL*Capital*

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The commodities trail

It is a familiar sight anywhere in the developing world: name any city...Rio, Johannesburg, Moscow, Cairo…or even somewhere in the beaten down parts of New York City and London if you are in ''luck: you stop your car on a red traffic light..only to realize that the semaphore was stolen.Where did it go? And why would anyone, a vandal certainly, steal something like this?

The answer is at the heart of this amazing being, this giant living organism that is the global economy.

Traffic lights are made of metals, usually copper and zinc, that are vital components of international trade, international derivative transactions and financial settling that occur daily in global stock exchanges.

Obviously thieves don´t usually picture commodities exchanges when they are stealing traffic lights. They just know a guy in their local communities that will pay them a price for each kilo or pound of copper or zinc they can get. So there they go, in the middle of the night to steal the lights.

It is no surprise that the price this random guy pays (and consequently, the average global level of metal stealing) fluctuates globally in perfect synchrony with global metallic commodity prices[1].

So what does this second guy, let´s call him the Receptor, do? Well, usually he also knows a guy. This Third Guy has a larger warehouse. Possibly he employs someone to break or melt the metal.In fact, it is

[1] https://en.wikipedia.org/wiki/Metal_theft

probably fair to call him a businessmen. His warehouse is probably quite large and it is likely that he has some connections in the customs department or the shipping industry, depending on the country.

Once he buys stolen metal from several ''receptors'' scattered around in his city, he will have enough to fill a container. People like him usually run quite smoothy operations. Then a fourth guy appears, let´s call him the Customs Guy. Obviously he, like everyone else, will also get his cut. And then the fitfh guy, lets call him the Sailman, because he will transport the stuff, will also get his.

Well, let´s pretend we are a fly, or to be modern, an invisible drone? Where this ship full of stolen copper from traffic lights will go?

Most roads in the current global economy lead to china. And over there there will be a Sixth Guy, the 'Custom Receptor'' that will buy the goods and sell to a Seventh Guy, the Trader, who will sell to the final owner: someone that needed this metal, to make some basic product (and China makes more metal based products than any other nation so there is demand for that) or, as is common over there, simply to store the metal, since that are not many attractive financial opportunities to store wealth in china and interest rates are low.

What does this commodities trail says about the world? For one thing, that everything is interconnected: certainly a traffic light thief in Rio or South Africa would never dream that his stolen possession would end up in China but very possibly this is exactly what happens.

Also, in our view, that despite their bad reputation, understanding commodities, and companies that produce commodities is an essential part for any serious analysis of a modern global stock investor

Since our three largest holdings Braskem, Minerva and Fibria are to some extent, commodities companies, we dedicate this letter to them.

Let´s deal with the easy criticism first: commodities companies get no love from investors (except when commodities prices are very high).How can we, long term value investors have such a significant part of our portfolio tied to commodity related companies?

First, the operational destiny of these three companies is not really correlated, in fact it is even inversely related for reasons we will explain soon.

Second, we disagree with part of the criticism that long term value investors have for commodity companies: yes, all things constant a commodity company should trade at lower valuations because its future earnings visibility is much smaller than, say, a global retail operation.

That being said, every company faces some degree of uncertainty. Every uncertainty should be discounted. ''Will the pulp price fall?' is one component of Fibria´s value as much as ''Have iphone sales peaked?'' is one component of Apple´s value.

There is always uncertainty in this probabilistic activity called investing and what we do as long term investors in any company is to build models, assumptions, probability matrixes and to average this scenarios having in mind long term trends and historical patterns.

Obviously a lot of hard work is required: to understand if a particular commodity is above or bellow its average historical norm, we should study the commodity, we should average and estimate.Not that different from analyzing a retail or tech company.

Granted, to remain in Apple's example, it is obvious its earnings volatility should be smaller than commodity producer's in most cases.But that´s why valuations discount exist.

The fact is that this house thinks it understands these three businesses, their prospects well enough and we think their valuations make them attractive holdings at the time of this writing.

Chart: Bloomberg Cmmodities Index, vs Metals Subindex, vs Agriculture Subindex, last 3 years

Above all we think commodity companies should be understood.That´s after all is the mission of a business analyst: understanding the underlying business.And we do think that after analyzing thousands of companies that some commodity companies offer more predictability when it comes to earnings and margins than many, if not most, non commodity companies.

But as most investing themes, commodity companies were in vogue when commodity prices were skyrocketing back in 2007 and now trade at depressed valuations on the back of depressed commodity prices, when maybe things should work in reverse.

Braskem

First and foremost, it is always an important reminder:, there are many factors that affect Braskem´s long term operating margins from the quality of its management team execution to the attractiveness of its portfolio of projects, from its choice if which resins to supply to the innovations being created at its labs[2].

That being said, it is a fact that a few commodity prices that tick on our bloomberg terminals every morning are crucial when judging the financial situation of the company:

First, to calculate Braskem´s spread we should calculate the difference between the prices of the resins it produces, like Polipropylene and Polietylene and the price of the imput it uses to make these resins, like Naphtha and, to a lesser extent , Natural Gas

Spread: Polyetylene spot price vs Naphtha, last 3 years

Finally, we should also pay attention to the so called Oil and Gas Ratio or how much Natural Gas a barrel of Oil would theoretically buy.And the reason is that since most of Braskem´s competition in the Americas use

[2] Braskem is the only brazilian company to consistenty appear on Fast Company´s list of 100 most innovative companies

Natural Gas to produce these same resins if this ratio would increase too much , Braskem's competitors could theoretically produce the same products cheaper than the company, stealing market share

So far things are looking great for Braskem.Petrochemical margins are having a very healthy time and the Oil to Gas ratio is the lowest it has been for the past few years

Oil to Natural Gas Ratio, last 5 years

Minerva:

Minerva buys cattle   from ranchers across south america to process them and sell them to small food operations, like restaurants and bars in Brazil and , especially, to clients abroad

Therefore, three indicators are quite telling when we want to monitor Minerva´s margins.

The first two are quite obvious: cattle prices should be as low as possible, since they are the most important cost the company incurs.But contrary to market´s concerns, exchange rates when looking at cattle prices are also drastically important since the US dollar is responsible for 70% of the company´s sales directly or indirectly.Therefore Cattle prices is U$ are a better predictor of margins for Minerva then the price of cattle in Brazilian Real.

A dream scenario would be a combination of low cattle prices and a very high Dollar to Brazilian real Real exchange rate.

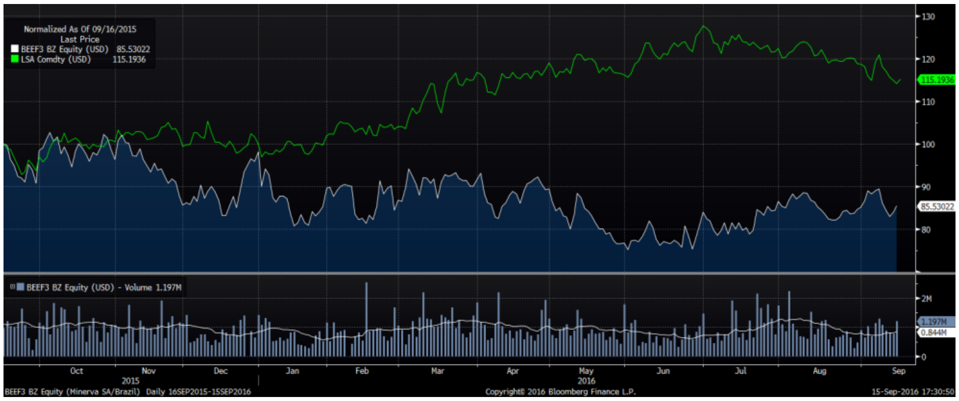
Finally and not so intuitively, oil prices also affect Minerva and contrary to Braskem, the higher the barrel of oil the better are the company´s prospects.

Why is that so? Because since we are talking about an exporting company, it is important to note that among the company´s top 10 customers, no less than three-Russia, Venezuela and Egypt- are prominent oil exporters and their economies depend to a higher or lesser degree on the price of oil.

Historically, since oil exporting countries are such an important part of the Cattle International trade as importers, high oil prices mean good sales for brazilian meatpackers abroad.

An important point for portfolio perspectives: investors tend to put commodity producers in the same basket but we feel very reassured noting that our two largest holdings have different results when it comes to the price of oil-Braskem benefits from a lower price while Minerva prefers a higher one. A very useful hedge.

This and many other nuances-so crucial for risk control- are frequently lost to unseasoned investors not used to observe commodity producers more carefully.



Minerva share prices(blue) vs Cattle prices (green) in US Dollars, Past 12 months

Fibria

Finally, being the largest and lowest cost pulp producer in the world, it is obvious Fibria benefits from basically two main inputs: pulp international prices (the higher the better) and the Brazilian Real to US Dollar exchange rate (since the company´s costs are mainly in real and its revenues in dollar)

At first blush, it is a fairly straighforward company to model.

But there are important strategic considerations: being the lowest cost producer means being able to operate at prices that no other company can match- a luxury most commodity producers like non chinese steelmakers certainly dont have.

One only need to compare Fibria’s margins with other producers: pulp prices going from high to low change Fibria´s fortunes from amazing to good while changes its competitor´s from fair to dreadful.

Pulp price (blue) , Fibria Ebitda margins (orange) & Stora Enso ebitda margins (green), past 12 months

To summarize, commodities are the blood running though the veins of the global economy. From coppear thieves to chinese pulp buyers everyone has a stake in the game.

We are confident about the long term prospects of these three important holdings in our portfolio and wil update our investors from time to time about future developments for them.

To overlook companies like these only because they produce basic commodities would be to stand back from this house´s main motto which is to search for the overlooked corners of finance.

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**.

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