FCL *Capital*

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An update on the Brazilian premium and discount story

Everybody knows the current state of the Brazilian markets. We have a government that is not only bizarrely incompetent and ideologically committed to destroying every possible good business opportunity that still exists in the country, but also one that is chronically corrupt.

On top of that, international investors no longer give the Brazilian market the benefit of doubt. Back in the sweet days of 2007, for a short period, the Brazilian market traded at a premium to its developed peers. For the first time ever, some multinationals rushed to list their subsidiaries in the local market. It made sense, since they would get higher valuations here than at their home markets.

Fast forward to the present. Brazilian companies are now trading at huge discounts. While we do not think this new reality is unfair, it certainly brings some opportunities since a few genuinely good Brazilian companies trade at discounted prices not because of their quality, but because of where they are from.

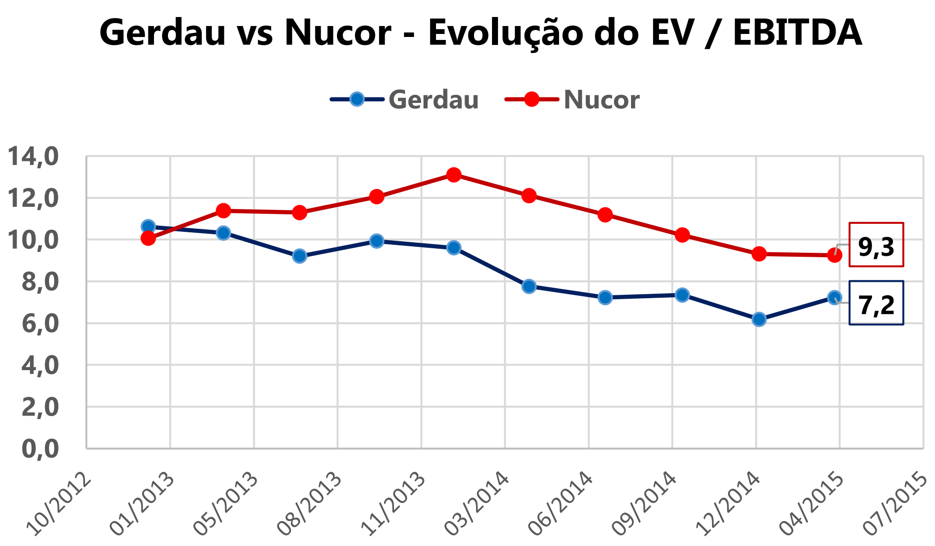
Therefore, in this context, a double mission presents itself to our team: while searching for good investments opportunities abroad - we live in increasingly global times and global markets and there is no turning back on this concept for us - we also look for specific investment opportunities created by the huge discount that Brazil is receiving right now.

Brazilian Companies vs International Peers, Estimated EV/EBITDA in 2015		
Industry	**Brazilian Company**	**International Peer**
Beauty Products	Natura – 8,74	Estée Lauder – 16,72
Building Materials	Duratex – 6,73	Sherwin Williams – 18,99
Car Rental	Localiza – 7,55	Hertz – 17,74
Retail Stores	Pão de Açúcar – 4,93	Carrefour – 6,54

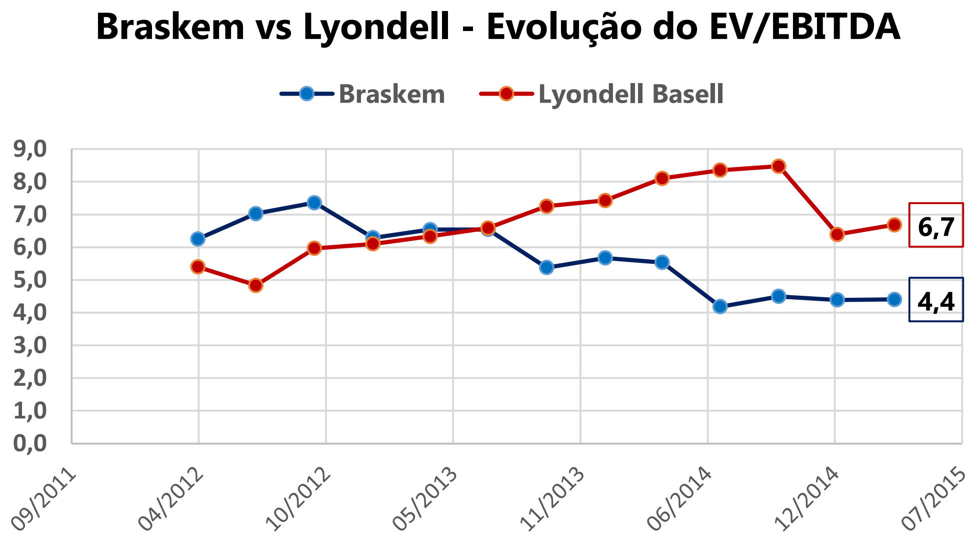
Source: Bloomberg

Last year we dedicated one of our letters to explore the difference in valuation between some Brazilian companies and their developed world counterparts. Our first example was the Brazilian steelmaker Gerdau against Nucor, a long steel company from the U.S. that is actually Gerdau's main competitor in that market.

The steel sector is certainly facing many challenges and this alone could be a theme for another letter. In every reasonable way except the country where the companies are from, Gerdau is a better company than Nucor - it has higher margins, better growth prospects, a better product mix and more diversification. However, Gerdau's historical premium to Nucor has turned into a huge discount in the past couple of years.



Next, we discussed Braskem and Lyondell Basell, an American basic chemicals company



While we could add a lot to these two examples, we would like to dedicate this letter to do a sum of the parts exercise in BTG Pactual, another of our holdings.

We have always been fascinated by Deep Value, a somewhat obscure corner of value investing that is dedicated to finding the true value inside companies with almost complete disregard to how they will trade in the future.

It is a giant calculation of the sum of the parts that make a business, and that is, in the end, how much a business should be worth.

Borrowing a chart from BTG's latest annual report:

Combined Adjusted Revenues (unaudited) *(in R$ million, unless otherwise stated)*	Year to Date 2013	Year to Date 2014	2014 % change to 2013
Investment Banking	459	456	-1%
Corporate Lending	767	692	-10%
Sales and Trading	1,729	2,833	64%
Asset Management	1,172	1,378	18%
Wealth Management	385	393	2%
Principal Investments	620	(485)	n.a.
Banco Pan	(124)	(80)	n.a.
Interest and Other	904	1,550	71%
Total revenues	**5,914**	**6,737**	**14%**

Now, let us go deep value and do some math, while trying to access what the business is really worth. First, we need to find the most adequate comparison possible with each division inside the company.

For the Investment banking, corporate lending and Sales & Trading divisions, that together certainly constitute the heart of an investment banking operation, we selected Goldman Sachs as an adequate comparison.

Next, we multiplied these three divisions earnings inside BTG by the same multiple that Goldman's stock traded compared to the company's own earnings. Certainly we are simplifying things and Goldman Sachs does a few things outside these three areas, but let us try to keep things simple. It is better to be approximately correct than precisely wrong after all

Next, we compared the asset management division inside BTG with Blackstone. We do think this is an adequate comparison because BTG's asset management arm has important private equity and real estate arms, being similar in composition to Blackstone's.

Next, wealth management. It seems BTG is capturing the fortunes of many Latin American clients the way Credit Suisse and UBS did on a global scale; which is why we selected Credit Suisse as our comparison.

Finally, principal investments. It is important to note that like any principal investment arm, BTG can and will have negative years. There is no better comparison to this than our beloved Berkshire Hathaway. While Warren Buffett will never be matched, he has certainly advised his investors to expect, from time to time, down years.

So to adjust for this, we took the division's revenue from 2013.It is certainly a conservative estimate, since the recent D'or deal will potentially generate billions in revenues for the company. But let's be conservative.

Finally, interest - It is certain that 2014 was a banner year in this division, since interest rates are notoriously so high in Brazil right now. To adjust for the cycle, we took the revenues from the last two years and divided by two.

Once again, simple but effective. Unlike the other areas, Brazil is a very particular market when it comes to financial margin interest. Brazilian banking operations are notoriously up in the profitability global rankings so we decided that the best possible comparison to this area was Itaú.

BTG Peer Analysis, per area in 2014				
Segment	**Peer**	**BTG Revenue (R$ MM)**	**Peer Multiple**	**BTG Division Value (R$ MM)**
Investment Banking	Goldman Sachs	456	11,32	5.156
Corporate Lending	Goldman Sachs	692	11,32	7.833
Sales And Trading	Goldman Sachs	2.833	11,32	32.069

Asset Management	Blackstone	1.378	9,31	12.829
Wealth Management	Credit Suisse	393	12,02	4.723
Principal Investments	Berkshire Hathaway	620	20,0	12.400
Interest	Itaú	1.227	8,47	10.392

Next, we would have a pre-tax, pre-expenses earnings measure:

(456 x 11.32) (692 x 11.32) + (2833 x 11.32) + 1378 x 9.31) + 393 x 12.02 + 620 x 20.0) + (1227 x 8.47) = 5156 + 7833 + 32069 + 12829 + 4723 + 12400 + 10392 = **85402**

Then, we would have to subtract personal and administrative expenses. Many assumptions would necessarily go into this calculation.

Combined Adjusted Operating Expenses (unaudited)	Year to Date		2014 % change to
(in R$ million, unless otherwise stated)	2013	2014	2013
Bonus	(947)	(845)	-11%
Salaries and benefits	(494)	(695)	41%
Administrative and other	(648)	(904)	39%
Goodwill amortization	(192)	(161)	-16%
Tax charges, other than income tax	(267)	(155)	-42%
Total operating expenses	**(2,548)**	**(2,759)**	**8%**
Cost to income ratio	43%	41%	-5%
Compensation ratio	24%	23%	-6%
Total number of employees	2,715	3,277	21%
Partners and associate partners	181	203	12%
Employees	2,403	2,899	21%
Other	131	175	34%

Since we are allowing for a profit in the principal investments area while only mildly subtracting the profits in the interest area, it is reasonable to assume bonus expense would be higher and tax expense would be lower, since the principals' area operates through holding companies in low tax jurisdictions.

Still, just to be conservative, let us suppose personal and administrative expenses would be 10% higher than they were in 2014 and the effective tax rate would be the same.

Then, we would have: R$ 85.402 - (1.1 x 2759) - (1- 0.142[1]) = R$ **70.671**

This would mean a market value of almost three times the company's current capitalization in the Brazilian stock exchange or, a target price of $ 78.09 per share against the price of roughly R$ 29 per share the company is currently trading.

Of course, we could be a bit more conservative and put a discount to the company's multiples. The company is located in Brazil after all. However, we do not think this huge discount is justified, especially considering that an increasing part of the company's revenues comes from abroad. Obviously, while it is true that this very simple exercise certainly does not exhaust our thesis in BTG, it also shows that no matter how bad things are for Brazil right now, no matter how mismanaged the Brazilian economy is, there are certainly many hidden gems out there.

Many companies as this one are right now paying an extra price just because they happen to be Brazilian and investors are scared, but once the dust settles a bit they will likely deliver substantial investment returns to the investors who were able to remain calm amid the panic.

[1] In 2014, the effective tax rate faced by the company was 14.2%