# FCL *Capital*

**April | 2014**

**BTG: A deep value case**

A third of the year has passed so far and our portfolio continues to perform badly. The market seems to have reached the temporary consensus that what is perceived as having no correlation to Brazil's economic growth is good (i.e. companies like BB Seguridade, Itaú and Natura). Those companies are performing very well and no valuation seems excessive, while for stocks seen as dependent on Brazil's growth (i.e. industrial companies in general), no price seems to be low enough.

We have seen many fads before and this one shall pass too.

Strangely, one of our most polemic, criticized and disagreed with positions last year (in a polemic portfolio overall) is among the top performers of the year, up there with the above-mentioned stocks.

BTG Pactual is not a much understood thesis by many of our investors and this is possibly our fault since in our letter about BTG a year ago, we took a lot of time to explain the general history and background of the company without digging further into the thesis. We will use this one to focus on the reasoning behind our investment.

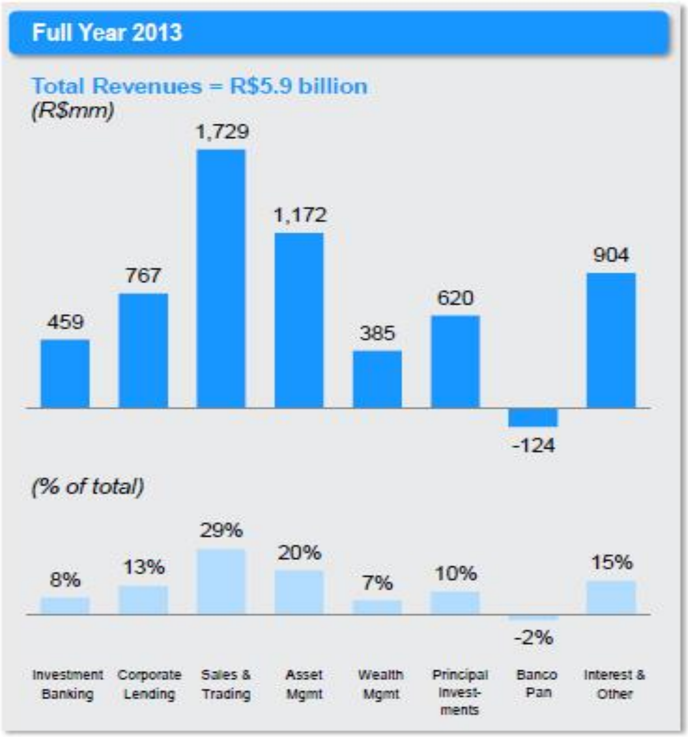
Starting from the beginning:

| BTG Pactual (BBTG11) - Overview (BRL Millions) | |
|---|---|
| Market Cap (30/04/2014) | **27,538** |
| Book Value | **16,090** |
| Earnings (Trailing 12M) | **2,882** |
| Earnings Estimate (Forward 12M) | **3,639** |

*Source: Bloomberg.*

First, BTG Pactual is for us a classic deep value case[1]. In our opinion, the market is not making a proper calculation of the sum of the parts of this business. So in this past year our team has done a lot of work to rearrange and recalculate BTG's divisions' future earnings and even being much more pessimistic than the market, we found significant upside.

Looking up the bank's results, its 2013 revenues are distributed this way:




As it frequently happens amongst our holdings, BTG is a long maturation idea. We didn't know that it would become a "respectable" thesis in 2014 and were prepared to wait longer if it was needed. So far, we haven't sold a single share and still believe that the company's stocks are significantly undervalued. Above all, BTG is a company surrounded by several myths:

[1] Deep Value is a subdivision of the value investment philosophy, where the investor attempts to evaluate the companies' assets and franchises, sometimes even in a liquidation scenario, and then buy the ones trading well below liquidation value, even if they are disliked by the market.

**Myth 1: It is not a value investment idea**

| Bank Multiple Comparison, 2013 | | | |
|---|---|---|---|
| | P/E | ROE | Price to Book |
| BTG | 5.64 | 18.35 | 1.53 |
| Barclays | 7.35 | 4.13 | 0.82 |
| Goldman | 11.06 | 18.13 | 1.16 |
| Nomura | 12.43 | 10.07 | 1.20 |

Fact: BTG is cheaper than any other investment bank on a P/E or book value basis, while its earnings are growing faster, in more promising markets.

**Myth 2: Its earnings are too volatile**

| BTG Pactual – Performance In The Past 4 Years | | | | |
|---|---|---|---|---|
| | 2010 | 2011 | 2012 | 2013 |
| Earnings | 1,127 | 1,922 | 3,255 | 2,775 |
| Annualized ROAE | 27.5% | 24.2% | 28.7% | 18.4% |
| Book Value | 7,346 | 8,540 | 14,145 | 16,091 |

Fact: BTG Pactual's earnings are higher and more stable than the earnings of its competitors, due to a stronger competitive position in the Latin American markets. Those markets suffer from less intense competition than developed ones in the investment banking arena, and with significant barriers to entry.

**Myth 3: BTG's earnings are too dependent of the banks' proprietary trading desk**

To address this myth there are 2 possible different paths we could take:

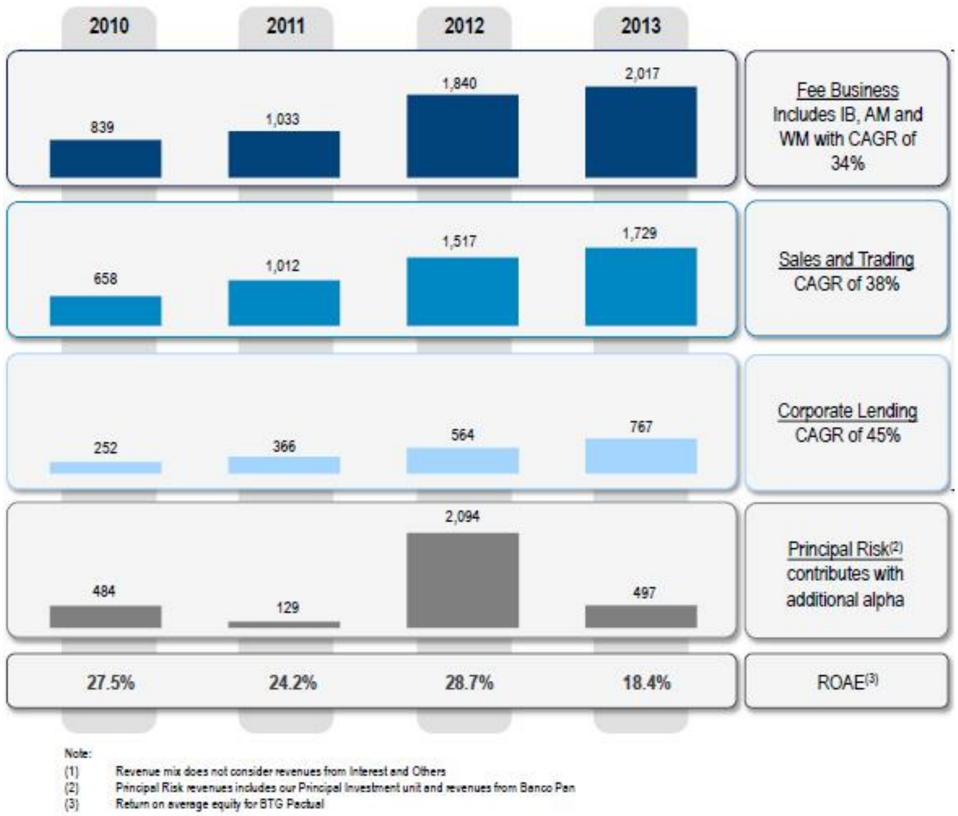
1) An asset value based approach – Here we consider the long-term holdings of the proprietary investment side, on a book value basis, while assuming the more liquid and volatile trading desks will produce no result in the future;

It is very hard to make a proper calculation, since the bank does not disclose the book value of every holding in their proprietary desk. Our suspicion is that if we compare the traded companies where BTG is the major shareholder, like Brazil Pharma and BR Properties, doing a sum of the parts calculation, we would conclude that the proprietary desk suffers an important "holding discount", i.e. is valued by the market much less than the sum of the parts which it owns.

2) A zero value approach - Since we cannot calculate properly the exact value of BTG's proprietary holdings, it would be conservative to estimate this arm will produce zero value in the future. This is what BTG's financial results would look like:

| BTG Pactual, 2013 | |
|---|---|
| Market Cap (30/04/2014) | **27,538** |
| Earnings (excluding Principal Investments) | 2,882 - 620 + 314 = **2,576*** |
| Price / Earnings (excluding Principal Investments) | **10.95** |

**Since the Principal Investments division was responsible for 10% of the banks revenues, we estimated that it was also responsible for 10% of its expenses. 'Earnings excluding principal investments' was a metric we used for comparison and analysis, with the only purpose of having an idea of BTG's earnings power without its principal investments division. The bank releases no such information. It is an estimate and therefore certainly not totally correct.*

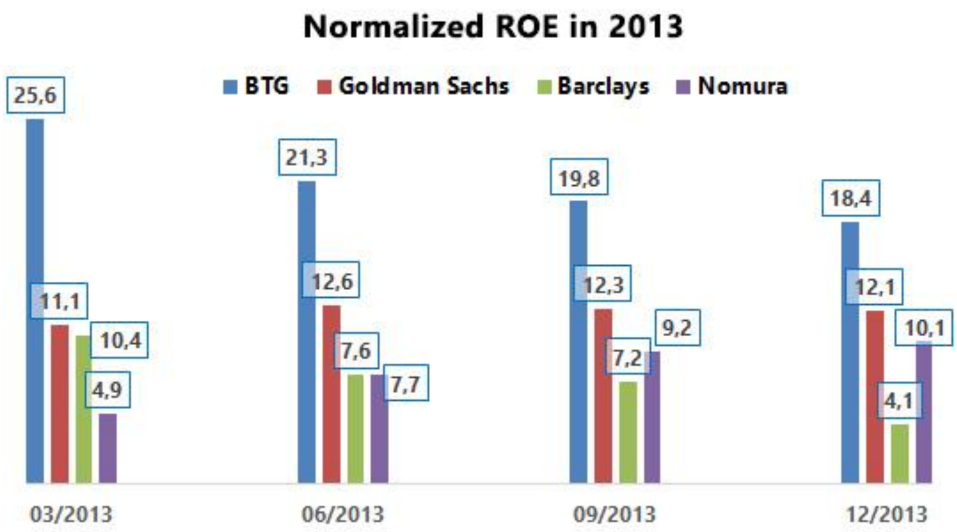



Fact: Even attributing zero value for the proprietary investments division, which is supposedly more volatile, BTG is cheaper and offers better returns than its global competitors.

**Myth 4: BTG deserves a low multiple because of capital market's activity in Brazil, which is still its main market, is really slow**

Stocks as we all know, behave differently than any other possession a person might have: if the price of, say, coffee or corn goes up, we will buy less of it. And we should do the same with stocks, but people often get carried away and decide to sell after the price goes down and to buy after the price goes up. No wonder the average investor, who cannot stomach the cycles in the stock market, does terribly, but even professional analysts are not immune.

For financial theory to make any sense, a somewhat cyclical company like BTG should trade at lower multiples at the peak of stock market activity - adjusting for the fact that the good times will not last forever and therefore the exceptional results shouldn't be seen as eternal. On the other hand, during times of slow activity the company's price to book value and P/E ratio should be higher (to reflect the fact that earnings are below their potential). Still, the contrary seems to be happening:

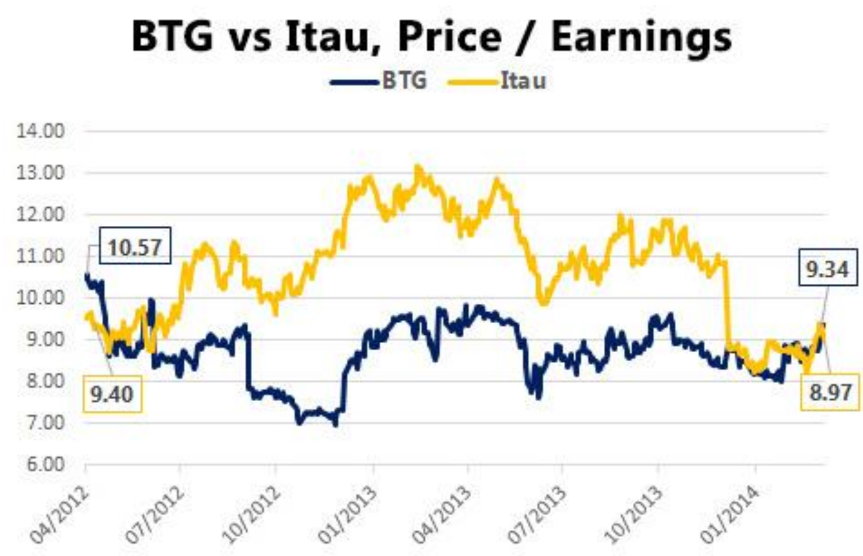

As we all know, the past few years were marked by a deceleration in Brazil's economic growth and especially, in Brazilian capital market activity. We see the effects of this fact exactly the opposite way as the market does. For us, it is the validation we were waiting for on this thesis.

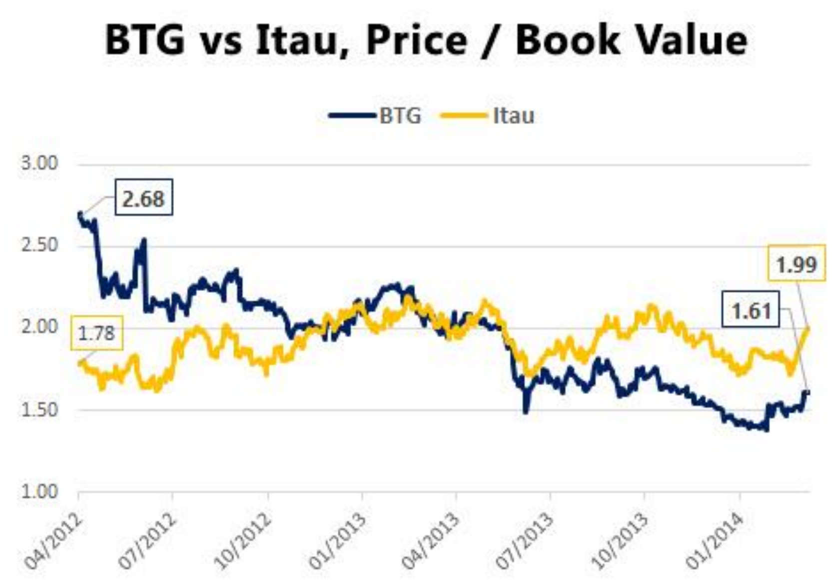
Even facing terribly slow markets, BTG has maintained its ROE close to the amazing 20% level, which its developed market's peers can only dream of. Simple logic would tell us that when Brazilian capital market's activity heats up, its ROE should go up, not down.

We should normalize the bank's earnings cycle and therefore attribute higher multiples in years of slow market activity like 2013.

**Myth 5: Itaú is a better investment idea at this moment than BTG**

Obviously, BTG Pactual an Itaú only share the fact that they are from the Brazilian financial sector, but they are very different companies. That said, there is clearly a premium to Itaú on a price earnings or price to book value basis.



First of all, it is obviously a very difficult comparison, but it is very hard to argue that Itaú's future earnings growth will be higher than BTG, given that:

a) Itaú is enjoying ROE of more than 20%, at its full potential, being a much larger company and the largest Brazilian private bank, while BTG is having almost the same level of profitability facing anemic capital markets' activity. It is almost unreasonable to think that in a normalized, long-term cycle, Itaú, being such a gigantic company, will be able to maintain higher levels of profitability than BTG;

b) BTG is proportionally a more internationalized company (as a percentage of its sales) than Itaú and it is located in markets like Chile and Peru, that will likely offer higher future earnings' growth than Brazil;

c) Brazilian average level of spread continues to go down over the long term;

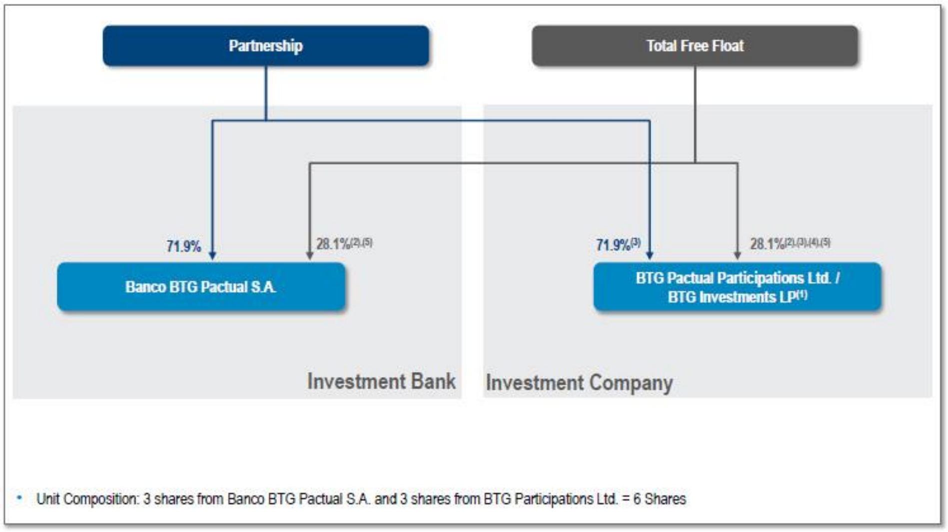
d) Latin America's capital markets are still very underdeveloped, but growing fast when judged on a long-term perspective;

e) BTG has a free option: it may someday be a truly international investment bank, competing shoulder to shoulder with the likes of Goldman Sachs. Itaú could never dream of a similar scenario.

All the above mentioned reasons lead us to think that BTG, offering the higher future earnings growth, should trade at a significant premium, not discount, to Itaú when it comes to multiples.

**Myth 6: BTG may have governance problems due to its complex shareholders structure**

At FCL, we give huge emphasis to the qualitative aspects of our work. It is in our blood to read the company's bylaws carefully and research about its partners and their motivations, its value chain, and so forth. Therefore, we do not think the eyebrows raised due to BTG tax structure are justified.




In fact, the structure not only makes sense, but is used by many similar companies. They use a tax free jurisdiction where a holding "investment company" is located and keep the parent company in the jurisdiction where the business takes place. We are comfortable with that. What we are not comfortable with are situations where we feel our interests might diverge from the interests of the company or its shareholders.

BB Seguridade, for example, a company that is widely seen as safe, has a problem we would be somewhat uncomfortable with: it has very significant commercial relationships with its major shareholder, Banco do Brasil. And as the Multiplus/TAM debacle showed, when we have major shareholders that are not doing so well and an open subsidiary that is thriving, temptation is really strong to change the terms of the agreement between the parts so the controller can get better terms of the relationship.

We are not saying it will certainly happen (probably won't in the next few years, since the company just went public last year), but this is certainly a fact that justifies a discount.

**Myth 7: BTG faces an uncertain future**

As our last year's letter on BTG has shown, an investment bank franchise, its talented people, its pool of knowledge, relationships and capital is something really hard to replicate. Many investment banks tried to enter Latin America and reach a significant scale, but failed.

Surely others will keep trying. It is a complex and unique region, full of idiosyncrasies and local factors.

BTG has leadership positions in several Latin markets, a strong brand and in our opinion, a brilliant future ahead. We feel that the future of BTG in say, 10 or 20 years down the road is in many ways safer and more certain than many of the leading giant Brazilian banks, which will face several important tests like changing regulations, declining spreads and increase in competition. BTG is our only bet in Latin America's financial sector and so far this year, our best performing position.