

# FCL*Capital*



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MONTHLY  
**LETTER**

# A region in need of education

Estácio, the context of the position...

Value investing, being the tough and extraordinarily interesting activity it is, has countless interesting plots.

One of them being the fact that often the one idea in your portfolio that makes you sick, prevents you from sleeping at night and even more importantly, that one idea that when asked about your portfolio when exchanging investment ideas, you wouldn't dare to tell even your best friend, even an admiring crowd, has this annoying habit of turning out to be your most profitable one.

For this house this cycle has happened at least once before: we bought Braskem right when it was mired in scandal: Lava Jato had just happened like an explosion and Braskem was right into the middle of it.

At the same time, we saw an incredible profitable and unbelievably cheap company. A problematic controlling shareholder that was getting the attention away from an amazing collection of factories and clients. In other words, a prodigy child from troubled parents. We built a sizable position in it at fire sale prices. That was not hard, since everyone was a seller. We felt very confident and prudent in our thesis. We just wouldn't discuss it with anyone for fear of being seen as careless. Back then it was the kind of idea that could almost damage the reputation of a prudent investment firm.

The result was one of the most profitable positions of this house so far. We bought most of our stake around R\$ 12 a share around 2014 and sold it around R\$ 55 in 2018.



Braskem Stock price, 2013-2018 , in BRL.



“ This letter will be about an idea that, just like Braskem, might make eyes roll and heads turn. ”

An unloved sector, dependent of a still nonexistent jobs recovery in Brazil and suffering from a recent change in regulations.

Most investors are focused in different ideas. Most investment banks would suggest their clients to look somewhere else.

At the same time, once again we see an incredibly cheap asset and a formidable company that will surely be a long term winner in Brazil in one of Latin America's most splendid market stories.

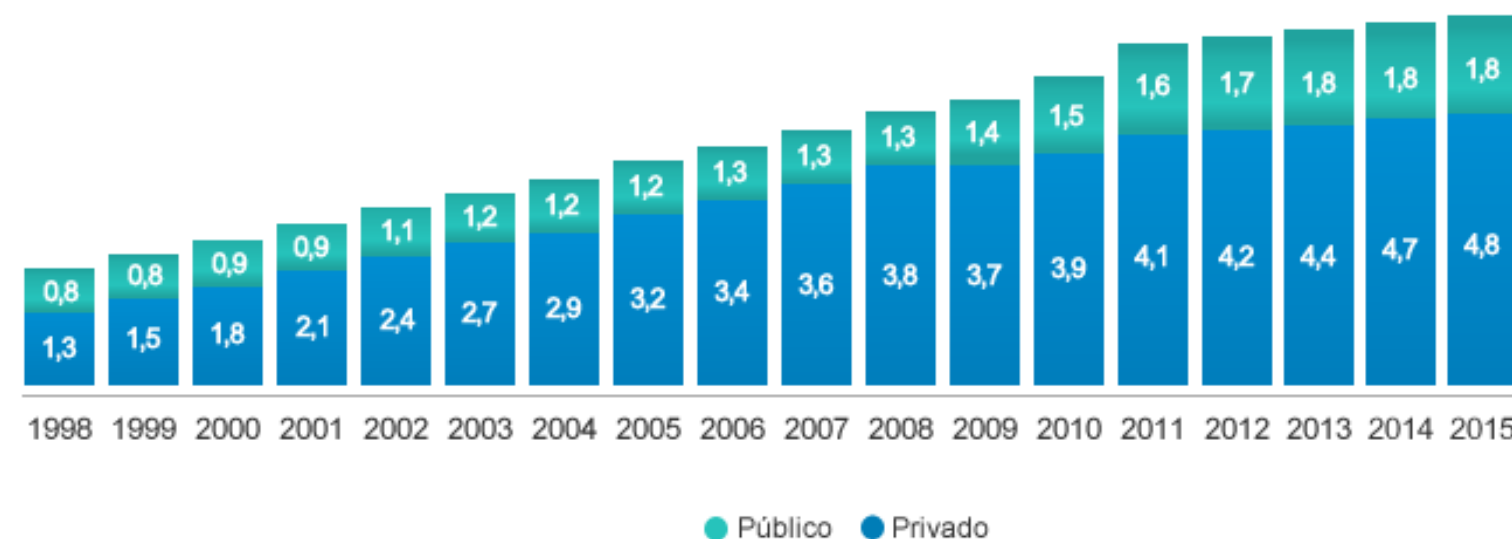
This is the context of our investment in Estácio, the Brazilian higher education company.

## History And background

Many things are still lacking for Latin America's lower and middle income classes, higher education certainly being one of them.

In Brazil, historically the state has tried to control the provision of third grade (University degree) and higher education but has failed miserably in doing so. In spite of a few elite public universities the expansion of population coupled with a (fortunately) higher share of Brazilians reaching middle school brought an explosion of demand for university diplomas.

Evolução no Número de Matrículas Presenciais no Ensino Superior (Milhões)



Fonte: MEC/INEP 2015

That demand could not be provided by the relatively few spots provided in public universities so reluctantly at first the state opened the door for private universities in Brazil.

That liberalization opened the way for a booming in access and provision of higher education in Brazil, being one of the fortunate stories of the Brazilian boom in the first decade of this century.

Groups like Estácio, based in Rio de Janeiro, Anhanguera, Kroton and Unip went from a questionable hybrid between foundation, Institute and Enterprise and became full-fledged companies, rapidly expanding in their markets, acquiring competitors and consolidating the sector. They would go on to become champions in a new and promising corner of the economy, helping some of their founders become dollar billionaires along the way.



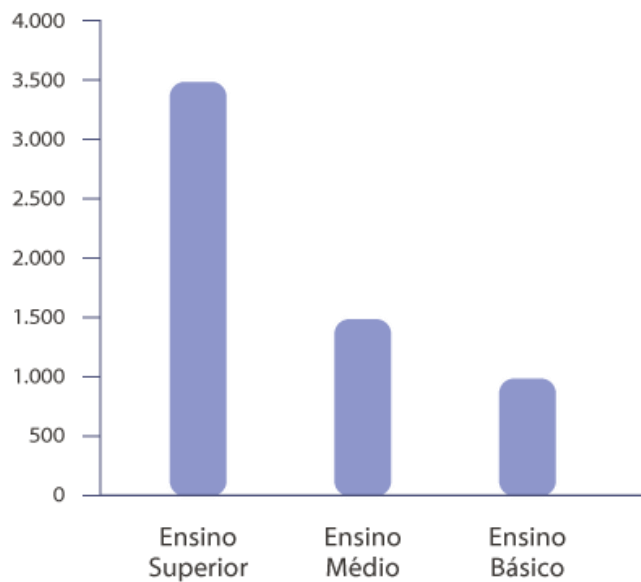
Overall, a fairly stereotypical picture of the students in the largest private educational groups in Brazil can be drawn. They tend to be:

- Middle income, ranging from class b to d
- Urban
- Young, aged 20 to 30
- Workers during the day (the vast majority of classes happen at night and especially with the recent deceleration of the FIES program, which will discuss in depth shortly, the students usually pay the fees out of pocket, usually with their own wages earned during the day. Keep this point in mind because it is the main point raised by the sell side and current bears in the sector).

# The Sector and competitors

Latin America in General and Brazil in particular, is still a region with a relatively low level of schooling. Brazil’s average years of education is a dismay 4.9, ranking the country 68th in total of 100 entries<sup>1</sup>. As in any asset, scarcity brings value: Brazilians that reach university command significant remuneration premiums.

Remuneração média por nível de escolaridade  
R\$/ mês, 2T16, 25-34 anos



Overall, the country has a relative excess of candidates and graduates in “liberal arts” activities, like Law, Communications and Marketing and a relative lack in Engineering and Medicine (but interestingly, not in dentistry).

The five largest private (including nonprofit) education companies in Brazil, ranked by 2017 revenues, are listed below:

Institution	2017 revenue (in billion BRL)
Kroton Educacional	5.555
Estácio Participações	3.379
Somos Educação	1.871
Ser Educacional	1.231
Fundação Getúlio Vargas	1.122

Over the past decade, the four largest private players (Kroton/Anhanguera, Estácio, Somos and Ser) acquired a number of smaller and regional players. They had everything going for themselves: expanding margins, almost unlimited untapped demand, growing affluence and disposable income and a generous government subsidy scheme, called FIES, that allowed poorer students to finance their fees. No wonder these companies commanded premium valuations on the Brazilian stock exchange.

Also, a new growth venue emerged in the past few years: the rise in online education. Kroton and Estacio in particular have taken the lead and have an increasing proportion of the provision of their services done virtually, with higher margins (albeit smaller total revenue) than in campus learning.

To sum it up, everything was going smoothly. Then things came crashing down in 2015-2017 as we shall see.

<sup>1</sup> <https://www.nationmaster.com/country-info/profiles/Brazil/Education>

# The Bear Case

**Anatomy of a country's downturn: (No longer) Employees during the day, (no longer) students at night**

When thinking about the troubles of the education sector in Brazil, the demons that keep bulls awake at night, one should probably start with the FIES.

Created in the 1970s, but dramatically expanded in the Lula years (2003-2010), FIES was a financing mechanism that provided affordability to thousands of lower class and low middle income students to pay for their tuition fees, basically with subsidized student loans. During the populist and fiscally lax Lula and Dilma administrations the terms were very generous: students would only have to start to pay their loans 18 months after graduation and at very generous terms.

Then, this being Brazil, first in 2015 and again in 2018, terms were abruptly changed and suddenly made a lot stricter. In other words, a mechanism that was being used for a significant share of new students in the major players like Estácio and Kroton, was suddenly not in the picture anymore, at least not to the same extent.

The drastic and unsurprising consequence was a decrease in the number of new FIES intakes<sup>2</sup>

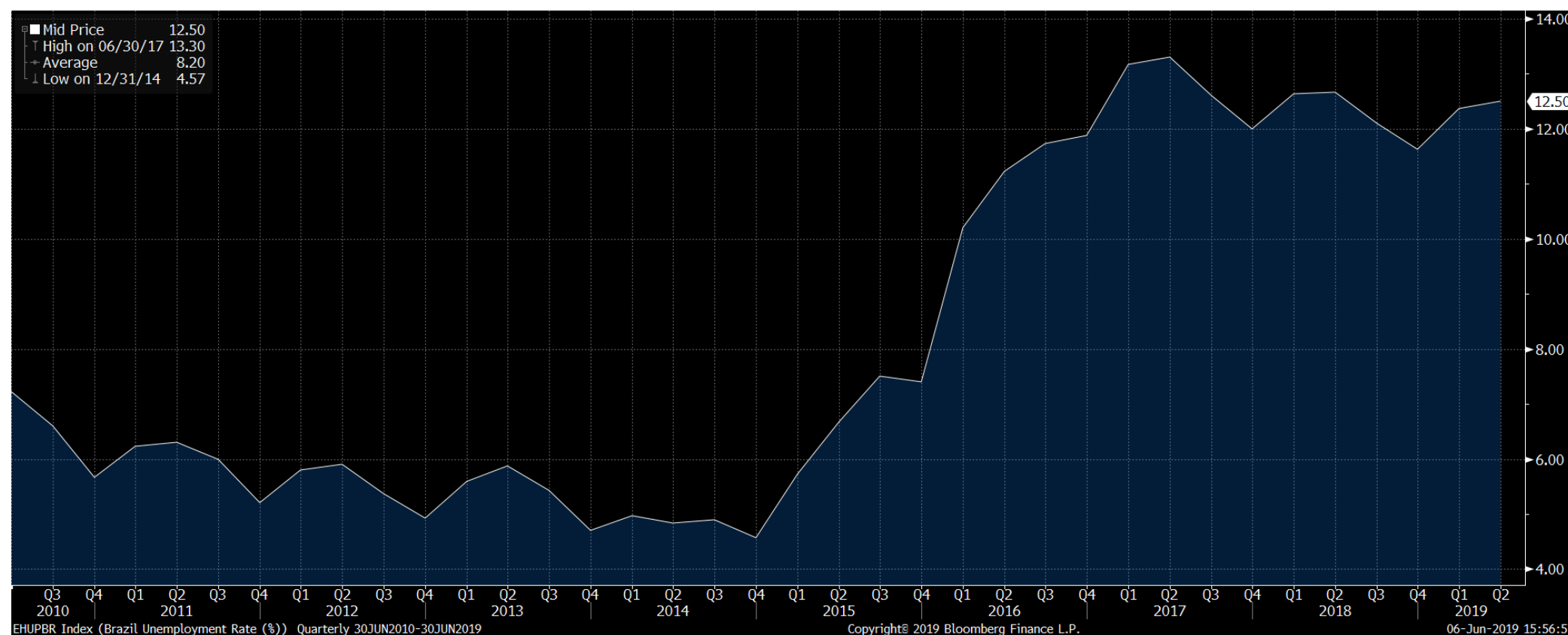
Captação ('000 alunos)	1T18	Abril/18	2018.1	1T19	Abril/19	2019.1	2019.1 vs 2018.1
Graduação Presencial	79,6	10,0	89,6	81,2	7,9	89,1	-0,5%
Base Ex-FIES	78,4	9,3	87,7	79,6	7,4	87,0	-0,8%
FIES	1,2	0,7	1,9	1,6	0,5	2,1	10,5%
Graduação EAD	63,9	12,3	76,2	84,9	13,1	98,0	28,6%
EAD 100%	54,0	11,3	65,3	64,5	12,0	76,5	17,2%
FLEX	9,9	1,2	11,1	20,4	1,1	21,5	93,7%
<b>Total da Captação</b>	<b>143,5</b>	<b>22,2</b>	<b>165,8</b>	<b>166,1</b>	<b>21,0</b>	<b>187,1</b>	<b>12,8%</b>

Source: Estácio – results release

Número de Unidades no Ensino Superior				1T19	1T18	% AH
Unidades	Próprias			155	128	21,1%
	Terceiros			1.410	1.210	16,5%
Descrição dos Indicadores Operacionais				1T19	1T18	% AH
Graduação	Alunos Presenciais	Alunos Presenciais	Captação (ex-ProUni)	108.407	104.158	4,1%
			Evasão	10,4%	11,2%	-0,8 p.p.
			Base	379.188	406.040	-6,6%
		FIES	% Captação Presencial	0,7%	2,6%	-1,9 p.p.
			% Base Presencial	17,4%	28,7%	-11,3 p.p.
		PEP	% Captação Presencial	10,9%	21,4%	-10,6 p.p.
			% Captação PEP50 na Captação PEP	71,1%	16,4%	54,6 p.p.
			% Base Presencial	14,5%	15,2%	-0,7 p.p.
	Alunos EAD	Alunos EAD	Captação (ex-ProUni)	199.798	199.683	0,1%
			Evasão	14,6%	13,0%	1,6 p.p.
			Base	536.890	551.874	-2,7%
Educação Continuada	Pós Graduação	Alunos Pós Graduação	Captação (Presencial + EAD)	17.259	10.970	57,3%
			Base (Presencial + EAD)	44.863	39.269	14,2%
	Cursos Livres e Preparatórios para Concursos	Alunos LFG, Cursos Livres e Preparatórios	Cursos Livres e LFG	39.067	41.883	-6,7%
	SETS	SETS	Livros Vendidos	562.778	502.480	12,0%

Source: Kroton – results release

At the same time, the second of the twin knockouts came: the Brazilian economic crisis.



Brazil Unemployment Rate ( 2010-2019)

Remember, dear reader, that those hundreds of thousands students were mostly young people paying their fees in one of two ways:

- 1) Out of their own pocket, thanks to their day jobs, provided by the country's (now lifeless) economic boom, or:
- 2) Through (no longer existent or at least no longer as generous) subsidies provided by the Brazilian government
- 3) A final injury: FIES disruption was especially painful for the companies cash flows since now private players would have to sometimes provide loans themselves or would have their cash flow collection come in slower than before.

Needless to say, the whole model came crashing down, and according to bears, it will never regain its status. In the next section we will discuss why this house thinks this consensus is wrong.

## The Numbers & Facts

In this section we will focus on Estácio because we think it is not only the cheapest, but increasingly the best managed and most promising education company in Brazil. Its geographical locations, distance learning unit, management, and other features makes in the eyes of this house its position unique. But, importantly, the same following lines could be said of Kroton and smaller companies like Ser.

Firstly, when looking through the market overreaction we can realize that, by and large, the companies were able to absorb the twin blows of economic recession and FIES curtailment pretty well.

Some companies were inventive: Kroton started providing subsidized loans itself. Estácio reinvented itself in terms of management quality: its margins, standardization, quality of expansion was way behind its peers and after a huge turnaround we would argue it is now the best in class.

Overall the number of students has stopped increasing but has not fallen. This might seem like an amazing accomplishment given the circumstances but once we think that still a small minority of Brazilians reach university and that this proportion desperately needs to increase in the coming decades if the country and its people want to have a shot in the 21st century, then it might not seem so amazing at all. It just means there is a huge untapped demand and that the sector is so necessary.

Besides, education is an essential good. Given the earnings premium given to those with a degree, it is no wonder the sector shows such resilience when faced with a recession.

Estácio (million BRL)	2016	2017	2018	2019( e)
Revenue	3,184	3,379	3,619	3,705
Free cash flow	639	809	896	942
Current market cap:	9,325			
Free cash flow yield	10,10%			
Est PE ( 2019) :	10,84			

As for Estácio itself, it is clearly one of the leaders and possibly the most promising company globally in the sector. From its roots in Rio de Janeiro, Estácio commands clear leads in several important Brazilian capitals and important cities.

UF	MUNICÍPIO	NÚMERO DE INGRESSANTES ESTÁCIO	SHARE ESTÁCIO NO MUNICÍPIO
RJ	RIO DE JANEIRO	39.180	42.5%
CE	FORTALEZA	19.254	43.0%
BA	SALVADOR	7.028	16.3%
PA	BELEM	6.870	25.1%
SP	SAO PAULO	5.945	2.4%

Overall a company that provides a basic need, has a leading position in a sector that is quickly going to oligopolization should command premium margins and that is becoming the case.

But there is more with Estácio: there is still a growing component with its distance learning unit.

We would argue that if its distance learning unit were a separate entity it would be a prime candidate for unicorn status. But the good news is that this is not the case: it is becoming clear that online and in-campus education will be complementary and that the leading institutions will aggregate this service when convenient for themselves and their students, generating huge entry barriers.

Overall, this house puts a very conservative 7% growth estimative for Estacio, only twice as fast as Brazil's long term GDP growth in one of the country most underserved needs. This would give us a 20x free cash flow multiple, or R\$ 60 per share, giving us a 98% theoretical upside from current prices.

# The Future Providers of an essential need

Depending on a country's long term prospects, it might be wise to make different long term bets in various parts of the economic engine. For example, when it comes to Asia this house is an enthusiast of stories revolving around urbanization, wealth creation and, increasingly, new business models yet untested in the west.

When it comes to Brazil we like to search for the idiosyncrasies: the companies that will thrive because of, not despite of, the country's problems. When push comes to shove Brazil, with its enormous and largely wasted potential, vast middle class, continental size and undereducated population will need Estácio and its peers.

Estácio provides clear growth ahead (once an investor is patient enough to look beyond the current fog), huge barriers to entry, growth options in the form of its distance learning division and most importantly, a very compelling, almost dirty cheap valuation

We see many routes for a possible compelling internal rate of return: 7% dividend yields, increasing margins, 10x PE, 10% free cash flow and, just as importantly, very reasonable or maybe even inspiring long term growth rate.

Also, we see a beautiful corporate history, a hard to replicate company and strong moats.

Over the past 12 months both of our funds (Brazil- focused FCL Hedge and globally minded FCL Opportunities) began building positions. Like the history of private education in Brazil, we feel this house's involvement with Estacio and its sector is only just unfolding.



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