FCL Capital

Annual Report | 2015

I- Performance

FCL Equities - Performance in 2015 (R$)	
Year of 2015	**+10.07%**
Since fund inception (22/11/2012)	**-14.25%**
Since club inception (03/04/2007)	**+148.12%**
Annualized, since 22/11/2012	**-4.82%**
Annualized, since 03/04/2007	**+10.93%**

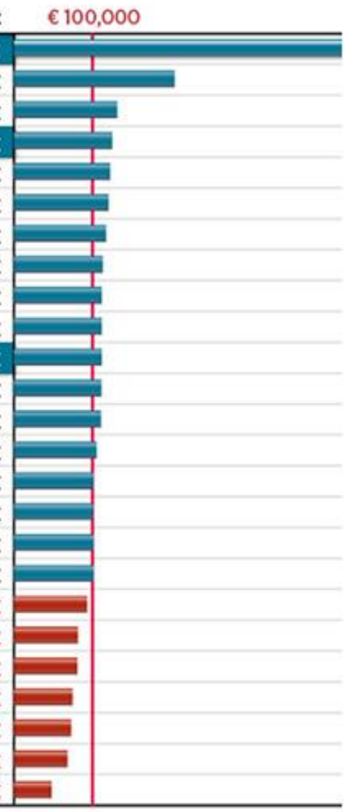
II- Operational Environment

Every period of history has to be read in context. Simple themes can be used to explain in few lines something that otherwise would be too complex to understand. If we had to come up with those themes that dominated 2015, we would list, first and foremost, the U.S. dollar strength against every other major asset class.

Investors started chasing the dollar, with the advent of monetary divergence, which is, the yield differential investors get now that the FED finally started hiking U.S. rates, against the other major Central Banks. The counterpart of this trade is that everything else, the Euro, the Yen, but very especially, commodities and everything related to emerging markets - their equities, their bonds, their currencies - suffered greatly.

In fact, a useful exercise would be to compare returns investors had in U.S. Dollars, in Euros, and in an emerging market currency, like the Brazilian Real. Certainly, any investor would find very dissonant returns depending on the base currency used to analyze the return in any investment.

On the domestic front, 2015 will be remembered as the year where a major part of the Brazilian society finally had to realize how unsustainable and irresponsible the economic policies adopted by the Brazilian administration since a decade ago were. Minister Levy came and went without being able to gain enough support inside the ruling workers party to implement necessary policies to balance the country's fiscal books.



What Investors got for € 100,000 in 2015

Comparison of different asset classes*

Investment		End-Year Result
Venezuela shares	IBC	417,200 €
Jamaica shares	JSE Market Index	202,620 €
Ireland shares	ISEQ Overall	130,340 €
German mid-cap shares	MDax	123,240 €
Greek sovereign bonds		121,030 €
Japan shares	Nikkei 225	119,220 €
China shares	Shanghai Composite	116,290 €
Russia shares	Micex	111,880 €
U.S. sovereign bonds		111,530 €
US dollar		111,220 €
Germany blue-chips	Dax 30	110,600 €
U.S. shares	S&P 500	110,410 €
Swiss shares	SMI	109,520 €
Euro zone shares	Euro Stoxx 50	105,260 €
Euro corporate bonds	low rating	101,160 €
German sovereign bonds		100,470 €
Overnight deposits		100,430 €
Gold		100,100 €
Emerging market shares	MSCI Emerging Markets	92,580 €
Lean hogs		80,630 €
Coffee		79,560 €
Greek shares	ASE	74,710 €
Oil	Brent crude	72,160 €
Brazil shares	Ibovespa	67,170 €
Ukraine shares	PFTS Index	47,720 €

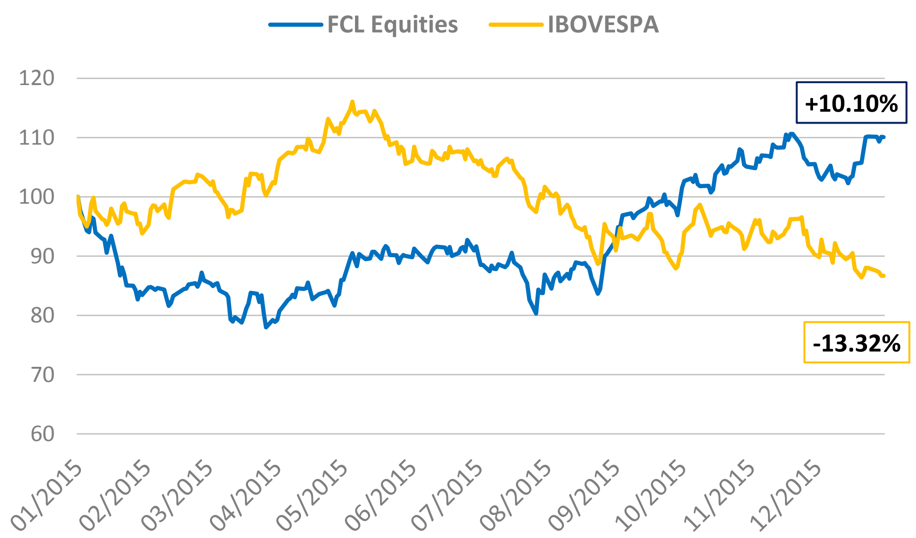
Source: Zero Hedge Blog

We think this short-term obsession is part of the problem. Much more important than how will the Brazilian fiscal accounts behave in 2016 is to implement the necessary reforms for Brazil to be a competitive economy, like the pensions reform, labor reform, tax reform and so on.

In this aspect, we do not see the necessary will inside the Brazilian society to incur the necessary short-term pain for the long-term gains. A classic Brazilian dilemma that can very well make the country become ever more a laggard in the 21st century.

Our fund had a decent, if not spectacular, year. After a very rough start in January, we became ever more confident in our strategy to increase exposure in foreign assets, protect our investors against the Real depreciation we had extensively foreseen in our previous letters, increase exposure in Brazilian exporters.

In short, adopted a simple strategy: buy quality companies with revenues in strong currencies and if possible, able to withstand or ignore a Brazilian economic slowdown.



The interesting thing about correct market predictions is that even when you are right, the timing and the speed of the correction will surprise you as much as anyone else.

We had long argued that that the true value of the Brazilian Real should be something around R$ 3.40 or R$ 3.50 per U.S. dollar. The interesting thing is that we remain with this conviction, although the real went from roughly R$ 2.50 per dollar to R$ 4.00 per dollar in this period. Therefore, we went from being very bearish (against the consensus) in the Brazilian Real to being cautiously bullish (once again very much against the consensus).

One point of pride for us: only 4 stocks in the Ibovespa index appreciated in US dollars this year. Of those four, this house, which runs a very concentrated stock fund that currently holds only six Brazilian stocks, had two of them among its four major positions: Braskem and Fibria.

A third stock, Minerva, which has been our largest position for most of the time in the past few years, ended the year up more than 30% in Brazilian Real and almost made the cut. All this in a universe of dozens of stocks, most of them facing terrible decline.

We do think this proves that stock investing is not a mere question of luck. Obviously, a health economic environment helps a lot. Nevertheless, we do think that in face of the adversities we faced in the past year, a double-digit appreciation in domestic currency of 10.10% is not a terrible result, although we recognize the fact that this is still not the level of returns our investors and we hope for in the long-term. The good news is that we think this shows our capacity to find decent stock ideas remains intact. Now that our fund will gradually be able to invest more abroad (see item 4 in this annual report) we think this ability will be central to our future success.

To end this section in a more somber note, it is easy to argue that the terrible economic environment in Brazil (especially at a time we could only invest in domestic stocks) was the reason for the subpar performance our fund had since its conversion from investment club three years ago. This is certainly part of the explanation.

However, the truth is that a different and maybe more important reason was the steady decline in the quality of investible assets in Brazil. The sheer number and quality of Brazilian listed companies declined significantly in the past five years. Some companies decided to delist their stock; some were acquired or went out of business, and all of them suffered with the economic crisis[1].

This is part of the reason this house is so focused in not incurring in this same of set of problems in the future. Our future is to invest in a "borderless world" where we can select companies based only on their future prospects, varying opportunities they bring and our ability to identify them and not by the geographical coincidence that they are listed in the Bovespa. This is the reason we dedicate the last section of this report to talk about the past, present and intended future evolution of our investment vehicle structure.

Best Performances in 2015 (US$)	Worst Performances in 2015 (US$)
Fibria Celulose: +14.98%	Contax Participacoes: -97.71%
Suzano Papel e Celulose: +13.80%	Brazil Pharma: -97.44%
Klabin: +9.83%	PDG Realty: -97.20%
Braskem: +5.56%	Metalurgica Gerdau: -90.00%
Raia Drogasil : -4.81%	Via Varejo : -89.17%
Total Observations: 291 – Positive: 11 – Negative: 280	

[1] A quick glance on the table of Brazilian IPOs in the past 10 years, with the vast majority listing in 2007, would support this thesis.

On a final note, since we plan to change our bylaws in 2016, it is safe to say one chapter of our fund is ending. The good news is that we think our ability to identify opportunities and therefore show good long-term performance with proper diversification will expand greatly.

The bad news is that any possible excuse of blaming a possible subpar performance on specific country economic problems (never an ideal excuse for value investors in the first place) will now be solely due to our inability to identify good economic opportunities, and every suggestion otherwise will ring hollow.

III- Management Diary - Portfolio & Performance Attribution

Although it may be useful to think in terms of years, the truth is that FCL's portfolio tends to constantly evolve over time, following a few specific themes that have long-term maturation and that this house thinks will be game changing.

One of the themes that dictated the ongoing evolution of our portfolio in 2015 was our desire to progressively increase our exposure in the U.S. currency against the Brazilian Real.

However, with the recent devaluation of the Brazilian currency, combined with the lack of quality seen in most Brazilian companies as discussed in the previous session, we are now more comfortable in holding cash in the Brazilian currency, while not giving up our long-term plan to increase exposure in non-Brazilian companies.

Our investors should therefore be aware that, over time, these two key positions, cash in the Brazilian currency (which turns out to be the cheapest and safest way to bet in the Brazilian currency appreciation in the medium term, without incurring unnecessary risks of being exposed to derivative contracts) and non-Brazilian companies (which bring us diversification and lessen our exposure to the Brazilian economy) should progressively increase.

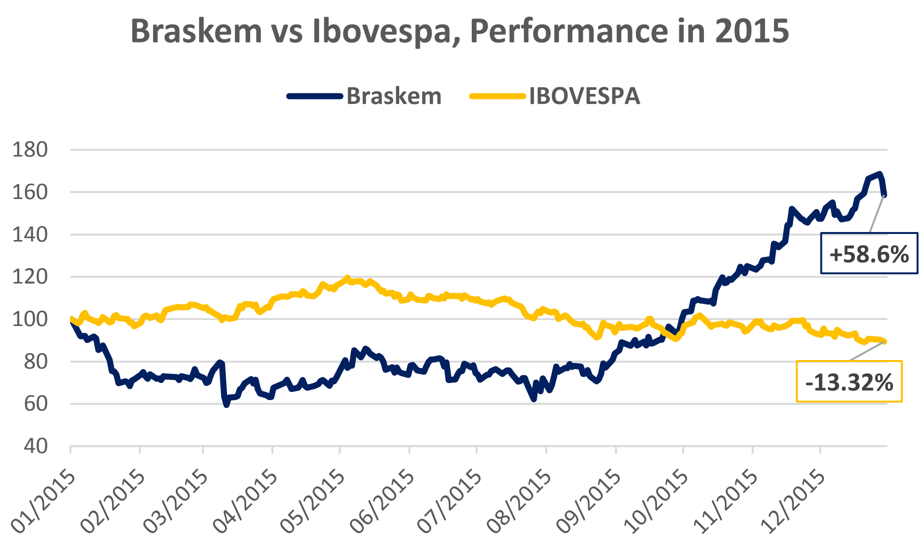
Our portfolio should see a year ahead where it is slightly less concentrated than usual, possibly holding several different medium sized positions in American, European and Asian companies, while slightly decreasing exposure in our main Brazilian holdings, which should continue to form the core of our holdings in the medium-term.

FCL Equities – Largest positions in 31/12/2015	
Minerva	**27.61%**
Braskem	**27.42%**
Fibria	**14.96%**
Apple	**7.83%**
Regus	**3.39%**
Cash & Fixed Income	**12.94%**

Braskem

Our main winner in the year was Braskem. After a terrible start of the year, we increased our position believing in the company’s capacity to generate revenues in strong currencies. We also believe Braskem will be able to withstand any possible impact of the political turbulence, and very particularly of the company’s president of the board's arrest, believing in the idea that a weaker currency would help Brazilian industrial production if not to thrive, at least to remain alive.

Because of the political turbulence, and very particularly the company's president of the board, who had been arrested, not to mention the idea that a weaker currency would help Brazilian industrial production if not to thrive, at least to remain alive. After the dust settled, the company started a rally that made its shares end the year with an appreciation of 57.82% in Brazilian Real.



Minerva

Minerva, which ended the year as our fund's major position (although by a very slight margin) and has been maybe our most important thesis in the past few years, also had a great year.

Over 2015 it was very satisfying to see that, brick by brick, our thesis that South America will gradually dominate the international meat trade, a market where Asian consumers will be at the center and where the current two different sub-markets will merge into a unified one.

One, a developing one, composed by the Arab countries as consumers and the Americas as suppliers. The other, a developed one, composed by the US and developed Asia as consumers, USA and Australia as suppliers that will gradually become just one market, as the recent lift of buying restrictions from China, Saudi Arabia, the USA and South Korea towards Brazilian exporters attest.

And most importantly, we believe South American producers, because of their competitive advantages there were exhaustively covered in this space in the past, will come to dominate this nascent unified market that is one of the most strategic assets in the coming decades.

Fibria

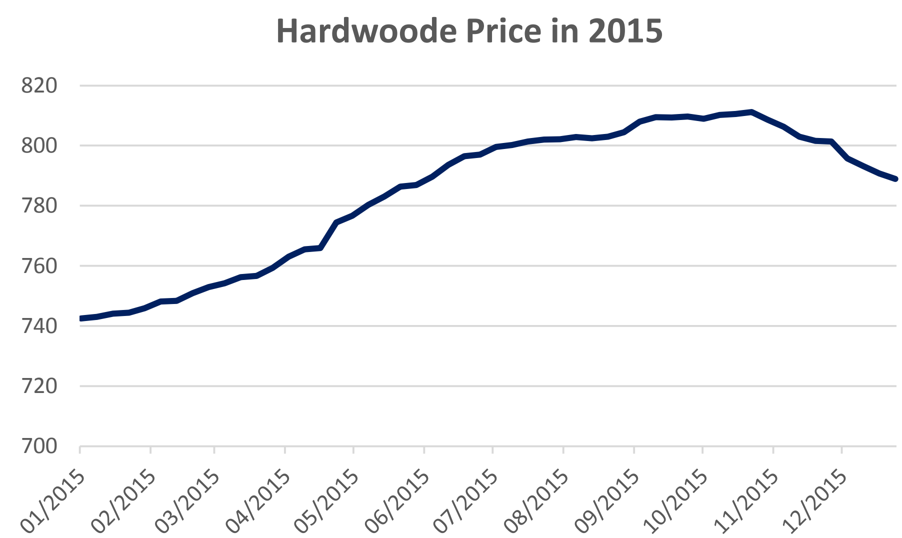
Another similar, secular trend we have faith on is the importance of the pulp market and the capture of Brazilian producers in general and Fibria in particular, of the value in this market.

It is a similar thesis to Minerva, in the sense that we have a market that it is currently underestimated by the international community, where future Asian demand will dictate how the future will play out.

And additional charm: Fibria is a very straightforward company for a valuation model: its profits depend basically on two components: the level of the U.S. dollar against the Brazilian Real (since all of its revenues are denominated in the American currency and almost all its costs in the Brazilian one) and the price level of hardwood pulp.

Many people think pulp and paper in general will have a bad future because of the progressive transition to a paperless office and paperless life. Although this is certainly a headwind for the company, it is less important than people think: nowadays 70% of its demand is tied to sanitary papers where the level of consumption of Chinese and Indian consumers should grow exponentially in the future as their income gradually converge to western levels.

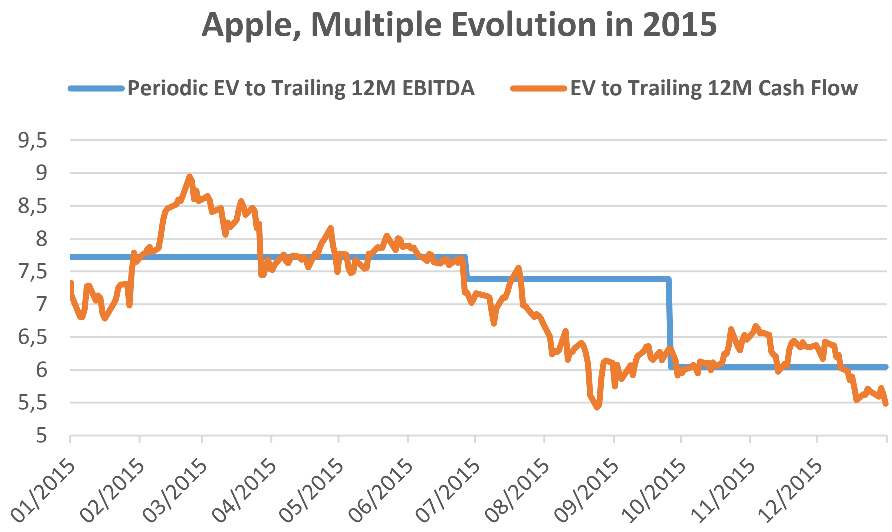
And since the demand side is bright, the supply side also gives support to higher pulp prices: the market has been keeping its tight balance between capacity expansions in low-cost producing countries and capacity closures in high cost countries, bringing higher market share for Brazilian producers in the process



Apple

Although Apple is obviously a non-Brazilian company, we will discuss it apart from the other companies in this group because it is so relevant to our portfolio. From nothing at the start of the year, Apple ended the year comprising 7.83% of our fund, making this position our fourth largest holding.

It was a great year operationally for the company, which reported record profits and cash flow, and a modest year financially-its stock ended the year slightly down in U.S. dollars. Why the discrepancy?



The market is afraid that the astonishing success Apple had with its iPhone, which is responsible for 66% of the company's sales nowadays, cannot be or at least will not be repeated in the future.

Therefore, a cheap multiple is in order. At the same time, since the growth in revenues is decelerating, there is always some friction in the transition from a base of investors chasing growth to a base of value investors like this house.

We disagree with the market's perspective and think the company's unique culture and brand will ensure a transition to a model of services with greater recurring revenues, successful new product launches and a secure place at the edge of the consumer technology frontier[2].

Terminated Positions: Direcional, Heringer, Portobello, Mills, Metalurgica Gerdau

The main reason 2015 was only a reasonable year and not an outstanding one was the fact our performance was hurt by a series of positions in Brazilian companies that were too dependent on the Brazilian economic cycle or Brazilian government programs. The rationale was that since the government has a huge presence in the local economy, better to be an ally than have the government as a foe. The problem is that since this same government now has to scale back many programs, some business models, particularly in the case of Direcional Engenharia, were no longer viable.

FCL Equities – The Losers of 2015	
Metalurgica Gerdau	**-85.31%**
Fertilizantes Heringer	**-74.39%**
Mills	**-72.15%**
Portobello	**-57.09%**
Direcional Engenharia	**-56.72%**

According to our calculations, this series of participations combined decreased our performance in almost 10% points. Besides Direcional, Heringer was a company in a promising sector, although still mired in corporate governance issues and we gradually felt any possible upside would not be passed along minority shareholders, as a recent transaction of a stock block sale

[2] See our November 2015 letter on unique cultures where we discuss Apple's challenges in more detail.

from the controlling shareholder, which changed hands at several times the market price attested.

In the end, we threw in the towel and ended our position after years hoping for a change in the structure and governance of the company.

Portobello and Mills where two medium sized positions where, unlike Heringer, we like the businesses and the company's management but we just judged that, considering the current valuations, we just didn't find enough discount in them to justify the high risk we would incur from being exposed to a sensible sector like construction materials in the current Brazilian economic context. Besides, we had fears, which turned out to be true, about the companies abilities to pass on higher input costs in dollars and to withstand a severe deceleration in the real estate sector in the country.

Gerdau

Gerdau was probably our most costly mistake in the past year. In our last annual report, we stated:

"Buying Gerdau shares is a great way to protect against a devaluation in the Brazilian Real. In fact, one of the major problems the company has faced competition with Turkish and Chinese steel imports is diminishing precisely because of the lower level of the Brazilian exchange rate, not to mention a possible increase of exports from Brazil and the higher level (when translated to Reais) of profits in the US operations."

This strategy proved to be our worst mistake in 2015. Between a correct macro call - devaluation of the Brazilian currency[3] - against an incorrect micro one (a troubled sector which we thought would sort out its overcapacity problems that have shown to be worse than forecast) as always the micro dictated the fate of the thesis, and Gerdau had a disastrous year, ending the year down -85.31% in R$. If we had excluded Gerdau from our portfolio, instead of the 10.10% appreciation, which we reported, our performance would be 17.71%. As always, the future is a lot easier when looked in hindsight.

Over the course of the year, we reassessed our thesis for the company, concluded the structural problems in the global steel sector was worse and more durable than we thought and, combined with the fact we were increasingly unhappy with the company's corporate governance, ended our position

Log-in Logística

Log-In has a unique place in our portfolio. The company certainly had a very disastrous year, with its shares ending the year down -64.42% and, since at the time of this writing the company only has R$ 28 million in cash against short term borrowings of more than R$ 200 million, bankruptcy is a serious and concrete possibility. There are several possibilities currently being discussed in the media, including an injection of capital by a new strategic investor or a waiver from some creditors. Against this horrible scenario, our investors might wonder why we just didn't sell our shares and ran away. There are a few reasons.

[3] Bear in mind that at the time of our last annual report, the U.S. dollar was changing hands at roughly R$ 2.60 reais per dollar.

The interesting thing is that Log-In is one of the few companies we still think is as strategic and promising as we ever thought. If the company is able to withstand the current drama it is facing, we think an amazing future may lie ahead.[4]

Our thesis is proved by the fact that even with the current horrible numbers in Brazilian industrial production; the company's viability is attested by the ongoing increase in the revenues of its cabotage division. Investors should be assured, it is a very small position, comprising only a little above 1% of our portfolio so even if the worst happens, and it is nothing that could hurt our shares significantly.

Therefore, Log-In became although involuntarily, our first distressed position. We like the risk reward scenario so far: if the company goes under, it will not hurt our fund too much. If it recovers, a very promising future with giant rewards for its shareholders lie ahead.

BTG Pactual

If Gerdau was, as we said, a costly mistake, we think BTG Pactual was among the imponderable things about the future that we do not think could be grouped among the mistakes a value investor could potentially avoid.

Like all the world now knows, the bank's founder and major shareholder was arrested and since an investment bank, unlike an industrial company, is nothing more than a collective of people,

[4] See our previous letters about Log-In for more detail.

brand and capital, the devastating result was that the bank's franchise was severely harmed. After a few sleepless nights and hundreds of long calculations about the bank's liquidation value, this house decided to sell all its position in the bank, a decision that judging by the current stock price turned out to be correct.

We still think BTG will survive and hope it will recover its strength but as far as value investors, we prefer to stay in the sidelines than jump back to a position that may very well bring risks we are not comfortable with.

Foreign Companies: Regus, Match, Whole Foods Market, Dufry

A new group that should progressively increase in importance in the next few years is the one of non-Brazilian companies. This should only be natural, since 98% of the world's GDP, and the vast majority of the world's best companies are not located in Brazil, so we see no reason we should only look for this one country in our search of value in the global markets.

Besides, there are many sectors not even represented in the Bovespa and the access to the world's major stock indexes should bring some well-needed diversification.

That being said, as we said in previous letters this transition should be gradual. We believe in gathering knowledge brick by brick and are skeptical of shortcuts and easy answers. We have been engaged in learning, travelling and a very humble and calm search of knowledge and value in world markets, where we could replicate the very distinct and typical way of investing this house has constructed for the Brazilian markets on a global scale.

So far, we have started positions that should gradually increase in number and size, in a group of very promising and distinct companies:

Regus - The global leader and largest provider of flexible workplaces. The company is incorporated in Luxemburg and listed in the London Stock Exchange. Our investment in Regus will be the theme of our February 2016 letter and the company's prospects and the overall sharing economy should be one the themes of our letters in the next year.

Match Group - The world leading provider of online dating products. The company has, among its brands and properties, the websites Match.com, Ok Cupid, Plenty of Fish and the dating app Tinder. Match group is incorporated in Texas and listed in the NASDAQ Stock Exchange in New York City.

Whole Foods Market is an American supermarket chain specializing in organic food, based in Austin, Texas. As of September 2015, the company had 91,000 employees and 431 supermarkets in the United States, Canada, and the United Kingdom.

Cash

The reasons cash had a significant increase through the year of 2015 were:

- Our lack of confidence in Brazilian assets, while our bylaws still limited our maximum exposure of investing abroad;

- Our lack of ability of finding good undervalued Brazilian securities that we judged had enough attractive risk reward opportunities in the face of the current Brazilian economic and political crisis;

- The rushed sale of our position in BTG Pactual which with a dramatic turn of events (see our comments on BTG Pactual above) forced us to liquidate our position in a rushed manner and therefore increased our cash exposure;

Finally,

- Our bullish call in the Brazilian Real against the US dollar. Since just holding cash yields in Brazil a 7% risk free inflation adjusted return (besides any potential exchange rate gains) and since we foresee a medium-term appreciation of the Brazilian currency against the American one, just holding cash at these levels of yield present a good risk return opportunity of appreciation, without incurring unnecessary risks of derivatives or other financial instruments.

IV- FCL's Investment Vehicle Structure Evolution

FCL Investment Club - 2007-2012

FCL Equities Fund - 2012-2016

New FCL Structure - 2016-???

As we have stated in previous letters, instead of diversifying our returns away from the ones incurred by our own investors through the creation of new structures and strategies, we are firm believers in the "Mungerian" concept of circle of competence: it is hard enough to do one thing right.

Our investment strategy will remain putting all our eggs in a single basket and watching this one basket very closely.

While we are happy with this decision and think it will reward ourselves and our investors with better long term risk adjusted returns, the bad news is that the structure itself will have to evolve from time to time.

During our investment club years, our main limitation was that we could not invest in any macro asset class at all, not even for hedging purposes and could not invest abroad or in bonds, and so forth.

Nevertheless, our main call at the time, that over time with the improvement in corporate governance and business environment in Brazil would gradually mean that the country's valuations would converge to international levels proved true and those were very successful years

During the FCL Equities years, the situation reversed completely. Over this period, we became increasingly concerned about the business and economic environment in Brazil. We looked for many ways to increase our exposure abroad. Since this did not happen, due to a number of reasons, with the speed we wanted, we opted instead to increase exposure in Brazilian companies with revenues in strong currencies, like Minerva, Braskem, Fibria and Gerdau.

The result for FCL in the "Equities" years was mixed. We judge the year of 2015 to be a great success in relative terms, after all our performance ended the year positive in + 10.07% against -13,31% of the Ibovespa Index. Our fund, for the first time, ended the past three-year period down, thanks to the terrible macroeconomic environment in the country that made virtually every Brazilian financial asset suffer almost regardless of fundamentals.

We dedicated countless hours and effort to select the best possible companies to withstand the economic situation but the macro environment is a powerful force: in the end, it was not enough to avoid falling valuations and negative returns, albeit we did significantly better than the Ibovespa Index.

We look to the future with a few certainties. The first one is that the current structure is not ideal anymore to protect our investors' capital. We want to be able to select assets all over the world and gradually are already starting to do so. We think our investors will be able to be better hedged, their wealth protected in strong currencies and tied to some of the best companies in the globe, many of them from developed markets without totally walking away from our know-how in emerging ones.[5]

How would a new structure look like? Initially not very different from the current one, but with two major differences:

- More flexibility to invest across the capital structure instead of only in the equity portion;
- An increase of our current limit of foreign exposure (i.e. our possibility to invest outside of Brazil, that was once set at 0%,

[5] We do have a monthly letter coming up about the advantages of analyzing and investing in emerging markets from a Brazilian perspective.

then was moved to 10%, now recently moved again to 20% and which we plan to finally raise to up to 100%.

The bad news is that, while we are deeply sorry for this, some investors may have to leave our partnership and our fund, since with the necessary change in the bylaws some may not be legally permitted to invest in an international fund like ours. For the ones remaining in our partnership we promise the same dedication and passion we always had.

If we are proud of one thing in so many years of partnership of our investors this is exactly it. We would not have survived in this competitive business without it, and our investors can be sure that this house has carried it since our first day and will carry it until its last.

FCLCapital

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Sobre a FCL Capital

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