FCL*Capital*

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Exchange Rates, Mandate and Discipline

The delicate balance of seeking competitive advantage through a superior organizational structure while keeping a strict discipline and focus on our investment strategy is and will always be one of our obsessions. Therefore, having long term investors aligned with our philosophy, along with a more flexible mandate is the means to an end. Even if that means declining new investments when they are not aligned. The final goal is to look for significant discrepancies between price and value in neglected pockets of the markets.

Macro considerations, like the inclination of interest rates, exchange rates or even a single year GDP growth only deeply interest us as long as they have an impact on one of our investment ideas. That being said, over the past couple of years we became more and more convinced that one of the greatest mispricing's occurring nowadays in the Brazilian markets and therefore one of the best risk/reward opportunities to be arbitrated away by investors is the level of the Brazilian currency.

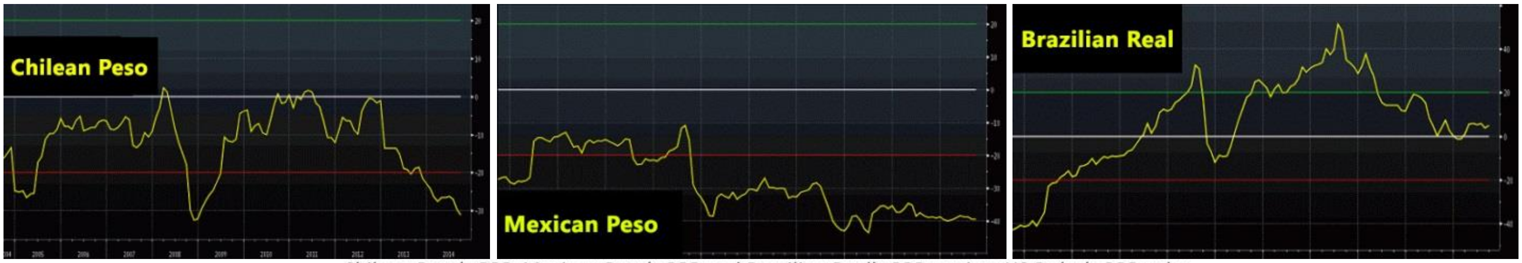
According to almost any possible metric, the Brazilian real seems grossly overvalued compared to most other currencies, especially the dollar and the Mexican peso. Before stating our reasons for this conviction, we would like to remind that we will deal with this perceived imbalance within our mandate, which is to find specific undervalued stocks in a company by company basis rather than to speculate in currency or future markets.

There are at least two possible ways we can easily demonstrate how far away from any reasonable value the real has gone: the elegant, charted models and graphs based on econometrics and simple common sense. Let's start by the elegant one:

1.1) PPP - A Clear Outlier

Since The Economist magazine started publishing its famous "Big Mac Index" over a decade ago, more attention has been given to the idea of "purchasing power parity", which simply means that goods and services should cost more or less the same, after been converted from one currency to the next. Whenever a country's products look "too expensive", its currency may be overvalued.

However, proponents of this theory have always noted that this rule is not written in stone. Obviously goods, and especially services, should be more expensive in, say, Switzerland than in Thailand. Therefore, for the theory to make any sense, very rich countries should have "expensive" currencies and emerging and lower income countries, cheaper ones.



Chilean Peso's PPP, Mexican Peso's PPP and Brazilian Real's PPP against US Dolar's PPP value.

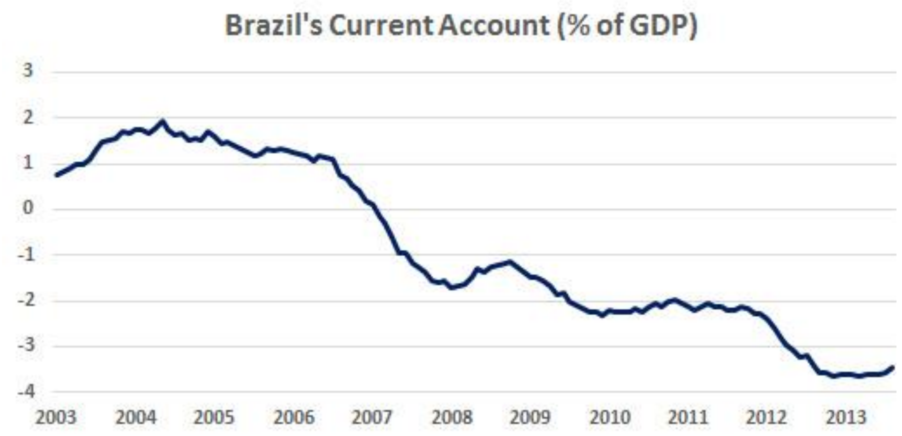
A quick glance at the above table, taken from a Bloomberg terminal, shows the Brazilian Real as a clear outlier. It is only cheaper than the currencies of ultra-wealthy countries like Norway or Switzerland (which are seven times and five times respectively richer than Brazil on a per capita basis) and almost on par with the American dollar (also five times richer than Brazil on a per capita basis). It is more expensive than the Euro.

Meanwhile, the Chilean and Mexican currencies', both of which are issued by countries richer than Brazil on a per capita basis, are 30% and 40% undervalued respectively if compared to the US dollar. Around the level, we suspect, the Brazilian real should be trading at.

1.2) Trade Balance

A chart is clearly worth a thousand words in this case. Brazil enjoyed significant trade surpluses for the past decade, helped by a relatively depreciated currency. Please note that the nominal level of exchange does not matter, but the real inflation-adjusted level of the currency does, and it has never been higher in Real's case – Nowadays, this reality is gone and Brazil will probably end 2014 with a negligible surplus, and is no longer being helped by high commodities prices.

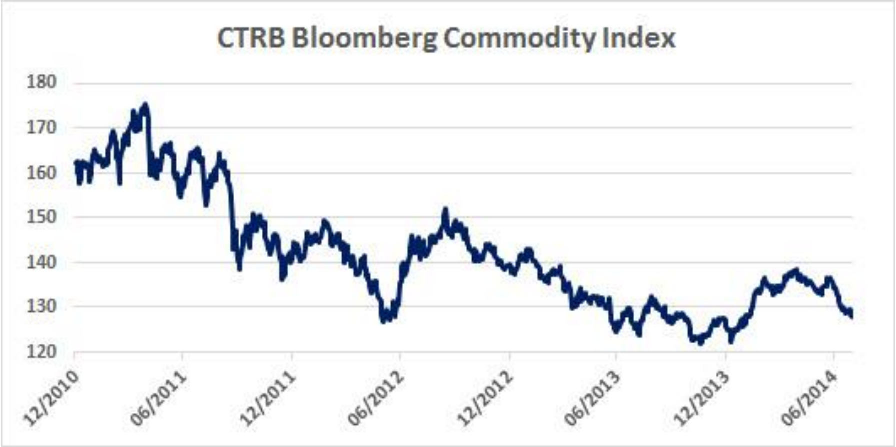
1.3) Current Account Balance



No one knows the exact level at which a country is no longer able to finance its transactions with the rest of the world, because this level depends on many specific factors. But, in any stance, a current account deficit that is already past the 3.5% to GDP ratio and still getting worse is cause for concern. A lower level of exchange rate is the obvious solution and seems almost inevitable to us.

1.4) Commodities Prices

China's economic ascendancy certainly had an indirect effect on Real's exchange rate, pushing up the price of commodities to unprecedented levels. Since Brazil has a commodity-heavy export list, with iron ore, sugar and soybeans representing a combined 30% of its total exports, it is clear that the change in dynamics that China will experience in the next decade will impact commodity prices and consequently help to devaluate the Brazilian currency. We expect less emphasis on investment, and therefore less iron ore imports and steel consumption, and a shift towards personal consumption.



1.5) The Artificial Factors: Interest Rate Differential & BCB Swaps

If it seems so clear that the Brazilian currency is grossly overvalued, why has it stayed that way? There are two straight answers: interest rate differentials, with the so called G-4 Central Banks[1], and the swap programs put in place by the Brazilian Central Bank that is artificially keeping the Brazilian currency in its current range of R$ 2.25 - 2.30 per US dollar.

The two factors are certainly temporary. Amongst the four main rich world central banks, only the ECB is still easing its policy and may embark on an unprecedented round of quantitative easing. Most economists expect the FED to end its quantitative easing by late 2014 and many are already expecting a rate rise in the first semester of 2015. The British central bank is even ahead in terms of normalizing its policy. Meanwhile, the Brazilian Central Bank swap program has its limits and no one expects it to last too much longer after this year's elections.

2) Anecdotal Evidences

Even without the help of econometric models and charts, any reasonably smart Brazilian can easily attest that there are bizarre realities in the Brazilian society. Ranging from real estate that is more expensive than in London or New York (!)[2], to some of the most overpriced restaurants (with only passable quality) in the world, to the

[1] The four main rich central banks: the US FED, the European Central Bank, the Japanese Central Bank and the British Central Bank.

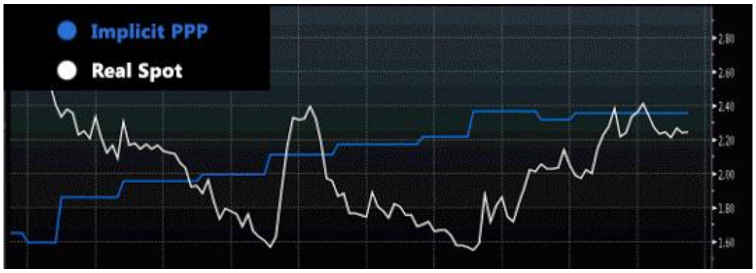
[2] http://www.estamosricos.com.br/2014/01/chuck-norris-x-vila-madalena.html
http://showmetech.band.uol.com.br/viajar-comprar-playstation-4-miami-barato-comprar-brasil/

common complaint made by any serious businessman that, apart from agribusiness, there is just not a single industry left where Brazil can compete with rest of the world because costs here are so much higher.

The Brazilian middle class has been notably invading shopping malls in Florida. This is, in our opinion, a clear symptom of economic sickness. No normal country would be so prohibitively expensive that its average citizens would dream to fly eight hours to a rich country where they are able to buy decent goods at fair prices.

We can adjust Brazil by any metric we want, like GDP, spending power, etc. and it is still crazy that this country would alone represent 70% of the gross sales made in some Florida Malls like it is the case. Why aren't tourists from, say, Mexico, invading malls abroad like Brazilians? They are a lot closer to Florida than Brazilians are. The answer, of course, is necessity - they do not live in an insanely expensive country like Brazilians.

Admittedly, not all of the high costs found in Brazil are due to its overvalued exchange rate, the famous "Brazilian cost" is very much alive and thriving. Not to mention Brazil's high taxes and the crazy bureaucracy that makes imports expensive and difficult[3], but we are convinced that the overvalued exchange rate plays a dual role: it makes Brazilians goods too expensive and the trip abroad cheaper than it would be.



A Dollarized Portfolio

To sum it up, the rise of the US dollar against the real is one of the best risk reward bets we can think of right now. On the other hand, as we said at the beginning of our letter, no matter how convinced we

[3] Since Brazil is unfortunately a somewhat closed economy with very high import taxes, Brazilian consumers' can't make a proper substitution of expensive national goods with imported cheaper ones.

are of a specific macro event or scenario, we should stick to our mandate as disciplined investors. We couldn't act any other way, because our investors naturally expect predictability, focus and transparency.

As we often say, one of the beauties of investing in stocks is that an investor can build positions and directional bets in almost any macro occurrence through stock selection. For example, any investor can bet in a rise or fall in interest rates (possibly through positions in banks or insurance companies), commodities (buying, for example, a gold or copper miner), real estate prices (through real estate brokers or developers), exchange rates (importers and exporters), and so on. That is, in our opinion, one of the most underappreciated advantages of stock investing.

At this house we like to view our portfolio as if it was a single company, with its different holdings as parts of this bigger company. According to our calculations, at least 70% of the revenues of our portfolio (the big company) are earned in US dollars or other rich world currencies. But, that is only the beginning of the story.

Going back to the case of the gold miner, it is reasonable to expect that in most cases there is some "leverage" in the thesis, because if the gold price rises, say, 10%, probably a pure-play gold miner will rise more than that, since the costs will practically remain the same, making the company's margins soar.

Likewise, some carefully selected specific companies in the Brazilian stock exchange could see their earnings rising proportionally a lot more than an eventual 20% or 30% rise in the US dollar, since they have revenues in the American currency and costs in the Brazilian one, making their margins rising exponentially.

Bellow, you will find a very superficial and summarized table of some of our investments and their situation after an eventual exchange rate devaluation:

Minerva

- 70% of its production is exported and earned in US dollars.
- Its debt is hedged, therefore an eventual rise in the US currency should not only make its investors keep its purchasing power, but it will bring a positive asymmetry.

- Its revenues should rise a lot more than its costs, therefore the company's cash generation should rise a lot more than any fall in the Brazilian currency.

Braskem

- 100% of its revenues, including its sales to Brazilian clients are referenced in US dollars.
- The company also has projects abroad and competes with imports, adding another layer of favorable asymmetry in case of a currency depreciation in regards to the competition with imports.
- Only 70% of the costs are in dollars. Therefore, any rise in the US dollar levels should greatly enhance the company´s prospects.

Gerdau

- Probably the most asymmetric case in our portfolio. Half of its production is outside of Brazil, therefore, when converted to Reais, the company's earnings should automatically rise in nominal terms.
- Its domestic production competes with imports that are entering the Brazilian market cheaply (in large part due to the overvalued exchange rate in Brazil) and its exports from the Brazilian plants have suffered in recent years.
- According to our calculations and previous studies done by third parties, a 1% rise in the American Dollar against the Brazilian Real should impact positively the company's overall cash generation by 4%, making one of the most favorably asymmetric cases in the Brazilian stock universe in case of a devaluation of the Brazilian currency.

BTG Pactual

- While it may seem that the bank's earnings should not be impacted by currencies movements (apart from normal trading desks' bets that are not the focus of this study), it is important to note that BTG is experiencing an important internationalization process, with recent purchases of institutions like Celfin in Chile and Serasin In Switzerland.

- Although BTG will not disclose the exact fraction of its earnings outside of Brazil, it is reasonable to estimate that an important percentage is in strong currencies and that would naturally keep its purchasing power in the event of a weaker real.
- BTG is by far the most internationalized Brazilian bank (as a percentage of total assets, Itaú is very far behind) and Brazil´s most likely candidate to be a global one. So, it also seems reasonable for us to expect that an even greater percentage of its revenues in the future will gradually come from G-7 currencies.

Log-In Logística

- Although sometimes Log-In is viewed as a company that could suffer in the event of a maxi-devaluation of the real due to its fuel costs that are mainly referenced in US dollars, it is important to note that the company's purpose is to be a better logistics solution to industrial companies in Brazil. Since the advent of a weaker exchange rate would certainly impact favorably Brazil's industrial production, even if hard to calculate, we assume that devaluation would be beneficial to the company.

With these explanations, a reminder is important: FCL is focused on specific company by company research, analysis and selection. We would never select an individual investment just because of a specific macro thesis. The most important aspects are still management quality and integrity, the individual business prospects and the valuation at which we are able to become a partner of the company. Although we don't subscribe to the separation of bottom-up from top-down analysis, always preferring a single holistic approach, the macro environment seldom is the main point in our considerations here.

We always build a portfolio for a longer time frame than an election cycle or a specific macro event and therefore would never go through with an investment because of a specific event. We like to "test", at least in suppositions, our portfolio under different scenarios. We stated in last month's letter that we think our portfolio would do well under exchange devaluation, and used this letter to explain why to our investors.

Next month we will discuss why we think some fixed income investments may not be so secure for secular investors as many assume and why we think specific stock selection may contain some of the best opportunities for long term investors.

To sum it up, we do think that many investors are confusing risk with volatility. The former is the possibility of having a smaller purchasing power in the future. The later means variability of returns in a given period, like a calendar year. Since this house has a secular perspective and strives to maintain our investors' purchasing power, we feel comfortable with underperforming index benchmarks in given periods to purchase higher and more visible absolute returns in the longer term.

As we said in last month's letter, we do not think we possess any superior knowledge about the Brazilian election outcome. Therefore, we have an "agnostic" portfolio, with no out of the money calls on Petrobras' shares or anything of the sort. We have been saying that if the current administration loses its job (as any sane person hopes), our portfolio will do very well, although it will probably trail the Ibovespa. On the other hand, if the current administration wins reelection, we think we will be very well positioned to outperform the market in relative terms (since we hold cheap, defensive companies that earn money in strong currencies), but our portfolio won't do as well.

This past month seems to have confirmed out thesis: as the opposition hopes increased, our shares have appreciated more than 7% in August alone, and still trailed the Ibovespa by a couple of points (since the index is heavily dependent on Petrobras and other mega caps that will certainly rise fast and first if a bull market occurs)[4]. Over the long term, we still think that we could not be better positioned than we are right now.

[4] In a typical bull market, small caps take longer than larger caps to rise, but with more intensity when it happens.