

FCL *Capital*

3Q 2023

Performance

FCL Opportunities	
Year to Date, 2023, in BRL	-2,01%
Year to Date, 2023, in USD	2,93%
12 Months, in BRL	5,81%
12 Months, in USD	13,56%
MSCI All Country Index, 12 Months, in USD	20,80%
Since Inception (30/01/2017), in BRL	86,52%
Since Inception (30/01/2017), in USD	15,50%
Avg Annual Return, since inception, in BRL	9,78%
Avg Annual Return, since inception, in USD	2,18%

At the end of the quarter, FCL Opportunities top 5 positions were:

Position	Country	% Fund NAV
Pinduoduo	China	13,3%
Uber	US	11,2%
Anta Sports	China	10,9%
HelloFresh	Germany	9,8%
Entain	UK	7,3%

FCL Opportunities Portfolio Composition on September 29th, 2023:

Portfolio Composition by Sector	
Consumer Discretionary	40,8%
Technology	18,4%
Healthcare	13,7%
Financials	9,2%
Telecom Services	5,4%
Industrials	4,8%

Currency Exposure	
USD	28,7%
EUR	16,6%
HKD	15,7%
BRL	15,2%
CNY	13,3%
Others	10,5%

Geographic Distribution	
China	29,0%
Europe	24,2%
USA	14,6%
Brazil	13,3%
Others	11,2%

Portfolio Concentration	
Top 5	52,5%
Top 10	83,6%
Top 15	92,3%

FCL Opportunities shares decreased by 2,01% year to date in 2023 in Brazilian Reais, due to the Brazilian currency's appreciation against the US dollar. As our long term investors know, we don't hedge short term currency volatility and over the short term differences in performance in BRL and USD should be expected as noted in our past investment letter.

In US dollars, FCL Opportunities has had a mildly positive performance so far this year, with its shares increasing by 2,9%.

In the past 12 months, FCL Opportunities shares increased by 5,81% in Brazilian Reais and by 13,56% in US Dollars.

Since the fund's inception in January 30th, 2017, FCL Opportunities has enjoyed a cumulative return of 86,5% in BRL and 15,5% in USD, giving the fund a compounded annual return of 9,8% in Brazilian real and 2,2% in US Dollars.

This house is definitely not satisfied with these long term compounded returns and throughout most of our fund's history we were able to enjoy much higher returns, well into the double digits in both currencies.

Overall a few negative factors combined to harm our performance in the past two years and momentarily bring our annual and cumulative returns below its long term trend and potential:

- A scenario of global instability with a decrease in the growth rate of the world's main economies and an increase in global interest rates that affects all economies but especially the emerging markets that this house specializes in;
- A "flight to quality" that made investors less interested in emerging markets and overallocated in the US economy as well as less interested in small and mid-cap companies;
- A very deep sell off in the Chinese stock market for punctual (slow growth post Covid reopening) and structural reasons (US boycotts, global supply chain realignment);
- A series of wars and negative shocks (global pandemic, Russia invasion of Ukraine, resurgence of Israel/Palestine conflict etc.) that made investors overlook our strategy and the kind of assets we invest in.

Fortunately we judge all of the above events as temporary. During over two thirds of the life of our Opportunities fund, our returns were well above every major benchmark, like the S&P 500 and the Nasdaq. We are confident that once those stormy clouds go away, with the end of the interest rate tightening cycle in the US and some cooling of the major geopolitical conflicts (Russia x Ukraine, US x China geopolitical hostilities etc) our FCL Opportunities fund can regain its all-time highs and return to its usual double digit annual performance.

A series of peculiar trends have occurred over the past few years in global finance:

1. A few giant technology companies outperforming everything else, especially small and mid-cap;
2. The US economy and US dollar outperforming every other economy by a wide margin and particularly, US assets getting ahead of its fundamentals while the rest of the world gets cheaper;
3. A deep skepticism with the Chinese economy and emerging markets in general;



Source: Bloomberg, FCL Capital

As it is often repeated in finance, trees don't grow to the sky and if something can't go on forever, it won't. This house can't say for sure when those trends will reverse but we feel confident that once they do, our Opportunities fund will once again shine and outperform, like we are used to.

Theses Update: Capri & IHS

For the thesis section of this letter, we decided to discuss not one, but the two most important components of our Opportunities fund performance so far in 2023. One positive and the other having a negative impact, but both going a long way to explain our performance this year.

The first was a core thesis we discussed through the years¹ and which finally had a happy ending this past quarter.² The second is a new thesis that has increased in importance in our portfolio since 2022, and to which we dedicated more recent space in our publications.³

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Capri

Our investment in Capri started in the third quarter of 2019, when this house first became interested in European fashion houses and how global investors were still unaware of the fact that the emergence of Asia would bring a completely new paradigm to the sector.

This macro thesis resulted in a number of investments over the years, some of which we discussed at length in this space, like Moncler.⁴

Capri was going through a rough patch: the company was until very recently known simply as Michael Kors, an American label more focused in accessories that was experiencing a decline in its brand power and success.

Under John Idol's leadership, Michael Kors became a true fashion holding company, buying the Italian high culture brand Versace and the British fashion brand Jimmy Choo while keeping their creative minds around. Even though all three brands had to face a turnaround, the path of travel seemed very straightforward to us: turn around the struggling Michael Kors brand in the US and increase access and exposure to the European brands by opening new stores in Asia, counting on the secular tailwind provided by the increasing affluence of its customers there.

This house certainly didn't have a lot of luck in the timing of this investment: we couldn't have predicted that less than six months after we first bought our stake the planet would face, for the first time in more than 70 years, a pandemic that would not only bring global economic activity to a halt, but also that all of Capri's more than 1.500 stores in every single corner of the planet and from all the three brands would have to close for several months.

¹ 1Q 2023 Letter in which we compare both our luxury investments: Capri and Moncler -

[https://8d6b179e-dfa9-4146-86f7-](https://8d6b179e-dfa9-4146-86f7-763a65725bc5.usrfiles.com/ugd/8d6b17_427ff795ca88492f8bde5f8c0ccaee44.pdf)

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Coffee & Stocks episode about Capri: <https://www.youtube.com/watch?v=jDpoIkNCOMM>

² <https://www.ft.com/content/da7c89fb-e3dd-4b2b-a66c-68bcebd0a62a>

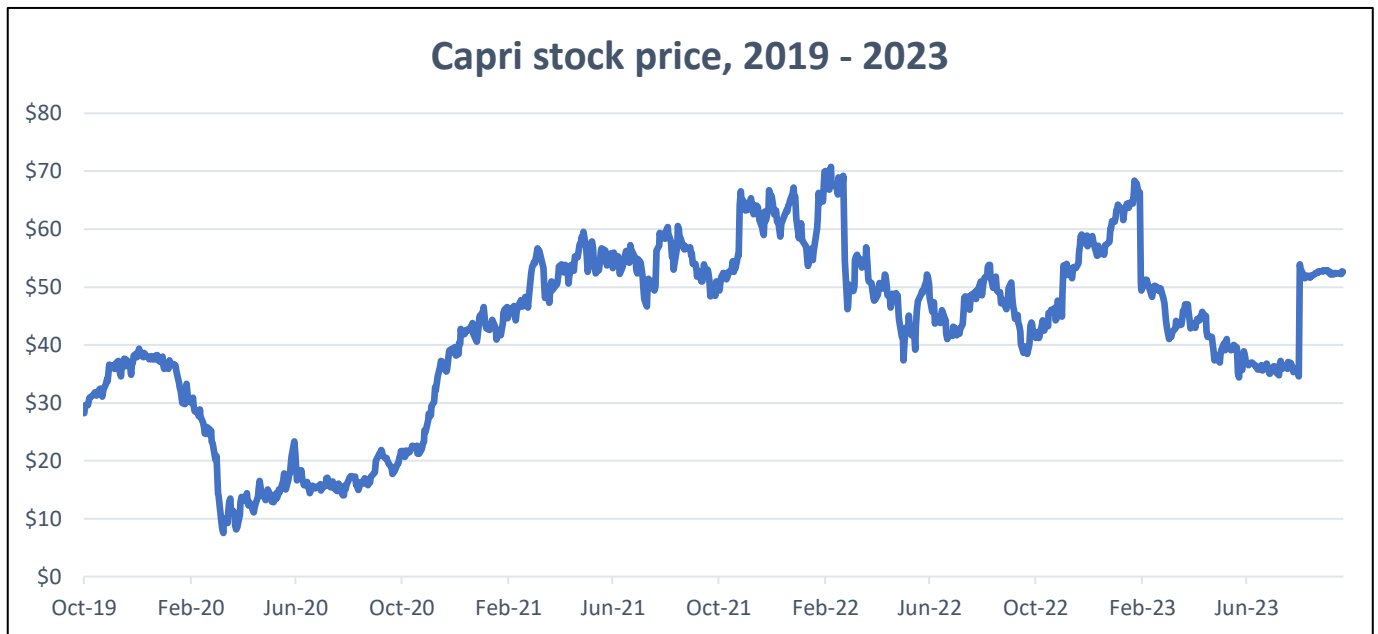
³ FCL 3Q 2022 Letter with our thesis section about IHS: https://8d6b179e-dfa9-4146-86f7-763a65725bc5.usrfiles.com/ugd/8d6b17_dd68c0832f84466594a10b3fe95feae0.pdf

FCL Podcast episode about our IHS investment:

<https://open.spotify.com/episode/4oPxnOmHg8d8QH4PP5hrZS?si=3dc2a5a4912c4b77>

⁴ Our macro thesis about European fashion houses was discussed many times in this space and most recently in FCL's official podcast, episode link:

<https://open.spotify.com/episode/6YUcgQt5D1440HLjEelMtU?si=c77e4428c78941bf>



Source: Bloomberg, FCL Capital

We had faith in the management's plan, and above all, faith in the power of its brands: in a Michael Kors turnaround and in the idea that European fashion houses like Versace were destined to conquer Asia. So, in the hardest possible moment for our thesis at the height of the pandemic, we decided to sit and wait. Sooner or later the world would reopen and the idea that animated our investment would come back and be perceived by investors.

With the benefit of hindsight, the sale of the business to its rival Tapestry Group, owner of brands like Coach and Kate Spade, might seem a bit bittersweet since Capri stock started 2023 trading at around \$64, roughly a 27% premium over the final merger price.

On the other hand, unlike the European houses that sell to the outright wealthy, Capri, and particularly Michael Kors, serve a more mass affluent niche and with the advent of a possible recession this year, those clients have been cutting or delaying some purchases, leading to a Capri profit warning earlier this year.

A second setback was John Idol's struggle to find a successor, with Michael Kors' CEO Joshua Shurman, which was being groomed as the heir apparent, leaving the group earlier this year.

These twin facts led to a negative price action in the stock this year and presumably influenced to Idol's decision to sell the business.

Since our Opportunities fund is focused on finding still relatively uncovered and obscure 21st century champions, on the day of the announcement we decided to sell our shares alongside other major shareholders instead of being part of the new group.

All in all, our FCL Opportunities fund stayed invested in Capri for exactly four years, with its shares going from around \$30 when we first bought the stock to a little over \$54 when we sold our stake, which resulted in an internal rate of return on our investment of

around 16% per year in US dollars and around 25% yearly in Brazilian real, an investment we find satisfactory.

Moreover, Capri was the main positive contributor to our fund's return in the third quarter, giving FCL Opportunities almost four points in performance.

The opposite side of this coin and our worst performance contributor was IHS, which subtracted some 3,5 points of our fund's performance in 2023.

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IHS

IHS is a position we first detailed in our 3Q 2022 Investor's Letter.⁵

To summarize very briefly the reasoning for our investment, IHS is:

- An obscure company in an obscure geography and therefore offering incredibly compelling valuation multiples that are only a fraction of the multiples that companies in the same industry enjoy in other markets;
- Positioned in a very attractive, stable and promising industry;
- A company in a leadership position in the young and exciting market of Nigeria, as well as making interesting inroads in other promising emerging markets like Brazil and South Africa;
- A company that due to its misunderstood industry offers predictable cash flows and yet global investors don't pay a premium for that.

Our investment started very auspiciously. When we first contacted management, the shareholder base was clearly frustrated. IHS had taken advantage of the frothy market conditions in 2021 to go ahead with its IPO.

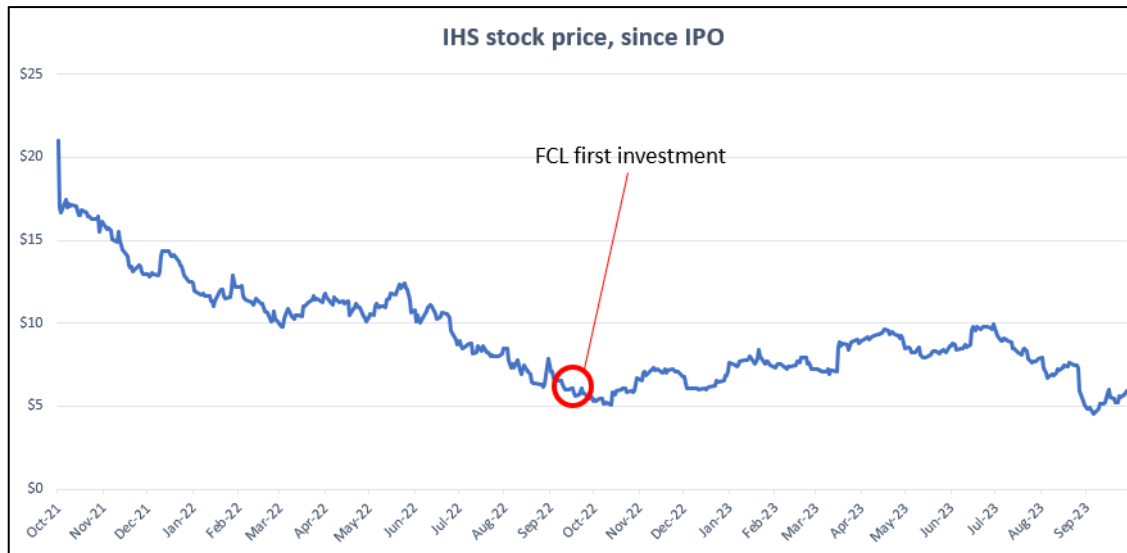
This in itself never seemed a problem to us. Since the dawn of financial markets, participants react to the incentives in place, going public mostly when the conditions are good and they know that they will get a high multiple on their business and doing the exact opposite during bear markets.

One additional problem that never bothered us: due to its concentrated shareholder base, with a few big shareholders having most of the company's equity, its daily average turnover volume sits between \$1 million and \$2 million. This fact makes IHS an uninvestable company for the big global funds that manage several billion dollars. But to this house, focused in niche companies and managing a fraction of the capital big global investors do, quite to the contrary, this seemed like a natural fit for our strategy and

⁵ https://8d6b179e-dfa9-4146-86f7-763a65725bc5.usrfiles.com/ugd/8d6b17_dd68c0832f84466594a10b3fe95feae0.pdf

undoubtedly this fact alone went a long way to explain the reason for the company's discount which seemed unfair to us.

So to sum it up, we found a company that not only was very cheap but we knew exactly why it was cheap and could buy the shares thanks to our smaller size and explore this to our advantage.



Source: Bloomberg, FCL Capital

One additional factor that boosted our confidence was how IHS itself appeared to view our firm and our investment via our FCL Opportunities fund as a natural fit. The management seemed genuinely receptive to our investment and inquiries, always very solicit and eager to engage and to listen.

Over the past year this house had countless positive interactions with IHS management, from several conference calls given by the company's management from their New York City headquarters and even at a lunch offered by the company in Rio. In all of these interactions we felt increasingly confident in the management's ability to carve a niche in the cell tower business in Africa and Latin America.

The one big setback we didn't anticipate was a governance conflict between IHS' management and its biggest shareholder and most important client, MTN, a leading African mobile network operator.

Over the past year, MTN and a few other big shareholders were showing their dissatisfaction with the IHS' plunging share price and the fact that their economic rights in the company didn't match their voting rights. This was due to a shareholder agreement signed just before the IPO to ensure a dispersed shareholder base and to guarantee that no single investor would acquire control of the company. As a result, MTN, which held 26% of the company's shares, only had a 20% voting stake in the business.

This, we were convinced, was fundamental to assure that the company would be managed with independence and that problematic conflict of interests would be avoided, since MTN, apart from being a major shareholder, is also IHS most important client.

Investor	Economic Ownership
MTN	25,5%
Wendel	22,6%
Emerging Capital Partners	11,8%
Korea Investment Corporation	6,5%
GIC Private Limited	5,4%
Sam Darwish (CEO)	4,2%

IHS biggest shareholders, source: company's SEC filings

As it became increasingly clear that a corporate movement was on the cards, we felt several possibilities were at play but overall we believed, and still do, that an independent IHS was in the shareholders best interest.

Our opinion was based on two well documented Brazilian cases: Smiles and Multiplus, that separately listed fidelity programs of the airlines Gol and Latam, respectively.

At first, investors cheered on their low capex and high ROIC prospects even though their parent companies were from the troubled airline industry. Amazingly, the fidelity companies that existed largely thanks to their parent airlines companies, became more valuable than the airline themselves. Gradually, and precisely for this reason, the temptation became far too big for Gol and Latam to expropriate the economic value of their fidelity companies. As a result, the airlines simply changed the economic terms of the relationships between them and Smiles and Multiples, severely harming both companies' shareholders.

So, to this house, an independent IHS where MTN didn't have control seemed logical and in everyone's best interest.

However, what ended up happening was at least in part even more dramatic. To continue on our previous analogy, it was as if Latam, all of a sudden, decided to prioritize Smiles over Multiplus.

In one short communication from September 8th, MTN stated that it would be transferring 2.500 network sites for which IHS provided tower services and would have their licenses renewed in late 2024 and 2025 to rival tower operator American Tower.

The share price action after the news was devastating, harming our fund's performance.

First of all, we need to put the announcement into perspective. MTN has only transferred the operation of 2.500 towers of the 16.000 or so towers managed by IHS in Nigeria. On a financial basis, those towers represent roughly 8% of IHS' aggregate revenue.

Even with this transfer, both companies are still heavily dependent on one another. Just last year, MTN sold and leased back 5.700 towers in South Africa to IHS. And finally, at

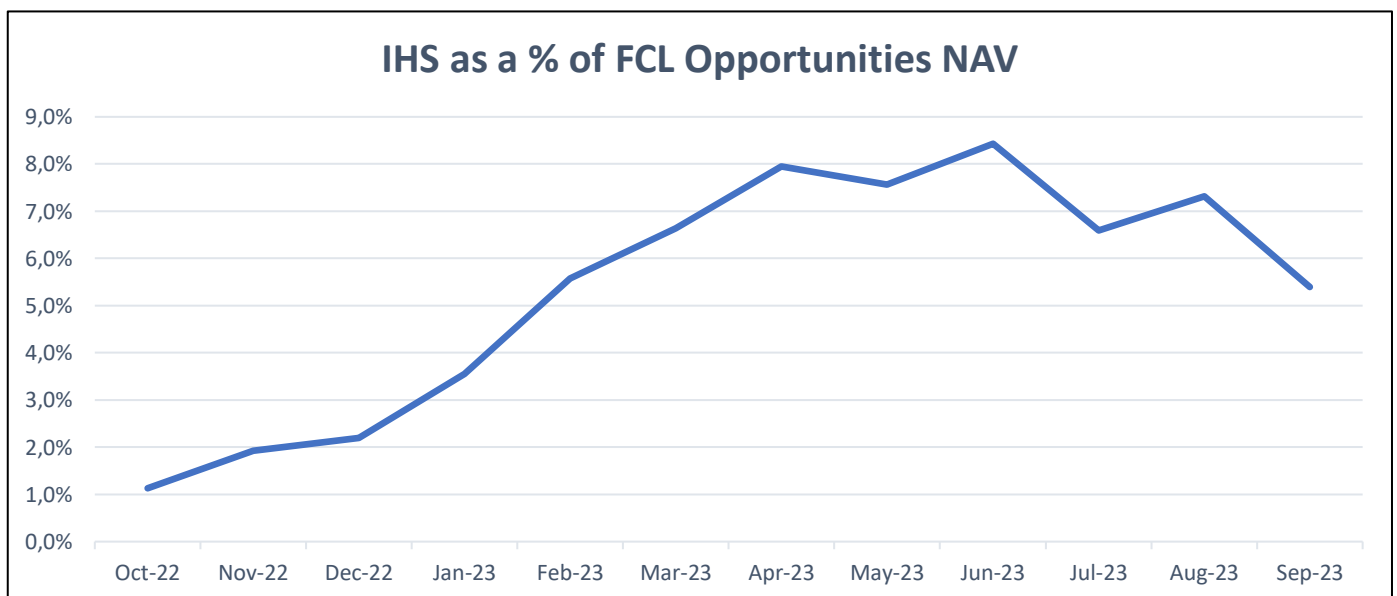
least in Nigeria, all other IHS towers leased by MTN have their agreements lasting for many more years, at least until 2029, so even if MTN wants to do further harm, it is unable to do so in the short term.

That being said, the announcement is certainly concerning, not only because MTN comprises over 60% of IHS revenues, but also because that was the first public case of a cell tower lease agreement being transferred, showing the sector might be more prone to competition than previously thought. Interestingly, the stock of Helios Tower, the closest competitor, fell in September almost as much as IHS itself, decreasing by 22%.

No doubt MTN's frustration played a big part in this. Suddenly their management seem to have become more interested in the tower business, even removing their IHS stake from their disinvestment pipeline. As a result, they appear to want a greater say in how IHS is run, especially considering the weak share price. According to IHS' management, MTN action was not rational: they are losing money switching to American Tower.

There are many uncertainties ahead. Maybe MTN just wanted to send a strong message but doesn't want to rock its whole relationship with IHS. Maybe this is just a tactic to extract better negotiating terms. Indeed, IHS CEO in a recent interview⁶ in Brazil hinted at not only that but also that he has doubts if MTN will really be able to switch to American Tower.

All in all, as this house said many times before, uncertainty is the enemy of the stock investor. We admire IHS's management, their entrepreneurial spirit and position in a promising location and a promising industry but due to the increased uncertainty and the fact that there is just so much going on behind the scenes that we are unaware of, we decided to decrease our position until we have a better understanding of all the moving parts of this investment.



Source: FCL Capital

⁶ <https://braziljournal.com/play/ihs-busca-crescimento-em-meio-a-disputa-societaria/>

We wanted to highlight our IHS investment to give our investors an ex ante *thesis rationale* for buying shares in the first place and then updating with our ex post assessment and reasoning behind the curtain as the events unfolded and our finished thesis progressed.

Obviously, there are many instances where unpredictable factors come into play. As it is often remarked, investing is a probabilistic activity.

We will keep updating our investors about our IHS stake in future letters.

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A China Update

*“These are ever changing times
I see the clock that upon the wall
Well, it don’t bother me at all
These are ever changing times”*

- Aretha Franklin in “Ever Changing Times”

It is, for better or worse, the single word this house is most associated with. And perceptions matter. After doing this self-assessment exercise countless of times with our investors, friends and colleagues, ahead of the words “Tinder” (as in “the crazy guys who invested in Tinder back in 2015”) and cemetery (“the dude who went to China and decided to buy the stock of a funeral parlor”), the word “China” is always the one people think off when they think of us.

It is not a completely unfair assessment. Since the foundation of our Opportunities fund in January 2017, China has been one of the cornerstones of our investment framework. Indeed as we exposed in our last annual FCL Day 2023⁷, China has been the top geography explaining the fund’s alpha since our inception. At a peak in early 2021 FCL’s exposure to China topped 40% of our fund’s assets and to this day it remains in double digits, at around 15%. Three of our five most profitable investments ever have taken place in that fascinating and also controversial country.

So, it is no surprise that every time our investors read some scary news story or that colleagues in the financial industry want to discuss the country, they ask for our assessment.

This letter will be an attempt to update and contextualize our ever evolving vision about this country that remains fundamental for our Opportunities fund long term success.

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⁷ https://www.fclcapital.com/files/ugd/8d6b17_ce6c20ff4b8542fc8985f83f6195342c.pdf , slide 29.

China's dazzling economic growth over the past four decades is nothing short of impressive, even miraculous. Indeed, there is no other episode in human history of so many people being lifted out of poverty in such a short time. From a miserable country in the 1980s China rose to become the world's second largest economy (well, actually the first, but more on that later).

Having said that, the current consensus about China is very straightforward. While it acknowledges that China's undeniable economic success is commendable and even puzzling given its dictatorial regime, it also believes that this impressive and unprecedented cycle of growth has finally come to an end due to:

- An overleveraged economy that, thanks to its Marxist roots, had its economic model and incentives putting too much priority in investments, especially unproductive ones, while too little emphasis was put on consumption;⁸
- A real estate crisis that was long coming and finally exploded in 2021. Presumably putting to rest China's economic model heavily dependent on investment and exposing the illusion of its stratospheric growth;
- China's recent aggressive rhetoric and measures: be it at home with its unpredictable policy making, including its "common prosperity" campaign and recent turn towards a more statist, national security driven model or abroad with its "wolf warrior diplomacy" and trade wars coupled with geopolitical antagonization launched by the US and, to a lesser extent, its European allies.

Considering those factors, so goes the consensus, the country's stock markets historically depressed valuations are not only deserved, but even more than that, China is uninvestable and should be avoided no matter the price since we are, after all, dealing with a totally unpredictable environment.

That would be a summary that we think sums up the major points of China bears. And they are many.

Let's now take each one of those arguments and expose our vision.

But first, let's discuss why China is so unique and special.

Below are two tables: the 10 richest countries on Earth on a GDP per capita basis and the 10 countries with the largest populations.

⁸ <https://carnegieendowment.org/chinafinancialmarkets/89466>

Country	GDP per capita in USD, 2022
Luxembourg	127.046
Norway	106.594
Ireland	105.362
Switzerland	92.410
Qatar	88.046
Singapore	78.115
United States	75.269
Iceland	74.663
Denmark	67.220
Australia	64.003

Country	Population, 2023
India	1.428.627.663
China	1.425.671.352
United States	339.996.563
Indonesia	277.534.122
Pakistan	240.485.658
Nigeria	223.804.632
Brazil	216.422.446
Bangladesh	172.954.319
Russia	144.444.359
Mexico	128.455.567

Source: Worldometers, FCL Capital

Note that, in spite of the fact that people say all the time that “The United States is the richest nation in the history of the world” that’s not really true. There are countries where the population is on average richer than the US, like Norway, Singapore and Switzerland, all amazing nations for sure, and probably some of the best places to live by most measures. But they are all “boutique” countries, meaning that while they offer a very high quality of life and standard of living to its citizens, they are not very relevant to the global economy due to their small size.

At the same time, obviously, there are larger countries population wise, than the USA, like China and India.

What has always made the US so unique and consequently responsible for more than a third of global GDP at its peak, is the combination of being a very large country while at the same time being a very rich country. One of the richest AND one of the largest.

Obviously, we are oversimplifying: there are incredible and unique strengths in the US model. To give a cursory example, anyone that has worked in finance even for a day can witness how far ahead its financial system is from the rest of the world, how its companies as a group have unmatched technological leadership, and so forth. It is a unique place and will remain so. But still, GDP is a number’s game. It is simply the size of a population times its per capita GDP (how much its citizens produce in a year).

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Everyone knows that it is extremely hard to transition from an underdeveloped economy to a rich one. The 20th century is full of countries that were able to escape complete poverty, but once its GDP per capita reached something close to 10.000 USD they stagnate and fail to fully develop. The reason for that is because going from, say, \$1.000 to \$10.000 GDP per capita basically means moving people from farms to cities (even if many live in precarious conditions in those cities), and also developing basic industries and infrastructure.

On the other hand, moving from middle income prosperity levels, such as Brazil currently, to levels closer to the US (or realistically, at least half of US levels, which is already enough to grant a country its place among the rich economies) is more about educating its workforce, having innovative companies, having a predictable and efficient economic and legal system, low levels of corruption and high levels of security, a system of efficiency instead of patronage, etc.

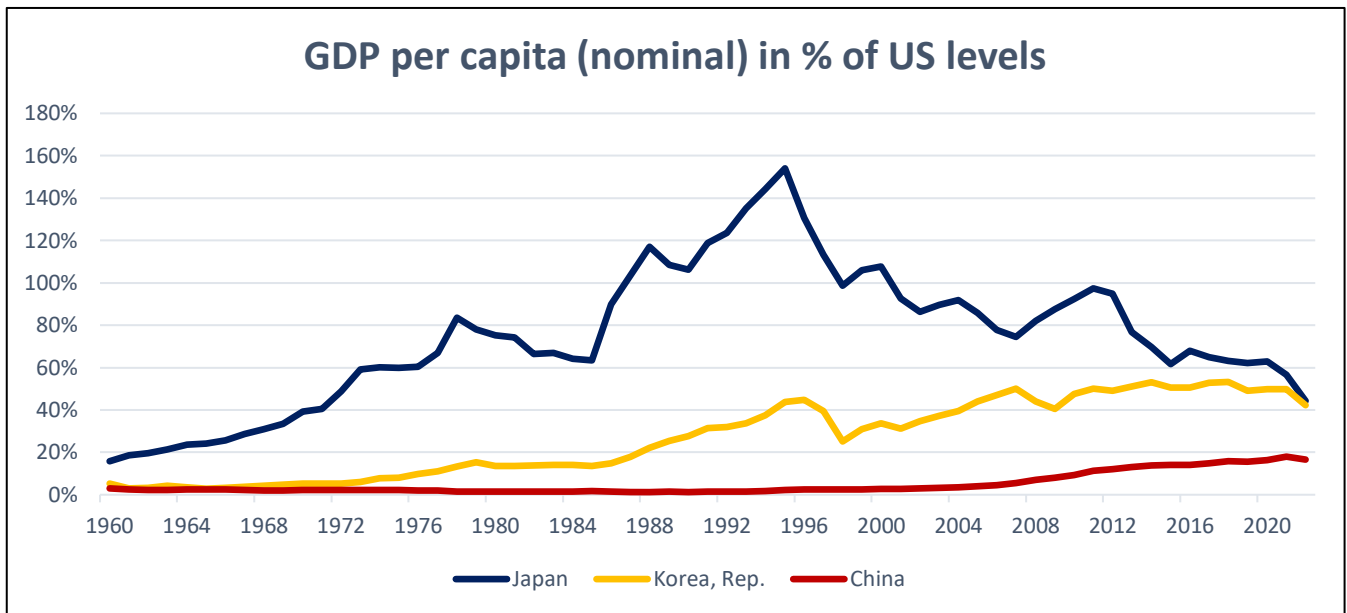
In the past 100 years only one region on Earth saw a large part of its population rise from extreme levels of poverty to levels close to the US per capita income: first with the Japanese miracle and then with the four “Asian Tigers” of South Korea, Hong Kong, Singapore and Taiwan. This region is East Asia.



East Asia: what's so special about this place?

But we still haven't mentioned, of course, the biggest piece of the puzzle. China is alone home to almost one in five people on the planet. Any transformation it is incurring is way more consequential for mankind than any other economic event in our lifetimes.

Now let's compare different Asian economies in its transition to developed level.



Source: datacatalog.worldbank.org , FCL Capital

Note that, at first glance, there is nothing unusual about China's economic rise when compared to its east Asian peers, except for the fact that being home to a fifth of humanity makes its transition a lot more consequential to the rest of the world.

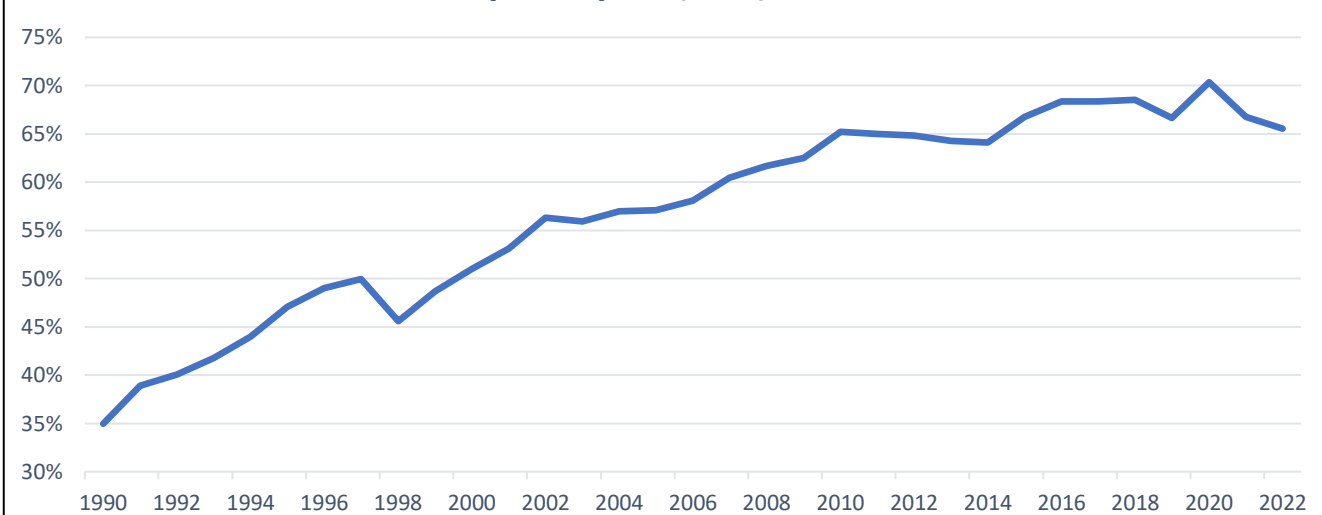
Also, unlike when it comes to say, Japan, the western press is fixated on China. Not a single day goes by without a new "end of China's miracle" story. There is some truth in all of those writings, but let's take the long term perspective.

To stay in one example, let's discuss Korea: the country, which nowadays has GDP per capita levels approaching the United States, entered the 1980s with a severe (and long forgotten) recession that decimated its balance of payments and, combined with an internal drought, made its GDP fall more than 4% in 1982 (a level that would be enough for current commentators to declare the end of China as a country if it occurred today).⁹

After that, and steadily marching in its progress, Korea faced a number of other crisis, including most famously the Asian Financial Crisis of 1997. But since Korea possessed the attributes listed above, it was able to progress towards developed level status and nowadays it has more than 70% of US GDP per capital levels in PPP.

⁹ <https://www.elibrary.imf.org/display/book/9780939934515/C3.xml>

Korea - GDP per capita (PPP) in % of US levels



Source: datacatalog.worldbank.org , FCL Capital

Now, there are certainly many problems in China's current economic model. Its real estate led investment model and current real estate crisis, in particular, should subtract something like a couple of percentage growth points from its GDP for at least the next two years. Add to that an erratic and dictatorial ruling party, depressed consumer sentiment, and more, there are certainly many challenges ahead.

But we only know about those challenges because they exist in China. Every emerging market at this level of development faces similar if not more insurmountable challenges, it is just that not that many people care. When Korea's GDP fell 4% in 1982 no one rushed to say (with thinly disguised pleasure) that its "growth miracle was over". Korea simply didn't matter that much to anyone. The importance of China naturally makes the country a lot more dissected and discussed than any other country at its development stage.

China is a paradox. On one hand an incipient, still relatively poor, unstable and developing emerging market and at the same time the most important economy on Earth alongside the United States.

So let's enumerate a few of the reasons we think China might advance towards developed level. But first, some basic math: China's population is roughly four times the US population. Therefore, mathematically speaking, if China's GDP per capita reaches 25% of US levels, both economies will have the same size.

Country	% of US GDP per capita (PPP)
China	28%
Brazil	23%
Poland	57%
Portugal	54%
Germany	83%
Switzerland	109%

Source: datacatalog.worldbank.org , FCL Capital

Now back to the original question. No one thinks that China will reach US levels of GDP per capita this century, like Switzerland and Singapore have. There are many reasons for that. But China is home to more than 20% of the world's patents. Its companies dominate cutting edge industries like electric vehicles and batteries, solar panels, online e-commerce and more. Its stock exchanges, including Hong Kong, form the world's second largest capitalization after the US.¹⁰

We could go on. But the point is, while no one thinks China will reach US levels of prosperity, does anyone seriously think that, having gone from 2% of US levels to 28% in the past four decades, the country's development has just suddenly and magically stopped in the last few years? While 28% sounds impressive, this is still half the level currently enjoyed by Poland or Portugal, and just enough to give China the 76th place in the world!¹¹

Does anyone seriously think that a country with such huge strengths as China will never reach Portugal or Poland levels of development? Is it really so impossible to conceive that, after going from 2% to 28%, China is incapable to perform one more double to 56% of US per capita levels in the next few decades?

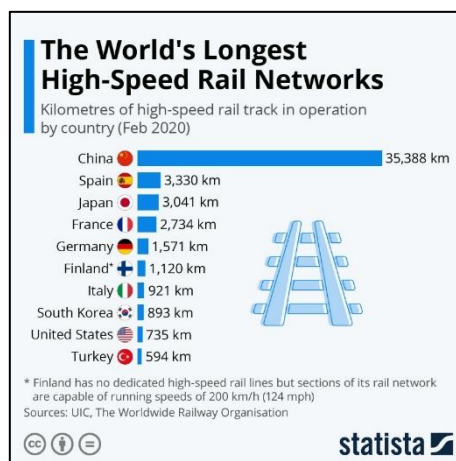
Or, to explore a different possibility, is it just something that, deep down, people are hoping won't happen?

Patent Applications by Country, 2021	
China	1.585.663
United States	591.473
Japan	289.200
South Korea	237.998
India	61.573
Germany	58.569
Canada	37.155
Australia	32.409

Source: World Intellectual Property Organization, FCL Capital

Skyscrapers (200m+) by Country	
China	1.048
United States	236
UAE	146
South Korea	79
Malaysia	59
Australia	57
Japan	48
Canada	37

Source: CTBUH, FCL Capital



¹⁰ Incredibly, even with this fact, Chinese stocks are increasingly shunned and sometimes openly boycotted by western fund managers when they should be seen as one huge source of alpha and diversification.

¹¹ <https://www.ft.com/content/8a7fb1d5-bb3a-48b7-aa72-1c522fd21063>

This house simply has never encountered a serious argument stating why it can't happen. So far we've only seen short term obstacles dressed as long term unsurmountable challenges. As always in the financial industry, people extrapolate the present.

And quite frankly, we've also seen a lot of inexplicable thinly disguised cheers for China to crash and stop developing. We partly understand why. A new world order is always frightening and one is surely coming because simple math tells us that when China reaches 50% of US levels of GDP per capita, which it will, its economy will be larger than the US and Europe combined. Times are indeed changing.

All of this is not to say this house is not monitoring China's current set of challenges with attention.

The past two years have been particularly busy, with the so called "common prosperity" campaign that had the apparent goal of "putting tech entrepreneurs back in line". China's government is not only a control freak, it is also incredibly expansive and totalitarian: it intervenes in whichever sphere of life it dislikes, from the fact that people are playing too much videogame or worshipping some boy band with too much adoration. It is after all a paranoid and jealous government. A king that doesn't like when a servant is shining too much or is too outspoken, like Jack Ma suddenly found out.

But again, all emerging markets face challenges. Some are plagued by currency crisis (Nigeria, Argentina). Some by hyperinflation. Some by frequent coups (just ask Mali). China, the largest emerging market, has a lot more strengths in it than any of those countries. Granted, it is certainly not Switzerland, but it will keep developing because its advantages are huge.

For stock pickers like this house, advantages of scale are always something that fascinates us because they create real moats and unbeatable companies. If unparalleled scale in the US in the 20th century helped create the likes of Walmart, Starbucks, Disney and other formidable companies, incredible scale in China in the 21st century is also helping the country to create global champions, like Alibaba, Anta, BYD, and so many others.

PPP Vs Nominal GDP

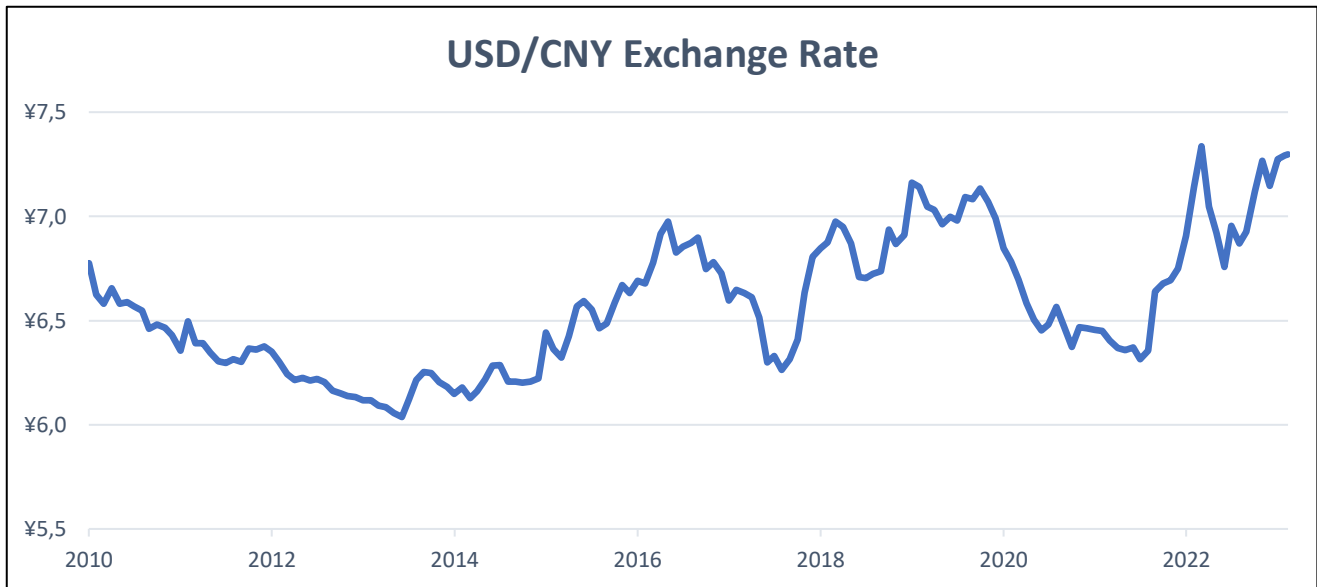
One important aspect of the so called "rivalry"¹² between China and the United States is the fact that, as we read every single day in financial media, China is "the second largest economy in the world".

Actually it is a little more complicated than that. There are two ways to measure GDP. The first and most famous is very straightforward: you simply calculate the total of goods produced in a given year in an economy and translate that to US dollars using the current exchange rate. China economy is currently around \$18 trillion against the \$24 trillion of the US economy.

But every serious economist have long known that poorer countries have lower prices than rich ones. A haircut in Beijing is a fraction of the price of the same service in New

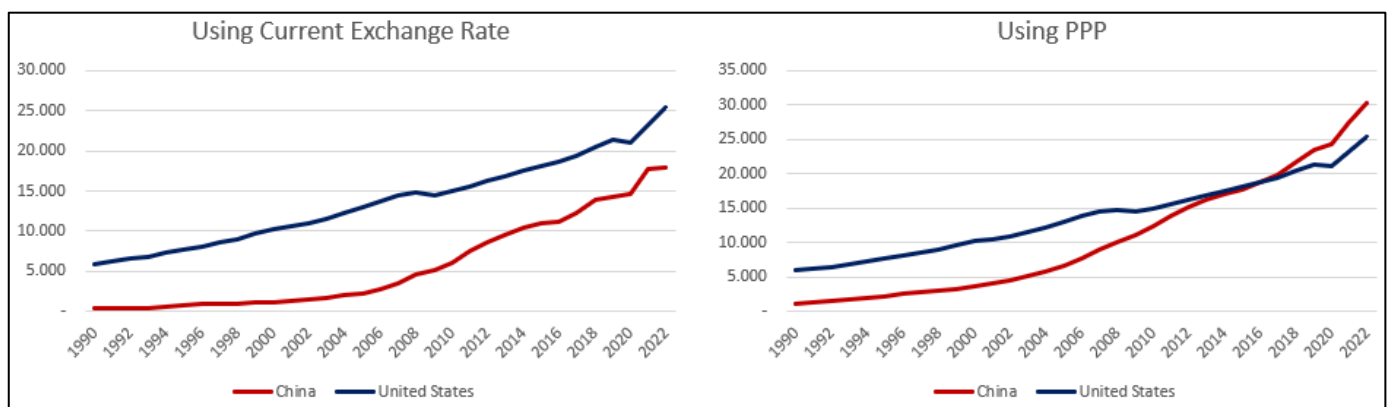
¹² We reject the term and see global commerce and finance as a win-win proposition.

York City even after accounting for quality differences. Furthermore, differences in prices and currencies make the series problematic. If you really want to compare different national economies or even the same economy across very different periods, the most recommended method is called the purchase power parity, which takes different price levels for the same products or services into account. By this measure, since at least 2016, China's economy is the largest in the world. The US advantage relies on an increasingly overvalued dollar that makes its goods more expensive when translated into other currencies.



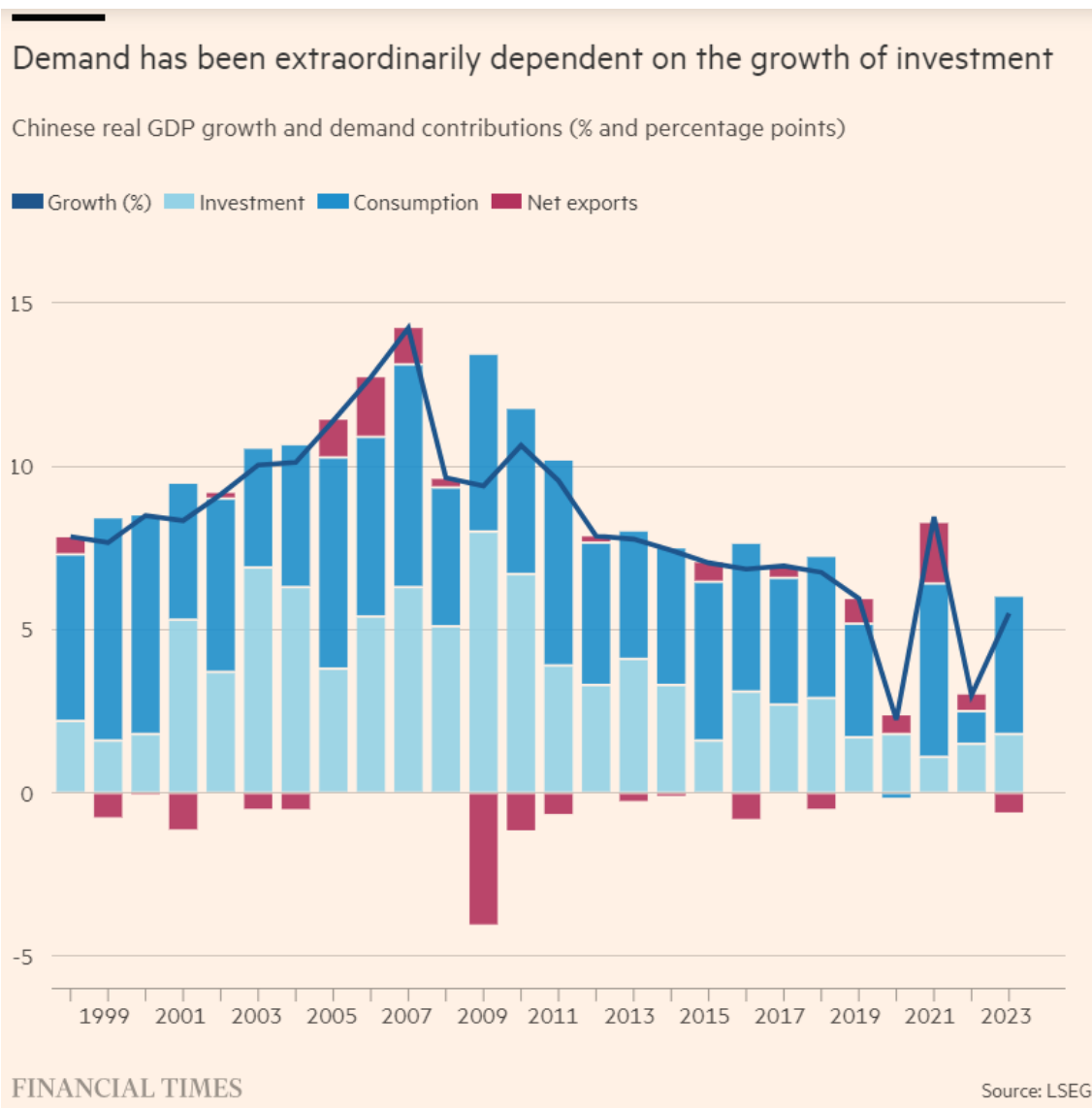
Source: Bloomberg, FCL Capital

GDP Comparison, in billions USD:



Source: datacatalog.worldbank.org , FCL Capital

The Future



Source: <https://www.ft.com/content/8a7fb1d5-bb3a-48b7-aa72-1c522fd21063>

Make no mistake: China faces real and complex challenges ahead. Its real estate crisis, geopolitical situation and economic model that relies on increasingly unproductive investments instead of consumption.

But above all, we think the so called “rivalry” is silly. Both China and the US are fundamental for the global economy and will continue to be for decades to come. None will disappear. And at the end of the day, the question of China becoming 95% of US GDP in ten years or, say, 110% is irrelevant. It is a global growth engine. Many of the planet’s best companies, which increasingly have no direct competitor in the West, call the country home.

To this house, avoiding, not trying to understand and navigate or, even worse, as it is increasingly common the US, outright boycotting China’s market and its investment possibilities reveals not only a distorted sense of patriotism but also total silliness.

The current depressed valuations in China are just like every other positive or negative hysteria. At first the movement happens for sound reasons, has some justifications, just remember the dot com boom with its truly amazing internet companies. The sudden change of economic direction seen in China after Covid indeed turned the country more unpredictable, and a discount was probably warranted. But China's stock markets are now full of opportunities with incredible companies valued as if they were going to disappear.

The fact is, investors are extrapolating ad infinitum many of the current problems China faces such as a more statist policymaking, a hostile geopolitical environment and the real estate crisis.

Make no mistake, there is an active movement of boycott against China and the reasons for this "industry" are manifold: From opportunistic politicians using the oldest trick in their toolbox to rally and scare the population against a foreign enemy, to lobbyists seeking to defend struggling US companies against more efficient Chinese competitors (just think of Facebook x TikTok or Tesla x BYD) and many others. The China hate industry unfortunately thrives.

Ironically, we disagree with the assessment of "China experts" in financial media, most of whom never even bothered to set foot in the country, when they mention their first reason for why a "China Armageddon" is an inevitability: demographic decline.

True, China's population will decrease slightly from now, from 1,4 billion people to some 1.3 billion by 2050. Its working age population will decrease faster although more slowly than in Japan, Korea and some other countries.

But people forget that China is still urbanizing. Its rate of urbanization is currently around 64%, growing roughly one percentage point per year for the past three decades and should only reach 90% around 2050. And what truly matters in terms of economic output is not total population, but active urban population since an urban worker produces several times more output in some cases than a rural worker. So China's urban population will keep growing even if its total population decreases.

The government can help this process if it enacts bold reforms, most urgently a modernization of its "hukou" system, which specifies the place where residents can access basic public services. Unlike most other countries, at least formally, it is hard for the average Chinese to migrate from the countryside to the most productive cities, although this is slowly changing.

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A Berkshire spat?

It is no secret that Charlie Munger is among the people this house admires the most. He's the other half of the formidable Berkshire Hathaway's duo and will become a centenarian next January.

Munger, unlike his partner, has always been a little more varied in his interests and his perspective a little more daring, a person a little less preoccupied with public perceptions about him. Over the decades the duo's unmatched investment record speaks for itself. But for seasoned Berkshire observers very subtle differences can be seen between them from time to time.

The pair made several trips to China, but unlike Buffett, Munger was personally influenced by his acquaintance of Chinese fund manager Li Lu, who is credited for helping him open his eyes to the China opportunity.¹³

As it is publicly known, Munger is not only an investor in Li Lu's fund, but the Chinese manager was the person responsible for presenting Munger the opportunity of investing in a then unknown battery maker called BYD back in 2008. He even arranged a meeting between Munger and BYD's founder Wang Chuanfu.

Berkshire would subsequently buy a significant stake in BYD and is still an investor to this day. Munger once reportedly said that BYD was "the best thing he ever did for Berkshire".

¹³ <https://www.reuters.com/article/us-dailyjournal-munger/charlie-munger-targets-active-managers-elon-musk-praises-china-idUSKCN1Q32V7>



Wang Chuanfu showing Buffet, Munger, and Bill Gates around a BYD factory in China, 2010

Fifteen years later this house bought for the first time a small stake in the same BYD for our FCL Opportunities fund. But that will be a story for another day.

In what is perhaps the closest this amazing duo has gotten to a public difference of opinions, Munger has been actively praising China. Asked recently about why he invests in the country, he replied flatly that “China’s companies are better and can be acquired at a cheaper price”.¹⁴

At the age of 99, Munger clearly shares this house’s vision that China will be a fundamental economic pillar of the 21st century and there is really nothing anyone can do about it, so better to join the opportunity. Buffet on the other hand, who sold some shares Berkshire held in BYD and in Taiwan’s TSMC this year, said he currently “doesn’t like the geography”, probably alluding to the possibility of conflict between the US and China in the future, but maybe also giving a nod to some of the current movement in the US that preaches China as an adversary, not an investment opportunity.

This house has never wavered from the facts about China. It is an emerging market, a difficult investment geography that is guaranteed to bring countless sleepless nights for anyone that invests in its public and private markets. But it is also a source of almost a fifth of global GDP and patents, home to many of the planet’s most amazing companies and the global economy major source of growth.

From European luxury goods makers to American sports manufacturers, to Apple and Tesla and more, many companies whole business models would be whipped out if there were no China. Like every good question, there is not really black and white but only

¹⁴ <https://www.youtube.com/watch?v=X75HkBZm6Po>

shades of gray as an answer and people tend to passionately gravitate to the extremes when discussing China.

Like every polarizing figure, the country will continue to stir passions and prejudice. And as the global investors community bifurcates in two camps regarding China we wanted this letter to be a loud and clear message to our investors about which camp this house stands on.