Report
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The Offer and the Aroma

A major event took place on July 17th last year: Sadia publicly announced its intention of making a public offer to acquire total shares of Perdigão, its main competitor in the production and processing of animal protein based foods. The proposed cash offer of R$27,88 to Perdigão shareholders represented a 35% premium over the stock price previous 30 trading days. Despite recurring rumors of potential changes in the control of both companies, the initial reaction of the market to the announcement was one of surprise and some perplexity. After all, it represented a pioneer transaction in the recent history of our capital markets. One in which a possible change of control would occur in the market, with no private premium, via a public offer by which all target shareholders would receive rigorously identical treatment, in line with Novo Mercado rules.

In the midst of a successful cycle of IPOs, favorable liquidity, soaring share prices, and a growing voluntary compliance by new companies with *Bovespa* best corporate governance standards, the possibility of a change of control in the market was positively perceived as good news in a time of change. It also brought in expectations of the end of a period of exorbitant private control premiums, a symptom of a market outdated in rules and tolerant in behavior.

But the time had not yet come. Just four days after the announcement, followed by a second attempt at a 4% higher price, Sadia management decided to definitively revoke the public offer, allegedly because the Perdigão controlling shareholders repeatedly rejected their proposals.

The fading outcome of this episode shortened its media exposure, but did not discourage us from remain thinking conceptually on its motivations, conditioning factors, and potential implications. Now that six months have elapsed, with the added benefit of the delay in publishing this letter, we took the decision to write about this topic, whose importance for our capital market transcends the specific merit of the offer.

The Corporate Control Market

In a market overwhelmingly dominated by a concentrated ownership structure, the possibility of a change of control via a public offer to all shareholders evokes enthusiasm among all parties involved. This is because, as a rule, attempts to buy corporate controls via public offerings, widely known as *takeovers,* are associated with the presence of underlying conditions that suggest greater maturity in a capital market and, consequently, more fairly priced shares.

Prices closer to companies´ fair values generally imply a more favor-

Our Performance

During this third quarter, Dynamo Cougar's quotas appreciated 6.2%, while *Ibovespa* recorded a negative result of 0.5% and *IBX* increased by 0.1%. During the year, the Fund accumulated a nominal gain of 16.4%, *Ibovespa* 8.9% and *IBX* 10.6%. Over the last ten years, Dynamo Cougar generated return of 22.4% *per annum* in dollar terms and 20.0% over Brazilian inflation (*IGP-M*). During this same period, *Ibovespa* appreciated 10.3% and 8.1% *per annum* and *IBX* 15.0% and 12.7% *per annum*, respectively over the same measures of US dollar and local inflation.

The Fund performed well during the quarter thanks to the satisfactory performance of some of its important positions, particularly Arcelor. Going beyond a technical discussion of the Mittal control change/public offering, the operating prospects of this sector remain positive, most especially in the case of this particular company. Among the intermediary positions that presented strong performance in the quarter, we highlight Porto Seguro (21.9%), Vivax (16.3%), and Fertibrás (41.2%), the latter motivated by its controllers' intention to make a public offering to go private. On the negative side, Pão de Açúcar was the main drop (-16.9%). Analysts keep on valuing the company based on its monthly sales performance, which brings high volatility over share prices. In fact, the impact of the changes that we expect in the company's operations will be longer-term than hitherto believed, and is not yet accurately reflected in the quarterly operating results. On the contrary, only the initial costs in this process have been shown in the latest financial statements. Thus, given the current valuation, we believe that the effect of these changes will be positive in the medium term.

We continually to marginally increase Dynamo Cougar exposure to the electric utilities and power sectors, and today have four different positions. Our view is that these companies show a low risk business performance, and should generate stable and high operating free cash flows, reinforced by a reduction in the payment of its debt services, due to a decreasing interest rate environment. Two basic concepts support this theory: i) In the power generation sector, we see that the rising price curve deriving from an increasingly tight supply scenario, has not yet been fully reflected in the valuation of some companies. ii) In the distribution sector, we identify an improvement in the regulatory environment, particularly with the recovery of past losses and a more benevolent perception of the next cycle of tariff revisions. This complex topic merits more detailed description. Since we are still in the process of adjusting these positions, we prefer to postpone specific comments on these companies to a future occasion.

able institutional environment. Change of control transactions, involving companies with a dispersed ownership structure, suggest a permanent possibility of arbitration. In other words, if someone believes that under his or her management, the company could attain superior results than those reflected by the current share price, this individual will strive to reach a position that assures him (her) the power over corporate decisions. If the new management is able to deliver the results planned, the company share price will rise and all shareholders will benefit from the successful change. If the new management fails, the possibility for a third entrepreneur to try his own chance is kept open. The mere possibility of a market change of control beckons a free way to the good functioning of the price system, installing a permanent mechanism of arbitrage, the vital signal of the dynamic capitalist resources allocation system.

As it is well-known, the activity of market change of control requires the presence of dispersed ownership structures. Ownership is deemed dispersed when each shareholder individually represents a reduced portion of a company's capital[1]. Under a concentrated ownership system, a single shareholder or small group of shareholders holds a significant stake of the capital of companies. Such participation translates into power to influence corporate decisions. In turn, the effective exercise of this power corroborates and characterizes the presence of a concentrated ownership system.

What is interesting here is that, in the case of companies with widely held ownership, there is a real possibility that control can be acquired via a public offering to all shareholders. In such event, if the offering is well received, the acquirer is able to purchase a substantial percentage of the asset total capital, thereby achieving sufficient representativity to gain the majority of the board of directors and, thus, run the company's business.

The idea that the control of a company is available in the market, that it can be freely achieved by any potential agent, and that it is no longer locked in the traditional control block, challenges our most deep-rooted practices. And this is precisely why it attracts interest and controversy over the topic. Moreover, the reality of companies with widely held ownership brings with it some new implications, both conceptual and practical.

The first of these relates to the value of shares. As a rule, a system of concentrated ownership imposes value differentials among shareholders. Common shareholders that are part of the control block, common minority shareholders and preferred shareholders have differentiated status in the event of a change in control. Everything else being equal, market prices tend to reflect this caste system, imposing a discount proportionally to the mathematical expectations of the participation of each shareholder in the control premium. On the other hand, under a widespread control system with common shares only, all shares become absolutely identical in the manner in which they take part in the gain deriving from a future change of control. In these circumstances, the control premium is said to be dispersed in the market. And here, share prices in reality and legally tend to reflect each stockholder's stake into the total value of the company. At the same time, they capture instantly any expectations of a management possible turnaround. A corollary is that, under this more equitable and democrat-

(1) *The simplicity of this definition allows for some flexibility in defining the limits of dispersion. Several limits are acceptable. For example, LaPorta et alli, (1988), classify as widespread a dispersion whereby the three major shareholders do not own more than 20% of capital. As always, full references can be found in our website: www.dynamo.com.br-biblioteca.*

ic regime of distribution of value, market prices tend to reflect – as more accurately and efficient the market is - the intrinsic value of the share.

The second result is that the performance of management begins to be followed by a larger number of market participants. A badly managed company will attract new 'owners', who can come aboard at any time via the market and, with them, as a general rule, another team of managers. In an active market for corporate control, sleepy managers will be less protected or entrenched.

The third lesson learned here is that share prices must be taken into account with more care. If a public offering is the gateway for new controllers, the share price is the entrance ticket. If the company is well priced in the market, the higher the toll, and the lesser the incentive for any potential acquirer. On the contrary, in the absence of genuine capital market interest from the management in place, the trend is for the shares to be negotiated at a discount, thereby opening room for external arbitration, which places executive tenures at risk. Accordingly, market prices set to external competitors the level to which the bar must be leaped over; prices act as thermometers monitoring the company's external level of immunity. Given the direct relationship between quality of management and share prices, under a widely held control system available in the market, the role of market prices is that of permanent evaluators of executives and, consequently, as agents of discipline, balancing the interests of executives and that of shareholders alertness to capital market signals. In this same context, when these agendas do not converge, the personal resistance of some executives and of shareholders connected to them to potential takeover threats is more than understandable.

However, what is regarded as unprecedented in our market is commonplace for other investors. At this time, we should recover some historic appointments, and recall discussions, experiences, and results of the long-standing and intense takeover activity in the US market. Despite time and space differences, they can still teach us a lesson or two or, at least, illustrate a few matters.

Takeovers – Causes and Consequences

The eighties were notable for intense conflict in corporate America. Estimates for 1976 to 1994 reveal close to 45 thousand control changes in the market, including mergers, public offerings, divestments, and LBOs (leveraged buy-outs), amounting US$3.3 trillion. Close to 30% of the total US manufacturing sector was sold between 1976 and 1987 and 143 (28%) Fortune 500 companies in 1980 had new controllers in 1989[2]. This period became known as the *takeover era*.

A number of differing factors converged to explain this sizeable movement of physical and financial assets. The backdrop was one by which the huge conglomerates founded in the sixties and seventies showed symptoms of fatigue. A huge volume of resources generated in mature and protected businesses were being squandered in exploits totally alien to these organizations' core activities, thereby depleting value. The new competitive environment marked by deregulation, wider exposure to the global market, and major alterations in costs and demands standards, required changes in capital structure, management techniques and in the corporate organization matrix of these large groups.

Also, at this time, antitrust legislation began relaxing its merger and acquisition restrictions. Several industries, such as petroleum and gas, transportation, broadcasting, and, mainly, financial services, experienced lower entry obstacles and a wider exposure to competition, leading to increased capital mobility. The rapidly developing technology related to acquisitions given the great increase in the availability of specialized human capital (financial and legal) and, particularly, the rise of financial products meeting these new requirements. Chief among these were riskier debt securities, paying higher rates, which became known as *junk bonds*[3].

The reasons for the appearance of takeovers are more widely understood and clearly defined, but their consequences defeated any consensus. Since inception, controversy has been present in the debate of the effects of takeovers over corporate performance and over the production of wealth and welfare.

Critics have mustered a host of arguments against the efficacy of the market for corporate control:

i) It has produced neither economic wealth nor social welfare. The high premiums paid on acquisitions have generated gains for seller shareholders but have added no value for buyers. In some cases, transactions were merely transfers of labor resources (restructuring, downsizing, sale of assets) to financial or speculative capital (selling shareholders, LBO companies);

ii) The movement resulted in an unfavorable environment for the compa-

(2) *Data from Jensen (2000). (Full references can be found in our website: dynamo.com.br-biblioteca).*

(3) *Junk bonds are widely perceived as being the prime fuel of takeover movements. This term junk is derogatory. In fact, they are low rating securities with no investment grade. Their creator, Michael Milken, used to describe them as securitized loan or a preferred stock with fixed dividend. In 1988, the junk bond market increased to approximately U$200 billion. However, only 22% of this total was applied to acquisitions and only 3% to hostile offers. 77% of the junk bonds issued between 1980 and 1986 were utilized in internal investment programs, mainly in fast growing industries such as cable TV, Telecom, healthcare, and construction (cf. Scott 2000).*

nies by forcing their executives to assume a defensive and shortsighted position, an example being the reduction of P&D expenses, detrimental to the companies' long-term goals;

iii) It only worked thanks to excessively high acquisition prices, provoked by arrogant and over-confident executives (*hubris hypothesis*), levered by excess debt availability with no commitment to adding value to shareholders;

iv) It was basically driven by tax gains to be exploited by the buyers, with no corresponding real economic value;

v) It was allowed only by asymmetrical information and imperfections that prevail in capital markets, which tends to not access correctly the true value of companies, opening room for arbitrage opportunities (Stein 1988).

Discussions of the takeover activity in US press gained an acid mood. The media regarded the movement as no more than a huge game of theft purely in the interests of greedy financiers, to the detriment of laborers effort[4].

So multifaceted is this topic that not even Warren Buffet escaped unscathed. In 1985, in a series of takeover and corporate control debates organized by the Columbia Law School 1985, Buffet revealed his concern: "I have puzzled over this subject for a long time. And the more I puzzled and observed, the less satisfactory all the usual answers seem"[5]. At the time, Buffet expressed his concern at the adverse selection caused by the excess of liquidity generated by the acquisitions market. And this was the reason for his own conflicting views: in his role as CEO, he accepts the market's flaws and that even competently run companies can sometimes be negotiated at less than fair value, thereby generating an arbitration opportunity for 'megalomaniac' buyers pressured by huge leverage and occasionally lacking in managerial credentials or ethics. Here, Buffet suggests the need for some regulation to combat abuse. Despite the fact that twenty years have elapsed, the relevance of this discussion persists, and is part of a catalogue of defenses that certain executives marshal to convince their shareholders to reject third party offers.

On the other hand, as an investor, Buffet refuses to relinquish his right to the last word on the decision on whether or not to sell his investments. On recalling his first equity market experience, aged only eleven, when he bought his first three Cities Service shares, Buffet felt that "if anybody wanted to buy that company, they should come to me". Since then, he has reiterated his belief that the decision to sell should be exclusively that of the shareholders and not of the executives: "The hired hands were to run the operations but not to make ownership decisions. Their personal equation (managers) is simply far different from that of the owners. If they can keep the keys to the store, they usually will". He concluded that "when I get all through, my heart belongs to the shareholders; I come down with the shareholders, but I would like to figure out ways to attack those problems that I´ve talked about".

With the benefit of hindsight and the support of considerable empirical evidence, it takes a significant rhetorical effort of very special circumventing conditions to regard takeovers as negative[6]. Jensen (2000) estimates that the movement has generated a net wealth for these companies' shareholders of almost US$900 billion, and that this return did not accrue at the expense of the other stakeholders. The capital market had aided in promoting the necessary adjustment in the companies' production capacity, thereby eliminating the excess supply in US industry. The evidence of value creation and increased microeconomic efficiency are borne out by the aggregate data pointing to a substantial improvement in wealth and growth of the American industry productivity during the eighties[7]. Junk bonds enabled new players to enter the M&A market bringing in competition to the sector. At the same time, they were able to increase the M&A movements range of action, reaching large companies, which then also became subject to market scrutiny and discipline. Jensen (2000) was also unable to identify any evidence that R&D expenses had been sacrificed during this period. On the contrary, he notes that industry aggregates R&D grew at 5.8% *per annum* between 1975 and 1990.

Several studies show that companies attempting to protect themselves

(4) *A highly critical description of the most notorious buyout company, KKR, can be read in Barbarians at the Gate by Bryan Burrough, a Wall Street journalist covering the RJR-Nabisco acquisition transaction. Former SEC president, Joseph Grundfest (1993) commented that, in addition to the deplorable conduct of some of the protagonists, this episode exposes the total absence of internal controls of RJR-Nabisco board of directors, the true "barbarians inside the gate". In Merchants of Debts: KKR and the Mortgaging of American Business, George Anders details the modus operandi of the most notorious buyout company, and shows several investment cases. In another interesting book, The New Financial Capitalists- KKR and the Creation of Corporate Value, Baker and Smith (1998) dissect the KKR case via a meticulous economic analysis. They emphasize KKR's historic contribution through its financial innovations and through the creation of a new business model. They also seek to redeem the company's image by describing the internal importance of values such as loyalty, collaboration, and respect for the work environment.*

(5) *These discussions were compiled in a book entitled Knight, Raiders & Targets: The Impact of the Hostile Takeover (Coffee, Lowenstein, Rose-Ackerman, ed.), published in 1988.*

(6) *For example, Haan and Riyanto (2005) put forward the hypothesis that certain investment projects can bring private benefits to the executives as well as generating a high return for the shareholders. In this particular case, the threat of a takeover could minimize management's efforts to move the project forward and, consequently, deprive the shareholders of a profitable investment.*

(7) *Total productivity growth of the US manufacturing industry factors soared from 1.4% during 1950-1981, to 3.3% during 1981-1990.*

from a takeover threat establishing provisions against changes in control, regardless of whether achieved via States rules of incorporation or by a direct provision in their bylaws, began to show deterioration in a number of performance indicators. For example: a lower growth of revenues and profits (Gompers, Ishii, and Metrick 2003), a reduction in total factor productivity and in returns on capital (Bertrand and Mullainathan 2003), a diminishing pace of corporate innovations (Atanassov, 2005), a decreased attention to long-term performance with reduced R&D expense levels (Mahoney *et alli* 1997). As part of "enjoying a more quiet life", the trend is for these executives to "build empires" instead of seeking to add value for their shareholders (Santaló 2004), to invest more in acquisitions (Gompers *et alli* 2001), in addition to increasing their compensation packages (Borokhovich *et alli* 1997). On the other hand, the constant threat of takeovers helps to discipline the use of free cash flow in profitable companies, without causing an excess distribution of resources that could place less profitable companies at risk of insolvency (Oprea 2005). The corporate control market encourages the dismissal of executives who neglect to fight for the shareholders' best interests (Shleifer and Vishny 1988, Zhao 2002), help to discipline low performance companies in both the US (Mikkelson and Parth 1997), and UK markets (Dickerson *et alli* 1998).

Finally, market's judgment must be examined. Here, it is clear that that capital market perceives this inferior operating performance and penalizes companies that insulate themselves from this external control mechanism. Accordingly, evidence shows a direct and inverse ratio between share prices and the presence of provisions. Let us examine this: Caton and Goth (2003) found superior returns in the group of companies with a lower number of poison pills[8]. Gompers, Ishii, and Metrick (2003) explain that an investment strategy that had bought shares from companies with fewer anti-takeover defenses and had sold a higher defense portfolio, would have obtained a result in excess of 8.5% *per annum* during the nineteen nineties. Chi and Lee (2005) identified an inverse relation between the number of provisions (governance index) and the value of the company, chiefly in companies where free cash flow is greater. Bebchuk and Cohen (2005) found the same relation between staggered boards[9] and firm value.

Dynamo Cougar x IBX x Ibovespa
Performance up to September/2006 (in R$)

Period	Dynamo Cougar	IBX	Ibovespa
60 months	485,64%	346,49%	244,00%
36 months	164,40%	166,91%	125,74%
24 months	64,35%	76,20%	56,45%
12 months	26,20%	19,53%	16,31%
3 months	6,16%	0,08%	-0,58%

NAV/Share on September 29th, 2006 = R$ 125,0101565

Based on the in-depth US experience and on many empirical results, there is no doubt that takeover activities are a welcome asset in our capital market. They uphold the supremacy of share price, impose constant watchfulness of management, indicate arbitrage opportunities, and suggest increased capital allocation effectiveness.

The contention that takeovers involve a 'truculent', 'unfair', or even 'hostile' (from the Latin, *hostilis*, of the enemy) approach is an exaggerated definition of what is merely an unsolicited proposal made with no forewarning, and would not survive a more thorough analysis. The true threat posed by a takeover falls against management's inefficiency, the sleepiness attitude of executives who, when high grounded, can become the true enemies of their shareholders.

If the vitality of a capital market depends basically on the importance of, and interest in, share prices, it is easy to see why a market that accepts the possibility of changes in control via public transactions is more usually associated with higher valuation and liquidity standards.

Despite not having succeeded, Sadia's offer to gain control of Perdigão could be an early sign of the Brazilian capital market's evolution. With the adherence of many companies to Novo Mercado rules, over time, a widespread control situation could become a more frequent occurrence, as was the case in companies such as Lojas Renner, Embraer, Eternit, Lupatech, and Odontoprev, among others. The positive valuation of IPO´s will favor this trend, as controllers shareholders consider the feasibility of selling their shares in the market.

Although the outcome of the Telemar episode was not as proposed by the controllers, it also points in this direction. The general speculation at present is that other controllers are seeking routes other than that originally pro-

(8) *The term poison pills became confused with its generic equivalent, and is commonly attributed to any type of takeover provision. To be more specific, poison pills are a type of provision, where special rights are granted to shareholders in certain circumstances, among these, a possible future takeover. The poison pill topic is wide-ranging and interesting and will be examined exclusively in another Letter.*

(9) *Staggered or classified boards is a fairly common anti-takeover device in the US. It occurs when board members are elected at different times, with overlapping mandates. In practice, this means that new shareholders will only obtain board majority after two or three terms.*

posed by Telemar. This might successfully lead to the migration of all shareholders to the same class of shares with dilution of control.

Widely spread control in the market unleashes several auspicious developments: companies remain under permanent and diligent market observation, quality requirements on the performance of business are more demanding, there are open room for genuine entrepreneurship, the information content of the price system is greater, shareholders have the option to democratically exercise a basic right. In other words, a certain *aggiornato* aroma is in the air. End result: all agents win as will the economy as a whole.

Rio de Janeiro, January 22nd, 2007.

Dynamo Cougar x Ibovespa x FGV-100 (in US$ dollars)

Period	DYNAMO COUGAR* Quarter	DYNAMO COUGAR* Year to Date	DYNAMO COUGAR* Since 01/09/93	FGV-100** Quarter	FGV-100** Year to Date	FGV-100** Since 01/09/93	IBOVESPA*** Quarter	IBOVESPA*** Year to Date	IBOVESPA*** Since 01/09/93
1993	-	38.78	38.78	-	9.07	9.07	-	11.12	11.12
1994	-	245.55	379.54	-	165.25	189.30	-	58.59	76.22
1995	-	-3.62	362.20	-	-35.06	87.87	-	-13.48	52.47
1996	-	53.56	609.75	-	6.62	100.30	-	53.19	133.57
1997	-	-6.20	565.50	-	-4.10	92.00	-	34.40	213.80
1998	-	-19.14	438.13	-	-31.49	31.54	-	-38.4	93.27
1999	-	104.64	1,001.24	-	116.46	184.73	-	69.49	227.58
2000	-	3.02	1,034.53	-	-2.63	177.23	-	-18.08	168.33
2001	-	-6.36	962.40	-	-8.84	152.71	-	-23.98	103.99
1stQuar/02	13.05	13.05	1,101.05	3.89	3.89	162.55	-2.76	-2.76	98.35
2ndQuar/02	-19.15	-8.60	871.04	-22.45	-19.43	103.60	-31.62	-33.51	35.63
3rdQuar/02	-22.31	-28.99	654.37	-31.78	-45.04	38.90	-44.17	-62.88	-24.28
4thQuar/02	29.76	-7.86	878.90	38.00	-24.15	91.67	45.43	-46.01	10.12
1stQuar/03	4.47	4.47	922.65	4.63	4.63	100.55	5.39	5.39	16.06
2ndQuar/03	27.29	32.98	1,201.73	38.16	44.55	177.07	34.33	41.58	55.91
3rdQuar/03	19.37	58.73	1,453.83	24.72	80.29	245.56	22.34	73.20	90.74
4thQuar/03	22.18	93.94	1,798.51	35.98	145.16	369.91	39.17	141.04	165.44
1stQuar/04	4.67	4.67	1,887.16	2.35	2.35	380.16	-1.40	-1.40	161.72
2ndQuar/04	-4.89	-0.45	1,790.04	-8.66	-6.51	339.30	-11.31	-12.56	132.11
3rdQuar/04	35.12	34.52	2,453.91	23.73	15.67	443.56	21.13	5.92	181.16
4thQuar/04	22.17	64.35	3,020.19	25.32	44.96	581.16	21.00	28.16	240.19
1stQuar/05	-1.69	-1.69	2,967.41	-1.66	-1.66	569.87	1.06	1.06	243.80
2ndQuar/05	5.41	3.62	3,133.23	2.98	1.27	589.80	7.51	8.65	269.60
3rdQuar/05	32.32	37.12	4,178.29	25.21	26.80	763.71	31.63	43.01	386.50
4thQuar/05	2.97	41.19	4,305.49	3.13	30.77	790.73	0.75	44.09	390.17
1stQuar/06	23.32	23.32	5,332.90	18.89	18.89	958.98	22.51	22.51	500.48
2ndQuar/06	-3.88	18.54	5,122.20	-4.58	13.44	910.48	-2.68	19.23	484.40
3rdQuar/06	5.68	25.27	5,418.57	2.64	16.44	937.17	-1.03	17.99	478.36

Average Net Asset Value for Dynamo Cougar (Last 36 months): *R$ 484.762.285,28*

(*) *The Dynamo Cougar Fund figures are audited by Price Waterhouse and Coopers and returns net of all costs and fees, except for Adjustment of Performance Fee, if due.*
(**) *Index that includes 100 companies, but excludes banks and state-owned companies.*
(***) *Ibovespa average.*

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