Report
Dynamo 50
PUBLISHED BY DYNAMO ADMINISTRAÇÃO DE RECURSOS LTDA. – 2nd QUARTER 2006 www.dynamo.com.br

Going Public - II

In our last quarterly Letter, we described the chief reasons why companies go public. We also saw that in this current cycle, a strong equity market has been one of the main motivations for taking such a decision. Now, our aim is to examine two other related topics: i) the main patterns of IPO cycles in other countries and their relation to the Brazilian case, ii) the internal mechanics of the offerings and Dynamo's competitive situation in this context.

Patterns

Our last Letter documented considerable evidence of the phenomenon known as the 'hot issues markets' in IPO. Initial share offerings tend to come in cycles, where entrepreneurs seek to take advantage of windows of market opportunity to sell their companies. Two other empirical patterns also appear in IPO cycles, one being first-day *underpricing* and the other long-term *underperformance*. The trend here is for IPO prices to appreciate in the first day of trading[1] and to underperform the market for a longer period, typically, five years[2].

There are a number of not mutually exclusive explanations for this underpricing, the most common being:

(i) Asymmetric information between issuers and buyers whereby the former are required to "leave a little money on the table". The issuers consent to sell at a price that they consider to be less than fair, given the buyers' ignorance of the quality of the assets, for which they ask a discount.

(ii) Asymmetric information between the buyers themselves, where less informed investors will take all the shares they ask in thouse deals which more informed investors don't want them. This explanation known as the winner's curse hypothesis. For this reason, less informed investors will only submit purchase orders at a discount.

(iii) The signalling effect, where the company "leaves a good taste" with investors, possibly when insiders are planning an additional future sale (follow-on).

(iv) The "information cascade" phenomenon where buyers watch the movements among themselves. If nobody takes the initiative to buy, the transaction risks failure. To avoid this, the issuers accept a lower price at the beginning of the race, to fuel the first buy decisions.

(v) In more regulated markets, underpricing can also be used to reduce the appetite of eventual lawsuits prosecuted by investors who could latter claim to have been wronged.

Long-term underperformance is more observed when companies are going public at the peak of the IPO cycle, and more frequent between smaller/younger companies. In fact, US market evidence shows no trend to long-term underperformance in the case of more aged/established companies going public at times other than IPO volume peak period[3]. The chief explanations for long-term IPO underperformance are:

(i) Differences of opinion hypothesis. An intriguing theoretical result shows that it is the more optimistic investors who establish IPO prices, sometimes even due to the absence, at first moment, of short

(1) *This phenomenon exists in almost every market. Ritter (1998) gathers evidence of underpricing in 33 countries, where first day returns varied, on average, from 6.5% to 80% per country. In a US sample of 13.3 thousand companies that went public between 1960 and 1996, the average weighted return for the first day of trading was 15.8%. (As always, full references are available in the Dynamo website).*

(2) *Ritter (1998) further demonstrates that, in the US, from 1970 to 1993, the performance of a group of IPOs, measured as from the first trading day closing, over the following five years, was 5.2%pa below the performance of the companies selected as the benchmark group.*

(3) *Example: Fields (1995), Ritter (1998), and Miller (2000).*

Our Performance

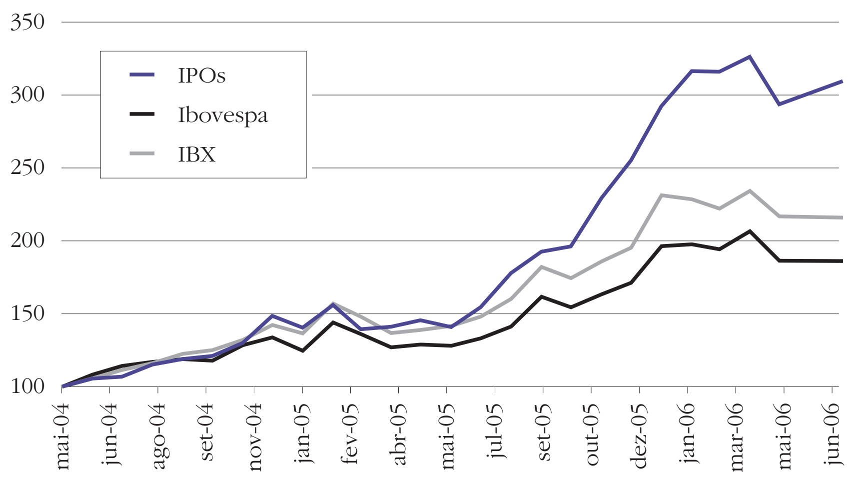
During the second quarter of this year, Dynamo Cougar recorded a negative yield of 4.2% in local currency, Ibovespa dropped by 3.0%, and the IBX by 2.8%. This semester, we presented a 9.6% gain, compared with Ibovespa's 9.5% and IBX's 10.50%. Over the last ten years, Dynamo Cougar has generated a return of 22.5%pa in US dollars, and 20.2% pa over the IGP-M. During this same period, Ibovespa appreciated by 10.9%pa in US dollars and 8.9% pa over the IGP-M, the IBX by 15.3% pa, and 13,1%[aa], respectively over the same indices.

Due to concerns over the US FED's tightening, considerable volatility was observed in emerging markets, particularly as of May. After a prolonged period of net inflow, a number of local and foreign investment vehicles that invest in Brazilian equity market have suffered substantial redemptions. Bovespa dropped by over 20% from its peak of almost 42 thousand points achieved at the beginning of May. Despite its speed and size, we have concluded that this drop represents an adjustment of financial flows without necessarily denoting a deteriorating corporate business environment. Although the exchange rate was subjected to some overshooting, partly influenced by the bond market's episodic stress, (mainly in the long portion of the treasures curve linked to the IPCA, where overseas investors experienced problems in liquidating their positions and sought a hedge in the exchange market), Brazilian country-risk seismograph, after a rapid hiccup, resumed its relatively calm behavior.

We took advantage of this episodic market downturn to increase the Fund's main position exposures, particularly in Itaúsa, one strategies[4]. Moreover, this model also shows that the greater the difference of opinion between the buyers, the higher the IPO price will tend to be. Over time, when more data becomes available, the differences between optimist and pessimist tend to lessen and the share price to fall.

(ii) The perception of the IPO as an 'event', where the banks generate a fad atmosphere by concentrating their efforts on selling and creating an apparent excess demand to push on the transaction[5]. This hypothesis admits that companies presenting higher initial returns tend to deliver worse subsequent returns. A US survey of individual IPO investors concluded that only 26% of buyers did any fundamental analysis of the relation between the offer price and the firm's underlying value (Ritter 1998). In fact, we have observed the impact of this phenomenon in our market where new comers are foreign investors almost exclusively focused on IPOs issues and, in practice, knowing very little about more traditional companies. Another symptom of this atmosphere of distraction caused by the alluring IPO ambience is the fact that investors don't query the overriding presence in these new companies' bylaws of provisions preventing changes in control. And this is a common procedure in other countries' IPO cycles as well. This evidence seemingly refutes the observation that attempts to include anti-takeover provisos in established companies are immediately dismissed by increasingly thorough shareholders. All that remains to be said here is our promise to explore this oddity more deeply in a future Letter.

Chart 1 – IPOs index x Ibovespa x IBX (base 100 May/2004)



Source: Economática e Dynamo

(iii) The same idea of a 'window of opportunity' where huge volumes of concentrated IPOs highlight the issuers' tendency to time the right market moment. As we saw, empirical tests have shown that the long-term performance of companies going public at the peak of the IPO cycle is mediocre.

Given the market's current liquidity allied to the substantial volume of secondary sales, this current cycle of offerings hints at a convergence with the IPO fluctuation patterns in other countries, where investor optimism feeds and incites opportunities for companies to go public.

Another typical IPO feature, underpricing, also appears here. To date, the return on our IPOs' first day of trading, weighted by the respective offer volumes, has been 10,0%. Only in one of the thirty transactions analyzed did the first day of trading close below the distribution price. In a longer historic series of the US market, we see an interesting link between positive first day returns and volumes of subsequent IPOs, suggesting that companies continue going public while prior offers appear to succeed. This is why requests for new offer registrations continue to arrive at CVM (Brazilian Securities and Exchange Commission).

Regarding long-term underperformance, it is still too soon in our cycle to analyze it, although our "IPO index" (described in the previous Letter) remains significantly outperforming other market indicators (Chart 1).

So far, we have a sample of mature companies, of good quality, and with distinguished by-laws. At least, in this core aspect, these credentials suggest that this IPO cycle may eventually present a behavior pattern differing from the majority of external evidence shown. Naturally, this trend can only be confirmed upon examination of the quality of future transactions.

The Processes

Along with the reasons motivating companies to go public, another factor to be analyzed in this IPO phenomenon is the dynamics of the offering processes. The transactions are always intermediated by financial institutions, which are responsible for the interface between sellers and buyers. (Banks are in the middle of the front trying to meet the conflicting interests of two categories of customers: sellers and buyers). A delicate balance exists here, since if the agents perceive any shortcoming in the intermediary's conduct resulting in losses for either side, this could undermine the entire backlog of future transactions.

The winning business model in public offerings has been the process known as *bookbuilding* (gathering of investment intentions). Starting from a recommended price range, banks begin gathering the sensitivity of investors' demands until they reach a cut-off price that most satisfactorily meets the requirements of both parties. Potential buyers are encouraged to disclose their prices as soon as possible, based on which the book runners begin feeding information to the other investors and thus build up their offering book. In our cycle, based on the target public, the issues were separated into two tranches known, respectively as "retail offer" and "institutional offer", establishing a floor, generally of 10%, to the retail tranche to encourage small investor involvement.

When demand exceeds offer, the allocation between investors is apportioned, where the bank

(4)This result was proposed in a seminal article by Miller (1977) and is probably little known since it assumes a more realistic premise, but one that is incompatible with CAPM of non-homogeneous expectations. See also Miller (2000) and Boehme, Danielsen, and Sorescu (2002).

(5) *It is no coincidence that the process of selling the company to the institutional investors is known as the road show.*

Our Performance

of our portfolio shares that was most impacted during this period. Generally speaking, banks were heavily penalized by the recent Bovespa drop, even though the fundamentals remained intact. Here, we believe that this movement was linked to the fact that, along with the most liquid shares in the stock market, the banks most reflect local risk. This is due to the fact that, in the index hierarchy, the long-term fundamentals of both Petrobrás and CVRD are basically impacted by commodities prices expectations.

By increasing the Fund's investments in our principal positions, we reduced cash levels. Also, we continued to diminish some intermediary positions, up to, in few cases, sell them entirely. Accordingly, by the end of the semester, the Fund's five and ten major positions reached 65% and 85% of the portfolio, respectively, resulting in a higher than usual concentration. As a natural corollary of the portfolio's greater concentration on higher liquidity positions, Dynamo Cougar shares have become more volatile. We foresee no change to this situation until, at least, the end of the year.

coordinating the transaction carries out a discretionary appropriation process. In this case, *overbooking* is deemed to have occurred. Naturally, the greater the excess demand, the greater each investor's cut off. An interesting point is that the price indication feedback mechanism, together with the information cascade, creates a sense of some scarcity. This, in turn, inflates demand producing the uncommon result of an inversion in the curve, which gains a positive inclination to price. In other words, on learning of a probable overbooking volume, investors immediately include in their bid intentions a given cut-off, to ensure that their "real" demands are met.

In theory, the suggested price range could be altered during the sales period as an adjustment to the sensitivity of demand. This maneuver has been little used in our IPO cycle. In most cases, the distribution prices have tended to remain within the suggested initial range. In some exceptional cases, a price in excess of the interval was disclosed only moments before the final price was established. In two instances only, the distribution price was set below the initially proposed range[6].

Bookbuilding can also involve a *greenshoe*, which is the possibility of the sale of an additional allotment of shares by the financial agent[7]. When the market price drops to below the distribution price, the coordinating bank can repurchase a number of shares equivalent to the greenshoe volume, thereby acting as a price stabilization mechanism. If the price goes up, the bank exercises its option to buy the additional stake (already sold) from the company itself or from the selling shareholder.

Auction theory has been the subject matter of a huge amount of literature seeking to explain the reasons for the success of this dominating mechanism that has almost eliminated all other procedures[8]. One of these points out that analysts' coverage is broader in the instance of bookbuildings and that the issuers are willing to bear the higher cost of this procedure, as compared with the traditional auction, to 'buy" more analyses[9]. Another line of argument reinforces the fact that, as we have seen above, bookbuilding method gives the bank greater discretionary power, with a margin to cultivate and encourage reciprocal behavior with investors. In other words, those that reveal their prices up front and/or are frequent buyers in offerings are usually rewarded with larger allocations[10]. Here, some abuses can arise, and the banks' enormous discretionary power in preparing the books (choosing the customers and their respective allocations) is usually contained by their concern for their reputation, a vital asset to assure involvement in future transactions.

At this time, we can already see that this is a market where Dynamo has no competitive edge over other investors. Let us examine this in more detail. Firstly, the decision to invest in an IPO requires speed. As a rule, very little is known about companies before they go public. On average, 21 days elapse between when information becomes available and the pricing day, far too short a period for us to obtain what we deem to be a reliable level of knowledge on the company. Moreover, during this cycle, many companies have been the first in their segment to go public, which requires even greater research efforts than before. Lastly, with the increasing number of IPOs, the interval between offers has dropped in proportion to the quality of the analyses carried out by the banks coordinating these transactions. This has also contributed to generating a further problem for investors, particularly overseas investors with worldwide mandates[11]. In such circumstances, these investors tend to find themselves hostages of the assets they have already been able to examine, probably those of the companies that came during the initial stage of the cycle. This could be the reason for the increasing differences between the valuations of the recently listed companies against those of the Ibovespa or of others more traditional ones, inasmuch as fundamentals alone can not explain this gap, because, on average, IPOs operating results have been reasonably aligned with the coordinating banks' initial covering projections[12].

If a value-oriented approach can't respond, behavioral analysis seems to provide some clues, in this instance. Given the considerable overseas liquidity, when big fund managers raise new money, they generally tend to allocate these additional resources in companies they already know, taking three expected approaches, as we have described in our previous Letters discussing behavior finance: sheltering behind the 'safety' of the known (status quo maintenance), basing their decisions on more available information (availability bias), and avoiding the additional cost of an analysis whose return is uncertain (sunk cost).

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

Period	Dynamo Cougar	IBX	Ibovespa
60 months	365.12%	253.42%	152.91%
36 months	202.32%	223.01%	182.47%
24 months	92.44%	105.96%	75.36%
12 months	48.73%	52.35%	45.60%
3 months	-4.24%	-2.80%	-3.04%

NAV/Share on June 30th, 2006 = R$ 117.7580017

Furthermore, as we have seen, the procedural mechanics of IPOs encourages and awards premature disclosures on a company valuation (early bids), and also tends to favor the more assiduous investors at such events. Since these parameters usually prevail, we see ourselves at a double disadvantage. On the other hand, some banks are able to see us not only based on the brokerage potential fees that we could generate, but on our long-term investor reputation, which is of value in building up their books, an approach that is often recommended by the companies themselves.

Lastly, the offerings mechanics still favor an optimistic bias in settling prices, since, at this initial stage, investors cannot rent shares to sell. In the presence of short position restrictions, it is the more optimistic who establish the prices. It is hard for value investors, who usually require a margin of safety for their investments, to obtain a competitive edge in this market. Accordingly, the presence of this type of investor is currently not much found in IPOs' shareholders lists.

(6) *These were Localiza and MMX. The latter, a very recent transaction, is not shown in our last Letter's data table.*

(7) *This term originated with the Green Shoe Company, the first company to utilize this mechanism.*

(8) *Examples: Jagannathan and Sherman (2006), Wilhelm (2005), Sherman (2005), Kutsuna and Smith (2004).*

(9) *This explanation coincides with the view described above of IPOs as 'events', where analysts coverage acts as a marketing channel. Degeorge, Derrien, and Womark (2005) describe the presence of conflicts of interest since, in the aftermarket of companies that they have taken public, underwriters analysts use to issue reports that are more favorable than the market. They also described how analysts tend to recommend purchasing IPOs of other banks, when they are ready to take a new company public.*

(10) *Rocholl (2004) suggests that institutional investors commonly 'guarantee' difficult transactions, by placing orders at the end of the period, and being compensated with more generous allocations at the hot deals. In his recent book (2006), this is how Barton Biggs describes this typical big investor behavior: "He traded intensely, which created a lot of commissions for the brokers and which, in turn, got him big allocations in hot IPOs".*

(11) *According to our estimates, overseas investors were responsible for the purchase of 64% of the total IPO volume.*

(12) *The exception being Grendene, a negative surprise.*

After a lengthy hibernation period, this IPO cycle is welcome news in our capital market. As a rule, the companies it has taken public are of excellent quality, mature, financially robust, with modern by-laws, and good growth prospects.

To date, our problem has been one of understanding the valuation gap of these companies in relation to others, whose qualities, in our opinion, do not differ significantly. If, on the one hand, the former deserve a premium for being listed under the Novo Mercado rules, the latter should be entitled to a lower discount, based on a history of known performance and proved virtues. Our point here is that, in a relative risk/return evaluation, the spread between these two categories of companies seems to be too wide.

Our instinctive response to phenomena that we do not fully understand is to deepen our analysis, test and re-test our theories, in addition to redoubling our efforts to adapt ourselves, within the limits of our genotype. The result of this work is the fact that, today, we have three IPO positions representing around ten percent of our portfolio. Even so, a portion of these investments was only enabled when we took advantage of a recent market downturn, based on a greater knowledge we acquired on these companies in the post-public relationship. On the other hand, in this IPO cycle, we identified some unusual elements in the companies' intentions, in investors' behavior and in the gearings of the offerings, that require monitoring and selectivity, but which have aroused no comment in the general environment of well-being arising from the very healthy results obtained to date.

If this generalized optimism prevails and the projected accelerated growth occurs, our analysis will prove to have been over cautious. In that case our performance will not follow, at first, the ones of more aggressive portfolios. However, should this occur, we are convinced that the companies we own, with their known and proven attributes, will also benefit from these same opportunities and, thus, in the medium term, we shall also find ourselves in a very interesting position.

Rio de Janeiro, July 27th, 2006.

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
1st Quar/02	13.05	13.05	1,101.05	3.89	3.89	162.55	-2.76	-2.76	98.35
2nd Quar/02	-19.15	-8.60	871.04	-22.45	-19.43	103.60	-31.62	-33.51	35.63
3rd Quar/02	-22.31	-28.99	654.37	-31.78	-45.04	38.90	-44.17	-62.88	-24.28
4th Quar/02	29.76	-7.86	878.90	38.00	-24.15	91.67	45.43	-46.01	10.12
1st Quar/03	4.47	4.47	922.65	4.63	4.63	100.55	5.39	5.39	16.06
2nd Quar/03	27.29	32.98	1,201.73	38.16	44.55	177.07	34.33	41.58	55.91
3rd Quar/03	19.37	58.73	1,453.83	24.72	80.29	245.56	22.34	73.20	90.74
4th Quar/03	22.18	93.94	1,798.51	35.98	145.16	369.91	39.17	141.04	165.44
1st Quar/04	4.67	4.67	1,887.16	2.35	2.35	380.16	-1.40	-1.40	161.72
2nd Quar/04	-4.89	-0.45	1,790.04	-8.66	-6.51	339.30	-11.31	-12.56	132.11
3rd Quar/04	35.12	34.52	2,453.91	23.73	15.67	443.56	21.13	5.92	181.16
4th Quar/04	22.17	64.35	3,020.19	25.32	44.96	581.16	21.00	28.16	240.19
1st Quar/05	-1.69	-1.69	2,967.41	-1.66	-1.66	569.87	1.06	1.06	243.80
2nd Quar/05	5.41	3.62	3,133.23	2.98	1.27	589.80	7.51	8.65	269.60
3rd Quar/05	32.32	37.12	4,178.29	25.21	26.80	763.71	31.63	43.01	386.50
4th Quar/05	2.97	41.19	4,305.49	3.13	30.77	790.73	0.75	44.09	390.17
1st Quar/06	23.32	23.32	5,332.90	18.89	18.89	958.98	22.51	22.51	500.48
2nd Quar/06	-3.88	18.54	5,122.20	-4.58	13.44	910.48	-2.68	19.23	484.40

Patrimônio médio do Fundo Dynamo Cougar nos últimos 36 meses: *R$ 411,125,465.53*

(*) 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.

Please visit our website if you would like to compare the performance of Dynamo funds to other indices: ***www.dynamo.com.br***

For any further information, visit our web site:

www.dynamo.com.br

DYNAMO

DYNAMO ADMINISTRAÇÃO DE RECURSOS LTDA.

Av. Ataulfo de Paiva, 1351 / 7º andar – Leblon – 22440-031
Rio – RJ – Brazil – Phone: (55 21) 2512-9394 – Fax: (55 21) 2512-5720