Report
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De-Listings: Markets, Monopolies and Regulation

As expected, the probable changes in the Brazilian Corporate Law are being preceded by a healthy debate. On one side, there is the group that defends the current status arguing that the proposed changes will yield such a level of protection to minority shareholders that it will result in the destruction of our capital markets. On the other side, there is the group that believes that the proposed changes are too narrow and as such will have no impact in the markets.

There is a growing list of high quality studies and papers that analyze how the level of protection of minority shareholders in a given country shapes its capital markets*. Dynamo has been researching this issue extensively over the last two years, and we believe it is important to share our ideas and opinions on this topic.

The main argument of the group opposing changes in our Corporate Law is based on an utterly false dilemma, that is, that more protection to minority shareholders will destroy our capital markets. As corroborating evidence, they point to the growing number of companies that, faced with the mere possibility of changes in the Law, are opting to de-list their shares from Brazilian exchanges. Conceptual arguments aside, this line of thought does not survive a more detailed analysis of the facts, as we shall see below.

More protection, better markets

All recently published research on equity markets concludes unequivocally that better protection to minority shareholders results in more developed capital markets, as can be clearly confirmed by the examples of the markets in England and North America. The fact that investors look for markets where they feel protected is intuitive. In its present structure, with preferred shares and an acute misalignment of interests between minority and controlling shareholders, the Brazilian capital markets were able to grow during the 70's and 80's because of fiscal incentives and a quasi-mandatory demand for equities. The demand was mandatory because the funding for the recently-born pension funds was growing very rapidly and they needed to diversify assets. In addition, through so-called Fundo 157, Finor and other fiscal incentive funds, investors purchased shares with a portion of their due taxes. When these two factors ceased to prevail, demand for equities was drastically reduced.

The example of the German Neuer Markt is highly illustrative. This market was created by the German Bourse in 1996 and the private contract for listing requires a much higher level of transparency and protection for minority shareholders than that of the main market. The results were impressive. From 1949 to 1995, only 356 companies went public in the German market. From 1996 to 1999, 206 companies went public in the Neuer Markt thereby accepting its restrictive rules (for comparison purposes, in 1996 alone, 598 companies went public in the Nasdaq).

Stock De-listings

From the perspective of the potential negative consequences of the changes in our Corporate Law, we argue that it is impossible to destroy what does not exist. The fact is that we do not have a true capital markets in Brazil. The quality of such a market is better judged by the capacity of new companies to finance their growth via selling equity to the public. The absence of a consistent IPO market in Brazil is a severe constraint for the development of private equity and venture capital funds inhibiting a great number of entrepreneurial initiatives in our country.

The official data supplied by the CVM on the number of companies filing for listing is misleading because the real objective of the vast majority of such companies is not to sell shares to the public (issuance of debentures and Annex IV are more frequently the reason behind these filings). We filtered down the data and concluded that, since 1996, only 7 companies went public through IPO's in Brazil. Since 1990, only 27. On the other hand, the number of companies that went private and de-listed their stock in the same periods was 202 and 338, respectively.

With respect to the recent increase in the number of companies de-listing, it is important to note that most of the important ones were controlled by foreigners. From their perspective, all they were doing is cost-of-capital arbitrage. Since the multiples in Brazil are low, foreign companies can access capital abroad at a lower cost and buy back stocks cheaply in Brazil. This trend is particularly evident when there is a previous sale of control to a foreign owner, as analyzed in our previous report.

Even if not for the possible changes in the Corporate Law, we believe this trend will accentuate in the near future, as this cost-of-capital arbitrage continues to be highly profitable. In a sense, this is a healthy process for our market, since the companies leaving the public markets never had any interest in having Brazilian outside shareholders. The main problem in our capital markets is not that more companies are de-listing but that fewer companies are going public.

We can explore this issue a bit further. Even if we accepted the argument that our insipid capital markets could be destroyed by a massive retreat of public companies going private caused by the changes in the Law, we would first have to consider who would finance such a bold move. In the case of the foreign companies, as described above, the answer is simple. In the case of Brazilian companies however, aside from controlling shareholders using their own

* *we are referring mainly to the research papers published in the last three years by Professors Rafael La Porta, Florencio Lopes-de-Silanes, Andrei Schleifer, Edward Glaeser (all from Harvard), Robert Vishny, Luigi Zingales (Chicago), and Simon Johnson (MIT).*

money, the issue is a little more complicated. It would be highly unlikely, for instance, that BNDES or IFC, which maybe the only two sources of long term funding in Brazil, would lend money to companies to allow them to de-list. These institutions usually prefer to finance companies that are going in the exact opposite direction.

Another source of financing could be private equity funds. The problem here is that these investors usually demand, through a shareholder's agreement, clauses for protecting their minority shareholder status that are a lot more rigorous than the changes being proposed for the new Law. The last resource, and the one more frequently mentioned, is the transfer of listing to a stock market outside Brazil. Well, this is not a credible threat since it is very hard to find a stock market that is less regulated but broader and more liquid than ours.

We can conclude then that, from the point of view of keeping the highest level of private benefits to themselves, controlling shareholders will still be much better off by keeping their companies public even if all proposed changes in the Law are approved by Congress.

Fair Value ("Valor Econômico")

One of the itens of the project to change the Law that is generating discussion is related to the establishment of a minimum price in de-listing tender offers and in the exercise of redemption rights. In the draft of the new Law, such minimum price is called Economic Value but its concept is closer to Fair Value, as it should be supported by a valuation performed by an independent source, such as an investment bank, much like a Fairness Opinion frequently used in the U.S.

With regards to the exercise of redemption rights, the Law currently determines that in the few cases when such rights are exercisable, redeeming shareholders will receive book value or, if previously included in the by-laws, economic value. In practice this system will always result in the lower of the two values as only companies that believe their assets to be overvalued will include the possibility of economic value in their by-laws. The new Law determines the Economic Value as the basis in all cases. Currently, the controlling shareholder can tender for the non-controlling shares in his company at any price. If, on one side, the right to de-list is a legitimate one, on the other side, it is important that these processes are conducted fairly and with total transparency. As we have said before, the conflict of interests that arise when a controlling shareholder decides to de-list his company is impossible to be managed. As is the case in markets where conditions are quasi-monopolistic, the presence of a strong regulatory body to arbitrate these situations is essential.

When companies go public, investors evaluate whether the offering is fair. If too many investors conclude that it is too high, the shares will not be sold. Even though there is a huge disparity in the level of knowledge and information about the company, the interests of seller and buyers are reasonably aligned. Company executives ought to be as transparent as possible so that investors may evaluate their prospects correctly. But at the end of the process the final call are the investors' to make.

Conversely, when the company is de-listing, the interests become immediately conflicting. Minority investors, faced with only one real alternative – selling - become hostages of the controlling shareholder who holds a monopoly on the relevant information. Try to imagine a de-listing road show; the managers trying to convince their shareholders that business is terrible, that they are incompetent, that competition is increasing, margins are deteriorating, etc.. It is surreal but, unfortunately we have been present in more than a few of these discussions as it is a growing reality of our capital markets.

Therefore it is more than reasonable that the law establishes a minimum value for de-listing. As opposed to an IPO, de-listing is not a process where the interests of the participants converge to a level where the deal may be reached. For this reason, an arbitrator who will perform an independent valuation is the best solution even though valuation is definitely not a precise science. The process contemplated in the new law is clever. The Board (which is always controlled by the majority shareholder), select a list of 3 firms, of which one will be chosen in a vote at a Shareholder's Meeting where the controlling shareholder cannot vote. The basic valuation criteria should be the discounted cash flow method and, as always, the CVM must monitor the entire process.

This issue is highly relevant in the present stage of our capital markets. In addition to legislative changes currently being discussed in Congress, the CVM is considering alternatives to improve its existing regulations for de-listing and tender offers made by controlling shareholders, the basic rules of which are stated in Instructions 229 and 299. For this reason, we intend to further discuss this issue in one of our upcoming reports.

Control Premium

There has also been criticism with respect to how the new law deals with the control premium, that is, tag along rights. As it stands, any sale of control may be restricted to the shares owned by the controlling shareholder. The combination of large private benefits of control with the possibility of acquiring this " key to the safe" by purchasing only 16.7% of total capital has led to astronomical controlling premium in Brazil. The current project only contemplates the return of tag along rights to the minority common shares (preferred shares are still left out) which was part of the law until 1997. The government sponsored the exclusion of this provision from the law so as to facilitate the privatization process.

Still, some controlling shareholders argue that the premium belongs only to them. They base their argument on the facts that (i) they are the only shareholders that dedicate 100% of their time to the company, and (ii) from time to time, they are required to offer personal guarantees on banks loans taken by the company.

First, it is important to understand that there is a very fundamental difference between employment contracts and ownership of shares. Dedication to the company is directly compensated through an employment contract that should best align the interests of managers to those of the shareholders. To the extent that such alignment usually results in stock options for employees, the sale of the company could also generate extraordinary gains to people with employment contracts. However, to justify that only controlling shareholders should receive the control premium because it is part of their compensation as employees of the company is a clear distortion of reality that does not contribute to a fair and healthy partnership.

The issue of personal guarantees is a simpler one. If a company cannot finance its operations based on its own balance sheet and assets, - which, by itself, may be a signal that it should not be listed in the first place- the controlling shareholder should actually charge for the guarantee he is extending. But to argue that the premium should be paid exclusively on the controlling shares, calculated who knows how, is nonsensical. And, in any case, the development of the credit markets in Brazil will help minimize this aspect.

The other side

On the other side of this controversy, there are those who understand that the proposed changes will not yield satisfac-

tory results because they are too narrow. In essence, their argument is that the main cause of the problem is not being attacked, that is, preferred shares are not being simply prohibited. It is true that the project to alter the existing law does not contemplate tag along rights to preferred shares, and also does not reduce the limit of 66.7% of the capital that a company may issue in preferred shares (it should be noted that new companies will be subject to a limit of 50% in new issuances).

Previous versions of the project stated that in order to issue new preferred shares, companies would have to guarantee a true preference to these shares. This preference could take the form of either (i) tag along rights at 80% of the price of the controlling shares, or (ii) rights to a preferred dividend of 3% per annum over the book value. The current version also included the alternative of a dividend for the preferred shares 10% higher than the dividend for common shares. Since the majority of the Brazilian companies have already included this 10% differential in its by-laws, it is unlikely that many companies will opt for either of the first two alternatives.

Having said that, we believe that to underestimate the relevance of the project just because the issue of preferred shares may not have been dealt correctly is a short-sighted view. The project does offer numerous fundamental changes, of which we highlight the return of the tag along right to all common shares and the definition of the economic value as the sole price criteria for de-listing offers and redemption rights.

Conclusion

A detailed analysis of the research that has been published recently on capital markets brings us to some indisputable conclusions. By and large, the larger the degree of protection to minority shareholders:

(i) the lower the cost of capital to the companies (i.e higher multiples)
(ii) the larger the number of publicly traded companies,
(iii) the higher the dividends,
(iv) the smaller the number of companies with defined control, and
(v) the larger the dispersion of shareholders.

In other words, broad and developed capital markets are unmistakably associated to efficient protection to minority shareholders. Therefore, the project that proposes the changes in the Brazilian Corporate Law is a remarkable step in the correct direction,as it shall result in a more balanced relationship between controlling and non-controlling shareholders.

Needless to say, it will not be enough. The great evolution of our capital markets will come when controlling shareholders realize, by themselves or compulsorily because of the new law, that their private benefits of control are smaller than the gains generated by the potential reduction in the cost of capital of their companies. Only then will Brazilian companies advance in the direction of more democratic structures of capital, instead of the oligarchical structures that currently prevail in Brazil.

If successful, the project being elaborated by Bovespa to create a new market similar to the German Neuer Markt, which through a private contract for the listing, demands companies to treat shareholders fairly, could accelerate this process of democratization, or dispersion of the ownership of Brazilian companies. One more topic for an upcoming report.

Dynamo Cougar x Ibovespa x FGV-100

(in US$ dollars - commercial selling rate)

Period	DYNAMO COUGAR*			FGV-100**			IBOVESPA***		
	Quarter	Year to Date	Since 09/19/94	Quarter	Year to Date	Since 09/19/94	Quarter	Year to Date	Since 09/19/94
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
1st Quar/98	16,55	16,55	675,66	18,15	18,15	126,83	15,07	15,07	261,14
2nd Quar/98	-8,70	6,40	608,30	-19,40	-4,80	82,80	-19,60	-7,50	190,30
3rd Quar/98	-33,50	-29,20	371,20	-27,20	-30,70	33,10	-33,40	-38,40	93,50
4th Quar/98	14,20	-19,10	438,10	-1,20	-31,50	31,50	-0,10	-38,40	93,30
1st Quar/99	6,81	6,81	474,80	11,91	11,91	47,20	12,47	12,47	117,36
2nd Quar/99	24,28	32,75	614,36	24,60	39,44	83,41	2,02	14,74	121,76
3rd Quar/99	3,17	36,96	637,01	-4,71	32,87	74,77	-7,41	6,24	105,34
4th Quar/99	49,42	104,64	1001,24	62,92	116,46	184,73	59,53	69,49	227,58
1st Quar/00	6,15	6,15	1068,96	11,53	11,53	217,56	7,08	7,08	250,77
2nd Quar/00	-2,43	3,57	1040,57	-6,26	4,55	197,67	-9,03	-2,59	219,10

(*) The Dynamo Cougar Fund figures are audited by KPMG 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.