Report
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The Card's Credit II

In our previous Report, we described the structure of the credit card business in Brazil, with an emphasis on the role played by the merchant acquirers companies. We then described the context surrounding the regulatory changes proposed by the Brazilian Central Bank, contrasting our analysis of these transformations against the prevalent market opinions.

In this Report, we continue to narrate our investment in Cielo and Redecard, addressing the issue of the existing conflicts of interest in the industry and analyzing the impacts of these regulatory updates on the competitive landscape of the acquirers companies. Finally, we use the case to weave a few comments concerning contrarianism in investing.

Conflicts of interest

As investors we were always wary of the conflicts of interest surrounding the acquirers, arising from the dual function played by Brazilian banks in the credit card space: besides being the card issuers, they are shareholders/commercial partners of the acquiring companies. As we have seen in the previous Report, the acquiring business is similar in nature to, and sometimes indistinguishable from, the banking activity, requiring a high degree of strategic coordination between the subsidiary companies and their controllers.

As a review: in the credit card business, the interchange fee is paid to the issuer by the acquirer. In Brazil the two dominant acquirers have issuing banks as controlling shareholders. In theory, one could swing the interchange fee in favor of the issuer without changing the system's total cost, that is, without encumbering merchants or cardholders. Therefore, in principle, there is room in the value chain to benefit the issuer at the acquirer's expense.

The cash advances on credit sales offered to merchants are another acquiring service that interests both parties. Discounting receivables is a typical banking service. They now constitute part of the acquirer's revenues – more so Redecard's than Cielo's – due to a lack of focus by banks and a slight tax advantage enjoyed by acquirers. Yet there is nothing fundamentally preventing banks from competing in this segment and thus stealing market share from acquirers.

Even the very task of merchant affiliation is essentially an activity where interests are convergent. The affiliation procedure, the commercial effort of winning a new customer, is in most cases carried out by the banks even though it constitutes the core element of the acquiring business. How much could the banks theoretically charge for this service? Cielo and Redecard possess no long-term contracts establishing the rights and duties of each party with regards to this service. It therefore constitutes a risk, a potential open flank in the acquirers business model.

The banking shareholders of Cielo and Redecard attempt to minimize the perceived conflict-of-interest risk faced by minority shareholders by arguing that controlling shareholders have a high reputational risk at stake, should they harm the acquiring business in their favor. The structure of the relationship between acquirers and their respective controllers originated before they went public. Therefore, according to the banks, it would be unfair to now alter this *status quo*. They also recall their reputation of high standards of corporate governance, developed and cultivated with capital markets along the years, which it is far more important than any tactical or opportunistic interest. Finally, they observe that acquirers and issuing banks possess similar minority shareholders and it would be nonsensical to take sides with one shareholder base over the other.

Despite the euphonic speech, during Redecard's delisting process, Itaú-Unibanco played untuned. At that time, they intentionally exposed the existing conflicts of interest between the companies, taking a tactical advantage of the uneasiness this caused among Redecard's minority shareholders to move forward a deal that made economic and strategic sense for their own shareholders.

Competition

As with the regulatory issues, where the market believed the industry would suffer more drastic disruptions than we deemed probable, analysts generally expected the ban on exclusivity contracts to have severe repercussions for the industry's competitive landscape. In this respect, we agreed upon the course of market analysis. Our difference was a matter of degree. While investors predicted a substantial drop in margins and returns on capital over a short period of time, we believed the adjustments would come more gradually and less drastically. A few factors led us to these conclusions.

As discussed, the acquiring activity is inextricably related to the banking business, and, as such, should in some way mirror the pattern of competition between Brazilian banks. The country's banking industry is a fairly concentrated one, with five large commercial banks with national scope (Banco do Brasil, Caixa Econômica Federal, Itaú-Unibanco, Bradesco and Santander), and a few other mid-sized and/or regional competitors (HSBC, Citibank, Banrisul, among others).

To become a sizeable player in the acquiring space, one would first need to establish commercial alliances/ partnerships with one of these names. Considering that Banco do Brasil, Bradesco and Itaú-Unibanco already have partnerships with the incumbents, and that Caixa and HSBC have renewed their long-term contracts with Redecard and Cielo, only Santander and a few regional banks remain as viable options.

This unique configuration of our banking industry – few players, national scope, and vertical integration – turns precarious any comparison between Brazil and other markets. The regulatory experience of promoting competition in the acquiring space in other countries took place in very distinct competitive environments, with little similarity to Brazil. In more fragmented markets, the incumbents' market share and competitive advantages were far less prevalent when the regulator intervened to open the market. In our minds the unusual structure of our banking sector conferred higher resilience to the incumbents.

Analysts placed their bets in the commercial aggressiveness of Santander. When the bank announced a partnership with Getnet, an important card processor from Brazil's southern region, the shares of Redecard and Cielo stumbled. Investor's forecasts gave the benefit of doubt to Santander, attributing to the new comer a rapid gain in market share up to 10-15%. At first glance, we found that the incumbent's competitive position was in fact more solid than the market anticipated. The partnerships with associated banks, along with the reliability of their networks, and the high switch costs associated with the merchant changing their banking relationships on several levels – cash advances, credit lines, discounted fees, overdraft protection, etc. – imposed considerable challenges to new entrants. We expected some loss of share among incumbents, especially in market niches, where specialized players could build their networks. But we did not expect new entrants to be able to compete on a national scale.

Indeed, up until today, this is what has effectively unfolded. Santander made it clear from the start that they would rather take part in its large profit pools, than promote an uncontrolled pricing battle thereby transferring value to merchants in detriment of acquirers. Quite the opposite: they chose to leverage their acquiring results by offering incentives through their 'integrated current account' package. Even thou, they had been having a hard time delivering their affiliation guidance, initially set at overly optimistic levels.

Another flank of potential competition could come from different kinds of players altogether; from network providers such as credit card processors, or even from the large retail chains, potentially seduced by the industry's high returns. Again we concluded that the decision of starting a merchant acquiring network from scratch involved many non-trivial risks for such players. We met with many of Brazil's largest retail companies and their feedback was consistently assuring: that acquiring was not their focus, that the undertaking would involve large physical investments as well as execution risks, and that the expertise required was not negligible. It would rather secure a good commercial agreement with one of the large networks. As to credit card processors, they lacked solid relationships with partnering commercial banks. So even if, in principle, they could develop the necessary IT systems and surpass the industry's existing technological barriers, they would not be able to gain scale without the help of a major banking ally. The challenge of developing a robust network with national reach seemed, here again, immense.

The possibility that new entrants could quickly gain market share by adopting an aggressive commercial strategy serving the large retail chains was a much debated conceptual issue at the time. Securing relationships with the larger vendors, the new agents would attain the financial stability and momentum required to cope with the capital requirements in building an extensive network. This argument permeated many reports and backed the hasty growth projections new entrants were expected to accomplish. This made sense except for the fact that the prices charged by incumbents for large retail vendors were already at extremely competitive levels. As a result, a commercial strategy focusing solely on large accounts would probably not prove sustainable. While we were still organizing and solidifying our understanding of the subject, we borrowed a few insights from the study of network structures, a theme we covered in our Dynamo Report 63 (Feb. 2010) where we noted:

"There is a widespread perception in the market today that companies that make capture of transactions on credit cards and debit cards, so-called 'acquirers', in this case Cielo and Redecard, should present significant falls in their profitability in future years. One reason for such

concern is the possibility of entry of new players, something allowed by regulatory initiative that imposed the end of the exclusivity of the relationship between acquirers and card associations ('flags'), and consequently the requirement of interoperability of the POS (point of sales) machines. Analysts predict that the newcomers will go after big retailers first, as a way to gain volume (scale) and thus pay for the initial capex to establish their networks. Moreover, by taking these important customers (hubs) from the incumbents the new comers would deal a harsh blow to their competitors. It turns out that in this space, the economic contribution of large costumers is not proportional to the volume of transactions they generate. In the incumbent networks, Cielo and Redecard, the profitability seems to be generated by the small costumers, the retail one. The commercial hub is not an economic hub. Of course, it makes sense for incumbents to retain their big customers as a way to generate volume and keep their transaction costs competitive. But it is not fundamental to the profitability of the business at the end of the day. Moreover, as prices to large customers are already low, the entrant will find it difficult to monetize its initial capex following a strategy to attack the commercial hubs. Our analysis in this segment is still at the beginning and deserves more investigation, but the lesson suggests that acquirers' network in Brazil seem to present business models more robust, where attacks targeting commercial hubs, theoretically most exposed to competition, do not produce substantial damages to the business' sustainability. Moreover, much of the profitability of these companies comes from small clients, 'hidden' inside the network and representing a higher threshold for a new entrant to achieve sufficient scale."

A few months following the above commentary we decided to put our hypotheses to test. We designed an independent field research on the retail segment and hired a specialized consultant to carry it out. From a sample of 250 vendors interviewed periodically we closely monitored the acquirer's commercial actions, as well as the immediate reactions from smaller establishments and the corresponding negotiations that followed shortly after. As a leading indicator from primary source, the research aided us in moments of low visibility, providing us with real-time information from the battlefront.

With regards to the competition between the leading incumbents, Redecard and Cielo, we again anticipated a more benign outlook for both companies than market in general, which believed in a fierce contest for the merchant's preference. Maintaining the status quo was in both companies' best interest. Our basic assumptions were: there would be some competition, some new entrants would gain market share, revenues from POS rentals would decline, and average discount rates would fall. But on the other hand the market would keep growing at double-digit rates for a while and that would help compensate the negative impacts of competition on Redecard's and Cielo's results. Even after the staggering increase in credit card usage in the last decade, credit card penetration among Brazilian families still remained below the prevailing international levels. At that time both companies' profit pool amounted to around BRL 3 billion, constituting a relevant portion of their controlling shareholders' results. Promoting an aggressive discounting policy would, at the end of the day, only transfer part of this pool to merchants, something that made no economic sense nor founded a precedent in the history of competition among Brazilian banks.

In this respect, however, we were caught off-guard. What unfolded after the ban in exclusivity contracts was an initiative from Redecard towards aggressively reducing prices for the larger establishments. And our field research could not help us here either, since it was aimed at smaller-scale establishments. We still find it hard to interpret this move since it hurt both Redecard's and Cielo's margins, the latter having been forced to mimic the strategy to preserve its market share. Following this, the companies' stock prices dropped further. This effect created a self-enforcing bias of negative outlooks among analysts, since the episode seemed to confirm their pessimistic predictions. It was not an easy period for us; our investment theses were being strenuously tested.

We began to feel in our bones what we already knew from prior experience: the proposition of contrarian investing is much easier said than done. It reminds us of those endurance competitions. Conceptually seducing at the starting point, irresistible as a narrative after it's over. But during its execution... a long while of suffering. Headwinds and slippery grounds constantly test the challenger's determination. Swimming against the current constitutes a painful decision in itself. But persisting after being dragged by the current, farther behind your starting point, can be even harder.

New entrants announcing their plans to build their own acquiring networks permeated the daily papers news. The government continuously threatened to review the industry's *status quo*. Vendors' complaints grew harsher, as they demanded a more reasonable balance in the relationship. Analyst's reports reinforced almost daily the disastrous scenario faced by incumbents. In the arithmetic of POS devices, two minus one was less than one, since besides eliminating their 'redundant' machine, vendors would get a discount on their remaining POS. Merchant discount rates were capped by more than 30%, or 50bps, in no time. The discounting receivables business would soon be swallowed by banks. Industry returns would quickly revert to the mean. And now, as if the litany was not enough, incumbents were facing mutual aggression. News agencies, Reuters, Bloomberg, sell-side analysts, sales associates, brokers, and traders, persistently reminded us, in unison, of how the market had been right and how we were mistaken about the speed of competition after the exclusivity ban.

Our immediate reaction at the moment was to double our research efforts. We practically set up camp in the companies, contacting executives across many divisions and hierarchical levels. We refined our field research. We reached out to our contacts and spoke to retailers. Above all, in this delicate period, one of Dynamo's characteristics, atypical among investment managers, proved to be fundamental: our culture of group decision-making.

We know from prospect theory, one of the pillars of behavioral finance, that the sensation of losing is about 2.5 times more intense than that of winning. Being wrong hurts. It has been said that the human body is a complex physiological and psychological thermostat: our organisms are endowed with homeostatic control mechanisms that are always trying to reestablish our balance. As soon as discomfort arises, some process will try to sooth it. Our instincts are programmed to back out from losing positions as soon as possible. In the realm of financial decision-making, a liquid market is always offering investors a chance of eliminating their discomforts and moving on to a new thesis.

Thence lays the importance of collective decision-making. In a group setting, there is more room for deliberative processes to emerge, neutralizing the primary individual reflexes. When the whole world seems to be conspiring against individual convictions, the collective process can bring serenity and perspective to decision-making, leading to a more balanced interpretation of the situation. The case of the acquirers seemed so robust to us that the collective system acted as a group reinforcement, a consensual seal of approval to keep us on course, despite all the turbulence.

It was in this environment that we soon concluded that Redecard was retreating from its price discounting initiatives with medium and large retail chains, and that the discounts would not be offered to smaller vendors, limiting the commercial attack's lifespan and scope. Even though market analysts and our own mechanical reflexes were telling us otherwise, we increased our exposure to the sector, both in Redecard and Cielo. Meetings with executives reinforced the feedback that Redecard would be revising their strategy in light of the disappointing results. Shortly thereafter, the change in the company´s management team confirmed this interpretation. With depreciated price levels prevailing, and P/E multiples in the vicinity of 13x, we increased our position in Redecard by 60% and almost doubled our stake in Cielo.

In February 2012, Itaú-Unibanco announced a tender offer to purchase Redecard's shares for BRL 35/share. At that point the stock was trading around BRL 28/share. While we can't say we expected the announcement, we cannot say it was entirely surprising either. During our tenure as Redecard shareholders, we considered this possibility many times, especially when prices plummeted. As we have seen, Redecard's and Itaú-Unibanco's businesses are inextricably linked, there is a conflict of interest arising from the bank's dual function as both a card issuer and a shareholder of Redecard, and there is strategic value to be extracted from Redecard, in the form of operational and commercial synergies that only the bank could capture.

Assuming the ongoing intention by the bank to support Redecard's existing business model, the tender offer for BRL 35/share was somewhat frustrating regarding our expectation of upside potential. On the other hand, it made sense for the controller shareholder to fully benefit from the attractive valuation and simultaneously free itself from the burden of managing conflicts of interest, which only seemed to increase in a structure with two public companies.

Still, the offer confirmed our intuition regarding the high value the banks ascribed to the acquiring business. It would not make sense for Itaú-Unibanco to pay BRL 11 billion in cash to acquire Redecard and then shrink the business. As we deemed the offer credible and saw no room for negotiation, we sold our stake in Redecard at a market price above BRL 34/share.

Indeed, this initial reaction proved to be the right move, since, shortly thereafter, as we have seen above, Itaú-Unibanco caught us by surprise deciding to pursue Redecard´s delisting process in a tough way.

Soon after, we were presented with another non-obvious opportunity. The time was September 2012. The government's interventionist stance grew stronger, and, along with it, the perception of higher regulatory risks throughout several sectors of the economy. The electricity companies had been the most recent victim of this trend, following a controversial provisional measure by the government regarding the renewal of their concession contracts. Fear for the fate of credit card industry spread across the market. At that time, the acquiring sector did not even have an established regulator. Given its proximity to, experience with, and knowledge about the banking industry, the Central Bank seemed to the best candidate. Considering the government's impulse towards interference, all the uncertainty brought with it a perception that the regulatory agenda could be seized by a more opportunistic move from the executive power. The press claimed that the Ministry of Finance and the Central Bank were analyzing potential measures to cut the credit card fees, as per the President's direct request. In this environment, Cielo's shares were down 25%.

In contrast, Cielo´s operational results remained solid, with revenues and net profits growing around 30% year over year. We went back to Brasília, deepened our discussions with industry participants, and double-checked our research work and our field data. Apparently nothing had really changed. The regulatory agenda followed its ´normal´ course, which consisted of technical discussions with market agents. So we decided to increase our stake, even though the environment seemed inhospitable. Shortly after, in March 2013, Cielo reported another excellent quarter (4Q12). The regulatory noise was dying down. The market recovered its confidence in the industry and Cielo shares trade currently at P/E multiples around 17x 2013E earnings.

Since our initial investment in Cielo, the company's profits grew approximately 50%, we received around 30% of our acquisition cost in the form of dividends, and valuation (measured in P/E multiples) expanded over 30%, going from 13x to 17x. We also earned a good amount of revenue from stock lending, which paid a fee of 20% per year in the peak of the market's pessimism. The aggregate of these results was a significant return for our investors, in a difficult period for Brazil's stock market, when the Ibovespa was trading 30% down.

Contrarianism is not a feature we wish to be known for. It is simply a temporary state, a circumstance derived from our condition of value investors. Our purpose is to invest whenever there are substantial distortions between price and value, be that with or against the crowd. What really distinguishes us is not our relative picture among investors´ ecosystem, yet the possibility we have to take on investments over a long time horizon. And this attribute, at the end of day, proceeds from our investors' patience.

Looking back through the rearview mirror with the benefit of hindsight, three years after the ban of exclusivity contracts between card associations and acquirers, there are no doubts that the regulatory move was effective in changing the industry's competitive landscape. Fees were down (especially MDR), new entrants emerged (Santander, Elavon-Citi), others preferred to secure a bigger share in the industry's profit pool by signing better contracts (Caixa, HSBC), and others still move behind the scenes (First Data, Global Payments). The incumbents, Cielo and Redecard, were forced to improve the quality of their existing services (wireless POS devices, contractual agreements with telecom companies), and increase the number of new services (mobile POS devices, mobile-card, ecommerce, and rewards programs). Their shareholders backed strategic moves through partnerships with technology companies (Cielo) or even opted for a delisting (Redecard). Without major disruptions or abrupt interventions, the regulatory initiative promoted a new era in the competitive dynamics of the industry.

Our investment in the acquiring industry has been proved a permanent challenge. It demands an continuous job analysis and management discipline, requiring a daily effort in gathering information from remote sources, in extending our relationship network, in thinking outside the box, updating our mental models, testing our convictions and defying our dispositions.

Following the positive performance of Cielo's stock in the last few months we have been reducing our stake in the company accordingly, although it still represents an important investment for the fund. We know that the regulatory risks remain, as has recently been observed in Europe and the United States: mature markets still showing signs of regulatory activity. On top of this, considering this business's nature, the conflicts of interest with the controlling banks will always be present. Intensifying competitive pressure cannot be dismissed either. We continue to pay keen attention to industry events, maintaining our high guard. At this moment, the attributes of the business, coupled with the quality of management, continues to present interesting perspectives for this investment, which, over the last four years, has bore good fruits for our investors.

Rio de Janeiro, August 15th, 2013.

DYNAMO COUGAR x IBX x IBOVESPA
Performance up to July/2013 (in R$)

Period	Dynamo Cougar	IBX	Ibovespa
60 months	111,8%	2,8%	-18,9%
36 months	52,5%	-5,9%	-28,6%
24 months	37,4%	-18,0%	-1,0%
12 months	8,2%	-2,6%	-14,0%
Year to date	0,7%	-9,5%	-20,9%

NAV/Share on July 31th = R$ 406,289771737

DYNAMO COUGAR x FGV-100 x IBOVESPA
(Performance – Percentage Change in US$ dollars)

Period	DYNAMO COUGAR* Year	DYNAMO COUGAR* Since 01/09/93	FGV-100** Year	FGV-100** Since 01/09/93	IBOVESPA*** Year	IBOVESPA*** Since 01/09/93
1993	38,8%	38,8%	9,1%	9,1%	7,7%	7,7%
1994	245,6%	379,5%	165,3%	189,3%	62,6%	75,1%
1995	-3,6%	362,2%	-35,1%	87,9%	-14,0%	50,5%
1996	53,6%	609,8%	6,6%	100,3%	53,2%	130,6%
1997	-6,2%	565,5%	-4,1%	92,0%	34,7%	210,6%
1998	-19,1%	438,1%	-31,5%	31,5%	-38,5%	91,0%
1999	104,6%	1.001,2%	116,5%	184,7%	70,2%	224,9%
2000	3,0%	1.034,5%	-2,6%	177,2%	-18,3%	165,4%
2001	-6,4%	962,4%	-8,8%	152,7%	-25,0%	99,0%
2002	-7,9%	878,9%	-24,2%	91,7%	-45,5%	8,5%
2003	93,9%	1.798,5%	145,2%	369,9%	141,3%	161,8%
2004	64,4%	3.020,2%	45,0%	581,2%	28,2%	235,7%
2005	41,2%	4.305,5%	30,8%	790,7%	44,8%	386,1%
2006	49,8%	6.498,3%	43,2%	1.175,8%	45,5%	607,5%
2007	59,7%	10.436,6%	68,4%	2.048,7%	73,4%	1.126,8%
2008	-47,1%	5.470,1%	-50,1%	973,3%	-55,4%	446,5%
2009	143,7%	13.472,6%	151,9%	2.603,3%	145,2%	1.239,9%
2010	28,1%	17.282,0%	15,2%	3.013,2%	5,6%	1.331,8%
2011	-4,4%	16.514,5%	-20,6%	2.373,0%	-27,3%	929,1%
2012	14,0%	18.844,6%	11,8%	2.664,3%	-1,4%	914,5%

2013	DYNAMO COUGAR* Month	DYNAMO COUGAR* Year	FGV-100** Month	FGV-100** Year	IBOVESPA*** Month	IBOVESPA*** Year
JAN	1,7%	1,7%	3,3%	3,3%	0,8%	0,8%
FEB	1,7%	3,4%	-2,7%	0,5%	-3,3%	-2,5%
MAR	-0,9%	2,4%	-5,6%	-5,2%	-3,7%	-6,2%
APR	0,8%	3,3%	-1,4%	-6,5%	-0,2%	-6,4%
MAY	-4,7%	-1,6%	-11,0%	-16,8%	-10,1%	-15,9%
JUN	-8,2%	-9,7%	-9,5%	-24,7%	-14,7%	-28,2%
JUL	-0,5%	-10,1%	-0,5%	-25,0%	-1,7%	-29,4%

Average Net Asset Value for Dynamo Cougar (Last 12 months): R$ 1.982.114.140

(*) 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 closing.

Please visit our website if you would like to compare the performance of Dynamo funds to other indices:

www.dynamo.com.br

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