Report
DYNAMO 84
4/4 2014

RenneЯ: *The Path of the Palindrome*

In the previous Report, we described Renner's trajectory with an emphasis on the context of our investment in the period from 1994 to 1998. We now recover the narrative from 2005, the moment in which JC Penney (JCP) decided to leave Brazil by selling its stake in the company. JCP decided to do so through a public offering in the capital markets, making Renner the first corporation listed under Bovespa's Novo Mercado rules. The idea now is to continue Renner's history chronologically until today, providing context for our recent investment.

In a way, Renner's "re-IPO" was a success for everyone. JCP left the country with a check for US$286mm, Renner received primary capital, being allowed to pursue its expansion plans, and investors – now in a company without a controlling shareholder, listed under the Novo Mercado rules – were about to witness a long trajectory of stock appreciation[1].

1 *At the time, JCP was glad to leave the country. Its pior international experiments in Mexico and Chile were unsuccessful, and the strategy then was to focus only on American operations. With the benefit of hindsight, it would have been best for them if JCP had remained as Renner's shareholder. Ironically, Renner is nowadays worth US$3.6b, while JCP is worth US$2.3b.*

The following years were extraordinary for Renner. Brazilian consumers benefited from a benign macroeconomic environment, a growth model oriented towards consumption, with an abundance of credit and an increase in household debt, employment growth and real wage growth, besides substantial public transfer policies. In the "micro" environment, Renner was reaping the rewards and results of careful strategic planning and a meticulous execution. It established itself as a must-have anchor in the boom of shopping centers in Brazil. With the right commercial strategy and cost efficiency, the company showed, year after year, solid growth of same-store-sales and expanding operating margins.

The table below summarizes a few indicators along this period.

In the eight and a half years following Renner's reentrance in the stock market up to December 2013, the company opened 153 new stores, an average of 18 stores per year. Gross margins and store productivity (as measured by EBITDA/square-meter) expanded

Lojas Renner – Main Figures 2005-2013

	Dec. 2005	Dec. 2013	CAGR nominal	CAGR real*
Net Revenues (R$ million)	1,136.4	3,913.8	16.7%	10.9%
Ajusted Ebitda (R$ million)	142.0	837.1	24.8%	18.6%
Net Profit (R$ million)	80.3	407.4	22.5%	16.4%
Ajusted Ebitda Margin	12.5%	21.4%		
Net Revenues (R$ thousand)/m2	7.7	9.6		
Total Sales Area - thousand m2	150.7	436.3		
Number of Card Users (million)	8.7	22.5		
Number of Stores: Renner	66	217		
Camicado/YouCom		61		
Number of Workers	6,262	16,367		

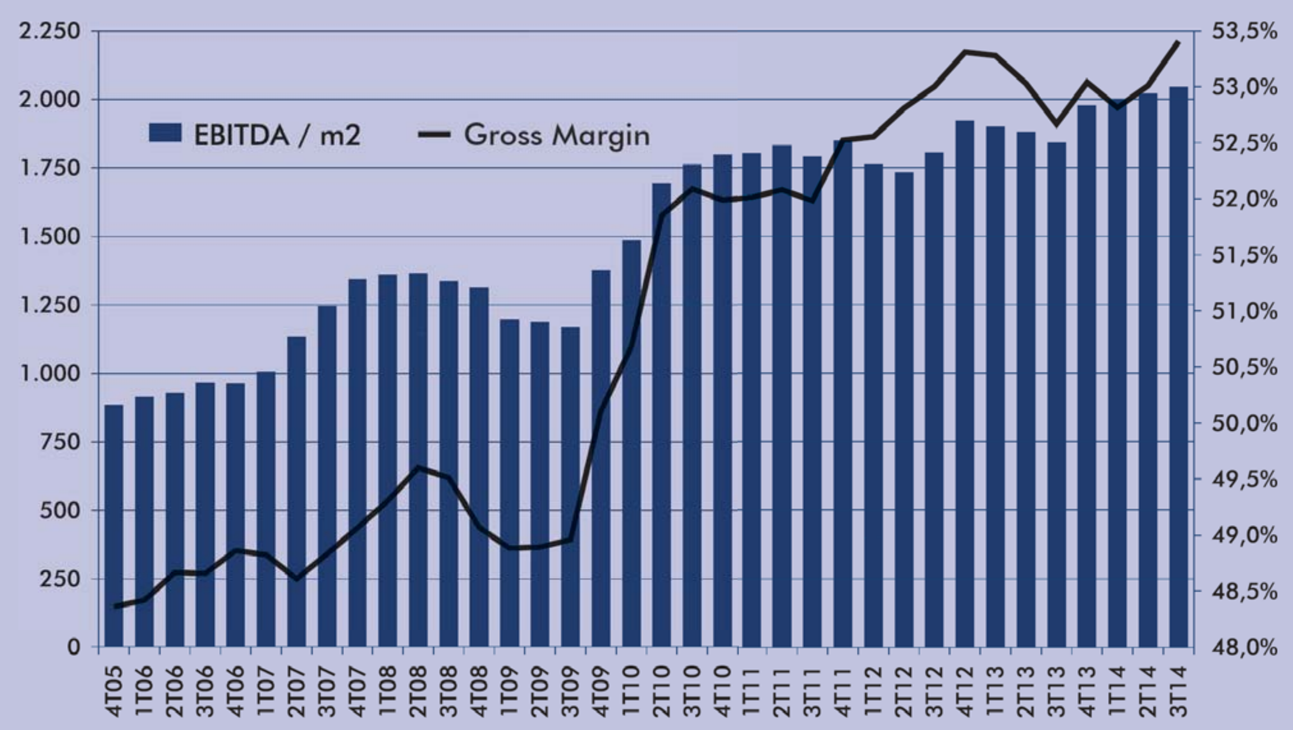
* Above IPCA

throughout the entire period, illustrating the quality of Renner's marginal growth (chart 1). That is, Renner was able to reach new client frontiers without compromising profitability, which is always a challenge for retailers expanding rapidly. Along this period, the "lifestyle" methodology deepened its roots. A larger segmentation of styles led to an increase of cross-selling and brought more volume to stores, leveraging sales, improving gross margin, and helping to establish Renner's brand even more.

In parallel, the operating infrastructure also advanced: the Retek system gained new modules, allowing it to integrate logistics and purchase planning, distribution centers and shared services center expanded, and the supply chain's velocity of reactivity increased. With the appreciated local currency there was a larger mix of imported products. Besides the traditional private label card, other new financial products were successfully launched in this period, such as personal loans, insurance, and 0+8 installment financing (with interest). Later on, the co-branded cards (Visa and Mastercard) would arrive. The results of Renner's financial operations are impressively consistent. They drive sales without carrying them, showing that a credit discipline is incorporated in the company's DNA. In comparison to other companies in the retail sector, such as Riachuelo and Marisa, the relative contribution of financial services vis-à-vis the retail product is smaller for Renner, suggesting a more robust commercial operation and a smaller exposure to the fluctuations of economic cycles. Still, with the several successive product innovations that took place, and the perfecting of credit approval processes and invoice management, the participation of the company's financial operation in its total EBITDA doubled in this period, going from 10.7% in 2005 to 20.8% in 2013.

Well, now to the negative side of the story. During these eight and a half years since Renner's return to the capital markets in July 2005 until December 2013, we were practically never invested in Renner, with two short-lasting exceptions in 2005 and 2009. In this period, the compounded nominal return of Renner's shares was 31.9% per year, higher than Dynamo Cougar's 21.9% per year return. Putting this in perspective, with the benefit of hindsight, it was a huge mistake.

Chart 1 - Productivity: EBITDA/m2 X Gross Margin



Despite growing a bit apart from the company during the JCP period, without, of course, completely losing touch, we held a privileged memory of our intense previous experience with the company. So by the time of the IPO, we had the opportunity and the means to make an important investment in Renner, and perhaps carrying it with us along all these years. But we judged that paying around 15x earnings was a bit of a stretch – we were just at the beginning of a cycle of IPOs in Brazil and had not yet witnessed a prolonged period of consumption growth that could justify such "high" multiples as this. At that point, we also could not see Renner's ability to continually produce efficiency gains, as we could not imagine that the rapid growth would also come with gross margin expansion. As a result, we made a small investment in the IPO. The stock soared quickly after and we soon sold our stake. We committed the most common value-investing mistake, which is believing that high multiples contain traps disposed by excessive optimism from other investors. Following this mantra, experience – once again – tells us that better opportunities will arise in the future, as a prize for our patience. And indeed, statistical evidence shows us that such a consistent stream of positive results along so many years are the exception, and not the rule, in the corporate world. And so we interpreted as a skill of discipline, what was really a mistake in the discipline of skill.

Using an analogy from hypothesis testing, we have said that the way we invest here at Dynamo aims to minimize "Type II" errors, the error of "accepting" bad investments. This means that, eventually, we will make "Type I" errors, which means "rejecting" good investments. Along these 20 years, Renner is maybe the most prominent example of a Type I error we made, again, with the benefit of hindsight. And it wasn't a matter of carelessness. We discussed the case over and over again, from time to time, but we always concluded that the market was fairly pricing all opportunities. We also acknowledge today that there was some anchoring bias stubbornly surrounding each round of discussion.

A financial investor has at his disposal both price and liquidity to trade assets at any time. We have remarked in previous Reports, that this condition, together with a few characteristics of human physiology, behavior, and individual psychology (reward, anxiety, ambition, social influence) can at times produce bad decisions. But gladly there are also positive aspects to it. For example, the opportunity to update our judgments, to review and correct our mistakes at every moment. And so we exercised this prerogative at the end of 2013. At the beginning of 2014, the market offered us a good opportunity to increase our exposure to the company's stock. Since then, we have gained conviction in the thesis that is nowadays one of the main investments in our portfolio.

Our confidence lies in a few elements. The first of which is the competitive environment, where Renner finds itself in a very advantageous position. Its market segment can be split into two groups. The first group, the "anchor stores", consists of the established companies operating with a large number of stores (over 200), many of which are large (over 1000 square meters). In this group, we find Renner alongside C&A and Riachuelo. They offer a large variety of clothing articles and accessories at affordable prices, always using private label brands. As we have seen, their clients also benefit from the option of the private label card, which offers the possibility to finance their purchases. And indeed, most of the sales in these chains falls under this category of financing. The second group of competitors is composed of specialty retailers. They are usually family businesses with a few stores, many of which operating under a franchise model, and some with a long history of informality. Most stores are typically small (between 50 and 150 square meters) focusing on a specific consumer profile, and/or offering a niche product.

We know that specialty stores usually offer higher quality products and have an edge in terms of fashion. Some have strong brands, are well-managed, and have been delivering consistent growth. But these are the exceptions. In our view, the specialized model has structural disadvantages when compared to the anchor stores, and this difference might increase in the next few years. The lack of scale brings about numerous challenges for these companies, such as an increase in the sourcing cost, the inability to establish quality control on their imports, besides facing a much higher occupation cost in shopping malls, which can reach, measured in cost/square meter, from 300% to 500% the effective cost that the anchor stores pay. Facing such cost pressures, these companies are forced to raise prices, thus losing their relative competitiveness.

In the past, informality was the main handicap by which the specialized stores could counterbalance these efficiency differences. With the increased efficiency of tax collecting policies, such as the requirement of electronic invoices, this practice was virtually extinguished. Nowadays, growth in the majority of these companies is dependent on the franchise model, which benefits from another fiscal particularity: the *Simples Nacional* tax regime. Besides that, these companies have less access to capital, or to financing at competitive rates due to their size. Many of them, benefiting from the recent positive macro environment, expanded their footprints to levels beyond what we think is prudent. In this more challenging environment that we are currently experiencing, there are signs that some of these companies are facing problems with unprofitable stores, and continue to face difficulties in maintaining product and service quality necessary to justify their higher target prices.

This challenging scenario also makes life harder for those companies based in a franchise model. In this system, the franchise, not the company, makes the final decision concerning merchandise purchase. The franchise business model works as a good operating leverage in periods of consumption growth, when the expectations of the company and the franchisees are positively aligned. In this environment, where optimism prevails, the company expands its business employing mainly capital from third parties. On the other hand, as soon as the franchisee finds himself in a tougher financial position, or a little insecure concerning the future, he will tend to be more conservative in his orders. As a consequence, the stores will contain less novelties, since new collections will face a narrower channel in which to flow, which can compromise sales even further. That is, when consumption slows down, the franchising system keeps acting in a pro-cyclical manner, in this case making the situation worse, since the franchisee, the weakest financial link, is usually more sensitive to the negative cycle.

With a gain in scale and continuous operational improvement, Renner has been diminishing the distance from specialized stores, not only in terms of the perceived quality of its products, but also in terms of the store environment and the very buying experience. With this, the company's value-proposition has become very competitive, conjugating good product quality / buying experience at accessible prices.

The retail business in Brazil presents some peculiar characteristics. E-commerce and international chains (excluding C&A) have not gained much relevance here. Of the ten largest apparel retailers in the world, only Inditex (Zara) has more than ten stores in the country. Even Zara, which has been here for over fifteen years, only recently reached their initial goal of 50 stores, while their original proposal was to do it in just three years. The reasons why they are so behind in their business plan are well known to experts: Brazil has a (extremely) complex tax structure, high import tariffs, terrible infrastructure logistics, and widespread bureaucracy. If we look at Inditex's store opening pattern in recent years it is clear that the company is directing its growth efforts to Asia and Europe.

E-commerce companies, in addition to facing these same problems, need to overcome the huge logistical challenge of reaching the final consumer (last mile) in Brazil, not to mention the high working capital needs. Hence, sales through this channel only have a 2% share of the total market. We have no doubt that these two forces – international and e-commerce chains – represent a long-term threat to large local retail chains. However, within a more predictable time horizon, the competitive environment will continue to be determined by the dynamics of the game played between anchor stores and satellites (specialized stores).

A second set of explanations for our optimism lies in the new logistics project that is being developed internally at Renner for some years. The idea is to optimize the entire supply chain through a complete redesign of how goods are stocked in stores. The traditional model used in distribution centers was called cross docking. In this concept, all goods arrive at CDs and within 48 hours are distributed in packs to the stores, according to a predetermined grid of criteria. But the fact is that Brazil is a continental country with widely scattered demographic, socio-economic and climatic dynamics. The consumption profile, and hence the sales pattern, capture this wide latitude of choices between consumers spread throughout our territory. Some models / sizes / colors are more accepted in certain places, others less so. The new logistics concept incorporates this response from the retail end and feeds the stores according to sales sensitivity. That is, only a portion of the goods is distributed in the first place – not in packs, but units (SKUs). The merchandise that remains will be dispatched according to the stores' precise demand. This is the system known as push and pull.

The benefits are numerous. The system optimizes transportation with a lower volume of internal transfers, decreases inventories and the storage area in the stores, reduces the stock out, as well as the need for markdowns at the end of each collection. The idea is that each store receives only the SKUs that suit its sales profile, improving inventory turnover and allocation of products at the store level. Since the system is smart, it learns from feedback, which should produce a finer tune with the specific demands of each store over time, improving not only the management of the new collections, but also the assertiveness of deliveries as it incorporates information on characteristics of SKUs, its own brands, lifestyles, the seasons of the year and so on.

This distribution center/store dynamic will also be applied down the chain, in the supplier/distribution center vector. Renner has been working with and accrediting their suppliers so that they are also able to deliver the goods with an adequate response time to feed the demands of the nearest distribution center. The idea is to reduce the lead-time between a purchase placed by Renner and delivery made by the supplier, increasing the chain's reactivity. Today the local supplier (70% of total supply) delivers within 35-50 days, which creates inefficiencies, since it is very difficult to accurately predict what will be the sales behavior one month and a half ahead. Reducing lead-time is key in yielding an optimal mix of merchandise. It is not an easy task since most of these investments and process improvements will fall on the suppliers. Renner has been providing all the necessary support to help them, building a trusting long-term partnership.

The implementation of the push and pull happens in parallel with the deepening of the fast fashion concept, which is the strategy of offering mini-collections under the premise of causing a feeling of exclusivity and fostering the perception of scarcity in the customer, and reducing the risk of collections losses. The combination of these two initiatives is management's big bet. In addition to improving inventory management, with a more adequate distribution to each store's sales profile, the idea is that all areas of the company start to react more quickly to signals being issued by the end client. The final result of these improvements should be reflected in increased sales, store productivity and gross margin. As in the case of 'lifestyles' – the results of which were really felt after 2009 –, these improvements should also take time to make a difference. In turn, they unveil an agenda that unfolds with time, providing successive opportunities. For example, Renner has been taking advantage of the changes being implemented to emphasize the importance of simplicity as a corporate value. Therefore, a number of unnecessary internal tasks are being eliminated, as well as routines that have little effect on the customer's satisfaction level or the business' final performance.

We know that the new logistics program is complex and requires a collective effort of the company's various business units, and so it involves relevant execution risks. Everything, from the collections design to the training of the stores attendants, should be adapted to become consistent with the push and pull/fast fashion philosophy. At the same time, because of its breadth and depth, it can promote a new upward shift in the company's operating margin, as we have seen with other previously successful initiatives.

This combination of continuous productivity gains and margin expansion in a favorable competitive environment provides Renner a promising horizon of profitable growth. The company also sees great potential for expansion, projecting to reach 2021 with 408 stores, not to mention the investments in Camicado (home decor) and YouCom (young fashion). That is, the operating efficiencies allow Renner to expand to regions where the retail economics are not attractive to companies with lower margins. In this model, efficiency, scale and growth produce positive feedbacks, feed on

Dynamo Cougar x IBX x Ibovespa
Performance up to December 2014 (in R$)

Period	Dynamo Cougar	IBX	Ibovespa
60 months	85.5%	-4.5%	-27.1%
36 months	40.6%	5.1%	-11.9%
24 months	13.2%	-5.8%	-18.0%
12 months	6.6%	-2.8%	-2.9%

NAV/Share on December 31 = R$ 456.671033174 themselves, allowing Renner to reinvest its profits with high return rates over time.

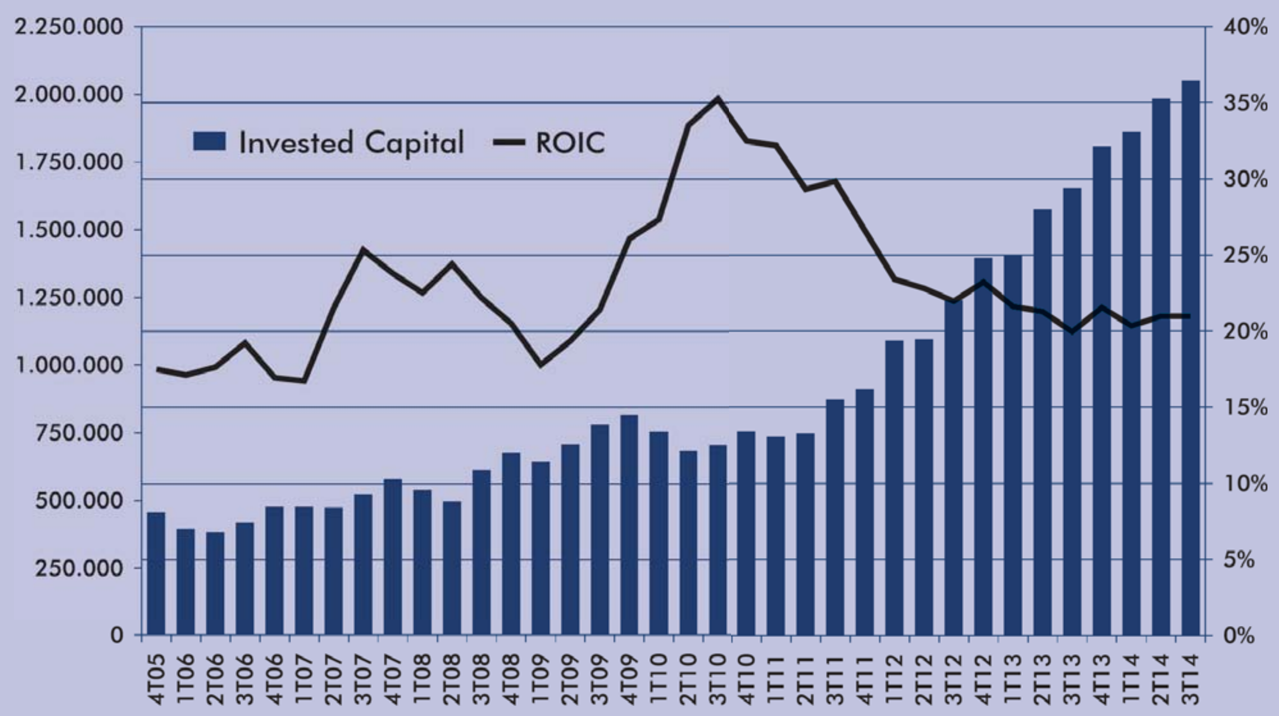
Let us now look at the risks and the main counter arguments of our thesis.

In Chart 2, we see Renner's invested capital multiplying by three for the past four years compressing the company's ROIC from 32% to 21%, a fact that has generated some discomfort among investors, especially those who are more concerned with the short term results. We know that this increase in committed resources imposes an additional challenge to the company in making them profitable precisely in unfavorable economic times. Our reflex is to look at this phenomenon from a broader perspective, understanding it as an effort to anticipate investments in the present to put the company in a position to capture consistent gains in the future, as described above. The macro environment suggests adjustments, reduced public transfers, possibly with a lower consumer buying power and eventually even some unemployment impact. No doubt it's a challenging context that should impact sales. However, we do not believe that women will stop buying fashion and, in the fight for the consumer's share of wallet, we see Renner with a more interesting value proposition. A more concerning impact in a possible macro environment deterioration would be an increase in Renner's portfolio default rate. Like with any credit transaction, it is subject to business cycle fluctuations. Here again, we see Renner with a long and proven history of discipline and conservatism in its financial services management, but this is a subject to be closely followed.

Besides that, competitive threats described above hang in the air. Mostly from e-commerce, bringing the new concepts of omni-channel retail, a rupture that has already become a reality outside Brazil. The online transformation is so acute that even the recent push and pull investment would become anachronistic, since sales logistics in this channel follow different dynamics. The threat of disruption caused by e-commerce is something that concerns us. We know that the company follows this movement, and we rely on Renner's ability to adapt, but we must remain attentive to this phenomenon's development speed.

Another recurring subject of concern among investors is related to Galló's succession. Renner now has many qualified executives, a group of leaders that

Chart 2 - Return on Invested Capital



has been in the company for a long time and that understands the business deeply. There is, therefore, a genuine talent "pool" which is being prepared, from where a more organic recommendation for succession is expected to flow. It seems natural to expect that Galló himself will be leading this process, giving it even more legitimacy. Like other well-conducted succession experiences, an important step in this gradualism should be given with the presence of the current CEO in the Board of Directors, as soon as the transition is underway. In any case, this item already deserves the Board's attention, especially when the company's executive compensation package is being structured.

In this respect, our recommendation as active investors would be to remember that, because of their history of hits, Galló and his team deserve the benefit of the doubt. That is, the governance structure should be such that it allows the executives full autonomy to come up with initiatives, while the Board of Directors is in charge of monitoring their implementation. The Board also has the important task of designing the compensation plan. In addition to pursuing the general objectives of attracting, retaining and motivating talent, the art of a well designed compensation package is to specify the goals of each contributor, connecting them to the purposes of the strategic plan. We do not have the space or the intention to further develop this issue here. With we had to choose only one recommendation in Renner's case, we would suggest that this core of top managers be granted stock-option packages that would give them greater economic exposure to the company. It may seem outdated, especially in a time where creating different share classes is popular, with the Googles, Facebooks and Alibabas, where the intention in these cases is to give more voting power to shareholders with little *ownership*. Our contention is precisely the opposite with respect to Renner, where we would prefer to award more ownership to shareholders with less voting power.

Renner's valuation today is no longer the bargain it was in the past. And it couldn't be. The company trades today at a 2015 P/E around 17x, which means that some growth for the coming years is reflected in the company's market value. The analysis through multiples only provides a simplistic picture and does not capture the dynamics of the recent investment cycles mentioned here. In our view, given the successful history of operational ramp up when opening Renner stores, it makes sense to adjust this multiple by the investments in new stores that haven't matured yet – capex already incurred but bringing no positive impact on the income statement yet.

Disregarding external elements, in the fashion retail business, management competence makes a special difference. The business ultimately depends on a consumption decision that results from a combination of numerous interacting variables: individual preferences and tastes, subjective elements such as a sense of empowerment and exclusivity, the actual buying experience, and even weather fluctuations. The product offering has to suit this changing reality. And the entire production chain has to move with agility to update these instant signals from the sales points. It is definitely a management-intensive business.

In this changing environment, Renner's early insights, some dating as far as 1992, and consistency are impressive. Their "enchantment" principle – elevated to the status of corporate 'mission' – sounds typical of modern neuromarketing books at the boundary of applied research in consumer psychology: the need to create a "neurological connectivity" with the consumer, an emotional identity, a deep psychological connection. Other elements that are nowadays present in discussions about different retail business models, such as a concern for the customer's buying experience, stimulating impulse buying, and self-service, were all already on Renner's agenda back then. The successful strategic repositioning at the time, and the precise execution later on, always respecting the needed pace until the 4 Ps (price, product, point of sale and promotion) described in the previous Report were harmoniously functioning, are a lesson in retail turnarounds, something which, ironically, the very JCP would not be able to do twenty years later[2]. The view that the company's future would depend on the development of the supply chain, on a state of the art technological infrastructure, on a corporate culture based on intensive training, that Renner should become a national player, that their expansion would be mainly based on malls, and at first occupying other retailers´ space, are other examples of dead-on

2 *In November 2011, Ron Johnson, accredited by his successful background in both Target and Apple, became CEO of JCP with the mission of revitalizing the company. Johnson announced an ambitious plan aiming at adapting JCP to the new demands of the modern consumer, the so-called millennial generation. According to his vision, the entire store concept needed to be reconfigured, promoting a radical transformation in the buying experience. Johnson altered, at a moment's notice, the entire company's pricing, which had been traditionally based on discounts. The result was catastrophic. He changed the Price, without first delivering Product. The JCP of 2012apparently did not learn from the Renner of 1992.*

DYNAMO COUGAR x FGV-100 x IBOVESPA

(Performance – Percentage Change in US$ dollars)

Period	DYNAMOCOUGAR* Year	DYNAMOCOUGAR* Since Sep1,1993	IBOVESPA*** Year	IBOVESPA*** Since Sep1,1993
1993	38.8%	38.8%	7.7%	7.7%
1994	245.6%	379.5%	62.6%	75.1%
1995	-3.6%	362.2%	-14.0%	50.5%
1996	53.6%	609.8%	53.2%	130.6%
1997	-6.2%	565.5%	34.7%	210.6%
1998	-19.1%	438.1%	-38.5%	91.0%
1999	104.6%	1,001.2%	70.2%	224.9%
2000	3.0%	1,034.5%	-18.3%	165.4%
2001	-6.4%	962.4%	-25.0%	99.0%
2002	-7.9%	878.9%	-45.5%	8.5%
2003	93.9%	1,798.5%	141.3%	161.8%
2004	64.4%	3,020.2%	28.2%	235.7%
2005	41.2%	4,305.5%	44.8%	386.1%
2006	49.8%	6,498.3%	45.5%	607.5%
2007	59.7%	10,436.6%	73.4%	1,126.8%
2008	-47.1%	5,470.1%	-55.4%	446.5%
2009	143.7%	13,472.6%	145.2%	1,239.9%
2010	28.1%	17,282.0%	5.6%	1,331.8%
2011	-4.4%	16,514.5%	-27.3%	929.1%
2012	14.0%	18,844.6%	-1.4%	914.5%
2013	-7.3%	17,456.8%	-26.3%	647.9%
2014	-6.0%	16,401.5%	-14.4%	540.4%

2014	DYNAMOCOUGAR* Month	DYNAMOCOUGAR* Year	IBOVESPA*** Month	IBOVESPA*** Year
JAN	-7.3%	-7.3%	-10.7%	-10.7%
FEB	3.4%	-4.2%	2.8%	-8.2%
MAR	6.9%	2.5%	10.4%	1.3%
APR	3.1%	5.6%	3.6%	5.0%
MAY	-0.2%	5.4%	-0.9%	4.1%
JUN	4.7%	10.4%	5.5%	9.8%
JUL	-1.7%	8.4%	2.0%	12.0%
AUG	6.0%	14.9%	11.1%	24.5%
SEP	-12.5%	0.5%	-19.3%	0.4%
OCT	2.0%	2.5%	1.2%	1.6%
NOV	-1.6%	0.9%	-4.5%	-2.4%
DEC	-6.8%	-6.0%	-11.8%	-14.4%

AverageNetAssetValueforDynamoCougar
(Last12months):R$ 2.099.201.428

(*) 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.

insights. Coming hand in hand with the successive strategic hits, was a precise execution, reflected in the operating and financial results. In these twenty-some years ahead of Renner, Galló and his team seem to have the gift of taming those "rebel" consumption variables, transforming them in known geometries, the four retail vertices, and giving Renner's trajectory the same consistency of the palindrome, an expression of its own name.

"Renner is a company that reinvents itself," management said in the 2005 annual report, when JCP was leaving the company and Renner was becoming a corporation. It is striking that a company has undergone such radical ownership changes in such a short time without showing any reflection on the day to day operations. From a family control, to becoming a multinational subsidiary, to finally turning into a corporation, all in less than a decade. Without any inertia or paralysis. On the contrary, with a continuous trajectory of revenue and operating income growth.

There is only one reasonable explanation for this phenomenon. While the ownership of the shares changed address, the role of "company owner" was fulfilled by competent executives. This group conceived and executed all the company's major strategic decisions, subverting textbooks and the stablishment. In Renner's history, the Agent is the principal. And the Principal, only a supporting agent.

Rio de Janeiro, January 19, 2015.

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