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Dispersion of Capital Ownership:

The (hopefully) upcoming pulverization of shares in Brazil

After a period of inertia, the debate about the modernization of the Brazilian capital markets resurfaced strongly during these past six months. The Government, rightly concerned with sources of financing for the next growth cycle, offered its support and sponsorship to the reform of the Corporate Law, welcomed the birth of the Novo Mercado in the Bovespa, and intensified its regulatory presence through a reinforced CVM. On top of all that, it approved in the National Monetary Council new investment rules for the local pension funds, which should encourage them to invest in companies with better governance and more modern corporate designs. It is expected that the BNDES (Brazilian development bank) shall follow the same route with respect to how it invests its own resources.

The Bovespa inaugurated an ambitious project by establishing three different listing levels for public companies according to the quality of their governance features and also by creating an entirely new market for companies with truly outstanding governance criteria. This so-called Novo Mercado should be the eldorado for investors looking for clear and fair rules on corporate matters. Institutional investors, after experimenting the bitterness of minority investments and the excessive sweetness of participating in controlling blocks through shareholder's agreements, are now beginning to work towards the improvement of governance for all shareholders of the companies they invest in.

International academic research of the highest quality[1] offer empirical support to the thesis that there is a positive relationship between the level of protection of minority investors and the relatively low cost of capital for companies. Foreign investors endorse the thesis by announcing their intention to invest more in companies where it is possible to understand clearly how profits flow to all shareholders, without friction costs in the process.

Some local minority investors have obtained important concessions from controlling shareholders in the *aggiornamento* of the by-laws of their companies, albeit at a somewhat high cost for organizing this collective action. By their own initiative, some majority shareholders – very few yet, it must be said - became genuinely interested in improving the corporate design of their firms.

The likely outcome of this remarkable convergence of interests should be an actual and potential reduction of the so-called "private benefits of control" (please see Report 22). In the international literature [1], such benefits are considered the main obstacle to the democratization or dispersion of capital, even if this is the most efficient form of ownership of capital from both a macroeconomic and microeconomic perspective. With these reforms, there is even a chance that we begin the transition from the destructive relationship between private benefits and public losses to the more optimistic and well known Mandeville statement, endorsed by Adam Smith, according to which, the production of public benefits arises even from private vices.

These are all reasons for jubilation as it confirms an evolution, which is just as positive as it is late, of our capital markets. At Dynamo, we have been following this trend for many years and it has never been as mature as it is now. In the course of 2001, all these simultaneous initiatives should produce, we hope, a better climate for investments in listed companies in Brazil. For number of firms, the returns shall be allocated in a more balanced form, reducing the expropriation of minority shareholders. As a consequence, it is possible that multiples of Brazilian companies will gradually increase to levels closer to the ones present in more developed markets, with which we compete. In our opinion, the only thing still lacking for the ignition of this engine is a successful case of a company with a high standard of corporate governance - success, in this case, understood as access to abundant and cheap capital.

Delightful and long awaited perspectives. But nevertheless, how close are we to the markets of the developed world, markets that provide funding for production and technological innovation with extraordinary efficiency? After all these positive developments, regardless of the amount and quality of the work, there is at least one more task that is just as essential as it is complex: the effective democratization of the ownership of capital of publicly-traded Brazilian companies. What is the relevancy of this point? The answer to this question is the main theme of this Report.

In Brazil, although not common, it is possible to find companies that have good results but whose market value is close or even below its net cash position. This circumstance is unthinkable in a situation where the ownership of capital is dispersed, and this is so for a very simple reason: there will always be investors ready to arbitrage this kind of distortion by accumulating enough shares to change management, if they are responsible for the anomaly. As such, at any given moment, the value of a publicly traded company with dispersed capital tends to reflect its fundamentals. In fact - and this is the key point we are trying to make – any discrepancy between the market value and the fair value based on fundamentals will quickly attract the attention of arbitrageurs, which is exactly the reason why such discrepancy should be temporary. A parallel with what happened in the US markets during the 80's is inevitable. Within the same context, the attitude of institutional investors changed from a "if we do not like the management, we sell the shares…" to a more realistic approach of "if we do not like the management, why should we be the ones to leave ?" It was this change of posture on the part of institutional investors that created

(1) Porta,R.L., Lopez-de-Silanes, F., Shleifer, A., Corporate Ownership Around the World, *October 1998, working paper, Harvard University e Bebchuk, L.A., A Rent-Protection Theory of Corporate Ownership and Control, Discussion Paper Nº 260, June 1999, Harvard Law School.*

the basis for the evolution of corporate governance in the US during the 90's.

As we know, quite different is the scenario when companies have a controlling shareholder (or a group of). In this case, the management of the company is in practice inaccessible to the other shareholders no matter how poorly the firm is run. It is obvious that there is no possible arbitrage. For example, the controlling shareholder may opt not to distribute any dividends (save for the minimum required by the Brazilian law) even if the company has no immediate investment plans. As a consequence, the company will probably accumulate vast amounts of cash which usually converts into market value at a huge discount as investors suspect, and rightly so in most cases, that they will never receive their fair share of these assets (it is certainly worth remembering the Warren Buffett test to the decision of companies not to distribute all of its earnings: measured in periods of five years how much of a dollar of retained earnings has been transferred to the market value of the company). Still, a more extreme case happens when the controlling shareholder has no foreseeable need for third party equity capital or, even worse, when it wishes to sell his shares charging a premium be that will be the highest exactly when the remaining shares are the lowest. In both cases, management, which is employed by the controlling shareholder, looses interest in the capital markets, does not publish transparent accounts and has no patience for analysts. The stock becomes neglected, brokers stop publishing research, and investors that need value and liquidity are the real losers in the process.

When capital ownership is dispersed, such attitude on the part of those who have the right to indicate the management is rapidly and severely punished. There will always be investors ready to buy more shares, as they know the real value of the company. In the extreme, they will have to buy enough shares to be able to interfere in the management of the company but nothing prevents them from doing so. Therefore, it is no longer necessary for equity investors to make virtual provisions for the idiosyncrasies of the controlling shareholder. Or put differently, when ownership is not concentrated, the market value of companies will reflect the average of the investors' expectations about the future of their businesses. And that is the basic premise for a more efficient capital market. Inversely, controlling shareholders and controlling blocks built through shareholders' agreements configure a clear signal of the relative backwardness of our market, no matter how good are the rules and regulation in place.

What is the process through which companies go from concentrated to dispersed ownership? The answer to this apparently simple question involves more guessing than irrefutable empirical evidence. In the case of the U.S., it seems that three factors had great influence in this process. First, a well-developed regulatory environment together with an efficient monitoring and punishment system reduced the scope for the expropriation of minority shareholders (*tunneling*) and, hence, turned the decision to loose control relatively cheap. Second, competition between companies may result in situations where the equity market is the only viable alternative for funding new investments. The controlling shareholder then has to decide between having its control diluted or having his company loose a lot of value, which reduces the difficulty of his decision, even though not necessarily his personal pain. Finally, there is the impact of the inheritance tax. More often than not, in order to pay such tax, heirs must sell assets and shares are usually among the most liquid and modular. Moreover, hiring professionals to run the corporation may more easily solve the management problems that arise from the multiplication of heirs through generations.

In addition to these explanations, there are other more controversial, but probably valid, thesis. Among them, the most notable is the argument that the structure of ownership of companies in a given country portray characteristics of "path dependence", that is, the prevailing structure depends on the format of the previous structure, in a relationship of interdependent and successive events that will conform its own history. Such dependency may be explained by inertial factors (cost of adaptation) and by political factors (reaction to changes from controlling shareholders when control is concentrated or from executives when it is dispersed). In a very interesting research paper, Bebchuk and Roe[2] argue that path dependence is the reason why, even in times of globalization, there still persists significant differences among countries in the ownership structure of their companies, when so many other economic characteristics have converged. Such persistence is uncomfortable. If, as it seems to be the case, companies with dispersed owners permit the creation of more efficient capital markets (by reducing the cost of capital and increasing the availability of long term funding for production of goods and services) then, in a world where competition is global, Brazilian companies have a comparative disadvantage which results in adverse social and macroeconomic impacts.

Once the theory of path dependence is accepted, the natural conclusion is that any changes in the pattern of capital ownership of companies can only happen if there is some kind of off-market intervention since, left to its own devices, the market would always tend to perpetuate the existing structure. In this respect, we note that in certain countries in Europe, and especially in England, some of the big corporations had their origin in the privatization of state-owned enterprises. Here in Brazil, we have the recent successful placement of a huge lot of Petrobras shares through a pulverized sale where buyers could pay with a portion of their long term compulsory worker's fund contribution, that could not be used otherwise. The government has already announced its plan to follow the same route for the privatization of Furnas, an energy generation company with a net worth of more than R$ 9 billion. Investors are very hopeful about Furnas, as the government seems intent on creating the first Brazilian corporation. If it succeeds – energy policy questions aside – other companies, including private sector ones, may follow, and, hopefully, our path will be broken and a much healthier dependence may start to prevail.

From our practical experience with Brazilian companies, it is possible to add one more positive fact. There is a company where certain policies followed by the management attracted several smaller investors. We are referring to Eternit, whose history (including the serious asbestos problem) we described in more detail in our Report 17. Around the end of 1998, Eternit had a market value of R$ 160 million when it had a net cash position of R$ 170 million. In the last three years, it generated, on average, approximately R$ 88 million in free cash flow. Yet again, we had the classical situation where the cash flow not being distributed to shareholders led to a huge discount by investors. After a long negotiation, a group that comprised more than 80% of the total voting capital (in fact, only voting shares have any liquidity in the market) reached an agreement according to which there is pre-established minimum level of cash that the company needs to carry. Any and all of the excessive cash is either invested at an attractive return or is immediately paid out in dividends. An attractive investment is defined as the ones approved by 5 out of six board members (who are appointed by several different shareholders) if it is in its core business, and by unanimity if it is diversification. With this clear and straightforward

(2) Bebchuk,L.A. & Roe,M.J., A Theory of Path Dependence in Corporate Ownership and Governance, Discussion Paper Nº 2666, October 1999, Harvard Law Scool.

rule, since negotiations began in December 1998, the stock went from R$ 225 to R$ 343 in December 2000 and, on top of this price appreciation, the company paid out approximately R$ 367 per share in the period. What was the impact of such generous dividend policy in the capital structure of the company? In 1994, the average transaction value in the exchange was R$ 60.000, between 1994 and 1998, R$ 47.300, in 1999, R$ 20.900, and in 2000, only R$ 14.800. In December of 1998, there were 11.95 million shares owned by shareholders that possessed less than 500 thousand shares. In November of 2000, that number had grown to 31.74 million. Although the stock is not yet traded in large volumes, it has been reasonably liquid lately. This rehearsal for dispersed ownership can be explained by the interest of smaller shareholders to invest in a stock with a high expected yield that will not be subject to change by a controlling shareholder.

If the initiatives towards democratization of capital prosper in Brazil, we will be facing an interesting situation. In markets where the capital of companies are already dispersed, corporate governance efforts are centered on the potentially conflictive relationship between shareholders and management executives. However, until now, the governance scenario in Brazil has been focused almost exclusively in another kind of conflict: majority versus minority shareholders. What is curious is the fact that, whereas every comma and dot has been fiercely negotiated by the opposing sides in the current discussion about the reform of the corporate law (the *Lei das S/A*), our legal framework for dealing with the conflict between management and shareholders is quite modern and advanced. It is indeed rather strange that we already have in place governance mechanisms that are typical of more developed markets when we are still struggling to improve very basic issues of ours. But this is exactly what happens, as we will show below. The most important event in a corporate democracy is the General Shareholders' Meeting (GSM), when, among other things, the members of the board, who will then choose the executives, are elected. Among the most valued and important corporate governance criteria concerning a GSM are: cumulative voting, vote by proxy, small percentage of ownership needed to call a GSM, previous access to a complete list of shareholders, and short period of time for blocking shares that will be voted with at a GSM. Well, we have them all. What we lack are true corporations. In summary: where we could have good quality governance, we do not have what to govern (yet); where we have many companies in need of governance, we are still producing appropriate conditions to govern.

The gnostics say that the best way to get rid of a sin is to commit it, since the regret and remorse will be responsible to eliminate it in the future. This would be an exotic argument to suggest optimism with our capital markets. There are several others that are more pragmatic: (i) the creation of the *Novo Mercado* by Bovespa and the efforts of some government agencies to fill it up with a new corporate breed: companies with dispersed ownership; (ii) the successful fragmented sale of Petrobrás shares by BNDESPAR and the announcement that others should follow; (iii) the proof offered by the case of Eternit that somewhat stable and predictable returns coupled with the resulting increase in liquidity (as should happen to companies with good businesses and modern corporate design), attract the savings of smaller investors; and (iv) last, but definitely not least, there is the lab work done by the government to build this inside-out Frankenstein that should be Furnas privatized through a pulverized sale. For a new modern corporate structure to thrive, all that is needed now is an unequivocal case of success with explicit scenes of comparative advantage through lower cost and abundant capital. Such is a virtue of capitalism. If it happens, our market and investors will be much better off, and so will be the country.

Dynamo Cougar x Ibovespa x FGV-100

(in US$ dollars - commercial selling rate)

	DYNAMO COUGAR*			FGV-100**			IBOVESPA***		
Period	**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
1998	-	-19,14	438,13	-	-31,49	31,54	-	-38,4	93,27
1stQuar/99	6,81	6,81	474,80	11,91	11,91	47,20	12,47	12,47	117,36
2ndQuar/99	24,28	32,75	614,36	24,60	39,44	83,41	2,02	14,74	121,76
3rdQuar/99	3,17	36,96	637,01	-4,71	32,87	74,77	-7,41	6,24	105,34
4thQuar/99	49,42	104,64	1001,24	62,92	116,46	184,73	59,53	69,49	227,58
1stQuar/00	6,15	6,15	1068,96	11,53	11,53	217,56	7,08	7,08	250,77
2ndQuar/00	-2,43	3,57	1040,57	-6,26	4,55	197,67	-9,03	-2,59	219,10
3rdQuar/00	4,68	8,42	1093,99	0,88	5,47	200,31	-6,10	-8,53	199,63
4thQuar/00	-4,98	3,02	1034,53	-7,69	-2,63	177,23	-10,45	-18,08	168,33
1stQuar/01	-0,98	-0,98	1023,40	-10,06	-10,06	149,33	-16,00	-16,00	125,39

(*) 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.

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