Report
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Renner: The Geometry of Retail

Towards the end of 2013, we began to acquire a stake in Lojas Renner. We increased our participation in the beginning of 2014 after the shares fell 15% in just two months, accumulating a total drop of 30% from its last peak in May 2013. We had long relished the prospect of having Lojas Renner as one of the main investments in our portfolio. Our aim is now to relate the story behind our involvement with the company. The text turned out quite lengthy, which is why we decided to divide it in two. In this Report, we narrate the journey until 2005, with an emphasis on our investment in the period between 1994 and 1998. Renner was our first case of extensive involvement with an invested company. It turned into an emblematic experience for us, with typical traces of first relationships: a series of positive interactions, fueling promising expectations, interrupted by an abrupt and disappointing ending. Following the chronology, in the next Report, we resume the company's story from 2005 until today, describing the most recent events. As we shall see, there is a clear thread of continuity in the trajectory of Renner's management. Even so, those who might be interested solely in the company's current condition, if they prefer it, may skip this Report without loss of context.

Antonio Jacob Renner was born in 1884. The great-grandson of the first generation of German immigrants in the state of Rio Grande do Sul, AJ started to work with 12 years old, and, at 27, he was one of the founding partners at a family textile company, focused on making raincoats. The business was not doing well; the partnership did not resist and had to be restructured the following year. In his role as a traveling salesman, AJ noticed the need for an impermeable fabric of higher quality. In the new shareholder structure, he assumed the partnership and took charge of the company's management. And so *A.J. Renner & Cia.* was born. AJ researched materials, invested in equipment. The final product, the *Capa Ideal (Ideal Coat)*, was a huge success. It leveraged the original business and boosted AJ´s entrepreneurial spirit.

In the 1920s, the company was already the industry leader in the spinning and textile businesses in the state of Rio Grande do Sul. The company started to produce several clothing items based on wool, and, later, linen. *AJR & Cia* innovated in spinning technology and became known for the quality of its products. In 1922, the first commercial establishment was set up next to the company's factory, and so Lojas Renner, the retail branch of the business, was born, still without a registration as an independent legal entity. Starting in 1934, Lojas Renner would begin to sell on credit.

The company prospered and verticalized. It went as far as planting the linen used in the manufacturing of its textiles. AJ immersed himself in diverse business segments, acting directly or as a shareholder of businesses such as felts, paints, sewing machines, footwear, soap, linen spinning and textile, porcelain, cement articles, and tanneries. The retail segment grew tracking the expansion of the manufacturing branch, being transformed into a department store in the 1940s. AJ stood out in both the corporate and political environments, receiving the epithet of "captain of industries".

AJ was also a precursor in a field that would nowadays be called corporate social responsibility. His employees had access to credit unions, childcares, and health services. The company was a pioneer in adopting employee incentive plans. In 1942, when people went to the streets to protest against companies with a German heritage, their employees built barricades to retain the riot in the factories. In the same manner, the workers of *AJR & Cia* did not adhere to the general strikes.

In 1965, there was a shareholder restructuring in the holding company, resulting in a spinoff of its subsidiaries. Lojas Renner became an independent legal entity, and two years later, one year after its founder passed away, the company went public.

The second half of the 1960s and the decade of 1970s were a period of continuity and relative prosperity (cfr. Garcia 2011[1]). The second generation took charge of expanding the business of Lojas Renner according to the principles established by its founders. Concern with the product's quality, respect for clients, earnestness, conservative financial management, small levels of debt, reinvestments in the business, innovation in the product mix in stores (result of the several prospecting trips abroad), commercial and financial innovations, such as the launch of "Kanto Kente" dedicated to youth fashion (a kind of *lifestyle avant la lettre*) and the private label card already in 1973 are all examples of values and actions the company relied on at that time.

The 80s were a tougher period for Lojas Renner. The competition in the retail sector became more hostile with the arrival of C&A in Brazil (1976), a qualified and well capitalized competitor. The macroeconomic environment worsened substantially, Brazil went through a recession, and saw rises in both inflation and interest rates. The reduction in disposable income among consumers suggested a need for a readjustment in the product mix and sales prices in commercial stores, in order to make goods more accessible. The challenging times would also reveal the convenience of promoting changes in store operations, which, until then, had preserved the same model from its early days in the 1930s. Each sale was followed by an individual salesman. Few products were displayed in the stores, and each store had its own "merchandise reserve" placement, to where the sales force had to go every time to check each client request. The service process was slow, onerous, and refractory to impulse sales. To make things worse, all of this happened at the moment of transition from the second to the third generation of family shareholders.

In the beginning of the 90s, it became clear that the company needed some changes. The company's board decided to hire a professional to develop a strategic plan that would guide the company in the future years. The professional chosen to do so was José Galló. Soon after, Galló was invited by the board to execute the project he proposed. The new managing director arrived at Renner aged 41, bringing with him a professional background that was entirely dedicated to retail. From his first internship in a wholesaling company (*J Alves Veríssimo*), to an experience in a department store in the south of Brazil (*Imcosul*), to his own retail business, to the task of developing a strategic plan to a holding whose main asset was a supermarket chain (*Josapar*), until finally accepting the invitation to build and execute Renner's strategic plan.

The family assured Galló that he would have broad autonomy, which was effectively confirmed soon after. At that point, Renner had already abandoned appliance sales, but the identity and DNA of a department store was still clearly present in the company. The store windows were filled with bazaar articles, bed, bath and table products, porcelains and so on. From then on, however, Renner would be a company solely focused in women's fashion items. Women became its target market, and the idea of "enchantment" emerged as the basic principle driving the development of all dimensions in this relationship. Renner would gain, in a definitive way, a strong existential identity. The annual report of 1992 outlines this period of transformation:

Renner has decided to change. In the past few years there were significant changes in consumer behavior, provoked by factors including an unstable economic environment, which made consumption in the period swing between moments of great euphoria and moments of depression. Nevertheless, besides the external and hence uncontrollable factors, we have concluded that the company needed a few adjustments. After all, in the last few fiscal years, we have not always presented satisfactory results and we believe that, to a large extent, we can achieve important improvements by adapting the company to the market.

Research from the time indicated that the recall of Renner´s brandname was larger than its effective sales. The results also suggested that its customers would like to buy more Renner products but were not able to do so. Galló initiated the change process by first altering the sales mix and recalibrating the sales prices. Without compromising the quality of its products, the company started to work with a sourcing that was more adequate to the purchasing power of its target clients.

The response was quick. The company's gross margin entered a long trajectory of continuous expansion and the results flowed through to the cash balance. As a result, Renner went a step beyond in the execution of its strategic plan repositioning itself commercially. The stores were all reformulated and standardized. Following the successful model of C&A, the company began to introduce its own brands, and abandoned the concept of boutiques and third-party brands. The stores now had more space for display the products. The "merchandise reserve "system that was previously established was finally abandoned and replaced by self-service, which accelerated the sales process and stimulated impulse buying. The points of

1 *Garcia, Adalberto (2011),* Longevity in Brazilian Organizations: The Case of Lojas Renner S.A. *Universidade do Vale do Rio dos Sinos, Unisinos, São Leopoldo, RS.*

sales were redesigned, computers were substituted and optical readers were installed. In the following year, now 1994, Renner already had resources to hold promotional campaigns, attracting more and more customers to its stores. And thus the four P's comprising the pillars of a healthy retail operation were carefully implemented by Galló: price, product, point of sales, and promotion.

At the same time these more visible actions were being put in practice, some other fundamentals of the company's corporate structure were sedimented. The mission of enchanting clients required new capacities, dispositions and mentalities. In a way, a true cultural change was taking place. Renner's employees were now required to undergo an intensive training regime which eventually evolved into one of the characteristic traits of the company in the following years. The technology infrastructure, the digital systems and controls all received a higher level of attention and investments. In a similar fashion, the importance to develop a supply chain came about during that period, and so did the strategic insight that new store expansions would be focused on shopping malls.

It was in such a context that Dynamo first became acquainted with Renner. The company's market value was around $15mm, and its stock was very illiquid. In that period, when FX markets were unstable and shareholders were less protected, an investor in Brazil would typically concentrate attention in more liquid investments, with wider exit doors. The *Plano Real* was just a few months old, too early to conclude that this time was different, that inflation would finally be domesticated. In such an environment, stocks from smaller and more illiquid companies, the so-called second and third tiers, used to trade with significant discounts over their underlying intrinsic values. Our main belief since those early days was that, by carefully mining through these tough veins, value investors could find interesting nuggets in their sieves made of diligent and cohesive analysis. (More ahead, we would discover that finding the gem is only the first step. Realizing the fair value of a business in a stunted capital market was, on the other hand, a great challenge. But that is another story).

And so it was the case of Renner, to which we were first introduced by our dear friend Geraldo Hess. After analyzing the available financial statements and carrying out our usual calculations, the picture showed attractive. Soon, we were in Porto Alegre. However, looking through the numbers, not a trivial investment proposition appeared. The company only had a small local footprint – at the time, Renner's nine stores were all in the state of Rio Grande do Sul – and had just passed through a challenging period, having faced an unstable macroeconomic environment and predatory competition. Little leverage, that was true, but no resources for nurture growth ambitions. A traditional family controlled company, going through a very recent experiment with an independent, professional management. There was also the worrying presence of founders shares, which is never comfortable.

The art of value investing consists of the ability to identify, beyond the apparent disorder of the mosaic of interactions that comprises a company, attributes that are capable of unlocking hidden value.

In the case of Renner, two particular qualities caught our eyes: reputation and management. Renner already boasted an excellent reputation at that time. Their brand was known in the region they operated and was often associated with seriousness, integrity, and was seen as carrying an honest value proposition for its clients. The new managing director was proving he was the kind of manager every investor looks for: gifted with a unique strategic vision and at the same time obsessed with the daily execution of the business; ethical, committed to shareholders, and passionate for the retail business. Just as an anedoctical example, during his family vacation in the United States, Galló's favorite pastime was to drive around main street America visiting malls and stores to learn the new trends and fashions as well as new business models in the retail industry... And, finally, as we mentioned, the third pillar sustaining our investment case in Renner was a very attractive valuation.

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

In our fourth Dynamo Report, in October 1994, we wrote our first account about our investment in Renner. There, we wrote:

Among our less liquid investment, we were very happy we were able to buy a reasonable amount of Lojas Renner's stock. Renner is a department store strongly concentrated in clothing, which underwent a very bad period in 1991, but were able to revert the situation ever since. Sales in 1994 are expected to be more than double those of 1992, with an excellent operating margin for the sector (between 5-6% pre-tax, according to our estimates). After reorganizing their existing nine stores (all in the state of Rio Grande do Sul), the company is now dedicated to expanding its footprint. In November, there will be an opening in the city of Florianópolis (state of Santa Catarina), and next year in the cities of Joinville and Curitiba (all in neighboring states in the South of Brazil). Disregarding the excellent growth opportunities and the positive results already achieved, we bought the majority of our position at an earnings multiple for 1994 of around 5x. The only really negative factor is the presence of founders shares, which significantly reduces the potential for appreciation. We are confident nonetheless that the company will extinguish those soon, and, to this point, we are even proposing a few possible remedies for this situation.

It is impossible not to feel a certain nostalgia of the days where P/E multiples were around 5x… but, well. We then began to visit the company more often and interact more fully with directors and board members, as per our usual habit of "active" investing. There we met impressive and hardworking professionals, including Professor Egon Handel, an accounting wizard who is until today a board member of Renner. The third generation of Mr. AJ Renner's heirs were showing signs that the succession dilemmas, typical of family businesses, were well taken care of. As manager, Galló had complete freedom to act. Oh, and he was also promised by the controlling shareholders that if the business plan was successfully implemented, he would receive a *Monza* (a popular car in Brazil at the time) as a bonus…

Thereafter, the board of directors was refreshed with a few new faces. Dynamo was invited to participate in 1996, and in the same year, the founders shares were extinguished. Soon after, an employee stock option plan was implemented, awarding 60 executives, alongside a regular stock repurchase plan. The company borrowed some long-term credit (BNDES and IFC) to finance its expansion, communications with investors were always objective and transparent, and minority shareholders were treated with respect.

At that point, Renner already reaped the rewards of both its strategic repositioning and a solid execution of its business plan. The four P's of Galló, as well positioned vertices of a well-known geometry, were beginning to domesticate the ambiguous variables of the retail business. The positive results were backing the expansion plans. Renner was moving forward to other States in the South region, beyond Rio Grande do Sul. São Paulo would be the next big challenge. The success of the *Plano Real*, which paved the way for economic stability, brought purchasing power and confidence back to consumers. The end of inflation also exposed the frailties of retail companies that were badly managed. For a well capitalized company, that was a moment of opportunity. At the same time, C&A was proving to be a belligerent competitor. They directed sales campaigns around Renner's stores, always aiming to destabilize the company financially. With more fire power in 1998, C&A already had 61 stores in Brazil and represented a constant threat for Renner.

This combination of factors: i) growth opportunities arising from the difficulties other retail companies were encountering; ii) a certain competitive vulnerability considering its regional geographic positioning, all indicated that Renner could and should be a national player. But for such, it would be necessary to capitalize the company further. And so began the talks with JC Penney (JCP). What started initially as talks about a potential joint-venture ended with an offer to purchase Renner's controlling shares. The controlling family decided to sell their stake, and JCP followed up with a public offering to acquire the remaining outstanding shares.

Unfortunately, the entire delisting process was not properly carried out, and disappointed us profoundly. Not only did the offer price seem far from reasonable for us – especially considering the potential benefits a partner like JCP would bring to the company –, but the entire deal structure frustrated us. It consisted of a discounted price for sellers who opted to sell first and limited the total amount of shares that would be acquired. As such, investors were drawn into taking a rash decision, risking to take a price that was 20% below the offer price, or not selling their shares at all, staying permanently illiquid. The offering memorandum had no information about JCP's future business plans for Renner, or even about their intention to delist its shares. The purchase price JCP paid for the controlling shares was also not disclosed[2].

2 *In our Dynamo Report 21, from the fourth quarter of 1998, we provided a more detailed account of this episode.*

At the time, the premium paid for ordinary shares was very high in Brazil, especially since preferred shares had no tag-along rights. But the asymmetric structure of the deal left investors both surprised and disappointed, since Renner had been developing a good rapport with investors and the capital markets. After a few "back-and-forth"s, and after facing "résistance" from a few long-term investors who were equipped with reasonable arguments, JCP decided to improve their offer. Benefiting from the strong depreciation of the Brazilian Real in January 1999, we were able to sell our stake at a better price without JCP having to pay a higher dollar amount. But the JCP deal, and this entire episode with Renner, served as the basis for improving the regulation of our capital markets, specifically the legislation about public offerings, surmised in the CVM instructions 299, 345, and 361.

Following the offer, Renner entered a new phase, no longer as a family owned company, but as a subsidiary of a multinational corporation. Renner was never delisted, but in practice, its relationship with capital markets was interrupted. JCP injected $80mm into the company, paving the way for future expansion.

The following years were marked by an acceleration in store openings: 14 new stores in 1999 and another 14 in 2000. Until 1998, in 33 years of history (as an independent legal entity), and 76 years since the founding of its first commercial establishment, Renner counted 21 stores. In just two years, it would open another 28. Indeed, the retail crisis some competitors were facing brought many opportunities. With the bankruptcy of Mesbla and Mappin, Renner started to occupy premium points of sales in the malls in São Paulo, Rio de Janeiro, Minas Gerais and Brasilia, benefiting from a rare opportunity. This episode provides a reliable picture of Renner's DNA; a rare fine-tuning between planning and execution. The company noticed an opportunity was arising, prepared for it, and at the right time, responded aggressively and precisely by taking a non-trivial decision of doubling its store count in just two years.

The strategy JCP adopted in Brazil was completely different from the ones implemented in Mexico and Chile, its previous international experiences. While in Chile they practically imported the American retail model, in Brazil they opted to preserve Renner's brand and not interfere with the commercial and financial day-to-day operations. The choices of the fashion collections, the product mix in stores, and the structure of financial products were all set locally. Their confidence in the strategic orientation and in the experience of the local management was such that no foreign director was dedicated to Brazil. Not surprisingly, Renner was the only international experience that has generated profit for JCP´s shareholders.

The main contributions that JCP made to Renner were in the areas of internal controls, information systems, administrative processes, logistics and a proper development of a supply chain. All of which were of utmost importance in a period of rapid store growth. JCP´s experience brought robustness to Renner's back-office, and more control over its supply, sustaining a consistent and rapid growth.

Lojas Renner - Main Figures 1994-2005

	Dec. 1994	Dec. 2005	CAGR nominal	CAGR real*
Net Revenues (R$ million)	88.5	1,136.4	26.1%	16.1%
EBITDA (R$ million)	10.1	142.0	27.2%	17.0%
Net Profit (R$ million)	7.0	80.3	24.9%	14.9%
Ajusted Ebitda Margin	11.4%	12.5%		
Number of Stores	9	66		

* Above IPCA

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.

At this time, an important fashion retail trend was introduced in the company, and would bring important repercussions: the concept of *lifestyles*. This is a way of segmenting the display of products in stores by "lifestyles", creating a stronger identification with the fashion collections among clients. Renner fully implemented this model, extending it to all of its own brands. The rewards were reaped a little further ahead: increase in cross-selling, reduction in markdowns, rise in the average ticket, with the consequent expansion in the gross and operating margins. The implementation of this model required an adaptation from several areas of the company, from the product development processes, information systems, inventory controls, logistics, sales, up to the very operation of the individual stores. The process would get better with time. As the complexity of its operations rose more and more, 2005 was the year to bring about *Retek*, a state-of-the-art software for inventory management which would contribute to improve operational results in the following years. The table above captures Renner's main indicators in the 1994-2005 period.

In 2005, JCP opted to divest from Renner, as it had done with its other international operations so as to concentrate its efforts in the American market, where it was facing many challenges. And JCP decided to do so through both a primary and secondary public offering, along with making a few changes to Renner's bylaws, complying with the rules for listing in Bovespa's *Novo Mercado*, the local highest standard of corporate governance.

In our next Report, we continue our narrative beginning with the very start of the "Renner-corporation", and arriving at the present-day scenario, where we provide an overview of our recent investment.

Rio de Janeiro, January 19, 2015.

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