Report
Dynamo 36
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After the tag, along should come investors

Tag along, has become an increasingly popular buzzword in Brazilian business conversations. In the context of capital markets, it means the right of a shareholder to withdraw from a company by selling his shares when another shareholder does the same. It is a commonly employed mechanism in shareholder agreements built to create a controlling block of shares, when each party have the right to sell his/her shares when one or more signatories of the agreement decide to sell their shares to a third party. In this case, such right to sell usually grants the same price and payment conditions for all parties that agreed to this be bound by this clause. More recently, tag along has become a major corporate governance principle in companies with a defining controlling shareholder associated with minority investors. For a very good reason: it is actually one of the most efficient mechanisms for aligning the interests of all shareholders of a company, as we will attempt to explain in this Report.

The use of tag along clauses has become more frequent with the development of the private equity industry and the growing presence of financial investors holding material stakes in companies. In the case of a private equity fund, the logic is clear: when these investors take the decision to invest in a company, as a general rule, they are associated with a strategic partner, whose presence is fundamental to the feasibility of the initial business plan. The tag along mechanism is always an option, not an obligation. When the third party buying out and replacing the operating partner is, at least, equally capable of ensuring the continuity of the business, financial investors will then willingly renew the shareholders' agreement and continue in the company.

Up until May 1997, in the event of a change in the controlling shareholder of a listed company, Brazilian Corporate Law (Law 6.404 of December1976), through article 254, granted tag along rights for common shares (and not for preferred shares as is usually mentioned). The new Law 9.457 revoked article 254. Apparently, the motivation for suppressing this article was inspired by the casuistic judgement by the gov-

Our Performance

During the third quarter of 2002, shares of Dynamo Cougar went up by 17.7% which brought the annual result to 40.3% (both figures in Reais; in Dollars, the figures were up 29.8% for the fourth quarter and down (7.9%) for the year). This good result looks even better when compared with the *IBOVESPA*, which dropped by 17.8% in 2002, with the *IBX* that went up by 5.7%, or even the *FGV-100* which rose 15.5% (all figures in Reais). The difference between Dynamo Cougar and *IBOVESPA* returns in 2002 was the second highest in our ten years of operations, loosing only to that of 1994 (see table).

Since its inception in September 1993, Dynamo Cougar has returned 878.9% in US dollars, while *IBOVESPA* rose only 10.1% for that same period. On a annually compounded basis, the return of Dynamo Cougar was equivalent to 27.7% *p.a.* which compares with *IBOVESPA* at 0.8% *p.a.* If measured in relation to inflation, more specifically, the *IGP-M* for this same period of close to ten years, Dynamo Cougar earned 30.7% *per annum* and *IBOVESPA*, 2.7% *per annum*.

The year of 2002 was our tenth year of operations (in 1993 we only operated for four months). Results for the whole period were quite good in spite of the wide variability. In fact, we had two outstanding years (1994 and 1999), one very good year (1996), a very bad year (1998), and several average years.

In relative terms, results were also positive. Dynamo Cougar beat *IBOVESPA* in nine out of these ten years, the *FGV-100* in eight, and the *IBX* in six of the seven years in which this index has been in existence. While we believe that the fund should continue to beat the main market indices on a medium term basis, it is reasonable to expect that the over-performance will be lower over the next few years. It is useful to remember that, despite the emphasis placed on these comparisons, we do not manage Dynamo Cougar with the objective of beating any particular index. Nevertheless, we think that the longer the period of analysis, the more sense the comparison makes as accidents of luck (or lack of), positive or negative, do not hold up against the test of time. As such, it is possible to make statistical analysis of better quality.

Getting back to the subject of the year of 2002, the stocks that contributed the most to our success were those of *Coteminas, Caemi, VCP,* and *Fosfértil*. To a lesser degree, the performances of *Ultrapar* and *Eternit* where important. On the other hand, shares of *Itaúsa, Brasil Telecom Participações, Saraiva,* and *Ipiranga* performed poorly in 2002. It is no coincidence that the first group is comprised solely of companies that either export or substitute imports in the domestic market, while the second group sell only non-tradables in the domestic market.

A curious outcome of 2002 was that of the 55 *IBOVESPA* companies, the shares of only four increased in dollar value, three of which are strong exporters (*Vale, Sid. Tubarão,* and *Aracruz*) and the fourth (*Gerdau*) has revenues which are

Dynamo Cougar x Ibovespa – Performance year to year (in R$)

Period	Dynamo Cougar	Ibovespa	Dynamo Cougar/Ibovespa
1993*	371,51%	271,54%	26,9%
1994	2365,25%	1052,43%	113,9%
1995	10,68%	-0,88%	11,7%
1996	64,17%	63,77%	0,2%
1997	0,79%	44,43%	-30,2%
1998	-12,49%	-33,35%	31,3%
1999	202,99%	150,95%	20,7%
2000	12,61%	-10,47%	25,8%
2001	11,12%	-9,79%	23,2%
2002	40,30%	-17,80%	70,7%
Since inception**	878,90%	10,10%	788,9%

(*) form september 1st (**) in US dollars ernment that by doing so, it would expedite the sales of controlling shares within the scope of the Brazilian Privatization Program, the PND. Released from the obligation to purchase all common shares, interested parties could acquire these companies with less cash. A side effect, but actually very desirable from the seller's perspective, was that, in these circumstances, the buyers could pay a much higher control premium. Later, close to the end of the *PND*, article 254 was reinstated – as article 254A – through the recent change in the Brazilian Corporate Law, effected via Law 10.303 which became valid in March 2002. Today, the law guarantees that the sale of the control of a listed company may only occur if the purchaser undertakes to make a public offer to acquire the remaining voting shares at a price equivalent to 80% of the price paid for the controlling shares.

Furthermore, Law 10.303 modified article 17 of Law 6.404 and, in its first paragraph, defined three features from which one must be chosen in order to permit these preferred shares to be publicly traded. One of such features was precisely the subordination of such shares to the requirements of article 254 in relation to the ordinary shares, that is, a tag along right at 80%. In parallel, other institutions started developing other initiatives which reinforce and expand the scope of article 254A. *BOVESPA* (São Paulo Stock Exchange) introduced levels for its listed companies' corporate governance quality. At the highest level, known as *Novo Mercado* (New Market), companies can only issue common shares and all shareholders are granted tag along rights at the exact same conditions as the controlling shareholder (as opposed to the 80% threshold of the Law). At Level 2 (one level below the *Novo Mercado)*, preferred stock may be issued provided they are granted tag along rights at 70% of the price of the controlling shares and the tag along for common shares is increased from the 80% of the Law to 100%. The *BNDES* which has been trying to foster the development of the Brazilian capital markets, recently implemented a new policy whereby it offers different degrees of support based on a corporate governance criteria, with special focus on tag along rights.

There is still an important issue pending and that has to do with the fact that changes of control that would trigger tag along rights may sometimes be hard to be defined. We lack the space here to cover this topic but we have no doubt that the *CVM* (Brazilian Securities Commission) will play an important role in directing the market towards the correct implementation of article 254A as it has been provided by the new Law, being the *CVM* Instruction 361/2002, which regulates public offers of shares (to which paragraph 3 of article 254 refers) a first step in this process.

The course from the import of the concept through to its dissemination among us was full of theoretical and empirical debates. Understanding the importance of the concept of tag along is not trivial, especially since its meaning in Brazil differs from that of its origin. The most common reaction is to associate the tag along to share of the control premium. In Brazil, unfortunately, we have become used to abnormally high premia paid for controlling shares in relation to preferred shares that trade in the market. In our Report 26, we presented an in-depth analysis of the genealogy of the control premium and exhibited a table showing the very generous premia paid in recent control transactions in Brazil. So, if I assume that the stock I own may be valued at a premium of X% when control is sold and I estimate that such sale will occur in Y years, all I need to do is to discount the value of the stock including the premium for this same length of time at a rate equivalent to my opportunity cost to compute intrinsic value of a tag along.

The importance of the tag along goes well beyond this simplistic financial calculation. It is far, far (and this repetition could be carried on further) more strategic. If the shares owned by the controlling shareholder can be sold at a price different than the price payable to minority shareholders (that is, if price will be paid at all), then these incentives could lead the controlling shareholder to take decisions exclusively in his own interests rather than those of the company. For example, when company A pays a control premium on an acquisition, it uses its own funds, which belong to all the shareholders on a proportionate basis. If company A is later sold and there is a high control premium paid only to its controlling shareholder, this means that, in practice, the cost of the referred acquisition was socialized but the gains were privatized, that is, the gains were divided unequally. Similarly, to implement a new project (a new unit or an expansion), the company's cash would be utilized and this asset, obviously, is owned indirectly, but proportionately, by all shareholders. By the same token, in the event of a sale with a control premium paid only to the controlling shareholder, he will benefit disproportionately from the benefits of this investment even if the funding for such came proportionately form all shareholders via the use of the company's cash Even the dividend policy, so conservative in our country, is affected, since a premium control can also apply on the company's cash while dividends are paid out proportionately (actually, dividends for preferred shares may be 10% higher than for common shares as this is one of the advantages that preferred shares may carry as defined by Law). In all of this cases, it becomes clear how the very economic calculation and rationale of

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partially linked to the dollar. The superiority of exporting companies last year was so strong that one cannot avoid asking if this trend may continue in the future.

In answering this question, it is important to look at some objective factors. First, from the point of view of analyzing an exporting company, what really matters is the annual average exchange rate. In reality, we should attempt to look at the specific average exchange rate of the actual exports of each company since sales can be seasonal. But, in practice, this is not feasible, so we focus instead on the average exchange rate for the year, an acceptable proxy.

Throughout 2002, the average dollar rate was of R$ 2,93. In 2001, it was R$ 2,35. In other words, a the devaluation, measured by the average exchange rates was only 24.7%, well below the almost 52% devaluation measured by the year's opening and closing exchange rates. If the average dollar rate for 2002 is equal to that of the beginning of the present year, R$ 3.54, the effective export devaluation will be 20.8% (NB:- the average exchange rate through April 30th was R$ 3,40).

Another key factor, albeit harder to estimate, is inflation of local costs. Clearly, the increase prices of domestic products and services will reduce the benefits exporters gained from the devaluation. Nevertheless, although the impact varies from one company to another, the local costs of exporting companies are unlikely to increase, on average, by more than the devaluation as measured by the average exchange rate. If this were to occur, it is reasonable to assume that the exchange rate would devalue further (endogenously), thereby increasing the average exchange rate.

In any case, the analysis of the preceding paragraphs has an excessively short-term focus, the year 2003. It is our belief that the competitive position of Brazilian exporting companies has been structurally, and not just temporarily, improved. A major consensus in the government's economic policy is the emphatic significance it gives to exports.

Moreover, because this will be the first year of a new government who has never been in power, and also because of the potential impact of a war in Iraq, we believe that the economic scenario for this year is more uncertain than usual. Although we continue to believe that the forecasting of short-term behavior of the economy and the market is so difficult that it is almost useless, it is a fact that the economic policy of the previous government policy was more predictable. In other words, the variability of possible scenarios was narrower.

Our investment policy has remained unchanged over the last ten years. We continue to invest in companies with good fundamentals, managed (or controlled) by ethical, competent and ambitious individuals whose interests are aligned with ours. For Brazilian companies that are able to compete in the global market , exporting will be profitable for a long time. And, in more uncertain times like the one we are going through this year, the quality of management is even more important. The portfolio of Dynamo Cougar reflects this view.

corporate management can become seriously undermined (and, in fact, this is what we see happening often in our investments), if there is no tag along in such circumstances.

Worse, let us imagine a company whose capital is divided as follows: one-third in common shares and two-thirds in preferred shares. The controlling shareholder holds 60% of the common stock (20% of total capital). A potential purchaser of 100% of the company's capital (in most cases, foreign investors prefer to purchase 100% since their cost of capital cost is usually lower in their home countries), must purchase the controlling shareholder's 20% plus all minority shares. It should goes without saying that the lower the price paid to the minority shareholders, the greater the premium payable to the majority shareholder. Given the highest price the purchaser is prepared to pay for the entire company, from the purchaser's point of view, the possibility of a high control premium is merely a problem of allocating the funds that such purchaser is prepared to pay. But this places the controlling and the minority shareholders against one another competing in a zero-sum game. From the point of view of the misalignment of interests within the company, the situation could not be worse. The lower the price of the preferred share in the market, the greater the chances of a high control premium, and that is a strong incentive for fabricating misleading bad news and for accounting manipulation. As mentioned in prior Reports, this is the main reason why, in the past, Dynamo has found itself in the odd position of having executives/controlling shareholders attempting to convince us that their company's situation is significantly worse than we thought, while we strive to prove the contrary. All these imbalances underscore the scope and importance of the tag along. Recently, in Brazil, the process of privatization (but not only this) brought many private equity funds and financial investors in general to acquire the control of a number of companies. Almost invariably, this type of shareholder has already set a date to sell off his position and their remuneration is a function of the difference between the purchase and sale price. Here, undoubtedly, given the improprieties that derive from the search for high control premiums, the value of the tag along is crucial.

Fortunately, as we have said earlier in this Report, Brazil has shown progress in this context. The combination of the progressive approach of our legislators, of *BOVESPA* and the *BNDES*, coupled with the actions by the more enlightened controllers, tag along for preferred shares (already guaranteed in the case of common shares by 254A of Brazilian Corporation Law) is part of the by-laws of a number of listed Brazilian corporations. This is a significant step forward.

Three companies have been pioneers in this process. One of the most significant was the case of *ULTRAPAR* which, in March 2000 granted a 100% tag along for all of its outstanding shares regardless of the class. Because of the subtleties of the legal aspects involved in contracting this right in the specific corporate structure of *ULTRAPAR*. Some months before *ULTRAPAR*, *SARAIVA* offered its shareholders a corporate restructuring specifically designed to permit the migration of all preferred shareholders to a new class of preferred shares – PNB shares, for which a 90% tag-along was granted. Finally, in June of 2000, as it was undergoing its IPO, *IDEIASNET*, which only has common shares issued, included in its bylaws a clause stating that any shareholder who wished to acquire more than 25% but less than 40% of the capital had to make a proportional tender offer to all existing shareholders. And if anyone wishes to acquire more than 40% of the capital, it has to tender for all outstanding shares at the same price.

During 2002, *MARCOPOLO*, *CELESC* and *NET* implemented *BOVESPA* Level 2 of corporate governance (100% tag-along for common shares and 70% for preferred shares.) Also, *SABESP* and *CCR* moved to the *Novo Mercado* (no issue of preferred shares and tag along for common shares at 100%). *BANCO DO BRASIL*, currently undergoing a positive revolution in its corporate structure on course to the *Novo Mercado* (including submission to the *BOVESPA* Arbitration Committee, an unusual step for a state-controlled company), has already transformed all its shares into common shares with a 100% tag along in the event of its privatization. The only reason that the *BANCO DO BRASIL* is still not listed in the *Novo Mercado* is that it has not yet been able to comply with the rule of a minimum 25% free float.

Dynamo Cougar x Ibovespa x FGV-100
Performance up to december/2002 (in R$)

Period	Dynamo Cougar	FGV-100	Ibovespa
60 months	365,50%	215,97%	11,06%
36 months	75,56%	32,96%	-33,60%
12 months	40,30%	15,49%	-17,80%
6 months	25,23%	16,94%	0,86%
3 months	17,72%	25,19%	31,93%

NAV/Share on 12/31/2002 = R$ 36,03606947

Lastly, in order to comply with new article 17 of the Brazilian Corporate Law, as commented above, the following companies have opted for the 80% tag along for their preferred stock: *ETERNIT, MARISOL, PERDIGÃO, DURATEX, GRAZZIOTIN, RANDON PART, FRAS-LE, PETROPAR, WEG, CEDRO, PETTENATI, COTEMINAS, CIQUINE PETRQ, GERDAU, ITAUBANCO, ITAUSA*, and *F.CATAGUAZES* (approved by the Board of Directors and, currently pending approval of the Shareholders' General Meeting).

This is a reasonable number of companies and expect to see it gradually increase. But it also means that a substantial portion of the responsibility for this acceleration of what we hope is a trend, is incumbent on investors. It is vital to resist the temptation to create a modern market based exclusively through new laws and regulations. Every time there is a corporate misbehavior by any party, the reflex is to build a rationale for creating a new legal restriction or impediment. Both controlling and minority shareholders, especially the latter, have been particularly active in the battle to formally safeguard their rights. The point is that once relevant corporate improvements are adopted by some companies, like the tag along, investors' discrimination should become a mechanism of natural selection for the evolution of the market. Obviously, this argument must be based on the premise that good corporate governance cannot substitute sound fundamentals, for there is no use having a company with flawless corporate governance engaged in bad business

If there is any truth in the generally accepted belief that, in the savageness of an unregulated environment, the controlling shareholder is so powerful that the minority shareholder vanishes, it is no less true that in environments subject to excessive regulation and intervention, the controlling shareholder will not show up to take his company public. For this very reason, even those who aspire to a robust and efficient capital market have all the incentives not to succumb to over regulation and draw up minimal and fair regulations, just enough to ensure that everything else is a result of free negotiation between the parties involved.

The tag along case is a perfect example of such dynamics. Having been introduced to realign interests in a particular context, by its very nature, it now permits the natural selection of good companies that have agreed to offer an equitable value distribution clause in the event of sale of control, to be naturally selected. At the same time, and conversely, its implementation by some companies and not by others, underlines the need to closely examine the reasons for which a given organization does not implement a tag along clause for its minority shareholders. This role should be taken especially by the large investors in our capital markets: the pension funds, the *BNDES*, and mutual fund managers. For tag along to become widespread, the time has come for the investor to play its part.

NB:

The Berkshire Hathaway Annual Report was published just a few days before this Report went to print[1]. Warren Buffett dedicated six pages of this report to corporate governance, a topic he had not addressed since 1993. He commented specifically on a number of points discussed by us in our last Report, including the

(1) *The full text of the report, which is worth reading, is available in the www.berkshirehathaway.com site.*

impact of the new Sarbannes-Oxley Law ("Sarbox") on the Berkshire-Hathaway structure.

In summary, Buffett's view is that, over the last ten years, senior executives of US companies perceived that due the absence and lack of interest of the true owners of the companies they managed, CEO's became the real, unchallenged, bosses. They took advantage of this situation by manipulating financial figures and awarding themselves outrageous compensation packages, even when their companies' operating performance was only mediocre.

In theory, it was the responsibility of the boards of directors of these US companies to curb such abuse. However, the vast majority of these board members did not possess the three qualities considered by Buffett to be essential for a high quality work in boards: business knowledge, interest and shareholders orientation.

Moreover, even better qualified board members encounter problems in performing their roles, due to what Buffett refers to as the "boardroom atmosphere". Speaking from his own experience of involvement with nineteen boards of listed companies over the last forty years, it is his belief that the board environment provides no motivation for debate and dissent is not encouraged. For a board member to question an over-generous compensation package of a CEO (drawn up by board members extremely well paid by these very executives), or the logic of an acquisition proposed by management, was like "belching at the dinner table". For no other reason, the change established by the Sarbox Act that Buffett feels will have the most positive impact is the requirement for board directors to meet without the presence of the CEO.

Resolving this problem will necessarily require a substantial involvement of big investors. Given the current share ownership structure of the majority of US companies, it is possible to assemble substantial blocks of shares with twenty (or even fewer) shareholders, almost all of them institutional investors. If these shareholders simply refuse to reelect inept board members, they will be contributing more to the necessary changes than any legal reform. This form of collective action is often hampered by the fact that many of these institutional investors live in glass houses of their own. Even so, some important and influential investors are already trying (with increasing success) to lead shareholders' movements in troubled companies.

In any case, changes in board procedures, increased transparency, or better qualified board members are features welcomed by everyone including the CEO's themselves. The real test will be what will happen with executive remuneration, a topic which will most likely remain very controversial.

In the case of Berkshire Hathaway itself, Buffett says that in order to adapt his company to the Sarbox requirements, he will increase the number of board members and invite representatives of big shareholders. He believes that these individuals are best qualified for this role, given their obvious interest in the company. Curiously, Buffett says that Berkshire Hathaway will not offer any directors and officers insurance (D&O), a standard practice in almost all listed US corporations.

It will be very interesting to monitor the election of these new board members, although, as Buffett clearly emphasized, the manner in which he and Charlie Munger manage the company will not change.

Rio de Janeiro, March 11, 2003

Dynamo Cougar x Ibovespa x FGV-100

(in US dollars)

Period	DYNAMO COUGAR*			FGV-100**			Ibovespa***		
	Quarter	Year to Date	Since 01/09/93	Quarter	Year to Date	Since 01/09/93	Quarter	Year to Date	Since 01/09/93
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%	-	-38,40%	93,27%
1st Quar/99	6,81%	6,81%	474,80%	11,91%	11,91%	47,20%	12,47%	12,47%	117,36%
2nd Quar/99	24,28%	32,75%	614,36%	24,60%	39,44%	83,41%	2,02%	14,74%	121,76%
3rd Quar/99	3,17%	36,96%	637,01%	-4,71%	32,87%	74,77%	-7,41%	6,24%	105,34%
4th Quar/99	49,42%	104,64%	1001,24%	62,92%	116,46%	184,73%	59,53%	69,49%	227,58%
1st Quar/00	6,15%	6,15%	1068,96%	11,53%	11,53%	217,56%	7,08%	7,08%	250,77%
2nd Quar/00	-2,43%	3,57%	1040,57%	-6,26%	4,55%	197,67%	-9,03%	-2,59%	219,10%
3rd Quar/00	4,68%	8,42%	1093,99%	0,88%	5,47%	200,31%	-6,10%	-8,53%	199,63%
4th Quar/00	-4,98%	3,02%	1034,53%	-7,69%	-2,63%	177,23%	-10,45%	-18,08%	168,33%
1st Quar/01	-0,98%	-0,98%	1023,40%	-10,06%	-10,06%	149,33%	-16,00%	-16,00%	125,39%
2nd Quar/01	-6,15%	-7,07%	954,28%	-1,76%	-11,64%	144,95%	-3,73%	-19,14%	116,97%
3rd Quar/01	-27,25%	-32,40%	666,97%	-33,81%	-41,52%	62,12%	-36,93%	-49,00%	36,84%
4th Quar/01	38,52%	-6,36%	962,40%	55,88%	-8,84%	152,71%	49,07%	-23,98%	103,99%
1st Quar/02	13,05%	13,05%	1101,05%	3,89%	3,89%	162,55%	-2,76%	-2,76%	98,35%
2nd Quar/02	-19,15%	-8,60%	871,04%	-22,45%	-19,43%	103,60%	-31,62%	-33,51%	35,63%
3rd Quar/02	-22,31%	-28,99%	654,37%	-31,78%	-45,04%	38,90%	-44,17%	-62,88%	-24,28%
4th Quar/02	29,76%	-7,86%	878,90%	38,00%	-24,15%	91,67%	45,43%	-46,01%	10,12%

(*) 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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