Report
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Our Knots

In the previous Report, we highlighted Brazil's relative position in World Bank's Doing Business Report, a ranking that attempts to measure the quality of the business environment across countries. We have seen that the country's carelessness with this crucial aspect of a nation's competitiveness may be related to its inability to grow sustainably. We interrupted our argument with a disquieting concern. In spite of having established a robust platform of digital records, we could not improve the life standard of our companies, which continue to face the worst statistic in the world for the time required to comply with tax obligations. In this Report, we will resume our narrative, illustrating the practical difficulties that our companies face on a daily basis. Self-imposed knots we need to untie.

Across the globe, the digitalization of the relationship between tax authorities and contributors seems to have allowed businesses to capture efficiency gains from simplifying their daily operations. Here in Brazil, the implementation of the electronic platform did not completely extinguish previous obligations. Instead of simplifying, it often led to an accumulation of tasks. Let us take, for example, a hypothetical retail company that operates in many Brazilian states. In addition to preparing an individual SPED (Public Digital Bookkeeping System) file for each of its stores, the company needs to deliver a GIA (information and verification guide) for each state. The SPED may have arrived, but the previous obligation remains. Similarly, in some states there are both electronic consumer invoices, which informs the treasury of each transaction in real time, and 'citizenship obligations', which are really nothing more than re-sending the same information in a different format. There is redundancy in the information produced. The amount of requirements has increased as companies are required to crosscheck all of their files for consistency since the electronic medium does not tolerate even fractional differences. At each additional module of electronic documentation, verification and reporting procedures build up a little more.

Companies must report every transaction to the tax authorities, register every purchase and every sale document by document, reporting individual consumer data in the 'citizenship obligation' forms, and yet, may face fines of up to BRL 2,000 for a BRL 10 transaction should they omit the customer's national registration code (CPF). All this technological apparatus captures an enormous amount of digital records that may be used against businesses should they incur in any distraction or lapse in providing information.

No doubt, the integration of digital files with automatic bar code scanning has significantly reduced the time spent previously with manual forms. On the other hand, additional spending on IT systems in many cases surpasses the savings in labor costs. Today, there is no single ERP software that handles every regulatory need. Specialized softwares do not integrate fluently with comprehensive systems as Oracle and SAP. A Deloitte study indicates that the costs incurred with personnel, consulting and systems to calculate and pay taxes in Brazil is around 3.5% of revenues for small companies, 0.5% for medium, and 0.2% for large ones. In the manufacturing industry, Fiesp (state of São Paulo industry federation) estimated a cost of 1.16% of net revenues for all companies, divided between 0.77% with tax-related employees and managers, 0.31% with obligations, software and outsourced services, and 0.08% with judicial expenses, especially lawyers. For every BRL 100 paid by the manufacturing industry in taxes in 2012, another BRL 6.49 was spent, on average, with bureaucracy related to such taxes (Fiesp, 2013). Increased digitalization did not reduce the country´s number of taxes nor its tax burden. On the contrary. At the time of the Dynamo Report 61 (1Q2009), we had 85 tributes in place in Brazil – ranging from taxes, duties, tariffs, and contributions. Today, the list has 92. The tax burden was 33.1% of GDP in 2009, reached 35.4% in 2014.

If our hypothetical retail company happens to operate a distribution center (DC) in a state where the ICMS (sales tax similar to VAT) in collected through a tax substitution (ST) mechanism, the complications grow exponentially. On the DC, the retailer ends up playing the role of the forward tax substitute, with a tax rate calculated on a 'presumed' retail margin, a percentage determined by each state's tax authority. Thus, in addition to GIA-ICMS forms, the retailer must complete the GIA-ST forms (as the forward tax substitute) for each reference month and for each registered state. If the DC is in São Paulo (SP), for example, the retailer has to pay the ICMS forward substitution tax for the state of SP and, if the product is transferred for sale in Rio de Janeiro, the retailer must collect the ICMS tax as a forward substitute again, but now to the State of RJ. This puts pressure on cash flows, not to mention the need for complicated refund procedures for amounts paid twice (obligation of refund by SP, because the sale occurred in RJ). Such complexity imposes obvious overloads on logistics costs. From companies handling reallocations between DCs, to trucks crossing interstate borders, taking invoices for a 'stroll' across the country, to investments in fixed assets in inhospitable regions. The national 'tax madhouse' takes precedence over economic logic.

The entanglement of fiscal federalism also extends to municipalities, each one requiring its own different tax form, without any kind of standardization. The NFS-e (electronic invoice for services), still under development, is expected to fix this problem.

At the federal level, the statements of federal tax debits and credits (DCTFs), covering all federal taxes, must be filed on a monthly basis. The contributions (PIS and COFINS) are also seeing growing requirements, and now the reporting companies must disclose all documents they used in their calculations of tax debits and credits. The requests continue to proliferate. Retailers who operate their private label cards, must in some states disclose how much was sold through the card. Again, we see unending redundancy.

If our hypothetical retailer operated in 20 states with forward tax substitution, through 300 branches and, say, 5 distribution centers, it would generate over seven thousand tax files annually only considering SPED and GIA files related to the ICMS sales tax and its forward tax-substitution. In total, there will be tens of thousands of tax payment forms and around one and a half million digital sales coupons informed every year.

Looking in perspective, the advances in electronic bookkeeping have not brought about all the expected benefits for Brazilian companies. True, they are important in the fight against informality and tax evasion, and they have in fact improved the competitive position of formal businesses. On the other hand, from the perspective of simplifying and improving the business environment, little was felt. In practice, the program served the purposes of bureaucracy, expanding its control over companies and increasing the efficiency of tax collection. Interestingly, the Brazilian IRS said the following about this initiative:

"Aligned with the actions contained in the Accelerated Growth (PAC) Program, which are intended to remove the administrative and bureaucratic barriers to economic growth, it is intended that the SPED may provide a better business environment for the country, reducing the 'Brazil cost', modernizing the interaction between government and businesses in general. [All this] in contrast with the pragmatism of results-oriented approaches, very common in projects that are only intended to increase tax revenues."

Apparently, some extraneous obstacle trumped the way, diverting these good intentions precisely in the direction they expected to avoid. The technology became a tool, and the 'analog' bureaucratic mentality continues to thrive in the digital age. The country is modernized but does not advance. Produces work without efficiency. Pedals a bicycle without its chain.

The criterion 'obtaining building permits' is another topic of the Doing Business Report where our performance has been appalling. In the latest ranking, we placed 174th among 189 countries. Under this criterion, the Report investigates the time spent, cost and number of procedures to build a commercial property. In Brazil, 19 procedures were identified - getting permit, obtaining technical liability waiver, firefighters certification, occupancy permit, property registration, operating license, and so forth. The time and costs associated with each procedure are then estimated. As with the other criteria, a standard methodology is followed in order to obtain comparable data in all countries. For example, well-defined characteristics are assumed for the commercial establishment (purpose, type of construction, size of the land and building area, number of floors, location, access, property value, water and sanitation connections), as well as for the company owning the property (limited partnership with 5 partners holding 100% of the capital, 60 employees, at least one engineer).

Among the three sub-items, our worst performance was in the number of days required to complete all the necessary paperwork for obtaining licenses and registrations: 426 days, just ahead of Cyprus (677), Cambodia (652), Zimbabwe (448) and Barbados (442)[1].

Indeed, life is not easy for real estate companies in Brazil. The difficulties start early in obtaining ownership documents. The registries are not yet fully computerized. Many properties do not have a registration, only a transcript of the transmissions, as they are still under the old regime. In this case, the entrepreneur needs to do a full check. Since the properties are not georeferenced, it is common for areas to coincide between neighbors. The process of generating ownership registration is immersed with obstacles.

Even in the case of buildings with proper registration, caution is needed. Some hide old problems with their title deeds, such as a fraudulent sale. It is not enough to know the owner and to get the record of ownership, one must often ask for a twenty or even fifty-year certificate, and map the entire history of the property in order to avoid surprises. In the North, for example, it is very common to have several owners for the same piece of property.

1 *As a new feature this year, the Report collected data from two different cities from eleven countries, including Brazil. In this criterion, São Paulo recorded 400 days and Rio de Janeiro 467 days, only better to Cyprus and Cambodia.*

Environmental aspects are another source of regulatory complexity faced by companies. Local governments commonly request reports of state environmental agencies - CETESB in São Paulo, INEA in Rio – in order to pull the property's history, its previous activities, and evaluate the so-called 'contaminants'. Businesses complain that these state agencies lack the sense of urgency. The demands are long, and the responses are slow. This process can take any time from six months to ten years in the more complicated situations. It involves numerous requirements such as, for example, the need for groundwater monitoring wells. The property owner must promote so-called "campaigns", hiring a company accredited by the environmental agencies to assess and monitor the presence of unwanted substances (sulfur, benzene, chloride, etc.). The execution of necessary constructions of any engineering service requires the issuance of an 'ART' – technical responsibility note - made by the CREA (regional engineering council).

In order to 'expedite' the steps of the process, state agencies created 'licensing portals', where the entrepreneur learns the necessary procedures for obtaining licenses. The INEA-RJ's website, for example, lists 34 'general documents' - to be obtained from INEA and other agencies (IBAMA, CREA, IRS, Board of Trade, and Civil Registry). Under 'forms and scripts' we find 58 requirements. Under 'laws and regulations' we find 331 regulatory acts, including guidelines, technical instructions, norms, resolutions, etc. In CETESB's website, under the item 'state legislation' another 438 normative guidelines for São Paulo are found. In addition to the federal legislation, larger companies operating in various regions of the country need to deal with this plethora of state regulations, not to mention the numerous municipal requirements.

In larger projects, the complexity rises exponentially. Impacts on roads, on traffic, and on the neighborhood, as well as noise issues, shading, etc., must all be considered. In some cases, there is a need for a mitigation action, formalized by the signing of a 'conduct adjustment agreement' ('TAC' in Brazil) through which the entrepreneur undertakes a compensatory urban action, be it opening a new pathway, building a walkway, a parking lot, etc. There is no objective rule for establishing such compensation. In many cases, the requirements baffle the entrepreneurs, reaching up to 5% of the cost of the project, stressing its budget. The lack of objectivity in normative texts end up leaving businesses vulnerable to the subjective interpretations of the city hall's technical body. A study by Booz & Co. estimates that the cost of red tape for construction and home building in Brazil reaches around 12% of the final value of the property, approximately BRL 18 billion per year, doubling the time required for completion.

Comparative experience shows that a zoning system with clear and well-defined rules facilitates license approvals and the growth of the real estate market, positively affecting the economic development of a nation. On the other hand, an overly restrictive and complex urban planning rule produces the opposite effect, limiting the supply of real estate and increasing prices. It seems we still have not learned to take this issue seriously. Quite the opposite. To our knowledge, our language is the only one in which the word 'zone' (derived from 'zoning') has become synonyms with disorderliness.

Brazil is a country with a long bureaucratic history. Rooted in a tradition of patrimonialism, the state assumes roles typically played by civil society in other nations. Political regimes alternate, but the idea of the state as a provider perpetuates and grows. In the recent democratic experience (the last thirty years), a predominantly opportunistic political stance continued to promise social welfare in exchange for votes. The larger the state, the more seductive the promise, the greater the political base that sustains the state itself. Hard to break, this gear feeds on itself. The resulting corollary: a dense Government machine, a hyperbolic bureaucracy.

Over-regulation and bureaucracy impose perverse obstacles in the way of business activity. The above analysis focused on the direct costs incurred by the country's companies, giving practical texture to that troublesome relative statistic, captured in the quantitative ranking of the World Bank. But there are also indirect damages affecting the economy as a whole, admittedly through the reduction in the level of investments, the inability to efficiently allocate resources, and the loss of productivity. Not to mention the associated byproducts: corruption and informality.

We know of the difficulty in changing the mechanism described above. The fact is that the country could recover a more sustainable growth path, through a public policy agenda addressed to improve the business environment, by reducing our regulatory overload. Other countries are already on to this path, as in the example of Sweden, which set up an Agency to tackle this issue[2].

Our role as investors is more modest, but not less challenging. We have a fiduciary duty to protect our shareholders' wealth by investing in the best possible manner, whatever the business environment. Devoid of normative purposes, we adopted a more cynical attitude. Thus, we begin to see another side to this story. The same over-regulation that imposes costs and difficulties for companies is a protection to their business. It constitutes high barriers to entry for new participants. If the costs of doing business are high for established companies, they can become discouraging and even prohibitive for a new entrant. In this sense, Brazil

2 *The Agency for Growth Policy Analysis, commissioned by the Swedish government, has among its objectives to "assess the effects of reducing administrative costs, analyze the effects of policies, and determine how the regulatory framework is impacting business productivity".*

Table 1 – Beer Market - Data from 2011

	Germany	France
Total Consumption (mln hl)	91.2	20.1
Per Capta Consumption (l)	111	32
Total Revenue (US$ bn)	7.8	3.1
Net Revenue per hl (US$)	85	155
EBIT Mg	9%	23%

Source: Platou and Bernstein Research

is one of the most isolated countries in terms of corporate competition, a safe place for established companies.

Several obstacles hamper greater levels of competition. There are those imposed by the companies themselves. Scale, network effects, domination of a distribution channel, high switching costs, absolute cost advantages, and product differentiation, to name a few. Other barriers emerge in the outside corporate walls, and end up helping the already established businesses. Tariff and non-tariff barriers, lack of a logistical infrastructure, excess of regulations, specifications, approvals, and licenses. No wonder we see little presence of international players in the two sectors described above, retail and homebuilding, where our regulatory and tax idiosyncrasies prove unsurmountable.

As a basic principle of capitalist dynamics, profits tend to normalize. In theory, the excess return acts as a bait for new entrepreneurs. The resulting increase in supply reduces the relative scarcity, rebalancing the market. Economists are puzzled with the phenomenon known as "persistence of profits". How to explain those sectors and companies that can maintain high margins for so long? Academic empirical studies denounce precisely the regulatory burden as one of the main reasons for the persistence of profits by incumbent firms (Eklund and Desai, 2013). That is, over-regulation inhibits competition preserving the profitability of established players. We do not need so much econometrics to reach similar conclusions. We know from practical experience that the day to day reality in a business is an intermittent search for differentiation and survival. According to the above diagnosis, there are two ways for a company to stay ahead of the competition. Running faster all the time - which requires a rare capacity for innovation and even reinventing business models – or, after gaining an advantage, build blockades so that others can not reach it.

In countries with a large public sector, bureaucracy tends to gain its own agenda, or can be captured by the interest of private sectors. Be that as an unintended consequence of well-intentioned public initiatives, or as a result of deliberate interventions, excessive regulation ends up creating obstacles to free competition, favoring established participants.

In general, where there is less competition, there is more leniency in the corporate environment. The cranks of the creative process get jammed. Entrenched, companies invest less. The returns tend to be larger. An environment with less competition favors the incumbent companies.

Two years ago, in our Dynamo Fund Report of October 2013, our team in London precisely illustrated the argument when analyzing the beer market. Beer is a local business, where distribution and marketing are key. In both respects, size matters. After reaching a reasonable scale, it is hard for a company to be dethroned without its competitor losing too much money for a long time. Four major international players virtually dominate the major Western markets.

With the help of Table 1 above, we provoke our reader with the following question: which of the two markets would the industry's profit pool be higher, in Germany or in France?

The answer is counterintuitive, in a way: they are nearly identical, around US$ 700 million. Despite the volume, revenue, and more expressive per capita consumption, the German market presents a much more intense competition than the French. At the time, eight players held a 54% share of the market, while in France 77% of the market was dominated by only three breweries. Competition imposes discounts in prices and higher expenses - in advertising, for example. This is reflected in lower revenues per hectoliter and lower operating margins for German players, despite the country's national preference for beer.

Another example is the cement industry, which is also a business with local characteristics. The product is perishable, so the plants demand geographical proximity to the sources of raw materials. Industrial plants that are near mines (of raw materials such as limestone, iron ore and gypsum) and at the same time, not far from the consumer market boast a wide competitive advantage. As with beer, cement

Table 2 – Cement Market - 2014

Company	Country	Market Share %	Market Position in the Country	Market share 3 Biggest Players	Ebitda/ton US$
Cemex	Mexico	42%	1°	79%	61.23
Argos	Colombia	50%	1°	94%	59.52
Votorantim	Brazil	36%	1°	64%	48.28
Oyak	Turkey	16%	1°	36%	21.70

Source: Companies, Countries Cement Associations, Investment Banks.

does not travel well, and importations tend to be marginal. Let us see Table 2 above:

Colombia, Mexico and Brazil are concentrated markets, where the main player has significant market dominance. Which translates to better operating results, captured by higher EBITDA per ton. Turkey is a very fragmented market for industry standards. The three largest players 'only' share 36% of the market, and the seven largest share 63%. The consequence is that the market leader has an EBITDA/ton well below their peers abroad. Of course there are other elements besides the number of participants that affect the competitive dynamics of the industry. For example, the standard of capacity utilization (in cement) or the mix of preferences among consumers (in beer). Still, the degree of concentration is often a reliable gauge of intra-industry competition levels.

The beer market in Germany and the cement market in Turkey are exceptions. The rule in these two industries is concentration, given the characteristics described above. Interestingly, in both cases, regulatory initiatives may help explain part of the exception. The so called Purity Law of German beer *(Reinheitsgebot)*, initially established in Bavaria in the early sixteenth century, determined that the brewers would use only water, barley and hops for brewing. They say that the Royal Decree's initial intention was to avoid the use of wheat in brewing, in order to avoid competition with bread production. In practice it ended up banning the use of other ingredients, some of them used as preservatives by manufacturers from other regions. Hampered the storage, transportation and penetration of external producers, the beer market in Germany has acquired an *even more* local characteristic, contributing to shape a tradition of more fragmented production.

In the Turkish cement industry, the regulation sets a maximum limit of 25% market share for each player. As seen in the table above, in other countries, it is common for the main producer to hold a largest share. Turkey is a thriving market, the fourth largest per capita consumption of cement in the world, but due to the increased competition, producers make less money per ton than elsewhere.

The two examples above illustrate the other side of the argument. Earlier, we described how over-regulation can wither the business environment, producing barriers to competition and rewarding the established incumbents. Now, specific regulatory decisions ended up generating more competition. In one case, as unintended consequence - the Purity Law in Germany in order to avoid the competitive use of raw materials, eventually fragmenting production in the beer industry. On the other, as a deliberate initiative, through which the Turkish authorities sought to prevent the concentration in the cement market.

Brazil is a closed and well-protected country. Part of this protection comes through over-regulation and the excessive complexity of our business environment. In many sectors, market concentration is high. Few players capture large shares. These leading companies enjoy the twin advantages of scale and less competition. This translates into

Dynamo Cougar x IBX x Ibovespa Performance up to July 2015 (in R$)

Period	Dynamo Cougar	IBX	Ibovespa
60 months	100.5%	0.6%	-24.7%
36 months	42.3%	4.1%	-9.3%
24 months	31.5%	6.9%	5.5%
12 months	18.8%	-7.2%	-8.9%
Year to date	17.0%	2.7%	1.7%

NAV/Share on July 31 = R$ 534.3011

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%

2015	DYNAMOCOUGAR* Month	DYNAMOCOUGAR* Year	IBOVESPA*** Month	IBOVESPA*** Year
JAN	-2.7%	-2.7%	-6.4%	-6.4%
FEV	0.1%	-2.7%	1.7%	-4.8%
MAR	-6.1%	-8.6%	-11.0%	-15.3%
ABR	10.4%	0.9%	17.8%	-0.2%
MAI	-4.9%	-4.0%	-11.6%	-11.8%
JUN	2.4%	-1.7%	3.1%	-9.1%
JUL	-6.8%	-8.4%	-12.4%	-20.4%

AverageNetAssetValueforDynamoCougar
(Last12months):R$ 2,228,406,907

(*) 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.

higher returns. As an evidence, we cite the fact that in many sectors the companies here in Brazil achieve higher margins than their peers abroad.

Not coincidently, we hold some investments of this nature. Established companies that achieved mature stages in their life cycles. As survivors, they learned to find the path to growth in an environment often hostile to business activity. Today, they are leaders in their respective markets, enjoy the advantages of scale, offer quality products and services, and dominate their distribution channels. They accumulate both the experience of management and process technology. They know what works and what doesn't, and they hit more than they miss. Lojas Renner, Cielo, Itaú-Unibanco and AB InBev/Ambev may be evoked as the main representatives of this group.

We know that excess returns and the persistence of profits are the exception rather than the rule. In economics, the universal force of gravity acts towards the direction of mean reversion and profit equalization. There are cases where the extramural barriers, when torn down, expose the weaknesses of an artificially protected business model, as captive animals exposed suddenly to the wild. That is not the case of the above companies. They were able to take advantage of their leadership positions to develop attributes that ensure their sustainable competitive advantage. Still, changes in the standards of regulations or changes that simplify the business environment can reverberate to these companies. Hence we must remain diligent in monitoring these investments. After all, that disposition is part of our modus operandi. We operate in an industry – investing – with no barrier to entry, where the daily reality of new entrants requires a permanent perseverance from the 'older' ones.

Rio de Janeiro, August 31, 2015.

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