Report
DYNAMO 54
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Cherry Picking

In recent Reports we covered some circumventing features quite typical of this IPO cycle: investor optimism, the healthy (or not) opportunism of certain entrepreneurs, abundant liquidity, the early experiments of dispersed ownership, the hastiness of the process, the role of value investors such as Dynamo, and, last but not least, the presence of "mechanisms to protect shareholders dispersion", the name we gave here to antitakeover provisions, the local poison pills. All that was missing was an analysis of the main actors: the companies and their business.

A proper timing, as in May the IPO Cycle in Brazil completed its third anniversary. Since Natura's début, we have seen no less than 92 new *Bovespa* company listings[1]. Throughout this period, our view on the matter evolved gradually. At first, we viewed with caution and some skepticism, the proposition underlying valuations to pay up front for the doubtful success of as yet little known businesses. Even the experiment of listing under the Novo Mercado's rules was still very recent. Over time, we began to better understand some business models and to perceive the quality differential of certain executives and corporate cultures. That positive surprises emerged is unquestionable. And so, with criterion and selectivity, we invested in a few IPOs.

The aim here is not an in-depth description of the companies, nor a detailed analysis of our expectations for these investments. Apart from lacking space, we would rather use this Report to illustrate our participation in these offerings, to share with our readers something of how we view these companies and their businesses. A number of the features that we like to find wherever we invest are also present in these companies: entrepreneurs with good reputation, competent executives, low management turnover, alignment of interests, strong corporate culture, well entrenched competitive advantages, significant barriers to entry, focus on costs, capacity to innovate and adapt, high returns and preferably increasing ones, attractive/reasonable valuations that do not rely on external drivers to be justified. In this context, we would include a further component: a genuine motivation to go public.

GVT

GVT was founded in 1999, aiming to provide telecommunications services, including transmission of voice and data. The business began as the result of an opportunity arising from the General Telecommunications Law issued in 1997, enabling privatization and the beginnings of competition in this segment.

GVT is a mirror operator authorized to compete against the Region II[2] fixed telephony concessionaire, and licensed to render communication and multi-media services to Regions I and III. The company's strategy of rapidly occupying market niches in its area has been successful. The basic idea is to take advantage of its updated network, leveraged by a focused and aggressive commercial practice, to seek high growth segments and customers requiring high quality customized services. As the network expands and consolidates, substantial barriers are thrown up against

(1) *In this sample, we considered some companies that really went public during this cycle, although, legally, they were already listed, such as CPFL, TAM, Lojas Renner, Cyrela, Tractebel, Rossi, São Carlos, Gafisa, Cremer, Romi, and Cia Hering.*

(2) *The General Concession Plan split Brazilian national territory into four regions: Region I – Southeast (except São Paulo), Northeast, and North (partial); Region II - South, Central-West, and North (partial); Region III - São Paulo; Region IV – long distance.*

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Over the second quarter of the year, Dynamo Cougar earned 21.5%, amounting a gain of 27.8% in the first semester. *Ibovespa* appreciated by 19.5% and *IBX* by 17.8%, for the quarter, reaching a gain of 22.3% and 20.3%, respectively, in the first-half of the year. Over the last ten years, Dynamo Cougar has recorded a real gain of 22.5%^{pa} above inflation measured on the *IGP-M*, and 26.8%^{pa} in US dollars. During this same period, the *Ibovespa* appreciated by 5.6%^{pa} over the *IGP-M* and 9.2%^{pa} in US dollars and the *IBX* 10.9%^{pa} and 14.7%^{pa}, respectively.

Almost all the Fund's investments performed well during the quarter. Ten positions, representing 59% of the portfolio, increased by more than 20% over this period. This same performance was identified in important *Ibovespa* and *IBX* index positions. In other words, a fair wind blew for any boat on the water with its sails hoisted.

Yet another quarter of net inflow of money into *Bovespa* and a surplus of foreign direct investments, a strong bull marcompetitors entry. At the same time, new market niches, with increasing returns can be potentially explored, as fixed costs are heavily diluted in this kind of business.

Regulated technological services require a combination of somewhat atypical management skills, such as taking into account regulatory incentives and gaps, identifying technological innovation dynamics, perceiving consumer preference trends, accurate timing the non-modular investments in an capital intensive business, etc. In fact, the quality of management has been an important differential for GVT. Experienced executives and hands-on shareholders provide a forceful sense of strong leadership and a well-defined business culture. The team has been working together for several years and has acquired considerable reputation. The company has a proper designed incentive system with a well designed stock options plan. Its operating results continue to underscore management's commitment to cost controls.

GVT's IPO decision came at a moment when the company sought attractive investment opportunities, for which its then fragile balance sheet position was inadequate. In fact, the offering was the end result of a long debt rescheduling with its creditor banks. Here we have what we see as genuine motivation: bringing in new partners to finance expansion projects, while simultaneously seeking to maximize capital's structure. The company used close to 30% of total funds obtained (R$ 1.076 billion) to prepay its debts and now boasts a sound cash position to meet any working capital and capex needs.

In general, market analysts valued new comers with a premium over traditional fixed telecom companies, which use to trade in very low multiples. A more detailed analysis of GVT's growth model revealed that, to a certain extent, the implicit IPO valuations were anchored by these discounted benchmarks. This encouraged us to pay the projected growth with a certain margin of safety. In fact, GVT has been showing consistently good results, an example being this second quarter when it showed a 28% increase in earnings and 39% in EBITDA year over year – gaining close to three percentage points in margin. Interestingly enough, the company's business model is not dependent on acquisitions or consolidation to grow. It is growing organically and increasing its market share through its successful new product and service launches.

ODONTOPREV

Odontoprev is Brazil's largest dental benefits company, with a market share close to 20% in member numbers. The segment of dental plan has some interesting drivers: i) a structural imbalance between supply and demand for dental services, i.e., although Brazil has a large number of qualified dentistry professionals, access to this service by the majority of the population is still very restricted. ii) the supply of dental care service under the public system is limited and ill distributed. iii) penetration of the corporate benefits packages is at an embryonic but promising stage. iv) new distribution channels have arisen, such as insurance brokerages and benefit consultancies. v) improvement in regulatory trends are striving to reduce informality and to introduce better management practices.

Odontoprev holds a key position in this rapidly growing market, in which the rest of the competition is small or less focused. The company's economic model is based on factors ensuring an attractive and protected business, such as: i) availability of a broad and customized portfolio, ii) excellent controls over its authorized professional network, iii) high quality proprietary information system, built over its nineteen years of existence, iv) need for initial expenses for the acquisition of new clients, involving a performance risk, thereby leveraging the market position of the leader, v) positive working capital and low capital expenditure requirements. Thus, *Odontoprev* enjoys high returns and competitive advantages that are almost impossible to replicate.

CEO Randal Zanetti and his group of executives have in-depth experience and specialization in the sector. Besides that, the majority of their wealth is invested in the shares of the company, despite the fact that the corporate control is widely spread throughout the market. The IPO occurred in a context of the exit of a private

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ket. Interest rates coming down and exchange rate appreciation in Reais. Records in the IPO market as well. A recent study revealed that Brazil was responsible for ten percent of the global IPO market so far in 2007. The impact on the business environment is already making itself felt.

It is an indisputable fact that Brazil's solid macroeconomic bases and high foreign liquidity levels have jointly conspired with a more mature capital market (increased financial openness and improved legal protection) to produce unprecedented results. From 2003 through June 2007, *Bovespa* listed companies gained R$1.5 trillion in market cap. In the last eighteen months alone, the companies obtained close to R$42 billion in primary equity issues and a further R$132 billion in debt ones, i.e., the equivalent of just under half Brazil's gross fixed capital formation in 2006. Unlike other times when higher market capitalization was restricted to a movement of appreciation of secondary market securities, in this cycle the market highs actually reached the companies' balance sheet.

The combination of a general increment on valuations with an abundance of liquidity and open access to external funds finally enabled the companies to know the capital market in its most genuine role: as a source to raise money at competitive costs. And, from that point on, a lot of positive consequences come aboard. Thanks to more robust corpoequity investor speeded up by the deadline of its investment vehicle. The founders and executives sold proportionally less and continue to be significant shareholders. We were able to monitor the evolution of the company's operational performance and its internal controls, right when the first offering was filed under *CVM*, prior to the temporary postponement of the definitive transaction. This boosted our confidence in paying for the growth implicit in the high IPO multiples.

There is absolutely no doubt that *Odontoprev's* arrival in the market has enhanced its professionalism, and has inculcated in management a practical sense of accountability, one that is perceived in its concern with capital market issues and its conscientious endeavors to dialogue with investors.

ALL

ALL (América Latina Logística) is Latin America's biggest independent railway logistics operator, and was founded in 1997 (then known as *Concessionária Brasileira*), when it won the Southern Network bid under the *PND* (National Privatization Program). Since then, *ALL's* consolidated network has expanded to the point of incorporating the Southern portion of the São Paulo State *Ferroban* network, in addition to two Argentinean railways (Central and Mesopotamia). More recently, *ALL* acquired the control of Brasil Ferrovias, comprised of three routes, *Ferronorte, Novoeste*, and *Ferroban*. As a result, the company integrated a great part of Brazil's Southern, Southeastern, and Central-west railway network, covering an area responsible for 78% of South America's grain exports and 75% of *Mercosul's* GDP.

Basically, the company's strategy is to exploit its inherent competitive edge, offering logistics solutions levering rail-borne volumes. Its entire corporate decision rationale is based on maximizing returns on invested capital. ALL's market share of its addressable market is still very low. This way, management priorities are not placed in the commercial area. Corporate challenges can be stated as a complex operational research problem solving: which trajectory of locomotives will maximize the return on invested capital given a certain volume of rolling stock and the restrictions imposed by the existing railway network?

Discipline of capital, a constant focus on cost controls, and a strong meritocratic corporate culture have all produced consistent results. In terms of both revenue and EBITDA, *ALL* is growing and maintaining significantly high levels of return.

The initial offering was a combination of secondary and primary shares issue for funding investments to improve the railway network. We acquired a minor stake in the IPO, which we sold later, given the combination of the good share performance and our concern with the proximity of a secondary follow-on. We were concerned that a lower economic interest of some shareholders responsible for building the corporate culture could reduce the company's punch in pursuing its operational targets. We were wrong.

We rebuilt a reasonable position when we perceived the potential opportunities inherent to the purchase of Brasil Ferrovias. We did a more in-depth study of the logistics routes and bottlenecks, the dynamics of the extension of farming frontiers, the possibility of the industrial business, and the growth potential of the network's productivity, all showing us that *ALL* management's track record could easily handle more aggressive assumptions in the sensitivity analysis of our DFC.

LOCALIZA

Localiza is the largest car rental network in Brazil with 300 branches. The company is active in both car rental and fleet management businesses, with close to 370 corporate clients. In addition to that, Localiza sells used cars through thirty sale centers.

These three businesses are synergic and scalable. A larger fleet ensures increased geographic flexibility in renting vehicles, broader coverage, a more customized service supply, greater ability

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rate financial statements, expansion projects are beginning to come off the drawing board. Furthermore, defying tradition, some Brazilian companies are going shopping in foreign markets. At the same time, new kind of businesses arrive at our equity market and these neophytes companies show every sign of capturing the first movers advantages. Consolidations abound in a number of different segments: real estate, health care, education, sugar and alcohol, financial services, retailing, meat and food products, equipments, and software, among others. Spillovers and linkages effects are expected to proliferate throughout technological platforms, management systems, and supply chains. Under this new logic of economic calculation, companies are testing the waters of formalization.

A prolonged cycle of successful IPOs could become an important institutional landmark, impacting the entire business chain, by motivating early entrepreneurial activity, challenging the standard (patrimonial) corporate culture, and suggesting new ways for doing business in Brazil, as the one of the public company.

In this context, regardless of natural periodic asset price corrections customarily reserved by equity markets, it would seem that this bull market will leave behind a promising legacy.

to manage prices, in addition to a natural dilution of fixed costs. The rental business generates scale and bargaining power in purchasing vehicles from the manufacturers. In turn, the resale unit balances out the fleets' occupancy rate, reduces vehicle depreciation costs, and provides a flow of updated information for the rental sector, helping to fine tuning the yield management.

Another basic benefit for this integrated business platforms is the company's brand name, built on its robust corporate reputation. It is a known fact that used car sales profitability are basically dependent on the credibility of the seller's brand. Reputation minimizes the problems arising from information asymmetry between buyers and sellers, allowing sellers to capture part of the discount of this type of transaction[3].

Localiza holds a 20% share of a highly fragmented market. Its three main competitors jointly hold nearly 15% of the car rental market and the remainder is split between close to two thousand small operators. To be sure, this kind of market distribution shows a remarkable characteristic of this business, which is a low entry barrier, combined with a high protection to growth[4].

Company's management is one of the best quality: experienced, enthusiastic, and extremely competent executives. Over the last few years, the company has grown at twice the market rate, levering the sector's growth drivers: income improvement, greater credit card penetration, growing tourism, increased air traffic, the trend to outsourced corporate fleets, and greater replacement service demand.

The IPO came at a time when the founding shareholders decided to expedite the company's institutionalization, and took advantage of a private equity investor's withdrawal decision. The initial price was below the suggested range and the after-market turned to be lukewarm. Although we had begun watching the company before it went public, after the IPO, we had the opportunity to interact with senior management which caused a very positive impression on us. We took this opportunity to build a solid position. With time and Localiza's excellent communication work, the market begun to satisfactorily price the company's prospects.

VIVAX

Vivax was founded in 1996 to acquire and operate cable TV concessions. In 2004, the company purchased Bell Canada's operations thereby significantly increasing its subscriber base. By its IPO on February 2006, the company was operating 34 concessions, supplying cable TV to over a million homes, and was Brazil's third largest cable TV provider.

Vivax focuses chiefly on the higher income stake of the market where it encounters less competition. Its concession area covers thirty-one towns in the State of São Paulo, two in Rio de Janeiro, and Manaus. In almost all of these, the only competition comes from DTH service providers that do not offer local content.

This competitive strategy is based on the network's bi-directional quality and capacity of at least 750 MHz. Vivax technology provides a higher quality of transmission services than its competitors, regardless of whether the latter are cable TV operators (DTH or MMDS technology) or broadband telephony companies (DSL). A further competitive advantage is that Vivax provides direct customer services in addition to local content programs, via its twelve dedicated channels.

The IPO was timed to coincide with the private equity investor's search for liquidity when the company required funds to expand its operations and upgrade its capital structure. This resulted in a primary and secondary offering.

The company's chief executives, Christopher Torto and Fernando Norbert, remained as majors shareholders, which ensured a desired convergence of interests. They are both hands-on guys involved in company's day-to-day activities and have an in-depth experience in the sector. They have shown capital discipline and have successfully timed the difficult decision to expand the network and/or make acquisitions. In businesses based on network structures, prior decisions regarding its geography (location) and its geometry (design) have significantly impact over future re-

(3) *Since George Akerlof's classic paper (1970) the used car market has become a typical example of the information asymmetry problems between buyers and sellers. The paper was originally published in the Quarterly Journal of Economics, 84 (August 1970) and entitled "The Market for Lemons: Quality Uncertainty and the Market Mechanism".*

(4) *This is due to the fact that the capital required to operate in this segment is very low – at the limit, just one vehicle. However, thanks to the scale and flexibility of their fleets, the market leaders are able to sustain surgical marketing expenses for a long time, thereby restricting the ability of these small local players to grow.*

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BREAKING NEWS:

In fact, over the last few days, we have seen increased market volatility reflecting investor uncertainty on an environment too complacent with historically low risk premiums. It is still too early to understand the magnitude of these impacts over the economic activity or even over the expectations underlying current valuations in Brazil. We shall remain alert to events, carefully reflecting in the Fund's cash position and in the profile of our portfolio, our level of comfort with current market prices.

turns. Based on all this – improved services mix, solid concession area demographics, customer fidelity, lower maintenance costs, and superior network quality - Vivax holds solid competitive advantages and the marginal returns on future expansions are expected to be high. We were also aware that Net Serviços, which already hold substantial operations close to Vivax's concession area, could target Vivax for acquisition. In fact, eight months after the IPO, Net acquired the company thereby anticipating a significant part of the return that we expected in this investment.

TRACTEBEL

Tractebel Energia was founded in 1997 after Eletrobrás subsidiary Eletrosul's spin-off. In 1998, Tractebel (then called Gerasul) was acquired by Tractebel Group based on Belgium, which latter become under control of Suez Energy International, a subsidiary of the Suez Group. Although Tractebel had been listed since its privatization, Suez treated it as a private company – i.e., minimal transparency and very low liquidity. In 2005, the Suez Group changed its strategic approach and decided to transform Tractebel into a really public company. The "new" IPO occurred via a secondary offering in which the controllers sold a portion of their position in the market. The company was listed under the Novo Mercado rules and the Suez Group's message of commitment to the local capital market was perceived as credible. Investors ignored their natural skepticism on secondary offerings and the fact that the shareholder structure of the Group preserved some possibilities for conflict of interests.

Tractebel is Brazil's leading private power generator with an installed capacity of 5.9 thousand MW and supplying 7% of the domestic market. It has eleven operational plants and a further two under construction, all based in the South and Central-West regions of Brazil. This represent an interesting production mix: hydroelectric and thermal plants, with a diversification of fossil (coal, gas, and oil) and renewable (water and, more recently, sugarcane bagasse) fuels.

Tractebel was the first private power player to take advantage of Brazil's electrical sector's deregulation. Right from early 2002, the company pro-actively was able to attract free customers that had been authorized to exit the captive market under distribution utilities concessions.

Thanks to its balanced production mix and good volume of assured energy, Tractebel's experienced executives, with their in-depth knowledge of the nature and complexities of the Brazilian electricity sector, successfully put pioneering selling practices in place, thereby building up a diversified portfolio of contracts and a consistent short-term energy trading strategy. While sales to the distributors ensure cash flow stability, the company's more than 100 free customers portfolio enables increased contracting curve flexibility. At the same time, this excess of physical ballast over the effective dispatch allows the company the possibility to arbitrate the spreads of spot prices vis à vis its average contract prices. Furthermore, Tractebel has also been very successful in anticipating energy scarcity situations and, consequently, future market prices. The company was contracted at high prices during post-rationing excess of supply. On the other hand, 25% of its total resources are uncontracted for 2011-2012, when an energy shortage is expected.

Tractebel is not a cheap company and trades at a premium to comparables. Nevertheless, we find a fairly reasonable normalized return, mostly due to the quality of its management, the company's capital discipline, and the defensive nature of the business. Moreover, some unpriced options could surprise positively, such as an energy price curve higher then currently projected or an acquisition opportunity in the sector.

As we said, the intent here was to show some of Dynamo investments in this IPO cycle, highlighting the factors that led us to perceive these companies as good investment opportunities, despite the inherent problems in the process for a typically fundamentalist investor. Needless to say, there are some operational or corporate/alignment of interests aspects of these companies that require monitoring. For example, although we fully understand the reasons that led companies such as GVT and *Odontoprev* to include poison pills in their by-laws (as described in our last Report), conceptually, we fear that these provisions could deprive them of the benefits of a genuine market for corporate control. We also continue to follow with attention the *insiders* reduced interests in *ALL*

DYNAMO COUGAR x IBX x IBOVESPA
Performance up to June/2007 (in R$)

Period	Dynamo Cougar	IBX	Ibovespa
60 months	552.71%	456.46%	386.35%
36 months	206.95%	204.41%	160.13%
24 months	137.23%	123.75%	115.98%
12 months	59.51%	47.80%	48.34%
3 months	21.51%	17.81%	19.49%

NAV/Share on June 30th = R$ 187.831563930 and Localiza. Naturally, these elements and movements are all adjusted in the relative size of theses investments in our portfolio.

It's worth to reinforce that the motivation to go public in all the companies mentioned was not merely for opportunistic reasons, timing a favorable market momentum. In these and other cases, the laudable IPO decision is part of a wider evolutionary context, a stage transposed on the company's development path. The award was a voucher to permanently access financial resources at competitive costs.

Rio de Janeiro, September 5th , 2007.

DYNAMO COUGAR x IBOVESPA x FGV-100
(in US$ dollars)

	DYNAMO COUGAR*			FGV-100**			IBOVESPA***		
Period	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
1999	-	104.64	1,001.24	-	116.46	184.73	-	69.49	227.58
2000	-	3.02	1,034.53	-	-2.63	177.23	-	-18.08	168.33
2001	-	-6.36	962.40	-	-8.84	152.71	-	-23.98	103.99
1stQuar/02	13.05	13.05	1,101.05	3.89	3.89	162.55	-2.76	-2.76	98.35
2ndQuar/02	-19.15	-8.60	871.04	-22.45	-19.43	103.60	-31.62	-33.51	35.63
3rdQuar/02	-22.31	-28.99	654.37	-31.78	-45.04	38.90	-44.17	-62.88	-24.28
4thQuar/02	29.76	-7.86	878.90	38.00	-24.15	91.67	45.43	-46.01	10.12
1stQuar/03	4.47	4.47	922.65	4.63	4.63	100.55	5.39	5.39	16.06
2ndQuar/03	27.29	32.98	1,201.73	38.16	44.55	177.07	34.33	41.58	55.91
3rdQuar/03	19.37	58.73	1,453.83	24.72	80.29	245.56	22.34	73.20	90.74
4thQuar/03	22.18	93.94	1,798.51	35.98	145.16	369.91	39.17	141.04	165.44
1stQuar/04	4.67	4.67	1,887.16	2.35	2.35	380.16	-1.40	-1.40	161.72
2ndQuar/04	-4.89	-0.45	1,790.04	-8.66	-6.51	339.30	-11.31	-12.56	132.11
3rdQuar/04	35.12	34.52	2,453.91	23.73	15.67	443.56	21.13	5.92	181.16
4thQuar/04	22.17	64.35	3,020.19	25.32	44.96	581.16	21.00	28.16	240.19
1stQuar/05	-1.69	-1.69	2,967.41	-1.66	-1.66	569.87	1,06	1,06	243.80
2ndQuar/05	5.41	3.62	3,133.23	2.98	1.27	589.80	7.51	8.65	269.60
3rdQuar/05	32.32	37.12	4,178.29	25.21	26.80	763.71	31.63	43.01	386.50
4thQuar/05	2.97	41.19	4,305.49	3.13	30.77	790.73	0.75	44.09	390.17
1stQuar/06	23.32	23.32	5,332.90	18.89	18.89	958.98	22.51	22.51	500.48
2ndQuar/06	-3.88	18.54	5,122.20	-4.58	13.44	910.48	-2.68	19.23	484.40
3rdQuar/06	5.68	25.27	5,418.57	2.64	16.44	937.17	-1.03	17.99	478.36
4thQuar/06	19.56	49.77	6,498.25	23.01	43.23	1,175.83	24.08	46.41	617.65
1stQuar/07	9.67	9.67	7,136.29	10.07	10.07	1,304.32	6.72	6.72	665.84
2ndQuar/07	29.34	41.85	9,259.40	28.84	41.81	1,709.26	27,19	35,73	874,08

Average Net Asset Value for Dynamo Cougar (Last 36 months): *R$ 706.965.154,44*

(*) 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 average.

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