Brazil From a Value Investor's Perspective

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Administração de Recursos

Summary

1. Taming Inflation – a tale of 15 years
    a. Where we are coming from
    b. Where we could be headed

2. Key strategies that worked for us

3. Three investment ideas for the next few years

Taming Inflation: A tale of 15 years

Recent Brazilian macro economic history can be divided in three phases:

<u>1.</u> Initial efforts to curb inflation (Jul/94-Dec/98)

- Artificially overvalued currency peg
- Very high real interest rates
- Growing current account deficits and foreign exchange debt
- Lower inflation boosts investment and productivity

<u>2.</u> Fixing the collateral damage (Jan/99 – Dec/03)

- Extended period of undervalued currency
- Beginning of interest rate and sovereign debt reduction cycle
- Improved current account and foreign debt
- Poor economic growth (subdued investment and productivity)

<u>3.</u> New growth cycle takes shape (04 - ??)

- No foreign exchange debt / lower overall sovereign debt
- Currency back to "normal" / lower interest rates
- Growth in credit penetration
- Formalization, investment and productivity break out.

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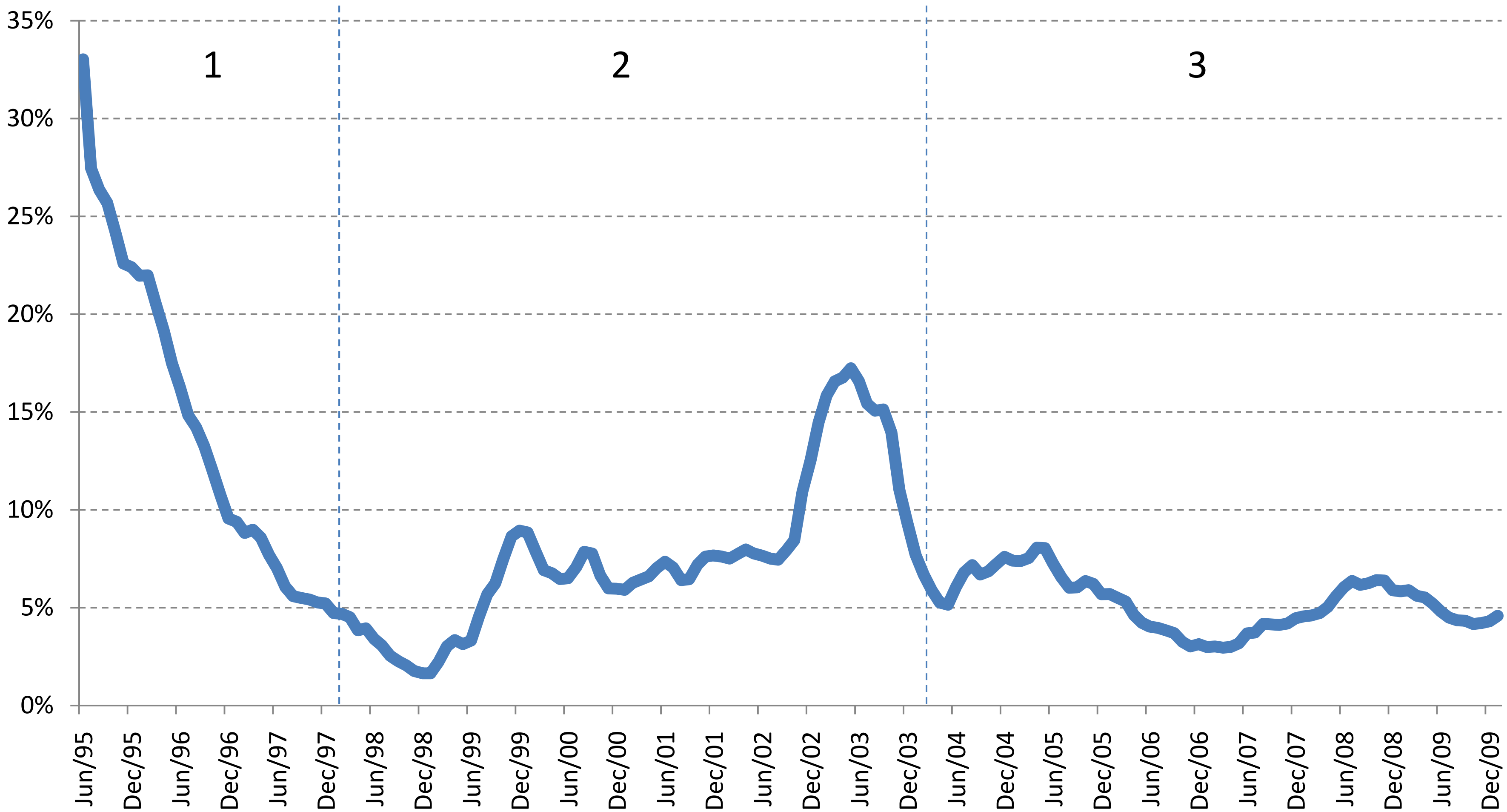
Where we are coming from: Inflation Index (IPCA) - TTM



Source: IBGE

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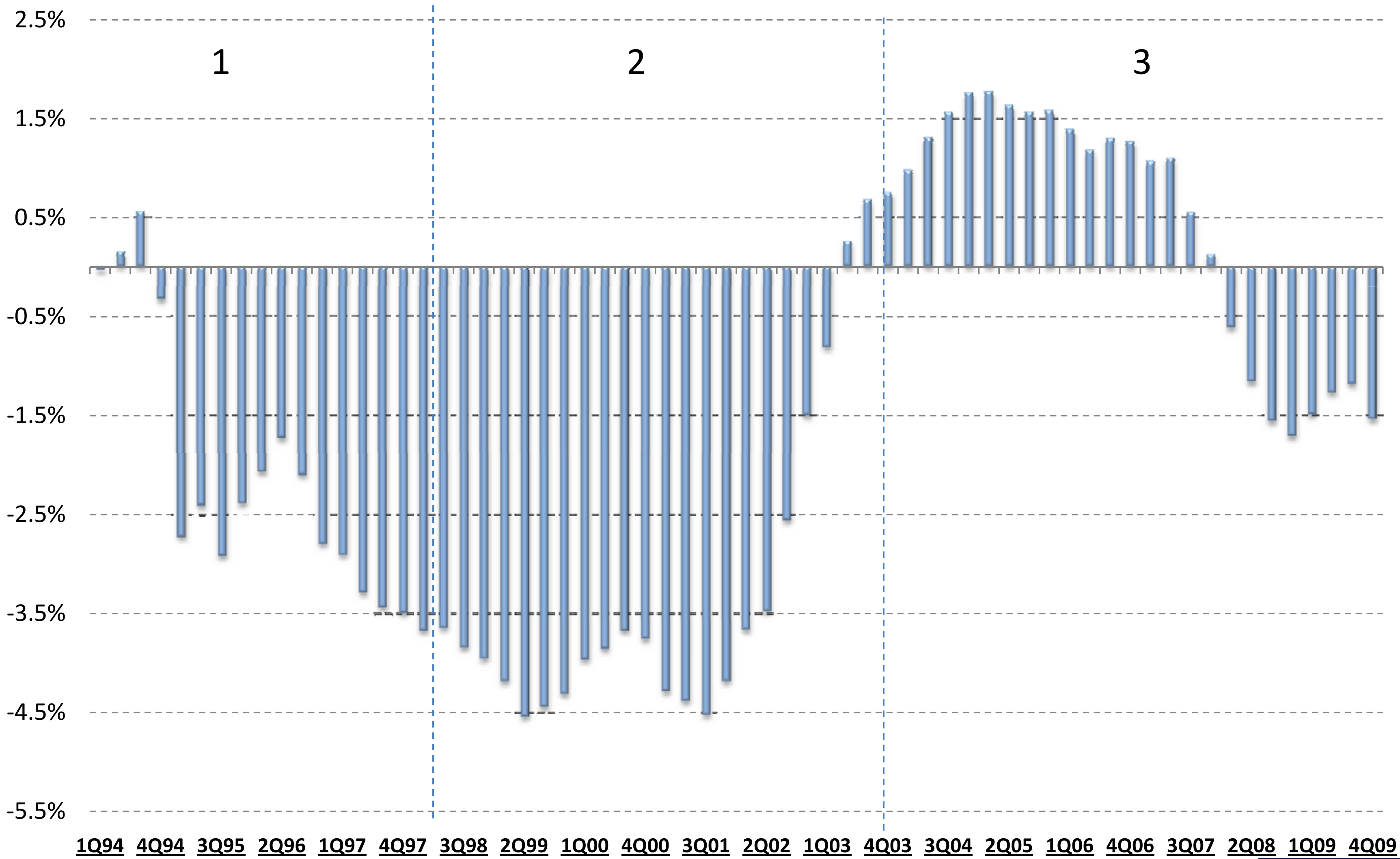
Where we are coming from: Current Account (as % of GDP)



Source: Central Bank of Brazil

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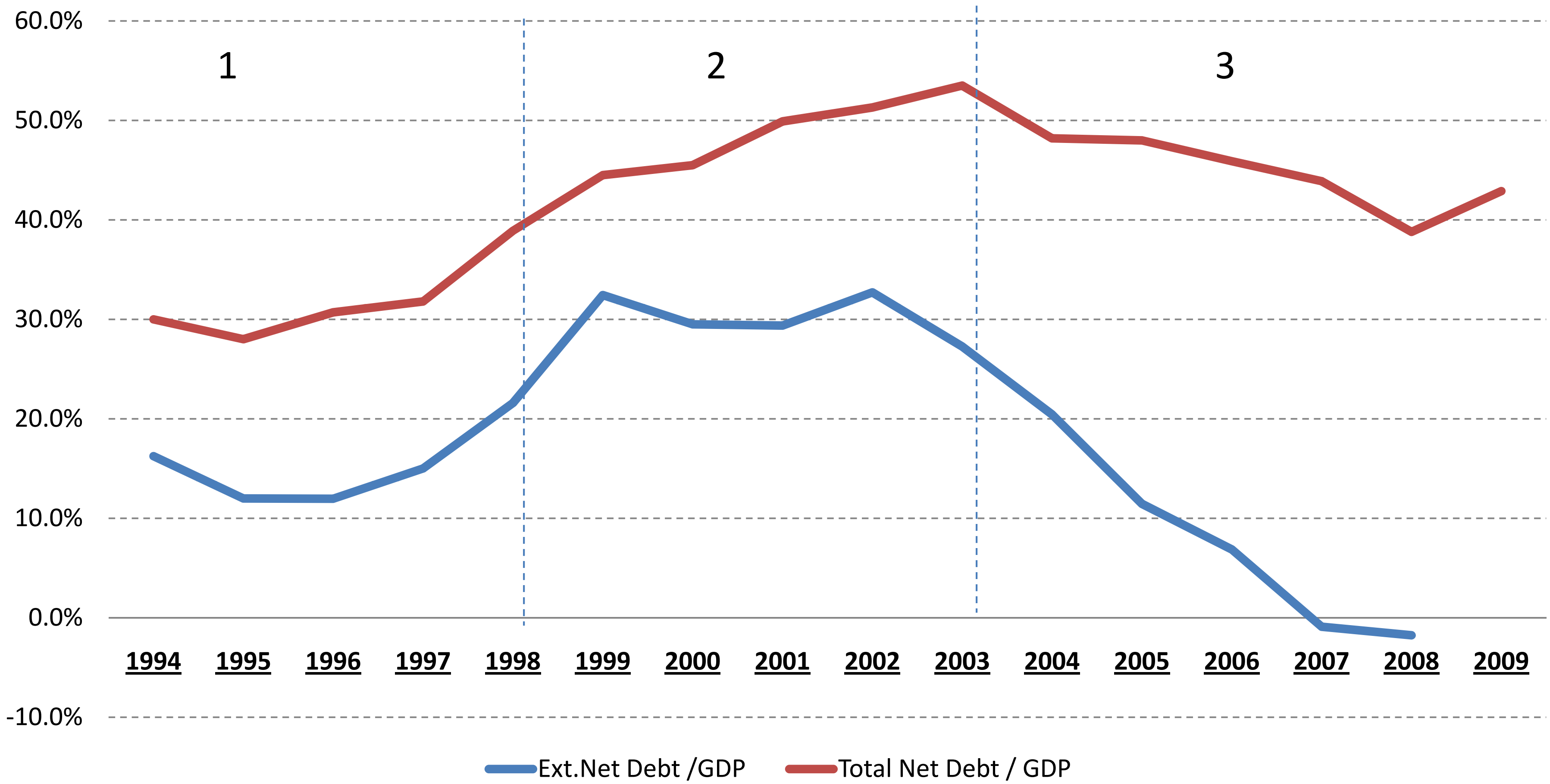
Where we are coming from: Government Debt (total and external)



Source: Central Bank of Brazil

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Where we are coming from: Interest Rate (SELIC – Overnight rate)

Source: Central Bank of Brazil

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Where we are coming from: FX – BRL/USD, adjusted for inflation

Source: Central Bank of Brazil

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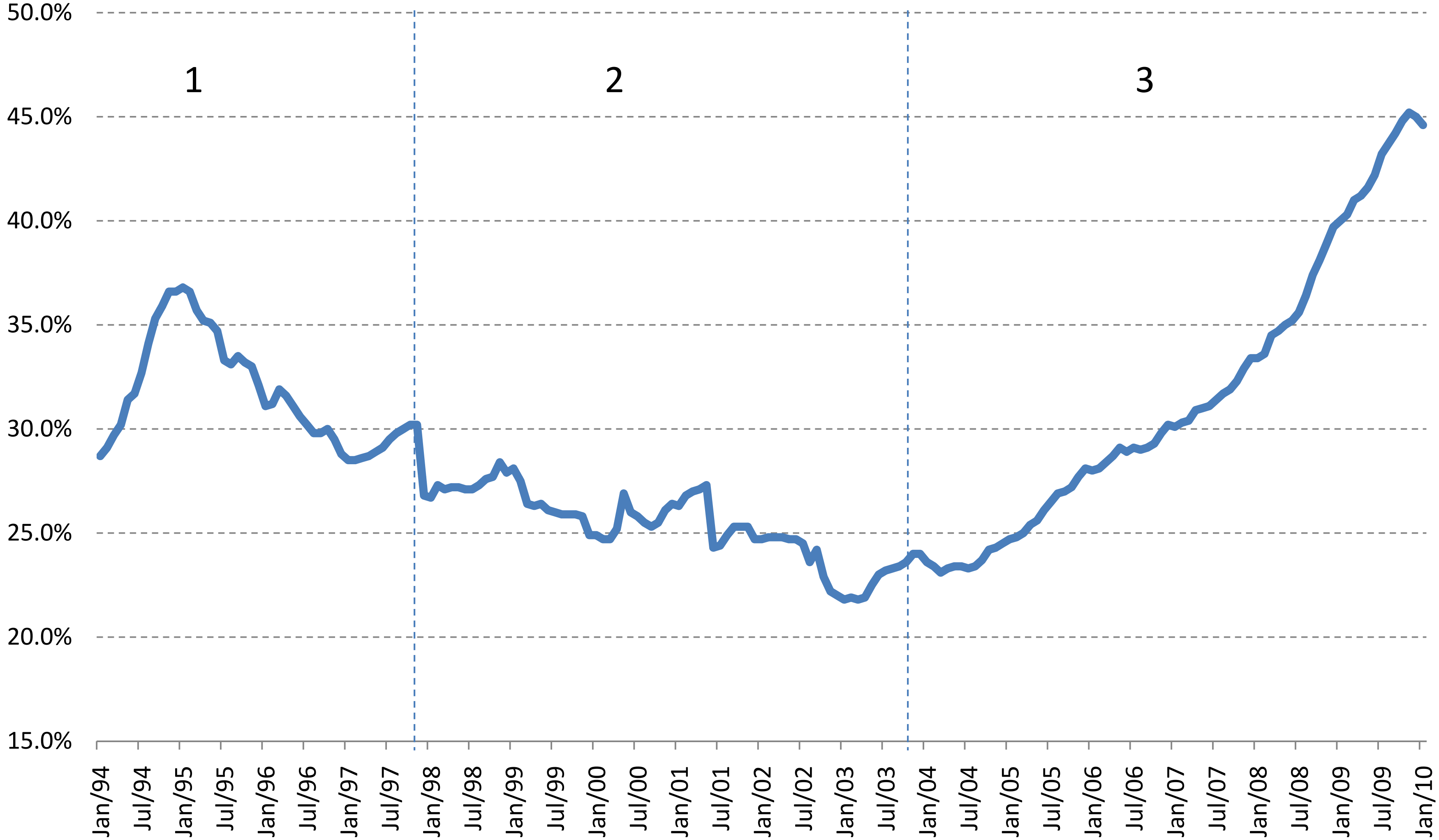
Where we are coming from: Total Credit/GDP



Source: Central Bank of Brazil

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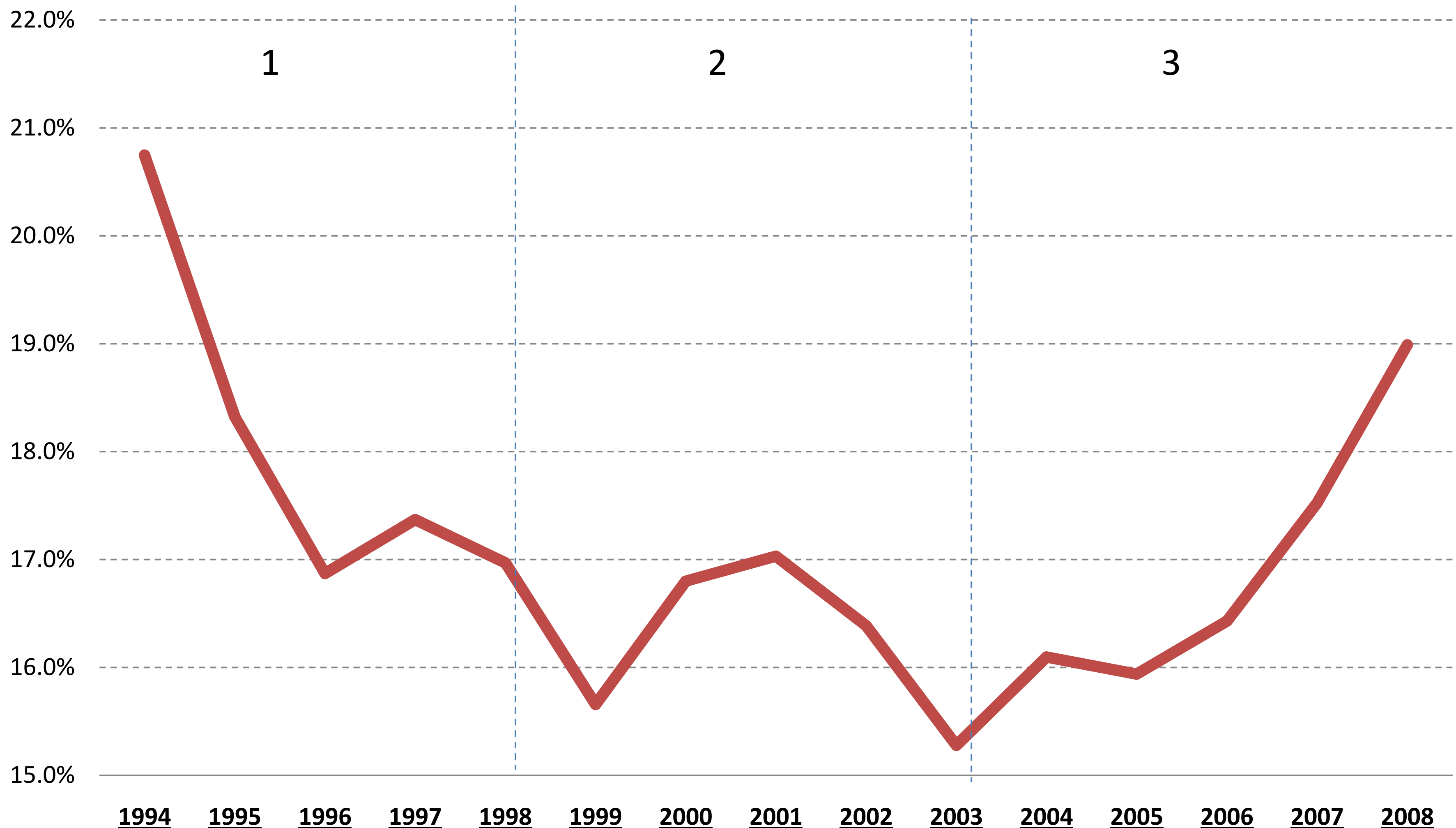
Where we are coming from: Fixed Capital Investment / GDP



Source: Central Bank of Brazil

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Where we could be headed

Having dealt with the severe macro economic imbalances...

... a new set of variables will play a key role in the future

- External accounts in order
- Sovereign debt under control
- Inflation normalized
- Well developed and stable banking system

- Tax evasion is plummeting / formal job market growing
- Capital markets are becoming deeper
- Productivity is well-positioned to take-off

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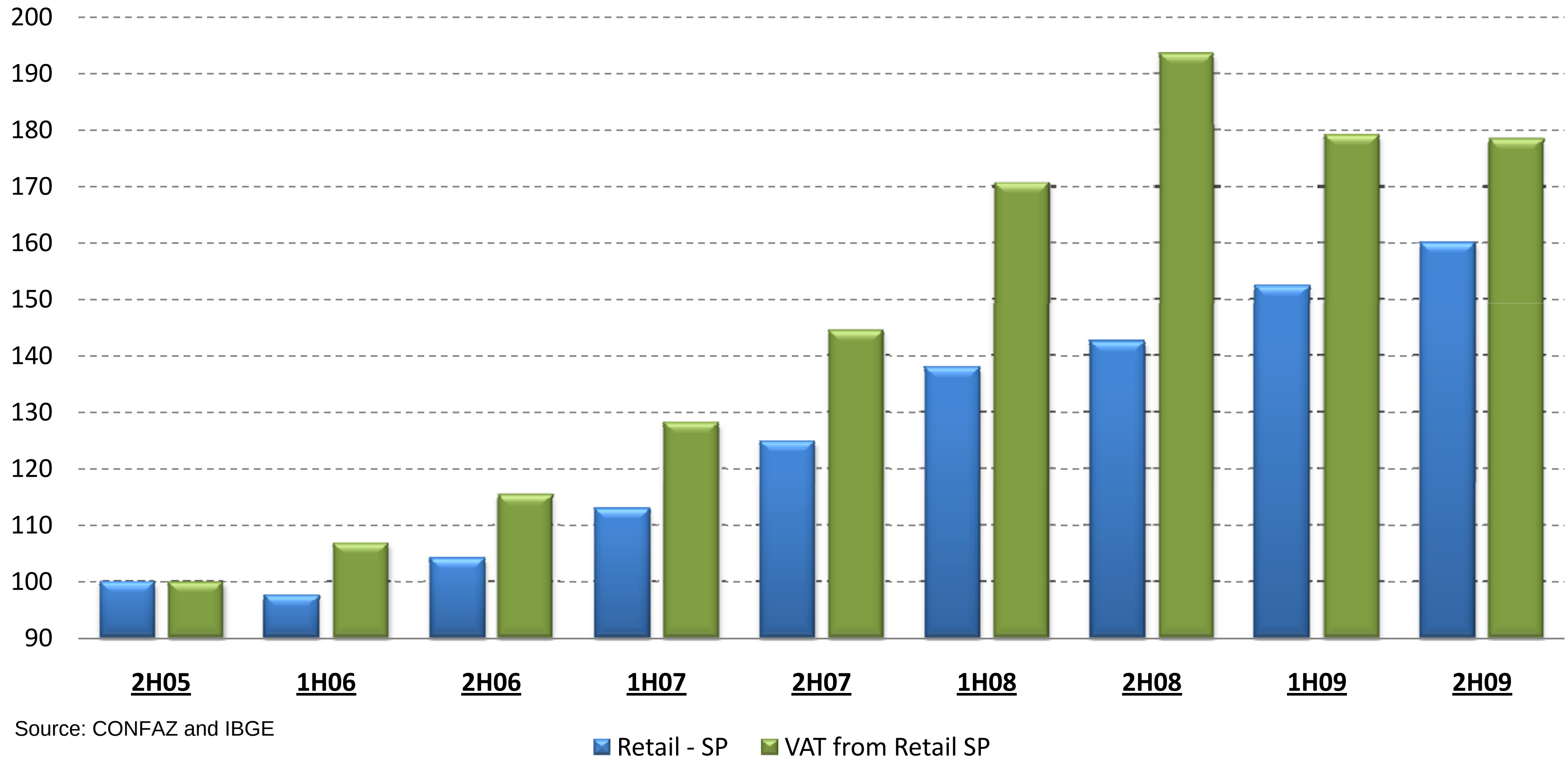
Where we could be headed: Retail Sales in São Paulo x VAT collection



Source: CONFAZ and IBGE

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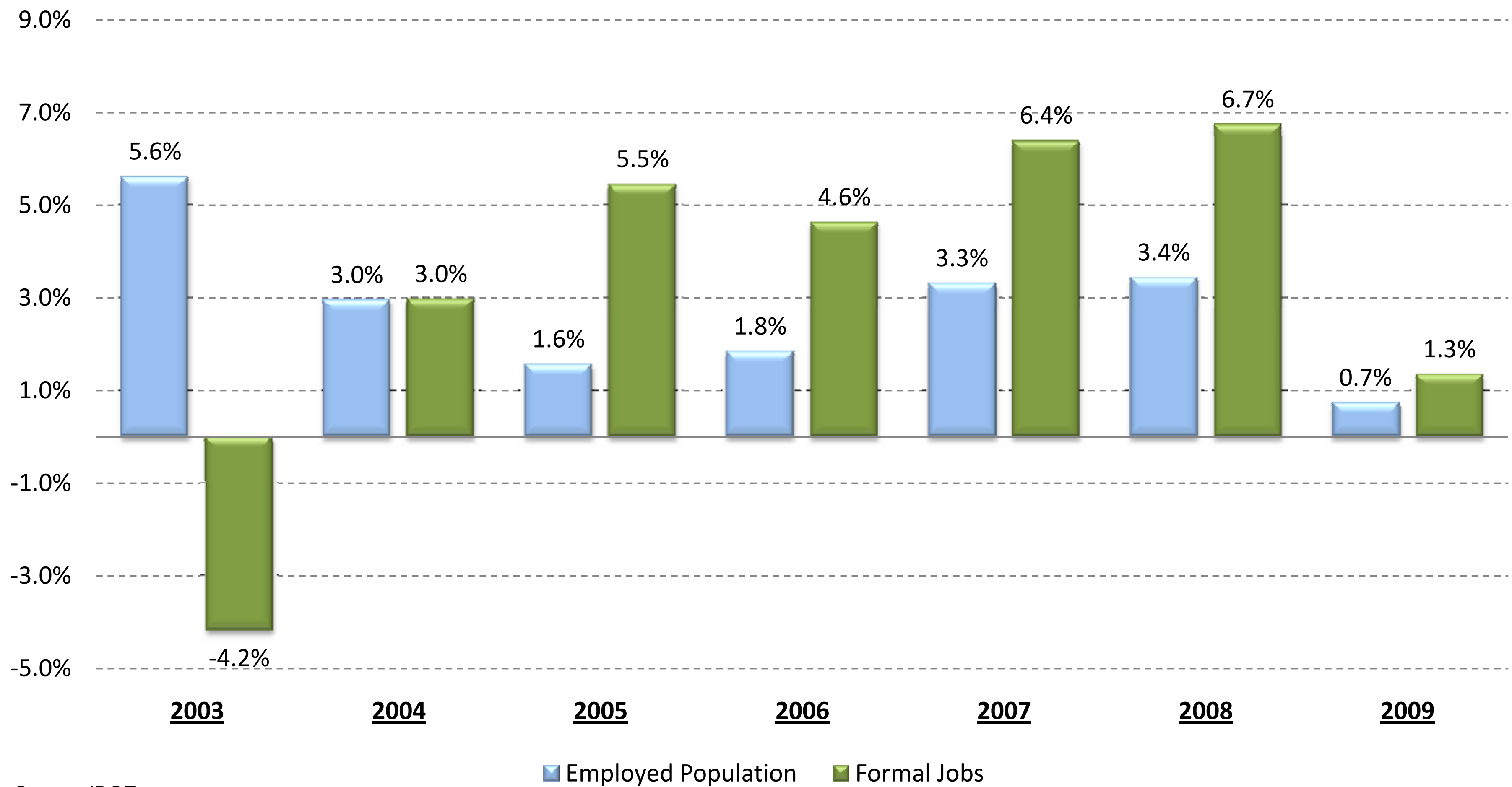
Where we could be headed: Growth of Employed Population x Formal Jobs



Source: IBGE

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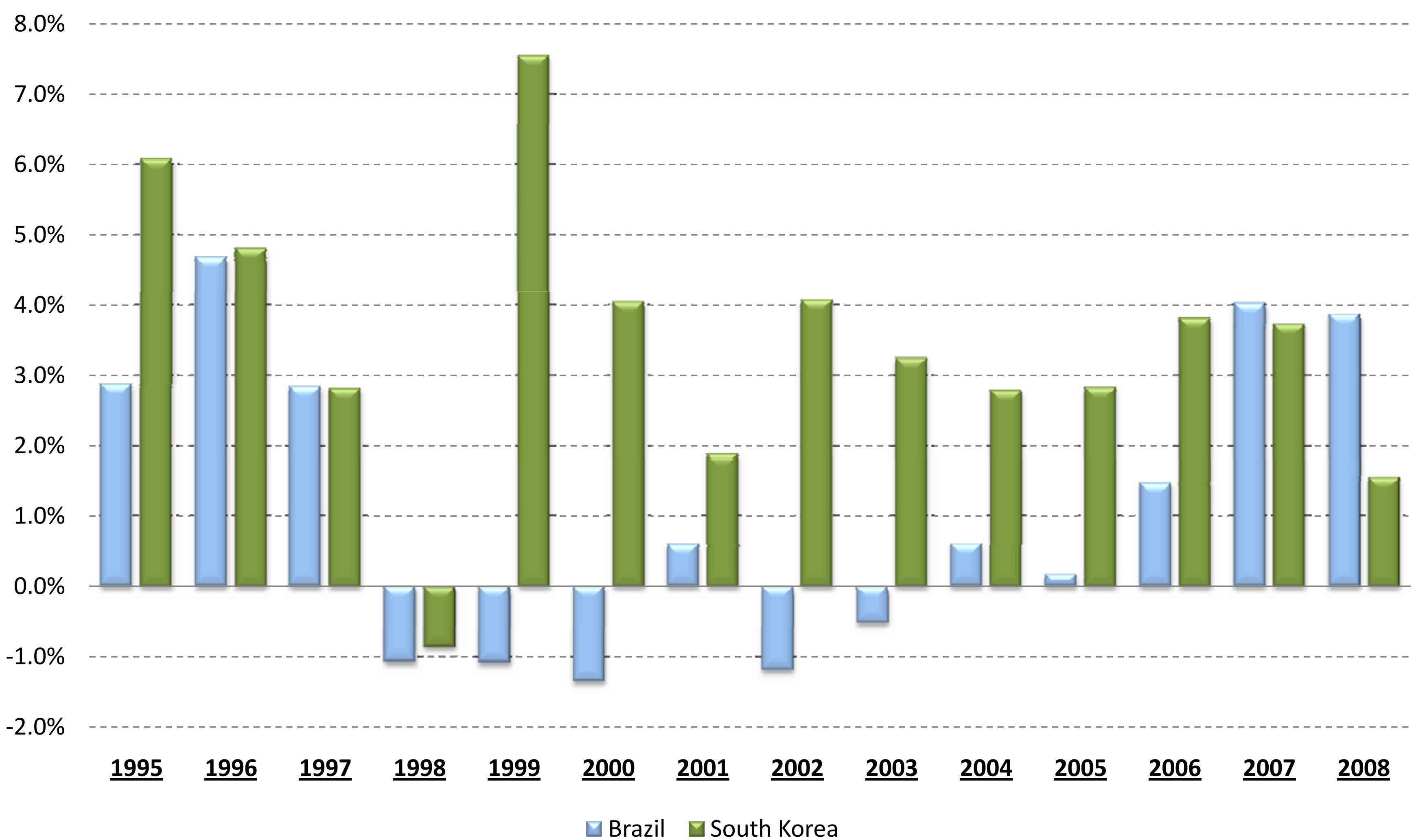
Where we could be headed: Change in Productivity Index (Brazil x Korea)



Source: International Labour Organization

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Where we could be headed: Dramatic changes in Capital Markets

Capital Markets Recent Changes

- More than 100 companies went public in 5 years (less than 10 in previous 15 yrs)

- At least another 50 issued secondary public offerings

- Almost BRL 200 billion (USD 100 billion) were raised

- Ownership and corporate governance have made significant strides

- Brazilians are developing an equity ownership culture

- Market for BRL denominated corporate debt is emerging

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Key strategies that worked for us

But, what does it all mean for a long term equity investor?

Key Questions

- **How different is it to invest in equities in this environment?**
- **Should we think about businesses differently?**
- **Does it pay to be long term oriented?**

Key strategies that worked for us

Through the years, selective stock picking paid off:

- Competition trumps growth

- Dominance over distribution makes for the deepest moats

- Understand the macro but don't over emphasize its importance

- It pays to think long term when everybody else is momentum-driven

- Good businesses may turn out to be bad investments if interests are misaligned

So, it's not so different after all

Three investment ideas for the next few years

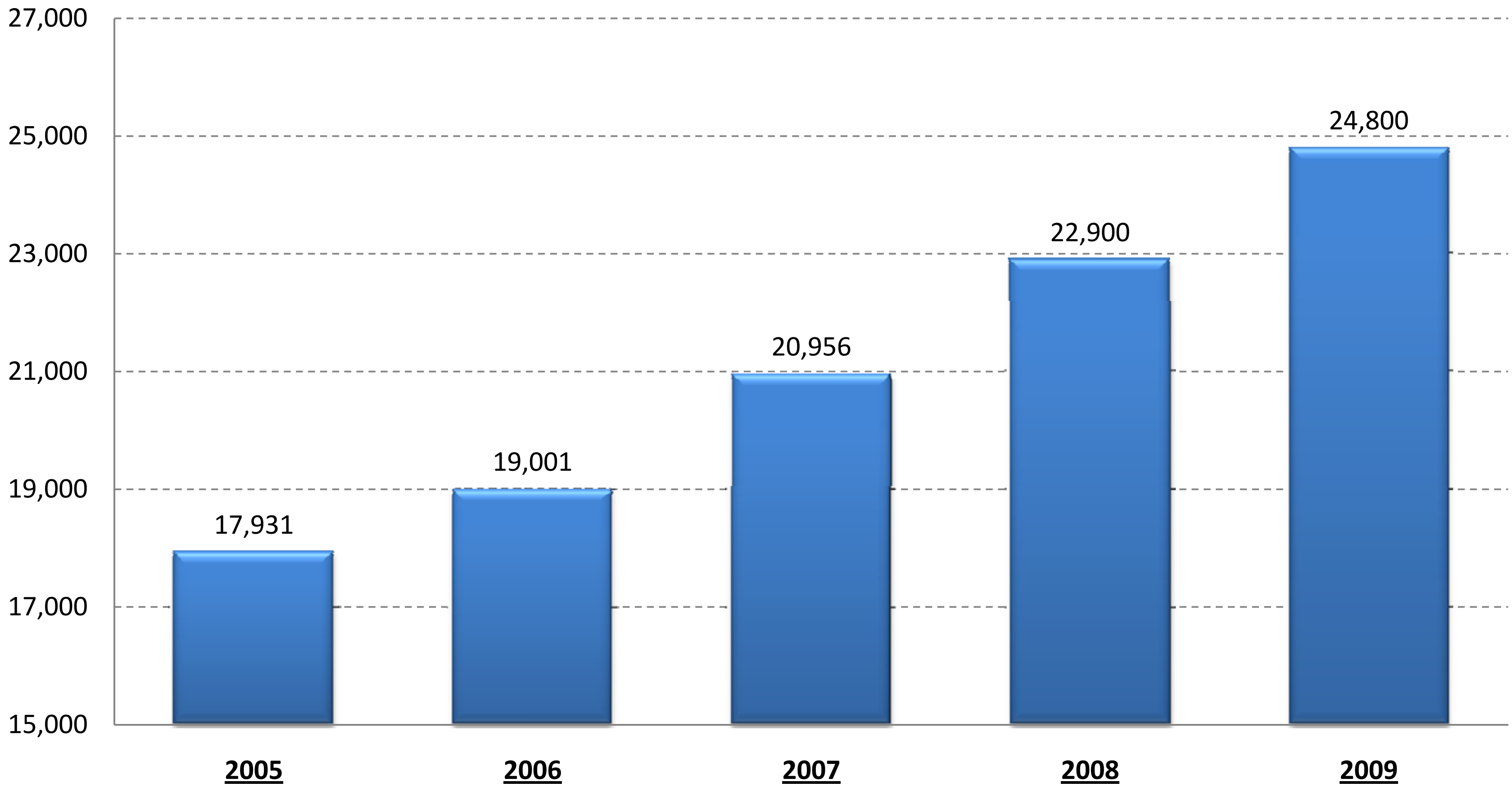
Common characteristics:

- Privileged competitive position
- Benefiting from the macro economic trends
- Managed by competent and trustworthy people
- Trading at reasonable valuations

TOTVS

Company Highlights	**- Largest ERP software provider in Brazil** **- Focus on small and mid-sized enterprises** **- 40% market share in Brazil. Over 60% in core markets (less than 250 employees)**
Market Cap	**R$ 3.6 billion**
Value Creation Drivers	**- Significant barriers to entry in distribution/sales/implementation** **- More than 450,000 companies with revenues larger than US$ 8 million and less than 250 employees** **- Penetration of ERP software below 8%** **- Trend towards formalization (less “tax flexibility”) accelerating growth in penetration**

TOTVS: Fast Growing Active Client Base



Source: TOTVS

Ultrapar

Company Highlights	**- Conglomerate that controls 2nd largest fuel distributor in Brazil** **- Over 5,000 gas stations operating under Ultra's brand name ("franchisees")**
Market Cap	**R$ 12 billion**
Value Creation Drivers	- **Formalization driving margins and market share** - **Auto ownership driving volume growth** - **Gas stations located in key areas with dominant micro-regional market share** - **Possible spin-off / divestment from other less attractive businesses**

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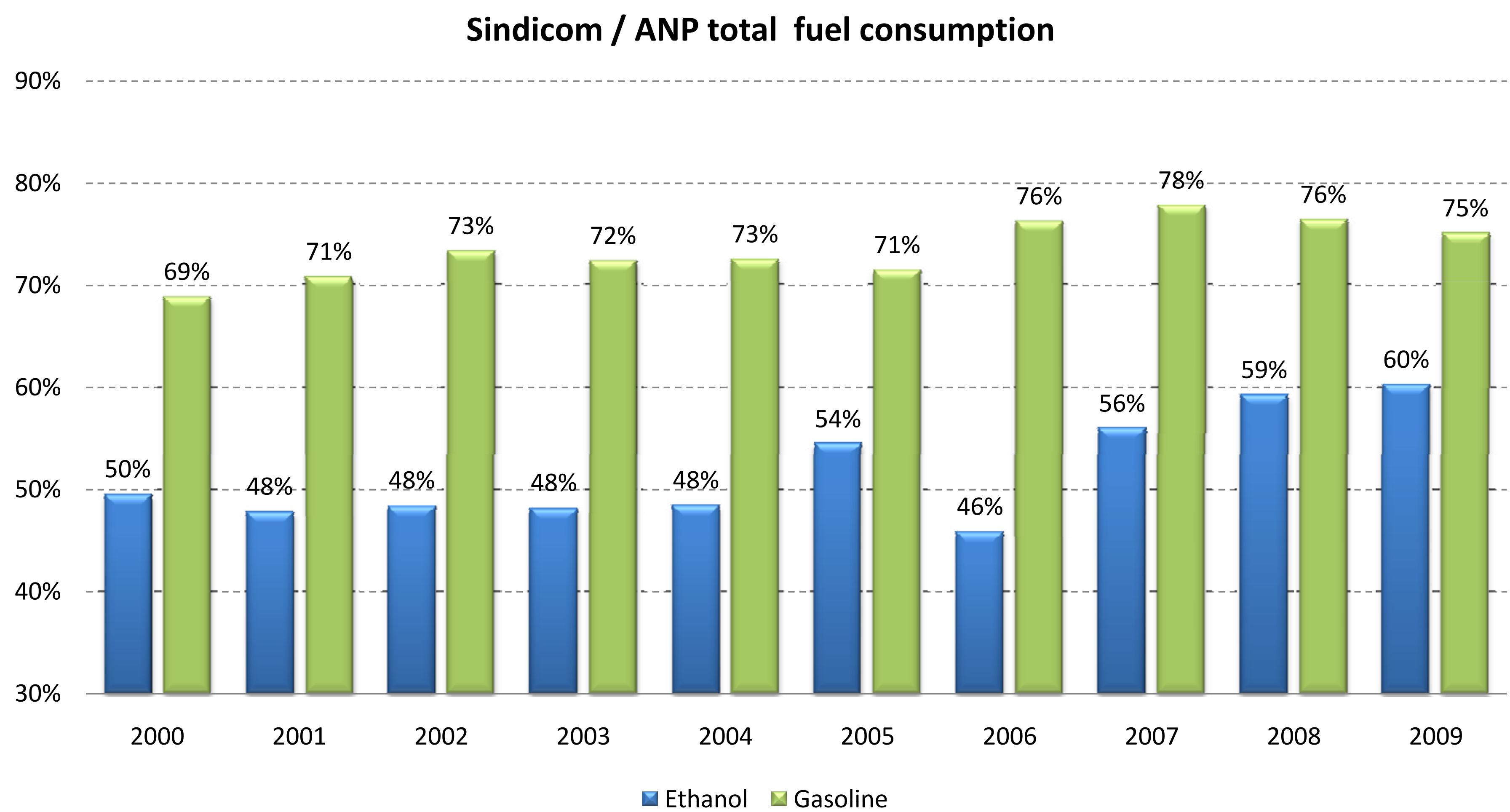
Ultrapar: Larger Players (Sindicom) retaking market share



Source: SINDICOM

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Banco Itaú

Company Highlights	- Largest financial institution in Brazil (by market cap) - 10th largest in the world by market cap and 1st by ROE - Dominant market share in key segments (consumer finance, credit card, mid-size companies)
Market Cap	R$ 165 billion
Value Creation Drivers	- Exceptional management team - Solid capital base (BIS ratio of 15%) - Credit penetration growing fast (lower interest rates + formalization) - Strong barriers to entry deriving from highly verticalized business model - Partnerships with 350 retailers for issuance of credit cards - 6 banks control 80% of the market - Large part of profitability from transactional/franchise business (cards, asset management, fees)

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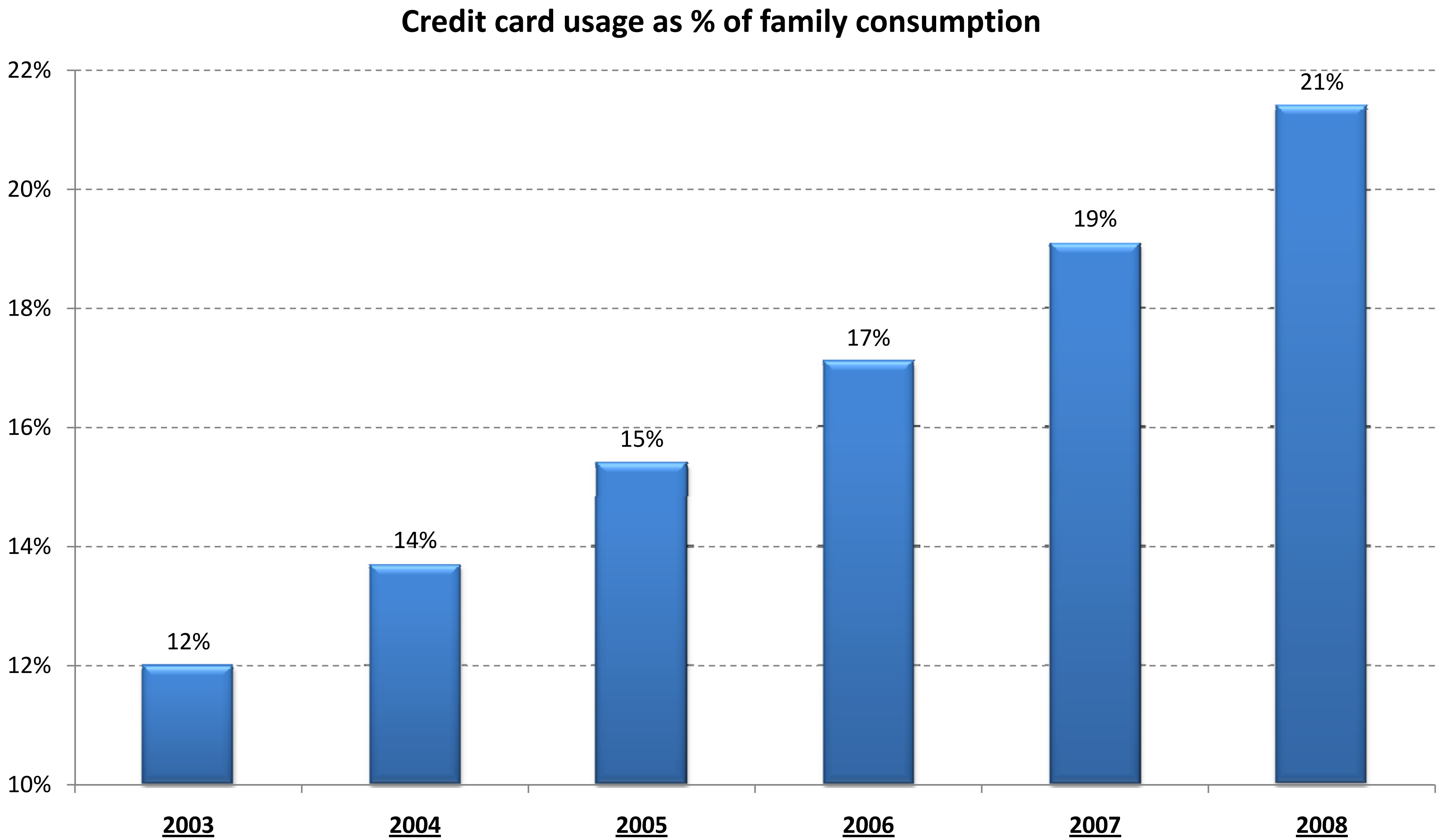
Banco Itaú: Credit cards are a major source of growth



Source: Central Bank of Brazil

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Banco Itaú : A final note

- Brazilian banks performed very well during the crisis and have emerged stronger

- Among many reasons, we think one should be singled out:

- STATUTORY DIRECTORS, BOARD MEMBERS AND CONTROLLING SHAREHOLDERS OF BRAZILIAN BANKS HAVE THEIR ENTIRE NET WORTH AT STAKE IF THEIR BANKS FAIL. ALL THEIR PERSONAL ASSETS ARE FROZEN FOR THE DURATION OF THE LIQUIDATION PROCESS AND MAY BE USED TO COVER ANY SHORTFALL. THERE IS ALSO A TAIL OF 12 MONTHS

-**Would the excesses in the banking industry in the US and Europe have happened if this rule had been in place?**

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Report
DYNAMO 61
JAN FEB MAR 2009

ATtributes

Since 2003, the World Bank has annually updated its *Doing Business*[1] publication, an attempt to measure the quality of the global business environment. The countries in question are ranked according to microeconomic factors, such as: starting a business, dealing with construction permits, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business.

In the 2009 edition, Brazil was demoted to position 125 out of 181, placed uncomfortably below Bhutan (124th) and above Micronesia (126th). Our worst performance was identified under "paying taxes" where Brazil ranked in 145th place. This item consists of three indicators, one of which is a proxy for the size of the tax burden and another two that seek to measure the complexity of the administrative processes required to comply with tax liabilities. In one of these items measuring the number of hours per year required to prepare, file returns and pay taxes, Brazil came last in the global ranking having a attained a record number of 2.6 thousand hours, miles away from Cameroon, which came in second to last at 1.4 thousand hours.

Brazil today boasts an arsenal no less than 85 taxes, named in many different ways[2]. The cost of our tax bureaucracy is prohibitive. Its impact on the private sector is already very well know: distorts the structure of production and employment, provides incentives for tax evasion and illegality, reinforcing the competitive disadvantage for law-abiding companies. What is less known is the fact that the Government itself has begun to feel the perverse impact of its complex tax system. Accordingly, in 2003, a constitutional amendment established that Fiscal Offices should have access to "priority funds" to act in an "integrated manner" in order to "share filings and tax data"[3]. This led to a number of initiatives among the Federal, State, and Municipal Departments of Treasure. Chief among these was the increased use of *ST* (tax substitution), the *PMATA* (Tax and Customs Administration Modernization Project), and Technical Cooperation Protocols, which led to the formation, and commitment to development and implementation, of *SPED* (Public Digital Bookkeeping System).

Under Brazilian tax substitution system, the obligation for paying a given tax is transferred to a third party taxpayer. Thus, multi-stage taxes (due more than one time along the supply chain) become VAT (value added, one-time tax), thereby simplifying the tax payment system by concentrating the respective liability on a single party.

SPED, which was introduced by presidential decree, is a tool whereby fiscal and accounting forms are converted compulsorily into digital format. The aim of this system, which comprises three main sub-projects (accounting bookkeeping,

Note: Our Performance

As from this quarter, Dynamo Reports will no longer include the *Our Performance* section. At the close of each quarter, our investors will receive together with their statements of accounts, our comments on performance for that period. The Reports will continue to have the main text, covering current topics in the world of investments, finance, markets, business, and companies. We plan to carry on producing four Reports per year, which may eventually come to be delivered over differing periods of time. With that, we intent to maintain the same standards and style of analyses, without undermining the up-to-date nature of the comments previously given in *Our Performance*, as has recently been the case

1 *www.doingbusiness.org*

2 *Tribute in Portuguese is used as synonymous with tax. The full of Brazilian taxes list can be found in http://www.portaltributario.com.br/tributos.htm.*

3 *Article 1 of Constitutional Amendment No. 42, approved on December 19, 2003, introducing sub-item XXII of Article 37 of the Brazilian Constitution.*

tax bookkeeping, and electronic invoices) is to electronically validate and authenticate all commercial and tax-related filings[4].

This unprecedented and ambitious program has now attained priority status. Electronic invoicing has been compulsory for twenty-five sectors of the Brazilian economy as from December 2008[5]. Recent studies estimate that, by the close of December 2010, nearly 20,000 companies will have adapted to this system, and a further three million by December 2012. The project is likely to radically transform the business environment of the Brazilian economy, hitherto notorious for its informality and tax evasion.

At the beginning, this initiative was a response from the technical staffs of some States Treasures to a Federal legislative guideline. As time passed, the States and Counties Treasures recognized the huge potential to increase their tax collection, if the project is successfully put in place. After all, the tax authorities will have a clearer and better overall picture of the economy. Remote and far-flung organizations of borderline legitimacy will become visible and exposed. With this expanded processing and data cross-checking capacity, the tax authorities will gain greater control over Brazilian taxpayers.

Furthermore, several private sector companies that comply with their tax obligations rapidly enrolled with the project, recognizing that this was an opportunity to diminish the huge competitive advantage that tax evasion and illegal practices represented for their competitors. Thus, this program now ranks as one of Brazil's rare examples of successful public and private sector alliances.

This has all occurred at a time when Brazilian tax burden has reached unprecedentedly high levels. Also, not only has the financial crisis cut the wings of public revenue growth, but has also required an increase in countercyclical expenditures and/or tax exemptions, in the current environment of a budget agenda at a high level of government expenditures with defined destination. In this context, any action leading to a potential increase in public revenues without altering tax burden seems auspicious.

It is not our intention here to make normative considerations on these trends and ventures. This would be an incursion into areas pertaining to ideological and political aspects of the role, the size, and the competence of the Government. The social return of public transfers, the regressive profile of Brazilian tax structure, the Government's current expense:investment ratio, or the crowding out effect of public spending over private investment, are all crucial elements for a qualitative analysis of the performance of the public sector, but these are not part of our focus at present. We also have no idea of what the impact would be of a highly efficient and *pan-optical* tax system in an environment where 40% of the work force is not officially registered and where 25% of total corporate revenue for 2008 was simply not declared[6].

We start from the premise, and on the understanding, that this route towards greater efficiency of the *res fiscalis* seems irreversible, even if the results could still take some time to appear. In the case of the tax substitution, results have already arrived. According to the State of São Paulo Treasure, the leading supporter of this measure, *"... tax substitution is one of the government's major allies in combating tax evasion. By transferring the tax collection to the beginning of the supply chain, the tax authorities have simplified the process of monitoring payment of the respective tax and have also assured tax justice, by thwarting the unfair competition of some companies that do not pay their taxes in full. Moreover, the system also represents a substantial gain in tax administration efficiency and reduces the related costs thanks to more concentrated controls"*.

SPED (Public Digital Bookkeeping System) is a novelty and requires substantial investment of time and money for companies and governments to adapt to the new requirements. The project has taken longer than planned, but it will certainly be implemented. Enforcement is assured by administrative legislation and criminal law. Obviously, in the context of a definitive impact on tax evasion and on illegal practices, the effectiveness of this program is conditional upon better equipped official bodies. Although the general direction is accurate, we must not underestimate the risks involved in implementing this program if the necessary investments on equipments, even more crucially, on people, do not occur.

The idea behind this Report is to illustrate how some of our investments are positioned in order to directly benefit from these moves. Not that the investment thesis in these companies is based solely on the success of these ventures; far from it. We met the theme from our bottom up analysis, not vice versa. This is just one more ingredient added to season already appealing business models. As pointed out above, the initiative is timely and, it would seem, irreversible. Its objective is unique, although hits the companies in which we invest in different ways. Let us examine some cases.

4 *The Government is currently working on other projects targeting new taxes or segments: transportation services, social security, financial statements, corporate income tax, services invoices, electronic controls of inventories and production.*

5 *The pioneer sectors were: manufacturers of automobiles and related products, cement, medications, meat products, alcoholic beverages, soft drinks, steel, pig iron, and electric energy suppliers.*

6 *Estudo Sobe Sonegação Fiscal das Empresas Brasileiras (Study of Brazilian Corporate Tax Evasion), Instituto Brasileiro de Planejamento Tributário, March 2009.*

Adapting to this new digital certification environment requires a substantial investment in equipment and personnel. The process of analyzing and updating databases and files, upgrading telecommunications and IT infrastructures, redefining operating and accounting processes to enable them to be reflected in integrated systems, training teams to fill out, verify, and validate the electronic files, are but some of the preparatory tasks involved. Thanks to the huge simplification in manual routines, personnel cost reductions, lessened "physical" bureaucracy, diminished volumes of paper, etc., the resulting benefits will most certainly materialize in due course. When fully implemented, the system will become increasingly efficient and reliable and is also expected to eventually reduce expenses incurred on tax assessments and fines. If such a positive result will be attainable for *SPED* users only over a certain period of time, the opportunity is already knocking at the doors of the software companies.

Totvs is a Brazilian market leader in developing and marketing ERP (Enterprise Resource Planning) software, with a base in excess of 23 thousand far-ranging and diversified customers. It also boasts a wide scope distribution listing of more than 103 channels (including representatives and franchises). Thanks to a successful policy of integrating several acquisitions over the years, the company is ideally positioned to benefit from the momentum that the electronic tax program could represent for its own business model.

Dynamo has been monitoring and investing in the IT sector since 2001. This area has benefited from the countless transformations in the Brazilian economy and in the country's business environment over the last twenty years, among them: the end of two-digit inflation, increased trade opening, privatization, increased competition, the end of the IT market reserve, greater professionalization (sophistication) of companies management in general, reduced IT product prices, and telecommunications advances. These changes encourage and facilitate corporate investments in IT tools focusing on companies' increased productivity, management efficiency, internal control levels, and effective planning.

Totvs has consistently taken advantage of this favorable environment, and has grown steadily via both acquisitions and organic means. In addition to its product quality development, a major success ingredient has been the structure of its distribution channel and the competence of its services. The Totvs business model is based on its widely distributed sales force and, particularly, on the technical support it provides throughout the process of implementing a system, a critical stage in assuring the customer's acceptance of the respective product. And this is a particularly interesting competitive edge since its target market is small and medium companies, which presupposes some scale in supplying services, and also it requires a nuclear familiarity with its clients' potential base, features that new market entrants would have difficulty in replicating. Initially, it would seem that training and maintaining a team of specialists to monitor every step of the implementation process would represent an increment in customer acquisition costs. But this rapidly is transformed into increased client base fidelity and, thus, represents a growth of the maintenance fee revenues (recurring revenues), a higher margin business. This reinforces the principle that Totvs offers a product deemed a "utility of low churn", since software management is increasingly a "critical element for the operational stability of clients".

In Totvs' more systemic corporate model approach, *SPED* does not represent an isolated opportunity to including a new functionality in a software license sales package. It is actually a movement with wider and longer lasting impacts, one that expedites the irreversible path towards informatization for a huge spectrum of small and medium companies hovering on the verge of digital life. And even in the case of already IT user companies, further ERP software investments will be crucial to achieve increased operating efficiency, and also to comply with specific tax authority requirements. And here, Totvs has taken some less obvious strategic action such as its recent launch of an institutional brand promotion campaign, together with an announcement of a significant R&D expenditure (approximately R$100 million).

Thanks to its sharp growth over the last few years, Totvs has reached a point where it can offer quality products with all the essential functionalities, at a cost compatible with the budget constraints of its target market, still relatively untouched by ERP. This operating leverage can also be observed in the company's increased margins. During this first quarter, Totvs' EBITDA margin rose by 26.2%, five percentage points over the same quarter last year and four points above the last quarter of 2008. At a time when many sectors of the economy are still suffering from the financial crisis, Totvs has recorded increased revenues in the region of 20% per quarter, continues to hire people, and has added close to five hundred clients per quarter to its base.

Naturally, this speed of growth imposes additional strains on the company's work capacity. A variety of brands, increased numbers of products, international expansion, and maximization of its R&D expenses are but some of the areas requiring close monitoring. Moreover, it can be expected that, over time, Totvs will encounter increased competition in its target market. This is likely to put pressure on the cost of the company's qualified personnel, already a scarce resource in its market. However, in our view, none of this will undermine the company's rapid ascent. There is no doubt that the requirements for improving the electronic tax environment have leveraged the ERP software industry, and that Totvs' business model has shown competence in grasping the opportunities available in this segment.

Ultrapar – Ipiranga

The fuel distribution market has co-existed for many years with practices such as product adulteration (dilution using solvents or water) and tax evasion. With the opening of the market in the nineteen-nineties, the number of distributors rapidly multiplied from ten to four hundred companies, most of them operating irregularly. At the end of the decade, the volume of fuel drawn from the Paulínia refinery by companies not associated with the Sindicom amounted to over 70% of the total volume sold7. This problem was addressed by tax substitution when the refineries became liable for paying the taxes due along the supply chain, specifically ICMS (value-added tax) and PIS-Cofins (labor and social security taxes). But even then, no solution was immediately forthcoming. A number of companies resorted to legal action to challenge the new tax system, a practice that, at the time, was dubbed "the injunction industry". The contention surrounding the ICMS was partially reduced in 1998, when the State of São Paulo Justice Tribunal suspended all injunctions then in force. The PIS-Cofins problem endured and, in 2000, was settled by Provisional Measure No. 2.037/00 and, later, by Law No. 9.900, which reduced to zero the rate of these taxes on distribution, and concentrated their payment in the refineries.

At the time, the consumption of fuel ethanol was not so important and the authorities efforts concentrated on gasoline and diesel oil. With the advent of flexible fuel vehicles, the ethanol market grew very sharply, bringing with it the old familiar tax evasion and adulteration practices. Besides that, while gasoline production is concentrated in no more than a dozen refineries controlled by Petrobras, ethanol production occurs in around 350 plants. This fragmentation of interests adds further challenges to legality. Hence, the market share of the distribution companies represented by Sindicom reaches only 60% in the ethanol market, comparing to 77% of the gasoline market and 84% of the diesel market. This also explains the fact that the bulk of ethanol tax substitution is still an obligation due to the distributor (60%) and only a smaller portion (40%) is the responsibility of the ethanol mills, while, for the gasoline market, 100% of the ST is a refinery liability. Furthermore, the installation of flow meters (device enabling the production flow count and which significantly contributed to putting an end to tax evasion in the beer industry) is still pending specific regulation for its installation in ethanol mills.

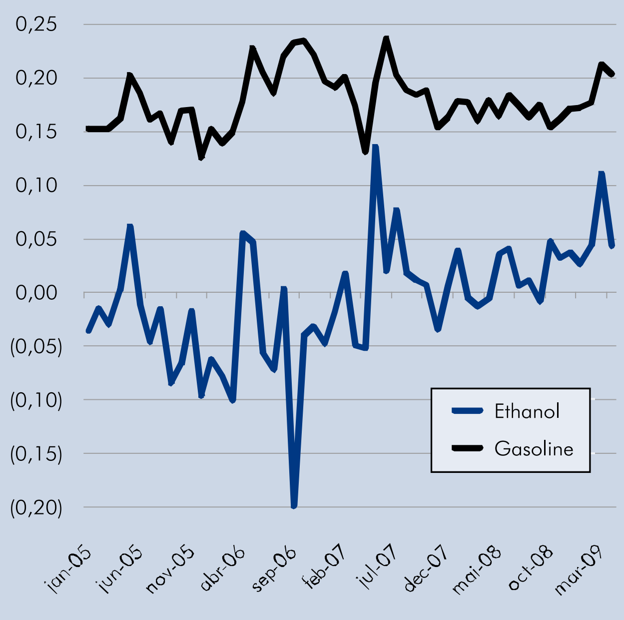
Taxes are a major stake of consumer price of fuels. In the case of gasoline, for example, taxes represent around 40-50% of the pump price. Tax evasion represents a significant competitive edge in this market. The *PIS-Cofins* payable on distribution is equivalent to approximately eight cents (in R$ terms) per liter of ethanol, while the gross margin for this fuel is around four or five cents per liter. Distributors that do not pay these taxes can charge, say, six cents per liter less than a taxpaying competitor obliging it to operate under a negative margin and still record a margin of six to seven cents per liter.

As a rule, these tax evasion and adulteration practices are associated with the suppliers and retailers 'private label' service stations, in other words, gas stations that have no fuel supply agreement with the leading brand name distributors. Just as an example, in December 2008, of Brazil's almost 36 thousand service stations, no fewer than 15.8 thousand were 'private label' establishments (44%). Moreover, most of these gas stations are in the State of São Paulo, the country's biggest producer and distributor of ethanol. It is no coincidence that the ethanol operating margins of São Paulo market distributors have historically been consideraly lower than gasoline margins, as shown in the chart below.

Threatening tax evasion represents a combination of opportunities for the fuel distribution business: i) it eliminates the advantage held by unfair competition; ii) it undermines the business model of the majority of service stations not operating under a brand name, thereby enabling free access by legitimate

7 *Sindicom is the association sheltering the ten largest fuel and lubricant companies active in Brazil. Sindicom companies comply with legitimate market practices.*

Chart I
Gross Margin of Fuel Distribution in São Paulo - R$/liter



Source: ANP, Esalq and Dynamo

brand name distributors to this massive potential market; iii) it offers an opportunity of arbitrage in the higher volume and higher seasonal market, São Paulo. In fact, thanks to the more recent measures now in place, a trend to improvement can be observed in this sector, since the distributors' ethanol margins ceased to be negative (see the same chart above).

The potencial increase supply of 'private label' gas stations could also represent a negotial advantage for the established distributors, since this would probably lessen the capital expenditure incurred on purchases (up front payments, discounts, etc.), thereby increasing the return per liter sold.

The tax evasion fight and the trend towards a gain of market share of the established brand names should result in a significant reduction in the number of distributors in the market. At the other side, the move to concentrating production among the ethanol mills has been quite slower. As a result, the distributors' bargaining power over the ethanol producers will increase. It is no coincidence that Cosan, Brazil's biggest sugar cane producer acquired Esso and also now acts as a distributor. The move is a material signal for ethanol producers that the other side of the table holds a stronger competitive edge to make profits from the arbitrage opportunities in this market.

With this pressure on illegality, the dynamic of the retail fuel sector competition should finally fall on the underlying features of this business, i.e., scale (distribution logistics), brand (retail service), and management. Here, Ipiranga is unique.

Ipiranga is Brazil's second largest fuel distributor, second only to BR Distribuidora, a wholly owned Petrobras distributor. The greatest concentration of its gas stations is in the South and Southeast regions of the country, where volumes are greater. With the acquisition of Texaco, Ipiranga now has approximately five thousand service stations, thereby increasing its exposure in the Center West, North, and Northeast of Brazil. The geographic range of its resale and the quality of its logistic assets afford the company an unprecedented potential for obtaining scale gains in the purchase of new stations (operating leverage), thus reinforcing its competitive edge in a growth environment.

The Ipiranga brand name was built over many years from a perspective to approach the business as a retail service provider and not as a wholesale commodity producer. The attention to brand management of the former Ipiranga controllers, allied to the Ultra Group's experience in acquisitions, has produced very positive results. Operating margins improve from quarter to quarter, a reflection of management's ability to obtain scale gains in their business. Since the acquisition of Ipiranga in 2T2007, the company's EBITDA per liter increased by close to 40%. The recent acquisition of Texaco, whose gas stations are being converted faster and at costs below those projected, appears to assure additional gains thanks to the wider range of the network, dilution of the SGA expenses, and maximization of the logistics base.

In a context such as this, it is not difficult to perceive the huge opportunity for Ipiranga if the measures that threaten tax evasion succeed in forcing non branded service stations into legality. It is as though the leading player of ethanol distribution is up for sale.

Drogasil

Retail medications represent another sector where Brazil's complex tax system and tax evasion cause huge distortions. In 2006, according to IMS Health, there were close to 55.6 thousand drugstores, a volume close to that of the USA (58 thousand). However, while in the US, U$291 billion in medications was sold in 2008, in Brazil, the corresponding volume of sales was only U$17 billion. The fact that, here, we have approximately the same number of pharmacies in a market seventeen times smaller makes little sense to us. Furthermore, in the US market, the major pharmaceutical retailers are responsible for almost 40% of the sector's total revenues, while independent operators (those not associated with any retail chain) hold 30% of the sales units. In Brazil, 93% of the total volume of pharmacies is independent.

Over the last ten years, we assisted a trend to concentration of the retail pharmaceutical market in many countries. A movement that makes a lot of economic sense. Let us explain. Unlike other commercial activities, in the drugstore retail business, there are few major barriers to the entry of new competi-

Dynamo Cougar x IBX x Ibovespa
Performance up to March/2009 (in R$)

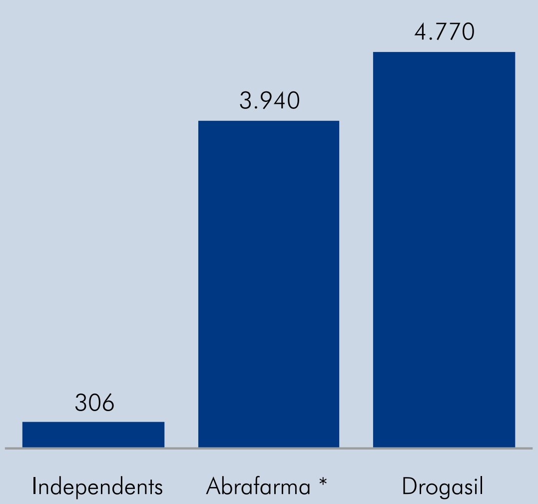
Period	Dynamo Cougar	IBX average	Ibovespa average
60 months	141.13%	129.66%	-86.29%
36 months	18.09%	13.99%	8.71%
24 months	-6.07%	-6.55%	-9.69%
12 months	-23.04%	-30.41%	-32.10%
3 months	7.07%	10.68%	9.60%

NAV/Share on March 31sd = R$ 145.209094096 tors. As a rule, capital is not a problem, since pharmacies are usually small establishments, neighborhood stores, requiring little initial capex. Brand names are also a less visible factor in this sector, thanks to the dominant consumer perception that drugstore products are all identical. To a certain degree, location can be an important factor in certain towns but, again, given the size of the stores in Brazil, this is less of a determinant than for other retail business, such as supermarkets, for example. After all, would the average consumer be willing to pay more for the same aspirin at Pharmacy "X" across the street?

If the retail of pharma products seems to be a low differentiated activity, looking like a commodity business, the cost of sales should bring some competitive edge. And, in this case, a lower unit cost should prevail among big players. Direct negotiation under advantageous conditions with the pharmaceutical industry, and the ability to dilute the fixed cost of the logistics infrastructure and of the investment in the IT systems essential to good retail operations, are the exclusive privileges of the big chains. Accordingly, size is a competitive credential as, indeed, the concentration movement in many countries has shown. But the extreme fragmentation of competition in Brazil shows that, in fact, this does not occur here. Other ingredients distort the fine logic of pure economic calculus. Once again, the informal economy and tax evasion explain the distortion.

As in the case of Ipiranga, an analysis of profit per unit sold (in this case, box of medicine) confirms the benefits of tax evasion as shown in the table below. According to data published by Drogasil, in 2008, the company got an average price of R$11,60 per box sold, generating a gain of R$0,56 per unit. With the level of ICMS (VAT tax) of close to 18%, i.e., R$2,10 per box, the enormous competitive advantage of tax evasion is obvious and is the only thing that could explain such an atypical market profile: the existence of a so large number of independent pharmacies.

Chart II
Revenues per Store (R$ thousand)



* Average of Abrafarma members excluding Drogasil

Source: Abrafarma, Drogasil, Dynamo

The above table presents an additional illustration. According to Abrafarma data, in 2006, Drogasil's revenue per store, was approximately 16 times greater than the average figure for the independent drugstores. Running a store requires substantial fixed costs (personnel, utilities and rent expenses). So, revenue per store becomes a crucial indicator to gauge the profitability of the business. And, given that Drogasil itself works under low margins (approximately, 3-4% of net margin), it is even harder to understand how the independent pharmacies can exist with no scale gain.

In fact, a careful survey8 revealed that approximately 23% of all taxes due along the supply chain of Brazilian pharmaceutical sector are evaded, close to 40% of the labor force is not registered, and 27% of sales of medications in certain therapeutic categories occur via an illegal change of prescriptions.

With the advent of the tax substitution system, of the electronic invoice, of the requirement for tax filings to be electronically recorded, and of remote product tracking systems, the tax authorities now have powerful mechanisms for combating such unfair practices. Thus, we believe that the share of independent players will lessen, leaving space for the retail chains. The natural move to concentration in the sector should finally accelerate, as was the case in other countries. With this, the dynamic of the competition in the sector should become increasingly based on legitimate business practices. And here we regard Drogasil as being extremely well positioned.

Drogasil numbers among Brazil's five largest pharmacy chains. It is present in five states and 73 municipalities, with 270 establishments, 68% of them in the State of São Paulo. Since 1998, under the leadership of its CEO, Mr. Cláudio Roberto Ely, the company has consistently invested in such a manner as to ensure an edge over the competition. Accordingly, throughout this difficult period, Drogasil successfully cultivated features which would become increasingly important in the consolidation of the sector. Highlighted among these are: i) efficient cost and supply chain management, via the company's own up-to-date distribution structure, of purchases made directly from the industry, and of a technology system customized for its particular business. In addition to the direct benefits of a lower cost per unit sold, these infrastructure investments ensure a better management of inventories enabling the company to attain

8 *"The Underground Pharmaceutical Sector Economy; Barrier to the Growth of the Brazilian Economy and Risk to Public Health", ETCO (Institute of Competition Ethics), December 2005*

the lowest stockout indices in the entire industry9; ii) Excellence in customer services. Here, Drogasil moved away from the traditional approach, as described above, of the standard (non differentiated) retail establishment. Based on the concept that good service in the store would not only lever sporadic sales, but would also generate greater customer fidelity, Drogasil has invested very subtly in personnel training, seeking to create a culture of excellence in service. For example, store attendants are concerned in helping customers in all their needs, complementing the sale of medications by offering other products, such as personal hygiene items, diapers, etc. In addition to that, Drogasil comply strictly with all the regulatory requirements, which include the prohibition to substitute medications of the prescriptions and the requirement for a pharmacist to always be present throughout opening hours, circumstances not always found in the competition's establishments.

The fight against illegitimacy in this sector gained strength in early 2008 when the State of São Paulo introduced tax substitution into the medication chain. With this innovation, the *ICMS* that used to be paid at the time of sale of the medication to the customer, was incorporated by the retailer into the purchase price of the merchandise. This policy had two major impacts on the pharmaceutical market: i) it drastically reduced the possibility of tax evasion, and ii) increased the working capital needs for the retail players since the upfront payment of the tax obligations increased the monetary value of inventories. Both impacts favored the competitive edge of Drogasil, which had never based its business model on any tax prerogative. To be sure, the company had cooperated as a volunteer on steering public projects for the introduction of the electronic invoice. In addition to that, since it went public in July 2007, Drogasil became the sector's most highly capitalized company.

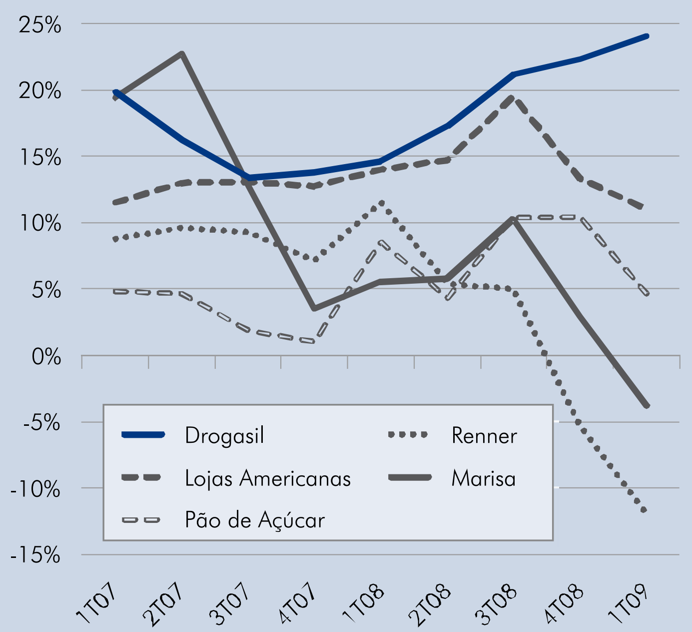
Again, it was no coincidence that, over the last two years, Drogasil recorded the best operating performance of its history, increasing its market share in all segments. The growth in same stores sales that, throughout 2007, had already performed well (approximately 15%), grew substantially over the last twelve months, attaining 24% in the first quarter of 2009, placing the company in a lead position in the retail ranking (see table).

Drogasil's operating results were also good, with its consolidated EBITDA increasing by 180% since 2005. This was a particularly admirable performance if we consider the growth in its store base over this period. This is contrary to the standard retail tenet that the EBITDA margin would undermine during times of aggressive organic expansion. This is because, at such times, the pre-operational costs of the new units are high and are still on a growth curve, which tends to lead to below potential capacity sales.

Over the last three years, Drogasil´s store base has grown by 65%, and the company is now present in three new states: Goiás, Brasília, and Espírito Santo. Notwithstanding, its market share in all areas where it is present is still modest (no more than 11%). As we have seen over the last ten years, the company has built the fundamentals of a healthy growth, which will probably accelerate, given the opportunity of the consolidation of the retail pharmaceutical sector, based on the expectation of the decline of the informality in this segment.

A healthy business environment is an essential prerequisite for a nation's sustainable development. As Brazil reveals itself as an emerging economic force in the global scenario, as an attractive destination for foreign investors, the cohabitation with archaic microeconomic structures becomes an anachronism. Tax legality and formal employment upheld by a straightforward and fair tax structure are passports to productive investments and creative competitiveness. A virtuous cycle should emerge, creating a fertile terrain for business opportunities. At this level, investors monitoring the day-to-day activities of potential target companies can already identify those that would benefit from such a favorable environment.

Chart III
Same Store Sales Growth - QoQ



Source: Cos

9 *A major portion of pharmacy sales is under doctors' prescriptions. It is a longstanding consumer custom to make these purchases in a single establishment that stocks all items in the respective prescription. Thus, the stockout has a multiplying negative impact, since the one missing item undermines the potential sale of the other prescribed products.*

Dynamo Cougar x FGV-100 x Ibovespa
(Performance – Percentage Change in US$ dollars)

Period	DYNAMO COUGAR* Quarter	DYNAMO COUGAR* Year to Date	DYNAMO COUGAR* Since 01/09/93	FGV-100** Quarter	FGV-100** Year to Date	FGV-100** Since 01/09/93	IBOVESPA*** Quarter	IBOVESPA*** Year to Date	IBOVESPA*** 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	-	-38.4	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
2002	-	-7.86	878.90	-	-24.15	91.67	-	-46.01	10.12
2003	-	93.94	1,798.51	-	145.16	369.91	-	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
3rdQuar/07	7.46	52.43	9,957.63	15.72	64.10	1,993.66	16.39	57.98	1,033.74
4thQuar/07	4.76	59.69	10,436.57	2.63	68.42	2,048.71	9.78	73.43	1,144.60
1stQuar/08	-1.74	-1.74	10,253.11	4.09	4.09	2,136.62	-4.06	-4.06	1,094.11
2ndQuar/08	16.40	14.37	11,950.74	11.55	16.11	2,394.95	17.94	13.16	1,308.33
3rdQuar/08	-32.92	-23.28	7,983.42	-23.37	-26.01	1,480.89	-38.71	-30.65	763.15
4thQuar/08	-31.09	-47.14	5,470.06	-17.58	-50.05	973.34	-35.86	-55.52	453.66
1stQuar/09	8.08	8.08	5,919.86	5.05	5.05	1,027.53	10.63	10.63	512.51

Average Net Asset Value for Dynamo Cougar (Last 36 months): R$ 869.505.435,63

(*) 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.

Please visit our website if you would like to compare the performance of Dynamo funds to other indices:

www.dynamo.com.br

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DYNAMO

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