CATÓLICA LISBON
SCHOOL OF BUSINESS & ECONOMICS

UNIVERSIDADE CATÓLICA PORTUGUESA

Arezzo&Co

HOLD	**6.1% upside**
TARGET PRICE	R$ 30.0

Bloomberg Ticker	ARZZ3
Share Price	R$ 28.3
Market Cap	R$ 2,508M

Share price as of June, 2014

Source: Bloomberg

September, 2014

Arezzo&Co Equity Valuation

Arezzo&Co is a Brazilian company, among the leaders in the women footwear retail market in Latin America. It designs and develops affordable luxury shoes and accessories under the brand names Arezzo, Schutz, Anacapri and Alexandre Birman.

The company operates a very flexible business model, in which all shoes and accessories are designed internally, but its production can be either handled internally or outsourced to third-party manufacturers. Similarly, its sales strategy is based on a combination of owned, franchised and multi-brand stores, as well as a recently developed e-commerce platform. This flexible business model allows the company to determine the most profitable combination of the above factors, without losing control over its brands, product design and quality, while generating high returns on invested capital.

Arezzo&Co benefits from Brazil's dynamic consumption market, in which branded products assume a greater importance as Brazilians move up the income ladder. Despite the recent economic slowdown, the prospects for the domestic retail sector remain strong.

Based on a 5-year DCF valuation, it is estimated a price target of R$ 30.0 per share for Arezzo&Co. At current values, this price target implies a 6.1% upside, which results in a HOLD recommendation.

SEPTEMBER, 2014

Inês de Carvalho Freire
152210008

José Carlos Tudela Martins
Advisor

DISCLAIMER

Dissertation submitted in partial fulfillment of requirements for the degree of MSc in Economics, at Universidade Católica Portuguesa

CATÓLICA LISBON
SCHOOL OF BUSINESS & ECONOMICS

UNIVERSIDADE CATÓLICA PORTUGUESA

Equity Valuation
Arezzo&Co

Inês de Carvalho Freire

152210008

Advisor: José Carlos Tudela Martins

Dissertation submitted in partial fulfillment of requirements for the degree of MSc in Economics, at the Universidade Católica Portuguesa

SEPTEMBER 2014

ABSTRACT

Arezzo&Co is a Brazilian company, among the leaders in the women footwear retail market in Latin America. It designs and develops affordable luxury shoes and accessories under the brand names Arezzo, Schutz, Anacapri and Alexandre Birman.

The company operates a very flexible business model, in which all shoes and accessories are designed internally, but its production can be either handled internally or outsourced to third-party manufacturers. Similarly, its sales strategy is based on a combination of owned, franchised and multi-brand stores, as well as a recently developed e-commerce platform. This flexible business model allows the company to determine the most profitable combination of the above factors, without losing control over its brands, product design and quality, while generating high returns on invested capital.

Arezzo&Co benefits from Brazil's dynamic consumption market, in which branded products assume a greater importance as Brazilians move up the income ladder. Despite the recent economic slowdown, the prospects for the domestic retail sector remain strong.

Based on a 5-year DCF valuation, it is estimated a price target of R$ 30.0 per share for Arezzo&Co. At current values, this price target implies a 6.1% upside, which results in a HOLD recommendation.

PREFACE

The conclusion of this dissertation is not only the so expected end of my master's degree but also the proof that with hard work, persistence and, above all, the support of an amazing family and friends everything is possible.

First, there are no words available in the world to express the gratitude I have for the unconditional love, patience and support of my parents, Graça Galvão and Francisco Freire. Between two continents, three countries and thousands of late hours on the phone, they were always available to help me, listen and to give me strength towards the conclusion of this work.

Second, I would like to thank all my professors at Católica-Lisbon, especially my advisor prof. Tudela Martins for his constant availability and quick response to all my questions and doubts, as well as to Arezzo&Co investor relations' Leonardo Reis and Vanessa de Oliveira for their contribution to this work.

Last but not the least, I want to thank all my friends and colleagues, spread between Portugal and Brazil, for their amazing friendship and ability to keep me smiling during the entire process of this dissertation. I would specially thank G8, the best combine classmates and friends I will ever have, my lifetime friends that prove that there is no distance, nor years, that can offset our companionship, and all my friends at Católica-Lisbon, especially Francisca Horta for her patience and helpful feedback.

To everyone that supported me during this dissertation and not mentioned above, a big thank you.

TABLE OF CONTENTS

1. INTRODUCTION

The aim of this dissertation is to present a fair valuation of Arezzo&Co' shares based on a complete and thorough analysis of its business model and future prospects as well as on a detailed study of the various valuation methodologies commonly used by equity research analysts.

Arezzo&Co is a Brazilian company among the leaders in the footwear and accessories industry in Brazil. It designs and develops women shoes and accessories under four brand names: Arezzo, Schutz, Anacapri and Alexandre Birman. The company has an interesting asset light business model that combines both own and outsourced production as well as several different sale channels, from owned and franchised stores to multi-brand retailers and an e-commerce platform. The reason for choosing this company has to do with its interesting and complementing business model and with the fact that it operates in an industry with good future prospects in Brazil and significant tradition in Portugal. Being the Portuguese shoes a reference for its quality and having Arezzo&Co no relevant presence in Europe, presenting Arezzo&Co in this dissertation could inspire further studies on the company's future strategy, that could consist of a potential internationalization of its manufacturing facilities to Portugal as a way to penetrate and compete within the European footwear market.

Throughout the years, the issue of companies' valuation has been subject of discussion among finance practitioners and, until the moment, there is no "one sizes fits all" approach for every company. Therefore, in this dissertation a brief overview of the most commonly accepted valuation methodologies, its main characteristics, advantages and disadvantages will be presented firstly. Secondly, and in order to start analyzing the company's business model, the recent major macroeconomic developments in Brazil as well as the most relevant aspects of the footwear and accessories industry in the country are presented. Based on the industry momentum, on Arezzo&Co business model and growth perspectives the DCF valuation methodology is chosen as the most suitable method in this case. However, since there is no single correct answer to value a company, a sensitivity analysis to the most relevant operational and valuation parameters that influence the company's DCF valuation is also presented as well as a Relative Valuation in order to complement and to ensure that growth assumptions are in line with what the market believes to be correct.

To conclude, the results of this dissertation are compared to those of a selected equity research analyst, with the aim of highlighting and justifying the main differences encountered.

2. LITERATURE REVIEW

2.1 VALUATION METHODS

The issue of Companies Valuation has been subject of discussion in Finance for several years, thus there is a broad range of different opinions and ideas on the topic. According to Damodaran (2002) there are three main consensual methods for valuing firms: the discounted cash flow (DCF) models, the relative valuation (method of multiples) and the real options valuation (option pricing models). All of them share common characteristics and can be seen almost as a simple rearrangement of the same methodology, with the only differences being the underlying assumptions (Young et al., 1999). This well shared idea has real practical relevance since it gives the opportunity for finance practitioners to compare different valuation estimates arising from different valuation approaches with the ability to understand what were the assumptions causing this difference (Young et al., 1999). The following sections will go into detail on the first two methods outlined by Damodaran, leaving the option pricing valuation apart since it will not be used in the case study in question.

2.1.1 DCF models

The foundations of the DCF valuation method is based on the present value approach and on the valuation findings of Professors Merton Miller and Franco Modigliani (1958).
The idea behind this method is that the value of an asset is simply the future cash flows generated by that asset, discounted to the present at a rate reflecting the riskiness associated with those cash flows and added up at the end (Luehrman, 1997a). However, when valuing firms, the consensual approach is to estimate its cash flows for a specific explicit period and after that time assuming a steady state condition for the firm. At this steady state condition, one should consider a terminal value for the cash flows that grow at a constant nominal rate in perpetuity (Kaplan and Ruback, 1996).

$$Value = \sum_{t=1}^{n} \frac{E[CF_t]}{(1+r)^t} + \frac{Terminal\ Value_n}{(1+r)^n}$$

Where,
$E[CF_t]$ – Estimated Cash Flows in period t
r – Discount Rate
n – Explicit period (years)

Since it becomes difficult to accurately forecast cash flows after the explicit period considered, it is assumed that cash flows stabilize and the Terminal Value can be calculated. The terminal value is an important piece of a DCF valuation since it often represents a large portion of the total value of the firm (Hitchner, J., 2003). By assuming that the firm will continue on growing at a constant rate forever, the terminal value can be estimated as follows:

$$Terminal\ Value_n = \frac{E[CF_{n+1}]}{r-g}$$

Where,
$E[CF_{n+1}]$ – Estimated Cash Flows one year after the Explicit Period
r – Discount Rate
g – Constant Growth Rate

As a firm grows and time passes, the firm will eventually start growing at less than or equal to the nominal growth rate of the economy, reflecting both the expected inflation and real growth rates (Kaplan and Ruback, 1996).

2.1.1.1 Cash Flows Definition

There are several ways of applying this valuation approach. One can opt to value a firm as a whole, using Free Cash Flow to the Firm (FCFF[1]) as input to the model, or to value the firm directly to equity holders, using Free Cash Flow to Equity (FCFE[2]) instead. While FCFF reflects the cash flows generated by the firm's operation activity that are available for all the capital providers, the FCFE reflects only those cash flows available for the equity owners (Copeland, Koller and Murrin, 2000). This distinction implies two different techniques of the same valuation method: the enterprise DCF model and the equity DCF model (ECF), respectively. These two approaches use different cash flows and discount rates. However they will yield consistent estimates of the firm value as long as there are no mismatch between cash flows and discount rates.

2.1.1.2 Discount Rate Estimation

In finance, risk is defined as the possibility of actual returns differing (for better or worse) from

[1] FCFF – The residual cash flow after meeting all operating expenses, reinvestment needs and taxes but prior to any payments to either debt or equity holders. (Damodaran, 2002)
[2] FCFE – The residual cash flow after meeting all expenses, reinvestment needs, tax obligations and net debt payments. (Damodaran, 2002)

the expected returns projected by investors. Since risk cannot be observed directly, finance analysts have developed several ways of estimating it, using available market data, usually past data when considered representative of investors' future expectations. This gives rise to the most controversial piece of a DCF valuation: the discount rate. This rate is seen as the opportunity cost of capital, that is, the return an investor expects to earn by investing his money in a similar project with similar risk as the one of the cash flows being discounted (Luehrman, 1997b).

Therefore, the discount rate also referred as the cost of capital works as a mirror of the risk inherent to the cash flows. It depends on who is providing the capital, i.e., it depends if we are talking about equity investors, debt capital providers or both.

2.1.1.2.1 Cost of Debt

The cost of debt is the current rate a company pays on interest-bearing debt securities, assuming that the firm is borrowing at market rates (Hitchner, J., 2003).
The simplest case for computing the cost of debt is when a company has long term bonds being widely traded on the market. In these situations, the cost of debt can be considered as the yield subjacent to these long-term bonds. However, when this is not the case, Damodaran (2002) claims that the cost of debt can be roughly estimated by adding a risk-free rate and the default spread of the company.

$$k_d = r_f + \text{default spread}$$

The discussion on the choice of the risk free rate will be addressed in the next section while assessing the issue of estimating the cost of equity. The default spread is the compensation for the risk of a company not being able to honor its debts. Once debt is always senior to equity the only reason for a company to default on its payment is not having sufficient cash flows to cover it. Usually, firms are rated by rating agencies (such as Moodys or S&P) and consequently have an associated default spread, which can be used to compute the cost of debt. When this is not the case, an analyst may construct a synthetic default spread based on interest coverage ratios[3] (Damodaran, 2002).

[3] The Interest Coverage Ratio is equal to EBIT divided by the Interest Payment.

2.1.1.2.2 Cost of Equity

In opposite to the cost of debt, the cost of equity is much more difficult to compute since we cannot directly observe it in the market. The most commonly model used to estimate its value is based on the Capital Asset Pricing Model and is referred to as CAPM. However, there are several other estimation models, such as the APM[4] and the Multifactor models that highlight other key risk factors different from what CAPM considers.

I. CAPM (1964)

Sharpe[5] was the first to introduce the CAPM. The underlying assumption of the model is that equity investors are well diversified, i.e. they are only faced with undiversifiable risk – the Market Risk.

According to CAPM, the cost of equity (k_e) is assumed to be equal to the sum of the return provided by a risk-free asset and a risk premium that compensates the investor's exposure to the Market Risk, which in turn is adjusted by the parameter β (systematic risk) that represents the security's sensitivity to the market. The translating equation of the model is the following:

$$k_e = r_f + \beta\left[E(r_m) - r_f\right]$$

Where,
r_f – Risk-free rate
β – Systematic risk (beta)
$\left[E(r_m) - r_f\right]$ – Market risk premium

To carry on with the computation of the k_e through CAPM, it is necessary to estimate each one of the three elements that compose the equation: the risk-free rate, the market risk premium and the β.

Risk-free rate

In theory, the risk-free rate is the return required by investors on a default-free security or portfolio of securities. Therefore, the best estimate for this risk-free asset would be the return on a zero-beta portfolio of securities, constructed in a way that produces the minimum variance possible. However, due to complexity problems associated with the computation of such

[4] Arbitrage Pricing Model
[5] William Sharpe

portfolio, Copeland, T. et al. (2000) suggest that the best proxy for the risk-free rate is a 10-year government bond. The reason behind such assumption is the fact that usually this bond matches both the duration of the cash flows of the firm being valued and the stock market index portfolio considered. This provides consistency to the valuation, the β and the market-risk premium. Additionally, it is also important to stress that 10-year government bond is normally less sensitive to changes in inflation and has relatively low liquidity premium in comparison to longer-maturity government bonds.

Market Risk Premium

The market risk premium, or equity risk premium ("ERP"), used in CAPM is the average return demanded by investors as a premium over the risk-free rate for investing in an equity portfolio diversified both within and across sectors. Among practitioners, historically, this well diversified portfolio has been considered the local market index. However, this assumption should be revised when one is considering countries with relatively small and risky listed companies. The same revision applies when estimating the market risk premium for non-mature economies. Damodaran (2002) recommends the use of the market risk premium from a mature market, like the United States, plus a country risk premium adjustment, based either on default risk spreads, on relative standard deviations or both.

The estimation of the market risk premium is often made by looking at historical values (Damodaran 2010), assuming that some period of the past provides the best indication of the future. Ibbotson Associates produces an annual publication called "Stocks, Bonds, Bills and Inflation" ("SBBI") that provides one of the most commonly cited equity risk premium estimates in the field of valuation. The equity risk premium is calculated by Ibbotson Associates using the average return on the S&P500 over the average return on default-free securities and compiles data from 1926 until the present time.

There are three main controversial issues when choosing the right ERP: the risk-free security, the horizon period and the averaging technique considered. According to Damodaran (2010), "the risk free rate chosen in computing the risk premium has to be consistent with the risk free rate used to compute the expected returns". Thus, if the 10-year government bond is used in CAPM as the risk free rate, the ERP has to be the premium earned by stocks over that rate. Regarding the time period considered, some practitioners argue that risk aversion of investors is likely to change over time and therefore using a shorter period provides a more accurate estimate. On the other hand, considering shorter-periods brings noise to the valuation (increasing the standard errors) and consequently overwhelming the advantages of more

updated information. Additionally, even the most recent periods contain unique events that may induce investor's risk aversion. Thus, by including market data measured over the entire set of economic scenarios available, the model can better anticipate similar events in the future instead of overemphasizing one period over another (Annin and Falaschetti, 1998). To conclude, in what concerns the averaging technique applied, the arithmetic average is more consistent with the mean-variance framework of CAPM and thus, apparently, a better predictor for the risk premium. However, geometric average takes compounding into account and is therefore a better predictor in the long run. For valuation purposes where there is the need to discount cash flows over a long period of time the most accurate measure would then be the geometric average.

Finally, as it was previously stated, countries with relatively short and volatile equity markets histories should add an extra variable to its equity premium, which is referred in literature as the country risk premium. There are several measures of country risk and one of the easiest and most accessible is the rating assigned to a country's debt by rating agencies (S&P and Moody's, for example). This rating reflects the default risk of the country, which is, in many ways, affected by the same factors that drive the equity risk and is associated with a default risk spread over the US treasury bonds (Damodaran, 2010). However, this is only a measure of the country's default risk and thus one would expect the country equity risk premium to be larger than the default risk spread. Damodaran (2010) suggests looking at the volatility of the equity market in the country relative to the volatility of the country bond to estimate the additional spread. On the other hand, there are other numerical country risk scores that have been developed by entities and services that represent a much more comprehensive measure of a country's risk. In Brazil, the most commonly used measure is the Emerging Markets Bond Index – Brazil ("EMBI+Brazil") and it was developed by J.P. Morgan Chase. According to the Brazilian Central Bank, this measure reflects the weighted average premium paid by a portfolio of Brazilian external debt securities denominated in US dollars over the treasury bonds of the United States. It is important to note that this measure is in US dollars and therefore it is necessary to add a currency exchange rate adjustment to bring this figure to the national currency, Brazilian Real. A simple way is to add the difference between the long-term inflation rates of the United States and Brazil, since in the end the purchasing power parity should remain the same.

Beta (β)

In order to capture the systematic risk, the equity risk premium (market risk) is adjusted by the beta (β) – a measurement of volatility of the excess return of an individual security relative to that of the market portfolio (Hitchner, J., 2003). Each public company has a correspondent beta

and the stock market as a whole has a beta equal to 1. Therefore, this measure can be interpreted the following way:

$\beta > 1$ => the security is riskier than the market;

$\beta < 1$ => the security is less risky than the market.

In finance, there are several opinions on how to better estimate the beta for a company. Yet, the most conventional one is to estimate it by regressing the historical returns of the firm against the historical returns of the market index. When doing this regression, an analyst has three major choice concerns to take into account: the length of the estimation period, the return interval and the market index that should be considered. The task of choosing such parameters is relatively more important when the markets have few stocks listed or are dominated by one or few major stocks. Besides, from this approach result betas that are almost always too noisy or skewed due to the several estimation assumptions required. Thus, this method is not considered as the most useful measure of a company's equity risk. Moreover, this approach is not possible for private firms, or for those whose stocks have not been traded in the market for a long period. As a solution, some authors argue that estimating an industry average beta is better. The industry average beta is typically more stable and reliable than an individual company beta since measurement errors tend to cancel out (Copeland, et al, 2000). To construct this beta, it is necessary to find the betas of comparable listed companies unleveraging them and then compute the average. The unleveraging process is necessary since each beta found (called levered beta) reflects the capital structure of the associated company. The final beta to use in the valuation procedure is then the average industry beta adjusted for the capital structure of the specific company being valued. It can be done by applying the following formula (Damodaran, 2002):

$$\beta_l = \beta_u \left[1 + (1 - t)\frac{\mathrm{D}}{\mathrm{E}}\right]$$

Where,

β_l – Company's Beta (levered beta)

β_u – Industry Average Beta (unlevered beta)

t – Tax rate

D/E – Debt to Equity Ratio

Given that the beta is regarded as the tendency of a security's return to respond to fluctuations in the market, it is common understanding that cyclical firms (operating in businesses more sensitive to market conditions) will have higher betas. Moreover, an increase in financial

leverage (D/E) will increase the variance in the net income of the company, making the equity investment in the firm much riskier. The same can be concluded for operating leverage decisions.

It is also important to note that the beta for a firm is a weighted average of the betas of all the different businesses the firm operates in using as weight the proportion of the firm's value resultant from each business.

As it was previously said, there are other models that also estimate the cost of equity of a security. These models relax some of the restrictive assumptions that CAPM imposes such as ignoring transaction costs or the supposition that investors do not have access to private information.

II. APT and Multifactor Models

The Arbitrage Pricing Model (APM) appears as a more generalized version of the CAPM with the only restriction being that securities faced with the same exposure to the market have to be traded at the same price. The rationale behind the estimation of the cost of equity (k_e) is similar to that of the CAPM, however instead of considering only the market portfolio risk it allows for unspecified market risk factors to be accounted for in the model arguing that the beta from the market risk premium does not fully explain the systematic risk (Damodaran, 2002). The fact that APM does not specify the risk factors to take into consideration leads to the appearance of other models. Several authors suggest specific economic variables for the undefined statistical factors. For example Chen, Roll and Ross (1986) suggest that industrial production, changes in default premium, shifts in the term structure, unanticipated inflation and changes in the real rate of return are variables that can be used to come up with a model for estimating the k_e. Others like Fama and French (1993) suggest a three-factor model, where the factors are not only the risk premium on the market portfolio but also the risk premiums on small size and high book-to-market ratio firms, respectively.

2.1.1.3 Main DCF Approaches

2.1.1.3.1 WACC Based Approach

Historically the standard approach to a DCF valuation has been to discount the FCFF at the weighted average cost of capital (WACC). The reasoning for assuming this rate is that it should reflect the cost of each source of capital weighted by the value they have on the capital structure of the firm, this way capturing all the value created or destroyed by the firm's financing program. In this approach the tax benefits of having debt in a company's capital structure are taken into account within the WACC formula. In Brazil, this tax benefits consider both the income tax (IR) and the social contribution on net income (CSLL). The cost of debt and the cost of equity are both estimated as it was described in previous sections.

$$\text{WACC} = k_e \frac{E}{D+E} + k_d \frac{D}{D+E}(1-t)$$

Where,

k_e – Cost of Equity

k_d – Cost of pre-tax Debt

t – Current tax rate for the company

D – Pre-tax debt, in market values

E – Equity, in market values

The correct approach to the WACC-based DCF valuation is to consider a different WACC for each year reflecting the capital structure of that year. However, given that this would demand several computations, Copeland et al. (2000) suggest that the same WACC should be used in all the projection period. Moreover, they suggest that one should think about a target capital structure rather than the current structure of the firm since changes like management financing decisions or changes in the market value of the outstanding securities may occur in a way that the current capital structure does not reflect the capital structure prevailing over the whole period. There are three steps to follow in order to find the target capital structure:

- Estimate the current market value based capital structure of the firm
- Review the capital structure of comparable firms
- Review management choices for financing the business and its implications

However, Luerhman (1997a) states that the WACC-based method is currently considered obsolete. It does not mean that this methodology no longer works but instead, advances in

technology and software as well as valuation models more tailor-made according to manager's needs are now considered superior to this old fashion method.

2.1.1.3.2 APV Approach

"To divide and conquer" (Brealey, 2008)

Nowadays a better alternative valuation methodology is to value each business operation independently and then add-up their respective present values. This approach is called Adjusted Present Value (APV) and relies on the idea of value additivity. It allows managers to realize the main sources of value creation within the firm and to configure the valuation in the way that makes more sense for the people managing each segment (Luerhman, 1997a).

The first step in using this method is to estimate the present value of the firm (V_u) as if it was entirely financed with equity, i.e., considering that it has no debt. For this purpose, one should discount the after-tax FCFF using the opportunity cost of capital that, in this case, is simply the unleveraged cost of equity, i.e., the k_e computed using the unleveraged beta (β_u) of the firm.
Second, the financing side effects should be taken in consideration and the present value of its costs and benefits to the firm have to be calculated. The largest side effects of a company's financing program are the interest tax shield on debt (a plus) and the bankruptcy costs (a minus) (Damodaran, 2002). Regarding the computation of the present value of the interest tax shield one should use the following formula:

$$\text{PVTS} = \sum_{i}^{n} \frac{\text{t} \times \text{k}_\text{d} \times \text{D}_i}{(1 + \text{k}_\text{d} + \pi_d)^i} + \frac{Terminal\ Value_n}{(1 + \text{k}_\text{d} + \pi_d)^n}$$

Where,
t – Marginal tax rate (assumed constant in perpetuity)
k_d – Cost of debt
k_dxD – Interest on debt
π_d – Probability of default

There is some discussion among academics on which rate should be used to discount the interest tax shield. Some agree that interest payments as well as interest tax shield fluctuate for the same reasons as the operating cash flow and therefore should be discounted at the corresponding rate.

[6] $Terminal\ Value_n = \frac{\text{t} \times \text{k}_\text{d} \times \text{D}}{k_d + \pi_d - g}$, where g is the terminal growth rate previously defined

Others consider the interest payments as risky as the principal and therefore the interest tax shield should be discounted at the cost of debt. However, Luerhman (1997b) concluded k_d to be the best approach if one considers an upward adjustment since in some extreme situations companies may be able to pay the interest on debt but are unable to benefit from its tax shields. This leads one to assume the latter as more risky and therefore deserving a higher discount rate. A common upward adjustment can be simply to add the probability of default to the cost of debt, which can be extracted from bond ratings for the respective type of debt.

Korteweg (2007) estimates the bankruptcy costs in a general way, including the total distress costs both before and after default. He finds that these costs can be identified from the market value and beta of firm's debt and equity. Korteweg also states that on average these costs are around 26.2% of firm's value, considering all the industries. Damodaran (2002) suggests that the present value of the bankruptcy costs can be calculated by multiplying the value of the unleveraged firm by the percentage of these costs for each period:

$$\text{PVBC} = \sum_{i}^{n} \frac{\text{BC}}{(1 + \text{k}_\text{d} + \pi_d)^i}$$

Where,
BC – Bankruptcy Costs as percentage of the unleveraged firm value
π_d – Probability of default after considering debt

The final enterprise value appears as a sum of each different component of value. Since the PVTS only occurs while the firm is still operating, this component of value must be multiplied by the probability of no default. In turn, the PVBC must be multiplied by the probability of default.

$$Enterprise\ Value = V_u + (1 - \pi_d) \times PVTS - \pi_d \times PVBC$$

The fact that APV allows accounting for several financing side effects rather than just only the interest tax shield is one of the reasons why this approach is seen as an upgrade of the WACC method. Moreover, there are several times where WACC is not the appropriate method to use and APV always seems to work in those cases. For instance, WACC is only useful when a company has a very simple and constant capital structure – otherwise one would have to be always adjusting for changes in the firm's capital structure. Companies with complex tax positions will also be poorly served with WACC.

To conclude, it is important to stress that the power of APV relies on the managerial relevant information it can provide. Managers are no longer stuck with only the information about how much a company is worth but have also full access to where the value comes from.

2.1.1.4 Applicability and some drawbacks of DCF Valuation

The fact that discounted cash flow valuation relies on the estimation of cash flows to the future and respective discount rates makes this methodology more suitable for some firms than others. Companies where these forecasted cash flows are well founded, and where a proxy for risk can be found and used to obtain the discount rates are for sure more appropriate targets for this kind of technique. According to Damodaran (2002), there are some concerns when doing the DCF valuation, like the measurement of risk of the cash flows for private firms. Most risk/return models usually consider risk parameters from historical market prices of the asset being analyzed, which for a private firm is not possible. Nevertheless, a flexible solution to go around this problem is to look at the riskiness of comparable traded companies.

2.1.2 Relative Valuation

As Goedhart, Koller and Wessels (2005) state, "any analysis is only as accurate as the forecasts it relies on" and thus performing a relative valuation, or Multiples Valuation, appears as a useful tool to complement and enhance a DCF valuation. The objective of such valuation is to value an asset based on how similar assets are priced within the market, relying on the assumption that the market is correct on average (Damodaran, 2002). Furthermore, it works as a tool for companies to understand the differences between their performance and that of its competitors as well as a way to recognize the key factors that create value in the industry.

A multiple is simply the ratio between a market value and a key statistic that is assumed to be related with that market value (Suozzo et al., 2001):

$$\text{Multiple} = \frac{\text{Market Value of the Asset}}{\text{Measure of Value of the Asset}}$$

This method, also known as Relative Valuation, is a four-step procedure, where the first two steps consist in selecting the relevant value measures and the identification of the set of comparable firms, the peer group (Milicevic, 2009). After gathering all the market value variables and the value driver measures for all the elements of the peer group, it is possible to calculate the multiples for each peer. The third step is to aggregate all these multiples into single

numbers and estimate synthetic peer group multiples. Finally, to determine the value of the firm being valued, the synthetic peer group multiples must be applied to the corresponding value driver of the firm in question (Milicevic, 2009). The hypothesis of this method allows estimating what the market would currently pay for the firm being valued. However, there is no obvious method to determine which measures of value are the most appropriate ones for constructing the valuation (Kaplan and Ruback, 1996).

For simplification purposes, Suozzo et al. (2011) suggest two major types of multiples: the enterprise multiples and the equity value multiples. The enterprise multiples express the value of the entire firm, i.e., the value of all claims on a business relative to a statistic that relates to the entire firm, such as sales and EBIT. On the other hand, equity value multiples express only the value of shareholder's claims on the firm, relative to a statistic that applies only to the shareholders, such as earnings (the residual left after payments to all non-equity claimants). Practitioners prefer to use equity value multiples because market capitalization does not require a further adjustment for net debt as it is the case with enterprise value multiples. Additionally, Goedhart, et al. (2005), stress that it is always better to consider forward measures rather than historical ones since they are more accurate predictors of future value and, when that is not possible, one shall consider the latest possible data[7] of the historical period. Therefore, the most widely used multiples are based on companies' earnings (net income), book values or revenues (sales).

According to Damodaran (2012), multiples based on earnings are the most commonly used among analysts and are determined by the same fundamentals that determine the value of a firm in a DCF model: expected growth, risk and cash flow potential[8]. An example of such type is the Price Earnings Ratio (P/E)[9] that is simply the market value of equity per share divided by the earnings per share. However, this ratio is not flawless since the way in which earnings per share are estimated across firms may vary. Moreover, Goedhart, et al. (2005) state that the P/E ratios have also two more additional drawbacks: they are affected by the capital structure of the firms, which can be manipulated, and the earnings contain several non-operating items, such as on-off time events, that can mislead the valuation.

Similarly to multiples based on earnings, the book value multiples are also influenced by the same determinants as the DCF model. However, one of the most important determinants is the

[7] The last four quarters data, called Trailing multiple.
[8] Firms with higher growth rates, lower risk and higher payout ratios, with other things remaining equal, should trade at much higher multiples of earnings than other firms.
[9] $\mathrm{P/E} = \frac{\text{Market Price per share}}{\text{Earnings per share}}$

return on equity (ROE)[10] earned by the firm. The Price-to-Book Ratio[11] can be computed by dividing the total market value of equity by the total book value of equity, where the market value of equity reflects the markets' expectation in what concerns firm's earning power and cash flow generation, while the book value of equity is simply the difference between the book value of assets and the book value of liabilities. For Damodaran (2012), the major advantage in relation to the earnings multiples is that firms with negative earnings can be valued using this sort of ratios.

Finally, in the most recent years analysts have increasingly turned to alternative multiples such as multiples of revenues[12] or firm-specific measures. There are significant advantages in using measures like revenues since these are always available even for more troubled firms and they are relatively difficult to manipulate as other accounting values such as earnings. However, it can also mislead an analyst to assign a high value for a firm that is generating a lot of revenues while losing significant amounts of money. A company needs both to generate profits and cash flows in order to have value.

To sum up, while performing a valuation based on comparable companies one should be aware of three main issues: all multiples relying on accounting rules may be subject to some type of manipulations; to understand what is considered a typical high or low value for a multiple; and to identify what are the main fundamentals determining the multiple and the implications of its alterations on that same multiple.

2.1.2.1 Applicability and some drawbacks of Multiples Valuation

Relative valuation is particularly useful when there are a large number of comparable firms being traded on the market where the company being valued operates. However, although intuitive and easy to use its qualities are also its main drawbacks. The process of selecting the appropriate set of comparable firms can be very difficult since companies should be similar in several aspects, such as: growth rates, cost of capital, capital structure, ROIC[13] and/or the business composition. This choice is also somewhat subjective and can be affected by the selection of the analyst that best suits his/her intuition about the firm. Identifying the sector where the firm operates in or, for example, looking at the main competitors stated in a firm's Annual Report could be two possible ways of reducing this problem. Another problem is the

[10] Higher (lower) returns lead to higher (lower) price-book ratios.

[11] $\text{Price to Book Ratio} = \frac{\text{Market Value of Equity}}{\text{Book Value of Equity}}$

[12] An example: $\text{Price to Sales Ratio} = \frac{\text{Market Value of Equity}}{\text{Revenue}}$

[13] ROIC stands for Return on Invested Capital

choice of the appropriate financial indicators to consider as the value driver for the valuation, which is something subject to a wide discussion among practitioners. Moreover, different multiples can lead to conflicting conclusions and could be meaningful in different contexts, so these are also points that have to be taken into account when choosing the right multiple for the valuation.

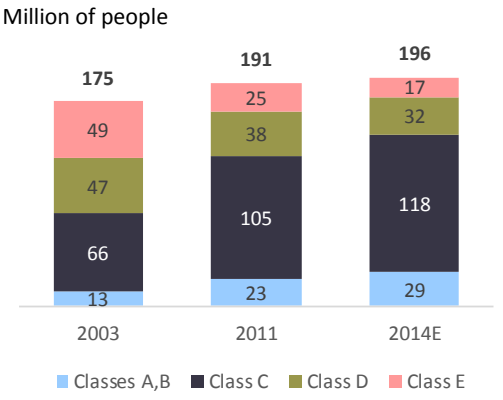
To conclude, the first required hypothesis that the market is on average pricing accurately the firms cannot be always the case, leaving this type of valuation much more susceptible to market errors and biases.

3. INDUSTRY AND COMPANY OVERVIEW

3.1 MACROENOMIC OVERVIEW

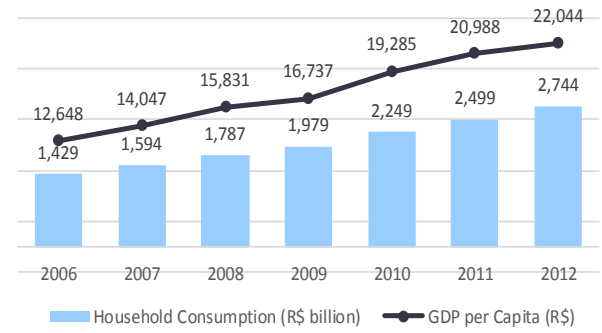
Brazil ranks 7th among the largest economies in the world and the 5th most populated country. Since the beginning of the 21st century, due to higher global commodity prices and more effective government policies, Brazil has witnessed impressive gross domestic product (GDP) growth rates, consistently above those from more developed economies. Throughout this period, the Brazilian government has developed several initiatives to promote the economic stabilization in the country allowing for almost a decade of inflation rates under control and unemployment rates at historical lows. This macroeconomic stability and the several government's social reforms over the past 15 years have boosted household income growth and contributed for the emergence of a preponderant middle class. Studies from Fundação Getulio Vargas ("FGV") estimate that between 2003 and 2014 approximately 47 million people will join the socioeconomic class C[14], also known as the "consumption class". Figure 1 illustrates that are as many middle- and upper-class Brazilians as the number of inhabitants from France and United Kingdom combined.

Figure 1 - Socio-Economic Classes



Source: Fundação Getulio Vargas ("FGV")

Figure 2 - Consumption Indicators



Source: Brazilian Statistics Bureau ("IBGE")

More recently, the global rising inflation and the deteriorating international economic situation slowed the country's economic growth, with GDP growth rates falling to c. 0.9% in 2012 and 2.3% in 2013. However, the Brazilian Central Bank responded to these economic concerns with a package of economic measures, including the reduction of interest rates, tax cuts and infrastructure investments in order to stimulate economic recovery. Despite this economic slowdown, the prospects for the domestic retail sector remain strong. The long-run economic

[14] Monthly income per household (2011): class E – Up to R$ 1,085; class D R$1,085 – R$ 1,734; class C R$ 1,734 – R$ 7,475; classes B/A +R$ 7,475

expansion will be sustained by the large middle class and from the country's favorable demographics as working-age adults represent nearly two thirds of the population, and its stagnation is not expected to peak until 2020-2025, being a country relatively young and economically active.

Key Macroeconomic Indicators

Figure 3 – GDP Real Growth Rates Comparison

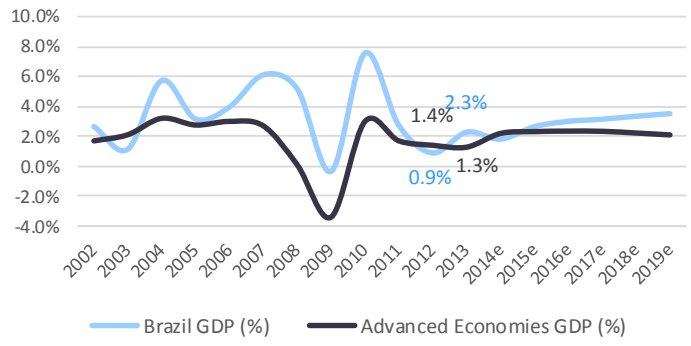


Figure 4 - World GDP Ranking (2013)

(Current US$, trillion)

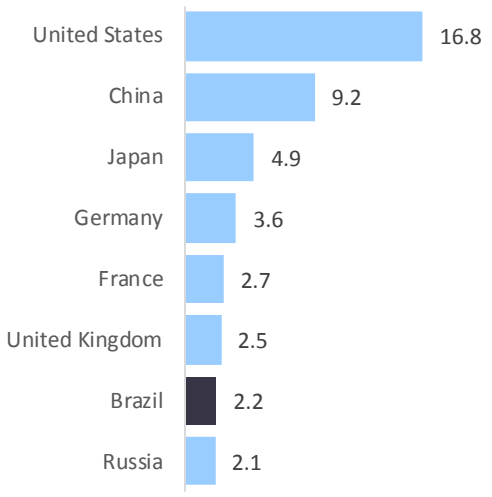
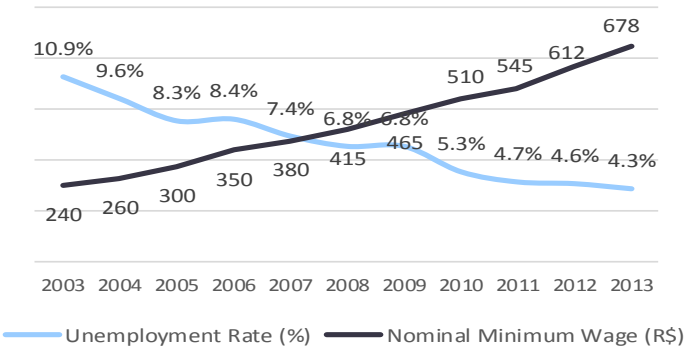


Figure 5 - Unemployment Rate vs Minimum Wage



Source: IBGE, International Monetary Fund ("IMF")

Brazil Demographic Indicators

Figure 6 - Population Age Structure (2012)

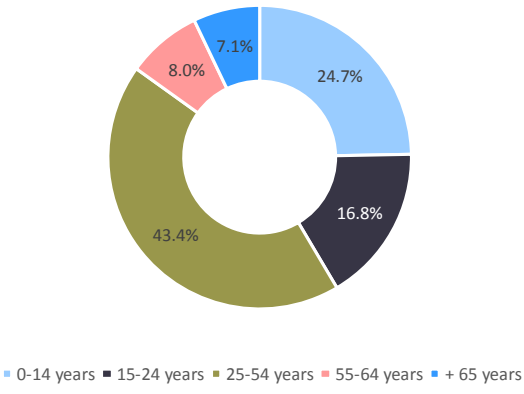
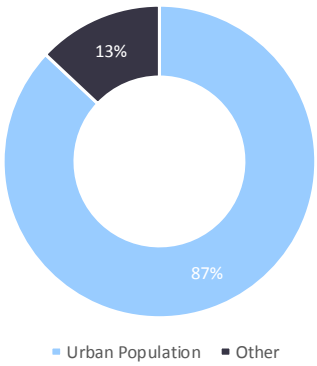


Figure 7 - Urbanization (2012)



Source: IBGE, World Bank

3.2 THE BRAZILIAN FOOTWEAR INDUSTRY

3.2.1 Brief History

Brazil, the largest country in Latin America, holds the 3rd position in the ranking of world footwear manufacturers, with production mostly destined to supply the domestic market, the 4th largest in the world.

The economic development of the Brazilian footwear industry began in Rio Grande do Sul (RS), one of the southern states of the country, with the arrival of the first German immigrants in 1824. Having settled in Vale dos Sinos, RS, they brought with them the crafts culture particularly of leather goods. The first Brazilian footwear factory appeared in 1888 and year-by-year, the state of Rio Grande do Sul developed to become one of the largest footwear clusters worldwide.

Although the concentration of large size companies is located in the state of Rio Grande do Sul, the Brazilian footwear industry is gradually being developed in other regional poles. Particularly to the Southeast, in the inland of São Paulo state (cities of Jaú, Franca and Birigui), and the Northeast (states of Ceará and Bahia), where there are fiscal incentives and a vast and cheaper workforce. Footwear production is also growing in the states of Santa Catarina and Minas Gerais.

Figure 8 - Footwear Production by Region

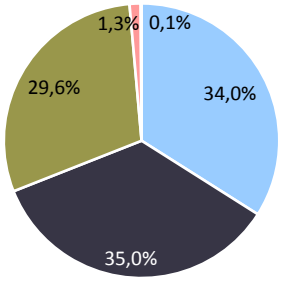
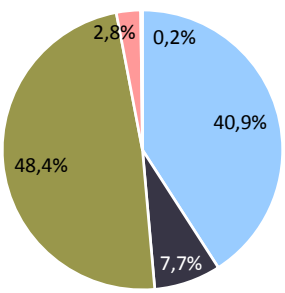
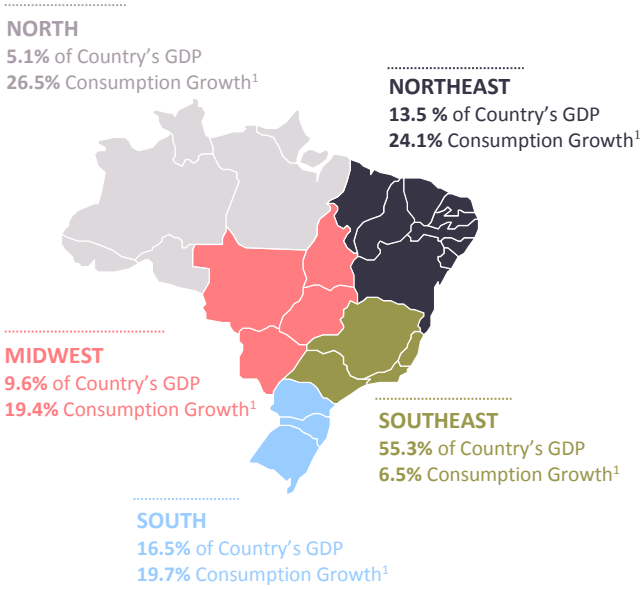


Figure 10 - Footwear Companies by Region



Source: Brazilian Footwear Association ("Abicalçados")

Figure 9 - Brazilian Regional Descripancies (2012)



(1) IBOPE estimates for consumption growth rates between 2011 and 2012

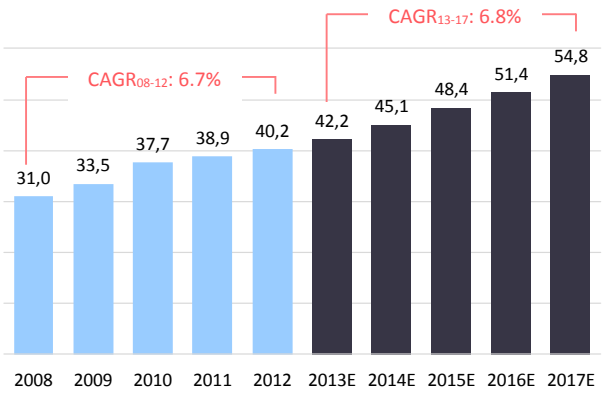
Source: IBGE, Brazilian Institute of Public Opinion and Statistics ("IBOPE")

The industry is composed by over 8,000 manufacturers, which produce more than 800 million pairs of shoes per year, being c. 120 million destined to exports to more than 140 countries, and the remaining 680 million to supply the domestic demand. The United States and Argentina are the major consumers of Brazilian shoes, accounting together for c. 28% of total exports value. The Brazilian footwear industry is recognized by the quality and high specialization within different and complex categories, representing an important player in the women's shoe segment worldwide. The industry has been evolving, in the recent years, in order to increase the value of its products and to create competitive advantages over the expanding Asian players in the country.

3.2.2 Footwear Retail Market

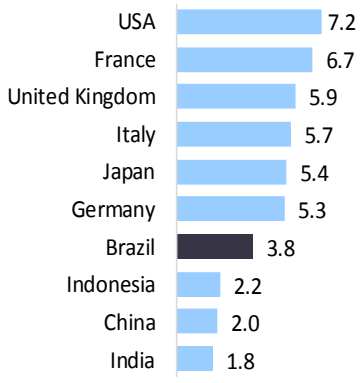
The Brazilian footwear market reached R$40.2 billion in 2012 at the retail level and is expected to grow at a CAGR[15] of 6.8% over the next four years, reaching an estimated R$50.8 billion in 2017. Although sizeable, this segment has still much room to grow and it seems like a matter of time for the still low footwear consumption per capita, in the country, of 3.8 pairs per year to close some of the existing gap between the developed economies such as the US (with 7.2 pairs per capita) or France (with 6.7 per year).

Figure 11 – Footwear Retail Sales



Source: Brazilian Footwear Retailers Association ("APLAC")

Figure 12 – Footwear Consumption per Capita (2012)



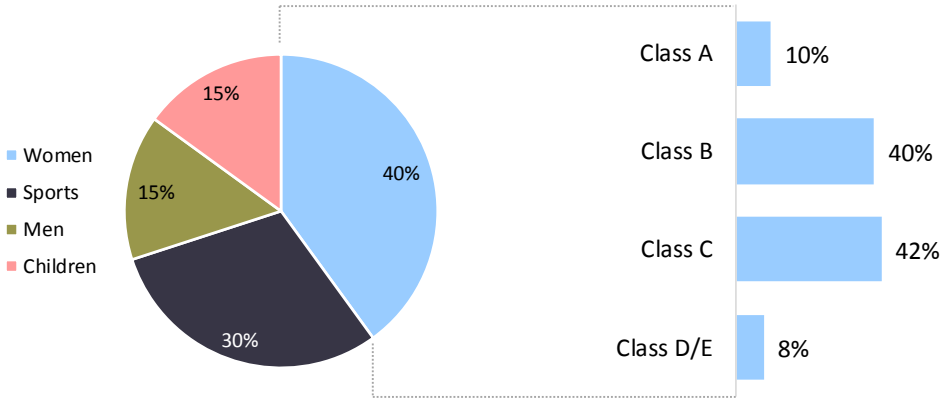
Source: World Footwear Year Book (2013)

As it was previously stated, approximately 85% of the Brazilian overall shoe production is destined to the domestic market, a clear evidence of the strong consumption potential of the country. Recent macroeconomic conditions like favorable demographics and increasing consumers' income have been boosting this consumption capacity. Brazil has a young population of more than 65% of Brazilians, or 130 million people under 39 years old, who are

[15] Compounded annual growth rate

the focus of the apparel and footwear sales. Additionally, in the past few years, the country has been witnessing an increasing participation of women in the workforce, a segment responsible for approximately 40% of total footwear consumption. This economic empowerment and financial independence among Brazilian women has been a key driver for women's footwear and apparel industry growth.

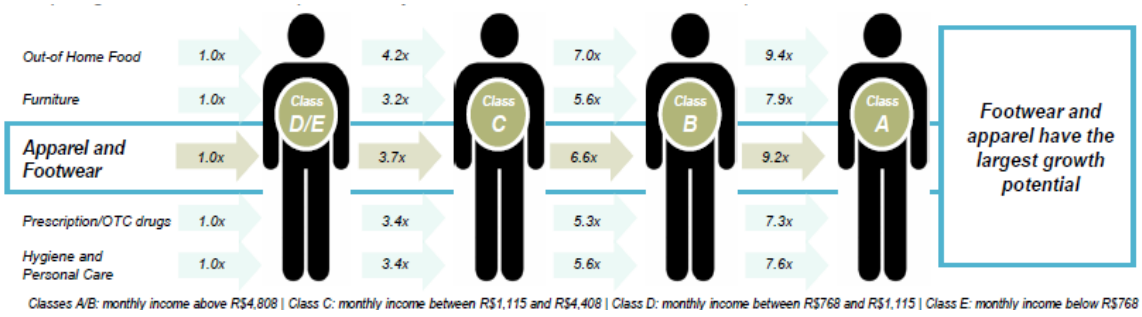
Figure 13 – Footwear Consumption by Segment (2012)



Source: APLAC, Mintel Study (2013)

The industry is characterized by high income-elasticity, meaning that with increasing purchasing power individuals tend to increase their expenses with clothes and footwear products. The Brazilian economic momentum of the past recent years has led to the emergence of a preponderant middle-class, which created a massive consumption potential especially among the population of social classes B and C.

Figure 14 – Industries Income Elasticity



Source: Arezzo&Co

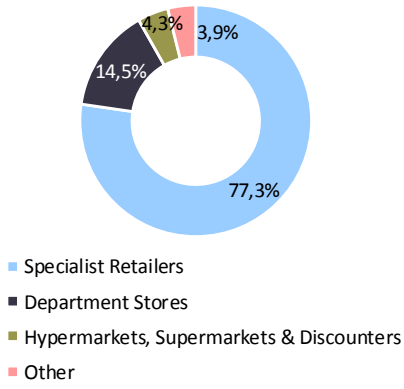
Lower-income consumers make up the largest share of the Brazilian population. Rising incomes and living standards offer plenty of potential to retailers. The fastest growing social class is class D, essentially, the lower middle class. Upwardly mobile consumers, now enjoying improved lifestyles coupled with an increased purchasing power, although incomes remain

relatively low, drive most of class D expansion. Between 2008 and 2018, the number of Brazilians consumers living on annual gross income less than US$ 5,000 is expected to drop by one fifth. As lower-end incomes improve, apparel and footwear retailers in Brazil are changing their offer to tap into the potential of this emerging consumer group.

The footwear retail market in Brazil is highly fragmented, consisting of approximately 29,000 footwear retail companies. Such fragmentation is well funded in a sector marked by few specialized and capitalized chain players, regional competition and neighborhood reach.

There is a wide variety of footwear store categories such as specialized stores and family-run businesses, department stores, and even supermarkets sell shoes. Although the family-run businesses are still the largest type of stores within the Brazilian market, these unstructured retailers are losing space as some emerging large players start to capitalize and expand their operation. Online stores, for example, have become an important sales channel for footwear products, especially among the young consumers due to the considerable increased exposure to technology and internet in past recent years.

Figure 15 – Footwear Distribution Channels



Source: Euromonitor

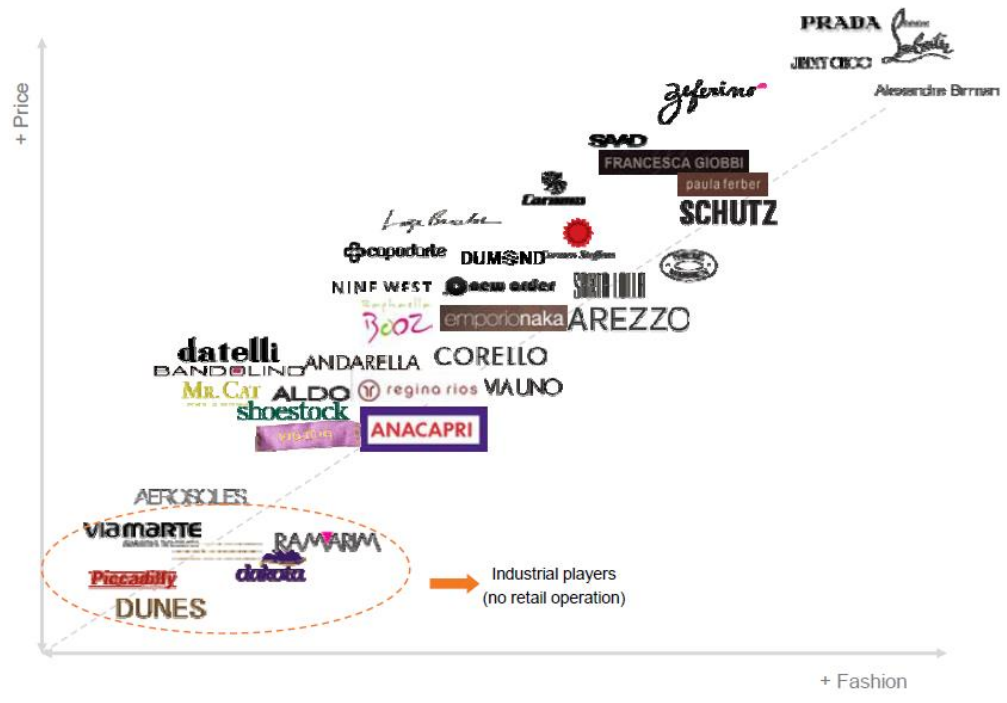
It is interesting to note that the women footwear market in Brazil is characterized by the limited presence of imported products and brands, except when one considers the niche of high-income consumers. Despite Brazil's booming middle class and demand for international brands, very few foreign companies are well established in the country due to the successful fast-fashion model adopted by most of the leading national players that makes it very hard for the international products to be competitive. The market's high operation costs, the inefficiencies arising from the distance between the production site abroad to the retail stores, and the high import tariffs are key barriers for an international player to enter in the country. Moreover, the cultural particularities of a large and diversified country like Brazil are quite hard to identify and adapt when is a foreigner player trying to develop products for the Brazilian population.

Less reliant on imports, domestic chains can position themselves at the lower-end of the price spectrum, making it easier for them to move into markets where incomes may be raising, but have not yet reached the same level as in larger cities.

Additionally, most leading footwear retailers in Brazil operate under a hybrid model of proprietary and franchised stores with the latter accounting for most of the stores base. Part of the reason for Brazil's comparatively high number of apparel and footwear specialists is the urbanized landscape of the country. In 2011, 85% of Brazilians lived in urban areas, a higher percentage than in many markets such as the US and other BRIC nations. However, the 10 largest cities account for only one fifth of the urban population. This means that, although there are a high number of locations able to support apparel and footwear specialist stores, gaining a regional or national coverage requires a larger network, which explains the need for the franchise model.

To conclude, Figure 16 presents a fashion/price positioning of the main footwear players in the country, as well as the positioning of Arezzo&Co brands: Arezzo, Schutz, Anacapri and Alexandre Birman. Please refer to the appendix for a brief description of some of these companies.

Figure 16 – Positioning of Main Footwear Players in Brazil



Source: Itaú BBA Research

3.3 COMPANY OVERVIEW

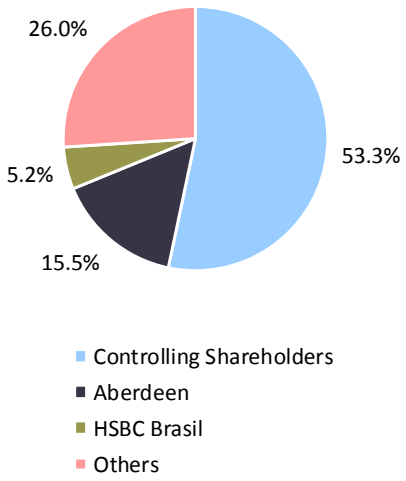
3.3.1 Company's History

Established in 1972, in the city of Belo Horizonte, Minas Gerais, by the brothers Anderson and Jefferson Birman, Arezzo&Co grew up to become a market leader in the women footwear and accessories industry in Latin America. The first milestone to consolidate its first brand Arezzo in Brazil's women footwear industry was in 1979 with the launch of the Anabela sandal, covered in jute thread that soon became a best-seller in the country.

In the 80's the company switched its production to a vertically integrated model, enabling a greater quality control throughout the entire manufacturing process, from the production of leather and soles to the finished product. In 1990, Arezzo&Co started to enhance its investments in the creation of own retail stores as well as in the development of a franchise business model, extending its sales network to the countryside areas of Brazil. Still in the 90's the company closed its operation in Minas Gerais and replaced it with a hybrid production model, combining both internal and outsourced production, in Vale dos Sinos, Rio Grande do Sul. The company also transferred its commercial operations to São Paulo and adopted the fast-fashion concept, developing 7 to 9 different collections every year.
In the 2000's, Anderson Birman acquired his brother's share of the company and incorporated his son's own brand, Schutz, creating together with the already existing brand Arezzo, the Arezzo&Co group. Also by this time, the company expanded its brand portfolio creating Anacapri and Alexandre Birman brands aiming at targeting new consumer segments.

In 2007, the Brazilian private equity Tarpon acquired a minority stake in the company, helping with the development of its corporate structure and governance standards. Four years later, in 2011, Arezzo&Co became a public company with its shares traded at Novo Mercado, the highest level of corporate governance of São Paulo Stock Exchange (BM&F Bovespa). In 2012, Tarpon sold its entire stake in Arezzo&Co, being no longer part of the company. As of December 2013, the controlling shareholders, Anderson Birman and his son, Alexandre Birman, held together approximately 53.3% of the Company's shares, with the remaining 46.7% being free float.

Figure 17 – Ownership Structure (2013)

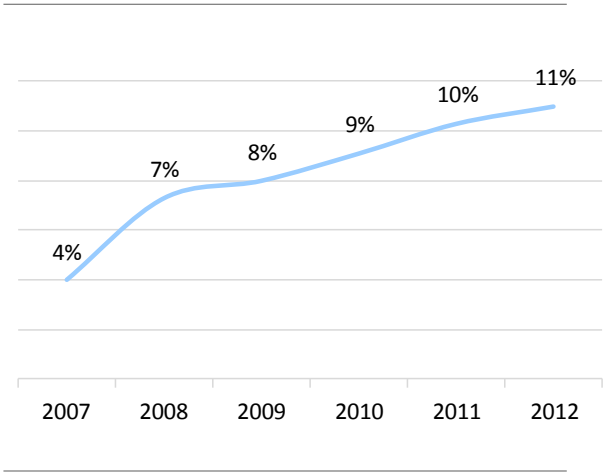


Source: Arezzo&Co

3.3.2 Brands' Positioning

Arezzo&Co is a multi-brand company, with different brands targeting particular consumer groups and usage occasions. The strong platform of brands, Arezzo, Schutz, Anacapri and Alexandre Birman, enables the company to capture growth from different income segments with no cannibalization between them. Over the past five years, Arezzo&Co has been able to increase its market share in Brazil's women footwear industry, representing c. 11%, in 2012, according to Euromonitor research.

Figure 18 – Arezzo&Co Market Share



Source: Arezzo&Co

Arezzo and Schutz are the most significant brands, accounting together for more than 96% of Arezzo&Co total gross revenues. This two brands aim at targeting consumers from income-classes A and B, which are currently benefiting from their large disposable income for discretionary products, like footwear and apparel. Anacapri brand was launched in 2008 and it targets a lower and broader income consumer group offering more casual, lower priced shoes and accessories. On the opposite side of the spectrum, Alexandre Birman, created one year later, targets higher price points as well as more fashionable and formal occasions.

Figure 19 – Company Brands and Positioning (2013)

	AREZZO	SCHUTZ	ANACAPRI	Alexandre Birman
Foundation	1972	1995	2008	2009
Brand Profile	**Trendy** and **New** Easy to Wear, Eclectic	**Fashion** Up to Date, Bold, Provocative	**Pop** Flat Shoes, Affordable, Colorful	**Design** Exclusivity, Identity, Seduction
Female Target	16 - 60 years old	18 - 40 years old	12 - 60 years old	20 - 45 years old
Average Retail Price	R$ 189.0 / pair	R$ 305.0 / pair	R$ 110.0 / pair	R$ 960.0 / pair
% Total Gross Revenues[16]	60.4%	35.7%	3.4%	0.5%

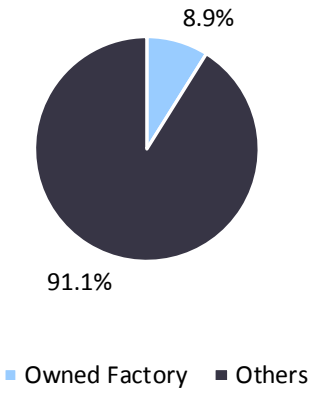
Source: Arezzo&Co

[16] 2013 Total Gross Revenues, including international and domestic operations

3.3.3 Business Model

The company operates a very flexible business model, in which all shoes and accessories are designed internally but its production can be either handled internally or outsourced to leading footwear industries in the country. Currently, approximately 91.1% of the production is outsourced to third parties while the remaining 8.9% is manufactured in-house. In 2010, these figures were 84.2% and 15.8%, respectively for outsourced and in-house production, which highlights the company's confidence towards a more outsourced production structure.

Figure 20 – Sourcing Model

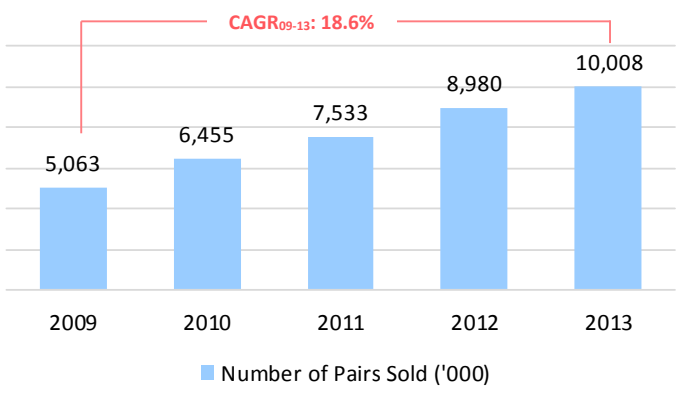


Source: Arezzo&Co

However, Arezzo&Co does not simply outsource its production to third parties. It has full control over each shoe's design, brand, prototype development and even raw material selection. The company's scale and asset light structure gives it flexibility to source a large number of SKUs[17] from various factories on a short period and at competitive prices. Every year, the company develops approximately 11,500 models that are gradually filtered by product development and sales teams to finally manufacture and deliver to stores roughly 6,000 models within 7 to 9 different collections per year.

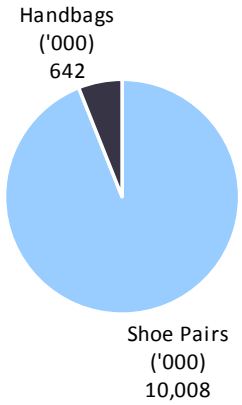
With an annual average growth rate of 18.6% between 2009 and 2013, Arezzo&Co hit the record mark of 10 million sold pairs of shoes, with 10,008 thousand pairs and 642 thousand handbags sold in 2013.

Figure 21 – Evolution of the Number of Pairs Sold



Source: Arezzo&Co

Figure 22 – Number of Shoes and Handbags Sold (2013)

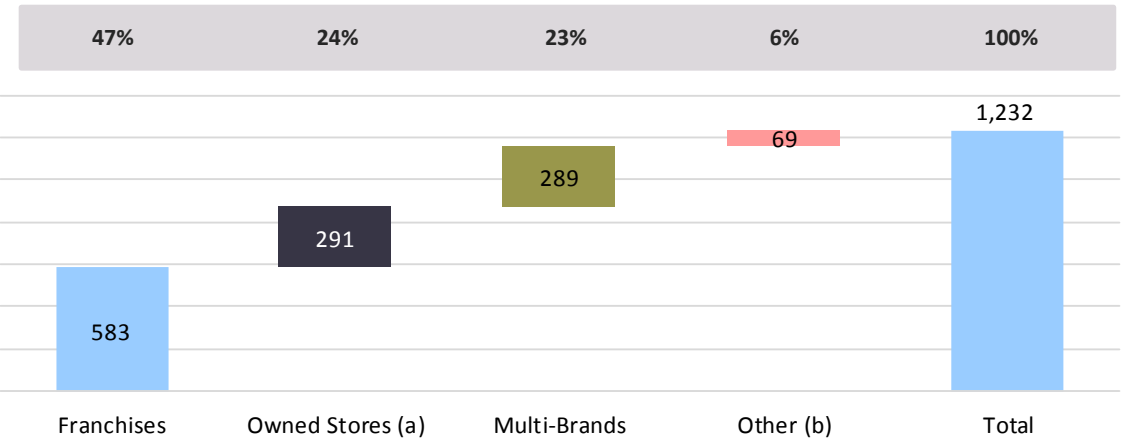


Source: Arezzo&Co

[17] SKU – Stock Keeping Unit

Arezzo&Co's flexibility is also found at the distribution level, in which the company operates a multiple distribution model combining owned, franchised and multi-brand stores, as well as an e-commerce platform. Arezzo&Co brands are also found in over 50 countries worldwide through multi-brand and department stores. Arezzo&Co distribution model allows the company to determine the most profitable combination among channels, widens stores capillarity and brands' visibility.

Figure 23 – Gross Revenues* Breakdown by Channel (2013) – R$ million



* Includes domestic and international revenues
(a) Includes e-commerce revenues
(b) International revenues and other revenues in the domestic market

Source: Arezzo&Co

Arezzo&Co own stores are strategically located to leverage sales and stand as a way to improve the company's knowledge on retail best practices and point-of-sale ("PoS") management through the direct contact with costumers. The company domestic owned stores are mainly located in São Paulo and Rio de Janeiro and, on average, present an annual revenue per store 1.5x higher than a franchised store.

On the other hand, the franchise model allows for a rapid expansion with relatively low capital disbursement. Franchise stores are adapted to the specific necessities of each region and are geared towards attaining high profitability levels, enabling the company's footprint presence at geographic areas where it would not make economic sense for own stores. Arezzo&Co franchise model has been consistently awarded the Franchising Excellence Stamp from the Brazilian Franchising Association (ABF) since 2004.

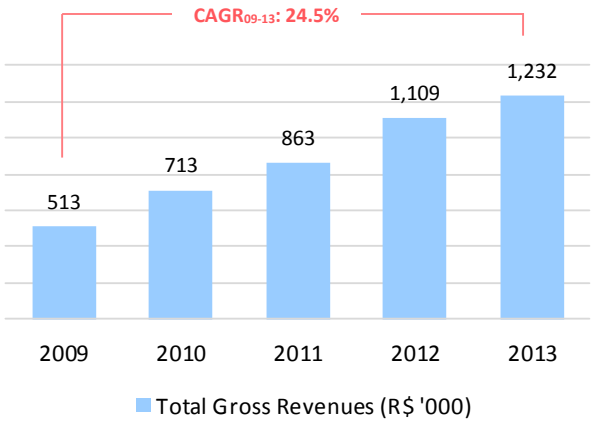
Finally, the multi-brand retail stores and e-commerce platform consolidate the strength of the other distribution channels by increasing the capillarity in small-size cities. Sales through these channels reach all the Brazilian states, as well as around 50 countries abroad, including Portugal.

3.3.4 Evolution of the Key Operating and Financial Indicators

Over the last 4 years, Arezzo&Co gross revenues have been growing four times faster than the footwear retail market in Brazil, with a $CAGR_{09-13}$ of 24.5%. This is the result of the company's primary growth strategy of enhancing its position as a fast fashion retailer, bringing the newest trends quickly to the market, at affordable prices, through an expanding network of owned and franchised retail stores, in the domestic market. Currently, the company has c. 2,077 employees and its international operations account for only 5% of total gross revenues.

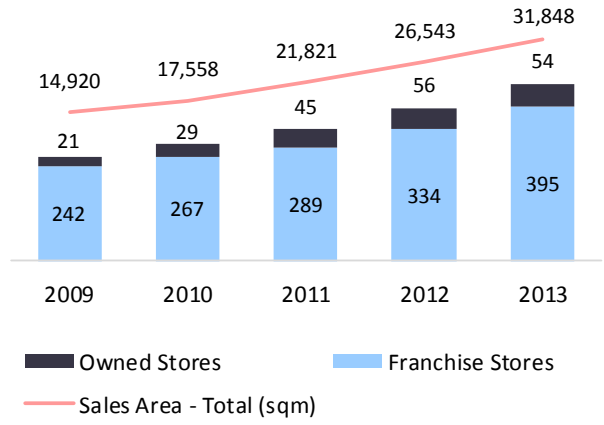
In 2013, the Company reached a total number of 449 domestic stores, of which 54 owned stores and 395 franchised stores (totaling approximately 32,000sqm of sales area) and 9 international stores. This represents an annual average growth rate of 14.3% of the total number of stores of the company, between 2009 and 2013.

Figure 24 – Total Gross Revenues Evolution



Source: Arezzo&Co

Figure 25 – Number of Stores Evolution

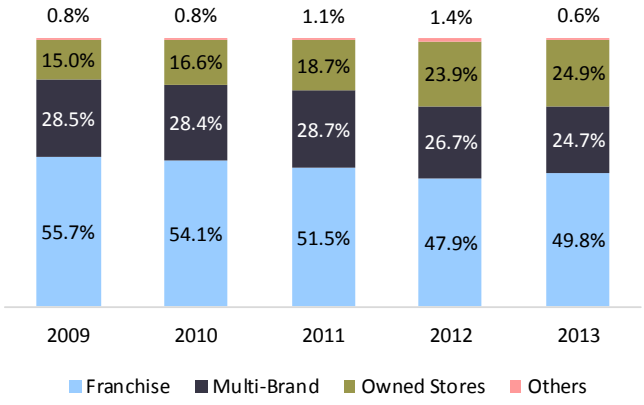


Source: Arezzo&Co

Arezzo&Co successful retail oriented structure, through its three distribution channels, has allowed the company to quickly expand its presence throughout the country. Currently the most relevant distribution channel is the franchise model, accounting for 49.8% of domestic gross revenues. After the IPO, the company concentrated in the development of its own network of retail stores in order to have a better control over its brands awareness and costumers interaction. Currently, the own stores distribution channel represents c. 24.9% of total revenues, from the 15.0% it represented back in 2009.

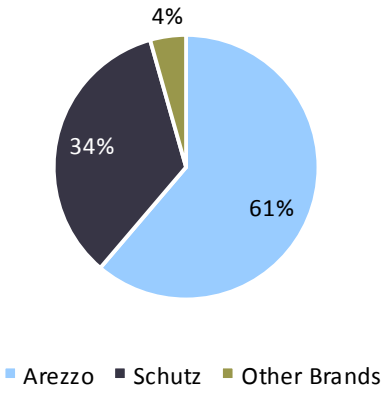
Arezzo&Co sales through the multi-brand stores channel represented 24.7% in 2013, which corresponds to 2,451 multi-brand stores across the country. This channel enhances brands capillarity and fills the gap left by franchised and own stores, which consequently helps in the consolidation of the brands.

Figure 26 – Domestic Gross Revenues by Channel Evolution



Source: Arezzo&Co

Figure 27 – Domestic Gross Revenues by Brand (2013)



Source: Arezzo&Co

Arezzo&Co operates a strong portfolio of brands that allow it to capture growth from different income segments and growth strategies. Arezzo is the most developed and consolidated brand, with an already strong penetration among the multiple distribution channels of the company. In 2013, the flagship brand represented approximately 61.2% of the company's total domestic gross revenues and had a total sum of 357 franchised and owned stores in every state of the country.

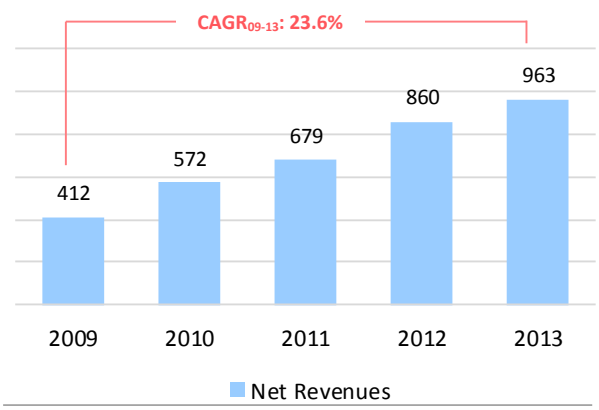
Schutz is the company's second most premium brand that has started with a go-to market strategy relying upon independent multi-brand stores. Although being an efficient strategy from a returns perspective, it hampers brand's development when you have no control of the point-of-sale. Thus, since the IPO, Arezzo&Co has been investing in the development of Schutz mono-brand stores – first through flagship and owned stores and then, in 2012, with the roll out of the franchise model for the brand. Currently, Schutz brand represents 34.4% of total domestic revenues and is present in more than 65 owned and franchised stores.

The remaining 4.4% domestic revenues come from Anacapri and Alexandre Birman brands. Anacapri brand holds eight own stores in São Paulo and is sold in multi-brand stores throughout the country. Similar to what it did with Schutz, the company has recently started to develop the franchise model of Anacapri with 15 franchised stores opened by the end of 2013. Alexandre Birman has only two owned stores located in São Paulo and its products can be found at leading luxury retail stores in Brazil and abroad, such as in Saks Fifth Avenue and Bergdorf Goodman, in New York.

The above-explained strategy allowed the company to increase its net revenues (gross revenues minus the taxes on revenues) at an average annual growth rate of 23.6% between 2009 and 2013.

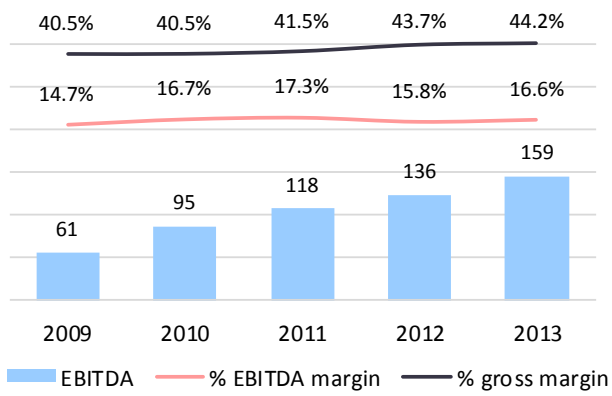
Moreover, the company's asset light structure, with approximately 90% of production outsourced and an extensive franchise network allows it to have low CAPEX needs, of c. 4.6% of total net revenues on average over the last four years. With this ability, the company has been able to maintain stable and controlled margins, while keeping an attractive ROIC figure of on average 34.8% over the past five years. Figure 31 shows a slight but reasonable decrease in ROIC over the last couple of years explained by Arezzo&Co recent strategy of expanding its network of owned stores.

Figure 28 – Net Revenues Evolution (R$ million)



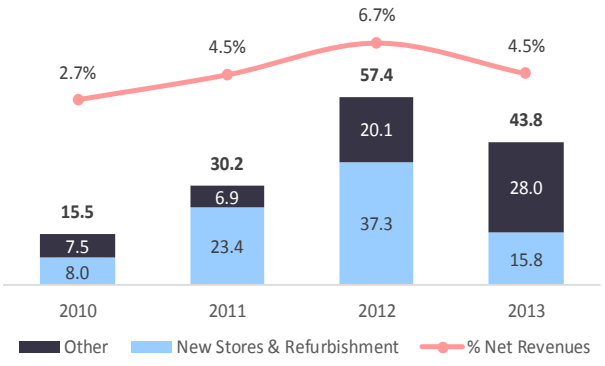
Source: Arezzo&Co

Figure 29 – EBITDA (R$ million) and Margins (%) Evolution



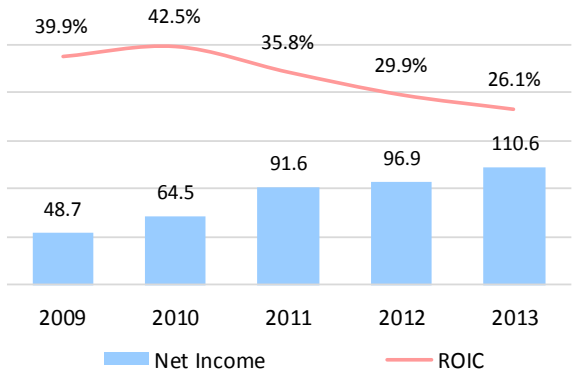
Source: Arezzo&Co

Figure 30 – CAPEX Needs (R$ million)



Source: Arezzo&Co

Figure 31 – Net Income (R$ million) and ROIC (%) Evolution



Source: Arezzo&Co

4. EQUITY VALUATION

4.1 VALUATION PROCESS AND GENERAL ASSUMPTIONS

In order to find a target value for Arezzo&Co shares, two different valuation approaches are chosen, the DCF Valuation and the Multiples Valuation. The reason for choosing more than one valuation methodology is that this allows for all the required assumptions and considerations of each method to be better assessed and compared providing more complete and consistent results. These different valuation methods will take into consideration the future objectives of the company as well as its performance over the last years. Some studies of the sector, management interviews and reports from other equity research analysts will also be taken as a reference for some of the assumptions considered.

To begin, a DCF Valuation will be made, using the previously described WACC approach. This methodology seems to be the one that bests suits Arezzo&Co characteristics and stage of development, since it fully captures the company's future growth evolution and perspectives. For this purpose, the Free Cash Flow to Firm (FCFF) will have to be forecasted for an explicit period, discounted back to the present at the appropriate discount rate, WACC, and assumed to grow at a constant rate after that period. Since Arezzo&Co is still in a challenging growing phase, consolidating new brands' positioning in the market and evaluating strategic options for its future, the explicit-forecasted period will be 5 years since a longer period might end-up biasing any forecasted evolution. The terminal growth rate applied will be 6.8%, the forecasted footwear retail industry revenues' CAGR[18] for the period 2013 to 2017.

Secondly, since forecasting future cash flows is a very judgmental process and for which there is no single correct answer, a sensitivity analysis will be performed to some operational and valuation parameters such as the terminal growth rate, the cost of capital and the gross margins, in order to establish a reasonable value range for Arezzo&Co shares.

To conclude, the Multiples Valuation will be made with the aim of comparing the price obtained with the one computed using the WACC method. In order to do so, a peer group of comparable companies will have to be defined. For the composition of the set of comparable companies, the industry in which the companies operate in, their business composition and growth perspectives will be taken into consideration.

[18] Nominal growth rate, in Brazilian Real, APLAC

4.2 AREZZO&CO VALUATION

4.2.1 DCF Valuation

As was previously stated, the first thing to do when valuing a company through the DCF valuation technique is to forecast its future cash flows. For this purpose, each constituent item of the FCFF will have to be estimated in nominal terms for the explicit period of 2014 to 2018. For the years after 2018 the previously referred terminal growth rate of 6.8% will be assumed.

Figure 32 presents the major macroeconomic assumptions, supplied by the Brazilian Institute of Statistics (IBGE) and by the Brazilian Central Bank (BACEN), which will serve as a basis for some of the FCFF projections.

Figure 32 – Macroeconomic Projections

Macroeconomic Assumptions	2014E	2015E	2016E	2017E	2018E
GDP real (%)	2.0%	2.0%	2.5%	3.0%	3.0%
Inflation Rate (%)	6.4%	6.0%	5.7%	5.5%	5.5%
Selic (%)	10.9%	12.2%	10.4%	9.5%	9.5%
TJLP (%)	5.0%	5.0%	5.0%	5.0%	5.0%
Exchange rate (BRL/EUR) - EoP	3.23	3.06	3.13	3.19	3.25
Exchange rate (BRL/EUR) - average	3.15	3.14	3.10	3.16	3.22

Source: IBGE, BACEN

Arezzo&Co distributes its products under four different brand names - Arezzo, Schutz, Anacapri and Alexandre Birman - and through three major distribution channels - franchised, multi-brand and own stores. For internal management purposes, the company monitors its consolidated gross revenue by brand name and sale distribution channel. However, it is organized as a single business unit for operating, commercial and administrative purposes. Therefore, a brief analysis of the future evolution of each brand and distribution channel will be made in order to estimate the company's gross revenues and gross margins, but the remaining projections will be built on a consolidated basis.

4.2.1.1 Forecasting the FCFF[19]

I. Revenues

Arezzo&Co revenues come in its majority from the sale of products and services to franchisees, multi-brand clients, and to the final consumer of its owned stores. The company's strategy can be seen as a matrix of three main brands across three distribution channels, with each brand and each sale channel in its particular stage of maturity. The owned store channel represents a way

[19] Please refer to the appendix for Arezzo&Co complete financial statements projections

to create greater brand awareness coupled with operational efficiencies, and it is a platform for the company to understand the best retail practices such as the store layout, shopping experience and the portfolio mix to have in its stores. On the other hand, in order to widen its distribution capillarity and brands' visibility, the company relies on franchise and multi-brand stores, and more recently on the online sales channel.

In Brazil, revenues are measured net of sales returns, discounts and taxes. However, since it is not possible to segregate these values for each sales channel its evolution is projected upon gross revenues and the taxes and returns are discounted afterwards proportionately for all channels.

In order to estimate Arezzo&Co gross revenues, projections are made separately for the domestic and the international market. According to management, the company will remain focused on domestic market consolidation and since, on average, the international market has been representing approximately 5% of total sales, this ratio will be kept constant for the next five years. Within the domestic market, revenues are estimated individually for the three previously described retail formats, and a brief analysis of each brand evolution is made. In addition, the evolution of the recently developed e-commerce platform will also be taken into account. In the past, sales from this channel were accounted in the own store sales revenue's line. However, with the growing broad brand penetration in Brazil and the changing consumer habits, this channel is expected to become more meaningful over the upcoming years.

Over the last couple of years, the company has been mostly concentrated in developing and consolidating its most recent brands, namely Schutz and Anacapri, within the domestic market, since its flagship brand, Arezzo, already has a strong penetration among all the company's distribution channels. For this purpose, the company focused on opening mono-brand stores, i.e., owned and franchise stores of each brand. However, from 2014 onwards, this trend is expected to slightly change and no owned stores will be opened in the upcoming five years. The company will focus on the expansion of its franchised retail chain, which means that, throughout the next few years, sales from owned and multi-brand store formats will be gradually offset by the evolution of the franchise business model.

Alexandre Birman does not have a material impact on revenues and it can be seen simply as a way to demonstrate the company's ability to design and manufacture high fashion and luxury shoes with no defined strategy for this brand for the near future.

Below there is a more detailed explanation of all the assumptions that will be considered to project each sale channel revenues evolution.

i) Mono-brand Stores (Owned and Franchised Stores)

In order to estimate the revenues arising from Arezzo&Co mono-brand stores, there are two major factors to consider, the number of store openings and the stage of maturity of each store.

Store openings

Based on the previously described future strategy of the company, focus will be given to the franchise retail store format, which means that the company is not planning to open any additional owned store in the next five years, but rather expand and develop its already existing ones.

On the other hand, in what concerns the franchise sale channel, each Arezzo&Co brand is at a different stage of development. Arezzo is the most consolidated brand, being present in almost all the national territory. Its strategy is more of a maintenance strategy, focused on restructuring and adapting the already existing store's base and slightly reducing the number of new store openings. Therefore, according to the management the company is expecting to open on average c. 20 stores / year over the next five years, five stores below its historic average. Schutz, and more recently Anacapri, on the contrary, had the roll out of their franchise model during the last couple of years, which means that the company will maintain a strong rhythm of store openings over the next five years, with 15 and 25 new stores opened per year, for Schutz and Anacapri, respectively. Figure 33 displays the average number of owned and franchise stores in each stage of maturity.

Figure 33 – Estimated Number of Stores

Number of Stores Estimation	2013	2014E	2015E	2016E	2017E	2018E
Own Stores						
Total Number of Stores (#) - Average	**55**	**55**	**55**	**55**	**55**	**54**
Mature Stores	21	25	37	51	55	54
3Y Stores	4	12	14	5	-	-
2Y Stores	12	14	5	-	-	-
1Y Stores	14	5	-	-	-	-
New Stores	5	-	-	-	-	-
Franchise Stores						
Store Openings (#) - EoP						
Arezzo	29	20	20	20	20	20
Schutz	17	15	15	15	15	15
Anacapri	15	25	25	25	25	25
Total Number of Stores (#) - Average	**365**	**425**	**485**	**545**	**605**	**665**
Mature Stores	240	254	278	312	365	425
3Y Stores	14	25	34	53	61	60
2Y Stores	25	34	53	61	60	60
1Y Stores	34	53	61	60	60	60
New Stores	53	61	60	60	60	60

Source: Arezzo&Co, Dissertation Estimates

Store's Stage of Maturity

Since there is no historical information regarding the revenue breakdown of Arezzo&Co mono-brand stores, a starting point for the value of revenues/store for each stage of maturity will be assumed based on 2013 figures. According to the management, Arezzo&Co franchise and owned stores mature, linearly, in approximately three complete years, representing c. 60% of the revenues of a mature store in the opening year, growing to 71% in its first entire year, to 85% in the second, and achieving 100% during its third full operational year, after which the store is considered mature.

New Stores Revenues: as it was stated recently opened store represents approximately 60% of the revenues from a mature store at the end of the year. Based on 2013 figures, revenues/store of a recently opened franchise and own store are estimated to be approximately R$ 1.1 million and R$ 3.5 million, respectively. Total revenues from this category of stores will simply be the number of opened stores in the year multiplied by the revenue / store previously stated. This revenue/store figure will be adjusted for the inflation rate of the period, meaning that there will be no changes on the store layout and efficiency of a recently opened store over the next five years.

It is important to highlight that new stores do not always open at the beginning of the year, meaning that a new store does not operate during its entire first fiscal year. For this reason, it will be considered that a new store operates, on average, 6 months in its opening year.

Stores with less than three years: the revenues for these stores will grow in order to achieve the correspondent percentage of the mature store revenues, previously described. For example, revenues from a store in its first entire year of operation will evolve in order to go from the 60%, in the previously year (when it was a recently opened store), to the 71% of the projected revenues from a mature store for that year. The rate at which the stores evolve is called same-store-sales (SSS) growth rate, since it refers to the difference in revenue generated by an existing store over the previous year. This measure is like-to-like, and avoids comparing stores that are fundamentally not comparable.

Mature Stores Revenues: it will be assumed that revenues from mature stores will evolve according to the historical average of the SSS Sell-In growth rate of c. 1.2x the inflation rate of the period for franchise stores, and the management assumption of SSS Sell-out growth rate, of 1.0x the inflation rate for owned stores. The SSS Sell-Out (Sell-In) is a metric developed by the company that incorporates the growth rate of own (franchise) stores opened for at least 13

consecutive months. This average multiplier of the inflation rate was considered in order to catch operational efficiencies from the evolution of mature stores throughout the years. Figure 34 illustrates the same-store-sales ladder of a franchise and an own-brand store.

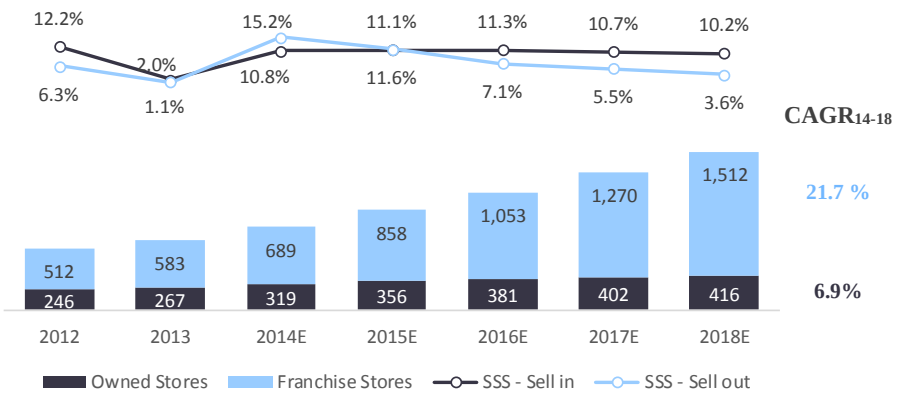
Figure 34 – Store Maturity Ladder

Maturity Ladder		2013	2014E	2015E	2016E	2017E	2018E
Own Stores							
Average Revenue/Store (R$ million)							
Mature Stores		**5.8**	**6.2**	**6.5**	**6.9**	**7.3**	**7.7**
3Y Stores	**100%**	5.8	6.2	6.5	6.9	7.3	7.7
2Y Stores	**84%**	4.9	5.2	5.5	5.8	6.2	6.5
1Y Stores	**71%**	4.1	4.4	4.7	4.9	5.2	5.5
New Stores	**60%**	3.5	3.7	3.9	4.2	4.4	4.6
SSS Sales (%)							
Mature Stores			6.4%	6.0%	5.7%	5.5%	5.5%
3Y Stores			26.2%	25.7%	25.3%	25.1%	25.1%
2Y Stores			26.2%	25.7%	25.3%	25.1%	25.1%
1Y Stores			26.2%	25.7%	25.3%	25.1%	25.1%
New Stores			6.4%	6.0%	5.7%	5.5%	5.5%
Franchise Stores							
Average Revenue/Store (R$ million)							
Mature Stores		**1.9**	**2.0**	**2.1**	**2.3**	**2.5**	**2.6**
3Y Stores	**100%**	1.9	2.0	2.1	2.3	2.5	2.6
2Y Stores	**84%**	1.6	1.7	1.8	1.9	2.1	2.2
1Y Stores	**71%**	1.3	1.4	1.5	1.6	1.7	1.9
New Stores	**60%**	1.1	1.2	1.3	1.3	1.4	1.5
SSS Sales (%)							
Mature Stores			7.8%	7.3%	6.9%	6.7%	6.7%
3Y Stores			27.8%	27.2%	26.8%	26.5%	26.5%
2Y Stores			27.8%	27.2%	26.8%	26.5%	26.5%
1Y Stores			27.8%	28.9%	30.0%	31.2%	32.6%
New Stores			6.4%	6.0%	5.7%	5.5%	5.5%

Source: Arezzo&Co, Dissertation Estimates

This combination of same-store sales growth yields an expected gross revenue CAGR between 2014 and 2018 of 6.9% and 21.7% for the own-store and franchise store sales channel, respectively.

Figure 35 – Domestic Gross Revenues Projections



SSS Sell Out: measures the growth rate of revenues arising from own stores opened for at least 13 consecutive months.

SSS Sell In: measures the growth rate of revenues arising from franchise stores opened for at least 13 consecutive months.

Source: Arezzo&Co, Dissertation Estimates

ii) Multi-Brand Stores Revenues

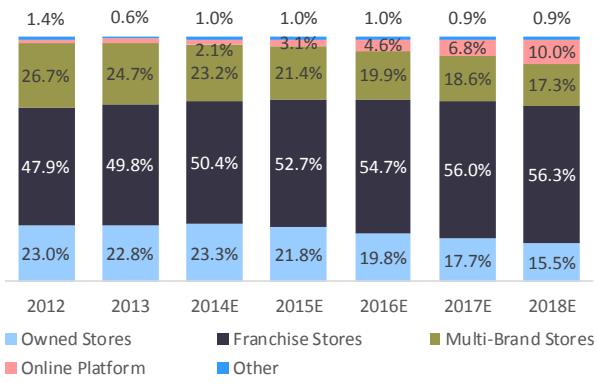
In the last couple of years, with the rollout of Schutz and Anacapri brands, Arezzo&Co has been de-registering some multi-brand retailers in order to avoid excessive overlap with its franchise network. According to Arezzo&Co management, this sales channel is expected to grow on average 10.0% in the next five years. Taking this into consideration, it was assumed that revenues per store would adjust for inflation and the registering number of new multi-brand retailers will present an average growth rate of 3.9% in order to reach the expected revenues average growth rate. Sales of Arezzo&Co's shoes at multi-brand retail stores will slightly reduce its weight on total domestic revenues from the currently 24.7% to 17.3% in 2018.

iii) Web Channel and Other Revenues

For the next five years, it is important to consider a new line of revenues arising from the e-commerce. Since its inception, the company's online sales platform has only been serving the Schutz brand and has been presenting extraordinary growth results, representing already c. 7% of the brand's revenues (approximately 2.0% of total domestic revenues, c. R$ 24 million, in 2013). In 2014, however, the company will conclude the implementation of a new and improved online platform adding Anacapri and Arezzo products to its online portfolio. Therefore, this sales channel is expected to gradually increase its participation on the company's overall domestic revenues. For projection purposes, it is assumed that this channel will linearly increase its participation on total domestic revenues to c. 10.0%, in the next five years. The other revenues business line reflects the sale of the excess raw material and has been representing approximately 1.0% of total domestic revenues, which will be assumed to keep constant for the explicit projection period.

Figure 36 captures the company's expected domestic gross revenues evolution for the next five years.

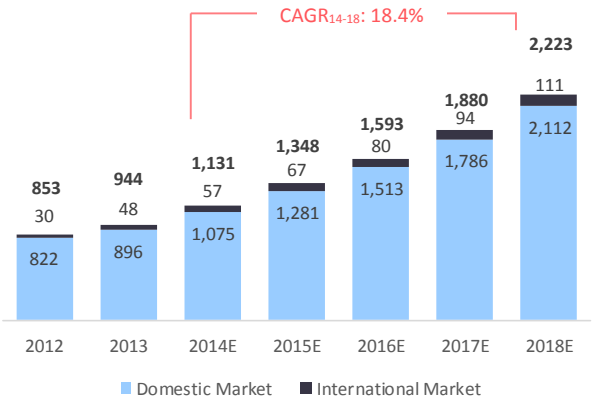
Figure 36 – Domestic Gross Revenues by Segment



Source: Arezzo&Co, Dissertation Estimates

After estimating Arezzo&Co gross revenues it is necessary to discount the taxes on revenues, sales returns and rebates. The company´s revenues are subject to state VAT, contribution tax for social security financing, contribution tax for social integration program, social security tax and state sales tax. For simplification purposes, it will be assumed the average aliquot of the last four years, applied to all the sale channels, and the value will be kept constant for the entire projection period, representing approximately 21.3%[20] of total gross revenues.

Figure 37 – Consolidated Net Revenues (R$ million)



Source: Arezzo&Co, Dissertation Estimates

II. Gross Profit

Arezzo&Co gross margin is extremely dependent on the management's ability to design a product, figure out the value proposition for the consumer and then determine the sale price at the store. The company estimates that cost advantages over its competitors are between 20% and 25%. The company's ability to design and build each prototype in-house enables pre-negotiated terms with supply agents as well as a quicker time-to market of 40 days compared to most competitors who typically take 50 to 70 days to take their products to the market. Cost of goods sold ("COGS") mainly include costs incurred with skilled labor or handwork, the transport of shoes from the suppliers to the retailers and costs of raw materials such as leather, plastic, rubber, textiles and injected soles.

Arezzo&Co operates with fixed mark-ups in its franchise and multi-brand retailers. This means that most of its gross margins, in percentage of net revenues, are fixed. Within the franchise model, the price the franchisee pays to Arezzo&Co for the product has a total value composed by the goods' cost and royalties, which involves, among others: services provided to the franchisees, training, specialized consulting and assistance on the layout and construction of the stores. The franchisee also contributes to an advertising fund, which has the objective to invest in branding. Since the company values its partnership with the franchisees, whose mono-brand stores are totally dedicated to Arezzo&Co's brands, following rigid image and communication standards, the price demanded to the franchisees is normally lower than the price paid by the multi-brand stores. Additionally, the company suggests the same store price for the products to all its distribution channels, which leads its owned stores to obtain higher

[20] Includes sales discounts, returns and rebates.

gross margins on sales to the final consumer than the gross margins obtained from sales to franchisees and multi-brand clients. According to the management, gross margins are 42% (mark-up[21] of 2.3x) and 38% (mark-up of 2.0x), respectively for franchise and multi-brand business lines. The gross margin of the owned-stores channel is more volatile and it will be considered 62.5% (mark-up of 3.7x), the average between 60% and 65% in line with management expectations. Also according to the management of the company, it is considered a gross margin of 20% for the international market and 55% for the e-commerce sale channel, since the company sells its entire online portfolio at a discount.

The company's planned expansion of its franchise network to represent 53.5% of total revenues in 2018 from the current 47.3% will pressure overall gross margin to slightly decrease in the next five years. In 2013, gross margin was 44.2% and it is expected to be closer to 42.7% in 2018.

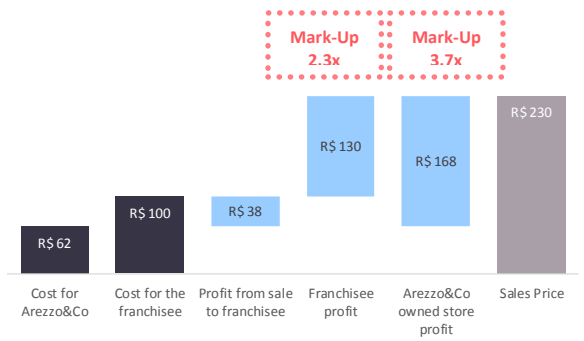
Figure 38 – Gross Profit Breakdown by Sale Channel

	2014E	2015E	2016E	2017E	2018E
Consolidated Gross Profit	**491**	**582**	**684**	**803**	**949**
Gross Margin (%)	**43.4%**	**43.2%**	**42.9%**	**42.7%**	**42.7%**
Own Stores	157	175	187	197	204
Gross Margin (%)	62.5%	62.5%	62.5%	62.5%	62.5%
Franchise Stores	206	256	315	380	452
Gross Margin (%)	38.0%	38.0%	38.0%	38.0%	38.0%
Multi-Brand Stores	105	115	127	139	153
Gross Margin (%)	42.0%	42.0%	42.0%	42.0%	42.0%
Other	1	1	1	1	1
Gross Margin (%)	5.0%	5.0%	5.0%	5.0%	5.0%
WEB channel	12	22	38	67	116
Gross Margin (%)	55.0%	55.0%	55.0%	55.0%	55.0%
International market	11	13	16	19	22
Gross Margin (%)	20.0%	20.0%	20.0%	20.0%	20.0%

Source: Arezzo&Co, Dissertation Estimates

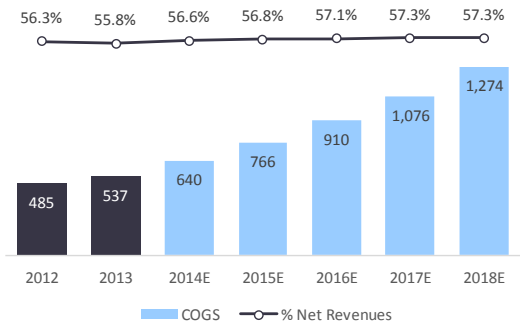
Through a backward cost-plus equation it is estimated that consolidated COGS will represent, on average, 57.0% of total net revenues, from 2014 to 2018 - a slight reduction when compared to the average of recent years.

Figure 39 – Economics of Arezzo&Co Franchising



Source: Arezzo&Co

Figure 40 – Consolidated Cost of Goods Sold



Source: Arezzo&Co, Dissertation Estimates

[21] Mark-up = Sales Price / Cost of the Good

Figure 39 displays the economics of an Arezzo&Co franchise store, which shows that the company receives 4.4x the gross profit per shoe in its own store than a shoe sold to a franchise store. The chart uses an example of a shoe sold for R$ 230, of which Arezzo&Co will receive a profit of R$ 168 when sold through its own store and R$ 38 when sold to a franchised store.

III. EBITDA

As it was previously stated, Arezzo&Co operates as a single business unit, with a consolidated expense structure for all the distribution channels. There are two major lines in Arezzo&Co' expense structure (i) commercial expenses and (ii) general & administrative expenses.

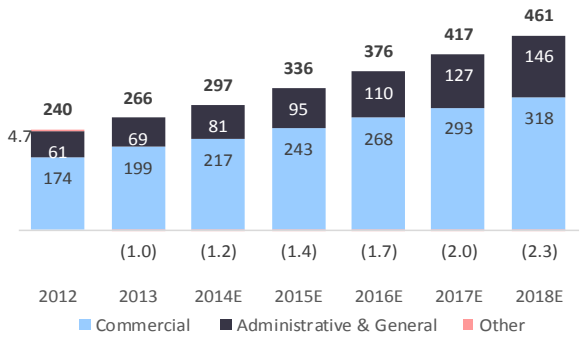
i) Commercial Expenses: It is possible to break down commercial expenses in two major components: expenses related to the sell-in, which includes the whole structure of pre-selling (sales, logistics and supply) to the franchise and multi-brand stores, and the expenses related to the sell-out, which are the selling expenses related to the actual operation of the owned store retail network.

According to the management, approximately 50% of the sell-in expenses are variable (assumed to evolve as a percentage of the franchise and multi-brand stores net revenues) and include freight, commissions to production agents and commissions to sales representatives. The remaining 50% are fixed, evolving according to the inflation rate, and mostly related to virtual merchandising, showroom and pre-sales expenses, as well as the management structure to support sourcing and expansion. On the other hand, the sell-out expenses, i.e., expenses related to owned stores operation, are 20% fixed and the remaining 80% variable, assumed to maintain the same historic average percentage of owned stores net revenues.

ii) Administrative & General Expenses: Administrative & General expenses are mostly comprised of the R&D/product design structure and headquarters' operation expenses, which are inherently fixed. These costs have been growing on average 2.8x the inflation rate and so it is maintained the same assumption for the future.

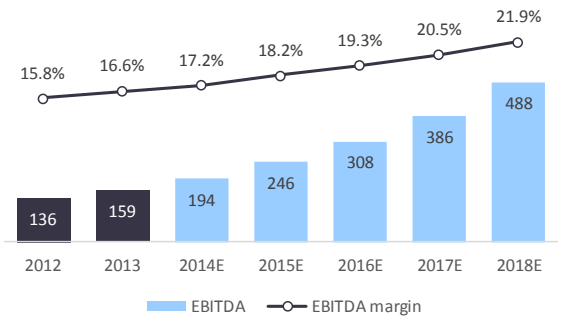
Given the above stated assumptions, EBITDA margins are expected to gradually increase in the next five years, from the current 16.6% to 21.9% in 2018.

Figure 41 – SG&A Expenses (Revenues) – R$ million



Source: Arezzo&Co, Dissertation Estimates

Figure 42 – EBITDA (R$ million) and EBITDA Margin (%)

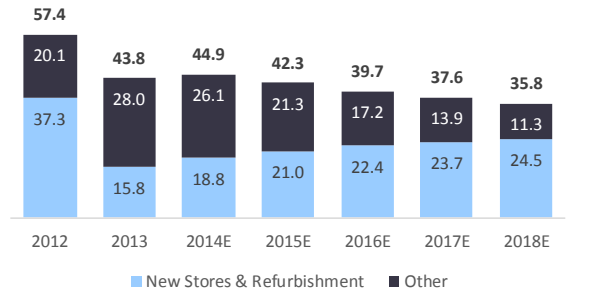


Source: Arezzo&Co, Dissertation Estimates

IV. CAPEX & Depreciation

The company's capital expenditures requirements can be broken into three types (i) investments in the expansion or renovation of owned sales outlets, (ii) corporate investments including IT, facilities, showrooms and offices, and (iii) other investments primarily related to the modernization of its industrial operations.

Figure 43 – CAPEX (R$ million)



Source: Arezzo&Co, Dissertation Estimates

According to management, there is no anticipation of future changes in the current capital expenditure policy of the company. Therefore, it is assumed that Arezzo&Co will keep investing approximately 5.9% of owned stores gross revenues, the 2013 percentage, in the expansion and refurbishment of its existing stores. The year of 2013 is the most comparable, since it was the only year with no own stores opened. For the other required investments, it will be assumed that the company will invest a percentage of the consolidated gross revenues, which will linearly decrease to approximately 0.4% total gross revenues, since there are no major investment plans for the upcoming years.

Depreciation and amortization expenses are composed of the depreciation of (i) existing fixed assets, and (ii) future fixed assets investments (CAPEX). Depreciation expenses of existing fixed assets will be projected in accordance to the historic breakdown provided in the annual accounts of the company. Similarly, depreciation expenses of the CAPEX will be forecasted based on the historic average depreciation rates for each type of the company's fixed assets. As a result, depreciation & amortization expenses will represent, on average, approximately 0.9% of consolidated net revenues in the next five years. Please refer to the appendix for the projected CAPEX ladder.

V. Working Capital

The Net Working Capital is a measure that indicates the ability of a company to meet its current needs and it can be seen simply as current assets minus current liabilities. For the estimation of the FCFF, in the current assets side of the equation are included the accounts payables and the inventory, while on the other side of the equation, the current liabilities, one can find the accounts payables and other non-cash short-term expenses. In order to find the value of the net working capital one can estimate each of its components based on the evolution of historical indicators such as ratios and, in more general cases, as a historical percentage of gross revenues. For example, the value of future Inventories is estimated based on the ratio Days in Inventories[22], being the 2013 figure c. 55 days. Figure 44 presents all the considerations made to forecast the remaining components of the Net Working Capital.

Figure 44 – Working Capital Needs

Working Capital	2014E	2015E	2016E	2017E	2018E
Current Assets	**432.0**	**514.0**	**604.9**	**714.2**	**842.5**
Trade Accounts receivables	290.8	346.5	408.4	483.1	571.4
# Days in Net Revenues	94	94	94	94	94
Inventories	101.4	121.4	143.7	170.5	201.8
# Days in Inventory	58	58	58	58	58
Taxes recoverable	21.4	24.2	27.0	30.1	33.2
# Days in Expenses	26	26	26	26	26
Other receivables	18.3	21.9	25.8	30.5	36.0
as % of Net Revenues	1.6%	1.6%	1.6%	1.6%	1.6%
Current Liabilities	**88.4**	**69.0**	**81.1**	**95.3**	**111.9**
Trade accounts payable	41.5	49.7	58.9	69.9	82.7
# Days in COGS	24	24	24	24	24
Tax and social liabilities	20.3	22.9	25.5	28.4	31.5
# Days in Expenses	25	25	25	25	25
Labor liabilities	15.1	(17.1)	(19.1)	(21.3)	(23.5)
# Days in Expenses	19	19	19	19	19
Other liabilities	11.5	13.5	15.8	18.3	21.3
as % of Expenses + COGS	1.2%	1.2%	1.2%	1.2%	1.2%
Net Working Capital	**343.5**	**445.0**	**523.8**	**618.8**	**730.6**
Δ Net Working Capital	**52.5**	**101.5**	**78.8**	**95.0**	**111.8**

Source: Arezzo&Co, Dissertation Estimates

4.2.1.2 Cost of Capital and Capital Structure

According to the literature review, the next step to reach the value of Arezzo&Co shares is to determine the correct discount rate at which the cash flows will be discounted: the weighted average cost of capital (WACC[23]). This discount rate reflects the cost of each source of capital

[22] $\text{Days in Inventory} = 365 \times \frac{\text{Inventory}}{\text{Cost of Goods Sold}}$

[23] $\text{WACC} = k_e \frac{E}{D+E} + k_d \frac{D}{D+E}(1-t)$

in the company, weighted by the value they have on its capital structure.

Historically, the company has always been trying to keep the net debt figure between -1.0x and 0.0x EBITDA. According to the management, the Brazilian government subsidizes loans for domestic companies that manufacture and operate inside the country, which makes it profitable to get the loan and invest the money in the bank. Thus, in order to estimate the company's total debt it was assumed the historical average debt / equity ratio of c. 16.6% of the last four years, which yields net debt / EBITDA ratios within Arezzo&Co desired range.

Figure 45 – Financial Debt

R$ Million	2012	2013	2014E	2015E	2016E	2017E	2018E
Total Financial Debt	**94.1**	**98.4**	**98.9**	**115.3**	**134.7**	**159.6**	**191.6**
Debt / Equity Ratio	20.7%	19.1%	16.6%	16.6%	16.6%	16.6%	16.6%
Net Debt / EBITDA	-0.8x	-0.5x	-0.4x	-0.2x	-0.2x	-0.3x	-0.4x
ST Debt	42.8	59.8	54.1	63.1	73.7	87.3	104.9
% Total Debt	45.5%	60.8%	54.7%	54.7%	54.7%	54.7%	54.7%
LT Debt	51.2	38.6	44.8	52.2	61.0	72.2	86.8
% Total Debt	54.5%	39.2%	45.3%	45.3%	45.3%	45.3%	45.3%

As previously discussed in the literature review, one shall consider a target capital structure at market values rather than the current capital structure of the company. As a result, after reviewing the capital structure of comparable companies, and similarly to what happens with Arezzo&Co, all major footwear and apparel retailers are cash intensive, i.e., the net debt figure (total financial debt less cash and cash equivalent) is negative, meaning there is excessive cash on the companies' balance sheet. For this reason, it is assumed that the company has no debt in its balance and is completely financed with equity, which means that the WACC value is equivalent to the unlevered cost of equity[24] (k_e).

In order to reach the unlevered cost of equity it is necessary to estimate some parameters, as it was described in the literature review. First, it will be assumed a risk-free rate (r_f) of 2.7%, representing the average return of a 10-year US T-bond over the last 12 months. The reason for choosing the United States has to do with the fact that it is a mature economy with good credit ratings, something that is not expected to change in the near future. Second, for the market risk premium ($[r_m-r_f]$) and the country' specific risk premium (r_c) it will be considered, respectively, the Damodaran estimates of 5.5% and the average of last 12 month JP Morgan EMBI+ index of 2.3%, as defined in the literature review.

[24] $k_e = r_f + \beta[r_m - r_f] + r_{br} + r_c$

In Brazil, it is also necessary to add the exchange risk (r_c) of 3.4% (difference between the long term annual inflation rates of Brazil and the US) in order to bring the WACC to Brazilian reais (R$). In order to estimate the beta (systematic risk) of the company the approach described in the literature review will be followed, which yields a value of 0.80 for the median unlevered beta (β_u), also known as the industry unlevered beta. At this moment, one is able to compute the unlevered cost of equity, reaching a value of 12.8%.

WACC - Weighted Average Cost of Capital	Median
Risk Free - Rf	2.7%
Country Risk (Brazil) - Rbr	2.3%
Market Risk Premium - (Rm – Rf)	5.5%
Beta Levered	0.80
Exchange Rate Risk - Rc	3.4%
Cost of Equity - Ke	**12.8%**
Gross Cost of Debt	9.2%
Income Tax	27.8%
Cost of Debt - Kd	**6.6%**
D/E	0.0%
D/A	0.0%
WACC - R$ nominal	**12.8%**

Taking all the above assumptions into consideration, Arezzo&Co enterprise value (EV) through the WACC method is R$ 2,575 million, implying a price target of R$ 30.0 per share, as of December 2013. This target value corresponds to a potential upside of 6.1% in relation to the current market price [25] of R$28.3 per share, which represents a neutral, or hold, stock recommendation according to Deutsch Bank classification.

DCF Valuation		2014E	2015E	2016E	2017E	2018E
Periods		**0.5**	**1.5**	**2.5**	**3.5**	**4.5**
EBIT		184	232	290	363	460
(-) Income Taxes	**27.8%**	(51)	(64)	(81)	(101)	(128)
(+) Depreciation&Amotization		10	14	18	23	27
Operational Cash Flow		**143**	**181**	**227**	**285**	**360**
(+/-) Δ Working Capital		(53)	(101)	(79)	(95)	(112)
(-) Capex		(45)	(42)	(40)	(38)	(36)
Free Cash Flow to Firm		**46**	**38**	**109**	**152**	**212**
WACC (median)	**12.8%**					
Discount Factor		0.94	0.83	0.74	0.66	0.58
Discounted Free Cash Flow to Firm		**42.9**	**31.4**	**80.5**	**99.9**	**123.3**

Enterprise Value		**% EV**	**2,575**
Explicit Period		15%	378
Perpetuity		85%	2,197
g	**6.8%**		
(+) Cash & Cash Equivalents (2013)			186
(-) Financial Debt (2013)			-98
Equity Value			**2,663**
Target Share Price	**88.637**		**R$ 30.0**
Current Price (as of 13/jun)			**R$ 28.3**
Upside Potential			**6.1%**

[25] As of June 13, 2014

4.2.1.3 Sensitivity Analysis

Since the process of forecasting future cash flows is very judgmental, in this section, a brief sensitivity analysis to some operational and valuation parameters such as the terminal growth rate, the cost of capital and gross margins will be presented.

A relevant premise to test is the number of store openings within the next five years. According to the management, Arezzo&Co will not open any additional owned stores in the near future. However, by testing this assumption it is possible to conclude that, if the company opened 15 more owned stores (5 of each brand), maintaining the strategy for the franchise sale channel, the target price would increase by 4.3% (to R$ 31.3). On the other hand, if the number of store openings is revised for both sales channels, franchise and owned stores, the price of Arezzo&Co'shares could reach R$ 32.6 (+8.4% in relation to the estimated price target).

Figure 46 – Sensitivity Analysis

Owned Stores

Frachised Stores	-15	-2	0	6	15
-15	29.8	29.2	28.8	29.1	30.0
-6	30.6	30.0	29.5	29.9	30.8
0	31.1	30.5	**30.0**	30.4	31.3
6	31.6	31.0	30.5	30.9	31.8
15	32.3	31.7	31.3	31.6	32.6

Owned Stores GM

Web GM	-2.5%	-1.5%	0.0%	1.5%	2.5%
-2.5%	28.6	29.0	29.5	30.1	30.4
-1.5%	28.8	29.2	29.7	30.3	30.6
0.0%	29.1	29.5	**30.0**	30.6	31.0
1.5%	29.4	29.8	30.4	30.9	31.3
2.5%	29.7	30.0	30.6	31.1	31.5

WACC

g	-1.5%	-0.5%	0.0%	0.5%	1.0%
-1.0%	33.9	28.4	26.3	24.4	22.8
-0.5%	36.9	30.5	28.0	25.9	24.1
0.0%	40.5	32.9	**30.0**	27.6	25.6
0.5%	45.1	35.8	32.4	29.6	27.2
1.0%	51.0	39.4	35.3	32.0	29.2

As it was previously stated, the gross margin ("GM") of the owned store sale channel is variable, and depends on the company's ability to efficiently predict how much it will be able to sell within its owned stores at a full price and how much will have to be sold at a discount price. According to the management, this margin usually varies between 60% and 65%, for this reason each one of these cases was studied. At the same time, it was also assumed a similar reduction and improvement in the web-commerce gross margin, as this is a relatively recent channel and its commercial strategy is still in a development phase, with margins likely to change with a more aggressive or soft price strategy. It is possible to conclude from the first table in figure 46 that the price target of Arezzo&Co is slightly sensitive to this assumption, and it may vary between R$28.6, in the worst case scenario, which combines the lower gross margins for both channels, and R$31.5, under higher gross margins for both of these segments

To conclude, it is also important to test two of the most controversial parameters within the valuation community: the perpetuity growth rate and the discount rate applied. As expected,

Arezzo&Co price target is very sensitive to these variables, which originate a value range for the price target between R$ 22.8 and R$ 51.0, respectively in the worst and best case scenarios.

4.2.2 Relative Valuation

A relative valuation is a useful tool to complement a DCF valuation and to ensure that growth assumptions are in line with what the market believes to be correct.

The first thing to do when performing this type of valuation is to choose the company's peer group. In order to do so, one should try to look for companies within the same industry sharing similar economic and business characteristics such as capital structure, cost of capital and expected growth. Arezzo&Co has no direct comparable company in the Brazilian footwear retail market and for this reason it is considered a group of 11 companies, among which are Brazilian apparel & footwear retailers, multinational players in the footwear industry such as Nike, Adidas and other worldwide apparel retailers. Even though one could argue that international companies are not comparable since the company has no relevant activity worldwide, these companies are the ones presenting the most similar capital structure to that of Arezzo&Co and for this reason it was decided to create a mix of all these companies. The selected companies were collected from peer groups considered by other equity research analysts that cover Arezzo&Co and from Bloomberg consensus.

According to the literature review, multiples based on earnings (such as the P/E ratio) are the most commonly used since they are determined by the same fundamentals that determine the value of a firm through the DCF methodology: expected growth, risk and cash flow potential. However, analysts nowadays are also using alternative multiples such as multiples on revenues (EV/Sales) in valuations, since these are always available even for the most troubled firms and are relatively more difficult to manipulate than earnings.

The table below presents the company set of comparable firms and Bloomberg's expectations for both the forward-looking EV/Sales and P/E ratios, as of June 2014. The estimation of Arezzo&Co financial indicators is made in line with the DCF valuation previously presented.

Company	Country	Market Cap (US$ million)	ROE	P/E 2014 E	EPS $CAGR_{13-}$	EV/Sales 2014 E	Sales $CAGR_{13-}$
Brazilian Apparel & Footwear Retailers							
ALPARGATAS-PREF	BRAZIL	2,335	18.5%	14.2x	18.7%	1.2x	14.1%
LOJAS RENNER SA	BRAZIL	4,126	30.8%	20.4x	10.2%	2.1x	10.1%
GUARARAPES	BRAZIL	2,774	17.0%	12.5x	16.2%	1.3x	13.9%
CIA HERING	BRAZIL	1,503	34.4%	n.a.	5.2%	1.7x	7.7%
Global Footwear & Apparel							
ADIDAS AG	GERMANY	20,610	12.0%	17.7x	15.9%	1.0x	5.3%
BATA INDIA LTD	INDIA	1,365	24.8%	n.a.	23.5%	3.3x	15.3%
TOD'S SPA	ITALY	3,694	17.2%	20.6x	5.5%	2.6x	6.1%
INDITEX	SPAIN	93,979	27.4%	28.4x	7.0%	3.8x	9.1%
NIKE INC -CL B	UNITED STATES	67,546	24.6%	25.2x	9.7%	2.3x	9.6%
STEVEN MADDEN	UNITED STATES	2,214	20.0%	16.0x	8.7%	1.4x	7.1%
BROWN SHOE CO	UNITED STATES	1,213	14.2%	21.0x	56.5%	n.a.	2.1%
Average (Total)			21.9%	19.6x	16.1%	2.1x	9.1%
Arezzo&Co (Thesis)			**21.5%**	**18.9x**	**26.3%**	**2.3x**	**18.3%**
Premium / Discount				*-3.1%*		*9.0%*	

Source: Bloomberg

Based on the P/E ratio, the company is valued at a price target of R$ 31.0 per share (+3.2% relative to the DCF Valuation). However, when considering the EV/Sales the difference is slightly higher. As one can observe, Arezzo&Co valuation based on this multiple is lower than that of the DCF valuation as apparently the company is being valued at a premium when compared to its peers, resulting in a price target of R$ 27.6 (-8.0% relative to the DCF valuation).

Figure 47 – Relative Valuation

R$ million	EV	Equity	Price Target	Dif.
P/E		2,748	R$ 31.0	3.2%
EV/Sales	2,362	2,449	R$ 27.6	-8.0%
Arezzo&Co (Thesis)	**2,575**	**2,663**	**R$ 30.0**	

These different conclusions anticipate some of the disadvantages of this methodology of valuation. First of all, multiples are static figures representing investors' image of the companies at a certain moment in time, failing to capture one company' specific features such as its positioning within the market of operation, respective growth prospects, among others. Moreover, as it was already stated, Arezzo&Co has no direct comparable company in its industry and region of operation, as the company operates a multi-brand and multi-channel business model in the Brazilian footwear industry with no other listed player with these characteristics. Thus, the relative valuation becomes somewhat misleading. For these reasons, one should not base its analysis solely on the relative valuation, but rather used it to create a value range between which the company's price target may vary. In this case, the suggested value range for the price target of Arezzo&Co would be between R$ 27.6 and R$ 31.0, the EV/Sales and P/E multiples, respectively.

4.2.3 Main Risks to the Valuation

As every company or business, Arezzo&Co is subject to several risk factors that may influence positively or negatively the company's future performance and, as a consequence, its target price.

Production Model: The company's production depends at a great extent on third-party manufacturers since it currently outsources approximately 91% of its total production. Managing this supply chain, as well as negotiating raw material supply contracts at competitive prices, pose significant challenges for Arezzo&Co and an inefficient management of the supply chain could pressure the company's margins and the quality of its products.

Business Model: Arezzo&Co future growth heavily relies on the company's ability to franchise, since this channel is expected to represent approximately 54% of total gross revenues, from the current 47%, in the next five years. There are two major concerns related to this sale channel that may affect the company's performance: (i) the delay and default of payments by the franchisees, and (ii) the company's ability to maintain a good relation with its franchisee network. For the last seven years, the company has been considered one of the best franchise businesses in the country, with approximately 96% satisfaction among its network of franchisees. It is important for the company to maintain this level of satisfaction and a strong relation with the franchisees so that it ensures the strong growth expectations for this channel.

Industry, Competition and Macroeconomic Factors: The Brazilian footwear retail sector is highly competitive as shoes are sold in several sale channels such as large women footwear retailers, small local players and other retail stores like supermarkets and department stores. Therefore, increasing competition could adversely impact the top line growth and profitability of the company. Additionally, significant changes in import tax laws that lift the current tariff on imported shoes could increase the competitiveness of international players and potentially affect the company's market share. Moreover, the footwear and accessories sector is heavily influenced by general economic cycles, as consumers are sensitive to variations in the interest rates, availability of credit and unemployment, among other factors that affect discretionary consumer spending. Therefore, a period of depressed consumer spending could have a material adverse effect on the company, and could result in a revenue growth below the estimates.

Brand Recognition and Fashion Trends: Arezzo&Co may be unable to respond appropriately to changing trends in the fashion industry or swings in consumer preferences. The company competes with several other players in terms of price, quality, style, purchase experience,

promotions, store location and decoration, among other factors. Considering that consumer preferences and fashion trends are heavily volatile, it is fair to state that the company's success depends on its ability to accurately identify and anticipate such changes and to respond accordingly. If the company is unable to efficiently manage such volatility, it could be negatively hit by declining sales, higher inventory levels, and/or lower margins.

Key Personnel: One final risk factor is the possibility of the loss of key personnel or the inability to attract qualified employees. As Arezzo&Co performance significantly depends on key persons such as Anderson Birman (chairman) and Alexandre Birman (CEO), the loss of one of them could probably lead to substantial undesirable effects on the company's results.

5. COMPARISON WITH BANCO SAFRA VALUATION

In this chapter, the previously described DCF valuation will be compared with the valuation performed by the analyst Alan Cardoso from Banco J. Safra. The valuation from Banco Safra was chosen since it was the equity report dated closer to the valuation database assumed in the dissertation, and for which was possible to understand all main assumptions in order to compare the two valuations. It is important to highlight, that at the time of Banco Safra's report, the company's financial statements of year-end 2013 were not available, and for this reason these figures may diverge from the ones considered in the dissertation. Please refer to the appendix for additional details on Banco Safra's financial projections.

Both analysis consider the DCF method as the best methodology to estimate Arezzo&Co price target, however, Banco Safra considers 10 years as the explicit forecasted period while the valuation suggested in this dissertation assumes 5 years. According to Banco Safra's valuation, Arezzo&Co price target should be R$ 35.5 per share, approximately 18.2% above the valuation presented herein. The differences can arise from (i) the assumptions considered to forecast the free cash flow of the firm, and/or (ii) the estimation of the discount rate and perpetuity growth rate. Below each one of the major assumptions considered within both valuations will be explored.

I. FCFF Estimation

Revenue growth: Banco Safra forecasts a CAGR of 13.5% for the top-line in the period from 2014 to 2019, while in the thesis valuation it is estimated a CAGR of 18.4% for net revenues over the same period. Banco Safra considers that there is limited room for the Schutz brand to grow within the Brazilian market as the market share of this brand is reaching its full potential in its segment of operation, Class A consumers. On the other hand, the bank assumes that the Anacapri brand should partially offset Schutz' slower growth rate, however, given the reduced size of the stores and the lower average ticket per shoe it should lead to a small annual increase in total sales. In the dissertation valuation, however, this analysis is very difficult to make as it was assumed an average revenue per store equal to all brands. For this reason, the top-line growth rates can be slightly higher than it should as it is assumed the opening of 25 Anacapri franchise stores in comparison to 15 Schutz stores per year.

Gross and EBITDA margins: the bank estimates gross margins to stay fairly constant throughout its full-blown explicit forecasted period, between 44.2% in 2013E and 44.0% in 2016E. However, according to the management, this assumption is questionable since the company does not expect to open any addition owned-store in the next few years and will

instead invest in the franchise store model, pressuring the company's gross margins down, as assumed in the dissertation. With regard to EBITDA margin, both models are quite aligned reflecting the scale gains with the opening of more stores, increases in the multi-brand channel and the expansion in the e-commerce platform.

CAPEX: Banco Safra expects an average CAPEX between 2014 and 2019 of c. 2.5% of net revenues, split into 1% for company-owned store openings and refurbishing, and 1.5% for IT, logistics and other projects, which is reasonably aligned with the premises of the dissertation.

Net Working Capital: Banco Safra does not assume major changes in working capital needs relative to 2012 as a percentage of net revenues. In the dissertation valuation, it is assumed the 2013 final ratios as the best proxy to estimate each constituent item of the working capital. For these reason, there are some differences in these figures between both valuations.

II. Discount Rate and Perpetuity Growth Estimation

It is possible to state that the discount rate is definitely the most sensitive issue in every DCF valuation and very susceptible to discussion among equity researchers. For this reason, most of the researchers abstain to publish all the required assumptions to arrive at this value. Banco Safra is no exception and thus it only states the final values of 12.2% and 13.3% for the WACC and k_e, respectively. With little information to consider, the only issue possible of questioning is the difference between the k_e and WACC, which leads one to assume that Banco Safra considered a target capital structure for the WACC computation rather than the actual capital structure. However, as it was previously described in the section related to this matter, all major worldwide footwear companies have a similar capital structure to that of Arezzo&Co, i.e., with net debt equal to zero. Even though the WACC considered by Banco Safra appears to be quite close to that considered in the dissertation valuation, its difference produces a great impact in the price target considered. Having said that, applying the discount rate of 12.2% in the dissertation analysis, it would suggest a price target of R$ 33.5, which is slightly more aligned with the one considered by Banco Safra's report on Arezzo&Co. In what concerns the perpetuity growth rate few information has been disclosed, so it is not possible to run a very thorough analysis. The bank considered a perpetuity growth rate of 6.5%, while in the dissertation was assumed the footwear industry estimated growth rate of 6.8% for the next four years.

6. CONCLUSION

Based on a detailed analysis of Arezzo&Co business model, its growth perspectives and comparison between two valuation models, it was possible to arrive at a recommended price target of R$30.0. The DCF valuation model was chosen as the best methodology to value the company as it fully captures the company industry momentum, the management vision for the future of the company and the personal understanding of the analyst performing the valuation. This price suggests a potential upside of 6.1% in relation to the company's current share price of R$28.3, which represents a hold stock recommendation.

Industry momentum. Arezzo&Co is one of the leading companies in the women footwear and accessories industry in Latin America, representing approximately 12% of Brazil's footwear retail market. The country's favorable demographics and the increasing disposable income available to the Brazilian population, backed by an increasing number of women entering the workforce, perceive a good industry momentum for the company. In 2012, the market reached R$40.2 billion and is expected to grow at a CAGR of 6.8% for the next four years.

Multi-brand business. Arezzo&Co business model allows the company to target different clients, from high-end consumers, less sensitive to macro-economic effects, to middle class consumers, the fastest growing consumer class of the Brazilian market. This fact enables the company to both shield from a possible deterioration of the country's macroeconomic conditions, like a high-inflation economic scenario, and benefit from consumption booms like the one felt in Brazil over the past few years.

Asset light business structure. Throughout the next few years, Arezzo&Co will focus on the expansion of its franchised retail chain, which means that this sale channel together with the recently developed e-commerce platform will gradually offset revenues from owned stores and multi-brand retailers. This will enable the company to have a fast and healthy financial expansion with low requirements of capital expenditures. The company's ability to combine different sale channels allows it to maintain interesting EBITDA margins which should continue to grow as the company gains scale. Moreover, approximately 91% of the company's production is outsourced to third parties contributing to the Arezzo&Co high operational leverage. As a result, over the next five years the company is expected to maintain an attractive ROIC of 30.4% on average and a ROE of 26.6%, being this latter considerably below its potential as the company still retains a large net cash position since its IPO.

Different opportunities for growth. Since the company benefits from such a comfortable cash

position, there are additional growth paths besides the one foreseen for the business as it currently is. Part of this cash could be used towards an acquisition of a relevant competitor in the market. This movement could both further expand the company's market share in the Brazilian market as well as enabling the company to enter in a different segment of operation like men's footwear or sports footwear for instance, two growing segments of activity.

To conclude, one should not forget that any process of forecasting a company's future performance is associated with a level of uncertainty and subject to several risk factors that may influence positively or negatively the company's future cash flows and, as a consequence, its target price. Arezzo&Co valuation is heavily dependent on its ability to franchise and efficiently manage its third-party manufacturer's network. Other major risks include the possibility of a deterioration in its competitive positioning and changes in the macroeconomic scenario and industry dynamics.

7. APPENDIX

Appendix A – Brazil's Top Footwear Retailers

Andarella was founded in 1977, and is the first shoe boutique in the state of Rio de Janeiro. Since then, the company expanded its operation to 21 states and the Distrito Federal. In 2001, the company started its franchise system and currently has 69 stores.

Capodarte's first store was opened in 1991 in Jardins, one of the most fashionable neighborhoods in São Paulo. The company belongs to the Paquetá Group and currently has 40 stores in 16 Brazilian states, mixed among franchised and proprietary. Capodarte's 2013 revenue reached R$84 million.

City Shoes was founded in 1996 in Rio de Janeiro, focused on women's fashionable accessories at reasonable prices. In 16 years, the company reached 80 stores and revenues in 2012 of approximately R$66 million. In comparison with 2011, the company presented a 10% growth in revenue and a 20% growth in number of stores.

Corello brand was created by Familia Silvarolli in the 60's. The company owns 15 proprietary stores in São Paulo and Distrito Federal, and operates under the fast-fashion concept. Despite its focus on women's footwear, the company commercializes purses and other women's accessories.

Dumond is Paquetá Group's proprietary women brand, with 31 branded stores, in 15 Brazilian states and 50 countries and was founded in 1992. In addition to its core focus on shoes, the company also sells purses and other women's accessories. Dumond operates a franchise system and posted R$111 million revenue in 2013.

Mr. Cat was founded 30 years ago by Ari Svartsnaider. The company has 118 stores throughout Brazil and is present in all of the country's northeastern states. It recently created two new brands, focused on the younger market: Cat Girl, for women and Cat Ho for men.

Santa Lolla brand was created in 2002. However, the actual store expansion began in 2004 with the opening of the first franchise store. Since then, the company has recorded strong growth and currently accounts for 105 stores widely spread throughout Brazil. In 2011 the company registered c. R$150 million in revenue.

Shoestock opened its first store in September 1986. The initial concept was to select shoes from large producers and specific ateliers, purchasing and selling at lower-than-average prices. After the model proved successful, the company started to design and order the production of its own shoes.

Via Uno was founded in 1991 in Novo Hamburgo, Rio Grande do Sul. The company is one of the largest footwear industries in Brazil and operates through c. 100 stores, 30 owned stores, 370 franchise stores in Brazil and abroad. Via Uno recorded approximately R$120 million revenues in 2012, and entered in the Brazilian equivalent to Chapter 11 in 2013.

Income Statement	2010	2011	2012	2013	2014E	2015E	2016E	2017E	2018E
Gross Revenues	**712.9**	**862.6**	**1,108.7**	**1,232.1**	**1,438.4**	**1,714.2**	**2,025.5**	**2,389.7**	**2,826.4**
% yoy		21.0%	28.5%	11.1%	16.7%	19.2%	18.2%	18.0%	18.3%
Deductions	(141.3)	(183.7)	(248.4)	(269.1)	(307.0)	(365.9)	(432.3)	(510.0)	(603.3)
Sales Returns and Discounts	(19.5)	(27.3)	(38.0)	(50.1)	(48.2)	(57.4)	(67.8)	(80.0)	(94.7)
Sales Taxes	(121.8)	(156.4)	(210.4)	(219.0)	(258.8)	(308.5)	(364.5)	(430.0)	(508.6)
Net Revenues	**571.5**	**678.9**	**860.3**	**963.0**	**1,131.4**	**1,348.3**	**1,593.2**	**1,879.6**	**2,223.2**
% yoy		18.8%	26.7%	11.9%	17.5%	19.2%	18.2%	18.0%	18.3%
Cost of Goods Sold	(339.9)	(397.5)	(484.5)	(537.2)	(640.0)	(766.0)	(909.7)	(1,076.5)	(1,274.1)
Gross Profit	**231.6**	**281.4**	**375.8**	**425.7**	**491.4**	**582.3**	**683.5**	**803.2**	**949.1**
% Gross margin	40.5%	41.5%	43.7%	44.2%	43.4%	43.2%	42.9%	42.7%	42.7%
Operational Revenues (Expenses)	(136.2)	(163.7)	(240.0)	(266.3)	(297.3)	(336.4)	(375.6)	(417.1)	(461.3)
Comercial	(95.4)	(119.5)	(174.5)	(198.6)	(217.4)	(243.2)	(267.6)	(292.6)	(317.7)
Administrative & General	(44.2)	(45.9)	(60.8)	(68.7)	(81.1)	(94.7)	(109.7)	(126.5)	(146.0)
Other Operational Revenues (Expenses)	3.5	1.7	(4.7)	1.0	1.2	1.4	1.7	2.0	2.3
EBITDA	**95.5**	**117.7**	**135.8**	**159.5**	**194.1**	**245.9**	**307.9**	**386.0**	**487.8**
% EBITDA margin	16.7%	17.3%	15.8%	16.6%	17.2%	18.2%	19.3%	20.5%	21.9%
Depreciation and Amortization	(2.7)	(4.1)	(7.6)	(11.0)	(10.4)	(14.2)	(18.3)	(22.7)	(27.3)
EBIT	**92.8**	**113.7**	**128.2**	**148.5**	**183.7**	**231.7**	**289.6**	**363.3**	**460.5**
% EBIT margin	16.2%	16.7%	14.9%	15.4%	16.2%	17.2%	18.2%	19.3%	20.7%
Financial Revenues (Exepenses)	(3.5)	11.8	5.3	7.6	11.1	12.6	6.4	6.5	10.3
Financial Revenues	4.4	20.7	18.2	20.5	20.3	21.8	17.1	19.0	25.1
Financial Expenses	(8.1)	(9.2)	(12.3)	(12.4)	(9.1)	(9.1)	(10.6)	(12.4)	(14.7)
Exchange Rate Variations	0.2	0.2	(0.5)	(0.5)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
EBT	**89.3**	**125.5**	**133.5**	**156.1**	**194.8**	**244.3**	**296.0**	**369.8**	**470.8**
Income Tax	(24.8)	(33.8)	(36.6)	(45.6)	(54.2)	(68.0)	(82.4)	(102.9)	(131.0)
Net Income	**64.5**	**91.6**	**96.9**	**110.6**	**140.6**	**176.3**	**213.6**	**266.9**	**339.8**
% Net Margin	11.3%	13.5%	11.3%	11.5%	12.4%	13.1%	13.4%	14.2%	15.3%

Appendix C – Arezzo&Co Balance Sheet

Balance Sheet	2010	2011	2012	2013	2014E	2015E	2016E	2017E	2018E
Current Assets	**209**	**432**	**514**	**553**	**611**	**679**	**805**	**979**	**1,211**
Cash and cash equivelents	8.0	15.5	11.5	13.8	179	165	200	264	369
Short-term investments	5.0	158.0	190.6	171.9	-	-	-	-	-
Trade Accounts receivables	132.4	179.6	208.8	247.5	291	347	408	483	571
Inventories	48.9	57.4	76.1	85.1	101	121	144	171	202
Taxes recoverable	7.9	10.2	14.3	19.2	21	24	27	30	33
Other receivables	6.9	11.7	12.2	15.6	18	22	26	30	36
Non-Current Assets	**59**	**78**	**123**	**151**	**185**	**213**	**235**	**250**	**258**
Long-term receivables	22.9	16.8	14.1	15.1	15.1	15.1	15.1	15.1	15.1
Deferred income and social contribution taxes	14.4	10.0	6.3	5.5	5.5	5.5	5.5	5.5	5.5
Other Long-term receivables	8.5	6.8	7.9	9.6	9.6	9.6	9.6	9.6	9.6
Property, plant and equipment	21.4	30.3	61.1	68.5	103.0	131.1	152.5	167.4	175.9
Intangible assets	14.8	31.1	47.8	67.1	67.1	67.1	67.1	67.1	67.1
Total Assets	**268**	**511**	**637**	**704**	**796**	**892**	**1,040**	**1,228**	**1,470**
Current Liabilities	**94**	**102**	**127**	**144**	**150**	**140**	**162**	**190**	**224**
Loans and financing	27	21	43	60	54	63	74	87	105
Trade accounts payable	28.7	37.3	35.5	34.9	42	50	59	70	83
Tax and social liabilities	9.5	14.4	19.4	18.2	20	23	26	28	31
Labor liabilities	13.8	12.2	15.4	13.6	15	(17)	(19)	(21)	(24)
Dividends and interest on equity payable	12.0	14.3	8.9	7.6	7.6	7.6	7.6	7.6	7.6
Other liabilities	2.5	3.2	5.3	9.8	11.5	13.5	15.8	18.3	21.3
Non-Current Liabilities	**28**	**24**	**55**	**45**	**52**	**59**	**68**	**79**	**94**
Loans and financing	19	18	51	39	45	52	61	72	87
Related parties	2.1	0.9	1.0	0.9	0.9	0.9	0.9	0.9	0.9
Provisions for labor, tax and civil contingencies	4.6	4.3	3.0	4.8	4.8	4.8	4.8	4.8	4.8
Tax installments	0.4	0.2	-	-	-	-	-	-	-
Advances from third parties	0.4	0.1	-	-	-	-	-	-	-
Provision for investment losses	-	-	-	-	-	-	-	-	-
Other liabilities	1.2	1.1	0.0	1.2	1.2	1.2	1.2	1.2	1.2
Equity	**146.22**	**384.05**	**453.90**	**514.54**	**594.2**	**693.1**	**809.6**	**958.8**	**1,151.6**
Capital	92	279	280	285	285.5	285.5	285.5	285.5	285.5
Accumulated Net Income (Income Reserves)	38	105	153	208	287.8	386.7	503.2	652.5	845.2
Net Income	65	92	97	111	141	176	214	267	340
Dividends Paid	44	36	33	53	60.9	77.4	97.1	117.6	147.0
Payout Ratio (%)		57%	36%	55%	55%	55%	55%	55%	55%
Proposed additional dividends	16	-	20	21	20.9	20.9	20.9	20.9	20.9
Total Liabilities + Equity	**268**	**511**	**637**	**704**	**796**	**892**	**1,040**	**1,228**	**1,470**

2.3 CapEx - New Stores		2010	2011	2012	2013	2014E	2015E	2016E	2017E	2018E
CapEx - New Stores & Refurbishment		**8.0**	**23.4**	**37.3**	**15.8**	**18.8**	**21.0**	**22.4**	**23.7**	**24.5**
% Gross Revenues Own Stores		7.3%	15.3%	15.2%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%
						1.7%	1.6%	1.4%	1.3%	1.1%
CapEx in 2014	**9.5%**					**18.8**				
Depreciation (Period)						0.9	1.8	1.8	1.8	1.8
Accumulated Depreciation						0.9	2.7	4.5	6.2	8.0
CapEx in 2015	**9.5%**						**21.0**			
Depreciation (Period)							1.0	2.0	2.0	2.0
Accumulated Depreciation							1.0	3.0	5.0	7.0
CapEx in 2016	**9.5%**							**22.4**		
Depreciation (Period)								1.1	2.1	2.1
Accumulated Depreciation								1.1	3.2	5.3
CapEx in 2017	**9.5%**								**23.7**	
Depreciation (Period)									1.1	2.2
Accumulated Depreciation									1.1	3.4
CapEx in 2018	**9.5%**									**24.5**
Depreciation (Period)										1.2
Accumulated Depreciation										1.2
Gross Accumulated CapEx						**18.8**	**39.8**	**62.2**	**85.9**	**110.4**
Depreciation						**0.9**	**2.8**	**4.8**	**7.0**	**9.3**
Accumulated Depreciation						**0.9**	**3.7**	**8.5**	**15.5**	**24.9**

2.3 CapEx - Other		2010	2011	2012	2013	2014E	2015E	2016E	2017E	2018E
CapEx - Other		**7.5**	**6.9**	**20.1**	**28.0**	**26.1**	**21.3**	**17.2**	**13.9**	**11.3**
% Gross Revenues		1.1%	0.8%	1.8%	2.3%	1.8%	1.2%	0.9%	0.6%	0.4%
Corporate (IT, offices, etc)		**5.8**	**6.1**	**18.4**	**25.2**	2.3%	1.6%	1.1%	0.7%	0.5%
Other		**1.7**	**0.8**	**1.7**	**2.7**	1.2%				
CapEx in 2014	**9.6%**					**26.1**				
Depreciation (Period)						0.9	1.8	1.8	1.8	1.8
Accumulated Depreciation						0.9	2.7	4.5	6.3	8.1
CapEx in 2015	**9.6%**						**21.3**			
Depreciation (Period)							1.0	2.0	2.0	2.0
Accumulated Depreciation							1.0	3.0	5.0	7.0
CapEx in 2016	**9.6%**							**17.2**		
Depreciation (Period)								1.1	2.1	2.1
Accumulated Depreciation								1.1	3.2	5.4
CapEx in 2017	**9.6%**								**13.9**	
Depreciation (Period)									1.1	2.3
Accumulated Depreciation									1.1	3.4
CapEx in 2018	**9.6%**									**11.3**
Depreciation (Period)										1.2
Accumulated Depreciation										1.2
Gross Accumulated CapEx						**26.1**	**47.4**	**64.6**	**78.6**	**89.9**
Depreciation						**0.9**	**2.8**	**4.9**	**7.1**	**9.4**
Accumulated Depreciation						**0.9**	**3.7**	**8.6**	**15.7**	**25.0**

Appendix E – Banco Safra's Main Assumptions

	2012A	2013E	2014E	2015E	2016E	2017E	2018E	2019E
Net Revenue	860	988	1,123	1,290	1,470	1,666	1,862	2,058
Growth (%)	26.7%	*14.8%*	*13.6%*	*14.9%*	*14.0%*	*13.3%*	*11.8%*	*10.5%*
Gross Profit	376	436	493	567	647	734	819	904
Margin (%)	43.7%	44.2%	43.9%	43.9%	44.0%	44.0%	44.0%	43.9%
EBITDA	144	166	190	228	273	322	366	411
Margin (%)	16.7%	*16.8%*	*17.0%*	*17.7%*	*18.5%*	*19.3%*	*19.7%*	*20.0%*
D&A	-8	-11	-13	-16	-18	-20	-21	-23
EBIT	128	155	177	212	255	302	345	388
Financial Result	5	5	5	4	4	4	6	8
EBT	134	160	182	216	259	306	351	396
Income tax	-37	-47	-53	-62	-73	-86	-96	-108
Tax rate	*-27.4%*	*-29.1%*	*-28.9%*	*-28.6%*	*-28.4%*	*-28.0%*	*-27.5%*	*-27.2%*
Net Income	97	113	130	154	186	220	254	288
Margin (%)	*11.3%*	*11.5%*	*11.5%*	*12.0%*	*12.6%*	*13.2%*	*13.7%*	*14.0%*
# of shares (million)	89	89	89	89	89	89	89	89
EPS (R$)	1.09	1.28	1.46	1.74	2.09	2.49	2.87	3.25

Source: Arezzo&Co and J.Safra

DCF (R$ million)	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Net income	130	154	186	220	254	288	316	345	375	404	433
Net Margin	11.5%	12.0%	12.6%	13.2%	13.7%	14.0%	14.0%	14.0%	14.0%	14.0%	14.0%
Depreciation/ Amortization	13	16	18	20	21	23	25	28	30	32	35
% of Net Revenues	1.2%	1.2%	1.2%	1.2%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%
Capex	-40	-33	-36	-38	-40	-40	-44	-48	-53	-57	-61
% of Net Revenues	-3.6%	-2.6%	-2.4%	-2.3%	-2.1%	-2.0%	-2.0%	-2.0%	-2.0%	-2.0%	-2.0%
Working Capital	321	369	421	477	533	589	647	707	767	827	886
% of Net Revenues	28.6%	28.6%	28.6%	28.6%	28.6%	28.6%	28.6%	28.6%	28.6%	28.6%	28.6%
Change in Net Working Capital	-39	-48	-52	-56	-56	-56	-58	-59	-60	-60	-59
Free Cash Flow	**64**	**89**	**116**	**146**	**180**	**215**	**239**	**265**	**292**	**320**	**348**
% of Net Revenues	5.7%	6.9%	7.9%	8.8%	9.6%	10.4%	10.6%	10.7%	10.9%	11.1%	11.2%
YoY	34.9%	38.9%	30.1%	25.8%	23.0%	19.4%	11.6%	10.8%	10.1%	9.5%	8.8%
Debt Issuance / Amortization	14	17	20	24	16	19	21	22	24	26	28
FCFE	**78**	**106**	**136**	**170**	**196**	**234**	**260**	**288**	**317**	**346**	**376**
YoY	25.0%	35.8%	28.1%	24.9%	15.0%	19.3%	11.3%	10.7%	10.0%	9.3%	8.7%
Reversion of Net Financial Results	-5	-4	-4	-4	-6	-8	-8	-9	-10	-11	-11
Reversion of Debt/Amortization	-14	-17	-20	-24	-16	-19	-21	-22	-24	-26	-28
FCFF	**59**	**85**	**112**	**142**	**174**	**207**	**231**	**256**	**282**	**309**	**336**
YoY	39.0%	43.6%	31.7%	27.5%	21.9%	19.1%	11.7%	10.9%	10.2%	9.5%	8.8%

Source: J.Safra

Valuation Summary (R$mn)	
WACC	**12.2%**
Terminal Value Growth Rate	6.5%
PV Cash Flow	1,048
PV Perpetuity	1,996
Fair EV (R$)	**3,044**
Net Debt 14	-106
Minority Interest 14	0
Fair Equity Value	**3,150**
Market cap	2,659
Shares	88.64

Target Price - (R$)	35.50
Current Price (R$)	30.00
Upside	18.3%
Rating	**Neutral**

Appendix F – Other Equity Research Recommendations

Bank	Tg Price	Date
Goldman Sachs	32.1	28/05/2014
HSBC	35.0	16/05/2014
Deutsche Bank	29.0	06/05/2014
Itaú BBA	32.5	29/04/2014
Credit Suisse	34.0	29/04/2014
Banco BTG Pactual SA	35.0	29/04/2014
Nau Securities Ltd	29.0	15/04/2014
Banco J. Safra	35.5	09/12/2013
Average	**32.8**	

Source: Bloomberg

Appendix G – Executive Summary

Investment Thesis

Arezzo&Co is a Brazilian company, among the leaders in the women footwear retail market in Latin America. It designs and develops affordable luxury shoes and accessories under the brand names Arezzo, Schutz, Anacapri and Alexandre Birman.

The company operates a very flexible business model, in which all shoes and accessories are designed internally, but its production can be either handled internally or outsourced to third-party manufacturers. Similarly, its sales strategy is based on a combination of owned, franchised and multi-brand stores, as well as a recently developed e-commerce platform. This flexible business model allows the company to determine the most profitable combination of the above factors, without losing control over its brands, product design and quality, while generating high returns on invested capital.

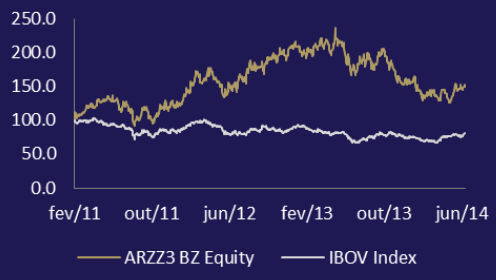
Arezzo&Co benefits from Brazil's dynamic consumption market, in which branded products assume a greater importance as Brazilians move up the income ladder. Despite the recent economic slowdown, the prospects for the domestic retail sector remain strong. The long-run economic expansion will be sustained by the large middle class and from the country's favorable demographics as working-age adults represent nearly two thirds of the population. Additionally, in the past few years, the country has been witnessing an increasing participation of women in the workforce, a segment responsible for approximately 40% of total footwear consumption. This economic empowerment and financial independence among Brazilian women has been a key driver for women's footwear and apparel industry growth.

CATÓLICA LISBON
SCHOOL OF BUSINESS & ECONOMICS
UNIVERSIDADE CATÓLICA PORTUGUESA

Arezzo&Co	
HOLD	**6.1% upside**
TARGET PRICE	R$ 30.0
Bloomberg Ticker	ARZZ3
Share Price	R$ 28.3
Market Cap	R$ 2,508M

Share price as of June, 2014
Source: Bloomberg

STOCK PERFORMANCE



Source: Bloomberg

ANALYST

Inês de Carvalho Freire
152210008

Valuation

Based on a 5-year DCF valuation, it is set a price target of R$ 30.0 per share for Arezzo&Co. At current values, this price target implies a 6.1% upside, trading at 18.9x P/E_{14E} and 2.3x $EV/Sales_{14E}$. This DCF valuation assumes a WACC of 12.8% in nominal reais, beta of 0.8 and 6.8% perpetuity growth rate in nominal terms.

Risks

Arezzo&Co valuation is heavily dependent on its ability to franchise and efficiently manage its third-party manufacturer's network. Other risks include the deterioration in its competitive positioning, changes in macroeconomic scenario and market dynamics.

DCF Valuation		2014E	2015E	2016E	2017E	2018E
Periods		**0.5**	**1.5**	**2.5**	**3.5**	**4.5**
EBIT		184	232	290	363	460
(-) Income Taxes	**27.8%**	(51)	(64)	(81)	(101)	(128)
(+) Depreciation&Amotization		10	14	18	23	27
Operational Cash Flow		**143**	**181**	**227**	**285**	**360**
(+/-) Δ Working Capital		(53)	(101)	(79)	(95)	(112)
(-) Capex		(45)	(42)	(40)	(38)	(36)
Free Cash Flow to Firm		**46**	**38**	**109**	**152**	**212**
WACC (median)	**12.8%**					
Discount Factor		0.94	0.83	0.74	0.66	0.58
Discounted Free Cash Flow to Firm		**42.9**	**31.4**	**80.5**	**99.9**	**123.3**

Enterprise Value		**% EV**	**2,575**
Explicit Period		15%	378
Perpetuity		85%	2,197
g	**6.8%**		
(+) Cash & Cash Equivalents (2013)			186
(-) Financial Debt (2013)			-98
Equity Value			**2,663**
Target Share Price	**88.637**		**R$ 30.0**
Current Price (as of 13/jun)			**R$ 28.3**
Upside Potential			**6.1%**

Estimates

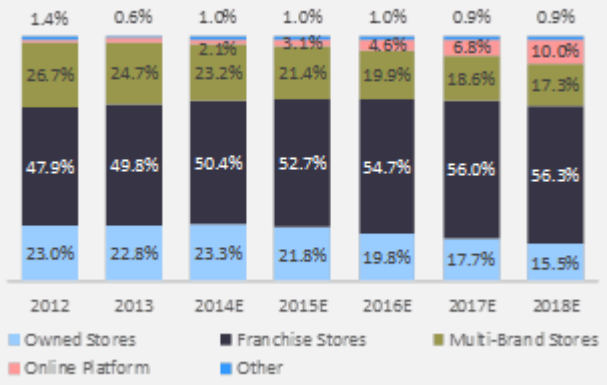
Top-Line Growth: Over the last couple of years, the company has been mostly concentrated in developing and consolidating its most recent brands, namely Schutz and Anacapri, within the domestic market, since its flagship brand, Arezzo, already has a strong penetration among all the company's distribution channels. For this purpose, the company focused on opening mono-brand stores, i.e., owned and franchise stores of each brand. However, from 2014 onwards, this trend is expected to slightly change and no owned stores will be opened in the upcoming five years. The company will focus on the expansion of its franchised retail chain, which means that, throughout the next few years, sales from owned and multi-brand store formats will be gradually offset by the evolution of the franchise business model.

Alexandre Birman does not have a material impact on revenues and it can be seen simply as a way to demonstrate the company's ability to design and manufacture high fashion and luxury shoes with no defined strategy for this brand for the near future.

According to management, the company will remain focused on domestic market consolidation and since, on average, the international market has been representing approximately 5% of total sales, this ratio will be kept constant for the next five years.

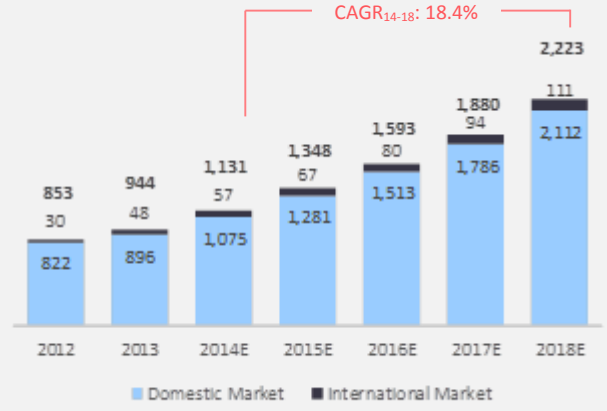
With the growing broad brand penetration in Brazil and the changing consumer habits, the online sale channel is expected to become more meaningful over the upcoming years, reaching 10% of total sales in 2018.

Domestic Gross Revenues Evolution



Source: Arezzo&Co, Estimates

Consolidated Net Revenues (R$ million)



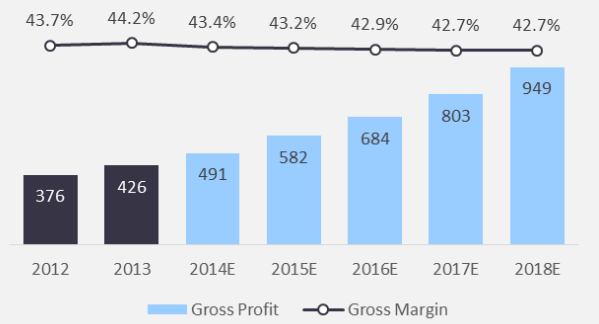
Source: Arezzo&Co, Estimates

Gross and EBITDA Margins: As Arezzo&Co operates with fixed mark-ups on franchise and multi-brand sale channels there is a strong predictability on the company's gross margins. According to the management, gross margins are 42% and 38%, respectively for franchise and multi-brand business lines. The gross margin of the owned-stores channel is more volatile and it is considered to be 62.5% the average between 60% and 65% in line with management expectations. Also according to the management of the company, it is considered a gross margin of 20% for the international market and 55% for the e-commerce sale channel, since the company sells its entire online portfolio at a discount. It is perceived a slightly reduction on the company's gross margins as it expands its franchise network of stores.

One the other hand, the franchise network expansion benefits the EBITDA margin as the company's gains scale and is able to reduce R&D expenses, as well as other product manufacturing and commercial expenses, as percentage of net revenues. As a result the EBITDA margin of Arezzo&Co is assumed to increase from the current 16.6% to 21.9% in the next five years.

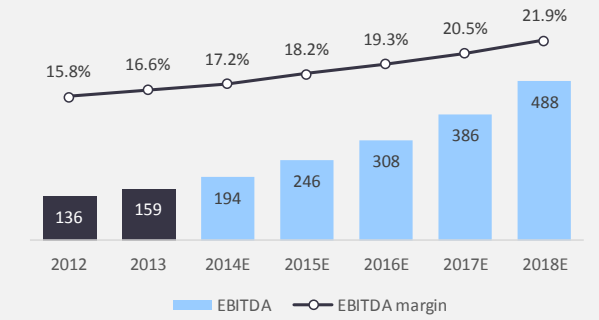
CAPEX, Working Capital and Debt Levels: According to management, there is no anticipation of future changes in the current capital expenditure policy of the company. Therefore, it is assumed that Arezzo&Co will keep investing approximately 5.9% of owned stores gross revenues, the 2013 percentage, in the expansion and refurbishment of its existing stores. For the other required investments, it will be assumed that the company will invest a percentage of the consolidated gross revenues, which will linearly decrease to

Gross Profit (R$ million) and Gross Margin (%)



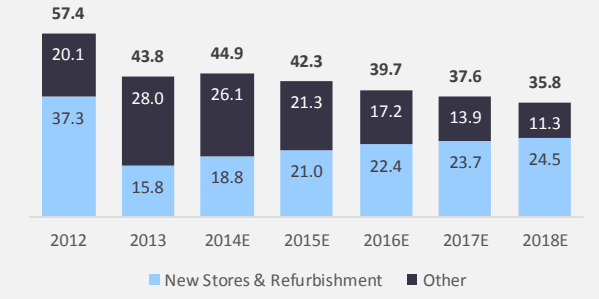
Source: Arezzo&Co, Estimates

EBITDA (R$ million) and EBITDA Margin (%)



Source: Arezzo&Co, Estimates

CAPEX (R$ million)



Source: Arezzo&Co, Estimates

approximately 0.4% total gross revenues, since there are no major investment plans for the upcoming years.

Regarding the working capital needs, it is assumed that the company will maintain the 2013 final ratios to estimate each constituent item of the working capital.

Finally, it is assumed that the company will maintain its net debt (cash) police between -1.0x and 0.0x EBITDA.

Operating Data	2012	2013	2014E	2015E	2016E	2017E	2018E
Number of Stores							
Owned	56	54	54	54	54	54	54
Franchised	334	395	455	515	575	635	695
Multi-brand	2,351	2,451	2,533	2,626	2,733	2,850	2,971
SSS Sell-In	12.2%	2.0%	10.8%	11.1%	11.3%	10.7%	10.2%
SSS Sell-Out	6.3%	1.1%	15.2%	11.6%	7.1%	5.5%	3.6%

Income Statement (R$ million)	2012	2013	2014E	2015E	2016E	2017E	2018E
Net Revenues	**860**	**963**	**1,131**	**1,348**	**1,593**	**1,880**	**2,223**
yoy (%)	26.7%	11.9%	17.5%	19.2%	18.2%	18.0%	18.3%
Gross Profit	**376**	**426**	**491**	**582**	**684**	**803**	**949**
Gross Margin)%)	44.2%	43.4%	43.2%	42.9%	42.7%	42.7%	0.0%
EBITDA	136	159	194	246	308	386	488
EBITDA Margin (%)	15.8%	16.6%	17.2%	18.2%	19.3%	20.5%	21.9%
Net Income	**97**	**111**	**141**	**176**	**214**	**267**	**340**
Net Margin (%)	11.3%	11.5%	12.4%	13.1%	13.4%	14.2%	15.3%
Net Debt	**(108)**	**(87)**	**(80)**	**(49)**	**(66)**	**(105)**	**(177)**
Net Debt / EBITDA	-0.8x	-0.5x	-0.4x	-0.2x	-0.2x	-0.3x	-0.4x
ROIC	**29.9%**	**26.1%**	**27.0%**	**27.8%**	**29.5%**	**32.2%**	**35.7%**

Balance Sheet (R$ million)	2012	2013	2014E	2015E	2016E	2017E	2018E
Current Assets	**209.1**	**432.4**	**513.6**	**553.1**	**610.8**	**678.6**	**805.2**
Cash & Short Term Invest.	13.0	173.6	202.2	185.7	178.8	164.6	200.3
Inventories	48.9	57.4	76.1	85.1	101.4	121.4	143.7
Accounts Receivables	132.4	179.6	208.8	247.5	290.8	346.5	408.4
Other	14.8	21.9	26.5	34.8	39.8	46.1	52.8
Non-Current Assets	**59.1**	**78.3**	**123.0**	**150.8**	**185.2**	**213.3**	**234.7**
Other	22.9	16.8	14.1	15.1	15.1	15.1	15.1
Net PP&E	21.4	30.3	61.1	68.5	103.0	131.1	152.5
Intangible Assets	14.8	31.1	47.8	67.1	67.1	67.1	67.1
Total Assets	**268.2**	**510.6**	**636.6**	**703.9**	**796.0**	**891.9**	**1,039.9**
Current Liabilities	**93.8**	**102.3**	**127.4**	**143.9**	**150.1**	**139.7**	**162.4**
Loans & Financing	27.4	20.9	42.8	59.8	54.1	63.1	73.7
Other	66.4	81.4	84.6	84.0	96.0	76.6	88.7
Non-Current Liabilities	**28.2**	**24.3**	**55.3**	**45.5**	**51.7**	**59.1**	**67.9**
Loans & Financing	19.4	17.8	51.2	38.6	44.8	52.2	61.0
Other	8.8	6.5	4.0	6.9	6.9	6.9	6.9
Shareholder's Equity	**146.2**	**384.0**	**453.9**	**514.5**	**594.2**	**693.1**	**809.6**
Total Equity + Liabilities	**268.2**	**510.6**	**636.6**	**703.9**	**796.0**	**891.9**	**1,039.9**

Source: Arezzo&Co, Estimates

8. BIBLIOGRAPHY

I. Academic Literature

Alpalhão, R. and Alves, P., 2005. The Portuguese Equity Risk Premium: what we know and what we don't know, Applied Financial Economics, 14, pp. 489-498.

Annin, M., Falaschetti, D., 1998. Equity Risk Premium Article, Valuation Strategies, Ibbotson Associates.

Andrade, G., 1999. Do appearances matter? The Impact of EPS Accretion and Dilution on Stock Prices, Harvard Business School Working Paper.

Banco Central do Brasil, 2013. Risco-País, Diretoria de Politica Econômica, Departamento de Relacionamento com Investidores e Estudos Especiais.

Booth, L., 1999, Estimating the Equity Risk Premium and Equity Costs: New Way of Looking at Old Data, Journal of Applied Corporate Finance, 12(1), pp. 100-112.

Brealey, R., Myers, S., and Allen, F., 2008. Principles of Corporate Finance, 9nd ed., McGraw Hill International Edition.

Bruner, R.F., K.M. Eades, R.S. Harris and R.C. Higgins, 1998, Best Practices in Estimating the Cost of Capital: Survey and Synthesis, Financial Practice and Education, 14-28.

Chen, N. F., Roll, R., Ross, S., 1986. Economic Forces and the Stock Market, Journal of Business, 59(3).

Copeland, T., Koller, T., Murrin, J., 2000. Valuation: Measuring and Managing the Value of Companies, 3rd ed., John Wiley & Sons.

Costa, L. G., Costa, L. R., Alvim, Marcelo, 2011. Valuation: Manual de Avaliação e Reestruturação Econômica de Empresas, 2nd ed. Atltas.

Damodaran, A.,2002. Investment Valuation: Tools and Techniques for Determining the value of Any Asset, 2nd ed., John Wiley & Sons.

Damodaran, A., 2003. Measuring Company Exposure to Country Risk: Theory and Practice, Stern School of Business.

Damodaran, A., 2008. What is the risk free rate? A Search for the Basic Building Block, Stern School of Business.

Damodaran, A., 2010. Equity Risk Premiums (ERP): Determinants, Estimation and Implications – The 2010 Edition, Stern School of Business.

Damodaran, A., 2012. Relative Valuation and Private Company Valuation, Lecture Note Pack 2.

Fama, E. and French, K., 1993. Common Risk Factors in the Returns on Stocks and Bonds, Journal of Financial Economics, 33(1), pp 3–56.

Fama, E., and French, K., 1996. The CAPM is Wanted: Dead or Alive, The Journal of Finance, 51, pp. 1947-1957.

Fernández, P., Carabias, J. M., 2006. 96 Common Errors in Company Valuations, IESE Business School.

Goedhart, M. and Haden, P., 2003. Emerging markets aren't as risky as you think, The McKinsey Quarterly, 2003 Special Edition: Global directions.

Goedhart, M., Koller, T. and Wessels, D., 2005. The right role for multiples in valuation, The McKinsey Quarterly, Web exclusive, March 2005.

Goetzmann, W. and Ibbotson, R., 2005. History and Equity Risk Premium, Yale School of Management.

Hitchner, J., 2003. Financial Valuation: Applications and Models, John Wiley & Sons.

James, M. and Koller, T., 2000. Valuation in Emerging Markets, The McKinsey Quarterly, 2000 Special Edition: Asia revalued.

Kaplan, S. and Ruback, R., 1996. The Market Pricing of Cash Flow forecasts: Discounted Cash Flow VS. The Method of Comparables, Journal of Applied Corporate Finance, 8(4), pp 45-60.

Korteweg, A., 2007. The Costs of Financial Distress Across Industries, Working Paper.

Lettau, M., Ludvigson, S. and Wachter, J., 2008. The Declining Equity Risk Premium: What role does macroeconomic risk play? Review of Financial Studies.

Liu, J., Nissim, D. and Thomas, J., 2000. Equity valuation using multiples, Journal of Accounting Research, 40(1).

Luehrman, T. A., 1997a. What's It Worth? A General Manager's Guide to Valuation, Harvard Business Review, May-June 1997, pp. 132-142.

Luehrman, T. A., 1997b. Using APV: a Better Tool for Valuing Operations, Harvard Business Review, May-June 1997, pp. 145-154.

Markowitz, H., 1952. Portfolio Selection, The Journal of Finance, 7(1), pp. 77-91.

Mehra, R. and Prescott, E., 1985. The Equity Premium Puzzle, Journal of Monetary Economics, 34(4).

Miles, J.A., and J.R. Ezzell, 1985, Reformulating Tax Shield Valuation: A Note, Journal of Finance, 40(5), pp. 1485-1492.

Milicevic, B., 2009. The Standard Multiples Valuation Method and Its Criticism, Faculty of Organizational Sciences Belgrade

Modigliani, F., and M. Miller, 1963, Corporate Income Taxes and the Cost of Capital: a Correction, American Economic Review, 53, pp. 433-443.

Myers, S., 1974, Interactions of Corporate Financing and Investment Decisions – Implications for Capital Budgeting, Journal of Finance 29, pp.1-25.

Ross, S., 1976. The arbitrage theory of capital asset pricing, Journal of Economic Theory, 13(3), pp 341–360.

Ross, S., Westerfield, R., and Jaffe, J., 2005. Corporate Finance, 7th ed, McGraw-Hill/Irwin.

Sharpe, W., 1964. Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk, Journal of Finance, 19(3).

Suozzo, P., Cooper, S., Sutherland, G. and Deng, Z., 2001. Valuation Multiples: A Primer, UBS Warburg.

Young, M., Sullivan, P., Nokhasteh, A. and Holt, W., 1999. All Roads Lead to Rome – An Integrated Approach to Valuation Models, Goldman Sachs Investment Research.

II. Other Sources

"World Economic Outlook", IMF (April 2014).

"Retail Sector Brazil", Emerging Markets Insight (April 2013).

"Foreign invasion: Why, how and what it means for locals", BTG Pactual (April 2014).

"Brazil Apparel and Footwear Market Outlook 2017", Ken Research (October 2013).

"Brazil Consumer – Still Constructive, But Limited Upside", Credit Suisse (October 2013).

"Footwear Brazil - A Snapshot", Mintel (2013)

"Industrial Capsule: Footwear in Brazil", Euromonitor (January 2014).

"Brazil fits the world", Indústria Brasileira de Calçados Do Brasil (2012).

"World Footwear Yearbook", Portuguese Footwear, Components and Leather Goods Manufacturer's Association (2012).

"Arezzo&Co Company Note – Initiation of Coverage", Banco J. Safra (December 2013).

"Retailer with Attractive Growth and Profitable Model", Bradesco (April 2012).

"I Want these Shoes!", Itaú BBA (April 2011)

LIST OF FIGURES

LIST OF APPENDIX

LIST OF ABBREVIATIONS

ABF – Brazilian Franchising Association
APLAC – Brazilian Footwear Retailers Association
APM – Arbitrage Pricing Model
APV – Adjusted Present Value
BACEN – Brazilian Central Bank
BRIC – Brazil, Russia, India and China
CAGR – Compounded Annual Gross Rate
CAPEX – Capital Expenditure
CAPM – Capital Asset Pricing Model
CEO – Chief Executive Officer
CF – Cash Flow
CSLL – Social Contribution Tax Rate
DCF – Discounted Cash Flow
EBIT – Earnings Before Interest and Tax
EBITDA – Earnings Before Interest,Tax, Depreciation and Amortization
ECF – Equity Discounted Cash Flow
EMBI – Emerging Markets Bond Index
ERP – Equity Risk Premium
EV – Enterprise Value
FCFE – Free Cash Flow to Equity
FCFF – Free Cash Flow to the Firm
FGV – Fundação Getulio Vargas
GDP – Gross Domestic Product
GM – Gross Margin
IBGE – Brazilian Statistics Bureau
IBOPE – Brazilian Institute of Public Opinion and Statistics
IMF – International Monetary Fund
IPO – Initial Public Offer
IR – Income Tax Rate
PoS – Point of Sale
PVBC – Present Value of Bankruptcy Costs
PVTS – Present Value of Tax Shields
ROE – Return on Equity
ROIC – Return on Invested Capital
RS – Rio Grande do Sul
SBBI – Stocks, Bonds, Bills and Inflation
SG&A – Sales General and Administrative Expenses
SKU – Stock Keeping Unit
SSS – Same-Store-Sales
US – United States
WACC – Weighted Average Cost of Capital