

Recommended ESG Portfolio

Sector Note
15 February 2023

10 ESG stock ideas for February

Our ESG Portfolio for February

The ten picks in our February ESG Portfolio are Arezzo, Embraer, Itaú, Localiza, Porto Seguro, Raia Drogasil, Raízen, Sabesp, Santos Brasil, and Weg. Sabesp is the newcomer, replacing Equatorial. We believe SBSP3 is pricing in almost none of the potential upside from privatization, while the new management team could pave the way for significant operating improvements.

We are maintaining exposure to financials through Itau and Porto Seguro. We are increasingly confident that Itaú will continue to outperform its main peers, and its 2023 guidance points to R\$35.5bn in earnings (+15% y/y; 20.6% ROE and 7.3x P/E 23E), according to our estimates. As for Porto Seguro, we expect its results to improve significantly over the next few Qs (especially this year) on the back of the repricing of its auto insurance policies and a strong improvement in its loss ratio. We project that Porto will reach R\$1.8bn bottom line in 2023 (+65% y/y), implying an attractive valuation of 9.6x P/E 23.

In the capital goods & transportation space, we have Embraer, Localiza, Santos Brasil, and Weg. Embraer provides exposure to the rebounding aviation industry and remains an exciting value call. Meanwhile, Localiza should get a boost from the gradual normalization of the automotive industry and relevant synergies from the merger with Unidas. As for Santos Brasil, we expect it to benefit from a positive pricing environment. And finally, Weg continues to have a crisis-proof model given its diversification across various markets and its exposure to compelling global manufacturing trends.

In the retail sector, we have Arezzo and Raia Drogasil. We highlight Arezzo's resilient expansion in local market, onboarded brands and additional M&A and licensing opportunities. As for RD, the superior execution, solid growth plan, and a complete investment roadmap for its digital (and omni) platform secure a 38% bottom line CAGR 2022-24.

Based on FY24 multiples, we think the market is ignoring Raízen's LT growth plans (3-year EBIT CAGR estimated at 20%) and the value the company has consistently generated from operating upstream and downstream segments in an integrated manner.

Table 1: Recommended ESG Portfolio

| Company | Ticker | Weight | ADTV (R\$m) | Upside potential | Mkt cap (R\$m) | P/E 23 |
|---------------|--------|--------|-------------|------------------|----------------|--------|
| Arezzo | ARZZ3 | 10% | 95 | 40.6% | 8,541 | 17.0 |
| Embraer | EMBR3 | 10% | 111 | 53.7% | 11,500 | 20.7 |
| Itaú | ITUB4 | 10% | 935 | 32.7% | 257,363 | 7.4 |
| Localiza | RENT3 | 10% | 411 | 44.0% | 48,326 | 17.4 |
| Porto Seguro | PSSA3 | 10% | 40 | 11.6% | 17,381 | 9.7 |
| Raia Drogasil | RADL3 | 10% | 152 | 30.3% | 38,043 | 29.9 |
| Raízen | RAIZ4 | 10% | 69 | 167.6% | 30,851 | 11.7 |
| Sabesp | SBSP3 | 10% | 186 | 15.6% | 37,237 | 9.0 |
| Santos Brasil | STBP3 | 10% | 34 | 61.5% | 6,949 | 12.2 |
| WEG | WEGE3 | 10% | 258 | 30.4% | 160,883 | 30.1 |

Source: BTG Pactual estimates

Analysts

Carlos Sequeira, CFA

New York – BTG Pactual US Capital LLC
carlos.sequeira@btgpactual.com
+1 646 924 2479

Rafaella Dortas

Brazil – Banco BTG Pactual S.A.
rafaella.dortas@btgpactual.com
+55 11 3383 3470

Renata Faber

Brazil – Banco BTG Pactual S.A.
renata.faber@btgpactual.com
+55 11 3383 2000

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ESG Portfolio Performance

In the last 30 days, our ESG portfolio (+0.0%) outperformed the Ibovespa (-3.0%) and the benchmark (S&P/B3 -2.4%).

Table 2: Performance (last 30 days)

| | Weighted performance |
|------------------|----------------------|
| Arezzo | -0.2% |
| Embraer | 0.4% |
| Equatorial | -0.3% |
| Itau | 0.2% |
| Localiza | 0.4% |
| Porto Seguro | 1.5% |
| Raia Drogasil | -0.5% |
| Raízen | -1.1% |
| Santos Brasil | -0.3% |
| WEG | -0.1% |
| Portfolio | 0.0% |
| Ibov | -3.0% |
| Benchmark | -2.4% |

Source: BTG Pactual

Summary of our February picks

Arezzo

While global consumption (mainly for discretionary items) has been driven by pent-up demand and higher 2020-21 savings in recent months, mainly among higher-income households, with Arezzo a clear outperformer in our coverage, with apparel segment as a key driver), exploring its superior execution in brand management and the successful operation of its asset-light franchise and multi-brand model, as well as license agreements and its house-of-brands ecosystem, which includes additional opportunities with Reserva. ARZZ3 is up 2% YTD (trading at 20x P/E 2023) and remains one of our main calls, reflecting: (i) resilient expansion in local market, boosted by ecommerce and multichannel growth in the coming years, and by a faster (resilient) rebound in consumption among higher-income classes; (ii) onboarded brands like Vans and Reserva, with additional M&A and licensing opportunities; and (iii) healthier results in the US operation thanks to wholesale and ecommerce channels and price repositioning since 2020.

ESG. Arezzo's sustainability strategy is based on 3 very clear pillars: i) responsible production: generating value for society by developing a responsible and safe production chain; ii) healthy environment: developing products considering their full life cycles; iii) empowering people: ensuring an inclusive, safe and prosperous environment for all. Public commitments include: 100% of the supply chain tracked and certified (pillar 1), 100% of packaging produced with recycled and/or biodegradable materials (pillar 2), and 100% of suppliers/employees trained annually on relevant topics (pillar 3). In terms of digital innovation, we applaud the creation of its New Technologies Development Center to support the development of solutions connected to its business.

Embraer

After a soft operating performance in Q3, Embraer reaffirmed its FY22 guidance, implying solid deliveries in Q4, reflecting the rebounding commercial aviation and strong momentum for the executive segment. Most of this improved delivery outlook is driven by the easing of the component shortage, the main reason behind the weak performance in Q3. Besides the better earnings momentum, Embraer provides exposure to the rebounding aviation industry and remains an interesting value call (e.g., eVTOL ramp-up, cybersecurity, defense and Boeing's arbitration). Moreover, we see ERJ trading at an attractive valuation of 7.3x EV/EBITDA23 (vs. international peer avg. of 14x), offering a good entry point.

ESG. Embraer's ESG commitments include reaching carbon neutrality in its operations by 2040 by using 100% energy from renewable sources and gradually increasing the use of Sustainable Aviation Fuel (SAF) on its flights; developing products based on new sustainable technologies, such as electric, hybrid, and hydrogen propulsion; and having 100% of electric energy coming from renewable sources by 2030. Thus, for the 2050 net zero emissions target, the company expects to achieve it mostly by (a) developing disruptive products, services and sustainable technologies (e.g. electrification, hybrid, SAF); (b) working together with suppliers to make its aircraft fly on 100% SAF; and (c) launch of the zero-emission eVTOL aircraft by 2026.

Itau

While momentum for banks isn't positive, Itaú seems to be the incumbent bank that is gearing up best to compete in a tougher environment. Led by its young, new CEO Milton Maluhy, who is heading up a massive digital transformation of the "old bank", we are increasingly confident that Itaú will continue to outperform its main peers. The bank reported decent Q4 results last week with ROE at 19.3%, even though it booked R\$1.3bn in extra provisions (R\$720mn post-tax) related to Americanas (AMER). Its remaining AMER exposure was also addressed by reducing the extra provisions already booked in the balance sheet (now "stamped" as AMER), which should make 2023 #s look cleaner as extra provisions from this event will not be needed. We estimate 2023 guidance implies R\$35.5bn earnings (+15% y/y; 20.6% ROE). Thus, despite rallying ~7.5% since Q4 #s were reported, the bank is still trading at an attractive of 7.3x P/E 23E.

ESG. On the environmental front, Itau is committed to reducing its scope 3 carbon emissions by 50% by 2030 and becoming net zero by 2050. In 2021, the bank launched its climate commitment platform to encourage new partners and suppliers to neutralize carbon emissions, as well as its carbon offset platform to leverage transparency in the voluntary carbon market. On the social front, we believe the material point relates to the relationship with clients, which should ideally be transparent and fair. In this sense, we see the bank working to improve its NPS and educating clients financially. By 2025, Itau plans to have 40-45% women in leadership positions, along with 50% representation in new hires. In terms of governance, the board of directors has an important role in ESG: approving, guiding, and monitoring the sustainability strategy and providing policy based on long-term vision. In 2021, the issues discussed by the BoD included the new ESG governance structure, evolution of the bank's positive impact commitments, and climate strategy.

Localiza

Localiza is a high-quality name and offers an interesting risk-reward ratio today. We foresee relevant synergies from the business combination with Unidas (~R\$9.3bn) and expect the market to gradually price-in these synergies as the company move forward with the integration. On top of this, we expect a gradual normalization of the automotive market, supporting Localiza's fleet renewal process with improved purchase conditions and a supportive pricing environment. Looking longer term, the maturation of new business opportunities, such as car subscription, should also help unlock value on the shares. Localiza's LT fundamentals are also very much intact for the segment, with many product segments having low penetration rates. Trading at 17.4x PE23, (vs. 5y historical average of 30.7x), we see room for re-rating.

ESG. Corporate governance is one of Localiza's strengths. The company has an active and diverse BoD with members from varied backgrounds. On the social front, we highlight strong relationships with clients (measured by NPS) and employees (low turnover and diverse environment). And on the environmental front: (i) waterless car washing across its entire network, reducing water consumption from an average of 30L to 200ml per wash while improving waste and effluent management; (ii) 98% of fleet is flex-fuel, allowing clients to fill up with ethanol (less pollutant than gasoline); and (iii) 16.79% of energy consumption came from renewable sources last year (vs. 14.65% in 2019).

Porto Seguro

As seen in the last couple of Qs, auto insurance loss ratio has been under pressure, as lower vehicle supply drove up car prices, which kept impacting 2022 results. However, we now expect for its results to improve materially in the next few Qs (and especially in 2023), as the repricing of its auto insurance policies starts impacting results and improving loss ratio more significantly. And the company reported better-than-expected Q4 #s last week, while expectations of a stronger reduction on car prices could be an important tailwind (as it has happened in the US market). Thus, we increased our bottom-line projection in 2023 recently to R\$1.8bn (+65% y/y). With low exposure to political risk and regulatory changes, we believe valuation is attractive (at 9.6x P/E 23, even after a ~5% rally post-Q4 results), and a strong earnings momentum expected should be a good combination for the stock to perform well in the following months.

ESG. Porto has always been an example in terms of corporate governance, and, more recently, we see the company working to address environmental and social points. Most of the materials points are on the social front. When we look at relationships with clients and employees, Porto's figures show that it has strong ties with these stakeholders.

Raia Drogasil

RD has evolved from a traditional retailer to a more complete health ecosystem in the next few years, which should be gradually incorporated into its multiples by the market. After recent quarterly results showed positive signs, mainly profitability-wise, we still see RD as one of the main structural calls for exposure to the retail sector. The stock trades at a big premium to Brazilian retailers (30x P/E 2023E vs. 14x for the sector). But superior execution (much higher store productivity than peers), a solid growth plan, and a complete investment roadmap for its digital (and omni) platform, securing a bottom line CAGR 2022-24 of 38%, reinforce our bullish view.

ESG. Raia Drogasil's sustainability strategy is based on making people, its business and the planet healthier. The company established pragmatic goals for 2030: (i) reducing 50% of the health risk factors of employees engaged in its healthy habits promotion program; (ii) having a work environment that is perceived as healthy by at least 80% of its employees; (iii) providing nutritional guidance to 100% of its employees; (iv) achieving gender equity across all employment categories at its head office, stores, and distribution centers; and (iv) having 40% of Raia branded products with eco-efficient packaging.

RADL3 has a sustainability committee led by a board member that is responsible for developing and proposing ESG commitments and actions to the BoD. Considering the high number of customers (42mn), information security and data protection are key factors for the company. Besides having applicable policies/procedures and a dedicated department engaged in this topic, periodic audits are conducted to ensure the implementation of controls. In terms of diversity, Raia boasts a high proportion of women in leadership positions (27.3% of the BoD, 26.3% of executive management – VPs and directors – and 68.5% of operational management – pharmacy managers) and implemented an inclusive recruitment process to ensure that its people are aligned with its position and strategic goals.

Raízen

We're keeping RAIZ to our ESG portfolio. While risks associated with changes in PBR's fuel price policy exist, we also see lower odds of fuel tax exemptions being maintained after March, adding some upside to ethanol prices as it may regain some competitiveness based on higher gasoline prices. A more environmentally conscious agenda from the new government could also help to avoid major interference on fuel prices like it happened in the past. We also expect improving sugarcane yields to improve margins via cost dilution in the upcoming 2023/24 crop-year. With ST earnings' visibility now marginally better, momentum could also improve soon. Based on FY24 multiples, we think the market is ignoring RAIZ's LT growth plans (3-year EBIT CAGR estimated at 20%) and the value the company has consistently generated from operating upstream and downstream segments in an integrated manner.

ESG. We see biofuels - and ethanol in particular - as one of the key components in the transition to a low carbon economy. Raízen's products contribute to reducing emissions and the company's production processes focus on the management of byproducts and the optimization of natural resources. By focusing on advanced biofuels such as cellulosic ethanol, we believe Raízen is poised to occupy a privileged position in global trade. The company also has targets to reduce its own carbon footprint and water use until 2030.

Sabesp

We rank Sabesp as our top pick among state-owned utilities names. Not only is the state government publicly pursuing the privatization agenda, but the stock doesn't seem to be pricing in any upside from such a scenario. We currently see the name trading at an implied EV/RAB 23 of 0.75x, which indeed seems to be pricing in its inefficiencies as an SOE. Sabesp currently underperforms its regulatory EBITDA by around 15-20%, which would justify the name trading closer to ~0.8x EV/RAB. However, we don't think the re-rating will come exclusively from privatization as the company recently announced a new CEO – Andre Salcedo – with a vast experience at BNDES and water utility Iguá and a new team of executives could pave the way for significant operating improvements. Due to the current regulatory framework, we believe a privatized Sabesp could be valued at 1x EV/RAB, implying a share price of R\$80, or 45% upside on current prices. And considering the relevance of Sabesp, we could see the name being sold at a higher premium. But privatization will naturally be a lengthy and challenging process, as the state government will have to negotiate with municipalities and gain approval from the state and municipal legislatures. Governor Freitas aims to conclude the process by 2024.

ESG. Sabesp has been publishing its suitability report for over 15 years. Social initiatives include: taking 15,000 families out of precarious and unhealthy living conditions, cleaning up the New Pinheiros River, and providing subsidized tariffs to more than 868k families in need. Regarding customer service, a material factor in the sector, Sabesp operates 407 branches and offers digital services 24/7. Finally, the company promotes education measures for its customers, helping reduce per capita water consumption in recent years.

Santos Brasil

We remain bullish on the name based on a supportive pricing environment in Santos and attractive valuation levels. Our LT view reflects: (i) better regulatory environment in port industry; (ii) better competitive dynamics at Santos, creating favorable pricing conditions for SBTP; and (iii) solid balance sheet, supported by its net cash position. Santos Brasil's largest contract for its Tecon Santos terminal will expire at the end of March and negotiations for renewal has started, for which we are expecting a 25-30% price hike, which should drive a major EBITDA expansion this year (+30% y/y in our estimate). Trading at 12% real IRR, we see the investment case becoming even more attractive.

ESG. Santos Brasil has interesting initiatives in each of the ESG dimensions. On the environmental front: recycling of 83% of generated waste, establishment of reduction targets for 2024: 50% reduction in waste generation, 30% reduction in water consumption and 15% reduction in GHG emissions. On the social side: 1,000 days without lost time injuries (LTI) and the development of a fatigue sensor pilot project for truck drivers. On the governance front: the board of directors is composed of 40% independent members and 25% women, ESG targets for senior management, sustainability committee to assess ESG actions and suggest improvements, and annual report audited by a third party (uncommon among Brazilian companies: only ~23% of IBOV companies had adopted this practice in 2021).

Weg

Weg's fundamentals remains solid, reflecting its impressive execution during and after the pandemic and reinforcing its crisis-proof business model. In such an uncertain market, we see WEGE3 as a defensive pick (long USD in ROIC terms). Looking long term, Weg is heavily exposed to several compelling global manufacturing trends: (i) electric mobility, with sizable investments by automakers in fleet electrification; (ii) energy efficiency, as higher energy costs increase the need to reduce energy waste; (iii) digitalization and automation; and (iv) renewable energy, as the world migrates to greener energy. Trading at 30x P/E 23, Weg's current valuation implies a small premium to global peers.

ESG. Weg benefits from the trend of investments in clean energy and in more efficient electric motors. These trends mean growth opportunities for the company but, when we think about Weg's ESG practices, we are also comfortable. The company has strong corporate governance practices and focus on innovation and client satisfaction. It also has a low employee turnover and is working to increase diversity.

Appendix 1: Methodology of our ESG recommended portfolio

We are launching our first ESG recommended portfolio. ESG is becoming increasingly important to our clients and the investment community in general, so building an ESG portfolio is another step in increasing our ESG research efforts and is also a way to help investors advance on this agenda.

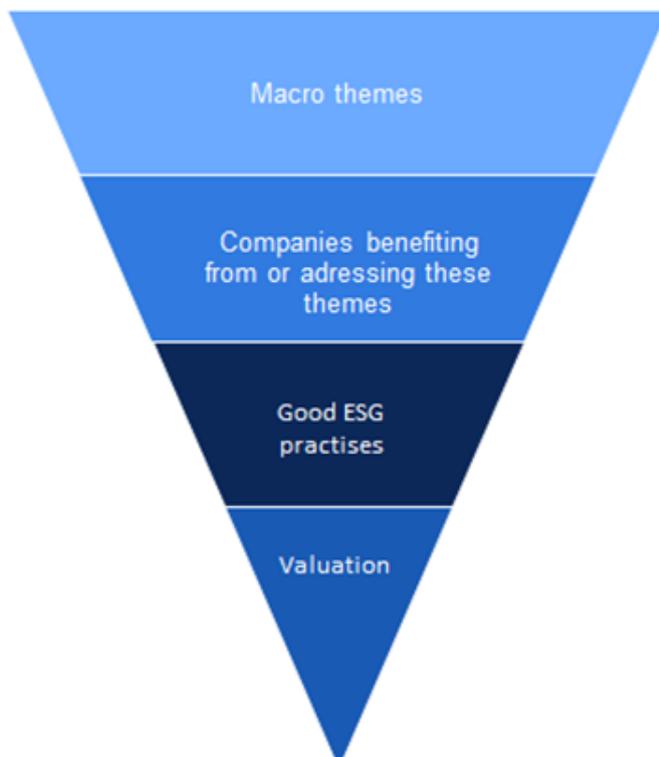
Rationale behind our portfolio. The first step in assembling our portfolio was to identify macro themes related to ESG, which are material for Latin America and could set trends in the region. We defined 8 themes that, in our perception, will become increasingly important and could represent threats to some sectors and an opportunity for others.

After that, we identified companies addressing these themes (i.e. those with solid corporate governance practices or those working to increase diversity) or companies with a business model that benefits from these themes (i.e. those whose main business is clean energy generation or waste management).

After defining this universe, we narrowed the number of companies by understanding which ones have good ESG practices. Of the remaining companies, we chose the 10 on which our analysts have a BUY rating and believe have positive momentum. Our portfolio will be reviewed on a monthly basis.

Can a company with low ESG standards ever become part of the portfolio? Yes, if the valuation is attractive enough and we believe that, despite company X's current low standards, it is running the extra mile to close the gap.

Figure 1: Step by step methodology



Appendix 2: Defining the 8 ESG macro themes

#1) Low carbon economy. Climate change is the main threat to humanity, and the fastest way to tackle this issue is by limiting, offsetting and/or reducing carbon emissions. 196 nations (including Brazil) signed the Paris Agreement, committing to limit global warming to below 2, preferably to 1.5 degrees Celsius, compared to pre-industrial levels. Many governments already regulate companies' carbon emissions and, although Brazil doesn't have any regulation on this subject except from the CBIOS, many companies are already committing to net zero and/or offsetting their carbon emissions.

#2) Transition to clean energy. It is impossible to transition to a low carbon economy without increasing the use of clean energy. To reach net zero by 2050, investments in clean energy have already started and are expected to intensify this decade. According to the International Energy Agency (IEA), renewables are expected to represent 90% of the global power sector's capacity growth in 2021 and 2022. If the energy sector follows the plan to reach net zero by 2050, the share of renewables in global electricity supply is expected to rise from 27% in 2019 to 60% in 2030, while the share provided by coal plants without Carbon Capture, Usage and Storage (CCUS) falls sharply from 37% in 2019 to 6% in 2030. And despite Brazilian energy being cleaner than in many developed countries, locally we are also seeing a trend of investments in wind and solar power generation.

#3) Net promoter score (NPS). In a world of stakeholder capitalism, clients are probably companies' most important stakeholder – at the end of the day, you cannot sell a product or service if you don't have a client. NPS is the best metric to measure client satisfaction and a high NPS probably means the company has room to increase market share, has loyal clients and is close enough to clients to understand their needs – which will probably also bring innovation.

#4) Innovation. This has always been important for companies, but it became crucial as the technological advance increased competition (and reduced barriers for new entrants) in several sectors. Companies with good ESG practices also tend to be innovative, mainly due to their diverse workforce (diversity brings creativity), long-term focus (which creates an environment where people are encouraged to experiment) and strong relationship with stakeholders, especially clients and suppliers (these companies are close enough to clients to listen to feedbacks and understand their needs, while suppliers are seen as partners that bring solutions and grow together with companies).

#5) Digitalization. Digitalization is a social trend, which is disrupting some companies and sectors, but also bringing several opportunities. Digitalization brings several opportunities of scale for companies and increases the choices that clients have – as well as the speed they can hire or cancel products/services.

#6) Diversity. Increasing diversity and inclusion is a challenge for companies, but many studies show that a diverse and inclusive environment is positive for results. It is easier to attract and retain talents in a diverse workforce, and a diverse environment tends to be more creative, which favors innovation.

#7) Good corporate governance practices. Corporate governance is about ethics, strategic planning, transparency, processes and responsibility. It should be the base of ESG, as we understand that a company cannot cause a positive social and environmental impact in the long term without good corporate governance practices.

#8) Waste management/circular economy. Another challenge of society is to reduce the amount of waste sent to landfills. We see companies already committing to “no waste” policies, creating a plethora of opportunities for companies that work with recycling, the circular economy, compostable materials and waste treatment.

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|---------------|----------|---------|--------------------------|------------|
| Arezzo | ARZZ3.SA | Buy | R\$77.52/US\$14.99 | 2023-02-14 |
| Embraer | ERJ.N | Buy | US\$12.48 (ADR) | 2023-02-14 |
| Itau Unibanco | ITUB4.SA | Buy | R\$26.38/US\$5.10 | 2023-02-14 |
| Localiza | RENT3.SA | Buy | R\$55.46/US\$10.73 | 2023-02-14 |
| Porto Seguro | | Neutral | R\$26.90/US\$5.20 | 2023-02-14 |
| Raia Drogasil | DROG3.SA | Buy | R\$23.00/US\$4.45 | 2023-02-14 |
| Raízen | RAIZ4.SA | Buy | R\$2.98/US\$0.58 | 2023-02-14 |
| Santos Brasil | STBP3.SA | Buy | R\$8.02/US\$1.55 | 2023-02-14 |
| WEG | WEGE3.SA | Buy | R\$38.36/US\$7.42 | 2023-02-14 |
| Sabesp | SBSP3.SA | Buy | R\$54.50/US\$10.48 (ADR) | 2023-02-14 |

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Statement of Risk

Arezzo. [BRARZZ] - Arezzo is subject to local macroeconomic conditions, mainly GDP and inflation. On top of that, increase in raw material prices and/or deterioration of local competition could have an adverse impact on the results. Company specific risks include the fashion risk and the execution risk related to the stores opening plan.

Embraer. [BREMB] - Investment in Latin American equities, such as Embraer shares, is subject to exchange risk, as well as unexpected fluctuations of the local economy, and Embraer's business model is dependent on access to international capital markets to offer competitive financing terms to its prospective clients. Investment in aircraft producers is subject to aerospace economic cycles, airline solvency, competitive pricing pressures, foreign competition, and new product development, certification and production ramp-up risks.

Itau Unibanco. [BRITA] - Latin American banks can be affected by changes in both global and local economic conditions and are also subject to political, interest rate, and foreign exchange risks. Our target prices are highly dependent on the level of country risk.

Localiza. [BRRENT] - Localiza is subject to local macroeconomic conditions. Negative economic dynamics such as weak GDP growth, an inflation spike and a hike in interest rates could hurt results. Company-specific risks include cost of growth and execution strategies.

Porto Seguro. [BRPSSA] - Latin American financial companies can be affected by changes in global and local economic conditions, and they are also subject to political, interest rate, and foreign exchange risks. Porto Seguro operates in a highly competitive industry, where the leading retail banks have a significant presence.

Raia Drogasil. [BRRADL] - Main risks are 1) macro environment, 2) competition and 3) regulation.

Raízen. [BRRAIZ] - Raízen's businesses are subjected to several risks such as (i) weather risks that affect sugarcane productivity; (ii) sugar price and ethanol price volatility; (iii) regulatory risks related to its fuel distribution business; (iv) increasing penetration of electric vehicles (EV); (v) competition of informal players across both its marketing and sugarcane businesses; (vi) macroeconomic risks in Brazil and Argentina; and (vii) risks to the success of increasing penetration of renewable fuels globally.

Santos Brasil. [BRSTBR] - (1) Competition in Port of Santos, (2) Governmental dependency – Santos Brasil's ability to grow is tightly linked to the continuous improvement, expansion, and maintenance of the transportation (primarily rail and road networks) infrastructure to which Santos-Brasil is connected, as well as the maintenance and improvement of the draft of its berths. The Brazilian government, in its various levels (municipal, state, and federal) has historically under-spent on transportation infrastructure. This could remain true and existing bottlenecks could take a while to remedy.

WEG. [BRWEGE] - Downside risks include (1) significant commodity price volatility, which could jeopardize margins until achieving full pass through; (2) technical and managerial personnel shortage delaying international expansion; and (3) a continuous deterioration of global industrial production output, leading to a stiffer competitive scenario. Upside risks include (1) a faster ramp up of investments in production facilities, driving higher margins; (2) significant market share gains, offsetting a pale global growth scenario; and (3) continuous international expansion, either via local agreements and selective M&A.

Sabesp. [BRSBSP] - Given their regulated nature, the electricity and water utility sectors are subject to political and/or legal interference. Therefore, the federal (or state) government(s) could implement changes and/or more severe rules/regulations that could hurt companies' cash flows. In addition, an abrupt change in FX rates could negatively impact foreign investors, since companies' tariffs are adjusted by inflation annually.

Valuation Methodology

Arezzo. [BRARZZ] - Our 12-month forward target price is DCF based (cost of equity of 12.0% and g of 6.5%, in nominal USD).

Embraer. [BREMB] - Our 12-month forward target price is DCF-driven with a WACC of 9.5% (nominal terms in USD) with a Ke of 10.5% and Kd (pre-tax) of 5.6%.

Itau Unibanco. [BRITA] - Our primary valuation tool for LatAm banks is the Gordon growth model, which works with profitability levels, cost of equity, and expected growth rates. Our 12-month TP of R\$35 is based on a 21% sustainable ROE, 15% cost of equity, and 8% growth, producing a target P/BV of 1.9x, which we apply to our 2023YE BVPS estimate.

Localiza. [BRRENT] - Our 12-month forward target price is DCF-driven.

Porto Seguro. [BRPSSA] - Our primary valuation tool for banks and insurance companies is the Gordon growth model, which considers profitability, cost of equity, and expected growth rates. Though it is typically most useful when valuing homogeneous companies with stable growth rates, we also find it helpful in valuing Brazilian insurance names. Our 2023YE TP of R\$30 is based on a 17.5% sustainable ROE, 13.5% cost of equity, and 8% growth, producing a target P/BV of 1.73x, which we apply to our 2023YE BVPS estimate.

Raia Drogasil. [BRRADL] - Our 12-month forward target price is DCF based (cost of equity of 9.6% and g of 5.0%, in nominal USD).

Raízen. [BRRAIZ] - We value Raízen based on DCF for each business unit separately, and use target multiples as a sanity check. We use an average nominal USD WACC of 9% and g of 2.5%.

Santos Brasil. [BRSTBR] - Our 12-month forward target price is DCF-driven.

WEG. [BRWEGE] - Our 12-month forward target price is DCF-driven.

Sabesp. [BRSBSP] - Our target price for Sabesp is DCF-derived, discounted at a real WACC. Our model contains rate reviews every five years, with a long-term real regulatory WACC rate of 7%. We also assume the operation is perpetual, with no perpetuity growth.