

MILES CAPITAL

First Letter – Six Years Foundation
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Miles Capital: Six Years of Foundation

Dear investors,

Today, August 22, 2023, is a special day for Miles Capital. It's been six years since the first quota of our Miles Acer Long Bias fund. Our Long Only product, Miles Virtus, was launched a semester later and is now five and a half years old. Therefore, we would like to briefly share our thoughts and lessons learned over the years.

First of all, let's look at our management style. Miles differentiates itself by having the skill to combine a long-term fundamentalist vision with the perception that market distortions and asymmetries generate short- and medium-term opportunities, and consequently substantial compound returns for our quotaholders.

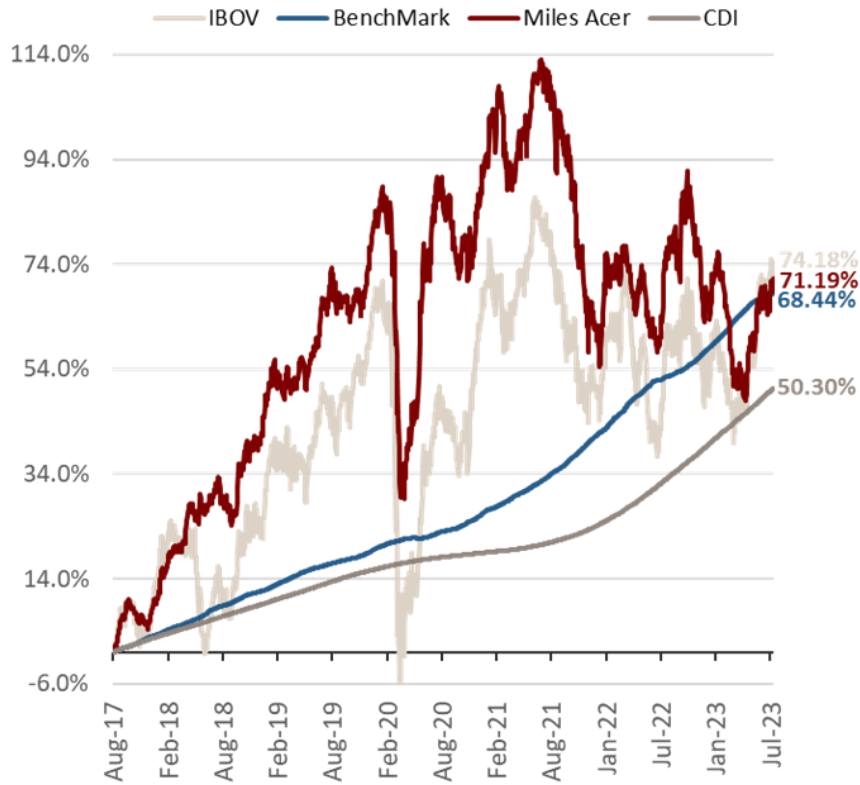
In the period up to July 2023, the Miles Acer Long Bias quota rose 71.19% versus 68.44% for its benchmark (IPCA + Yield IMA-B), representing 141.68% of the CDI¹ in the period (Figure 1). This return is close to the IBOV² (74.18%), but the fund's volatility was much lower than that of the index (16.38% vs. 25.76% - Figure 2).

¹ Interbank Deposit Rate (CDI)

² Brazilian Stock Exchange

Figure 1 - Performance of Miles Acer vs. CDI, IBOV and Benchmark (IPCA + Yield IMA-B)³

(Fund Start: Aug/22/2017; Reference Date: Jul/31/2023)



Source: Miles Capital

Figure 2 - Miles Acer Long Bias volatility vs. Ibovespa

(Fund Start: Aug/22/2017; Reference Date: Jul/31/2023)

	Miles Acer Long Bias	Ibovespa
Volatility	16,38%	25,76%

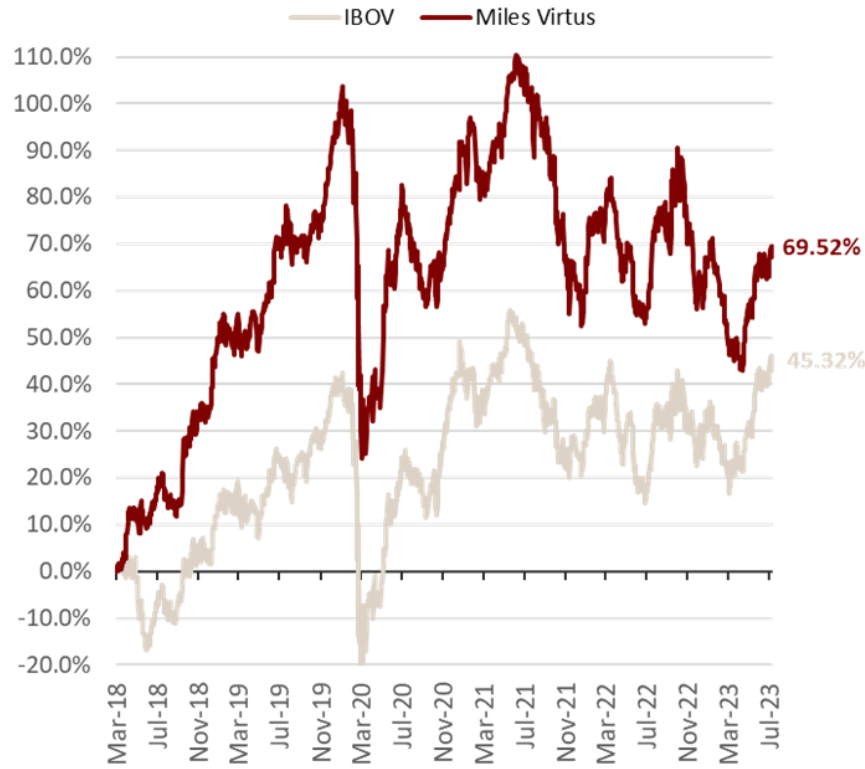
Source: Miles Capital

³ CDI and Ibovespa are not performance targets or parameters. They are merely economic benchmarks.

The Miles Virtus Long Only quota, whose benchmark is the IBOV, has appreciated 69.52% since its launch, outperforming the index by 24.20% (Figure 3) and also running with lower volatility (21.47% vs. 26.46% - Figure 4).

Figure 3 - Miles Virtus Long Only Performance vs. IBOV⁴

(Fund Start: Mar/19/2018; Reference Date: Jul/31/2023)



Source: Miles Capital

Figure 4 - Miles Virtus Long Only volatility vs. Ibovespa

(Fund Start: Mar/19/2018; Reference Date: Jul/31/2023)

	Miles Virtus Long Only	Ibovespa
Volatility	21,47%	26,46%

Source: Miles Capital

⁴ Ibov is not performance target or parameter. Is merely an economic benchmark.

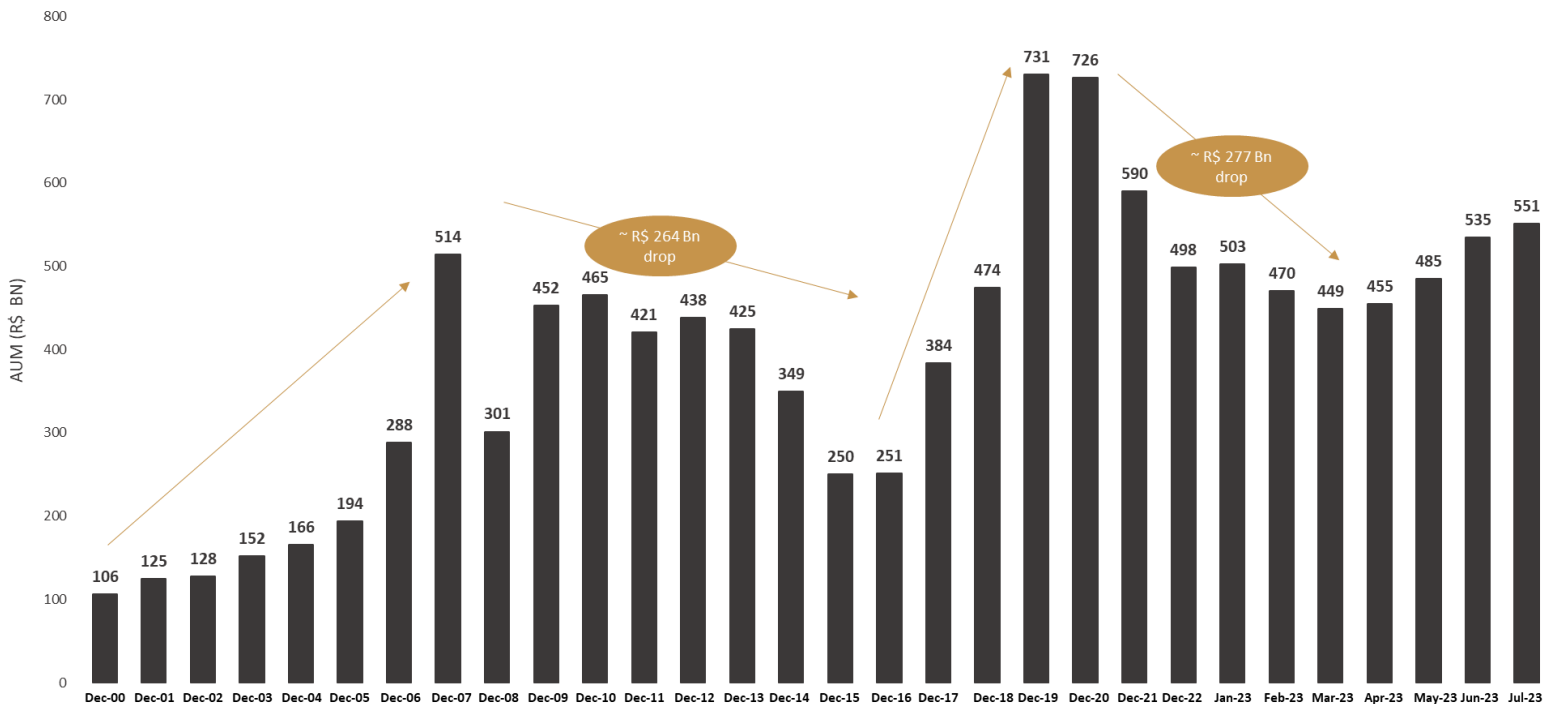
These six years were marked by intense volatility. Just to cite a few examples, we have been through two very polarized elections in Brazil, constant political and fiscal crises, the COVID-19 pandemic, unprecedented interest rate rises in developed economies, and the Russian-Ukrainian War.

Reflecting on our trajectory since the first quota, we understand that there have been two quite distinct periods in terms of performance over these six years:

- 1) The first 4 years - Aug/2017 to Jun/2021 - were very positive, with the funds remaining in the 1st quartile of the market for almost the entire time,
- 2) The last 2 years - Jul/2021 to Jul/2023 – were a period of strong reduction in the size of the industry, in which we performed below what we consider satisfactory.

Over this time, we have learned a lot from a market, business, and management point of view. We have reinforced our understanding that, given the brutal stock market cycles in Brazil (Figure 5), we have to be very rigorous in the size of our assets under management, in order to maintain quality and agility. In addition, we took the decision to "go back to basics" and focus solely on Brazilian equities, using other markets occasionally only as hedging instruments. In this spirit, we recently reinforced our team responsible for covering domestic sectors (the house's main focus).

Figure 5 - Evolution of AuM in the Brazilian Equity Fund Industry

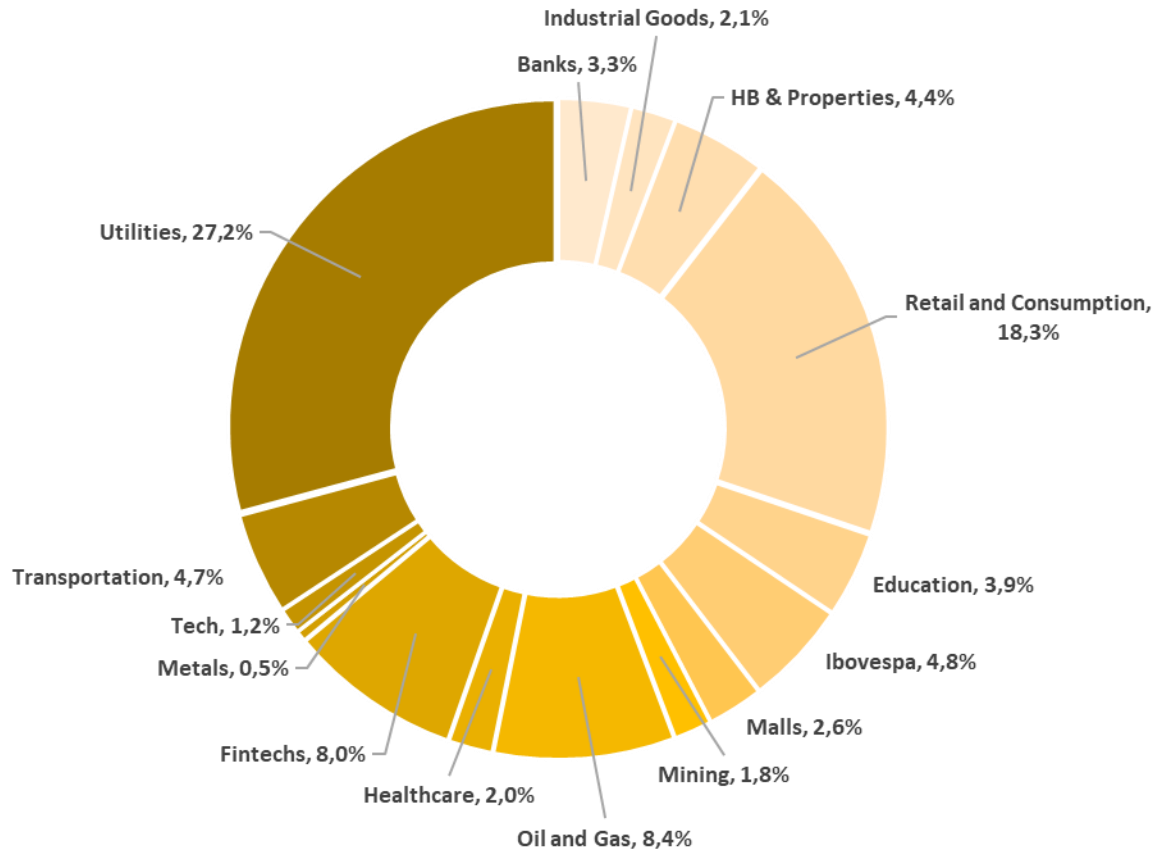


Source: Anbima (Investment Funds Bulletin Jul/23 - Pg.3: Net Assets - Constant by Class)

Looking ahead to the next 12 months, we are more optimistic about the stock market in Brazil and we now have a diversified portfolio with good exposure to the improving fundamentals of the Brazilian economy (Figure 6). We highlight a large part of our portfolio comprises dominant companies in sectors like retail, fintechs, construction, and education, which are considerably discounted in relation to their historical multiples and fundamentals.

In addition, we highlight an important allocation to the Utilities sector. In this sector, we see high quality companies trading at IRRs above 10% in real terms, a valuation discount both in relation to peers and to the sector's historical average (measured as the spread to NTN-B).

Figure 6 - Breakdown of the Miles Acer Portfolio (base: July 2023)



Source: Miles Capital

As we are completing six years of "life", we would also like to share with you one of the biggest asymmetries we are observing for the next 12 months: Sabesp! We believe that we are entering a unique moment, the results of which could be very favorable for all stakeholders (Consumers, State, and Investors).

Of the fund's various positions, this is just one, but considering our track record in the sector, we believe that this case helps us to understand how we position ourselves and the due diligence we seek to carry out.

Sabesp: The strategy to become Latin America's largest utility

This document is part of the letter published by Miles Capital.

The utilities sector, and particularly the sanitation sector in Brazil, has certainly been one of the topics we have dedicated ourselves most deeply, not only in these 6 years at Miles, but also in the partners' previous experiences. All in all, we have spent almost 20 years analyzing the subject.

More specifically regarding Sabesp, the subject of this letter, we can say that in our careers we have rarely seen a Utility with such a divergence of understanding among the market players and with such a wide range of value possibilities.

The size of the asymmetry... we believe that the current multiple of approximately 0.75x EV/RAB¹ indicates the worst-case scenario for the company, in which it is neither privatized nor implements any turnaround, as other state-owned companies - Eletrobras, Cemig, Copel, and Copasa - did even in periods when they were controlled by the government. We think this scenario is very unlikely, given that Sabesp's new management has announced a series of concrete measures to make the company more efficient, and because we believe that the company's privatization is one of the São Paulo government's top priorities.

As we see a limited downside and especially because we see a massive upside if the scenario that we believe to be the most likely materializes, we consider Sabesp to be the best asymmetry in our portfolio for the next 12 months!

Important decisions lie ahead... after the announcement of Phase Zero of the studies conducted by the IFC², based on which the São Paulo state government officially announced that it would follow the strategy of privatizing Sabesp, we are now entering a critical moment in which crucial decisions will be taken.

For us, the definition of how the company's post-privatization regulation will be structured will be a game changer towards a successful process in which the interests of consumers, the state, and investors are maximized or not.

¹ EV/RAB: Enterprise Value/Regulatory Asset Base

² IFC: International Finance Corporation, World Bank's member.

The “Win-Win” path... we argue that if a regulation that incentivizes efficiency is implemented, Sabesp should trade at an EV/RAB multiple close to 1.5x (R\$140/SBSP3), which would represent a potential appreciation of more than 135% versus the current share price. From a public policy perspective, an equally important factor is that the regulatory model that incentivizes efficiency is also the one that leads to lower tariffs (as argued in section 3), making it more attractive to accelerate investments and consequently contributing to the universalization of services.

The “Lose-Lose” path... on the other hand, with a regulation that does not encourage efficiency, we could be facing a scenario in which both consumers and investors fail to maximize their interests.

Once again, the main difference between these two scenarios is the regulation! Therefore, this will be the main point of our analysis. Figures 1 and 2 on the following pages seek to illustrate this.

We are confident that the São Paulo government will pursue the best model for privatization and thus maximize the benefits for all stakeholders. We see a good alignment between all interests in this process and foresee a high probability of a favorable scenario for Sabesp. With significant efficiency gains ahead and given its differentiated growth opportunity, we believe the company could become a more interesting case than the top companies in the electricity sector and, in a few years, the largest utility in Latin America!

Figure 1: “Win-Win” Scenario
(assuming privatization)

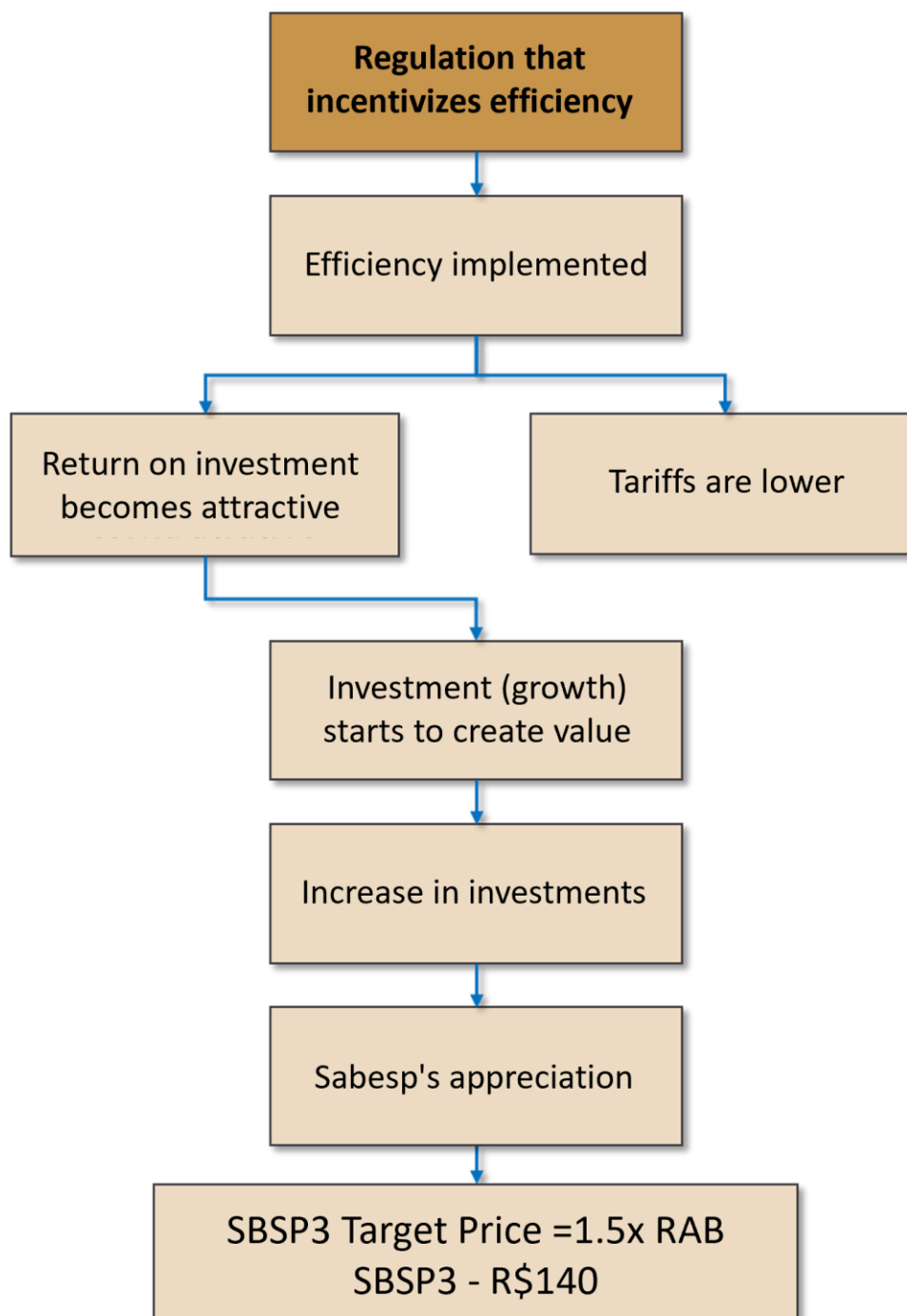
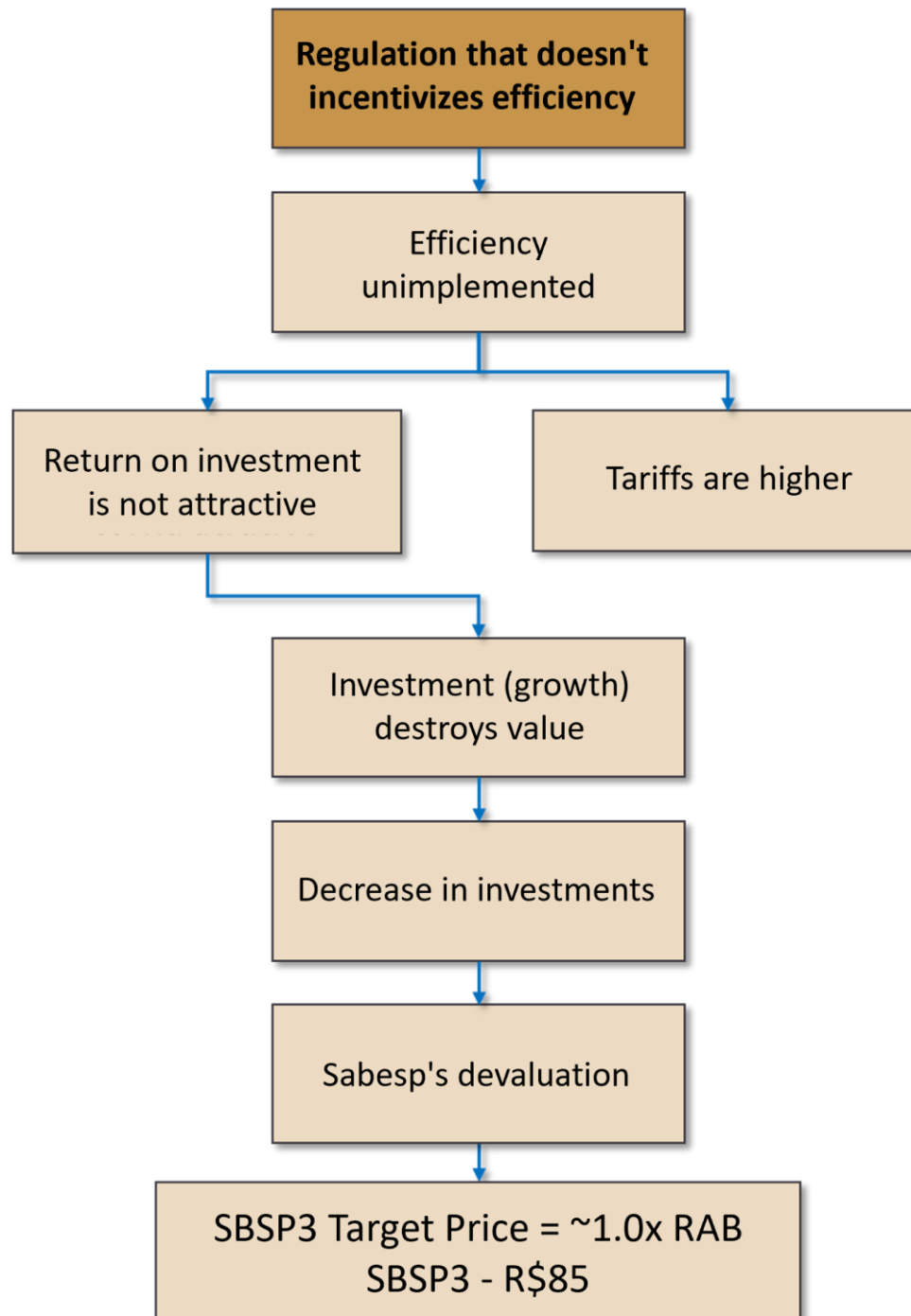


Figure 2: "Lose-Lose" Scenario
(assuming privatization)



Section 1: Differences in regulation: Sabesp vs. Distribution Companies

DisCos' regulation... In the electricity distribution sector, ANEEL applies discretionary incentive-based regulation (Price Cap Regulation), using benchmarking models to define an "*efficient structure*" of costs for each company. In short, in each tariff cycle, new efficient limits are set for each utility and a trajectory is defined for the operator to get closer to these limits, with any excess efficiency being partially shared with consumers. In this way, an efficient company that can perform better than its regulatory parameters can carry over part of this efficiency to subsequent tariff cycles, with a clear incentive for the concessionaire to consistently chase new gains.

As a result of this model, we basically have the following effects: 1) the return on the investment of the efficient concessionaire exceeds the regulatory return, which causes investors to assign a premium valuation to the asset base (listed distribution companies in the electricity sector trade, on average, above 1.5x RAB), 2) there is an incentive to accelerate investments and, 3) tariffs start to have a component with a downward vector, since part of the efficiency gains is shared with consumers. We try to explain this in section 3 entitled "*Regulation that incentivizes efficiency leads to lower tariffs*".

Sabesp's regulation... As for Sabesp, technically, the regulation applied also follows a model of incentive regulation - as explained by ARSESP (Public Services Agency of São Paulo State) in the tariff review process. However, the regulator faces some structural difficulties of the sanitation sector in Brazil, such as the lack of standardization in the data reported by the companies and the low maturity of the industry in general. These factors make it harder to create benchmarks and build the cost structure of a "*reference company*".

The consequence of this is that, regarding regulatory opex³, the regulation applied ends up resembling a Cost-Plus Regulation model. In order to project Sabesp's regulatory opex, the regulator analyzes the company's historical costs and applies "qualitative write-offs" (cuts) to those opex items it considers unnecessary for providing the sanitation services. In addition, ARSESP changes operational drivers presented by the company that affect the projected opex for the next tariff cycle. The table below shows the difference between the opex forecast by Sabesp and that projected by the regulator in the three tariff review processes the company has already undergone.

³ OPEX: Operational Expenditures (considering here only the manageable expenses Personal, Material, Services and Others – PMSO)

Figure 3: Difference between regulatory opex granted by Arsesp vs. the projected in Sabesp's business plan for the tariff cycle

Tariff Cycle	2013-2016	2017-2020	2021-2024
Opex ³ Arsesp vs. Sabesp	-9,4%	-14,8%	-17,3%

Source: Arsesp (Technical Notes NTF RTS/004/2014, NT. F-0006-2018 and NT.F-0016-2021)

The application of this methodology and its results - at least those seen until today - lead investors to understand that there is no room for the company to perform more efficiently than the regulatory parameters. In this way, the market understands that cost-cutting initiatives will be fully captured by the regulator.

Therefore, we have that:

- 1) the maximum return that the concessionaire can obtain is equivalent to the regulatory return;
- 2) a meaningful vector for lowering tariffs is reduced since there are no incentives for the concessionaire to seek efficiency gains in the form of cost reduction.

Section 2: Comparison between Sabesp and DisCos valuation

By definition, a company that performs in line with its regulatory parameters, including the cost of capital, would have an EV/RAB multiple of 1.0x as its fair value. On the other hand, a company that consistently manages to be more efficient than its regulatory parameters and carries over part of this efficiency to following tariff cycles should negotiate with a premium for its asset base, given that the company can obtain returns higher than the regulatory return.

Sabesp's valuation with a regulation without incentives for efficiency (current)... Sabesp currently trades at approximately 0.75x EV/RAB, reflecting the fact that the company is quite inefficient versus its regulatory parameters (we estimate that 2022 adjusted EBITDA was approximately 33% below regulatory EBITDA).

However, the current level of inefficiency is not just due to costs. Currently, Sabesp's realized revenue does not reach regulatory revenue and there are payments obligations to the municipality of São Paulo that are not fully covered by the tariff. In our view, these factors are detractors of 0.10x to 0.15x EV/RAB in the company's valuation, and their solution depends more on regulatory adjustments than on the company's management efforts.

With all that said, even in a scenario in which a turnaround occurs and it succeeds, the company would have a performance in line with or below the regulatory one, limiting the valuation to 1.0x to 1.2x EV/RAB (here, we already consider that a reduction in the cost of capital in the privatized company could add up to approximately 0.2x to the fair multiple; see figures 5 and 6 on the following pages).

DisCos valuation... On the other hand, the electricity distribution sector trades at average multiples above 1.5x EV/RAB, reflecting the possibility of carrying efficiency gains over time. In the table below, we see a clear correlation between the operator's performance and its valuation.

Figure 4: Correlation between EBITDA performance in relation to Regulatory and EV/RAB multiples

Company	Equatorial*	Energisa*	CPFL	Neoenergia*	Sabesp
EBITDA/ Regulatory EBITDA	132%	127%	126%	118%	67%
Current EV/RAB	1,88x	1,81x	1,58x	1,44x	0,75x

Source: ANEEL, ARSESP, companies releases and Miles Capital

*These companies have tax benefits (Sudam/Sudene) that influence their fair value but are not incorporated in the realized EBITDA. Without these benefits, the multiples would be ~0.15x RAB lower and more comparable with Sabesp, which does not have the benefits.

Sabesp's valuation in a regulation with incentives for efficiency... Now let us make this valuation comparison assuming that Sabesp is privatized under a regulatory model that incentivizes efficiency in a similar way, in terms of results, to that practiced in the electricity sector.

If Sabesp achieves a level of efficiency like energy distributors, with the same degree of predictability, and has clear rules on maintaining this efficiency between cycles, we believe that the company should negotiate with a valuation premium due to the enormous opportunity to grow its asset base. This opportunity is not present in the same magnitude for the majority of distributors in the electricity sector, because they already have universalized services and, in the medium term, should only invest the equivalent of regulatory depreciation.

Below, we present a sensitivity analysis whose result is the fair EV/RAB multiple for the company according to its degree of efficiency (realized EBITDA in relation to regulatory EBITDA) and its degree of investment (realized capex versus regulatory depreciation).

To make it easier to understand, we have split the analysis into two tables. First, in Figure 5, we show the sensitivity in a scenario in which Sabesp is not privatized, in which we assume that the cost of capital would be in line with the regulatory WACC and, therefore, there would be no gains from the difference in this parameter. Subsequently, in Figure 6, the same sensitivity is shown in a privatization scenario in which we consider a reduction in the cost of equity of 100 basis points in relation to the regulatory WACC.

Figure 5: Sensitivity of the EV/RAB multiple to efficiency and capex (non-privatization scenario where the cost of capital = WACC Reg.)

Sensitivity EV/RAB		EBITDA/Regulatory EBITDA						
		0.70x	0.80x	0.90x	1.00x	1.10x	1.20x	1.30x
Capex/ Depreciation	0.50x	0.78x	0.85x	0.93x	1.00x	1.07x	1.15x	1.22x
	1.00x	0.75x	0.83x	0.92x	1.00x	1.08x	1.17x	1.25x
	1.50x	0.71x	0.81x	0.90x	1.00x	1.10x	1.19x	1.29x
	2.00x	0.67x	0.78x	0.89x	1.00x	1.11x	1.22x	1.33x
	2.50x	0.62x	0.75x	0.87x	1.00x	1.13x	1.25x	1.38x
	3.00x	0.56x	0.70x	0.85x	1.00x	1.15x	1.30x	1.44x

Inefficient and state owned

Efficient and state owned

Delta 3,0x-1,0x	-0.19x	-0.13x	-0.06x	0.00x	0.06x	0.13x	0.19x
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Figure 6: Sensitivity of the EV/RAB multiple to efficiency and capex (privatization scenario where the cost of capital < WACC Reg.)

Sensitivity EV/RAB		EBITDA/Regulatory EBITDA						
		0.70x	0.80x	0.90x	1.00x	1.10x	1.20x	1.30x
Capex/ Depreciation	0.50x	0.80x	0.87x	0.95x	1.03x	1.10x	1.18x	1.26x
	1.00x	0.78x	0.87x	0.96x	1.05x	1.13x	1.22x	1.31x
	1.50x	0.77x	0.87x	0.97x	1.07x	1.17x	1.27x	1.37x
	2.00x	0.76x	0.87x	0.99x	1.10x	1.22x	1.34x	1.45x
	2.50x	0.74x	0.88x	1.01x	1.15x	1.28x	1.41x	1.55x
	3.00x	0.73x	0.88x	1.04x	1.20x	1.35x	1.51x	1.67x

Private on current regulation

Private on improved regulation

3,0x-1,0x	-0.06x	0.01x	0.08x	0.15x	0.22x	0.29x	0.36x
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Source: Miles Capital

We can see that when the company is efficient ($\text{EBITDA} > \text{Regulatory EBITDA}$), making an investment above the regulatory depreciation generates value, whereas for an inefficient company ($\text{EBITDA} < \text{Regulatory EBITDA}$), an investment above the regulatory depreciation destroys value.

In this way, we conclude that if Sabesp continues with its current level of inefficiency in relation to regulatory parameters, the greater the investment, the greater the de-rating of the company's valuation, with investors paying ever smaller multiples. On the other side, it is also true to say that, when becoming an efficient company, the higher the capex, the higher the multiple assigned by investors.

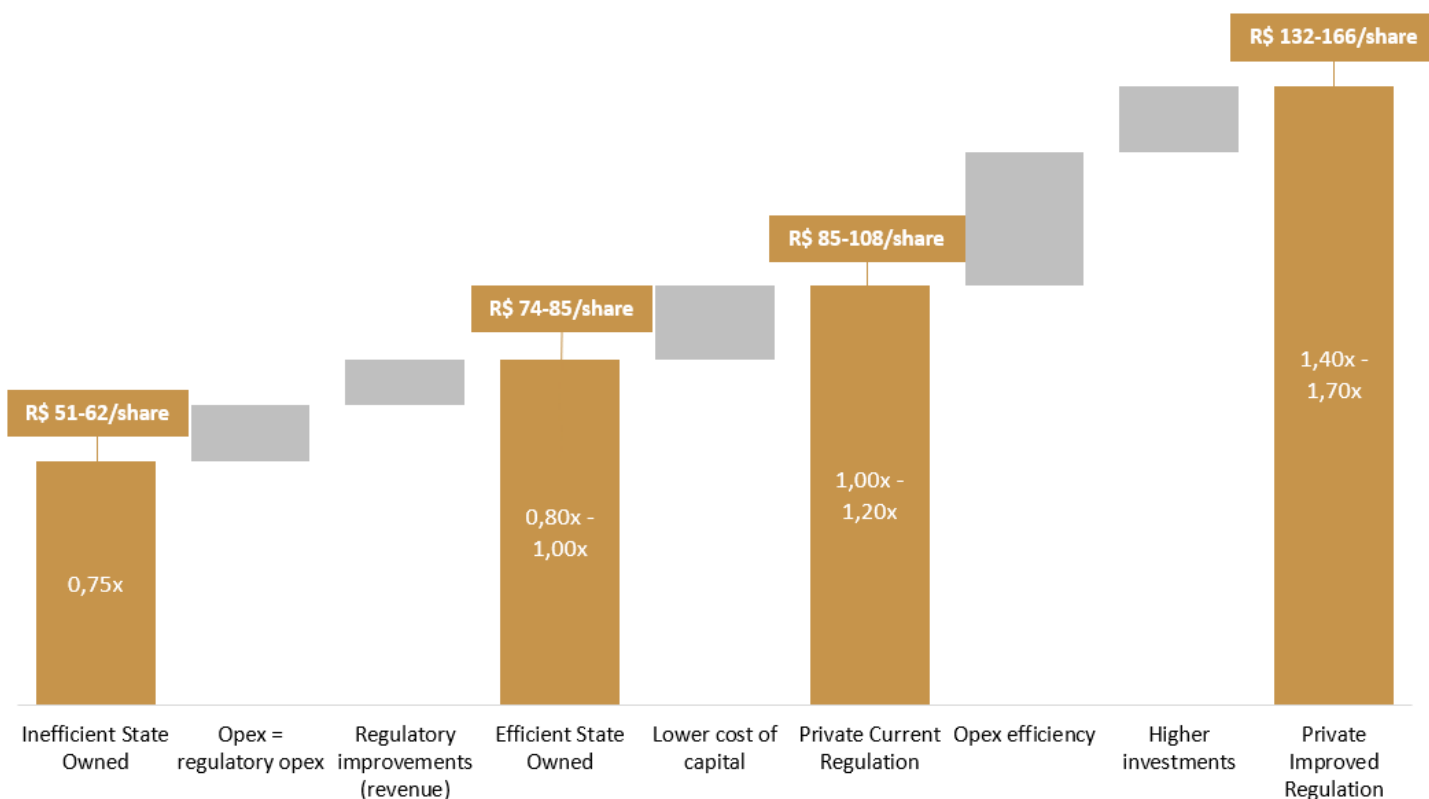
In addition, we believe it is worth commenting on the influence of the cost of capital in defining the valuation (the only variable that is different between the simulations in Figures 5 and 6). A reduction in the cost of capital, which is often perceived by investors in a privatization process, makes the value creation even more significant when the investments of an efficient company are increased. This is another crucial factor that aligns the interests of shareholders and society by encouraging investments in universalization.

In a scenario that we see as quite reasonable, in which Sabesp performs 20% to 30% above the regulatory level (in line with efficient players in the electricity sector) and invests 2.5x to 3.0x its regulatory depreciation, we see a multiple of 1.4x to 1.7x EV/RAB (justifying our expectation of a re-rating to approximately 1.5x EV/RAB).

Finally, based on what we have discussed so far, we present a summary of what we believe to be the expected value range for Sabesp in each of the following scenarios:

- 1) **Inefficient State Owned** (maintaining current inefficiencies): 0.70x to 0.80x EV/RAB => As per the area highlighted in orange in Figure 5.
- 2) **Efficient State Owned** (resolving cost inefficiencies): 0.90x to 1.00x EV/RAB, depending on the treatment of the other inefficiencies => As per the area highlighted in yellow in Figure 5.
- 3) **Private Current Regulation**: 1.0x to 1.2x EV/RAB => As per the area highlighted in blue in Figure 6.
- 4) **Private Improved Regulation**: 1.4x to 1.7x EV/RAB => As per the area highlighted in green in Figure 6.

Figure 7: Valuation build-up (EV/RAB) of Sabesp and share price in different scenarios



Source: Miles Capital

Utilities company with the greatest potential for growth and value generation... We conclude this section by saying that we have a bias that Sabesp's growth potential could lead to an even more significant re-rating of its multiple. For context, the São Paulo government has announced an investment plan for Sabesp until 2029 of R\$66 billion, while we estimate the company's current asset base at approximately R\$75 billion. Beyond this, we see the potential for Sabesp to become one of the main vehicles for sanitation universalization in Brazil, an opportunity worth hundreds of billions of reais in investments.

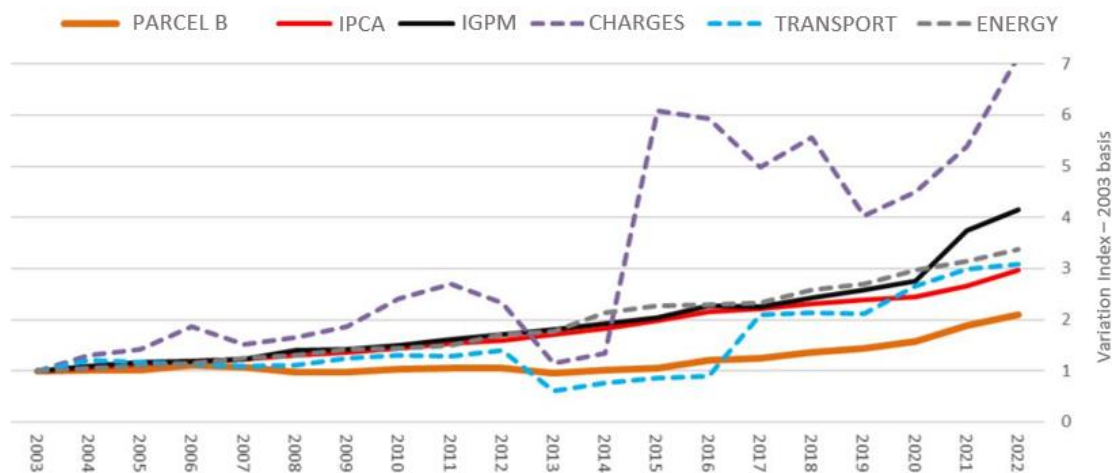
Section 3: Regulation that incentivizes efficiency leads to lower tariffs

History on DisCos... As a way of assessing the impact of a regulation with well-defined incentives for efficiency on tariffs, we turn again to the example of the electricity sector. Figure 8 shows the historical evolution of the various components of electricity tariffs, as well as the IPCA and IGPM inflation indexes.

It should be noted that the growth in "Parcel B" (the component that pays for investments and covers the concessionaires' manageable costs) was much lower than inflation measured by the IPCA or the IGPM between 2003 and 2022.

During this period, several privatizations took place in the electricity sector, which, together with a regulatory model that incentivizes efficiency, generated a virtuous cycle of investments, universalization of services and efficiency implementation.

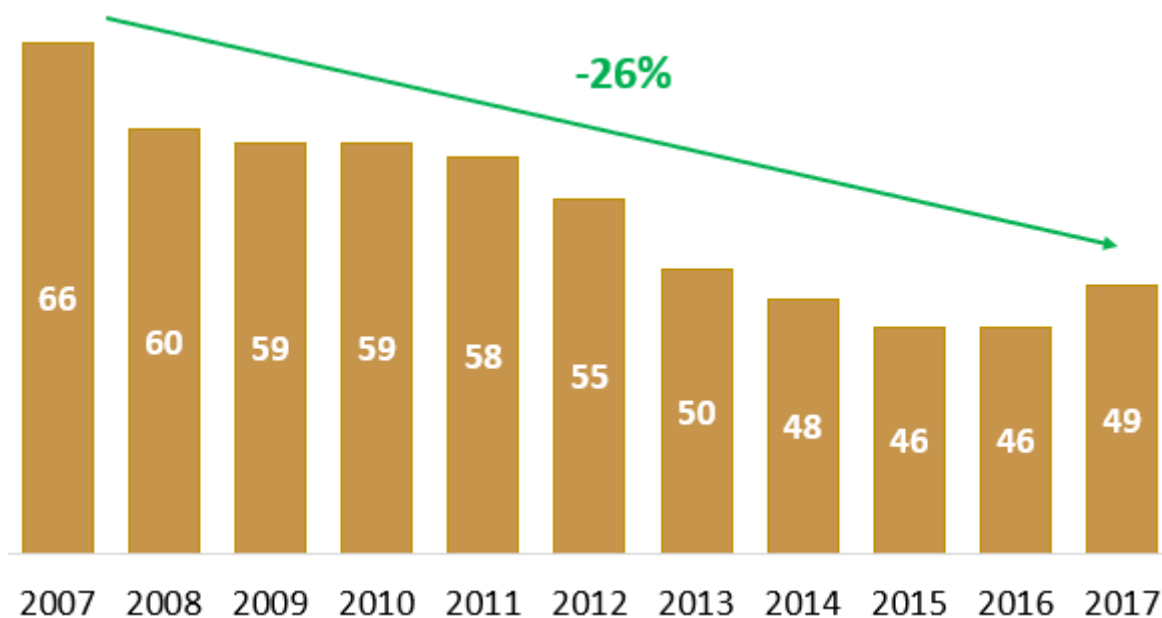
Figure 8: Variation in electricity tariff components, IPCA and IGPM



Source: i4 Economic Regulation, ANEEL

To reinforce this point, we refer to a study conducted by ANEEL in 2018 that analyzed the specific evolution of the weight of regulatory costs in tariffs. In the period from 2007 to 2017, there was a 26% reduction in this component in real terms, showing how a regulation with incentives for efficiency generates a downward vector for tariffs.

Figure 9: Evolution of regulatory opex in the electricity tariff from 2007 to 2017 in real terms, in R\$/MWh



Source: ANEEL (Technical Note nº 27/SRM/SGT/SPE/SRD-2019)

Tariff reduction potential in sanitation... Below, we seek to understand the potential for tariff reductions at Sabesp if the company is encouraged to seek the efficiency levels of private peers.

To do so, as shown in Figure 10, we considered the costs per economy (consumer unit) of a sample of the largest mature concessions owned by private players. In addition, we adjusted our calculations to reflect scale gains, since Sabesp serves a number of economies of almost 50 times that of the concessions analyzed.

Tariffs could drop 8% in the next cycle... We see a potential reduction of approximately 56% in Sabesp's manageable opex. If 50% of these efficiency gains are shared with users, the tariff reduction would be approximately 8%. We emphasize that the carried efficiency implicit in this exercise is in line with that practiced by efficient companies in the electricity sector.

Finally, we would point out that, over time, new efficiency gains would probably still be captured since, on this model, the private concessionaire would be constantly seeking new efficiencies.

On the other hand, with a regulatory model with low incentives for efficiency, it would be difficult for the concessionaire to seek such significant reductions in the cost structure, reducing the benefit for the consumer over time.

Figure 10: Potential reduction in Sabesp's manageable opex in relation to mature private concessions

	Aegee			Manaus	Igua	BRK	Average	Sabesp	%
	Guariroba	Prolagos	Teresina		Cuiabá*	Saneatins			
Number of economies	634	446	429	598	426	649	530	24,551	
Cost per employee	42	72	36	30	97	101	63	250	-75%
Employees/economies	1.4	0.8	1.9	2.6	1.2	1.6	1.6	0.5	216%
Personal opex/economy	58	59	69	80	119	164	101	126	-20%
OPEX/economy	150	176	216	292	233	367	239	313	-24%
OPEX/economy with scale	113	154	166	213	163	203	138	313	-56%

Source: Companies releases, SNIS and Miles Capital.

*For all concessions, we are using data from the last twelve months in relation to 1Q23, except for Iguá Cuiabá, where we are using data from 2022. Some operational data, such as the number of employees, when not provided by the companies, was collected from SNIS (public database of the sanitation sector).

Monetary values in thousands of reais. Number of economies and employees per economy in thousands.

Conclusions

As we have tried to demonstrate in this letter, we believe that there is a high probability of a very favorable scenario in terms of value in Sabesp's privatization. That is because we see a strong alignment between what maximizes value for the investors and the consumers.

It is possible to achieve a wide range of values for Sabesp, and of this consists the very favorable asymmetry and strong upside potential we see, since current valuation already reflects the worst-case scenario for the company.

We reiterate that a regulatory model that successfully incentivizes efficiency is the only one that can maximize the interests of both investors and society. We believe that the choice of this model would lead to a strong appreciation of Sabesp, create a downward vector for tariffs and accelerate investments towards universalization of services.

In addition, we highlight the company's enormous growth potential. In the current concession area alone, Sabesp should practically double its asset base when it completes the investments needed for universalization. Apart from this, Sabesp has a clear competitive advantage to serve the rest of the São Paulo state in the future (the current concession covers around 70% of the state's consumers) and could become the main vehicle for leading universalization in the rest of the country, accumulating significant scale gains.

As we argued in that letter, we believe that there is a high probability that Sabesp will have a fair EV/RAB multiple close to 1.5x, so that in a few years we would have a company worth more than R\$200 billion, making it the largest utility in Latin America!