Stone Co 4Q22 Earnings Conference Call

March 14, 2022

Operator:

Good evening, ladies and gentlemen. Thank you for standing by. Welcome to the StoneCo fourth quarter 2022 earnings conference call. By now everyone should have access to our earnings release. The Company also posted a presentation to go along with its call. All material can be found online at investors.stone.co.

Throughout this conference call the Company will be presenting non-IFRS financial information including adjusted net income and adjusted net cash. These are important financial measures for the Company but are not financial measures as defined by IFRS. Reconciliations of the Company's non-IFRS financial information to the IFRS financial information appear in today's press release.

Finally, before we begin our formal remarks, I would like to remind everyone that today's discussion may include forward-looking statements. These forward-looking statements are not guarantees of future performance and therefore you should not put undue reliance on them. These statements are subject to numerous risks and uncertainties that could cause actual results to differ materially from the Company's expectations. Please refer to the forward-looking statements disclosure in the Company's earnings press release.

In addition, many of the risks regarding the business are disclosed in the Company's Form 20-F filed with the Securities and Exchange Commission, which is available at www.SEC.gov. I would now like to turn the conference over to your host, Rafael Martins, VP of Finance and Investor Relations Officer at StoneCo. Please proceed.

Rafael Martins – VP of Finance and Investor Relations Officer

Thank you, operator, and good evening, everyone. Joining us today on the call we have our CEO and Board member, Thiago Piau and our Chief Strategy Officer, Lia Matos.

Today, we will present our fourth quarter 2022 results, discuss some recent trends and provide an updated outlook for our business.

I will now pass it over to Thiago so he can share some highlights of our performance. Thiago?

Thiago Piau – CEO

Thank you, Rafa, and good evening, everyone.

Let me start by reviewing the key highlights for the year and 4Q22 that we lay out on slide 4 of our presentation:

1. **We successfully drove strong growth with improvement in profitability.** Our revenue doubled in 2022 while our Adjusted Net Income reached R$526 million. In the quarter, Adjusted Net Income reached R$235 million, a 44% sequential growth. This achievement was largely a result of a successful price execution and strong operational leverage, while we improved engagement with our clients and continued to invest in our growth.

2. **We generated increasingly stronger cash flows**. Our company is generating cash in a very consistent way and has a strong balance sheet and liquidity to fund its growth ahead. Our Adjusted Net Cash increased by R$1.2 Bn in 2022 and R$385mn in the fourth quarter alone. We expect that our cash flow generation will remain strong in 2023.

3. **In Financial Services, we expanded our client base, offered new solutions and captured higher take rates.** In 2022 we generated strong profitable growth in our client base while improving unit economics both through price execution and increase in monetization from our banking solutions. In the fourth quarter, MSMB TPV grew 23% YoY, almost 2 times the industry growth. Active client base grew 48% YoY to 2.5 million merchants, at the same time that we increased take rates by 50 bps compared to last year. Additionally, total banking deposits reached R$4 Bn, R$3.6 Bn of which in the MSMB segment, reaching almost 693 thousand active banking clients. I think such results show our ability to pass along price increases, gain market share and improve engagement with our clients at the same time.

4. **In Software, we gained scale, improved operating margins and advanced on product integrations.** Software revenues grew 21% YoY in the fourth quarter and our adjusted EBITDA margin reached 16.2% in the 4Q22, the highest margin since we acquired the business. We gained efficiency while also investing in several areas to better serve our clients, like customer service and product integrations. We have integrated our financial services platform to POS and ERP solutions in strategic verticals, opening a key cross-sell opportunity which we believe is unique within the industry.

5. **Last, we enhanced the capabilities necessary to execute the next phase for Stone.** We added to our team experienced and seasoned leaders, strengthening key capabilities in banking, credit, product, tech and risk, which will be crucial for our plans in the coming years.

I am excited to share these results with you, which mark the completion of our turnaround in 2022, with the company well positioned to continue its successful story. Most importantly, we have executed our turnaround maintaining our special culture and strong devotion to serve our clients.

Finally, we are also successfully completing our CEO transition and I am confident that, under Pedro's leadership, Stone will evolve on an even stronger future and 2023 will start a new chapter in our journey.

Now, I am very happy to bring Pedro to send a message to all of you:

Pedro Zinner – new CEO

Thank you, Thiago, and good evening everyone. I am really excited to be here and looking forward to leading the team in our journey. Over the first months of this transition, I was able to see how much has been delivered in 2022 and how well set the company is to address the opportunities we see ahead of us. I was also positively impressed by the quality of our people and our strong culture. The team has defined clear priorities for 2023, and I see this as an important first step for the path ahead. I will take the CEO role in April, and today will participate in the call only as a listener. I look forward to meeting all of you soon.

Thiago, back to you.

Thiago Piau – CEO

Thank you, Pedro, it's great to have you on board and I wish you great success. I will now pass it over to Lia, who will provide more details about our fourth quarter performance and strategic updates. Lia?

Lia Matos – Chief Strategy Officer

Thank you, Thiago and good evening, everyone.

I will start on slide 5 with some highlights of our overall performance. In the fourth quarter, we surpassed our guidance in all metrics, reaching R$2.7 Bn in Total Revenue, R$316 mn in adjusted EBT and R$235 mn in adjusted Net Income. As Thiago already mentioned, this quarter reinforced a good balance between growth and profitability within our business.

Now, let's move directly to slide 7, so we can discuss our performance in the Financial Services segment.

In 4Q22, revenue increased 49% year-over-year, to reach R$2.3bn. Adj EBT increased to R$286mn, with margins increasing from negative levels in 4Q21 to 12.4% in 4Q22, showing our discipline in allocating capital to grow our financial services platform.

Moving to slide 8, our MSMB payments client base increased by 48% year-over-year, to 2.5mn active merchants, with 212 thousand net addition of clients. Regarding our net adds trend, our focus has been and will continue to be on onboarding the best clients, both in the SMB and in Micro segments, reaching healthy levels of contribution margin per client, higher average TPV within each client tier and lower churn. Also, by optimizing our commercial strategy of Ton and Stone offerings within our multiple sales channels, we were once again able to see client base growth in all client tiers this quarter. I think this approach is pretty unique in the market and has led us to good levels of profitable TPV growth, as I will show on the next page.

MSMB TPV reached R$82 billion in the quarter, 4% higher than the high-end of our guidance of between R$78-79 billion and growing 23% year over year, almost 2 times industry growth levels. We were able to produce that growth while increasing our take rates by 50 basis points year over year. MSMB Take Rate remained stable sequentially at 2.21%, which was positively impacted by higher average prices in the quarter and positive client mix, offset by a seasonal increase in debit over credit volumes.

On slide 10, I show some highlights of our banking business, which has evolved significantly in 2022:

This quarter, we have reached 693 thousand merchants actively using our banking solution, a 41% year-over-year increase, with client deposits growing 84% in the same period, reaching R$3.6bn in 4Q22. I think the evolution in overall client deposits speaks to the quality of our client base, with a healthy mix in terms of average TPV, and the value of having our banking solution attached to our acquiring solution, with no incremental marketing investments. Not only does that provide a superior experience to our clients, who can rely on having the complete banking and acquiring experience in one single app, it also provides us with a steady flow of cash-in volumes, from card TPV, PIX and other payment methods. As an example of this additional engagement, PIX-in volumes tripled in 2022 to R$44bn and increased 22% quarter-over-quarter, mainly driven by higher PIX P2M volumes.

Another important highlight worth mentioning is the launch of "Super Conta Ton" in the 1Q23, our full banking solution for micro clients. We expect Super Conta Ton to drive growth of overall level of deposits and banking revenue going forward.

I also want to take a brief moment to update you on where we are on Credit. Our focus in the second half of 2022 was on building a fully automated process for credit underwriting and granting through the Stone App. We also made our decision models more sophisticated through enhancement of data, strengthened the team, reviewed and approved our risk policies and ran the first tests with a small number of clients, with positive initial results.

In the first half of 2023, we expect to expand the size of our testing with clients, with an emphasis on management of guarantees, testing and improving the quality of the decision models and credit lifecycle monitoring and renegotiation through the app.

In the second half of the year, we want to begin scaling working capital loans to our clients. We will take a conservative approach and the level and speed at which we do so will depend on the macro scenario and our risk appetite. Our initial focus will be providing working capital loans to the SMB segment. We are also planning the launch of Credit Cards to both Micro and SMB segments and are exploring opportunities for cross selling credit in Linx.

Moving to slide 11, I want to briefly talk about Key Accounts. As we have been reinforcing for some quarters already, we have been shifting our priority from Sub-acquiring business to Platform Services within the segment. I want to remind our investors that platform services encompass a range of client segments that distribute our solutions by integrating our payments and banking platforms to their own offerings, such as software providers, e-commerce platforms and omni-channel retailers. We see an attractive opportunity to continue to serve these client segments, which is evident by the strong level of growth in Platform Services TPV. The effect of this decision is a decline in Sub-acquiring volumes and an improvement in overall Key Accounts take rate. This quarter, Key Accounts TPV decreased 18% year-over-year, due to a 57% decrease in sub-acquirer volumes and an increase of 32% in Platform Services TPV.

In slides 12 and 13, I am going to shift to discuss some performance highlights of our Software segment. In slide 12, we can see a consistent growth in our top line combined with improvement in our operating margins. Revenue grew 21% year-over-year to R$376mn and our Adjusted EBITDA more than doubled year over year to R$61mm, with Adj EBITDA margin increasing 760bps to 16.2%. This improvement in margins is mainly related to dilution of fixed costs, normalized cloud costs and ongoing cost control efforts.

In slide 13, I will recap some elements of our strategic evolution in software.

- Our Core POS/ERP continues to be the driver of the segment growth, with revenues increasing 23% year-over-year due to an increase in locations and in average ticket. The performance in the Core reflects the unique attributes and vertical breadth of our solutions, that have a leadership position in several retail verticals, such as apparel, footware, optics, pharma, among others. As we evolve our software strategy, we see the central priority of our digital solutions being to enable those brick and mortar clients to sell more through digital channels by using our marketplace hub, ecommerce platform or Order Management System. Digital solutions had a lower growth of 4% this quarter, especially due to the weaker performance of our Ads and Impulse businesses.

- A crucial evolution in 2022 was the integration of our financial services platform to POS/ERP solutions in strategic software verticals. We believe this will be key for us as it opens up an important cross sell opportunity to be explored through differentiated offerings to our clients. The focus for 2023 on that front will be to build the optimal Go to Market strategy, leveraging both the Stone distribution through the hubs as well as our software distribution franchisees.

- Finally, as we did in 2022, in 2023 we will maintain the same approach to cost discipline while we invest in developing new products, improve our client's experience and explore selective M&A opportunities to gain ground on new strategic verticals.

Now, I want to pass it over to Rafa, so he can discuss in more detail some of our key financial metrics. Rafa?

Rafael Martins – VP of Finance and Investor Relations Officer

Thank you, Lia. I will now begin on slide 14 to discuss the evolution of our costs and expenses.

Before I talk about the quarterly evolution, I would like to zoom out to the evolution in the year because I think it shows the tangible results of our focus in improving the profitability of the business. Throughout 2022, we saw operating leverage gains in almost all lines. Our costs and expenses as a percentage of revenue decreased more than **14 hundred** basis points in the fourth quarter compared to the prior year.

- Cost of services decreased from 34.5% of revenue in the fourth quarter 2021 to 25.8% this quarter, a gain of 870 basis points
- Our Selling expenses as a percentage of revenue decreased 200 basis points to 15%
- Administrative expenses grew less than our revenue, gaining 130 basis points of operational leverage.
- Financial expenses decreased 270 basis points as a percentage of revenue, as our positive cash flow generation gave us comfort to use more of our own cash to fund our prepayment business.

Now, let me give the main highlights of our sequential quarterly evolution:

- Costs of Services as a percentage of revenue decreased 100bps to 25.8%, mainly due to lower costs in Software and efficiency gains in our registry business TAG, logistics and banking.
- Administrative expenses as a percentage of revenue increased 100bps to 11%, mostly driven by non-recurring higher expenses related to third-party advisory and seasonal personnel expenses. As Lia will detail shortly, in 2023, a key priority for us is opex discipline, and we do <u>not</u> expect this line to grow more than inflation along this year. We expect that administrative expenses will reduce on an absolute basis in the first quarter of 2023.
- Selling expenses decreased around 40 bps as a percentage of revenue, as a result of roughly stable marketing expenses and despite increased investments in our sales force.
- Following the trend seen in 3Q22, Financial Expenses decreased 3.1% quarter-over-quarter and as a percentage of revenue decreased 380 bps to reach 33.4%. This is mainly explained by higher use of our own cash to fund our prepayment operations. Although having a positive effect in financial expenses, this has, on the other hand, led to a decrease of interest on cash, as noted by Other Financial Income decreasing R$20.6mn quarter-over-quarter.
- Other expenses increased to R$85.2 million in the quarter, increasing 90 basis points as a percentage of revenue. The quarterly increase was mainly due to impairment from proprietary operational software and write-off of non-core assets, amounting to R$33.7 million, which were partially compensated by a gain in the sale of POS.

As shown in slide 15, in addition to our P&L evolution, we have been consistently generating cash and improving our liquidity. Our Adjusted Net Cash balance improved by around R$385mn in the quarter, reaching R$3.5 billion at year-end. In the year, Adjusted Net Cash increased by R$1.2 bn. As I just mentioned we have used a little more of the cash generated by our business to fund our prepayment operations, given our already very strong cash position.

Before I talk about our 1Q23 outlook, a brief comment on a change we are making starting next quarter regarding our non-IFRS adjusted metrics. Starting next quarter, our managerial adjustments to IFRS results will no longer include adjustments related to share-based compensation expenses. Until now, we adjusted those expenses related to extraordinary grants and already did not adjust share-based expenses related to annual recurring incentive plans. To better align calculation, comparability and simplify the understanding of our financial results, we decided to be closer to IFRS reporting metric and stop adjusting all share-based compensation expenses from our results from 1Q23 onwards. To help you reconcile our future results, we have provided in the appendix of our presentation and in our earnings release, historical numbers with the new adjustment policy.

Now, moving to our 1Q23 outlook on page 16:

- We expect total Revenue and Income above R$2.6 billion in 1Q23, representing a year-over-year growth above 25.6%.
- For MSMB TPV we expect volumes between R$77 and R$78 billion in 1Q23 compared with R$63.4 billion in the first quarter of 2022, representing a year over year growth between 21.5% and 23.1%.
- Finally, already considering share-based compensation fully as expensed in our income statement, we expect adjusted EBT of more than R$265 million compared to R$276 million for the fourth quarter.

As a reminder, the first quarter is usually seasonally weaker compared to fourth quarters, because of higher volumes transacted during Holiday Season at year-end.

With that, let me turn the conference back to Lia, so she can comment a bit on our priorities for 2023. Lia?

Lia Matos – Chief Strategy Officer

Thanks, Rafa. In 2022 we have set up a strong foundation to execute on our 2023 and longer-term priorities. Let me just highlight where our focus as a team will be this year. You can follow those highlights on page 17 of our presentation:

1. First, we will keep growing efficiently. Our plans for this year contemplate more opex discipline and a continued focus on MSMB growth while maintaining our approach to pricing based on internal return hurdles, allocating capital wisely.
2. It is also imperative that we maintain a strong cash flow generation and overall liquidity position. This provides us with more flexibility to invest in the growth of our business.
3. We will continue to work hard to expand our core through the evolution of our banking offers to Micro and SMB Clients, leading to higher client engagement. Together with this, we are on track to relaunch our working capital solution and launch our debit and credit cards to MSMB clients.
4. We will further develop the execution of our software strategy, strengthening our approach to cross-sell financial services into software client base with differentiated, integrated solutions.
5. Finally, after an enormous evolution on this front in 2022, we will maintain focus on evolving our management system and enhancing Stone's unique culture.

With that said, operator, can you please open the call up to questions?