Stone Co 2Q23 Earnings Conference Call

August 16, 2023

Operator:

Good evening, everyone. Thank you for standing by. Welcome to the StoneCo second quarter 2023 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, Pedro Zinner, Chief Executive Officer at StoneCo. Please proceed.

Pedro Zinner – Chief Executive Officer

Thank you, operator, and good evening, everyone. Joining me today on the call is our Chief Financial Officer and Investor Relations Officer, Mateus Scherer, our Chief Strategy Officer, Lia Matos and our Head of IR, Roberta Noronha.

I will start today's call by giving you some of my thoughts on the second quarter and then I will turn it over to the team to walk through our results in more detail.

Overall, I was pleased with our performance in the second quarter.

- Externally from a commercial perspective - We generated strong growth by continuing to win in the areas we want to prioritize.

- Internally within the Company - We made progress across a broad range of initiatives to make our services and operations better and more efficient.

- And Financially - we produced results above our expectations, as we continued to ramp up our profitability and accumulated more cash firepower.

As I evaluated the quarter, I also looked at how we performed relative to the priorities we outlined at the beginning of the year.

1. Our first priority was to "Grow with Efficiency". In 2Q, I think we met our objective by generating strong top-line growth with a significant improvement in our profitability. Our total revenue reached R$3.0 billion, an increase of 28% year over year, and exceeding our guidance by 3%. Coupled with the top line improvement, Adjusted EBT surpassed guidance by 19%, reaching R$447 million, - the highest mark for quarterly Adjusted EBT in our history. As a

result, adjusted net income grew 5.8 times year over year, reaching R$322 million, and yielding a net margin of 10.9% in the quarter.

2. Our second priority was to Generate Cash. Adjusted net cash increased R$1.6 billion year over year and R$338 million quarter over quarter, to reach R$4.3 billion. This increase was mostly driven by the consistent cashflow generation of the business, while we continue to invest in client growth and product and technology development.

3. Our third priority consisted on focusing on the Expansion of our Financial Services Business. The Financial Services segment presented healthy TPV and client base growth, and showed improvements in monetization from clients. MSMB TPV increased 19% year over year, to reach R$83.3 billion, despite macroeconomic headwinds in the period from higher interest rates, higher industry delinquency, and declining consumer credit card limits. Our growth in the quarter was 3.7 times the industry growth. It is also important to highlight that during the quarter:

    - We consistently grew our MSMB client base, with 204 thousand net adds,
    - MSMB take rate increased 9 basis points sequentially to reach 2.48%,
    - We have also expanded our banking solutions with the launch of debit cards, and we are now piloting credit cards for Stone clients, and
    - We continued to test our credit product with early results very much in-line with our expectations.

4. Our fourth priority was to evolve our Software Business. After delivering a first quarter below expectations, we were able to improve our Software results. Revenue for this segment reached R$383 million, with a 17% adjusted EBITDA margin, and a 620 basis points improvement on a quarter over quarter basis. I am happy to see that while we are evolving the strategic fit of our software business, we are also capturing short term efficiency gains.

5. Last, but not least, it is also worth highlighting that this quarter we took another important step towards having all the right resources in place to build a “fit for purpose organization”. As announced in May, I would like to formally welcome Mateus Scherer as our CFO and IRO and Roberta Noronha as our Head of Investor Relations. I am very excited to be working with Mateus and Roberta as we set the next stage of growth for the company. I would also like to thank Rafa and Silvio for all the work they have done and to all the invaluable contributions they have made to Stone.

I am also pleased to announce that we are hosting our first StoneCo Day in New York this November. I am excited to share our views on the business and how we are building an end to end value proposition for Brazilian Commerce in the future. As we approach the event, we will share further details with you.

Now I would like to pass it over to Lia, for a discussion on the second quarter 2023 performance and strategic updates. Lia?

Lia Matos – Chief Strategy Officer

Thank you, Pedro and good evening, everyone.

I am going to start with the highlights of our Financial Services segment on page 6.

In 2Q23, revenue in the segment increased 32% year over year, to R$2.6 billion, mainly attributed to the performance in our MSMB client segment. MSMB performance was mostly influenced by above industry TPV growth, higher take rates and an increase in our client base. This, combined with operational leverage realized in our costs and expenses, resulted in adjusted EBT of R$398 million and a 15.6% EBT margin, representing a sequential improvement of 250 basis points.

On slide 7, let's review the MSMB performance in a little bit more detail.

Our payments client base experienced robust growth, reaching approximately 3 million active merchants, an annual increase of 43.3%. Quarter over quarter this represented net additions of 204 thousand active clients. The sequential deceleration in net additions from 1Q23 was driven by the conclusion of targeted marketing campaign efforts within the period.

Through strategic optimization of our Ton and Stone offerings across our sales channels, we successfully sustained the expansion of our client base across all tiers within the MSMB segment.

Moving to slide 8, MSMB TPV increased to R$83.3 billion, a 19.3% year over year growth and 3.7 times above industry growth. Despite being impacted by slower overall industry growth, we are very happy with this result, which was in-line with our 2Q23 guidance and illustrates our strong relative performance and the power of our value proposition and offerings. Looking ahead, we are confident that this relative performance will continue and that we will continue to gain market share in the segment.

Our MSMB take rate also presented notable improvement on a quarterly and yearly basis. This quarter, take rate reached 2.48%, increasing 9 basis points quarter over quarter and 38 basis points year over year. The annual improvement can be attributed to

- Continued adjustments in our commercial policy,
- Stronger growth in our micro and small clients, which have higher take rates,
- The effects of changes in debit and prepaid card interchange cap regulation, which went into effect as of April 2023, and
- Contribution from our banking solutions, mainly floating and PIX revenues.

On slide 9, I give a quick update on Key Accounts TPV. TPV decreased 32.5% year over year, in line with our expectations, due to our de-emphasis of low-margin sub-acquirer volumes. As a result of adjustments in our commercial policy and mixed shift within the segment, Key Accounts' take rate increased 28 basis points year over year.

Now, let's move to the Banking performance on slide 10.

Our banking active client base increased 3.2x year over year and 33.4% quarter over quarter, to reach 1.7 million active merchants. This strong growth was a result of the launch of "Super Conta Ton" in 1Q23 and the continued activation of banking combined with our acquiring solutions for Stone clients.

Total deposits reached R$3.9 billion, slightly up quarter over quarter. This quarter we had a one-time decrease in client deposits of R$286 million as a result of the shift in the chargeback and cancellation collection process for Ton, with no impact to our P&L. Excluding this one-time effect, our overall deposits would have increased 7.8% sequentially, compared to 5.6% growth in our MSMB TPV, which illustrates the increasing engagement with our banking solutions.

Due to the significant increase in banking clients driven primarily by growth in micro client accounts, which generate lower revenue contribution in comparison to SMB clients, ARPAC decreased to R$25 from R$37 in 1Q23 and R$39 in 2Q22.

We strongly believe in the power of combining our banking and acquiring offerings to MSMB clients. As such, we are working hard to enhance existing features and develop and launch new banking products. As an example, this quarter we launched debit cards and have already started piloting credit cards for Stone clients. We are also working to enhance client experience related to the different features that we offer, as well as the integration of our banking to selected ERPs within our software portfolio.

On slide 11, I would like to provide a quick overview of our credit offering.

Through the end of July, we had disbursed R$26 million to around 850 clients, with an outstanding balance of R$23.5 million. The early performance of our vintages is in line with our enhanced credit underwriting standards, with personal guarantees and lien on receivables being executed as expected.

As we have discussed, we will take a conservative and disciplined approach towards the expansion of this solution, growing the portfolio depending on market conditions and taking the necessary time to observe full cohort performances.

Now, let's move to slide 12 and shift to the highlights of our Software business.

In 2Q23, Software revenue increased 9.2% year over year, to reach R$383 million. This growth was driven by continued organic active store expansion in our Core POS and ERP business, mainly in the SMB segment.

Top line grew 6.9% sequentially, mostly due to an increase in set-up revenues in our core segment, related to the client base growth.

Software adjusted EBITDA increased 25.1% year over year, to reach R$66.5 million, which equates to a 17.4% margin and a sequential margin improvement of 620 basis points. The EBITDA margin expansion is a result of

- Higher revenue in the period and
- Operating leverage in costs and expenses, which included a reduction in share-based compensation expenses and lower levels of cost of services, mainly due to increased capitalization of R&D projects.

These effects were partially offset by our continuous investments in our sales team and in marketing, as well as severance costs in the amount of R$6.5 million related to an adjustment made to our organizational structure. In the 2Q23, we reduced headcount associated with our ongoing integration efforts within StoneCo – which should drive additional benefits going forward.

As Pedro mentioned, while we evolve on capturing short term efficiency gains, we are advancing on the strategic fit of software within StoneCo: we have advanced on prioritizing two important verticals for driving financial services and software cross sell while also testing different go to market initiatives.

As we have mentioned, the process of building our end-to-end platform is a multi-year journey, but we believe we are taking the right steps to enhance and sustain our value proposition to our clients in the future.

We expect to provide further details during our StoneCo Day in November.

Now, I want to pass it over to Mateus to discuss some of our key financial metrics. Mateus?

Mateus Scherer – Chief Financial and Investor Relations Officer

Thank you, Lia. I am excited to take on this new role within Stone and look forward to working with the team in building the future of StoneCo together.

Moving to slide 13, let's discuss our costs and expenses, on an adjusted basis.

- Cost of Services reached R$685 million, increasing 9% year on year and decreasing 400 basis points as a percentage of revenue, to reach 23.2%. Compared to the previous quarter, it decreased 5% and 340 basis points as a percentage of revenue. This sequential improvement can be explained by

  - Lower technology expenses, driven by R&D projects' reassessments that led to higher capitalization and a R$21 million non-recurring benefit in the quarter and
  - Change in the allocation of variable compensation between our costs and expenses, which reduced allocation to Cost of Services.
  - I would like to highlight that even if we excluded the unusual positive effect of R$21.0 million from our results, we would still have gained operating leverage in cost of services of 270 basis points compared to the previous quarter.

- Administrative expenses increased 2.5% sequentially, which resulted in a 60 basis points reduction as a percentage of revenue compared to the previous quarter. Important to highlight that Administrative expenses for the 2Q23 are 9% below the levels of the 4Q22, mainly as a result of the efficiency initiatives associated with our Zero Based Budget process. Our expectation is that, from this point onwards, Administrative expenses should grow sequentially broadly in line with inflation, leading to further operating leverage.
- Selling expenses grew 22.6% year on year and 5.6% sequentially, decreasing 50 bps as a percentage of revenue on a quarter on quarter basis. The slight sequential improvement is due to lower marketing investments in the period.
- Financial expenses increased 16.6% quarter on quarter and 240 bps as a percentage of revenue, to reach 35.9%. The increase was driven by three factors:
  - (i) growth in prepaid volumes,
  - (ii) our conservative decision to hold a higher cash balance in the quarter and
  - (iii) a slight increase in the duration of receivables sold.
- Lastly, other expenses decreased 22.2% sequentially and 110 basis points as a percentage of revenue. The variation in other expenses can be mainly attributed to a positive net effect of R$19.6 million in our share-based compensation expenses, primarily due to lower tax provisions.

Moving to slide 14, I would like to talk about our cash generation. Adjusted net Cash increased by R$338 million this quarter to reach R$4.3 billion. The main driver for this was the strong cash flow from our operations, as well as a sequential decrease in capex, as in 1Q23 it was higher than usual due to a specific marketing campaign in the period that drove additional POS inventory. On a year on year basis, Adjusted Net Cash increased R$1.6 billion.

Now, moving to our third quarter 2023 outlook on page 16:

- We expect total Revenue and Income above R$3,075 million in 3Q23, representing a year on year growth above 22.6%.
- For MSMB TPV we expect volumes between R$87.0 and R$88.0 billion in 3Q23 compared with R$74.7 billion in the third quarter of 2022, representing a year on year growth between 16.4% and 17.8%.
- Finally, we expect adjusted EBT of more than R$470 million.

Before jumping to our Q&A, I would like to highlight that this is the last quarter we are providing quarterly guidance, as we will begin to provide a longer-term outlook of our results during StoneCo Day in November.

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