Stone Co 2Q21 Earnings Conference Call
August 30, 2021

Operator:

Good evening, ladies and gentlemen. Thank you for standing by. Welcome to the StoneCo second quarter 2021 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 at www.Stone.co on the Investor Relations section.

Throughout this conference call the Company will be presenting non-IFRS financial information including adjusted net income and adjusted free cash flow. 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 might 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 here today we have Thiago Piau, our CEO, Lia Matos, our COO and Chief Strategy Officer, and Marcelo Baldin, our CFO.

Today, we will present our 2Q21 operational and financial results as well as discuss some recent trends that we are observing. I will pass it over to Thiago so he can share the main highlights of our performance. Thiago?

Thiago Piau – CEO

Thank you, Rafa, and good evening everyone. Thank you for participating in our 2Q earnings call.

The second quarter of 2021 was marked by an acceleration of our core SMB business, an evolution in our strategic roadmap, balanced by a challenging short-term scenario in our credit product.

Our SMB fundamentals are very strong, with accelerating TPV growth and record net addition of clients. The high growth in our SMB segment led us to be the fastest-growing player in the payments industry this quarter, largely driven by over 1 million SMB clients and over 100% SMB TPV growth.

This accelerating growth was achieved with healthy unit economics, with TPV per client and revenue per client, excluding credit, both increasing quarter over quarter. We have been looking more at revenue per client than take rates because we believe this is a metric that better demonstrates our ability to monetize the relationship with our clients. Nevertheless, take rate in SMBs, ex-credit, was stable quarter over quarter at 1.79% compared to 1.80% in 1Q21.

Our TON product has moved from being an experiment and optionality to becoming a proven and high growth solution that added over 140 thousand new clients, 83% more than the previous quarter and over 60% of the net addition of clients of the leading player in the micro merchant space. Our Pagar.me SMB product, which enables clients to accept payments online, is proving the strength of the online opportunity in Brazil, with 93% year over year TPV growth in 2Q21 and a 63% 2-year CAGR, while presenting take rates above 3%.

Also, the engagement of our SMB clients with our financial platform showed a significant improvement in the quarter, with prepaid card TPV, banking money-in and money-out volumes, and total banking accounts balance all growing between 4 and 5.5 times. Besides, the number of Stone SMB clients settling in our digital bank account increased 45% quarter over quarter to 273 thousand clients. The traction we are seeing in our banking transactional volumes, together with the strong growth in number of active accounts, give us confidence to make sizable investments in our digital account infrastructure, as we believe this will be key to improve engagement and the level of satisfaction of our clients.

Our total revenue excluding credit grew by 68% year over year, and the acceleration of our SMB business was the main driver behind such growth. Encouraged by this growth, we have continued to invest in our business to drive further growth in areas such as technology, distribution and customer service operation.

Our consolidated results were significantly impacted by short-term challenges in the credit product, with higher levels of NPLs and decreasing expectations of recovery of non-performing clients than we previously expected. Although we recognize that our underwriting risk capabilities and collection process still have to evolve given the early stage of our credit solution, we are facing an unexpected deterioration of credit collaterals, given the problems associated with the registry of receivables systems. For further details about these short-term challenges, you can refer to our recently released teach-in on August 25th.

As a result of a more uncertain scenario regarding the enforcement of guarantees, we decided to take a cautious approach and stopped disbursements while our team rebuilds our product given the new environment, and we follow the registry of receivables evolution. We have also increased coverage for potential losses and, as a result, our credit product contributed negatively to our reported revenues by R$397 million in the quarter.

Despite these short-term challenges, I want to highlight that our opportunities regarding credit are huge. In the short term, we will continue to serve the working capital needs of our clients through prepayments, which is running smoothly, while we focus on a turnaround of our credit operation as Lia will double click shortly.

In Software, our business continues to show great organic traction. As the deal with Linx closed on July 1st and we started managing the company, we reinforced our beliefs about how valuable the asset is, despite investments needed to enhance the business in the future. Linx is a scarce asset built over decades in which clients are sticky and switching costs are high; the company has an unparalleled level of data from retailers in a very granular way for each one of the verticals, which will enable a more assertive and differentiated offering of financial products in the future. We are pleased to welcome aboard the Linx team this quarter, that has an incredible knowledge about retail and we are excited to work together on this journey onwards. As a reminder, Linx will start being consolidated into our financial results in the 3Q21.

Before I pass it over to Lia, I would like to close with some thoughts regarding how the quarter has helped us to re-enforce our long-term vision:

We recognize that we made mistakes in our execution in credit, especially not foreseeing how the malfunctioning of the registry system could harm our business. However, this situation has also brought an impressive amount of learnings that we will use as fuel to boost the construction of what we envision as being a much better credit solution aimed at serving good merchants better.

We are building our capabilities for the long term and therefore we will continue to expand and enhance our core SMB operations, opening new hubs and improving our execution. We will make significant investments behind our financial platform, which is a huge opportunity, and keep working hard to provide more financial solutions and workflow tools to our clients. We expect to further advance in our partnership with Inter with the ambition of creating more and better buying experiences between Inter consumers and Stone Sellers. Lastly and more important, we keep our devotion to making our clients happy and to the evolution of our team.

We believe that the incredible learnings from this quarter will take us to a new phase of our business and we are even more convinced of the opportunities ahead. When we look backwards it is incredible to see the evolution of our team and of our business, and it makes us confident and eager for the years ahead. We are in the early stages of our journey to become the partner of choice of SMBs in Brazil and will continue to work hard to make sure they can rely on us for their most important financial e technology needs.

With that said, I will pass it over to Lia. Lia?

Lia Matos – COO and Chief Strategy Officer

Thank you, Thiago, and thank everyone for joining us today.

Let me start by talking about the evolution of our core SMB business, which includes the Stone product for brick-and-mortar SMBs, our Pagar.me product that enables SMB clients to sell online and our TON product, focused on micro-merchants. As shown on page 4, while Stone and Pagar.me had their volumes growing almost twofold reaching close to R$38 billion in TPV, TON volumes in the quarter jumped to R$1.5 billion, threefold when compared to the previous quarter and 27 times higher than the previous year. This solid growth in the SMB segment led our company to post the highest TPV growth in the industry this quarter. Since we had a weaker comp in 2Q20 because of lockdowns, we are also showing our SMB 2-year CAGR TPV growth, which accelerated from 42% in 1Q21 to 48% in 2Q21 and 58% in July.

Moving to page 5, we highlight that we have not only grown our SMB client base fast, but we also did so with quality. We have added 188 thousand new active clients in the quarter, with net adds in our Stone and Pagar.me products reaching 47 thousand and our micro merchant solution, TON, adding 140 thousand. The balance of net adds between Stone and TON are a result of our decision to maximize unit economics of clients based on their profile and size, while offering solutions that are best suited for each client segment, as we moved the lower TPV clients demand from Stone to TON product, while the hub operation targeted larger SMBs. As Thiago said, on top of having our historical record net addition of clients, we have also seen increasing average TPV per client in all products within our SMB segment. The average TPV of SMBs ex Micro has grown 29% year over year and 8% quarter over quarter, whereas average TPV of our micro merchant client base has grown 126% year over year and 60% quarter over quarter.

Moving to page 6, we have seen continued penetration and engagement with our financial solutions, especially banking transactional services. The number of active banking clients has increased over 5x when compared to last year and 43% compared to last quarter, reaching 340 thousand clients, with the number of SMB clients in Stone that are settling transactions in Stone account increasing to 273 thousand. With that, the percentage of Stone clients using at least one financial solution increased from 20% last year to 48% in the second quarter 2021.

Banking money-in and money-out volumes in SMBs have surged, increasing 4.4x to R$4.9 billion and 5.5x to R$14.6 billion respectively, while total prepaid card TPV grew 4.4x to R$294 million and total banking accounts balance grew 3.8x to R$862 million.

Now, moving on to slide 7, I want to talk about the short-term challenges we are facing with our credit product. As we have said in the teach-in released last week, the registry of receivables system that was implemented in early June is not yet fully functioning and since then we better understood how relevant the problem of collateral leakage is. As a result of this, we see more uncertainty in the short term in our ability to enforce guarantees of non-performing contracts. This scenario has led us to take a cautious approach and stop disbursements already in June. As you can see in the chart, in July the disbursements were nearly zero, with only few exceptions to test the registry system.

We also made an effort to adapt our credit metrics to more common market standards, as we are presenting here: in the top right of the page, we show that our gross outstanding balance in this new methodology remained flat, due to the combination of lower disbursements and loans repayments from clients.

Even though we had the perspective of lower NPLs and improving recovery rates after the beginning of the new regulatory framework, before the transition we already had provisions for over 100% of the outstanding balance of clients that were not paying us for 60 days or more. However, because of a potential deterioration in the quality of the guarantees given the challenges being faced with the registries, we decided to constitute an even higher reserve to cover not only for the portfolio in which we see no payments for 60 days or more, but for all clients that are not being able to reduce principal for 60 days or more, even though they are still paying interest.

So, looking at the portfolio, we have an outstanding balance of roughly R$2 billion, for which we have constituted bad debt reserves of R$781mm. These reserves represent a coverage of 209% for clients with more than 60 days without payments and 112% for clients not amortizing principal for 60 days or more.

The overall scenario in credit has led us to make an adjustment in the fair value of our portfolio which negatively impacted our revenues by R$397mm this quarter. Despite the worse than expected performance, we have received over 100% of the disbursed amounts from 4Q19 and 1H20 cohorts, as shown in the presentation.

From now on, we will treat this legacy portfolio separately from new disbursements, so we can properly track the performance of each of them.

Moving to slide 8, as Thiago already mentioned, I want to do a quick recap of our vision, comment about recent learnings and what we are doing differently in order to have a more robust credit product. As we previously indicated, our vision for what we call internally as "Stone Capital", is to build an asset-light model, in which funding and underwriting risk for credit stays with multiple partners. Our product has to be easy to sign-up to, completely embedded in our core financial platform and SMB operation, rates must be attractive and simple to understand and reconcile, repayment should be aligned with our client's cash flows and for better clients we should present better conditions. Although we recognize that we have to work around the risk associated with our credit product, many of the features mentioned above we already built and we understand that the opportunity to offer working capital solutions to SMBs is huge. The new receivables registry system will be transformational for Brazil and, when it is fully operational, it will create the basis for a much bigger market for collateralized credit. In this process, we believe that merchants' data will be key and our software business gives us an edge for the future.

Even though our credit solution was developed during a period with significant negative external factors such as the lockdowns brought by the pandemic and the short-term problems with the transition to the new regulatory framework, we also had many learnings in this process. First, we developed a product with the assumption of a functioning registry system, which is yet to occur. Second, our previous assumption regarding recovery of non-performing contracts was higher than observed in 2Q21, influenced by how relevant the problem of collateral leakage is. Finally, we also made in 2019 the decision to use the fair value methodology when accounting for credit results, which although is an IFRS standard, brings a lot of volatility and creates more management complexity.

We are working very hard to address all these points and have already taken some important steps. We brought in 2021 a more experienced team to improve our credit scoring model, risk management and funding capabilities. We are also enhancing policies and processes to improve underwriting risk through a broader set of collaterals, access guarantees that were contractually given to us and enhance our recovery process and re-negotiation capabilities. Starting in the 3Q21, new credit contracts will be accounted for on an accrual basis. We are also exploring new partnerships to enable the asset light model we envision.

Now, moving on to page 9, we highlight the performance and strategic roadmap of our software business. We are happy with the advancements we've made in the quarter and really excited for what lies ahead, not only because our solutions continued to grow at a strong pace but especially due to the conclusion of the Linx acquisition, which will be consolidated into our results from 3Q21 onwards.

Pro-forma software revenue increased three-fold to R$62.4 million in the quarter, which organically represents a 52.5% growth. With Linx, pro-forma revenue would have grown 31% to R$305 million, reaching over R$1.2 billion annualized software revenues. The number of subscribed clients in our software portfolio in 2Q21 grew four-fold to 143 thousand while Linx reached 72 thousand software clients, a 13% growth.

In page 10, we talk about our current focus and priorities in Linx.

As Thiago mentioned, as the deal closed on July 1st and we started managing the company, we reinforced our beliefs about how valuable the asset is: First, a profound knowledge of how retail operates in Brazil, and products that have deep integrations to retail workflows, giving stickiness and high switching costs to the business, as well as very low churn ratios. Second, the unparalleled level of data from retailers in each vertical will give us an edge in the future in terms of more differentiated financial offerings. These strengths of Linx made the company increase net revenues by 13% year over year in the second quarter, despite the noise related to the delay in the approval of the acquisition that took almost one year to occur.

Today, we have five main priorities regarding Linx:

- First, to migrate Linx Pay to the Stone Platform and create offers to further penetrate financial products to Linx's client base;
- Second, invest in technology capabilities to enhance the existing platform, aiming to improve client satisfaction and achieve scale in the SMB market;
- Third, to build the infrastructure and tools to enable merchants to have a multi-channel storefront, selling their products seamlessly across multiple channels, online and offline;
- Fourth, to build a data management architecture that enables us to create new financial and technology products; and
- Lastly, capture synergies and cost efficiencies.

On page 11, we give a quick update on our Key Accounts business. We saw two different growth dynamics within this client segment in the second quarter. First, we saw low growth in sub acquirer volumes, which present more volatility and lower unit economics. On the other hand, our Platform clients, to whom we can offer value-added services that result in better unit economics, grew its volumes by 62% in the quarter. These platform clients encompass a wide range of business models, including marketplaces, e-commerce platforms, software companies and omnichannel retailers, and are the strategic focus in our Key Accounts business.

It is important to note that although we serve sub acquirers because of incremental contributions, these clients are less strategic. As an example, our top two sub acquirers only represent approximately 3% of our consolidated revenue net of funding costs, and we expect this number to decrease in the future.

On page 12, we bring an update on our strategic investment and partnership with Inter. We are very excited to work closely with Inter´s team to advance on our four main value creation drivers, which were mentioned in our 1Q21 earnings call.

- First, we have three main focuses: (i) to integrate Linx's platforms on Intershop, enabling Linx clients inventory to be sold through Intershop digital channel, enabling an omnichannel purchase journey to Inter Consumers. (ii) help Intershop to serve non-account clients leveraging Stone Payments and Risk management platforms. (iii) Help do digitize Stone and Linx food service clients through Intershop.
- Second, we see an opportunity to create a data architecture that will enrich both consumer and seller ecosystems and, through targeted offerings and incentives, help drive more buying experiences between Inter consumers and StoneCo sellers
- Third we are jointly working to offer credit and working capital solutions to StoneCo and Inter client base, as well as exploring cross selling opportunities to strengthen both ecosystems.
- Lastly, we have finalized initial funding agreements and are further exploring opportunities to leverage Inter's retail distribution for Stone funding capabilities

With that, I will pass it over to Rafael, who will discuss our financial results in more detail. Rafa?

Rafael Martins – VP of Finance and Investor Relations Officer

Thanks, Lia. Despite the short-term headwinds with the credit product that we previously discussed, we remained focused on the long-term, investing heavily for growth.

As shown on page 13, we increased our investments by approximately R$ 180 million when compared to the same period last year, with our marketing investments growing over 230%, salesforce headcount almost doubling, technology headcount increasing over 90% and our customer service and logistics personnel growing 88%.

In slide 14 we can see that our underlying business remains strong, with a 45% client base growth excluding TON, reaching 766.5 thousand clients, while TON increased its client base by 9.4x, to 330 thousand clients. The growth in client base was accompanied by an increase in average TPV in SMBs, which resulted in StoneCo presenting a 58.6% TPV growth to R$ 60.4 bn or R$ 58.6 bn, when excluding Coronavoucher volumes.

Our total revenue and income was R$ 613.4 million in the second quarter, representing a 8.1% decrease when compared to last year. The lower figure is primarily driven by a negative contribution of R$397 million from our credit product.

Moving to slide 15, we can see that our operating leverage was strongly impacted by the negative effect in revenue from credit and our decision to keep investing heavily in our business to support long-term growth. Also, financial expenses increased as a percentage of total revenue and income due to a higher CDI in Brazil.

Now, going into more detail on each P&L line item on page 16, our revenue from transaction activities grew 57.9%, driven largely by the strong TPV growth in SMBs. Revenue from subscription services and equipment rental also presented strong results, growing 90.1% when compared to last year, driven by both an increase in our software revenue and a significantly larger Stone SMBs client base. Our Financial Income, which combines the revenue from prepayment and the credit products, was affected by the negative result of the credit product of minus R$397.2 million as a result of the increase in provisions for expected losses in credit and ended up decreasing 87.7% to R$ 40.0 million in the quarter. Excluding revenues from the credit product, our financial income would have grown 67% YoY, demonstrating the strength of our pre-payment operation.

Our Cost of Services were R$302.4 million this quarter, 52.2% higher than the previous year. This increase was mainly due to higher investments in our technology and customer support teams and higher investment in TAG, as well as higher costs related to depreciation of POSs.

Administrative expenses were R$121.8 million, 35.5% higher than last year due to higher third-party services, mainly expenses with software services, higher D&A expenses, especially due to amortization of fair value adjustment on intangibles related to acquisitions, and higher travel expenses. Compared with the previous quarter, administrative expenses were 3.6% higher.

Selling Expenses were R$223.2 million in the quarter, an increase of 94.6% year over year, mostly as a result of higher marketing investments, mainly in TON and investments in hiring of salespeople. Compared with the first quarter of 2021, Selling Expenses increased by 37.1%, mostly due to the same reasons that I just mentioned.

Financial Expenses were R$157.6 million, 151.8% higher than the previous year, mainly due to the higher outstanding volumes of prepayment and credit and higher cost of funds, mostly due to the higher and increasing base rate in Brazil.

Other Income, net, was positive by R$777.0 million, mainly related to a mark-to-market gain of R$841.2 million related to our investment in Inter. Excluding this effect, Other Income was negative R$64.2 million, 60.2% higher year over year, mostly explained by share-based compensation expenses and issuance fees regarding the USD 500 million bond offering that was successfully concluded in June.

Finally, moving to slide 17, we show that our business excluding the credit product continues to grow at a strong pace: Total Revenue and Income grew by 68% YoY, with take rates and earnings before taxes also increasing rapidly on an yearly basis.

Before we start the Q&A, I would like to revisit our outlook for the year. Given the short-term challenges in credit, we decided to suspend previous guidance of take rate and adjusted net margin for 2021. We are keeping our guidance of active client base between 1.4 million and 1.5 million clients including TON and approximately 950 thousand clients excluding TON. It is important to highlight that Linx will be fully consolidated from 3Q21 onwards.

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