Stone Co 3Q20 Earnings Conference Call
October 29, 2020

Operator:

Good evening, ladies and gentlemen. Thank you for standing by. Welcome to the StoneCo third quarter 2020 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, Investor Relations Executive Officer at Stone. Please proceed.

Rafael Martins - *Investor Relations Executive Officer*

Thank you, operator and good evening everyone. Joining us here we have Thiago Piau, our CEO, Lia Matos, our COO and Chief Strategy Officer, and Marcelo Baldin, our CFO.

On today´s call, we will present our operational and financial results for the third quarter 2020 and we will be available for Q&A after our prepared remarks. I will pass it over to Thiago so he can share with you the main highlights of our performance and discuss the strategic direction we are heading to. Thiago?

Thiago Piau – *Chief Executive Officer*

Thank you, Rafa and thank you all for joining us today. Let me quickly share some thoughts here before we start this presentation.

First, I would like to say that I am very proud of our team that was able to adapt quickly to this new reality brought by the Covid-19 outbreak, never losing focus on the most important things for us, our clients, our people and our results. This was the toughest quarter ever in terms of execution and I think that the team surprised again with an amazing work, both in terms of organic execution and strategic evolution.

We run our business based on our strong culture, with a team of entrepreneurs who aim to change our clients' reality with better products and superior services.

By (i) having focus and a clear strategic direction, (ii) giving autonomy to this big pool of talents in whom we trust and (iii) implementing a robust management system focused on technology and execution, we were able to post a strong result in our core business while seeing powerful traction of new initiatives, such as banking, credit, software and TON. These areas, which are currently in different maturity stages in terms of their roadmap, enhance our ecosystem and are already contributing to our results.

In fact, in the past three months, TPV growth accelerated to more than 113%, with strong net addition of clients and advancements on the penetration of new solutions, resulting in record TPV, revenue and adjusted net income for a single quarter in our history.

Even though we are happy with our growth trajectory we think that we are still far from our potential and therefore we will keep investing heavily on technology, team development and channel distribution as we see ourselves still in the early days of our business.

We will keep running our business with a young, fast and small company mentality where we are passionate about customers and obsessed about details even though we already have some scale. We will continue betting on operational leverage, discipline capital allocation and people development.

Now, moving to the presentation, I would like to start on page 3 with some highlights. As we indicated in the last earnings call, the client base had a strong bounce back, with more than 63 thousand clients being added in the quarter, a number 26% higher than 1Q20. Our strong performance across segments led to a record TPV growth in the quarter, with nearly 70 billion reais being processed by Stone, representing 114% annual growth. This includes over 20 billion reais in Coronavoucher, the government's temporary financial aid to mitigate the impacts of the COVID-19, which we process mainly through our fintech-as-a-service strategy. When we exclude the Coronavoucher volumes, TPV growth accelerated, posting 48% in the quarter and 52% in September, taking us back to pre-covid growth levels.

This strong volume was followed by a substantial monetization, with an increasing quarter over quarter take rate of 1.76%, when we exclude the direct impact of the Coronavouchers, and 1.30% for the reported take rate. The combination of high volumes with healthy take rates generated a record total revenue and income of R$934mm, representing a 46% growth when we exclude other financial income, which is mainly yield on cash.

Aiming to balance our long-term growth and profitability, we increased investments in the quarter while experiencing operating leverage, which brought our adjusted net margins back to pre-covid levels, at nearly 31%, generating nearly 288 million reais in adjusted net income.

Our brick and mortar SMB operations posted a sharp recovery, with TPV growing 48% against the previous quarter and a strong penetration of additional financial solutions. We are quickly advancing in creating our complete financial platform to replace our clients' traditional banking relationships. In September, we reached more than 357 thousand digital accounts, a 44% growth against last quarter. We also celebrated an important milestone in our credit product, which reached more than 1 billion reais in total outstanding balance, counting with healthy ROA and controlled delinquency rates.

As we mentioned in the 1Q20 earnings call, we are very well positioned to help our clients with the digitization trend, which accelerated this year. Our online TPV growth jumped to 575% this quarter, with a combination of strong cohort economics from the digital SMBs and our fintech-as-a-service platform, which counted with a tailwind from coronavoucher.

On the software front, we reached more than 340,000 subscribed clients in the quarter, with over 20% organic growth against last quarter. In addition to that, in October we invested in Questor, an ERP for accounting offices and SMBs, which brings around 6,000 clients to our base and expands our ecosystem with ERP accounting capabilities. Regarding the Linx acquisition, Linx shareholders' meeting to vote on our transaction is scheduled for November 17th, and we are very confident we have the best proposal, bringing the best outcome for Linx´s clients, team and shareholders.

TON, our solution for micro-merchants increased its client base nearly 85% quarter over quarter, reaching 65,000 clients. It is important to remember here that we are reporting TON´s client base separately and these clients are not accounted for in our active client base of 583,000 clients in acquiring. We are increasing investment in this new venture, aiming to have a complete platform to meet the needs of this specific clients with an outstanding service level backed by technology and self-service.

With the strong growth pace in our core businesses and the accelerated ramp-up of our new solutions, we are continuing our hiring activity in Q4 2020, strengthening our team in several areas, including sales and technology. For that, we are happy to count with a vast talent pool brought by over 100,000 applications for the *Recruta* program this year, our largest recruiting process, which aims to find the best talents in Brazil to work in different areas of the company.

Now, let´s move to page 4. We are building three highly synergistic platforms under the StoneCo umbrella:

- The first is a financial platform for SMBs, which we are building with the hubs, our ABC platform and our incredible customer service. Here, we aim to replace merchant´s existing relationships with their banks, offering a full financial service platform with local presence, the best customer service and an amazing user experience.

- The second is a fintech-as-a-service platform, where everything we offer for SMBs as a product, we offered as a service in an open platform with simple APIs to digital clients, large accounts, marketplaces, wallets, sub-acquirers and software partners.

- The third is a new strategic front, where we are building a full-commerce platform available to merchants of all sizes, both for traditional retailers in the offline world who want to digitize their businesses and for digital-native players who want to quickly scale their businesses based on our software platform. We believe that the investment in Linx is the best foot forward in this third asset.

Although we see a lot of synergies between the platforms, they will have full independence, with merchants being able to use them separately, integrated with 3rd party partners if they want or to choose our combined solutions, with better value proposition.

As shown on page 5, the company posted a V-shaped recovery in the third quarter, driven by continuing economic recovery and strong execution. Our overall TPV grew almost 114%, and even excluding coronavoucher´s direct impact, we had higher growth levels than in the first quarter of the year. Also, when we exclude Coronavoucher´s impact, we see the growth accelerating every month since April, from 9% to more than 52% in September.

This robust growth is reflected in our record quarterly total revenue and income and adjusted net income, with margins bouncing back to 31%, a level that enables us to continue to invest heavily on growth.

Now, with that said, I will pass it over to Lia so she can discuss our strategic evolution and key priorities. Lia?

Lia Matos – *COO and Chief Strategy Officer*

Thanks, Thiago and good evening, everyone. Thanks for joining us today.

Let me start with the evolution of our financial platform for SMBs on page 6. Our client base is back to a healthy growth level, even excluding TON, with 26% more net adds when compared to the 1Q20. Looking at TPV, our growth was not only higher than in the first quarter, but also accelerated every month from April to September, when it reached 52%.

As Thiago mentioned, we continue to foster a long-term relationship with our brick and mortar SMB clients, helping them to manage their business and sell more. For that, we recently began to scale our new financial solutions. The graph on the right side of the page shows that the percentage of clients using more than payments jumped from 12% in January to 27% in September by either taking credit, being an active user of our digital banking account or both. The successful penetration of new solutions is driving a positive impact on monetization, and, despite the COVID-19 effects, we are seeing take rates in the hubs going up again.

We see plenty of opportunities to upsell our new solutions to SMB clients by offering the best customer service and simple, intuitive products at fair prices.

As we show on page 7, a huge step forward in this direction will be the full launch of our ABC platform in the fourth quarter, when we expect to migrate all our SMB clients to the platform. With this, our clients will have access to a comprehensive set of financial services through a single integrated experience, including all payments methods, prepayments, credit, wire transfers, *boleto* issuance and bill payments, pre-paid cards, payment links and a virtual shop. We will also enable our clients to accept PIX transactions directly on the POS, using a dynamic QR code, bringing more security and convenience to retailers.

Moving to page 8, we show our banking platform's fast ramp-up, with the number of digital accounts jumping to 357 thousand clients, nearly three times more than 1Q20, including over 88,000 merchants receiving their sales directly into a Stone digital account. In addition, due to a combination of the high engagement of digital banking clients and the initial strong traction of our fintech-as-a service platform, the number of transactions increased eightfold, with revenues jumping approximately 370% in the quarter when compared to 2Q20.

Slide 9 shows the evolution of our credit solution, which achieved a significant milestone last quarter, surpassing over 1 billion reais in total outstanding volume. More than 73,000 merchants now use these working capital loans, which they seamlessly pay by deducting a small percentage of their sales every day. Our product remains fairly conservative with a small duration of seven months and an average ticket for new loans of 19,000 reais, the equivalent of roughly a month of their TPV. We remain very focused on balancing risk and profitability, which is reflected in our relatively stable ROA and low expected losses, despite the COVID-19 impacts.

We see a huge opportunity ahead of us, and we will leverage our distribution and proprietary credit scoring model to continue to serve merchants with our working capital solutions. Also, as we have already indicated, in the coming months this operation will start to be funded with third-party capital through a FIDC structure which will allow us to limit our credit exposure while maintaining good economics.

Moving on to page 10, we show the traction of our TON initiative, our new venture to serve micro-merchants and autonomous workers. In the third quarter, we reaccelerated investments in marketing campaigns for the product, and we saw the client base grow nearly 85% quarter over quarter, reaching 65,000 clients at the end of September. The Compound Monthly Growth Rate for TPV from April to September was 40%, which shows the product's strong initial traction.

Now I want to talk a little bit about the evolution of our fintech-as-a-service business. In page 11, we illustrate the current and future capabilities of our platform and how we serve different types of clients offering financial services according to their business model needs.

First, let´s talk about the digital SMBs. Here, we enable payments as a feature embedded in commerce platforms. With a very easy setup, clients can start selling with complete abstraction of the complexity of managing online payments.

Secondly, we serve more digitally mature merchants that look for increased conversion rates through a direct integration with our platform and need the ability to customize the functionalities according to their needs. Through our APIs, it is easy for them to connect and access the features of our platform such as authorization re-trials, split payments, prepayments, chargeback disputes, reconciliation, antifraud and analytics. The combination of the capabilities of our platform enable such large clients to greatly streamline the way they manage their financial services operations, improving their productivity.

Lastly, we enable tech companies such as marketplaces, subacquirers, wallets and fintechs in general, to provide financial services to their own clients as part of their product offering in a white label manner, such as a branded POS device, white label digital account, prepayment services to their clients, among other services, which can all be achieved through simple API integrations.

The capabilities of our platform result in improved conversion rates, high availability and a complete suite of services which, simply put, leads to increase our client's sales and success. We continue to work hard in evolving our platform to serve the evolving needs of our clients.

On page 12, we show some highlights of the results of our fintech-as-a-service business. Our online TPV jumped nearly 575% in the quarter, growing four times more than the previous quarter. There was a powerful contribution from coronavouchers volumes processed through our platform for different integrated partners such as wallets and sub-acquirers. However, even excluding the government´s program's impact, volumes grew above 76% in the quarter, four times more than the growth experienced in the 1Q20.

As we have just indicated, our digital solutions are not exclusive for large or more digitally mature players. Our platform also offers simple features to connect small e-commerces, social sellers, and brick-and-mortar SMB clients to the digital world. As the graph on the right side of the page shows, our digital SMB cohorts represent high revenue retention which speaks to the power of our business model, allowing us to grow as our clients grow and mature.

On page 13, we show our evolution in software. As you can see, in the third quarter we had strong, fully organic growth in our software client base, which increased more than 20% when compared to the previous quarter, reaching over 340,000 subscribed clients. We remain focused on helping our merchants digitize their businesses. For instance, the number of posts in our social media management solution, mLabs, grew more than 160% in just one year, reaching over fifty billion post impressions through the platform per month.

Lastly, on top of the organic growth, we are happy to welcome a new company to our ecosystem, bringing new solutions and more entrepreneurs. Questor is an ERP for accounting offices and SMBs. Their accounting clients serve more than 450,000 businesses across the whole country and process 1.5 million individual paychecks monthly.

With this strategic update I will pass it over to Rafael, who will discuss our financial results in detail. Rafa?

Rafael Martins - *Investor Relations Executive Officer*

Thank you, Lia. Starting with slide 14, we present our top-line evolution in the quarter. We reached 583,000 clients, excluding TON, mainly due to the strong performance in the hubs. With our brick and mortar SMB operation showing promising trends and additional investments to grow, we do expect to keep a strong net addition of clients at the end of the year, despite the seasonal effects, accelerating in 2021.

Our TPV grew 114% in 3Q20 compared to last year, reaching 69.7 billion reais. There is a significant contribution of 21.6 billion reais here of Coronavoucher volumes. Coronavoucher is a government financial aid program targeting the most vulnerable part of the population as autonomous and informal workers and people without income. Those individuals receive the amounts in a prepaid card and many of them used the card to transfer money to different digital wallets and to buy goods. So, when those digital wallets use Stone fintech-as-a service platform to process the cash-in transactions, we capture the related TPV.

If we consider only volumes apart from Coronavoucher, TPV was R$48.1 billion in the quarter, nearly 20% higher than our highest historical quarterly TPV, which had been reached in 4Q19, a seasonally stronger quarter.

Total Revenue and Income was R$934 million in the third quarter, a 39% increase year on year. Excluding Other Financial Income, which mainly comprises interest on cash, Total Revenue and Income grew 45.5% year over year.

As shown in slide 15, the massive TPV brought by the coronavouchers led to a reported take rate of 1.30% in the quarter. However, the take rate in the hubs continued to increase, contributing an additional 4bps in the take rate this quarter, resulting in a 1.76% take rate excluding the effect of coronavouchers volumes, a 2bps increase from last quarter comparable metric.

Moving to slide 16, we show our consolidated P&L and on slide 17, the evolution of our operating leverage and profitability. This quarter, we experienced a significant increase in our operational leverage, reaching record adjusted net income of 287.9 million reais. In addition to the usual adjustments in the net income related mainly to the share-based compensation program launched at the IPO, this quarter we included a R$13.5 mm effect related to Linx M&A expenses and present value adjustments related to earn-out of companies we have invested in.

Our operating costs and expenses decreased by nearly 12 percentage points from last quarter, representing 48.6% of our total revenue and income. Financial expenses declined from 9.4% to 6.9% of total revenue and income, mainly as a result of the lower base interest rate and higher efficiency.

This combination resulted in a sharp increase in our adjusted net margin, which went from 22.5% last quarter to 30.8% this quarter, and our adjusted pre-tax margin, which recovered from 29.9% in the previous quarter to 45.2% this quarter.

Now, going over in more detail to each P&L item, our Cost of Services reached 208.1 million reais or 22.3% of Total Revenue and Income in the quarter, increasing 5.5 percentage points when compared to last year. This increase was mainly due to i) higher provisions and losses, which does not include provisions for delinquency related to our credit product, ii) significant investments in technology and customer service, iii) higher card brand fees, and iv) variable compensation.

Compared to previous quarter, Cost of Services as a percentage of revenue decreased 7.5 percentage points, primarily because of i) a lower depreciation expense due to a change in the POS depreciation period from 3 years with a residual value of 30% to 5 years, with no residual value, ii) lower provisions and losses, iii) gains of scale in transaction costs, and iv) lower brand fees.

Administrative Expenses were R$106.2 million, or 11.4% of Total Revenue and Income, 0.8 percentage points higher than the prior-year period, mostly due to higher third-party services and higher personnel expenses.

Selling Expenses were R$139.5 million in the quarter, an increase of 37.3% versus last year, mainly due to higher investments in TON and variable compensation. Compared to last quarter, the line presented a 2.2 percentage points operating leverage, mostly explained by a lower average number of salespeople and severance costs accounted for in the second quarter of 2020, which were partially compensated by higher marketing investments in TON.

Financial Expenses were R$64.7 million, a decrease of 36.1%, compared with the third quarter of 2019, mainly due to the lower CDI rate, which more than compensated for the significantly higher volumes in the quarter.

Finally, on slide 18, we show our adjusted free cash flow, which was 288.6 million reais in the third quarter, over seven times our 3Q19 figure, mainly driven by a higher adjusted net income and better working capital.

With that said, operator, please open the call up to questions.