Stone Co 3Q21 Earnings Conference Call
November 16, 2021

Operator:

Good evening, ladies and gentlemen. Thank you for standing by. Welcome to the StoneCo third 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, Chief Strategy Officer, and Marcelo Baldin, our CFO.

Today, we will present our 3Q21 operational and financial results as well as discuss some recent trends that we are observing. Now, 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.

As we start a new phase of our business with the full integration of Linx and as we complete 3 years as a public company, I want to start on page 1 by talking about what motivates us to work hard every day, which is our purpose.

Our purpose is to serve the Brazilian Entrepreneur, transforming their dreams into results. In our point of view, any person who wakes up every morning to build or run a business is an entrepreneur. We want to help them think bigger and turn their dreams into business results, by serving them with excellence and helping their business to thrive.

We believe that serving entrepreneurs is the best way we can positively impact Brazilian society. We want to do this by promoting fair financial relationships, enhancing business productivity, and providing more sales options. We aspire to be a positive force to transform the retail and financial industry through more balanced relationships.

To achieve our goals, we decided to build the best financial operating system for Brazilian entrepreneurs. Since our early beginnings, we have always strived to build our business around merchants. This has motivated us to build the hyper-local distribution that enabled us to be closer to our clients, the proprietary technology that provides cost efficiencies and the reliability that our clients want, and the best customer service in our industry.

With the acquisition of Linx and our current set of solutions for multiple retail verticals, we seek to build the best workflow tools to generate efficiency for our merchants and help them sell more through multiple channels. We are only at the beginning of our journey in combining software and financial services to bring even more tangible results to our clients, and we are really excited with the opportunities ahead.

On page 2, we show that at the end of the third quarter, our consolidated TPV reached R$75 billion, representing a 54% year over year growth and a 26% quarter-over-quarter growth when excluding coronavoucher volumes. More importantly, our Active Client Base increased twofold when compared to last year, reaching 1.4 million clients, driven by our record-high net addition of clients in quarter, of 294 thousand. The number of Active Digital Banking accounts grew at an even faster pace, surpassing 420 thousand in the quarter.

In software, with the inclusion of Linx, we had over 200 thousand clients using at least one of our solutions, with annualized revenues close to R$1.3 billion, up 17 times year over year. Even more encouraging, the retention rate at Linx Core stayed at high levels, of 99%.

Now Moving to page 3, we show that TPV growth was primarily driven by the MSMB operation, which is the combination of micro and SMB operations. The MSMB TPV grew at a 2-year CAGR of 61% in the third quarter, accelerating from 48% in the second quarter and 42% in the first quarter. While the more mature SMB operation was able to grow TPV over 70%, the micro merchants' volume surged to R$3.4 billion in the quarter, nearly 23 times higher than the previous year.

On page 4 we show that the consolidated net adds in MSMBs also accelerated to approximately 290 thousand in the quarter and as a result we reached over 1.3 million active payment clients, over 2 times higher than last year and 3.3 times higher than two years ago. We also posted record-high net adds when excluding the micro segment, with over 80 thousand, of which approximately 77 thousand in MSMB segment, representing an 82% growth quarter over quarter.

As Lia will detail further in the presentation, we balanced this accelerated growth with solid unit economics. We reduced client acquisition costs, improved the average revenue per merchant both in SMBs and micro and kept payback periods under control, ranging from 11 to 15 months.

Before I pass it over to Lia, I want to recap our main strategic movements and what lies ahead. As we indicated in the beginning of the year, we will keep investing heavily in our engineering, sales, marketing, and operational teams to expand our capabilities and deliver on our purpose. In the third quarter, we significantly increased the level of investments in our business. We have invested approximately R$120 million more opex in the growth of our operation and in new businesses when compared with the third quarter of 2020. This, combined with higher interest rates, impacted our margins and even though we started to reprice clients, managing our payback strategy with discipline, we are doing this in a way that we keep good levels of growth and don´t jeopardize our relationship with our merchants, which is the most important thing given the opportunities we have.

Looking ahead, we see several avenues of growth that reinforce each other to create more value to clients with good unit economics:

- We still see a big room to expand our MSMB client base, given that we estimate there is over 8 million SMBs and over 20 million Micro clients in Brazil;
- Our ability to grow active base compounds with the potential to increase revenue per merchant over time by offering additional solutions to our clients;
- In credit, we envision three products to attend to different client needs: our current credit product that we are turning around, credit card, and overdraft. We continue focused on engineering, improvement of our operation and strengthening of the team. We'll start testing the credit in small scale shortly. Additionally, I would like to welcome the team of Gyra+, a recent investment that we expect to close in the fourth quarter.
- We see the software opportunity in SMBs at the very beginning: our footprint and distribution, combined with vertical knowledge and integration capabilities provide the building blocks to our vision of software and integrated financial services in the SMB space.
- When we look at Linx' clients, they have approximately R$350 billion in annualized GMV and we monetize only 0.3% of such value. Also, those clients have approximately R$200 billion in annual TPV and mid-single digits penetration with our payment solutions. We see plenty of room to grow organically in current verticals, expand vertical coverage through new investments, further help our clients with integrated financial services offers and with products to help them sell more through multiple channels.

Lastly, we will always keep our eyes on the long-term opportunities, building a humble organization, eager to learn, devoted to serve our clients in the best way we can envision, and helping the team to reach its full potential through an ownership mentality.

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

Lia Matos – Chief Strategy Officer

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

I want to start on page 5 talking about growth and engagement with our financial operating system. Active banking client base increased over 4-fold when compared to last year, reaching approximately 423 thousand clients, with the number of SMB clients who are settling transactions in the Stone account reaching 320 thousand. We also saw main engagements metrics improving on a quarterly and yearly basis, such as total accounts balance, which reached over 1 billion reais at the end of the quarter, a threefold increase year over year.

Net cash inflow from the legacy credit product in the third quarter was R$483 million, which reduced the credit portfolio to approximately R$1.6 billion from R$2.0 billion in the previous quarter. The coverage ratio remained above 100% and our legacy credit portfolio is performing as expected.

This quarter, we have shifted most of the focus in the credit business to building the team, engineering capabilities and operation so we can resume credit offering to our clients. we envision building 3 credit solutions, based on their most important business needs.

i. First, we are turning around our credit product by implementing improvements to our original short-term loan so we can carefully move forward in test mode, even with the registry system not working as expected. Such improvements are: (i) inclusion of personal guarantee from business owners and other businesses they may have, (ii) a better risk scoring through additional data, (iii) implementing minimum and maximum monthly payments (to facilitate early signs of default while providing more flexibility on payment terms), (iv) improving the product so that clients better understand impacts on their future cash flows and lastly (v) enhancing our early renegotiation capabilities
ii. Also, we are working to launch two shorter term, lower ticket products: first, credit cards, which will provide our clients with a credit limit to use on day-to-day business expenses. Second, Overdraft, giving our clients the convenience when they need to pay for unexpected or emergency expenses and their cashflows are not enough to meet those needs.

As a step towards strengthening our team, we are really happy to welcome the team of Gyra+, a data-driven SME lender which operates under a fee based, asset light approach.

We plan to initiate a testing phase in small scale with short-term loans, between the 4Q21 and 1Q22, with focus driven towards getting feedback for engineering and improvement of the operation.

Our insurance solution, though still in pilot mode, is showing encouraging initial results, with 14,500 active contracts - in which we earn a fee without underwriting risk. Merchants, their families and employees have multiple insurance needs, and we are working to provide them superior financial protection. This is another important step towards our goal to be the best financial operating system for Brazilian merchants.

On slides 6, 7 and 8 I will provide more color on unit economics and monetization opportunities we see ahead.

In slide 6, we show that we have been able to accelerate TPV growth and net addition of clients in the MSMB segment while keeping healthy levels of monetization. Average revenue per merchant in SMBs is around R$365, while in micro is R$117, showing improvements compared to last year. We also improved overall acquisition costs, with CAC roughly stable for SMBs' and 17% lower for micro-merchants, and maintained a stable operational cost to serve, but with higher funding costs. As a net result, the payback periods for new cohorts has ranged between 11 and 15 months. Due to the increase in the Brazilian base rate experienced throughout past quarters, we have started to adjust our commercial policies to the new interest rate environment.

In slide 7, we show that, in banking, we have been able to not only grow client base, but also improve monetization for each client. Banking number of clients increased fourfold and ARPU improved over 30% year over year in the quarter. The insurance product, which is still in pilot mode, also improved ARPU since its inception.

In slide 8 we want to show the rationale behind our investments in growth. Taking a broader look at the monetization opportunity in SMB merchants, we see that the average revenue per merchant that use payments is R$ 340, and when they use our banking product with a prepaid card, they generate an additional $30 monthly; If they decide to use the protection of life and business insurance, they generate an additional $40 monthly. Clients that have fully paid down their loans with us have generated a monthly revenue of R$327 when we look on an accrual basis. Lastly, the average monthly subscription for SMB clients currently using our POS and ERP solutions is R$160.

In page 9 we give a quick update on our Key Accounts business, which grew volumes by 10.5% backed by two different underlying trends. First, sub acquirer volumes, which continue to decrease share in overall volumes and revenues, decreased when compared to last year. Currently, our top two sub acquirers represented only around 1% of our revenue net of funding costs, down from approximately 3% in the previous quarter.

Conversely, platform services increased volumes by 55% and currently represent around 60% of Key Accounts' revenue. Here, we enable third party software providers and platforms to embed payments and financial services through API integrations.

In slide 10 I want to shift to talk about our software business. In the 3Q21, our consolidated software revenue was R$314.8 million with 200 thousand software clients. Revenue was 17x higher than 3Q20 or 27.5% higher on a proforma basis, considering Linx. Linx's recurring revenue grew 15.5% in the quarter, with core POS/ERP solutions increasing 21.2%, driven by both higher average tickets and an increase in the number of stores served. The consolidated software revenue from our portfolio ex-Linx, which encompasses 10 companies, grew 182% year over year to R$53.1 million.

On page 11, we give an update on Linx integration and our priorities ahead. This quarter we executed the new leadership organization, the integration of main back-office functions, especially Finance; migrated half of Linx Pay subacquirer clients, with approximately 80% having already opted-in and we plan to conclude this process by year-end;

We are now shifting focus to capturing the growth opportunities we see ahead and prioritize execution within different parts of the business.

- The first set of assets shown in the page is where we are investing in growth and quality. We will continue to drive organic and inorganic growth within each vertical and invest to expand presence in new verticals. Our OMS and Impulse solutions are key assets to help our clients digitize their catalogue, better reach consumers and sell more through multiple channels. Linx's Brick and Mortar gateway and QR gateway are important building blocks to enable software and payments integration and we will continue to strengthen and improve such solutions.
- We are turning around our ecommerce platform from a product perspective to reach better scalability and improve features.

On page 12, I want to highlight the strength and opportunities within the Linx businesses, with its deep knowledge of different verticals, attracting a powerful set of loved brands within Brazilian retail. Linx's software solutions are present in over 106 thousand locations, some of which are the main franchises of Brazilian retail, where the relationship with stores is similar to that of SMBs. Linx´s stores locations jointly transact close to R$ 350 Bn of GMV and around R$ 200 bn of TPV, of which we have only mid-single digits payments penetration.

On page 13 we take a boarder look at our software business, considering both Linx and Stone software portfolio, and the representation from different client tiers.

Key Accounts currently represent 9% of total software revenues. For this client segment our execution is geared towards a high level of customization of large retailer's workflows. Given the digital/omni maturity of our clients, this is an important segment regarding partnerships we are building with consumer facing companies related to marketplace integration.

Mid/large clients account for 80% of software revenues and in this segment vertical expertise is key. We see an attractive monetization opportunity by creating integrated financial services offerings specific to each vertical's needs. Also, we see the opportunity to help these clients to sell more through multiple channels with an efficient omnichannel integration.

SMBs account for 11% of overall software revenues. We have over 120 thousand SMB clients using software and 1.3 million MSMB payments clients. We are working to leverage on our distribution capabilities to drive organic growth of software in this client segment.

On page 14 we wanted to share some initial experiences where we are working to improve the efficiency of our client's processes though payments and open banking integrations with software. We highlight multiple benefits depending on their specific needs, such as enabling automatic settlement between service providers and hired professionals, such as hair stylists in hair salons. This specific feature is possible through the integration of Trinks, our POS/ERP for beauty, with the Stone platform and saves our clients time and money by avoiding double taxation. Like this example, there are several others highlighted in the page that are brought by different integrated solutions. We are only at the beggining of this journey, but we are very excited with the value we can bring to our clients in the future.

Now I will shift it over to Rafael who will give an update on our financial performance in the quarter and evolution since our IPO. Rafa?

Rafael Martins – VP of Finance and Investor Relations Officer

Thanks, Lia.

Now, we are entering the last section of the presentation, the financial highlights. As show on slide 15, our total active client base grew over two-fold, reaching nearly 1.4 million clients. While our micro merchant active base grew by 8.4x to 545 thousand clients, we also saw a record high net adds excluding micro of 80.3 thousand, ending the quarter with 847 thousand clients.

Our total revenue and income was R$ 1.47 billion in the third quarter, representing a 57% increase when compared to last year. Linx consolidation, which added R$262 million in revenue, and the growth of our existing business contributed positively to this growth and the lack of revenue from our credit product contributed negatively. Our business, excluding Linx and our credit product, grew revenue by over 55% year over year. The credit product, on the other hand, which contributed with R$156 million revenue in the third quarter last year, didn´t contribute to our revenue this quarter because we temporarily paused new disbursements, as mentioned in our previous earnings call.

Looking at our TPV, we reached R$75 billion on the quarter, or approximately R$300 billion on an annualized basis. This does not include Linx Pay volumes. TPV ex-coronavoucher grew 53.6% year over year.

In slide 16, we show our consistent market share gains in payments. Looking at the main players in the market with public available data, StoneCo reached nearly 13% of market share in TPV. If we consider only our MSMB volumes, market share over total market volume is approximately

9%. More importantly, we can see that our MSMB business has been gaining share in a very consistent way, with our highest ever quarterly market share gain of over 1.3 percentage points, as you can see on the chart in the bottom right of the page.

Moving on to slide 17, we show the proforma results with Linx, both including and excluding the credit product. As Thiago mentioned, the pro forma growth of our business was 46% when excluding the credit product and 26% when we see reported numbers with credit.

There are 4 elements I would like to highlight here.

First, our business kept high growth levels after the acquisition of Linx. Interesting to highlight, our business model is protected against inflation, both in the payments business, which capture a take rate of nominal transactions, and in the software business, which has inflation-adjusted contracts.

Second point to highlight is that in this quarter we had significantly higher opex investments in growth and new solutions, as Thiago has mentioned previously. So, you can see cost of services and selling expenses increase at a higher pace than our revenue. In cost of services, we have investments in TAG, our registry platform, and other data center costs to support the growth of our operation, incremental investments in our technology, customer service and logistics teams. In selling expenses, we have investments in the expansion of our hubs operations, higher marketing expenses and higher investments in TON.

The third point to highlight is that our administrative expenses increased significantly, over 100% year over year. Here we had over 63 million reais this quarter of one-off fees paid to advisors relative to the Linx and Banco Inter transactions, besides higher amortization of fair value adjustments on intangible assets related to acquisitions, and G&A expenses related to our software operations apart from Linx. Important to note that in this quarter we have separately disclosed the mark-to-market results from our investment in Banco Inter. We had a loss of R$ 1.3 billion this quarter, compared to a gain of R$ 841 million in the previous quarter.

The fourth point to highlight is financial expenses. As Lia mentioned, basic interest rate has increased significantly in Brazil over the last quarters. This, combined with strong growth in our prepayment volumes led to an increase in financial expenses, pro-forma for Linx of over 290%. We are adjusting our commercial policy to this new environment, balancing the pace we expand our business with healthy monetization, but we still see in the third quarter and in the fourth quarters of 2021 lower margins than usual because of that effect. As we mentioned a couple of times in the past, usually there is a lag between changes in CDI and our commercial strategy adjustment.

As a result of those factors, our adjusted net income was R$133 million in the third quarter. If we exclude our credit solution, adjusted net income was R$152 million, mainly because of the financial expenses we still had in our P&L related to our legacy credit portfolio.

Now let´s move on to page 18, where we show our reported P&L. We grew revenue by 57%, with subscription revenue growing over 300%, mainly as a result of Linx consolidation. Excluding Linx, subscription revenue grew 64%, largely driven by higher active client base combined with higher contribution from our software solutions. Transaction revenue grew less, at 23%, mainly because of coronavoucher revenue in the third quarter of last year; excluding those, transaction revenue grew a little over 47% year over year. Our Financial Income grew by 32.1% year over year including revenue from our credit solution, which contributed to R$ 156.5 million in revenue in the third quarter of 2020 and virtually zero to this quarters' results. Our prepayment business continues to grow at a strong pace, with our Financial Income excluding credit and Linx growing by approximately 100% year over year. Lastly, Other Financial Income increased 96.7%. This increase was mostly because of the higher base rate in Brazil, which was partially compensated by lower average cash balance.

Costs and expenses increased mainly because of Linx consolidation and for the reasons I have just mentioned before in the previous page. In our press release, we give more details of the growth drivers excluding Linx consolidation.

Moving on to slide 19, we can see the evolution of adjusted net income, which reached R$133 million this quarter. Also, as we have mentioned in our earnings release last quarter, we have now evolved our managerial view of Adjusted Free Cash Flow and other cash flow metrics. We believe this provides a more assertive way to look at cash flow, especially given the dynamics of prepayment and credit solution, as well as additional disclosure to investors to understand our business. In our earning release, we detail the changes we have made.

So, looking at the table on the right hand side of the presentation, we see that our adjusted free cash flow, which does not take into account our cash flow from credit and prepayment operation, remained relatively stable year over year, despite the strong increase in investments. We have generated R$238 million of adjusted free cash flow in the quarter, slightly higher than last year. The increase was mainly driven by a much higher cash net income, which grew by 168% and lower CAPEX, partially offset by lower cashflow from working capital variations.

In the quarter, our prepayment business has required R$2.5bn of cash, which we funded mainly through sale of receivables. Our credit business has released over R$480 million in cash flow, as we are collecting loans from our legacy portfolio, with no new disbursement. Also, we have disbursed R$4.7bn in the quarter for the acquisition of Linx, which was funded by our follow-on offering in the third quarter of 2020.

Moving to slide 20, three years have passed since we became a public company. And we believe it is a good moment to come back to some of the messages we have provided by our IPO, what we have done since then and what we are doing now.

By that time, we intended to develop solutions in the banking space and to serve micro-merchants. Since then, our solutions in banking and micromerchant space have gained significant scale, despite being still in early days. Active clients in banking have surpassed 420 thousand and we have surpassed the mark of half a million merchants with our TON solution. Looking ahead, we aim to be the best financial operating system for Brazilian merchants, as Thiago has mentioned in the beginning of our call.

Also, we have mentioned back in 2018 that we would selectively pursue acquisitions, especially in the software space. Since then, we have invested in 12 companies, being today the #1 company in software for retail management in Brazil. And looking ahead we aim to be the best workflow tool for Brazilian merchants and help them drive sales through multiple channels.

By the IPO, we also said that we intended to continue to grow our base of Stone hubs. We have increased from 180 proprietary hubs in 2018 to over 450 hubs today, gaining density of coverage. Our client base increased from a little over 230 thousand by the third quarter of 2018 to 1.4 million clients now, of which 1.34 million MSMBs. As Thiago said, we believe there is still plenty of room to grow, with nearly 30 million MSMBs in Brazil.

Following to the next slide, we show how our metrics changed since our IPO. We grew our client base at over 80% 3-year CAGR and our TPV and Revenue in a 50% and 53% 3Y CAGR, respectively. Our Adjusted net income has increased from R$89mn in the quarter to R$133 million now, although we continue to invest heavily in our business.

We improved our ability to recruit talents, with over 130 thousand applications to our Recruta program this year. We maintained very high service levels, with calls rated as excellent in our customer support roughly stable at 92% and the SLAs from our logistics at 96%. Also, we have raised the bar for ourselves. Whereas in 2018 we had the goal to pick phone calls in 20 seconds, we now do it in 5 seconds.

We are proud of what we achieved since we got our first client in 2014 but we are much more excited with the opportunities ahead of us. We are just in the beginning of our journey.

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