Stone Co 4Q20 Earnings Conference Call
March 11, 2021

Operator:

Good evening, ladies and gentlemen. Thank you for standing by. Welcome to the StoneCo fourth quarter and fiscal year 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 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 operational and financial metrics for the fourth quarter and 2020 results. I will pass it over to Thiago so he can share with you the main highlights of our performance. Thiago?

Thiago Piau – Chief Executive Officer

Thank you, Rafael, and good evening everyone. Thank you for joining us in our fourth quarter 2020 earnings call.

Before we dive into our 2020 results, I want to talk a little bit about our strategic direction and the moat of StoneCo. As a client-centric company we are always trying to assess how we can help our merchants to become better every day.

I believe our moat is about empowering small and medium businesses to win through 3 important strategic steps, two of which we are already executing well and the third one is becoming a new dream for us.

- First, we want to delight our clients and gain their trust by offering a complete set of financial solutions through a world class technology and service, replacing their existing banking relationship and becoming the dominant financial provider of SMBs in Brazil. Our Stone and Pagar.me teams are working hard to accomplish this goal every single day, building an amazing culture of talented people and client obsession.

- Second, we want to offer enterprise-level workflow tools to empower our clients to better manage their businesses, driving operational efficiency and connecting them to online channels so they can sell more. We started the second phase of the business almost two years ago and we are happy to see great evolution of our team towards this direction. The investments we made and the acquisition of Linx put us in a unique strategic position to achieve this goal. We are working hard to make sure the team achieves the same levels of client satisfaction and disciplined execution we were able to build in Stone and Pagar.me.

- The third strategic step, and this challenge we still have to tackle, is to answer a very simple question: how can we drive more customers to our merchants? How can we incentivize consumers to shop in our merchant base? We can now start dreaming about answering this question and we know that data infrastructure, user experience and technology integration between our businesses are key elements to make this happen.

Moving to results, 2020 has been a year of great achievements despite all the challenges imposed by the pandemic. I believe we balanced disciplined execution with important strategic steps, continuing to deliver strong results. Our team did a great job and today we are bigger and much better than we were a year ago. We continued to present strong profitable growth and long-term value generation.

Moving on to the presentation, I would like to start on page 4 with client base dynamics.

We have significantly scaled our client base in many fronts. In payments, we posted on the fourth quarter a record quarterly net addition of clients and we keep increasing investments, paving the way for a continued acceleration in 2021. In fact, even with the negative impacts brought by the Covid-related lockdowns, we reached over 652 thousand active payment clients in 2020, 2.4 times 2018 levels.

On top of that, now we count on almost 114 thousand clients in TON, our solution to micro-merchants, and we see very strong levels of growth in 2021.

The number of clients with credit solutions grew to nearly 90 thousand, almost four times 2019 figures, and the number of open digital accounts surpassed 500 thousand, eightfold the number posted in 2019, with over 133 thousand clients using it as their main settlement account.

Lastly, the number of software clients in our ecosystem grew to nearly 390 thousand, almost three times 2019 levels.

We have evolved fast in the convergence of our solutions. In 2019, 10% of our SMB acquiring clients used at least one other financial product offered by us, and by the end of 2020, that number jumped to 34%, with new cohorts presenting even higher numbers.

Besides that, the percentage of clients using both our software and payments solutions also increased from 22% in 2019 to 30% in 2020. As Lia will discuss later in more detail, this trend is improving our unit economics on SMB clients, which is the reason why accelerating our client base is among our top priorities today.

We had a record addition of TPV in a year, having added R$81 billion of TPV in 2020, a similar level to the total TPV processed in 2018. In fact, the processed volume increased over 150% in just two years, despite Covid impact in 2020.

While we are committed to fast growth and even though we are investing heavily in our business, in 2020 our adjusted net income grew 12% with an adjusted net margin of 29% despite all COVID-related impacts. We have also reported our record Adjusted Free Cash Flow generation, which reached over 653 million Reais in 2020, growing more than 57%.

Finally, we were able to scale while keeping high customer service levels, achieving a first call resolution index of 94% and 91% of the calls rated as excellent by our clients. Stone was created to provide the best-in-class service for its merchants. Even with the business growing fast and gaining scale with additional solutions, we will never change the commitment we have with our clients. We will work hard to keep providing the best customer experience our clients can get every single day.

With that said, I will pass it over to Lia to discuss our results in more detail. Lia?

Lia Matos – *COO and Chief Strategy Officer*

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

I want to give some highlights along our three main businesses: Stone, Pagar.me and our software business.

Let me start first with the evolution of Stone. As shown on page 5, the business continues to accelerate and at the same time improve quality. We saw TPV growth in the hubs accelerate to 45% versus 42% last quarter. Our hubs are also improving unit economics, with higher TPV per client than we had a year ago. Additionally, the productivity of the salespeople in the hubs reached its peak in the fourth quarter, while levels of churn reduced, which helped the company achieve the highest-ever net addition of clients in a single quarter, almost 70k clients.

We also want to highlight the continued evolution of our hubs performance. As we can see in the graph on the bottom right, even our more mature hubs continue to present strong growth, with number of clients continuously increasing, while maintaining the number of salespeople per hub relatively flat since the beginning of 2018.

Moving on to page 6, we are happy to see the higher activation and engagement within our ABC platform.

The graph on the left side of the page shows that the percentage of Stone clients using an additional financial solution increased from 10% in 2019 to 34% in 2020. Also, the number of clients using at the same time payments, banking and credit, the so-called heavy users, increased from nearly zero in 2019 to over 5% of our payments client base in 2020.

As the graph in the middle of the page shows, heavy users have a greatly improved unit economics and our team continues to work hard to improve engagement. Our average revenue per client increases when they start to use additional features, with heavy users reaching over 2.5 times higher revenue than clients with payments only.

The growth and quality of unit economics in our SMB business have made us confident to double down on our investments in 2021 to further accelerate growth and increase our penetration on a growing addressable market of over 120 billion reais in revenue.

Now, on page 7, we discuss the evolution of our financial products beyond payments.

As Thiago mentioned, in the 4Q20 we reached more than half a million open digital accounts with over 133 thousand clients already using Stone as their main settlement account. We also saw the total accounts balance increasing 92% and the TPV of pre-paid cards jumping 52% against the third quarter.

Our credit portfolio reached 1.5 billion reais, distributed among nearly 90 thousand clients, with healthy monthly returns ranging from 2% to 2.5%. We continue to enhance our credit scoring model, provisioning and collection tools, especially as we experience a second wave of Covid in Brazil, with lockdowns being imposed in some areas. For this reason, we are being even more selective while disbursing new credit. We have also started to manage new metrics, such as risk-adjusted return and risk-adjusted return net of funding costs. These metrics better factor in the portfolio profitability, as they essentially reflect the total IRR (internal rate of return) for a series of cashflows at different timeframes.

During this quarter, we took a first step towards limiting our risk exposure by raising approximately 500 million reais in the domestic market through a FIDC. Additionally, we expect to raise more funding for the product throughout the year, allowing us to keep growing this product fast while further limiting our credit exposure.

In addition to the great SMB results, we have seen a significant evolution in Ton, our solution for micro-merchants. On page 8, we show that TON´s client base has reached 114k clients and our net addition of clients already represents approximately 16% of the organic net adds of the leading player in this market.

We see unit economics improving with healthy take rate and TPV per client combined with lower client acquisition cost, a key variable to succeed in this segment. Besides, following Stone´s DNA, Ton keeps differentiating itself in the segment by providing superior client service. The level of service perceived by the clients reached 87%, with an upward trend at the end of the year.

Just one year in, Ton already shows promising trends, and we expect even more improvements as we accelerate our investments in this new venture in 2021. Even though our focus is to invest in growth acceleration, the strong unit economics we have seen indicates that Ton might achieve break-even already in the end of 2021.

Still related to TON, we decided to expand the scope of our media agreement with Grupo Globo, which was exclusive to TON, to the whole StoneCo group, which gives us flexibility in terms of media allocation. We executed the flip of Globo's ownership in TON to the StoneCo level so we now own 100% of TON. We believe this structure is better aligned to generate bigger returns on media capital allocation.

Let´s now move to page 9, to our fintech-as-a-service platform, Pagar.me. Throughout 2020 we have seen substantial evolution in Pagar.me, with fourth quarter TPV growing approximately 80% year on year.

Pagar.me revenues from small businesses accelerated reaching 94% year on year growth in the fourth quarter, with take rates considerably higher than what we see in the Stone hub operations. There are components of Pagar.me small business economics we like and want to share with you. First, every day we see more new digital-native merchants being born. Second, our small clients grow while using our solutions, so we have more TPV from the same clients over time, and Pagar.me offering is still heavily concentrated in gateway, payments and antifraud solutions, with still low prepayment penetration and an optionality to drive more revenue per client as we evolve to banking and credit solutions, which we expect to start still in 2021. The small business operation of Pagar.me is what really drives earnings growth and we believe this is the biggest profit pool opportunity for Pagar.me going forward.

On the other hand, in the fourth quarter we faced headwinds in revenue growth in key accounts, driven mostly by the impact from lower take rate levels, which had a significant influence from the reduction in the Brazilian CDI interest rates, from 5.0% in 4Q19 to 1.9% in 4Q20, as prepayment pricing for key accounts is usually linked to CDI; and a reduction in share of wallet in some of our key account clients. The decline in take rate of Pagar.me key accounts was the main driver of overall take rate reduction in the company.

Looking ahead, we are shifting Pagar.me key accounts operation from a commoditized based on price relationship to a customized based on margin approach. As we always said, key accounts operation brings volatility in terms of TPV and revenue growth, but has small impact in our profitability.

Now, moving on to page 10 I want to talk about our software business. The number of clients using our software solutions has reached nearly 390 thousand at the end of 2020, almost three times 2019 numbers and annualized pro-forma revenue has surpassed R$200mm as of 4Q20, with a 55% organic year on year growth, demonstrating the ability of those solutions to drive adoption and monetization. We offer our clients POS and ERP solutions in different verticals, such as retail, food, health, leisure and beauty, among others, as well as solutions which help our clients to better connect with their customers and sell more.

Despite not being able to talk too much about Linx acquisition as it is still pending antitrust approval, we see that the combination of our software initiative and Linx will create a leading player in workflow tools for retail, adding strategic vertical presence and enterprise solutions that help clients to increase sales by connecting them to digital channels. We see great opportunities to further penetrate financial solutions into Linx client base by migrating clients from Linx Pay Hub to our platform so we can increase value proposition to those clients.

We remain very excited with the opportunities in Linx. We firmly believe that the combination of the two businesses will accelerate Stone's goal of empowering Brazilian merchants by offering enterprise-level workflow tools to help them better manage their businesses, drive operational efficiency and connect to online channels so they can sell more and grow.

More than our results and positive influence in our industry, we are very committed to our country and happy to support society through tough times. We think that the best way to improve our country´s productivity in the long term is to have good investments in basic education and employability initiatives. Besides our regular support to basic education, like Alpha Lumen, a non-profit school focused in empowering gifted children from vulnerable and low income families, we have started piloting professional qualification training aimed at improving employability.

Those are the two social impact initiatives in which we will be focusing our attention going forward. In addition, in 2020, we have donated R$15mm to the construction of a COVID-19 vaccine factory and the construction of a temporary hospital in Rio de Janeiro, as well as R$26mm in subsidies to our clients in order to help them navigate the challenges imposed by the pandemic.

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

Rafael Martins - *Investor Relations Executive Officer*

Thanks, Lia. Starting on slides 11 and 12, you can see the evolution of the number of active payment clients, TPV and revenue for the fourth quarter and full year 2020. Despite the Covid impacts, our payment client base grew by 35.7% this year reaching 652.6 thousand clients excluding TON and our TPV grew by 60% in the 4Q20, reaching a total TPV of almost R$210bn in the full year.

We have also surpassed 1 billion reais of quarterly revenue for the first time, with our revenue growing by 28% year over year despite the challenges from COVID-19 and the headwinds from a lower CDI interest rate in our Pagar.me key accounts take rate.

Our consolidated take rate, excluding Coronavoucher, in the quarter was 1.64%, 12bps lower than the previous quarter. The lower figure is mainly due to seasonal effects, mainly (i) a higher proportion of debit over credit and (ii) the effect from revenues which are unrelated to TPV, including POS subscription and credit revenues, which have a negative impact on take rates in the fourth quarters due to strong volume seasonality. In 2019, we saw a similar behavior in the fourth quarter, with take rates going down 11 bps when compared to the previous quarter.

When compared to the fourth quarter of 2019, take rate excluding Coronavoucher volumes was 16bps lower. This difference is mainly explained by the lower take rates of key accounts in Pagar.me, which we already explained previously.

Now, let´s move to slides 13 and 14 to discuss our operating leverage and profitability.

In the 4Q20, we have reached our highest historical adjusted net margin of 35.7%, even with significant investments in our operations, which we will detail shortly.

In 2020 we saw a very peculiar dynamic with the Covid impacts being strongly reflected specially in two occasions: (i) first, the financial expenses in first quarter, when we decided to reinforce liquidity and (ii) second, in our total costs and expenses in the second quarter, when lockdowns happened and we saw revenue growth decelerating while we kept investing in new products and had one off expenses related to a team resizing in mid may.

After the first half of the year, as you can see in the graph on page 13, we have re-gained operating leverage in our business. Our financial expenses have also decreased as a percentage of revenue, mainly due to lower base rates in Brazil. This higher efficiency led our adjusted net margin to bounce back to pre-Covid levels in the second half of the year, with the record quarterly adjusted net margin of the company in the fourth quarter.

Those factors above were partially offset by strong investments, such as (i) building our TON operation, (ii) hiring of technology team in different areas of the company including Pagar.me and Stone, (iii) investments in customer service and logistics, (iv) hiring of sales team, (v) software expansion and (vi) increase in marketing expenses. Many of our investments appear in the form of opex in our P&L and are already factored in our margins.

Now, going over in more detail on each P&L line item on page 15, our Cost of Services reached 213.2 million reais or 21.3% of Total Revenue and Income in the quarter, increasing 4.9 percentage points when compared to last year. This increase was mainly due to (i) higher investment in our technology and customer service teams, (ii) costs from our software solutions and (iii) higher transaction and deployment costs to support our operation.

When compared to the previous quarter, Cost of Services as a percentage of revenue decreased 1 percentage point, primarily because of (i) lower provisions and losses and (ii) lower deployment costs as a percentage of revenue.

Administrative Expenses were R$122.5 million, or 12.2% of Total Revenue and Income, 3 percentage points higher than the prior-year period, mostly due to higher third-party services related to Linx transaction and more expenses related to software solutions. When compared to the third quarter of 2020, Administrative expenses were 0.9 percentage points higher mostly due to the higher third-party services which were partially compensated by lower personnel expenses as a percentage of revenue.

Selling Expenses were R$139.9 million in the quarter, or 14.0% of revenue, broadly in line with the 13.9% reported in the prior year period despite higher investments in marketing, especially with TON. Compared with the third quarter of 2020, we saw a 1 percentage point improvement, mostly explained by lower personnel expenses as a percentage of revenue, partially compensated by higher marketing investments.

Financial Expenses were R$64.2 million, a decrease of 40%, compared to the fourth quarter of 2019, mainly due to the lower CDI rate, which more than compensated the significantly higher volumes in the quarter.

Other Operating Expenses were R$90.2 million in the fourth quarter of 2020, compared with R$2.5 million in the fourth quarter of 2019. This difference is mainly related to (i) donations, including a R$10mn donation to support the construction of a factory for the production of COVID-19 vaccines, (ii) higher share-based compensation expenses, mostly related to the tax and social charges provisions in relation to the appreciation of our shares in the quarter and (iii) higher POS losses as a result of COVID-19 impact on SMBs. Compared with the third quarter of 2020, Other Operating Expenses were 4.4 percentage points higher as a percentage of revenues, explained by the same factors of the year over year comparison.

One thing that we would like to highlight is that in terms of social initiatives we gave fee exemptions to our clients in an amount of R$26 million and we have donated R$15 million for the construction of a temporary hospital and a COVID-19 vaccine factory. If we had adjusted the impact of those initiatives in our P&L, which we didn't, our adjusted net income would be close to R$1bn.

Finally, as shown on slide 16, we have been able to generate increasing adjusted free cash flow despite all the investments mentioned previously. Also, we have kept our diligence in capital allocation aiming at generating great returns.

Our adjusted free cash flow grew 86% in 4Q20 compared to 4Q19 to R$345.9mm, mainly due to higher net income and better working capital dynamics, reaching over R$653.5mm in the full year.

Also, during the year we have spent R$76mm in the repurchase of our own shares with an average price of $29.65, which generated very positive returns.

Besides, we have purchased R$1.3 billion in Linx shares in the open market at an average price of R$36.5 per share, which is below our offer approved in the shareholders meeting.

Before I pass it over to Thiago, I would like to recall that during our IPO in 2018 we had two expectations over the medium-term: a total revenue and income growth above 40%, with adjusted net margins between 30% and 35%. And, even with the headwinds brought by the Covid pandemic, we are very proud to say that we were able to exceed our expectations, with revenues growing at a 45% CAGR in the last two years and adjusted net margins at 29% for the full year 2020 and 35.7% in the fourth quarter. We expect to accelerate growth in 2021.

Now, I would like to pass it over to Thiago, so he can wrap up our 2020 results.

Thiago Piau – *Chief Executive Officer*

Thanks, Rafa. Before I talk about what we see ahead of us, I want to show on slide 17 our assessment of what we did right and where we failed looking back at 2020.

We are very proud of some achievements during the year. First, we experienced a solid team improvement, while keeping a strong culture, one of our most valuable assets. Also, we saw great evolution of strategy and execution of Stone and Pagar.me, with results pointing to an encouraging future prospects way beyond payments.

We were able to rapidly adapt to the new reality with Covid lockdowns as we kept a solid financial management of the company, focusing on liquidity management and efficiency in operations and capital allocation, promptly providing support to our clients, team and overall community. We were able to balance strong growth and profitability at the same time.

Finally, we took a very important strategic step with the acquisition of Linx and the expansion of our ecosystem of software solutions and the moat of Stoneco.

More accretive than highlighting the positive results is to understand our mistakes and where we failed so we can learn and evolve.

To start, we made the wrong decision regarding the level of resizing in the hub and customer service operations as well as cutting short TON investments too early in the first half of 2020. Given the fast bounce back of our client base, we can now say that it would have been better to hold overcapacity to serve better our clients and to grow more rapidly during the second half of the year and, given the results we are seeing in TON, we should have maintained investments during the first half.

In addition, we were slow in transitioning our key accounts' strategy to a more customized solutions relationship with focus on margins. We kept some relationships based on acquiring prices longer than we should, which is not strategic to our future.

We were also slow in launching our ABC platform in our own standards; we could have done faster.

Lastly, we believe that we could have advanced more in initiatives for digitization of retail, in addition to the Linx acquisition.

Now, moving to slide 18, let me share some thoughts about what we expect for 2021, keeping in mind that my comments do not include any effect of Linx acquisition, as we are still waiting for regulatory approval.

- Due to the improved unit economics we are seeing, we are aiming to accelerate our net addition of clients and we expect to cross the mark of 1 million clients in payments in 2021, excluding TON; we also expect strong growth rates in TON on top of that.
- To support our growth, we will keep investing heavily in our operation. We expect to grow our commercial and technology teams by at least 60% during the year, continuing to provide the best service of the industry while we expand our product offering to more and more clients.
- Also, due to the increasing usage of additional products from our clients, take rates should go up throughout 2021, both at Stone and Pagar.me.

- With that, despite having larger scale, we expect our revenue growth to accelerate significantly from the 2020 levels, due to the powerful combination of a bigger client base and increasing monetization per client.
- Despite the heavy investments, we do not expect our adjusted net margin to be very different from what we saw in 2020. We are always pursuing the long-term value generation and we are investing to grow as fast as we can. However, our business model allows us to generate strong operational leverage and even during times of massive investments we expect to observe healthy margins.
- We expect tax rates to be at similar levels as in 2020

To finalize the first part of our earnings call I would like to say that we were born in 2012 with a clear purpose: to help merchants to better manage their businesses and sell more by offering best-in-class service and products, delivered by a talented team of hard-working people who always put our clients at the center of everything we do. This is our commitment with all our stakeholders. Our strong culture and client centricity are the pillars that will support us in this exciting journey that we are just starting.

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