StoneCo

Earnings power remains underappreciated by the Market; Notes from the road

Reiterate Rating: BUY | PO: 20.00 USD | Price: 17.90 USD

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Equity

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More than payments

We spent the past few days visiting investors in NY and Boston with Stone's mgmt. team, including Mateus Scherer, CFO, Mateus Biselli, Chief Client Officer of SMB, and Roberta Noronha, IRO. Mgmt. walked through the earnings roadmap through '27, which was originally unveiled at the Investor Day in mid-November (report). The plan consists of i) the transformation of Stone beyond payments and into banking and credit products, ii) market share gains in MSMB, and iii) operating leverage. According to mgmt., the successful execution of the strategy should yield net income of at least R$4.3bn in '27, implying CAGR of 30% from '24. In our view, such guidance remains underappreciated by the Street, which forecasts 14% earnings CAGR through '26, to R$2.6bn (60% below '27 guidance). As such, we see significant room for positive earnings revisions and for the stock to re-rate higher. We reiterate our Buy.

7 main topics of discussion

Main topics discussed during the meetings included: i) changes in senior management, ii) potential disruption from Pix, iii) competitive landscape, iv) credit strategy, v) software strategy, vi) banking strategy, and vii) regulation. *We provide details below.*

Credit rebuilt from scratch and more conservative growth. Mgmt. expects the credit portfolio to expand to R$800mn by year-end '24 from R$300mn currently, a much more conservative approach from before when the book expanded by R$1.5bn in one year. The product was re-launched in March '23, with the first sizable co-hort in July/August. Credit losses are running below 10% but mgmt. is conservatively provisioning 20% of originations (more in line with peers' experience). Monthly rates range from 3-5% (in line with industry rates for working capital loans), average ticket size of c.R$40k (up from R$10-15k before), and duration of 12-18 months.

Among the main changes made to the credit product, mgmt. noted the hiring of experienced executives, revamping of back-office, pricing the product as an unsecured loan, improving guarantee from the shareholder of the company, and more transparent monthly payment for the client (which makes it easier to renegotiate in case of non-payment). Finally, with the recent acquisition of a Financeira license, Stone should be able to enhance its funding source to support the credit operations.

Software enabling TPV growth and efficiency gains. Mgmt. sees software as an enabler of TPV growth and providing room for efficiency gains. Mgmt. is refocusing Linx into 4 verticals (Gas stations, Food, Retail, and Pharma) from 12, where it thinks it can offer a better value proposition to its clients. These 4 verticals provide an annualized TPV opportunity of R$217bn, or 60% of its current SMB TPV of R$358bn, which should enable Stone to grow volumes above the industry, or at a 13% CAGR through '27.
(Continued on next page)

Stock Data

Price	17.90 USD
Price Objective	20.00 USD
Date Established	16-Jan-2024
Investment Opinion	C-1-9
52-Week Range	8.09 USD -18.87 USD
Mrkt Val / Shares Out (mn)	5,852 USD / 326.9
Free Float	93.4%
Average Daily Value	90.52 USD
BofA Ticker / Exchange	STNE / NAS
Bloomberg / Reuters	STNE US / STNE.OQ
ROE (2023E)	10.9%
ESGMeter™	Medium

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SMB: Small and Medium merchant Business
MSMB: Micro, Small and Medium merchant Business

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Furthermore, the integration of the software operations (backoffice, salesforce, incentives) should allow for efficiency gains even as Stone expands into financial services, supporting opex growth below revenue growth.

Banking - improving cash-out features. The banking product is fully integrated with the payment system for 100% of micromerchant transactions and 80-90% of SMB transactions. While the banking product has all cash-in features, mgmt. has been working on improving the cash-out function (such as credit card and payroll). The successful execution of the strategy should allow deposits to grow at a 26% CAGR through '27, twice as fast as the expected TPV growth. Mgmt. does not plan on remunerating the deposits, as companies view them as working capital rather than savings (the money sits in the account for only 4-5 days).

Competition is stable and rational. The micromerchant segment is basically composed of 3 players (Stone, PagSeguro, and Mercado Pago) whose prices are publicly available online and have remained stable. Meanwhile, in the SMB segment, prices are negotiated directly with clients and are based on a holistically approach, but there are no indications of pressure. Mgmt. reiterated that companies are in the process of rebuilding margins and profitability.

Pix disruption and opportunity. Pix has been very successful in P2P transactions in the micromerchant segment, gaining share from debit. Pix is also gaining share in P2M transactions and already account for 6% of Stone's total SMB TPV. The economics of a Pix transaction are positive for Stone, as the rate charged is similar to a debit transaction, but it generates a float revenue (as the client must have a Stone banking account enabled) and has lower costs. Also, Pix has been supportive of reducing cash transactions, thus increasing industry TPV. Mgmt. thinks the user experience still is better for payment with cards for bricks and mortars transactions (but it should decline with the introduction of NFC for Pix) and sees difficulties in Pix parcelado gaining relevance over cards given poorer economics for card issuers.

Regulatory noise likely to persist. While the banks (card issuers) are likely to continue to blame the high rates practiced for credit cards on the interest free installment option offered at the retailer, Stone's mgmt. believes that the high rates are a function of the lack of portability of the product.

Industry TPV growth slowing down. Industry TPV growth is expected to decelerate to single digits going forward (at around GDP + inflation) given the already high card penetration in the country.

New CEO refocused the Company. Pedro Zinner, new CEO since early '23, has been instrumental in refocusing the Company into 20 projects/initiatives from 150.

Price objective basis & risk

StoneCo (STNE)

Our PO of US$20 is derived from a target P/E of 16x on our '24 non-GAAP EPS estimate. Our target PE multiple is one standard deviation below historical average, challenging perspectives for the industry in the long-term and execution risks.

Downside risks: 1) increased competition, which could limit growth in clients and TPV, and lead to lower profitability, 2) potential regulatory changes, which could pressure pre-payment revenues, 3) poor execution in deploying the credit product could lead to high credit losses.

Analyst Certification

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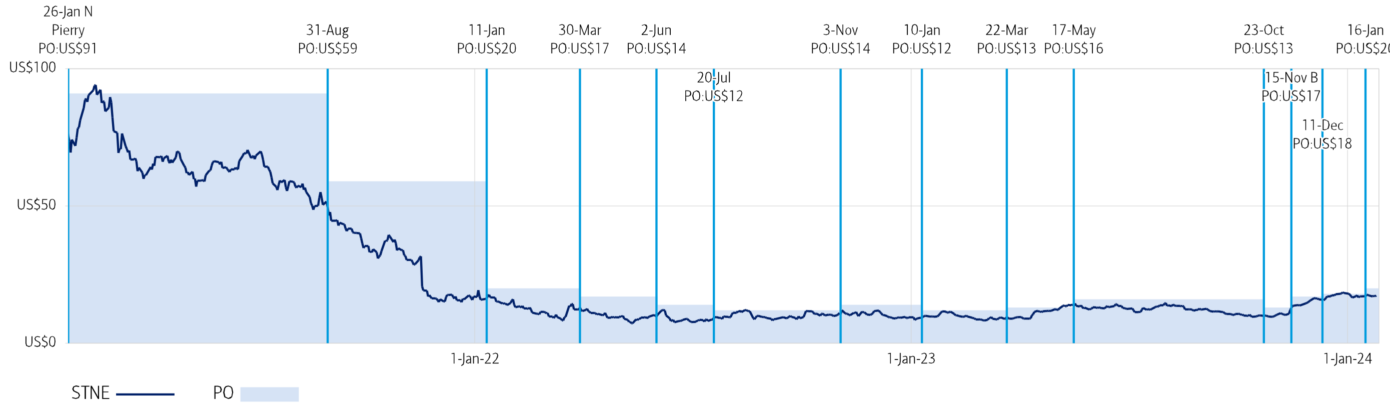
StoneCo (STNE) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

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Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	156	53.79%	Buy	94	60.26%
Hold	72	24.83%	Hold	48	66.67%
Sell	62	21.38%	Sell	35	56.45%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
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Sell	807	22.84%	Sell	383	47.46%

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