StoneCo.

What Happened to the stock?

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I first wrote about Stone on Twitter to answer a question on Stone's performance. Since then, many people have kindly asked a few questions about the future returns for Stone, so I decided to create this Substack to contribute with fellow investors.

I'm not writing an initiation except an initiation report, so if you know nothing about Stone, I suggest you access IR's website and study a bit first. My objective is to write an update on the investment case in qualitative and quantitative stances.Let us remember that Stone has a few businesses:

I) Acquiring (BRL20bn TAM), which the revenue is composed by POS Rental and revenue from total payment volume (TPV), which is the TPV * MDR (Merchant Discount Rate).

I believe that Stone could disrupt legacy practices, older technologies, and incumbent vendors in the Brazilian market, empowering the merchants with technology and offering a hyper-local experience.

The company served clients solving many internal conflicts of interest incumbents have understanding, performing, and controlling clients' experiences. Though this might sound like bullshit, it's been impressive how management empowered mid-level management to roll out Proprietary/Franchise Stone Hub.

For instance, if Cielo wants to operate in a new local, that must have authorization from the controlling shareholder (Bradesco) to do so, which creates considerable friction between the controlling shareholder and Cielo's sales team.

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Over the years, the strategy offered its product where incumbents didn't want to, boosted Stone's market share, creating customer loyalty, that ultimately enabled Stone to compete against incumbents. However, acquiring is a commodity business with an acceptable margin; pre-payments (discounting receivables) are lousy (low ROIC) because they are intensive in invested capital (working capital needed).

For instance, when Cielo (segment incumbent) went public in 2006, it planned to accelerate revenue growth with the discounting receivables business. Although taking five years to Cielo ramp up the product, it could discount a massive amount of receivables over the following years.

However, Cielo spent quite a while anticipating @140% of CDI (average of overnight interbank rates in Brazil), affecting its ROC massively, as the discounting required tons of capital.

Forward-looking, rising rates will create margin pressure for the acquiring business, especially those with leveraged balance sheets (STNE and CIEL would be the most impacted and PAGS the least).

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PagSeguro leverages its balance sheet using its capital, while Stone uses FIDCs (3rd party capital), in which the cost is spread over CDI.

Honestly, I believe there is a confirmation bias regarding Stone. It went public surrounded by operational tailwinds (significantly lower funding cost), top-notch management, and shareholders.

We have to be very careful from now on. First, Stone has always reported high NPS but ceased recently. I talked to a senior manager, who ensured me there were no malicious reasons. I believed him but would love to keep the tracking.

Second, we don't know how pricing will behave from now on, but clients will disapprove of any change in pricing policy. Stone charges clients differently: i) micro merchants have to follow a non-negotiable price table; ii)SMB can negotiate directly with the company, so there is flexibility; iii) large merchants pay a percentage of CDI.

So far, Stone hasn't made any change in the price table, so its lagging fund cost raising in almost twelve months, clearly impacting its margin. Moreover, they will lose volume raising prices, primarily because many customers are concentrating transaction volume on Stone as one of the cheapest.

About pricing power, acquirers have little or none. In Brazil, the Central Bank has been implementing very restrictive rates to suppress inflation. Rates rose from ~2% to ~8%, and the fwd curve implies 12% for Jan 2023. There is no chance to pass through.

Imagine a vendor going to a gas station to explain that the rates increased because the Central Bank is applying a restrictive rate level.

Lastly, again, I must admit that Stone's culture is client-centric. So even though they face fund costs and other macro headwinds, they are investing a massive amount of money in improving customer experience.

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In the last quarter, Stone invested more than ever (through G&A expenses) in customer experience – I looked each quarter to 1Q19. More experienced analysts know how hard it is to find senior management hurting short-term PnL with a long-term mindset.

II) Banking (BRL10bn TAM)

Stone believes there is a significant opportunity to provide clients with additional financial solutions, given that those products, when offered by incumbents, present similar characteristics as payments: traditional players and legacy business models have limited focus on client service, transparency, and innovation.

In 2019, Stone started leveraging their distribution (lagging PAGS for a while), service, and tech capabilities to expand rev. per client.

The company offers a digital banking solution designed to enable clients to conduct financial transactions, issue boletos, pay bills, and integrate their businesses' financial data more efficiently and cost-effectively. As of Dec. 2020, Stone had >500k open accounts, a quite impressive 50% penetration rate.

Breaking down this TAM, most of the revenue comes from the interchange rate for credit cards, which is 3x greater than debit (0,5%). So it's hard to believe Stone will be able to gain a relevant share, as, on 8th October, the Central Bank (CB) opened a public hearing to discuss a 0,5% cap on interchange fees charged on prepaid cards, in line with debit cards. Unfortunately, the CB doesn't disclose how much they charge for prepaid cards, but I estimate around 1,5%, similar to credit cards.

In the short term, Stone is the least impacted company (PAGS and MELI have more exposure to this source of revenue), but the cap creates an inconvenience for future cash flows, as Stone is entering this segment.

III) Software (BRL11bn TAM)

With Stone's software solution, they increase the value proposition to clients, streamlining operational and back-office tasks, which improves the lifetime value of client's relationship and enables Stone to access an incredible amount of data that helps offer a financial solution to each client.

I have some difficulty understanding this TAM. The product Stone is selling isn't the reconciliation software, ERP, gateway, accounting service, or even ERP. Instead, they subsidize the software to acquire valuable data on their merchant's working capital, which helps improve pricing and risk management for different businesses.

Beyond that, a few industries experts told me that incorporating Linx's operations is a complete disaster. They relocated a considerable portion of Linx's workforce to Stone's operation and lost many senior managers from ERP solutions. I don't consider this a yellow flag to the investment case since no one is assessing upside risk for Linx. However, this sort of internal move minimizes the probability of Linx succeeding.

IV) Credit (BRL80bn TAM)

Stone has developed a product to allow their clients to effortlessly contract, monitor, and pay back loans by fully integrating the credit solution within the payments platform. I estimate a penetration rate of 12% by YE21.

By the end of 2019, the company was providing more information about the credit biz to the market (credit portfolio was brl170m in the 4Q19). As of 3Q20, the portfolio reached brl1,1bn with ROA@2% p.m.

With STNE raising 3rd party funds (FIDC) to scale credit portfolio, the market expected a BRL3bn credit portfolio by 21e and BRL6bn in 22e. The message implied was that not only would credit boost revs., but also increase take rate.

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However, STNE asset quality has deteriorated quickly, w/ NPLs 60d reaching 25% in 2Q21 (without principal payments, or 19% without any charge). As a result, total provisions reached BRL800m, representing 40% of its credit portfolio(!).

Reasons for the deterioration of NPL:

1. **Credit underwriting (Stone limits ~150% of monthly TPV and offers credit to new merchants): not using capabilities for credit analysis, focusing only on collateral, but not in the merchant capacity on repaying the loan;**

2. **The issues with the register of card receivables: Stone explained it through this link;**

3. **Lack of renegotiation policy: $STNE acquired scale so fast that it couldn't manage a renegotiation team.**

Instead of expecting a BRL6b credit portfolio by YE22, the market assumes ~BRL1bn. But, of course, it will take a while for Stone to fully recovers from its previous losses.

Looking ahead

First, I think Stone did an awful job communicating with the market about different businesses they were entering. For instance, in the last quarter reported (3Q21), we had problems in NPLs, funding cost, Linx's integration, and even higher G&A in customer experience investments.

Analysts expecting an acquiring business PnL certainly freaked out this quarter. However, I'm almost sure the market would not have punished Stone's shares if they had better communication. Actual PnL was terrible, indeed, but there shouldn't be a surprise.

I was stunned by how complex the company became after reading the last 20-F. But then, after reading all notes and footnotes, I concluded that many sell-side analysts have no idea how to estimate a cash flow for Stone.

I don't want to sound arrogant; I just checked how FIVE banks that have coverage on Stone reached their price target. Not so surprised, I must say, they trust their multiple analysis to reasonably estimate Stone.

What caught my attention was the standard deviation for long-term margins they estimate (pre-tax margin from 20% to 50%), which I consider empirical evidence to my initial statement.

Second, it's not clear to me if Stone is a margin or a growth company. When I draw my cash flow, knowing if the company invests through PnL, cash flow, or even both helps me access actual profitability.

With that said, my analysis regarding future cash flows will have a conservative approach, especially Stone's pricing power, which I will treat as limited (commodity-like).

To evaluate Stone, I modeled the company twice. The first model, assuming operational figures before the storm; then, considers structural changes in the business.

Stone (explicit modeling next 5 yrs) in BRL mn	2021	2022	2023	2024	2025
Net income (R$)	2.172	3.407	4.704	6.076	7.599
(-) changes in working capital	-1.639	-1.334	-1.658	-1.539	-2.216
(+) D&A	934	927	933	952	982
(-) capex	-820	-939	-1.045	-1.169	-1.325
FCFE	**647**	**2.060**	**2.934**	**4.319**	**5.040**

The image above shows Stone's cash flow before headwinds, modeling a payment company trading under low rates scenario, low losses in credit portfolio, and winning share in acquiring consistently across the years.

As a result, considering the stock price at US$17 and considering an exit multiple of 20x, we'd have an outstanding 44% nominal IRR. Even if we squeeze exit multiple to 10x, we would have an appealing 25% IRR. Let's check the "new" Stone below.

Stone (explicit modeling next 5 yrs) in BRL mn	2021	2022	2023	2024	2025
Net income (R$)	-916	680	1.594	2.600	3.688
(-) changes in working capital	660	-510	-549	-611	-637
(+) D&A	114	342	419	419	334
(-) capex	-510	-785	-815	-891	-779
FCFE	**-652**	**-273**	**648**	**1.517**	**2.608**

Considering the identical exit multiples, we would have a 19% and 1% IRR, respectively. I'd never use a multiple above 15x with Stone's financial, implying an 11% IRR. From a quantitative standpoint, higher rates, credit losses, and limited pricing power are the reasons for such changes in estimates.

If someone asks if there are downside risks to my conservative cash flow, I'd say yes. Losses could prove higher, Linx could lose time to market, pricing power could be worse.

However, if someone asks if there are upside risks, I'd say yes! I took a very conservative approach to cash flow. Several sell-side analysts erased the credit business, keeping the credit portfolio on the balance sheet, though.

Excluding the credit portfolio is ridiculous and will prove an unnecessary evil to Stone's cash flow, as I believe in the company's ability to run a credit portfolio.

Now, if you're bullish on Stone because the stock has dropped 80% from highs, consider that for every 100bps raise on CDI, ~150mn reduces Stone's net income.

In 2021, the average CDI will be around 3,8% against 9% in 2022. Almost 800mn losses in earnings considering one factor would be fair considering higher losses from credit portfolio and many more.

Bottom line, Stone is trading 11% implicit IRR considering a conservative cash flow. With the risks on balance, I would not invest in the company until better visibility in the credit portfolio.

I'll gladly pay US$17, 20, 25, even 30 bucks if they prove me wrong in the credit portfolio. For instance, if Stone cracks the code for the credit portfolio, my IRR would quickly go to 30%, so I wouldn't mind paying 30-50% up from this price range (16/18).

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