Thoughts on StoneCo

The IPO prospectus of StoneCo is great. The only thing I had to do to write this thesis is to put it into context, summarize it (lots of copy and paste, but not copying in this case means probably a lower quality of the thesis) and add some thoughts on valuation. Here is the result.

What is FinTech?

Financial technology (FinTech) brings about a new paradigm in which Silicon Valley's innovative technologies are poised to continue to disrupt and permeate throughout Wall Street's core financial businesses. J.P. Morgan CEO Jamie Dimon warned in his annual letter to shareholders that these Silicon Valley startups are coming to eat Wall Street's lunch. And indeed, FinTech's like Lu.Com, Stripe and One97 have achieved huge success and are actually multi-billion market cap companies.

FinTech is not merely one type of solution. Rather, it is an ecosystem of digital tools designed to serve a multitude of needs. The areas experiencing the greatest activity today are payments, funding, lending, investing, business services and digital currencies. E.g. digital payments have become a mainstay in the life of nearly all consumers.

Recently, Berkshire Hathaway announced $600 million in investments into 2 FinTech companies; StoneCo and PayTM. Obviously, Todd Combs and the Berkshire management see tremendous promise in the future of mobile payments and the FinTech industry as a whole. Ant Financial, Alibaba's finance affiliate controlled by billionaire Jack Ma, agreed to buy a stake in the Brazilian payments firm StoneCo as well.

Aside from Buffett and Jack Ma, another billionaire family is also seeking to increase its stake. Madrone Capital Partners, backed by heirs to the Walmart Inc. fortune, has also indicated it wants to buy more shares. Among other shareholders of StoneCo are 3G Capital Inc -- of billionaire Jorge Paulo Lemann -- and former Brazil central bank chief Arminio Fraga.

Major banks, credit card companies and financial giants have long controlled payments but their dominance looks increasingly shaky. Since 2014, investors have poured $130 billion into ground breaking technologies like Blockchain and mobile payments. Thanks to next generation payment methods that bypass banks and credit cards, the unbanked and underbanked have been increasing their economic activity.

Previously, many financial services firms had no desire to extend their services to the emerging markets' middle class. FinTech firms, however, are uniquely positioned to serve them. Given their highly scalable platforms, adding a middle class banking customer with a few thousand dollars in savings or who requests a loan for a few hundred dollars may still be profitable. In China and India, the number of middle class consumers is growing at 6% per year, compared to just 0.5% growth in developed markets. Globally, the middle class is adding approximately 160 million people each year. There is a huge potential revenue from extending financial services to the unbanked.

Digital payments

The global payments industry is a $100 trillion plus market consisting of large and small companies fiercely competing for retail, cross border transactions, peer to peer services, and e-commerce. Big financial companies like Citi, JP Morgan Chase and Bank of America collect consumer deposits, provide low-cost funds to support loan origination, and facilitate retail and cross border payments. Startups developing Blockchain and smart contracts will redefine the relationship between customers, suppliers, and vendors. MasterCard and Visa are heavily spending to preserve their dominant market share in credit cards. With so much at stake, the category is attracting considerable investment.

The payments industry is experiencing significant transformation because of changing consumer behavior. The industry has moved from traditional checking/savings accounts to seamless "one-click" messenger applications like Alipay, WeChat and PayTM. Payment firms such as Stripe, Adyen and PayTM are disrupting banks, credit card companies and payment processors. Stuck with out of date infrastructure, these incumbents are trying to remain relevant by expanding into adjacent markets, including point of sale and peer-to-peer services. Tech giants like Apple, Google and Samsung all provide cash-less and card-less payment solutions for consumers at the point-of-sale. Major retail chains are already using their platforms. Big tech's sophistication and considerable financial resources pose a unique competitive threat to legacy financial services providers.

These days even the corner coffee shop needs to offer in-store as well as desktop and mobile ordering options to customers, while accepting physical payment in cash, credit, debit, gift cards, as well as digital payments from mobile wallets on phones and wearables, money transfers from apps, and sometimes even in a variety of cryptocurrencies. Take, for example, the payment methods accepted at Starbucks, according to their website: Gift cards, Starbucks Mobile App, Chase Pay, Apple Pay, PayPal, Visa Checkout, Credit Cards and Cash. All of these forms of payment need to occur instantaneously, while ensuring security, reliability, and integration across the business's other accounting, inventory, and order fulfillment systems. For many firms, offering such a complex web of payments options requires working with third-party FinTech firms that offer point-of sale hardware, cloud-based software solutions, and payments infrastructure to facilitate these transactions. The end result is that payments firms are entrenched as an essential component of retail business operations around the world.

Brazil

Brazil is a geographically vast country, of continental proportions, composed of more than 5,500 cities and 200 million people to date. According to Neoway, there are currently approximately 9 million small and medium businesses in Brazil, battling the difficulties associated with the high cost banking environment and the infrastructure challenges that such a vast geography imposes, while trying to grow their businesses despite these challenges.

Brazil is a large and fast-growing market for financial technology solutions. According to the World Bank, Brazil GDP and Private Consumption Expenditures in 2017 were R$6.6 trillion and R$4.2 trillion, respectively, up from R$6.3 trillion and R$4.0 trillion, respectively, in 2016. According to Statista, retail e-commerce sales in Brazil excluding digitally distributed services and digital media downloads were approximately R$61.8 billion in 2017 and are expected to grow to approximately R$104.8 billion by 2022. According to the World Payments Report 2017, Brazil is the fourth largest market in the world for non-cash transaction volumes. The payments market has continued to grow and demonstrate resiliency to macroeconomic fluctuations in Brazil.

Despite Brazil's large size, its payments market remains less penetrated and has greater growth upside than more mature economies, such as the United States and the United Kingdom.

- Electronic payments volume represented 28.4% of total household consumption in Brazil in 2016. This penetration percentage is lower than comparable measures of 46.0% and 68.6%, respectively, in the United States and the United Kingdom.
- 27.0% of the Brazilian population aged 15 and above had a credit card in 2017, compared to 65.6% in the United States and 65.4% in the United Kingdom.
- In 2017, 17.6% of the Brazilian population aged 15 and above used the internet to pay bills or made online purchases over the previous year, compared to 77.2% in the United States and 80.7% in the United Kingdom.

In the early years, the merchant acquiring market in Brazil was still a duopoly dominated by two payment processing companies owned by the country's largest banks that had exclusive arrangements with the global networks. In 2010, the Central Bank of Brazil and Brazilian antitrust authorities implemented a series of initiatives to create a regulatory framework aimed at fostering a more open and competitive environment.

StoneCo's founders envisioned to help the small and medium businesses in Brazil be more productive and efficient, by leveraging technology, a differentiated approach to service and support, and local proximity. They believed that owning direct distribution is the only way to create a true understanding of merchants' needs, and to be able to respond effectively to those needs by establishing a relationship of trust and transparency.

There is a range of business needs that can be addressed through better technology to make those merchants more productive and profitable. With the roll-out of their Stone Hub strategy, their experience in thousands of cities has enabled them to understand how they can provide better commerce solutions to merchants and act as a partner, introducing the best technologies and solutions that can help them grow and become more competitive.

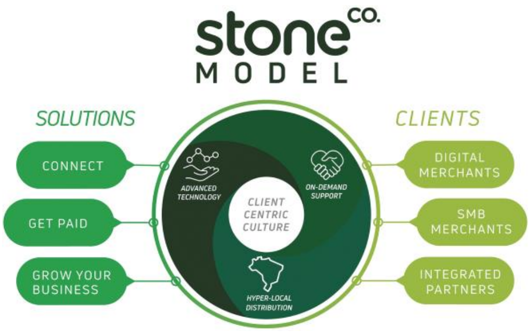
There are various important trends that are impacting the growth and market opportunity for their services in Brazil:

- Increasing Use of Electronic Commerce — Commerce in Brazil is increasingly being transacted through electronic accounts, such as credit, debit, and prepaid cards, eWallets, and mobile devices instead of cash and checks.
- Increasing Shift to Digital Channels — Consumers and merchants are increasingly conducting commerce through digital channels online and through mobile devices.
- Growing Use of Omni-Channel Commerce —As a result of the growing use of electronic commerce and the increasing shift to digital channels, consumers and merchants are increasingly conducting commerce across more than one channel. Businesses are responding to increased consumer spending online and through mobile devices by increasing their e-commerce and mobile commerce capabilities.
- Expanding Use of Technology at the POS —As the costs of technology have decreased in Brazil, access to the internet has increased, and software has become easier to use, merchants are using more solutions, such as smart POS devices, integrated POS terminals, mobile devices, and specialized software applications to run their front-of-house operations and back-office functions.
- Deployment of Technology Services is Changing —As a result of the growing use of omni-channel commerce and the expanding use of technology at the POS in Brazil, service providers are increasingly deploying technology in new ways, including through: (1) cloud-based solutions; (2) integrated software solutions; (3) mobile devices; and (4) third-party applications.
- Deployment of Financial Services is Changing —As a result of these trends, the deployment of financial services is also changing. More financial services are being provided outside of traditional bank branches, such as at the point-of-sale or online, and more financial services are being provided by non-bank firms that are using technology to deliver these services more efficiently and conveniently.
- More Open Regulatory Environment —The regulatory environment for the payments industry in Brazil has undergone significant changes in the past few years due to a concerted effort by the Central Bank and the Brazilian government to foster innovation and promote more open and fair competition. In 2010, the Central Bank and antitrust authorities initiated a series of measures that eliminated the exclusivity of certain vendors and opened up the market to new entrants. Since then, a new regulatory framework has been developed and government authorities have been fostering competition.
- Growing Market in Small and Medium-Sized Cities —The incremental growth of electronic payments in Brazil will be significantly driven by commerce in small and medium cities. According to a 2015 McKinsey report, small and medium cities with populations between 20,000 and 500,000 inhabitants will account for more than 50% of total consumer spending growth in Brazil between 2015 and 2025. This spending growth will be compounded by the continued shift to electronic payments to generate above-market growth rates for electronic payment volumes in Brazil.

The company

StoneCo is a leading provider of financial technology solutions that empower merchants and integrated partners to conduct electronic commerce seamlessly across in-store, online, and mobile channels in Brazil. They have developed a strong client-centric culture that seeks to delight their clients rather than simply providing them with a solution or service. In their initial years, they were inspired by Zappos' approach to customer relationships. One of the first decisions they made relating to the business was to build the customer relationship team in-house, to serve clients of all sizes and channels. Brazil suffers from a general lack of a service mentality and, being entrepreneurs, they understood the sense of urgency that exists and wanted to assure they would not frustrate their clients by having them wait in line or make multiple phone calls to solve a simple issue. This Zappo's type of customer centricity, in their case merchants centricity, which only can be the result of a deeply embedded "customer first" culture, is very hard to replicate and might turn out to be a very unique competitive advantage.

StoneCo created a proprietary, go-to-market approach called the Stone Business Model , which enables them to control the client experience and ensure that interactions are provided by their people or technology. The Stone Business Model combines their advanced, end-to-end, cloud-based technology platform; differentiated hyper-local and integrated distribution approach; and white-glove, on-demand customer service.



The Stone Business Model is disruptive and has enabled them to gain significant traction in only four years since the launch of their service. In 2017, they were the largest independent merchant acquirer in Brazil and the fourth largest based on total volume in Brazil. In 2017, they became the first non-bank entity to obtain authorization from the Central Bank of Brazil to operate as a Merchant Acquirer Payments Institution. In the same year, they grew their total revenue and income to R$766.6 million, an increase of 74.3% from 2016. They have managed this rapid growth while maintaining high-quality service and obtaining high NPS (Net Promotor Score), a measure of the willingness of customers to recommend a company's products and services. As of August 2018, they had an NPS of 65, the highest NPS among their peers in their key markets in Brazil.

The combination of the various proprietary and vertically-integrated elements of the Stone Business Model are difficult to replicate in full. This provides them with strong protective barriers to entry which may make it difficult for competitors to replicate the value proposition.

They served over 200,000 active clients in Brazil as of June 30, 2018, including digital and brick-and-mortar merchants of varying sizes and types, although their focus is primarily on targeting the approximately 8.8 million small-and-medium-sized businesses, or SMBs. They also served over 95 integrated partners as of June 2018, which use or embed StoneCo's solutions into their own offerings to enable their customers to conduct commerce more conveniently in Brazil. These integrated partners include global payment service providers, or PSPs, digital marketplaces, and integrated software vendors, or ISVs.

The balance sheet

StoneCo has $1.6 billion in total liabilities compared to $1.84 billion in total assets. StoneCo clearly uses a significant amount debt to boost returns, as it has a debt to asset ratio of 0.9. StoneCo reported negative cash flow over the past several quarters.

The Stone Technology Platform

StoneCo developed and operate the Stone Technology Platform which brings together an integrated suite of advanced technologies designed to provide differentiated capabilities and seamless omni-channel commerce client experiences in a more secure, all-in-one environment. The platform was developed to operate in a completely digital environment and enables them to develop, host, and deploy their solutions, conduct a broad range of transactions seamlessly across in-store, online and mobile channels, manage the distribution hubs, and optimize the client support functions—all in a fully-digital, fully-integrated, and holistic manner. Given its digital DNA and cloud-based architecture, the platform is agile, reliable, and scalable with fast processing speeds and a broad range of capabilities that can be maintained and expanded relatively easily and cost-effectively. The advanced nature and flexibility of the platform enables them to provide a number of technologies and benefits, which provides operating advantages, including the ability to:

- Connect and integrate easily with their clients —StoneCo develops and provides a range of powerful connection and integration technologies, user-friendly client portals, and convenient reporting tools that are simple and easy to use. These were designed to eliminate the technical complexity and difficulty that many clients and partners typically encounter when trying to conduct electronic commerce, and they are designed to require minimum effort to implement by their clients or personnel. StoneCo has publicly published their proprietary APIs, which provide a set of programming instructions and standards to access and connect to their systems. StoneCo has also developed a set of SDKs, which provide software development tools, code, and documentation to help third-party developers create applications on their platform. Together, these help their clients connect to their systems easily and make StoneCo a partner of choice for many ISVs, PSPs and marketplaces seeking to do business in Brazil.

- Provide seamless omni-channel experiences — StoneCo designed the platform to enable merchants to conduct commerce and reconcile data seamlessly across various sales channels in a single, brick-and-motar store or multi-location environment, online through an e-commerce or mobile commerce enabled website, or inside of a mobile application. This provides a competitive advantage that appeals to merchants and integrated partners who are increasingly operating across more than one channel and are looking to provide their consumers with a streamlined shopping experience.
- Implement and deploy new capabilities — StoneCo utilizes their digital, cloud-based architecture and integration capabilities to implement and deploy new features and technologies to their clients and integrated partners. The technology platform provides the flexibility to do this easily without the need for expensive upgrades, complex conversions, or lengthy service disruptions. This enables them to provide their clients with the latest functionality in a quick and frictionless process. In addition, the architecture and infrastructure are designed for rapid scalability, which enables them to expand the capacity and manage utilization efficiently and cost-effectively.
- Utilize AI and Machine Learning Technology — The digital DNA and cloud-based architecture of the platform enables them to generate, capture and aggregate a vast array of data across the various business activities. For example, they have developed and deployed machine-learning technologies throughout the enterprise to leverage this data to improve the speed, functionality, and quality of many of their services and operations. For example, they use AI to: (1) predict merchant behavior and enable proactive action by their sales teams; and (2) increase the accuracy of their fraud management. In addition, they use AI in many of the internal processes to create better efficiencies and performance. For example, they use AI to: (1) improve the management and interpretation of the operational KPIs; and (2) better predict cultural fit, job satisfaction, and long-term performance of job candidates during the talent recruitment and retention processes.
- Operate at Low Marginal Costs —The architecture and various operating advantages of the Stone Technology Platform enables them to run the business increasingly efficiently and with lower incremental transaction costs.

Payments Volume and Processing Fees

StoneCo derives a substantial part of their revenue from fees earned as a percentage of the TPV (total payment volumes) of their clients. Their TPV is primarily driven by:

- Growth of volume within their active client base. As active clients grow their transaction volume, the TPV will also grow. Their active clients are positioned in attractive growth market segments. The focus is primarily on targeting the approximately 8.8 million SMBs in Brazil, which have historically been underserved. In addition, despite the large size of Brazil's economy, its Payments market, particularly among SMBs in small and medium cities, remains less penetrated and has greater growth upside than more mature economies, such as the U.S. and the U.K. StoneCo also targets the e-commerce market, which is expected to grow faster than the overall Payments markets in Brazil.
- Growth of their active client base. Growth of their active clients is driven by (i) growth in the number of merchants resulting from openings and ramp-up of Stone Hubs; (ii) growth in the number of integrated partners in specific verticals and niche market segments; (iii) growth in their e-commerce merchant base.

The quarterly TPV grew 192% in a two-year period, from R$6.3 billion for the quarter ended June 30, 2016 to R$18.5 billion for the quarter ended June 30, 2018, and the number of active clients expanded 216% over the same period, from approximately 63,500 active clients as of June 30, 2016 to approximately 200,600 active clients as of June 30, 2018.

A significant part of the net revenues is generated through fees they charge for providing end-to-end processing services using the Stone Technology Platform, which include the authorization, capture, transmission, processing and settlement of transactions. In the case of e-commerce merchants, they may additionally charge a fixed fee per transaction to provide gateway services.

Deep expertise and track record

StoneCo's founders and several members of their management team have deep expertise in developing and delivering disruptive financial solutions. The team has a proven track record of founding, investing, and scaling several successful financial technology businesses in Brazil, including:

- Pagafacil —an e-commerce escrow service, which was sold to private investors in 2004;
- NetCredit —a provider of consumer credit solutions, which was sold to BNG Bank in 2009;
- Braspag —an e-commerce payments solution provider, which was sold to Grupo Silvio Santos in 2009;
- PGTX —a payments technology company, which was sold to Pontual in 2014;
- Sieve Group —an e-commerce price comparison service, which was sold to B2W in 2015 and
- Moip —an e-commerce payments facilitator, which was sold to Wirecard in 2016.

Their board of directors is comprised of highly successful senior executives that combine strong global operating, financial, and regulatory experience with deep expertise in the financial services, payments, and technology industries. In addition, StoneCo has attracted a strong base of world-class investors, many of whom have been key strategic advisors to the company and have consistently increased their investment in the group over prior capital rounds. The mix of the entrepreneurial, executive, board, and shareholder experience and expertise provide a key competitive strength for the company.

André Street is the Chairman of the board of directors. He has held the position of member of the board since 2014. In 2000, he founded Pagafacil.com, a company specialized in internet payments in Brazil that partnered with websites such as I-Bazar, Mercadolivre, Lokau.com and Arremate. In 2005, he founded Braspag Tecnologia Em Pagamentos, a service provider of payment solutions in Latin America, where he served as CEO until 2009, when the company was sold. In 2007, he also founded Netcredit Promoção de Crédito S.A., a consumer credit company that geared towards facilitating business growth by offering extended payment terms and emphasizing digital credit approval processes. Mr. Street is a founding partner of ACP Investments Ltd – Arpex Capital (formed in 2011), a company focused on investing in e-commerce technology companies in Latin America and in the United States. While at Arpex, he founded StoneCo Ltd., the issuer company, controller of Stone Pagamentos S.A. and Mundipagg Tecnologia em Pagamentos S.A., two of their subsidiaries. Between 2012 and 2015 he had indirectly controlled Sieve Group Brasil Tecnologia S.A., a holding company that was owner of several technology companies, sold in 2015. He also served on the board of directors of B2W Companhia Digital S.A. from 2015 to June 2018 and currently serves on the board of directors of Lojas Americanas S.A. In 2010, Mr. Street completed the Owner President Manager Program at Harvard Business School.

Thiago Dos Santos Piau is the Chief Executive Officer, a position he has held since 2017. Prior to 2017, he was their Chief Operations Officer and prior to 2016, he was the Chief Financial Officer. He is a partner at ACP Investment Ltd. – Arpex Capital, where he was responsible for the definition of the business strategy, investment structuring, merger and acquisition transactions and oversees the management of portfolio companies. In 2011, he founded Paggtaxi, a company that facilitated the payment of taxi rides through a mobile app and credit card machines, where he served as a partner until 2013. Mr. Piau conducted studies in mechanical engineering at Universidade Federal do Rio de Janeiro from 2007 to 2011 and participated in the Key Executive Program at Harvard Business School in 2013. He also participated in the Owner President Manager Program at Harvard Business School in 2018.

Growth

StoneCo's distribution is a key competitive strength that will enable them to expand their footprint and market penetration and continue to extend the reach of their business. They intend to continue to:

- Grow the base of Stone Hubs —As of June 30, 2018, they had nearly 180 operational Stone Hubs across Brazil and expect to continue to launch new hubs to increase their coverage and penetration of the market. The strategy of targeting underserved, small-and-medium sized cities, combined with their speed and agility, provides StoneCo with a significant growth opportunity. Following the development of the Stone Hub, they have established highly-scalable, plug-and-play processes that enable them to deploy new hubs faster and more effectively, with more efficient hiring, training, and selling.
- Grow the base of Integrated Partners —As of June 2018, they had over 95 integrated partners, such as PSPs, marketplaces, and ISVs. These integrated partners represent an important growth channel for StoneCo to capture more e-commerce and software-integrated payment volumes. StoneCo expects to continue to leverage their powerful connectivity and integration capabilities, including the Mundipagg gateway and Pagar.me PSP platform, to grow their base of integrated partners and help their existing clients grow their businesses.
- Sell additional solutions to their clients —As in-store merchant locations continue to become digitalized, the broad suite of solutions and their omni-channel commerce capabilities provide StoneCo with significant opportunity to sell additional existing solutions into their client base. StoneCo intends to leverage the strong relationships and distribution capabilities provided by their Stone Hubs to sell additional solutions to their merchant base with a view to minimizing incremental acquisition costs.

StoneCo intends to develop new solutions and capabilities for their current client segments to better serve their clients and further empower them to grow their businesses, such as:

- Digital Banking Solutions —StoneCo is developing a suite of digital banking solutions designed to enable their clients to conduct financial transactions, receive and remit funds, issue boletos, pay bills, and integrate their enterprise financial data in a more efficient, streamlined, and cost-effective manner than traditional bank accounts.
- ERP Software —StoneCo is deploying ERP software to help merchants in the food and beverage industry manage and integrate their point-of-sale transactions with their front-of-house functions and back-office operations more effectively. They also aim to identify opportunities to develop and deploy ERP software into other industry verticals.

And StoneCo intends to develop new solutions and capabilities for their new client segments, to address new business opportunities that leverage their technology, solutions and distribution, such as Micro-Merchant Commerce —they are deploying an independently branded easy-to-use, out-of-the-box, and cost-effective solution, which combines point-of-sale technology with their payment acceptance services and a fully integrated digital wallet account and bank card to help the approximately 5.5 million micro-merchants in Brazil, according to Neoway data as of June 2018, who may not need all of the advanced functionality of the standard offerings, to run their businesses more effectively.

StoneCo intends to enter new markets. The Stone Business Model is well suited to serve clients in other markets where their technology, solutions, and support model can continue to disrupt traditional vendors and legacy business models. Opportunity exists in:

- New Sectors —They are exploring new complementary business opportunities in adjacent sectors, such as digital banking and vertical-specific software solutions. In the future, they may selectively expand into other sectors where they see an opportunity to leverage their capabilities to provide a differentiated value proposition for clients, such as CRM solutions and loyalty programs.
- New Geographies —They are also expanding their geographic footprint by growing the base of Stone Hubs across Brazil. In the future, they may also seek to grow their business by selectively expanding into new international

markets where they can leverage the Stone Business Model .

Competition

The Brazilian payments industry is highly competitive and fast-changing. StoneCo faces competition to acquire merchants from a variety of providers of payments and payment-related services. Primary competitors include traditional merchant acquirers such as affiliates of financial institutions and well-established payment processing companies, including Cielo S.A., a company controlled by Banco Bradesco S.A. and Banco do Brasil S.A., Redecard S.A., a subsidiary of Itaú Unibanco Holding SA, Getnet Adquirência e Serviços para Meios de Pagamento S.A. (Santander Getnet), a subsidiary of Banco Santander (Brasil) S.A. Other competitors include other payment processing companies, such as PagSeguro Digital Ltd., First Data Corporation, Global Payments—Serviços de Pagamentos S.A., a subsidiary of Global Payments Inc., Banrisul Cartões S.A.(known as Vero), a subsidiary of Banrisul S.A., Adyen B.V. and SafraPay, a unit of Banco Safra S.A. StoneCo also faces competition from non-traditional payment processors that have significant financial resources and develop different kinds of services, including gateways, PSPs, other reconciliation providers and ERPs. Other means of payment, both digital and traditional, including cash, checks, money orders and electronic bank deposits or transfers, compete indirectly with their products and services.

The most significant competitive factors in this segment are price, brand, breadth of features and functionality, scalability and service capability. While competitive factors and their relative importance vary based on the size, industry and focus of each merchant, StoneCo seeks to differentiate from their competitors through their disruptive business model. And interestingly enough, Brazil’s own internal regulations mean that outside FinTech companies like PayPal will not be able to easily muscle in and compete.

Risks

For a comprehensive risk assessement, please look at section “risk factors” (page 22) of the IPO prospectus.

- The first risk is fierce competition (previous paragraph).
- The second risk relates to the rapid developments and change in the industry. This market is characterized by rapid technological change, new product and service introductions, evolving industry standards, changing client needs and the entrance of nontraditional competitors. In order to remain competitive and continue to acquire new merchants rapidly, StoneCo is continually involved in a number of projects to develop new services or compete with these new market entrants, including the development of mobile phone payment applications, e-commerce services, digital banking, ERP, digital wallet account and bank card, prepaid card offerings, and other new offerings emerging in the electronic payments industry.
- And the third risk relates to regulation. Their business is subject to Brazilian laws and regulations relating to electronic payments in Brazil. Pagar.me has applied to the Central Bank to be licensed as a payment institution, and is awaiting such Central Bank approval. While Pagar.me is permitted to continue operations as a payment institution pending the outcome of the approval process, the failure to eventually obtain such approval would have material adverse effects on the business. In addition, Pagar.me currently operates as a payment scheme settlor pursuant to Central Bank license exemption, and depending on its growth in volumes processed, will be subject to the applicable regulations to operate as a payment scheme settlor.

Valuation

StoneCo is by no means a classic low risk value stock with a huge margin of safety. Actually, it’s the prototype of a high risk growth stock. It probably will be a bumpy road for the StoneCo stock, especially the first few years, with lots of risks that can materialize. StoneCo is currently trading @ a market cap of 6.5B USD. So is this company going to double, triple, quadruple or even more? Well, I just don’t know.

Many times, analysts project companies like these to grow @ double rate digits and often they are wrong. Only 10 percent of the high growth companies maintain 20 percent real growth 10 years on. But there are indeed exceptional growth stocks, e.g. Amazon, Verisign, Nvidia and Constellation Software. And it is not exceptional that these companies trade @ 20 to 25 times EBITDA.

Valuing companies like StoneCo, early in the life cycle, is difficult, partly because of the absence of operating history. Like Buffett, Munger and Klarman, I also believe that valuations based upon EBITDA multiples in general don't make sense at all. You should avoid that, as much as possible. The traditional value investor critique from Buffett, Munger and Klarman is simple and correct: it isn't actually cash flow because it excludes necessary expenses and capital reinvestment.

But there are exceptions. John Malone, faced with the capital intensive and competitive needs of the early cable industry, was likely the first to introduce EBITDA to Wall Street. If companies create value, e.g. gaining market share, without profits, the best attempt to measure this "yet unprofitable value creation" might be EBITDA. The same counts for companies early in their lifecycle and companies that come into existence from a special situation, like spinoffs. For these companies, net income, or other measures, do not reflect the value that might be accumulated or earned. EBITDA might give a better performance picture when traditional metrics are negative.

Let's suppose that StoneCo will be one of these exceptional companies with a consistent growth rate of 20% or even more over 10 years and let's assume that the EBITDA of StoneCo equals 250M USD soon and take that as the starting point. Then the EBITDA 10 years from now approximately will be 1.5B USD. If by then the stock trades @ 20 to 25 times EBITDA, the company will actually trade @ a market cap of approximately 34B USD. The stock currently trades @ 6.5B USD. You could argue that the stock has the potential to become a 5 to 6 bagger.

The question is if StoneCo will be one of those elite long term growth stocks. Time will tell. And once again, obviously Todd Combs and the Berkshire management see tremendous promise in the future of mobile payments. There is research out there suggesting that the annual global growth rate of mobile payments 2016 – 2021 is 52% and Brazil is just scratching the surface of this trend.

Cordially,

Peter

Peter Coenen
Founder & CEO of The Value Firm®
1 December 2018