NORDSTERN CAPITAL

Partnership Memo: 4th Quarter 2021

New York, January 22nd, 2022

Dear NORDSTERN CAPITAL Partners and Friends:

Inflation

"inflate: increase (something) by a large or excessive amount"
- definition from Oxford Languages

Supply-chain disruptions, anti-globalization, China-US decoupling, COVID-19, lockdowns, maybe even corporate greed – all are possible explanations contributing to the recent increase in prices for goods and services. However, the root cause of inflation is to be found in its very definition: an increase by an excessive amount in the money supply.

I am unable to judge the right or wrong of government spending and stimuli, or the necessity of Federal Reserve financing of government debt at this scale. Every measure might be warranted. Nonetheless, monetary and fiscal policy of the last decades have maneuvered the US economy into a trap: an extraordinary debt load that can be sustained only with ultra-low interest rates, now coupled with increasing inflation.

Some of the highest echelons have argued that inflation is going to be 'transitory'. Once the pandemic is over, strong secular counterforces, e.g. innovation, will rather lead to deflation. While those opinions might have merit, I believe that the spending prowess of politicians, for good reason or not, will easily counter any counterforces. The supply of money will keep increasing excessively, hence: inflation.

The traditional method to rein in inflation is to increase interest rates to tighten credit. The Federal Reserve is now 'tapering' (printing money, but slower) and is expected to raise interest rates this year. Raising rates from zero to 1% in 2022, as it is currently discussed by central bankers, won't curb the current inflation levels. However, the Federal Reserve claims to be ready to do what's necessary.

Unfortunately, this might prove impossible. The US debt load does not allow for any meaningful rate increases. Following this logic, inflation will keep galloping for the time being, regardless of current market or FED expectations or political talk. In the end it might have to work itself out just like an unstoppable virus.

"Inflation is like toothpaste. Once it's out, you can hardly get it back in"
- Karl Otto Pöhl, former Chairman of the German Central Bank

NORDSTERN CAPITAL

Nobody loves me

Imperial Metals is a Canadian gold and copper mining company. Some readers will stop right here…as did I when I first heard about it. What's more 'boomer' than a gold miner? Answer: a small mining company that doesn't do earnings calls, conference presentations or any kind of promotions, and doesn't have any sell-side coverage.

I could talk at length about this business, its world class stewardship (Murray Edwards) or the company's rich history. However, I will just present our estimated free cash flows (FCF) for Imperial Metals:

Years →	2022	2023	2024	2025	2026	2027	2028	2029	2030
Assumptions:									
Gold in $ per oz	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800
Copper in $ per lbs[#]	4.50	5.30	6.00	6.50	6.00	5.50	5.00	4.75	4.50
USD / CAD	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Cash Flows in million CAD$:									
Mt Polley re-opening costs[##]	(40)								
Mt Polley FCF from operations[###]		172	206	230	206	182	158	146	134
Red Chris ramp-up costs[*]	(162)	(165)	(176)	(197)	(134)	(62)	(37)	(15)	(9)
Red Chris FCF from operations[*]	90	87	141	247	232	128	229	334	363
Red Chris FCF from high-grade pods[**]		80	40						
Huckleberry re-opening costs[##]		(50)							
Huckleberry FCF from operations[***]			125	150	125	100	75	53	50
TOTAL FCF in million CAD$:	**(112)**	**124**	**336**	**431**	**430**	**348**	**424**	**527**	**538**

 # based on Jefferies Metals & Mining copper price forecast, 2022-01-13
based on Imperial Metals management comments
based on Nordstern Capital assumptions, management comments, and historic ore production at WX and Springer zones
** based on Newcrest Technical Report on Red Chris Operations (NI 43-101), published 2021-11-29*
*** Nordstern Capital assumptions. Newcrest will publish its early mining plans in the next months with more accurate estimates*
**** based on Nordstern Capital assumptions, management expectations regarding operating costs, and historic ore production*

The market offers the above cash flow stream for CAD$500m, Imperial Metals' current enterprise value. Each purchased share acquires the proportionate ownership, and therefore the company's future cash flows.

Mining operations are susceptible to a multitude of potential problems. For example, Imperial Metals had a serious dam breach in 2014. Furthermore, the above cash flow estimates are based on commodity price forecasts. Lower commodity prices could turn Imperial Metals into a disappointing investment. On the flip side, higher gold and/or copper prices could significantly increase the above cash flows. I believe that notable inflation will continue, and future gold and copper prices will more likely go up than down.

The 'conservative' presumption that nobody would be willing to pay more than 5-times trailing free cash flow for a mining company results in a terminal value of CAD$2,690m[1]. The IRR for the entire cash flow stream (including initial investment and terminal value) would be more than 40% over nine years.

A cash flow generation machine that returns more than 40% IRR over 9-years. What's not to love?

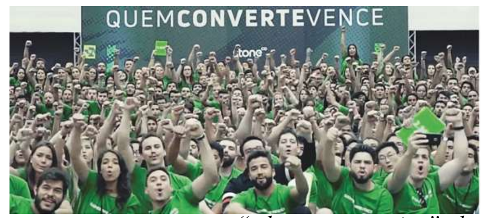
[1] Terminal Value = 5 x CAD$538m = CAD$2,690m

Everybody hates me

StoneCo Ltd (Stone) was a darling of the 2020 stock market, but in 2021 the stock price dropped more than 80% from $95.12 to $16.86 at year-end. Everybody (and their tax-loss selling mother) hated it.

The Brazilian fintech Stone is stewarded by André Street, one of the youngest billionaire founders, and has earned the trust of long-term owners such as the Walton family and Warren Buffett. Its clients are primarily SMBs and I believe Stone has Brazil's best boots-on-the-ground hyper-local hyper-energized sales force.

"I want to be part of the Green Angels…let's paint Brazil green"
- Stone job applicant



quem converte vence = "who converts wins" aka "always be closing!" (image: IPO Prospectus)

2021

Buy-now-pay-later has a long tradition in Brazil. Instead of waiting for anywhere between 1-12 month to collect their money from a card transaction, small merchants often opt for immediate prepayment of these receivables for a discount. Until recently, these prepayments could only be performed by the merchant's point-of-sale (POS) provider, such as Stone. A quasi-monopoly allowed the industry to charge 1-3% per month (up to 36% interest per year) for this service to the locked-in merchant. This is Stone's biggest business[2]. The interest is paid by the merchant on day one via a deduction, and the principal is owed to Stone by a card issuing bank, which in turn has guarantees of its own from Visa or Mastercard[3]. Low-risk high-return[4].

2021 confronted Stone's business with a perfect storm. The Central Bank of Brazil (CBB) introduced a registry system which would allow anyone to bid for such prepayment transactions. The intent is to create a competitive market with lower interest rates for the previously captive merchants. This poses a threat to Stone's margins. In addition, to fight rampant inflation, the CBB raised interest rates from 2.00% to 9.25%, which resulted in significantly increased funding costs for Stone. Moreover, the CBB launched low-cost (mostly no-cost) instant payment ecosystem PIX[5], which might pressure Stone's payment transaction fees.

Besides charging for payments, Stone is also using the transaction data to create a credit scoring system for risk assessment of unsecured lending to its SMB clients. Stone's payment platform deducts interest and principal of such loans directly from the merchant's future revenue. However, Stone had to provision 40% of the outstanding loan balance for bad debt last year as 35% of the loans became non-performing due to several technical and operational mishaps. Stone decided to stop the entire lending program[6].

Stone does not only provide financial services to its SMB clients but also wants to serve software solutions. However, their hyper-local sales force has been less effective in selling software, often requiring third-party helplines, and has not been able to provide the stellar level of service on the software side that Stone clients are used to[3].

---

[2] About 40% of revenues according to StoneCo 3Q2021 Financial Results
[3] According to Nordstern Capital research
[4] Says the economist: "I see this works in practice, but it will never work in theory"
[5] https://www.bcb.gov.br/en/financialstability/pix_en
[6] StoneCo 2Q2021 earnings presentation

Future

"If things are not failing you are not innovating" - Elon Musk

Stone's 2021 was disappointing. Let's move on and look at the future of Stone's revenue streams:

Prepayments: The CBB's new registry system opens competition for prepayment transactions. However, it is still the merchant who chooses the counterparty for the prepayment[7]. I believe this will help Stone to win this market. A merchant who is using another POS competitor is now free to choose Stone for prepayment services. Imagine our green Stone missionary making the rounds from coffee store to restaurant to barber shop, etc. and asking the busy store owner: "*Olá, you know me, we are friends, I know you have a POS from Cielo, those cutthroats…keep them if you must, but give me all their prepayments and I can give you a better rate*". Contrast that with the picture of a banker cold calling a busy shop owner and inquiring about financial transactions. If it were me, I'd immediately hang up and block that number. While competition will undoubtedly lead to reduced margins, I expect Stone to utilize its unrivalled sales force to gain market share in the medium term. Even with today's 10% funding costs, Stone can still realize net interest margins close to 20%. Increased prepayment volume might more than make up for lost margin.

Payments: PIX is expected to reduce payment transaction fees (MDR)[8] in Brazil. However, current studies show that PIX is not affecting credit card usage and Stone makes most of its MDR from credit card transactions[7]. In fact, credit card penetration is growing faster than MDR erosion[7]. The biggest loser against PIX is cash. Increased credit card transaction volume might more than make up for lost margin.

Credit: I believe Stone's true destiny is to ultimately create Brazil's best credit scoring system for SMBs à la Jack Ma's Ant Group (which is a Stone shareholder). If Stone can capture the payment transaction data of a large part of Brazil's SMBs, they should be able to assess creditworthiness of its clients better than anyone else, certainly better than any traditional banks. The first attempt to ramp up this business failed miserably last year. Well, let them rethink, restart, regroup, and iterate further toward success. Management communicated that Stone would test new credit solutions in 2022 and be back at scale in 2023[7].

Software: The key to the lending business is the payments data. The key to the payments data is client retention. The key to client retention is to add value. Linx, acquired by Stone last year, holds close to 50% market share in management software (CRM, ERP, taxes, loyalty, inventory, accounting, …) for retail in Brazil[9]. The hubs will educate its SMB clients this year how Linx software can add value to their business[7].

Valuation

Despite disappointments, Stone was still a vastly profitable business in 2021 that generated cash, invested in growth, made acquisitions, and repurchased shares. Sales are expected to grow around 50% over the next couple years and Stone shares currently trade at 9x forecasted earnings 2-years out[10]. Why all the hate?

---

[7] According to Nordstern Capital research
[8] Merchant discount rate (MDR) is a charge paid by merchants to payment service providers for every transaction
[9] Linx company presentation March 2021
[10] Goldman Sachs: StoneCo earnings forecast as of 2021-11-16

NORDSTERN CAPITAL

NORDSTERN CAPITAL

The Nordstern Capital partnership can flourish thanks to our partners' trust, which empowers us to ignore short-term stock price volatility and to focus on decision making for long-term investment success. I am convinced that the dedicated focus on the long-term cash flow prospects of our investments will result in better long-term returns.

Long-term oriented accredited investors who are not partners yet are encouraged to apply. Looking forward to hearing from all of you.

Happy (Chinese) New Year,

Johannes Arnold

____

Johannes Arnold, Nordstern Capital Investors LLC