Q3 2011 Earnings Call

Company Participants

- Clovis Poggetti Junior, VP of Finance and IR Officer
- Eduardo Chedid Simoes, EVP of Products and Business Development
- Roberta Noronha, IR
- Romulo de Mello Dias, CEO

Other Participants

- Carlos Macedo, Analyst
- Craig Maurer, Analyst
- Federico Rey-Marino, Analyst
- Henrique Caldeira, Analyst
- Paulo Ribeiro, Analyst
- Saul Martinez, Analyst
- Victor Schabbel, Analyst

Presentation

Operator

Pardon me, this is the conference operator. Good morning. Welcome everyone to Cielo's Third Quarter 2011 earnings conference call. (Operator Instructions) As a reminder this conference is being recorded. This conference call is being broadcast live on www.cielo.com.br/ir. We remind you that questions for the question-and-answer session may be posted on the website.

Before proceeding, let me mention that forward-looking statements are based on the beliefs and assumptions of Cielo management and on information currently available to the Company. They involve risks and uncertainties as they relate to future events and therefore depend on circumstances that may or may not occur. Actual performance could differ materially from those anticipated in any forward-looking comments as a result of macroeconomic conditions, market risks and other factors.

Now, I'll turn the conference over to Ms. Noronha, who will begin the presentation.

Roberta Noronha {BIO 20488075 <GO>}

Hello?

Operator

You may begin.

Roberta Noronha {BIO 20488075 <GO>}

Hi. Good morning. We would like to thank you all for participating in our Third Quarter results release.

Here with me, I have Romulo de Mello Dias, CEO; Clovis Poggetti Junior, Vice President of Finance and IR Officer; Eduardo Chedid, Executive Vice President of Products and Business Development; Paulo Guzzo, Executive Vice President of IT and Operations; (Tadeu da Costa), Commercial Executive Vice President of (Large Accounts); (Antony Beadu), Executive Vice President of Retail; and also the teams of IR and Finance.

Now, I would like to turn it on to Romulo.

Romulo de Mello Dias {BIO 2054119 <GO>}

Good morning. Thank you for joining us for another results conference call. With the Third Quarter numbers, we present the results of the first 15 months in the new multi-brand scenario. It is feared in a more competitive environment despite challenging, brought growth and efficiency to Cielo.

In our traditional business scope, we continue to pursue differentiation through a closer relationship with our clients and with new products that bring more sales to them.

One of this new initiatives is Cielo Premier, our technology platform which allow merchants, stock brands or issuing banks to develop promotions aiming at making their customers loyal.

However, we want to grow even further this traditional scope and lead new technologies that promote the change of cash and check for electronic means of payment. Examples are our initiatives in mobile payments and e-commerce.

On the slide 3, we have some highlights of the quarter. Net income totaled BRL457.6 million, up 8% as compared with Q2 with net margin of 37.8%. With regard to the same quarter last year, our net income decreased 6%, but you have to remember that the baseline of 2010 was high and that quarter, our net income increased 23% in comparison for the Third Quarter of 2009 while the market showed some reduction in the earnings.

For the first time in the last five quarters, POS rental revenue growth increased 2.7% quarter on quarter with the average rental price of BRL64.7 per month per POS, the highest rental price to represent in the market.

With regards to the same quarter last year, our financial volume of transactions showed a significant growth. According to the market criterion in which the installments are recognized at the moment of the purchase allowing the comparison with other players, the growth was 20.4%. In the accounting criterion, the growth represent 18.6%.

In the same period, the credit volume growth was 21.2% and the debit volume was 14.4%. The debt financial volume presents a lower year-over-year growth rate when compared to other quarters. Two main reasons, first, we have the strong comparison base as in Q3 '10; the year-on-year growth of our debt cart was 29%

In that period, we received stronger associate to the Visa brand, which that product Visa has close to 65% of the market.

Another factor was the migration of some large merchants, profit accounts mainly, in the supermarket sector to other acquires. In these factors, the penetration of debt is around 45% higher when compared to other segments.

On the other hand, this movement was offset by the growth in other segment and as well by the credit products.

Our net operating revenues plus repayment of receivables with credit value adjustments in Q3 were BRL1.2 billion, up 6.5% over Q3 '10.

In the Third Quarter, we announced the partnership with credit card to capture Diners transactions, which focus mainly in the high income population, and soon we will start acquiring Discovery and American brand with more than 50 million clients around the world.

Once again, Cielo was recognized by dedicate publications and was elected best specialized services according to all economic publications, Exame, Valor Economico and IstoE Dinheiro.

In the quarter, Cielo was elected one of the best companies to work by Voce S/A which belongs to Exame and the best in strategy and management.

In August, Cielo joined the Global Compact, an initiative developed by United Nations, which aimed to support the participation of both the private sector and other social actors (to accept) responsible corporate citizenship, universal social and environmental principles to meet the challenge of globalization.

On slide 4, we addressed the macroeconomic environment. Despite the macroeconomic indicators, the GAAP indicate growth. In historical comparisons, we start to perceive the first signs of a possible deceleration.

GDP growth has been frequently downgrade and according to data from the most recent focused report, it's expected to grow 3.3% in 2011. Retail sales reduced its growth rate and in August volume was up 6.2% year on year.

Even though other indicators are preserved, we fear that such growth levels are not sustainable in the new macroeconomic scenario we are facing. And therefore, consumption might decelerate.

On slide 5, we would like to elaborate on another of our highlights in this quarter. We can see in the left graph the financial volumes share between Cielo in our main competitor since the beginning of the multi-brand scenario.

Since Q4 '10, our share has been increasing from 56.9% to 57.2% in Q1, 57.7% in Q2, and now 57.9% in Q3 of this year. In the graph of the right, we run the same analogies taking into consideration our universal pre-acquired that will lead information about the operations. In this case, there was a simultaneous quarter on quarter.

Now I would like to go to Clovis Poggetti who will continue our presentation.

Clovis Poggetti Junior

Thank you, Romulo and good morning to all. On slide 6, we detail our Third Quarter performance and show the key indicators with year-on-year and quarter-on-quarter comparisons.

Throughout the presentation, we will discuss them in more details. But now I would like to call for you attention and reinforce a comment already made my Romulo that our Third Quarter 2010 results, despite the more competitive scenario, were still very resilient and therefore a very strong comparison case.

This fact impacts our analogy pretty much in all our result lines. Considering net MDR for credit transactions, we present a double-digit reduction when compared to the Third Quarter last year reaching in the current quarter 118 bps, one basis point higher than the one presented in the Second Quarter.

When analyzing the debit product, the net MDR was 77 bps an increase of 3 bps compared with the previous quarter mainly due to the higher participation of medium and more merchants.

On our next slide number 7, the upper left graph shows a 12.5% increase in the number of transactions as compared with the same quarter in 2010.

On the upper right graph, the 18.6% growth in the transaction financial volume of credit and debit transaction captured in the quarter, which totaled BRL79.8 billion. And in the last graph on this slide, we have the number of active clients that is merchants that has carried out a transaction in the last 60 days, which reached BRL1,153,000 growing 0.5% year on year and 3.4% quarter on quarter.

On slide 8, we show our merchants breakdown. Since the beginning of the multi-brand scenario, the medium and small merchants have slightly increased their participation both in volume as in revenues. In the Third Quarter 2010, they represented 41% of our financial volume and 67% of our commissions and rent revenues.

On slide 9, we present evolution of our commissions and rental revenues. Over to the Second Quarter this year, total commission revenue increased a BRL68.2 million or 9% mostly due to the 6.9% increase in financial volume, the product mix with higher credit growth versus debit in a higher growth merchant discount rate partially offset by a higher interchange rate.

POS rentals increased 2.7% quarter on quarter. This was the first time in the last five quarters that we present our growth in this line.

In the same period to the POS base grew 3.8% and there was an increase of GPRS devices in proportion to the total days with higher rental fees and a slight reduction of rental price that reached BRL64.7 in the quarter. I wanted to mention the highest rental price in the market.

On slide 10, we present information on our prepayment business that had been growing gradually with preserved levels of return. In the upper graph, we show the growing trend of our prepayment of receivables revenues which achieved BRL160 million of in the Third Quarter this year representing 41.1% growth compared with the same period of 2010.

On the second graph, the prepaid financial volume increased for the ninth consecutive quarter totaling BRL3.9 billion or 7.7% of the credit volume.

The average term of the prepayment receivables operation presented a small decrease going from 58 to 56 days, the reason being that this product is still mainly focused on small merchants.

On slide 10, let's look at our performance with costs. The cost of service provided totaled BRL365.6 million in the quarter, increasing 15.3% year on year and 6.8% quarter on quarter. We present a cost analysis in which we eliminate the impact of our subsidiaries and the additional brand fees.

So generally, this is the key and allows us to draw a comparison of our cost reduction performance on an equivalent base. As we can observe as a result of this analysis, our cost in absolute terms would have decreased 0.9% year on year and increased 1.6% quarter on quarter.

Comparing the unit cost or the cost per transaction and adopting the same methodology, the reduction year on year would have been 11.9%. And finally, when excluding the depreciation in order to eliminate the impact of POS mix change, the unit cost reduction would have been significant 16.2%. Applying the same analysis in the comparison to the Second Quarter this year the unit cost would be 4.8% lower and without depreciation 5.5% lower.

On slide 12, we comment on our operating expenses. They represented BRL165.8 million in the Third Quarter this year, 52.3% higher year on year and 39.1% quarter-on-quarter.

The increase both in the annual and quarterly comparisons are chiefly due to other expenses, which was a result of higher provision for contingency and marketing expenses derived from initiatives to gain and retain clients. Such initiatives occur in different area as trade marketing to improve their relationship with merchants, client loyalty campaigns and partnership with banks as well as clients.

Examples of these initiatives are the project (inaudible) power to Cielo Fidelidade and contains such as Compra Premiada Ourocard Cielo and Bradesco, Banco do Brasil and also partnership with gas station chains among others.

Adjusted EBITDA in the first graph on slide 13 total BRL741.2 million in the quarter, up 3.4% compared to the Second Quarter with adjusted EBITDA margin of 61%.

Simply for the comparison exercise, our adjusted EBITDA margin without considering our subsidiaries was 62.9% in the Third Quarter this year.

Net Income totaled BRL457.6 million in the quarter, down 6.3% as compared to the same quarter in 2010 and up 8% quarter on quarter.

Once again, I would like to point out that this result extremely significant ones as you are aware Cielo's profit in the Third Quarter 2010 when compared to the Third Quarter 2009 already presented a 23% growth. Therefore our comparison base was very strong. The net profit margin in the Third Quarter this year was 37.8%.

Now I would like to hand it over to Romulo.

Romulo de Mello Dias {BIO 2054119 <GO>}

On the slide 13 (sic; see presentation slide 14), we present our first line of solutions which for us are fundamentals and will more than ever use our expertise and boost our competitive advantage to differentiate ourselves.

Our quest is to create value to our clients, maximizing their sales through the most comprehensive value preposition in the market, covering capture, processing, value added, anti-fraud and productivity solutions. In this slide we highlight some of the products we offer in different solutions.

Thank you for joining us. And now we will take your questions. Operator, please.

Questions And Answers

Operator

(Operator Instructions) Henrique Caldeira, Barclays Capital.

Q - Henrique Caldeira {BIO 16441196 <GO>}

You mentioned that rental fees or rental revenues actually were up for the first time in the past five quarters. Can you just elaborate more how do you see this revenue line evolving from here in terms of the install base and pressure on rental fees and more specifically why don't you think -- you mentioned before that MDRs on debit increased given a higher participation of the smaller merchants or do you expect the same impacts to happen on rental revenues and why are we not seeing this? Thank you.

A - Romulo de Mello Dias {BIO 2054119 <GO>}

Henrique, in terms of POS rental revenues, one of the main reasons why we were able to increase the POS rental is due to the fact that you have a high penetration of the GPRS. So the GPRS allow us to charge more from the merchants because it provides mobility and as well, you don't have to pay the deal of the telecom.

Regarding the MDR debit, I will ask Clovis to answer the question.

A - Clovis Poggetti Junior

Hi Henrique. The point, MDR debit went up in this quarter in the result, as Romulo mentioned before, is the result of big merchants transferring their volumes to other acquires, okay. So this is more effect of the mix than otherwise even though price is going up.

For the future, we may say that both POS' and MDR given the competitive scenario and landscape that we have mainly for POS', should be fair to assume the number, the overall number going down slightly with the passing of time.

A - Romulo de Mello Dias {BIO 2054119 <GO>}

And also complimenting the question of also the debit entity, it's important to highlight what I said during my speech.

Supermarket has a stronger -- has a higher penetration of debit when compared to credit. We have around 45%. So it's the reason why when you compare and also take into consideration that the Third Quarter of last year was -- we had a strong growth, we also have, let's say, some loss that went to our main competitor. And when we compared this and take into consideration the fact that the penetration of the debt in these accounts that you lost, at the end of the day the growth of debt was not so high, but was more than compensated by credit and as well in other segments that you were able to gain market share.

Q - Henrique Caldeira {BIO 16441196 <GO>}

And based on that, how do you view your guidance, outlooks for the guidance you provided in the past quarter now with only quarter left for the year? How do you feel that stands compared to your view?

A - Romulo de Mello Dias {BIO 2054119 <GO>}

In terms of growth, we are seeing some, let's say, trends in the economic scenario that the macroeconomic measure and as well the prices that have these happening around in Europe and as well in other countries -- yesterday, I was having a dinner and I had the opportunity to share and people are more, let's say, afraid to do purchase because if you take into consideration the unemployment rate and as well the scenario that we have, we wouldn't have to expect a deceleration in the growth in the economy. So having said that, we're trying to say, that we are more close to the low of the growth in terms of total sales volumes that we provide to the market and it's relate more to a macroeconomic environment than anything else.

Q - Henrique Caldeira {BIO 16441196 <GO>}

In terms of MDRs?

A - Romulo de Mello Dias {BIO 2054119 <GO>}

Yes. With the information the environment that we have today, we are more close to, let's say, to the better scenario. We say that would be between one and five and now we are more close to 1 bps.

Q - Henrique Caldeira {BIO 16441196 <GO>}

Okay. Perfect. Thank you.

Operator

Craig Maurer, CLSA.

Q - Craig Maurer {BIO 4162139 <GO>}

Two questions for you today. First, what are you seeing from new entrants at this point? Has there been any progress made by Santander to improve their offering? And secondly, the POS rental pricing, the average per terminal, it was down a little versus Second Quarter. What will keep that above your main competitor or do you eventually see the average monthly rent per terminal reaching parity with your main competitor as wireless penetration in the market ease and job? Thanks.

A - Romulo de Mello Dias {BIO 2054119 <GO>}

Regarding the first question, the new entrants and what you are seeing is Santander is a (inaudible). They got aggressive --they are aggressive and they are commercially strategy and I think they are gaining some market share and expect what you will be able to reach higher market share in the coming quarters. Regarding the POS rental price, Craig, it's important to mention and to highlight that our -- that POS rental price is the highest in the market. We didn't do any kind of, let's say, strong reduction in our POS rental prices. The reason why when you compare last quarter Q2 with this quarter, it's flat. We didn't see any -- we didn't change our policy and we didn't see any reduction in POS rental price.

So it's depending on the baseline that you are departing you can come okay, we'll increase or we'll decrease. But our rental price is around 65%, almost 65% debt POS.

Q - Craig Maurer {BIO 4162139 <GO>}

Right. But do you expect over time that the rental price will reach parity among the competitors within the market?

A - Romulo de Mello Dias {BIO 2054119 <GO>}

When you say -- we expect to have at least we will try to reach this target. And also take into consideration if you have a high penetration in the small segments that our POS rental price will be -- we'll try to have a higher price.

Q - Craig Maurer {BIO 4162139 <GO>}

Okay.

A - Clovis Poggetti Junior

And Craig, I think also important for you to consider in your analysis the difference in terms of the mix of POS' among all the players, okay. Just an information in our case taking the Third Quarter this year numbers, we have in our base 29% of what is POS. Okay, so for sure this is also helping a lot keeping the average rental fee at the level that we have.

Q - Craig Maurer {BIO 4162139 <GO>}

Okay. Thank you very much.

Operator

Carlos Macedo, Goldman Sachs.

Q - Carlos Macedo {BIO 15158925 <GO>}

I have a couple of questions on the expense side of your income statement. Just if you can give us some more color on that provisions for contingency that you made during the quarter. Are they maybe not one-time provisions, but do you expect to see them at the same levels going forward or is this something that was -- that happened this quarter specifically that you had to address? And second marketing, was this basically -- I mean, marketing expenses in the first half of the year weren't to the level that you have spoken about before and this quarter they were significantly higher. Are you catching up? How should we think about this marketing expense line going forward? Thanks.

A - Clovis Poggetti Junior

Hi Carlos. I will start with your contingency question. Very, very important and I call attention of everybody. This should be treated as a nonrecurring event, okay. We are talking here about we have total BRL80 million affecting in terms of contingencies provisions, okay, BRL12 million for tax contingencies and the other BRL6 million between labor and other contingencies, okay. And this is directly related to re-evaluation of the risk of the claims, re-evaluation made by our lawyers, okay. Reinforcing consider it as a nonrecurring event.

A - Romulo de Mello Dias {BIO 2054119 <GO>}

Regarding the expenses, the marketing expenses, Carlos, we decide to do some expenses that are related to revenues. It's -- our control in terms of costs and expenses continues to be the same and we think we can also deliver with the result in this line, but it's important to highlight some clients for instances that you gain, such as their distributor order (inaudible) partnership with banks. We just launched our new campaign in the media with Compra Premiada, which is a partnership with Ourocard from Banco do Brasil which allow the merchants to receive some gifts and as well the customers when they use their credit card, Ourocard in our POS.

So all of these lines of expenses are related to partnerships that you set up and we expect that it will present the results. Well that present some results in other numbers, but it will present results in the coming quarters.

Q - Carlos Macedo {BIO 15158925 <GO>}

Good. But just so we can almost -- so we can put in our models, is -- should we look at this as a percentage of revenues or should we look at this as a number that's independent of this and will stay around BRL40 million level as opposed to the BRL20 million level where it was before? How do we think about these marketing expenses?

A - Romulo de Mello Dias {BIO 2054119 <GO>}

I think the percentage of revenues is better to expect.

Q - Carlos Macedo {BIO 15158925 <GO>}

Okay. And that it should be somewhere between what it was this quarter and maybe what it was earlier this year?

A - Romulo de Mello Dias {BIO 2054119 <GO>}

This quarter.

Q - Carlos Macedo {BIO 15158925 <GO>}

Okay.

Operator

Victor Schabbel, Credit Suisse.

Q - Victor Schabbel {BIO 17149929 <GO>}

Just a quick question on the dividend payout, you guys reduced last time you paid dividends close to something around 70% of the net profit. Considering this strong performance fee in the prepayment business, should we expect this 70% should be capped for the next year or is there any room for any kind of improvement regarding the payout ratio? Thanks.

A - Romulo de Mello Dias {BIO 2054119 <GO>}

We expect growth in the prepayment. I think as we said before in our -- in other conference call, it is an important line of our business and we do have, let's say, a scenario when you consider everything that our IR guys had the opportunity to talk to you, that we -- with the information that you have, I would say that this would be the next level, you would keep the same 70%.

Q - Victor Schabbel {BIO 17149929 <GO>}

Okay. Great. Thanks.

Operator

Paulo Ribeiro, HSBC.

Q - Paulo Ribeiro {BIO 1929952 <GO>}

My question is in regard to the regulatory environment. There has been talks in the market. Central Bank is going to come with a new report and one of the proposals would be to end the exclusivity between (ELO) and you guys -- AMEX, you guys and EPPICard and Redecard. So any views on that and how is the development of ELO so far for you guys? I know all the POS, the rates have accepted, but are the volumes growing as much as you expected? Thank you.

A - Romulo de Mello Dias {BIO 2054119 <GO>}

Thank you, Paulo. Regarding the new report that will be presented by Central Bank, we do not expect anything thing, let's say, different from what you have seen so far. I cannot say they are going to say something or not about this, what you mentioned about the programs that you have with ELO and AMEX and the fact that we don't work with EPPICard. But I can tell you that there is -- if you don't allow R&D, if you don't allow the companies to invest, we just mentioned that we launched a new campaign for LO, you also mentioned that we're investing in our IT platform to allow the creation of L and the fact that AMEX also does not have the same penetration that Visa and MasterCard have.

So I think we should take into consideration, what's the percentage that the market overall that a certain product would have and after this -- these products or this new initiative should be shared with other competitors.

And about LO, if I also understood correctly your question, how we stand, how we are in terms of LO, I will ask Chedid to answer your question.

A - Eduardo Chedid Simoes {BIO 16447904 <GO>}

Hi Paulo. I believe that we will see volumes picking up from now on. As I told you guys, we've just launched a new campaign where we're basically welcoming L to our POS machines. We've explained to all the merchants that it's ready to go and that means that's been a very much aligned campaign with the banks.

Now the issuing banks can start issuing with much more speed. So we do expect L figures to go up this quarter, but I'd say that first and Second Quarter of next year was much more strength.

Q - Paulo Ribeiro {BIO 1929952 <GO>}

Perfect. Thank you. Just a quick follow-up. Romulo, do you think you have an open channel with the Central Bank to talk about your views of what they, as you expressed now, the fact they would invest in LO, invest in campaigns and all that and the potential end of this exclusivity, something there is an open conversation or is something -- you know when we know and they communicate to the whole market? Thank you.

A - Romulo de Mello Dias {BIO 2054119 <GO>}

What we're going to communicate or not, unfortunately we cannot control and let's wait and see what's going to be published. But about our relationship with Central Bank and other regulatory agents, we do have a very good relationship with them. We have -- I have here in my team one guy that's responsible and help not only Cielo, but I would say also the industry and the relationship with all the players that it's necessary to have the relationship with them.

Q - Paulo Ribeiro {BIO 1929952 <GO>}

Great. Thank you very much and congratulations.

Operator

Federico Rey, Raymond James.

Q - Federico Rey-Marino {BIO 15009016 <GO>}

My questions have been already answered. Thank you.

Operator

Saul Martinez, JP Morgan.

Q - Saul Martinez {BIO 5811266 <GO>}

Most of my questions have been answered, but just kind of a high level question. It seems like strategically you are going in a different direction perhaps in Redecard. If you look at the expense lines specifically, obviously Redecard had a pretty meaningful reduction in their headcount. They seem to be really focused on the cost line. This quarter you guys increased your personal expenses. You have increased your marketing as well.

Obviously it seems like you guys feel like perhaps there is an opportunity to gain share. But can you just comment a little bit on your strategic direction and why you think it's the right one and does that -- should we take that as meaning you feel like you are going to continue to perhaps gain share from your major competitor?

A - Romulo de Mello Dias {BIO 2054119 <GO>}

Thank you, Saul, for your question. In strategic direction, we do respect what our main competitor is doing. I think they have great confident, great strategy and we do respect what they are doing. Our strategy is focused not to gain market share, but to provide pertinence for our shareholders.

So this is our strategic direction, how to provide growth for our shareholders and having said that what we need to do to increase revenues, to reduce costs and expense. It seems and I understand what you are saying, I understand that some -- and let us say, okay, why you increase the marketing expenses, why you increased because that could reduce as well our headcount for the sake of the argument.

But we do think we have some initiatives, some partnerships, some joint ventures, some investments in our key platform, some investments in our products and services that will allow us to differentiate ourselves mainly when you take into consideration the new environment. Let's not forget that newcomers are coming to the market and you need to be ready when they are, let's say, fully operational.

So ELO probably will be launched at the preposition next year. First data, I don't know when, but the LO, I would say that the new players is the (elegance) they want that probably we will launch first before compared to the others.

So our strategic direction continues to be same. I want you to make a statement here, for you guys about costs and expenses. We continue to be very focused on these lines. It doesn't mean the fact that we grow the lines of costs and expenses, it doesn't mean that we are, let's say, we are reducing because we just want to reduce but what's the price of these initiatives.

It will affect the line of revenue, it affects the line of revenue. Revenue compared to cost, I have a good preposition when I cut -- for instance, if I reduce the headcount or if I reduced some lines in terms of IT and as well market as I said, marketing -- out thought and fears as an expense but on the other side it provides more revenue for us.

So our strategy is to follow and to deliver results bottom line if it's necessary to have not the same kind of initiatives that the market is taking, but on the other hand, we provide more revenue than in comparison with earnings. We will provide, let's say, better momentum, better visibility and better numbers, it's the strategy that we try to follow.

Operator

(Operator Instructions) Showing no further questions, this concludes the question-and-answer session. At this time, I would like to turn the floor back to Mr. Dias for any closing remarks.

A - Romulo de Mello Dias {BIO 2054119 <GO>}

I would like to thank you all for your participation and anything else or any doubts that were not clear, we are here to answer your questions. Thanks a lot.