Q3 2012 Earnings Call

Company Participants

- Clovis Poggetti, CFO and IR Officer
- Roberta Noronha, IR
- Romulo de Mello Dias, CEO

Other Participants

- Craig Maurer, Analyst
- Daniel Abut, Analyst
- Domingo Salarina, Analyst
- Marcelo Cintre, Analyst
- Paulo Ribeiro, Analyst

Presentation

Operator

Good morning, everyone, and thank you for waiting. Welcome to Cielo's Third Quarter 2012 results conference call. This event is being recorded, and all participants will be in a listen-only mode during the Company's presentation. After Cielo's remarks, there will be a question-and-answer session. (Operator Instructions)

This event is also being broadcast live via webcast and may be accessed through Cielo's website at www.cielo.com.br/ir where the presentation is also available. Participants may view the slides in any order they wish. The replay will be available shortly after the event is concluded. Those following the presentation via the webcast may post their questions on our website. They will be answered by the IR team after the conference is finished.

Before proceeding, let me mention that forward statements are based on the beliefs and assumptions of Cielo and on information currently available to the Company. They involve risks and uncertainties because they relate to future events and therefore depend on circumstances that may or may not occur. Investors and analysts should understand the conditions related to macroeconomic conditions, industry, and other factors could also cause results to differ materially from those expressed in such forward-looking statements. Now I'll turn the conference over to Mrs. Roberta Noronha. Mr. Roberta, you may begin your presentation.

Roberta Noronha {BIO 20488075 <GO>}

Thank you. Good morning. I'd like to thank you all for joining us as we present our results from the Third Quarter of 2012. With me today are Romulo de Mello Dias, our CEO; Clovis

Poggetti Junior, CFO and Investor Relations Officer; other members of the executive group, the Finance and Investor Relations team. Now, I'd like to hand it over to Romulo please.

Romulo de Mello Dias {BIO 2054119 <GO>}

Good morning. Thank you for joining us for another results conference call. Our operating performance in the Third Quarter of 2012 was a result of the solid fundamentals we continue to present. Among the main highlights of the quarter, on slide 3, net income totaled BRL589 million, up about 29% year on year with adjust net income margins at 38%. EBITDA was BRL783 million, up 32% over the same period of 2012, with margins at 58.5%. Year on year, our financial volume grew 19.5% according to the market criterion where all installments are recognized at the time of purchase, and 20% according to the accounting criterion. In the same period, credit volume was up 21% to BRL61 billion. Debit volume was up 18% to BRL35 billion. Our net (inaudible) plus prepayment receivables adjusted for present value were BRL1.6 billion, up 28% over Q3. This quarter we also conclude the acquisition of 100% of the US company Merchant e-Solutions.

I'd like to highlight the awards received during the quarter. Cielo won the Best and Biggest award from Exame magazine for the sixth consecutive year as the best service industry Company in the Third Quarter. The Company was also chosen for the 12th consecutive year as one of the best companies to work for by the guide in Voce S/A magazine. It was also award best financial services Company in Epoca Negocios Annual Report from Epoca Negocios magazine.

Additionally, Cielo was also recognized as the best financial services Company as in As 1000 melhores da Dinheiro 2012 ranking from Istoe Dinheiro magazine. Last but certainly not least, Cielo achieved the top spot in the Institutional Investor Magazine ranking, receiving a special recognition in achieving the first place in market average analyzed by the ranking. With eight first place, Cielo was the Company with the executive team that ranked (inaudible) in the following categories; Best IR Team, Best CEO, Best CFO and Best IR Professional, according to both the buy-side and the sell-side.

On slide 4, we have the Company's key financial indicators for Q3. Indicators that were not mentioned in the quarter highlights include the number of transactions capital at 14.3% year on year to BRL1.3 billion in the quarter and more than BRL3.8 billion in these nine months of 2012. Important to mention that with such figure, Cielo ranks among the top five acquirers in the world. Total unit cost plus expenses net of subsidiaries were almost flat. Finally regarding net MDR, it was stable, both in relation to the previous quarter and the same period of 2012 (sic; see slide four "2011"). Now, I'd like to go to Clovis who will take it from here.

Clovis Poggetti {BIO 16529642 <GO>}

Thank you, Romulo. Good morning every one. On our next slide, number five, the upper left graph shows the 14% increase in the number of transaction as compared with the same quarter in 2011. On the right, we have a 20% growth in the financial volume of credit and debit transactions kept during the quarter, which totaled BRL96 billion. And on the left graphs of the slide, we have the number of (technical difficulty) which are those who have carried out at least one transaction in the last 60 days, and that reaches BRL1.3 million, up 2% quarter on quarter and 12% year on year.

On slide 6, we have the evolution of our commissions and POS rental revenues. Revenues from commissions grew about 20% or BRL164 million over the Third Quarter last year, mainly due to the increased financial volume. As compared to the Second Quarter this year, total commissions were (technical difficulty) so mostly due to the increased financial volume as the net merchant discount rate, as already mentioned by Romulo, remained practically stable.

POS rental revenues were up 43% year on year mainly due to an 18% increase in the installed base, and also to a higher participation of wireless or GPRS equipment which continue to grow and reached 44% (technical difficulty) installed base in the quarter. Something that needs to be absolutely clear regarding this subject is the fact that the growth in the wireless base is a direct consequence of higher demand from merchants for this product. And this return is consequence of not only the mobility effect but also of the benefits received by the merchant in choosing such a solution.

Let me explain. Despite of the fact that the rental fee charged on the product is higher than the one that we charge for the dial in all fixed POS, not only the telecom cost the shift, for example, in data transfer plan, but also all management of such expense is taken care by Cielo. This is a complete offer to the client that when we fix the POS, do not need to worry about telecom, maintenance, call center, paper rolls, among others.

On slide 7, we have some information about our prepayment of receivables operation. In the first graph, prepayment of receivables generated BRL208 million in revenues in the quarter, up 30% over the Third Quarter last year. In the second chart, the financial volume was BRL6.4 billion representing 10.5% of our total credit volume and the average term of these operations rose from 58 days to 59 days.

On slide 8, let's look at our cost performance. The costs of service provided increased BRL435 million in the Third Quarter, up 19.1% over the same quarter of 2011 and 6.7% over the Second Quarter this year. As we are used to do, we present a cost analysis here where we eliminate the impact of all subsidiaries. As a result of this analysis, we can see that the absolute cost is up 18.5% year on year and up 7.3% quarter on quarter. Analyzing unit cost by the same method, the cost would have grown 3.7% year on year. Finally, if we exclude depreciation in order to eliminate the fact of the changes in the POS mix, the unit cost would have increased 3.4%. Under the same analysis but compared to the Second Quarter this year, the unit cost would have increased 3.2% and without depreciation for 5.4%.

On slide 9, we have our operating expenses. These reached BRL195 million in the Third Quarter, up 22% year on year, but down 13% quarter on quarter. The year-on-year increase is chiefly due to the rise in sales and marketing expenses. The quarter-on-quarter reduction was chiefly the result of the decline in sales and marketing expenses as in the Second Quarter this year this line was particularly high because of the postponement of First Quarter initiatives. In the Third Quarter, sales and marketing expenses represented 4% of total net revenues, including net revenues from prepayment of receivables operations.

EBITDA showing on the left of slide nine (sic; see slide 10 "slide 10"), totaled BRL783 million in this quarter, up 32% over the same period 2011. EBITDA margin in this quarter was 58.5%. Net income totaled BRL589 million the quarter, up 29% over the Third Quarter last year, and 7% over the Second Quarter this year. Adjusted net income margin was at 38%. And now I'll go back to Romulo.

Romulo de Mello Dias {BIO 2054119 <GO>}

I would like to take the opportunity to reiterate that Cielo's fundamentals remain robust. We continue to strengthen the Company with initiatives such as those we recently announced, like the launch of Crediario products and the acquisition of Merchant e-Solutions. The Brazilian market still has growth potential in the payment industry and we believe we are well positioned to continue to lead the industry by offering merchants, banks and consumers a highly reliable service that promotes normalization and security, not just in transactions but in general.

We know that we have challenging quarters ahead given the new competitive environment. Nevertheless shall we continue to follow this strategy as we always have and we are confident that we will deliver. Finally I'd like to stress our commitment to transparency with the quality in everything that we do respecting all our stakeholders and always guided by best corporate governance practice to add value for our shareholders. Thank you for your attention and we look forward to your questions. Operator, please.

Questions And Answers

Operator

(Operator Instructions) Daniel Abut, Citigroup.

Q - Daniel Abut {BIO 1505546 <GO>}

A quick (technical difficulty) on the POS rental revenue issue. If my numbers are correct, the implied average rental price for POS per month was about BRL74 in the Second Quarter of 2010, i.e., before the end of (facilities). Then it kind of bottomed out in the Third Quarter of 2011 at about BRL66. And it's now almost BRL80, in last part because of what Romulo was saying that we may get change in the mix between wireless and wire lines that now presents 44% in the wireless that have the higher rate of (inaudible) but could you help us understand better what happened in the average price of each of the two sets? What happened with the average price of the wire line, how much it has come down because of competitive pressure, and therefore how much that was upset then by the change in mix?

Then going forward, if I recall you correctly, you always said at the peak of the competition that smaller merchants who's never got much of an issue of MDRs, but the key variable in the negotiation was more POS rental. Is that coming back to any extent now that the newcomers are getting more aggressive as you said with smaller merchants? I think you mentioned in prior calls that we may be getting more aggressive with smaller merchants, is that variable (inaudible) negotiations and does (inaudible) more discounts in the POS rentals coming back as we think about how this average price may evolve into the future?

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

Hi, Daniel. Regarding the (extra) rental, the price per month, the main reason as we have explained -- as Clovis explained during his speech is the fact that we are increasing the penetration of GPRS. The merchant is asking for GPRS. As we had the opportunity to share during the Portuguese conference call, we said that we would like to offer more broadband and unfortunately or fortunately the merchants are preferring to chose the wireless. So the fact that we increase as well our cost and depreciation and as well our operation expenses related to the fact that we've also increased the penetration of GPRS.

Talking about the -- our expectation for the coming months and while not to say it for the next year, I would say that the price per POS will be lower compared to the one that you have even though that we expect to increase the penetration of GPRS, and why because you are seeing more competition, which is your second question, meaning there is more merchant than a medium merchants. More and more these merchants are, let's say sensitive to the price that you rent for them. We are doing, let's say, some analysis in order to address this, let me say, new (inaudible), not correctly to say because we are already facing more less pressure.

Just to make my point a bit more clear, when I consider the growth that you have in the whole Company, in Cielo, if I consider only the small and medium merchants, our growth would be much, much lower, around 5%, 6% or 7%. And the main reason why we are growing less than the other sectors is the fact that we are, let's say, feeling more the competition that's coming from this typical segments. It's the reason why we are expecting, concluding my speech at this point, a lower price per POS in the coming months. But at the end of the day, a nominal growth in terms of rental revenues.

Q - Daniel Abut {BIO 1505546 <GO>}

The other reason was (inaudible), you said that you expect to continue reaching the penetration of wireless. You are at 44% in the mix already. How much higher can that number go?

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

I think we can increase more. As I said, we are trying to offer broadband. It will depend on the reaction, but we are not saying the penetration, but what I can say at this stage that the 44% in our strategic (technical difficulty) was to have this breakdown going up.

Q - Daniel Abut {BIO 1505546 <GO>}

Thank you, Romulo.

Operator

(Domingo Salarina), J.P. Morgan.

Q - Domingo Salarina

My question regards the prepayment of receivables. We know that incremental growth -- I mean the Company achieving higher percent of (inaudible) credit volume prepayment sequentially, virtually every quarter, exception of the second Q in -- which was actually a very lower quarter, but now reaching 10.5%. And in a way, we saw stabilization at 10.5% Q on Q. We have still very, very healthy spreads. Is that what you consider to be a more sustainable level for prepayment of receivables? Do you see room for growth? How do you feel about that revenue line? Thank you.

A - Clovis Poggetti {BIO 16529642 <GO>}

As Romulo had the opportunity to share during Portuguese conference call, 10.5% is more challenge for us to increase, if I compare to 7.3%, to 7.2% when we had -- in one, it's the Second Quarter when we didn't increase the penetration of the prepayment. Having said that, I would say that I am not saying that's the gap or that you're not going to grow anymore, but we expect (technical difficulty) but not on the same speed that you were having so far. More important that also this line of revenues is related to the level of SELIC. And SELIC, as you know, and CDI, of course, is going down. The reason why the revenues per se of this line of -- of this specific line of business that you have, it was almost flat when compared to the Second Quarter. But again, they are very important line for us, these are very important business for us. We will continue to devote a lot of efforts in this specific segment.

Q - Domingo Salarina

Okay. Then also you mentioned rather in the Portuguese call this morning, just want to get a bit more clarity on that, when you look at the general macroeconomic scenario, what sort of volume growth are you comfortable with kind of indicating or guesstimating for next year? Something more I mean, I understood lower than the 20% but something above the 15%, what kind of number did you have in mind?

A - Clovis Poggetti {BIO 16529642 <GO>}

As we all have said, the numbers, we are not -- since we launched the product in 2009, we are not providing guidance in terms of percentage that we can achieved but we expect that the macroeconomic environment will (technical difficulty) to prepayment.

Q - Domingo Salarina

And now the total credit and debit volume growth --?

A - Clovis Poggetti {BIO 16529642 <GO>}

I am sorry. I thought that you are talking about prepayment. In terms of total credit and debit for the industry as a whole, I would say that this will probably grow about the mid teens. As you know, this quarter according to our calculation was below 15%. This includes only the two components that we published the results. It's necessary to wait for the numbers from (inaudible) as well from product labels. But I would say that the growth of the industry in this quarter wouldn't be much higher than 15%. It's the reason why when you take a look and you try to predict or to have an expectation about 2015, I would say that mid teens considering the penetration, considering the growth, and moreover consider the penetration of 15% is, let's say, the best scenario that we have in our hands right now.

Q - Domingo Salarina

Understood. Thank you, again and congratulations on the quarter.

A - Clovis Poggetti {BIO 16529642 <GO>}

Thank you.

Operator

(Operator Instructions) Paulo Ribeiro, HSBC.

Q - Paulo Ribeiro {BIO 1929952 <GO>}

I was in the call in Portuguese earlier today too, but I just want some clarity on the direction of the MDR, the net MDR. You mentioned earlier that you expect end to end, meaning end of 2012 to the end of 2013, a drop of about 6 to 7 basis points. Is that the blended net MDR, is that just for credit and a segue into the next question which is the strength of your debt, net MDR in this quarter in particular. Can you talk a little bit about the change in mix increasing in (inaudible) or not that impacted credit and what happened with the debt net MDR this quarter? Thank you.

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

Yes, Paulo, in terms of direction of MDR with the information that you have with the level of awareness, let's say, that you have at this stage, I would say that's more close to that range that I mentioned during the Portuguese call between the six and seven in the blended net MDR, so together credit, debit and the (inaudible) installments.

About your second question related to this trend of net debt MDR, I would say that they were flat. And as you know (inaudible) on the B2B product that we offered is stronger in the Second Quarter than the Third Quarter. So as you know the net MDR for Agricard is much, much lower when compared to the net MDR that you have for debt in the whole.

Q - Paulo Ribeiro {BIO 1929952 <GO>}

Okay, perfect. And in terms of credit net MDR, what was the behavior of the participation of interest re-installments this quarter? Was there any increase?

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

It's almost stable. It didn't change very much. So if we compare credit (inventory) days and credit installment, we do not see any kind of difference, strong difference compared to the last quarter.

A - Clovis Poggetti {BIO 16529642 <GO>}

The mix among the three products stays, as we mentioned, quite stable, one-third for each; one-third, one-third, one-third, light changes between the quarters, but overall picture consider this as a fair number.

Q - Paulo Ribeiro {BIO 1929952 <GO>}

Okay, perfect. And just to follow up. Then, you mentioned earlier in this call, I guess, that the competition between medium and small size is increasing, so you see lower growth from that segment, and they are particularly sensitive to POS as has been the case, prices. So what is your strategy regarding large accounts? You expect maybe to be more aggressive in terms of net MDR among those accounts, would you --- do you think that are the kind of products would make a big difference to your competitor and would you be willing move in that direction with your controlling shareholders?

A - Clovis Poggetti {BIO 16529642 <GO>}

Paulo, Cielo will continue to focus on profitability. Market share is important but not per se. So you are not fight for a market share even though that we expect mainly from large merchants that the number that we have today is a lot, around BRL12 billion in total sales volume. Some of this BRL12 billion was not recognized in the First Quarter, and we expect that will happen during the current quarters because of the migration. They have IT channels, our clients, when they decide to change the acquired company.

Regarding the lower growth, if I understood correctly, your first question about the sensitive of growth, the sensitive to price of the POS I would say mainly they are small segments. They are, let's say, sensitive to POS. This is the reason why we are expecting to have a lower price per POS as I mentioned for Daniel. But on the other hand, I would say the nominal rental business will be higher when compared to the numbers that you provide for the whole year of 2012.

Q - Paulo Ribeiro {BIO 1929952 <GO>}

Perfect, I asked a lot of things in that question, I'm sorry. But getting back to last point, Conta Integrada, you think that product is something that puts you in a disadvantage not having as close as an integration with your partner banks, you main banks as the other large -- the other two acquired, we used to have something that you can offer, something similar, how you compete with that product offering?

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

Conta Integrada is a very important solution that Santander is providing to the market but we have some initiatives if our banks that are partners of Cielo, (inaudible) banks, that we think we can address appropriately the way that Santander and the others are trying, let's say, to reach the competition. I would say that not happened. So easy, because when you are part of one, just one company, when you are a monoline, in terms of price, how to change your price policy is easier in this regard. But on the other hand it's a more challenging scenario when you need to develop IT products and service to your customers.

I know the challenge that Cielo has in terms of IT operations and products when you need to launch a new product. So I would say, and respecting a lot our main competitors that, yes, you're right, at Conta Integrada, we are not a product and even what our main competitor did delisting the shares. It's going to be a more challenging scenario, but at the end of the day we think that we can compete with the tools, with the infrastructure, with the product, with the service that you have. And as well if it's necessary, but always trying to position Cielo at a premium price. If it's necessary, also addressing the price of the POS or the price of the MDR taking into consideration it is a large account, if it is a small, if it is a medium, so on and so forth.

Q - Paulo Ribeiro {BIO 1929952 <GO>}

Perfect. Thank you very much.

Operator

Craig Maurer, CLSA.

Q - Craig Maurer {BIO 4162139 <GO>}

Would you please comment on how things are shaping up through the first few weeks of October versus prior quarter? In addition, have you seen the foreign entrance like (Al Avon) and (GPN) being any type -- have they gotten off the ground yet, is the question? Thank you.

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

Craig, if your question is more related to Al Avon, I would say that we respect, we do respect the Al Avon and the other competitors but we are not seeing, let's say, a strong presence in Brazil. In the future including Al Avon, Santander and the others as you share (inaudible) I would assume that they would have all together, with the exception of Redecard, between 15% and 12%. But at this stage, I would say that Al Avon we see one restaurant and another one is important but we're not seeing, I'd say, a strong presence that will provide a strong difference in terms of market share, so on, so forth.

Q - Craig Maurer {BIO 4162139 <GO>}

Okay and has Redecard's behavior changed at all over the last few months?

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

They changed more in February, okay, when they were more aggressive. And now they are, let's say, more --- the situation is more stabilized.

Q - Craig Maurer {BIO 4162139 <GO>}

Okay. Thank you.

Operator

(Marcelo Cintre), Deutsche Bank.

Q - Marcelo Cintre

So my question is basically on marketing expense and the incentive fees paid to the partner banks. So what should we expect on incentive fees, we should expect higher fee for 2013? And also what level of marketing expense to the revenues should we expect? Should we continue to expect a 4% of net revenues as marketing expense for 2013?

A - Clovis Poggetti {BIO 16529642 <GO>}

The market and sales expanses is related to the partnership that you have with merchant institution campaign, sales (inaudible) and as well we've some campaigns that you have with some banks. Some of the banks, we pay them directly and we deduct a percent of incentive that you pay from the revenues that you have. So we submit, it depends on the kind of campaign that we will deliver, and you agree with that. Talking about 2013, I would say for the next year we expect that this line will grow, but at this stage we are not providing any soft guidance. What I can tell you that the new scenario in considering what is happening in market, we probably will have to increase the incentives that you pay to the partner -- to the banks that you have in our portfolio.

Q - Marcelo Cintre

Okay, that's great. Thank you.

Operator

This concludes today's question-and-answer session. I would like to invite Mr. Romulo de Mello Dias to proceed with his closing statement. Please go ahead, sir.

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

I'd like to thank you all for your participation, and we look to seeing you at our Q4 conference call. Thank you. And have a nice day.

Operator

And that concludes the Cielo's audio conference for today. Thank you very much for your participation. Have a good afternoon. And thank you for using Chorus Call.