

Q1 2014 Earnings Call

Company Participants

- Clovis Poggetti, CFO & Director-Investor Relations
- Rômulo de Mello Dias, Chief Executive Officer
- Unverified Participant

Other Participants

- Frederic de Mariz, Analyst
- Jorge Kuri, Analyst
- Matthew C. O'Neill, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, everyone, and thank you for waiting. Welcome to Cielo's First Quarter 2014 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. At that time, further instruction will be given.

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.

Before proceeding, let me mention that forward statements are based on the beliefs and assumptions of Cielo's management and on information currently available to the company. They involve risks and uncertainties because they relate to future events and therefore depend on circumstance that may or may not occur.

Investors and analysts should understand that 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 will turn the conference over to Mr. Rômulo de Mello Dias. Mr. Rômulo, you may begin your presentation.

Rômulo de Mello Dias

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Good morning. I'd like to thank you all for joining us as we present our results from the first quarter of 2014. With me today are Clovis Poggetti, CFO and Investor Relations Officer; other members of the management team, finance and IR teams.

On page three, we can see the highlights of the quarter, compared to the same period last year.

In Q1, Cielo's net income totaled BRL 803 million, up 27% year-on-year representing a 44% margin. EBITDA reached BRL 1 billion, up almost 17% and EBITDA margin at 55%. Transaction financial volume totaled almost BRL 120 billion, up 22%. Net operating revenue reached BRL 1.8 billion, up 19.3% year-on-year.

Another quarter highlight was Cielo signing a memorandum of understanding to participate in Stelo, a new facilitator for online payments and digital wallet, in a notice to the market disclosed on April 16. Additionally, Cielo was included in the OTCQX ADR 30 Index, an index of the 30 largest companies listed on the OTC market in the United States according to market value, trading volume and liquidity.

On next slide, number four, we have the evolution of the financial transaction volume with credit and debit cards. Looking at the breakdown by product, the year-on-year comparison shows that credit volume was up almost 18% and debit volume almost 31%, excluding the other product (03:41) over the total debit amount, given that such product presents a very low price due to the extremely high tickets, the debit financial volume capture would be up 28.4% year-on-year.

Keep in mind Q4 2013 seasonality, when very substantial numbers are present due to the Christmas sales, the total volume evolution was down 9%, as you can see in the graph.

In the same period, credit volume decreased 8% to BRL 73 billion, while debit was down 11% to BRL 46 billion. Excluding the other products (04:26) over the total debit amount, the financial volume of capture would be down 9% Q-o-Q.

On page five, we plot the graph of the year-on-year financial volume growth for each quarter since the first quarter of 2012. We're able to see a cyclical move, in which 2012 present decrease in the growth rates, while 2014 show an opposite behavior, with rates growing. The goal of the graph is to depict the statistical challenge that you have to beat in 2014.

On the next page, number six, the same information is presented in a different way to illustrate the behavior expected from the growth rates for the current year. It should be, in the most quarters, lower than the ones from 2012, given the arguments already mentioned.

On page seven, we present the number of transaction captured in Q1. Year-over-year, we see a 21% increase representing 1.3 billion transactions. Compared to Q4, the number of transactions fell 6%, given the Christmas seasonality impact.

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Speaking of operating indicators on page eight, we present the number of active points of sale, which had record one transaction in the last 30 days and the number of the installed POS. We can see in the graphs that all indicators show growth in the periods.

In comparison with the first quarter of 2013, the number of installed POS grew 7.4% and in comparison with previous quarter, increased by 2%. Wireless devices reached 57.3%. The increase of the active point of sales in the same period reached 11% compared to the same period last year. In comparison with Q4, the active point of sales grew 0.6%.

Now, I would like to hand the call to Clovis Poggetti to continue the presentation.

Clovis Poggetti {BIO 16529642 <GO>}

Thank you Rômulo. Good morning, everyone. On page nine, we have our net operating revenue which totaled BRL 1.8 billion, growing 19.3% over the first quarter last year. This revenue increase is chiefly related to the higher financial volume captured, partially offset by the product mix with greater participation of debit. Compared with the fourth quarter of 2013, net operating revenue experienced a mild deceleration of 1.9%, given the seasonal nature of Christmas retail sales.

On the next page, page 10, we have our expenses. Total expenses reached BRL 919 million in the first quarter this year, up 21.1% over the same quarter of 2013 and down 11.7% over the fourth quarter last year. The cost of services provided was BRL 659.7 million in the quarter, growing 18.4% year-over-year and reducing 9.3% quarter-on-quarter.

Detailing the items that most impacted cost in the period we have: increased cost mainly related to Merchant E-Solutions, due to the appreciation of the average U.S. dollars against Brazilian reais; increase in rent fees given the increased number of transaction; logistics services, maintenance, activation of terminals, exchange of discontinued terminals for new ones, increase in equipment base on wireless technology, software releases, updates and purchase of parts for terminals.

Compared to the previous quarter, expense reduction is chiefly related to the decrease in costs related to call center and maintenance (08:36), activation of terminals and supplies, given the increased demand in the fourth quarter during the Christmas period and also to the payment of rent fees, given the lower volume of transactions in the first quarter this year compared to the fourth quarter last year.

Our operating expenses presented BRL 259.2 million in this quarter, up 28.6% compared to the first quarter last year and down 17.3% compared to the fourth quarter 2013. The main increase over the same period last year was in personnel expenses due to the adjustment in salaries and labor charges for the two years of the Cielo Retention Program granted 2012; increase in head count and appreciation of the average U.S. dollars against Brazilian reais in the period and this is for the subsidiary, Merchant E-Solutions.

In the quarter-on-quarter comparison, the reduction was chiefly the decrease on sales and marketing expenses, due to less initiatives, media purchase and marketing and in the

general and administrative expenses line, excluding depreciation, mainly impacted by the reduction in professional services expense. On the same slide, we can see total expense per transaction at BRL 0.70 in line with the total expense per transaction of the first quarter 2013 and 6% lower than the fourth quarter last year.

I would like to take this slide to comment that in the coming quarters, we will have an increase in the expenses with projects. We now understand the projects that will support our leadership position. What we are saying here is that the previous range of BRL 0.72 to BRL 0.75 of cost and expense per transaction will now be between BRL 0.75 to BRL 0.78.

Following, we can see on page 11, the revenue from prepayment of receivables operations, the main component of financial result. In first quarter of the year, gross revenue was BRL 410 million, an increase of 80.2% compared to the same period last year and 4.3% in relation to the fourth quarter last year.

Now, let's present the managerial analysis, netting the cost of funding. In this analysis, the resources used to prepay receivables is (11:23) the same cost of funding we have when we prepay our receivables flow with the issuer banks. According to this managerial analysis, net revenue was BRL 191 million for the quarter, increase of 53.2% compared to the first quarter and fourth quarter last year, respectively. The difference in the growth rates of gross and net revenues in the quarter is chiefly explained by the customer mix.

Additional indicators regarding the prepayment of receivables operation are shown on slide 12. While we can observe that the prepaid volumes increased 64.4% year-on-year and slightly decreased 0.8% quarter-on-quarter. The amount in the quarter totaled BRL 13.6 billion or 18.7% of total credit volume. The average term was stable.

On slide 13, we have our financial performance with EBITDA in both absolute amounts and margin. EBITDA totaled BRL 1 billion in the first quarter this year, up 16.7% year-on-year. EBITDA margin was at 55.1% in the first quarter this year. EBITDA margin was down by 1.3 percentage points over the first quarter last year. Compared to the fourth quarter EBITDA declined by 9.7% and margins increase it by 5.9 percentage points.

On slide 14, we show that our net income totaled BRL 803 million, up 27.4% year-on-year with a net income margin of 44.2%. Compared to the fourth quarter last year, net income rose 11.4%, while margin had an increase of 5.3 percentage points.

Now I'll go back to Rômulo.

Rômulo de Mello Dias

I'd like to take the final comments to mention that we continue with the same optimistic outlook for the sector, continuous solid growth, rational competition and incremental investments for the year to consolidate our leadership position.

Now I'd like to hand to (13:52) who will talk about the World Cup and the impact on our business.

Unverified Participant

Good morning, everyone. We have reviewed our World Cup analysis in order to have a more precise projection of the impact on our financial volume. The basic assumptions were: 23% growth of purchase volume of foreign tourists during the whole year, same as the South African experience, which impact positively.

On the other hand, we modeled Brazil reaching the finals, which means seven matches equivalent to seven national holidays and also four host cities that have announced local holidays during the matches played at those cities. So far, less cities than expected confirmed those local holidays which is good news. Given those assumptions, we estimate a negative impact on volumes captured by Cielo of approximately BRL 1 billion.

Now back to Rômulo.

Rômulo de Mello Dias

Just a small correction, not seven national holidays, that's four national holidays.

Unverified Participant

No. The equivalent of seven national holidays, those are what we model as the Brazil games.

Rômulo de Mello Dias

Okay. This is what I want to share with you and thank you for your attention. Now we are ready to take your questions. Operator, please.

Q&A

Operator

Ladies and gentlemen we will now begin the question-and-answer session. Our first question comes from Mr. Frederic de Mariz, UBS.

Q - Frederic de Mariz {BIO 15383052 <GO>}

Hi, everyone. Thank you for the opportunity for the conference call. I have a couple of questions. The first one is one the growth of prepayment. We saw a large growth in the first quarter and I was curious to hear in which segments of merchants you had seen the most progress, if it's with the large or the small ones? And also, how we should think of the impact of the Selic rates on the spreads for the prepayment?

And I have a second question which is on the POS. We saw a small increase in the base of wireless POS, that now represent a bit less than 60%. And I was curious to hear from you where you think we're going to stabilize the mix between wireless and the other ones? Should it be 60/40, or do you think wireless can continue to grow? Thank you.

A - Rômulo de Mello Dias

Thank you, Fred, for your questions about prepayments. The growth will continue to be in both sides, in small and medium merchants and as well in the large merchants. You can see, if you take a look at the average ticket it was around BRL 3,000. About Selic rates, of course, this also helps in terms of the revenues because we - not for the big clients because it will charge as a percentage of CDI, but in terms of small and medium clients, of course, it helps.

Regarding the second question about the penetration of our wireless terminals. We continue to see possibility to have growth for the wireless terminals and because the clients continue to demand.

Q - Frederic de Mariz {BIO 15383052 <GO>}

Okay. And where do you think would be a good equilibrium then for the wireless?

A - Rômulo de Mello Dias

It's difficult to say. It will depend on the demand, but it can be higher than 6%. But so far, it's too early to say. But the inclination of - or the trend of the curve continues to tell us there is still room to grow.

Q - Frederic de Mariz {BIO 15383052 <GO>}

Got you. Thank you.

A - Clovis Poggetti {BIO 16529642 <GO>}

And Frederic, just another comment with regards the Selic rate, as Rômulo mentioned, these in one moment benefit the company, but don't forget considering our analysis that also our funding costs are heated. The higher the Selic, when we prepay our receivables with the issuing banks, we are also heated on this sense, okay. But net-net, it's positive.

Q - Frederic de Mariz {BIO 15383052 <GO>}

Okay. Perfect. Thank you.

Operator

Our next question comes from Mr. Alexandre Spada, Itaú BBA.

Hello, guys. Good morning. It's Rafael (18:20) on behalf of Spada. So we have two questions. And our first question would be related to the dividend payout policy. And we

just want to confirm if Cielo will maintain the same payout ratio, around 70%, observed in the last quarters, net dividends and interest on equity.

And our last question would be about - you mentioned the increase in cost per transaction with the new projects. And could you give us some color when it could return to normal levels? Thanks.

A - Rômulo de Mello Dias

About the first question. Dividend payout, 70%; the answer is, yes.

A - Clovis Poggetti {BIO 16529642 <GO>}

And how far with regard the projects, it's early to see what we are talking about projects that for sure are going to help us and consolidate our position. But early to say about incremental revenues. We prefer to say by now and we consider these as revenue assurance, instead of incremental revenues.

Q - Operator

Okay. Thanks.

Our next question comes from Mr. Matthew O'Neill, CLSA.

Q - Matthew C. O'Neill

Hi, good morning. I was hoping you could just reiterate the discussion around the guidance for the total market volume growth. I know at the beginning of the year, we talked about growing slightly less than the 16% to 18%. Did I miss that? I'm sorry if I did at the very beginning of the call.

A - Rômulo de Mello Dias

You're talking about markets or the growth of the industry? I didn't get the point.

Q - Matthew C. O'Neill

Yes, sorry. The total growth of the industry, I remember (20:30) we discussed this, the 16% to 18% volume.

A - Rômulo de Mello Dias

Yeah. I don't have, let's say, enough information to have another opinion about the growth of the market for the whole year. For sure, the first quarter was better and the second also is going to be not on the same pace, according to the information that we have. But for the whole year, I would say that it would difficult to surpass 18%. So, the reason why we kept our informal guidance for the growth of the industry, as we said during the last call.

Q - Matthew C. O'Neill

Got it. And if I may one follow-up on a totally different subject. I noticed the comment in the press release on Stelo, I guess the digital wallet initiative that you guys are now part of with your parent company. And I was just wondering if you could discuss the functionality of that and as we think about it as a competitor to the global PayPal offering, does it also provide for ACH connectivity, as we think about it, at least in the U.S., or is it – will it just be limited to credit and/or debit cards?

A - Rômulo de Mello Dias

Yeah, the purpose of this initiative was to create a company to act as a sub-acquirer. Cielo has a relationship with the merchants and we realize that a big portion of the revenues was going to the sub-acquirers. And also, with the banks, we can act on both sides. The banks have the relationship with their customers, so the digital wallet is very important to them with one-click transaction. And we have a very good flow of information, so in terms of activity (22:28), in terms of the level of approval that we can provide to the merchant for sure is going to be higher, considering the fact that the banks know very well their clients.

So together, Cielo plus the banks create a new company; a separate governance we think is going to be very important for us because we have good strength in our hands that can be convert into results for the shareholders.

Q - Matthew C. O'Neill

Thank you very much.

Operator

our next question comes from Mr. Jorge Kuri with Morgan Stanley.

Q - Jorge Kuri {BIO 3937764 <GO>}

Hi, how are you? A couple of questions, the first one on the projects you're planning to invest on, if you can provide us with more color of which are these projects. And then the second is about prepayment as a percentage of credit card volumes, reached 19% this quarter is that the level that we should think going forward or do you think that there is room to increase it a bit further? Thank you.

A - Clovis Poggetti {BIO 16529642 <GO>}

Hi, Jorge. With regard to projects, unfortunately, what I can tell you is that projects related to our leadership and differentiation position, that's only – for sure, we are talking about BOB, the Best of Both Project, and...

A - Rômulo de Mello Dias

Related to Merchant E-Solutions.

A - Clovis Poggetti {BIO 16529642 <GO>}

Related to Merchant E-Solutions, the platform, et cetera (24:01), but also new ones that for now I cannot give you further details. And with regard the second question...

A - Rômulo de Mello Dias

About the prepayment, Jorge, as we said in our last conference call, the main purpose of the companies and the main target is to increase in revenues. Having said that and considering the evolution in the recent quarters and also that we increased when I mentioned - when I answered Fred's questions, we increased not only in small and medium merchant but also with the large clients, with large merchants. I would say that probably, though that we are not foreseeing - foresee the percentage as a number because you are foreseeing revenues, I would say that the percentage should be around between mid and high teens.

Q - Jorge Kuri {BIO 3937764 <GO>}

Okay. Thank you very much.

Operator

Our next question comes from Mr. Frederic de Mariz with UBS.

Q - Frederic de Mariz {BIO 15383052 <GO>}

Thank you. Just a quick follow-up, Rômulo (25:21), if you allow me. You mentioned during your presentation that competition was rational. Can you give us an update on what you see? I remember during the last conference call, we seem to see some more aggressive competition in specific cities, maybe in the northeast of Brazil. Is this over? Are you seeing any new trends, especially from your two large competitors? Thank you.

A - Rômulo de Mello Dias

Maybe I didn't get the right point, but what I can tell you about the competition, we continue to see the same behavior, more rational environment, mainly from the second player. And regarding the third player, continues to be the same. They are very aggressive on price and they want to increase the penetration and I think, at the end of the day, considering the large network, the large number of branches that they have, they are going to increase their share. But in terms of competition, today we see a more rational behavior.

Q - Frederic de Mariz {BIO 15383052 <GO>}

Okay. Got you. Thanks.

Operator

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

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A - Rômulo de Mello Dias

I would like to thank you all for your participation and we look forward to seeing you in our Q2 conference call. Thank you and have a nice day.

Operator

This concludes Cielo's audio conference for today. Thank you very much for your participation. Have a good day.

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