Q2 2018 Earnings Call

Company Participants

- Clovis Poggetti, Jr., Chief Financial Officer & Investor Relations Officer
- Eduardo Campozana Gouveia, Chief Executive Officer
- Gabriel Mariotto, Business Analytics Director
- Victor Schabbel, Director-Investor Relations

Other Participants

- Alexandre Spada, Analyst
- Brad Erickson, Analyst
- Carlos G Macedo, Analyst
- Carlos Gomez-Lopez, Analyst
- Craig Jared Maurer, Analyst
- Jorge Kuri, Analyst
- Mario Pierry, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, everyone, and thank you for waiting. Welcome to Cielo Second Quarter of 2018 Results Conference Call. With us here today, we have Señores Clovis Poggetti, Victor Schabbel, Gabriel Mariotto, Marcelo Noronha, Eduardo Gouveia. This event is being recorded and all participants will be in a listen-only mode during the company's presentation.

After the Cielo remarks, there will be a question-and-answer session. At that time, further instructions will be given. This event is also being broadcast live via webcast and may be accessed through Cielo website at http://ri.cielo.com.br/en/ 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 management 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 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. Eduardo Gouveia. Mr. Gouveia, you may begin your presentation.

Eduardo Campozana Gouveia {BIO 16447861 <GO>}

Good afternoon. Thank you all for joining us for another conference call to discuss our results.

For me in particular, this is a special occasion full of sentiment, a mix of gratitude and a sense the job was done. Due to personal and family reasons explained over the last weeks, the second quarter call is the last one for me. It was a great pleasure sharing our results and spend time with you at meetings and conference. I have always enjoyed exchanging experience and ideas with analysts and investors here at Cielo. Thank you very much for all your support during these last months.

Despite all the challenges we faced, together, we were able to plant the seeds that will allow Cielo to grow into a leader of this fast growing industry. As I say goodbye, I want to thank all our employees who over these last 19 months helped me to deliver a leaner, more agile and modern company, which offers a comparable portfolio and it's much closer to its customers.

I say goodbye with a sense the job was done, confident that the Cielo that I leave is now a much more efficient company than the one I was proud of (00:03:15) last year. (00:03:19) thanks a lot for everything.

I will now leave the call, hand it over to Clovis Poggetti who will discuss our recent initiatives and our second quarter results. Here with us following the call, we also have our Chairman of the Board, Marcelo Noronha. We will start our presentation with Gabriel Mariotto, our Head of Business Analytics, who will discuss the trends seen over the first half of the year.

Please, Gabriel, go ahead.

Gabriel Mariotto

Okay. Thank you, Gouveia. Good afternoon, everyone. We maintained a vision we shared last quarter that with the Brazilian retail sector has been showing signs of a consistent recovery, although still low and gradual. The numbers shown by Cielo Broad Retail Index, ICVA, for the second quarter confirm this scenario. As you can see on slide 3, retail sales accelerated, but with less strength in real terms. Keep in mind that the second quarter numbers included non-recurring events that pushed the sales down.

The truckers' strike in May and Brazil's World Cup matches in June were released by the very specific analysis on these events to the market and the media. On the other hand, these impacts were mitigated by sales around two important dates on the Brazilian retail calendar, Mother's Day in May, and Valentine's Day in June which outperformed expectations. Comparing with the equivalent periods of last year, the growth of both dates gaining above the pace of growth of the remainder of those months.

Now, looking at inflation with a two-year historical perspective. In 2016, we saw prices jumping to a level of 10% increase in 12 months, and then sharply declining to 1% in 2017, shrinking the nominal revenue growth of retailers. In the second quarter of 2018, inflation returned a bit to around 2%, which helps merchants investing.

Talking about the evolution of sectors in general, the durable goods sector, which includes apparel, department stores, electronics, construction materials has been following overall retail acceleration, but in a bit slower pace. The non-durable goods which include supermarkets, gas stations, drug stores has been driving most of the growth. And finally, the services group has been showing relatively steady growth over the last two years. A positive sign is that all regions in Brazil have shown recovery sign even in Brazilian states that were still causing decreased consumption in real terms such as Rio de Janeiro and the federal district, the ICVA numbers in real terms were a bit above zero in this year's second quarter. Before I hand you over to Clovis, I'd just like to remind you that the ICVA represents the retail activity as a whole, it is not a proxy of the cards market let alone a proxy for Cielo's performance.

Thank you all for the attention. Now I turn to Clovis.

Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Thank you, Gabriel. Before we start the presentation, I would like to thank Gouveia for the opportunity of working with him. It was a very rich and challenging period in which I had the opportunity to contribute with a greater control of costs and expenses making Cielo more efficient company. For these and for all the opportunity in learning, I just have to thank you and say it was a pleasure.

Now moving on with our presentation on slide 4, I would like to highlight the results of our work and our customer-centric focus. Over the last few years, we have invested a lot in order to have the ultimate IT platform in a more agile corporate structure so we could react to the changes seen in our industry. Today, all these efforts have been rewarded by a portfolio of exclusive products. No other acquirer offers such a complete range of products and services at Cielo. Although the acceptance of brands no longer yield (00:08:18) the differential as it used to be in the past, we still are the acquirer which accepts the largest number of brands both national and regional. This is a relevant feature in more distant locations of the country where only a few players offer it. Also, we expanded our offerings of capture solutions with a large number of additional POS terminals to meet the demand of our diversified customer base.

In addition to those – to these factors, we have a higher penetration of LIO with its own development added to new solutions being created. All these is to help our customers to manage their businesses with better control of sales, inventories and above all helping them to sell more. Concerning the micro and small merchants, our entry level segment, we successfully started selling POS terminals through Stelo. As we will see later, we started strong and we'll continue this way. The reason for such a complete portfolio is very simple, we want to maintain our leadership position in the markets where we already are leaders and we want to gain leadership in the markets where we are not. For this reason, among several products we have, we highlight the prepaid card, which will be available in this month of August both at Cielo and Stelo. I am referring to the prepaid card in both companies because our customers will have soon the option to receive the money without needing a bank account, both when the terminal is sold or when rented. The positioning will be very clear, with Cielo's POS bearing the quality and reliability so recognized and valued by the market, while at Stelo, we will pursue these initiatives thoroughly and aggressively putting more pressure on the base of the pyramid (00:10:29).

As you can see, we are moving forward supported by our partner banks and our own channel. We are moving on with this strategy defined 18 months ago with greater agility, proximity, and commercial assertiveness.

The next slide is a good example of this movement and presents the image of our Prepaid Card issued by Elo to be made available to those clients who wish to receive the funds from their sale in a card like this. So, the message that I want to enforce here is that, we are more than leaders in the Brazilian acquiring industry. We are the acquirer with the most complete portfolio, and we don't stop here. The Prepaid Card will be made available in August, and within a few months, we will announce new products that will make easier for our clients to capture transactions while assisting them in their day-to-day activities in a much simpler and agile way.

Now, I'm going to hand the presentation over to Victor who will talk about the numbers of the second quarter. Victor, please go ahead.

Victor Schabbel {BIO 17149929 <GO>}

Thank you, Clovis, and hello, everyone. Here on slide 6, on the left side, we have a chart where we talk a little bit about the volume performance. Here, we invite you all to make the following adjustments to exclude the Agro products and also exclude from the total volumes the Multivan ones, right, the ones that are now migrating to the full acquiring model as the industry gets opened. When we do this, we can see that Cielo reported 4% volume growth year-over-year. And out of this volume growth, we highlight that on an adjusted basis, credit would have grown 8% year-over-year compared to 7% without the adjustment and debit would have grown – would have shrank 2% year-over-year compared to a 8% decline without the adjustments. Here, we can see that when we exclude the Multivan volumes where most of it are related to Elo, a brand that is mostly exposed to debit, we can see that the performance of Cielo was not that different to the one posted by the industry.

If we were to consider the three large acquirers that have already disclosed their numbers, Cielo, Rede and GetNet, the volume growth in the industry would have been up 7%. So the 4% in total volume growth that we posted was then a consequence mostly of a slowdown in the Large Accounts segment due to some client losses that we had during the quarter. Given the fact that this is a segment that is less profitable and is a segment where we have already been very successful due to our product differentiation and level of service, we are not competing at least in that segment at all costs, reason why we basically decided to lose some accounts during the quarter to some of the other incumbents, the other large acquirers.

On the right side of the slide, we show the performance of our POS base. For the first time in 10 quarters, we are delivering POS growth again on a sequential basis of 0.5%. This is a consequence not only of the good performance seen or posted by Cielo LIO that reached 80,000 terminals during the quarter from 49 in the previous one and only eight a year ago, but also due to the very positive performance that we had at Stelo, right?

Stelo is the company that we acquired at the beginning of the year in order to explore the segment of selling devices. So in the next slide, I will exactly talk a little bit more in detail about the performance of Stelo so far. Considering the first six months of the year, we already have 52,000 active devices on the street and by active we mean here devices that processed the transaction in the last 30 days, so the conservative and very transparent methodology that we have. Out of it, we have behind these devices 40,000 active merchants. And in this period of time, we had 93,000 POSs already sold. The only difference between the number of devices sold to the active ones refers to the lead time for us to deliver the devices. Given the fast growth posted by the industry, deliveries have been taking a little bit longer than in – at the very beginning of this industry. Most of the acquirers have been working to find alternatives and this is exactly our case.

We have been working in the last months with new suppliers in order to make sure that our clients are well-served, and get the device the sooner possible. We already have, among all the acquirers, one of the shortest period of time for the deliveries should take place, right? All the acquirers are taking over 20 working days to have the devices delivered. So that's the only reason why we have this gap between the number of devices sold and the active ones. But soon, these devices are going to be delivered, and will soon become active.

In the following slide, I will then talk a little bit about the performance of our revenue yields. For the sake of time, I will talk more about the sequential performance, the chart on the right side. There, we can see that revenues that are not linked to volumes, for example, rental revenues contributed negatively to 2 basis points impact to the revenue yield, right? This is still a consequence of this slowdown on the rented POS base. Although the POS base has been – the rented one has been shrinking at a slower pace, right, which is another positive behind the POS performance. And also, not to forget, we would also highlight here on the POS side the positive contribution coming from the growth of LIO and further increase in the penetration of wireless devices. It still has a negative factor behind the revenue yield performance. We have the combination of product and client mix.

On the product side, the quarter was positive, as I mentioned, credit growth outpaced by a big margin with debit performance. So the product mix was positive. Unfortunately, we still have the Large Accounts segment outpacing the retail one given that Large Accounts pay less compared to retail clients. The client mix was still negatively impacting our performance and together the product mix are positive and the client mix are negative, we ended up having a 1 basis point negative impact on our revenue yield.

As positive factors, we highlight the service tax that we moved back to the previous way of collecting the tax after the supplementary law that was approved, changing the way the tax was collected, was suspended by the Supreme Court. So we will keep the former way of collecting taxes until we have a final decision on that matter.

This decision to move back to the previous way was because by doing that we would be in a safer position in order to avoid potential legal disputes and legal questions about the way we collect the taxes. And these generated a positive 2 basis points impact.

The other positive impact was related to other factors; for example, capturing new brands that are mostly exposed to credit; for example, American Express and Hiper – these two brands or the capturing of these two brands ended up adding 1 basis points to our revenue yield. The other two came from the Receba Rápido product or Quick Credit Payment that added 2 basis points in the quarter to our revenue yield.

When we look at the price dynamics both on our year-over-year or on a quarter-over-quarter basis price hasn't been a negative or a big negative factor to our revenue yield. This is a result of the more accommodated times that we are living in, but here I would like to highlight an important thing.

As soon as we move more aggressively, more assertive to new segments or to more profitable segments in order to maintain our leadership or conquer the leadership in segments where we are not the leaders yet, probably we are going to see a potential bigger pressure on the price factor been (00:21:28), however, offset by a better mix factor, because once we grow in more profitable segments of the smaller merchants, the contribution of mix is expected to be positive. So in this very same chart, we might see a shift between the columns that are shown there, probably price (00:21:51) could get worse in the future, but expectation is for the mix to get better, right?

In the following slide, slide number 9, I will highlight a few financial figures mainly related to Cateno.

As I said, the three acquirers together – Cielo, Rede and GetNet – posted a volume growth in the quarter of something like 7% year-over-year. This was exactly the very same growth base posted by Cateno, which has been following a very healthy growth base in the previous quarters and continues to perform that way, with its top line being then positively impacted.

When we move to the chart in the middle of the slide, we can see a decline in our EBITDA. This is a result of the maintenance of the revenue trends seen in previous quarters; although, we already have some positive indications on the operational signs that things are getting better; for example, our POS base resuming (00:23:07) growing this quarter, for example.

We still have the very same trends on a revenue standpoint or very similar ones to those seen in the previous quarters, but this quarter, specifically, we saw an increase of the expenses and costs; the expense is mostly related to the marketing campaigns that we carried out starting on April in order to give publicity to the products and services that we are now adding to our customers and the costs mostly related to efforts to improve the level of service and also related to the fact that we are now capturing brands that are more expensive on a brand fee standpoint.

That's why the results were impacted. So in a nutshell, we would say before the revenues can recover after we have just started showing the first signs of improvement on a operation standpoint, we first have to spend money, invest in order to create room for better figures to come out. So we are now working with the current results should be seen (00:24:24) as at least a short-term floor in the coming quarter before we can see our revenue trends improving and consequently being translated into a better bottom line trend as well.

And finally, on Cateno side, we now see Cateno's earnings accounting for 17% of the cash earnings at Cielo, showing the importance of our diversified revenue stream and business model, basically in line with the efforts that we have been carrying out so far.

So now, I will hand back the call to Clovis. Please, Clovis.

Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Thank you, Victor. Before opening the call to the Q&A session, let's move to slide 10, to discuss our guidance. Here we have the figures for volume growth within the range expected for this year, according to our expectations.

In the quarter, we saw deceleration due to a continued migration (00:25:26) of volumes captured under the Multivan to the full acquiring model. And as Victor mentioned, we also lost some Large Accounts clients.

We remain confident and we reiterate our expectations of volume growth since we foresee a gradual improvement of the macro scenario. Also, we will have a more favorable basis effects (00:25:49) throughout the second half of the year.

Likewise, we also reiterate our expectations for total expenses, which should have a similar trend in the second half, which increased marketing expenses among others due to our commitment to deliver new products and solutions for our customers in the short term. Thus, we should end the year with total expenses, up between 2% and 4%.

And finally, CapEx should follow the same rationale, with LIO expansion and new products launched during the second half we expect CapEx to range between BRL 300 million and BRL 400 million invested for this year.

Now, I would like to talk in more detail about the material fact (00:26:39) published yesterday evening along with our results. The board of directors, following the executive board recommendation, approved the largest dividend distributions for the fiscal year of 2018.

On slide 11, you can see details on the distribution announced yesterday. With our goal of ensuring a proper return to shareholders and at the same time reiterating our commitment to creating value (00:27:06) over the long run, we decided to announce dividend distribution in a fixed amount for the fiscal year of 2018 to be paid over the next quarters. We aim at providing security and the assurance of an attractive carryover to our shareholders, which we make (00:27:25) the short-term operational decisions that will guarantee better results in the future. We wanted to provide full visibility as to the remuneration to be paid as we saw additional expectations in the market with some analysts with a more positive view and other with more pessimistic opinions.

For this reason, we choose not to commit to a payout ratio, but rather to a fixed number. It's worth mentioning that this is the highest amount paid to Cielo's shareholders in the company's history. On the bottom of the slide, we made an exercise that shows that in 2016, we allocated nearly 30% of income as dividends and interest on equity.

Last year, we increased the payout to 70% (00:28:16) and paid BRL 2.7 billion. This year, we will pay BRL 3.5 billion, which depending on the analyst estimates implies an expected payout of 80% to 100%. In order to provide an adequate carryover, we also announced a change in the payment schedule from semi-annual to quarterly. Therefore, we are adjusting this new schedule with a higher payment of BRL 1.75 billion to be made in September followed by two payments of BRL 875 million in the first and second quarters of 2019.

The record date of payment of these two payments will be announced in the future by a notice to shareholders following the standards adopted by the company. Shareholders who hold the shares close to the expected date of payment will be eligible for the dividends. As you can see, the idea is to reward those long-term shareholders who hold the shares until the respective payment dates.

With all that said, we are now ready to take your questions. Operator, please.

Q&A

Operator

Thank you. The floor is now open for questions. The first question comes from Carlos Macedo with Goldman Sachs. Please go ahead.

Q - Carlos G Macedo {BIO 15158925 <GO>}

Thanks. Good afternoon, everyone. I have a couple of questions. First, thanks for all the disclosure and the release, it's a lot of information. You talked about being a market leader in the markets where you're in and the markets where you want to expand to. There's a risk that you spread yourself a little bit too thin. But my question is more on the strategy hope to employ, of course, the large merchant and the medium-sized merchant market you know very well the micro-merchant market is one that's new for you. How do you expect to gain leadership there? Is it going to be via price? Is it going to be via product? Is it going to be via distribution? Is it going to be via the partnership that you always had with the banks? How do you expect to drive volumes and gain your leadership there given that you're just starting off in that market with 90,000 POS terminals outstanding?

Second question, you basically came out with a number of promotions in the second quarter in the Cielo brand, not the Stelo brand, the Cielo brand that were based around a three-month offer that then changed prices; and just – I asked this in May when you released results, just coming back to the question now, how has the churn been in those promotions, because for someone in the (00:31:27) price increases quite significantly and given this is mostly rental, there's very little cost for the merchants to leave, can you just comment a little bit how churn has been? Thanks.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Hey. Hi, Carlos. With regards to your first question, I think it's worth it to mention a company used to have a kind of one size fits all model in the past, and one thing that we have been doing in the last two years is changing to what we can say customizing our offering to what is demanded by, let's say, our customers. And the point is, let's say, to the customers that demand premium services, okay, we will have premium services to offer, and to the customers that demand the very basic ones, we are okay, ready to work in such segments (00:32:17).

Of course, when you go to the bottom of the pyramid, these guys they are much more sensitive to price, and the point is if price may be the only variable, let's say, being taken into – when this merchant takes the decision, we will fight with these two. Don't forget a very powerful message is, company is not here to destroy service (00:32:47), exactly the opposite, we are here to generate service (00:32:50), but we will balance these statements with the other one that we just gave to you in terms of, we will defend our leadership position in the segments where we are leaders and we will go to take a leadership position where we are still not leaders, okay.

This is something that we will have to do in a case-by-case analysis, but that is the message that I want to give to you all.

A - Victor Schabbel {BIO 17149929 <GO>}

In that sense – sorry, (00:33:22), just to address the other points you raised, right, in that sense I think it's worth making clear that there will be – naturally, depending on the segment, a combination of price, products and distribution, right? So pillars of our investment case here at Cielo, so pillars of our company. And we are going to use them in order to explore the segments, where we are not the leaders yet, for example, right.

In that sense, just moving to the question you made about marketing expenses and marketing – not (00:33:57) expenses, but the marketing campaigns that we put out, starting in April, we decided to first convey some of the products or the product (00:34:09) that we already had that was somewhat quite successful, Cielo Controle that gives predictability to the customers.

It was a product already there. It was a product for us to prepare the ground at Cielo for a stronger push in the small-sized merchant segment, right. So before entering that more assertively and more aggressively, we needed to prepare the ground.

So following the push in Cielo Controle, we moved to Cielo Livre or Cielo Free (00:34:45), right, in order to give a new opportunity to the customers, a new alternative for them to use or accept cards without buying a device or even renting. And soon we are going to make a bigger push in that segment with other products that we are about to launch or other initiatives that will make clear how effective we are going there.

In terms of the churn that you asked, we can say that there is no big difference, no mature difference to the churn that we already have at the company.

On the opposite in some of the products, for example, Cielo Controle, the churn is even lower, right, slightly lower. So we are not seeing a change there.

Q - Carlos G Macedo {BIO 15158925 <GO>}

Thank you, Victor. Thank you, Clovis. Just one follow-up here, I mean, Clovis, you mentioned prices that main difference, do you believe that – Stelo, a well-known brand in Brazil. Do you feel that it's well-known enough to fight the other brands that have been – I know it's a new market, but they've been around for like – PagSeguro has been around for a little bit longer. In other words, you talked about marketing expenses staying kind of flattish through the end of the year from the second quarter level. I have to believe that it will entail a significant amount of marketing to get the brand to be well-known amongst these clients that don't believe and know Cielo that well.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Carlos, you are right. Of course, we cannot say Stelo is a well-known company as we speak today, but the idea is, let's say, to improve this and to make it very, let's say, the customers are aware of these. But don't expect, let's say, don't forget that not only marketing will make this company to, let's say, improve its volumes, but let's say, we also have the idea to operate with our partner banks in other channels, okay. The combination of these factors, distribution plus marketing in our view can play a significant role in that specific market.

Q - Carlos G Macedo {BIO 15158925 <GO>}

Okay, perfect. Thanks, Clovis.

Operator

Okay. The next question comes from Craig Maurer with Autonomous Research. Please go ahead.

Q - Craig Jared Maurer {BIO 4162139 <GO>}

Yes, hi. Thanks for taking the question. So I wanted to follow up on the prior question and just the market clearly, in the way stocks are trading, is assuming that Cielo is going to destroy value at the low end of the market, and what I really wanted to understand was the type of resources you're willing to put to work there because if we look at your biggest market expenditure that I know of historically it was 2016 where you spent about BRL 320 million, and if I look at my own forecasts, I expect – just PagSeguro, forget some – Mercado Livre and others, to spend 40% more than your biggest year just in the micro-merchants segment in 2019, yet you have all your segments to support.

So I really want to balance the discussion by understanding how much you're really willing to increase marketing over time because to me without a long-term sustained commitment, that is an order of magnitude more than you've ever been willing to spend in marketing, I don't see how the brand will be prevalent enough to destroy value in the way that some are suggesting.

A - Victor Schabbel {BIO 17149929 <GO>}

Hi, Craig, again, and the idea is not to destroy value (00:38:34), of course. When we discuss marketing, for example, don't forget in the figures that you mentioned 2016, we had not only marketing, but also sales expenses and the amount that we spend with owners (00:38:48). This number in terms of what was expended in 2016 (00:38:52) can be a good proxy. We strongly believe that the combination of this new level in terms of market plus the power of our distribution channels can play a significant role in this new segment, okay. Destroy value (00:39:19) never, okay. But we go for the leadership position.

And as I just mentioned in the previous question, when you analyze this bottom of the pyramid, this whole new world that was – that is successfully developed, most of these guys, they take only price, so we may have to adjust in a some recurring base (00:39:46), it will always depend. You can see that the competition in that segment is increasing, but we will not – we will try to make and to extract the value (00:40:02) to benefit most as much as possible, but we go also to take the leadership position in the new segment. That's it (00:40:11).

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Craig, I would add here one thing that we mentioned in the conference call in Portuguese, right. We, Cielo, we have been the leaders in many profitable and important segments of our industry, and we will work hard to keep this leadership position there. In these new segments given that they are brand new for us, the profitability that we can get there even if it's – the profitability it's lower than what the current leaders are getting, it's a positive. So the marginal contribution or the margin of contribution of these segments for us will be positive. So this is one thing that we keep in mind.

On top of it, although we have to invest in marketing, we have to show the customers that we have the products, we have the services that they need. We also rely here differently from many other competitors out there on the big and strong support coming from the partnering banks, right. And this is a big differential, not only for the brand awareness, but for the distribution, right. Because of that, we were able in just a quarter to get to 52,000 active POSs from only 4,000 a quarter before. So, this shows a little bit that even without spending much, the clients are already aware because we get the support from other sources from the partnering banks.

Q - Craig Jared Maurer {BIO 4162139 <GO>}

Just one follow-up, if I could turn the call to your longstanding existing markets, are you seeing any different activity from newer entrants like Stone and First Data, First Data discussed very strong growth on their earnings call, and so (00:42:13) understand the competitive dynamic within the core market?

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Craig, in the, let's say, the mid (00:42:19) of the pyramid, the new guys they are more active and let's say, they keep as aggressive as they always were, okay. Let's say, there was no change, which means they are still aggressive.

Q - Craig Jared Maurer {BIO 4162139 <GO>}

Okay. Thank you.

Operator

Okay. The next question comes from Jorge Kuri with Morgan Stanley. Please go ahead.

Q - Jorge Kuri {BIO 3937764 <GO>}

Hi. Thanks for the call. The 52,000 active merchants that you gained in the quarter, were all those new customers to Cielo, or were there – they were Cielo customers that decided to switch to the Stelo brand or – and also, what percentage of those you think didn't accept cards before? I just want to understand a little bit the profile of that customer base that you acquired, or did you particular (00:43:26) take market share from an existing acquirer, if you can help us understand where do they came from.

And then what is the sort of growth that you think – the net adds that you think you should have, say, six months from today, is 50,000 a quarter the right number some of the longstanding micro-merchant acquirers like Pags and mainly are adding around 100,000 (00:43:58) a month, and so just wanted to understand where did you think your ramp-up should be within the next six months?

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Hi, Jorge. I will start and then Victor add some comments. Let's say with regard the 52,000 active merchants, most – but most of these guys are new to our base, let's say, the combined base, okay, the cannibalization is quite small, okay, and the information we have is also most of the guys, let's say, new adopters, they were not used to work with cards and they are now using the solution.

With regards next steps (00:44:50)?

A - Victor Schabbel {BIO 17149929 <GO>}

In regards to what you expect to the future, Jorge, thanks for the question, although, we are not giving a formal guidance, we have naturally the best expectations given the good start that we had, right. So we are very confident that there is a lot of demand for the product. We are only being careful right now because of the constraints the industry is facing in terms of supply of devices. That's why we have been working hard since the beginning to find alternative suppliers. So we can fulfill the demand and keep the shortest lead time or delivery time to our customers within the industry. If you look at the time that is required from most of our competitors to deliver the devices to the customers that are buying them, you will find that Stelo is the one that has the shortest. This is a result of the big effort that we are putting there and is a result also of the expertise in logistics that we have. So as a result, because of these constraints, we are confident that we are going to be relevant at some point in the future. So you are going probably to see this growth phase accelerating going forward. But that's it. We are not, let's say, we are not going to commit right now to any specific number.

Q - Jorge Kuri {BIO 3937764 <GO>}

All right. If I may add a question along the same lines, this – and I know it may be early for this, but if you could provide any sort of guidance, that would be great. The 52,000 new merchants that you got during the quarter, do you have any sense of what their spend will be on cards on an annual basis? I mean, given the type of merchants they are, the type of sales that they have, what sort of like average spend do you think they'll get for you on a full-year basis?

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Well, Jorge, so far looking at the client base that we already have, we are talking about clients that are spending something like BRL 2,000 a month, right, so these should be the best reference.

Q - Jorge Kuri {BIO 3937764 <GO>}

Okay. All right. Awesome. Thank you very much.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Thank you, Jorge.

Operator

Okay. The next question comes from Mario Pierry with Bank of America Merrill Lynch. Please go ahead.

Q - Mario Pierry {BIO 1505554 <GO>}

Hi, everybody. Good afternoon. Let me ask you two questions as well. You talked a lot about (00:47:43) gaining market share, and we have seen the effects of a - changes in regulation, increased competition in Brazil, the effects it has had on your profitability. Looking at your ROE, has declined from 125% in 2012 to 21% only this quarter. The same time your EBITDA margin has contracted from 57% to 39%. So I'm just trying to get a sense here, how much more are you willing to sacrifice, right, or you - maybe what - if you can give us how is the compensation of management determined. Is it purely bottom line? Is it market share, or there some type of profitability metric involved?

Second question is related to potential regulatory changes in Brazil. We saw there's a Senate Committee coming up with some recommendations in shortening the payment cycle, may be changing debit cards to a fixed fee, also possibly putting a cap on interchange on credit card transactions. I would like then to hear from you, if you can give us an update where we are, how do you see regulation evolving from now? Thanks.

A - Operator

Hi, Mario. I will take advantage of your question just for some comments. I think they are really worthy to be taken into consideration (00:49:16). First one (00:49:18) when we analyze such a long period of time going - looking back, it's not fair to compare EBITDA margins and et cetera because we had the consolidation of new businesses and new business that didn't have the same margins as the acquiring business that we have. That's comment number one.

Comment number two in a very objective way, we have been passing through a perfect storm in the last two, almost three years, okay. Perfect storm in terms of the market situation, no need to mention what happened. The competition that increased, the Multivan that hit our figures in terms of top line, the mortality of the merchants that hit (00:49:58) our rental business that was always very resilient. And also (00:50:03) going down affecting the receivables business. All of this together happening at the same time, the same direction that hitting the company, we already discussed this a lot, so top line under pressure in terms of volumes and also revenues.

And then in the last two years working hard the company in terms to be - trying to be more efficient in order to offset part of these effects. Now we believe - we strongly believe we are in a kind of inflection point. These second quarter results, maybe the third quarter result, maybe the bottom (00:50:38) even, let's say, the situation from a macro perspective is better - just slightly better, but it's still not good. And so it seems that the worst is behind, but it is still not good and even not being as good as we expected. We took the tough, but the right decisions in terms of investing in the past that we believe are relevant, and this - there is no magic - increased our expenses. So we are still facing the tough situation in terms of top-line volumes and revenues, and we had such a increase in expenses because we had to create, let's say, the ways to – in short to medium term start benefiting from everything that we have been investing. Of course, we are confident that what is ahead of us and that's why I said to you these may be the bottom, okay. It's a matter of time for us – from our perspective, it's a matter time for us to start benefiting from all the initiatives in investments that we made in the last few months, couple of quarters.

Still on that side, Mario, answering your question about the compensation, we have a very aggressive model here at Cielo with most of the compensation of management being variable, linked naturally to the budget that should be delivered during the year and are also linked to the share performance given the vesting period that we also have.

In that sense, what I have to say here is that we had the full support of our controlling shareholders in order to make what was needed to be done in the short term even if at the expense of short-term earnings in order to make sure that we would continue to generate long-term value in an industry that – where the profitability is still quite promising, right.

You mentioned that the profitability, the margins came down. Yes, they came. The industry went through a big transformational process, right. But the outlook is still quite compelling, mainly for those with scale, right. You need to be big. You need to have the firepower for you to roll out technologies, for you to get the most in terms of profitability. That's exactly the mind-set and we are going to move – keep moving in the right direction even if it comes at the cost, at the expense of short-term earnings, and we have the full support of the board in that regard.

Now, I will give back to Clovis for him to address the regulation – the regulatory question.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

(00:53:33) the following with – in terms of the regulation, we always said, we believe that the ultimate objective from, let's say, the regulator is to allow any merchant that decides to work with cards , for example, such a merchant to pay the fair (00:53:46) price. And it may sound romantic, but how to reach its fairness (00:53:52) is what really matters, and according to our view is through competition, Central Bank creating the greenfield, for example, for companies to start doing the business and then through – such a higher competition, price is going down.

We know there are discussions taking place, okay, in terms of the settlement period mainly, okay. We strongly believe that (00:54:21) may have a lot on this front in terms of – and this also adding volumes to the whole industry because of some unique characteristics of the product, but the T-Plus 30, T-Plus 15, T-Plus 2 (00:54:37) is something that is more frequent on the discussions.

In our view, Cielo, of course, helping in such a process. Cielo, we'll honor anything that may help in the merchant to sell more, that is our objective as well. And what can be different than what we had been saying the last couple of (00:55:07) that we may see a shortening of the settlement period in a shorter period of time. For example, we never know that for example the T-plus 2 (00:55:20) in two years, maybe in three years. That's hard to say.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. Thank you very much.

Operator

Okay. The next question comes from Alex Spada with Itaú BBA. Please go ahead.

Q - Alexandre Spada {BIO 16687974 <GO>}

Hi, thank you. Hi, gentlemen, thank you for taking my question. Based on the figures shown in the presentation regarding the yield behavior or breakdown, it sounds that Cielo has not been responding to price pressure from competitors over the last quarters. In other words, it seems that rather than matching prices originally offered by competitors, Cielo has been more often not seen (00:56:04) – just simply letting clients go instead of matching their prices. Does it make sense to think about Cielo's positioning this way? Also, if this is the case, does the company intend to change this strategy and start to respond differently when clients receive a better price from competitors, or is this not the case?

A - Operator

(00:56:30) question. We have been very active in the industry and depending on the segment, depending on the offer that is made we do match, we do even lower the price that is offered, but these depends on the segment, on the region, so there are many factors also on the niche of where the merchant operates; for example, if it's a strategic one for us, if it's not, right. So depending on a few factors, we will – going to match or even defend as much as we can in order to the client truth state (00:57:11). The only difference is that we might see this number becoming increasingly effective as soon as we go further down in the pyramid more aggressively into segments where you have been seeing more growth, right. So this is only one thing that we just highlighted in order for people to be on the same page, but addressing your concern or your question, yes, we have been matching, we have been effective reacting to the competitive pressure in order, again, to sustain the leadership that we want to sustain in the markets, in the segments where we are already the leaders. So this hasn't changed.

Q - Alexandre Spada {BIO 16687974 <GO>}

So, it hasn't changed, so you're not becoming, I'm going to say, more aggressive in matching than you were in the past and you don't plan to do that going forward?

A - Operator

It only depends on the way the competition is evolving. So far given the way the competition has been, let's say, evolving, we have just following the same practices that we were following the previous quarter. So the competition is challenging. So we do see pressure on many fronts. So I highlighted a few clients that we lost in the Large Accounts segment; here we lost to some of the other incumbents, other large players. In mid-sized merchants, we see both the order incumbents and also new players being very active and we are responding to them. In the micro, very small entrepreneurs, we are being the newcomers, right, being aggressive there. So it depends on the niche, but it hasn't changed materially compared to what we have been doing in the previous quarters.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. Thank you. That's clear.

Operator

The next question comes from Carlos Gomez with HSBC. Please go ahead.

Q - Carlos Gomez-Lopez {BIO 18107094 <GO>}

Hi. Good morning. I had two questions. The first one is – the first with the decline in debit cards, obviously having to do with the movement in Elo, how much longer do you expect to see this decline? And where do you think your ultimate market share is going to be in debit card after the market normalizes? And the second one is if you can update us on any possible plan to have a listing in the United States. Thank you.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Thanks, Carlos. In regards to debit, we are almost over in the transition process from the Multivan to the full acquiring one. There is less than BRL 1 billion left in our systems being captured under the Multivan model. So probably in the next quarters, we are going to see this number declining further, becoming probably irrelevant, right?

With that said, the market share that we are going to end up having, although there is no target for market share, we do want to be the leaders. This is a fact, but there is no clear target for each of the segments. The market share in both debit and credits, which might be a good reference for you, will be pretty similar. So in the past, we had a big difference between market share in debit versus credit. Now, with this new market environment, there might be no relevant difference between the two.

Q - Carlos Gomez-Lopez {BIO 18107094 <GO>}

Thank you. (01:01:00) listing.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

I didn't get the other question, Carlos.

Q - Carlos Gomez-Lopez {BIO 18107094 <GO>}

Possible ADR listing.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

We already have the OTC ADR in place. We are obviously studying and considering our ADR levels in order to satisfy the demand for the shares that we have. So what we can - what we might say is that we are studying this as we speak.

Q - Carlos Gomez-Lopez {BIO 18107094 <GO>}

But no timing.

Operator

Okay. Next question comes from Brad Erickson with KeyBanc Capital Markets. Please go ahead.

Q - Brad Erickson {BIO 18494007 <GO>}

Hi. Thanks for taking the questions. Just two follow ups, first on the marketing front for Stelo. Can you kind of talk about what the strategy is between brand marketing versus performance marketing in terms - in sort of the buckets and how you think you'll acquire customers? Second piece of that is just how you're seeing and expect customer acquisition cost to trend over time?

And then lastly just maybe lay out the one or two or three factors where you see opportunities to differentiate on the product front as you increasingly address this micro-merchant segment? Thanks.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Thanks for the question. So first on the marketing side, we are still studying the best approaches that should be adopted and given the strategies that we are going to soon implement at both Stelo and Cielo, right, because both companies are going to be active in that segment. So not only Stelo will be exploring the micro entrepreneurs, I think Cielo will be positioned there as well with different products, different services that soon we are going to announce and this is part of the marketing strategy for the second half. So the idea is to have investments in both, right? So this you will soon get a sense on. And in terms of differentiation in that segment, we have to basically keep adding services, right, to these customers that we see most of them as banks, but usually not using that much financial services. So there is potential for you to, for example, add the prepaid card that we just announced. And also, we are adding new solutions soon exactly to provide these customers with greater convenience, right? This is one idea we cannot, let's say, anticipate much in that sense but there will be other products in order to satisfy for the needs in that segment.

Q - Brad Erickson {BIO 18494007 <GO>}

Thank you.

Operator

Okay. The next question comes from Carlos Macedo with Goldman Sachs. Please go ahead.

Q - Carlos G Macedo {BIO 15158925 <GO>}

Thanks. Hi, guys. Thanks for taking another question. Just very quick, going back to I think the question that Jorge asked earlier on the 50,000 clients with Stelo. Could you just give us a breakdown of what percentage of these clients had bank accounts and what percentage of these clients were captured via the bank network - distribution network, Bradesco, Banco do Brasil? Thanks.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Well, we will not give disclosure on the breakdown between the two banks. Both have been very supportive. But what we can say is that, so far, given the fact that we are launching the prepaid cards now, it should be in place - available now in August, most of these clients do have a banking account, right? So out of these 52,000 active POS devices, we have most of it linked to a banking account.

Q - Carlos G Macedo {BIO 15158925 <GO>}

I didn't mean to separate between the two banks, just wondering what distribution channel was used to get these accounts, whether it was an Internet or via the branches?

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

(01:05:19), Macedo. Most of it were the branch networks from both Bradesco and Banco do Brasil.

Q - Carlos G Macedo {BIO 15158925 <GO>}

Okay. Perfect. Thank you.

Operator

Okay. The next question comes from Jorge Kuri with Morgan Stanley. Please go ahead. Taking the line (01:05:40) of Mr. Kuri from Morgan Stanley is now open.

Q - Jorge Kuri {BIO 3937764 <GO>}

Hi. Jorge Kuri from Morgan Stanley. Thanks for the follow up. I just want to go back to something Clovis said. Did I understand correctly, Clovis, that you said that it is possible that within the next one, two, three years that the settlement period of cards may be moved downwards from 30 to two days or something shorter. Is that what you said? And I'm asking because, if that's what you really believe, it's kind of like surprising that you're venturing into the micro-merchant space where the vast majority of profitability in that business comes from the anticipation of receivables, and you can see that by looking at the statements of the companies that operate in that space. The transaction business requires a level of scale that is just not there yet, and most of the profits come from the prepayment. So thinking about that business - going into the business in size without the prepayment seems a bit odd and maybe I didn't understand. So would you mind clarifying? Thanks.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Okay. Thank you, Jorge. The point is exactly is this, the recommendations that were sent to Central Bank from the only analysis (01:07:01) made by the Senate, just as an example on this regard, say people have 15 days, now and then, people are still in 1.5 year later.

The important thing that I think is what the – for all of you to take into consideration is all the discussions they have been quite balanced. Okay. Central Bank knows the pros and cons of every single idea in measure and on this regard specifically for sure Central Bank, the regulator, is taking into consideration all the players, so for example, not only the merchants, but also acquirers, but also insurers and also the card holders, okay? The fact that some segments could be more affected by a measure like this is exactly what is being analyzed, okay? It's hard to say when it's going to happen. I'm just saying to you that this is being analyzed. (01:08:10) of course taking into consideration of shorter period than compared to what we had before. But it's hard to say exactly when something like this may happen.

Operator

Okay. The next question comes from Mohamed Ahmed (01:08:30) with FGP. Please go ahead.

Hi. Thank you very much for taking my question. I got two questions, one pretty quick and the other maybe a bit longer. The first question is on the products mix in your slide on a quarter-over-quarter basis. One of the things you said was that your volume in the quarter was a bit light relative to the market because you let go of some larger accounts and didn't drop your price, but at the same time, the mix impact was negative. And this on top of the fact that your credit volume was higher than debit, so given that credit was better than debit and large account you had some losses there, why did this not become positive, can you give us a little color on that? And then I have one follow-up.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Thanks, Mohamed (01:09:17), very good point. Yes, we saw deceleration has slowed down in the big merchant segment due to the slight losses that I mentioned. This, however, was not enough for us to see the Retail space, for example, outpacing the Large Accounts segment. On the opposite, we continue to see the Large Accounts segment doing better. It decelerated. This is the main reason why we posted this deceleration during the quarter exactly because of the slowdown seen in the big merchant segment because there in the retail, we continue to see the environment as it's still quite challenging with volumes not recovering yet, mostly due to two factors: the economic recovery has been very gradual and the growth has been pushed by bigger merchants, and by the very small ones, right, and second because there we have been facing the competition greater one since mid-2016 when we had the multi – the opening of the market through the Multivan process, right? So there, we have, as I mentioned before, large players, the other incumbents operating actively in that segment, the mid-size ones, and also new guys on the block also trying to grow there, that's the reason.

Q - Operator

Okay. And my second question is about the inflection that you guys talked about a little earlier in the call. For that to happen, clearly, Cielo Brazil's results need to turn around or at least stabilize and then grow. Even adjusting for the tax accounting, I think Cielo Brazil revenue were down 2%, and I realized that there's actually a positive impact there, so organic would actually be worse.

So can you give me a sense of that given that we have good visibility on cost because you control it, but on the revenue side, when can we expect to turnaround because you need your terminals at least on the rental side to stabilize, which they still haven't. And you need to be able to grow volumes at a faster rate than you have in the past, while keeping pricing, which is proving to be difficult.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Not a good point, Mohamed (01:11:40). Here, our idea is to start seeing the trends improving there at Cielo Brazil. We mentioned quite precisely the impact of the new tax collection approach or to be more precise, we are resuming the approach we have beforehand. So these generated an impact at Cielo Brazil of something like BRL 31 million positive impact. And obviously, on top of this positive impact, what we are waiting to have is better trends coming as a result of the better trends we are starting to see on the operational side, right?

At Cielo Brazil, we still had some contraction on the POS base space, but the contraction was smaller compared to the one seen during the first quarter. So the trend is for you to keep improving. The quality also improved, so we have more LIOs out there. We have more wireless terminals out there. So, all of these should start helping us out to deliver better trends at Cielo Brazil as well, right, not only at other subsidiaries like Cateno. So that's what makes us more constructive for the upcoming quarters. Obviously, these might take some time. That's why we are saying that the third quarter figures might be similar to those seen now in the second quarter because you have to see the better operational trends maturing before they can translate into better top line ones. But we do expect them to materialize still in the coming quarters given the first signs of improvement that we already had.

Q - Operator

Thank you very much.

Okay. Excuse me. This concludes today's question-and-answer session. I would like to invite Mr. Clovis to proceed with his closing remarks. Please go ahead, sir.

A - Clovis Poggetti, Jr. {BIO 16529642 <GO>}

Okay. I would like to thank you all for being with us today on our earnings call. We will remain working hard, expecting a second half this year in which we can start capturing the rewards of the initiatives implemented over the last few months. And I reinforce what I said earlier, we will work to defend our leadership in the markets where we are already leading and we will go after the leadership in both segments that we are still not leading, okay? Thank you and have a good day.

Operator

This concludes Cielo conference call for today. Thank you very much for your participation, and have a nice day.