

Q2 2016 Earnings Call

Company Participants

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

Other Participants

- Alexandre Spada, Analyst
- Marcelo Cintra, Analyst
- Mario Pierry, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, everyone, and thank you for waiting. Welcome to Cielo's Second Quarter 2016 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 instructions 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 webcast may post their questions on our website.

Before proceeding, let me mention that forward (sic) [forward-looking] (01:03) 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 circumstances that may or may not occur. Investors and analysts should understand that 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 Mr. Rômulo de Mello Dias. Mr. Rômulo, you may begin your presentation.

Rômulo de Mello Dias

Good morning. I'd like to thank you all for joining us today on this conference call in which we will talk about Cielo's results for the second quarter of 2016. Joining me are Clovis

FINAL

Bloomberg Transcript

Poggetti, CFO and Investor Relations Officer, as well as members of the management, finance and Investor Relations teams.

On page three, we can see the highlights of the quarter compared to the same period of last year. For Cielo Consolidated, net operating revenue totaled R\$3.1 billion, up by almost 10% compared to Q2. EBITDA was R\$1.3 billion, almost flat compared to Q2 of last year, margin of 44%. Consolidated net income reached R\$989 million, up 13.8% compared to Q2 of last year with a margin of 32%.

Some highlights of our most relevant business. Regarding Cielo Brasil, the Cielo financial volume totaled R\$143 billion, an increase of 9.9% compared to Q2 of 2015. In the net revenue pro forma of purchase of receivables, operations reached R\$339 million, a 21% increase compared to Q2 of last year reaching 20.4% of the credit financial volume. Cateno's net revenue increased 6.6% to R\$609 million in Q2. The Cateno's EBITDA margin was 42.7%, a decrease of 3.3 points in relation to Q2 of last year.

With regards to other highlights, I'd like to point out the following achievements. Ranked first in the service category of the largest and the best companies ranking of Exame magazine for the 10th consecutive year. Amongst the 10 best Brazilian companies according to Corporate Governance Index IG100. Amongst the best companies to start a career according to the Você S/A magazine for the sixth consecutive year. Ranked 10th amongst Brazil's most valuable brands in a study conducted by IstoÉ Dinheiro magazine in partnership with Millward Brown Vermeer. Cielo is a company with the highest satisfaction level in the Escolha PME, SME Selection Award prepared by O Estado de S. Paulo newspaper in the POS terminal category.

On the slide four, we present evolution of the guidance released earlier this year. With respect to our understanding of the evolution of the credit and debit card financial volume for the industry, we've revised our guidance on growth between 5.5% and 7.5% to a higher range between 7% and 9% with Cielo growing in line with the industry. We cannot refer to the quarter situation because not all participants have already released information.

Regarding the cost of Cielo Brasil and Cateno jointly after eliminating impact of subsidiaries via equity interest, growth in the first semester of this year was 7.7%. Given the stronger financial volume capture, this item was also changed. The initial estimate of valuation between 4% to 6% was revised to a new range of 6% to 8%. During the presentation, Clovis will give more details for both Cielo Brasil and Cateno.

Finally, with regard to the investment in POS terminals, we invest in the first half the total amount of R\$100 million. Given the impact of other external factors such as the economic situation, which has caused an increase in mortality, especially offers small and medium merchants and the implementation of the Multivan project, we also changed the estimate for the full year decreasing R\$50 million, the total CapEx in terminals. It means on your guidance, our R\$400 million in POS investment in 2016.

I would now give the floor to Clovis Poggetti who will continue with the presentation.

Clovis Poggetti {BIO 16529642 <GO>}

Thank you, Rômulo, and good morning, everyone.

Moving to page five, we present the frame with information to monitor Cielo's businesses. The information about Cielo Consolidated presented in table one shows that the net operating revenue in the quarter totaled R\$3.1 billion, 9.8% higher than second quarter last year. The increase in net revenue is mainly related to the continuous expansion of Cielo's business, including revenue from the Ourocard arrangement in Cateno, M4U's mobile credit sales and depreciation of the dollar in revenues generated in the U.S., the Merchant e-Solutions. All of these partially offset by decreased gross MDR.

Quarter-over-quarter, revenue increased by 0.7%, the growth is related to the increase in revenues of subsidiaries due to continued business expansion, partially offset by the average dollar depreciation in the quarter, applied in the consolidation of foreign investments and due to concentration of the Agro product in the second quarter this year.

Our total Cielo Consolidated expenditure was R\$1.96 billion in the second quarter, 17.7% higher than the same quarter last year. And the main in this comparison were the cost of subsidiaries' Merchant e-Solution due to average dollar appreciation in the quarter and its continued business expansion and also M4U due to increased sales from mobile credit sales.

Quarter-over-quarter, the amount is 4% higher mainly due to the cost of subsidiaries' M4U and Merchant e-Solutions and higher sales and marketing expenses in Cielo Brasil. And finally, we have our Cielo Consolidated net income which totaled R\$989 million, up 13.8% year-over-year and down 0.6% quarter-over-quarter. Other tables will be discussed in the next slides.

Thus, let's move onto page six. On this page, I would like to discuss the table four, Cielo Brazil, but let's first check the evolution of the main business drivers. The financial volume presented a growth of 9.9% year-over-year reaching R\$143 billion, excluding the product Agro, such a growth would be of 6.8%. In the breakdown by product, credit grew by 4.5% while debit grew 17.9%. Quarter-over-quarter, total volume increased to 2.2% and excluding Agro, it went down by 0.4%, by product, credit and debit increased 1.7% and 2.8% respectively.

Regarding the change in volume, I would like to remind you that, although the Elo brand is already been captured by other acquires according to the Multivan project, its entire volume is still reported by Cielo. This quarter, Elo's total volume was R\$22.1 billion.

In terms of POS terminals, numbers came in line with second quarter last year, and their increase in migration to wireless terminals was of 4.3 percentage points. Compared to first quarter this year, the base fell by 0.6%, mainly as a result of the current economic scenario, reflected in a lower number of affiliation and a high number of uninstallations and the Multivan project.

Finally, the operations of purchase of receivables are an important lever for Cielo Brazil. The purchase of receivables volume increased by 15% year-over-year reaching R\$16.5 billion, representing 20.4% of the total credit volume.

The net revenue pro forma reached R\$339 million in the quarter or 22% up compared to the same quarter last year, sequentially from first quarter this year, while volume increased to 3.3%, the net revenue pro forma decreased 1.4% due to the lower average dollar (10:09). Now, after the discussion the behavior of Cielo Brazil business levers let's analyze its performance.

Net revenue increased 4.8% to R\$1.8 billion in the quarter. The increase is related to the higher financial volume capture due to the continuous expansion of the business, partially offset by a decrease in the revenue yield that was 126% in the quarter, compared to 132% in the second quarter last year. This decrease is directly related to the concentration of Agro product volume in the quarter.

Importantly, without considering the Agro product, the yield would present a lower variation from 134% in the second quarter last year to 132% in this quarter.

Quarter-over-quarter, Cielo Brazil net revenue decreased 1.6%. The reduction is related to the decrease of 5 basis points in the revenue yield, when compared to the first quarter this year, which was 131%. This reduction is mainly related to Agro product concentration in the second quarter. This considering the Agro, the yield variation would have been 2 bps.

Speaking now of total spending, it increased 9.3% to R\$857 million in the quarter, compared to the same period of 2015. This increase was primarily due to higher financial volume captured, increased number of transactions and expenses concentrated in the quarter related to higher expense due to retirement, severance payments and increasing sales and marketing expenses.

As convened from the justification, in total spending of Cielo Brazil, there is a variable component related to the financial volume capture, number of transactions or logistics. That's why at the beginning of the presentation, Rômulo mentioned that we revised the guidance as the financial volume, one of our metrics will be above our initial expectation.

Quarter-over-quarter, the total expense increased 4.9% due to the same reasons. And finally, we have the Cielo Brazil net income, which reached at R\$1.1 billion in the quarter, up by 13% year-over-year and decreased 4.8% quarter-over-quarter.

Let's move to page seven to discuss Cateno performance. In the first table, we present the comparison with the second quarter last year. Cateno's net revenue went up 6.6% to R\$609 million in the quarter. The increase is mainly related to the increasing financial volume captured in the Ourocard Arrangement, partially impacted by the concentration of the Agro product. Quarter-over-quarter, there was an increase of 2.8%.

FINAL

Total expenditure increased by 10.1% to R\$445 million, mainly related to the continued expansion of the Ourocard brand, which impacts related costs and expenses and the focus given in the second quarter to the issue of Elo cards by Banco do Brasil, excluding extraordinary expenses that totaled R\$23 million in the quarter mainly to the embossing and posting of Elo issued cards, the total expenditure would have increased at 4.4% year-over-year.

Quarter-over-quarter, Cateno's total expenditures ex-extraordinary would have decreased 1.5%. and finally, Cateno's net income was R\$129.5 million, up 5.1% year-over-year. Quarter-over-quarter, net income increased 1.6%. It's important to note that in Cateno, there is amortization of intangible assets for the period of 30 years, representing R\$96.4 million per quarter.

In the figures presented in the second table, amortization is not initially considered, creating what we call business result. In this view, the net income in the quarter was R\$193 million. This will serve as the basis for the analysis of its contribution to Cielo in the cash analysis.

In the accounting column, the net income already reported of R\$129.5 million is the starting point for the analysis of Cateno's contribution to Cielo after impact of financial expenses, related to the creation of the new company.

As we can observe, there is a negative contribution of R\$70.6 million in the quarter. This number comes from a R\$90.6 million contribution, representing 70% of the net income, net of financial expenses contracted by Cielo after tax effect in the amount of R\$161.2 million.

Similarly, but excluding only amortization between the cash basis concept, as shown in the final column, the contribution of Cateno to Cielo, after the impact of financial expenses is negative at R\$3.1 million. As already Cielo considering the cash analysis, Cateno becomes accretive in the second-half this year.

On the next slide, number eight, we present Cielo's current debt. The company's leverage decreased to 1.2 times net debt to adjusted EBITDA for the purchase of receivables revenue, attesting here, the company's strong cash generation capacity. It is also important to mention the milestone in the quarter, which was the payment of R\$1.5 billion in principal, and R\$300 million in interest related to the public debentures, which took place in April.

Now, I would like to hand the call back to Rômulo.

Rômulo de Mello Dias

To conclude my comments, I'd like to announce that we've repositioned our brand in order to sustain our relevant position that impact industry, which has been receiving a torrent of new entrance. To do that, we even changed our slogan. Now, we are a machine of ideas. We understand that such change is necessary in view of the evolution of the

means of payments industry worldwide, (16:12) in the past took years to be developed. Now, arising only a few months.

So, for us not to be swallow (16:18) startup, we decided to change. What brought us here will not be enough to move us forward. Within this context, Cielo's challenge is not only to innovate, but offer new services to merchants and its clients. Thus, to change the mindset, we reorganized several structures by promoting young talents.

To translate innovation into a language closer to retail, we also launched a new marketing campaign called Fantastic Entrepreneurs it's films (16:49) show how Cielo's diversified portfolio of products and services can move any business to a new one as a real machine of ideas.

We are really excited with this change and remain determined to deliver our mission of delighting our clients with the best solutions of leading, profitable and sustainable company, with devoted employees.

So, I conclude my comments here and thank you for your attention. We're now at your disposal to answer your questions. Operator, please.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Mario Pierry, Bank of America, Merrill Lynch.

Q - Mario Pierry {BIO 1505554 <GO>}

Hi. Good morning, everybody. Can you hear me?

A - Rômulo de Mello Dias

Yeah, we can.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. Sorry about that. So, my main question is related to, if you have any concerns about potential upcoming changes in regulation specifically for the repurchase of receivables, if you have any updates that you can give to us?

A - Rômulo de Mello Dias

Thank you Mario for your question. I understand that right now the industry is having some discussions with the Central Bank, and it's clear for us that, what we are doing it's completely following, what's within the law. So, right now, we are very, let's say, comfortable with the situation that we have. And there are some options that we are examining such as significant (18:40) orders.

FINAL

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. Are there any dates that we should be watching out for and do you expect Central Bank to formally make an announcement either way?

A - Rômulo de Mello Dias

As you may know, Central Bank is not responsible to say anything about (19:01) or something else or something similar. And why because it's something that is not under his supervision - it's supervision. Having said that, we are having let's say a good conversation with them trying to address what we are doing to the industry (19:21) as a whole has been doing so far.

And let's remember that also other companies do exactly the same thing even the factoring companies. So there is, I'm just trying to provide you with more information in order to allow you to conclude by yourself what should be done or not? But we are not expecting any kind of let's say secular or new resolution saying something about that, because it's something not under its supervision.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. Thank you very much.

Operator

The next question comes from Marcelo Cintra, Goldman Sachs.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Hi. Good morning, everyone. Thank you for taking my question. My first question is regarding your costs and expenses guidance, which were increased to 6% to 8% growth. You mentioned during the call that it was mainly related to stronger expectations for transaction growth. So I just like to hear from you like if transactions were to remain in line with your initial expectations for the year, if the cost and expenses, will be up for the year? And I also would like to have some more color on Cateno, we saw some margin pressure, I understood that there were some non-recurring costs over there, but my main doubt here is, when we can see maybe some synergies or further improvement on margins for Cateno? And then I'll follow-up with the second question. Thank you.

A - Rômulo de Mello Dias

Thank you Marcelo for your question. About the costs and expenses, the new guidance that we've provided between 6% and 8%, as you said is mainly due to stronger transaction growth that we are delivering. So, this is as you - as also you mentioned or Clovis mentioned there in the call that more than 60% is variable costs.

And when he said that the total financial volume would grow at the beginning of the year between 5.5% and 7.5%, taking into consideration inflation of 7% and also the fact that Cielo at that point in time we're expecting that we will grow below the industry and now we have revised this guidance. We are saying that, it's not between 5.5% and 7.5%, and

Bloomberg Transcript

now it sat between 7% and 9%, and Cielo will grow according to the industry, so in line with industry.

So with this two things together, and if you consider the midpoint just for the sake of the argument (22:08), we are talking about a number, I'm not saying that we are going to grow 8%, but just to make 7.5% a year.

If you say that our growth would be 8% and before our growth would be between 4.5%, 5%, which is below 5% the bottom of the previous range, you can see that there is a strong difference between the other guidance and with new guidance that we're providing. So in other words, what we are saying that, we are not increasing the total cost and expenses of the company that are under our control.

In other words, and I repeat what I said during the first conference call in Portuguese language, if we - if the performance of the company and the industry would be the one that we said during the first call, our results or our total expenses plus costs would be in line with the former previous range - with the former range or between 4% and 6%.

So, with this kind of statements, I'm trying to stress the fact that we continue to be concerned about to deliver it or the range that we said that we will achieve in terms of costs and expenses and - but on the other hand, if the performance of the industry is bad and if the performance of the Cielo is better considering the total sales volume, we need to address some costs, because we consider another kind of range in terms of growth.

About Cateno, your second question, the margin pressure that you mentioned, I would say that's mainly due to some non-recurrent events such as R\$23 million that you have due to - mainly to embossing - embossing cards. So there is also other non-recurrent events, but we decide to focus on this, because this was the most important one.

So in other words, the second quarter of Cateno shouldn't be considered as a proxy for the whole year. So if you take into consideration, the first quarter of Cateno compared to the second quarter, there is a disconnection between the performance of the first quarter and the second quarter. I would say that of course, because of the deterioration of the macroeconomic situation, Cateno is also suffering in terms of the revenues and other things, but I would say that the second quarter as I said before is non-recurrent events and the revenues will grow more than expenses of the company.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Okay. Thank you. Just a follow-up on Cateno. Should we expect maybe some synergies, mainly using first quarter this year as a reference or even last year? Could we expect some synergies improvement on margins or the levels reported on first quarter and last year should be a normalized level?

A - Rômulo de Mello Dias

The synergy is something that we always take a look what can be done, what should be the performance of each line. What I can tell you that we are working on this kind of

FINAL

synergies, some of the things (25:29) appear in the first, because we have more than one year operating at Cateno, and if you take a look in the performance of the - unfortunately, don't - you don't have and we don't have the performance of 2014 third quarter (25:51), but you have the performance of the whole year. So, what we can tell you that we continue to take a look, as I said before, and some changes (26:00) in the short-term.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Thank you, and if I may just ask a quick last question, it's related to the Multivan project, I just would like maybe to get a follow-up from you, when we will see all the acquires on the market accepting all the card brands and the entire client base of Cielo also accepting our Orchard brand, should we expect this for this year, or its only something for us (26:28)? Thank you.

A - Rômulo de Mello Dias

Yeah. Multivan project for sure, this year is going to be concluded (26:37) with demand players of the industry.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Thank you very much.

Operator

The next question comes from Alexandre Spada from Itaú BBA.

Q - Alexandre Spada {BIO 16687974 <GO>}

Hi, gentlemen, good morning. Thanks for taking my question. You reiterated in the Portuguese call, the intention you have 50,000 LIO terminals installed into late 2016. Can you provide at this point, any comments on what would be the pricing of those terminals, as far as I know in the last conference call, the pricing had not yet being fully defined. Can you make any further comments on that?

A - Rômulo de Mello Dias

Yeah. Spada, right now, we're making some pilots in order to see the reaction, the acceptance of deal, in terms of price that we intend to (27:33). What I can tell you, as I said during the call in Portuguese, is that the demand continues to be very high and right now we have a good province to supply and to offer the demand that we are receiving. But for sure, the price is going to be more expensive than the regular term, now because you're not comparing apples-to-apples, it's apples-to-bananas, because we also have not only electronic payments, but we also have the management of the business and some important tools that you are delivering in the marketplace of Cielo LIO.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. Thank you. So at the end of the day, it's not yet fully defined?

Bloomberg Transcript

A - Rômulo de Mello Dias

Yes.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay, clear. Thank you.

Operator

The next question comes from James Peterland, Barclays (28:25)

Yes, thank you very much. My first question actually was on the Merchant e-Solutions business, if I adjust for foreign currency in that business over the past four quarters or so, it looks as the growth has been trending down from double-digit to low single-digit. Can you talk a bit about what's happening in that division? And then secondly on terminals, I think last time we spoke to you in the process of completing a large tender for point-of-sale terminals, can you talk about - if that's being concluded and whether that's benefiting your CapEx guidance to conclusion of that contract? Thank you.

A - Rômulo de Mello Dias

You asked about the evolution of Merchant e?

Q - Operator

Right, Merchant e-Solutions adjusted for FX.

A - Rômulo de Mello Dias

Yeah.

Q - Operator

Local currencies for me.

A - Rômulo de Mello Dias

The FX as you know is something that really affected performance of Merchant e (29:27) because by the - at the end of the day, we have a hedging account in terms of the amount of money that you raise in order to fund the acquisition of Merchant e. But the performance of Merchant e is, well seeing that the fact that we - when you decided to make net FX (29:46) that should be necessary in order to go to another step in terms of platform, IT platform. We are - the total result of this initiative together with the fact that now since the beginning we are receiving EBITDA. So in other words, this CapEx if you wanted to have a new platform should be necessary to be - should be implemented anyway because we had a deal to provide a better service to our clients. But on the other hand, what you had, when you decided start to buy Merchant e is that we also had EBITDA, so it was CapEx that came together with EBITDA. So, the total - the total - the combination of the two things is something that really - we are really happy for the - this step that we took.

And about the questions (30:50), when we adjust by a fact, if the results is falling, I will ask Clovis in breakout to provide more information. There is some things that happened such as - we changed the company, we moved the company to Atlanta, the new place where the - sorry to say is a place where usually they acquire the space, the cost of living is much lower when compared to the cost of living in Redwood City. We also have some savings in terms of tax and other things. So, to talk about FX and that we have in Merchant e, I will ask Clovis to answer the question?

A - Clovis Poggetti {BIO 16529642 <GO>}

Hi, James (31:32). The point is that, we had also - we are having this year some one-off event with regard to Merchant e. Let's say events that are not so relevant, for example in our consolidated phases, but when analyze it in individual basis for Merchant e, they ask them how relevant with regards to moving from California to Atlanta, Georgia, okay. And also some partnership fees, that were renegotiated, increasing for this quarter, the cost of the day-to-day (32:07) transactions, but - that's it.

A - Rômulo de Mello Dias

And, about your other question James (32:16), in term of the beach (32:17) for POS, yes, we did very big deal and we don't have only one supplier. We have (32:28) and have orders. We were able to have, let's say a very good deal in our opinion, and it's not a firm order, something that we indicate how many - and also very fun, as I forgot to say, sorry (32:49).

But coming back about the price and the indication, it's not the firm order. If you make a comparison between, aligned companies then you have to indicate to the suppliers, the manufacturers of the airplanes. We give - we provide an indicator, I want to have 10 new airplanes during the next two years. To some extent, it's almost the same what we give, we indicated to this big main suppliers, the amount of terminals that you have the intention to buy, and as well the price that we have the intention to buy. It's almost a firm order, but at the end of day is not completely a commitment, if you will.

Q - Operator

Sure. Thank you.

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

A - Rômulo de Mello Dias

Thank you, guys for participating in another conference call of Cielo's results. And as usual, we are here to answer additional questions that you may have with the team of IR and also with myself and Clovis. Thank you, and have a nice day.

Operator

That does conclude the Cielo's audio conference for today. Thank you very much for your participation. Have a good day and thank you for using Chorus Call.

This transcript may not be 100 percent accurate and may contain misspellings and other inaccuracies. This transcript is provided "as is", without express or implied warranties of any kind. Bloomberg retains all rights to this transcript and provides it solely for your personal, non-commercial use. Bloomberg, its suppliers and third-party agents shall have no liability for errors in this transcript or for lost profits, losses, or direct, indirect, incidental, consequential, special or punitive damages in connection with the furnishing, performance or use of such transcript. Neither the information nor any opinion expressed in this transcript constitutes a solicitation of the purchase or sale of securities or commodities. Any opinion expressed in the transcript does not necessarily reflect the views of Bloomberg LP. © COPYRIGHT 2022, BLOOMBERG LP. All rights reserved. Any reproduction, redistribution or retransmission is expressly prohibited.

FINAL

Bloomberg Transcript