Q2 2021 Earnings Call

Company Participants

- Claudio Oliveira, Unknown
- Gustavo Henrique Santos De Sousa, CEO

Other Participants

- Daer Labarta, Analyst
- Jeffrey Brian Cantwell, Analyst
- Mario Lucio Pierry, Analyst
- Neha Agarwala, Analyst

Presentation

Operator

Good afternoon, everyone. Thank you for waiting. Welcome to Cielo's Second Quarter of 2021 Results Conference Call. With us here today we have Mr. Gustavo Sousa; Filipe Oliveira; and Daniel Diniz. This event is being recorded and is also being broadcast live via webcast and may be accessed through Cielo website, at ri.cielo.com.br/en, where the presentation is also available. Participants may view the slides in any order that you wish. The replay will be available shortly after the event is concluded. Remember that the participants of the webcast will be able to register via website questions to Cielo that will be answered soon.

Before proceeding, let me mention that forward-looking statements are based on the beliefs and assumptions of Cielo management and on information currently available to the company. They involve risks and uncertainties 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. Based on the presentation published this morning on the company's website, this conference call is open exclusively for questions and answers. (Operator Instructions) I now pass the floor to Mr. Gustavo Sousa for opening remarks.

Gustavo Henrique Santos De Sousa {BIO 17683157 <GO>}

Thank you very much. Good morning, everyone. Thank you for participating in our earnings call. In this initial message, I intend to cover the highlights of our results and our strategic priorities. So starting with our earnings. Our net income of BRL 180 million, with no one-off items in the period, this is a 33% growth versus the First Quarter of 2021 on a recurring basis. Besides that, this was the Third Quarter reporting net income growth in a year-over-year comparison. Our TPV presented a 30% growth year-over-year. When we look specifically at the combination of the SMB with the long tail segment, we showed a 49% growth year-over-year. We have also shown strong discipline in spending control, with a 5% decrease in normalized (inaudible) year-over-year. Now moving on to our strategy and priorities. The company's strategy does not change. We continue with the same direction -- expand the ecosystem, including credit and value-added services and innovation repayment solutions, while improving operations, especially the quality of services provided in the traditional acquiring business. Having said that, we intend at first to identify and expedite the measures that will allow us to offer the best experience to our customers. What you can expect in coming months? The optimization of the commercial model. We have already hired 500 new employees that expanded our commercial force. This team is already trained and powered with technology. We have had some headwinds, with quarantines, which hindered the pace of client acquisition, but we have already had important results, such as a relevant increase in period [ph] activation rates. Important improvements are already being implemented in the company's logistics system in view of processes and contracts with partners. Improvements in last-mile logistics. In recent months, we have tested a new face-to-face service to meet the demand of our customers, such as installation and maintenance of equipment. We have structured a team of professionals, new to Cielo and newly formed [ph], well trained, who go to the client to solve problems, and we have named this initiative Heroes. The model showed promising indicators, with client satisfaction superior to the main benchmarks in the industry. We implemented these initiatives as a pilot in six cities, and we are now ready to expand the Heroes model to 153 cities, which represents 80% of the calls made by our customers. We are also investing to improve our call center service, (inaudible) systems, processes and internalizing some key positions such as the quality and data analysis. Our customers must have faster and more efficient services. These were the highlights in terms of deliveries that are already taking place and should be complemented in the next few months. I hope to be able to discuss the results at the next earnings conference call. Better serving the customer is our top priority. It is the basis for advancing on the other pillars of our strategy. We have important advances in the first half of this year in terms of innovation in new business, as it was the case with the start of the WhatsApp P2P operation and the (inaudible) that we structured to grant working capital lines to our clients. We will continue to advance in this type of initiatives. We understand that these agendas makes sense if we have an excellent service and if this quality is perceived by our customer base. Our ambition is high in terms of service quality and customer satisfaction. Thank you for participating and for listening. We now open the Q&A session. Thank you.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Mario Pierry, with Bank of America.

Q - Mario Lucio Pierry {BIO 1505554 <GO>}

Gustavo, I have two questions. On your release, you talked about problems with the new receivables registry system, and that led you to book provisions of almost BRL 14 million in the quarter. Can you give me a little bit more color what is the problem? And when we think about this BRL 14 million, what does it represent of the overall book? Then my second question is related to your take rate. It surprises me that your take rate went down, right? Because you showed that your mix of volumes have improved a lot, right? You're growing more in the SMB, in the long tail segment. So you're de-emphasizing the large corporates. We saw that the credit mix versus debit improved. I think it was the first time that we saw credit growing faster than debit since the pandemic started. So can you also give me a little bit more color on why you continue to see pressure on revenue yield and what can you do, going forward, to stabilize that?

A - Gustavo Henrique Santos De Sousa {BIO 17683157 <GO>}

Thank you, Mario. I'll take your first question, and I'll pass the second to Filipe. So on the receivables. As you know, we have had an important implementation in the Brazilian system. So we still remain (inaudible) in terms of integrating processes, of doing configurations among all of the market players. With that, we have seen increased operational risk. This operational risk is related to synchronizing the information across the different registrars of receivables in the country. With that, we decided to record a provision. We are going after recovering what generated this provision, and we'll let you know how this progresses in the next quarter. But it's completely related to increasing operational risk that we're having in the first phases of the implementation of the receivables center here in the system, integrating acquirers, financial institutions and also the registrars of those receivables. To take your revenue yield question, I'll pass it to Filipe. Filipe, please?

A - Claudio Oliveira {BIO 16986340 <GO>}

Mario, thank you for your question. So basically, we have movements in two directions here when we look at the revenue yield generating positive pressure. We have increasing (inaudible) liquidation penetration, which reached around 39% in valuation terms in those [ph] segments. We also have a better mix of clients since we have a larger penetration of SMB compared to large accounts in this last quarter. We also have a better mix of products, as you mentioned, since debit has been losing a little bit of its best [ph] leadership that it had in the last quarters during the pandemic. On the other hand, we have two effects that are generating negative pressure in the revenue yields. The first one is prices, general prices in the market, which means basically the competitiveness of the market is still pushing prices down across the market as a whole. The second is a bit of a mathematical effect that is that, basically, you have POS Rental fees are fixed. Once you have a volumes recovery in the market, imagine a client that pays BRL 100 in rents and all of a sudden they may double their volume, the yield of the rent is going to go down by half. So it's a mathematical effect of volumes recovering and not a real effect in terms of prices.

Q - Mario Lucio Pierry {BIO 1505554 <GO>}

Okay. Is there a strategy here for you to offset some of this pricing pressure, going forward?

A - Claudio Oliveira {BIO 16986340 <GO>}

Sure. In our view, the main way to increase revenue yield is to increase the penetration of prepayment volumes, which is one of the main strategies here in the company. The second one is further increasing the mix of (inaudible) SMB and micro merchants relative to the large accounts. So those are two main initiatives that we have in terms of increasing revenue yield.

Operator

The next question comes from Jeff Cantwell, with Guggenheim Securities.

Q - Jeffrey Brian Cantwell {BIO 15025614 <GO>}

Can you tell us a little bit about payment volumes? It looks like a nice step-up year-over-year and sequentially. So I was just curious if you can sort of drill down into what you're seeing this quarter across SMB, in particular? And how sustainable do you think growth in your payment volumes is as you contemplate the back half of this year? Are there any callouts or anything you want to discuss so we can set expectations for the back half of the year.

A - Gustavo Henrique Santos De Sousa {BIO 17683157 <GO>}

Jeff, Gustavo here. I'm sorry, but your question got really choppy for us here. We couldn't hear (inaudible). If I understand, you're asking for some color on prepayment volumes on SMB in long tail. Is that around that?

Q - Jeffrey Brian Cantwell {BIO 15025614 <GO>}

Yes. Yes. If you don't mind, let me just back up. To focus on your payment volumes, I was just curious if you can drill down into what you're seeing this quarter in your SMB segment, in particular. Then I was hoping you can discuss how sustainable you think growth in your payment volumes is in the back half of this year. So yes, that's the crux of it.

A - Claudio Oliveira {BIO 16986340 <GO>}

Jeff, thank you for your question. So we have resourced our commercial sales capabilities in order to grow our TPV volumes in both SMB and also micro merchants, but micro merchants on a lower scale than SMB. Our main focus here is SMB. So we imagine that this new sales model with the reinforced team will start seeing traction in the next couple of quarters, which will perpetuate or at least maintain this rhythm that we have of growth in the segment. Additionally to that, as I mentioned before in the last question about the revenue yield, we also have a very strong initiative here to cross-sell products, especially prepayment products, to those segments. So that should be another good news in that segment that we want to present in the next quarters: both one in growth and also prepayment volume growth.

Q - Jeffrey Brian Cantwell {BIO 15025614 <GO>}

Got it. Got it. Is this any better? I hope you can hear me. My second question was on your expenses, and it looks like you're reducing your normalized expenses. So it looks like your margins expanded by 3.5 ppt this quarter, quarter-to-quarter. So how sustainable is that?

We look pretty closely at your operating leverage. I guess I'm just curious if you can talk about your level of confidence that you can drive positive operating leverage, going forward. I understand there's a lot of moving pieces to that question. So maybe can you just give us color on how you're thinking about OpEx and operating leverage, going forward?

A - Claudio Oliveira {BIO 16986340 <GO>}

Sure. So as you saw, this was a really good performance in terms of reducing costs. The company has delivered in the last quarters. Of course every cost reduction has its limit. You (inaudible) reduce costs forever. We do believe, however that there's still some place for further efficiency gain in the company. However we also have many new initiatives, especially increasing the quality of service, that may require additional expenditure in the next quarters. So the net effect, we don't have it yet. We don't know if it's going to -- if the prices of the costs are going to keep going down or if eventually they're going up because of those new investments, but we have those two movements happening at the same time.

Q - Jeffrey Brian Cantwell {BIO 15025614 <GO>}

Okay. I appreciate all that color. Then lastly, can you talk a little bit about your key strategic priorities? This is in reference to Slide 13 in the presentation, particularly in payments innovation. Can you talk about WhatsApp? There's a lot of investor interest in this one. So we would like to think out a little bit over the medium term. I guess what I want to understand is, is this the direction that payments are going in Brazil, to platforms like WhatsApp? Then underneath that, is this SMB-friendly? Is it consumer-friendly, in particular? I just want to understand the context for you guys, because you're certainly positioning this as part of your payments innovation strategy. So I just wanted to get your thoughts on what that could mean for you guys as you think out over the medium term.

A - Claudio Oliveira {BIO 16986340 <GO>}

Sure. Jeff, as we saw in other countries, initiatives such as (inaudible) or even WhatsApp payments, they have significantly increased the share of digital payments in the overall economy, and we believe we have a movement that could be seen very similarly here in Brazil with all the initiatives that have been happening in the market. Just to give us some more color, Brazil has around 40% penetration of card payments in the total expenditure, consumer expenditure, in the country. We imagine this figure could still go up by at least 10 basis points, percentage points, in the next couple of years. So we believe there's a huge market here for different types of solutions, and there's not necessarily cannibalization between the new forms of payments and the old ones. However it's a good opportunity for any acquirer that wants to be relevant in the market. So Cielo has decided to position itself at the forefront of those initiatives by partnering with WhatsApp in order to provide the P2P payments, and we believe this is going to be a really good way to increase the volume pool of the market overall for every acquirer.

Operator

The next question comes from Neha Agarwala, with HSBC.

Q - Neha Agarwala {BIO 17722501 <GO>}

I guess I want to follow up on WhatsApp Pay. Are the volumes of WhatsApp Pay already, in part, included in your total TPV? And going forward, as the volumes that WhatsApp Pay pick up, I understand this is currently only P2P, but would that be included in your overall TPV? Or would you show that separately? My next question is on the terms. I think in your Brazilian call, on your Portuguese call, you mentioned about the term products for the SMBs. Could you elaborate a bit more on that? I wasn't sure what it is. And are you already giving out working capital loans to your merchants?

A - Gustavo Henrique Santos De Sousa {BIO 17683157 <GO>}

Neha, Gustavo here. I'll start with your working capital loans question. We are ready to do that in terms of product and balance sheet. We will likely see this disbursement number of working capital loans pick up on the upcoming quarters. So we have worked on specifics only for that during the Second Quarter of this year. On the third and Fourth Quarter, we'll start to share the first disbursements related to that. I'm talking mainly about working capital lines dedicated to our SMB portfolio. Filipe here will talk about WhatsApp Pay. Filipe, please?

A - Claudio Oliveira {BIO 16986340 <GO>}

Neha, thank you for your question. WhatsApp Pay. We see a huge potential for WhatsApp in Brazil. They have 120 million users in the country, virtually 100% penetration in smartphones in the country, really a well-reputed and reliable service in the minds of the Brazilian people, in general. So we see them as having huge potential. They decided to roll out the solution carefully, which, in our view, was very wise. So they phased the adoption of users quite carefully in the last couple of months. If I'm correct, only last month they made it available for every user in the country. So we see here on our sales side, we see numbers that are above our initial expectations, which is really good. We can't really further comment on WhatsApp's numbers because we have an NDA with them.

Q - Neha Agarwala {BIO 17722501 <GO>}

That's perfectly okay. But would you be including the volumes that you process for WhatsApp Pay into your TPV, or not?

A - Claudio Oliveira {BIO 16986340 <GO>}

Yes. We incorporate that volume here.

Q - Neha Agarwala {BIO 17722501 <GO>}

So if you incorporate that, I assume that will put further pressure on your revenue yields, because these volumes have low margins. Is that right to assume?

A - Claudio Oliveira {BIO 16986340 <GO>}

It's still very small to make a difference in our numbers overall. So I would say it's negligible in our volume.

Q - Neha Agarwala {BIO 17722501 <GO>}

Okay. But in the coming quarters, it could become more meaningful. So that could be a headwind for overall revenue yields.

A - Claudio Oliveira {BIO 16986340 <GO>}

Yes. It could be more meaningful. Because of the NDA, I can't really tell you about the revenue of those transactions. But yes, it could eventually influence the revenue yield.

Q - Neha Agarwala {BIO 17722501 <GO>}

Understood. On the working capital loans, which you're preparing to disburse mostly in the second half of the year, is that the term product that you were mentioning for the SMB segment?

A - Gustavo Henrique Santos De Sousa {BIO 17683157 <GO>}

Neha, can you repeat the last part of the question?

Q - Neha Agarwala {BIO 17722501 <GO>}

I think you mentioned something called a term product for the SMB segment. Is it the same as the working capital loan? Is that what you meant? Maybe it was lost in translation.

A - Gustavo Henrique Santos De Sousa {BIO 17683157 <GO>}

I got it. I got it. So in our presentation, when we refer to term products we are referring to receivables discounting and also to prepayments that is done in two days instead of getting credit or in 30 days. Or in a longer period, a client can adopt the product (inaudible). This is what we call term products in our releases, in our presentations. When we refer to working capital lines, we specifically call them credit. So we're talking about two (inaudible) of products, okay?

Q - Neha Agarwala {BIO 17722501 <GO>}

Okay. The credits in the coming months, that will be completely originated and underwritten by Cielo? Or would the bank be involved?

A - Gustavo Henrique Santos De Sousa {BIO 17683157 <GO>}

That will be completely originated by Cielo in its client base. Bear in mind that Cielo's client base is made up of clients that were originated by Cielo or that were originated by buying a partner base [ph].

Q - Neha Agarwala {BIO 17722501 <GO>}

Okay. So even if a client comes from a Bradesco branch, you can give a working capital loan to the client?

A - Gustavo Henrique Santos De Sousa {BIO 17683157 <GO>}

Yes. Because clients that are originated to banks that are partners with Cielo, that have agreements with Cielo, they have a, call it, a dual relationship. They have a banking relationship with that given bank, and they have an acquiring relationship with Cielo, right? Both parties, the bank that holds the checking account and Cielo, who has the acquirer relationship, can offer a number of products; credit being one of them.

Q - Neha Agarwala {BIO 17722501 <GO>}

Okay. Because I think previously the point of contention here was that if a client comes from a Bradesco channel, then Bradesco would like to offer the working capital loans, rather than having it done through Cielo. So has that been sorted out with the controlling shareholders?

A - Gustavo Henrique Santos De Sousa {BIO 17683157 <GO>}

There is no barrier for that. This strategy of bringing credit across the client base from Cielo regardless of who originated the client is totally approved by the Board.

Operator

The next question comes from Tito Labarta, with Goldman Sachs.

Q - Daer Labarta

A couple of questions also. First, I guess following up on the payment volume growth, decent growth in the quarter. But if we look at your competitors, they all grew roughly about 11%, 12% on the quarter, at least the ones that have reported so far. So just to understand a little bit the competitive dynamics. Is this just because you're losing share with large merchants, and that's where you see the competition growing? Because you showed some good trends on the SMB side. But then you're still not getting the benefits on the revenue yield. I mean you mentioned that growing with SMB should help that revenue yield. So just to understand, are you also seeing pricing pressure on the SMB segment? And do you ever think you'll grow faster than the competition? Or you're just willing to lose share to sort of protect profitability. I just want to think a little bit about the dynamics on the payment volume growth. Then I have a follow-up question on the receivables market, which I can ask afterwards.

A - Claudio Oliveira {BIO 16986340 <GO>}

Yes. You're correct. The market share loss is basically because of the large accounts. We have announced a strategy a couple of quarters ago that we're going to focus more and more on the SMB side and eventually lose some large accounts that were not as profitable as we desired here in the company. So that strategy is what's causing this market share loss, which you observed well. In terms of revenue yield, you're not seeing the benefits yet. We do see some benefit. If you look at the Slide 11 of the presentation, you see year-over-year the client mix and revenue mix component of revenue contributing quite positively to increase revenue. We do see, on the other hand, some other factors, such as overall price competitiveness in the market, increasing the overall revenue. In that sense, (inaudible) the positive effect that we have of the client mix. So that's what's happening. So yes, SMB penetration has been helping. However we don't see that in the net effect because of other effects.

Q - Daer Labarta

All right. But do you think that the revenue yield, if we look there on Slide 11, you were at 79 bps in 2Q20. Is that a reasonable sort of assumption of where you can get back to as you increase market share with SMBs? Or how much can it improve from here?

A - Claudio Oliveira {BIO 16986340 <GO>}

We unfortunately can't provide any forecast, but the overall trend is that we want to keep improving the mix of SMBs. So that could potentially, yes, have a good benefit overall.

Q - Daer Labarta

Okay. All right. Understood. Then my question on the receivables market. I guess two parts. One is the issues that have operational issues. Have those been resolved? Do you have an expectation for when those get resolved? And the working capital loans that you're planning to do, are those based on the receivables market working? Is there a relation between one and the other in terms of, like, having collateral from these receivables? Just to get a sense of why you needed those provisions and when you can reverse those or things will be operating as they should.

A - Gustavo Henrique Santos De Sousa {BIO 17683157 <GO>}

Thank you, Tito. So the new receivables dynamics in the country, this is very important. It's very significant in terms of improvement for possibilities and competitiveness of cost of credit for clients as a whole. I'd classify the operational issues related to that as completely normal, and we are very close to finalizing all of them. So it is a huge mass-scale implementation. Eventual problems were likely to happen then. I believe the market as a whole is very close to stabilizing everything, okay?

Q - Daer Labarta

Okay. Gustavo, that's helpful. And just on the second part of the question, on the loans, will they be contingent on this working? Or (inaudible), you don't need the receivables markets to work (inaudible)? Or you do?

A - Gustavo Henrique Santos De Sousa {BIO 17683157 <GO>}

The loans that we are planning to do as far as [ph] working capital lines, yes. They rely on the infrastructure of the market, because we're talking about working capital lines based on receivables. So we're talking (inaudible) about the type of products because this (inaudible), where by (inaudible) sales history of a given client, we offer credit that is backed by future receivables, right? In order to working those future receivables, we need the infrastructure of this new market, okay this new market for receivables. That is already working well in function, okay? This new product for us is still together in traction.

Operator

(Operator Instructions) The Q&A session is concluded. I would like to turn the floor back over to Mr. Gustavo Sousa for his closing remarks.

A - Gustavo Henrique Santos De Sousa {BIO 17683157 <GO>}

Thank you, everyone, for the participation. If you have any follow-up questions or comments, please follow up with our IR team. We'll see you in the next call. Thank you.

Operator

The Cielo conference call is concluded. Thank you very much for your participation. Have a nice day.