

Q3 2017 Earnings Call

Company Participants

- Clovis Poggetti Junior, Chief Financial Officer and Investor Relations Officer
- Eduardo Camposana Gouveia, Chief Executive Officer & Director
- Victor Schabbel, Analyst

Other Participants

- Alexandre Spada, Analyst
- Carlos G Macedo, Analyst
- Craig Jared Maurer, Analyst
- Gerardus Vos, Analyst
- Jorge Kuri, Analyst
- Mario Pierry, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, everyone, and thank you for waiting. Welcome to Cielo's Third Quarter 2017 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.

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 has concluded. Those following the presentation via the webcast may post their questions on our website.

Before proceeding, let me mention that forward statements are based on the beliefs and assumptions of Cielo's management and on information currently available to the company. They involve risks and uncertainties because they relate to the future events and, therefore, depend on circumstances that may or may not occur. Investors and analysts should understand that macroeconomic conditions, industry conditions, 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. Eduardo Gouveia. Mr. Gouveia, you may begin your presentation sir.

Eduardo Campozana Gouveia {BIO 16447861 <GO>}

Good morning. I would like to thank you all for joining us on this conference call to discuss Cielo's third quarter 2017 results. Joining me today is our CFO, Clovis Poggetti; and our IR, Victor Schabbel. It's our pleasure to begin this call by noting the gradual recovery of the retail sector and Brazil economy.

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The Cielo Broad Retail Index reported a consecutive increase in retail sales during September and August, both in nominal and real terms. After two years of the retail sector decline, recent figures point to a continuous improvement with September results even more positive than those record in the previous month. This dynamic contribute to Cielo's net income results which was, again, over BRL 1 billion with a high cash generation.

Despite economy and competitive challenges, revenue trends are gradually improving with our revenue yield contracting at a much slower pace by now. In addition, and an ongoing commitment to a greater efficiency and focus on profitability enabled us to record a substantial drop in total expenses, which will probably enable us to beat our guidance for this year.

The upturn of our revenues and efficiency gains were followed by strong results of our subsidiary, Cateno. We see net income growing nearly 27% year-over-year and contribution exceeding BRL 100 million in cash profit. Cateno revenue accounts for 10% of sales results.

For us, this is only the beginning of a very promising venture. Importantly, I would like to confirm our commitment to shareholders. We continue working hard with dedication to improve future results based on our four strategic pillars. These are: a focus on our clients and a commitment to serving their needs, while developing the very best working environment and maintaining our reputation as one of the best companies to work for.

We also have an ongoing commitment to efficiency and control expenses so we can deliver solid and sustainable long-term results. Additionally, we continue to invest in our digital evolution process sustaining our proactive role in the industry transformation.

In summary, we are confident that we are in the right path.

With that, I now would like to hand the call to Clovis who will discuss in more detail the trends seen in the third quarter. Clovis, please.

Clovis Poggetti Junior

Thank you, Gouveia. Good morning, everyone. On slide 3, you can see our operational highlights. In the third quarter this year, the volume capture in our (04:32) activity grew 11.3% excluding the Agro product versus 8.4% growth recorded in the previous quarter, a relevant acceleration chiefly due to debt volume which stepped up 18.3% year-over-year versus 17.5% growth presented in the second quarter. Worthy to mention the performance

of credit volumes that also improved reaching 6.3% year-over-year compared to 4.5% quarter-over-quarter.

Our POS base including new terminals decreased at a lower phase. We recorded a loss of 57,000 terminals this quarter compared to 75,000 terminals in the second quarter, down 3.2% year-over-year and 4.1% quarter-over-quarter. The client mortality and competition were still the main drivers to the decrease in the number of POS followed by of (05:49) in a stronger process of baseline cleanup of inactive terminals that no longer generate revenues. This (06:04) process represented around 30% of the terminal base reduction in the third quarter.

Competition was also a relevant factor, but it's important to mention that with the impact of the market opening known as multivan losing its strength as suggested by higher volumes captured by this model by other competitors, we believe that the pressure on our POS base should diminish initiating a stabilization process.

Moving on to next slide, you can see our financial highlights. As Gouveia mentioned, we have an ongoing commitment to operating efficiency reflected in the drop in our total expense. This quarter, total expenses for Cielo Brazil and its subsidiary, Cateno, fell 0.3% year-over-year due to better cost control and the implementation of several relevant projects at Cielo Brazil.

Process optimization at Cateno especially related to customer services and card embossing were also contributors. The challenging economic backdrop impacted profit and EBITDA this quarter. EBITDA decreased 6.1% year-over-year and margin contraction of 0.8 percentage points in the same period, but increases 1.4% sequentially.

Net income increased 0.8% year-over-year and net margin expanded 1.8 percentage point chiefly due to the company's financial deleverage process. Quarter-on-quarter comparison, net income grew 2.3%.

On the next slide, we will detail the operational and financial highlight of our subsidiary Cateno. Total financial volume capital, excluding specific segments, was up 7.8% year-over-year, reaching BRL 58 billion. Profit grew 27%, boosted by improved volumes, but also by the expense reduction, as we just spoke in previous slides, attesting for the great potential still to be explored. On the graph where we can see Cateno's results contribution for cash base profit, the company has already accounting for 10% of Cielo's results, substantial growth when compared to last year.

Moving on to next slide, we will discuss our guidance for the year. Our total volume grew 6.7% year-over-year or 7.7% excluding the other product, slightly above our expectations. While we reiterate our initial guidance, it's worth noting that as of the fourth quarter, we expect to lose volume with a stronger migration to the full acquired model.

Regarding total expenses, we are pleased to report that they already fell 3.2% year-over-year considering the first nine months. Despite expenditures high mainly at Cielo Brasil in this quarter and the expectation of higher expenses in the last quarter of the year, we

understand our numbers will be below the suggested guidance with our expenses showing a nominal contraction in 2017.

We ended the first nine months of the year with CapEx of BRL 120 million. We still estimate a mild pickup in the fourth quarter due to the rollout of LIO Version 2 (09:53).

We are now available to start the Q&A session. Operator, please.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Jorge Kuri with Morgan Stanley.

Q - Jorge Kuri {BIO 3937764 <GO>}

Hi. Good morning, everyone, and congrats on the numbers. Can you maybe give us some details about the Receba Rápido product that you're using to provide early settlement of credit cards? What level of fees are involved there? And if we compare that product with the traditional factoring of receivables, is there a way that you can tell us which is more profitable or equally profitable? And just so can we understand how as Receba Rápido picks up, what does that mean for the underlying profitability of the business?

And then the second question is on - and you alluded to this during your introduction, but just wanted to see if you could provide us more details on the cyclical recovery that you're seeing in your business. I mean, clearly there was a big change in the trend with these numbers and I want to understand to what extent this is now the beginning of what you think is a longer recovery? And what is underpinning that? So any detail that you can provide would be great. Thank you.

A - Eduardo Camposana Gouveia {BIO 16447861 <GO>}

Hi, Jorge. How are you? Thank you for the question. About Receba Rápido, we are seeing the product - we only launched the product by the mid of the first semester of this year. And the product is a little bit more profitable because you joined (12:03) the terms, the discount and we are putting a lot of focus to sell this product in our (12:20) the medium merchant - the micro merchant.

We believe that it's a little bit more easy to sell when combine (12:34) prepayment business in one product. And we are not seeing some cannibalization of our prepayment business and we believe that it's a good [12:47] we can have a penetration in the mid of pyramid of our business.

About the trends we believe that when we see some data from our NCDA (13:06), we are seeing some good data about, good signs about the recovery of the macro scenario in Brazil combined the decrease on inflation, decrease of (13:16) and decrease of

unemployment. And we are seeing some good signs. The last two months we had good results in our NCDA (13:34) in Brazilian retail sector. And we are very confident that we are in the beginning of this recovering process.

When this process have and we have this process, we believe that we can recover part of the mortality in POS basis. And recover part of (13:55) because you have more (13:55) installments. This is our perception in the short term that we had in the last few months.

Q - Jorge Kuri {BIO 3937764 <GO>}

Thanks. If I just may follow-up on that last part, is it fair to say that given the sequential improvement, and the better trends that you're seeing that it is possible that volumes return to maybe either very high single-digit, sort of like 8% or 9%, or low double-digit, 10% to 11% in 2018?

A - Eduardo Campozana Gouveia {BIO 16447861 <GO>}

We believe that we can recover to high single and the low double. But remember, Jorge, we began this month of October, the (14:45) that we can lose part of our Elo brand (14:50) volume that in revenues, as we mentioned before, we'll have the compensation because we begun to appoint (15:05) part of the business. Then we believe that the recovery will have in good shape in the next few quarters, but we are beginning the process of (15:22) in Brazil.

Q - Jorge Kuri {BIO 3937764 <GO>}

All right. Thank you very much.

A - Eduardo Campozana Gouveia {BIO 16447861 <GO>}

Thank you, Jorge.

Operator

The next question comes from Carlos Macedo with Goldman Sachs.

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

Good morning, gentlemen. Thanks for taking the question. Good afternoon down in Brazil. The question I have is in the POS rental business. You talked about how the number of POS terminals should level off going forward, a little bit of a view there. Do you feel like - and you talked about how 30% of it was from merchants going out of business. Do you think that's going to change now with merchants coming back, you should actually see the POS terminals go up?

Second question, again, in the same topic. We've seen your competitors, I think, Getnet was the one launching the sales of POS terminals at a reduced price compared to what you charge for rent. I think in the same report, we heard, Gouveia, you're talking about a pilot program that you're running to do the same thing. Is that something that you expect

will be a core part of Cielo strategy going forward or is it just, again, a minor part of your target market in merchants? Thanks.

A - Eduardo Campozana Gouveia {BIO 16447861 <GO>}

Thank you, Macedo. We believe that the POS (16:36) the decrease of the speed of mortality in the number of POS in our – last quarter was 4-point something and this quarter it's 3-point something. And we believe that with the speed decreasing of our POS basis in our white space (17:10) and subsequently, we will compensate by the (17:17). When we have seen the economy recover, we will see more merchants are creating and we will recover part of this base.

As I mentioned before – Clovis, we believe that the (17:36) in this case will be so important for our penetration in the small merchants. We've begun to disclose the number of (17:53) in the value, the value chain of the small merchant, we believe that we will have good results in pricing and in volume.

A - Clovis Poggetti Junior

And Carlos, building up on Gouveia's comments, what we believe is that we have been living a kind of perfect storm. Everything that could hit the business somehow, let's say, decided to work at the same time in the same direction that is putting a huge complexity on the business. What is my point? For example, the market situation, leading low volumes or single-digit growth, which is, let's say, very serious because let's not forget that we are working in a still very low-penetrated industry. This market situation also leading to a huge mortality. And then, such a mortality, let's say, affecting a business that was, in the past, very stable, let's say, very resilient, the POS rental business, okay, a business that in the past helped a lot to offset pressures in terms of MDRs.

Because of the multivan project, so having the small brands (19:34) fully open, et cetera, we had an additional, let's say, level of competition that also put an extra pressure in this rental business.

So, that's a combination of this macro, the combination of this modality, competition, et cetera. Then we have what we are seeing with the yield of the company. The point is that, it seems it's too early to say, it seems that things are getting better, it seems that maybe the worst is behind us. If that's true, let's say we should see, with regard to the rental business, let's say, the churn somehow diminishing because of the mortality, okay. The competition effect was always there, will always be there. But what is also very important with a better environment, we do believe that, let's say, the number of affiliations is going to improve. And overall effect will be the POS base on how it's stabilizing and who knows maybe start going up in a couple of quarters, okay.

The new process, as Gouveia just mentioned, is very important because, let's say, we had in the past a huge benefit with the migration from the fixed to the wireless POS, sure. Who knows that depending on how successful is LIO, and we are betting a lot in this, let's say, solution. This should help the average rental fee to be kept the same or even going – start going up. So the point is, we are still being hated because of all the macro situations

that we mentioned, yes, but again let's be positive in terms of maybe the worst is behind and we'll start seeing better things from now on.

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

Thanks, Clovis. Just a follow up here on LIO. You have 24,000 terminals. Obviously, the rollout has been slower than expected. I think you expected 50,000 by the end of last year. This year...

A - Clovis Poggetti Junior

Agree.

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

...I think 100,000. What's holding LIO back at this point do you think? Is it a price point? We heard people say that you lowered price for LIO in certain segments in order to get more penetration. Is it a price point? Is it a product? Is it just the fact the market has been weak? I mean what's holding LIO back?

A - Eduardo Camposana Gouveia {BIO 16447861 <GO>}

I said a few years ago, we are seeing - we are building the ecosystem of softwares (22:57) ecosystem. And we are building these ecosystem and integrate a lot of software houses and a lot of systems. And we had some delays in this process to build. As we know, we launched the LIO Version 1 without printer. And this is a huge barrier of penetration in Brazil because the customer of our merchants asking about the receipt. And the Version 2, we launched with printer as we believe that is a little bit more easy to have the good penetration with ecosystem of systems and softwares. The new barrier to penetrating, to be very clear (23:55) that the Version 1 didn't have the printer.

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

Okay. And you think that with the printer and with the software you're going to be able to accelerate penetration. Do you have a target for next year given that this year is probably - the problems have held it back?

A - Eduardo Camposana Gouveia {BIO 16447861 <GO>}

We don't have a target. But we believe that we have a strong penetration (24:18). We began to deliver - disclosure the number now and we believe something around this year yet - something around 52,000 to 70,000 LIOs and we believe that with the building of ecosystem of software and system we believe that we have strong value perception in the market.

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

Okay. Thanks, Gouveia. Thanks, Clovis.

A - Clovis Poggetti Junior

Thank you, Macedo. Bye-bye.

Operator

The next question comes from Alexandre Spada with Itaú BBA.

Q - Alexandre Spada {BIO 16687974 <GO>}

Hi, gentlemen. Good afternoon. Thanks for taking this question. I would also just - would like to discuss the POS rental business. There seem some - there's been some news saying that Cielo has a pilot project to sell terminals as well rather than renting them. So, my question is how does the profitability of a terminal sale compared to that of a terminal rental? Also, our understanding is that this initiative has been carried out by Stelo, a company in which Cielo has a 30% stake. That said, how are the economics of this initiative being split between Cielo and other shareholders of Stelo? Thank you.

A - Eduardo Camposana Gouveia {BIO 16447861 <GO>}

Thank you, Spada. This rental demo is not the only hardware process. The hardware plus the services that including this rental fee is a (25:55) but will center the law in such package that we deliver when we rent terminal POS. In our case, we believe that you have one business for one kind of customers or merchant that we keep our rental process terminal. We are seeing the market - Brazilian market for micro, micro, micro merchant. The selling - the way that they are selling terminal is having some penetration in this micro, micro business. This is a cash traditional business like that's driving and like a small salesman that we are seeing. It's possible in the future, few years, another company to complement our offer. Continues (26:59) rent terminal at Cielo and (27:03) and on the other companies.

A - Victor Schabbel {BIO 17149929 <GO>}

Spada here. It's Victor. Following up on what Gouveia basically said. Yes, you are right. We have a pilot running with our affiliating banks in two cities on the country side of the state of São Paulo. It's a small pilot. The idea is to focus on the bottom of the pyramid offering a solution that is being demanded by these type of clients that we were not exactly serving because they don't want to pay the rent. They want to have their own terminal. And the idea is to start offering the solution using a different brand, a different structure so we don't take the risk of cannibalizing the POS rental. And what we can assure to the investors, in order to avoid any kind of potential conflict, the economics of this business is going to be 100% in the hands of Cielo. And this will become clearer for the market as the pilot evolves, as the operation there evolves, right? So, more details will be provided as time goes by. But the idea is to have it developed. And answering your question about profitability. Yes, it is profitable but you have to bear in mind that this is for a specific segment. This is for a specific niche. And the idea is to benefit from the contribution coming from these marginal growth.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay, but Victor, is that more or less profitable than the traditional POS rental issuer to rent for the same type of client?

A - Victor Schabbel {BIO 17149929 <GO>}

Well, in general, if you look the all-in contribution, it's pretty much the same, right.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. Interesting. Thank you.

A - Eduardo Camposana Gouveia {BIO 16447861 <GO>}

Thank you, Spada.

Operator

The next question comes from Mario Pierry with Bank of America Merrill Lynch.

Q - Mario Pierry {BIO 1505554 <GO>}

Hi, everybody. Good morning. Let me ask you two questions as well. The first one, I would like to go back to the quick receivables product. I wanted to understand here, you said you introduced this at the beginning of this year. I wanted to understand if there was pressure. Are you seeing maybe there's a potential change in regulation and thus you should be offering this product? How many days our clients getting paid, and if this is a product now being offered to all clients or is it just a handful of clients, and how big do you expect this to get. I think you showed this quick receivables accounted for 0.7% of card transactions.

The second question has to do with the pressure in your revenue yield, revenue yield was down about 15% year-on-year. If you can just give us some color where these pressures are coming from, already mentioned some of these is clearly the rental business. But also if you could discuss trends that you're seeing for credits and debit MDRs especially as we're seeing a lot of new entrants in Brazil? Thank you.

A - Eduardo Camposana Gouveia {BIO 16447861 <GO>}

Thank you, Mario. We believe that (30:35) new products, again, it's easy to sell - it's simple to sell because we have a package that (30:47) the merchant and things are well the sales that we are doing and the receivables they have to - that is going their bank account in two days. Again, it's easy. It's profitable and we believe that the opportunity to improve our profitability here in the company. We are in the beginning we launched in the mid of the first semester and we are putting profits on thresholds. We had some penetration with this product. Again, it's for one specific part of our base pyramid.

Second question, small leasing (31:42) rental revenue of POS. The MDR continues to be very stable in the last four to five months, and the mix exchange from big accounts and small version, more an equation, more portion of big merchants and lower debt than threat. We believe that we are seeing (32:13) and the pricing installment, but this volume, the growth of debt continues to be very strong. The combination of this kind of mix of broad customer and decrease in the rental revenue is the decrease of (32:41). Again, we

are seeing decreasing in the speed of reduction of the huge revenue. This is a good sign for us compared with the last two or three quarters.

A - Clovis Poggetti Junior

Hi, Mario. I think also just a reminder here is that we saw credit, let's say, somehow improving in this quarter, okay, growing 6.3% compare to the 4.5% in the last quarter. Of course, with a varying environment, with a varying economy, we expect credit also going there, okay? Debit still going faster, but credit growing more compared to what we have seeing in the last couple of quarters. What I would like to call your attention is the fact that with regards to Cielo, given the full acquire in the multivan and these changes, don't forget that we will lose volumes regarding a brand that is mainly debit, but we will start chartering brands that are credit. And one mainly, let's say, presenting higher average ticket. Somehow, this is going to improve, let's say, the quality, if we may say so, of the yield, okay? Don't forget to take this into consideration.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. Let me go back and follow-up on the quick receivables then. Are all of your competitors also offering this type of products? I believe (34:43) have been offering it before. But if you can give us some color whether or not GetNet is also offering this? If you have any new news on potential changes in regulation, which would reduce the payment cycle in Brazil? And maybe the reason why you started to do this now?

A - Eduardo Camposana Gouveia {BIO 16447861 <GO>}

Mario, not yet. We are seeing opportunities headed - began before the Cielo and we are seeing that is the opportunity to address for some issues this kind of product - we have package of receivables. Then, it's a strong opportunity that we are trying to furiously get the Cielo portfolio.

Q - Mario Pierry {BIO 1505554 <GO>}

All right. Thank you.

A - Eduardo Camposana Gouveia {BIO 16447861 <GO>}

Thank you, Mario.

Operator

The next question comes from Craig Maurer with Autonomous Research.

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

Yeah. Hi. Thanks. Well, I hop on the call late. I was wondering if you could talk about whether or not the share shift that's happening between network brands in Brazil, specifically Visa seemingly losing share and Elo and MasterCard gaining share. Has that had any impact on your MDR or the economics of your business? Thanks.

A - Victor Schabbel {BIO 17149929 <GO>}

Hi, Craig. This is Victor. Thanks for your questions. No. Not really. It doesn't really changes the economics for us.

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

Okay. That was it. Everything else I had has been answered. Thank you.

A - Victor Schabbel {BIO 17149929 <GO>}

Thank you.

A - Eduardo Camposana Gouveia {BIO 16447861 <GO>}

Thank you so much.

Operator

The next question comes from Gerardus Vos with Barclays.

Q - Gerardus Vos {BIO 3301062 <GO>}

Hi. Thanks for taking my question. I have four if I may. First of four, would you be able to kind of quantify the kind of volume impact you expect in Q4, as the migration to full acquire model can complete? Then secondly in the last quarter you talked about selective price increases you are able to push-through. I was wondering if you were - have been successful in that, and roughly what has been the impact there on the yields? Then thirdly, just following up on the kind of yields, I missed that earlier answer on the kind of main impacts on the yield, and I calculated on the lining, it fell down 200 to 300 basis - sorry 2 basis points to 3 basis points sequentially. What would you expect there for Q4? And then finally a short one on the timing of the divestment of Merchant e-Solutions? Thank you.

A - Eduardo Camposana Gouveia {BIO 16447861 <GO>}

Thank you, Gerard. We began this process of fully acquiring in October. And we believe, by the end of this year, we would be - the process will be complete. And we will lose volumes because the participation of Elo in the total market is bigger than mix and (38:10). But in terms of (38:13), we believe that the impact will be neutral in the next quarter and the next year.

We believe that we will compensate the volume that we will lose mainly in debt because the euro is mainly in debt volume (38:34) that we will recover part of this volume less than the Elo (38:44) installment that you have put on business in a little bit more high when compared with the debt mix. Then we believe that in next year, the impact of acquiring will be (39:03) in terms of revenues. Okay?

Q - Gerardus Vos {BIO 3301062 <GO>}

Thank you.

Operator

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

A - Eduardo Camposana Gouveia {BIO 16447861 <GO>}

Once again, I would like to thank you for your participation on this conference call. We are confident that in improvement environment, Cielo will continue to be industry standout, delivering even more positive results over the coming quarters. Cielo wishes you happy holidays. Thank you very much.

Operator

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

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