Q1 2018 Earnings Call

Company Participants

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

Other Participants

- Alexandre Spada, Analyst
- Carlos G. Macedo, Analyst
- Carlos Gomez-Lopez, Analyst
- Domingos Falavina, Analyst
- Mario Pierry, Analyst
- Zane Keller, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, everyone, and thank you for waiting. Welcome to Cielo's First Quarter 2018 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 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 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'll turn the conference over to Mr. Eduardo Gouveia. Mr. Gouveia, you may begin your presentation.

Eduardo Campozana Gouveia {BIO 16447861 <GO>}

Good morning, everyone. Thank you all for joining us on this conference call to discuss our first quarter results. Today, I am here with me Clovis Poggett, our CFO; Victor Schabbel, our Head of IR; and Gabriel Mariotto, our Intelligence Officer.

I would like to begin this call by talking a little bit about the ongoing recover of our economy. After many quarters of soft economy performance, we are finally starting to see a gradual improvement of the scenario. We know that has come in a very broader way, but at least we are back to our growth path.

In order to give you more details about what has been going on in the retail space, I invite here Gabriel Mariotto, our Intelligence Officer, and responsible for Cielo Broad Retail Index, the ICVA, to join us to discuss a little bit in more detail the most recent trends posted by the industry. Gabriel, please feel free to talk about the latest data that you have.

Gabriel Mariotto

Thank you, Gouveia. I'm happy to be here this morning to share some of our thoughts about the most recent performance trends that we are seeing in the retail space. As you all probably know, we released the ICVA numbers for March back on April 17. They showed, as seen on slide 3, a strong acceleration both on nominal and real terms when compared to the figures seen in February even when adjusted for calendar effects.

As witnessed in 2017, the growth path that the industry seems to be back in has its own ups and downs. In May last year, for example, we had figures that were somewhat softer than people were expecting. Likewise, we had this year of February that brought to the scene a deceleration that wasn't supposed to come in a scenario of improving economic activity. This volatility between certain months is a result of the specific dynamics that we are seeing on a sector-by-sector and region-by-region basis.

Looking at the different factors, the ones exposed to non-durable goods have been doing better, with accelerating growth in the last three quarters. In this group, we have supermarkets, drug stores and gas stations, among others, that usually sell the so-called fast-moving consumer goods.

On the durable goods side, a segment that is usually seen as a reference for identifying the economic trends, we had less exciting figures. In the last quarters, sales growth has been there in both real and nominal terms. The pace however has been almost stable, differently from the acceleration seen in the non-durable segment. The different behaviors posted by the merchants exposed to the durable and non-durable segments might suggest that the long awaited economic recovery should be coming at a more gradual pace than potentially expected by the markets.

The good news is that the overall better environment is a reality in all regions of the country. While there's a clear stronger recovery in the South region, all regions have been showing signs of accelerating retail sales. Weren't (00:05:10) from our specific aspects affecting some of the states in Brazil like Rio de Janeiro and the Federal District, the performance would have been even better.

Generally speaking, the volatility between some months naturally raised concerns about the pace of the economic recovery. Looking closer at the sector and region trajectories, as I have just done, we can say that as of now, sales are improving and points to a path of gradual recovery.

Before handing back to Gouveia, I'd just like to remind 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.

Now after sharing our views on the most recent retail trends, I would like to thank you all for the time and hand back to Gouveia.

Eduardo Campozana Gouveia {BIO 16447861 <GO>}

Thank you, Gabriel. Now we'll move on the presentation to slide 4. I'm happy to share with you our new marketing campaign.

After some time away off the big media, we are back with our strong campaign, talking about our very successful Cielo Controle product. With over 150,000 clients, Cielo Controle targets the merchants that who want greater predictability. With a fixed monthly fee, based on the amount of sales that is expected to be generated, the client knows more properly how much he is going to spend with us and how much he will receive after each sales he makes. It's easy and simple. It is clearly a product for the bottom of our pyramid entry-level merchants that want simplicity and a good level of sets. (00:06:58)

The idea of pushing more strongly this product was to protect more properly the base of our pyramid, which is today more exposed to other alternatives than in the past. As we move more aggressively to segments that were not properly explored like micro merchants, it's important to have a broad and complete product portfolio for all the different needs that the merchants have.

In that sense, we will soon intensify our approach in this more merchant segment by being more aggressive in the sale of (00:07:34) device for those clients that who don't want to pay their rental and are not demanding a high-level of sets, (00:07:40) For those that still want a close relationship and sound of support we are working on other products that will target the entry-level merchant. All of this is being done together with our partnering banks as a way to assure Cielo's leading position in Brazil (00:08:00)

We are the leader in the market as a whole. We want however to be the strongest player with the best value proposition for our clients in all segments of our markets. This wasn't possible in the past when we were still dealing with the hold-out of our new IT platform. Now that we are moving forward, getting close to the end of the hold-out, products can be more easily developed and putting a production. That's the reason we were able to intensify the launching of products starting mid last year, and that's why we are going to bring great solutions to the market in the coming months.

Following our more aggressive strategy and more complete broad portfolio, we will have, from now on, a stronger and recurrent presence in the bigger media. This is key for us to being front of entry-level clients, who has proven to offer a great growth opportunity, not only for acquirers, but also for banks.

With all that said about our short- to medium-term strategy, I'm going to hand the presentation to Clovis who will talk about the numbers that we post during the quarter. Clovis, please go ahead.

Clovis Poggetti Junior

Thank you, Gouveia, and good morning, everyone.

On slide 5, I would like to start talking about our volume growth. As discussed in previous calls, with the migration from the Multivan model to the Full Acquiring one, Cielo was expected to benefit from a greater exposure to credit volumes, as we started to capture Hiper (00:09:42) and American Express brands that operate in the credit segment.

On the other hand, as our competitors initiated the process of capturing Elo, a brand that operates with both credit and debit but is primarily exposed to debit, we were expected to lose some share there in the EBIT transactions. This was exactly what happened in the fourth quarter and was once again seen in the first quarter of this year. Our debit volumes, excluding the agro products, decelerated, growing by 1.5% year-over-year compared to the 8.3% in the previous quarter.

On the credit side, however, we saw our volume growth accelerating reaching 10.1% year-over-year in this quarter compared to 9% in the previous one. Here, it's worth noting that we had both the impact of the migration from the Multivan to Full Acquiring model and also the overall improvement of the macro scenario. The better the economic situation, the more likely is the recovery in the credit to be seen.

While volumes are doing well with growth rates being sustained at good levels and credit outpacing debit, which is positive for our yields, as a negative note, we continue to have pressure on our POS base. Seasonality factors, coupled with a challenging competitive environment

[Technical difficulty] (00:11:18-00:20:38)

Operator

[Foreign Language] (00:20:38-00:20:44) Mr. Clovis, you may proceed, please.

Clovis Poggetti Junior

Okay. Thank you. And really apologies for this, guys. I will restart from slide 5, okay?

So I would like to start talking about our volume growth. As discussed in previous calls, with the migration from the Multivan model to the Full Acquiring one, Cielo was expected to benefit from a greater exposure to credit volumes as we started to Hiper (00:21:10) and American Express, brands that operate in the credit segment.

On the other hand, as our competitors initiated the process of capturing Elo, a brand that operates with both credit and debit but it's primarily exposed to debit, we were expected to lose some share there in the debit transactions. This was exactly what happened in the fourth quarter and was once again seen in the first quarter of this year. Our debit volumes, excluding the Agro product decelerated, growing by 1.5% year-over-year compared to 8.3% in the previous quarter.

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While volumes are doing well with growth rates being sustained at good levels and credit outpacing debit, which is positive for our yields. As a negative note, we continue to have pressure on our POS base. Seasonality factors, coupled with a challenging competitive environment mainly on the bottom of our pyramid and in mid-sized merchants, led us to post another drop in the number of our POS terminals. It is important, however, to call attention to a few important aspects behind this contraction.

The ramp-up of our value-added LIO terminal continues and is helping the mix to improve further. This has been pushing up the penetration of wireless terminals, reducing the pressure on the rental revenues. Moreover, although the pace of contraction is similar to the one seen in the previous quarter, the revenue trend that we are now posting is more benign, benefiting from better price dynamics and increasing value generation on a client-per-client basis. This doesn't mean that we are happy with the numbers that we are showing.

On the opposite, I'm just highlighting here some of the positive factors that are arising from the efforts that we have put in place in order to have our POS base back to the growth path. There is more to be done and we are confident that it is a matter of time for the company start presenting better figures.

On the next slide, we can see in more detail that more positive factors that I have just mentioned. On the chart on the left, we can see that our revenue yield declined by 11 basis points on a year-over-year basis.

In the annual comparison, the main driver behind the yield compression was the rental revenue that declined in the period, mostly due to the compression of our POS base at the same time that the volumes kept expanding. Because of declining numerator, the rental revenue; and growing denominator, the volume, we had a 8-basis-point negative contribution to our yield coming only from the rental business.

Following the rental, we had the mix still playing against us. While we already had the credit outpacing debit in both first quarter 2018 and fourth quarter last year, the carryover is still negative given the strong growth posted in debit during the period. More important, however, continues to be the contribution coming from the big account segment.

Volumes coming from big merchants kept outpacing the ones from small and mid-sized clients. This is now the main negative mix factor playing against our yield. As a positive highlight, we have prices contributing to only 3 basis points of the contraction seen in the period in our Receba Rápido product, adding 8 basis points in the first quarter of 2018 compared to the same quarter of the previous year. More important for us, however, is the evolution of our yield on a sequential basis.

On a quarter-over-quarter analysis, as shown on the chart on the right side, the rental business contributed positively to 4 basis points. This was a result of more stable rental revenues at the same time that volumes naturally decelerate from a quarter to another, in this case, due to seasonality.

Mix during the quarter had no contribution to the yield as a factor growth in credit versus debit was offset by a stronger performance of the big account segments compare to the retail one. Following what we saw in the annual comparison, our Receba Rápido product continues to boost our yield, adding 3 basis points to the overall number. As an important negative in the quarter, which offset partially the more positive trends, including the ones related to price, we had a higher ISS tax deb. In light of the new regulatory framework (00:26:51) for collecting services tax in Brazil, the company decided to provision conservatively at the highest level possible. The service tax will be paid.

While the matter is still being discussed by authorities with the new way to collect the service tax being questioned in core (00:27:10), the company continues to conservatively provision it. This unfortunately took approximately 2 basis points out of our yield in the quarter. Weren't for a greater service tax, our revenue yield would have been even higher on a quarter-over-quarter basis.

Now moving on to slide 7, we have the figures for our costs and operating expenses, which were once again kept under control. Together, cost and expenses grew by 1.9% compared to the numbers seen one year ago. This continues to be a consequence of the company's efforts to arrive at the most efficient corporate structure possible even in a more challenging competitive environment.

Our EBITDA, however, dropped by 9.8% year-over-year. Despite having our revenues coming down at a slower pace compared to the previous quarters, they were still the main factor behind the decline of our EBITDA. As a result, we had our margins coming down by 2.6 percentage points on a year-over-year basis. Our reported net profit, on the other hand, stood at BRL 1 billion, practically flat compared to the first quarter 2017. This was mostly driven by the ongoing financial deleveraging, which helped support our bottom line.

During the quarter, it's worth noting that we had a non-recurring item totaling BRL 75 million that positively impacted our bottom line. Due to the lower tax rates in the U.S., our deferred tax liabilities in Merchant e-Solutions' balance sheet were updated, generating a onetime gain. Weren't for this, our net profit would have amounted for BRL 932 million, a 7% year-over-year decline.

On the next slide number 8, we briefly talk about the positive contribution coming from Cateno. Following the trends seen in previous quarters, volume growth continued to come at a good level, expanding 7.1% year-over-year. This translated into a healthy gross revenue growth, which was partially offset by a higher service tax due to the new regulatory framework. The cost control initiatives that have been in place for a while now continue to help boost the operating performance, driving earnings to expand by 14% year-over-year. As a result, Cateno's cash and earnings accounted for 11.8% of the Cielo's consolidated fees.

And then, let's move to slide number 9, where we present our guidance. Adjusted for the volumes captured under the Multivan model, Cielo posted a 8.2% year-over-year growth, slightly above the high end of our 5% to 7% guidance for the year. This was primarily a result of the faster credit growth seen in the quarter, which was only partially offset by the slowdown in debt. If a sound pace like this to sustained in the coming quarters, we would be naturally considering a visit our volume growth guidance for the year.

On the cost and expense side, we posted a 4.1% year-over-year decline when adjusted for higher brand fees in place since the beginning of the third quarter 2017. While this is a result of our ongoing effort and commitment to greater efficiency, we note that upcoming figures should be less favorable given the low base that we are now starting from and the expected increase to be seen in some expenses going forward, mainly marketing. Accordingly, we stick to our 2% to 4% growth in our adjusted cost and expenses for the year.

In terms of CapEx, we are still way short to our target range from BRL 300 million to BRL 400 million as most of the investments are expected to come in the upcoming quarters, mainly during the second half of this year.

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

Q&A

Operator

Ladies and gentlemen, we'll now begin the question-and-answer session. Our first question comes from Domingos Falavina, JPMorgan.

Q - Domingos Falavina {BIO 16313407 <GO>}

Thank you everyone for the opportunity. My first question – it's actually two questions. First one's a short one. You used to disclose some data about your overall terminal contraction year-on-year. How much was driven by macro factors and how much by competition? I remember reading back into the crisis (00:32:15), it was like 70% macro, 30% competition. You switched to 50-50. So I would like to get an update on that ratio and then I have a second question.

A - Clovis Poggetti Junior

Thank you, Domingos. About the compress of our terminal basis, we saw that we had less – pressure of macro is about 30% to 40% now in the first quarter compared with the past. And the other one is the results about the Full Acquiring process that was put in place since October last year and the competition. Then, we decided to go ahead and prepare a lot of actions to support the – our strategy, meaning to put a strong market campaign, strong relationship with banks, improving the engagement of the banks in the acquiring process, then new customer. Then, we believe that we are pushing this line, too, in the medium term to have a recover in this number of POS.

Q - Domingos Falavina {BIO 16313407 <GO>}

Got you. Thank you. Second question, it's actually a bit more structural and strategic question. It seems to us that like at least reading some of the complaints of small machine associations and some of their asks (00:33:50) that fixed cost is really what sort of drives most of their asks (00:33:56). And it becomes even more clear when we look at the success of some players that are selling terminals (00:34:02) obviously, but I guess it would have been the just more obvious one.

And when we look at the marketing campaigns you guys launched, it seems to be focused on cellphones (00:34:10), which at least to us here in practice seems like you only have rental fees in the terminal rather than have yours (00:34:17) to the extent that it's a flat scene (00:34:19) no matter how much you sell instead of the offers, which seems to be sort of the ask (00:34:26).

So my question here is, how was the project around Cielo Controle? How many surveys did you conduct and why are you basically incentivizing that on marketing and not Cielo for the sale of the terminal? I'm just getting a conflict of like what we perceived to see the demand on the low end and what you guys are trying to offer. It just – we can't reconcile that.

A - Victor Schabbel {BIO 17149929 <GO>}

Hi, Domingos, Victor here. Before Gouveia can add to your question about the strategy and the products that we are launching, I would first talk a little bit about the speech that some on the Street might have about having a leaner structure. So fixed cost is really what matters and having a more efficient platform is easier for them to reach certain clients and et cetera.

The fact is that Cielo, as everyone know, is the largest player in the industry with over 50% market share. We are working to serve the best way possible all the type of merchants, so with very different demands. So, for this to happen, we have to - to have a big infrastructure, right. So logistics, client support for - that is very important for the big clients and also important for the mid-sized ones.

While when you work with micro merchants, individuals, obviously that you rely less on the level of service and much more on marketing and just distributing the devices that you sell, right? So the fixed cost is by nature smaller in this segment, right?

So, obviously, the barriers for you to entry that segment is also smaller, right, so it's easier. It's about investing in marketing and selling devices, right? So it's not really a big deal there.

So, in that sense, Cielo wants to work with everyone, doing the best we can to offer the best solutions. So it's part of this strategy to have these somewhat big fixed costs that we have. That's why it's so important for us to dilute it with volumes coming from the very different segments, for example, the big account segment. But it's part of the market positioning that Cielo has, right?

So, for those that say that they are more efficient, I would say that this could be seen as somewhat misleading because when you work only with - for certain niche, obviously, that you can adopt your strategy and your structure for serving just that niche. But we have to be careful. Depending on the niche, you might have fewer fixed costs, but the barriers for new entrants to come are very small, right? So that's what I would like to add.

And now, I hand to Gouveia.

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

Adding about the products portfolio, Domingos, so we decided to give the first movement is to sell through campaign and through our distributors the Cielo Controle. We try to simply - it's a very simplistic and easy to understand the results about the product for the customers. It's a fixed monthly base value and we include all the machine MDR and the prepayment in a monthly base value fixed. And we believe to show this product to the - our member base billing for the bottom of pyramid.

With the first movement using these products, rental terminal and we use the Stelo, the brand Stelo to sell the machine. We began two months ago with a movement and we are seeing good results in these two months that we began to sell Stelo for the micro business in our portfolio. Then this is the beginning of this quarter to sell more products, to sell more solutions for the - as Victor mentioned before, we have today products for whole kind of customer in our total member base.

Q - Domingos Falavina {BIO 16313407 <GO>}

So it's just the first strategy to go with Controle. The second one later will be basically then to go with Stelo.

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

We believe that is the first movement that we did. We decided to go a little bit more strong to show the Cielo brand and the Cielo portfolio, and we began with Controle, we will see LIO, we will see Stelo, we will see some flags (00:39:43) of position in the market with another products.

Q - Domingos Falavina {BIO 16313407 <GO>}

Okay. (00:39:49) Thank you.

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

Thank you so much, Domingos.

Operator

The next question comes from Carlos Macedo, Goldman Sachs.

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

Hi. Good morning, gentlemen. Thanks – or good afternoon already. Thanks for taking questions. I got two.

One is just going back to the Controle product. I mean, if you compare it to everybody else, it really is less expensive if the merchant does less (00:40:14) and the maximum first amount of transaction that you say for the 3G machines, say, BRL 500. But as soon as you go above that level, it becomes a lot more expensive than all your peers. Just trying to get an understanding, how big is that market of potential clients that make less than BRL 500 (00:40:38) that target that market? The average merchant there sells around BRL 1,500 a month last year, probably more now at the end of the year. How big would that market be? And what do you think you can gain and how much do you think this can add to your transaction value?

Second, a question on Cateno. Strong numbers, good momentum. Obviously, we have, as of October 1, the reduction on the debt interchange. Do you think that the growth can partially offset that or will you still have a fairly decent negative impact on revenues if that comes in? Thank you.

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

Thank you, Carlos. About the Cielo Controle, we saw a strong adoption of the small merchant. As you know, we have today something about 200,000 small merchant that is in our base now in Cielo. Then, we believe that the pillars about the simplicity, easy to have the conciliation and it's a little bit easy to understand and to contract this product in our market. The number of potential merchant depends on the market. We believe that to have a strong potential to implement new merchants (00:42:13) to sell for new merchants in the base of permit.

A - Clovis Poggetti Junior

And hi, Carlos. It's Clovis. We think at Cateno, we hold the growth in terms of volumes can, let's say, offset the impact, okay. But being conservative, let's say, we are going to be impacted negatively in the first moment. That's – we expect the negative impact in Cateno depending on, let's say, the market – how market behaves in terms of Cielo and the impacts here. It can be positive in the first moment. And then the consolidated figures, I would consider something neutral to slightly positive.

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

Okay. Thanks, Clovis. Just going back to the first question, do you think it's a risk – I mean after the first three months when we had the promotional price, the take rate for the Controle product, at least cheap the one, if you get an average merchant that does say BRL 1,500 a month, it's 12% compared to something like 6% for (00:43:32), 8% for (00:43:33), 4.5% for Product Siguro (00:43:36). Is it a risk that you might get some backlash from these merchants that when they realize that the price went up as much as it did and then you start having some (00:43:46), say, towards the middle to the end of this year?

A - Operator

Hi. It's (00:43:52) here. I mean, we've been already selling this plan, the Cielo Controle, for more than a year now and have more than 200,000 clients on this plan. So the way – what we're selling (00:44:10) position as what Gouveia I mentioned is the simplicity and the control. They know what they're going to save at the end of the month.

And I don't know if we can do this – the compressional (00:44:21) as you we were doing. Of course, when we take Product Siguro (00:44:25), for instance, they have to buy the terminals. So at least for the first year, they have to accommodate the monthly payments on the terminals as well. That doesn't happen on Cielo Controle. And all the competitors – actually (00:44:41), they have a first year 50% discount, and we have three months and our three months is more aggressive than their – on the first year.

So it's a different marketing strategy. How do you acquire the clients? But for us, we've been seeing like a good profitability and good attrition rate on our current clients. So, we're not very concerned about that right now.

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

Okay. Thank you so much.

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

Thank you, Carlos.

Operator

The next question comes from Greg Mirror, Mutuals Research (00:45:20).

Yes. Hi. Thanks. Two questions. On the prepayment business, it was mentioned in the text last night that pressure could come on the yield in that business to seal the (00:45:40) great changes and other things. But could you maybe segment whether you're talking about pressure across the board or just pressure in the mid to large merchant base where you're going to be negotiating, but I don't think the smaller merchants in your base have the power to negotiate those rates?

And secondly, in terms of the yield, I'm just curious how you view the yield going forward. If you're increasing customization, increasing marketing, all these things seem counterintuitive to a rising revenue yield. Thanks.

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

Thank you, Greg (00:46:26). About prepayment, we are seeing a pressure in price in the top of pyramid, in the big accounts that is paying attention about the cost of money, the SELIC. And when we see the SELIC, the decline in the - we see high pressure in the big accounts.

In the bottom of pyramid, in the small merchants, we see not pressure in price but we saw some competition in prepayment business. Then, the volume is the big challenge in the bottom of pyramid and price in the top of pyramid.

The second question - could you repeat the second question, please?

Q - Operator

Yeah. I just was curious about how you view the revenue yield over the course of the next, call it, year or two. It doesn't - it's counterintuitive to think the revenue yield might stabilize if you're driving toward increased customization across your merchant group plus you're also talking about significant increases in marketing and promotional spend.

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

In the short term, Greg (00:47:51), we are seeing a stabilization in the - we're working hard to recover part of the rental revenue. We are pushing - the banks are pushing our sales team while pushing our marketing campaign to try to recover part of the huge (00:48:16) coming from the rental fee.

It depends on the mix of products, credit and debit. We are seeing the credit volume is a little bit more health compared with debit. Remember that we are losing part of Elo (00:48:35) sales because (00:48:37). That was implemented in last October, and the mix of big account and the small merchants. This is the - we believe that you have stabilization this year in short term and a gradual increase in the long term.

Q - Operator

Okay. Thank you.

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

Thanks so much, Greg (00:49:07).

Operator

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

Q - Mario Pierry {BIO 1505554 <GO>}

Good morning, everybody. Let me ask two questions as well. The first question is looking your EBITDA margin. You used to be a 65% EBITDA margin company roughly 10 years ago and your margin has been coming under pressure pretty much on a consistent basis. You're now at 44%. I wanted to try to get an idea of where do you think your margins will eventually stabilize?

The second question is related to the recent implementation of caps on interchange fees on debit card transactions. I know that becomes effective later this year. I was wondering, how do you think that the banks are going to react to this loss of revenues and how are you planning on – or if you're planning on passing on the benefits that you have to your costs to merchants or what is the strategy that Cielo is going to take? Thank you.

A - Clovis Poggetti Junior

Hi, Mario. It's Clovis. Regarding the EBITDA margin, I think it's worth mentioning here the point that taking such a long-term analysis, we should take into consideration the fact that we have been, in addition to let's say this more competitive environment that we are living since a couple of years ago, but we also have been consolidating new companies with lower EBITDA margins.

So, for example, we had in 2012 the acquisition of Merchant e-Solutions that has a different accounting system and we discussed this in previous meetings and calls, okay? We had later, for example, the joint venture with Banco do Brasil in the creation of Cateno, a beautiful business, but it had in the first year a lower margin compared to Cielo. Now, we see given all the efforts in terms of making it more efficient, greater and beautiful margins as well. So this consolidation, let's say, should not be kept apart in the analysis.

Going forward, of course, we are in a scale-based business, okay? And then, it also depends on, let's say, how the whole market is going to behave in terms of aggressiveness. We are seeing as already, let's say, mentioned by Gouveia in the mid-sized to the bottom of the pyramid a more active scenario. Okay? We had also our considerations in terms of the receivables business, let's say, facing let's say a tough scenario because of the SELIC rate.

But what hits us, let's say, hits everybody. And we expect – it's too early to say – that this can bring certain level of rationality because it's our understand that some of our competitors were being very aggressive in MDRs and rental, and funding such aggressiveness through the receivables – being the receivables under pressure, that's our belief. In certain moment, we should see more rationality in terms of MDRs.

And what is, let's say, easier to say is whatever depends on costs and expenses being more efficient to sustain – help to sustain the levels, the company, we're continuing to do. But I cannot, let's say, give you a full answer given the lack of visibility how the market is going to behave in terms of the top line. And also, let's not forget one last comment that Brazil is still very low penetrated, so several actions are being taken in order to help faster the increase in penetration, more volumes, also better results for us.

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

Mario, about capping in debt, we – it depends on the speed of changing the market that we will adopt. For big accounts, we believe that you have more speed for small merchants. We believe that you have not so intense speed to change price (00:54:21). Then we believe that in short term, we have (00:54:25) to impact.

We will not see any movement with banks. We didn't discuss any point about the – any reaction about banks, about the – we believe that the banks will solve this problem internally.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. Now, that's clear. So just to go back then on the banks, because this is a loss of revenues for them, right, and there're many ways that they can compensate for this. They can increase annuities on cards and things like that, and they can also increase rebates charge from Cielo. So there has been no discussion about changing rebates or anything like that.

A - Victor Schabbel {BIO 17149929 <GO>}

Mario, Victor here. Well, that's a good and important point. You are right. This could have been a way to think about addressing these smaller revenues that they are going to get with the interchange in debit transactions. But once we, as an acquirer, we start paying more rebates, for example, we lose competitiveness compared to other acquirers that don't pay these rebates, right? So – and the banks are obviously aware of that.

So at least at this point, we don't see these as a way to address these kind of smaller revenues that they should be making from October 1 onwards, right, in debit. So I don't think they should be moving the direction. At least, this is something that was not put into discussion at any given point in time, right? So we are not discussing these.

And as Gouveia said, they might find a way to mitigate these smaller revenues elsewhere, not through the relationship they have with us. Because, as you all know, we are in a much more competitive environment than in the past and we require everything that we can have in terms of competitiveness to get back to the track that we have on suite.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. Thank you.

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

Thank you, Mario.

Operator

Our next question comes from Mohammed Ihmad, SGP (00:56:58).

Hi. Thank you guys for taking the question from me. One quick question on terminals. I know that you broke it down by 70% competitive, 30% macro, but could you give us a sense of the 5% quarter-over-quarter decline? What percentage it would have been to merchants switching to purchase terminals versus rented terminals? Just trying to get a sense of how much of it is from a model change of competitors versus simple competitive losses to people with same model as you. And then I have a follow-up.

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

Thank you, Mohammed (00:57:42). The first quarter of this year and the first quarter of each year is impacted by the seasonality. We saw that by Christmas and Black Friday. A lot of merchants asking for acquiring company (00:58:03). Second terminal is not a terminal to support the demand-supported seasonality and it's very common. In the beginning of the year, we have the return of this second terminal to support the seasonality of the end of each year.

Q - Operator

No, I understand that because, I mean, even last year in Q1, you had 5% quarter-over-quarter decline. So, from that perspective, I understand there's a degree of seasonality, but I would have expected compared to Q1 last year where you had just started consolidating off the installed base of terminals post the opening of the remaining parts of the market.

This quarter would have been a bit better than that, our Q1 2017, on a quarter-over-quarter basis. And given that it wasn't, I'm just assuming if there's an added factor that they have to improve on that end, but then added competition coming from the selling of terminals. And if you could give us a sense of like was it like responsible for like on a sequential basis, a percentage decline in install base or 2% decline in install base, just from your customer switching to a purchase terminal?

A - Clovis Poggetti Junior

Remember that we had last year compared to this year put in place the Full Acquiring model that is the second terminal, it depends on the preferential acquiring company we had told in the second quarter. We had more competition and we continue to have in Brazil. Mostly, the macro scenario is not recovered as we expected.

Q - Operator

Okay. Just in addition to that, would you guys sort of break down how big or how material is bottom of your pyramid in terms of your terminal rental base or revenue base? Like, Americas is the bottom of the pyramid?

A - Victor Schabbel {BIO 17149929 <GO>}

Yeah. Hi, Mohammed, Victor here again. While we don't disclose this information, but in order to try to help you out understand the contraction of the POS based on a sequential basis, we have, as Gouveia said, the seasonality playing against us. The macro recovery at the beginning of this year wasn't as strong as most people expected, including us. So I think these also weighed a little bit and contributed to the seasonality to be also worse.

The migration to the Full Acquiring model also played - continues to play against the POS base. And on top of it, as you mentioned and as you asked how much of the decline is related to clients migrating, for example, to the sale of device type of approach, here the thing that we have been reiterating is that although we have some migration clients that call us and ask to leave Cielo because they basically bought a device elsewhere, although we have that, this is not the most significant part of the churn that we have. What happens is that we are not absorbing the marginal growth, at least not yet or not in the 1Q, that we could have been absorbing that would offset the churn in our more conventional business, which is the rental in the midsized merchants. This is what is happening.

So it's not a matter of losing the merchants through the sale of devices in a meaningful way, but not gaining the ground in this segment, in this market that could help - have been helping us offset the decline in our more conventional business, okay?

Q - Operator

Yeah. No, that's great. That's very clear. Thank you, Victor. Just a question on take rate side, then. Could you give me a sense of, from a merchant pricing perspective, I know you have the higher brand fees which you carve out, but the revenue impact is different than the expense impact. I think it's BRL 72.3 million versus BRL 60.6 million. So can you give me a sense from a merchant perspective, do they see the difference in the pricing or is it that you're just carving it out for our benefit and from market perspective, it's all part of one pricing, therefore, really going forward, we should be looking at overall pricing and not carving out the brand fees?

A - Victor Schabbel {BIO 17149929 <GO>}

Yeah. Sure. When we talk about the extra revenues that we are making with the new remuneration structure of this local brand, this is a revenue that we make with them and not that we charge from the merchants, right? So from the merchants, you have the rental, you have the MDR, you have Cielo Controle, which is a package with a flat fee. These are the revenue refers exclusively to the processing of the brand and it's not charged from the merchant.

Q - Operator

Okay. And what about the BRL 72.3 million in expense, how does that flow then? It's also related with brand?

A - Victor Schabbel {BIO 17149929 <GO>}

This is the brand fee that is charged from the acquirers. So, all the acquirers capturing this brand also pay this brand fee, obviously depending on the volume that they capture. Since they are smaller than us, they should be paying less in terms of this brand fee. So, it should be smaller than the BRL 70 million that we posted. But for example, in an extreme situation that will never happen, but if we were not to capture this brand any more, this expense would be zero, right? While on the revenue side, we would still be capturing some revenues because we do the processing, right? So, we do the processing for them even when the transaction is captured by other acquirers, right? Was it clear?

Operator

Our next question comes from Carlos Gomez, HSBC.

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

Hi. Good morning. Two questions. The first one is if you can refer to competitive pressure on the MDR and then both on the credit and the debit side and if anything has changed significantly there in the last few quarters and you can define that in terms of basis points?

The second refers to Argentina. We know that there is their sales process going on, you had referred to in the past. We would like to know if – and obviously you are going to look at that, if that is something that you think you would on your own or with somebody if you going were to approach it, and if Argentina is a market where you might think of (01:05:05) Thank you.

A - Clovis Poggetti Junior

Thank you, Carlos. We are seeing the MDR level is – the behavior of MDR is stable. When we see there our bridge about here do we see that in the mall, the high impact is not price. When you compare the competition landscape, we are in the high competition landscape now compared with the last year, then we are seeing the pricing in MDR is quite adapting in a stable way.

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

Okay. So to understand correctly, the debt competition expresses itself in other ways but not necessarily in the pricing of the MDR?

A - Clovis Poggetti Junior

Not yet we have, but the most important part of the – our huge compression comes from the handle fee.

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

Okay.

A - Clovis Poggetti Junior

Thank you, Carlos.

A - Victor Schabbel {BIO 17149929 <GO>}

On your question, Carlos, sorry, about the potential transaction in Argentina where we have a potential acquire there selling its operation or the bank's basically selling their operation there, we usually say that we look at all the opportunities that we have on the market. We are always evaluating whether it makes sense or not, and this applies to any kind of transaction that might be going around here in our market than elsewhere. So Cielo is as a big player in that industry. We are always paying attention to the opportunities. And this also applies in this specific case that you mentioned.

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

That is fine. But if you could, again, because we understood that you will look at it, but again if it is perhaps too large for you to go alone or would you think of linking up with somebody? And second, is it a market where you do might think about entering even if there is – if you don't buy anything?

A - Clovis Poggetti Junior

The evaluation that we are doing, Carlos, is to go alone, but it's possible to build a group of companies to invest there. Today, we are not seeing to go with another player to see and to evaluate the opportunity in Argentina.

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

That's very clear. Thank you very much.

A - Clovis Poggetti Junior

Thank you, Carlos.

Operator

The next question comes from Alexandre Spada, Itaú BBA.

Q - Alexandre Spada {BIO 16687974 <GO>}

Hi, gentlemen. Thanks for taking my question. I have one question on the LIO terminals. The number of terminals has been growing by approximately 4,000 per month, which translates to about 200 new terminals per business day. At first sight, that number seems to be low for a company with the capillarity that Cielo has. That said, does the company consider this level satisfactory? Is this within the plan that has been established for this initiative? Or if you expect an acceleration, what could be the drivers behind this acceleration? Thank you.

A - Gabriel Mariotto

Alexandre, Gabriel here. So , first of all, I mean, in the past three months, we'll be introducing more the next generation of the new terminals. And of course, we have been having some substitution of the old one, the first version. So, when you think in consideration only the difference between the base, so there's some exchange on the old version for the new versions on those numbers as well. And I have to take it into account that we still didn't make any kind of strong marketing effort to promote remotely. So we are only selling that on our channels and as the clients get interested. So, on the website, on our internal sales force, but we, of course, we plan to be a little bit more aggressive on that in the next couple of months, I would say.

Q - Alexandre Spada {BIO 16687974 <GO>}

So, that means you do expect an acceleration in the expansion rate?

A - Gabriel Mariotto

Yeah. I mean, the number that was being excluded right now is expected for 100,000 terminals by the end of the year. That number couldn't be disclosed. (01:10:12)

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay, okay. Okay. Thank you very much.

A - Clovis Poggetti Junior

Thank you, Spada.

Operator

Our next question comes from Zane Keller, Barrow, Hanley.

Q - Zane Keller {BIO 19325579 <GO>}

Hi. Thank you for your time. I have two sets of questions. The first is around the point of sale terminals. You simply said in your press release that you expect the terminals to grow either in the second quarter or third quarter of this year. Can you give us some color on why you're so confident you think that will happen after the very substantial churn we saw in the first quarter?

And second question related to that is, previously, you had said that you expect POS terminals to bottom out between 1.4 million to 1.5 million terminals. Do you have any updated expectations around that figure?

A - Victor Schabbel {BIO 17149929 <GO>}

Hi, Zane, Victor here. So we are, as you know, working hard on many fronts, right? We are trying to control the best way we can the churn, right, in order to reduce it. I think this is one of the sides where we have a long way ahead of us for many improvements. And on top of it, on the affiliation side, we also can do better and push harder. And this is exactly what we are doing now with more marketing campaigns, a closer relationship with partnering banks, so we can boost affiliation, control more properly the churn. So we can once again post increasing numbers of POS terminals, right?

So this is a goal that we have internally to once again post growth in a market that has a lot of potential. So we have to change this trend, this negative one that we have been witnessing in the last quarters. So we do want to capitalize or to take advantage of the marketing campaigns that we are doing, so we can have more likely a much better second half in that sense, right? So if these figures don't really improve in the very, very short term, second Q for example, we are working to have it coming in the second half with better numbers as we push our sales efforts upwards, marketing, et cetera. So we can again benefit from the growth in the market and also economic recovery that we are going through, right? So this I would say about the recovery of the number of POS terminals.

And you mentioned – sorry, the second question or the follow-up that you did, could you repeat it, please?

Q - Zane Keller {BIO 19325579 <GO>}

Yeah, sure. So I think previously, there had been this guidance out there that the company expected the number of terminals to bottom out at approximately 1.4 million to 1.5 million terminals. Is that still the expectation or are you revising that potentially higher?

A - Victor Schabbel {BIO 17149929 <GO>}

Yeah. We currently have almost 1.6 million, right, terminals out there. There has been some pressure, as you saw over the last quarters. So we do believe that we are close to the bottom, right? So we do believe that we are likely going to change the trend, so we can resume growing again at some point anytime soon, right?

In the next quarters, you guys are also going to see the number of terminals that we are selling as well, right, so not only terminals that we are selling at this point through Cielo, but the active clients that we have there as well. So altogether, obviously, we are going to keep showing separately. But altogether, the numbers should show you all that we are in a much better trend hopefully in the next quarters. Again, if not in the second Q, probably in the second half, we are going to post better trends. We are working very hard to have that happen.

A - Clovis Poggetti Junior

This is my point and we are working hard to improve the banks to involve our sales team to put a strong campaign, a marketing campaign in the TV, in the Web. We believe that the whole way that we are putting pressure to recover the trend of the terminal base.

Q - Zane Keller {BIO 19325579 <GO>}

Okay. Great. And just one more sort of question around the fact of the prepayment business. How quickly do you expect spreads to compress and what is the worst-case scenario for spreads?

A - Victor Schabbel {BIO 17149929 <GO>}

If I may here on the spread side. In the past, we were used to see the prepayment rates that we charge close to 2 times the SELIC. In our previous call in Portuguese, there was a question basically in that sense, if the rates would converge likely to the historical levels. And the answer was probably no. Today, we have the rates close to 3.5 times the SELIC.

So, converging to 2 times is not the most likely scenario, mainly because of the change in the mix of clients that we have been having over the last five years in this product, right? So, we have been increasing our exposure to these smaller merchants also as a way to improve the returns and also increase the value generation here at the company. Because as you know, it's a very cash-intensive business, so the returns, depending on the use, are not exactly that great, although they contribute a lot to the earnings.

So, with that in mind, we have been working harder to increase the exposure to the mid and small-sized merchants now with this more competitive environment. Since we have been seeing some of the acquirers lowering quite a lot the MVR, offering very attractive POS rental offers, so they can make money only through the prepayment, this has been a strategy adopted by some of our competitors. We do want to bring some rationality there, also lowering the rates going forward to be more competitive in that product as well.

So, as a result, the use should or the rates in the prepayment products should come down, but probably not through the 2 times the SELIC as in the past. So, maybe something between 2 times and 3 times, so maybe 2.5 times should be the point of convergence at some point in the medium term, probably not as fast as the year, but maybe in the next few years, something like that. So, this I think is the best answer for your question.

Q - Zane Keller {BIO 19325579 <GO>}

Okay. Thank you.

A - Victor Schabbel {BIO 17149929 <GO>}

You're welcome.

Operator

The next question comes from (01:18:13)

Hi, everybody. Thank you for taking my question. I just wanted to know more about the CVA, the (01:18:22) for the retail segment. In March, it has reached one of the most improved numbers, almost 5% in nominal terms, so what are the company's expectations for the following quarters? Thank you.

A - Clovis Poggetti Junior

I will pass to Gabriel Mariotto, that is our guy that - intelligence guy here in Cielo, but it's important to see the seasonality of the CVA. Please, Gabriel.

A - Gabriel Mariotto

Okay. So, hello, (01:18:58) What we can say is, as I mentioned earlier, if you take last year for example, we saw let's say May, we have – May or March, sorry, just take the number here once back, but it's March. Yeah, we had a month that we expected a very high growth rate. So, if you asked this question last February, we would tend to say that it was a pace of recovery, stronger pace of recovery, but then we were surprised. So, that is why we usually focus on what really happened because we have the data here and it's difficult to make prognostics. But what we see is that the trajectory is very consistent. If you take the series of ICVA growth rates, you can say that it is the clear trajectory going upwards. It's very difficult to make any forecasts.

Q - Operator

Okay. Okay. Thank you, Gabriel.

The next question comes from Tiago Dias, (01:20:25) Goldman Sachs.

Hi, gentlemen. Thank you very much for the opportunity. On Stelo, I think it would be quite relevant if you could provide us with any quantitative guidance on how do you expect to be – the ramp-up in terms of number of clients, NPV (01:20:42) growth going forward? And with that, how long do you think it should take for Stelo to catch up in size with its main competitors? Thank you.

A - Gabriel Mariotto

Tiago, thanks for the question. We began, in fact, two months ago with the Stelo the distribution of using the site and the Web and the banks, the branch. Then, we are in the beginning of the process. The results of the two months encourage us. We see a strong path to Stelo and we put a lot of pressure to go in a little bit more forward and with a more speed to see the real results of Stelo. We are very happy with the beginning of this process and we believe that to have some good sounds about the results of the new merchants. As Victor (01:21:57) mentioned before, probably in the next quarter, we will deliver the figures and the number of Stelo to show you that the strategy for the bottom pyramid is doing well, selling terminal for. We believe that we'll be a relevant player in this segment.

Q - Operator

Great. Thank you very much.

A - Gabriel Mariotto

Thank you, Tiago.

Operator

Our next question comes from Domingos Falavina, JPMorgan.

Q - Domingos Falavina {BIO 16313407 <GO>}

Thank you for taking a follow-up question. Just on the marketing, I think was a bit more explored in the Portuguese call. It's clear that you intend on raising some of your marketing expenses. My question is just what kind of metric are you looking at? Specifically, like we were comparing some of the Google trends in terms of search or keywords of like some of your competitors than you, and it was bit striking to us that despite being by far the largest player in terms of market share that the brand awareness of Cielo today, at least using that metric, is not as high as some of your significant smaller players. So as you boost up your marketing campaigns, what kind of metric are you looking at? Like, is there something we can also check there will be the metric you are looking to see if you are going to continue to invest more or less to reach your goal in terms of brand awareness?

A - Victor Schabbel {BIO 17149929 <GO>}

Thanks, Domingos. Well, we carry out many type of different surveys frequently here internally with the support of consulting firms that are specialized in marketing and brand awareness. So you mentioned one type of, let's say, tool that we have to say is not exactly the one that we rely exactly on, right? It has its limitations. So we do have internal ones that in our view are more accurate and shows Cielo's positioning depending on the different type of clients, different niches, different type of size of clients. So we do carry out studies that are very detailed to assess our position in terms of brand awareness. Given what we are seeing, we identify that for certain type of clients, there was a big need to push campaigns in the big media because our clients that are more exposed to this type of let's say media, right, for example, micro merchants, individuals, right?

For the more conventional and regular market that we were exposed to the midsized and large-sized merchants, the regular B2B approach that we have has proven to be extremely successful, right, using all the different tools, digital channels and et cetera, and we are extremely well-positioned there. So we identified the need to adjust the marketing strategy for certain segments, and this is exactly what we are doing. Since we decided to answer more aggressively...

Q - Domingos Falavina {BIO 16313407 <GO>}

I understand.

A - Victor Schabbel {BIO 17149929 <GO>}

Go ahead.

Q - Domingos Falavina {BIO 16313407 <GO>}

Sorry. I understand that the metric we're looking is not ideal and I understand you had better. But is anything public that we can look at? I guess that's what I'm trying to get.

A - Victor Schabbel {BIO 17149929 <GO>}

I don't think so, because for any player now, this is very strategic information, right, because for this niche that (01:25:47) are exploring the most now, which is the micro merchants and individuals, basically, the players realize that it's a matter of you to be in front of the client the most that they can. So, investing a lot in terms of marketing and selling devices, all right? So it's key for any player willing to go there to have this information. So I think all the other players are also working internally with their own data instead of relying on any public one.

Q - Domingos Falavina {BIO 16313407 <GO>}

All right, understood. Thank you.

A - Victor Schabbel {BIO 17149929 <GO>}

You're welcome.

Operator

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

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

Thanks for the call of the first quarter. See you soon in the next quarter. Thank you very much.

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.