Q2 2017 Earnings Call

Company Participants

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

Other Participants

- Alexandre Spada, Analyst
- Carlos G Macedo, Analyst
- Domingos Falavina, Analyst
- Eduardo Nishio, Analyst
- Eduardo Rosman, Analyst
- Frederic de Mariz, Analyst
- Lucas Lopes, Analyst
- Mario Pierry, Analyst
- Rafael Frade, Analyst
- Tito LaBarta, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, everyone and thank you for waiting. Welcome to Cielo's Second 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. At that time, further instructions will be given.

This event is also being broadcast live via webcast and may be accessed to Cielo's website at www.cielo.com.br/ir, where the presentation is also available. Participants may view the slides in any order they wish. The replay will be available shortly after the event is concluded. Those following the presentation via webcast, may post their questions on our website.

Before proceeding, let me mention that forward statements are based on the beliefs and assumptions of Cielo's management and on information currently available to the company. They involved 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. Thanks for joining our conference call to discuss the second quarter results. Together with me, we have Clovis Poggetti, our CFO and Victor Schabbel, our IR Director. With two quarters of the year already behind us, I'm happy to say that the company was able to deliver good results, with solid earnings and cash generation. This has been possible due to our strong commitment to greater efficiency and our continuous focus on profitability.

The whole company keeps working hard to control costs and expenses, at the same time that we start absorbing the benefits coming from the gradual deployment of important projects that we have been working on for a few years though.

Among the main ones, we highlight ongoing rollout of the new IT platform called Star, that will gradually replace our legacy IT structure in the next 18 months, besides pushing for more to be done with less.

I would like to reinforce the importance of the four pillars sustaining our operation. On top of focus on efficiency, we have been moving forward with our digital evolution. Faster and more collaborative decision-making process has been developing, with the first initiatives have been recently deployed based on our agile approach, (03:10) squads, multitask, multidisciplinary of teams, Cielo delivered new CRM tools and more is yet to come. This more modern and dynamic way of organizing our teams is also part of the focus that we have on our people.

We keep working constantly, investing and creating on labor environment that can both improve our employees quality of life and recognize those that have been generating the best results.

Our focus on efficiency, digital evolution, people are linked to development of an increasingly (03:45) client-centric model. Altogether these four pillars will sustain and allow our franchising evolve with Cielo being ready to provide our customer with the best solutions in the market.

Finally, I am happy to highlight that our dividend payout ratio was increased moving back to historical levels. For this year, already, we are going to distribute 70% of our net profit as dividend from 30% previously (04:15). This is a result of both the strong cash position and generation that the company enjoy and the successful financial deleveraging process that we went through in the last years.

Also, as a fine off (04:32) strength of our business, we had recently a great demand for the quotas in our FDIC that we made available to the market. We opened up our investment vehicle, adopted in our prepayment business for the third parties. The book building process was four times oversubscribed with the rate being among the cheapest in the market. These are only a couple of examples that help us show the quality of our franchise.

Now, Clovis will talk briefly about the trends seen during the quarter.

Clovis Poggetti Junior

Thank you, Gouveia. Good morning, everyone. On slide number 3, we have the operating highlights of the company. During the second quarter we posted an 8.4% year-over-year growth of the volume capturing the acquiring business, excluding the Agro product. It's worth mentioning that this figure implies a relevant acceleration compared to the 4.3% growth that we delivered in the previous quarter.

Once again the debit volume accounted for most of this growth having expanded by 17.5% year-over-year, accelerating further from the 10.3% growth that we saw in the first quarter.

Although, it's still weaker than (05:51) the growth pace seen in our credit volumes improved, having expended by 2.2% year-over-year in this quarter compared to 0.1% in the previous one.

In regards to our POS base, we identified a reduction in the pace of contraction from 103,000 terminals lost during the first quarter this year, we had a loss of 80,000 in the second quarter. Accordingly, the POS base contracted by 4.4% quarter-over-quarter in this second quarter compared to 5.3% quarter-over-quarter in the previous one. It's worth noting that most of the drop was influenced by higher value-added terminals that accounted for roughly 60% of the contraction seen in the quarter.

Among the factors that have explained the contraction in our POS base, we continue to have merchants mortality and competition as the main ones. In terms of competition, the opening of the market in regards to smaller brands played an important role. Once the opening of the market or the process known as multivan lose strength as suggested by the volumes captured through this model, we should enter an accommodation process of our POS base.

On the next slide we have some of our main financial highlights. As Gouveia mentioned, we continue committed to delivering greater operational efficiency with the reduction of our total expenditures being a consequence of our efforts.

In this quarter, total expenditures at Cielo Brasil and Cateno dropped by 6.2% year-over-year due to a better cost control and deployment of some phases of important projects at Cielo Brasil, and optimizations at Cateno, mainly in regards to customer service.

Due to the current scenario, both our revenues and our EBITDA were pressured with the latter having dropped by 5.1% year-over-year. Our efforts to deliver greater efficiency, however, allowed us to post an expansion of our EBITDA margin of 1.2 percentage points compared to the second quarter last year.

In regards to our net income, we had a slight increase of 0.5% year-over-year helped by the ongoing financial deleveraging of the company.

On the following slide, we talk about our guidance for 2017. With half of the year already behind us, we decided to exit (08:26) some of our estimates while reiterating others.

The growth in our total volume reached 4.8% year-over-year or 6.4% net of the Agro product, in line with our expectation for the full year. Although we should benefit from a better base effect during the second half of this year, we know that volumes that we should lose in the context of the migration to the full acquiring model make us reiterate our guidance.

On the total expenditures side, we are pleased with the 4.7% year-over-year contraction posted so far. Given the lower inflation expectation, and the job done by our team on controlling costs and expenses, we are revising down our growth expectation from 4% to 6% to 0% to 2% for this year. The implied acceleration is a clear consequence of the fact that more normalized market expenses should weight on our expenditures during the second half this year.

In regards to our CapEx, after ending these first six months of the year with BRL 74 million, we are revising down our estimates to something between BRL 150 million and BRL 200 million from the original BRL 400 million.

We are still working with an acceleration in the second half this year, because of the rollout of LIO Version 2.

Now, we can open for Q&A.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Eduardo Rosman, Banco BTG Pactual.

Q - Eduardo Rosman {BIO 16314825 <GO>}

Hi, good morning everyone. I have a couple of questions on the POS rental business. In the previous quarters you mentioned that roughly 70% of the drop in the POS base was explained by the macro rate and high mortality of SME clients and 30% competition. So, I wanted to know if these changed in the second quarter or is the ratio like 70% macro and 30% competition remain the same?

I also wanted to know if – with the full adoption of the full acquiring model in the second semester, if you believe that competition will start becoming more of an issue for the POS base or not? Still on your POS base business, we saw that on – if we compare to first quarter, the year-on-year decline accelerated, which probably indicates that the base will keep trending down in the second semester. I know it's hard to make forecasts in the environments like the one Brazil is going through, but I wanted to get a sense of when do you believe POS base can start stabilizing. So if you could comment on that, it would be helpful? Thanks a lot.

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

Thanks Eduardo. About the mortality and competition in our POS base, today it's about – the last figure (11:55) we did about 50-50. We saw continuous mortality impact in our POS base and the main reason about our yield decline is rental POS, and the second is about the (12:18) acquiring. The competition about our POS base began last July when the market (12:29) the multivan process that all acquiring began to capture all brands, Visa, Master, Elo in the whole POS, and we expect for the next quarter an accommodation about this POS base.

A - Victor Schabbel {BIO 17149929 <GO>}

And Eduardo, Victor here speaking. As Gouveia said, the multivan process is almost over shifting to the full acquiring soon. This should led through an accommodation of the competitive environment here in our industry; but as you know with the POS base contracting by 15% year-over-year in the second quarter, we should definitely have a negative carryover effect on the POS rental revenues going forward, although we should see a deceleration of the contraction of our POS base with our POS base accommodating at lower levels going forward.

This is our expectation, although we don't have a soft guidance or a guidance for this. The trend itself as we saw in the second Q already points to a deceleration of our contraction, the reason why we are seeing this accommodation in our POS base, basically staying closer to the current levels going forward.

Q - Eduardo Rosman {BIO 16314825 <GO>}

Perfect. Just a very quick follow-up on the POS base. I know you do not disclose the revenue, of the POS anymore. But is it fair to say that given that your POS base is down like 15% year-on-year that your POS revenues are also down, let's say, more than 10% at least year-on-year?

A - Victor Schabbel {BIO 17149929 <GO>}

Yeah, our POS rental revenues came down by something like high single-digit to low teens during the quarter on a year-over-year basis. This is the range that we saw our POS rental revenues coming down during the second Q.

Q - Eduardo Rosman {BIO 16314825 <GO>}

Perfect. Thanks a lot.

Operator

The next question comes from Domingos Falavina, JPMorgan.

Q - Domingos Falavina {BIO 16313407 <GO>}

Thank you very much for the opportunity. Any – my question – actually, two questions, the first one is more on yield, but I'm going to depart from the answer you gave to Rosman. Assuming that the revenue with POS, they actually declined around 10% or so, high-single to low-double digits and whenever we look at the total revenues, they actually decreased by about similar level, about 8% year-on-year. If volumes were flat or didn't grow at all, it would imply that your revenues from MDR would have to probably shrink something around 6%.

Given the volumes grew 7%, 8%, it would imply that the MDR actually shrank in the mid-teens to, like 14%, 15%. So, could you comment if that makes sense and what exactly is driving this MDR shrinkage on a year-on-year? And then, I will make the second question.

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

Hi, Domingos, thank you for that question. We saw again – I will repeat (16:00) the first question. The decline in our revenue (16:05) of our rental revenue, the main factor is the contraction in our POS base, but we saw, again, a great difference of our debt in our volumes, although we have already a slight improvement in price (16:24).

Another point is about the volume growth continued to be supported by large accounts compared with small and SMEs merchants. Then, the combination of the three big factors, we saw the decline in our yields. When we saw the MDR, we saw a resilience (16:54) profit and we didn't change the strategy, our market strategy, and this is our scenario and we are a little bit seeing the market.

A - Clovis Poggetti Junior

Hi, Domingos. This is Clovis here. Let me take advantage of this moment to make some general comments in terms of the yield. It is fair to say that company faced pressure in terms of MDR for example, let's say it is always. Okay? We always had pressure. In certain moments, let's say, the pressure was more intense, in other moments, less intense or not so intense, but the pressure was there.

But what we had in the past offsetting a lot this effect was the rental business, rental business that, let's say, was presenting a sound, let's say, performance in terms of growth and also, let's say, company benefiting from the shift from the fixed to the wireless POS. So, again, the rental business performance offsetting part of the pressure that company always faced in terms of MDR and then we all had the yields that are going down for a couple of basis points.

Company – just reinforcing what Gouveia said now is company didn't – did knock (18:54), to make it even more clear, its strategy. What is happening now is that the rental business unfortunately is also under huge pressure. We don't have more, let's say, that benefit in terms of one thing offsetting the other. We had the two elements, MDR and the rental business, under pressure.

And why the rental business is now under pressure? You all guys, you know we have the macro situation, which means mortality much higher than what we used to have in the past, which means a lower affiliation, even, let's say, the inflation adjustment for the country that is good, but talking about the rental business only, you all know that the rental fee was adjusted in every anniversary and the multivan project that also adds some element in terms of competition also helping to put more pressure in the rental business.

That's exactly what is happening. That's why we have, in addition to the mix effect, mix in terms of products and also mix in terms of segments. So, you know it means everything is happening at the same time in the same direction and that helped to understand the trend that we are presenting in terms of the top-line.

And to conclude, sorry to take much longer than what I expected, but I think the main message is also there is – there was not and there is no change in terms of our strategy (20:52) and going forward as well.

Q - Domingos Falavina {BIO 16313407 <GO>}

Very clear. So, it seems to me that like your top-line is under pressure not because of new competitive strategy changing, but rather more like macro factors and then the part you control your doing great, which is the cost part, right, you are slashing costs quite significantly. And on that part, we noticed that the guidance sort of gives room to either accelerate growth expansion in the second half or to over deliver on it and I guess my question is which of the two?

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

Domingos, we saw – this is one pillar of our structure that we mentioned in the beginning of this year. One is people (21:44) people, clients, innovation, digital transformation, efficiency. We put more pressure to control costs and we have some good news. The teams are very (22:01) in this process and we see some results – solid results in the process to save some costs. It's clear that when we saw a decline in the volume, we saw some saving costs, but part of – big part – big portion of the savings coming from the process that we have put in place to save some money here.

A - Victor Schabbel {BIO 17149929 <GO>}

And in this sense, Domingos, the reason why we are revising down our guidance for the year from 4% to 6% growth of our total expenditures to 0% to 2% is because we are aiming at delivering our total expenditures growth below inflation. As Gouveia said, this is a strong commitment that we have internally in delivering a more efficient – Cielo a more efficient platform going forward not this year, but also in the coming years as well.

And you guys might ask why a 0% to 2% growth if we were able to deliver an almost 5% contraction of total expenditures year-over-year in the first half of this year? The fact is that when we look at the growth in first half, we have to make some adjustments from some non-recurring events that we had in the previous year and also throughout this year. For example, the departure of some executives last year that increased the personnel expenses in 2016, some accounting or provisions that we made last year as well, when we adjust that, the growth of our or the contraction of our total expenditures was closer to 2% year-over-year and not 5%. The reason why we should see an acceleration going forward in the second half due to seasonality and also some marketing expenses...

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

Can I add something, Victor? We prepare a strong and good campaign in the second period of this year, in the second semester, and we phased (24:34) this campaign to begin and the payoff of the campaign is so good. It's - here, your business will not stop with Cielo. And we had a strong campaign based on segments. We prepared 12 films online to - not TV ads and we will see some marketing expenses going to grow a little bit more than we've had in the first part of this year.

Q - Domingos Falavina {BIO 16313407 <GO>}

Very clear. Thank you very much for the explanation.

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

Thank you so much. Thank you so much.

Operator

The next question comes from Carlos Macedo, Goldman Sachs.

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

Good morning. Thanks, gentlemen. Thanks for taking questions. Two questions, first, a little bit on strategy, number of merchants has been declining down 10% year-over-year, yet when you look at your value, transaction value, that keeps going up at a faster pace. Essentially what we are seeing is that the transactions per merchant are up 16% - 17% in the second quarter, which is a very strong number given the environment. Can you talk about the strategy a little bit? What's going on? I mean are you losing just the merchants that didn't transact? What's going on there? Because this has an implication for price and MDR, given that the merchants that transact more typically have lower MDRs.

Second question, if you allow me, just on prepayment, strong yield in the quarter, could you talk a little about that if that's the factor of the receivables fund that you built up or is there a slight shift in strategy with respect to which merchants are prepaying? Thank you.

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

Thank you, Macedo. The first question about - I talked about the concentration in the second quarter in the large accounts. We see a huge and a good performance of how the huge large accounts compare with the SME segment. And large accounts have a strong performance in transactions compared with SME. This is the main reason about the number of transactions growing faster than the decline of the top-line.

And about the prepayment business, we are focused on – a huge focus on profitability and we engage the people, engage the team to focus in more a portion of a small business, the prepayment business. And again, we are focused on profitability, profitability, profitability in the prepayment business.

A - Clovis Poggetti Junior

And just to build on Gouveia's comment, I think also in terms of the receivables business, that was a good momentum to show to you guys that company is also focusing on the return on the invested capital on such a business.

Okay, the penetration dropped to something close to 19% (28:11), but, let's say, the operation is doing quite well, but, of course, if we analyze total revenue, let's say, the drop is because of the SELIC, because of the drop of SELIC, but taking the analysis based on a spread point of view, you are all going to see – on a material point of view, that's exactly the number that we disclosed, you guys will see that the number increased by 11%.

So, the focus and we always said that penetration is not necessarily the focus of the company in terms of the receivables business, but the bottom-line, the revenue that this business brings, the bottom-line that this business brings. So, sorry to interrupt, but just taking advantage of this moment to present this concept, company is also paying attention to the value that is generated by the business.

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

Thank you, Poggetti.

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

Okay. Thank you. Thank you for your answers.

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 you two questions. Just going back here on some of the questions that were asked, but first on the expenses, your guidance for expenses of zero to 2% implies growth of 20% roughly in the second half of this year versus the first half of the year primarily, I think as you mentioned, due to higher marketing expenses. But when I go back and look at marketing expenses, they represent roughly 4% of your total expenses. So, can you give us an idea exactly what are these marketing expenses and how much should they represent of your total costs? So, that's question number one.

Question number two has to do with your revenue yields. We saw, like you mentioned here, a big contraction, primarily due to POS rental. But my understanding was that you were trying to implement price increases at the end of the second quarter. So, I wanted to get an idea, how successful have you been implementing these price increases? Are you continuing to increase prices in order to compensate the slowdown that you're seeing and when should we see the benefits of these price increases? Thank you.

A - Clovis Poggetti Junior

Mario, I will begin in the second question about the – we are practicing with a lot of (31:17) analytics to understand if we can increase some prices for (31:27) segment in some part of this region – of this country. And we are doing some adjustment in our price of rental POS base and in MDR. We are very careful. We are doing (31:53) careful to support this process. We did in the last month (32:04) of the quarter and we have (32:09) the process to recover part of the revenue.

A - Victor Schabbel {BIO 17149929 <GO>}

And on the expenses side, Mario, this should be clear here. As Clovis mentioned, we launched on July a new campaign, development of our brand position based on the Máquina de Ideias concept or Ideas Machine concept that the company has been adopting since last year. And now, we have a greater client segmentation going forward. And because of the launching of this campaign on July, we are going to see a much bigger concentration of expenses, mainly marketing expenses, in the second half. So, probably something like 5% of the net revenues at Cielo Brasil being marketing expenses.

This is not a target that we have. It's just a reference of how fast it should increase in the second half, driving us to believe that the zero to 2% growth guidance that we have for total expenditures makes sense, right. Because once again, if you look at the 5% contraction of our total expenditures in the first half without making adjustments from non-recurring items mainly seen last year, you will think that the acceleration would have to be severe for us to get to the zero to 2%. And this is not the case, because the contraction of the total expenditures was closer to 2% on a recurring basis in the first half, and we are now going to see some acceleration in some lines going forward, reason why we are confident that we should be able to deliver the zero to 2% growth of total expenditures in the full-year.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. My question there is more related, right, you had like – just looking at Brazil and Cateno, you had expenses of roughly BRL 5.3 billion in 2016, right, and you have done BRL 2.4 billion in the first half. So, it means that in second half, you're expecting at least BRL 2.9 billion in expenses. So, what I'm trying to understand is there's increase in the second half versus the first half. But what you're saying it's primarily because of marketing expenses. Everything else, you think should be growing in line with inflation.

A - Victor Schabbel {BIO 17149929 <GO>}

Yes, exactly. And another aspect is that once you have some gradual improvements in the overall trends, for example POS base and volumes, you also have variable costs increasing as well. So, as you have a gradual improvement, you also should expect a gradual increase of our variable costs, the reason why we also work with the zero to 2% growth going forward.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. And just a follow-up into the prices. Looking at the markets, we're seeing a lot of new entrants in Brazil. Can you just describe how are the entrants trying to compete for market share, if you're trying to increase prices? And again, I understand you're being very careful. But does this open the door for new entrants to come in and underprice you or how are your seeing the competition in terms of being rational with prices, especially in the POS sector?

A - Clovis Poggetti Junior

Mario, we continue to see the big players continue to be quite rational in the marketing. As you mentioned, we have seen some new entrants (36:15) a little bit more aggressive with pricing with another model to sell POS. And again, from the (36:28) customers to the top, we're a little bit more rational, and in the (36:35), we see a more aggressive competition and – begun again since the advent of Multivan in (36:51) when we opened the whole POS (36:56) in Brazil.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. Thank you very much.

A - Clovis Poggetti Junior

Thank you, Mario.

Operator

Our next question comes from Frederic de Mariz, UBS.

Q - Frederic de Mariz {BIO 15383052 <GO>}

Good morning, everyone. Thank you for the conference call, for the opportunity. A couple of questions, the first one on prepayment. You decreased a little bit the volumes. You mentioned you were focusing on profitability and the spread was at an all-time high of 32%. Obviously, we're seeing the banks, they're not really lending. But how do you feel about that rate, considering you're not taking a credit risk?

Do you think you can maintain it at that level for the next few months, basically what you see in the prepayment product? And then, the second question is on the disclosure, Gouveia, you've been at the company for two quarters now. We ask a lot of questions about POS cards (37:53). How do you think about the disclosure? Do you think there's anything you guys could improve going forward to make it easier to read the numbers? Thank you.

A - Clovis Poggetti Junior

Thank you, Frederic. We saw in the prepayment business lower demand from the big accounts in the last quarter. We didn't see any change of the banks compete against us. We didn't see any movement. And again, we continue to be focused on profitability. We saw a huge portion of small business, small merchants in our mix of prepayment business in the last quarter. We're more focused on profitability. We're more focused on efficiency in this segment of our revenues. The second quarter - could you repeat, please?

Q - Frederic de Mariz {BIO 15383052 <GO>}

Yes. Do you think there would be something you could improve in terms of disclosure, especially for the revenues yield, to make it more simple to read POS revenues versus MDR?

A - Clovis Poggetti Junior

Yeah. We're trying to look into the numbers and we always (39:26) the results that we had.

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

You know, Fred, of course, we are always open to discuss, okay. No problem with that. But let's say we do believe we have a good set of information, given let's say all the conditions that we have. We already discussed the big influence of the particularities, being the only public company disclosing figures. So, we really discussed, but let's say that's exactly what we have for now, okay.

Q - Frederic de Mariz {BIO 15383052 <GO>}

Okay, thank you.

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

Thank you.

Operator

The next question comes from Rafael Frade, Bradesco.

Q - Rafael Frade {BIO 16621076 <GO>}

Hi. Good morning, all. I have two questions. The first one is I have some hard time here to consolidate what's going on with the MDR with the prepayment business. So, the impression is that the MDR is suffering, as you mentioned, by a shift in terms of mix for larger clients that there's less competition on this, while in small clients - in small merchants, there are big competition, while the prepayment seems to be exactly in the opposite direction. So, if you could help us to understand this dynamic. And the second one would be related to the full (41:01) MDR model, how it has been - how has been the discussions to start to capture Amex, Hiper and other cards? If you're advancing on it, it's something that we should (41:15) maybe relevant for the third quarter? So, if you could give some color on it, it would be great.

A - Clovis Poggetti Junior

Thank you, Frade. It's – about the prepayment business, we saw a spread, and we hold this spread because the – and increased a little bit in the last quarter, because we saw a decrease in our (41:44) and we're holding small merchants the fixed price of prepayment. And the contribution of revenue of the SME is bigger than the big customers. This is the explanation about the contribution about – the more contribution of small merchants in our prepayment business.

About the full acquiring process, we've begun to test with Amex and Hiper in our side and we saw some big players, big acquiring (42:32) acquiring process Elo. And we believe that in the last two or three months, we put in place (42:47) to capture Amex and Hiper here as a (42:58) acquiring company. The impact is more in the volume than in the revenue, because the portion of that Elo brand is high, it's about 85%, and the revenue that we see in the Amex and Hiper more acquired than the (43:23) prepayment business. And this is the main impact in the – it's volume in Elo, and we recovered part of the revenue with Amex and Elo, because it's basically (43:42).

A - Victor Schabbel {BIO 17149929 <GO>}

And Frade, let me reinforce something that Clovis mentioned about the MDR earlier today. The trend of the yield has been down – downwards, as you guys have been seeing. Once again, the main highlights here were the contraction of our POS rental revenues on a year-over-year basis, then we have the mix effects from the greater participation of debit compared to credit, and also the greater participation of big accounts compared to the retail. For four quarters in a row now, the Large Accounts segment has been outperforming materially the smaller merchants in terms of volumes. And this has been generating an impact on the mix.

And on top of it, we also had some MDR decline on a year-over-year basis in line with what we have been talking about of something like 3 basis points to 6 basis points contraction every single year. This time because of this multivan process it was closer to the high-end, to the 6 basis points contraction; but these were the effects behind the contraction of our revenue yield. Altogether they drove the revenue yield down as we saw during the second Q, okay?.

Q - Rafael Frade {BIO 16621076 <GO>}

Okay. So let me try to put the first question in another way. So in the previous quarter, you mentioned that for the last five months you had an – at the same basis, you had a change in the MDR for the same segments and the same mix. How it performed in the quarter? And also when – if there are some negotiations, it's only on MDR or is it also in prepayment or it's the prepayment less renegotiation on it?

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

Frade we saw a resilient process in our MDR (45:58) last quarter.

A - Victor Schabbel {BIO 17149929 <GO>}

And in regards to the difference, Frade, it is regarding the first half last year, right. So on a year-over-over basis, you'll see the contraction and last quarter you see the MDR resilient.

And in terms of the prepayment if I'm not mistaken, and please correct me if I'm wrong – if I understood wrongly your question – in terms of the prepayment the fact is that we have been pushing for penetrating more in the retail segment where the profitability is greater, as Clovis highlighted, and the demand dropped a little bit specifically this quarter on the large accounts segment, but this has a lot of seasonality, so it can come back later on. But the fact is that the push, the focus is on the retail segment.

Q - Rafael Frade {BIO 16621076 <GO>}

Okay. That's perfect. Thank you.

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

Thank you, Frade.

Operator

The next question comes from Tito LaBarta, Deutsche Bank.

Q - Tito LaBarta {BIO 20837559 <GO>}

Hi. Good morning. Thanks for the call. I have a couple of questions also. I guess just following up a bit on the revenues, I understand all the moving parts and the pressure that that's caused on revenues. But I guess at what point do you think there's an inflection point, and revenues can begin to grow again? Will it simply be a function of the economy improving? You mentioned all these are mixed (47:30) and everything else going on as well. When do you think that inflection point happens? Is it end of this year or is it more next year when the economy grows? And maybe in a more normalized environment, when the macro is growing again what's kind of a sustainable level of growth for revenues? I would imagine the double-digits you saw in the past maybe more difficult, but if you maybe can give some color on how we should think about that, I guess more longer-term?

And then my second question, I guess following up on expenses, also in addition to marketing expenses, the general and administrative expenses also rose quite a bit in the quarter, up 7% year-over-year, the press release mentioned they're related to strategic projects. Is there room for some cost savings there? Will those costs continue to grow around that level? If you can give some more color on that it would be helpful. Thank you.

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

Thank you, Tito. (48:25) our revenue in the next quarters, some accommodation of this process. It depends basically on the recovery of the macro scenario – the macro economy, and with a slight recovery, we note recovery in (48:46) and improve our revenue in a lot of lines. And we see some accommodation in the next quarter, and we expect a slight recovery (49:05) of the macro scenario.

A - Clovis Poggetti Junior

And also, I think I'm somehow quite realistic and optimistic now because imagine the following, we are all seeing that what we are facing in terms of the top-line is, let's say, much more related to the rental business that is suffering because of the macro, because of the mortality, because of the lower affiliation, etc. So what is my point? As soon as market, let's say, turns and becomes better we should see lower mortality, we should see a better affiliation, we should see better volumes, even in terms of the mix improving in terms of the credit and installments. And then my point is that in such a scenario of course the company has been doing, I'm suspicious to say (49:57) a very good job in terms of efficiency. Imagine a better company, a more efficient company benefiting in such a better environment what would be the outcome. So that is the homework. We have been delivering resilience, no change in the strategy, we are sticking to our strategy, doing our homework, and let's say, (50:25) of course, but we know that a part of what is happening does not depend on us.

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

About the second quarter, Tito – the second question is we saw strong control in the second quarter, and we believe in the long-term and medium-term, and long-term the expenses increased lower than inflation of Brazil. This is the gain of the efficiency that we see in the medium and the long-term.

Q - Tito LaBarta {BIO 20837559 <GO>}

Okay and that's including the general and administrative expenses roughly below inflation?

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

Yes.

Q - Tito LaBarta {BIO 20837559 <GO>}

(51:15) Okay. Thank you. Great. And then if I could just, I guess, follow-up a little bit on the revenue, and I know it's hard to forecast, right, but I'm – should we – should it be more in line with volume growth as some of the pressures subside with the POS, the mix? Do you think revenue growth would go back to be in line with volume growth or will continue to be below given some of the pressures will be ongoing?

A - Victor Schabbel {BIO 17149929 <GO>}

Hi, Tito. Victor, here. On the medium to the long-run we should expect volume growth to be stronger once again benefiting from card penetration in Brazil, domestic consumption growth, inflation pass through. So the volume growth should be once again stronger in the future, this is our expectation. Not anymore growing as fast as we had in the past, 15%, 20% because we also had a faster economic and – faster growth of our economic environment back then, and also a much higher inflation back then, but should definitely be a healthy volume growth going forward. But as we have been saying in the last years and we continue to reiterate that the trend is for the prices to gradually accommodate at lower levels coming down gradually over time. We have always talked about 3 basis points to 6 basis points contraction in MDR every year as part of this process. So as a result the revenue growth in the processing business should grow slightly below the volume growth in the future. But it should definitely resume growing sometime in the medium-term to the long-term.

Q - Tito LaBarta {BIO 20837559 <GO>}

Okay. Great. That's very helpful. Thank you.

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

Thank you. (53:13)

Operator

The next question comes from Alexandre Spada, Itaú BBA.

Q - Alexandre Spada {BIO 16687974 <GO>}

Hi, gentlemen. Good morning. I have just one quick question. Do you have any updates on the regulatory front in regards to the eventual shortening of the settlement time of credit card transactions? It appears that the subject is totally out of the press, but you have been probably interacting with the regulators on a frequent basis and maybe you have some news to share with us? Thank you.

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

Spada, thank you for the question. No news about regulation, no news directly to the point. And this is – we (54:00) meeting with the regulators.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. Thanks Gouveia. Very clear.

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

Thank you, Spada

Operator

The next question comes from Lucas Lopes, Credit Suisse.

Q - Lucas Lopes {BIO 18956724 <GO>}

Good morning. Thanks for taking my question. Considering what has been discussed so far you have been doing a great job in the retail segment, the wholesale segment, and correct me if I'm wrong, you have been – actually been able to gain a lot of market share here. The wholesale segment, however, is not – has not been impacted by the multivan project, and so the migration (54:45) acquiring of all brands in the near future could change a little bit the competitive landscape. I wanted to listen to your thoughts on this, on how the competitive environment of the wholesale segment will evolve in the second half of the year?

And in the past, correct me if I'm wrong, I recall you conveying that large accounts used to account for more or less 35% of your volumes, and considering the strong performance so far, how the - what's the breakdown between wholesale and retail nowadays?

And if I may ask a second question although the operating performance of the business has been slightly weaker than most expected, the markets should have welcomed the increased payout to 7% especially amid the ongoing deleveraging. In light of, considering that the FIDC, they should release some capital to the company, the excess capital at Cateno, do you see more opportunities to increase the distribution of proceeds to shareholders in the near future? Perhaps 2018? And that's - those are my questions. Thanks.

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

Lucas thank you for the question. We are very happy with the increase of (56:03) our payout from 30% to 70%. (56:08) demonstrates that we are trying to give more (56:19) value to shareholders. I believe we have to celebrate this moment now, and after that we see another project (56:27), but we are very happy, and with the decision that we have taken for this second quarter. About your first comment with multivan, the competition increased since July last year, and we will not see any movement in the change of competition, change of the market landscape (57:00). Again, we see the offset in the revenue from neutral to (57:12) because AMEX and Hiper is more credit and Elo is more debit.

We will not see any movement, any change in the competition because (57:32). The competition was increased with multivan process one year ago. Another comment about the payout we were waiting for this question. That was taken with the full support of our board. We have a strong support to our board in the focus to deliver value to the shareholders.

Q - Lucas Lopes {BIO 18956724 <GO>}

Okay. That's clear. Thank you.

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

Thank you Lucas.

Operator

Next question Eduardo Nishio, Banco Plural.

Q - Eduardo Nishio {BIO 15333200 <GO>}

[Foreign Language] (58:18-58:30) - sorry. The first question is related to the full acquiring process. I - I'm sorry to come back to that point as well. My view is that the full acquiring is where you have the competition, essentially where is the competition. I don't see why you see a slowdown and decrease of competition on POS rental and also on MDR, I think especially in MDR, where the full acquiring in the second half of the year starts to kick in. I just want to know if you could elaborate a little bit more about that, and then I - I'll do my second question. Thank you.

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

Eduardo, I respect your position, but I disagree. The multivan process anticipated (59:37) the competition landscape. The differential to have (59:44) brands that we had in all the acquiring we had in the past. For example Cielo had exclusivity with Amex, Elo, Alelo and one year ago, we opened whole terminals in Brazilian market to offset whole brands when the competition was there, (01:00:14).

The true acquiring process we achieve a movement in the volumes Elo, (01:00:27) directly to other acquiring to get pass-through and we will begin to accept into the volume of Amex and Hiper. Again, we saw the competition increased a lot last year, the middle of last year, to now, and before acquiring we believe that you have accommodation of same volumes, (01:01:06).

Q - Eduardo Nishio {BIO 15333200 <GO>}

Okay. But then the pressure on MDRs probably will come with the full acquiring, no? So.

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

Yeah.

Q - Eduardo Nishio {BIO 15333200 <GO>}

Multivan doesn't touch on that point?

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

I feel obviously. The pressure in the MDR was again doing this process because they had hold the brand pass through the whole terminal. It's possible to compete in MDR of one brand, but the competition was there, was in the mid of last year.

A - Clovis Poggetti Junior

And Nishio, the acquirers, they have been offering prices for different type of transactions like credit, debit, installments and things like that, not necessarily differentiating the prices for the brands, this is one reason why it shouldn't make a big difference there. And on top of it, the differential in the past was accepting the brands. And with the Multivan process, accepting the brands wasn't anymore a problem. So everyone was able to offer Elo or all the brands. And as a consequence, the competitive environment evolved, right, in the last 12 months. That's why we don't see the full acquiring itself changing it since the Multivan already drove to these development of the competitive scenario.

Q - Eduardo Nishio {BIO 15333200 <GO>}

Okay. Then my second question is more towards looking to future, and you mentioned that we won't see volumes growing again 15%, 20%. I was wondering what will be the number that we should work for the entire industry and like GDP plus inflation pass-through and plus some sort of classification factor on top of that, perhaps 10%, 15% will be a good number? And then, on costs, if you could elaborate a little bit about your bulk (01:03:31) project that's ending this year. Probably, you have cost reduction next year and should we expect a few years in a row cost growing, rising than inflation? Thank you.

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

We saw and we will see. We will recover based on the micro scenario Nishio. And we saw a CDA (01:04:05) that we publish every month, a slight recovery in consumption in our other business. Then we believe that we will have and we believe (01:04:21) next quarter.

A - Clovis Poggetti Junior

(01:04:29) sales expenditures as a whole costs and expense together Nishio, let's say, it's fair to assume both together growing below inflation that's what we expect, of course, delivering operational efficiency.

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

To focus Nishio, in two big areas change of process pertaining to suppliers, the way to do this is two areas. One is call center, the second one is (01:05:10). We want to be more efficient in these two big areas here and we are exiting good years from this process that we are putting (01:05:24) to be more efficient. Call center and (01:05:27).

Q - Eduardo Nishio {BIO 15333200 <GO>}

Okay. Thank you.

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

Thank you, Nishio.

Operator

The next question comes from Mohamed Ahmad, SGP (01:05:44).

Hi. Thank you very much for taking my question. I just like to sort of circle back to the net MDR scenario. Based on the numbers that you've given us for terminal revenue growth, terminal share, it seems like you're facing sort of almost like a 10 basis point net MDR compression for each of these last two quarters. And the breakdown I seem to get is about 6 basis points for like-for-like, just price declines, then about 3 basis point from mix of merchants, large versus small, and then 1 basis point from debit to credit switch. Would you say that those are ballpark numbers and do you expect – I mean, what do you expect for that going for the second half?

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

You are right. We see a compression in our revenues based on POS, and we really expect accommodation in this process we will see continue through our POS and mortality in the

(01:06:53-01:06:59) and we saw a changing mix large accounts in segments, more than that but this is the scenario that we expect for the (01:07:16).

A - Clovis Poggetti Junior

And then Mohamed (01:07:17), you are right with your math ballpark, this is pretty much the impact that we are seeing mainly on a year-over-year basis right because as we highlighted during the call, recently the MDR has been quite resilient. That's why we feel confident that we are going through, right now, an accommodation process, so the pressures should ease going forward. And also as a result of our effort and our focus on profitability that we have been conducting some price optimizations recently, we are trying to rationalize the prices for each of the segments that we are exposed to and this is the expectation that we have, a easing process in terms of the pressure on our (01:08:16) and MDR in general.

Q - Operator

Okay. And just like – while you correct those numbers, were year-over-year not sequential, but even the sequential net MDR decline was something like 5 basis points which sort of surprised me because I would have figured given that a lot of changes happened last year, sequentially at least you start to see some degree of stabilization but that doesn't seem to be the case.

A - Clovis Poggetti Junior

Well, it was much less than that, Mohamed (01:08:43), and because most of the contraction in our use and by most it was really significant was POS rental revenue contraction. And the other part, which was MDR, was influenced by the mix. The additions of large accounts that we had during the quarter basically drove down the huge (01:09:11) company as a whole. It's unfortunately hard for us to talk about average prices right now at Cielo, because we have so many different segments, so many different type of clients that it's important and we do these internally to look at the trends for our prices on a per segment basis. And by doing it, we can assess that the prices have been resilient over the last months which again made us confident that the pressure should ease going forward.

Q - Operator

Okay. And could you just comment on the what the share of the non-big three merchant acquirers in the market is year-over-year? So what was it this time or maybe January last year and what is it today?

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

It's about 50% – 5%. Sorry about that. 5%.

A - Clovis Poggetti Junior

So (01:10:19) should have 5%.

Q - Operator

And so 5% today versus what was it about in January last year?

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

Well, it should have grown from 2% a year ago. So...

Q - Operator

Okay. So it is growing as a percent of old volumes; so from 2% to 5% year-over-year?

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

Yeah.

A - Clovis Poggetti Junior

Yeah.

Q - Operator

Okay. Thank you.

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

Thank you, Mohamed (01:10:46).

Q - Operator

And e-commerce play any role on this or this is just offline share?

A - Clovis Poggetti Junior

No. It's everything. It's e-commerce and all the players operating in the market.

Q - Operator

Okay.

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

We'll continue to hold the portion of the e-commerce business in Brazil Mohamed (01:11:04). Remember whole line and the big players in e-commerce Brazil continue to perform very well here.

Q - Operator

Okay.

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

Thank you.

Operator

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

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

Thank you all for participating in our conference call. We will keep working hard to deliver stronger results going forward mainly for our stakeholders. We are very happy about the addition of our team and confident that Cielo will keep spending in its leading franchise. See you next conference call. Thank you.

Operator

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