

Q3 2016 Earnings Call

Company Participants

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

Other Participants

- Alexandre Spada, Analyst
- Henrique Navarro, Analyst
- Marcelo Cintra, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, everyone, and thank you for waiting. Welcome to Cielo's Third Quarter 2016 Results Conference Call. This event is being recorded and all participants will be in a listen-only mode during the company's presentation. After Cielo's remarks, there will be a question-and-answer session. At that time, further instructions will be given.

This event is also being broadcast live via webcast and may be accessed through Cielo's website at www.cielo.com.br/ir where the presentation is also available. Participants may view these slides in any order they wish. The replay will be available shortly after the event is 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 macroeconomic conditions, industry conditions and other factors could also cause results to differ materially from those expressed in such forward-looking statements.

Now, I'll turn the conference over to Mr. Rômulo de Mello Dias. Mr. Rômulo, you may begin your presentation.

Rômulo de Mello Dias

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

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

On Page 3, we can see the highlights of the quarter compared to the same period of last year. For Cielo Consolidated, net operating revenue totaled BRL 3.1 billion, up by almost 5% compared to Q3 of last year. EBITDA was BRL 1.4 billion, up 1.5% compared to Q3 with EBITDA margin of 45%. Consolidated net income reached BRL 1 billion, an increase of 15% compared to Q3 with margin of 33%.

Some highlights of our most relevant business. Regarding Cielo Brazil, net income totaled BRL 914 million, up 17% year-over-year and net product pro forma of purchase of receivables reached BRL 340 million, up 7.2% year-over-year, reaching 21% of the credit financial volume.

Cateno's net income totaled BRL 138 million in Q3, up almost 5% year-on-year. Cateno's EBITDA margin was 44.7%. Regarding Cielo Brazil and Cateno combined, total cost plus expenses reached 4.7% growth year-on-year.

With regards to other highlights, I'd like to point out the following achievements. We were ranked first in the Financial Service sector by Época NEGÓCIOS 360° yearbook of Época NEGÓCIOS magazine for the fifth consecutive time. We were the only Brazilian company amongst the top 100 world's most innovative companies by International Forbes Magazine, ranked first in the financial/non-financial sector by Latin America Executive Team 2016 Institutional Investor Annual Ranking for the fifth consecutive time.

Ranked first in the services sector by Empresas Mais Award of O Estado de S. Paulo newspaper, ranked first on the financial service sector in the 150 Best Companies To Work For award by Você S/A Magazine and Cielo was included in the Dow Jones Sustainability Index 2016 Portfolio as of September 2016.

Now I would like to hand the call to Clovis who will continue the presentation.

Clovis Poggetti {BIO 16529642 <GO>}

Thank you, Rômulo, and good morning everyone. Let's move to page 4. On this page, we can see the evolution of Cielo Brasil's main business drivers. The captured financial volume presented expansion of 4.5% compared to the third quarter last year, reaching BRL 143.5 billion. Excluding the other products, such growth would be 5.8%.

In the breakdown by product, credit grew 2.1% while our debit grew 7.8%. Quarter-over-quarter, the total volume increased 0.7% and excluding the other products, the increase would be 2.4%. By product, credit and debit increased 0.4% and 0.9% respectively.

It is worth mentioning that Elo's brand financial volume which is currently considered under Cielo's total volume was BRL 22.4 billion, a 33% increase year-over-year and 1.3% quarter-over-quarter. Out of this total, BRL 1.9 billion or 8.4% of Elo's brand entire volume is

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currently captured by other acquired under the Multivan project. Considering the entire volume captured by the company, the volume captured today by other acquirers under the Multivan project would account for 1.3% of total. The installed POS base dropped by 3.8% year-on-year and 2.1% over the second quarter of this year. The sharpest drop in the POS base is a result of the current economic scenario reflected in the lower number of affiliations and a higher number of uninstallation due to SME's mortality, also justified by the competitive scenario especially in view of the Multivan project.

Wi-Fi and GPRS equipment ended the third quarter accounting for 70.4% of the installed base, an increase of 3.8 percentile points compared to the third quarter last year and one percentage point compared to the second quarter this year.

And finally, the purchase of receivables operations which is another relevant level for Cielo Brazil. The purchase of receivables volume increased by 11.3% year-over-year, reaching BRL 17.2 billion, representing 21.3% of the credit volume.

The pro forma net losses of purchase of receivables went up by 7.3% to BRL 340.8 million in the third quarter this year compared to the same quarter last year. Quarter-over-quarter, the volume increased 4.3% and the pro forma net product was up 0.4%.

Now that we have disclosed the behavior of Cielo Brazil business levers, let's analyze its performance. Net revenue increased 6.4% to BRL 1.8 billion in the third quarter. The increase is related to the higher financial volume captured due to the continuous expansion of the business and by an increase in the revenue yield, which was 128% in the quarter compared to 126% in the third quarter last year.

It is worth mentioning that excluding the Agro product, the revenue yield would basically remain stable from 1.30% in the third quarter last year to 1.31% in the third quarter this year. Quarter-over-quarter, Cielo Brazil's net revenue increased 2.4%. The outcome is related to the revenue yield growth by 2 basis points compared to the second quarter when it was 126%. This increase is mainly due to the decrease in the Agro products in the second quarter. If we exclude the Agro products, the yield variation would have come in line.

Speaking now of total spending, we had an increase of 6.8% year-over-year to BRL 878 million in the quarter compared to the same period of 2015 and up 2.5% when compared to the second quarter this year. We will discuss expenses on the next slides. And finally, we have Cielo Brazil's net income which, after benefiting from the financial deleveraging process, reached BRL 940 million in the third quarter, a 17% increase compared to the third quarter last year and 0.9% compared to the second quarter this year.

On Page 5, we will discuss Cateno's performance. Cateno's net revenue increased 0.6% or BRL 609 million in the third quarter versus third quarter last year. The increase is mainly related to the expansion of financial volume captured in the Ourocard Arrangement, which in turn was impacted by a decreased volume of the Agro product in the third quarter. Compared to the second quarter, there was 0.1% decreased.

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Total expenditure which will also be discussed in the next slide totaled BRL 433 million, up 0.7% year-on-year and down 2.7% compared to the second quarter. Finally, Cateno's net income reached BRL 137.6 million, an increase of 4.6% compared to the third quarter last year. Compared to the second quarter, net income increased 6.3%.

It's important to note that we have the amortization of intangible assets in Cateno for a period of 30 years representing BRL 96.4 million per quarter. In the figures presented in the second table, amortization is not initially considered, creating what we call the business result. In this view, net income in the quarter was BRL 201 million. This will be the basis for us to analyze its cash contribution to Cielo.

In the accounting column, the net income already presented of BRL 137.6 million is the starting point for the analysis of Cateno's contribution to Cielo after the impact of financial expenses related to the creation of the new company.

As we can observe, there is a negative contribution of BRL 67.4 million in the quarter. This number comes from a BRL 96.3 million contribution, representing 70% of net income, net of financial expense contracted by Cielo, after tax effects in the amount of BRL 163.7 million.

Similarly, but excluding only amortization cash basis, as shown in the final column, the contribution from Cateno to Cielo after the impact of financial expenses is positive at a BRL 0.1 million. As already indicated in this cash analysis, Cateno starts being accretive in the second half of 2016.

On the next slide, page six, we broke down Cielo Brasil and Cateno total expenses. Cielo Brasil total expenses totaled BRL 878 million in the third quarter, up 6.8% compared to same period last year and 2.5% over the second quarter of this year.

Total costs totaled BRL 578.7 million, up 3.7% compared to the same quarter last year and 5.3% compared to the second quarter this year. In the breakdown, fixed cost totaled BRL 115 million, up 21% year-on-year, mainly impacted by an increase in rental and service data center maintenance expenses, necessary due to the incorporation of business-as-usual projects which had been delivered and up 14% quarter-over-quarter mainly impacted by administrative expenses due to the cycle of licenses renewal of Cielo's corporate systems.

Variable costs totaled BRL 366 million in the third quarter, up 2.8% year-on-year, mainly impacted by higher expenses related to the installation and uninstallation of POS solutions for the Olympic Games partially offset by reduced rent fee costs due to the slowdown of volumes captured and lower telecom costs, more specifically (12:32), in view of a reduction in inventory levels in 2016. Compared to the previous quarter, variable cost increased 4.7%, also impacted by higher expenses related to the installation and uninstallation of POS solutions for the Olympic Games and partially offset by lower processing costs.

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Operating expenses increased 13.3% compared to the third quarter of 2015, impacted by higher sales and marketing expenses with institutional campaign to reposition the brand, as well as marketing activities held in conjunction with issuing banks. Compared to the second quarter, expenses dropped 2% due to lower personnel, general and administrative expense.

Cateno's total expenditure totaled BRL 433 million, a slight increase of 0.7% year-on-year, and a drop of 2.7% over previous quarter. Total cost totaled BRL 403 million in the third quarter, down 1.4% year-on-year and 2.8% compared to the second quarter. The variable cost which account for most of the Cateno's expenses totaled BRL 301 million, down 2% year-on-year mainly due to lower rent fees costs and reducing processing costs, in view of a lower volume of transactions captured and partially impacted by an increase in embossing and postage expenses, due to a higher number of cards issued, cards optimization, and Brazilian postal service inflation adjustment.

Compared to the second quarter, variable costs went down 4% chiefly due to a reduction in embossing and postage costs. In view of a slower pace in the issuance of cards in current quarter compared to the widespread action to issue Elo cards in the second quarter this year and reduced customer service costs due to the bank employees strike.

Operating expenses totaled BRL 31 million, up 40% compared to the same period last year due to the effect of higher personnel expenses and expenses related to the advisory services in charge of migrating the activities to Cateno's structure.

Turning to page seven, you can see a summary of total expenses of Cielo Brasil plus Cateno, which amounted BRL 1.3 billion, up 4.7% year-on-year, that is to say in line with the guidance released.

On the next slide, number eight, we present Cielo's current debt. The company's leverage decreased to 1.1 times net debt to EBITDA adjusted for purchase of receivables product, attesting here the company's strong cash generation capacity.

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

Rômulo de Mello Dias

To conclude the presentation, I would like to thank you all for our partnership over these few past years. I'd like to reaffirm my decision to leave the company is a natural move and does not represent any repertoire (15:32) for Cielo. I had the honor of presiding the company for eight-years-and-a-half and with support of all shareholders, I took the lead of great achievements at the company. The transition has been going smoothly and will be concluded on January 2, and as of this date, I will remain as member of the company's Board of Directors.

Cielo is a company with solid performance, a result-oriented management and recognized in the market for its high governance standards, which grants the company true confidence in the continuity of its business regardless of its Chief Executive Officer's

replacement. The company remains confident in its business strategy. We will keep investing in the differentiation and diversification of its revenue lines and ensures that directions will not change.

Cielo keeps focused on the fundamentals which brought it here: profitability, operating efficiency, excellent customer service, innovation with results and a qualified team. Eduardo Gouveia is an industries professional. He has already acted as Cielo's Commercial Vice President and he's currently the CEO of Alelo. His knowledge of the group and his business expertise qualify him for the CEO position.

The model chosen for this transition is an example of governance. It has been a smooth process with enough time, so that Gouveia can be prepared to take the new role. All of that for the company to follow its course regardless of the external challenges. So, I conclude my comments here, and thank you all, again, for your attention.

Now, we wait for your questions. Operator, please.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Marcelo Cintra with Goldman Sachs.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Hi. Good morning, gentlemen. Thank you for taking my question. Actually I have two questions. The first one is regarding the business of purchase of receivables. I just would like to - I understand that the company is not providing a guidance for 2017, but I just would like to better understand how we should see trends for the following, let's say, four quarters to six quarters in terms of spreads given a lower SELIC rate which is expected by the market.

And also in terms of volumes, like volumes for receivables discounted as percentage of credit, credit transactions, is at historical highs, but I just would like to better understand if these levels are sustainable, if it's fair to assume lower levels going forward? Mainly, if some of these volumes could migrate to the banks. And if it's fair to assume maybe at lower results, lower income from this segment given that these revenues represents like 40% of the earnings, the pre-tax profit of the company.

And then I will follow-up with my second question.

A - Rômulo de Mello Dias

Thank you, Marcelo for your question. I think you've raised the three main drivers in terms of growth of prepayments. The first one is penetration, so percentage of the volume of

credit you have. As you know, we reach in this quarter our high penetration. We reach 21.2%.

The second point about lower SELIC also is going to affect next year, because as we mentioned during the conference call in Portuguese, it's something – even though that's for the big accounts, we work as a percentage of CDI which is close to SELIC. At the end of the day, it's going to affect also what we can charge.

And last but not the least, the volume of credit. If you talk about the volume of the industry as a whole, of course, we are including debit. And debit to some extent is being responsible for the, let's say for the growth we fulfilled (19:53). As we mentioned in our conference call, here also in English, the credit growth in this quarter was around 2% in the case of Cielo. So the raw material that you have to work is not growing at the same pace that when compared to debit. And why? Because of the economic situation, because of the – people are, to some extent, afraid about (20:22) what can happen. And with all of these things together, what you can say that for the next year, prepayment is going to be a challenged product to be – in order to grow.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Okay. Perfect. Just a quick follow-up. On the penetration front, as you mentioned, it's at historical highs, but it is fair to assume lower penetration going forward or this 20% – around 20% level its sustainable?

A - Rômulo de Mello Dias

I think it's basically – we don't see a reason why we should expect a lower penetration. I would say that in the future maybe, when the banks have more – I'd say, willing to work with credit, maybe we could have another situation. But at this stage, I don't see one reason why we should expect a lower penetration of the product.

And on the other hand even though that it is possible scenario, could reduce the penetration that we will reach today, also we are trying to work in order to increase the penetration considering the tools that we have in our hands and considering the possibilities – considering how we can work in order to develop and to create, plus there's many things that should be developed to, let's say, to increase not only the profitability but also the penetration of the product.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Okay. That's perfect. Thank you. My second question, it's regarding efficiency and your margin evolution. As you mentioned, like, revenue generation for prepayment would be challenging and I believe that also looking at the revenue, revenue generation on Cielo Brasil could also remain relatively weak given weak growth for the entire industry and further increased competition. So, what should we expect in terms of margins for your operations? Do you believe that you could continue improving your margin, your EBITDA margins going forward? And also considering the stable – considering fixed and variable costs, mainly on the fixed cost side, you could maybe drop this fixed cost base going forward. Is it fair to assume or what we should expect in terms of this trend? Thank you.

A - Rômulo de Mello Dias

Before talking about margins, I think it should be good at this point to remember what we share with you today. I'm talking about also the conference call in Portuguese. Yes, we have a challenging year in 2017. But as you said, we expect a better year in 2018. So it's like a curve, that when you - the shape of the curve suffers a little bit because of the economic situation and also because of some challenge that you have in the short-term.

In terms of the margins, I will ask Clovis to answer, but please, Clovis.

A - Clovis Poggetti {BIO 16529642 <GO>}

I'd say, Marcelo, with all the challenges that we have ahead of us in terms of the macro, volumes, competition, the rental business, everything that we already discussed and we mentioned here. There is no magic. When you have such a pressure in the top line, we must - to deliver even more in terms of savings, cost and expenses.

In the Portuguese conference, we had a question, for example, saying some concerns in terms of the increase that we have in the fixed costs in this quarter, because of some projects that were delivered. There is no magic, we will have to deliver something in terms of savings in the variable costs, in the expenses, in order to keep and delivering the efficiency that we are committed to. Whether this is going to be enough to keep the margins, to make the margins slightly higher or to offset part of this pressure, have to save enough. Company is, of course, working hard looking to the bottom line. That's what I can tell you with the information that we have for now.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Okay. That's very clear. Thank you for the clarification.

Operator

Our next question comes from Alexandre Spada with Itaú BVA.

Q - Alexandre Spada {BIO 16687974 <GO>}

Hello, gentlemen. Good afternoon. I have a few questions. The first is it was stated three times during the Portuguese call that there has been no changes in the competitive environment over the last month. That was striking to me and now that (25:22) has rolled out a new strategy in the retail segment on an attempt to recover part of the market share lost over the last year. So with that in mind, would you affirm that these new strategy from (25:42) has been so far perceived as neutral for Cielo?

A - Rômulo de Mello Dias

This part is very hard to say that it's neutral for Cielo. We do respect a lot (25:54), Santander and other competitors. We also have our own (26:01) to address, let's say, what our competitors are doing. So, I cannot say that's neutral because - of course, we are competing every day by each client which is, let's say, business as usual. But I wouldn't say

that's neutral because they're a very important company, very well respected and they couldn't say that.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. Thank you. Second question relates to guidance. So, year-to-date, if we disconsider (26:37) the extraordinary items of the second Q, your costs are growing less than the bottom of the guidance provided for the year. So, what are the odds of sustaining that performance in the last quarter so that the total costs end up being below the 6%, which is the bottom of the guidance ignoring, of course, the extraordinary impacts of the second Q?

A - Rômulo de Mello Dias

Let's remember that it's a soft guidance, the guidance about the total cost, total expenses is also related to the total sales volume that we're expecting from the (27:15) and that at the end of the day, for Cielo. And when we said that the total cost those (27:24) expense would be in the range between 4% and 6%, you're expecting a growth of the industry between 5.5% and 7.5%.

We revised this guidance saying that we are expecting between 7% and 9% for the growth of the industry and meanwhile, we also revised the guidance for the costs, the new range between 6% and 8%. So, in other words, we are likely to - if you exclude the second quarter, in terms of the, let's say, considering the extraordinary events for some items that you have such as (28:08) and others, but also it's important to remember that more than 50% of the total costs of the companies are related to variable costs.

So, what we're trying to do, as Clovis mentioned, on the other hand, if the top line does not come exactly in line with our expectations, we need to address and to control what you can control. And what you can control if you don't control the top line? You control the expense, plus the cost of the company.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. So, if I understood correctly, unless we have an acceleration in volume growth in the last quarter, it is possible that you end up finishing the year either close to the bottom of the guidance or eventually even below that, does that make sense?

A - Rômulo de Mello Dias

Makes sense. (29:01).

Q - Alexandre Spada {BIO 16687974 <GO>}

Thank you. And my last question also on guidance. The CapEx of terminals is year-to-date way below the indication for 2016. So, can you please comment on the reasons for that and the expectations for the year at the end of the day? Sounds to me that the number will end up being way below the guidance, but I'd like to hear your thoughts on that.

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A - Rômulo de Mello Dias

Probably it's going to happen (29:27) because of the mortality of the SMBs, small-medium business and also because of the, let's say, the growth of the industry that is below what we were expecting when we provided the guidance for the CapEx for 2016. But at this stage, we decide not to revise, but even though that you have a good (29:52), probably you are not going to reach BRL 400 million in terms of CapEx.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. Do you also attribute part of that to the dollar depreciation year-to-date?

A - Rômulo de Mello Dias

Yes. It is also one part of the explanation because the dollar compared to last year, when we provide the guidance for CapEx, of course, it translates into reais, what we had. So, you have mortality, you have (30:23) and you also have a new price for the dollar. So, these things together are having (30:30) some extent the problem by the end of the year to have a lower number when compared to BRL 400 million.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. Thank you very much.

Operator

The next question comes from Henrique Navarro with Santander.

Q - Henrique Navarro {BIO 16188960 <GO>}

Hi, everyone. Thank you for taking my call and question. Well, Cielo has been using the CG, the Credit Guarantee Fund to face the situation that we have in Brazil regarding the (31:04). As far as I understood from the Portuguese call, Cielo has no green light from the Brazilian Central Bank to do so. So, I believe the Brazilian Central Bank will eventually give a position on that when they approve your IP. So, my question is when do you expect the Brazilian Central Bank to approve your IP, I mean, how long had you been under this approval process? When do you expect this to be completed? Thank you.

A - Rômulo de Mello Dias

It's hard to say when they're going to approve the IP of Cielo, but I would say that probably by the beginning of next year.

Q - Henrique Navarro {BIO 16188960 <GO>}

Okay. Thank you.

Operator

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

A - Rômulo de Mello Dias

I would like to thank you all who participated in our conference call today. And as usual, we are here to answer additional questions that you may have. Thank you and have a nice day.

Operator

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

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