

Fitch Affirms Cielo's IDRs at 'BB'; Outlook Negative

Fitch Ratings-Rio de Janeiro-11 November 2020:

Fitch Ratings has affirmed Cielo S.A.'s Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BB', with a Negative Outlook, and its Long-Term National Scale Rating at 'AAA(bra)', with a Stable Outlook. At the same time, Fitch has affirmed the senior unsecured notes for Cielo's wholly owned subsidiary, Cielo USA Inc., at 'BB'.

Cielo's ratings reflect its leading position in the Brazilian merchant acquiring and payment processing industry, with a broad network of affiliated merchants and market penetration. The company's competitive advantage relies in part on the relationship with and distribution network of two important banks in the Brazilian banking system, Banco do Brasil S.A. (Foreign and Local Currency IDRs 'BB-', Outlook Negative, Long-Term National Scale Rating 'AA(bra)', Outlook Stable) and Banco Bradesco S.A. (Foreign and Local Currency IDRs 'BB', Outlook Negative, Long-Term National Scale Rating 'AAA(bra)', Outlook Stable). This gives it access to a broad customer base to acquire merchant accounts. Cielo's commitment to maintain a strong liquidity position, coupled with conservative credit metrics and strong financial flexibility, underpinned by a sizable pool of accounts receivables and strong access to funding, remain as key factors for the ratings.

The ratings incorporate the expectation that Cielo's market share will continue to decline, given the company's strategy to recover profitability. In Fitch's opinion, the entry barriers in the payments industry have decreased, which could further increase the strong competition and pressure profitability. Cielo has the important challenge of adapting its strategy to the technological and structural changes in the sector, reducing reliance on the traditional acquirer model, increasing its penetration among smaller clients and improving business diversification.

The analysis continues to incorporate the low counterparty risks associated with the Brazilian banking system, as more than 95% of the volume of transactions is concentrated in banks rated 'BB-' and above or that are partially guaranteed by Visa and Mastercard. Cielo has virtually no direct credit exposure to cardholders, as the card-issuing bank guarantees cardholders' payments, while the company's exposure to merchants is limited.

The Negative Outlook for the LC and FC IDRs reflects the Negative Outlook of Bradesco's and Banco do Brasil's IDRs, as well as the other Brazilian leading banks' IDRs, like Itau (Foreign and Local Currency IDRs 'BB', Outlook Negative, Long-Term National Scale Rating 'AAA(bra)', Outlook

Stable) and Caixa (Foreign and Local Currency IDRs 'BB-', Outlook Negative, Long-Term National Scale Rating 'AA(bra)', Outlook Stable).

Key Rating Drivers

Challenges from Increased Competition: The market dynamics for the Brazilian payment industry will continue to change quickly and Fitch expects competition to remain strong in the near term. The sector should continue to evolve rapidly, with technological innovations and new payment options, structurally changing the traditional business model. The pure acquiring model should remain on a declining trajectory and Cielo has the important challenge of quickly adapting its business model to this environment and improving diversification in other products like financial solutions and software services.

Cielo is the largest Brazilian merchant acquirer, with an estimated market share of 38% as of June 2020, based on a proxy with the five largest Brazilian acquirers. The company lost approximately 13 p.p. of market share since 2017, when about half of Brazil's total processed volume (TPV) was processed through Cielo, and Fitch expects it to continue to fall gradually in the medium term. More capitalized market participants contributed to a more aggressive growth strategy, significantly pressuring operating margins. Despite the significantly increased competition in recent years, pressuring the market share of the top players, the industry remains highly concentrated. The two largest participants still account for approximately 67% of the market.

Financial Volumes to Decline: Fitch anticipates a decrease in Cielo's credit and debit transactions in 2020 and 2021, despite the expected growth of the sector in Brazil. This reduction is due to Cielo's revised strategy that prioritizes profitability, with increasing penetration among smaller clients, the tough competitive environment and the expected negative impact of PIX (a digital payment platform) on the volume of debit transactions. Fitch projects Cielo's TPV will decrease by 8% in 2020, affected by the disruptions related to the coronavirus pandemic. For 2021, Fitch's base case projections incorporate TPV decreasing 16%, as debit transactions will be pressured by PIX and the volume of credit transactions will decrease due to Cielo's revised strategy. Cielo processed BRL453 billion in credit and debit transactions in the first nine months of 2020, down 8% compared with 9M19.

Fitch expects low single-digit growth in TPV for the Brazilian market in 2020 despite the reduction of transactions during the second quarter due to the coronavirus pandemic. The negative effect of the pandemic was concentrated in 2Q20, followed by gradual improvement in volumes, as social distancing measures eased, consumer spending and confidence began to recover and e-commerce penetration increased. For 2021 and on, Fitch expects the market to return to

10%-15% annual growth, supported by the low penetration of credit and debit cards in the country. Fitch projects Brazil's GDP to decline 5.8% in 2020 and grow 3.2% in 2021.

Cash Flow Generation to Decline: Increased competition in the payments industry in Brazil and more aggressive pricing have resulted in a contraction in Cielo's cash flow generation since 2018. Fitch projects Cielo's adjusted EBITDA to decrease to BRL2.3 billion in 2020, followed by a gradual recovery to BRL2.7 billion in 2021. These figures negatively compare with adjusted EBITDA, including financial income derived from the acquisition of receivables from merchants, of BRL4.2 billion in 2019 and BRL6.2 billion in 2018, according to Fitch's calculations. The reduction in the net interchange fee, in revenues from point of sale (POS) equipment rental and in the financial income from the acquisition of receivables, combined with lower growth of the volume of transactions, pressured EBITDA generation. Cielo's capacity to gradually recover EBITDA will depend on its ability to successfully increase the volume of smaller clients in its TPV mix, the penetration of the acquisition of receivables over total credit volume, a recovery in Cateno's profitability and an increase in product diversification.

Fitch expects Cielo to generate strong FCF of BRL5.6 billion in 2020, due to the positive impact of working capital, assisted by the company's conservative decision to reduce the acquisition of receivables during the coronavirus pandemic to improve liquidity. For 2021 and 2022, Fitch projects moderately negative FCF, as Cielo resumes the acquisition of receivables activity. Base case projections incorporate annual investments between BRL600 million and BRL650 million, and dividends of 30% of net income.

Low Risk of Credit Loss: Cielo has virtually no direct credit exposure to cardholders, as the card-issuing bank guarantees cardholders' payments, while the company's exposure to merchants is limited. The company is, however, partially exposed to card-issuing bank defaults on a payment settlement for Visa and MasterCard transactions. The risk associated with Visa and MasterCard transactions is mitigated because more than 95% of the volume of transactions is concentrated in banks rated 'BB-' and above. For some non-investment-grade banks, Cielo's risk management policy requires the card-issuing bank to pledge collateral.

Strong Capital Structure: Fitch projects net adjusted leverage, measured by the net debt to adjusted EBITDA ratio, including financial income derived from the acquisition of receivables from merchants, of close to 2.5x in 2020 and gradually reducing in subsequent years. As of Sept. 30, 2020, Cielo had BRL12.2 billion of total debt, including BRL3.0 billion of FIDC (Receivables Investment Funds), and net adjusted leverage was 2.3x, higher than the average of 1.4x from 2015 to 2019.

Derivation Summary

Cielo is the leading company in Brazil's merchant acquiring and payment processing industry with an estimated market share of 38%. The second-largest is Redecard (not rated; controlled by Itau Unibanco S.A.) with 29% market share and the third-largest is GetNet (not rated; controlled by Banco Santander Brasil S.A.) with 15%. Compared with small players, such as Stone (not rated) and PagSeguro (not rated), the three leaders have some competitive advantages due to their controlling shareholders' structure, as the affiliation with these leading banks gives them access to a broad customer base to acquire merchant accounts. As is characteristic of the industry in Brazil, Cielo has no direct credit exposure to cardholders, as the card-issuing bank guarantees cardholders' payments. Cielo's ratings incorporate the counterparty risks associated with the Brazilian banking system. Cielo is also well positioned in terms of R&D in technology, reducing the risk of obsolete systems, while small companies have higher technology risk.

Key Assumptions

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Volume of credit and debit transactions to decrease by 8% in 2020 and 16% in 2021;
- Volume of credit and debit transactions of Cateno to decrease by 6% in 2020 and increase by 5% in 2021;
- Annual investments between BRL600 million and BRL650 million;
- Dividends of 30% of net income in 2020 and 2021.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Ratings upgrade unlikely.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- An increase in the volume of credit and debit transactions with banks rated 'BB-' and below without collateral being pledged by the card-issuing bank or not guaranteed by MasterCard;
- Weakening credit profile of the main banks that operate with Cielo;

- A significant loss due to fraud and charge-backs;
- Tougher competition leading to a significant loss of market share and profitability;
- Significant changes in regulatory risk;
- A negative rating action on Brazil's sovereign ratings that leads to negative rating actions on Banco do Brasil, Bradesco, Caixa and Itau could result in negative rating action for Cielo.

Best/Worst Case Rating Scenario

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

Liquidity and Debt Structure

Strong Liquidity: Cielo has strong liquidity and financial flexibility. As of Sept. 30, 2020, Cielo had cash and marketable securities of BRL6.2 billion and BRL3.1 billion of debt maturing up to the end of 2021, of which BRL3 billion consisted of FIDC. At the same date, the company had BRL5.7 billion of debt maturing in 2022 and BRL3.4 billion in 2023. Cielo has good financial flexibility to address upcoming maturities and strong access to the bank and capital markets. About 92% of total cash is invested in Brazil and 8% abroad.

As of Sept. 30, 2020, Cielo had BRL12.2 billion of total debt, of which about 23% was denominated in foreign currency. Total debt was composed of private and public debentures (51%), FIDC (25%), bonds (23%), and others (1%).

Summary of Financial Adjustments

Fitch includes financial income from the acquisition of receivables from merchants in EBITDA.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

Cielo USA Inc.

---senior unsecured; Long Term Rating; Affirmed; BB

Cielo S.A.; Long Term Issuer Default Rating; Affirmed; BB; Rating Outlook Negative

; Local Currency Long Term Issuer Default Rating; Affirmed; BB; Rating Outlook Negative

; National Long Term Rating; Affirmed; AAA(bra); Rating Outlook Stable

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Applicable Criteria

[Corporate Rating Criteria \(pub. 01 May 2020\) \(including rating assumption sensitivity\)](#)

[National Scale Rating Criteria \(pub. 08 Jun 2020\)](#)

Applicable Model

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 ([1](#))

Additional Disclosures

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