

Conference Call Transcript
2Q21 Results
Cielo (CIEL3 BZ)
August 03, 2021

Operator:

Good afternoon, everyone, and thank you for waiting. Welcome to Cielo 2Q21 results conference call. With us here today, we have Mr. Gustavo Sousa, Filipe Oliveira, and Daniel Diniz.

This event is being recorded and is also being broadcast live via webcast and may be accessed through Cielo's website at ri.cielo.com.br/en/, 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. Remember that the participants of the webcast will be able to register, via website, questions to Cielo that will be answered soon.

Before proceeding, let me mention that forward statements are based on the beliefs and assumptions of Cielo's management and on information currently available to the Company. They involve risks and uncertainties because they relate to future events, and therefore depend on circumstances that may or may not occur. Investors and analysts should understand that conditions relate to macroeconomic conditions, industry and other factors could also cause results to differ materially from those expressed in such forward-looking statements.

Based on the presentation published this morning on the Company's website, this conference call is open exclusively for questions and answers. If you have a question, please press *1 on your touchtone phone at this or any time. If at any point your question is answered, you may remove yourself from the queue by pressing *2. Questions will be taken in the order they are received. We do ask that, when you pose your question, you pick-up your handset to provide optimum sound quality.

I now pass it to Mr. Gustavo Sousa for opening remarks.

Gustavo Sousa:

Thank you very much. Good morning, everyone. Thank you for participating in our earnings call.

In this initial message, I intend to cover the highlights of our results and our strategic priorities. Starting with our earnings, our net income of R\$180 million, with no one-off item the period between, this is a 32% growth versus the 1Q21 on a recurring basis. Besides that, this was the third quarter reporting net income growth in a year over year comparison.

Our TPV presented a 30% growth year over year. And when we look specifically at the combination of the SMB with the long tail segments, we showed a 49% growth year over year. We have also shown strong discipline in spending control, with a 5% decrease in normalized spending year over year.

Now, moving on to our strategy and priorities, the Company's strategy does not change. We continue with the same direction: expand the ecosystem, including credit and value added services, and innovations in payment solutions, while improving operations, especially in the quality of services provided in the traditional acquiring business.

Having said that, we intend at first to intensify and expedite the measures that will allow us to offer the best experience to our customers.

What can we expect in the coming months? The optimization of the commercial model. We have already hired 500 new employees that expanded our commercial force. This team is already trained in our technology.

We have had some headwinds with quarantine, which hindered the pace of client acquisition, but we have already had important results, such as a relevant increase in activation rates.

Important improvements are already being implemented in the Company's logistics system, review of processes and contracts with partners, improvements in last mile logistics.

In recent months, we have tested a new face to face service to meet the demands of our customers, such as installation and maintenance of equipment. We have structured a team of professionals using Cielo's uniform, well-trained, who go to the clients to solve problems, and we have named this initiative Heroes.

The model showed promising indicators, with client satisfaction superior to the main benchmarks in the industry. We implemented the initiative as a pilot in six cities, and we are now ready to expand the model to 152 cities, which represent 80% of the calls made by our customers.

We are also investing to improve our call center service, reviewing systems, processes and internalizing some key positions, such as the quality and data analysis. Our customers must have faster and more efficient service.

These were the highlights in terms of deliveries that are already taking place and should be complemented in the next few months. I hope to be able to discuss the results at the next earnings conference calls.

Better serving the customer is a top priority. It is the basis for briefing on the other pillars of our strategy. We have important advances in the 1H21 terms of innovation in new business, and it was the case with the start of the WhatsApp P2P operation and the FIDC that we structured to grant working capital lines to our clients. And we will continue to invest in this type of initiative.

We understand that these agendas make sense if we have an excellent service, and if this quality is perceived by our customer base. Our ambition is high in terms of service quality and customer satisfaction.

Thank you for participating and for listening, and we now open the Q&A session. Thank you.

Mario Pierry, Bank of America:

Good morning, everybody. Thank you for taking my questions. Gustavo, I have two questions. On your release, you talked about problems with the new receivables registry system, and that led you to book provisions of almost R\$14 million in the quarter. Can you give me a little bit more color? What is the problem? When we think about this R\$14 million, what does it represent of the overall book?

And then my second question is related to your take rate. It surprises me that your take rate went down, because you showed that your mix of volumes have improved a lot. You are growing more in the

SMB and the long tail segment, so you are deemphasizing the large corporate. We saw that the credit mix versus debit improved, and I think it was the first time that we saw credit growing faster than debit since the pandemic started. So can you also give me a little bit more color on why you continue to see pressure on revenue yield, and what can you do going forward to stabilize that? Thank you.

Gustavo Sousa:

Thank you, Mario. I will take your first question, and pass the second to Filipe. On the receivables, as you know, we have had an important implementation in the Brazilian system. So we are still in a learning curve in terms of integrating process, doing a conciliation among all of the market players, and with that we have seen increased operational risk.

This operational risk is related to synchronizing the information across the different registrars of receivables in the country. With that, we decided to record a provision. We are going after recovering what generated this provision, and we will let you know how this progresses in the next quarter.

But it is completely related to increasing operational risk that we have in the first stages of implementation of the receivables center here in the system, integrating acquirers, financial institutions, and also registrars of those receivables.

To take your revenue yield question, I will pass it to Filipe. Filipe, please.

Filipe Oliveira:

Thank you for your question. So basically we have movements in two directions here when we looked at the revenue yield. Generating positive pressure, we have increasing B2 liquidation penetration, which reached around 39% in *varejo e empreendedores* segments. We also have a better mix of clients since we have a larger penetration of SMB compared to large accounts in the last quarter. And we also have a better mix of products, as you mentioned, since debit has been losing a little bit of its best leadership in the last quarters during the pandemic.

On the other hand, we have two effects that are generating negative pressure in the revenue yield. The first one is general prices in the market, which means basically the competitiveness of the market still pushing prices down across the market as a whole.

And the second is a bit of a mathematical effect, that basically POS rental fees are fixed. And once you have volumes recovering in the market, imagine a client that pays R\$100 in rents, and all of a sudden they double their volume. The yield of their rentals is going to go down by half. So it is a mathematical effect of volumes recovering and not a real effect in terms of prices.

Mario Pierry:

OK. And is there a strategy here for you to offset some of this pricing pressure going forward?

Filipe Oliveira:

In our view, the main way to increase revenue yield is to increase the penetration of pre-payment volumes, which is one of the main strategies here in the Company. And the second one is further increasing the mix of *varejo*, SMB and micro merchants, relative to the larger council. Those are two main initiatives that we have in terms of increasing revenue yield.

Mario Pierry:

OK. Thank you.

Jeff Cantwell, Guggenheim Securities:

Thanks, guys, and nice results here. Can you tell us a little bit about payment volumes? It looks like a nice step up year over year and sequentially. So I am just curious if you can sort of drill down into what you are seeing this quarter across SMB in particular.

And how sustainable do you think growth in your payment volumes is if you contemplate the back half of this year? Are there any call outs or anything you want to discuss so we can set expectations for the back half of the year?

Gustavo Sousa:

Jeff, I am sorry, but your question got really choppy for us here. We could hear it perfectly. If I understand, you are asking for some color on prepayment volumes on SMB and long tail. Is that around that?

Jeff Cantwell:

Yeah. If you do not mind, let me just back up. To focus on your payment volumes, I was just curious if you can drill down into what you are seeing this quarter in your SMB segment in particular.

And then, I was hoping you can discuss how sustainable you think growth in your payment volumes is in the back half of this year. That is the crux of it.

Filipe Oliveira:

Jeff, thank you for a question. So we have we have reinforced our commercial and sales capabilities in order to grow our TPV volumes and both SMB and micro merchants, but micro merchants on a lower scale than SMB. Our main focus here is SMB.

So we imagine that this new sales model and the reinforced team will start getting traction in the next couple of quarters, which will perpetuate, or at least maintain this pace that we have of growth in the segment.

Additionally to that, as I mentioned before in the last question about the revenue yield, we also have a very strong initiative here to cross-sell products, especially prepayment products to those segments. So that should be another good news in this segment that we want to present in the next quarters, both volume growth and also prepayment volume growth.

Jeff Cantwell:

Got it. My second question was on your expenses. It looks like you are reducing your normalized expenses. So it looks like your margins expanded by 3.5 this quarter, quarter to quarter. So how sustainable is that? We look pretty closely at your operating leverage, and I guess I am just curious if you can talk about your level of confidence that you can drive positive operating leverage going forward.

I understand there is a lot of moving pieces to that question, so maybe can you just give us color on how you are thinking about OPEX and operating leverage going forward? Thanks.

Filipe Oliveira:

As you saw, this was a really good performance in terms of reducing costs the Company has delivered in the last quarters. Of course, every cost reduction has its limit. You cannot just reduce costs forever. We do believe, however, that there is still some place for further efficiency gain in the Company.

However, we also have many new initiatives, especially increasing the quality of service, that may require additional expenditure in the next quarters. So the net effect, we do not have it yet. We do not know if the costs are going to keep going down or if eventually they are going up because of those investments, but we have those two movements happening at the same time.

Jeff Cantwell:

OK. Appreciate all that color. And then lastly, can you talk a little bit about your key strategic priorities? This is in reference to slide 15 in the presentation, particularly in payments innovation. Can you talk about WhatsApp? There are a lot of investors interested in this one. So we would like to think out a little bit over the medium term. And I guess what I want to understand is, is this the direction that payments are going in Brazil, to platforms like WhatsApp?

And then, underneath that, is this SMB friendly? Is it consumer friendly in particular? I just want to understand the context for you guys, because you are certainly positioning this as part of your payments innovation strategy. So just wanted to get your thoughts on what that could mean for you guys as we think about over the medium term. Thank you.

Filipe Oliveira:

Jeff, as we saw in other countries, initiatives such as Pix or even WhatsApp Payment, they have significantly increased the share of digital payments in the overall economy. And we believe we have a movement that could be very similar here in Brazil with all the initiatives that have been happening in market.

Just to give us some more color, Brazil has around 40% penetration of card payments in the total consumer expenditure in the country, and we imagine this figure could still go up by at least 10 p.p. in the next couple of years.

So certainly there is a huge market here for different types of solutions, and there is not necessarily cannibalization between the new forms of payments and the old ones. However, it is a good opportunity for any acquirer that wants to be relevant in the market.

So Cielo has decided to position itself at the forefront of those initiatives by partnering with WhatsApp in order to provide the P2P payments, and we believe this is going to be a really good way to increase the volume for the market overall for very acquirer.

Jeff Cantwell:

Okay, great. That is very clear. Thanks so much, and congrats again.

Neha Agarwala, HSBC:

Thank you for taking my question. Again, I want to follow up on WhatsApp Pay. Are the volumes of WhatsApp Pay really important in your total TPV? And going forward, as the volume of WhatsApp Pay picks up, I understand this is currently only P2P, but would that be included in your overall TPV, or would you show that separately?

My next question is on the turn. I think on the Portuguese you mentioned about the turn product for the SMBs. Could you elaborate a bit more on that? I was not sure what it is. Are you already giving out working capital loans to your merchants? Thank you so much.

Gustavo Sousa:

Neha, I will start with the working capital loans question. We are ready to do that in terms of product and balance sheet, and we will likely see this disbursement of working capital loans pick up on the coming quarters.

So we have worked on specific funding for that during the 2Q21, and in the 3Q and 4Q we will start to share the first disbursement related to that. And I am talking mainly about working capital line dedicated to our SMB portfolio.

Filipe will talk about WhatsApp Pay. Filipe, please.

Filipe Oliveira:

Neha, thank you for the question. We see a huge potential for WhatsApp in Brazil. They have 120 million users in the country, virtually 100% penetration in smartphones in the country. A really well-reputed and reliable service in the minds of the Brazilian people in general. So we see demand as having a huge potential.

They decided to rollout the solution carefully, which in our view was very wise. So they phased the adoption of users quite carefully in the next couple of months. And if I am correct, only last month they made it available for every user in the country.

On our sales side, we see numbers that are above our initial expectations, which is really good. We cannot really further comment on WhatsApp numbers because we have an NDA with them

Neha Agarwala:

That is perfectly OK. And would you be including the volume that you process for WhatsApp Pay into your TPV or not?

Filipe Oliveira:

Yes, we incorporate that volume here.

Neha Agarwala:

So if you incorporate that, I assume that puts further pressure on your revenue yield, because these volumes have no margins. Is that right to assume?

Filipe Oliveira:

It is still very small to make a difference in our numbers overall. I would say it is negligible in our volume.

Neha Agarwala:

But in the coming quarters, it could become more meaningful. So that could be a headwind for overall revenue yield.

Filipe Oliveira:

Yes, it could be more meaningful. Because of the NDA, I cannot really tell you about the revenue of those transactions, but yes, it could eventually influence the revenue yield.

Neha Agarwala:

Understood. And on the working capital loans, which you are preparing to disburse mostly in the 2H21, is that the turn products that you were mentioning for the SMBs segment?

Gustavo Sousa:

Neha, can you repeat the last part of the question?

Neha Agarwala:

I think you mentioned something called the turn product for the SMB segment. Is it the same as the working capital? Is that what you meant? Maybe it was lost in translation.

Gustavo Sousa:

I got it. In our presentation, when we referred to turn products, we are referring to receivables discounting and also to prepayment that is done in two days. Instead of getting credit in 30 days or in a longer period, a client can adopt this product, which is an automatic prepayment product that gives a payment fee in two days. This is what we call a turn product in our release and in our presentations. When we were to working capital lines, we specifically call them credit. So we are talking about two families of products.

Neha Agarwala:

OK. And the credit that you will be rolling out in the coming months, that will be completely originated and underwritten by Cielo, or would the bank to be involved?

Gustavo Sousa:

That will be completely originated by Cielo on its client base. Bear in mind that Cielo's client base is made up of clients that were originated by Cielo, or that were originated by partner banks.

Neha Agarwala:

OK. So even if a client comes from a Bradesco branch, you can give a working capital loan to the client?

Gustavo Sousa:

Yes, because clients that are originated through banks that are partners with Cielo, that have agreements with Cielo, they have a dual relationship. They have a banking relationship with that given bank, and they have an acquiring relationship with Cielo.

Both parties, the bank that holds the checking account and Cielo, who has the acquiring relationship, can offer a number of products, credit being one of them.

Neha Agarwala:

OK. I think previously the point of contention here was that if a client comes from a Bradesco channel, then Bradesco would like to offer the working capital loans rather than having it done through Cielo. So has that been sorted out with the controlling shareholders?

Gustavo Sousa:

There is no barrier for that. This strategy of granting credit across the client base from Cielo, regardless of who originated the client, is totally approved by the Board.

Neha Agarwala:

OK. I understood. That is great, Gustavo. Thank you so much for the clarification.

Tito Labarta, Goldman Sachs:

Good morning. Thanks for taking my question. A couple of questions also. First, following up on the payment volume growth, a decent growth in the quarter, but if we look at your competitors, they all grew roughly about 11%, 12% on the quarter, at least the ones that reported so far. So I just want to understand a little bit the competitive dynamics. Is it just because you are losing share with large merchants and that is where you see the competition growing?

You showed some good trends on the SMB side, but then, you are still not getting the benefits on the revenue yield. You mentioned that growing with SMBs should help that revenue yield. So just to understand, are you also seeing pricing pressure on the SMB segments? And do you ever think you will grow faster than the competition, or you are just willing to lose share to sort of protect profitability? I just want to think a little bit about the dynamics on the payment volume growth. And then I have a follow up question on the receivables market that I can ask afterwards.

Filipe Oliveira:

You are correct. The market share loss is basically because of the large accounts. We have announced the strategy a couple of quarters ago that we were going to focus more and more on the SMB side, and eventually lose some large accounts that were not as profitable as we desired here in the Company. So that strategy is what is causing this market share loss, which you observed well.

In terms of revenue yield, we are not seeing the benefit yet. We do see some benefit. If you look at the slide 11 of the presentation, year over year, the client mix and revenue mix component of revenue are contributing quite positively to increase revenue yield. We do see, on the other hand, some other factors, such as overall price competitiveness in the market, increasing the overall revenue in that sense, and knowing the positive effect that we have of the client mix.

So that is what is happening. So, yes, the SMB penetration has been helping. However, we do not see the net effect because of other effects.

Tito Labarta:

Thank you for that. And do you think that the revenue yield, if we look at slide 11, you were 79 bps in 2Q20. Is that a reasonable sort of assumption of where you can get back to as you increase market share with SMBs? Or how much can it improve from here?

Filipe Oliveira:

Unfortunately, we cannot provide any forecasts. The overall trend is that we want to keep improving the mix of SMB, so that could potentially have a benefit overall.

Tito Labarta:

Understood. Thank you. And then my question on the receivables market, two parts: one, the operational issues, have those been resolved? Do you have an expectation for when those will get resolved? And the working capital loans that you plan to do, are those based on the receivables market working? Is there a relation between one or the other in terms of like having collateral from these receivables? Just to get a sense of why you need those provisions, and when you can either reverse those or things will be operating as they should.

Gustavo Sousa:

Thank you, Tito. There are new receivables dynamics in the country. This is very important. It is very significant in terms of improvement for possibilities in comparing the cost of credit for clients as a whole.

I classify the operational issues related to that as completely normal, and we are very close to finalizing all of them. So it is a huge, mass scale implementation. Eventual problems are likely to happen, and I believe the market as a whole is very close to stabilizing everything.

Tito Labarta:

OK. Thanks, Gustavo. That is helpful. And on the second part of the question, the loans, will they be contingent on this working, or is that completely separate, you do not need the receivables market to work to do the lending?

Gustavo Sousa:

The loans that we are going to disburse as working capital lines, yes, they rely on the infrastructure of this market, because we are talking about working capital lines based on receivables. You know that

very well, Tito, we are talking about the type of product in Brazil called '*fumaça*', whereby knowing the sales history of a given client, we offer credit that is backed by future receivables. In order to lock-in those future receivables, we need the infrastructure of this new market, of this new market for receivables.

Tito Labarta:

OK. Perfect. Thanks, Gustavo.

Gustavo Sousa:

That is already working well and functioning. This new product for us is still to get its traction.

Tito Labarta:

That is fair. Thank you.

Operator:

The Q&A session is concluded. I would like to turn the floor back over to Mr. Gustavo Sousa for his closing remarks.

Gustavo Sousa:

Thank you, everyone, for their participation. If you have any follow up questions or comments, please follow up with our IR Team. We will see you in the next call. Thank you.

Operator:

Cielo's conference call is concluded. Thank you very much for your participation, and have a nice day.

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