PAGSEGURO (BUY, TP: $69)

INVESTOR CALL WITH RICARDO DUTRA, CEO

February 4th, 2021

We held a call with Ricardo Dutra following our initiation last week (see Initiation: Winning Wallet Share). We talked through the Pagbank opportunity and how to think about the credit ramp (~BRL100m/quarter) and getting to the targeted 30% contribution to group revenue by end-2024 (7.5% today). Elsewhere, near-term focus will likely be on the credit-debit mix which has improved in Q1 and will support near-term net margins.

Separately, we have pushed up our target from USD64 to USD69. Having spent a lot of the last week since initiation speaking to investors, we now think it is fair to include the balance of receivables in our net cash position.

Detailed call notes

Pagbank

We ran through the main drivers of Pagbank revenue with the CEO, incorporated into three main buckets:

- **1. Credit:**
  - Quite clear on ambitions for loan book ramp: BRL100m per Q. This is the target for Q1 (which I assume is broadly in the bag) with Q2 onwards only variable around Covid and macro - which remains rather uncertain in Brazil.
  - Focus on merchants for the foreseeable, rather than consumers
  - In general, the message was, big opportunity in credit, but we're not going crazy. Need to tread carefully particularly with Covid as added uncertainty, and the underlying Acquirer business is growing very well and in good shape.
  - Yes, there is competition for credit offerings, but:
    - Long tail to chase for all with unbanked. This is the primary target
    - Existing merchant relationships a huge advantage
    - Banks tend to serve existing customers. Example: they tried to target mPOS business but ultimately gave up
    - Not competing against Nubank, for example, which is typically targeting existing banked customers (and higher wealth individuals, with a millennial focus). Nubank model is to offer loans/credit cards from the start and take it from there; PAGS starts with transactions and moves into credit once it knows the customer
- **2. Interchange:**
  - Expected to drive the greater chunk of Pagbank revenue in the longer-term forecasts, followed (closely) by credit and then wallet/other.

    - We have revenue weighted more toward credit, so we might be under-clubbing future cash card issuance (and over egging credit slightly); we're actually below the 30% contribution by end 2024 by ~5pp
    - Cash cards to be the driver of this rather than credit cards
- **3. Wallet:**
    - Not likely to be monetised materially but as a source of engagement: main usage today is:
        - 1/ Wire transfers (zero rated), then 2/ Bill payments followed by 3/ Mobile top ups (both charged for)
        - QR usage is actually pretty low which is not dissimilar to MELI's messaging (~20% of Pago wallet TPV).
        - The CEO is cautious on the prospects for QR take-up given relatively high (and rising) card penetration and established consumer behaviour. NFC could improve the consumer paying experience, but cards retain a cultural resonance. *(Note, this is not a problem so long as PAGS can continue to issue cash cards: it books an MDR as Interchange, rather than through the Wallet)*
        - Also, the CEO doesn't see PIX taking off as a transaction means, but rather predominantly as a means to replace existing, expensive legacy wire transfers
- Regarding all longer-term forecasts for Pagbank, the CEO admitted that it is difficult to be too scientific over the exact splits
- Reiterated "well on track" to hit Pagbank contributing to 30% of group revenue by end 2024 (7.5% today).
- Look at the Chinese Super Apps but situation is different there
    - China went from cash straight to phones
    - Credit has been around in Brazil for a long-time (albeit not extended to the bulk of the population)
    - Instalment plans are a key component of purchase culture in Brazil
    - Hard to see Brazilian buying a 55" TV on a smartphone culturally
- Touched on other services: payroll loans in Guarulhos in a pilot aimed at consumers
- Insurance and asset management to follow
    - No real engagement on crypto adoption in the wallet (despite PYPL Nov-20 launch and SQ Cash App usage dating back further)
        - Note, PYPL saying new cryto holders are x2 as engaged than prior.
        - (We would think that with a young POP and history of inflation, cryto holding in the wallet would be a great mechanism for engagement)

<u>Acquirer business</u>

- Seen a slightly better mix of credit vs debit in Q1. The Brazilian government is talking about the potentially restoring Coronavouchers to millions of Brazilians, which could positively impact volumes (though negatively impact take rates)
    - A high credit mix is one of the most important drivers of profitability for PAGS due to
        1. Higher net MDR on credit (vs debit) – in rough terms confirmed at a gross profit of ~300bps/transaction vs 110bps on debit, and
        2. Factoring the receivables

    - Credit contribution to TPV dropped to 54% (9m 2020) from 58% (9m 2019) which drove a 5pp drop in net margin (PAGS reported 21% for 9m 2020). So, this points to a more profitable Q1, other things equal
- Very enthused on the opportunity coming out of Wirecard Brasil (Moip).

Group profitability

- The business is being run for growth and Pagbank investments (which cost the group 3pp net margin in 9m 2020) are pretty independent of macro. We thought this might be flexed for credit mix but if not, it means group profitability will swing mainly on Covid fortunes.
    - Note, running the business for growth is a good thing in our view
    - However, Brazil investors tend to be more focused on net margin, with weakness being something of a drag on the share price therefore (vs peers)
- Losses in Pagbank only forecast through to 2022 when it should be accretive
- Ultimately net margins should be in the ballpark of the Acquirer business, subject to execution on NPLs. If better, margins can come in ahead, likewise could dilute if don't execute well on lending.

Target to USD 69 from USD 64

- Our valuation on Initiation included the net cash position of PagSeguro
- Based on subsequent interactions with the market, we now think it is fair to also include the net balance of receivables over payables
    - Note, this valuation methodology is one which Stone explicitly points the market to (while PagSeguro does not)
- The receivables book for PagSeguro results from it factoring receivables for instalment payments, the revenues (financial income) from which make up over 30% of total group. The obligations sit with the issuer banks – and not the merchants - with Itau, Bradesco and Banco do Brasil being the biggest lenders. As such, these are very low risk cash flows.
- The average duration of the receivables is just less than 90 days i.e. reflecting average instalment periods of 3 months, versus a potential maximum of 12-month instalment plans offered.
- We make no other changes to our valuation other than the net cash position

Chart 1: PagSeguro SOP - target from USD64 to USD69

USD million	Metric	Forecast	Multiple	100% EV	% of EV
Payments	Acquirer TPV 21e	38,747	0.45	17,436	81%
Pagbank	10% premium to precedent			4,073	19%
Total value				21,509	100%
2021e net cash (inc net receivables)				1,186	
SHOUT, millions				329	
Equity				22,695	
Value per share				**69**	
Price				55	
Upside				**25%**	

Source: New Street Research estimates