

Q2 2019 Earnings Call

Company Participants

- Bruno Cals de Oliveira, Chief Financial Officer
- Guilherme Nahuz, Investor Relations Director

Other Participants

- Samuel Alves, Analyst
- Unidentified Participant
- Vinicius Figueiredo, Analyst
- Vinicius Ribeiro, Analyst
- Yasmin Brandao, Analyst

Presentation

Operator

Good morning. Welcome everyone to Hapvida 2019 Second Quarter Results Conference Call. Today, with us we have Bruno Cals, CFO; and Mr. Guilherme Nahuz, Investor Relations Director. We'd like to inform you that this event is being recorded, and all participants will be in a listen-only mode during the Company's presentation. (Operator Instructions)

Today's live webcast may be accessed through the Internet address at www.hapvida.com.br/ir. Before proceeding, let me mention that forward-looking statements are based on the beliefs and assumptions of Hapvida management and on information currently available to the Company. They involve risks, uncertainties and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions and other operating factors could also affect the future results of Hapvida and could cause results to differ materially from those expressed in such forward-looking statements.

Now, I'll turn the conference over to Mr. Bruno, who will begin the presentation. Mr. Bruno, you may begin your conference.

Bruno Cals de Oliveira {BIO 21030463 <GO>}

Good morning, everyone. Thank you so much for your presence in this conference. We're very happy to talk to our shareholders in the market about our second quarter 2019 results. Recent months were very intense at our Company and we've experienced a breakthrough. Our operations in Joinville in the state of Santa Catarina was the first and

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the South region of Brazil and it's now working completely with a verticalized structure with a general hospital of high complexity procedures, two clinics, and two diagnostic units. In May, we started the acquisition of the Sao Francisco Group, one of the main companies for private insurance in Brazil. They had a high operational performance and we also acquired the Cariri hospital in Juazeiro do Norte, state of Ceara, to expand our operations in the Northeast region of Brazil. This hospital is being operated by Hapvida since August 1st, 2019.

In July we announced the acquisition of America Group in the state of Goias with hospital diagnostic units and others. And then we acquired RN Saude in the state of Minas Gerais. These transactions help us to expand our geographic position and give us leadership in number of members in Brazil. More importantly, these acquisitions are complementary to each other and they will help us develop our business model in other regions of the country. This generates synergies within Hapvida and synergies within the companies acquired. In July we issued debentures in the value of BRL2 billion and growth of five and seven years, which contributes to a better capital composition for our Company. We acquired the AAA rating from Fitch Ratings, which confirms Hapvida's healthy condition. In July we finished the acquisition amounting for BRL2.6 billion. With these resources, these proceeds will reinforce our own network and the companies that were recently acquired by our Group.

Now I'd like to give the floor to Mr. Guilherme Nahuz, our Investor Relations Director, who will give you further details about our 2019 second quarter results.

Guilherme Nahuz {BIO 16728154 <GO>}

Thank you, Bruno. Good morning, everyone. I know that you want to ask your questions so I'll try and be brief during my comments. The presentation is available at our Investor Relations website. So let's go to Slide Number 4, you see the evolution of our member base for healthcare and dental in the last 12 months. So June 2018 to June 2019, you see a robust growth both in health and dental. In health, we had a 6% growth. According to ANS, the national private health insurance agency, the industry grew 2% approximately and we grew 6% in healthcare. In the right-hand side, you see that we have continued growth in our dental member base so 8.8% growth and if we look at the rest of the industry, the growth was of around 5.7%. So, Hapvida is outperforming the market both in healthcare and dental and we continue to gain market share.

In Slide Number 5, you can see the average ticket amount for healthcare and dental. In healthcare, we had an 8.5% growth, similar for the collective plans and individual plans. And on the right-hand side, you can see the average ticket amount for dental so a slight reduction of 2.6%, but there was a change in mix. We had an increase in emergency tickets, which have a lower average ticket amount than the full product. Now on the next slide, you can see the numbers regarding our own service network. Our service continues to grow. We finished the quarter with 27 hospitals at 1,873 beds. This growth is due to the new hospitals that were acquired and started operating and also with -- due to the expansion of the number of beds of our existing hospital units. We also finished the quarter with 19 walk-in emergency units, 82 clinics, and 88 diagnostic units. So, you can see that our own service network continues to grow.

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This is the largest own service network in the North and Northeast regions of the country and now we're also going into other regions with Greenfield operations as well as acquisitions already announced to the market. In the second quarter this year, we started the operations of the General Hospital in Joinville as Bruno mentioned and we also opened seven new clinics, three of them focused on preventive medicine. This is pretty much aligned with the Company's objectives of expanding the programs of coordinated care, preventive care, and management of chronic patients. The main goal is to improve the quality of life of our members and contribute to a good control of medical loss ratios in the long term.

In Slide Number 7, you can see our medical loss ratio chart. So, we changed the way these numbers are presented. Now we are also considering total medical loss ratio, which includes all movements of provisions during a period of time, including IBNR incurred but not reported claims as well as SUS reimbursement provision. So, the total medical loss ratio was 59.9%. So, an improvement of 1.1 percentage points compared to the same period of 2018 so second quarter of 2018. When we look at the medical loss ratio, excluding IBNR and including SUS, the public health care system reimbursement provision, then we see a slight increase of 0.5 percentage point. This has positive and negative impact on the quarter. The earnings release has a detailed section on that. The second quarter of 2018, we experienced a few events that were not repeated in this quarter.

On the right-hand side, you have a table showing you the medical costs at our Company. First, we have the cash cost and then the total medical and hospital costs for reconciliation calculations of our medical loss ratio. Slide 8 now. Let's look at net revenue and gross profit. On the left-hand side, we have a chart about our net revenue. You can see that the trajectory of strong growth continues. We had a 15% growth in the second quarter as well as in the whole year, accrued numbers. So we're talking about an increase in the number of members, an increase in the average ticket as well as price adjustments that were implemented and that were needed for this economic balance of our contracts.

In Slide Number 9, you can see charts of the selling and administrative expenses, so the cost of acquisition on the left-hand side and the administrative expenses on the right-hand side. We've had a 10.1% change in our selling expenses -- level of our selling expenses, which was pretty much the same as compared to the second quarter of 2018. The main variations that impacted these numbers that you see on these charts can be found on the earnings release. But you can see an improvement in the accrued numbers, significant improvement actually.

On the right-hand side, you see the administrative expenses. Once again, this is the reason -- the ratio between the total of our administrative expenses and net revenue. So it was 10.3% in this quarter, which is compared -- comparable to 11.1%, which was our results for the second quarter of 2018, a significant reduction of 0.8 percentage points compared to last year.

In the earnings release, you'll find the main positive and negative impacts during the second quarter, as well as the positive and negative impact of the second quarter of 2018 for a very fair comparison. The most important point here is that the Company has been

showing its ability for operational leverage and its capability of reducing the ratio of administrative expense -- expenses consistently. So when we compared these periods, we can see a reduction in the rate and a slight increase in the current semester. In the earnings release, you will find more details about that.

In Slide Number 10, you will see charts about the EBITDA and net income of our Company. EBITDA went through strong growth in the second quarter of 2019 compared to the first quarter of 2019, accrued numbers as well, very good, over 10% growth. And we can also see the EBITDA margin there, which is a consequence of the factors that I already mentioned. On the right-hand side, you can see net income and net margin with significant growth comparing the same period and accumulated numbers with around 20% growth. And in Slide 11, you can see our free cash flow and CapEx charts. A strong cash generation over BRL22 million, more than double the cash generation of the second quarter of 2019. And on the right-hand side, you can see our investments CapEx. This is mainly due to the expansion or building of hospitals, clinics, and labs.

Well, that's all. We're now open for questions. Thank you very much and have a great day.

Questions And Answers

Operator

Thank you. Ladies and gentlemen, we'll now start our Q&A session. (Operator Instructions) Mariana Hernandez from Credit Suisse has the first question.

Q - Yasmin Brandao {BIO 20355084 <GO>}

Good morning, everyone. This is actually Yasmin. I have two questions. First of all, can you tell us about the sales at Joinville? Do you have anything new in your portfolio? Now the second question, can you give us further details about how much of the cost of Joinville is considered variable cost and how much is fixed costs so that we can plan ahead for the rest of the year? Thank you very much.

A - Bruno Cals de Oliveira {BIO 21030463 <GO>}

Hi, Yasmin. This is Bruno. Thank you for your question. About Joinville, our sales are within the predicted levels. We started selling only on the 1st of May and the hospital's operations have started on April 25th. Our sales team started working on the 1st of May. So, this is always in the predicted levels. We've been talking to potential customers who have come to visit our units and they are really liking what they see. Some of you have been there and you see that we have a very modern operational unit there. So, always in the predicted levels. Throughout the next months we intend to add contracts with larger companies, companies with over 5,000 lives as well as individual contracts, but this is all within the expected levels for this period of the year considering that we started sales on the 1st of May.

I cannot give you the exact data of our -- that operational unit because our release is only about consolidated costs. But what I can tell you though that generally speaking,

approximately 80% of the cost of our own service network are fixed costs. So these are physicians, rent, water, and power; this is basically fixed as well nursing, administrative personnel. In the beginning of the operations you have a higher percentage that will impact the revenue of that region, but in a consolidated manner that would account for about 80%. In the next years, we expect Joinville to join the same level of operations of our -- the other units we have in the regions of North and Northeast of the country.

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Q - Yasmin Brandao {BIO 20355084 <GO>}

Okay. Thank you very much.

Operator

Next question by Thiago Macruz from Itau.

Q - Vinicius Figueiredo {BIO 20592660 <GO>}

Good morning, everyone. Thank you for having my question. My name is actually Vinicius. My first question is about the organic growth in your member base. What are the main drivers of this organic growth for? Is this more related to a growth in market share or a growth in the corporate market in the regions you already operate or this number can also be boosted by the North and Northeast regions in which you're starting operations? And can you also comment on collective ticket adjustments? What was the behavior in recent months? Thank you very much.

A - Bruno Cals de Oliveira {BIO 21030463 <GO>}

Hi, Vinicius. Thank you for your question. This is Bruno speaking. Organic growth, when we look at the North and Northeast regions, the economic environment there has not started to improve as in other regions. In the South and Southeast regions, we see a better employment level; but that does not apply to the North and Northeast regions yet. We've been growing there by growing our market share basically in cities we already operate like Salvador and we've been also going into new regions. I've just announced our hospital in Juazeiro do Norte, which has already started operations. Our sales team is working hard in this region, which is a new region for Hapvida in the North and Northeast part of the country.

So talking about the next 12 months, we'll have a few drivers that will impact our growth. First of all, the economic scenario. We'll have to make sure if in the next 12 months we'll start to see a better employment level in the North and Northeast regions, which we expect to grow to be better. So, it is really important to start our operations in new cities there and after the acquisition of our companies, we'll have a better platform to start selling more in those locations and do what we do best, which is to implement our business model and grow in each location that we start operating. So, this is the plan for the next 12 months.

Now about the collective ticket that you asked, I was talking to the Guilherme about that earlier today. We've been working hard with our relationship team and our pricing team to find alternatives that we can use so that we don't overwhelm customers with price

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adjustments. One of the alternatives we found was to start co-participation in our plans for customers that are already part of our member base. In June 2018, approximately 34% of our collective healthcare customers had some type of co-participation in their products. And in June 2019, this number was 37%. So in one year we can see a change, which shows how much we've been working to insert co-participation and decrease readjustments for our customers. We know that we had double-digit readjustments in the last few years, as you well know, based on our Company numbers. So, the ticket readjustment was a bit smaller this time, but the medical loss ratio was really, really good. Considering that we have new units, Joinville with its high complexity unit and this reclassification of expenses for cost of BRL3.6 million, and our loss ratio was around 69%, which is a very good result in our opinion. So, ticket readjustments were not as high as in recent years, but we are trying to work with co-participation, cross-selling of dental plans, franchisee program. So, we're trying to find alternatives for our customers so that we can have a long-lasting partnership with them. This will help us to control costs and keep our profitability level.

Q - Vinicius Figueiredo {BIO 20592660 <GO>}

Thank you very much Bruno. That was very clear.

Operator

Moving on Vinicius Ribeiro from Bradesco.

Q - Vinicius Ribeiro {BIO 18631644 <GO>}

Good morning. About MLR, Bruno, if you look at 2019 as a whole, can we expect improvements in MLR? Because Joinville will start diluting these numbers more from now on because of the fixed costs. Now, have you presented any gains of scale? Are you expecting the MLR to improve in the rest of 2019? That's my question.

Now I have a second question, which is also related to another one that you already answered. Looking at the North and Northeast regions, the 2019 evolution of sales, is that aligned with your plans that were defined in the beginning of the year or are there any major changes?

A - Bruno Cals de Oliveira {BIO 21030463 <GO>}

Hello Vinicius. Thank you for your questions. When it comes to MLR, as you know, we don't provide -- we don't have any type of guidance for the future, but we'll continue working hard to keep the same levels, having the best MLR in the country as we've had in recent years. I cannot tell you exactly what these rates will be for the whole of 2019 though. Now from the commercial perspective, the first quarter was below our expectations. Our commercial team is working hard and then April was a bit better, May even more and June was great. So, we were able to recover from the low numbers of the first quarter and we were able to achieve the targets defined for the first semester of 2019. So, the second quarter was better when it comes to sales, and we're working hard to continue with this performance.

Q - Vinicius Ribeiro {BIO 18631644 <GO>}

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Thank you very much, Bruno.

Operator

Next question by Samuel Alves, BTG Pactual.

Q - Samuel Alves {BIO 18720076 <GO>}

Good morning. Bruno, Guilherme and everyone. I have two quick questions. The first one about the organic growth. You've talked about it about having a higher level of sales in Joinville. But can you comment on the July performance? And qualitatively speaking, does it make sense to see -- I mean, to have a higher growth of the healthcare member base in the second quarter of 2019 compared to the first quarter of 2019? And also can you comment on the evolutions in churns, both for individual and corporate plans in the second semester?

A - Guilherme Nahuz {BIO 16728154 <GO>}

Thank you for your question, Samuel. Well, we cannot give you any guidance about the second semester of 2019, but we forecasts -- we forecast growth that -- growth rates that are aligned with our numbers. So we cannot give you any specific numbers for the second semester, and we cannot give you any numbers about June, because this release will be made only 45 days after closing. But what I can tell you is that we're going to work hard for the second semester, and we expect to keep the same levels of growth that we've had historically.

In terms of churn, we don't see any structural change. Companies have stopped to make major cuts of their employees. So we've seen the traditional churn or turnover in companies, both for the collective healthcare plans and the individual healthcare plans. So there was no major impact on our healthcare and dental plans due to that.

Q - Samuel Alves {BIO 18720076 <GO>}

Okay, thank you very much.

Operator

Now next question Rafael Bajos [ph], Santander.

Q - Unidentified Participant

Good morning, Bruno and Guilherme. Can you give me further details about the acquisition process? And what can we expect from now on of the synergies between the groups?

A - Bruno Cals de Oliveira {BIO 21030463 <GO>}

Hi, Rafael. Thank you for your questions. I'll give you an update about our acquisitions. First, about the acquisition in -- of the Sao Francisco Group. We've received ANS' approval for this acquisition, and we've received the approval of the General

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Superintendent at CADE for this acquisition. But the law says that after the General Superintendent approves, you need to wait for 15 days, because the Board may require a revision. But these 15 days have been suspended by CADE, the Administrative Council for Economic Defense, so we don't know when this will be approved by the Organ. And on August 25th, we're going to have our General Assembly, which will decide on -- and discuss the approval of all these acquisitions.

The America Group, while this acquisition is still being analyzed by the ANS, the national regulatory agency for private health insurance plans, and CADE, the Administrative Council for Economic Defense, while it has already been approved by its General Superintendent and it's been published in the official newspaper. RN Saude was the last acquisition announced. We've already sent the application to CADE, but we haven't sent it yet to ANS, so this is probably going to take a while. Now the general hospital of Cariri. This is a hospital unit, so it does not need ANS approval, and because of the size of the acquisition, it does not need CADE's approval either. So, we're starting our operations in the city of Juazeiro do Norte in Ceara already. So these are the updates of our acquisitions.

I cannot tell you exactly when we're going to get the approvals and benefit from the synergies of our acquisitions because of that. So, we still need to wait for the next steps in order to define when we are going to start operating with those companies and start implementing our integration plans.

Q - Unidentified Participant

Okay. Thank you very much.

Operator

(Operator Instructions) Thank you. If there are no further questions, I'd like to give the floor to Mr. Bruno for his closing remarks.

A - Bruno Cals de Oliveira {BIO 21030463 <GO>}

I would like to thank you all for participating in our conference call. Our Investor Relations team is always available to you, if you have any other questions about our results or about any other information regarding our Company, just get in touch. Thank you once again and we'll continue to work hard in order to deliver excellent results in the next quarters, as just like we had in the second quarter of 2019. Thank you very much, and have a great day.

Operator

Thank you. This concludes today's presentation. You may disconnect your line at this time, and have a nice day.

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