

Q2 2017 Earnings Call

Company Participants

- Grace Cury de Almeida Gonçalves Tourinho, Chief Financial Officer, Chief Operating Officer & Investor Relations Officer

Other Participants

- Bruno Giardino, Analyst
- Joseph Giordano, Analyst
- Luciano Campos, Analyst
- Marco Calvi, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Thank you for standing by. Welcome to the Conference Call of Qualicorp to announce the results of the Second Quarter of 2017. Today with us, we have Ms. Grace Tourinho, CFO and IRO and Mr. (0:22), IR Manager.

This event is also being broadcast live via webcast and may be accessed through the Qualicorp website at www.qualicorp.com.br/ir and an MViQ platform at www.mviq.com, where the slide deck is available. We also inform that this conference call is being recorded and participants will be connected in listen-only mode during the company's presentation. Afterwards, we are going to start the Q&A session when further instructions will be provided.

Now, I would like to turn the conference over to Ms. Tourinho, who is going to open the conference call. Please, Ms. Tourinho, you may start.

Grace Cury de Almeida Gonçalves Tourinho {BIO 17244138 <GO>}

Good morning, everyone and thank you very much for your presence. I would like to open this conference call, emphasizing the consistency of our operations. Consistence, which right now is more evident because of the evolution of our results. However, I need to reinforce that this work did not start and does not finish now. It has always been very much focused in meeting the real needs of our customers.

There are many improvements that have been implemented over the past few years with the support not only of management but also of our entire staff. I don't know if you remember, when I started three years ago in the company, those of you who has been following our performance for more than three years, I did not join as CFO. I was in the

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operation and I had many opportunities of improving not only control, automating, but along this time and everything that we have delivered gradually was improved by (02:38) our results but always focusing on meeting and we always wanted to invest in meeting more and more our customers' needs.

This is very important to emphasize because this is continuing work that we have been doing in the company. Likewise, this is not the end of it. We still have more to do. We know that the company has the condition to deliver even more value to our customers, employees and shareholders.

Let us now focus on Qualicorp's performance in the second quarter 2017 and year-to-date for the first six months of the year. Going straight to slide number 3 where you can see our main indicator, we have obtained an adjusted EBITDA margin of 46%, a growth of more than 5 percentage points over the second quarter of 2016 and very close to the first quarter in this year with the total EBITDA of BRL 236 million.

This is the result again of consistent work aiming not only at the reduction of cost and expenses, but also sales which is the company's DNA and the provision of services that are best suited to our customers that will effectively add value and keep the customers in hold.

Another important highlight is all investments that we have made to keep the customers with us, to retain customers because it's much more difficult when there are new sales. Another part of this point is that we're still generating cash even in a quarter when we pay interest that relates - relative to our debentures and also paid out dividends to our shareholders. And since the beginning of the year, we have been able to reduce our net debt by more than 62%.

Now moving to slide number 4, in the evolution of our portfolio, it's important to highlight the gain in direct sales of 25,000 lives which did not involve CapEx. That's why it is booked in the line of additional sales. We started having these as of June 2017 and it should be seen as something extraordinary. At the time of the long crisis we have been going through, it's normal for us to have these specific gains, such as what we had in the third quarter of 2016.

In this manner, organic sales are a bit low last year, especially because of higher prices and the macro scenario that is even more difficult. We have had a more greater share in the health club accounting for 30% of our portfolio with the growth as compared to the same quarter last year. The churn has suffered the impact of a low of less 18,000 lives when the company made the decision of bringing the operation in terms of in-sourcing it.

In the past, we had an outsourced manager for our health club and in-sourcing this operation made it possible for us to save BRL 15 million. We have two objectives, not just providing services to this group of customers that have been growing in a differentiated way, but also in terms of having an adjustment in improving the positive margin of lower cost products.

This had been our decision when – and in in-sourcing the portfolio, we saw that we needed but to terminate 18,000 lives. This is also one-off effect. We don't have any other outsource portfolio that will have this type of reduction that is significant as we had this quarter. But it's very important to explain both in terms of added and excluded lives so that you understand the company's churn and sales expenses that will have an impact in our bottom line.

Lastly, this quarter, we have had a reduction of 4,000 lives. We understand that is a difficult time for sales and customer retention and we are working on developing alternative product preparing and communicating our customers about adjustments in order to assure a healthier portfolio and to keep this always under control. This is something that we do every day. No one in this company likes to make adjustments just for the sake of making them. Price adjustments present a faster growth in our customer base. We're still analyzing the market closely and we are open to good businesses, including the second alternative for the company's growth.

Now, moving to slide number 5, net revenue in this quarter, we have had a consolidated growth of 8.4% year-on-year, and again, showing the resilience of our business in spite of the increases of PIS and COFINS through taxes over the broker's gross revenue with an impact only in June 2016. A 1.1% increase in the segment is due to the higher revenue of Affinity because of the increase in sales volume.

Another point that we need to take into account in analyzing the second quarter of 2017, is number one, the loss of corporate contract of SMB both when we compare year-on-year and the two quarters in a sequence. So we had a business that was maturing during 2016 and consolidated all deliveries in December. And this expansion is being booked now in 2017, now that we have the full year of all deliveries that was done in the previous period.

Now moving to the slide number 6 on costs, the gross margin of the second quarter of 2017 of 76% has grown, if we compare year-on-year and the sequential quarters, considering that we've not had any significant impact of relevant terminations as we had in Q1 2017. Reduction with expenses with personnel, both year-on-year and in the two quarters in a sequence. The annual increase in terms of financial transfers is basically the effect of the adjustment in our portfolio.

In the chart below, to the left, we demonstrate quarter-on-quarter margin and growth results year-to-date over the past 12 months, thereby eliminating seasonal effects and emphasizing the evolution the company obtained and once again, the consistency of the work that we are doing. Every time we talk to you, I always ask you to look at the past 12 months which shows our long-term work, not just one quarter.

Now moving to admin expenses on slide number 7, we can say that admin expenses have gone down, both in comparative terms, as well also compared to the previous quarter. Just as in the line of cost, we have had a significant reduction expenses with personnel. If we consider all cost with personnel, administrative sales and cost, we have had the savings of more than 11% comparing with Q1 2017 and 13% when we compare it to the

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second quarter of 2016, once again hoping to deliver more and more improvement to our customers. We have built many controls that were first manual and then we had IT. And as we delivered everything (12:07-12:12) so that all the deliveries that we made have helped us to reduce personnel expenses.

Outsourced services, here we had a slight increase if we compare year-on-year and this especially due to IT expenses which I wouldn't call expenses but rather investments in IT. And also in terms of tele services, which are necessary for us to provide better services to our customers.

About expenses with occupancy, here, we have managed to save even more. If we add the lines of administrative and commercial costs compared to Q2 2016, we have been able to attain a 24% reduction explained especially due to the moving of three (13:05) companies to (13:06). We have reduced mostly amount of our rent and we returned in October 2016 seven floors of our head office in São Paulo.

In addition to that, we have also been able to save even further with condominium and utilities expenses, which have helped us to deliver these numbers. With all these savings, we have been able to gain almost 3 percentage points in the margin, if we compare year-on-year. Again, if you look at this chart that I really like - on the right-hand side, lower right-hand side, we highlight the continuous gain in margin in the past 12 months, which is the result of the effort that was made, not just by management but all employees of the of the company. And here again, there is an initiative that we call GMD which is expense cross-sectional management. And they are the main safe keepers of expenses. There are people in the company who look very carefully line by line of our financials, 12 people very much focused and have done extraordinary work. And part of the result that we are delivering are precisely the result of this very minute work that is being done internally by these great champions of savings.

Now, going through the line of sales expenses on page 8. Historically and the second quarter is always our best time for sales in the year. In this manner, we understand sequential increase is something that is totally seasonal. If we compare to the second quarter 2016, we have gained more than 3 percentage points in margin, a result of the more efficient use of the funds for sales purposes focusing on our target customers through the Internet and other medium.

In analyzing specifically the expenses with commission to third parties, they grow both sequentially because of higher sales, as well as compared to the second quarter 2016 in spite of few organic sales but because of the adjustment of 2016 and prices are planned with a direct impact in commissions. On the chart, that is also my favorite, when you look at year-to-date numbers past 12 months, there is a gain in margin that exceed by 4 percentage points in 12 months. It's important to emphasize here that we are not afraid of investing in more campaigns and sales incentive if necessary. But we will definitely seek this in the most assertive and efficient manner possible.

Now, moving to slide number 10, when we have that provision for bad debt which was in a similar level as the previous quarter, and if we say it as a percentage of the revenue, at a

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level very close to what we delivered in 2Q 2016. We emphasize the seasonality of our business with the peak in the fourth quarter, especially because 70% of our portfolio is adjusted in July.

But also, we highlight the internal effort that has continued to reduce the fall (17:00) rates and we are much closer to our customers and we offer options to them in addition to a termination, and we make them effective if they so wish. It's important here to highlight that on May 10, the Normative Resolution 412/2016 that obliges the company to make effective immediately the cancellation of the plan and when requested by the customers.

In this manner, the company has been cancelling immediately when customers so request even with refund or reimburses for customers who are not covered.

Now going to other operational revenues and expenses, this quarter we have had the one-off effect in this group of expenses. In May 2017, we wrote off the values receivable from Potencial

in the case of sale in 2016 and we had the maintenance of a minimum quantity of lives in this portfolio. In this manner, we had a negative net effect that was extraordinary, of BRL 28.4 million of which - BRL 40.6 million of write-off in accounts receivable and BRL 12.2 million of deferred taxes.

Now, going to slide number 10, in financial revenues and expenses, basically here, once again, there has been few changes on the slide. This is a reminder the BRL 8.8 million is monetary update referring to the 25% debt we still had to pay after the purchase of Aliança. We emphasize that this corresponds to about BRL 250 million in 2Q 2015 and this acquisition will be completed in the third quarter of 2017.

Still, regarding financial expenses, as we pay interest rates of the debentures amounting to more than BRL 40 million in 2Q 2017, we have had few expenses referring to this monetary correction,

and we had that in the November 2016

Now moving to slide 11, regarding EBITDA, we have capped EBITDA level of the past quarter, growing 23% as compared to the second quarter of 2016. Year-to-date numbers in 2017, we have been able to exceed in the last 12 months where we were greater by 24.5%, while we seek to demonstrate that the work that we are doing is continuous and consistent and doesn't depend on external factors.

In this manner when we report our EBITDA in this chart, we compare it to previous periods. We are discounting the effect of the loss with Potencial and the gain with the sale. If we do that in the chart with the last 12 months, you can see clearly the trends of the operations that is increasingly more efficient, gaining margin by its own merit.

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Now moving to slide number 12, this is the net income. The reported net income considered the negative net impact of BRL 28.4 million regarding the losses with Potencial. When we compare with the result of the first half of 2017, we should consider that last year we have a tax gain of BRL 137.7 million, which was booked in the first quarter of 2016, meaning our recurring net income has also been growing in 2017.

Our tax rate closed the second quarter of 2017 at 33% in contrast with 40% if we compare the quarter of 2016 taking out the one-off effect of the taxes that were booked in the first quarter 2016, thereby showing the dedication, that hard work that we have been doing in our company to create an operation that is increasingly more efficient.

Moving now, going to slide number 13 about CapEx and our capital structure, the highlight here is the reduction of more than 72% of our net debt after continued cash generation. We should be reminded that in the second quarter of 2017, we paid out dividend regarding the second half of 2016. There were no relevant investments neither acquisition of portfolios. The acquisition of Uniconsult (22:46) that we announced last quarter still waiting for approval of regulation agency.

Now, going to cash flow on slide 14, the operation of cash flow has a (23:02) CapEx of more than BRL 68 million in the quarter which is below last quarter. It's due specially to the payment of interest rates that we did this quarter, this interest rates of debentures and also a profit sharing payment for our staff, another smaller amount that we'll pay this quarter.

With regards to the return on invested capital, it's been growing and it has reached the rate of 48% which is a reflection (23:37) of the maturity of the investments that we have made in the company.

Lastly, I would like to open for questions and answers.

Q&A

Operator

Thank you. We are now going to start our Q&A session. The first question comes from Mr. Marco Calvi from Itaú BBA.

Q - Marco Calvi {BIO 19854632 <GO>}

Hello. Good morning, everyone. My first question regards churn. In the scenario that organically speaking, slightly more difficult this quarter, could you give us some color in terms of what you're seeing for the rest of the year for the third and fourth quarter, then more specifically for the third quarter when there will be adjustment? What is the scenario of sales? Could you share with us what will happen in terms of gross sales and churn especially now on the next quarter?

A - Grace Cury de Almeida Gonçalves Tourinho {BIO 17244138 <GO>}

It's really a difficult question to answer. If we say that the economy has been improving, but it's not as good as seeing a major evolution in sales. It is a major challenge for us internally, because our portfolio has to undergo major adjustments and this is in a consecutive way. No one here takes pleasure with adjustments. This has an impact on our sales and so adjustments that are delivered to our customers, we always wanted to be as small as possible.

We know things are not easy. We are being very honest. It's not easy to sell our products now at this time, but this is the company's DNA. It is a product that is necessary, everyone in Brazil knows how important it is to have good health plan, especially when families can have a health plan. And what we have been doing internally is to present new products, new opportunities in order as to meet our customers' needs and affordability.

So this is what we will be seeing over the next few quarters. We cannot assure this to you how successful we are going to be, but we are working in partnership with many different carriers to deliver, to present more attractive products to the market in order to attract customers.

With regards to churn, we have invested a lot, really a lot, especially retention of our customers, which is much more cost effective for us to retain our customers for longer and in meeting their needs as they might have difficulties in terms of paying.

So I believe that in spite of deterioration and the crisis, of course, we are going to fill it slightly more. But in July - (27:41) June and July, they tend to be similar and this July was similar to last year's July. I think that the peak is in August, especially because adjustments take place in July and no matter how much we tell our customers, not only the reason why it is necessary to make adjustments because we want to create a culture that our customers may contain the loss ratio. And unfortunately, the health carriers need to adjust prices because of a higher loss ratio. Now if we think of the next quarter, the month of July is very close to what we had last month in 2016.

Have I answered your question?

Q - Marco Calvi {BIO 19854632 <GO>}

Yes, you have, Grace. Thank you very much.

Operator

The next question comes from Mr. Luciano Campos from Bradesco BDI.

Q - Luciano Campos {BIO 16181710 <GO>}

Good morning, Grace and Pedro (28:50). Could you give us more details about the termination of lives from the health club, what was the rationale for that? And your savings, are they one-off or recurring? And also, could you tell us about other revenues and the behavior? Thank you very much.

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A - Grace Cury de Almeida Gonçalves Tourinho {BIO 17244138 <GO>}

(29:32), with regards to the health club, it's important to highlight that these 18,000 lives, they were not our internal decision. We analyze the entire portfolio, all the health club portfolio. And if we didn't bring in this operation, reductions could have been even greater. The objective was to receive the entire portfolio within Qualicorp, even the portfolio with a margin that we call that is even more reduced because of cost, so lower cost in the market. And it's important to highlight that these carriers, we internally decided not to work with them because of margin and also because of a combination of factors which was margin and geography which led us to reduce or to terminate these 18,000 lives.

A - Operator

This is Pedro (30:40). With regards to other revenues, there is a macroeconomic scenario which is not getting any better. So, if at the same time we're losing, these companies also dismissed their employees. So there is a reduction in lives, but their result is small as compared to the company's numbers. So obviously, we are paying attention. We do not like to lose customers or lives. But for the time being, our focus is still the same and that is the resilience (31:20).

Q - Luciano Campos {BIO 16181710 <GO>}

Okay. Thank you very much.

Operator

Second (31:31) question comes from Mr. Joseph Giordano from JPMorgan.

Q - Joseph Giordano {BIO 17751061 <GO>}

Good morning, everyone. Thank you for taking my question. My question regards regulation, usually they've peak in the third quarter and today you are obliged to cancel plans immediately. What has changed in terms of your retention strategy considering that these terminations to date takes place more immediately.

A - Grace Cury de Almeida Gonçalves Tourinho {BIO 17244138 <GO>}

Thank you very much for your question, Giordano. The company has been working for two years in trying to understand what is important for our customers. Oftentimes, it's not just important to reduce prices, there's a certain group of customers that still wants to have specific hospital or the specific network. And in understanding that the company has been transforming and our products in cutting on things that might not been so important for them.

For example, reimbursement. This is one of the things that we have been doing. What we usually do internally and this something we've been learning since June is to listen to our customers. We listen to our customers that complains that they had in regards to our day to day businesses, has let us to learn a lot and to improve the portfolio of products that we make available to our customers.

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So first of all, we have a wider array of products available that are best suited to our customers' needs and wishes. Secondly, the need of adjustment and the work that was developed with carriers and Qualicorp that we do on behalf of our customers and we do well in advance in order to show why there is a price adjustment and also preparing our customers financially speaking, so that it's not a surprise that they get an adjustment or a price increase in July in their plans and just out of the blue.

So the whole company is taking part, whichever is better suited to meet the needs of the customers with more up-to-date information and with shorter time, the time to transform and retain these customers and in meeting all other needs that they might have.

With regards to the provisional management that mandates us to cancel immediately whenever customers ask so, we sometimes say that we have other products to provide services to them. We want customers, whenever they leave Qualicorp, so that they know which product they will be finding in the product and what is the difference in terms of Affinity products, where they are today, to a product that they might be able to buy out in the market.

This is our obligation in terms of being very clear and providing very clear information to our customers and obviously, the decision belongs to them and they have the right to cancel and we are mandated to terminate it immediately if they so wish. So I think, in reality and being very honest, that this has been helping us as our customers used to call after the term of the contract and then we would report to the carriers if the cancellation took place in that month, sometimes forcing them to pay an extra month. Today, I don't have to do that and this was outlined to them, they didn't like it and it was necessary because of the balance in the company.

So in reality, Qualicorp, is forced to pay one month because we don't cancel them before the month of one month. And this is the cost Qualicorp needs to incur in. So today, we have opportunities of providing even better services to our customers without looking or sounding so unfriendly to them.

Operator

The next question comes from Mr. Robero (36:22) from the Bank of America.

Good morning, Grace and Pedro (36:26). My question regards the company's marketing and sales strategy. Are there any more relevant changes in the strategy? How do you see the quality of what you had been doing in terms of your leads? And looking into the future, if the environment for growth sales remains difficult, do you think we needed to make any adjustments?

A - Grace Cury de Almeida Gonçalves Tourinho {BIO 17244138 <GO>}

Thank you, (37:04). This is a good question. In reality, we've been monitoring our leads since last year. This has not dropped and in reality, we have a very specific target. And our customer targets today is much more, those on the Internet than those sitting down watching TV or the 9 o'clock soap opera. So if you see - many company hardly watch any

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TV today. They are more on Netflix and we need to adapt to all these changes, and this is basically what we have been doing.

I do not see in a short time span any changes in their strategy, in terms of us needing to make any major investments. But we pay attention and we will be monitoring and if necessary, we are going to make the necessary investments. And Pedro (38:09)...

A - Operator

This is Pedro (38:12) speaking. So today, this is much more related to affordability. So our sales is much more focused on developing products that are affordable and attractive to customers and we do that together with carriers. Investments today is not so important, the most important thing is to have affordable products to sell. We don't need to invest so much in our marketing campaign but rather on having good products to sell.

Thank you for your answer.

Our next question comes from Mr. Bruno Giardino from Santander.

Q - Bruno Giardino {BIO 15974970 <GO>}

Good morning, Grace and Pedro (38:55). Congratulations on your work. Now, that the second quarter is past, what you could do in terms of reducing personnel, I think that you have done most of what you could do.

Now, looking into the future, which are the focus areas for your work for the next 12 months? And I apologize, I know you mentioned this, but what was the average adjustment of your portfolio in July? Thank you.

A - Grace Cury de Almeida Gonçalves Tourinho {BIO 17244138 <GO>}

Bruno, thank you for your question. Our average adjustment in July was BRL 21.9 million. And with regards to cost reduction, I don't want to talk about cost reduction just for the sake of talking about cost reduction and this would not represent the result of our work. Just (40:11) you to understand we have always been much more concerned in paying attention at our customers and meeting their needs. We are spending more on what is important for our customers. Some things that are not important for our customers, we are cutting. So this is in fact greater efficiency.

Another thing in the past, three years ago when I joined the company, we launched many manual controls which have now been automated with the IT delivery. This delivery has not yet ended. We are right in the middle of what that has only just started. We want to meet the needs of our customers and to provide the best services possible to them. We want to keep them in with us.

So basically, the responsibility of our internal and champions in the company have the task of keeping our savings safe. And we want you to pay attention that when we're trying to understand the operation and going to details, yes, you can see opportunities are cut.

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Well, what we are doing - this is duplicity, this is not adding any value to our customers. And we found that there are other ways of adding value to customers, and this is basically what we have been doing and reviewing, our operations and what we saw in the past.

And we need to constantly revisit and to pay different attention especially with technology that is available to us. So if you ask me, Bruno, what else do you have to do, well, I will answer, a lot, a lot really. So today, not just me doing things because they are no longer in operation. So I am much more focused on financial department and Investor Relations. But there is work being done by other areas, operations, customer service. We never had a customer service director.

The company has been investing in looking at our customer service, very much concerned with them. Today, we have an executive officer centered and focused just on managing customer relationship. In the past, there was someone do two things at the same time. So, today, we have a much greater focus on customer relationship. And so, with efficiency, we have been able to deliver improvements. And in this manner, we have been able to face more efficiency and producing results to our customers.

Was I clear, Bruno?

Q - Bruno Giardino {BIO 15974970 <GO>}

Thank you. Very clear.

A - Grace Cury de Almeida Gonçalves Tourinho {BIO 17244138 <GO>}

Thank you.

Operator

Thank you. We are now closing our questions-and-answer session. I would like to give the floor to Ms. Tourinho for her closing remarks. Please, Ms. Tourinho.

A - Grace Cury de Almeida Gonçalves Tourinho {BIO 17244138 <GO>}

I would like to thank you all, especially those of you who have been following our company and all the results that we are delivering. Everyone really hopes that we go on working and we have very positive results in terms of delivering better and better performance. This is the result of teamwork and there are many people aligned around the same objective in terms of providing better services to our customers and in this manner we also improve our operations.

Thank you all very much and we'll keep working with the same pace.

Operator

The conference call of Qualicorp has now ended. We thank you all for your participation and then have a good day. Thank you.

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