Q2 2013 Earnings Call

Company Participants

- Eduardo Noronha, COO
- Wilson Olivieri, CFO and IRO

Other Participants

- Pedro Montenegro, Analyst
- Rafael Frade, Analyst
- Scott Hendrickson, Analyst

Presentation

Operator

Good morning, ladies and gentlemen, and thank you for waiting. Welcome to Qualicorp's conference call to discuss the results of the second quarter of 2013.

We have with us today Mr. Wilson Olivieri, the CFO and IRO; Mr. Eduardo Noronha, the COO; and Mrs. Natalia Lacava, the Superintendent of Investor Relations. This event is being recorded and participants will be in listen-only mode during the company's presentation, after which we will begin the question-and-answer session, when further instructions will be given. (Operator Instructions)

I would now like to turn the floor over to Mr. Eduardo Noronha, who will start the conference call. Mr. Noronha, you may proceed.

Eduardo Noronha {BIO 15227354 <GO>}

Thank you, operator. Good morning, everyone. I would like, once again, to thank you all for participating in our conference regarding the second quarter of 2013 results. As mentioned in previous calls, we started this year with a robust plan to capture internal gaps of efficiency and leverage our sales. And the results achieved in this quarter show the maturation of these actions and their respective impacts, some of them absorbed by the challenging macroeconomic environment under which we are living, and some of them clearly expliciting our numbers, for example, the record sales in this quarter.

In order to better qualify this effect, I would like to emphasize the following points. First, record of gross sales, as already mentioned, in this quarter we reached our historical record of gross sales, reaching 123,000 lives in our affinity segment, 38.5% higher than the first quarter of this year.

And second, our net adds grew 40% when compared to the first quarter, with 47,000 new lives. In this year, we have accumulated 66,000 new lives. Both our gross sales and the significant improvement in net adds are clear effects of our sales plan developed for this year.

Third, talking about expenses, we remained stable when compared to the first quarter, even having to absorb an increase of 70.6% in selling expenses as a result of the higher sales volume for the quarter. And fourth, the cancellation in delinquency rates remained in levels above the historical average, but we can notice a stabilization of their balance between first and second quarters of this year.

And talking about delinquency, I would like to highlight that, starting this quarter, we will demonstrate more detailed information will be shown by Wilson in order to facilitate the analysis of their origin. And finally, our EBITDA margin is stable when compared to the previous quarter in the same period of 2012, growing nominally 5.2% and 31.4% respectively.

I would like to point out that versus last year we absorbed 320 basis points impact of delinquency and specifically in this quarter, 225 basis points in selling expenses compared to the last quarter. Those negative impacts are offset by the efficiency gains experienced in this period.

Now, I will pass the word to Wilson that will follow with a detailed presentation of the results. Then after Wilson's presentation, I will return for the closing. Please, Wilson.

Wilson Olivieri {BIO 17325685 <GO>}

Thank you, Eduardo. Thank you all for being here with us today, as we really appreciate your support all along. And Eduardo has given you a few details on the pages one through four on the presentation, for the ones that are following us on our website presentation. So, kindly request you to move to page five, and where we are going to start by giving you a quick overview on the beneficiaries performance.

As you can see here on the bar chart on the left-hand side, still on our affinity segment, our compounded annual growth rate is running at 34.4%, which is very interesting at the current situation we are experiencing in the country. If we look at the corporate and others performance, we would see that going in the same period, which is about three years at a -- as levels of like 9%. Considering that we have approximately 1.4 million lives in the corporate and others that are TPA related, with the numbers starting flat, so all of this growth basically comes from organic sales on the corporate side.

On the pie chart on our right-hand side, you would see that still as in the past quarters, 60% of those lives are coming from corporate and others and approximately 40% of those lives are coming from the affinity segment. Although the affinity segment, as we all know, represents 91% of our revenues, but still in terms of number of lives the other segments of the company are also very relevant.

Moving please to page number six, we have a more detailed analysis on our lives, and as you can see here, in the health affinity segment, we basically grew about 40.2% when compared to last year, and almost 39% when compared to the quarter-over-quarter in the gross additions line.

As you note here, with 123,000 lives, as Eduardo mentioned, we actually had the historical record of the company in terms of gross adds, kind of going in the wrong direction when you compare to the current economic situation of the country. So, as you can also see here, in total affinity portfolio, we have added -- we have reached 1.8 million -- a little more than 1.8 million lives this quarter, which represented a growth of 23.2% when compared to the second quarter last year or even 3.3% with the previous quarter.

Finally, in terms of total number of lives, as you see here, we surpassed the mark of 4.5 million lives, so we have 4,532,000 million lives that we currently care, growing almost 13% versus prior year, and almost 2% when you compare to the previous quarter.

In page number seven, if we take a closer look at how much of these sales have represented in terms of net revenues, we will see that we reached almost BRL280 million this quarter in terms of net revenue, representing an increase of 32.3% when you compare to last year, and almost 5% when compared to prior quarter. The affinity segment, as we can see here, represented 250 -- almost BRL257 million in revenues, which is just at growing almost a 37% rate versus prior year.

As I mentioned on the corporate and others segments, although they have the vast majority of lives, like representing 60% [ph] of the number of lives, they actually represented about BRL23 million worth of revenue, showing an increase versus prior quarter and a decrease versus the same quarter last year, mostly due to the fact that we did have some new sales schemes in the same quarter last year, which we did not experience this year as well.

Overall, as I mentioned earlier, the important here is 32.3% growth in top line in the current moment of the country seems to be a very interesting growth level at this moment.

Looking at the next page, it's page number eight, we will take a look at the cost of service of the company. And as you can see here, our total cost of services increased 21.4% this quarter compared to prior year, and it's basically nominally flat when you compare to the prior quarter, showing, of course, the efficiency gains that we've been talking to you for a few months already.

Our gross margin with that performance has actually reached almost 75%, more specifically 74.9% in second quarter '13, meaning an improvement of 230 basis point compared to last year, and 120 points -- basis points compared to the last quarter.

This, of course, as we mentioned, is a result of the stronger cost control measures that we've been putting in place, which are mostly focusing on internal processes, and on the typical areas that are accounted for in this group of expenses, namely registration department, collection department, billing department, call center, and some of the IT maintenance of the current structure. So, as you all know, these areas are very much labor intensive, so this is what we have been able to extract a few basis points of savings due to the efficiency gains.

In the next page, number nine, looking at the administrative expenses, as you can see here, our recurring administrative expenses increased by 15.5%, which is very much in line with the orientation we constantly give you, which is our fixed costs, they should not increase by more than half of the increase in sales, so it is very much in line with that assumptions right now.

And if you compare to the last quarter, we actually show a nominal reduction of almost 4%. That, again, a result of some of the efficiency gains we are putting through the corporations here. As a percentage of net revenue, as you can see on the graph on this slide, we see the administrative expenses decreasing from 30.6% in second quarter '12 to a 36.7% [ph] of net revenue in second quarter '13. So, if we look at the last quarter, there was 29.1%, showing also that it has reduced.

If you were to exclude the depreciation and amortization expenses, which would be like a more reasonable analysis, we have shown a dilution in administrative expenses is still of 50 basis points compared to last year and 164 basis points compared to last quarter.

In page number 10, the next level of expenses, which is selling expenses. As you can see here, we have increased by 16.1% when compared to prior year, showing the leverage we have experienced on this indicator compared to the growth of net revenue of 32%, and again, due to a lot of actions that we have put together, especially on this line. When you compare to the previous quarter, however, you see growth of 17.6%, and as you all know, this is mostly due to our conservative accounting modes, and once we sell the lives, we account for those costs of commission right on the spot. So that means the record of sales that we experienced on the second quarter has actually affected our commission expenses on the same pattern for this quarter.

So, moving to page number 11, I think that the hardest issue of the company in the last few quarters. This is when we talked about the uncollectable receivables. And so, as Eduardo mentioned, in order to demonstrate a more accurate performance of the bad debt expenses to the investment community, we started to classify operational losses in an account called other operational expenses. So, therefore, we showed here on this table on page number 11, the reported amount and where we have reclassified to operational losses. So, that gives us a much better picture of what the actual bad debt expenses are representing on the company.

So, if you see on the bottom of the slide, where it says the bad debt breakdown, we actually show the recovering data that we have been talking to you for a few months, mostly coming from the collection agencies that we have engaged the company, which just so, by now we are engaging four collection agencies that has already increased the rate by almost 24% this quarter versus what we have been able to recover in the last quarter regarding bad debt payers.

In page number 12, where we see the other operating income, we also note here that it represented a BRL4.3 million increase when compared to the previous quarter, especially due to two factors. Number one, our operational loss regarding to Padrao migration of BRL12.1 million that we absorbed this quarter are part of this amount and they were partially offset by some reversal in accruals for contingencies of BRL8.3 million that became positive this quarter.

If you remember, we do have a lot of contingencies balances on our balance sheet coming from periods of 2008 and 2009, and as soon as these balances are maturing, they are no longer demanded by timing, so we write them off and that turns out to be a credit on our P&L.

So net-net, and by the way, some details on the Padrao collection issue, that refers to the accounts receivable and accounts payable balances that Padrao had with their operators, mostly Amil, that was the main provider of Padrao at the time, there was this difference that came from previous periods that we actually assumed this quarter, so right now the accounts receivable and payable between Padrao, Old Lives [ph], and Amil are literally zeroed out. So, we do not expect that to be repeated in the near future, as much as we might not have such big impacts on the reversal of accruals of like BRL8.3 million, they should come back to normal levels like we experienced in previous quarters.

In page number 13, we will give you a quick look at our financial income and expenses. And as you can see, financial income is a result mainly of two sources for us, interest on financial investments for cash available that we have, and interest and penalties from late payments of premiums from beneficiaries.

On the financial income coming from investments, we had two phenomenals when compared to prior year. Number one, the fact that the current interest rate for the country right now is well below what used to be last year. And number two, after the third quarter last year when we paid completely Padrao acquisition and we gave an advancement to Alianca, our balance for cash available for investments has been reduced, so that's why we saw a decrease of 35.7% on that specific line.

On financial expenses, below, however, it is important to highlight that we actually recognized an almost BRL35 million of monetary adjustment coming from Alianca and Praxis acquisitions, I would say mostly from Alianca.

As you all know, these balances adjusted on a monthly basis, and of course, resulting on the quarterly result we have here, coming from two main forms, that could come from two main forms specifically. One, it's a regular monetary adjustment due to the discount rate that we reviewed on a monthly basis and it has represented about 40% of this BRL35 million adjustment we showed.

And the second, which we do not review as frequent as we review the discount rate, is what we call the mark-to-market changes, especially on EBITDA estimates. So, with the current performance of Alianca, they seem to be moving towards a better EBITDA than what we have estimated so far, so once we acknowledge that they done IFRS and CPC, we have to recognize the increase of the amount we have to pay Alianca. That was supposed to happen early next year, more specifically April 14th, and we have been able to renegotiate for April 15 payment. So, having said that, this has generated 60% of this adjustment of BRL35 million on this line called financial income and expenses.

Next page, page number 14, we basically show our reconciliation between EBITDA and -- net income and our adjusted EBITDA. And as you can see here, consolidated adjusted EBITDA grew by 31.4% when we compared to previous period, and 5.2% when compared to last quarter, very much in line with our revenue performance. So, we changed a record level of BRL98.3 million of nominal adjusted EBITDA in second quarter '13. This growth, of course, a result of our strong increase in revenue, as we showed earlier, combined with the incorporation of Padrao and Alianca acquisitions that generated important operational improvements.

The EBITDA margin has reached levels, as you can see, higher than 35% this quarter, which is fairly flat when you compare to the second quarter '12, even considering that our bad debt line has increased by 3.2 percentage point, so imagine if we had to bad debt line in normal circumstances we would be looking at margins higher than 38% for this quarter, and the other operational expenses line, also with the BRL12 million hit that we received from Padrao increased by 160 basis points.

So, as we can see, evenly with those indicators we have been able to show a lot of operational leverage in other expense lines of our P&L, showing that we truly work hard in controlling costs and increasing the efficiency of the company.

Getting close to the end, a quick look on our adjusted earnings. As you can see, we reported a net income adjustment both in line of BRL1.6 million, which if we extract the effects of the BRL35 million adjustment from Alianca, we would be looking at an adjusted earnings of BRL36.6 million. That would be more than double than what we have experienced in the same period last year, representing a growth of almost 29% when compared to the same indicator last quarter.

Finally, as you can see in page number 16, our CapEx, we have invested almost BRL10 million this quarter in CapEx, as usual mostly in our IT platform development and we should expect this line to be a little bit more aggressive during the second part of the year, where we are pushing a little harder in terms of implementing our new IT platform on time, which is expected to happen late 2014, early 2015.

And finally, if not, I would like to give you a picture of our capital structure. As you can see, our total net debt has decreased from early this year by almost 16%, and the main reason for that decrease is, as we always say, the cash generated by our operations, which is fairly strong that has allowed us to have a total net debt in the company today of BRL373 million, meaning that we have a leverage, which is lower than one annual EBITDA. So, it's a very interesting leverage rate for the company.

So, having said that, I would like to turn back to Eduardo for his final considerations before the Q&A session.

Eduardo Noronha {BIO 15227354 <GO>}

Okay. Thank you, Wilson. Before we close the presentation and proceed to the question-and-answer session, I would like to emphasize that we are focusing in directing all resources we find to be need, working towards reducing delinquency and cancellations, our two main challenges in this period.

I also take this opportunity to communicate some changes in our organizational structure that shall take effect in this August. We will move from 12 Directors to five Vice Presidents. With this change we seek to further streamline our decision-making process, as well capture internal synergies, reducing interface areas. This is another step in the maturation of our business model and our governance too.

Thank you, and let's move to the answer -- question-and-answer session.

Questions And Answers

Operator

Thank you. We will now start the question-and-answer session. (Operator Instructions) Our first question is from Rafael Frade with Bradesco. Go ahead please.

Q - Rafael Frade {BIO 16621076 <GO>}

Hi, good afternoon, everyone. My first question is related to the average price that you have. Looking for the quarter, we saw a small increase in the average price, around 1% per affinity member, but as you already mentioned in some previous talks, most of your churn, or a big part of your churn is related to clients that have higher average ticket, given that they are in some cases they are increasing price due to being another age range, and also you are increasing more significantly for other regions, so all those factors would be expected to be reducing at least before the readjustment of new lives, you will be reducing your average price, so I would like to understand if there is any other reason that explain this increasing price Q-on-Q?

A - Wilson Olivieri {BIO 17325685 <GO>}

Hi, Rafael. Thank you for participating on the call. And well, the answer to your question is a little more complex than just a straight answer in the phone. We have some varieties in terms of brokerage fees, especially in the months whereby we sold a lot of lives, as you know, we broke the record. But I mean, technically speaking what I could tell you is we still see a high level of sales on SulAmerica products.

They tend to be the highest price levels on our sales force, and we also see Bradesco participating much more than historically on the mix of the sales, so they both represent sales of high price products. But I think in order to answer directly your question, we would need to be a little more detailed, but in the macro basis, they will be probably the main reasons why we would see a better price average this quarter than what we have seen in previous quarters.

Q - Rafael Frade {BIO 16621076 <GO>}

Right. Thank you, Wilson. Just a follow-up on some question on the Portuguese conference call. You mentioned that that sort of looking at this point, your best expectations for the year in terms of delinquency would be around 8.5%, 9%. This 8.5%, 9% compares with the previous, with the new way that you are showing, it's compared with the 8.1 in the second quarter or with the 7.6?

A - Wilson Olivieri {BIO 17325685 <GO>}

Yes, it is compared to the previous model, yet. We're probably going to let you know shortly how that would be on the new model. But the reason why we would like to stress that, at the time, the BRL12 million hit from Padrao, originally it was supposed to be accounted for on this line, and that's why we are showing it separately. So, aside the BRL12 million of Padrao, 8.5% to 9% would be on the old model aside that adjustment.

Q - Rafael Frade {BIO 16621076 <GO>}

Great. And again, just a follow-up. You also mentioned in the Portuguese conference call that you would expect -- still would expect improvement of 100 bps to 150 bps in margin for the year. This is considering the higher delinquency, right?

A - Wilson Olivieri {BIO 17325685 <GO>}

Yes, Rafael, that is correct. As we can see on the first half of the year results, I think we have been able to mitigate a little more than expected all of this growth on the bad debt. So, we'd still have a lot of strategies to be implemented during the second half of the year. Some of them have already been implemented in the first half. They will be maturing on the second half. So, our expectations of 100 basis points to 150 basis points increase consider bad debt at levels of 8.5% to 9%.

Q - Rafael Frade {BIO 16621076 <GO>}

Okay. Thank you, Wilson.

A - Wilson Olivieri {BIO 17325685 <GO>}

You're very welcome.

Operator

Our next question is from Pedro Montenegro with BTG. Go ahead please.

Q - Pedro Montenegro {BIO 17225319 <GO>}

Hi, good morning, everyone. So my first question is on the evolution of delinquency and churn rates following the record high price adjustment already implemented by you in July. While I would like to get an update here and know how the clients are initially reacting to this price hike, if possible. And the second point is related to Amil, another important players decision to stop selling individual plans. Well, if you could mention the impacts, you should have or maybe the impacts that I mean, decisions already having in your gross additions, it would be great? Thank you.

A - Wilson Olivieri {BIO 17325685 <GO>}

Pedro, thank you very much for being here with us. Thank you for the call. So the first question regarding the price increase effect. I would say that, as you will know, there are two main effects on that period that are seasonal for Qualicorp. So number one, we should of course, not expect the same records we've seen in terms of growth there from the second quarter in this during the third quarter. Prices are, on average, 13% to 14% more expensive than they used to be. So, we should definitely pick up to the same levels of sales of the second quarter, mostly towards the end of the year. But for the third quarter, we'd still see an interesting level of gross adds, of any gross sales, but of course affected by the price adjustment. We will not experience the same records we experienced in the previous months.

If we go now to churn, it's still a little early to say, because as we all know, bills were sent to our customers during the month of July. They did not pay us during the month of July, so we are going to go after them during the month of August. So, they might turn out becoming churn somewhere in September or in October. But the preliminary data that we have raised today shows that we are pretty much experiencing the same level of increase in churn as a consequence of the price adjustment as we have experienced last year.

So, to give you a very preliminary data like on the numbers we had reached so far, last year at the same time we have seen an increase of like 20% on the churn lives, and we are experiencing the same level of 20% at this point in time. I would not take that as a given number, because it is still too early on time. But one of the things that we have this year that we did not have before is the comparison on the early stage of the churn.

So, comparing on those indicators, we see that we have not had a bigger pressure this time than what we have seen last year. So, that is as far as we can go on that front.

Regarding the Amil plans, we believe that that will create a major opportunity for us to explore, and the reason why we believe that is because Brazilians that would buy individuals plans from Amil and Golden Cross will still need a medical plan. And once they will only find individuals plans in Brazil from Unimed System and from smaller operators, on the good brands, including Amil and Golden Cross, they would only have availability of products through Qualicorp.

And so, therefore, we strongly believe that we have a major opportunity. However, due to the current economic situation of the country, due to the levels of churn we are experiencing and the effects of this price adjustment of 13% to 14% that we have imposed to our members, we are not recommending anybody to increase their estimates for this year in terms of portfolio of lives. So we would recommend to stick with the 10%, 11% growth on affinity health lives for the year. And if we see that during the third quarter these numbers are showing some better push, we will, of course, let you know as soon as we learn that.

Q - Pedro Montenegro {BIO 17225319 <GO>}

That's great, Wilson. Thank you very much

A - Wilson Olivieri {BIO 17325685 <GO>}

Thank you.

Operator

The next question is from Scott Hendrickson with Permian Investment Partners. Go ahead please.

Q - Scott Hendrickson {BIO 16142394 <GO>}

Hi, good morning guys. Nice job on the top line there. My question is regarding the organizational change. Could you maybe give a little bit more color on what drove that? And also if there is anything more we can expect around the organizational change going forward over the next six months or so?

A - Wilson Olivieri {BIO 17325685 <GO>}

Hi, Scott, thank you very much for being here. Thank you for your compliment as well, and hopefully the first quarter of many with news like that.

So, in terms of our organizational structure, as you all know, since we had our CEO leaving the company November last year, Heraclito, that some of you had a chance to meet, Junior has been sitting on that chair and he has been actually looking for some of our own executives to basically run this business, and he gave himself a period of time like 12 to 18 months, which we are still within that frame.

So one of the things he has done is, he has given Eduardo, that who is here with us in the call today, the opportunity to basically stick and look over all of the areas of the company, until very recently that position was more like on a staff mode. So, right now he is in charge of all of the operations. And by reducing the number of people in the top line of the organization, we have actually given, not only Eduardo, but the whole structure of the company an opportunity to streamline all of the decision-making process.

So just to have an idea, as Eduardo said on his part of his speech, we had 12 Directors all going to towards one single person, so right now we have some of those Directors turn out to be Vice Presidents, some of those will remain at the more operational level. But with that we can make all of the decisions of the company right now in a group of six executives, excluding Junior; Junior would be the seventh, which makes this process much more efficient and much more effective, once you talk about a company that's growing at the pace that we are growing.

So we still have areas of responsibility, of people looking over sales, people looking over after sales, finance and administrative and IR will still remain with me, we also have any specific area they will calling technical area that will look after all of the other business lines that are no health products, such as TPA, connectivity, and health management, and what we've done is sales after 12 -- another responsible for all of our operational activities.

So having said that, we strongly believe that our decision-making process will be much more efficient from now onwards.

Q - Scott Hendrickson {BIO 16142394 <GO>}

Makes sense. Thank you.

A - Wilson Olivieri {BIO 17325685 <GO>}

You're very welcome. Thank you.

Operator

(Operator Instructions) This concludes our question-and-answer session. I would now like to turn the floor back to Mr. Eduardo Noronha for final remarks.

A - Eduardo Noronha {BIO 15227354 <GO>}

I would like to thank you all for being here with us today. As usual our IR area available to talk to you afterwards, if you feel some necessity, okay. Thank you.

A - Wilson Olivieri {BIO 17325685 <GO>}

Thank you all. Have a great day. Thank you.

Operator

The conference is now concluded. Thank you for attending today's presentation, and please disconnect your lines.