

Q1 2014 Earnings Call

Company Participants

- Carlos Lazar, Investor Relations Officer
- Frederico Brito e Abreu, Chief Financial Officer
- Rodrigo Galindo, Chief Executive Officer
- Unidentified Speaker

Other Participants

- Luciano Campos, Analyst
- Ruben Couto, Analyst

Presentation

Operator

Good morning ladies and gentlemen, and thank you for waiting. At this time, we would like to welcome everyone to Kroton Educacional's First Quarter 2014 Earnings Conference Call. Today we have with us Mr. Rodrigo Galindo, Kroton's CEO. We would like to inform you that this event is being recorded and all participants will be in listen-only mode during the company's presentation.

After the company's remarks are completed, there will be a question-and-answer session, at that time further instructions will be given. (Operator Instructions). Also today's live webcast, both audio and slide show may be accessed through Kroton Educacional's Investor Relation's website at www.kroton.com.br/ir by clicking on the banner 1Q14 Webcast. The following presentation is also available for download on the webcast platform.

The following information is available in Brazilian reais, in accordance with Brazilian's Corporate Law and Generally Accepted Accounting Principles, BR GAAP, which now conforms with International Financial Reporting Standards, IFRS, except where otherwise indicated. Before proceeding, let me mention that forward-looking statements are based on the beliefs and assumptions of Kroton 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 the company and could cause results to differ materially from those expressed in such forward-looking statements.

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

Rodrigo Galindo {BIO 17238232 <GO>}

Good morning everyone and welcome to the earnings conference call of Kroton Educacional for the first quarter of 2014. With me today is our IRO, Carlos Lazar; our CFO, Frederico Brito; our Marketing Vice President (inaudible), and our Director of Graduation and Vocational Courses, (inaudible).

I would like to kick off today's presentation on slide 3 with the highlight in the periods. The first quarter once again brought excellent results for Kroton. The start of the year was marked by a very successful admissions and re-enrollment process for the first semester of the year that led us to reach 635,000 post-secondary students, which represents a student base growth of 22% and leads us to expect yet another good year for Kroton. In the second recruiting process for vocational students under the Pronatec program, we enrolled around 15,000 new students for growth of 88% on the previous recruiting process. This strong operating performance allowed us to obtain very strong financial results as well and with EBITDA of BRL331 million, EBITDA margin of 49.2% and adjusted net income of BRL290 million which is 56% more than in the first quarter of last year.

Cash flow posted an excellent performance in the quarter with cash flow after CapEx of BRL180 million which represents an EBITDA to cash conversion rate of 69% on a pro forma basis. These indicators already show just how strong Kroton's performance was in the quarter and we will give more details during today's presentation.

Let's go now to today's presentation starting with details on the company's operating performance. I now invite our Marketing Vice President, (inaudible) to present our operating results in the quarter.

Unidentified Speaker

Thank you Rodrigo. Good morning, everyone. Let's move to slide 5. You can see that our enrollment of new undergraduate students for the first semester of 2014, which is the most important recruiting event of the year. On the chart on the left shows new enrollments in on-campus education where we went from 44,000 to 52,000 students, which represents a growth of 18%.

In distance learning, we went from 131,000 new students enrolled in the first semester of last year, to almost 150,000 new students in the first semester of this year, a growth of 14% which also above our target. Therefore, we reached almost 202,000 new enrollments in the cycle, which represents a growth of 15% from the first semester of last year.

In slide 6, you can see the growth in the total number of postsecondary students between the end of fourth quarter of last year and the first quarter of this year. As we

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mentioned, our successful new enrollment and re-enrollment process in the first semester is critical for ensuring a successful year and for surpassing our targets.

In all, we enrolled over 213,000 new postsecondary students to set a new record of the final student base of almost 635,000 new students, representing a growth of 22% compared for the first quarter of 2013. On slide 7 we show the number of students with FIES student financing. At the end of the recruiting process, we had nearly 111,000 FIES students, which represents around 63% of our on-campus undergraduate student's base and an increase of almost 5 percent points in relation to the base of the end of 2013. This record number of students which we're financing reiterates our confidence in the program and once again demonstrate the important role that it plays on our new enrollment and re-enrollment process.

And lastly, we continue to have a high percentage of students who are eligible for FIES and financing of around 98%, which attest to high quality of our academic programs and institutions. Now I handle the conference to Paulo de Páse [ph], which will continue the presentation about Pronatec.

Thank you Galindo, good morning, everyone. On slide 8 we present an information on Pronatec, the federal government's program to promote vocational education. As mentioned before, we are participating in the (inaudible) segments in which students are fully subsidized by the federal government.

During the second semester of the program, we enrolled around 16,000 students, which is 88% more than in the previous master. This growth was made possible by the increases in the number of units of 89% and in the number of academic programs of 280 compared to the first process in which we participated last year. Note that also 77% of enrollments were in programs in the morning and in the afternoon periods which optimizes the use of our campuses during this period of (inaudible). The regions with the (technical difficulty) were the Midwest region and the Southeast region, which accounted for almost 58 [ph] of total enrollments. I now invite our Investor Relations Officer, Carlos Lazar to present our financial performance in the quarter.

Carlos Lazar {BIO 17238206 <GO>}

Thank you, Paulo. Well, moving on so to slide 11 to show the performance of the -- sorry, slide 10, to show the performance of the on-campus postsecondary business. Here, we show the net revenue that grew 43% from the first quarter of last year, driven mainly by the student base growth to the excellent admissions and re-enrollment process for the first semester of the year. The lower volume of discounts, the higher average ticket and also the impact from the Pronatec revenue, which this quarter was BRL9.7 million.

Gross income reached BRL234 million with gross margin of 10.3 percentage point higher than the year before, driven by the efficiencies in the college projects and also by the restricted control of costs that we adopted in our operation. Likewise, operating income was 85% higher than the first quarter of last year with operating margin of 49% or 10.9 percentage points higher also impacted by the strict control of operating expenses.

Moving on now to slide 11 to show the performance of the distance learning segment, and here during this quarter, the net revenue of this segment, which is BRL209 million, growing 33% from the year ago quarter, driven basically by student base growth. Gross income grew 37% with gross margin of 81.3% or 2.2 percentage points higher than in the same period -- same quarter last year, influenced by the projects to capture efficiencies and economies of scale in the operation. Also, the operating income in the segment grew by 35% in relation to the first quarter last year with operating margin of 68% or 0.6 percentage points higher.

Moving on to slide 12 to show the financial performance of the primary and secondary education business, and as we mentioned in the earnings release, this segment was impacted by -- in the quarter by an operational problem in distribution of teaching materials. So I should also note here that all the measures regarded to correct these problems have already been taken and we expected to mitigate their impact over the coming quarters. As a result, the primary and secondary education segment post net revenue growth of 7% from the first quarter last year, which was driven by the higher sale of materials to the book collections to the associated schools and by the growth in the management contracts.

Gross income was mainly affected by the line of cost of goods sold due to effects of the logistics area and the reinforcement of the sales team, which also affect performance of the operating income, which declined by 4% from the first quarter last year. And now on to slide 13, we can see the performance of the adjusted EBITDA and the net income in the quarter. Adjusted EBITDA in the first quarter was BRL332 million with margin of 49.2% for an expansion of 5.5 percentage points from the same period last year, which is explained by the stronger performance of the three businesses, and also the success of the student recruiting processes and the operating efficiency captured. Note that the EBITDA was adjusted by the non-recurring items that amounted to BRL5.3 million in the quarter, which are basically related to expenses with the Anhanguera merger and with integrations. Adjusted net income in the first quarter was BRL290 million with net margin of 43.1%, increasing by 6 percentage points from the same period last year.

Note also here that the adjustments on net income includes not only the non-recurring cost and expenses considered on EBITDA but also the amortization of intangible assets from acquisitions. I will now invite our CFO, Frederico Abreu to continue the presentation.

Frederico Brito e Abreu {BIO 16674822 <GO>}

Thank you Carlos. Good morning, everyone. Moving to page 15, this next four pages, present the performance of our working capital, accounts receivables and provision for doubtful accounts. On page 15, we can analyze and can understand the performance of working capital measured in days of net revenue. So comparing working capital to last year to the first quarter last year, we have a decreased in 11 days if we look at working capital actual numbers and 15 days if we compare with pro forma numbers.

This pro forma numbers are basically the accounts receivable of FIES corrected and adjusted by the late repurchase we have this quarter of BRL117.3 million that were

supposed to be repurchase on the end of March and the actual repurchase date was the 2nd of April.

So adjusting by these effect, we have a very positive evolution on our working capital. And this is basically the result of three things, the first, reduction on the ex-FIES average receivables term. This is the result of an analytical process of revenue assurance and also renegotiation actions, with the term, the actual terms today converging to a level that we consider recurring and stable for the future.

The second is a very strict control for recognizing FIES revenue which I want to emphasize, we only recognize FIES revenue for students that have their contracts renewed, only those students have their revenues recognized.

And a very structured partners for contracting and renewing FIES financing and also controlling our debt clearance certificates. So, a strict control of FIES also terms. And finally, rigorously monitoring of our policy for supplier payments, which again we consider to be now at levels that we consider is acceptable for the future.

Moving to page 16, we look at PDA for the three segments, the on-campus, distance learning and primary and secondary. The main message here are two, first, we are using exactly the same methodology for provisioning since 2010, so we did not change our provisioning methodology. And second, we have, we can see a stability in all segments in terms of PDA. This is good news. We are also seeing a stability in terms of collection therefore our PDA is pretty much stable over the last quarter. So starting with the on-campus we have a reduction from 4.3% to 3.4%. This is mainly driven by an increase on FIES in the mix. If you look at the right hand side, ex-FIES PDA it's stable on the level of 6.4%.

And on the FIES, we have a change on the rules of the program in the beginning of the year. Basically with a change resulting that all new FIES contracts became part of the Guarantee Fund. The economic conditions for the Guarantee Fund are difference for the conditions for the co-signer. Basically, we have a commission of 5.63% over the net revenues, which we are already accounting and we have a reduction in future losses for potential delinquencies.

So, the co-signer, the company is responsible for 15% of any potential loss on the guarantor the company is responsible for 1.5% of any potential loss. So 10 times lower than the co-signer. So the combination of the two, leads to an adjustment in the PDA. So the level we were adopting last year of 2.25% is going to be decreased over the next quarters reflecting a lower PDA for the Guarantee Fund clients.

And on the distance learning segment, we have a stability at 6.6% of net revenues and close to the levels of the on-campus ex-FIES students. And finally, a small decrease on the PDA for the primary and secondary and marginal decrease. So also was (technical difficulty) on the PDA.

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Moving to page number 17, we can analyze the accounts receivable, the net accounts receivable for the businesses. We have a total, we ended the quarter with a total of BRL444 million in net accounts receivable with 293 in post-secondary, 85 million in distance learning and 66 million in primary and secondary. This total accounts receivable includes the effects of the delay in the repurchase. On the left hand side, we have also the pro forma where we exclude the balance of FIES that was not repurchased on the due date. Moving to page 18, we can see the performance of the average receivable term in each of our business.

So main message, we can see a decrease in the face to face in the on-campus business. The criterion number one is the total term for the whole ex-FIES and FIES students, we have a decrease of 26 days. If we look only at ex-FIES students, we can look at criterion number two and three. We have also decrease of 14 or 13 days for ex-FIES.

And if you look at criterion number four, we can see the evolution only for FIES students. Here it's important to look at the two analysis, the real and the pro forma. If you look at the pro forma, which is adjusting for the effect of the delay of the repurchase of the FIES credits, we have a decrease of 40 days compared to last year from 90 days to 50 days.

If we do not exclude that effect, we would have an increase, we have an increase of 11 days basically on that delays on the repurchase. So on the face to face positive news continues decreasing in the terms. For the distance learning, we said in previous calls that we have a convergence of PDA and collection practices between the distance learning, the distance learning and the postsecondary, this is what we are seeing. We have a similar PDA and we are converging also the average receivable term. We end the quarter with 46 days which is close to the average receivable terms from the face to face.

And finally on the K-12 Education, we had a stability on 142 days. This is the quarter with the high impacts on accounts receivable because it is the term where we have most of the sales realized and this is the quarter where we have the higher receivable term but it's stable compared to last year.

Moving now to slide number 20. We can look at the -- at CapEx and we have two analysis here, one is the recurring CapEx on the left hand side and the other on the right hand side is the total CapEx already including the special projects. So, if we look on the right hand -- on left hand side, our CapEx in the quarter was 43.3 million, which is 6.4% of net revenues. We call that the level that we consider for the year is around 6%, so this level should converge to 6% throughout the year. And on the right hand side, we add the special projects, so we have a total of BRL52.5 million, which is 7.8%. And here the total level of CapEx over net revenues for the year should remain, should be about 10%. So it means that for the next quarters we should have an increase in the investment in special projects and therefore we should converge to a level close to 9% to 10% of net revenues.

Moving to page 21. We have net debt, so an increase -- we can see an increase in cash and cash equivalents from last year to this year, an increase of 69% of about BRL220 million. This is basically the result of our operational cash generation and this is already

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discounting all the dividends that were paid throughout the period and any debt or interest that was also paid throughout the period.

If you look also at loans and financing which is basically financial debts, we have a stability at around BRL565 million. So net cash or net debt is the net debt of BRL32 million. If we add up all the short-term and long-term debt, that are mainly related with M&A, sellers notes and with FIES [ph], which is tax credit of BRL239 million. We have a net debt of BRL272 million, which is about 0.3 times EBITDA, so it's a very, very comfortable level of leverage.

I want also to add that beginning of April, and this is not reflected on these numbers here, we decided to prepay part of our financial debt. We have a debenture today of BRL550 million, we decided to pay BRL150 million. We'll be increasing the interest rates and our excess cash. The value that we can generate by this anticipation is positive. We have a payback of about 5 months and we decided to use part of our cash to prepay this debt. So means that we remain with BRL400 million in net debt. And the scheduled, the payment schedule is the same as the original one with the first payment of 20% of the remaining balance on December 2014.

And now cash generation on page 23. We can see here the cash generation before CapEx, after CapEx and after CapEx and special projects. If we compare the right hand side, which is the operation -- operating cash generation after all CapEx, last year 116.9, this year adjusted by the later repurchases of FIES we have BRL173 million, which is 53% EBITDA to cash, so our level of EBITDA to cash is close to last year, which was already very high. This level, remember that the odd quarters of the year so the first quarter and the third quarter are usually quarters with a lower cash generation, and this is mainly due to FIES, the process of repurchases of FIES, which is important is that we are generating at the level that is close to last year and which is very positive in general.

So, now I hand the word to Rodrigo for the closing remarks.

Rodrigo Galindo {BIO 17238232 <GO>}

Let's go please to the last slide of today's presentation for my closing remarks. We ended the first quarter of the year with strong results. EBITDA of BRL332 million or 52% more than the first quarter of 2013. And we are talking here exclusively about organic growth. Net income was BRL290 million for a strong net margin of 43.1%, increasing 590 basis points year-over-year. And pro forma cash generation after CapEx was BRL180 million, which represents a very strong EBITDA to cash conversion ratio of 55%.

Once again, the undergraduate student base posted very strong growth of 24% on the prior year and Pronatec has surpassed our expectations by enrolling 15,000 student -- new students. And all of this was achieved while maintaining higher -- high standards of quality as demonstrated by our excellent indicators in the Enade, the Enade exam, which were the best of any listed company in Brazil and on par with the public state sponsored universities.

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We also approved the distribution of BRL65 million in dividends, which will be paid to our shareholders on May 26. It is important to mention that here that -- this dividend come in addition of the BRL483 million related to the extraordinary dividend authorized by the amendment to the association agreement with Anhanguera announced last week.

In closing, I'd like to emphasize that we are confident in the progress being made in the merge with Anhanguera and we are now waiting the ruling from CADE to (inaudible) shareholders meeting to vote on the matter. (inaudible) preparation and over to 20,000 hours having been invested in planning this integration is that a long time of integration, a lot of time spent or invested in this integration which has allowed us to gain a detailed understanding of the operations of the companies and further strengthened our conviction that the merge will bring benefits for all, for all our stakeholders. Finally, I'd like to quote from the message from management in this quarter's earnings release.

When we started the process to restructure Kroton's operation, we were frequently asked whether it would be possible for a large scale educational model to combine higher profitability, strong growth rates and quality education. Now, some years later, we have proved that yes this challenge is possible.

Kroton is showing that profitability growth and quality, can advance together if they are supported by an efficient and responsible management model.

Once again, thank you for participating in today's call and we will now begin the question-and-answer session. Thank you.

Questions And Answers

Operator

Thank you. Ladies and gentlemen we will now initiate the question-and-answer session. (Operator Instructions) The first question comes from Luciano Campos with HSBC. Please go ahead.

Q - Luciano Campos {BIO 16181710 <GO>}

Hi, Rodrigo. Hi, everyone. My first question is about volumes, I mean again your admissions in the first quarter was very strong. I wanted to know if you already have, I mean any view on the percentage of this intake which are actually transference from other competitors and if you have a percentage of the intake process that are this kind of students that are really is typical first year students. And if you're already seeing any change on that pattern after you get a lot more visibility and penetration with FIES, if FIES is actually helping you with this transfers of students from other players, that's my first question. Thank you.

A - Rodrigo Galindo {BIO 17238232 <GO>}

Hello, Luciano. Thanks for the question. It's Rodrigo talking, speaking. And I always try to answering and then (inaudible) could complete. The impact of transferences in these

numbers are marginal, first because in the intake process, the transferences are considerate in the re-enrollment numbers and not in the new intake numbers.

So, but even in the re-enrollment numbers are marginal. I really release more number. So, they are not impacting, they are not being impacted by our FIES execution. So, (inaudible) could complete the answer.

A - Unidentified Speaker

No, just to put the number into the comment -- into Rodrigo's comment, Luciano, it's less than 0.4% of our total number of re-enrollments considered so it's very, very small number. We actually as of today, we don't feel any impact of the FIES incomes of transferring of the students between the institutions from the competition or somewhere else.

But just to compliment Luciano even being small our number is positive. That means that we received much more transparencies than we give.

Yeah. Yeah.

Q - Luciano Campos {BIO 16181710 <GO>}

Thank you. That was very clear. Second and last question, is there any expectation on your side to have to put much more money on general and administrative expenses for the rest of the year. I am just puzzled here why you are not increasing your guidance for 2014 after the big results of the first quarter? Is there anything that we should expect in terms of G&A for the rest of the year? Thank you.

A - Unidentified Speaker

No, actually Luciano. We -- our position about the guidance is we will not revise the guidance but we are very, very comfortable that we can deliver BRL910 million in EBITDA. Of course we know we have opportunities, but we will wait the results of the second semester intake process and re-enrollment process. And once you realize we have very successful, we believe we will have, but once we have proof of this we can announce our new guidance. Before of this we will maintain our BRL910 million on guidance waiting the intake in re-enrollment process, how the last 12 quarters, we are conservative and the market knows that we are conservative and we would just give to the market the number that we are really comfortable that we can deliver.

Q - Luciano Campos {BIO 16181710 <GO>}

Just specific on G&A Rodrigo, should we expect kind of the same level. A little bit more, a little bit less for the rest of the year?

A - Rodrigo Galindo {BIO 17238232 <GO>}

Luciano, this is Frederico. You have G&A in two levels; you have corporate expenses and the G&A from the units. In terms of corporates is not expected that we grow corporate

expenses throughout the year at the level that is in line with net revenues. Usually we grow more net revenue than we grow corporate. And in the G&A of the units the same.

So, the point is, dependent on the re-enrollment and dependent on the new intakes that we have on second semester, the delta, the additional revenue that we may capture in this intake and re-enrollment process, most of it should be translated to EBITDA because the G&A and corporate expenses are fixed. So, we are not comfortable to provide a new guidance because we are not -- we do not know how the re-enrollment and the new intake process will be, we are assuming our budget. If the real re-enrollment and intake is different from our budget, we will be comfortable to announce the new guidance in part of the increase in EBITDA is because G&A and corporate expenses are pretty much fixed.

Q - Luciano Campos {BIO 16181710 <GO>}

Thank you, Stalio [ph]. Thank you everyone.

Operator

The next question comes Ruben Couto with Brasil Plural. Please go ahead.

Q - Ruben Couto {BIO 19172367 <GO>}

Good afternoon, everyone. Thank you for taking my question. Actually it's a quick one, regarding the cycle for distance learning. Could you guys give us like a rough idea, in which type of modality being telepresence or semi-presence is growing more. I mean, for instance, telepresence course is accounted for how much of the 150,000 new enrollments during this first quarter? That is my question. Thank you.

A - Unidentified Speaker

Actually we have Unopar offering telepresence and Uniasselvi offering semi-presence. So, we can't separate the effects by the model and the brand. So, we have different level of growth.

Q - Ruben Couto {BIO 19172367 <GO>}

It's okay. If your could disclose the brand that's okay.

A - Unidentified Speaker

Yeah, we'll not disclose the number but conceptually what we can say is, we are just, we are growing more in Unopar brand, that offers the telepresence model, but we are still, we are growing a lot in Uniasselvi too. In the telepresential model. So, the level is not short distance but in Unopar we are growing a little bit more than Uniasselvi. This is the main message. We don't disclose it separately these numbers.

Q - Ruben Couto {BIO 19172367 <GO>}

That's fair. Thank you.

Operator

(Operator Instructions). We're showing no further questions. This does conclude the question-and-answer session. At this time, I would like to turn the call back over to Mr. Rodrigo Galindo for any closing remarks.

A - Rodrigo Galindo {BIO 17238232 <GO>}

Thank you everybody to participating on this call. And our IR area is available for further questions. Thank you.

Operator

Thank you. This does concludes today's presentation. You may disconnect your lines at this time. Have a nice day.

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