

Y 2016 Earnings Call

Company Participants

- Grace Cury de Almeida Goncalves Tourinho, Chief Financial Officer and Investor Relations Officer
- Natalia Lacava, Superintendent of Investor Relations
- Unidentified Speaker

Other Participants

- Joseph Giordano, Analyst
- Ruben Couto, Analyst

Presentation

Operator

Good morning, ladies and gentlemen, thank you for standing by. Welcome to the Conference Call of Qualicorp to release the results of the Fourth Quarter of 2016. Today with us, we have Mr. Jose Seripieri, CEO; Ms. Grace Tourinho, CFO and IRO; and Ms. Natalia Lacava, Superintendent of Investor Relations.

This conference call is being simultaneously transmitted on the Internet through a webcast and may be accessed at the address www.qualicorp.com.br/ri and on the platform Engage-X, where you can also find a slide deck. This conference call is being recorded and participants will be connected in listen-only mode during the company's presentation. Then we are going to start the questions-and-answer session when further instructions will be provided. (Operator Instructions)

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

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

Thank you. Good morning to everyone and thank you very much for your presence. We have closed the year of 2016 with a feeling that we did our duties. I would like to remind you that we started 2016 with major challenges, the macroeconomic scenario, the very challenging scenario and in our market, we felt the impact of the sale of Unimed Paulista that took place in Q4, 2015. Considering, all this scenario, we took a step forward and we're focused on many initiatives, financial, operational that made it possible for us to deliver consistent results quarter-after-quarter. Then -- now, I would like to highlight the main things that we did in the fourth quarter of 2016 onwards.

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First, it was the renewal of our debt. We issued debentures in the total amount of BRL711 [ph] million with CDI plus 1.30 on year [ph] to pay previous debt that we had with higher rates. Also, having a longer term to pay the loan for another three years. After changing our debt, we could beat the earnings of the second half of the year of approximately BRL0.51 per share.

If we take the payout of dividends of May 2015 to May 2017, when we are going to pay 140 million, together with the capital reductions that we have had so far with a window of two years, in the total, we are giving a return of more than BRL1 billion approximately BRL1,120 million about 20% of the company's market value.

In other acquisitions, we also made acquisitions with 127 lives that were included to Qualicorp in December 2016. We have also bought in February 2017, 75% of Uniconsult with the purchase auction that will be made over the next five years. Uniconsult is a benefit manager operating in the interior of the State of Sao Paulo. Both of them were acquired for about 1.1 times its billings, and we are really interested in increasing our portfolio organically or through acquisitions in order to generate value to the company. We also streamline our headcount.

It's important to highlight the company's focus on controlling and reducing costs. We have just optimized and adapted our team of employees, which will provide a savings of about 12% comparing year-on-year. Obviously, you will not be able to see the positive impact of this reduction in the first quarter of 2017 because of the cost of labor terminations, but this -- you will see the results from the second to the fourth quarters of the year. I thank you for your confidence and trust and we will continue seeking more efficiency and better results for the company.

Now, I would like to turn the conference over to Ms. Lacava.

Natalia Lacava {BIO 17175216 <GO>}

Good morning, everyone. Thank you for being in our call, and I'm going to start on slide number three talking about the main indicators. I think the main highlight is our year's margin more than 40% in 2016. This was above the guidance that we had given to you in the beginning of the year with a stable margin of 39.

Almost 790 million EBITDA, which is an amount that we find very important for the company. We would also like to highlight for this quarter, this increase in the fourth quarter of 2016 more than 500 bps of improvement in the margin, and we are going to get into more details during the presentation about this.

We improved efficiency. We cut expenses, and these are strategies that optimize the company's revenues in spite of some difficulties that we had to deal with.

So now as we move to the next slide, and along the presentation, now I'll be talking about each one of our initiatives.

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Now, on the slide number four talking more about our portfolio. I think the highlight here is our churn that has gone down both as a sequence and year-on-year. But in a sequence, this is related to seasonality of our businesses, so Q3 -- that's when the price adjustments occur. So that's why this is natural and we were expecting this. And year-on-year for Unimed Paulistana affected our quarter. And we also wanted to improve retention with alternative products. We are also dealing with a more challenging macroeconomic scenario, but considering everything that we saw in 2016 for Brazil, we consider that our churn in 2016 was smaller than 2015, this was an accomplishment that we made.

Another point here that Grace mentioned, we acquired a portfolio of 27,000 lives, very profitable portfolio that we paid one times the billings. This is one of the acquisitions providing the greatest return to the company. And I think that this will help the company to keep growth and stability in our member portfolio. We should mention here more strategically, even though our acquisition of portfolios have reduced over the past few years, we are always analyzing the market.

There are many opportunities, the market is big and the transactions are always assessed and will always be part of the company's strategy, always assessed as an alternative for the company to grow, when these acquisitions might make sense providing high return. So as Grace mentioned, Uniconsult providing significant gains to the company.

Now on to the next slide, when -- and I would like to talk more about sales. Our sales kept above 90,000. As a reminder in Q4 '15, we had a positive effect because of Unimed Paulistana. We could take it, people that had individual products of Paulistana that's why it was slightly above the usual. That's why it looks like there is a drop, but the sales in Q4 is very much in line with what we expected to do this quarter.

Now going to slide number five, when we talk about net revenue, the consolidated effect of 3.5% in the yields. As I had mentioned to you before, Grace mentioned, and I will reinforce, when we look at this growth in 2015, we need to be reminded that Unimed Paulistana had an effect along the whole year and we had to sell part of it. So 3.5% of growth is robust considering everything that happened in 2015. So there was a maturity that contributed for you to see this growth very significant of 17% in the fourth quarter in 2016, as compared to the fourth quarter of 2015.

Now going to slide number six and now going into the lines of cost. I think it's worth mentioning the expansion of gross margin. I think as we implemented all our projects, this analysis is slightly distorted because there were many costs that were added for us to implement our new projects. So I had to exclude all costs otherwise it would have dropped 12.5% in 2016 in absolute numbers.

So in spite of collective bargaining and everything that we expect, so we could drop this line by 12.5%. And our gross margin would have increased, if I exclude the effects that were hurting it. So there were many initiatives of the improvement that were implemented along 2016. There were efficiency projects and very strict control along the year and many factors that have contributed for this result. And this is evidence of everything that we have been sharing with you of everything that we've been doing.

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Now, moving to slide number seven, when we talk about admin expenses, here the drop of this line was 1.4 in Q4, 2016 in absolute numbers. If we take depreciation, there was a slight increase on this line. And I think what I would like to draw your attention to is that we have managed to return seven floors of our headquarters in Sao Paulo in a consolidated manner, all occupancy expenses dropped 15% in 2016. So as a reminder, in terms of occupancy expenses, we have all lines. So commercial, administrative, but in a consolidated manner, we reduced by 15% our occupancy expenses and we managed to deliver this reduction.

We also had an adjustment in 2016 [ph]. This is very common in the last quarter. I think this is very clear for everyone. The excellent results, the company has obtained attaining more than 100% of our goals and we had a minor adjustment in Q4 that raise slightly this line by about 1 million or 2 million, as compared to the previous quarter. And this is natural, this always happens in the fourth quarter of the year.

Now, going to the next slide talking about selling expenses, and this is one of the highlights of our quarter providing a very relevant contribution both in a quarter and in a year. Basically, there are two important things for us to mention here, the first one is that we cut costs in advertising with a sharp drop in our advertising costs, we are focused on online advertising and this did not affect the amount of sales of our company. This was a very accurate or successful strategy that we implemented.

And also, in terms of controls and incentives for the channel, we worked intensely, and we could take advantage of our more favorable competitive environment to occupy the space and to use the environment to reduce our expenses and to increase our sales, want to keep our sales at the same level, and thereby we managed to reduce significantly our expenses.

Now, going to slide number nine. Going to our bad debt -- provision for bad debt, here there is nothing new really. We have talked about being -- we were expecting an increase on this line because of the economy, we closed the quarter with 8.8, therefore 2017, I can tell you that depending on how the economy evolves, this line might still eat up a little bit of our margin and we are going to try to counteract this with other cuts, but we are confident that the number is not out of control. So as a reminder it's just one installment of the monthly dues. We have many collection strategies being implemented that assure that this is under control. In Q1, 2017, we still have some pressure on this line, but this will not affect the goals that we have mentioned to you.

In terms of others, there are many items here, other operating and income -- other operating income and expenses, there are contingencies and so on and so forth. Here the highlight is the operational damages or operational losses that we have already mentioned to you several times before reconciliation of invoices. It's just calculation and mathematics that can be positive or negative. It's the current account that we control, and in 2015, it was positive, in 2016, it was negative, and our goal is to improve this process always and always, and I think we have succeeded in doing that. There has never been a quarter very significant numbers in this line. This is something that we have been working to have the smallest impact possible in the company's bottom line.

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Now, on slide number 10, financial income. This line has been behaving as expected. So the cash and dividends, they had an impact when we talk about other income. In 2015, we had the effect of Unimed Paulistana in this line, which did not happen in 2016, and the financial income was better than in 2015.

And for the year, we -- with the restructuring that the company implemented and in 2016 - that's still [ph] occurred in 2016, but not in 2015, but there is nothing new here. You already know that we had already talked to you about this.

Now, going to slide number 11, the adjusted EBITDA. I started the presentation, talking about this. So we reached 40% margin during the year, almost 790 million in EBITDA margin, 39% margin in the quarter. And as a reminder Q4, this are the [ph] trend to drop margin because this is when some investments were concentrated and some end of year campaigns, and this year we managed to wholesales and not to make all these investments. That's why the margin of the fourth quarter is so high with a very small variation as compared to what we did in previous quarters.

Now, on the next slide, net income. Here is our -- the company's capacity to pay dividend. We had a tax effect interfering the year's bottom line that's why, we have 420 million for the whole year. But regardless of that, we have managed to make the company payout dividend as the same proportion as the cash flow.

This is a victory. It's a quite reasonable return for 2016.

Another highlight, here is our tax rate. If you look, we closed 2016 with a tax rate, if we exclude tax benefits of 38.6%, which proves that the results that we have been working on to reduce the company's problems and this was at high end 50% in cash and with everything we did in terms of restructuring and studies today, the tax rate is 38.6, and we're almost getting to the 34 that we are expecting and this helps a lot in terms of dividend payout. This is money that we can allocate to pay more to shareholders.

Now slide number 13, the CapEx and capital structure. We closed the year with a CapEx of almost 130 million. And as highlighted last quarter, there was a commercial reciprocal agreement, and this is different from others because this is related to the maintenance of operational and financial agreements of the company before the regulators of the country. So there is an additional guarantee -- this contract has an additional guarantee, as compared to other contracts, as the company closed before with the carrier that was quite relevant, it's the carrier that took on the entire portfolio of Unimed Paulistana. Additionally, we also add, as you know, portfolio that we mentioned for the amount of 16 million, 27,000 lives, almost 1.5 million gross billings, and it was the largest acquisition we have remained.

And lastly, talking about cash flow on slide number 14. Here, we did not put on the slide, ROI reached almost 43%. It's interesting to see this -- see ROIC going up when it suffered a little bit, but now it's going back to ROIC. So we are going back to ROIC and as a result of the maturation of investments proving that they -- and the cash flow of 400 million, it's a historical record for the company, very close to what we paid out to investors this year.

And in terms of the business model, the company's capacity to generate cash and to increase your returns.

In this manner, I end my presentation. I thank you all for the partnership, and we are available to answer any questions you may have. Thank you very much.

Questions And Answers

Operator

Thank you. Now, we are going to start our Q&A session. (Operator Instructions) Our first question comes from Mr. Joseph Giordano from JPMorgan.

Q - Joseph Giordano {BIO 17751061 <GO>}

Hello, good morning everyone, Grace and Natalia, thank you for answering my question. You are doing very good work at the micro level to affect the macro performance. As we move towards 2017, how are you seeing the growth trends? What do you see in terms of the dynamics of the market? And considering the macroeconomic scenario that is poor, I would imagine that there are -- may be other difficulties, in some other companies. Do you see any potential for opportunities for M&A in the long term?

And secondly, we have what you call the so-called popular plan or the low income plan. What could the positive or negative impact of these types of plans in the company's bottom line?

A - Natalia Lacava {BIO 17175216 <GO>}

Hello, thank you, for your questions. As to the growth in 2017, what we've seen in January and February, we see some stability. I think Uniconsult portfolio that we have just bought have -- drove our portfolio to be slightly positive, but as I always tell you, it's our capacities is kind of limited. So -- and the portfolio is almost flat considering Uniconsult. For the year, we don't see any reason to -- for any more significant changes. We think there is stability. January and February are usually very difficult because it's the beginning of the year, everyone is on vacation.

So I think for the first quarter, it's kind of stable, the second quarter is usually one -- is usually a good quarter, usually one of the best of -- in the year. But for 2017 guidance, we don't see any reason why we should change, which is a year with the portfolio moving sideways.

As to the market dynamics and M&A opportunities, we are always analyzing the portfolios available in the market. And I think that with the macroeconomic scenario and in the health market, I think Qualicorp is differentiated because we have a huge diversity of products. And if customers have any difficulties, we have alternatives to offer, which our competitors do not have in terms of products. They usually work with just one carrier, so Qualicorp differentiates itself because it provides a wider range of options to our customers, which is good at times of crisis. So the M&As that we have made and also everything that

happened in the past in terms of us gaining market share has improved the capillarity and diversity of our products. So this may happen more often, and we are being very careful and cautious in terms of our -- in analyzing M&A opportunities, but it might become part of our everyday businesses in 2017.

With regards to your second question, I'm going to ask Tourinho to help.

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

We have a project, it's just an idea there is nothing concrete in terms of our low income product. In Qualicorp through our brokerage business or a benefit administrator, we are a distributor of benefit and we also work with after sales, controlling everything that we distributed through our brokerage businesses. So everything that can be done in terms of making products cheaper for our end users without any loss to users is always good. In any segment and society, there is a pursuit for cheaper or more affordable, more democratic products and this holds true in many different industries.

It can be through products and processes, better managed products, medically speaking in terms of the configuration of our products or through projects in terms of as we recall the affordable health, which we might implement, but our position is that any new product needs to preserve users obviously and that users are duly informed of everything.

As a reminder, if this happens, it will be optional. Going back to the beginning our main objective, as Qualicorp with or without new products is to reduce price adjustments. For any carrier, the market needs to move in order not to lose any more margin. This is important for the process as a whole.

Q - Joseph Giordano {BIO 17751061 <GO>}

Thank you very much. Just one follow-up with regards to the price increase that you've mentioned. What do you see for this year? Inflation has been going down quite fast. What are you expecting in terms of price increase in the middle of the year?

A - Unidentified Speaker

This varies a lot from one carrier to the other. So sometimes we have an insurance company, a co-operative or a more vertical Group. First, I don't have information right on my hand, I don't have those numbers right now. But and it's -- so it's difficult for me to give you more details about this issue, and I would not like to say to give you inaccurate information. And I would like to wait for an analysis of our technical area before giving you any answer.

Q - Joseph Giordano {BIO 17751061 <GO>}

Thank you.

Operator

Our question comes from Mr. Ruben Couto from Itau BBA.

Q - Ruben Couto {BIO 19172367 <GO>}

Good morning, everyone. Could you repeat the number of lives and the amount you paid for Uniconsult?

A - Unidentified Speaker

Oh, yes. Uniconsult, we bought 75% of Uniconsult totaling 17,500 [ph] lives and the amount is about 17 million.

Q - Ruben Couto {BIO 19172367 <GO>}

Thank you. I would like to go back to commercial issues focusing more on Q4 with a drop year-on-year, but the fourth quarter of 2016 [ph], you had a very strong non-recurring effect because of the problem Unimed Paulista had, if you were to adjust Q4 '15 in a more normal basis, which drop would we be seeing. Can you give us that number?

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

So this 26% you mean the drop in volume or costs because in the process of Unimed Paulista with a gross estimate because it's very difficult for us to calculate those. We think that in sales in 4Q '15, we gained 15,000 lives in sales in the whole process of settlement. So we could sell for customers, who had individual product. So I think that in sales, we'd have made 100,000 and having 93 today.

In terms of costs, the costs were very much concentrated, so we estimated 5 million in -- including all lines get affected and I can't give you a very, very accurate number. It's about 5 million for us to go through this process and this involve the call center building, a service structure in Q4 '15. So if you look at commercial expenses of the fourth quarter of '15 versus '16 is more. So this drop of 26% is recurring, in fact because of the two facts that you mentioned in that conversation.

And the new way, you are using as an incentive for the channel new incentive, so it's much more structural then on different basis. Yes, you are right. There is a lot of structural factor. If you were to estimate, you may start [ph] 15,000 lives that we sold more and then new turns us into commission and then I can give you more details, 15 lives in commissions. So basically 100% -- 50% excuse me in terms of average ticket. The average ticket in 2015 was higher because those who use to have individual products bought for a higher ticket. But you see this in the line of commissions to third parties because this is something additional that we paid and in terms of sales campaigns.

And in terms of sales campaigns, it was related to Paulista. And I can say with some confidence that most of the reduction was due to strategies and changes that we implemented in the channel.

Let me just clarify because Natalia has given you the total numbers, actually when we bought 75% of that company, we paid 6.5 million. The other 25% that we will buy over the next five years and this has been level defined to be at the same price level in five years, there are two formulas. I can either buy it for the next five years or if they reach 100,000

lives, whichever happens first, if it reaches 100,000 lives, then we will buy it earlier. So in reality, the 75% the company will spend 6.5 million. And today, we have about 7,500 lines - 17,000 sorry.

Operator

We now close our Q&A session. We would like to turn to give the floor back to Ms. Natalia Lacava for her closing remarks.

A - Natalia Lacava {BIO 17175216 <GO>}

Thank you all very much. As usual, the entire Investor Relations team, myself and Tourinho [ph] are available to answer any questions you may have. And have a good day. Thank you all very much.

Operator

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

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