Q3 2015 Earnings Call

Company Participants

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

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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 Third Quarter 2015 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 Relations website at www.kroton.com.br/ir by clicking on the banner 3Q15 Webcast. The following presentation is also available to download on the webcast platform.

The following information is available in Brazilian real in accordance with Brazilian Corporate Law and Generally Accepted Accounting Practices BR GAAP, which now conforms with International Financial Reporting Standards, 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 Calvo Galindo {BIO 17238232 <GO>}

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Good morning everyone and welcome to the quarterly earnings conference call of Kroton Educacional for the third quarter of 2015. With me today is our IRO, Carlos Lazar; and our CFO, Frederico Abreu.

Let's start today's presentation on slide four, with the highlights from the third quarter. There are three factors, with the greatest potential impact in the education industry in an adverse macroeconomic scenario, which our new enrollments, dropouts and delinquency. And one way to show Kroton solidly is to analyze the behavior of these three indicators in the quarter.

New enrollments grew by 4% and despite a decline of 84% in the numbers of new FIES students, new enrollment in the On-Campus business declined by only 6%. In the distance learning, new enrollments posted double-digit growth of 10% and in total, we grew 4% in new enrollments.

The second indicator dropouts are completely under control at Kroton. With dropout rate in both the On-Campus and Distance Learning business remaining stable and without any signs of pressure. And delinquency the third indicator also under control. The delinquencies remained stable in both the On-Campus and Distance Learning businesses. In the On-Campus business, provisioning has stabilized at 6.5%, the same level as in the previous quarter, and the same level in the same quarter last year. While in the Distance Learning business, the level completely stable at 7.4% in comparison with third quarter and second quarter of 2015. These three indicators reinforce our confidence that even in scenarios marked by macroeconomic instability, our operation is capable of overcoming the diversities.

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Moving on, the slide five shows another important indicator, which is average ticket. The chart on the left-hand side shows the evolution in the net average ticket in the On-Campus business. We present two analysis of average ticket in the quarter. First, we show the effective average ticket; and second, we make an adjustment by clearing the one-off sales actions, which impact only revenue in the third quarter. These actions involve offering discounts or extensions on enrollment fees, which are one-off and granted at annuities and only to new students in 2015 admission process, which means that they impact only the third quarter, but have no effect subsequent quarters.

We believe this second scenario analysis normalizes the average ticket to permit more adequate composition over the long-term.

And I think the normalized ever tickets, which excluded the effects from the one-off sales actions in the quarter, the average ticket in the On-Campus business increased 6.5% year-over-year. Compared to the previous quarter, the normalized average ticket in the On-Campus business remain stable.

The chart in the right side -- right-hand side shows the same analysis for the Distance Learning business with normalized average ticket in the quarter declining 3.2%, which is basically explained by three factors. First, the repositioning of the prices in certain markets; second, the higher number of new students to comply with the new rules, and third, the higher number of 100% web based Distance Learning students from which the average ticket is lower. Compared to the previous quarter, the normalized average ticket in the Distance Learning business remain stable.

The expectation is for the average ticket to increase in the fourth quarter and for 2016, we also expect an improvement in the average ticket mainly due to the new pricing methodology adopted in both the On-Campus and Distance Learning business.

Let's go now to slide six, which provide details on our financial performance in the year, in the year-to-date compared with the same nine-month period last year. The numbers are very strong with EBITDA margin increasing from 36.2% in 2014 to 42.2% in 2015, up 600 basis points. The performance of net margin was even better, which increased from 28.9% in 2014 to 35% in '15, up 610 basis points. Contributing to this performance were the successful integration of Anhanguera, the strict control of costs and expenses, and the capture of economies of scale and efficiency gains in our operations, at Anhanguera as well at Kroton's other brands. And best of all, we are very confident that there are too many major opportunities for capturing synergies and efficiency gains going forward.

Another very important factor I should mention is Kroton's cash generation, which this quarter came to BRL334 million. Cash generation in the quarter helped us to end the period with a robust cash position of almost BRL500 million. We do not let the challenges of resume macroeconomic scenario, but our numbers shows that our operation is very strong, stable and resilient.

To summarize our scenario, we have new enrollments growing by 4%, dropout remained stable, delinquency remained stable and average ticket under control in a trend of strong and growing cash generation is a very good scenario. We are optimistic, since these results enabled us to further reinforce Kroton's strategic pillars, such as quality, innovation, growth and operational efficiency, which will allows us to continue creating value on a sustainable basis.

I will now pass the call over to Carlos Lazar, our IRO, who will present our financial results in the quarter.

Carlos Lazar {BIO 17238206 <GO>}

Well, thank you, Rodrigo, and let's start on slide eight, where we can see the financial performance of our On-Campus Postsecondary business considering only the undergraduate and the graduate on-campus, language course and also vocational education operations, the Pronatec.

Net revenue here grew 11% year-over-year, driven mainly by the student base growth, resulting from our recruiting process and by the higher average ticket. Compared to the prior quarter, net revenue fell 50%, mainly to the seasonality of revenue recognition in even-numbered quarters because of the students, who finalized their enrollment and re-enrollment processes, after the close of the first and third quarters.

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Gross income was BRL586 million, grown 16% against last year with gross margin up 2.8 percentage points driven here mainly by the revenue growth and also the ongoing capital efficiency gains at earnings, which here includes the impact, or the initial impact from the operational research software implemented in the second semester.

Operating income before marketing expenses increased at 22% year-over-year with operating margin of 48.9% in the first nine months of the year. And then operating income -- in the first nine months for the year. Operating income was BRL1.4 billion with operating margin reaching almost 50%.

Turning to slide nine, you can see the performance of the DL segment, which includes the Distance Learning Undergraduate, the Graduate and also some unrelated programs and preparatory courses. Net revenue here was 286 million, remaining stable year-over-year and here it's important to note that despite the positive performance from the admissions and re-enrollment processes, this business -- the revenue of this business was impacted by the lower average ticket as mentioned before regarding the one-off discount.

Gross income grew 7% in the period with gross margin of 78.8%, or 5.3 percentage points, higher than the same period of last year, mainly to the efforts to reduce payroll expenses including the progress of migration from Anhanguera model of two on-campus classes per week, one on-campus class per week in the DL academic model.

The Distance Learning operating income before merger expenses grew 19% year-over-year, with a margin of 68.7%, or almost an 11 percentage points higher than the previous periods, due to the capture of significant synergies and also operating efficiency gains in DL operations. Year-to-date operating income all was almost BRL600 million, with operating margins of above 66%.

Turning to slide 10, you can see the performance of the Primary & Secondary education, the K-12 business in the third quarter, compared to the same quarter last year, the lower revenue in the Primary & Secondary business was due to the rescission of some contracts of private schools that we already announced by the beginning of this year.

The highlight was the good performance of the line management contracts and own operations, which grew 10% year-over-year. Gross income in the quarter was BRL19 million with gross margin of 56.5%, or 8.6 percentage points above the previous year. Here the evolution is due to the lower cost in the quarter as a consequence of the measures that we are put in place in the segment.

The operating result of this (technical difficulty) was BRL14.5 million, with operating margin of 42.7%, up 19.4 percentage points year-over-year due to also efficiency gains captured through changes in the administrative structure and also better performance of the publishing, printing and logistics operations. In the first nine months of the year, the operating income was BRL63 million, pretty much stable with the previous year.

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On slide 11, you can see our corporate and selling & marketing expenses. Starting with the corporate expenses, we had BRL70.5 million in this quarter, or 5.7% of net revenue, so down 0.8 percentage points year-over-year due to basically three main factors. First, the changes made in the administrative structures after the Anhanguera merger. On the top of that, also the corporate restructuring carried out during the year, especially in the first and second quarter, actually, especially in the second and third quarters. And also the important reduction in expenses achieved by the strategic sourcing process and greater budget austerity.

Selling and marketing expenses as a ratio of net income increased by 0.5 percentage points year-over-year, reflecting the identification of commercial actions during the recent recruiting process that we conducted.

On slide 12, we can see the performance of EBITDA in here. The adjusted EBITDA of the third quarter was BRL508 million, increasing 27% year-over-year with an EBITDA margin expanding 6.4 percentage points to 41.2%. In the year-to-date, adjusted EBITDA was BRL1.7 billion up 57% with EBITDA margin expanding almost 1 percentage point, reaching 42.2%. Well, performance is really confirms the success of our initiatives in terms of gain efficiency and also the really rigid control of costs and expenses.

Let's remember that EBITDA was adjusted by non-recurring items of BRL48.4 million in this quarter down already from the previous quarter with the main source being this quarter specifically, the non-recurring regarding layoffs from the Anhanguera merger that accounted for BRL20 million. Besides this, we had some events related to the Uniasselvi sale and also some events regarding the closing of two On-Campus units during the period. For the fourth quarter, we do understand that these indicators should again present a further decrease.

Turning to slide 13, you can see the performance of net income in the period and net income here adjusted includes not only the non-recurring costs, but also the amortization of intangible assets. In the quarter, adjusted income was BRL407 million, with net margin of 33%, expanding 6.4 percentage points year-over-year. In this first nine months of the year, net income was BRL1.4 billion, with net margin of 35%.

To conclude this part of the presentation, I would like to invite for you to go to the next slide, where we show the evolution in the company's results on a pro-forma basis using combined figure of Kroton and Anhanguera for the first nine months of '14 and '15. In this analysis, we can see a solid and consistent performance delivered, even if we take in consideration that the first half of 2014 Anhanguera adopted a accounting practice different than those from Kroton. The highlights where the growth of 10% in top-line, 28% in adjusted EBITDA, and finally 33% in adjusted net income.

As noted in the beginning of the presentation, we also observed a very robust margin expansion both in EBITDA of 6.0 percentage points and net income of 6.1 percentage points even in a current scenario demonstrating again our capacity to adjust to the new situation, so that we can once again deliver very strong results with excellent operating performance and growing profitability.

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Well, I will now invite our CFO, Frederico e Abreu to continue the presentation.

Frederico Brito e Abreu {BIO 16674822 <GO>}

Thank you, Carlos. Good morning, everyone. So, on the next pages we will see working capital, CapEx and cash flow. So, I will invite you to page 16, where we can analyze PDA, Provision for Doubtful Accounts and we can see how this PDA compares business by business with previous quarters.

And before getting into the numbers, I would like to convey here some messages. The first is that PDA is calculated using the same methodology since 2010, and it's based on the statistical analysis of historical billing and collections data. So, we are keeping the same methodology since 2010 and Anhanguera is on the same methodology since third quarter last year.

And also on the numbers, we have some very important and strong messages here. The first, as you can see our PDA remained stable in each of the three businesses, this is very important. So, Rodrigo mentioned in the beginning despite the macroeconomic challenge, we are able to keep our PDA stable.

Second, and if you look at our managerial reports, we can see since last year, an improvement in collections month-over-month in the rates of outstanding balances is under control. And this is the result, this improvement in collections is the result of a series of management changes that we are doing in our operation and we presented those changes, some of those changes in the Kroton and you can see on our website this presentation.

The third thing that is important, we are keeping our conservative PDA on our private installments payment, our PEP, which is a product that we have launched in the beginning of 2015. We are keeping the same 50% PDA over revenues also on this quarter.

The fourth thing that is important to mention, if you look at our balance sheet and if you look at our accounts receivable, you can see that our coverage ratio in our accounts receivable remains very healthy, variable boosts, and pretty much in line with other quarters, this is also very important factor that we are and we have an adequate provisioning practice.

And finally, you can see on next page is that we have stability in our average receivable term, I put some more details here on the call, but this is also very important thing. So, these messages are very important. I am now going to get through the numbers. So, if you look on the left-hand side in green, you can see On-Campus Postsecondary business. We have a PDA in the third quarter of 4.4%, which is down from the previous quarter and 1.6 percentage points above last year.

Basically, why this increase happened? This is basically because of PEP, of our Private Special Installment Plan. As you know, we are very conservative and the increase is basically related to that. If we exclude PEP and also FIES student, so on the right bars on the On-Campus business, you can see that our PDA is stable at 6.5%, excluding the PEP, PDA effect, stable at 6.5%, which is very healthy and very positive.

If you look at Distance Learning, our provisioning is also stable at a level of 7.4%, and if you look on the right-hand side on Primary & Secondary business, the K-12, we have a drop to 1.1%, which is a drop of 2.1 percentage points, and this is mainly the result of also important efforts on collection over the associated schools, remember here that we do not collect directly from students, we collect from associated schools and we are seeing over the last quarters an improvement in this collection process.

So, I'd like to emphasize before moving to next page. That again, in the more challenging macroeconomic scenario, we are managing to keep our provisioning level stable, and this is mainly because of the efficiency gains, synergies also with Anhanguera and our improvement in collection operations.

So, moving to page 17, here you can see the accounts receivable and before getting into the numbers, the first thing that is important here, you see a big increase in FIES accounts receivable. This is not new since the implementation of the Normative rule number 23, our accounts receivable in FIES has been increasing. Remember that we have four payments in 2015 that will be paid, one in 2016, one in 2017 and two in 2018, and therefore this increase in accounts receivable was already expected and it's the biggest and the largest increase we have in accounts receivable in this quarter.

The second thing is, despite these Normative rule number 23, that of course, impacted our accounts receivable. Today, we can say and by the end of the quarter that we've received a 100% of the amount that was scheduled to be paid during the third quarter. So, we end up the quarter without any delays on FIES, this is very important to mention.

The third thing, we are being able every month to offset our federal taxes against FIES certificates. This is also positive. And finally, we are one month late on the receivement from the Pronatec balance. The revenues from June should have been received in inside third quarter, they were not paid inside the third quarter. They were paid on October 19th, but the fact is our accounts receivable were impacted negatively by one month delay in Pronatec.

So, as a result, as you can see we have BRL1.5 billion in accounts receivable, from which BRL1.2 billion related to on-campus from, which BRL884 million are related to FIES, but this was already expected and we have BRL200 million from Distance Learning and BRL29 million from Primary and Secondary.

So, I'll invite you to page 18, where we can understand how these accounts receivable translate in average receivable term and the impact that we have on cash flow.

So, you can see basically on page 18, the average receivable term. I'll start to read the On-Campus in green, and here we have three, basically three analysis. The first is the average term for all On-Campus students, including students that FIES students, non-FIES students, Pronatec students and PEP students.

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So, overall our accounts average receivable term increased 44 days, which is a big increase from last year. And the main effect, the main explanation for this increase, as you will see is related to FIES.

So, on second analysis, we exclude FIES from accounts receivable term, but we are including here PEP and Pronatec and here you can see an increase of 13 days compared to last year, or a decline of 8 days compare to the previous quarter. So, why this increase? The most important effects on ex-FIES receivable term is related to PEP. As you know PEP is a financing mechanism we have here. It has a much longer average receivable term. Therefore this is impacting part of the increase in accounts receivable term compared to last year.

The second, Pronatec, because of the delay I have mentioned before, one-month delay is also contributing negatively to the increase. And if you only look at the paying students excluding PEP in the Pronatec students, you can see, not on this page, but a short, a small increase compared to last year. So, accounts average receivable term for paying students excluding PEP and Pronatec increased from 62 days last year to 64 days this year, which is two days increase, which is pretty stable and very positive.

Compared to previous quarter, you can see a decrease of eight days and this is important and is a result of our renegotiation practices that was conducted from first to second semester. And you can also see by stability in our attrition rates and therefore we are seeing here a decrease of 8 days.

If we only look after the paying students, students they are not FIES, are not Pronatec, are not PEP compared to previous quarter you can see a decrease of 17 days from 81 days last quarter to 64 days this quarter, okay.

Now if you look at the third analysis, the FIES, this is where the most, the largest increase is. You can see an average receivable term of 132 days and this is an increase of 55 days over last year. This is expected, these number of days is expected to continue increasing until the end of the year. Then as I mentioned, starting in 2016, we are going to start receiving the amount due from 2015. Therefore, this term should converge until 2018 to the previous 60 to 70 days of accounts receivable in FIES, okay.

Now, in Distance Learning, we have an increase of 15 days, but if you compare to last quarter, the decrease of five days and this is basically the results of the convergence, as we have been mentioning in the other call, the convergence of the practices and collection practices from Distance Learning to On-Campus. Distance Learning is still below the average term of On-Campus and we should expect basically a convergence of number of days.

But an important point here is, this increase in average receivables days is not bad, if PDA is under control, which is the case, why, because we are generating with this increase in average receivable term in Distance Learning, an additional financial income related with interest is fine on late payments. And the amounts that we've accounted in the third quarter alone in Distance Learning on these revenues was 14.8 million, which is 61% higher than last year, and if you look at the full year, the nine months of the year, these revenue in fines and taxes is 35.7 million, which is 75% higher than last year, which was also an important source of income.

And finally, if you look at the average receivable term of K-12, we have a decrease of 23 days in here, is again the result of more effective collection efforts on the Associated Schools. So, on average receivable terms despite again the macroeconomic challenge, we are having the term under control, also on this side.

Now moving to page 20, you can see CapEx. Here CapEx is presented in the same way we've been presenting to the markets in previous quarters. On the left side, you have CapEx related to recurring and expansion projects and on the right side, you have also on top of that, what we call here special projects, which are more structural projects to support long-term growth.

So, we've invested a total in the quarter in CapEx of BRL90.8 million, or 7.4% of net revenue, in here we are including investments in facilities, development of content system software et cetera.

As we look at the year-to-date nine months, our CapEx was 244 million, which is 6.2% of net revenues, and very important, down 1.2 percentage points compared to last year. If we have special projects, our total CapEx in the quarter was 101.5 million, which is 8.2% of net revenue and if we look at the full year, nine months of the year, we have BRL301.5 million or 7.7% of net revenues.

And here is very important, this is in line with the guidance of CapEx that we presented to the market in the beginning of the year, is a level below last year, but nevertheless we are not delaying any investments, in any strategic project, in any new academic program, in any new greenfields or in any new distance learning center. We are being able to spend less, but not constraining and not putting at risk our future growth.

Now, moving to page 21, you can see net debt. Some very important messages here. First, our cash position grew 24% since last quarter. If we consider bank debt, our net debt was down 27%. If you add up all of our short-term and other long-term debts related to taxes and M&A, our net debt was 638.8 million which is down 17% from last quarter. And basically, this is a very healthy position. If you look at the current scenario, we are having 0.33 times EBITDA. We have a lot of room to increase our leverages needed, if we have any M&A opportunities. So this is a very healthy level.

In this level of cash, already includes two things; the first, our payment of dividends related to second quarter, which totaled 99, this is already included in this net balance; and the second, our repurchase of buy-back of own shares that we conducted in the third quarter of 85 million, okay. So these two negative effects are already contained in our cash balance by the end of the quarter.

And now moving to cash generation on page 23, you can see a free cash flow from operations and also free cash flow. You can see here, a very important and a very solid

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free cash flow from operations we've generated in the quarter. After all CapEx, BRL346 million, which are 75% EBITDA to cash, This is very strong cash flow generation, despite the impacts of Normative rule number 23. And therefore there are some reasons, why we are having this cash generation efforts, as you saw the results are very strong. The second our average receivable term is stable. The third our payment days to our suppliers is increasing. This is the results of several renegotiations of contracts that we've conducted throughout the year. And last, we are with our FIES repurchases on schedule despite the PN, the Normative rule number 23. So, very strong news on cash flow generation.

And I'll hand the call back to Rodrigo for his closing remarks.

Rodrigo Calvo Galindo {BIO 17238232 <GO>}

Thank you, Fred. To conclude today's presentation, I would like to make some closing remarks. First, I want to comment on this strategic importance to Kroton of the Studiare acquisition. More than just a simple acquisition, the Studiare transaction is an important strategic move that shows the company's plans to reinforce innovation, as a strategic pillar. Studiare will bring to Kroton know-how and strategy in applied educational technology.

Studiare's initial focus will on developing adaptive learning, which is one of the pillars of KLS 2.0. The platform will serve all areas of the company and optimize the academic management, which reinforce our commitment to delivering a high quality education on a large scale supported by innovative tools.

Another highlight I want to mention is the student recruiting process for 2016. The process has already begun, and the initial signs are very positive in both On-Campus and Distance Learning, but of course it's too early to make an analysis, since the process will be concluded only in mid-April, but we are confident until now.

Also in the quarter, we approved the distribution of dividends of BRL74 million to ensure a constant flow of distributions to our shareholders. And other important factor is the set up of projects for 2016. We already have mapped more than 300 projects for next year, which included advances in important drivers of the value creation for the company.

Two of the most important for increasing efficiency is the rollout of KLS 2.0 and the maturation of the operational research tool. In 2016, students in the first, second and third academic semesters will be using KLS 2.0. The second version of the operational research tool will be launched and the tool will be implemented at 100% of our On-Campus units. And these three factors together will allows us to increase the efficiency gains in the creation of classes.

Another important product is the rollout of the strategic sourcing project. In 2016, new categories will be included provide an even more cost-cutting opportunities to be captured. To help drive our growth, we have expansion projects involving greenfield projects and new distance learning centers, both of which are in the process of approval at Ministry of Education.

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And finally, one of the initiatives with the greatest potential to create value for the company is the retention program, which is a set of projects to improve students retention at Kroton. We see enormous potential in this product and we are optimistic with the perspectives. Once again, Kroton has demonstrated its highest capacity to adapt. The results shows that the company is capable of generating value in the short and long-term by overcoming our diversities and delivering high quality education on a large scale.

Let's go now to slide 26, where I want to comment briefly on the people, who make Kroton. The results in the third quarter and first nine-month are very positive, but all of this was only delivered because we have robust management system, a solid organization culture and most importantly, because we have been able to maintain a chain professionals, who are technically prepared, highly motivated and have the proper incentives.

During this third quarter, Kroton's most important people management event was held, the meeting of leaders. For three days more than 400 leaders from across the country for corporate offices and operational units from all business segments and corporate areas came together to discuss the organization's future. The event was a great opportunity to reinforce the company's culture to recognize the delivery is made, strengthening meritocracy and motivate leaders to take on new challenges.

This is the team that you see here on slide 26, who together with our modern 34,000 employees delivered Kroton's results too often, I extend my profound appreciation. Once again thank you for participation in today's call, and now we will 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) Seeing no question, this concludes the question-and-answer session. I would like to turn the call back to Mr. Rodrigo Galindo for any closing remarks.

A - Rodrigo Calvo Galindo {BIO 17238232 <GO>}

Once again, thank you all for participation in today's call, and our IR area is available for further information. Thank you.

Operator

And thank you, sir. This does concludes today's presentation. You may disconnect your line at this time. Have a nice day.

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