

Q3 2015 Earnings Call

Company Participants

- Grace Cury de Almeida Gonçalves Tourinho
- Mauricio Ceschin
- Natália Lacava

Other Participants

- Rafael Frade

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and thank you for waiting. Welcome to Qualicorp's Conference Call to discuss the results of the third quarter of 2015. We have with us today Mr. Mauricio Ceschin, the CEO; Mrs. Grace Tourinho, the CFO, COO and IRO; and Mrs. Natália Lacava, the Investor Relations Superintendent.

This event will be recorded and participants will be in a listen-only mode during the company's presentation, after which, we will begin the question-and-answer session when further instructions will be given.

I now turn the floor over to Mrs. Lacava who will start the conference call. Mrs. Lacava, you may proceed.

Natália Lacava

Hello. Thank you. Good morning, everyone. Thanks, again, for joining us on this conference call. I'll start with going to our results operational and financial results. And then, I'll turn the word over to Grace, who will make some additional remarks over this quarter.

So let's start on page slide number 3, where we have the main indicators. Here, I wanted to call attention for our performance on net revenue. We saw a 13.6% year-over-year increase, which reflects the price increase we applied during this quarter of 17.8%, plus the mix effect that you all guys know will have some down trade, some changing on the sales ticket which makes net revenue growth affection. So this is what composes our net revenue.

The other thing I wanted to call attention is the revenue line, which we performed, in our view, very well. So, our expenses consolidated increase at only 2% year-over-year much

lower than our cost inflation and reflect all the strategy that we've been doing to mitigate the cost increases negotiating with suppliers and be very strict on our (02:04) cost management, too.

With all that, we made - we reached an adjusted EBITDA margin of 43% only Qualicorp and consolidated with CRC 41%, which represents an important improvement year-over-year and quarter-over-quarter. So, we're very happy with that performance. There is a lot of work still to do but we think that all the strategies we have been discussing with you guys are starting to show up in our numbers.

The next thing on this slide I wanted to mention is the very strong balance sheet we have because, even after the capital reduction, you can see our indicators - our equity indicators is still very healthy. Net debt to EBITDA, net debt to equity is still keeping up with a very, very, very healthy level given the strong cash flow that the company has.

So jumping now to slide number 4 where we have the portfolio performance. As you see here, we still have over 5 million lives in our portfolio all combined. There is no deterioration versus last quarter, and we will detail this further in our next slide number 5, where we have all the details in breakdown of our portfolio.

Here on this slide, I wanted to make two comments basically. The first one, the 26,000 negative net adds, we have anticipated to you guys this performance giving the Unimed Seguros process and migration. So, we lost during this process 12,000 lives and this is composed here in this quarterly results. So out of the 26,000, we have 12,000 that comes from the Unimed Seguros and the remaining piece is the organic additions over the quarter.

I want to remind everyone that this quarter is a seasonally weaker quarter given the price readjustments so it's natural to have a deterioration in churn. And then combined with that, we have all the macro situation in Brazil, which also weighted a little bit in our results. So this is an important sector to mention in this slide.

The second thing, although not very meaningful from a results perspective, is the performance of health management portfolio. You have here 70% decline. Just wanted to know - for you guys to know that there is one specific contract that the client decided to internalize, so that's why we saw decline in the number of lives. However, from a revenue perspective, it did not impact us much during this quarter because we saw much more volume coming from our existing clients. So, despite this performance on the portfolio, on the revenue side we didn't feel much.

Going to the next slide, slide number 6 where we discuss our net revenue. So, here we have a little bit more details on the revenue. The Affinity portfolio increased revenues by 14.4%, again on a combination of price readjustment on 90% of our portfolio of 17.8%. This was the level of price increase and the mix effects.

Also remind everyone that during last year in the second quarter, we had the Potencial results. Potencial is a company we created because of the antitrust process. And this

portfolio was sold in the second quarter. So third quarter 2015 is the first quarter that we don't have Potencial any more in our results. So that also affected the year-over-year performance of our revenue.

The second thing I wanted to mention here is the performance of CRC/Gama. The 62% year-over-year increase on revenue reflects the new countries that are coming in and are maturing. So this is a process that we have been discussing with you, too, guys, a while. So the new products are coming, are showing up some results, we are implementing. And that's the reason why we have the 62% year-over-year increase.

Jumping to slide number 7, where we discuss the costs, the cost of services. Here, I wanted to call attention for our gross margin which showed up improvement both year-over-year and sequentially. And in this line, I wanted to show up some numbers here that I think are important to remember.

The first one is the third-party services. We saw 14% year-over-year increase and 12% sequentially. You have a seasonal effect here because all the price readjustment process towards July makes much more demand on our call centers, so we have much more clients asking, calling us, and asking for several questions on the product, asking alternative.

We also had the process of Unimed Seguros that affected our third quarter results, also people, all the migration happened in third quarter, so people who also call us. So the call center volume increased considerably during this period, which made the increase in our cost of third parties.

The second thing I wanted to mention is occupancy expenses. We had the state tax on our new headquarter affecting this quarter. This is a normal process. It's not in common. It's common that the tax is only charged a couple of months later the construction. So, it's also a regular thing to happen, but it was an extraordinary BRL 1 million expense but it should not happen again.

The second thing - the third thing actually that I wanted to mention is the Others line, which was affected by mail expenses related to the price increase letters we sent to clients, and also some legal lawsuits that we have been doing throughout the year. The company has been negotiating in making contracts in advance, so this also affected the Others line, but it's part of our strategy a while already.

Going to the slide number 8, we have the admin expenses. I think we have a lot of good news on this line. You can see very large declines in several lines here. The number one is the personal expenses. This is related to the fact that we reversed part of our bonus program, given we normally do a semiannual, it's sometimes even quarterly analysis of how the company is performing. And during this quarter, given the performance we have been doing, we reverted a piece of our bonus provisioning. And that justified the personnel reduction.

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The second thing on third-party, this has come mainly due to the one-times we had in third quarter 2014, so do not happen again. And that is a good thing to show because in the third quarter 2014, we have been very vocal about the one-offs, and I think, we have the opportunity one year later to really prove that there were really one-offs and 40% down year-over-year justifies the reduction in these lines.

Also, in the third-party services, we also have all the expenses related to the Unimed Paulistana process, migration process. All the kits for the new products or affected products were sent in the third quarter, actually September. And that has cost us BRL 1 million during this quarter and this is all included in the third-party service. So, if it was not for this effect, the reduction would be even larger.

Then moving to slide number 9, when we talk about selling expenses. Here, in general terms, the increase both year-over-year and quarter-over-quarter is in line with the price increase. So we saw a 17.5% year-over-year and 15.8% quarter-over-quarter. This is completely in line with the performance of our ticket, so the fact that prices go higher make also commissions go higher and other expenses go higher.

The only point that I would stress out here is the one related to campaigns. This respects the seasonality of the quarter, so we normally do a stronger effort on the campaign side. Also, on third-party commissions, there are some mismatch in terms of timing, so the selling of March, for example, gets paid in April. The selling of June gets paid in July. So because of this mismatch, there is some year over increase on this line.

And lastly, on commercial, we have the publicity and advertising, which was reduced a little bit quarter-over-quarter 5%. And inside this number - this number is composed by BRL 1.6 million institutional campaign we did during this quarter. So if it was not for this campaign that I think we discussed that with you guys a couple of months ago, the reduction would be even, even larger. But anyway, we did the institutional campaigns, the number, it is what it is, but even though we saw a 5% reduction.

We have been very analytical and critical on this line, so we are strengthening the efforts on the lines that we believe has a more direct effect on sales and we are reducing efforts on some lines that we believe are not very linked and correlated to sales in order to boost our sales at the same time of controlling better costs.

Then moving to the slide number 10. We have the bad debt and other operating income. Here, we have bad debt going to 6.4% versus the 5.4% last year and 5.6% last quarter. We have been sharing with you guys the fact that recoveries were going down because we clean up all the inventory of bad payers that we have been doing over to last year. So it's natural.

We completely expected that this line was going to go down, and this is a piece of the explanation about bad debt increase. The other thing is really the moment of price increase, which brings delinquency higher combined and, of course, with the macro scenario we are living here in Brazil.

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Then on the other operating line, I don't think we had much news here. The line came very, very low as we normally imagine. This line is a little bit - sometimes a little bit negative, a little bit positive. This is completely under what we expected to be. So, no major news here on this line.

Then moving to slide number 11, that will discuss the financial results. Just wanted to call attention here for our short-term investment income. We see here a huge increase of year-over-year, that is because of our cash balance, which have been accumulating. This should not keep on in the fourth quarter, giving the capital reduction we paid to shareholders. So, you should see that line going down again, giving the payments we have done to shareholders.

Then jumping to slide number 12, finally, we discussed the EBITDA, which is the combination of everything I discussed before. So, we did a 43% margin only Qualicorp, which compares with 40% last year and 41% last year. And all-in, including CRC, we did 41%, which also compares with 41% last quarter. So, we are very happy to show up this margin improvement, especially in the environment that we are living, is the combination of a lot of efforts and a very hard work, on controlling expense. As we discussed it before, we were able to negotiate with a lot of suppliers to make the contract readjustment much less than inflation, and that is showing up in the results this quarter.

Then moving to slide number 13, where we have the net income. We have a BRL 64 million net income, which is the accounting net income, the base for dividend payment. The performance year-over-year and quarter-over-quarter is affected by some one-off effects that we have during last quarter. So, for example, the second quarter 2015, I recognized the gain on capital from potential sales, which makes the income a little bit higher than a regular level. So if I were to adjust, we would have a 22% year-over-year increase and 50% quarter-over-quarter increase in income, which reflects the top line growth and expenses control.

Then moving to slide number 14, we have the CapEx. The CapEx on IT is smoothly increasing, giving all the new system we are implementing, and Grace should mention that a little bit further down into the subject. And the other thing is the Rights segment agreement that we did with Vectorial. So we brought from Vectorial the right for the brokerage services with the insurance company called Unimed Norte Nordeste and Central Norte Nordeste for the timing of five years. So this was the right of Vectorial, we acquired that right. So we now have the right to use those insurance companies - sell the insurance companies of those operators.

Then moving to slide number 15, where we talk about cash flow, and we are getting close to the end. We have here a table with a very clear information on cash flow. So cash flows (16:49) costs were BRL 150 million on the operating side. And here, I wanted to call attention, we pay interest semi-annually. So we pay in the first quarter, and third quarter.

So even with the interest payment accumulation in the third quarter of over BRL 30 million, we did a BRL 152 million operating cash flow, which shows up very strong improvement in our operating level. After CapEx, cash flow was BRL 60 million. I wanted

to call attention for the BRL 60 million intangible. Part of this comes from the CRC/Gama payment. Remember that we were supposed to pay in shares. We decided that for the benefit of our shareholders to not dilute shareholders even further and also to not compromise a part of our income for dividend payments.

So we decided to pay in cash, instead of shares that's reflecting here in our cash flow. If I were to exclude that effect, I would be generating more than BRL 100 million, which is in line with what we have been sharing with you guys. So the cash flow operations keeps on very strong helping us to reduce our indicators - liquidity indicators and helping also to bring some strength for further dividend payment.

So with that, I conclude my quarterly presentation. I'll now turn the word over to Grace, who will make some additional remarks. Grace, please go ahead.

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

Thank you, Natália. Good morning, everyone and thank you for your attendance. I would like to present the main (18:31) held in this quarter. First the annual price adjustment applied to the majority of our portfolio in July.

Second, the retention plan for Unimed Seguros that impacted this quarter. Third, the retention plan for (18:49) impact on next quarter, impacting the shares. Related to annual price adjustment, we set up a multifunctional team, fully dedicated to meet greatly impacts of price adjustment and retain our customer in the company. We developed a strong performance, regarding the (19:09) and the customer communication and the customer strategic and (19:15) products.

In the customer communication, we make communication plan in order to clarify crucial issues for the client regarding the price adjustment like why are the plans adjusted, how were the adjustment levels established, what is Qualicorp's goal as administrative regarding the rate reduction and the alternative offers?

The customer service call center, trained and resides to meet this specific demands of price adjustment. Creation of a simulator that allows to the call center operators to offer with agility, the three to five most appropriate plan option for each client. Creation of a hot site, with the main questions of price adjustment. In the downgrade in our technology products, renegotiation with the operators in order to offer downgraded plan options with no grace periods during the price adjustment period.

In development of new product with the operators to be offered for clients and may which early saw with the new price of the original plan. Now, related to Unimed Seguros retention plan, due to the (20:31) Unimed Seguros to cancel Affinity contract, hold with Qualicorp, we took the following providence.

We do the stabilization in offering without grace period of an alternative products to Unimed FESP. To all of this 32,000 lives coverable by Unimed Seguros, we are able to retain about 60% of each client base with slightly higher revenue.

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In Unimed Paulistana retention plan, after the termination (21:10) due to the difficulties faced by the operator in the last years, we took the following initiatives; rehabilitation, proactive offer of new products, (21:26) for extension from grace period. We provide also two offers for each client; one with the same price, and another one with similar coverage. Negotiation, with other operators to offer products with special price conditions and reduced grace period. Implement of the taskforce between differential areas of the company to promote and manage in just one month a large scale operational process, covering all of our customers sales and sales channels.

And we were able to retain them in excess in order of the rate of more than 70% of our previous portfolio in Unimed Paulistana. (22:14) tax initiatives, the conclusion of the capital reduction that we just had in October, approval of the transfer of that activities of Qualicorp (22:24) by our board of directors allowing sales tax rate reduction, which will regenerate a real annual sales of BRL 13 million.

Tax benefits related to interest on capital of the group's subsidiaries allow a real saving for cash of BRL 13 million. It's worth noticing that the company has not yet completed all its to increase tax efficiency. And we also sees other possibility for improvement. We are working hard on that front where we believe we can bring more positive news in the future.

Finally, I want to say that I still see a lot of work to be done with Qualicorp to improve operational efficiency. I believe this most dedicated moment of our economy is an opportunity to us, to renegotiate with our suppliers. And even with some macroeconomic difficulties impact our ability to grow, I still see 2016 with an EBIT result, EBITDA growth, cash flow increase and a great dividend distribution to shareholders. Thank you all.

Natália Lacava

Now, we would like to open for question-and-answer session, please.

Q&A

Operator

Thank you. We will now start the question-and-answer session. And our first question comes from Rafael Frade of Bradesco. Please go ahead.

Q - Rafael Frade {BIO 16621076 <GO>}

Hi, good morning all. I would like just to follow up on Grace's comments about how was the process in the price increase this year. When we look the evolution of the average ticket, we see that it's increased really close to what you mentioned at the average row increase, indicating that maybe there were no major downgrades or changing plans and this kind of thing.

So, I would like to get more color on this process, how it was also at the end of the day declines keep this more or less the same plan or there were a lot of downgrades? So, if you can you give us more color on this, it would be great.

A - Natália Lacava

Hello, Rafael, this is Natália, speaking here. I'll try to help you. If Grace has any additional comments, she can jump in. So, basically, you're right. I mean, in terms of ticket increase, you see a still stronger ticket increase and you are also right in the fact that the number of downgrades during this quarter, it was not considerably meaningful, we had some. I can get that information for you, I think, anywhere between 9,000 to 10,000 people downgraded the plan, so it was not meaningful to make a dramatic change in our average ticket increase during this quarter.

The thing is that what we feel from clients is that there is some resilience on downgrading the plan. Normally, people call us asking for the downgrade and then they realize that they are cutting off their coverage, they give up, they say, no I'm going to try to cut other expenses, I'm going to try to keep the plan. So we still have on hold some clients that call us during this quarter asking for alternatives and they're still within the base thinking about what they're going to do.

So we receive around 25,000 clients asking for alternatives, but they still have not made their decision. We are keeping with the plan so far. So anyways, making a long story short here, we have - the conclusion we have is we have a resilient base of clients, we have a lot of clients that do have ability to keep on with the pricing increase and cut in other expenses. As you know that we are focused on the mid to high income class, so that gives us some cushion for that and that's helping us to keep on with the revenue increase.

Q - Rafael Frade {BIO 16621076 <GO>}

Right. Maybe a follow-up on this, what I would like to understand is that this increasing churn would be expected to be one of the reasons is the huge price increase but you are providing some alternatives like plans with copayments or plans with more strict network - and but given that most of the clients think that they didn't downgrade the plans, those alternatives were not helpful to reduce the churn. So this churn is really happening, because for other factors, mainly more from macroeconomic than really for the price readjustment. (27:37)

A - Natália Lacava

Yes, exactly. We still see the main reason of complaints, when people churn, we try to offer alternatives and the person does not accept, the argument is really the financial distress, so yeah, most of our churn comes from clients more in the low end. Sometimes we don't have the alternative because he is already in the very low end of the base, so this is one factor. A piece of our churn is because I don't have a cheaper solution because he already is in the low end. So this is one factor.

The other factor is people sometimes, they have, let's say a national plan, and they decide to go to a regional plan in that city. As small regional plans, we don't have a

relationship with 100% of the insurance companies in Brazil. So sometimes people decide to move to a neighborhood plan, a small plan. So this is mostly the reason for the churn. So I agree with you. I think the macro is waiting a lot on the churn, not only the price increase. Mauricio, do you want to add something?

A - Mauricio Ceschin {BIO 18750717 <GO>}

No, I just want to add that what happens is that the churn is bigger in the lower end prices and the product mentioned. Then, I mean, in the higher level of prices, in terms of products that we sell, so as you go down in types of products and prices, churn goes up, and that's the reason why, and I kind of explained to you that. And one of the things I just wanted to point is just I wanted to mention is that although we have some people downgrading in around 10,000, it's funny that we have still people upgrading plans, and not in the same rate, but you have the number, isn't that approximate number, don't you Natália?

A - Natália Lacava

Yeah. It's around 3,000 clients upgrading their plans during third quarter of 2015.

A - Mauricio Ceschin {BIO 18750717 <GO>}

That's it.

Q - Rafael Frade {BIO 16621076 <GO>}

Okay. That's very clear. Thank you.

A - Mauricio Ceschin {BIO 18750717 <GO>}

Thank you.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Ms. Natália Lacava for any closing remarks.

A - Natália Lacava

Thank you, everyone, again. We, in the investor relations team, we are open for your follow-up questions throughout the next days. Feel free to reach us. Thank you again for your support. And have a nice weekend.

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

Thank you, everybody.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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