Q3 2016 Earnings Call

Company Participants

- Flavia Oliveira, IR Manager
- Leonardo Moretzsohn, CFO
- Pedro Thompson, CEO & IR Officer

Other Participants

- Bruno Giardino, Analyst
- Marcelo Santos, Analyst
- Marcio Osako, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. Thank you for standing by and welcome to Estacio's Conference Call to discuss the Third Quarter of 2016 Results. This event is also being broadcast simultaneously on the Internet via webcast, which can be accessed on the Company's IR website www.estacioparticipacoes.com.br/ir together with the respective presentation and the earnings release.

We would like to inform that during the Company's presentation, all participants will only be able to listen to the call. We will then begin the Q&A session when further instructions will be given. (Operator Instructions)

This conference call contains forward-looking statements that are subject to risks and uncertainties that could cause the Company's actual results to differ materially from those in the forward-looking statements. Such statements speak only as of the date they are made and the Company is under no obligation to update them in light of new information.

I will now turn the conference over to Mr. Pedro Thompson, CEO and Investor Relations Officer. Please Mr. Thompson, you may proceed.

Pedro Thompson {BIO 19803506 <GO>}

Thank you. Good afternoon, everyone. Welcome to our conference call to discuss our results for the Third Quarter of 2016. Here today are Leonardo Moretzsohn, our CFO. And Flavia Oliveira, our IR Manager. Just to remind you all that there will be a Q&A session as soon as the presentation is over.

Let's go straight to Slide 3, which shows the agenda of our presentation. We will be addressing the following points; quarterly highlights, where we present (inaudible) revenue and EBITDA and the changes to our Executive Board; operational performance, which deals with the student base and increase in the average tickets due to the various recovery initiated introduced in the Second Quarter; financial performance showing our main indicators, which have become more consistent after implementation of the new policies and the final remarks, where we highlight some of the new strategies and 2017 guidelines.

Moving to Slide 5, here you can see the new structure of our Executive Board, which has been subjected to important changes with the election of executives with extensive experience of the market and now comprises as CEO and six executive officers. Now, I will introduce my new team who had arrived to help us overcome the challenges currently facing the Company.

The first one, Mr. Leonardo Moretzsohn joined Estacio in October as CFO, has introduced his career in the financial, strategic planning development. And corporate management areas of several major companies, including as CFO and CEO such as (inaudible), he has also been a member of Board of Directors of companies in Brazil and abroad. We are certain that Mr. Moretzsohn will make a vital contribution to the Company and help us deliver consistent results to our stakeholders.

The second one, Mr. Mauricio Ignacio, is our HR Officer since October of this year and brings with him a deep knowledge of the human resources, change in management organizational transformation in strategic areas. Before joining Estacio, he was HR officer with several leading companies, including Contax Participacoes and Coca-Cola. We elected as our Academic Officer, Hudson Mello, Marketing Officer, Higino Viegas and Distance Learning Officer, Aroldo Alves from our in-house talent programs of all whom have brilliant careers and performance outstanding for the Company. The new elected Board has brought a new look to the Company. We have a common objective and major challenge to be overcome being fully committed to delivering excellent results, more innovation in our team, putting people first. And meeting our shareholders' expectation.

I will now continue with this quarter highlights. On Slide 6, we can see that our net operating revenue improved, closing the quarter at BRL763 million, 7.6% (inaudible) the Third Quarter of 2015 and we registered a (inaudible) of EBITDA. Following the replacement of accounting policies and practices implemented on the last quarter, we have booked some processes and despite the continuation of challenging environment here in Brazil and we registered 14.6% upturn in EBITDA over the Third Quarter of last year to BRL194.5 million, with a margin of 25.5%, 1.5percentage points higher than the same period last year.

A fair comparison however would be to exclude the effects of the discounts on the new FIES rates, which did not exist in prior period as well non-recurring expenses from the internal restructuring and ongoing expenses with M&A and non-recurring advisory services, in which the Third Quarter EBITDA would come to BRL210.3 million, 23.9% up on the Third Quarter of the last year, accompanied by a margin of 27.6%, a substantial 3.6percentage points improvement. This performance is direct result of the guidelines we set out for the second half of 2016, focusing on immediate initiatives to recover the tickets, reduce costs and expenses. And generate cash.

Now, let's go to Slide 7. Here I present our deliveries in the second half, which were totally in line with the guidelines presented in our Second Quarter release. These deliveries refer to the recovery of the tickets, faculty performance gains. And advertising expenses. Operating expenses also improved, (inaudible) of the ongoing change in corporate's future in cash generation.

I will now hand you over to our IR Manager, Flavia, who will go into more details on our initiatives to recover the tickets as well as the performance of our student base.

Flavia Oliveira {BIO 20130905 <GO>}

Thank you, Pedro. Now on Slide 8, you can see the results of our efforts to improve our tickets. In the first part of 2016, the average on-campus ticket came to BRL625, while the average distance learning tickets stood at BRL189, an increase of 9.1% and 14.1% over the same period last year. This performance shows that the guidelines revised and prioritized by the management in order to restore the details and ensure a better revenue performance are being effective. We managed to reduce the percentage of freshmen discount and scholarship, marking the beginning of the process to improve our new sales strategy. With intake based on less discounts and scholarships, the Company aims to build a more sustainable student base, reducing the dropout rate on initial periods and ensuring that (inaudible) of children have better options to pay what they own.

Moving on to our student base on the same slide, we closed the Third Quarter 2016 with 548,000 students in total; around 2% more than last year. We have 383,000 students enrolled in on-campus courses and 161,000 in distance learning program, as well as 2,700 students from the recent acquisition. At this point, it is worth noting the growth of our graduate base with total 76,500 students at the end of the Third Quarter, up by 30% in distance learning segment and 11.5% in the on-campus segment. This was a result of the changes and improvements developed along the year, prioritizing the academic and operating performance of this segment. Now, I will hand you over to our new CFO, Leonardo. Please go on.

Leonardo Moretzsohn {BIO 15216920 <GO>}

Thank you, Flavia. Good morning, everyone. So let's start showing by taking all to go to slide number 11, where we can see the net operating revenue of (BRL763.1 million) in Q3 this year, which is 7.6% higher than the same period last year. It's important to mention that this is (inaudible) of 2% of the net revenue from the FIES contract regarding to Executive Decree 741, which we had an impact of BRL7.1 million in Q3. Excluding this effect, the net revenue would have grown by (8.3%), in line with the period increase in the average ticket and offsetting BRL11.6 million reduction in Pronatec revenue due to the graduation of the last students in this segment.

Jumping into the next slide, 12, you can see that cash cost of services represented 48.7% of net operating revenue this quarter compared to 51% in the same period last year. Margin gains of 2.3percentage points, essentially due to the personnel line, which had a positive impact due to the longer faculty vacation period this year, which was 30 days compared to 15 days the same period last year. In addition, I have to mention as well that various initiatives were implemented to optimize the management of faculty costs, including one, greater control to ensure the application of online subjects whenever foreseen in the curriculum matrix; two, expanding the offer of telecourses; and three, offering directed study classes in the distance-learning segment. As a result, faculty costs recorded 3.5percentage point margin gain over the same period last year on the net revenue churns.

Selling expenses represented 10% of net operating revenues corresponding to a margin gain of 2.7percentage points with important gains in both the PDA and marketing lines. The end of the Olympic Games institutional campaigns and the reassessment of the Company's marketing campaign began to produce results, generating a year-over-year margin gain of 1.7percentage points. In addition, after the fine-tuning of internal controls in Q2 this year and the creation of a specific area focusing on collection and the treatment of defaulting students, short-term initiatives led to a 0.9percentage point improvement in PDA over the same quarter last year.

It's important to emphasize that and call your attention to some of the initiatives that are in place and will remain for the next year. One, the use of a specialized advisory services for the charging effective in active students, establishing portfolio recovery targets based on benchmarking sector peers. Two, the implementation of analytical studies to improve recovery and collection process through association with credit agencies. Three, modification of the active and inactive students collection scale, anticipating and improving communication with students via the various negotiation channels. Four, initiatives for new forms and payment. Fifth, stricter rules regarding their protest in the inclusion of the 40 students in credit protection phase III. And last but not least, the definition of the units 2017 overall collections target. With this initiative, we're expecting sure increasingly efficient collection with low default.

Coming back to the numbers. In operating expenses table, we can see that G&A expense represents 16.3% of the net operating revenue this quarter, a 3percentage point loss over the same period last year, mainly due to the performance of the personnel and third-party services lines.

Personnel expenses were impacted by BRL3.8 million as a result of the process to reduce the corporate structure and rationalize staff numbers. This led to a margin of 1.6percentage points in this line. If this effect was excluded, the margin loss would have come to 1.0percentage point, mainly due to the quarter's collective bargaining agreement with administrative staff.

Expenses with third-party services were impacted by almost BRL5 million in addition to expenses with, one, advisory and auditing services related to the revision of accounting policies and practices in 2Q this year; and second, expenses with advisory and consulting services related to the M&A negotiations in course.

Moving to Slide 13, we present our net income for the quarter, which came close to BRL136 million, representing 7.2% more compared to the last year. Thanks to all of our efforts -- the Company efforts to improve performance, while the net margins stood at 17.8%. It is also important to mention that this was the highest quarterly net income figure for several years.

Moving to Slide 14, it is an important message. The average non-FIES receivables period improved by eight days over the same period last year. Thanks to the Company's initiatives, we are focusing on improving our collection campaign and students debt renegotiation policies. Account receivable increased in Q3 this year, primarily due to an upturn in FIES accounts receivables. In comparison to last year, Estacio's average receivable period increased by 12 days to 141 days, strongly impacted by the delays in amending the FIES contract for the second semester of this year and the consequence of the flow of transfer this quarter, which increased the average FIES receivables period in total to 249 days.

On the next slide, cash and cash equivalents closed at BRL575 million, conservatively invested in fixed-income instruments pegged to the CDI interbank rate, government bonds and certificates of deposit with top-tier banks in Brazil. This is strictly following the policies and rules established by the Company Board.

I'll now -- the breakdown of the gross debt of BRL811 million is composed by three bonds issued by the Company, two loans, the IFC and the capitalization of equipment leasing expense in compliance with the Law 11,638. The reduction of BRL234 million in loans and financing line over last year was essentially due to the settlement in March this year of an entire debt related to a foreign-currency loan from Banco Itau, which in total was $100 million. We have also to consider the commitment for future payments related to past acquisitions of BRL92.5 million, as well as tax payable in instalments of close to BRL20 million, which makes Estacio's gross debt comes to BRL923.3 million at the close of this quarter, resulting in net debt of almost BRL348 million.

This slide also shows our CapEx, which comes to around BRL40 million, basically reflecting investments in campus and the unit maintenance in line with the strategy of preserving cash. A number of non-priority projects and expansions were discontinued. But without jeopardize the operations of the Company. At the same time, in order to optimize and improve our system, we increased our investments in the academic model and new IT architecture. As a result, total investments represented only 5.3% over -- of the period.

In Slide 16, operating cash flow of BRL195 million this quarter reflects a substantial improvement in performance over the same period last year, especially when you look at the EBITDA to operating cash flow conversion ratio, which stood at more than 100% compared to 55.3% one year ago.

Jumping to Slide 17, we would like to explain in more details the payment of the interim dividends approved by Extraordinary Shareholders' Meeting last November 10. The amount in question was BRL420 million, as established in the Protocol and Justification of the merger of the Company's shares by Kroton and the spilt as follows: Two-thirds of that, BRL280 million, to be paid in two installments this year. First instalment in next November 22 and the second instalment by December 15. Share of the Company will be traded as ex-dividend as of today.

The remaining one-third of BRL140 million will be paid given the possibility of freeing the FIES payments this year or at the beginning of next year. And aiming to maintain the solidity of our cash flow. The Board of Directors has been authorized to declare these dividends at a time deemed to be most appropriate for the Company, even before the approval by CADE, the Brazilian antitrust authority. In this particular regard, shares will only be traded ex-dividends as of the fourth business day following the Board of Directors meeting in which the dividends are declared.

Now, I would like to hand you back to our CEO, Mr. Pedro Thompson, who will bring the presentation to a close by talking lead about our guidelines for 2017, following by his final remarks. Thank you.

Pedro Thompson {BIO 19803506 <GO>}

Thank you very much, Moretzsohn. It's a pleasure to have you here (inaudible) in the transparency of our results. I will now conclude our presentation with slides 19 and 20. We set out our guidelines for 2017 and its strategies we believe to be important to continuing our improvement process. Intake strategy. To ensure sustainable revenue growth, we will present our student intake strategies and begin to adapt to the following initiatives, which are being implemented for the rest of the enrolment cycle. Resizing up the sales force and new incentives for the sales team and the channel mix; more restrictive policies for the granting of discounts and scholarships; the definition of intake targets and KPIs also based on the average tickets and revenue; and the last one, price alignment with the competition and elasticity studies.

Marketing and advertising plan. Estacio's marketing strategy has been based on national campaigns and the strong use of online and media channels. Following an intensive reprisal of these campaigns' performance and results, the Company decided to adopt a more regionalized strategy, with messages that take cultural and competitive skills and especially, the strength and recognition of the Estacio's brand in each location, into greater consideration.

Faculty costs. Given that this is the Company's biggest cost item, we have some initiatives that are already in place and expected to achieve impact in the short-term. First one, cost planning in relation to faculty activities outside the classroom; second one, definition of an annual offering of a group of subjects with a low operation performance; and the last one, expansion of 20% distance-learning content ceiling to the legacy courses in acquired companies.

Our last strategy is the cash generation. Based on the guidelines already implemented this year, in 2017, we expect more effective cash generation based on, first one, exploring collection incentives; second one, better control over CapEx; and the last one, increased procurement efficiency, with longest working capital terms and synergies.

We can now move to the Q&A session. Thank you.

Questions And Answers

Operator

Thank you. Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) Bruno Giardino, Santander.

Q - Bruno Giardino {BIO 15974970 <GO>}

Hello. Good afternoon, everyone. Congratulations on the results. First question on the intakes in the second half, could you please tell us how was the performance if you were to exclude the because of the fact of the Rio de Janeiro because of the fact of the Olympic games? And second, could you please detail what were the main changes to the student renewal process when comes to the renegotiation of students that were not updated on payment? Thank you.

A - Pedro Thompson {BIO 19803506 <GO>}

Thank you, Bruno. The first one, the schedule of the Olympic Games in Rio. We have started intake time to put on some students base. So we have more challenge here. It's a fact. Okay? And regarding the -- if you can repeat your second question please?

Q - Bruno Giardino {BIO 15974970 <GO>}

What were the main changes to the student renewal process, especially those students who were not -- who fall back in payment?

A - Pedro Thompson {BIO 19803506 <GO>}

Yes. This is your first one, that we have, how can I put you a (inaudible) go to two years, three years and we are applying a lot of discounts -- aggressive in discounts to recover these receivables. Okay? And the last one is our organic receivables that we now have agenda of collection with structure process with third parties to help us in our strategy, it's a focus even more in our collection.

Operator

Marcelo Santos, JP Morgan.

Q - Marcelo Santos {BIO 20444938 <GO>}

Hi. Good afternoon. Thanks for taking the question. It's regarding the G&A expenses, even if we remove the non-recurring items that you singled out in the release, we would still see a level of G&A, which is substantially above what we have been seeing in the previous quarters. So I want to understand what's the outlook for this line? Is this a level that is a recurring level going forward, or what should happen? That's the question.

A - Pedro Thompson {BIO 19803506 <GO>}

Thank you, Marcelo. In fact the first one, our G&A expenses, it's a fact that we are less efficient due to some facts like IT expenses that we have with some (technical difficulty) and some of our legal expenses too. Okay? And you have a second question, all right?

Q - Marcelo Santos {BIO 20444938 <GO>}

No. This was the question. Thank you.

Operator

(Operator Instructions) Marcio Osako, Safra.

Q - Marcio Osako {BIO 6748109 <GO>}

Hi, everyone. I have just one question related to faculty costs. During this quarter, there was a sharp reduction. I just wanted to know if there was a reduction in the number of teachers in quarter two to the Third Quarter and what was the impact of the 30-day vacation you had in this quarter and if you could tell us the amount of savings related to it? Thank you.

A - Pedro Thompson {BIO 19803506 <GO>}

Thank you. So this is the impact of the Olympic Games schedule. In fact, we have these impacts due to the vacation of the teachers here in the city of Rio. But it was a zero impact. The most aggressive impact on this account is due to the -- our organic initiatives with less classrooms and more efficiency with students per classrooms, students per teachers.

Q - Marcio Osako {BIO 6748109 <GO>}

Okay. But did you have any reduction or layoffs of teachers in this quarter?

A - Pedro Thompson {BIO 19803506 <GO>}

We just optimized our -- yes, the result. I cannot give you now some numbers about that. But we did meet our (trim fit) of our teacher base in the Third Quarter.

Operator

(Operator Instructions) There seems to be no further questions. I would like to turn the floor over to Mr. Pedro Thomson for his final remarks.

A - Pedro Thompson {BIO 19803506 <GO>}

I'd like to thank you all for taking part in our Third Quarter results call. Our Events and Relations department is always available to help you with any questions you may have. Our contact information is in our website. We hope to see you again at our conference call next quarter. Once again, thank you very much and have a great day.

Operator

The conference has now -- this concludes Estacio's conference call. You may now disconnect and have a good day.