

Q3 2018 Earnings Call

Company Participants

- Grace Cury de Almeida Gonçalves Tourinho, Chief Financial Officer & Investor Relations Officer
- Pedro Henrique Rocha Nocetti, Investor Relations Manager

Other Participants

- Guilherme Baiardi, Analyst
- João Julio Matos, Analyst
- Marco Calvi, Analyst
- Olivia B. Petronilho, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, ladies and gentlemen, and thank you for holding. At this time, we would like (00:00:07) Qualicorp's Conference Call to discuss the results of the Third Quarter 2018. We have with us today, Mr. José Seripieri Filho, CEO, Mrs. Grace Tourinho, the CFO; and Mr. Pedro Henrique Rocha Nocetti, the IRO and IR Manager.

This event is also being broadcast live via webcast and may be accessed through Qualicorp's website at <http://www.qualicorp.com.br/ir>, where the respective presentation can be found. This event will be recorded and all participants will be in listen-only mode during the company's presentation. Ensuing this, we will go on to the question-and-answer session when further instructions will be given.

I would now like to turn the floor over to Mrs. Grace Tourinho who will start the conference call. Mrs. Tourinho, you may proceed.

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

Good afternoon to all of you and thank you very much for your presence at our third quarter 2018 conference call. As in previous years, we concentrate most of the price readjustments of our portfolio between July and September. 33% of our clients undergo a readjustment. And this year 2018, the focus was to retain our clients and this involves all of the areas of the company which meant that we try to develop accessible projects and to place them at a disposal of our clients through communication and active offers for downgrades.

With this, we were able to significantly improve our performance reducing the loss of lives vis-à-vis the previous year even after the readjustment. While we expect for this year is to end the year with an organic net loss of approximately 60,000 lives vis-à-vis a loss of 150,000 that we had in 2017. However, we still foresee further opportunities to absorb some market portfolio.

I would now like to give the floor to Pedro. Pedro, you may proceed.

Pedro Henrique Rocha Nocetti {BIO 20904123 <GO>}

Thank you, Grace. Good afternoon to all of you. And we begin on slide number 4 and begin to speak about our portfolio. We ended the third quarter 2018 with an improvement vis-à-vis the third quarter 2017. This improvement is not only in absolute levels, but also in relative levels as a percentage of our customer base.

And this is a very clear impact of the retention work as a company. And based on a comparison in the third quarter 2018, we were able to do a downgrade for more than 28,000 lives, a level that is double of what we were able to downgrade in the third quarter of 2017. So, this is what the retention work obtained. When we analyze the growth specifically, we have a growth in the annual comparison.

With retail sales wholly, there are no non-organic effects in this level of gross adds for the third quarter 2018. And the share of the Clube de Saúde (00:04:05) 24% in the total of gross adds. With this, we ended the quarter of 2018 with minus 42,000 lives in our portfolio, a loss that is 40% lower vis-à-vis the third quarter 2017.

Now, for the first nine months of the year, the performance was practically 73% better compared to the first nine months of 2017. We go on to the fourth quarter of 2018 and preliminary data from October point to an annual improvement vis-à-vis October 2017, improvement of 50% in our annual performance, which means that we're losing less lives in October 2018 compared to October 2017.

And as Grace has already mentioned, what we expect is that this will continue on and with more accessible products available the full year and with the retention work that is being carried out during the entire year, we will be able to resume our increase in number of lives year-after-year.

We now go on to slide 5 to speak about our net revenues, BRL 491 million for the third quarter of 2018. We have a sequential increase vis-à-vis the second quarter because of the price readjustment. And as part of this price readjustment, there is the impact of a ticket that is below the average of the portfolio, as well as the impact of the downgrades. So, what we see is, there's an effective increase of the ticket of 10% between June and September.

When we look at the annual comparison, the third quarter 2017 and the third quarter 2018, there is a reduction in revenue, once again due to the lower level of lives in our portfolio and perhaps somewhat less revenue from brokerage and advances.

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We go on to cost and expenses for the company on slide number 6. You can observe that gross margin for the third quarter 2018 close in the annual comparison, as well as in the sequential comparison which means that we have been able to capture value with less expenses with personnel and spending less or with lower cost in royalties.

When you look at the graph below, we show you the evolution during the last five quarters. This is the evolution of the gross margin and the capture of value in the company has proven to be consistent, even in a scenario where it is very difficult to increase revenue. This is thanks to our in-house work looking in-house, peaking results, peaking efficiency, and trying to rationalize the use of our resources.

In slide number 7, we speak about administrative expenses, SG&A. We have a trough in the annual comparison of approximately 3.4% and a trough in quarters of almost 7%, clearly due to less expenses with personnel. When we compare the second quarter 2018 with that of 2017, in 2018, we had an extraordinary effect in expenses with personnel that was not repeated in the third quarter.

When we observe the annual increase in other administrative expenses, we do have an effect of an increase in regulatory contingency. If we look at the graph once again, we show you the evolution of administrative expenses and how much they occupy of our net revenue and the trends that we show to rationalize expenses in this particular item.

In commercial expenses and selling expenses, we would like to remind you of the impact of the IFRS 15 in the way that we show these selling expenses. We have the in-house commissions and third-party commissions because of sales. These are part of our results in the amortization line item. And besides the amortization, we have the amortization of sales campaigns that are linked to awards based on sales. In the second quarter of 2018, we have already capitalized approximately BRL 6.5 million in sales campaigns.

And in the third quarter 2018, we capitalized BRL 7.7 million in sales campaigns and awards. Therefore, this is part of our results and will continue to be part in the next 24 months. When we look at the increase in third-party commissions, these are recurrent commissions and brokerage. The increase is due to the compensation policy of the company with the outside channel, the channel that helps us to retain lives and to maintain lives in the company's portfolio and to carry out good sales. This is an expense that brings a return to the company, brings us good customers, and allows us to retain customers generating results for the company.

And the Qualicorp's sales force lies in the broker and the sales channel. Once again, we can increase our sales policy if necessary if this will bring more lives to the company in the medium- and long-term. This is something that we perceived as to do (00:11:06) at the beginning of the year, we do this whenever necessary and we'll continue to do it.

Having said this, I would like to return the floor to Grace who will speak about the profit sharing plan and other aspects.

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

We had a big surprise which is the significant improvement vis-à-vis the second quarter 2018. We obtained a percentage of 5.2 of net revenues and (00:11:35) to highlight the intense work recover the losses accounted for in the previous quarters, mainly including the Aliança segment. Compared to the previous year, we more than doubled the volume of losses recovered.

When we compare the second quarter of 2017, we recovered BRL 8 million in the third quarter of 2018. Additionally to this and something that was very helpful with the non-recurring event was the recovery of BRL 6 million referring to customer credits with injunctions in the operator.

With this, our profit sharing plan has obtained a level desired and we believe that we will recover this figure even more in the fourth quarter as every fourth quarter focuses on a campaign to be able to capture the 13th salary that our clients receive. And this is also helpful for us.

We go on to slide number 10 and we speak about financial results. We can see the same trends that we observed in the second quarter of 2018, where we have the financial revenues with applications that have no impact because of SELIC. Once again, fines and interests for defaults are due to the change of our policy in November of 2017, where our fine when from 10% to only 2%. And when it comes to financial expenses, we are faced with the same situation when we speak about the update of our debenture. Once again, they suffered because of this policy. And the monetary restatement, we no longer have anything as we paid the last acquisition in 2017 which was Aliança. So, our financial operations remain at the same level.

On slide 11, we see the EBITDA. We see a sequential recovery of volume and margins associated to better expenses with personnel and the losses within collectible credits (00:14:08) that made possible a growth of almost 13%. Our focus continues to be the same, to have an efficient company with quite a bit of room for improvement.

We go on to net income on page 12. When we compare the third quarter of 2018 with the previous year, we had a stable net income, despite a reduction in operating profit, reaching a margin of more than 22% and a growth of almost 24% in comparison with the second quarter 2018, because of the improvements in operational results. This clearly shows the company's capacity of delivering good results, even in a more challenging scenario and by paying dividends. When it comes to the tax burden in this quarter, we stood at 34.9% vis-à-vis 36.5% in the second quarter 2018 and 35.5% in the third quarter 2017.

We now go to our slide referring to CapEx and indebtedness. On September 28th, based on the unanimous decision of the company's Board of Management, we signed a non-compete contract with our founding shareholder. The cost of acquisition is of BRL 206.9 million, BRL 150 million of payments and BRL 57,000 retained as taxes. This contract will be amortized during the period it is in effect which is 72 months beginning in October of

2018. If we exclude the effect of the non-compete contract, our net debt will fall approximately 60%.

We go on to slide number 14 to speak about our cash flow. Our operational cash flow after CapEx of more than BRL 180 million for the quarter considers the improvement in the working capital accounts with greater investments in sales. We would like to remind you that the interest on debentures are normally paid on the second and fourth quarter of every year.

At this point, we would like to conclude our presentation. Thanking you for your attention and we will go on for the question-and-answer session.

Q&A

Operator

We will now begin the question-and-answer session. Our first question comes from Mrs. Olivia Petronilho from JPMorgan. You may proceed, ma'am.

Q - Olivia B. Petronilho {BIO 19090195 <GO>}

Good morning, Grace and others. Allow me to focus on the evolution of Clube de Saúde and the share on gross adds, what is the performance of the new plan that we have been discussing in the Northeast to have more accessible prices? And if this is the reason for the loss of participation of Clube de Saúde or if it is the impact of the downgrades?

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

Olivia, to respond to your question, Clube de Saúde is one of our segments with very good sales. The great issue is that we have increased the incentives, we're focusing on sales campaigns to sell products with a higher ticket. And this is the result that we have been observing already in the second quarter and that culminated in the third quarter with a greater share of participation for higher ticket products, with a decrease for Clube de Saúde.

An important point is that we needed to have the products in hand. We were able to deliver these products throughout the first four or five months of 2018. We initially placed them in our in-house channel beginning in June. And in the third quarter of 2018, we began to sell these products in our outside channel with incentives to sell them. And these are the results that we're seeing. Of course, our intention is to sell a bit of everything, but we do see that there is more room for a slightly higher ticket for plans (00:19:29) compared to Clube de Saúde.

So, this represents 1% in sales, compared to 30%. And this 30% therefore refers to new products, 21% refer to the downgrades. We adopted strategy Aliança of carrying out active offer for downgrades to a significant part of our client base. We have many more clients during the downgrade and I think you realized this in the call and we have a change in the downgrade profile as well.

We have people who changed from one segment to the other - another that is immediately below, and, of course, the ticket will also be lower. And I believe that this could be a path to have a downgrade of 30% lose a (00:20:33) significant part of downgrade with a higher ticket and the rejection will be lower.

Q - Olivia B. Petronilho {BIO 19090195 <GO>}

Thank you. Thank you very much.

Operator

Our next question comes from Marco Calvi from Itaú BBA. You may proceed, sir.

Q - Marco Calvi {BIO 19854632 <GO>}

Hello, and have a good day. A question about your financial pass through or transfers. We observed a substantial improvement in this line item year-on-year. I would like to know which are the main company initiatives underlying this improvement, change in the profile, if you could comment on the main initiative - or incentives in the company that's underlies this improvement?

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

Marco, thank you very much for your question. In truth, there's a bit of everything. It's a combination of the product mix of the regions where they are sold. We have also started to work with this line with quite a bit of caution and attention. And the trend is that it will continue to absorb the enhancements we are carrying out. I truly cannot specify (00:22:00) the specific action. It's a combination of three or four activities that we have put in place to be able to achieve this goal. I truly will not be able to fully respond to your question, but we're at your entire disposal to discuss this more specifically subsequently.

Q - Marco Calvi {BIO 19854632 <GO>}

Thank you very much, Grace.

Operator

Our next question comes from Roberto Otero from Bank of America. You may proceed, sir.

Good afternoon. In truth, this is Pedro (00:22:43) and thank you for taking my question. I have a follow-up on the first question. If we consider that there is an improvement in the macro environment going forward, will you expect a stronger dynamic in the improvement over your plans in 2019? Or do you think that this dynamic will continue to be ever more challenging? This is my question.

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

Thank you, Pedro (00:23:14) for your question. Speaking very honestly, I still think, we are dealing with a very challenging scenario. It is important to mention that the economic

resumption will represent a second wave of improvement and liberal professionals are waiting some time before coming back or before carrying out an upgrade in their plans.

I don't doubt that we will have a significant improvement in the country. Nevertheless, we do not expect that this will happen at a very fast pace. And because of this, we're going to roll up our sleeves and do our homework, which means to work consistently, finding improvements in other lines, while it is difficult to obtain more revenues. I hope I have been able to respond to your question.

Q - Operator

Yes. Very clear. Thank you very much.

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

Thank you for the question.

Operator

Our next question comes from Mr. Guilherme Baiardi from BTG Pactual. You may proceed, sir.

Q - Guilherme Baiardi {BIO 19339786 <GO>}

Good day and thank you for taking my question. A follow-up on the partnerships in the company. I think there has been a capital restructuring in the company, if you could perhaps comment on this?

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

Guilherme, thank you very much for your question and this is a very motivating company. The focus of the company is the financial area to do good work, to have a sound recovery in 2019. All of this has been carefully conceived. Part of this has been put in place. We have got our hoping (00:25:13) to become a brokerage company and our coming products will be invoiced through this brokerage. This will be very helpful.

My - the intention of the company is to improve its capital structure (00:25:31) by incorporating the brokerage company that is just below the holding itself. And this is what we will be able to deliver in 2019. We still cannot inform you when, but we're trying to do this as fast as possible.

Q - Guilherme Baiardi {BIO 19339786 <GO>}

Thank you. Thank you very much.

Operator

Our next question comes from Mr. (00:25:55) from Bradesco Bank. You may proceed, sir.

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Good day, and thank you for the call. First, referring to the commissions that were mentioned, the value has had an increase vis-à-vis the second quarter, and of course, vis-à-vis the same quarter last year and you have mentioned that you are going to give more incentives to the sale channel if necessary. What are your expectations in terms of the behavior for specific line items for 2019 commissions?

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

Yes. Going back to what Pedro mentioned, what is more important at present when it comes to commission is to have an underlying intelligence to know which is the type of product we're going to give to the broker and in which market? I do not see any problem in offering incentives for those products that more attractive in terms of profitability for the company or to work with a specific market.

What is interesting about this work that is underway is that we have no problem in investing as long as the investment will bring us the expected return and this will be done. We may eventually diversify our investments in marketing, but the intention is to remain at the same level with which we invested in the second quarter of 2018.

Q - Operator

Thank you very much, Grace. And simply a follow-up. Is there any products that you're planning to give more incentives to, products with a higher average ticket? Because, if I understood properly, you believe that the resumption of the economy may take longer (00:28:08) in this field.

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

Our intention in the company is to work with a combination - a combination of the margin of the products that would generate higher margins for the company. And depending on the market and depending on the competition in the market and the product that it can generate, we will work on this. We can't give you a very straight answer, because of the new sales strategy that we preserve in-house. I would like to guarantee that we do have an intelligence underlying all of this and this is how we're making our investments.

Q - Operator

Thank you. Thank you very much for the response.

Our next question comes from Mr. João Matos from Santander. You may proceed, sir.

Q - João Julio Matos

Good day to all of you and a very quick question. I would like to understand if the credit that refers to the injunctions of customers or clients is recurrent or not?

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

It is non-recurrent. This is a one-time effect that took place during this period. And you will not see this credit appearing quarter after quarter. It refers to BRL 6.1 million precisely.

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Operator

Our next question comes from Mrs. Mariana Hernandes from Credit Suisse. You may proceed, ma'am.

Good afternoon. This is (00:29:58). And first of all, congratulations for your results. And I have two questions. The first refer to the downgrade. If we observe, this has increased a great deal vis-à-vis the year 2017. Will this continue going forward?

The second question, we can see that there is a sequential drop...

A - Pedro Henrique Rocha Nocetti {BIO 20904123 <GO>}

(00:30:33), good afternoon. This is Pedro. When we think about downgrade, this is something seasonal. The active offer of products takes place during the readjustment cycle. The intention is to have a trough in the downgrades in the coming semester, and eventually it can increase once again in the second quarter of 2019 because of the readjustment and we can perhaps offer lower cost products at that time. Now, this is my response regarding the downgrade.

Your second question, if you could repeat it, please?

Q - Operator

The sequential drop of gross adds.

A - Pedro Henrique Rocha Nocetti {BIO 20904123 <GO>}

Once again, there's a seasonality underlying this. When we readjust a product, we readjust our stock and the list price (00:31:26) for sales, which means that we end up having a drop in the gross adds. And the intention is that, through new campaigns, we will be able to resume or recover this in the months coming forward.

Q - Operator

Which is the peak of your downgrades in your understanding?

A - Pedro Henrique Rocha Nocetti {BIO 20904123 <GO>}

This quarter. It was this quarter and the trend is for the downgrades to trough.

Operator

As there are no more questions, we would like to return the floor to Mrs. Grace Tourinho, the IR Officer for the company.

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

Thank you all very much. Our conference call ends here and we are at your entire disposal to dissipate any doubts that you may still have regarding the results of the company for the third quarter. Thank you very much.

Operator

The conference call for Qualicorp ends here. We would like to thank all of you for your participation and have a good afternoon.

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