Y 2010 Earnings Call

Company Participants

- Carlos Alberto B. Lazar, Investor Relations Officer
- Rodrigo Calvo Galindo, Chief Executive Officer

Other Participants

- Alexandre Pizano
- Luis Azevedo
- Luis Bresaola

Presentation

Operator

Good morning, ladies and gentlemen. And thank you for waiting. At this time, we would like to welcome everyone to the Kroton Educacional Fourth Quarter 2010 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 a listen-only mode during the company presentation. After the company's remarks are concluded, 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 slideshow, may be accessed through Kroton's Educacional Investor Relations website at www.kroton.com.br/ir by clicking on the banner 4Q10 Webcast. The following presentation is also available to download on the webcast platform.

The following information is available in Brazilian Reais and in BR GAAP except when otherwise indicated. Before proceeding, let me mention that forward-looking statements are based on beliefs and assumptions of Kroton management and on information currently available to the company. They involve risks, uncertainties and assumptions as 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 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>}

Thank you. Good morning everyone and welcome to Kroton Educacional's fourth quarter 2010 results conference call. With us here today are Carlos Lazar, our IR Officer; and Renato Friedrich, our CFO; and Frederico Abreu, our M&A Director.

And in slide three, we can see that we closed 2010 with EBITDA of 63 million and a margin of 9.8%, exceeding our pro forma EBITDA guidance of 60 million disclosed to the market in August 2010. And our net revenue totaled 642 million and the gross margin stood at 34%. This performance was only possible thanks to the important measures taken after the acquisition of IUNI and integration project, which we currently covered in detail in the third quarter and which can be summed up as follows.

One, termination of 1,079 employees; two, implantation of the new post secondary academic model; and three, a substantial reduction in costs and expenses in the post secondary and corporate units. These measures had a significant impact on the company performance. The great majority of the integration and turnaround projects were implemented in August 2010. Consequently, in order to ensure a better understanding of the results... resulting impact on Kroton, we consolidated the results in two periods, pre-integration from January to July 2010 and post-integration from August to end of the year. In the three slides, I will comment in detail on these three important integration results.

On slide four, you can see clearly how performance improved before and after the integration process. The first graph shows just how much costs have fallen. Between January and July, Kroton represented 77.7% of net revenue versus only 61% in the post-integration between August and December, a decline of 22% or around 17 percentage points. If we look a little closer at this performance, we can see that all the main cost lines recorded a reduction.

In the graph on the right, you can see that costs with post secondary faculty and personnel fell from 49.9% of net revenue to 44.2%, a decline of 11% due to the layoffs resulting from the change of the academic model.

The bottom left graph shows the administrative costs dropped even more, felling by 9 percentage points or 66.2% from 16.2% to 7.1% of net revenue, reflecting the rigorous cost management procedures implemented in our post secondary units.

Rent also recorded a robust decline, falling from 11.7 to 9.7 of our net revenue, a reduced of 17% due to beginning of the rental contract renegotiations.

So on the next slide we can see that the post secondary gross margin widened from 22.3 to 39% between the two periods, an increase of 75%. The graph on the right shows that SG&A expenses fell 4 percentage points from 16 of net revenue to 12% of net revenue, confirming the self control on expenses. The outcome of all this change can be seen in the graph on the left. The post secondary margin after SG&A and provisions, which was a mere 0.5% before the integration, jumped to 21.3% in the post integration period, an extremely large increase of around 21 percentage points, showing that the post secondary results have moved to another level.

It's also worth noting that the entire turnaround process was followed by revenue growth between the periods before and after the integration. Even with implementation of an aggressive integration product, dropouts remained stable and new entrants actually moved. In other words, we managed to implement a series of structural changes in the post secondary segment without compromising the normal course of the business.

In the next slide, we can see the impact in the corporate area. The main impacts of the turnaround were concentrated in the post secondary segment and corporate area. As we have just seen, the post secondary gross margin increased from 0.6, 0.5% to 21.3%. Looking at slide six now, we can see the impact on corporate expenses. These expenses came to 35.9 million between January and July, averaging 5.1 million per month and giving an annualized total of 61.6 million, equivalent to 9.6% of accumulated net revenue. Between August and December, however, corporate expenses stood at 18.1 million or 30.6 million per month.

If we annualize this figure, it comes to 43.6 million or 6.8 of net revenue. In other words, corporate expenses -- 9.6% of net revenue before the integration and only 6.8 after integration, a 29.3% of reduction thanks to the synergy gains.

An analysis of the pre and post integration results clearly shows that the integration process had a massive impact lifting the company to a new level of performance.

Now, let's look at some of company's fourth quarter operating details. I will now hand over to Carlos Lazar who will continue the presentation.

Carlos Alberto B. Lazar {BIO 17238206 <GO>}

Thank you, Rodrigo. From slide eight on, we will look in more detail at our post secondary students.

The company closed 2010 with 85,367 post secondary students, of which 76,000 enrolled in graduate courses and 9,100 in graduate courses. It's worth highlighting that only one point... 1,360 students dropped out between the third quarter and the fourth quarter of 2010, less than in the quarters before the Kroton and IUNI integration, showing that the implementation of the new post academic model had no impact on the dropout rate.

As you can see in the graph on the right, the number of graduate students grew by 1.6% between the third and the fourth quarters from 75,000 to 76,300. In regards to the intake process of 2011, we should point out that the enrollments is taking place into the end of March. However, the number of new entrants enrolled to-date is more than the same period of last year. We are therefore positive and expect to reach our budget targets.

On slide nine, we show an analysis of our performance in regard to FIES loans. Since June last year, the number of new FIES contracts has moved gradually, and we already have more than 7,000 contracts signed and more than 2,500 being processed. Given that Kroton is responsible for 8% of all new FIES contracts signed in Brazil, while our stake in the post secondary markets in Brazil is only around 2%. The figures underline Kroton's successful execution in the FIES program.

Moving now to the K-12 comments, I'd like to go to slide 10 where we can see that Kroton closed 2010 with 720 associated schools in its network, totaling more than 265,000 students. One differentiation of Kroton's primary and secondary education is the ability to come up with educational solutions that meet the needs of a specific market niche. One such example was the creation of the Catholic Education Network in 2008 which now has more than 40,000 students. We took another step in this direction in November 2010 with the operational start-off of the Christian Education Network, driving towards evangelical schools throughout the country. It is important to note that these niche networks do not result in any larger scale benefits, since management is completely integrated.

Another planned initiative in this segment was the launching of the Pitágoras Network Channel through which we have direct live contact with more than 500 schools. It is an important tool that enables us to deliver part of the network services such as feature training programs. The Pitágoras Network Channel is also important mechanism to build and to reinforce the school loyalty, because we implemented this with greater -- free of charge for the schools.

These are the services which only our network offers and which will tend to further increase our contract renewal ratio, which is already very high at around 93%.

We are equally positive in regard to 2011. Although K-12 enrollments continued through mid-April, we have already exceeded the 2010 figure and we expect the student base to record organic growth of between 6 and 8%.

Now let's start the financial performance comments. Before beginning this specific comments, it's worth noting that expect where otherwise indicated, all the following amounts excludes non-recurring costs and expenses and refer to the corporate results, therefore considering the consolidating of IUNI only as of March 2010.

On slide 12, you can see that our annual gross and net revenue increased by 80% and 76% in that order over 2009. Net revenue from post secondary education rose by 101% over 2009, chiefly due to the incorporation of IUNI. The 1% decline between the third and fourth quarters was due to the application of the Tuition Adjustment Process, which adjust the value of monthly installment in accordance with each student's actual course time. As a result, the volume of conditional discounts moved up between the two periods.

Net revenue in the primary and secondary education segment increased by 16.9% over 2009, giving average annual growth of 17.2% in the last four years. In the fourth quarter, net revenue from K-12 fell by 13.9% over the previous two months, given that the final column is seasonally the weakest in the segment. On the other hand, it increased by 60% over the same period of 2009. The average fourth quarter post secondary monthly ticket remained flat over the quarter before in around R$500. The annual K-12 education ticket was R$350.

Regarding non-recurring, I would like to ask you to go to slide 13 where it shows the non-recurring cost and expenses related to the acquisition and integration of IUNI. These figures totaled 36.7 million in the year, primarily due to the substantial reduction in personnel, which generated 20.5 million in layoff expense. These costs and expenses were higher than originally planned mainly to the more severe adjustments to our structure. On the other hand, these adjustments are already benefiting our financial and operating results as we could see during the beginning of this presentation. Non-recurring expenses amounted to 4.8 million in the fourth quarter. It's worth noting here that we do not expect any non-recurring costs and expenses from the integration income during June 2011.

The next slide shows our cost of goods and services, which totaled 398 million in 2010, equivalent to 66% of net revenue, excluding non-recurring costs. The post secondary segment was responsible for 86% of the total annual cost, with K-12 accounting for 14% mostly from cost of goods sold. The fourth quarter post secondary costs were impacted by our opening of special groups for students entering in September 2010.

In the fourth quarter, including cost of goods sold for primary and secondary education segment was due to the disposal of material worth around 1.5 million by one of the networks in December 2010. Also indicates the segment, the 46% during cost of services was due to the implementation of several initiatives in the fourth quarter 2010 to develop the business structure, including the creation of the new Christian Network and also the hiring of new staff and service providers. These new level of costs will substantially improve the segment relations with the currency associated schools and ensure that it develops in a consistent manner.

Slide 15 shows gross profit trends. As you can see, post secondary gross profits jumped by 140%, chiefly to the acquisition of IUNI as well as the initial impacts of the company's restructuring initiatives. The primary and secondary education gross margins narrowed due to the increasing costs which we mentioned before. In comparison between the fourth quarter and third quarters, must take seasonal effects into consideration, especially in the K-12 segment. In fourth quarter 2010, total gross profit fell by 24% over the previous three months and in 2010 as a whole. However, the total amount of gross profit moved up by 62% over 2009 to R$202 million.

Let's move on now to slide 16. Total general, administrative, selling and marketing expenses represented 22.2% of net revenue in the fourth quarter, 6 percentage points down on fourth quarter 2009. The positive highlight was the reduction in personnel expenses, which represented 5.8% of net revenues in fourth quarter 2010, reflecting the reorganization of the workforce. Slide 16 also shows our PDA, which totaled 28.1 million in the year, equivalent to 4.7% of net revenue.

On this point, it's worth mentioning that the company started to use a loss provision model based on a historical debt collection performance. The behavior of this collection curves along the year was entailed and sufficient PDA was constituted to cover probable losses. This methodology held since 2010 provides the surety that the provision made is enough to cover future potential losses. As a result, fourth quarter PDA totaled R$5.3 million, 28% with adding previous three months, proving that we were already covered what insufficient for any eventual losses. In the year as a whole, PDA represented 4.7% of net revenue, 1.1 percentage points up on 2009. And finally, in 2011, we're expect PDA between 4.5 and 5.5% of net revenue.

Moving on to slide 17, you can see that the consolidated accounts receivable turnover rate in first quarter 2010 increased by 14 days over the quarter before. The -- was strictly due to seasonal effects in the post secondary segment, where turnover increased from 60 to 73 days, and 54 days recorded in fourth quarter 2009 was impacted by adjustment to the historical value of accounts receivable registered in the period and by the fact that the fourth quarter 2010 figure includes long-term assets from IUNI's former direct financing portfolio.

The 75-day increase in primary and secondary education segment was due to the initiation of beginning for 2011 contract, a standard feature of this segment and which happens during the fourth quarter.

As you can see on the slide 18, unlike fourth quarter 2009, the company reported positive EBITDA in the fourth quarter 2010 despite the seasonal effects. This reverse was impacted due to acquisition of the IUNI and the benefits of the integration and turnaround plan, which had a big impact on the post secondary segment and corporate expenses. In the year as a whole, the company posted EBITDA margin of 8.7% on EBITDA, an EBITDA of R$52.2 million. It's worth noting here that the company at once too affected by the pre-restructuring cost and expenses composition until July 2010. The -- EBITDA margin grew from minus 0.8% in 2009 to 2.6% in 2010.

On slide 19, you can see that cost on these assets R$9.9 million in the fourth quarter 2010 allocated as follows: R$2.3 million in IT equipment and library, R$3.1 million in systems development and software license, R$2.7 million in laboratory and similar equipments, and R$1.0 million in improvement and expansion works. Therefore, we have reduction R$39.3 million in each --, equivalent to 6.6% on net revenues.

We expect 2011 CapEx to be below or around 6% of net revenues, including reimbursement, on-demand maintenance and expansion of existing campuses, but excluding acquisitions.

Finally, on the slide 20 which concludes the results section of this call, shows our fourth quarter cash flow. Kroton increased its level of cash in the fourth quarter due to seasonal reduction in collections from post secondary and especially in the K-12 business. We took out loans cover our increased cash needs in regard to investments, payment of the final R$25.1 million installment of the IUNI acquisitions and premium of classification in the 30 --.

However, we believe our year-end net debt of R$57.7 million is comfortable in relation to expected cash flow. In addition, we expect a partial recovery of our cash position as early as the first quarter of 2011.

I would now like to hand over back to Rodrigo Galindo for his final comments before going to the Q&A session.

Rodrigo Calvo Galindo {BIO 17238232 <GO>}

Thank you, Carlos. The total -- which brings this presentation to a close.

2010 was the year of Kroton's post secondary integration and turnaround. There were several opportunities for generating value in the company, and we focused our efforts on the reduction in the negative post secondary results. The integration was concluded, the turn around was effected, and the result arrived at. Our post secondary gross margin increased from 0.5% between January and July to 21.3% from August to December. And the segment's profitability moved the debt to another level.

Corporate expenses fell by almost 30%. The integration was concluded in August and we closely monitored our operation between September and December to make sure that it has stabilized. Now in 2011, our goals are complete --. For Kroton, 2011 is a year of growth and we have divided this growth into three vectors. First; margin growth; second, growth through acquisitions; three, a current organic growth.

We're aiming to achieve an EBITDA margin of 23% in the coming years. Our current margin is around 15% and we haven't made that methodology all the necessary actions to pursue the target level by 2013.

Bridging the gap between 15 and 23% involves five distinct groups of actions, all of which have been identified and are being implemented. One example is the unification of campuses and -- with seasonal units like --. We are convinced that we can apply the same discipline and rigor to raising the EBITDA margin to 23% as we did through the turnaround process.

The second growth vector is growth through acquisitions. As of January 2011, we have reactivated our acquisition pipeline which was suspended throughout 2010 due to the Kroton and IUNI's integration. Negotiations are already underway and we expect to announce the first acquisition at the end of the second quarter. It is important to point out that the company's current management has an excellent track record in the integration of acquired institutions. In IUNI, this theme has already affected in the acquisitions and integrations while Kroton has acquired 11 units, giving 19 acquisitions in 12 months.

The third growth vector is the organic growth. We intend to continue growing organically in both the post secondary and K-12 segments. The number of students in post secondary entrants in the first quarter is in line with our budgets and is already higher than the same period throughout last year. In post secondary, we expect from 7 to 9% of net revenues increase in 2011. In the primary and secondary education segment and K-12, we expect net revenue to maintain the same organic growth rate as we ended the last three years, between 15 and 17%.

We also expect accelerated growth from our Distance Learning Project implemented in 2011. In just two months on operations, we already have 50 centers including 16 associated schools, underlining the project's high synergy potential with K-12. The company is offering 11 graduate courses programs where we had more than 500 students enrolled up to March 18th. We are convinced that this modality will play a key role in ensuring more step revenue and margin growth in the long-term. In light of the results presented and the company's project prospects for the coming year, we are extremely positive in regard to our 2011 results.

Now, let's go straight to the Q&A session. Thank you very much.

Questions And Answers

Operator

Ladies and gentlemen, we will now initiate the question-and-session. [Operator Instructions]. Your first question comes from Luis Azevedo with Bradesco.

Q - Luis Azevedo {BIO 18959015 <GO>}

Good afternoon. My questions is regarding the M&A activity, now that you have primary divested units. Let's suppose that you get more aggressive in making acquisitions, I'd like to know if do you think that these acquisitions with M&A could affect the guidance to reach 23% EBITDA margin by 2013 or that -- that it should not affect the EBITDA margin with acquisitions? Thank you.

A - Carlos Alberto B. Lazar {BIO 17238206 <GO>}

This is Carlos speaking. Actually, we think that the acquisition strategy that we have for this and for the coming years will not impact our target of 23% on EBITDA margin as we have very aggressive integration methodology. So, we believe that we can integrate, we have a very good historical integrating, in acquiring companies, and bringing these acquired companies to a very good level of EBITDA of a contribution margin than anything else. So, we believe that the -- we continue with the targeted EBIT even with the acquisition that we may do during the next years.

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

Complimenting the answer, one of the most important skills that the management of Kroton have is the capacity to make the turnaround and -- in -- acquired.

When we analyze any acquisitions that the IUNI made in the past in 2008, when we analyze the EBITDA margin before and after the acquisitions, these eight acquisitions brought 1.6% of EBITDA margin before the acquisition. And the year after acquisition, we jumped this number to 21% of EBITDA margin. So, that is an important skill that the company have. It's changed the level of performance of institutions acquired. So, we believe we can do acquisitions and delivery the 23% EBITDA margin at the same time.

Q - Luis Azevedo {BIO 18959015 <GO>}

Thank you.

Operator

Thank you. Your next question comes from Alex Pizano with Merrill Lynch.

Q - Alexandre Pizano {BIO 16609273 <GO>}

Hi. Thank you. I just wanted to make a quick question on receivables. How much -- can you still improve annual receivables and what kind of seasonality can we expect on that going forward, and if you could break down what's the seasonality of a normal post secondary student --? Thank you.

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

Yeah. Alex, we added... in 2010, we added a few additional steps in our procedures, in our time line. But, we still have a lot to improve in that. We added also additional collection agencies, so that is still room for improvement.

The seasonality in accounts receivable, it grows into the half. So, it starts quite low in the first quarters, the first and the third quarter, and then goes up, the frequency goes up in the second and fourth quarter. So, there is a seasonality. We are unifying the time lines between the IUNI and -- slowly we expect the behavior, the delinquency behavior to become more standard between the two companies, but we still have different companies with different behaviors. So, receivables have room for improvement.

Q - Alexandre Pizano {BIO 16609273 <GO>}

Thank you. And just second question on delinquencies. How much do you think is a sustainable rate for provisioning for delinquencies?

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

Yeah. What we announced in the release here, it's between 4.5 and 5.5%. This is the total delinquency. What we expect moving forward is some impact from, coming from FIES. We are driving higher delinquencies to FIES, moving the students to these kind of financing. So, we expect our own receivables to show progressively a better performance.

Q - Alexandre Pizano {BIO 16609273 <GO>}

Okay. Thank you.

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

You're welcome.

Operator

Thank you. [Operator Instructions]. And your next question comes from Luis Bresaola with BES Securities.

Q - Luis Bresaola

Hi. Good afternoon. I just have a quick question, follow-up question for --. I just would like to know if you -- in 2011, what is the percentage of this year of all these students enrolled for the PDA, if you have had allotted -- in this intake? Thank you.

A - Carlos Alberto B. Lazar {BIO 17238206 <GO>}

For the 2011 enrollment process, we believe that the impact of this years will be not so big, but we're still confident that the FIES will probably impact this sector as a whole in the coming years. But for this specific process, the impact will not be so relevant.

Q - Luis Bresaola

Thank you.

Operator

This concludes the question-and-answer session. At this time, I would like to turn the call back to Kroton for closing remarks.

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

Okay. So, thank you very much for the participation. And our IR Department are available for more questions. Thank you.

Operator

Thank you. This does concludes today's presentation. You may now disconnect your line at this time. Have a nice day.