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Bloomberg Transcript

Q3 2016 Earnings Call

Company Participants

- Grace Cury de Almeida Gonçalves Tourinho, Chief Operating Officer, CFO & IR Contact
- José Seripieri Filho, Chairman & Chief Strategic Officer
- Natália Lacava, Investor Relations Officer

Other Participants

- Bruno Giardino, Analyst
- Joseph Giordano, Analyst
- Luciano Campos, Analyst
- Marco Calvi, Analyst
- Rodrigo Gastim, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Thank you for standing by. Welcome to the Conference Call of Qualicorp to announce the Results of the Third Quarter of 2016. Today, with us we have Mr. José Junior, CEO; Ms. Grace Tourinho, CFO and IRO; and Ms. Natália Lacava, Superintendent of Investor Relations.

This conference call will be recorded and participants will be connected in listen-only mode during the company's presentation. Then, we are going to start the question-and-answer session when instructions will be provided.

Now, I would like to turn the conference over to Ms. Grace who's going to start the conference call. Please, Ms. Tourinho, you may start.

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

Good morning, everyone and thank you for your attendance. I would like to show to you the main accomplishments of the third quarter of 2016; first, the issuance of debentures with a premium payment of the debentures that we used to have; the approval of the payment of interim dividend; and the completion of our negotiation for the headquarters of the company in São Paulo.

Yesterday, we completed the issuance of debentures raising BRL 611 million (01:42) at a CDI cost plus 1.30% on year, with quarterly interest rates three-year time to mature in

November 2019 and we made the prepayment of the debt that we used to have amounting to BRL 542 million that we had (02:03) at the CDI plus 1.65% and CDI plus 1.60%. In this manner, we have a longer debt for another three years at more competitive rates in spite of the more challenging market scenario.

With these loans solved, yesterday, our board of directors approved the payout of dividends at the amount of BRL 247 million, approximately BRL 0.90 per share. This amount refers to the net income of the first quarter of 2016 minus 5% of legal reserve. The date of payment will be on November 25, 2016 on the shareholding days of November 11 of 2016.

Lastly, we have finally managed to negotiate the rent of our headquarters here in São Paulo. You must all remember that we have transferred three companies of the group to Barueri in February 2016. Almost 500 employees were moved to a new headquarters. In this manner, we have some vacant floors.

Now, in September, we have completed the renegotiation with the delivery of seven floors of our head office, which is already taking place, and started on October 1, 2016, with monthly savings for the company of BRL 700,000, annualized BRL 8.4 million. At the same time, we have also negotiated non-annual correction. The contract is frozen for two years to be adjusted only in September 2018.

Now, I'm going to turn the conference over to Natália so that she can give you more details about the quarter. Thank you very much.

Natália Lacava

Good morning, everyone. Once again, thank you for your presence at our conference call. I'm going to start on slide number 3 with our main indicators. I'm not going to go over line-by-line. I think that on this slide, it's worth mentioning our EBITDA, BRL 208 million with a margin of almost 40%; it's a history record for the company and above what we imagined to reach and what we've been sharing with you. And because we've managed to cut costs and spend more efficiently, along the presentation, we will mention each one of the details. But this is basically another point, which we should not fail to mention, once again, a two-digit growth in revenues.

As you know, there were some effects along last year with some portfolios leaving with higher taxes for our brokerage house. And in spite of them, we managed to raise our net revenue by more than 14%. Lastly, Grace mentioned the renegotiation of our debt and you can see that our debt indicators are still very low. And so we are really confident with the debentures that are in our balance sheet, and we still have a very healthy financial statement.

Now on slide number 4, the evolution of our portfolio. So, in our Affinity, we lost actually 21,000 lives. In medical hospital Affinity, we should highlight the gross adds of 131,000 lives this quarter. And as you must have read in the press release, this was because of a new customer, a trade association that chose us. And I would like to make a note here that the company regards importance to mention, there is a broad market of lives in the affinity market, but there are spreads between our competitors or directly with those entities. This is a market that is as big as Qualicorp or even bigger.

And it is part of our organic strategy, especially at challenging economic times, with income of our customers becoming more and more difficult, we are seeking market share. So in spite – even though these movements do not take place every day, they are part of our growth potential.

We had an operational profit here with a new portfolio, and I think that it's worth analyzing whether we include the portfolio or not. But my point here is that just as we have lost some contracts because carriers left the market, we may also win other contracts, and this must be part of our everyday business. We made a point of highlighting in our financials for you to analyze and to be as transparent as possible, but we see this movement as organic.

Another point on the slide is our churn, it's really gone up because of the adjustment. There was an adjustment of 22%. We had a number of downgrades that was greater than we were having in the past few quarters. But we're comparing it to the previous year that the increase is not so significant and this might be suggesting that our customers are at a perfect level, with low ticket they have no alternatives.

And another thing that is important to share with you is the result of a recent research that we did with cancellations. We'd been seeing a growing number of people who tell us that they're moving to the public healthcare system. Many of you have had meetings and heard us saying that it was more or less one third of our (08:37) was going to the SUS or the public healthcare system. So, we are being affected by the challenging macroeconomic scenario. And even so, with all of our retention strategies, revenue is still reacting, since the company has always have been of retaining higher value-added customers.

Now, on slide number 5, talking about our net revenue. The two-digit growth, as I mentioned, of 14.2%, there were many effects on this line, just as a remainder. So, we had (09:27), our move to Barueri, the increase of taxes in the brokerage house, and Unimed Paulistana leading our portfolio. And in spite of all these challenges, we have managed to mitigate all of that with many strategies such as moving to Barueri, moving out of São Paulo downtown and with higher value-added customers and still make our net revenue grow by two digits.

On slide number 6, we have the cost of services. On personnel line, we should highlight what we've been doing in our projects with Gama. And this needs to be very clear that this had a counterpoint in our revenues. So if you look at our health business, it's been growing by 50% a year. So, in spite of all the measures that I will be mentioning in our presentation in cost, that means the expenses. So, there is an offset in terms of revenue. And we are very close to breakeven, which is what we had agreed on – promised to you earlier this year.

The most relevant line in the cost is royalties; that has followed its usual line. So it's expected to go up sequentially because of adjustments, because it's 100% variable. And in spite of that, our gross margin has gone up by more than 100 bps (11:13) reaching 75%.

On slide number 7, about administrative expenses. So there are a few points that I would like to mention. In the line of personnel where you see an increase, it's important to highlight that there was an adjustment last year, a reversal of (11:36) in last year's results. And this quarter, we have also had a negative adjustment and there was an expectation of spending less on this line depending on the evolution of the company's performance along the year. But the company was able to find savings that offset this year's challenges and still have margins close to 40% this quarter. And that's why it was more limited in the personnel line and there was an adjustment because of the expectations. We're very close to the budget that we had for this year.

In terms of third-party services, we had the system change, some legal or lawyer fees, and short-term contingencies with which we spent BRL 1 million. And so, this line is part of admin expenses, because it's related to contingency expenses, and thus it's related to the company's administrative structure.

Now, moving to slide number 8, sales expenses. So, this is where we gained margin because of higher efficiency, and here, we had a positive contribution of sales, because as you've seen, they remained stable, combined with the sales mix, today, our sales ticket is influenced by the lower ticket and most importantly our strategy of maximizing and allocating our funds in the most efficient way.

So, we've been cutting on advertising. So, we cut by almost 25% year-on-year. But then on the other hand, we've been investing more in sales campaigns and commissions. And this has been quite effective for the company's bottom line.

Now, on slide number 9. Bad debt, there is not much of a secret. We told you we were expecting this line to increase. Because of the environment, it's 7.6% even after the adjustment, and we do not see this as something that is out of control. We were expecting an increase and it came really within our expectations.

We continue to work on the recovery and we are bound to have a more marked recovery next quarter because of the adjustment process and increasing bad debt. So we have a broader base to work on, and next quarter it's going to be slightly larger, and we have been seeing that by the end of the year, this line will be very close to 7% or 8%.

The line of others, the consolidated result is very close to 0 and we should break down. So, we had contingency expenses and this is natural. Sometimes it's positive or sometimes it's negative, depends very much on contingency, they mature. And we had some reversals here, and we also had BRL 2 million, because of advanced payment to brokerage house. That did not take place as we expected and this expense was in our balance sheet. And because of all of that, this line of others is very close to zero, is down by BRL 1 million.

Now, on slide number 10, you can see all our financial income. This is all very clear. We've had reduction of our yield, because of the continuing evolution. So we have a cash structure that is increasingly smaller, because we find it more efficient and that's why we reduced the interim financial investments, and in expenses, the main contribution is the debentures.

Another line that people have been asking me about is the other financial expenses. The increase that you see here in the year is very much related to IOF that we pay because of a mutual fund that we have about BRL 5 million, it's between our subsidiaries. And this will be offset with the issuance of our debentures. So, do not expect the IOF or these mutual funds to continue in the future.

Now, on slide number 11, finally talking about EBITDA and we started our presentation talking about it. We saw a record of BRL 208 million with a margin of almost 40%, in spite of bad debt going up by more than 100 basis points and all the difficulties that we had to deal with along the years. So we consider this result even above our expectations. So, we are very happy with it. (17:06) and net income of BRL 74 million. And here more than talking about the net income, to talk about our dividend. And I would like to draw your attention (17:24). If you're looking the income tax rate, it's at 40%. We used to be at 45%. So, this is the result of the work that the company has conducted along the year. We have not yet eliminated all our inefficiencies, but we have managed to reduce significantly all tax inefficiencies that we had in our financial statement. And in this manner, we can pay more dividend.

On slide number 13, so we had BRL 16.5 million CapEx in the quarter influenced by IT, that is the main line contributing for the CapEx. And in terms of debt, the drop of our net debt, considering the increase in cash and cash generation in the period, as Grace mentioned, the dividend, and this will go down after we pay out our dividends.

Finally, the cash flow, I think here I would like to highlight that this is seasonal. So we pay quarterly interest. That's why you didn't see anything on Q2 and then you're seeing it now on Q3. Moreover, we had a variation of working capital that was negative, because of advanced payments to carrier, and we will receive them in full before the end of the year. We have already received some of it in October, and we will get part of it in November. So, until December, this will be zero. And this has influenced our working capital this quarter.

In spite of all seasonality and the effect of the working capital, we have reached an operational cash flow of almost BRL 90 million, that is more than the BRL 61 million that we had last year. So, our company is delivering more and more cash generation (19:41). So we have ROIC of almost 45%. It's been the greatest since 2012, if we exclude the period of tax benefit that was retroactive. So, it is sustainable and recurrent. This has been a historical record for our company in terms ROIC.

So, I end the presentation, and now we are available to answer any questions you may have. Thank you all very much.

Q&A

Operator

Thank you. We are now going to start the question-and-answer session. Mr. Marco Calvi from Itaú BDA is going to ask a question.

Q - Marco Calvi {BIO 19854632 <GO>}

Good morning, everyone. Thank you for the call. My question regards gross sales. Could you give us some more color of the 104,000 lives in the quarter, how much of it comes from the health plan?

And also, what you said of 40% of churn moving to the public healthcare system, my question is can you retain part of this migration through the health club product? And what is in the hands of the company in terms of strategy to be able to retain these large amount of lives moving to the public healthcare system? So, what is your plan to retain those lives? Thank you.

A - Operator

Hi, Marco. Thank you for your questions. As to gross sales, this quarter, it's about 15% to 20% that the health club represented of all of our sales. As to the strategy, Grace will be talking about it. But in fact, as customer says that it's totally impossible for them to be, even though the product is 20%, 30% cheaper, it's hard for us to retain. And Grace is going to share with you.

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

Hi. Unfortunately today, there's a large number of customers really going to the public healthcare system. In the last internal survey that we had in the company, this number has gone up. Two or three years ago, on average, it was about 30% of people who were going to the public healthcare system, and today, it's 40% to 45% now. So we are already seeing and we hear all the time that people are really having difficulties to pay their monthly fee. And not even a discount that we offer with the other products that are cheaper, even that is impossible for them to pay. And then we do have churn in the company. This is a period that we are not seeing incentives along the crisis.

Qualicorp did not feel the crisis so much at first, but the longer it lasts, we'll feel it more and more. But we are somehow trying to deliver to our customers and our products that they may at least choose; but unfortunately, we are seeing an increase.

With regards to our strategy, it hasn't changed much in terms of what we always told you. We are in close contact with our partners. We are more and more trying to design products that will best meet demand. So finding coverage alternatives that have more affordable prices so that we have more product alternatives, and this has been one of the company's strategies.

Q - Marco Calvi {BIO 19854632 <GO>}

Thank you very much.

Operator

Mr. Joseph Giordano from JPMorgan is going to ask a question.

Q - Joseph Giordano {BIO 17751061 <GO>}

Good morning, everyone. Thank you for taking my question. I have a few questions regarding the growth of your basis. Just as Natália mentioned, there are many opportunities of capturing other portfolios. Have you matched your potential in terms of capturing contracts that might already exist in the trade associations with which you already have agreement or contract?

The second question regards your churn. I figure it's quite high because there are some cancellations. And so, how do you see it in terms of sales insurance starting October? And the market might be slightly restless about this especially with Unimed. How much does Unimed – what is Unimed's share in your new sales?

A - Natália Lacava

Hi, Joseph. Regarding what I said, yes, inside the company, we map, we have a strategic mapping. But as I told you, we've been working and we have been working for a long time and we are effective at some point and we have been migrating lives. This is not something that happens every quarter. It's not easy. It's constant work of the showing value-add that Qualicorp provides to our customers and we've been able to convince some of our partners that we can have better conditions or better terms in Qualicorp. This is not fast nor easy work. It's part of the company's strategic line. We monitor those portfolios in terms of market share.

As to your question in terms of the market from now on, the market is quite challenging. There is an improvement in terms of what we delivered this quarter. And as you know, churn is the last number that closes. We work on the basis 60 years later. So, it's difficult for us to give you a guidance. But for the year, what we've been sharing with you right from the beginning, this is very close to breakeven for the year as a whole. We still have that expectation; might be a little bit better or worse, but it's not going to be too far from breaking even for 2016.

As to Unimed, yes, we still have Unimed as our customer and many customers come to us. But, of course, this has gone down significantly, because of all the public information. But we still have a smaller percentage of our sales for Unimed of more or less 1,500 sales per quarter.

Q - Joseph Giordano {BIO 17751061 <GO>}

Thank you very much.

Operator

Mr. Luciano Campos from Bradesco BBI would like to ask a question.

Q - Luciano Campos {BIO 16181710 <GO>}

Good morning, Grace. Good morning, Natália. This is about price increases of 22.1%. There is a consultancy we discovered that talks about an 18% average for corporate plans and could you mention whether there is any correlation that is consistent and long-lasting between the prices of corporate prices and Affinity prices? Did you have a higher increase this year? This is my first question.

Second question regards personnel expenses. You also proposed many adjustments and the annual increase on the slide, that was 11% in an annualized base. This number, 11%, is this a valid indicator for us to think about these numbers for next year? Many of the adjustments that you suggest may or may not happen again in the future, whether it's more than 20% growth that it's been?

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

I'm going to answer the second question. As for personnel expenses, you're right, this is it. You may consider that 11% is a normalized number and should serve as a basis for next year. The only reason why I mention this is that our forecast is moving as you reach, there is a schedule in terms of our goals and each one of the goals and every quarter is susceptible to adjustments. We may be very far away from our goal or very close to it.

And in terms of modeling, you are right. It does make sense. But next year, it may happen that along the quarters depending on how the company delivers results, there may be positive or negative results based on the numbers that we delivered, this is provisioned. And as we get closer and closer to payment, we adjust the provision so as to make it closer to reality.

As to your first question, basically about our adjustment of 22% in contrast with corporate of 18%, I would just like to (31:39) our experience even (31:42) is that many of the corporate negotiation of corporate health plans, it was not just the rate. The rate was smaller, because there were changes in the plan. Many times, we couldn't get a coverage and reduced certain coverage or even making the members to have a co-pay, thereby attenuating the increase.

In this manner, I do not think we can compare. It's not bananas with bananas. These are different type of internal negotiations between the company and the health carriers that has made these adjustments be slightly smaller. And feeling that I have had especially with our internal customers, this happened. And maybe Junior can say a few more things. Junior, please.

A - José Seripieri Filho

This issue of adjustment of corporate plans, we cannot look at in isolation. Many of those corporate plans, and I wouldn't be able to tell you how many, but many of the corporate plans are cancelling their current health plan providers transferring to different carriers. I'll give you an example. The growth of Intermédica (33:41). A company that offers certain health insurances, and there is an adjustment of 18% or 22%. But there are cases of 40%, up to as much as 50% adjustments for corporate plans. Then the company decides to terminate and not to renew and she goes to a category of plan that in theory is inferior, because it's a different product modeling. We do not count those cases, because they did not consolidate. But effectively, there was a request for adjustment.

Secondly, some companies in order to avoid major adjustments, they have specific negotiations that are retroactive. For some claims that were outliers, they were not in the curve, isolated cases. So, I confirm what Grace said that it's impossible to compare them directly one-to-one, corporate and Affinity. They are branded similar products in actuarial terms, but this is just the way they look.

Q - Luciano Campos {BIO 16181710 <GO>}

Thank you, Junior, Grace and Natália. Thank you very much.

Operator

Mr. Rodrigo Gastim from BTG would like to ask a question.

Q - Rodrigo Gastim {BIO 19694950 <GO>}

Good morning, everyone. First one, going back to commercial expenses and the stability of the sales levels that has helped us line this quarter, so what were the main drivers this quarter for this line of commercial expenses? Should we expect similar levels from now into the future? This is point number two.

Secondly, it's almost BRL 50 million in dividends that – was there any change? And what is your dividend payout strategy in terms of buying back? Are we going to remain close to 100% payout of the accumulated interest? Do you think you will keep this at superior levels next year? Could you share with us more details about the payout of dividends?

A - Operator

Good morning. With regards to commercial expenses, I'm going to be very clear and honest with you, as we neglect in our accounting our commercial expenses, so it locks a leverage of deleveraging. So, when we have very high sales, we deleverage the margin. When sales are smaller, it leverages the margin. So this contribution in the commercial area in margins is related to the fact that the sales were not the peak of the year. So, this provides leverage in performance because of accounting. Moreover, it's also important to emphasize the strategy, advertising. We should invest more in direct campaigns. That has also contributed. I don't know if you remember in first line media and this has contributed and we have felt that this has provided an evolution in sales and we will keep that strategy until the end of the year.

So, let me guess, another 10% next quarter. So, sales expenses will go up by more than 10%, because I will need to neglect all the expenses of the quarter. And with regards to your second question, I'm going to let Grace answer it.

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

With regard to the payout of dividends, obviously, we want to try to pay 100%, but I can't promise that to you. In fact, this year our main objective was to pay the debt that we had with Itaú that was going to mature in January 2017 (38:21). With the renegotiation of our debt, we no longer needs to have that money in our cash. And as we do not have in the short, short term any major investments to make, except the payment of (38:40) will be in September and now our cash flow is (38:44).

We can and we are confident to pay 100% of our profits in the first half of the year. This is what we will be doing. Now, on the same day, when we settled and we finalized this longer debt. In reality, while we don't have any major investments to make, we are very much likely to pay out all the cash that we have in the company, but we cannot assure this to you, and we are not pledging to do that, and this needs to be approved by the board of directors, and our payout, it should be about 50% of our interest. Maybe, Junior would like to complement.

A - José Seripieri Filho

I agree with you. The issue of 100%, the fact that we did it is not a role. So, while we can, we will do that, but it might not be the same next year.

A - Operator

Well, precisely, also, because if something interesting comes up, then we're ready to face it.

Q - Rodrigo Gastim {BIO 19694950 <GO>}

Junior, Grace and Natália, thank you all very much.

Operator

Mr. Bruno Giardino from Santander would like to ask a question.

Q - Bruno Giardino {BIO 15974970 <GO>}

Hello. Good morning, everyone. First question is about the transfer of lines. We know that this can be recurring in your business. But I'm trying to understand the dynamics of this process. So, it might involve financial amount, how do you that?

Second point regards co-payment plans that are becoming something more natural in the corporate market, but they have not yet taken off?

A - Operator

Hi. Good morning. With regards to your first question. There are several portfolios that are without competitors directly with entities. There are different ways for us to convince them. So, sometimes customers get a very high adjustment, and then they had no option and they come to us because we have a very broad portfolio. So, we can offer many different projects to just one entity. Sometimes they have a direct relationship and there is a high increase and then they come to us. Sometimes they are with our competitors with few alternatives of products. And some other times, the entity has admin work and they can't manage. It's too much for them on financial expense that they have to administer the plan. They can't recover it. They can't break even. And they ask us to step in to see whether we maybe more efficient in managing it.

So, there are many reasons why entities come to us. This is very much related to product diversity, price and admin costs for them to keep the health plans.

And with regards to co-payment, Grace will answer.

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

With regards to co-payment, there's a major expectation. We're working intensely in order to implement this as fast as possible in Affinity. However, the price differences is very small for customers to really choose co-payment. It's about 10% to 15%, which does not make customers do something. So, my hope today is especially due to the large adjustments in the corporate area, many plans already have co-payment. And the market is going to learn more about that, because today our customer that is corporate might become one of our customers. And then our difficulties to sell our plan with co-pays, as they've seen it, they've seen it works, and it's not a big deal, then yes, we might be able to sell larger numbers of that. But for the time being, unfortunately, this is not the case. This migration has not yet happened.

The main obstacle is to discount for them to see the benefit. For me, it's a cultural issue, plus the discount. Obviously, if they feel that there's a difference of 30%, they will be more inclined to try to understand it and maybe change.

So, first it's a cultural issue. And secondly is that the difference today is very small really. So, this movement is very unique and we do not visualize how we would like to see or how we should for the health industry and how it can get better.

A - Operator

May I add something here?

Yes, please.

Co-participation or co-payment is important, and it's more educational in terms of inhibiting excessives and things that would be unnecessary by users. So, customers that go to the doctor and they ask to do so many tests because their friend did, this is just a very generic example. However, we cannot expect to transfer to users the responsibility that belongs to carriers and major medical and hospital providers.

So, it's medical management that we try to help them; so the uncurbed increase of medical and hospital costs. So, co-pay will not solve that problem. So today in Brazil, there is a problem that is chronic of an excessive increase of hospital and medical costs and this needs to be addressed. Co-pay is part of solving the problem. But this is not the only solution for everything. It would be unfair with users.

Q - Bruno Giardino {BIO 15974970 <GO>}

Okay. This is very clear. Thank you for your answer.

Operator

Thank you. The questions-and-answers has now ended. I would like to turn the conference over to Ms. Natália Lacava for her closing remarks.

A - Natália Lacava

Thank you all very much for your presence here today. Our Investor Relations team is fully available to answer any questions you may have in the future. So, please have a good day and thank you all very much. Thank you.

Operator

The conference call of Qualicorp has now ended. We thank you for your participation and we wish you a good day. Thank you.