Y 2018 Earnings Call

Company Participants

- Gabriel Portella, Chief Executive Officer
- Marco Antonio Antunes da Silva, Vice President of Operations & Technology
- Ricardo Bottas, CFO

Other Participants

- Felipe Salomao, Amalyst
- Unidentified Participant

Presentation

Operator

Good morning. Welcome to the conference call of Sul America to announce the results of the fourth quarter of 2018.

Today here with us, we have Mr. Gabriel Portella, CEO of Sul America and there will be audio slides that can be accessed on the Investor Relations website at the address www.sulamerica.com.br/ri.

All participants will be connected in listen-only mode during the company's presentation. And then we are going to start the questions-and-answer session when further instructions will be provided. (Operator Instructions) Sul America's conference call is being recorded and the audio will be available right after its end in the company's Investor Relations website.

Now we would like to turn the conference over to Mr. Gabriel Portella, SulAmerica's CEO, who's going to start the presentation. Please, Mr. Portella, you may start.

Gabriel Portella {BIO 18012687 <GO>}

Good morning, everyone. I am here with Sul America's Executive Committee. During 2018, we closed another year with great improvement, a very consistence trajectory and very positive, especially considering that we have just gone through the three worst years in Brazilian economy and I would like to highlight on the side of revenue growth of revenue even greater than the year before reaching 12.5%, an expressive mark of BRL20.5 billion, growth in the basis of health and dental members reaching 3.4 million members, an increase in the fleet of automobiles reaching 1.6 million vehicles, and an increase in reserves of pension of BRL7 billion and record assets under management almost BRL42 million.

On the side costs and expenses, we reduced the loss ratio, reduced the cost of marketing, it's under control and had a reduction of the percentage of admin expenses. With the combination of these two factors combined rate of 97%, the smallest since our IPO in 2007 and its meaning in terms of strong operational results, demonstrating our capacity to operate even better in low interest rate environment. In a nutshell, we have had another excellent year with record net income of BRL905 million, 7% above last year and growing return for shareholders, reaching 15.2% in the year. And we started 2019 expecting the economic scenario in the country to get better, especially in future cycles, especially in indicators of employment and income and we believe we are well prepared to make the most of this more favorable scenario.

Now I'd like to turn the conference over to Ricardo Bottas, our CFO and IRO who is going to comment on the highlights of the quarter and the year. Then we're going to have a Q&A session. Bottas, Please.

Ricardo Bottas {BIO 18071813 <GO>}

Thank you. Gabriel. Good morning, everyone. So there are some slides (inaudible) our presentation, so that we may move to the Q&A session. So, starting on Slide number 2 of the slide deck, we can see the consolidated revenue that reached BRL20.5 billion in 2018, BRL5.3 billion in the fourth quarter and a growth in the year of 12.5% with a highlight of our business lines.

Growth in health and dental that grew 13.6% in the last year and then you combine with the more members and price adjustments that were applied during the year that seek better profitability. Automobile grew 9.7%, thereby consolidating the recovery as a result of recovery of volume and the size of the fleet in 2018. Revenue from life and personal accident, an increase of 14% were the highlight of our travel insurance product. In addition to the fast pace in sales of new contracts and the high level of retention of existing contracts, assets under management grew 21.3% and now assets under management closed the year with almost BRL42 billion.

Next slide just showing the breakdown of our revenue mix, stable as compared to 2017 with a total of BRL20.5 billion in 2018 about 96% corresponds to insurance operation. On Slide number 4, you can see the operational highlights and here we concentrate the annual results and we are going to go into more detail about the quarters. So overall, you can see an evolution in all the indicators, except the expected reduction in the financial result because of the Selic interest rate. On the third line of the table, talking about loss ratio, you can see a significant recovery of consolidated loss ratio, which closed the year at 74.7%, a reduction of 1.1 percentage points with a consistent reduction in health loss ratio and the relevance recovery of automobile loss ratio in 2018, as compared to 2017.

Here it's also important in Q4 is that the consolidated loss ratios is at the 71.1% increase or 1.2 percentage point as a result of higher loss ratio in health and dental as compared to Q4 '17. And as a reminder, in the fourth quarter of 2017, there was a strong loss ratio, rather strong reduction in the loss ratio, which also showed a consistent reduction of loss ratio in 2017 with a consistent reduction in loss ratio in the year. So it's important to highlight that we have been able to consistently reduce the gap between the high and lower loss ratios that you see in the quarters of the past few years.

The gross margin in the year improved by 1.1 percentage points, a growth of more than BRL480 million. In absolute terms the results of combination of growth in revenue practically all segments and reduction in total loss ratio, which reflects operational gains. Admin expenses closed the year with 8.7% in total revenue, a gain of 0.3 percentage points, thereby showing our operational leverage and control of expenses in spite of intense investments in technology and innovation.

As a result of our efficiency gains, our combined ratio was 97% in 2018, an evolution of 1.7 percentage points, the best combined ratio since the IPO in 2007 [ph]. The gross margin efficiency gains for admin expenses in 2018 offset the reductions of 24.6% in the financial results, as I mentioned in the beginning because we already expected that considering the Selic interest rate. And this was very challenging and shows our capacity to offset by that drop by far and net income closed the year with BRL905 million in 2018, 17% greater than the previous year as a result of our operational results and also we have more interest on equity and some reversals of deferred assets. The return on average equity in 2018 was 15.2% average equity, an increase of 0.7 percentage points as compared to 2017, demonstrating our commitment with a constant growth of the company, but always associated to improved profitability.

Now going to Slide number 5, talking about Health and Dental, operational revenues grew 13.4% in the year, 12.7% in the quarter. All portfolios of affinity plans have good performance with a highlight of SME Health with a growth of 23.5%, Dental 22.2% growth in 2018. Talking about members, we have also had a significant growth 8% in the number of members as compared to 2017. And here, we would like to highlight the growth of affinity plans, there was an increase in members of dental 19% and 8% in Health SME in terms of number of members in addition to the constant recovery of our corporate affinity portfolio that also had a net growth for the fourth quarter in a row. The gross margin of health and dental portfolio was relatively stable as compared to the fourth quarter of 2017 with a growth of 16% in the year compared to the year before.

On the next slide, we have here more detail about the development of loss ratio in the quarters and the lower part of the slide for the year. And then looking at the longer periods like we'd like to emphasize we maintained loss ratio under control, reaching 79.2% in 2018 with a gain of 0.4 percentage points when compared to the previous year. And as I mentioned this best -- this is the best loss ratio since the 2010 for this portfolio. In the lower part of this chart, we can see the loss ratio for the quarter, which was 74.6% in the last quarter 1.8 percentage points when compared to 4Q '17 and as I said before, had been a very positive quarter for loss ratio.

So this is a calculation of our loss ratio within the year to show that we have a consistent figures among the years. It's important to comment on annual levels of loss ratio and the reduction of the gap. And as an example, I can show you some series previous to these shown on the slide; for example, in 2012 the distance between the highest and the lowest loss ratio was 15 percentage points. In 2017, it was 13 percentage points. And now this distance in 2018 was only 8 percentage points between the highest and the lowest loss ratios. So that's very important to -- and provide subsidies for the -- to support the work of the company showing that we have consistent figures in terms of improvement of loss ratio along the years.

On Slide 7, automobile showed an improvement, BRL3.4 billion in revenue with an increase of 9.7% and a reduction in loss ratio of 5.3 percentage points. These results show the strength of our operations and basically leveraged by the evolution of investments of a new underwriting tool and a macro environment that's more positive with a decrease in the tax rate. And as you know, that's the best record in terms of sales of new vehicles, which provides an important component to reduce the average age of the fleet.

Operating revenues grew by 2% and loss ratio remained under control. Our commitment with the recovery of the profitability of the segment and the successful initiatives resulted in a growth of 66.5% of the gross margin in 2018 or BRL222 million in absolute terms. In the 4Q, we reached BRL132 million in gross margin, 2.2% higher than 4Q '17. This recovery of the growth in the insured fleet, one of the highlights of the year remained consistent in the last quarters and as I mentioned before, was a cumulative growth of 8.6%, reaching 1.6 million vehicles.

On Slide 8, Property and Casualty; this segment increased 2% in the year. In the quarter, there has been a reduction of 6% in revenues. Year-to-date, we had an increase of 4.1% increase in loss ratio, impacted mainly by higher number of claims and more severe claims as we mentioned before, especially in condominiums and corporate portfolios.

Slide 9, Life and Personal Accident; this had an increase of 14% year-to-date in 2018, 34.6% in the fourth quarter when compared to last year with the highlight of travel insurance, whose revenues grew more than 84% in the year and now account for 6% of our portfolio. The growth in revenues combined with the gain in efficiency in expenses, an improvement of 3.5 percentage points in loss ratio allowed us to close the year with a growth in margin of 95%. In the next slide in pension, we highlighted reserves reached BRL7.2 billion, an increase of 14.7% when compared to December 2017. An important highlight with the portability that was -- net portability was positive.

On Slide 11, in savings bonds, revenue reached BRL54 million in the year with a growth of 3.3%, following the growth of Leader product in the market, which is rent guaranteeing insurance, that's closely linked with the recovery of the real estate market for this portfolio to grow and we believe that the environment is very good. Savings bonds reserves added to BRL662 million with a growth of 5.9%.

On Slide 12, Asset Management; here we reached a record level of BRL42 billion of assets under management with a combination of increase in pension assets 15%, third-party assets that grew 8% in the period and our own portfolio of assets, which grew 6%. Operating revenues of our asset management operation grew by 23% in the 4Q and 21% in 2018, mainly due to higher performance rates related to a mix of allocation of assets that was more advantageous, in addition to increase in administration fees. The largest participation in multi-market funds and the allocation of third-party funds also reached

53% versus 42% in 2017 and now reflects the best -- better opportunities in the best macroeconomic scenario and lower interest rates.

On Slide 13, we have Administrative Expenses; the rate reached 8.7% with a 0.3 percentage point improvement, due to gains in operation efficiency and bridging a strict control of costs and expenses. It's important to remember that this ratio as it improves, captures the investments we make in (inaudible) technology, innovation and we have better experience with our broker channels. In the fourth quarter, it was 9.7%, it was worse than the previous quarter due to some aspect that's part of our operations that have not happened in 4Q '17. There has been some regulatory penalties and expenses associated to higher interest on equity. There is also some administrative expenses but overall, it's important to look at the behavior of SG&A in the year, that shows a constant recovery in terms of our capacity to leverage on these expenses.

On Slide 14, we show 5,000 employees with a growth of 2% when compared to the previous year strongly associated to the ramp up of our investment projects, especially digitization and innovation that hired new teams. Also this growth is according to our expectations and plans. And finally portfolio of investments on Slide 14, the profit despite this drop in the financial results associated to the Selic rate there is the contribution that comes from our mix of assets and the profitability of our own assets that has a yield of 110% of CDI year-to-date 2018, against 102% in the previous year, helping to minimize, partially minimize the impact of the lower contribution of Selic interest rate.

Now let's move on to the Q&A session.

Questions And Answers

Operator

Ladies and gentlemen. Excuse me, we are now going to start our questions-and-answer session. (Operator Instructions) The first question comes from (inaudible) from Santander.

Q - Unidentified Participant

Good morning, everyone. And thank you, Gabriel and Ricardo. I would like to talk about co-participation more the impact from the standpoint of service providers. We are aware of Sul America's strategies to tackle high loss ratio in different ways and co-participation has been shown its role in that. So users are more used -- tend to use the plan more rationally. I would like to hear from you what service providers as a whole still as a reflex of you having more co-participations because I would imagine the times people go to the (inaudible) admissions, even has reduced. We know that many providers have goals for a number of patients and number of visits and so in terms of the carriers and how you manage that?

A - Gabriel Portella {BIO 18012687 <GO>}

Hello, this is Gabriel. I'm going to let Marco Antonio, Antonio is our Operations VP, who today is in charge of Health and Dental. He will be answering your question. And then I might complement anything although I don't believe his answer will need complementation.

A - Marco Antonio Antunes da Silva {BIO 19109942 <GO>}

Well, thank you, Gabriel. Thank you for your question too. So co-participation is an approach that's Sul America has been using for a long time. The aim is to involve and to engage members in terms of having commitment in rational use of the network. Of course, it affects directly and indirectly the providers. As co-participation is sometimes paid by the company or by the member, what we see is how co-participation products may somehow make people or members use the network in a more rational way.

So most times, most products have co-participation, what we cannot tell you or determine because today providers, they do not have the vision. They didn't know when there is co-participation or not. That is not supposed to influence the utilization of a network or the volume of VDs or ambulatory clinics or office visits.

Operator

Next question. Felipe Salomao from Citibank.

Q - Felipe Salomao {BIO 19237023 <GO>}

Good morning, Portella, Bottas. Thank you very much. I have one question about health loss ratio. And as you said there was a deterioration of 180 basis points comparing Q4 '18 with Q4 '17. Could you please give us slightly more detail about for the reason of this deterioration was there increase in frequency or were there any other reasons, more specifically when all that most of the contracts have their prices readjusted in the third quarter. So I am slightly worried when the loss ratio of the fourth quarter goes up because that might be an indication that the price adjustments made in the third quarter maybe were not enough, which would make us think that there will be a few quarters with a deteriorating loss ratio. Is this what happened? Could you give us slightly more detail? Thank you.

A - Gabriel Portella {BIO 18012687 <GO>}

Thank you, Felipe. This is Gabriel. So in the fourth quarter had a reduction and the main reason is seasonality. The second point, which is important to comment and you have been following us, the attention is that we have been always trying to reduce volatility rather than seasonality as Bob has mentioned. So we have variations between quarters and last year it reduced, it was just 16% the variation between quarters.

So we want to assure the process -- so we want to reduce volatility. The key point is that for the fifth year in a row, our annual loss ratio has been going down. So the trend in our loss ratio once again in 2018 confirms the trend of the drop, the falling trend and accounts everything as part of the day to day process of managing insurance and it's not really related to frequency and if you look at the first quarter of 2018, you're also going to see an increase of 2 percentage points in loss ratio because then the comment was the same what happened but we see that deep down other quarters offset that, it's a long-term process and the long-term trend is a trend of reduction.

And, what was mentioned in his part that in 2012, we had a difference of 15 points from the highest to the smallest. In 2018 that difference was 8 percentage points between the highest and lowest loss ratio. So you're comparing the peak loss ratio and then trough loss ratio and the difference has been going down. This gap is reducing. So we want to control, we did not see any increase in admissions or previous authorizations anything that would increase and we are very confident technically speaking because we know that effect of frequency that may have influenced the fourth quarter.

We really believe that as Gabriel said, the difference between the periods and then revenues are slight different. We do not believe that this influences.

Q - Felipe Salomao {BIO 19237023 <GO>}

Perfect, thank you very much for your explanation.

Operator

Next question is from (inaudible) from Bradesco BBI.

Q - Unidentified Participant

Good morning, everyone. Thank you for the opportunity to ask my questions. I would like you to give some color on the -- what was the amount regarding the regulatory fund and if there is any relationship to the fact that (inaudible) left and what do you expect for 2019 and also what do you expect this figure to be in 2019?

A - Ricardo Bottas {BIO 18071813 <GO>}

Hi, Nicholas. I understood the first question. I'm not sure the second was so clear, but we'll advance and try to explain. SG&A, in the fourth quarter, we noticed when compared to the previous quarter there was a record of provision for regulatory fines. This record had not happened in the fourth quarter, doesn't mean that it didn't happen in 2017, but it happened at different point in time.

There was the possibility of receipt [ph], which is a financing program for fines of the government to repay and anyhow there is some co-relation related to the growth in the portfolio. This is a constant search to minimize such effect, but I would say that, that is much more due to the impact of a comparison basis rather than saying there has been an unexpected growth regarding that part. As for third-party services, as we saw in the fourth quarter, we had a higher volume third-party services associated to consulting and technology services,which are strongly associated to our growth and speeding up in some areas of digitization and technological advances that we're making, in addition to the current ones in the automobile area for example that requires support, also additional advances in our pricing tool. So what we had this year was a higher concentration in the third and fourth quarter. Especially in the fourth quarter, we hired more people, engaged more people also because we had more projects to be carried out in that period. So it's a strong correlation there. So again, we have a constant challenge of reducing and controlling costs in other areas to finance this constant development that we're doing in our processes. This is the part related to third-party services.

In terms of personnel, because we had better results of the company and due to our plan and also technical and operating aspects in -- for the compensation scheme for all employees, there is a need to make provisions given the higher income and the higher expectation of profit sharing in the company. So if we have not had a good performance, this expense had not happened. So it's not significant because it's associated to a better performance of the company.

In terms of other expenses associated to taxes, it has a more significant impact, but in the year, it's not associated. Its tax related, usually PIS and COFINS. And in our statement from the subsidiaries companies to the parent company, we made some statements throughout the period. And there is a difference -- in terms of a mismatch between PIS and COFINS that although allotted in the third and fourth quarter or among the quarters, so again in the year figure, this is neutralized. These are the main effects in terms of SG&A. I would like you to please ask the second question again because it was not very clear, if you may.

Q - Unidentified Participant

Thank you. The first question was also related to G&A. If you could, pay the amount of regulatory fines out, there has been anything related to the fact that (inaudible) left?

A - Ricardo Bottas {BIO 18071813 <GO>}

Oh the G&A associated to his leaving the company oh, is that the question? The answer is no. It's a provision related to the good results and to the good income to pay compensation. As for regulatory fines, this variation was lower than BRL10 million in comparison terms, but it's neutralized or offset, if you look at the year figures.

Q - Unidentified Participant

Okay, thank you.

Operator

Next question from Eduardo (inaudible) from Banco [ph].

Q - Unidentified Participant

Good morning. Thank you for the opportunity. I have two questions. The first one relates to what we are trying to do in terms of smoothening the loss ratio and removing the volatility of it. I know that you have found out that before, but just to make it a bit clear, what are you actually doing in essence to try to smooth in the figures and how can we look at the quarters from now on?

Try to have more, to predict better the seasonality among the quarters. So the third quarter, the first is the weakest, the fourth is the strongest, is that the real seasonality, will this continue in the future? And the second question is regarding costs. I know you've mentioned already, but there are three areas that we must understand better. First, other administrative expenses that we saw a significant increase year-on-year impairment and other receivables have also increased significantly and finally, the last one you mentioned about a regulatory fine that in terms of the amount, it's not quite clear how much they amounted to. I know there has been an increase of BRL50 million in the third quarter, I would like to confirm that if that is what you had in the fourth quarter. Thank you.

A - Ricardo Bottas {BIO 18071813 <GO>}

Thank you for the question. So talking about the loss ratio in the year, it's important to make it clear that the work we do is that is intense. Of course, there is a certain seasonality throughout the year, which is natural for the portfolio. There are different periods when loss ratio either goes up or down and what we are talking here is the difference in loss ratio, because sometimes obviously over the past few years, we have been investing in technology so that we are able to capture as fast as possible. Your currencies are any ups and downs in loss ratio so that we may gradually understand the dynamics or volume and that we manage it.

And then there is some variation, which is a result of seasonality, which is natural, without your having an increase in frequency of certain procedures. So this is work that we started a long time ago; 2011, 2012 and we are still going on and every year we reduce the loss ratio.

Just to understand a little bit more about that point. So you catch -- you use technology to capture cost and to know more about the volumes in the month. There are two things; we can't change seasonality, because this is related to what the population feels. So these differences in seasonality when we look at epidemiology entities, they're natural in the health market. We need to work on seasonality compared to the volumes that we get throughout the year and this is something that we do every quarter. Thank you very much.

This is Bottas speaking. As to admin expenses and as to fines, there was a variation within the year considering the usual and expected growth, it's a dynamic that is there last year. It was slightly smaller last year -- year before last. In 2017, there was a (inaudible) which is the refinancing program of the government for the payment of taxes, but the usual volume considering they represent activity in the company's revenue is related to the company's history.

The component of acceleration and we have mentioned that a few times, we also see a behavior that sometimes expenses in absolute terms suffers more pressure than indexation associated to indicators and also related to a behavior change over years whenever we reinforced this technique. And once again, we do not show this information to show how much is in investment plan in there because our commitment is to continue reducing and managing admin expenses in the overall. We feel that administrative expenses is under more pressure in the short-term than it used to be in the past when investments in technology were notably just mobility and that they were amortized. So there was a big investment and then they were booked as expenses.

Today, you don't buy equipment. Today we have contracts of services consulting and things that are normally -- you immediately spend that, that's not booked as investment and there is an amortization. I think this change in behavior has also exercised some pressure on us over the past two years is the change in behavior, it's natural. Other companies are dealing with that to, the dynamic or investments. In the past, they used to be much more in the long term and they required more investment and today this is small, the dynamics it's ability [ph]. So the way we make fast deliveries and scale rapidly also represents a challenge for us. That's why, although the revenue, the expenses have grown in absolute terms, we are happy with it. We are confident. I don't know if I've answered your question but once again there is also a seasonality in administrative expenses. If you compare quarter-on-quarter, you need to eliminate those effects and I think that the variation throughout the year is important to understand the behavior of admin expenses over one year. Okay.

Q - Unidentified Participant

Thank you.

Operator

Next question (inaudible) from JPMorgan.

Q - Unidentified Participant

Good morning. Gabriel, Ricardo and (inaudible). Thank you for the opportunity. My aspect is more about how when we look at the loss ratio like a film of the recent years, we see a good job in terms of managing loss ratio. There has been constantly falling and every year several basis point, but we see that the coordinated care is one of the main initiatives you have to help this continuous drop in loss ratio.

I would like to have an update, most of this pressure on expensive comes from this investments, right. So if you could update us on what are the initiatives, if you see any window from now on in the next six months or one year that we could see new initiatives being implemented, and also in line with the loss ratio, if you could talk also about the negotiation of close packages or procedures, how much of the medical cost is re-linked to that type of procedure?

A - Gabriel Portella {BIO 18012687 <GO>}

Thank you. This is Gabriel speaking. I don't see a window. It's a huge forge. We look to the future and being very assertive regarding that all the investments we've made in the health area as well as in other areas of the company recently have been matured in following years in 2018. For health as well as automobile is a great example that as a result of investments we made in the past. So our goal is to look forward always.

So coordinated care was an initiative we started in 2018. It's no longer a pilot project. There are 130,000 people in our platform that have enrolled, 1,100 physicians have -- are participating of that. So they are able of keep track and follow up with our members in a more -- in a -- with a closer look and the best result is also the impact on loss ratio. But it's having a broader model of management with a responsible use of the health plan with the best support from physicians.

So we only see advantages on coordinated care. Today loss ratio is a result of all investments and actions we've made in the past that you are aware of and that shows this is why we had a reduction in lost ratio and we believe that towards the future for the benefits we have a huge opportunity and it may seem a bit theoretical now, but the answer to this is the growth we have on an everyday basis. We see the growth of members in the coordinated care platform and all the initiatives we have implemented and continued, the market dynamic has not changed. We have changed our positioning.

As for the second question, all the process that's been affected by global area has an -- accounts for 20% of our total cost and has been growing not only on our part, but also on the need of health providers that also understood this need. So the idea is to have greater cost control, more probability of costs, although the scenario is always challenging in-house because it's inherent to the activity. Since we started making this investment, we are very optimistic as to the results and what we could still do for the future.

Q - Unidentified Participant

Perfect, thank you.

Operator

Excuse me ladies and gentlemen. (Operator Instructions) Ladies and gentlemen, if there are no further questions, I give the conference back over to Mr. Gabriel Portella for his closing remarks.

A - Gabriel Portella {BIO 18012687 <GO>}

So thank you all very much. I think that summarizing, this has been a special year for everyone in Sul America. We are very happy to see the consistency in our results and we -- and we are very happy with that to see the engagement of our employees -- and we see more and more that no one can do anything alone, much to the opposite. It's a whole team in our day-to-day, we trying to do the things better and better and I would like to thank the whole team, the more than 5,000 employees. I would also like to thank the support that we have received from insurance broker and consultants, business partners, service providers that provide care to our members better and better to shareholders that support us and other stakeholders and everyone related to the company. Thank you very much and have a good day.

Operator

Sul Americas earnings release conference call has now ended. Thank you very much and have a good day.