Q1 2011 Earnings Call

Company Participants

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

Other Participants

- Analyst
- Joao Carlos Santos
- Luis Felipe Bresaola
- Márcio Osako

Presentation

Operator

Good morning ladies and gentlemen. And thank you for waiting. At this time, we would like to welcome everyone to Kroton Educacional's First Quarter 2011 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's presentation. After the company's remarks are completed, 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 slide show maybe accessed through Kroton Educacional's Investor Relations website at www.kroton.com.br/ir by clicking on the banner 1Q11 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 the beliefs and assumptions of Kroton management and on information currently available to the company. They involve risks, uncertainties and assumptions, because 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>}

Good morning everyone and welcome to Kroton's first quarter 2011 results conference call. With us here today are Carlos Lazar, our IR Officer; Renato Friedrich, our CFO; and Lima, our Administrative Director.

I would like to begin our presentation on line three, commenting on our first quarter 2011 highlights.

In post secondary education, there were too many highlights. To any 3,000 for secondary presence, reaching a new company record and exceeding our budget. The other highlight refers to FIES loans, which continue to grow substantially.

Now, we have more than 13,000 students, representing 16% our undergraduate student base. In primary and secondary education, we recorded 6.3 increase in the number of students and 7% increase in the number of schools. We also registered a high -- of contact renewals with the schools which stood at 93%. The new different learning revenue problem is now under established cross of feature. After just four months of operations, you already have 2,600 students.

The company's first quarter results recorded substantial growth over first quarter 2010, thanks to the initiative taken during the integration and -- on post secondary segment, which clearly took the company to a higher performance level.

Our net revenue came to R$195 million and our EBITDA totaled R$52.1 million with the margin of 26.7%. It is worth noting that we had no recurring cost and expenses in the quarter. All these totaled for R$107,000 in the first quarter '11.

Now let's talk about the company's operating performance -- with Life Science. On right side, we can see the results of an intense sales drive and the company's various campaign to attract new students since November 2010, a total of 22,967 new students has enrolled by March 2011, 14% more than the first quarter of 2010. Of this total, 20,099 students are undergraduate students and 2,868 are graduate students.

The fourth quarter students figures clearly show that this is the intense restructuring in 2010. There was no increase in the drop out rate or any decline in the enrollment rate or the contrary. The drop out rate fell considerably and we track a record numbers of new students. The total number of post secondary students increased by 80% from 85,300 to 92,200 students. In undergraduate and graduate terms, it -- undergraduate students will move it by 7% and on graduate students we are by 20%.

On the next slide, we can see Kroton's new provisional map for post secondary location. In May, we announced the sale of our operations in -- our process of improving margins and operational inefficiency. In 2008, before the acquisition of UNIC, Kroton had undertaken 14 acquisitions. Of this total, 11 had their operations adjusted and began delivery such as factor results -- we did not reach the minimum performance level required by the company were sold in the Ciudad Victoria and -- in 2010 and now Rio de Janeiro in 2011.

No new sales are expected given that the other 11 units are already recording at a greater level performance levels. We also closed our unit in Belo Horizonte in Minas Gerais state transferring the students to new navy campuses with no operational impact in order to improve the quality and rebuild cost and expenses.

On the other hand, we launched an operation in the states of Alagoas with the -- EBITDA and another unit in Minas Gerais, we will strengthen our presence with... Together, these two new units, we offer 14 undergraduate programs and 1400 basis annually. With big adjustments, the company currently have 37 post secondary education unit in 27 cities in nine state.

On slide seven, represents an analysis of our performance with regard to FIES loss. we have already surpassed our first half target of almost 10,000 new FIES student, reaching 10,174 in May. If we add the 2905 students that mid grade from their own FIES to the new program, Kroton already has more than 13,000 students with new FIES contract, that means 16% of our undergraduate base of students. Note that 11.1% of this student enrolled in 2011, it's all sold throughout FIES contract, showing that a program should make an increasing contribution to new student growth.

Another highlight was the growth of the student based eligible for FIES from 61% and less three month quarter to 77% in this quarter. In the first quarter, we have we were visit by several evolution commissions, resulting an improvement ratings of our cost and increase its FIES eligibility. As I have -- we are very close to the target of 80% of our undergraduate students by eligible for FIES.

Finally, according to the latest statement from -- new measures maybe enrolled and endorses to make FIES launch offerings more selectable for recently launched process. This changes should be positive for the industry and will further increase that eligibility of the company instruments.

Moving on now to analyze the primary and secondary education segments on slide eight, Kroton began 2011 with 771 associated schools in all state of Brazil and six more units outside the country. That means 7% on the previous year. The renewal rate among associated schools remain high at around 93%.

In other words, 93 out of every 100 school renewed their contracts in the following year, clearly demonstrating the quality of our teaching systems and our solid relations with the associated school network. Between 2010 and 2011, the primary and secondary vacations student base grew by 6% to 181,000 students in the private sector.

In the private sector, the growth was about 9%. To project our -- sector network was recently restructured and remain present in four municipalities one less than 2010. Despite the decline in the number of students projected renew should actually increase, because the other services offers such as management consulting and system valuation among other have expanded. We are also participating in the final phase of -- in two municipalities, which -- the number of students over 2010, which we are exercising.

On the next slide, we used to highlight one of the most important project frankly launched in the company, the distance learning project launched at the beginning of 2011 with -- graduate classes. In less than four months, the number of students in distance learning enrollment exceeded 2006 rounded to 600 students in 121 at credit centers.

As mentioned in the previous earning disclosure, more then 700 associated primary and secondary educations schools are being integrated to participate at distant learning centers making us an important players in this segment and eventually as expected, which enable us to offer following the state of the country. We also relaunch our product in 27 cities. We already have it our own bridge.

As for the distant learning undergraduate projects, we expect the ministry of education approval by the close of the third of 2012. This projects we've also realized on some of our associated schools, because in distant learning partners. We are completing that the distance learning segment -- and become an important company growth driver in the coming years.

We would like now to invite Carlos Lazar, our Investor Relations Officer to present our financial performance.

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

Thank you, Rodrigo.

Before beginning my comments on our financial performance, it is worth noting that in order to ensure better comparisons, all the following amount excludes near term costs and expenses and refer to the pro forma first quarter 2010 results in the consolidation of unit results for the entire quarter.

On slide 11, you can see that our net revenue increased by 6% over first quarter 2010. Net revenue from post secondary education declined it by 3% over first quarter 2010 chiefly due to the 4.4% increase in the number of students for March 2011.

The average post secondary ticket was R$504 and the average ticket for the undergraduate students was R$553, 4.4% compared to the first quarter 2010 while the average graduate ticket fell by 35.6% to R$155 per month. This specific reduction was accorded by two different factors. The first was the company's strategy to qualifying its employees in order to do what we did -- the distant learning -- for our professors and members of staff. And the second reason was the decline -- for the decline was affected the good portion of the process began on February and March and therefore only made a partial contribution to the quarter's revenues.

The primary and secondary location segment, which accounted for 31% of total revenue in first quarter of 2011 on account of seasonality. Year-over-year growth was 13% reflecting the higher member of book collection sold in the private network and increase in the average ticket, which climbed by 7.3% over 2010 to R$375 per students per annum.

Moving to the slide 12, we showed that the cost of goods and services totaled R$107 million in the first quarter of 2011, equivalent to 54.9% of net revenues, pretty much the same level of the first quarter 2010. In the post secondary segment, it's worth noting that the 1.3 percentage point decline in courses related to professors and deposit services between the first quarter of last year and first quarter of 2011 was mainly due to the introduction of the new academic model. And also it's worth to note them here that the decline in rent cost of 1.1 percentage points was thankful to the ongoing initiatives to increase margins in the company.

The keys to our costs were impacted by the disposal of old kitchen materials,, but we also launched the -- network by the end of last year. And we are strengthening the services provided to associated school investing in this operations.

So, let's comment about the gross profits on slide 13. And we can see that the post secondary education increased by 29% between the last quarter of '10 and first quarter of this year, reaching R$ 50.7 million with a margin of 37.7% or 3 percentage points more than the same period of previous years. The day rectification gross margin narrowed from 71.2% to 61.9% in this quarter.

This was mainly pursued by the increase in cost, which we talked about prevalent. And here it's only worth notes that the factor that pushed this cost up and reduced our gross profit. They will impact, they will have this impact in the first place, but we expected that the post impacts will be level itself for the -- of the average tickets that we could manage to do already during this year and from the maintenance, the renewal rates of 22% and also from increase of this driven base that was by 6%.

Let's move on to slide 14; total general and administrative selling and marketing expenses represented 16.8% of net revenues in the first quarter, 3.5% as -- compared to the same period of last year.

First on G&A expenses corresponded to 12.3% of net revenues, slightly less than the 12.6% recorded last year. Selling and marketing expenses fell by 37.6% in the same period. Enrollment of new students, which grew about 14% over 2010 and reached a new company record showed that this reduction will not affect the effectiveness of the sales initiatives.

About the provisions on slide 15, we'd like to note here that the total PDA totaled R$7.2 million in the quarter equivalent to 2.7% of net revenue. In order to understand this provision, it is important to look at the business segments separately. In the post secondary segment, the company has been using a lost provision model based on our historical debt collection performance since 2010.

The behavior of the collection curves along the year is detailed in sufficiently PDA is constituted took over probable losses. The entire balance of accounts over due by more than 360 days is fully write it off from the company's balance sheet.

The methodology ensures that the provisions are sufficient took over for potentials which were losses. So the ratio of post secondary PDA to net revenue was 5.1% in the first quarter 2011 versus 4.5% in 2010. In the K-12 segment, this ratio was 0.5%. We also wished to point out here that at the present moment, Kroton does not maintain commercial agreements with any financial situations for the sale of receivables.

Moving on to the slide 15, we can see that the consolidated accounts receivable turnover in the post -- education remains stable increasing only one bit compared to the first quarter of 2010. Despite the fact with the post secondary accounts receivable turnover stood at 61 days, there was a positive factor here. Of the R$91.8 million in the -- tuition and agreements receivable in the first quarter 2011, R$2.1 million refers to the FIES credits, which should be booked in the FIES line.

However, we were unable to make this classification, because despite our analysis, internal analysis, the fact that this projects were impeded for FIES. They were not yet registered in the FIES system. So we have bought that conservative approach and only recognize the credit EBITDA account, when FIES system...

It is R$13.1 million removed from the monthly provisional agreement with -- the accounts receivable turnover would fall about -- around 51 days, so 10 days lower than as it is today. The accounts receivable turnover for K-12 included by 53.7% over the third quarter 2010 due to the seasonal nature of the business. The 23.2% reduction in the number of days compared to the first quarter of 2010 was a result of our restructured clients financing policy about in 2011.

And slide 17, we show our EBITDA and margin like during the beginning we recorded an EBITDA R$52.1 million in the first quarter of 2010 and 2011 so with a margin of 36.7%. EBITDA included substantially over fourth quarter 2010 and by 26% over the first quarter 2010. And the margin widened by 4.3% As mentioned in the previous earnings disclosure, no long-term costs and expenses related to the cost of integration and the turnaround process in 2010 was booked in this quarter.

The amount of R$474,000 were booked here refers to the consolidation signs related to -- quarter office and post secondary vacation unit -- from the Belo Horizonte City, state of

Minas Gerais. It's more remembering that EBITDA for the entire year of 2010 was R$63.1 million while we recorded this R$52.1 million in this specific quarter.

Moving on to the next slide, you can see that we could reverse our net loss of R$7.3 million in the forth quarter 2010 and recorded a net income of R$32.7 million in this first quarter with a margin of 16.8%. Year-over-year, net income grew around 25%. About CapEx on slide 19, we can see that Kroton invested R$8.3 million in the first quarter allocated as follows: 1.2 million in equipment, 2 million in systems and software, 3.2 million in laboratory and equipments, 1.8 million in improvements and expansion works. CapEx was equivalent to 4.3% on net revenue in this quarter, below the 6% -- established by the company rules.

Finally, we can talk about the cash flow on slide 20. In the first quarter 2011, the company recorded a positive cash flow, remain with the level of that very close to the previous quarter. So in the sense, we believe that our growing net debt of 59.2 million it's comfortable in relation with the cash flow expected for the year.

Those were the results for the first quarter of 2011. And now I would like to ask Rodrigo for his final comments before going to the Q&A session.

Rodrigo Calvo Galindo {BIO 17238232 <GO>}

Let's go to slide 21, which brings the presentation to a close.

2010 was the year -- post secondary integration and turn around. This challenge was meet and the results were already coming clear in third quarter 2010 fourth quarter 2010. Our first quarter in 2011 as we demonstrated that the company have entered a new level operating and financial platform. We are exceptionally pleased with our first quarter results, which brought 80% grew in undergraduate students, 6% growth in primary and secondary students, more than 2,600 distance learning students in just formal 6% grew in net revenue.

In relation to financial result, we had about non-recurring cost as an expense in first quarter '11 and delivery. EBITDA of more than 52 million with an EBITDA margin of 26.7%, net income of more than R$32 million, but there is two great work to do in 2011 during which we will be implementing our growth strategy, and we have divided the growth strategy in three major categories.

First, margin growth, second growth for acquisitions and third organic growth. In regard to margins, we have -- series of measures to ensure continued margin growth in the coming years and we are -- to implement it then. We know what we need to do, we are doing it and by 2013, we will have reached another level of results. Our track record in the last three quarters underlying with our capacity to deliver.

The growth piece by acquisitions, we will be -- our post secondary acquisitions sharply. And we expect to announce our first acquisition in the second quarter 2011. In relation to organic growth, we expect to announce 74 new post secondary courses in 2012 and 2013.

These new courses will create a further 14,800 -- in the 37 current units. We also expect consistent growth on distant learning and also in K-12 10,000 engage well. We are confident. We see excellent opportunities for Kroton in the coming years and we are fully prepared to implement initiatives that we'll add value to the company.

I would like to thank everyone for their participation. And now let's go straight to the Q&A section.

Questions And Answers

Operator

Ladies and gentlemen, we will now initiate the question-and-answer session. [Operator Instructions].

Your first question comes from the line of J. C. Santos with BTG Pactual.

Q - Joao Carlos Santos {BIO 15122452 <GO>}

Good afternoon everybody. Just a question on the selling and marketing expenses. You've seen a selling and marketing expenses going -- well, lower number than what we had in the fourth quarter of 2010 assuming the industry a little bit of a trend here of having the admission process, the initial cycle more, concentrated by the end of the first quarter and also expecting that to happen in the third quarter as well in the admission process. So, I was just wondering if you were seeing sort of a shifting the seasonality for the value expenses, I don't know if I -- reduce it year-over-year. So, if you could give some comments on how these lines should -- going forward. Thank you.

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

Thank you, J.C., this is Carlos speaking. Regarding the selling market expenses, yes, we -- right, we saw the decline mainly between year-over-year, but also quarter-over-quarter between the first quarter of last year and first quarter of this year. There's nothing related to the seasonality of the business itself. It's more related to the -- how we are spending the money and using the money in terms of marketing. We are investing a lot in our sales force. We mentioned before another opportunity we have 90 people working, selling our products in the streets.

So we are investing of that and we started earlier. We started by last year by the third quarter last year to do these initiatives and to go to the streets and sell it. So during the first quarter, we recruited followed the same trend, almost the same trend and the results were very, very good overall. Because as we mentioned, during the presentation, we could present very good number of enrollments breaking out records. So we believe that we will continue to have the same level of selling and market expenses for getting next... We don't expect it any major change on the number at all. Okay?

Q - Joao Carlos Santos {BIO 15122452 <GO>}

All right, Carlos. Thank you very much. And just a few if you could make a brief comment on the income tax and social contribution because of little bit lower than what we were expecting there was anything specific this quarter, or we should assume same laterals going forward this year. Thanks.

A - Renato Friedrich {BIO 16888676 <GO>}

This is Renato speaking.

We did some changes in our legal structures that allowed us to have a better synergy, tax synergy between the many companies. So this is the main reason benefiting from tax loss we had in the past. This is the main reason.

Q - Joao Carlos Santos {BIO 15122452 <GO>}

That's excellent. Thank you very much.

A - Renato Friedrich {BIO 16888676 <GO>}

You're welcome.

Operator

Your next question comes from the line of Mafe Gandhi with HNC Capital.

Q - Analyst

Hi, good morning. Thanks for taking my question. My question was along the lines of having to understand the EBITDA margin, clearly like the 26% EBITDA margin sales great performance congratulations for that. I wanted to understand how that related to the target of 23% EBITDA margin that was presented in Jan of this year? And how you see those margins evolving going forward?

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

Hello, good morning. This is Rodrigo speaking. With this result in first quarter, we will still remain our target in R$101 million EBITDA in the year 2011. So we're still expecting 15% of EBITDA margin this year that are estimated, we don't change it. We have a very good first quarter, but we still remain our projections to the year and our guidance to the year.

The relation with this number ended 33% in our EBITDA guidance to 2013, we need to implement another -- and another acts like restructuring in rental cost and the classes, which is -- sufficient number of the student and another thing that we are planning to do to get our 33% already -- 23% our EBITDA margin.

Q - Analyst

Okay, great. Yeah, thank you.

Operator

Your next question comes from the line of Marcia Osako with Itaú.

Q - Márcio Osako

Hi. Good afternoon everyone. I have two questions. The first one very quickly on the organic growth in the post secondary. I guess let you know if you still maintain the 6 to 9% growth in this year given that the growth in this quarter was 2.6% and then you sold the Rio de Janeiro operation. So, this is my first question. And the second one regarding the G&A expenses. How much of these 70% increase that you had year-on-year related to the consulting services that you contracted, I think in the forth quarter and you comment to release and when do you expect you conclude this project, so that we can see a reduction in G&A? Thank you.

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

Hello Márcio, it's Rodrigo speaking.

About your first question, you are right and the revenue in 2010, we won't have a small reduction because of the sale of the Rio de Janeiro operation, but and about 1% of the net revenue is very low net revenue reduction, but the result of the cost -- the Rio de Janeiro operation is negative. So we don't have impact in EBITDA margin project, our EBITDA margin projects. So, we expect a little bit increase of this projection, because we don't have more, there is negative impact of the Rio de Janeiro operation.

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

Regarding the expenses, the consulting expenses, we started doing our project in during their fourth quarter last year. This quarter, we repeated the same level of the expenses, around the same level. And we do expect it to go during this year with this level.

There are not only one single project, but several other projects here to increase the efficiency of the company in the long run. So this year, we've expected the volume of expenses and consulting expenses specifically will be around the same level.

Q - Márcio Osako

Okay, thank you.

Operator

Your next question comes from the line of Luis Bresaola with Espirito Santo, Inc.

Q - Luis Felipe Bresaola {BIO 15381072 <GO>}

Good afternoon everyone. My question is regarding the acquisitions. The lot of new acquisition for 2011, I would like to move -- looking to finance those acquisition throughout the year. Thanks.

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

Hello Luis, it's Rodrigo speaking.

We have two personalities to finance our acquisitions. We have that and we have equity, We are analyzing possibility in using both of the relative. And within that, we have these opportunities on the table and we are analyzing, which one is direct and with time. For a complete acquisition projects in the next two years the debt opportunity that we have are not enough to finance in this growth, this acquisition growth. So, we must go to the equity opportunity, to the equity, but we are analyzing when is the best time to make the operation.

Q - Luis Felipe Bresaola {BIO 15381072 <GO>}

Okay. Thanks.

Operator

Your next question comes from the line of Yash Patel with HNC Capital.

Q - Analyst

Hi gentlemen. I had a few questions. In terms of seasonality, can you just remind me in terms of what, I see that you have seen historical seasonality in EBITDA margin. Can you explain why that is in terms of the quarters? That's my first question; I have two follow ups on that.

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

Hi, this is Carlos speaking.

The main reason for this seasonality is the case to our business that we have around 70% of the revenues recognized during the first quarter of the year.

Q - Analyst

Got it, okay. Second one relates to FIES. I think you have said in the presentation, you can make a comment of 77% of your student base is eligible, did I hear that correctly for FIES? And of that 77%, you have approximately 16% or some other number like that enrolled in the FIES program; is that correct?

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

That's correct. We have already 77% of our trend is what is eligible to the new FIES. This leverage can even go higher, because as presented during the event today, the new -- is talking about some flexibility in terms of drop to -- for the FIES. So, we do expect that this number...

Q - Analyst

Okay, got it. And then the last thing was relating to not your presentation but your earnings release page three. You have a chart there, which basically says that evolution of students in Q1 2011 and then there is a chart below, which says evolution of students, April 2011. And basically the only difference between the chart shows a lower drop out rate in that second chart. I guess I just don't understand that conceptionally, because these are students drop out or they haven't. So, can you explain what this chart means, please?

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

Sure, it's very simple. The first graph is only considering the renewal -- student occurred into the end of March. But in just beginning of this year, it was kind of delay in this renewal. So, and we did receive a lot of renewals actually something around 3,000 renewals during April; but this renewals once, its linkage should -- not the enrollment process, but the renewal process from normal course. So, that's why we put two difference at last year to present the one -- the only in this one is impacted mainly the net revenue, because we didn't consider the net revenue, the renewals aftermarket or after -- but you can consider as the number of students, the total number of students as of April, because we had some renewals occurring during this specific month. Is that clear for you?

Q - Analyst

Yeah, I think so. I mean if I can just rephrase, I guess another way of thinking about it is the way you defined drop outs -- effectively the people that don't renew that were eligible to renew. And so they don't say -- they don't make a statement high and dropping up, they just basically don't re-enroll for the program, and then they go into drop out bucket. But what you're saying is that there was effectively one month lag or 3 million or whatever 3,000 of these students effectively came back and paid tuition in April, and so they are effectively not drop out. Is that the way we think about it.

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

Exactly. It's pretty much like this.

Q - Analyst

Okay, all right. Thank you very much and very nice. Congratulations.

Operator

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