

Q3 2019 Earnings Call

Company Participants

- Bruno Ferreira Blatt, Chairman
- Grace Cury de Almeida Goncalves Tourinho, Chief Financial Officer and Investor Relations Officer
- Pedro Nocetti, Investor Relations

Other Participants

- Bruno Giardino, Analyst
- Frederico Mendes, Analyst
- Joseph Giordano, Analyst
- Thiago Macruz, Analyst
- Unidentified Participant

Presentation

Operator

Good morning, ladies and gentlemen, and thank you for standing by. At this point, we would like to welcome you to Qualicorp's Conference Call to discuss the results for the Third Quarter 2019.

We have with us today Mr. Bruno Blatt, CEO; Mrs. Grace Tourinho, the CFO and IRO; and Pedro Nocetti, IR Manager. This event is being broadcast live via webcast and may be accessed through Qualicorp website www.qualicorp.com.br/ir, where the respective presentation is also available. This event will be recorded and participants will be in listen-only mode during the Company presentation. Ensuing this, we will go on to the question-and-answer session when further instructions will be given.

We now will turn the floor over to Mrs. Tourinho who will start the conference.

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

Good morning, everyone. And it is with great pleasure that I begin our third quarter 2019 earnings call. This has been a very challenging quarter to be able to achieve everything we wanted and this was done with the help of all of the areas in the Company. Before talking about the results, it is important to talk about the important changes in the Company that were reported in recent days.

On the 12th we concluded the sale of approximately 10% of the Company capital owned by founding shareholder Jose Seripieri Filho to Rede D'Or. Also last Tuesday, the Board of Directors elected Bruno Blatt, Chairman of the Qualicorp Group to replace the Company's Founder who remains a relevant shareholder. On the same occasion Heraclito Gomes was unanimously elected Chairman of the Board. The following are also part of the Board.

Well, Otavio de Garcia Lazcano, Financial Vice President of Rede D'Or Sao Luiz , and Mauro Teixeira Sampaio, Legal and Human Resources, Vice President of Rede D'Or. Leaving the Board are Jose Seripieri Junior, Leonardo Pereira, Raul Rosenthal.

Founded in 1997. Qualicorp is nowadays one of the leaders in the administration, management and sale of collective corporate and affinity health plans providing health services to over 2.5 million beneficiaries. Therefore Qualicorp owes sincere -- thanks to Jose Seripieri Filho who worked as Director and Adviser of the Company. The Company would also like to thank Leonardo Pereira and Raul Rosenthal for their services.

I take this opportunity to welcome President Bruno Blatt and Heraclito and Board members.

Bruno Ferreira Blatt {BIO 21352052 <GO>}

Hi, good morning to all of you and I would like to thank the shareholders and the members of the Board of management who has elected me unanimously. Today is a special day. We began a new cycle at Qualicorp and I have received several messages from operators, brokers, distributors and leaders. But I was especially warmly welcomed by employees and this gives me great joy to work.

For many years, I worked as an entrepreneur, as an executive. I founded a broker. In five years we created a portfolio of 1 million and some live. And during this trajectory, I carried out a very good relationship with operators and I lead an area of product development expansion strategy. I have a great deal of enthusiasm and very confident in the challenge that I am now taking on in this Company. The Qualicorp team has carried out excellent work in terms of reducing cost and in increasing retention. And now is the moment to focus on market motivation to expand our portfolio to create more competitive products, and of course to work on M&A.

We have more than 10 million premiums and our mission is to offer quality services to companies. I have great passion for what I do. And I feel that I will be very qualified. I will bring in new experience and new ideas in this new cycle for Qualicorp. Our team will, of course, pursue all the opportunities.

And I would now like to turn the floor over to Grace and Pedro who will refresh all the results.

Pedro Nocetti {BIO 20904123 <GO>}

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Thank you, Bruno. Welcome once again and gentlemen and ladies, I begin with Slide number 4, speaking about our portfolio. In the last seven quarters that we have reported, when we think about the same quarter in 2018, we observe an improvement in the churn year-on-year. We have observed an improvement in the churn and it has not been different in this third quarter of 2019. As everybody knows, this is a quarter that concentrates a large part of the readjustments in our medical and hospital portfolio. I highlight the work of our customer management, a management that works with a focus not only on retention but on the customer journey within the Company in the quest to deliver satisfaction and a perception of value, the perception that Qualicorp delivers very good services. This has enabled us to improve our churn year-on-year since 2017.

Regarding the growth, as for the third quarter we have a growth in both comparisons. As a result of our sales campaigns that began especially in the second fortnight of May with a focus on digital sales. This has already generated a positive impact on the third quarter. Above all, we have been able to convert practically all of the sales that are incoming to the Company through the digital channel. In January, 12% of the sales were done through the digital channel, 71% in June and we ended September with 96%. Preliminary data for November point to 98%. And with this we have been able to obtain gains that you will be able to observe in our operational costs and expenses.

To still speak about gross adds, we acquired a portfolio of 6,000 lives in the southern region. This is not only aids us to reduce the volume of large lives during the quarter, but also opens room to develop a portfolio in a region that is very interesting for us to increase our share. With this we end third quarter in terms of lives and affinity with a net loss of 25,000 lives, a performance 39% better vis-a-vis 2018. When we look at the consolidated figures for the nine months, it shows us we will be able to obtain greater stability in our beneficiary base, especially when we compare 2018 and 2017.

In the other segments, we have an increase of lives in the corporate and SME segment and in TPA. And the later has had an impact on revenues that is not very significant.

On slide number 5, we're now going to speak about net revenue, an increase in the annual and sequential comparison and here we have the impact of the price readjustment in most of our portfolio. Because of this, the average ticket increase is giving us more revenues and of course an increase in brokerage in the affinity segment. We also have had a growth in the other segments. Thanks to the increase of our portfolio both in the corporate and SME segments.

We go on to slide number 6, referring to costs. Gross margin increased more than 100 basis points in the comparison and here we observed a reduction of expenses with personnel. Thanks to the improvement and enhancements of the processes, because of the great predominance of digital sales and a reduction in expenses with severance pay that has an impact on the first semester in the company. You can also observe an increase in some services that refer to IT systems that were used at the beginning of the year and that will replace our legacy systems. It is very possible that in coming quarters, we will discontinue these legacy systems and this should show an improvement vis-a-vis prior quarters. In terms of royalties, we have a savings of 6% for the nine months for the -- because of the work of the Company.

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Gross margin as a whole do observe that in the last five quarters, we have been able to maintain our gross margin above 81% which is very important. We have taken additional steps towards improving this the enhancement of margin, the enhancement of processes that enable us to have greater efficiency.

I now go on to slide number 7 to speak about SG&A. There is a drop of almost 5% in the sequential comparison, an improvement in expenses with personnel. The first semester quite impacted with severance pay the third quarter no longer with this impact, and we have a natural drop in expenses with personnel, leading to a reduction of administrative expenses. I would also like to refer to the reduction in amortization, thanks to the maturity of investments made by the Company.

Now, before giving the floor back to Grace, I would like to refer to slide number 8 to selling expenses. You will observe that the amortized volume for commissions on new sales that involves awards, increases in the annual and sequential comparison, reflecting not only an increase in sales as mentioned previously, but also our policy to award for new sales, a policy that came into effect in May and the trend is for the volume of amortization to grow. We are dealing with commissions while -- based on the old regime before the IFRS and because of competence we would be spending almost BRL19 million in the first semester. If compared to other semesters, it would be BRL17 million in the third quarter '18 and BRL17 million in the second quarter of 2019.

Now before returning the floor to Grace, I would like to conclude in terms of our commercial performance. As important an increasing sales is ensuring they become effective so as to generate longer-term effects for the Company. Under this vision Qualicorp is doing very well with this new tool and is fully confident that with more accessible products and with the engagement that we have from our sales force, we will go back to having a consistent growth in our beneficiary base. I now give the floor to Grace who will speak about other highlights of the Company.

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

Thank you, Pedro. We now go on to Slide number 9, where we can speak about bad debt and collectible receivables that is undergoing its best moment. Thanks to successful initiatives, downgrades, the retention of customers, working closely with our customers. Now, when we analyze the result of the nine months, we are able to observe that we have generated more than 2 percentage points in margin for the Company. We maintain our focus and we continue to be confident that we can obtain better results as we are able to reduce the loss of life as a whole. This would have a very positive effect. We go on to Slide 10, financial income. In the third quarter we had a very special situation where we have the financial expenses with the new debentures, but also a strong increase with the cash investments that remained within the Company. This revenue will drop in coming quarter, as we paid out capital in an amount of BRL980 million in the -- on November 5th.

We go to Slide number 11 to speak about EBITDA. And the situation could not be different. We have been carrying out in-house work. We have one more quarterly historical record for the Company based on the growth of revenue and margin. I highlight the work of the Company in terms of adjusting processes and implementing the digital transformation.

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We have developed this in-house. When we think about the strategic planning of the Company, these are the guidelines that we have and we are convinced that the results have been consistent, but they can also improve further.

We go to slide number 12 to speak about net income. In the third quarter, there is an increase in the comparisons reflecting a higher operational results of 39% increase. Now this is the best in terms of the rate. Now as I'm going to speak further ahead, we are going to reduce this fiscal inefficiency in the coming quarters.

In slide number 13, to conclude, CapEx and indebtedness. The Company ended the third quarter with a net debt of BRL108 million. We remind you that we paid BRL182 million in dividend in the month of August. This position will change in the fourth quarter '19, because of the payment of capital.

We now speak about cash flow on Slide 14. The operating cash flow, after CapEx, stood at BRL100 million for the quarter, lower than the previous quarter due to a higher volume of taxes and commissions paid and also a slight drop in our working capital accounts. These are the main items that happened. Most of this is due to be premiums that we give to the operators as the last day of the month fell on a Monday. And I remind you that in the last quarter the closing of June this happened on Sunday. This hampered us somewhat and the immediate cancellation that we had, this is the most difficult period for our customers because of the seasonal increase. And there is a natural lull. We will recover this with operators that [ph] were intensifying this and we will probably recover this in the fourth quarter.

Before going on to questions and answers, I would like to refer to what has been done to enhance the fiscal and Company -- structure of the Company. We go on to slide number 15. And first of all, I would like to thank our shareholders at Qualicorp that approved the capital reduction at the extraordinary general assembly on August 15. Thank the legal area team that organized this entire process. IT, because of all the operations we had to do within our system. Thank the commercial team that had to make adjustments, enabling us not to lose any revenues and we achieved this very successfully in the operational and financial segments. Therefore, I would like to thank the entire Company for making a difference.

The payment of this reduction was paid out to shareholders and they were with us on October 18. The conclusion of this operation, along with the new debentures, positions us with a much more efficient capital structure when that will generate value for our shareholders. Presently, we have 50% of resources of third parties and 40% are our own resources and because of this, we have accrued BRL1.3 billion paid out to shareholders between dividends and capital reduction.

We go on to Slide 16 to speak about our incorporation. This was approved on October 31st, but we still have a great deal to do. This means that we now have an operating holding that will generate revenues opening up space to retread fiscal inefficiencies and we will reduce our rate of taxes to a more acceptable level. This also opens up opportunities to think about opportunities that could deliver greater value to our

shareholders in the medium term. We are ready to harvest the results of all of this work in coming quarters.

Thank you very much to all and we can now go on to our question-and-answer session.

Questions And Answers

Operator

Thank you very much. (Operator Instructions) Mr. Joseph Giordano from JP Morgan would like to pose a question.

Q - Joseph Giordano {BIO 17751061 <GO>}

Hey, good morning to all of you, Bruno, Grace and Pedro. Thank you for taking my question. The first question is to Grace. I would like to better understand the part referring to expenses if there is still the effect of restructuring. And which will be the level of expenses going forward for the Company as part of the marketing strategy and the new activation of this channel, which will be the behavior of this line item in coming quarters? Churn has improved and which will be the behavior. And if Bruno can respond to the second question what are you thinking in terms of the growth for Qualicorp going forward? Thank you.

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

Thank you, Joseph for your questions. When it comes to our expenses, I too request some trust from you. We have carried out a great deal of work to make this operation effective, especially because of the speed with which it was done. But you know me very well, we cut down our expenses day after day. We always find new things. But more importantly than that we are focused on our customers. All of the expenses that we are reducing has to be done to create value for our customers. 58% of our service is being done by the digital platform. And nowadays our customers are able to see that we offer much better services and this gives the Company a very important return. We know that we are offering better services but of course, we will continue to improve on this.

Pedro will speak about marketing and the channel.

A - Pedro Nocetti {BIO 20904123 <GO>}

When it comes to our campaigns and the awards, the awards that we mentioned has fully complied with its goal. We have the engagement of the broker to ensure the sale is done digitally. We have created a channel to service broker in a more expeditious and direct way. When it comes to the awards per se, this level should be maintained until the end of the year at least. Once again, we're always working in this process. We could optimize these awards and ensure that we can generate more value in the long term. And if it becomes necessary to increase expenses to grow once again, we will not fear making this investment, Joseph. But we're thinking of accounts, we're increasing the volume of activation in the quarter and this of course will increase our commercial expenses.

I now give the floor to Bruno.

A - Bruno Ferreira Blatt {BIO 21352052 <GO>}

Joseph, good morning and thank you for your question. I feel very comfortable at responding to your question. We have a good relationship with operators and distribution channels. We have 10 initiatives to sell more competitive products. We are working in new markets, we have several ideas that we would like to implement here. And of course, we know the potential the Company has. This is my second day in the Company. Without a doubt in future meetings, I will have more details regarding this new action plan. I will participate in all the conference calls and will be available to all of you to be able to offer this information to you in a timely fashion. Thank you, Joseph.

Q - Joseph Giordano {BIO 17751061 <GO>}

Thank you for the response.

Operator

Citibank would like to pose a question.

Q - Unidentified Participant

Good morning. First of all, I would like to congratulate Bruno for the new position. Good luck in this new challenge. I have two questions. The first is a follow-up in terms of the Company restructuring. This was made very clear by Grace. I would like to know if there is anything you would like to share about this new structure. And as the restructuring happened this year, if it makes sense to think about an extraordinary effect for the fourth quarter, something that will be annualized? I would like to understand this dynamic. Now the average readjustment was of approximately 17.5% this year, which I believe is quite steep. I know this is strategic review, but if you could share with us the negotiation with the operators, and if you could improve this level of readjustment? Thank you.

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

Leandro [ph]. Thank you for the questions, an excellent question. When it comes to the tax rate, we do want to get to 34%, below 34%. Obviously, when we speak about the fourth quarter this is the vision that we have. We're concluding an internal study to avoid the fiscal losses that were part of the holding and that we had not foreseen before incorporating the brokerage company. This study is underway. And next week we should conclude it to be able to include this in our studies.

Of course, this will be subject to several in-house approvals as well as an audit. But of course we are working on this very productively and this should allow us a very good outlook. When it comes to that specific line item of our results in the fourth quarter, that will be annualized so that we can use it throughout coming years, especially the year 2020. The idea, yes, is to have a much more efficient rate below 34% for taxes. And we want to use the interest on shareholders' capital as well. This has been the Company desire as we pay out great dividends and would like to continue to do so 100% of

dividends. This is not a commitment, but if we don't have cash availability of course this is what we would like to aim to do, once again subject to the necessary approvals.

I will give the floor to Pedro now.

A - Pedro Nocetti {BIO 20904123 <GO>}

And when it comes to the readjustment, we do have a brokerage company. Well we are speaking to the operators. And for this specific point in time, we cannot speak about lower readjustment for the coming year. We do have room for a slight improvement, but it will continue to be a challenging scenario when you transfer this to the Qualicorp customers and we're in that daily struggle of being able to put on the shelf and in the channels new products that can be used as an alternative. But when we speak about the readjustment, there is room for a reduction, but nothing significant.

A - Bruno Ferreira Blatt {BIO 21352052 <GO>}

Leandro, good morning and thank you for the welcome. To reinforce what was said by Grace and Pedro, we do have several initiatives in term of competitive products. This will allow us to have a significant increase in beneficiaries and new competitive products that will perhaps help us to work less aggressively in terms of the readjustment. We're working arduously on this for the year 2020. Thank you. Thank you very much.

Operator

Mr. Thiago Macruz from Itau BBA would like to pose the question.

Q - Thiago Macruz {BIO 16404924 <GO>}

Hey, good morning. Good morning Bruno. And if you allow me, I have two questions. We see improvement year-on-year. Now, are you planning an improvement going forward or have you done all the increments that you can imagine and what will be happening in November?

Second question, of course one of the great focuses for you is a retention that we have seen, a lower number of downgrades and an improvement in retention. Now the question is if with customer retention you were able to maintain the conditions that customers had previously or not.

A - Pedro Nocetti {BIO 20904123 <GO>}

(inaudible) good morning. Who is speaking is Pedro. To respond to your question, that was very interesting. I would like to go back one year when in 2018 we intensified the process for customer retention and the downgrading projects. That year this was done because of a necessity and a demand in the Company to be able to show the customer that we were working close to them and we actively offer practically 80% of our beneficiary base an alternative product so that the customer could face up to that readjustment. Of course when you adopt this strategy, you take a customer that needed to do the downgrade to -- truly doing the downgrade and sometimes, although it was not

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a priority for the customer, the customers did accept to do the downgrade. This is a position that will be ever more consolidated in the coming quarters. The customer that did a downgrade last year will remain in a more comfortable position in the coming quarters. And this is what we foresee. Thanks to this retention strategy. There is a macro issue which is a resumption of employment in the country. And although the readjustment is quite steep, customers are now able to think that they will be able to maintain themselves in our portfolio. More specifically, speaking about the fourth quarter, remember that the fourth quarter will still have a remain of the readjustment. So for a month or more, we have had a loss of lives. But as I mentioned in my speech, we are doing well. We're heading towards a more stable portfolio for the year 2019 as a whole.

Q - Unidentified Participant

Thank you. Thank you very much.

Operator

Our next question comes from Bank of America.

Q - Bruno Giardino {BIO 15974970 <GO>}

Hey. Good morning to all of you and welcome Bruno. Thank you to the rest of you. In terms of how to work with more accessible products, more competitive products, do you think that your partnership with Rede D'Or could adds to this aspect? And which are the products that need to be changed to obtain this goal in terms of the remuneration of the channel or the operators you work with, which are the variables that you would be changing in this case?

A - Bruno Ferreira Blatt {BIO 21352052 <GO>}

Bruno, good morning. Thank you for the question and thank you for the welcome. One of the other challenges in Rede D'Or of course is the creation of new products. I have quite a bit of knowledge about this and we believe that Qualicorp will look for this not only in Rede D'Or but in the entire market. We have hundreds of options that we have that presently we are not exploring. We can have more competitive, more accessible, more adequate products. We are quite calm that we do have these avenues, these possibilities and we believe that this will bring back some customers. And we're highly enthusiastic with the growth that we can have not only with new products but new channel or through M&A. I hope I have responded to your question.

Q - Bruno Giardino {BIO 15974970 <GO>}

Yes, we will continue this in our next conversation. In terms of the portfolios that have a readjustment in the fourth quarter, we have only Medi. What is happening with the mix of that portfolio? Is this a reason of concern for the fourth quarter? Thank you.

A - Bruno Ferreira Blatt {BIO 21352052 <GO>}

Bruno, this portfolio that you mentioned specifically has a much lower level of readjustment. If compared to those who were in charge of that portfolio previously, this is

not a portfolio where we foresee the risk of losses. As I mentioned, we're doing very well and we will have stability in our portfolio for 2019.

Q - Bruno Giardino {BIO 15974970 <GO>}

Very good. Thank you. Thank you for the responses.

Operator

Mr. Fred Mendes from Bradesco would like to pose a question.

Q - Frederico Mendes {BIO 19832788 <GO>}

Good morning to all of you. Thank you for the call and thank you for these new initiatives. I have two questions. In terms of your strategy, simply to try to understand what you're thinking about in terms of your projects in health perhaps leveraging greater efficiency and a more specific point that refers to your royalties with an increase year-on-year. What is it that we can expect for this line item in 2020? Will it continue to grow, or will we begin to see a descent? Thank you very much.

A - Bruno Ferreira Blatt {BIO 21352052 <GO>}

Fred, good morning. Thank you for the welcome. As we mentioned at the beginning health is one more project in the Company and I need some more time to fully grasp the meaning. I can promise that with time not only health, but also other projects will be developed in the Company.

Fred, regarding the royalties, of course this has been the work of the Company in the last quarters, and we do have fluctuations that are in line with the price readjustments. That is why I always request that you look at the movement of the royalties accrued for nine months. We have been able to achieve a reduction.

Q - Frederico Mendes {BIO 19832788 <GO>}

Very good. Thank you very much. And the question is if going forward this is a line item that will continue to grow with the growth of revenues? And -- thank you very much.

A - Bruno Ferreira Blatt {BIO 21352052 <GO>}

Fred, simply to add to this without a doubt there is room. We have done a great deal. We have several achievements in terms of this line item. There is very small room, when you compare the entire year especially compare it with 2018. Now with the digital sales, we're also working to obtain some improvement in this line item, but -- this is incipient work that is merely beginning now so that we can harvest some successes in the future. And we have to be very careful with this line item. We have a very good relationship with all entities, they are our partners. And this is important in our business without a doubt, we can make additional enhancements. But they will be done in a longer period of time in that line item that I mentioned. And everything will be based on a win-win situation. Once again, we do need this positive incentive to retain the customers in our portfolio. I don't know if this responds to your question or questioning.

Q - Frederico Mendes {BIO 19832788 <GO>}

Yes, it does. Thank you very much.

Operator

As we have no further questions, we will return the floor to Mrs. Grace Tourinho for her closing remarks. You may proceed, ma'am.

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

Thank you very much for this call. I would like to thank all of you for the confidence and have an excellent weekend with the holiday.

Operator

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

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