Y 2016 Earnings Call

Company Participants

- Flavia Menezes de Oliveira, Investor Relations Manager
- Leonardo Moretzsohn De Andrade, Chief Financial Officer
- Pedro Thompson Landeira de Oliveira, CEO and Investor Relations Officer

Other Participants

- Bruno Giardino, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. Thank you for standing by and welcome to Estacio's conference call to discuss the fourth quarter of 2016 results. This event is also being broadcast simultaneously on the Internet via webcast, which can be accessed on the company's IR website, www.estacioparticipacoes.com.br/ir and Engage-X platform, together with the respective presentation and the earnings release.

We would like to inform you that during the company's presentation, all participants will only be able to listen to the call. We will then begin the Q&A session when further instructions will be given. (Operator Instructions)

This conference call contains forward-looking statements that are subject to risks and uncertainties that could cause the company's actual results to differ materially from those in the forward-looking statements. Such statements speak only as of the date they are made and the company is under no obligation to update them in light of new information.

I will now turn the conference over to Mr. Pedro Thompson, CEO and Investor Relations Officer. Please, Mr. Thompson, you may proceed.

Pedro Thompson Landeira de Oliveira {BIO 21085761 <GO>}

Thank you and good morning, everyone. Welcome to our conference call to discuss our results for the fourth quarter and full year of 2016. With me here today are Leonardo Moretzsohn, our CFO; and Flavia Oliveira, our Head of IR. Just to remind you all, there will be a Q&A session as soon as the presentation is over.

Let's go straight to slide two which shows the agenda of our presentation. We will be talking about the following points: quarterly highlights, where we present the priorities of this new management and the results highlights; second, operating performance, which deals with the student base and increase in the average tickets, thanks to the various recovery initiatives introduced during the second quarter; third, financial performance, showing more consistent indicators after the implementation of new policies; and finally, the final remarks, where we highlight some of the new strategies and guidelines for 2017.

Moving to slide three, where I will talk a little about this new management's priorities. 2016 was a period of change, which began with the election of the Board of Directors in April. The entry of new independent members in the election of the new Chairman of the Board of Directors provided Estacio's management with a more accurate view on governance. From the beginning, it became clear, they need to review our strategies, policies, internal practices, mainly because of the economic downturn and regulatory restrictions experienced by the company. Therefore, we began with the replacement of a -- with the event of the entire Board of Executive Officers and some of the main corporate managers.

I was elected as CEO at the end of September. Subsequently, we hired new executives with extensive market experience into key positions and Mr. Leonardo Moretzsohn, our CFO. We are also concerned with the appreciation of our internal talents to compose the new Board of Executive Officers, people with energy to change and internal knowledge required to recognize the strength and credibility of our company with more than 45 years of operations. This skill development strategy is to face the current challenging environment experienced by Estacio.

Thus, we readjusted the corporate structure with the objective of focusing our core business. From the beginning, we understood the need to improve our operating leverage opportunities. So we restructured our business to eliminate non-priority projects given the macroeconomic crisis in Brazil and to strengthen our processes and management of our business units; in a separate way, the on-campus and distance learning modalities.

We also revised our significant accounting practices and policies, which were responsible for adjustment in the results of the second quarter of 2016. Based on the best governance practices and in order to ensure the correct compatibility of information presented to the market, we restated the comparative information for 2014, 2015 and the first quarter of 2016, and made one-off adjustment in the second quarter of '16.

With these lessons learned, the company created a compliance area and internal controls area, which together with the governance with management area aims to ensure that the revision of policies and practices will continue and become a permanent fixture. I can say that changes were not easy, but were absolutely necessary in order to realign our management and prepare the company for sustainable growth and to be able to exploit the operational leverage of its scale.

I will now continue with further highlights on slide four. We see that our net revenues came to 3.2 billion in 2016, 7.6% up on 2015, excluding the effect of the present value adjustment of FIES receivables in 2015.

In the fourth quarter of '16, EBITDA totaled 207.3 million, more than 100% up on the fourth quarter of 2015 with the following positive impacts. The first one, 43 million from the reversal of the provision accrued on the second quarter for some FIES receivables. Second, 7.2 million from the FIES discount rate as the second half of 2016. And third, 46.7 million from the sale of receivables. For a fair comparison, excluding those impacts, comparable EBITDA would have come to 134.8 million, 30% than the fourth quarter of 2015; accompanied by a margin of 16.9%, up by 3.4 percentage points.

In 2016, EBITDA came to 652.4 million, 3.1% up on 2015. Excluding the following non-recurring effect or effects that did not occur in prior periods, as shown in the table, comparable EBITDA would have come to 691.2 million, 10.5% up on 2015; accompanied by a margin of 21.7%, up to 0.6 point year-on-year, virtually flat over 2015.

I will now turn the floor over to our IR to present with more details the performance of our student base and tickets. Flavia, you can go now.

Flavia Menezes de Oliveira {BIO 20130905 <GO>}

Good morning, everyone. I will talk about slide number five. Estacio closed 2016 with a total of 508,000 students, 2% more than in 2015 as it can be seen in the chart on the right side of the page. This growth is mainly due to the 3.4% increase on the on-campus undergraduate base, which was significantly influenced by 3.8 percentage points increase in the segment retention rate. We believe that with the changes in the students accounting policy, our base is cleaner, and tend to show lower dropout rate. The 27.2% growth in our distance learning graduate base also contributed to the student base. Our partnerships also played a key role in the segment's intake process.

I must comment on the 2.2% reduction in our distance learning undergraduate base over fourth quarter 2015, which came 106,900 students. In 2016 distance learning had three enrollment cycles only, unlike the previous years when intake occurred every quarter, we thus extended the periods of its two main intakes in order to reduce the operating cost of the smaller enrollment cycle. In spite of the decline in the segment's student base in the fourth quarter of 2016, it is worth noting that the 3.7 percentage points increase in the retention rate over the fourth quarter 2015.

Moving onto slide six, I will talk about distance learning and on-campus average ticket, beginning with the on-campus segment. Ticket increased by 9.3% in the fourth quarter 2016 over the same period last year. Analyzing the on-campus undergraduate segment only, we see an increase of 7% in the fourth quarter, in line with the inflation adjustment. The on-campus graduate segment increased by 24.3% in the fourth quarter due to the higher prices for the new students and the gradual reduction of scholarships and discounts granted. Therefore, it is worth noting the deductions line, which dropped 11.5 percentage points over gross operating revenue.

In fourth quarter 2016, the distance learning average ticket increased by 24.1% over the same period last year, due to the change mainly with regards to their relationship with partner centers and the management of their performance.

In 2016, we see an increase of 5.3% and 6.7% in the on-campus and distance learning segments, respectively.

I will now turn the floor over to our CFO, Leonardo Moretzsohn who will talk about our financial performance.

Leonardo Moretzsohn De Andrade {BIO 15216920 <GO>}

Good morning, everyone. Let's move to slide seven. I will present the net revenue figures. As you can see, in the first-half the net revenue came to close 797 million in Q4 '16, 8.2% up compared to the same quarter of 2015. In 2016, net operating revenue came to BRL3.2 billion, 8.6% up on 2015.

In spite of the price adjustment applied by the based on inflationary costs in the year, net revenue was negatively impacted by: first, 51.3 million reduction in on Pronatec revenue due to the graduation of the last students in this segment; second, 17 million reduction on the other revenues, mainly due to the end of the Rio 2016 Olympic Games project related to training offered by Estacio to the volunteers; and third, 40.3 million increase in other deductions due to the accounting of transfers to distance learning partners as of Q4, 2015.

Additionally, the 1.8 percentage point increase [ph] in scholarships and discounts as a percentage of gross operating revenue between 2015 and '16, mainly due to the significant increase in monthly tuition exemption and discounts granted during the intake cycle of the first half of 2016.

Moving on to slide eight, I will talk a little bit about our operating costs. The cash cost of services represented 57.1% of the net operating revenues in Q4 '16, an increase of 2.2 percentage points versus almost 55% in Q4 '15, essentially due to the personnel line which had three positive impacts in Q4 '16 as follows.

First, 14.5 million increase in collective bargaining agreements mainly due to the payment of retroactive amounts. Second, a non-recurring amount of 6.9 million referring to referring to faculty severance, due to internal restructuring. And third, an amount of 17.9 million referring to a difference of fewer vacation days granted in Q4 '16 over Q4 '15.

It's worth remembering that vacations to be granted in Q4 '16 were granted in Q3 '16 due to the Rio 2016 Olympic Games, increasing Q3 '16 results over Q4 '16. Excluding these points highlighted on the slide, the margin in personnel cost line would have increased by approximately 2.3 percentage points in Q4 '16.

Next jump into slide nine, we present our operational -- operating expense. Selling expenses margin increased by 15.5 percentage points in Q4 '16. Provision for doubtful amounts margin increased by 10.9 percentage points in Q4 over the same period in 2015 [ph]. Due to the reversal of 43 million from the provision recorded in 2Q 16 to comply with the obligation with FNDE related to the specific receivables from FIES students.

In the second half of '16, we evaluated the matter with our internal and external legal advisors, deepened the study of each student's academic performance and concluded that it has not breached the rules of academic performance, which were object of the provision, and thus reversed in Q4 '16, the amount previously accrued. Note that the net effect in the full year is null.

Another factor that significantly influenced this year in Q4 '16 was the sale of the receivables portfolio, in the amount of 47.1 million, of which 62.7 from the sale of the customer portfolio and 15.7 million from the present value. It's worth noting that the sales of receivable portfolio are thoroughly approved and should always represent a better opportunity for the company when compared to the historical recovery of said values.

Regarding market expense, the end of Olympic Games' institutional campaigns and the review of our marketing campaigns began to produce results, generating a year-on-year margin gain of 4.5 percentage points. It's worth noting that this line represented a 6.7% of net revenue in 2016, of which 8% in first half of '16 and 5.4% in the second half of '16.

In 2016, G&A expenses represented 13.8% of the net operating revenue, 1 percentage point down on 2015, mainly due to the one-off adjustment of Q2 '16 in the amount of 28.1 million, as a result of the revision of the company's contingency base, taking into account the nature and market assumptions.

The following lines also underwent one-off adjustments. First, personnel, due to internal restructuring as a result of the reduction on the corporate structure and staff adjustments; and outside services, due to the additional expenses, legal advisors involved in the ongoing M&A negotiations.

It's worth noting that the BRL19 million reduction in the institutional events line in 2016, due to the end of the Rio Olympic Games project, which partially offset the one-off effects I have just talked about.

Moving to slide 10, we see that net income of BRL124 million reported in Q4 '16 was a result of 109.7% increase in the period EBITDA, which exceed the increase in the depreciation and amortization line and in the negative financial results in this period. Net income fell by 16.4% in '16 over -- compared to 2015, essentially due to the increase in the negative financial inflows, and depreciation and amortization lines.

In '16 the financial results of 86.3 million negatively impacted by the increase of approximately 27 million in the financial discounts line, due to the more aggressive campaigns we carried out in second half of 2016 to recover credits, mainly from students who lost FIES support. It's worth noting that revenue with fines and interest on monthly payments in arrears also increased by approximately BRL17 million, which did not exceed the increase in financial discounts.

Moving to slide 11, we present the average receivables days. We continued to focus on improving our collection campaign and the student debt renegotiation policies, the results of which have already become apparent in the performance of average non-FIES receivables days, which improved by 12 days in comparison with Q4 2015.

The increase in the accounts receivables in Q4 '16 was primarily due to the upturn in FIES accounts receivable. Estacio's average receivables days came to 132 in Q4 '16; 2 days lower than the same period last year, even being impacted by the delays in amending the FIES contracts for the second half semester of 2016 and the consequence of the flow of transfers this quarter. As a result, FIES receivable days averaged 236 days.

On slide 12, in the first table we see the information on our capitalization and cash. Cash and cash equivalents closed 2016 at 404 million, conservatively invested in fixed-income instruments pegged to the CDI interbank rate, government bonds and certificates of deposit with top-tier Brazilian banks.

Bank debt of BRL1 billion correspond mainly to: the company's debenture issues, second series of 300 million, third series of 187 million and fourth series of 100 million; the loan from IFC, first installment of 48.5 million and second of around BRL20 million; and the capitalization of equipment leasing expenses in compliance with Law 11638.

The 38.6 million reductions in loans and financing lines over Q4 '15 was essentially due to the settlement in 2016 of a foreign currency loan from Banco Itau of BRL227 and the entire first issue of debentures of approximately BRL214 million. To compose cash spent with these operations, we issued a BRL300 million in Promissory Notes in November 2016 and 100 million in debentures in December, which is the fourth issue; both operations carried out with Banco Itau.

Including commitments for future payments related to past acquisitions which totaled BRL125.9 million, as well as taxes payable in instalments of 15.9 million, our gross debt came to BRL1.16 billion at the end of 2016, resulting in a net debt of BRL760.4 million.

If you see [ph] on this slide we presented our investments. In 2016, we invested 186.8 million, 118.8 million of which in maintenance mainly in the upgrading of systems, equipment, libraries and laboratories in our units. In 2016, the investments accounted for nearly 5.9% of the period net revenue, mainly in our academic model and in the new IT architecture project, which increased by 25.1% and 59.1%, respectively, over 2015.

On the slide 13 we present our cash flow. Operating cash flow was positive by 51.7 million and 339.7 million in Q4 2016 and 2016, respectively. So the special improvement over the same period last year, especially when analyzing the EBITDA to operation cash flow conversion ratio, which stood at 23.8% in Q4 '16, versus 3.8% in Q4 2015. In 2016, this ratio was 52.1% against minus 14.4% in 2015.

Now, I would turn the floor back over to our CEO, Pedro Thompson, for his closing remarks. Pedro, please?

Pedro Thompson Landeira de Oliveira {BIO 21085761 <GO>}

Thank you, Mr. Moretzsohn. Well, to finish our presentation, I present our 2017 objectives on slide 14 and 15. Since we took on the challenge to manage Estacio, we implemented the relevant changes focusing on three great drivers of value creation.

First one, maintain the organizational climate. With so many changes inflict on short time, our major concern was the maintenance of the organizational climate in order to establish a good level of productivity among the employees. Therefore, focal points have been appointed in each executive area, whose main mission is to report their needs, concerns and perceptions of new challenges faced by the company.

The first results could already be observed in Annual Climate Survey concluded in February 2017. This survey conducted by an external consultancy firm specialized in human resource project, was answered by more than 10,000 people, equivalent to an engagement of 73% of Estacio's employees and achieving a significant overall result of 74% level of satisfaction.

Redesign one of Estacio's most important projects, enrolling new students in applied science in the first cycle of 2017. We believe that actually Estacio's profitabilities growth is mainly driven by the scale of its operations.

It's focused in efforts on making significant changes to some one of the main pillars of the company's intake strategy including: our new pricing strategy, we reduced the number of scholarships and discounts granted in order to simplify the management of processes to enroll new students; regionalization of marketing campaigns, we exchanged our advertising strategy from a more national institutional focus to a more regional appeal, using a cheaper and more efficient communication channels in each location; resizing of the sales force, the number of sales advisors nearly tripled bearing on aggressive approach with high financial returns vis-a-vis the investment on this channel; new goals on compensation systems, at the same time we expanded our sales force, we also restructured our goals, KPIs in order to associate them with quality rather than just quantity, the inflated net operation revenue of intake.

Moving to slide 15, another major objective is to recover operating and financial results focusing on the cash generation. The need to restructure policies and practices in the financial area, aiming at greater control also resulted in some changes in the management of the financial area itself. One of the greatest projects we began implementing was the redesigning of the charging and collection processes. The work will be focused on creating a future of timeline payments with a significant reduction in regular and aggressive benefits granting to defaulting students and the creation of policies that encourage timeline payment. The focus is no longer on PDA and debts more than 180 days overdue, but on collection since the beginning of the debt, exclusively through specialized companies contracted for such purpose. In addition, the charging processes will be more rigorous, with shorter contact intervals, blacklisting and protest, using cluster strategies based on the debtor's profile.

We also had the launch of Estacio's Installment Payment Program. Students enrolling in Estacio as of the beginning of 2017 can pay their monthly tuitions through Estacio's

Installment Payment program or PAR, which allows the students to pay half of the total amount of the course while studying and the other half after graduation. The payment instalments will occur gradually. Students can pay 30% of the tuition in the first two semesters, 40% in the third semester, 50% in the fourth semester and 60% as of fifth semester.

We believe that a healthy business is the interest with student base we insisted, is the secret for the sustainability of a post-secondary education company. For this reason, it began its plan to build student loyalty, mainly focused in reducing dropout rates. The reduction in dropout rates is a great opportunity to improve profitability given the company's full cost structure is better used, optimizing the returns efforts to attract students.

Before concluding our presentation, I want to show on slide 16, that our 2015 ENADE results disclosed last week reached similarly to previous year, reaffirmed the success of our teaching model. In this cycle, 98% of our courses were evaluated with positive results which grades above 3 as we can see the first chart. In the second chart, we also can see the evolution in the number of institutions with positive grades totaling 97%, eight of our institutions were graded 4 on a scale of 1 to 5, with 3 being the minimal.

We are proud to say that Universidade Estacio de Sa, the largest single institution of our Group is among the eight institutions graded 4 in the evaluating -- in the evaluation cycle. It is worth noting that institutions on courses graded 4 or higher have priority in some MEC processes, leveraging potential and autonomy to open new courses, distance-learning centers and increase the number of places, reducing regulatory growth restrictions, with qualitative results that prove the group's educational sustainability. The level reached in our group is something totally disruptive to our business model.

I would also like to emphasize that students of courses evaluated in the 2015 cycle accounts for approximately 55% of our total base, which allowed a significant qualitative growth in the general indicators. Universidade Estacio de Sa, for example, reached the level of institutions graded 4 and became the second best private university in Rio de Janeiro, only behind PUC-Rio, a traditional non-profit institution.

We are very happy with the results achieved with a part of sustainable long-term work with collaboration of more than 7,000 faculty members and whose work we continue with great diligence and clearance.

With this announced results, I confirm on behalf of Estacio, that we are proud to be one of the educational groups whose results of academic quality evaluations most improved. I highlight our commitment as one of Brazil's largest education institutions to balance an operation with a scale of more than 0.5 million students in order to deliver academic excellence. Therefore, I can say that Estacio begin 2017 with energy focusing on ongoing pursuit of better operating academic and financial performance. We learned a lot in 2016 and we are sure that 2017 will be a year of hard work. We can now move to Q&A session. Thank you.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the Q&A session. (Operator Instructions) Our first question comes from Bruno Giardino with Santander. Please go ahead.

Q - Bruno Giardino {BIO 15974970 <GO>}

Hello. Good morning, everyone. The first question, could you help us to understand the movement in the provision for doubtful accounts in the quarter? As -- when we look our financial statements we see that the 47 million from the net sale of receivables had been already written off, but apparently this transaction represents a gain of a similar size in this line. So I just wanted to understand this movement, if my understanding is correct.

A - Pedro Thompson Landeira de Oliveira {BIO 21085761 <GO>}

Bruno, can you repeat your question please, because we didn't get it?

Q - Bruno Giardino {BIO 15974970 <GO>}

Okay. We had this 47 million net impact from the sale for receivables in the quarter. And as far as we understand, this 47 million was already out of your provision for doubtful accounts and we saw this coming back to your results as a gain. Is this interpretation correct? So when we look at your PDA, we should adjust for this 47 million, is that alright?

A - Pedro Thompson Landeira de Oliveira {BIO 21085761 <GO>}

Yes, you are right. The accounting policy was to reverse PDA of this value. Just to emphasize that the sale of these receivables was a trade that we made and we compare the return of the discounts of that we had in this receivable with our organic recuperation of the receivable and it was much higher to the opportunity to sell. But, your thoughts about the accounting treatment is correct.

Q - Bruno Giardino {BIO 15974970 <GO>}

Okay. Thanks. And a second question, if I may. In the cost line you commented on impact of 15 million regarding two retroactive agreements with your faculty. I just wanted to understand if it was already expected by you when you assumed the company or if this was a new negotiation you had to make recently? That's it.

A - Pedro Thompson Landeira de Oliveira {BIO 21085761 <GO>}

No, no, I didn't expect in those terms.

Q - Bruno Giardino {BIO 15974970 <GO>}

Okay. Thanks.

Operator

(Operator Instructions) Since there seems to be no further questions, I would like to turn the floor over to Mr. Pedro Thompson for his final remarks.

A - Pedro Thompson Landeira de Oliveira {BIO 21085761 <GO>}

I would like to thank you all for your taking part in our results conference call. Our Investor Relations department is always at your disposal to help you with any question you may have. Our contact information is available in our website. We hope to see you again at our conference call next quarter. Once again, thank you very much and have a great day.

Operator

This concludes Estacio's conference call. You may now disconnect and have a good day.