Q2 2018 Earnings Call

Company Participants

- Carlos Lazar, Investor Relations Officer
- Jamil Saud Marques, Vice President of Finance
- Mario Ghio, CEO, Basic Education
- Roberto Valerio, Vice President, Distance Learning
- Rodrigo Galindo, CEO & Member of Board of Executive Officers

Other Participants

- Marcelo Santos, Analyst
- Roberto Otero, Analyst
- Thiago Bortoluci, Analyst
- Vinicius Ribeiro, Analyst

Presentation

Operator

Good morning, ladies and gentlemen, and thank you for waiting. We would like to welcome you at this time to Kroton Educacional's Second Quarter 2018 Earnings Conference Call. We would like to inform you that this event is being recorded and all participants will be in listen-only mode during the company's presentation.

After the company's remarks are complete, there will be a Q&A session for analysts and investors. At this time, further instructions will be given. (Operator Instructions). Also today's live webcast, both audio and slideshow, may be accessed through Kroton Educacional's Investor Relations website, at www.kroton.com.br/ir by clicking on the banner 2Q18 Webcast.

The following presentation is also available to download on the company's website. The following information is available in Brazil Reais and in accordance with Brazilian Corporate Law and Generally Accepted Accounting Principles, BRGAAP, which now conforms with International Financial Reporting Standards, except where 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 also rely on currently available information and, of course 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 the company and could cause results to differ materially from those expressed in such forward-looking statements.

Now, I'll turn the conference over to Kroton's CEO, Mr. Rodrigo Galindo, who will begin the presentation. Mr. Galindo, you may begin the conference.

Rodrigo Galindo {BIO 17238232 <GO>}

Good morning, everyone. Welcome to the results conference call of Kroton Educacional in the second quarter, 2018. For the first time, we're using simultaneous interpreting so that we can provide information simultaneously to our domestic and international stakeholders and we would love to hear your feedback on this initiative later.

Together with us, we have our IRO, Carlos Lazar; and our VP of Finance Mr. Jamil Marques and the leaders of our two main lines of business, Mr. Mario Ghio; and the Higher Education CEO, Mr. Roberto Valerio.

In today's presentation, we will discuss the main operating and financial highlights of the quarter and we'll give you an update on our organic and inorganic growth projects in all lines of businesses where we operate. Something that's very important starting in the first quarter of 2018, we started reporting consolidated results with and without greenfield effects, because this is of course something that's very relevant for our strategy.

They have a very long maturity curve and as such, there is a higher negative impact in the margins in the first half of the year. And what we hope to do by doing this is to offer you greater comparability with ex-greenfield operations.

If I were to summarize the most relevant messages of this conference call, I think we have six of them. First of all, I would like to reinforce that the first quarter earnings, show that we are on track to deliver the guidance. When we look at those projections, we see that they will probably be delivered on. And the second message is that our organic growth projects, and I think this is the most relevant message of all, is that we are being very successful in the implementation of these organic growth project.

Just to give you a little flavor between 2017 and 2019, one, we will have 61 new on-campus units and all have been successfully implemented so far.

At the end of the presentation, we'll go back to that and I think that the numbers we'll show you will give you an indication of the size and magnitude of this opportunity ahead of us in the next year. The third message is that we have maintained a very high level of operating cash generation post CapEx with a conversion above 56%, and of course, this not considering the PN23 amounts that we have received in August.

So therefore, the conversion rate was above 56%, which bears fruit of our soundness. The fourth message is that we're really focusing on customer centricity, academic success is our priority, because we think long-term, a company can only generate value in the long term if they are able to resolve the issues of their students, of their customers and this is what we call academic success.

We are putting a lot of energy and resources to that goal, and this is actually based on three pillars; quality, experience and here, we refer to experience in all such points of academic, non-academic experience, on-campus, distance learning and also employability.

So with these three pillars, we create, what we call, academic success and just to give you an idea, 37 of the 126 projects of the company now revolve around this topic.

The fifth important message is that, our digital transformation process is proceeding very successfully and bringing on positive results. It's very impressive to see the amazing results we have obtained through the integration of business areas and now, business areas can understand that digital transformation is part of our business and all of this has been driving efficiency and development of our system.

If you're interested in finding out more about digital transformation, we have some comments about this initiative in the administration message of this quarter, or please get in touch with our Investor Relations department. We would love to give you more information on that. And we are certain that in the long term, this will completely revamp the company and that in the short term, it's actually adding much more value than we had expected.

And the sixth message is that, our acquisition of Somos is moving on very smoothly, and to talk about this acquisition, I would like to ask you to turn to slide 4, where I will give you an update on this acquisition, that was announced on April, 23.

As we had previously discussed, we'll be using part of our own cash for the financing but we will also go to the market to obtain those. Well, and the first thing, we had to do of course was to get the ratings and we were very successful in that. From Fitch, we got a AAA [ph] , which is the highest rating in that scale and in Standard & Poor's we got a AA, both for corporate and for the debentures operation.

So, once again, it's AA by Fitch, that's valid both for corporate and for the issuance of debentures. And our holding Saber that will be responsible for the acquisition of Somos has already been registered as a listed company by CVM as a category B issuer and also this is essential to broaden our access to the lending markets, final registration was granted on August 13th, and we are in a quiet period right now. We cannot give you more information about the debt, but the instrument has already been approved by our Board and they [ph] can be found in CVM's website, should you -- would like to look at some more information about it.

Additionally, as we are waiting for the CADE's evaluation and approval of Somos, we have completed the due diligence process and we have a Clean team working very hard on the planning of the integration of the companies. We know that nothing should be executed at this point, but we can very carefully plan for those integration activities.

And this is what we're doing, as we build in other integration processes. And this has been essential to capture benefits and synergies, of course we have -- we can't wait for the closing and approval from CADE, but of course the initiatives will only be implemented after the approval. We have 35 people involved, working on 25 function (inaudible) and we're feeling very satisfied with the performance.

All of this reinforces our confidence in the potential for synergies, the potential for growth and therefore the potential that this transaction for our company.

I'll now hand it over to Carlos Lazar, our IRO, who will proceed with the analysis of our financial results for segments and consolidated results.

Carlos Lazar {BIO 17238206 <GO>}

Thank you, Rodrigo. Let's turn now to slide 6 for an analysis of the main line in the second quarter '18. I would like to reinforce that both the results for this quarter and year-to-date results are proceeding according to expectations. So therefore the guidance we have announced in the last quarter will be delivered on. And like we did in the previous quarter, we will share with you two visions of consolidated results.

One, excluding the results of the assets sold in 2018, and another vision that removes the impact of the new units, the greenfields that are still maturing and therefore, putting a pressure -- a timely pressure on our results and earnings.

Looking to the chart at the upper part of the slide, let's see consolidated vision ex-FIES [ph] on 2Q18, we see net revenue of 1.5 billion, up 1% in comparison with the previous year, reflecting the enrollment -- positive enrollment and re-enrollment in on-campus and distance learning and also the contribution of new centers launched in the first half of the year.

We also have the impact of the acquisition of Leonardo Da Vinci, a K12 school, that was acquired in August last year.

Now let's take a look at adjusted EBITDA, totaling 641.5 million in 2Q'18, with a margin of 42% down 7.6% and 400 basis points, which reflects the one-off increase on our costs relating to the opening of the new unit.

I would like to reinforce that the numbers are completely within what's expected and we'll give you more information at the end of the presentation about the performance of the new units.

Now, looking to the right side of the slide, we see adjusted net income, reaching 562 million this quarter, with a margin of 36.8% dropping 12% and 550 basis points respectively, as a result of the impact of the new greenfields and also the lower interest or financial results. Now let's take a look at the lower half of the slide, excluding the impact of greenfields, revenues reached 1.5 billion in line with, what we recorded last year, which proves the resilience of our operations same-stores [ph] in a year, where we see a very large number of graduation of FIES students, following the huge enrollments of 2013 and 2014. If compared to 2017, our FIES-base is now 34% lower and represents 29%.

At the same time, our net revenues from FIES, dropped 31% if compared to 2Q '17. Even though, we continued to implement efficiency levers and looking for new value generation sources, the change in profile of students, impacted our adjusted EBITDA, which totaled 652 million in 2Q'18, with a margin of 43%, down 6.1% and 300 basis points in the annual comparison.

As to 2020, we should continue to feel the pressure in the provisioning for losses, because of this change in the mix of students, and I would like to emphasize that we're still feeling very comfortable with the premises we adopted in relation to PEP and PMT, which we'll discuss later with you. Finally, adjusted net income ex-greenfields was at 572 million (sic - 573.9 million) in the quarter with a net margin of 37.8% down 10.2%, and 450 basis points, reflecting the same effects we have already described.

Now moving on to slide 7, where we see the variations in the most important lines. Starting with on-campus, I think it's important to underscore that we removed the impacts of assets sold, so with this, we have recorded an increase of 1.3% in net revenue in this segment, which is a very positive achievement in a very adverse macroeconomic scenario.

And this is of course due to the quality of our education and the strength of our commercial campaigns, which resulted in student recruitment and positive retention. And we also have the contribution of the newly opened units.

Besides staff and other important impacts to mention in this segment was the increase in the average ticket of 0.5%. This, of course is due to the participation or increase in the medicine and engineering program. Following the trends in net revenues, gross profit saw an increase of 0.6% and in spite of all the efficiency initiatives we continue to implement, we saw a drop of 50 basis points in gross margin. This is a one-off impact of the increase in cost, also relating to the launch of new units.

This effect also had an impact on operating results and margins, and also in the provisioning for the segment with the substitution of FIES students and with a higher number of out of pocket students, all of this puts pressure on our operating results. I think it's important to remind you that in 2018, we have the largest number of graduations among FIES students after the strong wave of recruitment that we saw in 2013 and 2014.

Now moving on to Distance Learning. There was a decrease of 1.6% in net revenues, because the tuition for these projects are not eligible to scholarship or discount. This decrease was more than offset by efficiency, because there was an increase of 1.5% in profit -- gross profit and also 280 basis points in gross margin.

And as you know, we have introduced a new tutorship [ph] model in early 2017 that has significantly improved their performance. And we also have an increase in the number of 100% online students. This line of course is much leaner in terms of cost.

And finally, operating results, pre-marketing increased 3.7% with a gain in operating margin of 370 basis points what contributed to this result was the larger number of debt negotiations with our students that was reflected in the increase in the interest receivables line, in line with our new collection policies.

Now moving on to K12, net revenues saw a hike of 12.2%, especially because of the acquisition of Leonardo Da Vinci. This is called that also (inaudible) (Technical Difficulty) entrance in the premium K12 education with very expressive [ph] tuition, but also lower margins, all of this was reflected in a contraction in the gross margin and also in operating margins.

And now that we are trying to increase our presence in this segment, and now with integration of Somos as well, we expect to see better results in the segment as a whole. And besides that, we will continue to expand it.

And now, I finish my part of the presentation and I hand it over to our VP of Finance, Mr. Jamil Marques.

Jamil Saud Marques {BIO 21416820 <GO>}

Thank you very much, Carlos. In this part of the presentation, I will talk about our level of provisioning for losses in our average receivables term. Starting on slide 9, we'll take a look at the provisioning per-se [ph] , for losses of each type of students, and ex of course FAIR, FAC/FAMAT and NOVATEC.

Starting with the on-campus segment, our PDA was 13% in 2Q18, an increase of 260 basis points in the annual comparison, reflecting the growth in the PEP and PMT base of students.

In comparison to the previous quarter, PDA remained stable, and if we consider only the PDA of out-of-pocket students, there was an increase of 30 basis points, in comparison to 1Q'18, and this derives from the adjustment that were made to meet the delinquency expectations, that we had in a very adverse macroeconomic scenario.

It's important to emphasize that this decision to increase our PDA is in line with our very conservative policies in this area.

Now, taking a look at the middle of the slide, where we see the numbers of distance learning, our PDA was 9.9% in the quarter, down 10 basis points vis-a-vis Q2'17, this reflects a lower number of PMT students in this period, late enrollment.

In the quarterly comparison, there was an increase of 20 basis points, and of course, this had an impact on the out-of-pocket PDA with an increase of 30 basis points too, because of the growth in the 100% online students, besides the impact of the macroeconomic scenario, as we have seen before.

Finally, moving on to the right side of the page, we see basic education where we remained flat at 0.8% which attest to the robustness of our policies. Moving on to slide 10, where we see the average receivables term per segment also excluding impact from FAIR, FAC/FAMAT and NOVATEC.

Starting with on-campus, the average term was 181 days in 2Q'18, up 25 (sic. 35) days in the annual comparison.

This is a result of the impact of PEP and PMT and also a deterioration in out-of-pocket average term. In average, out-of-pocket terms we recorded 99 days longer, 9 days in comparison to Q'17, this is also an impact or a consequence of the more asset macroeconomic scenario and also a larger number of debt negotiations with our students.

At the same time, the FIES average term reached 166 days, 21 longer than the previous year, and here what we saw is that the lower FIES revenue is what's really made a difference. We have already received this 50% [ph] that are owned to us as under PN23 and those amounts will have an impact in 3Q18 [ph] . Finally, the average PEP and PMT average terms reached 425 days growing 137 days, in line with the ramp up expected for this type of product.

Now moving on to distance learning, the average out of pocket term was 95 days in 2Q18, increasing 4 days in the annual comparison. Once again, this is due to the challenging macroeconomic scenario and the increase of the 100% online students. In relation to 1Q18, we have eight days more and this is due to the seasonality we normally observed in the quarter.

In PMT DL, the average term stood at 472 days, 241 days higher than the average term of 2Q'17. And finally the average receivable terms in K12 amounted to 85 days in this quarter, 56 days before or lower than 1Q'18 and as a result of the seasonality inflection [ph] efforts. The results we are showing in this quarter are a reflection of our difficult macroeconomic scenario that continues to be very challenging, but at the same time, we can show the resilience of our operations sustained by the focus in our academic success for our students.

And starting July 2018, more than 80% of our collection initiatives have been implemented, which includes this (inaudible) indicators, loss provisions, average term and dropout rates, and we've always tried to find the best balance between the three.

And now, I would like to invite you to see next the discussion of CapEx cash generation, indebtedness starting in slide 12. If we look at the charts on the left side, we see the recurring CapEx which recorded BRL108 million, a ratio of 7% of net revenues in the period, that was impacted [ph] mostly in development of content, systems and software licenses.

With this, recurring semester CapEx totaled 209 million, 7.2% of net revenues, up 11% in the annual comparison. We also have investments that relate to special projects and greenfield projects. By adding this up, the total CapEx in 2Q'18 represented 163 million or 10.7% of our net revenues. And in this semester, CapEx stood at 278 million, 9.6% of the net revenues for the period to support all of our organic and digital transformation projects for the second half of the year. We will see those investments pick up even more reaching 13.5% as announced in our guidance.

Moving on now to slide 13, we'll take a look at cash generation in the quarter and year-to-date in the semester. In this quarter, as we had been discussing, our cash generation was affected by the re-enrollment curve and the lowest volume are representatives [ph] of FIES, besides the impacts on working capital that was caused by the change in the profile of our students and also in terms of financing.

Thinking of the semester, as we have discussed in the first quarter call, we had some seasonal effects, which also created a negative impact of 198 million, if we were to adjust this, our cash generation would have been BRL600 million with a conversion of 58% in the semester.

For the third quarter 2018, we expect a far more robust operating cash generation which includes 786 million that have already been received from July to now, including BRL400 million under PN23 which now has been settled. And in spite of all of this, our cash generation post CapEx in the period was extremely robust at 318 million, and with an EBITDA to cash conversion of 56.3%. Our free cash flow was negative in 408 million reflecting the dividend payout in this period, totaling BRL329 million, besides the stock repurchases volume amounting to BRL204 million. In the next slide, I will show you a little more on the operating cash generation post CapEx and special projects for free cash flow.

So, starting with slide 14. Let's start with the operating cash generation post CapEx of 318 million, we invested 136 million in the first quarter in our expansion project.

This includes 33 million in organic expansion initiatives and 106 million that's refer to the acquisition on on-campus higher education schools and also the Leonardo Da Vinci school.

In terms of value-added to our shareholders, we have compensated our shareholders with 533 million of which 204 million in stock repurchase, considering the multiples [ph] our shares were been traded at and its potential for valuation.

Those stock repurchase operations were completed within the framework of the programs that's valid up to December 2018 as we have announced in the previous conference call. We also paid dividends for 2 periods in that 148 million referred to 4Q '17 and 181 million for 1Q'18, adding up to 329 million in disbursements in the quarter.

Moving on to cash and third-party value generation debt amortization and interest, here we saw an impact in consumption of 22 [ph] million, if we add everything together, our free cash flow was negative in 408 million in 2Q '18.

Now, turning to slide 15, let's take a look at our net debt. Kroton closed 2Q'18 with a total cash equivalent of 1.1 billion, down 26.8% in the quarterly comparison, because of the consumption of cash I have explained and that includes stock repurchase transaction.

Adding our debt and short-term and long-term liabilities, net cash was 720 million, here of course we have also some short and long-term receivables to think about such as the 50% of FIES installments that were not paid into 2015, and that were received in early August, and that will cause an impact on 3Q'18.

We also have the second part of the payment for the sales of Uniasselvi and also the payment for the sale of FAIR and FAC/FAMAT that took place in August 2017. So therefore, the net cash was 1.7 billion at the end of 2Q'18. This cash will be very important to sustain our growth plans and also to finance part of the Somos acquisition. Now, I thank you all for your attention and I'll hand it over to Rodrigo for his final remarks.

Rodrigo Galindo {BIO 17238232 <GO>}

Thank you very much, Jamil. Well, moving to slide 17 as I said in the beginning of the presentation, we are being very successful in our organic expansion plans especially on campus, and I would like to share with you some of the initial numbers of the new units we have opened. I think that they serve as an indication of the success of the project.

Before 2018, we were not opening as many campus [ph] we had opened 6 units, but in 2018, we became much more vocal in relation to our intention to grow organically and start with more greenfield projects that have a longer maturity, but did also bring much higher return.

So in -- so we -- for us it really made sense for the company in alignment with other inorganic growth strategy such as Somos to implement an organic growth project in our on-campus unit. So we had announced in the last call, the opening of 10 new units, but in the second half of the year, we have opened another 13 greenfields and in addition to this, we have completed the acquisition of 2 on-campus small-sized higher education institutions, one in Bacabal in Maranhao and on July 3, we also received the approval to acquire an asset, a small sized asset in Joao Pessoa, Paraiba.

With this, we have 25 new units in 2018. We also have some very small units that are being used as accelerators for our activities, because like this, we'll be able to drive growth, so we have 25 new units being opened in 2018. If we add everything up, we'll finish the year with 173 campus on-campus, implemented and for 2019, we are expecting 30 new units, our management's plan, will or has established that, student recruitment will continue and we -- if student recruitment for 2018, so as such we'll close 2019 with 173 campus, this represents growth of 54% in comparison to the 112 campus we had in 2017.

Since, each of our units can add 3,000 students to our base, the 61 units that have been or will be launched between '17 and '19, will add 183,000 new students to the company when fully mature. And this represents 47% of our student base in 2Q'18. So, as you can see, it's a huge opportunity even if it's a long-term project, it will add a lot of long-term value to the company.

And let's take a look now at the current status of this project. Here we see some more information and we can compare this to our business plan. The margins is still small, but the combined net revenue for this unit are -- is in fact 38% above and student recruitment was 24% above the original business plan.

As for overhead and G&A, we are 16% below the business plan. It's worth highlighting that the business plan, the original business plan counted on a return rate of 26.2% in 10 years and 42.4% in perpetuity. Those were very adequate return rate, and with the potential upside, performance can be even better. So return on foreign investments -- foreign investors will be great, as you can see.

We've been successful in all implementations, so far. Now, moving on to the last slide. I have some final remarks. First of all, even though we are still working on student recruitment and re-enrollment for the second half of '18, we have completed around 60% of the process, similar to last year and the current student recruitment curve is growing very well.

This, as a result of our competitive advantages such as quality education, our employability portal, we also have a position as the most preferred brand in education and also the payment plans we offer to our students besides other tools that deliver the best experience to our alumni.

Now, in terms of acknowledgements, we are very proud to achieve once again first place among the most innovative companies in Brazil. This is an award that shows that we are proceeding very successfully in our digital transformation and innovation efforts. We want to become the most digital educational company in the world and we are working on it and this is our ambition as a company.

And I would like to talk about two very relevant partnerships that we have established recently, and that adds more to this digital transformation process.

In June 19, we announced the partnership of Cubo Itau, we will the sponsors of Cubo Education. They are migrating to a 12-storey building and will have 5 storeys dedicated to specific areas, one of them is education and Cubo Education is being sponsored by Kroton. All of this have created the largest EdTechs hub in Brazil, so that we can add value to development of education in Brazil.

And since we operate very closely to start-up companies, in addition to promoting education, we will also be able to transform the culture of our students. We'll came across several technology solutions and disruptive educational technologies that will create opportunities for Kroton.

We will also give our students the opportunity to experience innovations in the Cubo start-up environment. Kroton will be responsible for a whole floor dedicated to education in Cubo Itau. There we'll incubate and accelerate a tax besides having learning space, studios for recording videos and other classrooms prepared for different methodologies and innovative technologies, part of our innovation team at Kroton will be allocated to this space, I think it's a win-win proposition for all involved.

We'll able to understand business needs and it will be fantastic for Kroton, because we'll be able to select companies that can really make a difference providing solutions for Brazilian education and Kroton. In July 27, we established a partnership with Udacity, an American platform of open enrollment program in the area of technology and the first joint project was the creation of an executive MBA in digital marketing, which puts together Udacity's digital marketing program with our digital marketing, MBAs from Anhanguera and Unopar.

The content was developed in partnership with Google, Facebook, Hotspot, MailChimp and Hootsuite. And all of this will enable us to offer both a MBA program with state of the art technology and new development.

And with this partnership we'll be able to offer state-of-the-art products and also make our digital transformation go forward. So we want to establish partnerships with partners like this. And as announced, we have implemented a new organizational structure, this is something that we had started more than a year ago. We have higher education on-campus and higher education distance learning as part of this.

It's important to remember that the blend education is now becoming more prevalent and all of this together with syllabus components will be offered both on-campus and in other fronts, according to the applicable law.

In the vision of the company and organisational structures that can capture this hybrid trend is the way to go. Roberto Valerio has become the CEO for higher education, which concentrates our operations in this segment, besides marketing and sales. And we think that, this will add a lot of value to the company. Our Board of Directors has approved the distribution of dividends totaling 177.6 million, representing BRL0.11 per share with a payout of 40%. Dividends will be paid out on August 29th, 2018.

The first half of the year was very challenging as you know, but once again, we were able to demonstrate our resilience, our solidity and our ability to execute. We are building the pillars that will define the direction of the company for the future with an organic growth project that is actually surpassing our expectations and plans. We had a very transformative acquisition to boast, Somos, this will enhance our participation in the K12 market, and expand our ability to operate and we are also investing in digital transformation in the company and working very hard to improve the quality of education and the student experiences.

What we want is to transform lives of our students and help them achieve all of their goals. So we are feeling very optimistic about the results we have delivered. We'll deliver on the guidance, but even more than that, it's important to consider the long-term benefits we are building in the company whether through organic growth projects, through digital transformation, with an impact in the medium and long-term and focus on customer centricity and academic success.

All of this will add value in the medium and long-term and makes us feel confident that we are on track. Thank you very much and now you're all invited to participate in the Q&A session.

Questions And Answers

Operator

Thank you very much. We're opening now for the Q&A session. (Operator Instructions) Our first question is from Mr. Thiago Bortoluci from Goldman Sachs. You may proceed.

Q - Thiago Bortoluci {BIO 20909105 <GO>}

Thank you very much. I have two question in relations to PEP. Could you please explain a little more about the dropout rates for PEP and is it correct to -- to think that it's actually a little below the out of pocket students and from the BRL170 [ph] million that you have mentioned. How much of this balance relates to students that have already dropped out in relation to DL, considering the maximum load of 40% and assuming that the adaptation occurs, are your academic models ready to seize this opportunity?

A - Rodrigo Galindo {BIO 17238232 <GO>}

Thank you very much, Thiago. I'll start with the second question about the increase in the digital content, workloads in on-campus programs. So the answer is that we are fully prepared to seize this opportunity, if it's approved in our academic centers. We have loads [ph] of 30% to 40%, whatever percentage, the Ministry of the Education defines can be implemented in our centers, if there is swift approval of this change.

And I'll hand it over to Jamil to talk about PEP.

A - Jamil Saud Marques {BIO 21416820 <GO>}

Hi, Thiago, thank you very much for your question. Well, in relation to dropout rates, it's difficult to analyze this, because the PEP is present in different cycles than in out of pocket, but the dropout rates continue to be in line with the out of pocket students dropout rate, all the way through graduation.

So in relation to the receivables that apply to the students that have dropped out or drop outs, we don't give any guidance on this information, but what I can say is that it's in line with the drop out expectation.

Q - Thiago Bortoluci {BIO 20909105 <GO>}

Jamil, could you explain a little bit about how much you hope to recover in terms of drop out?

A - Jamil Saud Marques {BIO 21416820 <GO>}

In this 50% recovery expectation, we hope to recover 20% of drop out students.

Q - Thiago Bortoluci {BIO 20909105 <GO>}

Thank you very much, Jamil for your answers.

Operator

Our next question is from Mr. Marcelo Santos from JP Morgan. You may proceed.

Q - Marcelo Santos {BIO 17186991 <GO>}

Good morning, everyone. Thank you. I would like to talk a little more about K12, specially in online [ph] course. I think that this is still not very representative in your portfolio, but we could use it to analyze essentially the gross margin, which is now at 22% down 19 points with the addition of Leonardo Da Vinci, this of course shows the relatively low gross margin. And last year, you gave us the impression that we would be at 30% in margin, in this segment. So, what are the levers you are thinking of exploring to improve this margin or is it something what would be the value generation levers here for the next quarters?

And the second question is about distance learning. What's the share between 100% online and hybrid? I think that hybrid is probably growing and what is the competitive scenario and outlook? What's the dynamic in these products?

A - Mario Ghio {BIO 17352490 <GO>}

Thank you very much, it's Ghio here. I would like to answer your first question, first, okay? And then Marques, Valerio will continue. Exceptionally in this semester, Leonardo Da Vinci had a very strong impact because it came up together with several one-off impacts.

Leonardo Da Vinci was a family-owned company, its debt was based on the cash reign [ph] and now, and part of the revenues this year were brought forward to the end of last year, especially for the companies that prefer to pay on the spot, pay for their tuition on the spot and some of the services were also paid in advance in the first quarter.

So now that we are reporting on the 2Q, all the expenses are correct, but we have also a large part that was reported in advance, it's important to highlight that all of our K12 business considering the flagship and greenfields, as they mature can reach the results we have been discussing and that we've showed you on the Kroton Day especially now that new units are being open, several of the fixed costs will be diluted by greenfield and we'll see an improvement in addition to the correction of seasonality, I was talking about.

Greenfields will bring down several of the fixed cost in overhead, so we are still feeling very confident on the margins we have announced to you.

A - Roberto Valerio

Hello, and I'm Roberto. In relation to your question about Distance Learning and the online programs, it's important to say that our strategy is still focusing on the on-campus programs. This is a strength we have because the programs allow for greater interaction with the students.

We have been tallying [ph] a lot of 100% online programs, but with the increase in competition, this 100% online has been used as a warfare [ph] tool, we don't want to reduce the hybrid programs too much in terms of pricing, but we can use this other tool.

It's important that we consider the 65,000 offers that we have in distance learning, this is of course something that was created with a multiplication of centers and we can price and analyze the competition program on program, a lot of people use the 100% online offering as a tool to compete with other players, and we know that our competitors are also offer 100% online programs, very few offer 100% on-campus. So it's only natural that 25% of our recruitment happens on 100% online, but we continue to focus on on-campus, especially with the expansion of web [ph] premium, which is on-campus activities 1 or 2 times a week.

Operator

Our next question is from Mr. Roberto Otero from Bank of America. You may proceed.

Q - Roberto Otero {BIO 16689399 <GO>}

I have a question about cash generation. We saw an improvement in the first quarter, but still below historical levels, I would like to know the level of conversion of EBITDA for the first quarter, what should we expect?

A - Jamil Saud Marques {BIO 21416820 <GO>}

Hi, Roberto. In operating cash generation, actually we are below the previous comparison period, because since 2017, the government has been advancing the last installment of PN23 and we also have a change in working capital with the substitution of FIES by other types of students, so we have been saying that we are expecting a small drop in comparison to the previous year, something not very expressive and PN23 if it were incurred [ph] , we would have a drop even higher than 8 points. On the total conversion, this is not very significant. 2019 will be a more challenging year, but we hope to go back to the historical conversion rates in 2020. Thank you very much.

Operator

(Operator Instructions). The next question comes from Mr. Vinicius Ribeiro, Bradesco BBI.

Q - Vinicius Ribeiro {BIO 18631644 <GO>}

Thank you very much. First of all, I would like to follow up on Leonardo Da Vinci. How long do you think it will take to reach higher margins for the Leonardo Da Vinci operations? And what about the greenfields in this region? When will they be implemented? And the second question is about the on-campus expansion. We have the negative margins in some of the campus and I would like to know for the 30 campus that will be open in the first semester 2019, should we expect a similar effect or is there a difference depending on the size of the campus and number of students or can we extrapolate this for 2019?

A - Jamil Saud Marques {BIO 21416820 <GO>}

Vinicius, thank you very much for your questions. When we talk about margin improvement in Leonardo Da Vinci, we know there are two effects, in fact, three effects, right? First of all, the improvements in the asset, and I think that as of the next conference call, we'll start to see this, there is a correction of seasonality and revenue, which now will be deferred as of the fourth quarter '18.

And then the opening of greenfields with the positive impacts following Leonardo Da Vinci, we'll hope to start with enrollments in September next year for lessons starting in January 2020.

A - Rodrigo Galindo {BIO 17238232 <GO>}

Thank you very much. Here is Rodrigo. In relation to the 30 greenfields for 2019, all of them implemented in the first semester 2019. There was no reason to believe that they will have lower potential than the original potential.

Everything is in the Tier 1 of our implementation math. Our statistics model is very robust, so basically, we have information that comes from the call centers, from the statistics bureau, from the Secretariats of Education and we put everything together to reach a better understanding of which cities have higher potential for greenfields.

This is something we have been doing for the last four years. We believe that our model is very affirmative and it has been driving our success in greenfield implementation, we use another model to know where in the city the campus should be set up, those are the two key points, first of all, choosing the right city, and then the right location and we are prepared for both.

And from those cities in the 30 units while they are are all on the same tier as those implemented last year. So, we don't believe that they have lower potential than the other one.

Q - Vinicius Ribeiro {BIO 18631644 <GO>}

Thank you very much, Rodrigo.

Operator

(Operator Instructions). Now I would like to hand it over to Kroton for their final remarks.

A - Rodrigo Galindo {BIO 17238232 <GO>}

I would like to thank you all for participating in this earnings conference call and our team is available for any further questions. Our Kroton Educacional earnings conference call is now closed. We thank you all for participating and wish you a great day.