Q1 2013 Earnings Call

Company Participants

- Eduardo Noronha, Chief Operating Officer
- Wilson Olivieri, Chief Financial Officer

Other Participants

- Brad Doppelt, Analyst
- Josh Milberg, Analyst

Presentation

Operator

Good morning, ladies and gentlemen, and thank you for waiting. Welcome to Qualicorp's conference call to discuss the results of the first quarter 2013. We have with us today, Mr. Wilson Olivieri, the CFO and IRO, Mr. Eduardo Noronha, COO, and Mrs. Natalia Lacava, Superintendent of Investor Relations. This event will be recorded and participants will be in listen-only mode during the company's presentation, after which we will begin the question-and-answer session, when further instructions will be given. (Operator Instructions)

I'll now turn the floor over to Mr. Wilson Olivier, who will start the conference call. Mr. Olivier, you may proceed.

Wilson Olivieri {BIO 17325685 <GO>}

Thank you very much. Thank you all for being with us today. We appreciate your time, as usual. So we will look over this first quarter results for 2013 and we would like to start with Eduardo giving you the opening remarks. So please, Eduardo.

Eduardo Noronha {BIO 15227354 <GO>}

Thank you, Wilson. Good morning, everyone. I would like to thank you all for being here with us in the conference call for our first quarter results of 2013. These results that we will show today are much in line with our internal budget, and considering the challenge in macroeconomic conditions in this period, we consider it to be a strong result.

As we have been saying, we started 2013 with a strong plan to capture both internal and sales opportunities and we are happy to say that the initial results of our plans are already starting to show up. Therefore, among several factors, I would like to highlight four points that contributed in a more meaningful way to the first quarter results.

First one, growth resumed, our Affinity portfolio, that stayed flat in the last two quarters, this time showed a net addition of 38,000 lives. The important growth in Affinity coupled with all the business segments have led to almost 3% quarter-over-quarter revenue growth, and 37% year-over-year, to BRL267 million.

Second one, we are able to reduce costs and increase productivity. The combined effect of these two factors brought us an increase in our EBITDA margin of 123 bps year-over-year, even though we had to absorb an increase of 240 bps year-over-year in TPA. On a sequential basis, our EBITDA margin expanded 235 bps, reaching 35% and leading to BRL93.4 million in EBITDA.

Third, investments in improvement actions. The efficiency gain we were able to reach allowed us to invest in different actions to improve sales and internal profits, without jeopardizing our short term results. In this sense, I would like to highlight, the increase of almost 60% year-over-year in publicity and advertisement, and hiring specialized consultancies to support better PDA and churn management, being these two factors the biggest challenges for the company in here.

And fourth, CapEx. In this period we invested BRL6.7 million in our new IT platform, that after implemented should allow us to reach a new level of operational efficiency, guaranteeing a more robust model to support future growth. So, we are extremely optimistic about the evolution of our gross adds throughout the year, and strongly believe that the current level of churn can be reduced with our retention actions, combined with a big effort on IT and operations, which should minimize operational attrition with our clients and lead to better perception of service quality. With that, we expect to resume stronger growth rates, which should help even to the cost dilution.

Now, I will turn the word over to Mr. Wilson Olivieri, who will proceed the presentation on our detailed results. Thank you.

Wilson Olivieri {BIO 17325685 <GO>}

Thank you, Eduardo. If you all have access to the presentation, we put out in the website, I will kindly ask you to be with us on page four, which brings the main indicators that Eduardo just listed to you.

In addition to what he has had said, I will only add on this very same page, the last schedule to the bottom, where we show some of the indicators related to liquidity. So as you can see here, if you look at our ratio of net debt as a percentage of equity, we would see that very much stable last quarter and this quarter, 0.2 times, but if you look at net debt as a percentage of the last 12 months adjusted EBITDA, we would have seen an improvement dropping it from 1.78 times to like 1.3 times this quarter.

Moving now to page number five, we have a couple of graphs that basically show the growth of the company, say second quarter 10 to your left, and as you can see, the only point I would like to highlight is that the growth on the Affinity number of lives for the company is much stronger than the growth that we experienced on the corporate and others, so the CAGR for this period on Affinity goes at around 36.5% per year. As in the corporate and other segments, although we carry more lives on that front, but we still grow there in a little less than 10%. So as you can see to your right, in the pie chart, 60% of the total number of our lives are still associated with corporate and other segments, while 40% of the number of lives are on the Affinity segment.

In page number six, this is what I think will probably invest a bigger part of our time on this presentation now. I'd like to start by saying that, as we've been saying in the past, we have not disclosed gross adds and churn until very recently, because those information were affecting some of our capacities regarding negotiating for new acquisitions.

So now that we have our first cycle of acquisitions done, and as I've been saying recently, we are more like a reactive acquirer, now no longer a more proactive acquirer, so we felt a little bit more comfortable in sharing that information with the market.

So having said that, as you can see here on this slide, if you look at the gross adds number in the first quarter '13, which is almost BRL90,000 for the quarter, that had grown almost 30% when compared to last year, and that has grown by 6% compared to the same quarter last year, coming to last quarter last year. It is also important to highlight that as we have been discussing with most of you, the churn level had increased significantly when you compare this quarter to the same quarter last year. It has more than doubled the size in terms of number of lives, and as you all know, part of it's coming from the acquisitions, and the main part is the acquisition called Padrao, and which has contributed to like almost 15% of that number.

However, on the positive side of that, we do see a reduction on the number of lives churn in the first quarter '13 when compared to the last quarter of last year, which is about 7.5% reduction, which we believe at this point, it's still related to the seasonal effect of the company, mostly than the actions that we are currently implementing, which I assume most of them due to be matured late this quarter, but that we will report in the second half of the year.

One point that is also important to highlight that you see on this slide here we call portfolio adjustments. As you all know, we have fully integrated the operations of Padrao during the first quarter of 2013, and once we did that we noticed that the portfolio that we are adding from Padrao during the last two quarters that consists (Technical Difficulty) we made it equivalent accounting lines, the number of lives that we account for in the Qualicorp portfolio equivalent to Padrao.

So therefore we do have now an equivalence between lives that are invoiced and lives that we are reporting to you, that is why you have to go through that adjustment on the total portfolio of lives. Those lives, they do not refer to specific months, they are lives that were in our portfolio from Padrao that were not invoiced at the time. So that's why we had that adjustment.

Continuing on that slide, I think a few other important points to highlight. The number of beneficiaries, as you can see, went up from 3.9 million same quarters last year to 4.4. It's about a little more than 13% growth, represents more than 520,000 lives added to our portfolio. If we compare to the fourth quarter last year, we would see still a growth of more than 85,000 beneficiaries. So if you look at the additional 524,000 lives, we would see that 67% of that addition came from the Affinity segment, which is a little more than the 350,000 lives, and about 33% percent of that addition came from a segment called corporate and others.

If we take a closer look at the Affinity segment, we can see that we've grown 25% that indicator versus last year, and that is a combination of organic growth and the acquisition we have made during this period. And it's still looking only at health, life portfolio there was a growth of almost 29%, taking the portfolio of lives to 990,000 Affinity health lives to almost 1.3 million lives at the current quarter. Our portfolio beneficiaries in the corporate and other segment grew from 2.5 million to almost 2.7 million lives, which is another 7% growth versus last year, and a 2% growth if you compare to the last quarter last year.

So, having said that, I think we have covered some of our performance in terms of number of lives, and we hope to have met some of the demands from our investors in terms of adding a little more flavor to this information on that front.

If you please move with me to page number seven, then we show what the effect of this number of lives has brought on our net revenue side. As you can see here, we have invoiced net revenues of almost BRL267 million for this quarter, being 17.4 million of those coming from our Alianca. That represented an increase of 34.4% when you compare to same period last year. And if you look only at the Affinity segment, which is our core, we have invoiced BRL244 million, with growth from last year of 37%, and if you compare with the last quarter last year, we still grew a little bit less than 3%, at a 2.7% rate.

In the corporate and other segments, we have reached BRL22.3 million of net revenues from this quarter, which represents growth of 11% compared to last year. Here, I'd like to make a quick observation, meaning that, as you all know, a large part of our order in corporate number of lives comes from TPA. Only on the TPA segment we carry about BRL1.4 million, and that number of lives is currently stable, it only fluctuates if you add more employees, or if you fire employees of the companies that we have rendered service. So that's why the growth in number of lives from that segment does not follow the same lives of Affinity. If we were to extract the TPA, the number of lives of that group, you would see we have grown lives in corporate and others as we grow Affinity.

In page number eight, we would like to share with you some more details on our cost of goods, cost of services, as a matter of fact, which have increased about 34.6%, as you can see here on this slide, representing, I would say, a level of growth very much equivalent to our revenues. In other words, as you all know, the lines that we accounted for here on this group of expenses are very much variable, so that variability is following around the same trend of the revenue, even when you compare with last quarter, which is about 3.2% growth, and when you compare with the same quarter last year.

Probably one point that would be interesting to highlight is the increase on the third party services, especially when you compare to the last quarter, which was about 15.5%. That's mostly coming from the call center area and a few operational activities due to the incorporation, as I mentioned earlier, of the activities of Padrao and some of the activities from Alianca.

In page number nine, we would like to show some details on the administrative expenses. As you can see, expenses have increased versus last year at a rate a little lower than 19%, showing that we do leverage a bit during this period on our revenues, if you consider our revenues grew by almost the double of that size. So we do have a lot of effects of some of the profit changes and some of the cost control that we have implemented already paying out on this line. Just to have an idea, if you look at first quarter '12, that line represented 33% of our net revenues, while in the first quarter '13 has dropped to like 29.1% of net revenues, showing how much we've leveraged.

As we said on the previous slide, I think, a quick mention on the third party services is that have increased the same way versus prior quarter by a almost -- by little more than 17%. That is due to a few companies that we hired in terms of consulting to help us on controlling the churn and in reducing the bad debt, as we will see that line specifically shortly. We have engaged a few specialized companies to help us working with those indicators, and I'll talk more about it later, so they were accounted for on this line third party.

Page number 10. If you look at our selling expenses, you will notice that, especially when you compare with the first quarter last year, we only grew by 3.2%, and if you compare it with the fourth quarter last year, we actually had a reduction of almost 5%, and one of the reasons why is that we have a lot of discretionary expenses here, and when you compare with the fourth quarter, you do find a seasonal effect, which is typical in our business. We do invest a little more on this selling expense groups during the fourth quarter, that's why we do see a seasonal effect bringing down the first quarter.

But if you compare with the first quarter '12, you would also see some of the results of some changes in processes that we have made, so it's clear here that we are being able to sell more at a lesser cost. And that's why you see our expenses growing to -- on the selling side, reaching about BRL50 million, even investing in marketing for this quarter about BRL11.1 million, which are paying out on our sales side. As you saw, our gross adds for this quarter were almost 30,000 lives per month, so very much in line with our expectations and our internal budget, as Eduardo has mentioned.

In page number 11, that is definitely by far the most important indicator of this company today. Every single Qualicorp employee is fully dedicated in bringing this indicator down for obvious reasons. If you see the growth we experienced in the first quarter 2013 versus the same quarter last year, you will see, we have more than 87% growth on that indicator. Although, on the positive side, as expected, we do see a reduction on the first quarter 2013 versus last quarter by almost 8%, and that is mostly due to seasonal affects. Whilst we still believe that the actions we are taking have not reflected fully in the first quarter, they should start paying out like late this quarter, but mostly on the second half of the year.

As we always said, we are still pursuing a lot of activities in mitigating this growth on this indicator. So some of them are like we are stimulating a lot of direct debts, which is the automatic payment for our customers, not only on the new sales, but also on our portfolio of lives as well. We have started the test of saving some of our customers to the black list, and so we are very anxious to see what the reply to that will be. We are approaching our customers with more aggressive retention tools and on top of all of this, not less important, as I mentioned earlier, we have engaged a few specialized collection agencies and consultancy companies specialized on that front, that we will see them paying out for sure late this quarter, early next semester.

Page number 12, we do have a quick look on the other operating income. And as you can see, on the first quarter 2013, we did have an additional contingencies that were accounted for in our balance sheets, which represented the biggest majority of the BRL3.1 million that we had to accrue, mostly regarding to the costs of some of acquisitions that we had. Financial income and expenses, in page 13, as we all know, the interest rate in Brazil have been reduced significantly, especially when you compare with last year, and not only that, but with the payout of some of our acquisitions that happened in the third quarter last year, we also had a lower amount of cash being invested, so that came out with a decrease on our financial income of about almost 35%.

Interesting though, that we have to highlight here that on our financial expenses line, we do have a recognition of about BRL12 million, which is called a monetary adjustment for the call option that we have to buy Alianca, Praxis and GA. As you know, we report our results very much in compliance with CPC, and not by IFRS rules. So, based on those indicators, we do have to adjust those balances in the quarter.

And if you remember, during the fourth quarter call and the fourth quarter results, we had about BRL15 million accounted for in this line, but they were representing five months worth of growth, so in this case we have what should be about the running rate in three months of the first quarter about BRL12 million in that line.

In page number 14, we are now getting close to the end, we do have a quick reconciliation starting out of net income, and showing all of the expenses to adjusted EBITDA, and I think the most important thing here, that Eduardo has already highlighted, we have been able to grow margins in first quarter '13 versus prior quarter by 235 bps, and also, if you compare to the same quarter last year, we did see an increase of 123 bps on that indicator, reaching a 35% margin in this quarter.

And one thing that I would like to highlight is that 35% margin on this quarter is a result of the main indicator of the company, which is today, losses and uncollectable, at an 8.5% level. So if you were to bring that indicator back to our old historical levels, so let us say 5% at a high end, that means we are using 3.5% of our margins on that indicator, meaning that we will be having this call, if that indicator were in the normal circumstances, we would be talking about 38% to 39% margins early in the year, even prior to the price adjustment in this year. So, that's the main reason why the main focus of the company is trying to bring churn and bad debt close down to normal historical levels.

Adjusted earnings that we saw in page number 15, I think the most important thing here is that we have reached a BRL16.3 million adjusted earnings, which grew 7.4% when you compare to last year, especially due to the reasons we have discussed here, and the adjustments on interest expenses and financials and we more than doubled when compared to the last quarter. Of course, last quarter was with some adjustments as well, as we expressed on the fourth quarter call, so we would be looking at levels of like BRL15 million to BRL16 million on this indicator, more consistently.

Finally, the last page of our presentation, a quick picture of our CapEx, as Eduardo already mentioned, we invested a little less than BRL7 million, mostly in developing our IT platform. And a very important indicator that we would like to share with you is our total net debt, as you can see here, has dropped by almost BRL30 million, from almost BRL450 million to BRL420 million, mostly due to our cash generation capacity, and also due to the fact that we paid out some of the interests in February of the debentures as contracted.

Now having said that, I would like to finalize the presentation part and start with the question-and-answer session. Thank you.

Questions And Answers

Operator

Thank you. We will now start the question-and-answer session. (Operator Instructions) And the first question comes from Josh Milberg, Deutsche Bank.

Q - Josh Milberg {BIO 2004065 <GO>}

Good afternoon, everyone, and thanks for the call. My first question is on your gross adds. I was just hoping you could give some additional perspective on how much of the growth in the quarter was driven by expansion into new regions versus existing areas; and then also how much of an impact ramp up of some of your newer operating agreements have had.

A - Wilson Olivieri {BIO 17325685 <GO>}

Josh, thank you so much for being with us here. Thank you for the call. In terms of the growth of gross adds for this quarter, what I can share with you is that we had 70% of those sales coming from Rio and Sao Paulo, and 30% of the sales coming from the remaining part of the country.

And as you know, because we are developing further our geographic expansion, you should probably see throughout 2013 this relationship changing, whereby Sao Paulo and Rio should reduce a bit, while other parts of the country should be increasing, because we have the four branches we've opened last year, maturing throughout the year in 2013 in addition to, as we said on the Qualicorp Day, another at least three regions that we expect to open, most of them in North-East. So you should probably see that flowing in different manners.

In terms of new operators, that are Bradesco, Amil, and Intermedica, we have made a few adjustments, especially on the second half of last year, and what I can share with you now is that we have put in place strategies that are allowing us to say that we are very much in line with what we have agreed with all of them.

So, we are trying to be very cautious on that front because, as you know, they are all very good partners we have. And what I can tell you is, they have been going as expected at this point in time, because, as I mentioned earlier, we did not have the same experience like that last year, especially with Bradesco. So now we have put a strategy in place, whereby we are accommodating and accomplishing targets that we have assumed for all of them so far.

Q - Josh Milberg {BIO 2004065 <GO>}

Okay, that's great. And then my second question is just if you could revisit your outlook for the July price hike. I just want to know if there were any changes to your expectations there. And if you could answer, just quickly explore what you see as being the factors behind this whole phenomenon of increased usage of health plans in the market, and your outlook there too. That would all be very helpful. Thanks.

A - Wilson Olivieri {BIO 17325685 <GO>}

Thank you, Josh. That's actually a great question. As we have said in many calls, we do know that there is a big medical inflation/deflation pressure in the country today, so there are other public companies that are in the healthcare arena, and you probably heard from them directly, so you wouldn't need us to say.

What we expect here is, historically, due to the fact that we help our partners controlling medical loss ratio and things like that, what we see always is, at least, about 5 percentage points on our price adjustment that should be below the average medical inflation.

We do strongly believe that our strategy is still in place. We are negotiating as we speak here. We have a group of people negotiating right now with all of our providers, because our main price adjustment is in July, and we do believe we will be able to keep that track record.

But what I can tell you, though, is that if in last year we see a medical inflation around 16%, for sure we will be experiencing an inflation that's higher than 16 for this year. So, as I said, we are in the middle of the process of discussing it, but I would bet about a couple of additional extra points. So, making an example, if the inflation rate for medical activities in Brazil were to be 18% this year, most likely our price adjustments will be around 13, 14. But it's still being negotiated, a little early to say, but one thing that we are seeing is that most likely it will be higher than it was last year.

Q - Josh Milberg {BIO 2004065 <GO>}

Okay, very helpful. Thanks for that.

A - Wilson Olivieri {BIO 17325685 <GO>}

Thank you, Josh.

Operator

Thank you. And the next question comes from Scott Hendrickson from Permian Investment Partners.

Q - Brad Doppelt

Yeah, this is actually Brad Doppelt for Scott. But given that your margins are on the rise, and you have generated a substantial amount of free cash flow, and your shares seem relatively attractive, I mean how do you think about share repurchases in the future to help shareholder value? And I mean, would you use just current free cash flow, or think about taking up incremental debt as well?

A - Wilson Olivieri {BIO 17325685 <GO>}

Thank you very much for being here in our results this quarter as well. And that is a very interesting question. We are receiving a lot of questions from some of our investors regarding that matter, and I have to be very honest with you, yes, we are studying that possibility. Of course, if you look at the Brazilian regulation, there are certain limitations for that action. In other words, we do not have to have any loss carry forwards on our balance sheet, we have to have enough profit, and then we have to make a decision with the cash and profit you have. If you are going to pay dividends or if you want to use the cash to buy back shares or, even as you said, if you would consider the possibility of getting some funds in the financial market in order to generate value.

So what I can tell you is, technically speaking, we are not ready for that right now. In 2013, we may have some opportunities in the second half of the year, but I do not think that would be relevant. So that would definitely be a question to be visited around 2014. And the direct answer to your point is, yes, we would consider the possibility of playing that role, like buying back shares, if the technical conditions and the shares out in the market would allow us for that strategy. So this is a strategy we would consider aside of the fact that we would discuss on paying dividends as well.

Q - Brad Doppelt

Thank you.

A - Wilson Olivieri {BIO 17325685 <GO>}

Thank you

Operator

(Operator Instructions) We have a follow-up question from Josh Milberg from Deutsche Bank.

Q - Josh Milberg {BIO 2004065 <GO>}

Yes, Wilson, thanks for taking the additional question. And sorry if you already covered this, but your quarter-over-quarter revenue growth for the Affinity segment outpaced your growth in average life, if I am not mistaken. So I just wanted to better understand the factors behind that movement.

A - Wilson Olivieri {BIO 17325685 <GO>}

Yeah, Josh, let me just look at the numbers. (inaudible) Yeah. Number of lives in --

Q - Josh Milberg {BIO 2004065 <GO>}

The average large number?

A - Wilson Olivieri {BIO 17325685 <GO>}

The average life number, to be very -- I would say that that means we are selling more A&B products than we are selling the life products, which is very much -- so the average ticket of the sales is higher than the portfolio.

Q - Josh Milberg {BIO 2004065 <GO>}

OK. Very good.

Operator

Thank you. And as there are no more questions at the present time, I would like to turn the call back over to Mr. Wilson for any closing remarks.

A - Wilson Olivieri {BIO 17325685 <GO>}

Thank you very much. On behalf of Eduardo, myself, Junior, Natalia, and the whole team of Qualicorp, I would like to thank you all for being with us on the call today. And as usual, if there is anything we have not covered, please don't hesitate to give us a call, we will be glad to help anytime. And we do look forward for a very bright future for Qualicorp, and to all of us here that are on this call as well. Thank you very much, and have a great day.

Operator

Thank you. This concludes today's teleconference. You may now disconnect your phone lines. Thank you for participating, and have a nice day.