

Q4 2014 Earnings Call

Company Participants

- Alex Fernandes Oreiro
- Grace Cury de Almeida Gonçalves Tourinho
- Wilson Olivieri

Other Participants

- Rafael Frade

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and thank you for waiting. Welcome to Qualicorp's Conference Call to discuss the results of the fourth quarter of 2014. We have with us today Mr. Wilson Olivieri, the IRO; Mr. Alex Oreiro, the CFO; and Ms. Grace Tourinho, the COO.

The event will be recorded and participants will be in listen-only mode during the company's presentation. After which, we'll begin the question-and-answer session and further instructions will be given.

I will now turn the floor over to Mr. Wilson Olivieri, who will start the conference. Mr. Olivieri, you may proceed.

Wilson Olivieri {BIO 17325685 <GO>}

Thank you very much, operator. Thank you all for being here with us in another call for the results of the fourth quarter of 2014. On top of the executives that the operator mentioned, we also have Mauricio. He is actually in Europe right now. He's still in Portugal. He will participate at the call with us and he will be available for the Q&A session as well.

We are also today welcoming Grace Tourinho. As the operator said, to our team, she's having her first experience with our team of investors in U.S., so she will help us with the introductions for this call.

So, Grace, please could you start?

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

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Thank you, Wilson. Good morning, everyone. I'm very happy to join Qualicorp's team, and it's a privilege to present the company fourth quarter results. Our portfolio of beneficiaries grew 12% year-over-year, reaching 5.1 million lives, a result of Affinity Segment with 1.9 million lives, growth of 0.6% year-over-year, and in the Health division, 7.1% year-over-year.

The Corporate and Others segment growth have increased 20.2% year-over-year, totaling 3.2 million lives, mainly due to CRC Gama acquisition. Our recurring net revenue, excluding CRC Gama, grew 21% in 2014, reaching BRL 1.5 billion as a result of 17% price readjustment in part of our portfolio, growth of 7.1% in our portfolio of Health Affinity lives, partially offset by the downgrades applied for the reduction of the churn. This was one of the positive initiatives that we had in the company.

Our recurring adjustment (sic) [adjusted] (02:56) EBITDA, excluding CRC Gama, grew by 26% in 2014, closed the year with approximately BRL 570 million and reached 39% of margin.

We closed 2014 with an account net profit of BRL 138 million compared with a net loss of BRL 12 million in 2013. The retroactive adjustment of PIS and COFINS tax was more than compensated by the monetary adjustment of Aliança and allow us, for the first time, to distribute dividends in the amount of BRL 116 million, BRL 0.43 per share.

Thank you very much. Now, I will turn the word over to Wilson Olivieri.

Wilson Olivieri {BIO 17325685 <GO>}

Thank you, Grace. Thank you, all. And I would believe that you all have the presentations that we made available in our website. So, kindly I ask you if you could please bear with me in page number 4 because this is just for the sake of classifications here.

As you all know, like we did on the third quarter results release, the first column to the left that's named ITR, it shows exactly all the consolidated numbers as they are shown on the results that had been registered at CVM last night. So, built into those numbers, so we can appropriately compare our data with the previous quarter, we believe there has to be two adjustments that we would create numbers that are comparable.

Number one, that if we look in the column called PIS/COFINS retroactive. So, on this column, we see almost BRL 15 million that relates to the retroactive credit of 2014 and the remaining BRL 120 million, that refers to the retroactive prior of 2014 to the other five years. And the other column that's called Unity Health Solution, that Grace like to call CRC/Gama, you'll probably going to see us talking about the same thing. It just has two names. One is Unity Health Solution, the other one is CRC/Gama. They're actually the same thing.

If we exclude both of these columns, we will get to the right-hand column what we call recurring fourth quarter 2014, with the numbers that are actually comparable to the past. So, as Grace stated already, we see almost BRL 1.5 billion of net operating revenue and

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an EBITDA of BRL 568 million, which will be the basics of the next slide that we're going to be looking at right now.

So, moving to the next page, page number 5, I think there are just a couple of items that I'd like to stress on this graph. First, that you can clearly see on the bar graph to your left that the gray line, where we have the Corporate and Others number of lives, we saw a fairly large increase in the third quarter 2014, and that's mostly due to the acquisitions we had of the CRC/Gama business.

And that has created a change on the right-hand chart that we used to see a lower participation of Corporate and Others on the bulk of the lives that we have on our portfolio, and it has increased due to that acquisition up to a point that we currently had 63% of our lives coming from the Corporate and Others Segment, and 37% coming from Affinity. But again, as we all know, this 37% of lives, they generate more than 93% of the revenue. So, it will still continue to be the core and the bulk of our business.

In page number 6, where we look a little closer on the performance of our number of lives. I think a lot of numbers to look at, but I think a few highlights worth mentioning here. First of all, in the fourth quarter 2014, the net adds that we see - the gross adds that we see here at almost 108,000 lives, that shows that our average per month on that quarter was about 36,000 lives, pretty much in line of our expectations. But what was a little bit below our expectations was the churn running at around 86,000 lives for the same period.

If we go all the way to our right and look at the total number level of 2014 and 2013, we will see that we added gross amount of lives in both years at around 420,000. So, our sales were pretty much flat 2013 and 2014.

But if you look at our churn, you will see that we only grew by 2.8% year-over-year, meaning that that was exactly the reason why we were able to grow our total portfolio of lives by 7.1% or a net adds of 98,000 lives for the year.

So, as we've been saying all along for quite a few quarters now, I think our actions and our activities that we've been investing in reducing churn are showing off right now on these numbers.

Adding just a couple of more comments, as we may - as we saw on the prior graph, I think worth highlighting the TPA numbers on recurring fourth quarter 2014, almost at 2.2 million lives growing from 1.4 million lives the same period last year, mostly coming from the acquisitions we made.

Moving now to page number 7, please, we will start talking a little bit about the financial data. So, on our net revenue, as I mentioned earlier, in the fourth quarter 2014, the percentage of total revenue was 93.5% for the Affinity Segment. Meaning that for the fourth quarter, it is higher than historical, showing here that we have been growing Affinity on a faster pace than we've been growing the other business units that we had.

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Another thing that is reasonable to mention is even though Corporate and Others has been going through a difficult times, you see that we have generated more than BRL 100 million worth of a revenue in 2014, which represented a growth of about 12% on net revenue, coming out with a total growth of 21.4% as Grace already mentioned, which I would like to split. Looking closely at the Affinity revenue, where you see that we actually grew only Affinity by 22.2%, which means we had delivered the high end of our expectations at this point on time in terms of revenue at almost BRL 1.4 billion specifically for Affinity.

In the next page, where we look at the cost of services or start looking a little bit more closer to our cost, I think a few indicators to highlight. Number one, if you look at the bar graph and the line graph at the bottom of the page, you'll see that our gross margin has increased this quarter to 75.4%, which is the highest on the period that you see on the graph, coming from a couple of quarters of growth, showing that most of our efforts in retaining costs on those operational lines are also paying out at this point on time. Some of them coming from implementation of new features or systems, others coming from changing processes, but all of that moving towards the same direction, which means trying to increase efficiency on those lines.

If there is one point that I think would be interesting to highlight is on the line called Others that has a note b on that. If you look at the column 2014, you see that we've spent on that line BRL 40 million, which represented a growth of 63% versus prior year. And most of these adjustments are coming from accruals on contingencies due to our strategy of SERASA, it's part of that, and a few other contingencies coming from lawsuits regarding medical services. So, this is why we have increased a little bit that specific line. But still with that increase, we're able to mitigate that increase in other lines, reaching operating gross margins of about 75.4%.

In the next page, where we look at the administrative expenses, I think here, based on the few questions that I have received from last night into this morning, I think we will disclose a little bit more details on the non-recurring lines. So, if you look at the description that we put together at the earnings release, you'll see there were a few lines of one-times that we have listed that affected our third quarter results. And I'm going to name here the four that we believe are the most important and actually in order of size.

If you remember, when we had a reduction on our taxes, PIS and COFINS, I would say mid-year last year, there was a big discussion on if we could actually credit our sales of the past five years with the same reduction. So, we engaged a couple of law firms and companies specialized in tax planning. And in order for us to be able to accommodate all of this BRL 154 million that we credit ourselves regarding the prior period, we engaged into a contract. And part of that contract was paid in the fourth quarter, and that is BRL 10 million. So, why I'm stressing that discussion? Because if we had not paid that, which comes to that on this slide, we would not be able to receive all of the benefits of the prior years. So, these are investments, in fact, that are actually allocated in expense.

The second line, which refers to donation for the elections that we had, as you all know, presidential elections, Qualicorp contributed to the process with an amount of BRL 7.8 million, which is also booked to the fourth quarter. Then we also had some leftovers from

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cost from the acquisition of Tempo and Aliança, if you remember the additional 15% we acquired, about BRL 4 million that came in, in this quarter as well. And finally, with the addition of some new executives and the accrual of hiring bonus for those executives, we had an extra amount this quarter of about BRL 4 million. That should add non-recurring for this quarter at about BRL 26 million on that sense.

Another point that is very important that we have not listed here because, of course, it's a recurring expense but it comes out of a reduction in the bad debt line. So, we also accrue on these expenses here, as what we call third-party services, the fee that we paid to the collection agencies. So, once we had a success and we had a fair amount of balance (14:56), as we will see in a few minutes, of collecting additional money, we end up increasing costs on that line as well. We just did not list that as a one-time because it is not one-time once I'm still collecting money out. But it is another information that is important to consider when we look at these SG&A expenses.

Reason why we've been always discussing with the market that, based on our business model, we should always look at what I call an all-in condition. So, credits and debits, considering all of them together, if we are adding value to the shareholder and to the company, I think this would be the most important indicator on those lines.

I know we can get into more details in the Q&A session, so I would please kindly ask you to move to the next page with me page number 10, where we see selling expenses. And for selling expenses here, we don't have much to say, because if you look at the growth year-over-year, you see that we've been growing those lines at a 20.4% rate, which is pretty much in line with the growth of our price adjustment combined with the growth on our portfolio of lives.

Just if you look at the quarter-over-quarter, especially on three lines - two lines, one called Sponsorships and the other called Publicity and Advertising, as we do strategically every year, we kind of enhanced our investments on those lines at the fourth quarter, so we can start early next year, like 2015, with the better leveraging on our new sales. And this is exactly what we've done. So, for the ones that have access to the Brazilian TV network, you would probably have seen Qualicorp on the primetime TV on the Globo network a few times on the past few weeks. And this is part of the investment that you see here.

I think this page number 11 probably shows what I believe to be the best indicator that we have all throughout the year. The bad debt, as you know, mostly uncollectible receivables, closed surprisingly, on the fourth quarter 2014 at a low level of 5.5%. Even for us here, we would expect that this quarter would have at least 100 to 150 basis points - it would be higher than this. But I think our strategies and all of our efforts have been reflected on our results now.

In such a way that if you look at the slide, right underneath this one, you see what we call the recovering line. If you add what we have recovered in the four quarters of 2014, you will see that we recovered BRL 21 million. And in the four quarters of 2013, we recovered about BRL 9 million. So, that means this project has added to the company in the last two

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years an amount of BRL 30 million, not only in cash but also in results because that goes directly to our result.

So, even considering the amount of money we pay to the collection agencies and the accruals that we had to put together due to the litigations that we received because of blacklisting people, it's still worthwhile to continue with the project because it adds a fair amount of value to the company on that sense.

Moving to the next point, it's still in the same page; I think another very important component of our call today is this line called operational losses, which actually did not generate losses this quarter; it generated gains. This BRL 33 million of credits here are coming out of a relationship that we have internally. You remember that, I would say at least during the last two years, we were hit by a negative amount in this slide because our conciliation of data regarding invoices that we received from the operators versus the invoices that we actually believe we should pay were generating differences consistently.

We have put a huge task force together internally enhancing development of the systems to seek for that opportunity. And then what we were able to get was a better reconciliation of the registration data of our beneficiaries in terms of address, name, documentation number. And then we could better match whatever we had to receive from these people or not, we had to pay to our providers.

And having said that, we were able to reverse most of the debts that we had taken throughout 2014, which represents about two-thirds of this balance, and we were also able to reverse a few of the debts that we had in 2013. So, on that front, we were able to generate their gain, and we expect that from today onwards, with the systems that we have implemented, and the processes that we have changed, that this line should not generate any more surprises - nor to the good, nor to the bad. So, our expectations that for the future, we would keep this line very close to zero balance.

And again, I know in the Q&A session we can get into a bit more detail. But this was a great achievement for us internally, so we can match the records that we have in-house with the records that our providers also have. And so, that has helped us significantly on that front.

In page number 12, where we talk a little bit more about the financial income and expenses, I think most of these numbers, first, are affected by the continuous increase in the interest tax rates that we're experiencing here in Brazil today. So, they not only generate higher levels of income from short-term investments, but they also increase our interest paid for our debentures and for our - with Bradesco and with Itaú, as we see.

A couple of highlights that I think are interesting here are, if we look at the line called Monetary Adjustment from Call Option of Aliança and GA, you'll see that in 2014, we were affected by about BRL 140 million on that line. That was mostly compensated by the retroactive PIS and COFINS credit that we were able to assume on the third quarter. But more important in all, in the fourth quarter, you see there only a BRL 7.6 million of debit on that line, which represents the current status that we have with Aliança.

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We only have a call option for 25% of the company now. And this should be the balance to be accrued every quarter from now onwards. So, unless if Aliança really performs well, better than expected, which would be good news to share with you in any way. But if they don't, we believe this should be above the balance that should be we're hitting (22:04) our results from now onwards.

In page number 13, we have a very - summary of our EBITDA performance. And again, I'm not going to repeat what we've said already, but in the quarter we reached a 38.8% margin, excluding, of course, the CRC/Gama effect, with an almost BRL 153 million of margin, closing the year at BRL 568 million, margins at about 39%, which are, just to have an idea, about 147 bps higher than what we reported in terms of margins for 2013.

But if you remember, we had some - we had a few onetime in 2013 adding for a BRL 13 million of credit that if we exclude those, we would potentially be looking at an addition of 250 basis points of margin this year versus last year, which, in our opinion, considering a very difficult macroeconomic environment that we experienced in 2014, with the elections, with the World Cup, with the loss of Brazil in German game, 7 to 1, that was a major issue here in the economy in Brazil. So, altogether, still reaching out for those kind of growth in the EBITDA margin, I think are very well received here.

In page number 14, we will look at the net income or loss results, and why we had started looking at this indicator this quarter for the first time. Because now, we finally - we start talking about dividend payment. So, in the fourth quarter 2015, we generated an income, BRL 19 million, that concluded our year for a total full net income of BRL 139 million.

One of the questions that we have received regarding the taxes that are shown on our results, they were pretty higher than what we saw in the third quarter. The effect that we had was a small - a lower tax rate in the third quarter due to the absorption of the credits from the prior - the retroactive PIS and COFINS. So, once you look that comparison, you could potentially, say, oh, the taxes have increased, but they have not, they have actually come back to what it is, our regular level, around 48% for the accounting book.

And the reason why we had such a high level of taxes in the accounting is because we have all of the amortization of goodwill from the acquisition of Carlyle in 2010, which should be over in 2016. So, accounting numbers should go back to a little more normalized levels shortly.

Getting close to the end and the final slide here was probably the best one, I think. It is a very summarized version. If you look at the BRL 138 million of net earnings that we've generated in the year, we have to take the non-controlling interest out, which is BRL 16.4 million coming down to BRL 122 million of distributed net income.

Based on the Brazilian regulation, we have to reserve legally a 5% of the amount, meaning that we have a distributable earnings of BRL 116 million. If you look at the data here, by law because we belong to the Novo Mercado, the new market, and based on our bylaws, we were supposed to mandatorily distribute 25% of it, but we have approved

with our board an additional 75% distribution, meaning that we are paying out 100% of our earnings of 2014.

Technically speaking, if you look at (25:53) formal requirements we have based on CVM rules, we still have to give 30 days of period to the minority shareholders so they can analyze the results on a more detailed basis. So, all in, we should be paying out this no later than the first two weeks of May as soon as we can put all these formalities together.

So, I think no later than May 15, we should be distributing approximately BRL 0.43 per share. That would represent a yield of about 1.8% right now. And another thing that we have approved with our board, it's down below the chart, that our frequency of payment for dividends will be averaged 12 months. We will pay on an annual basis, and we'll continue with the statements that we've been making (26:41) recently, meaning, we will pay a minimum of 50% of the accumulated losses at the time and regarding the fact that we maintain about 10% of the estimated revenue for the year on our gross cash side.

So, the very last slide on my part here is the CapEx. And as you can see, 2014, we closed with a CapEx investment of about BRL 96 million, which is a little higher than what we have shared with the market recently, mostly due to the acquisition of CRC/Gama. So, this is one of the indicators where the numbers are consolidated. And as we've discussed in the past, we had to move all of the CRC people from their location. They used to work to a new location, and so those investments were booked here.

So therefore, we've missed our CapEx number by a bit. But still, as you can see, a large part of the CapEx is still developing the IT platform, which has started paying out with the reversal we had on the operating losses.

And finally, if you look at our total net debt, we have reduced it by 41%, even though we have engaged in another debentures with Itaú with BRL 300 million, but still with the cash generation for the period allowed us to reduce the full net debt by 41%.

And so, before we go into the Q&A session, I would like to pass the word to Alex, so he can add a few more information to you that are very important. Alex, please?

Alex Fernandes Oreiro

Thank you, Wilson. Thank you, all, again to be with us today here. A very, very fast information. We announced yesterday, too, our rating with Standard & Poor's, the agent, and we have now a local ratio, which is brAA+ and for us it's - we're very proud to announce that. If you access the site of Standard & Poor's, you can have more details about the description of our ratio. But basically, if we could resume the analysis, basically, they report that we have the leadership of the segment, very strong generation of cash flow, a low risk of the management of the cash policies internally, and this financial good position for us. That's all. Thank you, Wilson.

Wilson Olivieri {BIO 17325685 <GO>}

Thank you, Alex. So, operator, please get ready for the Q&A session. Thank you.

Q&A

Operator

Thank you. We will now start the question-and-answer session. Our first question comes from Rafael Frade at Bradesco.

Q - Rafael Frade {BIO 16621076 <GO>}

Hi. Good morning, everyone. I have a few questions. First, a few, there's a general perception that when you look for Affinity revenues, it grew less than the members in the quarter indicating a lower average ticket. But at least from what I saw, it was more - was mainly related to royalty revenues.

So, the question would be why royalty revenues were lower this quarter compared with the previous quarter. This would be the first question.

A - Wilson Olivieri {BIO 17325685 <GO>}

Hi, Rafael. Thank you for being here with us. To be very honest with you, I haven't looked into that specifically. But I would say if you look at any specific quarter, especially on the royalty side, there's a very complicated relationship we have with the professional associations. So, every now and then, we have to supply them with the information so we can pay them.

So, you might have some fluctuations from quarter-to-quarter just regarding operational issues. But to be honest with you, I don't see any macro environment or any technical reason why that should be lower.

So, if it is lower this quarter, either we paid something earlier or we might come up or paying something in the first quarter 2015. But there's no major reason why royalty should have a different performance than what we've experienced the last quarter.

Q - Rafael Frade {BIO 16621076 <GO>}

Okay. Perfect. Additional question related to the operational gains that you had in the quarter. I'd like to understand a little better the mechanics here. I want to understand that losses related to this previously were recorded in the other operational line. But from what I understood, it could be, in fact, a reduction in the gross revenues. I would like to understand if this is the case. And also, one of the question that we have is, where are the provisions related to the previous operational losses?

I understand that, in fact, you don't have provisions. But it is in the line of values to be identified by the operators. Is that right? It's much more understanding where the previous losses were booked and where are they recorded in the balance sheet.

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A - Wilson Olivieri {BIO 17325685 <GO>}

Okay. Rafael, what we have here, and just going back to the same page. Right here. So, every single debit and credit regarding to losses and gains of operational issues, especially on this what we call in Portuguese here - try to translate that - which is matching invoices on a recurring basis. It is all booked on this line called operational losses. The only point is, on this line, we don't have only specifically that subject. We also have in here some of the reversals that we have for contingencies that we have booked on our balance sheet. Sometimes, our provisions or accruals for other contingencies that are new, coming in and out. So, it's a fair large amount of situations that are booked on this line.

But to your point, let me try to explain exactly how that works. Let's say for the sake of example, our cutoff date of invoicing customers, for the sake of an example, is in the 20th of the month. For operational reasons, the system works like that.

The cutoff of our providers is on the 25th. So, that means between the 20th and the 25th, people are still being born, people pay their debt, people cancel, new people are - new sales are performed. So, having said that, on an operational basis, we have a full department here that reconciles that amount on a daily basis, making sure that whatever our providers are charging from us, it is the same thing that we believe we have to pay.

So, in the past, if you look at 2011, 2012 and 2013, what we used to do was we would be discussing that - or we'd be reconciling those accounts on a daily basis accumulating the balances. And then at the end of the year, when the auditing would look at - Deloitte would look at our number, they would say, okay, you cannot move to the next year with this balance outstanding. No matter if it was a credit or debt, just happen to be debt all throughout these years.

So, then we would book that against our results on this line called operational losses. But that does not mean that we gave up on reconciling the data. One of the most - the biggest advantage we had on this fourth quarter was we were able to match the registration data, as I said during the call, of every single beneficiary that we have and it's dependent. So the documentation number, the address with our providers.

So having said that, a lot of the balance that we believe here that was supposed to be payable to a provider was not actually payable because it was part of the debt that we had already assumed. So having said that, the only way - you were right in the sense that relationship of the premiums (35:32) that on a working capital level. So, they're always accounts payable and receivable to us. They don't flow to our results. The only piece that flows to our results, when I cannot match the payables and receivables, and that flows to this line called operational losses.

So, what has happened this quarter was that by reconciling all of these data that we accumulate throughout the years, we found out that we could actually reduce that payable that we had on our balance sheet. So, we reverse the debt that we had made throughout the year in the past couple of years.

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Q - Rafael Frade {BIO 16621076 <GO>}

That's perfect. Just to make clear. So, which is the line in the balance sheet in the liability that we see this amount? Do you know? Because it's not a provision. I think that most of the people are thinking that's a provision, but it is a payable.

A - Wilson Olivieri {BIO 17325685 <GO>}

No.

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

It's payable.

A - Wilson Olivieri {BIO 17325685 <GO>}

It is actually - It is differences between payables and receivables that we have on the balance sheet that end up hitting the P&L. But if you look on our balance sheet, it is on short-term accounts receivable and short-term payable, depending on how the balance is behaving at the cutting date...

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

(36:46)

A - Wilson Olivieri {BIO 17325685 <GO>}

...that we have. In Portuguese, you would see the accounts called [Foreign Language] (36:50-36:52), which is premiums to be repaid.

Q - Rafael Frade {BIO 16621076 <GO>}

Okay. Perfect. And just - you mentioned previously some - well, not expenses in the G&A, there were material expenses related to these operational gains to make this system better in this quarter or not? Is it something that we had during the year?

A - Wilson Olivieri {BIO 17325685 <GO>}

Well, the investments we made to improve the system are all in CapEx. So, we do not have any material effect. Now, specifically this feature of the system is in place, if I have any maintenance, then we hit the expense. But until it became operational, it was all pre-operating, so account booked in CapEx.

Q - Rafael Frade {BIO 16621076 <GO>}

Okay. That's perfect. Thank you, Wilson.

A - Wilson Olivieri {BIO 17325685 <GO>}

Thank you, Rafael.

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Operator

There are no further questions. I would like to turn the conference back over to Mr. Olivieri, the IRO, for closing remarks.

A - Wilson Olivieri {BIO 17325685 <GO>}

So, again, I'd like to thank you all for being with us here, Alex, Grace and the whole team with Mauricio that is following us from Portugal. And again, as usual if there is any further questions, please just call us here. We'd be happy to help anytime. Thank you.

Operator

The conference has now concluded. Thank you for attending. You may now disconnect.

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