

Q1 2018 Earnings Call

Company Participants

- Grace Cury de Almeida Gonçalves Tourinho, Chief Financial Officer & Investor Relations Officer
- Pedro Henrique Rocha Nocetti, Investor Relations Manager

Other Participants

- Marco Calvi, Analyst
- Olivia B. Petronilho, Analyst
- Rodrigo Gastim, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, thank you for waiting. Welcome to Qualicorp's Conference Call to discuss the results of the first quarter of 2018. We have here today, Mrs. Grace Tourinho, CFO and IRO; and Mr. Pedro Henrique Rocha Nocetti, IR Manager. This event is also being broadcast live via webcast and may be accessed through www.qualicorp.com.br/ir where the presentation is also available.

We also inform you that this will be recorded and that you will be listening-only mode during the company's presentation and then we have Q&A where more instructions will be provided.

Now, I give the floor to Mrs. Grace Tourinho who is going to open this conference.

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

Good morning all and thank you for the presence. Before I talk about the results themselves, it's important to emphasize that it's being reported based on IFRS 9 and 15 enforced from January 1, 2018 the operations and most important ones are in revenue. What was previously reported in revenue were net to allowances and (00:01:43) costs and where we have financial reversals (00:01:47) of Affinity contracts in losses. We will be looking at historical losses instead of waiting for 60 days.

And also in commission for new sales that's been amortized for 24 months, what's important here is that when we did readjustments, we did an adjustment within the result of the company for you to be visualize the other four months that are being amortized. So we look for the costs (00:02:26) of all the acquisitions in the last 24 months to see the total. So amortizations will now be more linear in our balance. Pedro will give you more

details on the insight (00:02:40) of each line. And also we have to report that we look back at last year and we follow the same rules in 2018, so that can be comparable.

Now going to slide 3 to talk about our indicators which a net revenue closer (00:03:03) to the quarters that have compared, the levels (00:03:07) were similar to last year, EBITDA BRL 237 million. Even after delivering more than BRL 240 million to our shareholders in dividends and re-acquisitions, we maintain the same level of net debt results of our swing in (00:03:26) operational cash flow and, thereas, makes us comfortable to invest is in more of the organic growth of the company as we have been doing. And the results should be seen from the second quarter of 2018.

Also in terms of expenses with sales campaigns or even inorganic, capturing opportunities of acquiring backlogs as we have in last two quarters, and also to keep paying dividends to the shareholders as we did yesterday, completing 100% of profit in 2015. So this is the fourth year that we distribute 100% of the net profit of the company. Our focus is to grow and make this company even more efficient. And now I give the floor to Pedro.

Pedro Henrique Rocha Nocetti {BIO 20904123 <GO>}

Thank you, Grace. Good morning, everybody. Thank you for participating on this conference. I would like to start on slide 4 talking about our portfolio that has been something we have paid much attention to and the investors have as well. I emphasize here improvement in the absolute number level of churn. So when you look especially through the first quarter of 2017 to compare, you can see that we decrease the absolute numbers 7% of our churn, and that is an improvement in the macro scenario as well as competition scenario that's more favorable for us to keep our customers. And this has been done in a very intense way by the company. Simply as been shown in (00:05:18) results, we believe that we'll be able to improve the churn as compared to 2017.

In relation to gross ads, it grew as compared annually and sequentially, and we see a participation of 20% of our segment Clube de Saúde health club. I want to emphasize here some points that will explain better the performance of our gross additions. We had a new entity coming in with about 18,000 lives in the portfolio It's part of the business of the company, not only to include penetration within the companies or the entities that we already have, but also bring new organizations to business. So these 18,000 lives, I emphasize, this is organic, this is merit of the operation.

Additionally, to this organic gross adds, we had backlog acquisition of 18,000 lives in the first quarter. And you can say that after many quarters losing lives, we increased 11,000 lives. It's important to emphasize in this moment, following the second quarter of the company, our levels in April indicate that it's positive. So are being able to sell more, invest in campaigns, as I'm going to emphasize more later, and we have been able to keep our customers that is (00:07:04) giving us a positive figures.

Explaining the other segments of the company, other products, we have a reduction of about 220,000 lives in other products, but this is insured lives that left the backlog, and the revenue here was low. And I also emphasize the reduction of top management

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backlog. It's less than 1% of (00:07:42) the company in the last month. Then finally in small and medium-size business, you see a large increase in lives. And we had the acquisition of Vision Med that we emphasize that we acquired, but this activation (00:08:00), so to say, was this year.

So let's see slide 5 and talk about revenue. As Grace mentioned previously, we have IFRS 15 affecting revenue, where we had in our revenue by titles of agreements, nowadays, they get from the costs (00:08:28) with royalties what means that the base (00:08:32) of revenue decreases, but there's no change in gross profit. There is no changes in the gross profit. This is very important. What we no longer have in revenue, we will have in less costs.

About the first quarter and the net revenue, we have little comparison because of this top management incorporation that we (00:09:08) have in the revenue that comes from Golden/Vision Med. In Affinity, we have a smaller mean backlog throughout the first quarter, especially when you compare to the previous quarter, although we have closed the first quarter with 11,000 lives more than compared to last year. In average, we worked with less lives, this is why the net profit dropped just a little bit.

Now slide 6 in relation to costs, emphasizing that we have a smaller baseline or smaller bases, you can share (00:09:55) the revenue that we reported previously. So where you saw repairs (00:10:02) of around BRL 50-some million, now you see around BRL 24 million, BRL 25 million each quarter, which is the result of yield (00:10:13) taken from these costs what was coming in as revenue.

The gross margin in the first quarter grows where we could decrease (00:10:26) because of what we did as well as last year and also because in 2018 we had an impact with rescissions and demissions (00:10:36) in the first quarter. Something that's important to explain to you, I believe that it was a question for many of you, this business and the expenditure with outsourced people, when you compare 2018 to the first quarter of 2017, it increased.

And this increase, if you see the other slides, was compensated because we have a drop in administration expenditures. And this is because in third party, we started to do this. If we consolidate outsourced personnel in the administration, you'll see that we save about 12% if you compare the years, because we have less explanatory and legal business and also because we internalized the health club, the Clube de Saúde, that what we did in the second quarter of 2017, which will have impact this year also. In the graph that you see, you can see the profits (00:11:49) every quarter, consistent evolution continues even in a scenario as I emphasized. The net profit is - net revenue is a challenge, but we could grow margin.

Now looking at administrative expenditures, continue to look, if you check the recurrent one, that decreased 2% if you compare to our previous year. If you compare to the fourth quarter of last year, it was 21%. I have to emphasize that in the fourth quarter of 2017, we have negative effect because of regulatory contingencies, but did not repeat this last quarter. As far as (00:12:40) outsourced people, the reduction's compensated by the

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increase in costs, generally speaking, expenditure was staff (00:12:53). We have savings, because we had a review and our workforce, and less expenditure were the demissions (00:13:04). If we check all of the expenditure along the consolidated (00:13:09) administration costs and commercial costs, we have savings of more than 21% as compared to 1Q 2017. Even if you analyze the first quarter of last year with expenditure we had with rescissions (00:13:26) we still saved 13%. So this is expenditure (00:13:32) adjustment. This is to turn the company more efficient.

And on the other graph, we emphasize once again the effort of maintaining administrative expenditure at reasonable levels. I can say that thanks to what we did up to this point, we are confident that we can grow gaining a margin.

And now look at slide 8 commercial expenditure. As far as that is concerned I have to emphasize once again the impact of IFRS 15 that the changes the way that we are showing this thing. (00:14:16) Because of this new norm, we no longer recognize commissions because of new sales internally and externally in the competence of sales, and we capitalize that and amortize for 24 months. So as Grace mentioned, what you are seeing in the first quarter of this year is amortization of the sales we had in the last 24 months. Likewise in the first quarter of last year, you see the sales of March 2017 and 24 months back.

As a way of guaranteeing that we can compare and also can facilitate analysis of the operation, we maintain amortization of (00:15:12) new sales that's (00:15:14) in the commercial side. If you analyze why, this - well, this will cause a little difference in consolidated of commercial expenditure. Before we have by competence, now we have amortization, no longer a commission but amortization. And for you to - or have this in mind (00:15:39), if we extend commissions for new sales, we would have results instead of BRL 18 million, BRL 14.9 million; instead of BRL 18.8 million in the fourth quarter, we would have BRL 16.4 million; and instead of BRL 17.4 million in the first quarter last year, we would have BRL 17.3 million.

And to explain a little bit the business, the commissions of third-parties that you see today in our results statement, are considered only recurring commissions and co-brokerage, which is a policy of payment that we do for our external sales that is linked to the performance of these channels of sales, considering sales retention, how much they are working for the company and for the retention of sales for the company. And you see a reduction in your comparison. It's important to give your message especially when you observe sales campaigns.

I'm not afraid of investing, we are willing to spend more as long as we have results. And this line will grow in the second quarter, especially if you compare 2018 versus 2018 (00:17:17). As I emphasized before, we are selling more, we are improving our sales performance. In order to stay on that, we're going to spend more, but we will have results and we will grow.

(00:17:34) I give the floor to Grace. Thank you. And I'll come back to for Q&A.

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

Thank you, Pedro. Now slide 9, which is the provision for doubtful debt, it's important to mention that due to IFRS 9, we report not only effective loss, but also the loss we expect based on historical aspect in terms of delinquency. So the value that was repaired (00:18:07) for investment was also adjusted so that we can compare information.

Now talking about the provision for doubtful debt, it improved considering the last semester. What is natural due to the seasonality of the business, when we compare to the first quarter of last year, it's worth reminding that the impact of customers who cancelled because of that (00:18:36) that occurred in the fourth quarter of 2017. When we had many cancellations in PDG (00:18:44) was comparable to this quarter, we expect for better values in the next quarter.

Slide 10, financial results, basically, if you have in mind (00:18:57) that in October 2017, the company signed a term of adjustment of performance (00:19:02) with the national agency, where we can no longer fine the customers in 10% because of delayed payment, but now it's 2%. This is why our revenues accelerated from the fourth quarter of 2017, as compared to the first quarter of last year.

When we talk about financial expenditure, we have the effect of no longer have Aliança we no longer carry the cost of this size of (00:19:35) paying for Aliança, the size of reduction in SELIC that helped to reduce expenditures with this debt (00:19:45).

Now slide 11. We'll be talking about EBITDA. In order to compare as well as to report in a more reliable way what we were used to do with you, we reorganized EBITDA after IFRS 15 with amortization of the commissions for new sales. Since we accumulate 24 months and we amortize three months of the quarter, there will be no large difference, not even after advancing (00:20:20) IFRS 15.

So on the result itself, it's important to demonstrate the maintenance of EBITDA in relation to the first quarter of 2017, here showing what our business is like. We are very efficient. Efficiency was able to compensate not only a smaller revenue because of bad debt, but also a worsening of EBITDA (00:20:48) on that quarter. We have continuous work (00:20:55) on daily basis in order to contain costs and render the company even more efficient by 12 (00:21:04). Comparing the first quarter of 2017 and 2018, we have mentioned that the drop of 7% annual is in part because of tax benefits that were obtained in the beginning of 2017, but not always we can repeat every quarter because in this benefit, we brought for the first quarter of 2018 and 2017, the effect of the last five years.

We had it all in the first quarter of 2017, this does not happen in 2018, but a small rate (00:21:42) will happen that has to do with a period of 2018. So our tax rate close the first quarter of 2018 in 37% as opposed to the fourth quarter of 2017 that was 33% and 28% in the first quarter of 2017, that was understood as positive effect. Part of this growth is due to the incorporation of Aliança that we had in December. They are (00:22:11) no longer

distributed according to the present (00:22:14) profit and now it's the real profit, true (00:22:18) profit.

And we may say that we are setting works to turn Qualicorp S.A. in an operational company that will - in a definitive way will bring to the group a structure of capital that's even more efficient, resulting in increasing the capacity of distribution of interest on company capital, BRL 1.8 billion of social (00:22:46) capital. We are going to use the expenses of Qualicorp, which was something that we didn't do before, and will improve the effective tax rate not in a punctual way. And we had around 13 companies, we reduced to 9, and after the incorporation of Aliança, we have 7 now. With this double liberation (00:23:16), we have 6 companies.

From the standpoint of did it work (00:23:21), this helps a lot, administration-wise. It simplifies operations, control, audits and now the legal part that is very cumbersome. We took the (00:23:35) first half, which was the approval in the board meeting on May 8 of incorporation of Quali Corretora and Quali S.A. We will soon becoming a family, and I count on the support of all the shareholders to participate in order to make this incorporation happen until the end of the year.

Slide 13 in relation to CapEx and indebtedness. We have mentioned that by the end of March, the acquired Administration (00:24:12) along with ASBEN Corretora acquired almost 11,000 lives that were addition to the portfolio of Affinity with a annual growth revenue around BRL 10 million or the net debt is stable in relation to December 2017. But I remind you that although stable, we paid BRL 150 million dividend besides impacting more the (00:24:37) BRL 94 million in re-acquisition of shares. It's a part of the profit (00:24:43) that we cancelled at the end of the quarter, the total of shares that we maintained in treasury and that were acquired during three different programs of re-acquisition, at median price of BRL 21.

Now our next slide of cash flow that has operational cash flow after CapEx more than BRL 250 million (00:25:09) for the first quarter, growth of almost 10% as compared to the first quarter of 2017. Our ROIC, 47% in the first quarter. So, a huge ROIC considering investment that we did in a very rigid way.

So, thank you all and now we go to Q&A.

Q&A

Operator

Thank you. We'll start now Q&A. The first question Marco Calvi from Itaú Corretora. Go on please.

Q - Marco Calvi {BIO 19854632 <GO>}

Good morning, I have two questions here. The first one in relation to this new avenue (00:26:26) that has been appearing (00:26:28) in terms of investment of acquisition of

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backlog. Could you share with us any figure, any study that you did on the potential of acquisitions, what can we expect in relation to that for this year or the coming year? Could you share figures with us?

And second question has to do with improvement of margin in EBITDA, because it's amazing the improvement of EBITDA margin even having the pressure of taxes. Could you talk about where do we stand in relation to what you have delivered in 2017? In my opinion, it was great performance. And where do we stand, where can we reach considering a drop in expenditures? Thank you.

A - Pedro Henrique Rocha Nocetti {BIO 20904123 <GO>}

Good morning, Marco. This is Pedro. And backlog acquisition, we're opened, it's much more a matter of what the market presents to us. We have cash flow generation that allows us to capture these opportunities. And I will not (00:27:53) capture money (00:27:55) the company. So these acquisitions, if we look 18 months back, we did some. But of course for that, we looked at many, and you have to look very carefully, not just the profitability - momentary (00:28:16) profitability, but also the health of the backlog.

Because for you (00:28:20) to bring a backlog for the company that appears to be profitable, but as time goes by, it doesn't work, I am going to have a better relationship with the operator and also the health of the backlog is going to be jeopardized. So we don't have nothing in focus right now, but opportunities come up and we will require whatever is interesting for the company, not only in Affinity. For the quarter, we did affinities in small and medium companies and we're open to go forward.

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

Question number two, Marco. Thank you for your question. It's a constant work (00:29:12) of the company. Honestly, this year, we have huge challenge not only because of the first quarter that we reduced something in the first quarter and (00:29:27) second semester, which is expected, we expect a reduction of the rate from 10% to 2% of fines and this will impact. And our challenge this year is to renew and minimize this impact as much as possible. The organization knows that we have huge challenge, but we also have to look for newer things. The company has not cut (00:29:56) I'm very cheerful, I think bonus has been given (00:29:59) huge support in (00:30:03) and people who are working and bringing new initiative for me (00:30:08) to become even more productive.

So we have the huge road ahead, but to anticipate anything now it's too early. What we can promise is that we will probably compensate the negative impact that everybody is aware of. What we would like to do and what we're looking for is to bring positive result after all this work. But we'll only be able to visualize this on the third quarter, so I would like you all to trust me and wait a little bit, but we are doing our homework rest assure.

Q - Marco Calvi {BIO 19854632 <GO>}

Okay. Thank you.

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Operator

Our next question comes from Rodrigo Gastim from BTG.

Q - Rodrigo Gastim {BIO 19694950 <GO>}

Good morning. Two questions here. First one in relation to the dynamics for the second quarter, how much effort you are doing in searching new products that are more accessible when you renegotiate with a client. I'd like to know first, how is the construction of new products with the operators is going? Do you expect that new products will be more accessible for the customers so we can improve? And also, a new readjustment between 5% and 18% and how much do you intend to pass over this year? How can the churn - will impact on the third (00:31:55) quarter?

And the second question is, Grace, could you explain a little bit better, I didn't quite understand, the incorporation of the brokers. Are you going to have fiscal optimization (00:32:07), and could you explain step-by-step how this is going to be done? And where - what's the magnitude of the benefit that this would bring to the company? These are the two questions. Thank you.

A - Pedro Henrique Rocha Nocetti {BIO 20904123 <GO>}

Good morning, Rodrigo. This is Pedro. In relation to these dynamics, right now, I have not closed readjustments with the operators. Some of the most important ones have not been included yet. The first adjustments that we are getting feedback are better than last year's. Of course, as you mentioned, they are better than last year. So I believe that yes, this would give some relief. But in a scenario where you'll have an economy that isn't recovering, readjustment always hurts the financial health of the client and their capacity to remain in the company.

As I mentioned, we are taking a huge step in relation to our products. For some clients, we already have, in others, we are in the final phase of negotiation. So I believe for some clients who have products for before (00:33:35) adjustment, in some cases, we have the product there (00:33:38) between July and August. But we are preparing ourselves very well for this readjustment period, not only new products, but also with the retention channel that's prepared. So I believe that our capacity of being able to keep the clients and increase sales, we can improve this performance throughout this year of 2018. And about the other part of your question, Grace will answer.

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

The idea of not having a holding is that the holding does not have any fiscal efficiency. I pay interest on company profits for holding, but I cannot pay from the holding to the shareholders, where we would have much more benefit. Because I don't know if you recall in 2015 (00:34:38), we reduced the capital of the companies of the holding, where the money of the company was taken to Qualicorp S.A. to be able to reduce capital and be more efficient financially, a capital structure that will be more efficient.

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So what happens? The fact is when I take the holding aside and I have an operational holding, every cost (00:35:08) of holding, I don't use them. I don't use them because there's no billing (00:35:16) there. So we will be able to optimize functioning. And in addition to that, I will have a social (00:35:28) capital within the holding of BRL 1.8 billion, so I'll be able to pay interest on the company's capital. There is a return of almost BRL 50 million. So, this will benefit - this is the first step to give us muscles for us to do more interesting things in the company.

So it's a movement that makes sense. It's very difficult to be done because we're talking about a company that has open capital, I will have to change the statute (00:36:11) of the company, including the possibility of it also working as broker. So you have to talk to (00:36:18), to the shareholders asking for the authorization. It's a bureaucratic time that we have to follow and it's huge. It takes around 150 days and we'll try to do this as fast as possible, but as fast possible there is a lot of red paper (00:36:39) involved that, frankly speaking, the company will have more flexible muscles to pay dividends and have a capital structure that's much more efficient. This is the first step that we achieved this year. Did I answer your question?

Q - Rodrigo Gastim {BIO 19694950 <GO>}

Yes, very clear. Thank you. Very, very clear. Only one thing on the first question. You have mentioned in the beginning that April was better than last year. So, you recovered sales. In April, sales accelerated, so you see improvement and this is only the 11th, but do you have any forecast for May or anything real-time so we could have a look of what's going to happen qualitative-wise as far as sales is concerned? Could you share with us?

A - Pedro Henrique Rocha Nocetti {BIO 20904123 <GO>}

Pedro, again. Talking about April preliminary data, to compare April, April was much better than the monthly mean sales of the first quarter, in turn, did not get any worse throughout April. So I'm talking about a positive (00:38:09) April within these preliminary figures. May, the first glimpse I have for May is that sales performance will be sustained. Of course, I don't have May's churning (00:38:23) as yet, but the quarter is towards maintaining its positive performance. June is a month that always comes with lots of expectation. Commercial appointment always implements in June. It's the month that's just before readjustment, so I believe that we have a good growth perspective for the second quarter.

Q - Rodrigo Gastim {BIO 19694950 <GO>}

Thank you. That was very clear. Grace, thank you for your answer too.

Operator

Next question from Olivia Petronilho from JPMorgan.

Q - Olivia B. Petronilho {BIO 19090195 <GO>}

Good morning, Grace. And Pedro, my question is you have commented that April was better. What's your expectation? How do you - you think of a scenario of increasing prices.

Bloomberg Transcript

What do you expect for the more accessible plans, what are the roles of these plans as far as growth is concerned? And the dividend, if we assume that there's recovery, how much do you see today as target to leverage the company? How much could we think as far as leveraging the company?

A - Pedro Henrique Rocha Nocetti {BIO 20904123 <GO>}

Hi, Olivia. For 2018, I believe that we are putting efforts in sales. We are better structured in relation to retention of clients, according to the operator - or putting strength in the operator and internal work. But I cannot ignore that the second quarter, especially talking from July to October, it's a challenging period, because it's the adjustment period. So we'll try to gain some fat in second Q. And the effort is huge, but I cannot guarantee that we're not going to have any losses. We are working entirely (00:40:43) in the company with this extract (00:40:48). It means that we may enter with 20,000 lives more or less. It is a scenario that we are working with right now. I believe that leveraging, Grace will talk about that.

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

In relation to dividends, because of the huge - (00:41:12) cash flow that characteristic of the company, we don't need much CapEx or much investment. We don't have (00:41:26) as people say. So for us to pay 100% of dividends based on interest on company capital plus some acquisition in dividends. In relation to leverage, this is the second point, other structures that we've been doing in acquiring is to render the company with the possibility of better leverage. But the company is too conservative, it's important to have this in mind, there is a net debt of around BRL 130 million, I don't believe that it wants more than one-to-one leverage, that's what it does annually.

So I'd say that we are far from acquiring that, and this will be step by step. I would say this would be step two. But we are still taking step one, which is to work on our societary restructure (00:42:29) in order to take the second step, but it's not a promise as yet. I have to go beyond many internal approvals in order to conquer that, but it's normal that it will eventually happen. We'll be working on that, but we still have to take step one, societary (00:42:51) restructure for this bunch (00:42:54) to be operational, takes around 150 days.

Q - Olivia B. Petronilho {BIO 19090195 <GO>}

Okay. Thank you.

Operator

Thank you. There are no further questions. So I'd like to give the floor to Grace Tourinho.

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

Once again, I would like to thank you all for being here. I know this is a quarter that has some accountable issues involved. Nevertheless, we're trying to demonstrate to you the best way possible and all the readjustments that were done, we could have simplified adjustments, but we're trying to do it in a way that we could compare and bring to you the

same results with the same foundations that we had previously. And we were successful in relation to that. The impacts are very small in relation to adopting the norme (00:43:55) 15 as well as 9.

Any questions you have, please ask us. We are here at your disposal to explain anything that maybe was not explained so well. Okay? So our team here is available, so am I for you. So, please, if you have any question, feel comfortable to call us. Thank you and have a great day.

A - Pedro Henrique Rocha Nocetti {BIO 20904123 <GO>}

Thank you. Have a good day.

Operator

Thank you. Teleconference of Qualicorp is over. Thank you for your participation and may you have a good day.

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