

Q3 2010 Earnings Call

Company Participants

- Luiz Kaufmann, Chief Executive Officer

Presentation

Operator

Good evening, ladies and gentlemen and thank you for waiting. At this time we would like to welcome everyone to Kroton Educacional's Third Quarter 2010 Earnings Conference Call.

Today we have with us Mr. Luiz Kaufmann, Kroton's CEO.

We would like to inform you that this event is being recorded and all participants will be in a listen-only mode during the company's presentation. After the company's remarks are completed there will be a question-and-answer session. At that time further instructions will be given. [Operator Instructions].

Also today's live webcast, both audio and slide show, may be accessed through Kroton Educacional's Investor Relations website, at www.kroton.com.br/ir by clicking on the banner Webcast 3Q10.

Before preceding 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 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 company and could cause results to differ materially from those expressed in such forward-looking statements.

Now I'll turn the conference over to the CEO, Mr. Luiz Kaufmann, who will begin the presentation. Mr. Luiz, you may begin your conference.

Luiz Kaufmann {BIO 1428444 <GO>}

Hey, thank you. And thank you all for joining us for today's conference call in which we will discuss Kroton's results for the third quarter of 2010.

We also have with us today, taking part in the call, Renato Friedrich, our Chief Financial Officer; Rodrigo Galindo, Chief Operating Officer of our post-secondary segment and

Carlos Lazar, Head of Relations.

Starting the presentation with slide three, I am pleased to inform you that the company's results already reflect in a very consistent manner the actions implemented during the process of integration of IUNI and the turnaround of Kroton. During the past several months we have implemented the main projects of our PMI, of our post-merger integration plan, including a new academic model for the post-secondary segment, and new organizational structure, unified financial management systems and an integrated planning and control process.

With these initiatives we have already captured synergies even more than R\$ 35 million per year. The result for the third quarter and expansion with the financial performance for the months of August and September already reflect the new operational conditions of the company. It's important to observe that most of the adjustments, especially related to the work force optimization occurred in July. In other words, in July our cost structure, but have not been optimized.

Moving on to slide five, some remark from our detailed business. With regard to primary and secondary education, please remember that the new associates schools and student intake in this segment takes place only at the start of the year. And that most of the revenue in this segment accrues in the first quarter, when educational materials are delivered to associate schools.

Our network of 720 associated schools serves more than 26,500 students, 24,000 of whom are shared by Projecta, our brand for the public school sector. In the third quarter we continued to implement new educational tools designed to endow our teaching and learning -- which increasingly distinctive competitive advantages.

These initiatives include following: introduction of our new education portal; our Robotics Project in partnership with Lego; digital classrooms using digital whiteboard and individual netbooks for each student; the Mind Lab project, which involve board games and other activities to help students develop brain power; and finally, a 3D digital library with more than 3,500 3D mathematics, physics, chemistry and biology lessons made possible by an exclusivity agreement that we signed on September with Designmate, an Indian company that is a leading developer of e-learning software.

The agreement we made enable us not only to make significant enhancement to the quality of teaching and learning in associates schools, but also to generate additional revenues from licenses of the 3D content library to third parties.

In slide six we highlight the evolution of post-secondary students. Our student intake in the mid year end of exam was over 10,000 students. This was what more than we had expected and budgeted for. Our student intake in mid year is typically lower than at the start of the academic year in January and in the second half of the year, the average number of students usually falls below the first half. In the third quarter 6,400 students graduated and we had a similar drop-out of students will be in the normal range for this

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year. The resulting final balance for the quarter was 85,500 students in the post-secondary segment.

Slide seven now; in May of this year, the Ministry of Education introduced new rules for the federal government instituted loan program, the new FIES with significant improvements in the terms and conditions for student loans. Then in June with politics and intense communication program to inform our students, mainly delinquent students and students with a high wish or probability of dropping out about the conditions of the new loan program. And as you can see from slide seven, the number of student loan contracts signed since June through the new FIES has grown very positively.

Kroton ended the quarter with almost 5,000 contracts signed in addition to 3,000 contracts that are awaiting approvals. Also in October, the federal government launched a new guarantor fund enabling students from low income parents to apply for loans without requiring cosigners and thereby facilitating access to the FIES program. Kroton has already appeared to the guarantor fund scheme and expects to reach over 10,000 contracts by the end of the first quarter of next year.

Slide eight details the non-recurring costs and expenses relating to the acquisition and integration of IUNI, totaling R\$ 16.7 million in the quarter. The broad majority of these expenses are related to severance payments resulting from the very big work force optimization concentrated in the month of July. The adjustment process was more severe than originally planned benefiting the company's financial results. The amount of non-recurring expenses, positive EBITDA amount was going to reflect. We do not foresees significant non-recurring cost and expenses in the reminder of the year.

On slide nine, the adjusted net revenue rose 68% in the first nine months compared to the corresponding period of last year, reaching R\$ 469 million. This growth mainly reflects the absorption of IUNI. The adjusted net revenue rose 92% in post-secondary and 17% in primary and secondary education.

Revenue remained stable between the second and third quarters of this year, despite the reduced contribution from primary and secondary schools due to the seasonality in these segments. The average monthly post-secondary commission was R\$ 500 in the quarter and the annual commission per students for the primary and secondary segment as previously announced was R\$ 249.

As shown in slide 10, profits recurring gross profit excluding non-recurring cost was on R\$ 154 million in the first nine months and 53 million in the third quarter. The structuring actions undertaken by the company resulted in a reduction in the cost of services, especially for faculty in the post-secondary segment. Consequently gross margin in the third quarter was 34%, up 11% compared in the second quarter. In post-secondary operations, which were mostly impacted by restructuring, gross margins went up to 32%.

Kroton's operating expenses in the third quarter, in slide 11, amounted to R\$ 33.8 million, excluding non-recurring expenses of R\$ 5.6 million. The very positive highlight was the

reduction in personal and administrative expenses, which fell from 15.3 million in the second quarter to 10.2 million in the third quarter, thanks to work force optimization.

Slide 12 shows the provision for doubtful account amounted to R\$ 7.4 million in the third quarter, down 11% compared with the second quarter. The reduction in provision for doubtful account was due to a reduction in delinquency rate among all secondary students as well as the positive effect of the FIES student loan program. The ratio between PDA and adjusted net revenue in post-secondary previous quarter fell to 5.3%. In the primary and secondary segment, PDA was 0.7% in this quarter.

The company reversed the negative EBITDA of the previous quarter as shown in the slide 13, thanks to the results of its restructuring plan. Recurring EBITDA for the quarter was R\$ 19 million. It defines non-recurring cost and expenses which also excludes expenses that are related to start-up and Greenfield project for new units. EBITDA for the quarter would be R\$ 22 million, even for fears that it may restructure, new restructuring cost structure was due in place in the month of July. It reached EBITDA margin in August and September after restructuring was 16.3%.

Slide 14 shows that the adjusted net result improved from a net loss of R\$ 11.8 million in the second quarter to an adjusted net income of R\$ 7.9 million in the third. Adjusted net income in the first nine months of the year totaled to R\$ 19 million.

Turning to slide 15, we can see that the new FIES student loan program combined with a more rigorous strength and collection quality has already benefited our receivables portfolio. Accounts receivable from students in the post-secondary segment fell from 60 days, compared to 99 days at the end of the third quarter of last year.

Slide 16 shows, a breakdown of our CapEx. Kroton invested R\$ 10 million in the third quarter seeing 3.6 million in computer equipment and libraries, 1.4 million in systems development and software licenses, 1.8 million in laboratory and similar equipment and 3.2 million in expansion of our physical facilities.

The total invested corresponds to 6.3% of the company's adjusted net revenue in the quarter. It's important to mention that we are having a strict control of CapEx, and we are also having a very vigorous policy on the opening of new branches. All courses are now weighted from an economic standpoint taking in to account the full cycle, natural dropouts during the course and additional expenses that are very usually required -- last few years.

As you can see in slide 17, the company ended the third quarter with a cash position, amounting to R\$ 41 million. We maintain a lower level of debt, total debt is now R\$ 24.8 million, so that the net cash is a positive R\$ 16.2 million.

Slide 19 sums up our management agenda for 2010, which we are following strictly. Having completed the integration of IUNI and with the new academic model and stable operations the company is now focusing on a very comprehensive strategic review, which includes redefining the cost portfolio and pricing policies in order to enhance student attraction and retention and also in order to improve the company's profitability.

In 2011 we also expect to resume our acquisition process.

I would also like to confirm our earnings guidance to the market. The target that we have announced in the second quarter will be surpassed. We expect the pro forma adjusted EBITDA for 2010 to surpass the previously announced target of R\$ 60 million. We also expect that the annual EBITDA run rate based on the August-December period will surpass the R\$100 million through the year what we have previously indicated.

Several additional initiatives to keep continuously improving margins are currently being implemented. These include a comprehensive restructuring of interest structure between different units to reduce the rent cost. Our course portfolio redesigned to gradually eliminate courses with negative margins and improve margins in general continues through redesign and scale gains in administrative costs. With these initiatives we expect EBITDA margin to reach 22 to 23% by 2012, 2013.

Before closing and opening up for questions and because this is my last conference call as CEO of Kroton, I would like to thank everyone for your confidence in our company. As you may know, my contract with Kroton, which expires on December 31 had clearly defined objective, the acquisition of IUNI, the post merger integration project, turning around some problematic units, restructuring the organization and building a strong and potent management team.

Having achieved all of these goals, I am very pleased to announce that Rodrigo Galindo will takeover as CEO on January 1. Rodrigo is currently the Chief Operating Officer of the post-secondary segment. He has a long and proven experience in higher education as the CEO of IUNI before its acquisition. In the months since the acquisition, Rodrigo has played a key role in coordinating the integration project and has my respect and admiration as well as the admiration of our Board and employees. I'm really confident that this lead to highly successful in leading Kroton's continuing expansion.

So, now with no further delay, I would like to move straight on to questions and answers. Thank you very much.

Questions And Answers

Operator

Ladies and gentlemen, we will now initiate the question-and-answer session. [Operator Instructions]. This concludes the question-and-answer session. At this time I would like to turn the floor back over to Mr. Kaufman for any closing remarks.

A - Luiz Kaufmann {BIO 1428444 <GO>}

Okay. Thank you very much. If there are no questions, I thank you very much for your participation. And we will remain at your disposal for additional information as and when necessary. Thank you very much. Have a good day.

Operator

Thank you. This does concludes today's presentation. You may disconnect your line at this time. Have a nice day.

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