Q2 2017 Earnings Call

Company Participants

- Carlos Alberto Bolina Lazar, Investor Relations Officer
- Frederico Brito e Abreu, Chief Financial Officer
- Rodrigo Calvo Galindo, Chief Executive Officer

Other Participants

- Rodrigo Gastim, Analyst

Presentation

Operator

Good morning, ladies and gentlemen, and thank you for waiting. At this time, we would like to welcome everyone to Kroton Educacional's Second Quarter 2017 Earnings Conference Call. We would like to inform you that this event is being recorded and all participants will be in listen-only mode during the company's presentation. After the company's remarks are 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 slideshow, may be accessed through Kroton Educacional's Investor Relations website, www.kroton.com.br/ir, by clicking on the banner Second Quarter '17 Webcast.

The following presentation is also available to download on the webcast platform. The following information is available in Brazilian reals in accordance with Brazilian corporate law and Generally Accepted Accounting Principles, BRGAAP, which now conform with International Financial Reporting Standards, IFRS, except where otherwise indicated.

Before proceeding, let me mention that forward-looking statements are based on the beliefs and assumptions of Kroton management and all 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 Kroton's CEO, Mr. Rodrigo Galindo, who will begin the presentation. Mr. Galindo, you may begin your conference.

Rodrigo Calvo Galindo {BIO 17238232 <GO>}

Good morning, everyone, and welcome to the quarterly earnings conference call of Kroton Educacional for the second quarter of 2017. With me today, our IRO, Carlos Lazar; and our CFO, Frederico Abreu.

During today's presentation, we will highlight our results in the second quarter, which were very consistent and point out the efficient and the management actions that supported this improvement and demonstrate operating indicators that improved significantly, such as student base, dropout rates and delinquents, all of which will attest to the solidity and resilience of our operations.

But before we go into analyzing the results, I'd like to present a more structural topic. Right about the strategic decision for the company that true positively impacted these challenges -- or the company's challenges in the years to come. Our message from the management in the earnings release today addresses this topic, but I'd like to reiterate it here in the conference call.

We believe the academic and financial results achieved by Kroton in the recent years showed that there are three pillars of success: quality, operating efficiency and growth, with an adequate strategy that added a lot of value to the company, and we continue to see a lot of value in these levers: quality, operating efficiency and growth.

In terms of the first driver, quality, there's two opportunities to improve the student academic experience, which leads to increased quality and the employability for our students, reinforcing our competitive advantages and the value proposition for the student.

Regarding growth, we continue to see several opportunities for organic and inorganic growth in all businesses, on-campus undergraduate, business learning undergraduate, graduate, continued education, and primary and secondary education. During the presentation, we will add a bit more color of these opportunities, but growth is certainly part of Kroton's plans for the years ahead.

In terms of operating efficiency, one of Kroton's trademarks, we are certain that efficient leverages we have at the company today, and we will discuss it more -- in more detail during this presentation, will be more than sufficient to offset the effects from margin's pressures that the compression of the average student base, an increase in PEP will cause in the next two years and the results delivered in 2017 attested to that.

Therefore, operating efficiency is a true part of the company's DNA. However, we cannot settle and think that the success factors that brought us this far will be sufficient to guarantee success in the future. For that reason, we are seeking to anticipate changes in this scenario and the current transformations in the world, an increasingly digital world. Thus, we are inaugurating today a new phase in our company and starting our journey towards digital transformation.

This does not mean that growth, quality and operating excellence will no longer be relevant in this new phase of the organization. Quite to the contrary, they will be valued even more and help materialize this digital transformation, and we think they will be even maximized with the digital transformation we are seeking. Understanding the meaning of digital transformation is also important. Being digital is not simply offering more technology. We are already doing that.

Today, we use cutting-edge technology to provide educational services, which we do very well. Methodologies like flipped classroom, technologies like adaptive learning, digital student -- our Digital Student Portal, our Digital Faculty Portal, our academic model, the KLS 2.0, and our employability project, Conecta Channel, are clear examples of how we already use technology to provide high-quality services.

But we believe that digital transformation is much more than that. Undergoing a digital transformation means changing the organization's mindset, creating an organization future based on agile management models and thinking digitally.

If we look around certain sectors of economy already has suffered the consequences of not taking business back and have been engulfed by new business models. In education, we have yet to feel pressure from the disruptive models that threaten the industry, but there is another reason to begin this journey now. We'll create the disruption in our industry rather than protect ourselves from it.

We have the opportunity to create a large-scale global case of digital transformation in an educational company, and we are taking on these challenges. We know this task will be neither easy nor short. It's actually a journey, a long journey, but we are confident that beyond this decision to protect ourselves from potential disruption of our industry, it will also bring opportunities to significantly improve the experience of our students to create new business opportunities in our extended core segments or adjacent business, increase the efficiency of our process and provide our students with increased quality and employability conditions.

Five years from now, Kroton will be a totally different company, a digital company that will be able to, through digital advancement, improve its key factors of success: growth, operating efficiency and quality.

Now let's see our operational and financial results for which I invite our Investor Relations Officer, Carlos Lazar.

Carlos Alberto Bolina Lazar {BIO 17238206 <GO>}

Thank you, Rodrigo. So let's move now into the analysis of the quarterly results. So please turn to slide four, which shows the operating pillars of -- which remained very strong. In our undergraduate base, we once again were able to deliver growth of 3% in the base despite the challenging macroeconomic and industrial scenario due to the constant efforts of our sales team, the actions under our retention program to reduce our cost and especially the quality of our educational work offering. As KLS 2.0 advances, the perception of quality increases and as more students experience our learning systems.

Starting -- so in the Distance Learning segment, the undergrad student base expanded 5% year-over-year to 516,000 students, and our comprehensive offering here of Distance Learning programs and formats ranges from 100% online programs that offer greater flexibility to enable our students to match their studies with their other activities and their other life -- and their lifestyle.

To the premium distance learning programs, which are more exclusive programs, such as nursing and engineering that demand more on-campus meetings and extend the offering of such programs to more remote locations. Considering the results of the two segments and the on-campus also had a very similar performance like the Distance Learning, the undergraduate base reached 933,000 students, expanding 2% year-over-year.

Turning to dropouts -- to dropouts, we were very pleased to report significant improvements in the dropout rates in both segments of 105 basis points in the On-Campus segment and 176 basis points in the Distance Learning segment. We continue to make progress in our retention program with two more projects implemented, the Retention center and also the project Sinfonia [ph] Sync [ph] Project. The retention center involves putting agents at units and dedicated call center for handling dropouts repeatedly when the students announced the plans to dropout and also particularly when they -- we identify through our predictive models that the student have a high probability of dropping out, all of which underscores the topics important to classes.

Meanwhile, the Sinfonia project, which formed a group of -- the second group actually in the second semester of last year and another one in the first semester of this year give the employees for all the levels -- for all levels of the company in the corporate site the opportunity to participate in all phases of the student's life cycle, accompanying their experience from civil admission exam to the classroom to better understand their reality and perceptions, which, of course, will help us to rethink and enhance our processes resulting in a better and a very interesting experience and also many improvements to gain from the insights from this group.

And last, we present the provision of the -- for dropthrough accounts, for the students paying out-of-pocket in our On-Campus and Distance Learning segment.

In the On-Campus segment, the PDA remains stable at 7.5% in quarterly comparison, demonstrating the adequate provision that we are putting now, of course, respecting the macroeconomic scenario that we are having in the country.

In the Distance Learning segment, PDA increased slightly from 8.3% in the first quarter to 8.5% in this quarter, with slight deterioration in the delinquency of new students.

Well, let's now -- enter now in the average ticket analysis in slide five. Starting with the On-Campus segment, the net average ticket in the quarter increased by 12.6% year-over-year from BRL760 to BRL866, benefit the year and the large part of improvement in the program mix with more health care in the near programs, combining also with the higher number of PEP students, which has the higher average ticket since they are not eligible for scholarships and discounts.

I should also mention that our scholarship and discount policy has been -- have become more restrictive and large in part have been succeeded by these kind of financing projects like PEP and PMT. And last, another factor supporting the higher ticket in the On-Campus was the annual tuition increase. So as a result, we ended this first half with an average ticket of BRL866 or 15.1% higher than the same period of last year.

The chart on the right shows the average ticket in Distance Learning, which fell 1.5% to BRL262, mainly due to recent FIES strategy of operating more temporary scholarships, especially now in the beginning of 2017. And now with, therefore, no impact in the average ticket result 2018, so we expect a recovery in 2018.

In the first half of this year, the average ticket in this segment was BRL262, increasing 6.2% year-over-year also by the higher number -- impacted by the higher number of the premium distance learning students that has a higher average tuition. So we can see that our operational pillars remain very solid with expansion in the student base, a higher average ticket in both businesses and a lower dropout rate, and above all, a stability in our PDAs.

So let's conclude this part and start the overview in our results. Starting with Slide seven, which we provide a summary of all segments. Starting with the On-Campus Postsecondary education. We had a net revenue growth of 10% year-over-year. And as I already explained before, the revenue growth was driven basically by the increase of average ticket and the stable figure -- the evolution of the student base.

Meanwhile, the gross income in the On-Campus segment grew by 15% with gross margin expanded 370 basis points. In addition to the revenue growth, this result was due to the continuous focus on efficient gains in our operations supported by the initiatives such as the increase of penetration of interactive courses, the rollout of the operation research software, the software that we used in the comprehension form classes; and the KLS 2.0 and besides the austerity measures to control costs, which included the renegotiation of contracts through the strategic sourcing project.

As a result, operating results from the marketing -- before marketing increased 10% with margin expansion of 30 basis points year-over-year. Higher pressure on operating margin from the higher PDA rate due to the growth of PEP and PMT student base, we managed to deliver a stable margin supported by the efficient and cost control initiatives mentioned earlier.

Remember that we are maintaining our provisioning policy of 50% for PEP and PMT until we have more representative samples of the delinquents of these students in the future. And as the students also are gaining more relevance in our base, we should continue to see some pressure in the operating margin, but that means that we will continue also to focus on the levers that we have already mapped and also develop new levers to mitigate the effects and continue through the path of delivering solid and very good results.

Let's turn now to the Distance Learning segment, which posted a net revenue growth of 10%, driven by expansion in the student base and also by the rollouts of the PMT in these segments. The Distance Learning growth revenue was 12% with growth margin expansion of 120 basis points, also driven by efficiency gains in the segment, which included the optimization of the tutor model and economies of scale, which more than offset the higher costs associated to the higher PDA and also the increase in the number of centers.

Another factor here helping to reduce the costs is the expansion of the base of students that uses the 100% web delivered since their cost structure is lower compared to the blended learning model. So this supported a 9% increase in the operating result before market and the margin decreased by 110 basis points mainly to the higher PDA related to the offering of PMT, which combined with the high delinquency in this segment, pressuring the result as explained.

Let's go now to the last part, the Primary and Secondary segment, where net revenue fell by 5%, reflecting the lower volume of book collection sales compared to a year ago. However, we are able to offset the decline and deliver growth -- income growth of 9% with gross margin expanding by 6 -- 760 basis points along with operating results growth of 10% and operating margin of 700 -- almost 700 basis points growth.

These numbers reflecting our -- the austerity in the costs and a control of expenses and, of course, our continuous efforts to make the operation even more efficient. Note that we expected that this segment will recover within the line -- actually in the line of revenues in the second half of this year.

So let's go now to slide eight, which shows our consolidated results. Net revenue in the quarter came at BRL1.5 billion, up 9%, driven by the performance of the On-Campus and Distance Learning especially. And this brought net revenue in the first half to almost BRL 3 billion or 10% higher than the last year.

The adjusted EBITDA in the quarter grew 11% to BRL700 million, with margin expanding 60 basis points to 46.1%. This performance was driven by -- because of the net revenue growth and also all the order efficiency that we collected in this type. The adjusted EBITDA was BRL1.3 billion in the semester, growing 10% year-over-year with the margin expanding 20 basis points to 46.4%.

In the next slide, we're going to more details on the evolution of the adjusted EBITDA between the second quarter of this year and last year. And at the bottom line, you can see the adjusted net income, BRL645 million in the quarter, up 15%, with the margin expanding 210 basis points. And also in the semester in the first half of the year, we had a BRL1.2 billion, up 16% year-over-year with also net margin growing the same level, about 220 basis points to 42.4%.

Slide nine, we show the main factors affecting the EBITDA margin between the second quarter this year -- of this year and last year. So let me start with an analysis looking to the EBITDA margin of 45.5% last year. And here, we have -- we started to have the effects of the charging of the FIES administrative fee, which impacted the margin by 43 basis points in this specific quarter. Let's remember that this impact should be neutralized after third quarter because that started third quarter last year.

Moving on to next box, you can see the sharp increase in the total PDA due to the reduction of the FIES student base combined with the expansion of the PEP and the PMT student base, which adversely affected the EBITDA margin by almost 400 basis points. So you can see that cross-mix, we didn't have to do anything. In terms of efficiency, we have a margin about 41%.

With the actions that I already described, including positive inflations of the KLS, of the operation research system, all the strategic sourcing, the optimization in the distance learning model, among other actions, we were able to neutralize all the negative impacts. In the EBITDA we deliver a margin of 46.1%, pretty much in line with the last year and we continue, of course, to seek out new opportunities for creating value and guarantee the robust results while delivering the guidance of this year.

So I now invite the CFO, Frederico Brito e Abreu.

Frederico Brito e Abreu {BIO 16674822 <GO>}

Thank you, Carlos. Good afternoon, everybody. In the next pages, I'll provide some color on accounts receivable, capital expenditures, our free cash flow and also our cash and our net debt position. So before moving to the first topic, which is accounts receivable, I would like to provide some color, more qualitative color before jumping into the numbers on what was the performance this quarter. So I think the main message is there's a positive evolution in pretty much all the indicators that we have to analyze accounts receivable. Those indicators are positive from a quantitative point of view and also looking at some leading indicators that I'll comment in a while.

So despite, of course, the challenging and all the tough unemployment scenario that we have, presenting those indicators is very positive for us. So the first indicator that I would like to comment on is the coverage rate of our accounts receivable and what we can see that it remains adequate and even with an increase year-over-year. So our coverage ratio, which is the amount of provision that we have in our balance sheet for our accounts receivable is increasing, which basically means that we are, let's say, covering more of our potential future loss on accounts receivable. So this is a good indicator.

The second indicator is our provisioning rates. It's pretty much stable compared to previous quarter -- last quarter. This is a good sign of our health of our accounts receivable despite, as I mentioned, the challenging macroeconomic scenario, especially in terms of unemployment. And in addition, you can see also in the beginning of the presentation that our tuition rate -- our tuition rates are down, and this is a very important, clearly, leading indicator for future potential lower delinquency. Okay. So PDA is stable with lower attrition is also positive.

And finally, our third indicator is our average receivable term, which continues to show signs of recovery, not only in FIES, but also in out-of-pocket on-campus. It's the first quarter in almost 20 years where we have a reduction in out-of-pocket on-campus receivable term. This is also a very positive and encouraging sign of the health of our accounts receivable.

So now I'll invite you to move to page 11, where we present the PDA, the PCLV [ph]. I'll start with on-campus, total PDA in the quarter for face-to-face on-campus at 10.4%. This is an increase of 390 basis points year-over-year, and this is mainly the -- a mixed effect with the expansion of PEP and PMT students. These are fine students with a longer maturity. If we compare it to the previous quarter, we can see a reduction, and this has to do with the seasonal effect of PMT students we provide the possibility of PMT in the beginning of the semester and then the students in the second part of the semester ruled the PMT and they are converted into paying or PEP students. So typically, PMT only happens in the first and in the third quarter of the year.

And so if we isolate the PEP and PMT effects and we look at the right side of the green bars, you can see stability for PDA, for out-of-pocket paying students stood at 7.5%. This is important because over the last year, we've been increasing a bit quarter after quarter with PDA, but all of our indicators, managerial indicators on recoverability, attrition, delinquency are showing signs of improvement, and therefore, we decided to keep it stable and for the first quarter in almost one year.

If we look at the Distance Learning in the middle of the page, we have PDA stable of 10% quarter-over-quarter. Compared to last year, is an increase of 245 basis points. This is mainly again the mixed effect of PMT, which is these funding we provide in the beginning of the semester.

If we look only at the same balance of our distance learning students, PDA was at 8.5%. This is 20 basis points over the previous quarter. It's a short increase but finds an important message that is different from the face-to-face in Distance Learning. We have only very recent data that started to show some positive signs but not enough for us to stabilize PDA, so we decided to increase once again PDA.

Remember that until the end of last year, we had some more flexibility in the renegotiation of distance learning students, this means that we provide a longer payment condition. And because of that, we are being conservative in provision higher for those longer term so that we avoid any surprises in terms of future PDA. And finally, on the right side of the page, we have the Primary and Secondary with a stable PDA of 0.8%.

If we move now to page 12, we can see the performance of average receivable term. There's some important message in here. So on face-to-face, in green, you can see overall stability. If we open by type of payments term, you can see different trends here. So starting for the out-of-pocket face-to-face students, excluding the Pronatec, you can see for the first quarter in almost one year a decrease in three days year-over-year, and this is a reversal of the upward trend that we showed over the last three quarters. This is mainly due to the growth in our recovery reflecting our correction actions and also our reduced record flexibility in negotiations of reenrollments with our students which is a positive sign. We expect this trend to continue over the next quarter, and this is an important message here.

If you look at FIES, 144 days, still high than what we've shown in 2014. This is mainly due to the PN23. So you can see that we've already started to observe a decrease 16 days year-over-year. And the trend is that -- is 144 days converged to the levels of 2014 over the next quarters. So also positive trend in FIES.

And I would like to remind you that we've already received the second installment of PN23 in the 2nd of August. This is not reflected in these numbers because it's going to reflected in the third quarter numbers. But we've received already BRL198 million, which basically is the second installment. So we are still missing the final installment of PN23 to be paid in 2018.

If we look at PMT and PEP, there is an increase of 29 days, which is natural maturation of our financing product, so it's in line with our expectations. It's a long-term product. The student pays by the end of the course, so it's normally -- this increase does not surprise us here.

Moving to Distance Learning. We can see an increase of 11 days, from 80 to 91 days on the paying students. This is mainly the result of two things. The first, we have a higher proportion of our online -- fully online students in our base, these students have a higher attrition. So we are being more conservative in terms of provisioning and also, we have an impact in terms of our average receivable term. But also, we're more flexible by -- until the end of last year in terms of reenrollment and the consequence is lower attrition. But the consequence is a higher average, which is long term. But in non-PMT, which is the funding we provided in the beginning of the semester, you can see 231 days. And it's the same trend that we have on face-to-face, so no surprises here.

And finally, on the bottom, the primary and secondary education with average receivable term of 90 days. This is a 9 days increase. It's mainly seasonal. If you remember, we changed, we are changing the calendar of sales. We are anticipating as much as we can the sales to the school, which is positive for the students. So year-over-year, we have this discussion, but there's no any point of concern here on this average receivable term, okay.

So changing topic and moving to page 14. We can look at our investment, our CapEx. We have in the quarter a total of BRL108.2 million in investments, which is 7.1% of our net revenues. Out of which, 40% was invested in content, system and software. Most of these investments are related to quality and innovation, so important long-term investment, and 23% were related to expansion and improvements of our units to prepare them to the shift that we are having in our portfolio moving to more engineering and health program which requires an investment. So a good part, almost two-thirds of our investments are related to quality improvement, innovation and also adequation of our units to provide a better experience and a better portfolio to our students.

If we add up our special projects and Greenfields, so related to growth, our total CapEx was 122.5 in the quarter or 8.1% of net revenues. Keep in mind that for the year, we provided a guidance of 8.9%, so we are still below the guidance, but we expect to accelerate the investments on the second semester, which is typically -- which happened over the last two years. So we should be by the end of the year reaching the range of 8.9% as we provided as guidance.

Moving now to page 15, you can show -- you can see here the cash generation is a positive messages here. It was a strong quarter in terms of cash generation. It was a strong semester in terms of cash generation. I'll start with the quarter. If you look at the operational cash flow after CapEx and special projects, a total of 448.5 million, which is almost 70% of EBITDA to cash. So a very strong performance.

If you look at the semester, which is more comparable, there are some seasonal effects in FIES year-over-year. Last year, we had a delay in the payments of FIES to the second quarter. So the second quarter last year had a heavier receivable of the FIES. But in the first quarter last year, we pretty much get the receivable almost nothing so a better comparison if looking at the semester where this affects our method. So if you look at the semester, our free cash flow from operations, 679 million, 55% of EBITDA to cash, which compares to 47% EBITDA to cash last year, which represents an increase in our EBITDA to cash of 7.5 percentage points, which is very strong despite a larger proportion of PEP, PMT in our accounts receivable. We are converging gradually to the historic levels of EBITDA to cash we have in the past.

Also, on cash generation, if you look at the bottom of the chart here, the free cash flow already discount in dividends, interest and debt. Look at the semester on the right side of the page, you can see -- and already excluding the final -- the last line of this page, already excluding the receivables from what we received from the sale of Uniasselvi, which is a nonrecurring free cash flow that happened last year. So excluding that effect, we can see that our free cash flow was BRL251 million this semester, which compares to BRL172 million last year. So this is an increase of 46% increase in our free cash flow. Already including 40% dividend payment that we've paid related to last quarter, so very strong free cash flow as well.

And this relates to next page, and because of this strong free cash flow, you can see on page 16 a positive evolution, a very positive evolution in our cash in our net debt position. So starting with our cash, we've ended up the quarter with BRL1.4 billion in cash received, almost 51% higher than last year. This is mainly the consequence of the information I provided on free cash flow. If we discount all the debt financial and non-financial debt, you can see the net cash position, the net balance cash is higher than that on the amount of BRL792 million, very strong.

And if we add up other accounts receivable, short and long-term debt, we still have pending not only related to FIES, the normative rule number 23, but also related to the sale of Uniasselvi, which is certain with low risk. If we add up those receivables on our net cash position, we ended up the quarter with a positive cash balance net of debt of 1.9 billion, which is extremely strong, which is important to lever and to use that funding for some of the projects Rodrigo will mention in a while. So it's a very strong cash position and -- in a macroeconomic scenario that is so volatile and uncertain is certainly something really important.

And I would like to move to page 18. On page 18, we present something that is -- we are very happy to present you something new. It's something that we've made public today, which is a partnership with one of the largest banks in Brazil to provide innovative and unique solution for private funding to our students. We started, as you remember, to offer PEP, which is using our own fund in the beginning of 2015. And since then, we've provided some information to the market that we were willing and looking to build a partnership with a bank. That partnership is now being announced. The bank is BV Financeira. It's a company owned of Banco Votorantim, which specialize in customer finance for retailers with more than 20 years of experience.

And this impressive partnership will offer private student financing floor and to graduate students at all of our institutions for postsecondary students at Kroton.

BV Financeira is the retail brand of Banco Votorantim, which in turn is one of the Brazil's largest banks in Brazil. It's formed by a strategic partnership between Banco do Brasil, which is Brazil's largest bank and Votorantim Grupo, one of the largest private conglomerates in Latin America.

And BV is, as you all know, among the market leaders in vehicle financing, has a wide portfolio of financial products offered by dozens of branches with national popularity. So it's definitely a very strong partner to us. This partnership represents an important addition to Kroton's current offering of PEP and basically seeks to facilitate the PEP to our students and for potential new students to financing in Brazil. So we're happy to be able to extend this offer.

This is a commercial agreement. There's no societary, there's no shareholders, any exchange of shareholding participation. It's commercial. It's signed for 10 years with a possibility of renewal. It consists on sharing risks and results on a 50-50 basis between Kroton and Banco Votorantim. Banco Votorantim will be responsible for conducting credit analysis, for providing capital and also for collection of our students. And Kroton will be responsible for several operational and commercial activities and also, to subsidize interest rates for our students. So the students will not pay real interest rates. They will pay only inflation, and the subsidy of those interest for our students will be fully subsidized by Kroton.

The product is already being offered in some of our units, as we speak, so some of our students are already experiencing this potential offer. We should fully roll out this product in 2018, and we should evolve carefully in agreement with BV, testing, getting more experience. And as we get more comfortable on the partnership, we will certainly extend this partnership to a broader range of students.

The payment terms of FEP are exactly the same as PEP, and we will start using and offering this FEP to our PEP students that are in the process of reenrolling in the semester, so these students are having access to these FEP products. And we expect gradually over time that FEP will represent a growing larger proportion of our student financing options to our students. So it's an important partnership.

And now, I want to pass the call back over to Rodrigo for his closing remarks.

Rodrigo Calvo Galindo {BIO 17238232 <GO>}

Thank you, Frederic. Now we are talking in slide 19 about our growth opportunity in the company. I know we have -- we still have a huge opportunity, growth opportunity in all segments that we operate, on-campus, distance learning and K-12 businesses.

Let's start with the on-campus businesses, talking about the new courses and the actual units. We asked from Ministry of Education 434 new courses, and we are in process to implementing these new courses. It's a huge increase. Just to give you a perspective about how important is this increase, we -- in the beginning of the year, we had 1,923 courses and we will go to 2,357 courses, an increase about 23% in the portfolio on the actual units. And in these numbers, we are disregarding the new courses in the Greenfields. We are talking only about new courses in the actual units. They are based on the engineering and health courses, so that means more novel courses with higher tickets. So a very important strategy to make strong brands and increase average tuition in our units.

The second lever of growth in the On-Campus business is the Greenfields opportunities. As we mentioned in the previous earnings -- on these conference calls, we have a plan to implement 100 Greenfields in the next five years. We already asked 50 of these 100 and 8 of these 100 are already approved by Ministry of Education. They are in the cities of Joao Pessoa, Luis Eduardo Magalhaes, Bacabal, Vitoria da Conquista, Bom Jesus da Lapa, Jequie, Arapiraca and Tucurui. All of them will be launched in the first semester of 2018. We are expecting more than these eight.

We have some products that are in the final stage to be approved by Ministry of Education. And if they are approved in October or November, we have space to improve the number of 8 new campus in 2018, the first semester of 2018. And we still have 52 in process to be analyzed by Ministry of Education. So a huge opportunity to grow through Greenfields in the On-Campus businesses.

The other opportunity is the M&A opportunity. Considering that our growth has been in the past based in our successful track record in mergers and acquisitions, we have space to continue in M&A and to continue to create value delivering M&A. But now, our strategy is based in small and mid-sized institutions in places, in cities that we not operate yet. So we are working to make negotiations with these institutions, and our strategy is to make acquisitions in small and mid-sized cities and cities where we not operate yet.

We have, at the same time, a very important opportunity in the graduate business. We can increase the portfolio, we can increase the experience of the students. Our market share in graduate studies is much lower than our market share in undergraduate. So we have a lot of space to increase our market share in graduate and delivers more value and grow with this strategy.

Talking about the Distance Learning. We have a new regulatory frame in Brazil. And in one hand, this regulatory framework of Distance Learning is expected to increase competition, it also given us opportunities to increase our base of distance learning centers. And the fact is the regulatory barrier is lower, yes, the regulatory framework resisted [ph] the regulatory barrier. But it's only one of barriers to enter in this industry. Other barriers, including the Distance Learning teaching methodology, the quality of the product, the portfolio of the programs, technology, managing of the network of partners, all of which are fundamental for the success of a Distance Learning center.

And we believe we are very well prepared to transform -- to guarantee all these barriers in our favor in this new regulatory frame. So we believe that we can. We are prepared to transform the threat of increased competition into a major growth opportunity for Kroton. We already have 400 distance -- new Distance Learning centers in process to be launched, 200 of them will be launched until the end of August this year and 200 in January 2018.

Besides the new Distance Learning centers, we are improving and increasing the offer of Distance Learning premium. What is Distance Learning premium? The offer of more novel courses, like engineering and health courses in the Distance Learning centers. This is a very important strategy because at the same time, gives more novel perception of the brand of Distance Learning center and increase the average tuition of Distance Learning products. So we are improving and increasing -- expanding the offer of Distance Learning center, increasing the number of courses and increasing the number of centers that offers these courses.

Then we have the expansion of the portfolio in -- for other courses and other ways to offers of Distance Learning. For example 100% online, semi-presential or blended courses. And in the end, for Distance Learning, we do have the same opportunity than in our campus, that is to improve the graduate services with new offers, new markets and being more efficient in the Distance Learning graduate services. Our market share in this business is much lower than we can be and we have a lot of space to improve our market share growing in the Graduate segment.

For the K-12, in the primary or secondary education, we see opportunities for organic growth of our learning system operation and context. The operation at schools through mergers and acquisitions combined with organic growth, so we have three main opportunities: organic growth, M&A, in-learning systems and M&A in management of schools. We are working in all of these three opportunities and we see that K-12 could be a very, very important avenue of growth in the mid-term in our company. So all these growth opportunity are in the table. We are working to guarantee that all of them will be delivering going forward.

Let's go now to the next slide, slide 20. And we are analyzing the efficient opportunities that we have in 2017 and that we will have in 2018. In 2017, we are already being pressured by the improve of the provision for losses because of the trends, the change of the mix, with reduced on FIES and more students on PEP that requires more provisions, that means more expenses.

So in one hand, we have pressure from -- because of more expenses because of PEP. But on the other hand, we have a few levers of efficiency that we are delivering in 2017 and they are being sufficient and the result shows that they're being sufficient to guarantee the same margins that are a little bit increase of margins against 2016. The same levers of margins that we have in 2017 we still have in 2018, what gives us comfort that we are in a good trend to deliver the same level of margins in 2018.

So -- which -- what are these levers, this efficient lever? The first one is our new academic model, the KLS 2.0 plus our operational research system that allows us to put more students in the same class. Together, the new academic model and the operational survey guarantee efficiency in the 2017 and will guarantee efficiency in 2016 (sic - 2018). We are still in the -- we are in the fifth semester of the maturation of KLS 2.0, so we still have the same opportunity going forward until the tenth semester, so 2.5, more 5 semesters, 2.5 years getting opportunities on efficiency in these levers.

The second lever is the digital discipline in the On-Campus business. The law allows us to offer 20% of digital discipline in the On-Campus business and we are, today, around 16%. So we still have space to achieve 20%, and we still have space to discuss this increasing quality with this strategy.

The third strategy, the third lever of efficiency is the strategic sourcing project. In the second semester of this year, we will launch the wave 5 of the strategic sourcing project, which brings new opportunities for savings and cost cutting.

And lastly, I want to mention the product to optimize our collections with improvement in process, systems and policies, which represents a major opportunity to increase efficiency by optimizing renegotiations with the students and the recovering of doubtful accounts, will start capture benefit in 2018. So these four levers will helping us to guarantee margins in 2017 and will guarantee the same level of margins in 2018.

Let's go now to the last slide for our closing remarks in slide 21. We are practically in the middle of the student recruiting process for the second semester of this year, which will last until early September and it is still too early to comment on the final results, but we remain confident in the resilience of our student base despite the more challenging and uncertain macroeconomic scenario that we are facing in Brazil now.

And the second item, I should mention in the beginning of this presentation about our two main challenges that we have in the company, growth and digital transformation. Accordingly, we need to put our organization structure, align it with the challenges that we have with the company. So we have two new Vice President positions. They are created one month ago. They are the Management and Expansion Vice President, and the Technology and Digital Transformation Vice President.

The first one, the Management and Expansion Department will be led by Julia Goncalves, who was Director of our Project Portfolio Management Officer, our PPMO. She will be responsible for the main organic growth initiative in the On-Campus undergraduate, Distance Learning and investment management firms. Meanwhile, the Technology and Digital Transformation Department, we will actively participate in digital transformation, which will enable simultaneously the continuity of the technology services that we provide today, the evolution of the platforms and services and the changing of the company's mindset to digital transformation, not only in the technology area itself, but in the company as a whole. We are in the process of hiring this new Vice President of Technology and Digital Transformation, and we will make the announcement shortly.

Moving to the next topic. The Board of Directors maintained the distribution of dividend at level 40% of distributable report net income, which amounted BRL207.9 million based on adjusted net income for the second quarter of 2017, which corresponds to approximately BRL0.13 per share.

And in the last item, I want to mention two awards that Kroton recently won. For the sixth straight year, the company was winner the IR Magazine Awards Brazil 2017, receiving awards for best IR by CEO or CFO and that IR invested by a large cap company, and we thank the financial community for this award. And in this third edition the Valor Innovation award sponsored by the newspaper Valor Economico in Brazil highlighted that 150 companies operate in Brazil that knew how to extract from an economic -- economically critical phase the vision that investment in innovation must be maintained for those planning to grow their -- in their industry, with aging categories covered by the survey, Kroton was elected first place in services.

We are very confident about the opportunities ahead of us and that we manage to deliver high-quality education with scale, efficiency and growth now further supported by our digital transformation strategy.

Thank you for your participation in today's call. And now, we will begin the question-and-answer session.

Questions And Answers

Operator

Ladies and gentlemen, we will now initiate the question-and-answer session. (Operator Instructions) Our first question comes from Mr. Rodrigo Gastim of BTG. You may proceed.

Q - Rodrigo Gastim {BIO 19694950 <GO>}

Yeah, yeah, thanks. Good afternoon, everyone. So going back to the digital transformation subject. I may imagine this is one of the main pillars of your strategic planning design for the next five years. So my question here is how should we correlate this digital transformation with quality measurement for the student? And here, obviously, more focused on the metrics of employability and salary increase.

Does this digital transformation has for you guys as one of the main targets to clarify, not only for investors, but for all stakeholders in the chain, the real value that Kroton diploma brings to the students. This is the point that I would like to address this afternoon. Thank you for the question.

A - Rodrigo Calvo Galindo {BIO 17238232 <GO>}

Hi, Rodrigo, it's Rodrigo speaking. I will start the answer. The call is not very clear. I understand a part of your question. If I don't answer all of them, please let me know after my answer. So first, digital transformation will not change our purpose of value for our student. Our purpose of value is exactly the same, employability, and we already do this and we already measure this. What we are doing with digital transformation is helping to do this more strongly in an easier way with easier measures and giving for the students a better experience.

So it's not new, it's not the digital transformation that will start the digital deliverables -- our purpose of value for students. We already do this, but we believe that we have a lot of value to improve in our purpose of value for our students using more digital. I will give some examples. For example, we have in the journey of the student in our institutions, he starts in the intake process and it concludes in the graduation of this student. So we have four years of this student, and we have a lot of point of contact with this student in between these four years.

So we have space to improve the experience. For example, in the intake process, in the re-enrollment process, when the students are asking for some document in the administrative areas, in the academic areas for the student that wants to study, doing their project, their ride between home and school, giving much more numbers and information for these students to put in the Canal Conecta in a much better experience for these students to have more access for more job markets.

So this kind of improve of the experience of the students, digital can help us. Of course, we do a lot of this. But in a digital transformation, we can change completely the experience of these students. There is one expression in digital transformation, that is liquid expectations. What is liquid expectations? When one student is paying his tuition in a faculty, in a university, he don't compare the quality of his payment, of his profits, he don't compare with another faculty. He compare with high -- top 5, for example, that he pays automatically.

So with liquid expectations, we need to provide the best experience ever for our students in payments, in academics, in -- when he was looking for jobs. So this is what we are looking for, go digital in our projects. But more than go digital, what we are looking for is to be digital, is to transfer -- transform the company in a digital company, in a company that thinks digitally. And it means a much more agile company using methodologies like Agile, Scrum with quick decisions, with being able to answer for the market demand.

So this is to transform a company in a digital company. The first step that is to go digital, to improve the experience of the student is the easiest part of the digital transformation. The most difficult part is to change the mindset and the culture of the organization to really be digital. I hope I answer your question. Please let me know if not.

Q - Rodrigo Gastim {BIO 19694950 <GO>}

Yes, this is perfect. Good to hear that. Thanks for the answer.

Operator

(Operator Instructions) This concludes the question-and-answer session. At this time, I would like to turn the call back to Mr. Rodrigo Galindo for any closing remarks.

A - Rodrigo Calvo Galindo {BIO 17238232 <GO>}

I'd like to thank you for the participation of the conference call, and our IR is available for further questions. Thank you, and good afternoon.

Operator

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