Q1 2019 Earnings Call

Company Participants

- Carlos Alberto B. Lazar, Investor Relations Officer
- Jamil Saud Marques, Chief Financial Officer
- Mario Ghio Junior, Primary and Secondary Education Executive Officer
- Roberto Valerio Neto, Postsecondary Education Executive Officer
- Rodrigo Calvo Galindo, Chief Executive Officer

Other Participants

- Javier Martinez, Analyst
- Leandro Bastos, Analyst
- Luiz Mauricio Garcia, Analyst
- Marcelo Santos, Analyst
- Maria Tereza, Analyst
- Rodrigo Gastim, Analyst
- Thiago Bortoluci, Analyst
- Vitor Tomita, 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 First Quarter 2019 Earnings Conference Call. We would like to inform you that this event is being recorded. And that all participants will be in listen-only mode during the company's presentation. After the company's remarks complete, there will be a question-and-answer session for analysts and investors. 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 at www.kroton.com.br/ir by clicking on the banner 1Q 2019 webcast. This presentation is also available to download on the company's website. The following information is available in Brazilian real in accordance with Brazilian Corporate Law and generally accepted accounting principles, 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's management and also 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 the 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. Thank you for participating in Kroton earnings conference call on the first Q 2019. With us today our IR Director, Carlos Lazar; our Finance Vice President, Jamil Marques; Roberto Valerio for Higher Education; and Mario Ghio, K-12.

Before we begin, the presentation let me say we have been through an important moment in the late 2018, as we acquired Somos, changing our profile. Today we work more in the relevant statement. We've broadened our operations in K-12. The company had to review the way it disclosed its earnings, because we had to make adjustments in the format of our disclosure to align our management practices and the way we present our results to the market. In addition, we also had the impact of IFRS 16. We made all the adjustments to be in line with the new accounting practice.

I know it makes it more complex to understand our numbers and we're trying to present this reports on the first Q 2019 with all possible views so that the financial market can have a better understanding of the analysis going back to 2018. For example, in 2018, we also applied a pro forma analysis applying IFRS 16, so it's more comparable to 2019 performance. IFRS was applied on both years. We also made comparisons of Somos' and Kroton's separately, so you can compare to the company's guidance. And we also presented the earnings as the company was consolidated. It will be clear as you look at our slides and listen to the presentation, but we know it's more complex to understand our numbers. Our IR team is at your service to provide all the necessary explanation. We're trying to provide most transparency so that in this new phase of the company beginning now will be presented in full transparency to the financial community.

Let me begin today's presentation from a message I deem extremely relevant, our expectation for the 2019 guidance. Now, as we show our results, our numbers in this new way as it's more difficult to interpret the results because of the complexity and comparison it's more important to look at the future and think about the future value generation in Kroton. That's why we are providing full level of details. In this guidance, we made available also a number of forecast generation so the market feels comfortable not only regarding our performance, but also cash generation from our operations.

Separating, Somos and Kroton. Ex-Somos, we also presented consolidated results in slide 4 in the first Q results. There are some peculiar numbers and higher education seasonally have impacted our analysis. So the operating results seems lower but that would be recovered in the following quarters. In K-12, we have the seasonality of PDA from 2018 which is very different from the seasonal effects we will see in 2019, so that's yet another distortion even in the pro forma comparison. So if you want to look at the projection of results, the guidance would be the best number, that's why we start from the guidance.

As expected, 2019 will be a challenging year. Macroeconomic scenario is unfavorable, high unemployment and will have our last year of big volume of CS students phasing out. Even under these challenges, our guidance prospects are positive. Today we published three guidances: Somos and the original structure of Somos, excluding Pitagoras and including SETS, the service structure for technical program at Somos. The second guidance will be Kroton ex-Somos, that is Kroton without considering the acquisition of Somos so not considering the expenses or the earnings from Somos, and the third one the consolidated company guidance.

Now Somos will present its guidance in 2019 so the financial market can follow the capture of synergies from Somos. Kroton ex-Somos guidance will be shown this year again to show that independent from Kroton's original operations ex-Somos continues very sound and also, well, the consolidated company guidance, which talks about the performance of the consolidated company considering all effects. After the brief introduction, we move to slide 4, the guidance we're publishing today. First, two views; first, on the left Somos' guidance that was already published in March is now confirmed. On the right Kroton, ex-Somos guidance, not considering the Somos acquisition and in line with the trends we anticipated early this year to both on the guidance and on the release, all numbers include the application of IFRS 16 in those years 2018 and 2019, so that the numbers are comparable.

Now back to the Somos guidance on the left. Somos adjusted EBITDA moved from R$545 million to R$670 million, growing 23%. The greatest impact is cash generation. We moved to a positive cash generation after CapEx of BRL 150 million in 2019. On the right, the guidance of Kroton ex-Somos. Our net income dropped 2.4% because we have less intake of PEP in the first half of 2019. PEP accounted for only 11% of new students and because this is a higher ticket, the revenue is lower. However, the revenue that we have now creates more cash generation. So we have a lower net revenue by 2.4%. As we prioritized cash generation in 2019, we reduced non-recurring expenses this year at Kroton ex-Somos. So it makes more sense to look at the EBITDA line, which includes non-recurring expenses. This one in fact will be one of the indicators that will determine the variable compensation of executives, replacing adjusted EBITDA. So we will focus EBITDA in Kroton ex-Somos company because it includes non-recurring expenses that were reduced in 2019.

Now Kroton ex-Somos EBITDA expected for 2019 is R$2.5 billion, margin of 45.2%, which is an increase of 1.2% and 160 basis points compared to 2018 because we reduced non-recurring expenses and we also had a good intake process in the first half of 2019. Now projections for cash generation and conversion post CapEx, compared to 2018 and excluding PN23. Now the increase in cash generation is 12% with a conversion of 26.5%, that is 260 basis points above 2018, making Kroton already in a positive trend. So, Kroton ex-Somos R$670 million in cash generation post CapEx, a growth of 12% with positive cash generation already in 2019.

Slide 5: You have the consolidated Kroton guidance. That is the official projection of the consolidated company, including all effects including the acquisition of Somos. Two comparisons: First, to the society earnings of 2018 that is including only the 80 days after Somos was consolidated in Kroton financial report. The second comparison is to pro forma 2018 results, considering the 12 months of Somos. On the left the messages are, net revenue growth 25%, adjusted EBITDA growth 13% and operating cash generation post CapEx growth 64%.

In the pro forma or corporate analysis, the consolidated net revenue will be flat for two reasons that Kroton ex-Somos, revenue was impacted by CS students phase-out. And almost the revenue was already designed when we took over the operation in October 2018. The revenue was already planned for so it's flat, a drop of 0.9% in the pro forma analysis.

Adjusted EBITDA in the pro forma analysis will also remain flat, but EBITDA will grow 21.1% compared to 2018 reaching R$3 billion in 2019. And we still have synergies to capture from Somos operations and also opportunities to grow margin in our new higher education unit. Guidance for the adjusted net profit is R$1.3 billion, margin of 18.3%, an increase of 14% and 240 basis points compared to 2018. Part of EBITDA gains will be consumed by higher financial expenses, higher debt, because of the acquisition of Somos and also a higher depreciation from recent investments made by the company. This is the first time we provided guidance for operating cash generation post CapEx, an extension which will be R$800 million, a growth in society analysis of 64% and a pro forma 40% growth. And the EBITDA to cash conversion is 26.3%, a relevant growth, better from 40% in the pro forma analysis or 67% in the society pointing to important growth in 2019 and a positive trend in following years. The final message on guidance is that 2017 and 2018 were years of investment. We acquired our new owned schools, new center, and K-12 demanded that and they still demand relevant investment but the prospects are very favorable for this year and especially the following years.

Now slide 7, I will talk about the main operating results that is the basis for our projection. Slide 7 shows indicators of higher education. On the left, you see a very favorable student intake in the first half of 2019, growing 1.4% in intake ex-ProUni even with the challenges as we mentioned a very competitive scenario, high unemployment and a relevant reduction in FIES students.

The final numbers have been published at the end of April, but we had a drop in our student base of 4%. But at the same time, we had a very good intake of On-Campus students growing 4% and the drop in our base was not because of more dropout. Our dropout On-Campus fell 20% between 2017 and 2019. The drop was because of the phase-out of FIES students, which was already predictable, because in 2013 and in 2014, we had a big intake of FIES students. Since these were the biggest numbers, we believe that the pressure on this FIES student phase-out will be reduced.

Now because the intake early this year was successful and it is relevant this is a very important result to sustain a robust performance in 2019. Distance Learning, we have a strategy to protect our ticket and margin you will see the results so we kept the intake stable. Now dropout rate in Distance Learning, we had a drop in On-Campus students even considering a change in the profile because of FIES student phase-out.

Now in Distance Learning, we had an increase, as we have a bigger share of 100% web distance learning, but we're still below the numbers of 2017. On the right, for your information, you see the FIES student phase-out from a peak of 260,000 students in 2014 or 61% of our student base and at the end of this year the reduction will be more than 75% in the number of FIES students. They will account for only 14% of our student base On-Campus or less than 6% in the overall student base. The projection for 2020 and 2022 is that FIES will be only residual in our student base.

In summary, our higher education operating indicators are under control and have a positive trend, especially as of next year, where the FIES phase-out will have less pressure. Now slide 8. We'd like to show some of our main operating indicators in K-12, which has become more relevant in our organization. In the release published today, we have a table with a number of operating indicators. We'll now talk about some of the most relevant. For comparison, we've included Somos numbers also in the first quarter of 2018 in a pro forma report to show the real growth in each operation.

On the left, you see the information on private schools and students that use our core content solutions. We are agnostic regarding the pedagogical choice of schools. They can use learning systems or textbooks. It is a choice of the school method. We are ready to meet the needs, with learning systems or textbooks. We keep long-term contracts with schools, whether they choose to use learning systems or textbooks. On the left, you see the number of schools and students in these schools with which we have contracts in 2019. More than 3,500 schools, actually 3,538 schools are using our K-12 integrated service platform, a total number of 1.3 million students. That is the growth of 11% or 15.3% compared to 2018.

That is a growth of 11% in the number of schools and a growth of 15.3% in the number of students in our K-12 service platform. We believe this segment has a huge potential to grow both in our penetration in Brazil's 3.5000 schools with which we already have a contract, in addition to dozens and dozens of schools with which we still do not have a commercial contract.

We're very enthusiastic about the launch of our new go-to-market strategy our new proposal of building commercial relations with schools. We talked about that in our last call and we're very optimistic with the intake of students for 2020. We no longer have a product approach.

We now build commercial relationships in our service platform. The Somos commercial team that worked isolatedly has been integrated, incentives have been aligned. Our commercial force is all beginning to understand the school need and provide the school needs.

This was a complete mindset change in our commercial team and we believe it will add a lot of value in our relationship with partnered schools. In this new concept the greatest differential is our solution portfolio which is integrated, flexible, includes recognized brands in learning system, textbook, counter-shift solutions, everything backed by a broad support to schools: pedagogical consulting, teachers' training, and technology platform.

On the right side of the slide, more operating indicators in K-12 for the other business unit which is the management of schools, our own schools and contracts. We closed the first Q 2019 with 37,000 students enrolled in our 54 schools a relevant increase of more than 50% compared to the first Q 2018.

And considering also the acquisitions by Somos and by Kroton meeting different audiences in several regions 50% growth in the number of schools and 50.1% growth in the number of students that includes organic plus inorganic growth. These are the operating indicators. We have another list of operating indicators in our release published today.

With that we close the first part of the presentation. I'll give the floor to Carlos Lazar, our IR Director to talk about financial highlights in the first quarter 2019.

Carlos Alberto B. Lazar {BIO 17238206 <GO>}

Thank you very much Rodrigo. I would like to start to -- by calling your attention to some of the changes in our system for releasing information. So, you're all invited to turn to slide 1. Starting this quarter, our financial performance will be released in two segments higher education and K-12. Higher education will be divided into three business units; our own units, third-party units, and continuing education. And continuing education will be divided into business units K-12 platform and core management.

In higher education, the division between our own units and third-parties have a clear reason because our own units are both managed by Kroton truly and in those, we are responsible for all lines relating to costs and expenses.

And the third party units are managed by partners and the partner is responsible for the P&L lines. So, the management dynamics and result structure is very different between the two with different margins as well. That's why it makes sense to consolidate results in different business units.

As for the continued education business unit, there we concentrate all postgraduate activities for On-Campus and business learning all the courses and also SETS that came to us originally from Somos.

As for the K-12 education, it's now structured in two major business units with the K-12 service platform and also with contract and National Textbook Program that we're going to call the K-12 platform for sure and that encompasses all products and services offered to partner schools such as physical and digital content, pedagogical support, assessments, teacher training, and the like in those business units.

We also consider the services that are rendered through the national textbook program and also agreements we have with education authorities. The private K-12 platform and the national textbook program are reported in a unified way because they use the same areas of support marketing.

And as soon as the expenses can be aggregated, we will treat those units in an independent way in relation to the K-12 education. So, in school management we have the performance of our own K-12 schools and also some agreements we have for managing third-party schools.

Now, we are hired by large companies to manage their school units and also the counter-shift activities and operations of Red Balloon including several units. Red Balloon is consolidated in school management because most of students weren't studying in autonomous units.

They are not meant to K-12 schools. And we inform this for comparison purposes all numbers will present from now on include 1Q 2018 and 2019 the application of IFRS 16 which came into force this year.

So, let's turn now to slide 13, starting with the analysis of the consolidated higher education segment. Looking to the left of the slide, net revenue totaled R$1.3 billion, down 1.8% in the annual comparison due to the decrease in the student base which as commented ended up offsetting the solid intakes of 1Q 2019.

Going to the middle of the slide, we see a decrease in gross income related to consolidation of SETS numbers. However, when we exclude SETS gross margin would have been stable reflecting scale gains and the benefit of several efficiency levers such as strategic sourcing in spite of the pressure coming from new units.

Finally, higher education operating results show a reduction in margins related especially to the impact of SETS consolidation and the launch of the new units and events that are seasonal and in fact, impact, for example, our provisions for losses and also marketing expenses which will probably normalize as the year progresses.

Now, turning to slide 15, let's take a look at K-12. Also for comparison purposes, we are conducting our analysis with 1Q 2018 pro forma considering the Somos numbers in one 1Q 2018 after converging our accounting practices with those of Kroton and the half of last year. The variation of net revenue reflects two effects in the PNLD.

Mostly purchases that should have been made in 2017, but that were made in the first quarter of last year and also some postponement of purchases that were put off to the second semester of the year. And even in the pro forma analysis we see that the order lines are growing.

In addition to this our growth earnings grew 1% and 200 basis points in the margin with the start of capturing synergies from Somos and increasing efficiency in management of schools.

Finally, we have our operational results post-marketing of K-12 growing 1.5% and 200 basis points in spite of the increasing marketing expenses related to the new go-to-market within the K-12 platform, which will increase our revenues even more expressively as of next year.

In slide 17, we see the consolidated results adding our higher education and K-12. This we have just seen in the pro forma solution considering Somos in 1Q 2018 for comparison.

In the consolidated net revenues we have a reduction of 4.3% a reflection of the smaller number of higher education students and also the PNLD effect that is now being neutralized along the year and that will lead to a reduction in the guidance of only 0.9%.

Our EBITDA margin had a retraction of 270 basis points, especially because of the one-off impacts in the increase of costs related to the launch of new units in addition to the different seasonality in the national textbook program and the marketing expenses.

For this line, I would like to reinforce once again that the EBITDA guidance for the company in the consolidated company is R$3 billion growing 21%. The EBITDA drag for Kroton ex-Somos is also positive growing 1.2%.

Finally, we had adjusted net income down 38.6% especially because of the higher level of financial expenses, the debt related to the acquisition of Somos and also the depreciation lines that result from the investments that was conducted in the last few years.

With this, I conclude the session and I will hand it over to Jamil Marques.

Jamil Saud Marques {BIO 21416820 <GO>}

Thank you very much. On slides 19 and 20. I will try to give you some more guidance on our provision for losses in this segment broken down by type of students and also average term. We start in Slide 19 on the left, where we see the PDAs for higher education consolidating the losses in both On-Campus and Distance Learning in comparison with 4Q 2018 we see an increase that was driven by a few factors.

First of all, a higher recognition of revenues from the Late Enrollment Installment Plan students that was more noticeable in 1Q 2019 and almost double in relation to 1Q 2018 but this is a one-off event and we'll see probably an excessive drop in 2Q 2019 leading to an increase in the semester of 15% approximately.

There was also change in the profile of our student base with high number of graduation of FIES students that have lower level of provisioning. Those effects were partially offset by the lower offering of SETS in the latest intake cycle and also by the highest contribution of On-Campus out-of-pocket students that have also a lower level of provisioning.

If we're considering only the out-of-pocket PDA students reached 9% this quarter, down 1.6 percentage point vis-a-vis 4Q 2018. I would like to say that, even though there was a drop that resulted from the mix effect I have mentioned. In relation to 4Q 2018 we observed an increase of 0.2 percentage points in out-of-pocket On-Campus PDA. And in Distance Learning, we see that it remains flat provisioning remains flat.

In On-Campus the increase was due to the fact that even though there was a reduction in the effective losses and recovery of the tuition that is made the increase in the out-of-pocket base also led to higher number of delinquent students and also to higher level of agreements. In Distance Learning, we enjoy more favorable solution because the efficiency in collection -- the increase in collection has offset the adverse macroeconomic scenario and we were able to reduce our provisioning.

Going to the right side K-12 PDA was 0.6% in the quarter, down 20 basis points vis-a-vis the comparable quarter in the previous year. This is the result of incorporation of Somos and the highest contribution of B2B business in this segment. In addition to the mix effect we also observed a decrease in the PDA coming from school management. This is the consequence of the more premium profile of the acquired units. In the comparison with the previous quarter, we see the seasonality effect.

Moving to slide 20. The average term for receivables. In higher education was 169 days in 1Q 2019, up 21 days in the annual comparison. This increase can be explained by the PEP and Late Enrollment Installment Plan's maturities that climbed 101 days in relation to 1Q 2018. Additionally we saw an increase in the average term for out-of-pocket which was driven by more agreements in On-Campus.

It's important to mention, however, that we are now slowing down the pace of agreements in fact, because when we look at the comparisons with the fourth quarter, it's now much more acceptable. The average FIES term was 107 days an improvement of 30 days vis-a-vis the previous year and with a decrease of 43 days and it wasn't even 43 days in comparison to the previous quarter. This situation is a one-off situation because since 2017 the government has been anticipating payments from November to December instead of January and this reduces the contribution of FIES in the fourth quarter.

Going now K-12. The average term of receivables was 93 days, 48 days less than the annual comparison. This of course shows an improvement in the collection of our school.

With this, I close the session on term of receivables. And on slide 22, I would like to turn to CapEx expansion investments and cash generation. The first thing to highlight is that we eliminated the profits of special project CapEx and we are now presenting in segregated way only the investments that focus on the organic expansion of the company.

And on the left you see the CapEx that includes all investments relating to the current businesses including those special projects that excluding any investments to fund the organic expansion of the company.

So starting with the left side of the slide, our CapEx was R$107 million in 1Q 2019 on par with R$2018. Even with the calculation of Somos this led to a decrease of 1.6 percentage point in the evaluation with the net revenues. Most of the CapEx was earmarked to the development of content and systems, expansion and improvements. to our units in line with our policy of promoting a more premium group of programs with a focus in health care and engineering. Our investments in expansion totaled R$41.1 million in this quarter reflecting our expansion strategy.

Going now to the right side of the slide, with post CapEx operating cash generation. We consumed R$230 million in operations, in 1Q 2019 above the level of the previous quarter also because of the nature of the K-12 business, which concentrates several meaningful cash in the first quarter of the year.

Looking at Kroton ex Somos. Well, the cash consumption was practically stable with the performance of out-of-pocket students offsetting any delays in the FIES amendment schedule. And also, I'd like to state that the guidance for the year is growth of 64% in both CapEx, cash generation with a positive generation of R$800 million. In Slide 23 I would like to explain some of the movements related to those R$230 million post-CapEx operating cash consumption. First of all, we had R$BRL 107 million invested in growth initiatives of which R$45 million in organic expansion. We opened 12 new units in the first half of the year and R$61 million were invested in the acquisition of subsidiaries, of course, we have to pay for those acquisitions. Secondly, we dispersed BRL R$267 million for the repayment of interest of our debt in the quarter. Adding up these factors together with the other effects, our free cash flow in 1Q 2019 nets to a consumption of R$589 million.

If we move now to slide 24, I would like to shed some light on our net debt starting with our cash position in 1Q 2019. At the end of the first quarter 2019, our position was a reduction of 22% in comparison to 4Q 2018 reflecting the effects I have just mentioned those R$589 million. Adding up the bad and short- and long-term liabilities our net debt R$5.5 billion in 1Q 2019 and if we add receivables in the short and long-term, which includes the second half of the payment for Uniasselvi's adjusted to net present value and also the payment of FAIR and FAC/FAMAT, we closed 1Q 2019 with net debt of R$5.4 billion, represents growth of 8.4% in comparison with 4Q 2018 mostly because of the reduction in cash equivalents that were offset by the reduction of obligations in payments of M&As and interest expenses.

I would like to close here by saying that our financial position is well-solid and in line with expectations considering the debt profile we acquired after Somos. And with this, I'll turn it over to Rodrigo for his last remarks.

Rodrigo Calvo Galindo {BIO 17238232 <GO>}

Slide 26. Final considerations and update on our organic expansion projects. Since 2017, we launched 64 new units, greenfield units including acquisitions to accelerate opening new units. Another seven will be launched in 2020, totaling 71 new units or a growth of 63% compared to our initial position of 112 units in 2017.

Bigger concentration in the north and northeast, a mix that has more premium programs, especially in health care that have a great demand, but it's not enough to open new units. We have to do previous work to select the right city, identify the best location in each city to ensure a successful implementation of the new unit.

Our numbers show we are successful. The greenfields project is truly successful. We have two indicators to show you that the consolidated result until 2018 we had a net consolidated revenue of greenfield projects 15% above our business plan. So if we add up other business plans up until 2018, we delivered 15% more above the business plan. So it is a truly robust greenfield program.

Intake for 2019, shows this robustness is sustainable and consistent, the intake with 11% above our goal. So we're doing well and we're happy with the results of our greenfield project.

Now slide 27, to update our digital transformation project. We've spoken a lot about it, and we will still continue to talk about it, because this is key for the company and it doesn't end because it is a mindset change. We decided to engage in a journey that will change the company's face. It had a later beginning but not an end.

Let me give you an update. The digital transformation is based on three pillars. The final goal is to generate a cultural transformation. The first pillar is agility in scale, so we can implement agile models of system development. To that, 100% of our team is now using agile methods. We have more than 600 people in 55 agile teams. They have ensured the delivery of more than 500,000 hours of development in the last 12 months. Using agile management team is a relevant a daring change placing Kroton as one of the few Brazilian companies that has 100% of its development team working on agile team.

The second pillar of the digital transformation is the development of digital capabilities, we considered key for us to be recognized as a digital company. We are now investing time, resources, attracting and retaining talent to develop these capabilities in the organization. What are they? System architecture, analytics, customer experience and user experience design. The numbers are very significant when we include all the information that we knew and that we analyzed to improve operations on different fronts.

The third pillar is open innovation, which materializes through a partnership with Cubo Itau. It's a direct contact with this innovation ecosystem that brings fresh air to the whole company. We have an active pipeline with 250 startups that is with core con to these 250 startups, 30 startups we have already started curatorship or connection, eight already have a pilot design, two are in practical experience, and five we have concluded investment or we are closing investment, which can be to buy part of the equity or higher services from these startups that is already generating concrete value to our operations as we participate in this innovation ecosystem.

All of these initiatives are already producing an impact in our culture, which is the ultimate goal of the digital transformation. To reinforce this culture in the company, we've conducted more than 27,000 hours of training in digital transformation with more than

35,000 certifications in 2018 and 2019. It is a clear evidence we're going through a digital transformation. The company is truly revolutionizing the quality and speed of delivery guided by our strategic planning that focuses on student success.

And I want to talk more about that in our final slide 28 which is student success. The digital transformation has contributed for a great improvement in our Net Promoter Score indicator, the NPS which evaluates the level of satisfaction the perception of our students about the academic experience, the services we deliver to them, and the different business units.

Now we measure NPS monthly in different contact points academic, administration service done in the last 12 months. As we make this comparison year-on-year, we were able to improve the performance in all possible analysis. In our own units, the growth was 38 percentage points extraordinary. And third-party units, we've improved four percentage points; the number was high already. And in graduate program, the increase was 48 percentage points. We are improving significantly in the perception of students on the quality of the services we delivered.

In 2018, as we prepared our strategic plan, we placed our student success in the center of the process building a whole culture of customer centricity, which is key for a digital culture. 15 months later the significant improvement of NPS is a clear evidence we are on the right track.

In conclusion, if I could summarize our key messages in this earnings call today this guidance is highly consistent. We see a positive trend in cash generation, a good outlook for the next few years robust operating indicators in K-12 and in higher education important evolution in our strategic projects, such as the new Somos go-to-market, the organic expansion, the digital transformation. No doubt all of this allows for us to view an even more promising future for Kroton performance.

Thank you all for participating. I'd like to invite you to a Q&A session now. Thank you.

Questions And Answers

Operator

Thank you. We will now open the Q&A session. [Operator Instructions] First question from Mr. Marcelo Santos from JPMorgan. Marcelo, you can begin.

Q - Marcelo Santos {BIO 17186991 <GO>}

Good morning everyone. Thank you for taking my question. I have two questions. One I'd like to hear more about seasonal effects you mentioned, which may have impacted our analysis of higher education. Especially On-Campus, we see a lower ticket, but in this quarter we will see the effect of inflation. So that's why I wanted you to talk more about seasonal effect.

And also the positions or the late Enrollment Installment Plan, which was much higher than before. And again, in Distance Learning, the result was not very consistent with the student base ticket because you see the revenue you combine your own units most partners, it went up 11%. So I'd like to understand the impact on this line. These are my two questions.

A - Jamil Saud Marques {BIO 21416820 <GO>}

Okay, Marcelo. This is Jamil. Beginning from seasonal effects, on higher education, first, average ticket, the seasonal effect we had a change -- an important change in our processes, especially in the end of 2018, which led to some important effects to be postponed.

First, renegotiation of debt within active students, so it reduced the principal and so it reduced the revenue. And because of process changes it had more impact in the second half of 2018 than in the first half of 2018.

And because of these same changes, the adjustment in the workload that students decide if they want to study more or fewer disciplines they usually make a choice for fewer disciplines. In 2018, we had more concentration of this process in the second half of the year.

So in the first quarter -- in the first half of 2018, we did not feel this effect. But in the second half of the year, yes we did feel this impact. Now in 2019, these processes will be normalized. So these negative effects will be more uniformly distributed in the first and second half of the year. So as you compare year-on-year, the first quarter has this effect.

On-Campus had a drop of 2%. Just to give you more color on this these two effects, they represent two percentage points as we compare the first Q 2019 to the first Q 2018. And that's why we believe that the average ticket in the first half will be in line with inflation.

The second question PMT on Late Enrollment Installment Plan, we did see an increase of 100% in the PMT revenue. What happened was that we had an acceleration in the intake and in the recognition of these students in 2019, and in 2018 these factors had a later effect. So we had more revenue from these students in the second half of the year in 2018.

Now about this 100% growth of PMT, we will see a drop in the second half of this year. So we expect that in this half it will grow more in line with what happened last year in 2018.

Now regarding, Distance Learning revenue, I'll give the floor to Roberto. He will talk about this.

A - Roberto Valerio Neto {BIO 2243533 <GO>}

Thank you, Jamil. I think a comment we can make about Distance Learning revenue, you spoke about a drop in our student base and an increase in the revenue and why do we not see this on the ticket.

The explanation is simple; perhaps you will remember that in the case of Anhanguera, the model we used with partners is variable depending on the performance. So in one case we had found 36%, Anhanguera 33% and the other 3% will be in a pool to be distributed among the network of partners based on results.

Now the partner network of Anhanguera specifically had a performance below what we provisioned. And so this is a reversal of this provision. So it impacts the revenue but not the average ticket.

Q - Marcelo Santos {BIO 17186991 <GO>}

Perfect. Thank you for the explanation.

Operator

Our next question comes from Luiz Mauricio Garcia from Bradesco. Luiz, you may continue.

Q - Luiz Mauricio Garcia {BIO 17432519 <GO>}

Good morning. First question, if you could speak a bit more about your own school. The information you disclosed on page 21 was very interesting, but I'd like to understand the main reasons for this drop. I mean, we have some clear numbers when we look at the number of out-of-pocket students.

But what do you see as the biggest impact on these numbers? I mean, if it is because you have a more competitive environment On-Campus impacting your units or if it is Distance Learning? And how do you view this number for the future? This would be my first question.

And the second question, what can we expect? I mean you also talk about PDA. I'd like to know what we can expect. I mean you've already spoken about this, but what can we expect for the future I mean compared to first Q?

A - Jamil Saud Marques {BIO 21416820 <GO>}

Hi, Luiz, thank you very much for your question. Jamil here. In relation to our own units, in fact we are expecting a decrease for the year but not as sharp as we saw in the first quarter for two effects.

First of all, the PDA -- well PMT in the data I mentioned is -- was announced in the first quarter and also out-of-pocket revenue; if not as announced it will be in the second quarter because of those net effects in the second quarter. We'll see a much more favorable scenario. So when we look to margin it's really a one-off situation in the first quarter this consumption of margin.

And we also have market expenses to think about. They will grow along the year but because of our strategy for allocation of resources, they are more concentrated in the first half of the year.

As for PDA, what do we expect? With the mix that we have seen that's not very different from last year defect in the payment form the effect would be practically neutral. So the offending factor is the decrease in FIES students when we talk about out-of-pocket is 10% to 12% in average.

When you look exclusively to out-of-pocket in On-Campus, well we saw an increase of PDA because in spite of this trends for -- increased the results of trends for making agreements. So currently we are expecting neutrality here. And in Distance Learning, the working capital is looking much healthier because the average terms have reduced. So for Distance Learning has been a lot more positive but for the first quarter our provisioning for Distance Learning remains flat.

Q - Luiz Mauricio Garcia {BIO 17432519 <GO>}

Okay. So the number of agreements that's tied for now, so this should be the level -- the seasonal level we should expect?

A - Jamil Saud Marques {BIO 21416820 <GO>}

Yes. For On-Campus, yes.

Operator

Our next question is from Mr. Javier Martinez, Morgan Stanley. You may proceed.

Q - Javier Martinez {BIO 15226046 <GO>}

Thank you very much. I have two questions. First of all, about PEP students. You mentioned in the release that the dropout was really in line with out-of-pocket and specifically considering the PEP students have already graduated while the first three happened in 2015 and now with graduation. What could you learn from the behavior of those PEP students who have already graduated and that are -- how are they behaving?

And secondly about content, especially learning systems, which I believe that you're marketing as of now with -- under the seller's brands and that will generate revenue for 2020. So first of all about the product, were you able to make adjustments to the product or any changes in the product that you are marketing now? Or didn't you have enough time for that?

And secondly, did you make any changes to your sales team for these products such as adopting incentives or cross-selling strategies? So can we feel your influence on this product basically?

A - Jamil Saud Marques {BIO 21416820 <GO>}

Javier, good morning. I am Jamil. I will answer about PEP and then Ghio will answer about K-12. In relation to SETS, it's too early to tell. We don't have much information available, but in fact, yes, there was a group of 1,600 students graduating in the first quarter and it's been positive.

One of the points we observed is, in terms of behavior is, on-time payments among these students after they graduate and in comparison to before graduation, what you see is that, of course, there is an increase in delinquency but as well as although to 20% in relation to what we used to pay after graduation.

And if you consider that PEP students, delinquency rates are slightly better than our out-of-pocket -- for out-of-pocket students. When you look at the modeling, we believe that they are on positive bias. Besides that, dropout rates, if you consider the number of students graduation, there might be not so good.

But when you consider credit and the provision for them, we see more graduated students and this is beneficial and so it's still very early to tell. But in terms of behavior, we believe it's a positive behavior that they exhibit.

A - Mario Ghio Junior {BIO 17363553 <GO>}

And I'm Ghio. I'll be answering your questions about K-12, starting with the end of your question with the go-to-market and the commercial team. This has been our focus already this year, the reorganization of the go-to-market strategy and we counted on two main pillars.

Firstly, ensuring that this department has the adequate leaders and also strengthening our sales team, so our sales reps and the pedagogical consultants that work with us at the project was increased by 25% if we compare it to the team last year, considering the combined company. So it's a more robust team under very determined leadership, another important point in the go-to-market strategy.

We are agnostic. We provide traditional learning or the learning systems, through textbooks or through learning systems. So our consultants sell both learning systems and textbooks in an integrated approach and this, of course, increased our potential for closing deals.

When you go and visit a school and as you leave it up to the school to choose what they want to use, of course, you'll have a much better chance of making a deal. And as for the first half of your question, the product itself, the cycle -- on this cycle we are talking about, we had -- we have the products that were already in our portfolio.

We're starting now a new cycle of investments for the products we have in next year's portfolio, but we have unleashed value through several technology initiatives in this -- products using this holistic approach.

Just to give an example in our learning system in 2018, we had six million homeworks that were completed along the year. And up to now, considering last week, we had on this year 30 million homeworks. So the digitalization of the learnings experience is progressing by leaps and bounds and this brings systematic benefit to capture data, we know the shortcomings of our students and this is helpful for the professors and teachers alike, who'll never know of deficiencies.

So we are a company now offering digital products and the school may choose several analogue products as well. And this, of course, is how we present ourselves to school. Allow me to highlight that we have few clients who prefer to go digital 100%. All print materials, they leave aside. They don't even want to receive them. So, I think that we're making a lot of progress. And then, very -- and very soon we'll be able to report more on our go-to-market strategy progress.

Q - Javier Martinez {BIO 15226046 <GO>}

Thank you very much. If I can go back to your first question, there aren't that many students who have graduated already, but have you noticed a difference between 30, 50, 70 PEP students? For example, are they above the expectations, or not? So when exactly the -- you will be able to reverse this over-provisioning you did for them?

A - Mario Ghio Junior {BIO 17363553 <GO>}

We haven't seen many differences between 35 -- 30, 50 and -- 30, 50. And in relation to the accounting we use this 50% criteria. In our vision this is the adequate provisioning. And now, we're going to also work on dropout rates and graduations to fine-tune our accounting measures.

Q - Javier Martinez {BIO 15226046 <GO>}

Thank you very much.

Operator

Our next question comes from Leandro Bastos from Citibank. Leandro, you may continue.

Q - Leandro Bastos {BIO 21416405 <GO>}

Hello. Good afternoon. I have two questions. First, talking about increase -- or reduction in ProUni offset by the sound intake, how can we understand this line? This is my first question. Second is a follow-up on guidance, looking at cash generation. This guidance is post-CapEx, but what do you expect for expansion this year in the greenfield project? Also on K-12, I know that you cannot give us a number, but may be just an order of magnitude? Thank you.

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

Hello, Leandro, this is Rodrigo. Thank you for you questions. I'll answer the second question and Jamil will answer your first one on ProUni. About the guidance, yes, the R$800 million guidance of cash generation includes all the company investments.

Regarding investments, which now also includes special projects, but does not include expansion and greenfield -- organic expansion and greenfield projects, which totaled R$240 million. So this is the order of magnitude of our expansion investments, which is not included in the cash generation guidance.

A - Jamil Saud Marques {BIO 21416820 <GO>}

About the reduction, you mentioned in ProUni. ProUni produces a seasonal effect, depending on when we had the intake and other effects. So this effect of increase is just a seasonal effect. So in general, it is important to see that we always have a margin of additional places to ensure that we'll be able to meet the needs along the cycle.

Q - Leandro Bastos {BIO 21416405 <GO>}

Okay. Thank you. Thank you, Rodrigo. Thank you for the answer.

Operator

Our next question comes from Guilherme Palhares from BTG Pactual. You may continue.

Q - Rodrigo Gastim {BIO 19694950 <GO>}

Good morning everyone. This is Rodrigo Gastim. I have two questions. First, on average ticket. You have explained the seasonal effect in the first and second half. Now looking at out-of-pocket students, you already have the first data. What was the adjustment applied on students? And how much came from the new intakes? I'd like to understand the ex-mix effects looking at same costs. So can you talk about that? I mean have you really been able to pass on your pricing to increase the pricing? And how much was the price adjustment for existing students?

And then a question to Ghio. I'd like to understand a bit more about the market for learning systems, for private schools, specific conversation we have with investors, that this market already has a high rate of penetration. So I'd like to understand from you, when you look at the strategy, I mean, not only you sell the concept of a one-stop shop to partnered schools, but what about growth for learning systems? Are you going to get more market share from the competition? Or are you going to work with the public system? I mean, where do you expect growth to come in this segment? These two questions. Thank you.

A - Jamil Saud Marques {BIO 21416820 <GO>}

This is Jamil. About the average ticket; first, the seasonal effects I mentioned are more visible on out-of-pocket students. Now the other information you requested we cannot really open this data, but both have grown that's all I can tell you. Now to Ghio.

A - Mario Ghio Junior {BIO 17363553 <GO>}

Thank you for the question. One of the things that has transformed in the company gathering is that now we no longer have this breakdown of what is learning systems market and what is textbook market? Today 3800000 student use learning systems and 3000400 use learning systems and 2800000 use textbook.

Although we are present on both sides of the market, schools prefer a more flexible solution. Schools prefer to have an option wherein some segments they can use textbooks, plus the services of the learning system; and in other segments they use only the learning systems, plus its services. This is a very powerful value proposition exclusive on our market. It is our number one lever of growth.

Of course for schools that love the concept of learning systems we have different methodologies to offer, highly well-known brands to offer. So yes we want to grow market share, but we believe the perfect solution for schools is not one or the other, but it is for the school to be able to choose from all of these options.

And what we have seen in our go-to-market initiative is that, this is what schools expect. Brazil has offered this system of learning systems for a long time. Textbooks also have existed for long time, but now schools have a choice to have their own mix and I will reinforce what we said in answering Javier's question, digital inclusion knowing that teachers are using the platform, students are using, parents are informed. This is really important for school.

Q - Rodrigo Gastim {BIO 19694950 <GO>}

Excellent. Thank you Jamil, Ghio.

Operator

(Operator Instructions) Our next question comes from Maria Tereza from UBS. You may continue.

Q - Maria Tereza {BIO 18715964 <GO>}

Thank you for taking my question. I have two questions. One about Distance Learning, you said the higher dropout rate is related to a mix where you have more 100% online. What do you expect for the future in this mix? Are you going to have more hybrid programs which would perhaps reduce the dropout rate in Distance Learning? Or shall we expect this indicator to remain high?

Second question is a follow-up on what Ghio already mentioned. Like you understand what is a revenue growth driver? The number for 2019 is there already for Somos, but I would like to know if you have any pace to have a higher number? What lines of business do you view as more positive in the negotiation? And if this cash generation number is basically coming only from synergies? What if there are other drivers? Thank you.

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

Now this is Rodrigo. Thanks for the question. I'll answer the first one and Ghio will answer the second one. In Distance Learning today, we have in our Distance Learning products three different services or byproducts 100% web, which accounts for 20% of the base; once a week which accounts for 65% of the student base; and premium which accounts for 15% of the student base. These are you know ballpark numbers.

Now the dropout of 100% web is significantly higher than the dropout rate of the other segments. Dropout of once-a-week is the lowest, actually lower than premium. The big dropout rate is the once-a-week program. Now the 100% web is growing because of the market, despite the fact that our priority product is once-a-week and our go-to-market is trying to privilege to favor, the once-a-week because we know that the present value of students is higher because the average revenue is higher because you have a lower dropout. But because of the market because all the market offers as a priority 100% web some students choose 100% web and the idea is that these two segments will grow.

Now premium web is also growing in our student base. Three years ago it was 0. Today it accounts for 15% of the student base. We believe these two levers may move may change, but how fast they move will determine if the dropout rate will go higher or not. We believe web premium will grow and 100% web will grow up.

So they will take share from once-a-week. That's why, it's difficult to predict the future dropout. But in all segments, we can indicate really in each segment become more efficient to lower the dropout rate using more efficient predictive models more efficient technologies. So the mix, we wanted to be more important than the specific dropout in each group.

Now if the dropout rate grows 100% web then it will be more difficult, but if premium can grow faster than 100% web then we will be able to control the dropout rate. There are many variables, but I've given you some context information so you can take your own conclusions. Okay?

Q - Maria Tereza {BIO 18715964 <GO>}

Perfect, thank you Rodrigo

A - Mario Ghio Junior {BIO 17363553 <GO>}

Now Maria Tereza let me use this call to make a comment on our guidance this year. We included in this year's revenue, I mean in the information we provided to you a conservative view considering that the government would really delay the national textbook program so that was already included in the guidance.

At that time we anticipated this might happen and for this reason, we included that in our guidance. So the program for 2019, we expect it to be 70% lower than it would be if it were just a normal purchase and this has already been included in our guidance.

So one of the revenue upsides we may have this year and we will certainly have next year is the national textbook program that is that the books will be purchased as planned and not only a lower percent which is this year 30% only to replenish the textbooks. So this would be a revenue upside.

Now the other lever of growth in our K-12 platform is what we call P-A-R, PAR which is partnership with schools in a learning system based on books. So first the school select the books then we systematize. We include that in the system with all the services of learning systems and we had CAGR, a compound annual growth rate of 70%.

And this year it was under-structured so we intend to keep a robust growth. In learning systems and I'm going back to Gastim's question, these schools are really happy because they have realized they can choose a hybrid option including textbook and learning systems.

And when I talk about our learning systems, BH is a very good brand. The product is really nice, but the marketing was basically in Rio De Janeiro. So it has a huge potential for growth in Brazil. Also Pitagoras was very much regional in Minas Gerais.

But now with our national sales force this brand can also grow throughout Brazil. And our brand focused on schools that have a lower price which also includes a new package of services. So it will also be a growth lever. So I spoke about 3. Only on the K-12 platform, we have three positive affect; so the national textbook program, we have a possibility of revenue upside, PAR or partnerships will continue to grow and learning systems can still expand because these two are the only regional brands.

Q - Maria Tereza {BIO 18715964 <GO>}

Perfect. Thank you Ghio. Thank you Rodrigo.

Operator

Our next question is from Vitor from Itau BBA. You may proceed.

Q - Vitor Tomita {BIO 19238819 <GO>}

Good morning everyone. I have two questions. First of all, could you give us an update on the progress of the cost synergy initiatives at Somos? And what gains have you obtained so far? And a second question that we have, could you please elaborate more on the initiatives that leads to the reduction on nonrecurring costs for the guidance?

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

Good morning, Vitor. In relation to the synergies, from the very beginning of the integration, we have been trying to capture Somos synergies as fast as possible in cost and expenses. And as we announced in the guidance, we increased the number of synergies to be captured to R$265 million. And R$115 million of the R$265 million have already been incorporated even in the fourth quarter of last year or our longest year. This is the information on the guidance. We also have other cost synergies in logistics and other projects that are taking place along the year. And at the end of the year and early next year, it will lead to more synergies.

So answering your question, we have already captured R$115 million of those synergies that were announced, and also the delinquency in relation to what we had announced. In relation to nonrecurring, while this reduction has two things, we have incorporated parts of this as recurring, even in the restructure of units and other projects related to rent or find other possibilities of restructuring.

And as for expansion and M&A, there's a slight decrease in relation to the previous year. Those are the two effects that leads to a drop in nonrecurring along the year. Just to complement this, I think first of all, there was effective reduction of expenses. We're trying to become more efficient and we're also cleaning the nonrecurring, whatever had something that was not sure about it, whether this was nonrecurring or not we decided to give the recurring aspect. So that's why, we saw a decrease in nonrecurring as well because of those two effects.

Q - Vitor Tomita {BIO 19238819 <GO>}

It's clear. Thank you very much.

Operator

Our next question is from Mr. Thiago Bortoluci, Goldman Sachs. You may continue.

Q - Thiago Bortoluci {BIO 20909105 <GO>}

Good morning, everyone. Thank you for taking the questions. In fact, we have three questions on our side. Could you talk a little bit about the operating margin dynamic both on On-Campus and Distance Learning? It would be very helpful for the analysis. And secondly, I'm trying to understand the impact of IFRS 16 in the guidance in the quarterly results. And I see, there's a depreciation line show R$75 million in this quarter. So does it make sense to multiply this by four to reach the annual impact in thinking of the ex-IFRS guidance? Do you think that margin of 40% is in line with what you're expecting?

And also a follow-up on the PDA of course, it's a big if, but assuming that the delinquency rates will continue in line with what we've seen so far. Does it make sense to expect a reduction in provision and even a reversal in the PDA investment in the balance sheet? Those are the questions.

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

Good morning Thiago. Thank you very much for your questions. Well, about the margin dynamic, it's not very different from what we saw in the third quarter, considering we have the national textbooks program. In terms of marketing, it's not more concentrated than before and this -- with this drop coming, it will come from On-Campus with Distance Learning preserving or even increasing margin, and this is similar to what we will see in third-party units.

And to break down the numbers for you for 2019, the EPS impact was -- IFRS impact if we make up with [indiscernible], we would have R$460 million, R$470 million in EBITDA. And more specifically, in relation to depreciation -- in addition to depreciation for example, we have an impact on IFRS 16 of financial. In Somos, I know also the present value adjustment, so the impact is a little more than you are expecting for depreciation. In net income it's important to highlight that the impact is higher than that. Net income suffered with R$80 million with the IFRS 16 because the depreciation is higher than our expenses, wasn't easy and this number would be R$95 million.

In relation to PEP, of course, we see a trend for improvement and of course with an eventual reduction in PDA, but with a maturity and then this will be reflected in the balance sheet in the short term.

Q - Thiago Bortoluci {BIO 20909105 <GO>}

Let me ask a last question with the acquisition of [indiscernible], does it change our positioning or the competitive scenario for you in any way?

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

Well, we are really focusing on K-12 and we're feeling very confident that there's a lot of room for us to make progress in it.

Q - Thiago Bortoluci {BIO 20909105 <GO>}

Thank you, very much.

Operator

Okay. Now I'll hand it over to Kroton for their final remarks.

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

I would like to thank you all for participating in our earnings call and our Investor Relations Department is at your disposal for anything you need.

Operator

With this, we close the Kroton Educacional conference call. We thank you all for your participation and please have a great day.