Q2 2014 Earnings Call

Company Participants

- Mauricio Ceschin, Chief Executive Officer
- Unidentified Speaker
- Wilson Olivieri, Investor Relations Vice President

Other Participants

- Rafael Frade, Analyst
- Unidentified Participant

Presentation

Operator

Good morning, ladies and gentlemen, and thank you for waiting. Welcome to Qualicorp's Conference Call to discuss the results of the Second Quarter of 2014. We have with us today Mr. Mauricio Ceschin, the CEO; Mr. Wilson Olivieri, the IRO; Mr. Alex Oreiro, the CFO; Mrs. Natalia Lacava, the Superintendent of Investor Relations. This event will be recorded and participants will be in listen-only mode during the company's presentation, after which we will begin the question-and-answer session when further instructions will be given. (Operator Instructions).

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

Wilson Olivieri {BIO 17325685 <GO>}

Thank you very much, operator. Thank you all for being here with us. Good morning, everyone. And as the operator mentioned, Mauricio is here with us today for his first earnings release call on the second quarter of 2014. So I'd like to give the word to Mauricio for his initial remarks.

Mauricio Ceschin {BIO 18750717 <GO>}

Good morning everybody, welcome to our call. It's a pleasure to be here and we'll soon start the -- we'll start presentation and afterwards we can talk or we can complement anything. Thank you.

Wilson Olivieri {BIO 17325685 <GO>}

Thank you, Mauricio. Again once more thank you all for being here with us today. I would assume you are probably following us with the presentation we have made available in our website. And I would kindly request you to please move to page four; we're going to start directly with the details. And as you can see in page number four, we see a couple of graphs in there, both of them regarding our portfolio evolution. And I think there are a couple of items that I'd like to highlight on this slide.

So number one is the compounded annual growth of our total number of lives, which if you consider the timeframe of this graph, you'd be looking at more than a 10% growth per year. That you would actually split that into two pieces, the first piece that would be the corporate and other segment that would be growing on a manual basis of around 8% per year. And the most important segment of our business, which is the affinity side would be actually growing on this graph at around 15% a year, assuming all of the acquisitions. If you were to exclude the acquisitions effect you would still be looking at a company that is being organically growing its number of lives by a level of around 18%. As usual, if you look at the pie chart on the right hand side, you would see there is corporate and others in terms of number of lives it still represents almost 60% of the number of lives of this company. But as you all know, the 41% side which is the affinity accounts for about 92% of our total revenue. So it's by far the most important segment, in terms of revenue and margin generation.

In page number five, we see a closer look and more detailed look at the number of lives on our portfolio. And there are here a couple of points that I'd like to highlight. Number one, the gross adds, as you can see with more than 103,000 lives added in this quarter. We are showing increases, especially if you compare to the last quarter of about 6%.

So, of course, we have not sold as much as we did second quarter last year, if you remember, there was an historical record, the economic circumstances at the time were different, but it's still 103,000, almost 104,000 for the quarter for us was an interesting level. I think the second biggest highlight and probably if you were to ask me out of the most the two most important highlight, I think this is the one of them that refers to churn.

As you all know, we are following it as all of the churn behavior, the churn performance. And I think this quarter at a 6 -- a little more than 65,000 lives churned, we have shown significant increases -- significant improvements, not only comparing to prior quarter where our performance was 12% better, but also when you compare to prior year where on that comparison our performance was like almost 15% (inaudible).

So that has allowed us to bring down our total portfolio of lives of health at 1.4 million lives, showing growth if you compare with last year of a little more than 8%, which is absolutely in line with the growth in health life that we have been experiencing, that we've been sharing with you for the full year of 2014.

Couple of other points on this graph, if you look at our growth in health of this 8.2, you would see that, as I mentioned to you, it's mostly coming from a great performance in churn, which we believe is probably setting a better terms for the churn we might experience on the third and the fourth quarter, but we'll get back to that point shortly.

In terms of what we call new products here, you also see I think an interesting point is a negative number of lives of 81,000 lives, that's referring mostly to one of our dental contracts that expires with one of our professional associations in Rio de Janeiro. But as you know this represents a very small amount of revenue. So -- but in terms of number of lives, it is important and effects our growth. Positive points however are on the TPA segment. As you can see here we have grown 6.7% if you compare with the same quarter last year and almost 1 percentage point if you compare with the prior quarter, meaning that we are already focusing on that segment aligned with our acquisition of the two units of Tempo which we will probably touch basis in a bit. And finally, if you look at our corporate life, that is showing about 1.2 million lives, they show a decrease when you compare with last year mostly due to a couple of contracts that were canceled.

And another thing that I think it is important to highlight and was actually stated during the Qualicorp Day for the ones that had the opportunity to be there with us, we had reclassified our number of -- our threshold in terms of number of lives for small and medium enterprises, that's why you see such a big reduction of that life, because in fact what we are doing now is we're having our corporate sales force watching out for the small and medium enterprises as well and we have made a cut of a threshold like 299 lives. So what we have done is, all of the lives that we were previously considering small and medium enterprises there are higher than 300 lives that have been reclassified to corporate side.

If you are there with me page number six then we see a quick local on our net revenues. And then you see that we have grow our net revenues were up BRL344 million this quarter by 23% if you compare with the same quarter last year, which is pretty much in line with our expectations for our full-year growth this year.

So we are very much in line with our expectations. And as I mentioned earlier, 92% of this net revenue comes from the affinity segment and corporate and others is, they are contributing with about 8% of those. But very importantly however is, even though corporate and others are contributing with 8% of our total revenue, they are also growing at an almost 20% rate. So that means the fact we focus in affinity does not mean that we are also pursuing growth in other business lines of our business.

In page number seven, we would like to share with you a little bit of our cost of services performance. And a couple of points that I'd like to highlight. Number one, this cost of sales has increased by almost 28%. So a little more than what we have increased our revenues. So therefore, our margins for this quarter gross margins were about 74%, which means about 100 bps lower than what they were last quarter. The three main points here to explain that there is especially personal expenses, where you -- we have increased some of our operational capacity here, especially in terms of number of head count. And as I mentioned earlier, our churn has been coming down and among other strategies that we have used one of them is improving our operational facilities, so people that would potentially churn, that they were not happy with our services, they have actually continued with us.

So of course the benefit that we see on this increase is returning on the churn reduction. As we've also discussed in Q4 a few meetings before, IT investments have also increased on our expenses. So, especially in terms of new license we have acquired, they have hindered [ph] this expense line as well. And finally, which is basically part of a consequence of our black listing strategy, sending some of our customers to black list, as expected, we are seeing an increase in some of those customers going to lawsuits because they feel that was not fair to have them sent to black list.

So, even though we see a increase in this line, as I'll show you shortly, the revenues that -- the gains we are bringing out of that strategy is still compensated by far for this increase.

Page number eight, what you see here in administrative expenses is also an increase, a little lower than 26% and I would like to have here to highlight especially there was in positive. In terms of positive here, we see that our margin growth, sorry, our percentage -- administrative expenses as a percentage of revenue, if you see the graph have actually decreased. So even though you see an increase on that level, it still show that you are leveraging somehow compared to our expenses with the previous quarter.

And also the third-party services is one of the main generators of this gain because we had a few expenses that we had in the first quarter and have not been repeated on the second quarter, although on the negative side, we did have a couple of points that affected us even though it's lower, one refers to our rental expenses because as you know, we have moved from our old offices to the new offices. In this quarter because the moving process takes a while we were basically hindered by two rate expenses and also in terms of the acquisition of Tempo.

Some of the expenses related to consulting and auditing and due diligence hindered our quarter as well, although most of those will potentially come next quarter, but for this quarter we already had some of those expenses, which were not big enough to offset the leveraging that we show on the graph.

In page number nine, looking at commercial expenses, selling expenses, if you will, we see growth of about 25%. And interestingly here, one of the reasons why it has grown if you compare with prior quarter is because we sold more lives than we sold in the first quarter. That's the good news. But I would say the more conservative news refers to the fact that if you all have noticed this quarter there was a huge distraction in the Brazilian market overall, due to the World Cup, there we're not different than any other company here.

So therefore we had to put a little bit more effort, especially when you look at sales campaign, sponsorships and publicity and advertising. So if you were to make that normal calculation that we always do in terms of cost of acquisition, you would see that cost of acquisition of our new life this quarter was higher than what you would expect or you would have seen in other quarters. That's why we were able to show some growth in our gross lives, even though we went through a very difficult quarter on that indicator.

Page number 10 what we have is the bad debt overview, which is if you remember at the beginning of our call I mentioned that we have two very important highlights. Number one was churn and number two was bad debt. As you can see here bad debt this quarter was

5.3% of our net revenue and I think one of the major reasons why that has happened if you look at the second point here on this slide, you see we have recovered about BRL6 million in the second quarter of '14.

And the main reason why we did that even though we did not have the benefits of the (inaudible) from previous quarter, we were much more aggressive on our black listing strategies. As you notice numbers here may (inaudible) because one of the reasons why we had an increase in losses in the previous administrative slide, but in the other hand we recovered about BRL6 million worth of past due payment.

So as I always mention to you we are always watching that cost benefit analysis very closely. Because in the meantime, it still benefits us having the aggressive black listing strategy, because if you look at this slides here, we're showing we have recovered so far about BRL17 million and the cost of considering that -- of recovering those past due payments have been much smaller than that. But if we feel in any point of time that that cost benefit analysis may change we definitely may review that strategy.

In the same page on the other operating income expenses, I think the most important highlight here is the reductions we see in operating losses which have been a strategy we are using here very for a long time and some reconciliation process we have put in place, it seems they are working already and I think that's, as we've always mentioned this set of expenses, they should be pretty close to zero. And I think we are kind of getting there as time goes by.

Page number 11, in financial income and expenses. I think a couple of points that are important to highlight. First of all if income from short-term investments, if you recall, we have made a fairly large payment in April 2 to pay for the remaining 60% of Alianca. The check we wrote was actually higher than BRL270 million. So that brought the average cash available for investments in this quarter down significantly. So that explains why our income from short-term investments have reduced.

And another point that is also interesting, which is being major comments in the previous quarter refers to the monetary adjustment from call option, especially for Alianca. This quarter it has come down to BRL7.6 million which is only the monetary adjustment referring to the remaining 40% of Alianca and we had not any -- we have not made any adjustments in market-to-market situation because we -- last time we did that, we have actually projected enough against for Alianca in order to avoid those in the future. So this should be about the size of the barrack [ph] you should be looking at the next few quarters.

In terms of having said that, our cash which we will see shortly closed this quarter at about BRL92 million, which is the lowest you will see I believe since we started -- became a public company, and the reason why because we rolled (technical difficulty).

Page number 12, we would actually give you here a quick overview of how this, all of this ups and downs have turned down in terms of EBITDA. So as you see here, our adjusted EBITDA has come out at BRL126 million for the quarter, which represented a margin of like

36.8%, which was, as you can see here, better than last year but not as good as first quarter, because if you remember, we mentioned, first quarter was a good quarter because several expenses that were supposed to have hindered the quarter did not, so that's why first quarter was unusually high. So kind of down now to levels that are absolutely within our expectations for the year, as we've been always sharing with you.

Another point to highlight here is the net income at BRL24.4 million positive has also contributed to reducing our net operating losses on our balance sheet. So, putting us on the right direction hopefully for the second half of this year of paying out some dividends. As I've always mentioned, this would be statistically relevant for 2014, where we are pretty much on track for that payment as well.

Next page number 13, we're talking about adjusted earnings, and I think here, the 24.4 million that I mentioned of net income. If we were to exclude out of those the non-cash items such as stock option and the monetary adjustment and also if you were to add back the amortization relating to goodwill and to portfolio of acquisition, you would be looking at a potential total cash earnings of like BRL94.2 million, meaning that we would be paying -- we would be talking about a BRL0.33 per share in terms of cash earnings. So it's pretty well considering if we exclude all of this non-cash item.

Page number 14; we are looking at our CapEx performance, not much different than previous quarters. So CapEx in IT, is still moving forward with the implementation of a better platform. And the others here that you see at almost BRL12 million, refers mostly to the investments we've made to change our headquarters. So we are now already all fully installed at the new headquarter. So you should not see major CapEx investments in the following quarters meaning that for the following quarters we would be still focusing and investing in IT.

In terms of capital structure, as usual, we have reduced our net debt by about 2.5% mostly coming from our operational generation of cash as always.

Next page, getting pretty close to the end, looking at our return on invested capital, I think this is an important slide that we have added in the most recent quarters shows the continues growth since second quarter last year in terms of a ROIC reaching out this quarter at 31.4% even considering all of the intangible investments that we have made so far. So allowing us to stress here the situation where even with the intangibles we have generated gains and (inaudible) have also generated gains to our company. So having said that, having gone quickly through the presentation, I would like to turn back to the operator, so we can start the Q&A session. Thank you.

Questions And Answers

Operator

Thank you. We will now start the question-and-answer session. (Operator Instructions). Our first question comes from Rafael Frade of Bradesco. Please go ahead.

Q - Rafael Frade {BIO 16621076 <GO>}

Hi, good morning, gentlemen, I have two questions. First, if you could give us an update on were there any of your (inaudible) potentially changing your capital structure that you mentioned during the Qualicorp Day if you have any update on that?

And the second question is related to your tax expenses in the quarter, you have a little less than 5 -- around BRL5 million related to write-off of some tax credits. If you could give more color on that, would be great.

A - Wilson Olivieri {BIO 17325685 <GO>}

Rafael, we will try to take mostly, could you please be more specific with the capital structure changes that you mentioned just so we know we're giving you the right answer.

Q - Rafael Frade {BIO 16621076 <GO>}

Sure, you were mentioning that you were analyzing for example, to maybe raise debt to roll out the your current debt or maybe leverage the company and eventually doing dividend payments with that, if there is any update on this discussion.

A - Wilson Olivieri {BIO 17325685 <GO>}

Well, thank you, now it's clear. We are still about the same pace -- we are still in that situation. We in order -- based on our (inaudible) for us to get any leverage for the company.

We needed some approval from the Board, so we actually were able to discuss that point with the Board during the last meeting and we received some approvals, so we can look at leveraging the company. Definitely we are going to leverage the company, especially for purposes of updating our indexes, our economic indexes with ANS, but we are still deciding on how much we are going to do and like what kind of instruments we use.

So yes, you should potentially be looking at Qualicorp leveraging a little bit in the second half of this year, but the instruments are not still decided and we of course are looking for the cheapest one in the market for the longer term possible, but we still don't have a final position on which instruments that will be. And if you could please repeat your second question about the tax credit, again.

Q - Rafael Frade {BIO 16621076 <GO>}

Sure. So in this quarter you have around BRL5.4 million related to I don't know for sure what it is. But tax credits that you have losses in this quarter. So this was one of the reason for the higher tax rate in the quarter, it seems to -- maybe it's related to some controlling company that don't have result in this quarter or something like that.

A - Unidentified Speaker

Yeah, this relates to companies that are having accumulated losses, and because we don't have perspective to enjoy profits in the near future. We have to write off their credit.

Q - Rafael Frade {BIO 16621076 <GO>}

Right. Just to make clear, but I think that at least looking for your companies, it seems to be in that link, the one that is incurring losses and there is -- so is there no way to at least to use those results in order of the subsidiaries to at least you do not have this tax loss.

A - Unidentified Speaker

We do have the strategy to try to enjoy that benefit in some of our other subsidiaries, but from an accounting perspective and from the IFRS we are obliged to write off until we close a project to enjoy those benefits. So you might see the number going back to our balance sheet, which is find a way to absorb those benefits in a different subsidiary.

Q - Rafael Frade {BIO 16621076 <GO>}

All right. That's clear. Thank you.

A - Wilson Olivieri {BIO 17325685 <GO>}

Thank you Rafael.

Operator

Our next question comes from Rael Grossy from NukeLuke Capital [ph]. Please go ahead.

Q - Unidentified Participant

Hi, I just have one question, I want if you can give some update on the issue related to the PIS and COFINS taxes, the part related to the past, the last five years of possible credits that the company is studying. Do you have any update on these and if we should see this in the third quarter on the balance sheets of the company.

A - Mauricio Ceschin {BIO 18750717 <GO>}

Yeah, thank you Rael, for being with us here. Well, one thing that I've mentioned actually we did mention that during the Qualicorp Day, that is the 100% guarantee is the possibility of Qualicorp to assume a lower tax rate from now on. So that thing we have already implemented and that's the thing that is 100% guarantee.

Regarding the past, we have actually two discussions in the table; number one is, if we can actually absorbed completely all of the -- the taxes that we have paid since 2010 when the regulation was actually changed creating the benefit of the registration company, and even so if we do that we have still a discussion going out with our auditors here regarding if they would hit our P&L all at once or if you would have to amortize that according to our capacity of absorbing down on a cash basis.

So this is not much different than the few times I've discussed that, it's a very complex issue, so we are very optimistic in terms of our capacity to being able to absorb the past five year's gains of that change. But we still are not a 100% guarantee how we can do it and if we can do it? So, as I mentioned in other opportunities, as soon as we have 100%

certainty of what we're going to do we definitely are going to let you guys know, but at this point of time, I would say from zero to 100 I'm like 75% optimistic that this will take place, but until I'm 100% I still would not consider that on my results yet. Did that help?

Q - Unidentified Participant

Yeah, sure, can you give some idea of the value, do you have these until now?

A - Wilson Olivieri {BIO 17325685 <GO>}

Yeah, we are talking, if we're to look back the last five years, we're talking about a little more than BRL100 million potentially.

Q - Unidentified Participant

Okay.

A - Wilson Olivieri {BIO 17325685 <GO>}

That's why we have to be very careful in dealing with that number because it changed significantly the direction for this year. So, as you all know, everyone know, was we're pretty conservative and until we are 100% positive just please hold back for that.

Q - Unidentified Participant

Okay, thanks.

Operator

Our next question comes from Ed Kaufman [ph] from Morgan Stanley. Please go ahead.

Q - Unidentified Participant

Yeah, hi, thanks for the call. I was wondering if you could update us on your outlook for churn in the second half given the price increases announced in July.

A - Wilson Olivieri {BIO 17325685 <GO>}

Hi, thanks very much for being with us, of course we can. During the Portuguese call we actually have the same question a couple of hours ago, and what are being shared with everyone is the last indicator we've closed in any giving cycle is churn and the debt because as soon as we can recover more and more lives, we will try to recover those lives within the given period for as long as we can. So considering that assumption is kind of early it's still to say what's going to be the final outcome. So it has created here some indicators comparing to the same period of last year, trying to figure out how our customers would behave this year versus 2013. So what we have seen so far, how are we measuring that.

So let's say, I had a group of customers where the due date for payments were the 20th of July. So this year I looked into that and I noticed that 20% of those customers did not pay me on time and I looked at the same date, at the same conditions last year and I notice that the same 20% did not pay us. So the conclusion on that assumption is that we are not experiencing so far an increase on our churn higher than what we had experienced last year. In other words, last year we had a growth in churn third quarter compared to second quarter, there was about 20% and this seems to be the same level we are experiencing so far. I like to stress that this does not mean the final results will be the same. They could potentially be either lower or higher, but we could be looking at potentially at a situation, assuming a 17% price adjustment this year compared to the 14% last year, that would potentially be worse than that. So at this point in time this indicator seems to be pretty much in our favor, targeting to about a 20% increase in churn for this quarter, but it's still kind of early to assume this is the final number.

Q - Unidentified Participant

And if I could follow up with a question, could you give us a update or outlook on the expenses related to the Tempo acquisition, you said that most of them will come in the next quarter and only part of them came in the second quarter. So what are we looking forward to in the third quarter for Tempo legal and due diligence expenses?

A - Wilson Olivieri {BIO 17325685 <GO>}

Well, as you know the final approval for that acquisition actually happened yesterday, day before yesterday with a General Assembly here. So once that acquisition has been approved, we still have a fair -- this is Brazil, so we still have a fair amount of formal procedures we have to go through. So we need lawyers, we need consultants. So I still don't have a final number to share with you guys in terms of how much Tempo acquisition would cost. What I can tell you is last quarter we probably were hindered by a couple of million reis. So not mentioned but it's still already part of the game, but we should be having a more good overview for that number, I would say within the next 10 days. Once all of the consultants and lawyers will finalize the procedures.

Q - Unidentified Participant

Thank you.

A - Wilson Olivieri {BIO 17325685 <GO>}

Thank you Ed, it's a pleasure.

Operator

(Operator Instructions) There are no questions at this time. So this concludes our question-and-answer session. I would now turn the conference over to Mr. Wilson Olivieri. Please go ahead.

A - Wilson Olivieri {BIO 17325685 <GO>}

So thank you all (inaudible) for being here on the second quarter results. And it's a pleasure having you all, I will wish you all have a great day and a nice weekend. Mauricio please.

A - Mauricio Ceschin {BIO 18750717 <GO>}

Same as Wilson, I would like to thank you, thank you all and hope to see you soon, maybe here in Brazil or in US and we are going to hear from each other in the next call. Thank you very much.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.