Conference Call Transcript

2Q18 Results
Estácio Participações (ESTC3.BZ)

August 15, 2018

CONFERENCE CALL SCRIPT

2Q18 RESULTS

OPERATOR:

Good morning, ladies and gentlemen, thank you for standing by and welcome to Estácio's conference call to discuss the results for the **second quarter of 2018**.

This event is also being broadcast simultaneously on the Internet, via webcast, which can be accessed on the Company's IR website: www.estacioparticipacoes.com.br/ri.

We would like to inform you that all participants will only be able to listen to the call during the presentation. We will then begin the Q&A session, when further instructions will be given. Should you need any assistance during the conference, please, request the operator's help by pressing star 0.

This conference call may contain forward-looking statements that are subject to risks and uncertainties that could cause the Company's actual results to differ materially from those in the forward-looking statements. Such statements speak only as of the date they are made, and the Company is under no obligation to update them in light of new information.

I will now turn the conference over to **Mr. Pedro Thompson,** the Company's CEO. Please, **Mr. Thompson**, you may proceed.

PEDRO THOMPSON:

Thank you. Good morning everyone.

Welcome to our conference call to discuss the results for the second quarter of 2018.

Just to remind you all, there will be a question-and-answer session as soon as the presentation is over.

Before beginning our presentation, I would like to announce a few recent changes in the IR department. After nine years working at Estácio as head of the IR department, Flavia leaves the Company to pursue new opportunities. We would like to thank her for her dedication and important contributions to the Company.

To strengthen the department, we announce the arrival of Renato Campos as Department Manager. Renato worked at the IR department of BRMALLS for four years. We also announce the new IR Officer, Rogério Tostes. Tostes worked was Statutory Investor Relations Officer at TIM for ten years and a sell-side analyst in several industries for more than five years.

The contributions to the IR team aim to improve the quality of communication with the market

Let's begin with slide 2 of our presentation with some quarter highlights. I would like to emphasize that we remain focused on **improving our operational performance**, thanks to initiatives to ensure revenue growth and efficiency gains, in accordance with the planning that has been in place since 2017.

Despite some adversities in 2017, and especially in the first half of 2018, such as a reduction in government financing programs and a highly unstable economic scenario, we kept to the business plan by improving nearly all of our financial and operational performance indexes. These results arise from our commitment to the pursuit of operational excellence and focus on the Company's continuity.

Regarding the quarter highlights on the first slide, net operating revenue totaled R$963.7 million, 5.5% up on the second quarter of 2017. Revenue increased despite the 26.4% decline in the FIES student base in the period, chiefly due to an increase in average ticket and improved student retention rates, which we will show in details below. It is worth noting that the non-FIES student base moved up by 9.2%, of which % in the on-campus segment and YYX in the distance-learning segment, as we will speak next.

As a result of the projects and continuous efforts to improve efficiency, the second-quarter cash cost of services accounted for 41.9% of net operating revenue, a 5.9 percentage point margin gain. Therefore, our Gross Profit came to R$536.1 million in the second quarter, 20% up on the same period in 2017, ratifying the plan to implement operational improvements, announce at the close of 2017.

We have been able to improve our operational performance. The EBITDA margin came to 31.8% in the first half of 2018, 4.7 percentage points more than the 27.1% recorded in the first half of 2017 (and above the average margin of 20.6% between 2014 and 2018). Excluding the non-recurring effects of the six-month period, EBITDA came to R$618.7 million, with a margin of 32.6%, 5.4 percentage points more than in the first half of 2017.

Our **Net Income** reached R$236.9 million, 42.5% up on the second quarter of 2017.

At the close of June 2018, Estácio's cash balance totaled R$401 million. In August, we received the transfer of FIES' last installment of PN23, totaling R$342 million. And from May until the last disclosure, Estácio repurchase R$122.2 million in Company shares.

I would also like to highlight that in July 2018, the rating agency S&P reaffirmed Estacio's rating at brAAA with a stable outlook, proving the Company's solid financial structure.

Moving on to slide 4, we can see that the student base increased by 3.4%, to 558,200 students. The highlights are the 21.1% growth in the distance-learning student base and in retention rates, which reached 85.0% in the on-campus segment and 80.9% in the distance-learning segment, a significant improvement when compared with the same period in 2017. When analyzing the undergraduate student base, excluding FIES and Prouni students, the increase was 9.2% on 2017.

On the organic growth front, our strategy focuses on the expansion of the distance-learning business, as well as on the expansion of the course portfolio in our on-campus units, mainly health courses, especially Dentistry protocols. In the second semester opened more than xx new courses in the on-campus, distance-learning and Flex segments.

Regarding the distance-learning segment, we have a 100% online platform and a special structure to support partner centers. Therefore, we rapidly expanded the **network of accredited centers**, which moved up from 238 to 451 at the close of the second quarter of 2018, an increase of 213 centers over the second quarter of 2017. The expansion of distance-learning centers is one of our strategic priorities for the coming years and has been our main growth driver, since we are authorized to open up to 350 new centers per year, given our academic excellence.

Another highlight was the 57.9% growth in the **Flex student base.** The Flex segment is a distance-learning product that requires students to occasionally be present at our centers and has an average ticket of nearly double the average ticket of 100% online courses.

The distance-learning growth offset the 4.8% decline in the **on-campus student base**, which was under the effects of the xx% decrease in the FIES + Prouni student base. Please note that the regular students' base increased by 9.2% in both modalities (xx% of which in the on-campus segment and YY% in the distance-learning + FLEX segment).

Moving on to slide 5, I will talk a little about our **average ticket**.

In the second quarter of 2018, the **on-campus** average ticket totaled R$799.8, an increase of 6.4% compared with the same period in 2017, mainly due to the impact of the new DIS campaign and the adjustment in senior students' monthly tuition, in line with the inflation in the Company's costs.

The **distance-learning** average ticket increased by 14.4% in the second quarter compared with the same period in 2017, to R$273.7.

In the distance-learning segment, we highlight the 58% increase in the Flex student base, which has a higher average ticket than the average ticket of 100% online courses (R$451.9 versus R$257.4, respectively). The 6.0% decline in the Flex segment's ticket was due to price repositioning, which contributed to the increase in the number of Flex enrollments.

I will now turn the floor over to Gustavo Zeno, our CFO, who will comment on our financial results.

GUSTAVO ZENO:

Thank you, Pedro.

On **slide 6,** I will begin by talking about the performance of our **Net Revenue** in the quarter.

The second-quarter Net Operating Revenue totaled R$963.7 million, 5.5% up on the same period in 2017, mainly due to the R$108.1 million upturn in revenue from monthly tuitions, due to the increase in average ticket and improved student retention rates.

The discounts and scholarships line improved by R$69.4 million, due to the maturation of students who joined Estácio after the change in the Company's pricing strategy. The effect of this strategy is offset by the increase in gross revenue.

There were less significant impacts in other lines, the most important was the R$9.5 million decrease in taxes, due to the reversal of PIS and COFINS recorded in the first quarter of 2018, resulting from the temporary effect of the loss of the Prouni benefit, which I will explain further on.

Moving on to slide 7, I will talk a little bit about our operating costs.

Our **cash cost of services** accounted for 41.9% of net operating revenue in the second quarter, representing a 5.9 percentage point margin gain, mainly in the personnel line, due to the implementation of the new faculty career plan and the increase in the sharing of disciplines in the curriculum matrices.

The Personnel costs line was impacted by R$3.0 million in the second quarter, due to costs from the termination of administrative employees. We optimized our structure following internal headcount efficiency benchmarking efforts, with calculation of unit target size and implementation of appropriate quality service standards. Excluding this impact, the Personnel line accounted for 31.1% of net operating revenue, a 6.1 p.p. margin gain, instead of 5.8 p.p. in comparison with 2017.

In the on-campus segment, other ongoing measures aim to improve the management of faculty costs and include the alternate route, the increased offer of equivalent disciplines and the offer of probation classes.

In the distance-learning segment, we implemented initiatives to improve teachers' efficiency and response time in interactions with students, which increased the average number of students per class by 31%, from 158 in the second quarter of 2017 to 206 this quarter, without affecting the quality of the services provided. The same initiatives implemented in distance-learning disciplines have also benefitted the online disciplines offered in the on-campus segment.

In addition to the improved management of personnel costs, the 0.5 p.p. margin reduction in rental costs also contributed to a margin gain in the quarter, as more campuses merged in the last 12 months when compared with the number of new units.

On slide 8, we present our **operating expenses**.

Selling expenses accounted for 16.1% of net operating revenue in the second quarter, a 3.2 percentage point margin loss over the same period in 2017, mainly due to the 5.1 percentage point increase in PDA.

To explain this variation, I would like to remind you that until December 31, 2017, Estácio accrued 100% of the monthly tuitions overdue for more than 180 days and as of January 1, 2018, we started using the new standard on financial instruments (IFRS9 – CPC 48) for students who pay monthly tuition, based on the concept of expected loss at the moment of revenue recognition, which increases according to the aging of accounts receivable.

Accordingly, the allowance for doubtful accounts was lower in the first quarter of 2018 when compared with the second quarter of 2018, given that, in order to complete the enrollment of new students and senior students in the first quarter, the first fee of the semester must be paid, not generating accounts receivable for this monthly tuition in the first quarter. Additionally, the accounts receivable recognized in the short term (12 months), referring to the 106,000 students who joined the DIS program in the first quarter of 2018, corresponds to approximately 25% of the total monthly tuitions paid in installments only, considering four-year courses.

The quarter-on-quarter increase in the PDA was due to a seasonal upturn in accounts receivable given that the above-mentioned mitigating facts do not occur in the second quarter.

Moreover, the second-quarter PDA was also affected by (i) the 8,300 students who joined the PAR financing program in the second quarter, compared with the same period in 2017, in which the provisioning corresponds to 50% over the long-term revenue net of APV; (ii) the R$10.8 million impact from the 2,900 students who dropped out or did not re-enroll in the semester, given that when PAR students drop out, do not re-enroll and do not enter into any agreements, we provision 100% of the total balance receivable from these students. This criterion is conservative regarding the non-recovery of overdue credits, even though the balance remains due and the Company continues negotiating with students in order to recover these amounts; (iii) R$1.0 million impact due to the provision of 15% on net revenue, net of APV, of the diluted monthly tuition of students who joined the DIS program; and, finally (iv) the R$7.3 million impact from the dropout of DIS students who did not pay and did not enter into any agreements.

The effects I have previously mentioned led to a variation in the PDA of regular students in the second quarter; however, this effect is mitigated when we analyze the semester.

This slide also show another line of selling expenses: **advertising expenses.** This line posted a margin gain of 1.8 percentage points, accounting for 3.6% of net revenue. We intensified online media investments in the first quarter to strengthen the enrollment campaigns, thus reducing expenses in the second quarter. In the first half of 2018, the margin gain came to 0.5 percentage point. The campaigns are focused on lower cost and higher efficiency.

General and administrative expenses accounted for 13.2% of net operating revenue, a 1.6 percentage point margin loss compared with the second quarter of 2017, essentially due to the 0.9 percentage point margin loss with third-party service expenses, mainly from non-recurring advisory expenses, which impacted this line by R$6.4 million.

We have been working in four major projects to increase performance with renowned advisory firms, as Pedro will explain. Excluding this non-recurring expense, general and administrative cash expenses accounted for 12% of net operating revenue, a margin loss of 0.5 p.p. only.

Moving on to slide 9, we can see that second-quarter **Net Income** totaled R$236.9 million, 42.5% up on the second quarter of 2017, mainly due to the reversal of income tax and social contribution.

The Prouni tax benefit substantially fell in 1Q18 because of one of our subsidiaries was temporarily suspended for not having the Tax Debt Clearance Certificate (CND). Consequently, the Company fully recorded the income tax and social contribution tax liability in the first quarter of 2018, without the benefit of Prouni in March. In the second quarter, we solved this problem and we reviewed the first-quarter tax basis in accordance with the effective law. Accordingly, the tax liability recognized in excess in the first quarter of 2018 was reversed.

The Prouni tax benefit returned to historical levels in the first half of 2018 and should remain at similar levels throughout the year.

Excluding the reversal of the provision, in the amount of R$9 million in PIS and Cofins expenses and R$47 million in income tax and social contribution expenses, second-quarter Net Income totaled R$181 million, an increase of 8.8% in comparison with the same period in 2017.

Net income came to R$434.3 million in the first half of 2018, with a net margin gain of 6.2 p.p. on the first half of 2017, mainly due to the R$135.4 million increase in EBITDA in the period.

Moving on to slide 10, we have the **Average Receivables Period**.

The FIES receivables days was 15 days lower than in the second quarter of 2017, reaching 247 days, due to the transfer of FIES' second installment of PN23, totaling R$167.4 million, in August 2017.

The average non-FIES receivables days were in line with the same period in 2017, at 75 days.

We remain focused on improving our collection and student debt renegotiation campaigns.

Moving on to slide 11, we can see the information on our **Capitalization and Cash** in the first table.

Our cash and cash equivalents totaled R$401.0 million on June 30, 2018, conservatively invested in fixed-income instruments pegged to the CDI interbank rate, in government bonds and certificates of deposit with top-tier Brazilian banks.

Our bank debt of R$426.4 million mainly corresponded to our debenture issues, the loans with the IFC, the issue of promissory notes, subsidized financing from regional development agencies and banks, and the capitalization of equipment leasing expenses in compliance with Law 11,638. The R$607.3 million year-on-year reduction was due to the settlement of the third debenture issue, the payment of the first tranche of the promissory note in November 2017, the settlement of the loan with IFC in May 2018 and the payment of a portion of the principal of the 2nd and 4th debenture issues in April and June 2018.

Including bank loans, commitments payable for acquisitions, and taxes payable in installments, Estácio's gross debt totaled R$657.8 million. Accordingly, our net debt totaled R$99.9 million, nearly 0.11x our EBITDA.

Debt and operating cash generation levels allow the Company to carry out its operating activities, meet its financial commitments and implement new expansion and growth strategies using its own funds, as well as contract loans and financing.

I would also like to emphasize that in July 2018, the rating agency S&P reaffirmed Estácio's **rating** at brAAA with a stable outlook, proving the Company's financial strength.

Also on this slide, we show our second-quarter **CAPEX**. We invested R$38.5 million, 13.6% more than in the same period in 2017, essentially due to investments in buildings and improvements in the second quarter of 2018.

Moving on to slide 12, the operating cash flow (OCF) before CAPEX was a positive R$125.2 million, R$95.4 million less than in the second quarter of 2017, essentially due to the payment of income tax and social contribution of R$49 million. As previously mentioned, this was a consequence of the Prouni tax benefit that significantly fell due to the temporary suspension of Prouni enrollments in one of our subsidiaries. Consequently, the second-quarter OCF before CAPEX/EBITDA ratio was 45.7%.

Year-on-year, there was a seasonal variation in the payment of FIES, of approximately R$77.0 million in the second quarter. Consequently, the OCF before CAPEX/EBITDA ratio was 53.4%. Excluding the variations from the Prouni impacts and the seasonality of FIES payments in the second quarter of 2018, cash conversion was 65.7% of the OCF.

I will now turn the floor back over to our CEO, Pedro Thompson, for his closing remarks.

PEDRO THOMPSON:

Thank you, Zeno.

Moving on to slide 14, I would like to emphasize that we are in a new phase, with new projects that aim at improving our operational efficiency, and are expected to begin showing significant results in the coming periods. We are looking out for the Company's continuous revenue growth and student base.

Regarding the efficiency projects, the highlights are:

- **Strategic sourcing:** we restructured our supply department, whose main purpose is to optimize all of the Company's global spending categories in order to obtain significant gains by reducing acquisition prices and the supplier base, as well as improving the quality of services delivered, ensuring better controls and reducing financial expenses. Since the beginning of 2018, various contracts are being renegotiated, including advertising and marketing, IT, telecommunications, rent, cleaning, security and maintenance. The benefits of this initiative will be recurrently observed as of the second half of 2018.
- **Pricing:** This initiative comprises: (i) strategic pricing review with greater granularity, through in-depth analyses of price elasticity; (ii) optimization of the commercial policy on discounts and scholarships during the intake and renewal cycle; and (iii) creation of tools to improve revenue management. Consequently, the Company has been investing in increasing its profitability and ability to approach the market on a granular basis by defining more specific strategies targeted at each student group and enabling effective communication in the markets it operates. The benefits of this project will be observed as from 2019.
- **Loyalty:** Consists of reducing academic dropout rates and financial evasion, increasing renewal rates and improving the student experience. We have already noticed tangible results of this initiative in the first semester. The project consists in a detailed diagnostic that covers the students' entire journey based on the identification of the main dropout triggers and assessment of the Company's processes, as well as the detailing and implementation of initiatives designed to prevent students from dropping out. More than 80 initiatives have already been identified, 20 of

which were implemented in the first half of 2018. We believe that dropout rates will significantly decline in the coming cycles, as was the case in the second quarter of 2018.

- **Intelligent Collection:** Our aim is to increase overdue credit recovery volumes by improving the management of specialized collection firms, customizing initiatives for each overdue profile.

Talking about growth, as I have already mentioned, our Cash reached R$401 million at the end of June. In August we received the transfer of FIES' last installment of PN23, totaling R$342 million and, as announced in the recent CVM358 forms, since May we repurchased R$122.2 million. I am sure that we are well positioned to seize growth opportunities by taking advantage of our capital structure.

On the organic growth front, the strategy is focused on the expansion of the distance-learning business, as well as on increasing the number of courses offered in all segments. In the distance-learning segment, the Company has already achieved solid and sustainable returns compared with those of our competitors, driven by competitive advantages, such as academic excellence, scalability of the technical platform and local partnerships. In addition, we continue focusing on efficiency gains and student loyalty, strategies that have been in place since 2017, in order to expand the student base.

That being said, Estácio begins the second half well positioned, with new expansion and efficiency gain projects, in addition to a more solid structure to capture growth opportunities!

We can now move on to the question and answer session.

Thank you.

CLOSING REMARKS

OPERATOR:

As there seems to be no further questions, I would like to turn the floor over to **Mr. Pedro Thompson** for his closing remarks.

PEDRO THOMPSON:

I would like to thank all of you for participating in our results conference call.

Our Investor Relations department is always at your disposal to help you with any questions you may have. Our contact information is available on our website.

We hope to see you again at our conference call next quarter.

Once again, thank you very much and have a great day!

OPERATOR:

Estácio Participações' conference call is now over. Thank you all for joining us and have a good day.

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