2Q16 Conference Call Transcript – Q&A – SULAMÉRICA

Operator

We will now start the Q&A session. Our first question comes from Mr. Gustavo Schroden - Bank of America Merrill Lynch.

Gustavo Schroden (Bank of America Merrill Lynch)

Good morning. Good morning, Gabriel, good morning, Arthur, thanks for the opportunity. I will make two questions; the first is related to pricing. I believe that you just concluded the price readjustment cycle in health and I'm considering an average price increase of approximately 18%. Firstly, I would like to know if this figure makes sense. I'm also working with a VCMH (medical inflation) of more or less 15%, twice the IPCA (consumer price index), and this leaves out around 300 BPS to spare. Since the price readjustment is enough to absorb this increase or inflationary pressure, do you believe these 300 BPS are enough to absorb a higher frequency and, thus, could your loss ratio remain resilient in the next twelve months? This is my first question, I will ask the second one later.

Mauricio Lopes (Vice President of Health and Dental)

Good morning, Gustavo, thanks for the question, it's Mauricio speaking.The VCMH and price increase impacting the portfolios are not the same across the board. We have several portfolios and several different realities, a significant share of them with the negotiations over, it's a fact, but they have a different mix, it's not a simple linear figure. What we continue to see is: the market continues to suffer with an increase in the average cost and an increase in frequency. The challenge is to put the work tools to handle frequency, and I believe we've been trying to do that, which may lead to a difference in VCMH. The average cost component is maybe a bit simpler to control now. There are frequency control tools which have a longer maturity, but as we started with them a while ago, they are maturing at different rates, but they are indeed maturing and are controlling specific items in a very good manner, in others we are still evolving. So we can't say if your 15 or 18 in price versus the VCMH is real or not real. There are mixed and positive effects among the several components of the portfolio.

Gustavo Schroden (Bank of America Merrill Lynch)

OK, I'm sorry to insist. But if we look at what happened in the last cycle, the initiatives carried out by the company have been successful so far, and, together with an adequate pricing – I think – adequate so far, it's been successful. So maybe you could comment, more qualitative than quantitative, for the reasons you just mentioned, if it's possible to keep this resilience in the health loss ratio, given, well, the measures taken and, I think, maintaining an adequate pricing, i.e. I would like to understand, because in every adverse macro scenario in the past economic cycles we normally had a worsening in the loss ratio, which didn't happen so far. So, if you could elaborate a bit on it, I would appreciate.

Mauricio Lopes (Vice President of Health and Dental)

All working elements we have point to the good development of the tools which are being built. The underwriting, which I think is the second point in your considerations, is being made very consciously. We've been fighting in markets in which we believe we have a good competitive situation, and we've been leaving markets where we don't see this condition, or at least we've been showing less appetite in terms of price. As for claims, the maturation of the tools should bring sustainability to what we've been doing, which means we shouldn't see a disruptive movement in health in any way, on the contrary, there is a continuity of the very consistent work being done for more than 4 years.

Gustavo Schroden (Bank of America Merrill Lynch)

Good, that's great, thank you. Moving to the second question, I think it's more related to the company's overall growth, in terms of premiums. Recently, the company reduced its payout ratio to 25% and I'd like to understand, looking forward, given the regulatory changes that may arise, like a higher capital requirement, and a part of this will already have in 2016 or 2017, if you may correct me, but there will be a higher regulatory capital requirement. What do you believe – given your balance sheet and the recent change in the payout ratio – is a sustainable premium growth level in the next two, three years, taking into account all the variables I mentioned?

Arthur Farme (Vice President of Control and Investor Relations)

Gustavo, thank you for the question, this is Arthur. Beginning at the end, we can't give you an indication of sustainable growth, what we can tell you is: the growth levels we've been showing make us comfortable and already considers the regulatory scenario, whether SUSEP's, which already announced and implemented their concepts of risk-based capital, or ANS's, we don't anticipate any sort of impact for what we have planned for the company's capital going forward.

Gustavo Schroden (Bank of America Merrill Lynch)

OK, thank you. Just to conclude, do you think I can consider a sustainable growth in the low double digits, 10% to 12%, with the payout ratio of 25%, as reasonable?

Arthur Farme (Vice President of Control and Investor Relations)

Well, I don't know if a growth of 15% in health can be considered low double digits, but I think that what we've been presenting in terms of growth, as I said, is comfortable for our structure. The automobile portfolio's performance, for example, was worse than what we would like, it had a better performance in 2015 and there is nothing we noticed in the first half results or when we look at the market which may anticipate deterioration in this portfolio, so, yes, we are prepared for this movement.

Gustavo Schroden (Bank of America Merrill Lynch)

Great, thank you. Congratulations on the health results.

Operator

Our next question: Marcelo Cintra – Goldman Sachs

Marcelo Cintra (Goldman Sachs)

Hi, good morning, everyone, thank you for the question. My first question is related to the administrative expenses, which, in my opinion, is running at a healthy level. I would like to understand a bit how we should see this, both the administrative expenses and its ratio, if this is sustainable or if we had any one-off event this quarter. Then I will ask my second question. Thank you.

Arthur Farme (Vice President of Control and Investor Relations)

Hi, Cintra, this is Arthur. I think the level reported in the quarter, or in the first half – if you'd like to consider that – is an adequate level. There was no one-off here, neither positive nor negative. Obviously, depending on the inflation level, this will impact the labor agreement negotiations. In relation to other expenses, we've been properly negotiation the inflation pass-through and productivity gains where we deem important. I believe the company has been reaping fruits of an increase in productivity in a general manner. If we look at our revenues, at the headcount, we've been more productive when we look at a longer time series and that's the expectation going forward. I don't know if I help you with this answer.

Marcelo Cintra (Goldman Sachs)

You do help. It's just that I honestly thought it was a very healthy and strong figure for the quarter. My second question is has to do with the auto segment. Firstly, when we look at the evolution versus the first quarter – when I believe premiums were much weaker – there was a significant evolution. I would like to understand if there was more aggressive pricing, more aligned with the market in the last months of the second quarter, and what do you expect for the loss ratio until the end of the year. I understand the scenario continues to be very challenging, but should this worsening continue or be more aligned with this reported figure?

Eduardo Dal Ri (Vice President of Auto and Massified)

Marcelo, it's Eduardo Dal Ri, thank you for the question. In fact, we've been feeling that the market has been more conservative in the past 45-60 days. In a way, prices today are more adequate to the current risk level. As everyone is aware, there was risk deterioration, the market saw a worsening in risk after the fourth quarter, including the fourth quarter of the last year. So, yes, this difference in premiums, mentioned by you, in the second quarter, doesn't mean we're being more competitive. Of course we're more competitive, but this is much more related to the market, which has been bringing prices up to be more adequate to the risk, than more competitiveness from our side, i.e. we lowering our prices. We've been choosing to leave our price more adequate to the risk. We've been pursuing that in our pricing. And now we are seeing market agents defining its premiums in this way as well. I believe that, in terms of competitiveness, this will be dominant from now on. I don't believe we will return to more competitiveness, more aggressiveness, even because theft and robbery figures and inflation levels have been resilient, they are not decreasing. We expect improvements, but the numbers don't show that, however. So, being very pragmatic to answer, yes, the market is being more conservative in terms of pricing, keeping them at more adequate levels.

Marcelo Cintra (Goldman Sachs)

Perfect, thank you very much.

Operator

Our next question: Thiago Kapulskis – BTG Pactual

Thiago Kapulskis (BTG Pactual)

Good morning, everyone, thanks for the opportunity to ask a question. I have two questions, and the first goes back to the health segment. What I think was very interesting to notice in the insured members' base – mainly when we consider corporate and SME – is that we saw a different dynamic from other players; yesterday another player reported a significant decrease in the number of members. I'd like to understand a bit what you are doing to maintain the number of members, if it's only pricing strategy or if there is anything else you're doing to differentiate yourselves from the rest of the market, and if you see any change in this member trend going forward. If you expect stability or if maybe we can see a decrease… Well, how we can look at this point. And my second question has to do with taxes. Your tax rate is still very high, around 40%. Is there anything you can do to try to reduce that? Well, is there anything to be done or should we expect that the effective tax rate will remain more or less in these levels? Thank you.

Mauricio Lopes (Vice President of Health and Dental)

Hi, Thiago, thank you for the question, this is Mauricio. In relation to the base of members, what we've been doing is an interesting mix of commercial expansion, with several new branches being opened – Matias can explain in detail, if you are interested – where we have new options for the sales force. The second point is that we've been continuously redesigning our product, in the last years, trying to make it more adherent to the reality of each location. Making two comments in relation to product design, I can highlight the concept of health management, which we've been working for several years now and has been translating into a very interesting value proposition to our customers – whether a prospect or a current customer – and this has been showing results over time. So, I believe this value proposition has been attracting attention. Obviously, it doesn't sustain itself if it doesn't come together with a sustainable reduction in claims for the customer. So the measures in claims management carried out in the past years show the quality of the work being done in terms of maintaining the network of providers, managing authorizations and payments, and this is very clear for the customers. I believe these four items together lead to higher retention and higher sales, always with a controlled and balanced underwriting.

Arthur Farme (Vice President of Control and Investor Relations)

Thiago, it's Arthur. In relation to our tax rate, yes, it's quite high and it's even higher since September of last year, due to the increase in the social contribution (CSLL) rate. Right now, there's nothing we can anticipate that could change this reported rate, but we are studying, ultimately evaluating everything that can be done to mitigate this impact in our results.

Thiago Kapulskis (BTG Pactual)

Perfect, the answers are clear. Thank you.

Operator

Our next question: Rafael Frade – Bradesco

Rafael Frade (Bradesco)

Good morning everyone. Firstly, talking about the evolution of members in the health segment, if you could give a little color if it came more from current customers or new ones. Just to have an idea because, as it was commented several times, we had a relevant increase in unemployment in the quarter, so I'd like to understand how was the relation between the movements of current customers versus the entrance of new customers. My second point is related to the price readjustment, which shall impact more the second half of the year. Given the high values we've seen in the SME and affinity portfolios, if you could give us some visibility about downgrades, if they have intensified this year, maybe being more affected by the price readjustments, or if they have not been so different from what we've seen in the last years.

Maurício Lopes (Vice-Presidente de Saúde e Odontológico)

Rafael, this is Mauricio, thank you for the question. I will start backwards, OK? I will start with the maintenance of customers. We've been seeing some downgrades, but in a much lower relevance than we imagined. Some products are being redesigned for some customers in some situations. But what we've been seeing indeed is a significant increase in co-participation, much higher than seen before. Just to give you a figure, considering contracts with more than 5,000 lives sold this year, 100% of them were in co-participation, which means this really is a trend for corporate contracts. In retail, unfortunately, we still don't see co-participation gaining traction, but I think it will become more important over time. At least that's the bet I guess the market makes, because a co-participation experience brings more rationality to the whole market. Still talking about retention, even though we haven't seen an increase in downgrades yet, the market is more rational in terms of pricing, the customers find a good cost-benefit relation in SulAmérica, whether because of the size of the network or the product offered, or even by the value proposition the product carries, i.e. the price we've been offering. And they are staying, a little less in retail, it's a fact, and a little more in the corporate segment, but in general we've been doing a good job in retention. Obviously there is a set of retention initiatives which we have developed in-house over a bit more than one year, and I believe we talked about them in one of the questions made in the last earnings conference call. When it comes to sales, I think the opening of new branches brought new brokers to get to know the product, especially retail products, and the regional expansion we made, in some more relevant regions, brings comfort to the local customer and this open up sales opportunities and, once again, I believe the value proposition is proving to be correct and appropriate to the moment our country is in, a moment of recession, which means claims and health management is aligned with the reality and will continue to be a strong point, regardless of any macroeconomic change, given the ageing population, the change in the epidemiological profile and the need to look more carefully to prevention and promotion continuously. I believe this mix explains a little the growth in sales and the retention of current customers.

Rafael Frade (Bradesco)

Understood. Just to follow-up, the understanding is that, in fact, this growth came a bit more from retail than from corporate itself, isn't it? Why?

Mauricio Lopes (Vice President of Health and Dental)

If you could please repeat, I couldn't get the question.

Rafael Frade (Bradesco)

Sure. So, is the view that the growth seen in the quarter came more from retail than from corporate?

Mauricio Lopes (Vice President of Health and Dental)

No, no. The two segments are behaving – depending on the region, product, channel – they are behaving asymmetrically, but we have been able to grow in both portfolios. The sales movement is permanent, while retention is stronger in corporate and weaker in retail. All in, you find the balance that gives you the difference between the two segments.

Rafael Frade (Bradesco)

OK, perfect, Mauricio. Many thanks.

Operator

Our next question: Francisco Kops – Banco Safra.

Francisco Kops (Banco Safra)

Good morning everyone. I have two questions; the first is directed to Mauricio in health. Actually, Mauricio, I would like to try to understand a little the difference in performance between you and your main competitor, at least. Do you think it is related to the channel, to the fact that SulAmérica has larger affinity segment? Do you think the affinity portfolio suffers less moral hazard pressure stemming from the rising unemployment, increasing frequency, or no, compared to the corporate segment, it doesn't work like that? Another doubt in health, if you could talk a bit about SulAmérica's geographic positioning, where you are expanding, because it seems you are doing an interesting geographical expansion. I believe this explains a little the market share gain you are showing. Then I will ask my second question. Thank you.

Mauricio Lopes (Vice President of Health and Dental)

Hi, Francisco, thank you, it's Mauricio again. Each portfolio has its reality, each player has its mix, the portfolios are not fully comparable, and so I think comparison is not really the goal here. The relevant point when it comes to moral hazard, if I may add, is that the corporate portfolio indeed suffers more with moral hazard if you think about unemployment. However, when it comes to income, it also impacts small companies and pressures affinity contracts, ultimately the three most significant portfolios. So I don't know exactly how moral hazard is different between these three. What I do know is: if we maintain our claims management efforts focused on the frequency of procedures, we can bring more stability to the operation, considering a more adverse and recessive macro scenario or even an improved one. I believe this is the key and it's been our focus over time. Regarding our geographic positioning, we've been opening branches across the country, in the Northeast, in the South, and obviously there are branches that need to be worked over time, and we've been trying to reach regions with relevant GDP to buy health insurance plans where we had a an insufficient network. The whole provider structure today, the relationship with SulAmérica's providers, was regionally broken down. Previously, it was consolidated in our headquarters, but it was broken down four years ago and the impact has been positive, because now our employee remains closer to the local network of providers, proximity is higher and negotiations more effective. I think this allows the commercial area to be more assertive when it comes to seeking new customers and the relationship area can keep these customers more satisfied. So, without specifying a single region, what we've been doing in all regions is to seek these locations and try to explore other options, which are several.

Francisco Kops (Banco Safra)

No, I think it's quite clear, Mauricio, thank you. If you allow me to make a second question, it's directed to Arthur. How are you preparing for lower interest rates, Arthur? This a consensus call nowadays, we are just waiting to see when and how much, so what can you comment about the investment positioning and even product strategies? Thank you.

Arthur Farme (Vice President of Control and Investor Relations)

Kops, I think this is a difficult question to debate right now. Obviously we are aware and alert, as you said, there is an expectation interest rates will fall, because we expect the economy will follow with its recovery, and then top line growth should be more vigorous than what it's been, and we've maintained a good growth pace in this recessive environment. So it begins at the top, with the economy growing again and we reaping these benefits with top line growth. In relation to operational and administrative costs et al, obviously the market will have to adjust to a new level of interest rates. You have seen it in previous cycles, this "seesaw", it's not new and it's a consequence of market rationality when it comes to pricing in an environment in which interest rates doesn't allow for investment income to compensate operational losses. You weren't born when this market ran at a combined ratio of 108%, mas if you look at History books, you'll find that. Interest rates were way higher in those moments. So, the Company is aware of this. Regarding the investment strategy, our policy's main driver, and Marcelo is here to confirm, if we don't highlight it here, it's ALM. We seek to protect the exposure of our liabilities. In addition, our asset management team has been successful in this sense, taking advantage of opportunities in other strategies, fixed-income, equities and our even corporate bonds, which, according to the standards when it comes to issuers, they've been scarce. Maybe Marcelo can help in this sense, he is here next come and will complement.

Marcelo Mello (Vice Presidents of Investments, Life and Private Pension)

Francisco, good morning. As Arthur mentioned, we are very aware and we have room for market risk, additional credit risk and we are following this prospective market of falling interest rates. There is great difficulty to find new opportunities in corporate credit at the moment, you've been following, the window is narrow, few issuances, but we are very aware, and regarding market risk – with the scenario we have – I believe opportunities may arise from fixed-rate and inflation-linked assets throughout the next half of the year.

Francisco Kops (Banco Safra)

Alright, thankyou.Thank you for the answers.

Operator

Our next question: Gustavo Lôbo – JP Morgan.

Gustavo Lôbo (JP Morgan)

Good morning everyone. I have two questions; the first is a follow-up to Kops' question. Earlier in the call you mentioned the auto market has been showing more rational pricing. I'd like to understand if this is taking into account the expectation of lower interest rates or if this is just a return to rationality given the increase in theft and robberies, after a more aggressive period. Most likely it will be a combination of both, but I'd like to understand what has been the most relevant driver, and then I come back for my second question.

Eduardo Dal Ri (Vice President of Auto and Massified)

Gustavo, it's Eduardo. The market has been more rational, in your own word, or more conservative because it's actually seeing the risks. Today there is a need to correct prices due to the risks, which are much more relevant than a future decrease in the interest rate, because the negative effects of the increase in theft and robbery rates and the higher inflation of auto parts have been high, causing much more concern than the future interest rate curve. Of course the market looks at all the variables and, in my opinion, the market is more conservative now, and by "now" I mean in the past 45-30 days we've been monitoring this movement daily, basically because these frequency issues are lasting in Brazil, at least for now, and I see the market passing to price this perception and even a future pessimism related to frequency. This pessimism is related to frequency, not results, because once the market becomes conservative, it tends to adjust – as it has done in the past – adjust price to the current level of risk. So, I believe that we can expect more rationality in the future. Not only because of frequency, but, as you mentioned, because eventually interest rates will fall as well.

Gustavo Lôbo (JP Morgan)

Perfect, that's very clear. Thank you. My second question is slightly more specific. When we look at your investment income, it was quite strong, despite a yield of only 94% of the CDI benchmark rate, and when we look at the breakdown numbers, at the other investment income line, we see more than R$40 million, while it was running at R$15 million in the past. I would like to understand the composition of this line and what should be its level going forward. Thank you.

Arthur Farme (Vice President of Control and Investor Relations)

Lôbo, this is Arthur. I believe there are three elements which explain at least part of this difference: additional fee for the payment in installments, as we saw a slight change in the profile; interests, for the same reason, interest for delay in payment and delinquency, and also means of payment affecting this item; and also a smaller impact of financial expenses related to contingent liabilities. I think these elements explain your point and this is a level you may consider.

Gustavo Lôbo (JP Morgan)

OK. So from now on this should continue to run at around R$40 million?

Arthur Farme (Vice President of Control and Investor Relations)

Yes.

Gustavo Lôbo (JP Morgan)

Thank you.