Conference Call Transcript

Hapvida

1Q24 Results

Operator:

Hello everyone, thank you for waiting. Welcome to Hapvida's first quarter 2024 earnings conference call. Joining us today are Jorge Pinheiro, CEO, Luccas Augusto Adib, VP and Guilherme Nahuz, IRO.

Should you need simultaneous translation into English? Please click on the interpretation button on the bottom toolbar and choose the English option. This event is being recorded and will be made available in the company's IR website along with the earnings release materials.

You can download the slide deck by clicking on the icon on the chat. Please refer to the disclaimers of this release at the end of the deck. During the company's presentation, all participants will be in a listen only mode. After the company's remarks, there will be a question-and-answer session. In order to ask a question, please click on the Q&A button on the bottom of your screen and write your name, company, and language to enter the queue.

Now I'll turn the floor over to Jorge Pinheiro, CEO, who will start the presentation. Jorge you have the floor.

Jorge Pinheiro

Hello everyone. Thank you very much for joining us in the first quarter of 2024 earnings conference call. Joining me today are Bello, Francianne, and in New York, we have Luccas, Guilherme, and Candido Neto, who will share some details with you.

We would like to express our solidarity with our brothers and sisters in the state of Rio Grande do Sul. They are facing an extremely difficult time. We're deeply sorry for all the losses suffered in this beloved state. We have set up a crisis committee with daily meetings where we have been discussing all our actions and initiatives for the region. Despite the difficulties, our hospital service network is fully operational with our teams working overtime. We have developed extraordinary operational rituals involving specialized teams in different areas to ensure care and support for our members in the region when they need it the most. We have set up our own air logistics scheme to make sure our units can operate fully with an appropriate inventory of materials and medication. Additionally, the company has been taking social actions providing care to the population in general and to mitigate the difficulties they are facing right now. We have also been providing full support to our employees in the region who are either homeless or displaced. To all of those working at Centro Clínico Gaúcho, Hospital Humaniza, and our other healthcare units in the greater Porto Alegre area, we stand with you.

Now let's get started on slide two of the presentation. Here you can see an overview with some financial highlights that will be further explored later by Luccas. But first, I would like to comment on some of them. The first quarter of 2024 was a historic quarter for us. We started the year with exceptional results that reflect the commitment and discipline in each one of the strategies implemented throughout 2023. And that is leading to significant improvements quarter after quarter. We have only been able to deliver these results because of our people. I would like to thank our team of over 65,000 employees for their dedication and commitment as well as our teams of doctors, dentists, and other service providers totaling nearly 130,000 people.

The evolution of our cash MLR was the highlight of the quarter with an impressive improvement of 4.3 p.p. against 1Q23. The ratio was 68%, exceeding the numbers of the last quarter of 2023, which had been the best ratio since the business merger, comfortably beating our historical seasonality. The reduction in cash MLR, together with the dilution of selling and admin expenses resulted in Hapvida Notredame Intermedica reaching another significant milestone. The record number of just over R$1 billion in Adjusted EBITDA, up 60% year over year. Our net revenue grew by about 4%, reaching R$7 billion, a result of the consistent and responsible pricing in new sales and the necessary adjustments in existing contracts, where we see a consistent evolution of the average ticket. The member's base remained stable through the quarter and the sales of new contracts continue strong. Our new clients have been choosing more verticalized products that help oxygenate the portfolio and future profitability, as they come through competitive and sustainable pricing. We know that healthy tickets and healthy portfolios are the foundations for the long-term sustainability of our business. Our capital structure also showed sequential advances. We reduced leverage in nominal terms with operational cash generation reaching close to 80% of EBITDA. Net debt over EBITDA. Net debt over EBITDA continues its gradual downward trajectory and in the quarter at 1.13x, a very comfortable level in our view.

Moving on to slide 3. Here I'd like to share a bit more about the progress we have made in the integration process. Over the past two years, several activities preceding systems integration have already been completed in São Paulo, such as operational standardizations, centralization of supply, and procurement of materials and medication optimization of our own and accredited networks. For 2024, we will complete the integration of the company's operations in São Paulo and we are in the final phase of systems implementation in our care units. Two waves of implementation, covering approximately 50 care units, have already been executed very successfully. Only two phases remain, which will take place in the coming months with the final systems turnover, that of the health insurer expected to take place in Q4. With the end of this integration journey, we will have a 100%

systemically integrated company with significant gains in customer journey control and full visibility of all our healthcare quality indicators which are key for our management. We understand that the integration investments we have made also translate into healthcare quality and customer satisfaction.

For example, looking at the overall complaint rate, or IGR - which is an index published monthly by ANS - NDI Saúde's IGR has been showing successive improvements, reaching its best position in the last 16 months. If we add up all of the group's operators, our position in the ranking would be #22, three positions better than the average of the major operators, which is 19.

It's important to mention our efforts in fighting dengue fever and other viral diseases. We are going through the largest dengue fever epidemic in the country's history, and so the company has been investing heavily in opening specialized units and increasing the number of beds to fulfill our mission. The volume of urgent ambulatory care and tests related to dengue fever and other viral diseases has been above our historical volume for the period. Some regions are already showing a reduction in volume, but in other regions, the volume remains pronounced.

Before I hand over to Luccas, who will give you further details about our results, I want to conclude by emphasizing that we continue focused and disciplined facing the challenges and making the most of the opportunities that come ahead of us in 2024 and working hard to continue the strategies implemented last year. We continue to invest in strengthening our operations and seeking a healthy balance in our margins. Once again, we want to thank the contribution of our employees, doctors, dentists, brokers, suppliers, and the trust of the Board of Directors, shareholders, and most importantly the trust of our customers.

Luccas, you have the floor. Thank you.

Luccas Adib – CFO

Thank you, Jorge. Hello, everyone and thank you for joining us. It's a great pleasure to be with you in another Hapvida's earnings conference call.

I'll get started on slide 4 about net revenue with the chart on the top left corner.Consolidated net revenue grew by 3.9% in 1Q24 compared to 1Q23, as Jorge mentioned earlier. Now let's move on to the chart on the top right corner about our health plan revenue, which had an increase of 5.7% year over year driven by a 10.6% increase in average ticket. In dental, here at the bottom of the slide, we had a 4% revenue increase also driven by the average ticket adjustment of 3.8%.

In revenue from sales of services and other activities, we had a reduction of 39.5%. Because of the sales of some assets such as San Francisco Resgate and Maida, as mentioned before. In the sales of services, we have two effects: first, the reflection of reduced demand in the quarter, especially January and February in line with what we saw in our operations in the market; second, we have maintained and will continue our selectivity in offering services to third parties, reducing our exposure to credit risk and prioritizing our hospital capacity for use by our members.

Now giving you further details about member base and average ticket on slide 5, we lost 11,000 lives on a net basis. So we are virtually stable quarter over quarter, reflecting a gradual downturn compared to the losses we saw in recent quarters.

Gross sales continue very robust. We added 480,000 new lives. High quality contracts, verticalized products and healthy pricing in line with our portfolio sustainability paradigm. Another piece of good news is that we have returned to grow in areas where we were in the integration process such as Minas Gerais.

As for the cancellations of nearly 490,000 lives, they are a result of the necessary adjustments for contracts, economic balance, and optimization, verticalization and regulation process of the care network. Turnover also showed balance this quarter.

At the bottom of the slide, you can see the evolution of the average ticket up 10.6% year over year. In the first column, net price, we had an increase of 11.4% reflecting price adjustment efforts already net of verticalization and copayment effects in existing contracts. In the second column, you can see -0.8% in what we call “mix”, which represents the net difference in average tickets between gross sales and cancellations. This exchange results from our commercial focus and a greater demand for more verticalized products with lower tickets, while cancellations are concentrated in contracts with higher tickets but with greater exposure to the accredited network, with higher MLR, less sustainable. We have even started to see again a migration of lives from insurers with higher tickets to our more verticalized product line.

All the movements mentioned above are part of the company's strategy and the plan to recover our historical margins, which continues firm and disciplined in 2024 and that is being executed with rigor and discipline, which is the keyword for the year.

On slide six, you can see how this connects with our main operational performance indicator, MLR. Our cash MLR this quarter was 68%, a decrease of 4.3 percentage points compared to 1Q23 and 1.3 percentage points compared to 4Q23, far surpasses its seasonality, which indicated an increase for the period. Our goal is a gradual and responsible margin recovery journey to overcome seasonality.

This is not rocket science. It's all about a series of initiatives that we implement, monitor and refine every day to deliver this evolution, and all of this is coupled with our perennial goal of delivering quality healthcare, as you can notice in our better position in the IGR historical rate. We continue to work hard on price adjustments, increasing verticalization, standardizing protocols, optimizing provider network and various cost control measures. As a result, per capita costs have been decelerating and verticalization and tickets have been increasing.

As Jorge mentioned earlier, it's important to highlight that we're going through possibly what it is, the largest dengue fever epidemic in Brazil's history, and we're closely monitoring the high volumes of urgent ambulatory care and tests. Volumes have been quite pronounced and above our historical levels in March and April.

On slide 7, you can see cash admin expenses excluding the effects of SOP, depreciation, amortization, and no recurring items, which were R$12.3 million of Maida impairment. Here we are half a point better than 1Q23 and 20 BPS above 4Q23. This quarter we included one more chart at the bottom of the page about personnel to help in our explanation in a more visual aid.

We had positive impacts in 4Q23 that were not repeated in 1Q24. We explained this last quarter but let me highlight this again. We had reversals of R$47.2 million between variable compensation from 2023 and reclassification of retroactive expenses from the dental sales team. This quarter we have made specific reclassification between lines of R$16.8 million and system maintenance moving from "location and operation" to "third party services" (without retroactive effect), just a line swap here. We also had nearly R$14 million in IT Expenses related to system changes that impacted the "third-party services" item in line with what we have been saying about specific one off expenses with these integrations.

Now back to Personnel graphic, we had positive impacts of first, an additional reversal of R$16 million from variable compensation in 2023, after final assessment of our goal achievement; and an allocation of variable compensation (R$10.5 million) and sales expenses (R$5.3 million) to cost, that was provisioned entirely in admin expenses in 2023. And finally, we have "others" column with R$5 million, which is basically provisions for salary increases. As I mentioned in the last call, we can see erratic behavior in the coming quarters. This is normal and expected since there are expenses related to systems integration with changes and implementation involving support staff travel, temporary coexistence of legacy systems with new systems which may cause this behave up or down. We are confident that there is room for improvement through initiatives that we will undertake as these integrations stabilize.

Now moving on to sales expenses on slide 8, we can see here a stable level compared to the previous quarter without major news, as we said earlier about the reallocations between admin expenses and selling expenses. The positive highlight here is on commissions for two reasons. First, due to a reduction of deferred acquisition cost write offs, the brokerage, due to a lower level of contract cancellations within these deferral periods. Second, after the system's implementation in Clinipam and NDI Minas, we updated the deferral periods, making them longer within our standardization of policies and processes. The reduction of R$12 million in Advertising and Marketing is normal, as expenses are temporarily lower at the beginning of the year while we structure the campaigns for the rest of the year.

Now PDD has increased by R$32 million, because we're being more conservative and slightly more rigorous in credit assessments, imposing an incremental safety view in light of IFRS 9. The remaining value in this line comes from a provision related to a specific client.

On slide 9, you can see our Adjusted EBITDA, which was a bit over R$1 billion in the quarter, a milestone in our history, as Jorge mentioned. And just to recap briefly, this is the company's highest EBITDA since the merger, resulting from an increase in net revenue, continuous efforts in different areas for cost control and optimization as well as rationalization of admin expenses.

Now moving on to slide 10, cash flow. This is a new chapter that we introduced last quarter to facilitate understanding of our cash management. Our free cash flow for 1Q24 was R$614 million, and also came at a very significant volume with a conversion of 80% of EBITDA into operating cash, an extremely healthy level.

Looking at the table in the bottom left corner, we can see cash consumption of R$132 million in 1Q24, which comes basically from the following math: R$614 million from free cash flow generation; R$35 million from M&A activities; and a consumption of R$781 million in financing activities, which I will detail later. We also had a balanced working capital manage between clients and providers, where we highlight the main cash consumption coming from rents and payment of annual bonuses in March, which usually happened in April. But even with the bonus we had substantial growth here.

We recorded payment of R$94 million in income tax and social contribution, remembering that there is a mismatch between competence and cash that was recorded in December and is paid in January and so. The amount is significant and reflects the profitability of our operational entities. It's important to remember that there is ongoing corporate restructuring program that will be accentuated once we are 100% integrated from a systemic point of view.

CapEx remains under control at R$105 million, and with significant investments in IT. We are projecting CapEx between R$600 million and R$1 billion, which should be slightly higher in the coming quarters, especially if we advance in the projects of hospitals in São Paulo and Rio.

On Slide 11, we can see M&A activities with a generation of R$35 million with the receipt of R$22 million from the remaining portion of the sale of San Francisco Resgate and R$21 million from the sale of Maida Health in February. Financing activities consumed R$781 million, driven by the payment of R$840 million from the 4th issuance of debentures with funds raised at the end of last year. We also had financial income of R$186 million, a profitability close to the CDI, respecting our conservative cash investment policy.

As you saw last week, our Board of Directors approved the raising of R$1 billion at the cost of CDI + 1.60 per year and maturity in 2031, to meet our upcoming maturities concentrated in the second half of 2024, restructuring our debt settlement. The payment already occurred in May and the cash is already in our balance sheet. With this, the company has maintained its disciplined, gradual, and responsible pace of deleveraging quarter after quarter, reducing net debt by R$404 million and dropping leverage from 1.38x to 1.13x EBITDA in the contractual covenant methodology.

Going to the last slide before we open for questions, we have our Regulatory Requirements, applied only to individual operators. So, when trying to compare with the consolidated company, there will be differences. Technical provisions had a slight retraction partly due to the increase in medical bills payable in March, following the increase in utilization, as we mentioned and the cost and another part from cash consumption, as we saw earlier.

In Regulatory Capital, we expanded our PLA surplus in relation to CBR with a net profit generated by the operators.

Thank you all for your patience. I hope this has been useful and now we open for questions. The questions will be answered by Jorge, by myself and Guilherme Nahuz, who's here with us. Thank you very much and have a great afternoon.

Q&A

Operator

We are now going to start the Q&A session for investors and analysts. When your name is called, a prompt to unmute your mic will pop on your screen.

Please unmute your mic and ask your question. We kindly ask you to ask only two questions by analysts, and please ask all your questions at once. Starting with our first question by Vinícius Figueiredo, sell side analyst at Itaú BBA.

Vinicius, we're going to enable your mic so that you can ask your question. Please go ahead.

Vinícius Figueiredo (Itaú BBA)

Good afternoon, everyone. Thank you for taking my question. I think we can start with a question about the competitive landscape. I think you talked a bit about this already, but a few weeks ago we saw a strong readjustment by the competitors. When we look at the readjustment in pool, which is made public for SMEs, but what can you tell us about the new product table? What can your commercial team see here in the behavior of Amill and other competitors here in the Southeast region of Brazil? Can we see Hapvida standing out as the one with the lowest price among these products, which is a bit different from what we saw at the end of last year?

Now you commented in other opportunities about how exchanges in the accredited network brings attrition with customers, but since PPO is an important point in your commercial perspective, it’s not only about losing this portfolio, but actually improving profitability. So, if there is no space to make changes in the accredited network, what are possible levers to improve MLR?

Hi Vinicius. Thank you for your questions. I will start by talking about the competitive landscape. What we can see throughout the industry and among competitors, is that we have made the necessary adjustments and the most radical ones last year and most operators made two to three adjustments throughout the year as well, but this year started, and we have made a first readjustment in Q1 and we might make another readjustment throughout the year, going back to our old practice of two annual reviews in those sales.

So, this year, we expect readjustments to new sales at a lower level than what we had last year because of all the readjustments in our portfolio, the advances in our verticalization and integration process put us in the position to make lower readjustments this year than last year.

About the competition, what we see is a similar dynamic. The competitors have made strong adjustments last year and almost all of them had similar readjustments, or a bit lower than last year in their product portfolio. So the whole industry is going to take two years in the cycle that is starting in May this year and will end in April next year with higher readjustments so that they can go back to historical levels of profitability.

Our model, given the verticalization integration and all the improvements that we have been making, allows us to be on average 30 to 35% less adjustments necessity then our competitors and this has been helping us greatly in corporate channels where we've been selling a lot.

About the PPO products, Vinicius, we have no network adjustments to be made. We have made changes throughout last year. We discontinued the sales of some of the products that we considered to be unsustainable, but on the other hand, we ended up encouraging the sales or creating products in PPO, because we have a good relationship with the providers that we now consider to be more sustainable. And this has led to improved margins in PPO as well.

So the recovery that we shared with you is stronger in HMO plans, but we can also see improvement in margins in PPO. PPO products are very important for larger cities like the greater São Paulo, Rio de Janeiro, and Belo Horizonte area, especially in Sao Paulo, which will compose our product grid and is essential so that we can have all types of offers to make to a large company in those regions.

Vinícius Figueiredo (Itaú BBA)

Great. That was very clear. Thank you very much Jorge Luccas and other executives and congratulations on your results.

Operator

Let's move on to our next question by Leandro Bastos, sell side analyst at Citi, Leandro. Please unmute your mic and ask your question.

Leandro Bastos (Citi)

Hi, everyone. Good afternoon. I have two questions here.

First, can you tell us about the effect of dengue fever in the months of March and April? Is the frequency much higher in Q2 as well and what can the effects be on MLR? Which is seasonally?

This is the first question, and the second, if you could talk a little - going back to the commercial dynamics, to the adjustment strategy in the large corporate channel - if we already have any visibility on the retail side, but even drawing a parallel here with what you discussed at last year's Hapvida Day, what is the strategy and level of adjustment that you will pass on average, thinking here for the large company channel. Thank you.

Jorge Pinheiro – CEO

Hi, Leandro, thank you for your questions. Starting here with the frequency and volumes we have been seeing. You know well our seasonality. It respects the variation in rainfall and temperatures that usually start in the north of the country and move towards the south-central region. It has been following the typical seasonality of recent years, but this year with more intensity, notably bringing dengue fever in various regions of the country. Therefore, we have more volume this year than the average of previous years, and we observe that some cities are already on a downward curve, which shows that the curve is typical, with about 45 to 60 days of increase and then a decrease in the period of less than that, city by city. So the curve respects its historical patterns, but with more intensity in demand for emergency room units and low-complexity hospitalizations. It is still early to talk about the second quarter, we do not have May closed yet, but again, we have more volume, on the other hand, I remind you that looking more towards the long term, this is part of the seasonality of our historical industry and that this should not affect our initiatives in the long term.

And regarding commercial and adjustments... Observing the mix between individual small businesses, affinities, and large companies, the result will bring us for this year, according to our strategy, something that can vary between 1 percentage point - maybe a little more than that - lower than what we applied last year. Adjustments vary according to each region. There is a slightly greater need for adjustment in SMEs and affinities in region 2 (south and southeast), and a smaller need in more mature regions, such as the north, northeast, midwest, and the countryside of the state of São Paulo. But the mix of all this should bring something around 1 percentage point / 1 percentage point and something lower than what we applied in the last cycle.

Operator

Moving on to our next question by Samuel Alves, sell side analyst at BTG Pactual. Samuel, please unmute your mic and ask your question.

Samuel Alves (BTG Pactual)

Good afternoon, everyone. I have two questions here on my side.

The first one is about the aspirational MLR. You talked earlier about how the company aimed to bring the MLR to around 68%. The question is, after this first quarter, which showed a victory in this recovery trajectory, can this aspirational target be a little higher or is this still the company's ambition? That's the first question.

And a second question more related to net adds. Luccas mentioned in the presentation that you have noticed a migration of sales from insurers with higher ticket to Hapvida in some specific segments. The question is, can you already anticipate a trajectory of organic base growth in the second quarter? You even commented in previous calls that you expected this to happen in the second half... It's more to confirm this growth trajectory perspective. If you still anticipate it only for the second half. Thank you.

Jorge Pinheiro – CEO

Regarding the loss ratio, 68% is a number that corresponds to the combination of pre-merger Hapvida NDI MLRs, pre-pandemic, not considering the recent acquisitions, because they bring higher MLR. So, reaching this number is truly remarkable. Delivering 68% before the integration processes are completed is something to celebrate for two reasons: first, it shows the consistency of implementing all the measures we have been taking, which, again, are not entirely concluded. We are still in the integration process, there is still verticalization to be done, there are still new portfolios to be launched. So, we still see room for improvement in the long term, respecting the seasonality of the first and fourth quarters, which are lower than the second and third quarters. It is also important to note that this first quarter benefited from lower volumes. So, it was a combination of factors that brought us to this very significant result.

Trying to answer you objectively, we expect this year to have a better MLR than last year. Just as in the second half of last year, there was a change in behavior, with much better results than in the first half of last year. So, we expect this first half to be better than the second half of last year. In other words, we made a plan for 2 years in which by the end of it, we would be at or near levels close to historical MLR, not considering recent acquisitions. That's more or less what we aim for.

So, maybe in the second/third quarter of next year, we will see at which MLR level we will be running because at that point we will see all measures fully implemented.

Regarding net adds, we bring very good news from the corporate side. It has been very active since the fourth quarter of last year until the first quarter of this year, with negotiations with medium and large companies. There have been significant contracts implemented during this period, as well as others already signed and in the implementation process, coming from insurers, operators, and cooperatives. The corporate sector remains active and gives us hope that over the next few months, we will have good chances of remaining active given the business pipeline.

As for the retail channels, we noticed that the beginning of the year was slow, in January/February, and then came an improvement trend. So, February was better than January, March was better than February, April was already better than March, May is better than April. A growing curve of retail sales, which is very good news, encouraging, since the best margins of the company come from here.

We have not yet reached target achievement in the retail channels. We are exceeding targets in the corporate channels, but the growth rate in the retail channels gives us hope that, continuing at this same pace, we will soon achieve targets in the retail channels as well. So, this convergence of accelerated corporate growth, reduction in cancellations, also because we completed the portfolio review now in April, and this heating up of the retail channels lead us to believe that we will have a good period from a commercial point of view. This second half, then, promises that we will have good results coming from the commercial area and, eventually, growth.

Samuel Alves (BTG Pactual)

Thank you, Jorge, and congratulations on the improvements that you have made.

Operator

Moving on to our next question by Gustavo Miele, sell side analyst at Goldman Sachs. Gustavo, please unmute your mic and ask your question.

Gustavo Miele (Goldman Sachs)

Good afternoon, Dr. Jorge, Luccas, Guilherme, and Bello. Thank you for the presentation. I also wanted to ask two questions, please.

The first one, going back a bit to the discussion on MLR, being more specific about the cost per life, we see a very strong performance in MLR, even in a scenario of stability in ticket prices quarter over quarter. So, we can infer a very strong cost per life performance. I wanted to know if you could share with us a bit how much of this cost performance comes from the rationalization of the portfolio that the company has been doing, by eventually churning contracts with slightly higher cost levels, and how much of this cost improvement you attribute to a more organic performance or legacy portfolio of the company that we can track through the verticalization KPIs you shared with us. So if you could give us some color into this, I would appreciate. That's my first question.

And a second topic I would like to explore with you is about capital allocation. We have been following for a few quarters now the pace of deleveraging and very strong cash generation. This quarter was no different. I wanted to know if it makes sense for us to think about the company eventually accelerating the plan for expanding its own network, accelerating investments in this regard, or if eventually thinking about returning this money to shareholders is something that is on the company's agenda and if that would this offend regulatory standards of solvency and other issues or not. I imagine not, but just to try to understand what the capital allocation strategy for the company in the coming quarters would be.

Jorge Pinheiro - CEO

Gustavo, thank you. I will start and then Lucas can complement my answer, especially regarding capital allocation and eventually also regarding the first question.

The cost per life responds to many variables. As we grow more in corporate channels, as we sell more radicalized products, sell more products with co-payment, that is, the product mix brings a decisive impact on the average medical cost per life. But of course, several of the other factors we mentioned here such as verticalization, renegotiation, network, material review, suppliers, special materials, medications, system implementation, prevention programs, procedure kits, etc., all contribute to helping us better control current user levels, that is, the current portfolio, and this adds to a strategy of selling products that are more geared towards verticalization. As I mentioned here before, we will maintain our portfolio with all products, but we prefer more vertically integrated products, which is our vocation, where we know this segment very well, we think we can extract better and it is where the Brazilian population demands more accessibility, which is where we are positioned, but maintaining the entire portfolio.

Regarding capital allocation, I will start, and Luccas will complement. Of course, last year, focusing on discipline and aiming to reduce leverage levels, we limited CapEx to around R$ 400 million. This year, we are setting a range that will vary from R$ 600 million to R$ 1 billion, and our cash generation will be sufficient for us to meet all these investments that will help us to verticalize and enhance, making new projects, we will build 3 hospitals, one in São Paulo, one in Rio, and another in Recife. We will reopen a hospital here in São Paulo. So, this year's CapEx, which can reach R$ 1 billion, already includes all of this. But Luccas, can you add something to my answer?

Luccas Adib – CFO

Sure, Jorge. Thank you. You talked about one of the main issues of the company's planned capital allocation, which is the successful execution of CapEx. This CapEx projection, as

Jorge very well commented, up to R$1 billion for us to follow our verticalization plan in strategic areas such as São Paulo and Rio de Janeiro.

But we see a scenario where the sector is going through a series of difficulties and we have room on the balance sheet, we are very well-positioned to look at opportunities that may emerge from this sector. So we are very focused on completing our integration, the cornerstone of the year is to complete the integration process in a successful, comfortable manner, generating as little friction as possible for the beneficiary. So the focus continues to be on integration. The company's focus is very strong on verticalization. So we have a lot of room in capital allocation, in verticalization.

This verticalization, passing through our scientific tests of CapEx suitability, in the light of what we understand as pertinent and necessary for the company at that time. So it is essential that we have these very rigorous capital allocation metrics in verticalization.

And we also have room to look at opportunities that may arise from an M&A perspective. It's not our focus for now. We're not looking at that right now, but by the end of the year, the company will reach a very comfortable leverage level, with room on the balance sheet, fully integrated, executing a good part of the CapEx we have projected for this. So we will be extremely well-positioned to look at important opportunities in capital allocation.

Now, a message we like to convey is that this capital allocation will not be made from the perspective of opportunistic M&A that may arise. We are not looking at anything specific, but they may arise. This allocation will undergo a need for testing within our rigorous logic of where we will allocate capital. We will not and do not want to buy just for the sake of buying, grow just for the sake of growing. We want to grow intelligently, make transactions intelligently. So we will be very well-positioned with our balance sheet to capture this, after the integration cycle ends.

I think naturally the company is on a trajectory of profitability. The operational entities are at an increasingly healthy profitability level. This translates into distributions within the operations to the controller via Payment of Equity Interest, via some optimization mechanisms we have here, including tax rates, and Hapvida Participações, realizing here a profit attributable to shareholders in the form of surplus net income, we will distribute as indicated by applicable law.

Now the company's focus remains very strong on integration, verticalization, and room on the balance sheet to look at important opportunities after this whole process.

Gustavo Miele (Goldman Sachs)

OK. Thank you very much. Have a great afternoon.

Operator

Moving on to our next question by Mauricio Cepeda, sell side analyst at Morgan Stanley. Mauricio, please unmute your mic and ask your question.

Mauricio Cepeda (Morgan Stanley)

Good afternoon, Dr. Jorge, Luccas, Nahuz. Thank you for the opportunity.

Still talking about CapEx. As far as I understand, there is a whole issue of verticalization that has greatly helped in MLR controlling. And I understand that it was good that you moved to a higher level of CapEx to increase this verticalization now in 2024. But if you could talk in a slightly more aspirational way about how far you intend to go with verticalization... If you have any internal goals, how this should translate into CapEx over the years, and where you should stop with it.

And the second question, which is also related to this, is whether this will lead to any type of regional selection, if it will be the case of verticalizing in some regions, I mean, in more micro-regions where it would be worth verticalizing there. Or if indeed you may have markets that are not attractive and in some way, you may deprioritize them and actually cease operations in those places. Thank you very much.

Jorge Pinheiro - CEO

Cepeda, thank you for your question. Of course, the best of our model, the best of our experience, lies in regions where we have a minimum concentration of lives that fund a broad in-house network covering outpatient, diagnostic, and hospital care. So we have minimum thresholds for this in terms of the number of lives.

We have already mapped out the entire Brazil, identifying all regions that would fit into this model, and that are our priority for expansion, but we have to make choices. At this moment, we are investing more in regions where we see potential for quicker returns, with a lower level of vertical integration, such as São Paulo, where we have made significant progress and are on this journey of verticalization, as well as Rio de Janeiro and other cities too. So, our strategy has been to expand in regions with the fastest returns, where we have more installed volume or greater potential for network growth.

In subsequent steps, we are naturally evaluating other cities where there is either no presence or very small presence of our operations and which may require investments. The great news is that there are many opportunities in Brazil. Brazil is immense, and we like many cities, but we have not yet operated with our model, and we prioritize investments according to the rate of return. Luccas, would you like to add anything?

Luccas Adib – CFO

I think you were very clear, Jorge. I fully agree with you. Cepeda, these adherence tests of our CapEx, looking at the operation, is something we are being very disciplined and vigilant about. So, observing the areas that align thematically with what we have in our strategic growth plan, the sectors of commercial growth, with what we see in terms of the product profile being offered in the HMO, with our verticalization capacity, is what we expect to exercise throughout this year and beyond. That's the direction we have in mind.

Mauricio Cepeda (Morgan Stanley)

Perfect, Luccas. Do you see more years of CapEx ahead?

Luccas Adib – CFO

We have many verticalization projects here. I don't think we stop here. The verticalization projects don't end with the hospitals in São Paulo and Rio. Jorge, would you like to complement here? Our chief strategist, who has everything about health in his head, can complement, but my vision of the company, as we are discussing internally is that this is a long avenue we will pursue, seeking to optimize our portfolios in light of the verticalization that makes the most sense for those markets. So, I don't think we will stop in São Paulo and Rio. There is room to optimize our portfolio in terms of MLR verticalization over the next few years.

Mauricio Cepeda (Morgan Stanley)

Thank you for your answers Jorge and Luccas.

Operator

Moving on to our next question by Joseph Giordano, sell side analyst at JP Morgan. Joseph, please unmute your mic and ask your question.

Joseph Giordano (JP Morgan)

Hello, good afternoon everyone. Thank you for taking my question.

Let's go back to MLR. There is a calendar effect here, which may be quite important... So what are the estimates? I want to establish the right expectations because if you look at Q1 and annualize this considering the seasons, we would be at a better level than other normalized MLR levels. So my first question is about April, maybe this is not the most relevant month, but when we look at the calendar effect, this can be relevant. Last year we had Tiradentes and Easter in April; Tiradentes didn't happen this year and Easter ended up being in March. So if you look at MLR in the first four months of the year. It's much better, but can you tell us about the magnitude of all of this? And separating this question, even trying to understand how you are seeing this in the former regions 1 and 2, what is the gap today? I imagine that in the legacy Hapvida perimeter it must be even better.

Moving on to the second question, returning to the issue of capital allocations and looking a bit at the health of many service providers, I wanted to understand, from the perspective of perhaps creating a slightly more high-end PPO product, if it would make sense for you to acquire some assets that are in a more intermediate/higher segment of the chain. Those are my questions, thank you.

Jorge Pinheiro - CEO

Hi Joseph, I'll start and then Lucas will answer the question about capital allocation. Regarding MLR, the company has been able to structurally reduce costs. The first quarter performed very well due to this and due to lower volume, which, combined, led to a historical MLR level. The good news is that the improvements are structural, and they will bring us consistent MLR reductions in the medium and long term, until the end of this journey, from May to May next year, considering seasonal variations, the calendar, whether due to holidays or a period of more intense or less intense viral infections. There will always be more intense periods, other periods less intense, but I think the most relevant thing here is to see that this stronger period of dengue, of viral infections that we had and are having, and the velocity, they have already passed and will pass, they are self-limited, they have a beginning and an end.

Therefore, our main concern is indeed to see the company's structure. If we can implement the best prevention programs, if we are delivering our verticalization schedule, integrating consistently, if we are able to make the best agreements with the network, with suppliers, in other words, we will consistently be reducing MLR and I can tell you that yes, we are at better levels today than last year, without a doubt. Considering any factor this year, and that is the expectation that we have for margin improvement, continuing to gain margin.

And regarding the PPO... yes, we have PPO products. There are almost 470 thousand PPO lives throughout Brazil, representing 5% of our portfolio, and we are increasingly qualifying our own network. Of course, this is a product that will always rely on the broadest network of providers, but it is natural that a portion of these users will use our own network, given the better facilities, physical installations, the best systems and protocols, the medical and technical nursing staff we have. With this, we noticed that a larger portion of PPO users has been using our own network more, as we offer it, even though it's the user's free choice, we offer it. We have a good presence in these regions, and we have already announced and will build another beautiful hospital in São Paulo, another beautiful hospital in Rio de Janeiro, in addition to a wonderful hospital that is in its final phase in Recife, and we will reopen another hospital, that is, we offer for all our users, including PPO users, a better and better service. It is possible, and that is our expectation, that an increasing population of PPO products, even with free choice, will choose and preferentially use our network.

Luccas, would you like to respond about capital allocation, please?

Luccas Adib - CFO

Perfect. Jorge. Regarding capital allocation, it's in line with what I mentioned earlier here. It is not 100% the company's vocation to work in this area, but it is an important vector of our generation of lives, not only in revenue generation, but the HMO plans that we close... So a portion goes to PPO for a corporate share, the other enters the HMO. So, we have to do the math here to know if we will have important allocations, aiming at the PPO strategy, the most sophisticated ones from 600 to Infinity. But it's very much in line with what Jorge just commented on. We are very focused on this integration process, on executing our CapEx to be able to verticalize. And it's very much in line with what Jorge just commented on. We will be very well-positioned, therefore, at the end of this integration cycle, at the end of another adjustment cycle, to be able to look at possible opportunities for inorganic growth here for the company, so it's very much in this line.

Jorge Pinheiro - CEO

To complement, Luccas, inorganic or organic... Through greenfield movements and even acquisitions. We have highly qualified hospitals, references in various regions of the country. They are the best hospitals in several of the regions where we operate and our approach is this: qualification of our own network, always being in the best locations, with the best technology, best professionals... We will always raise our quality and offer our user from the entire HMO and PPO portfolio, increasingly better products and with the best exclusive own healthcare network for them.

Joseph Giordano (JP Morgan)

Perfect. Thank you very much, Dr. Jorge and Luccas.

Operator

This completes the Q&A session. This is the end of Hapvida's first quarter 2024 earnings conference call. The IR team remains at your disposal should you have any further questions. Thank you for joining and have a great afternoon.