Q1 2020 Earnings Call

Company Participants

- Dennis Herszkowicz, Chief Executive Officer
- Gilsomar Maia Sebastiao, Chief Administrative, Financial and Investor Relations Officer

Other Participants

- Andres Coello
- Cesar Medina
- Diego Aragao
- Rodrigo Parrode
- Rodrigo Villanueva

Presentation

Operator

Good morning, and welcome to the TOTVS conference call to discuss the results of the first quarter of 2020. We have with us today Dennis Herszkowicz, the CEO; and Gilsomar Maia, the CFO. Note that all participants will be on listen-only mode during the company's presentation. After the presentation, we will start the question and answer session for investors and analysts, when further instructions will be given. (Operator Instructions) The audio is being simultaneously transmitted on the webcast at ri.totvs.com.br.

Before proceeding, we wish to clarify that any forward-looking statements that may be made during the conference call related to the business outlook, operational and financial projections and targets of TOTVS are based on beliefs and assumptions of the company's management as well as information currently available. Forward-looking statements are not guarantee of future performance. They involve risks, uncertainties and assumptions as they refer to the future events and hence depend on circumstances that may or may not occur. Investors should understand that general economic conditions, industry conditions and other operational factors could affect the future performance of TOTVS and could lead results to differ materially from those mentioned in such forward-looking statements.

I will now turn the call over to Mr.Dennis, who will begin the presentation on Slide 3. Mr.Dennis, please go ahead, sir.

Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you. Good morning, everyone. Thank you for joining us in our earnings conference call for the first quarter of 2020. Hope you and your family are all safe and well. In this unprecedented scenario, we have taken preventive measures to ensure the safety of all our stakeholders, keeping the operation going and seeking to balance short-term performance and the ability to execute the medium and long-term strategies, which remain without any changes and are aimed at building an ecosystem consisting of 3 dimensions: management software, represented by the ERP, HR and vertical solutions; techfin with B2B credit, financial services linked to employment and payments; and business performance with digital solutions to support sales and marketing.

It is in this scenario that on April 30, we concluded the acquisition of Supplier, which starts its journey at TOTVS as a fintech that is in a model that combines limiting equity risk essentially to its subordinated shares in FIDC, while preserving the financial spread in operations. This is possible only because apart from origination, Supplier also retained its capacity to define and apply the policy as well as to approve the credit, which is then assigned to the portfolio of the securitization fund.

I wish to reiterate that our aim is to move Supplier to the techfin model moving forward across the supply chains of clients, enabling B2B credit on recurring relations between clients and suppliers and providing a unique experience by integrating the management systems to Supplier's platform and using artificial intelligence and big data to continuously improve the credit algorithms. In fact, in the current scenario, we accelerated the pace of this integration in the product and distribution areas.

Additionally, I want to confirm that we will continue to prioritize the quality of credit granted, instead of the growth of the portfolio, something that we have been doing during the COVID-19 crisis and until now has preserved the resilience of Supplier's business model and the low history of losses. This track record is the result of a combination of the diversification of the number of clients, the low average ticket of credits and the average term of the portfolio of less than 60 days.

Here in M&A, but now on Slide 4, another strategic move we took in April was the acquisition of Wealth Systems, a partner of TOTVS since 2017, which provides CRM and asset-based solutions, especially for manufacturing, distribution and agribusiness chains. It fits into the business performance dimension.

I now move to our shareholders' meeting held on April 27, in which shareholders representing more than 67% of the company's capital participated and approved all the matters, including reducing the number of directors from nine to seven to speed up the decision-making process in the company with seven directors being reelected for a fresh term of two years; and the approval of the stock split of the company's shares at the proportion of three to -- three for one, making the price per share and per standard lot more accessible in order to increase liquidity.

In April, we also approved the second issue of debentures of the company to help settle the first issue of debentures and pay for the acquisition of Supplier. Despite our gross cash position of approximately BRL1.4 billion at the end of the quarter, our goal with this issue is -- was to strengthen our solid position and liquidity in order to give us greater flexibility while assessing the magnitude of the potential impacts of COVID-19.

I now hand over the presentation to Maia for his comments on the quarterly results, starting from Slide 5.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Thanks, Dennis. Good morning, everyone. Net revenue grew 3.8% quarter-on-quarter and 6.7% year-on-year despite a decline of 1.3% and 11.2%, respectively, in nonrecurring revenues. The decline was due to the drop in nonrecurring services revenue, a trend that was already observed in previous quarters with license revenues growing 0.8% from Q1 and 10.3% from Q4 '19, despite the onset of the COVID-19 crisis in the last two weeks of the quarter, given the increase in licensing of the corporate model, which grew 29% compared to 2019.

On the other hand, recurring revenue accelerated once again in the first quarter, growing 5.3% over Q4 and 13% over Q1 '19, exceeding 78% of total net revenue. Here, it must be noted that recurring revenue continued its double-digit growth even after disregarding Consinco's February and March revenues consolidated, which accounted for 2% of the recurring revenue in the quarter.

These sales in the quarter generated more relevant positive impacts on revenues in subsequent quarters. This recurring revenue performance is largely related to the acceleration of sales in the Q4, which is reflected in the increase in the annual recurring revenue, ARR, shown on Slide 6, which surpassed BRL2 billion in this quarter. Apart from sales and Consinco's results consolidation that represented BRL54 million of ARR addition, client renewal rate in the quarter was 98.5% and also contributed to this ARR level, which was attained despite the onset of the COVID-19 crisis in the second half of March, a period that concentrates sales deals.

Moving to Slide 7. The continuous growth in recurring revenue, combined with the operational efficiency gains registered by the company, resulted from growth again in the adjusted EBITDA margin, which reached 21.1%, up from both Q1 and Q4 '19. It's important to remember that this growth includes the full provisioning of bonus and long-term incentive plan based on the restricted shares proportionally to the quarter. Finally, note that the company did not cut workdays or wages of its employees nor did it reduce and restructure during the period.

Now on Slide 8. We can see that EBITDA growth combined with the positive financial result and the lower effective rate remain responsible for the 43.5% growth in the adjusted net income in first quarter '20 compared to first quarter '19. Compared to Q4, despite the growth in adjusted EBITDA, the increase in depreciation and amortization expense, especially in the effective tax rate of a seasonally higher quarter on account of the interest on equity decline in Q4, resulted in an adjusted net income from the period declining 11.8% from previous quarter.

Moving now to Slide 9. I will comment on cash flow and debt. The decline in free cash flow both year-on-year and quarter-on-quarter was mainly due to the payment of BRL197 million for the acquisition of Consinco. If we disregard the spend, free cash flow stood at

BRL89.7 million, which represents 125% higher than in the same period of last year and 24% lower than Q4 '19, especially due to the seasonal working capital requirement in the first quarter.

As such, the company ended the quarter with net cash of BRL866 million, corresponding to 1.8 times adjusted EBITDA of the last 12 months, demonstrating its financial strength so that we can overcome the moment of uncertainty that could arise in the short term.

I'll now turn the presentation back to Dennis for his closing remarks on the Slide 10.

Dennis Herszkowicz {BIO 17998338 <GO>}

Thanks, Maia. I wish to conclude this presentation by highlighting the following points. First, we will remain focused on executing our strategy to develop the three dimensions of our ecosystem. The acquisition of Wealth Systems is linked to the development of the business performance front, and the acquisition of Supplier is a fundamental pillar in the techfin dimension.

Number two, the second issue of debentures gives us the flexibility to maintain our position of strength and liquidity amid the COVID-19 crisis. We will remain focused on a highly disciplined management of costs and expenses so that we can continue to grow our results and execute our medium- and long-term strategy.

Number three, we are continuing our efforts to mitigate the impacts of the pandemic. Customer service, the continuity of our operations and the safety of TOTVERs are our main priorities right now.

Number four, we remain alert and continue to evaluate potential impacts from the developments related to the COVID-19 in order to take additional measures if required.

Finally, I wish to say that this is a time of learning and evolution for all of us. By doing our best, we will be capable of facing the current scenario while at the same time preparing ourselves for the resumption of this new normal and, why not, be able to emerge from it better than we entered as a society, as a company and as people.

We are now available for the questions-and-answer session. Thank you.

Questions And Answers

Operator

(Question And Answer)

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) Our first question comes from Cesar Medina, Morgan Stanley.

Q - Cesar Medina {BIO 16600229 <GO>}

Hi, thanks for taking the time to taking call. I have two questions. The first thing is that given the breadth and exposure that you have to the overall pulse of the economy in Brazil, if you can comment on what are you seeing in terms of the trends of activity in recent weeks. That's question number one, to gauge how the macro cycle is evolving. And question number two, like what are the signposts that you can mention as to -- any type of guidance as to how your business is going to be impacted in terms of the size of contracts on the recurring revenue, in terms of how the services revenues are -- non-recurring are going to be evolving et cetera. Thank you.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you, Cesar. This is Dennis. So look, first of all, I think that obviously April was probably -- and it's difficult to say otherwise, it's probably the worst of the month. I mean, March was half good and half not so good, because it's already in the last few weeks we went out to a quarantine. So we got some effect on the ability to sell to clients.

April obviously has been pretty much a quarantine month for the whole of the country. So yes, of course, there is an impact on the ability for new sales. And when we think of the impact on the ability of new sales, we are talking first of all of license. So of course, licenses in the second quarter will have an impact. It is difficult to precise right now exactly what is the impact, but there will be an impact.

What I can say regarding April is that it was better than we expected in the initial forecast that we made by the end of March. So it was a little better, but there is an impact.

In terms of recurring revenues, the impact is very small, because there is a delay. There is a lag between having a sale and this translating immediately into revenue. So the impact is obviously much smaller in terms of recurring revenues in the short term.

But, if we don't sell so much new sales to existing or new clients, this will have at some point an impact of decelerating the growth of the recurring revenues. This is important to say, right now we are not talking about decrease in the recurring revenues. We are talking about decelerating the pace of growth of the recurring revenues.

And finally, in terms of the non-recurring services revenues, we continue to have a good ability to allocate our teams. So the recurring revenues, they continue to be good. What is being impacted as I said, is the ability to sell new projects to clients and therefore to generate a replacement let's say to the inventory of ours that we already sold in the previous months. So we can expect some kind of impact even if, again I can say, April was better than we expected, when everything started. There will be an impact on the replacement of the services that we are allocating right now to clients. Maia, I don't know if you have anything to add.

A - Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

No. No, I think it's really -- so the non-recurring are going to be more negatively impacted this quarter. And services revenues in relative terms are going to be less impacted because we are basically performing the backlog of projects, we already sold in previous quarters. And of course...

Q - Cesar Medina {BIO 16600229 <GO>}

And in terms of impact on the quality of your receivables, have you seen customers trying to renegotiate the contracts on the recurring side? I don't know maybe downsizing the scope of the project. Have you seen anything of that nature?

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Maia, do you want to take that?

A - Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Okay. Okay. So in terms of receivables connecting to projects, no. So far, no. No, nothing relevant. So of course, eventually it can happen, but in a natural way. As Dennis mentioned, we've been able to have a good level of allocation of our tech employees, performing remotely the services, also because a significant part of our clients are also working remotely as well, mostly. So so far, it's not an issue, but we are watching closely this type of thing.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Just to add Cesar, not mentioning just the -- taking the advantage of not mentioning just the non-recurring services receivables. Receivables, in general, I mean, of course, in the beginning of the crisis, we thought that this could be the major impact. Because as all of us know lots of clients and major parts of the economy were pretty much shut down. But fortunately so far, I mean, that is very, very little impact. So -- and we are not even postponing the payments to the vast majority of clients. So so far, so good. That's the good message that we can relay to you.

Again, we are not lowering the guard because the crisis is not over. But at least today, we can say that it is not an issue so far.

Q - Cesar Medina {BIO 16600229 <GO>}

Got it. Thank you so much.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you, Cesar.

Operator

Our next question comes from Andres Coello, Scotia Bank.

Q - Andres Coello {BIO 16205255 <GO>}

Yes, thank you for taking my question. Dennis, I would like to ask a little bit about the taxing opportunity for Totvs. I understand that the acquisition of Supplier and with artificial intelligence and also your base of customers and your capabilities, you tend to connect small companies with their suppliers whenever there is some financing need in between, right? Like you will detect when a certain company may need financing in order to complete the acquisitions from a suppliers and that you may play a role in this model, in this transaction.

I was just wondering first, if Totvs will use its own capital; meaning, if you will eventually use capital to lend to your own customers in order to complete their transactions? Or if you will have a financial partner that will allow you to connect the plan? And if you have a financial partner, more or less, if you can talk a little bit about how you will monetize these relationships,

how Totv -- is it based on a commission basis on -- will you have -- perhaps will you get a share of the interest that will be charged to the company getting the loan? Just if you can describe a little bit about the model.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Perfect. So I'm going to start. And later if Maia wants to add, it's good. So -- no, we will definitely not use our balance sheet to finance clients in Supplier or any other type of taxing initiative. It's not the case. Supplier is an autonomous company. It has its own financing partners and its own capabilities. So no, we will not use Totvs' balance sheet. What we will use is an investment, a small investment of around 5% of subordinated shares in securitization plan, which in Brazil is called FIDC, F-I-D-C that already exists, is a large FIDC that exists for more than 15 years.

It is a AA+, if I'm not wrong, FIDC. So it's a very, very solid, very stable long-track record. And it works with Supplier ever since the beginning. So this is the main financing tool for the work of Supplier, and it has always been like this. So it will not change.

But yes, there is the possibility that we will use other types of financing, other types of partners in this regard. But so far, the FIDC has been more than enough for all the needs of supplier. In terms of the model itself, as I said in the retail statement, the beauty of Supplier is that they are keeping everything. So they are not just originating the credits. They originate the credit plus they keep all the approval of the policy of the credit.

So they are not simply an originator. They keep the spread with them. And what they do is that they relay the credit originated to the FIDC, which is remunerated by a fixed rate. So it is a model, as we are saying, of Fintech in the beginning. That's the model that we are bringing Supplier right now to us. And we will be moving into what we call a taxing model in which we will add a very different type of journey, customer experience for the clients in which they have all these credit natively integrated into the management solutions, such as the ERP and so on.

In addition to that obviously, we will use all the resources that we have available in terms of artificial intelligence, in terms of the big data that we generate to increase, and to improve the algorithms of the credit approval to obviously have more credit limits being generated in a safer mode. So that's the -- roughly the business model that we have for Supplier. Maia, if you want to add something, please?

A - Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

No. I think that's all, Dennis. You explained everything. It's okay.

Q - Andres Coello {BIO 16205255 <GO>}

Okay, well, thank you very much.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you.

Operator

(Operator Instructions) Our next question comes from Rodrigo Villanueva, Bank of America.

Q - Rodrigo Villanueva {BIO 16358124 <GO>}

Thank you. Good morning Dennis, Maia. I hope you and your families are well as well under this crisis. I have a question related to your cash position and also relating to M&A. You ended the first quarter with a very strong cash position. But probably after paying for Supplier, you will still have around BRL 1 billion.

So I'm wondering if this is mostly to keep liquidity, to face the crisis. Or if this should help you potentially be doing some M&A? I mean, I believe that in some cases crisis could be interesting in order to be doing M&A. But in other occasions probably it's better to be more cautious. So basically my question is what's your way of thinking on this respect? Thank you so much.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you, Rodrigo. Look, the cash position obviously is something that in this type of crisis is extremely important. So yes, we are fortunate to have this level of solidity in our balance sheet. And we took the second issue of debentures exactly to keep this position impact for us. It is important to mention that the second issue of debentures has a provision in which we can terminate the issue after the 90th day.

So if the crisis goes and if things normalize, we will have the ability very fast to return this money, which is not so cheap. So it's just a kind of an insurance that we would like very much to have right now. So having said that, of course, M&A continues to be on the table. We already did the acquisition of wealth systems during the crisis in April. So yes, we are actively analyzing opportunities. And yes, we believe that the crisis will generate new opportunities for us.

So we are very alert to all this, but we will be as disciplined and as conservative as we have always been. It will not change right now and should not change right now.

Q - Rodrigo Parrode

Understood. That's very clear. Thank you so much.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you.

Operator

Our next question comes from Diego Arago, Goldman Sachs.

Q - Diego Aragao {BIO 17889908 <GO>}

Yes. Good afternoon, everybody. Thank you for taking my question. I just want to explore a little bit more the current COVID-19 situation. I mean if we would make a parallel with the 2015 recession, what are the main difference you are seeing at this point internally, I mean with Totvs and Totvs' positioning and on the market, especially with your clients? I guess, it will be great just to understand what are the main difference here. And eventually, what do you see as an opportunity as we face and live this situation? Thank you.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you, Diego. It's an interesting question. I mean, especially because we are still in the midst of the crisis. So there might be more things to come. We don't know yet. But what I can say already, at least, from my side -- obviously Maia, if you want to add later. But I think that the main difference is that, first of all, this crisis is hitting the whole world at the same time. I mean, in 2016, it was much more a local crisis. So this is the first major difference. I mean everyone on the planet is together on this one, let's say.

And the second difference and I think it's even more important than the first, is that this crisis is almost, at least for the West, it's almost like a comet that came out of nowhere. I mean in 2016, it was something that was building over time. So it was a process, let's say. This crisis is exactly the opposite.

I mean, it's extremely profound, but it is -- it came from one day to the other. I mean, we were going okay, life that was normal during the first 15 days of March. And after the 16th, things started to move extremely fast. And in one week, everyone at Totvs was already working from home office, for example. And the majority of our clients also started to work very fast from home office. I mean retail was shut down from one day to the other all over the country.

So again, that's the main difference, I mean it was out of nowhere and extremely fast and profound. But at the same time, a good difference let's say is that it is not directly related to anything wrong that any company did or that the economy did. I mean, it's clearly something that comes from the outside, which means, in our opinion that it will solve itself faster probably than it did in 2016.

In terms of Totvs specifically, I think that we are entering -- we entered better same, this crisis in a much different position. So in 2016, the company came from an acquisition that was a tough one, I mean the Bematech acquisition, it gave a lot of work at the time. It came from a process of succession in 2015 that was not successful as well. It came from -- it was in the middle of a change in the business model that was very difficult, as any change in the business model is.

So right now we are in a completely different position I mean we are extremely strong financially. We are on the rise in terms of financials and operations. We have a level of product quality that is much. much higher than the previous years. The NPS is much higher. The level of churn is much lower. The relationship with the client is much, much better right now.

We are on the offensive. I mean we are building new dimensions, new addressable markets. We have made the succession. And this time at least as far as today it was successful. The migration of the business model is definitely completed, I mean more than 70% of new sales are SaaS-based. A good portion of clients already are on the cloud. So again, I think that the crisis is of a different nature and has a different impact. And on the other hand for Totvs specifically we are in a much, much stronger, much, much better position than we were in 2016.

And I believe that the clients in some way, they are also better than they were in 2016. I mean even if no one expected, what is happening right now, I think that they were better prepared. They were more digitalized. They were more sophisticated already in terms of their operations. So again, I think that everyone was a bit more resilient, than they were in 2016.

A - Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Yes. Dennis, maybe...

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Maia, so please, Maia, go ahead.

A - Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Yes. What I could complement is -- so as a consequence of everything that Dennis described today, the company has a much higher level of recurring revenue. So almost 80% of our revenues are recurring. So it protects much more the company to fit and the "potential damage" that the declining license and nonrecurring services sales can provoke in our results are much, much more limited than it used to be at that time.

Also Dennis said, so clients were at the time coming from a more expansive for growth moment in Brazil. Companies clearly were in a mood of expansion. And in some terms when they had to shift to a more restrictive scenario in terms of investments, part of our clients they, have to reduce significantly the level of investments and users they have in their contracts. In this case, in this moment, I think companies were just cautiously getting out of recession. And I have in my opinion, clients not so over-served in terms of access and users, they have. Of course we can see contracts down.

But proportionally, I might expect much less than that time. On the other hand as Dennis said, we have a more generalized problem among the sectors in the economy. And it's a more challengeable aspect in terms of delinquency. That's maybe one of the main points we are watching here.

Q - Diego Aragao {BIO 17889908 <GO>}

That's very helpful. Maia and Dennis, thank you for that. And just -- and I just want to follow up also on Rodrigo's question related to M&A, if I may, I remember that you have like a big M&A pipeline, and a lot of potential targets. And I was wondering if there is any reason to believe that you could change your M&A strategy, especially considering the impact on valuation for the sector and also the potential impact for some of your let's say regional competitors? Thank you.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you, Diego again. No, I don't foresee major changes. I mean it continues to be exactly the same core pillars. I mean it will not change on that regard. And in terms of the discipline, we will continue to have exactly the same level of discipline. What might happen and we are already seeing some signs of this is that, of course, valuations will be more -- it will -- they will be lighter let's say compared to 1 month or 2 months ago.

So in terms of M&A, I would say that probably the only silver lining of the entire crisis, because even if we are better than we thought, we are still worse than we could be without the crisis. I mean one of the key things that will be better because of the crisis will be the execution of the M&A strategy.

Q - Diego Aragao {BIO 17889908 <GO>}

That's great. Thank you.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you Diego.

Operator

(Operator Instructions) This concludes today's question-and-answer session, I would like to invite Mr.Dennis to proceed with his closing statements. Please go ahead sir.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you. Thank you again, for everyone to participate and to be confident in the company. I would like to take the opportunity again to thank all the stakeholders, especially the Totvers. These are, as we are saying our fighters. Right now, they are at their homes working very, very hard to keep our clients running. Let's remember that we are critical to our clients I mean, even if there is a store that is closed,

they still have to keep the operations in the back office running. So it is essential that we keep the clients running and we are doing that. So thank you again everyone and let's hope that we are in the second half of this crisis. Thank you. Bye-bye.

Operator

That does conclude the Totvs audio conference for today. Thank you very much for your participation. Have a good day, and thank you for using Chorus Call.