Q3 2015 Earnings Call

Company Participants

- Alexandre Mafra Guimaraes, Deputy Chief Executive Officer
- Gilsomar Maia Sebastiao, Corporate Finance Officer
- Rodrigo Kede de Freitas Lima, President

Other Participants

- Unidentified Participant
- Vivek Mehta, Analyst

Presentation

Operator

Good morning. Welcome to TOTVS' Conference Call to discuss the Third Quarter of 2015 Results. We have with us Rodrigo Kede, President; Alexandre Mafra, CFO; and Gilsomar Maia, IRO. All participants will be in a listen-only mode during the company presentation. After the presentation, we will have a question-and-answer session for investors and analysts, when further instructions will be given. (Operator Instructions) The audio is being broadcast live via webcast at ir.totvs.com.br.

Before proceeding we wish to clarify that any forward-looking statements that may be made during the conference call, related to business outlook, operational and financial projections and targets or process are based on the 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 future events and therefore depend on circumstances that may or may not occur. Investors must understand that general economic conditions, industry conditions and other operational factors could affect future performance of TOTVS' and could lead to results that differ materially from those mentioned in these forward-looking statements.

Now, I'll turn the conference over to Mr. Rodrigo Kede, who will begin the presentation. Mr. Kede, please go ahead.

Rodrigo Kede de Freitas Lima {BIO 19064913 <GO>}

Good morning, everyone. Thank you for participating in our third quarter 2015 earnings conference. This was my first full quarter as a President of the Company. And as I took over the position on June 15, 2015, and I believe it's worth spending some time to talk about what I saw, what I learn, how I see the company going forward.

Can you please move to slide two. After 90 days, I continue to believe that despite the tough economic and political environment, we are in, Brazil, which is still a country with several business opportunities. The current scenario shows that after all we have a country with strong and independent institutions. We have the seventh largest consumer market of the globe and in a few years it might become the fifth, with more than 200 million people. We are still a country with a low level of IT penetration as a percentage of GDP, especially as compared to develop as nations and especially in the SME market.

I do believe that TOTVS is the company that is best positioned to capture this future growth. TOTVS' today, not only a software company, but mainly a business solutions company. With a broad portfolio that includes back office, more business solutions and collaboration productivity platform. It is driven by resulting business issues for our clients and making them even more efficient and comparative. TOTVS presence in 10 different industry segments and became the absolute leader and the largest technology company in its service market. We have invested almost BRL1 billion [ph] in research and development in the last five years, which shows our capacity to invest in innovation. We were elected the 22nd most valuable brand in Brazil and also elected by (inaudible) the most influential business newspaper, the most innovative company of the IT sector in 2015. TOTVS was the first company in technology to IPO in Brazil and Latin America with a strong and independent board which reviews what is in great in our DNA, the obsession to lead and define market standards.

There are two specific matters, I would like to cover today. My view of the third quarter results and the conclusion of our deal with Bematech.

In this third quarter, despite the economic and political environment of deterioration we are able to deliver a 4.2% of revenue growth year-to-year. Sequentially, better than the second quarter, which we grew 2.7%.

Different and better than the second quarter we grew our EBITDA marginally and our net income in 5.3% year-to-year. Even considering additional costs related to our restructuring program. On the scenario where the GDP is down by 3% for the year, with the labor cost going up around 10% and being present and exposed to 10 different industry segments of our economy. This shows that the company has a resident business model and is being able to make a transition from licensed subscription, which by the way grew 20% year-to-year in the right way.

In addition to that we have been able to manage costs and expenses in a very responsible way. I would also like to spend a few minutes talking about the Bematech's view, presented on the slide three. The deal was announced on August 14, approved by the shareholders of both companies on September 3 and by the Brazil antitrust agency CADE on October 22.

Retail is one of the key sectors of the Brazilian economy, representing more than 50% of the over 4.6 million companies formally established in Brazil, according to the official Brazilian statistics. Bematech is the leading provider of technology solutions for retail, food service and hospitality, whose hardware and software solutions are present in more than 50% of the point of sales across Brazil. It is now the most relevant reference in technology for retail with 0.5 million client base, with popularity in the whole country, which sticks by itself.

Our objective with this transaction is to lead the digitalization of the Brazilian retail sector, which we believe is already ongoing for several weeks. We will make the Brazilian retail more modern, efficient and productive through integrated business solutions that includes back office and core solutions, point of sales, automation, physical solutions, e-commerce, mobile, means of payment and a strong collaboration platform.

We believe that the client behavior has shifted to integrated solutions and no longer a stand-alone software products or services. Together, we will serve the entire retail chain combining know-how of brick and mortar retail and e-commerce with the most comprehensive portfolio of specialized solutions for all retail sub-segments, such as food service, supermarkets, wholesalers, apparel and footwear, department stores, electronics and home appliance, construction materials, drug stores, cosmetics, hotels, car dealerships, passenger transportation, among others. Together, we have the largest distribution network and we'll be able to serve our clients with presence in more than 5,000 cities, providing integrated solutions at more than 0.5 million clients to start with.

In fact, the current client base will also be the source of a large database where analytics will be able to provide insights on consumer market, which we see great value in the future. We are very excited, we've seen many opportunities to capture. We have decided to accelerate the integration process without losing focus on the elocution of the fourth quarter, which is traditionally very important for the technology sector, particularly in a difficult economic environment like the one we are facing now.

We will now hear Maia, who will continue the presentation commenting on other events in the quarter on slide four.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Thank you Kede. Good morning, everyone. The second relevant event in this quarter was the release of the final tranche of the credit line contracted from BNDES, the amount of BRL181 million. With this 100% of the credit line contracted in October 2013, for the development and sale of TOTVS solutions, in the amount of BRL659 million have been made available to the company. This operation have a grace period of 24 months for the amortization of the principal, which ended in October 2015. Thus the principal will be amortized on a monthly basis from November 2015 to October 2019.

The third significant event in this quarter was the new share buyback program approved by the Board of Directors on September 28. The program is effective for 12 months starting from September 29, 2015, during which up to 1.6 million shares, equivalent to 1%

of the total shares may be repurchased. It's important to note that the previous share buyback program approved on February 27, 2015 was 100% executed by September this year.

Please move on to slide five for our comments and the results in the quarter. Total revenue grew 4.2% year-on-year, driven by recurring revenues, which grew 6.5% and accounted for 61.6% of the total revenue, compared to 60.4% in the third quarter of 2014. Of the total recurring revenues in the quarter 91% are software revenues. Non-recurring revenues grew 0.9% year-on-year and were positively influenced by the growth in other services not directly related to software, such as consulting services, which grew approximately 38% as shown on the slide six. These are other services also had a positive influence on the 7.9% growth in services revenue.

Software revenue grew 2.7% year-on-year, negatively influenced by the performance of license fee revenue and positively by subscription and maintenance revenues, as shown on the slide seven. Software recurring revenue, which includes maintenance and subscription, grew 6.3% year-on-year and accounted for 82% of all software revenues in the quarter, compared to 79% in the third quarter 2014.

Maintenance revenues grew 4.7% year-on-year and 1.5% quarter-on-quarter. Despite the lower volume of license sales in previous periods and the reduction in subscriptions due to the fall and partial cancellations requested by clients, facing financial disputes pending [ph] lay off process. Subscription revenue grew 19.5% year-on-year and continuous should be the main driver of growth of recurring revenues and accounted for almost 30% of the software recurring revenues into the quarter. This double-digit of organic growth in subscription sales was also affected by the downturn in the Brazilian economic activity, though to a lesser extent than license sales, which fell 11% year-on-year. In addition to the macroeconomic environment, the decreasing license sales can be attributed to the transition with the subscription model, which has been grabbing part of the license sales pipeline for new clients.

A quarter-on-quarter base, license fee revenue recovered by 4.3% mainly influenced by the 13% growth in sales to new clients, as shown on the slide eight. The recovering the number of licenses to new clients came along with the 10% growth in the average ticket, and as a result of the behavior commonly seen among large clients, which traditionally invest more in IT, in the second half of the year. This quarter, the subscription model added 773 new clients, 3.5% less than in third quarter '14 and 14% less than second quarter '15.

On the other hand, average monthly subscriptions of these clients was up 141% over third quarter '14, and 48% over second quarter '15, which shows that the declining was concentrated in micro enterprise. As TOTVS Intera subscription model, which focuses on the small and medium companies evolves, it's natural to expect that the average monthly subscriptions increased, since its target markets consists of a bigger company than those of Fly01, which focuses on microenterprises, which accounted for significant volume of subscription sales in previous years.

Those transition to the subscription model remains fully in course. The addition of new subscription clients accounted for 58% of all new clients added in the quarter. The same percentage has in the last 12 months and higher than third quarter '14, when the addition of new licensing clients was even greater than subscription.

We now hand over the presentation to Mafra, who will comment on the software contribution margin on the slide nine.

Alexandre Mafra Guimaraes {BIO 16015106 <GO>}

Thanks, Maia. Good morning, everyone. Software contribution margin ended the quarter at 64.8%, now 150 basis points year-on-year and 190 basis points quarter-on-quarter. In addition to the factors mentioned by Maia, that negatively affect revenue growth. The IGP-M index, the inflation index used to adjust recurring revenues, was materially lower during 2015, when compared to the same period in 2014.

In terms of software costs and expenses, wage increases due to collective bargaining agreements, in the quarter were close to IPCA index and retroactively [ph] affected provisions for Christmas bonus and vacations. Furthermore, we have optimized our structure, resulting in a restructuring program and hiring reductions, which negatively affect the software contribution margin in the quarter by 70 basis points.

Moving on to slide 10, the decrease in service contribution margin in Q3, 2015 by 280 basis points year-on-year and by 150 basis points compared to Q2, 2015, reflects the higher increase in service costs than in service revenue. As in the software business, we also optimized our service structure, which negatively impacted service contribution margin by 90 basis points. In addition to these the decline in contribution margin is related to the lower allocation of implementation service professionals, due to the drop in software sales in previous periods. And to wage increases resulting from collective bargaining agreements in the regions of Belo Horizonte, Rio de Janeiro and Recife in Q3 2015.

For comments on selling and administrative expenses, please move to slide 11. Selling and commission expenses combined decreased 30 basis points as a percentage of net revenue year-on-year. This decrease is mainly due to the drop in license sales in the period and the sales mix between franchisees and owned banks. Advertising and market expenses grew 20 basis points year-on-year, mainly due to the lower expenses in Q3 2014, with the end of the Soccer World Cup. In comparison with the previous quarter, these expenses fell by 40 basis points, chiefly due to the higher concentration of investments in marketing Q2 2015, with the Universo TOTVS event and lift the launching of the new advertising campaign.

Allowance for doubtful accounts remaining relatively stable, both in the year-on-year and quarter-on-quarter comparisons, despite the higher delinquency levels, seen in the economy during the quarter. Then finally general and administrative expenses, management fees and other expenses decreased 160 basis points year-on-year. This reduction was achieved through synergy gains and the cost reduction initiatives that were implemented as well as the renowned reversal related to variable prices of acquired companies, in accordance with the achievement of financial and non-financial targets (inaudible) set and not met, largely due to the macroeconomic assumptions continually just set the targets.

We will now comment on EBITDA and EBITDA margin on the slide 12. Excluding a non-recurring effect of restructuring costs of BRL3.9 million and the reversal of the provision for obligations related to the acquisitions in the amount of BRL6.4 million. Adjusted EBITDA ended the quarter with a year-on-year decrease of 2.2%, totaling BRL102.7 million and adjusted EBITDA margin of 22.1%, now 150 basis points. As mentioned by Maia, this mismatch between the IGP-M and the inflation costs, which is more related to the IPCA has created an additional challenges for the EBITDA margin.

On slide 13, this mismatch examined. As can be seen, the IGP-M has shown a recovery and is reducing the difference with the IPCA. However, since the inflation pass through in recurring contracts is done on an annual basis. This recover of the IGP-M tends to contribute more relevantly, to the growth of recurring revenues of the coming quarters, while costs have been adjusted in levels closer to the IPCA during the year. Here we reiterate our commitment to discipline at management of costs to ensure their conversions with the growth base of revenue in a sustainable manner, while preserving the investments required to pave the way for new growth cycles.

Moving on to slide 14, net income for the quarter amounted BRL71.7 million reaching year-on-year growth of 5.3% and the net margin of 15.4%, or 10 basis points above the Q3 2014. In the quarter-over-quarter comparison, net income increased 18.6%, however note that the Q2 2015 was completed the purchase price allocation profits of collective wage, and it was booked the accumulated amortization effect of 12 months intangible assets in the amount of BRL5.5 million. We saw this impact on the Q2 2015, the quarter-on-quarter growth of net income was 8.8%.

Speaking now of cash flow and debt on slide 15, gross cash of the company ended the quarter at almost BRL833 million and net cash at BRL49 million. The increase of BRL137 million in gross cash was mainly due to the operating cash generation of BRL93 million equivalent of 130% of the net income in the quarter. The amortization of 40% of the principal amount of debentures issued by TOTVS in 2008, in the amount of BRL32 million. The payment of interest on equity amounts to BRL29 million related to the first half of 2015. The inflow of BRL181 million in prohibited [ph] lines, hired from BNDES in 2013, and the buyback of the company's shares, net of share disposals in their total amount of BRL48 million.

TOTVS has always been committed to financial discipline. We work hard to further increase our financial capacity to remunerate our shareholders, pay our debts, as well as to finance our organic and inorganic investments.

We will now go back to Kede for his closing remarks on slide 16.

Rodrigo Kede de Freitas Lima {BIO 19064913 <GO>}

Despite the bad economic and political scenario with the country in economic recession with significant market uncertainties. We believe we've finished third quarter with a differentiated position. We added 1,340 new clients, we grew 19.5% in subscription revenue, grew 6.5% in recurring revenue, grew 4.3% [ph] in total revenue and 5.3% in net income converted a 130% of net income in the period, in net operating cash flow and closed the deal with Bematech and then started the integration and synergy process.

I'd like to finish the presentation recognizing that we want and we can grow faster. Given the BRL2 billion [ph] company in revenues, which is also a very diversified in our portfolio and prices in 10 different industry segments. These characteristics are exactly what make us better than our competitors and best for our clients. Size and muscles for investment in innovation do matter. Our diversified business with low dependency in one industry segment and the very large in broad portfolio, and finally a high level of corporate governance.

To conclude, I believe it's important to mention that during these uncertain times, we will intensify our drive for synergies and operational efficiencies. While we will continue to invest in innovation, new solutions, new technologies, products and more than idle company. Driving by the purpose of making our clients more efficient and more productive.

I thank you all for your participation and we are now starting the Q&A session.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) Our first question comes from Vivek Mehta with ShearLink.

Q - Vivek Mehta {BIO 20779266 <GO>}

Hi, guys. Thanks for taking my question. I had a question about your operating expenses, you've done a pretty good job in managing those in a tough environment. As we look out to next year in 2016, what do you guys think that, we should expect as investors in terms of operating expense growth? Thanks.

A - Rodrigo Kede de Freitas Lima {BIO 19064913 <GO>}

Hi, this is Rodrigo speaking. You should expect the same way of managing expense, which means that, what we try to do in a responsible way, is to see our revenue trends and try to accommodate our SG&A [ph] accordingly and we'll continue to do that. So you shouldn't expect any different direction next year. We'll continue to manage expense according to revenues and according to the overall market environment.

Q - Vivek Mehta {BIO 20779266 <GO>}

So, if I look at your commercial expenses, they are growing significantly less than inflation. What can we, especially we expect more like inflationary type growth next year, or do you think it will continue to be below the levels of inflation? Meaning there are more cost cuts to be add. Can you cut further costs from here?

A - Rodrigo Kede de Freitas Lima {BIO 19064913 <GO>}

Yes, we do have room to cut costs if needed. From an SG&A point of view, I wouldn't expect any cut own sales, because we believe that's an important area to keep the team on board and driving sales. But rather than that, you should see the Company managing expenses and being more efficient and more productive.

Q - Vivek Mehta {BIO 20779266 <GO>}

Okay. Thank you.

Operator

Our next question comes from (inaudible).

Q - Unidentified Participant

Good morning. Thank you for taking the questions. Actually I have two questions. The first one is on to understand where is the pressure on EBITDA margin because you mentioned restructuring costs. I'd like to make the difference between what is one-off and what is more recurring in order to have an idea of it, would be the EBITDA margin going forward, that's the first question.

And the second one that when you mentioned from culmination [ph] of maintenance due to some clients defaulting. Do you mean that the attrition has increased and so what's the attrition level at the moment?

A - Rodrigo Kede de Freitas Lima {BIO 19064913 <GO>}

Okay. So, hi John. Let me try to answer the first part on restructuring costs. As we finished the second quarter and entered the third quarter, we had one scenario for the rest of the year. We decided to reduce our restructure. So, we could keep or grow our margins going forward.

Now there is a discussion, is still in fourth quarter about the tax increases and the mandated increase that will drive labor costs higher. So, if your question is about this is one-time off, we cannot answer that, we might have more depending on the overall economic environment and the top line, how the top line comes.

Second, we usually don't give any guidance on margin going forward, but again, I think as an overall direction, we manage the company to keep or move our margins up, that's why we did the restructuring. On our churn, I think if I understood correctly, your question was about the churn in maintenance. Most of the churn that we have is not related to clients that we have lost. Most of the churn is concentrated on our base clients that because of the economic environment have reduced their scope with us.

Of course, we do have some losses of clients, these losses are mainly concentrated, a very small from a financial point of view, they're not material because they're concentrated in the low part of the pyramid, very, very small clients, what we call nano-clients. So, again just to finish the point, our churn is not actually a churn, but a reduction and its scope in current client base because of the economic environment, which as you know we are a company that we value our clients and we always try to find a way and keep the client for the long-term.

Q - Unidentified Participant

Okay. Thank you very much.

A - Rodrigo Kede de Freitas Lima {BIO 19064913 <GO>}

Thank you.

Operator

Our next question comes from (inaudible) with Morgan Stanley.

Q - Unidentified Participant

Hi guys, thanks for taking my questions. So just an update on the competitive environment. If you can share with us, the market dynamics in this tough economy. I guess, this will be very helpful. Thank you.

A - Rodrigo Kede de Freitas Lima {BIO 19064913 <GO>}

Okay. So look, overall our pipe, as I think, I mentioned in third quarter our pipe is, if you go segment-by-segment, its either the same or bigger than what we saw last year, which is good, but also shows that the clients are taking more time to beside given the uncertainties that we see overall in Brazil economic and from a political point of view. We have not been losing deals, it is the other way around, we given our portfolio in our industry expertise, we have been seeing clients in coming into us to discuss alternatives on buying TOTVS.

So, I don't see any specific competitor that is creating an issue for us. I think our main issue today is mainly concentrated on the economic environment and the base where the clients are making the decisions.

Q - Unidentified Participant

Okay, Rodrigo. Very helpful. Thank you.

A - Rodrigo Kede de Freitas Lima {BIO 19064913 <GO>}

Thank you.

Operator

Our next question comes from Vivek Mehta with Shearlink.

Q - Vivek Mehta {BIO 20779266 <GO>}

Hi, guys. Thanks for the follow-up. When I look at your maintenance revenue, which grew 5% this year how much would be IGP-M benefit? What you guys are seeing on that? Is that about 8% or 9%?

A - Rodrigo Kede de Freitas Lima {BIO 19064913 <GO>}

What's the dynamics, I lost my -- to complete the answer. But I think the dynamics is, you do have an IGP-M, there is a little above 4% that helps. You do have addition of new clients that helps, not the subscription clients because they're on the subscription line, but the traditional clients that helps. And you do have on the other way around, what we discussed before the reduction in scope of the current client base, when the clients are going through the times they request to reduce scope. So that is into dynamics, we see these are the three main components. Maia you want to complete?

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

Yes, so in the end most of the maintenance growth is coming from the IGP-M updates. And as Rodrigo mentioned, we have basically three variables in the maintenance equation. One is the new maintenance addition from new license sales, and considering the declining license in the last year and year and a half, it is negatively affected the inflow of new maintenance in that equation.

The second variable is the IGP-M update that we already commented. And the third one is the churn or attrition rate regarding those maintenance we lose, sometimes because of clients under some pressure, financial pressure and as Rodrigo described here in some case asking us to help them because they are fine people they don't need all the access they have. And clients especially in the micro enterprise space some of those companies going out of business.

Q - Vivek Mehta {BIO 20779266 <GO>}

Okay. You need, it seems like you need about BRL60 million a quarter of license fees in order to make up for the churn? Is that a fair estimate?

A - Rodrigo Kede de Freitas Lima {BIO 19064913 <GO>}

So, considering the reales [ph] of the market seems that you're right. But there is another trending course, of the especially regarding the new clients in the (inaudible) space. There are clients choosing in a natural way the subscription model. What does not contribute to the maintenance line. So every new client we had to subscription contribute just to the revenue subscription stream. So that's an order thrown off of recurring revenue growth, but is now contributing to that specific line.

Q - Vivek Mehta {BIO 20779266 <GO>}

Okay. Thank you. I'll follow-up with you guys offline with a few other detailed questions. Thank you very much.

A - Rodrigo Kede de Freitas Lima {BIO 19064913 <GO>}

Okay. You're welcome.

Operator

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

A - Rodrigo Kede de Freitas Lima {BIO 19064913 <GO>}

I once again thank you all for your participation in our third quarter earnings conference and I wish you all a great day and rest of the week. Thank you very much.

Operator

That does conclude TOTVS audio conference for today. Thank you very much for your participation. Have a good day and thank you for using chorus call.