

Q1 2016 Earnings Call

Company Participants

- Gilsomar Maia Sebastiao, Executive and Financial Vice-President / Investor Relations Officer
- Laercio Jose de Lucena Cosentino, Chief Executive Officer and President

Other Participants

- Andres Coello, Analyst
- Daniel Federle, Analyst
- Diego Aragao, Analyst
- Sunil Rajgopal, Analyst

Presentation

Operator

Good morning. Welcome to TOTVS conference call to discuss the Results of the First Quarter of 2016. We have with us Mr. Laercio Cosentino, CEO, and Mr. Gilsomar Maia, CFO and IRO. Note, that all participants will be in listen-only mode during the presentation. After that, we will have a question and answer session for investors and analysts when further instructions will be given. (Operator Instructions). The audio is being simultaneously webcast at ri.totvs.com.

Before proceeding, we want 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 of TOTVS are based on beliefs and assumptions of the Company's management as well on 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 condition, industry condition and other operational factors could affect the future performance of TOTVS and could lead to results that differ materially from those mentioned in such forward-looking statement.

Now, I will turn the call over to Mr. Cosentino who will begin the presentation. Mr. Cosentino, please go ahead.

Laercio Jose de Lucena Cosentino {BIO 6567039 <GO>}

Good morning everyone. Thank you for attending the Company earnings conference call regarding the first quarter of 2016. I wish to kick off with the main recent events shown on slide three.

On February 15, 2016 in Sao Paulo IT companies association and the IT employee union signed a collective bargain agreement that fixed a 10.7% wage increase, of which 8.5% with effect from January 1st of 2016 and 2.2% with effect from November 1st, 2016. Note that Sao Paulo represents about 43% of TOTVS' total payroll.

On April 26th 2016, in our shareholders meeting approved a distribution of the dividends in amount of 66.6 million equivalent 40 cents of Brazilian real per share for the fiscal year of 2015 to be paid on May 11th 2016. The dividend amount added to interest on equity paid on August 19, 2015 and January 13, 2016 correspond to a 65% of 2016 net income.

In the same shareholders meeting also approved the composition of the Board of Directors consisting nine members including eight independent members, it may lead up to annual general meeting of 2018.

In addition to myself, Pedro Passos, German Quiroga, Pedro Moreira Salles, Maria Helena Santana, Sergio Foldes, Danilo Ferreira da Silva, and Wolney Betiol were reelected and Mauro Rodrigues da Cunha was elected to the Board.

At the first Board meeting after the shareholder meeting, Pedro Passos and German Quiroga were re-elected Chairman and Vice-Chairman respectively. And also were indicated the Board members who will be part of Company's committees. For the personnel and compensation committee, Pedro Moreira Salles and me as the CEO of TOTVS.

For the Audit Committee, Maria Helena and Danilo Ferreira and Mauro Rodrigues da Cunha and for the strategy and technology committee, German Quiroga and Wolney and me.

I now turn the floor to Maia for his comments on the results of the quarter starting from slide four.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Thank you, Laercio. Good morning, everyone. The consolidated results of first quarter '16 presented in the quarterly information report include Bematech results for the period. In order to preserve comparability, we have presented the pro-forma unaudited consolidated results that combine the results of TOTVS and Bematech corresponding to three month period for first quarter '15 and fourth quarter '15.

Total revenue in the quarter declined 1% year-on-year and 3.5% quarter-on-quarter mainly due to the non-recurring revenue decrease of 12.9% year-on-year and 12.2% quarter-on-quarter as show in the chart on the left. In contrast, recurring revenue grew 8.7% year-on-

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year and 3.1% quarter-on-quarter. The behavior of recurring and non-recurring revenues led the share of recurring revenues to 60.6% of total revenue in the first quarter '16 which is 5.4 percentage points above the first quarter '15.

When analyzed by business, the chart on the right, software revenues increased its share of total revenue to 64.4% in the quarter, mainly due to the decrease in the share of hardware revenue in the period, which corresponded to 10% of total revenue in first quarter '16. And the growth in software recurring revenues as shown on slide five.

As shown in the chart on the left, software revenues maintained their performance of previous quarters, that is growth in recurring revenue from subscription and drop in the share of new recurring revenues from license fees. The description revenue grew 16.3% year-on-year and for the first time exceeded the quarterly license revenue even the later have incremental license from the corporate model in the quarter.

The growth in subscription revenue was due to the higher share of sales to new small and medium clients especially under TOTVS Intera model, which is also helped to increase the average new monthly subscription of the quarter.

Maintenance revenue grew 5.6% year-on-year, despite the lower volume of license sales in the previous periods and the higher volume of partial maintenance cancellation due to the economic crisis. Together subscription and maintenance revenues offset the license fee fall and led the recurrency of software revenue to 85.5% in first quarter '16 which is 6.2 percentage points above first quarter '15.

In the chart on the right side you see that the software contribution margin fell 2.5 percentage points year-on-year mainly due to license fee fall and the mismatching between inflation test and the maintenance revenue measured by IGP-M and the cost inflation for the period.

In the quarter-on-quarter comparison, the contribution margin grew 3.2 percentage points despite the 8.5% wage increase in Sao Paulo, which effect from January first. This margin growth is mainly due to the reduction of recurring labor costs as a result of the restructuring promoted by the Company during the second half of 2015.

The chart on the left side of the slide six, license fee revenue fall 30.2% year-on-year and total BRL51.5 million in first quarter '16. The drop in license was mainly due to the economic crisis in Brazil, which affected most notably the sales dynamic to larger clients. The migration of part of the sales pipelines in new clients to subscription model, especially among the smaller clients and the 40% decrease on incremental license fee of the corporate model.

In the corporate model, clients have unlimited access to management solutions for which they pay an incremental license fee at the beginning of each year based under real growth of the previous year.

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Thus this reduction is a consequence of the lower growth of the clients under the corporate model in 2015. In the chart on the right side, we see that the number of software clients added decreased by 21% year-on-year and by 4.4% quarter-on-quarter.

The year-on-year decline is mainly due to the lower level of new subscription sales to microenterprise on account of the economic crisis in Brazil.

In the quarter-on-quarter comparison, decline was mainly among new licensing clients added, which besides the economic movement reflects the migration of part of the sales pipeline of new clients to subscription.

Now I invite you all to move to slide seven to discuss services and hardware. In the chart on the left side, there is a decline by 0.9% in first quarter '16 comparing to first quarter '15 by 4.5% when compared to four quarter '15. Year-on-year variation is mainly due to the 8.3% decline in software implementation services in the period due to the lower pace of sales in recent quarters. And the 14.2% increase in services not related to software implementation, which had accounted for 37.7% of the services revenue in first quarter '16. Service contribution margin increased by 9.4 percentage points in first quarter '16 when compared to the previous quarter. Despite the wage increase in Sao Paulo and the reduction in servicing revenue in the period. These recovering services contribution margin is chiefly due to the reduction in personnel costs resulting from the restructuring carried out during the second half of 2015.

In hardware, in the chart on the right side, the year-on-year drop of 4.6% in revenue is due to the lower number of new establishments opening as well as the change in tax legislation. Especially in Sao Paulo where fiscal printers were replaced by the fiscal equipment named S@T, which has lower price.

It's worth mentioning that change in the tax legislation should collaborate to grow recurring revenue from tax software solutions reducing the share of new recurring hardware revenue in the total revenue.

In the quarter-on-quarter comparison, the 25.3% decrease in revenues is also due to the seasonal effect on hardware sales in the period.

This trend in hardware revenue combined with increase in hardware cost due to the FX rate during 2015, the reduction in income grant by the Parana state government since September 2015 resulted in the decline in the hardware contribution margin during the period.

For comments on selling and administrative expense, please move to slide eight. Starting from the chart on the top left corner, selling and commission expense taken together dropped 1.8% year-on-year and 6% quarter-on-quarter declining by 0.4 percentage point their share of net revenue in first quarter '16 in the quarter-on-quarter comparison.

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This reduction was mainly due to the decrease in commission expense mainly resulting from the sales mix between license and subscription fees and the sales mix between franchisees and own unions. The restructuring in personnel cost is carried off during the second half of 2015 despite the wage increase in Sao Paulo already mentioned. It's also worth mentioning that, we have recently adjusted the remuneration model of our sales team in order to align the incentives mainly related to subscription model, which tend to cause a short-term increase in selling expense at the higher rate than total software revenue.

On top right corner, at the advertising and marketing expense corresponded to 1.5% of net revenue in first quarter '16 versus 1.8% in first quarter '15. The decrease is chiefly due to the revision of the Company's general marketing plan and the beginning of the integration of TOTVS and Bematech marketing activities.

Expenses with allowance for doubtful accounts on bottom left corner corresponded to 1.4% in first quarter '16 comparing to 1.8% in first quarter '15 and 2% in fourth quarter '15.

These allowance reflects the level of delinquency observed in the operation during the period. It's important to mention that, considering the current level of delinquency in the market, the Company will continue its credit analysis policy in its effort to recover the debts already provisioned.

Finally, on bottom right corner, general and administrative expenses plus management fees and other expense increased 2.2% year-on-year, but decreased 3.5% quarter-on-quarter after excluding the non-recurring items of fourth quarter '15.

The quarter-on-quarter comparison, the decline chiefly reflects the headcount reduction carried out in fourth quarter '15, the beginning of the integration of the administrative areas of TOTVS and Bematech.

Moving now to EBITDA and net income in slide nine. In the chart on the left side, EBITDA in first quarter '16 totaled BRL14.6 million down 12.4% year-on-year and up 34.8% over the adjusted fourth quarter '15.

EBITDA margin in the quarter stood at 20.8%, which means a reduction of 270 basis points year-on-year and an increase of 590 basis points quarter-on-quarter.

This year-on-year decline was mainly due to the decrease in software contribution margin resulting from the declining license sales, the mismatch between the revenue inflation and recurring cost inflation and the decreasing hardware contribution margin especially by the FX rate effect over rising costs and also the reduction and the income grant by the Parana state government.

The quarter-on-quarter growth resulted primarily from the recovery of software and services contribution margin and the optimization of administrative structures.

In net income, chart on the right side, year-on-year decline was largely due to the negative financial result in first quarter '16 primarily due to the increasing net debt in the financial revenue from the sales of minority interest in ZeroPaper in first quarter '15.

The quarter-on-quarter comparison, adjusting net margin increased by 30 basis point mainly due to the growth in EBITDA margin in the period. Now, speaking about cash flow and debt on slide 10.

Gross cash decreased by BRL71 million in the quarter mainly due to the net income excluding non-cash items, in the amount of BRL102 million. The working capital investments of BRL74 million impacted by the pre-payment of solutions hired for cloud operations in the amount of BRL18 million an increase in inventories in the amount of BRL8 million in the period.

The payment of interest on equity for the second half of 2015 and the partial amortization of the principal of the BNDES loan hired by TOTVS in 2013 and the partial amortization of principal amount of Bematech's the debentures issued in 2014.

Thus net debt ended the quarter at BRL473.5 million corresponded to one time adjusted EBITDA for the last 12 months.

Now I turn the presentation back to Laercio for his closing remarks on slide 11.

Laercio Jose de Lucena Cosentino {BIO 6567039 <GO>}

Thank you, Maia. In first quarter '16, the economic scenarios in Brazil combined with transition from the licensing model to the subscription model resulted in a year-on-year decrease of 1% in the Company total revenue. Subscription revenue grew 16% and as a percentage of total revenue overtook total license fee revenue which declined 30% year-on-year.

The EBITDA margin ended first quarter '16 at 20.8%, 590 basis points higher than adjusted EBITDA margin in fourth quarter 2015. Margin recovered quarter-on-quarter despite of 3.5% decline in total revenue and the

seasonal effect of wage increase in Sao Paulo, mainly because costs and expenses structure adjustments rolled out by Company in second half of 2016.

We believe that the economic situation is complex, but we are confident that we are on track in the integration of Bematech operation. That's part of execution of our strategy, which has three pillars. Segmentation, providing business solution even more essential that is specialized in the client core business. Software as a service provide a solution base in subscription model prepared for cloud for the mobile device and fluig platform.

By integrating things individual and the business in an agnostic way. Now, we are available for the Q&A section.

Questions And Answers

Operator

Ladies and gentlemen, we'll now begin the question-and-answer session. (Operator Instructions) Our first question comes from Andres Coello, Scotiabank.

Q - Andres Coello {BIO 16205255 <GO>}

Yes, thanks for taking my question. I was wondering if you could give just an update on your international operations and perhaps if you are thinking in diversifying abroad or to enhance your strategy of diversifying abroad? And my second question is on the seasonality of the Olympic Games, if I recall correctly, there was certain seasonality during the World Cup and I was wondering if the Olympic Games are probably going to have a similar impact during the second half of this year? Thank you.

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

Good morning Andres, this is Maia speaking. Starting from the last question related to the seasonality, the eventual seasonality related to Olympic Games, in our view, we can have some impacts in operations, but basically related to the Rio de Janeiro's operation because the Olympic Games are going to be concentrated in that city. And certainly, it will affect the routine of the city especially in terms of mobility and public transportation what can create some specific match there.

But overall Rio de Janeiro, we don't believe, we should see a similar impact in the whole operation because when we compare to the Soccer World Cup we had, all regions in Brazil being affected by the games, even Amazon for example what is out of these event now.

But moving forward to the first question, relating to the international operation, after Bematech, we have less than 5% of total revenues coming from international operations, what is still small. And especially in this moment it could be interesting to have a more relevant operateoning in abroad. But that's our reality now. We still see -- we still see a lot of work to do the international, especially in Latin America, but be more specific to your question in terms of diversification. It's always a possibility throughout our history we've been approached by companies in other regions. That's why we have clients in Europe, in US and other regions. And -- but we normally we don't start an international operation in a region not having a relevant installed base or not having someone else that can explore adequately that region.

Yes, eventually, you can see TOTVS exploring other regions, but not in a kind of a greenfield approach by itself. Am I -- have I addressed --

Q - Andres Coello {BIO 16205255 <GO>}

Okay.

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

Your question properly.

Q - Andres Coello {BIO 16205255 <GO>}

Yes, so basically you are not thinking in launching greenfields, but perhaps you remain alert for acquisition opportunities perhaps in certain niches or certain industries, but you do still see international expansion or something relevant in the long term if I understand correctly?

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

Yes. You are right in the long-term, yes. In the short to medium term, it's more difficult to see relevant things in this front because we are keeping our focus in this transition to the subscription model, especially here in Brazil. And then after that, we can move forward to this kind of discussion.

Q - Andres Coello {BIO 16205255 <GO>}

Okay. Thank you.

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

You're welcome.

Operator

(Foreign Language) The next question comes from Diego Aragao, Morgan Stanley.

Q - Diego Aragao {BIO 17889908 <GO>}

Hi, guys, thanks for taking my question. My question is related to Bematech. Please correct me if I'm wrong, but apparently results were weak in 2015 and somewhat missed your expectations I guess. And in this quarter from what we can see, the hardware segment contracted on the top line side, why has the contribution margin contracted strongly year-on-year for some reasons including FX?

So my question is the following, was this scenario somewhat baked into your numbers at the time of the acquisition? And if not how this should impact the timing for these acquisition to pay off? Thank you.

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

Hi, Diego this is Maia speaking. Regarding the hardware operation, there are some variables we already knew before the transaction like the continuation of fiscal printer especially in Sao Paulo that's the largest location for this kind of market.

Other elements we already knew is the FX rate impacts in these business. What we were not expecting was the commercial decision of Bematech not to transfer the FX impact into

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price in 2015. And obviously the fiscal change in the Parana state that reduced the tax incentives in that region. So the last two elements were out of our plans and the first two were part of our plans.

When we exercised the projections of Bematech, we did some kind of distress scenarios having FX rate even higher than we are now. So, we cannot be surprised now about cost impacts, but in terms of top line, we are also expecting some declining in sales because of the fiscal printer. I confess to that, we were somehow positively surprised about the performance of hardware because after discontinuation of fiscal printers in Sao Paulo, if we could expect a more relevant decline in hardware sales and if you take a look in the figures, we are talking about 5% decline.

So, if you compare to Q4 and Q3, hardware revenue was somehow flat year-on-year and what demonstrates that Bematech has been able to replace "fiscal printer" for other products. So, what's important because Bematech product is occupying that space left by fiscal printers.

In our daily operations, what we are doing? We are gradually adjusting prices to recompose the FX element as we mentioned previous quarter. When we disclosed the Q4 results, we announced that we were adjusting prices and we are doing that gradually because we are measuring the price sensitive of the market. And in terms of the cost structure, more specifically the tax incentive in Parana state, we are studying alternatives even in Parana or in other place, how we can surpass this element because in term, and there is a specific term of hardware -- our main worries are in terms of quality and cost, so we have to assure that any alternative we consider about the hardware business we have to preserve the high quality of Bematech's equipment's and have a cost, competitive cost of production.

Q - Diego Aragao {BIO 17889908 <GO>}

Okay. And sorry, Maia, if I missed it, but -- so can you share with us the timing for the acquisition to pay off, I mean, what was the plan at the time and how those things that you mention will impact the ability to put this plan in place?

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

Look, to have the full return, normally in acquisition, we consider three to four years at least. And Bematech is not different. Of course there is two elements, I mentioned that were out of our plans can take us a little bit out of this projection, but on the other hand, as I told you, the performance of hardware sales are positively surprising us. And some initiatives in terms of solutions, integration is also running faster than we were originally expecting.

Recently we had some market perceptions about Bema cash solution, having the equipment of Bematech together with the software of TOTVS embedded in that equipment. And that's kind of a mobile point of sales solution, combining software in the equipment for commercial automation. The first reaction was very positive and we are now following the performance of sales for the next months. Okay.

Q - Diego Aragao {BIO 17889908 <GO>}

Perfect, Maia. Very clear. Thank you.

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

You're welcome.

Operator

The next question comes from Sunil Rajgopal, HSBC.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Hi, thank you for taking up the question, I'm sorry, if I were to re-ask this question. I was positively surprised with the EBITDA margin recovery in this quarter compared to the Q4. I would like to understand if this is the new level that we should be expecting for the quarters going forward? And also if there are any costs or savings items, which we should be considering for Q2 and afterwards? Thank you.

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

Hi, Sunil. Thanks for the question. Actually Sunil, when we disclosed Q4 and we had that 14.9% EBITDA margin, even after excluding the non-recurring items, at that time, we mentioned that we didn't see that margin level as the normalized one of our Company.

Again, and we don't have a guidance of margin in our Company in year. I have to be careful not to give you a guidance, but we understand that taking all the elements on the table, from the market and the international -- the internal measures, we are taking to adjust the structure to the new reality of the market.

We understand that we can present this year a more stable performance than we presented last year. So we expect to have less volatility in our quarterly results, and what can give us more confidence that we are pressing the right buttons, let's say in our daily operations.

Of course, I cannot state that this is the new margin level of our Company because, as I told you, we don't have a margin guidance, but we understand we can have much less volatility in this kind of measure this year. Okay.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Sure. Thank you. And if I could just ask a follow up, during this quarter, I did see some personnel expenses going up because of the re-negotiation of the salaries and which account for about 40% of your total personnel base. And when does the rest of the 60% become due, and what's the kind of impact that we should be expecting for Q2. Any color on that would be great?

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

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Sao Paulo, is related the larger location in terms of payroll distribution. And it's concentrated in Q1. So it affects the full Q1 results. The other -- the remaining 60% is more concentrated between September and November. So, it affects partially the Q3, but more relevantly Q4. So, there are two moments in the year where we see more relevantly these kind of wage increase affecting results Q1 and Q4.

As the general inflation in Brazil is coming down a little bit, eventually, we can see the next negotiations closing in a lower percentage and also taking into consideration the current moment of the employment market in Brazil. So, that's my view. Of course we have to wait a little bit and see, but Sao Paulo because of its relevance somehow works as an important indicator for the rest of the market. But basically in Sao Paulo the negotiation was following the inflation index and that was a mutual [ph] sensibility about the moment of the market trying to split that adjustment into two parts, one part on a base date of January and a second one in November.

And I think these kind of flexibility will be observed and eventually followed by the other, other places in the market.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Sure. Thank you Maia.

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

You're welcome. Good day.

Operator

The next question comes from Daniel Federle, Credit Suisse.

Q - Daniel Federle {BIO 16643672 <GO>}

Hello, good afternoon, thank you for taking my question. My question is related to the SaaS. I would like to know, which kind of client has been more interested in SaaS and if it has been a decision from the client or from the sales person? Thank you very much.

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

Hi, Daniel. Maia, speaking here. Software as a service, let's say subscription more clearly is being more popular among the smaller companies. That was one of our assumptions when we launched the subscription model, we were believing that larger companies would stay on license model for a while, and it's been confirmed. We've seen more and more smaller companies naturally following the subscription because it requires a much lower levels initial investment and existing clients since they have already acquired license they, especially in this moment that the market is like freezing, they are assuming a more conservative positioning. And maybe it's not an adequate moment to, trying to convince those clients to move from license to subscription you know. And then as a consequence we've seen subscription been more focused on new clients, smaller companies in license

being -- becoming more concentrated on existing clients and larger companies. That's the profile of companies choosing subscription at this point.

Q - Daniel Federle {BIO 16643672 <GO>}

Thank you, Maia.

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

You're welcome.

Operator

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

A - Laercio Jose de Lucena Cosentino {BIO 6567039 <GO>}

I thank you all for taking part of our conference call and wish to state that we remain focused in executing our strategy. Have a nice day everybody.

Operator

That does conclude the TOTVS's audio conference for today. Thank you very much for your participation, have a good day. And thank you for using Chorus Call.

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