Q1 2017 Earnings Call

Company Participants

- Douglas Henrique Furlan, Investor Relations Manager
- Gilsomar Maia Sebastiao, Chief Financial Officer and Investor Relations Officer

Other Participants

- Frederico Mendes, Analyst
- Richard Dineen, Analyst

Presentation

Operator

Good morning. Welcome to TOTVS Conference Call to discuss the results of the first quarter of 2017. Today we have with us, Mr. Gilsomar Maia, CFO and IRO; and Mr. Douglas Furlan, IR Manager.

Note that all participants will be in a listen-only mode during the presentation. After that, 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 via webcast at ir.totvs.com.

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 target 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 future events and, therefore, 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 conference over to Mr. Maia, who will begin the presentation. Mr. Maia, please go ahead, sir.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Good morning, everyone. Thank you for participating in our conference call to discuss the results of the first quarter of 2017.

Starting on slide three, where we have the recent events related to the general meeting and TOTVS new campus in Sao Paulo. The Shareholders' Meeting held on April 20 was attended by shareholders representing 75.7% of the total shares with 35.2% of total shares being represented via remote voting form. All matters in the agenda of the meeting were approved, of which we highlight, one, the unanimous approval of the dividends distribution proposal in the amount of BRL7.4 million for the year of 2016 to be paid to the shareholders on May 10, 2017. The dividend amount, together with the interest on equity announced in 2016, totaled BRL91.6 million and correspond to 60% of the net income from the fiscal year of 2016.

Second, unanimous approval of the proposed management annual global compensation for the fiscal year of 2017. And, third, the election of Gilberto Mifano, Maria Leticia de Freitas Costa, and Henrique Andrade Trinckquel Filho as new independent members of the Board of Directors with 7.7% approval of total shares.

Another recent event that deserves to be highlighted is the moving of the office to the new Head Office in March. In this new campus, TOTVS house in a single location almost 3,000 employees, who were earlier is spread across seven locations in Sao Paulo city and the metropolitan region.

The new head office is a technology center specially designed for TOTVS, with more than 21,000 square meters, inspired by leading technology companies in the Silicon Valley in California. Apart from the benefit of concentrating in a single location the Company's development, sales and administrative operations in Greater Sao Paulo, the new head office has an exclusive area for customer service in an environment designed to provide innovative experience on major technological trends, such as mobility and cloud computing, which are key components in the Company's strategy to promote digital transformation among its clients.

Now, I begin my comments on the results of the quarter on the slide four. It's important to remember that, in order to maintain comparability, the pro forma consolidated figures for the 12 months ended in Q1 2016 also includes Bematech's results.

In this quarter, net revenue increased by 1.6% year-on-year as a result of the 8% growth in recurring revenue, which corresponded to 64.4% of net revenue in the quarter, 3.8 percentage points higher than Q1 2016 and have the decrease of 8.3% in non-recurring revenue. In the last 12 months, recurring revenue increased its share of total net revenue by 5.7 percentage points.

When analyzed by business, slide five shows that the 5.3% growth in software revenue and 2.8% in hardware revenue positively impacted the net revenue growth year-on-year. Services revenue reduced its share of total net revenue by 2.5 percentage points year-on-year and totaled BRL128.6 million in Q1 2017, the same level of Q4 2016.

In hardware, the year-on-year growth is mainly driven by sales of automation solutions in the period, especially Bemacash. It's worth mentioning that the automation solutions growth is a consequence of the Company's strategy of offering solutions that contribute to the more efficient management of our clients' businesses, making them increasingly competitive in their business segments. In comparison with the previous quarter, the reduction in revenue was mainly a consequence of the seasonality of sales in the period.

In services, year-on-year decrease is a result of a 1% decline in software implementation services, chiefly due to the lower pace of sales observed in recent quarters and a 20.5% decrease in services not related to software implementation services, mainly reflected in lower sales of consulting services since second half 2016 and the AGR [ph] BPO operations sold in 2016.

Software revenue in Q1 2016 grew 5.3% year-on-year, 4 percentage points higher than growth in the last 12 months, mainly due to the growth in subscription revenue and increase in the corporate licensing model, which I will comment on slide six.

Revenue from the software licensing model, which combines license and maintenance revenues grew 5.7% quarter-over-quarter, that seasonally driven by the incremental license from the corporate model, which totaled BRL13.9 million in this quarter, 29.5% higher than incremental license from Q1 2016.

In the corporate model, clients have unrestricted access to TOTVS management solutions, for which they pay an incremental licensee fee at the beginning of each year based on their real growth in the prior period, which shows the results in an adjustment in the monthly recurring maintenance fee of these clients. This growth in incremental amount reflects the quicker pace of growth among clients under this model in 2016, especially in the agribusiness, factoring and healthcare industries, despite the worsening economic scenario in Brazil and the fewer clients added in the licensing module during the period.

Subscription revenue grew 31.3% year-on-year and 6.7% quarter-on-quarter, boosting software revenue growth, which grew quarter-on-quarter for the third consecutive quarter. This growth in subscription revenue was due to a higher share of sales to new small and medium clients in the last 12 months, especially under the TOTVS Intera model.

It's important to mention that Intera sales of March did not affect the quarter subscription revenue since the first billing occurs in the month following the sale. However, the ARR, or annual recurring revenue, shown in the chart to right of the slide has captured sales of March, since this is very common metric in the SaaS world measures the evolution of recurring revenue over the next 12 months based on contracts signed up to the end of the period.

In Q1, the ARR subscription totaled BRL280.7 million, 36.2% above the Q1 2016, representing a net addition of BRL20.7 million in the quarter. ARR's year-on-year growth over the last five quarters shows that we are evolving and transitioned from the licensing to the subscription model, a key element to reach our goal of turning TOTVS into a single subscription Company and promoting digital transformation in our clients.

In addition to the growth of Intera in Fly01, the ARR growth reflects the migration of 69 customers from maintenance to subscription on Q1 and the acceleration of Bemacash sales in the last quarters, which I will comment now on slide seven.

Bemacash is another initiative from TOTVS to explore Brazil's migrated price market and is also an entry point to our business solutions, contributing to generate new software sales opportunities in the medium term for micro enterprises that becomes small and medium in the future.

In the quarter, we have sold 1,073 new Bemacash units, despite the negative seasonal effects of sales in this quarter. It's worth to remember that most of Bemacash sales made in recent periods did not affect the subscription revenue yet, since the Bemacash clients become software customers between the eighth and eleventh months after contracting the solution when they start paying for the software subscription.

Now I invite Douglas, which will comment on software results on slide eight.

Douglas Henrique Furlan

Thank you, Maia; good morning, everyone. Before starting my comments on software results, I'd like to remind you that TOTVS costs and expenses in Q1 2017 were fully affected by the 6.29% wage increases established by the collective bargaining agreement to Sao Paulo employees, who represents about the half of TOTVS total payroll.

In addition to the salary adjustments, a collective bargaining agreement also established the payments in August 2017 of a bonus equivalent to 10% of one salary with reference date of December 2016. This bonus in the amount of 1.8 million was fully provisioned in Q1. The software contribution margin for the quarter dropped 210 basis points in comparison to Q1 2016, reflecting the increase in software costs and the higher growth of R&D investments, then the growth of software revenue during the period.

The year-on-year increase in software costs reflects basically the share of complementary solutions provided by partners in the period, whereas the increase of R&D investments mainly reflects the wage increases in the last 12 months. Compared to Q4 2016, the increase in the software contribution margin was mainly due to the combination of the software revenue growth, already commented by Maia, with the reduction in R&D investments, mainly due to the conclusion of innovation projects, specifically for the healthcare segments and cloud, besides the additional expenses due to restructuring carried out by TOTVS in Q4 2016.

On slide nine, the Q1 2017 sales contribution margin increased by 80 basis points quarter-on-quarter, despite a wage adjustments in Sao Paulo, mainly due to the organizational restructuring carried out by the Company, which resulted in additional costs due to employee termination in Q4 2016, but reduced the recurring personnel expenses in Q1 2017.

In the year-over-year comparison for Q1 and for the last 12 months, the reduction in service contribution margin mainly reflects the lower allocation of service professionals due to the slower pace of project sales, as well as the collective wage adjustments made, which were not fully transferred to service project prices in the period.

Moving to slide 10, hardware result in the quarter grew 24.9% year-on-year with a contribution margin of 37.5%, 660 basis points higher than Q1 2016. This growth is largely due to the conversions of price adjustments made by the Company and the FX rate variation in 2016. In the last 12 months, results from hardware dropped to 10.8%, mainly due to the decline in net revenue from hardware, decrease in economic subsidies, and the capitalization of BRL5.7 million of Bematech's hardware research and development expenses in 2016.

Now, we talk about selling and administrative expenses, please move to slide 11. In Q1, selling expenses and commissions jointly increased their proportion of net revenue by 160 basis points, when compared to Q1 2016 and by 70 basis points in the last 12 months. This increase is due to the change in the sales mix between franchisees and own branches, the higher volume of software sales in the subscription model and the adjustments to the compensation model of the sales team in first half 2016.

In comparison with the previous quarter, the increase is primarily due to the growth in net revenue from software in the period and the wage increase in Sao Paulo. In Q1 2017, general and administrative expenses, together with management fees and other expenses, reduced its relevance of net revenue by 230 basis points quarter-over-quarter, mainly due to the amount of BRL19.7 million added to the provision for contingencies in Q4 2016, and a reduction of the Company's management structure in Q1.

It is important to mention that this block of expenses was negatively affected by the non-recurring write-off of fixed assets in the previous facilities left behind during the migration to the new campus in the amount of BRL1.9 million. The allowance for doubtful accounts corresponded to 1.6% of net revenue in Q1 2017, the same level of Q4 2016, reflecting the delinquency levels seen in the operation during the period.

Advertising and marketing expenses corresponded to 1.7% of net revenue in Q1 2017, as against 1.5% in Q1 2016, chiefly because the growth in net revenue was lower than the wage increases and adjustment in contracts with suppliers meeting during the last 12 month.

On slide 12, EBITDA in Q1 2017 adjusted by non-recurring write-off of fixed assets of the previous facilities in Sao Paulo amounted BRL90.1 million, 48.4% higher than adjusted EBITDA in Q4 2016 and the adjusted EBITDA margin was 16.1%, up 510 basis points from the adjusted EBITDA margin in Q4 2016.

Adjusted quarter-over-quarter EBITDA growth was primarily a consequence of the growth in software revenue, mainly driven by revenues from incremental licensing fees in the corporate model and by subscription revenue, as commented earlier by Maia, and the reduction in G&A expense.

Year-on-year, even with the software and hardware revenues increase, adjusted EBITDA declined 21.4%. This drop is mainly due to the reduction in contribution margin from services and the increase in commercial and administrative expense.

On slide 13, the year-on-year adjusted net income drop was higher than the drop of adjusted EBITDA, especially because of the higher financial expenses mostly affected by the increase in the long-term interest rates that is used to update the main financing lines and debentures, and a decline in the financial revenues due to the reduction of gross cash and debt.

In comparison with Q4 2016, net income growth was lower than EBITDA growth, because of the lower tax rate of Q4 2016 as a consequence of the fiscal benefit related to interest on equity approved in December 2016.

Now, I'd like to turn the call back to Maia to comment on cash flow and debts on slide 14.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Net debt dropped 7% year-on-year and 8% quarter-on-quarter, and represented 1.3 times adjusted EBITDA in the last 12 months, same level of Q4 2016. Free cash flow in Q1 was 31% higher than in Q4, mainly due to the 59% decline in the working capital needs and the lower volume of investments in fixed assets.

On the other hand, the financing activities used 26% more funds due to the partial amortization of the principal of debentures issued by Bematech in 2014. The payment of withholding income tax on interest on capital, as commented by Douglas, and the payments of financial review instalments contracted in previous quarters, especially related to the investments in the new head office. In comparison with Q1 2016, free cash flow increased by 690%, mainly due to the 88% drop in working capital needs in the period.

In the last 12 months, free cash flow was positive at BRL214 million compared to a negative free cash flow of BRL315 million in the previous period, mainly a consequence of the reduction in working capital investments by 64% and the payment of BRL474 million in the corporate reorganization with Bematech in Q4 2015.

Despite the higher free cash flow, gross cash declined 39% in the last 12 months, mainly due to the start of the amortization in Q4 2015, of the principal amount of the financing line taken by TOTVS from BNDES in 2013, and the amortization of BRL48 million referring to the remaining principal of the debentures.

I now turn to slide 15 for my final remarks. In this quarter, total software revenue accelerated year-on-year growth with 5.3% versus 1% in Q4 2016. This was the third consecutive quarter of quarter-on-quarter growth. It shows that the transition to the subscription module has already passed the inflection point and established a growth trend in software revenue.

Subscription revenue grew 31% year-on-year and reached BRL280 million in ARR, a 36% year-on-year increase, which also contributed to a 7% growth in recurring software revenue in the period. We are determined to establish a turning point, as well as a sustainable growth trend for the Company's profitability just as we have done with revenues. Thus, the 48% growth in adjusted EBITDA over Q4 2016 should be understood as a sign of our determination.

Now, we are available for the Q&A section.

Questions And Answers

Operator

Excuse me. Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) Our first question comes from Mr. Fred Mendes with Bradesco.

Q - Frederico Mendes {BIO 19832788 <GO>}

Good morning, everyone, and thanks again for the call. I have just one follow-up question. When you look at the breakdown of the commercial expansions, there is a significant increase in the selling expense year-over-year, but of course there is a connection between the selling expense and the commissions given the change in the compensation model. Is it possible for you to give us a breakdown of direct and indirect sales or, at least, tell us how the indirect sales are evolving and if you saw any improvement on these matters? Thank you.

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

Thank you, Fred. This is Maia speaking. Regarding your question related to commercial expense, we have in this block of expense, two lines; one is the selling expense itself and the second one is commission. Selling expenses is basically the cost of our direct sales team and the commission expense related to our distribution channels. So, since we launched the subscription model, we try to set up incentives of our sales people in order to align their incentives to sell license and subscription.

So in practical terms, they can make the same amount of money selling both things and that created some misconnection between selling expenses and top line specifically in the case of subscription model. What is not a case for the commission expense, because commissions work like revenue share, so it's a percentage of our revenues and it's more aligned with our top line as well.

A - Douglas Henrique Furlan

And talking about the participation of the sales via franchisees, I can tell you that in the past quarters we have seen the franchisees increasing their participation over their software sales and subscription, which is also helping us to increase the growth of subscription in the past quarters. So this model is getting more material among them and this is helping us to increase this participation.

Q - Frederico Mendes {BIO 19832788 <GO>}

Thank you, Maia. Thank you, Douglas. Just one more, I think, on the same line. As you are changing the way how you sell, right. I mean, focus more on the subscription model rather than the license, should we see a decrease in the provisions for that debt as we move forward, because the guys in the subscription model, he's paying on a monthly basis, I guess, the risk of bad debt, at least in our margin, should decrease and do you think this line of thinking is -- is it makes sense?

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

It make sense in the long run, because it's important to remind that in the traditional licensing model, the client acquire license comparable with software and pays in a monthly basis our maintenance fee. But in an extreme scenario, our client can stop paying the maintenance and keep running our software, because they bought the license. And in the subscription model, they are just describing our service and if they stop paying the subscription fee, so they don't have the software available anymore.

So in this sense, the subscription model can be helpful for delinquency, but there is this delinquency higher -- these higher levels of delinquency we have today can be more related to the macroeconomic scenario as a whole. But partially, yes, we can correlate to the business model, what can be helpful, but I shouldn't create some expectations that just the change to subscription could address 100% of the delinquency problem we have today.

Q - Frederico Mendes {BIO 19832788 <GO>}

Okay. Thank you very much, Maia.

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

You're welcome.

Operator

Our next question comes from Richard Dineen with UBS.

Q - Richard Dineen {BIO 5517898 <GO>}

Hello. Hi. Thanks very much for taking my question, but congratulations on some good sequential operating momentum. I just wondering if we should expect, sort of, continuation of those improvements in the major revenue segments as the economy continues to recover. Just wondering how much visibility you have on Q2 and the second half of the year? And if it is going to be possible to narrow down your EBITDA guidance at any point, so any thoughts on that would be helpful? And maybe one follow-up after that.

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

Thanks, Richard, for your question. So, maybe it's good to test quickly through the main revenue streams we have. So starting from license, the license was bounced in the Q1 because of the performance of corporate model. The remaining license, all of the corporate model, is still declining comparing year-on-year, they're declining about 12%. Although when we compare the environment today with one year ago, we see a little bit more optimistic humor in the market, so what can be favorable for license performance throughout this year.

I don't mean that the declining trend in the traditional license model can be reverted; but in my personal view, we shouldn't see this year a strong declining license as we saw in the previous two years.

What can be helpful for short-term in terms of margin is probably, you remember in the last two years that strong declining license hurt our bottom line a lot.

The second line related to maintenance is, there is a good correlation with license fee. Always I try to remind people that we have three main variables in the equation of maintenance. One is, churn. That is still high. We saw a very little improvement this quarter, but nothing relevant in terms of churn.

The second variable is inflation, that's coming now consistently, specifically last month we saw IGP-M being negative and it can be unfavorable for adjustments throughout the year. And the third variable is the additional of new maintenance contracts coming from new licenses. So, and then I can connect these comments with my previous one, so related to the license performance.

So if license performs in a more stable way during this year, eventually we can offset essential negative impacts coming from inflation rates in a lower pace and eventually we can see some improvements in terms of churn withdraw for this year. So maintenance probably will not perform so well as it performed in Q1, because corporate model provoked a very positive impact in Q1, but we have a good chance to see maintenance more stable throughout the year too.

Services are really under pressure yet. We have a matter of technical allocation, our sales technicals are not fully allocated for a while. It has been a problem to have a better shape in terms of services results. Measures we've been taking here is basically trying to sell smaller projects of services, because we can quickly see the implementation moving forward and as a consequence the results in services too.

And also, we are trying to have a more efficient implementation services too. So, it's somehow is fruitful and we should see some improvements will bring in a gradual way.

And the last one related to hardware, hardware has a very clear seasonal behavior in Q1. There is a negative seasonality for hardware business everywhere. We see hardware business really improving consistently. There is a structural change in the hardware business of Bematech after the merger of Bematech with TOTVS.

And as probably you remember, we have discontinuation of fiscal features in middle of '15 and it impacted negatively the results of hardware, but that's from -- from that point on, we've been able to enhance the quality of hardware business of Bematech, trying to sell more business solutions than fiscal solutions in the aggregate and that can explains the good performance of hardware and we have good expectations for hardware revenue line for this year, as well as we've been able to create more and more cross-selling with our existing clients in softwares and trying to take more advantage of that merger.

In terms of bottom line, the lower inflation phase also create some positive expectations to have a low level in salary adjustments for the rest of the year. And it can have a lower pressure over cost as a consequence. If we see the positive trend in terms of software revenue, so the new subscription model is adding more revenues than affecting negatively. Top line, it can't recover part of our margins for the year. So -- and we see this as -- possibly should be in that range of the EBITDA guidance we gave last quarter. I don't know, if I'm clear and what makes --

Q - Richard Dineen {BIO 5517898 <GO>}

That was really fantastic and very detailed. I'm sorry, if I can have one very quick follow-up just on the Brasil Maior tax benefit that you mentioned. If there are anyway sort of waiting the probability of changes to do that benefit. And if there are any other tax benefits that you get right now that could be under risk if you've gotten this early trigger different sort of taxes and sort of seeking to increase tax revenue. Just wondering if there is anything else we should be having in back of our minds?

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

Okay, good. So after the launching of that provisional measure from federal government, the Trade Association of Technology Firms started to move and trying to interact with government, with the executives and legislatives, trying to explain the government that if their aim is to enhance the tax collection, they are going in the other way around. So, they are moving to tax -- the payroll instead of tax -- the consumption of technology. And the whole technology industry is more and more moving to an automation way in which the label tends to become a less relevant element in the cost structure of technology for instance.

So if tax authorities change the fixation to payroll to development in the mid- to long-run they will collect less tax, so it makes no sense. It makes no sense in their side to collect more taxes and also makes no sense for -- especially for local developers. So every time government consider to tax the development, the payroll, it distantiate local developers. So it will stimulate people to develop technology abroad. It makes no sense. So it will create some disadvantage to local developers of technology.

I know that's not an easy conversation, because government is in big pressure in terms of fiscal accounts and -- but we are trying to crystalize [ph] them in order to realize that they are taking a wrong measure. I -- personally I believe, it's going to be analyzed and -- in a -- in about one month, not more than that, because the provisional measure is going to be in place in 1st July. So, if they don't pick up final decision about that matter, it will be too late. And if that provisional measure is kept as it is today, what we are seeing from most of the companies in our market and that's what is in our mind, we have to transfer into price, there is no other choice.

So this change in terms of taxation is going to affect more than 50 different sectors in our economy, so it changed structurally the cost structure of sectors and companies in our economy. So, it's difficult to accept that companies will just absorb that cost. So there is no choice. And in our case, when you take a look in our figures, it's clearly identified that our big challenge is related to service, so there is the most concentrated problem "we have to address." Okay.

Q - Richard Dineen {BIO 5517898 <GO>}

Right. Okay. That's really helpful. Thanks. Thanks for all of this, and nice comments. Your [ph]remarks did help us as always, and congratulations gentlemen on the quarter.

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

Thank you.

Operator

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

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

So, thanks for everyone to be part of our conference call today. It was a good beginning of the year comparing to the beginning of last year. We know that we have a lot of work to do here. But our main challenge today is trying to establish, as I mentioned in my final remarks before the Q&A session, is trying to establish growth trend in the bottom line as we will able to do in the top line. So, I thank you everyone again for this part of our conference call today, and very good day for everyone. Thank you.

Operator

That does conclude TOTVS Audio Conference for today. Thank you very much for your participation. Have a good day, and thank for using Chorus Call.