

Q3 2016 Earnings Call

Company Participants

- Alexandre Apendino, Chief Sales Officer
- Douglas Furlan, Investor Relations Manager
- Gilsomar Maia Sebastiao, Chief Financial Officer and Investor Relations Officer

Other Participants

- Diego Aragao, Analyst
- Susana Salaru, Analyst

Presentation

Operator

Good morning. Welcome to TOTVS Conference Call to discuss the Results of the Third Quarter of 2016. Today we have with us Mr. Gilsomar Maia, CFO and IRO; Mr. Alexandre Apendino, Chief Sales Officer; and Douglas Furlan, IR Manager.

Note that all participants will be in a listen-only mode during the presentation. After that, we will start with 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 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 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 call 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 third quarter of 2016.

Starting with the recent event on the slide three, related to the integration of Fly01 Start application ready for the smart POS LIO and SmartRede provided by Cielo and Rede respectively. Fly01 Start app is part of our business platform for micro and small business and plays the role of POS already integrated with the new generation of acquires Pin Pad. Besides having the features of a point of sale, the solution also comprise back office features in the cloud to register products and access business management data.

The Fly01 Start runs stand alone, but also comes fully integrated with Bemacash, and then can be used as an additional point of sale. This initiative is another example of joint work between the teams of TOTVS and Bematech, and put us in a market never reached before even by Bematech which are the mom-and-pop shops that only use the Pin Pad as technological support to their businesses.

Now, I will start my comments on the quarterly results on the slide four. Just to remind you that, for better comparison, the consolidated pro forma figures unaudited for the third-quarter 2015 include the results of Bematech in said period. Note also that the figures for the quarter do not include the August and September results of TOTVS RO, a company that provides BPO services in HR sold in August 2016.

By the way, the sale of this operation was an important factor for the 0.4% quarter-on-quarter reduction in our total recurring revenue, chart on the left; and the 6.7% reduction in services revenue, chart on the right. Year-on-year, total revenue fell 6.9%, mainly due to the 22% decline in non-recurring revenues as shown in the chart on the left. By contrast, recurring revenues grew 5.8% year-on-year and reached 62.3% of total revenue, increasing by 7.5 percentage points from the same period in 2015.

When analyzed by business line as the chart on the right shows, we see that year-on-year decline in total revenue was concentrated in hardware and services.

In relation to software revenue shown on the left side of slide five, 1.4% year-on-year reduction shows that the 36.7% decline in license revenue was almost fully offset by the growth in recurring revenue especially by the 22.6% growth in subscription. The quarter-on-quarter comparison, software revenue remained stable showing that the accelerated growth of the subscription model is already able to more than offset the drop in license sales.

The reduction in license sales in previous periods coupled with the churn of maintenance contracts, whether due to the full or partial cancellation because of the economic price, has been reducing maintenance revenue. In addition to these factors, 27 licensing clients migrated to the Intera subscription model this quarter, reducing maintenance revenue in the quarter by approximately R\$0.5 million. Moreover, Intera sales have been very important for the growth of subscription revenue reaching this quarter outpaced license revenue by R\$21 million.

To comment on this transition for the subscription model, I now invite Alexandre Apendino.

Alexandre Apendino {BIO 20185832 <GO>}

Thanks, Maia. Good morning, everyone. We have very good news about subscriptions to share in this conference call. The growth of subscriptions by 23% year-on-year and 8% quarter-over-quarter, as Maia mentioned, was positively impacted by the sales of Intera, our subscription model launched in June 2015, in which the client set and managed the number of identities or IDs to have unrestricted and simultaneous access to TOTVS management, productivity and collaboration solution.

With a little more than one year from Intera launching, we are even more convinced that we made the right choice. Intera has shortened sales cycle to lower initial investment, which is also very positive for new sales to clients under this model, if the client want to have to buy new license to add more IDs, but merely adjust Intera monthly fee in accordance to the number of IDs.

Besides Intera monthly fee already includes the standard cloud infrastructure, access to the fluid platform and the e-learning center, the elements to the digital transformation we are promoting the market. Today we already have more than 90,000 active Intera IDs. This quarter, we have impressive number of clients added. We added 846 clients mainly in the Intera and Fly01 and sold almost a 1,000 units of Bemacash, a 127% more than in the second quarter of the year.

Bemacash combines Fly01, our solution for micro and small companies contracted under the subscription model, with Bematech's commercial automation equipment and fiscal solution. Important to mention that Bemacash sales in the quarter and Intera sales in September did not affect our quarterly subscription revenue. From the eighth month of hiring Bemacash, the client starts paying subscription for the management software. In Intera, the first billing is done in the following month after the sale.

Sum up, recurring revenue in this quarter does not reflect our entire subscription base at the end of the quarter. To address this issue, the Annual Recurring Revenue, ARR presented in slide six, the most popular metric in the SaaS world to measure evolution of the recurring revenue over the next 12 months of contract signed at the end of the current period, deducting any cancellation already requested.

Total ARR of software, in the chart on the left, grew 9% year-on-year or 3.2 percentage points above the growth in recurring revenue of software in the quarter. Meanwhile, ARR subscription, the chart on the right, grew 25.2% year-on-year, despite of the crisis or 2.6 percentage points above the growth in subscription revenue in the same period, showing that subscription sales are growing much faster.

Now, I'll turn the call to Douglas.

Douglas Furlan

Thank you, Apendino. Good morning, everyone. Still on slide six, another way of looking at the speed up of the subscription model is through the quarter-on-quarter ARR growth, which was 3.8% in the second quarter and 9.8% in the third quarter resulting in a net addition of R\$21 million this quarter versus R\$7.7 million in the previous quarter.

Moving now to slide seven, software contribution margin closed the quarter at 62.1%, down 310 basis points year-on-year, mainly because of the combination of the lower software revenue and the maintenance of investments in R&D, client services and support. Compared to the previous quarter, the 70 basis points reduction in the contribution margin is primarily related to the wage increases in the quarter in Belo Horizonte and Rio de Janeiro, and their impacts on the provisions for vacations and Christmas bonus coupled with the alignment made in the classification of Bematech's (inaudible) which mainly impacted the research and development line.

Please turn over to slide eight to discuss services and hardware. In services, the decline in contribution margin year-on-year reflects the 8% decrease in revenues from software implementation in the period mainly on the lower volume of sales; and the 29% decrease in services not related to software implementation especially (inaudible). Both were negatively impacted by the higher number of holidays in Rio de Janeiro because of the Olympic Games.

We are also using this period of lower allocation and putting more effort on the training of service professionals in order to increase their productivity. The wage adjustments in the third quarter in Belo Horizonte, Rio de Janeiro and Recife also had a negative impact on service contribution margin in the quarter.

In hardware, we recorded an extraordinary expense of R\$2.4 million related to an adjustment of average cost in the quarter. Without these adjustments, hardware contribution margin reached 35.1%, which is an improvement of 230 basis points from the second quarter margin.

This margin of 35% here represent a decline year-on-year mainly because of three factors; the reduction of tax subsidies in the state of Parana since September 2015; the non-capitalization of R&D projects since the fourth quarter 2015; the changes in the state tax loss especially in the state of Sao Paulo where the fiscal printer was replaced by S@T fiscal equipment which has a lower unit value in margin, but on the other hand helps to increase recurring revenue from software fiscal solutions, and has been sold as part of Bemacash, which has been growing consistently as already mentioned by Apendino.

Now talking about selling and administrative expenses, please move to slide nine. Starting with the chart on the top left, selling expenses and commission jointly grew 6.1% year-on-year and 3.9% quarter-on-quarter. Compared to the previous quarter, the decline mainly reflects additional expenses to adjust the compensation model of the sales team due to the transition to subscription as already commented in previous quarters and the declining license and services sales in the period.

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On the top right, advertising and marketing expenses corresponded to 2.7% of total revenue in the quarter compared to 2.2% in the second quarter, chiefly reflecting the higher investments in marketing the third quarter with the launching of the new advertising campaign. The 12.2% decrease year-on-year was mainly due to the revision of the company's general marketing plan at the integration of TOTVS and Bematech.

Allowance for doubtful accounts on the bottom left corresponded to 4.8% of total revenue in the quarter compared to 1.5% in the third quarter 2015. The increase in this quarter is mainly due to the additional provision of R\$17.2 million related to a higher credit risk of a large client in the services segment. Excluding this additional provision, allowances for doubtful accounts corresponded to 1.6% of net revenue.

Finally, on the bottom right, G&A expenses plus management fees and other expenses fell 10% quarter-on-quarter mainly due to the R\$9.2 million gains from the sale of the BPO operation. Excluding this sale, expenses increased their ratio of net revenue by 90 basis points because of the decrease in net revenue and the additional expenses related to the post migration of internal systems in the quarter and to higher non-recurring expenses with lawyers [ph].

Now, I'd like to turn the call back to Maia to discuss EBITDA on slide 10.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

EBITDA in this quarter adjusted for the sale gain from the BPO operation, inventories adjustment and additional bad debt provision came to R\$86.5 million, down 26% from the same period in 2015, and 10.7% from the second quarter. As shown throughout this conference, this reduction in adjusted EBITDA was mainly due to a combination of the transition to the subscription model which reduced software contribution margin initially and the lower sales due to the economic scenario, affecting more clearly the service contribution margin as well as tax issues that affected hardware margin.

Now talking about net income on slide 11. The year-on-year decrease in adjusted net income higher than the decrease in adjusted EBITDA is mainly due to the company's current net debt position compared to a net cash position in third quarter 2015. Quarter-on-quarter, adjusted net income grew 18.9%; thanks to the tax effect from the interest on equity declared and paid [ph] in the quarter.

Moving now to slide 12, we will comment on cash flow and debt. Despite increasing working capital in this quarter, gross cash decreased by R\$79 million in the period, mainly due to the following payments. Investment in fixed assets in the amount of R\$19.8 million of which R\$5.8 million is related to investments in the company's new campus. It's worth mentioning that the total amount of investment originally estimated by the company, R\$90 million, has been reviewed to R\$80 million, of which around 50% to be financed in at least three years.

Investment of R\$11.8 million in intangible assets especially related to the creation of TOTVS digital, a new integrated digital environment to interact with clients, prospects,

channels and partners scheduled for launch in the first quarter of 2017. Payment of interest on equity for the first half of 2016 in the amount of R\$43.6 million; and amortization of R\$48 million referring to the principal outstanding of debentures issued by the company in 2008. Thus, net debt amounted for R\$478.4 million in third-quarter 2016 equivalent to 1.2 times pro forma adjusted EBITDA in the last 12 months.

Now I move on to slide 13 for my final remarks. In summary, the transition to the subscription model accelerated this quarter. Subscription revenue grew 22.6% year-on-year and reached 17% of software revenue. Taking into account the subscription sales in September, the annual subscription revenue increased by 25% year-on-year with an annualized net addition of R\$21 million quarter-over-quarter, thanks mainly to Intera sales. Bemacash sales grew 126% quarter-over-quarter with almost a 1,000 unit sold.

Moreover, hardware contribution margin excluded adjustment of inventories ended the quarter at 35%, a growth of 230 basis points over the second quarter. More recently, Fly01 Start has been integrated to Smart POS LIO and SmartRede. We remain aware that this accelerated transition to the subscription model impose margin challenge in the short term, especially in acute recessionary economic environment and high cost inflation. However, we remain convinced that this transition also generates value relevantly and makes TOTVS and our clients much more prepared for the recovery of the Brazilian market.

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

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instruction) Our first question comes from the Susana Salaru with Itau.

Q - Susana Salaru {BIO 16170633 <GO>}

Hi. Thank you for taking our question. First question, if you guys could elaborate a bit more on the perspectives of the margin in the next quarters? And when will we see inflection point in margins? That will be our first question. And second, on the trend of the migration for this or adoption of this subscription model, how do we evaluate the speed that's happening now? Do you think it's whether you are expecting when you first did the business model or it's faster or slower than you were expecting? Thank you.

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

Good morning, Susana. And this is Maia speaking. Thanks for your questions. I will start from the second question, regarding subscription model. Actually, the subscription model in this point specifically is going faster than in our plans originally. Of course, it's important to remind that it's a kind of first time we experience this transition in our life here at TOTVS. And all the projections we made, we knew that it wouldn't be exactly.

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On the other hand, we know that the downturn in the sales of license also came much stronger than we were expecting to. But in terms of subscription, that was your question specifically, it's moving faster than we were planning. Part of this acceleration, we can attribute to a more familiar -- familiarity of our sales people to the subscription model since we just completed like a little bit more than one year as Apendino mentioned in his speech.

In terms of margin, that was your first question. As I mentioned in my final remarks, we know that this transition in this point specifically, it cause some additional challenge for us especially because the gap we had in license sales reflecting maintenance and especially services at this moment is not fully compensated or offset by sales of subscription. Although, when we take into consideration the annual recurring revenue, we start to see that in one year we can see more clearly the benefits of this transition.

On the other hand, we have -- cost inflation is still high especially in our market where our label is one -- a specialized one even though we have a high level of the unemployment rates in our market specifically in our industry of technology. It's not so true because people -- technical people in our market is always under a good demand.

And we knew when we start that transition that the first two years would be those more complicated, more challengeable and more clearly from the 30-year on, it would be more clear and show the improvements of margin in our view. But of course, there are lots of different variables in the table to see that inflection point as you asked.

Q - Susana Salaru {BIO 16170633 <GO>}

Thank you, Maia. Very clear.

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

You're welcome.

Operator

(Operator Instructions) Our next question comes from Diego Aragao with Morgan Stanley.

Q - Diego Aragao {BIO 17889908 <GO>}

Hi. Thanks for taking my question. Two questions, if I may. The first one is regarding your cash flow. It seems that your cash generation is deteriorating as you lose license sales and maybe because maintenance in revenue growth decelerated as well. So, I was wondering if you can add more color on how we should think about your cash generation during the transition on your business model? Thank you.

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

Thanks Diego for the question. This is a very good question in terms of cash flow. You are right. This transition, besides of the results impacted, also brings some impacts in our -- especially in working capital because we can -- every time we sell a subscription instead of

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a license, it creates some gap in terms of the downpayment related to the license upfront. But if you take a look in our working capital this quarter, it was a positive working capital. And if I'm not wrong, maybe this is the first working capital positive in cash flow in the last four quarters, if I'm not wrong. So, gradually we are getting part of the benefits of this transition.

Of course, there is another limit helping significantly this improvement in working capital related to the level of inventories at Bemacash -- at Bematech, sorry. We ended 2015 with a much higher level inventories and as we were evacuating the production to the reality of the market, we could have a more reasonable levels of inventories.

The delinquency is still putting some pressure in working capital, and if we see some recovery in economy, it would be in my personal view one of the first main fronts of improvements because clients seem under delinquency. They should firstly try to regularize what they do to us and then they can be back to purchase or to buy new users, new identifications.

Q - Diego Aragao {BIO 17889908 <GO>}

Okay, perfect. Very clear, Maia. And the second question is actually a follow up on what Susana just asked regarding the subscription revenue model. You just said that it is growing faster than expected. So my question is, is this happening because of a faster cannibalization of the traditional business model or because it's getting more traction among segments or even like clients that maybe you will not be serving via the traditional model? Thank you.

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

So specifically in terms of what you call cannibalization, I would say that in the beginning it was more true. But more recently what we have seen is we are achieving more and more clients, smaller clients that probably in this moment wouldn't acquire license. That's my feeling. Smaller companies, probably they wouldn't acquire license because they would have relevant disbursement in the beginning. But of course, when we see the pipeline, if you mean cannibalization sales of subscription that if we didn't have the new model would be sold under the traditional licensing model, yes, we have part of it. But more and more we've been able to achieve the kind of a new market, I would say, if comparing to a scenario in which we will have just the license model.

Q - Diego Aragao {BIO 17889908 <GO>}

Okay. Very clear, Maia. Thank you.

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

Welcome.

Operator

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

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

So, I would like to say thank you for everyone that participated in our conference call, and reinforce that we are convinced that this transition is going to be a positive generation in terms of value for the company, for investors and clients. And we will stay focused in this transition and in the cost control channel. So, thanks again and have a good day. Bye.

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.

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