Q2 2014 Earnings Call

Company Participants

- Alexandre Mafra Guimarães, Human Relations and Organizational Infrastructure Vice-President, Executive and Financial Vice-President
- Gilsomar Maia Sebastião, Investor Relations Officer and Corporate Finance Officer

Other Participants

- Sunil Rajgopal, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to TOTVS Second Quarter 2014 Results Conference Call. Today, we have a Mr. Alexandre Mafra, CFO and Vice President of Human Relations and Organizational Infrastructure; Mr. Gilsomar Maia, IRO and Corporate Financial Officer.

We'd like to inform you that all participants will be in a listen-only mode during the company's presentation. After TOTVS remarks, there'll be a question-and-answer session for investors and analysts when further instructions will be given. Today's live webcast may be accessed through TOTVS website at ir.totvs.com. To view the company's results presentation in its original format on the webcast platform, click on plus zoom at the right bottom corner of the presentation.

Before proceeding, we would like to mention that during this conference call, forward-looking statements may be made relating to TOTVS business prospects, operational and financial estimates, and goals, based on the beliefs and assumptions of TOTVS management and on information currently available. Forward-looking statements do not guarantee performance. They involve risk, uncertainties, and assumptions because they relate to future events and therefore depend on circumstance that may or may not occur. Investors should understand that general economic conditions, industry condition and other operational factors could also affect TOTVS future results, and could make these results differ materially from those expressed in such forward-looking statements.

Now, I'll turn the conference over to Mr. Alexandre Mafra, who will begin the presentation. Mr. Mafra, you may begin the conference.

Alexandre Mafra Guimarães

Good morning, everyone. Thank you for participating in TOTVS' second quarter results conference call.

I would like to start from slide two by commenting on the main events that occurred since the first quarter results conference call. First, the acquisition of Virtual Age in May which was another step in the execution of our industry specialization (02:20) strategy. It's specifically in the textile and apparel chain. With Virtual Age, we increased our presence in this sector with cloud solutions serving more than 500 clients, among them, some of the largest Brazilian manufacturers, wholesalers and retailers of shirts, trousers, suits, and jeans.

Besides this acquisition, we have two events related to shareholders remuneration, which were approved at the Board of Directors Meeting held on July 28. The first event is the announcement of interest on equity of R$0.13 per share and a total of R$21.8 million should be paid on August 20. As in the last year, this is an intermediate interest on equity. That means calculated based on the result of the first half of the year and the interest on equity regarding the second half will be analyzed at the end of the year.

The second event is the new share buyback program that allows us to purchase up to 1.4 million shares during our one year period, which is equivalent to 1% of the current free-float. This program aims to maximize the value (03:53) generation for shareholders and the purchased shares may be used to fulfill the stock options exercise related to the company's share-based incentive plan, and may also be held in treasury, canceled and/or subsequently sold.

Now, I turn the call to Maia, who will proceed with the comments of the quarter's operating and financial results starting from slide three.

Gilsomar Maia Sebastião

Thank you, Mafra, and good morning, everyone. First, I would like to remind you that the financial information regarding this quarter already includes two months' results of Virtual Age, important acquisition that Mafra just mentioned.

Having said that, in this quarter, the net revenue grew 11% year-on-year. This growth was driven mainly by the maintenance revenue that grew 16.5%. The license and services revenue grew 4.7% and 7.3%, respectively in this quarter. In the last 12 months, the total net revenue surpassed R$1.7 billion and grew approximately 50%, again above the CAGR of the last five years.

In slide four, we have the recurring revenue that grew 16% on Q2 2014, amounting to R$976 million in the last 12 months, a CAGR of 12%, being the main driver of total revenue growth. Increasing the relevance of the recurring revenue in our revenue breakdown, both organically and inorganically is part of our growth strategy. In this quarter, the recurring revenues represented 59% of the total revenue. Recurring revenues other than those included in the maintenance line already surpassed 19% of the total revenues. These are the revenues are mainly connected to software rentals and cloud solution subscriptions.

Now, please move to slide five. On the left side of the slide, we demonstrate impact of the Brazilian World Cup which reduced the number of working days by 12% in the Q2 2014 when compared to Q2 2013. These lower number of working days negatively affected license and services, given the shorter time available to prospect and close sales as well as to render services of implementation and consultancy from the quarter. Nonetheless, we grew our non-recurring revenues by 4.4% year-on-year.

In the second graph, we notice that the average non-recurring revenues per working day into Q2 2014 increased 19% when compared to Q2 2013. This growth reflects the higher efficiency achieved mainly by the sales teams who had to consider the impact of the match days and their allocation planning process.

On the right side of the slide, we see that the average license revenue per working day also increased 19% year-on-year, mainly due to the 39% (07:22) growth in the average to get to new clients in the quarter. Despite the fact that this revenue line is the one most affected by the number of working days, the average services revenue per working day grew 22% in the same period. The effort of the sales teams to execute the project is clear here, especially, when we consider the additional complexity in matching their agendas with our clients and the shorter time available to render the services.

Now I invite everyone to move to slide six to discuss the cost and expense as a percentage of net revenue. Before we enter into the cost and expense, I would like to remind you that on July 3, the Labor Court mandated a collective labor agreement for the participants based in São Paulo, setting our wage adjustment of 7.5% as of January 1 of this year.

As we had already provisioned our 7% adjustment in Q1, 2014 we complemented the provision with an additional 0.5 percentage point adjustment. The impact of these additional provision in Q2, 2014 related to salaries and location (08:44) provisions from Q1 amounted to approximately R$400,000.

Now, starting the cost and expenses analysis, we have in the first line of the graph the cost of developing and delivering our solutions, which decreased 0.3 percentage points year-on-year, being above the 45.5% of Q1 2014. In the last 12 months, this group gained 0.6 percentage point participation over the net revenue, reflecting investments in the industry specialization and technology platform innovation.

The cost of services represented more than 6% of this group. And in this quarter, the sales teams were able to grow (09:31) revenue when enhance the gross margins, both year-on-year and quarter-on-quarter. Once again, this efficient gain is even more relevant when we take into account the fewer working days which affect the services (09:45) revenue more directly than its related costs.

R&D is the second biggest cost in this group. Its growth is mainly due to diversification (09:56) the industry specialization of our solutions as well as the consolidation of the R&D functions from the companies acquired in the last 12 months. When compared with Q1 2014, R&D grew less than the total revenue, showing the higher number of professionals on holiday during the World Cup. We reiterate our commitment to cost discipline in order to dilute costs in the medium-term and long-term without compromising investment necessary to execute the solution development roadmap.

We now move to the cost of license fee, which is the last representative line of this group. The higher relevance of this line compared to 2013 reflects the expansion of solution partners which combined with investments in research and development are part of TOTVS strategy of industry specialization. The lower relevance of this line in the Q1 2014 when compared to Q2 2014 is mainly due to the dilution caused by incremental license revenue from the corporate model in Q1.

And now going to the next group, the cost group linked to sales was a statement (11:13) of percentage of net revenues year-on-year, both as a group and individually. The seasonality of the advertising expense affected the comparison with the previous quarter as TOTVS advertising campaign traditionally begins in the second quarter. In the same period, there was also a reduction of approximately 12% in the levels before (11:35) come which does not reduce our focus and seeking out sustainable reduction of these items.

We complete the analysis with the group linked to administrative expense. The variation of the provisions for variable remuneration and consolidation of acquired companies were the main elements for the increase of 0.3 percentage points of this group, year-on-year, as a percentage of net revenue.

Now I turn the presentation back to Mafra, who will continue from slide seven.

Alexandre Mafra Guimarães

Thanks, Maia. In nominal terms, EBITDA increased 12% and reached R$111 million, reflecting the company's search for efficiency gains, through cost control and planning for the World Cup period. We made great efforts to produce more with less time in order to minimize the impact of fewer working days in the EBITDA margin of this quarter, which ended in 25.3%, representing an increase of 30 basis points over Q2 2013.

The margin gain of this quarter plus the gain from the previous quarters resulted in the expansion of EBITDA margin by 30 basis points in the first half of 2014 versus the same period in 2013. Moreover, a 25.8% margin recorded in this semester is 70 basis points higher than the margin from the last 12 months.

Turning now to slide eight, we have the evolution of net income, which grew by R$10 million or 18.5% year-on-year, mainly driven by EBITDA growth and the financial result in the period.

Thus net income totaled R$64 million and net margin 14.6%, up 90 basis points year-on-year. Therefore, net margin of the quarter surpassed the average margin of both the semester and the last 12 months.

On slide nine, we can see that TOTVS ended Q2 2014 with a cash position of R$401 million and a net debt of R$35.7 million compared to a net cash of R$90.6 million in Q1 2014. This reduction of the net cash position is mainly due to the payment of R$50.1 million related to the Virtual Age acquisition and the payment of R$116.5 million in dividends related to the fiscal year of 2013.

I reiterate that we continue to improve financial capability to maintain the execution of our plan for organic and inorganic investments aiming primarily to strengthen our operations in the most prominent industry sectors in terms of growth, our technology platform, and our Latin America presence.

Now, I invite everyone to move to slide 10. I would like to finish the presentation highlighting that even with the complexity of the second quarter of 2014, we were able to grow the net revenue by 11%, grow our recurring revenue by 16%, grow the non-recurring revenue per working day by 19%, grow the EBITDA by 12%, expanding the EBITDA margin by 30 basis points, and grow net income by 18.5% and the net margin by 90 basis points.

The investments in specialization (15:57) by industry and the commitment of the TOTVS team allowed us to achieve these results and provide confidence to keep pursuing the goals set for the year of 2014. Therefore, we will pay attention to the macroeconomic scenarios and sectorial dynamics of the markets where we operate and maintain our cost discipline without putting the future of the company at risk, and without losing sight of the creation of the new sustainable growth cycles, making TOTVS simple, more agile, more connected, more cloud, and more essential.

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

Q&A

Operator

Thank you. The floor is now open for questions from investors and analysts. Excuse me, our first question comes from Sunil Rajgopal with HSBC.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Hi, good morning, everyone. This is Sunil here calling from HSBC. I just had one very quick question on the margins. I wanted to know what's the company expecting in terms of future margin trends? Should we expect the margins to improve from here? Because we saw about 30 basis points improvement in margins during this quarter, and then the last quarter too, we saw some improvements year-on-year. So should we expect a small improvements going forward in the margins, because I suppose in this quarter the – there was some bit of pressure due to the lower working days. So should we see this pressure easing off going forward and see there should be a margin uplift?

A - Gilsomar Maia Sebastião

Hi, Sunil, this is Maia speaking. Thank you for the question. Actually, based on this first half of the year, as you mentioned, we already knew previously that it would be a very complex period to – to extend the margin. And especially for the seasonality, the negative seasonality of the first quarter and also for the World Cup period in the second quarter. For the second half, we have a very relevant working – number of working days. And we count on that, of course, to leverage our operational structure here and our operational margin. And as Mafra just mentioned in the end of his speech, we was to pursue our target of margin expansion for the year. Yes, we are. Of course, we have to be very careful about the scenarios we have in our different sectors, market sectors. But that's the direction we are going on.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Sure. Thank you very much. And very quickly, if I can, just one more question. I mean we have seen some kind of pressure because of the various industry exposure, because the primary industries in Brazil still continue to lag behind, and due to the economic conditions right now in Brazil. So, I mean, how are these industries performing and what is the kind of new uptick that you're seeing from this primary industries? Is there a rise in the order backlog or something of a – key trends that you're seeing?

A - Gilsomar Maia Sebastião

Actually, comparing to the end of 2013, relatively, we don't have so many significant change in terms of sectors – dynamic of those sectors. Of course, we have some sectors that publicly everyone knows that is facing some extra difficult. But in general, I would assume that most of the sectors connected to services are warmer – there are many more than the rest of these sectors.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Sure. Sure. Thank you very much. Very helpful.

A - Gilsomar Maia Sebastião

Thank you, Sunil.

Operator

That does conclude today's question-and-answer session. I'd like to invite Mr. Alexandre Mafra to proceed with his closing statements. Please go ahead, sir.

A - Alexandre Mafra Guimarães

Thanks, everyone, for participating. We will keep working to always be innovative making our customers more competitive in their business. We know that our success is completely linked to the success of our clients, and we can – linking together, we can do better. See you in October in the Q3 conference call. Thank you.

Operator

The second quarter results conference call is over. Have a nice day.