Q4 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
- Laércio José de Lucena Cosentino, Chief Executive Officer

Other Participants

- Andrés Coello, Analyst
- Michel Morin, Analyst
- Sunil Rajgopal, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to TOTVS Fourth Quarter 2014 and 2014 Results Conference Call. Today, we have Mr. Laércio Cosentino, CEO and Board Member; Mr. Alexandre Mafra, CFO; and Mr. Gilsomar Maia, IRO and Corporate Finance Officer.

We would like to inform you that all participants will be in a listen-only mode during the company's presentation. After TOTVS remarks, there will be a question-and-answer session for investors and analysts, where further instructions will be given. Today's live webcast may be accessed through TOTVS website, at ir.totvs.com.

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 risks, uncertainties and assumptions because they relate 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 also affect TOTVS future results and could make these results differ materially from those expressed in such forward-looking statements.

Now, I will turn the conference over to Mr. Laércio Cosentino, who will begin the presentation. Mr. Cosentino, you may begin the conference.

Laércio José de Lucena Cosentino

Good morning, everyone. Thank you for participating in this conference call and for giving us the opportunity to discuss TOTVS fourth quarter and 2014 results.

In 2014, TOTVS was able to combine growth and revenue, net profit, and the cash generation once again, despite specially a challenging environment created by the deceleration in the activity and the productivity of the Brazilian economy, which was also enhanced mainly to the World Cup and the Presidential Election.

In parallel to the deceleration, cost inflation remained above the inflation adjustments on the recurring revenues during the year, requiring a higher discipline in cost and expense management. While the last 12 months the IGP-M index ended through the year in 3.67%, the IPCA index reached 6.41% in the same period.

The IGP-M is the index used to readjust the majority of TOTVS' recurring revenue contract. The IGP-M showed more volatility in the short-term than IPCA, but both indicators tend to converge in the medium-term. Although we haven't reached our internal goals of revenue growth and EBITDA margin for the year and the quarter, we believe that the results were significant, considering the Brazilian GDP growth close to zero. We are not happy with the results. We are taking action to strengthen TOTVS as a company, but we offer adjustments that are necessary for Brazil to grow again.

Now, I invite Maia to comment on the quarter and on our results, start on the slide two.

Gilsomar Maia Sebastião

Thanks, Laércio, and good morning, everyone. I would like to start by commenting on the recent events of the period. The first one is the payment of interest on equity related to the second semester on January 14, 2015 the amount of R$19.5 million corresponding to approximately R$0.12 per share. All the shareholders at the end of the trading session of December 22, 2014 were entitled to this interest on equity.

The second event regards the second release of the BNDES financing line contracted in 2013 in the amount of R$227.6 million on November 2014. With this inflow, the BNDES has already released 72% of the total amount approved in 2013. I remind you that the amortization period of this financing line is 72 months, including a 24-month grace period counted from the hiring date.

Starting the comments on the quarter and the year-end results, I ask you to move to slide three. The net revenue grew 10% in 2014 and 5.6% in the quarter year-on-year, both below the last five-year CAGR. The services revenue was the most affected line by the reduction in the number of working days in 2014. Nonetheless, it grew 9.1%. When analyzed per working day, the average services revenue grew 11.9% in 2014.

On slide four, we can have a better understanding of the revenue growth in the most representative market industry sectors. The charts on the left show the representativeness of each industry sector in the total net revenue. The charts on the right show the year-on-year growth of each of these industries.

Retail grew 22.2% and increased its representativeness from 7.4% in 2013 to 8.2% in 2014. The differential of TOTVS' offerings to this market industry comes from the integration of TOTVS' back office solution with point of sales, credit analysis, queue management and inventories solutions, integrating the retailers with the other members of their value chain.

Financial services grew above the average in 2014 increasing its share to 8.5% of net revenue. This industry is a traditional information technology investor with relevant contribution to the recurring revenue and to the integration of other market industries.

On the other hand, manufacturing grew less than the average once again. Thus, it's participation in the net revenue which was 35% in 2011 and 32% in 2013, reached 30% in 2014. This is a very important industry sector too, since it also contributes relevantly to the recurring revenues and plays important role in the value integration approach. Among the other industry sectors that in aggregate grew faster than the total net revenue, the highlight was the healthcare sector which grew almost 40% year-on-year.

On slide five which shows dynamics of license revenue in 2014, we can realize that starting from the graph in the top left side, we see that the growth of 3.7% of license revenues resulted from the growth of 6.5% in subscription and 3.1% in traditional license sales. On the right, we see that the growth in revenues from subscription was driven by sales to new clients which grew 147% in the year. It's important to highlight that these sales represent only the first monthly subscription since the second one becomes part of the recurring revenue of existing clients, though the subscription revenue from existing customers which grew 5.8% takes approximately 12 months to fully capture the growth of each new client added.

The lower left corner, we can see that the growth of the traditional license revenue was concentrated in sales to new clients which grew 10.9%. These sales were most impacted by larger projects, which is evident in the 30% increase in the average ticket per transaction and the 20.6% decrease of the number of clients added, shown in the chart on the right.

Also in the same chart on the right, we can note that the subscription model added 849 new clients, 89.5% more than in 2013 with emphasis on the 4Q 2014 when 295 clients were added, accounting for a growth of 156% over Q4 2013. It's part of our commercial strategy to improve the subscription sales and consequently the recurring revenues.

Now, let's move to slide six to talk about the recurring revenues. In 2014, the total recurring revenues exceeded R$1 billion and reached 58.9% of the total revenue. Between 2013 and 2014, the recurring revenues grew 14.4%, while maintenance grew 13.3%. Excluding the non-recurring effects of approximately R$11.7 million booked in maintenance revenue in Q4 2013 and R$33.2 million of revenues of acquired companies not fully consolidated in 2013, the growth in maintenance revenue was 10.7% in 2014.

The company's recurring contracts are adjusted every 12 months in the anniversary of their signing dates, mostly by the IGP-M index of the last 12 months. Thus, the recurring revenue captures the inflation of the current year and the immediately preceding year.

On slide seven, there's a chart with the history of the IGP-M. If we assume a linear distribution of anniversaries throughout the year, the recurring revenue would have captured 5.8% of adjustment in 2014. This percentage represents the midpoint between 6.2% and 5.4% which are the 12-month IGP-Ms of 2013 and 2014, respectively.

Thus, the 10.7% of maintenance growth in 2014, as mentioned before, accounted for almost five percentage points of growth above the average of IGP-M for the period. Still in the charts, we have the IPCA history which is the index used by the Brazilian government to measure country's inflation. Note that the average 12-month IPCA of 2013 was 6.2%, the same as the IGP-M level that year. However, the average 12-months' IPCA of 2014 was 6.3%, 0.9 percentage point higher than the IGP-M. Thus, it's clear that there was a mismatch between the revenue inflation and the cost inflation in 2014.

Now, I turn this presentation back to Mafra, so he can comment on the cost and expense on slide eight.

Alexandre Mafra Guimarães

The operating costs and expenses grew 10.4% in the year and the direct personnel costs and expenses accounted for 49.3% of the total operating costs and expenses. The collective bargaining agreements of 2014 resulted in a weighted average salary readjustment of 7.2%.

In São Paulo, this process didn't allow personnel layoffs for 10 months. Personnel layoffs historically occur naturally along the year in order to adjust the costs and the salary structure. This process caused a higher number of layoff in the Q4 2014, resulting in an additional cost of approximately R$5.8 million. This layoff, sums with the salary readjustment from the collective bargaining agreement, closed at between September and November, resulted in approximately 3.4% of growth in payroll between the third and the fourth quarter.

The cost group related to license fees, cost of service and R&D expenses presented in the first line on the top of the chart, concentrates the major part of the personnel expenses, and consequently, was the most affected in the Q4. Beside this impact, the growth in this cost group as a percentage of the net revenue was mainly due to the head count growth mostly related to technical support and the consulting division, the maintenance of investments in the industry sector specialization, and the innovation in technological platform in 2013 and 2014.

The decrease in the marketing and selling expenses looks relevant. As a percentage of net revenues, it's chiefly related to the communication strategy that was more concentrated in the pre-World Cup period.

Now, going to the group of administrative expenditure. The growth in these expenses is mainly due to the integration of the administrative teams from the companies acquired between 2013 and 2014. This group's reduction in the Q4 is basically due to the reduction in the G&A expenses that were affected in the Q3 by additional M&A expenses of approximately R$2.7 million. Here, it is worth mentioning that we will maintain our effort to enhance the administrative efficiency in both, the daily basis activities and in the integration of acquired company.

Going to the consolidated EBITDA on slide nine, the EBITDA margin ended the year in 24.6%, 30 basis points below 2013. This reduction was mainly caused by the mismatching in the inflation indexes mentioned before by Maia. Despite the inflation indexes mismatching, the fourth quarter margin was also affected by non-recurring expenses from the payroll adjustments and by the impairment provision of R$1.6 million related to the Umove.me intangible assets valuation booked in the other expenses line. When the non-cash impact of this impairment is adjusted, the Q4 EBITDA margin reached 23.7%, a growth of 30 basis points over Q4 2013.

Now, let's move to slide 10 to discuss the net profit. The net profit totaled R$69 million in the quarter, 13.7% higher than the same period of the last year with net margin of 15.2% or 110 basis points higher than 2013.

In 2014, net profit grew 17.8%, 9.1 percentage points above the EBITDA growth with a margin of 14.8%, 100 basis points over 2013. 2014 net margin is the highest margin ever achieved by the company in a fiscal year since its IPO in 2006. This net profit growth above the EBITDA growth is chiefly due to a better financial result in 2014, a low effective tax rate, and a lower depreciation and amortization growth. The positive financial results was affected by the combination of financial revenue growth due to higher financial and investment position during 2014 and the reduction in the mark-to-market expenses from the convertible debentures.

The lower effective tax rate was mainly due to higher fiscal benefits from Lei do Bem due to the higher relevance of R&D expenses over the net revenue and the EBIT, and due to the non-deductible debenture mark-to-market financial expenses commented before.

Now talking about dividends on slide 11. On January 26, 2015, the board of directors approved the proposal for distribution of dividends to be submitted for deliberation at the General Shareholders Meeting. The proposal provided the distribution of R$124.4 million in dividends for 2014, resulting in R$0.77 dividend per share. Assuming the total dividend proposal, sum of interest on equity and dividend, the company will pay R$1.02 per share representing a payout of 63% and then increase of 6.9% on the remuneration per share over 2013.

On slide 12, we have evolution of the cash position during 2014. We started the year with nearly R$87.5 million in net cash and R$533 million of gross cash. The main reasons that caused this variation in cash position were, the operating cash generation of R$332 million corresponding to 76.1% of 2014's EBITDA, investments in the intangible asset of R$102 million related to the acquisition of Ciashop, the payment of PC Sistemas´ earn out in Q1 2014, and the acquisition of Virtual Age in Q2 2014. The payment of R$158 million of dividends and interest on equity related to the first nine months of the year and the second release of the BNDES financial line contracted in 2013, net of further amortization in the amount of R$174 million.

TOTVS ended 2014 with a net cash position of R$68 million and a gross cash of R$698 million, which shows our potential for cash generation and our financial capacity to implement the organic and inorganic investment plan.

Now, I invite you to move to slide 14 for the final remarks of Laércio.

Laércio José de Lucena Cosentino

Overall, even considering the context explained during this conference, the company ended 2014 showing 14.4% of recurring revenue growth, 19% of growth in client added under the subscription model, 10% of net revenue growth, 17.8% of net profit growth, and 17.7% of growth in net operating cash generation.

We continue to believe in the potential of the Brazil and its entrepreneurs, even with the potential short-term negative effects that the recent measures taken by government's new economic team may cause these adjustments in the policy should be very important for the country to regain the market confidence, the confidence of entrepreneurs and to establish the days for a new cycle of grow and invest.

We will maintain our investment innovation, specialization by industry sector and the quality, having the client as our main focus, without losing sign of cost discipline. Technological innovation is a key tool for increasing the productivity and the competitiveness in the company, especially medium and small ones.

In this sense, we have decided to expand our sales effort in software subscription models during 2015. We will continue to work hard to make TOTVS even simpler in its process and strategies, more agile and using the development and implementation cycle, more connect to our clients, more cloud promoting integrated platform and management solutions in the cloud, more essential to the core business of our clients.

From now own, we are available for Q&A.

Q&A

Operator

Thank you. The floor is now open for question from investors and analysts. Our first question comes from Michel Morin, Morgan Stanley.

Q - Michel Morin {BIO 1873971 <GO>}

Yes. Good morning. Two questions if I may. Laércio, I was wondering – 2014 was a more difficult year clearly. Do you feel confident that there has been no change in your competitive position in the marketplace? In other words, are you maintaining your market share or do you even think that perhaps you've even gained market share in a difficult market environment?

And then the second question would be around pricing. You mentioned the impact of the inflation adjustments, the fact they're being lower in this particular quarter. But more broadly, do you have the ability to raise prices irrespectively of that inflation adjustment? Can you go above and beyond that? What flexibility would you have to do that at some point? Thank you.

A - Laércio José de Lucena Cosentino

Hi, Michel. Laércio. (22:27) don't change the core business of TOTVS in fourth quarter. I think if you analyze the bigger markets and the growth, of course, 10%, I think the Brazilian market in technology information maybe increasing less than this. Okay? (22:47).

A - Gilsomar Maia Sebastião

And the second question, Michel – this is Maia speaking – regarding inflation. We basically know historicals. We understand that we have completely good capacity to pass through the inflation impact, especially in times like this in which we see inflation spread out for over all the factors in the economy. We see a similarity in terms of condition of our customers, also affecting through their inflation to their customers. And in this way, we understand that we have this ability to pass through the inflation.

Q - Michel Morin {BIO 1873971 <GO>}

Great. Thank you very much.

A - Gilsomar Maia Sebastião

You're welcome.

Operator

Our next question comes from Ivan Hernandez, Scotiabank.

Q - Andrés Coello

Yes. Hello. This is actually Andrés Coello. Just a question. Obviously, the growth under the subscription model was very strong, 156%. I think that's very, very strong. And my question is whether those new clients are also buying a maintenance licenses, and if those clients are also paying for installation fee. In other words, whether the acceleration of new clients under the subscription model should also impact maintenance and service because obviously maintenance and service were slower on a quarterly basis -- actually, maintenance fell 0.4% on a quarterly basis which doesn't seem to be matching the fact that you're accelerating sales to new clients under the subscription model. So I was just wondering if you are expecting that the subscription model should also help you accelerate not only license fees revenues in the future, but also maintenance and service.

A - Gilsomar Maia Sebastião

Hi Sunil (sic) [Andrés] (24:51). This is Maia speaking. So in this quarter, we brought the breakdown of our license revenues, separating what is the portion related to – possibly to that traditional license sales model and the subscription sales model. The subscription regarding the license, they do not affect the maintenance specifically. And getting back to your question, we considered that part of our traditional licenses growth then should be captured by the subscription models. Yes, you are right. It can affect not only the license revenue growth, but also the maintenance because the license [ph] tweaks (25:49) the maintenance growth in the moment, just after the license sales, you're right.

But we understand that in the case of subscription, we have recurring model similarly to maintenance. That's the reason why we separated the figures. So actually when you see in our earnings release that line describing the subscription model revenues from existing customers, that exactly is recurring revenues, because that comprised the second subscription on. So only the first one is reflected in the new client sales, and from the second one on, we consider as sales to existing customers. I don't know if it's clear to you or not.

Q - Andrés Coello

Yeah, it is clear that after the first month the revenues go to recurring inside license, right. But I was wondering if normally what you are – if what you're seeing in the market is that new client under subscription is also paying for installation and is also paying for maintenance in addition to his license.

A - Gilsomar Maia Sebastião

Our subscription comprised already maintenance there. The installation, you are right, it separates in the services revenue line. But if you would take into consideration that most of those customers under subscription think should be smaller customers, the volume of the implementations therefore that those projects generate proportionately is much lower than sales of traditional license model at that point.

In our understanding in the beginning of this process of adoption for subscription, we understand that more – you probably see smaller companies adopting firstly the subscription model. And consequently, it can produce less impact in terms of services growth. The big customers normally supported our private decisions and under traditional license models they demand more for services proportion and much more than the smaller companies than the subscription.

Q - Andrés Coello

Okay. Thank you.

A - Gilsomar Maia Sebastião

You're welcome.

Operator

Our next question comes from Sunil Rajgopal, HSBC.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Sorry. I just wanted to check. The company had stopped giving guidance for the future, and particularly, with considering the weak macro backdrop in Brazil and then there is a shift in the strategy in the business model as such. So I wanted to check, what are your expectations for this year in terms of revenue growth and EBITDA margins? Is the Q4 levels the new levels, or should we think that there could be an improvement in the overall environment for this year?

A - Gilsomar Maia Sebastião

Hi, Sunil. This is Maia speaking. So actually, one of the motivations for the transition to subscription was the different scenario in terms of macro economy comparing to our projections in the past. So when we projected our targets, our goals of margin, we took into consideration a certain level of revenues, obviously, to scale up all operation and provoking some margin gain. As we saw the economy much lower level of activity, it compromised our sales and revenues, and consequently the scale was lower than were imagined that time.

Frankly, for this year, we have the economy as an external factor that affects not only top, but all companies in the market. We understand that our model is a resilient one not just because we have a relevant portion of our revenues as recurring revenues, but also because we have low concentration of customers. We have a very spread-out presence all over the country in segments in different – in companies in different size. And in our view, we understand that subscription should keeping that performance growing. It's hard to precise now because we are just in the early stage of that subscription process.

And being clear, we do not expect license to bring annually any – very relevant growth. Of course, it will depend on the demand of the market for license. We believe that medium to large enterprises will keep their demand for license. And in that (31:42), historically, what we see is sales to new clients on the traditional license model being more affected by macro scenario than sales to existing.

Actually, we do not understand that we can have a big change in our top-line dynamics, especially if you consider that we are running our maintenance with a low level IGP-M. If any of the measures taken by government increase IGP-M in the near future, it can have futurely have response in the maintenance line and the other recurring revenues that's relevant for our revenues and can probably at least partially compensate any negative side of the macro scenario economy.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Right. And do you have any update with regards to the EBITDA margin progress, or should we expect that this year to be – I mean, in comparison to 2014, do you think it will be more of a level of Q4, or do you think there is a scope for accelerating the margins? Because I understand there's substantial pressure on the personnel costs which are going up higher than what the inflationary cost could be passed on to the consumers.

A - Gilsomar Maia Sebastião

Look, in terms of cost pressures we have two big moments in the year. One is the Q4, as you could see in this quarter. So when we have almost 6% of our payroll being adjusted and the other 50% is adjusted in the first quarter. So these two moments of the year are the most pressured moments in terms of cost. And we have the rest of the year quote-unquote to capture inflation over our revenues.

In terms of margins, EBITDA margin that was your question...

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Correct.

A - Gilsomar Maia Sebastião

...probably we tend to have a little bit more pressured margin in the beginning of this year because the other half of our payroll will be adjusted. And if you take a look in our historical figures, you're going to see that the first quarter we have one event called incremental licensing from the corporate models that historically represents about 20% to 30% of our license revenues in first Q, so we depend on the performance of that corporate model in the first quarter.

In the rest of the year I believe that the dynamic of our revenues probably can recoup part of the effects of this pressure from the beginning of the year. It's hard to establish here if it's going to be completely stable or a little bit higher because it will depend on the dynamic of traditional license sales and also the adherence or the adoption of subscription from the market.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Sure. Thank you very much.

A - Gilsomar Maia Sebastião

You're welcome.

Operator

I'll turn the conference over to Mr. Laércio Cosentino.

A - Laércio José de Lucena Cosentino

I want to thank you all for participating in this conference call. And I want to say that we will continue developing (35:53).

Operator

Thank you. TOTVS fourth quarter results conference call is over. Have a nice day.