Q3 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

- Andre Baggio, Analyst
- Andrew T. Campbell, Analyst
- Andrés Coello, Analyst
- Michel Morin, Analyst
- Sunil Rajgopal, Analyst
- Valder Nogueira, Analyst
- Vera R. Rossi, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to TOTVS Third Quarter 2014 Results Conference Call. Today, we have Mr. Alexandre Mafra, CFO and Vice President of Human Relations and Organizational Infrastructure, and Mr. Gilsomar Maia, IRO and Corporate Finance 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 will 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.

Before proceeding, we'd 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 circumstance that may or may not occur.

Investors should understand that general economic conditions, industry conditions and other operating 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 on our third quarter results conference call. I would like to start from slide two by briefly reviewing the main events that occurred since the second quarter results conference call.

Firstly, I would like to highlight that the extraordinary shareholders meeting held on October 22 elected two new Board members, Rodrigo Kede and Romero Rodrigues. Rodrigo Kede is the CEO of IBM Brasil. And Romero is the Founder of Buscapé, a price comparison website, and the Global CEO Price-Comparison Platform of Naspers.

With these two additional members, the Board has reached its maximum composition of nine members as per its bylaws, of which four have extensive experience in the field of information technology and eight are independent.

The second event is the launching of the Version 12 of TOTVS' Management System by the end of September. This new version incorporates the three technological concepts that are part of TOTVS' future vision; fluid technology, essentiality and agile ERP.

The application of these three concepts resulted in an easier-to-use version with an intuitive interface that features processes and indicators from several sources on a single screen, on a services-oriented software architecture that simplifies the solutions deployment and the adoption of mobile and cloud in computing technology.

From Version 12 on, all the company's management software will receive software upgrades with the continuous launching of new features for TOTVS products, without the need to migrate to a new version. Clients can activate new features when they are ready to use them. Since the systems are permanently updated naturally following the innovations in our SaaS concept, TOTVS can maintain its recognized characteristic of avoiding disruption to its clients.

Now, I invite Maia to start the comments on the quarter results, starting from slide three.

Gilsomar Maia Sebastião

Thanks, Mafra, and good morning everyone. In this quarter, the total net revenue grew 8.6% year-on-year. Once again, the maintenance fees were the main growth catalyst growing 16.3% in this period.

The services revenues grew 8.8% despite the final phase of the Soccer World Cup, which was concentrated in the regions where TOTVS has its own branch that reduced by 4.7% the number of working days year-on-year. Considering the average revenue by working days, the services revenue grew 14%.

The license fees decreased 9% year on year, mainly due to the reduction of sales to large enterprise differently from what we had in the first semester of this year. This quarter, the new clients addition rose from 774 clients to 900 clients, a growth of 16% quarter-on-quarter. Approximately 27% of these new sales were closed in a license rental or subscription of Software-as-a-Service model based on recurring monthly payments.

In sales to existing clients, the 37% growth in the number of sales was more than offset by the 36% decrease in the average ticket, resulting in a decrease of 11.8% year-on-year. Approximately 24% of the total revenue from these clients are already connected to commercial models (6:06) based on recurring monthly payments.

Similarly to the quarterly analysis, the last 12 months net revenue growth of 13.4% was driven by maintenance and services revenues. This behavior is also noted in the last five-years period shown on the last side.

Moving to the slide four, in the chart on the left side, we see services and maintenance grow higher than the license fee growth in the last five years, which highlights our commercial strategy of prioritizing the recurring revenues and broaden the offerings based on monthly payments, organically, or by the acquisition of companies with high recurring commercial models.

In the chart on the right, the priority given to recurring revenues is shown by the increasingly relevance of maintenance revenues in contrast to the reduction of license fees. It's also worth mentioning in this same chart the stability in the relevance of services revenues, which shows associated trajectories on the license fees, reiterating the importance of software implementation services even when there is no license sales, as well as the growth of recurring services related to the cloud computing solution.

This transition from license sales to subscription reduces the growth rate of total revenues in the short term since recurring revenues are recognized on a monthly basis. On the other hand, the higher volume of recurring revenue tends to raise the total revenue in the medium to long term given TOTVS' historical high client retention rates.

On slide five, we see that the recurring revenues surpassed R$1 billion in the last 12 months, representing 58% of total revenue, from which 8% are related to recurring revenues despite maintenance. In the quarter, the recurring revenues grew 16.4% year-on-year, representing 60% of net revenue. We believe that the company's strategy, combined with the demand for models (8:29), based on monthly payments, tend to broaden the relevance of recurring revenues in the total revenue.

Now, I ask everyone to move to slide six to discuss cost and expenses as a percentage of net revenue. The growth of cost and expenses in the quarter was 3.4 percentage points lower than the last 12 months' growth. In the same comparison, the revenue growth was 4.8 percentage points below the last 12 months' growth. This higher deceleration in revenue growth increased relevance of cost and expense, especially those not directly related to the quarter's sales. An example of that is the first line in the chart that comprise the cost related to development and delivery of our solutions, which rose 1.9 percentage points when compared to the second quarter.

This growth was chiefly influenced by the research and development line and is related to the consolidation of a full quarter results of Virtual Age against two months' consolidation in previous quarter; the collective bargain agreements in Belo Horizonte, Salvador and Rio de Janeiro; additional efforts to launch the Version 12 of TOTVS' solution; and implementation of new tools to manage the R&D projects. It's also worth mentioning that in the same period, the cost of services line, which represented 61% of this block, maintained its trajectory of a gradual gross margin expansion coming from 3% in the second quarter to 4.5% in the third quarter.

The cost of license fees remained stable in absolute figures, showing that despite of its denomination that associates with the license fees revenue, this line is also affected by the maintenance revenue due to the commercial models (10:36) based on recurring monthly payment. This group of cost and expense rose its relevance by 0.5 percentage points in the last 12 months, reflecting the investments in the industry specialization and the innovation in technological platforms, and in a lower proportion to the expansion of the ecosystem of solutions partners that together with the R&D investments are part of the industry specialization strategy.

Moving to the second group related to sales, the reduction of 0.5 percentage points over second quarter is mainly related to events in advertising anticipated to a period before the beginning of the Soccer World Cup held on the second quarter. Another point that contributed to the lower relevance of this group was the lower level of provision for doubtful accounts, reflecting the lower delinquency in the quarter.

In the last line of the chart, we have the group related to the administrative structure, which rose 0.3 percentage points its participation over second quarter, mainly due to expenses related to M&A projects which amounted approximately R$2.7 million in the quarter.

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

Alexandre Mafra Guimarães

Thanks, Maia. The third quarter's EBITDA amounted R$105 million with 23.6 percentage margin. That said, the third quarter margin presented a 190 basis point contraction year-on-year given the lower deceleration of costs and expenses versus the net revenue deceleration in the period.

As Maia commented before, this deceleration in revenue is a result of the postponing of investments by large enterprise and the transition to a software subscription model that we are promoting. This transition to subscription negatively affects revenue growth and, consequently, EBITDA growth in the short term due to deferral in the revenue recognition.

On the other hand, the higher level of recurring revenue that we pursue aims to positively affect revenue and EBITDA growth in the medium and long term, reinforcing TOTVS' sustainable growth, predictability of results and operational leverage. Thus, we released the material facts yesterday, in which we removed our guidance since they were based on assumptions of costs and expenses dilution as a result of revenue growth.

Nonetheless, the removal of this guidance do not exclude the constant search for growth, operation efficiency and EBITDA margin expansion from the company's agenda.

Now, on slide eight, we see the evolution of the net profit, which grew 20.7% year-on-year, totaling R$68 million, mainly driven by better financial results and effective tax rate. Due to that, the net margin hit 15.3%, and as in the second quarter, the net margin of the quarter surpassed the accumulated margin of the year-to-date and from the last 12 months.

On slide nine, we present the evolvement of cash position, which amounted R$417 million at the end of the third quarter, a net cash of R$16 million versus a net debt position of R$36 million in the second quarter. This increase of R$52 million on the net cash position is mainly due to the 40% growth in the operating cash generation, which totaled R$101 million, corresponding to 97% of the quarter's EBITDA.

This high conversion of the EBITDA to operating cash illustrates one of the effects of the higher level of recurring revenues since the license fees are the revenues with longer tenure in accounts receivables. The R$10 million CapEx investments divided in approximately R$4 million invested on servers and computers and approximately R$4 million in the facilities of new headquarters of Rio de Janeiro branch.

The investments, intangible in asset that amounted R$13 million related to variable price of Virtual Age and the new investment in GoodData; the payment of approximately R$22 million of interest on equity related to the first semester of 2014. The net share buyback that totaled R$13.8 million and the amortization of R$26 million of financing lines contracted from BNDES in 2008. This makes clear that TOTVS has financial capacity to invest organically and inorganically, reinforcing our industry-oriented approach and our technological platform without compromising the shareholders' remuneration.

Now, I invite you to view slide 10. Overall, even within this context described, the company ended the third quarter showing 8.7% net revenue growth, 16.4% recurring revenue growth, addition of 900 new clients, 20.7% net profit growth and a 39.7% higher operating cash generation.

I reiterate that we keep in our agenda the constant search for growth, operation efficiency gain and margin expansion. Therefore, we will keep our attention over the macroeconomic scenarios and sectorial dynamics of the markets where we operate, maintaining our cost discipline without putting the future of the company at risk and without losing sight of the creation of 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. Our first question comes from Mr. Andrew Campbell with Credit Suisse.

Q - Andrew T. Campbell {BIO 1762233 <GO>}

Yes. Thank you for taking my questions. I had two questions actually related to the former guidance that you used to provide. And I can understand why perhaps you don't want to provide guidance for this year or for the next several quarters given the transition that the company is in, the macro environment, et cetera. But my question is whether or not, over a long-term basis, if the view that you have on the business and, eventually, where profitably will get, if you were to think, I don't know, three years, five years out, has that really changed? Has there been a structural change over that period? So, that would be my first question.

And then, the second question is on the international operations, where you also removed you guidance. Is that really just because you were removing the other guidance that you removed the international part as well or is there something different that's happening on the international side? Thank you.

A - Gilsomar Maia Sebastião

Good morning, Andrew. This is Maia speaking. Starting from the last question related to international operations, actually we removed those guidance related to international mostly because of the Brazilian operation since one of the reference were the revenues here in Brazil, as you said. So, since we are transitioning the commercial model (19:37) of the company for the years, it can affect (19:41) the base to determine the percentage of the international relevance.

In terms of the other guidance related to the breakeven point of international, it's also somehow related to these deferral effects of the top-line growth from recurring models, but also related to the – some specific contracts (20:05) in specific countries. A clear example is the Argentinean country – the Argentinean market, sorry. And so – but in the aggregate, we see clearly the international market going to the breakeven or close to that. But really considering now the variables surrounding the matrix, it made more difficult to keep those matrix in our guidance.

In terms of the whole guidance and those related to EBITDA margin and in R&D, as a percentage of net revenues, it's really related to this transition to SaaS, because one of the assumptions we had when we established those guidance was the top-line growth, because our concept at the time was, okay, we will achieve more operating leverage through top-line growth. At that time, we also projected a completely different scenario for the Brazilian economy. So, we are supposing going to have a second year in a sequence with a very low GDP growth, and we were not imagining that at that time. And also, this transition to SaaS is not favorable for short term top-line growth.

From a quarterly base, it's not aligned with the principles of our company. As you already know, you follow us since the IPO, we do not mention the company, especially in terms of margin, on a quarterly – just on a quarterly basis, because most of our costs are not completely variable costs in terms of quarterly sales. One clear example is the R&D line. So, if we start to follow too much the quarter in terms of fixed cost, it can drive us to a wrong way. Even not giving you guidance is, in our mind, we do not see a completely – a change in our business model in the short term.

So, we are talking about here a portion of our revenues related to license that are transitioning to subscription in a gradual process, because in our understanding for a length of time – a long length of time, companies will still demand for license and will not lose opportunity. So, companies that still demand for license purchase, we will sell. But of course, on a daily basis, we'll be proactive trying to give preference selling subscription, but we will not – again, we will not say no for any customer. And in our view, that transition tends to be gradual. Of course, it will depend not only from us, but also from a market demand, and that's one of the reason we didn't just replace or substitute our guidance for different matrix.

We need a little bit more flexibility in this way (23:50), especially to realize clearly the pace of this transition and to understand how fast demand can be accelerated or not in terms of subscription. I don't know if I addressed properly your question.

Q - Andrew T. Campbell {BIO 1762233 <GO>}

Yes, I appreciate it. Thanks, Maia.

A - Gilsomar Maia Sebastião

You're welcome.

Operator

Our next question comes from Mr. Valder Nogueira with Santander.

Q - Valder Nogueira {BIO 3490951 <GO>}

Hey, guys. Good afternoon. One question. As you've shown in the press release on the curves of how the different revenue lines have behaved throughout of the time, your license revenue profile has already reflected some of this SaaS (24:41) migration. It was a natural course of the business and also has to do with the mix of the company that you inorganically have added to the portfolio. That is all clear to me. That is – it's also clear on the type of software that you sell and a specific series that you sell. That's very clear to me. So, besides that, what was the main driver for you to decide to speed up that migration? Was it an internal factor or was it an external factor?

A - Alexandre Mafra Guimarães

So, thank you Valder for your questions. Actually, there is a group of things that motivated us to go in that direction. Some of these things I can simplify here. One is, as you probably remember, like some time ago, we launched an offering we called Series 1. It's for microenterprise. It's a pure subscription and cloud offering. We charge about R$99 per month per user. And for this kind of experience, we have got a very good feedback from this microenterprise.

In parallel, throughout the time, and as you could in the course of our revenues, we've been more flexible in terms of commercial negotiations. So, if we have to give discounts, we prefer to give discounts in license than in maintenance, for example, in order to preserve our recurring revenues. And as you mentioned, every company we have acquired recently bring this kind of characteristic, very high recurring model, so contributing much more to maintenance and a few to license. So, mostly those companies, they don't have license, licenses are more an exception for them.

And every time we drive part of our sales pipeline to those companies we have acquired, we are speeding up this process of transition from license to subscription or a more recurring model. Of course, it hurts in a more long perspective the top-line growth in terms of license and explained part of the acceleration of license. And we understand that is healthy for the business in a long-term perspective.

If we assume that a customer is going to pay us a similar amount of money in a four-year period, after that, we – that customer's paying the same and then we can better monetize our installed base. And then, from that point on, we'll start to be in the opposite position, so having better revenues with a similar cost structure. And that is our main objective to maximize the value of the company in the business and to establish a more sustainable growth model.

Q - Valder Nogueira {BIO 3490951 <GO>}

Okay. That's a good answer. The second part of my question is in order for us to determine how much the EBITDA margin curve will come down to then go up, is it more crucial the industry that you concentrate your efforts on or the verticals in order to have to achieve that, some industry may be more willing to go on the cloud model, on the SaaS (28:56) model, or is it a matter of the size of the business?

A - Gilsomar Maia Sebastião

It's more related to a company size than a sector. Very small company as – like microenterprise seems to be a very simple solution and easy to deploy, completely in the cloud and having almost no services, so being charging only monthly – on a monthly base. Specific parts of the systems can be also provided in this way. But a large enterprise tends to be not so open for this kind of solution in the short term, because most of these companies are concerned about OpEx and CapEx conversation. So, OpEx is going to affect the result and CapEx just the cash flow.

In small and medium companies, like single-owner companies, companies led by entrepreneurs, tend to think more about cash flows, like working capital and cash flow. These companies, our feeling is, the acceptance of a more recurring base and model tend to be better accepted. Of course, there is a mindset to be changed in terms of software ownership. Some companies, they do not feel so comfortable not to have the ownership of the software, remembering that our software supports very critical routines. And some of our customers, they like to have the ownership of that system because in their mind if any problem occurs, they have their system in their computers, their servers, and so – but we know that cloud is becoming more and more popular, people are absorbing the concept, digesting this kind of thing. And then, in our view, it tends to be more demanding for the market, that's the point. Hope I have addressed properly your questions.

Q - Valder Nogueira {BIO 3490951 <GO>}

Yes, yes, you have. And that may lead to, let's say, a better alignment of the verticals that you have because it makes all the sense for you to maximize that?

A - Gilsomar Maia Sebastião

Yeah, one example, may be, Valder, I can give is your sector. The financial sector is a traditional demander for Software-as-a-Service. Even during the past, we didn't have this kind of denomination. Financial institutions are not so addicted to license because they have some constraints in terms of big (32:12) level of fixed assets they have in their balance sheet. So they – historically, they – always, they prefer to pay for services than to capitalize an investment.

And that explains or illustrates one good example of that portion of our license that are recurring. That sounds a little bit strange. So, it's really a recurring license, because we rent the license instead of sell the license to this kind of institution. But it's becoming more popular. We're seeing other players in the market and offering more and more cloud and SaaS solution.

One example – another example I can give here is Microsoft with Office 365. So, it's really gaining traction in the market. So, they – we've heard that they are thinking about to stop selling license next year of Office and just sell subscription of Office 365. So, it's going to change hugely the industry, if it really happens, because especially large institutions – they see this kind of license what we see (33:33) as a CapEx investment, not as an OpEx. So, if they really change to sell exclusively through subscription, it will change even the budget dynamics of some companies.

So, it's one example of things that are in course that can gradually change the mindset of executives and, eventually, entrepreneurs as well.

Q - Valder Nogueira {BIO 3490951 <GO>}

Thank you.

A - Gilsomar Maia Sebastião

You're welcome.

Operator

Our next question comes from Ms. Vera Rossi with Goldman Sachs.

Q - Vera R. Rossi {BIO 1540531 <GO>}

Thank you. I have two questions. My first question is on how long this transition of model it will take in terms of, like, revenue slowdown and pressure on margins? And when we pass this phase, what would be the level of profitability? Without giving us numbers or guidance, will the level of profitability in a normalized revenue growth environment and cost environment will be similar or lower than before? Thank you.

A - Gilsomar Maia Sebastião

Hi, Vera. So, starting from the first question, relating to the length of this transition, really, that's one thing that we do not control 100%, to be frank. As I answered Andrew, we've been more and more proactive in that direction, so to invite customers to choose subscription instead of license. But we know that for a long time, companies still will demand for license. Of course, the number of companies demanding for license in our view tends to reduce. And more and more we are going to see companies demanding more for subscription than software - a license of software. That transition, in my view, is already in course. So that length of period of five years we've put in our chart demonstrate that it's happening.

But our feeling is it tends to be a little bit faster for the future, especially because we intend to be a little bit more proactive in that direction, but it's hard for us to actually state here to give you a more solid or more clear perspective of how long it can take. What I can - I'm not giving you guidance to this, it's not a very short-term transition. So, as I said previously, since we do sell license for companies that are demanding license, that transition will not be done in a -- like in a single year for sure. It's going to be a multiple-year process. Of course, the shorter it takes, earlier we can get the benefits of that process. So, you can imagine that we will do your best to make that transition in a way that can be good for both sides, TOTVS and its clients.

And in terms of profitability, we understand maybe this quarter can be used for in the sense to emulate, like to exercise how much sensible the margin of the company can be. R$80 million in license, it's really a point of all of our average, because in average in the last years we've been having like R$90 million in license per quarter, sometimes a little bit more, a little bit less than that, but about (37:50) R$90 million. In this month, having R$10 million below that average, it can illustrate well how much it can affect our margin. So, even having R$10 million less in license in an upfront revenue, having R$2.7 million of non-recurring revenues in G&A, our margin came to this level of 23.5%. It doesn't mean we are happy with that level. But we can use that mathematics to illustrate how sensible it can be.

So, it will not transform completely the business model of the company in terms of financial metrics, in terms of figures – financial figures. And it's important to highlight here that we will keep our financial discipline in terms of cost control independently what model (38:55) we are running. Of course, on a quarterly base, depending on if we have more or less licenses, can affect the quarterly margin. But in an annual base, I believe it can be less – much less volatile than it is in a quarterly base.

Q - Vera R. Rossi {BIO 1540531 <GO>}

Okay.

A - Gilsomar Maia Sebastião

(39:21).

Q - Vera R. Rossi {BIO 1540531 <GO>}

Hello? So, just for me to see if I understood correctly. So, the volatility of the margins will decline because it's a model – the subscription model, it's a model that you have a better consistency in your revenues. But probably the margins will likely be lower or it will require the company to reduce costs to maintain the margins. Is that correct?

A - Gilsomar Maia Sebastião

Look, the cost structure is more related to the level of sales, not revenues, sales we can generate. In terms of predictability of our profitability, as you asked me, you are right. So, a more recurring model tends to be more predictable, because it's easier to project the level of revenues. But in this mid time, so in – when we are transitioning a little bit more from license to subscription, it can provoke an extra – more volatility in margins, because we are switching from license that is an upfront revenue to a subscription. But it's really a transitory point.

So, that's why I answered Andrew in terms of the guidance, because we didn't establish new guidance because we need a little bit more flexibility in the short term. But it doesn't mean it will completely destroy the financial figures of the company. So, we needed a little bit more flexibility in this new term, but it's aiming a much better future for the company.

Q - Vera R. Rossi {BIO 1540531 <GO>}

Okay. Thank you.

A - Gilsomar Maia Sebastião

Okay. You're welcome.

Operator

Our next question comes from Mr. Andre Baggio with JPMorgan.

Q - Andre Baggio {BIO 6863260 <GO>}

Maia, I have two questions. The first, so just to clarify on this volatility for the margins. If I understood correctly, the volatility will remain because the transition to SaaS will be done over time, so just in the very long future that (41:55) you will not have the volatility of the margin. I mean the next few quarter, we still should see the volatility because of the sale of license which can fluctuate?

A - Gilsomar Maia Sebastião

Baggio, really, I understand that the R$80 million of license, it's not a good reference for us. Let's say, through the next quarters we return to the average of R$90 million, it can enhance a little bit our margin. But in parallel, we will keep that transition in course. So, we have both force in place.

In this quarter, we had just one. The transition kept in course, but the license were very weak, especially among large enterprise, so that most of that gap comparing the R$80 million to the R$90 million of our average came from some postponing, especially from large enterprise, so postponing investment. And so, we are able to return even to the average of R$90 million, it can recompose our margin in the short term. Okay?

It could have been much more in terms of how the volatility of license can be a part of this then (43:31) the subscription, because subscription processes is going to be consistently in course, in my view, okay?

Q - Andre Baggio {BIO 6863260 <GO>}

Okay. Maia, and the final question I have, can you explain a little bit with more details the value of revenue per license declined from R$15,000 to R$10,000 year over year. What exactly is this related to? Because I understand it could be related to the size of the clients, but I want to know exactly what is the number of sales. Is it per clients? Because I understood that one client should be the same in this regard if it's more large, because you charge per user. So, I want to know exactly what this measure is about.

A - Gilsomar Maia Sebastião

It's per client, Baggio. And then, larger clients, since they tend to have more users, they will have a larger ticket; and in the opposite way, the smaller customers, a small number of users and a small ticket. So, when we put together – and in a quarter like this in which we have a very low level of sales to large customers, the average ticket is more impacted by the small clients.

Q - Andre Baggio {BIO 6863260 <GO>}

So, a client is CMPG (45:04) instead of a user?

A - Gilsomar Maia Sebastião

Yes, that's right.

Q - Andre Baggio {BIO 6863260 <GO>}

Perfect. Thanks a lot.

A - Gilsomar Maia Sebastião

You're welcome.

Operator

Our next question comes from Mr. Michel Morin with Morgan Stanley.

Q - Michel Morin {BIO 1873971 <GO>}

Hi, it's Michel Morin from Morgan Stanley. So, two questions, if I may. The first is regarding the delays that you saw from large customers. I'm assuming - given that you mentioned this was related to political uncertainty, I'm assuming that this continued into October, and perhaps if you can comment on whether or not October was perhaps even the worst month and what you've seen since, if anything?

And then, secondly, given the market reaction today I was wondering if you can update us on your buyback authorization and how you think about balancing buybacks with other potential uses of cash? Thank you.

A - Gilsomar Maia Sebastião

Hi, Michel. Starting from the first question related to the delay of large accounts, giving you a little bit more color on this quarter. So, October was not that different comparing to the third quarter. And I attribute this behavior to the political scenario. So, we are a few days from the final of the elections. So, I believe in October, companies were still under the scenario, the expectations about the name of the new President. And then, I believe, companies now have a little bit more elements in hand to project some scenarios for next year.

So, that's a very challengeable moment for companies to project and make budget for 2015. And we know that traditionally part of the companies have a behavior to use the remaining budget in the fourth quarter to make some investments. Of course, the macro scenario is not that favorable, as you know, here in Brazil. We have to be a little bit more careful in this kind of comment, because if you put it all together it can give you the impression that the fourth quarter is easy, and in a very easy way, we can do a very, very good quarter.

So, I don't believe in that. So, it tends to be complex. But we had to pursue a recovery in our license among those large accounts, because we didn't lose those accounts to competitors. Most of that was really delayed, postponed from large accounts. So, we had to keep in touch with those companies, trying to converge those opportunities. But again, it's not a simple thing.

Now, going to the second question related to our buyback program, our buyback program we have is primarily to support our stock option plan. Of course, we follow all the time the stock price. We understand what's the movement of the stock price and the necessities we have to support the stock option plan. And that's one of the matters we can discuss consistently with our board of directors, the best usage of our cash.

But considering that in parallel, we have a pipeline of M&A. The priority is to reinvest the money in the business. We have more opportunities to reinvest and to strategically approach things we understand it's important for the future of the business. The priority is this kind of thing. And secondarily, we can allocate more or less resources on our buyback program, but we have that flexibility to discuss this kind of thing with the board. That's one thing that exists.

Q - Michel Morin {BIO 1873971 <GO>}

Great. Thank you very much.

A - Gilsomar Maia Sebastião

You're welcome.

Operator

Our next question comes from Mr. Sunil Rajgopal with HSBC.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Hi, Maia. This is Sunil from HSBC. I have one very quick question. Would you be able to provide us with the timeframe for the revenue payback that is essentially the difference between selling in a traditional model versus the rental model? How long would it take to reach the similar revenue levels?

A - Gilsomar Maia Sebastião

Hi, Sunil. So, in terms of timeframe, it's about four years in general. Of course, some of our offerings have a shorter and others are a little bit longer periods than that. But in average, I would tell you that about - it's about four years. In a four-year period, in net present value, a customer tends to pay a similar amount. So, if we are able to retain a customer more than that, we can better monetize that install base of users and recurring revenue. It's a good reference, about four years. But as I told you, especially simpler solutions tend to be a shorter timeframe.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Sure. And if I may, I just have one more question with regarding to the cost structure. I don't know if you have told this already, but it would be helpful if you can remind us what percentage of your total costs are fixed versus the variable?

A - Gilsomar Maia Sebastião

So, my pure variable costs are more related to sales expense, like selling expense, then commission expense, especially commissions are really directly related to revenues. And with – we have a more deferred revenue in a subscription model, we have a more deferred commission as well. Of course, commercially, we can incentivate a little bit our sales force giving a little bit more commission in the beginning and then in a linear way, but it's really a very tactical and operational thing on a daily base. But in my mind, we have also deferral in this kind of thing.

The other lines are not so affected by that, because R&D more related to roadmap and the launching of new (52:57) things, and one thing that I didn't flag when I answered your first question about the timeframe is that conceptually this kind of subscription model is more helpful for sales force in terms of it requires a less – a lower level of initial investment. So, it reduced an entry barrier in some new clients. So, it tends to be positive for sales force and that's what we've seen in our experiences with this kind of Series 1 initiative and even with the companies we acquired. So, that's the point.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Sure.

A - Gilsomar Maia Sebastião

And the rest of the costs are more fixed costs. And then, it's under our cost discipline independently in how much concentrated we are in a subscription or in a license model. We – it's mandatory for us to be very, very disciplinated in terms of cost control here (54:10).

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Sure, Maia. Thank you very much for your answers. It's very helpful. Thanks.

A - Gilsomar Maia Sebastião

You're welcome.

Operator

Our next question comes from Mr. Valder Nogueira with Santander.

Q - Valder Nogueira {BIO 3490951 <GO>}

Thanks for the follow-up. Very good questions by the former guy. And riding on those questions is, how do you see the alignment of your franchise to this new model? I know that part of them have already been as we've seen the revenue growth (54:45) profile that's shown in the presentation and the press release that intuitively they have already been selling more and more subscription model. But how is the alignment offered in – for this new venture?

A - Gilsomar Maia Sebastião

That's a very good question, Valder. The franchise here, I understand that we have an advantage comparing to other players in this respect, because our franchises are exclusive channels and we remunerate our franchises over the recurring revenue since beginning.

So, they – and if we try to break down the process of our franchise, even though they have a high portion of their revenues related to service and license sales, through commissions, most of the profits they make are related to commissions over maintenance, over recurring revenues, because they have no costs involved in maintenance because all of the support, all of the development, all of the elements related to maintenance and to the recurring is done by TOTVS directly. So, they really help us in terms to monitor customer satisfaction and to be geographically close to our customers. And that was – justified that recurring commission they have together with the exclusivity they have.

So, intensifying this kind of recurring model can be acceptable (56:41) for those franchise as well. Remind that they have already a good level of commission, recurring commission over recurring revenue. It can – I understand your question in the matter of – in the short term, they also can have a little bit – a little pressure in terms of incentives to their workforce as well in terms of sales. But they understood pretty well the importance of having these kind of alternative in their commercial approach.

So, in some opportunities, it's very helpful to have this low level of initial investments to win the competition. And then, having more customers, they can maximize their business as well. So, they are very aligned. I cannot give too much details in terms how we can incentivate, but we are incentivating customers in terms of new customers and sales to existing customers are differentiated. And depending on the moment, we can be more or less aggressive on that. That's the kind of flexibility we have to have here.

And with subscription, it's not different. It's not different. So, we have some small incentives to partially offset this kind of negative impact in the franchisee. But they have a very good mindset in terms of recurring revenues and recurring commission. So, that's not an unsurpassed issue when we talk to them.

Q - Valder Nogueira {BIO 3490951 <GO>}

Then any difference in the profile of bad debt in the new model vis-à-vis the old model?

A - Gilsomar Maia Sebastião

Look, bad debt tends to be more similar what we have with maintenance. So, it's a recurring revenue, has very small ticket, and tends to be better in this aspect of bad debt. In the other hand, we have to be even more careful about churn, because as I explained to Sunil on the previous question, the retention rate of our customers, they are very important. That is important metric for us. In a subscription, it's even more important, because more longer we retain the customer, better we monetize that services we are providing to the customer.

Q - Valder Nogueira {BIO 3490951 <GO>}

Thanks.

A - Gilsomar Maia Sebastião

Welcome.

Operator

Our next question comes from Mr. Steven Fernandez (59:47) with Scotiabank.

Q - Andrés Coello

Yes. Thank you. This Andrés Coello. I have a question on the bigger picture of the transition. I think you already discussed the short-term impact of migrating to SaaS. But my question is more related to how the new model changes the potential for ERP penetration in Brazil and in Latin America? I understand that ERP penetration in the SME segment in Brazil is currently approximately 22%, 25%. It's probably half the penetration rate in the U.S.

So, my specific question is this, under the previous model you will charge customers, based on the licensing model, you will charge a significant down payment that was probably a big down payment and now you are charging that customer on a monthly basis. So, my specific question is this, when we think about the new customers, how much they were – on average, how much they were paying in the past, how much was the down payment in the past, compared to the monthly installments that they will now do? More or less, if you can give us – even if it's just a very wide idea of the difference in how much they will pay now on a monthly basis compared to a single down payment in the past? I think that will be helpful.

And also, if you can provide us any updated view on the ERP penetration in Brazil and how the migration to SaaS increases the potential for expanding or penetration more rapidly in the Brazilian market?

A - Gilsomar Maia Sebastião

Okay, (1:01:36). Thank you very much for questions. It's also very interesting question, because you addressed that subscription approach in a way to help us to enter new customers and enhance the penetration of the market. So, you are right, the penetration of Brazilian market is much lower than developed markets. Our sense it seemed like your, like 22%, 25% seems reasonable, even though we don't give a very high importance to this kind of figure, because we understand that for this kind of statistics, a company that made a very small investment, a very initial investment in a system, in a management system, is considered in this kind of statistic as a penetrated company.

And as you know, we now are model (1:02:41) the first move, the first investment from a new customer is just the beginning of the game. So, that is when the game starts. So, from that point, it's much easier to penetrate more that customer than before. But you are right, the penetration is low. This kind of subscription model seems to be helpful to penetrate, to convince companies because the amount of money they have to invest is much lower than if they were acquiring license, et cetera.

As I said in the beginning of this conference, we have also to take into consideration there is a cultural behavior to be displayed, like companies - if you are concerned about the ownership of the system in some specific situation, because as I said, our system support very critical routines and in specific situation, customers, they feel more comfortable when they have their systems running on their premises. And we understand that's the kind of education process we have to do. But you are right, it's helpful in terms of penetration. And to give you a sense of relevance, I will use our historical metrics. So, in average, a new customer spend like $25,000 to $30,000 in license, two times of that in services.

So, I'm saying that like let's take R$30,000 in license and R$60,000 in services, so we are talking about a project of almost R$100,000. And then, we - normally, we charge a maintenance of 30% of that license on an annual basis. So, of course, we charge it in a monthly basis, but when you are considering an annual basis, the total maintenance represents about 30% of the license. So, in a year, a customer could consider R$30,000 in license, R$60,000 in services, and other R$10,000 in maintenance, so R$100,000 project in a one-year period. In a subscription, it depends on exactly what the solution you are demanding, but the R$60,000 in services tend to be similar, okay, because the effort of implementation is not that so different.

But the amount of recurring tends to be higher than the R$10,000 of my example. So, it tends to be about like R$12,000 approximately. Just to be - let me see here, like, yes, like - no, it's not R$12,000, it's like R$17,000 to R$18,000, almost the double of the maintenance this customer is paying, depending on the offering. It's higher in terms of monthly payments, but we can dilute that investment in a length of time for the customer. Am I clear in my explanation, (1:06:38)? Or...

Q - Andrés Coello

No, I think you are very clear. So, just to summarize, so in the past, the customer will pay during the first year approximately R$100,000 to get the project started, no?

A - Gilsomar Maia Sebastião

Yes.

Q - Andrés Coello

And under the new model, he is going to pay the same R$60,000 for the service, because it's likely to require installation services in the past, but it's the R$30,000 that he was paying in the past for the license is probably not going to be there anymore, but instead of paying R$10 million of maintenance, he is now going to pay approximately R$18 million, no? So, instead of R$100,000, he is going to pay approximately R$80 million, no? So, it's a 20% reduction in how much you discussed in that client to acquire the license. Am I right to see it that way? I mean, in the past, you will get R$100,000, now you are getting probably R$78,000 for that same customer, but of course that customer will stay with you for a long time. And therefore, in longer term, it can generate more revenue than the R$100,000 that it will generate under the previous model. Am I right in thinking that way?

A - Gilsomar Maia Sebastião

Yes, you are right. And of course, we are getting on a hypothetical example here. We cannot generalize for all projects in the same way, but your rationale is correct. And one thing here that's important to explain is even if our service is – if we get more efficient in the implementation, that customer tends to spend the same R$60,000, and why? Because that's the amount of money that customer is available to afford.

In a customer's mind, okay, I can expend that amount of money in implementation. If my implementation comes cheaper, that customer tends to implement more than usually we see a customer implementing a solution. And you are right, so we can dilute the investment because here we are talking about in terms of subscription of monthly payment. So, that customer doesn't have to disburse, in my example, the R$30,000 upfront, it's diluted throughout the time. So, for cash flow – from a cash flow perspective, it's more favorable for the customer.

Q - Andrés Coello

Okay. Perfect. And so, just one really final question, have you changed your view on potential penetration of ERP in Brazil? I mean, as you migrate to the new model, internally the company has changed its projections regarding the potential for the market or it remains more or less the same? I understand that you cannot provide guidance on this particular issue, but I think it will be helpful to know if at least internally the company is now thinking in growing more aggressively.

Actually, we saw your licenses increasing or the number of transactions in the third quarter increasing by 31% year-over-year. I think that there was already a certain acceleration in the third quarter. But I wonder if internally the company feels more – of course, there's the macro issue as well, but if you feel – the company feels more optimistic that the new model will help accelerate penetration in the long term?

A - Gilsomar Maia Sebastião

Look, this kind of metric is one of the assumptions we had to revise in our projections, because – we have to review in our projections, because if you take the number of new clients we added in the last three years, it's very similar. So, we are not able to accelerate that addition of new customer. It's out of our expectations, it's under of our expectations...

Q - Andrés Coello

Okay.

A - Gilsomar Maia Sebastião

...comparing to our projections when we defined those guidance. So, conceptually, if that was the only variable for penetration in Brazil, it's under our expectation then comparing to the past. But again, penetration is not that relevant in our analysis. And why? Because of that I explained, so a company that make – acquired a single-user license, in my example, is considered a penetrated company, and in practical terms, it's not penetrated.

Secondly, even those companies more evolved in terms of software usage, every day he has new demands of technology. We have customers that are with us 30 years and consistently they come requiring new things or we have new things to offer and implement more things, sell more things to them. So, it's – really in the technology industry, it's hard to say that a customer is fully, fully penetrated.

Q - Andrés Coello

Okay. Thank you.

A - Alexandre Mafra Guimarães

(72:03), and one of the best things in this kind of a subscription model is that without this initial payment, the company can implement more, can make more service. So, this kind of thinking can be really good for us.

Q - Andrés Coello

Okay.

A - Gilsomar Maia Sebastião

Okay, Andrés. Thank you.

Q - Andrés Coello

Thank you.

Operator

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

A - Gilsomar Maia Sebastião

Thank you all for the participation in this conference call. I hope we can talk during the next – in the next quarter. Have a good day. Bye-bye.

Operator

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