Q2 2012 Earnings Call

Company Participants

- Alexandre Dinkelmann, VP, Strategy and Finance
- Gilsomar Maia, Planning Officer

Other Participants

- Loren Lewallen, Analyst
- Matt Neal, Analyst
- Michel Morin, Analyst

Presentation

Operator

Good morning. Welcome everyone to Totvs 2Q '12 results conference call. Today with us we have Mr. Alexandre Dinkelmann, Vice President of Strategy and Finance; and Mr. Gilsomar Maia, Planning Officer.

(Operator Instructions) Please also note today's call is being recorded. Today's live webcast may be accessed through Totvs' website at www.totvs.com/ir.

Before proceeding, let me 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 cause these results to differ materially from those expressed in such forward-looking statements.

Now I will turn the conference over to Mr. Alexandre Dinkelmann, who will begin the presentation. Mr. Dinkelmann, you may begin your conference.

Alexandre Dinkelmann {BIO 16100739 <GO>}

Good morning, everyone. Welcome to Totvs Second Quarter 2012 earnings conference call. I would like to start this conference highlighting three important events for the Company this quarter. First, Totvs was appointed the Company of the Year in the Exame magazine's issue biggest and better, which evaluated the 1,000 largest companies in Brazil, taking into account among other factors growth, profitability, wealth created per employee and liquidity.

Second, a new advance of Totvs brand, which reached the 18th position in the ranking of the most valuable Brazilian brands in 2012. This position is even more relevant when we consider that this brand was created just seven years ago and it was compared to strong consumer brands in the rating process.

Third, Totvs held its Investor Day in June at the Company's headquarters in Sao Paulo and also for the first time in New York. Now I would like to invite Maia, Totvs Planning Officer, to proceed with the Second Quarter earnings presentation.

Gilsomar Maia {BIO 16400533 <GO>}

Good morning, everyone. On the slide 3, we have double-digit growth in net license fee revenue, up 10.3% over second 2Q '11, which is higher than first-half '12 growth, and shows the positive evolution of license fee revenue in the year.

It's important to highlight that the license growth was observed both in sales to new customers with the addition of 907 new customers, 20% higher than 2Q '11 and in total sales to existing customers, which were 10.6% higher than those from 2Q '11.

The next slide, we see the net service revenue growing by 10.2% in the quarter. This pace of double-digit growth in the quarter is lower than first-half '12, mainly due to software implementation service.

In Brazil, these services have maintained their course of efficient gain, but the service team increase was affected by the pace of license sales in prior period. In international operations, the services were affected by the reduction in the number of branches, especially in Mexico.

Now on slide 5, we have the net maintenance fee revenue, with double-digit growth as well despite the slowdown seen in the last 12 months inflation quarter, which confirms the high level of customer based loyalty and the growth potential, amongst small and medium companies.

As a result, on the slide 6, the total net revenues grew by two digits totaling BRL350 million in the quarter and surpassing BRL700 million in the first-half '12.

Proceeding to the slide 7, in the upper last corner, the group of R&D expense, cost of services and cost of license followed the downward trend as a percentage of net revenues, mainly due to R&D expense this quarter. However, the execution[ph] of development roadmap can accelerate R&D expense throughout the year.

Monitoring these three lines of expenditure jointly, it's important to check whether the investments in R&D result in long-term margin gains through more efficient implementation and regulation of license costs, and also in R&D investments.

In the upper right corner, in the selling commission bad debt in marketing expense block, we also observed the decrease of the percentage of net revenue. Mainly due to sales mix changes in certain commissions and due to management initiatives to increase efficiency in the selling expenses line.

In the same slide in the lower left corner G&A and management fees presented a slight increase as a percentage of net revenue. This increase was mainly due to the accrual of bonuses in 2012, proportional to the achievement of financial and non-financial goals and due to the increase of infrastructure and communication express in the period.

Now on slide 8, we highlight the 26.8% growth in the 2Q '12 EBITDA, and the 27.9% first-half '12, exceeding the CAGR for the last five periods in both analysis. Also important to highlight evolution of EBITDA margin which reached 26.5% in 2Q '12, 330 basis points higher than the margin shown in the Second Quarter of last two years.

Now, I ask Alexandre to proceed.

Alexandre Dinkelmann {BIO 16100739 <GO>}

Thank you, Maia. On a slide 9, we broke down the EBITDA margin into the Brazilian operation, that's our core business, and the impacts of Digital TV, also known as TQTVD and international markets. The purpose here is to increase the visibility of our businesses that have different maturity levels.

In the first line, we have the EBITDA margin of the Brazilian operation, which reached 28.7% in the 2Q 2012, representing an increase of 350 base points over the 2Q '11.

In the second line, we have the negative impact of 1.3percentage points from TQTVD in this consolidated margin. However, in the year to date, the negative impact of Digital TV's 0.6percentage points or 10 base points lower than the first half of 2011.

In the third line, we see the impact of the international market operations, which was 30 base points better than 2Q 2011. And in the year to date was 80 base points better than the first half of last year. These improvement reflect a set of actions we have taken since the Fourth Quarter in order to make our international operations reach the EBITDA breakeven in the second half of 2014, representing between 3% and 5% of the Company's consolidated revenue in 2016.

On slide 10, we see the cash flow and debt level. I emphasize that the operational cash flow accounted for more than 90% of EBITDA in the quarter, which allowed a decrease of net debt to BRL6 million at the end of the quarter, despite the payments of BRL65 million of dividends. Our balance sheet provides enough financial strength and flexibility to fund our long-term investments.

Moving to slide 11, we have the traditional financial dashboard where we highlight the growth of revenue and EBITDA, as well as the net income growth which was significantly higher than EBITDA mainly due to the reduction of net debt and the consequently reduction of financial expenses in the period.

This net income growth wasn't even higher, because of increase of the effective tax rate due to the reduction of fiscal benefits related to R&D expenses.

Lastly, slide 12 summarizes the quarter and outline how the management team has been guiding its agenda on the pillars of growth, fidelity and margin.

In the growth dimension, we highlight the license fee revenue and net income growth, and addition of almost 1,000 new customers which accounted for almost 20% growth over 2Q11.

The performance in the quarter confirms that we are on the right path and in accordance with our plans to accelerate our growth during the year.

Regarding fidelity, we highlight the revenues from the existing customers, which were 10.6% higher than 2Q11, the 12% growth from maintenance revenue and Totvs brand ranked as 18th most valuable Brazilian brand.

Finally in terms of margin expansion, we had 26.5% of EBITDA margin, which shows an increase of 330 base points over 2Q11, and the net income growth of 31%. These indicators show that Totvs is on track, through the consistent execution of its long-term plan with a distinctive combination of growth and increasing profitability.

From now on, we are available for the Q&A session.

Questions And Answers

Operator

(Operator Instructions) Michel Morin, Morgan Stanley.

Q - Michel Morin {BIO 1873971 <GO>}

I just wanted to follow-up. I think in the press release you mentioned that in the Digital TV there was a staff reduction. So I was just wondering if you can quantify, what kind of impact that had on costs, just trying to normalize here what kind of expense level we should see starting in Q3.

Then similarly in the international markets, it looks like there was a little bit more of a drag on margin in the Second Quarter than in the First Quarter. So I was just wondering what is happening there, what's driving that. Thank you.

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Hi Michel, this is Alex speaking. Thank you for your questions. Let's start with the Digital TV question. Basically, we reduced approximately 20% of the workforce in the business. So it's a pretty good proxy to envision the future costs of operation.

Regarding margins, when we compare Second Quarter and First Quarter, we were happy with the performance of the Second Quarter in the sense that we were -- we are in the path of increasing our efficiency in the service side, also in the R&D side. And because of Brasil Maior effect, we could also anticipate part of the roadmap in terms of R&D. So basically we are using this positive effect in order to enhance and anticipate part of our roadmap in terms of innovation. So we are showing no consistency in the way that we are pursuing our margin expansion.

Q - Michel Morin {BIO 1873971 <GO>}

So Alex, thanks for that. But just to clarify on your last point, so did I hear you right in saying that basically a lot of the benefits that you have gotten from Brasil Maior have actually been reinvested in the business and especially in R&D?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Yes.

Q - Michel Morin {BIO 1873971 <GO>}

Okay. Great. That was my next question. Alex I also just wanted to clarify something that came up on the Portuguese call about maintenance revenues, because it does seem like on a sequential trend they were a little sluggish, certainly a little bit weaker than we had anticipated.

And of course we take into account, inflation and license sales in the last 12 month. The one variable that we don't have is churn in your client base. And I'm wondering if there has been a -- perhaps a worsening of the trends there, that might explain the performance. Thank you.

A - Gilsomar Maia {BIO 16400533 <GO>}

Good morning, Michel, this is Maia speaking. In terms of maintenance, we haven't observed significant change in terms of churn in this quarter. What maybe is better to analyze maintenance, probably you realized that, but this quarter we start to also provide the net amount of maintenance. That discounted this tax and sales, discount in cancellation. When you take a look on net maintenance fee, you can see that the growth between First Quarter and Third Quarter was 1.5%.

I know that it's lower than previous quarter, but actually we had considered before that if you take into consideration that one important element is the inflation update, it was on track in my opinion in the course we were imagining. I don't know if I clarify your doubt exactly.

Q - Michel Morin {BIO 1873971 <GO>}

Yes. That's very clear. Thank you very much.

A - Gilsomar Maia {BIO 16400533 <GO>}

Welcome.

Operator

Matt Neal, Invesco.

Q - Matt Neal {BIO 17098412 <GO>}

My question is related to the 28% year-over-year increase in G&A. What I'm trying to figure out is the BRL4.8 million increase year over year. I am trying to determine the amount of that that is related to the Executive Officer change to non-statutory position and then infrastructure and telecom. So I would like to get a breakdown there.

Then also, it seems when you were talking about G&A and management fee, you mentioned an increase in the compensation related to goals, so I am curious to see how -- if that falls in under G&A, the goal related compensation? And just in general educate me on this transition and the impact from Executive Officer to the Executive Officers no longer having a statutory position. Thank you.

A - Gilsomar Maia {BIO 16400533 <GO>}

Thank you for the question, this is Maia speaking. The first question you made related to G&A. You are correct, in this specific quarter we had some executives that were previously -- they were occupying a statutory position and they left those positions. So we had to reduce the management fees and in other hand the G&A was increased because of that.

In terms of the whole G&A expense, we can consider this kind of movement with deductives, but also significant part of our G&A expenses are related to some fixed costs we have. Example is rentals of buildings we use and in Brazil we have a kind a similar behavior as we have in maintenance. So every 12 months, we have inflation of the dates over those contracts, rental contracts and then -- so we observed some increase in that direction.

But all the time G&A's were in line, we are very careful with that. And we understand that as the Company grows, we have some new levels of G&A and then in the -- after that we try to provoke some dilution to G&A. Exactly in the beginning of this year, we understand that we establish a new level of G&A and then we work hard to dilute that G&A throughout the year and the next years.

In terms of management fee, compensation, when we explained them about the provision of bonuses, when we take a look on 2011 the same point, the same time point, we didn't have any provision in terms of bonus. We are not reaching our goals at that time and we accrue the bonus throughout the year in accordance with our achievements.

So comparing 2011-2012, this one important element that explains why management fee looks somehow stable even with the reduction of number of the statutory positions.

Q - Matt Neal {BIO 17098412 <GO>}

Okay. So just to confirm, if we're speaking about G&A specifically, a bulk of the increase was driven by rental increases, so is that correct?

A - Gilsomar Maia {BIO 16400533 <GO>}

Yes. Part of that increase came from the executives that left the statutory position. Second reason is the infrastructure in communication expenses that we observed some increase, especially because of inflation updates we have.

Q - Matt Neal {BIO 17098412 <GO>}

Okay. I guess, my second question is in regards to doubtful accounts. You're provisioning 1.5% of sales. Can you give some color on what was driving the delay in payments from your customers and if you plan to keep provisions at this level? Thank you.

A - Gilsomar Maia {BIO 16400533 <GO>}

In terms of doubtful accounts, what we observed differently from previous quarters when we were discussing this kind of matter related to international operations is specifically in the 2Q '12, case related to doubtful accounts were more concentrated in Brazil, and specifically in some big customers, big accounts, and even more specifically in services related to consulting, management consulting, projects and some other implementation project. So it's not a generalized behavior, it's more concentrated in some big accounts.

Our personal feeling is -- probably there is an influence from the macro economic scenario that some of those companies suspended their projects and they also suspended the payments. But when we take a look on the names below that provision, we see very good names. So there is a chance to see part of that provision been revert in the future. But being conservative, we had to accrue that provisional.

Q - Matt Neal {BIO 17098412 <GO>}

Okay. Thank you very much.

Operator

Michel Morin, Morgan Stanley.

Q - Michel Morin {BIO 1873971 <GO>}

Alex, just noticing on your slide 10, your net debt, which is basically zero and I think you filed a couple of days ago for a shelf debenture offering. So I was just wondering what you and the Board might be thinking about with respect to use of cash going forward and potential returns to the shareholders. Thank you.

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Okay, Michel. We are always analyzing on all funding options for our investments. The good point is that we have a pretty flexible and strong balance sheet because of these cash flow generation. So in the last couple of years, we were able to reduce our liability rate, which gives us possibility to increase leverage for the future.

The information that was released recently about the debentures, it's not true, we are not pursuing any concrete transaction that time. But we are always talking with the market in order to understand best options, and when we need them you go for them. So definitely we are not working so far in any specific transaction in terms of capital markets.

We don't think of changing our dividend policy, so starkly we have been distributing 50% of our net profit to shareholders. We don't see any reason to change that, because we envision investments for the next years in terms of growth and expansion, so that's why we want to have this balance sheet prepared for future investment.

Q - Michel Morin {BIO 1873971 <GO>}

Great. Thank you very much.

Operator

Matt Neal, Invesco.

Q - Matt Neal {BIO 17098412 <GO>}

I'm curious in regards to the Digital TV platform. And I am sorry I have to ask you, I'm sure you have articulated this in the past, but what opportunity do you see there and what's your strategy in Digital TV going forward?

A - Gilsomar Maia {BIO 16400533 <GO>}

Okay. So this year we have -- now, in fact we have the law that obligates the adoption of this platform in Brazil, which is really a relevant fact for the business. And now after this law we have more, we can see better results ahead.

In this sense, this quarter we adjusted the cost structure of the business in order to speed up profitability. Because of the changing legal environment, we have been approached by investors that are interested in syncing with Totvs in this business. We are right now analyzing opportunities. And this year will be a watershed regarding this investment. We believe that now we can show better prospects in terms of profitability.

Q - Matt Neal {BIO 17098412 <GO>}

Okay, excellent. Thank you very much.

Operator

(Operator Instructions) Loren Lewallen, Select Equity Group.

Q - Loren Lewallen {BIO 17231394 <GO>}

Congratulations on your very solid results today. I just have a few questions. First, I'm wondering if you can talk about the current sales environment and the outlook for license sales, commenting on your pipeline, your general view of how you can perform in this Brazilian economy. It seems to have slowed quite a bit over the last couple of months.

The second question is, if you could help us better understand the impact of the Brasil Maior plan on your profit generation this quarter, I know you reinvested some of that, but I'd love any sort of insights you can give us on the net positive impact that had on your profitability.

Then finally, if you could comment a little bit on the expense side, particularly on selling commission and R&D bucket. And you had very good leverage there and I'm hoping you can comment a little bit on the source of that, particularly for example on the selling side where you actually had a decline in cost year on year. And also whether we might expect to see that kind of strong leverage over those expenses, as we give into back half of the year. Thank you very much.

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Okay. Hi Loren, thank you for your questions. I will start with the first one regarding sales environment.

One of the strengths of our business model is that we are able to be close to clients in different industries and regions and Brasil is a continental country. So in this sense, we see that the general GDP metrics don't reflect what's happening mainly in the small and mid-sized business arena.

As we have this wide offerings in the market, we are able also to reallocate efforts and focus in order to capture growth opportunities. And that's what we are doing this year. That's why despite the slowdown in the general economy, we were able to accelerate our license sales in the quarter.

And it's in line with our plan, so in this sense we are working to accelerate our growth during the year, in the next two quarters. So it's basically in line with what we are seeing in the market.

And regarding the Brazilian economy, it's really tough to say if it's going to decelerate or accelerate. We believe that because of our resiliency in our business model, we are able to protect our revenues even in a worse scenario. So this is the first question.

I will pass to Maia in order to answer the next two questions.

A - Gilsomar Maia {BIO 16400533 <GO>}

Hi Loren, just going forward to your question, the second, regarding Brasil Maior impact, one thing that's important to clarify is Brasil Maior is reflected in the same lines of cost and expense as it used to be reflected. What I mean by that, the Brasil Maior changed the way we calculate the social contribution over payroll. So instead of to be calculating that based on salaries, we start to calculate as a percentage of sales. But the way we allocate that cost is still the same.

So we didn't change the way we recognized the tax on sales, and the way we recognize the social contribution over the payroll. So the impact is reflected in all cost and expenses line that you have personal expenses related. And in terms of leverage, it was your third question. Leverage of sales, commission and other expenses related to our business operation.

We understand that we still have a lot of room to explore in terms of leverage and efficiency internally. Since the beginning of 2011, we have been investing a significant time here trying to improve the performance and the efficiency of our services; implementation service team. And we've been able to present part of this efficiency in our service margin.

In other lines, we start to be more focused now, example is the R&D. We acquired almost two years ago some development franchisees, some developer -- external developers and we are working hard to integrate that new development structure with our business structure. So there are some synergies to be extract from that front.

Then commissions always reflects the sales mix, so the portion of our sales drawn through franchisees and our own channels. Actually I see in 2012, the portion or the distribution between sales through our own channels and third party channels, the franchisee is more balanced than 2011.

In 2011, performance of our franchisees were much better than our own. In 2012, I see it more balanced than 2011. So it's closer to 50-50 and it sounds good for us. I don't know if I addressed all of your questions, but if you want you can complement your question.

Q - Loren Lewallen {BIO 17231394 <GO>}

That's great. That was very helpful. Just as a brief follow-up on Brasil Maior, that was helpful how you explained the allocation across your different cost lines. Can you comment on the total net benefit, just how much smaller your tax bill was due to Brasil Maior? Then the second one, if I could add one and then I'll let someone else ask questions. On the gross margin side, we saw license gross margin drop quite a bit to a lowest level, maybe ever or at least in a long time, whereas, as you pointed out, service improved.

And I was wondering if you can just comment on the gross margin for those two line items going forward, do we expect results similar to Q2 to carry out going forward or do we expect things to revert towards historical levels?

A - Gilsomar Maia {BIO 16400533 <GO>}

Okay. So regarding Brasil Maior impact, really when Brasil Maior were launched at the end of 2011, we were talking to the market that in our mind we could see an impact of about BRL20 million a year of Brasil Maior. Actually to discuss the quarterly impact of Brasil Maior is something not very simple, because part of the savings from Brasil Maior, we've been investing in our own structure. So it's not a good exercise to isolate the saving from Brasil Maior.

But what is important to keep in mind is the size that can produce an impact in the year, then after that the Federal government has changed Brasil Maior, reducing a little bit more the percentage of social contribution over sales from August on, so in this quarter specifically we had the social contribution of being calculated as 2.5% of our sales.

From August on, it's going to be 2%. So probably that initial figure, we've estimated about BRL20 million in a year can be increased. We still didn't calculate exactly how much, but just to give you a sense of size and impact.

And the other question related to license costs. License costs reflect, cost we have with third party solutions embedded or not in our own solutions. Actually, what we have is kind of partners developing complimentary solutions to ours. Our strategy for the future is important to attract these kind of partners, because we know that probably we will not be able to develop everything at the same time.

So it's important to have these kinds of guys developing interesting things with us, then against us. And when they develop things in our platform and we embed these kind of solutions, consequently we have to pay some remuneration to these partners. So it's fair enough.

But being more specifically to your question, taking a look to the rest of the year, I see that probably we are going to see a similar level of license cost to the rest of the year, but in a long-terms view, we understand that our investments in R&D has to be converted into a dilution of that line, what I mean by that. So it's interesting the medium to short term to have this kind of complementary solutions, but in the long-long term we want to see our own solutions growing faster and diluting this kind of costs. Am I clear in my explanation?

Q - Loren Lewallen {BIO 17231394 <GO>}

That's very clear. Thank you. And on the service side, the margin improvement there was very impressive, maybe you're about to get to that. But if you could just talk a little bit about whether you'd expect to maintain or improve margins from here on the service side going through the year or whether we might see them fall back again?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Hi Lauren. This is Alex speaking. It's really hard to preview on a quarterly basis and give you guidance, so we avoid this. But on the longer term, we believe that we will consistently improve our operations in the service side. And basically it derives from two main factors, one is efficiency itself, so we are investing technology and training in order to make our people more productive in the field.

And also the mix is changing, so we are adding more value to our service offerings to our clients, which also impacts positively our profitability in the service side. So in the longer term, yes we believe that we will keep the path of improvement. But it's really hard to tell you something about the next quarter, or next couple of quarters.

Q - Loren Lewallen {BIO 17231394 <GO>}

Very good. Well thank you very much for your time, gentlemen.

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Thank you.

Operator

(Operator Instructions) I'm showing no other questions at this time. So I would like to turn the call back over to Mr. Dinkelmann for any final remarks they may have.

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

I'd like to thank you all of your time with us and mainly Totvs' team, our biggest competitive differential. So thank you all.

Operator

The conference has now concluded, and we thank you for attending today's presentation. Your may now disconnect. And have a wonderful day.