

Q2 2019 Earnings Call

Company Participants

- Dennis Herszkowicz, 'President'
- Gilsomar Maia Sebastiao, 'CFO, IR Officer Member of the Executive Officers Board'

Other Participants

- Cesar Medina
- Guilherme Hagiara

Presentation

Operator

Good morning, and welcome to the TOTVS conference call to discuss the results of the second quarter of 2019. We have with us today Dennis Herszkowicz, the CEO; and Gilsomar Maia, the CFO. The audio is being simultaneously webcast at ir.totvs.com.br.

Before proceeding, we wish to clarify that any forward-looking statements that may be made during the conference call related to the business outlook, operational and financial projections and targets of TOTVS are based on beliefs and assumptions of the company's management as well as on information currently available. Forward-looking statements are not guarantee of future performance. They involve risks, uncertainties and assumptions as they refer to future events, and hence depend on circumstance that may or may not occur. Investors should understand that general economic conditions, industry conditions and other operational factors could affect the future performance of TOTVS and could lead results to differ materially from those mention in such forward-looking statements.

I will now turn the call over to Mr.Dennis, who will begin the presentation. Mr.Dennis, please go ahead, sir.

Dennis Herszkowicz {BIO 17998338 <GO>}

Good morning, everyone. Thank you for participating in our conference call.

Once again, I begin by expressing my satisfaction with the results of the second quarter of the year and with a big thanks to everyone at TOTVS. Starting the presentation on Slide 3, where we mention a few highlights of the quarter. The first is a follow-on offering made by the company during the period through the issue of 27 million shares and raising more than BRL 1 billion to fund a cycle of acquisitions. The success of the offering makes us

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confident that we will be able to achieve our goals and bring lasting results for the future of the company.

The partnership agreement signed with VTEX and MODDO are aligned with these goals. VTEX is the leading digital commerce platform, and with this alliance, we now offer integrate management and e-commerce software solutions to more than 30,000 clients. Through our alliance with MODDO, we will offer an order management system, OMS platform, bringing TOTVS's -- bringing to TOTVS's clients an integrated solution within a new omnichannel scenario. Through these alliances, we are underlining our strategy of becoming a business partner and helping our clients to improve their sales performance.

And it was to showcase our clients -- to our clients and partners the new technologies and market trends that we held on June 25 and 26, the Universo TOTVS event, the first since 2015, and being one of the leading technology events in the market, featuring 60 stands, 200 hours of events and 250 activities that include lectures, segmented tracks, labs, case sessions and masterclasses with more than 4,500 visitors per day. During the quarter, we also announce the sale of the hardware operation in the US to the Reason Capital Group. This sale reaffirms our strategic plan of focusing on 100% on the software operation. Finally, I welcome Izabel Branco, who takes over as the new Human Relations Officer of the company.

I now hand over the presentation to Maia for his comments on the quarterly results starting from Slide 4.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Thanks, Dennis. Good morning, everyone. In this quarter, total revenue grew 8% year-on-year and totaled BRL 564 million especially due to the acceleration of recurring revenue, which grew organically by 12% to BRL 425.8 million, corresponding to 76% of total revenue in the period.

Part of the growth in recurring revenue reflects the 9.6% increase in ARR as shown in the chart from the left of Slide 5, which totaled BRL 1.8 billion this quarter. Another element that also contribute to the growth of recurring revenue was the client renewal rate presented in the chart on the right of the slide, which reached 98.7%, and once again, evidence the high loyalty of our clients. Now on Slide 6, The scalability of the software business is advanced by the more than 40% increase in EBITDA, which totaled BRL 116.3 million in the quarter. This performance was mainly due to the acceleration of recurring revenue growth and to a high operating efficiency level that allowed the dilution of costs and expense and led to a year-on-year increase of 470 basis points in EBITDA margin of 20.6%, in accordance with IFRS 16, or 270 basis points increase in a margin of 18.6% disregarding IFRS 16.

Moving to Slide 7, We can see that EBITDA growth was the main factor leading to quarter-on-quarter growth of 31% and year-on-year growth of 109% in net income. In addition to EBITDA, the net income performance is mainly related to the reduction of amortization expense and also to the improvement in net financial results, due to the declining gross

debt without IFRS 16 and financial revenue result in from the financial investments of proceeds raised in the follow-on. Now I will comment on cash flow and debt on Slide 8. The 16% year-on-year growth in free cash flow was mainly due to the 69% increase in earnings before taxes, combined with higher working capital investments, the negative variation in the net assets of discontinued operations and the payment of BRL 5.3 million for the acquisition of 20% interest in RJ Consultores.

Additionally, the company ended second quarter '19 with net cash of BRL 866 million, thanks to the growth of operating cash flow generation and with the proceeds raised in the follow-on. I now turn the presentation back to Dennis for his closing remarks on Slide 9.

Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you, Maia. I would like to leave this final message for all.

First, we have been maintaining double-digit organic growth in recurring revenues. We have maintained also operational efficiency improvements, which means that costs and expenses increased below revenue growth. And with that, EBITDA margin has expanded 470 basis points, reaching 20.6%. We have also made the evolution of the software business through the partnerships to help clients improve the sales performance.

And we have started a new growth cycle, driven by initiatives focus on client satisfaction and by a better and broader portfolio management solutions. Finally, we have made a follow-on, which means that we have the funds for the new cycle of M&A. We are now available for the questions-and-answer session. Thank you.

(Question And Answer)

Operator

(Operator Instructions) Our first question comes from Cesar Medina, Morgan Stanley.

Cesar Medina {BIO 16600229 <GO>}

Hi. Thanks for taking my call. Great quarter.

Congratulations on the results. I was wondering if you can provide more color in terms of how the techfin initiative are going. Any metrics that you can share with us, any time line in terms of the development of the business and the outlook for when are we going to get more regular disclosure on this topic.

Dennis Herszkowicz {BIO 17998338 <GO>}

Hi, Cesar.

Thank you. This is Dennis. Look, we have started the partnership with Rede. So in this quarter, we have had already a small contribution, very small contribution from this partnership.

We will not be disclosing amount as of now, maybe in the future. And in terms of numbers per se, we do not intend to share much numbers, at least in the beginning, especially because they are few, very small. What we can share obviously, and we think that this is much more important right now, is the information on quality. And in terms of quality, it's exactly what we have been communicating to you in the past few weeks.

We see 3 different main buckets of opportunity. The first one is payments. And inside payments, in which we are more advance for obvious reasons of the market, the frame for partnerships is already there and so on. We are advancing as planned.

So the partnership with Rede, as I said, is already on the street, and we are adjusting every day to get a better performance and a better efficiency. We have been improving the sales of TEF So for example, in June, we had a record number of new clients for TEF, which is a good leading indicator, let's say, of our ability to increase the volumes for Rede among our clients, which in the end, translating to more revenues for us coming from these partnerships. So this is progressing as planned. And in terms of the education opportunity, as I said in the Portuguese call, I think that we are moving as well, and we have here 2 different aspects.

The first one is that we are advancing in terms of the R&D investments and preparations for making eduCONNECT, which is the product that we have there to become a payment platform as well as a good platform in terms of functionality and usability for students. So we are progressing well on this front. On the other hand, we are still looking and discussing with multiple partners contracts. Our intention in terms of the education is mainly to have one partner, one single partner.

But if we can find a partner, a good suitor that fulfills everything that we expect, there is no problem whatsoever to have more than one partner and to take a more open approach in terms of the opportunity of payments in education. Then we have the issue of Bemacash, and it's very much the same as with education. So we are progressing very well in terms of what we call the unlocking of value of Bemacash. So as you all know, we already made the product agnostic in terms of devices, which is something very good.

We have launched in the second quarter as well, and this is news, we launch the version that runs in PC computers, which for Brazil is something that is important. One of the problems of the software for micro retailers is exactly where they will run -- where the clients will run the application. And many, many times, they want to run in a regular PC So now we have this option as well for clients. But on the other hand, we continue to look for a partner that will take charge of the distribution, which we believe is the most important challenge that we have in terms of the Bemacash.

In any case, we have restructured the distribution, the organic distribution platform of Bemacash. And I can say to you that we have had, in the second quarter, the best quarter

in terms of gross additions of new clients for Bemacash. It is still not something very significant. But in terms of comparing with the past performance, it is going better than it was before.

Then we move to the second bucket, main bucket, which is credit. And as we have been saying, here, the opportunity clearly is for us to get into the relationship between clients and suppliers. And there, we see the opportunity for partnerships. So we are discussing these with a few company.

And I think that we will have news in the coming months, maybe in the coming weeks, let's see. It does not depend only on us. And the third opportunity is the one with payroll credit, payroll anticipation, and it's very similar to the opportunity with credit. So we are -- as we speak, we are discussing with many different possible partners.

There, we don't see the necessity to have just one partner. We are taken a more open approach. So again, it is a matter of maybe a few weeks for us to have something to show, but we have to wait a little.

Cesar Medina {BIO 16600229 <GO>}

Thank you.

Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you.

Operator

(Operator Instructions) Our next question comes from Guilherme Haguiara, Bradesco BBl.

Guilherme Haguiara {BIO 18467376 <GO>}

Good morning. And thanks for taking my questions.

My first question is on the recurring revenue side. We find it encouraging to see your comments about how across-the-board the improvement was, but we were just wondering, what are the further strategies to keep up with this pace of growth, of double-digit growth, seeing the magnitude of your base already? And how is the performance relating to new clients being acquire? And also, how the cross-sell in your existing customer base is doing? That will be my first question.

Dennis Herszkowicz {BIO 17998338 <GO>}

Thanks, Guilherme. This is Dennis again.

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Look, we have been encouraged by the results that we delivered so far in the year. So we have been able to deliver the double-digit in the first, and we have accelerated a little more in the second. And as I said in the Portuguese call for those that were listening there, every time that you raise the bar, of course, the next year becomes more challenge in. The next quarter becomes more challenging.

So as I was saying to Fred before, when you have to grow 12% over 100, in absolute terms, it's 12. When you have to grow again 12% over 112, in absolute terms, it's a little more. So of course, it is more challenging, and we already have a huge client base and a very large recurring revenue base. But again, I think that we are taking the approach of one quarter after the other, and so far, we have been able to do that.

We will work as hard as we can, as we have been doing, to continue to do that, but I cannot guarantee that we will do what we did in these 2 quarters. The encouraging news is that, as you said, it is across the board. So in terms of segments, in terms of regions, in terms of subscriptions versus maintenance and license, I mean, we have been accelerating in all these different dimensions, which means that also, in terms of new clients compare to additional sales to existing clients, it is the same situation. We continue to have much more sales to existing clients simply because the client base is so big.

But we have been able to accelerate growth and sales to both of them, existing clients and new clients. And again, this a healthy sign for us, and we believe that if we are able to keep this type of performance, of course, it's going to be easier for us to sustain this double-digit, but we cannot guarantee that.

Guilherme Haguiara {BIO 18467376 <GO>}

Okay. That's very clear.

My second question, more on the nonrecurring side of the business. We saw some strong growth for your license revenue in the quarter, and we appreciate your comments on increase sales volume since the beginning of the year. But we just want to get a better color on what were the main factors benefiting this line. I mean what type of clients started buying more licenses? How do you see this evolving with the potential better sentiment in Brazil for the second half? So what can we think of when talking about licenses?

Dennis Herszkowicz {BIO 17998338 <GO>}

Sure.

That's a good question. Look, in terms of licenses, there are 2 -- more than 2, but I would comment on 2 specific things. First, we have restructured a little our large enterprise area here. And the performance there has improved compare to past years.

So this large enterprise, which was previously, call it, private, here, we have made this large enterprise unit much more aggressive in terms of sales, of getting new clients and in

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increasing the share of wallet of the existing clients, which is a change in the behavior. Because in the past, what was called the private was much more focused on a kind of different, let's say, more upscale type of catering to the clients, let's say. And right now, we have in addition to this taking care of the clients, we have also put in place more aggressive sales targets. Unfortunately, results are coming from there, so this is number one.

The second is that manufacturing for us, which is a very relevant, actually the most important segment that we still have here, is a fragment in which the license model, the maintenance model is still strong. And we have had a very good performance, a very good acceleration in manufacturing. So it's an additional factor that helped us to have these strong results in licenses. And talking -- what was the second point? Guilherme, can you remind me?

Guilherme Haguiara {BIO 18467376 <GO>}

Sure.

I mean I think you touched a bit upon the client profile, but also, how do you see this line perform in the second half, if not the macro itself but at least the sentiment becomes more positive in Brazil with the reforms progressing? Should we expect the model to accelerate?

Dennis Herszkowicz {BIO 17998338 <GO>}

Look. It's difficult to say right now, but what we are seeing, and this was reinforced during the Universo TOTVS, was that clients have come to the conclusion, at least the ones that we spoke to during the event, they have come to the conclusion that, unfortunately, they have not invested enough in technology in the last few years. So it was not -- it was actually a surprise for them as they told us to see that TOTVS had invested so much in innovation in the last few years, and had so many different products and innovation there at the event. So this is actually the most important results of the Universo TOTVS.

The perception by clients, the vast majority of the clients that were there, that they are lagging a little in terms of investments in technology, which obviously for us is something that is good and does not necessary depend on the economy performing better. So I believe that we have, let's say, a good perspective in terms of clients trying to close the gap, in which they go up in the last few years. Let's see.

Guilherme Haguiara {BIO 18467376 <GO>}

Okay.

Thanks that's very clear.

Dennis Herszkowicz {BIO 17998338 <GO>}

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Thank you. Guilherme.

Operator

This concludes the Q&A session.

I would like to invite Mr.Dennis for his closing remarks.

Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you all. I want to say a special thanks again to all the stakeholders here especially all the employees of TOTVS, the ones that we call TOTVERs. The quarter was a very, very good quarter, and actually, the semester was a very strong semester for us.

And it is on their performance and their work and their commitment that we deliver this. So I would like to thank them all. And also, thank the clients, thank the Board, thank the franchisees, very, very important for us. And their performance in this quarter and this semester was a very relevant contribution to the performance of the corporation.

So again, thank you for the confidence in the company and participating in the call. Have a wonderful day. Thank you.

Operator

This concludes TOTVS conference call for today.

You may disconnect your lines. Have a nice day and thank you for using Chorus Call.

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