Q2 2017 Earnings Call

Company Participants

- Douglas Furlan, Investor Relations Manager
- Gilsomar Maia Sebastião, Chief Financial Officer/ Investor Relations Officer

Other Participants

- Diego Aragão, Analyst
- Fred Mendes, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to TOTVS conference call to discuss the results of the second quarter of 2017. Today, we have with us Mr. Gilsomar Maia, CFO; and Douglas Furlan, Investor Relations Executive Manager.

Note that all participants will be on listen-only mode during the presentation. After the presentation, we will start the question-and-answer session for investors and analysts when further instructions will be given. The audio is being simultaneously webcast at ir.totvs.com.

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 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 therefore depend on circumstances 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 these results to differ materially from those mentioned in such forward-looking statements.

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

Gilsomar Maia Sebastião

Good morning, everyone. Thank you for participating in our conference call. I'd like to start the call on slide 3 where I'll talk about the artificial intelligence platform, Carol, and all the steps taken to promote digital transformation among our clients.

Launched on June, Carol is designed to improve ownership of client data and extend the analytical capacity and speed of decision making process in the face of a growing volume of information. Carol will also service a virtual assistant, answering questions and offering business insights. Using Deep Learning techniques, Neural Networks and Machine Learning solutions, Carol already offers applications for the retail and education sectors.

For Retail the first application was developed together with the Bemacash team using sales data captured through this Internet of Things device and providing clients with information to help them in sales forecasting and product pricing. In Education algorithms that are using internal and external information such as social networks were developed in Carol to measure the risk and financial impact of the school dropouts while also recommending actions to mitigate this risk.

Carol is now part of our portfolio as a platform, already integrated with our industry management applications as well as with ERP, HR, and productivity and collaboration platforms. Over the past year, the teams working the development of these applications and platforms hired data scientists who are developing algorithms in Carol which are being embedded into the industry vertical applications, mainly with the participation of clients.

Moving to the second recent event of the quarter, on July 31 the board of directors approved the distribution of interest on equity related to the first half of 2017 in the amount of BRL 32.9 million, equivalent to about BRL 0.20 per share. The said interest will be paid on October 6 to shareholders of the company as of August 3.

Now, I'll start my comments on Q2 results on slide 4. In order to maintain comparability, the pro-forma consolidated figure of the 12 months ended in Q2 2016 also include Bematech's results. Net revenue this quarter grew 1% year-on-year, resulting from the 8% growth in recurring revenue and the 10% drop in non-recurring revenue with recurring revenue accounted for two-thirds (00:04:29) of the total net revenue in the quarter or 4.3 percentage points higher than the second quarter 2016.

In the last 12 months, recurring revenue increased its share of the total net revenue by 5.4 percentage points. When analyzed by business on slide 5, we see that the growth in software and hardware positively impacted the year-on-year growth in revenues. In hardware, the year-on-year growth of 3.5% was driven a 9% growth in sales of non-fiscal solutions, which accounted for 75% of hardware revenue in the quarter and more than offset the 7.6% decline in sales of the fiscal hardware.

The growth of non-fiscal solutions is a consequence of the company's strategy to offer solutions that combine software and hardware and collaborate towards a more efficiency management of its client's business making them increasingly competitive in their business segments. The transition of fiscal solutions before exclusively non-recurring also creates opportunities for the growth of recurring software revenues. In services, a quarter-on-quarter variation reflects the declining software implementation services at large clients mainly due to the drop in license sales in previous quarters.

In the year-on-year comparison, the variation was also due to the 21.4% decline in services not related to software implementation, reflecting the lower sales of consulting services since the second half 2016 and the sale of subsidiary, TOTVS RO, in August 2016.

Software revenue in Q2 grew 6.6% year-on-year or 3.7 percentage points higher than the growth in the last 12 months, resulting from the combination of 1% growth in the licensing module, which includes license and maintenance revenues and the 36% growth in subscription that I will now comment on slide 6.

The licensing module moved from 84% share of software revenue in Q2 2016 to 80% this quarter. This drop is a consequence of lower license sales and factors that also negatively affected maintenance revenue such as delinquency, contract reductions, and the decline in inflation especially in this quarter, measured by IGP-M accumulated in the last 12 months.

Subscription revenue accelerated the year-on-year growth for the sixth consecutive quarter and accounted for 20% of software revenue, up 4.4 percentage points from Q2 2016. In the last 12 months subscription revenue grew 30%. This growth in subscription was essentially due to the growth in the number of the small and medium clients under TOTVS Intera model in the last 12 months. Note that Intera sales in June did not affect subscription revenue in this quarter. Since, in this model, the first billing is made in the month following the sale, but has already affected the ARR from subscription as I'll explain on the slide 7.

ARR or annual recurring revenue grew 42% in Q2 reaching BRL 304 million, a net addition of BRL 23.3 million from Q1. ARR measure the evolution of recurring revenue for the next 12 months based on contracts signed until the end of the period. Apart from Intera sales, ARR in the quarter reflected the migration of 27 maintenance clients to subscription, Fly01 and Bemacash sales in recent quarters. In Q2, we sold 1,093 new Bemacash units which will become software clients as of the 11th month of contracting the solution when they'll start paying for the software subscription.

I'll now hand over the presentation to Douglas, who'll comment on software results on the slide 8.

Douglas Furlan

Thanks, Maia. Good morning, everyone. Software contribution margin dropped 100 basis points quarter-on-quarter. This variation was chiefly due to the increasing software costs, which reflected the share of complementary solutions provided by partners in the sales and the stability of R&D expenses, which were already impacted by the provisioning curve of profit sharing in the period.

On slide 9, in the year-on-year comparison in the last 12 months, services contribution margin declined, essentially reflecting the lower allocation of services professionals due to the lower sales of projects and the wage increases in the last 12 months which were not fully transferred to services prices.

On slide 10, hardware gross margin grew 430 basis points year-on-year and 250 basis points in the last 12 months. The growth year-on-year and in the last 12 months is mainly due to the combination of price adjustments and the effects of exchange rates on costs. The year-on-year growth in hardware contribution margin was lower than the gross margin growth, essentially reflecting the reduction of government subsidies in the quarter. This reduction in subsidy was due to the change in sales mix and the reduction in presumed ICMS credit calculated in the quarter, due to the higher increase of hardware components acquired when compared to the sales growth.

For comments on the main selling and administrative expenses please move to slide 11. In Q2, selling expenses and commissions jointly increased their share of net revenue year-on-year, mainly reflecting the change in sales mix between franchises and own units, and the higher volume of softer sales in the subscription model. Compared to previous quarter, the decline in the share is mainly due to the drop in licenses.

G&A plus management fees and other expenses reduced their share of net revenue quarter-over-quarter. This decrease is mainly because of the reversal in the amount of BRL 4.3 million of the provision for contingencies related to the payment of PIS and COFINS made through judicial deposits by Bematech due to the inclusion of ICMS in the calculation base of this contribution. This reversal follows the recent Federal Supreme Court decision determining the exclusion of ICMS from the calculation base of PIS and COFINS.

Advertising and marketing expenses corresponded to 2.4% of net revenues in Q2, as against 2.2% in Q2 2016, because the growth in net revenues was lower than the wage increases and adjustments in contracts with suppliers. Compared to Q1, the share increase is mainly due to the seasonality observed in the marketing investments.

On slide 12, adjusted EBITDA in Q2 amounted to BRL 82 million and adjusted EBITDA margin was 14.9%. The quarter-on-quarter decline in adjusted EBITDA and adjusted EBITDA margin was due to the lower software results in the period, mainly caused by the reduction in license revenues because of the incremental revenue from corporate model charged in Q1. Year-on-year, the decline in adjusted EBITDA was essentially due to the reduction in services results and the increase in selling and administrative expenses.

On slide 13, the steeper year-on-year decline in adjusted net income than in adjusted EBITDA chiefly resulted from the increase in depreciation and amortization expenses, especially due to the start of asset depreciation of the company's new headquarters in São Paulo and the higher share of negative financial results over EBITDA in the period.

I now return the presentation to Maia to comment on cash flow and debt on slide 14.

Gilsomar Maia Sebastião

Net debt corresponded to 1.3 times adjusted EBITDA in the last 12 months, remaining unchanged from Q1. Free cash flow was 9.7% higher than in the previous quarter, especially due to the increase in operating cash generation. Despite the increase in free cash flow, gross cash decreased quarter-on-quarter mainly due to the payment of the interest on equity and dividends in the second quarter. Year-on-year free cash flow grew 34% as a consequence of higher operational cash generation and less cash used in investing activities.

I will now move to the slide 15 for the closing remarks. In this quarter, software revenue accelerated its year-on-year growth to 6.6% or 3.7 percentage points higher than the growth in the last 12 months, boosted by the acceleration in subscription for the sixth consecutive quarter. Subscription revenue grew 36% year-on-year and already accounts for 20% of total software revenue. Annualized recurring subscription revenue grew 42% in Q2 and exceeded BRL 300 million, which already corresponds to 30% of the maintenance revenue of the last 12 months.

Non-fiscal hardware solutions solution grew 9% contributing to one more quarter of year-on-year growth in total hardware revenue. Moreover, some of these non-fiscal hardware solutions, such as Bemacash, played the role of Internet of Things device, capturing data used in the development of artificial intelligence algorithms in applications.

Despite the instability of the Brazilian environment, companies have been looking for smarter solutions that help them to become more competitive and to make faster and more assertive decisions. That's why we remain committed to promoting digital transformation among our clients through specialized business solutions and platforms for productivity, collaboration, Internet of Things, and now artificial intelligence with Carol. We are also committed to achieve our goals for the year, both in subscription growth and EBITDA.

We are now available or the questions-and-answers session.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Diego Aragão, Morgan Stanley.

Q - Diego Aragão

Hi. Good afternoon, guys. Thank you very much for taking my question. So, look, if we would separate your business, the traditional license sale and the subscription business model, should we think that maybe the competitive landscape is different among those two segments? Thank you.

A - Gilsomar Maia Sebastião

Hi, Diego. This is Maia speaking. Actually, no, what we have, we have some new offerings made to different markets as Bemacash for example, that's a new initiative, and coincidentally that is a solution that born under the subscription model in a pure SaaS concept. So, it's a cloud and subscription solution.

For that solution specifically, we have a completely different market of microenterprise and the competitive landscape is completely different. Actually, there is no dominant player in this part of the market. The competitive landscape is based on very, very small players. Actually, TOTVS with Bematech is the only player that can be the full provider of a commercial automation solution.

And when we talk about our main market of the small and medium business, actually, we face those names we've been talking about for all of our interactions and everyone in this market is moving in this direction of subscription, of course, each one in different ways and different manners, but everyone is moving to cloud, subscription and so on.

Q - Diego Aragão

Okay. Perfect, Maia. Thank you very much. So, another question if I may regarding the subscription business model. Once you achieved, let's say, the breakeven with your customer, what kind of profitability, what kind of margin could we expect from those customers? Thank you.

A - Gilsomar Maia Sebastião

This model has an implied characteristic that in the beginning, if you make a kind of isolated cash flow, actually in the beginning we have some cash burden, because we spend more money than we make with that client. And retention, of course, is one new metric in that case. Even in our traditional license model, maintenance has been always the most profitable revenue stream that we have.

In subscription, this case is not different, but it becomes even more relevant in terms of profitability. It depends on solution we sell and the profile of sales with specific clients – through specific clients. But you are right, after some months, we reach a kind of breakeven with that client, and from that point on, we have a much, much more profitable condition.

Talking about the company in general, we see that in this transition, we have beginnings more pressure in terms of cash flow generation and consequentially margin. But in the future, conceptually speaking, the company would be able to even present better performance of profitability and margin than it's used to present before that transition to subscription.

Q - Diego Aragão

Okay. Perfect. Maia, can you just remind us when exactly you reach the breakeven? I mean, how much it takes for you to reach the breakeven with those customers?

A - Gilsomar Maia Sebastião

Actually, Diego, we haven't disclosed that to the market because it's a very strategic data for competitors, because it can help people to make change in their pricing process in order to create some constraints for competitors. And it changes a lot depending on the solution we are talking about and the profile of a client and the usage that client will make, but it takes months actually. It takes months to reach that point, okay.

Q - Diego Aragão

Okay. That's fine. Thank you.

A - Gilsomar Maia Sebastião

You're welcome.

Operator

Our next question comes from Fred Mendes, Bradesco.

Q - Fred Mendes {BIO 17221617 <GO>}

Good afternoon, everyone, and thanks for the call. I have two questions. I mean the first one, I mean, looking at the costs and already 2018, can we expect an improvement considering that you are doing the integration of Bematech and I guess this also impacted this quarter? So, I mean, looking ahead next 12 to 18 months, how should we expect this line? That was the first question.

And then, the second one, when you look at the top line, how do you see the maintenance revenue for the next quarters and even in 2018, considering that IGP-M continues to fall and it seems that you do not have seen a change in the churn yet? And of course as a follow-up, if you have seen any change in the churn, I guess, in July already? Thank you.

A - Gilsomar Maia Sebastião

Hi, Fred. I will start from the second question related to maintenance. Just to recap to everyone, maintenance, normally I used to say that maintenance has two main variables that explain the behavior of that revenue stream. The first one is the churn that impacts the starting point of this recurring revenue. This quarter, when we annualize our churn, it was slightly higher than we saw in previous quarter. It was a little bit above 9% when we annualized that. Also, it impacts in this composition of maintenance as the first variable I'm listing now.

The second one is the inflation update, and as you mentioned, IGP-M, that's the main inflation index used in our installed base has strongly declined in the recent months. Actually, in this quarter, we have like two months of negative IGP-M index. So, one year ago, IGP-M was running like 10% in 12 months and now it's running below 2%. So, it gives you how strong was that a drop and actually I don't see today any relevant signals of recovery of that index to be frank.

And the third variable is the new flow of new contracts coming from license sales, and we can observe the behavior of license sales in recent quarters. So, putting all together, our expectations, of course, it's hard to make predictions in this moment of Brazil; all kind of projections are complex. Of course, internally, we work hard here to reduce the churn. But it's true that part of that churn comes from an external [indiscernible (00:23:56) that we do not completely control, like delinquency and even indirectly unemployment rate also can impact part of our maintenance churn. But as much as we can, we try to be closer to our clients and work on this retention rate and trying to reduce as much as we can the churn. So, in our plans here, we are working to reduce churn.

Second part, related to IGP-M, that's a variable that we do not control – completely we do not control. It's hard to create expectations here of an increase in the index; on the other hand, what is positive. So, we can count on this scenario of a low – very low IGP-M to the rest of the year and we can take our measures here to have a more hard control over costs, trying to push down some expense. So, it's part of our daily operations.

And the last one related to license. So, based on the last two, three recent quarters, we saw some slight positive signals of recovering license. But I have to confess that license tends to become even more difficult to predict, because as subscription model evolves, it tends to drag small and medium opportunities among the small and medium firms toward subscription model and then the remaining opportunities – and the license model tends to become even more concentrated among large enterprise. And this kind of account has a longer sales cycle. It takes some more complex decision process from the client side and it becomes even more complex to make – to have a very assertive conversion rate, especially in terms of timeframe when the accounts are going to be closed.

And – but as we have talked to you guys in previous quarters, we don't believe that license – since we have a very weak base for comparison in terms of license, we don't believe license is going to decline in the same way we had in the last two years for example. And depends on how the market evolves. We have a chance to see some small, very low rates of growth in license for this year, what can be positive also for maintenance as a consequence.

Talking about the first question related to cost, we are very focused in our plans of integration with Bematech. This year, we are working hard to put all of the process and systems in the whole Bematech operation, so it will give us more possibility to have a more linear processes and also to be able to extract some synergies for next years.

So, 2018, based on our plans, we will be running both operations in the same platforms in the same solutions, observing the same process. And it gives us more opportunities to have a lower pressure in this cost line and as a consequence extract more synergies since we see subscription evolving strongly and it creates good perspectives for cost dilution, too.

Q - Fred Mendes {BIO 17221617 <GO>}

Perfect. That's very clear, Maia. Thank you.

FINAL

A - Gilsomar Maia Sebastião

You're welcome.

Operator

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

A - Gilsomar Maia Sebastião

So, I'd like to thank you all once again for participating in this conference call. And I'd like also to kindly ask the analysts to update their projections available on new agencies like Bloomberg and Reuters because we realize that the few projections available on those new agencies are really not updated and sometimes people can have a impression that these results we released are far from projections and we haven't seen that comparing to the reports issued by the analysts. So, once again, thank you very much for your participating and have a good day. Bye-bye

Operator

That does conclude TOTVS' audio conference for today. Thank you very much for your participation. Have a good day. And thank you for using Chorus call.

Bloomberg Transcript