Q3 2018 Earnings Call

Company Participants

- Gilsomar Maia Sebastiao, Chief Financial Officer
- Juliano Tubino, Vice President of Business and Digital Strategy
- Sergio Serio, Investor Relations Manager

Other Participants

- Eric Wolf

Presentation

Operator

Good morning and welcome to TOTVS conference call to discuss the results of the third quarter of 2018. With us today, we have Gilsomar Maia, CFO; Juliano Tubino, Vice President of Business and Digital Strategy; and Sergio Serio, Investor Relations Manager.

Note that all participants will be in listen-only mode during the Company's presentation. After the presentation, we will start the Q&A session for investors and analysts, when further instructions will be given. (Operator Instructions) The audio will be 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 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 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 results to differ materially from those mentioned in such forward-looking statements.

I'll now turn the call over to Mr. Tubino, who will begin the presentation. Please go ahead.

Juliano Tubino {BIO 20575696 <GO>}

Good morning, everyone. Thank you for participating in our earnings conference call. I will begin the presentation by commenting on the main recent events starting on Slide 3. Taking one more step forward in the Bemacash strategy, that we started last year with the projects that involves smart device design, software innovation and integration with means of payments.

In October, we launched the Bemacash Smart POS. Using the same software platform already available in the Bemacash tablets, the Bemacash Smart POS is a complete solution for point of sale that contains cloud-based financial management software with sales inventory and accounts receivable control, artificial intelligence solution that help the business owner in pricing, sales forecast and other business insights, as well as receipt printing and integration with means of payments. Develop is the micro and small businesses in mind. The combination of management technology and use of payments enabled control of sales and management of the business from end-to-end, from anywhere or any device, including smartphones. Following the same distribution model of the Bemacash solutions. The entire Bemacash Smart POS sales process will be supported by TOTVS Store, whether the customer buys directly or through the Bemacash channel, we will be providing a 100% digital purchase experience for them. With that, we want to provide small business, besides a solution that integrates smart devices. POS software, end means of payments. We also want to offer business management and artificial intelligence solutions. Therefore, broadening the access to technologies that until were only available to large enterprises.

Moving to Slide 4. We are also celebrating iDEXO one-year of operations. With an operating model focused on connecting startups, entrepreneurs and developers to customers in the pursuit of innovative business solutions. iDEXO already has 30 startups actively engaged with us in business development. Integrating to our portfolio solutions from fintechs such as payments receivables collection and digital currencies and also Industry 4.0 retailtechs and back office.

We will be increasing our ability to take innovative solutions to our base customers. By the year-end, the community will have 45 high growth startups under a revenue share model, also note that all the startups iDEXO community will have their solutions sold directly by top stores. Therefore, increasing our portfolio of solutions that will be purchased and contracted digital.

Evolution of iDEXO operations will enable the institute to increasingly become a major incubator of the new cooperative venture model in Brazil. Especially for TOTVS, expanding the Company's capacity in its future initiatives that are focus on innovation, business and product development.

Now I will hand over the presentation to Sergio Serio, who will comment on revenue performance in the quarter starting from Slide 5. Sergio, please go ahead.

Sergio Serio

Thanks, Juliano, and good morning, everyone. Software revenue was the key driver of growth in total net revenue, growth of the 2.6% quarter-on-quarter growth and the 4.8% year-on-year growth. As we can see on Slide 6, the quarter-on-quarter growth in software revenue was mainly driving by the 21.8% growth in license revenue. This growth is essentially associated with the higher share of sales to large clients in the period. Positively impacted by the increase in the IGP-M and inflation index in the last 12 months, the growth in maintenance revenue was more factored that contribute the growth of software revenue in the period. In the year-on-year comparison, it's worth highlighting the

26.7% growth in subscriptions revenue, that combined with license and maintenance in revenues growth drove the 4.8% growth in software revenue during the period. Note that this quarter for the first time subscriptions revenue surpass the barrier of BRL 100 million. This is an important milestone for the Company in the transitions through the subscription model.

As shown in the graph on the left in Slide 7, despite the growth in license and maintenance revenue represented by the blue bars in the graph, subscriptions revenue has consistently increased its shares of software revenue over the quarters and has other which is 25% of the revenue line. In third quarter 2018, thanks to the higher number of clients addition, especially in the TOTVS Intera model, subscriptions revenue grew 2.9%, surpassing the BRL 97.2 million in the previous quarter, reaching the BRL 100 million already mentioned. Annualized recurring revenue from subscription shown on the right chart of the slide, total BRL 444.9 million, up 4.5% quarter-on-quarter and 33.2% year-on-year. And essentially due to the higher volume of sales of products with lower average tickets related to the strategy of management and business open platforms, such as Fluig and GoodData and the cancellations of Bemacash due to the defaults on the units sold before second quarter 2018, when the sales model was changed.

Moving to Slide 8. The year-on-year reduction in adjusted contribution margin from software is due to ramp up in the research and development reflecting the new investments in innovation and the FX rate impact on TOTVS Labs structure. The additional Support costs to meet higher demand from clients added in the period and new regulations that took effect in 2018, such as e-Social, whose compliance deadline was extended and the increase in software costs due to the increase in sales of partners' solutions

The quarter-on-quarter reduction in adjusted contribution margin from software is mainly due to the increase in R&D which apart from the reason mentioned above also reflects the salary adjustments resulting from collective bargaining agreements in several regions where TOTVS operate, which represents around 20% of the total R&D payroll.

Regarding services on Slide 9, adjusted contribution margin from services were 110 basis points compared to third quarter 2017. As mentioned in previous quarters, the growth in services revenue continues to reflect the higher pace of sales of services registered in recent quarters. If you take the last 12 month at the base for comparison, the 1.8% decline in cost of services is due to the restructuring carried out during the second half of 2017. This reduction coupled with sales leads to a margin of 5.8% in the last 12 months of 2018, which is 320 basis points higher during the same period last year.

Moving now to Hardware on Slide 10. Adjusted contribution margin from hardware decreased by 300 basis points in third quarter in 2018 from third quarter 2017 and by 470 basis points quarter-on-quarter. As already reported in previous quarters, this reduction reflects the lower pace of fiscal printers sales, whose margin are higher due to the change in the tax law in several Brazilian states replacing the fiscal printer with other solutions, such as S@T in Sao Paulo and electronic invoice in other states. Comparing the last 12 months, apart from the aforementioned reduction in hardware revenue caused by the decline in sales of fiscal solutions, the decrease of 580 basis points in adjusted hardware margin was due to the increase in R&D expenses in the period. This increase is related to the effect of FX rate in relation to the R&D teams based outside Brazil and investments in development of the new BemaGo platform designed for smart device for the Internet of Things.

Moreover, in the third quarter 2018, Bemacash sales totaled 672 units compared to 691 units in second quarter 2018. The maintenance of Bemacash sales volume is due to the changes made in the sales model in the second quarter 2018 to simplify the purchase process and reduce defaults inherent to this market segment. Also worth noting that since April 2018, purchases using the Brazilian taxpayers ID number, CPF are made exclusively with credit card through the TOTVS Store.

I now hand over the presentation to Maia, who will comment on selling and administrative expenses on Slide 10.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Thank you, Sergio. Good morning, everyone. The 0.2 percentage point variation in selling and commission expense in the quarter is mainly associated with the performance of license fees in the period. Year-on-year, this expense went from 17.3% to 16.2% mainly due to the reduction of recurring personnel costs in Q4 2017. and dilution by the growth of software revenue, and also by the deferral of variable compensation as a result of IFRS-15. It's important to note that the level of these expenses in the quarter is lower than that observed in the last 12 months, which also dropped comparing to the same previous period. Regarding general and administrative expense, management fees and other expense, the reduction of 0.8 percentage points from second quarter 2018 is related to the integration of Bematech's administrative operations concluded in Q4 2017. And the lower provision for conclusions in this quarter due to the progress of lawsuits in the period.

Here, it's also worth mentioning that in the last 12 months this line of expense fell 1 percentage point and was trailing to focus on cost control. And concluding with the allowance for doubtful accounts, which remained at 2% of net revenue, the same level as in second quarter in the last 12 months. This quarter is still high level of the folds was worsen it by our large accounts that entered in judicial reorganization.

Now to talk about EBITDA, please go to Slide 11. As clearly seen in the chart, the quarter-on-quarter growth in EBITDA was due to the increase in software result, net of selling expense and combined with the decreasing highly results in the administrative expenses and adjusted EBITDA grew 43.7% rising from BRL 62.3 million to BRL 89.5 million, due to the increase in software result and the decrease in selling and administrative expenses in the period. In the last 12 months, apart from the factors just mentioned, it's worth noting the growth in services result. In this period, adjusted EBITDA totaled BRL 341 million, up 15.6% growth and margin was 14.9%, representing an increase of 160 basis points from the same previous period.

Moving now to Slide 13. The performance of the EBITDA combined with the reduction in depreciation and amortization expense and a lower effective tax rate led to 39% growth quarter-on-quarter in net income. In the year-on-year comparison, the 83.5% growth in net income was driven by EBITDA growth, since the reduction in amortization expense related to intangible assets arising from M&As was more than offset by the effective tax rate.

Now move to Slide 14 for comments on cash flow and debt. Free cash flow generation grew 52% year-on-year, mainly due to be 215% increase in EBIT and the reduction in working capital. Quarter-on-quarter free cash flow grew 27.3%, due to the reduction in working capital and accounts receivable and tax recordable, and the lower income tax and social contribution paid. Moreover, despite a payment of dividend as an interest in equity this quarter reflected in financing activities. Net debt declined more than 70% year-on-year and 51% quarter-on-quarter, this decrease led to a net debt to adjusted EBITDA ratio of 0.3x in the last 12 months, the lowest since the merger of Bematech in Q4 2018.

Moving now to Slide 15, for the closing remarks. During today's presentation, we saw that 3 years after we started the migration process to the subscription model in spite of an economic scenarios is still in a recovery stage, the results show that the Company has reached a turning point with growth acceleration in revenue and EBITDA margin increase. The last 12 months view makes this trend even clear the adjustments made to the cost infrastructure combine it with the growth in software revenue, especially by a 32.5% growth in subscription led to a 15.6% growth in adjusted EBITDA. In addition, the financial position has also presented significant improvement with free cash flow generation 52% higher led to a net debt declining by half year-on-year, reaching 0.3x EBITDA with the lowest level since the transition process is started. To sum up, TOTVS is increasingly better prepared for new growth cycle.

Now we are available for the Q&A session.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) Our first question comes from Eric Wolf (ph) with Hulk Reach (ph).

Q - Eric Wolf {BIO 18716316 <GO>}

Hello, congrats on the solid performance in a tough operating environment. Quick question, I think there might be a problem with the line, because I can't hear any response, but I was curious if you could talk just a little bit, if you can clarify the effective tax rate going forward?

A - Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Okay. This is Maia speaking, Eric. Thanks for the question. Actually in this quarter, the effective tax rate was really affected by the interest on equity we paid. On an annualized base, our effective tax rate is running about 26%, if I'm not wrong. Comparing to all historical rates, we see that this ratio of 26% is -- a little bit is like -- is like a both our our recent results and previous years. We still have the second half results that could be part of these interest on equity calculation. And as a consequence, it can complement our dividend payout for the full year figures. And as a consequence, it can grow some incremental reduction in our effective tax rate for the year. In the long run, we don't have a guidance of effective tax rate and that's probably, the statutory rate in Brazil is about 34%. So we see the Company is still by far from that level, especially taking into consideration the benefit from these interest on equity and also the benefit we have as a kind of tax shield from our research and develop investments. Am I clear in my explanation?

Q - Eric Wolf {BIO 18716316 <GO>}

Yes, still -- so that you clear the 26% is the year-to-date effective tax rate and there is a possibility it drops lower based on the various factors affecting Q4. Is that -- or 26%, was your thought that what it will be for the full year?

A - Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Yes, that's right.

Q - Eric Wolf {BIO 18716316 <GO>}

Okay. Got it. Switching gears, I don't know if somethings you've discussed before, but especially given it sounds like your outlook for the business were past the elections, you are almost in a net cash position at this point. Any thoughts, given the valuation, which as we've discussed is well below kind of anything and just about any other geography that exists in software. Any thoughts on potentially deploying capital for share buybacks?

A - Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Eric, in terms of market, you're right. So this pre-election period that came up to the end of October was a very, very tense moment in the whole country and it made business people in general to hold most of their actions in terms of investment plans. And so far, we haven't significant change comparing to these figures, we are presenting this for the quarter. Personally, we have some positive expectations for the end of this year and then especially for the beginning of the next year. So it seems to have a positive expectation about the next government. Of course, it has to be converted into reality business on the practical measures of this new government. But it seems that the business environment is a little bit more optimistic for the new future. It can be favorable for our performance in general and then be more objective to a question about buyback shares. It's always a possibility, considering the tax legislation in Brazil, I confess that it's never the first one, because we understand basis on the tax should provoked by the interest on equity. And secondly dividends, they are not taxable in Brazil. We have the higher priority, the payment of interest on equity dividends and then we can see share buyback as a clear alternative.

Q - Eric Wolf {BIO 18716316 <GO>}

Got it, okay. And then I know you have discussed as well, but ADR given just the continuing drumbeat of valuations that Brazilian companies listed in the US seems to get. I know there are different levels of ADR and to do kind of a level three, the one that's more complicated, maybe difficult. But any further thoughts on that as a way to make it easier for foreign investors to purchase shares?

A - Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Yes. So it's a subject we have assessed some years ago. Of course, in another context here regionally, so Brazil as we know in much better shape at that time and we are reassessing that possibility. You're right. So when we compare companies involved in a very similar process, we are pressing through here, they have relevant spread in terms of multiple comparing to our current multiples of valuation, it's a clear alternative we have here, especially, when we take into consideration our free float. So almost 90% of our free float is formed by foreigners, institutional investors based out of Brazil. And personally, I see as a very good possibility to work in the direction from ADR in a certain moment.

Q - Eric Wolf {BIO 18716316 <GO>}

Excellent, well congrats again on the good performance. Thank you again, sir. Thanks.

A - Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Thank you very much, Erik. Have a good day.

Operator

(Operator Instructions) I would like to turn the floor back over to Mr. Gilsomar Maia for his closing remarks.

A - Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

So I would like to thank you everyone again for participating in our conference call today. And reminding everyone that we are here available, our IR team is always available to help you in any question you have additionally to those made here and I deserve -- I really wish to everyone a very good day. Thank you very much. Bye-bye.

Operator

That does conclude the TOTVS conference call for today. Thank you very much for participating. Have a nice day and thank you for using Chorus Call.