

Q3 2013 Earnings Call

Company Participants

- Alexandre Dinkelmann, EVP of Strategy and Finance and IR
- Gilsomar Maia, Corporate Finance Officer

Other Participants

- Carlos Sequeira, Analyst
- Fabio Levy, Analyst
- Marcelo Santos, Analyst

Presentation

Operator

Good morning. Welcome everyone to the TOTVS' Third Quarter 2013 results conference call.

Today with us we have Mr. Alexandre Dinkelmann, Executive Vice President of Strategy and Finance, and Mr. Gilsomar Maia, Corporate Finance Officer.

(Operator Instructions)

Before proceeding, we would 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 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'll 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' Third Quarter 2013 results conference call.

I'd like to start on slide 2, talking about the new financing lines hired from the national banks for economic and social development, BNDES amounting to BRL659 million. Of this total, BRL597 million will come from the line called PROSOFT for funding the research, development, and marketing of TOTVS solutions.

This line bears interest at 1.5% per year plus long-term interest rate, TJLP, which is currently at a nominal rate of 5% per year.

BRL59 million will come from the financing line called PSI, with interest of 3.5% per year for funding the research, development, and marketing investments of our agnostic platform Fluig for process, collaboration, and identity management. And the remaining BRL3 million will come from the social credit line, which bears TJLP in order to finance investments made by the Institutes of Social Opportunity, which is maintained by TOTVS and aims to support and monitor the employability of youth in need and people with disabilities.

Now, amortization will occur in 72 months with a grace period of 24 months for the principal amount amortization.

These lines establish funding for the already planned investments in innovation and specialization of TOTVS solutions, and also improves our capital structure efficiency and strengthens our financial capacity for inorganic investments.

Still on slide 2, we have Intelie as the winner of TOTVS Start it up, a contest of starts-up launched by TOTVS Ventures in April of this year. Intelie develops real-time data analytic solutions.

It's worth mentioning that the contest had over 1,100 starts-up enrolled. The winners award is an immersion of five days in TOTVS Labs in Silicon Valley, as well as a potential capital investment of BRL1.7 million by TOTVS Ventures. An MOU is signed with the Company and the due diligence process is underway.

I reinforce that TOTVS Ventures is the venture capital arm of TOTVS, which seeks to leverage the value creation through investments in high-growth potential companies that have relation to the core business strategy of TOTVS.

In addition to the contribution of financial resources, our differentiation is the creation of synergies between invested companies in our business ecosystem, from the standpoints of technology, solutions, and distribution, as well as approaching TOTVS to entrepreneurs with ideas that can further accelerate the innovation pace for our customers.

Going now to the financial performance on slide 3; net revenue grew 14% year on year, higher than the LTM growth and the last five-year CAGR. In the same period, license fee revenue grew 8%, mainly due to sales to existing clients, which grew 28.5% year on year.

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This growth came not only from the natural growth of our clients, but especially from our ability to offer additional solutions that meet their needs including the core ERP itself.

In the sales to new clients, the average tickets decreased 22%, when compared to the Third Quarter of last year, and increased 34% when compared to the Second Quarter of this year.

This quarterly variation of the average tickets comment[ph] about TOTVS and the average value reflects the average size of projects sold in the period. LTM average value is more stable, and reflects in a better way the market's behavior.

Our sales pipeline remains very consistent with a lot of opportunities, especially in industries that are service-oriented.

However, the sales cycle remains longer, especially the opportunities related to large clients, which affect our short-term visibility on the conversion rate of these opportunities into new sales.

Moving to service revenue, we had a growth of 15% year on year, also overcoming the growth in the LTM and the average growth of the past five years, showing that the increase in the service team's productivity is still ongoing.

Over the past 12 months, this revenue line increase was around 13%, also reflecting the strong growth in consulting service, e-learning, and services related to cloud computing.

Maintenance revenue remains strong, showing the high level of loyalty of the Company's client-base, which is composed mainly of small and mid-sized clients.

It's worth mentioning that the performance of this line is very important to keep our level for recurring revenue.

Now, on slide 4, we have the recurring revenue consisting primarily of maintenance contracts, software license leases, subscription, and cloud computing. Recurring revenue grew more than 30% in the quarter compared to the previous year.

For example, assuming that the Fourth Quarter of this year recurring revenue is equal to that of the Third Quarter, recurring revenue for the full year of 2013 would have grown 13.5% over 2012. In practice, the stability of the recurring revenue reflects the long-term relationship we have with our clients, allowing us to expand the solutions and service provided to them over time.

TOTVS will keep the specialization process of its solutions and its sales team, intensifying investments, both organic and inorganic in sectors and in regions with greater business opportunities in order to continue capturing the growth of the Latin America software market.

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Now I invite Maia to proceed from slide 5.

Gilsomar Maia {BIO 16400533 <GO>}

Thanks Alexandre. Good morning, everyone. Now, talking about costs and expenses on slide 5. The group of license cost, services cost in R&D have its participation of net revenue increased by 2.5 points in the quarter when compared to the previous year. About two-thirds of this increase are related to R&D, which has its increase as a percentage of net revenue mainly explained by the fact that these investments in innovation and specialization are in line with the plan for the year, unlike sales which are below the plans.

We are confident about maintaining our investments in R&D, even in a still complex macro scenario because of our medium and long-term vision about business opportunities related to technology is encouraging.

Another line that will [ph], as a percentage of net revenue was the cost of license, which represents the cost of solutions provided by partners. This growth is due to the expansion of the ecosystems of partners maintained by TOTVS, which is more important to convert opportunity to industry-specialized sales.

Most of this cost doesn't have the same relevance when analyzed with the recurring revenue.

Finishing this first group of cost, the cost of services decreased when compared to the previous quarter, having the gross margin of the quarter reached the same level of one year ago.

The Company reiterates that it will continue its efforts to gain efficiencies in its services operations, recovering from a below-than-expected performance in the first half of the year.

Going to the second group of expenditures in advertising, sales, commission and allowance for doubtful accounts, there was a decrease of 0.4 points as a percentage of net revenue when compared to the previous quarter and 0.7 points in the year-on-year comparison.

This change is mainly due to the reduction in participation of commission expense as a percentage of net revenues, which was affected by the sales mix in the periods.

This third group comprising G&A and management fees remains stable in the quarter and it has been decreased as a percentage of net revenue historically.

These efficiency gains over the years result from the combination of administrative efficiency managing the daily operations and integration of acquired companies. We

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understand that there is room for efficiency gains in this group and we will continue to pursue these gains.

Moving to the evolution of EBITDA on slide 6, for the first time in the history of TOTVS the quarterly EBITDA surpassed BRL100 million, totaling numbers BRL105 million in third Q 2013.

Moreover, when the decrease of margins, EBITDA for the last 12 months already exceeded in 4.5% the amount of the entire year of 2012. Here the history of the last five years help us to illustrate that margin swings in the short term may occur since investments in advertising and R&D are not capitalized and follow the medium and long-term planning contributing directly and indirectly to the revenue generation.

We will continue to seek increase in the Company's operating efficiency while keeping a strict cost management discipline. Given its target market and its continental presence on the ground, TOTVS has a business model that leads to margin expansion in the long term.

Moving to slide 7, net income reached BRL56.4 million representing 31% growth year-on-year. This growth was positively affected by a better financial result due to the lower gross debt and by the income tax reduction arising from the payment of interest on equity in August.

Also it's worth to highlight the historical growth of recent years above 20% as well as the expansion of almost 4 percentage points in the net income margin.

Now the conference returns to Alexandre, proceeds from slide 8.

Alexandre Dinkelmann {BIO 16100739 <GO>}

Thanks Maia. The Company's net cash position changed from BRL18 million in the Second Quarter to BRL38 million in the Third Quarter of this year. Even with the payments of interest on the equity in August, the semiannual amortization of the PROSOFT financing line obtained in 2008, the semiannual amortization of debentures issued in 2008, and the payment of the acquisition of RMS.

Here I would like to remind you that the gross debt shall present an increase of BRL250 million in the Fourth Quarter due to the release of the first tranche of the financing line recently hired from BNDES as mentioned earlier in the call.

Before we move on to the Q-and-A session, I would like to reiterate the pillars that guide the management's agenda in the Company's value creation in the long term as well as the ongoing initiatives presented on slide 9.

In innovation, the launching of Fluig, our agnostic platform that operates in different environments and with different systems for identity processes, content, and collaboration

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management, which is becoming the natural interface of management systems used by the companies.

These investments reflects our vision about the software market future, enhancing the client's productivity, as well as bringing a lighter and more natural interface for management systems. We are excited about the potential adoption of this platform, the specialization of our solutions to drive the core business demands of companies.

As mentioned, more and more we need to deepen the adherence of our solutions for the customer's core business. We are moving forward according to our plans, investing in several verticals that we are currently serving.

TOTVS' Ventures initiatives to attract disruptive innovations in the industry of information technology to our ecosystem.

And finally the financial support from BNDES for investments in innovation and development of total solutions portfolio. This funding brings us more firepower to make our organic and inorganic investments.

In growth, the revenue growing 14% in line with our historical CAGR, and the organizational structure being guided to capture opportunities by sector and region, especially in sectors more service oriented, both organically and by acquisitions.

In loyalty, some evidences of the high level for our clients loyalty, such as the growth of 13.3% in recurring revenue and 28.5% in sales to existing clients; and the maintenance of investments in brand building, which is also a key element for the future of both loyalty and growth.

And in margin, the focus on service efficiency and the commitment to the expenditures discipline combined with scale gains of the Company's business model tend to lead to margin expansion in the long term.

From now on we are available for the Q-and-A session.

Questions And Answers

Operator

(Operator Instructions) Fabio Levy, BTG Pactual.

Q - Fabio Levy {BIO 18720123 <GO>}

Quick question on your recent acquisitions, if you could talk about more on how is the integration of all the acquisition that you have made especially during the first semester of the year and what is the strategy for each segment that we can (inaudible) on the overall operations?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

This is Alexandre speaking, Alex. So we are talking about PC SISTEMAS, a company that was focused on the wholesale segment and they were very strong also in the cash and carry market. We are talking about PRX, a company that was totally focused on agriculture.

So these were the two acquisitions made in the first half of the year with this orientation of specialization. So both are being well run from the integration standpoint. What we do in any process is to assess weaknesses and strengths of these targets and how we can add value in the weakness and try to really keep the strengths of the company for a while.

In the case of PC, from the administrative standpoint it's totally integrated. We also -- we could work with them in order to make (inaudible) offering available throughout the country. It was also very important from the R&D perspective.

We are now talking with them in terms of how we will evolve the technology, the platform, and the product. So the teams are working together and the main point about the integration process is that as these companies are vertically oriented, they are easily integrated in the structure that we have in the Company.

Now we see PC as our hub of the wholesale and distributions industry in Brazil. The headquarters of the company is in Goiania in the mid-west of Brazil, and there we concentrate all the efforts of this industry in this hub.

The same is about PRX in the agriculture industry. They are located in the countryside of Sao Paulo and we want to keep this expertise there locally. It's very important to keep this concept of hubs.

So from that -- the administrative standpoint, in the very short run, we are able to integrate operations. We also worked very hard in the short run in order to train all the sales force and the service division in getting this knowledge from these companies.

So the same process that we have. So this is the way that we think about integrating vertical companies. We have a roadmap of integrations in the short run, in the mid run and in the long run. But there are important assumptions that we always use.

We don't want to create disruption internally in the targets in the sense of losing talents. On the contrary we work very hard in keeping the talents and showing them that it's a new place for their lives, but it's a better place and mainly we avoid any disruption in terms of clients.

So we always reassure our policy of keeping the products and evolving that and giving a better support for the clients, so giving them a sense that we can really scale the business and reinforce the investment capacity of the Company. So this is the mantra for us whenever we talk about M&A.

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Q - Fabio Levy {BIO 18720123 <GO>}

So when we take the -- we saw a strong relative growth in this quarter partially because of the full consolidation of those two companies. But the same time are we seeing any reacceleration on organic growth related to this new acquisition, meaning that if you are accessing new addressable market because of those acquisitions, are we seeing already some impact on revenues related to these new acquisitions when hunting for new clients?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Yes. This -- our history, knowing most of the cases our experience is that just after the completion of the deal, we are able to accelerate the sales performance of the targets because we insert these targets into our ecosystem.

We can expand the capillarity of this offering into the markets. We train very fast our distribution network and we also migrate all the opportunities in the industry towards these new hub acquired.

So we really try to exercise the complementarity approach in order to really gain or add more value to the acquisition. So in this sense they become the natural hub of the business. So that's why we see a very good impact since the beginning of any transaction.

Operator

Marcelo Santos, JPMorgan.

Q - Marcelo Santos {BIO 20444938 <GO>}

I would just like a little bit more color for your views on the trend of clients demanding more technological solutions to their core business in opposition to the traditional ERP solution which is more to the back office.

So as we see penetration increasing, do you think clients start to have more ERP and then they might go for an analytical solution? So I would like to understand better how you see this trend and what are you preparing to cope with that? And any color would be nice.

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

This is very important point in our strategy. We see that happening in the SMB market, in the high-end market. And that's what's driving our strategy in reinforcing specialization within TOTVS.

Why that? We see that Brazil is a very competitive market for everybody. Any client is facing competition. So we have a diversified economy. We have a private sector-driven economy, a lot of new companies trying to grab market share.

So nobody has a easy life in terms of competition in Brazil. And that's a good driver for us because business models are evolving a lot because of technology. Companies are trying

to establish new ways to achieve their clients, new distribution channels using technology and digital channel.

There is also a big challenge in terms of productivity in Brazil. Labor force is expensive and not necessarily productive. So that's why we are seeing very different industries in Brazil adopting technologies, some of them late adopters. So in general, non-tradable industries are late adopters in terms of technology.

And that's one of the vectors that we want to capture more and more in Brazil in the next cycle of 5 to 10 years.

So what does it mean? That even if a company, technically speaking, is 100% penetrated in terms of software, they want upgrade, they want to switch from, internal developed software to new software addressing their core needs.

So this is what we are seeing for smaller, mid-sized companies, and also big companies. And you are right, in terms of the back office ERP, the driver behind that is about companies that's growing so intensely that they need more robust solutions.

So in general they start using very small solutions provided by very local vendors, and then this vendor, typical vendor is not able to scale up and to follow the intense growth of their clients, and then there is also addressable marketing terms of new needs for back office activity. So these two dimensions combined present very good prospects for our market.

Operator

Carlos Sequeira, BTG Pactual.

Q - Carlos Sequeira {BIO 1798391 <GO>}

My question is on the competitive landscape, if you can tell us a bit how the market is today, I mean, breaking it into the different type of clients like the large clients, medium and smaller clients, how the competitive environment is? And as a follow-up question, if you can tell us a bit more about the Fluig project and how it's evolving and what we can expect from it?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

So starting from the first one, the competitive landscape, we have to analyze it by segment as you said. So starting from the high-end market, it's really a well-penetrated market.

Here I don't see big momentum in terms of top line growth for ERP. What we see in terms of potential demand is about vertical solutions that can be connected with existing solutions.

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So this is a driver that we want to explore. And in terms of this competitive landscape, there is no one that's really addressing this specialization process. In general, big international companies, they have a more horizontal approach, and the customization of the solution in terms of the industries is made by channels.

So we have -- and we are seeing good opportunity to explore in the high-end virtual solutions adoption. But it takes time because they tend to be more affected by the current macro scenario.

So what we see now, there is a big difference between the dynamics of the SMB market and the high-end market. Having said that, when we go to the SMB markets, then competition is totally connected to the industry that we are talking about. So competition in health care is very different than competition in education or any other industry that we cover in our portfolio.

So we are able to cover now the 10 biggest industries in Brazil, in the Brazilian economy. Then for each industry we have different competitors. Most of them, I would say 100% of them are smaller than us, even looked from the perspective of the industry.

But they have some strengths in terms of specialization, in terms of focus, that's why we have impact in specialization.

There are two ways to tackle with this competitive landscape in the SMB market. One is to invest more in -- organically, and the second is to buy companies that are good competitors, and that could have a good fit in terms of not only strategies, but also cultural perspectives.

In terms of Fluig, it's being launched this semester. We have the impact in this solution in the last couple of years. It's a combination of investments made in Brazil, and also in the Silicon Valley at TOTVS Lab.

And it's a new way of seeing software adoption by companies and individuals within the companies. So the value proposition here is to create a new layer for the client that brings or combines tools for collaboration, tools for workflow management, tools for content management, and identity management.

So the idea is to really improve or increase productivity within the company, and providing a more natural and user-friendly interface for any software, not only TOTVS, but anyone -- any software that's used within the company. Then we can really put these functionalities in this layer which is deployed -- or can be deployed in the cloud or (inaudible), and we can make the ERP really lighter and more flexible, and more scalable.

So that -- the idea is something that's very innovative. Nobody is having this holistic approach, and we want to start that trend. And it's very adherent to -- in our view to the clients' needs.

This first phase that we are exploring this offering with our clients, developing some pilot projects, it's been -- it's going very well. We will have a chance to talk with you specifically about Fluig making demonstrations in the future in TOTVS Day that we will have here in Brazil and New York next week. So I invite everybody to join us in this presentation.

Operator

(Operator Instructions) Well it appears that we have no further questions at this time. We will go ahead and conclude today's Q-and-A session. At this time, I'd like to turn the floor back over to Mr. Alexandre Dinkelmann. Sir?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

I'd like to end this conference reminding everyone that TOTVS has a unique position in the market due to the combination of both our continental coverage and the very relevant presence we have in the major industries of our economy.

So this positioning allows us to innovate with solutions which integrate value chains. When we talk about innovation, I mean R&D investments which put TOTVS among the five main Brazilian investors in the R&D worldwide, so it's very relevant.

So we will keep investing to be even more essential to our clients. So thank you very much for your participation in the conference. And most importantly, thank you for TOTVS team for its daily hard work in order to make us the strongest firm in the industry.

Operator

And we thank you sir, and to the rest of the management team for your time today. TOTVS' Third Quarter results conference call is now over. Thank you, everyone for your attendance. Take care, and have a nice day.

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