Y 2018 Earnings Call

Company Participants

- Dennis Herszkowicz, Chief Executive Officer
- Gilsomar Maia Sebastiao, Chief Financial Officer and Investor Relations Officer

Other Participants

- Eric Wolff, Analyst
- Unidentified Participant

Presentation

Operator

Good morning, and welcome to TOTVS Conference Call to discuss the results for the Fourth Quarter and Full Year 2018. With us today we have Dennis Herszkowicz, CEO; and Gilsomar Maia, CFO. Note that all participants will be on a listen-only mode during the Company's presentation. After the presentation, we will start a question-and-answer session for investors and analysts and further instructions will be given. (Operator Instructions) The audio is being simultaneously webcast at ri.totvs.com.br.

Before proceeding, we wish to clarify that any forward-looking statements 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 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 the results to differ materially from those mentioned 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.

Dennis Herszkowicz {BIO 17998338 <GO>}

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

As highlighted on slide three, on November 26, the Company announced to the market my election as the new CEO and the election of Laercio as the new Chairman. I am very pleased with this opportunity to lead the largest software company in Latin America and I am also confident that we are starting a new and very successful journey for TOTVS.

Today is my 80th day at the Company and I am having the pleasure of sharing with you the performance in the fourth quarter and the full year of 2018. First of all, the Company approved the payment of interest on equity of BRL13.1 million, corresponding to BRL0.08 per share to be paid on May 9 in 2019. With this resolution, the payout in 2018 was (ph) 77%.

I now hand over the presentation to Maia for his comments on the quarterly results starting on slide four.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Thank you, Dennis. Good morning, everyone.

Software revenue grew 8.2% year-on-year in the fourth quarter and 5.9% in 2018, accelerating strongly compared to the year-on-year growth of 2.7% in 2017. As a result of this acceleration, software revenue surpassed the mark of BRL2.1 billion in the year. This performance of software revenue is largely due to the recurring revenues, which came to BRL1.5 billion in 2018, growing 5.6% year-on-year in the quarter and 5.4% in the year, mainly due to the sale of subscriptions and license, which generated new maintenance revenues (inaudible) inflation pass through during the period. In addition to license sales, the pace of (inaudible) sales and increased efficiency in project delivery also contributed to the year-on-year growth in non-recurring revenues (inaudible) in the fourth quarter and 7% in 2018.

Now moving on five. We have the annual recurring revenue, which came to BRL1.7 billion in Q4 '18, up 3.3% from the third quarter and 8.3% from the fourth quarter '17. This now represents a net addition of BRL55.8 million in the quarter and shows the Company's strong capacity to expand its solid base of recurring revenues, which reflected in the client renewal rate of 97.9% this quarter.

Recurring revenue is the Company's premium revenue stream is directly related to the scalability of the software business model. As you can see on slide six, recurring revenue growth accounted for two-thirds of the absolute growth in the software revenue in 2018. Acceleration in software revenue growth associated with greater operating efficiencies led to adjusted EBITDA growth of 17.9% with adjusted EBITDA margin of 16.4%, increasing 160 basis points from 2017, which reflects the recovery of our software margin.

Software costs increased 3.3% in 2018, lagging the growth in software revenue of 5.9%, resulting in the increase of 90 basis points in gross margin (ph). The increase in gross margin resulted from the greater efficiency in software project deliveries despite additional costs incurring over the year in support activities to meet increased demand arising from the new regulations implemented during 2018.

TOTVS software expense also increased at a slower pace compared to software revenue, reflecting the gains in operating efficiency in selling and administrative expense, despite the negative effects of the increase in research and development expense related to investments made in innovation during the period, development efforts related to new regulations and the FX rate impact on the structure of TOTVS Labs in California (inaudible).

Compared to the previous quarter, the 13.3% decline in adjusted EBIT mainly reflects seasonal effects such as salary adjustments to team from collective bargaining agreements (inaudible) marketing content in addition to the lower level of non-recurring revenues and higher concentration of provision for contingencies in the quarter.

Moving to adjusted net income on slide seven. You can see that year-on-year growth is mainly due to the increase in adjusted EBIT and the decline in amortization expense. Compared to the previous quarter, the decrease of 18.4% in adjusted net income reflects the seasonality inherent to the period. As evident from the decrease in EBIT which was partially offset by improved net financial result and the reduction in effective income tax rate.

On the slide eight, cash flow and debt, you can see that free cash flow grew 13.5% year-on-year in 2018, primarily due to the 29% increase in operating cash flow generation in addition to higher investment in acquisition of (inaudible) equity increased emphasis of assets in the period. The decrease of 23% in free cash flow compared to the previous quarter mainly related to seasonal effects as already mentioned for (inaudible) Q4 in addition to the seasonal increase in working capital investments due to the payment of 13th salary, vacations and taxes.

Finally, net debt decreased 84% year-on-year and 51% quarter-on-quarter. The decrease resulted in a ratio of 0.1 times net debt to last 12 month adjusted EBIT, despite the payment of dividends and interest on assets which is reflected in net cash from financing activities in Q4.

(inaudible) the Company's solid financial position (inaudible). I now turn the presentation back to Dennis for his closing remarks on slide nine.

Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you, Maia.

In 2018 TOTVS resumed the acceleration of software revenue organic growth which came to 8% in 4Q '18 and 6% in the year despite an economic scenario of slowing and gradual recovery. The acceleration of revenue associated with greater operating efficiencies led to an increase of 18% in adjusted EBITDA from software in the year and an increase of 160 basis points in EBITDA margin from software.

The software operation is the priority for TOTVS and we will continue to invest in it. That's why we have started to report software and hardware results separately down to their

EBITDA margin. The results show that TOTVS has already built its description model that, combined with this monthly maintenance model represents a solid base of recurring revenues, which have already surpassed BRL1.5 billion in 2018 and accounted for 73% of software revenue combined with high levels of client renewal rates.

Accordingly, we have prepared ourselves for a new growth cycle, sustained by a better and broader portfolio of management solutions available besides seeking opportunities in new markets, which will enable us to advance in the value chain of our clients. Finally, with significant progress in our financial position in 2018, with an increase of 14% in free cash flow and the ratio of net debt to EBITDA of 0.1 has let us to take advantage of new inorganic opportunities.

We started 2019 focused as usual on the satisfaction and success of our clients, maintaining the portfolio growth pace and delivering (inaudible) innovate and produce. These energy of making it happen, delivering on our promises and internally doing if necessary, always in a smart and balanced manner will be posting to each move customer interaction, sale, and projects we work on.

Now -- we are now available for the questions-and-answers session. Thank you.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-and-answer session (Operator Instructions) Our first question comes from inaudible) with Bradesco.

Q - Unidentified Participant

Hi, good morning and thanks for taking my questions. My first question is regarding the recurring service revenue, which -- I mean, we noted, there is some part of that previously just under service revenue that's now part of the recurring and we would just like to have some more visibility on what type of revenue this comes from and what would be the margin differential between the recurring service revenues and the pure software margins?

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

Hi, this is Maia speaking. So actually that recurring revenue was there disclosed in previous quarter. And the difference between the total recurring revenue we have according to the maintenance and subscription and the total software recurring revenue is related to some recurring software revenue, service revenues that we sum up together. Those revenues are related to services like cloud services, AMS, so application management software services and also services related to managing (inaudible) describe software as services. Most of them are a part of our subscription fee. So in terms of nature, we are talking about revenues with the different characteristics. So in the end we are putting together things that have a similar profile and further (ph) we have a much higher margin comparing to lot of traditional implementation service. So in overall it doesn't change that much the visibility we have in terms of profitability of recurring margins. And also the remaining services that you see as non-recurring they are more specifically related to implementation services. I hope that was clear, no?

Q - Unidentified Participant

Yes, that's very clear. Thank you. And if I may just have a follow-up question. As we are kicking off 2019, we were wondering if you have already seen some improvement in the day to day negotiations with clients and if you have seen the better sentiment in Brazil turning into actual contracts. And also, if when we look at the renewal rate you're showing for 2018, how much of that was related to client mortality and how it kind of improve with a better macro scenario?

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

Okay, good. So the -- first of all, it's important to call your attention to the delinquency rate we had in this quarter which was much lower than we had in previous quarter. And if this quarter specifically, we have some relevant accounts that individually they expect negatively the result. But excluding those exceptional case, you where -- we have seen the declining of the delinquency rates. Those delinquencies are interesting (ph) in terms of results for this quarter specific and connecting that with our renewal rate, we see that better activity on a quarterly basis is not so relevant in our view. So because we have a very high retention rate, so close to 98%, 98.5% so it's really high that retention rate. A portion of that is, as you mentioned related to mortality rate (ph) so if we allocated 100% of that gap as the renewal rate to mortality that might be even low, but of course it's not totally related to mortality but a relevant portion of that is related to mortality.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Just to a complement what Maia said the main reason for us to boost the renewal rates starting in this quarter and we would do it in all the coming quarters is because we want the market to know that we have a very high level of locking in our clients. The main reason for us to use that client is to use because the client is closing its door. So if you consider 98%, 98.5% which is the average that we had in the last four quarters that we provided the information, I mean, it is a very high level considering that there is a natural rate of mortality among the more than 30,000 clients that we have. So regardless of what we do, there will be a minimum amount of mortality among the clients. So when you put this into perspective, I mean, again, the main message here from the level of locking that we have with our clients and obviously we feel good with the level of recurring revenue that we have is very, very high and very, very healthy.

Q - Unidentified Participant

Okay. That's very clear. Thank you.

Operator

(Operator Instructions) Our next question comes from Eric Wolff (ph) with (inaudible).

Q - Eric Wolff {BIO 19092003 <GO>}

Well, thank you for taking the time. A few quick questions some of the new disclosure, which was helpful on the breakup of software margins. I think last year, it looks like you had some improvement 16% growing to 16% from 14% I think if we look back, previously we either (inaudible) we were at kind of mid-20s. Dennis, how do you see the margins trending in software over the next couple of years and do you think it's feasible to get back to historical profitability levels?

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Hi, thanks. This is Dennis. Look, it's maybe a bit early to give the visibility for two years, but I can say to you that I feel that the trend is positive. I mean, we've been increasing the software margins. It was very important for us, as we said, to start to report the EBITDA margins down to the separation between software and hardware because obviously right now the hardware is a drag on the consolidated EBITDA margin. So, yes, I think that the trend is positive. It's very difficult to say exactly what we envision for these two years. But the metric is positive. But we see room for improvement.

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

Eric, as a good complement. This is Maia speaking. As Dennis said, of course, it's hard to give you exactly the course of our margin but if you take a look on the full-year figures there are some metrics in that. My view especially related in terms of cost control that was one year that we could show more clearly the efforts made in order to have a more stronger control on costs of course taking of advantages on actions we took in 2017 in terms of integration of our operations, but if you take a look on our software revenue growth that was above 6% in 2018 and our total expenses grew about half of that. So even though our provision for delinquency and contingencies came in a very high pace, so even controlling those provisions in a high (ph) level the total expense came about half of the growth at top line. So it shows fairly -- really we see no reasons to say that the margin will not grow. So of course the natural process of software is very scalable business leads to see a margin improvement through all the time.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

And then just to add to what Maia said, Eric. Of course, we do have -- we continue to have room for improvement in cost control synergies and so on. So, yes, there is room for this and during the coming quarters as we has come in the previous quarters as well. But the main focus will be this and message is very important to be clear. The main focus of the Company will be on growth. I mean, as Maia said software is a very scalable business. If we accelerate the growth, if we find a new client (ph) to generate additional recurring revenues for the Company this by itself without any cost control, but obviously if we have cost control, it would be even better. I mean, just the acceleration in terms of the top line growth, this will result in better margins. It is based on recurring revenues.

Q - Unidentified Participant

Got it. That's very helpful. One quick follow-up to that. Can you give any commentary, I know it's early in the year, but it seems like a lot of the kind of macro indicators in Brazil have gotten materially more positive over the last few quarters -- sorry, over the last, I guess two or three months in particular. Didn't show up at on this past quarter. Just curious, any comment you have looking out into this year. Any thoughts on potential acceleration in license revenue or recurring revenue?

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Okay, Eric. This is Dennis. To be honest with you, I think that the performance in terms of revenues and sales in the fourth quarter was not obviously great. But it was very decent performance in terms of software. I mean, the acceleration of the growth to more than 8% organically when you compare with the third quarter of 2017. I mean, again, considering the low level of inflation still low level -- the low level of economic activity during the whole year and even in the fourth quarter with the election and so on, I mean, I'm very honestly I think it was the decent performance in terms of revenues and sales of software. Obviously if we take into consideration hardware it is what we do. Looking into this year, as we said in the Portuguese call, I think that the first outlook is good. We had our sale convention in the second week of January. The energy there was very, very positive. I was very glad to have met more than 2,000 people that represent the full distribution platform of focus, both our own offices and obviously the franchisees as well the channels. So I think that we will have a better year in 2019. It is still may be too early to say how better it will be because unfortunately the last two years, we thought that we all thought that the economy would really improve and it didn't, at least not as much as we thought. So we hope that this year is better for the economy and in any case, I think that this year will be better for profits. It's simply difficult to say precisely how much it will be this year.

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

And if I could complement again even with this macro scenario in 2018 nationwide. Again, we grew 6% organically in software. Of course, it's not the growth rate, doesn't show the potential of our Company market. But it's more than the double that we grew in 2017. So even with that economic scenario, we were able to accelerate the growth of the Company. And when you look at the annual recurring revenue, you see also that we had a good performance in Q4, a very strong one, and the upcoming, especially from the, new sales we closed in the quarter, especially after the election process ended and also coming from new clients and new accounts we closed in that period. So we are optimistic about the future. Of course, we have to see more -- that general optimism in the market being translated into more transactions, into more deals, but in general, our sales people and clients are more optimistic about the year.

Q - Unidentified Participant

Okay, thank you. If I may have just one quick final one. The -- can you talk about all the opportunities you see within this potentially rollout additional products and you kind of hinted that. I think I go for it in some point perhaps anyone else this morning called out potential favorable opportunities. It seems like there's a lot of untapped opportunity. Just curious how you're thinking about attacking this opportunities and when we might get a clearer picture of what you have in mind there.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Sure, Eric. Thank you again. Look, yes, there are lots of opportunities. You mentioned payroll and obviously need one of the main opportunities that we have considering that we cater to along one-third of all the registered payroll will in the entire country. I mean, you're talking about, around 10 million employees having their payrolls processed in our software. So yes, this is one of the opportunities, but it is not the only one. I mean, what we have here is the opportunity to on one hand continue to put back and to improve the core that we have with the (inaudible) and payroll. Also to synergize and to deepen our knowledge and our solutions in terms of the segments in which we operate, and on the other hand obviously look for additional cross-selling opportunities that we have inside these huge base of clients. I mean, we are talking about more than 30,000 clients, which has revenue -- combined revenues of more than BRL1.6 trillion (ph) in the last 12 month. And this is one-fourth of the GDP of the country that are being processed in our solutions. I mean, the opportunity goes beyond the score, goes beyond the segments goes beyond the cross-selling opportunities and it means that we have new markets in which we can operate. So this is one of the things that we will start to focus from now on. Never forgetting about the platform that we have all of the new opportunities, all the new markets in which we will operate and see if that obviously is one of them. They have to be connected and they have to leverage on this platform of core and segments that we already have. This is the main stronghold that we have. The 30,000 clients, the BRL1.5 billion in recurring revenue, the level of relationship that we have with our clients and obviously the distribution platform that we have, with our own offices and the dozens of different channels that we have all over the country.

Q - Unidentified Participant

Excellent. Thank you. Keep up the good work.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you.

Operator

Our next question comes from (inaudible) with Bradesco.

Q - Unidentified Participant

Hi, thanks for taking my follow-up. Just touching upon the importance of growth, you've mentioned and also in the Portuguese call. In the release you mentioned that education and agro businesses grew quite considerably and we were wondering how much of these relatively smaller segments within your portfolio can add -- achieve overall growth with an accelerated performance, what is the strategy in these new niches and on a more broader aspect, how can we see a pickup in the corporate market in the license sales already in the first quarter?

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you. This is Dennis, again. Look in terms of the segments, obviously, this is a strong hold, this is (inaudible) for operating in all the segment is very, very important viewed with a lots of opportunities. It helps us gather the different economic scenario that we have, so we're not fulfilled in just if this one segment does not perform we will suffer as much as the segments. So this is the strength. But on the other hand, is the other side of the coin, obviously when you have maybe 10 or 11 segments you don't necessarily have the focus and the resources to be the leader and to be the best guy in all of the segments. So right now we are obviously analyzing and discussing which in segment we're good enough, which segment deserves our attention, our focus and our investments. It might be that all of them do. It might be that a portion of them do. It might be that we, one of the, in all of them but we accept that we will be leaders in some and not necessarily leaders and we will adjust the level of investments to some of them. We still don't have the final answers on these regards. I think it's too early, at least since my arrival here. It's not that we were not analyzing this. Obviously we were. But since I arrived, I wanted to take a big dive in all of these analysis. So in maybe in the short to medium term, we will come to the conclusions in this regard. And I am very confident that we will find the right answers and that new leverage in the segment that we feel that we have the best portfolio and that we have the best expertise and opportunities for this leveraged. Specifically in terms of the situation -- just as an example, we have a very, very good market share in terms of higher education -- in education. So this means that we have for example, more than 3.5 (ph) million students using our solutions with schools and universities using our solution. This is a huge opportunity for example in terms of feedback. The level of penetration for credit cards in these payments, in these B2Bs is close to zero. So it's a huge opportunity. So in addition to other opportunities that we have in selling the core solutions and selling the software both the solutions that we have, in addition to all these, we also have the opportunities for a new pockets for new money inside the budgets of our clients, to advance in the value chain that we provide to them and to capture a higher level of take rate among the expenditures of these clients. With regards to license sales, I don't know if Maia wants to add to this.

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

Okay. So the last two years, we had a very, very strong performance at corporate model in Q1. If I'm not wrong, it was like 30% -- over (ph) 30% sequentially in the last two years. I see it's much less probable to see growth in that pace. It's always important to remind that corporate model has an incremental license fee just when clients grow. So if they're not having growth (inaudible) in terms of incremental license revenue in Q1, it doesn't mean that (inaudible). So for sure we will have an incremental license charges. I don't believe we will have that pace of growth we had in previous years, but I believe we have a reasonable level of incremental license fees from corporate model in Q1.

Q - Unidentified Participant

Okay, that's clear. Thank you for taking my follow-up and best of luck.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you.

Operator

(Operator Instructions) I would like to turn the call back over to Mr. Dennis for his closing remarks.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Well, I want to end the call on a positive note to give an optimistic message to all of you. Obviously to thank you all for participating and for the confidence in the Company. And this positive note comes from the fact that I have found here a great company, a company with lots of strength. it is also as I said by more than 30,000 clients and has more than BRL1.5 billion in recurring revenues, that it has and it's been accelerating recurring revenue. And also about the team that I have found here. I mean, the team is very, very competitive. It is a period that we have navigated that and I hope that I will be able to have this Company and this team (inaudible). So again, thank you very much. We will be available for further questions. Thank you, everybody.

Operator

This concludes TOTVS conference call for today. Thank you very much for your participation and thank you for using Chorus Call.