

Q3 2019 Earnings Call

Company Participants

- Dennis Herszkowicz, President and Chief Executive Officer
- Gilsomar Maia Sebastiao, Chief Financial Officer, IR Officer & Member of the Executive Officers Board

Other Participants

- Fred Mendes, Bradesco

Presentation

Operator

Good morning and welcome to the TOTVS conference call to discuss the results of the second quarter of 2019. We have with us today Dennis Herszkowicz, the CEO, and Gilsomar Maia, the CFO. Note that all participants are only in listen-only mode during the conference presentation. After the presentation, we will start the question and answer session for investors and analysts when 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 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 management, as well as information currently available. Forward-looking statements are not a 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>}

Thank you. Good morning everyone. Thank you for participating in our conference call. I am very pleased to once again announce the results of TOTVS for the third quarter of 2019. This month, I complete one year leading the company, happy about the challenges that we overcame during the period and motivated by what is yet to come. Last week, we announced the acquisition of 88.8% of the capital of SUPPLIER for BRL455 million, as shown on Slide 3. SUPPLIER focuses on providing credit in the recurring relationship

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between clients and suppliers through a virtual B2B private label model. This is a disruptive and innovative approach in which it is responsible for the definition and application of the credit approval policy, as well as the origination, even when it is transferring the portfolio and the credit risk to third-party financial institutions.

Another innovative aspect is that the origination of loans is driven by the supplier himself, which makes its own structure quite lean. SUPPLIER is TOTVS' main TechFin vehicle, a business unit created to simplify, expand and reduce the cost for clients' access to credit and other financial services. Over the coming months, TOTVS and SUPPLIER will develop an agnostic platform that we will enable full integration with the management softwares of companies, aiming for a frictionless journey for clients and suppliers. The platform will also enable the use of big data, continuously improving the credit approval algorithms. It will be a journey that will take SUPPLIER from TechFin to the ultimate TechFin model.

During the third quarter, we also concluded the sale of Bematech to ELGIN, transferring all hardware operations developed in the Brazilian territory. As announced at the start of the transaction, this sale reaffirms our strategic plan of focusing 100% of the team efforts and resources on the software operation. To conclude, we sold CIASHOP to VTEX. As announced on May 2019, we signed a joint operation agreement between TOTVS and VTEX, which is already in full steam, and we sold CIASHOP to them for BRL21.5 million. After the approvals were obtained and other conditions precedent for the conclusion of the transaction were met, this generated a positive net effect of BRL11.7 million in the company's third quarter results, which is an extraordinary effect on both EBITDA and net income in the period.

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

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Thanks, Dennis. Good morning everyone. The third quarter total revenue increased 7.5% year-on-year to BRL575 million, mainly due to the recurring revenue that represented 76% of total revenue and reached BRL437 million, organically growing 12.2% year-on-year or 12.6% when eliminated impact of the sale of CIASHOP. This growth was driven by higher sales to both new and existing clients, combined with the maintenance of high client renewal rate and inflation adjustments. This level of customer renewal rate is evident on Slide 5 where we see them increasing to 98.9% in the quarter.

Also note, the net increase of BRL44.6 million in annual recurring revenue, ARR, which reached BRL1.86 billion in the quarter, an increase of more than 10% over the same period of last year.

Moving to Slide 6, The continuous gains in operating efficiency that the company has been pursuing, together with revenue growth over the quarters, enable it to once again expand adjusted EBITDA margin, which reached 20.9% in third quarter '19, 410 basis points higher than the third quarter '18 and 30 basis points over the second quarter of this year.

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Moving to Slide 7, we can see that the net income growth, both year-on-year and quarter-on-quarter, was mainly driven by EBITDA growth, combined with a better financial result coming from the reduction in gross debt and remuneration on investment of proceeds from the follow-on offering.

Moving now to Slide 8, I'll comment on the company's cash flow and debt. Despite the 126% growth in earnings before tax, the higher amount of interest paid due to the payment of non-conversion premium of debentures issued in 2008 combined with a lower amount of tax offsets in 2019 led free cash flow generation to increase 5.4% year-on-year. Thus, the company ended third quarter '19 with net cash position of BRL999.2 million, which is 15.4% higher than in second quarter, due to the free cash flow generation in the quarter.

I'll now turn the presentation back to Dennis for his closing remarks on Slide 9.

Dennis Herszkowicz {BIO 17998338 <GO>}

Thanks, Maia. The main closing messages about the results are, first, the continuous organic growth of recurring revenues, which corresponded to more than 75% of the company's net revenues; the effective management of costs and expenses resulting in greater operating efficiency and generating an expansion of adjusted EBITDA margin, which reached 20.9%; the execution of the new market strategy, which is going ahead of the plan with the acquisition of SUPPLIER being the step stone for TechFin; and finally, in the M&A front, we have started to deliver on the equity raised in the follow-on, committing close to half of the proceeds in just five months.

I also take the opportunity to mention that yesterday, after the release of the third quarter results, we concluded the sale of Bematech International operations, two reasons. And here is a funny story. At the recent meeting, Juliano Tubino, one of our Vice Presidents, raised an interesting point. In this transaction, we are swapping approximately BRL200 million in revenues from Bematech for approximately BRL200 million in revenues from SUPPLIER. This is the type of deal we want to continue to pursue.

We are now available for the questions and answers sessions. Thank you.

(Question And Answer)

Operator

Thank you. The floor is now open for questions. (Operator Instructions) Our first question comes from Fred Mendes, Bradesco.

Fred Mendes {BIO 17221617 <GO>}

Good morning, everyone. Thanks for the call. Again, I have just two remaining questions here. I mean, the first one, again, about SUPPLIER. If you already have any study, just to give us an idea about the percentage of the clients from TOTVS, the 30,000 clients that

you have, that could potentially be an affiliate. Of course, that every 1% already makes a significant difference. So just if you -- I know it's too early, but if you already have something similar to that. And then the second question related to provision for contingencies. We do understand some volatile line, you might already mentioned that a few times. But then this quarter, in particular, the increase does call the attention. So just wondering if there is something specific here in the third Q. Thank you.

Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you, Fred. This is Dennis. Regarding the first question, yes, we are doing our exercises here. Obviously, we are not going to put forward numbers at this moment, especially because we are starting this work. But I can say to you that we believe that we have plenty of opportunities for SUPPLIER or the affiliates here with our client base. We have hundreds, maybe a few thousand clients that are in the hundreds of millions or in the billions in terms of revenues. So these are obvious targets for becoming affiliates, and even guys with less than a few hundred million reais could be potentially affiliates as well. It's going to depend on the quality of the governance that these companies have, the type of clients that they operate, the average ticket that they have. So these sometimes are more important information than the size of the potential affiliate itself.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

And Fred, this is Maia speaking. Regarding the contingency line, yes, you are right, so the growth also is call our attention to. As we already discussed in the past, there is some expectation that we see some reduction in this line in the future. Unfortunately, that reduction still didn't come. And in our view, as we follow the number of suits in which the company is involved, we have seen an important reduction in number of new suits. And so it's more a matter of reassessing the -- that base of processing course and so it's really hard to predict exactly what's going to happen on a quarterly base. One year, the nine months, we see an important increase of about 22% as well. So it's hard to make projections for the short term, but we still keep that expectation to see a decline in this line in the near future.

Dennis Herszkowicz {BIO 17998338 <GO>}

Fred, just complementing what Maia said, I mean it's exactly this. What we are seeing here in the quarter and in the year-to-date numbers, this relates to best suits that were filed. So the most important visibility that we can have here in the company is that the flow of new suits is decreasing and it is decreasing in a good manner. So probably in the coming years, and unfortunately, it's something that takes years to solve, we will definitely see a reduction in this line, especially as a percentage of revenue. So unfortunately, for the short term, if the -- just this works faster, sometimes it's not so good for us because it makes the process -- the suits finish faster, and obviously, this makes for higher provisions or even higher payments actually, but the number of new suits is decreasing in a consistent way.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

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Yes, and when we take a look on the results and overall, we see some important improvements in other lines like allowance for the doubtful accounts, in which we saw important reduction year-on-year of 21%. And when we see the third quarter specifically versus third quarter of '18, we see more than 40% decline. So it's one important evolution year-on-year in terms of churn, as we have already mentioned in previous quarter. We saw also an important improvement in this deal. And unfortunately, the contingent line is one that we still couldn't see the same thing. But in our view, it's a matter of time.

Fred Mendes {BIO 17221617 <GO>}

Perfect, very clear. Thank you, Dennis, thank you Maia.

Dennis Herszkowicz {BIO 17998338 <GO>}

You're welcome.

Operator

(Operator Instructions) This concludes the question-and-answer section. At this time, I would like to turn the floor back to the company for any closing remarks.

Dennis Herszkowicz {BIO 17998338 <GO>}

Well, this was a short one, but I think that the Portuguese one was a bit longer. So I would like again to thank everyone for participating and for the confidence in the company. As I said in the beginning, it is an honor to have completed one year here at the company. It was a full year of accomplishments. And obviously, I would like to thank very, very much each and every one of our close to 12,000 TOTVERS. This is the combination of the 7,000 direct employees and also all the teams from the franchisees, also the 35,000 clients that we have, all the partners. So thank you again for a very, very successful year, and I hope that we have a good year in 2020. Thank you very much. Bye, bye.

Operator

Thank you. This concludes today's TOTVS conference call. Have a nice day.

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