

## Y 2017 Earnings Call

### Company Participants

- Gilsomar Maia, CFO
- Laercio Cosentino, CEO
- Unidentified Speaker

### Other Participants

- Andre Baggio, Analyst

### Presentation

#### Operator

Good morning and welcome to the TOTVS conference call to discuss the results of the fourth quarter and full-year 2017. Today we have with us Laercio Cosentino, CEO; Gilsomar Maia, CFO and Sergio Ribeiro [ph], Investor Relations Manager. Note that all participants will be in 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. (Operator Instructions) The audio is being simultaneously webcast at [ir.totvs.com](http://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 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 will now turn the call over to Mr. Maia who will begin the presentation. Mr. Maia, please go ahead.

#### **Gilsomar Maia** {BIO 16400533 <GO>}

Good morning, everyone. Thank you for participating in our conference call. As usual, we will begin the presentation by commenting on key recent events on slide three. The first was TOTVS was present once again as the only Brazilian tech company in the global ranking published annually by the consulting firm Strategy, which ranks 1,000 public companies that most invest in research and development. This is further evidence of the

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importance of innovation for TOTVS as a driver of its own transformation and also to bring the client solutions that simplify the business world.

The second event was TOTVS Day, Investor Day held at the beginning of last December at the new headquarters of TOTVS, where presentations were made on the latest developments in the digital journey and transition to subscription strategies. Also, the over 60 analysts present in the event had the opportunity to view the new facility and had demonstrations of some of the solutions for the education and manufacturing segments, as well as Carol, our artificial intelligence platform. The third event was the Board of Directors decision in December regarding the distribution of interest on capital for the second half of 2017 in the amount of BRL17.4 million.

Now, I will begin my comments on the results on slide four. In 2017, net revenue grew 2%, while recurring revenue grew 8.7% corresponding to 67.5% of net revenue in the quarter and 65.8% in the year, which is 4 percentage points higher than in 2016. As shown on slide five, this revenue growth is mainly driven by software revenue, which grew 6.2% in the year and 5.6% in the fourth quarter. Total revenue in turn was driven by 34% growth in subscription revenue, shown on slide six, which accounted for 20.7% of software revenue in 2017 and 23.2% in Q4 '17. The growth of 9.5% in subscription revenue in comparison with the third quarter represented the highest growth rate in this line in a quarter since the beginning of the transition to subscription two years ago when TOTVS Intera was launched. This transition brought challenges related to the reduction in license revenues and its diverse effect on maintenance revenue, which were worsened by the economic recession in Brazil. On the other hand, subscription [ph] sales accelerated and software revenue already returned to the growth rate [ph] during 2017, as shown on the chart on the left side in slide seven. However, we don't consider revenue as the best metric to measure the performance of subscription sales in the quarter. The first monthly fee billing of TOTVS Intera is mainly the following months after the sale. Thus, revenue in the quarter is positively affected by two monthly fee when subscription sales closed in the first month of the quarter, by one monthly fee on sales closed in the -- sales in the third month contribute only to the revenue of the subsequent quarter.

We believe that the annual recurring revenue, ARR, shown on the chart on the right, maintains comparability between the periods by annualizing all the subscriptions sold. Note that, as ARR accelerates, subscription revenue accelerates in subsequent figures. ARR from subscription totaled BRL368 million in Q4 '17. This amount is 19.5% higher than the subscription revenue of BRL309 million in 2017, which represents revenue growth in 2018 resulting from sales made throughout 2017.

Now I turn the presentation to Sergio Ribeiro, which we will comment on software results on slide eight. Sergio took over the position of Investor Relations Manager early this year. He is in TOTVS since 2006 and has led the area of institutional relations in the past three years. Please, Sergio, proceed the presentation.

## Unidentified Speaker

Thanks, Maia, and good morning everyone. The decrease of 40 basis points in adjusted contribution margin of 2017 result mainly from the increase in research and development

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expenses above the adjustment level of recurring software contracts. This cost increase is essentially related to wage adjustments resulting from collective bargaining agreements in the period and additional investments in innovation, especially those related to the specialization of business solutions, open platforms and micro enterprise segment. In the quarter, the increase in adjusted contribution margin from software chiefly reflects the growth in subscription revenue and the reduction in cost to the layoffs in the quarter.

Turning now to services on slide nine. The adjusted contribution margin decreased in 2017 mainly due to the 3% drop in revenue from implementation of services and by the 11% decline in revenue from consulting services. These decreases were mainly due to the lower pace of sales and consequently lower allocation of professionals, especially in the first half of 2017. In the quarter-on-quarter comparison, the decreases in services revenue and adjusted contribution margin were essentially due to fewer business day. In the year-on-year comparison, the adjusted contribution margin from services in the fourth quarter increased mainly due to the restructuring, which resulted in a negative impact of BRL3.9 million from layoffs.

Moving now to hardware in slide 10. The decline in adjusted contribution margin from hardware in 2017 and in the fourth quarter was mainly due to the decline in sales of fiscal printer, whose gross margin is higher and to the drop in revenue from economic subsidy, especially in the third quarter due to inventory levels. Revenue from sales of hardware solutions grew 2.3% in the year, mainly driven by the growth in revenue from Bemacash sales. In 2017, more than 6,500 Bemacash units were sold compared to almost 2,800 units in 2016.

To discuss about selling and administrative expenses, please go to slide 11. The year-on-year increase in selling expenses and commissions as a percentage of net revenue essentially reflects the growth in software sales in the subscription model. As subscription revenue expands its recurring base and as new sales reduce its share in the base, selling expense will get diluted. In the year, the increase in general and administrative expenses plus management fees and other expenses as a percentage of net revenue was mainly due to wage adjustments resulting from collective bargaining agreements, which were higher than inflation adjustments obtained on recurring revenues and additional expenses with the merge of PC Sistemas and Virtual Age, and the administrative integrations of Bematech, all of each contribute to the structural [ph] adjustment carried out in the fourth quarter of '17. The decline in comparison with the third quarter was strictly due to the structural adjustment and the effect on bonus provision related to the achievement of individual and overall targets. With regard to allowance for doubtful accounts, the increase in recent quarters (inaudible) a gradual improvement in overall timely payments of the portfolio reflects the additional provision made on account of the recent situation of some companies in difficult, such as additions for judicial re-organization.

Now I will turn the presentation back to Maia to discuss the data on slide 12.

**Gilsomar Maia** {BIO 16400533 <GO>}

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Thanks, Sergio. In 2017, the decline in adjusted EBITDA resulted from the combination of the following factors. The more than proportional increase in selling expense due to transition to the subscription model, decline in service revenue caused by the reduction in sales of projects and to the first half of the year in the lower allocation of professionals, the decline in sales of fiscal printers and lower economic subsidies in hardware, and the increase in general and administrative expense, mainly due to the inflation adjustment on costs and an additional expense with the operational integration of the companies acquired in previous period.

In the quarter, EBITDA grew 13.8% year-on-year and 11% quarter-on-quarter. This structure adjustments carrying out in the fourth quarter combined with the growth in recurring revenues to adjust our structure to the SaaS reality in order to recover profitability without compromising the company's capacity to grow and innovate.

And to conclude the comments on the result on slide 13, apart from the variation in adjusted EBITDA, as commented, the decline in adjusted net income this year is mainly related to the increase of depreciation, resulting from investments made, especially in the second half of 2016. In the quarter, the tax on financial income calculated on the investment of proceeds from the issue of debentures in the third quarter and inflation adjustment over provision for contingencies are reflected in the financial results. The variation in income tax and social contribution is essentially linked to the reduction in interest on capital during the period.

Now I'll move to slide 14 for the comments on cash flow and debt. Despite the decline in net income, as commented in previous slide, operating cash flow grew 26% in the year and 34% over Q4 '16, mainly due to the 92% reduction in working capital requirement. This growth in operating cash flow combined with the 49% reduction in CapEx in 2017 resulted in 57% increase in free cash flow. As a result of these cash flow generation, net debt declined 33% in 2017, corresponding to 1.1 times adjusted EBITDA in the year.

I now turn the presentation to Laercio for his closing remarks on slide 15.

### **Laercio Cosentino** {BIO 6567039 <GO>}

Thanks, Maia. Good morning everyone. Based on all that was presented in this conference call, we can affirm that the year 2017 marks a period of return of growth of (inaudible). We registered 6% organic growth in (inaudible). Subscription revenue grew 34% and annualized fourth quarter subscription fee -- subscription revenue in 2017 by 19.5%. (inaudible) relates to the (inaudible) for subscription (inaudible) effect for economic recession in Brazil prevented us for our achieving our EBITDA and net income targets in 2017. We made adjustments to the cost structure to align better with the growth in recurring revenue, but without compromising the company's capacity for growth, profitability and innovation. Despite these challenges, the continued financial discipline enabled us to increase the operational cash flow and consequently reducing net debt. The year was also marked by (inaudible) three pillars of TOTVS' digital growth [ph], among which are highlight in the call; in Culture and Environment, the inauguration of the company's new headquarter in Sao Paulo, a technological campus specially designed for TOTVS and inspired by the most modern working environment for the technology

companies around the world; in Processes and Service, the use of agile development and project management. the project management; Offering and Portfolio, the launch of our artificial intelligent platform Carol and inauguration of iDEXO, an institute whose mission is to connect startups, entrepreneurs and developers to pursue [ph] new business solutions.

In 2018, TOTVS remains focused on the success of its clients with the mission of simplifying the business world, supporting our clients in the digital journey, offering the best business solutions for companies of all sizes and segments.

Now we are available for the question-and-answer session.

## Questions And Answers

### Operator

Excuse me, ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) Our first question comes from Andre Baggio with JP Morgan.

### Q - Andre Baggio {BIO 6863260 <GO>}

Hi, Laercio and Maia. Can you talk a little bit about the development of new features, new software that you are having in the pipeline, so for example, how is going -- Carol, artificial intelligence and may be other initiatives (inaudible)?

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

Good morning, Baggio. Thanks for the question. In terms of new solutions and features, based on our announcements in previous quarter, I will highlight Carol as intelligence platform. So when we had our Investor Day here at headquarters, we had the opportunity show you guys some of the usages we are seeing for this kind of technology. That's somehow a kind of (inaudible) technology, that can complement all of our solutions we have in our portfolio. And actually it can work together with the solutions provided by our competitors too.

So in case of Carol, we can also use it as one element to convince clients to move to cloud. And besides Carol, I should highlight to you the solution we have to be in cloud. We have developed a kind of platform that manage infrastructure of cloud. It's not a solution itself to clients, but it's more feature as you asked me. So actually that platform gives us flexibility to offer more than one single option for clients in terms of the rest of our portfolio.

I would also highlight solutions related to mobile application and more recently we have launched a mobile app to our research and -- human resource solutions here and basically using services of our more traditional solutions for HR, but giving more flexibility for the end user to get information on their hand. I don't know if Laercio want to highlight any other --

**A - Laercio Cosentino** {BIO 6567039 <GO>}

Baggio, Laercio speaking. And we can compromise this (inaudible), the main version of (inaudible). We believe so much that we need to develop platform that can be used in different systems. (inaudible). And a new technology that is also being developed right now is (inaudible) platform that you can connect different software. And you can join and make the convergence of software. This is one factor that's very important. We work so much that many of our customers have so many solutions that can be used in (inaudible) Carol and cloud platform softwares, and our act [ph] in the top of the (inaudible) solutions.

**Q - Andre Baggio** {BIO 6863260 <GO>}

Okay. And a related question, can you describe a little bit on competitive environment. Let's say, do you think it's your market share among your clients is being maintain more or less similar, let's say, do you feel new competitive pressures?

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

Actually, Baggio, one thing that has changed in our market is in terms of who is the owner of the (inaudible) in the best in our (Technical Difficulty). In our view it's not applicable anymore this kind of view. So today, we see more and more companies using more than one technology provider and in this sense part of my answer, I could say yes, we see more competitors surrounding our clients. But on the other hand, we have more opportunity to explore with our clients and the clients of our competitors too.

One example, some clients that are now using our classical solutions like (inaudible) and vertical solutions and they use fully on top of it and Carol is going the same way. So, it's one some of good examples we can give. That's more in line with new way to consume technology. So, I hope I have been clear, but actually, yes, we see more names coming to the market, but on the other hand the market is more flexible to consume more than one solution; so, yes.

**Operator**

(Operator instructions) This concludes today's question-and-answer session. I'd like to invite Mr. Cosentino to proceed with his closing statement. Please go ahead, sir.

**A - Laercio Cosentino** {BIO 6567039 <GO>}

Thank you for participating in this conference call and have a nice day and a nice year too. Thank you.

**Operator**

That does conclude TOTVS audio conference for today. Thank you very much for your participation. Have a good day.

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