

Q3 2012 Earnings Call

Company Participants

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

Other Participants

- Andrew Campbell, Analyst
- Loren Lewallen, Analyst
- Matt Neal, Analyst

Presentation

Operator

Good morning. Welcome everyone to Totvs' Third Quarter 2012 results conference call. Today with us we have Mr. Alexandre Dinkelmann, Executive Vice President of Strategy and Finance; and Mr. Gilsomar Maia, Planning Officer.

(Operator Instructions) Today's live webcast may be accessed through Totvs' website at www.totvs.com/ir.

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 will turn the conference over to Mr. Alexandre Dinkelmann, who will begin the presentation. Mr. Alexandre Dinkelmann, you may begin your conference, sir.

Alexandre Dinkelmann {BIO 16100739 <GO>}

Good morning, everyone. Welcome to Totvs' Third Quarter earnings conference call. I would like to start this conference highlighting three important events for the Company this quarter, presented on slide 2.

First, Totvs was awarded for the second year in a row the Best Company in the Information Technology Industry by the newspaper Valor Economico, a traditional business newspaper in Brazil. Second, Totvs held its seventh annual public meeting with analysts and investors. For the second time in a row, the meeting was held on the premises of Expo Money Sao Paulo, one of Latin America's major investment and financial education events.

Third, the change in the rate for calculating the social security contribution, INSS, from August the 1st on which was lowered from 2.5% to 2% of gross revenues, excluding cancellations and unconditional discounts.

In addition, in the Third Quarter, there was also a change in the accounting policy for the social security contribution classification, beginning to be presented as a deduction from net revenues and not longer in cost and expenses.

For comparison purposes, in the Second Quarter figures the effect of the social security contribution was reclassified from costs and expenses line to revenue deduction.

Moving forward, on slide 3, comparing year on year, net revenues grew 13.5%, higher than the 11% growth achieved in the Second Quarter. This comparison does not take into account the social security contribution on revenues.

The acceleration of total net revenues compared to the Second Quarter was mainly driven by almost 19% growth in service revenue, resulting from the combination of above average growth in consulting service and in other complimentary service such as e-learning and data center hosting, besides the consistent improvement of efficiency in software implementation. Measures such as the variable compensation tied to project profitability and the creation of Totvs private division has contributed to the implementation service performance.

We will continue and aim to have more value-added service in our mix in line with two important goals, loyalty of our customers and margin expansion. With 12.5% growth year on year, also higher than the Second Quarter, maintenance showed its strong record as a result of the customer's base loyalty and the ability of our resilient business model to pass through the cost of inflation as well.

License revenue growth in the Third Quarter has diverged from our internal expectations, since the growth in the Third Quarter did not exceed the Second Quarter year-on-year growth. These expectations from the license line were based on the historical seasonality of our sector, traditionally stronger in the second half and on the better macroeconomic scenario expected for the rest of the year, in addition to the pipeline built throughout the year.

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We have realized that the current macro scenario has caused the postponement of the pipeline opportunities conversion cycle into new license sales. We have also realized that the macro scenario affected our clients industries on an almost uniform way. Thus, a representative volume of opportunities remained outstanding after the closing of the Third Quarter.

Yet when we look at the Company's top line performance, shown on slide 4, we see that the total net revenues already surpassed BRL1 billion in the nine-month period and mainly that Totvs has maintained the ability to grow net revenues consistently this quarter in line with previous years.

Now I ask Maia, our Planning Officer, to proceed.

Gilsomar Maia {BIO 16400533 <GO>}

Thank you, Alexandre. Now on slide 5, the Company's cost and expense overview presents a decrease as a percentage of net revenues in every calculation. The group of cost of license fees and services and research and development expense decreased as a percentage of net revenue, both in comparison with third Q and in the nine-month period.

This decrease is mainly due to the greater efficiency of software implementation schemes[ph], the higher share of services not directly associated with software implementation which have higher growth margin and the payroll tax release from the Brasil Maior plan.

In comparison with Second Quarter, the slight change in the percentage of net revenue primary reflects the dilution of cost of services, which is connected with the services revenue growth above the average growth of net revenues in the quarter.

Monitoring this three lines of expenditure jointly, it is important to check whether investment in R&D result in long-term margin gains through more efficient implementation, dilution of license cost, higher productivity of development teams and dilution of R&D investments through new license fee.

On slide 6, the group consolidates the main expense related to the sales process, consisting of advertising, selling and commission expense and allowance for doubtful accounts, which increased its relevance as a percentage of net revenues in third Q. Such increase is concentrated in the lines of advertising expense and allowance for doubtful accounts.

Increase in advertising expense, which was higher than the total net revenue increase, followed the Company's planning after the communication plan revision mentioned in third Q '11.

The increase of allowance for doubtful accounts is concentrated in implementation and consulting services rendered to large clients, even though the small and medium-sized clients before also increased throughout the year. The Company is reviewing its process of credit approval and the execution of larger scale services in order to mitigate this risk.

Concluding the cost and expense analysis, the group of general and administrative expense and management fees also decreased as a percentage of net revenues in all comparisons. This decrease is mainly due to the payroll tax release from the Brasil Maior plan and the provision for bonuses paid to the Company's executives as a result of achieving financial and non-financial targets.

Now I want to turn the conference over to Mr. Alexandre Dinkelmann again.

Alexandre Dinkelmann {BIO 16100739 <GO>}

Thank you, Maia. On slide 7, we broke down the EBITDA margin into three groups; the Brazilian operation, the Digital TV project and international market.

As mentioned before, our intention in presenting such breakdown is not generating any perception for investors about EBITDA adjustments or non-recurring similarities[ph]. Our goal here is rather to give more visibility to all on how business units with different levels of maturity and development contribute to Totvs results.

In summary, the Company has been able to expand margins in the Brazilian operation through the actions already mentioned on this conference call such as more productivity in the development areas, more efficiency in software implementation services and a more value-added service mix. We are also working on improving both the Digital TV and the international market results.

In the nine-month period of the year, the EBITDA margin of the Brazilian operation grew 280 basis points, whereas the consolidated EBITDA margin increased 350 basis points in the same period, reaching 27%. This performance gives us confidence that we are on track to achieve our EBITDA margin guidance for 2013 through 2016.

On slide 8, we see in a longer term perspective that Totvs has consistently worked on expanding its profitability, and the Third Quarter confirmed this trend of improvement when compared to previous years. It also confirms that Totvs can get a consistent top line growth and margin expansion capacity, a distinctive combination.

Moving to slide 9, in the nine-month period both EBITDA and net income increase were 28.3%. In this quarter EBITDA increased almost 29%, amounting to BRL99 million, the highest amount ever reported by the Company in a quarter. On the other hand, the net income growth did not follow EBITDA's growth this quarter, having being affected by the higher volume of financial expenses resulting from the mark-to-market of convertible debentures and the increase in the effective tax rate, which reached 34%.

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The increase in the effective tax rate was primarily impacted by three factors. One, the decrease of the Lei do Bem benefit on the R&D, given the less relevance on R&D expenses to EBIT as well as the decrease in R&D expenses eligible for the aforementioned benefit, as mentioned to you in the Fourth Quarter of 2011.

Two, the impact of financial expenses from the conversion of debentures, which are non-deductible as they do not affect the Company's cash position. And finally, the provision for bonuses, also non-deductible according to Brazilian legislation.

On slide 10, we have the cash flow and debt levels. Totvs ended the Third Quarter with a net cash of BRL99 million, as a result of cash generation in the period and the reduction of gross debt, mainly due to the conversion of debentures and semi-annual payments of BNDES Prosoft financing lines. This scenario shows the Company's financial strength for new investments. We understand that Totv's is able to access competitive funding instruments in terms of cost and service for our future investments, and we will go for them.

Lastly, slide 11 summarizes the quarter and also outlines how the management team has been guiding its strategic agenda, based on the pillars of growth, fidelity and margin.

Regarding growth, we highlight the service revenue growth and the almost 77% increase of sales to new clients. Especially, our net revenue has been growing during the year at the same level of recent years, despite a more adverse macroeconomic scenario.

In terms of loyalty, we highlight the acknowledgement of Totvs as the best company in the industry, and the maintenance fee revenue growth, which reflects the fidelity of our existing customers.

And finally, regarding margin expansion, we have reached almost 28% of EBITDA margin, which shows an increase of 380 basis points over the Third Quarter of last year. These indicators show that Totvs is still on track combining resilience, growth and margin expansion.

From now on, we are available for the Q&A session.

Questions And Answers

Operator

(Operator Instructions)

Andrew Campbell, Credit Suisse.

Q - Andrew Campbell {BIO 1762233 <GO>}

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My question is related to the balance sheet and in addition to the very strong cash generation that you had in the quarter, you also have the conversion of debentures that also reduced the outstanding debt. So my question is how do you think about the balance sheet as you will now be accumulating cash and going to a much higher net cash position?

Do you believe that the payoff to that policy may be reevaluated and how are you thinking about other potential uses of the cash? Thank you.

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Thank you for your question. We don't intent to change the policy -- the dividend policy. Historically, we have been paying from 50% to 60% of dividend payout. So as we understand that it's something that should not be volatile, we are not planning to change that. The good thing is that we -- as of our capital structure, we understand we have very good conditions to access competitive funding options in the market and as we have ahead of us good investment opportunities, we want to access these funding options. So in the mid-term, we intend to increase the leverage of our balance sheet. That's the idea.

Q - Andrew Campbell {BIO 1762233 <GO>}

Okay. And do you continue to actively explore M&A opportunities as well?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Yes, M&A is a part of this investment program in Brazil and outside Brazil.

Q - Andrew Campbell {BIO 1762233 <GO>}

Okay. Thank you very much.

Operator

Matt Neal, Invesco.

Q - Matt Neal {BIO 17098412 <GO>}

I had a question on provisions for doubtful accounts. Just focusing in on the trends in the small and mid-sized clients, have you seen an increase uptick this quarter? I didn't see that mentioned for small and mid last quarter, so could you just give an update on the momentum that's building there and then how you specifically plan to address this? Then I've a follow up question after that.

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

So comparing the Third Quarter with beginning of the year, what we saw was an evolvment in this line and part of the provision was due to the SMB market. So approximately 50% of that. First quarter and Second Quarter they are comparable in terms of size of the provision. But we saw definitely that in the beginning we had more bigger clients accounting for the provision and then part of that was increased in the SMB.

This is something that of course we are paying attention, but it's -- in our view it's under control, mainly the bigger tickets that were included in this provision. And we have just adopted some measures in order to control the risk of several big service contracts such as consulting, which was one of the big sources of increase of provision during 2012.

Q - Matt Neal {BIO 17098412 <GO>}

Okay. I guess my second question is on Digital TV. I just -- sorry, that I have a limited knowledge of the business structure here. But the non-recurring revenues that you saw in this quarter, please clarify they're not necessarily one-off revenues but they are related to the core business of selling software for television. Is that correct?

A - Gilsomar Maia {BIO 16400533 <GO>}

Yes. That's correct. This is Maia speaking, Matt. Actually, when we mention non-recurring revenue, we were regarding the revenue model of Digital Television, because it's based on TV set sales by the producers. So there is no recurrence module involved in this case. It's not a one-off event.

Q - Matt Neal {BIO 17098412 <GO>}

Okay. Do you have any updates on Digital TV in regards to business development momentum?

A - Gilsomar Maia {BIO 16400533 <GO>}

Not really. We are working with some (inaudible) to have investors with us in this business, but we are analyzing -- the first actions we took was to align the level of posts, then we made some reductions in the headcount of TV -- Digital Television last quarter. And it's brought some results in terms of adequating the cost structure. But really, no recent news about Digital Television.

Q - Matt Neal {BIO 17098412 <GO>}

Okay, excellent. Thank you very much.

A - Gilsomar Maia {BIO 16400533 <GO>}

My pleasure.

Operator

(Operator Instructions) Loren Lewallen, Select Equity Group.

Q - Loren Lewallen {BIO 17231394 <GO>}

Congratulation on another very strong quarter. My question was on the pacing of license sales over the last few months. You talked about how there were some sales in the pipeline that didn't close and I was wondering if, as you looked at the sales of licenses over the quarter and into October, whether you saw stability over that period, a

deceleration, an acceleration? Then also related to that, what your current outlook is for the business over the coming quarters?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

So as we were saying to everybody, we were expecting acceleration during the year according to our expectations about the macro scenario. So First Quarter and Second Quarter showed this trend. What we perceived in the Third Quarter is that we noted the turning point of the Brazilian economy didn't take place actually. There are good expectations here. Also 2013, there was a much better economy in the country. But so far we haven't seen stronger signals of this recovery.

What we see is a strong pipeline, a lot of discussions, negotiations, demonstrations with our clients spread through different industries that we cover here in Brazil. But primarily what we saw was that the sales cycle was taking longer, and in practical terms this is making that visible our Fourth Quarter has much more responsibility in terms of what we are pursuing for the year. So again, what we see here in Brazil is that the economy has stopped the deterioration process, which is good, but the turning point so far is not really present.

But expectations are good for 2013 compared to 2011 and 2012. So what we are seeing here in Brazil in the last two years, the economy is growing less than 2% and despite this more complex macro environment, Totvs has been able to expand its business at the top line at the levels that you are seeing. So mixed signals that our business model and our position in the market is really robust and all homework that we are doing now in the Company is preparing our sales and making us better for this recovery, for this upturn in the economy.

Q - Loren Lewallen {BIO 17231394 <GO>}

That's very helpful. Can you comment at all on the growth in your pipeline? I know you said that's improved, so it would be interesting if you could comment on your pipeline?

Then, secondly, another related follow-up. When you talk to customers, what are they saying is the cause for the delay, I guess? I imagine it's the overall economy, but what are they looking for in order to actually take that order and to turn it into sales and to make that purchase decision?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

So in terms of pipeline, we have an advantage here in Brazil because we cover important industries. So we are divided into 10 verticals. So we have to -- in order to reallocate new investments and focus depending on the macro scenario and how this macro scenario is impacting different industries. We have the pipeline spread throughout our segments in terms of size. We are talking with big clients as well as SMB clients. So there is no big difference in terms of the size of the clients. In terms of industries, there are industries that are -- that are showing better prospects in terms of sales and in terms of use of software.

In general, industries that are less mature in the adoption of software and ERP. I would mention some of them. Education is an industry that is presenting very good prospects and we have a very strong position in the market. Retail is an important industry, logistic services in general. The Brazilian economy is becoming a service oriented economy. So a few examples of where we see good opportunities in the market.

Q - Loren Lewallen {BIO 17231394 <GO>}

Okay. Thank you.

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

I'm not sure if I addressed your questions. But I believe that you had a second part in your question.

Q - Loren Lewallen {BIO 17231394 <GO>}

Yes, I guess -- well, the first one is I was wondering if you at all quantified the growth in your pipeline. So if we look at your pipeline today, is there some dollar amount that you put on your pipeline today versus a year ago and how that's increased?

And the second was more related to what customers are waiting for and do they tell you -- like, in the US, we see people waiting for the election and the fiscal cliff, or people talk about elections in China. Are those -- do we see customers in Brazil talking about similar things or is it a whole different set of macro events they are waiting for to go ahead and put an order in for a new ERP system?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

In terms of the size of the pipeline, we see the increase of the pipeline in line of our growth expectations. So it's in line with our mid-term growth expectations. In terms of the Brazilian environment, I don't see personally any trigger, specific trigger or a specific event. It's more about the global mood and the confidence about the country resuming its growth pattern. So again, the government is adopting a lot of measures in order to keep incentives for people to consume and for companies to impact. And that's just the process of resuming the growth pattern. So no event in specific.

Q - Loren Lewallen {BIO 17231394 <GO>}

Great. Thank you very much for taking those questions.

Operator

(Operator Instructions)

Well it appears that we have no further questions at this time. We'll go ahead and conclude our question-and-answer session. I will now like to turn the conference back over to Mr. Alexandre Dinkelmann for any closing remarks. Sir?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Yes. I would like to thank you all for being with us in this conference, and I would like to thank also Totvs team -- for the team and hard work as well as the confidence about our future. We have been demonstrating consistency in expanding our business both at the top and bottom lines and we believe that we are much more prepared for the expected upturn of the Brazilian economy. So thank you all.

Operator

And we thank you, sir, and for the rest of the management for your time. We thank you all for attending today's conference call. Totvs' Third Quarter results conference call is over. Again, we thank you all and have a nice day.

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