# Q3 2020 Earnings Call

## Company Participants

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

## Other Participants

- Frederico Mendes
- Maria Tereza Azevedo

## Presentation

### Operator

Good morning. And welcome to the TOTVS Third Quarter of 2020 Earnings Results Conference Call. Here with us, we have Mr.Dennis Herszkowicz, CEO; and Gilsomar Maia, CFO.

We would like to inform that all participants will be on listen-only mode during the company's presentation. Subsequently, we will initiate a Q&A session for investors and analysts when further instructions will be provided. (Operator Instructions) This audio is being streamed simultaneously in the Internet at ri.TOTVS.com.br.

Before proceeding, we would like to clarify that forward-looking statements made during this conference call regarding TOTVS's business prospects, projections, and operating and financial goals are beliefs and assumptions of the company's executive board as well as information currently available. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties, and assumptions as they refer 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 operating factors may affect the future performance of TOTVS and may lead to results that differ materially from those expressed in such forward-looking statements.

Now, we would like to give the floor to Mr.Dennis, who will start the presentation as of Slide 3.

Mr.Dennis, you have the floor.

### Dennis Herszkowicz {BIO 17998338 <GO>}

Good morning to everyone, and thank you for participating in our earnings results for the third quarter of 2020.

After a second quarter in which the resilience of TOTVS's business model was put to the test, we witnessed a recovery throughout the third quarter in the pace of economic activity and in the progress of the company's technology and credit solutions, operations in the different regions of our country. Within this country aiming to offer increasingly differentiated solutions to our customers, we launched two new products and made a new partnership during this quarter.

Our first launch was the TOTVS Consignado platform. This is a Techfin product, which in this case is aimed at facilitating and simplifying the management of prime and payment payroll loans allowing loan approvals to be carried out without any manual intervention by the clients HR through native integration with TOTVS system payroll excess directly by our financial partners BV and Creditas ensuring more accuracy and agility throughout the process.

The second is novelty is the launch of the instant payment model for TOTVS financial service customers in line with the main trends and recent developments in the national financial sector introduced by the central bank. We have developed a new model that will support financial institutions of all kinds to join the new system of payment and instant transfers, PIX, which will modernize and simplify these day-to-day operations of peoples and enterprises.

We also have a new partnership with Mercado Livre, which we believe will allow our retail customers to offer their inventories and market their products in a simple and automated fashion, further strengthening their omnichannel strategy through the integration between TOTVS Omni by Moddo and the marketplace of Mercado Livre.

Now, I will give the floor to Maia that will talk about the technology results as of Slide 4.

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

Thank you, Dennis.

The net technology revenue continued its consistent growth trajectory having increased 9.4% year-on-year and mainly due to the 12% growth in recurring revenue. Now, the non recurring revenues, however, remain stable in the same period with license revenues increasing 17% and service revenues dropping 10% in the line with the trend observed in previous quarters.

Now when we compare it to the second quarter, the 4.7% increase in net revenue reflects the 19% growth in non-recurring revenue especially in the license life, which reached a strong expansion of 35% together with non-recurring services that grew 8.7%.

Now going back to the recurring revenue, the year-on-year growth of 12% in the quarter and 12.8% in the nine-month period is the result of the combination of the following factors: the evolution of sales both for base customers and for new customers, the maintenance of the high level of the renewal customer rate over 98%, now contract updates, and the consolidation of Consinco and Wealth Systems results as of the second quarter of this year.

As we can see in the chart on the left of Slide 5, the annual recurring revenue, ARR, calculated based on the contracts in force and forced at the end of the quarter grew 14.9% year-on-year. The net addition of ARR total R$56.7 million this quarter, an amount 27% higher than the addition of R$44.6 million in the third quarter of 2019. This growth in ARR at a level higher than the organic 8.2% growth and recurring revenue is essentially associated with the greater volume of shortfalls granted in the new sales part of the important and successful commercial technique already commented in the second quarter. This was during the closing sales of the COVID-19 pandemic period. Such ARR performance is an element that contributes positively to the recurring revenue in the upcoming quarters. In addition to the sales of cloud solutions and solutions that help customers operate remotely as noted in the previous quarter, we the -- sales of Consinco Wealth Systems are also highlighted for this performance.

Now on Slide 6, we will talk about our EBITDA. The adjusted EBITDA in this quarter presented a new expansion totaling a growth of 23.3% over the third quarter of 2019 with 270 bps of margin expansion, which reached 23.6% margin, which demonstrate the Company's operational leverage capacity. Year-to-date the EBITDA margin expansion was 190 basis points showing the discipline and the execution of the strategy and the resilience of the company's business model even in the face of an exceptionally challenging year.

Now, I will now present the results of supplier credit products on Slide 7.

The recovery trend in credit production which started in the second quarter was confirmed in the third quarter with a V-shaped recovery. The production in September was the highest since January 2019. This performance in production reflects the resumption of economic activities in the chain served by supplier as well as the strong gain in penetration in the sales volumes with its affiliates. This also translated into an increase in the credit portfolio as shown in the chart on the right, which again exceeded R$1 billion. And in the cash position for the third quarter, which is closer to historical levels as shown in the chart on the left side of Slide 8 in contrast to the surplus cash presented in the second quarter, which had a negative impact on the results of that quarter.

In the chart on the right, we see a more conservative behavior by supplier in establishing the limits for credit granting since the beginning of the COVID-19 pandemic. Especially, in the behavior of the portfolio of items that are up to 30 days overdue, which showed the highest increase in delinquency in May and is currently below pre-COVID-19 levels.

If we consider the average portfolio term of about 60 days, supplier has already rotated its portfolio three times during the pandemic, and the rate of effective losses that increased at the beginning of the pandemic is currently below the historical low average of this indicator. This goes to show the resilience of suppliers business model and its discipline in credit granting, which had an impact in the significant evolution of results in the third quarter as shown on Slide 9.

Credit product revenues grew 82% compared to the second quarter of 2020. In addition to the recovery in the production of credit, the consolidation of only two months of suppliers results in the second quarter also had an impact on this growth. When compared to the third quarter of 2019, the 11% reduction in these revenues is mainly associated with the reduction in the average Selic rate, which decreased from 6.15% in the third quarter of 2019 to 2.1% in the third quarter of 2020, which had an impact on the nominal rate of suppliers credit products even with the average spread for the period having remained stable.

Also year-over-year, EBITDA showed a 28.6% reduction mainly due to the change in suppliers capital structure with most of the credit portfolio allocated to the FIDC and a reduction in its subordinated quotas for the FIDC. This change in capital structure also increased suppliers return on equity from 7.3% to 16.6% year-over-year. In comparison with the second quarter, EBITDA went from R$0.3 million to R$12.9 million. This performance is essentially the result of the following factors: an increase of 220 basis points in the gross margin, the positive effect of be PCLD, which went from R$0.5 million in comparison to minus R$4.9 million in the second quarter of 2020. We also had the consolidation of only two months in the second quarter of 2020 and a cash position in the third quarter of 2020 that is closer to historical levels.

On Slide 10, we can see that the increase in EBITDA was the highest factor leading to the growth of the cash earnings in the comparisons that we saw. It's important to highlight that we had a 35.8% growth quarter-on-quarter, and 21.8% growth in the past nine months.

I will now hand it over back to Dennis for his final remarks on Slide 11.

## **Dennis Herszkowicz** {BIO 17998338 <GO>}

Thank you, Maia.

Here is my is my final message. Number one, we are following our medium and long-term strategy to consolidate an ecosystem with three dimension with products and partnerships that are going to add more and more values to our customers. We keep on looking to develop new products and partnerships and to offer the best tools that can help you grow. Number two, we keep on having a robust and consistent journey in the growth in technology as we can see in a year-on-year growth rate of 27% in ARR.

Our credit operation is also showing robust signs of recovery as we can see in the V-shaped recovery for credit. This goes to show that our business is resilient even in the face of the challenges presented by COVID-19. Number three, we are doing all of that while taking care of everything in-house and we grow in a (inaudible) and profitable way. This also shows that we have scalability and robustness for TOTVS's business model. We had our highest EBITDA margin within the last five years at 23.8% and I would like to thank all of the TOTVERs for being a part of this.

Finally, number four; we are sure that our combination of business with the Linx is going to allow for the best creation of value for both companies, their shareholders, their clients, and their employees, and this is based on the highest standards of governance always based on equality for every shareholder. After compliments from the main shareholders at TODOS, we decided to have an extraordinary general meeting on the 27th of November 2020 to talk about this offer of combining businesses even before we talk to the -- to Linx during a meeting.

We've summoned our shareholders because we want to talk about the fears, which we don't think are justified when it comes to Linx and when it comes to their independent advisors. We strongly believe in the ability of Brazilian business people to reinvent themselves in this unprecedented time. Focus has been a key word for us TOTVS. Based on this word, we've also been able to gradually retake the course of evolution in our results both in operations and finances. We see quality in execution, and in our medium and long-term strategy. We are building and strengthening our presence in the three pillars that are a part of our ecosystem, management, tax and business performance. This has only been possible, because of the efforts made by every TOTVER, because this year they spared no efforts to make sure we had the continuity of our operations, the development of new products, the maintenance of services and customer service to our clients.

We are now available for the question-and-answer session.



# Questions And Answers

## Operator

(Question And Answer)

Ladies and gentlemen, we are now going to start the Q&A. (Operator Instructions) Our first question is from Mr.Fred Mendes from Bradesco.

## Q - Frederico Mendes {BIO 19832788 <GO>}

Good morning to everyone and thank you for taking my question. I have two questions here. Number one would be the recovery of your margin is very strong and this is something that we expected with us low Selic. I know that you don't provide us a guidance, but when we see the trend and when we see the figures of 2019, and there is still room for improvement in funding a new problem products if we can see a margin above the levels of 2019. This is number one.

And my second question, I would like to better understand also the grace period and sales, if it weren't for the grace period, this would be stronger. So, I would like to understand when we can see the end of the impact and when we can see an organic recurring revenue going back to normal.

### A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you, Fred. This is Dennis speaking.

Fred, regarding the supplier as you stated, the recovery was very strong much better than we expected actually, we already had at the end of the second quarter signals that things were recovering. Nonetheless, this was a certain positive surprised when we saw the results of the third quarter, especially when we saw the margin. So, this is more along the lines of what we mentioned during the second quarter, because the second quarter had that X, where we had changed our capital structure and increase funding and the FIDC. And due to this, there was some leftover fund that had to be remunerated strongly and simultaneously a drop in the revenue generated by the reduction of origination and the size of portfolio, because of the drop of economic movement and the drop of the credit limits in order to better reassure the default index and the loss index.

So, once, everything was working and very quickly actually, which is our characteristic of supplier that is a little bit different from the traditional trade of TOTVS, here the business is a bit more volatile; it goes up and down, right? But when we had or when the economy started going back to normal, when the default rates dropped, the loss rate maintaining itself. The credit limits were increased the origination also increased the portfolio evolved and the revenue, of course, also took off.

So, as we didn't raise more funds and FIDC, the cost continued more or less the same. So, what does this mean? It means that practically all the revenue progress that we had. Well, it turned into an increase of margin now after all of this explanation what I can say is. Yes, there are absolute conditions that if the supplier business continues performing and recovery in origination and in the size of the portable, there is no doubt that the margin will continue increasing. This is a business that fintech techfin. Well, it does has a scalability, which is significantly greater than what it had in the former traditional model. Yes, we do believe that this margin will evolve throughout time.

### Q - Frederico Mendes {BIO 19832788 <GO>}

Maia, regarding grace periods; could you say something about this?

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

Now regarding the grace period, well, this is something that we mentioned during the second quarter. Well, this is a trade practice or a commercial practice that is not new to us. We had already tried out this type of tactic between 2016 and 2017. This was a very difficult period for the Brazilian market. This also -- incidentally, there was a subscription model. And one of the tests that we made was to have a number of accesses in the broadest part more than what they hired for a period of time that is determined. And if the customer, for example, decides to maintain a higher access level, then they start paying. This would be like a premium model. This is a tactic.

The other one would be to extend the time that we grant without charging. And in the past, this was highly effective. We started using it again during the pandemic. It was one of the instruments that we granted to our commercial team, and we believe that this strongly contributed to closing sales and this postpones a little bit. The reflection of the sales turning into complete revenues for the company, because this is something specific. Now gradually we have also reduced this. The market allows us to reduce these type of practices.



## Q - Frederico Mendes {BIO 19832788 <GO>}

Well, I hope that we are -- I hope that we go back to the past levels and not distant date.

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

Exactly, we use this in large scale during the most difficult months that were April, May and June. We started realizing a lesser need and during the third quarter, we already started going back close to the normal levels. So currently, we are very close to normal levels in terms of grace period, which means that as ARR was faster than the revenue, here we have a good indication for the upcoming months and for the upcoming quarters.

## Q - Frederico Mendes {BIO 19832788 <GO>}

Very clear. Maria and Dennis. Thank you very much.

## Operator

Our next question from Maria Azevedo from Santander. You have the floor.

## Q - Maria Tereza Azevedo {BIO 16178885 <GO>}

Good morning to everyone. Thank you for the call. I have two questions. My first question would be a follow-up of the M&A process of Linx. Could you elaborate a little bit more regarding convictions? What are the main levers? And what is TOTVS's proposal in terms of governance? And what will be the upcoming processes? Do you have any positioning from the shareholders of Linx regarding how this operation will take place from here on?



## A - Dennis Herszkowicz {BIO 17998338 <GO>}

Good morning, Maria Tereza. Thank you for the question.

Yes, as we already stated that our proposal starting by governance. We believe that it presents differentiated level. So, I will give you some examples here. No, we are not treating differently any shareholder in our proposal. We are exactly offering the same conditions to all our shareholders. And this is the elemental -- this is the elemental point. And this is what we are doing and Linx and both our listed companies. Number two, we have maintained since the beginning a level of transparency and everything that we do.

So, in no given moment, we questioned -- there were no question from shareholders, from Board members or even from the press. They never questioned if we disclosed everything that had to be disclosed, not necessarily. Well, things didn't happen exactly this way. Mean -- the minutes of the Board member meeting from Linx states clearly that the founders did not communicate to the independent Board members that they were dialoguing together with us.

Now from the governance point of view moreover, there is a certain disparity that for us and for myself. Well, this shows how fail governance is the amount of financial advisors and legal advisors or aids that are being used here. Therefore, you know just the amount just demonstrates the need of providing explanations that the other proposal demands and with all of the support we've seen that throughout these a bit more than two months a number of things must had to be adjusted. This is in the second contract of the proposals questioning, and even analyzing, decisions from the regulators about the different pathways that were followed.

Anyhow, we do believe that there are still matters to be addressed, the essence of the proposal, where we have fines that are twice the amount of the EBITDA of Linx continue there, now the compensation above any Brazilian level for the founders, this continues there. So, we do understand that despite all of the adjustments that were forced on the other proposals. There are still others that should be done.

Now regarding the synergies, Maria Tereza, I believe just so we don't extend ourselves, I'll talk about revenue synergies mainly, because of the cross selling opportunities amongst the base the opportunities to broaden, the distribution structure of Linx products using this TOTVS platform. We have we can unite our techfin portfolio as a Linx payment portfolio. And at last, we have everything regarding big data that would become a great driving force for all of these initiatives. And in expenses as both companies have MOs that are very similar, it is natural to be able to find major synergies and with an execution risk relatively low.

And finally, we have everything regarding goodwill. That is something that is reasonably guaranteed. All of this being said, I can say that yesterday we received the recommendation from the independent committee of Linx's Board and they disregarded the synergy. Of course, we do understand the reasons that are behind this rejection, but we believe that this only strengthens the problems, the credibility problems that all of this generated. It wasn't only TOTVS the one that placed a synergy study. You, Fred, and other, people also made their own analyses based and information that was available to everybody. So, we disagree. We disagree categorically with this analysis.

In terms of next steps, Maria Tereza, just to bring this point to an end, we have to wait a little bit. And we actually have to see if the regulator is going to make a statement. Well, we do believe that there are shareholders from Linx that, yes, want to request the suspension of the meeting of the EGM before the SEC as we want the regulator to manifest themselves in favor. Why? Well, so the -- so that we have the ability of -- so that we -- so they can vote on our proposals as soon as our F4 is effective. And maybe with our meeting being carried out and perhaps our shareholders, well, they will probably show the support based on the conversations that we had in the past weeks with most of them.

So, yes, I believe that this should be the past. If this is true, well, we still have to wait a little bit more, okay?

## Q - Maria Tereza Azevedo {BIO 16178885 <GO>}

Perfect, Dennis. Thank you very much for the clear answer. Here's my second question, the core business. ARR is doing really well, surpassing our expectations of growth. What kind of opportunities do you see for growth in the core either with market share or software? Do you think you have room for improvement with the core?

## A - Unidentified Speaker

Well, Maria Tereza, we believe so. We've seen and we've been talking about it in the conversations with you, the analysts, and with investors as well. We've realized that the pandemic has created this generalized perception. And I am talking about different segments of the industry in different sizes of businesses when it comes to the gap that we have related to investments in technology and software within the last few years.

When we think about the period between the end of 2014 and the middle of 2019, Brazil went through a major crisis as we are all aware of. And because of that, the level of investments in technology went down. However, the economy was changing, the way we created relationships and we sold to customers was changing as well. The way we managed companies, the way we dealt with insights everything was going through changes.

And during that period when the whole world was investing in technology and solutions and they were doing it at a much greater scale than in the past, Brazil companies were actually reducing those investments because of the economic crisis we were going through, a very long, very deep economic crisis. So, in our opinion, the pandemic made that crystal clear. That is why we've seen willingness and I don't even want to use the word obligation, but that's kind of an obligation to make up for the lost time and to accelerate their investment in all of the themes we've been talking about. The cloud, omnichannel structures, digitalization, scalability, and all of that can only be solved by technology. We can only address that with software.

So, yes, Maria Tereza, we do believe we still have a lot of room for growth in our core business. That is why we now have two years of growth with two digits with our recurring revenue in the core business. We do believe that we can make that continue being true for a long time.

## Q - Maria Tereza Azevedo {BIO 16178885 <GO>}

Perfect. Thank you very much. And congratulations.

## A - Unidentified Speaker

Thank you.

## Operator

(Operator Instructions) This is the end of our questions-and-answer session. I now hand it back over to Mr.Dennis for his final remarks. You may begin, Mr.Dennis.

## A - Dennis Herszkowicz {BIO 17998338 <GO>}

Once again, I would like to thank everyone for being here. Special thanks to all of our TOTVERs. At the end of the day, we are only able to deliver everything we deliver in technology and credit because of the effort and engagement we have from the whole team, especially, during such trying times as the pandemic. So, once again, thank you very, very, very much. And I can tell you that we are still fighting for delivering value to you. We want to cater to our customers in the best way possible. We also want to keep our very, very great governance level.

This ended up being a shorter earnings release call. And as I said before, this has to do with the amount of advisors we have here. Most analysts right now had a conflict in their schedule. So, we don't have as many attendees to ask questions today.

Once again. Thank you very much. Enjoy your day and I'll see you next quarter.

## Operator

This is the end of the TOTVS earnings release presentation. Thank you very much and enjoy your day.