Q1 2014 Earnings Call

Company Participants

- Alexandre Mafra Guimaraes, CFO
- Gilsomar Maia, IRO and Corporate Finance Officer

FINAL

Other Participants

- Michel Morin, Analyst
- Richard Dineen, Analyst
- Vera Hoffa, Analyst

Presentation

Operator

Good morning, welcome everyone to TOTVS's First Quarter 2014 Results Conference Call. Today's web we have Mr. Alexandre Mafra, Human Relations and Organizational Infrastructure Vice-President, Executive and Financial Vice-President; and Mr. Gilsomar Maia, Investor Relations Officer and Corporate Financial Officer. (Operator Instructions)

Today's live webcast may be accessed through TOTVS's website at IR dot TOTVS dot com dot br. Before proceeding, we'd like to mention that during the conference call forward-looking statements made be made too[ph], relating to topics, business prospects, operational, and financial statements[ph] and goals based on the beliefs and assumptions of top[ph] management and on the 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. These[ph] (inaudible) should (inaudible) that general economic conditions in these three[ph] conditions and other operational factors could also effect positive[ph] results and could cause these results to differ materially from those expressed in such forward-looking statements. Now, I'll turn the conference over to Mr. Alexandre Mafra who will begin the presentation. Mr. Mafra, you may begin.

Alexandre Mafra Guimaraes {BIO 16015106 <GO>}

Good morning, everyone. Thank you for participating in TOTVS' Q1 Results Conference Call. Before we talk about the results, I would like to comment on the main events presented on slide two that (inaudible) after the[ph] Q4 2013 results. The addition[ph] closing are[ph] 70% (inaudible) shares on February 6th[ph], which became the top[ph] (inaudible) solution of calls platform[ph] to support these clients[ph], e-commerce operations, and Federal industry factors.

The real action of the Board of Directors (inaudible) Monday[ph] for the next two years. Approval[ph] by the shareholders meetings held on March 14. Just recalling[ph], the Board's Pedro Luiz Barreiros Passos[ph]. They[ph] are the chairman, German Quiroga[ph], and vice chairman; (inaudible) and the covering[ph] (inaudible) CEO, Luis Carlos Afonso[ph], Pedro[ph] (inaudible). Maria Helena Santana who also chairs the (inaudible) Committee[ph]. Pedro Moreira Salles who also chaired the Remuneration Committee[ph].

This same[ph] meeting also approved the distribution of R$150.9 million in (inaudible) corresponding to R$0.71 cents of reals per share totaling R$155.8 million of total shareholder remuneration for the financial year of 2013. Corresponding to R$0.95 cents of reals per share. This total remuneration is 31% higher than the one approved in the previous year.

We also held[ph] (inaudible) on April 15th. The Company's biggest[ph] (inaudible) event[ph] which was attended by more than 2,700 guests; including clients, prospects, partners, franchisees, journalists, buy and sell-side analysts who could know[ph] a little bit more about our solution and strategy; as well as an[ph] main trends[ph] of the software market.

Now, I turn the call to Maia[ph] who (inaudible) by sharing with you our operating and financial results on slide 3.

Gilsomar Maia {BIO 16400533 <GO>}

Good morning, everyone. Before starting the comments on the results, I'd like to remind you that the financial information regarding this quarter and the last 12 months are relating to the sharp[ph] First Quarter figures. The total net revenues were more than 50% in the quarter compared to the same period of last year. In the last 12 months, the 160% [ph] growth also exceeded the last five year CAGR. The three revenue lines with[ph] (inaudible) with 15[ph]% growth in license fees, 17.5% in services, and 14% in those new fees[ph].

Moving onto slide 4; on the left, we have the breakdown of licensed revenues between the incremental license from corporate model and other assets[ph]. The incremental license from the corporate models totaled R$20 million in Q1 2014, an increase of 20% over the same period of this past[ph] year. Besides the higher amount of incremental revenues, the number of clients under this model that has to pay for incremental license fees increased 7.6%.

It's important to recall that clients under[ph] these models, the incremental license fee in the First Quarter of the year based on their real[ph] growth in the previous years. Also, having the written[ph] number of assets to top[ph] management people[ph]. First, there is no incremental license in these clients roles[ph]. Since most of the clients in the corporate model are medium and small companies, historically, this model has been mainly[ph] to accelerate its growth in times of economic expansion. Also, (inaudible) to economic downturns.

(inaudible) in the graph on the right side, which compares the incremental license revenue from the corporate model with the previous years since the[ph] (inaudible) in a five year period. Returning to the graph on the left side, we also see that the other[ph] license grew 15[ph]% in the quarter. This growth was mainly due to the sales to new clients, which grew 98% year-on-year. This percent is what's called (inaudible) by large pay-ins[ph] closed in the quarter shown by the 112[ph]% increase in the average (inaudible) over Q1 2014.

Relevant short-term valuations in the average (inaudible) are a two-fold process[ph]. With that[ph] the company's capacity to provide solutions for clients of recent size and[ph] industry factors. As well as the historical (inaudible) distribution of large accounts closed during the year. This becomes[ph]more evident when we take into account the 4% growth in the 12 months average (inaudible) off days[ph] to new clients. In the same 12 month period, licensed payers grew by 27[ph]% as a whole with a 6% lower average (inaudible) and a 82%[ph] higher number of sales.

This higher number of sales combined with this lower average (inaudible) shows an investment fraction[ph] made by clients who are reallocating with those[ph] from short to long-term. Effective[ph] (inaudible), it means that advancements[ph] in licensing the short-term, (inaudible) implementation projects would reduce this call[ph]. And more resources[ph] allocated through recurring and mostly maintenance payments for the year[ph].

In Fractioning[ph] approach, you called this[ph] (inaudible). The larger companies have also adopted this recently[ph] (inaudible). (inaudible) debt with[ph] the lower growth in license fee revenues compared to services and maintenance revenues in the last three years.

The commercial and technological flexibility reflected in the diversity of commercial models and inflation performance[ph] also encouraged these fractionate[ph] behavior. At least one[ph] of the (inaudible) reviewed that explains[ph] the Company's[ph] market leadership and the revenues consistently[ph]. An examples of these flexibilities are a licensed sales for consumer[ph] users are[ph] under the corporate model. The possibility of implementing solutions in stage[ph] reflecting the quiet maturity and need[ph]; and the recurring monthly maintenance fees[ph].

Looking at[ph] recurring revenues on the slide 5, we present the total recurring revenues, which grew 12% in the quarter reaching almost R$1 billion over[ph] the last 12 months. The recurring revenues expansion[ph] is part of the Company's strategy for growth in the margin expansion. Mostly payments have made[ph] the description[ph] in cloud computing services. It should be more relevant in our next revenues[ph] contributing to the corporate evolution in the new and[ph] long-term.

Regarding cost and expense, I invite everyone to go to slide six where we have the cost and expenses as a percentage of net revenues. The correct and negotiation[ph] process regarding the wage increase on specific[ph] (inaudible) for San Paulo[ph] affected costs and expenses in Q1 2014. This year, this process has (inaudible) it should be[ph] concluded that the Company (inaudible) accrued[ph] a wage increase of 7% as of January 1st in accordance with the Trade Association[ph] (inaudible).

Moving to the cost and expense groups. The first group, which represents the cost of all of our[ph] solutions decreased when compared to both Q2 2013 and Q4 2013. The reduction in[ph] (inaudible) in the three lines of calls[ph]; the license fees, services, and R&D[ph]. In R&D, the reduction is mainly due to the capitalization of our (inaudible) which result[ph] from August to September in Q4 2013. The additional provisions for occasions and third parties[ph] in Q4 2013 at the conclusion of some projects in Q4 in which more development partners participated.

In the last 12 months, R&D expense increased 27%. Here, once again, we reiterate our commitment with cost and expense (inaudible) without (inaudible) cycles at risk[ph]; and always taking into account the return on investment (inaudible). The reduction in cost of license fees in this quarter reflects the lower share of embedded complementary third party solutions. Infrastructure solutions provided by our partners in the software segments.

In concluding comments on this group, software searches[ph] extended at the lower rate due to services[ph] revenues both in Q1 2014 during the year and in the last 12 months compared[ph] reflecting the greater efficiency in the public services[ph] (inaudible).

This productivity gains at[ph] (inaudible) especially for our clients. To address this matter, we have initiatives such as the expansion[ph] of TOTVS's implementation performed remotely. The investments in developing implementation of rates, which tend[ph] to make implementation faster and more effective; in addition to growth of cloud source[ph]. The second group related to sales were presented a higher share of net revenues both in Q1 2014, year-on-year and the last 12 months compared[ph]; mainly reflecting higher expenses with the long[ph] (inaudible) about four counts[ph].

This growth in the long and full (inaudible) four counts[ph] is mainly due to the overdue[ph] credits recovery in Q1 2013; and to the financial problem faced[ph] by large clients in Q1 2013. (inaudible) commission expense together realized[ph] the net revenue in the Q1 year-on-year comparisons in the last (inaudible). These expenses are directly related to sales by on branched than[ph] franchised as well as the breakdown of net revenue in the period. Continuing[ph] the different commission libels[ph] of their revenue line.

Moving to the last group, (inaudible) these calls[ph], maintenance. They represent (inaudible) over[ph] net revenue in the quarter. When compared to last quarter even with the accrual[ph] for Sao Paulo's wage increase and for management fair[ph] (inaudible) inflation[ph]. Now, I turn the presentation back to Mafra[ph] who will continue from his[ph] slide 7.

Alexandre Mafra Guimaraes {BIO 16015106 <GO>}

The (inaudible) began when the main rooms of[ph] costs and expenses. It raised the EBITDA margin to 26.5%. This margin with (inaudible) increase of four[ph] basis points compared to Q1 2013; and 310 basis points compared to Q4 2013. EBITDA[ph] increased 17% in that[ph] (inaudible) , R$114 million This growth is higher than the last five year CAGR, which demonstrates the relevance of involvement presented in Q1 2013[ph].

On slide 8, we have the net income increase, which was higher than (inaudible) both in year-on-year and the LTM[ph] comparison. In the quarter, five year[ph] adjustments of the business interest accrual, the net income increased 18% mainly driven by the EBITDA growth and lower depreciation and amortization in the period. Thus, Q1 2014 net margins reached 14.3% .representing an increase of 40 basis points over Q1 2013.

Now on slide 9; the Company ended the quarter with almost a half million reals in cash. Net cash totaled R$90 million about R$3 million higher than Q4 even with the amortization of R$26 million of the financing line[ph] higher from the MBS[ph] in 2008. The payment of R$90 million has interest on everything related to the second half of 2013. Then[ph] the disbursement of R$37 million in distribution[ph] may be related to the attribution[ph] of 70[ph]% of CiaShop´s shares and their now[ph] payment of R$0.60[ph].

It's worth mention the business approved[ph] at the shareholders meeting held on March 14th, totaling[ph] R$115 million were paid[ph] on April 10th[ph]. Thus the impact of this business will be reflected in Q2 2014 cash flow. The total[ph] cash balance combined with its next year[ph] cash generation in this debt for five[ph], which is very profitable in terms of[ph] competitive were paid for our[ph] financial capacity for organic and inorganic investments. (inaudible) primary[ph] and bring forth our operation in more prominent industry sectors in terms of growth in our technology platform and in our presence in Latin America. Now, I invite everyone to go to slide 10.

In summary, the First Quarter results highlights were a 15% growth in net revenue. The 20% increase in incremental license from the corporate model. The 14%[ph] growth in maintenance fee; the 17[ph]% growth in the business with five basis points expansion in EBITDA margin year-on-year; and a 310[ph] basis points quarter-on-quarter. The 18.7% growth in net income. We know that 2014, it is[ph] an unusual year. But they think TOTVS's[ph] start of the year shows that we are on the right track.

The entire TOTVS' team is committed to the challenge of driving the EBITDA margin to a level of (inaudible) 27% projected in our guidance. Moreover, the variable compensation of our effective[ph] and participation is based[ph] among other methods[ph] on the achievement of this level of cooperation[ph] of efficiency. The challenge is to enhance the efficiency[ph] in a sustainable way without losing at reasoning[ph] (inaudible) for[ph] (inaudible) cycles especially those related to the innovation of our technology platform and the industry utilization[ph] process.

In the end, our innovation (inaudible) and this should make[ph] our clients more competitive in their business and focus simpler[ph] (inaudible), and more connected, more cloud[ph], and more (inaudible). Because we know that our success relies on our clients' success. Now, we are available for the Q&A section.

Questions And Answers

Operator

The floor is now open for questions from investors and analysts. (Operator Instructions) Your first question comes from (inaudible) Vera Hoffa from Goldman Sachs.

Q - Vera Hoffa

Hello. I have two questions. My first question is about the licensed revenue. Do you think that the level of growth we saw in the First Quarter in the meetings is sustainable for the next quarters? My second question is about your provisions for bad debt[ph]? What is causing these increasing provisions and of bad debt as a percentage of revenues? Also, the increasing number of days in accounts receivables? Thank you.

A - Gilsomar Maia {BIO 16400533 <GO>}

Good morning, Vera. This is Maia speaking. Thank you for the questions. The questions and actually the reporting[ph] (inaudible) license[ph]. Your question was relating to the sustainability of the licensed (inaudible) we had in this quarter. The technical terms[ph] is it's hard to, to state here that this percentage of gross is going to -- is going to be observed in the following quarters. Really, we always, we try to drive ourselves more based on the last 12 months vision than based[ph] on a single quarter.

We understand that the market is pretty similar. We haven't seen any deterioration in our pipeline. But we understand that things we did in the past are gradually being converted into results. In our understanding, if we have a chance to be better in license than in the other lines, it will be more a consequence of our own efforts than a matter of market enhancement, if am I[ph] clear in my explanation. Actually what I mean is we understand that we can do better this year as a whole in license.

It's not a simple challenge considering all of the events we have this year in the particular they[ph] bring to the market. But to achieve our goals, we have to learn[ph] to go in that direction. Going to bad debt; bad debt is running and particularly in this quarter at 1.8% of our performance revenue. It is one of the highest levels we had. It's a little bit of both the percentage of net revenue we had fully[ph] (inaudible) from last year. But it was above 1.6%. We see really some financial difficulties especially among large companies. Really it's not a systemic problem.

It's more concentrated in some specific and a few list of names. We are not comfortable with these debt levels. This 2013, but really conservative where[ph] the company has to have a provision for an allowance for those four counts. We have no option at all. In our view, we have to stay conservative. But in the other hand, of course, we will try to control as much as we can. But really since we have seen some financial difficulty from customers, we've had to give to now some signal that we can change that reality in the short-term.

Going to the last questions, relating to specifically the days of our accounts receivable. There is a connection within accounts receivable and specifically licensed. Because breaking down our total revenue into the three lines; maintenance is a monthly payment. Services, we have depending on the moment, we have about two months of accounts receivable and that's it[ph]. Then, the part of our --- part of our revenue debt, we have more (inaudible) is related to license.

In a quarter in which we have debt performance and license, it's reflecting some incremental accounts receivable. It's more connected to the revenue breakdown. Also, we, and monthly[ph] we have been able to could be credited for customers historically especially from (inaudible). But it's more connected to the license performance[ph] of the quarter[ph]. I don't know if she'll[ph] address both of the[ph] (inaudible) your questions.

Q - Vera Hoffa

Yes. Thank you very much.

Operator

Our next question comes from Michel Morin of Morgan Stanley.

Q - Michel Morin {BIO 1873971 <GO>}

Yes. Thank you. Good morning. I was hoping to talk a little bit about the licensed revenue growth. First of all thank you for the at[ph] disclosure on the contribution from M&A over the last 12 months.

That's very helpful. I'm wondering has the M&A had a disproportionate impact on your licensed revenue growth this past quarter? Does that create a little bit of noise in the number that we're looking at? Then regarding your gain of some large new accounts, what can you tell us about the competitive landscape? Are you picking up these accounts from competitors? Or, what's driving the performance there? Thank you.

A - Gilsomar Maia {BIO 16400533 <GO>}

Good morning, Michel. Maybe in terms of attributions[ph], the effecting[ph] licenses is very low. Really that impact is more concentrated in services and maintenance. If we just for a kind of generic or calculation, if you assume like let's and trying to break down that R$11 million we disclosed in our --- at our total net revenue excluding license and try to refer[ph] how that revenue could be breaking services and maintenance based on the relevance of those two lines in our total net revenue. Probably it will give you a good sense about the contribution. But really the contribution license is almost nothing.

In terms of competitive landscape, we haven't seen significant change in this quarter specifically. Again, in our view we understand that measures we take --- we took in the past related to industries for salvation[ph] and things related to training programs for people related to that strategies. It enhances our capacity here. In terms of acquisitions helping us on that; indirectly in some cases, yes.

Companies we acquired that are right[ph] considering the previous years' figures are also performing well. In the aggregate you know that we offered the acquisition announcement. We help companies we acquired and consequently we also help those organically[ph]. In our organic view, the performance of licenses is really related to our organic performance.

Q - Michel Morin {BIO 1873971 <GO>}

Great, thank you very much.

A - Gilsomar Maia {BIO 16400533 <GO>}

Yes.

Operator

Our next question comes from Richard Dineen with HSBC.

Q - Richard Dineen {BIO 5517898 <GO>}

Thanks and good morning, everyone. Just actually a follow up[ph] I think really to Vera's question earlier on the maintenance revenues. You took in your --- in the drivers of the maintenance revenue growth Third Quarter. You talk about the sort of flow through from the license sales in previous quarters.

I guess just given your comments on some of the difficulties that you might face with license and maintaining this current rate of license growth. What is the implication there for the revenue, maintenance revenue as a result of that? If you could maybe just help us sort of explain how one could impact the other? If we're going to be taking down those expectations in future quarters? That would be helpful, if that makes sense? Thanks.

A - Gilsomar Maia {BIO 16400533 <GO>}

Hi, Richard, it's Maia speaking again. Really in terms of performance of this license and the connection to connecting them to maintenance specifically. Before entering the calls and the[ph] effect of license and maintenance fees. I just want to remind you about that R$9 million we had in the Q4 in the maintenance. We disclosed that R$9 million was a nonrecurring event even though relating to maintenance. Because we will regularize[ph] from some contracts relating to maintenance at that moment. If you exclude that R$9 million in the Q4 and compared it to the Q1, you're going to see that the real performance of maintenance. In our comments related to maintenance, we realize that they[ph] just want to remind you about that.

Q - Richard Dineen {BIO 5517898 <GO>}

Yes, right, thanks.

A - Gilsomar Maia {BIO 16400533 <GO>}

Going, and going back to license now. In our business model, yes, there is a cause and consequence effect relating to maintenance and in license. Of course, the previous performance we didn't have any[ph] about license. You are right, in fact, effective[ph] also maintenance. But we mentioned in our earnings we (inaudible). There is a fraction[ph] in behavior of our company.

The companies are trying to do that[ph] up front, realizing[ph] license. In those negotiations, they are opener to say[ph] even a higher level of maintenance. Preserving the recurring revenue in the negotiations; so we really --- we are flexible sometime in defense[ph]. What creates in the longer term it will likely change in that correlation between license and maintenance. If we take the last three years, we see[ph] license growing much less than maintenance, for example. I know that part of that comes from inflation adjustments. But another part is related to these fractioning[ph] behaviors of the sales[ph] we've been able to close.

Projecting the potential impact of the EPI since[ph] performance recently, we have a lag from a[ph] license sales to maintenance impact. In average historically, it's about two quarters. Specifically, when we talk about large accounts, these lags is a little bit larger. Because a project related to the implementation of those large accounts. It sometimes takes more time than normally it takes more, there's more than medium accounts. It tends to take a little bit longer to reflect the maintenance. But on the other hand, we've been able to pass[ph] through inflation in a very good shape.

Also, the retention of our cost reviews[ph] (inaudible). In my view, since we have a good days' line of maintenance, it's not. It's not going to be simple to keep the same performance of maintenance. Thus[ph] we are --- on the other[ph] hand we have good attributes to conduct maintenance and are in good shape for the rest of the year[ph].

Q - Richard Dineen {BIO 5517898 <GO>}

Right, OK, and thanks (inaudible). Thanks for helping us on this. Just a super quick follow up, if I may. You talked before we had the Marco Seville[ph], Simon[ph] (inaudible) last week, last time of the president[ph] last week. I know in the past you kind of played down any significance of that on your business.

That's quite understandable that it's not obviously directed mainly in your part of the market. But I'm just wondering and given that there may be a few little and sort of changes. I just wanted to confirm that's still your expectation. Or is there anything that you've seen that could potentially have some bearing on TOTVS in the near or indeed long-term from that pretty important bit of legislation? Anything, that will be helpful as well.

A - Gilsomar Maia {BIO 16400533 <GO>}

OK, so there is no direct impact from that referring to (inaudible) in our business. Indirectly, it can effect all companies in the market. But directly, no it doesn't affect us directly.

Q - Richard Dineen {BIO 5517898 <GO>}

Right, OK. That's what we've come[ph]. I guess that's what we just dreamed up[ph]. Thanks for the clarification. Thank you, gentlemen. and thanks for the call.

A - Gilsomar Maia {BIO 16400533 <GO>}

You're welcome.

Operator

(Operator Instructions) This concludes today's question and answer session. I'd like to invite Alexandre Mafra to say a few closing statements. Please go ahead, sir.

A - Alexandre Mafra Guimaraes {BIO 16015106 <GO>}

Thanks again for our participation and have a great day.

Operator

Thank you, TOTVS' First Quarter Results Conference Call is over. Have a nice day.