Q2 2013 Earnings Call

Company Participants

- Alexandre Dinkelmann, EVP, CFO, IR
- Gilsomar Maia, CFO

Other Participants

- Mauro Forman, Analyst
- Michelle Morin, Analyst
- Nick Estrada, Analyst

Presentation

Operator

Excuse me. This is the conference operator. I do apologize. We're experiencing a slight technical difficulty. Again, the conference will begin in just a moment. Thank you.

Good morning. Welcome, everyone to TOTVS' Second Quarter 2013 results conference call. Today with us, we have Mr. Alexandre Dinkelmann, Executive Vice President of Strategy and Finance, and Mr. Gilsomar Maia, Corporate Finance Officer.

(Operator Instructions)

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. Dinkelmann, you may begin your conference.

Alexandre Dinkelmann {BIO 16100739 <GO>}

Good morning, everyone. Welcome to TOTVS Second Quarter 2013 Results Conference Call. Firstly, I will start talking about the acquisition of RMS, announced last July, presented on slide two.

RMS develops enterprise management software for retail and supermarket industries. And was appointed two times in a row as the first software company in the Top of Mind ranking published by the Supermercado Moderno magazine, a standard publication in the Brazilian industry.

This is another acquisition that addresses our specialization strategy, strengthening our position, in this case in the retail segment, especially for supermarkets.

We see a very interesting potential in this segment, especially in the integration of the value chain comprising manufacturers, distributors, wholesalers, cash-and-carry and now supermarkets. Today TOTVS has a dominant and unique positioning in all these stages of the value chain. And we want to explore this huge potential.

Besides this M&A transaction involving RMS, we also had two acquisitions made by TOTVS Ventures since the First Quarter 2013 earnings release.

First, an investment of $16 million in GoodData, a company based in San Francisco, California, focused on providing solutions for business analytics in the clouds, with big data technology offered in the size model.

It's important to highlight that in the addition to the investment made, TOTVS now has a seat on the Company's boards and the distribution exclusivity of GoodData Solutions in Latin America, bringing this new technology to the region and TOTVS clients.

This operation reinforces TOTVS Ventures' capacity of adding value through synergies in every transaction made, since TOTVS Ventures goes beyond the role of being just a financial investor.

In addition, it also confirms on a global basis the value of our presence in distribution capacity.

Second, ZeroPaper, a company focused on providing cloud solutions for individual entrepreneurs. We do believe in this kind of solution that addresses the base of the pyramid of the Brazilian market where the market is still fragmented and with a very attractive growth potential.

Before presenting our financial performance, I'd like to reiterate that we remain focused on executing our strategy of enhancing the specialization by industry and by company size, organically and via M&A, with additional surgical investments made by TOTVS Ventures, initiatives related to TOTVS' core business strategy.

Going now to the financial performance on slide three, we highlight the total net revenue growth of almost 16% year-on-year, higher than the last 12 months growth and the last five year CAGR. I highlight here that this faster growth came from all revenue lines.

We continue to expect an adverse year in the Brazilian economy, which may affect the potential of doing business as a whole. This leads to us to predict the year with a good degree of caution.

However, we also reaffirm that we will continue to seek for a broad portfolio and strong presence in the region, the maximization of opportunities in regions and industries that show higher business potential.

On slide four we will drill down a little more, relative to the license revenue growth, which exceeded 12% year-on-year. This growth in license revenue came from the combination of the 18% growth in number of sales with the average ticket decrease of 5%. The larger number of sales was mainly driven by sales to existing clients which grew almost 23%.

The downturn of average tickets was more concentrated in sales to new customers, which was almost 11% lower. However, on the other hand, in the last 12 months there was an increase in the average tickets to new customers of more than 23% and a 7% decrease in the average tickets to existing clients.

I reiterate the short term fluctuations in average tickets are common because it represents the average size of projects sold in the specific period. I'll now reveal the last 12 months show more clearly the market dynamics.

Moving on service revenues on slide five. This line of revenue had the highest growth of the quarter with 19.5% growth. In the last 12 months the growth reached 13.6%, exceeding the last five year CAGR.

This line's performance was mainly due to the partial productivity recovery of implementation services, besides the higher number of working days in the quarter.

Going to the maintenance fee revenue on slide six, we see that for another quarter this revenue line overcame 15% of growth year-on-year and 13% in the last 12 months. This performance reflects our focus on customer loyalty, which is reflected in the consistency and in the recurrence of this revenue line.

By the way, talking about recurrence and consistency, on slide seven we present the total recurring revenue which grew 12.6% year-on-year, accounting for more than 56% of total revenues in the Second Quarter.

It's worth mentioning that the changes of this line as a percentage of total revenues is due, among other factors, to the growth pace of other lines of non-recurring revenues, which, in the Second Quarter, had a faster growth, especially in licenses and implementation services, changing the revenue mix in the quarter. For this reason, we will focus on the growth rate of recurring revenue period-by-period.

Recurrence is part of TOTVS business model and strategy. In the short term, recurring revenues can reduce the average growth rate of total revenues, given the flow of monthly recurring payments. But on the other hand, it brings more predictability and sustainable growth in the longer term.

Now I will invite Maia to proceed from slide eight.

Gilsomar Maia {BIO 16400533 <GO>}

Thanks, Alexandre. Good morning, everyone. Now talking about the costs and expenses on slide eight, the group of license costs, servicing costs and R&D grew 1.9percentage points as a percentage of net revenue in the year-on-year comparison.

Approximately half of this increase is due to the high investment in R&D. We understand that even in most adverse scenarios like this, we must maintain our investments in innovation in order to enhance our competitiveness in the future, making our growth sustainable in the long term. The other half is due to the lower margin of services, reflecting the lower level of efficiency of services team in 2013.

In the quarter-on-quarter comparison, this group of costs and expenses fell 0.4percentage points. This decrease is partially due to the better margins of Second Quarter, but is still below the levels seen in 2012 and the lower relevance of third party solutions reflected in the cost of license fee.

Moving forward to the second group, which concentrates advertising, sales and commission expense, and allowance for doubtful accounts, the increase from 19.4% to 21.1% between first Q and second Q 2013 was mainly due to the seasonality of the marketing campaign which is intensified in the Second Quarter. And due to the allowance for doubtful accounts which returned to the level of 2012.

It's important mentioning that in the First Quarter 2013, the decrease was mainly due to the overdue credit recovery that was accrued in previous quarters. In this line of allowance for doubtful accounts, we still note a concentration on a few clients facing financial difficulties.

On the third and last group representing G&A and management fees, the reduction both in the year-on-year and quarter-on-quarter comparisons is mainly due to the efficiency gains in the structure and the search for productivity.

We emphasize here that we keep seeking efficiency gains in this group of expense.

Moving to slide nine, EBITDA increased 6.7% year-on-year, amounting to BRL98.9 million in the Second Quarter 2013, with EBITDA margin of 25%. In short, this reduction of

2.1percentage points on the margin, when compared to Second Quarter 2012, was mainly due to the maintenance of investments in R&D and advertising and the decrease of services profitability in the period.

We reiterate our commitment to preserving investments in R&D. And to keep improving the efficiency of the service teams, given the marketing potential.

We also reiterate that over the years, the EBITDA margin may fluctuate. But the combination of TOTVS' business module in each target market leads to margin expansion in the long term. This fact is highlighted in the last 12 months' EBITDA presented in this slide.

On slide 10 we highlight net income growth in line with the net revenue growth in both quarterly and last 12 months comparisons.

In the Second Quarter 2013, the net income reached BRL54 million, 14.3% growth year-on-year, higher than the EBITDA, mainly due to the lower level of both financial expense and effective tax rate.

Moving to slide 11, the net cash position changed from BRL84.5 million in first Q 2013 to BRL18 million in Second Quarter 2013. The main reasons for this reduction are the dividends payment, the GoodData investments reflected in intangibles, and the generation of operating cash flow of BRL86.3 million, corresponding to 87% of EBITDA in the quarter.

It is also worth noting that increasing gross debt is mainly due to the obligations from acquisitions.

Now the conference returns to Alexandre -- proceeds from slide 12.

Alexandre Dinkelmann {BIO 16100739 <GO>}

Thanks, Maia. On slide 12, we would like to close the presentation by referring to the three strategic pillars of growth, loyalty and margin that guide the management's agenda, aiming to value creation for the Company in the long run.

Regarding growth, we highlight the 16% growth of net revenue in this quarter, besides executing the specialization strategy, combining organic investments with the most recent acquisition of RMS.

At loyalty, we emphasize the growth of 15% in maintenance revenue and the recurring revenue growth of almost 13%, both in the quarter.

And for the margin pillar, we highlight the EBITDA margin of 26.1% in the last 12 months in order to see the trends in margins for the Company in the recent quarters, minimizing the natural margin volatility on a quarterly basis.

Regarding the margin, we will continue to seek efficiency and cost discipline with emphasis in the service and administrative areas, as well as maintaining our investments in innovation reflected in the R&D line, which are key elements for TOTVS to capture sustainable and long term growth in our market.

We understand that in times of crisis or more adverse scenarios we must invest in our business with the proper discipline to capture our market opportunities.

The management reiterates its view on the relevant potential of the Brazilian market of management systems, especially among small and medium size enterprises. And keeps deepening the specialization strategy with the goal of increasing the Company's ability to capture market opportunities, even in adverse economic scenarios such as the one in the beginning of the year.

Thus, increasingly we are becoming stronger, both internally and externally, for the next cycle of growth in our markets. From now on, we are available for the Q&A session.

Questions And Answers

Operator

Thank you. The floor is now open for questions from investors and analysts. (Operator Instructions) Please hold while we poll for questions. Our first question comes from Michelle Morin with Morgan Stanley. Please go ahead.

Q - Michelle Morin {BIO 20313522 <GO>}

Good morning. I was just wondering if you can talk a little bit about the trends that you saw in the underlying business in the quarter because this was a little bit of a noisy quarter. You had the impact of some acquisitions.

You had some calendar effects, you know. But I'm trying to understand if you -- and I know that you don't provide organic growth rates, but is it fair to conclude from the results that you really did see, on an underlying basis, increased activity obviously from your existing clients, but also increased activity and interest from potential clients?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Good morning, Michelle. And thank you for your question. As we were saying, since the First Quarter we have a pipeline spread across very different industries and also regions. And in this quarter -- the Second Quarter -- we were able to close some of the dues[ph] of this pipeline.

So when we analyze what's happening in Brazil, of course there is a level of activity -- stronger, depending on the industry that we are talking about. And TOTVS[ph] all this massive distribution network and continental presence coped with also a very large portfolio in terms of industries. It gives us a good possibility of grabbing business opportunities where they are.

So this is what happened this quarter. OF course, we will keep -- you know that we are working hard in order to keep the pace. But the cautiousness is the name of the game for the remainder of the year. So it's really difficult to say if -- you know -- we will have good quarters ahead of us because of all these complex scenarios that we are facing in Brazil in terms of level of confidence of consumers and also entrepreneurs and business people.

So actually what we are doing, in sum, is to really maximize business opportunities where they are in terms of regions and in terms of industries. And that's our job here.

Q - Michelle Morin {BIO 20313522 <GO>}

Alex, you started off by talking about the pipeline. So did you replenish the pipeline as well? I mean, if you concluded -- if you were able to execute on what was in the pipeline, is there still a decent pipeline out there relative to where you were three months ago?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Yes. We have a decent pipeline. What we see is that the cycle is longer than our historical pattern, mainly, when we talk about new clients. But the pipeline is positive. And we are working hard to conclude that.

Q - Michelle Morin {BIO 20313522 <GO>}

Okay. Great. Then is there any color that you'd be willing to share with us in terms of industry trends? We know that you have big exposure to the manufacturing sector. And I would assume that with a weaker real that might be part of the economy, but that might start to feel a little bit more confident. Are you seeing signs of that happening?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Yes, depending on the niche. Because the vertical manufacture is too broad. So our strategy is at the sublevel. So we have to really define our strategies depending on the niche. And we are trying to capture business opportunities also with manufacturers.

But in order to help you know and understand our big strategy and how we see these portfolios in terms of industries evolving, we believe that in Brazil and Latin America -- mainly in Brazil -- industries that are more untradeable[ph] they tend to present better growth prospects in terms of new license.

So we are talking about education. We are talking about computers. We are talking about logistics, retail. And these are industries that are doing very, very well for us. And these industries are supporting our growth performance.

When we talk about manufacturers, structurally, despite these exchange rates performance -- these recent performance -- we know that in general they also face structural challenges. And we are here investing also with them in order to help them with these challenges.

But we see, structurally, also, that they are very important, not only for recurrence. We are talking sometimes about big clients. But also the process of expansion of part of these manufacturers into other fields such as logistics, distribution, sometimes retail.

So TOTVS, in our understanding, has a unique position to connect all these value chain from the manufacturers, going to logistics, wholesalers, distributors and retail. And we want to capture these kinds of opportunities.

So that's why, even if these manufacturers are not presenting huge prospects in terms of new licenses, in the short term they are very strategic for us for this concept of recurrence and also this connection process of value chains in Brazil.

Q - Michelle Morin {BIO 20313522 <GO>}

All right. Okay. Thank you. And Alex, if I may, just a quick second question here. Is the management fee in the cost structure -- we almost never talk about it because it's small -- but it is running lower than the year-ago levels. And I'm just wondering should we read anything into that? I mean, does this tell us that as a management team, you're provisioning less because you're not hitting targets?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

No. We are not seeing any big difference in terms of prospects of having our variable compensation for the Company.

Q - Michelle Morin {BIO 20313522 <GO>}

Okay. Thank you very much.

Operator

Our next question comes from Mauro Forman with BPG. Please go ahead.

Q - Mauro Forman

Hi, Alex. A quick question. I don't know how much you can disclose at this point, but what about GoodData and maybe the time share for Brazil? My understanding is it's not[ph] a very good software. There could be a lot of added value here for clients in Brazil. But I don't know if you could comment more of the timing and the plans of incorporating the GoodData technology into your platform here in Brazil?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Okay. Mauro, thank you for your question. GoodData is a company that's really moving the industry in the US in terms of bringing a new business model to the BA industry -- business analytics -- using Big Data technologies and cloud solutions.

So you know one of the biggest aspects or items of this valuable[ph] position is that they can provide something that's cheaper, faster to be implemented. So it tends to be disruptive for the industry.

So in this sense, we believe it has a great fit to Latin America and to our base. And that's why we established this strategic relationship. We want to lead this process of bringing innovation into our continent here.

So this master is important for us because we are training our people. You know, exchanging skills. We have people in California being trained. And also they are coming to Brazil to train our sales force.

In parallel, we are investing in order to have our products totally integrated into GoodData. So by the end of the year, we believe that we have the go-to-market strategy.

Q - Mauro Forman

Okay. Thank you.

Operator

Next question comes from Michelle Morin from Morgan Stanley. Please go ahead.

Q - Michelle Morin {BIO 20313522 <GO>}

Okay. Thank you. I'll just keep on asking questions, Alex. So listen, on TOTVS Ventures, I'm just curious. Can you share with us kind of what the vision for this is? How significant could this become in terms of how much capital are you willing to put into this business?

And how are you going about screening for the opportunities and managing these opportunities because it's a very different kind of skill that you need. And I don't know if you've kind of recruited people who maybe have a venture capital background. Or how you're going about running that part of the business. Thank you.

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Okay. Michelle, thank you for your additional question. TOTVS Ventures is important for our strategy. Not necessarily in the short term we see big financial impacts. But when we see our future in terms of portfolio, in terms of technologies, in terms of offerings, innovation, it's good also to bring from the outside innovation. And to work together with very talented entrepreneurs.

The way that we screen opportunities starts always from the strategic fit. The same way that we do in terms of M&A. So we have our strategy and we always use these drivers in order to filter.

The first filter is how adherent[ph] these startups or these companies in their early stage they help us with our strategy. So we could say some things that are driving our initiatives, such as mobility, big data, analytics, collaboration has in general cloud business model. So these are the things that we are pursuing.

And we want not to be positioned not just as a financial investor, but also bringing all these business network and distribution skills that we have here in order to speed up the success of these early stage companies. So that's the strategic driver.

When we talk about the team, yes, we brought people that had worked before within the industry. We also have people with technology background in the team.

So again, we try to be different than the (inaudible) venture capital. So we have the same financial discipline, but also bringing our technological knowledge and experience to the table.

Q - Michelle Morin {BIO 20313522 <GO>}

And in terms of size, Alex? I mean, if you were to take a guess as to how relevant how much money you might have invested in terms of face value investments over the next three years, what kind of range are we talking about?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

We have this figure. We are not disclosing so far. But in order to help you with some color, we are pretty flexible in terms of time[ph] of deals. So we can move back in reaching early stage companies. And ZeroPaper was a case with a small ticket of investment. And we can also work with deals at the level of GoodData involving $16 million. So we are pretty flexile in this sense.

The idea here is not to really make as many deals as possible. The idea is to really be very collaborative[ph] and strategic in the choices. So you should expect this same level of activity in the future.

Q - Michelle Morin {BIO 20313522 <GO>}

Okay. That's very helpful. Thank you, Alex.

Operator

(Operator Instructions) Our next question comes from Nick Estrada with NCM. Please go ahead.

Q - Nick Estrada {BIO 16721624 <GO>}

Hi. Can you just give a little bit of guidance as to kind of what you expect for the rest of the year in terms of revenue growth margins?

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Hi, Nick. Thank you for your question. As a policy, we don't disclose our expectations about the year in terms of revenues or EBITDA. But I will try to help you with some qualitative points.

So far, when we analyze what's happening at the macro level in Brazil, it's really hard to figure out the turning point of expectations. So we are still facing a complex scenario, more risk averse, and a level of confidence not going up.

So in this sense, we are cautious in terms of the second semester. And what's in our hands is to still work hard on grabbing business opportunities in terms of regions or industries. And we have a very strong position in order to capture business opportunities where they are. But cautiousness is the name of the game so far. Okay.

In terms of margins, as we told during the presentation, what's the most important driver for us is to make the right investments in order to pave the way for the longer term. That's the main driver of the management and the board. We are not concerned about the short term margin.

So you could see that this Second Quarter, we had a margin compression when we talk about percentage. But when you see the bottom line in terms of absolute numbers, we delivered strong result.

And it's also important to mention that we expand all R&D investments in the OpEx. So we do not capitalize our R&D, which is good for you because you have the visibility of what we are doing for the short, mid and long term. So that's the way that we drive our business.

And despite these current scenarios, we see very good opportunities of investing in terms of R&D. Organic and also M&A.

Q - Michelle Morin {BIO 20313522 <GO>}

Great. Thank you.

Operator

This concludes our question and answer session. I would now like to turn the conference back over to Mr. Alexandre Dinkelmann for any closing remarks.

A - Alexandre Dinkelmann {BIO 16100739 <GO>}

Okay. I'd like to thank you all of your time with us. We are available to answer any questions that you may have. And also I'd like to thank (inaudible). We are here in order to really capture business opportunities despite these complex scenarios that we are facing in Brazil.

And it's also worth mentioning, as I just answered Nick's questions, that we managers and also the board, we are driven by long term decisions. That's the way that we manage our business. We are concerned about making the right investments in terms of R&D, in terms of brand building in order to have better possibilities of revenues in the future.

That's the name of the game for TOTVS. We are not here to manage just short term margins. Okay. Thank you very much.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.