Q2 2021 Earnings Call

Company Participants

- Dennis Herszkowicz, CEO
- Gilsomar Maia Sebastião, Chief of Financial & IR Officer
- Juliano Tubino, Vice-President of Business & Digital Strategy, Micro & Small Enterprises and Financial Services
- Unidentified Speaker, Unknown

Other Participants

- Enrico Trotta, Analyst
- Leonardo Olmos, Analyst
- Marcelo Peev dos Santos, Analyst

Presentation

Operator

Good morning. Welcome to TOTVS' Second Quarter of 2021 Earnings Results Video Conference. With us today are Mr. Dennis Herskowicz, CEO; Juliano Tubino, Vice President of Strategy and New Business; and Gilsomar Maia, CFO.

We would like to highlight that the organization and conduction of this video conference is following the essential health and safety measures according to our legislation and health protocols required by the competent authorities.

We would like to inform that all participants will watch the video conference during the company's presentation. Afterwards, we will begin the Q&A session for investors and analysts, when further instructions will be provided. (Operator Instructions) The audio and video are being presented simultaneously on the internet, at ri.totvs.com.br.

Before proceeding, we would like to clarify that statements made during this conference call concerning the business perspectives, projections and operational and financial goals of TOTVS are beliefs and assumptions of the company's management as well as information currently available.

Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions since they refer to future events and, therefore, depend on circumstances that may or may not occur.

Investors should understand that general economic conditions, the industry conditions and other operational factors may affect TOTVS' future performance and may lead to results that differ materially from those expressed in such forward-looking statements. Now we would like to hand the floor to Mr. Dennis, that will start the presentation, starting on Slide 3.

Dennis Herszkowicz {BIO 17998338 <GO>}

Good morning, to everyone. I hope you are well, safe and healthy. A drop in critical hospitalizations and that's as a result of the progress of the vaccination program is the news we have all been waiting for. This has enabled the first signs of activity normalization. With everyone's effort, we hope we're coming close to the end of this very difficult period.

Internally, this effort has translated into another quarter full of progress regarding the execution of our strategy to build our B2B ecosystem that goes beyond ERP, expanding our addressable market and increasing our take rate. Once again we've maintained the balance between growth and profitability, staying within the Rule of 40.

For this, I would like to express my gratitude and recognition for the work and dedication of each one of the TOTVERs this quarter. With a team united by the same ambition, we continue daily engaged and committed to the digitalization journey which aims to expand TOTVS, always aware of the unique opportunity we have to expand more the value generated to our customers and throughout the entire relationship chains.

Finally, after completing the acquisition of RD Station and the consolidation of the results for the month of June, starting this quarter we will start presenting the financial and operational results of TOTVS segregated by the different business dimensions.

The first of them is Management. It is the foundation in which the dimensions of the ecosystem are being built. It includes our ERP, HR solutions, the specialized solutions for 12 economic segments and where the data and integration are generated.

The second is the Business Performance dimension. Here, we seek to leverage results, performance and relationship with the different business areas of our customers. Here, we also consolidated the digital marketing platform, RD and tail [ph], and the sales support solutions, ecommerce and OMS.

We finally have Techfin. The dimension seeks to simplify, expand and financially enable access to B2B financial services through the intensive use of digitalization and Big Data. It is currently composed of solutions of credit and new products. Now Maia and Tubino will elaborate on the results of the quarter, starting on Slide 5. Maia, you may proceed.

Gilsomar Maia Sebastião

Thank you, Dennis. As Dennis has already mentioned, this quarter TOTVS showed once again a balance between growth and profitability, with an increase of 22% in consolidated net revenue and adjusted EBITDA margin of 24.1%, totaling 46%, within the Rule of 40, an increase of 13percentage points year-on-year, with all 3 dimensions presenting performance that are worthwhile highlighting.

In Management, recurring year-on-year organic growth showed further evolution, rising from 12% in Q1 of '21 to 16%, driven by a 26% growth in SaaS revenue. In Business Performance, the highlight is also the recurring revenue, and we have a 50% growth year-on-year. And Techfin, suppliers credit production reached a new record, ending the quarter at more than BRL 2.4 billion. This is a growth of 93% in contrast to the same quarter last year.

As planned a little over two years ago, we currently have a number of drivers that are driving our growth. The Business Performance and Techfin dimensions are gaining quick relevance and represent together more than 15% of the consolidated revenues for the quarter and 36% of the year-on-year growth of the same revenue. Together, Techfin, Business Performance and SaaS Management represented more than 40% of the revenue during the quarter and have already accounted for more than 70% of growth in our revenue, as shown on the charts to the right.

This revenue growth that together with discipline in management costs and expenses led to an increase in the consolidated contribution margin and, consequently, a 34% growth in EBITDA, as we can see on the chart on Slide 6. It is worth noting, as you can see on the left of the slide, the Business Performance and Techfin contribution margin combined represented 9.8% of the quarter's contribution margin and were responsible for 32% of the year-on-year growth.

Now analyzing the results of each dimension, on Slide 8, we highlight the net revenue of the Management dimension, reached BRL 679 million during the quarter, showing a year-on-year growth of 13%, in contrast to 10% of growth in Q1. This growth was mainly driven by the acceleration of the recurring revenue, which grew 16% year-on-year and totaled BRL 560 million during the quarter and 82% of the Management net revenue, the highest ever recorded in a quarter.

This mark achieved by our recurring revenue is the result on the focus given to SaaS and cloudification, as we can see on the chart at the center. The SaaS revenue grew 26% year-on-year, compared to 24% of growth during Q1, as a result of the 68% increase in new signings and the 35% increase in cloud revenues, especially in the segments of agribusiness, distribution and retail.

And aiming to meet the growing demand for cloud solution, we are expanding our availability zones, with the inauguration of the new zone in the northeast of Brazil, which were added to the zones to the southeast, and this will provide lower latency and optimize performance to customers.

Finally, as you can see on the chart to the right, ARR, annual recurring revenue, presented a new record net addition of BRL 119 million, exceeding by BRL 100 million the 94% Q2 of 2020 performance [ph], and by 32% Q1 this year. We are accelerating SaaS, added to the increase in the renewal rate that is at a level close to 99% for the contractual adjustments in the period.

Now on Slide 9, the progress in recurrence associated with reduction of provisions during the first half. This is 300 basis points during the first semester. This expansion was possible even with the investment in the modernization of the portfolio and in the increase in quality, aiming to leverage new avenues of growth and increase the efficiency in the allocation of resources. Now I give the floor to Tubino, who will comment on Business Performance and Techfin, starting on Slide 10.

Juliano Tubino {BIO 20575696 <GO>}

As mentioned in the last call, we worked a great deal on the Performance dimension with RD, with the month of June already consolidated in the results of the quarter representing more than 90% of the ARR in this dimension. The recurring revenue from Business Performance represented 98% of the dimension revenue, with an organic growth of 50% year-on-year, as you can see to the graph on the left.

As of the next quarter, it will be possible to observe the organic addition of ARR from all operations together, but it is worth noting that the organic addition of RD Station in the quarter was BRL 16.9 million. This performance had as main levers the addition of new customers, the upsell driven by the product-led growth, PLG, strategy, besides the company's capacity to work with cross-sell with other offers such as CRM.

We also highlight the strong evolution of digital commerce, observed in the graph at the right, which grew 251% in number of clients year-on-year and had the number of clients in production that are already generating GMV, gross merchandise volume, multiplied by 7. The annualized GMV has already reached BRL 189 million. We see in the digital marketing platform a wide avenue for growth in the market that is taking its first steps in Brazil, but with a prospect of great expansion in the short term. Until then, we did not have a strong player that could consolidate the market. Besides being the strong player, the integration of this platform and the dimension itself will give TOTVS a huge competitive edge.

We go on to Slide 11, where we notice that despite being a new dimension focused on growth, the Business Performance business model is already scalable, with a 51% contribution margin. If we consider the pro forma numbers for the quarter, adding the results of April and May of RD Station, the contribution margin equals that of Management dimension, with 53%.

It is also worth mentioning that RD Station alone ended the quarter with recurring revenue advancing 47% year-on-year, with a positive EBITDA margin, which is something above the acquisition plan for the period. We go on to Slide 12. Techfin, that maintained its accelerating trend, advancing 126% over the Second Quarter '20 and 9.6% over the First Quarter '21.

As shown in the graph on the left, the supplier operation once again set a new record, of BRL 2.4 billion, as mentioned by Maia, of credit production this quarter, driven by the metallurgical, civil construction and IT equipment sectors as well as the high cycle of Selic rate hikes.

As a consequence, the loan portfolio also attained the highest level, of BRL 1.4 billion, shown in the chart above-center, which is not even higher due to the seasonal event of agribusiness off-season, which typically has a longer average term, leading to a reduction in the overall average of 9% when compared to the First Quarter '21.

The integration between TOTVS and suppliers continues to advance, with 2 more TOTVS Mais Negocios affiliates added in the quarter, totaling 5 in production, and we anticipate more clients, that have generated BRL 1.4 million in revenue from credit products in the Second Quarter '21, a 25% growth versus the period [ph] quarter.

Moreover, we can see in the graph at the bottom-right the number of clients activated with the new Techfin products that increased ninefold when compared to the Second Quarter '20, with an acceleration of this growth and number of clients remaining very strong in the second semester.

Finally, as we can see in the graph at the bottom-center of the slide, all of this production performance was achieved without neglecting the discipline in credit-granting, reflected in low levels of delinquency of 250 basis points below the Brazilian average and still slightly below the levels observed before the pandemic.

Even with a low level of default, because there was no reversal of provisions from previous periods we had a higher expected loss provision this quarter compared to the previous quarter. When we add this to the effect of the time lag in the passing on of the Selic rate, since the revenue recognized reflects a portfolio originated in previous months, which does not happen with the cost of funding always updated with the current interest rate, we had a reduction of BRL 3 million in the contribution margin, presented on Slide 13. When normalizing these 2 effects, Techfin's contribution margin shows a growth of 6.4% quarter-on-quarter.

Finally, the supplier funding structure concentrated in FIDC has allowed a significant increase in its return on equity, which in the last months reached 56%, 39percentage points above the Second Quarter '20 and 30percentage points above the First Quarter '20. I would now like to return the presentation to Dennis, who will speak about our moves forward in terms of ESG.

Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you, Tubino. Let us now go on to Slide 15. And as we mentioned in the previous quarter, as the largest technology company in Brazil we will seek whenever possible to bring our advances and initiatives in ESG.

This quarter, we can highlight the release of our data privacy policy, a document aligned with the LGPD, which demonstrates a priority given by TOTVS to the topic. The release of the Annual Integrated Report and the Diversity and Inclusion E-book, based on transparency and global best practices.

One of the highlights of the Integrated Report was the materiality update, which counted on the engagement of several stakeholders and whose results will be used by management in prioritizing the ESG agenda topics for the next biennium. The election of TOTVS as the best company in TMT, technology, media and telecommunications, sector in the institutional investor ranking.

On Slide 16, I can say as a final message that, like in a tennis game, we are and will always be in motion, either with a strong M&A agenda with a large and diversified pipeline, looking for creative ways to unlock value; as, for example, the movement with Dimensa, which will now have dedicated resources, greater focus and autonomy.

There were 2 quarters with hard work and significant strides in all the 3 dimensions that make up our strategy of building the ecosystem of B2B technologies. In Management, recurrent revenue already reaches almost three years of growth in a 2-digit range, even with the undisputed leadership in the Brazilian ERP market, which reinforces that the market is far from maturity.

In Business Performance, with the completion of RD Station acquisition, we took a decisive step in structuring this dimension, which has a high potential for value generation. We will bet heavily on this dimension, with a broad strategy of GMV generation and take rate increase.

Finally, in Techfin, we are just beginning our journey. There is much more to come. Our goal is to revolutionize the financial services offering by expanding our portfolio with personal and more competitive products to help companies to overcome the challenges of their business using the power of technology.

We will continue on this growth path. We see a brilliant future with enormous opportunities. TOTVS is a beneficiary of the digitalization of the economy, including the management sphere. We are now at your entire disposal for questions and answers. Thank you.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Marcelo Santos, from JPMorgan.

Q - Marcelo Peev dos Santos {BIO 16605663 <GO>}

The first refers to ERP. Which are the transactions that would make sense to do over RD? How can you complement this? And which is the focus?

The second question refers to Management, which would be your focus in coming years, thinking of technology. You have shown an increase in margin. Is this what we should expect in coming years?

A - Unidentified Speaker

I can begin with RD Station. When it comes to best performance, our strategy is to truly help clients in everything that refers of their penetration into the market, with sub-categories, categories of software and technology. RD has given us greater strength, very strong marketing automation, and it begins to have success in the CRM sphere.

As you asked, this extends to customer experience, solutions, analytics, experiences, solution marketing, everything that in a certain way will help the client to relate, to better understand their clients and to carry out more digital sales.

When we refer to the second question that you asked about the Management margin, now this dimension perhaps is the most mature dimension that we have. It is developed. It doesn't mean that the market is mature. We have grown in the last few years and have shown this with the levels of recurrent revenues.

This dimension has increased significantly, and it is natural to imagine that the scale gain that we have in this dimension will continue to take place. If we look at the Management dimension, this gain of scale will still be possible. What I foresee is that the dimension and the company will take [ph] a margin leap greater than the one in the last year. This is not something that perhaps we will expect, perhaps because of the nature of the company's revenue. It is primarily recurrent and 80% in Management, and it is natural to see an evolution more in line with what we saw in last years in recurrent revenue.

Once again this will not allow us to take a huge leap. Perhaps, quarter-on-quarter, we may have more volatile behaviors, but on an annual basis, at least, is what I foresee.

Operator

Our next question, from Mr. Enrico Trotta, BBA Itau.

Q - Enrico Trotta {BIO 16742911 <GO>}

I have 2 questions. I would like to ask about suppliers. We've seen the increase. And because of the Selic, I would like to know if you are thinking about other funding alternatives for suppliers and what options these would be. When we see a mismatch between cost and revenue because of the Selic, when will you see suppliers margin going back to normal? When this increase of Selic will reflect on the revenue and when suppliers margin will be closer to what we saw during Q1? I would like to understand these points within supplier.

In RD Station, you had already mentioned that RD was exceeding your initial expectations in your budget, and I would like to know what RD's performance will be, especially during

Third Quarter, and how do you see the cross-selling with your currents at [ph] TOTVS, bearing in mind the results of RD.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Okay. I will start. And Tubino and Maia, if they want to add something, that would be excellent. Now when we think about suppliers, specifically, I would say that, yes, we have been assessing for some time different funding possibilities. We see a present and a brilliant future for suppliers. In terms of growth, we see strong and sound growth, as you could see with a level of default way below the market average and even below the historic average for suppliers.

So this strong growth brings funding challenges. And for that, we have to be creative. So yes, rest assured that throughout the future we will use alternatives and options that will allow suppliers to grow as it has been growing.

Now regarding the mismatch, it is difficult to say exactly when the mismatch will end because we really don't know when the strong actions in the Selic will end. Today well, the market shows us that at the end of the year and during the beginning of the year these movements of points, 71 points [ph] in each meeting, well, they will stop. As the average term of the portfolio is more or less 50 days, once this stops, in a month things will go back to normal. But until these ups and downs go on with our Selic, we won't be able to see exactly what the funding costs will be and the revenue.

Now funding costs. Yes. We felt the effect of the mismatch, but we also felt the effect of the different fundings. This is a specific characterization of the FIDC model, which presents advantages. Nonetheless, there are points that can cause problems. When the operation grows rapidly, like right now, well, first you fund and then you -- the funding works with origination and creating portfolio. And as a consequence, with new revenues.

Today this -- now we had the effect of 2 things. We had a greater cash positions because of the fundings that reflected on growth and also the mismatch of these rates on the revenue and also on expenses.

Now in terms of RD, Enrico, I am going to repeat what was mentioned as soon as we acquired RD. RD is growing at a good pace. It had been growing at a good pace. It's a highly differentiated company. It is difficult to find a B2B tech company that has the maturity and presents the growth that RD has offered.

So our intention is not to generate any type of disruption in its pathway. So yes, we will do the integration and the extraction of synergies calmly, of course. We have been in talks since the approval by the antitrust agency. Tubino will mention this. There is also a strong proximity with the RD team.

So we are finding different pathways, and we see possibilities with all of these synergies. But we will do things calmly because we want RD to continue its path. I want to add, we don't want to bring problems that currently don't exist in RD.

Now what about the growth of RD that is noted and in parallel? We see the growth of our digital commerce operations. We practically tripled the amount of customers in our digital commerce platforms. This shows a positive effect. And RD benefits itself, and it will benefit itself in the upcoming years because of the digital maturity of our countries; the pandemic boomed this. Now all the customers relate to their customers in an automated way in a digitalized way. When we analyze in-depth, they were able to increase the throughput [ph] of the operation, the amount, the increase, the amount of customers. They increased the cross-selling, they increased retention. This shows the maturity of the market requesting solutions. RD helps us a lot in this type of positioning.

Operator

(Operator Instructions) Our next question comes from Leonardo, from UBS.

Q - Leonardo Olmos {BIO 21197412 <GO>}

My question is about Management. The revenues, the part of SaaS, doing very well and is quite high. I would like to hear more about the segments that have done so well and that you remarked on the release; retail, for example. What is it that happened specifically? And how do you foresee the growth in cloud management in the second half of this year?

A - Gilsomar Maia Sebastião

The segments that we mentioned here are segments that, in fact, have had a very good dynamic. We mentioned metallurgy, for example, agribusiness. These are sectors that have been undergoing a very good dynamic year-on-year. And consequently, this has given them a thrust, and they have become ever-more effective in terms of management. We see other sectors that are recovering.

But as you mentioned, cloud, we're working a great effort towards digitization. Some sectors are doing better, and they also have a higher capacity to invest, and they're going to use digitization as one of their competitive edges.

The fact is that this digital world sometimes makes us think of ecommerce, omnichannel that, of course are doing very well. But that's not it. It also requires that you have management, a very correct management. This ends up demanding that you revisit processes, tools because of the new digitization tools. Obviously it is more connected to sectors such as the retail one, distribution. But very generally, the digitization is impacting all the segments.

Q - Leonardo Olmos {BIO 21197412 <GO>}

And based on what you said at the very beginning, demand for these sectors has been strong and the sectors are growing this year. Of course you have a good share of credit among these clients. On the part of TOTVS, which are the other product launches or service launches that could have had an impact on the Management dimension? Or has it only been the growth of clients?

A - Gilsomar Maia Sebastião

I mentioned the issue of digitization, which has a consequence being demand for segmented solutions. We have to enter more into each client, and we also have to revisit some back-office routines. In several cases, we have clients that are migrating to the cloud, and of course this creates an opportunity to revisit them, to implement ecommerce and omnichannel and see if there could be other solutions, going forward, along the lines of digitization, electronic signatures, for example, CRM as well as other similar tools.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Maia, if you allow me, the HR itself has had a very strong growth for us. We have been on our journey these last few months, possibly since last year, of significantly expanding our portfolio. TOTVS has always been strong and continues to be very strong in the payroll, in the HR segment, but we have made great strides and launched several novelties in terms of human capital.

Our client base is ever more sophisticated and demands that from us, and we have responded to them. HR is a typical example of how we are becoming more sophisticated and the growth potential that this can bring about in the Management market.

Operator

(Operator Instructions) At this point, we would like to end the question and answer session. We now return the floor to Dennis for his closing remarks.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

I would like to thank you once again. Thank the TOTVERs. Once again a very difficult quarter with very positive results, indeed. I recall that the new quarter has already begun. We have another battle before us. But doubtlessly we will have a performance and excellent efforts. I would like to take advantage to congratulate Tubino. We did bring him here in vain. It is his birthday today. So on my behalf and on behalf of TOTVS as a whole, happy birthday. Have a good day.

Operator

The TOTVS conference call ends here. We would like to thank all of you for your participation. Have a good day.