Q2 2018 Earnings Call

Company Participants

- Eros Alexandre Jantsch, Business Vice President for Small Companies
- Gilsomar Maia Sebastiao, Chief Financial Officer, Investor Relations Officer
- Sergio Serio, Investor Relations Manager

Presentation

Operator

Good morning. Welcome to TOTVS Second Quarter of 2018 Conference Call. Today we have with us Mr. Gilsomar Maia, CFO; Eros Jantsch, Vice President for Small Businesses, and Sergio Serio, Investor Relations Manager. Note that all participants will only be able to listen to the conference call during the presentation. After that, we will start with a question-and-answer session for investors and analysts when further instructions will be given. (Operator Instructions) The audio is being simultaneously webcast at ir.totvs.com.br.

Before proceeding, we wish to clarify that any forward-looking statements that may be made during the conference call related to the business outlook, operational and financial projections and targets of TOTVS are based on beliefs and assumptions of the company's management as well as information currently available. Forward-looking statements are not guarantee of future performance. They involve risks, uncertainties, and assumptions as they refer to future events, and hence depend on circumstances that may or may not occur. Investors should understand that general economic conditions, industry conditions, and other operational factors could affect the future performance of TOTVS and could lead results to differ materially from those mentioned in such forward-looking statements.

I will now turn the conference over to Mr. Maia, who will begin the presentation. Mr. Maia, please go ahead, sir.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Good morning, everyone. Thank you for participating in our conference call. I will begin the presentation by commenting on the main recent events on the slide three. The first event is the increase of Bematech's interest in RJ Participacoes by the incremental acquisition of 20% of the capital stock of RJ for BRL4.3 million. As a result, Bematech now holds 80% interest in RJ, and the remaining 20% call option was extended to 2021 based on RJ's business and succession plan.

The second event to be highlighted is the maintenance of the IT sector in the tax relief of payroll until 2020 based on a federal law enacted on May 30, 2018. The law established that from 2021, the employer's social security contribution will no longer affect the revenue at a rate of 4.5%, and will again be levied on the payroll at the rate of 20%. We focused still on the service operation, given its predominance of payroll as a cost component. The deadline established by law contributes to prepare the service operation both in terms of efficiency and in price in order to mitigate possible effect from 2021.

And the third event is the Board of Directors approval for the distribution of dividends and interest on capital for the first half of 2018 in the total amount of BRL32.7 million, corresponding to BRL0.20 per share, of which BRL18 million refer to dividends corresponding to BRL0.11 per share and BRL14.7 million refer to interest on capital corresponding to BRL0.09 per share. Both dividends and interest on capital will be paid on October 3rd, 2018 to the company's shareholder on August 1st, 2018.

Turning now to slide four. We also highlight the study Enterprise Application Software released by Gartner in June, which reiterates TOTVS' leadership in the ERP market in Brazil with a participation of 50.5% in 2017, which represents an increase of 0.9 percentage point compared to 2016, and 0.2 percentage point from 2014, which is the last year before switching to subscription model. The same study also points TOTVS in the first position in Latin America with a 31.6% share of the ERP market, which represents an increase of 0.7 percentage point compared to 2016.

I now turn the presentation to Eros, who will comment on revenues in the quarter on the slide five. Eros, please go ahead.

Eros Alexandre Jantsch {BIO 19708262 <GO>}

Thanks, Maia, and good morning everyone. The 2% quarter-on-quarter growth in net revenue was driven by a seasonal increase in hardware sales and the progress of service projects in the second quarter. In addition to the seasonal evolution, the increase in service sales in previous quarters also contributed to a year-on-year growth of 11% in service revenue, which added to the increasing software revenue, led to a 4.4% year-on-year growth in the net revenue.

On the other hand, the quarter-on-quarter reduction of 3.9% in software revenue was mainly due to the 33% drop in license revenue shown on slide six, particularly related to the incremental license revenue from corporate model in first quarter. There is also a seasonal element as shown on the year-on-year growth of the quarter and the last 12-month period. And by the way, year-on-year comparison shows that software revenue growth has been generated by subscription revenue, which grew 31% in the quarter and almost 35% in the last 12 months.

In the charts on the left of slide seven, it becomes clear. We can see that the blue bars in the chart representing the sum of licensing and maintenance revenues have not grown in the past three quarters. And our software revenue growth has come from subscription revenue represented by orange bar. Subscription revenue grew 2.7% this quarter, rising from BRL94.6 million last quarter to BRL97.2 million this quarter. This performance of the subscription was negatively affected by the higher concentration of sales in June due to the strike of truck drivers in the last week of May. The sales of June will contribute to the third quarter revenue and are included in the annualized subscription exercise on the chart to the right of the slide.

Additionally, revenue growth in subscription ARR were also negatively impacted by two factors linked to the adjustments in the Bemacash cash sales model. First one is a higher volume of cancellation due to the delinquency coming from units sold before first quarter of 2018 when sales by credit card were implemented, and second, the reduction in sales resulting from the change in software chargeability from the first month of subscription. Despite these factors, subscription annual recurring revenue ARR totaled BRL425.6 million in the second quarter, an amount that represents 40% growth year-on-year, and 5.7% growth quarter-over-quarter.

I now turn the presentation to Sergio Serio who will comment on the software result on slide eight.

Sergio Serio

Thank you, Eros, and good morning everyone. The year-on-year reduction in the adjusted software contribution margin is a result of the combinations of R&D and support costs. Despite the reduction in recurring costs with personnel performed in 2017, the growth of these lines reflects the wage increase resulting from collective bargaining agreements in addition to the new investments in innovations made by the company in the period. The quarter-on-quarter reduction in the adjusted software contribution margin is associated with the reduction in software revenue commented by Eros, and increasing costs due to the higher volume of (inaudible) holidays in first quarter, and the additional cost of support to meet the demand from new customers added in the period and from the existing customers due to the new regulations that came into effect in the first half of the year such as e-Social.

Turning now to services on slide nine, the adjusted service contribution margin grew 600 basis points over second quarter '17 and 310 basis points over first quarter '18. The growth in services revenue was mainly due to the higher pace of services sales observed in recent quarters and the higher allocations of services professionals in the quarter. When we use the comparison of the last 12 months, the reductions of 2.1% in services cost is a consequence of the adjustment of tax structure promoted throughout second half '17. These reductions led to margin of 5.6% in the last 12 months or 340 basis points higher than in the same period of the last year.

Turning now to hardware on the slide 10, the adjusted hardware contribution margin was 580 basis points lower than second quarter '17 and 670 basis points lower in the comparison of the last 12 months. The main elements that resulted in this decline were the increasing R&D as a result of expenses with institutes hired to comply with the IT Law and the drop in sales of fiscal printers, which have a higher gross margin.

The 240 basis points quarter-on-quarter increase in the adjusted contribution margin reflects the increase in sales of fiscal solutions in the second quarter '18 due to the maintenance of tax solutions in Minas Gerais and the incentive by the Government of

Santa Catarina to regularize the use of fiscal printers and also the recovery of sales volume due to the negative seasonality in first quarter '18. Such negative seasonality of the first quarter can be seen in the chart on the left on slide 11.

On the chart to the right of the same slide, we show the increase in the share of fiscal solutions in the product mix caused by the demand commented on the previous slide. The increase in sales of tax solutions, as shown, which have a higher margin led to an increase in the margin of hardware results in the second quarter '18. In addition, in second quarter '18, Bemacash sales totaled 691 units, compared to 1,093 in second quarter '17. As commented previously by Eros, this reduction is a consequence of the change in the sales model of Bemacash, which aimed to simplify the sales process delinquencies.

To talk about selling and administrative expenses, please go to slide 12. In the quarter, selling and commercial expenses as a percentage of net revenue declined in relation to the previous quarter due to the mix of sales between own channels and franchises and the revenue mix. Year-on-year, the reduction of 5.7% in selling expenses is explained by the reduction in recurring costs with personnel in fourth quarter '17 and the deferral of variable compensation as a consequence of IFRS 15.

Regarding general and administrative expenses, management fees and other expenses, the year-on-year reduction is mainly associated to the provisions for contingencies in second quarter '17 being lower than the quarterly average of the same year, and also to the additional expenses with the incorporation of PC Sistemas in second quarter '17, and the integration of Bematech's administrative operations during last year, both contributed to the reduction of recurring costs with personnel in fourth quarter 17.

Turning to the advertising and market expenses, the year-on-year and quarter-on-quarter variation reflects the company's annual marketing plan, and the allowance for doubtful accounts represents 1.9% of net revenue in second quarter '18 compared to 2.3% in first quarter '18 and 1.4% in second quarter '17. This provision reflects the higher level of currency delinquencies, which resulted in a negative effect of BRL3.2 million with the adoption of IFRS 9. Excluding the IFRS 9 effect, the provision represented 1.4% of net revenue, the same level observed in the second quarter of 2017.

I now return the presentation to Maia who will comment on EBITDA on slide 13.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

As we can see in the chart, the quarter-on-quarter reduction in adjusted EBITDA was due to the reduction in software results, partially offset by higher service and hardware results and reductions in commercial and administrative expenses. Year-on-year adjusted EBITDA increase came from the software and services results that more than offset the decrease in the hardware results. The change in the product mix continued to reduce hardware results with the discontinuation of fiscal printers in a more advanced stage and the development of high value-added solutions such as Bemacash and smart device for the Internet of Things.

In the last 12-months comparison, with the increase in software and services results, even partially offset by the reduction in hardware results, has not yet (inaudible) EBITDA growth due to the amount still required by the allowance for doubtful accounts, part of the commercial expense, and by the provisions for contingencies, part of the administrative expense.

Moving now to slide 14, the EBITDA performance is the main element that even with the improvement in financial results and income tax and social contribution led to a reduction in net income quarter-on-quarter. In the year-on-year comparison, the 7% increase in net income came in mainly from the EBITDA improvement due to the reduction in amortization expense linked to the lower expenses related to intangible assets arising from the acquisition of companies was more than offset by the higher net financial expense and the higher effective tax rate in this quarter.

Now I will move to cash flow and debt on the slide 15. Free cash generation grew 20% year-on-year, mainly due to the growth in the earnings before income tax and social contribution and the reduction of investment in working capital. Quarter-on-quarter, the free cash flow generation grew 66% and the operating generation grew 53%, mainly by the reduction in working capital investment and the lower volume of interest payments, given the interest amortization of debentures accrued in first quarter '18 and also the lower CapEx level.

Additionally, net debt fell almost 50% year-on-year and 23.5% quarter-on-quarter. Even with the payment of dividends and interest on equity reflected in the second quarter '18 financing flow. This reduction led net debt to the level of 0.7 times last 12 months adjusted EBITDA, which is the lowest level since second quarter '15.

I'll now turn to slide 16 for the closing remarks. Throughout this conference, we saw that net revenue grew 4.4%, driven by software and services revenues that grew 4.4% and 11% year-on-year respectively. Subscription revenue grew 31% year-on-year, that accounted for more than 25% of software revenue. Adjusted EBITDA increased year-on-year by 4.5% with the stable margin, and free cash flow generation grew 66%, and net debt fell by half year-on-year, reaching 0.7 times EBITDA.

We are now available for the Q&A session.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) This concludes today's question-and-answer session. I would like to invite Mr. Maia to proceed with his closing statement. Please go ahead, sir.

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

So I'd like to thank you everyone for the participation in our conference call. Reminding that our IR team is here available in order to help if you need any additional assistance. And everybody have a very nice day. Thank you very much. Bye.

Operator

That does conclude the TOTVS audio conference for today. Thank you very much for your participation. Have a good day and thank you for using Chorus Call.