

Q1 2013 Earnings Call

Company Participants

- Alexandre Dinklemann, EVP
- Gilsomar Maia, CFO

Other Participants

- Andrew Campbell, Analyst
- Diego Aragao, Analyst
- Loren Lewallen, Analyst
- Michel Morin, Analyst

Presentation

Operator

Good morning. Welcome everyone to Totvs' First Quarter 2013 Results Conference Call. Today with us we have Mr. Alexandre Dinklemann, Executive Vice President of Strategy and Finance; and Mr. Gilsomar Maia, Corporate Finance Officer.

(Operator Instructions) Today's live webcast may be accessed through Totvs' website at www.totvs.com/ir.

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 Dinklemann who will begin the presentation. Mr. Dinklemann, you may begin your conference.

Alexandre Dinklemann

Good morning, everyone. Welcome to Totvs First Quarter 2013 Results Conference Call. Firstly, I will start talking about the acquisition of PRX announced last April presented on

slide two. PRX develops and implements Totvs solution for the Agribusiness industry serving approximately 60% of the country's sugarcane mills as well as several grain cultures.

With the acquisition of PRX aligned with our specialization strategy, we will create a Center of Excellence for Agribusiness, which will combine Totvs solutions portfolio with the expertise of more than 180 PRX employees. Brazil is a global benchmark in Agribusiness. And with this move, we aim to raise Totvs to this level. And thus, explore the opportunities in this sector, both in Brazil and abroad.

Going now to slide three, we have the total net revenue which grew 8.7% in Q1 and 10.8% in the last 12 months; both periods, excluding the social contribution impact from Brasil Maior plan. Much of this growth is a recurring revenue result which has grown above the average of total revenue over the past 12 months as shown on slide four.

Between the First Quarter of 2012 and the First Quarter of 2013, recurring revenue grew by 13.8% and reached almost 59% of total revenue compared to 56% in Q1 '12. In the last 12 months, recurring revenue increased more than 11% reaching 57% of total revenue. The recurring model may reduce the total revenue growth rate in the short-term since it is recognized in a monthly base. But on the other hand it brings greater predictability and growth in the long-term.

Just to illustrate that if the first Q '13, recurring revenue is annualized it would result in approximately BRL900 million for the full year, or 10.5% growth over 2012, even not counting the inflation adjustments that would be captured over the period.

The expansion of recurring revenue is part of the Company's strategy addressing both pillars of growth and loyalty since we believe that the model favoring the recurrence is more effective, especially among the small and medium companies adding greater predictability of revenues to the business.

Now on slide five we observe the evolution of license fee revenue which grew by 6.8% in the last 12 months and decreased 1.7% over the Q1 2012. This quarter is influenced by charging the incremental license of the corporate model which we can see on slide six.

Remembering customers under this model pay an incremental license to Totvs in the First Quarter based on the actual growth of the previous year. That means only if there is real growth there is incremental license. In the First Quarter of the current year the increment amounted to BRL17.3 million, 4.7% lower than the first Q of last year indicating that the clients under this model kept growing above the overall average of the economy in real terms since this deceleration of the incremental license was much lower than the deceleration of the Brazilian GDP.

Sales to new customers were 26.7% lower in the first Q mainly due to the decrease of 22% in average ticket. However in the last 12 months sales to new customers grew 23% and average ticket grew 23.4%.

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In summary, short-term fluctuations in average tickets are common because it represents the average size of customers added in the specific period. In Auroville the last 12 months show more clearly the market dynamics, but the beginning of the year has been more challenging than expected. So sales came below our expectations. We are not happy with this performance. Historically, sales to new customers are more sensitive to economic scenario, especially larger companies that reduce investments in the short-term, lengthening our sales cycle.

When slowdowns like these extend, this more conservative approach is also observed in medium; and small-sized companies.

Moving to slide seven, service revenue ended the quarter with 6.8% growth over the First Quarter of 2012. In the last 12 months this line grew by 11.4%. The growth of this revenue stream in the First Quarter of 2013 at the slower pace than in the past 12 months is mainly due to the sales mix of licenses with greater participation of franchises as well as to the established baseline for comparison in the First Quarter of 2012 when this line grew almost 23% over the First Quarter of 2011.

Concluding comments over revenue on slide eight, the maintenance revenue ended the First Quarter with 15.2% growth over the same period of 2012. In the last 12 months, this line grew by 12.4%. This growth was due among other factors to the emphasis on recurrence, especially with the smaller customers and focus on the loyalty of the customer base enhanced by the creation of the clients vice presidency.

Now I invite Maia to proceed from slide nine on.

Gilsomar Maia {BIO 16400533 <GO>}

Thanks Alexandre. Good morning, everyone. Now on slide nine we have the evolution of the three main groups of operating costs and expense as a percentage of total net revenues. The first line of the chart represents the group of license costs, service costs, and R&D which concentrates most of the personnel expense. Once again I remind that Totvs does not capitalize its investments in R&D. So the reported result presents the entire investment performed with no deferred effects.

In first Q '13, this group reached 46.8% of total net revenue representing an increase of 0.7percentage points over 4Q '12 mainly because of 7% wage increase due to the collective bargaining agreement in Sao Paulo which was higher than the overall growth of net revenue for the same period.

The second line regards the group of advertising expense, sales commissions and allowance for doubtful accounts, representing 19.4% of first Q '13 total net revenues, a decrease of 0.3percentage points over 4Q '12. This reduction was concentrated in the provisions for doubtful accounts which was 52.6% lower than presented in 4Q '12. The decrease in delinquency of consulting and implementation services provided to large customers in Brazil was the main reason for the reduction of this group since part of the provisions booked in previous quarters has been reversed in first Q '13.

The third and last line of the chart represents the group of G&A and management fees that declined 0.4percentage points primarily by the combination of scale gains and reduction of certain statutory positions eliminated in second Q '12 after change on hiring regime for some officers.

Moving to slide 10, the EBITDA margin of 26.1% was stable compared to first Q '12. When analyzed over the last 12 months, the EBITDA margin reached 26.7%, up 1.8percentage points over the previous period. The 12 months view illustrates well that over the years the Company EBITDA margin may fluctuate, but the combination of Totvs' business model in the target market leads to a margin expansion in the long-term.

On slide 11, we have a summary of the quarter presenting among others the net income of BRL51.9 million in first Q '13 and BRL209 million in the last 12 months. What means on a year-on-year growth of 4% for first Q '12 and 12.6% for the last 12 months period respectively. In first Q '13 the growth difference between EBITDA and net income is mainly due to the higher effective tax rate.

Moving to slide 12, the chart shows the net cash position changing from BRL162.7 million in 4Q '12 to BRL84.5 million in first Q '13. The main reasons for this reduction are the payment of PC Sistemas acquisition considered as intangibles, the payment of interest on equity declared in 4Q '12 and the amortization of financing line with BNDES, denominated pro soft[ph]. The company's capacity for cash generation and leverage through competitive credit lines in terms of cost and tenure supports the execution of the Company's investment plan which has presented its first results with the acquisitions of PC Sistemas, Umove.me and PRX.

Now the conference returns to Alexandre. He proceeds from slide 13.

Alexandre Dinklemann

Thanks Maia. Ending with slide 13, we summarize how the management guides its agenda and analyze the operation's performance, seeking a balance among the three pillars of growth, loyalty, and margin with the goal of creating value for the Company in the long-term.

Regarding growth, we highlight the 10.8% growth of net revenue in the last 12 months besides reinforcing the specialization strategy and the acquisitions of PC Sistemas and PRX, at loyalty we emphasis growth of 12.4% in revenue from maintenance and recurring revenue growth of 11.4% both in the last 12 months.

And for the margin pillar we highlight the EBITDA margin of 26.7% in the last 12 months. The management reiterates its view on the relevant potential of the Brazilian market of softer management systems especially among small; and medium-sized 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 this 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 opened for questions from investors and analysts. (Operator Instructions)

The first question comes from Michel Morin of Morgan Stanley. Please go ahead.

Q - Michel Morin {BIO 1873971 <GO>}

Good morning, everyone. Thanks for taking the question. I was wondering, Alex, given the license sales were a little sluggish this quarter, did you -- do you think that part of that might be related to the calendar effects this year, specifically the timing of Semana Santa and one less day in February. I didn't know if any of that might have played a role, or if you are seeing any change on the competitive front? Thank you.

A - Alexandre Dinkleman

Good morning, Michel. Thank you for your question. This is a factor, but we opted not to highlight that for your investors. But of course that it affects marginally our business when we compare the number of working days in the period compared to last quarter, it affects for example service. And in Brazil when we have these big holidays close, in general what we perceive is that the economic activity tends to react after the sequence of these big holidays. But again we believe it's marginal. It was not a key factor.

Q - Michel Morin {BIO 1873971 <GO>}

Okay. Then if I may, you mentioned the PRX acquisition, would you mind sharing with us kind of its revenue run rate? I think you gave a number for 2012, but given that it's growing fairly fast I was wondering if you could give us kind of a First Quarter revenues figure for that entity. I know that you're not consolidating it until Q2, but the more recent info would be helpful.

Then also on the bad debt, Maia, in the release you mentioned that it returned to normal historical levels. And I was wondering how we need to interpret that because it seemed to us that perhaps the Q1 level is a bit lower than historical levels and we would anticipate that it would go up a little bit from here on a sequential basis. So if you can clarify that that would be helpful. Thank you.

A - Alexandre Dinkleman

Just to clarify your question, are you asking about PRX or PC Sistemas; PC is the logistics and wholesale.

Q - Michel Morin {BIO 1873971 <GO>}

Yes. I was asking about PRX which you're announcing today. What the revenues were last year and specifically what they were in Q1. I know you had no contribution to Totvs in Q1, but how much revenue did they do in Q1?

A - Alexandre Dinklemann

We are not disclosing this information, Michel. What we inform you as you said was figures from 2012. As you also know, we haven't included these numbers in our First Quarter. So far our intention is not to disclose this information.

Q - Michel Morin {BIO 1873971 <GO>}

Okay.

A - Alexandre Dinklemann

But for a company that's growing well, has been growing well in the past, what's worth mentioning here is the strategic rationale for this acquisition. It's really reinforced our positioning in the Agriculture business and it's becoming global. It's not only limited to Brazil. So we are seeing in all decision-making process taking place in Brazil related to other countries. So that's why it's very strategic for us.

We want to be recognized in an international basis as one of the strongest players in the agriculture space.

Q - Michel Morin {BIO 1873971 <GO>}

How significant is the non-Brazil part of the business for them?

A - Alexandre Dinklemann

The trend is relevant for the international expansion. But so far it's been marginal.

Q - Michel Morin {BIO 1873971 <GO>}

Okay.

A - Alexandre Dinklemann

But it's -- the prospect is very good. The prospect for Brazil is also very good.

Q - Michel Morin {BIO 1873971 <GO>}

Yes. Great. And on the bad debt question?

A - Alexandre Dinklemann

Could you repeat the second question about that?

Q - Michel Morin {BIO 1873971 <GO>}

Yes. So the bad debt was that you -- in your press release you said that the provision this quarter returned to historical levels. And that -- and I wasn't sure how to interpret that because as a percentage of revenues it was much lower than what we've seen in a very long time. So I was wondering if there was -- if we should anticipate that it might actually go back up a little bit in Q2 as a percentage of revenue.

A - Gilsomar Maia {BIO 16400533 <GO>}

Hi, Michel. This is Maia speaking. When we say historical levels, historical levels in terms of allowance for doubtful accounts is about 1% of total revenue. And as you know, last year this line running -- was running about 1.5% or a little bit higher than that, so higher than historicals. Specifically this quarter it came like 0.8% on total revenues, so they're a little bit below historicals, but we indicated that this quarter we had some reversal of provisions of allowance for doubtful accounts we had in the previous quarter.

So excluding those reversals, we are in a trend to the historical levels, but I wouldn't drive you in the direction to assume that the next quarters we will present exactly our historicals because if you remember on Q4 '12 we implemented a new credit policy, specifically for services and in terms of consulting services. And these policies are going to be applied to the new sales. The previous ones were under the old and more flexible credit policies. And we can never say that we wouldn't have problems with those. Have I been clear?

Q - Michel Morin {BIO 1873971 <GO>}

Yes. So just to make sure on that last point, you're saying that the new policy are stricter, tighter so you expect to kind of reverse the trend of the last few years; right? Because I think if I look at the last few years it has been going up.

A - Gilsomar Maia {BIO 16400533 <GO>}

Yes. Our intention is to bring it back to the historical level. Of course it's (inaudible).

Q - Michel Morin {BIO 1873971 <GO>}

Okay. Great. Thank you very much.

Operator

(Operator Instructions) The next question comes from Andrew Campbell of Credit Suisse. Please go ahead.

Q - Andrew Campbell {BIO 1762233 <GO>}

Yes. Thanks for taking my question. I wanted to know since the end of the First Quarter, have you sensed any relevant change in the market dynamics compared to what you guys saw throughout the First Quarter? And my second question was just on the international operations because I notice that this quarter there was no specific disclosure of the performance of international operations. So if you could give us any updates on how they have performed? Thank you very much.

A - Alexandre Dinklemann

Hi, Andrew. Good morning. I will start with the second question; okay? So international market as you know, we have the guidance for 2014. At the end of this year we intend to reach break-even. We are working these directions. So far results are in line with our expectations. The idea of the Company is to disclose international operations information on an annual basis in order to really give you this visibility.

You can see the growth of international operations on a quarterly basis. But you know in order to give you the visibility of this break-even guidance; we intend to disclose that on an annual basis. So far results are in line and we are confident that we will reach our objectives. So in terms of market dynamics, just to make clear, you asked about April and the beginning of May how we are seeing compared to the First Quarter or the First Quarter compared to the year?

Q - Andrew Campbell {BIO 1762233 <GO>}

No. You're correct actually. The April and the beginning of May, if you've seen any relevant change in the market dynamic compared to what drove the sales performance in the First Quarter?

A - Gilsomar Maia {BIO 16400533 <GO>}

Andrew, this is Maia speaking. And just to clarify a little bit, when Alex said break-even about international market, the break-even is going to be achieved by the end of 2014; okay? That's the target. And getting back to your question of market dynamic, we haven't seen any significant change from the first Q to these moments to be frank.

Q - Andrew Campbell {BIO 1762233 <GO>}

Okay. Thank you very much.

Operator

And we have a follow-up from Michel Morin from Morgan Stanley. Please go ahead.

Q - Michel Morin {BIO 1873971 <GO>}

Thanks. So I just wanted to check, you've been highlighting the impact of the change in social contribution effect on your top line. Am I correct in assuming that disappears in the Second Quarter?

A - Alexandre Dinklemann

Yes. Second quarter we will have the same legislation, the same rules apply for both quarters.

Q - Michel Morin {BIO 1873971 <GO>}

Okay. So that will no longer be highlighted. Okay. And you've also started providing the recurring revenues I think since last quarter, and I just wanted to know how can we think

about trying to model that? I'm assuming it's all your maintenance revenues. And I think you were mentioning on the last call, Alex, that a portion of the service revenue is as well.

And so I was just wondering if there's anything that you would suggest that we could be thinking about and how to think about that going forward? Also thinking about the impact of any future acquisitions, is there anything in the acquisition strategy that is focused on growing that recurring component? Thank you.

A - Alexandre Dinklemann

Okay. So I'll start, Michel. These are things that we have been talking with analysts and investors since the beginning of 2012. Actually one year ago we were preparing you for you know this thing. And we said to you that we would start to disclose this recurring dimension in 2013. That's the idea and of course that we intend to also improve the disclosure of this kind of business.

This trend in Auroville and we believe it's adherence to our fiscal client[ph] in the SMB space. It also helps us in terms of improving predictability in the Company from the financial perspective. In terms of M&A, what we see pending on the potential targets, yes. They tend to bring this kind of revenue mix. An example is PC, the company that we acquired in January, related to wholesale, retail, and logistics.

They have a very strong recurring profile in their revenue mix. So yes. Probably you tend to see also targets acquired by Totvs bringing this recurring model to our company.

Q - Michel Morin {BIO 1873971 <GO>}

Okay. Great. That's very helpful. Thank you.

Operator

The next question comes from Loren Lewallen of Select Equity Group. Please go ahead.

Q - Loren Lewallen {BIO 17231394 <GO>}

Hi. Good morning. Thank you for taking the question. My first question is if you could talk a little bit about the changes you've been making to your sales force. Selling expenses up quite a bit and I remember a bit over a year ago you went through a big wave of hiring -- or maybe it was a couple years ago -- to build out the vertical capability. Then last year the selling expense growth was not that large and now we're seeing it pick up again. So I'm wondering if you can talk a little bit about how many people you've added and how large the overall sales force is currently? And also where in particular those people are going, which verticals you're focusing on?

A - Gilsomar Maia {BIO 16400533 <GO>}

Good morning. This is Maia speaking again. You're correct. This is not a new move. We have started this kind of change in our sales force since last year at least. And this process is still ongoing. We are giving more and more focus on verticals and segments. And this

requires some investment in terms of our team. It doesn't mean we are mandatorily increasing the number of our headcount. It sometimes represents some change we have to make in our team in order to (inaudible) for this new approach.

In our sense it can be more effective in terms to capture the opportunity in the market. We have said that frequently. And that's one of our delays. Specializing more and more our sales team and also service team. We believe it's going to be more effective in terms of sales and delivering our solutions on the field.

Q - Loren Lewallen {BIO 17231394 <GO>}

That's helpful. I guess what I still don't fully understand is that this expense was up 20% year-over-year despite the fact that Brasil Maior should be benefiting you. And actually excluding Brasil Maior effect, it's probably up more than that. But then you said you weren't necessarily adding people. So is it a -- are you changing the comp structure meaningfully? I'm just trying to understand what's driving that expense increase and where the run rate sits going forward?

A - Gilsomar Maia {BIO 16400533 <GO>}

Okay. What I mean is you shouldn't understand that 100% of this growth, or this increase, represents a head count addition, you know? Part of that net release is a headcount increase. But part of -- the other part it's represents substitutions[ph], you know?

Q - Loren Lewallen {BIO 17231394 <GO>}

It represents -- sorry what did you say?

A - Gilsomar Maia {BIO 16400533 <GO>}

Replacement.

Q - Loren Lewallen {BIO 17231394 <GO>}

Replacements. Okay. And are there certain sectors or areas -- when we saw license growth negative, were there certain sectors of the economy that you saw performing better and maybe those are the areas you're investing in versus others which are tougher at this point?

A - Gilsomar Maia {BIO 16400533 <GO>}

So there are no big news here. Sectors more connected to services, we are investing more because those sectors are showing more prominence in terms of opportunities, you know? Especially those connected to location, for example, logistics sectors more oriented to services than industrials are presenting more opportunities and consequently we are putting more investment and effort at this moment.

Q - Loren Lewallen {BIO 17231394 <GO>}

And from a market share standpoint, did we see any -- are you seeing any shifts in these places where you're focusing and putting more investment?

A - Gilsomar Maia {BIO 16400533 <GO>}

Not really at this moment. We are trying to track a little bit deeper this kind of indicator. But up to now, I don't have any relevant change to describe.

Q - Loren Lewallen {BIO 17231394 <GO>}

Great. Thank you for your time.

A - Gilsomar Maia {BIO 16400533 <GO>}

Thank you.

Operator

The next question comes from Diego Aragao of Morgan Stanley, please go ahead.

Q - Diego Aragao {BIO 17889908 <GO>}

Hi. Good evening guys. Just a follow-up question regarding the competition, can you describe how the competitive landscape at this point? Is there any impact from the competition in the results? Thanks.

A - Alexandre Dinklemann

Hi, Diego. This is Alex speaking. Good morning. As I said in the previous conference call, the competitive landscape is pretty the same as we saw last year. So it's a tough competition. The competition is not in just one dimension, so it depends on the segments that we are talking about on the niche. So in the high-end market we have a kind of competition in the SMB space, the competition is much more related to verticals.

So it's specialized and regional competition. At the base of the pyramid, so the competition is different; it's a more fragmented market. So we haven't seen any difference of the competitive level during this quarter. The level of difficulty is the same. So we understand that the macro scenario and the length of the economic cycle have impacted more on a relative basis of performance rather than competition.

Q - Diego Aragao {BIO 17889908 <GO>}

Great. Thanks guys.

Operator

(Operator Instructions)

At this time, I would like to turn the floor back over to Mr. Alexandre Dinklemann for any closing remarks.

A - Alexandre Dinklemann

I would like to thank you all for your participation in the call. And mainly I would like to thank Totvs team. The team is committed to keep working hard in order to maintain Totvs as the best software company in Brazil and also in Latin America. So thank you all.

Operator

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

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