Q1 2018 Earnings Call

Company Participants

- Alexandre Haddad Apendino, Services and Relationship Officer
- Gilsomar Maia Sebastiao, Chief Financial Officer
- Sergio Serio, Investor Relations Manager

Other Participants

- Andre Baggio, Analyst

Presentation

Operator

Good morning. Welcome to TOTVS Conference Call to discuss the Results of the First Quarter of 2018. Today, we have with us Gilsomar Maia, CFO; Alexandre Apendino, Services and Relationship Officer; and Sergio Serio, Investor Relations Manager. Note that all participants will be on listen-only mode during the presentation. After the presentation, we will start the 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.er.

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 the beliefs and assumptions of the company's management as well as on 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 call over to Mr. Maia, who will begin the presentation. Mr. Maia, please go ahead.

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 is the shareholders meeting held on April 5, in which shareholders representing 85% of total shares participated, with shareholders representing 49% of total shares being represented via remote voting form. The meeting approved all the items on the agenda among which I'll highlight the following.

The new Board of Directors composition consisting of 7 reelected members; Pedro Passos, Claudia Elisa, Gilberto Mifano, Laercio Cosentino, Maria Leticia Costa, Mauro Cunha, Wolney Betiol; and two new members elected; Guilherme Stocco Filho and Paulo Sergio Caputo.

Guilherme Stocco Filho was an advisory member of the strategy and technology committee of TOTVS last year and he is currently a member of the technology committee at B3, as well as a consultant to Buscape and (inaudible). Paulo Sergio Caputo independent Board member at CSU CardSystem, founding partner of Oria Gestao de Recursos with large experience in technology companies such as Bematech and Datasul. And also served us Vice President of Strategy at TOTVS between 2008 and 2009. The elected board members will hold their mandates until the end of shareholders meeting of 2019 and their profiles are available on TOTVS Investor Relations website ir.totvs.com.br in the Corporate Governance Board of Directors session.

Another item approved at the meeting was the change in shareholder base incentive and retention plan, which includes: to delink the investment of the Annual Bonus of participants in shares of the company for eligibility to the incentive plan; to establish the annual individual performance appraisal, as a criterion for granting the restricted shares set by the Board of Directors within the limits approved by the General Meeting of 2015; and for the shareholders program, to require eligible participants to hold continuously and uninterruptedly, the equivalent of 12 gross salaries in TOTVS shares on the date of the grant. These changes were made to improve the plan approved in 2015 to achieve the following objectives: increase the medium and long term alignment of the interests between participants and shareholders; enhancing the sense of ownership and commitment of participants through the concept of investment and risk; and strengthen the incentives for retaining and providing long-term stability to participants reading the context of a public company.

Moving onto slide four, another event of the period occurred on April 3rd with the election by the Board of Directors of Juliano Tubino, as Vice-President of Business Strategy and Digital. In his career, Tubino has gathered experience in the areas of digital marketing, sales and innovation. having held diverse executive positions include Chief Marketing Officer, at Accenture Digital, Netshoes and Amazon.

In this quarter, we also inaugurated the new Bematech hardware plant in Sao Jose dos Pinhais, Parana, which enables us to unify the operations previously distributed over three facilities in the series of Curitiba and Sao Jose dos Pinhais. TOTVS also entered in the Internet of Things solutions market with the launch of the Bema Platform that can bring to gather data from connected device and be used in business application.

Before beginning the comments on the results of the quarter, I wish to point out that the new Accounting Standards IFRS 9 and IFRS 15 came into effect this quarter. The adoption of IFRS 9 resulted in a provision of allowance for doubtful accounts based on the historical losses recorded in the accounts receivable aging-list range, including trading those to, combined with the clients propensity to pay provided by the credit bureaus.

On the other hand, the adoption of IFRS 15 resulted in revenue recognition during grace periods, upon deferral and/or provisioning of selling expense and commissions, in order to linearize the result over the estimated life cycle of recurring contracts. Revenue from services was also adjusted by determining the percentage of completion of projects based on the costs incurred versus the updated estimates of total costs required to conclude the project. The adoption of this new accounting standards resulted in a positive impact of BRL5.9 million in net revenue, BRL3 million in EBITDA and BRL2 million in net income in the quarter. The application of these standards on balance of December 31st, 2017 resulted in a negative impact of BRL8 million which was recognized under equity in January 2018.

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

Alexandre Haddad Apendino {BIO 20185832 <GO>}

Thanks, Maia. Good morning, everyone. As shown in the slide on the right is the last 12 months figures, and in the slide at the center comparing year-on-year, net revenue growth has been driven by recurring revenue, which already exceeds two-thirds of the total revenues in the quarter corresponded to almost two percentage points above the level of 2017. In this quarter, non-recurring revenues grew 2% quarter-on-quarter. And as we can see on slide six, this increase is mainly associated with software revenue, which grew 6.8% over the previous quarter and 6.5% year-on-year.

As shown on the slide seven, softer revenue was leveraged year-on-year by the 38% growth in the subscription revenue and 14 percentage growth in the licensing revenue. Here, I wish to draw your attention to the growth in subscription and licensing revenue, in all comparison base, which reflect sales growth and market recovery in the period. The reduction in maintenance revenue shows that the growth in license combined with the inflation update by IGPM has not yet been sufficient to offset the financial churns of this recurring revenue.

In the chart to the left on slide eight, we can see that the growth of the licensing model during the quarter came mainly from increments in the corporate model, which totaled BRL17.9 million, an increase of almost 29% compared to the increment in 2017, which itself was 29.5% higher than in 2016. In this model, clients have unrestricted access to TOTVS management, for which they pay an increment of license fee at the beginning of each year based on the actual growth in the prior year. As such, this growth in the increment amount reflects the pace of growth among clients under this model in 2017, especially in the manufacturing, healthcare, logistics industry.

Another aspect that draws attention to this chart is the increase of the subscription revenue came in from 18% of software revenue to almost 24% in an year. This performance is mainly due to sales of the subscription, which can be observed from the net addition of annual recurring revenue from subscription, which is shown in the chart to the right on the slide. Note that as ARR accelerates, subscription revenues accelerate in the subsequent periods.

I now hand over the presentation to Sergio Serio, who will comment on the software results on slide nine.

Sergio Serio

Thank you, Apendino, and good morning everyone. The year-on-year increase of 20 basis point in adjusted software contribution margin is essentially to the result of the growth in subscription revenue, as just commented by Apendino. The reduction of recurring costs with personnel in fourth quarter '17 also contributed to the performance and to face the probable effect on the wage bill resulted from the collective bargaining agreement to be concluded in Sao Paulo. In the quarter-on-quarter comparison apart from the growth in subscription revenue, the seasonal contributions from the increment in the corporate model also contributed to the 210 basis points growth in adjusted software contribution margins.

Talk [ph] now about services on slide 10. By the decline in revenue, adjusted contribution margin grew 390 basis points year-on -year and 140 basis points quarter-on-quarter. This is mainly due to the reduction in recurring costs with personnel during the second half of 2017 and the effects of BRL3.7 million resulting from the adoption of IFRS 15. In the comparison with the last 12 months, the reductions was due to the decline in the revenue from software implementation services and the reductions in revenue from consulting services. These decreases were mainly due to the lower pace of sales and consequently lower allocations of professionals, especially in the first half of 2017.

Moving now to hardware on slide 11. The drop in adjusted contribution margin from hardware year-on-year and for the last 12 months was mainly due to the drop in sales of fiscal solution, which have a higher gross margin and by the increased investment in research and development due the normalization of expenses with institutes contracted to comply with the IT law or Lei da Informatica. In the quarter-on-quarter comparison, the decline in adjusted contribution margin reflects, apart from the drop in sales of fiscal solutions, the negative seasonal effect from the first quarter shown in the chart to the left on slide 12. In the chart to the right on the same slide, the drop in sales of fiscal solution is clear, especially due to the continuation process of fiscal printers.

On the other hand, the chart clearly shows the growth in the share of sales of other solution, actually those related to the so-called directed corporatization through large clients. These sales are largely cross-selling synergies between TOTVS and Bematech operations, by which higher value added solutions are offered for new client, as well as cross selling of solutions to TOTVS' clients. Moreover, Bemacash sales in the period totaled 1,042 units compared to 1,513 first quarter '17. This reduction is mainly due to the change implemented in January this year in the Bemacash sales model transaction. Using the individual tax payer number, this sales model is now made exclusively with credit card through the TOTVS' store. Besides simplified the process for clients, this change aims to reduce default levels. To discuss about selling and administrative expenses, please go to slide 13.

The year-on-year decline in aggregate selling expenses and commissions essentially reflects the net effects of reduction in recurring costs with personnel in 4Q '17. The increase in commission expense, as a result of the sales mix between on-channels [ph] and franchises and the growth in license sales. In the year-on-year comparison, the increase in general and administrative expenses together with management fees and other expenses is associated with the provision for continuation in 1Q,'17 being lower than the quarterly average of 2017. And the higher provision in the 1Q,'18 due to the BRL2.02 [ph] million adjustment resulting from the reconciliations of judicial deposit balance and our positions on the legal proceedings at the court.

The quarter-on-quarter decrease in this Group of expenses was mainly due to the additional expenses incurred in 4Q,'17 with the merger of Virtual Age and the integration of the administrative operations of Bematech both of which contribute to the reduction in recurring personnel costs.

Regarding to the allowance for doubtful accounts, the increase in the quarter mainly reflects the higher level of clients default at the start of the year, which resulted in a negative effect of BRL3.2 million with the adoption of the new IFRS 9 standard.

I'll now return the presentation to Maia, who will comment on EBITDA on slide 14.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

As we can see in the chart, the result of services was once again positive in both quarter-on-quarter and year-on-year base, despite the reduction in revenue compared to this still negative results in 12 month. The change in the product mix will continue to reduce hardware results with the continuation of fiscal printers in a more advanced state, then the development of high value added solution such as Bemacash and smart device for the Internet of Things.

But it should be noted that in all comparisons, result from software being the company's core activity has recovered its contribution to EBITDA with growth in revenue, especially subscription and the reduction in selling and administrative expense despite the additional impact of provisions for doubtful accounts and for contingencies. As such, we concluded that the year-on-year and quarter-on-quarter improvement in EBITDA is mainly driven by the growth in software results and cost control.

Moving now to slide 15, the performance of the EBITDA is the key element that combined with the reduction in amortization of intangible assets from acquisitions led to the growth in net income, both year-on-year and quarter-on-quarter.

Now, I move to slide 16, for the comments on cash flow and debts. Though taxable income grew 21% year-on-year and 625% quarter-on-quarter, operating cash flow generation decreased by 11% and 27% respectively. The two main factors leading to this reduction were the increasing working capital since the quarter did not end on a business day, which resulted in the settlement of the receivables by customers at the start of second quarter '18 and the increasing income tax and social contribution payments due to the new rule established by the Brazilian IRS, which does not allow the offset of federal tax with credits before the filing of some fiscal obligations that we will occur in June. The decline of 37% year-on-year and 14% quarter-on-quarter in net debt, with reduction in free cash flow in the quarter is related to the change in the flow of investments, which resulted in an increasing CapEx, as opposed to the reduction in disbursement with lease agreements and, consequentially, the reduction in gross debt.

Compared to the last 12 month, free cash flow grew 18.7%. This increase in cash flow led to a 37% reduction in net debt, which went under one time, adjusted EBITDA in the last 12 months.

I now move on to slide 17 for the closing remarks. During this call, we saw that recurring revenue grew 5% driven by subscription revenue, which grew 38% year-on-year and reached almost 24% of total software revenue. Annual recurring revenue from subscription grew more than 43% and surpassed BRL400 million. The growth in licensing revenue from the corporate model grew 29% year-on-year. The growth in software result and the reduction in selling and administrative expense were the main factors that contributed to the year-on-year growth of 7% in adjusted EBITDA and 9% in adjusted net income. And net debt declined 37% year-on-year returning to below one time EBITDA. This result underlines our focus on sustainable growth, without compromising the capacity for growth, profitability and innovation of TOTS.

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) Our first question comes from Andre Baggio, JP Morgan.

Q - Andre Baggio {BIO 6863260 <GO>}

Good morning to everyone. So we have seen a good stage of licence, we have seen that subscription remains with a healthy growth. Can you say that back of that is very attributable, I have seen it [ph] in the economy Brazil? Or is there anything really the software that you're developing that is also causing this acceleration in the license?

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

Hi, Baggio. This is Maia speaking. So if I heard you correctly your question, you're asking about the growth of licenses it's related to some -- related to our products or related to the market weakness.

Q - Andre Baggio {BIO 6863260 <GO>}

Correct.

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

Okay. So actually now if you take a look on our figures of license quarterly, you're going to see that the number of new -- of new clients added declined in line with the trend we've seen in the recent quarters. And consequentially we've seen an average ticket increase as a consequence, reflecting the average size of clients we've been solding -- we've been sold license to them. Actually it's more a matter of economic dynamic in our market and it's not directly related to our product. I don't know Apendino, if you want to complement something. So it's really, it's really more a reflect of especially entrepreneurial environment, so business owner seems to be a little bit more confident about the environment and they are not so driven by fiscal year results for example, they tend to take decisions in accordance with the -- their market confidence.

Q - Andre Baggio {BIO 6863260 <GO>}

Thank you. And then I have a follow up question that, I remember talking to you about the migration of people or software from the traditional model into the subscription model. How ready is the software itself for this transition, how -- when you think about the declines in itself. So what prevents you from accelerating, I saw, there was a small number of clients, which migrated to modest. So what prevent a bigger actually migration of the clients at this stage?

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

Good. So yeah, right the migration is really in a very low pace. Actually, we have no changes in this matter. We have been more reactive in this -- in this matter because we understand that we might be proactive when we see more clearly a very favorable moment to have this kind of conversations with our clients. Actually our product is ready to the migration if you mean, in terms of cloud. And so that you can see the -- among the subscribers addition. We have majority of those subscribers, who are at -- run our solution in the cloud. So and here we are talking about the same, exactly the same solutions that maintenance payers are using today. So in terms of products, there is no big issue to be addressed.

Of course, part of our research and development investment is related to some technical elements that we can improve in order to be more and more efficient in some public clouds because our software was originally designed to run on premises and more recently, we've been able to get very good performance in our own infrastructure. Today we are working hard in order to have a similar performance or even better in some public clouds, like Amazon in AWS or Azure from Microsoft and more recently, we're talking to Google cloud as well. So I wouldn't -- I wouldn't associate directly that low level of migration to a product -- a product reason. It's more a matter of our confidence about the movement of the market to address that conversation with our clients. We don't want to end up that conversation having some discussions about the maintenance, the current maintenance contracts or even not having a relevant number of clients migrating to subscription, so.

Q - Andre Baggio {BIO 6863260 <GO>}

Okay. Understood. Well, thanks a lot.

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

Okay.

Operator

(Operator Instructions) This concludes today's question-and-answer session. I would like to invite Mr. Maia to proceed with his closing statements. Please go ahead, sir.

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

So I'd like to thank you everyone again for participating in our conference call today. And I wish everyone have a good day. Thank you. Bye-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.