Q1 2015 Earnings Call

Company Participants

- Alexandre Mafra Guimarães
- Gilsomar Maia Sebastião

Other Participants

- Bernardo Teixeira
- Michel Morin
- Sunil Rajgopal

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to TOTVS' First Quarter 2015 Results Conference Call. Today with us, we have Mr. Alexandre Mafra, CFO; and Mr. Gilsomar Maia, IRO and Corporate Finance Officer. We would like to inform you that all participants will be in a listen-only mode during the company's presentation. After TOTVS' remarks, there will be a question-and-answer session for investors and analysts, when further instructions will be given. Today's live webcast may be accessed through TOTVS' website at ir.totvs.com.

Before proceeding, we would like to mention that during this conference call, forward-looking statements may be made relating to TOTVS' business projects, 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 operating factors could also affect TOTVS' future results and could make these results differ materially from those expressed in such forward-looking statements.

Now, I'll turn the conference over to Mr. Alexandre Mafra, who will begin the presentation. Mr. Mafra, you may begin the conference.

Alexandre Mafra Guimarães

Good morning everyone. Thank you for participating in Q1 2015 conference call. Starting from slide two, I would like to talk about the main event that took place since the disclosure for the fourth quarter results. The first one is the acquisition of Neolog, a company focused on developing software solution in the SaaS model for the logistics and supply chain management market. Its solution aims to reduce costs and data management resources for clients throughout the whole supply chain. This acquisition is also part of our specialization strategy and reinforces our position in the logistics sector, adding Neolog's solutions and business know-how which allow us to explore opportunities to optimize costs and increase efficiency in key sectors of Brazilian market.

The second event is the launch of Fly01 platform with Redecard, which aims to expand the penetration of management solutions in the microenterprise market. Fly01 is a complete cloud-based management solution available through monthly subscriptions, which has no need for investments in infrastructure and it is sold in the form of apps available at the platform store.

The platform is present in the market initially through three complimentary offerings. One, the e-commerce solution from CiaShop, which enables entrepreneurs to set up a virtual store in a few minutes, already adapted to use Rede's means of payment. Two, TOTVS Série 1 management system with automatic reconciliation of receivables originating from Rede's systems. Three, mobile POS that will allow entrepreneurs to get a consolidated view of their business in both the virtual and physical stores.

And third event is the dividends payment approved by the Ordinary and Extraordinary Shareholders' Meeting held on March 30, 2015 of R$124.368 million corresponding to R$0.77 per share. And the fourth and last event is the new share buyback program approved by the Board of Directors Meeting held on February 27, 2015 in the amount of 1.6 million shares equivalent to 1% of the company's total stock. The program's main purpose is to meet the stock option plan.

Now, I invite Maia to comment on the quarter results starting from slide three.

Gilsomar Maia Sebastião

Thank you, Mafra. Good morning everyone. Before entering the financial comments, I would like to remind you that information throughout 2014, from this quarter on, we will be providing some new breakdowns of revenues and costs. In revenues, a subscription line was added which comprises commercial modules in which there is no ownership transferring of license fees. The amounts presented in this line were reclassified mainly from license fees and, to a lesser extent, from maintenance and service lines. In costs, we added a new line for the software technical support conducted by telephone and/or Internet, which was previously part of the cost of services. With these new breakdowns, we could also provide the contribution margins of software and service businesses.

On the slide three, we see that the total revenue grew 6.3% year-on-year and 0.7% quarter-on-quarter. This chart presents the revenue breakdown between recurring and non-recurring and shows that the growth of the total revenue came primarily from recurring revenues, which grew 11% year-on-year and 3% quarter-on-quarter. It's worth noting that this growth of 11% is higher than the four year CAGR of total revenue and the recurring revenue represented 60.7% of total revenue, the higher recurring level ever achieved by TOTVS in a quarter. In addition, from the R$278.4 million of first quarter 2015 recurring revenues, over 90% are software revenues.

On the slide four, total revenue is broken between software and service businesses. Servicing revenues grew 8.3% year-on-year. When analyzed by working day, service revenue grew 11.4%. Software revenues accounted for 70% of total revenue and grew 5.5% year-on-year, below the 11% growth in total recurring revenue mentioned in the previous slide.

On slide five, we note that recurring revenue from software, which is the sum of maintenance and subscription, grew 11% year-on-year. Maintenance revenue increased by 3.5% quarter-on-quarter. Year-on-year, this line increased by 7.4%, exceeding by almost 2 percentage points the average 12 month IGP-M from April 2014 to March 2015. These maintenance performance is even more relevant when taking into account the 10% decrease in license revenue. Approximately two-thirds of license sales in the first quarter of 2015 were due to existing customers. These sales fell by 4.6% year-on-year mainly due to the 12% reduction of incremental license fees of the corporate model in first quarter of 2015, reflecting the slower pace of economic growth in 2014.

Slide six illustrates the transition that the company's revenue model is undergoing, especially when compared to the growth of license fees and subscriptions. While subscriptions increased 47% year-on-year, the license revenue decreased 10%. The customer addition of both models helps to understand the decrease in license and increase in subscriptions. Year-on-year, the license sales had less 189 customers than first quarter of 2014. On the other hand, subscription sales had more 262 customers than first quarter of 2014. Since the subscription revenue is still lower than license revenue, the positive effect of subscription is still not enough to offset the negative effect of the license decrease in the composition of total revenue growth, especially the revenue deferral effect that the subscription has on our model tax (09:46).

On slide seven, we can see the impacts of this revenue model transition on the software contribution margin to the extent that the reduction of short-term revenue growth reduced cost dilution especially in cost of support and research and development. Even with this transition in course, we see that the software business sustaining a relevant contribution margin in the medium to long term, the higher level of recurring revenue tends to post little impact revenue and contribution margin of software.

Moving to slide eight, we have the service margin contribution. Quarter-on-quarter, the service margin has strongly recovered mainly because of the additional costs of layoffs that occurred in 4Q 2014. In the last 12-month period, service margin remained stable but the year-on-year comparison shows that we are able to be more efficient in the business line.

Now, I return the presentation to Mafra who will continue from slide nine.

Alexandre Mafra Guimarães

Thank you, Maia. In this slide, we present the selling and administrative expenses of the period. The first group related to sales and commission expenses decreased by 30 basis points in Q1 2015 compared to Q1 2014 as a percentage of net revenues. Compared to Q4 2014, these expenses increased 130 basis points mainly due to, one, the investments in training of the sales team to sell subscriptions to small and medium companies; and, two, the change in the sales mix both among franchisees and own branches as well as a more client size which impacted the commission expenses.

Next the group of administrative expenses and management fees which reduced its participation on net revenues 20 basis points quarter-on-quarter mainly due to the lower provisioning for bonuses related to financial and individual targets of our executives and to the provisioning of our stock option plan. In the last 12 months, this group remained stable, mainly due to the margin of these administrative gains of the acquired companies. Then, advertising and market expenses grew 50 basis points year-on-year and decreased 50 basis points quarter-on-quarter as a percentage of net revenues. This variation in the growth base of expenses is mainly explained by the atypical distribution of these expenses in 2014 due to the Soccer World Cup in Brazil.

Lastly, allowance for doubtful accounts reached 1.8% of total net revenues, the same level as in Q1 2014. In the last year, the company adjusted its credit policy and maintained its efforts to recover provisioned credit losses, driving this line down to 1.5% in the last 12 months. The company will continue this effort over the course of 2015.

On the next slide, we present the EBITDA margin which ended the Q1 2015 in 25%, down 150 basis points year-on-year and up 160 basis points quarter-on-quarter. The EBITDA margin increase quarter-on-quarter was mainly due to the higher contribution margins from the software and services businesses and the lower administrative expenses as a percentage of net revenues.

The EBITDA margin management in this quarter was also impacted by some challenges such as, one, the 12-month average inflation measured by IGP-M of 3.8% when compared to the 12-month average inflation measured by IPC-A of 7.5%. Two, the wage increase of 7% resulted from the Collective Bargaining Agreement in Sao Paulo. And three, the 12.4% drop in the incremental licenses from the corporate model.

On slide 11, we present the net income which totaled R$70.9 million in the quarter, a 15.1% growth year-on-year with net margin of 15.4% that is 110 basis points higher than in Q1 2014. In the last 12 months, net income grew 16.9% and the net margin was off (15:23) 15.1%, expanding 120 basis points on the 12-month ended in Q1 2014.

Net income outgrew EBITDA due to the net financial income of R$14.7 million in Q1 2015 compared to a net financial loss of R$2 million in Q1 2014. The effect mainly to, one, the higher financial results driven by increased balance of financial investments; two, the lower financial expenses in the year-on-year comparison, resulting mainly from the non-recurring adjustments of the debenture interest provision in the amount of R$2.8 million of the Q1, 2014. And, three, the results from the sale of minority interest in ZeroPaper in January 2015.

The net income was also impacted by the increase in the effective tax rate due to, one, an adjustment to the 2014 income tax provision related to TOTVS' subsidiaries; and, two, a smaller share of R&D projects eligible to Lei do Bem in relation to the earnings before taxes.

On slide 12, we present the cash growth of the period, which amounted R$733.6 million with net cash of R$90.5 million. The cash growth of R$35.7 million was mainly driven by, one, the operating cash flow of R$84.7 million corresponding to 119.5% of net income. Two, the investments of R$10.2 million on fixed assets, mainly related to the acquisition of machinery and equipment. Three, the payment of R$23.2 million for acquisitions, including the acquisition of Neolog and the payment of previous acquisition installments. And, four, the payment of R$19.5 million of interest on equity related to the second half of 2014.

The financial health of the company is evidenced here as well as the ability for organic and inorganic investments in order to strengthen our industry sector approach and technology platform.

I now invite you to move to slide 13. In this slide, we note that the company's efforts to expand its recurring revenues especially through the expansion of sales in subscription model are already generating results.

In this quarter, we expanded the recurring revenues by 11% and the subscription revenues by 47%. TOTVS expanded its EBITDA margin by 160 basis points in the quarter-on-quarter comparison even with, one, expansion of the subscription model, which tends to (19:01) negatively impact EBITDA in the short-term due to the deferral of the revenue recognition; two, the falling (19:10) incremental license from the corporate model; three, the 7% wage increase in São Paulo; and four, the lower number of working days in the quarter.

This result shows that the company will not lose height of its costs and expenses discipline especially in this initial period of greater emphasis on software sales in the subscription model. It's important to keep in mind that TOTVS will maintain its investments in innovation, specialization by industry sector and quality, because raising the productivity and competitiveness of our client is also essential to our sustainable growth.

From now on, we are available for the Q&A session.

Q&A

Operator

Ladies and gentlemen, we will now begin the question and answer session. . Our first question comes from Bernardo Teixeira with BTG Pactual.

Q - Bernardo Teixeira {BIO 20314982 <GO>}

Hi, guys, good morning. So my question here is in subscription revenues. I'm just trying to understand here and get a better breakdown of it actually. Impressively, the growth you guys had in year-over-year terms, 47%, just trying to understand how much of this came from organic growth, and how much of this came with the help of the acquisition you guys made. Thank you.

A - Alexandre Mafra Guimarães

Bernardo, could you just repeat your question a little bit more?

Q - Bernardo Teixeira {BIO 20314982 <GO>}

Yes, definitely. So the growth in year-over-year terms of the subscription revenues was 47%, right. So I'm just trying to figure out how much of this came from organic growth and how much of this came from, well, let's say help from the M&A you guys did in the previous years. So, that's it.

A - Alexandre Mafra Guimarães

Okay, so in our earnings release, we provided the number of the consolidated figures from the acquired companies primarily Virtual Age. If I'm not wrong, the figure we consolidated was about R$10 million in total revenue and in recurring revenue, it was about R$1.5 million. That can be primarily allocated to subscription.

But here it's important to bear in mind that most of the acquisitions we do we help companies to enhance their performance just after the acquisition and then part of our sales pipeline is driven to those companies. So in our internal view we don't consider 100% of those sales as inorganic because certainly part of those sales, the acquired company is closed, certainly would be closed by talking to individuals you know, that's the point.

Q - Bernardo Teixeira {BIO 20314982 <GO>}

Thank you.

A - Gilsomar Maia Sebastião

Welcome.

Operator

Our next question comes from Sunil Rajgopal with HSBC.

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Thank you very much, I just had two questions. One is on your expectation of revenue growth for this year and next, what's your view on the growth rates? And then also in terms of margins, I see this quarter the margins were around 25%, do you expect the margins to hold onto these levels or would there be any pressure coming in incrementally as the market slows down? Thank you.

A - Gilsomar Maia Sebastião

Hi Sunil, good morning. This is Maia speaking. In terms of margin, Sunil, so people that are following us for a long time they know that quarterly we can have some volatility in our EBITDA margin, mostly because of some sales performance especially in license. So what I mean by that. If we have a similar level of license sales every quarter we should have a more stable EBTIDA margin. In our year-end figure normally we have a pretty stable margin, but quarterly it's really dependent on these quarterly sales.

In terms of year-end figures, I don't believe we should see big volatility in our margin. The only possibility is if we have a huge conversion or transferring of sales from license to subscription. But taking into consideration that transition is going to be more diluted or small (25:07), I don't believe it can happen.

In a quarterly basis in the first Q we have a strong impact from the salaries readjustment in which we have about 45% of our payroll under adjustment. And in Q4 we have about other 45% being adjusted. Those two quarters are more affected in terms of cost pressure.

And in terms of top line, the sales volatility (25:42) of our industry shows that the first quarter is the weaker normally in our sector. And historically, stronger – the sales are stronger in the second half of the year. Normally that's the behavior of our industry. Am I...

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Right.

A - Gilsomar Maia Sebastião

Have I addressed your question?

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Yes, yes. But just a little bit more color on what's the kind of growth levels that you are projecting or budgeting for this year? Is there any numbers that you're actually projecting for this year in terms of growth? Because excluding the inflation angle, the growth rates were nearly 0% excluding the inflation and M&A. So I just wanted to know what's your view on the growth rates if we ex out the inflationary environment.

A - Gilsomar Maia Sebastião

So Sunil, first of all, it's important to bear in mind that part of that deceleration of revenues is due to the transitioning to the subscription model. So if you take the revenue – the recurring revenue growth that's about 11%, even excluding inorganic elements you are going to see that our growth is above inflation. Okay?

But secondly, we are not – last year we decided to – we decided not to disclose guidance especially in this transitioning period because we have too many force working together in the same time. So we have this transitioning course, we had some volatility inflation costs and revenues; we have acceleration in Brazilian economy that's one important variable.

So because of that high number of important variables, we decided at this moment not to provide any kind of guidance to the market in terms of topline and margin as well. But I believe that taking into consideration our historical figures and performance and considering the level of recurring revenue we have and the predictability we can have in terms of even the services, for example, that's one relevant portion of our non-recurring revenue, is not really a very complicated choice to make how the company can grow. Of course, it will depend more on your projections of economic growth of the region and then also how fast this transitioning can be. At this moment, I unfortunately I cannot share any kind of internal projection with you. Okay, Sunil?

Q - Sunil Rajgopal {BIO 16275679 <GO>}

Thank you.

A - Gilsomar Maia Sebastião

You're welcome

Operator

Our next question comes from Michel Morin with Morgan Stanley.

Q - Michel Morin {BIO 1873971 <GO>}

Yes. Hi, everyone. I was wondering if you can give us a little bit of color on how you've changed your sales force incentives in order to incentivize, departmentally incentivize growth in subscriptions and how that has gone? Are there still any lingering issues there that might allow you to even accelerate the growth from here on subscriptions. So that's the first question.

And then the second question is I know the subscriptions are still pretty small, but from an accounting standpoint as you grow that revenue stream and as you sign new contracts, should we expect to see some deferred revenues show up on the balance sheets? Thank you.

A - Gilsomar Maia Sebastião

Good morning, Michel. Starting from the second question regarding the deferred revenues in our balance sheet, it's not on the table now. Really I understand your point because there is a sales booking internally so we know how much of annual recurring revenue we've got selling new subscriptions. But in our revenue recognition practices, we do not disclose it in our balance sheet. Eventually what we can do is provide it as complementary information in our earnings release.

We have a similar situation when we talk about service projects because we have, quote unquote, backlog of projects sold to be performed and then it's more a matter of execution to recognize that service as a percentage of completion. It can be some complementary information we eventually can provide but I don't believe it can be disclosed in our updated financial statement. At least at this moment I don't see any chance for that.

Going to your first question, regarding sales force incentives, we have – first we have two different force. So force one is our direct team and that direct team we have – what we try to preserve is the total compensation of our sales executives. And then consequentially we have some mismatching some – between our expenses and revenues because we have a relevant revenue deferral and we cannot defer the remuneration of our executives in the same way.

And since we are doing a relevant effort in reducing the initial investment of our customers, we are making the lives of our sales executives easier, quote unquote, so they should be able to sell a little bit more than if they were 100% under license model.

What I mean by that, in the end if our sales people sell a little bit more than they should if they were just under a license model they can have even a little bit higher compensation.

So in the end we are trying to incentivize people to bring more customers because certainly we can have a better dilution of our costs and expense. In terms of franchisees, with franchisees the exercise is a little bit different because franchisees are incentivized are commissionated by our recurring revenues. And so they are very attracted by subscription also because they can get benefits on that.

In the short term, we have to be smart enough to identify what the best opportunity to offer subscription. In my view subscription probably will not be the best option for all sales opportunity.

And we are helping our franchisees and our sales people to work smartly in this sales pipeline breakdown and find opportunity which subscription can be more adequate (34:21), can eventually unlock some conversations and speed up the sales process.

And in order that really base it on the profile of that potential customer so that licenses is more appropriate. So in the end our franchisee is very aligned with us, they make more money with subscription, and we understand that the transition to subscription is going to be – will not be as disruptive to earning (34:56) in the short term, so we give a good balance between license and subscription even for our franchisees.

So they probably wouldn't – will not have this growth shown in their cash flow as well. I don't know if I addressed properly your question, but we have different programs (35:23) here to incentivize in different manners.

A - Alexandre Mafra Guimarães

Michel (35:28)

Q - Michel Morin {BIO 1873971 <GO>}

Yeah, no that's great color. Sorry go ahead, Maia.

A - Alexandre Mafra Guimarães

We try all the time to align the incentives because we know especially in this economic scenario that we now have nowadays, the subscription model is very good for our workforce, commercial force. So we have aligned incentives and in the end it's the client choice, okay?

Actually, it's helpful for sales teams, our own then franchisees, because we believe that part of our sales wouldn't be closed without subscription. So and no sales is the worst scenario for sales people, that's it. So in the end they recognize that we're doing an effort to help them to sell more in the end, that's the point.

Q - Michel Morin {BIO 1873971 <GO>}

No, that's great color, thank you. And maybe just to follow-up on that, are you actively trying to convert some of your existing subscribers to a subscription model, or is this really just targeting new subscribers, or new clients?

A - Alexandre Mafra Guimarães

At this moment, Michel we are directionating more for new customers. We understand that we should, this 4Q the whole team with too many change at the same time and at this moment we are orienting our team to focus subscription more in new customers. Existing customers eventually, they can choose subscription, but we understand that it tends to be less a fast process. And I think in a second moment eventually we can study an approach to our existing customers also.

Q - Michel Morin {BIO 1873971 <GO>}

That makes sense. Thank you.

A - Alexandre Mafra Guimarães

You're welcome.

Operator

Our next question comes from Jason (38:19) with Invesco.

Hi, I just have a quick question on the tax. I know probably it's early, but the potential tax increased from 2% to 4.5% for the IT sector, what's the company's plan for that? Maybe it's too early to say. Are you able to pass the tax increase to the end customers, or are you able to just – are you just absorb by yourself?

A - Alexandre Mafra Guimarães

Sorry, really, I couldn't hear you so well. But I – if you could repeat a little bit louder your question it would be great.

Q - Operator

Okay, sorry, sorry about that. Just on the tax issue. So the potential increase of tax from 2% to 4.5% are you – the company – is the company planning to pass on those tax increases to the end customers? Or are you able to pass on those tax increase or are you just going to absorb by the company?

A - Alexandre Mafra Guimarães

Look, actually we are waiting a little bit more to see how the discussion in the Congress is going to be finished. That 2% to 4.5% increase is the proposal of the executive government, and so it – following the business proposal for the Congress we've seen that in most of the proposals haven't came out exactly the same way of the proposition. But trying to be more objective to your question, we have contractually eventually some condition to do that, but we prefer not to assume a position at this moment because there's some variables as market condition on the table.

We should wait for the final text of this new law after the Congress analysis and the President approve them. Maybe it's too early to state here a clear position, but what we try to be very clear and explain to all is what is the elements of the discussion and so with those elements you can estimate how much it could impact in a worse scenario in which we shouldn't be able to pass through anything. So anything we can (41:27) pass through can be an upside over that exercise.

A - Gilsomar Maia Sebastião

We did a lot of scenarios but now we have to wait for the final approval of the Congress.

Q - Operator

Okay. So I understand the different scenario analysis, but in contract terms is any – so it's not said in the contract terms that if the tax increase will pass on a certain percentage to the end customer to share the cost or is there no such – I mean, probably it's too early to say right?

A - Alexandre Mafra Guimarães

Yes. Look, contractually we have elements to do that but we have to take into consideration, as I said market, condition and the movement of the economy. So it could be much simpler for me to say yes we have instruments in hand, but we have to consider the practical reality in which (42:40). Okay?

Q - Operator

Okay, got it. Understand. All right. Thank you.

A - Gilsomar Maia Sebastião

You're welcome.

Operator

. This concludes today's question-and-answer session. I'd like to advise Mr. Alexandre Mafra to proceed with his closing statements. Please go ahead, sir.

A - Alexandre Mafra Guimarães

I want to thank you all for participating in this call and I would like to say that we will keep working to expand our recurring revenues, maintaining our cost to the next best discipline, while improving the efficiency of our operations. Thank you very much.

Operator

That does conclude TOTVS' audio conference for today. Thank you very much for your participation, have a good day.