

Y 2016 Earnings Call

Company Participants

- Douglas Furlan, Investor Relations
- Gilsomar Maia, Chief Financial Officer, Investor Relations Officer
- Laercio Jose de Lucena Cosentino, Chief Executive Officer and President

Presentation

Operator

Good morning. Welcome to the TOTVS Conference Call to discuss the Results of the Fourth Quarter of 2016 and Full Year 2016. Today we have with us, Mr. Laercio Cosentino, CEO, Mr. Gilsomar Maia, CFO and IRO and Mr. Douglas Furlan, IR Manager.

Note that all participants will be in a listen-only mode during the presentation. After that, 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.

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 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 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, sir.

Gilsomar Maia {BIO 16400533 <GO>}

Good morning, everyone. Thank you for participating in our conference call to discuss the results of the fourth quarter and full year of 2016. Before starting the presentation, I would like to remind everyone that to preserve comparability, Q4'15 and 2015 numbers are pro-forma as they include Bematech's, three month and full year results respectively for these periods.

Now, I begin my comments on the quarter's results on the slide three. Net revenue grew 2.3% over Q3. Year-on-year, net revenue fell by 3.7% in Q4 and 3.5% in the year, due to a 16.8% drop in non-recurring revenues. Recurring revenues grew 7.2% in the year and accounted for 61.8% of total revenue in 2016 or 6.2 percentage points above 2015.

When analyzed by business on the slide four, we see that the year-on-year drop in net revenue was concentrated in Services and Hardware revenues. In Services, the reduction resulted from a drop of almost 6% in software implementation services due to a slower pace of sales to larger clients throughout the year, as well as a reduction of 13.5% in services not related to software implementation, negatively affected by the sale of the HR [ph] BPO operation in August 2016. And by the lower sales volume of consulting services in the second half of 2016.

In hardware, the decrease reflects the recession in Brazilian economy and the mix variation resulting from the change in the state's [ph] legislations such as in the state of Sao Paulo, where fiscal printers were replaced by the fiscal equipment, S@T, which has a lower unit price.

Software revenues closed the year at R\$1.4 billion despite transition of subscription model and the economic recession in Brazil. In the quarter, software revenue grew 2.3% over Q3 mainly due to the 9% growth in subscription that I will now talk about on the slide five.

Subscription revenue totaled R\$64 million in Q4 '16 already accounted for 18% of the software revenue. This is the second quarter in a row that software revenue grows over the previous quarter, mainly due to the acceleration of the subscription growth throughout the year.

This acceleration in subscription growth more than offset the drop in license sales and the lower maintenance growth over the last two quarters as shown in the last chart on the slide. The growth in subscription is mainly a result of more than 4,000 clients added organically in this model in 2016. Among this new clients, we can highlight micro enterprise with our Fly01 software and the small and medium companies in Intera model.

Our subscription model launched in June 2015. Intera has a shorter sales cycle due to its lower initial investment, which also tends to be very positive for new sales to existing clients. These client do not need to buy new license to add identities, only the value of the Intera monthly fee is adjusted to the new number of IDs.

In addition, Intera monthly fee includes the standard cloud infrastructure, access to the fluid platform and access to the e-learning centers, key elements for the digital transformation we are promoting in the market.

It's important to mention that Intera sales in December did not affect the Q4 subscription revenue. Since the first billing is made in the following month, that [ph] has already affected the annual recurring revenue, ARR of subscription presented on the chart on the right side of the slide.

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In Q4 '16, the subscription ARR totaled R\$260 million, 28% higher than Q4, '15. The net addition of ARR was R\$25 million against R\$21 million in Q3. The ARR is a common metric used in the SaaS world to measure the evolution of recurring revenue over the next 12 months based on contracts signed up to the end of the period.

The ARR's growth reflects in addition to the growth of Intera and Fly01 the migration of 45 clients from maintenance to subscription in Q4, in the acceleration of Bemacash sales, which I will comment now on the slide six.

Bemacash includes Fly01 software and Bematech's tax [ph] and commercial automation solutions. Most of Bemacash's sales made over the year did not affect the subscription revenue yet. These new Bemacash clients become software clients between the 8th and 11th month after contracting the solution, when they start paying for the software subscription.

We have sold nearly 2,800 Bemacash units in 2016 in the retail, apparel, bars and restaurants and food truck segments and certified more than 300 resellers throughout the year. In 2017, we will continue the training program to resellers with the goal of ending the year with 1,000 certified Bemacash resellers. Bemacash is another initiative from TOTVS to explore Brazil's micro enterprise market, which comprises more than 4 million formally established companies and it's also an entry point to our business solutions contributing to generate new software sales opportunities in the medium term or micro enterprise that becomes small and medium in the future.

Now, I invite Douglas which will comment on software results on the slide seven.

Douglas Furlan

Thank you, Maia. Good morning, everyone. The software contribution margin closed the year at 62.6% when excluding the additional costs of R\$1 million with layoffs from the structure adjustment in the fourth quarter 2016. The decrease in the adjusted contribution margin is a consequence of the stability of the software revenue in the year.

Already mentioned by Maia, combined with the increase in the cost of support and R&D expenses due to wage increases from collective bargaining agreements, investments in the integration of Bematech solutions portfolio and the renewal of client service and support processes.

In the quarter, the adjusted contribution margin fell mainly because of the wage increases in Joinville, Porto Alegre and Sao Paulo where the company has development centers.

On slide eight, the service contribution margin fell by 190 basis points in the year when excluding the additional cost of R\$2 million with lay-off from the structural adjustment in the fourth quarter, 2016. This reduction in service margin was mainly due to the lower volume of sales from consulting services, already mentioned by Maia, in addition to the collective wage increases throughout the year.

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In the fourth quarter, 2016, in addition to these factors, the reduction in service margin was mainly a consequence of the remaining wage adjustment from the collective bargaining agreement signed in the first quarter of 2016 in Sao Paulo.

It is important to mention that the additional cost with layoffs from the structure adjustment represents a reduction of recurring labor costs of about R\$1.8 million per quarter.

On slide nine, the hardware contribution margin, excluding the non-recurring items was 34.2% in 2016, against 40.3% in 2015. This reduction was due to the decreasing hardware revenue combined with the lower economic subsidies established by the government of Parana in September 2015 and Bematech's R&D capitalization in 2015.

It is important to mention the evolution of hardware margins throughout the year. Most notably in the third and fourth quarters, when margins were above the full year margin. In fourth quarter of '16, the contribution margin was 37.5%, 240 basis points higher than the fourth quarter '15.

The year-on-year growth in contribution margin, despite the 8.8% drop in hardware revenues was mainly due to the growth in hardware gross margin and the increase in economic subsidies resulting from the change in the sales mix during the period.

Now, talking about selling and administrative expenses, please move to slide 10. Selling expenses and commissions, excluding the additional costs with layoffs from structure adjustments increased their proportion of net revenue, mainly due to the growth of selling expenses.

This growth is a consequence of the change in sales mix between franchisees and own branches, and the higher volume of software sales in the subscription model.

In the fourth quarter of 2016, the quarter-on-quarter growth was mainly due to the growth in software sales and the wage increases in Sao Paulo. G&A expenses plus management fees and other expenses excluding non-recurring items increased its proportion of net revenue by 160 basis points in 2016, mainly explained by the additional provision for contingencies of R\$19.7 million in the fourth quarter, 2016.

As a consequence of the review of the past outcomes of lawsuits and the circumstances of new proceedings in which TOTVS is the defendant. The combination of the decline in the company's net revenue and the wage increases made throughout the year also collaborated for the increase of these expenses as a percentage of net revenue.

Advertising and marketing expenses corresponded to 2.2% of net revenues in 2016, compared to 2.5% in 2015 chiefly due to the revision of the general marketing plans and the synergies from the integration of marketing activities of TOTVS and Bematech.

Now, I'd like to turn the call back to Maia to discuss EBITDA on slide 11.

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Gilsomar Maia {BIO 16400533 <GO>}

Thank you, Douglas. In Q4, the adjusted EBITDA totaled R\$60.7 million, a 25.8% (sic - 29.8%) decrease year-on-year and the margin was 11%. This reduction is made in a consequence of the additional provision for contingencies mentioned by Douglas.

In the year, the adjusted EBITDA decreased by 21.5% and totaled R\$358.7 million. Adjusted EBITDA margin for the year was 16.4%, compared to 20.2% in 2015.

As presented in this conference, this reduction in margin came in mainly from the software and services businesses, hence [ph] we can see a clear hardware margin recovery in the last three quarters. The growth of subscription model re-established an upward trend in software revenue that ended the year stable.

In parallel, labor inflation and investment in portfolio integration and customer services resulted in an increase of cost and expense. This dynamic combining with Brazilian economic recession explains the margin pressure we have been having.

The acceleration of subscription ARR which ended the year 28% above Q4'15 together with the structure reductions that we've been conducting give us the confidence that we are close to reach a turning point in our software and services margins.

Now, talking about net income on the slide 12. The decline in adjusted net income in 2016 at a faster pace than the decrease in adjusted EBITDA is mainly due to the change in the company's capital structure, from a net cash position in Q3'15 to a net debt position in 4Q'15, and the higher long-term interest rate TJLP in 2016, which is the main index of financial costs of debenture and financing lines from BNDES.

Moving now to slide 13 to talk about cash flow and debt. In 2016, gross cash decreased by R\$212 million chiefly due to working capital investments of R\$124 million, net investment in fixed assets of R\$53.6 million, of which R\$22.6 million related to investments made in the company's new campus, the payment of R\$50 million related to intangible assets including the payment of part of the acquisition price of Unum, a Bematech invested company and investments for the creation of TOTVS Digital, amortization of principal amount of financing lines taken from BNDES in 2013 and amortization of R\$48 million referring to the remaining principal amount of debentures issued in 2008. Net debt totaled R\$479 million in Q4'16, equivalent to 1.3 times 2016 adjusted EBITDA.

Now, I turn the presentation to Laercio to continue on the slide 14.

Laercio Jose de Lucena Cosentino {BIO 6567039 <GO>}

Thank you, Maia. Good morning, everyone. In 2016, we took another important step towards promoting digital transformation and we commenced Single Subscription Company. We invested even more in the innovation [ph] of our solution, especially in the platform, mobility and cloud. And we grew more than 20% in subscription in the year of economic recession in Brazil.

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We evolved in the alignment of commercial incentives related to the subscription model, as well as elaboration of a new marketing plan, increasingly digital, aiming to increase the sales leads, especially in the subscription model. We also made progress in the development of TOTVS Digital, to be launched in the first quarter of 2017.

TOTVS Digital is a completely a new digital environment, focused in interaction between TOTVS, distribution channels, salespeople, clients, prospects and partners.

We renewed part of the senior management in 2016 and hired a new executives aligned to the culture of a subscription-based company, as part of the company's succession plan. Today, we have a collaborative, digital and results-driven team that use technology and business knowledge to promote innovation and understands that the client's success is our success.

We will continue our journey to turn TOTVS into a single subscription company, developing

solutions for the clients of our clients and increasingly connecting people, things and businesses.

The progress made in the transition part of subscription over the last 18 months, combined with the company's investments and the opportunities in Brazil give us the confidence that TOTVS is on the right path to resume growth and profitability in 2017.

Now, we are 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. Laercio to proceed with his closing statements. Please go ahead sir.

A - Laercio Jose de Lucena Cosentino {BIO 6567039 <GO>}

As I just said, 2016 was very important to -- in the journey to transform TOTVS into a Single Subscription Company. It's also important to mention the creation of the Governance and Designation Committee, whose function is to evaluate the appointment of the new members to the Board of Directors and increasingly reinforce the company's corporate governance practice. For 2017, the guidance disclosed [ph] reflect our confidence that we are on the right track to resume the growth and the profitability.

Thank you for attending our conference call and have a nice day and a great year.

Operator

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

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