

Q2 2016 Earnings Call

Company Participants

- Gilsomar Maia Sebastiao, CFO & IRO
- Laercio Cosentino, CEO

Other Participants

- Claudia Deberaldine, Analyst
- Diego Aragao, Analyst

Presentation

Operator

(Starts Abruptly) ri.totvs.com.

Before proceeding, we wish to clarify that any forward-looking statements that may be made during the conference call related to 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 must understand that general economic conditions, industry conditions and other operational factors could affect the future performance of TOTVS and could lead to results that differ materially from those expressed in such forward-looking statements.

Now, I will turn the conference over to Mr. Cosentino who will begin the presentation. Mr. Cosentino, please go ahead.

Laercio Cosentino {BIO 6567039 <GO>}

Good morning, everyone. Thank you for participating in the conference call to discuss TOTVS results for the second quarter of 2016. I wish to kick off with the main recent events shown on slide 3.

On May 11, the company paid to its shareholders the dividend approved at the Shareholders Meeting held on April 26, 2016 in the amount of 66.6 million related to the fiscal year 2015. On August 1, the Board of Directors approved the distribution of interest on equity related to the first half of 2016 in the amount of 43.6 million, equivalent to about BRL0.27 per share, which is 49% higher than the interest on equity paid related to the first

half of 2015. That interest will be paid on August 24 to shareholders of the company as of August 4.

Also on August 1, TOTVS sold its Human Resource BPO operation to Propay, a company that has been providing BPO activities for over 16 years. With this movement, TOTVS reinforced its strategy for a specialization, (inaudible) department in the activity to boost sales of TOTVS solution and providing greater value of its clients.

In May, TOTVS signed a partnership agreement with National Computer Corporation, the biggest technology company in Russia, to set up the National Platform, a company that will develop and market integration in the new management system that will be developed based on TOTVS technology platform. With this project, TOTVS is testing a new to exploring opportunities in the international market without losing focus on Brazil. Also in this quarter, we took an important step in the reorganization of our organizational structure with the election of Gustavo Basto and Marcelo Eduardo that together head over 30 years of TOTVS and will be responsible for the macro-segments of Supply Chain and Services, respectively.

These management changes are part of company's strategy, which established a divided organizational structure in macro-segments through the core business solutions integrated with back-office solutions, which contribute to the integration of the major value chain.

Finally, on slide 4, we start our investments in facilities of our new head office. As announced to the market, on October 16, 2013, the company signed a built to suit agreement for its new head office. It's a 10-year agreement, starts from delivering of the building is scheduled for February 2017.

In addition to tangible and intangible administrative synergies to be captured with the concentration of the main company's administrative, development and sales departments in Sao Paulo area in just one place. This new campus will contribute to a faster spread of culture between contribute between employees, especially between those that became recently part of TOTVS, like Bematech.

This new campus will also have an exclusive area for client service and will provide an innovative environment to help reinforcing mobility and cloud, which are essential elements in our strategy. The total investment in the facility is estimated at approximately BRL90 million.

I now turn the presentation to Maia for his comments on the results of the quarter, starting on slide 5.

Gilsomar Maia Sebastiao {BIO 16400533 <GO>}

Thank you, Laercio. Good morning, everyone. Before starting my comments, I wish to remind you that to preserve compatibility we have presented consolidated pro-forma

unaudited figures of second quarter '15, which includes the results of Bematech during that period.

This quarter, total revenue decreased by 2% year-on-year and 1% quarter-on-quarter, mainly due to the decrease of 15% year-on-year and 4% quarter-on-quarter of non-recurring revenue shown on the chart to the left. Recurring revenues grew 8% year-on-year and reached 61.7% of total revenue, which represents an increase of 5.8 percentage points over second quarter '15.

When analyzed by business, as the chart on the right, we see that the drop in total revenue was concentrated in hardware and services revenue. On the other hand, the decline from the first quarter '16 was concentrated on the 3% drop in software revenue, which I will comment now on slide 6.

Software revenue remained stable year-on-year since the growth in recurring revenue from maintenance and subscription offset the 32% decline in non-recurring license fee revenue. The 17% growth in subscription revenue in this period was largely due to the sales to new small and medium clients under TOTVS Intera model, which completed one year last June. In this first year of TOTVS Intera, the growth in subscription revenue exceeded the decline in revenue from the licensing model, represented by the license and maintenance revenues, as shown on the chart to the left.

Compared to first quarter '16, the 4.2% growth in subscription revenue was not sufficient to offset the decline in revenue from the licensing model, especially the 23% drop in license revenue. In fact, the decline in license sales in early periods, combined with the suspension of maintenance agreements due to the higher default levels and partial cancellation of maintenance due to the layoffs at clients, resulted in a 0.6% decline in maintenance revenue during the quarter.

Despite all these short-term effects on software revenues associated with the transition to the subscription model, the company did not reduce its R&D investments. Actually, TOTVS has made new investment in client services and support involving adjustment in internal routines, teams and software solutions. As a result of this combination, software contribution margin fell by 4.4 percentage points year-on-year. In the quarter-on-quarter comparison, apart from all that I just mentioned, the 2.8 percentage points drop in contribution margin mainly resulted from incremental revenue of BRL10.7 million from the corporate model reported in first quarter '16, as shown on this chart to the left on slide 7.

Excluding this incremental revenue from the corporate model, the quarter-on-quarter decrease in license fee revenue came to 3%, mainly due to the 9% drop in new clients addition during the period. As already commented in previous quarters, the decline in license sales has mainly been the result of economic downturn in Brazil and the partial migration of the sales pipeline of more new clients to the subscription model, especially smaller ones.

Despite this market momentum, we added 847 new clients in the licensing model, 900 new clients in the subscription model and 440 new clients of Bemacash in this quarter.

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The Bemacash solution combines TOTVS management software for micro enterprise, the Fly01, and the subscription model with commercial automation and fiscal solutions of Bematech. It's worth mentioning that sales of Bemacash solution did not affect the subscription revenue in second quarter '16 since new clients of Bemacash become software clients from the eighth month of hiring the management solution when they start paying the subscription.

To conclude our comments on software results, we share on slide 8, an exercise carried out internally, which simulates the impact on growth and softer revenue if the company had chosen to sell its software solutions exclusively through the subscription model since 2013. In this hypothetical exercise, the quarterly license revenue was deferred in 16 quarters and any impact of churn inflation adjustment and migration fee were not considered.

In short, if the company had chosen to sell its solutions only through the subscription model since 2013, the growth in software revenue in second quarter '16 would have been 11%, which reinforces the mid long-term financial benefits of the subscription model.

I now invite you all to move to slide 9 to disclose services and hardware. The chart on the left shows that services revenue fell 4.8% compared to 2015 and remained stable quarter-on-quarter. The year-on-year variation is mainly due to the 7.8% decline in software implementation services in the period, which accounted for 62% of the services revenue in the quarter, chiefly due to the lower pace of sales in recent quarters.

As in first quarter '16, services contribution margin increased from the previous quarter, growing 140 basis points in second quarter '16. This recovery in services contribution margin is chiefly due to the reduction in recovery in personnel costs resulting from the cost and expenses structure adjustments carried out by the company during the second half of 2015.

In case of hardware, shown on the right side of the slide, the 7.8% drop in revenue compared to second quarter '15 chiefly reflects the economic downturn in Brazil and the change in tax legislation, especially in the state of Sao Paulo where fiscal printers were replaced for the S@T equipment, which has a lower value per unit, but in the other hand, helps drive the growth from recurring revenue from fiscal software solutions. Apart from the decline in revenue, hardware margin was adversely impacted by the year-on-year comparison and the reduction in tax incentives in the state of Parana. In the quarter-on-quarter comparison, the 7% growth in revenue reflects the seasonality of hardware sales and the price adjustments related to FX rate, which also helped drive the growth of 190 basis points in the contribution margin.

For comments on selling and administrative expense, please move to slide 10. Starting with the chart on the top left, selling expense and commissions jointly grew 3.6% year-on-year and 0.4% quarter-on-quarter. This increase mainly reflects the higher volume of software sales under the subscription model since the transition to subscription does not impact the sales in compensation.

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On the top right, advertising and marketing expenses corresponded to 2.2% of total revenues versus 3.1% in the second quarter '15 and 1.5% in first quarter '16. The year-on-year decrease is chiefly due to the revision of the general marketing plan and integration of the marketing activities of TOTVS and Bematech. The quarter-on-quarter growth reflects the seasonality of this expense line.

Expenses with allowance for doubtful accounts in the top left corresponded to 1.3% of total revenue compared to 1.6% in second quarter '15 and 1.4% in first quarter '16. Note that considering the current level of defaults in the market and the increase in the balance of accounts receivable past due, the company will follow closely this matter and will work on the recovery of the debts already under provision. And finally, on the lower right corner, general and administrative expense plus management fees and other expense increased 7.5% year-on-year mainly on account of wage increases, net off, layoffs.

Moving now to EBITDA and net income on slide 11. The chart on the left shows that EBITDA in the second quarter '16 totaled BRL96.9 million, down 20.8% year-on-year and 15.4% quarter-on-quarter. EBITDA margin in the quarter reached 17.8%, down 420 basis points year-on-year. The year-on-year decline in EBITDA was chiefly due to the drop in contribution margin from the software and hardware, both already commented before. In the quarter-on-quarter comparison, the decline in EBITDA is mainly due to the drop in software revenue, largely reflecting the reduction in license revenues.

In the case of net income, shown by the chart on the right, the year-on-year decline was largely due to the negative financial result in the second quarter '16, primarily as a consequence of the reduction in financial revenues due to the payment of the transaction with Bematech in fourth quarter '15. In the quarter-on-quarter comparison, the decline in net income compared to the drop in EBITDA largely reflects the increase in the company's net debt during the period, as shown on slide 12, where I will make my comments on cash flow and debt.

Gross cash decreased by BRL60 million in the quarter, mainly due to the payment of dividends regarding the 2015 fiscal year, the partial amortization of the principal amount of the BNDES loan hired in 2013. Net debt totaled BRL493 million in second quarter '16, equivalent to 1.2 times pro forma adjusted EBITDA in the last 12 months. It's important to remember that the remaining BRL48 million regarding the principal amount of the debentures issued in 2008 will be amortized in this month of August 2016.

I now turn the presentation back to Laercio for his closing remarks on slide 13.

Laercio Cosentino {BIO 6567039 <GO>}

Thanks, Maia. In short, the additional revenues from the 17% growth of subscription revenue exceeded the decline in revenues from the licensing model and kept the softer revenue stable in year-on-year comparison. In June this year, TOTVS Intera completed one year of its launch, the subscription model in which clients define and manage the number of identities, they will be enabled to gain unrestricted and simultaneous access of all management, productivity and collaboration software solutions from TOTVS.

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This first year has shown that we are on track. We already had more than 600 clients in Intera model, which correspond to more than 65,000 identities using our management system and collaborating with our subscription revenue growth. It's also worth mentioning that the second quarter '16, subscription revenue did not reflect the Bemacash sales recorded in 2016.

Bemacash, as mentioned by Maia, combines TOTVS management software for microcompanies, Fly01, in the subscription model, with automation, hardware and fiscal solution of Bematech. In this quarter, Bemacash sales for new clients reached 440 units, a 48% increase over the amounts sold in first quarter of 2016. This growth is mainly a consequence of the company's hard work in training its seller [ph] in order to increase the subscription sales among smaller companies.

In summary, these two initiatives brought over 1,000 new clients and show that subscription is important for our growth and for increased efficiency of our operations, especially in more adverse economic scenarios, in which the combination of subscription and the cloud can be alternative to the clients and for us to reduce costs, and at the same time, increase the operation productivity.

Despite this impact in the revenue associated with the transition to the subscription model and the Brazilian economy momentum, we did not reduce our investments in innovation. On the contrary, we carried out the new investments to innovate and support to our client, and we were recently elected by Valor Economico newspaper as the most innovative company in IT industry.

We are close to moving from mostly B2B for a B2C company, directly connect with individuals and in a much more elegant way with things through our same-stores that we integrate our technology in the rising [ph] environment. That is, we are developing solution used by clients of our clients. We also raised our service and hardware margins quarter-on-quarter and started to invest in our new headquarters, reinforcing our strategy on cost discipline and on the continuous service of efficiency gain in our operations.

We are working to make TOTVS and our clients much more prepared for the recovery of Brazilian market. We have seen some initial signs of market activity recovery that hasn't translated into sales yet, but we are confident that Brazil will come out of this much stronger. Now, we are available for Q&A.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-answer session. (Operator Instructions) Our first question comes from Claudia Deberaldine, Credit Suisse.

Q - Claudia Deberaldine

Hello, good afternoon. Thanks for taking my questions. Given the current leverage, what do you imagine for dividend distribution going forward? And my second question is, the BRL appreciation shouldn't have taken the hardware margin to a better level? Thanks.

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

Hi, good morning, Claudia. Starting from the last question related to -- could you just repeat the beginning of your second question?

Q - Claudia Deberaldine

Yeah, sure. I was thinking about the BRL appreciation that shouldn't have taken the hardware margins to a higher level?

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

In terms of the hardware margins, we have some elements impacting this contribution model. The first one is the FX rate, that we have been adjusting our prices readily in order to recoup and decompose the FX impact we have in our costs since last year.

The second element is related to the tax [ph] side regarding the (inaudible), which was changed in last September, September of '15 and actually we don't see any kind of possibility to de-lever. So, in practical terms, in my view what we can have for the forward period in terms of hardware margin is a matter of efficient volume and convergence of costs and price because having the more stable FX rate, it's favorable to address this part of gross margin of hardware.

Related to the first question of dividend, as payout ratio, historically, we have been paying about 60% of our net income per year. Uptil now, we don't see any trend to change the historical levels, but actually we should never exclude any possibility to have some -- a slight change in this percentage in one, this fiscal year, for example.

But uptil now, I don't have any (inaudible) to change this level.

Q - Claudia Deberaldine

Okay.

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

Have I addressed your second question, totally?

Q - Claudia Deberaldine

Okay. Thanks, Maia.

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

You're welcome.

Operator

Our next question comes from Diego Aragao, Morgan Stanley.

Q - Diego Aragao {BIO 17889908 <GO>}

Hi, Maia; hi, Laercio. Thanks for taking my question. My question is regarding your license sales, that declined 30% year-on-year. I was noting that the license revenue reached the lowest level since 2007, if I'm not wrong. And given the recent trends, these are likely to keep impacting your service, but more importantly your maintenance revenue growth in the next few quarters. So, the question is, are you close to stabilize it? Apologies for that, but I am asking this because maintenance revenues is still 45% of your total revenue and probably the most profitable part of your business. And if we would assume a scenario where you will continue to generate very little revenue from license, I think it will be very hard for you to grow maintenance revenue. Actually, it could eventually decline given that total or partial churn rate among clients.

Once again, apologies for the long question, but I just want to understand your view about this and whether this is a fair assumption. Thank you.

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

Hi, Diego, this is Maia speaking. Regarding the license sales, you're right, this is probably the lowest level we've been running this trend [ph] of revenue and there is one important element affecting license sales, that is the downturn in the economy, especially because after the new subscription model launched in last year, though the smaller and medium clients readily they started to choose the subscription model. And then the license model became more concentrated among the larger enterprise, which freeze investment for a long time. And as a consequence, as we said, it affects the sales of license and maintenance performance.

Now, if we see some recovery in the Brazilian economy, it can be very helpful to unfreeze those opportunities, especially larger enterprise, regarding license and eventually we can see some specific recovery of license sales in the some quarters. But this trend, excluding the specific elements related to the downturn of the Brazilian economy, the long-term trend is clear, that is a declining trend in the license fees.

And on the other hand, we see the subscription sales in a contrary trend. So, as I told you, gradually smaller and medium clients are migrating from license to subscription. We should see some kind of offset in the maintenance when we compare to subscription.

So, in summary what I mean is, one thing that we try to demonstrate in our earnings release, when we compared the performance in 12 months of our license model, putting together license revenue plus maintenance, comparing to subscription revenue. And even in this very early stage of Intera model, we already see that the subscription revenue builds length of time we're able to offset negative effects of license decline.

So, in the end what I'm saying is, you're right; depending on the performance of license sales, we can see some negative impact in license, but on the other hand that's a natural flow of opportunities migrating from license to subscription. And contractually [ph], subscription should be able to more than compensate that negative impact in license and maintenance.

Q - Diego Aragao {BIO 17889908 <GO>}

Okay, Maia. Thank you very much.

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

You're welcome.

Operator

(Operator Instructions) Our next question comes from Diego Aragao, Morgan Stanley.

Q - Diego Aragao {BIO 17889908 <GO>}

Hi guys, thanks for those follow-up questions. Just want to understand after a year since you launched the TOTVS Intera, how the franchisees are dealing with this new product, I mean, if you could just comment on how is the relationship with the franchisees at this point and during this transition to a subscription business model, that would be very helpful. Thank you.

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

Hi, Diego. It's important to remind when we launched this model one year ago, we started selling subscription just from our direct sales force. And as a consequence, when we compare the maturity of our sales force including the franchisees, our own team is a little bit more advance than the franchisees. But in this meantime, franchisees were completely adhering with the subscription model. Today, when we compare -- when we offset the productivity of our sales force including franchisees in terms to measure the productivity to see whether it's reachable [ph] or not this year's target, we translate average sales to subscription.

Even then, they fell in license. So, for franchisees, it's important to remind that one of the key elements to keep exclusivity, the regionality exclusivity of our franchisee is their sales target. So, of course, franchisees, like business owners, they are concerned about financial aspects of everything, but they also consider -- they take care of -- about their exclusivity, trying to find ways in executing the action plan, (inaudible) only to reach their targets. Because that's, as I said, that's one of the main items they have to follow in order to preserve their exclusivity, and that's one thing.

Franchisees are completely convinced that is the future. There is no regret about franchisee -- from the franchisee side about the subscription model. Actually, they see this movement of process as an effort from TOTVS to help everyone to sell more. They know, if we didn't have a subscription model in our hand, probably we would be selling less than

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we actually. And the last comment that's important from the franchisees perspective is, the largest revenue stream of a franchisee is service. And second is the recurring commission over the recurring revenues, of course, and then comes commission of a license.

So, license is not so -- billing [ph] needs to be so relevant in their P&L as it reached -- in our P&L. And differently than from time, we will know the guys can think about it. That is very different for the franchisees to accept subscription, it is not in this way, because they know that. If they sell a solution quickly to a client under subscription model, as a consequence they will make money for this. That's the largest revenue for them. In summary, this relationship is very good and there is no concerns about subscription from the franchisees side.

Q - Diego Aragao {BIO 17889908 <GO>}

Okay, thank you, Maia.

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

You're welcome.

Operator

(Operator Instructions) This concludes today's question-and-answer session. I would like to turn the conference over to Mr. Cosentino for his final considerations. Please go ahead, sir.

A - Laercio Cosentino {BIO 6567039 <GO>}

Okay. I'd like to say thank you for participating in this conference call and have a nice day. Thank you.

Operator

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

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