

Q3 2017 Earnings Call

Company Participants

- Douglas Furlan, Investor Relations
- Gilsomar Maia, Chief Financial Officer and Investor Relations Officer

Presentation

Operator

Good morning. Welcome to the TOTVS conference call to discuss the results of the third quarter of 2017. Today, we have with us Gilsomar Maia, CFO; and Douglas Furlan, IR Executive Manager. Note that all participants will be in 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 ri.totvs.com.br.

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 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 {BIO 16400533 <GO>}

Good morning, everyone. Thank you for participating in our conference call. I would like to start the presentation on slide three, where I will talk about the main recent events. The first highlight is the operation of iDEXO, an institute whose mission is to connect startups, entrepreneurs and investors with key companies from the main industry sectors, many of them are already TOTVS clients; develop innovative solutions together.

Located in an area specially dedicated to its activities within the new TOTVS campus, iDEXO will provide to startups and the developers' community of TOTVS' infrastructure and tech platform. These companies can get investments from TOTVS and other iDEXO members, being also able to sell their solutions at TOTVS Store. This initiative is part of

TOTVS' strategy to increasingly open its platforms, such as ERP, HR, fluig and Carol to team up with its partners and the developers' community in order to help its clients to gain productivity through specialized business solutions, digital platforms, cloud infrastructure, mobile and Internet of Things.

The second event I would like to highlight is the issue of non-convertible debentures amounting to BRL200 million, which will bear interest corresponding to 105.95% of the daily average interbank rate accumulated variation, which will be paid semi-annually. The principal will be amortized in a single installment on September 15, 2020, and will be used for working capital, investments within the scope of the company's corporate purpose and prepayment of other debts as was the key of the full early redemption of BRL20.7 of the debentures issued by Bematech in 2014.

In short, the lengthening of gross debt amortization resulting from this debenture issue leads to a better alignment with the operational cash generation resulting from the transition process to the subscription model that TOTVS is going through.

I now begin my comments on the quarterly results on slide four. Note that, to facilitate comparison, the consolidated performance numbers for the 12 months ended in Q3 '16 also include the results of Bematech. This quarter net revenue grew 4.6% year-on-year, which is 1.9 percentage points higher than the growth in the last 12 months, bolstered by the 10% growth in recurring revenues. It's important to highlight that this double-digit growth is organic and comes mainly from subscription, which also boosted the 7.4% growth in software revenue shown on slide five, where we will present the revenue breakdown by business line.

After three quarters of decline, services revenue grew again by 9% quarter-on-quarter due to the increase in software implementation services at larger clients as a result of the license sales in previous quarter. The year-on-year growth of 0.9% was driven by growth in services not related to software implementation, which accounted for 32.6% of servicing revenue in Q3.

In hardware, the 3% decline in revenues year-on-year was due to the 35% drop in fiscal printer sales, which led to the reduction in share of fiscal hardware sales over hardware revenues to 17.4% in the last 12 months, down 2.7 percentage points from last 12 months Q3 '16. In the other hand, revenues from other hardware solutions were 2%, mainly driven by the growth in revenues from Bemacash unit sales that totaled 2,135 units in Q3 compared to 1,093 in Q2 and 998 units in Q3 '16.

In software, the growth has sped up year-on-year for the fourth quarter in a row and was 2.3 percentage points higher than the growth in the last 12 months. Compared to the previous quarter, software revenue grew for the fifth consecutive quarter as shown on slide six. The year-on-year growth in software revenue was due to the combination of 1.8% growth in the licensing model, which includes license and maintenance revenues and the 34.4% growth in the subscription. The year-on-year growth of the licensing model is strictly due to the 5.4% growth in license fee revenue, which was driven by the higher share of sales to new large clients.

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The maintenance revenue increased by 1.3% year-on-year, positively affected by non-recurring revenue of BRL1.5 million related to the regularization of some contracts in the quarter. It's important to highlight that maintenance revenue continues to be affected adversely by delinquency, contract redirections, the decline in the last 12 months IGP-M index.

Subscription revenue continues to increase its share of net revenue from software. In Q3, subscription revenue accounted for 21.3% of total software revenue, up to 4.3 [ph] percentage points from Q3 '16. The year-on-year growth in subscription revenue was essentially driven by the growth in the number of the small and medium clients of TOTVS Intera in the last 12 months. Note that these last 12 month subscription growth is in the same level of some main SaaS players growth as shown on the slide seven.

It's important to mention that Intera's sales in September did not affect subscription revenue in the third quarter. Since, in this model, the first billing occurs in the month after the sale, but has already affected the ARR from subscription. ARR which stands for annual recurring revenue grew 42% in Q3, reaching BRL334 million. We added BRL30 million of ARR in the quarter, the highest amount ever added by the company since the launching of TOTVS Intera in June 2015.

Now I hand over the presentation to Douglas who will comment on the software result on slide eight.

Douglas Furlan

Thanks, Maia. Good morning, everyone. Software contribution margin fell quarter-on-quarter, mainly reflecting the 5.8% increase in R&D. This increase was mainly due to the provisioning curve of bonus in the period, wage increases and the higher innovation investments related to open platforms and the micro enterprise segment. In the year-on-year comparison, the decline in software contribution margin was lower than in the last 12 months, mainly due to the speed up of the year-on-year software revenue growth in the last four quarters, as mentioned by Maia.

On slide nine, services contribution margin grew 470 basis points compared to Q2, mainly due to the 9% growth in service revenues and the better allocation of the service team in the quarter. In the last 12 months, the reduction in service contribution margin was due to the lower allocation of service professionals due to the lower sales pace of projects and the wage adjustments, which were not fully transferred to the price of service projects in the period.

On slide 10, hardware gross margin declined 130 basis points quarter-on-quarter, mainly due to the drop in the sales of fiscal printers, which have higher gross margin.

The quarter-over-quarter decline in the hardware contribution margin is due to the lack of tax subsidies in the period. Since the increase in the raw material volume acquired in the period was higher than the growth of hardware sales and the higher expenses with R&D institutes booked in the quarter. In the last 12 months, hardware contribution margin

increased 360 basis points due to the combination of price adjustments and the impact of the exchange rates on costs during the period.

Now talking about the main selling and administrative expenses, please move to slide 11. In Q3, selling expenses and commissions jointly increased their percentage of net revenue year-on-year, essentially reflecting the change in sales mix between franchisees and own branches and the higher volume of software sales in the subscription model. Compared with Q2, these expenses raised their percentage of net revenues, mainly due to the higher license sales made by franchisees.

G&A plus management fees and other expenses, excluding non-recurring items increased their percentage of net revenue year-on-year. This increase is mainly due to the BRL7.4 million increase in provision for contingencies when compared to Q3 2016, the wage increases and the additional expenses with Bematech and future wage [ph] integrations booked in the quarter. In the quarter-over-quarter comparison, the increase was mainly due to the growth of provisions for contingencies in Q3, the reversal of bonus and profit sharing booked in Q2 and the additional expenses with the Bematech integration.

Moving to slide 12, EBITDA margin was 11.1% in Q3, down 380 basis points from Q2. EBITDA amounted BRL62.3 million as against BRL82 million in Q2. The quarter-on-quarter decline in EBITDA was mainly due to the lower hardware results and the increase in selling expenses and provisions for contingencies as shown in the left side of this chart.

In the last 12 months, the decline in EBITDA and EBITDA margin was mainly due to the transition to subscription, which negatively affected the software revenue growth in the short term and consequently the dilution of costs and expenses, the effects from the economic recession in Brazil on delinquency rates, cancellations and reductions of maintenance contracts and on the increase of provisions for contingencies, besides resulting in a lower services sales pace and the IGP-M inflation index mainly used to adjust maintenance contracts which was significantly lower than cost inflation.

On slide 13, despite the reversal of income tax due to the deduction of the announced interest on equity, the decrease in adjusted net income quarter-on-quarter was mainly due to the decline in EBITDA as shown in the left side of this chart.

I now return the presentation to Maia to comment on cash flow and debt on slide 14.

Gilsomar Maia {BIO 16400533 <GO>}

The operating cash generation in Q3 (inaudible) adjusted net income year-on-year, and quarter-on-quarter. In the last 12 months, operating cash generation grew 32.6%, also in contrast to the reduction in EBITDA and the net income in this period. Free cash generation for the quarter grew 7.4% year-on-year, mainly due to the higher levels of fixed asset investments made in 2016 in the company's new campus in Sao Paulo. Net debt decreased 25% year-on-year and reached 1.2 times adjusted EBITDA in the last 12 months, already taking into account the issue of TOTVS debentures amounting to

BRL200 million which is part of the generation of BRL125 million in financing activities in the quarter.

Moving now to slide 15 for the closing remarks. We are making significant progress in the transition to the subscription in 2017. This year, the share of subscription sales through franchisees increased, contributing to the growth of this model among small and medium companies. We added almost 5,000 new subscription clients in 2017 which led to 33% growth in subscription revenue in the last 12 months, and to 42% growth in ARR, which already corresponds to 33% of annual maintenance revenue. This performance gives us the confidence to maintain subscription growth guidance of at least 30% for 2017.

As a consequence of this transition to subscription, we have seen more than proportional growth in commercial expense, while we build our installed subscription client base as this client base gains relevant commercial expense with new sales tend to be diluted. Additionally, the effect of the Brazilian economic recession have been felt in the sales to existing clients, in the delinquency rates, in the maintenance churn, in decrease of provision for contingencies. In addition to it, the relevant IGP-M decrease in the year that contributed negatively to EBITDA in 2017.

Based on this scenario, we reviewed our projections and renewed the adjusted EBITDA guidance for the year of 2017. Therefore we are performing a reduction of recurring expenses with personnel of about BRL30 million per year. Also, in Q4, we will conclude the back-office integration of Bematech. These actions, combined with the growth of recurring revenues into a back cover structure to assess reality in order to recover profitability without compromising the company's growth and innovation capacity.

Now, we are available for the questions-and-answers 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. Maia to proceed with his closing statements. Please go ahead, sir.

A - Gilsomar Maia {BIO 16400533 <GO>}

So I'd like to say that we are not comfortable with this level of profitability presented in this quarter and reinforcing that we work in order to recover that, but not compromising innovation and capacity of the company. And I'd like to thank everyone again for participating in the conference call and have a good day. Thank you.

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.

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