Conference Call Transcript
Portuguese to English
4Q14 Results
TOTVS (TOTS3 BZ)
January 29th, 2015

Operator:

Good morning. Welcome to TOTVS's 4Q14 and 2014 results conference call. Today we have Mr. Laércio Cosentino, CEO and Board Member, 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's remarks, there will be a question and answer session for investors and analysts, when further instructions will be given. Should any participant need assistance during this call, please press *0 to reach the operator.

Today's live webcast may be accessed through TOTVS's 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's business prospects, operational and financial estimates and goals, based on the beliefs and assumptions of TOTVS's 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 operational factors could also affect TOTVS' future results and could make these results differ materially from those expressed in such forward-looking statements.

Now, I will turn the conference over to Mr. Laercio Cosentino, who will begin the presentation. Mr. Cosentino, you may begin the conference.

Laércio Cosentino:

Good morning everyone. Thank you for participating in this conference call and for giving us the opportunity to discuss TOTVS' 4Q and 2014 results.

In 2014, TOTVS was able to combine growth in revenue, net profit and in cash generation once again, despite the specially challenging environment created by the deceleration in the activity and the productivity of the Brazilian economy, which was also enhanced mainly by the World Cup and the presidential elections.

In parallel to this deceleration, cost inflation remained above the inflation adjustments on recurring revenues during the year, requiring higher discipline in cost and expenses management.

While the last 12 months IGP-M index ended the year in 3.67%, the IPC-A index reached 6.41% in the same period. The IGP-M is the index used to readjust the majority of TOTVS' recurring revenue contracts. The IGP-M shown more volatility in the short term than IPCA, but both indicators tend to converge in the medium term.

Although we haven´t reached our internal goals of revenue growth and EBITDA margin for the year and the quarter, we believe that the results were significant, considering the Brazilian GDP growth close to zero.

We are not happy with the results. We are taking action to strengthen TOTVS as a company, but aware of the adjustments that are necessary for Brazil to grow again.

Now I invite Maia to comment on the quarter and annual results, starting on slide two.

Gilsomar Maia:

Thanks, Laércio, and good morning everyone. I would like to start by commenting on the recent events of the period. The first one is the payment of interest on equity related to the second semester on January 14th, 2015, in the amount of R$ 19.5 million, corresponding to approximately R$0,12 per share.

All the shareholders at the end of the trading session on December 22th, 2014, were entitled to this interest on equity.

The second event regards the second release of the BNDES financing line contracted in 2013, in the amount of R$227.6 million, on November 2014.

With this inflow, the BNDES has already released 72% of the total amount approved in 2013. I remind you that the amortization period of this financing line is 72 months, including a 24-month grace period counted from the hiring date.

Starting the comments on the quarter and the year-end results, I ask you to move to slide 3. The net revenue grew 10% in 2014 and 5.6% in the quarter year on year, both bellow the last 5 year CAGR.

The services revenue was the most affected line by the reduction in the number of working days in 2014. Nonetheless, it grew 9.1%. When analyzed per working day, the average service revenue grew 11.9% in 2014.

On slide four we can have a better understanding of the revenue growth in the most representative market industry sectors.

The chart on the left shows the representativeness of each industry sector in the total net revenue. The chart on the right shows the year on year growth of each of these industries.

Retail grew 22.2% and increased its representativeness from 7.4% in 2013 to 8.2% in 2014.

The differential of TOTVS offerings to this market industry comes from the integration of TOTVS' back office solution with point of sales, credit analysis, queue management and inventories solutions, integrating the retailers with the other members of their value chain.

Financial Services grew above the average in 2014, increasing its share to 8.5% of net revenue. This industry is a traditional information technology investor, with relevant contribution to the recurring revenue and to the integration of other market industries.

On the other hand, manufacturing grew less than the average once again. Thus, its participation in the net revenue, which was 35% in 2011 and 32% in 2013, reached 30% in 2014.

This is a very important industry sector too, since it also contributes relevantly to the recurring revenues and plays an important role in the value integration approach. Among the other industry sectors, that in aggregate grew faster than the total net revenue, the highlight was the healthcare sector, which grew almost 40% year on year.

On slide five, which shows the dynamics of license revenue in 2014, we can realize that starting from the graph in the top left side, we see that the growth of 3.7% of license revenues resulted from the growth of 6.5% in subscription and 3.1% in traditional licenses sales.

On the right, we see that the growth in revenues from subscription was driven by sales to new clients, which grew 147% in the year. It is important to highlight that these sales represent only the first monthly subscription, since the second one becomes part of the recurring revenue of existing clients.

Thus, the subscription revenue from existing customers, which grew 5.8%, takes approximately 12 months to fully capture the growth of each new client added.

In the lower left corner, we can see that the growth of the traditional license revenue was concentrated in sales to new clients, which grew 10.9%. These sales were most impacted by larger projects, which is evident in the 30% increase in the average ticket per transaction and in the 20.6% decrease on the number of clients added, shown in the chart on the right.

Also in this same chart on the right, we can note that the subscription model added 849 new clients, 89.5% more than in 2013, with emphasis on the 4Q14 when 295 clients were added, accounting for a growth of 156% over the 4Q13.

It is part of our commercial strategy to improve the subscription sales and consequently, the recurring revenues.

Now, let us move to slide six to talk about the recurring revenues. In 2014, the total recurring revenue exceeded R$1.0 billion and reached 58.9% of the total revenue. Between 2013 and 2014, the recurring revenue grew 14.4%, while maintenance grew 13.3%.

Excluding the non-recurring effects of approximately R$11.7 million booked in maintenance revenue in 4Q13 and R$33,2 million of revenues of acquired companies not fully consolidated in 2013, the growth in maintenance revenue was 10,7% in 2014.

The Company´s recurring contracts are adjusted every 12 months in the "anniversary" of their signing dates, mostly by the IGP-M index of the last 12 months. Thus, the recurring revenue captures the inflation of the current year, and the immediately preceding year.

On slide seven there is a chart with the history of the IGP-M. If we assume a linear distribution of anniversaries throughout the year, the recurring revenue would have captured 5.8% of adjustment in 2014. This percentage represents the midpoint between 6.2% and 5.4%, which are the 12-month IGP-Ms of 2013 and 2014, respectively.

Thus, the 10,7% of maintenance growth in 2014, as mentioned before, accounted for almost 5 p.p. of growth above the average IGP-M for the period.

Still in the chart, we have the IPCA history, which is the index used by the Brazilian government to measure country´s inflation. Note that the average 12-month IPCA of 2013 was 6.2%, the same as the IGPM level of that year. However, the average 12-month IPCA of 2014 was 6.3%, 0.9 p.p. higher than the IGP-M.

Thus, it is clear that there was a mismatch between the revenue inflation and the cost inflation in 2014. Now I turn this presentation back to Mafra, so he can comment on the cost and expenses, on slide eight.

Alexandre Mafra:

The operating costs and expenses grew 10.4% in the year and the direct personnel costs and expenses accounted for 49.3% of the total operating costs and expenses.

The collective bargaining agreements of 2014 resulted in a weighted average salary readjustment of 7.2%. In São Paulo, this process didn´t allow personal layoffs for 10 months. Personal layoffs historically occur naturally along the year in order to adjust the cost and the salary structure.

This process caused a higher number of layoffs in the 4Q14, resulting in additional costs of approximately R$5.8 million.

These layoffs, summed up with the salary readjustments from the collective bargaining agreements closed between September and November, resulted in approximately 3.4% of growth in payroll between the 3rd and the 4th quarter.

The cost group related to license fees, cost of services and R&D expenses, presented in the first line on the top of the chart, concentrates the major part of the personnel expenses, and, consequently, was the most affected in the 4Q14.

Besides these impacts, the growth in this cost group as a percentage of net revenue is mainly due to: the headcount growth, mostly related to technical support and the consulting division; the maintenance of investments in industry sector specialization; and the innovation in technological platforms in 2013 and 2014.

The decrease in the marketing and selling expenses group´s relevance, as a percentage of net revenues, is chiefly related to the communication strategy that was more concentrated in the pre-World Cup period.

Now, going to the group of administrative expenditures. The growth in these expenses is mainly due to the integration of the administrative teams from the companies acquired between 2013 and 2014.

This group´s reduction in the 4Q14 is basically due to the reduction in the G&A expenses, that were affected in the 3Q14 by additional M&A expenses of approximately R$2.7 million.

Here, it is worth mentioning that we will maintain our efforts to enhance the administrative efficiency in both the daily basis activities and in the integration of acquired companies.

Going to the consolidated EBITDA on slide nine. The EBITDA margin ended the year in 24.6%, 30 basis points below 2013. This reduction was mainly caused by the mismatching in the inflation indexes mentioned before by Maia.

Besides the inflation indexes mismatching, the fourth quarter margin was also affected by non-recurring expenses from the payroll adjustments and by the impairment provision of R$ 1.6 million related to the Umove.me intangible assets valuation, booked in the other expenses line. When the non-cash impact of this impairment is adjusted, the 4Q EBITDA margin will reach 23.7%, a growth of 30 basis points over 4Q13.

Now, let us move to slide 10 to discuss the net profit. The net profit totaled R$69 million in the quarter, 13.7% higher than the same period of the last year, with net margin of 15.2%, or 110 b.p. higher than 2013.

In 2014, net profit grew 17.8%, 9.1 p.p. above the EBITDA growth, with a margin of 14.8%, 100 basis points over 2013. 2014 net margin is the highest margin ever achieved by the Company in a fiscal year since its IPO in 2006.

This net profit growth, above the EBITDA growth is chiefly due to: a better financial result in 2014; a lower effective tax rate; and a lower depreciation and amortization growth. The positive financial result was affected by the combination of financial revenue growth due to a higher financial investment position during 2014 and the reduction in the mark to market expenses from the convertible debentures.

The lower effective tax rate was mainly due to higher fiscal benefits from “Lei do Bem”, due to the higher relevance of R&D expenses over the net revenue and the EBIT, and due to the nondeductible debenture mark to market financial expenses commented before.

Now talking about dividends on slide 11. On January 26, 2015, the Board of Directors approved the proposal for distribution of dividends to be submitted for deliberation at the

General Shareholders' Meeting. The proposal provides the distribution of R$124.4 million in dividends for 2014, resulting in R$0.77 dividend per share.

Assuming the total dividend proposal – sum of interest on equity and dividends – the Company will pay R$ 1.02 per share, representing a payout of 63% and an increase of 6.9% on the remuneration per share over 2013.

On slide 12 we have the evolution of the cash position during 2014. We started the year with nearly R$87.5 million in net cash and R$533 million of gross cash.

The main reasons that caused this variations in cash position were: the Operating cash generation of R$332 million, corresponding to 76.1% of 2014's EBITDA; investments in intangible assets of R$102 million, related to the acquisition of Ciashop, the payment of PC Sistemas' earn-out in the 1Q14, and the acquisition of Virtual Age in the 2Q14; the payment of R$158 million of dividends and interest on equity related to the first nine months of the year; and the second release of the BNDES financial line contracted in 2013, net of other amortizations, in the amount of R$174 million.

TOTVS ended 2014 with a net cash position of R$68 million and a gross cash of R$698 million, which shows our potential for cash generation and our financial capacity to implement the organic and inorganic investment plans.

Now, I invite you to move to slide 14 for the final remark of Laércio.

Laércio Cosentino:

Overall, even considering the context explained during this conference, the Company ended 2014 showing: 14.4% of recurring revenue growth; 90% of growth in clients added under the subscription model; 10.0% of net revenue growth; 17.8% of net profit growth; and 17.7% of growth in operating cash generation.

We continue to believe in the potential of Brazil and its entrepreneurs. Even with the potential short-term negative effects that the recent measures taken by government's new economic team may cause, this adjustment in policy should be very important for the country to regain the market's confidence, the confidence of entrepreneurs and to establish the basis for a new cycle of growth and investment.

We will maintain our investments in innovation, specialization by industry sector and in quality, having the client as our main focus, without losing sight of cost discipline. Technological innovation is a key tool for increasing productivity and the competitiveness in companies, especially medium and small ones.

In this sense, we have decided to expand our sales efforts in software subscription models during 2015. We will continue to work hard to make TOTVS even: simpler – in its processes and structures; more agile – reducing the development and implementations cycles; more connected to our clients; more cloud – promoting integrated platforms and management solutions in the cloud; more essential – to the core business of our clients.

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

Susana Salaru, Itaú:

Good morning, thank you for the question. Actually, I have two questions. First, could you talk a little about the cycle of new license sales in relation to terms and discounts? Are clients asking for longer terms and bigger discounts or are these two parameters stable for the sales cycle?

Actually, I would like to understand how the sales cycle is evolving, if it is stable or if it can be extended a little further. That would be the first question.

Then, I would like you to talk a bit more about churn in the quarter. We would like to understand why it was higher than the historical figures and which measures you will take to reverse this increase in churn. That's it, thank you.

Gilsomar Maia:

Good morning, Susana.

Alexandre Mafra:

Let's begin by the first question, related to the sales cycle. We do not see any major change in the sales cycle in relation to the previous quarters. The discount level and the term have remained virtually unchanged, the only difference is that in the first quarter we have all of corporate, whose cycle is a little bit different from the rest of sales for the year.

But, to give you a yes or no answer, no. We have not had any major change in this.

Laércio Cosentino:

The corporate cycle has followed its nature in recent years.

Susana Salaru:

Perfect, thank you.

Gilsomar Maia:

In relation to churn, it is important to bear in mind that it may be initiated by the client or by TOTVS, so, in this case, when churn is initiated by the client, it has to do with issues related to contract cancellation or suspension. The client either has changed solutions or is having financial problems and has requested that the contract be suspended. That's when churn comes from the client.

There are situations in which churn comes from TOTVS, for example, when a client fails to pay the maintenance fee for three months, as of the fourth month, we take the initiative of suspending the maintenance service for this client and, consequently, we stop billing him.

This does not mean that the client has changed systems, especially for clients who bought the license in one methodology; they continue using the system.

Sometimes, because of their financial situation or because of one-off issues that cause clients to default, we suspend our services after this term. If the client comes back later and settles his debt, we resume billing maintenance and, in this specific case, we may even have the portion in which we did not accrued the billing.

In this quarter, specifically, we did not see an increase in terms of cancellation, for example, due to change of relevant system, at least. Default among certain clients was a little higher in the second situation that I described and, of course, churn is not flat along the year.

It varies throughout the year. What happened in the fourth quarter was that we had slightly higher churn and a very low IGPM rate. That graph that we put in the presentation and in our release shows that, for example, October, which was the first month of the quarter in which we felt its full effect, was the lowest point in the IGPM curve, at 2.9%.

So it affected us deeply, this moment combined a very low IGPM rate and slightly higher churn, plus slightly lower maintenance additions, also due to higher sales at the beginning of the year to large clients, who bring in proportionally less maintenance for us and take longer too, because the projects are longer and we take longer to receive new maintenance from these contracts. Some of these license sales were also a little weaker, as was the case in the last quarter.

Alexandre Mafra:

Susana, I have one last point to give you a little more color on that. 25% of our churn was concentrated in ten clients, who are exactly in the situation that Maia has just explained, between concession and default. All these clients have continued using our software, so we believe it is matter of time for them to begin paying maintenance again.

We won’t see such relevant groups of clients repeating this behavior in the coming quarters.

Susana Salaru:

That was clear. Thank you.

Daniel Federle, Credit Suisse:

Good morning, everyone. My question is related to the SaaS sales initiative. I believe that you have disclosed it and talked to the internal sales teams and franchisees. I would like to know if it has been well accepted and what its goal is. Is it to sell 10% as SaaS, or try to force all the sales as SaaS? I would like to hear a little about this metric that was implemented and if that parameter of proportion between license and subscription revenue, which you had showed, of R$1 in license being converted into R$0.25 in subscription.

I would like to know if the four to one proportion is actually being accepted by the market or if maybe the proportion has to be a little lower, or may even be a little higher. I would appreciate it if you could give a little color on that.

Laércio Cosentino:

Daniel, good morning. We sell what the market wants to buy. The first step we took was to adapt and adjust all our systems, all our sales team so that we could offer both our traditional model - licensing - and the SaaS model.

We see 2015 as a year of transition in which we will check at all times exactly what the market is willing to buy and we will make our sales based on it. So we don't have a defined parameter, if it is 10%, 15% or 20%. What these figures that we presented to you comparing 2013 and 2014 show is that there is growth and we are monitoring this growth.

On the other hand, if the client wishes to buy the license and have the licenses in perpetuity, we will continue to sell it. If you look at the 2013 figures compared with 2014 and if look at 2015, extrapolating this curve a little bit, you get what we believe the market will buy.

We also believe that small clients, smaller clients, if we divide our clients into small, medium and large, are a lot more motivated than large clients to buy SaaS because the entry barrier is a lot lower. Large clients are still thinking a lot about OPEX and CAPEX.

When you see the comparison between these two things, there are accounting ways to activate or not activate the software. This will take a little longer in our opinion.

Regarding the model that you mentioned, of R$1 to R$0.25, it is more or less that.

Gilsomar Maia:

I think your question was also about how the franchises and the sales team received this recommendation to focus more on SaaS. This is something new for them. Of course, like everything we do, we begin with our own team at first and then we move on to the franchises as well, so we are always our own test platform.

The sales teams with whom we interacted have received the model very well. To be honest, I think that, in the current economic scenario, it helps to have an element like this. It is another alternative for the sales team.

We give them some guidelines, of course, the decision on what to offer is not completely up to the sales executive, but they understood the model well, they understand our goals and, as Laércio mentioned, we believe that this process will concentrate on smaller companies at first.

Daniel Federle:

Perfect, thank you. If you'll allow me, I would like to make a follow up question on churn. I understood there is a concentration on some clients; I would like to understand if there is a concentration in a specific segment. We see some very negative news on companies in the construction and oil sectors. Is this related to churn in this quarter?

Alexandre Mafra:

No, we do not have an extremely relevant concentration in any specific segment.

Daniel Federle:

Great. Thank you.

Valder Nogueira, Santander:

Good morning, everyone. My first question is a follow-up on Daniel's question. License revenue grew by 4%, while commission costs fell by 7% despite accelerated license sales. My question is about this. How should we understand this mix of sales speed and commission revenue in this new model? How is it in 1Q? How did it affect your commission structure or was it not very different?

Alexandre Mafra:

Valder, thank you for your question. I think basically the best scenario for you to look at is the year. In quarters, you may have a mix between private, own sales and franchise sales that change this result a little. The best scenario is to look at the year and we know our private operation grew and we don't pay commission on it.

This goes to selling expenses, so when you look at the best scenario to follow in 1H16, you should look at the whole year, not a specific quarter.

Valder Nogueira:

OK. The second question is: sales speed under this new SaaS model, which you were already selling, was quite strong in the first quarter after the announcement and, I believe, a lot higher than market expectations for the new model. Am I correct in this perception?

In this sense, the challenge for the market is to know what we can extrapolate for the future about this speed, because in addition to the average ticket – and this is your business decision to sell more micro, more macro, to bigger clients to smaller clients – this speed will give the slope of the revenue margin curve.

What could you tell us, first, about this migration speed, and, both in relation to Daniel's and Suzana's questions, part of the answer is already there, but what about the breakdown of sales volume between new clients and existing clients? Is it easier than you thought to sell this new model?

Laércio Cosentino:

Valder, good morning. Basically, when you say that the subscription was better accepted by smaller clients, then you have a higher number of clients, and you have seen that in the last quarter licensing has returned to the level of R$90 million and this has affected a little the total number of licenses.

What we are working on, what the best-case scenario would be, is to be able to maintain licensing, while we attract new clients, who wouldn't be coming to us because of an entry barrier, prices, etc... the best-case scenario would be the mix of both models.

So we are looking very closely to see if we can combine these two things, continuing with traditional licensing while bringing in new clients under this new modality, creating a mix. As there is a one-month subscription, in the first month it is 1/48, then it is 2/48, 3/48, and then, with time, we add this license that we have deferred.

That's how we are working, proposing to put this revenue on top of our licensing.

Valder Nogueira:

But the sales speed of this model has been a positive surprise, hasn't it? Once again, I understand this dynamic that you have explained, but the share of this new model in the sales mix in the first quarter after this decision was announced really jumped out at us, even though you had already been selling under this model in the past; almost 30% of the units sold to new clients were under this new model accompanied by an increase from 65% to 75%, if I'm not mistaken, in the share of existing clients in the new model.

Laércio Cosentino:

This has further encouraged TOTVS, because we can see we are on the right track, but it's what I told you: there was a substantial increase in the number of clients, but the ticket is lower. And you can see that we have reached the mark of R$90 million.

So we are very pleased not only with how fast clients are adhering, and these are smaller clients, but with how fast our sales force is adhering. And, thanks to this sales force balance, we don't have a mismatch in sales force compensation, etc.

So we have been having the best of both worlds so far. This hybrid model allows us to continue having attractive remuneration in all our channels while, at the same time, we don't have higher cash needs to subsidize - which is what most companies have to go through - in the subscription model.

Valder Nogueira:

I understand. So is it fair to maintain more or less this speed that we saw this quarter?

Gilsomar Maia:

Valder, as Laércio mentioned, we are testing its acceptance by the market. Of course we are always working to do more, but the beginning seems to have been good. And this is what Laércio mentioned and I reinforced last quarter, the Company has chosen to combine these two alternatives, licensing and SaaS.

I imagine that, in a scenario like the one we have had, SaaS is a good alternative from the commercial standpoint. And, especially with smaller clients, this may help us eventually take some talks to the next level.

I think we need to monitor a little more, be a little careful at this moment because we still do not have sufficient history to say that the level is this or more or less. Of course we always work to add more, but we should wait a little longer. The beginning was good, but it is worth waiting a little longer.

Valder Nogueira:

OK. Thank you.

Yannick Bergamo, Banco Fator:

Good morning. In relation to this strong retail growth, I would like to have a better idea of how much of this comes from acquisitions and, in general, what kind of product and segment is doing better.

Gilsomar Maia:

Good morning, Yannick. This is a very polemical issue for us, first because of the way we calculate our revenue and figures per segment; we calculate it on a client by client basis and then revenue is classified per segment in accordance with the client's core activity

It is difficult to say exactly how much of a company's revenue went to each segment because, depending on the client's sector, revenue goes to a different destination.

The second point is the aspect that we always reiterate: the companies that we acquired immediately after the acquisition also benefit from our sales pipeline. We direct sales that we would close ourselves to the company that we have acquired. So that company begins capturing part of our organic growth.

The ideal, of course, would be to look at the big picture. There is, in fact, an inorganic component there. According to our estimates, retail grows a little more than the total average; I can't give you a precise figure, but it grows a little more than the average.

It is a fact that retail has slowed down in the recent past, especially in the second half of the year. I think it was very clear in the results of retail companies, which you also cover. But, in annual terms, retail grew more than the average for the other segments.

Yannick Bergamo:

OK. Thank you.

Fabio Levy, BTG Pactual:

Good morning. The first question is about your tax breaks. Now, with all this initiative to increase the government's tax revenue, do you see any risk of any change in Brasil Maior, and what would the impact on your EBITDA be if you were totally excluded from the benefit. That is the first question.

Gilsomar Maia:

Good morning, Fábio. In relation to the tax breaks, you are probably referring to the Brasil Maior plan. This plan was launched in 2011, implemented for a two-year period and, at the end of last year, it was converted into a permanent system.

There are many sectors covered by this INSS collection issue. It is true that, at the beginning, it led to a tax break, to a positive effect for the companies. But there were adjustments in our costs above the IPCA inflation rate.

So, what happened in these two or three years is that the positive effect that we had was actually absorbed by these cost adjustments.

If we went back to the old system today, we would have a very perverse combination, because I would pay an INSS tax, for example, of 20% on a base that has already incorporated the tax break, so we would have a worse situation than the one before Brasil Maior.

Frankly, in the technology sector, we don't see any change this way because, when we see the IT sector as a whole, it was not a sector that generated deficit for the government. When we compare the tax collected on revenue with tax collected on payroll in the past, there was an increase. So, there is not a hole.

I wouldn't be able to say exactly how much, but it would certainly be something relevant, not only for TOTVS, but for all the companies in our sector.

Fabio Levy:

Any idea of its impact on EBITDA? Are we talking about 5% to 10% or something more substantial?

Gilsomar Maia:

In terms of overall figures, it is difficult to make this calculation on the spot, but this is something that you can simulate in a few minutes with your model. Our direct personnel costs, excluding commissions to franchises, etc., our direct payroll cost, is almost 50% of our total cost, the one we report in charts in our release.

If you assume that we would have at least 20% INSS tax on these personnel costs, compared to what we pay nowadays, which is around 2% INSS tax on revenue, you can have an idea on the magnitude of this delta.

Fabio Levy:

Are all personnel costs impacted or only the costs for technology staff?

Gilsomar Maia:

Everyone. I don't know if it is clear how you could simulate this.

Alexandre Mafra:

Of the 50% that Maia mentioned about our cost, you have to estimate how much refers to salaries. On top of that you have the 20%.

Fabio Levy:

OK. The second question is about total revenue. As we saw the monthly IGP-M price index at a much higher level in November and December and there is a chance of an increase to levels closer to 6%, 7%, maybe in the coming quarters we will already see something along these lines Do you see a higher risk with this movement of higher default and higher churn? Because this 3% average increase already led to slightly higher default and churn; if it accelerates to an increase of 7%, 8%, do you see any risk of higher default pressure? Would you be able to pass it through to prices without major problems as the IGP-M starts to go up?

Gilsomar Maia:

In relation to the IGP-M, you are right in your understanding about the behavior. The response is not so immediate; there is in fact a delay in the IGP-M capture. So, in fact, if you take, for example, a contract that was restated in October, its restatement impacted the quarter for three months: a contract that is renewed in November, two months, and in December, only one month. This December contract will impact two months in 1Q15 and the November contract, one, and so one and so forth.

So we have a delay in the capture of the inflation curve. When we look at this curve that we plotted in the graph for you, and considering this last statement, at the end of the year, we captured a large share of the decline in the IGP-M from the beginning of the year until now.

First, considering what you have said, that there may be a recovery in the IGP-M and that all the related factors, such as tariff increases, and even the dollar, may lead to a recovery in the IGP-M, we will take a few months to begin capturing this recovery in a more relevant manner. Bu this creates, in fact, an adjustment repository for us in the future.

As for our capacity to pass this through to clients, history has shown that this is not an issue because, as I always say: when inflation is not concentrated, it is a little bit more dispersed across the economic sectors, it is something with which all the sectors live with. So, just like us, our clients are having to pass inflation through to their clients. So this is not an exclusive practice of TOTVS that offends clients. It is a common practice, set forth in contact.

We have been able to associate the IGP-M with churn. I don't believe that the return of the IGP-M will lead to a higher churn.

Alexandre Mafra:

We are monitoring this very closely, Fábio, to reinforce what Maia has just said, we see very little connection between an increase in the IGP-M and default.

Gilsomar Maia:

This is all based on history, Fábio.

Fabio Levy:

Perfect. Thank you for the answers.

Operator:

As there are no further questions, I now turn the floor to Mr. Laércio Cosentino for his final remarks.

Laércio Cosentino:

I would like to thank you all for participating in this conference call and say that we will continue building our TOTVS. We are at a moment of model transition, but, at the same time, we really believe in everything we are doing. The results are there. I wish everyone a great 2015.

Operator:

Thank you. TOTVS conference call is now concluded. Thank you all for your participation. Have a nice day.