Conference Call Transcript
2Q14 Results
TOTVS (TOTS3 BZ)
July 31, 2014

Operator:

Good morning. Welcome to TOTVS's 2Q14 results conference call. Today we have Mr. Alexandre Mafra, CFO and Vice-President of Human Relations and Organizational Infrastructure, 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. To view the Company's results presentation in its original format on the webcast platform, click on "+ zoom" at the right-bottom corner of the presentation.

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. Alexandre Mafra, who will begin the presentation. Mr. Mafra, you may begin the conference.

Alexandre Mafra:

Good morning everyone. Thank you for participating in TOTVS's 2Q results conference call. I would like to start from slide two by commenting on the main events that occurred since the 1Q results conference call.

First, the acquisition of Virtual Age in May, which was another step in the execution of our industry specialization strategy, specifically in the Textile and Apparel Chain.

With Virtual Age, we increased our presence in this sector with Cloud solutions serving more than 500 clients, among them some of the largest Brazilian manufacturers, wholesalers and retailers of shirts, trousers, suits and jeans.

Besides this acquisition, we had two events related to shareholders' remuneration, which were approved at the Board of Directors meeting held on July 28th. The first event is the announcement of interest on equity of R$0.13 per share, in a total of R$21.8 million, to be paid on August 20th.

As in the last year, this is an intermediate interest on equity, that means: calculated based on the results of the 1H14, and the interest on equity regarding the 2H will be analyzed at the end of the year.

The second event is the new share buyback program that allows us to purchase up to 1.4 million shares during a one-year period, which is equivalent to 1% of the current free float.

This program aims to maximize the value generation for shareholders, and the purchased shares may be used to fulfill the stock option exercises related to the Company´s share-based incentive plan, and may also be held in treasury, cancelled and/or subsequently sold.

Now, I turn the call to Maia, who will proceed with the comments of the quarter's operating and financial results, starting from slide three.

Gilsomar Maia:

Thank you Mafra, and good morning everyone. First, I would like to remind you that the financial information regarding this quarter already includes two months results of Virtual Age, the important acquisition that Mafra just mentioned.

Having said that, in this quarter, the net revenue grew 11% year on year. This growth was driven mainly by the maintenance revenue that grew 16.5%. The license and services revenues grew 4.7% and 7.3% respectively in this quarter.

In the last 12 months, the total net revenue surpassed R$1.7 billion and grew approximately 15%, again above the CAGR of the last five years.

On slide four we have the recurring revenue, that grew 16% on 2Q14, amounting to R$976 million in the last 12 months, a CAGR of 12%, being the main driver of total revenue growth. Increasing the relevance of the recurring revenues in our revenue breakdown, both organically and inorganically, is part of our growth strategy.

In this quarter, the recurring revenues represented 59% of the Total Revenue. Recurring revenues, other than those included in the maintenance line, already surpassed 9% of the total revenues. These other revenues are mainly connected to software rentals and cloud solutions subscriptions. Now, please move to slide five.

On the left side of the slide, we demonstrate the impact of the Brazilian World Cup, which reduced the number of working days by 12% in the 2Q14 when compared to 2Q13.

This lower number of working days negatively affected Licenses and Services, given the shorter time available to prospect and close sales, as well as to render services of implementation and consultancy on the quarter. Nonetheless, we grew our non-recurring revenues by 4.4% year on year.

In the second graph, we notice that the average non-recurring revenue per working day in 2Q14 increased 19% when compared to 2Q13. This growth reflects the higher efficiency achieved mainly by the service teams, who had to consider the impact of the match days in their allocation planning process.

On the right side of the slide, we see that the average license revenue per working day also increased 19% year on year, mainly due to the 39% growth in the average ticket to new clients in the quarter.

Despite the fact that this revenue line is the one most affected by the number of working days, the average service revenue per working day grew 22% in the same period.

The effort of the service teams to execute the projects is clear here, especially when we consider the additional complexity in matching their agendas with our clients' and the shorter time available to render the services.

Now, I invite everyone to move to slide six to discuss the costs and expenses as a percentage of net revenue.

Before we enter into the costs and expenses, I would like to remind you that on July 30th, the Labor Court mandated a collective labor agreement for the participants based in São Paulo, setting a wage adjustment of 7.5%, as of January 1st of this year.

As we had already provisioned a 7% adjustment in 1Q14, we complemented the provision with an additional 0.5 p.p. adjustment. The impact of this additional provision in 2Q14, related to salaries and vacations provisions from 1Q, amounted to approximately R$400,000.

Now, starting the cost and expense analysis, we have in the first line of the graph the costs of developing and delivering our solutions, which decreased 0.3 p.p., year on year, being above the 45.5% of 1Q14.

In the last 12 months, this group gained a 0.6 p.p. participation over the net revenue, reflecting the investments in industry specialization and technology platform innovations.

The cost of services represented more than 60% of this group, and in this quarter, the service teams were able to grow the service revenue and enhance the gross margin, both year on year and quarter on quarter.

Once again, this efficiency gain is even more relevant when we take into account the fewer working days, which affects the service revenue more directly than its related costs.

R&D is the second biggest cost in this group. Its growth is mainly due to the intensification in the industry specialization of our solutions, as well as the consolidation of the R&D functions from the companies acquired in the last 12 months.

When compared with 1Q14, R&D grew less than the total revenue, showing the higher number of professionals on holidays during the World Cup. We reiterate our commitment to cost discipline in order to dilute costs in the medium and long-term, without compromising the investments necessary to execute the solution development roadmap.

We now move to the costs of license fees, which is the less representative line of this group. The higher relevance of this line, compared to 2013, reflects the expansion of solution partners which, combined with investments in research and development, are part of TOTVS's strategy of industry specialization.

The lower relevance of this line in the 1Q14, when compared to 2Q14, is mainly due to the dilution caused by the incremental license revenue from the corporate model in 1Q.

And now going to the next group, the cost group linked to sales was stable as a percentage of revenues, year on year, both as a group and individually. The seasonality of advertising expenses affected the comparison with the previous quarter, as TOTVS's advertising campaign traditionally begins in the 2Q.

In the same period, there was also a reduction of approximately 12% in the allowance for doubtful accounts, which does not reduce our focus on seeking a sustainable reduction of this item. We conclude the analysis with the group linked to the administrative expenses.

The variation of the provisions for variable remuneration and the consolidation of acquired companies were the main elements for the increase of 0.3 p.p. of this group, year on year, as a percentage of the net revenue.

Now, I turn the presentation back to Mafra, who will continue from slide seven.

Alexandre Mafra:

Thanks, Maia. In nominal terms, EBITDA increased 12% and reached R$111 million, reflecting the Company's search for efficiency gains, through cost control and planning for the World Cup period.

We made great efforts to produce more with less time in order to minimize the impact of fewer working days in the EBITDA margin of this quarter, which ended in 25.3%, representing an increase of 30 b.p. over 2Q13.

The margin gain of this quarter, plus the gain from the previous quarter, resulted in the expansion of EBITDA margin by 30 b.p. in the 1H14, versus the same period in 2013. Moreover, the 25.8% margin recorded in this semester is 70 b.p. higher than the margin from the last 12 months.

Turning now to slide eight, we have the evolution of net income, which grew by R$10 million, or 18.5%, year on year, mainly driven by EBITDA growth and the financial result in the period.

Thus, net income totaled R$64 million, and net margin 14.6%, up 90 b.p. year on year. Therefore, net margin of the quarter surpassed the average margin of both the semester and the last 12 months.

On slide nine, we can see that TOTVS ended the 2Q14 with a cash position of R$401 million and a net debt of R$35.7 million, compared to a net cash of R$90.6 million in 1Q14.

This reduction of the net cash position is mainly due to the payment of R$50.1 million related to the Virtual Age acquisition, and the payment of R$116.5 million in dividends related to the fiscal year of 2013.

I reiterate that we continue with full financial capability to maintain the execution of our plan for organic and inorganic investments, aiming primarily to strengthen our operations in the most prominent industry sectors in terms of growth, our technology platform and our Latin America presence.

Now, I invite everyone to move to slide 10.

I would like to finish the presentation highlighting that, even with the complexity of this 2Q14, we were able to: grow the Net revenue by 11%; grow our recurring revenue by 16%; grow the Non-recurring revenue per working day by 19%; grow the EBITDA by 12%, expanding the EBITDA margin by 30 b.p.; and grow net income by +18.5% and the net margin by 90 b.p.

The investments in specialization by industry and the commitment of the TOTVS team allowed us to achieve these results and provide confidence to keep pursuing the goals set for the year of 2014.

Therefore, we will pay attention to the macroeconomic scenarios and sectorial dynamics of the markets where we operate and maintain our cost discipline without putting the future of the Company at risk, and without losing sight of the creation of new sustainable growth cycles, making TOTVS simpler, more agile, more connected, more cloud, and more essential.

Now, we are available for the Q&A session.

Sunil Rajgopal, HSBC:

Good morning, everyone. I just had one quick question on the margins. I wanted to know what is the Company expecting in terms of future margin trends. Should we expect the margins to improve from here? Because we saw about 30 b.p. improvement in margins during this quarter, and then in the last quarter too, we saw some improvements year on year.

So, should we expect that small improvement going forward in the margin? Because I suppose in this quarter there was some pressure due to the lower working base. So, should we see this pressure easing off going forward, and should there be a margin uplift?

Gilsomar Maia:

Thank you for the question. Actually, based on this 1H14, as you mentioned, we already knew previously that it would be a very complex period to expand margins, especially for the negative seasonality of the 1Q, and also for the World Cup period in the 2Q.

For the 2H, we have a very relevant number of working days, and we count on that to leverage our operational structure and our operational margin, and, as Mafra just mentioned, in the end of his speech, we still pursue our target of margin expansion for the year.

Of course we have to be very careful about the scenarios we have in our different sectors, market sectors. That is the direction we are going now.

Sunil Rajgopal:

Sure. Thank you very much. And very quickly, if I can, just one more question, we have seen some kind of pressure because of the various industry exposure, because the primary industries in Brazil still continued to lag behind, and due to the economic conditions right now in Brazil.

How are these industries performing, and what is the kind of new uptake that you are seeing from these primary industries? Is there a rise in the order backlog or something, what are the key trends that you are seeing?

Gilsomar Maia:

Actually, comparing to the end of 2013, we do not have so many significant changes in terms of sectors, dynamic of those sectors. Of course we have some sectors that publicly everyone knows are facing some extra difficulties. But, in general, I would assume that most of the sectors connected to services are warmer, much more than the rest of the sectors.

Sunil Rajgopal:

Sure. Thank you very much. Very helpful.

Operator:

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

Alexandre Mafra:

Thanks everyone for participating, we will keep working to always be innovative making our customers more competitive in their business. We know that our success is completely linked to the success of our clients and, thinking together, we can do better. See you in October in the 3Q conference call.

Operator:

TOTVS' 2Q results conference call is over. Have a nice day.