Operator:

Good morning. Welcome to TOTVS' 3Q14 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' 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' 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' business prospects, operational and financial estimates and goals, based on the beliefs and assumptions of TOTVS' 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 our 3Q results conference call. I would like to start from slide two, by briefly reviewing the main events that occurred since the 2Q results conference call.

Firstly, I would like to highlight that the Extraordinary Shareholders meeting held on October 22nd elected two new board members: Rodrigo Kede and Romero Rodrigues. Rodrigo Kede is the CEO of IBM Brasil and Romero is the founder of Buscapé, a price comparison website, and the global CEO for price comparison platform of Naspers.

With these two additional members, the Board has reached its maximum composition of nine members, as per its Bylaws, of which four have extensive experience in the field of information technology, and eight are independent.

The second event is the launching of the version 12 of TOTVS Management Systems by the end of September. This new version incorporates the three technological concepts that are part of TOTVS' future vision: Fluid Technology, Essentiality and Agile ERP.

The application of these three concepts resulted in an easier-to-use version, with an intuitive interface that features processes and indicators from several sources on a single screen, on a services-oriented software architecture that simplify the solutions deployment and the adoption of mobile and cloud computing technologies.

From version 12 on, all of the Company's management software will receive soft upgrades, with the continuous launching of new features for TOTVS products, without the need to migrate to a new version.

Clients can activate new features when they are ready to use them. Since the systems are permanently updated, naturally following innovations in SaaS concept, TOTVS can maintain its recognized characteristic of avoiding disruptions to its clients.

Now I invite Maia, to start the comments on the quarter results, starting from slide three.

Gilsomar Maia:

Thanks Mafra and good morning everyone. In this quarter, the total net revenue grew 8.6% year on year. Once again, the maintenance fees were the main growth catalyst, growing 16.3% in this period.

The service revenues grew 8.8%, despite the final phase of the Soccer World Cup, which was concentrated in the regions where TOTVS has its own branches that reduced by 4.7% the number of working days year on year. Considering the average revenue by working day, the services revenue grew 14%.

The license fees decreased 9% year on year, mainly due to the reduction on sales to large enterprises, differently from what we had in the 1S14.

This quarter, the addition of new clients rose from 774 clients to 900 clients, a growth of 16% quarter on quarter. Approximately 27% of these new sales where closed in a license rental or subscription of software as a service models, based on recurring monthly payments

In sales to existing clients, the 37% growth in the number of sales was more than offset by the 36% decrease in the average ticket, resulting in a decrease of 11.8% year on year. Approximately 24% of the total revenue from these clients are already connected to commercial models based on recurring monthly payments.

Similarly to the quarterly analysis, the last 12 months net revenue growth of 13.4% was driven by maintenance and services revenues. This behavior is also noted in the last five years period shown on the left side.

Moving to slide four, in the chart on the left side, we see services and maintenance growing higher than license fees grow in the last five years, which highlight our commercial strategy of prioritizing the recurring revenues and broaden the offerings based on monthly payments, organically or by the acquisition of companies with high recurring commercial models.

In the chart on the right, the priority given to recurring revenues is shown by the increasingly relevance of maintenance revenues in contrast to the reduction of license fees.

It is also worth mentioning in this same chart, the stability in the relevance of the service revenues, which shows a dissociated trajectory from the license fees, reiterating the importance of software implementation services, even when there is no license sale, as well as the growth of recurring services related to the cloud computing solutions.

This transition from license sales to subscription reduces the growth rate of total revenue in the short term, since recurring revenues are recognized on a monthly basis.

On the other hand, the higher volume of recurring revenue tends to raise the total revenue in the medium to long term, given TOTVS' historical high client retention rates.

On slide five, we see that the recurring revenues surpassed R$1 billion in the last 12 months, representing 58% of the total revenue, from which 8% are related to recurring revenues besides maintenance. In the quarter, the recurring revenues grew 16.4% year on year, representing 60% of the net revenue.

We believe that the Company's strategy, combined with the demand for models based on monthly payments tends to broaden the relevance of the recurring revenues in the total revenue.

Now, I ask everyone to move to slide six to discuss the costs and expenses as a percentage of the net revenue. The growth of costs and expenses in the quarter was 3.4 p.p. lower than the last 12 months growth. In the same comparison, the revenue growth was 4.8 p.p. below the last 12 months growth.

This higher deceleration in revenue growth increased the relevance of costs and expenses, especially those not directly related to the quarter's sales. An example of that is the first line in the chart that comprises the costs related to development and delivery of our solutions, which rose 1.9 p.p. when compared to the 2Q.

This growth was chiefly influenced by the research and development line, and is related to the consolidation of a full quarter results of Virtual Age, against two months consolidation in the previous quarter; the collective bargain agreements closed in Belo Horizonte, Salvador and Rio de Janeiro; additional efforts to launch the version 12 of TOTVS's solutions; and the implementation of new tools to manage the R&D projects.

It is also worth mentioning that in this same period, the cost of services line, which represented 61% of this block, maintained its trajectory of a gradual gross margin expansion, coming from 3% in the 2Q to 4.5% in the 3Q.

The costs of license fees remained stable in absolute figures, showing that, despite of its denomination that associates it with the license fees revenue, this line is also affected by the maintenance revenue, due to the commercial models based on recurring monthly payments.

This group of costs and expenses rose its relevance by 0.5 p.p. in the last 12 months, reflecting the investments in industry specialization and the innovation in technological platforms, and in a lower proportion, to the expansion of the ecosystem of solutions partners, that together with the R&D investments are part of the industry specialization strategy.

Moving to the second group, related to sales, the reduction of 0,5 p.p. over 2Q is mainly related to events and advertising anticipated to a period before the beginning of the Soccer World Cup, held on the 2Q.

Another point that contributed to the lower relevance of this group was the lower level of provisions for doubtful accounts, reflecting the lower delinquency in the quarter.

In the last line of the chart, we have the group related to the administrative structure, which rose 0.3 p.p. its participation over 2Q, mainly due to expenses related to M&A projects, which amounted approximately R$2.7 million in the quarter.

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

Alexandre Mafra:

Thanks, Maia. The 3Q's EBITDA amounted R$105 million, with a 23.6% margin. That said, the 3Q margin presented a 190 b.p. contraction year on year, given the lower deceleration of costs and expenses versus the net revenue deceleration in the period.

As Maia commented before, this deceleration in revenue is a result of the postponing of investments by large enterprises and the transition to a software subscription model that we are promoting. This transition to subscription negatively affects revenue growth and, consequently, EBITDA growth in the short term, due to the deferral in the revenue recognition.

On the other hand, the higher level of recurring revenue that we pursue tends to positively affect revenue and EBITDA growth in the medium and long term, reinforcing TOTVS' sustainable growth, predictability of results and operational leverage.

Thus, we released a material fact yesterday, in which we removed our guidance, since they were based on assumptions of costs and expenses dilution as a result of revenue growth. Nonetheless, the removal of this guidance do not exclude the constant search for growth, operational efficiency and EBITDA margin expansion from the Company's agenda.

Now, on slide eight, we see the evolution of the net profit, which grew 20.7% year on year, totaling R$68 million, mainly driven by better financial results and effective tax rate. Due to that, the net margin hit 15.3% and, as in the 2Q, the net margin of the quarter surpassed the accumulated margin of the year to date and from the last 12 months.

On slide nine, we present the evolvement of cash position, which amounted R$417 million at the end of the 3Q, a net cash of R$16 million, versus a net debt position of R$36 million in the 2Q.

This increase of R$52 million on the net cash position is mainly due to the 40% growth in the operating cash generation, which totaled R$101 million, corresponding to 97% of the quarter's EBITDA. This high conversion of EBITDA to operating cash illustrates one of the effects of the higher level of recurring revenues, since the license fees are the revenues with longer tenure in accounts receivables.

The R$10 million CAPEX investments, divided in approximately R$4 million invested on servers and computers, and approximately R$4 million in the facilities of new headquarters of Rio de Janeiro branch; the investments in intangible assets that ammounted R$13 million, related to the variable price of Virtual Age, and the new investment in GoodData; the payment of aproximately R$22 million of interest on equity, related to the 1H14, the net share buyback that totaled R$13,8 million; and the amortization of R$26 million of financing lines contracted from BNDES in 2008.

This makes clear that TOTVS has financial capacity to invest organicaly and inorganicaly, reinforcing our industry oriented approach and our technological platform without compromising the shareholder’s remuneration.

Now I invte you to view slide 10. Overall, even within this context described, the Company ended the 3Q showing: 8.7% net revenue growth; 16.4% recurring revenue growth; addition of 900 new clients; 20.7% net profit growth; and a 39.7% higher operating cash generation.

I reiterate that we keep in our agenda the constant search for growth, operational efficiency gain and margin expansion.

Therefore, we will keep our attention over the macroeconomic scenarios and sectorial dynamics of the markets where we operate, maintaining 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.

Andrew Campbell, Credit Suisse:

Thank you for taking my question. I have two questions related to the former guidance that you used to provide. I can understand why perhaps you do not want to provide guidance for this year or for the next several quarters, given the transition of the Company is in, the macroenvironment etc., but my question is whether not over a long term basis if the view that you have on the business and eventually where possible will get if you were to think three-five years out. Has that really changed? Has there been a structural change over that period? So that would be my first question.

And the second question is on the international operations where you also removed your guidance. Is that really just because you were removing the other guidance that you removed international part as well or is that something different that is happening on the international side? Thank you.

Gilsomar Maia:

Starting from the last question related to international operation, actually, we removed those guidance related to international mostly because of the Brazilian operation. One of the references was the revenue here in Brazil. As you said, we are transitioning the commercial model of the Company throughout the years, it can affect the base to determinate the percentage of the international relevance.

In terms of the other guidance, related to the breakeven point of the international, it is also somehow related to the deferral effect of the topline growth, from the recurring models, but also related to some specific contracts in specific countries. A clear example is the Argentinean market.

In the aggregate we see clearly the international market going to the breakeven or close to that, but really considering all the variables surrounding the metrics, it made more difficult to keep those metrics in our guidance.

In terms of the whole guidance and those related to EBITDA margin and R&D, as a percentage of net revenues, it is really related to this transition to SaaS, because one of the assumptions we had, when we established those guidance, was the topline growth because our concept at the time was “OK, we achieved more operating leverage through topline growth”.

At that time, we also projected a completely different scenario for Brazilian economy, so we supposedly are going to have a second year in a sequence with a very low GDP growth and we were not imagining that at the time, and also this transition should start, it is not favorable for short term topline growth.

On a quarterly basis, it is not aligned with the principles of our Company. As you already know, you followed us in the IPO, we did not measure the Company, especially in terms of margin, just on a quarterly basis, because most of our costs are not completely variable costs in terms of quarterly sales.

One clear example, the R&D line, if we have started to follow too much the quarter in terms of costs, it could have driven us to a wrong way. Even not giving you guidance, in our mind we do not see a complete change in our business model in the short term, so we are talking about a portion of our revenues related to license that is transitioning to subscription in a gradual process, because in our understanding, for a long length of time, companies will still demand for licenses and we will not lose opportunity.

Companies that still demand for license, we will sell, but on a daily basis, we will be proactive, trying to, insert this, selling subscription, but again, we will not say no for any customers. In our view that transition tends to be gradual, of course, it will depend not only from us, but also from a market demand and that is one of the reasons we did not just replay or substitute our guidance for different metrics.

We need a little bit more flexibility in this period, especially to realize clearly the size of the transition and to understand how fast demand can be accelerated or not in terms of subscriptions. I do not know if I addressed properly or not your question.

Andrew Campbell:

Yes, I appreciate it. Thanks, Maia.

Gilsomar Maia:

You’re welcome.

Valder Nogueira, Santander:

OK, guys. Good afternoon. One question: as it is shown on the press release, on the curves on how the different revenue lines have behaved throughout the time, your license revenue profile has already reflected some of this SaaS migration. It was a natural course of the business and it also has to do with the mix of the Company that you inorganically have added to the portfolio.

That is all clear to me that it is also clear on the type of software that you sell, specific series that you sell, that is very clear to me. So, besides that, what was the main driver for you to decide to speed up that migration? Was it an internal factor or was it an external factor?

Gilsomar Maia:

Thank you, Valder, for your question. Actually, there is a group of things that motivated us to go in that direction. Some of these things I can exemplify here. One is, as you will probably remember, that some time ago we launched an offering we call series one, it is for micro-enterprise, it is a pure subscription cloud offering. We charge about R$99 per month for users. And for this kind of experience we have got very good feedbacks from these micro-enterprises.

In parallel, throughout the time, as you could see in the curve of our revenues, we have been more flexible in terms of commercial negotiations. If we have to give discounts, we prefer to give discounts in license than in maintenance, for example, in order to preserve our recurring revenues.

And as you mentioned, every company we have acquired recently brings this kind of characteristic — very high recurring modules, thus contributing much more to maintenance and little to license; most of those companies do not have licenses, licenses are more an exception for them.

And every time we drive part of our sales pipeline to those companies we have acquired, we are speeding up this process of transition from license to subscription or a more recurring model.

Of course, in a longer perspective, the topline growth in terms of license explains part of the acceleration of licenses, and we understand that is helpful for the business in a long-term perspective.

If we assume that a customer is going to pay us a similar amount of money in a four-year period, after that that customer pays the same and then we can better monetize our install base. From that point on, we start to be in the opposite position: having better revenues with a similar cost structure. And that is our main objective — to maximize the value of the company in the business and to establish a more sustainable growth model.

Valder Nogueira:

OK. The second part of my question is: in order for us to determine how much the EBITDA margin curve will come down and then go up, is it more crucial that the industry that you concentrate your efforts on, or the verticals, in order to achieve that, some industries may be more willing to go for the cloud model, for the SaaS model? Or is it a matter of the size of the business?

Gilsomar Maia:

It is more related to a company's size than sector. In very small companies, like micro-enterprises, it seems to be very simple solution and easy to deploy completely in the cloud and then having almost no services, so being charged only on a monthly basis. Specific parts of the system can be also provided in this way, but large enterprises tend to be not so open for this kind of solution in the short term, because most of these companies are concerned about OPEX and CAPEX conversations.

OPEX is going to affect their results and CAPEX is just cash flow. Small and medium companies, like single-owner companies, companies led by entrepreneurs, tend to think more about cash flows — like working capital and cash flows. These companies, our feeling is, the acceptance of a more recurring base module tends to be better accepted.

Of course, there is a mindset to change in terms of software ownership. Some companies do not feel so comfortable not having the ownership of the software, remembering that our software supports very critical routines, and some of our customers like to have the ownership of that system, because in their mind, if any problem occurs, they have their system in their computers, their servers.

But we know that cloud is becoming more and more popular, people are absorbing this concept, digesting this kind of thing, and then, in our view, it tends to be more demanding for the market. That is the point. I hope I have addressed properly your question.

Valder Nogueira:

Yes, yes, you have. Then that may lead to, let us say, a better alignment of the verticals that you have, because it completely makes sense for you to maximize that.

Gilsomar Maia:

One example maybe, Valder, in this is your sector. The financial sector is a traditional demander for software as a service. Even though in the past we did not have this kind of denomination, financial institutions are not so addicted to license because they have some constraints in terms of Basel levels, level of fixed assets, they have in their balance sheets, so historically they have always preferred to pay for a service than capitalizing on investment.

And that explains or illustrates one good example of that portion of our license that is recurring, that sounds a little bit strange. It really is a recurring license, because we rent the license instead of selling the license for this kind of institution. But it is becoming more popular. We have seen other players in the market offering more and more cloud and SaaS solutions.

Another example I can give here is Microsoft Office 365 — it is really getting traction in the market. We have heard that they are thinking about stop selling licenses next year, for Office, and just sell a subscription of Office 365. So it is really going to change the industry if it really happens, because especially large institutions see these kinds of license for Office as a CAPEX, actually, not as an OPEX.

So, if they really change to selling it exclusively through subscription it will change even the budget dynamics of some companies. This is one example of something that is in course that can gradually change the mindset of the executives and then, eventually, entrepreneurs as well.

Valder Nogueira:

Thank you.

Vera Rossi, Goldman Sachs:

Thank you. I have two questions. My first question is on how long this transition of model will take, in terms of revenue slowdown and pressure on margins, and when we pass this phase, what will the level of profitability be? Without giving us numbers or guidance, will the level of profitability in a normalized revenue growth environment and cost environment be similar or lower than before? Thank you.

Gilsomar Maia:

Hi, Vera. Starting from the first question, related to the length of this transition, really, that is one thing that we do not control in length, to be frank. As I answered Andrew, we have been more and more proactive in that direction, so as to invite customers to choose subscriptions instead of licenses. But we know that for a long time companies will still demand a license.

Of course, that number of companies demanding licenses, in our view, tends to reduce. And more and more we are going to see companies demanding more subscriptions than software licenses. That transition, in my view, is already in course. So in that period of five years we put in our chart demonstrates that it is happening. But our feeling is that it tends to be a little bit faster in the future, especially because we intend to be a little bit more proactive in that direction.

But it is hard for us to state here, to give you a more solid or clear perspective of how long it can take. What I can give you guidance is that it is not a very short-term transition, so, as I said previously, if we will still sell licenses for companies that are demanding licenses, that transition will not be gone in a single year, for sure. It is going to be a multiple-year process.

The shorter it takes, the earlier we can get the benefits from that growth. So you can imagine that we will do our best to make that transition in a way that can be good for both sides — TOTVS and its clients.

And in terms of profitability, we understand that maybe this quarter can be useful in this sense to emulate, to exercise how much sensitive the margin of the Company can be. R$80 million in license is really a point out of our average, because in average, in the last years, we have been having like R$90 million in licenses per quarter, sometimes a little bit more or a little bit less than that, but about R$90 million.

And this quarter having R$10 million below that average can illustrate well how much it can affect our margin. So even having R$10 million less in license in an upfront revenue, having R$2.7 million of non-recurrent expenses in G&A, our margin came to this level of 23.5%. It does not mean we are happy with that level, but we can use that mathematic to illustrate how sensitive it can be.

So it will not transform completely the business model of the company in terms of financial metrics, in terms of financial figures. And it is important to highlight here that we will keep our financial discipline in terms of cost control, independent of what model we are running. Of course, on a quarterly basis, if we have more or less licenses, it can affect the quarterly margin, but on an annual basis I believe it can be much less volatile than it is on a quarterly basis.

Vera Rossi:

OK, just for me to see if I understood correctly: the volatility of the margins will decline because the subscription model is a model in which you have a better consistency in your revenues, but probably the margins will likely be lower or it will require the Company to reduce costs to maintain the margins, is that correct?

Gilsomar Maia:

Look, the cost structure is more related to the level of sales, not revenues, sales we can generate. In terms of predictability of our profitability, as you asked me, you are right — a more recurrent model tends to be more predictable, because it is easier to project the level of revenues.

But in this mid-time, while we are transitioning a little bit more from license to subscription, it can provoke an extra small volatility in margins because we are switching from license, which is an upfront revenue, to a subscription. But it is really a transitory point.

That is what I answered Andrew in terms of the guidance, because we did not established a new guidance because we need a little bit more flexibility in this short term, but it does not mean it will completely destroy the results of the Company. We need a little bit more flexibility in this short to mid-term, but it is aiming at a much better future for the Company.

Vera Rossi:

OK, thank you.

André Baggio, JP Morgan:

I have two questions. The first is just to clarify this volatility of the margins. If I understood correctly, the volatility will remain because the transition to SaaS will be done overtime. So, just in the very long future you will not have the volatility of the margin and in the next few quarters should still see the volatility because of the sale of licenses, which can fluctuate.

Gilsomar Maia:

Baggio, really, I understand that the R$80 million of license is not a good reference for us. Let us say that in the next quarters we will return to the average of R$90 million, it can enhance a little bit our margin, but in parallel we will keep that transition in course, so we have both courses in place.

In this quarter we have just one, the transition kept in course, but the license was very weak, especially among large enterprises, so that most of that gap — comparing the R$80 million to the R$90 million of our average — came from some postponing, especially from large enterprises; from postponing investment.

So, if we are able to return even to the average of R$90 million, it can recompose our margin in the short term, OK? It will depend much more in terms of how the volatility of margins can be on a quarterly basis, than the subscriptions, because the subscription process is going to be completely in course, in my view, OK?

André Baggio:

OK. And the final question: can you explain a little bit with more details the value of revenue per license declined from 15 thousand to 10 thousand, year over year? What exactly is this related to? Because I understand that it could be related to the size of the client, but I would like to know exactly what the number of sales is. Is it per client? Because we deduce that one client should be the same, regardless of it is larger, because it is charged per user, so I would like to know exactly what this measure is about.

Gilsomar Maia:

It is per client, Baggio. And then, larger clients tend to have more users, they will have a larger ticket. And, on the opposite way, the smaller customers, the small number of users and a small ticket. So, when we put it together, and in a quarter like this, in which we have a very low level of sales to large customers, the average ticket is more impacted by the small clients.

André Baggio:

So a client is a CNPJ instead of a user?

Gilsomar Maia:

Yes, that is right.

André Baggio:

Perfect. Thanks a lot.

Michel Morin, Morgan Stanley:

Hi, it is Michel Morin from Morgan Stanley. So, two questions, if I may: the first is regarding the delays that you suffered from large customers, I am assuming — given that you mentioned this was related to political uncertainty — that this continues into October and perhaps, if you can comment on whether or not October was worse, and what you have seen since, if anything.

And then, secondly, given the market reaction today, I do not know if you can update us on your buyback authorization and how you think about balancing buybacks with other potential uses of cash. Thank you.

Gilsomar Maia:

Hi, Michel. Starting from the first question, related to the delay of large accounts, giving you a little bit more color on this quarter, October was not that different comparing to the 3Q, and I attribute this behavior to the political scenario.

We are a few days from the final of the elections, so I believe that in October companies are still under this scenario, so the expectations about the name of the new president, and then I believe companies now have a little bit more elements in hand to project some scenarios for next year.

So, that is a very challenging moment for companies to project their budgets for 2015 and we know that, traditionally, part of the companies have a behavior to use the remaining budget in the 4Q to make some investments.

Of course, the macro scenario is not that favorable, as you know, here in Brazil. We have to be a little bit more careful in this kind of comment because if you put it all together it can give you the impression that the 4Q is easy and in a very easy way we can do a very, very good quarter. I do not believe in that.

It tends to be complex, but we have to pursue a recovery in our license among those large accounts, because we did not lose those accounts to competitors. Most of that was really delayed, postponed from large accounts. We have to keep in touch with those companies, trying to converge those opportunities. But again, it is not a simple thing.

Now, going to the second question, related to our buyback program, the buyback program we have is primarily to support our stock option plan. Of course we follow all the time the stock price, we understand the moment of the stock price and the necessities we have to support the stock option plan, and that is one of the matters we can discuss competently with our board of directors. The best usage of our cash.

But considering that in parallel we have a pipeline of M&A, the priority is to reinvest the money in the business. We have more opportunities to reinvest and strategically approach things we understand are important for the future of the business, the priority is this kind of thing.

And secondarily we can allocate more or less researches on a buyback program, but we have that flexibility to discuss this kind of thing with the board. That is one thing that exists.

Michel Morin:

Great. Thank you very much.

Sunil Rajgopal, HSBC:

Hi. I have one quick question. Would you be able to provide us with the timeframe for the revenue payback that is essentially the difference between selling in a traditional model versus the rental model, how long would it take to reach the similar revenue levels?

Gilsomar Maia:

In terms of timeframe, it is about four years in general. Of course some of our offerings have a shorter and others little bit longer periods than that, but in average I would tell you that it is about four years.

In a four-year period, in net present value our customers tend to pay a similar amount. So, if we are able to retain a customer more than that, we can better monetize that install base of users and recurring revenues. It is a good reference, about four years. As I told you, especially simpler solutions tend to be a shorter timeframe.

Sunil Rajgopal:

Sure. And if I may, I just have one more question. Regarding to the cost structure, I do not know if you have told us already, but it would be helpful if you can remind us what percentage of your total costs are fixed versus the variable.

Gilsomar Maia:

My variable costs are more related to sales expenses, like selling expenses and commission expenses. Especially commissions are really directly related to revenues, and when we have a more deferred revenue in a subscription model, we have a more deferred commission as well.

Of course, commercially, we can incentivize a little bit our sales force, giving a little bit more commission in the beginning, and then in a linear way. But it is really a very tactical and operational thing on a daily basis. But in my mind, we have also deferral in this kind of thing.

The other lines are not so affected by that, because R&D more related to road maps and the launching of new things and one thing that I did not say when I answered your first question about the timeframe is that conceptually this kind of subscription model is more helpful for resources, in terms of requiring a lower level of initial investment. It reduced an entry barrier in some new clients, so it tends to be positive for our sales force, and that is what we think, in our experiences with these kinds of periods, even with the companies we acquired. That is the point.

And the rest of the costs are more fixed costs and then it is our standard costs discipline, independently how concentrated we are in a subscription or in a license model, it is mandatory for us to be very disciplined in terms of costs control.

Sunil Rajgopal:

Sure Maia. Thank you very much. That was very helpful. Thanks.

Valder Nogueira, Santander:

Thanks for the follow-up. A very quick question. And riding on those questions, how do you see the alignment of your franchise with this new model? I know that part of that has already been, as in the revenues, shown on the presentation on the press release that intuitively they have already been selling more subscription models, but how is the alignment for this new venture?

Gilsomar Maia:

That is a very good question, Valder. I understand we have an advantage comparing to other players in this respect, because our franchises are exclusive channels, and we remunerate our franchise over the recurring revenues.

If we try to breakdown the process of our franchise, even though they have a high portion of their revenues related to services and license sales through commissions, most of the profit they make is related to commissions over maintenance, over recurring revenues, because they have low costs involved in maintenance because all of the support, all of the developments, all of these elements related to maintenance and to the recurring is owned by TOTVS directly.

So, they really help us in terms of monitoring customer satisfaction and be geographically close to our customers. And that is what justifies that recurring commission they have, together with the exclusivity they have.

So, intensifying this kind of recurring model can be attractable for those franchises as well, remembering that they already have a good level of recurring commission over recurring revenues. I understand your question in the matter of the short term, they can also have a little pressure in terms of incentives to their workflow, as well in terms of sales.

But they understood pretty well the importance of having this kind of alternative in their commercial approach. In some opportunities, it is very helpful to have this low level of initial investments to win the competition.

By having more customers they can maximize their business as well. So, they are very aligned. I cannot give too much details in terms of how we can incentivize, but we are incentivizing franchises in terms of new customers, and sales to existing customers in a differentiated way. Depending on the moment we can be more or less aggressive on that. That is the kind of flexibility we have to have here.

And with subscription, it is not different. So, we have some volume to partially offset this kind of negative impact in the franchises, but they have a very good mindset in terms of recurring revenues and recurring commissions. So, that is not an unsurpassed issue when we talk to them.

Valder Nogueira:

Is there any difference to the profile of bad debt? The new models vis-à-vis the old models?

Gilsomar Maia:

The bad debt tends to be more similar to what we have in maintenance, which is a recurring revenue, with very small tickets, and tends to be better in days of bad debt.

On the other hand we have to be even more careful about churn, because, as I explained to Sunil on the previous question, the retention rate of our customers is a very important message for us, in a subscription it is even more important, because the longer we retain the customers the better we monetize that service we are providing to the customer.

Andres Coelho, Scotia Bank:

Thank you. I have a question on the bigger picture of the transition. I think you already discussed the short-term impact of migrating to SaaS, but my question is more related to how the new model changes the potential for ERP penetration in Brazil and Latin America.

I understand that ERP penetration in the SME segment in Brazil is currently approximately 22%, 25%, it is probably half the penetration rate in the United States. So, my question is this: on the previous models you would charge customers based on the licensing models, you would charge a significant downpayment, that was probably a big downpayment, and now you are charging that customer on a monthly basis.

So, my specific question is this: when we think about the new customers, on average how much they were paying in the past? How much was that downpayment in the past compared to the monthly installments that they will now do? More or less if you can give us, even if you can just give a very wide idea of the difference in how much they will pay now on a monthly basis compared to a single downpayment in the past?

I think that would be helpful. And also if you can provide us with any updated view on the ERP penetration in Brazil and how the migration to SaaS increases the potential for expanding the penetration more rapidly in the Brazilian market.

Gilsomar Maia:

Thank you very much for your questions. It is also a very interesting question, because we address that subscription approach in a way to help us to enter new customers and enhance the penetration of the market.

So, you are right, the penetration of the Brazilian market is much lower than the developed market. Our sense is similar to your, like 22%, 25% seems reasonable, even though we do not give a very high importance to this kind of figure, because we understand that for this kind of statistics, a company that made a very small investment, an initial investment in a management system it is considered, in this kind of statistic, as a penetrated company.

And as you know, in our module, the first investment from a new customer is just the beginning of the game. So, that is when the game starts. From that point on, it is much easier to penetrate more that customer than before.

But you are right, the penetration is low. This kind of subscription model seems to be helpful to penetrate to convince companies because the amount of money they had to invest is much lower than if they were acquiring licenses and etc.

As I said in the beginning of this conference, we have also to take into consideration that there is a cultural behavior to be displayed. Companies are still concerned about the ownership of the system in some specific situations, because, as I said, our system support is a very critical routine. And in specific situations customers feel more comfortable when they have their systems running on their own places. And we understand that is a kind of education process we have to do.

But you are right, it is helpful in terms of penetration, and to give you a sense of relevance, I will use our historical metrics. So on average a new customer spends R$ 25.000 to R$ 30.000 in licenses, 2x of that in services, so I am saying that, let us take R$30.000 in license and R$50.000 in services. We are talking about a project of almost R$100.000.

And then normally we charge maintenance of 30% of that license on an annual basis. Of course we charge this in a monthly basis, but when you consider an annual basis, the total maintenance represents about 30% of the license.

So, in a year a customer could consider R$30.000 in licenses, R$50.000 in services and other R$10.000 in maintenance, so R$100.000 project in a one-year period.

In a subscription it depends on exactly what the solutions were demanding, but the R$60.000 in services tend to be similar, because the effort of implementation is not so different. But the amount of recurring tends to be higher than the R$10.000 of my example. So, it tends to be about R$12.000 approximately. Let me see here. It is not R$12.000, it is R$17.000 to R$18.000, almost the double of the maintenance this customer is paying, depending on the offering.

It is higher in terms of monthly payment, but we can dilute that investment in a length of time for the customers.

Was I clear in my explanation?

Andres Coelho:

I think you are very clear. So, just to summarize, in the past, customers would pay during the first year approximately R$100.000 to get the project started? And on the new model, they are going to pay the same ticket for the service because it is likely to require installation services, as in the past, but the R$30.000 that he was paying in the past for the license is probably not going to be there anymore, but instead of paying R$10.000 of maintenance, he is now going to pay approximately R$18.000?

So, instead of R$100.000, he is going to pay approximately R$80.000, so it is a 20% reduction in how much it is costing that client to acquire the license. Am I right to see it that way? In the past you would get R$100.000, now you are getting probably R$78.000 for that same customer? But of course that customer will stay with you for a long time, and therefore in the longer term it can get more revenues than the R$100.000 that it generated on the previous model. Am I right in thinking that way?

Gilsomar Maia:

Yes. You are right. Of course we are getting a hypothetical example here, we cannot generalize all projects in the same way, but your rationale is correct.

And one thing here that is important to explain is even if our services, we get more efficient with the implementations, that customer tends to spend the same R$60.000. And why? Because that is the amount of money that customer is available to afford. In a customers' mind, "OK, I can spend that amount of money in implementation".

If my implementation comes cheaper, that customer tends to implement more than we usually see a customer implementing a solution. And you are right, we can dilute the investment because here we are talking about, in terms of subscription of monthly payment, so that customer does not have to give us, in my example, the R$30.000 upfront. It is diluted throughout the time. So, from a cash flow perspective it is more favorable for the customer.

Andres Coelho:

OK. Perfect. And just one final question, have you changed your view on potential penetration of ERP in Brazil? I mean, as you might insert the new model, internally the Company has changed its projections regarding the potential for the market, or it remains more or less the same? I understand that you cannot provide guidance on this particular issue, but I think it would be helpful to know if at least internally the Company is now thinking in growing more aggressively.

Actually, we saw your licenses increasing, or the number of transactions in the 3Q increasing by 31% year over year. I think that there was already a certain acceleration in the 3Q, but I wonder if internally the Company feels more, of course, there is maturation as well, but if the Company feels more optimistic that the new model will help to accelerate penetration in the long term.

Gilsomar Maia:

This kind of metric is one of the assumptions we had to revise in our projections, because if you take the number of new clients we added in the last three years, it is very similar, so we are not able to accelerate that addition of new customers. It is out of our expectations, comparing to our projections when we define those guidances.

So, conceptually if that were the only variable for penetration in Brazil, it is under our expectations comparing to the past, but penetration is not that relevant in our analysis. Why? Because of what I explained, so a company that acquired a single user license in my example is considered a penetrated company. In practical terms, it is not penetrated.

So, secondly even those companies more evolved in terms of software usage, every day we have new demand of technology. We have customers that have been with us for 30 years, and consistently they come requiring new things, or we have new things to offer and implement more things, sell more things to them. So, it is really in the technology industry, it is hard to say that a customer is truly penetrated.

Alexandre Mafra:

And one of the best things in this kind of subscription model is that without this initial payment the company can implement more, it can make more services, so this kind of thing that can be really good for us.

Andres Coelho:

OK. Thank you.

Operator:

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

Gilsomar Maia:

Thank you all for your participation in this conference call. I hope we can talk to you in the next quarter. have a good day. Bye-bye.

Operator:

Thank you. TOTVS' 3Q results conference call is over. Have a nice day.