Operator:

Good morning. Welcome everyone to TOTVS's 2Q12 results conference call. Today with us we have Mr. Alexandre Dinkelmann, Vice-President of Strategy and Finance, and Mr. Gilsomar Maia, Planning 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.

Please also note today's call is being recorded. Today's live webcast may be accessed through TOTVS's website, at www.totvs.com/ir.

Before proceeding, let me 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's future results and could cause these results to differ materially from those expressed in such forward-looking statements.

Now, I will turn the conference over to Mr. Alexandre Dinkelmann, who will begin the presentation. Mr. Dinkelmann, you may begin your conference.

Alexandre Dinkelmann:

Good morning, everyone. Welcome to TOTVS's 2Q12 earnings conference call. I would like to start this conference highlighting three important events for the Company this quarter. First, TOTVS was appointed "Company of the Year" in the Exame magazine's issue "Biggest and Better", which evaluated the 1,000 largest companies in Brazil, taking into account, among other factors, growth, profitability, wealth created per employee, and liquidity.

Second, a new advance of TOTVS Brand, which reached the 18th position in the ranking of the most valuable Brazilian brands in 2012. This position is even more relevant when we consider that this brand was created just seven years ago, and it was compared to strong consumer brands in the rating process. Third, TOTVS held its Investor Day in June at the Company's headquarters in São Paulo, and also, for the first time, in New York.

Now, I would like to invite Maia, TOTVS's Planning Officer, to proceed with the 2Q earnings presentation.

Gilsomar Maia:

Good morning, everyone. On slide three, we have double-digit growth in net license fee revenue, up 10.3% over the 2Q11, which is higher than the 1H12 growth and shows the positive evolution of license fee revenue in the year.

It is important to highlight that the license growth was observed both in sales to new customers, with the addition of 970 new customers, 20% higher than the 2Q11, and total sales to existing customers, which were 10.6% higher than those from the 2Q11.

In the next slide, we see the net service revenue growing by 10.2% in the quarter. This pace of double-digit growth in the quarter is lower than the 1H12 mainly due to the software implementation services. In Brazil, these services have maintained their course of efficiency gain, but the service team increase was affected by the pace of license sales in prior periods. In international operations, these services were affected by the reduction in the number of branches, especially in Mexico.

Now on slide five, we have the net maintenance fee revenue with double-digit growth as well, despite the slowdown seen in the last 12 months inflation curve, which confirms the high level of customer base loyalty and the growth potential among small and medium companies.

As a result, on slide six, the total net revenues grew by two digits, totaling R$350 million in the quarter and surpassing R$700 million in the 1H12.

Proceeding to slide seven, in the upper left corner, the group of R&D expenses, cost of services and cost of licenses followed the downward trend as a percentage of net revenues, mainly due to R&D expenses in the quarter. However, the execution of development roadmap can accelerate R&D expenses throughout the year.

Monitoring these three lines of expenditure jointly is important to check whether the investments in R&D result in long-term margin gains through more efficient implementation and dilution of license costs and also in R&D investments.

In the upper right corner, in the selling, commission, bad debt, and marketing expenses block, we also observed a decrease as a percentage of net revenue, mainly due to sales mix changes, impact on commissions, and due to management initiatives to increase efficiency in the selling expenses line.

In the same slide, in the lower left corner, G&A and management fees presented a slight increase as a percentage of net revenue. This increase was mainly due to the accrual of bonuses in 2012, proportional to the achievement of financial and non-financial goals, and due to the increase of infrastructure and communications expenses in the period.

Now on slide eight, we highlight the 26.8% growth in the 2Q12 EBITDA and the 27.9% in the 1H12, exceeding the CAGR for the last five periods in both analyses. Also important to highlight the evolution of the EBITDA margin, which reached 26.5% in the 2Q12, 330 b.p. higher than the margin shown in the 2Qs of the last two years.

Now I will ask Alexandre to proceed.

Alexandre Dinkelmann:

Thank you, Maia. On slide nine, we broke down the EBITDA margin into the Brazilian operation; that is our core business, and the impacts of Digital TV, also known as TQTVD, and international markets. The purpose here is to increase the visibility of our businesses that have different maturity levels.
In the first line, we have the EBITDA margin of the Brazilian operation, which reached 28.7% in the 2Q12, representing an increase of 350 b.p. over the 2Q11.

In the second line, we have the negative impact of 1.3 p.p. from TQTVD in the consolidated margin. However, in the year to date, the negative impact of Digital TV is 0.6 p.p., or 10 b.p. lower than the 1H11.

In the third line, we see the impact of the international market operations, which was 30 b.p. better than the 2Q11, and, in the year to date, was 80 b.p. better than the 1H11. This improvement reflects a set of actions we have taken since the 4Q11 in order to make our international operations reach the EBITDA breakeven in the 2H14, representing between 3% and 5% of the Company's consolidated revenue in 2016.

On slide ten, we see the cash flow and debt level. I emphasize that the operational cash flow accounted for more than 90% of EBITDA in the quarter, which allowed a decrease of net debt to R$6 million at the end of the quarter, despite the payment of R$65 million of dividends. Our balance sheet provides enough financial strength and flexibility to fund our long-term investments.

Moving to slide 11, we have the traditional financial dashboard, where we highlight the growth of revenue and EBITDA, as well as the net income growth, which was significantly higher than EBITDA, mainly due to the reduction of net debt and the consequently reduction of financial expenses in the period. This net income growth was not even higher because of the increase of the effective tax rate, due to the reduction of fiscal benefits related to R&D expenses.

Lastly, slide 12 summarizes the quarter and outline how the management team has been guiding its agenda on the pillars of growth, fidelity and margin.

In the growth dimension, we highlight the license fee revenue and net income growth, and the addition of almost 1,000 new customers, which accounted for almost 20% growth over the 2Q11. The performance in the quarter confirms that we are on the right path and in accordance with our plans to accelerate our growth during the year.

Regarding fidelity, we highlight the revenues from existing customers, which were 10.6% higher than the 2Q11, the 12% growth of maintenance revenue, and TOTVS brand ranked as the 18th most valuable Brazilian brand.

Finally, in terms of margin expansion, we had 26.5% of EBITDA margin, which shows an increase of 330 b.p. over the 2Q11, and the net income growth of 31%. These indicators show that TOTVS is on track, through the consistent execution of its long-term plan, with a distinctive combination of growth and increasing profitability.

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

Michel Morin, Morgan Stanley:

Good morning, everyone. I just wanted to follow up, I think on the press release you mentioned that in the Digital TV there was a staff reduction, so I was just wondering if you can quantify what kind of impact that had on costs. Just trying to normalize here what kind of expense level we should see starting in the 3Q.
And similarly in the international market, it looks like there was a little bit more of a drag on margins in the 2Q than in the 1Q. So, I was just wondering what is happening there, what is driving that. Thank you.

Alexandre Dinkelmann:

Hi, Michel. Thank you for your questions. Let us start with the Digital TV question. Basically we reduced approximately 20% of the workforce in the business, so it is a pretty good proxy to envision the future costs of operation.

Regarding margins, when we compare 2Q and 1Q, we were happy with the performance of the 2Q in the sense that we are on the path of increasing our efficiency in the service side, also in the R&D side, because of the Brasil Maior effect.

We could also anticipate part of the roadmap in terms of R&D. So basically we are using these positive effects in order to enhance and anticipate part of our roadmap in terms of innovation. We are showing consistency in the way that we are pursuing our margin expansion.

Michel Morin:

Thanks for that. But just to clarify on your last point, so did I hear you right in saying that basically a lot of the benefits that you have gotten from Brasil Maior have actually been reinvested in the business, and especially in R&D?

Alexandre Dinkelmann:

Yes.

Michel Morin:

OK, great. My next question, I also just wanted to clarify something that came up on the Portuguese call about maintenance revenues, because it does seem like on a sequential trend they were a little sluggish, certainly a little bit weaker than we had anticipated, and of course we take into account inflation and license sales in the last 12 months. The one variable we do not have is churn in your client base, and I am wondering if there has been perhaps a worsening of the trends there that might explain the performance. Thank you.

Gilsomar Maia:

Good morning, Michel. In terms of maintenance, we have not observed a significant change in terms of churn this quarter. What maybe is better to analyze in maintenance, you probably realized that, but this quarter we started also to provide the net amount of maintenance already discounted this tax from sales, discount in cancellations.

When you take a look on net maintenance fees, you can see that the growth between the 1Q and the 3Q was 1.5%. I know that it is lower than the previous quarter, but actually we had considered before that if you take into consideration that one important element is the inflation update, it was on track, in my opinion, in the course we were imagining. I do not know if I clarify your doubt exactly.

Michel Morin:

Yes. That was very clear. Thank you very much.

Matt Neal, Invesco:

Good afternoon. My question is related to the 28% year-over-year increase in G&A. What I am trying to figure out is the R$4.8 million increase year over year. I am trying to determine the amount of that that is related to the Executive Officer change, the non-statutory position in infrastructure and telecom. So, I would like to get a breakdown there.

And also, it seems when you were taking about G&A and management fee; you mentioned an increase in the compensation related to goals. Does that fall under G&A, the goal-related compensation? And just in general, educate me on this transition and the impact from Executive Officer to the Executive Officers no longer having a statutory position. Thank you.

Gilsomar Maia:

Thank you for the questions. The first question you made relates to G&A. You are correct. In this specific quarter we had some executives that were previously applying statutory positions, and they left those positions, so we had to reduce the management fees, and in the other hand the G&A was increased because of that.

In terms of the whole G&A expense, we can consider this kind of movement with the executives, but also a significant part of our G&A expenses is related to some fixed costs we have. An example is rentals of buildings we use; in Brazil we have kind of a similar behavior as we have in maintenance, so every 12 months we have inflation updates over those rental contracts, and then we observe some increase in that direction.

But all the time G&A is one line, we are very careful with that, and we understand that as the Company grows we have some new levels of G&A, and then, after that we try to provoke some dilution in the G&A. Exactly in the beginning of this year we understand that we established a new level of G&A, and then we work hard to dilute that G&A throughout the year and the next years.

In terms of management fee compensation, when we explained about the provision of bonuses, when we take a look at 2011, the same time point, we did not have any provisions in terms of bonuses. We were not reaching our goals at that time, and we accrued the bonus throughout the year in accordance with our achievements.

So comparing 2011 to 2012, this is one important element that explains why management fee looks somehow stable, even with a reduction of the number of statutory positions.

Matt Neal:

OK. So, just to confirm, speaking about G&A specifically, the bulk of increase was driven by rental increases? Is that correct?

Gilsomar Maia:

Yes. Part of that increase came from the executives that left statutory positions. Second reason is infrastructure and communication expenses that we observed some increase, especially because of inflation updates we have.

Matt Neal:

OK. My second question is in regard to doubtful accounts. You are provisioning 1.5% of sales. Can you give some color on what was driving the delay in payments from your customers and if you plan to keep provisions at this level? Thank you.

Gilsomar Maia:

OK. In terms of doubtful accounts, what we observed, differently from previous quarters, when we were discussing this kind of matter related to international operations, specifically in the 2Q12, cases related to doubtful accounts were more concentrated in Brazil, specifically in some big customers, big accounts. And even more specifically in services related to management consulting projects and some other implementation projects. It is not a generalized behavior; it is more concentrated in some big accounts.

Our personal feeling is that probably there is an influence from the macroeconomic scenario that some of those companies suspended their projects, and they also suspended payments. But when we take a look on the names below that provision, we see very good names.

So there is a chance to see part of that provision being reverted in the future. But being conservative, we had to accrue that provision.

Matt Neal:

OK. Thank you very much.

Michel Morin, Morgan Stanley:

Thank you. Alex, I noticed on your slide ten your net debt, which is basically zero, and I think you filed a couple of days ago for a shelf debenture offering. So I am just wondering what you and the Board may be thinking about with respect to use of cash going forward and potential returns to shareholders. Thank you.

Alexandre Dinkelmann:

OK, Michel. We are always analyzing funding options for our investments. The good point is that we have a pretty flexible and strong balance sheet because of this cash flow generation. So, the last couple of years we were able to reduce our leverage rate, which gives us possibility to increase leverage for the future.

The information that was released recently about debentures is not true, we are not pursuing any concrete transaction that time, but we are always talking with the market in order to understand best options, and when we need them we will go for them. So definitely we are not working so far in any specific transaction in terms of capital markets.
We do not think of changing our dividend policy. Historically we have been distributing 50% of our net profit to shareholders, we do not see any reason to change that. Because we envision investments for the next years in terms of growth and expansion, so that is why we want to have this balance sheet prepared for future investments.

Michel Morin:

Great. Thank you very much.

Matt Neal, Invesco:

I am curious in regards to the Digital TV platform. I am sorry that I have to ask you, I am sure you have articulated this in the past, but what opportunity do you see there, and what is your strategy in Digital TV going forward?

Alexandre Dinkelmann

OK. Now in fact we have the law that obligates the adoption of this platform in Brazil, which is really a relevant fact for the business, and after this law we can see better results ahead.

In this sense, this quarter we adjusted the cost structure of the business in order to speed up profitability. Because of this change in legal environment, we have been approached by investors that are interested in signing up with TOTVS in this business. We are right now analyzing opportunities, and this year will be a watershed regarding this investment. We believe that now we can show better prospects in terms of profitability.

Matt Neal:

OK, excellent. Thank you very much.

Loren Lewallen, Select Equity Group:

Good morning, gentlemen, and congratulations on your very solid results today. I just had a few questions. First, I am wondering if you can talk about the current sales environment, and the outlook for license sales commenting on your pipeline, your general view of how you can perform in this Brazilian economy that seems to have slowed quite a bit over the last couple of months.

The second question is if you could help us better understand the impact of the Brasil Maior plan on your profit generation this quarter. I know you reinvested some of that, but I would love any sort of insight you can give us on the net positive impact that had on your profitability.

And then finally, if you could comment a little bit on the expense side, particularly on selling commission and R&D bucket. You had very good leverage there, and I am hoping you can comment a little bit on the source of that, particularly, for example, on the selling side, we actually had a decline in cost year on year, and also whether we might expect to see that kind of strong leverage over those expenses as we get into the back half of the year. Thank you very much.

Alexandre Dinkelmann:

Thank you for your questions. I will start with the first one, regarding sales environment. One of the strengths of our business model is that we are able to be close to clients in different industries and regions, and Brazil is a continental country. In this sense we see that general GDP metrics do not reflect what is happening mainly in the small and mid size business arena. As we have these wide offerings in the market we are also able to reallocate efforts and focus in order to capture growth opportunities.

And that is what we are doing this year. That is why despite the slowdown in general economy we were able to accelerate our license sales in the quarter, and it is in line with our plan. In this sense we are working to accelerate our growth during the year in the next two quarters. So, it is basically in line with what we are seeing in the market.

And regarding the Brazilian economy, it is really tough to say if it is going to decelerate or accelerate. We believe that because of our resilience in our business model we are able to protect our revenues, even in a worse scenario. So this is the first question. I will pass to Maia to answer the next two questions.

Gilsomar Maia:

Hi, Loren. Just going forward to your question, the second, regarding Brasil Maior impact, one thing that is important to clarify is, Brasil Maior is reflected in the same line of costs and expenses as it used to be reflected. What do I mean by that? Brasil Maior changed the way we calculate the social contribution over payroll.

So, instead of calculating that based on salaries, we start to calculate as a percentage of sales, but the way we allocate that cost is still the same. So we did not change the way we recognize the tax on sales and the way we recognize the social contribution over the payroll. The impact is reflected in all costs and expenses lines that you have personal expenses related.

And in terms of leverage, it was your third question, leverage of sales, commission and other expenses related to our business operation, we understand that we still have lots of room to explore in terms of leverage and efficiency internally. Since the beginning of 2011, we have been investing a significant time here trying to improve the performance and the efficiency of our implementation service team, and we have been able to present part of this efficiency in our service margin.

In other lines, we start to be more focused now, example is the R&D. We acquired almost two years ago some development franchisees, some external developers, and we are working hard to integrate that new development structure with our previous structures, so there are some synergies to be extracted from that front. And commission always reflects the sales mix, so the portion of our sales done through franchises and our own channels.

Actually, I see in 2012 the portion or the distribution between sales through our own channels and third-party channels, the franchisees, more balanced than in 2011. In 2011, performance of our franchisees was much better than our own. In 2012, I see it more balanced than 2011. So, it is closer to 50-50, it sounds good for us.

I do not know if I addressed all of your questions, but if you want you can complement your question.

Loren Lewallen:

That is great, that was very helpful. Just as a brief follow-up on Brasil Maior; that was helpful, you explained the allocation across your different cost lines. Can you comment on the total net benefit? Just how much small your tax bill was due to Brasil Maior?

And then a second one, if I can add one, and then I will let someone else ask questions, on the gross margin side, we saw license gross margin drop quite a bit to the lowest level maybe ever or at least in a long time, or, as you pointed out, service improved. I was wondering if you can just comment on the gross margin for those two line items going forward. Do you expect results similar to the 2Q to carry out going forward, or do you expect things to revert toward historical levels?

Gilsomar Maia:

Regarding the Brasil Maior impact, when Brasil Maior was launched, at the end of 2011, we were talking to the market that, in our mind, we could see an impact of about R$20 million a year of Brasil Maior.

Actually, to discuss the quarterly impact of Brasil Maior is something not very simple, because part of the savings from Brasil Maior we will be investing in our own structure, so it is not a good exercise to isolate the savings from Brasil Maior.

What is important to keep in mind is the size that can produce an impact in the year. And after that, the Federal Government has changed Brasil maior, reducing a little bit more the percentage of social contribution over sales, from August on.

In this quarter specifically, we had the social contribution being calculated as 2.5% of our sales. From August on it is going to be 2%, so probably that initial figure, we estimated about R$20 million a year, can be increased. We still did not calculate exactly how much, but just to give you a sense of size and impact.

And the other question, related to license costs, license costs reflect costs we have with third-party solutions, embedded or not in our own solutions. Actually, what we have is kind of partners developing complementary to ours, and in our strategy for the future it is important to attract this kind of partners, because we know that probably we will not be able to develop everything at the same time, so it is important to have these people developing interesting things with us than against us. When they develop things in our platform and we embed these kinds of solutions, consequently we have to pay some remuneration to these partners, so it is fair enough.

But being more specific to your question, looking at the rest of the year, I see that probably we are going to see a similar level of license cost to the rest of the year, but in a long-term view we understand that our investments in R&D have to be converted into a dilution of that line. It is interesting in the medium to short term to have this kind of complementary solutions, but in the long term we want to see our own solutions growing faster and diluting these kinds of costs. Am I clear in my explanation?

Loren Lewallen:

That is very clear, thank you. And on the service side, the margin improvement there was very impressive. Maybe you were about to get to that, but if you could just talk a little bit about whether you would expect to maintain or improve margins from here on a service side going through the year, or whether we might see them fall back again.

Alexandre Dinkelmann:

Hi, Loren. It is really hard to preview on a quarterly basis and give you guidance, so we avoid this. But in the longer term we believe we will consistently improve our operations in the service side, and basically it derives from two main vectors: one is efficiency itself, so we are investing in technology, in training in order to make our people more productive in the field, and also the mix is changing, so we are adding more value to our service offerings, to our clients, which also impacts positively our profitability in the service side.

So, in the longer term, yes, we believe that we will keep the path of improvements, but it is really hard to tell you something about the next quarter or next couple of quarters.

Loren Lewallen:

Very good. Thank you very much for your time, gentlemen.

Operator:

I am showing no other questions at this time, so I would like to turn the call back over to Mr. Dinkelmann for any final remarks he may have.

Alexandre Dinkelmann:

I would like to thank you all for your time with us, and mainly TOTVS team, our biggest competitive differential. So, thank you all.

Operator:

The conference is now concluded. We thank you for attending today's presentation. You may now disconnect, and have a wonderful day.