

## Private Client Research

8 November 2019

## Xero

## First-half FY20 result review

Xero (XRO) reported a first-half FY20 underlying operating earnings (EBITDA) of NZ\$65.9 million, a 91% increase on the same period last year and 17% ahead of Ord Minnett's forecast due to a combination of better-than-expected revenue and lower-than-expected R&D spending. There was no dividend.

Subscriber growth this half benefited from single-touch payroll (STP) legislation in Australia applying to small business employers. We note UK subscriber additions fell 32% half-on-half (HoH) as the second-half tailwind from the Making Tax Digital program in the UK unwound.

With no further legislative catalysts for cloud adoption on the horizon, we believe subscriber additions are likely to moderate to historical levels for Xero's more mature markets in New Zealand, Australia and the UK.

We note the share price appreciation of 10% (versus the S&P/ASX 200 rising 1%) on the day of the announcement was in excess of our revenue forecast upgrades of 5.4% in FY20, 6.6% in FY21 and 7.4% in FY22, expanding Xero's already-high valuation multiple. We note Xero is trading on an elevated enterprise value (EV) to sales multiple, even when compared to other global software as a service (SaaS) companies.

Despite the stronger-than-expected result, **we maintain our Lighten rating on Xero with a \$60.00 target price.**

- **Subscriber numbers** – Overall, Xero added a net 239,000 subscribers in 1H20 from 2H19, with the largest gains coming from Australia (+114,000) which represented 48% of net additions. The sharp rise in Australian subscribers was likely related to the government's single touch payroll (STP) legislation, which commenced for small employers (of 5–19 employees) on 1 July 2019. We forecast ongoing Australian subscriber growth in line with the five-year historical average of 68,000 per half. The deadline for micro employers (of 1-4 employees) to be STP-compliant is 30 June 2020, which could lead to another sharp rise in (albeit lower-value) subscribers in 1H21. We note, however, the Australian Tax Office (ATO) has listed at least six free software options for these micro businesses to achieve STP compliance, which could dampen the effect of the changes.
- **Revenue** – Xero's average revenue per user (ARPU) was about 10% better than our estimate. We had previously assumed a decline in ARPU in Australia and New Zealand (ANZ) as lower-value STP customers signed up. Instead, Xero noted positive ANZ ARPU trends were driven by an increasing emphasis in New Zealand on additional platform solutions, including payments and payroll. International ARPU saw positive effects from the first price increases for around three years in the UK and favourable USD currency rates within North America and 'rest of world'.

## Recommendation

Lighten

Risk

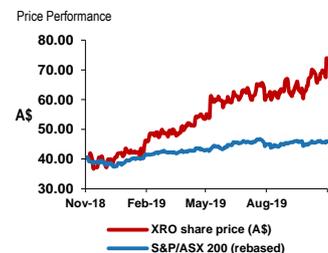
Higher

Target price

\$60.00

Last price

\$73.95



**Price Performance**


	YTD	1m	3m	12m
Abs	76.0%	17.2%	23.4%	72.1%
Rel	56.5%	14.7%	20.1%	57.3%

**Company Data**

Shares O/S (mn)	141
52-week range (\$)	74.54-36.10
Market cap (\$ mn)	7,172.88
Exchange rate	1.45
Free float(%)	67.3%
3M - Avg daily vol (mn)	0.49
3M - Avg daily val (\$ mn)	21.9
Volatility (90 Day)	33
Index	ASX 100
BBG BUY HOLD SELL	7 3 4

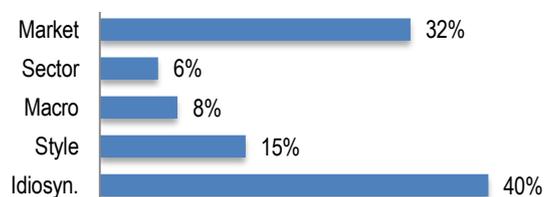
**Key Metrics (FYE Mar)**

NZ\$ in millions	FY19A	FY20E	FY21E	FY22E
<b>Financial Estimates</b>				
Revenue	553	718	881	1,049
Adj. EBIT	10	31	85	140
Adj. EBITDA	92	141	210	273
Adj. net income	(9)	5	45	88
Adj. EPS	(0.06)	0.03	0.32	0.63
BBG EPS	(0.02)	0.12	0.46	-
Cashflow from operations	114	148	199	257
FCFF	4	(2)	42	71
<b>Margins and Growth</b>				
Revenue growth	36.0%	29.9%	22.7%	19.0%
EBIT margin	1.8%	4.3%	9.6%	13.4%
EBIT growth	(134.6%)	212.9%	172.6%	65.6%
EBITDA margin	16.6%	19.6%	23.8%	26.1%
EBITDA growth	252.9%	53.4%	48.9%	30.4%
Net margin	(1.5%)	0.6%	5.1%	8.4%
Adj. EPS growth	(69.7%)	(153.5%)	881.0%	94.7%
<b>Ratios</b>				
Adj. tax rate	(88.4%)	40.9%	25.0%	25.0%
Interest cover	6.3	6.1	8.7	12.2
Net debt/Equity	NM	NM	NM	NM
Net debt/EBITDA	NM	NM	NM	NM
ROE	(3.0%)	1.2%	10.3%	16.1%
<b>Valuation</b>				
FCFF yield	1.1%	1.3%	1.7%	2.2%
Dividend yield	0.0%	0.0%	0.0%	0.0%
EV/EBITDA	112.4	73.3	49.0	37.2
Adj. P/E	NM	2,435.8	248.3	127.5

**Summary Investment Thesis and Valuation**

Xero (XRO) is a New Zealand-based software company that has developed cloud-based accounting software for SMEs and accounting practices. Since listing in NZ in 2007, it has expanded into AU, the UK, US, SE Asia and South Africa. We have retained our Lighten rating on the stock noting that Xero trades on an elevated EV/sales multiple even when compared to other global SaaS companies.

Our Sep-20 price target for Xero of \$60 is in line with our 15-year DCF (WACC: 10.02%, terminal growth rate: 3.0%, risk-free rate: 3.5%).

**Performance Drivers**


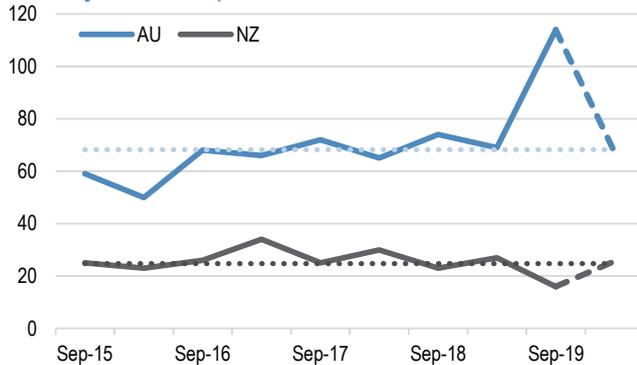
Factors	6M Corr	1Y Corr
<b>Market: MSCI Australia</b>	0.34	0.56
<b>Sect: Technology</b>	0.23	0.29
<b>Ind: Software &amp; Serv</b>	0.36	0.31
<b>Macro:</b>		
Crude Oil	0.40	0.29
TR/CC CRB ER Index	0.17	0.18
Non-Energy Commod	-0.33	-0.17
<b>Quant Styles:</b>		
LowVol	-0.41	-0.37
Value	-0.54	-0.36
Growth	0.41	0.27

Sources for: Performance Drivers – Bloomberg, Ord Minnett Quantitative and Derivatives Strategy; all other tables are company data and Ord Minnett estimates.

## Charting the Focal Points

### +130k ANZ net subscriber adds in past 6m

Figure 1: XRO ANZ subscriber HY net adds (000, 5 year averages shown by dotted lines)

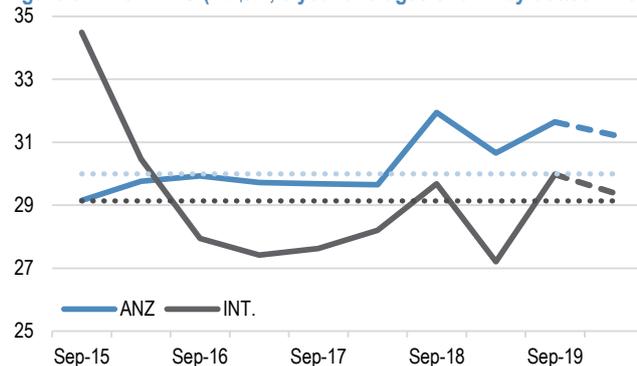


Source: Company reports, Ord Minnett estimates.

Xero added 130k net subscribers in 1H20 in the ANZ region: +114k in Australia and +16k in New Zealand. The Australian net adds were a record and likely as a result of a one-off benefit from Single Touch Payroll legislation in Australia with all businesses employing five or more employees now required to be compliant. Average subscriber adds over the last five years have been: +68k in Australia and +25k in NZ. We forecast +67k (Australia) and +26k (NZ) in 2H20.

### ARPU was a positive surprise in 1H20

Figure 3: XRO ARPU (NZ\$/m, 5 year averages shown by dotted lines)

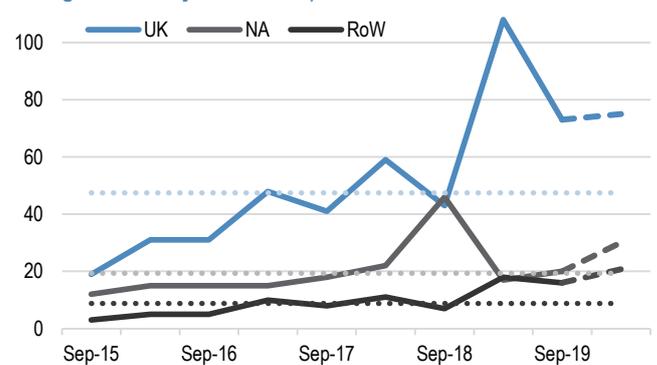


Source: Company reports, Ord Minnett estimates.

Xero reported better-than-expected ARPU with 1H20 growing +3% h/h in ANZ and International ARPU growing +10% h/h. ANZ ARPU saw increasing emphasis on upselling additional offerings in NZ, offsetting a drag from lower-cost STP solutions in Australia. Internationally, Xero raised UK prices for the first time in around three years.

### +109k int'l net subscriber adds in past 6m

Figure 2: XRO International subscriber HY net adds (000, 5 year averages shown by dotted lines)

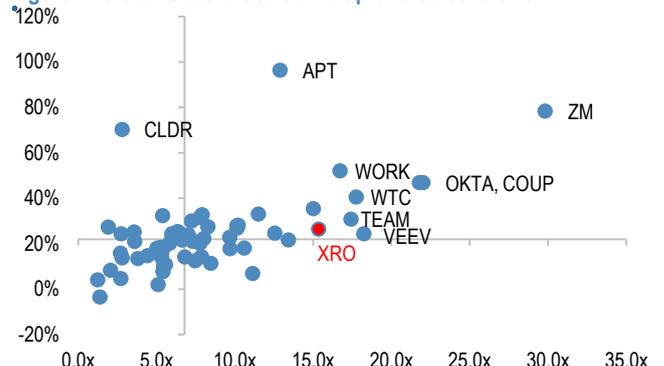


Source: Company Reports, Ord Minnett estimates.

Xero added 109k net subscribers in 1H20 in the International segment: +73k in the UK, +20k in North America and +16k in the Rest of the World. UK net adds fell from 2H19 which benefitted from businesses requiring to meet the 1 April 2019 compliance deadline. Average subscriber adds over the last five years have been: +48k in the UK, +19k in North America and +9k in the Rest of the World. We forecast +75k (UK), +30k (NA) and +21k (RoW) in 2H20.

### Retain Lighten on valuation

Figure 4: Global SaaS EV/Sales Multiple vs Sales Growth



Source: Bloomberg.

Our rolled forward Sep-20 price target of \$60/share is in-line with our DCF valuation. We have retained our Lighten on the stock noting that Xero trades on an elevated EV/Sales multiple compared to other global SaaS peers. (A larger version of this chart can be found at the back of this note.)

## 1H20 Result

Xero's 1H20 subscriber numbers were in-line with our estimates, but a better-than-expected 1H20 result from the company was driven by higher-than-expected ARPU (due to: platform solutions, payments revenue and FX) and lower-than-expected R&D spend.

With legislative changes now largely complete in Australia (Single Touch Payroll) and the UK (Making Tax Digital), we think subscriber growth coming from these markets could moderate as these markets reach maturity from an adoption perspective. This increases our focus on Xero's ability to grow ARPU in these markets (and NZ). While Xero continue to point out a strengthening in their partner channel in the US, 20k net subscriber additions was below our expectations.

Table 1: XRO – 1H20 result

		1H19	2H19	1H20E	h/h	pcp	OMLe	Diff.
<b>Subscribers</b>								
Australia	'000	657	726	840	16%	28%	795	6%
New Zealand	'000	324	351	367	5%	13%	378	-3%
United Kingdom	'000	355	463	536	16%	51%	532	1%
United States	'000	178	195	215	10%	21%	224	-4%
Rest of the World	'000	65	83	99	19%	52%	101	-2%
<b>Total</b>	<b>'000</b>	<b>1,579</b>	<b>1,818</b>	<b>2,057</b>	<b>13%</b>	<b>30%</b>	<b>2,031</b>	<b>1%</b>
<b>Revenue</b>	<b>NZ\$m</b>	<b>256.5</b>	<b>296.3</b>	<b>338.7</b>	14%	32%	<b>323.2</b>	5%
Cost of revenue	NZ\$m	(44.3)	(46.7)	(50.1)	7%	13%	(49.3)	2%
<b>Gross profit</b>	<b>NZ\$m</b>	<b>212.3</b>	<b>249.6</b>	<b>288.5</b>	16%	36%	<b>273.9</b>	5%
- gross profit margin	%	83%	84%	85%	94 bps	244 bps	85%	44 bps
Sales and marketing	NZ\$m	(115.7)	(132.3)	(146.1)	10%	26%	(147.3)	-1%
- as a % of sales	%	45.1%	44.6%	43.1%	-151 bps	-199 bps	45.6%	-245 bps
Product design and development	NZ\$m	(68.9)	(68.9)	(85.3)	24%	24%	(95.0)	-10%
- as a % of sales	%	26.8%	23.3%	25.2%	192 bps	-166 bps	29.4%	-422 bps
General and administration	NZ\$m	(31.1)	(35.0)	(41.1)	18%	32%	(37.2)	11%
- as a % of sales	%	12.1%	11.8%	12.1%	34 bps	3 bps	11.5%	65 bps
<b>EBITDA</b>	<b>NZ\$m</b>	<b>34.5</b>	<b>57.3</b>	<b>65.9</b>	15%	91%	<b>56.4</b>	17%
<b>Underlying NPAT</b>	<b>NZ\$m</b>	<b>(10.8)</b>	<b>2.3</b>	<b>2.4</b>	6%	nm	<b>(12.1)</b>	nm
Net debt / (Net cash)	NZ\$m	(138.7)	(100.6)	(101.4)	1%	-27%	(113.4)	-11%
DPS	NZcps	-	-	-	nm	nm	-	nm

Source: Ord Minnett estimates, company data.

- Overall subscriber numbers in-line with OMLe.** Xero added a net 114k Australian subscribers (h/h) which was higher than we had expected; this was driven by Single Touch Payroll legislation which extended to all employees from July 2019. North American subscribers fell short of our estimates, adding only 20k net subscribers.
- ARPU was better than expected.** ARPU was c.10% better than OMLe. We had previously assumed a decline in ARPU in ANZ as lower-value STP customers signed up; instead Xero noted that positive ARPU trends were driven by an increasing emphasis on additional platform solutions including payments and payroll. International ARPU saw positive effects from price increases in the UK and favourable USD FX within North America and the Rest of World.

**Table 2: XRO – 1H20 ARPU and AMRR**

		1H19	2H19	1H20E	h/h	pcp	OMLe	Diff.
<b>ARPU</b>								
ANZ	NZ\$/m	32.0	30.7	31.6	3%	-1%	28.7	10%
International	NZ\$/m	29.7	27.2	30.0	10%	1%	27.0	11%
<b>AMRR</b>								
ANZ	NZ\$/m	376.1	396.2	458.3	16%	22%	411.7	11%
International	NZ\$/m	213.0	241.9	305.8	26%	44%	279.0	10%

Source: Ord Minnett estimates, company data.

- **EBITDA beat OMLe by 17%.** The beat at the EBITDA line was due to a combination of better-than-expected revenue and lower-than-expected R&D spend.
- **No change to outlook commentary.** Xero have reiterated that FCF for FY20 is expected to be a similar proportion of total operating revenue to that reported in FY19 (which was 1.2%, 1H20 was 1.4%).

### Changes to earnings estimates

We have updated our modelling to include the result. We have increased our revenue estimates to reflect higher ARPU as well as reduced our R&D spend assumptions.

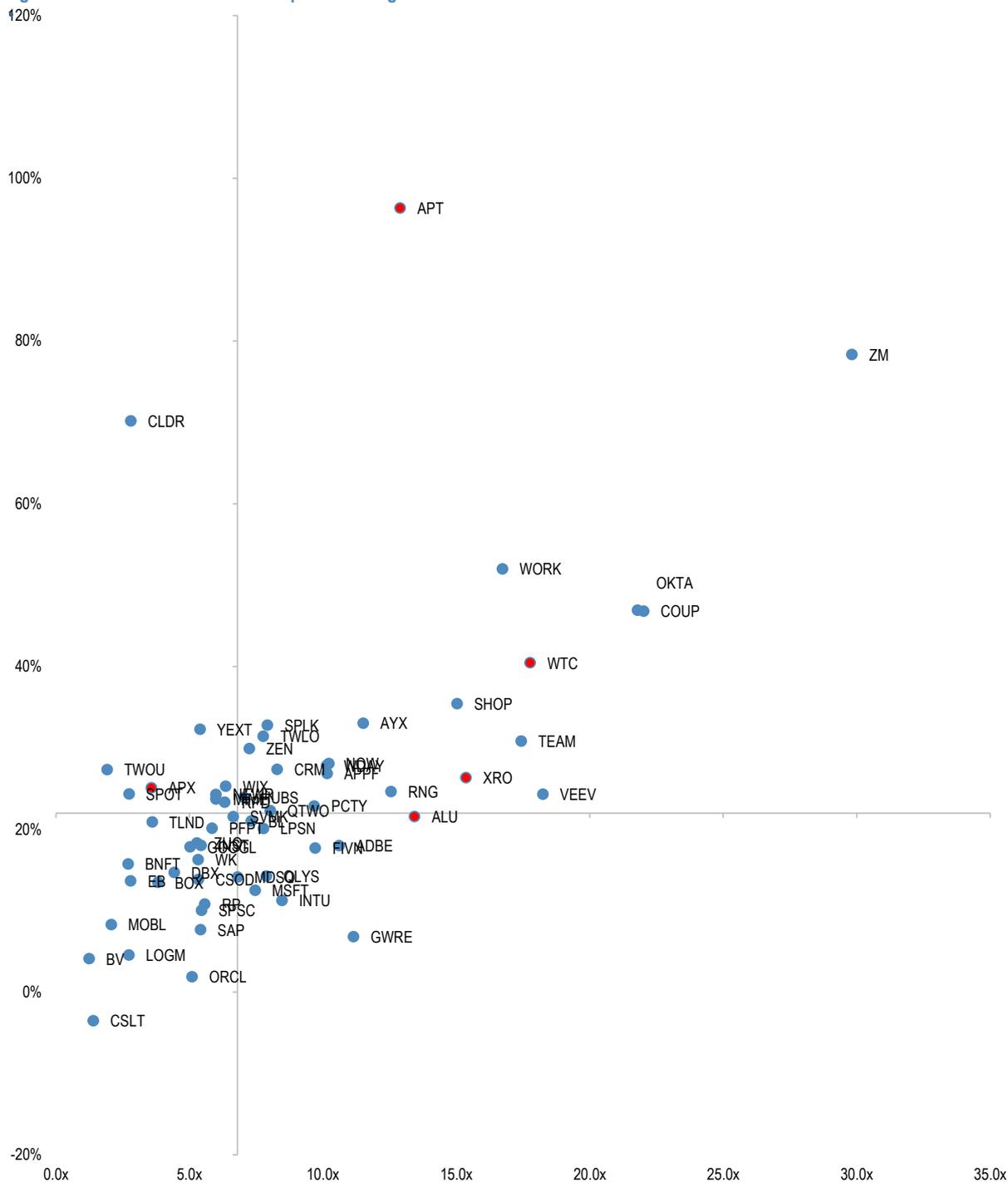
**Table 3: XRO – Earnings changes**

		FY20E			FY21E			FY22E		
		New	Previous	% Change	New	Previous	% Change	New	Previous	% Change
Operating Revenue	NZ\$m	718.2	681.7	5.4%	881.1	826.4	6.6%	1,048.7	976.7	7.4%
Norm. EBITDA	NZ\$m	140.8	119.7	17.6%	209.7	180.4	16.2%	273.5	229.1	19.4%
Norm. EPS	NZcps	3.3	(13.8)	nm	32.2	16.5	94.6%	62.7	39.8	57.4%

Source: Ord Minnett estimates.

## Private Client Research

Figure 5: Global SaaS EV/sales multiple vs sales growth



## Investment Thesis, Valuation and Risks

**Xero** (*Lighten; Price Target: \$60.00*)

### **Investment Thesis**

Xero (XRO) is a New Zealand-based software company that has developed cloud-based accounting software for SMEs and accounting practices. Since listing in NZ in 2007, it has expanded into AU, the UK, US, SE Asia and South Africa. We have retained our Lighten rating on the stock noting that XRO trades on an elevated EV/Sales multiple even when compared to other global SaaS companies.

### **Valuation**

Our Sep-20 PT for XRO of \$60/share is in line with our 15-year DCF (WACC: 10.02%, TGR: 3.0%, Rf: 3.5%).

### **Risks to Rating and Price Target**

Upside risks to our rating and price target include:

- Increase of migration from desktop to cloud software;
- Gain of market share in Australia and New Zealand markets;
- Ability to break into markets with established incumbents;
- Ability to pass on higher-than-expected price increases on products; and
- Ability to extract higher-than-expected operational efficiencies as the company scales up.

## Private Client Research

### Xero

NZ\$ in millions, year end Mar

<b>Profit And Loss</b>	<b>FY18</b>	<b>FY19</b>	<b>FY20E</b>	<b>FY21E</b>	<b>FY22E</b>	<b>Valuation Summary</b>	
						<b>\$m</b>	<b>\$ps</b>
<b>Revenue</b>	<b>407</b>	<b>553</b>	<b>718</b>	<b>881</b>	<b>1,049</b>	Current mkt capitalisation	10,419.33 73.95
Revenue growth	37.6%	36.0%	29.9%	22.7%	19.0%	Price Target	60.00
COGS	(76)	(91)	(104)	(119)	(132)	Capital growth to price target	(18.9%)
Operating Expenses	(241)	(314)	(393)	(467)	(539)		
<b>EBITDA</b>	<b>26</b>	<b>92</b>	<b>141</b>	<b>210</b>	<b>273</b>		
EBITDA growth	(190.9%)	252.9%	53.4%	48.9%	30.4%	<b>Trading Multiples</b>	<b>FY18 FY19 FY20E FY21E FY22E</b>
EBITDA margin	6.4%	16.6%	19.6%	23.8%	26.1%	PE Pre-abnormals	NM NM 2,435.8 248.3 127.5
Amortisation	(47)	(64)	(86)	(102)	(110)	PE Reported	NM NM 3,170.1 248.3 127.5
Depreciation	(8)	(18)	(23)	(23)	(23)	EV/EBITDA	397.6 112.4 73.3 49.0 37.2
<b>EBIT</b>	<b>(29)</b>	<b>10</b>	<b>31</b>	<b>85</b>	<b>140</b>	EV/EBIT	NM 1,039.5 332.1 121.2 72.6
Other Income							
Other Expenses	(1)	0	0	0	0	<b>Key Ratios</b>	<b>FY18 FY19 FY20E FY21E FY22E</b>
Net Interest	2	(14)	(23)	(24)	(22)	Dividend Yield	0.0% 0.0% 0.0% 0.0% 0.0%
<b>Pre-Tax Profit</b>	<b>(27)</b>	<b>(5)</b>	<b>8</b>	<b>60</b>	<b>118</b>	Franking	0.0% 0.0% 0.0% 0.0% 0.0%
Tax	(1)	(4)	(3)	(15)	(29)	Return on Assets (%)	(9.6%) (1.4%) 0.5% 4.0% 7.1%
Tax Rate	(1.9%)	(88.4%)	40.9%	25.0%	25.0%	Return on Equity (%)	(12.5%) (3.0%) 1.2% 10.3% 16.1%
Minorities						ROIC (%)	- - - - -
Abnormals (post tax)	0	(19)	(1)	0	0		
<b>Reported NPAT</b>	<b>(28)</b>	<b>(27)</b>	<b>4</b>	<b>45</b>	<b>88</b>	<b>Leverage</b>	<b>FY18 FY19 FY20E FY21E FY22E</b>
						Gearing (Net Debt / Equity)	NM NM NM NM NM
<b>Normalised NPAT</b>	<b>(28)</b>	<b>(9)</b>	<b>5</b>	<b>45</b>	<b>88</b>	Gearing (ND / (ND + E))	(55.8%) (39.8%) (35.1%) (47.1%) (64.1%)
Growth	(59.7%)	(69.3%)	(153.5%)	881.0%	94.7%	Net Debt / EBITDA	NM NM NM NM NM
						EBIT Interest Cover (x)	13.5 0.7 1.3 3.5 6.3
End of Period Shares	138	139	141	141	141		
EFPOWA	138	139	141	141	141	<b>Balance Sheet</b>	<b>FY18 FY19 FY20E FY21E FY22E</b>
						Cash	80 458 498 549 635
Reported EPS	(0.20)	(0.19)	0.03	0.32	0.63	Receivables	35 49 62 76 90
<b>Normalised EPS</b>	<b>(0.20)</b>	<b>(0.06)</b>	<b>0.03</b>	<b>0.32</b>	<b>0.63</b>	Investments	- - - - -
Growth	(59.7%)	(69.7%)	(153.5%)	881.0%	94.7%	Inventories	- - - - -
						Other Current Assets	4 79 95 95 95
DPS	0.00	0.00	0.00	0.00	0.00	<b>Total Current Assets</b>	<b>118 587 656 720 820</b>
Growth	-	-	-	-	-	Net PPE	21 91 89 88 90
						Total Intangibles	145 290 334 360 396
DPS/EPS payout	0.0%	0.0%	0.0%	0.0%	0.0%	Other Non Current Assets	5 2 4 4 4
						<b>Total Non Current Assets</b>	<b>171 384 428 451 490</b>
<b>Cash Flow Statement</b>	<b>FY18</b>	<b>FY19</b>	<b>FY20E</b>	<b>FY21E</b>	<b>FY22E</b>	<b>Total Assets</b>	<b>289 970 1,083 1,171 1,309</b>
Net Profit for Cashflow	(28)	(27)	4	45	88	Creditors	26 27 34 39 44
Depreciation & Amortisation	55	82	110	125	133	Current Borrowings	0 0 0 0 0
Non Cash Items	-	-	-	-	-	Current Tax Provisions	1 2 1 1 1
Working Capital Changes	36	117	164	239	309	Other Current Provisions	28 38 38 38 38
Other Operating Cashflows	(22)	(58)	(130)	(210)	(273)	Other Current Liabilities	6 38 47 47 47
<b>Cashflow from Operating Activities</b>	<b>41</b>	<b>114</b>	<b>148</b>	<b>199</b>	<b>257</b>	<b>Total Current Liabilities</b>	<b>61 105 120 124 130</b>
						Non Current Creditors	- - - - -
Capex	(15)	(16)	(14)	(21)	(25)	Non Current Borrowings	0 358 395 395 395
Net Acquisitions	0	(30)	0	0	0	Deferred Tax Liabilities	0 2 1 1 1
Other Investing cashflows	(64)	(94)	(126)	(127)	(146)	Other Non Current Provisions	2 0 0 0 0
<b>Investing Cash Flow</b>	<b>(78)</b>	<b>(140)</b>	<b>(140)</b>	<b>(148)</b>	<b>(172)</b>	Other Non Current Liabilities	3 152 169 169 169
						<b>Total Non Current Liabilities</b>	<b>5 512 565 565 565</b>
Inc/(Dec) in Borrowings	1	447	0	0	0	<b>Total Liabilities</b>	<b>66 617 685 689 695</b>
Equity Issued	0	0	0	0	0	Equity	538 628 644 644 644
Dividends Paid	0	0	0	0	0	Other Equity	0 0 0 0 0
Other Financing Cashflows	29	(303)	(22)	0	0	Reserves	20 69 95 134 177
<b>Financing Cash Flow</b>	<b>30</b>	<b>144</b>	<b>(22)</b>	<b>0</b>	<b>0</b>	Retained Profits	(335) (344) (340) (295) (207)
						Outside Equity Interests	- - - - -
Net Cash Flow	(7)	101	(8)	51	85	<b>Total Shareholders Equity</b>	<b>223 353 399 482 614</b>
						Net Debt	(80) (101) (104) (155) (240)

Source: Company reports and Ord Minnett estimates.

Please contact your Ord Minnett Adviser for further information on our document.

## Guide to Ord Minnett Recommendations

Our recommendations are based on the total return of a stock – nominal dividend yield plus capital appreciation – and have a 12-month time horizon.

<b>SPECULATIVE BUY</b>	We expect the stock's total return (nominal yield plus capital appreciation) to exceed 20% over 12 months. The investment may have a strong capital appreciation but also has high degree of risk and there is a significant risk of capital loss.
<b>BUY</b>	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over the next 12 months.
<b>ACCUMULATE</b>	We expect a total return of between 5% and 15%. Investors should consider adding to holdings or taking a position in the stock on share price weakness.
<b>HOLD</b>	We expect the stock to return between 0% and 5%, and believe the stock is fairly priced.
<b>LIGHTEN</b>	We expect the stock's return to be between 0% and negative 15%. Investors should consider decreasing their holdings.
<b>SELL</b>	We expect the total return to lose 15% or more.
<b>RISK ASSESSMENT</b>	Classified as Lower, Medium or Higher, the risk assessment denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, historical volatility of its share price, nature of its operations and other relevant quantitative and qualitative criteria. Risk is assessed by comparison with other Australian stocks, not across other asset classes such as Cash or Fixed Interest.

## Ord Minnett Offices

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