

28 July 2022



Xero (XRO)

The company will hold its Annual Shareholders Meeting at **11.00am Thursday 18 August 2022.**

Due to concerns around Covid it will be a virtual meeting. You can join the meeting [online here](#).

Company Overview

The company was listed on the NZX in 2006, and subsequently moved its listing to the ASX. It is a provider of online accounting software to small business. It has over 3.2 million subscribers; 1.3 million in Australia, 512,000 in New Zealand, 850,000 in the UK, 339,000 in North America and 226,000 in the rest of the world. It employs over 4,500 people in offices in Australia, New Zealand, UK, Canada, Singapore, Hong Kong, and South Africa.

Current Strategy

To be a leading supplier of online accounting software to small business.

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Key

The following sections calculate an objective rating against criteria contained within NZSA policies.

Colour	Meaning
G	Strong adherence to NZSA policies
A	Part adherence or a lack of disclosure as to adherence with NZSA policies
R	A clear gap in expectations compared with NZSA policies
n/a	Not applicable for the company

Governance

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment	Notes
Directors Fees	G	See below.
Director share ownership	G	Directors are not required to own shares.
Executive Remuneration	A	See below.
Golden parachutes/handshakes	A	See below.
Director Independence	G	A majority of Directors are independent.
Board Composition	A	See below.
Director Tenure	G	See below.
ASM Format	G	Virtual only – but Covid-19 impacted
Independent Advice for the Board	G	See below.

Directors Fees: Generally good disclosure. While no special exertion payments were paid in FY2022, there is no disclosure as to whether they are able to be made.

Executive Remuneration: The CEO is paid a base salary, a short-term incentive (STI) and a long-term incentive (LTI). The salary and 50% of the STI are paid in cash. The other 50% of the STI is paid by way of restricted stock units, vesting after one year. The LTI is paid by way of share options, vesting after three years.

NZSA notes the significant 18% increase to the CEO's fixed remuneration in FY22, as well as the increase to the STI 'target-level' opportunity (60% → 80%).

NZSA encourages fulsome disclosure in relation to any incentive payments made to the CEO, including disclosure of measures (or measure 'groups'), weightings, targets and the level of achievement associated with any awards.

Xero clearly discloses measures and weightings that comprise the STI and LTI methodology, as well as the level of achievement associated with individual components applied for the previous 5 years.

For the CEO, Xero's balance of incentives at target opportunity is approximately equal between STI and LTI, although is weighted more heavily towards STI at maximum opportunity (NZSA prefers a weighting towards LTI). Total available incentives are well in excess of base remuneration (160% at target), a position not generally supported by NZSA although we recognise that the CEO is subject to Australian benchmarks rather than those applicable in New Zealand.

We also note there is no 'cap' on the value of the LTI (again, a position not supported by LTI), although shareholders commensurately benefit as the CEO's LTI increases.

Nonetheless, the company notes the significant increase in CEO payment received in FY2022, largely as a result of the options awarded in 2019 vesting during the year. Total payments to the CEO in FY2022 amounted to a little over \$13m, a level unheard of in New Zealand. We believe that this level of payment has potential to create some political risk applicable beyond Xero relating to executive remuneration frameworks in New Zealand, and would encourage Xero to consider applying caps on the value (or number of options) associated with its share-based payments.

NZSA applauds the company's disclosure, amongst the best for a New Zealand company. We believe, however, that the framework design has led to an outcome that offers some risk exposure for Xero and other companies.

Golden parachutes/handshakes: The company operated a retention scheme from 2018 by way of share options. The last tranche vested in June 2022. NZSA does not favour any such payments without performance hurdles.

The company discloses the notice periods applicable to the CEO on leaving the organisation

In the interests of transparency, NZSA believes there should also be explicit disclosure around the severance terms associated with the CEO, including whether specific termination payments are offered.

Board Composition: The Annual Report includes a skills matrix, but it does not attribute skill sets to individual Directors to demonstrate how they contribute to the governance of the company.

The company does not participate in any form of emerging or future Director programme designed to develop and mentor the next generation of Directors. NZSA expect NZX50 (or equivalent) companies to participate as part of a responsibility to develop and mentor the next generation of Directors.

The nature of the company's board and operations indicates a strong commitment to thought, experiential and social diversity, with relevant experience for Xero.

Director Tenure: NZSA looks for evidence of ongoing succession or 'staggered' appointment dates that reduce the risks associated with effective knowledge transfer in the event of succession. We also prefer a term maximum of 9-12 years, unless there are exceptional circumstances that may apply.

The founder Rod Drury has served since the company was formed in 2006. NZSA recognises the unique role a founder plays on a company's Board.

ASM Format: NZSA prefers 'hybrid' ASM's (i.e., physical, and virtual) as a way of promoting shareholder engagement while maximising participation.

We recognise, however, the company's disclosure and logic for a virtual meeting based on Covid-19.

Independent Advice for the Board: NZSA looks for evidence, through disclosures, that a Board has access to appropriate internal and external expertise to support board assurance activities. We also look for evidence that Boards are across their risk management responsibilities.

Xero provides excellent disclosure on its risk management framework, highlighting the key role played by independent reviews within this framework. There is good disclosure of financial, operational and business risks provided.

Notwithstanding, it is unclear as to the extent to which key assurance roles have unfettered access to the Board or whether individual Board members are able to seek external advice to support decision-making.

Audit

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment	Notes
Audit independence	G	Good disclosure
Audit rotation	A	See below.

Audit Rotation: Whilst the company ensures the Lead Audit Partner is rotated at 5 years, it does not disclose if the Audit Firm is rotated at 10 years. The appointment date of the Lead Audit Partner is disclosed but not the date of appointment of the Audit Firm.

Ethical and Social

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment	Notes
Whistleblowing	G	Good disclosure.
Political donations	G	No donations were made.

We note Xero's commitment to the "MindTheGap" initiative in New Zealand, focused on gender pay equity. The company also discloses the specific initiatives it undertakes internally as part of their commitment to "qual pay for equal work".

Financial & Performance

Policy Theme	Assessment	Notes
Dividends and Imputation	n/a	No dividend was paid.
Capital Raise process	n/a	There was no capital raising.
Takeover or Scheme	n/a	

Xero's share price fell from \$136 to \$86.34 (as of 20th July 2022) over the last 12 months – a 37% decline. This compares unfavourably with the NZX 50 which declined by 12% in the same period. The capitalisation of XRO is \$12.9b placing it 2nd out of 131 companies, were it listed on the NZX by size and makes it a large company.

XRO are a NZ company that trades on the ASX. Its share price is listed in AUD, however its financials are all in NZD.

Metric	2022 (\$m)	2021 (\$m)	Change
Revenue	\$1,097m	\$848.8m	29%
Gross Profit	\$957m	\$730m	31%

Operating Surplus	\$41.9m	\$61.7m	-32%
NPAT	-\$9.1m	\$19.8m	n/a
EPS	-\$0.061	\$0.134	n/a
PE Ratio	n/a	1134	
Current Ratio	5.45	7.13	-24%
Debt Equity (adjusted)	1.27	1.71	-26%
Operating CF	\$236.4m	\$218.6m	8%
NTA Per Share	\$0.50	\$1.77	-72%
Equity Per Share	\$6.91	\$5.04	37%

XRO are continuing their growth strategy and as a result, revenues were up by 29% to \$1,097m and an improved Gross Profit of \$957m was recorded. The company gained 530k subscribers and has 3.27 million subscribers at balance date (2.74 million)

XRO continue to invest in sales and marketing and these expenses were up by 32% to \$405m whilst product design expenses were also up 49% to \$372m. General admin expenses were up 36% to \$144m. Aggregating these, total operating expenses were up by 37% to \$915m. Increased revenues and expenses led to a slightly lower Operating Surplus of \$41.9m (FY 21, \$61.7m).

NPAT was **-\$9.1m** and EPS were **-\$0.061**. Operating cashflows increased by 8% to \$236m and when measured in cents per share are \$1.58.

The company is in sound financial position with a high current ratio of 5.45 and a relatively comfortable debt equity ratio of 1.27. During the year the company increased its Intangible assets by 98% to \$959m and this caused a reduction in their NTA from \$1.77 to \$0.50.

XRO trades on extremally high premiums to its NTA.

In a detailed presentation [released to market](#) on 12th May 2022, XRO outlined a rather brief outlook statement where they stated: *“Xero will continue to focus on growing its global small business platform and maintain a preference for reinvesting cash generated, subject to investment criteria and market conditions, to drive long-term shareholder value. Total operating expenses (including acquisition integration costs) as a percentage of operating revenue for FY23 are expected to be towards the lower end of a range 80-85%”.*

Resolutions

1. That the Board is authorised to fix the auditor’s remuneration for the coming year.

This is an administrative resolution.

We will vote undirected proxies **IN FAVOUR** of this resolution.

2. To re-elect David Thodey as an Independent Director.

David Thodey was appointed to the Board in June 2019 and Chair in February 2020. He is also chairman of Tyro, Australia's only independent EFTPOS provider, and a non-executive director of Ramsay Health Care, a global hospital group. He was formerly CEO of IBM Australia and New Zealand and Telstra, and a director of Vodafone Group, CSIRO, CSL and TelstraClear. He was recognised for his services to business and ethical business leadership with an Order of Australia (AO) in 2017.

We will vote undirected proxies **IN FAVOUR** of this resolution.

3. To re-elect Susan Peterson as an Independent Director.

Susan Peterson was appointed to the Board in February 2027. She is currently the chair of Vista Group and an independent director of Property for Industry, Arvida Group and Craigs Investment Partners. She is also a board member of non-profit Global Women and was previously a member of the New Zealand Markets Disciplinary Tribunal. Susan is a past director of ASB Bank and Trustpower and was a past Ministerial appointee to the National Advisory Council on the Employment of Women. Susan holds a Bachelor of Commerce and Bachelor of Laws from the University of Otago.

We will vote undirected proxies **IN FAVOUR** of this resolution.

4. To elect Brian McAndrews as an Independent Director.

Brian McAndrews was appointed to the Board in February 2022 and is therefore required to offer himself for election. He is currently lead director of Frontdoor, the largest provider of home service plans in the United States and is Presiding Director on the board of The New York Times. He was previously a director of Chewy, Teledoc Health and Chairman of Grubhubis. His experience includes leading Pandora Media, a streaming music provider in the US, and aQuantive, a digital marketing services and technology company that was acquired by Microsoft. He holds a Bachelor of Arts with Honours in Economics from Harvard College and a Master of Business Administration from the Stanford Graduate School of Business.



We will vote undirected proxies **IN FAVOUR** of this resolution.

Proxies

You can vote online or appoint a proxy at <https://www.linkmarketservices.com.au/>

Instructions are on the Proxy/voting paper sent to you.

Voting and proxy appointments close **11.00am Tuesday 16 August 2022.**

Please note you can appoint the Association as your proxy. We will have a representative attending the meeting.

The Team at NZSA