

17 July 2023



## **Xero (XRO)**

The company will hold its Annual Shareholders Meeting at **11.00am Thursday 17 August 2023.**

It will be a virtual only 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 3.74 million subscribers in over 180 countries with offices in Australia, New Zealand, UK, USA, Canada, Singapore, Hong Kong, and South Africa.

During the year Steve Vamos who had served as CEO for 5 years retired and Sukhinder Cassidy was appointed CEO. In July 2023, the company announced Anjali Joshi was being appointed to the Board and (founder) Rod Dury and Lee Hatton were retiring from the Board.

Rod Dury will remain an adviser to the company.

### ***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	See below.
Executive Remuneration	G	See below.
Golden parachutes/handshakes	A	See below.
Director Independence	G	A majority of Directors are independent.
Board Composition	G	See below.
Director Tenure	G	See below.
ASM Format	R	Virtual only. See below.
Independent Advice for the Board and Risk Management	G	See below.

**Directors Fees:** Generally good disclosure however it is not disclosed if special exertion payments are made. This year, there is a resolution before shareholders to approve an increase in Directors Fees.

We note from the Notice of Meeting that *“This will not impact base fees and instead represents some changes to fees for specific roles and committees.”*. However, the major driver for the fee pool change is to allow an additional director on the Board, a position supported by NZSA.

**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 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 versus target for each component associated with any awards.

Xero clearly discloses measures and weightings that comprise the STI and LTI methodology. At the maximum STI and LTI achievement, the weightings are Base Salary 11%, STI 14% and LTI 75%. NZSA policy is that the weighting should be on the LTI to align with shareholders’ interests.

We commented last year on the then CEO’s total remuneration value and how this level of payment has potential to create some political risk applicable beyond Xero relating to executive remuneration frameworks in New Zealand, and that we would encourage Xero to consider applying caps on the value (or number of options) associated with its share-based payments. However, we also note that Xero’s CEO remuneration framework is likely to be comparable with similar companies in the US market.

NZSA applauds the company’s disclosure, amongst the best for a New Zealand company.

**Golden parachutes/handshakes:** 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 nature of the company’s board and operations indicates a strong commitment to thought, experiential and social diversity, with relevant experience for Xero.

NZSA notes the impending retirement from the Board of founder Rod Drury. NZSA always respects the role that founders play on a Board and we have no doubt he will be sorely missed. From a shareholders perspective, however, it is clear the company has a succession plan to ensure Xero has a sustainable governance future.

**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.

With the retirement of (founder) Rod Dury and Lee Hatton, all Directors have served less than 9 years.

**ASM Format:** NZSA prefers ‘hybrid’ ASM’s (i.e., physical, and virtual) as a way of promoting shareholder engagement while maximising participation. While Xero’s shareholders reflect the multinational basis of its business and global scale, we would still expect a hybrid meeting, wherever in the world it may be.

**Independent Advice for the Board & Risk Management:** 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.

Directors can, with the consent of the Chair, seek independent external professional advice. The Company Secretary has direct access to the Board but reports to the CEO. The General Manager of Assurance reports to the Executive General Manager of Risk and Assurance and also has direct access to the Chair of the ARM Committee.

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.

## **Audit**

NZSA assessment against its key policy criteria is summarised below:

<b>Policy Theme</b>	<b>Assessment</b>	<b>Notes</b>
Audit independence	G	Good disclosure.
Audit rotation	A	See below.

**Audit Rotation:** The company ensures the Lead Audit Partner is rotated at 5 years and discloses the rotation date however it does not disclose if the Audit Firm is rotated at 10 years or the appointment date of the Audit Firm.

NZSA also expects disclosure of the appointment dates of the Lead Audit Partner and Audit Firm to improve transparency for investors.

**Environmental Sustainability**

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment
Approach	G
Sustainability Governance	G
Strategy and Impacts	G
Risk and Opportunity	A
Metrics and Targets	G
Assurance	R

Overall approach: Xero’s Annual Report for 2023 has been prepared with reference to the Integrated Reporting Framework and structures the report into five areas, one of which is Social and Environmental. They have also produced a separate TCFD Statement for FY23. By virtue of being listed on the ASX, Xero will also be affected by the proposed Australian mandatory climate-related disclosures for all companies, starting with larger companies from 2024/25.

Xero has made good progress in their voluntary climate disclosures when assessed against NZSA’s Environmental Sustainability policies.

Sustainability Governance: In addition to disclosing a skills matrix showing the number of directors with high or moderate capability in nine areas of expertise, Xero also has an ESG Steering Committee and Climate Working Group.

Strategy and Impact: Xero say they undertake an annual climate-related risk assessment to inform their ESG strategy which then feeds into their company strategy. While Xero doesn’t have a dedicated climate adaptation roadmap, they do disclose a three-year climate reporting roadmap.

Risk and Opportunity: While work on comprehensively reporting on Xero’s climate-related risks and opportunities is still ongoing, they do disclose some preliminary physical and transitional risks.

Metrics and Targets: Xero discloses their Scope 1 -3 carbon emissions and have developed a number of climate-related targets.

Assurance: There was no mention of Xero’s sustainability reporting being audited or reviewed with the auditor (EY) stating that they only audited the financial statements.

**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 are made.

### Financial & Performance

Policy Theme	Assessment	Notes
Capital Management	G	See comments below.
Takeover or Scheme	n/a	n/a if no takeover

Xero's share price rose from \$86.34 to \$124.40 (as of 18<sup>th</sup> July 2022) over the last 12 months – a 44% increase. This compares favourably with the NZX 50 which rose by 10% in the same period – were it listed on the NZX, it would be the largest company with a market capitalisation of \$18.8b.

XRO are a NZ-incorporated company with its only listing on the ASX. Its share price is listed in AUD; however, its financials are all in NZD.

Metric	2021	2022	2023	Change
Revenue	\$848.8m	\$1,097m	\$1,400m	28%
Gross Profit	\$730m	\$957m	\$1,222m	28%
Operating Surplus	\$61.7m	\$41.9m	-\$59.8m	n/a
NPAT	\$19.8m	-\$9.1m	-\$113.5m	n/a
EPS	\$0.134	-\$0.061	-\$0.75	n/a
Subscribers	2.74m	3.27m	3.74m	17%
Capitalisation		\$12.9b	\$18.8b	46%
PE Ratio	1134	n/a	n/a	
Current Ratio	7.13	5.45	4.95	-9%
Debt Equity (adjusted)	1.71	1.27	1.36	8%
Operating CF	\$218.6m	\$236.4m	\$390.4m	65%
NTA Per Share	\$1.77	\$0.50	\$0.60	20%
Equity Per Share	\$5.04	\$6.91	\$6.96	1%

XRO are continuing their growth strategy and as a result, revenues were up by 28% to \$1,400m and an improved Gross Profit of \$1,222m (up 28%) was recorded. The company gained 470k subscribers and has 3.74 million subscribers at balance date (3.27 million)

XRO continue to invest in sales and marketing and these expenses were up by 16% to \$472m whilst product design expenses were also up 32% to \$490m. General admin expenses were up 17% to \$168m. Aggregating these, total operating expenses were up by 40% to \$1,282m. Increased revenues but also increased expenses led to a lower Operating Surplus of **-\$59.8m** (FY 22, \$41.9m).

NPAT was **-\$113.5m** and EPS were **-\$0.75**. Operating cashflows increased by 65% to \$390m (\$2.58 per share).

The company is in sound financial position with a high current ratio of 4.95. The company has over \$1b in cash and short-term deposits - but also over \$1b in interest bearing debt, resulting in a relatively comfortable debt equity ratio of 1.36. This rather unusual capital structure, driven by the company issuing convertible notes in FY21, has cost the company approximately \$16m for FY23 in net finance expenses.

The company has an NTA of \$0.60. unsurprisingly, given the technology focus of its core business, XRO trades on extremally high premiums to its NTA.

In a detailed presentation [released to market](#) on 18<sup>th</sup> May 2023, Xero provided a brief outlook statement on page 32 where that stated they: *will seek to balance growth and profitability in its approach to capital allocation, subject to investment criteria and market conditions, to drive long-term shareholder value along with reinvestment in strategic priorities management is targeting an operating expense to operating revenue ratio in FY24 of around 75%. This will improve operating income margin compared to FY23 Xero's long-term aspiration is to continue to improve its operating expense ratio and its operating income margin, although a specific timeline has not been set. These ratios, and their component parts, may vary from period to period as we identify opportunities for disciplined, customer-focused growth.*

### **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 Mark Cross as an Independent Director.**

Mark Cross was appointed to the Board in April 2020. He is Chair of Chorus and a Director of the Accident Compensation Corporation. He was previously a Director of Z Energy and Chair of Milford Asset Management.

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

**3. To elect Anjali Joshi as an Independent Director.**

Anjali Joshi was appointed to the Board 3 July 2023 and is therefore required to offer herself for election. She is a Director of Alteryx and LocoNav and was previously a Director of Lattice Semiconductor, Iteris, Mobileiron and McClatchy. She is on the advisory board of the Markkula Centre for Applied Ethics at Santa Clara University and an Executive in Residence at INSEAD in France.

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

**4. To reapprove the US Incentive Scheme.**

This resolution relates to the incentive scheme for certain XERO United States employees where the company grants options to purchased shares in the company. Security laws in California and US tax laws requires shareholders approval for such schemes. Full details are set out in the Notice of Meeting.

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

**5. To increase the Directors Fee Pool by \$600,000 from \$2,700,000 to \$3,300,000.**

The current Fee Pool was approved at the 2021 ASM. The policy is to review Fees every two years.

NZSA policy is that were companies seek to increase fees, this should be supported by an independent report detailing the benchmarking methodology, comparator company data and setting out the proposed Fees to be paid to each Director.

In this case, however, we note that there is no change to the individual payments received by directors, with the increase in fee pool providing scope for an additional director. We think this could have been made clearer in the Notice of Meeting.

On this basis, 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 15 August 2023.**

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

**The Team at NZSA**