Xero Limited interim report

For the six months ended
30 September 2015

xero

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Performance highlights

Executing on strong global growth with improving operating metrics

Executing on global growth opportunity

Annualised committed monthly revenue of $218.2 million, an increase of $85.9 million (65%) from $132.3 million at 30 September 2014.

Subscription revenues of $89.8 million, increasing $37.6 million (72%) from $52.2 million for H1 FY15.

YoY international growth of 110% operating revenue (76% in constant currency) and 79% subscribers in markets outside Australia and New Zealand.

North American subscriber growth of 114% over H1 FY15.

Market leadership

Delivered subscriber growth of 222,000 (60%) in the last 12 months to 593,000 paying subscribers globally.

Market leading cloud position in Australia and New Zealand (ANZ) with over 425,000 subscribers.

First small business cloud accounting company in the UK to surpass 100,000 subscribers.

Improving operating metrics while investing for growth

Gross margin has increased from 67% to 74% due to improved efficiencies and economies of scale across hosting and bank feed costs.

Operating and investing cash flows steady at $49.5 million compared to $48.5 million for H2 FY15.

Q2 FY16 cash usage has reduced from the prior four quarters reflecting a greater proportion of investment being funded by strong receipts.

Contribution margin in the more developed ANZ market increasing from 22% in H1 FY15 to 27% in H1 FY16 while continuing investments to drive operating revenue growth of 59%.

Net loss after tax of $44.3 million, an increase of $19.8 million from the $24.5 million loss for H1 FY15 but broadly in line with H2 FY15, reflecting the increased investment in product development and distribution channels.

Closing cash position of $224.5 million.

Chairman and Chief Executive report

Xero delivered strong global growth while improving operating metrics during the first half of the financial year reflecting positive overall business performance.

Financial highlights for the six months to 30 September 2015 were:

- annualised committed monthly revenue of $218.2 million, an increase of $85.9 million (65%) from $132.3 million at 30 September 2014
- subscription revenues of $89.8 million, an increase of $37.6 million (72%) from $52.2 million for H1 FY15
- 593,000 paying subscribers globally, an increase of 222,000 (60%) from 371,000 at 30 September 2014
- net loss after tax of $44.3 million, an increase of $19.8 million from the $24.5 million loss for H1 FY15 but broadly in line with H2 FY15, reflecting the increased investment in product development and distribution channels
- operating and investing cash outflows steady at $49.5 million compared to $48.5 million for H2 FY15 and impacted adversely by a declining NZD
- closing cash position of $224.5 million.

Growing market leadership

Over the past year, cloud market adoption has accelerated and Xero has strengthened its market position, continuing to be one of the fastest growing SaaS companies in the world.

With more than half-a-million subscribers using Xero globally, Xero continues to set the industry agenda for innovation, grow market share, and broaden its total addressable market.

Xero's global market position has attracted high value partnerships with world leading cloud technology companies, financial institutions and banks, giving small businesses access to sophisticated cloud platforms and services once only available to big business.

Key global highlights include:

- in the United Kingdom, Xero is the first small business cloud accounting solution to surpass 100,000 subscribers
- rest of the world expansion continues with subscribers in over 180 countries
- North America added 12,000 net new subscribers during the off-peak season to close at 47,000, a 300% improvement over subscribers added for H1 FY15
- cloud accounting market leader in Australia and New Zealand with 425,000 subscribers.

Product development and service delivery

The substantial investments in building Xero's team and internal capability is seeing us deliver innovation at a rapid cadence for Xero's customers.

We have:

- expanded the solutions ecosystem with over 40% of premium editions connecting to one of Xero's 400+ solution partners
- established significant global strategic partnerships and integrations with top technology companies that are shaping the future of cloud
- delivered hundreds of updates and more than 40 new

features, including payroll in 15 U.S. states, 11 strategic partnership integrations, automated Australian tax submission, and invoice reminders to speed up small business cash flow

- delivered best-in-class experiences and 99.99% uptime.

Experienced leadership

We have built a world-class team in all levels of the business that demonstrates disciplined execution to deliver on the global growth opportunity.

The Company has attracted top global talent to its board and executive teams across the world, while aligning for global execution. This includes:

- successful completion of the CFO transition to Sankar Narayan, a seasoned global public company executive with Silicon Valley experience
- alignment for growth by broadening the responsibilities of CMO, Andy Lark, to encompass global marketing, sales, partnerships and education
- accelerating automation and big data innovation under Tony Stewart who was recently appointed to the newly established role of Chief Data Officer.

Outlook

In the first half of this year the Company has continued to grow the team and its capability, leading the market in innovation with disciplined investments in product and distribution channels while delivering another period of strong growth in new subscribers. Operating metrics are expected to continue to improve as the Company continues to drive efficiencies through automation and economies of scale in cost to serve, customer acquisition and product development.

We've achieved strong growth for the first half and we're on track to achieve $200 million NZD subscription revenue based on June 2015 foreign exchange rates this financial year. The Company is focused on containing its full financial year cash outflow to similar levels to the prior financial year. This growth, as well as the rigour that we have established within the business, positions Xero for long-term value creation.

While early SaaS companies have been focussed on medium to large enterprises, Xero's connected ecosystem gives access to the global small business market, positioning us to maintain strong growth rates for an extended period of time and drive further revenue monetisation opportunities in the future.

Chris Liddell
Chairman

Rod Drury
Chief Executive

Management commentary

The information below compares the results for the six months to 30 September 2015 with the six months to 30 September 2014. It should be read in conjunction with the consolidated financial statements and the related notes in this report.

All numbers are presented in New Zealand dollars (NZD), except where indicated.

BUSINESS RESULTS

Six months ended 30 September	2015 ($000s)	2014 ($000s)	% change	6 months ended 31 March 2015
Subscription revenue	89,751	52,200	72%	68,728
Other operating revenue	3,113	2,095	49%	827
Operating revenue	**92,864**	**54,295**	**71%**	**69,555**
Cost of revenues	(24,497)	(18,016)	36%	(19,387)
Gross profit	68,367	36,279	88%	50,168
Percentage of operating revenue	74%	67%	7%	72%
Total operating expenses	**(119,600)**	**(65,162)**	**84%**	**(98,877)**
Percentage of operating revenue	129%	120%	9%	142%
Other income and foreign exchange	3,825	963	297%	1,485
Operating deficit	**(47,408)**	**(27,920)**	**70%**	**(47,224)**
Percentage of operating revenue	51%	51%	-	68%
Net interest income	4,689	4,128	14%	3,560
Income tax expense	(1,608)	(679)	137%	(1,399)
Net loss	**(44,327)**	**(24,471)**	**81%**	**(45,063)**
Percentage of operating revenue	48%	45%	3%	65%

Growth in operating revenue was driven by subscriber growth in all markets. The total operating expenses and the net loss after tax increased as Xero continues to invest in scaling its global business and delivering revenue and subscriber growth in this period and beyond. The net loss for the period was in line with the net loss for the six months to 31 March 2015.

EARNINGS BEFORE INTEREST TAX DEPRECIATION AND AMORTISATION (EBITDA)

Six months ended 30 September	2015 ($000s)	2014 ($000s)	% change	6 months ended 31 March 2015 ($000s)
Net loss	(44,327)	(24,471)	81%	(45,063)
Add back: net interest income	(4,689)	(4,128)	14%	(3,560)
Add back: depreciation and amortisation	13,604	7,713	76%	10,277
Add back: income tax expense	1,608	679	137%	1,399
EBITDA	**(33,804)**	**(20,207)**	**67%**	**(36,947)**
Percentage of operating revenue	36%	37%	-1%	53.1%

We have included EBITDA disclosures (a non-GAAP financial measure) as we believe it provides useful information for readers to assist in understanding Xero's financial performance. Non-GAAP financial measures should not be viewed in isolation nor considered as substitutes for measures reported in accordance with NZ IFRS. EBITDA is calculated by adding back depreciation, amortisation, net interest income, and tax expense to net losses.

EBITDA margins, which were affected by the deterioration of the NZD, improved compared to the six months ended 30 September 2014 and improved to a greater extent compared to the six months ended 31 March 2015, primarily due to operating efficiencies in cost of revenues offsetting additional product and sales and marketing investment.

OPERATING REVENUE

Six months ended 30 September	2015 ($000s)	2014 ($000s)	% change
Subscription revenue	89,751	52,200	72%
Other operating revenue	3,113	2,095	49%
Total operating revenue	**92,864**	**54,295**	**71%**

The 72% increase in subscription revenue during the six month period was primarily driven by the increase in subscribers from 371,000 to 593,000 at 30 September 2015, an increase of 60%.

Other operating revenue increased by 49% due to increased conference revenue.

OPERATING REVENUE – CONSTANT CURRENCY

As more than 75% of Xero's operating revenue is denominated in foreign currencies, the weakened New Zealand dollar during the period affected reported revenue. On a constant currency basis, subscription revenue grew by 64% and operating revenue by 63% compared to the six months ended 30 September 2014.

Six months ended 30 September	2015 ($000s)	2014 ($000s)	% change
Subscription revenue – constant currency	85,557	52,200	64%
Operating revenue – constant currency	88,552	54,295	63%

This analysis is a non-GAAP financial measure, which has been provided to assist in understanding and assessing Xero's financial performance during the half year, excluding the impact of foreign currency fluctuations. The constant dollar revenue translates revenue for the six months ended 30 September 2015 at the effective exchange rates used for the six months ended 30 September 2014.

SUBSCRIBER NUMBERS

At 30 September	2015	2014	% change
Australia	262,000	158,000	66%
New Zealand	163,000	119,000	37%
Australia and New Zealand (ANZ) total	**425,000**	**277,000**	**53%**
United Kingdom	102,000	61,000	67%
North America	47,000	22,000	114%
Rest of World	19,000	11,000	73%
International total	**168,000**	**94,000**	**79%**
Total paying subscribers	**593,000**	**371,000**	**60%**

Subscribers at 30 September 2015 grew by 222,000, or 60% to 593,000 over the 12 months from 30 September 2014, with 47% of this growth in Australia.

ANZ grew by 148,000 subscribers representing 53% growth in the comparative period, and International subscribers grew by 74,000 or 79%.

COST OF REVENUES

Six months ended 30 September	2015 ($000s)	2014 ($000s)	% change
Cost of revenues	24,497	18,016	36%
Percentage of operating revenue	26%	33%	-7%

Cost of revenues has decreased as a percentage of operating revenue compared with the comparative period due to efficiencies in the hosting and customer support teams, and reductions in bank feed costs per subscriber, thereby demonstrating economies of scale. This drove an improved gross margin of 74% in the current period.

SALES AND MARKETING

Six months ended 30 September	2015 ($000s)	2014 ($000s)	% change
Sales and marketing	70,885	38,329	85%
Percentage of operating revenue	76%	71%	5%

Sales and marketing costs increased by $32.6 million or 85% to $70.9 million in the six months ended 30 September 2015. However, these costs increased at a lower rate in the current period compared with the previous six months ended 31 March 2015.

The increase in sales and marketing costs related to the acquisition of new subscribers and the development of new channels and markets to drive sustainably strong global growth in the years to come.

PRODUCT DESIGN AND DEVELOPMENT

Six months ended 30 September	2015 ($000s)	2014 ($000s)	% change
Total product design and development costs (including capitalised development costs)	50,537	26,648	90%
Percentage of operating revenue	54%	49%	5%
Less capitalised product development costs	(22,499)	(12,848)	75%
Product design and development expenses excluding amortisation of capitalised development costs	**28,038**	**13,800**	**103%**
Less government grants	(1,726)	(1,285)	34%
Add amortisation of capitalised development costs	8,142	4,706	73%
Product design and development expenses	**34,454**	**17,221**	**100%**
Percentage of operating revenue	37%	32%	5%

Total product design and development expenses were $50.5 million in the period ended 30 September 2015, $23.9 million higher than in the comparative period. Of this, $22.5 million was capitalised, with the balance of $28.0 million included as an expense in the income statement. The amortisation of capitalised product design and development expenditure of $8.1 million was also included as an expense in the income statement giving a total net expense (after government grants) for the period of $34.5 million.

The expense in the Income Statement was affected by the percentage of costs capitalised during the period decreasing from 48% to 45% compared with the comparative period.

GENERAL AND ADMINISTRATION

Six months ended 30 September	2015 ($000s)	2014 ($000s)	% change
General and administration	14,261	9,612	48%
Percentage of operating revenue	15%	18%	-3%

General and administration costs were $14.3 million in the period ended 30 September 2015, $4.6 million higher than in the comparative period, and were driven by the geographic expansion and subscriber growth in the business.

HEADCOUNT

As at 30 September	2015	2014	% change
Total group	1,312	993	32%

Headcount increased by 319 or 32% in the past 12 months (taking the total headcount to 1,312) compared with a 60% increase in subscribers and 71% increase in operating revenue. The slower growth reflects the benefits of economies of scale and operating efficiencies notwithstanding investment in product design and development expenses and geographic buildout.

FOREIGN EXCHANGE AND INTEREST

Year ended 30 September	2015 ($000s)	2014 ($000s)	% change
Foreign exchange			
Cash flow hedging gains	3,559	7	NM*
Other foreign exchange losses	(61)	761	NM
Net foreign exchange gains	**3,498**	**768**	**355%**
Interest			
Interest income	4,704	4,128	14%
Interest expense	(15)	-	NM
Net interest income	**4,689**	**4,128**	**14%**

**NM stands for not meaningful.*

In accordance with Xero's treasury policy, a portion of foreign-denominated cash outflows are hedged on a 12-month rolling basis to limit the short-term impact of currency fluctuations. A weakened New Zealand dollar over the period resulted in cash flow hedging gains of $3.6 million.

Interest income in the period ended 30 September 2015 was $4.7 million, an increase of $0.6 million, or 14% on the previous period, due to higher cash balances following the $147.2 million capital raise in March 2015 partially offset by lower interest rates.

CASH FLOWS

Six months ended 30 September	2015 ($000s)	2014 ($000s)	% change
Net cash provided from (used in):			
Receipts from customers	88,667	51,373	73%
Other operating cash flows	(112,031)	(69,279)	62%
Total cash flows from operating activities	**(23,364)**	**(17,906)**	**30%**
Investing activities	(26,116)	(22,006)	19%
Total operating and investing cash flows	**(49,480)**	**(39,912)**	**24%**

Operating cash flows improved during the six months to 30 September 2015, with the September 2015 quarter performance an improvement over the previous four quarters.

Net cash outflows from investing activities increased by 19% as a result of disciplined investment in product development to drive sustainable growth in subscribers and revenue.

Operating and investing cash outflows increased to $49.5 million from $39.9 million, with the deterioration of the NZD adversely impacting current-period cash flows by $3.4 million compared with the previous period.

SEGMENT INFORMATION

	Australia ($000s)	New Zealand ($000s)	Subtotal ANZ ($000s)	United Kingdom ($000s)	North America ($000s)	Rest of World ($000s)	Subtotal International ($000s)	**Total ($000s)**
Six months ended 30 September 2015								
Operating revenue	43,428	21,428	**64,856**	16,440	7,492	4,076	**28,008**	**92,864**
Expenses	(34,763)	(12,864)	**(47,627)**	(17,339)	(28,749)	(1,667)	**(47,755)**	**(95,382)**
Other income	-	-	**-**	-	327	-	**327**	**327**
Segment contribution	**8,665**	**8,564**	**17,229**	**(899)**	**(20,930)**	**2,409**	**(19,420)**	**(2,191)**
Six months ended 30 September 2014								
Operating revenue	25,561	15,277	**40,838**	8,294	3,065	1,998	**13,357**	**54,195**
Expenses	(23,092)	(8,923)	**(32,015)**	(10,778)	(12,252)	(1,300)	**(24,330)**	**(56,345)**
Other income	-	-	**-**	-	195	-	**195**	**195**
Segment contribution	**2,469**	**6,354**	**8,823**	**(2,484)**	**(8,992)**	**698**	**(10,778)**	**(1,955)**

Subscription and other operating revenue is allocated to each region dependent on where the subscriber resides. Expenses are cost of revenues, and sales and marketing, and include direct in-region costs along with an allocation of centrally-managed costs and overheads.

ANZ – Operating revenue grew by 59% based on subscriber growth of 53%. This, along with cost efficiencies, resulted in the contribution improving as a percentage of operating revenue from 22% to 27%.

The improvement was largely due to the performance in Australia, with subscriber growth of 66% driving a 70% increase in operating revenue while expenses increased by 51%. Expenses in New Zealand grew at a similar rate to revenue given ongoing investment to further develop future revenue streams through linkages to enterprise and government.

International – Operating revenue has grown by 110% based on subscriber growth of 79% and a weaker New Zealand dollar. Although the contribution margin improved slightly, it reflects the investments to accelerate growth in the United Kingdom as Xero takes advantage of its online accounting leadership position in this market, and in North America given the very early stage of Xero's entry into this market.

KEY SaaS METRICS

	ANZ	International	Group
At 30 September 2015			
ARPU ($)	29.2	34.5	**30.7**
CAC months	9.0	21.0	**13.7**
Subscriber churn	1.0%	1.8%	**1.3%**
Lifetime value (LTV) ($)	2,069	1,396	**1,805**
Lifetime value/CAC	7.9	1.9	**4.3**
At 30 September 2014			
ARPU ($)	29.5	30.4	**29.7**
CAC months	7.6	18.2	**11.4**
Subscriber churn	1.0%	2.1%	**1.3%**
Lifetime value (LTV) ($)	1,950	965	**1,554**
Lifetime value/CAC	8.7	1.7	**4.6**

ANZ – Key subscriber metrics were broadly in line with the prior comparative period but an improvement on the six months to 31 March 2015.

International – ARPU increased by 13% due to a higher portion of new subscribers in the United Kingdom market adding higher ARPU products, and due to the weakened NZD against the United States dollar and British pound. This along with an improved gross margin and churn led to a higher LTV. The LTV/CAC ratio also increased despite the higher cost of subscriber acquisition.

ARPU is calculated as annualised committed monthly revenue at 30 September divided by subscribers at that time (and divided by 12 to get a monthly view).

CAC months or months of ARPU to recover CAC (cost of acquiring subscribers) represent the number of months of revenue required to recover the cost of acquiring each new subscriber. The calculation is sales and marketing costs for the twelve month period to 30 September less conference revenue (such as Xerocon) divided by new subscribers added (gross) during the same period, divided by monthly ARPU.

Subscriber churn is the number of subscribers who leave Xero in a month as a percentage of the total subscribers at the start of that month. The percentage provided is the average of the monthly churn for the twelve months to 30 September.

Lifetime value is the gross margin expected from a subscriber over the lifetime of that subscriber. This is calculated by taking the average subscriber lifetime (1 divided by subscriber churn) multiplied by ARPU multiplied by the gross margin percentage.

Lifetime value/CAC is the ratio between the lifetime value (described above) and the cost to acquire that subscriber, e.g. the gross margin derived from a subscriber in ANZ is currently on average 7.9 times the cost of acquiring that subscriber. This is an additional measure of sales and marketing efficiency, with industry commentators suggesting that a ratio of over 3 is satisfactory.

Independent review report

Review report to the shareholders of Xero Limited ('the Company') and its subsidiaries together ('the Group')

We have reviewed the interim financial statements on pages 14 to 24, which comprise the statement of financial position as at 30 September 2015, and the income statement, statement of comprehensive income, statement of changes in equity and statement of cash flows for the period ended on that date, and a summary of significant accounting policies and other explanatory information.

This report is made solely to the Company's shareholders, as a body, in accordance with our engagement letter. Our review has been undertaken so that we might state to the Company's shareholders those matters we are required to state to them in a review report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's shareholders as a body, for our review work, for this report, or for our findings.

Directors' responsibilities

The directors are responsible for the preparation and fair presentation of interim financial statements which comply with generally accepted accounting practice in New Zealand as it relates to interim financial statements and for such internal control as the directors determine is necessary to enable the preparation and fair presentation of the interim financial statements that are free from material misstatement, whether due to fraud or error.

Reviewer's responsibilities

Our responsibility is to express a conclusion on the interim financial statements based on our review. We conducted our review in accordance with NZ SRE 2410 Review of Financial Statements Performed by the Independent Auditor of the Entity. NZ SRE 2410 requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects, in accordance with generally accepted accounting practice in New Zealand as it relates to interim financial statements. As the auditor of the Xero Limited, NZ SRE 2410 requires that we comply with the ethical requirements relevant to the audit of the annual financial statements.

Basis of statement

A review of interim financial statements in accordance with NZ SRE 2410 is a limited assurance engagement. The auditor performs procedures, primarily consisting of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with International Standards on Auditing (New Zealand). Accordingly we do not express an audit opinion on those financial statements.

Other than in our capacity as assurance practitioner and providing remuneration and tax compliance services we have no relationship with, or interests in, the Group.

Conclusion

Based on our review nothing has come to our attention that causes us to believe that the accompanying interim financial statements, set out on pages 14 to 24, do not present fairly, in all material respects, the financial position of the Group as at 30 September 2015 and its financial performance and cash flows for the six month period ended on that date in accordance with generally accepted accounting practice in New Zealand as it relates to interim financial statements.

Our review was completed on 5 November 2015 and our findings are expressed as at that date.

Ernst + Young

Ernst & Young
Wellington

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Building a better working world

Financial statements

Income statement

	Note	Six months ended 30 September 2015 Unaudited ($000s)	2014 Unaudited ($000s)
Subscription revenue		89,751	52,200
Other operating revenue		3,113	2,095
Total operating revenue		**92,864**	**54,295**
Cost of revenues	4	(24,497)	(18,016)
Gross profit		**68,367**	**36,279**
Operating expenses			
Sales and marketing		(70,885)	(38,329)
Product design and development		(34,454)	(17,221)
General and administration		(14,261)	(9,612)
Total operating expenses	**4**	**(119,600)**	**(65,162)**
Foreign exchange gains		3,498	768
Other income		327	195
Operating deficit		**(47,408)**	**(27,920)**
Net interest income		4,689	4,128
Net loss before tax		**(42,719)**	**(23,792)**
Income tax expense		(1,608)	(679)
Net loss		**(44,327)**	**(24,471)**
Earnings per share			
Basic and diluted loss per share		($0.33)	($0.19)

Statement of comprehensive income

	Note	Six months ended 30 September 2015 Unaudited ($000s)	2014 Unaudited ($000s)
Net loss		(44,327)	(24,471)
Other comprehensive income*			
Movement in cash flow hedges (net of tax)	9	1,405	2,089
Translation of international subsidiaries		5,280	71
Total other comprehensive income for the period		**6,685**	**2,160**
Total comprehensive loss for the period		**(37,642)**	**(22,311)**

** Items in other comprehensive income may be reclassified to the Income Statement.*

The accompanying notes form an integral part of these financial statements.

Statement of changes in equity

	Share capital ($000s)	Treasury stock ($000s)	Share based payment reserve ($000s)	Accumulated losses ($000s)	Foreign currency translation reserve ($000s)	Cash flow hedge reserve ($000s)	Total equity ($000s)
Unaudited							
Balance at 1 April 2015	504,570	(12,565)	7,705	(155,474)	(758)	2,175	345,653
Net loss	–	–	–	(44,327)	–	–	(44,327)
Other comprehensive income	–	–	–	–	5,280	1,405	6,685
Total comprehensive loss	**–**	**–**	**–**	**(44,327)**	**5,280**	**1,405**	**(37,642)**
Transactions with owners:							
Issue of shares – employee restricted share plan	8,477	(8,477)	–	–	–	–	–
Accrual of shares – employee restricted share plan	–	–	5,075	–	–	–	5,075
Vesting of shares – employee restricted share plan	–	133	(133)	–	–	–	–
Accrual of restricted stock units	–	–	2,235	–	–	–	2,235
Vesting of restricted stock units	194	–	(194)	–	–	–	–
Accrual of share-based director fees and options	–	–	227	–	–	–	227
Accrual of employee share options	–	–	79	–	–	–	79
Exercising of employee share options	386	–	(49)	–	–	–	337
Accrual of share-based advisor fees	–	–	271	–	–	–	271
Accrual for equity portion of purchase of Monchilla	–	–	481	–	–	–	481
Balance at 30 September 2015	**513,627**	**(20,909)**	**15,697**	**(199,801)**	**4,522**	**3,580**	**316,716**
Unaudited							
Balance at 1 April 2014	341,436	(5,128)	4,682	(85,940)	(112)	–	254,938
Net loss	–	–	–	(24,471)	–	–	(24,471)
Other comprehensive income	–	–	–	–	71	2,089	2,160
Total comprehensive loss	**–**	**–**	**–**	**(24,471)**	**71**	**2,089**	**(22,311)**
Transactions with owners:							
Issue of shares – employee restricted share plan	5,824	(5,824)	–	–	–	–	–
Accrual of share-based employee benefits	–	–	2,926	–	–	–	2,926
Vesting of shares – employee restricted share plan	–	154	(154)	–	–	–	–
Exercising of employee share options	463	–	(96)	–	–	–	367
Accrual for equity portion of purchase of Max Solutions Holdings Limited	–	–	222	–	–	–	222
Accrual for equity portion of purchase of Paycycle assets	–	–	84	–	–	–	84
Vesting of shares – purchase of Paycycle assets	–	431	(431)	–	–	–	–
Balance at 30 September 2014	**347,723**	**(10,367)**	**7,233**	**(110,411)**	**(41)**	**2,089**	**236,226**

The accompanying notes form an integral part of these financial statements.

Statement of financial position

	Notes	At 30 September 2015 Unaudited ($000s)	At 31 March 2015 Audited ($000s)
Current assets			
Cash and cash equivalents		39,459	58,866
Short-term deposits		185,000	210,000
Trade and other receivables		26,844	21,499
Short-term derivative assets	9	5,584	3,151
Total current assets		**256,887**	**293,516**
Non-current assets			
Property, plant and equipment	5	16,646	16,631
Intangible assets	5	79,740	65,112
Deferred tax assets		4,642	1,427
Other receivables		1,796	1,712
Total non-current assets		**102,824**	**84,882**
Total assets		**359,711**	**378,398**
Current liabilities			
Trade and other payables		18,167	14,050
Employee entitlements		16,219	14,040
Income tax payable		2,581	2,218
Short-term provisions		45	26
Short-term derivative liabilities	9	612	130
Total current liabilities		**37,624**	**30,464**
Non-current liabilities			
Deferred tax liabilities		4,400	1,453
Long-term provisions		971	828
Total non-current liabilities		**5,371**	**2,281**
Total liabilities		**42,995**	**32,745**
Equity			
Share capital	6	492,718	492,005
Share-based payment reserve		15,697	7,705
Accumulated losses		(199,801)	(155,474)
Foreign currency translation reserve		4,522	(758)
Cash flow hedge reserve	9	3,580	2,175
Total equity		**316,716**	**345,653**
Total liabilities and shareholders equity		**359,711**	**378,398**

The accompanying notes form an integral part of these financial statements.

Statement of cash flows

	Note	Six months ended 30 September 2015 Unaudited ($000s)	2014 Unaudited ($000s)
Operating activities			
Receipts from customers		88,667	51,373
Other income		2,144	402
Interest received		4,002	5,151
Payments to suppliers and employees		(115,868)	(74,137)
Income tax paid		(2,309)	(695)
Net cash flows used in operating activities	7	**(23,364)**	**(17,906)**
Investing activities			
Purchase of property, plant and equipment		(2,571)	(6,168)
Capitalised development costs		(23,439)	(15,050)
Intangible assets		(139)	(190)
Rental bonds		33	(598)
Net cash flows used in investing activities		**(26,116)**	**(22,006)**
Financing activities			
Exercising of share options		312	367
Repayment of management loan		540	–
Payments for short-term deposits		(87,000)	(253,000)
Proceeds from short-term deposits		112,000	287,000
Net cash flows from financing activities		**25,852**	**34,367**
Net decrease in cash and cash equivalents		**(23,628)**	**(5,545)**
Foreign currency translation adjustment		4,221	427
Cash and cash equivalents at the beginning of the period		**58,866**	**14,886**
Cash and cash equivalents at the end of the period		**39,459**	**9,768**

The accompanying notes form an integral part of these financial statements.

Notes to the condensed financial statements (unaudited)

1. BASIS OF PRESENTATION

These unaudited interim financial statements of Xero Limited ('the Company') and its subsidiaries (together 'the Group') have been prepared in accordance with New Zealand Generally Accepted Accounting Practice and comply with the requirements of the New Zealand Equivalent to International Accounting Standard No. 34: 'Interim Financial Reporting', and International Accounting Standard No. 34. 'Interim Financial Reporting'. The Company is a profit-oriented entity.

Xero Limited is registered under the Companies Act 1993 and is an FMC Reporting Entity under the Financial Markets Conduct Act 2013.

2. ACCOUNTING POLICIES

(a) Changes in accounting policies and disclosures

Apart from the changes noted below, the unaudited interim financial statements have been prepared using the same accounting policies and methods of computation as, and should be read in conjunction with, the financial statements and related notes included in the Group's annual report for the year ended 31 March 2015.

During the half year, the Group modified the classification of grant income previously recorded in other income to be recognised contra product design and development expenses in order to more appropriately reflect the nature of the grant income. Comparative amounts in the consolidated Income Statement were reclassified for consistency, which resulted in $1.3 million being reclassified from other income to product design and development expenses for the period ended 30 September 2014.

The changes below were enacted in Xero's annual report for the year ended 31 March 2015 and affect the comparative income statement.

Revenue from providing bank feeds that was previously included in other operating revenue is now presented in the Income Statement as subscription revenue. For consistency, revenue of $227,000 for the six months ended 30 September 2014 was reclassified from other operating revenue to subscription revenue.

Foreign exchange gains and losses that were previously included in general and administration expenses are now presented in the Income Statement within foreign exchange gains. For consistency, a gain of $768,000 for the six months ended 30 September 2014 was reclassified from general and administration to foreign exchange gains.

(b) Critical accounting estimates

The same significant judgements, estimates and assumptions included in the notes to the financial statements in the Group's annual report for the year ended 31 March 2015 have been applied to these interim financial statements.

3. SEGMENT INFORMATION

The Group provides online accounting software for small businesses and their advisors, and has five operating segments based on geographical locations. These segments have been determined based on reports reviewed by the global executive team (the chief operating decision maker).

Segment operating expenses represent sales and marketing costs and service delivery costs including both in-country and an allocation of centrally-managed costs.

Unaudited	Australia ($000s)	New Zealand ($000s)	United Kingdom ($000s)	North America ($000s)	Rest of World ($000s)	Total ($000s)
Six months ended 30 September 2015						
Operating revenue	43,428	21,428	16,440	7,492	4,076	**92,864**
Expenses	(34,763)	(12,864)	(17,339)	(28,749)	(1,667)	**(95,382)**
Other income	–	–	–	327	–	**327**
Segment contribution	**8,665**	**8,564**	**(899)**	**(20,930)**	**2,409**	**(2,191)**
Six months ended 30 September 2014						
Operating revenue	25,561	15,277	8,294	3,065	1,998	**54,195**
Expenses	(23,092)	(8,923)	(10,778)	(12,252)	(1,300)	**(56,345)**
Other income	–	–	–	195	–	**195**
Segment contribution	**2,469**	**6,354**	**(2,484)**	**(8,992)**	**698**	**(1,955)**

Reconciliation from segment revenue to consolidated revenue:

Six months ended 30 September	2015 Unaudited ($000s)	2014 Unaudited ($000s)
Segment revenue	92,864	54,195
Corporate revenue	–	100
Total revenue	**92,864**	**54,295**

Reconciliation from segment contribution consolidated net loss before income tax:

Six months ended 30 September	2015 Unaudited ($000s)	2014 Unaudited ($000s)
Segment contribution	(2,191)	(1,955)
Corporate revenue	–	100
Product design and development expenses	(34,454)	(17,221)
General and administration expenses	(14,261)	(9,612)
Foreign exchange gains	3,498	768
Net interest income	4,689	4,128
Net loss before tax	**(42,719)**	**(23,792)**

At 30 September 2015, $79.3 million of the Group's property, plant and equipment and intangible assets was domiciled in New Zealand (31 March 2015: $71.7 million).

4. EXPENSES

Six months ended 30 September	2015 Unaudited ($000s)	2014 Unaudited ($000s)
Cost of revenues and operating expenses		
Employee entitlements	76,600	46,677
Employee entitlements – share-based payments	8,008	4,987
Employee entitlements capitalised	(19,952)	(13,286)
Advertising and marketing	26,614	11,001
IT infrastructure costs	14,161	8,107
Consulting and subcontracting	6,329	3,111
Lease/rental	4,460	3,488
Travel related	3,613	2,543
Superannuation costs	2,372	1,686
Communication and office administration	2,094	1,541
Directors' fees	393	241
Other operating expenses	5,801	5,369
Total cost of revenues and operating expenses excl. depreciation and amortisation	**130,493**	**75,465**
Depreciation and amortisation		
Relating to:		
Amortisation of development costs	10,098	5,772
Amortisation of other intangible assets	307	156
Depreciation of property, plant and equipment	3,199	1,785
Total depreciation and amortisation	**13,604**	**7,713**
Total cost of revenues and operating expenses	**144,097**	**83,178**
Depreciation and amortisation included in function expenses as follows:		
Cost of revenues	1,259	907
Sales and marketing expenses	1,534	906
Product design and development expenses	10,437	5,699
General and administration expenses	374	201
Total depreciation and amortisation	**13,604**	**7,713**

5. INTANGIBLES AND PROPERTY, PLANT AND EQUIPMENT

Unaudited	Software development ($000s)	Software licences ($000s)	Other intangible assets ($000s)	Goodwill ($000s)	Total ($000s)
Cost					
Balance at 1 April 2015	85,918	350	816	5,352	92,436
Additions*	24,576	795	152	–	25,523
Disposals and write-offs	(466)	(132)	(23)	–	(621)
Balance at 30 September 2015	**110,028**	**1,013**	**945**	**5,352**	**117,338**
Amortisation and impairment					
Balance at 1 April 2015	26,821	223	280	–	27,324
Amortisation	10,098	60	247	–	10,405
Disposals and write-offs	–	(131)	–	–	(131)
Balance at 30 September 2015	**36,919**	**152**	**527**	**–**	**37,598**
Net book value at 30 September 2015	**73,109**	**861**	**418**	**5,352**	**79,740**

* Includes $5.5 million of externally purchased assets.

Additions to property, plant and equipment were $2.0 million in the period, with $0.8 million relating to office fit-out (six months ending 30 September 2014: $6.8 million, $4.7 million).

6. SHARE CAPITAL

Movement in ordinary shares on issue

	2015 Unaudited (000s)	2014 Unaudited (000s)
Balance as at 1 April	136,008	127,610
Issue of ordinary shares – employee restricted share plan	486	183
Issue of ordinary shares – exercising of employee share options	91	64
Issue of ordinary shares – restricted stock unit schemes	8	–
Issues of ordinary shares – directors fees	2	–
Ordinary shares on issue at the end of the period	**136,595**	**127,857**
Treasury stock	(1,212)	(975)
Ordinary shares on issue at the end of the period excluding treasury stock	**135,383**	**126,882**

All shares have been issued, are fully paid and have no par value.

During the period the Company allocated 509,876 shares under the employee restricted share plan, at an average price of $17.64 (2014: 208,612 at an average price of $31.87). Of the shares allocated 24,350 were the reissue of shares held as treasury stock (2014: 25,884).

During the period, employees exercised 91,060 stock options under the US Equity Incentive Scheme, with an average exercise price of $3.42 (2014: 63,837 at an average exercise price of $5.75).

During the period the Company issued 270,554 Restricted Stock Units (RSUs) to employees, with an average price of $17.64 (2014: 62,003). During the period 13,280 RSUs vested; of which, 8,063 were converted to shares, the remaining 5,217 being surrendered to settle payroll tax liabilities.

Treasury stock includes unvested employee restricted share plan shares and unvested shares issued in relation to the acquisition of Monchilla, Inc.

7. RECONCILIATION OF OPERATING CASH FLOWS

For the six months ended 30 September	2015 Unaudited ($000s)	2014 Unaudited ($000s)
Net loss	(44,327)	(24,471)
Adjustments:		
Depreciation and amortisation	13,604	7,713
Deferred tax	(1,703)	(482)
Loss/(gain) on foreign exchange transactions	61	(768)
Share-based payments	6,378	3,638
Other	598	137
Changes in working capital items:		
(Increase)/decrease in trade receivables and other related items	(4,395)	(4,533)
Increase/(decrease) in trade payables and other related items	4,821	877
Increase/(decrease) in current tax payable	1,599	(17)
Net cash flows used in operating activities	**(23,364)**	**(17,906)**

8. FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT OBJECTIVES

Xero's hedging derivatives are recognised at fair value. Fair values are calculated using forward exchange rates that are quoted in an active market (level 2 on the fair value hierarchy). Foreign currency forward contracts are valued using a present value model that takes account of observable market inputs including spot exchange rates, forward rates, and forward rate curves.

Xero's other financial instruments are carried at amortised cost. The carrying amounts of these assets and liabilities do not materially differ from their fair values.

There were no transfers between classes of financial instruments during the period.

9. HEDGE ACCOUNTING

The Group uses derivatives in the form of forward exchange contracts (FECs) to reduce the impacts that movements in the exchange rate will have on the Group's New Zealand dollar cash flows. These hedges have been designated as hedges of highly probable forecast transactions (cash flow hedges under NZ IAS 39: 'Financial Instruments Recognition and Measurement'). The Group's policy is to hedge a portion of the next 12 months forecast cash flows.

During the period, hedging gains of $5,510,000 (before taxation) were recognised in other comprehensive income. During the period, a gain of $3,559,000 (before taxation) was reclassified out of other comprehensive income to the Income Statement (six months ended 30 September 2014: gain of $7,000). The remaining balance will be reclassified to the Income Statement in the 12 months following 30 September 2015.

Hedge position

At 30 September 2015 **Unaudited**	**Fair value ($000s)**	**Notional amount hedged (NZ$000s)**
Short-term derivative assets		
Buy USD – sell NZD	5,371	46,436
Buy NZD – sell AUD	213	14,194
Total	**5,584**	
Short-term derivative liabilities		
Buy USD – sell NZD	(48)	4,880
Buy NZD – sell AUD	(564)	17,122
Total	**(612)**	

10. SHARE-BASED PAYMENTS

The Group operates equity-settled, share-based compensation plans, under which employees provide services in exchange for non-transferable options, restricted stock units (RSUs) or shares. The value of the employee services rendered for the grant of non-transferable options, RSUs and shares is recognised as an expense over the vesting period, and the amount is determined by reference to the fair value of the options, RSUs and shares granted.

Employee restricted share plan (RSP)

Movements in the number of unvested restricted shares were as follows:

Unaudited	Number of shares 2015 (000s)	Number of shares 2014 (000s)
Unvested shares as at 1 April	607	377
Granted	510	209
Forfeited	(31)	(34)
Vested	(8)	(1)
Unvested shares as at 30 September – allocated to employees	**1,078**	**551**
Forfeited shares not yet reallocated – held by trustee	15	18
Total	**1,093**	**569**
Percentage of total ordinary shares	0.8%	0.4%
Ageing of unvested shares		
Vest within one year	377	290
Vest after one year	701	261
Total	**1,078**	**551**

The number of shares awarded pursuant to the RSP does not equal the number of shares created for the scheme as forfeited shares are held in trust and reissued.

Share options scheme

Movements in the number of share options outstanding are as follows:

Unaudited	2015 Weighted average exercise price ($)	2015 Options (000s)	2014 Weighted average exercise price ($)	2014 Options (000s)
Outstanding at 1 April	16.52	901	18.57	936
Forfeited	16.17	(208)	34.41	(180)
Exercised	3.42	(91)	5.75	(64)
Expired	–	–	22.85	(4)
Outstanding at 30 September	**18.62**	**602**	**15.54**	**688**
Exercisable at 30 September	17.76	212	6.76	264

Restricted Stock Units

Movements in the number of RSUs outstanding were as follows:

Unaudited	2015 Weighted average grant date fair value ($)	2015 RSUs (000s)	2014 Weighted average grant date fair value ($)	2014 RSUs (000s)
Outstanding at 1 April	17.68	531	38.24	21
Granted	17.64	271	30.04	62
Forfeited	16.65	(141)	37.29	(24)
Converted to shares	24.09	(8)	–	–
Surrendered to pay payroll tax	24.09	(5)	–	–
Outstanding at 30 September	**18.25**	**648**	**30.03**	**59**

11. COMMITMENTS AND CONTINGENCIES

Capital commitments

Capital commitments of $1,790,000 for building fit-outs were contracted for at 30 September but not yet incurred (2014: $1,420,000).

Contingent liabilities

There were no contingent liabilities at 30 September 2015 (2014: nil).

12. EVENTS AFTER THE BALANCE SHEET DATE

There were no significant events between balance date and the date these financial statements were authorised for issue.

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CRAIG WINKLER

MANAGEMENT:

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(CHIEF EXECUTIVE, CO-FOUNDER)

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(CHIEF FINANCIAL OFFICER)

DUNCAN RITCHIE
(CHIEF PLATFORM OFFICER)

ANGUS NORTON
(CHIEF PRODUCT OFFICER)

ANDY LARK
(CHIEF MARKETING OFFICER)

TONY STEWART
(CHIEF DATA OFFICER)

RUSS FUJIOKA
(US PRESIDENT)

CHRIS RIDD
(MANAGING DIRECTOR, AUS)

VICTORIA CRONE
(MANAGING DIRECTOR, NZ)

GARY TURNER
(MANAGING DIRECTOR, UK)

COMPANY SECRETARY:

MATT VAUGHAN

AUDITOR:

ERNST & YOUNG

LEGAL ADVISOR:

BELL GULLY

STOCK EXCHANGES:

THE COMPANY'S ORDINARY SHARES
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