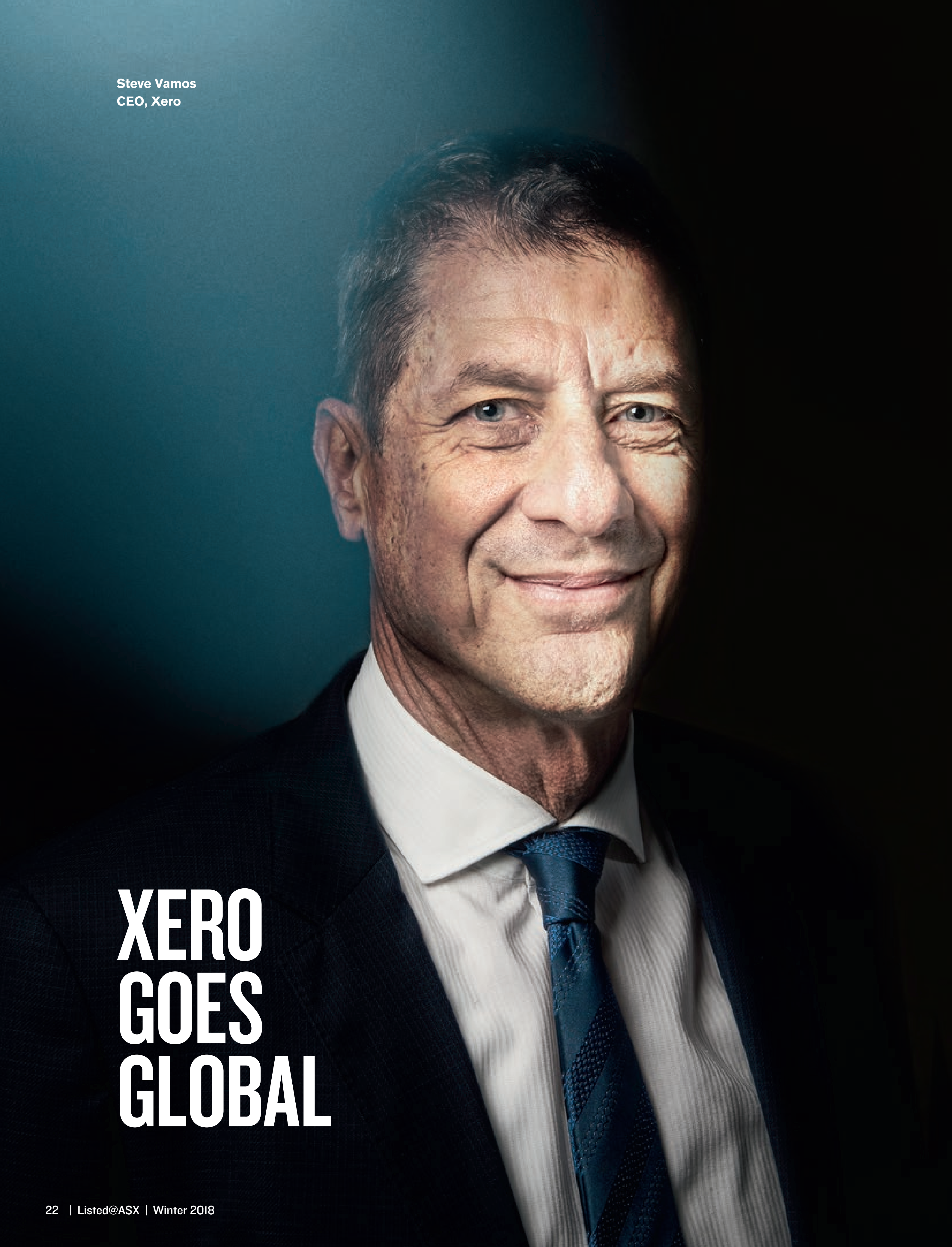
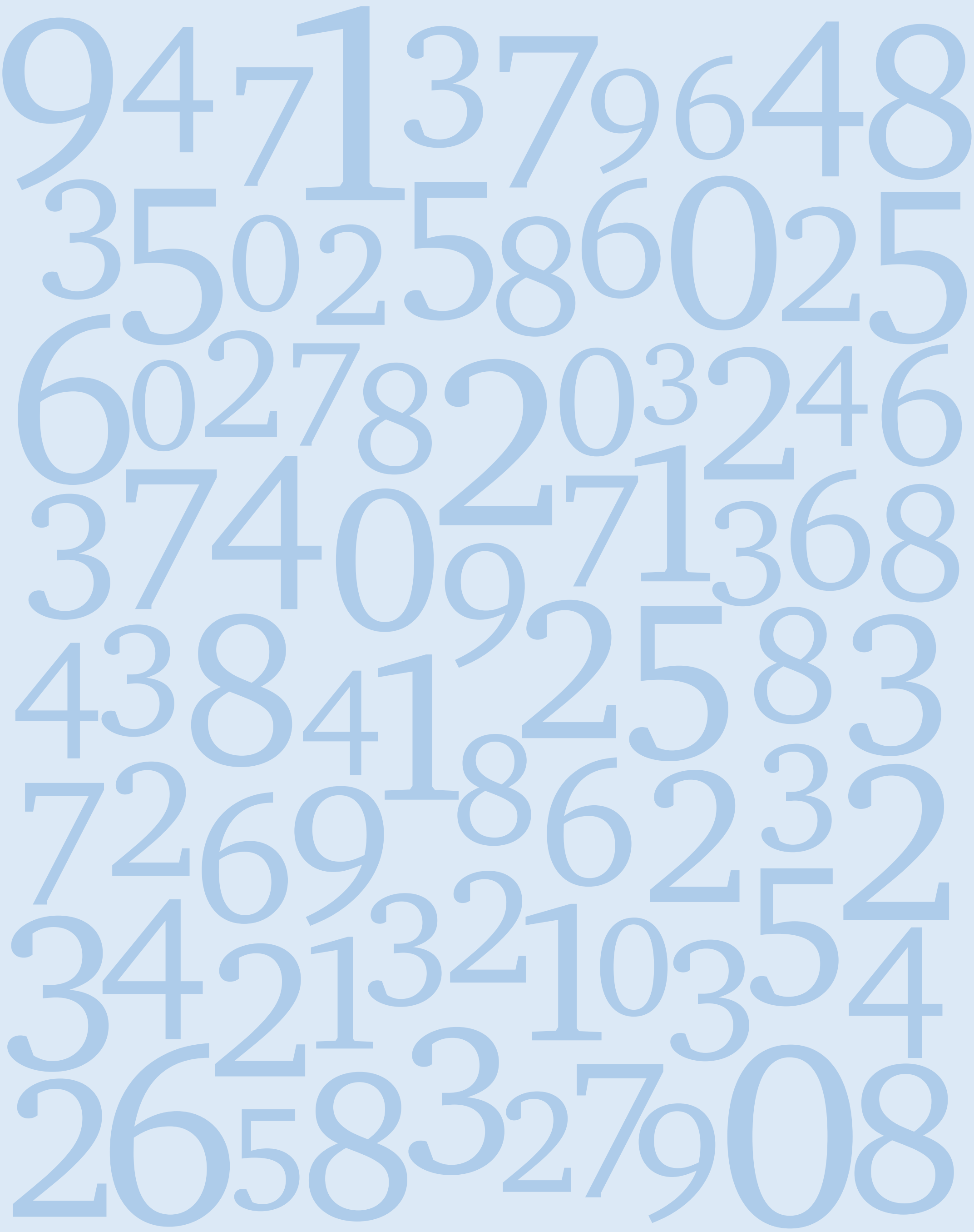


Steve Vamos
CEO, Xero

XERO GOES GLOBAL



The innovator is moving on with a new CEO and a global outlook. The question is whether it can maintain its antipodean business and at the same time build a truly international operation.

By Ben Power

Photography by Darren Purbrick

Accounting software provider Xero surprised the market early in March with an announcement that its high-profile founder, Rod Drury, was being replaced by experienced technology executive Steve Vamos.

The news had the potential to seriously destabilise the market and raise questions about the company's future. Drury was synonymous with Xero, and an entrepreneurial legend in New Zealand. He started the business back in 2006 in an Auckland apartment, and has driven the company to major success, with 1.2 million subscribers and a market capitalisation close to $5 billion.

When news of Drury's replacement hit the market, there was an initial jitter and the shares fell by six per cent from $32.88 to $30.85 within minutes. Rather than fall further, they recovered to continue the gains made in the last 12 months. Investors seemed comforted Drury wasn't departing entirely and would stay on to focus on innovation and strategy as a non-executive director.

The muted reaction was also evidence investors believe Vamos is the right person to drive Xero's strategy, which is to create a truly global small business platform encompassing accounting and financial services. "We've created a pretty exciting platform, and for us now it's really about scaling globally and operating globally as a business," Vamos told *Listed@ASX*, a few days before his 1 April start date.

Xero has a solid launch pad, with its strong Australian and New Zealand operations, and its recent move to a sole ASX listing. But the US market is looming as a tough nut to crack and execution will be vital. So too will be maintaining investor faith in its vision.

Vamos isn't a cleanskin. He had already been working with Xero's executive team. "I had the opportunity to get to know Rod and work with the business over the last 18 months," he says.

"It doesn't take much analysis to appreciate how special Xero is. It's accomplished a lot in a relatively short time serving small firms and providing the technology to help them manage their business and grow."

When announcing Vamos's appointment, Xero chairman Graham Smith told analysts and media in a conference call it was a huge challenge to transition from a founder CEO. But he said the priority was to continue scaling operations around the world, which requires a particular skill set.

Smith says Vamos was exceptionally well qualified. "Steve is aligned with Xero's strategy and culture and offers a smooth transition from a founder-led company to a multinational software company operating at scale all over the world."

Xero considered internal candidates, but needs Vamos' skills particularly gained over many years working in large multinational companies.

With more than 30 years' experience in technology and digital media, experiences at both ends of the corporate spectrum have given him a unique perspective.

"I have been in senior roles at big technology companies like Microsoft, Apple and IBM. At the other end I was CEO of NineMSN when it was a start-up and there was no online ad market. You start to see the difference between great and not great and the things that underpin a successful technology and global business," says Vamos.

"I can see how we can take all the wonderful attributes of Xero and evolve them to be more global. It's about taking the complexity that comes with size and making it simple and aligning the organisation to execute on a global scale," he adds.

Xero's strategy is to replicate the likes of Google and Facebook and become a global platform for millions of small business people. The company has built a strong subscriber base in Australia and New Zealand with accounting software that is delivered exclusively via the cloud and which provides real-time access to updated accounts data.

The company stole a march on its incumbent competitors, including Reckon and MYOB, which were relatively slow to adapt to cloud-based computing. Xero has also won plaudits and subscribers because its software is easy to use and has been called the Apple of accounting.

Xero has 518,000 subscribers in Australia and a quarter of a million in both New Zealand and the UK. It has a fledgling operation in North America with 110,00 subscribers. Along with other geographies it has 1.2 million subscribers in total.

North America will be one of the main battle grounds in its global expansion. There, it will face Intuit, which owns small business accounting program QuickBooks and has a market capitalisation of $US44 billion. That dwarfs Xero.

"In North America, Xero meets a better-prepared and better-resourced competitor than it has elsewhere," UBS analyst Phil Campbell told clients in a report released

in November last year, adding that momentum is promising in the UK.

He said that in the first half, subscriber growth in the North American market was slower than UBS forecasts (18,000 versus 37,000), which Campbell concedes were overly bullish. He writes, "this reflects management commentary that cloud penetration will be slower in this market at least for the next one to two years." But he said UBS was "optimistic Xero can accelerate growth off its base and build a sustainable presence."

Morningstar analyst Gareth James agrees the US may be more of a challenge than Xero expects. He notes the US financial system is quite complicated given state-based taxes. "We're still forecasting the company to significantly increase subscribers in the US; they can do that and still have a pretty small market share. But it still remains to be seen how the US is going to play out."

As a result, James says Xero has started to talk a more about other regions including Asia and South Africa. Regional nuances in accounting mean building a 'one-size-fits-all' global platform like Facebook may be problematic. Xero's main Australian competitor MYOB has also taken a different view to Xero. It has a regional rather than global approach, given accounting complexities across jurisdictions.

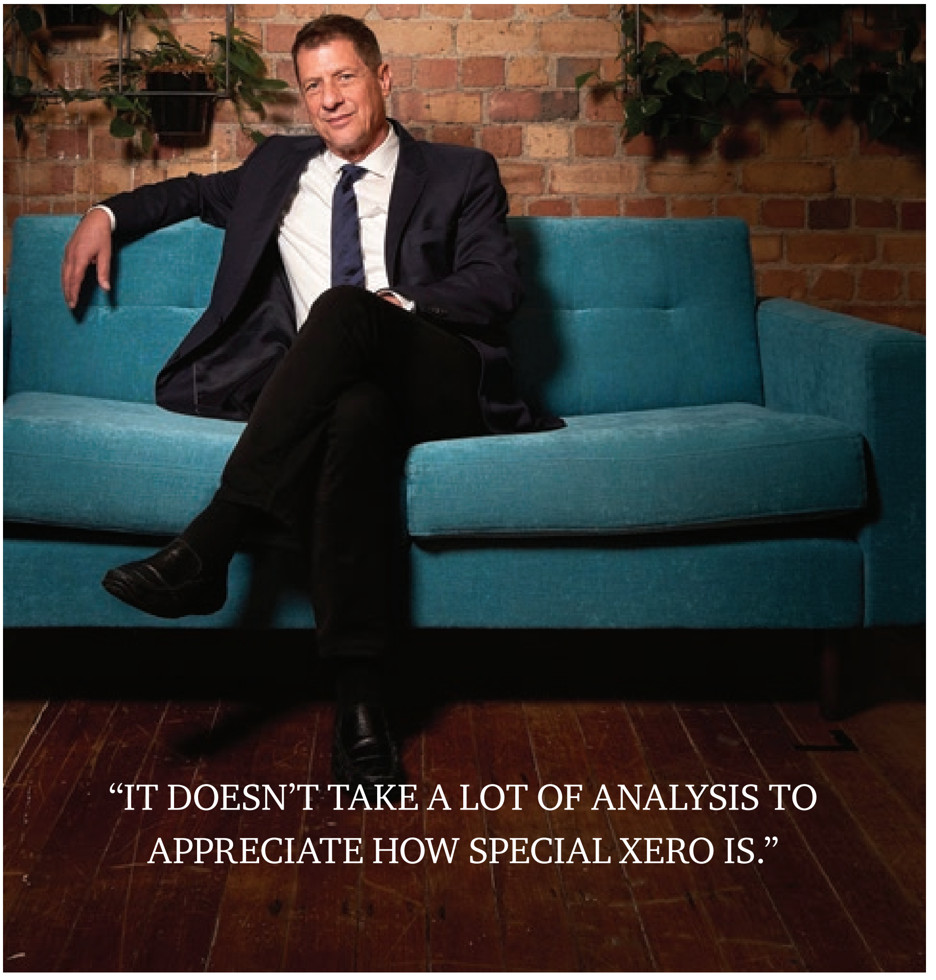
There is also a danger in rolling out a global strategy Xero could take its eye off the ball in Australia and cede ground to MYOB. The latter's $180 million acquisition of rival Reckon is currently being reviewed by the competition regulator the Australian Competition and Consumer Commission (ACCC). The commission has said, "if MYOB has a monopoly on this software, it would substantially lessen competition. We think there's a significant risk for customers that prices will increase and service levels will decrease."

James says if Xero started to stumble overseas and had to switch focus to Australia and New Zealand, and increase revenue, it would be challenging if MYOB acquired Reckon.

Xero's strong subscriber base in Australia and New Zealand flows through to earnings, with the company reporting a 37 per cent jump in operating revenue in the six months to 30 September 2017 to NZ$187.8 million. That allowed it to post its first positive EBITDA of NZ$5.4 million.

Drury told *Listed@ASX* the company is starting a new chapter. "Two and a half years ago we were generating NZ$100 million per annum; now that's NZ$100 million a quarter. We've pushed towards self-sustaining investment by becoming EBITDA positive; and this year is about driving the business to break-even cash flow.

"A lot of risk has been taken out of the business, and we've been explaining that to shareholders," he adds.



"IT DOESN'T TAKE A LOT OF ANALYSIS TO APPRECIATE HOW SPECIAL XERO IS."

Morningstar's James agrees Xero is at a critical juncture approaching cash flow positive status.

The company is also focused on expanding its offering. It has built the base operating platform for small business, but Drury says there is opportunity to build new apps on top of the platform.

James says Xero started off as an accounting software platform. "But it's really evolving more into a financial services platform. That's where they see it going."

Vamos concurs. "Ultimately, we're moving beyond accounting and really seeing the potential of what we have to create this platform that connects small business to banks and to suppliers and to their customers. So we have a platform here that if we think big and execute well our growth opportunities are very strong," he says.

But Xero also has its eye on the next technology revolution, artificial intelligence (AI). Cloud was the first revolution in accounting software but machine learning, AI and automation is next. In 2013, Xero started moving its subscribers to Amazon Web Services (AWS), a process it completed in 2016. The company has said the migration allows it to build software more quickly and harness new technologies.

On the phone hook-up announcing Vamos's appointment, Drury spoke about his passion for, and his desire to focus on, the next version of accounting. "We've built this amazing platform, built these amazing sales channels to get to small business for the first time, and now we can use the technology that we've moved onto the AWS platform and can build a whole lot of new products and services.

"I really want to do the stuff I'm passionate about because we get to reinvent business software really over the next five to ten years," Drury says. "So with Steve driving the ship, I can focus on building great products, AI and machine learning to rapidly expand the market."

Morningstar's James says while there is little doubt AI is going to increasingly become a part of software, it is unlikely to be transformational in accounting software for the next few years. Although, "it is already coming in in subtle ways," he says.

In its 2017 annual report, Xero noted it had already launched a personalised automation system for small business cloud accounting. When a small business owner creates an invoice, so they don't make a mistake, Xero automatically suggests the account code. The new technology provides a personal assistant for small businesses and their advisers.

Vamos says his vision – and what he wants to achieve in the role – is not radically different from Xero's existing strategy.

"Rod, the board and Sankar [Narayan, chief operating and financial officer], I believe, have done a great job in thinking ahead of the game in terms of what we need to do to establish ourselves for growth," he says.

"With the technology and our understanding of the business model, it's a platform that is ready to scale. In fact it already is by virtue of operating in a range of international markets."

Vamos wants to continue to develop Xero's business outside Australia and New Zealand. "That means in three to five years' we will operate on a global scale and bring value to small businesses around the world."

Another major pillar of further global expansion has been the move to a sole ASX listing. Xero's shares traded for the last time on NZX, New Zealand's stock exchange, in January this year and became solely listed on ASX from 5 February. It now ranks alongside online job board Seek, digital real estate ad firm REA Group and online vehicle sales site Carsales.com as a major ASX-listed tech stock.

The sole ASX listing was one of Drury's last major accomplishments during his reign as CEO, and gives the business better access to capital to fund global expansion. "As we grow market cap we need more funds to support that and that's what's so exciting about the Australian market. There's a lot of capital that flows in through the compulsory super savings regime. For where we're at on our journey, ASX feels like the best place to be right now," he explains.

Xero, Drury says, was becoming too big for the New Zealand market, with Kiwi funds making up some seven per cent of trading volume. "We were a very big fish in a small pond. We were really just too large for that market. We wanted to get into a market where we could grow, move through indices and get passive funds in as well," he says.

In the wake of the move to a sole ASX listing, the company was actively talking to Australian, US and UK investors. That included individual calls with investors, but also a road show with a series of investor meetings in Sydney, Melbourne and New York and a Morgan Stanley conference in San Francisco. "We're spending time educating people on the story and letting them get to know us," Drury says.

These activities are part of an ongoing active IR strategy led by an in-house team and headed by chief operating and financial officer Sankar Narayan. "We are always doing calls with investors, educating them on the story. We get amazing pick up from the events and presentations we do."

The move away from New Zealand generated some controversy. "It created quite a lot of noise," Drury says. "Some of the local funds management industry have been a little bit concerned the move would take some income away from them.

"It created a really important discussion around whether it has become harder or easier for companies to list in New Zealand. It's important in a healthy market there is a lot of new companies being started. We just didn't see the other companies come up behind us to take that trading volume," he adds.

Drury says the company was confident in its strategy and confident it was doing the right thing for shareholders, and it kept communicating and letting people know why it was moving to a sole ASX listing.

Xero's shares rose 10 per cent on the first day after they ceased trading in New Zealand. "That alleviated a lot of concerns and validated the strategy. It feels like it's been well executed," says Drury.

The sole listing also made sense because of Xero's strong brand in Australia. He notes the company's 500,000 subscribers interact with more than 12 million small business owners and consumers. "The brand was getting really well known so it wasn't like we were going new to the market where people didn't know us," he says.

Xero had looked at other exchanges including Nasdaq, but Drury says the fact ASX is well managed with good governance and transparency put it in front of other exchanges. And with six-monthly reporting, disclosure requirements are less onerous than for US exchanges, which require quarterly earnings announcements.

Above all, Drury says the sole ASX listing opened better access to the global investors Xero needs to drive ongoing global expansion. "We wanted to make sure we had the right sort of global investors – the people that would invest in companies like Amazon and Google who are really growing a big platform."

A sole ASX listing also simplifies operations, Drury says, adding a dual listing spread liquidity across two markets. "That made it harder for global investors.

"IN THREE TO FIVE YEARS' WE WILL OPERATE ON A GLOBAL SCALE AND BRING VALUE TO SMALL BUSINESSES AROUND THE WORLD."

They need to feel there is liquidity there to get in and get out and take a reasonable position."

Xero has so far raised more than NZ$470 million, including NZ$2 million before listing and NZ$15 million at listing. It has also made subsequent placements to shareholders, including MYOB founder Craig Winkler, Paypal founder and Facebook investor Peter Thiel, US-based hedge fund Matrix Capital Management and Silicon Valley venture capital outfit, Accel Partners.

At 30 September 2017, Xero had NZ$84.3 million in cash and short-term deposits. The company has also established a NZ$100 million stand-by debt facility with the Bank of New Zealand and ANZ, but says there are no current plans to draw down on the facility.

"We don't forecast them raising more capital because in theory they're going to turn cash flow positive in the next year or so," Morningstar's James says.

Drury says theshift to an ASX sole listing, along with a move to being EBITDA positive, has already attracted new shareholders. He notes many big global funds don't like investing in loss making companies, but they can now see Xero is on a path to generating free cash flow.

Drury says an added attraction is the cluster of technology companies listed on the ASX. "We were on our own in NZ at our scale," he says. "In the Australian market people do understand technology, and there are a number of other big internet companies to which we could be compared. Those firms have done a lot to educate the investment community, which is something we could leverage and contribute to as well."

ASX, which is seeking to attract more international tech listings, has labelled Xero's sole ASX listing as "the greatest vindication of the ASX's tech strategy so far."

Australasia is also a hot bed of cloud computing, Drury says. "When you look at the market penetration we have, there's no doubt Australia is one of the cloud-leading nations, which gives us tailwinds."

Morningstar's James says investor relations is vital to Xero's success.

"When you think about Xero and that type of company, investor support and investor confidence in the stock is really important. You have to keep the momentum of the story; you have to keep that going – it has to be positive and the outlook has to be exciting for investors. Rod Drury was great at that, he's incredible at that – he's very much able to sell a story. That's how he has got Xero this far without making a profit."

Vamos has not led an ASX-listed company as a chief executive, but he says he has been lucky to have the opportunity to be on ASX boards. That has given him a great insight into how boards of ASX-listed companies and management work well together.

"It's also given me a really good appreciation for the things our investors are concerned about. Setting clear expectations and good communication with our investors is important. I think Xero has done a good job and I'm really looking forward to working with Sankar in continuing to strengthen and develop those relationships," he says.

Vamos says he intends to stay on the board of Fletcher Building and Telstra.

Xero will remain a New Zealand-domiciled company headquartered in Wellington. Vamos told the conference call announcing his appointment as CEO there will be no structural changes. He will remain based in Sydney, but will spending an enormous amount of time in New Zealand where around half of Xero's people are based.

"Australia is our biggest business so I'll be spending time in both countries, as well as in our international businesses that are growing. So I'll take my time, but I'm open to moving and I'll place myself where I think I can best serve the business," he explains.

Since Vamos began at Xero in April his immediate focus has been to get to know the people, the operating rhythm of the company and the detail of the economics of the business model.

"Because I'm familiar with and very supportive of the strategy, doing that work is really more to make sure we get the execution right because good execution is 80 per cent of what strategy is about," he says.

Vamos says a great strategy means that a company is clear about how what it does today creates the future it wants. "I have an orientation to strategy which is not just about putting goals and big sign posts out there, it's about really making sure the organisation is clear and aligned and executing well.

"I am probably more oriented to execution and operational excellence around that because when I look at the successes and less successful companies I've worked with over the years, at the end of the day what differentiates them is open minded leadership that focuses on the detail of executing the strategy. That's really the focus I'll bring."

With Xero's strategy set, investors will now be focused closely on that execution.

Numbers game

Xero has been one of the handful of companies to innovate with a hybrid annual general meeting (AGM).

Its 2016 and 2017 annual meetings were both held in Sydney, Australia, recognising Australia was Xero's largest market by both revenue and subscribers in 2016 and 2017. For both meetings, Xero offered all shareholders access to a virtual meeting platform where they could attend and participate in the meetings. The company used technology provided by its share registrar, Link Market Services.

Xero's global head of strategy, Chris Teeling, says although he doesn't believe the physical, face-to-face conversation aspect of AGMs will be scrapped, hybrid AGMs in the next 10 years will start to become preferred because they enable much wider participation and a larger audience.

Teeling says a hybrid AGM does require more upfront preparation, but Xero is happy with the increased shareholder engagement. More than two-thirds of people attending Xero's 2017 annual meeting did so using the virtual meeting platform, with online attendees from around the world including Australia, Germany, Japan, Hong Kong, New Zealand, the Philippines, Singapore, UK and US.

Xero recommends having a virtual meeting platform in addition to holding a physical meeting to any listed company, Teeling says. "It's particularly useful as a business based in Australia or New Zealand with shareholders who are around the world, given the physical distance from them. Our business is at the forefront of technology globally so it makes sense to offer our shareholders services that reflect our passion for technology."