

Executive Summary

The following report has been prepared for Josh Potts who has been offered employment as a software developer at Xero Limited. The aim is to provide an in-depth analysis of the situation of Xero Limited using their annual report for the year ended 31 March 2012 and provide a recommendation to Josh Potts on whether he should accept the job. Josh has also requested information on the likelihood of wage growth in the near future.

Xero Limited is an online accounting software company founded in 2006 by Rod Drury that prides itself in its 'beautiful' and easy to use software. Xero Limited operates on the cloud which means the data can be accessed from any kind of internet access - including the user's laptop at home, work and smartphone. Xero is used by small business owners and their accountants as an accounting system to perform tasks such as sending invoices, tracking inventory and carrying-out pay runs.

The company presently has operations in the UK, US, Australia and New Zealand and are currently undergoing large global expansions, opening new offices in these overseas markets and employing a diverse range of staff for operations. While Xero is an exciting New Zealand company leading online accounting, the large costs of initial investment and a customer base that is still emerging mean that the company has yet to make a profit. On the basis of this report, I recommend that Mr Potts accepts the job, but he should not expect wage growth in the near future.

Profitability

Despite figures showing that Xero Limited has made a loss of nearly \$8 million dollars, the company achieved "outstanding growth" for the year ended 31 March 2012 according to Chairman Sam Knowles. Xero Limited has doubled their revenue from \$9.3 million to \$19.3 million and customer numbers are trended upward from 36,000 for the year ended 2011 to 78,000 in 2012. ②

Knowles acknowledges that Xero are "executing a growth strategy to become a global leader in online accounting." This strategy involves the execution of scaling internationally in three major markets of the UK, the US and Australia.

The Cash Flow Statement shows that Xero raised capital funds during the 2012 year through private offerings which raised over \$20 million and created a Share Purchase Plan which provided over \$15 million in capital. This Share Purchase Plan (SPP) allowed major NZ shareholders to invest further in Xero. This confirms that Xero's shareholders have faith in the company's expansions and are not put off by Xero's losses as it continues to grow. This should encourage Josh Potts to take the job because current investors with an interest in Xero Limited believe that this company has the potential to grow. With the confidence of investors and those involved in the online software industry, it is more likely that Josh Potts' job will be secure at Xero Limited. ①

Xero currently has high operating expenses as shown by the huge increase in expenses from the 2011 year, which were up nearly 10 million to \$28,385,000. These can be put down to the jump in employee entitlement costs of \$19,272,000, management of information in the US and marketing/advertising of close to \$3,000,000. ②

The employee entitlement expenses increased as Xero hired 81 new staff members and selected employees were offered employee share incentive plans.

In the report Rod Drury referred to Xero as a world leader of accounting software. Therefore Xero limited must ensure that their technology is progressive and incorporates new ideas. Over the 2011/2012 financial year, Xero integrated two acquisitions into their accounting software, Paycycle and Max Solutions Holdings Limited, which are new features to advance the software. This will make Xero's systems less impeding as they now include a payroll system/management and tax solution system which will attract more customers and thus allowing more profitability in future accounting periods. ①

Over the year Xero has continued to target small accounting businesses in the NZ and overseas markets and encouraged them to bring their clients on board. The cost of training and promotion has increased because of this, but getting these people onside has been critical in growing the customer base.

An increasing global customer base means that more staff like Josh Potts are required in offices worldwide to enable operating capability and product development. This will further advance/promote the product, attracting more customers and thus revenue. If Josh accepted the job offer he may in the future have the opportunity to work overseas for Xero, which would be very useful for his CV. ③

With revenue and customers on a steady upward trend and the net loss percentage improving from -80.15% in 2011 to -41.8% in 2012, Xero are moving in the direction of profits. Additionally, revenue is rising at a greater rate than expenses so total expense percentage is improving (from 193% in 2011 to 146% in 2012). If this continues, Xero Limited is likely to at some point reach profits and Xero Limited will be able to operate into the future, meaning Josh will have secure employment with Xero. ②

High expenses coupled with focus on growth internationally are the main reasons that Xero, to date, has never made a profit. Sam Knowles forecasts that "to maintain the momentum the company must continue to invest and it is to be expected that Xero will again make a loss in the next financial year".

Liquidity and Cash Management

Xero is a firm with a large volume of cash in its bank. The closing bank balance for the 2012 year shows a figure of \$38,976,000 in cash or cash equivalents. This is over \$20 million greater than the previous year's closing bank

balance of \$16,922,000 meaning that Xero has gained funds. These funds have come from the purchase of additional shares by current shareholders and will finance the growth scheme for Xero over the next few financial periods and be available for acquisitions. This funding has meant that Xero has few current liabilities and no long term liabilities as the company have not had to acquire bank loans to fund their investments. Along with the large quantity of cash in the bank, total assets for Xero Limited of over \$57 million are substantially helped by the upward trending intangible asset figure of \$10,260,000 for the year ended 2012. Additions in software development to maintain the "emerging leader" position in online accounting software is the main reason for the increase in intangible assets.

Discussion of cash flows in operating, investing and financing activities omitted from this exemplar.

High levels of assets and very few liabilities have led to a net asset figure of \$52,248,000 which accounts for the high current and liquid ratios of 6.93:1 and 6.86:1 respectively. Although cash rich, CEO Rod Drury dismisses the idea of using this money for dividend pay outs and is says "This isn't money for dividends, this is money for growth."

Employment Analysis

Xero Limited has a team of 194 at present, with 44 of these staff members being offshore. For the financial year ended 31 March 2012, Xero recruited 81 new team members as the company opened new offices in Canberra, Milton Keynes and San Francisco. The Australian team almost doubled in size from staff numbers of 14 to 27 due to the opening of the premises in Canberra and the trebling in Australian customer numbers to 16,000.

Xero is a company which heavily relies on its software. Therefore a large team of skilled software developers are crucial for the company to ensure it continues to keep the software advanced, which attracts customers and therefore increases revenue. Alongside a team of skilled software developers, Xero needs more staff in sales, customer support, marketing and business services - all of which will allow the business to attract and maintain customers for Xero Limited in future financial years. It is forecast that there will be many openings for innovative workers in the next couple of years as Xero plans to open an office in Los Angeles to push business in the US and continue the success in Australia with additional premises in Brisbane and Sydney.

Xero Limited is clearly a company that encourages their employees to love their work. Rod Drury is quoted as saying that a team pushing the boundaries is a key to success. A large number of software developers employed over 2012/2013 received \$10,000 bonuses - \$5000 at 6 months of employment and the balance after 12 months with the company. This is because Rod Drury wanted to attract the best possible human resources, after saying that Xero has to compete with Trade Me and Orion Health for software developers. These bonuses and the employee share scheme are incentives for staff to stay with the company and to do their best work.

It is of interest to Josh Potts, who has been offered a job at Xero to know whether there is potential for wage growth in the next couple of financial periods. Mr Potts should not expect wage growth in the near future - as Xero have established a share scheme for employees plus bonuses to attract new workers, it is unlikely that they will increase workers' wages on top of this, particularly as the company are still yet to make a profit.

However, the employee incentive plan will be attractive for Mr Potts as he may be issued shares which will allow him to own a piece in the company. It is quite possible, if Josh Potts was employed as a software developer, that he will receive one of the \$10,000 bonuses. The career advancement opportunities Xero provides as well as an innovative team of like-minded thinkers should also be persuasive for Josh Potts' decision.

Conclusion

I advise that Josh Potts accepts the job at Xero Limited. Employment at Xero will be a great opportunity for Mr Potts to advance his career with a forward thinking global leader in online accounting software. Josh Potts will have the chance to interact and work with a strong and innovative team. The employee share scheme may allow Mr Potts to own a part of the Xero Limited and share in potential successes.

Josh's job is likely to be secure due to the backing of Xero by shareholder confidence and investment which has led to large funds for Xero to be able to meet their debts and expand. If revenue continues to increase at a greater rate than expenses, Xero will begin to close the gap between making a loss and breaking even and should eventually reach profits, ensuring viability for Xero Limited and security for Mr Potts' job.

I do not believe that wage growth is likely at Xero Limited in the near future. The company is highly focused on global expansion with the goal of attracting customers and increasing revenue, therefore wage increases are likely to be several years away when, and if, Xero Limited begins to make profits. Xero Limited has created incentives and benefits other than wage growth for working for the company, including the employee share scheme and bonuses. Josh Potts will benefit from these while Xero drives its growth plan.

All sources cited and a bibliography provided.