Hyperion Asset Management

Company Profile **Xero Limited**

Main Business Activities

Xero Limited's (Xero) core business is Software-as-a-Service based (SaaS), user-friendly, feature-rich, small-to-medium sized enterprise (SME) accounting software. Xero's core markets are Australia, New Zealand and the U.K., with earlier-stage operations in and other countries. The product suite includes applications for both SMEs and accounting practices.

The company is rapidly evolving from a SME accounting software vendor to an SME platform, acting as an intermediary between users and an 'ecosystem' of third-party app developers. Xero is cloud-native with open-architecture and as a result users can easily integrate these third-party apps into their Xero software, enabling SMEs and accountants to manage a growing list of tasks with real-time data and reporting. The platform ecosystem consists of both Xero products (including bank feeds, accounting, payroll, expenses and projects) and hundreds of third-party applications, all sitting on a common platform or 'single source of truth'.

Xero is a product-led company, relying heavily on accountants and book-keepers for distribution (known as the 'partner channel').

Xero has a proven growth model, replicated successfully around the world. When entering a new market, the two priorities are developing the partner channel, and integrating the Xero product with banks (known as 'bank links'). Product localisation and direct selling are the next focus areas. Product innovation is always a core focus, but is largely centralised and rolled-out to all regions. This means all users are on the same software version, ensuring a consistent user-experience and driving research and development productivity.

Key Value Proposition to Customers

Xero has a strong value proposition to both SMEs and accountants/book-keepers, comprised of:

• A simple and logical user interface that appeals to a wide range of SMEs, and doesn't require technical accounting expertise (for SMEs);
• Widely adopted by accountants/book-keepers, who act as advisors to SMEs. Xero promotes adoption by accountants (known as the 'partner channel') via providing free accountant-specific software, education resources, and quality customer service;
• Seamless integration between Xero's software for SMEs, and Xero's software for accountants, enabling large efficiency gains via both parties having access to a common data set, or a 'single source of truth';
• A high degree of automation which saves both SMEs and accountants time and money. This automation extends from bank feeds updating financial information in real-time, to preparation of compliance lodgement obligations;
• A regularly improving and expanding product suite to accommodate SME growth and complexity; and
• A large third-party application ecosystem where both SMEs and accountants can simply download pre-integrated software solutions for myriad use cases.

Sustainable Competitive Advantages and Outlook

Xero has several aspects to it's sustainable competitive advantage including a superior cloud-native product, an excellent reputation among SMEs and accountants/book-keepers, high and increasing barriers to entry, and high switching costs as 'mission-critical' software.

Xero's sustainable competitive advantage will grow over time with scale, product expansion, data capture (an increasingly important in the age of Artificial Intelligence and Machine Learning), and rapid growth of its open platform where third-party applications are partners rather than competitors and Xero becomes the gatekeeper to the ultimate customer.

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Overall Company Growth Options

The primary hurdle in growing penetration of ancillary products is educating SMEs on the opportunity costs inherent in trying to do everything manually, which involves convincing SMEs to value their time. Xero has a competitive advantage in cross-selling ancillary products via having existing relationships with customers, the ability to offer deeper integration versus alternatives (even Xero platform ecosystem partners), the ability to offer in-app cross-selling (i.e. contextual selling), and the ability to bundle ancillaries with the core cloud accounting product.

Financial Services (payments) is the largest growth opportunity within the ancillary product suite where growth will be primarily volume-based as Xero educates merchants on the strong value proposition (efficiency gains and shorter receivables days outstanding via issuing e-invoices versus paper-based invoices). As well as the structural shift towards digital payments, the shift to e-invoicing also benefits from regulatory tailwinds. For example, the Australian Government will mandate e-invoicing for all agencies by July 2022 with 80% of invoices to be received electronically by July 2021 (we expect e-invoicing to progressively become the default invoicing method for all businesses).

Xero also has substantial optionality to expand its total addressable market in non-English markets, which is a medium to long-term strategic focus. Xero has a solid track record of execution in geographical expansion, driven by a combination of:

1) Xero's cloud-native software with a global code line. Hyperion estimates 80% of the software is the same across all regions, with 20% comprised of localisation for compliance and tax regulations; and
2) The business' 'cookie cutter' strategic playbook for entering new markets including an initial focus on developing the partner channel (Recruit/Educate/Grow) and integrating the Xero product with banks (known as 'bank links'), then onto product localisation and direct selling.

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