FY24 FINANCIAL RESULTS TRANSCRIPTION

Company: Xero Limited (XRO)

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[START OF TRANSCRIPT]

Operator: Thank you for standing by, and welcome to the Xero Limited 2024 Results Conference Call. I am joined by Xero's Chief Executive Officer, Sukhinder Singh Cassidy, and Chief Financial Officer, Kirsty Godfrey-Billy. All participants are in a listen only mode. There will be a presentation, followed by a question and answer session. If you wish to ask a question, you'll need to press the star key, followed by the number one on your telephone keypad. Please limit your questions to one question at a time. If you wish to ask a further question, please rejoin the queue. I would now like to hand the call over to Sukhinder Singh Cassidy, Chief Executive Officer of Xero. Please go head.

Sukhinder Singh Cassidy: Good morning from Sydney, Australia. Thank you for joining our investor briefing today, covering Xero's financial and operating results for the full year ending 31 March 2024. I'm Sukhinder Singh Cassidy, and I'm here with Kirsty, our CFO.

Moving to our results. Our first agenda item is a summary of Xero's performance during the full year. I'll then pass to Kirsty to cover our financial results in detail, before I finish with strategic priorities and Xero's outlook. After that, we'll move to Q&A.

So, moving to a summary of our results on Slide 5. We're really proud of this result, and in particular, it shows you we are capable of executing towards our future aspirations. You'll see that Xero has continued its track record of strong revenue growth, and at the same time, we have delivered a meaningful increase in profitability. Thats lead to us achieving a Rule of 40 outcome. I'm going to touch on the key metrics here, and Kirsty will discuss them in more detail later.

Revenue grew 22% to $1.714 million (sic – "1,714 million") or 21% on constant currency terms. Adjusted EBITDA of $527 million, is up $225 million, or 75% over last year. Together the strong operating results and improved free cash flow generation resulted in a Rule of 40 outcome of 41%.

Moving to the next slide, Xero is a macro resilient business that consistently delivers strong top line growth. This year, we saw growth balance between subscribers and ARPU, with subscriber growth of 11% year-over-year, and ARPU of 14%. The subscriber additions were 419,000 in the year. Price changes across our business edition and partner edition products were key drivers of ARPU increasing 14%, or 10% on a constant currency basis.

I'll now spend a few minutes outlining the regional contributions to this revenue growth, as well as the features we delivered on the product side to support this.

Slide 7 shows the continued strong revenue growth in our ANZ segment. We delivered 22% revenue growth year-over-year. Within this, subscribers grew 11%, and ARPU expanded 11%, or 9% on the constant currency basis, mainly from price rises. Both countries contributed to this, with Australia growing revenue by 23%, and adding a further 205,000 subscribers in the year. While New Zealand's revenue grew 15% and added 38,000 subscribers. This is a great outcome in the segment with high cloud accounting penetration, reflecting our strong brand presence in product operating in these markets. Alongside our ability to continue to bring small businesses to the cloud and offer more services.

Turning to the international segment, we delivered 24% revenue growth, 20% in constant currency terms, and reached 1.8 million subscribers, up 11% year on year. ARPU grew by 17% to $41, or 11% on a constant currency basis, mainly driven by price changes. In the UK, revenue increased 24%, with 20% in constant currency. Subscribers were up 11% year-over-year, with net additions of 107,000. This is a pleasing outcome in a period where there was no MTD tailwinds.

In North America, revenue increased by 17%. However, there are some noisy items affecting the comparison. Adjusting for this of revenue grew 22%. Total subscribers were up 10% year on year, with net additions of 38,000 for the year. Canada's net subscriber outcome of the year was subdued, mostly reflecting a lack of adoption tailwinds. We've made some GTM changes, which I'll touch on later, in response for execution there, and a cloud accounting backdrop.

In our rest of world market, revenue grew 26%, or 25% in constant currency terms. Total subscribers grew 12% year on year, with net additions of 31,000 in the year. The largest driver of subscriber growth in the segment was South Africa, where we continue to see good momentum.

Now moving to the next slide, and the product investment we made in FY24 to support this growth. The revenue growth we've delivered across our regions reflect the value of our products and the continued enhancements we've made. This slide shows our investment in completing the three most important jobs to be done, core accounting, payroll and payments in our three largest markets, Australia, UK and the US. In core accounting we've made great progress. In the US, we've upgraded our coverage to extend to more than 600 direct feeds. We've also increased the number of banks which use our bank statement extraction feature, which is Hubdoc, which extracts data to populate into Xero. We've also made a number of improvements to Xero Tax UK in the last year to support compliance changes.

In payroll, the work we've done over the past four months across products and engineering is making it easier for small businesses to onboard. We've also improved functionality in our UK offering for non-traditional work hours and pension needs. Alongside this new functionality, we have also modernised the payroll monolith, breaking it down to micro services, and removing 50% of unused code. This is a great achievement and highlights our focus on delivery for customers while modernising.

Payments is one of our biggest opportunities, and our new partnership with Bill in the US will allow us to driver deeper functionality as part of our 3x3 strategy. We've also made it more intuitive [and frictionless] for small businesses to sign up with Xero for payments. In November 2023, we became the first major small business accounting software company to launch eInvoicing in the UK. We will continue to unlock opportunities in these core areas to deliver value for our customers and support revenue growth.

Moving to the next slide, which shows how this translated into profitability. The chart on the left shows the meaningful change in adjusted EBITDA year on year, up 75%. This contributed to a strong free cash flow margin of 20%. You can see in the chart on the far right that adding this to revenue growth, where we use the 21% constant currency metric, resulted in a Rule of 40 outcome of 41%. This neatly shows how we shifted to deliver in profitability without moving away from adding value for customers and generating strong revenue growth.

Before I hand over to Kirsty, I want to summarise the actions we've taken against the commitments we made to you. FY2024 was a significant year of change for Xero and our team as we set the foundations for our next chapter of growth. We called out three key opportunities or goals in my first earnings call as CEO. These were to target a more balanced profitable growth, to be more focused in how we allocate resources, and to start on our journey to use new levers of growth. Underpinning this was a commitment to build on our capabilities and evolve to a more performance based culture. We've made a number of moves in FY24 to deliver on what we said we'd do. As I talked about, we successfully balanced growth and profitability to continue our strong revenue growth while modernising Xero and delivering a Rule of 40 outcome.

There are a number of key points of where we've been more focused in our allocation of capital. Key among these are our sharpened focus in the US, and the discontinuation of a number of non-core businesses, such as Waddle and WorkflowMax. We've started on our journey to use multiple levers for growth, and a focus on improving mix through onboarding enhancements, and becoming more dynamic in our CAC allocation. However, what I'm most excited about is the new capabilities we've added, and the steps we've taken to evolve our culture to be even higher performing and purpose driven. So, as I said, it's been a big year, and we're proud of what we've accomplished, but it doesn't stop here. We've made some moves early in FY25 which I'll speak to later. But for now, I'll hand to Kirsty to cover the financial results in more detail, before coming back here to wrap up.

Kirsty Godfrey-Billy: Thanks, Sukhinder, and good morning everyone. I'll now provide some further detail on our financial results for FY24, starting on Slide 13.

Before turning to the details, I want to echo Sukhinder's commentary on our FY24 financial performance. We have delivered a strong financial result with the pleasing Rule of 40 outcome. This slide highlights the key internal metrics we use to monitor our success. As we identified at our investor day, there are three key things you will notice about our financial performance this year. Our continued growth momentum, the value that customers place in Xero, both of which are reflected in our ARPU growth and also net subscriber additions. And finally, our focus on balance and growth and profitability shows in our OpEx ratio and significant revenue per FTE improvement.

Let's start by taking a deeper look at top line growth. This slide shows a breakdown of revenue between our core accounting revenues, and platform add-ons. Core accounting revenue growth of 24%, or 23% in constant currency was driven by subscriber growth and ARPU expansion, with the benefit of price changes. Platform revenues grew 22%, or 18% in constant currency, and remains at 11% of operating revenues. There was some drag in performance from the Waddle exit. The decrease in other revenues largely reflects reduction in Xerocon revenue. We only had one event in FY24 versus three in FY23.

Let's turn to the underlying SaaSmetrics that show how we generated revenue.

This slide shows our continued strong AMRR performance, alongside the key drivers, subscriber growth and ARPU expansion. On the left hand side you can see the change of mix between the two, with ARPU contribution expanding to reach 10.8% in constant currency this year, while subscriber growth was 11.2%. This shows our continued focus on ARPU expansion. Both drive AMRR, which as you can see on the right, translated into continued strong momentum, with growth in FY24 of 26%, or 22% in constant currency. This resulted in AMRR ending the year at more than $1.9 billion.

As a reminder this metric reflects the annualised benefit of our subscriber base and ARPU as at 31 March and indicates a revenue exit rate in absolute terms for our business moving into FY25. It's worth noting that price rises announced in Australia, which take effect in July, are not included in this number.

Turning to more detail on ARPU and churn. As we show on the left hand side of Slide 16, price changes were the largest driver of the 14% increase in ARPU, followed by FX benefits, primarily from the pound and US dollar. It's worth noting, the FX impacts included in these metrics are on a spot basis as of 31 March, rather than an average rates over the period. We saw limited benefits from a shift in our product mix, which we are more actively turning our focus to, but it is early days. The improvements we have made to our Australian product ladder demonstrate the work we're doing to build and support this muscle.

Platform attach was flat over the period, with key drivers outlined on the next slide. However, I want to touch on churn first. Churn is a key outcome we consider when looking at levers to drive the ARPU expansion. We have seen an uptick in partner product churn over the year as ABs managed undeployed inventory. This was largely in response to partner addition price rises from 2023. This translated to only a slight uptick in MMR churn, from an all-time low we reached post-COVID. With churn up 9 basis points over the year, and 5 basis points in the second half, This small impact reflects the lower price points of these products, which definitely impact on MRR churn. As you can see on the charts despite the uptick, we remain below the long term average, reflecting the value the customers continue to place in Xero to run their business.

Now turning to the drivers of platform revenue on Slide 17. We saw good growth in payments, offset by slow growth in payroll and Planday. On this slide are the activity indicated for each of these. While there were different factors across each, we see a significant opportunity in developing this lever, in line with our strategy to win the 3x3. This includes pricing and packaging work to support adoption and increase usage across our markets, targeted investment and product functionality to improve the customer experience, and changes to sales motions to better align our go-to-market priorities.

Starting on the left, we show that monthly invoice payment value has grown strongly, in the year to March has increased 18%. This was impacted by the timing of Easter, with the underlying trend better seen in the April data, where we delivered 30% growth. Revenue growth for the year to March was 36% in constant currency. In addition to the increase in volume, this reflected the unit economics margin expansion with our partners improving as we reach key growth and product development milestones. We see payments as a core opportunity which is reflected in this inclusion in the 3x3. We are focused on improving the user experience to increase customer uptake. For example, continuing to streamline the onboarding and workflow experience by working closely with our partners.

The middle chart shows employees paid through Xero payroll. This increased 7% since this time last year, across Australia, New Zealand and the UK where we offer this product. There is an element of normalisation and growth in Australia, where we have seen very high adoption following STP tailwinds in prior years. There's more work to be done to enable our product to better deliver to customers in the UK and New Zealand markets. This is a focus for product delivery in FY25. We're also reviewing our approach to product, packaging and bundling across markets, learning from our experience in Australia.

The right hand chart shows the number of Planday users at the end of each quarter since March '22, which increased by approximately 8% from the prior year. As we said previously, Planday has been going through a period of transition and to focus more on the smaller segment in its European home market. This has impacted the growth rate and the number of employees using Planday in FY24. One of the decisions made in this transition was to exit the Australian market, as we announced in April.

The final consideration for top line dynamics is our plan to address the long idle subscriptions. As we mentioned in the first half, we define long idle subscriptions as those that have been undeployed for more than 24 months and are not expected to be deployed in a reasonable timeframe. As you will see on Slide 18, the range has shifted down to 125,000 to 175,000. This can be due to partners either deleting early or indicating their plans to deploy.

We've also provided a more granular disclosure of the regions we expect to be impacted by the removal of these subscriptions. The majority of these subscriptions are located in our international segment across North America and the UK. As we said before, we plan to remove these subscriptions during the coming half and will update you on the outcome of conversations at our first half '25 results.

This will be a drag on subscriber growth, but benefit ARPU in that period. Based on the midpoint of the updated range we have provided is at 31 March '24, if these subscriptions were removed, the group ARPU would increase by 2% to 4%. The low ARPU nature of these subscribers means that removing them is expected to have minimal impact on FY25 revenue.

Moving to the next slide. Here we highlight how the CAC metrics I've discussed reflect the value Xero generates. LTV is a high level measure of the value customers bring to Xero over their lifetime, which on average globally, is around nine years. The chart on the left shows the continued expansion in LTV that Xero has delivered. This is reflected in the key contributors of LTV, which you can see on the right. ARPU is $39.29 and churn of 0.99%. We measure our efficiency of acquiring new subscribers through the value of the subscriber, or LTV, to the average cost of acquiring the subscriber, or LTV/CAC. The unit economics we generate in New Zealand and Australia reflects the value the Xero can deliver in a more developed market, with an LTV/CAC ratio of 14.3.

On the next slide, we break down how these metrics have evolved over the year. Starting on the left of the slide, we show how the drivers of LTV have moved. From left to right, subscriber growth contributed $1.3 billion to LTV uplift. ARPU expansion was the largest driver of the LTV uplift and contributed approximately $2 billion. The uptick in churn partially offset this increase, reducing LTV by $1.7 billion, and FX and gross margin were slight benefits

I wanted to touch on some of the related metrics highlighted in the chart on the right. LTV per subscriber, CAC and LTV/CAC. You'll also find these metrics in the appendix. LTV per subscriber grew 4% over the year to $3,732.00. CAC spend covers three broad areas, the cost of acquiring new subscribers, and investing in our brand for future subscribers, initiatives to educate existing customers to encourage retention, and costs associated with upselling and cross-selling to existing customers. The majority of acquisition costs were expensed in the period, in contrast to the revenue from subscribers added, which is earned over multiple years.

CAC spend increased 15% as we increased investment and brand recognition and performance marketing, particularly in the UK and North America. This included our partnership organisations with FIFA Women's Football, which came through in the first half. This resulted in CAC per gross add metric increasing by 9% over the year. The increase in CAC spend per gross add was more than offset by ARPU expansion.

This resulted in CAC funds falling to 15.2% from 15.9%, with similar trends in both the ANZ and international segments. While we don't expect to reach the same LTV/CAC in our international segment, over the long term, we expect to see it improve. Albeit, at times, it may move around as we become more dynamic in our CAC allocation as we see specific opportunities to invest. LTV/CAC fell slightly to 6.2% compared to 6.5% in March '23. The reduction here was due to the higher CAC per gross add.

Turning to Slide 21, and our cost base. Our high growth margin, combined with the strong revenue result has seen gross profit increase by 24% year on year. The chart on the left shows the trends with gross profit of $1.5 billion for the full year. We have remained disciplined in how we serve our customers, and this is reflected in an improved gross margin, up nearly a percentage point compared to last year. This focus on efficiency is part of our operating rhythm as we continue to look at new ways to improve and innovate in this space. A great example of this is how we have experimented with generative AI and Xero Central, our customer support and learning site, as well as other AI experiments throughout the onboarding process, which aims to reduce the need for human intervention.

Now moving to operating expenses. We delivered our guidance that operating expenses to revenue would be around 75%, with our ratio for year sitting at 73.3%. This significant improvement in efficiency reflects our commitment to balancing growth with profitability. The key driver of this improvement was embedding the changes post the step change and our cost structure following our 15% headcount reduction. We also benefited from greater clarity, speed and effectiveness across our organisation. It's also worth highlighting, the half on half seasonality we saw in this number, with the first half higher, reflecting timing of CAC spend, the flow through of our restructuring, and the timing of price rises.

In line with our commitment to balancing growth and profitability, we will invest to drive growth across our business in FY25. As such, we expect our OpEx ratio in FY25 to be around 73%. Sukhinder will talk about this later. To show you how we deliver an operational leverage while continuing to grow revenue, I'll take you through the individual function areas and our cost base.

Starting on the left, sales and marketing costs increased 15% against revenue growth of 22%, which resulted in these costs falling to 31.6% of revenue. [Spend] during this period included increased brand and performance marketing investment, including our partnership with FIFA. The benefit of this brand investment will roll through over time as brand awareness and recognition develops, particularly in our international markets.

Moving to product design and development costs. These fell to 30.7% of revenue. This area was where the majority of FTE reductions occurred as part of our restructure, and the significant decrease in spend here is due to these changes. Total or gross product development costs, including capitalised costs and excluding D&A, was 33.6% of revenue, down from 42.7% in FY23. This movement in total product spend is largely a reflection of our restructure, which was partially offset by planned reinvestment. Albeit, to a lesser extent than expected due to timing.

We expect to continue this investment in FY24, as we build on the momentum we've seen in our product velocity.

Finally, our G&A expenses. These fell to 10.8% of revenue, reflecting robust cost control. These efficiency improvements reflect our commitment to balance and growth responsibility. The net effect of this can be clearly seen in our adjusted EBITDA margin shown on Slide 24. As a reminder, adjusted EBITDA includes share based payments and focuses on providing a view of underlying business performance. Adjusted margins expanded over 9 percentage points in FY24, reflecting the benefits and efficiency across all functions in the business. There were limited non-operating impacts to EBITDA this period, with the largest item being the non-cash impairment of Xero Go, as we retired that product. The improvement in margins translated to a significant improvement in free cash flow generation.

Slide 25 breaks down the $240 million increase in free cash, into its constituent component, clearly highlighting both our strong growth and improved profitability. Taking a look at the key components of operating cash flow, starting with customer receipts, where we continued to see strong growth. This is mainly from subscribers and trends closely followed the growth in our reported revenue.

Moving across, the chart to payments to suppliers and employees, where you can clearly see the benefits of our restructure and subsequent margin expansion. This included $34 million of redundancy payments from our restructure. Excluding this, gross here was only $85 million. We continue to generate net cash interest receipts during FY24. The improvement here reflects higher earnings on our cash and term deposit balances given the current rate environment. I'd remind you that almost all of the interest expense we incur is non-cash amortisation of our convertible notes, which does not impact free cash.

Income tax payments had a small impact on our cash flows in the period. We are monitoring our tax payments carefully as we utilise our accumulated New Zealand tax losses, which you can see in our disclosures through the deferred tax asset movement on the balance sheet. Finally, capitalised costs mainly reflect product development, as well as a small amount of investment in physical assets.

Turning to Slide 26. The increase in cash generation was a key contributor to the $268 million increase in Xero's total cash position, including short term deposits of $1.5 billion as at 31 March. Our term debt liability entirely reflects the Xero coupon convertible notes that mature in December '25. This notes has offered us optionality for inorganic investments at a lower cost than than bank debt, with a mechanism that provides us flexibility in managing the dilution from our call spread, and the choice to settle in cash or shares. Given the flexibility that our convertible notes funding provides us, the significant improvement in our cash generation, and the growth we are delivering, we have a strong balance sheet, with our net cash position increasing more than $320 million from this time last year.

Thank you, and I'll now pass back to Sukhinder.

Sukhinder Singh Cassidy: Thanks, Kirsty. Now moving to Strategic Themes. Having recently spoken with you at our investor day, I'll briefly revisit our strategy. I also want to update you on a few recent moves we've made. We said on the investor day back in February this year, the next three years are themed, Winning on purpose. For us, this means providing winning solutions for our customers, living our purpose consistently in what we do, and how we do it as a company, and being purposeful and focused in what we choose to do, and what we choose not to do.

Turn to the next slide. As you know, our vision and purposes are constants at Xero. Successfully delivering on these is key to achieving our aspirations, which I'll cover in a few moments. Our how to win strategy, which you saw us lay out at investor day, has four key pillars, win the 3x3, winning the GTM playbook for Xero's next chapter, win the future, which is really about the focused bets and innovation, our medium/small markets execution. Lastly, unleashing Xero and Xero(s) to win. On this side, as you will remember, there are 12 key tactics, three under each stage. Now, I won't go through these again, but we'll be making moves against all of these, and we are doing so already, which I'll discuss on the next slide.

We've made a number of moves in recent months as we execute against our strategic priorities. To support winning the 3x3, we recently established a partnership with Deputy to embed time and scheduling into our core products in Australia. As part of this, we are exiting Planday in Australia, and will focus the Planday team and business in Europe and the UK. We've launched simplified product packages in Australia. This supports our GTM playbook to make it easier for customers to choose the right plan for them and their level of complexity.

Part of our focus, back to the future, and grow other markets efficiently, we restructured our Canadian sales team. This reflects us right sizing for the current cloud accounting backdrop.

We are also retiring Xero Go in the UK as we evolve our mobile efforts and focus on our primary segments. Finally, as part of continuing to unleash Xero(s) to Win, we promoted Diya Jolly to Chief Product and Technology Officer. Her leadership across these teams is improving the team’s ways of working together, particularly how our engineering and product functions operate together as we continue to evolve our capabilities and improved product delivery. You will notice many of these moves are about purposefully allocating capital towards our 3x3. This feeds into the next slide where I'll touch on our priority areas for product investment in FY25.

In core accounting, we want to continue to add value for our customers by deepening and localising local core accounting capabilities. We'll continue to support the evolving accounting and tax laws in Australia and deepen our UK tax offering. In the US we will continue to localise key bookkeeping and compliance features such as bank feeds, bank reconciliations, sales tax and reporting. Further, across all of our regions we will empower accountants and bookkeepers with bulk tools and insights.

Xero's multiyear modernisation program in Payroll has boosted momentum. Automation will be leveraged, especially in the UK, to simplify pay runs for SMBs alongside their compliance needs. To boost payment attach rates will continue to focus on reducing friction for small businesses onboarding to Xero. We're also going to provide more ways to pay for customers receiving a Xero generated invoice.

We will enhance the UK bill pay experience and introduce our [bill.com] embedded solution in the US. There's a lot here and you should take from this that product investment across our 3x3 is a priority as we add value for customers and support revenue growth.

This brings me to our FY25 outlook which reflects this investment we're making. Total operating expenses as a percentage of revenue is expected to be around 73% in FY25 and compared to FY24 product design and development cost as a percentage of revenue is expected to be higher. Of course, in addition to this, we continue to pursue our aspirations.

These are to be a world class global SaaS business from a very strong position today. We have the opportunity to double the size of this business and deliver Rule of 40 or greater performance. We will focus on high-quality growth which is a balance between subscriber growth and ARPU expansion. As I said before, these aspirations are powerful and purposeful so we will continue to pursue them aggressively over the short, medium and long-term.

To wrap up, there were four key themes you will have picked up from today's presentation. Our results show we are capable of achieving towards our future aspirations. It shows that we are delivering on our commitments. We are progressing our strategic priorities and purposefully allocating capital and we gave you a number of proof points to support this. Finally, we have shown that we're well-positioned to "Win on Purpose" as we move through the FY25 to FY27 strategic period.

Before I conclude, I want to acknowledge our teams around the world and I really want to thank them again for their hard work as we continue to do all we can do to support our customers and our partners. That concludes our presentation. I'll now pass over to the moderator for questions.

Sukhinder Singh Cassidy: Well, we want to thank you again for joining us today. We appreciate your time. We appreciate your support. We appreciate the continued curiosity and investment in our business and, of course, all of our shareholders as well. So thank you so much for your time and, of course, always a shoutout to Xero employees and the Xero team around the world for all they do to make this possible.

Kirsty Godfrey-Billy: Thank you.

Operator: Thank you for joining the Xero Limited 2024 results conference call. If you have any further questions, please contact the Xero Investor Relations team. If you're a media representative, please reach out to Xero's Corporate Communications team.

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