Xero Limited

2020 Interim Report

xero Beautiful business

Lovely Financials
Group, Atlanta

Contents

Highlights

Subscribers

Up 478,000 YOY

2,057,000

Total subscriber lifetime value

Up $1.4 billion YOY

$5.4 billion

Annualised monthly recurring revenue

Up 30%YOY

$764,100,000

EBITDA excluding impairments

Up $31,400,000 YOY

$65,900,000

Operating revenue

Up 32%YOY

$338,700,000

Free cash flow

Up $14,600,000 YOY

$4,800,000

Gross margin percentage

Up 2.4PP YOY

85.2%

Net profit after tax

Up $29,900,000 YOY

$1,300,000

Chair & CEO review

Graham Smith
Chair

Steve Vamos
Chief Executive

Dear shareholder

Xero has delivered an excellent set of results in the half year to 30 September 2019 with strong growth combined with improving gross margin and free cash flow.

During the half, operating revenue increased by 32% (33% in constant currency (CC)) compared to the same period last year. While continuing to invest heavily in growth, Xero achieved a free cash flow result of $4.8 million in the half year, an improvement of $14.6 million compared to the same period last year.

Xero achieved a significant milestone in the half, surpassing two million subscribers globally, to end the period with 2.06 million subscribers. While it took more than a decade to add Xero's first million subscribers, it took just two and a half years to add the next million, demonstrating the pace of Xero's adoption across a number of markets.

Further reflecting the momentum of the business, at the end of the period, annualised monthly recurring revenue (AMRR) exceeded three quarters of a billion dollars, increasing by 30% (30% in CC) to $764 million.

A number of significant trends are contributing to Xero's global expansion including industry, regulatory and technology shifts. These include the increased use of cloud technology by small businesses, the digitisation of tax and compliance systems, and the disruption of traditional financial services, whether it be new payment methods or technology such as e-invoicing.

Being 'born in the cloud' means Xero is well positioned to support the small business community and their advisors to maximise opportunities and adapt to the challenges these market changes present. In this way, we fulfil our purpose to help make life better for people in small business, their advisors and communities around the world.

These trends also provide clear context for Xero's strategic priorities, which are to drive cloud accounting, grow the small business platform, and build Xero for global scale and innovation.

A platform for beautiful business

We continue to invest in Xero's platform and made significant progress on our strategy in the first six months of our 2020 financial year.

We continue to drive seamless, simpler and smarter integrations between our customers' accounting data and other mission-critical small business needs.

Our platform currently provides customers with more than 200 connections to banks and financial services partners around the world, and we reached a new benchmark of more than 800 apps in our ecosystem during the half.

We have been investing heavily in technologies to support our platform, which will help Xero rapidly scale so we can deliver customer value and meet our growth ambitions.

Small businesses getting paid on time is important for their success and survival, which is why this is a focus of our platform strategy. In April we extended our relationship with global payments platform Stripe to help our small business customers get paid faster.

Hubdoc performed well in its first year as a Xero company, and we are looking to leverage Hubdoc's world class machine learning functionality to enhance and extend Xero's core product set. Hubdoc's data capture technology helps customers automate admin tasks like document collection and data entry.

We also announced other innovations at our two Xerocon events held in the half year. These included accelerated machine learning capabilities, new tools for small businesses and advisors to gain greater visibility into business health, and more seamless workflows.

Some updates demonstrating Xero's platform strategy are:

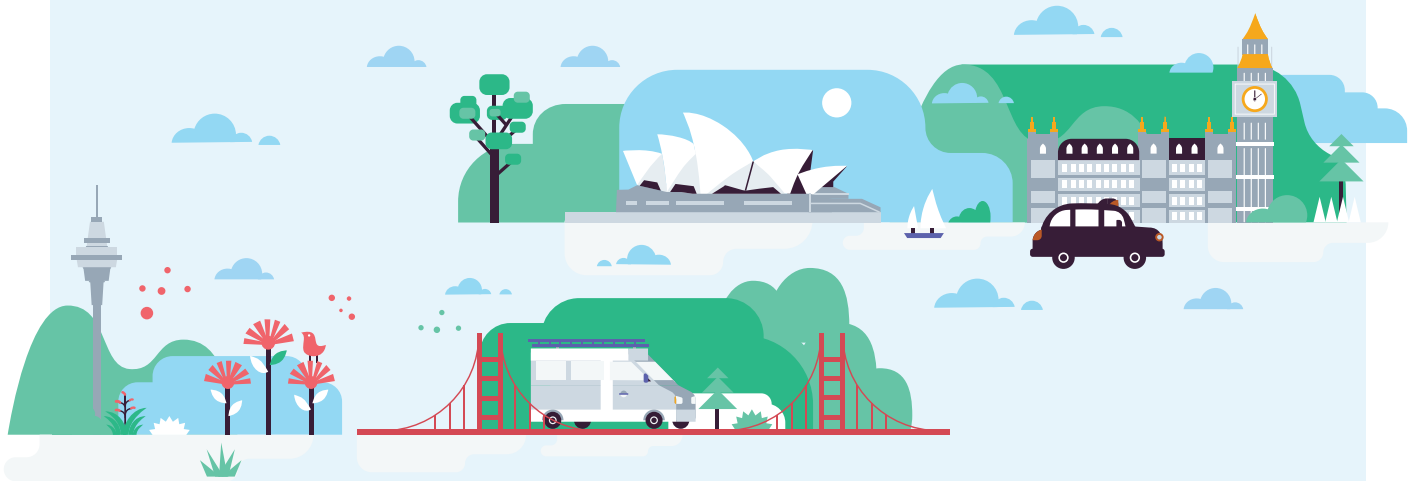
- With our ecosystem of more than 800 apps, Xero allows small businesses and their advisors to build a best of breed suite of tools for their industry and business needs. The comprehensive set of apps in Xero's marketplace includes payments, point of sale, reporting, customer relationship management, time tracking and inventory tools
- Our new Single Sign-On creates a more beautiful experience for users switching between Xero and connected apps, by logging in with one single set of Xero credentials. As this feature is more widely adopted, it will help to increase app usage by our customers and improve security
- We are investing in our app marketplace and other resources to ensure people in small businesses can select the right mix of apps to meet their individual business needs. We do this by helping advisors to create a curated experience for their clients with app recommendations from the marketplace

A launchpad for growth

The US$300 million of capital raised from the convertible notes issue in October 2018 provides us with considerable flexibility. It allows us to carefully assess future investment opportunities through a lens of how they support our strategic priorities. This capital supports the significant opportunity to enhance and extend Xero's small business platform and ecosystem capabilities, through the pursuit of complementary targeted acquisitions.

During the half we renewed our syndicated standby debt facility for a three year term. Global banks HSBC and Citibank were added to the syndicate alongside BNZ and ANZ, increasing the facility's size from $100 million to $150 million. More flexible terms were secured and the annual cost to Xero remains broadly unchanged, despite the 50% increase in the facility's size. While there are no immediate plans to draw on the facility, the scope has been expanded to include short-term liquidity requirements.

Steve Vamos, Xerocon
Brisbane 2019



Half year highlights

(All figures in NZD and comparisons are made against Xero's half year to 30 September 2018)

- Operating revenue was up 32% to $338.7 million (33% in CC)
- 30% growth in annualised monthly recurring revenue (AMRR) to $764.1 million
- 30% growth in total subscribers to 2.057 million
- Total subscriber lifetime value grew by 37% (38% in CC) to $5.4 billion, with more than $1 billion added in the half
- Free cash flow was $4.8 million, equating to 1.4% of total operating revenue
- Net profit after tax increased by $29.9 million to $1.3 million
- EBITDA excluding impairments of $65.9 million almost doubled compared to $34.5 million

Market highlights

- Australia subscribers grew by 28% compared to the same period last year and the region was Xero's first to pass three quarters of a million subscribers, ending the half year with 840,000 subscribers. Revenue was up 26% (29% in CC). The implementation of the Australian Taxation Office's (ATO) Single Touch Payroll initiative has contributed to continued strong demand for cloud accounting in this key market
- UK subscribers grew by 51% compared to the same period last year to 536,000 subscribers, becoming the second market to pass half a million subscribers. Revenue was up 51% (52% in CC). Results were driven by continued focus on building Xero's partner channel, investment in brand and marketing, and the implementation of HM Revenue & Customs' Making Tax Digital initiative. To meet growing customer demand, Xero announced the opening of a new office in Manchester that complements Xero's London and Milton Keynes offices
- New Zealand subscribers increased by 13% compared to the same period last year to 367,000, with revenue rising by 22%. Favourable average revenue per user (ARPU) trends were driven by a greater emphasis on additional platform solutions including Xero Payroll which benefited from the introduction of Payday filing by Inland Revenue on 1 April 2019 and the adoption by existing customers of higher value and function subscriptions
- North America subscribers were up by 21% to 215,000 compared to the same period last year as Xero continues to execute on its partner channel strategy. Revenue grew 34% (29% in CC)
- Rest of World continued momentum in subscribers, up 52% compared to the same period last year at 99,000 and revenue was up 43% (37% in CC). Growth was led by South Africa and Xero made further progress in Hong Kong and Singapore

Social and environmental impact (xero.com/socialimpact)

As Xero grows, we understand the importance of being accountable and acting responsibly - for our people, our communities and the planet. We take this responsibility seriously and have taken steps to invest in initiatives to reduce our impact on our environment and positively impact the communities in which we operate.

While we are early in our social and environmental journey, over the half we made good progress on a number of initiatives that will have a measurable impact for our communities.

We are taking action towards a net zero carbon footprint - Net Zero @ Xero - to offset our carbon emissions for the year to 31 March 2019 and going forward. We are also increasing our employee volunteering efforts with community organisations and looking at ways we can improve our support of non-profit and for-purpose organisations. We will continue to provide regular updates on further initiatives as they are implemented.

Leadership & board update

As Xero continues to scale, we have a significant focus on growing our talent, and improving our business processes for operational excellence.

We continue to develop our people and operational capabilities across the business with a focus on our technology, product management, strategy, and mergers and acquisitions teams. We are also adding executive talent and evolving our organisation to be ready for the future. Key leadership role updates include:

- Rachael Powell, previously Chief Customer, People and Marketing Officer has been appointed to the role of Chief Customer Officer and is responsible for global customer, sales, marketing, and communications functions
- The Chief People Officer role was re-established as a standalone role reporting directly to the CEO. Nicole Reid is Acting Chief People Officer until a formal recruitment process has been completed. Nicole recently joined Xero bringing strong HR career experience across both the financial services and technology sectors
- Damien Tampling joined Xero as Chief Strategy and Corporate Development Officer. Damien joined from Deloitte, bringing considerable technology and digital experience
- Tony Ward joined us as President of the Americas. Tony brings significant technology industry sales, marketing and product management skills to the role, having held senior positions at Microsoft, LinkedIn and DropBox

Keri Gohman, our former Chief Platform Officer, departed the business during the period. We are grateful to Keri for her contribution to Xero.

David Thodey joined the Board in June as a non-executive director and a member of the People and Remuneration Committee and Nominations Committee. David brings deep experience and relevant skills to our Board with more than 30 years' experience in the global technology and telecommunications sectors.

US-based non-executive director Bill Veghte retired from the Board at our annual meeting after more than five years of service. We are grateful for Bill's directorship and contribution to Xero.

Thank you

Xero's half year financial and operating results can only be achieved when we have employees, partners and customers who truly believe and appreciate the value we can deliver.

We thank the entire team of dedicated and talented people at Xero for their commitment and contribution to our business. To our valued partners and customers and to Xero investors, thank you for the trust and confidence you place in us every day.

Graham Smith
Chair

Steve Vamos
Chief Executive

Apparition Media, Melbourne

Management commentary

You should read the following commentary with the consolidated interim financial statements and the related notes in this report. Some parts of this commentary include information regarding the plans and strategy for the business, and include forward-looking statements that involve risks and uncertainties. Actual results and the timing of certain events may differ materially from future results expressed or implied by the forward-looking statements. All amounts are presented in New Zealand dollars (NZD) except where indicated. References to the period or H1 FY20 are for the six months ended 30 September 2019. References to the comparative period or H1 FY19 are for the six months ended 30 September 2018.

Non-GAAP measures have been included, as we believe they provide useful information for readers to assist in understanding Xero's financial performance. Non-GAAP financial measures should not be viewed in isolation or considered as substitutes for measures reported in accordance with New Zealand equivalents to International Financial Reporting Standards (NZ IFRS).

Business results

Six months ended 30 September	2019 ($000s)	2018 ($000s)	change
Subscription revenue	327,937	249,041	32%
Other operating revenue	10,721	7,486	43%
Total operating revenue	**338,658**	**256,527**	**32%**
Cost of revenue	(50,141)	(44,250)	13%
Gross profit	**288,517**	**212,277**	**36%**
Gross margin percentage	85.2%	82.8%	2.4pp*
Total operating expenses	**(272,507)**	**(215,706)**	**26%**
Percentage of operating revenue	80.5%	84.1%	-3.6pp
Other income and expenses	(199)	(1,237)	-84%
Operating profit/(loss) before asset impairments	**15,811**	**(4,666)**	**NM****
Asset impairments	(1,071)	(17,757)	-94%
Operating profit/(loss)	**14,740**	**(22,423)**	**NM**
Percentage of operating revenue	4.4%	-8.7%	13.1pp
Net finance expense	(10,943)	(4,929)	122%
Income tax expense	(2,461)	(1,213)	103%
Net profit/(loss)	**1,336**	**(28,565)**	**NM**
Percentage of operating revenue	0.4%	-11.1%	11.5pp

**pp stands for percentage points*
***NM stands for not meaningful*

Xero continued to execute on its growth strategy in H1 FY20 with strong top line revenue growth, and increasing margins delivering improvements to EBITDA, free cash flow, and net profit after tax.

Operating revenue growth was primarily driven by subscriber growth in all markets. Xero surpassed 2 million global subscribers in the half year, adding 239,000 new subscribers to total 2,057,000 at 30 September 2019. Cost of revenue decreased as a proportion of operating revenue due to continued efficiencies in the costs of hosting Xero's cloud services and further productivity gains from Xero Central (the customer service platform). Total operating expenses increased by 26% over the comparative period as Xero continues to invest in scaling its global business, developing new products, and driving quality subscriber growth.

The increase in net finance expense of $6.0 million was driven by coupon payments on the convertible notes issued in October 2018. Net finance expense was also higher due to amortisation of the related debt discount, a non-cash expense, offset by interest income earned on undeployed funds. The comparative period was impacted by non-cash impairments of $17.8 million compared to $1.1 million in H1 FY20.

Net profit after tax for H1 FY20 was $1.3 million, compared to a net loss after tax of $28.6 million in the comparative period which was impacted by non-cash impairments. The net profit in H1 FY20 is the first profit for an interim period and follows a net profit of $1.4 million in H2 FY19.

Earnings Before Interest, Tax, Depreciation, and Amortisation (EBITDA)

EBITDA disclosures (which are non-GAAP financial measures) have been included, as we believe they provide useful information for readers in understanding Xero's financial performance. EBITDA is calculated by adding back depreciation, amortisation, net finance expense, and income tax expense to net profit/loss.

Six months ended 30 September	2019 ($000s)	2018 ($000s)	change
Net profit/(loss)	1,336	(28,565)	NM
Add back: net finance expense	10,943	4,929	122%
Add back: depreciation and amortisation	50,110	39,182	28%
Add back: income tax expense	2,461	1,213	103%
EBITDA	**64,850**	**16,759**	**287%**
EBITDA margin	19.1%	6.5%	12.6pp

EBITDA for H1 FY20 increased by $48.1 million against the comparative period, resulting in EBITDA as a percentage of revenue increasing from 6.5% in H1 FY19 to 19.1% in H1 FY20 (a 12.6 percentage point increase). The comparative period was adversely impacted by non-cash asset impairments, including a $16.3 million write-off of the US payroll product and attributable goodwill relating to the decision to discontinue the US payroll product. This increase was also driven by the emergence of further operational efficiencies with total operating expenses as a proportion of operating revenue decreasing to 80.5%, compared with 84.1% in the comparative period.

EBITDA excluding the impact of non-cash share-based payments and impairments (a non-GAAP financial measure) is also provided as we believe it provides useful information to analyse trends in cash-based expenses.

Six months ended 30 September	2019 ($000s)	2018 ($000s)	change
EBITDA	**64,850**	**16,759**	**287%**
Add back: non-cash share-based payments	15,775	14,815	6%
Add back: non-cash impairments	1,071	17,757	-94%
EBITDA excluding non-cash share-based payments and impairments	**81,696**	**49,331**	**66%**
Percentage of operating revenue	24.1%	19.2%	4.9pp

EBITDA excluding non-cash share-based payments and non-cash impairments for H1 FY20 was $81.7 million, an improvement of $32.4 million or 66% compared to the comparative period, representing 24.1% of operating revenue. Operating revenue increased 32% while included expenses increased by 24% resulting in the improvement to EBITDA excluding non-cash share-based payments and impairments. This was driven by cost efficiencies across the cost of revenue, sales and marketing, and product design and development functions.

Cash flows

Free cash flow is a non-GAAP financial measure that has been included to show readers net cash generated by, and invested into, the business. We define free cash flow as cash flows generated from operating activities less cash flows used for investing activities, excluding cash used for acquisitions of, and investments into, businesses and strategic assets.

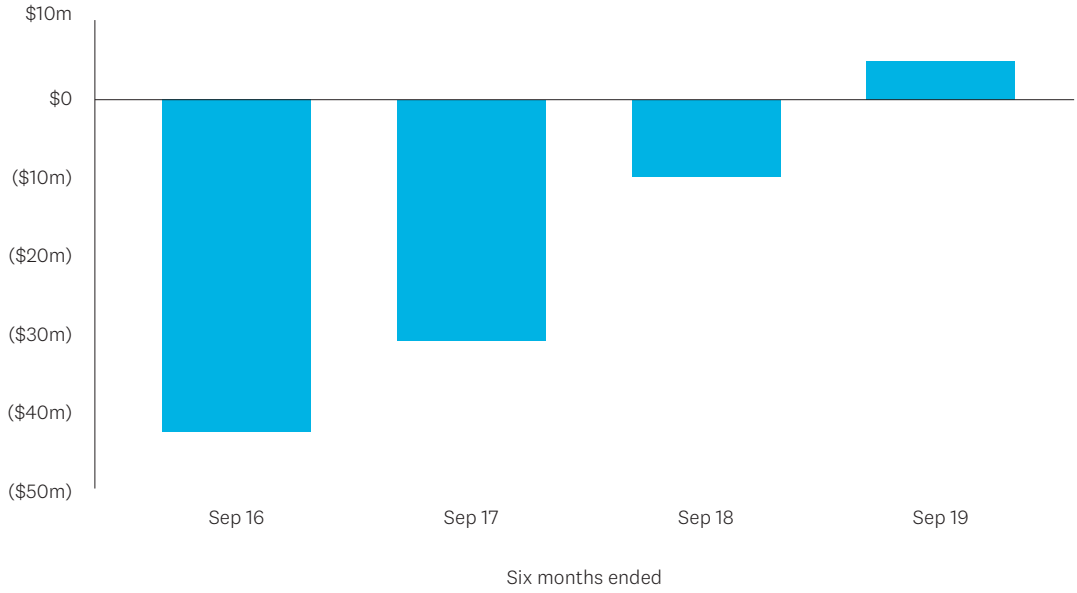
Six months ended 30 September	2019 ($000s)	2018 ($000s)	change
Receipts from customers	339,565	255,128	33%
Other operating cash flows	(268,026)	(219,140)	22%
Total cash flows from operating activities	**71,539**	**35,988**	**99%**
Investing activities	(66,710)	(76,071)	-12%
Add back: acquisitions	-	30,312	NM
Free cash flows	**4,829**	**(9,771)**	**NM**

Free cash flows for H1 FY20 increased by $14.6 million to $4.8 million, equating to 1.4% of total operating revenue, compared to a $9.8 million outflow in H1 FY19.

Receipts from customers increased by 33% or $84.4 million to $339.6 million which is closely aligned with revenue growth. Other operating cash outflows increased by 22% or $48.9 million to $268.0 million as operational discipline and efficiencies ensured operating cash expenditure continued to grow at a slower rate than associated revenue inflows. Net cash flows from operating activities increased by $35.6 million to $71.5 million as receipts from customers grew at a faster rate (33%) than payments to suppliers and employees (21%).

Cash outflows from investing activities, excluding acquisitions, increased by 46% or $21.0 million. The increase was largely driven by higher gross product design and development costs and higher capitalisation rates, resulting in cash spent on capitalised software development costs increasing by $20.3 million compared to H1 FY19.

Free cash flows



Operating revenue

Subscription revenue comprises recurring monthly fees from subscribers to Xero's cloud-based platform. Within a subscription, customers also receive support services and product updates.

Operating revenue includes subscription revenue as well as revenue from other related services, including attendance fees for conferences and events such as Xerocon, revenue share agreements with other financial web (finweb) service providers, and the implementation of online accounting and other software services. Subscription revenue comprises 97% of operating revenue in H1 FY20.

Six months ended 30 September	2019 ($000s)	2018 ($000s)	change	change in constant currency
Subscription revenue	327,937	249,041	32%	33%
Other operating revenue	10,721	7,486	43%	44%
Total operating revenue	**338,658**	**256,527**	**32%**	**33%**

Constant currency operating revenue (a non-GAAP financial measure) is provided to assist readers in understanding and assessing Xero's financial performance during the year, excluding the impact of foreign currency fluctuations. Constant currency operating revenue is calculated by translating operating revenue for H1 FY20 at the effective exchange rates for H1 FY19.

Subscription revenue increased by 32%, primarily driven by organic subscriber growth, with subscriber numbers at 30 September 2019 increasing by 30% compared to at 30 September 2018.

Other operating revenue increased by 43% with a significant amount of the increase attributable to the monetisation of finweb partnerships. In these partnerships, Xero partners with providers to offer online financial solutions to subscribers, such as payments functionality and access to lending, resulting in an associated share of revenue between Xero and the provider. A further component of other operating revenue is revenue from Xerocon events, which increased by 14% compared to the comparative period. Other operating revenue excluding conference income increased by 83% over the comparative period.

As 83% of Xero's operating revenue is denominated in foreign currencies, the comparatively stronger NZD against the Great British pound (GBP) and Australian dollar (AUD) during H1 FY20 compared to H1 FY19 had a negative impact on reported revenue. This was somewhat offset by the weaker NZD against the US dollar (USD). Accordingly, constant currency operating revenue for the Group was $2.9 million higher than reported operating revenue, resulting in an underlying revenue growth rate of 33% in constant currency.

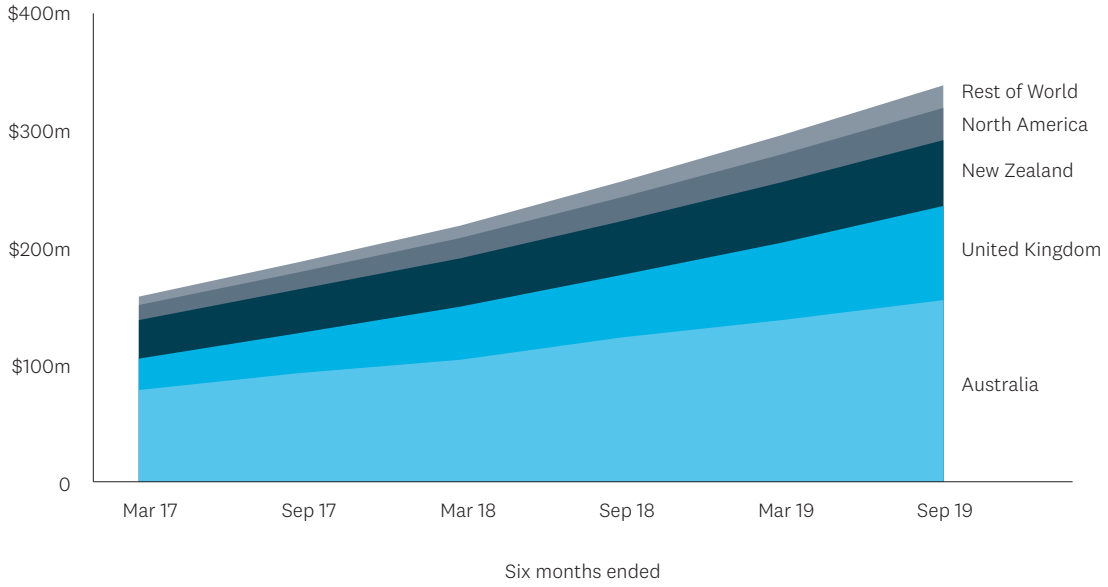
Operating revenue by geography

Six months ended 30 September	2019 ($000s)	2018 ($000s)	change	change in constant currency
Australia	155,177	123,295	26%	29%
New Zealand	56,245	45,946	22%	22%
Australia and New Zealand (ANZ) total	**211,422**	**169,241**	**25%**	**27%**
United Kingdom (UK)	80,419	53,353	51%	52%
North America	27,463	20,442	34%	29%
Rest of World	19,354	13,491	43%	37%
International total	**127,236**	**87,286**	**46%**	**45%**
Total operating revenue	**338,658**	**256,527**	**32%**	**33%**

Operating revenue for H1 FY20 was 32% higher than the comparative period, primarily due to subscriber growth in all of Xero's geographies. In the ANZ market, operating revenue grew by 25% (27% in constant currency), exceeding the 23% growth in subscribers. New Zealand operating revenue increased by 22% compared to subscriber growth of 13% due to increases in average revenue per user (ARPU) which was driven by a greater uptake of additional platform solutions, such as Xero Payroll. Australia operating revenue growth of 26% (29% in constant currency) was more in line with subscriber growth of 28%, with the release of lower ARPU payroll-only plans to support the introduction of Single Touch Payroll by the ATO, offsetting positive, platform-related ARPU trends.

International markets continued to exhibit strong growth, particularly the UK, which achieved an operating revenue increase of 51% (52% in constant currency) as strong subscriber growth in H2 FY19 continued into H1 FY20. Operating revenue in North America grew by 34% (29% in constant currency) while Rest of World markets grew by 43% (37% in constant currency) with strong performances in South Africa and Asia.

Total Group operating revenue by geography*



** represents each region's contribution to total Group operating revenue for the respective period*

Subscriber numbers

The definition of 'Subscriber' is: Each unique subscription to a Xero-offered product that is purchased by a user (e.g. small business or accounting partner) and which is, or is available to be, deployed. Subscribers that have multiple subscriptions to integrated products on the Xero platform are counted as a single subscriber.

At 30 September	2019	2018	change
Australia	840,000	657,000	28%
New Zealand	367,000	324,000	13%
Australia and New Zealand (ANZ) total	**1,207,000**	**981,000**	**23%**
United Kingdom	536,000	355,000	51%
North America	215,000	178,000	21%
Rest of World	99,000	65,000	52%
International total	**850,000**	**598,000**	**42%**
Total paying subscribers	**2,057,000**	**1,579,000**	**30%**

Subscribers grew by 30% compared to 30 September 2018, bringing total subscribers to 2,057,000. Subscriber net additions continued to accelerate, with 478,000 subscribers added in the 12 months ended 30 September 2019 compared to 432,000 in the 12 months ended 31 March 2019. 239,000 subscribers were added in H1 FY20, compared to 193,000 in H1 FY19. While it took more than a decade to add Xero's first million subscribers, it took just two and a half years to add the next million, demonstrating the increasing pace of Xero's adoption across a number of markets.

Xero continued to strengthen its presence in the established ANZ markets, growing subscribers by 23%, or 226,000 from the comparative period, with 130,000 added in H1 FY20. Australia added 114,000 subscribers in H1 FY20, the strongest half year of regional subscriber growth in Xero's history. Xero's position as market leader in Australia was cemented as the region passed 750,000 subscribers early in the period, to finish on 840,000 at 30 September 2019. The H1 FY20 result was assisted by the implementation of the ATO's Single Touch Payroll initiative, with Xero releasing a new payroll-only product in Australia to assist small businesses in their preparation for the new legislative requirements. New Zealand added 43,000 subscribers in the 12 months ended 30 September 2019, growing at a rate of 13% over the period.

The UK continues to lead the International segment, adding 181,000 subscribers in the 12 months ended 30 September 2019, an increase of 51%. This was up from the 40% growth achieved in the 12 months ended 30 September 2018. The UK performance continues to benefit from HM Revenue & Customs' (HMRC) Making Tax Digital initiatives under which businesses require software to process an increasing proportion of tax filings.

North American subscriber numbers increased by 21%, or 37,000 from the comparative period. Our partner channel strategy continues to make good progress in the geographies we have chosen to focus on, in both the US and Canada.

Rest of World markets also performed strongly with 52% growth in the 12 months ended 30 September 2019. Xero's presence in South Africa, Singapore, and Hong Kong continues to gain traction, supported by increased investment into these regions.

Regional subscribers at 30 September 2019*

Australia
840,000
2018 // 657,000

New Zealand
367,000
2018 // 324,000

United Kingdom
536,000
2018 // 355,000

North America
215,000
2018 // 178,000

**Rest of World subscribers of 99,000 at 30 September 2019 (65,000 at 30 September 2018)*

Annualised monthly recurring revenue

Annualised monthly recurring revenue (AMRR) is a non-GAAP financial measure, which represents monthly recurring revenue at 30 September multiplied by 12. It provides a 12-month forward view of revenue, assuming any promotions have ended and other factors such as subscriber numbers, transaction volumes, pricing, and foreign exchange remain unchanged during the year.

Constant currency AMRR (also a non-GAAP financial measure) is calculated by translating AMRR at 30 September 2019 at the foreign exchange rates at 30 September 2018, and is provided to assist in understanding and assessing year-on-year growth rates, excluding the impact of foreign currency fluctuations.

At 30 September	2019 ($000s)	2018 ($000s)	change	change in constant currency
ANZ	458,326	376,086	22%	23%
International	305,770	212,982	44%	42%
Total	**764,096**	**589,068**	**30%**	**30%**

Total Group – AMRR surpassed three quarters of a billion dollars during the period, ending H1 FY20 at $764.1 million. Growth in AMRR was principally driven by subscriber growth in all regions, resulting in $125.9 million of AMRR added in H1 FY20. In constant currency terms, total AMRR grew by 30%, consistent with subscriber growth, as Xero continued subscriber growth in all markets while maintaining high ARPU.

ANZ – Continued strong growth in subscriber numbers in Australia and increases in New Zealand ARPU during the year had a favourable impact on AMRR for ANZ, resulting in AMRR increasing 22% to $458.3 million. The comparatively weaker AUD against the NZD at 30 September 2019 compared to 30 September 2018 had a negative impact on reported AMRR, with constant currency AMRR growth one percentage point higher at 23%.

International – AMRR growth in the International markets was driven by growth in subscriber numbers and the impact of foreign exchange. The weaker NZD against the USD at 30 September 2019 compared to 30 September 2018 has had a favourable impact on the reported AMRR for the International segment. Constant currency AMRR growth of 42% was two percentage points lower than the reported growth of 44% and in line with subscriber growth.

Gross profit

Gross profit represents operating revenue less cost of revenue. Cost of revenue consists of expenses directly associated with securely hosting Xero's services, sourcing relevant data from financial institutions, and providing support to subscribers.

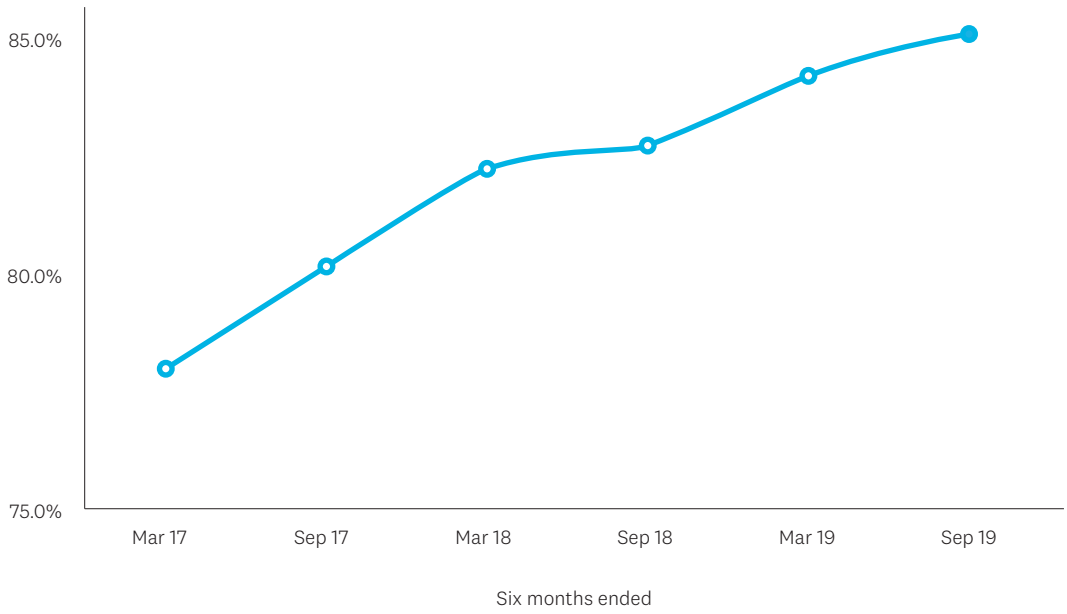
The costs include hosting and content distribution costs, bank feed costs, personnel and related expenses (including salaries, benefits, bonuses, and share-based payments) directly associated with cloud infrastructure and subscriber support, contracted third-party vendor costs, related depreciation and amortisation, and allocated overheads.

Six months ended 30 September	2019 ($000s)	2018 ($000s)	change
Operating revenue	338,658	256,527	32%
Cost of revenue	(50,141)	(44,250)	13%
Gross profit	**288,517**	**212,277**	**36%**
Gross margin percentage	85.2%	82.8%	2.4pp

Operating revenue growth of 32%, as well as efficiencies in cost of revenue, resulted in gross profit increasing by $76.2 million, or 36%, to $288.5 million. Cost of revenue for H1 FY20 grew by $5.9 million to $50.1 million, representing a 13% increase when compared to the comparative period. The primary reasons for the change in cost of revenue were increases in personnel costs related to higher headcount in Xero's customer support teams required to support more subscribers, and increased cloud hosting costs compared to the comparative period.

Cost of revenue decreased as a percentage of operating revenue compared to H1 FY19 due to efficiencies in hosting costs and in the customer support platform. Customer support has become more efficient due to a drive towards self service through the Xero Central platform rather than email-based support. There has also been an emphasis on customer education, opening Xero advisor certification to all customers rather than only accounting partners. This allowed headcount to increase at a much lower rate than subscribers and revenue. Xero has also realised efficiencies in hosting through optimising the Amazon Web Services (AWS) product mix. Gross margin for the period of 85.2% is an improvement of 2.4 percentage points compared to H1 FY19.

Gross margin percentage



Sales and marketing

Sales and marketing expenses consist of personnel and related expenses (including salaries, benefits, bonuses, the amortisation of capitalised commission costs, and share-based payments) directly associated with the sales and marketing teams, and the cost of educating and onboarding both partners and small business customers. Costs also include relationship management costs incurred to support the existing subscriber base. Other costs included are external advertising costs, marketing costs and promotional events, as well as allocated overheads.

Six months ended 30 September	2019 ($000s)	2018 ($000s)	change
Sales and marketing expenses	146,072	115,747	26%
Percentage of operating revenue	43.1%	45.1%	-2.0pp

Sales and marketing costs increased by $30.3 million, or 26%, to $146.1 million for the period, compared to operating revenue growth of 32% and subscriber growth of 30%. The majority of sales and marketing costs are incurred in acquiring new subscribers and are expensed in the period, in contrast to the associated revenue from those subscribers which is recognised over the life of the subscriber (currently around seven and a half years on average).

Sales and marketing spend has increased as Xero continues to pursue subscriber growth in all regions. Investment in sales and marketing in Australia and the UK increased in the period to take advantage of Single Touch Payroll and Making Tax Digital initiatives, contributing towards strong net subscriber additions in both regions. Sales and marketing costs in the Rest of World markets also increased as Xero continued to expand into South Africa and Asia. The positive effects are reflected in the subscriber and revenue growth for the Rest of World markets, which were 52% and 43% respectively.

The average cost of acquiring a subscriber has decreased to $382 per gross subscriber added in H1 FY20 compared to $402 in H1 FY19. The decrease is due to more efficient customer acquisition metrics in the international markets during the period. Improvements were most noticeable in the UK as the market matures and brand recognition grows. As a percentage of operating revenue, sales and marketing costs decreased from 45.1% in H1 FY19 to 43.1% in H1 FY20.

Product design and development

Product design and development costs consist primarily of personnel and related expenses (including salaries, benefits, bonuses, and share-based payments) directly associated with product design and development teams, as well as allocated overheads.

The proportion of product design and development expenses that creates a benefit in future years and meets certain requirements under NZ IFRS is capitalisable as an intangible asset and is then amortised to the Income Statement over the estimated life of the asset created. The amount amortised relating to the Xero product and platform is included as a product design and development expense.

Six months ended 30 September	2019 ($000s)	2018 ($000s)	change
Total product design and development costs (including amounts capitalised)[1]	**108,828**	**80,333**	**35%**
Percentage of operating revenue	32.1%	31.3%	0.8pp
Less capitalised development costs	(49,295)	(31,715)	55%
Product design and development expense (excluding amortisation of amounts capitalised)	**59,533**	**48,618**	**22%**
Less government grants	(2,474)	(2,379)	4%
Add amortisation of capitalised development costs	28,238	22,627	25%
Product design and development expenses	**85,297**	**68,866**	**24%**
Percentage of operating revenue	25.2%	26.8%	-1.6pp

[1] *Excludes impairments*

Xero continues to invest in its global product and platform, releasing a range of new features in H1 FY20, including:

- Single Sign-On allows users to switch between Xero and connected apps, by logging in with one single set of credentials. It will help to increase app usage by our customers and improve security
- Payment service on repeating invoices, enabling subscribers to be paid faster
- Construction Industry Scheme (CIS) add-on allows online filing of CIS returns directly from Xero to HMRC, as well as bulk emailing payment and deduction statements
- Xero HQ VAT enables UK accountants and bookkeepers to manage all of their Xero VAT clients in one place
- Xero Education has been re-platformed into Xero Central to provide a more connected experience across learning, support, discussions and profiles. In the four months since this was implemented, 10,000 new advisor certifications have been achieved, helping Xero reach a new milestone of 70,000 users having completed the Xero advisor certification

Total product design and development costs were $108.8 million in H1 FY20, $28.5 million or 35% higher than in the comparative period. Of this, $49.3 million was capitalised, with the balance of $59.5 million included within total product and design expenses of $85.3 million in the Income Statement. The amount capitalised represents a capitalisation rate of 45.3% of total product design and development costs for H1 FY20, which is 5.8 percentage points higher than the comparative period, and 0.9 percentage points lower than H2 FY19.

As a proportion of operating revenue, total product design and development costs for H1 FY20 (including amounts capitalised) increased by 0.8 percentage points to 32.1%, compared to 31.3% for the comparative period, highlighting the prioritisation of investment in Xero's global platform.

The amortisation of previously capitalised product design and development expenditure of $28.2 million was included as a non-cash expense in the Income Statement, giving total net expenses (after the netting of government grants) of $85.3 million for the period. Amortisation of previously capitalised development costs increased due to higher intangibles balances than in the comparative period.

Product design and development expenses increased by 24% on the comparative period as Xero continued to increase investment in product and innovation. As a proportion of operating revenue, product design and development expenses decreased to 25.2% in H1 FY20 from 26.8% in the comparative period.

General and administration

General and administration expenses consist of personnel and related expenses (including salaries, benefits, bonuses, and share-based payments) for executive, finance, billing, legal, human resources, and administrative employees, and the Xero Board. It also includes legal, accounting and other professional services fees, insurance premiums, other corporate expenses, and allocated overheads.

Six months ended 30 September	2019 ($000s)	2018 ($000s)	change
General and administration expenses	41,138	31,093	32%
Percentage of operating revenue	12.1%	12.1%	0pp

General and administration costs were $41.1 million for H1 FY20, $10.0 million or 32% higher than H1 FY19. General and administration costs as a proportion of operating revenue remained consistent with H1 FY19 at 12.1% as Xero invests in building out its strategy and corporate development functions.

Employees

At 30 September	2019	2018	change
Total Group	2,706	2,302	18%

Full-time equivalent (FTE) employees increased by 404 or 18% in the 12 months ended 30 September 2019, taking the total FTEs to 2,706, compared to a 30% increase in subscribers and 32% increase in operating revenue. The slower growth in FTEs compared to revenue and subscribers reflects the benefits of economies of scale and operating efficiencies, while continuing to increase investment in sales and marketing, and product design and development.

Net finance expense

Six months ended 30 September	2019 ($000s)	2018 ($000s)	change
Interest income on deposits	7,424	782	849%
Total finance income	**7,424**	**782**	**849%**
Interest on convertible notes	(13,681)	-	NM
Bank standby facility costs	(836)	(1,020)	-18%
Finance lease interest	(3,714)	(2,023)	84%
Other finance expense	(136)	(2,668)	-95%
Total finance expense	**(18,367)**	**(5,711)**	**222%**
Net finance expense	**(10,943)**	**(4,929)**	**122%**

Finance income in H1 FY20 was $7.4 million, an increase of $6.6 million from the comparative period due to increased cash and short-term deposit balances from the issue of convertible notes in October 2018. Proceeds from the convertible notes issue are largely undeployed and are held on deposit until required.

Finance expense increased by 222%, driven by interest on the convertible notes combined with finance lease interest. Of the $13.7 million interest on convertible notes $5.4 million relates to cash coupon payments with the remainder being the non-cash amortisation of the related debt liability discount. Finance lease interest increased by $1.7 million due to leases for office space entered into during the second half of FY19, particularly the Auckland building lease which has a 12 year term.

Segment contribution

Operating revenue is allocated to a segment depending on where the subscriber resides. Expenses include cost of revenue, sales and marketing costs incurred directly in-region, and an allocation of centrally managed costs and overheads, such as hosting and user support costs.

	ANZ ($000s)	International ($000s)	Total ($000s)
Six months ended 30 September 2019			
Operating revenue	211,422	127,236	338,658
Expenses	(80,378)	(115,835)	(196,213)
Segment contribution	**131,044**	**11,401**	**142,445**
Contribution margin percentage	62.0%	9.0%	42.1%
Six months ended 30 September 2018			
Operating revenue	169,241	87,286	256,527
Expenses	(71,535)	(88,462)	(159,997)
Other income	68	332	400
Segment contribution	**97,774**	**(844)**	**96,930**
Contribution margin percentage	57.8%	-1.0%	37.8%

ANZ Operating revenue for H1 FY20 grew by 25% compared to the comparative period, further reinforcing Xero's market leading position in the region. Australia led the growth in this segment as the ATO's Single Touch Payroll initiative contributed to strong demand for cloud accounting and payroll-specific solutions. Constant currency operating revenue grew by 27% compared to the comparative period, exceeding the 23% growth in subscribers largely due to the timing of subscriber additions impacting revenue.

The revenue result, along with continued cost efficiencies, resulted in an H1 FY20 segment contribution of $131.0 million. This was an increase of 34% over H1 FY19 and represents 62.0% of operating revenue, up from 57.8% in the comparative period. Across the ANZ segment, 130,000 net subscribers were added during H1 FY20 and 226,000 were added during the 12 months ended 30 September 2019, making these the best six month and 12 month periods respectively for the ANZ segment in Xero's history.

International Operating revenue for H1 FY20 grew by 46%, or 45% in constant currency, due to subscriber growth of 42%. The International segment had a positive contribution for the first time in H1 FY20, with a segment contribution of $11.4 million, compared to a contribution loss of $0.8 million in H1 FY19.

As a percentage of revenue, the contribution margin improved from -1% to 9% as scaling and efficiencies, particularly in the UK, combined with strong revenue growth. The contribution margin remained comparatively lower than that of ANZ, reflecting the emphasis on investment in subscriber additions in the UK, North America, Asia, and South Africa, as Xero continues to develop brand recognition and build distribution channels in these markets.

Key SaaS metrics

SaaS companies like Xero operate on many of the same performance metrics as traditional companies, such as revenue, cash flow, and customer numbers. However, understanding the performance of SaaS companies and being able to benchmark them requires an understanding of SaaS-specific metrics. Below are some of the headline metrics we use to manage and drive Xero's performance.

Average revenue per user (ARPU) is calculated as AMRR (see definition on page 15) at 30 September divided by subscribers at that time (and divided by 12 to get a monthly view).

CAC months are the months of ARPU to recover the cost of acquiring (customer acquisition costs: CAC) each new subscriber. The calculation is sales and marketing costs for the year excluding the deferral and amortisation of contract acquisition costs, less conference revenue (such as Xerocon), divided by gross new subscribers added during the same period, divided by ARPU.

Churn is the value of monthly recurring revenue (MRR) from subscribers who leave Xero in a month as a percentage of the total MRR at the start of that month. The percentage provided is the average of the monthly churn for the previous 12 months.

Lifetime value (LTV) is the gross margin expected from a subscriber over the lifetime of that subscriber. This is calculated by taking the average subscriber lifetime (one divided by churn), multiplied by ARPU, multiplied by the gross margin percentage. Group LTV is calculated as the sum of the individual segment LTV, multiplied by their respective segment subscribers, divided by total Group subscribers.

LTV/CAC is the ratio between the LTV and the cost to acquire that subscriber, eg. the LTV derived from a subscriber in ANZ is currently on average 12.3 times the cost of acquiring that subscriber.

We strive to maximise total lifetime value while maintaining the optimal level of investment to maintain a desirable LTV/CAC ratio. We can improve total lifetime value in multiple ways, such as increasing subscriber numbers, enhancing products and services for existing subscribers thereby increasing ARPU and/or reducing churn, and improving gross margin through cost efficiencies.

The table below outlines key metrics across Xero's segments:

At 30 September 2019	ANZ	International	Total
ARPU ($)	31.64	29.98	30.96
CAC months	8.6	16.0	12.3
Churn	0.82%	1.58%	1.10%
LTV per subscriber ($)	3,362	1,563	2,619
LTV/CAC	12.3	3.3	6.9

At 30 September 2018	ANZ	International	Total
ARPU ($)	31.95	29.68	31.09
CAC months	8.4	18.2	12.9
Churn	0.87%	1.55%	1.10%
LTV per subscriber ($)	3,064	1,558	2,494
LTV/CAC	11.5	2.9	6.2

ANZ – ARPU within the ANZ segment decreased by 1% compared to 30 September 2018, largely due to the weaker AUD against the NZD. This was partially offset by increases in ARPU within New Zealand, driven by a greater emphasis on additional platform solutions, including Hubdoc and Xero Payroll, which benefited from the introduction of Payday filing by Inland Revenue on 1 April 2019. The launch of Single Touch Payroll focused products in Australia, with a lower associated ARPU, has also contributed to the H1 FY20 ARPU result. In constant currency terms, ANZ ARPU increased slightly to $32.04. CAC months at 30 September 2019 was moderately higher than at 30 September 2018 as Xero continues to invest in its small business platform, ecosystem and finweb strategies that target existing customers, as well as investing to drive growth to further increase market share in the ANZ segment.

Despite a marginal decrease in ARPU, improved gross margin and lower churn led to a 10% improvement in LTV per subscriber within ANZ (11% in constant currency). Total ANZ subscriber LTV increased by $1.1 billion, or 37% to $4.1 billion at 30 September 2019 compared to $3.0 billion at 30 September 2018.

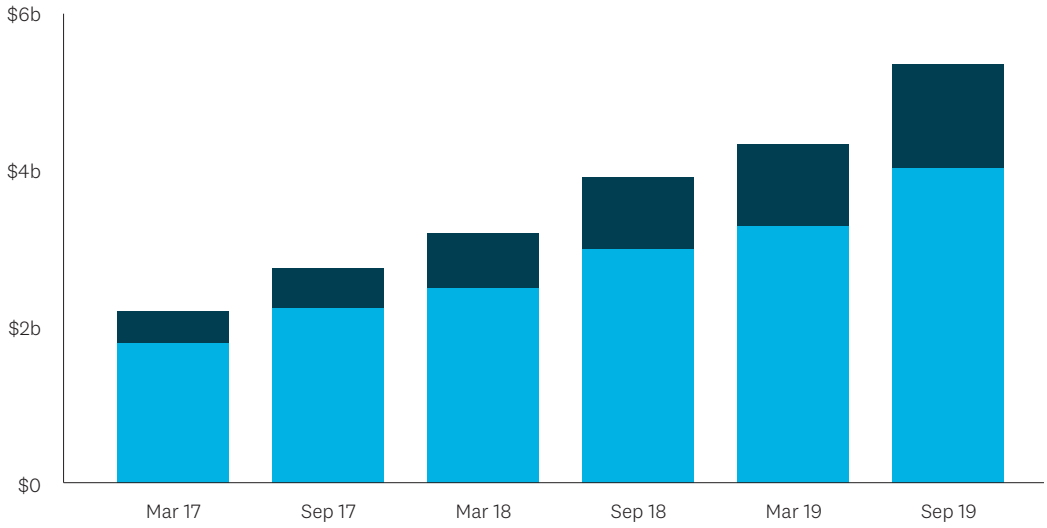
International – ARPU across the international segment increased by 1% (consistent in constant currency) against H1 FY19. A price increase in the UK for Standard and Premium pricing plans had a favourable impact on UK ARPU in August 2019. The comparatively stronger USD against the NZD also had a positive effect on ARPU within North America and Rest of World. However, this was offset by a shift towards the more efficient but lower ARPU partner channel in North America and Rest of World markets. Improving efficiency and quality of the International segment is evident in the fall in CAC months from 18.2 months to 16.0 months and an 11% reduction in the cost of acquiring each new subscriber compared to the comparative period.

Despite a slight increase in churn, higher gross margin and ARPU led to a 0.3% improvement in LTV per subscriber at 30 September 2019 compared to the comparative period (a decrease of 0.8% in constant currency). Total LTV for the international segment increased by 44% to $1.3 billion at 30 September 2019 compared to 30 September 2018 due to subscriber growth, particularly in the UK market.

Total Group – ARPU remained largely consistent with the comparative period and was also consistent in constant currency. This was due to increases in pricing in the UK, being offset by product and partner channel mix effects in the other international markets, and the impact of adverse FX movements (particularly the AUD).

LTV per subscriber increased 5% from the same time last year to $2,619, due primarily to improvements in gross margin, while ARPU and MRR churn were largely consistent with 30 September 2018. Group constant currency LTV per subscriber at 30 September 2019 was 6% higher than at 30 September 2018. Total subscriber LTV at 30 September 2019 was $5.4 billion, an improvement of more than $1.4 billion compared to 30 September 2018. Notably, more than $1 billion of total subscriber LTV was added in H1 FY20. CAC months decreased 5% to 12.3 months when compared to 30 September 2018, despite an ARPU decrease in actual currency, due to a 5% decrease in the cost of acquiring each new subscriber.

Total lifetime value



Independent Review Report

To the Shareholders of Xero Limited ("the company") and its subsidiaries (together "the group")

Opinion

We have reviewed the interim financial statements on pages 25 to 38, which comprise the statement of financial position of the group as at 30 September 2019 and the income statement, statement of comprehensive income, statement of changes in equity and statement of cash flows of the group for the six-month 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. 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 New Zealand Equivalent to International Accounting Standard 34: Interim Financial Reporting 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 New Zealand Equivalent to International Accounting Standard 34: Interim Financial Reporting. As the auditor of the group, 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.

We provide remuneration benchmark information and Australian research and development tax credit related compliance services. Other than these services and our role as independent auditor, we have no other relationship with, or interest in, the Group.

Partners and employees of our firm may deal with the Group on normal terms within the ordinary course of trading activities of the business of 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 25 to 38, do not present fairly, in all material respects, the financial position of the group as at 30 September 2019 and its financial performance and cash flows for the six month period ended on that date in accordance with New Zealand Equivalent to International Accounting Standard 34: Interim Financial Reporting.

Our review was completed on 7 November 2019 and our findings are expressed as at that date.

Ernst & Young

Ernst & Young
Chartered Accountants
Wellington

361 Degree Consultancy,
Singapore

Interim Financial Statements

Income Statement

Six months ended 30 September	Notes	2019 Unaudited ($000s)	2018 Unaudited ($000s)
Subscription revenue		327,937	249,041
Other operating revenue		10,721	7,486
Total operating revenue	**4**	**338,658**	**256,527**
Cost of revenue	5	(50,141)	(44,250)
Gross profit		**288,517**	**212,277**
Operating expenses			
Sales and marketing		(146,072)	(115,747)
Product design and development		(85,297)	(68,866)
General and administration		(41,138)	(31,093)
Total operating expenses	**5**	**(272,507)**	**(215,706)**
Asset impairments		(1,071)	(17,757)
Other income and expenses		(199)	(1,237)
Operating surplus/(deficit)		**14,740**	**(22,423)**
Finance income		7,424	782
Finance expense		(18,367)	(5,711)
Net profit/(loss) before tax		**3,797**	**(27,352)**
Income tax expense		(2,461)	(1,213)
Net profit/(loss)		**1,336**	**(28,565)**
Basic and diluted earnings/(loss) per share	6	$0.01	($0.21)

Statement of Comprehensive Income

Six months ended 30 September	Note	2019 Unaudited ($000s)	2018 Unaudited ($000s)
Net profit/(loss)		1,336	(28,565)
Other comprehensive income*			
Movement in cash flow hedges (net of tax)	8	197	798
Translation of foreign operations		(531)	1,751
Total other comprehensive income/(loss) for the period		**(334)**	**2,549**
Total comprehensive income/(loss) for the period		**1,002**	**(26,016)**

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

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

Statement of Financial Position

	Notes	At 30 Sep 2019 Unaudited ($000s)	At 31 Mar 2019 Audited ($000s)
Assets			
Current assets			
Cash and cash equivalents		110,898	121,527
Short-term deposits		385,130	336,819
Trade and other receivables		55,359	49,466
Derivative assets		93,763	77,328
Other current assets		1,288	1,478
Total current assets		**646,438**	**586,618**
Non-current assets			
Property, plant and equipment		92,290	91,491
Intangible assets	7	317,293	289,731
Deferred tax assets		2,494	1,613
Derivative assets		167	238
Other non-current assets		1,434	627
Total non-current assets		**413,678**	**383,700**
Total assets		**1,060,116**	**970,318**
Liabilities			
Current liabilities			
Trade and other payables		29,678	27,043
Employee entitlements		37,581	37,830
Lease liabilities		12,262	11,541
Income taxes payable		1,337	1,958
Derivative liabilities		1,658	147
Other current liabilities		32,864	26,560
Total current liabilities		**115,380**	**105,079**
Non-current liabilities			
Term debt		394,631	357,731
Derivative liabilities		92,341	77,367
Lease liabilities		69,746	71,308
Deferred tax liabilities		1,473	1,789
Other non-current liabilities		6,756	3,735
Total non-current liabilities		**564,947**	**511,930**
Total liabilities		**680,327**	**617,009**
Equity			
Share capital	10	643,736	627,848
Reserves		78,589	69,333
Accumulated losses		(342,536)	(343,872)
Total equity		**379,789**	**353,309**
Total liabilities and shareholders' equity		**1,060,116**	**970,318**

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

Statement of Changes in Equity

Unaudited	Notes	Share capital ($000s)	Treasury shares ($000s)	Share-based payment reserve ($000s)	Accumulated losses ($000s)	Foreign currency translation reserve ($000s)	Cash flow hedge reserve ($000s)	Premium on call spread options ($000s)	Total equity ($000s)
Balance at 1 April 2019		638,234	(10,386)	30,902	(343,872)	904	2,266	35,261	353,309
Net profit		–	–	–	1,336	–	–	–	1,336
Other comprehensive income/(loss)		–	–	–	–	(531)	197	–	(334)
Total comprehensive income		**–**	**–**	**–**	**1,336**	**(531)**	**197**	**–**	**1,002**
Transactions with owners:									
Share-based payments	13	9,327	(4,308)	12,712	–	–	–	–	17,731
Exercising of share options	10,13	10,869	–	(3,122)	–	–	–	–	7,747
Balance at 30 September 2019		**658,430**	**(14,694)**	**40,492**	**(342,536)**	**373**	**2,463**	**35,261**	**379,789**
Balance at 1 April 2018		**549,596**	**(11,852)**	**18,904**	**(316,729)**	**(102)**	**1,267**	**–**	**241,084**
Net loss		–	–	–	(28,565)	–	–	–	(28,565)
Other comprehensive income		–	–	–	–	1,751	798	–	2,549
Total comprehensive loss		**–**	**–**	**–**	**(28,565)**	**1,751**	**798**	**–**	**(26,016)**
Transactions with owners:									
Share-based payments	13	12,681	(11,124)	12,766	–	–	–	–	14,323
Exercising of share options	10,13	13,456	–	(3,393)	–	–	–	–	10,063
Issue of shares – acquisition of Hubdoc, net of issue costs		54,850	–	–	–	–	–	–	54,850
Premium on call spread options, net of issue costs		–	–	–	–	–	–	35,261	35,261
Balance at 30 September 2018		**630,583**	**(22,976)**	**28,277**	**(345,294)**	**1,649**	**2,065**	**35,261**	**329,565**

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

Statement of Cash Flows

Six months ended 30 September	Note	2019 Unaudited ($000s)	2018 Unaudited ($000s)
Operating activities			
Receipts from customers		339,565	255,128
Other income		2,773	2,451
Interest received		8,014	1,237
Payments to suppliers and employees		(264,459)	(217,675)
Interest paid		(10,320)	(3,128)
Income tax paid		(4,034)	(2,025)
Net cash flows from operating activities	**11**	**71,539**	**35,988**
Investing activities			
Capitalised development costs		(53,782)	(33,516)
Acquisition of Hubdoc		–	(30,312)
Capitalised contract acquisition costs		(7,258)	(7,032)
Purchase of property, plant and equipment		(5,305)	(6,939)
Other investing activities		(365)	1,728
Net cash flows from investing activities		**(66,710)**	**(76,071)**
Financing activities			
Payment of lease liabilities		(5,330)	(4,089)
Exercising of share options		7,747	10,063
Proceeds from borrowings		–	30,850
Repayment of borrowings		–	(733)
Costs related to issue of convertible notes		–	(504)
Payments for short-term deposits		(440,213)	(37,000)
Proceeds from short-term deposits		415,298	41,000
Net cash flows from financing activities		**(22,498)**	**39,587**
Net decrease in cash and cash equivalents		**(17,669)**	**(496)**
Foreign currency translation adjustment		7,040	728
Cash and cash equivalents at the beginning of the period		**121,527**	**20,955**
Cash and cash equivalents at the end of the period		**110,898**	**21,187**

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

Notes to the Interim Financial Statements

1. Basis of preparation

These unaudited interim financial statements of Xero Limited ('the Company') and its subsidiaries (together 'the Group' or 'Xero') have been prepared in accordance with New Zealand Generally Accepted Accounting Practice and comply with the requirements of New Zealand Equivalent to International Accounting Standard 34: *Interim Financial Reporting*, and International Accounting Standard 34: *Interim Financial Reporting*.

The Company is registered under the New Zealand Companies Act 1993 and listed on the Australian Securities Exchange and is required to be treated as an FMC Reporting Entity under the Financial Market Conducts Act 2013 and the Financial Reporting Act 2013.

The unaudited interim financial statements of the Group for the six months ended 30 September 2019 were authorised for issue in accordance with a resolution of the directors on 7 November 2019.

2. Accounting policies

(a) Changes in accounting policies and disclosures

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 2019.

Certain comparative information has been reclassified to conform with the current period's presentation.

(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 2019 have been applied to these interim financial statements.

3. Segment information

The Group operates in one business segment, providing online business solutions for small businesses and their advisors.

Xero has two operating segments: Australia and New Zealand (ANZ) and International. These segments have been determined based on how the Xero leadership team (the chief operating decision-maker) reviews financial performance.

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

Unaudited	ANZ ($000s)	International ($000s)	Total ($000s)
Six months ended 30 September 2019			
Operating revenue	211,422	127,236	338,658
Expenses	(80,378)	(115,835)	(196,213)
Segment contribution	**131,044**	**11,401**	**142,445**
Six months ended 30 September 2018			
Operating revenue	169,241	87,286	256,527
Expenses	(71,535)	(88,462)	(159,997)
Other income	68	332	400
Segment contribution	**97,774**	**(844)**	**96,930**

Reconciliation from segment contribution to net profit/(loss) before tax

Six months ended 30 September	2019 Unaudited ($000s)	2018 Unaudited ($000s)
Segment contribution	142,445	96,930
Product design and development	(85,297)	(68,866)
General and administration	(41,138)	(31,093)
Asset impairments	(1,071)	(17,757)
Other income and expenses	(199)	(1,637)
Finance income	7,424	782
Finance expense	(18,367)	(5,711)
Net profit/(loss) before tax	**3,797**	**(27,352)**

Depreciation and amortisation by segment

Six months ended 30 September	2019 Unaudited ($000s)	2018 Unaudited ($000s)
ANZ	6,845	5,235
International	9,286	6,478
Corporate (not allocated to a segment)	33,979	27,469
Total	**50,110**	**39,182**

At 30 September 2019, $337.9 million, or 83%, of the Group's property, plant and equipment and intangible assets was domiciled in New Zealand (at 30 September 2018: $271.3 million, or 81%).

Share-based payments by segment

Six months ended 30 September	2019 Unaudited ($000s)	2018 Unaudited ($000s)
ANZ	3,449	2,679
International	3,339	4,215
Corporate (not allocated to a segment)	8,987	7,921
Total	**15,775**	**14,815**

4. Revenue

Operating revenue by geographic location

Six months ended 30 September	2019 Unaudited ($000s)	2018 Unaudited ($000s)
Australia	155,177	123,295
United Kingdom	80,419	53,353
New Zealand	56,245	45,946
North America	27,463	20,442
Rest of World	19,354	13,491
Total operating revenue	**338,658**	**256,527**

5. Expenses

Cost of revenue and operating expenses

Six months ended 30 September	2019 Unaudited ($000s)	2018 Unaudited ($000s)
Employee entitlements	183,737	142,745
Employee entitlements capitalised	(53,973)	(35,248)
Share-based payments	21,148	17,445
Share-based payments capitalised	(5,373)	(2,630)
Advertising and marketing	50,089	34,329
Platform costs	18,842	16,316
Consultants and contractors	6,568	8,751
Computer equipment and software	11,216	8,851
Travel-related costs	7,864	5,682
Superannuation costs	7,061	5,286
Communication, insurance and office administration	3,976	3,110
Rental costs	2,575	1,493
Staff recruitment	1,396	711
Other operating expenses	17,412	13,933
Total cost of revenue and operating expenses excl. depreciation and amortisation	**272,538**	**220,774**

Depreciation and amortisation

Six months ended 30 September	2019 Unaudited ($000s)	2018 Unaudited ($000s)
Relating to:		
Amortisation of development costs	32,574	26,180
Amortisation of other intangible assets	6,215	4,931
Depreciation of property, plant and equipment	11,321	8,071
Total depreciation and amortisation	**50,110**	**39,182**
Total cost of revenue and operating expenses	**322,648**	**259,956**
Depreciation and amortisation included in function expenses as follows:		
Product design and development	32,235	25,840
Sales and marketing	12,664	9,473
Cost of revenue	3,467	2,492
General and administration	1,744	1,377
Total depreciation and amortisation	**50,110**	**39,182**

6. Earnings per share

The Group presents basic and diluted earnings per share (EPS) for its ordinary shares.

Basic EPS is calculated by dividing the net profit/(loss) attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares on issue during the period, excluding shares held as treasury shares.

Diluted EPS is determined by adjusting the net profit/(loss) attributable to ordinary shareholders and the weighted average number of ordinary shares on issue for the effects of all potential dilution to ordinary shares, which comprise convertible notes, restricted shares, options, and restricted stock units. Instruments are only treated as dilutive when their conversion to ordinary shares would decrease EPS or increase the loss per share.

Six months ended 30 September	2019 Unaudited (000s)*	2018 Unaudited (000s)*
Net profit/(loss) after tax	**$1,336**	**($28,565)**
Add back: foreign exchange revaluation on contingent consideration included in ordinary shares for basic calculation, net of tax	$246	–
Net profit/(loss) attributable to equity holders of the Group, used in calculating basic and diluted EPS	**$1,582**	**($28,565)**
Weighted average number of ordinary shares for basic EPS	**140,685**	**138,613**
Effect of dilution from:		
Share options	1,395	–
Restricted shares	433	–
Restricted stock units	329	–
Weighted average number of ordinary shares adjusted for the effect of dilution	**142,842**	**138,613**
Basic earnings/(loss) per share	**$0.01**	**($0.21)**
Diluted earnings/(loss) per share	**$0.01**	**($0.21)**

**Except for per share amounts*

For the period ended 30 September 2019, 6,474,084 shares that may be issued on conversion of the convertible notes and 219,201 shares that may be issued at the end of the Hubdoc acquisition contingency period are excluded from the diluted weighted average number of shares because their effect would be anti-dilutive. The notes and contingent consideration are anti-dilutive as a result of the corresponding adjustments that would be required to be made to net profit attributable to ordinary shareholders.

7. Intangible assets

Unaudited	Software development ($000s)	Contract acquisition asset ($000s)	Other intangible assets ($000s)	Goodwill ($000s)	Total ($000s)
Cost					
Balance at 1 April 2019	283,244	50,435	5,733	78,773	418,185
Additions*	58,944	7,454	114	–	66,512
Disposals	(13,787)	(6,963)	–	–	(20,750)
Impairments	(2,710)	–	–	–	(2,710)
Foreign exchange adjustment	–	2,189	–	–	2,189
Balance at 30 September 2019	**325,691**	**53,115**	**5,847**	**78,773**	**463,426**
Accumulated amortisation					
Balance at 1 April 2019	105,549	21,708	1,197	–	128,454
Amortisation	32,574	5,403	812	–	38,789
Disposals	(13,787)	(6,963)	–	–	(20,750)
Impairments	(1,432)	–	–	–	(1,432)
Foreign exchange adjustment	–	1,072	–	–	1,072
Balance at 30 September 2019	**122,904**	**21,220**	**2,009**	**–**	**146,133**
Net book value at 30 September 2019	**202,787**	**31,895**	**3,838**	**78,773**	**317,293**

** Included in software development additions is $7.8 million of externally purchased assets (2018: $5.0 million).*

8. Hedge accounting

The Group uses derivatives in the form of forward exchange contracts and vanilla foreign exchange options (outright purchased options and vanilla collars) to reduce the risk that movements in foreign exchange rates will affect the Group's NZD cash flows. Whenever possible, these hedges have been designated as a hedge of a highly probable forecast transaction (a cash flow hedge under NZ IFRS 9: *Financial Instruments*). The Group's policy is to hedge a portion of the next 18 months' forecasted cash flows.

During the period, a net hedging gain of $3.7 million (before taxation) was recognised in other comprehensive income (2018: hedging gain of $3.1 million). During the period, a gain of $3.4 million (before taxation) was reclassified out of other comprehensive income to the Income Statement (2018: gain of $2.0 million). The remaining balance will be reclassified to the Income Statement in the 18 months following 30 September 2019.

Foreign exchange hedge position at 30 September 2019

Unaudited	Average forward price	Fair value ($000s)	Notional amount hedged (NZD) ($000s)
Derivative assets			
Buy USD - Sell NZD	0.6794	4,906	60,253
Buy CAD - Sell NZD	0.8739	703	12,873
Buy NZD - Sell GBP	0.5024	182	17,800
Buy NZD - Sell AUD	0.9184	158	28,053
Total		**5,949**	
Derivative liabilities			
Buy NZD - Sell GBP	0.5154	(790)	59,731
Buy NZD - Sell AUD	0.9402	(1,062)	85,645
Total		**(1,852)**	

9. Financial instruments

Financial instruments recognised in the Statement of Financial Position include cash and cash equivalents, short-term deposits, receivables and payables, contingent consideration, term debt, and derivative financial instruments.

The Group's foreign exchange hedging derivatives are recognised at fair value. Fair value is determined using forward exchange rates that are quoted in an active market (level two on the fair value hierarchy).

The fair values of the conversion feature and call option derivative asset relating to the convertible notes are determined using valuation techniques. These valuation techniques maximise the use of observable market data where it is available and rely as little as possible on entity-specific techniques (level two on the fair value heirarchy). Inputs into the valuation include share price volatility and time to expiration.

At initial recognition, the fair value of the convertible notes was determined using a market interest rate for an equivalent non-convertible bond. The notes are subsequently recognised at amortised cost. The carrying value and the fair value of the debt component of the convertible notes at 30 September 2019 were $394.6 million and $457.8 million respectively. The fair values of the conversion feature and call option derivative asset at 30 September 2019 were $92.1 million and $88.0 million respectively.

The carrying values of the Group's other financial instruments do not materially differ from their fair value.

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

10. Share capital

Unaudited	Note	2019 Unaudited (000s)	2018 Unaudited (000s)
Balance at 1 April		140,774	138,449
Issue of ordinary shares - acquisition of Hubdoc		–	1,133
Issue of ordinary shares - exercising of employee share options	13	314	539
Issue of ordinary shares - restricted stock unit schemes	13	154	130
Issue of ordinary shares - employee restricted share plan	13	67	229
Issue of ordinary shares - exercising of director and advisor share options	13	60	–
Issue of ordinary shares - directors' fees		4	6
Ordinary shares on issue at 30 September		**141,373**	**140,486**
Treasury shares		(476)	(831)
Ordinary shares on issue at 30 September excluding treasury shares		**140,897**	**139,655**

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

During the period employees exercised 313,793 share options with a weighted average exercise price of $21.59 (2018: 539,321, $18.66).

During the period 209,680 restricted stock units (RSUs) vested, of which 154,251 were converted to shares with a weighted average price of $37.14. The remaining 55,429 were surrendered to settle payroll tax liabilities (2018: 199,213 vested, 129,643 converted at a weighted average price of $20.62, 69,570 surrendered to settle payroll tax).

During the period the Company allocated 130,354 shares under the employee restricted share plan, at a price of AUD62.86 (2018: 344,003, AUD45.15). Of the shares allocated, 66,823 were new shares issued, and 63,531 were the reissue of shares held as treasury shares (2018: 228,459 and 115,544 respectively).

During the period, a director and an advisor exercised 59,530 share options, with a weighted average exercise price of $16.76 (2018: nil).

During the period the Company issued 3,859 shares at a weighted average price of AUD57.55 to directors in lieu of cash payment for directors' fees (2018: 6,332, $43.27).

11. Reconciliation of operating cash flows

Six months ended 30 September	2019 Unaudited ($000s)	2018 Unaudited ($000s)
Net profit/(loss)	1,336	(28,565)
Adjustments:		
Depreciation	11,321	8,071
Amortisation	38,789	31,111
Share-based payments	15,775	14,815
Amortisation of debt discount and issue cost	8,248	–
Impairment of assets	1,071	17,757
Deferred tax	(889)	(501)
Tax losses utilised	(76)	(320)
Bad debts	814	752
Other non-cash items	269	1,642
Changes in working capital items:		
Increase in trade receivables and prepayments	(5,723)	(9,302)
Decrease in interest receivable	590	371
Increase in trade payables and other related items	635	91
Increase/(decrease) in current tax payable	(621)	66
Net cash flows from operating activities	**71,539**	**35,988**

12. Standby facility

On 14 August 2019 Xero renewed its standby syndicated facility for a further three year term. As part of this the facility was increased from $100 million to $150 million. Counterparties to the facility are ANZ, BNZ, HSBC, and Citibank.

The facility provides Xero with additional liquidity to cover unforeseen operating cash flow requirements. The facility remains undrawn, and there are no current plans to draw down on the renewed facility.

13. Share-based payments

The Group operates equity-settled, share-based compensation plans, under which employees provide services in exchange for non-transferable options, RSUs, or restricted shares. The value of the employee services rendered for the grant of non-transferable options, RSUs, and restricted 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 restricted shares granted.

Employee restricted share plan

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

Unaudited	2019 Number of shares (000s)	2018 Number of shares (000s)
Unvested shares at 1 April	371	522
Granted	130	344
Forfeited	(39)	(51)
Vested	(2)	(3)
Unvested shares at 30 September - allocated to employees	**460**	**812**
Forfeited shares not yet reallocated - held by Trustee	16	19
Total	**476**	**831**
Percentage of total ordinary shares	0.3%	0.6%
Ageing of unvested shares		
Vest within one year	275	426
Vest after one year	185	386
Total unvested shares at 30 September	**460**	**812**

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

Share options scheme

Movements in the number of options outstanding were as follows:

Unaudited	2019 Weighted average exercise price ($)	2019 Options (000s)	2018 Weighted average exercise price ($)	2018 Options (000s)
Outstanding at 1 April	31.91	2,995	20.65	2,225
Granted	60.50	603	38.22	1,951
Exercised	20.82	(373)	18.66	(539)
Forfeited/expired	37.18	(258)	30.82	(98)
Outstanding at 30 September	**38.64**	**2,967**	**30.36**	**3,539**
Exercisable at 30 September	20.66	376	18.96	376

Restricted stock units

Movements in the number of RSUs outstanding were as follows:

Unaudited	2019 Weighted average grant date fair value ($)	2019 RSUs (000s)	2018 Weighted average grant date fair value ($)	2018 RSUs (000s)
Outstanding at 1 April	38.89	370	21.64	401
Granted	65.08	400	45.83	251
Forfeited	49.41	(61)	26.66	(25)
Converted to shares	37.14	(154)	20.62	(130)
Surrendered to pay payroll tax	33.24	(55)	20.68	(70)
Outstanding at 30 September	**59.74**	**500**	**36.00**	**427**

The Company withholds shares under certain circumstances to settle tax obligations on vesting. Based on the market share price on 30 September 2019, future cash payments to meet tax obligations on the vesting of RSUs are expected to be $1.5 million (2018: $2.1 million).

14. Events after the balance sheet date

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

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Rod Drury
Lee Hatton
Dale Murray, CBE
Susan Peterson
David Thodey, AO
Craig Winkler

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Steve Vamos
Chief Executive Officer

Anna Curzon
Chief Product Officer

Kirsty Godfrey-Billy
Chief Financial Officer

Craig Hudson
Managing Director, New Zealand & Pacific Islands

Trent Innes
Managing Director, Australia & Asia

Rachael Powell
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Mark Rees
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Nicole Reid
Acting Chief People Officer

Chaman Sidhu
Chief Legal Officer & Company Secretary

Damien Tampling
Chief Strategy & Corporate Development Officer

Gary Turner
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Tony Ward
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