



1H FY2018 Result Commentary

CHAIRMAN'S & CHIEF EXECUTIVE OFFICER'S REPORT

Result Overview

Solution Dynamics Limited ("SDL" or "Company") produced an unaudited net profit after tax of \$0.832 million for the half year (1H FY17 \$0.704 million). This represents 18.2% year-on-year growth. Cash flow from operations was \$0.827 million (1H FY17 \$0.954 million) and the closing net cash position at 31 December was \$2.41 million (1H FY17 \$1.86 million). The Directors have declared an interim dividend of 4.0 cents per share (1H FY17 3.5 cents), fully imputed, a payout ratio of 69% of earnings per share.

Operational Commentary

Operating revenue grew 10.8% to \$11.3 million. Much of this was from gains in low margin postage revenue and subcontracted printing in the UK where SDL earns low margins. NZ domestic print revenue was under some pressure, falling fractionally year-on-year. The consequence of SDL's changing revenue mix – particularly the pressure on higher margin local print and mail volumes, more on that below – was a slight decline in the Company's gross margin percentage from 37.7% to 37.3% (dollar gross margin increased, up 9.7% to \$4.21 million). Costs continued to be well controlled, with Selling, General & Administration costs rising 4.6% with much of the increase coming from SDL adding additional resource, especially in the UK.

Software & Technology revenues showed a pleasing increase of 21.0% to \$2.93 million (1H FY17: \$2.42 million), as the Company's UK revenues in particular continue to build. SDL's UK channel partners are increasingly gaining sales traction. Furthermore, this first half revenue growth is despite some drag from the impact during the prior year of a major New Zealand customer no longer requiring Déjar to archive its invoices as it began to self store its documents.

SDL was pleased to be recently recognised for its growth in technology with the Financial Times rating the Company in the top 1,000 Asia-Pacific growth companies and allocating SDL to the technology sector.

In the traditional digital print and document handling services market, revenue declined 0.5% year-on-year to \$3.38 million (1H FY17: \$3.40 million). While this is a market which otherwise remains in overall decline, SDL has previously been able to grow print and mail revenues by picking up market share at a faster pace than customers have been switching to electronic communications channels. A key feature of the Company's first half was a noticeable increase in the rate at which customers switched to electronic communications. Historically, SDL has observed the annual rate of switching at around 5-7%, but the first half saw this increase to a rate of around 15%. We largely put this increased switching rate to some of SDL's customers becoming more cost focussed, as the Company also noticed a drop off in the level of ad hoc print/mail and development work against historic levels. The dollar gross margins SDL earns on electronic communications are lower than print and consequently this increase in switching is acting as a drag on the Company's earnings.

Outside of the switch to electronic, the Company is seeing print and mail growth from a range of industry sectors including financial services, debt collection, retail, freight and distribution, and



charities. SDL's web based, hybrid mail software offering – DéjarMail – has been instrumental in the capture of most of the new opportunities within our existing customers and securing a broadening range of new customers.

The Company is seeing increasing interest in its software technology in the UK and Europe, particularly DéjarMail. Mail resellers are attracted to DéjarMail as a means of capturing desktop mail volumes. SDL now has two large mail resellers in the UK and is seeing solidly growing volumes through these channels.

SDL has also recently extended its multi-channel communications offering to cover SMS and signed its first contract with an existing customer in the UK, in January 2018. While this is very low margin business, the volumes and revenues involved are significant and there is potential for this to show significant growth and make a noticeable contribution to earnings in FY2019.

Financial Performance

Earnings before interest, tax, depreciation and amortisation (EBITDA) improved by \$0.25 million (+22.8%) to \$1.32 million (1H HY17: \$1.08 million) on sales revenue that rose 10.8%.

Summary Financial Performance (all figures \$'000)	1H FY18	1H FY17	Yr-on-Yr \$ Change	Yr-on-Yr % Change
Total Revenue	11,292	10,187	1,105	10.8%
Cost of Goods Sold	7,080	6,348	732	11.5%
Gross Margin	4,212	3,839	373	9.7%
Gross Margin (%)	37.3%	37.7%		
Selling, General & Admin Costs	2,888	2,761	127	4.6%
EBITDA	1,324	1,078	246	22.8%
EBITDA Margin (%)	11.7%	10.6%		
Depreciation	102	107	(5)	-4.7%
Amortisation	53	32	21	65.6%
EBIT	1,169	939	230	24.5%
Net Interest	(2)	2	(4)	n.a.
Net Profit before Tax	1,171	937	234	25.0%
Taxation	339	233	106	45.5%
Net Profit after Tax	832	704	128	18.2%

The EBITDA result gain is partly the benefit of higher gross margin in Software & Technology, plus underlying Selling, General & Admin (SG&A) costs remaining well managed.

SDL's taxation rate in 1H FY2018 was 29.0% versus 24.9% in the prior period. This higher rate partly represents a one-off adjustment that lowered the taxation rate in 1H FY2017 taxation as well as the lack of UK tax losses which were fully utilised in FY2017. Going forward, the Company expects to be paying tax at the full rate on both New Zealand and UK earnings.

Revenue Analysis (all figures \$'000)	1H FY18	1H FY17	Yr-on-Yr \$ Change	Yr-on-Yr % Change
Software & Technology	2,933	2,424	509	21.0%
Digital Print & Document Handling	3,381	3,398	(17)	-0.5%
Outsourced Services	4,978	4,365	613	14.0%
Total Revenue	11,292	10,187	1,105	10.8%

The 21.0% growth rate for Software & Technology revenue streams in the first half was ahead of expectations. SDL's pipeline of opportunities and sales efforts in the UK and European markets are likely to ensure Software & Technology has a number of years of revenue growth ahead. The Company is still overly reliant on direct sales efforts by a couple of key staff, and a small number of large customers in the UK. We reiterate previous comments that SDL's small size and geographic distance from what is presently our most important growth market continues to present ongoing difficulties but the Company is nevertheless pleased with the expansion being achieved.

Digital print growth in 1H FY2018 was problematic as a result of the increased rate of switching to electronic communications noted above. While this trend will continue, the variability in the rate of change is less certain and difficult to predict. The industry has excess digital print capacity and rationalisation will inevitably occur.

Balance Sheet, Liquidity and Debt

SDL closed the half year with net cash on hand of \$2.41 million. A bank overdraft facility of \$0.2 million remains in place but is unused. The main capital expenditure in the half was in upgrading some of SDL's production-related software.

Selected Balance Sheet and Cashflow Figures (all figures \$'000)	1H FY18	1H FY17	Yr-on-Yr \$ Change	Yr-on-Yr % Change
Net Cash on Hand (net of debt)	2,408	1,858	550	29.6%
Non-current Assets	1,959	2,105	(146)	-6.9%
Net Other Liabilities	(398)	(570)	172	-30.2%
Net Assets	3,969	3,393	576	17.0%
Cashflow from Trading	904	893	11	1.2%
Movement in Working Capital	(77)	61	(138)	-226.2%
Cash Inflow from Operations	827	954	(127)	-13.3%

Book value (net assets) has increased by 15.1% to \$3.91 million. Working capital continues to be well managed. SDL made capital expenditure additions during the half of \$0.115 million, the majority of which, as noted above, was for software.

The seasonality in SDL's business, especially New Zealand print and mail, means sales and earnings are higher in 1H compared to 2H and accordingly the movement in working capital is negative in 1H, and positive in 2H. As SDL's software revenue, especially in the northern hemisphere, continues to grow, the extent of this seasonality is beginning to reduce.

The Company examined (and is still examining in some cases) a number of potential acquisition opportunities during the first half but retains its cautious approach to acquisitions and strong preference for organic growth. Nevertheless there may be “bolt on” opportunities where removal of duplicated costs means the effective acquisition multiple is low, or product extension opportunities where the acquisition fills a gap in SDL’s software portfolio plus SDL has the opportunity to sell its software into the acquired company’s customer base.

In early 2014 SDL introduced an Employee Share Option Plan (“ESOP”). That ESOP has issued options over 580,000 shares and 500,000 of these options became exercisable in March 2017 (the remaining 80,000 become exercisable in March 2018). During the first half of FY2018, staff exercised options over 190,000 of these shares which increased SDL’s shares on issue by 1.4% to 14.25 million shares.

Dividend

SDL is declaring an interim dividend of 4.0 cents per share, an increase of 0.5 cent per share or 14.3% on the prior year.

Earnings and Dividend per Share	1H FY18	1H FY17	Yr-on-Yr Change	Yr-on-Yr % Change
Shares on Issue (000)	14,249.8	14,059.8	190.0	1.4%
Earnings per Share (cents)	5.84	5.01	0.83	16.6%
Dividend per Share (cents)	4.00	3.50	0.50	14.3%
Dividend proportion imputed	100.0%	100.0%	n.a.	n.a.
Payout ratio	68.5%	69.9%	n.a.	n.a.

The dividend is fully imputed and the amount represents a payout ratio of 69% of earnings per share. An arrangement with NZ Trade and Enterprise (“NZTE”) in relation to helping fund UK market development requires the Company to cap the dividend payout ratio at less than 75% for the duration of the agreement. The NZTE funding agreement expires at the end of the current financial year and SDL thanks NZTE for its assistance, which has been very beneficial in helping the Company produce strong, positive results from its UK growth initiatives.

FY 2018 Outlook

The two trends that affected the first half – increased rate in transition of domestic physical volumes to electronic, offset by better software growth in UK and Europe – are expected to continue through the second half. How the relative magnitude of these two trends play out over the remainder of the year is difficult to forecast at this stage, and the timing of software deals in Europe will also affect the full year profit outturn.

SDL continues to examine potential acquisition opportunities and has a strong pipeline of new customer opportunities in the UK and Europe. This includes expanding the Company’s multi-channel distribution software to include SMS.

SDL has previously provided FY2018 guidance for earnings growth of around 15%. Following the first half result, and considering the strong software pipeline, the Directors are upgrading the full year earnings growth outlook to around 20%, with the caveat that some of the software pipeline may require additional upfront costs