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MANAGEMENT DISCUSSION AND ANALYSIS

FY2018 Result Overview

Solution Dynamics Limited ("SDL" or "Company") has produced an audited net profit after tax of $1.332 million for FY2018 (growth of 1.7%). This profit includes costs and losses from acquisitions made late in the financial year, which acted as a significant drag on the Company's profit. A like-for-like comparison (backing out the costs and losses from acquisitions) against the prior year saw pleasing growth in net profit after tax of 18.8%. Highlights of the result are:

- revenue growth of 13.7% to $22.7 million, with revenue from the UK and Europe up $1.0 million or 33.9% to $4.0 million
- EBITDA growth of 8.9% to $2.27 million (growth was 17.1% to $2.44 million excluding the effects of acquisition costs and losses)
- net cash on hand at 30 June balance date was $1.96 million
- the Directors have declared a final, fully imputed dividend of 3.50 cents per share (FY2017: 3.25 cents), taking the total dividend for FY2017 to 7.50 cents per share (FY2017: 6.75 cents), an increase of 11.1%

In late FY2018, SDL acquired Auckland-based Scantech (scanning and scanning/workflow software) and US-based DigitalToPrint Inc. ("DTP"), which provides a globally distributed print and mail solution.

Business Overview

SDL operates in the Customer Communications market (essential mail, interactive marketing communications and on-demand communications). The Company's products and services are represented by two revenue streams:

- Services (itself separated into digital print & document handling services, outsourced services and scanning); and
- Software & Technology.

Services includes digital print and mail house processing for mail items such as invoices, statements and promotional material. These are then distributed through New Zealand Post's ("NZ Post") mail delivery system. A number of the components included in this service, such as envelopes and postage, form part of outsourced service revenues. This service differs from traditional printing in that each document printed is typically personalised and unique. The revenue from Scantech is primarily included in Services (document handling services), while consulting and software revenues that are related to Scantech's software technology are included in the Software & Technology revenue stream.

Software & Technology develops and markets SDL's own software products related to a) multi-channel marketing communications, which includes: a) digital asset management, communication templates and campaign management, b) document archiving, c) document composition, d) desktop mail solutions, e) scanning and scanning workflow, and f) international cross-border print-on-demand management software. A range of further technology services are also offered relating to SDL's own software and the management of client data around the formatting, electronic output and archiving of customer communications. The US business, DTP, acquired by SDL in May 2018 is wholly included in Software & Technology.

Despite the ongoing erosion of transactional mail volumes, the Directors believe that SDL's key point of difference is in offering integrated solutions incorporating both physical print and digital technology. Some communications are better suited to print and will likely remain so for the foreseeable future. In other cases, use of software technology such as DéjarMail (SDL's desktop mail solution) can improve the handling efficiency, management and cost of physical mail. The Company's integrated range of print and software technologies means it is able to offer a holistic and distribution channel/platform-agnostic approach to managing its customers' communications needs.

The Company operates from leased premises in Albany, Auckland.

Acquisitions

SDL made two acquisitions late in the financial year, Scantech in April 2018 and DTP in May 2018.

Scantech is largely a "bolt-on" incremental transaction for the Company. SDL has offered scanning services to its customers for some time and then subcontracted this work to Scantech and taken a small margin in the process. Scantech has developed its own, in-house scanning workflow software, which means it is not reliant on click-cost-based external software to manage its scanning. There are opportunities to sell Scantech's software in the UK and customer pilot projects are currently underway.

DTP is a riskier acquisition for SDL as it is currently unprofitable and is likely to remain so in the coming financial year. In that sense, the purchase price for SDL is a combination of what has been paid (plus likely vendor earn-out) plus the cost to fund near-term losses. However, DTP opens two new opportunities for SDL; cross border printing and a toe-hold into the US market. Cross-border printing is where a company needs to print and mail for offshore markets. Companies typically have two options: either print-and-mail from their home country (expensive with international mail rates) or print in foreign countries (cheaper, but problematic around the logistics of managing a network of foreign printers, many of whom will have differing print composition requirements). DTP's software and network of printer relationships enables cross border printing and SDL was aware from discussions with existing UK customers that there was a market need for this functionality. Stepping – carefully – into the US market is an opportunity, but one that will require additional sales and technical support overhead over time. The Company is already bidding on a sizeable pipeline of work and the scale of potential revenue from individual opportunities is large, although we are under no illusions about the difficulty of succeeding in this market. Our initial observation is that the switch to electronic in the US, while underway, appears much slower and at a far earlier stage than in New Zealand.

Both acquisitions are structured with cash upfront payments and subsequent vendor earn-outs for reaching profit targets. Note that accounting rules now require intangibles to be allocated to items such as intellectual property and the value of customer contracts, rather than goodwill. Unlike goodwill, which remains on the balance sheet subject to annual impairment testing, the intangibles must be written off by amortisation through the Income Statement. SDL is opting to write down acquired intangibles over a relatively short four to five year period. This means the Company will incur a non-cash, amortisation charge against profit of around $0.23 million each year for the next four years. Furthermore, a portion (relating to customer contracts and some of the acquired software) of this charge is not tax deductible. For the purposes of calculating the dividend, the Directors have determined that acquisition-related amortisation will be added back to net profit after tax before determining the dividend.

Description and Review of Revenue Streams

SDL Services

SDL Services predominantly provides mail house operations to high-volume postal mail users, mainly those in the business-to-consumer sector. DéjarMail has expanded the market for SDL's print and post service down to the SME (small to medium enterprise) sector although the Company does not sell directly to SMEs but reaches this market through channel partners.

SDL Services operates leased, high-speed digital colour and monochrome printers. In addition to digital printing, Services also provides the usual ancillary document handling operations such as automated envelope inserting and flowrap.

Services revenue also includes a variety of outsourced functions or components such as postage, offset printing, freight, paper and envelopes. The Company has an access agreement with NZ Post which provides bulk mail discounts off NZ Post's retail rates, subject to SDL meeting minimum volumes requirements over a twelve month period. SDL continues to exceed NZ Post's minimum volumes under this agreement. The profit margins on many of these outsourced components, especially postage, are slim.

With general mail volumes continuing to decline, SDL's FY2018 mail lodgement volumes fell 8.6% although the Company's digital print volumes rose 7.6% as a result of new business wins offsetting declining volumes from existing clients. The differing growth outcome for mail lodgement versus print volumes is accounted for by two effects. The first is that not all SDL's digital print volumes are related to mail, and secondly, changes in the average number of printed sheets of paper per mail item means that print and mail volumes are not one-to-one correlated. Note that part of the decline in physical mail volumes is offset by an increase in email volumes processed by SDL; these rose by just over 30% during FY2018. SDL has continued to increase its market share of declining mail volumes albeit at a lower rate of gain than in prior years. Note that the growth in Outsourced Services revenue in the following table is a combination of both very low margin postage and the outsourced printing for DéjarMail volumes in the UK.

SDL Services Revenue Breakdown (all figures $000)	FY2018	FY2017	Percentage Change
Digital Printing and Document Handling	6,773	6,712	0.9%
Outsourced Services	9,907	8,213	20.6%
Total Services Revenue	**16,680**	**14,925**	**11.8%**

Growth in digital printing was largely the result of adding new business and several non-mailing digital print clients. Last year's result commentary noted one of the Company's major customers had rationalised its print output during FY2017, and SDL's FY2018 saw the full annualised effect of that change.

The Directors remain cautious about acquisitions and will only proceed on the basis that any transaction is expected to be value adding for shareholders, and with manageable financial and operational risk profiles. While SDL's net cash position provides financial capacity for further acquisitions, the Company is conscious of first ensuring the two recent acquisitions are well integrated and adding value.

SDL Software & Technology

Digital tools and the ensuing digital transformation mean communication channels and the customer engagement model in most businesses has needed to adapt and become nimble and personalised. Organisations increasingly need to employ more "pull" marketing tactics, drawing people in to their brands with interesting, informative and engaging content. Communication channels are no longer "one size fits all"; customers should receive messaging through an omni-channel or multi-media approach. SDL treats every form of communication – whether a customer email, an invoice or account statement, or a piece of marketing collateral – as a means to enrich and deepen the personalised relationships that our customers have with their customers.

The Company's history in mailhouse and fulfilment means we fully understand the importance of data accuracy, timely delivery, and cost efficiency. The ongoing investment in software and technology demonstrates the SDL's commitment to making the most of the digital transformation opportunities available to our clients.

SDL Software has developed four software engines that are used as required to develop customer solutions. The acquisition of DTP in late FY2018 added further software capability with that company's Jupiter product and the Scantech acquisition has added scanning workflow software:

1. Déjar

   Déjar is a digital archival system that provides the ability to efficiently store and retrieve electronic documents created from most formatting tools. Déjar allows users to exactly reproduce the original document and access these via a browser over the local network or via the Internet. The reproduced document can be printed, faxed or emailed and Déjar's security and history features ensure every document created and subsequent access event is recorded by User ID and date/time stamp.

2. Composer

Composer is SDL's electronic document creation software. It is flexible and allows customised documents to be built on the fly, based on information retrieved from databases. Based on templates it automatically creates templates, documents and letters with dynamic, customised content, formatted to each customer's requirements. Composer allows companies to easily standardise corporate documentation formats for all users, including regional and legal variations. Templates, documents, emails, letters and newsletters created by Composer are automated, ready to archive, print, publish online, or electronically distribute to customers in one step.

3. Bremy

Bremy is an integrated, multi-channel publishing and distribution solution for businesses across a broad spectrum of industries. It manages the work flow of digital assets, from document creation and revision, to final email or print-ready files and distribution through multiple channels, including print, email, web, digital signage and mobile. It helps streamline and provides integrity to document proofing and integrates with data sources to produce complex documents such as online or physical catalogues. It also has a Campaign Manager module to assist companies in creating and managing specific advertising programmes.

4. DéjarMail

DéjarMail is a web browser-based desktop mail management solution which allows customers to route mail correspondence, by file transfer or web browser portal (Post On Demand), to SDL or any other service provider for printing and delivery via post or any other medium. This delivers costs savings for smaller businesses and for larger companies' ad hoc mail.

5. Jupiter

Jupiter, acquired as part of the DTP acquisition, is a global print and mail solution that benefits Postal Administrations, senders and recipients, all via a "Managed Print and Mail Solution". Jupiter provides a technology platform which links together customer communication origin points such as ERP, transactional and marketing output with production and fulfilment on a globally distributed basis. Closely integrated with over 300 service providers globally, customers can use a highly flexible web service API to achieve simultaneous concurrent fulfilment across five continents, all while retaining visibility and control of the process via an intuitive and mobile friendly, web portal.

The scope for integration of the SDL product set with Jupiter's global fulfilment network opens the door to expansion of the markets that the range of SDL solutions can apply to.

6. Scantech software

Scantech's suite of software solutions include scanning applications to digitise physical documents, automated extraction of data from documents (both physical and digital) including workflows for the processing of this data and the automation of business processes such as accounts payable and accounts receivable. These are also integrated into SDL products, such as Déjar for archival and retrieval.

Software & Technology revenue is earned from three sources.

SaaS (Software as a Service) is an alternative to the traditional, now largely defunct, licensing of software. Under SaaS, rather than pay an upfront fee, customers opt to run SDL's software on a pay-as-you-go model, typically by way of a per-document or per-electronic transaction charge. Under this model, SDL will usually host the software (using third party hosting infrastructure, such as Amazon Web Services) and related data on behalf of the client. While SDL forgoes the benefit of any large up-front licence revenue, the SaaS approach does build an annuity revenue base that then generates value over a longer term. The trend in recent years has been for customers to prefer SaaS rather than acquiring a software licence, to the point where the Company no longer expects to sell licences.

Secondly, the company offers bespoke software development services where this is related to a customer using SDL's software. An example is a customer requiring a front end, web-based access portal to allow its clients to access the underlying data being stored or managed by SDL's software.

The third is the provision of programming, consulting, business analysis and design services that help clients to manage essential and marketing communications both by mail and electronic transfer.

Software encompasses all international software revenue and all revenue from all of our software products and services. It also includes Déjar revenue in New Zealand for digital document archival and management for SDL Services' customers. Note that a significant part of the revenue from DéjarMail is generated in SDL Services from the printing and postage component of the service.

In addition to New Zealand and Australia, both Déjar and Composer are sold internationally, mainly in the UK and Europe. Bremy is predominantly a New Zealand product, with several Australian and UK customers and the Company sees potential for ongoing and potentially strong growth in the UK, albeit from a low base. DéjarMail is continuing to see solid growth in the UK and given the early-stage client base in that region we expect this will be a secular growth trend that will run for a number of years. The roll out of Bremy to UK dental practices commenced during FY2017, although there was a period of additional development required, which constrained growth during the year. We continue to expect growth from Bremy, although as with DéjarMail, the speed of the take-up rate and eventual penetration levels is difficult to assess.

SDL sees a general trend for organisations to internally generate and self-store PDF files; this is likely to reduce demand for the Company's Déjar archival product over time.

In the UK, SDL has added additional sales and support personnel, as well as staff in Europe during FY2017 and incurred the full annualised impact on profitability from these costs during FY2018. Additional UK-based sales staff are currently being added.

Software & Technology generated revenue of $6.05 million in FY2018, an increase of 19.5% on the prior year's revenue of $5.07 million (and an acceleration of growth from 13.9% the prior year), largely the result of DéjarMail growth in the UK. There were no large, one-off licence revenues achieved, with some software development work undertaken and SaaS revenues continuing to build. Scandinavian postal operator, Post Nord's digital solutions arm, Stralfors, was added as a new customer in the second half, generating FY2018 revenue from setup and implementation, plus some software customisation.

Financial Performance

Revenue growth in FY2018 was generated by both Software and Technology, and Outsourced Services, both of which grew around 20% year-on-year, while Digital Imaging and Document Handling remained largely flat. Outsourced Services revenue gains are predominantly the effect of printing for DéjarMail volumes in the UK. Postage margins remain very low and this is unlikely to change as the wholesale rates and hence margin that New Zealand Post is able to offer is regulated by the Postal Network Access Committee, although changes to NZ Post's rebate requirements will negatively affect FY2019 margins.

Summary Financial Performance (all figures $000)	**FY2018**	**FY2017**	**Percentage Change**
Total Revenue	22,732	19,991	13.7%
Less: Cost of Goods Sold	14,315	12,274	16.6%
Gross Margin	**8,417**	**7,717**	**9.1%**
Gross Margin (%)	37.0%	38.6%	
Less: Selling, General & Admin	6,144	5,630	9.1%
EBITDA	**2,273**	**2,087**	**8.9%**
EBITDA margin (%)	10.0%	10.4%	
Depreciation	208	208	n.m.
Amortisation	161	78	n.m.
EBIT	**1,904**	**1,801**	**5.7%**
Net Interest	(5)	(1)	n.m.
Income Tax	577	492	17.3%.
Net Profit after Tax	**1,332**	**1,310**	**1.7%**
Tax rate	30.2%	27.3%	

FY2018 earnings were reduced by the Company's decision to make two acquisitions: Scantech, and DTP. The following table highlights the main costs involved from the acquisitions and provides a like-for-like comparison to SDL's results in the absence of these acquisitions.

Adjusted Financial Performance (all figures $000)	**FY2018**	**FY2017**	**Percentage Change**
Reported Net Profit After Taxation	**1,332**	**1,310**	**1.7%**
Acquisition-related costs (net of any tax):			
Acquisition costs (e.g. legal, due diligence)	118		
Post-purchase trading losses (ex-amortisation)	58		
Amortisation (of acquired intangibles)	49		
SDL like-for-like profit	**1,557**	**1,310**	**18.8%**
Earnings per Share like-for-like basis (cents)	10.69	9.32	14.7%
Dividend per Share (cents)	7.50	6.75	11.1%
Dividend Payout ratio like-for-like basis	70.1%	72.4%	

The effect of the acquisition drag on SDL's profitability was compounded by the fact that DTP losses are quarantined in a US entity for tax purposes and thus not available to be offset against profits in other areas of SDL. Also, amortisation of acquired intangibles (other than a portion of the software) is not deductible for tax purposes. These factors pushed up the Company's headline tax rate to 30.2% for the year and 32.2% in 2H (these factors will continue in FY2019).

The second half remains the seasonally the quieter half of the year, especially in New Zealand, although growth in software (and directly associated Outsourced Services) revenue is now beginning to produce a more balanced profit split.

The FY2018 result includes a pre-tax benefit of $0.23 million from the Company's market development agreement with NZ Trade and Enterprise ("NZTE"). This agreement expired in June 2018. SDL intends applying for further NZTE market development support for its US expansion efforts through DTP, however, this application is not able to be made prior to January 2019 and there is no certainty the Company's application will be successful.

The change in mix of revenue towards a greater component of low margin, outsourced services is causing SDL's percentage Gross Margin to compress, although the dollar Gross Margin is continuing to grow. This trend is likely to persist as DéjarMail's offshore revenue grows at a faster rate than the rest of the Company's business. Nevertheless, despite the percentage Gross Margin compression, SDL's ongoing focus on cost control saw the Company's EBITDA margin decline only slightly, to 10.0%. Part of the reduction is the deliberate and ongoing addition to sales and support staff in offshore markets, particularly the UK, and during FY2019 probably also in the US.

The following table highlights first and second half performance for the last two financial years. Note that 2H FY2018 EBITDA contains approximately $0.15 million of costs and operating losses related to the two acquisitions made late in FY2018 (the positive EBITDA generated by Scantech was well outweighed by the EBITDA loss from DTP).

SDL Half Financial Years (all figures $000)	2H FY2018	2H FY2017	Percent Change	1H FY2018	1H FY2017	Percent Change
Total Revenue	11,440	9,804	16.7%	11,292	10,187	10.8%
EBITDA	949	1,009	-5.9%	1,324	1,078	22.8%
EBITDA margin	8.3%	10.3%		11.7%	10.6%	
Tax rate	32.2%	29.9%		28.9%	24.9%	

Balance Sheet, Liquidity and Debt

Capital expenditure in FY2018 was $0.188 million, a drop of around 9% on the prior year ($0.206 million). The capex spend mainly related to IT equipment, a specialised booklet-making piece of print finishing equipment for which we see strong customer demand, and upgrading SDL's accounting and print job management systems.

The Company's net cash (i.e. cash net of interest bearing debt) position declined marginally, by $0.12 million or 6.0%, to $1.96 million, with the reduction a result of SDL investing $0.712 million in acquiring Scantech and DTP. Further payments for these two acquisitions are likely in FY2019 under vendor earnout arrangements.

At balance date the Company's sole remaining bank facility was an unused overdraft arrangement from ANZ Bank with a $200,000 limit.

Selected Balance Sheet and Cashflow Figures (all figures $000)	FY2018	FY2017	Change
Net Bank Cash/(Debt & Borrowings)	1,956	2,080	(124)
Non-Current Assets	2,871	2,008	863
Net Other Liabilities	(816)	(569)	(247)
Net Assets	**4,011**	**3,519**	**492**
Cashflow from Trading	1,677	1,599	78
Movement in Working Capital	(55)	82	(137)
Cash Inflow from Operations	**1,622**	**1,681**	**(59)**
Cash dividends paid	**1,039**	**808**	**231**

Net Assets includes goodwill related to the original purchases of the software products Déjar and Bremy. Bremy accounts for around three quarters of the $1.06 million carrying value of goodwill. An impairment test is conducted against the carrying value of these assets each year and the Directors believe the current value of these products remains comfortably in excess of their carrying values.

The acquisitions of Scantech and DTP have resulted in additional intangible assets of $1.047 million, mainly related to the value of software IP plus customer contracts these companies have in place. Unlike goodwill, these intangibles are required to be amortised under accounting rules and the directors have determined they should be written off over periods of four to five years depending on the type of intangible asset. This will mean an additional, non-cash, amortisation charge of around $0.23 million to the Income Statement for the next four years.

While SDL's balance sheet shows a positive net-cash position, the Company is also carrying leases on its premises and much of its printing and document handling equipment. The annual cost of rentals and leases was $0.72 million in FY2018 ($0.69 million in FY2017) and represents off balance sheet leverage. We note that in FY2020 the accounting standards relating to leases will change. Finance leases will be capitalised and shown as a debt liability, increasing the amount of debt on the balance sheet, as well as altering the Income Statement by mandating that part of the lease payment be accounted for as a financing (i.e. interest cost) charge.

Excluding the net cash balance from SDL's working capital, the Company currently operates with a slightly negative working capital balance. The Company adopts a positive view to this aspect of its balance sheet. It means SDL can generally continue to grow revenue without particular requirement to fund any additional working capital needs. Note that SDL's Other Current Liabilities figure included $0.335 million as a provision for the earnout liability in relation to Scantech and DTP. To the extent that the actual earnout varies from this provision, the difference will affect the FY2019 Income Statement (and will be disclosed a separate item).

Taxation and Dividends

Aside from minor timing issues and non-deductible expenses, the Company pays full New Zealand tax on locally generated earnings. SDL completely utilised its remaining UK tax losses during the year and is now paying UK tax. The recently acquired DTP business in the US is currently making losses. These are effectively ring fenced within the US and SDL is not able to group them to offset other profits. Until the Company is able to improve trading performance of DTP it will therefore show an abnormally high tax rate although this position will reverse if SDL is able to return DTP to profitability and utilise any US tax losses that are then available (note that the losses may possibly be recognised earlier for accounting purposes but this will not affect the cash tax position). Further, a portion (relating to customer contracts and some of the acquired software) of amortisation of acquired intangibles is not tax deductible and this will also bias the reported tax rate upwards until these are fully written down.

SDL only intends to pay dividends to the extent that it can fully impute them and also subject to SDL not experiencing any one-off requirements for abnormal capital expenditure or any significant acquisition activity.

Earnings and Dividends per Share	FY2018	FY2017	Percentage Change
Shares on Issue ('000)	14,560	14,059	3.6%
Earnings per Share (cents)	**9.15**	**9.32**	**-1.8%**
Adjusted Earnings per Share (cents) (a)	10.69	9.32	14.7%
Dividend per Share (cents)	7.50	6.75	11.1%
Dividend Proportion Imputed	100.0%	100.0%	
Dividend Payout ratio	82.0%	72.4%	
Dividend Payout ratio on Adjusted EPS	70.1%		

(a) Adjusted earnings per share is a non-GAAP accounting measure that is calculated by adding back the costs and losses relating to SDL's two recent acquisitions. It is provided to provide investors with a more meaningful like-for-like comparison against the prior year earnings per share.

Shares on issue rose slightly (+3.6%) over FY2018, entirely the result of SDL staff exercising Employee Share Option Programme ("ESOP") options that were issued in 2014. The bulk of ESOP options have been exercised with only 80,000 options now outstanding under this programme.

Operational Performance

The industry-wide decline in general mail volume is continuing and anecdotal industry comments suggest that the rate of decline increased in FY2018. SDL's mail volumes dropped 8.6%, partly cushioned by some new business gain. The Company's digital print volumes increased 7.6% on last year. SDL's print equipment has significant capacity, particularly from a high-speed, continuous printer under the DMS agreement with FXNZ. The Company has progressively transitioning a greater proportion of its print jobs from cut sheet printers onto the continuous printer as this provides efficiency benefits. Any material growth in continuous print volume under the DMS agreement would likely require a modest increase in the level of production staff and possibly some additional document handling equipment.

New Zealand Postal Market

The domestic postal services market continues to evolve, and changes in 2018 are not positive for physical mail volumes. Previously, in July 2015, NZ Post commenced the process of reducing the number of delivery days per week for standard letter mail in major towns and cities to three days, although it is continuing to provide six-day-per-week delivery for premium mail. Earlier in 2018, NZ Post announced a substantial increase in the price of mail that took effect from 1 July 2018. The price of a standard letter increased by 20 cents from $1.00 to $1.20, and bulk mail prices also increased along with tighter conditions to achieve bulk pricing.

There are examples of one-off sizeable mail price increases overseas, including Australia, in recent years. The experience has tended to result in a one-off step down in mail volumes, subsequently followed by ongoing volume erosion then continuing from the lower base. SDL has no reason to assume anything other than a similar experience is likely in New Zealand, with the main uncertainty around how quickly the Company's customers react and begin the push to digitise more of their communications.

These price changes by NZ Post may create opportunities for SDL as it may force some customers to accelerate moves towards greater use of digital communications solutions. The Company tracks how its major customers utilise print versus electronic delivery for transactional mail. FY2018 has already seen a pick-up in the rate at which customers are switching to digital and we expect a further, probably significant, step up in that rate during FY2019. SDL is well positioned to capitalise on this, given its breadth of technology offerings with solutions for digitally communicating with and servicing customers (these can also deliver significant communications and document creation cost savings).

Nevertheless, if the Company's customers opt in FY2019 to more rapidly switch towards greater electronic communications, SDL will inevitably suffer margin loss from lower utilisation of its printing assets and any revenue and margin gained from SDL Software & Technology will not be sufficient to offset this decline.

Risk Factors

The physical mail market will continue to decline in volume with the probability of a one-off more sizeable decline in FY2019 resulting from recent NZ Post price increases. This has several industry-wide implications. First, excess printing capacity in the mail house physical print sector, already a problem, will inevitably worsen. Secondly, increased competition for lower volumes may spill over into pricing and margin pressure. The risk is partly mitigated by SDL's ability to add value through its technology offerings although excessive price discounting of printing services would affect profitability across the entire industry and SDL would not be immune to this threat. Additionally, pressure on marginal print operators is likely to cause industry rationalisation, although SDL may benefit from being able to acquire distressed print volumes (without buying the associated print assets).

SDL's top five customers provided 40% of the Company's revenue in FY2018 with the largest customer accounting for 12% of revenue. Loss of one or more of those customers could cause financial results to differ materially from those outlined in the FY2019 Outlook section below. This risk is partly mitigated by having a number of these clients under contract, as well as the offset of expecting revenue growth outside these clients, particularly from DéjarMail.

The Company's software provides critical document management and storage functions for its clients. SDL needs to ensure it continues to maintain adequate levels of software quality control. SDL also regards IT and data security as a potential risk area and regularly reviews its IT and data security arrangements.

The Company operates a single site facility, albeit with an offsite for data and server backup. The Directors are conscious of the operational risk a single site implies for digital imaging operations. SDL has investigated reciprocal disaster recovery ("DR") plans with other printers, and the Company has some capability with Fuji Xerox, however, in general, print capacity mismatches have meant there are few possible solutions. SDL continues to explore DR options.

The Company relies on several third party distributors to market and support its software products, especially in international markets. There is no certainty that these arrangements will be successful in meeting revenue expectations and SDL may be required to devote more time and funds to support its existing international distribution structures.

Technology Innovation

SDL operates in both the old economy print/mail house business and the new economy document management business. While there are many areas where printed mail is continuing to decline, some elements (e.g. direct marketing) of print and mail remain reasonably resilient. Nevertheless, SDL is continuing to innovate and develop its software offerings to ensure the Company is agnostic in the communication channels it is able to offer its clients to communicate with their customers.

SDL has been progressively managing its portfolio of digital document software IP to ensure the Company is capable of making this progressive transition towards the growing emphasis on digital customer communications. This involves increasing internationalisation of SDL's revenues, both through software product development and acquisitions such as DTP, as well as the development of channel partners to build distribution.

Share Trading Liquidity

The Directors are conscious that the Company's shares trade infrequently and that this is likely to result in higher than desired share price volatility and limited ability for investors to enter or exit a holding. There are likely several factors behind this, but predominantly two main ones; the high extent to which large blocks of SDL's shares are held by parties who do not normally trade them, reducing the effective free float, and the fact that SDL is listed on NZX's secondary, NZAX, board. There is no action the Company can take in respect of the first factor.

On the second factor, NZX has commenced a process to review and simplify its Listing Rules, and as part of that is also looking to simplify its equity market structure and consolidate the NZAX and NXT markets into a single NZSX Main Board. The NZX Listing Rule review is well advanced but is still subject to FMA approval. Subject to timing of the approval of the new Rules, the window for the Company to transition from NZAX to the main board should open in early 2019. With the caveat that the Directors are yet to see and take advice on the updated Listing Rules, SDL intends to transition to a NZSX Main Board listing as soon as practical in 2019 and then review liquidity to see if further actions are warranted.

FY2019 Outlook

After a good result for FY2018, the Company is cautious for FY2019. The mail pricing actions by NZ Post will inevitably mean volume and margin erosion in SDL's print and mail house operations. While there will be some offsetting volume switch into SDL's digital revenues, the amount of dollar margin achieved for a digital communication processed by SDL is significantly less than for a similar print and mail communication.

Software revenues in the UK are continuing to increase and we expect this trend to continue in FY2019. In Europe, Post Nord is expected to begin progressively utilising SDL's technology, although the rate of customer take up is uncertain at this stage and the FY2018 result benefitted from one-off setup and customisation revenues for Post Nord. Furthermore, SDL has added additional support and business development infrastructure in the UK and the market development cost subsidy programme from NZTE expired at 30 June, meaning UK costs will show a sizeable net increase in FY2019.

The acquisition of Scantech will make a positive addition to earnings and that business is currently operating to expectations. However, the Scantech contribution will be partially offset by expected losses from DTP in the US. DTP has a number of very significant customer opportunities, but even if some of these are successfully closed, the lead times to fully implement and bring the customers on board may mean that little benefit is gained in FY2019.

Lastly, the accounting rules around amortisation of acquisition intangibles mean that SDL will incur an additional non-cash charge of around $0.205 million (after tax) per annum for the next four years. The Directors have determined that the non-cash charge for amortisation related to acquired intangibles will be ignored for the purposes of SDL's dividend payout policy.

The combined effect of NZ Post price changes on margins, expiry of NZTE market development contribution, intangibles amortisation and DTP losses are sufficiently large that it is only broadly offset by the addition of Scantech earnings and Software & Technology growth in the UK and Europe.

Consequently, SDL's outlook for FY2019 is for a modest decline of around 5-10% in reported net profit after tax. Note that this forecast includes the full year impact of amortising the intangible assets that were acquired with Scantech and DTP and if these are excluded, then FY2019 earnings are expected to show a low single digit percentage increase. The Company's forecast does include some moderate growth in new business assumptions and is subject to the usual risks that the print and mail house market remain extremely competitive and in decline.

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