23 February 2023

Directors' and Chief Executive Officer's Report

Result Overview

Solution Dynamics Limited ("SDL" or "Company") produced an unaudited net profit after tax of $2.46 million for the FY2023 half year (1H FY2022 $2.03 million), a year-on-year increase of 20.9%. This is a further record half year profit for the Company and represents earnings per share of 16.69 cents.

As in 1H FY2022, the extent of year-on-year first half growth in FY2023 reflects a high concentration of large international customer jobs in the period, along with usual seasonal 1H strength in the New Zealand operations, plus several modest one-off gains. International activity declined year-on-year as new customers and generally growing volume levels were offset by lingering COVID effects and, more recently, by increasing interest rates. SDL's customers in the US mortgage market have seen a very significant reduction in communication volumes and that sector is largely responsible for the fall in international and software revenue. The scale and speed of the mortgage market decline masked the ongoing growth opportunities for SDL in international software, which remains the primary expected driver of growth. Gross margin in International grew despite lower revenue due to growth in higher margin clients and improved cost management.

Growth in NZ print and mail services was the main success story in the half, with new customer wins contributing to significantly improved domestic results following several years of weakness. While the overall NZ mail house market remains in structural decline, renewed sales activity, led by SDL's digital offerings and postage management solutions, have produced gains in market share and resulted in revenue growth. Production efficiencies in the New Zealand mail operation contributed to higher gross margin, despite inflationary wage increases.

Cash flow from operations was $3.41 million (1H FY2022 $3.34million) with cash flow from trading improving 14.3% to $3.09 million. The closing net cash position at 31 December was $7.13 million noting that the prior period balance (1H FY2022 $7.00 million) included approximately $1.2 million of cash representing pre-payments of postage by customers. The current cash position does not include any postage pre-payment amounts, so represents clear cash available to the Company of around 49 cents per share (noting that the intra-month low cash position will normally be lower than the month end figure). The Directors have declared a fully-imputed interim dividend of 10.0 cents per share (1H FY2022 9.0 cents).

Operational Commentary

Operating revenue declined 1.6% to $23.34 million with the international decline not fully offset by growth in New Zealand operations. Software & Technology revenue fell 8.2%, largely driven by the mortgage market slump in the US reducing revenues from this segment by around 55%. Although US mortgage rates have somewhat stabilised recently, a rebound in mortgage communication volumes is not expected in the near term. The UK is seeing steady recovery in volumes from previously COVID-affected customers. While SDL's new business gains in NZ are producing improved results, pressure on pricing and margins is likely to develop over 2023 because of significant increases in paper costs. Although most customer contracts have a pass through on paper costs, this is expected to exacerbate and accelerate the structural shift to digital communications particularly for transactional mail volumes.

For the first time in many years, SDL broadly increased pricing to NZ mail house customers in 1H, offsetting a range of cost pressures.

SG&A costs declined 1.1% year-on-year, despite a general wage increase across the Company of around 5%. Some savings accrued from several unfilled roles, and efficiencies have been gained in technology and network costs.

SDL's traditional digital print and document handling services market revenue in New Zealand grew 7.9% year-on-year to $2.31 million (1H FY2022 $2.14 million). Most of this growth is from new customers with a smaller contribution from the price increase that was implemented during the period and which will mainly assist the second half in FY2023. SDL is now the clear leader in the New Zealand "Councils" communication market and this lead was extended in the first half. Last year the Company restructured its New Zealand sales efforts and team, and this half year saw the benefits from that move, with further gains in market share possible given the solid pipeline. Email volumes in New Zealand were up around 9% year-on-year.

While most COVID-related work practices around health monitoring, segregated teams and controlled facility access have been maintained, there has been an increase in staff working in the office although the extent of this varies significantly across functions. During the half, SDL renewed the lease on its Auckland premises and also refurbished the ground floor office space (which had been unchanged since the building was first occupied in 2005). This has contributed to improved staff morale and helped with the process of partial return to the office.

International sales efforts have narrowed to focus on specific verticals (e.g. global NGOs such as charities) that do business globally (with cross border mail requirements), provide business process outsourcing to global enterprises, and also to the cybersecurity breach notification market. The Company recently won a cross-border print and mail contract (into a developing market) for a financial services company. The pipeline of 2H international opportunities, mainly in the US, should begin to mitigate the slump in mortgage-related volumes although more difficult macroeconomic conditions are lengthening sales cycle times and introducing greater uncertainty around closing pipeline. SDL's branding and website will be updated during 2H along with efforts to grow inbound leads to complement what is mainly an outbound direct sales channel strategy at present.

Software functionality improvements, including combining some existing products into a Digital Mail Centre (DMC), are progressing. This is enhancing the platform for better scalability and cost-effective customer onboarding.

Financial Performance

Earnings before interest, tax, depreciation and amortisation (EBITDA) increased 13.5% to $4.11 million (1H HY2021 $3.62 million) on sales revenue that slightly declined by 1.6%.

Summary Financial Performance (all figures $000)	1H FY23	1H FY22 (a)	Yr-on-Yr $ change	Yr-on-Yr % change
Total Revenue	**23,344**	**23,718**	**-374**	**-1.6%**
Cost of Goods Sold (a)	14,322	15,129	-807	-5.3%
Gross Margin	**9,022**	**8,589**	**433**	**5.0%**
Gross Margin (%)	**38.6%**	**36.2%**		
Selling, General & Admin Costs (a)	4,911	4,968	-57	-1.1%
EBITDA	**4,111**	**3,621**	**490**	**13.5%**
EBITDA Margin (%)	**17.6%**	**15.3%**		
Depreciation	494	476	18	3.8%
Amortisation	55	97	-42	-43.3%
EBIT	**3,562**	**3,048**	**514**	**16.9%**
Net Interest	**26**	60	-34	-56.7%
Net Profit before Tax	**3,536**	**2,988**	**548**	**18.3%**
Taxation	**1,079**	956	123	12.9%
Net Profit after Tax	**2,457**	**2,032**	**425**	**20.9%**

(a) A reclassification has been made in the prior period (1H FY2022) of certain network communication costs totalling $0.43 million, from Selling, General & Admin to Cost of Goods Sold. This is solely a cost reallocation; there is no change to reported FY2022 EBITDA or Net Profit. Note this reclassification also only affects the FY2022 1H interim report; the full year FY2022 result includes the amended cost allocation.

The EBITDA gain is largely from improved Gross Margin, which was partly customer/sales mix benefit to Cost of Goods Sold, along with broadly flat Selling, General & Admin costs.

SDL's taxation rate in 1H FY2023 was 30.5% versus 32.0% in the prior period. The slightly lower tax rate was assisted by modest R&D tax credits.

Revenue Analysis (all figures $000)	1H FY23	1H FY22	Yr-on-Yr $ change	Yr-on-Yr % change
Software & Technology	17,125	18,645	-1,520	-8.2%
Digital Print & Document Handling	2,308	2,140	168	7.9%
Outsourced Services	3,911	2,933	978	33.3%
Total Revenue	**23,344**	**23,718**	**-374**	**-1.6%**

SDL's pipeline of opportunities in New Zealand, coupled with price increases implemented during 1H mean that 2H domestic revenue is likely to continue to show solid growth. Sales efforts and current pipeline in the US market in particular should generate additional revenue, including the recently won cross-border financial services print and mail contract. Pleasingly, the second largest US client has recently renewed its contract with SDL. As uncertainty in the global economy increases, larger customers' changes to contracts or changes in those customers' plans could materially alter the Company's revenue outlook.

Balance Sheet, Liquidity and Debt

SDL closed the half year with net cash on hand of $7.13 million, versus $7.00 million in 1H FY2022 (FY2022 included around $1.2 million of customer pre-paid postage balances). A bank overdraft facility of $0.2 million remains in place but is unused.

Capital expenditure was moderate at $0.24 million in the half, largely for a refurbishment to the fitout of the Albany offices (the offices had not been renovated since the Company first occupied the premises in 2005), along with minor items of print and computer equipment. Some of SDL's computer equipment is at or near end of life, meaning some functionality being moved to the cloud, but the remainder will require capital expenditure for replacement or upgrading.

Selected Balance Sheet and Cashflow Figures (all figures $000)	1H FY23	1H FY22	Yr-on-Yr $ change	Yr-on-Yr % change
Net Cash on Hand (net of debt)	7,129	6,998	131	1.9%
Non-current Assets (excl Right of Use)	1,677	1,665	12	0.7%
Right of Use Assets	3,032	826	2,206	267.1%
Net Other Liabilities (excl Right of Use)	-991	-2,065	1,074	-52.0%
Right of Use Liabilities	-3,079	-974	-2,105	216.1%
Net Assets	**7,768**	**6,450**	**1,318**	**20.4%**
Cashflow from Trading	3,092	2,705	387	14.3%
Movement in Working Capital	314	636	-322	-50.6%
Cash Inflow from Operations	**3,406**	**3,341**	**65**	**1.9%**

Book value (net assets) increased 20.4% to $7.77 million, largely the effect of strong first half earnings. The lease on SDL's Albany premises was renewed during 1H. Lease accounting (NZ IFRS 16) means that lease changes are capitalised through the balance sheet by creating a Right of Use asset and an offsetting Right of Use liability so the renewal had the effect of inflating both the asset and liability by approximately equal amounts. Working capital remains well managed.

Dividend

SDL has declared an interim dividend of 10.0 cents per share, an 11.1% increase on the prior year.

Earnings and Dividend per Share	1H FY23	1H FY22	Yr-on-Yr $ change	Yr-on-Yr % change
Shares on Issue (000)	14,719.8	14,639.8	80.0	0.5%
Earnings per share (cents)	16.69	13.88	2.81	20.3%
Dividend per share (cents)	**10.00**	**9.00**	**1.00**	**11.1%**
Dividend proportion Imputed	100.0%	100.0%	n.a.	n.a.
Payout ratio (on NPAT)	58.6%	61.9%	n.a.	n.a.

The dividend is fully imputed and the cash dividend amount represents a payout ratio of 58.6% of earnings per share. SDL has previously used NPATA as the basis for its payout ratio, however, given that the Amortisation charge (the second 'A') has significantly reduced, this is now less relevant. The Directors reiterate the full year payout ratio is expected to be in the 70-75% range.

While the Company has a strong net cash position, the Directors continue to maintain a preference for financial flexibility given the ongoing elevated level of global economic uncertainty. As noted in past reports, the extent of volatility in global markets and economies may provide SDL with the opportunity for cost-effective step-out or bolt-on acquisitions to broaden the Company's product offering or channels to market internationally. Possible acquisitions continue to be reviewed but none have progressed; any transaction must add shareholder value.

FY 2023 Outlook

SDL previously provided FY2023 earnings guidance of around $2.5 to $2.8 million, noting that a strong first half suggested a full year result towards the upper end of the range was possible.

A number of factors are likely to affect the second half, including ongoing gains in New Zealand operations (new business plus 1H price increases, less cost pressures), with ongoing weakness in US mortgage market communication volumes expected to be offset by international new business plus growth from existing clients. Sales costs will be added as the Company is hiring for sales efforts in the international NGO space, and for US enterprise sales efforts. Additionally, costs will be incurred for branding changes to the website and marketing collateral to better position SDL with the communications needs of global enterprise customers.

While the Company has an encouraging sales pipeline in New Zealand and the US, the full year outlook includes an element of assumption around new business success so delivering this, coupled with global macroeconomic concerns, represents a key risk factor to SDL's guidance outlook.

Based on the strong first half result and the above factors, SDL is increasing its FY2023 guidance to a range of $2.7 to $3.0 million. Significant volatility is possible around this guidance range.