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MANAGEMENT DISCUSSION AND ANALYSIS

FY2016 Result Overview

Solution Dynamics Limited ("SDL" or "The Company") has produced an unaudited net profit after tax of $1.016 million for FY2016. This represents 25.9% year-on-year growth although the prior financial year had only a modest tax expense versus SDL moving into a full tax paying position in FY2016.

- Growth for FY2016 at the net profit before tax level was 74.2%.
- The Company finished the year with net cash on hand of $1.412 million.
- The Directors have declared a final dividend of 2.25 cents per share, taking the total dividend for FY2016 to 5.25 cents per share (FY2015: 1.50 cents).

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 and outsourced services)
- Software & Technology.

Services includes digital print and mail house processing for mail items such as invoices, statements and promotional material. These are then distributed predominantly through NZ Post's 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.

Software & Technology, develops and markets SDL's own software products related to a) multi-channel marketing communications, which includes digital asset management, communication templates and campaign management, b) document archiving, c) document composition and d) desktop mail solutions. 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.

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 customer's communications needs.

The Company operates from leased premises in Albany, Auckland.

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-customer 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. Early FY2016 saw a high-speed, continuous-sheet laser printer installed into an expanded print room under an agreement which saw SDL become an accredited Document Management Solutions ("DMS") partner to Fuji Xerox New Zealand Limited ("FXNZ"). The first major client under this agreement is expected to commence print operations around mid-FY2017. The Directors emphasise that the sales cycles for the types of high-volume print customers targeted by DMS are typically long and DMS revenue growth is therefore likely to be both sporadic and lumpy.

SDL has also recently agreed to take over the physical print operations (under a sub-contract arrangement) of an existing print and software business. This should fully commence in early FY2017.

Services revenue also includes a variety of outsourced functions or components such as postage, offset printing, scanning, 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 very slim.

In spite of the ongoing general mail volume market decline, SDL's FY2016 mail volumes grew 3.0% while digital print volumes increased 4.6%, as a result of increased volumes from existing clients and new business wins. These increases are driven by our technology-based approach to customer communication solutions, as well as a strong customer service ethos. SDL continues to increase its share of a declining market. Note that the growth in Outsourced Services 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)**	**FY2016**	**FY2015**	**Percentage Change**
Digital Printing and Document Handling	6,120	5,888	3.9%
Outsourced Services	5,754	3,724	54.5%
Total Services Revenue	**11,874**	**9,612**	**23.5%**

SDL Software & Technology

SDL Software develops, sells and supports four solutions:

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 image can be printed, faxed or emailed and Déjar's security and history features ensure every image creation 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. It automatically creates templates, documents and letters with predefined, 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, through 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.

4. DéjarMail

   A web browser-based desktop mail management solution which allows customers to route mail correspondence 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.

Software & Technology revenue is earned from four sources.

The first is licence sales, where customers pay an upfront fee to acquire a licence to utilise SDL's software and then pay subsequent annual maintenance fees to receive support and the right to future upgrades. Licence revenue can be material to SDL Software's performance, but is also volatile from year to year.

The second is an alternative to licensing, where, rather than pay an upfront fee, customers opt to run SDL's software on a SaaS (Software as a Service) basis. This sees them use 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) and related data on behalf of the client. While SDL forgoes the benefit of any large up-front revenue, the SaaS approach does build an annuity revenue base that generates value over a longer term. The trend in recent years has been for customers to prefer SaaS rather than acquiring a software licence.

Thirdly, 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 fourth 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. DéjarMail's initial revenue came from Australasian clients, however, this has changed materially during FY2016 following its adoption by a UK software company operating in the dental practice sector. This saw an initial period of very rapid growth as an existing user base of practices was transitioned from an incumbent supplier. SDL believes this market has several years of solid growth available as the share of practices using DéjarMail continues to increase. Bremy is in the early days of being rolled out to UK dental practices, allowing them to run their individual marketing campaigns and this should also add to growth for several years, although as with DéjarMail, take-up rates and eventual penetration levels are difficult to assess.

Additionally, SDL has developed (using a third party developer) a print procurement module which was completed during the second half of the financial year. It is being utilised by a major print equipment supplier at one of its larger customers, a major bank, and may be rolled out further during FY2017.

Software & Technology generated revenue of $4.45 million in FY2016, an increase of 26.9% on the prior year's revenue of $3.51 million, largely the result of DéjarMail growth in the UK. As in the prior year, FY2016 saw no large, one-off licence revenues achieved although several smaller licences were sold, some software development work was undertaken and SaaS revenues continue to build.

Financial Performance

Revenue growth in FY2016 was largely from Outsourced Services, predominantly the effect of printing for DéjarMail volumes in the UK, although additional volumes from new and existing clients saw a modest 3.9% increase in print and document handling revenue, a good result in a declining market. Postage remains very low margin and this is unlikely to change as the wholesale rates and hence margin that NZ Post is able to offer is regulated by the Postal Network Access Committee. The standout revenue growth was Software & Technology, up 26.9%, largely on the back of technology component of DéjarMail growth (Software & Technology growth accelerated over the year with 1H growth of 14.2% and 2H growth of 40.0%).

Summary Financial Performance (all figures $000)	FY2016	FY2015	Percentage Change
Total Revenue	16,322	13,117	24.4%
Less: Cost of Goods Sold	9,239	7,323	26.2%
Gross Margin	**7,083**	**5,794**	**22.2%**
Gross Margin (%)	43.4%	44.2%	-1.8%
Less: Selling, General & Admin	5,388	4,680	15.1%
EBITDA	**1,695**	**1,114**	**52.1%**
EBITDA margin (%)	10.4%	8.5%	
Depreciation	252	202	24.8%
Amortisation	14	96	-85.4%
EBIT	**1,429**	**816**	**75.1%**
Net Interest	(10)	(10)	n.m.
Income Tax	423	19	n.m.
Net Profit after Tax	**1,016**	**807**	**25.9%**

SDL produced a very strong financial performance in FY2016 with ongoing gains in revenue (albeit partly from low margin revenue sources) and underlying profitability. The Directors were particularly pleased to report a sizeable increase in Net Profit after Tax despite SDL moving to a near-full tax paying position in FY2016 after only incurring a very modest tax liability in FY2015.

The second half remains the seasonally the quieter half of the year, especially in New Zealand, although growth in software revenue should begin to smooth this somewhat.

The FY2016 result includes a benefit of $0.08 million from the Company's market development agreement with NZ Trade and Enterprise ("NZTE"). NZTE assists by funding 40% of certain market development costs incurred in expanding the Company's software revenues in the UK (the agreement is over a three year period, with a maximum reimbursement of $0.428 million).)

The following table highlights first and second half performance for the last two financial years.

SDL Half Financial Years (all figures $000)	2H FY2016	2H FY2015	Percent Change	1H FY2016	1H FY2015	Percent Change
Total Revenue	8,562	6,415	33.5%	7,760	6,702	15.8%
EBITDA	764	418	82.8%	931	696	33.8%
EBITDA margin	8.9%	6.5%		12.0%	10.4%	
Tax rate	32.4%	6.4%		27.0%	0.2%	

The change in mix of revenue towards a greater component of low margin, outsourced services is seeing SDL's percentage Gross Margin compress despite significant growth in the dollar Gross Margin. This trend is likely to continue as DéjarMail's offshore revenue grows at a faster rate than the rest of the Company's business. Nevertheless, continued focus on cost control saw the Company's EBITDA margin expand from 8.5% to 10.4%.

Balance Sheet, Liquidity and Debt

FY2016 saw moderate improvement to SDL's net financial position. Further improvements in financial performance were partly offset by selective capital expenditure to de-bottleneck operations, development of the print procurement module and dividend payments.

The Company's net cash (i.e. cash net of interest bearing debt) position improved slightly from $1.34 million to $1.41 million over the year. This modest gain in net cash was mainly the result of SDL beginning to pay dividends at a payout ratio target of 70-75%, completion of the dedicated print room to house the high-speed laser installed under the DMS agreement, and the cost of developing SDL's print procurement module.

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)**	**FY2016**	**FY2015**	**Change**
Net Bank Cash/(Debt & Borrowings)	1,412	1,343	69
Non-Current Assets	2,065	1,647	418
Net Other Liabilities	(497)	(461)	(36)
Net Assets	**2,980**	**2,529**	**451**
Cashflow from Trading	1,394	1,039	355
Movement in Working Capital	(32)	(59)	27
Cash Inflow from Operations	**1,362**	**980**	**382**
Cash dividends paid	**633**	**0**	**633**

The bulk of the increase in Non-Current Assets of $418,000 is accounted for by capital expenditure for finalisation of the print room for the DMS-related high speed laser, the purchase of some document handling equipment, plus the capitalised cost of developing the print procurement module.

Net Assets includes goodwill related to the original purchases of the software products Déjar and Bremy. Bremy accounts for around three quarters of the $938,000 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 is in excess of their carrying values.

While SDL's balance sheet continues to show a 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 these leases was around $0.76 million in FY2016 ($1.15 million in FY2015) and represents off balance sheet leverage. The FY2016 result saw a modest full year benefit from the prior year's lease renewal on its premises at Canaveral Drive, Albany, reducing both the amount of space leased and annual rental cost.

Taxation and Dividends

In FY2015 the Company utilised the balance of its New Zealand tax losses and commenced paying tax late that financial year. As a result, FY2016 saw SDL move to a full tax paying position for the entire year. The Company has approximately $123,000 of tax losses available within its UK subsidiary and these are expected to be steadily utilised over the next few years, subject to maintaining UK profitability.

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 acquisition. While the Company's previous policy was to maintain a dividend payout ratio of at least 75% of earnings, this was amended following the agreement that saw NZTE agree to contribute towards SDL's market development costs for software in the UK. NZTE required SDL to ensure the UK growth opportunities were adequately funding from internal cash flow, and consequently required the Company to cap the dividend payout ratio at 75% for the duration of the agreement.

Earnings and Dividends per Share	FY2016	FY2015	Percentage Change
Shares on Issue ('000)	14,059	14,059	n.m.
Earnings per Share (cents)	7.23	5.74	25.9%
Dividend per Share (cents)	5.25	1.50	250.0%
Dividend Proportion Imputed	100.0%	100.0%	n.m.
Dividend Payout ratio	72.6%	26.1%	

Operational Performance

Despite the industry-wide decline in general mail volumes, SDL's mail volumes grew 3.0% and digital print volumes increased 4.6% on last year, supported by the new business wins (both new customers and new projects within existing customers). SDL's current print and related document handling equipment now has significantly increased capacity, notably from the early FY2016 addition of the high-speed, continuous printer under the DMS agreement with FXNZ. Any material continuous print volume under the DMS agreement would likely require a modest increase in the level of production staff.

New Zealand Postal Market

The domestic postal services market continues to evolve. NZ Post has amended its Deed of Understanding with the government. From 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.

These changes at 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 and the steady switch to new technology is progressing largely as expected. SDL is well positioned to capitalise on this, given its breadth of technology offerings. SDL has proven solutions for digitally communicating with and servicing customers, and these can also deliver significant communications and document creation cost savings. Nevertheless, the Company's customers opted to more rapidly switch towards greater electronic communications, SDL may suffer short run lower utilisation of its printing assets and any gains from SDL Software & Technology may be insufficient to offset this decline.

Risk Factors

The physical mail market will inevitably continue to decline in volume. This has several industry-wide implications. First, the mail house physical print sector will remain plagued by excess printing capacity. Secondly, the likelihood of heightened competition implies ongoing pricing and margin pressure, requiring SDL to continue to manage costs closely. 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 39.8% of the Company's revenue in FY2016. Loss of one or more of those customers could cause financial results to differ materially from those outlined in the FY2017 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.

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 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.

Bremy, SDL's digital asset and multi-channel communications system, has had its capabilities expanded through the addition of a Procurement function (for print initially, although the functionality is reasonably generic), with phase one of the development completed in the second half of FY2016.

FY2017 Outlook

After a strong result in FY2016, the Company expects that several contracts in place should provide the basis for ongoing revenue and earnings growth. This outlook is subject to the usual risks that the print and mail house market remain extremely competitive and in slow decline.

The Fuji Xerox DMS agreement is expected to provide some contribution to profitability in the coming financial year as the first client is likely to commence operations around mid-FY2017.

The initial contract to embed DéjarMail within a third party software solution to the dental sector ramped up significantly during the second half of FY2016. In FY2017 the combination of a full year's revenue from those practices plus increasing penetration of the dental practice market should see ongoing growth. Additionally, a customised version of Bremy is now being offered to dental practices to facilitate their marketing efforts and we expect this to progressively gain traction during FY2017.

SDL's outlook for FY2017 is for further improvement with growth of around 25% expected for net profit after tax. This forecast does include some moderate growth in new business assumptions outside of the DéjarMail dental contract, as well as the expected DMS contribution eventuating.

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