23 October 2019

2019 Annual Meeting: Chairman's Address

FY2019 was a year of both difficulty and opportunity for Solution Dynamics ("SDL" or "Company"). The difficulties occurred in the NZ domestic business, the legacy part of the Company, where the combination of the loss of several medium-sized accounts coupled with greater mail volume declines as a result of NZ Post price hikes, produced intense margin pressure. While SDL is responding by restructuring its local cost base, the cost savings inevitably lag the revenue and gross margin loss and the net benefits will only accrue during FY2020.

Additionally, the Company had an earnings drag from acquisitions made in late FY2018, although both acquisitions are progressively adding business value and have become core components of SDL's software technology offering.

On the positive side, the opportunities and new business gains occurred in the growth segment the Company is targeting, international software technology. Several new business wins are expected to be material to future growth prospects; these made minimal contribution in FY2019 but should progressively ramp up and are expected to contribute to very material earnings growth over the coming two years, subject to SDL successfully executing what are complex customer requirements.

Additionally, the acquisition of DigitalToPrint Inc ("DTP") in the US opened a beachhead into a new geographic region where the Company has not previously had direct presence. This has assisted with new business wins and contributed to what is the most prospective pipeline of sales opportunity SDL has experienced. While pipeline doesn't pay any bills, the success of converting some of the opportunities to date suggests that a US sales presence – and one that the Company is expanding – is likely to add future shareholder value.

FY2019 Financial Result

There's no sugar coating last year's result; it was very disappointing. While some factors, such as an aggregate drag from losses from acquisitions, plus the effect of acquired intangibles being amortised, were expected, the domestic business unexpectedly suffered badly and was significantly below initial forecasts. The reasons have already been mentioned and as noted, the process of implementing cost savings had little impact in FY2019 as restructuring to lower costs can only occur after the revenues begin to run down. Some clawback to earnings was achieved from a write-back of provisions relating to allowances for acquisitions that were not achieved (noting that this is a non-cash gain). The net outcome of these factors was a decline in FY2019 EBITDA of around 40% to $1.37 million, with reported net profit after tax down approximately 50% to $0.67 million. Revenue was up 10.7% to $25.2 million with all of the gains in Software & Technology, assisted by the inclusion of DTP for a full year.

Solution Dynamics' year end net cash on hand dropped to $1.18 million from $1.96 million the prior year. Operating cash flow at $0.4 million was moderately weaker than profitability would imply, partly from some late FY2019 contracts that had not been collected at year end. Capex of $0.4 million related to upgrading internal IT systems and replacing an aged inserting machine.

As noted, NZ Post hiked prices on 1 July 2018. Further exacerbated by the loss of several contracts, SDL's decline in mail lodgement volumes accelerated from 8.6% in the prior year to 15.1%. The Company has a

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limited amount of senior management resource and much of the focus during FY2019 was on international sales opportunities and ensuring execution of several large software contracts the Company had won. This lack of focus on the domestic business was intentional; the directors viewed the size of potential gains in international software technology opportunities as worth some reduction of focus on the New Zealand and expect that results in FY2020 and FY2021 will vindicate this assessment.

Solution Dynamics' FY2019 dividends totalled 4.0 cents per share (fully imputed), down from 7.5 cents the prior year. The Board's policy is to pay dividends of around 70-75% of earnings, subject to no abnormal internal requirements for unusual capital expenditure items or acquisitions, as well as being able to fully impute any dividend. A further market development grant was obtained from NZ Trade and Enterprise mid-way through FY2019, this time for the North American market. This grant limits SDL to a maximum dividend payout ratio of 75% of net profit after tax plus amortisation. The dividend payout in FY2019 was well below this maximum level, largely because the Company's net profit included a sizeable one-off, non-cash gain from writing back acquisition earn outs provisions.

Strategy

The Company's strategy is predominantly based around building the software technology business internationally. This is where most of managements' efforts and the Managing Director's time are now spent. It is proving successful, although we reiterate the message from last year that developing sales channels and selling into large organisations on the other side of the world is difficult. SDL has added further sales and support resources in the UK to support new business wins. The acquisition of DTP opened a beachhead into the US and additional resource has recently been added in that market, reflecting the breadth and scale of opportunities. The additional costs are running well ahead of further new business wins, however, the Company is confident that the healthy state of the current pipeline means it is quite probable that additional contracts will eventuate although the timing and how quickly they onboard is difficult to assess.

New Zealand mail volumes are expected to continue their decline, albeit at a slower rate than in FY2019. SDL continues to engage with other industry participants regarding industry change or consolidation opportunities and will look to engage in transactions if there is potential to improve the Company's strategic position and increase shareholder value.

Acquisitions Update

The Company's two acquisitions from late FY2018 provided their first full year contribution.

Scantech provides document scanning services in New Zealand. It has also developed software to manage the scanning process workflow. The workflow software has broader application than its internal use and sales have been made to print-related clients in the UK where privacy and data disclosure requirements mean organisations are increasingly required to scan and archive physical documents. The business performed below expectations domestically, mainly because of a lower level of activity in the usual flow of one-off back scan work.

DTP operates the Jupiter software platform, which provides functionality to manage and globally distribute print across a network over 300 printers in more than 50 countries. SDL's assessment of potential demand for this functionality from existing UK clients has proved correct. Jupiter is progressively being integrated in with SDL's other software engines and forms an essential component of the document management proposition the Company offers.

Neither acquisition met its earn out target and they collectively added to a moderate drag on FY2019 earnings. This does not mean they have not been worthwhile; DTP in particular we expect to add shareholder value, possibly significantly, over the coming two to three years.

Corporate Governance

SDL made the transition to the NZX main board late in the financial year. As part of that change, two additional directors were appointed, an Audit & Risk Committee founded, and a new Company constitution established. The directors continue to review liquidity following the change to the main board. There are structural issues (small market capitalisation, concentrated shareholder ownership, lack of research coverage) working against better liquidity and there is no easy solution.

FY2020 Outlook

The Company has previously provided guidance for FY2020 revenue growth of around 15% and for operating earnings (EBITDA) to recover to be broadly in line with FY2018 levels (around $2.3 million). This expectation relied on some expected conversion of pipeline into new contracts and early indications are that this seems likely, although not certain.

Current trading is running ahead of budget and revenue growth for the year is more likely to be around 20% (subject to the caveat of timing around new business onboarding). The risk bias to operating earnings guidance is now to the upside, although some risk remains as the Company's budget expects a strong second half, which is partly dependent on the timing of revenue from several new contracts and consequently the earnings upside potential is currently difficult to quantify with much degree of certainty.

Given that SDL is now dealing with much larger clients and contracts, especially following the move into the US market, we caution that timing uncertainties on larger opportunities mean there is the potential for greater volatility -- both upside and downside – than usual around actual results versus our guidance.

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