25 August 2022

Chairman's and Chief Executive Officer's Report

FY2022 Result Overview

Solution Dynamics Limited ("SDL" or "Company") recorded a net profit after tax of $2.56 million for FY2022, a 26.0% gain on the profit of $2.03 million the prior financial year. FY2022 earnings per share was 17.4 cents (on closing issued share), up 25.2% from 13.9 cents the prior year. This is a record result for the Company in what was a disrupted and difficult year.

The Company's revenue also recorded a record result at $40.13 million (up 13.2%). COVID modestly constrained revenue growth in both the domestic mail house and for some international customers. SDL's Software & Technology platforms continue to expand with revenue growth of 30% in FY2022, from a combination of new customers and expansion of activity amongst existing customers. Earnings before interest, tax, depreciation and amortisation ("EBITDA") increased 7.2% to $4.52 million.

Cash flow from operations was $2.98 million (FY2021 $2.61 million) and the net cash position at year end was $5.01 million (FY2021 $4.71 million). Historically, the year-end cash position has included an element of customer prepayment of postage (around $1.25 million in FY2021) however, this was repaid to customers during the second half of FY2022.

The directors have declared a final cash dividend of 4.0 cents per share (FY2021 4.0 cents), bringing total cash dividends for FY2022 of 13.0 cents per share (FY2021 11.0 cents). All dividends are fully imputed.

FY2022 Business Performance

FY2022 was a year of significant disruption for SDL, with the passing in November 2021 of long-term CEO, Nelson Siva, after a period of illness. The Company appointed the head of North America and international operations, Patrick Brand, based in New York, to succeed Nelson. Sincere and deep thanks are due to SDL's staff for operating through what was a difficult period around Nelson's illness and passing, and then assisting Pat, who was unable to travel to New Zealand for the first six months of his tenure as CEO.

The second half of FY2022 saw a refreshed focus on new business activity, especially in New Zealand following staff changes and a restructure of the sales team. This began to have a positive effect late in the financial year, although most of the benefit will begin to flow progressively over FY2023. Activity levels were further assisted by some new business following the closure of magazine and catalogue printer, Ovato. The Company has a strong prospect pipeline in New Zealand and is targeting growth in several key vertical market sectors internationally.

International volumes were broadly up, with strong gains in the cyber breach notice sector partly offset by significant weakness in US mortgage-related communications as interest rates rose significantly and depressed housing finance activity. Volumes in the UK rose as expected, up around 40% as that economy emerged from COVID constraints, although they remain well below pre-COVID levels.

The headwind from physical communications converting to digital continues. This is being exacerbated by postal organisations globally introducing significant increases in postage rates to offset the revenue erosion they are suffering from falling volumes. SDL expects this trend to continue and expects ongoing sizeable increases in postage rates in the markets the Company operates in, including New Zealand.

SDL is maintaining most of its COVID monitoring and safety policies, aimed at ensuring the Company's staff remain safe. Although some staff have been infected, COVID has not affected operations to date. Some partial return to working back in the office has commenced although the extent varies by function.

The main COVID effects were on volumes in the UK along with some impact from Omicron-related lockdowns in New Zealand. The hidden effect on SDL has been from an increase in the length of sales cycles due to the inability to travel for much of the year, constraining meeting sales prospects face-to-face. The Company's best estimate is that COVID reduced FY2022 revenues by – very approximately – around 5%.

Travel costs remained low, although the re-opening of New Zealand's borders in the fourth quarter of FY2022 allowed SDL's CEO, Pat Brand, to visit Auckland in June. COVID remains a factor in the shortage of skills across the technology sector, exacerbating staff cost pressures. Supply chain disruptions, along with a weaker NZ dollar, are affecting the cost (and timely availability) of paper and envelopes although for the most part these are pass-through costs (sometimes with a lag) and SDL has some forward orders in place to mitigate the cost pressure.

Given the operational issues, CEO change process, and increasingly difficult macroeconomic environment over the year, the Company was pleased to generate a record performance for the year.

Business Description

SDL operates in the global Customer Communications market (essential mail, interactive marketing communications and on-demand communications) across both the old economy print/mail house business and the new economy digital document management business. The Company's products and services are represented by two revenue streams:

- Services (split into Digital Print & Document Handling, and Outsourced Services); and
- Software & Technology.

Services operates solely in New Zealand. Digital Print & Document Handling revenues are generated from digital printing and mail house processing for two categories of mail items: transactional mail, such as invoices and statements; and direct marketing mail such as 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 Services revenues (these are typically very low margin activities). Digital printing differs from traditional printing in that each document printed is typically personalised and unique. Revenue from the Company's scanning operation is included in Services (for New Zealand scanning operations), while offshore consulting and software revenues that are related to SDL's software technology are included in the Software & Technology revenue stream.

Software & Technology develops and markets SDL's own software products which include:

- digital asset management, with communication templates and campaign management;
- document archival;
- document composition;
- desktop digital mail centre solution for "print on demand";
- consulting and software revenue from scanning and scanning workflow; and,
- international cross-border print on demand management software.

Note that SDL has several different business models for international clients. For some, SDL only provides software or related consulting services, but for others it also arranges third party printing and logistics on which it will typically earn a modest margin. For these latter clients, the software charge and print/logistics margins are typically aggregated into an overall charge to the customer. This means Software & Technology revenues are a mix of pure software and software consulting revenues for some clients, while others include third party printing and logistics revenues that are generated from SDL's software.

Transactional mail volumes in New Zealand and internationally are continuing to decline, although anecdotal evidence suggests direct marketing mail is seeing minimal erosion. Some types of communications remain better suited or are legally required to be printed, and the usage level of printed versus electronic communications varies significantly across industries, applications and countries. Technology such as Digital Mail Centre (DMC – SDL's print-on-demand desktop mail solution) can improve the handling efficiency, management and cost of physical mail. The Company's integrated range of print and software technologies enable the digital transformation of customer communications.

International Operations

Historically, SDL was predominantly a New Zealand digital print and mail house business with some international software revenue. That position first changed in FY2020, when SDL's international revenue surpassed its New Zealand revenue for the first time. Total Software & Technology revenue (some of which is revenue billed from New Zealand) as a proportion of total revenue is around 74% and expected to increase in FY2023.

Software development and support has mainly been based in New Zealand to date with some customer-facing employees in the UK and the US. Increasingly our customers based in the UK and the US require SDL to improve local market knowledge and response times by providing increased in-country technical support. Therefore, SDL expects to increase the number of technical support, testing, implementation, and DevOps staff in the northern hemisphere. This "globalisation of operations" process has been occurring for some time but has yet to reach maturity. The step change of moving from a New Zealand business that supports customers globally, to an in-time-zone, self-supporting international operation is challenging from a talent acquisition, management, and cultural perspective, along with a commensurate step change in cost structure.

Description and Review of Revenue Streams

Services

Services is the Company's New Zealand print and mail house operation that predominantly provides mail house operations to high-volume postal mail users in the business-to-consumer sector. Services operates leased, high-speed digital colour and monochrome printers. In addition to digital printing, Services also provides the ancillary document handling operations such as automated envelope inserting and flow-wrap.

Services revenue also includes Outsourced Services, which encompasses a variety of outsourced functions or components such as postage, third party offset printing, freight, paper and envelopes. The Company has an access agreement with NZ Post which provides wholesale rates and bulk mail discounts off NZ Post's retail rates. The gross profit margins on many of these outsourced components, especially postage, are low.

The Company's general mail volumes continue to decline albeit at what SDL estimates is a lower rate than the overall market fall; SDL's FY2022 mail lodgement volumes declined around 8%. The Company's digital print volumes also fell, declining around 7%. SDL believes consolidation of mail house capacity is inevitable and is confident it holds a strong, competitive cost position in the market.

On the digital communications side, SDL's volume of customer emails rose about 8%.

SDL Services Revenue Breakdown (all figures $000)	FY2022	FY2021	Percentage Change
Digital Printing and Document Handling	3,812	4,161	-8.4%
Outsourced Services	6,512	6,649	-2.1%
Total Services Revenue	**10,324**	**10,810**	**-4.5%**

SDL renewed the lease contract on its print equipment in FY2021 and mail house facility in FY2022. The Company believes it now has highly competitive rates for its continuous digital printing equipment. One of SDL's major New Zealand customers re-tendered its business during FY2021 and the Company re-secured the business for a further three-plus-two year term, albeit at lower gross margins.

The refocus on New Zealand sales, along with changes to the sales team, and the current strong pipeline provides the basis for a more positive outlook for FY2023, despite the overall domestic postal market remaining in decline.

SDL Software & Technology

Software & Technology generated revenue of $29.8 million in FY2022, an increase of 21% on the prior year's revenue of $24.6 million. Growth was from several sources including expansion from a leading global charities organisation that SDL secured in 2020, plus a large US-based multinational corporation continuing to roll-out SDL's Digital Mail Centre (DMC) platform globally. Mid-sized clients in the cyber breach notice sector contributed strongly to US growth, offset by weakness in financial services volumes, while the UK began to see a rebound from COVID-constrained volumes.

Software & Technology revenue is partly platform based, typically under SaaS (software as a service) arrangements, which can be priced as a monthly subscription, tiered on volume, or on a per document basis. It also includes revenue where SDL manages the total communications solution, based on the Company's software platforms, but including document printing and distribution for the customer. The printing and distribution component forms the larger part of Software & Technology's revenue and is generally lower margin.

In FY2022, we made substantial progress in "productising" our global customer communications platform, DMC. DMC simplifies onboarding of customers, and sending and tracking of documents, through physical and digital channels. DMC integrates with our document composition platform, Composer, along with our automation tool, Autoprod, to enable customers to create highly personalised communications at scale. DMC integrates with our print partner network through SDL's distributed print platform, Jupiter, to manage and provide real time status updates on job completion and mailing. Our expertise in global postage management delivers significant cost savings by leveraging DMC to optimise production and delivery logistics. Our objective is to grow SaaS platform revenue at a faster rate than print services.

As the speed of business increases, customer communications are increasingly moving to an "on-demand" model. This is especially true in marketing and regulatory notice applications. Global supply chain logistics issues have made it more difficult and more expensive to send physical "on-demand" content as well as introducing logistics delays in international mail. Additionally, availability and cost of envelopes and paper has been challenging. SDL's software and network of service providers ensures that "on-demand" communications can be produced and delivered on time and this functionality is enabling SDL to win business.

Communication channels are no longer "one size fits all"; customers now receive increasingly personalised messaging through multi-media channels. SDL's software platforms enable one-to-one personalisation of each 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 relationships that our customers have with their customers.

The Company is leveraging its position as a leader in global, "on-demand" communications to overcome supply-chain driven disruptions. One key area of focus in FY2023 is to better leverage SDL's marquee customers in the global charities and cyber security breach notice space as reference points for sales activity. This requires a ramp up of investment in sales and marketing, along with DevOps and customer support, in our key US and UK markets. Our DMC roadmap will continue to prioritise standardisation and integration, to support scalability, with much of this development expected to complete during FY2023.

For a more detailed view of SDL's software solutions, refer to the Company's website at: https://solutiondynamics.com/solutions/.

In FY2021, SDL was assisted in its American growth initiative by a market development grant from NZ Trade and Enterprise ("NZTE") that contributed towards the costs of expansion. The NZTE grant was fully utilised during FY2021 and there was no NZTE contribution in FY2022. SDL appreciates the financial and market assistance it has received from NZTE and is exploring possible further growth initiative support for FY2023.

In summary, enabling organisations to drive down cost of customer communications while improving client engagement is what we do at SDL. Leading brands rely on the Company's software to simplify sending of complex global customer communications through print and digital channels. SDL's global network of mail service providers delivers significant savings in print and postage costs as well as assurance against pandemic/supply chain driven business interruptions. As the secular decline in mail continues, SDL's software platforms provide an omni-channel bridge to digital transformation.

Financial Performance

SDL's growth in revenue and earnings over FY2022 resulted from ongoing expansion of its international business, predominantly in the US. The New Zealand business continued to feel pressure from the ongoing structural decline in volumes and pricing pressure resulting from excess industry capacity, but it nevertheless remains sustainably profitable. As previously noted, a refocus on New Zealand sales activity in early 2022 has already seen improvements to revenue and this is expected to continue into FY2023 although the print and mail house market remains very competitive.

Cost pressures, lower margins from a large New Zealand customer, along with change in revenue mix (lower FX gains and grant income) partially offset the solid revenue growth and held Gross Profit to a 3.3% gain on the prior year. SG&A costs were well controlled given inflationary pressures in some parts of the business, rising 1.6% on the prior year. EBITDA grew 7.2% to $4.52 million.

Summary Financial Performance (all figures $000)	FY2022	FY2021	Percentage Change
Total Revenue	**40,127**	**35,445**	**13.2%**
Less: Cost of Goods Sold	26,186	21,954	19.3%
Gross Profit	**13,941**	**13,491**	**3.3%**
Gross Margin (%)	34.7%	38.1%	
Less: Selling, General & Admin (SG&A)	9,422	9,277	1.6%
EBITDA	**4,519**	**4,214**	**7.2%**
EBITDA margin (%)	11.3%	12.8%	
Depreciation	885	1,156	-23.4%
Amortisation	168	283	-40.6%
EBIT	**3,466**	**2,775**	**24.9%**
Net Interest	59	70	-15.7%
Income Tax	844	671	25.8%
Net Profit after Tax	**2,563**	**2,034**	**26.0%**
Tax rate	24.8%	24.8%	

The "quality" of SDL's earnings improved in FY2022 versus the prior FY2021 earnings result which contained two one-off items (realised foreign exchange gain and NZ Trade & Enterprise market development grant assistance) totalling $1.14 million pre-tax. Neither of these one-off gains recurred in FY2022.

The following table highlights first and second half performance for the last two financial years. The timing of a small number of particularly large customer jobs during the year can materially alter the split of first and second half earnings.

SDL Half Financial Years (all figures $000)	2H FY2022	2H FY2021	Percentage Change	1H FY2022	1H FY2021	Percentage Change
Total Revenue	16,409	16,923	-3.0%	23,718	18,522	28.1%
EBITDA	898	1,369	-34.4%	3,621	2,845	27.3%
EBITDA margin	5.5%	8.1%		15.3%	15.4%	
Net Profit after Tax	**531**	**585**	**-9.3%**	**2,032**	**1,449**	**40.3%**

Balance Sheet, Liquidity and Debt

SDL closed the year with net cash (i.e. cash less interest-bearing debt) on hand at $5.01 million (FY2021 $4.72 million). This net cash figure excludes debt liabilities relating to Right to Use Liabilities arising from the Lease Accounting standard; these liabilities are approximately offset by Right to Use Assets. The net cash balance in FY2021 included approximately $1.25 million that was customer prepayment of postage; this was repaid during the second half of FY2022.

The Directors intend to maintain a prudent approach to balance sheet management and are conscious that a period of more difficult economic times may provide acquisition opportunities.

The Company maintains an overdraft arrangement from ANZ Bank with a $200,000 limit. This was unused during FY2022.

Selected Balance Sheet and Cashflow Figures (all figures $000)	FY2022	FY2021	Change
Net Cash/(Debt & Borrowings)	5,009	4,713	296
Non-Current Assets	1,541	1,816	-275
Right of Use Assets	3,447	1,210	2,237
Net Other Assets/(Liabilities)	-602	-1,458	856
Right of Use Liabilities	-3,481	-1,346	-2,135
Net Assets	**5,914**	**4,935**	**979**
Cashflow from Trading	3,902	2,372	1,530
Movement in Working Capital	-923	236	-1,159
Cash Inflow from Operations	**2,979**	**2,608**	**371**
Cash dividends paid	**1,904**	**1,903**	**1**

Capital expenditure for the year was minimal at $0.07 million. The Company does not capitalise any software development. Note that Right of Use assets and liabilities both increased in FY2022 as a result of SDL signing a renewal of the lease on its premises at Canaveral Drive, Auckland, commencing September 2022.

Net assets includes intangible assets of around $1.15 million of which the bulk ($1.06 million) is goodwill and subject to an annual impairment test. The balance of intangibles represents software and customer contracts from acquisitions which are now almost wholly amortised.

SDL operates with a largely neutral working capital balance, meaning growth typically does not require additional investment of capital, although international expansion and larger, “lumpier” contracts means month-to-month and intra-month cash flow movements have wider fluctuations.

Taxation and Dividends

SDL pays full New Zealand tax on locally generated earnings. In FY2022, the Company obtained some benefit from New Zealand’s Research and Development Tax Incentive (RDTI) which provides a tax credit equal to 15% of eligible R&D expenditure. The RDTI tax credit benefit is the primary reason why the overall tax rate of 24.8% is below the statutory tax rate.

A portion of amortisation of acquired intangibles (relating to customer contracts and some of the acquired software) is not tax deductible, although only a small balance now remains to be amortised.

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

Earnings and Dividends per Share	FY2022	FY2021	Percentage Change
Closing Shares on Issue ('000)	14,720	14,640	0.5%
Reported Earnings per Share (cents)	**17.41**	**13.89**	**25.3%**
Dividend per Share (cents)	**13.0**	**11.0**	**18.2%**
Dividend Proportion Imputed	100.0%	100.0%	
Dividend Payout ratio	74.7%	79.2%	
Dividend Payout ratio on NPATA	71.3%	72.0%	

The final dividend for FY2022 of 4.0 cents per share will be fully imputed and paid on 30 September 2022. The full year FY2022 dividends total 13 cents per share, up 18.2% on the prior year and within the Company's usual 70-75% payout ratio.

The number of shares on issue increased by 0.5% the year after one staff member exercised employee share option plan (ESOP) rights which saw 80,000 new shares issued. At year end, the Company had outstanding ESOP rights to two key staff members in the plan (including the CEO) who collectively held rights to 373,000 shares. Further ESOP issuance is likely during FY2023.

Risk Factors

Physical mail volumes in New Zealand are continuing to show structural decline, especially for transactional mail. This has been exacerbated by COVID increasing the emphasis towards electronic communications and postal organisations globally, including NZ Post, significantly increasing postage rates. Direct mail/marketing volumes have been steadier and SDL estimates have shown modest-to-little decline in New Zealand. The Company has several key domestic contracts that, if lost, could place material pressure on local profitability although much of this is under medium-term contract (SDL renewed a major print and mail contract for a multi-year term during FY2021). While SDL expects that consolidation in the New Zealand print market is inevitable, and has held industry rationalisation discussions with other participants in the print sector, the Company will not participate unless there is clear value enhancement for shareholders.

SDL's largest five customers accounted for 64% of revenue in FY2022. Loss of one or more of those would cause financial results to differ materially from those outlined in the FY2023 Outlook section below.

The Company's software provides critical document management, distributed print, and storage functions for its clients. SDL needs to ensure it continues to maintain appropriate levels of software development quality control along with well-trained staff for software delivery and support. Cyber and data security is a known high-risk area. The Company regularly reviews its IT and data security arrangements, including through the use of external consultants.

The Company operates a single site facility for its New Zealand print and mail house production, with an offsite for data and server backup. The Directors are conscious of the operational risk a single site implies for digital imaging and mail house operations. SDL has a reciprocal disaster recovery ("DR") plan with another printer, as well as backup capability with a division of its major print equipment supplier.

The Company mainly relies on distribution channel partners to market its software products into the UK, Europe and the US. This means SDL has little or no contact with many of the end user customers of its products. While these channel partner arrangements are currently stable there is not guarantee these arrangements will continue. SDL aims to ensure its software meets channel partner requirements.

At present, the Company expects ongoing growth from existing customers and new contract wins as sufficient to support growth expectations. However, the global environment (both in health and macroeconomic terms) remains extremely uncertain and this could materially affect the Company.

FY2023 Outlook

SDL reconfirms prior FY2023 guidance provided in July 2022, for reported net profit of around $2.5 million. In FY2023, a number of positive and negative influences are expected to affect earnings.

On the positive side, SDL is seeing strong new business activity in its NZ print and mail house, and expects underlying growth will occur in several key accounts and vertical markets internationally.

On the negative side, the Company is subject to increasing cost pressures, not all of which can be passed through to customers. Also, to further support and accelerate international growth, the Company intends to invest in additional sales and marketing capabilities, plus further in-market developer, support and DevOps personnel will be required in the northern hemisphere. SDL expects that the global trend of sizeable postage increases will persist and this will continue the push of certain types of communications towards digital channels. These cost and industry factors, coupled with macroeconomic headwinds from central bank interest rate increases, provide an offset to the Company's expected new business gains.

The net effect of the above positive and negative on FY2023 earnings is forecast to be broadly neutral. The Company cautions that significant volatility around this guidance is possible and some factors, such as global health and macroeconomic risks, are outside the Company's control.

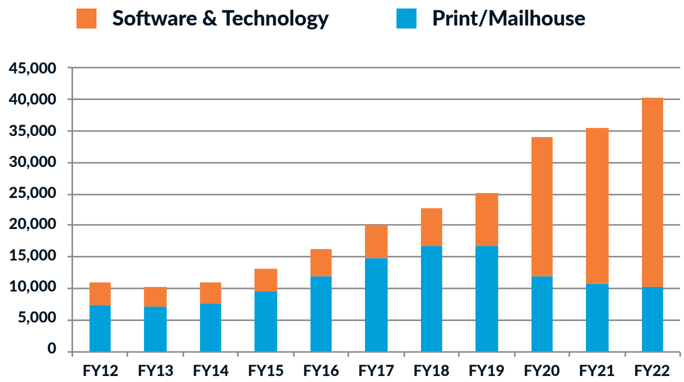
Key Financial Trend Metrics

Revenue ($000)

Revenue CAGR (10 yr) 13.8%

Software CAGR (10 yr) 23.2%

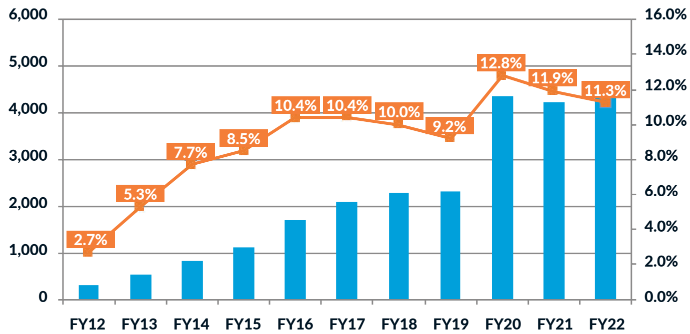
Print/Mail CAGR (10 yr) 3.5%



EBITDA ($ 000)

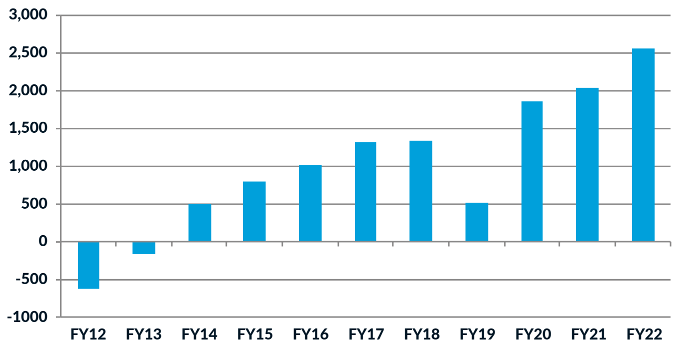
CAGR (10 year) 31.2%

EBITDA is as reported in financial statements, noting this is affected by the change of accounting standard to NZ IFRS 16 (accounting for leases) in FY2020 (increases reported EBITDA) so FY2020 onwards is not comparable with prior years.



Net Profit ($000)

Reported net profit. Note that SDL paid no tax from FY2012 to FY2014.



Dividends

Cents per share (excludes imputation credits).

All dividends are fully imputed.