



Independent Adviser's Report

In respect of the proposed allotment to Mr Craig Winkler and related parties of 20 million new ordinary shares in Xero Limited at NZ\$0.90 per share

28 April 2009

Index

1. Introduction	1
2. Evaluation of the Merits of the Allotment.....	5
3. Profile of Xero.....	14
4. Profile of Craig Winkler	26
5. Sources of Information, Reliance on Information, Disclaimer and Indemnity	27
6. Qualifications and Expertise, Independence, Declarations and Consents	29
Appendix I – Financial Statements.....	30

Abbreviations and Definitions

Allotment	the proposed allotment to Craig Winkler and related parties of 20 million new shares as part of the Placement
ARPU	average revenue per user
Board	board of directors of Xero
Code	the Takeovers Code
EBIT	earnings before interest and tax
FCF	free cash flows
IPO	initial public offering
NTA	net tangible assets
NZ	New Zealand
NZX	New Zealand Exchange Limited
NZSX	The main board equity securities market operated by NZX
Placement	the proposed placement of 25.8 million new ordinary shares by Xero Limited at a price of \$0.90 per share
Report	Independent Adviser's Report on the merits of the Allotment
Shares	ordinary voting shares in Xero
SaaS	Software as a Service
SPP	share purchase plan
UK	United Kingdom
USA	United States of America
VWAP	volume weighted average share price
Xero	Xero Limited
YTD	year to date
\$A	Australian dollars
\$NZ	New Zealand dollars
\$US	United States dollars

1. Introduction

1.1. Background to the Placement

Xero Limited (“Xero” or the “Company”) is a New Zealand registered company listed on the New Zealand Stock Exchange (“NZX”). The Company was established in June 2006, and is based in Wellington. Xero was founded by Rod Drury and Hamish Edwards in 2005, and since then has developed and launched an online accounting software platform.

Xero listed on the NZX on 5 June 2007, following an initial public offering (“IPO”) raising \$15 million at \$1.00 per share. No existing shares were sold in the IPO. The share offer was fully subscribed, and the Board of Xero decided not to accept oversubscriptions. Funds raised in the IPO have been used to develop and market the product, which is now used by over 6,000 customers around the world with key markets being New Zealand, the United Kingdom and Australia.

The board of Xero (“Board”) announced a potential capital raising on 2 April 2009, which was followed by the announcement on 7 April 2009 of a placement of equity to raise \$23.2 million (“the Placement”). The Placement share price is \$0.90, and the number of shares to be issued is 25.8 million. The funds raised in the Placement will enable Xero to accelerate the growth of its business in key international markets.

The Placement involves the subscription for new shares by a group of investors, which include high net worth individuals, habitual investors and an institutional investor. Some are existing shareholders, while others are new investors. One of the new investors is Craig Winkler who, along with related parties, has agreed to purchase 20 million new shares at \$0.90 per share, subject to Xero shareholder approval.

The Placement of the new shares has already taken place, with the exception of the 20 million shares proposed to be allotted to Craig Winkler and associated parties (“Allotment”). The Allotment is subject to shareholder approval under the Takeovers Code (“the Code”) because the Allotment will result in Craig Winkler and associated parties (collectively referred to hereafter as “Craig Winkler”) holding more than 20% of the issued share capital of Xero.

If the Allotment is approved by shareholders, Craig Winkler will hold approximately 24.6% of Xero’s shares and will hold the second largest number of shares after Rod Drury, who will hold 30.4% of the shares¹.

1.2. Summary of Placement

The Placement is a non pro-rata issue of new ordinary shares at a price of \$0.90 per share. This share price represents a premium of approximately 4.7% to the volume weighted average price (“VWAP”) of Xero over the five trading days before 2 April 2009, when the company announced a potential capital raising.

¹ The exact holding is subject to the level of the uptake by existing shareholders under the share purchase plan
Xero Limited - Independent Adviser’s Report

The following table summarises the investor participation in the Placement:

Xero Limited – Private Placement Investors		
	Number of Shares	Subscription (NZ\$m)
Bank of New Zealand	1,777,778	1.60
Sam Morgan	1,111,111	1.00
Graham Shaw	500,000	0.45
Other investors (including an institutional investor)	2,388,890	2.15
Initial placement (shares have already been issued as this was not subject to Xero shareholder approval)	5,777,779	5.20
Craig Winkler	19,500,000	17.55
Parties associated with Craig Winkler (see note below)	500,000	0.45
Proposed placement to Craig Winkler and associated parties (which is subject to Xero shareholder approval)	20,000,000	18.00
Total	25,777,779	23.20
<small>Note: Parties associated with Craig Winkler are his financial advisor and entities holding their respective investments – Binalong Rural Pty Ltd and Mordes Howard Pty Ltd</small>		

The Allotment of shares to Craig Winkler and associated parties will result in their collective stake in Xero exceeding 20%, and therefore is subject to approval by Xero shareholders by ordinary resolution. Shareholders will vote on 14 May 2009 as to whether they approve the Allotment to Craig Winkler and associated parties.

The capital raising will be followed by a share purchase plan (“SPP”) to all eligible New Zealand based shareholders on Xero’s share register at 5.00pm on 23 April 2009, which includes directors and staff and those who received shares under the already consummated private placement (excluding Craig Winkler and his associated parties).

It is estimated that at least a further \$2 million may be raised from the SPP, taking the overall capital raising to in excess of \$25 million. However, the exact amount to be raised from the SPP cannot be determined in advance as it depends upon the level of applications for shares from existing Xero shareholders.

The plan will enable each eligible shareholder to apply for new Xero shares at \$0.90 per share up to \$5,000. There is no cap on total amount to be raised from SPP. Xero will accept all applications up to \$5,000 per each eligible shareholder, in accordance with NZSX Listing Rules.

The SPP gives Xero shareholders the opportunity to participate in the capital raising and increase their respective interest in the company.

Applications and further details in relation to the SPP will be posted to the eligible New Zealand shareholders around 30 April 2009 with the SPP closing at 5pm on 18 May 2009. The share allotments in respect of the SPP are expected to occur around 25 May 2009.

Craig Winkler and his associated parties have agreed to embargo arrangements with Xero. Under these arrangements they are not able to sell any of the shares in Xero in the 12-month period from the date the new shares are issued.

The two largest current shareholders in Xero - Rod Drury (Chief Executive Officer) and Hamish Edwards (Managing Director - UK) - have also separately entered into embargo arrangements with Xero under which each of them will be restricted from selling any shares for the 12-month period from the date the new shares are issued.

Section 3.8 of this Report describes Xero's intentions regarding the use of the proceeds of this capital raising to grow the business.

1.3. Overview of Ownership Before and After the Allotment

Xero Limited - Top Ten Shareholdings				
Shareholders	Number of Shares before Allotment*	Shareholding before Allotment	Number of Shares after Allotment	Shareholding after Allotment
Rod Drury	24,668,002	40.28%	24,668,002	30.36%
Craig Winkler (incl associated parties)	-		20,000,000	24.62%
Hamish Edwards	6,960,000	11.37%	6,960,000	8.57%
Sam Morgan	2,911,117	4.75%	2,911,117	3.58%
Bank of New Zealand	2,177,778	3.56%	2,177,778	2.68%
Alistair Grigg	1,627,511	2.66%	1,627,511	2.00%
Graham Shaw	1,325,000	2.16%	1,325,000	1.63%
W5 Limited	1,000,006	1.63%	1,000,006	1.23%
Craig Walker	684,000	1.12%	684,000	0.84%
Anthony Bishop	599,998	0.98%	599,998	0.74%
David Kirk	559,400	0.91%	559,400	0.69%
Other new shares issued	2,388,890	3.90%	2,388,890	2.94%
Other investors	16,336,770	26.68%	16,336,770	20.11%
Total	61,238,472	100.00%	81,238,472	100.0%
<p>Note*: Number of shares before the Allotment to Craig Winkler but after the \$5.2 million allotment to other shareholders on 9 April 2009</p> <p>Note: The ownership presented above does not include SPP allotments, which are not expected to result in significant changes in the ownership structure because of the limit of \$5,000 per application by any shareholder</p>				

1.4. Regulatory Requirements

Rule 6 of the Takeovers Code prohibits:

- A person who holds or controls less than 20% of the voting rights in a code company from increasing their control of voting rights beyond 20%; and
- A person holding 20% or more of the voting rights in a code company from increasing their control of voting rights;

unless the person complies with exceptions to this fundamental rule.

Rule 7 of the Code outlines exceptions to the fundamental rule, including under Rule 7(d):

- By an allotment to a person of voting securities in the code company or in any other body corporate if the allotment has been approved by an ordinary resolution of the code company in accordance with this code.

As a consequence of the proposed Allotment, Craig Winkler's control of the voting rights in Xero will be greater than 20%, therefore shareholder approval is required in accordance with Rule 7(d) above. Rule 16(h) of the Code further requires that the notice of meeting containing the proposed resolution in respect of an allotment of voting securities referred to in rule 7(d) must contain, or be accompanied by an Independent Adviser's Report which complies with Rule 18 of the Code.

Rule 18 stipulates that the directors of the code company must obtain a report from an independent adviser on the merits of any proposed allotment under rule 7(d) having regard to the interests of those persons who may vote to approve the allotment.

1.5. Purpose of the Report

The independent directors of Xero have engaged Deloitte Corporate Finance to prepare an Independent Adviser's Report ("Report") on the merits of the Allotment of shares to Craig Winkler in accordance with Rule 18 of the Code.

Deloitte has been approved by the Takeovers Panel to prepare the Independent Adviser's Report.

Deloitte Corporate Finance issues this Independent Adviser's Report to assist Xero shareholders in forming their own opinion on whether or not to approve the Allotment. We note that each shareholder's circumstances and objectives are unique. Accordingly, it is not possible to report on the merits of the Allotment in relation to each shareholder. This Report on the merits of the Allotment is therefore necessarily general in nature.

This Independent Adviser's Report is not to be used for any other purpose without Deloitte's prior written consent.

2. Evaluation of the Merits of the Allotment

2.1. Basis of Evaluation

Rule 18 of the Code requires the directors of Xero to engage an independent adviser to prepare a report on the merits of the proposed Allotment of shares to Craig Winkler. There is no legal definition of the term “merits” in New Zealand in either the Code or in any statute dealing with securities or commercial law.

In the absence of an explicit definition of “merits”, guidance can be taken from:

- definitions designed to address similar issues within New Zealand regulations which are relevant to the proposed transaction;
- the Takeovers Panel’s guidance note on the role of independent advisors dated August 2007;
- overseas precedents; and
- the ordinary meaning of the term “merits”.

The New Zealand regulations² and overseas regulations³ in relation to takeovers focus primarily on fairness and reasonableness rather than “merits” and as such are of limited assistance.

The New Collins Concise Dictionary of the English Language defines the term “merit” as “the actual and intrinsic rights and wrongs of an issue, especially in a law case.” Black’s Law Dictionary defines “merit” as “the substance, elements or grounds of a course of action or defence.” These definitions imply that the essential elements of an issue should be considered as well as the issue itself, and an assessment is then made of the associated advantages and disadvantages of the issue in relation to the relevant party.

In our view an assessment of the merits of the Allotment should focus on:

- the level of control achieved by Craig Winkler;
- whether the Placement price is fair, taking into account:
 - the extent to which any premium for control is required;
 - the market price of Xero’s shares before and after the Placement; and
 - the pricing of other non-pro rata equity placements in the current market;
- the extent of ownership dilution and any value dilution experienced by existing shareholders;
- the likelihood of an alternative capital raising providing equivalent or greater benefits to existing shareholders; and
- the implications for shareholders approving, or not approving, the Allotment.

² NZSX Listing Rules and Guidance Note No. 10 issued by the Institute of Chartered Accountants of New Zealand (“Guideline on Independent Chartered Accountants Reporting as Experts to Shareholders”).

³ Policy Statements 74 and 75 and Practice Note 43 issued by the Australian Securities and Investment Commission and Rule 3 of the City Code (City of London).

Prospective Value of the Xero Business

As part of our analysis we have not performed a valuation of the Xero business. Businesses of the nature of Xero are extraordinarily difficult to value at the current age and stage of development. Essentially Xero is still an early stage business that requires further capital to prove its business model and develop the business to the stage where cash from operations can sustain further business development and reward shareholders by way of dividends. In this context value is essentially a bargain determined by what share of the company investors expect in return for the cash they are prepared to commit today in return for the expectation that, if the business is successful, they will receive a substantial return through its subsequent growth.

Our opinion should be considered in its entirety. Selecting portions of the evaluation without considering all the factors and analysis together could create a misleading view of the factors underlying the opinion.

2.2. Summary of Deloitte's Opinion

In our opinion, the Allotment has merit for, Xero shareholders.

The key points in our evaluation of the merits of the Allotment are:

- Craig Winkler's estimated shareholding in Xero of approximately 24.6% does not provide outright control but provides a measure of "negative control" (e.g. through the ability to block special resolutions, which would require a 25% stake). Rod Drury's shareholding already provides, and will continue to provide, him with an absolute level of "negative control". Therefore the position of small shareholders in relation to the control of Xero will not change significantly materially as a result of the Allotment.
- It follows that any control premium associated with Craig Winkler's shareholding should be modest.
- The Placement price of \$0.90 per share is at a premium of 4.73% over the VWAP of \$0.87 for the five days prior to the 2 April 2009 announcement of a capital raising, and a 14.8% premium to the VWAP of \$0.78 for the three months prior to 2 April 2009.
- This price premium is in contrast to several non-pro rata share placements announced recently, which have been priced at discounts to the issuers' pre-announcement share prices.
- The increase in Xero's share price since the announcement of the Placement reflects the benefits of the Placement to the business. However in assessing the fairness of the Placement price the relevant comparison is with the pre-announcement share trading levels and with the expected future share trading level if the Allotment was not approved.
- In our view, if the Allotment is not approved by shareholders, Xero's share price could fall significantly, reflecting the lower value of the business in the absence of Craig Winkler's involvement and financial support, and a less expansive growth strategy.

- While existing shareholders' ownership percentages will be diluted as a result of the Allotment, in our view the value of their shareholdings will not be reduced and may be enhanced because:
 - we believe the Placement price is fair;
 - shareholders benefit from the improved share price evident since the announcement of the Placement; and
 - part of this price increase is likely to reflect the value of Craig Winkler's involvement in Xero and the expanded growth strategy the Allotment allows. In effect, existing shareholders will have a "smaller share of a bigger pie".
- Xero's management and Board believe there is no other alternative capital raising plan available to Xero that delivers the same or greater benefits to the business and existing shareholders. Deloitte agrees with this assessment.

The following sub-sections consider in more detail our assessment of the merits of the Allotment.

2.3. The Level of Control Achieved by Craig Winkler

A key principle underlying the Takeovers Code is that all shareholders share in the value of control of a company, and that control should not be transferred without all selling shareholders having the opportunity to be paid a share price reflecting that control value. To facilitate this, the Code:

- Requires that any takeover offers (i.e. to acquire at least 50% of the voting rights in a company) be made at the same price to all shareholders; and
- Creates a so-called "no fly zone" for shareholdings of between 20% and 50%.

Shareholder approval is required for any party to obtain a shareholding of between 20% and 50%, and once in this zone the party can only increase its shareholding by making a takeover offer or gaining further shareholder approval. Effectively this means that:

- Parties cannot obtain the "negative control" associated with shareholdings of 20% or more without shareholder approval; and
- A shareholder cannot obtain 50% control by "creeping" towards that target through progressive small acquisitions, or acquiring another large shareholding, without making a takeover offer to all shareholders.

The proposed Allotment to Craig Winkler is not a takeover of Xero. Neither Craig Winkler nor any other party will increase their shareholding to more than 50% as a result of the Allotment or Placement. Craig Winkler's shareholding is likely to be approximately 24.6%, and therefore will not provide him with absolute ability to block special resolutions of the company, which require a 75% majority. Rod Drury, the largest shareholder, will retain this ability after the Placement. Craig Winkler may, in practice, have the ability to block special resolutions where a proportion of shareholders fail to vote. While Rod Drury and Craig Winkler collectively will own approximately 55% of the shares in the company, this is similar to the current situation where Rod Drury and Hamish Edwards collectively own 56.5% of the shares.

It follows that the Allotment will leave smaller shareholders in substantially the same position from a control perspective as they are in currently. Control will not pass as a consequence of the Allotment, and shareholders will not lose the right to be paid for control at some future date.

2.4. The Pricing of the Placement

In non-pro rata share placements it is important that the pricing is fair, to avoid possible transfers of shareholder value. In assessing the fairness of the pricing of the Placement we have had regard to:

- The extent to which any premium for control is required;
- The market price for Xero shares before and after the Placement announcement; and
- The pricing of other non-pro rata equity placements in the current market.

Requirement for a Control Premium

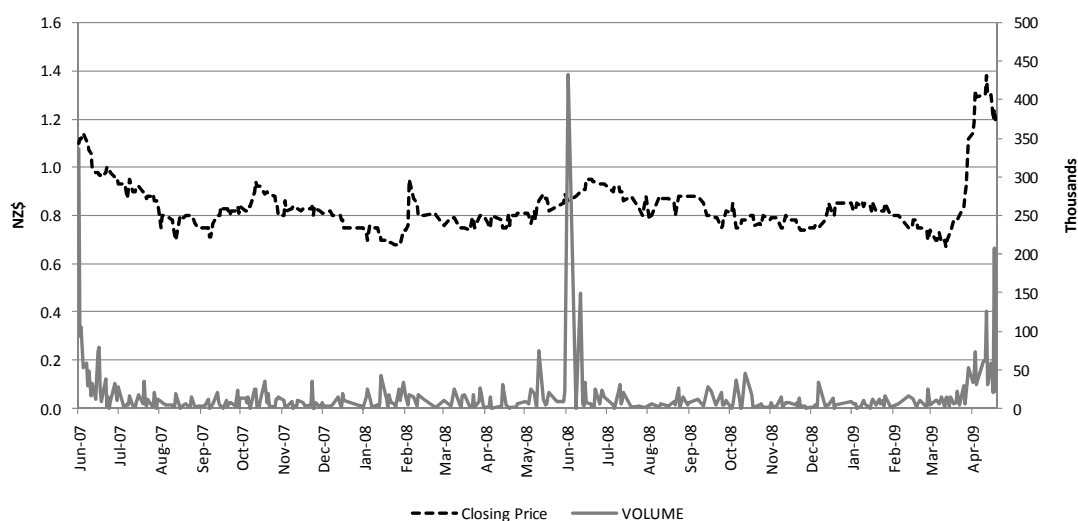
As discussed above, Craig Winkler will not be achieving control (i.e. a shareholding of 50% or more) as a result of the Allotment. He will achieve only a modest level of “negative control” (e.g. at 24.6% he will not, by himself, be able to block a special resolution). A degree of “negative control” is also already held by Rod Drury and to the extent that such negative control may have an influence on the value of smaller shareholdings in Xero, this will have been reflected in Xero’s share price since the IPO.

It follows that no premium for outright control is required in the pricing of the Allotment, and any premium for negative control should be modest.

The Market Price of Xero Shares

The market price for Xero shares over the period from the IPO in June 2007 to 24 April 2009 is summarised in the graph below.

Xero Market Share Price and Volume



Source: NZX, IRG

Note: Graph excludes trading days on which no Xero shares traded.

The share price has been sensitive to the company's news and market announcements, with an overall annualised volatility of 57% in the share price based on daily share price returns. The volumes traded have been relatively low with the average daily volume below 10,000 shares (excluding the trades occurring in June 2008 reflecting the sale of shares by a former Xero employee who was a shareholder).

The closing share price on 1 April 2009, immediately prior to the announcement on 2 April 2009 of a potential capital raising, was \$0.89, and it was \$1.14 prior to the announcement of the Placement on 7 April 2009. The shares have since risen to a price of \$1.38 on 16 April 2009, falling to \$1.14 on 24 April 2009.

The Placement price of \$0.90 per share is at a 4.7% premium to the VWAP of \$0.87 for the five trading days prior to 2 April 2009, and a 14.8% premium to the VWAP of \$0.78 for the three months prior to 2 April 2009.

Xero at the time of the IPO was a start up company with a business model that anticipated a lengthy period of negative operating cash flow as the company grew and achieved the economies of scale required to be profitable.

In our view the share price for Xero prior to the capital raising announcement reflected a balance between positive sentiments about the development of the business and concerns regarding the obvious need to secure additional capital for the business to progress to a point where operations were cash positive, overlaid with general market anxiety about economic conditions.

The positive reaction of the share price to the Placement announcement is likely to reflect:

- Removal of investor anxiety regarding the short term cash position of the business;
- Confidence that the business would have substantial cash resources to fund ongoing development (and expansion on a larger scale than before);
- Investors' desires to participate in the SPP, which required registration on the Shareholders Register at 23 April 2009; and
- Positive reaction to the endorsement of the Xero product and business model implicit in the decision by Craig Winkler to invest in the business.

If the Allotment were not to proceed, then in our view the Xero share price could fall significantly, reflecting the lower value of the business in the absence of Craig Winkler's involvement and financial support, and a less expansive growth strategy.

In assessing the fairness of the proposed Placement price, the most relevant comparisons are with the pre-announcement share price level, and the likely share price in the counterfactual "no Allotment" scenario, not the prices since 7 April which reflect the benefits of the Allotment proceeding. The \$0.90 Placement price is at a modest premium to the pre-announcement price levels.

Pricing of Placements in the Current Equity Market

The New Zealand capital markets have seen a significant uplift in equity capital raisings driven primarily by the need for companies to strengthen their equity position in the current difficult economic conditions and tight credit environment. While several capital raisings have been pro rata rights issues, for which pricing is less of an issue, a number have been non-pro rata placements. The latter have typically been priced at discounts to the pre-announcement share price.

Recent non-pro rata equity placement announcements are summarised below:

- Kiwi Income Property Trust (April 2009). Institutional placement raising \$50 million; new shares were priced at a 8.4% discount to the closing price of units on 31 March 2009;
- Fletcher Building (April 2009). Institutional placement and share purchase plan raising \$505 million; a discount of 12.5 % to the company's weighted average share price as of 31 March 2009;
- Freightways (April 2009). Underwritten placement raising \$45 million; 12% discount to the closing price of units on 6 April 2009, the day prior to the placement; and
- PGG Wrightson (September 2008). Placement to institutional and retail investors raising \$78.1 million; 14% discount from the previous day close price of \$2.10 per share.

In the current difficult market conditions, the need for urgency and certainty has encouraged companies to raise capital as efficiently as possible. Share placements have been commonly used, typically at a discount to the pre-capital raising share price. In this context, the pricing of the Xero Placement (at a modest price premium) appears reasonable.

2.5. Dilution of Existing Shareholders

In non-pro rata equity capital raisings, dilution of existing shareholders can take two forms:

- The reduction in their percentage ownership of the company; and
- The possible decrease in the value of their shareholding (e.g. if the placement price of the placement is below fair value and effectively transfers value from non-participating to participating investors).

The Placement (including the Allotment but excluding the SPP) will reduce the ownership percentage of non-participating shareholders by approximately 32%. For example a shareholder who previously held 1.0% of Xero's shares would as a result of the Placement hold 0.68% of the expanded shares outstanding. Part of the dilution has already occurred as a result of the placement of shares to certain strategic shareholders other than Craig Winkler. The dilution associated with the Allotment is approximately 25%.

This ownership dilution does not of itself reduce the value of non-participating shareholders' stakes. "Economic dilution" can occur if the placement price is below fair value. However we believe that existing non-participating shareholders are unlikely to suffer a reduction in the value of their shareholdings as a result of the Allotment because:

- We believe the Placement price is fair as discussed in section 2.4;
- The Placement has had a positive effect on Xero's share price; and
- Some of the share price increase is likely to be due to the value of Craig Winkler's involvement in Xero and the expected growth strategy the Allotment allows. In effect the existing shareholders will have a "smaller share of a larger pie".

We note that Hamish Edwards' ownership interest is diluted from 11.37% to 8.6% and he can no longer establish a joint controlling interest with any other shareholder, or block a 100% takeover. He is therefore arguably the shareholder most affected by the dilutive effects of the Allotment. However, we have been advised that Hamish Edwards has signed a Directors Certificate noting that in his opinion the consideration for and terms of issue of the new shares to Craig Winkler are fair and reasonable to the company and all existing shareholders.

2.6. Likelihood of an Alternative Capital Raising Proposal

Projections and budgets prepared in the second half of 2008 recognised the likely requirement for a further capital raising by mid-2009 to fill the cash short-fall projected. In addition, capital was recognised as particularly important for Xero to accelerate UK and Australia sales (and in particular to compete effectively against MYOB), and to build more global capability – for example to enable entry to the US market.

Steps were subsequently taken by the Board to assess the capital raising options. The board engaged Cameron Partners Limited to provide advice on, and assist with, the fundraising process. Cameron Partners Limited had also advised Xero at the time of the IPO.

Towards the end of 2008 and in early 2009, discussions were held with a discrete number of potential eligible investors and habitual investors. These lead to the following conclusions:

- The market for raising capital was challenging (and Xero had determined that debt was not freely available);
- Institutional investors were unlikely to be willing to materially participate in a fundraising, given the early stage nature of the business;
- The option of a rights issue was assessed. However, a rights issue was unlikely to raise the amount of capital required to fund Xero's growth opportunities and would not provide the strategic benefits to Xero which a placement to other parties (such as the BNZ and Craig Winkler) would offer. In addition, a rights issue would have most likely been priced at a substantial discount to the then current VWAP share price of Xero, given the volatile global capital markets. A rights issue would also have taken significantly longer to conclude, would not have been underwritten and would have provided an uncertain outcome for Xero's shareholders and the business generally;
- Discussions with BNZ, an existing shareholder, had led to the BNZ expressing a desire to increase its investment due to the commercial synergies identified between BNZ's SME offerings and Xero's product;
- A small number of new eligible persons or habitual investors also expressed an initial interest in participating in a fundraising; and
- A "No funding required" plan had been developed by Xero which demonstrated that it could be possible to grow the business with constrained capital by taking a range of cost-cutting measures, and relying on a limited capital raising to fund cash shortfalls. However, this strategy would have negatively impacted the long term projected profitability and value of Xero.

By early 2009 a capital raising in the order of \$5 million to \$10 million (including an SPP) looked possible. The Company had experienced accelerated growth in customer numbers through late 2008 and into 2009 alongside increasing acceptance of the Xero application and the successful launch of new updates, which were positive milestones for the business.

In early 2009 the Xero Board became aware of Craig Winkler's exit from MYOB and a meeting was arranged between Xero and Craig Winkler. Craig Winkler and his financial advisors carried out some due diligence on Xero and negotiations then commenced culminating in an agreement for Craig Winkler to invest \$18 million at \$0.90 per share.

Given this background and the current economic and capital market conditions, we do not believe that Xero would be able to develop a more favourable capital raising proposal than the Allotment. In particular we believe the quantum of funding and the other benefits associated with Craig Winkler's involvement would be difficult to replicate.

2.7. Implications of Approving the Allotment

If the Allotment is approved by Xero shareholders, the implications will include:

- Craig Winkler will become the second largest shareholder. He and Rod Drury will collectively hold a controlling interest in Xero. However, the minority shareholders remain largely in the same position as they are in currently;
- Existing non-participating shareholders' ownership percentages will be reduced by approximately 25% as a result of the Allotment;
- The additional \$18m of capital raised will materially enhance Xero's ability to deliver accelerated growth, in particular into the US market; and
- Craig Winkler will also bring his experience and expertise in the accounting applications business to Xero.

In our view the introduction of Craig Winkler to Xero's share register in such a substantial manner creates value for the company over and above that related to his introduction of additional capital. In effect Craig Winkler's investment represents an endorsement of the Xero product and business model and is likely to account in part for the share price escalation since the announcement of the Placement.

2.8. Implications of Rejecting the Allotment

If the Allotment is not approved by Xero shareholders, the implications will include:

- The funds raised in the Placement will be limited to the proceeds from other strategic investors of approximately \$5.2 million and potentially an additional \$2 million through the SPP;
- Deloitte believes Xero would be unlikely to find alternative investors willing to contribute a similar quantum of funds to that offered by Craig Winkler, or the same level of expertise in Xero's field;
- As a result Xero would likely follow a more constrained growth path and may have to forgo potentially valuable growth opportunities in international markets; and
- Xero's share price could also be negatively impacted, reflecting the lower value of the business in the absence of Craig Winkler's involvement and financial support, and a less expansive growth strategy.

2.9. Acceptance or Rejection of Allotment

Acceptance or rejection of the Allotment is a matter for individual shareholders based on their own views as to the terms and merits of the Allotment, the value of Xero, willingness to be diluted, future market conditions, risk profile, and other factors. Shareholders will need to consider these factors and consult their own professional adviser if appropriate.

3. Profile of Xero

3.1. Nature of the Business

Xero is a New Zealand registered company listed on the NZSX market operated by NZX Limited (“NZX”). The company was established in June 2006, and is based in Wellington.

Xero was founded by Rod Drury and Hamish Edwards in 2006, and since then has developed and launched an online accounting software platform.

Xero offers an online accounting platform to small businesses for their accounting and reporting. The Company operates a Software as a Service (“SaaS”) business model, whereby customers pay a monthly subscription fee for access to the platform.

The system does not require software installation on users’ own computers, rather it is accessed through the Internet from a computer or a device enabled for Internet connection. Upgrades to the application are available to customers as they log on to the system. Unlike the traditional desktop accounting applications, Xero does not require an up-front payment for the software and subsequent system upgrades.

Since the product is completely web based it has several unique points of difference over existing desktop accounting software which are outlined below:

- Xero’s customers pay a monthly fee for the use of the online system whereas other accounting software requires a substantial upfront payment for purchase of the product with further payments for product upgrades;
- Support costs are reduced significantly because support personnel only need to know about the current version, plus there is no need for complicated migration procedures from previous versions and supporting many upgrade paths;
- Xero is web based which enables users to access the information anytime and anywhere there is an Internet connection. This enables instant and easy access, with no backups required. Other accounting software products are typically hosted on a file server at the office or on home computers limiting the ability to access the information;
- Bank transactions automatically flow into Xero on a daily basis so there is no need to download statements from banks websites or wait for these to be posted. This enables bank reconciliations to be carried out with ease and improves cash management for customers;
- Xero offers an online help centre that provides customers with simple step by step instructions and online videos on how to operate Xero; and
- Xero runs an online blog website to provide customers with the latest news and developments, encouraging discussion.

In summary, the benefits of the Xero accounting platform include that it is: easy to use, is online, saves time, is cost effective, provides real time access for advisers, accountants and banks, assists in decision making and helps business owners to more easily manage their cash flow.

From launch of the product in New Zealand during 2007, Xero has developed UK and Australian versions of the product, entered those respective markets, released Accountants Edition versions. The company has also built interfaces which enable data transfers from other accounting systems. As at 31 March 2009, Xero had over 6,000 paying customers.

3.2. Competitors

There are few start-ups in the accounting SaaS sector because of the limited resources available to potential competitors to Xero. The investment required to establish a SaaS business is significant. There are two potential viable SaaS competitors to Xero - Zoho in the US and India (which is an early stage business undertaking product development) and Netsuite in the USA (offering an accounting product to medium size enterprises). Over time and as SaaS becomes more widely adopted, it is possible that other competitors to Xero may emerge.

The established accounting software providers (Sage in the UK, Intuit in the US, MYOB in Australia) have largely been unsuccessful in their attempts to develop online accounting offerings for various reasons ranging from data security to inability to develop a pure web-based application.

Accordingly, Xero wants to capitalise on the market opportunity that now exists by accelerating its international growth plans, and thereby cementing its position as a leading SaaS accounting software provider before others get a strong foothold.

Barriers to entry into the Xero target market for competitors include:

- In the current economic environment, there are limited resources to develop a high quality accounting platform and inability to achieve the economies of scale;
- Deep expertise in desktop applications (including marketing and sales strategies);
- Historical focus on vertically integrated business; and
- Established competitors are likely to have revenue cannibalisation and channel conflict issues if they were to fully move to an online accounting software offering.

3.3. IPO

Xero was established as a typical start-up business, with investment by the founders, Rod Drury and Hamish Edwards. They subsequently recruited a high quality management team to assist them to execute the vision of a global business, but focused initially on the New Zealand market. At the outset, the company raised capital from the founders, directors and selected employees of the company.

Xero recognised the need to grow quickly, and the requirement for an appropriate level of capital, as well as enhancing awareness about Xero in the international markets, and in 2007 the Company successfully achieved a listing on the NZX, raising \$15 million through an IPO.

These funds have allowed the company to launch the product in New Zealand without significant funding constraints, and develop the UK and Australian versions; establish a team in the UK; and make significant advances in building networks and marketing partnerships.

3.4. Post IPO Financial Performance

The actual performance of Xero for the period post IPO is summarised below:

Xero Limited - Statement of Financial Performance			
Year ending 31 March (NZ\$000)	2007¹ Audited	2008 Audited	6 months to September 2008 Unaudited
Operating Revenue	10	134	333
Total Operating Revenue	115	389	421
Interest Income	5	793	337
Operating Expenses	(1,169)	(5,488)	(4,221)
Net Surplus/Deficit	(1,049)	(4,310)	(3,465)
Customer Numbers	20	950	2,214
Source: Xero Financial Reports Note: (1) nine months results			

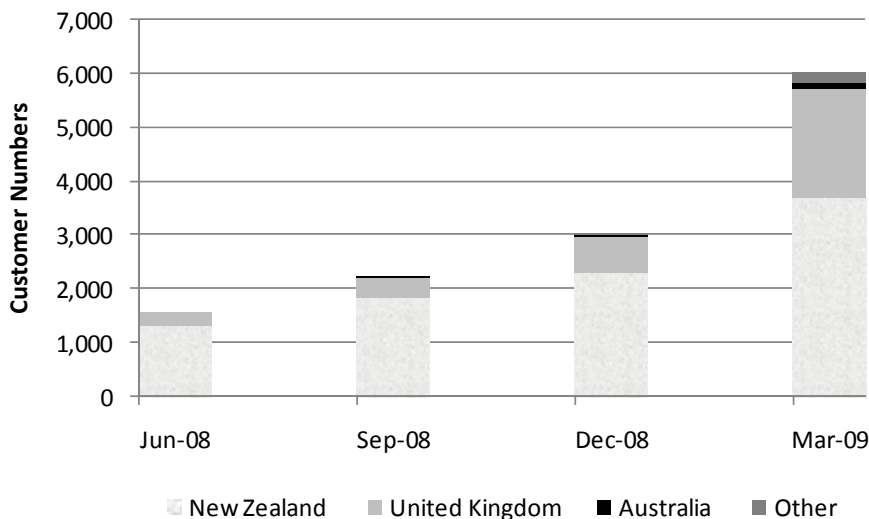
Revenue and Customers

Operating revenue increased from \$10,000 in 2007 to \$134,000 in 2008 with customer numbers growing from 20 to approximately 950 during this period. Operating revenue was \$0.3 million in the six months to 30 September 2008 with a further increase in customer numbers to 2,214. By 31 March 2009 customer numbers had exceeded 6,000.

In addition to operating revenue, Xero had interest income earned on cash balances following the IPO in June 2007 of \$0.8 million in 2008, and \$0.3 million in 2009 as the funds were used for the growth. Other income comprised mostly of Government grants, which increased from \$105,000 in 2007 to \$255,000 in 2008.

The graph below illustrates the growth in customer numbers by country achieved by 31 March 2009.

Xero Customer Growth Numbers



Source: Xero Management Information

The growth in customer numbers during the year to over 6,000 customers as at 31 March 2009 was supported by marketing and operational achievements by Xero including accreditation by the Institute of Chartered Accountants in England and Wales (ICAEW) in June 2008, establishing data feeds from the Australian banks and product developments including:

- Accountants Edition release in September 2008; and
- Australian general release in October 2008; and
- Global version general release in December 2008.

Xero is at different stages in its customer acquisition strategies in different countries using a combination of direct marketing and a referrals approach in New Zealand, while in the UK the customers are mostly obtained through referrals, such as accounting firms. The management envisages that customer acquisition in the USA will be mostly through partnerships and referrals.

Net Profit After Tax

At the net profit after tax level, Xero made losses of \$(1.0) million in 2007, \$(4.3) million in 2008, and \$(3.5) million in the six month period to 30 September 2008. This is in line with management expectations of a relatively high cash burn rate in the first few years of the operations as the application is developed, rolled-out and enhanced.

Total operating expenses increased from \$1.2 million in 2007 to \$5.5 million in 2008, with \$4.2 million incurred for the period to 30 September 2008. The growth in expenses is mainly attributable to higher salaries with higher staff numbers; marketing related expenses; and continued investment in product development and support.

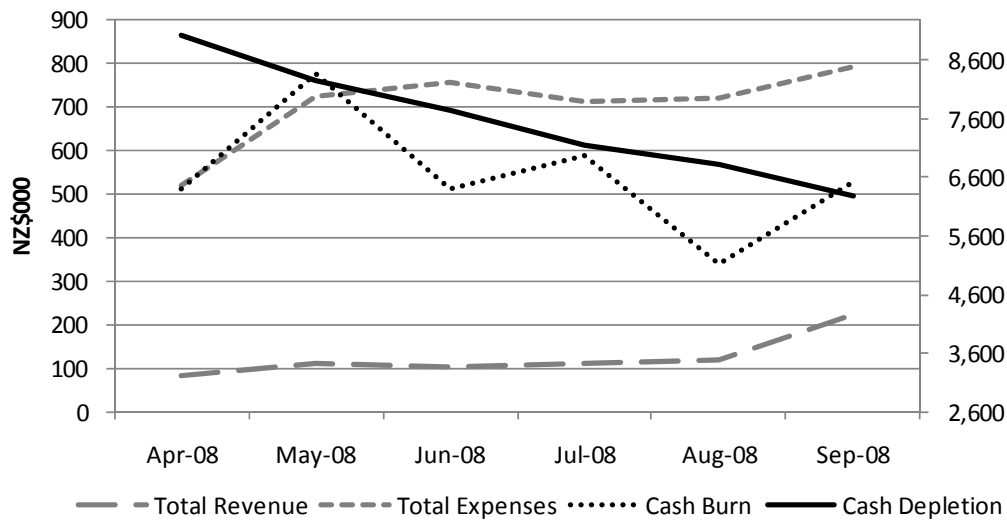
Xero had lower than expected growth in the UK and a more conservative approach to the launch of the Australian version. In response to that, management undertook a number of actions designed to constrain costs to ensure that cash depletion rates were appropriately managed.

It is expected that operating expenses for the year ending 31 March 2009 will be below the budget for that period. This illustrates the effect of Xero's cost management control which was implemented from mid – late 2008 as a result of lower than expected growth in customer numbers and operating revenue.

Cash Depletion

The following graph shows the trends in revenue and costs, and cash usage and cash balance depletion for the six months through to 30 September 2008:

Xero Cash Depletion



Source: Xero Management Information. Note: Detailed Cash Flow statement is presented in Appendix 1

The graph above illustrates that operating expenses significantly exceed revenue, both in dollar terms and in growth rates terms. The company has a monthly rate of cash depletion which varies between months but averages around \$0.5 million to \$0.6 million per month. The cash balance of \$9.5 million as at 31 March 2008 has consequently been depleted during the year, with an estimated cash balance of \$2.9 million at 31 March 2009 (based on current rate of cash burn and excluding any funding from the capital raising).

3.5. Current Financial Position

Xero's recent financial position is summarised below:

Xero Limited - Statement of Financial Position			
As at 31 March (NZ\$000)	2007 Audited	2008 Audited	6 months to September 2008 Unaudited
<i>Cash and Cash Equivalents</i>	1,514	9,517	6,280
Total Current Assets	1,681	9,955	6,509
Total Non Current Assets	325	1,924	2,325
TOTAL ASSETS	2,006	11,879	8,834
Total Current Liabilities	247	538	796
Total Non Current Liabilities	27	20	17
Shareholders' Funds	1,732	11,321	8,021
Total Equity And Liabilities	2,006	11,879	8,834
Source: Xero Financial Reports			

Current assets for Xero increased nearly 5.9 times from \$1.7 million as at 31 March 2007 to \$10.0 as at 31 March 2008; and were \$6.5 million as at 30 September 2008. Cash and cash equivalents make up the majority of current assets, and were \$9.5 million as at 31 March 2008 (compared to \$1.5 million in March 2007 prior to Xero's IPO in June 2007). Xero's forecast cash balance is \$2.9 million as at 31 March 2009 based on the expected rate of cash burn and prior to any funding from the capital raising.

Non-current assets were \$0.3 million as at 31 March 2007, \$1.9 million as at 31 March 2008 and \$2.3 million as at 30 September 2008.

Current liabilities more than doubled from \$247,000 as at 31 March 2007 to \$538,000 as at 31 March 2008 and were \$796,000 as at 30 September 2008. Accounts payable and other liabilities make up the majority of current liabilities.

Xero has a small amount of non-current liabilities on its balance sheet. The company has no term debt.

Xero's total shareholders' funds increased from \$1.7 million as at 31 March 2007 to \$11.3 million as at 31 March 2008 with \$15 million raised in the IPO, which was offset by negative retained earnings. Shareholders' funds were \$8.0 million as at 30 September 2008, comprised of \$16.8 million share capital and reserves and \$(8.8) million retained earnings.

3.6. Current Ownership and Governance Arrangements

As at 9 April 2009, Xero had 61,238,472 shares on issue, including 5,777,779 shares already allotted to strategic investors as part of the capital raising round on 9 April 2009.

The names, number of shares and percentage holdings of the ten largest shareholders are set out below.

Xero Limited - Top Ten Shareholdings		
Shareholders	Total Shares Held	% Shareholding
Rod Drury	24,668,002	40.28%
Hamish Edwards	6,960,000	11.37%
Sam Morgan	2,911,117	4.75%
Bank of New Zealand	2,177,778	3.56%
Alistair Grigg	1,627,511	2.66%
Graham Shaw	1,325,000	2.16%
W5 Limited	1,000,006	1.63%
Craig Walker	684,000	1.12%
Anthony Bishop	599,998	0.98%
David Kirk	559,400	0.91%
Other new shares issued	2,388,890	3.90%
Other Investors	16,336,770	26.68%
Total as at 9 April 2009	61,238,472	100.00%

On incorporation in July 2006, Xero had 1.5 million issued and fully paid shares, with 224,138 shares issued later in March 2007. There was a share split of 23.2-for-1 undertaken by Xero on 9 May 2007, which resulted in the total number of shares of 40 million before the IPO. Total number of shares on issue post IPO was 55 million.

The shareholder register post-IPO increased to 1,167 shareholders in July 2007, with the majority of investors holding minority stakes in Xero. Following the IPO, the founders of the company - Rod Drury and Hamish Edwards – had 44.5% and 12.5% stakes, respectively. Each existing shareholder of Xero before the IPO entered a deed of embargo prohibiting share disposal within the 12-month period after the IPO share issue.

Xero's largest shareholder is Rod Drury, who currently holds 40.28% of Xero. Rod Drury is the current CEO and a Director of Xero. Rod was named New Zealand Hi-Tech Entrepreneur of the Year in 2006 and 2007. In January 2006 Rod sold his award winning email archiving software company, Aftermail, to a US company, Quest Software. Rod was an independent Director of TradeMe and SQL Services at the time of their trade sales. Rod is still on the TradeMe Advisory Board and is also on the Trade and Enterprise Beachhead Advisory Board.

Hamish Edwards is Xero's second largest shareholder who holds 11.37% of Xero. Hamish Edwards is a Managing Director - UK and currently leads Xero's UK operations. He was formally CEO, now Chairman, of Openside, a New Zealand Chartered Accounting consulting firm.

Sam Morgan is an Independent Director who holds 4.75% of Xero. Sam is best known for founding online auction website TradeMe which, in 2006, was sold for \$700 million. Sam started his career at Deloitte Consulting before establishing TradeMe. Sam runs New Zealand's largest friend reunification site, Old Friends and also built online dating businesses in New Zealand, Australia and Canada. Sam is an active investor in New Zealand companies with holdings in a number of technology businesses including Sonar 6.

Graham Shaw is an Independent Director of Xero who holds 2.16% of Xero. Graham is a Chartered Accountant with 30 years experience in business. Graham provides mentoring advice to senior executives provides commercial advisory services to small business and sits on the boards of a number of corporate and not-for-profit organisations.

The other Xero directors comprising Phil Norman (Chairman) and Guy Haddleton (Independent Director) are also shareholders in Xero.

Phil Norman is Managing Director of Nortek Management Services Limited, a boutique advisory firm providing mergers and acquisitions advice and business development services for growth companies. He has over 30 years experience in the IT sector, having been an owner, manager, director and investor in a number of local and international companies.

Guy Haddleton is co-founder and CEO of US product innovator, Ascadia, which develops and markets products for consumer and business-to-business markets. Guy was founder, Chairman and CEO of enterprise planning software leader Adaytum, from 1990 to 2002, which after expanding from market leader in the UK to Europe, the USA and Asia Pacific, was sold in 2002, for US\$160 million.

Alistair Grigg is the Chief Operating Officer of Xero who holds 2.61% of Xero. Alistair joined Xero from Air New Zealand, where he was the Chief Information Officer, responsible for a global portfolio of over 400 enterprises systems, 200 staff and significant IT infrastructure outsource operations contracts with IBM, Axon and Telecom New Zealand. Alistair has an extensive IT background involving roles at IBM, Computer Associates and Geac as well roles in successful start-up ventures such as Telecom Xtra, Glazier Systems and Utiyx.

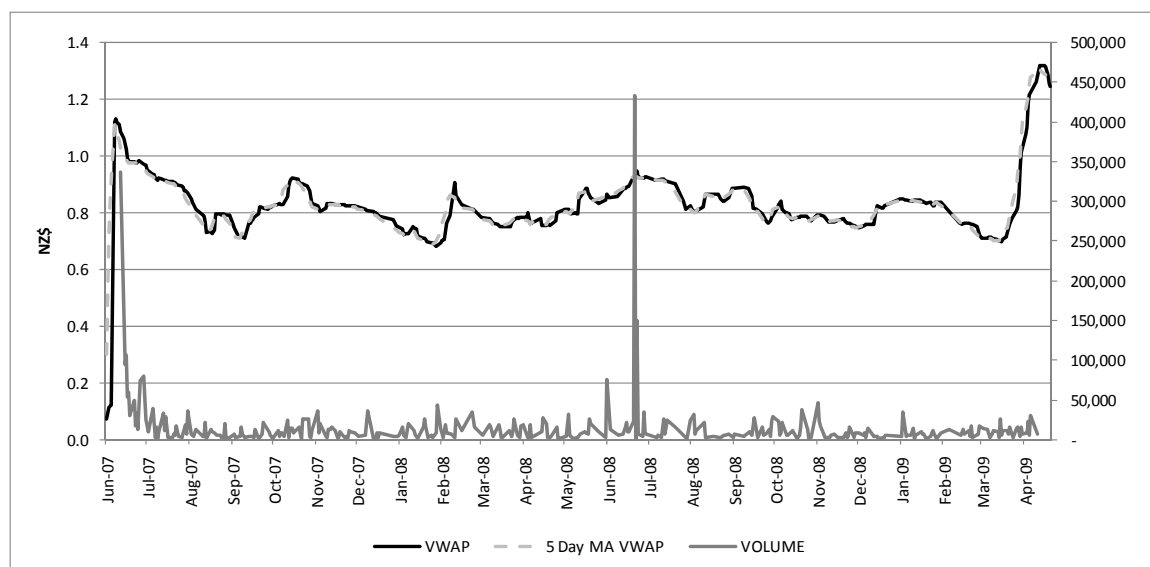
Craig Walker is the Chief Technology Officer of Xero who holds 1.12% of Xero. Craig is responsible for Xero's product development and architecture. Craig has a background in building mission critical Internet applications which include, co-founding software-as-a-service provider Viatx and working for leading Microsoft consulting firm Glazier Systems.

At February 2009 the majority of Xero's shares were held by Company Directors and staff. Other investors held the remaining 26.35% of the shares on issue.

3.7. Share Price Analysis

Set out below is a summary of the Xero share trading history since the company entered the NZX market on 5 June 2007. The graph shows the daily volume weighted average price (“VWAP”), five day moving average VWAP, and daily volumes of Xero shares since the company listing on NZX.

Xero’s Share Price History



Note: VWAP is zero when no trades took place in 5 consecutive days

Source: IRG, NZX

This graph includes the unusually high level of trading on 6 June 2008, where a total of 432,500 shares were traded at a total value of \$367,841 (\$0.85 per share). These trades reflect the sale of shares by a former Xero employee (who was a shareholder) that had decided to leave the Company, creating an opportunity for the BNZ to acquire its initial tranche of 400,000 shares in Xero.

A review of share price movements confirms that the share price is sensitive to company and market announcements. The announcements summarised below explain some of the share price movements.

- Announcements of a General Release of its small business accounting software (24 August 2007) and Xero will release a global version of its software (15 August 2008);
- Announcement that fully automated daily imports of bank transactions for Xero customers with Kiwibank, ANZ and National Bank (12 September 2007);
- Announcement that Xero won the overall TUANZ Telecommunications Innovation Award, along with the Commerce Award (12 October 2007);
- News from Australia that Xero’s competitor MYOB turned down a premium takeover offer. The offer was an indication of the merit in the accounting software industry (11 February 2008);
- Announcements of Xero’s full year financial statements and that Xero had exceeded its customer number target included in its Offer Document (14 May 2008);
- Announcement that Xero’s online accounting software was accredited by ICAEW (20 June 2008);

- Announcement of Xero’s half year financial statements (24 October 2008);
- Announcement about Andy Lark an internet marketing expert joining Xero’s Advisory Board (16 March 2009); and
- Announcement about Xero doubling customer numbers in the last three months and customer numbers exceeding 6,000 paying customers, including over 2,000 customers in the UK (31 March 2009).

The table below shows the share price range for Xero shares in the periods between IPO and potential capital raising announcement, strategic placement announcement and thereafter to 22 April 2009.

Xero Limited – Share Price		
	Low (\$)	High (\$)
5 June 2007 – 1 April 2009	0.67	1.17
2 April 2009 – 7 April 2009	1.02	1.19
7 April 2009 – 22 April 2009	1.20	1.39
Note: Analysis excludes trading days on which no trades of Xero shares occurred		
Source: NZX, IRG		

Since the IPO with an offer share price of \$1.00 in June 2007, Xero shares have traded between \$0.67 and \$1.17 before the potential capital raising announcement. The last share price on 1 April 2009, the day before the announcement of the potential capital raising, was \$0.92. Following the announcement share price increased to \$1.02 on 2 April 2009. The share price was in the range of \$1.12 to \$1.19 between 3 April 2009 and 7 April 2009, on which the strategic placement was announced. Since then the share price has increased further reaching a high of \$1.38 and on 24 April 2009 had fallen to \$1.14 per share.

Trading in Xero shares is intermittent with no trades on some days and relatively high volumes on the days of company announcements. The average volume of shares traded each month has varied from as low as 74 thousand (0.13% of shares on issue on 2 April 2009) in February 2009 to a high of just over 1 million in June 2007 (1.87% of shares on issue on 2 April 2009), excluding the month with the effect of the end of the embargo period.

The market reaction to the potential capital raising of Xero has been an increase in trading volumes as illustrated in the graph above. In the period since the announcement of the potential capital raising on 2 April 2009 to 22 April 2009 the volume traded was 832,506.

The Placement at \$0.90 per share represents a 4.7% premium over the VWAP share price of Xero of \$0.86 for the five trading days before the potential capital raising announcement, a 2.2% discount over the closing share price on the day before the potential capital raising announcement, 14.8% premium over the VWAP for the three months before the announcement, and a 14.7% premium over the VWAP for the six months before the announcement.

3.8. Use of Placement Proceeds

Since the time of the IPO, there has been continued investment into product development which started with development of the “initial product” and this has progressed through to the launch of country specific versions in the NZ, UK and Australian markets, as well as the launch of a global version.

Now that the product has been proven and is working well for existing customers, the next phase of the investment will be focused on accelerating Xero’s growth in its international markets. This will include marketing and building relationships with channel partners. These partners are expected to assist in building Xero’s brand as well as acting as a referral network.

Product development will continue, initially targeting some product “add-ons”, which will generate additional revenues from existing customers (e.g. a multi-currency upgrade) and will be closely followed by a roll-out of the US version of the product (and possible other country specific versions) to increase market coverage. Ongoing improvements to the existing product will also continue.

This investment reflects Xero’s strategy to drive revenue growth through:

- Increasing market coverage (beyond NZ) by enhancing the existing “global” product which can be used in any country, and then country specific versions (the key difference being in relation to treatment and rates of sales tax);
- Investing in building relationships so that the network of referral partners (telecommunication companies (“telcos”), banks, accounting firms) are equipped to act as Xero’s marketing partners – both through referrals of their clients and through raising Xero brand awareness by brand association and advertising in their customer publications or websites; and
- Enhancing the value proposition of the product, thereby increasing its attractiveness to new customers – particularly the conversion rate of customers using the product “on trial” (these trial customers are not counted by Xero as actual customers). This includes enhancement of the basic product as well as development of add-on options that some customers may regard as essential to the value proposition (e.g. multi-currency).

Xero sees that increased investment over the next two to three years has the long term potential to increase rates of growth in customer numbers, which can be significantly increased over that which would be achievable through a more conservative plan, with less funding. In the short term, however, this will result in an increased rate of cash-burn and the break-even point between revenues and costs being extended by at least a further 12 months.

Specifically, the intention is to invest in:

- Entering the US market: investing in marketing by establishing and developing partnerships, accessing networks and customer bases, networking with high powered individuals, and establishing a footprint in selected IT-focused areas of the US (e.g. California);
- Resourcing key marketing partnerships in the UK and Australia: investing in building relationships with parties such as Telstra in Australia (in addition to Australian banks and other partnerships);

- Further expansion of the Xero referrer network: continued investment in building relationships to obtain association of Xero with branded market leaders and enhance non-direct marketing through referrals; participation in events for the accounting industry professionals; investing in Xero blogs;
- Additional sales and marketing staff: employment of account managers and customer service personnel in New Zealand and overseas with an emphasis on winning customers in overseas markets (as well as managing the growth of the NZ business);
- Additional operational staff: employment of additional specialists for product development, support and training;
- The potential lease of offices in Sydney and Melbourne: providing a physical presence in Australia;
- Further enhancement of the application to tailor specific needs of the international markets (Australia, UK and USA); and
- Further upscaling the back office in New Zealand to accommodate the growth in business.

Xero also intends to use some of the funding for general working capital and balance sheet purposes to create flexibility and to help instil customer confidence. This should assist in accelerating the development of additional strategic partnerships in Xero's international markets.

4. Profile of Craig Winkler

Craig Winkler has been involved in software programming and business consultancy since 1984. While studying an undergraduate degree at the Royal Melbourne Institute of Technology he started a software company in partnership with a fellow student and grew that to form part of the MYOB Group, which he co-founded in 1991. Craig's focus during his career of more than 25 years in the IT industry has been on improving the way small businesses operate in Australia and internationally.

By 1996, Craig Winkler acting as joint Managing Director of MYOB had successfully grown the business into the leading supplier of accounting software in Australia. In 1996 MYOB was recognised as the Australian Small Business of the Year at the Telstra and Australian Government's Small Business Awards. In July 1999, MYOB listed on the Australian Stock Exchange with Craig Winkler as Chief Executive Officer.

The successful merger with accounting system provider, Solution 6, in 2004 solidified MYOB's position as a leading international source of the very best in solutions for owner-operated businesses and accounting practices. The merger was in line with MYOB's extended strategic vision to include specific solutions for accounting practices.

Craig Winkler was Chief Executive Officer for 9 years and continued to hold a major shareholding in MYOB.

In early 2009, Archer Capital – HarbourVest made a successful takeover offer for MYOB, paying around A\$437 million. Along with other shareholders, Craig Winkler sold his estimated 28% stake to the Archer Capital-HarbourVest private equity consortium. In February 2009, Craig Winkler resigned from the board of MYOB and his executive role.

Craig Winkler is no longer involved in MYOB as a director, executive, shareholder or in any other capacity.

Craig Winkler now divides his work time between business pursuits and assisting not-for-profit enterprises. He is not currently a shareholder or director of any New Zealand registered companies.

5. Sources of Information, Reliance on Information, Disclaimer and Indemnity

5.1. Sources of Information

The statements and opinions expressed in this Report are based on the following main sources of information:

- Xero Limited Annual Report 2008 and Interim Report 2009;
- Xero Limited Board Papers;
- Xero Limited Management Financial Information, February 2009;
- Xero Live Limited Share Offer Investment Statement (IPO Prospectus) 11 May 2007;
- New Zealand Investor Presentation – Xero Limited, Cameron Partners Limited, February 2009; and
- Other publicly available information, including from Bloomberg, OneSource, and NZX.

During the course of preparing this Report, we have had discussions with and/or received information from the management of Xero and Xero's financial advisers.

The independent directors of Xero have confirmed that Deloitte have been provided for the purpose of this Independent Adviser's Report with all information relevant to the Allotment that is known to them and that all the information is true and accurate in all material aspects and is not misleading in a material manner by reason of omission or otherwise.

Including this confirmation, we have obtained all the information that we believe necessary for the purpose of preparing this Independent Adviser's Report.

In our opinion, the information set out in this Independent Adviser's Report is sufficient to enable the independent directors of Xero and Xero shareholders to understand all the relevant factors and to make an informed decision in respect of the Allotment.

We consent to the issuing of this report, in the form and context in which it is included, in the notice of meeting to be sent to Xero shareholders.

5.2. Reliance on Information

In preparing this Report we have relied upon and assumed, without independent verification, the accuracy and completeness of all information that was available from public sources and all information that was furnished to us by Xero and its advisers.

We have evaluated that information through analysis, enquiry and examination for the purposes of preparing this Report but we have not verified the accuracy or completeness of any such information or conducted an appraisal of any assets. We have not carried out any form of due diligence or audit on the accounting or other records of Xero. We do not warrant that our enquiries would reveal any matter which an audit, due diligence review or extensive examination might disclose.

5.3. Disclaimer

We have prepared this Report with care and diligence and the statements in the Report are given in good faith and in the belief, on reasonable grounds, that such statements are not false or misleading. However, in no way do we or the independent directors of Xero guarantee or otherwise warrant that any projections or forecasts of future profits, cash flows or financial position of Xero will be achieved. Forecasts are inherently uncertain. They are predictions of future events that cannot be assured. They are based upon assumptions, many of which are beyond the control of Xero and its directors and management. Actual results will vary from the projections and forecasts and these variations may be significantly more or less favourable.

We assume no responsibility arising in any way whatever for errors or omissions (including responsibility to any person for negligence) for the preparation of the Report to the extent that such errors or omissions result from our reasonable reliance on information provided by others or assumptions disclosed in the Report or assumptions reasonably taken as implicit.

Our evaluation has been arrived at based on economic, exchange rate, market and other conditions prevailing at the date of this Report. Such conditions may change significantly over relatively short periods of time. We have no obligation or undertaking to advise any person of any change in circumstances which comes to our attention after the date of this Report or to review, revise or update our Report.

We have had no involvement in the preparation of the Placement-related documentation issued by Xero and have not verified or approved the contents of the documentation. We do not accept any responsibility for the contents of the Placement-related documentation except for this report.

5.4. Indemnity

Xero has agreed that to the extent permitted by law, it will indemnify Deloitte and its partners and employees in respect of any liability suffered or incurred as a result of or in connection with the preparation of the Report. This indemnity does not apply in respect of any negligence, wilful misconduct or breach of law. Xero has also agreed to indemnify Deloitte and its partners, employees and consultants for time incurred and any costs in relation to any inquiry or proceeding initiated by any person. Where Deloitte or its partners, employees and consultants are found liable for or guilty of negligence, wilful misconduct or breach of law or term of reference, Deloitte shall reimburse such costs.

6. Qualifications and Expertise, Independence, Declarations and Consents

6.1. Qualifications and Expertise

Deloitte is one of the world's leading professional services firms. Deloitte Corporate Finance is the corporate finance practice of Deloitte, providing corporate advisory, mergers and acquisitions, valuations and transaction support services.

The persons in the firm responsible for issuing this report are Alan Dent and Chas Cable.

Deloitte Corporate Finance, Mr Dent and Mr Cable have significant experience in the independent investigation of transactions and issuing opinions on the merits and fairness of the terms and financial conditions of the transactions.

6.2. Independence

Deloitte is not the auditor of Xero.

Deloitte Corporate Finance has not had any part in the formulation of the Placement or any aspects thereof. Our sole involvement has been the preparation of this report.

Deloitte Corporate Finance will receive a fee for the preparation of this report. This fee is not contingent on the conclusions of this report or the outcome of the Allotment. We will receive no other benefit from the preparation of this report. We do not have any conflict of interest that could affect our ability to provide an unbiased report.

6.3. Declarations

Advance drafts of this report were provided to Xero independent directors and executive management. Certain changes were made to the drafting of the report as a result of the circulation of the drafts. However, there was no material alteration to any part of the substance of this report, including the methodology or conclusions as a result of issuing the drafts.

Our terms of reference for this engagement did not contain any term which materially restricted the scope of the report.

6.4. Consents

Deloitte Corporate Finance consents to the issuing of this report in the form and context in which it is to be included in the Target Company Statement to be sent to Xero shareholders. Neither the whole nor any part of this report, nor any reference thereto may be included in any other document without our prior written consent as to the form and context in which it appears.

Appendix I - Financial Statements

Xero Limited Statement of Financial Performance			
Year Ending 31 March (NZ\$000)	2007 Audited	2008 Audited	September 2008 Unaudited
Operating Revenue	10	134	333
Other Income	105	255	88
Total Operating Revenue	115	389	421
Interest Income	5	793	337
Operating Expenses	(1,149)	(5,146)	(3,845)
Interest Expense	0	(4)	(2)
Depreciation & Amortisation	(20)	(342)	(376)
Operating Surplus/(Deficit) Before Taxation	(1,049)	(4,310)	(3,465)
Less Taxation	0	0	0
Net Surplus/Deficit	(1,049)	(4,310)	(3,465)
Source: Xero Financial Reports			

Xero Limited Statement of Financial Position			
As at 31 March (NZ\$000)	2007 Audited	2008 Audited	September 2008 Unaudited
Cash & Cash Equivalents	1,514	9,517	6,280
Current Tax Receivable	2	210	33
Trade Receivables & Other Assets	165	228	196
Total Current Assets	1,681	9,955	6,509
Property, Plant & Equipment	286	472	464
Intangible Assets	39	1,065	1,474
Other Non-Current Assets	-	387	387
Total Non Current Assets	325	1,924	2,325
TOTAL ASSETS	2,006	11,879	8,834
Trade Payables & Other Liabilities	243	532	789
Finance Lease	4	6	7
Total Current Liabilities	247	538	796
Finance Lease	27	20	17
Total Non Current Liabilities	27	20	17
TOTAL LIABILITIES	274	558	813
Share Capital	2,781	16,670	16,833
Retained Earnings	(1,049)	(5,359)	(8,824)
Foreign Currency Translation Reserve	-	10	12
Shareholders' Funds	1,732	11,321	8,021
TOTAL EQUITY	1,732	11,321	8,021
Source: Xero Financial Reports			

Xero Limited Statement of Cash Flows			
Year Ending 31 March (NZ\$000)	2007 Audited	2008 Audited	September 2008 Unaudited
Cash Flows from Operating Activities			
Receipts from Customers	-	130	388
GST Received	-	202	177
Interest Received & Other Income	97	975	441
Payments to Suppliers & Employees	(1,033)	(4,947)	(3,678)
Income Tax Paid	(17)	(235)	211
Net Operating Cash Flows	(953)	(3,875)	(2,461)
Cash Flows from Investing Activities			
Purchase of Sale of Property, Plant & Equipment	(275)	(330)	(114)
Capitalised Development Costs	0	(1,215)	(673)
Intangible Assets	0	(19)	-
Loans to Directors	0	(300)	-
Other Assets	(39)	(75)	-
Net Investing Cash Flows	(314)	(1,939)	(787)
Cash Flows from Financing Activities			
Issue of Ordinary Shares	2,800	15,000	-
Cost of Share Issue	(19)	(1,111)	-
Finance Lease Repayments	0	(5)	(3)
Net Financing Cash Flows	2,781	13,884	(3)
Net Increase/(Decrease) in Cash Held	1,514	8,070	(3,251)
Add Opening Cash Brought Forward	0	1,514	9,517
Exchange Rate Adjustments	0	(67)	14
Ending Cash Carried Forward	1,514	9,517	6,280
Source: Xero Financial Reports			