

## Spectra Systems Corporation

### Preliminary results for the twelve months ended 31 December 2017

Spectra Systems Corporation, a leading provider of advanced technology solutions for banknote and product authentication, is pleased to announce its preliminary results for the twelve months ended 31 December 2017.

This announcement contains inside information for the purposes of Article 7 of Regulation 596/2014.

#### Financial highlights:

- Revenue up 9% for the year at US\$12,170k (2016: US\$11,122k)
- Adjusted EBITDA<sup>1</sup> up 83% at US\$4,349k (2016: US\$2,383k)
- Adjusted PBTA<sup>1</sup> doubled to US\$4,010k (2016: US\$1,999k)
- Adjusted earnings<sup>2</sup> per share of US \$8.8 cents (2016: US 4.4 cents)
- Net income up over 187% at US\$3,280k (2016: US\$1,139k)
- Cash generated from operations of US\$4,669k (2016: US\$2,805k)
- Strong, debt-free balance sheet, with cash<sup>3</sup> of US\$11,181k (2016: US\$8,808k)
- Declaring annual dividend up 20% to US\$0.06 per share to be paid in June

<sup>1</sup> Before stock compensation expense and exceptional items related to inventory writedowns and acquisition costs

<sup>2</sup> Before amortization, stock compensation expense and exceptional items related to inventory writedowns and acquisition costs

<sup>3</sup> Does not include US\$1,099k (2016: US\$1,092k) of restricted cash and investments

#### Operational highlights:

- In-house production throughout 2017 with margin uplift through consumption of inventory previously manufactured through contract services
- Record phosphor sales of US\$4,313k (2016 US\$3,764k)
- Gross margin increased to 71% from 68% resulting from in-house manufacturing of covert materials, royalties and record high-margin phosphor sales
- Reduced operating expenses by US\$881k through a planned reduction of R&D and reallocation of internal resources to in-house manufacturing
- Brand Authentication and Secure Transactions Group performing in line with expectations
- Completed engineering staff reductions and facility consolidation which will allow us to redirect resources to increase manufacturing capacity in 2018 to support larger orders and mitigate performance risk

Commenting on the results, Nabil Lawandy, Chief Executive Officer, said:

"The Company's revenues have increased by 9% and PBTA has doubled over 2016 driven by sales of high margin phosphors, significant royalty payments by our licensee due to record print orders, and the inline performance of all other operating business lines.

"We have also laid the foundation for the expected adoption of a new security feature for polymer banknotes by a major central bank and have achieved success with the large scale production tests of our smartphone based TruBrand authentication technology.

"Furthermore, we have successfully initiated a new line of business in the consumer products area where our materials are used to ensure that coffee cups are functional with Keurig coffee makers which we hope will lead to similar opportunities in the consumer products area we have been focusing on."

"The Board therefore believes that the Company, by achieving key business milestones, will continue to perform well and has excellent prospects for ongoing earnings growth in 2018."

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## **Chief Executive Officer's statement**

### **Introduction**

Through achieving key commercial milestones, as described in the Review of Operations below, Spectra Systems has delivered an excellent performance for the 2017 financial year.

Revenue for the year was US\$12,170k (2016: US\$11,122k) due to record phosphor sales and higher royalties earned. Adjusted EBITDA (before stock compensation expense and exceptional items) for the year increased 83% to US\$4,349k compared to the prior year of US\$2,383k, which resulted in net income up over 187% at US\$3,280k (2016: US\$1,139k).

Having generated cash from operations of US\$4,669k (2016: US\$2,805k), cash at the period end amounted to US\$11,181k (2016: US\$8,808k), excluding US\$1,099k of restricted cash and investments (2016: US\$1,092k). This is notwithstanding US\$2,270k paid to shareholders during June in the form of the Company's inaugural dividend of US\$0.05 per share.

The Company therefore intends to declare an annual dividend up 20% at \$0.06 per share to be paid in June. The Company will continue to have sufficient cash resources thereafter to execute on its growth plans.

### **Review of Operations**

#### ***Authentication Systems***

The Authentication Systems business, which includes the security phosphor materials, generated revenue of US\$10,823k (2016: US\$9,848k) and adjusted EBITDA of US\$3,794k (2016: US\$1,928k). Authentication Systems revenues are driven by covert material sales and royalties through our licensing agreement with a major banknote supplier and printer to 18 central banks, including one G7 central bank, and directly to another G7 central bank. We are pleased to report that we continue to sustain a margin increase from using our in-house manufacturing facility.

The strong earnings from our covert materials business has been complemented with continued strong sales of high margin brand authentication materials and particularly phosphors related to a central bank's redesign of banknotes which was completed in 2017.

The TruBrand authentication business is performing on track and continues to have significant prospects in China bolstered by our highly successful large scale production test results with a major tobacco company printer in China in Q4 of 2017.

Based on our advances in 2017, we expect to execute a new direct licensing and supply agreement for a covert security product for polymer banknotes within the next two years. We expect that the translation of this new technology from a laboratory system to a finalized product will be funded under a development agreement with the central bank customer beginning in late 2018.

#### ***Secure Transactions Group***

The Secure Transactions Group performed in line with management expectations, generating adjusted EBITDA of US\$555k (2016: US\$505k) on revenue of US\$1,347k (2016: US\$1,274k).

This segment of the business is producing solid revenue growth as well as increased earnings. With the introduction of the 64-bit product along with our position as the only supplier with a virtual machine capability, we are confident we will continue to attract more customers from our competitors.

The Secure Transactions Group has won a new contract with the Maryland Lottery, 3 new licences and has continued to roll out 64-bit Premier Integrity. The Secure Transaction Group will complete their ISO-27001 Certification in 2018 and continue working with organizations such as the World Lottery Association (WLA) and the North American Association of State and Provincial Lotteries (NASPL). We are confident that we will see continued growth of the business in 2018.

## **Strategy**

The Company's strategy for increasing revenue and earnings is focused on brand authentication and specialty optical materials for security applications while maintaining a robust effort to commercialize our covert security technologies. The brand authentication sector offers significant short term growth and some very large opportunities for smartphone based technology while the covert banknote security area provides long term, multi-decade revenues once new contracts are executed. The banknote industry continues to have a CAGR of 3.3% and is expected to reach \$11.2 billion by 2021 (Smithers Pira, 1/2017). This growth continues in the face of Utopian goals of a cashless society by some central bank executives and any changes in this trend will go through a very long phase of transitions to new substrates, denomination reductions, and multifunctional security features before a decline of any significance takes place in the industry.

We have developed and introduced an impressive suite of covert authentication products which are currently under consideration by central banks and potential corporate licensing partners. These products are primarily targeted towards polymer banknotes where growth is beginning to outpace annual increases in paper banknote production. Through our close relationship with our direct G7 customer, we have become a trusted supplier of technology and have been asked to bid on several sensor upgrades, including our own sensors which are currently in use. We are confident that this will result in additional business and underpins our strategy of growing our business with existing customers in banknote security.

Mirroring the shift towards secure materials outside of banknotes, we began a restructuring of staff to allow us to market our optical materials in related areas such as process control and consumer products.

The Secure Transactions Group continues to innovate within the lottery ICS industry, reducing cost and increasing efficiency with the introduction of Virtualized Machines. The use of VM, we expect will allow us to win contracts from our competitors by offering more value to the customer and has become an integral part of the strategy of the group.

## **Prospects**

We are targeting five specific opportunities, two of which are relatively near-term and three of which are somewhat longer-term.

The important, near-term opportunities are:

- 1) The initial small-scale sales of TruBrand materials along with cloud based authentication services in 2018
- 2) The funded commercialization of a polymer banknote technology by a major central bank

The longer term (2-4 years) opportunities are:

- 3) A licensing and supply agreement for polymer based technology developed through external funding with a major central bank
- 4) The development and supply of further upgraded sensor capability to a G7 central bank in response to a standardization requirement
- 5) The adoption of our Secure Transactions Group products for sports gambling which is on the verge of being legalized in several states. From New York to California, lawmakers in at least 20 states are wagering that sports gambling could become legal in 2018 and are crafting legislation to make that happen within their borders.

In addition to these specific and defined targets, we continue to pursue banknote tenders with major central banks using other covert security features we have developed as well as our TruNote technology. Furthermore, we have a second polymer based technology which we believe may be of great value through a possible partnership with a polymer supplier. This is an approach we are exploring before reverting to the more traditional approach we have taken in the past where we license technology to a major banknote printer or supplier.

We are pleased that we are able to supplement our sustained and growing profitability with a number of near-term and longer-term prospects of a significant scale. We are particularly delighted that the authentication business outside of banknotes is growing ahead of expectations, which provides recurring revenue to supplement our long term banknote business with its characteristically extended sales cycles and delays. We believe that we have a number of transformative opportunities ahead in several aspects of our business that will drive near and long term earnings growth for the Company and its shareholders.

With the Company having a fourth year of sustainable profits and having sufficient resources to execute on its growth plans with its existing cash reserves, the Board is delighted to continue paying dividends. Its dividend policy takes account of the Group's profitability, underlying growth, and the maintenance of sufficient cash reserves. The Board therefore intends to pay an annual dividend of US\$0.06 per share on or about June 29, 2018 to shareholders of record as of June 8, 2018.

Nabil M. Lawandy  
Chief Executive Officer  
March 19, 2018

**Statements of income and other comprehensive income  
for the years ended 31 December:**

	<b>Note</b>	<b>2017 Unaudited USD '000</b>	<b>2016 Audited USD '000</b>
Revenue		\$ 12,170	\$ 11,122
Cost of sales		<u>3,514</u>	<u>3,524</u>
Gross profit		8,656	7,598
Operating expenses		<u>5,625</u>	<u>6,506</u>
Operating profit		3,031	1,092
Interest and other income		60	53
Foreign currency gain (loss)		<u>2</u>	<u>(6)</u>
Profit before taxes		3,093	1,139
Income tax benefit		<u>187</u>	<u>-</u>
<b>Net income</b>		<u>\$ 3,280</u>	<u>\$ 1,139</u>
<b>Earnings per share</b>	2		
Basic		\$ 0.07	\$ 0.03
Diluted		\$ 0.07	\$ 0.03
<b>Other comprehensive income (loss)</b>			
Unrealized loss on currency exchange		10	(33)
Reclassification for realized loss in net income		<u>(2)</u>	<u>6</u>
<b>Total other comprehensive income (loss)</b>		8	(27)
<b>Comprehensive income</b>		<u>\$ 3,288</u>	<u>\$ 1,112</u>

All of the Group's operations are continuing

**Balance sheets  
as of 31 December:**

	<b>2017</b>	<b>2016</b>
	<b>Unaudited</b>	<b>Audited</b>
	<b>USD '000</b>	<b>USD '000</b>
<b>Current assets</b>		
Cash and cash equivalents	\$ 11,181	\$ 8,808
Trade and other receivables	1,425	2,706
Inventory	3,754	2,915
Prepaid expenses	116	104
<b>Total current assets</b>	<u>16,476</u>	<u>14,533</u>
<b>Non-current assets</b>		
Property, plant and equipment, net	1,795	2,561
Intangible assets, net	6,967	7,304
Restricted cash and investments	1,099	1,092
Deferred tax assets	1,225	989
Other assets	151	146
<b>Total non-current assets</b>	<u>11,237</u>	<u>12,092</u>
<b>Total assets</b>	<u>\$ 27,713</u>	<u>\$ 26,625</u>
<b>Current liabilities</b>		
Accounts payable	\$ 200	\$ 402
Accrued expenses and other liabilities	1,521	1,437
Taxes payable	8	-
Deferred revenue	1,074	1,260
<b>Total current liabilities</b>	<u>2,803</u>	<u>3,099</u>
<b>Non-current liabilities</b>		
Deferred revenue	458	256
<b>Total non-current liabilities</b>	<u>458</u>	<u>256</u>
<b>Total liabilities</b>	<u>3,261</u>	<u>3,355</u>
<b>Stockholders' equity</b>		
Common stock	454	453
Additional paid in capital – common stock	55,224	55,061
Accumulated other comprehensive loss	(105)	(113)
Accumulated deficit	(31,121)	(32,131)
<b>Total stockholders' equity</b>	<u>24,452</u>	<u>23,270</u>
<b>Total liabilities and stockholders' equity</b>	<u>\$ 27,713</u>	<u>\$ 26,625</u>

**Statements of cash flows  
for the year ended 31 December:**

	<b>2017</b> <b>Unaudited</b> <b>USD '000</b>	<b>2016</b> <b>Audited</b> <b>USD '000</b>
<b>Cash flows from operating activities</b>		
Net income	\$ 3,280	\$ 1,139
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	1,103	1,098
Stock based compensation expense	123	124
Allowance for doubtful accounts	36	22
Deferred taxes	(236)	-
Provision for excess and obsolete inventory	92	-
Loss on disposal of assets	32	-
<i>Changes in operating assets and liabilities</i>		
Accounts and other receivables	1,246	1,524
Inventory	(932)	143
Prepaid expenses	(9)	21
Other assets	3	(3)
Accounts payable	(171)	(1,127)
Accrued expenses and other liabilities	89	(128)
Deferred revenue	13	(8)
<b>Net cash provided by operating activities</b>	<u>4,669</u>	<u>2,805</u>
<b>Cash flows from investing activities</b>		
Restricted cash and investments	(7)	(18)
Payment of patent and trademark costs	(396)	(390)
Payment of software costs	(8)	(124)
Asset acquisitions	-	(3,118)
Cash refund on property and equipment	405	-
Purchases of property, plant and equipment	(71)	(130)
<b>Net cash provided by (used in) investing activities</b>	<u>(77)</u>	<u>(3,780)</u>
<b>Cash flows from financing activities</b>		
Dividends paid	(2,270)	-
Proceeds from exercise of stock options	42	-
<b>Net cash used in financing activities</b>	<u>(2,228)</u>	<u>-</u>
Effect of exchange rate on cash and cash equivalents	9	(25)
<b>Net increase (decrease) in cash and cash equivalents</b>	2,373	(1,000)
<b>Cash and cash equivalents, beginning of period</b>	8,808	9,808
<b>Cash and cash equivalents, end of period</b>	<u>\$ 11,181</u>	<u>\$ 8,808</u>



## Notes to financial information

### 1. Basis of preparation

This report was approved by the Directors on 16 March 2018.

This financial information has been prepared using the recognition and measurement principles of US Generally Accepted Accounting Principles.

These principal accounting policies were used in preparing its financial statements for the year ended 31 December 2017 and are unchanged from those disclosed in the Company's Annual Report for the year ended 31 December 2016.

### 2. Earnings per share

The calculation of basic earnings per share is based on the net income divided by the weighted average number of common shares outstanding. Diluted earnings per share is calculated by considering the dilutive impact of common stock equivalents under the treasury stock method as if they were converted into common stock as of the beginning of the period or as of the date of grant, if later. Excluded from the calculation of diluted earnings per common share for the years ended December 31, 2017 and 2016 were 400,164 and 8,725,673 shares, respectively, related to stock options because their exercise prices would render them anti-dilutive. The following table shows the calculation of basic and diluted earnings per common share.

	<b>Full Year to 31 Dec 2017</b>	<b>Full Year to 31 Dec 2016</b>
Numerator:		
Net income	\$ 3,280,082	\$ 1,139,053
Denominator:		
Weighted average common shares	45,369,084	45,251,370
Effect of dilutive securities:		
Stock Options	2,512,699	46,000
Diluted weighted average common shares	<u>47,881,783</u>	<u>45,297,370</u>
Earnings per common share:		
Basic:	<u>\$ 0.07</u>	<u>\$ 0.03</u>
Diluted:	<u>\$ 0.07</u>	<u>\$ 0.03</u>

### 3. Nature of financial information

The Preliminary Announcement set out above is an extract from the forthcoming Annual Report and Accounts and does not represent statutory accounts for Spectra Systems Corporation. The statutory accounts of Spectra Systems Corporation in respect of the period ended 31 December 2017 will be delivered to the Registrars of Companies before the Company's Annual General Meeting.

It is anticipated that the Annual Report and Accounts will be circulated to shareholders of Spectra Systems Corporation by April 2018.