

Spectra Systems Corporation
Interim results for the six months ended 30 June 2017

Spectra Systems Corporation, a leading provider of advanced technology solutions for banknote and product authentication, is pleased to announce its interim results for the six months ended 30 June 2017.

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

Financial highlights:

- Revenue up 48% in the first half at \$7,157k (2016: \$4,822k)
- Adjusted EBITDA¹ at \$3,022k (2016: \$26k)
- Adjusted PBTA¹ at \$2,834k (2016: \$(164k) loss)
- Earnings per share of \$0.05 (2016: \$(0.01) loss)
- Cash generated from operations of \$2,668k (2016: \$1,628k)
- Strong, debt-free balance sheet, with cash² of \$9,451k (2016: \$8,122k) at 30 June
- Inaugural annual dividend of \$0.05 per share (\$2,270k in aggregate) paid in June

¹ Before stock compensation expense and foreign currency effects

² Does not include \$1,097k (2016: \$1,083k) of restricted cash and investments

Operational highlights:

- In-house production throughout the first half of 2017 with significant margin uplift and consumption of inventory previously manufactured through contract services
- Record phosphor sales in the first half of \$3,342k (2016 \$1,513k – including 5 months of sales from January 2016 acquisition)
- Gross margin increased to 75% from 62% resulting from in-house manufacturing of covert materials and record high-margin phosphor sales
- Reduced operating expenses by \$526k through a planned reduction of R&D and re-allocation of internal resources to in house manufacturing
- Brand Authentication and Secure Transactions Group performing in line with expectations
- Completed staff reductions and facility consolidation which will further reduce costs in 2018

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

"The Company's revenues for the first half of 2017 are nearly 50% higher than 2016 which was largely fueled by phosphour sales to a new central bank through one of our long standing customers. The central bank driving the demand is entering a note redesign and we are hopeful that this increased revenue will continue once that redesign is completed for a significant period of time. Adjusted EBITDA for the first half of the year is markedly higher than last year resulting in strong midyear profitability. The combination of ongoing increased margins from in-house manufacturing, along with lower combined R&D and administrative costs, and the performance of the brand authentication and Secure Transactions Group in line with expectations, will result in a significant increase in earnings for the full year.

In addition, based on the recent approval in China of our materials for smartphone authentication, we expect to undertake important large scale production testing and validation of the technology for use in the tobacco industry this year."

"The Board therefore believes that the Company, by achieving key business milestones, will continue to perform well for the remainder of 2017 with excellent prospects for ongoing earnings growth thereafter."

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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 is on track to deliver an excellent performance for the full 2017 financial year.

Revenue for the half year was \$7,157k (2016: \$4,822k) due to record phosphor sales and higher sales of covert materials. Revenue this year will be heavily biased towards the first half of 2017 with continued positive earnings anticipated throughout H2.

Gross margin increased to 75% from 62% resulting from in-house manufacturing for a G7 central bank and record high margin phosphor sales.

The fulfilment of all our covert materials orders to our G7 central bank customer and 18 other central banks through in-house manufacturing will have a significant and ongoing impact on our performance beginning with 2017.

As a result of the above factors, Adjusted EBITDA (before stock compensation expense) for the half year achieved \$3,022k compared to the prior year of \$26k.

Having generated cash from operations of \$2,668k (2016: \$1,628k) cash at the period end amounted to \$9,451k (2016: \$8,122k), excluding \$1,097k of restricted cash and investments (2016: \$1,083k). This is notwithstanding \$2,270k paid to shareholders during June in the form of the Company's inaugural dividend of \$0.05 per share. The Company has sufficient resources to execute on its growth plans with its existing cash reserves.

Review of Operations

Authentication Systems

The Authentication Systems business, which includes the security phosphor materials, generated revenue of \$6,548k (2016: \$4,264k) and Adjusted EBITDA of \$2,808k (2016: (\$139k) loss). Authentication Systems revenues are driven by covert material sales 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 have achieved significant margin increases from using our in-house manufacturing facility and with three consecutive quarters of operations we now have a refined understanding of this long-term uplift in margins.

The achievement of significantly higher margins for our covert materials has been complemented with continued strong sales and margins of brand authentication materials and particularly phosphors. The brand authentication business is performing on track and continues to have significant prospects in China bolstered by the recent approval of our TruBrand™ materials for use in tobacco products. The Company further expects to receive patent protection for this technology in the second half of 2017 with further expansion of the intellectual property protection over the following few years.

In addition to our current suite of products and technologies in this segment of the business, we expect to execute a development agreement, which should ultimately result in a licensing and supply agreement for a new technology for polymer banknotes, with a large supplier of banknotes this year.

Secure Transactions Group

The Secure Transactions Group, formed around the various gaming technology acquisitions made in 2012, performed in line with management expectations, generating Adjusted EBITDA of \$214k (2016: \$165k) on revenue of \$609k (2016: \$558k).

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 be able to attract more customers from our competitors.

Strategy

The Company's strategy for increasing revenue and earnings continues to evolve further towards brand authentication and specialty optical materials for security applications relative to the central bank focused efforts of the last several years.

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. With multiple developed technologies for both paper and polymer substrates already in front of potential customers, we no longer need to fund internally the development of covert banknote technologies. This strategy is expected to result in funded development of a new sensor and materials for polymer banknotes from a current partner beginning this year. In parallel, the Company is continuing to refine and market the Aeris™ machine and technology to specific customers, primarily in Central America and Africa.

The Company has made a significant and deliberate strategic decision to aggressively grow its revenue and earnings through the sale of secure materials beyond the covert central bank products. This approach focuses on generating high margins from our unique security materials, which include phosphors and taggants for brand authentication. Taggant sales for brand authentication using our TruBrand™ smartphone technology will create new revenue streams for both materials as well as for the Secure Transactions Group through cloud-based server authentication, bringing a fully synergistic benefit to the entire business. The path towards realization of this model has already gained traction through the recent approval of our smartphone-based authentication materials in China this year.

Mirroring the shift towards secure materials is an effort to continue to try and find ways to reduce and restructure our staffing as well as our infrastructure needs.

The shift in emphasis will accelerate revenue growth, reduce costs, and further increase and smooth out our earnings as we go forward.

Prospects

The Company's shorter term prospects have increased with the growth of the authentication business beyond covert materials and hardware. In addition, while we are transitioning to a mode of capitalising on our already developed covert technologies and customers, we have several significant opportunities ahead.

We are targeting seven specific opportunities, four of which are relatively near term and three of which are somewhat longer term.

The important, near term, and significant opportunities are:

- 1) The successful production-scale testing of our TruBrand™ taggants by several large tobacco suppliers in China
- 2) The sale of TruBrand materials along with cloud based authentication services
- 3) Increased revenue for the Secure Transactions Group from both online gaming, virtual machine capabilities our competitors do not have, and cloud-based authentication service for our TruBrand™ customers.
- 4) The funded development of a polymer banknote technology by a major printer of banknotes

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

- 5) A licensing and supply agreement for polymer based technology developed through external funding
- 6) The development and supply of further upgraded sensor capability to a G7 central bank in response to a standardization requirement
- 7) The sale of our smartphone technology TruNote™ for the authentication of banknotes

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.

Nabil M. Lawandy
Chief Executive Officer
September 5, 2017

**Statements of income and other comprehensive income
for the half year ended 30 June 2017**

	Note	Half Year to 30 Jun 2017 Unaudited USD '000	Half Year to 30 Jun 2016 Unaudited USD '000	Full Year to 31 Dec 2016 Audited USD '000
Revenue		\$ 7,157	\$ 4,822	\$ 11,122
Cost of sales		<u>1,782</u>	<u>1,846</u>	<u>3,524</u>
Gross profit		5,375	2,976	7,598
Operating expenses		<u>2,912</u>	<u>3,438</u>	<u>6,506</u>
Operating profit (loss)		2,463	(462)	1,092
Interest and other income		18	32	53
Foreign currency gain (loss)		<u>(5)</u>	<u>-</u>	<u>(6)</u>
Profit (loss) before taxes		2,476	(430)	1,139
Provision for income taxes		<u>33</u>	<u>-</u>	<u>-</u>
Net income (loss)		<u>\$ 2,443</u>	<u>\$ (430)</u>	<u>\$ 1,139</u>
Earnings per share	2			
Basic		\$ 0.05	\$ (0.01)	\$ 0.03
Diluted		\$ 0.05	\$ (0.01)	\$ 0.03
Other comprehensive income (loss)				
Unrealized loss on currency exchange		-	30	(33)
Reclassification for realized loss in net income		<u>4</u>	<u>-</u>	<u>6</u>
Total other comprehensive income (loss)		4	30	(27)
Comprehensive income (loss)		<u>\$ 2,447</u>	<u>\$ (400)</u>	<u>\$ 1,112</u>

All of the Group's operations are continuing

**Balance sheets
as of 30 June 2017**

	As of 30 Jun 2017 Unaudited USD '000	As of 30 Jun 2016 Unaudited USD '000	As of 31 Dec 2016 Audited USD '000
Current assets			
Cash and cash equivalents	\$ 9,451	\$ 8,122	\$ 8,808
Trade and other receivables	2,277	1,052	2,706
Inventory	3,442	2,966	2,915
Prepaid expenses	388	143	104
Deferred tax assets	619	170	619
Total current assets	<u>16,177</u>	<u>12,453</u>	<u>15,152</u>
Non-current assets			
Property, plant and equipment, net	1,954	2,719	2,561
Intangible assets, net	7,170	7,640	7,304
Restricted cash and investments	1,097	1,083	1,092
Deferred tax assets	370	819	370
Other assets	156	19	146
Total non-current assets	<u>10,747</u>	<u>12,280</u>	<u>11,473</u>
Total assets	<u>\$ 26,924</u>	<u>\$ 24,733</u>	<u>\$ 26,625</u>
Current liabilities			
Accounts payable	\$ 79	\$ 265	\$ 402
Accrued expenses and other liabilities	1,670	1,558	1,437
Deferred revenue	1,319	988	1,260
Total current liabilities	<u>3,068</u>	<u>2,811</u>	<u>3,099</u>
Non-current liabilities			
Deferred revenue	306	277	256
Total non-current liabilities	<u>306</u>	<u>277</u>	<u>256</u>
Total liabilities	<u>3,374</u>	<u>3,088</u>	<u>3,355</u>
Stockholders' equity			
Common stock	454	453	453
Additional paid in capital – common stock	55,164	54,950	55,061
Accumulated other comprehensive loss	(109)	(57)	(113)
Accumulated deficit	(31,959)	(33,701)	(32,131)
Total stockholders' equity	<u>23,550</u>	<u>21,645</u>	<u>23,270</u>
Total liabilities and stockholders' equity	<u>\$ 26,924</u>	<u>\$ 24,733</u>	<u>\$ 26,625</u>

**Statements of cash flows
for the half year ended 30 June 2017**

	Half Year to 30 Jun 2017	Half Year to 30 Jun 2016	Full Year to 31 Dec 2016
	<u>Unaudited USD '000</u>	<u>Unaudited USD '000</u>	<u>Audited USD '000</u>
Cash flows from operating activities			
Net income	\$ 2,443	\$ (430)	\$ 1,139
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	497	476	1,098
Stock based compensation expense	63	13	124
Allowance for doubtful accounts	-	-	22
<i>Changes in operating assets and liabilities</i>			
Accounts receivable	429	3,201	1,524
Inventory	(528)	(142)	143
Prepaid expenses	(282)	(23)	21
Other assets	(1)	-	(3)
Accounts payable	(291)	(1,199)	(1,127)
Accrued expenses and other liabilities	231	(8)	(128)
Deferred revenue	107	(260)	(8)
Net cash provided by operating activities	<u>2,668</u>	<u>1,628</u>	<u>2,805</u>
Cash flows from investing activities			
Restricted cash and investments	(5)	(9)	(18)
Payment of patent and trademark costs	(161)	(149)	(390)
Payment of software costs	(9)	-	(124)
Asset acquisitions	-	(3,118)	(3,118)
Cash refund on property and equipment	405	-	-
Purchases of property, plant and equipment	(31)	(71)	(130)
Net cash provided by (used in) investing activities	<u>199</u>	<u>(3,347)</u>	<u>(3,780)</u>
Cash flows from financing activities			
Dividends paid	(2,270)	-	-
Proceeds from exercise of stock options	42	-	-
Net cash used in financing activities	<u>(2,228)</u>	<u>-</u>	<u>-</u>
Effect of exchange rate on cash and cash equivalents	4	33	(25)
Net increase (decrease) in cash and cash equivalents	643	(1,686)	(1,000)
Cash and cash equivalents, beginning of period	8,808	9,808	9,808
Cash and cash equivalents, end of period	<u>\$ 9,451</u>	<u>\$ 8,122</u>	<u>\$ 8,808</u>

Notes to financial information

1. Basis of preparation

This report was approved by the Directors on 30 August 2017.

This financial information has been prepared using the recognition and measurement principles of US Generally Accepted Accounting Principles. The Group has not elected to apply IAS 34 Interim Financial Reporting.

The principal accounting policies used in preparing the interim results are those the Company expects to apply in its financial statements for the year ending 31 December 2017 and are unchanged from those disclosed in the Company's Annual Report for the year ended 31 December 2016.

The results for the half year are unaudited. The financial information for the year ended 31 December 2016 does not constitute the full statutory accounts for that period. The Annual Report and financial statements for the year ended 31 December 2016 have been filed with the Registrar of Companies. The Independent Auditors' Report on the financial statements for the year ended 31 December 2016 was unqualified and did not draw attention to any matters by way of emphasis.

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. For the first half of 2016, the exercise price of all options exceeded the average market price of the shares in issue and therefore are not considered in the diluted earnings per share calculation. The following table shows the calculation of basic and diluted earnings per common share.

	Half Year to 30 Jun 2017	Half Year to 30 Jun 2016	Full Year to 31 Dec 2016
Numerator:			
Net income	\$ 2,443,000	\$ (430,000)	\$ 1,139,000
Denominator:			
Weighted average common shares	45,319,499	45,251,370	45,251,370
Effect of dilutive securities:			
Stock Options	1,486,897	-	46,000
Diluted weighted average common shares	<u>46,806,396</u>	<u>45,251,370</u>	<u>45,297,370</u>
Earnings per common share:			
Basic:	<u>\$ 0.05</u>	<u>\$ (0.01)</u>	<u>\$ 0.03</u>
Diluted:	<u>\$ 0.05</u>	<u>\$ (0.01)</u>	<u>\$ 0.03</u>

3. Copies of this statement are available to the public on the Company's website at <http://www.spsy.com>.