

Spectra Systems Corporation
Interim Results for the Six Months Ended 30 June 2019

This announcement contains inside information for the purposes of Article 7 of the Market Abuse Regulation (EU) No. 596/2014.

Spectra Systems Corporation (the “Company”), 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 2019.

Financial highlights:

- Spectra expecting growth in earnings for full year, in line with latest market expectations
- Revenue of \$6,402k (2018: \$7,953k) due to exceptional G7 customer order in H1 2018
- Adjusted EBITDA¹ of \$2,461k (2018: \$3,930k), reflecting Spectra’s operating leverage
- Adjusted earnings² per share of US \$4.8 cents (2018: US \$7.8 cents), again reflecting Spectra’s operating leverage
- Cash generated from operations of \$1,993k (2018: \$4,051k)
- Annual 2018 dividend up 17% to US\$0.07 per share (\$3,213k in aggregate) paid in June
- Strong, debt-free balance sheet, with cash³ of \$11,142k (2018: \$12,295k) at 30 June

¹ Before stock compensation expense

² Before amortization and stock compensation expense

³ Does not include \$1,099k (2018: \$1,099k) of restricted cash and investments

Operational highlights:

- Execution of a five year service agreement with a major banknote printer and existing licensee
- Execution of a five year extension to a supply agreement with one of the world’s largest suppliers of security inks
- Execution of a ten year agreement with a multinational supplier of polymer for our newest machine readable banknote substrates
- New international jurisdiction contract win for the secure transactions group increasing its customers to 17 USA states and three international lotteries
- Market introduction of our TruBrand product in the Chinese market (>6,000,000 packs)

- Early stage research funding for future sensor technology development for a G7 central bank
- Full qualification of our phosphors with a security thread supplier to a major Asian central bank

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

"The Company's first half revenues and earnings are significantly lower than last year due to the front loaded scenario of 2018. This is fully in line with the Board's expectations for H1 and is due to the increased manufacturing of materials required in the first half last year by our G7 customer.

"Our H2 results are expected to be significantly higher than the second half of 2018 primarily due to revenue contracted in H2 relating to the development work for the same customer.

"The Board therefore believes that the Company is on track to achieve record earnings for the full year, as reflected by the recent significant trading upgrade issued on 17/9/2019, and continue the recent track record of growth fueled by new products and new business from long standing customers."

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Chief Executive Officer's statement

Introduction

Having achieved a number of key commercial milestones, as described in the Review of Operations below, Spectra Systems is on track to deliver an excellent performance for the full 2019 financial year as supported by the Trading Update released on 17/9/2019.

Revenue for the half year was down 20% at \$6,402k (2018: \$7,953k) due to lower material production in the first half of the year. Revenue this year will be biased towards the second half of 2019 with significant positive earnings anticipated throughout H2, including revenues contracted from our G7 development program in H2.

As a result of the above factors, Adjusted EBITDA (before stock compensation expense) for the half year was down 39% at \$2,461k compared to the prior year of \$3,930k.

Having generated cash from operations of \$1,993k (2018: \$4,051k), cash at the period end amounted to \$11,142k (2018: \$12,295k), excluding \$1,099k of restricted cash and investments (2018: \$1,099k). This is notwithstanding \$3,213k paid to shareholders during June in the form of the Company's dividend of \$0.07 per share.

Based on the expected revenue and earnings for the second half of the year, the Company anticipates a similar increase in the end of year dividend relative to 2018.

Review of Operations

Authentication Systems

The Authentication Systems business, which includes security phosphor materials, generated revenue of \$5,722k (2018: \$7,326k) and Adjusted EBITDA of \$2,280k (2018: \$3,681k).

Authentication Systems revenues were primarily in the form of royalty and licence payments by our licensee and direct sales to another G7 central bank. Revenues in the first half of the year relative to H1, 2018 are lower due to the higher than expected H1 2018 materials order.

We have executed a key exclusive supply agreement with a global polymer producer to provide the industry's first and only machine-readable polymer banknote substrate. This is a key development that could increase authentication revenues by an order of magnitude as we move up the banknote production supply chain through the combination of substrate and security in the polymer substrate.

We are delighted that the TruBrand authentication product has been successfully introduced in the Chinese tobacco market with over 6 million packs with our smartphone authentication in retail stores. In addition, working with our polymer partner, we have developed a new product family, a smartphone readable packaging film for use in the brand authentication market where print is not an option.

Secure Transactions Group

The Secure Transactions Group, formed around the various gaming technology acquisitions made in 2012, generated an Adjusted EBITDA of \$181k (2018: \$249k) on revenue of \$680k (2018: \$627k). The lower EBITDA in H1 is due to onetime ISO 27001 certification costs, recruiting fees and bonus payments aimed at employee retention. We are confident that the higher revenue will continue in H2 and result in equal or better margin performance for the group on a full year basis.

The group has also won a new contract with a major European lottery taking its international customer base to three lotteries, increasing its profile on the international stage as more jurisdictions consider outsourcing the internal control function.

Strategy

The Company's strategy for increasing revenue and earnings continues to be focused on brand authentication and specialty optical materials for security applications, while maintaining a robust effort to commercialize its covert security technologies with an emphasis on polymer banknotes. The brand authentication sector offers short term growth and some very large opportunities for smartphone based technology, while the covert banknote security sector provides long term, multi-decade revenues once new contracts are executed.

On the brand authentication front, we have formed new relationships with Retainagroup Limited, a UK based company which has deep inroads in the automotive field where we believe there are numerous large scale opportunities for both our traditional hand held reader products as well as TruBrand.

We have formed a partnership with one of the largest suppliers of polymer substrates used for banknotes with the goal of eventually being a supplier of polymer substrates with unique covert properties, a capability which has not been possible to date. Our effort in security features for polymer banknotes has been driven by the polymer banknote beginning to outpace paper banknote production; the CAGR of polymer substrate banknotes is estimated to be 18%, far outpacing paper substrates ^(a). Our newest machine readable substrate will allow central banks to use polymer for all denominations, without sacrificing the inherent substrate security previously only obtainable with paper substrates. We believe that once adopted by a central bank, we will not only have effectively expanded the available market beyond its current size, but on an exclusive basis.

(a) Global Polymer Banknotes Market: Industry Analysis & Outlook, Koncept Analytics (2019)

Prospects

The important, near-term opportunities (2020 – 2022) are:

- The increased number of tobacco packs sold in China with our TruBrand materials and smartphone App. Management is confident that TruBrand will reach several hundred million packs
- The adoption of one of our covert security products by a major Asian central bank
- The adoption of our phosphors for use by a supplier of products to a major Asian central bank
- Additional funding beyond the currently contracted research program with a G7 central bank

The longer term opportunities are:

- A licensing and supply agreement for polymer based technology developed with a major central bank
- The development and supply of further upgraded sensor capability to a G7 central bank following the contracted development phase

- The introduction of a secure polymer substrate to central banks, which combines high security and a durable substrate in one product

The list of prospects reflects the full pipeline of significant opportunities and does not include smaller growth areas, such as K-cups and non-banknote optical materials sales.

Of particular importance is the shift of the Asian central bank prospect from the long-term to the short term. This is a direct consequence of the issuance of an RFP which has been awaited for over a decade. Based on the timing of the responses, we believe that a decision will now be made on this part of the tender in 2020.

Nabil M. Lawandy
Chief Executive Officer
September 23, 2019

**Statements of income and other comprehensive income
for the half year ended 30 June 2019**

	Half Year to 30 Jun 2019 Unaudited USD '000	Half Year to 30 Jun 2018 Unaudited USD '000	Full Year to 31 Dec 2018 Audited USD '000
Note			
Revenue	\$ 6,402	\$ 7,953	\$ 12,494
Cost of sales	<u>1,969</u>	<u>2,084</u>	<u>3,527</u>
Gross profit	4,433	5,869	8,967
Operating expenses	<u>2,503</u>	<u>2,521</u>	<u>5,078</u>
Operating profit (loss)	1,930	3,348	3,889
Interest and other income	76	85	158
Foreign currency gain (loss)	<u>(7)</u>	<u>(9)</u>	<u>(11)</u>
Profit (loss) before taxes	1,999	3,424	4,036
Benefit (provision) for income taxes	<u>(11)</u>	<u>(6)</u>	<u>19</u>
Net income (loss)	<u>\$ 1,988</u>	<u>\$ 3,418</u>	<u>\$ 4,055</u>
Earnings per share	2		
Basic	\$ 0.04	\$ 0.08	\$ 0.09
Diluted	\$ 0.04	\$ 0.07	\$ 0.08
Other comprehensive income (loss)			
Unrealized gain (loss) on currency exchange	3	(8)	(19)
Reclassification for realized loss in net income	<u>7</u>	<u>9</u>	<u>11</u>
Total other comprehensive income (loss)	10	1	(8)
Comprehensive income (loss)	<u>\$ 1,998</u>	<u>\$ 3,419</u>	<u>\$ 4,047</u>

All of the Group's operations are continuing

**Balance sheets
as of 30 June 2019**

	As of 30 Jun 2019 Unaudited USD '000	As of 30 Jun 2018 Unaudited USD '000	As of 31 Dec 2018 Audited USD '000
Current assets			
Cash and cash equivalents	\$ 11,142	\$ 12,295	\$ 12,662
Trade and other receivables	2,011	1,088	1,214
Inventory	3,011	3,337	3,269
Prepaid expenses	229	171	141
Total current assets	<u>16,393</u>	<u>16,891</u>	<u>17,286</u>
Non-current assets			
Property, plant and equipment, net	1,651	1,662	1,587
Operating lease right of use assets, net	1,233	-	-
Intangible assets, net	6,490	6,802	6,697
Restricted cash and investments	1,099	1,099	1,099
Deferred tax assets	1,400	1,303	1,400
Other assets	151	147	150
Total non-current assets	<u>12,024</u>	<u>11,013</u>	<u>10,933</u>
Total assets	<u>\$ 28,417</u>	<u>\$ 27,904</u>	<u>\$ 28,219</u>
Current liabilities			
Accounts payable	\$ 329	\$ 263	\$ 269
Accrued expenses and other liabilities	701	978	827
Operating lease liabilities, short term	242	-	-
Taxes payable	3	3	3
Deferred revenue	887	985	703
Total current liabilities	<u>2,162</u>	<u>2,229</u>	<u>1,802</u>
Non-current liabilities			
Operating lease liabilities, long term	1,017	-	-
Deferred revenue	498	458	540
Total non-current liabilities	<u>1,515</u>	<u>458</u>	<u>540</u>
Total liabilities	<u>3,677</u>	<u>2,687</u>	<u>2,342</u>
Stockholders' equity			
Common stock	459	455	455
Additional paid in capital – common stock	55,465	55,298	55,390
Accumulated other comprehensive loss	(103)	(104)	(114)
Accumulated deficit	(31,079)	(30,432)	(29,854)
Less: Common stock held in treasury	(2)	-	-
Total stockholders' equity	<u>24,740</u>	<u>25,217</u>	<u>25,877</u>
Total liabilities and stockholders' equity	<u>\$ 28,417</u>	<u>\$ 27,904</u>	<u>\$ 28,219</u>

**Statements of cash flows
for the half year ended 30 June 2019**

	Half Year to 30 Jun 2019	Half Year to 30 Jun 2018	Full Year to 31 Dec 2018
	<u>Unaudited USD '000</u>	<u>Unaudited USD '000</u>	<u>Audited USD '000</u>
Cash flows from operating activities			
Net income	\$ 1,988	\$ 3,418	\$ 4,055
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	484	507	1,005
Stock based compensation expense	47	75	156
Lease amortization expense	126	-	-
Allowance for doubtful accounts	-	-	6
Deferred Taxes	-	(78)	(175)
Provision for excess and obsolete inventory	-	51	250
Loss on disposal of assets	-	-	1
<i>Changes in operating assets and liabilities</i>			
Accounts and other receivables	(795)	334	205
Inventory	258	366	235
Prepaid expenses	(87)	(56)	(27)
Other assets	-	4	1
Accounts payable	60	62	69
Operating leases	(100)	-	-
Accrued expenses and other liabilities	(127)	(547)	(696)
Deferred revenue	139	(85)	(345)
Net cash provided by operating activities	<u>1,993</u>	<u>4,051</u>	<u>4,740</u>
Cash flows from investing activities			
Payment of patent and trademark costs	(67)	(139)	(325)
Purchases of property, plant and equipment	(273)	(71)	(206)
Net cash provided by (used in) investing activities	<u>(340)</u>	<u>(210)</u>	<u>(531)</u>
Cash flows from financing activities			
Dividends paid	(3,213)	(2,728)	(2,728)
Acquisition of treasury stock	(2)	-	-
Proceeds from exercise of stock options	32	-	11
Net cash used in financing activities	<u>(3,183)</u>	<u>(2,728)</u>	<u>(2,717)</u>
Effect of exchange rate on cash and cash equivalents	10	1	(11)
Net increase (decrease) in cash and cash equivalents	(1,520)	1,114	1,481
Cash and cash equivalents, beginning of period	12,662	11,181	11,181
Cash and cash equivalents, end of period	<u>\$ 11,142</u>	<u>\$ 12,295</u>	<u>\$ 12,662</u>

Notes to financial information

1. Basis of preparation

This report was approved by the Directors on 20 September 2019.

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 2019 and are unchanged from those disclosed in the Company's Annual Report for the year ended 31 December 2018.

The results for the half year are unaudited. The financial information for the year ended 31 December 2018 does not constitute the full statutory accounts for that period. The Annual Report and financial statements for the year ended 31 December 2018 have been filed with the Registrar of Companies. The Independent Auditors' Report on the financial statements for the year ended 31 December 2018 was unmodified 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. The following table shows the calculation of basic and diluted earnings per common share.

	<u>Half Year to 30 Jun 2019</u>	<u>Half Year to 30 Jun 2018</u>	<u>Full Year to 31 Dec 2018</u>
Numerator:			
Net income	\$ 1,988,000	\$ 3,418,000	\$ 4,054,949
Denominator:			
Weighted average common shares	45,839,118	45,450,098	45,463,480
Effect of dilutive securities:			
Stock Options	2,633,209	3,509,747	3,472,948
Diluted weighted average common shares	<u>48,472,327</u>	<u>48,959,845</u>	<u>48,936,428</u>
Earnings per common share:			
Basic:	<u>\$ 0.04</u>	<u>\$ 0.08</u>	<u>\$ 0.09</u>
Diluted:	<u>\$ 0.04</u>	<u>\$ 0.07</u>	<u>\$ 0.08</u>

3. Leases

On January 1, 2019, the Company adopted ASU No. 2016-02, "Leases (Topic 842)" utilizing the modified retrospective adoption method which allows entities to not restate the comparative prior periods in the period of adoption when transitioning to Topic 842. Under Topic 842, the Company elected the package of transition practical expedients to not reassess (1) any expired or existing contracts that are leases or contain leases, (2) the classification of any expired or existing leases and (3) initial direct costs for any existing leases. Therefore, the consolidated condensed financial statements for 2019 are presented under the new standard, while the comparative periods presented are not adjusted and continue to be reported in accordance with the Company's historical accounting policy. This standard requires all lessees to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, for

all leases with a term greater than 12 months. The adoption of the new lease standard had a significant impact on the Company's consolidated condensed balance sheets due to the recognition of right-of-use assets for operating leases and a corresponding lease obligation of. The adoption of Topic 842 did not have a material impact on the Company's lease classification or on its statements of operations and liquidity.

The Company leases office space, manufacturing plants, warehouses and laboratory space. Certain real estate leases include one or more options to renew, with renewal terms that can extend the lease term for up to five years. The exercise of lease renewal options are at the Company's sole discretion. When deemed reasonably certain of exercise, the renewal options are included in the determination of the lease term and lease payment obligation, respectively.

Right-of-use ("ROU") assets represent the right to use an underlying asset for the lease term and lease liabilities represent the obligation to make lease payments arising from the lease. Operating lease ROU assets and liabilities are recognized at the commencement date of the lease based on the present value of lease payments over the lease term. When readily determinable, the Company uses the rate implicit in the lease contract in determining the present value of lease payments. If the implicit rate is not provided, the Company uses its incremental borrowing rate based on information available at the lease commencement date, including the lease term. The operating lease ROU asset also includes any lease payments made and excludes lease incentives. Lease expense for lease payments is recognized on a straight-line basis over the lease term. The Company has lease agreements with lease and non-lease components and has elected to account for the lease and non-lease components as a single lease component.

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