Spectra Systems Corporation

Audited results for the twelve months ended 31 December 2019

Spectra Systems Corporation, a leading provider of advanced technology solutions for banknote and product authentication and gaming security, is pleased to announce its audited results for the twelve months ended 31 December 2019.

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

Financial highlights:

- Revenue up 6% for the year at US$13,234k (2018: US$12,494k)
- Adjusted EBITDA[1] up 8% at US$5,473k (2018: US$5,045k)
- Adjusted PBTA[1] up 9% to US$5,235k (2018: US$4,782k)
- Adjusted earnings[2] per share up 6% to US$10.4 cents (2018: US$9.8 cents)
- Net income up 7% at US$4,335k (2018: US$4,055k)
- Cash generated from operations of US$5,789k (2018: US$4,740k)
- Strong, debt-free balance sheet, with cash[3] of US$14,250k (2018: US$12,662k)
- Declaring special annual dividend up 28.5% to US$0.09 per share to be paid in June to reflect freed-up cash

[1] *Before stock compensation expense*
[2] *Before amortization and stock compensation expense*
[3] *Does not include US$1,344k (2018: US$1,099k) of restricted cash and investments*

Operational highlights:

- Execution of a ten-year agreement with a multinational supplier of polymer for our newly developed machine readable polymer banknote substrates (MR-BOPP)
- Market introduction of our TruBrand product in the Chinese market (>6,000,000 packs) and scheduled machine tests for larger-scale production
- Covert technology submission to a major Asian central bank tender has resulted in a semi-final selection of Spectra Systems and one other company, with the decision pending
- Execution of a five-year extension to a supply agreement with one of the world's largest suppliers of security inks
- G7 central bank order for three advanced quality control units used in the manufacturing of banknotes with our materials
- Accelerated research funding for future sensor technology development for a G7 central bank with both phases of two approved and extending through Q1 2021

- New international jurisdiction contract win for the secure transactions group increasing its customers to 17 USA states and three international lotteries and the commencement of a product upgrade effort which will result in downstream personnel savings

- Full qualification of our phosphors with a security thread supplier to a major Asian central bank

- Execution of a five-year service agreement with a major banknote printer and existing licensee and renewal of a five-year service agreement with a G7 central bank

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

"The Company's revenues have increased by 6% and PBTA is up 9% over 2018 driven by significant early stage research funding for future sensor technology development for a G7 central bank and equipment sales to a major banknote printer."

"The delivery of two quality control devices to a tobacco manufacturer and the adoption of TruBrand smartphone authentication technology to protect a top cigarette brand in China has increased our chances of expanding the use of this product to the billions of packs in the market over time. In spite of expected delays due to Covid 19, we expect these production trials with the QC devices to take place in the second half of 2020, thereby shifting orders to 2021. In addition, we have testing underway with a polymer based solution for cigarette packaging as another modality of using our TruBrand technology."

"With the spread of the Covid 19 virus and the sporadic implication of banknotes as a means of transmission, we have received a significant number of enquiries from central banks and banknote equipment suppliers representing retail operations such as casinos regarding our Aeris banknote cleaning and disinfection system. This is unlikely to result in immediate sales but could create downstream, post coronavirus outbreak, interest to have readiness for future viral or bacterial pandemics."

"The rapid development of our breakthrough, first in the industry, machine-readable and highly transparent polymer banknote substrate will allow us to highlight this new product at the Banknote 2020 conference (re-scheduled to November 2-5, 2020 due to Covid 19) where we hope to enlist several central banks into trials which will allow us to be a viable supplier when they open their next tenders."

"Our strong two decade long relationship with a G7 central bank continues to drive the introduction of more advanced products and an increasingly steady stream of hardware sales. These advances in hardware are expected to result in even more advanced taggants, with increased revenues and margins in the long term."

"In addition, with the Company's strong cash position and ultra-stable banknote business, the Board is examining the possibility of expanding the business beyond authentication in areas where our core competence of optics, chemistry, and engineering could be effectively leveraged to more rapidly increase shareholder value."

"The Board believes that the Company, by achieving key business milestones, will continue to perform well and will exceed market expectations for 2020."

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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 2019 financial year, continuing its track record of year to year profit growth.

Revenue for the year was US$13,234k (2018: US$12,494k) due to early-stage research funding for future sensor technology development for a G7 central bank and equipment sales to a major banknote printer. In addition, sales of optical materials deferred from 2018 further enhanced our revenue in 2019. Covert materials revenue was down in comparison to the prior year which contained higher than normal customer orders. Adjusted EBITDA (before stock compensation expense) for the year increased 8% to US$5,473k compared to the prior year of US$5,045k, which resulted in net income up 7% at US$4,335k (2018: US$4,055k) despite a US$219K increase in tax expense as the Company has fully utilized its state net operating loss carryforwards and is now liable for payment of Rhode Island state income taxes.

Having generated cash from operations of US$5,789k (2018: US$4,740k), cash at the period end amounted to US$14,250k (2018: US$12,662k), excluding US$1,344 of restricted cash and investments as of December 31, 2019 (2018: US$1,099k). This is notwithstanding US$3,213k paid to shareholders during June 2019 in the form of the Company's dividend of US$0.07 per share.

With increased clarity on the terms of the Asian central bank bond requirements if we are successful, the Company is therefore declaring an annual dividend up 28.5% at $0.09 per share to be paid in June 2020. This is a one-time special dividend to return capital to shareholders as one of the key reasons for holding cash has been resolved. The Company will continue to have sufficient cash resources thereafter to execute on its growth plans.

Finally, the Board of Directors will be extending the share buy-back authorization of up to 4,500,000 common shares through the end of March 2021, under the same terms as announced on April 10, 2019. A total of 51,000 common shares have already been purchased and cancelled under this authority.

Review of Operations

Authentication Systems

The Authentication Systems business, which includes security phosphor materials, generated revenue of US$11,829k (2018: US$11,204k) and adjusted EBITDA of US$5,065k (2018: US$4,584k). Authentication Systems revenues are driven by sales of covert materials and their associated equipment and service, optical materials and license royalties. We sell covert materials directly to one G7 central bank and indirectly to 19 other central banks through our supply and licensing agreements with a major banknote supplier and printer who pays a license royalty for the exclusive rights to our technology.

The increased revenue is due to early stage research funding for future sensor technology development for a G7 central bank, equipment sales to a major banknote printer and increased sales of optical materials. Covert materials revenue was down in comparison to the prior year which contained higher than normal customer orders.

The TruBrand authentication business penetrated the Chinese market with the introduction of our product on over 6 million packs of cigarettes. However, a larger-scale trial on a different printing process has suffered a temporary delay due to the Covid 19 pandemic and is expected to be back on track by the second half of 2020. Once the print trial with our current customer is completed, we expect orders in the hundreds of millions of packs to follow. Further, we have good traction with other opportunities for TruBrand in areas ranging from sports memorabilia to tires which are not as directly affected by Covid 19.

Our optical materials-based product which allows k-cups to be compatible and functional with Keurig coffee makers continues to be a success and we are currently in trials with a new and larger supplier of fully compostable coffee pods for the Keurig system.

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, our MR-BOPP product. 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 featuring our MR-BOPP at the Banknote 2020 conference in Washington DC which has been rescheduled to November 2-5 due to Covid 19 and hope to interest central banks in validating the product performance for their specifications and next tenders for polymer substrates.

Secure Transactions Group

The Secure Transactions Group generated revenue of US$1,405k (2018: US$1,290k) and adjusted EBITDA of US$408k (2018: US$461k). The delays relating to the release of new lottery industry regulations which stalled additional revenue during 2018 from the usual software development related to the introduction of new games continued into 2019. Despite this, revenue increased 9% due to the effect of new contracts from 2018 and system conversions to our 64-bit Premier Integrity product. The Group has also won a new contract with a major European lottery taking its international customer base to three lotteries, and increasing its profile on the international stage as more jurisdictions consider outsourcing the internal control function. The lower EBITDA in 2019 is due to ISO 27001 certification costs and recruiting fees and salaries which are an investment in future lower operating costs, particularly on the software development side of the business. These increased salary costs are expected to last for approximately 18 months and will be recovered in reduced operational costs by 2022.

Strategy

The Company's strategy for increasing revenue and earnings continues to be focused on both brand authentication and a robust effort to commercialize our covert security technologies with an emphasis on polymer banknotes and technology driven existing central bank customers. The brand authentication sector offers short-term growth potential and some very large opportunities for smartphone-based technology, while the covert banknote security sector provides stable long-term, multi-decade revenues once new contracts are executed.

We have formed a partnership with one of the largest suppliers of polymer substrates with the goal of eventually being a supplier of polymer substrates with unique covert properties, a capability which has not been possible to date until the introduction of our MR-BOPP product. 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, MR-BOPP, 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 will do so on an exclusive basis.

Through our close, multi-decade relationship with our direct G7 customer, we have become a trusted supplier of technology and hence have already begun funded hardware work related to our existing sensors as well as new efforts to further improve their anti-counterfeit detection capabilities. We are strategically enabling our long-term G7 customer to use more advanced taggants which will result in higher revenue and increased profitability for many decades to come once implemented.

With a strong and sticky customer base in the banknote sector providing stability and growth, the Company is examining the possibilities of diversifying the business beyond authentication. Other business areas where our core competencies in optics, engineering, physics and chemistry are at the world class level include biotechnology assays, energy conversion, and medical devices. Over the next quarter, we will have concluded this study and will report to shareholders on our findings.

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

Prospects

The Company continues to have numerous long-term and shorter-term prospects. The shorter-term opportunities are expected in the 2020-2022 period and the longer-term opportunities are expected in the 2023-2025 time frame.

The important, near-term opportunities 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 once the Covid 19 situation resolves itself and we successfully complete the new print trial with our existing customer;
- The adoption of one of our covert security products by a major Asian central bank which has moved forward and has narrowed the field to Spectra Systems and one other company;
- 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 execution of a multi-million dollar sensor development contract with a G7 central bank; and
- The expansion of the optical materials business with compostable K-cup customers.

The longer-term opportunities are:

- A licensing and supply agreement for polymer-based technology developed with a major central bank;

- The supply of further upgraded sensor capability to a G7 central bank following the contracted development phase; and

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

We are pleased that we were able to supplement our sustained and growing profitability with a number of near-term and longer-term prospects of a significant scale. We believe that we have a number of transformative opportunities ahead in several aspects of our business that will sustain and potentially accelerate our earnings for our shareholders.

With the Company having a fourth year of sustainable profits, reaching their highest levels since listing, and having sufficient resources to execute on its growth plans with its existing cash reserves, the Board is delighted to provide shareholders with a significantly larger annual dividend this year as one of the major reasons for holding cash has been resolved, allowing for this one time, much larger dividend. The Company's dividend policy takes account of the Group's profitability, underlying growth, and the maintenance of sufficient cash reserves for current and in the pipeline requirements. The Board therefore intends to pay an annual dividend of US $0.09 per share on or about June 26, 2020 to shareholders of record as of June 5, 2020.

Nabil M. Lawandy
Chief Executive Officer
March 23, 2020

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

	2019 Audited USD '000	2018 Audited USD '000
Revenue	$ 13,234	$ 12,494
Cost of sales	3,847	3,527
Gross profit	9,387	8,967
Operating expenses		
Research and development	1,741	1,830
General and administrative	2,852	2,571
Sales and marketing	445	677
Total operating expenses	5,038	5,078
Operating profit	4,349	3,889
Interest and other income	197	158
Foreign currency gain (loss)	(11)	(11)
Profit before taxes	4,535	4,036
Income tax expense (benefit)	200	(19)
Net income	$ 4,335	$ 4,055
Earnings per share		
Basic	$ 0.09	$ 0.09
Diluted	$ 0.09	$ 0.08
Other comprehensive income (loss)		
Unrealized loss on currency exchange	(16)	(19)
Reclassification for realized gain in net income	11	11
Total other comprehensive loss	(5)	(8)
Comprehensive income	$ 4,330	$ 4,047

All of the Group's operations are continuing

Balance sheets
as of 31 December:

	2019 Audited USD '000	2018 Audited USD '000
Current assets		
Cash and cash equivalents	$ 14,250	$ 12,662
Trade receivables, net of allowance	1,497	1,075
Unbilled and other receivables	295	139
Inventory	3,081	3,269
Prepaid expenses	189	141
Total current assets	19,312	17,286
Non-current assets		
Property, plant and equipment, net	1,684	1,587
Operating lease right of use assets, net	1,104	-
Intangible assets, net	6,347	6,697
Restricted cash and investments	1,344	1,099
Deferred tax assets	1,400	1,400
Other assets	138	150
Total non-current assets	12,017	10,933
Total assets	$ 31,329	$ 28,219
Current liabilities		
Accounts payable	$ 357	$ 269
Accrued expenses and other liabilities	636	827
Operating lease liabilities, short term	191	-
Taxes payable	203	3
Deferred revenue	1,219	703
Total current liabilities	2,606	1,802
Non-current liabilities		
Operating lease liabilities, long term	945	-
Deferred revenue	667	540
Total non-current liabilities	1,612	540
Total liabilities	4,218	2,342
Stockholders' equity		
Common stock	459	455
Additional paid in capital – common stock	55,505	55,390
Accumulated other comprehensive loss	(119)	(114)
Accumulated deficit	(28,732)	(29,854)
Less: Common stock held in treasury	(2)	-
Total stockholders' equity	27,111	25,877
Total liabilities and stockholders' equity	$ 31,329	$ 28,219

Statements of cash flows
for the years ended 31 December:

	2019 Audited USD '000	2018 Audited USD '000
Cash flows from operating activities		
Net income	$ 4,335	$ 4,055
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	1,037	1,005
Stock based compensation expense	87	156
Lease amortization expense	256	
Allowance for doubtful accounts	(1)	6
Deferred taxes	-	(175)
Provision for excess and obsolete inventory	-	250
Loss on disposal of assets	-	1
Changes in operating assets and liabilities		
Accounts receivables	(420)	148
Unbilled and other receivables	(156)	57
Inventory	189	235
Prepaid expenses	(47)	(27)
Other assets	-	1
Accounts payable	88	69
Operating leases	(223)	
Accrued expenses and other liabilities	7	(696)
Deferred revenue	637	(345)
Net cash provided by operating activities	5,789	4,740
Cash flows from investing activities		
Restricted cash and investments	(245)	-
Payment of patent and trademark costs	(249)	(325)
Purchases of property, plant and equipment	(522)	(206)
Net cash used in investing activities	(1,016)	(531)
Cash flows from financing activities		
Dividends paid	(3,213)	(2,728)
Acquisition of treasury stock	(2)	-
Proceeds from exercise of stock options	32	11
Net cash used in financing activities	(3,183)	(2,717)
Effect of exchange rate on cash and cash equivalents	(2)	(11)
Net increase in cash and cash equivalents	1,588	1,481
Cash and cash equivalents, beginning of period	12,662	11,181
Cash and cash equivalents, end of period	$ 14,250	$ 12,662

Notes to financial information

1. Basis of preparation

This report was approved by the Directors on 19 March 2020.

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 2019 and are unchanged from those disclosed in the Company's Annual Report for the year ended 31 December 2018 except that the Company adopted ASU No. 2016-02, "Leases (Topic 842)" on January 1, 2019 using the modified retrospective method, which allows entities to not restate the comparative prior periods in the period of adoption when transitioning to Topic 842. 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.

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 year ended December 31, 2018 were 95,063 shares related to stock options because their exercise prices would render them anti-dilutive. For the year ended December 31, 2019, no shares were excluded from the calculation of diluted earnings per common share. The following table shows the calculation of basic and diluted earnings per common share.

	Full Year to 31 Dec 2019	Full Year to 31 Dec 2018
Numerator:		
Net income	$ 4,335,233	$ 4,054,949
Denominator:		
Weighted average common shares	45,868,615	45,463,480
Effect of dilutive securities:		
Stock Options	2,701,377	3,472,948
Diluted weighted average common shares	48,569,992	48,936,428
Earnings per common share:		
Basic:	$ 0.09	$ 0.09
Diluted:	$ 0.09	$ 0.08

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 ("ROU") 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. 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.

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. Nature of financial information

The statutory accounts of Spectra Systems Corporation in respect of the period ended 31 December 2019 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 2020.