

Spectra Systems Corporation
Interim Results for the Six Months Ended 30 June 2020

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 2020.

Financial highlights:

- Revenue of \$6,519k (2019: \$6,402k)
- Adjusted EBITDA¹ of \$2,442k (2019: \$2,461k)
- Adjusted earnings² per share of US \$4.6 cents (2019: US \$4.8 cents)
- Cash generated from operations of \$2,283k (2019: \$1,993k)
- Special annual 2019 dividend up 28.5% to US\$0.09 per share (\$4,123k in aggregate) paid in June 2020
- Strong, debt-free balance sheet, with cash³ of \$10,906k (2019: \$11,142k) at 30 June
- \$40,000 donated to US and UK charities supporting the fight against hunger during Covid-19

¹ Before stock compensation expense

² Before amortization and stock compensation expense

³ Does not include \$1,344k (2019: \$1,099k) of restricted cash and investments

Operational highlights:

- Execution of a new contract with a central bank to enhance existing authentication sensors to detect a unique type of counterfeit notes
- Continued research funding for future sensor technology development for a central bank
- Strong sales of optical materials for K-cups
- Launch of a new phosphor which outperforms existing leading materials and can be sold at a significant discount to incumbents
- Successful production of fully printed, machine-readable polymer banknotes with covert taggants
- Ongoing Covid-19 studies on Aeris banknote decontamination efficacy at a major University with Bio-Safety Level IV facilities
- Four lottery contract renewals for the secure transactions group

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

"The Company's first half revenues and earnings are fully in line with last year and the Board's expectations for H1 and our cash generated by operations is up by 14% relative to H1 2019. We have obtained new business from a long standing central bank customer which supports our position as the technology leaders for difficult technological requirements. Our K-Cup business continues to grow and we have introduced a new phosphor into the optical materials market which outperforms the best incumbent product on both brightness as well as price. Our machine readable polymer technology has been successfully incorporated into fully finished house banknotes which will serve as standards for the full rollout of the product to central banks. Furthermore, discussion with central banks during H1 have reinforced our belief that worldwide demand for banknotes will be significantly higher this year than last year and that this will positively impact our earnings in H2 of this year."

"Finally, our secure transactions group continues to win renewal contracts and our Aeris banknote cleaning system has attracted unprecedented attention from potential central bank and casino customers during the first half of 2020. We are optimistic that the Covid 19 fueled interest in Aeris will result in a sale of a unit in 2021."

The Board therefore believes that the Company is on track to achieve record earnings for the full year and expects both revenue and earnings to significantly exceed market expectation for the full year.

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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 2020 financial year and expects to significantly exceed market expectations for 2020, in spite of the Covid-19 pandemic.

Revenue was up 2% at \$6,519k (2019: \$6,402k) during the first half of the year. Revenue this year will be biased towards the second half of 2020 with significant positive earnings anticipated throughout H2. Increased revenues are expected from pre-production development contracts as well as larger demand for our materials to meet increased banknote demands of one of our existing central bank customers.

Adjusted EBITDA (before stock compensation expense) for the half year was flat at \$2,442k compared to the prior year of \$2,461k.

Having generated cash from operations of \$2,283k (2019: \$1,993k), cash at the period end amounted to \$10,906k (2019: \$11,142k), excluding \$1,344k of restricted cash and investments (2019: \$1,099k). This is notwithstanding \$4,123k paid to shareholders during June in the form of the Company's special dividend of \$0.09 per share.

Based on the expected revenue and earnings for the second half of the year, as well as the lowered cash requirements, the Company anticipates a similar end of the year dividend relative to the 2018 dividend paid in June 2019.

Review of Operations

Physical and Software Authentication Business

The Authentication Systems business, which includes security phosphor materials, generated revenue of \$5,826k (2019: \$5,722k) and Adjusted EBITDA of \$2,286k (2019: \$2,280k).

Authentication Systems revenues were primarily in the form of direct sales of materials and equipment to an existing central bank customer and royalty and licence payments by our licensee. Revenues in the first half of the year are in line with H1 2019.

We have advanced our machine-readable covert polymer substrate development to the stage of fully manufactured banknotes with all of the key security features central banks require. This is a key achievement 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 once we have the opportunity to roll the product out to a large number of central banks at the rescheduled Banknote Conference in July 2021. In the meantime, we have diligently worked on establishing marketing relationships with key representation agencies around the globe.

Another outgrowth of the polymer supplier relationship is the development of a new type of machine – readable security thread which is based on using similar polymer substrates which are compatible with security thread manufacturing. This has been described to two potential licensing partners in the first half of this year.

We have also been contracted by a long standing central bank customer to develop a new technology for relatively rare and exotic counterfeits. This contract provides new opportunities to enhance our machine-readable sales opportunities for upcoming tenders with other central banks.

With the TruBrand authentication product having been successfully introduced in the Chinese tobacco market with over 6 million packs with our smartphone authentication in retail stores in 2019, we are back on track after a delay due to Covid-19, to undertake a large scale gravure printing trial with our existing customer in H2 which has the potential to take the sales volumes into the hundreds of millions of units in 2021. In addition, we have had a successful trial with another implementation of the technology for tobacco packaging which is being marketed to other manufacturers in China and Europe. 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. This is being actively marketed to large brands such as Apple and BAT.

On the software security side of the Company's business, The Secure Transactions Group, formed around the various gaming technology acquisitions made in 2012, generated an Adjusted EBITDA of \$156k (2019: \$181k) on revenue of \$693k (2019: \$680k). The H1 results are in line with 2019. The group has renewed four lottery contracts during the first half of 2020, demonstrating the stickiness of our lottery customer base.

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.

Over the past four months, the Company has continued to explore possibilities of diversifying the business beyond authentication in areas where we can support this initiative with our world class core competencies in optics, engineering, physics and chemistry. We have identified certain intellectual property owned by another company, obtained academic feedback from Harvard University on this technology, and are now in the process of having the issued patents valued through an independent third party which has expertise in this area. The current candidate technology has applications to biotech assays, point of care testing and metrology. We expect to have made a decision on this specific technology by the end of H2.

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:

- Fulfillment of large orders for materials to a long standing central bank customer;
- Additional funding beyond the currently contracted research program with a long standing central bank customer;
- Execution of a multi-million dollar sensor development contract with a long standing central bank customer;
- 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 in 2021;
- Adoption of our phosphors for use by a supplier of products to a major Asian central bank;

- Expansion of the optical materials business with compostable K-cup customers;
- Sales of our newest patent pending phosphour product; and
- Sale of our first Aeris banknote decontamination system to a gaming casino.

The longer-term opportunities are:

- A licensing and supply agreement for polymer-based technology developed with a major central bank;
- Supply of further upgraded sensor capability to a long standing central bank customer following the contracted development phase; and
- Sale of secure polymer substrate to central banks, which combines high security and a durable substrate in one product.

The combination of these prospects, both short and longer term, has positioned the company to continue its revenue growth and earnings through 2025 while continuing to develop cutting edge technologies as needed to remain the innovation leaders in the authentication industry.

Nabil M. Lawandy
Chief Executive Officer
September 7, 2020

**Statements of income and other comprehensive income
for the half year ended 30 June 2020**

	Half Year to 30 Jun 2020 Unaudited USD '000	Half Year to 30 Jun 2019 Unaudited USD '000	Full Year to 31 Dec 2019 Audited USD '000
	Note		
Revenues			
Product	\$ 4,436	\$ 4,434	\$ 8,427
Service	1,191	1,033	2,982
License and royalty	892	935	1,825
Total revenues	<u>6,519</u>	<u>6,402</u>	<u>13,234</u>
Cost of sales	<u>2,168</u>	<u>1,969</u>	<u>3,847</u>
Gross profit	4,351	4,433	9,387
Operating expenses			
Research and development	823	891	1,741
General and administrative	1,330	1,403	2,851
Sales and marketing	300	209	446
Total operating expenses	<u>2,453</u>	<u>2,503</u>	<u>5,038</u>
Operating profit	1,898	1,930	4,349
Interest and other income	79	76	197
Foreign currency gain (loss)	<u>(1)</u>	<u>(7)</u>	<u>(11)</u>
Profit before taxes	1,976	1,999	4,535
Benefit (provision) for income taxes	<u>(81)</u>	<u>(11)</u>	<u>(200)</u>
Net income	<u>\$ 1,895</u>	<u>\$ 1,988</u>	<u>\$ 4,335</u>
Earnings per share	2		
Basic	\$ 0.04	\$ 0.04	\$ 0.09
Diluted	\$ 0.04	\$ 0.04	\$ 0.09
Other comprehensive income (loss)			
Unrealized gain (loss) on currency exchange	(9)	3	(16)
Reclassification for realized loss in net income	<u>1</u>	<u>7</u>	<u>11</u>
Total other comprehensive income (loss)	(8)	10	(5)
Comprehensive income	<u>\$ 1,887</u>	<u>\$ 1,998</u>	<u>\$ 4,330</u>

All of the Group's operations are continuing

Balance sheets**as of 30 June 2020**

	As of 30 Jun 2020 Unaudited USD '000	As of 30 Jun 2019 Unaudited USD '000	As of 31 Dec 2019 Audited USD '000
Current assets			
Cash and cash equivalents	\$ 10,906	\$ 11,142	\$ 14,250
Trade and other receivables	676	2,011	1,497
Unbilled and other receivables	929	-	295
Inventory	2,840	3,011	3,081
Prepaid expenses	234	229	189
Total current assets	<u>15,585</u>	<u>16,393</u>	<u>19,312</u>
Non-current assets			
Property, plant and equipment, net	1,795	1,651	1,684
Operating lease right of use assets, net	1,313	1,233	1,104
Intangible assets, net	6,228	6,490	6,347
Restricted cash and investments	1,344	1,099	1,344
Deferred tax assets	1,400	1,400	1,400
Other assets	130	151	138
Total non-current assets	<u>12,210</u>	<u>12,024</u>	<u>12,017</u>
Total assets	<u>\$ 27,795</u>	<u>\$ 28,417</u>	<u>\$ 31,329</u>
Current liabilities			
Accounts payable	\$ 356	\$ 329	\$ 357
Accrued expenses and other liabilities	583	701	636
Operating lease liabilities, short term	258	242	191
Taxes payable	278	3	203
Deferred revenue	719	887	1,219
Total current liabilities	<u>2,194</u>	<u>2,162</u>	<u>2,606</u>
Non-current liabilities			
Operating lease liabilities, long term	1,094	1,017	945
Deferred revenue	592	498	667
Total non-current liabilities	<u>1,686</u>	<u>1,515</u>	<u>1,612</u>
Total liabilities	<u>3,880</u>	<u>3,677</u>	<u>4,218</u>
Stockholders' equity			
Common stock	459	459	459
Additional paid in capital – common stock	55,537	55,465	55,505
Accumulated other comprehensive loss	(127)	(103)	(119)
Accumulated deficit	(30,960)	(31,079)	(28,732)
Less: Common stock held in treasury	(994)	(2)	(2)
Total stockholders' equity	<u>23,915</u>	<u>24,740</u>	<u>27,111</u>
Total liabilities and stockholders' equity	<u>\$ 27,795</u>	<u>\$ 28,417</u>	<u>\$ 31,329</u>

**Statements of cash flows
for the half year ended 30 June 2020**

	Half Year to 30 Jun 2020 Unaudited USD '000	Half Year to 30 Jun 2019 Unaudited USD '000	Full Year to 31 Dec 2019 Audited USD '000
Cash flows from operating activities			
Net income	\$ 1,895	\$ 1,988	\$ 4,335
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	515	484	1,037
Stock based compensation expense	29	47	87
Lease amortization expense	131	126	256
Allowance for doubtful accounts	-	-	(1)
<i>Changes in operating assets and liabilities</i>			
Accounts and other receivables	821	(795)	(420)
Unbilled and other receivables	(635)	-	(156)
Inventory	241	258	189
Prepaid expenses	(45)	(87)	(47)
Accounts payable	(1)	60	88
Operating leases	(126)	(100)	(223)
Accrued expenses and other liabilities	25	(127)	7
Deferred revenue	(567)	139	637
Net cash provided by operating activities	<u>2,283</u>	<u>1,993</u>	<u>5,789</u>
Cash flows from investing activities			
Restricted cash and investments	-	-	(245)
Payment of patent and trademark costs	(171)	(67)	(249)
Purchases of property, plant and equipment	(329)	(273)	(522)
Net cash used in investing activities	<u>(500)</u>	<u>(340)</u>	<u>(1,016)</u>
Cash flows from financing activities			
Dividends paid	(4,123)	(3,213)	(3,213)
Acquisition of treasury stock	(992)	(2)	(2)
Proceeds from exercise of stock options	3	32	32
Net cash used in financing activities	<u>(5,112)</u>	<u>(3,183)</u>	<u>(3,183)</u>
Effect of exchange rate on cash and cash equivalents	<u>(15)</u>	<u>10</u>	<u>(2)</u>
Net increase (decrease) in cash and cash equivalents	(3,344)	(1,520)	1,588
Cash and cash equivalents, beginning of period	14,250	12,662	12,662
Cash and cash equivalents, end of period	<u>\$ 10,906</u>	<u>\$ 11,142</u>	<u>\$ 14,250</u>

Notes to financial information

1. Basis of preparation

This report was approved by the Directors on 4 September 2020.

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 2020 and are unchanged from those disclosed in the Company's Annual Report for the year ended 31 December 2019.

The results for the half year are unaudited. The financial information for the year ended 31 December 2019 does not constitute the full statutory accounts for that period. The Annual Report and financial statements for the year ended 31 December 2019 have been filed with the Registrar of Companies. The Independent Auditors' Report on the financial statements for the year ended 31 December 2019 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 2020</u>	<u>Half Year to 30 Jun 2019</u>	<u>Full Year to 31 Dec 2019</u>
Numerator:			
Net income	\$ 1,895,000	\$ 1,988,000	\$ 4,335,000
Denominator:			
Weighted average common shares	45,820,928	45,839,118	45,868,615
Effect of dilutive securities:			
Stock Options	<u>2,747,538</u>	<u>2,633,209</u>	<u>2,701,377</u>
Diluted weighted average common shares	<u>48,568,466</u>	<u>48,472,327</u>	<u>48,569,992</u>
Earnings per common share:			
Basic:	<u>\$ 0.04</u>	<u>\$ 0.04</u>	<u>\$ 0.09</u>
Diluted:	<u>\$ 0.04</u>	<u>\$ 0.04</u>	<u>\$ 0.09</u>

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