

## 2018 RESULTS

### Management Discussion & Analysis

With the publication of its 2018 financial statements, the Group commences presentation of its results based on four segments: Digital TV, Cybersecurity, Internet of Things (IoT) and Public Access. While Public Access has been disclosed in prior financial statements, the former Integrated Digital TV segment is now divided into three new segments.

#### KUDELSKI GROUP SEGMENTS

The Digital TV segment provides secure, open, integrated platforms and applications for broadcast, broadband and mobile networks, enabling compelling and personalized viewing experiences. Such platforms allow digital TV operators and content providers to offer a wide range of high value-added pay TV services.

The Cybersecurity segment provides end-to-end cybersecurity solutions to a wide variety of customers across multiple sectors. The portfolio is based on four pillars: advisory services, technology, managed security services and proprietary R&D. The Cybersecurity segment leverages the Group's historical strengths in R&D to fuel a highly differentiated product and service offering across each of the four pillars.

With the IoT segment, Kudelski offers a resilient and easy-to-integrate and operate security solution. The Group's IoT offering includes the Kudelski IoT Security Platform, a pre-integrated, end-to-end solution providing device and data protection, and Kudelski IoT Security Services, such as advanced lab services and managed security services.

In the Public Access segment, SKIDATA, the Group's subsidiary, designs and delivers integrated solutions to provide seamless, user-friendly access for people and vehicles to sites and installations such as car parks, ski-lifts, stadiums, arenas and amusement parks.

#### DISCONTINUED OPERATIONS, ACCOUNTING CHANGES, CURRENCY EFFECTS

On August 20, 2018, the Group sold its SmarDTV Conditional Access Module (CAM) and set-top box activities through an asset sale transaction. Upfront cash consideration from the sale transaction amounted to USD 20.0 million. Group entities will continue to sell SmarDTV's CAMs and will benefit from commissions linked to the sales of CAMs and set-top boxes. In addition, the Group retained certain assets, including in particular SmarDTV's buildings and patents. On December 21, 2018, the Group acquired the 22.5% minority interest in SmarDTV for no consideration and, as a result, it now fully owns the remaining assets held for sale. SmarDTV's income statement items are reported as discontinued operations in the current period and in the comparative previous period. Buildings with a value of USD 14.4 million are classified as "assets held for sale" on the SmarDTV balance sheet. Revenues from SmarDTV's discontinued operations were USD 64.8 million in 2018, while operating

income and net result from discontinued operations were USD 0.7 million and USD 4.3 million, respectively.

As of January 1, 2018, the Group adopted IFRS 15, a new revenue recognition standard, and restated 2017 numbers accordingly. The adoption of IFRS 15 results in a USD 56.6 million reduction of 2017 revenues and an operating income reduction of USD 3.9 million. Principal versus agent considerations are the main restatement driver as they result in the recording of cybersecurity-related software subscription and partner provided support revenues on a net basis, while such revenues were previously recognized on a gross basis. The principal versus agent revenue impact for 2017 amounts to USD 51.8 million. Further restatements driven by IFRS 15, including criteria related to transfer of control, modified revenue recognition criteria and measurement of progress to satisfy performance obligations, drive the remaining decrease of restated 2017 revenues.

As of January 1, 2018, the Group adopted IFRS 9 Financial Instruments. The main impact of this newly adopted standard relates to the calculation of loss allowances for trade account receivables. With the new standard, such allowances are based on historical loss rates. The newly adopted standard results in a USD 10.6 million bad debt provision in the 2018 accounts.

The exchange rate impact on 2018 revenues and operating income is less material than in previous years. Exchange rate effects had a positive USD 12.2 million net revenue impact, mainly due to positive variation of the EUR/USD exchange rate. The favorable impact on operating income amounts to USD 1.0 million.

## **GROUP RESULTS**

In 2018, total revenues and other operating income decreased from USD 1,012.1 million to USD 919.7 million. Net revenues for the Group decreased by 8.5% to USD 908.2 million, mainly driven by the Digital TV segment, which posted a USD 72.1 million decline, and the Cybersecurity segment, which experienced a USD 20.9 million year-on-year decline. IoT generated marginal revenues as the segment's current primary focus is on the development of a secure IoT platform. At USD 6.8 million, Public Access growth was lower than target, reflecting in particular weak performance in the US market, the main growth driver of the previous years.

Other operating income decreased by USD 7.6 million to USD 11.5 million, mainly reflecting lower contributions from government grants. The reduction of government grants is due to the downsizing of R&D activities in France following the consolidation of the Group's R&D presence in selected other sites with a critical mass of resources.

Margin after cost of material decreased from USD 702.6 million to USD 648.9 million. Relative to total revenues, margin after cost of material increased from 69.4% to 70.6%, despite the shift of revenue mix from higher margin Digital TV to lower margin Public Access business. Relative margins increased in all segments, reflecting a concerted effort to focus on higher value-added services. Cybersecurity was the segment with the steepest improvement due to the growing share of proprietary technologies in the segment revenue mix.

Compared to 2017, the Group reduced personnel expenses by USD 14.5 million. A significant reduction of Digital TV headcount, partly offset by headcount increases at SKIDATA, drove the reduction of personnel expenses. The Group expects personnel costs to further decrease in 2019, benefitting from the full year effect of measures taken in 2018 and from further measures already defined and to be implemented in the course of the current year.

Total group headcount at year end was 3'743 compared to 3'962 at the end of 2017. Group headcount in France decreased by 125 employees. Headcount in other high cost locations such as Switzerland, Norway and the US decreased by 154 units. In India, the Group continues to grow, adding an additional 82 employees to reach a total headcount of 595. Total SKIDATA headcount increased by 63 to 1'502 employees at the end of 2018.

Compared to 2017, the Group reduced other operating expenses by USD 14.6 million, despite a USD 7.8 million increase of provisions. Legal and consultancy costs decreased by USD 19.6 million, reflecting in particular a reduction of legal expenses related to IP licensing activities.

The USD 29.1 million net reduction of Group operating expenses reflects the USD 74.9 million cost savings achieved with the 2018 restructuring program net of restructuring costs, currency effects and the cost of additional investment in the Group's key growth areas.

The 2018 restructuring program enabled a substantial reduction of recurring Digital TV expenses. The Group completed most of the restructuring measures related to its French operations in the second half of 2018, including the divestment of SmarDTV operations and the closure of a French R&D site. A further enabler of the 2018 cost reduction was tighter integration of Nagra and Conax operations. Operational excellence measures across the entire Digital TV organization allowed for material efficiency improvements. Similarly, the Group streamlined corporate functions supporting Digital TV activities through the simplification and digitization of key processes, the consolidation of the organizational structure and the migration of selected functions to lower cost locations. Finally, the Group consolidated its operational footprint, resizing underutilized locations and closing satellite offices.

Total operating expenses in 2018 were USD 613.1 million compared to USD 642.2 million in 2017, representing a net improvement of USD 29.1 million. In 2018, the Group incurred USD 40.2 million of restructuring and run-down costs for the restructuring of its Digital TV activities, compared to USD 22.5 million in 2017. Costs in 2018 related to additional investments in SKIDATA, IoT, Cybersecurity R&D and other growth areas represented USD 22.6 million. Finally, 2017 operating expenses, at average 2018 currency rates, were USD 5.5 million higher compared to 2017 reported expenses. The resulting savings from the 2018 cost reduction program amounts to USD 74.9 million.

Group operating income before depreciation and amortization net of restructuring costs was USD 76.0 million, a USD 6.8 million decrease over the previous year. At USD 43.1 million, depreciation, amortization and impairment were USD 4.5 million higher than in 2017, due to the depreciation of a newly introduced ERP system. Overall, the Group generated an operating loss of USD 7.3 million for the year, compared to an operating income of USD 21.8 million in 2017. Operating income net of restructuring costs was at USD 32.9 million in 2018 compared to USD 44.3 million in 2017.

At USD 10.4 million, interest expense was USD 1.9 million higher in 2018 than in the prior year, as the Group paid interest on a higher debt balance. The Group's primary interest-bearing liabilities include the CHF 200 million bond with a 1.875% interest rate maturing in August 2022, the CHF 150 million bond with a 1.5% interest rate maturing in September 2024 and EUR 78.8 million bank debt at SKIDATA. The Group posted USD 0.3 million of net finance expenses in 2018, representing an improvement of USD 2.3 million from 2017 and reflecting marginal foreign exchange effects. The Group booked USD 7.7 million of income tax expenses in 2018. Income tax expenses include a USD 6.6 million favorable change of deferred income taxes.

Overall, the Group generated a USD 24.3 million net loss from continuing operations in 2018, a decrease of USD 22.9 million from the previous year. The USD 4.3 million of net income from discontinued operations includes the accounting impact of the disposal of the SmarDTV set-top box and CAM assets. The main drivers of this gain are the USD 13.0 million gain on sale of fixed assets

and a USD 8.8 million impairment. Including discontinued operations, the Group booked a USD 20.0 million net loss in 2018.

## **DIGITAL TV**

The digital TV market continues to shrink, as a number of established pay TV operators shed subscribers. In particular, Conax operations generated lower revenues compared to the previous year. In 2018, revenues contribution from IP licensing was significantly lower than in the previous year, when the Group completed several licensing transactions.

Reported net digital TV revenues decreased by 14% to USD 443.5 million.

The Group's European Digital TV business grew by 0.2% in 2018 to USD 172.2 million. Most European markets were resilient in 2018, with the Group renewing and further expanding partnerships with large customers. In 2018, the Group extended its content protection partnership with Liberty Global, the world's largest international TV and broadband company. In France, the Group added anti-piracy services to fight illegal live streaming to the portfolio of services supplied to Altice-owned SFR.

At USD 175.5 million, the Americas business posted 20.2% lower revenues in 2018. In 2018, the Group completed IP licensing transactions with the NFL, Endeavor and Nascar Digital Media and recognized revenues related to an agreement closed in a previous period. However, IP licensing revenues in 2018 were substantially lower compared to 2017. The North American satellite TV subscriber base continues to decline. In 2018, Dish Network lost 1.1 million subscribers, 10% of its subscriber base, with a negative impact on Group's revenues. In South America, Brazilian revenues declined from 2017.

The Asia Pacific and Africa region posted 22.6% lower revenues in 2018, reaching USD 95.9 million. In 2017, set-top box sales to cable operators in Taiwan sustained Asian revenues, while the Group did not generate any material set-top box sale in 2018. Revenues in the Indian market were materially lower in 2018 than in the prior year, due in particular to the material reduction of sales in this market experienced at Conax.

Digital TV margin after cost of material grew from 86% in 2017 to 87.3% in 2018, due to the favorable development of the revenue mix.

Digital TV generated USD 111.9 million of operating income before depreciation and amortization net of restructuring cost, representing a USD 1.6 million improvement from the previous year. This segment's profitability benefits from the reduction of operating expenses driven by the 2018 restructuring program. In 2018, the Group reduced Digital TV operating costs by USD 74.9 million, incurring USD 40.2 million of restructuring and run-down costs. Reported 2018 Digital TV operating income before depreciation and amortization was at USD 71.7 million, compared to USD 87.7 million in 2017.

## **CYBERSECURITY**

Cybersecurity has grown to be a meaningful contributor of revenues for the Group. In 2018, Cybersecurity revenues, however, were lower than in the previous year while margin after cost of material increased, as the business mix continues to shift from lower margin technology reselling to higher margin advisory services, managed security services and proprietary technology sales. These

strategic pillars, while still representing a relatively small share of total cybersecurity numbers, are growing at solid two-digit rates.

In 2018, Kudelski cybersecurity's business generated USD 151.0 million of gross revenues, a 9.9% decrease from 2017. The application of the new IFRS15 revenue recognition standard results in the recognition of revenues from third party support contracts, software subscription and cloud-based services on a net basis. As a result, Cybersecurity net revenues were at USD 94.3 million in 2018.

The European region posted strong growth in 2018, increasing net revenues to USD 12.7 million, a 57.1% year-on-year improvement. The Americas were most affected by the shift of business mix, with net revenues declining by 23.9% to USD 81.6 million.

Margin after cost of material increased from USD 38.3 million in 2017 to USD 39.1 million. In 2018, 50% of the segment's gross profit dollars were attributed to its strategic business pillars, up from 36% in 2017, contributing to gross margin expansion of over 800 basis points to 41.4%.

The Cybersecurity segment generated a USD 21.3 million operating loss before depreciation and amortization, representing USD 2.0 improvement from the previous year.

## **INTERNET OF THINGS (IoT)**

The Group launched an IoT Security Center of Excellence in 2017, providing secure IoT solutions, hardware and software assessment and evaluations, recommendations and implementations of design and control frameworks and countermeasures to mitigate risks and protect investments.

In 2018, the Group ramped-up investments in the IoT domain with the development of a full IoT security platform, providing a pre-integrated, end-to-end solution on a variety of hardware devices and software-based clients. The Group has secured an initial portfolio of customers that is starting to generate early revenues and has built a funnel of prospects. In addition to extending its collaboration with U-Blox, the Group announced further partnership agreements with IDEMIA in the connectivity domain, Pepper IoT for consumer data protection on connected devices and Voith in the industrial IoT space. Kudelski's secure IoT platform offers customers the ability to manage the identity and authenticity of devices, enable secure access to data, control activation and revocation of devices and support long security lifecycles through countermeasures on a cellular narrowband network.

In 2018, IoT generated revenues of USD 2.0 million and an operating loss before depreciation and amortization of USD 19.5 million, reflecting the early development stage of this business.

## **PUBLIC ACCESS**

Public Access revenues increased by 1.9% in 2018. A sales slowdown in the last two months of the year resulted in lower than expected 2018 revenues and a year-on-year profit decline.

At USD 183.3 million, European sales marginally increased by 2.3% from the previous year, with weak development in markets such as Austria and Switzerland. Sales from distribution partners in Europe were also lower compared to the previous year.

In the Americas, SKIDATA generated revenues of USD 110.3 million, representing a decrease of 9.3% compared to the previous year. As local operations were sized to support growing sales volumes, the region generated marginal operating profit in 2018.

Revenues for Asia/Pacific and Africa grew by 23.1%, reaching USD 74.8 million. In this region, SKIDATA continues to benefit from favorable momentum as it broadens its market footprint. Early in the year, SKIDATA completed the acquisition of 51% of Cytel, a market leader for access control systems in China, thereby gaining a stronger foothold in the Chinese parking market. Total consideration for this acquisition was USD 5.8 million.

Public Access operating income before depreciation and amortization was below target, decreasing by USD 10.7 million to USD 21.1 million in 2018. Operating expenses for the segment increased by USD 20.3 million from 2017, while margin after cost of material improved from 56.4% in 2017 to 57.4% in 2018.

As SKIDATA increased its working capital by USD 7.7 million in 2018, the Public Access segment generated negative free cash flow in 2018.

## **BALANCE SHEET AND CASH FLOWS**

Total non-current assets decreased by USD 10.7 million to USD 696.7 million. 2018 investments in technical equipment and machinery in the Digital TV segment were lower compared to the run rate of previous years. As a result, tangible fixed assets decreased by USD 8.5 million. The USD 19.4 million decrease in intangible fixed assets is mainly due to the depreciation of assets capitalized with the acquisition of Conax. A USD 7.0 million reduction of technology assets and a USD 8.7 million reduction of customer lists, trademarks and brands drive the reduction of intangible fixed assets. Financial fixed assets at amortized cost increased by USD 14.1 million. USD 7.6 million of government grants previously classified as held for sale remain within the Group following the closing of the SmarDTV transaction and, as a result, are reclassified as financial fixed assets. IP licenses accrued during 2018 and to be cashed in at a later stage are a further driver of the increase of financial fixed assets.

Compared to December 31, 2017, total current assets increased by USD 10.6 million. A USD 0.9 million increase of inventories is mainly due to USD 3.7 million higher stock at SKIDATA. The Group decreased trade receivables by USD 30.3 million, as Digital TV entities systematically reduced outstanding receivables, improving by USD 26.8 million compared to the previous year.

Contract assets consist of amounts due from clients for projects recognized on a percentage of completion basis. They were previously presented as trade account receivables. Out of the total USD 59.9 million total contract assets, USD 53.3 million relate to SKIDATA. SKIDATA was also the main driver of the year-on-year increase.

Other financial assets at amortized costs increased by USD 10.8 million to USD 41.0 million. SmarDTV short-term subsidies previously presented as held for sale are now recognized as financial assets as they were not included in the SmarDTV sale transaction. At the end of 2018, cash and cash equivalents amounted to USD 86.0 million, an increase of USD 14.0 million from the end of 2017.

USD 14.4 million of assets classified as held for sale include buildings previously used by SmarDTV, as the Group envisages a sale of these buildings following the closure of the SmarDTV sale transaction. In the prior period, "Assets classified as held for sale" and "Liabilities classified as held for sale" included the fair value of SmarDTV's balance sheet items offered for sale.

Total equity decreased by USD 48.4 million, mainly reflecting the negative net income for the period, currency translation adjustments in other comprehensive income, remeasurements on post-employment benefits and the USD 5.6 million dividend payment.

Total non-current liabilities increased by USD 55.5 million to USD 484.4 million. Long-term financial debt increased by USD 40.7 million to USD 398.2 million, mainly driven by new long-term loans at SKIDATA.

Total current liabilities decreased by USD 23.0 million to USD 310.5 million. Short-term financial debt decreased by USD 2.8 million to USD 64.1 million.

In 2018, the Group used USD 4.7 million of cash flow for operating activities. First half operating cash flow was USD -43.1 million, while operating cash flow in the second half was USD 38.4 million. The main drivers of operating cash flow were USD 40.2 million of restructuring costs, USD 17.1 million of higher deferred costs and other net working capital headings, USD 16.9 million of other non-cash expenses mainly related to new non-cash provisions, and the USD 23.2 million reduction of accrued expenses.

The Group used USD 17.8 million cash for investing activities in 2018. First half investment cash flow was USD -25.5 million, while investment cash flow in the second half was USD 7.7 million. In 2018, the Group invested USD 15.7 million in tangible assets and USD 9.3 million in intangible assets. The net cash consideration for the acquisition of Cytel by SKIDATA amounted to USD 3.9 million. USD 11.9 million of deferred consideration mainly relate to the earn-outs paid by SKIDATA for the acquisition of Sentry. The sale of SmarDTV assets resulted in a USD 20.0 million cash inflow. Cash from financing activities amounted to USD 39.4 million, including in particular a USD 45.2 million increase of loans, of which USD 17.7 million represents a cash advance of government subsidies, and a USD 5.6 million dividend payment.

## **OUTLOOK**

The traditional pay TV business is expected to stabilize in 2019. While Digital TV revenues will continue to decline, the Group expects the pace of the top line regression to start tapering off. In 2018, the Group completed multiyear contract renewals with large pay TV customers, which is expected to secure revenues over a period of several years. The Group is implementing measures to further reduce Digital TV operating expenses. Such measures include the integration of R&D organizations into a consolidated unit, the streamlining of the product portfolio with an increased focus on profitable and promising products addressing new markets, a custom development approach to product areas lacking critical mass, the full integration of Conax and Nagra operations and a further rationalization of Digital TV global presence with the closure of smaller locations and the downsizing of underutilized sites.

With Cybersecurity, the Group will continue to drive the development of higher value product lines and expects continued growth of margin after cost of material. Cybersecurity is expected to continue adding new clients, expanding geographical coverage and, as a result, increasing profitability by leveraging strategic offerings and high-value services.

For 2019, the Group will continue to invest in the IoT domain, with development costs increasing to reflect the current cost run rate and with revenues still in the single digit million range.

In Public Access, short term measures to restore the segment's performance include stopping non-core, loss making projects optimizing the product portfolio and focusing on profitable, promising solutions, systematically improving working capital management, reviewing scope and structure of central functions, revising incentive systems and effecting changes in the organization. Further measures will release additional synergies within SKIDATA and with other Group entities. In 2019, Public Access will focus on improving cash flows and restoring a higher level of profitability.