

## 2016 HALF YEAR RESULTS

### Management Discussion & Analysis

In the first half 2016, the Kudelski Group grew its consolidated revenues, while maintaining solid profitability.

A less pronounced seasonality compared to previous years resulted in a strong first half 2016 for Public Access, which delivered its best ever first half revenue growth and absolute profitability. Revenues grew by over 50%, and Public Access posted its first ever positive first half operating income. As SKIDATA is now tracking deployment projects with a higher level of granularity, the Group started to systematically apply the percentage of completion (POC) method to such projects, which better matches revenue recognition with the actual progress of the work performed. Applying the first half 2015 revenue recognition method, Public Access would have achieved revenue growth of 28.3%.

The integrated Digital TV (iDTV) segment was resilient in this first half, with a stable core digital TV business and strong momentum at Conax. The Group continued to develop its intellectual property (IP) licensing activities, entering into additional patent licensing agreements. However, both revenue and profit contribution from IP licensing activities were lower than in the first half of last year, which was driven by an even stronger set of agreements.

In the first half of this year, the Group achieved significant progress in implementing its cyber security strategy. On May 3, the Group completed the acquisition of Milestone Systems, a well-established provider of security services in the network security domain. Milestone Systems provides the Group with a proven platform for the deployment in North America of cybersecurity technologies and managed service capabilities currently under development. Total consideration for this acquisition was CHF 41.3 million. At the first half run rate, the newly acquired business will contribute, on an annualized basis, CHF 77 million in revenues and a positive net income. On August 2, Kudelski Security formally launched its US operations at Black Hat USA 2016, integrating the newly acquired Milestone Systems operations and announcing a number of senior leadership appointments to expand its global presence. As a result of these developments, Kudelski Security will now benefit from a broader portfolio of tier one customers across multiple industries and geographies and a growing ecosystem of strategic technology partners, including F5, Palo Alto Networks, CrowdStrike and RSA.

Overall, total Group revenues for the first half 2016 increased by 12.5% to CHF 475.5 million, primarily driven by the 51.3% growth of the Public Access segment. At constant currency rates, Group revenues increased by 9.0%. Compared to the strong first half 2015, which was supported by a higher revenue base from IP licensing agreements, iDTV revenues for the first half 2016 grew by 1.7%.

The Group reported operating income of CHF 33.4 million, representing a CHF 2.5 million decline from the previous first half. Net income more than doubled, growing from CHF 9.8 million to CHF 21.0 million.

In 2015, the accounting treatment of foreign exchange differences was revised to consider all exchange differences in connection with subsequent measurements and settlements of debtors and suppliers as part of finance income/expense. In the past, the Group recognized exchange

differences related to debtors and suppliers as part of revenue and cost of material, licenses and services. As a result of this change, restated first half 2015 revenues increased by CHF 6.7 million in 2015, while cost of material increased by CHF 1.2 million. Restated first half 2015 operating income is therefore CHF 5.5 million higher than the previously reported operating income, while other finance income decreased by the same amount.

## **GROUP REVENUES AND PROFITABILITY**

Total revenues and other operating income for the first half 2016 increased by CHF 50.1 million to CHF 481.8 million. Revenues grew by CHF 52.7 million, while other operating income declined by CHF 2.5 million, as first half 2015 other operating income included a one-off CHF 4.1 million gain from the acquisition of Echostar's European set-top box operations.

"Margin after cost of material" (a pro-forma, non-IFRS item) increased by CHF 19.2 million to CHF 336.5 million. Relative to total revenues, margin after cost of material decreased from 73.5% to 69.8%. The main driver of this margin reduction relates to a shift of the revenue mix from relatively higher margin iDTV revenues to Public Access revenues. In the first half 2016, Public Access accounted for 29.2% of total revenues compared to 21.7% in the first half of last year.

Personnel expenses increased by CHF 21.2 million to CHF 212.9 million. Growth of personnel costs was primarily driven by higher SKIDATA headcount required to support business expansion, growth of the Group's cybersecurity activities and the consolidation for a full period of the Echostar International operations acquired on May 18, 2015. Total Group headcount increased by 217 to 3'676 employees as of June 30, 2016. SKIDATA was one of the drivers of this headcount increase, accounting for an additional 88 employees, mainly in North America. The acquisition of Milestone Systems added a further 88 employees in the United States. In Switzerland, the Group increased cybersecurity and core security technologies headcount by 17 employees reaching 784 at the end of June. Finally, the Group continues to expand its Indian operations, both in the iDTV and in the Public Access segments, adding another 48 employees for a total headcount of 359.

Compared to the first half 2015, other operating expenses increased by CHF 4.1 million to CHF 72.8 million. Legal costs, mainly related to IP litigation that was settled in the first weeks of this second half, were CHF 2.8 million higher, as compared to the first half 2015.

The Group's operating income before depreciation and amortization was CHF 50.8 million for the first half 2016, a CHF 6.0 million decrease over the first half 2015. At CHF 17.3 million, depreciation, amortization and impairment was CHF 3.6 million lower than in the first half 2015, reflecting the reduced levels of capital expenditures over the last five years. Overall, the Group generated operating income of CHF 33.4 million, compared to CHF 35.9 million in the previous first half.

At CHF 4.8 million, interest expense in the first half 2016 was CHF 4.3 million lower than in the previous first half, as the Group fully repaid the remaining CHF 165 million credit facility obtained in 2014 to finance the acquisition of Conax and issued a new CHF 200 million bond carrying a lower interest rate. The Group posted CHF 2.7 million of net finance expenses, representing a CHF 12.5 million decrease from the first half 2015. This improvement is due to the substantial reduction of negative foreign exchange effects compared to the previous year. Income tax expense increased from CHF 2.2 million to CHF 5.2 million. Overall, the Group improved net income by CHF 11.2 million, reaching CHF 21.0 million in the first half 2016.

## **INTEGRATED DIGITAL TV**

Reported iDTV revenues increased by 1.7% to CHF 336.7 million, representing a constant currency decline of 1.8% over the prior year period.

The Group's European iDTV business posted growth of 3.6%, reaching CHF 120.5 million. Growing revenues from Eastern European markets reflect the strong performance of Conax. Nagra anyCAST CONNECT deployments with Altice operators represent a further positive highlight from the European region.

In the first half 2016, reported revenues from the segment's Americas region declined by 20.0%. Brazil continued to slow down, generating less than half the revenues than it generated in the first half 2015. Other South American markets were also weaker compared to previous periods. In North America, the iDTV segment benefitted from the robust development of the core digital TV business, while patent licensing revenues were lower compared to the first half 2015.

The Asia/Pacific and Africa region posted revenue growth of 51.8% in this first half. Positive highlights included significant progress at Starhub in Singapore, where the headend migration project is on track and Starhub launched Netflix in May using the Group's MediaLive and anyCAST CONNECT solutions. In Taiwan, the Group continues to benefit from favorable momentum with cable operators. In India, Conax deployed high volumes of smartcards in this first half. Finally, the Group continued to expand its African footprint, with highlights in South Africa, where material volumes of SmarDTV set-top boxes were deployed in the first half, and Nigeria, where Nagra was selected for a nationwide digital terrestrial project.

Overall, operating income for the iDTV segment reached CHF 42.3 million, compared to CHF 59.4 million in the first half 2015. A resilient core digital TV business and a robust profit contribution from Conax are among the positive highlights for the iDTV segment.

In the first half 2015, segment profitability benefitted from patent licensing agreements with Netflix, Google, Disney and Bloomberg. In the first half 2016, profit contribution from patent licensing activities was lower than in the previous first half. However, this line of business continued to develop favorably, signing additional licensing agreements with Verizon, Fine Swiss Metals, Yahoo! and an unnamed Fortune 50 company in this first half and with further robust profit contribution accruing in the second half from new licensing agreements signed with Apple, RPX and Hulu, which resulted in the settlement of all ongoing patent litigation with Apple and Hulu.

While still loss making, the Group's cybersecurity business is starting to gain traction, as Kudelski Security assembled a strong leadership team, gained critical mass in the United States market through the acquisition of Milestone Systems and continued to expand its technology ecosystem through a broad network of partnerships.

## **PUBLIC ACCESS**

SKIDATA posted a 51.3% sales increase in the first half 2016, reaching CHF 138.8 million revenue, as it managed to reduce the strong seasonality of its business. Using the same revenue recognition methods as last year, SKIDATA would have achieved a 28.3% sales increase.

In Europe, revenues grew by 40.3% compared to the previous first half. Highlights of the European segment performance include a strong development of the Austrian business, driven by upgrades of software and related equipment and of the Dutch business with a newly won

smart parking tender with the city of Amsterdam. Further European markets with positive momentum included in particular Switzerland, France and Germany.

In the Americas, the acquisition and integration of Sentry drove last year's growth, while organic development supported this first half. First half 2016 highlights include the installation of access control solutions in ten Las Vegas MGM hotels and winning the largest contract in SKIDATA's history, a multi-year agreement with the City of San Francisco that is expected to generate revenues of USD 20 million.

Revenues for Asia/Pacific and Africa grew by 45.5%. The consolidation of SKIDATA's Australian parking subsidiary drove last year's growth, while organic development supported this first half. In addition to a continued strong performance in Australia, the Group benefited from positive momentum in other markets, such as Japan, where SKIDATA won the access control business of fifteen ski resorts in the Hakuba Valley.

Within the two year period 2014-2016, SKIDATA increased extra-European first half revenues from CHF 18.7 million to CHF 62.2 million.

Public Access operating income improved from a CHF 15.3 million loss in the first half of 2015 to positive CHF 0.2 million. For the first time in its history, SKIDATA generated a positive first half operating income. The profitability improvement was driven by the top line expansion and was achieved in spite of continued investments for the further expansion of the business, including, for example, the opening of new offices in Dubai and Mexico. Using the same revenue recognition methods as last year, Public Access operating income would have improved by CHF 5.6 million compared to the first half 2015.

## **BALANCE SHEET AND CASH FLOW**

Total non-current assets increased by CHF 38.9 million in the first half 2016, with tangible fixed assets increasing by CHF 1.3 million and intangible fixed assets by CHF 41.8 million. The first time consolidation of Milestone Systems added CHF 31.6 million to goodwill and CHF 8.1 million to customer list.

Compared to December 31, 2015, total current assets decreased by CHF 21.8 million. A CHF 7.3 million increase of inventory is mainly due to a larger than usual chip inventory established to hedge against potential supply bottlenecks from a chip vendor. The Group increased trade accounts receivable by CHF 7.9 million, as newly acquired Milestone Systems added CHF 9.5 million and SmarDTV increased its receivables by CHF 7.7 million. The CHF 12.5 million increase in other current assets is mainly due to other receivables increasing by CHF 7.8 million, including in particular a shift from long-term to short-term assets of amounts due for government grants. As of June 30, 2016, cash and cash equivalents amounted to CHF 87.5 million.

Total equity increased by CHF 5.2 million, mainly reflecting a CHF 21.0 million net income and a CHF 19.0 million capital distribution to shareholders.

Total non-current liabilities increased by CHF 1.0 million to CHF 310.9 million. Non-current liabilities include the CHF 200 million bond maturing in August 2022. Total current liabilities increased by CHF 10.9 million to CHF 343.4 million. Current liabilities include CHF 100.2 million of the CHF 110 million bond maturing in December 2016. In the first half 2016, the Group bought back CHF 2.7 million of this bond. A CHF 3.8 million increase of deferred/contingent consideration to CHF 15.2 million primarily relates to estimated future consideration for the acquisition of Milestone Systems that is contingent upon the company's achievement of certain earn-out targets.

During the first half 2016, the Group generated CHF 19.9 million of cash from operating activities, representing a decrease of CHF 15.5 million compared to cash flows generated during the first half of 2015. Change in working capital had a negative impact of CHF 19.4 million on the first half 2016 cash flows from operating activities. The Group used CHF 54.5 million of cash for investing activities, including cash used for acquisitions of CHF 32.0 million. Cash used for financing activities amounts to CHF 14.8 million, including CHF 19.0 million repaid as a capital distribution to Kudelski SA's shareholders.

## **OUTLOOK**

For the full year 2016, the Group expects growing iDTV revenues, driven, in particular by the expansion of the Group's cybersecurity operations and strong results from IP licensing. Second half iDTV revenues and operating income are forecasted to be higher than in the first half.

In the Public Access segment, seasonality effects are expected to be less pronounced compared to previous years. The strong first half momentum of SKIDATA is expected to continue in the second half, resulting in a robust full year growth and profitability that exceeds last year's.

For the full year, the Group forecasts continued strong cash generation with operating free cash flow in the same range as in recent years.