

## 2016 RESULTS

### Management Discussion & Analysis

The Group restored its strong growth momentum in 2016, increasing its consolidated revenues and operating income by 12.3% to CHF 1'067.4 million. Operating income increased to CHF 97.8 million, representing a 20.4% improvement over the previous year, while net income from continuing operations grew by 51.7% to CHF 74.8 million.

Integrated Digital TV (iDTV) segment revenues increased by 10.5% in 2016, reaching CHF 730.2 million, and segment operating income increased by 19.3% to CHF 99.4 million. iDTV benefitted from a stream of intellectual property (IP) licensing agreements, driving both segment revenues and profitability. In the first half 2016, the Group completed licensing agreements with Verizon, Fine Swiss Metals, Yahoo! and an unnamed Fortune 50 company. In the second half, the Group further accelerated the first half momentum by signing deals with Apple, RPX and Hulu.

In 2016, Kudelski Security, the Group's cybersecurity business, continued its expansion, establishing its position as a global provider of solutions that enable enterprise and public sector clients to detect and strengthen their security against cyber threats. In May, the Group completed its acquisition of Milestone Systems, a well-established provider of security services in the network security domain. Milestone Systems provides the Group with a strong 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. In January 2017, Kudelski Security acquired Dallas-based M&S Technologies, a cyber and network security provider that provides the Group with a strong foothold in the South Central region of the United States.

In the Group's core digital TV business, the current saturation of traditional pay TV offerings in developed markets resulted in decreased revenues, while sales from emerging markets increased over the previous year.

In July, the Group acquired NexGuard Labs B.V., a leading provider of watermarking technologies. While this acquisition contributed limited revenue and operating profit in 2016, NexGuard expands the Group's portfolio of end-to-end security solutions and enables the Group to better address the content protection needs of content owners and right holders. Total consideration for this acquisition was CHF 28.1 million.

Public Access maintained its strong momentum, achieving its best ever segment revenues and growing operating profits. Revenues grew by 14.4% to CHF 318.7 million and operating income grew by 9.0% to CHF 17.1 million. In Public Access, the Group completed two small acquisitions in 2016. In July, Mexico Grupo Signal, a Mexican distributor, was acquired through an asset deal for CHF 2.6 million. In August, the Group completed the acquisition of Protection Technology, a distributor operating in the states of Washington, Utah and Colorado, for CHF 6.0 million.

### GROUP REVENUES AND PROFITABILITY

Total revenues and other operating income for 2016 increased by CHF 116.6 million to CHF 1'067.4 million. Revenues grew by CHF 109.3 million, while other operating income grew by CHF 7.3 million, due in particular to a CHF 10.0 increase in government R&D grants (mainly French "Credit d'Impot Recherche"), as prior year grants were confirmed following the successful completion of tax audits.

“Margin after cost of material” (a pro-forma, non-IFRS item) increased by CHF 63.8 million to CHF 727.9 million. Relative to total revenues, margin after cost of material decreased from 69.8% to 68.2%. The main driver of this margin reduction relates to a shift of the revenue mix from relatively higher margin iDTV pay TV-related revenues to lower margin Public Access and cybersecurity revenues.

Personnel expenses increased by CHF 30.7 million to CHF 423.7 million. Growth of personnel costs was primarily driven by the consolidation of newly acquired entities, including Milestone Systems, NexGuard and the distributors acquired by SKIDATA. Increased SKIDATA headcount required to support business expansion and organic growth of the Group’s cybersecurity activities were further drivers of this growth. Total Group headcount at year end was 3’801 compared to 3’459 at the end of 2015. SKIDATA was the primary driver of this headcount increase, accounting for an additional 192 employees, including 91 employees in North America. The acquisition of Milestone Systems added a further 88 employees in the United States, while NexGuard contributed 35 employees, mainly in France. In Switzerland, the Group increased its cybersecurity and core security technologies headcount, leading to a total headcount increase of 16, mainly in R&D, to reach 783 employees at year end. Finally, the Group continues to expand its Indian operations, both in the iDTV and Public Access segments, adding another 92 employees for a total headcount of 403 at year end.

Compared to 2015, the Group increased other operating expenses by CHF 13.7 million to CHF 162.3 million. Change in provisions moved from negative CHF 4.0 million in 2015 to positive CHF 0.3 million in 2016. Travel, entertainment and lodging expenses were CHF 4.6 million higher, as the Group incurred expenses related to the setup of its new headquarters in Phoenix and reflecting higher headcount-related costs.

The Group’s operating income before depreciation and amortization was CHF 141.9 million in 2016, a CHF 19.3 million increase over the previous year. At CHF 44.1 million, depreciation, amortization and impairment were CHF 2.8 million higher than in 2015, reflecting higher asset impairments. Overall, the Group generated operating income of CHF 97.8 million, representing a 20.4% improvement compared to 2015.

The 2016 profit and loss statement includes one-off items resulting in CHF 1.0 million of additional costs. In 2016, the Board of Trustees of the Group’s Swiss pension fund reduced the fund’s technical interest rate from 3% to 2.5%, adopting LPP 2015 parameters. This change leads to the gradual decrease of the conversion rate from 6.4% in 2015 to 6.05% in 2018 for women and from 6.3% in 2015 to 5.9% in 2018 for men. The lower conversion rate results in a CHF 22.5 million reduction of Group pension fund liabilities and a personnel cost reduction of the same amount.

In December 2016, the Group initiated the restructuring of SmarDTV’s operations, which includes the closure of SmarDTV’s UK operations and the transfer of activities previously carried out in the UK to Group companies in Asia. In connection with these measures, the Group booked restructuring provisions and further customer-related provisions of CHF 9.6 million. In addition, the Group undertook restructuring measures to increase operational efficiency at its OpenTV and Nagra France subsidiaries, and in connection therewith, the Group booked CHF 3.0 million of restructuring provisions. In 2016, the Group continued to streamline its semiconductor supply chain for digital TV products, internalizing select chip development activities previously outsourced. As the reuse of stock sourced from an external party cannot be assured, the Group impaired such stock and all related assets, resulting in a negative impact of CHF 5.2 million. Additional impairments taken in 2016 include assets related to a user interface platform in the amount of CHF 1.8 million and CHF 3.9 million related to discontinued cybersecurity-related assets.

At CHF 9.9 million, 2016 interest expense was CHF 4.6 million lower than in the prior year, as the Group fully repaid the CHF 165 million credit facility with higher interest rates in 2015 and issued a CHF 200 million bond in 2015 and a CHF 150 million bond in 2016, both carrying lower interest rates. The Group posted CHF 5.1 million of net finance income, representing a CHF 14.3 million

improvement over 2015. This improvement is due to positive foreign exchange effects in 2016, as compared with the negative foreign exchange impact experienced by the Group in 2015. Income tax expense increased to CHF 19.0 million in 2016.

Overall, net income from continuing operations increased by CHF 25.5 million to reach CHF 74.8 million in 2016. As estimates of potential future contributions from the contractual earn-out provisions entered into in connection with the Group's sale of its NagralD Security business in 2014 are no longer considered reliable, the Group impaired the contingent consideration related to this transaction, booking a loss from discontinued operations of CHF 7.4 million. Overall, the Group improved net income by CHF 18.1 million, reaching CHF 67.4 million in 2016.

## **INTEGRATED DIGITAL TV**

Reported iDTV revenues increased by 10.5% to CHF 730.2 million.

The Group's European iDTV business marginally declined by 2.5% in 2016, reaching CHF 235.8 million. Growing revenues from Eastern European markets largely reflect the strong performance of Conax. On the other hand, the business generally experienced declining revenues in 2016 from large Western European markets, including Italy, Spain and Germany.

The Group's Americas business posted a 15.7% growth compared to the previous year. The primary driver of 2016 revenue growth in this region was the first time consolidation of Milestone Systems as of May 2016. Exceptional revenue contribution from intellectual property licensing agreements was a further growth driver in the Americas region. Growth in the Brazilian market continues to slow; in spite of the Group's positive competitive momentum, iDTV revenues in Brazil declined by 14% from 2015. Other South American markets were also weaker compared to previous periods.

The Asia/Pacific and Africa region posted revenue growth of 22.0% in 2016. Positive highlights included significant progress at Starhub in Singapore, where a large headend migration project generated material revenues in 2016. In Taiwan, the Group continues to benefit from favorable momentum with cable operators. In Korea, the Group extended its content protection partnership with KT Skylife, entering into an agreement for the protection of 4K video streams. In India, Conax deployed high volumes of smartcards while launching a cardless content protection solution. Finally, the Group continued to expand its African footprint, with notable achievements in South Africa, where SmarDTV deployed material volumes of set-top boxes, and Nigeria, where both Nagravision and Conax continued to expand in 2016.

Overall, operating income for the iDTV segment improved by 19.3%, reaching CHF 99.4 million. Emerging market activities delivered robust profit contribution, as did the IP licensing agreements concluded by the Group with Apple, RPX, Hulu, Verizon, Fine Swiss Metals, Yahoo! and an unnamed Fortune 50 company.

While still loss making, the Group's cybersecurity business continues to gain traction, as Kudelski Security further strengthened its team, gained critical mass in the US market through the acquisition of Milestone Systems and M&S Technologies, launched technology development initiatives and further expanded its technology ecosystem through a broad network of partnerships. Additionally, the Group launched a new Internet of Things center of excellence.

## **PUBLIC ACCESS**

SKIDATA continued its strong growth momentum from the previous year, posting a 14.4% sales increase in 2016 to reach revenues of CHF 318.7 million. Although SKIDATA completed two small acquisitions in 2016, its revenue growth was largely achieved organically.

In Europe, revenues grew by 5.2% compared to the prior year. Highlights of the European segment include strong development of the Austrian business, driven by upgrades of software and related

equipment, as well as positive momentum from its service business. On a worldwide basis, SKIDATA entered into over 900 new service contracts in 2016.

In the Americas, the acquisition and integration of Sentry drove growth in 2015, while organic development supported 2016. Highlights included the installation of access control solutions in eleven Las Vegas MGM hotels, new airport wins, including Oklahoma and Dallas Love Field, and 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.

Negative developments affecting one market resulted in a year-on-year slowdown of revenues for Asia/Pacific and Africa, declining by 4.2% from 2015. Fundamentals, however, remain strong, as SKIDATA is consolidating its leadership in several key markets. In Australia, SKIDATA consolidated its position and is now the market leader.

Public Access operating income improved by CHF 1.4 million, reaching CHF 17.1 million in 2016. The profitability improvement was driven by top line growth and was achieved in spite of continued investment in further business expansion, including, for example, the opening of new offices in Dubai and Mexico.

## **BALANCE SHEET AND CASH FLOW**

Total non-current assets increased by CHF 83.1 million to CHF 682.4 million at the end of 2016, with tangible fixed assets increasing by CHF 8.8 million and intangible fixed assets by CHF 85.0 million. The first time consolidation of Milestone Systems, Nexguard Labs, Protection Technology and Mexico Grupo Signal added CHF 63.4 million to goodwill and CHF 13.1 million to customer list. The CHF 10.9 million reduction of financial assets and other non-current assets was primarily driven by a CHF 8.8 million reduction of long-term deferred contract costs and the CHF 7.4 million impairment of the contingent consideration linked to the sale of NagralD Security.

Total current assets increased by CHF 91.4 million to CHF 581.6 million in 2016. A CHF 5.9 million higher inventory is mainly due to a CHF 9.7 million increase at SKIDATA. Trade accounts receivable were CHF 26.5 million higher compared to the prior year end, as newly acquired entities added CHF 12.0 million. Amounts due from customers for contract work accounted for CHF 14.9 million of the total increase in receivables, including CHF 6.1 million for Nagravisision and CHF 5.8 million for SKIDATA. The CHF 18.8 million increase in other current assets is mainly due to CHF 9.8 million of additional grants due from state and government institutions. At the end of 2016, cash and cash equivalents amounted to CHF 177.1 million, CHF 40.2 million higher compared to the end of 2015.

Total equity increased by CHF 52.0 million, mainly reflecting the CHF 67.4 million net income and the CHF 19.0 million capital distribution to shareholders.

Total non-current liabilities increased by CHF 141.6 million to CHF 451.5 million. Total long-term financial debt includes the CHF 200 million 1.875% bond issued in May 2015 that matures in August 2022 and the CHF 150 million 1.5% bond issued in May 2016 that matures in September 2024. The CHF 10.4 million decrease of employee benefit liabilities to CHF 67.4 million includes positive CHF 22.5 million from lower conversion rates of the Swiss pension plan as well as negative CHF 11.0 million from a change in demographic assumptions.

Total current liabilities decreased by CHF 19.0 million to CHF 313.5 million. The Group repaid the CHF 100.2 million outstanding amount of the CHF 110 million bond maturing in December 2016. Trade accounts payable increased by CHF 17.1 million to CHF 67.8 million, including CHF 13.3 million from newly acquired entities. Other current liabilities increased by CHF 32.9 million to CHF 156.3 million, including CHF 13.9 million from newly acquired entities. Higher accrued expenses are the main driver of the increase in other current liabilities, accounting for CHF 20.8 million of the total increase, including in particular provisions for supplier invoices related to customer projects

not yet received and additional provisions for expected legal costs related to our IP licensing activities in the US.

In 2016, the Group generated CHF 122.6 million of cash from operating activities, representing a CHF 16.2 million improvement compared to cash flows generated in 2015. The Group used CHF 109.2 million of cash for investing activities. CHF 63.6 million was used for acquisitions in 2016, including net cash out of CHF 29.0 million for Milestone Systems and CHF 27.0 million for NexGuard. In 2016, the Group invested CHF 47.6 million for purchases of intangible and tangible assets.

Cash in from financing activities amounted to CHF 26.3 million. This reflects the CHF 149.3 net proceeds received from the newly issued bond, the repayment of the CHF 110 million bond that matured in December 2016 and the CHF 19.0 million capital distribution paid to Kudelski SA's shareholders.

## **OUTLOOK**

The Group expects to continue growing in 2017, though it does not expect to achieve the same level of profitability as 2016.

In its core digital TV business, many established satellite and cable operators in developed markets are facing new challenges. Following a strong 2016 in emerging markets, the Group expects to consolidate its position in 2017 at a lower revenue level.

IP licensing activities are now well established. The Group expects to benefit from further agreements in 2017. However, in 2017 the Group does not expect to match the exceptionally strong IP licensing performance of 2016.

Kudelski Security will generate substantially higher revenues in 2017, benefitting both from the full consolidation of its newly acquired entities and sustained organic growth. The Group will continue to invest in the development of this business in 2017, including in particular the development of proprietary technologies, which will negatively impact contribution margins.

In the Public Access segment, SKIDATA is expected to maintain the growth trajectory of the last few years and generate higher profitability compared to 2016.