Chief Financial Officer's report

DIVERSIFIED REVENUE AND REDUCED CAPITAL EXPENDITURE

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Lily Liu
Chief Financial Officer
and Company Secretary

Summary of financials

	2017	2016	2015
Revenue £m	**£100.1m**	£96.2m	£93.5m
Gross margin %	**47.0%**	46.4%	47.8%
Gross research and development expenses £m	**£18.1m**	£22.4m	£19.9m
Adjusted operating margin %	**18.0%**	19.8%	21.8%
Operating margin %	**12.1%**	18.1%	14.1%
Adjusted profit before tax £m	**£18.0m**	£19.5m	£20.8m
Profit before tax £m	**£12.3m**	£17.9m	£13.6m
Adjusted diluted earnings per share	**20.7p**	21.2p	24.5p
Diluted earnings per share	**14.0p**	18.9p	16.1p
Net cash and treasury deposit balance £m	**£44.7m**	£49.3m	£69.7m
Net cash flow £m	**(£4.6m)**	(£20.4m)	£22.7m

Adjusted measures exclude items from the IFRS operating profit and profit before tax, such as restructuring and acquisition expenses, share-based payment charges, exchange differences on intra-group transactions and research and development expenditure credits, per the reconciliation of adjusted financial measures on page 103. Net cash includes cash and cash equivalents, and treasury deposits.

Through product portfolio diversification and a re-balancing of our global presence, we note progress in revenue quality underpinned through our continued transformation. The Group maintains its strong financial position, enabling a flexible response for growth opportunities.

Revenue

The Group achieved total revenue for the year of £100.1 million (2016: £96.2 million) representing a 4% increase. Whilst disappointed by the slower-than-anticipated revenue growth in the second half of the year, I am pleased to report a 23% product revenue growth excluding Ceramics.

In December 2017 we announced that we reached an agreement with SII to upgrade their current licence arrangement and replace its future royalty obligations in exchange for a total cash consideration of JPY2.98 billion (circa £20.0 million). This agreement substantially de-risks our future royalty stream. The 2017 royalty revenue includes £10.0 million derived from the one-off SII licence upgrade and replacement agreement. Total Licensee Royalties in 2017 were £16.4 million (2016: £13.3 million)

Sales into Graphic Arts grew by 62% reaching £12.8m for 2017 (2016: £7.9 million) and accounted for 13% of the total revenue for the year. The significant growth in this sector was driven by the success of the 1201 printhead by way of our master distribution agreement in China. In November 2017 we reported that there was a supply constraint that hampered delivery and restricted sales. These constraints have now been addressed and we expect further growth in 2018.

Our Industrial sector no longer includes revenues from the acquired EPS business as they have been reclassified to the Packaging and Product Printing sector. Industrial continues to be the largest sector for Xaar's technology, representing 43% of Group revenue in 2017 at £42.7 million, compared to 48% in 2016 (£45.9 million) on a like for like basis.

The largest revenue contributor in Industrial continues to be ceramic tile decoration. The Ceramics sector has now reached maturity with nearly all lines now converted to digital; revenue was £33.7 million in 2017 a decline from £42.3 million in 2016. The replacement market for printers and printheads has become key and intensity of competition in the sector has continued to drive down prices. The 1003 printhead has been successful and allowed the business to retain its prominent position in the replacement market for printheads. However, adoption of the 2001+ printhead has been slower than anticipated and the business has lost share in new printer installs. The Ceramics sector has fallen 20% since 2016 and now represents just over one third of total revenues.

There has been significant level of growth in nearly all other industrial sub-sectors. We are excited about the 83% increase in the combined Advanced Manufacturing and 3D Printing sectors. This has been driven by a shift in manufacturing processes for flat panel displays and also our leading-edge technologies for 3D Printing. We are equally encouraged about our first revenues of £3.9 million from the Textiles sector, a new market for us, driven by new products within our portfolio.

The Packaging and Product Printing sector has declined slightly by 3% and at £28.3m now represents 28% of the Group's total revenue (2016: £29.0 million, 30%). As mentioned above, we re-classified the EPS business into this sector. EPS grew by 109% thanks to a full-year contribution and continued growth in the business. Decline in sales into Coding and Marking of 53% was a combination of one-off Last-Time-Buy arrangements in 2016 for products previously manufactured in Sweden, and slower adoption of the next generation of products.

As a supplier of technology to OEM partners, our geographic sales split reflects where our OEMs are located, which is not necessarily the end-user location.

In 2017 Asia overtook Europe, Middle East and Africa (EMEA) as the Company's largest sales region. Sales into Asia accounted for £50.9 million (2016: £36.4 million) of sales, representing 51% of the Group's revenue.

Product sales i.e. excluding Licensee Royalties grew 49% largely due to the take up of new products going into Graphic Arts and Textiles. In Ceramics we have reversed the trend of decline in China with increased sales of both the 1003 and 2001+ printheads.

Sales into EMEA have fallen 28% with EMEA accounting for £29.8 million (2016: £41.7 million) of the Group's total sales. This reduction is mainly due to the result of falling sales to European Ceramics OEMs.

The Americas, with a total revenue of £19.4 million (2016: £18.1 million), grew 7%. Much of the growth in the Americas comes from the full year contribution of EPS; this growth was restricted by the decline in sales into Coding and Marking, driven by the one-off Last-Time-Buy arrangement in 2016.

Profitability

We reported an overall adjusted operating margin in 2017 of 18% (2016: 20%). This decline in profitability is due to a combination of factors. The removal of a one-off foreign exchange benefit in 2016 due to the Brexit referendum; a significant reduction of the Thin Film capitalisation from 2016 (£10.2 million) to 2017 (£4.9 million net capitalisation/amortisation) which was partially offset by a reduction in gross R&D spend; and increased royalties.

Gross profit margins increased from 46.4% in 2016 to 47.0% in 2017, helped by increased Licensee Royalties of £3.1 million. Gross profit margins excluding royalties fell from 37.8% to 36.6%. The reduction reflects increased price pressures in Ceramics, lower utilisation of the factory, higher costs on new products as sales volumes increased more slowly than anticipated, and the dilutive effect on the gross profit margin of the increased contribution of sales from products sourced from our partners.

Gross expenditure on R&D (before expense capitalisation/amortisation) decreased by 19% from £22.4 million in 2016 to £18.1 million in 2017 as a number of new products were delivered to market and resources are made available to support Go-To-Market activities. The first products from the Thin Film programme were made available in H2, and as required under International Financial Reporting

Chief Financial Officer's report continued

Standards (specifically IAS 38) amortisation of the programme commenced. In addition to the capitalisation of the Thin Film programme, £0.9 million was capitalised relating to the development of a new 3D Printer technology platform. This 3D printer technology was successfully demonstrated to selected potential customers and partners in late 2017. The net R&D spend for 2017 increased from £12.2 million in 2016 to £12.3 million.

Sales, marketing and general administrative costs increased to £16.9 million (2016: £13.4 million) on an adjusted basis, due to foreign exchange trading losses (2017: £0.6 million loss, 2016: £1.9 million gain) and a full year of EPS' costs.

Adjusted profit before tax of £18.0 million was recorded for 2017 (2016: £19.5 million). Underlying adjusted profit before tax (excluding the benefit of one-off SII royalties and foreign exchange trading losses) was £9.0 million, in line with revised expectations. Profit before tax as reported under IFRS was £12.3 million (2016: £17.9 million).

The tax charge on adjusted profit before tax was £1.9 million (2016: £2.9 million), representing an effective tax rate of 10% (2016: 15%) which compares favourably to the blended UK corporation tax rate for 2017 of 19.25%. The effective rate is low as Xaar benefits from intellectual property and our continued investment in R&D.

The tax charge on IFRS profit before tax was £1.4 million (2016: £3.1 million) representing an effective tax rate of 11% (2016:17%).

Effective from 1 January 2018 the US corporate income tax rate reduced from 35% to 21%. We do not expect this to significantly affect the Group's tax rate in the short term.

Adjusted profit after tax for 2017 was £16.1 million (2016: £16.6 million) and adjusted diluted earnings per share was 20.7 pence (2016: 21.2 pence).

Financial position

The Group maintains a strong financial position, which allows us to fund growth opportunities. 2017 was marked as a year for the business to start reducing its capital expenditure, as we move away from a vertically-integrated development and manufacturing model to working more closely with our strategic partners. We saw a reduction in our capital expenditure in the year of £5.3 million (or 49%) and a reduction in our capitalised development expenditure in the year of £3.8 million (or 36%).

We recorded £44.7 million of cash and treasury deposits at 31 December 2017, a decrease of £4.6 million compared to balances held at 31 December 2016, but an increase of £6.4 million from 30 June 2017.

Operating cash inflow, being adjusted profit before tax after adding back depreciation and amortisation, was £27.3 million (2016: £28.1 million). The change in working capital during the year represented a net cash outflow of £12.9 million. Receivables increased £9.2 million reflecting the phasing of revenue in the year, the establishment of terms with new customers, and extended credit terms for customers driving the adoption of our new products. Inventory increased £5.1 million as we ramped up production of new products and as sales of these new products give rise to an increasingly complex supply chain. This working capital impact was however offset by a significant reduction in fixed capital expenditure for the Group. Total cash outflow relating to intangible and tangible assets was £12.0 million in the year, including £6.5 million of capitalised development expenditure. Dividends accounted for £7.7 million of all cash outflows.

Intangibles

Intangible assets were reported at £32.7 million at 31 December 2017 (£27.4 million at 31 December 2016). These assets are largely associated with the Thin Film development project which was capitalised over the last four years. Amortisation of this project started in August 2017 after the design was frozen and development kits were made available for sale. We will amortise this technology platform over a 20 year period. In addition, £0.9 million was capitalised relating to the development of a new 3D Printer technology platform.

Treasury and currency management

As we continue to explore further acquisition opportunities, we carefully manage our cash and its corresponding liquidity profile.

With a more diversified business model as well as sourcing from strategic partners across the globe, the Group has increased exposure to foreign exchange risk, in particular to the US Dollar. As much as possible, we match our billing currencies to our settlement currency to achieve a natural hedge.

Dividend

As announced in 2014, the Company employs a progressive and sustainable dividend policy which takes into account the Group's future prospects, its underlying profitability and the future cash requirements of the business. The Board will recommend a final dividend of 6.8 pence for 2017 (2016: 6.7 pence) at the forthcoming Annual General Meeting (AGM), giving a total dividend for the year of 10.2 pence, a 2% increase over 2016 (10.0 pence). An interim dividend of 3.4 pence was paid during the year (2016: 3.3 pence). Subject to approval by shareholders at the AGM the final dividend will be paid on 29 June 2018, with an ex-dividend date of 31 May 2018, to shareholders on the register at close of business on 1 June 2018.

Lily Liu
Chief Financial Officer and
Company Secretary

21 March 2018