POLLARD
banknote limited

December 31, 2019

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FOR THE YEAR ENDED DECEMBER 31, 2019

March 11, 2020

This management's discussion and analysis ("MD&A") of Pollard Banknote Limited ("Pollard") for the year ended December 31, 2019, is prepared as at March 11, 2020, and should be read in conjunction with the accompanying audited financial statements of Pollard and the notes therein as at December 31, 2019. Results are reported in Canadian dollars and have been prepared in accordance with International Financial Reporting Standards ("GAAP" or "IFRS").

Forward-Looking Statements

Certain statements in this report may constitute "forward-looking" statements which involve known and unknown risks, uncertainties and other factors which may cause actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward looking statements. When used in this document, such statements include such words as "may," "will," "expect," "believe," "plan" and other similar terminology. These statements reflect management's current expectations regarding future events and operating performance and speak only as of the date of this document. There should not be an expectation that such information will in all circumstances be updated, supplemented or revised whether as a result of new information, changing circumstances, future events or otherwise.

Use of Non-GAAP Financial Measures

Reference to "Adjusted EBITDA" is to earnings before interest, income taxes, depreciation and amortization, purchase accounting amortization, unrealized foreign exchange gains and losses and certain non-recurring items including severance costs, acquisition costs and contingent consideration fair value adjustments. Adjusted EBITDA is an important metric used by many investors to compare issuers on the basis of the ability to generate cash from operations and management believes that, in addition to net income, Adjusted EBITDA is a useful supplementary measure.

Adjusted EBITDA is a measure not recognized under GAAP and does not have a standardized meaning prescribed by GAAP. Therefore, this measure may not be comparable to similar measures presented by other entities. Investors are cautioned that Adjusted EBITDA should not be construed as an alternative to net income determined in accordance with GAAP as an indicator of Pollard's performance or to cash flows from operating, investing and financing activities as measures of liquidity and cash flows.

Basis of Presentation

The results of operations in the following discussions encompass the consolidated results of Pollard for the year ended December 31, 2019. All figures are in millions except for per share amounts.

POLLARD BANKNOTE LIMITED

Overview

Pollard Banknote Limited ("Pollard") is one of the leading providers of products and services to lottery and charitable gaming industries throughout the world. Management believes Pollard is the largest provider of instant-win scratch tickets ("instant tickets") based in Canada and the second largest producer of instant tickets in the world. In addition, management believes Pollard is also the second largest bingo paper and pull-tab supplier to the charitable gaming industry in North America.

Pollard produces and provides a comprehensive line of instant tickets and lottery services including: licensed products, distribution, SureTrack® lottery management system, retail telephone selling ("tel-sell"), marketing, iLottery, interactive digital gaming, PlayOn™ loyalty program, retail management services, ScanACTIV™, lottery ticket dispensers and play stations and vending machines including charitable game systems marketed under the Diamond Game and Oasis trade names. In addition, Pollard's charitable gaming product line includes pull-tab (or break-open) tickets, bingo paper, pull-tab vending machines and ancillary products such as pull-tab counting machines. Pollard also markets products to the commercial gaming and security sector including such items as promotional scratch and win tickets, transit tickets and parking passes.

Pollard's lottery products are sold extensively throughout Canada, the United States and the rest of the world, wherever applicable laws and regulations authorize their use. Pollard serves over 60 instant ticket lotteries including a number of the largest lotteries throughout the world. Charitable gaming products are mostly sold in the United States and Canada where permitted by gaming regulatory authorities. Pollard serves a highly diversified customer base in the charitable gaming market of over 275 independent distributors with the majority of revenue generated from repeat business.

On May 1, 2019, Pollard acquired 100% of the common shares of Fastrak Retail (UK) Limited ("Fastrak") for a purchase price of £4.0 million, subject to standard working capital adjustments and potential future EBITDA and revenue earn-out payments. Fastrak, based in the United Kingdom, is a leading provider of lottery ticket dispensers, lottery play points and other retail merchandising products.

On February 3, 2020, Pollard completed the previously announced acquisition of mkodo Limited ("mkodo"). On December 6, 2019, Pollard signed a definitive agreement to purchase 100% of the equity of mkodo for a purchase price of £7.8 million prior to standard working capital adjustments and potential future earn-out payments based on certain EBITDA targets. mkodo is a leading provider of digital apps and user interfaces for the lottery and gaming industry.

Product line breakdown of revenue

	Year ended December 31, 2019	Year ended December 31, 2018
Lottery [1] [2]	77.8%	75.5%
Charitable [3]	15.7%	16.6%
Gaming systems	6.5%	7.9%

(1) Includes Fastrak Retail (UK) Limited ("Fastrak") which was acquired on May 1, 2019.

(2) Includes the business of Schafer Systems Inc. ("Schafer") which was acquired on October 31, 2018.

(3) Includes International Gamco, Inc. ("Gamco") which was acquired on February 1, 2018.

Geographic breakdown of revenue

	Year ended December 31, 2019	Year ended December 31, 2018
United States	60%	56%
Canada	21%	23%
International	19%	21%

The following financial information should be read in conjunction with the accompanying financial statements of Pollard and the notes therein as at and for the year ended December 31, 2019.

SELECTED FINANCIAL INFORMATION

(millions of dollars, except per share information)

	Year ended December 31, 2019	Year ended December 31, 2018	Year ended December 31, 2017
Sales	**$397.8**	$331.9	$285.6
Cost of sales	**306.7**	256.2	219.9
Gross profit	**91.1**	75.7	65.7
Gross profit as a % of sales	***22.9%***	*22.8%*	*23.0%*
Administration expenses	**40.6**	32.2	28.6
Expenses as a % of sales	***10.2%***	*9.7%*	*10.0%*
Selling expenses	**15.9**	13.4	9.4
Expenses as a % of sales	***4.0%***	*4.0%*	*3.3%*
Net income	**22.0**	14.9	16.8
Net income as a % of sales	***5.5%***	*4.5%*	*5.9%*
Adjusted EBITDA	**60.2**	48.8	44.0
Adjusted EBITDA as a % of sales	***15.1%***	*14.7%*	*15.4%*
Adjusted EBITDA excluding IFRS 16	**54.8**	48.8	44.0
Adjusted EBITDA as a % of sales	***13.8%***	*14.7%*	*15.4%*
Net income per share (basic and diluted)	**$0.86**	$0.58	$0.71

	December 31, 2019	December 31, 2018	December 31, 2017
Total Assets	**$352.3**	$305.6	$228.3
Total Non-Current Liabilities	**$175.6**	$142.9	$124.8

RECONCILIATION OF NET INCOME TO ADJUSTED EBITDA
(millions of dollars)

	Year ended December 31, 2019	Year ended December 31, 2018	Year ended December 31, 2017
Net income	**$22.0**	$14.9	$16.8
Adjustments:			
Amortization and depreciation	**27.1**	18.0	13.1
Interest	**6.4**	4.2	3.9
Unrealized foreign exchange (gain) loss	**(3.3)**	4.6	(1.4)
Acquisition costs	**1.2**	0.8	2.7
Severance costs	**-**	0.4	1.7
Contingent consideration fair value adjustment	**(0.2)**	-	-
Income taxes	**7.0**	5.9	7.2
Adjusted EBITDA	**$60.2**	$48.8	$44.0
Less impact of implementation of IFRS 16 Leases*:			
IFRS 16 related depreciation	**4.7**	-	-
IFRS 16 related interest	**0.7**	-	-
Adjusted EBITDA excluding IFRS 16 impact	**$54.8**	$48.8	$44.0
Lotteries and charitable gaming	**$50.2**	$38.4	$40.0
Diamond Game	**10.0**	10.4	4.0
Adjusted EBITDA	**$60.2**	$48.8	$44.0
Lotteries and charitable gaming	**$45.5**	$38.4	$40.0
Diamond Game	**9.3**	10.4	4.0
Adjusted EBITDA excluding IFRS 16 impact	**$54.8**	$48.8	$44.0

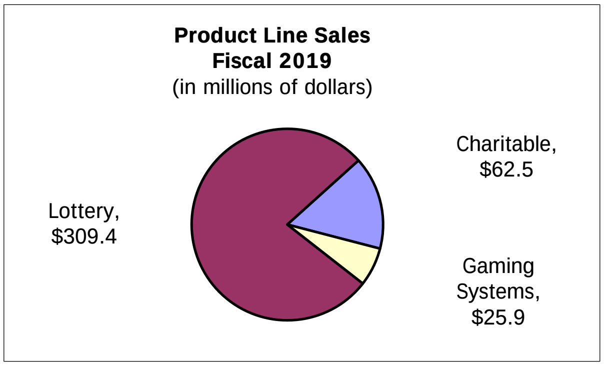
* IFRS 16 Leases was implemented effective January 1, 2019. Qualifying leases are now capitalized and an offsetting liability is recorded. The right-of-use asset is depreciated over the term of the lease and interest expense related to the liability is expensed over the term of the lease. As a result, Adjusted EBITDA has been increased by the conversion of operating lease expenses into depreciation and interest.

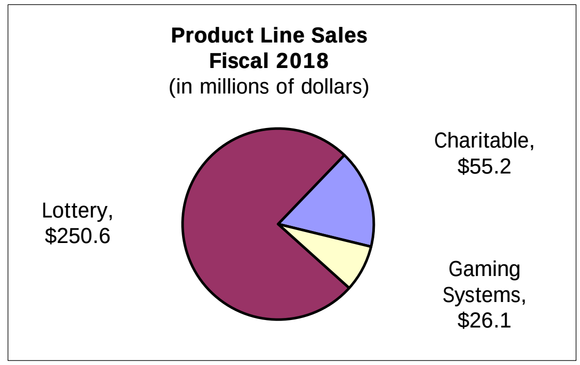
REVIEW OF OPERATIONS

Financial and operating information has been derived from, and should be read in conjunction with, the consolidated financial statements of Pollard and the selected financial information disclosed in this MD&A.

ANALYSIS OF RESULTS FOR THE YEAR ENDED DECEMBER 31, 2019

Sales

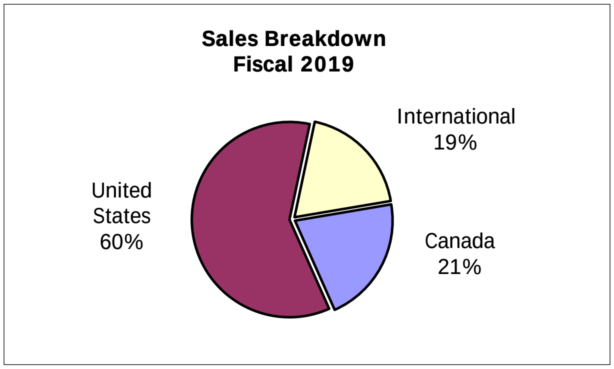


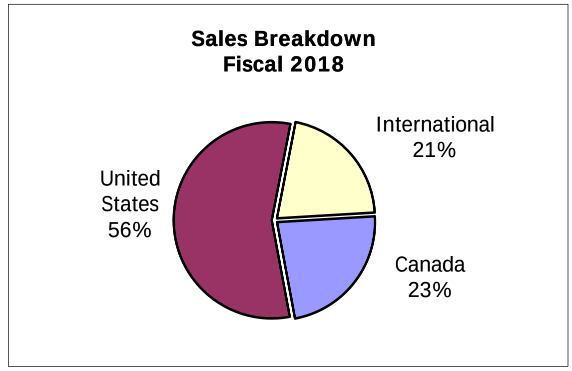


During the year ended December 31, 2019 ("Fiscal 2019" or "2019"), Pollard achieved sales of $397.8 million, compared to $331.9 million in the year ended December 31, 2018 ("Fiscal 2018" or "2018"). Factors impacting the $65.9 million sales increase were:

Higher sales of ancillary lottery products and services increased revenue in Fiscal 2019 by $28.8 million. This increase included the addition of Fastrak and a full year of Schafer in 2019, as well as increased sales of licensed products, iLottery, and digital and loyalty products. Higher instant ticket volumes in 2019 increased revenue by $19.4 million. Pollard achieved record quarterly instant ticket volumes in the fourth quarter of 2019 due to increased orders from existing customers. The fourth quarter of 2018 volumes were substantially lower due to a temporary reduction in customer orders. An increase in the instant ticket average selling price in 2019 further increased sales by $6.5 million. This increase was a result of significant sales of Pollard's proprietary Scratch FX® product and other value-added products in 2019.

Diamond Game's sales decreased slightly in 2019, reducing sales by $0.7 million compared to 2018 due to lower pricing in certain jurisdictions, which took effect midway through 2019. An increase in charitable gaming volumes increased sales by $3.4 million from 2018. In addition, a higher average selling price for charitable gaming products in 2019 further increased sales by $2.2 million.





During Fiscal 2019, Pollard generated approximately 71.8% (2018 – 69.8%) of its revenue in U.S. dollars including a portion of international sales which are priced in U.S. dollars. During Fiscal 2019 the actual U.S. dollar value was converted to Canadian dollars at an average rate of $1.327 compared to an average rate of $1.292 during Fiscal 2018. This 2.7% increase in the U.S. dollar value resulted in an approximate increase of $7.1 million in revenue relative to Fiscal 2018. During 2019 the value of the Canadian dollar strengthened against the Euro resulting in an approximate decrease of $0.7 million in revenue relative to 2018.

Cost of sales and gross profit

Cost of sales was $306.7 million in Fiscal 2019 compared to $256.2 million in Fiscal 2018. Cost of sales was higher as a result of the inclusion of Fastrak and a full year of Schafer in 2019, the increase in instant ticket and charitable gaming volumes, and higher exchange rates on U.S. dollar denominated transactions. Additionally, increased instant ticket manufacturing overheads contributed to the increase in cost of sales in 2019.

Gross profit was $91.1 million (22.9% of sales) in Fiscal 2019 compared to $75.7 million (22.8% of sales) in Fiscal 2018. This increase of $15.4 million in gross profit was primarily the result of the additions of Fastrak and a full year of Schafer in 2019, and higher instant ticket volumes, partially offset by increased manufacturing overheads. Higher charitable gaming sales also contributed to the increase in gross profit. The higher gross profit percentage was due to increased instant ticket volumes and ancillary lottery products and services which was offset by increased production inefficiencies. Gross margin percentage was impacted negatively during the fourth quarter of 2019 due to certain production inefficiencies stemming from a large increase in instant ticket order volumes impacting scheduling. Additional manufacturing costs were incurred to meet the higher demands during this time frame including higher levels of overtime, increased spoilage and increased freight costs.

Administration expenses

Administration expenses increased to $40.6 million in Fiscal 2019 from $32.2 million in Fiscal 2018. The increase of $8.4 million was partially a result of the inclusion of Fastrak and a full year of Schafer in 2019 which increased administration expenses by $2.2 million. In addition, higher compensation expenses to support Pollard's growth strategies of developing digital innovation products and higher professional fees further increased administration expenses. Professional fees, excluding acquisition costs, were higher by $1.5 million primarily due to higher legal fees incurred by Pollard to defend our intellectual property including certain patents. Acquisition costs were $0.4 million higher in 2019 relative to Fiscal 2018. These increases were partially offset by a $0.4 million reduction in severance costs as compared to 2018.

Selling expenses

Selling expenses increased to $15.9 million in Fiscal 2019 from $13.4 million in Fiscal 2018 primarily due to the addition of Fastrak and a full year of Schafer, as well as higher compensation and contract support costs.

Other expenses

Other expenses increased to $2.0 million in Fiscal 2019 from $0.4 million in Fiscal 2018, primarily due to the increased loss on equity investment as compared to 2018.

Foreign exchange

The net foreign exchange gain was $2.8 million in Fiscal 2019 compared to a net loss of $4.7 million in Fiscal 2018. The 2019 net foreign exchange gain consisted of a $3.3 million unrealized gain primarily a result of the decreased Canadian equivalent value of U.S. dollar denominated accounts payable and long-term debt with the strengthening of the Canadian dollar relative to the U.S. dollar. Partially offsetting the unrealized foreign exchange gain, Pollard incurred a realized foreign exchange loss of $0.5 million as a result of foreign currency denominated accounts receivable collected being converted into Canadian dollars at unfavorable foreign exchange rates.

The 2018 net foreign exchange loss consisted of a $4.6 million unrealized loss primarily a result of the increased Canadian equivalent value of U.S. dollar denominated accounts payable and long-term debt with the weakening of the Canadian dollar relative to the U.S. dollar. In 2018 Pollard added almost $29 million of U.S. dollar denominated debt, with the acquisitions of Gamco and Schafer, which is subject to revaluation through the income statement. At December 31, 2018, the Canadian dollar had weakened relative to the U.S. dollar, resulting in the substantial unrealized foreign exchange loss.

In addition to the unrealized foreign exchange loss in 2018, Pollard incurred a realized foreign exchange loss of $0.1 million as a result of foreign currency denominated accounts receivable collected being converted into Canadian dollars at unfavorable foreign exchange rates.

Adjusted EBITDA

Adjusted EBITDA excluding the impact of IFRS 16 Leases increased to $54.8 million in Fiscal 2019 compared to $48.8 million in Fiscal 2018. The primary reason for the increase of $6.0 million was the increase in gross profit of $19.1 million (net of amortization and depreciation and IFRS 16 impact). This increase was partially offset by higher administration expenses (net of acquisition and severance costs) of $8.4 million, an increase in selling expenses of $2.5 million, an increase in other expenses of $1.6 million and an increase in the realized foreign exchange loss of $0.4 million.

Interest expense

Interest expense increased to $6.4 million in Fiscal 2019 from $4.2 million in Fiscal 2018 primarily as a result of the additional interest expense related to increased long-term debt due to the acquisitions of Schafer and Fastrak, and additional interest expense incurred with the implementation of IFRS 16 effective January 1, 2019 of $0.7 million.

Amortization and depreciation

Amortization and depreciation, including amortization of intangible assets and depreciation of property and equipment, totaled $27.1 million during Fiscal 2019 which increased from $18.0 million during Fiscal 2018. The increase of $9.1 million was partially a result of $4.7 million of former operating lease costs being characterized as depreciation with the implementation of IFRS 16 effective January 1, 2019. The addition of Fastrak and a full year of Schafer, including the amortization and depreciation relating to the identifiable assets acquired, including intangible assets and property, plant and equipment, and higher depreciation and amortization on new equipment and intangible assets increased expenses in 2019.

Income taxes

Income tax expense was $7.0 million in Fiscal 2019, an effective rate of 24.1%, which was lower than our domestic rate of 27.0% due primarily to lower federal income tax rates in the United States and the effect of foreign exchange. Partially offsetting these reductions in effective rate was the non-deductible amounts relating to expenses incurred in the acquisitions.

Income tax expense was $5.9 million in Fiscal 2018, an effective rate of 28.5%, which was higher than our domestic rate of 27.0% due primarily to non-deductible amounts relating to expenses incurred in the acquisitions and the effect of foreign exchange. Partially offsetting these increases in effective rate was the lower federal income tax rates in the United States.

Net income

Net income was $22.0 million in Fiscal 2019 compared to net income of $14.9 million in Fiscal 2018. The primary reasons for the increase in net income of $7.1 million were the increase in gross profit of $15.4 million and the higher foreign exchange gain of $7.5 million. These increases were partially offset by the higher administration expenses of $8.4 million, the increase in selling costs of $2.5 million, the increase in other expenses of $1.6 million, additional interest expense of $2.2 million and the increase in income tax expense of $1.1 million.

Net income per share (basic and diluted) increased to $0.86 per share in Fiscal 2019 from $0.58 per share in Fiscal 2018.

Liquidity and Capital Resources

Cash provided by operating activities

For the year ended December 31, 2019, cash flow provided by operating activities was $29.3 million compared to $39.7 million in Fiscal 2018.

The primary reason for the reduction in cash flow provided by operations was a significant increase in our investment in non-cash working capital in 2019. In Fiscal 2019, increases in non-cash working capital used $22.5 million compared to decreases in 2018 which generated $4.0 million in cash, a $26.5 million difference.

In 2019, changes in the non-cash component of working capital decreased cash flow from operations due primarily to an increase in accounts receivable. The higher investment in accounts receivable reflects the higher sales volume from higher order levels building throughout Fiscal 2019, relative to a very low order level in the fourth quarter of 2018. In 2018, changes in the non-cash component of working capital increased cash flow from operations due primarily to a decrease in accounts receivable, partially offset by an increase in inventory and a decrease in accounts payable and accrued liabilities.

Higher net income before income taxes and after non-cash adjustments in Fiscal 2019 contributed $69.6 million to the cash provided by operating activities compared to $55.9 million in Fiscal 2018. Cash used for interest payments increased to $6.4 million in 2019 as compared to $4.5 million in 2018. Cash used for pension plan contributions increased to $7.4 million in 2019 as compared to $5.5 million in 2018. Cash used for income taxes paid was $4.0 million in 2019 compared to $10.2 million in 2018.

Cash used for investing activities

In the year ended December 31, 2019, cash used for investing activities was $38.3 million compared to $77.1 million in the year ended December 31, 2018. In Fiscal 2019, Pollard used $8.5 million, net of cash acquired, to purchase Fastrak. In addition, Pollard expended $17.2 million in capital expenditures, $4.0 million on our investment in our iLottery joint venture and $8.6 million on additions to intangible assets.

In Fiscal 2018, Pollard used $21.6 million, net of cash acquired, to purchase Gamco and $30.4 million to purchase Schafer. In addition, Pollard expended $15.1 million in capital expenditures, $2.8 million on our investment in our iLottery joint venture and $7.1 million on additions to intangible assets.

Cash provided by financing activities

Cash provided by financing activities was $5.6 million in the year ended December 31, 2019, compared to $42.6 million in the year ended December 31, 2018.

During Fiscal 2019, Pollard received net proceeds from long-term debt of $14.3 million. This receipt of cash was partially offset by $4.4 million of lease principal payments, which, starting in 2019 with the implementation of IFRS 16, are now shown as financing activities, and $3.8 million of dividends.

During Fiscal 2018, Pollard raised $35.4 million, net of expenses, from the issuance of common shares, which was used, in part, to repay $16.7 million of subordinated debt. In addition, Pollard received net proceeds from long-term debt of $27.9 million, partially to fund the acquisitions of Gamco and Schafer. These cash receipts were partially offset by $0.6 million of financing costs and dividends paid of $3.1 million.

As at December 31, 2019, Pollard had unused committed credit facility of $69.7 million, in addition to $7.4 million in available cash resources. These amounts, in addition to cash flow provided by operating activities, are available to be used for future working capital requirements, contractual obligations, capital expenditures, dividends and to assist in financing future acquisitions.

ANALYSIS OF RESULTS FOR THE PERIOD OCTOBER 1, 2019 TO DECEMBER 31, 2019
FOURTH QUARTER OF 2019

SELECTED FINANCIAL INFORMATION

(millions of dollars)

	Three months ended December 31, 2019	Three months ended December 31, 2018
	(unaudited)	(unaudited)
Sales	$100.0	$70.2
Cost of sales	78.0	56.9
Gross profit	22.0	13.3
Administration	10.9	7.9
Selling	4.1	3.6
Other expense (income)	0.2	(0.1)
Income from operations	6.8	1.9
Finance costs	1.6	4.2
Finance income	(1.0)	-
Income (loss) before income taxes	6.2	(2.3)
Income taxes:		
Current (recovery)	(0.9)	(0.4)
Future	2.5	-
	1.6	(0.4)
Net income (loss)	$4.6	($1.9)
Adjustments:		
Amortization and depreciation	7.1	5.3
Interest	1.6	1.2
Unrealized foreign exchange (gain) loss	(1.1)	3.1
Acquisition costs	0.6	0.2
Contingent consideration fair value adjustment	(0.2)	-
Income taxes (recovery)	1.6	(0.4)
Adjusted EBITDA	$14.2	$7.5
Less impact of implementation of IFRS 16 Leases:		
IFRS 16 related depreciation	1.2	-
IFRS 16 related interest	0.2	-
Adjusted EBITDA excluding IFRS 16 impact	$12.8	$7.5
Lotteries and charitable gaming	$11.9	$4.9
Diamond Game	2.3	2.6
Adjusted EBITDA	$14.2	$7.5
Lotteries and charitable gaming	$10.7	$4.9
Diamond Game	2.1	2.6
Adjusted EBITDA excluding IFRS 16 impact	$12.8	$7.5

Sales

During the three months ended December 31, 2019, Pollard achieved sales of $100.0 million, compared to $70.2 million in the three months ended December 31, 2018. Factors impacting the $29.8 million sales increase were:

Instant ticket sales volumes for the fourth quarter of 2019 were significantly higher, 57%, than the fourth quarter of 2018, which increased sales by $23.7 million. The reasons for this significant increase in instant ticket volumes were two-fold. The fourth quarter of 2019 saw record volumes of instant tickets sold, a result of increased orders from existing customers; while the comparative quarter from 2018 was significantly lower than the quarterly volumes achieved over the past few years. The fourth quarter 2018 reduction was a result of a temporary decline in orders from our customer portfolio as a number of our larger customers had lower orders during the quarter.

Additionally, higher sales of ancillary lottery products and services increased revenue in the fourth quarter of 2019 by $4.7 million. This growth was due to higher sales of licensed products, digital and loyalty products, and iLottery. The addition of Fastrak and a full quarter of Schafer in 2019 further increased ancillary lottery related sales. An increase in the instant ticket average selling price in the quarter compared to the fourth quarter of 2018 further grew sales by $0.8 million. This increase was, in part, a result of significant sales of Pollard's proprietary Scratch FX® product in 2019.

Diamond Game's sales decreased slightly in the fourth quarter of 2019, which reduced sales by $0.5 million when compared to 2018 due to lower pricing in a certain jurisdiction. An increase in charitable gaming volumes increased sales by $0.3 million from 2018. In addition, a higher average selling price for charitable gaming products in 2019 further increased sales by $0.8 million.

During the three months ended December 31, 2019, Pollard generated approximately 70.9% (2018 – 80.5%) of its revenue in U.S. dollars including a portion of international sales which were priced in U.S. dollars. During the fourth quarter of 2019 the actual U.S. dollar value was converted to Canadian dollars at an average rate of $1.314, compared to an average rate of $1.311 during the fourth quarter of 2018. This 0.2% increase in the value of the U.S. dollar resulted in an approximate increase of $0.1 million in revenue relative to 2018. During the fourth quarter of 2019 the value of the Canadian dollar strengthened against the Euro resulting in an approximate decrease of $0.1 million in revenue relative to 2018.

Cost of sales and gross profit

Cost of sales was $78.0 million in the fourth quarter of 2019 compared to $56.9 million in the fourth quarter of 2018. Cost of sales was higher in the quarter as a result of the substantial increase in instant ticket volumes. In addition, higher ancillary lottery product sales and the inclusion of Fastrak and a full quarter of Schafer in 2019 increased cost of goods sold as compared to the fourth quarter of 2018.

Gross profit was $22.0 million (22.0% of sales) in the fourth quarter of 2019 compared to $13.3 million (18.9% of sales) in the fourth quarter of 2018. This increase in gross profit was primarily the result of the significant increase in instant ticket volumes. Gross margin percentage was significantly higher than the fourth quarter of 2018, with higher margins achieved on instant tickets being partially offset by lower margins in Diamond Game due to the reduction in pricing. Gross margin percentage was impacted negatively during the fourth quarter of 2019 due to certain production inefficiencies stemming from a large increase in instant ticket order volumes impacting scheduling. Additional manufacturing costs were incurred to meet the higher demands during this time frame including higher levels of overtime, increased spoilage and increased freight costs.

Administration expenses

Administration expenses increased to $10.9 million in the fourth quarter of 2019 compared to $7.9 million in the fourth quarter of 2018. The increase of $3.0 million was partially a result of the inclusion of Fastrak and a full quarter of Schafer, increasing administration expenses by $0.4 million. Additionally, higher compensation expenses to support Pollard's growth strategies of developing digital innovation products, increased incentive accruals and additional acquisition costs of $0.4 million contributed to the increase. Partially offsetting these increases was a decrease in professional services of $0.4 million. Administration expenses in the fourth quarter of 2019 were similar to the amount incurred in the third quarter of 2019.

Selling expenses

Selling expenses increased to $4.1 million in the fourth quarter of 2019 from $3.6 million in the fourth quarter of 2018. The increase was primarily due to the addition of Fastrak and a full quarter of Schafer, as well as higher compensation and contract support costs. Selling expenses in the fourth quarter of 2019 were similar to the amount incurred in the third quarter of 2019.

Foreign exchange

The net foreign exchange gain was $1.0 million in the fourth quarter of 2019 compared to a net loss of $3.0 million in the fourth quarter of 2018. The 2019 net foreign exchange gain consisted of a $1.1 million unrealized gain primarily as a result of the decreased Canadian equivalent value of U.S. dollar denominated accounts payable and long-term debt due to the strengthening of the Canadian dollar relative to the U.S. dollar. The unrealized foreign exchange gain was partially offset by the realized foreign exchange loss of $0.1 million, as a result of foreign currency denominated accounts receivable collected being converted into Canadian dollars at unfavorable foreign exchanges rates.

The 2018 net foreign exchange loss consisted of a $3.1 million unrealized loss primarily as a result of the increased Canadian equivalent value of U.S. dollar denominated accounts payable and long-term debt due to the weakening of the Canadian dollar relative to the U.S. dollar. The Canadian dollar weakened approximately 5.5% since the beginning of the fourth quarter of 2018 and this movement, combined with higher U.S. dollar denominated debt relating to the acquisitions, generated a substantial unrealized foreign exchange loss. The unrealized foreign exchange loss was partially offset by the realized foreign exchange gain of $0.1 million, as a result of foreign currency denominated accounts receivable collected being converted into Canadian dollars at favorable foreign exchanges rates.

Adjusted EBITDA

Adjusted EBITDA excluding the impact of IFRS 16 Leases was $12.8 million in the fourth quarter of 2019 compared to $7.5 million in the fourth quarter of 2018. The primary reason for the $5.3 million increase was the higher gross profit of $9.1 million (net of amortization and depreciation and IFRS 16 impact) due primarily to the increase in instant ticket volumes. This increase was partially offset by the higher administration costs (net of acquisition costs) of $2.6 million, the increase in selling costs of $0.5 million, higher other expenses of $0.3 million and an increase in realized foreign exchange loss of $0.2 million.

Interest expense

Interest expense increased to $1.6 million in the fourth quarter of 2019 from $1.2 million in the fourth quarter of 2018 primarily as a result of the additional interest expense related to increased long-term debt incurred with the acquisitions of Schafer and Fastrak, and additional interest expense incurred with the implementation of IFRS 16 effective January 1, 2019 of $0.2 million for the quarter.

Amortization and depreciation

Amortization and depreciation, including amortization of intangible assets and depreciation of property and equipment, totaled $7.1 million during the fourth quarter of 2019 which increased from $5.3 million during the fourth quarter of 2018. The increase was primarily a result of $1.2 million of former operating lease costs being characterized as depreciation with the implementation of IFRS 16 effective January 1, 2019. Also, the addition of Schafer and Fastrak, including the amortization and depreciation relating to the identifiable assets acquired, including intangible assets and property, plant and equipment, and higher depreciation and amortization on new equipment and intangible assets increased expenses in 2019.

Income taxes

Income tax expense was $1.6 million in the fourth quarter of 2019, an effective rate of 25.5% which was lower than our domestic rate of 27.0% due primarily to lower federal income tax rates in the United States and the effect of foreign exchange. Partially offsetting these reductions in effective rate was non-deductible amounts relating to expenses incurred in the acquisitions.

Income tax recovery was $0.4 million in the fourth quarter of 2018, an effective rate of 16.3% which was lower than our domestic rate of 27.0% due primarily to non-deductible amounts relating to expenses incurred in the acquisitions and the effect of foreign exchange. Partially offsetting these reductions in effective rate was the lower federal income tax rates in the United States.

Net income (loss)

Net income was $4.6 million in the fourth quarter of 2019 compared to net loss of $1.9 million in the fourth quarter of 2018. The primary reasons for the $6.5 million increase in net income were the higher gross profit of $8.7 million, due primarily to the increase in instant ticket volumes, and the increase in the foreign exchange gain of $4.0 million. Partially offsetting these increases were the increase in administration expenses of $3.0 million, higher selling expenses of $0.5 million, additional interest expense of $0.4 million and the increase in income taxes of $2.0 million.

Net income per share (basic and diluted) increased to $0.18 per share in the fourth quarter of 2019 from a loss of $0.08 per share in the fourth quarter of 2018.

Quarterly Information
(unaudited)
(millions of dollars)

	Q4 2019	Q3 2019	Q2 2019	Q1 2019	Q4 2018	Q3 2018	Q2 2018	Q1 2018
Sales	$100.0	$103.2	$97.1	$97.5	$70.2	$94.5	$86.8	$80.4
Adjusted EBITDA	14.2	16.1	13.6	16.3	7.5	14.2	14.1	13.0
Net income (loss)	4.6	4.4	5.0	8.0	(1.9)	7.2	5.0	4.6

Effective the first quarter 2019 Adjusted EBITDA increased as a result of the implementation of IFRS 16 Leases. The amounts per quarter were $1.4 million in Q4 2019, $1.2 million in Q3 2019, $1.3 million in Q2 2019 and $1.3 million in Q1 2019.

The trend of increased sales, Adjusted EBITDA and net income, starting the first quarter of 2018, with the exception of the fourth quarter of 2018, was primarily as a result of higher instant ticket volumes and the acquisitions made during this timeframe.

The significant decrease in instant ticket volumes in the fourth quarter of 2018 reduced sales, Adjusted EBITDA and net income. Net income was further reduced by the large unrealized foreign exchange loss in the quarter.

Working Capital

Net non-cash working capital varies throughout the year based on the timing of individual sales transactions and other investments. The nature of the lottery industry is few individual customers who generally order large dollar value transactions. As such, the change in timing of a few individual orders can significantly impact the amount required to be invested in inventory or receivables at a particular period end. The high value, low volume of transactions results in some significant volatility in non-cash working capital, particularly during a period of rising volumes. Similarly, the timing of the completion of the sales cycle through collection can significantly impact non-cash working capital.

Instant tickets are produced specifically for individual clients resulting in a limited investment in finished goods inventory. Customers are predominantly government agencies, which result in regular payments. There are a limited number of individual customers, and therefore net investment in working capital is managed on an individual customer by customer basis, without the need for company-wide benchmarks.

The overall impact of seasonality does not have a material impact on the carrying amounts in working capital.

As at December 31, 2019, Pollard's investment in non-cash working capital increased $22.5 million compared to December 31, 2018, primarily a result of the increased investment in accounts receivable. The higher investment in accounts receivable reflects the increasing sales volume from increased orders levels building throughout 2019, relative to a period of very low orders in the fourth quarter of 2018.

	December 31, 2019	December 31, 2018
Working Capital	$79.2	$65.5
Total Assets	$352.3	$305.6
Total Non-Current Liabilities	$175.6	$142.9

Credit Facility

Pollard's credit facility was renewed effective December 31, 2019. The credit facility provides loans of up to $190.0 million for its Canadian operations and US$14.0 million for its U.S. subsidiaries. The borrowings for the Canadian operations can be denominated in Canadian or U.S. dollars, to a maximum of $190.0 million Canadian equivalent. The credit facility also includes an accordion feature which can increase the facility by $35.0 million. Borrowings under the credit facility bear interest at fixed and floating rates based on Canadian and U.S. prime bank rates, banker's acceptances or LIBOR. At December 31, 2019, the outstanding letters of guarantee were $10.7 million. The remaining balance available for drawdown under the credit facility was $69.7 million.

Under the terms and conditions of the credit facility agreement Pollard is required to maintain certain financial covenants including debt to income before interest, income taxes, amortization and depreciation ("Adjusted EBITDA") ratios and certain debt service coverage ratios. As at December 31, 2019, Pollard is in compliance with all financial covenants.

Pollard's credit facility is secured by a first security interest in all of the present and after acquired property of Pollard. Under the terms of the agreement the facility is committed for a three-year period, renewable December 31, 2022. Principal payments are not required until maturity. The facility can be prepaid without penalties.

Pollard believes that its credit facility and ongoing cash flow from operations will be sufficient to allow it to meet ongoing requirements for investment in capital expenditures, working capital, dividends and acquisitions.

Outstanding Share Data

As at December 31, 2019 and March 11, 2020, outstanding share data was as follows:

Common shares	25,635,658

On March 19, 2019, 5,000 common shares were issued through the exercise of stock options.

On May 24, 2019, 5,000 common shares were issued through the exercise of stock options.

Share Options

Under the Pollard Banknote Limited Stock Option Plan the Board of Directors has the authority to grant options to purchase common shares to eligible persons and to determine the applicable terms. The aggregate maximum number of common shares available for issuance from Pollard's treasury under the Option Plan is 2,354,315 common shares. On March 19, 2019, 5,000 stock options were exercised and an additional 5,000 stock options were exercised on May 24, 2019.

On November 5, 2019, the Board of Directors approved the award of 150,000 options to purchase common shares of Pollard for key management personnel. The options were granted on November 8, 2019, and have a seven-year term, vesting 25% per year over the first four years. The exercise price of the options is $20.70. As at December 31, 2019, the total share options issued and outstanding were 377,500.

Contractual Obligations

Pollard rents premises and equipment under long-term operating leases. The following is a schedule by year of commitments and contractual obligations outstanding, including related interest payments:

(millions of dollars)	Total	2020	2021	2022	2023	2024
Long-term debt	$146.0	$5.4	$6.4	$134.2	-	-
Operating leases	$18.1	$5.5	$4.5	$4.0	$3.2	$0.9
Total	$164.1	$10.9	$10.9	$138.2	$3.2	$0.9

Pension Obligations

Pollard sponsors four non-contributory defined benefit pension plans, of which three are final pay plans and one is a flat benefit plan. As of December 31, 2019, the aggregate fair value of the assets of Pollard's defined benefit pension plans was $65.5 million and the accrued benefit plan obligations were $92.0 million. Pollard's total annual funding contribution for its defined pension plans in 2020 is expected to be approximately $6.5 million, compared to $6.3 million in 2019, including $1.5 million in additional solvency payments.

One of Pollard's Canadian pension plans was subject to a solvency valuation beginning with its December 31, 2016 valuation. The solvency valuation is required to be updated annually. As at the December 31, 2018 valuation there was a deficit of $9.9 million, due to the low current levels of the mandated interest rate used to discount the future liabilities. As a result, Pollard is subject to additional special pension plan payments of approximately $1.5 million per year through to 2026. These additional solvency payments do not impact pension expense and therefore will not affect our net income or Adjusted EBITDA and will be funded from operating cash flows.

Off-Balance Sheet Arrangements

Other than the operating leases described previously, Pollard has no other off-balance sheet arrangements.

Related Party Transactions

Pollard Equities Limited and affiliates

During the year ended December 31, 2019, Pollard paid property rent of $3.2 million (2018 - $3.2 million) and $0.4 million (2018 - $0.5 million) in plane charter costs to affiliates of Equities. In addition, Pollard paid Equities $nil (2018 - $0.4 million) of interest on Pollard's subordinated debt.

During the year ended December 31, 2019, Equities paid Pollard $0.07 million (2018 - $0.07 million) for accounting and administration fees.

At December 31, 2019, Pollard owed Equities and its affiliates $0.5 million (2018 - $0.6 million) for rent, interest, expenses and other items. Included within property, plant and equipment and lease liabilities on the consolidated statement of financial position are right-of-use assets and corresponding liabilities for premises leased to Pollard from Equities. As at December 31, 2019, the net book value of the right-of-use assets was $10.8 million and the present value of the lease liabilities was $11.8 million.

Neogames S.à r.l. and affiliates

During the year ended December 31, 2019, Pollard reimbursed operating costs and paid software royalties of $5.7 million (2018 - $3.3 million) to its iLottery partner, which are recorded in cost of sales.

At December 31, 2019, included in accounts payable and accrued liabilities is a net amount owing to Pollard's iLottery partner of $0.1 million (2018 - $0.9 million) for reimbursement of operating costs and capital expenditures, and its share of operating profits.

At December 31, 2019, included in restricted cash and accounts payable and accrued liabilities is an amount owing to Pollard's iLottery partner of $2.6 million (2018 - $1.6 million) for funds relating to contractual performance guarantees.

Critical Accounting Policies and Estimates

Described in the notes to Pollard's 2019 audited consolidated financial statements are the accounting policies and estimates that Pollard believes are critical to its business. Please refer to note 2 (c) to the audited consolidated financial statements for the year ended December 31, 2019, for a discussion of the significant accounting estimates and judgements.

Future Changes in Accounting Policies

In October 2018, the International Accounting Standards Board issued amendments to IFRS 3 *Business Combinations,* that seek to clarify whether a transaction results in an asset or a business acquisition. The amendments include an election to use a concentration test. This is a simplified assessment that results in an asset acquisition if substantially all of the fair value of the gross assets is concentrated in a single identifiable asset or a group of similar identifiable assets. The amendments apply to businesses acquired in annual reporting periods beginning on or after January 1, 2020. Pollard does not expect the amendments to have a significant impact on the consolidated financial statements upon adoption.

Industry Risks and Uncertainties

Pollard is exposed to numerous risks and uncertainties which are described in this MD&A and Pollard's most recent Annual Information Form dated March 11, 2020, which is available under Pollard's profile on SEDAR (www.sedar.com).

Financial Instruments

Pollard is exposed to financial risks that arise from fluctuations in interest rates and foreign exchange rates and the degree of volatility of these rates, liquidity risk and credit risk. Pollard uses financial instruments, from time to time, to manage these risks.

Pollard's risk management policies are established to identify and analyze the risks, to set appropriate risk limits and controls to monitor risks and adherence to limits. The Audit Committee oversees how management monitors compliance with Pollard's risk management policies and procedures. The Audit Committee is assisted in its oversight role by Internal Audit, who undertakes regular reviews of risk management controls and utilizes the annual risk assessment process as the basis for the annual internal audit plan.

Risk Exposure

<u>Currency risk</u>

Pollard sells a significant portion of its products and services to customers in the United States and to international customers where sales are denominated in U.S. dollars. In addition, a significant portion of its cost inputs are denominated in U.S. dollars. Pollard also generates revenue in currencies other than Canadian and U.S. dollars, primarily in Euros.

In addition, translation differences arise when foreign currency monetary assets and liabilities are translated at foreign exchange rates that change over time.

<u>Interest rate risk</u>

Pollard is exposed to interest rate risk relating to its fixed and floating rate instruments. Fluctuation in interest rates will have an effect on the valuation and repayment of these instruments.

<u>Credit risk</u>

Credit risk is the risk of financial loss if a customer or counterpart to a financial instrument fails to meet its financial obligations.

<u>Liquidity risk</u>

Liquidity risk is the risk that Pollard will not be able to meet its financial obligations as they fall due.

Risk Management

Currency risk

Pollard utilizes a number of tools to manage its foreign currency risk including sourcing its manufacturing facilities in the U.S. and sourcing other cost of sales in U.S. dollars.

A 50 basis point strengthening/weakening in the foreign exchange rate between the Canadian and U.S. dollar would decrease/increase the income before income taxes by approximately $0.04 million for year ended December 31, 2019 (2018 - $0.02 million). A 50 basis point strengthening/weakening in the foreign exchange rate between the Canadian dollar and Euro would decrease/increase the income before income taxes due to changes in operating cashflow by approximately $0.08 million for year ended December 31, 2019 (2018 - $0.08 million).

Five manufacturing facilities are located in the U.S. and a significant amount of cost inputs for all production facilities are denominated in U.S. dollars, offsetting a large portion of the U.S. dollar revenue in a natural hedge.

As at December 31, 2019, the amount of financial liabilities denominated in U.S. dollars exceeded the amount of financial assets denominated in U.S. dollars by approximately $27.9 million (2018 - $36.1 million). A 50 basis point weakening/strengthening in the value of the Canadian dollar relative to the U.S. dollar would result in a decrease/increase in income before income taxes of approximately $0.1 million (2018 - $0.2 million).

Pollard also uses financial hedges, including foreign currency contracts, to help manage foreign currency risk. At December 31, 2019, Pollard had no outstanding foreign currency contracts.

Interest rate risk

A 50 basis point decrease/increase in interest rates would result in an increase/decrease in income before income taxes of $0.6 million for the year ended December 31, 2019 (2018 - $0.6 million).

Credit risk

Credit risk on Pollard's accounts receivable is minimized since they are mainly from governments and their agencies and are collected in a relatively short period of time. Credit risk on foreign currency contracts is minimized since the counterparties are restricted to Schedule 1 Canadian financial institutions.

Liquidity risk

Pollard's approach is to ensure that it will always have sufficient liquidity to meet its liabilities when due. Pollard maintains a committed credit facility including up to $190.0 million for its Canadian operations and up to US$14.0 million for its U.S. subsidiaries. At December 31, 2019, the unused balance available for drawdown was $69.7 million (2018 - $58.9 million).

The 2020 requirements for capital expenditures, working capital and dividends are expected to be financed from cash flow provided by operating activities and unused portion of Pollard's credit facility. Pollard enters into contractual obligations in the normal course of business operations.

Outlook

The lottery and charitable gaming industries remain very healthy with growth at the retail level continuing. In particular, consumer demand for instant tickets, and products and services related to instant tickets, remains strong with a number of factors driving greater retail sales: constantly changing ticket offerings, higher price points, larger and varied prize payouts, eye-catching graphics, licensed themes, innovative merchandising and focused advertising. Growth rates at the manufacturing levels are traditionally lower than growth rates at the retail level however we expect these positive growth rates to continue.

Lotteries are expanding their usage of ancillary products like innovative merchandising options, loyalty programs, digital apps, distribution and warehousing, retail support and other “back office” products. They are exploring more of these solutions, however many remain in development or early stages and lotteries have traditionally been slow to adopt these new methods and ideas. Revenue generated from these solutions are still developing and Pollard will continue to invest the necessary resources for the long-term growth of these products. We believe these products, in addition to the revenues generated directly from their sale, will also increase sales of instant tickets.

The foundation of our business is our instant ticket contract portfolio, which remains very strong. We do not have any major contracts coming due during 2020 but as is typical there are a few of our existing mid-size contracts that regularly come up for bid including in the next twelve months. We are hopeful of retaining or growing the long-term relationships we currently have in place. Our strategy is not to aggressively bid for large contract opportunities simply in order to gain market share, rather we look for opportunities to compete and strategically bid with a focus on positive margins through expanding our higher value and proprietary products.

At the beginning of March 2020 our new instant ticket warehousing and distribution operation for the Arizona Lottery went live. This is just another example of a key ancillary service we can provide lotteries which expands our touches with our clients and helps drive higher instant ticket sales.

A factor in our success has been the development of a number of unique proprietary products that allow our clients to generate greater returns for their good causes. Key examples of these include Scratch FX®, laminated products, such as PlayBooks®, and Clear Play™. Our ongoing growth and success in maintaining strong average selling prices on our products depends on our ability to develop more specialty value-added enhancements and we will continue to invest resources to develop more innovative products and services.

Interest in iLottery continues to be active among lotteries in North America. Traditionally, lotteries and state legislatures are slow to make the changes required to enable new revenue streams such as iLottery, and the adoption of these complex operations can take long periods. As a result, we do not anticipate many new iLottery operations going live during the next year. However, we believe in the long term new iLottery implementations will grow as lotteries recognize the critical importance of expanding distribution methods and the positive impact it can have on incremental revenue. Our existing operations in this space continue to develop, with stronger growth in those jurisdictions that allow a broader range of gaming options including selling e-instants versus jurisdictions that only allow the online sale of draw based game tickets.

The charitable gaming market has shown positive growth at the retail level over the last year and this renewed growth translates into additional incremental opportunities for our American Games/International Gamco operations. We have invested resources in additional press capabilities for our pull-tab production and we believe the positive market reception of our combined businesses will continue to provide strong free cashflow. Our Diamond Game operation will continue to focus on new jurisdictions for their charitable egaming machines. The impact of new pricing environments in certain jurisdictions, introduced in 2019, will continue to have a negative impact on a full year basis in 2020, however we believe this will be partially mitigated by our ability to introduce additional machines in these same markets.

We continue to invest heavily in our business through an ongoing capital expenditure program and increasingly, our development of digital solutions and other important intangible assets. We expect CAPEX in 2020 to be at similar or slightly higher levels then expended in 2019. Included in our planned capital expenditures are new egaming machines for our Diamond Game and Oasis operations, however this amount will vary depending on the timing of new jurisdiction implementation. With our continued strong cash conversion from earnings and a large senior debt facility in place, our cash resources allow us to fund required investments while still generating free cash-flow to provide for dividends, investment in working capital and make significant payments in servicing our debt.

On February 1, 2020, we completed the acquisition of mkodo Limited, a specialized technology company focused on mobile apps and user interfaces for the lottery and gaming industry. A key component of our vision is to expand our offerings and expertise through strategic acquisitions. We will continue to pursue appropriate opportunities which are both financially prudent and can enhance our business offerings.

Disclosure Controls and Procedures

Under National Instrument 52-109, "Certification of Disclosure in Issuers' Annual and Interim Filings," issuers are required to document the conclusions of the Chief Executive Officer and Chief Financial Officer (the "Certifying Officers") regarding the design and effectiveness of the disclosure controls and procedures. Pollard's management, with the participation of the Certifying Officers of Pollard, has concluded that the disclosure controls and procedures as defined in National Instrument 52-109 are designed appropriately and are effective at providing reasonable assurance of achieving the disclosure objectives.

Pollard has limited its design of disclosure controls and procedures to exclude controls, policies and procedures of Fastrak, as it was acquired not more than 365 days before the end of the financial period to which this MD&A relates.

Internal Controls over Financial Reporting

Under National Instrument 52-109, "Certification of Disclosure in Issuers' Annual and Interim Filings," issuers are required to document the conclusions of the Certifying Officers regarding the design and effectiveness of the internal controls over financial reporting. Management used the Internal Control – Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO 2013) as the control framework in designing its internal controls over financial reporting. Pollard's management, with the participation of the Certifying Officers of Pollard, has concluded that the internal controls over financial reporting as defined in National Instrument 52-109 are designed appropriately and are effective at providing reasonable assurance of achieving the financial reporting objectives.

Pollard has limited its design of ICFR to exclude controls, policies and procedures of Fastrak, as it was acquired not more than 365 days before the end of the financial period to which this MD&A relates.

No changes were made in Pollard's internal control over financial reporting during the year ended December 31, 2019, that have materially affected, or are reasonably likely to materially affect, Pollard's internal control over financial reporting.

Additional Information

Shares of Pollard Banknote Limited are traded on the Toronto Stock Exchange under the symbol PBL.

Additional information relating to Pollard, including the Audited Consolidated Financial Statements and the Annual Information Form for the year ended December 31, 2019, is available on SEDAR at www.sedar.com.

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